Local Government Finance Bill: The Final Assent

Zach Wilcox, November 2012

What is the current system and why is it being changed?

Central government holds the purse strings when it comes to local government finances. Grants from central government make up 64 percent of local government funding. This is much higher than the OECD average for local revenues as a percent of total local budget, which is around 50 percent.

Currently, local authorities' income comes from council tax, local fees/charges and central Government grants (in the form of specific grants and formula grant). Formula grant funds a wide range of local services, and it is given to all councils through a complicated technical process which redistributes centrally collected non-domestic property taxes (business rates).

The system, as it stands, creates three main problems:

- First, local authorities have **little autonomy** and no real means to increase their local funding outside of council tax.
- Secondly, authorities face a **disincentive to development**, as the costs of new developments are absorbed locally, but the benefits (additional business rates) are sent to central government. This means local government has no direct incentive to support business growth.
- Lastly, this system does not provide any incentives or mechanisms for local authorities to **work across their boundaries** to reap the benefits of cross-border investments.

Allowing local authorities to retain a portion of the increase in their business rates gives them more autonomy and incentivises local government to support development. By aligning local costs of development with localised benefits, authorities are more likely to support growth of non-domestic property, relieving pressures of high prices in property markets and supporting the needs of expanding businesses. Pooling business rates encourages local government to coordinate across boundaries on development projects that benefit the city region.

What is the status of the proposed changes?

The Bill now has Royal Assent. Local Authorities will start retaining business rates at the beginning of the 2013/14 financial year.

What is being proposed? (Condensed from DCLG)

- **Baseline:** At the beginning of the scheme, there will be a stable starting point for all councils such that no council is worse off on day one. A council's spending level in the first year (at the start of 2013-14) will be called their baseline funding level. Councils' baseline funding levels will be increased by inflation (measured through the Retail Price Index).

- **Tariff and Top up:** Where councils have a larger business rates base than their current spending, government will take away some of this business rate income as a tariff. Where councils have a smaller business rate base then their current spending, government will top up those authorities. Tariffs and top ups will be paid out every year. The level of tariff and top up will remain fixed but will increase in line with the RPI.

- **Local retention:** In addition to retaining the local share of their business rates baseline, councils will also be able to keep the local share (50 percent for many councils) of all their business rates growth. This means that the more an authority grows its business rates base, the better off it should become.
  - 50 percent where the billing authority is a county council, or is a district council in an area for which there is no county council, and the authority is a fire and rescue authority
  - 49 percent where the billing authority is a county council, or is a district council in an are for which there is no county council, and the authority is not a fire and rescue authority
  - 40 percent where the billing authority is a district council in an area for which there is a county council
  - 30 percent where the billing authority is a London borough council.

- **Levy and safety net:** Some councils may stand to gain a "disproportionate increase" in their spending power from business rates growth. Where this happens, government will take back a share of their growth (called a levy). The levy works such that, for each one percent increase in business rates base, no authority will see more than one percent increase in income (using the baseline). The money collected through this levy will be used to give financial help, a safety net, to authorities who see their income drop between 7.5 percent to 10 perecent below their baseline funding level. This might happen, for example, if a major business in their area closes.

  Note: If an authority loses a major rates payer during the course of the year, they must make up the income shortfalls until their safety net payment is calculated at the end of the year.

- **Resets:** If government believes the spending needs of councils become out of balance with the resources that they receive, they can reset the tariffs and top ups of business rates on councils. The first reset will occur in 2020/21, lasting seven years from the 2013/14 onset. Government aims that the system would only be reset every 10 years. However, in exceptional circumstances, a reset could be required outside of this period.

- **Two-tier areas:** In two-tier areas, district councils will retain the greatest share of business rate growth on the local share in the area. To ensure that proposals provide a strong incentive to increase growth it is right that the greatest reward, and risk, is placed on the tier of government which has the most levers over growth – and these are district councils. However, the calculations for splitting retained rates between county, district and fire and rescue authorities and the GLA adds further complexity to the system.

- **Pooling:** Councils will be able to group together voluntarily to pool their business rates and collaborate on promoting growth in their area. These pools would share both the risks and rewards of the scheme and should link places in a functional economic area. There are no additional formal incentives for pooling.

What next?

Get to the bottom of the Bill. The LGFB is not an easy read. Bob Neill MP said of Formula Grant: "Only three people have ever understood it; one is dead, one has gone mad, and the third has forgotten...the same is true of some of the complexities of local government finance." The Business Rates Retention Draft Regulations are currently out for consultation until 23 November 2012. Local government officials and other stakeholders should seek any technical assistance required to understand how the regulations will affect them and what challenges arise from the detail of the Bill.

Analyse potential impacts and risks of reset periods. Resetting the system introduces a lot of uncertainty around the future retention of additional business rates for authorities. The Government aims for 10 year resets, but we believe that is the minimum needed to preserve the incentive. With resets looming for the first time in 2020/21, local authorities will have seven years of uninterrupted rates retention. In order to make the most of the benefits of local retention, authorities should bring forward development sooner – where appropriate – and develop a finance and risk management plan for when the resets occur.

Encourage pooling. Local authorities interested in pooling have submitted their intent to DCLG this autumn, and proposals are due soon. Authorities should assess how they may benefit from pooling and what a strategic arrangement would look like. Pools must determine:

- **Geographic coverage**: must be whole local authority or county, can extend to larger areas, such as the LEP
- **Revenue distribution:** authorities in the pool determine how revenues will be shared
- **Governance:** pools must have a governance structure and nominate one authority to act as lead authority.

Pooling will require difficult choices to be made. It raises many questions: Will I benefit from pooling? Do I have to pool with my neighbours? How big can or should a pool be? Government aims to be as flexible as possible to approve as many pools that make geographic and economic sense. Engaging early with Government and other local leaders is a good first step.

What is the Centre for Cities' view?

The Centre believes the best and strongest incentives are clear, simple and provide certainty. As proposed, the current Bill lacks these qualities and, in some cases, creates perverse incentives for growth.

- A **safety net** is vital, but incentives are meant to work on both positive and negative performance; the system as proposed leans heavily on equity and could provide stronger incentives to grow. Particularly, the double taxation on levy authorities (50 percent sent to government plus another proportion based on their revenues in proportion to their rates baseline) reduces the incentives authorities face to accept development at the margin.
- **Reset periods** reduce the retention benefits to authorities for building development because they create more uncertainty; they create perverse incentives for authorities to delay developments until early in a reset cycle. Thus, longer periods between resets should be set.
- **Pooling** can help mitigate risks to authorities, assist in working across a functional economic area and increase the viability of TIF. Government should continue to be proactive in supporting pooling arrangements and clearly outline and demonstrate its benefits.
- **Not all places** can or should increase their total commercial floorspace, and they should focus on improving the business environment and current stocks instead. Thus, increases in economic value of property should be included in business rates retention, benefitting dense places and those with struggling or changing economies alike.
- **Tax Increment Finance** is available to local authorities, but not in its true form. Some authorities may benefit enough from business rates retention to increase prudential borrowing, but they still lack the powers and resources to engage in a ringfenced TIF with full rates retention outside of Enterprise Zones. This restriction acts as a barrier to local infrastructure investment.

Further reading

- **Banking on Growth: Trends in local government funding and finance** (2012) www.centreforcities.org/finance
- **Urban Outliers:** Will the Local Government Finance Bill incentivise growth in all England's cities? (2012) www.centreforcities.org/urbanoutliers
- **Capital gains:** What does the Local Government Resource Review mean for London? (2011) www.centreforcities.org/capitalgains
- **Room for Improvement:** Creating the financial incentives needed for economic growth (2011) www.centreforcities.org/roomforimprovement

Contact

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Is Government offering a strong incentive?

Characteristics of a good incentive	Local Government Finance Bill	Centre for Cities research recommendations
Sufficiently large	50 percent local retention above a predetermined baseline	40-60 percent local retention
No thresholds	Levies instead of thresholds	Levies better than thresholds, but can still reduce incentives
Incentivises the intended behaviour	Encourages commercial development, especially in places with higher demand; levy dampens the incentive	Encourages commercial development, especially in places with higher demand, but does not reward public realm and transport improvements that increase property values
Targeted at appropriate decision maker	Targeted at appropriate level of government, incentivising where planning decisions are made (shire districts benefit more than counties)	Targeted at appropriate level of government, incentivising shire districts in two-tier authorities more is appropriate
Simple and transparent	Difficult to discern how it works and how a local authority will fare	In order for an incentive to work, decision makers and voters need to understand how it affects them; much education will be needed for local government and voters
Predictable, long-term and credible	Initial seven year reset periods, with the aim of changing baselines every 10 years; can be reset more often if government sees fit	While seven year resets are predictable, the clause for more frequent resets reduces certainty; 10 years is not very long and can create 'delay incentives'; retention beyond the 10 year period is highly uncertain

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