Business rates reform:

Complexity ahoy?

Kieran Larkin, July 2011

With its tariffs, top-ups, levys, pools and protections for business you could be forgiven for thinking that last week's announcement on the Local Government Resource Review (LGRR) owed more to 17th Century mercantilism than a reform of local government finance.

The technical content will no doubt turn many off, but the reforms are tremendously important. They offer the opportunity to introduce real financial incentives for growth into the system of local government finance. In the week prior to the announcement, the Centre for Cities launched its own review of the options in a report entitled *Room for Improvement*.

Change is certainly essential. Currently councils see no direct financial benefit from supporting commercial development, but bear many of the costs both financial – needing to pay for extra services delivered to business – and political – dealing with local opposition to new development.

Consequently restrictions, executed via the planning system, limit the amount of commercial property in areas of high demand. When supply is constrained, prices rise – nine of the 50 most expensive office markets in the world are in the UK. This is bad for business and bad for the economy. With the move to localism, a framework of financial incentives that guides behaviour towards the national interest becomes ever more important.

The evidence suggests that re-localising the business rate could reverse some of this resistance, by creating a strong incentive for growth. For example, between 1999 and 2010, Oxford's business rates tax base increased by 45 percent. Perhaps if the city had been able to capture some of this increment it would have been inclined to permit further expansion.

Overall, Eric Pickles' announcement on the LGRR was fairly bold. While there are still many ways that the final settlement could end up being overly complicated, it is possible to chart a course that creates a strong, simple incentive for growth.

The basics of the new system are that local authorities will start from a baseline budget position similar to their funding in 2012-13. From this they will then capture some of the growth in the local business rate base. The key question is how much and for how long?

In *Room for Improvement*, we set out the requirements for creating a strong incentive for growth, arguing that it needed to be large, incentivise the right behaviour; simple and transparent, and long term. We recommended that the Government should choose between a system with **"resetting"** – starting the baseline for each council again – and one that only allows authorities to capture a **portion of the local**

growth – which the Government have termed the **"levy"**. In the end it looks like the new system will include both of these elements.

Our preference was for a simple fixed proportion of growth of around 40-60 percent. While this is an option in the consultation, it seems more likely that the "levy" will relate the growth in the business rate base to each authority's baseline. For example, if an authority increases its business rate base by one percent, its budget will rise by one percent. On the plus side this means all places face the same incentive. However, there is the possibility that the option will result in a more complex and bureaucratic system.

Resetting the system intermittently will weaken the strength of the incentive, although politically some sort of reset looks to be unavoidable and might help long-term stability. The Government has floated the idea of impromptu resets. These would take place *"on the basis of an objective assessment of how resources in the system were aligned with changing levels of underlying need."* This is not a good idea. Impromptu resets would introduce far too much uncertainty and the potential for partisan intervention.

But enough of the technical details. The big political question has been: will the reforms exacerbate regional disparities? Indeed, at the announcement Caroline Flint asked Eric Pickles to guarantee that no council would be worse off in five years time.

Equity considerations are of course important, but the idea that no council should lose out from any change would only realistically leave one policy option open – retaining the status quo. Clearly an incentive-based system will create relative winners and losers, otherwise it could not possibly function. Those places that are able to encourage development will see their revenues boosted, but areas not able to achieve the desired outcome will probably be less well off than under the current system.

The real question is whether the national benefits of boosting the economy justify the less attractive aspects of the reforms – and remember no one is recommending a system without substantial redistribution. Equally, the winners from an incentive system are not defined by a straight North-South divide. Cities like Preston, York and Leeds would all have benefited from an incentive system between 1999 and 2010. Over the long-run few cities see their business rates decline, so history suggests that only a few places would see a real decline in their revenues.

The Government currently has the opportunity to create a simple, strong, long-term financial incentive for growth. To do this it needs to ensure that a whole host of constraints and complexities around the edges do not chip away at what should be an important reform that benefits England's cities and the national economy as a whole. Eric Pickles has started out in the right direction, yet there still remains room for improvement.

Local Government Resource Review:
Consultation summary

Below we set out the main proposals and options outlined in the Local Government Resource Review Consultation. The full document can be accessed:
www.communities.gov.uk/documents/localgovernment/pdf/1947200.pdf

Scale of available resource

- Collected business rates in 2013-14 and 2014-15 will be greater than the funds allocated in the Spending Review to be distributed to local authorities. This "extra money" will be collected by central government and directed to local authorities via other grants, including the New Homes Bonus.
- From 2015-16, the Government will reconsider local government's responsibilities, so that the collected business rates match the required resources. In this sense, the responsibilities of local government will match the funding it raises, not the other way around.

Setting a baseline

- Each local authority will have a baseline position set for them by Government in 2013-14; this is likely to be similar to their formula grant allocation in 2012-13, with some adjustment for further spending cuts.
- Local authorities, whose business rates income is higher than their baseline, will pay the difference to central government in the form of a "tariff".
- Local authorities, whose business rates income is lower than their baseline, will receive a "top up" grant to raise revenues up to their baseline.
- The tariffs and top up grants will remain fixed for a set period before being reset. The Government has not decided whether the tariffs and top-up grants will rise with inflation (by the RPI).

System resets

- The Government will retain the option to reset the system if resources become too divergent from central government's estimate of core service pressures.
- A number of options for resets have been proposed:
    - Resets could be done on a fixed basis - i.e. every five or ten years - or on an ad hoc basis - on the request of the Secretary of State.
    - The system could be partially reset, redistributing just the baseline allocation, or fully reset, including any business rates growth accrued.

Creating a business rate incentive

- Local authorities stand to benefit from an increase in their local business rates over the baseline level (i.e., after the tariff or top up grant has been paid or received).
- There will be no overall cap on the amount of business rates growth from which a local authority may benefit.

Creating a levy on disproportionate growth

- While there is no overall cap on business rate growth, Government will collect a levy recouping a share of the growth from local authorities that have disproportionate benefit. The number of authorities to be affected by the levy is unclear.
- The Government proposes three options for this levy:
    - A fixed levy, based on pence in the pound, with the same rate faced by all authorities.
    - Different levy rates, with local authorities banded and assigned to a rate, depending on the size of their business rates base.
    - An individual levy for each local authority so that a one percent increase in local business rates would result in a local authority's total revenue increasing by one percent, relative to the baseline. *This one percent increase in revenues is subject consultation and it is suggested that it could be between 0.25-2.00 percent.*
- The wording of the consultation suggests that the individual levy is the most likely of the options to be taken forward.

Proceeds of the levy on disproportionate growth

- The revenues captured by central government from the levy will be used to manage business rates volatility. For example, caused by the closure of a major local business.
- A safety net will be created to limit the maximum decline in business rates a local authority might face in a single year and to restrict the percent by which a local authority is able to fall below its baseline.
- Other options for the unspent proceeds from the levy would be:
    - To increase all local authorities' baselines by a fixed percent.
    - To top up budgets in local authorities that had not contributed to the levy.
    - To target budget increases at areas that had undergone low business rates growth.
    - To spend the proceeds on projects which unlock growth, i.e. new infrastructure.
    - To save some of the resources to offset future volatility.

Revaluation

- The Government intends to keep the current five year revaluation timeframe.
- The tariffs and top up grants will be adjusted at the point of revaluation so that no local authority wins or loses at the point of revaluation.
- This means local authorities only gain from additional development and not an increase in rental values. Doing so, though, removes the incentive for local authorities to add amenities that contribute to the improvement of the overall business and public environment, increasing property values.

Pooling

- The Government is keen to encourage pooling within the new system. Local authorities that decide to pool their resources would be subject to a single top up or tariff settlement – which would then be redistributed locally.
- The authorities within a pool would also face a single levy rate.

- Pools would need to be voluntary and the Government has proposed that in two tier areas they should remain with county councils.

Tax increment financing

- The Government are considering the most appropriate way to deliver Tax Increment Financing (TIF) within the new retained rates system.
- Two options are proposed:
  1. **No further action by the government.** Local authorities would be able to borrow from the Public Loans Work Board against future business rates revenues within the new system, which they would be left to predict.
  2. **The growth from a specific TIF project would be retained for a set period of time and treated as being outside of the local government finance system.** Because this would entail fewer resources being available for government discretion it would need to be subject to stricter controls by central government.

Other points of interest

- To incentivise the production of green and renewable energy, all business rates collected by local authorities for those premises will be wholly retained by the local authority and not subject to any levies.
- Police and fire districts will not be affected by the new system and fluctuations in business rate funding. Their budgets will follow those set out in the Spending Review.
- Determinants of developments on the central list will not change, and those funds will continue to be sent straight to the central pot.
- There will be no changes to the current system of reliefs, including eligibility, and Government will provide funding to ensure that local authorities can continue to afford to provide this relief.

Eight further technical papers are expected in August. The Government's consultation will run until Monday 24 October.

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