# Business rates: maximising the growth incentive across the country

7 December 2017

## Executive Summary

**The devolution of business rates aims to incentivise economic growth by aligning fiscal interests with growth requirements.** The assumption is that allowing cities to have more control over business rates will encourage them to do what is necessary to increase this income stream, which would also help deliver economic growth.

For cities to be successful in the long term, they must adapt and respond to changing demand. **In today's economy, this means providing the appropriate environment to help develop and attract knowledge-based activities, which are more productive.** Some cities are already successful at attracting knowledge businesses and workers because they provide the right environment for them. Others face greater difficulty and need to achieve a more profound reshaping of their economy.

**But while the steps to achieving growth are different across cities, the business rates incentive is the same everywhere.** The business rates system rewards the expansion of commercial floorspace. This is the appropriate thing to do in already successful cities, where demand is high and more needs to be built. But in weaker cities the incentive will translate into local authorities allowing the development of large, out-of-town premises, matching the demand for lower value activities, instead of adapting their economy and attracting higher value and more productive businesses.

**This means the incentive reinforces the status quo**. Cities that are already performing well are given the right incentive to support growth (by building more), but cities that have weaker economies do not get a financial reward if they try to improve their business environment ahead of demand.

There are several adjustments that can be made to the system to make sure that it incentivises long-term growth in a greater number of cities and it rewards the contribution of other parts of the country:

1. **Allow local authorities to capture commercial property's value uplift**. This will encourage cities to improve their business environment and attract more knowledge-intensive industries, rather than just expanding floorspace.

2. **Simplify the system to make it more efficient and responsive**. There are two ways to do this:

    i. Implement more frequent revaluations, to make the system more responsive to market change, more predictable for businesses, and easier to understand;

    ii. Remove the cap on the total yield generated to allow local authorities to capture real rateable value growth and for more money to be generated and redistributed.

3. **Allow places that contribute to share the reward and the risk.** Within city-region economies, different areas play different roles, such as city-centres and industrial zones (home to businesses) and residential areas (home to workers). By pooling business rates revenues together, local authorities that are mostly residential would have an opportunity to benefit from the economic success to which they contribute.

Although these adjustments would help by making business rates devolution benefit a larger number of authorities, more needs to be done to assure financial sustainability locally. The over-reliance on business rates means that not all local authorities will have the ability to increase their revenues. Therefore creating a more comprehensive local finance system, with a set of devolved taxes and redistribution mechanisms, will be necessary to support places in the future.

## Introduction

Business rates devolution has been on the political agenda for several years now but the process so far has been drawn out. Despite a first step being initiated in 2013 that allowed local authorities to retain up to half of the growth in business rates, progress has stalled on increasing this to 100 per cent. The legislation, which had been making its way through Parliament for implementation in 2020, was dropped from the legislative programme following the General Election. But the Government has announced it is committed to pursuing the devolution agenda, with or without primary legislation. Part of the system is currently being piloted in some areas, such as Greater Manchester and the Greater London Authority.

The aim of full business rates devolution is to achieve two goals:

1. **Provide a funding tool for local authorities**, while central government grants are declining;
2. **Incentivise economic growth and good policy practice locally.** Fiscal autonomy would encourage local authorities to improve their economy by aligning fiscal interests with economic imperatives.

But while many concerns have been expressed regarding the fiscal risk for local authorities, less has been said about the ability of the business rates system to provide a sufficient incentive to local authorities to support economic growth.[1]

This briefing analyses the effectiveness of the current business rates growth incentive and explores how the system could be adjusted to be more in line with economic needs across cities. First, it describes the state of demand for commercial space across cities. It then explains the current growth incentive and proposes several adjustments to make it more effective to a wider number of cities. Finally, it investigates how business rates could recognise and reward the contribution of other places beyond cities. Before getting into the core of the analysis, Box 1 below summarises how business rates are calculated and how the system works.

**Box 1: How business rates work**

This box provides a brief summary of how business rates work. The main components of the business rates system are described below.

**Baselines, top-ups and tariffs**

In the initial year, each local authority is given a business rates baseline and a funding baseline. The business rates baseline is equal to the amount of business rates generated locally in this specific year. The funding baseline is the amount of money a local authority is presumed to need to deliver services. If the business rates baseline is higher than the funding baseline, the authority will pay a tariff so that it only retains enough money to cover its financial needs. If the business rates baseline is lower than the funding baseline, the authority receives a top-up. This means every local authority in the country is only left with a sum of money equalling its funding baseline.

**System reset**

Baselines, top-ups and tariffs must be reset after a certain number of years. This is because over time financial needs and revenues can change considerably and the system may no longer represent the economic reality of the area.

1 Amin-Smith N, Choo M, Glover J, Goldsworthy J, Jones N, Lucas L, Phillips D (2017), The local vantage: how views of local government finance vary across councils. London: IFS. https://www.ifs.org.uk/publications/9731

The shorter the period between resets, the lower the incentive to increase revenues: as growth is measured relative to the business rates baseline, frequent resets prevent accumulating extra money year-on-year. On the other hand, although a long period between resets increases local authorities' incentive to generate more revenues, it also makes the system less responsive to economic change and reduces the amount of money left for redistribution.

**Rateable value and revaluation**

Business rates are based on the estimated property value of non-domestic properties. The Valuation Office Agency (VOA) is in charge of evaluating the open market rental value of each property on a fixed date and for a set number of years – this is the **rateable value.**

Rateable values need to be updated over time to adjust to market prices. In the past, revaluations have taken place every five years. However the latest two revaluations were seven years apart, with the latest revaluation coming into force in 2017. In the 2017 Autumn Budget the Chancellor announced that starting in 2022 rateable values will be updated every three years.

**Business rates bill, multiplier and revenue cap**

The amount of business rates due for each property is calculated by applying a **multiplier** to properties' rateable value. There is also a range of relief to support specific businesses, such as the small business rates multiplier (which is lower than the standard multiplier) and the small business rates relief (which offers discounts of up to 100 per cent on business rates). Local authorities can also apply discretionary reliefs.

One specificity of business rates as a tax is that there is a **cap** on the total amount of business rates that should be generated annually, and the total yield is determined in advance. Opposite to most taxes – where the value of the tax base varies but the rate remains constant – in the business rates system the multiplier (i.e. the tax rate) is the variable, and is calculated so that the total properties' rateable values (i.e. the tax base) generates the expected yield.

Because of the cap, the multiplier changes at each revaluation to reflect the changes in rateable values and ensure the overall system generates the same amount as the previous year. It also changes every year in line with inflation.

**100 per cent retention mechanism**

Under the current system, which was introduced in 2013, half of business rates revenues are retained by local government as a whole. In addition, individual local authorities are allowed to retain up to 50 per cent of the growth they generate. This means that, while baselines, tariffs and top-ups remain fixed for the period, 50 pence of every additional pound generated above the business rate baseline year-on-year is retained locally.

The 100 per cent retention system proposed by the government would mean that all business rates revenues are retained by local government as a whole, and that individual local authorities can keep 100 per cent of additional growth above the baseline. This aims to give local authorities an incentive to increase their business rates revenue.

## The state of demand for commercial space

Around 55 per cent of businesses in Britain are located in cities, generating 62 per cent of the economy's output. This demand for space is reflected in the price of it: on average in 2015, **one square metre of commercial space was valued at an annual rental price of £99 in cities, compared with only £54 in the rest of the country.**[2]

This geography of the economy exists because of the benefits that different parts of Britain offer to businesses. **Cities offer access – access to skilled workers and access to a network of other businesses.** But this comes at the cost of more expensive premises, congestion and pollution. Where individual businesses locate depends on trade-offs they make between them.

The pull of cities has been growing in recent years, with businesses increasingly clustering within them. And this has implications for the demand for commercial space. As Figure 1 shows, the rateable value per square metre of city centre office space saw the fastest increase between 2010 and 2017, followed by suburban space.[3] This did not translate into large increases in floorspace though – while the number of properties increased in city centres, the fall in the average size of a property meant that there was little overall change in the amount of floorspace.

**Figure 1: Change by type of area, 2010-2017**

| | Number of units of property (%) | Rateable Value (%) | Floor space (%) | Rateable value per m² (%) | Average property size (%) |
|---|---|---|---|---|---|
| City centre | 11.0 | 20.4 | 0.9 | 19.2 | -9.1 |
| Suburb | 7.4 | 9.3 | 1.0 | 8.1 | -5.9 |
| Non-city | 9.6 | 7.8 | 5.0 | 2.7 | -4.2 |
| England and Wales | 8.7 | 11.5 | 2.8 | 8.5 | -5.5 |

Source: VOA, 2017

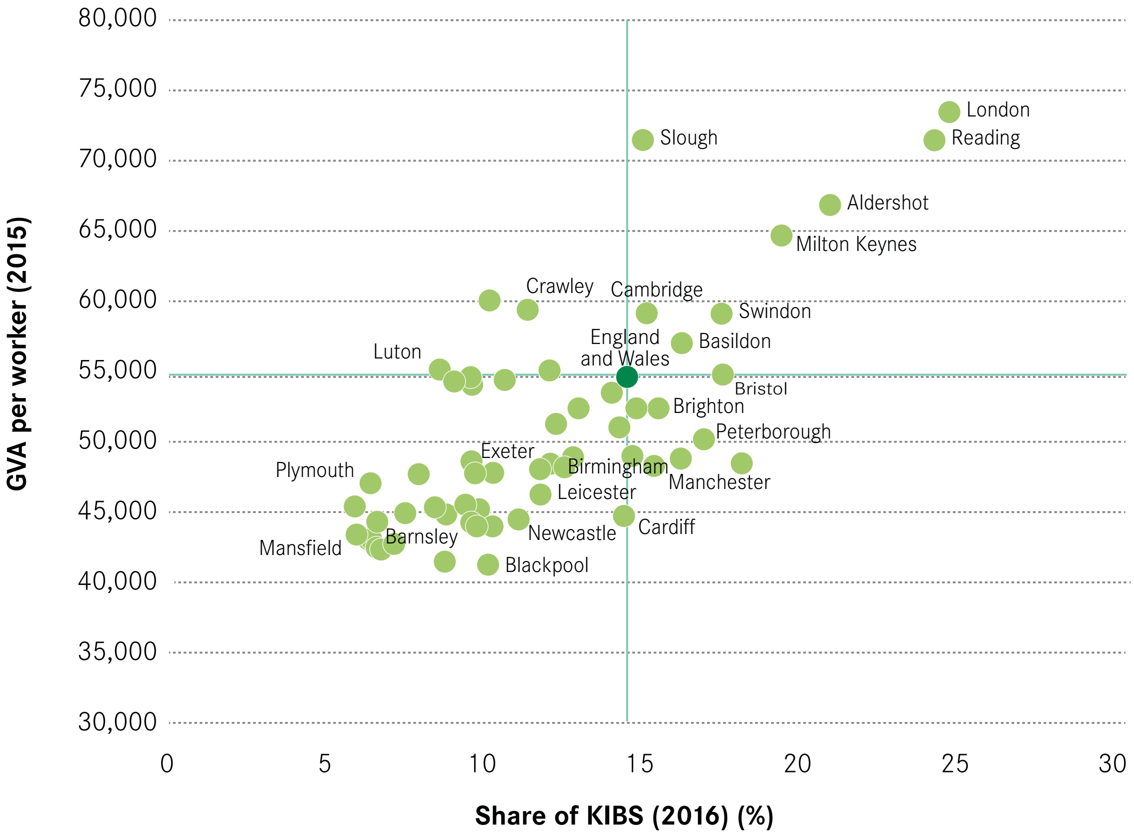
**Crucially, some cities offer these benefits to a greater extent than others.** Figure 2 shows cities by their share of knowledge intensive business services (KIBS) jobs and by productivity. Successful city economies provide greater access to knowledge, and therefore have a high share of KIBS jobs and high levels of productivity. These include London, Reading and Bristol. Weaker city economies, such as Plymouth, Barnsley and Mansfield, have a much lower share of knowledge-intensive jobs which is reflected in their lower productivity.

And this has implications for demand for commercial space. Cities that offer greater access to knowledge tend to see greater demand from knowledge-based businesses that are increasingly looking for a city centre location. Cities that do not offer access to knowledge struggle to attract these types of businesses, and so demand for city centre space within them tends to be weaker. What they do offer though is access

2 Data from the VOA using 2017 rateable values.
3 Noting that city centres were already the most expensive area in 2010, so that this effect is not the result of starting from a low base.

to lots of lower skilled workers and cheap land. These benefits appeal to businesses undertaking more routine activities, such as call centres, that prefer either a suburban or hinterland location.[4] And this shows in how demand for commercial space plays out in different cities. Box 2 illustrates this with the cases of Reading and Mansfield.

**Figure 2: Knowledge intensive business services (KIBS) jobs and productivity**




Source: BRES, 2017; ONS, 2016

**Box 2: Cost of commercial space in Reading and Mansfield**

Reading has a strong economy, with a large share of knowledge-based services. This has driven up demand for commercial space in the city centre in particular. In 2015, the average rateable value per m$^2$ was £126, but it was much higher in the city centre than in suburbs (one square metre of floorspace was rented at £196 a year in the city centre on average, compared to £107 in the rest of the city).

In contrast, Mansfield has had more difficulties in attracting businesses, and in particular knowledge-based services. The average rateable value was at £46 per m$^2$, suggesting a relatively low demand for commercial space. Although the city centre was on average more expensive than the rest of the city (£75 per m$^2$ against £43 per m$^2$ in suburbs), it was still relatively unattractive to firms. For instance the cost of office space in the city centre was cheaper than in Mansfield's suburbs.

This suggests that Mansfield tends to attract lower skilled, lower value services – that require larger floorspace and favour less central locations – but fails to attract more productive, city-centre based knowledge-intensive activities.

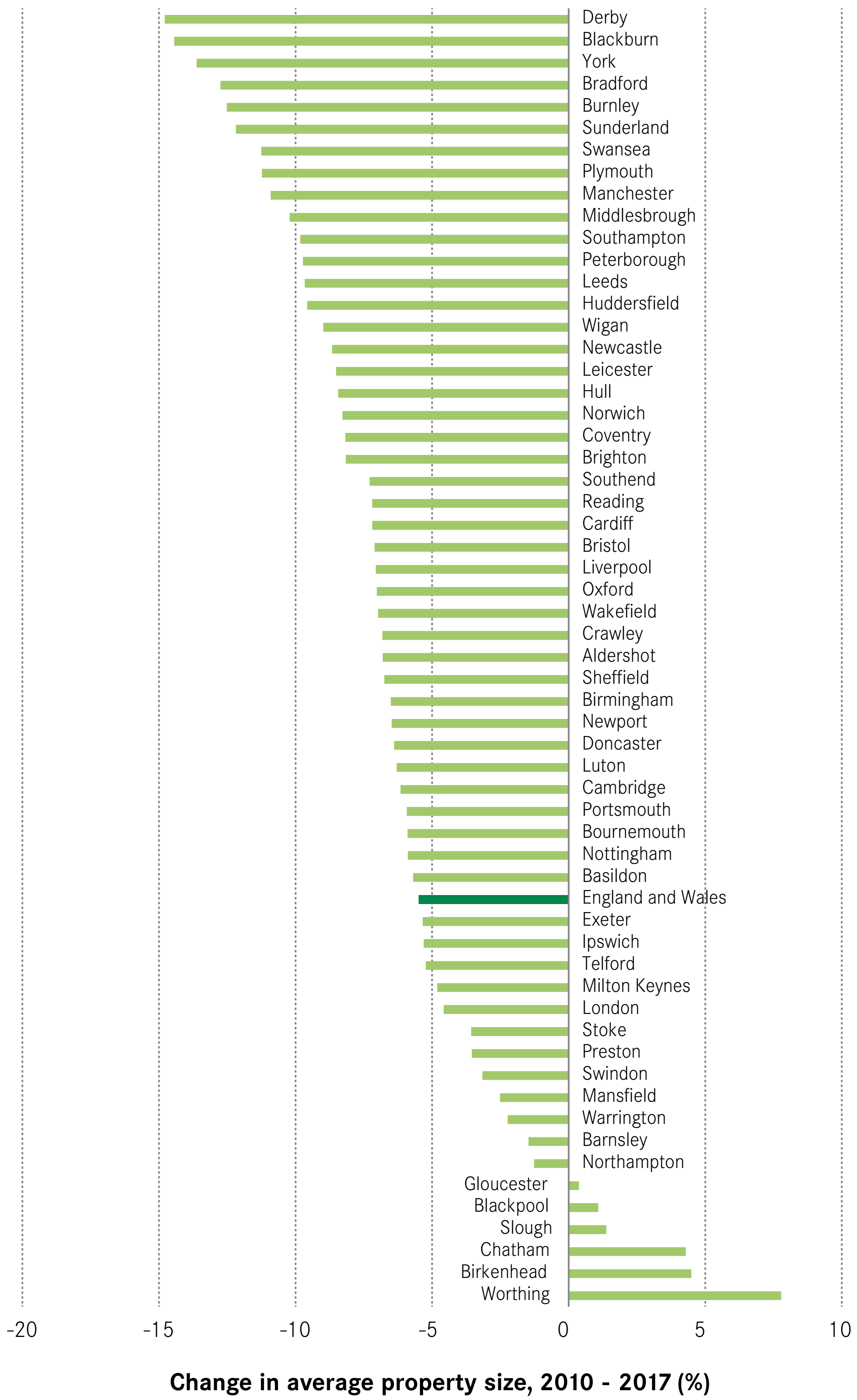
4 Swinney P (2017), Why don't we see growth up and down the country, London: Centre for Cities.

If the UK economy continues to specialise in ever more knowledge-intensive activities, then those cities that are able to attract investment in such activities will be the ones that will perform the strongest in the future. For weaker cities, while capitalising on demand in out of town areas will provide jobs and increase the output of the economy, the low-skilled nature of this demand will mean that it will do little to increase productivity. So the challenge for policy makers is to reduce the barriers that prevent these cities from attracting in such investment, aiming to 'reinvent' their economies rather than 'replicate' them with further investment in lower-skilled activities.[5]

**A further important trend to note in terms of demand is the reduction in the average size of commercial space.** Figure 1 above shows that average size declined across all geographies, while Figure 3 shows that it declined in all but six cities between 2010 and 2017.

5 Swinney P, Thomas E, (2015), A century of cities – urban economic change since 1911. London: Centre for Cities.

**Figure 3:** **Change in average non-residential property size, 2010-2017**




Source: VOA, 2017

## The economic growth incentive: issues and adjustments

One of the main aims of devolving business rates is to incentivise local authorities to put policies in place to grow their economies.[6] But as this section shows, the current system does not reward weaker cities that adapt their business environment to economic changes.

### The current incentive explained

The business rates system rewards places that increase the amount of commercial floorspace in their area. This is because the rateable values assigned to properties are fixed for a number of years, meaning that the only way to increase total tax take is to increase the amount of floorspace available.

This poses two problems. **The first is that it incentivises local authorities to permit development on where demand exists already.** In successful cities, which attract knowledge-intensive industries and have a productive economy, this is positive because it encourages the expansion of the supply of floorspace, in particular in their high-demand city centre. Whereas local authorities might not be willing to build more, mainly for political reasons, they will be financially rewarded for doing so under 100 per cent business rates retention. This is what the incentive aims to do: encourage behaviours that align with economic growth but that local authorities might not otherwise implement.

But this is less appropriate in weaker cities, where demand for city centre space is limited. The incentive encourages cities to take advantage of where demand does exist, which mostly comes from lower-skilled businesses in out of town locations. While this might encourage increase in output of the economy (more jobs), it wouldn't encourage increases in productivity (more output per job as a result of moving to higher-skilled activities). And it might also generate displacement of firms from city centre locations to newer out of town premises. This is because the incentive would not reward cities to invest in their city centre to attempt to make them more attractive places to do business.

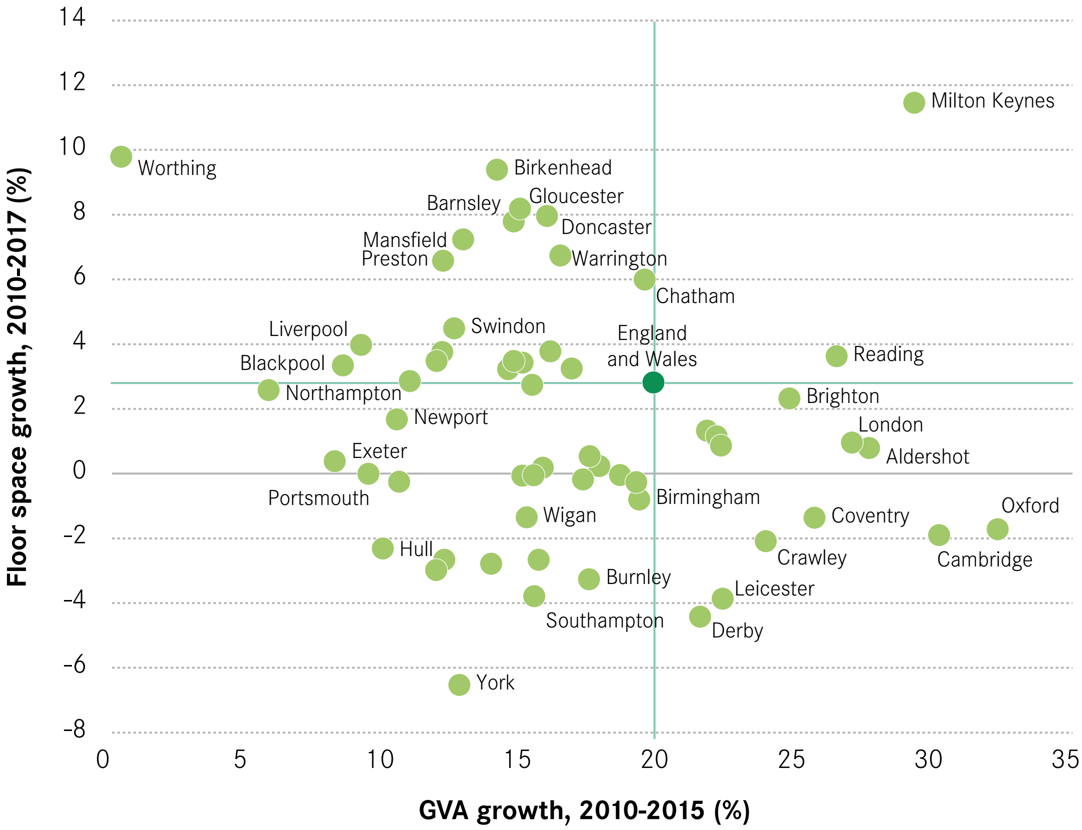
**Therefore the incentive reinforces the status quo**: cities that are already performing well are given the right incentive to support growth (by building more), but cities that have weaker economies do not get a financial reward if they try to improve their business environment ahead of demand.

**The second issue is the decline in the average size of units.** The system should reward economic growth, but as the industries that contribute the most to the economy tend to require smaller premises, using floorspace to measure growth is likely to become increasingly unsuitable.

This mismatch is clear when looking at the relationship between the growth incentive on one hand, and actual economic growth on the other. As shown on Figure 4, cities such as Brighton, Oxford and Coventry have experienced high growth in terms of GVA between 2010 and 2015 but have not seen a corresponding increase in floorspace. In contrast, some cities such as Birkenhead, Liverpool and Preston have considerably increased their floorspace despite economic growth being limited. So while the incentive might encourage the approparaite behaviour in some cities, it does not necessarily reward economic growth in every city.

6 DCLG (July 2016), Self-sufficient local government: 100% Business Rates Retention, Consultation Document.

**Figure 4:** GVA and floorspace growth




Source: VOA, 2017; ONS, 2016

## Improving the system to help more cities to grow

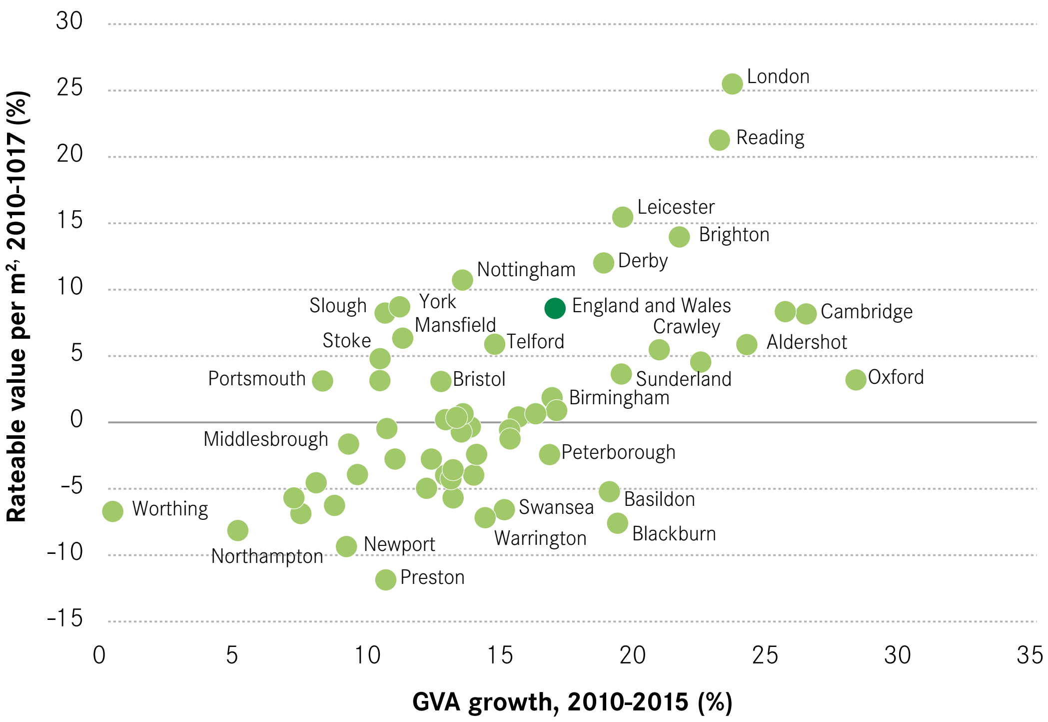
In order to incentivise long term economic growth in a larger number of cities across the country, business rates growth should also be measured using **the value uplift of commercial properties.**

Having those two incentives in place would allow local authorities to have two mechanisms rewarding growth: one by extending the number of taxable properties (i.e. increasing floorspace); the other by increasing the value of existing properties (i.e. capturing value uplift).

### *Benefits of the value uplift mechanism*

As shown in Figure 5, and in contrast to Figure 4, there is a clear correlation between growth (as measured by GVA) and property prices (measured by the rateable value per $m^2$). This indicates that property prices increase with economic growth. So allowing local authorities to capture the value uplift of commercial properties would help the business rates incentive to more correctly align with economic growth.

**Figure 5:** GVA and rateable value growth




Source: VOA, 2017; ONS, 2016

It would also give local authorities a direct financial reward for improving their urban environment. Through the value uplift mechanism, cities could increase their business rates revenues by:

- **Replacing low-quality, low rateable value buildings with higher quality and better adapted units.** Local authorities would then capture the benefits of upgrading or replacing dated premises, even though this would not increase floorspace.[7]

- **Making places more attractive to firms and investors by strengthening the economic fundamentals such as skills and transport.** This would have an indirect impact on rent, rateable value and the final business rate bill.

By allowing cities to capture the value uplift, the system would reward cities that improve the quality of the business environment – for instance by investing in their city centre. This is one of the elements needed to help attract more productive and knowledge-based activities.

### *How to make it work?*

There are three major components that must be implemented for the value uplift incentive to work: carry out more frequent revaluations, lift the cap on business rates revenues, and consider the interaction with the existing incentive.

### 1. Make property revaluations more frequent

Because revaluations are too infrequent and might create large changes in local authorities' finances, the Government currently readjusts individual local authorities' tariffs and top-ups after revaluation, so that it

7 Local authorities only capture part of this currently: if a property is significantly improved it will be given a new rateable value, even in-between revaluations. But this will align with previous revaluation's prices, instead of current value prices. This means ad-hoc revaluations capture physical changes but not broader economic changes.

has no impact on local finances.[8] By doing this it prevents local authorities from capturing rateable value growth arising from revaluation. Firms on the other hand still pay the price for infrequent revaluation, and can experience large changes in their bill, as was the case after the 2017 revaluation.

Annual property revaluations would make rateable value changes less extreme, which would ease the pain for firms. For local authorities, this means the government would no longer need to re-adjust tariffs and top-ups accordingly. And in effect, this would allow local authorities to capture the value uplift of properties.

Year-on-year revaluations would have three main impacts:

- **Allow cities to benefit from growth more quickly,** as yearly revaluations would adjust property values, allowing cities to capture any uplift immediately.
- **Prevent sudden and relatively unpredictable changes in rateable value,** which many businesses experienced following the latest revaluation in April 2017. Year-on-year revaluations would make rateable values more closely related to real market values, making them easier to predict, understand and accept for taxpayers, with possibly fewer appeals (see Box 1).
- **Bring more certainty to the revaluation timeline.** Currently values are set up to be updated every five years, but the latest revaluation, in 2017 was delayed by two years. Frequent and fixed revaluations would bring more clarity and certainty for local authorities and businesses alike.

The 2017 Autumn Budget announced that rateable values would be revaluated every three years instead of five, starting in 2022.[9] This is a welcome step forward, but annual revaluations are needed to fully align the system with the economy. Several countries have managed to move to an annual revaluation system, as detailed in Box 3.

### Box 3: Revaluate frequently: International examples

#### The Netherlands[10]

In the Netherlands, property taxes (residential and non-residential) are all based on expected sale market values, referred to as WOZ, that are revaluated every year.

Initially revaluations took place every five years, but this was progressively increased to every year in 2007. The move to year-on-year valuations has brought several positive outcomes, including a more standardised and efficient process (between 1997 and 2014 annual costs have decreased from €190 million to €150 million), fewer complaints and appeals, and greater market transparency (for instance WOZ values are now used for other purposes, such as mortgage appraisals).

The year-on-year revaluation process has the following characteristics:

1. **It relies more on mass valuation than on traditional appraisal**. Different sources are used to assess property values, the bulk coming from property advertising websites. Self-assessments are also sent to gather more precise information, especially to obtain rental prices in the case of commercial properties.

8 DCLG (July 2016), Self-sufficient local government: 100% Business Rates Retention, Consultation document. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/535022/Business_Rates_Retention_Consultation_5_July_2016.pdf.

9 HM Treasury, Autumn Budget 2017. https://www.gov.uk/government/publications/autumn-budget-2017-documents.

10 Kathmann R, Kuijper M, The three key principles for mass appraisal: data quality, data quality and data quality (2016), Annual World Bank conference on land and property.

2. **It is decentralised**. Valuations are conducted by municipalities on the basis that they have better knowledge and understanding of the market. A central agency defines valuation characteristics and requirements, and ensures processes have been followed correctly.

3. **It requires cooperation**. Municipalities are encouraged to work together and share data and practices. They also work with property owners and occupiers themselves, which is thought to increase their acceptance of the tax as they are taking part in its assessment.

There are a certain number of risks and difficulties related to this system. It put pressure on the administration (in this case municipalities) to deliver data on a yearly basis, and demands high-level quality controls throughout (especially when it comes to self-assessment). It also requires shifting skillsets in favour of scientific and economic-related occupations.

**France**[11]

In France, the levy on non-residential property used to be calculated on Land Registry values that had not been updated since the 1970s. From January 2017, values are updated on a yearly basis and are based on estimated rent. Business renters are required to declare the amount of rent they pay as part of their annual tax return which, coupled with specific information on size, location, and type of business activity, allows to model an estimated rental value for each property.

Similar to the Dutch case, revaluations are conducted at the sub-national level. In each county, a commission is in charge of determining the correct values based on collected data on rents. Individual municipalities are consulted to guarantee estimated rents correspond to reality and also help to determine property characteristics at a higher level of granularity.

**More frequent revaluations would however make local authorities more vulnerable to downturns in the economy too.** Currently local authorities are guaranteed the same amount of money until top-ups and tariffs are reset, and revaluations do not affect their revenues. Under this proposed system, local authorities are the winners when the economy is growing, as they generate extra revenues year-on-year. Conversely businesses are the winners during a recession, as they see their rates fall.

### 2. Remove the cap on business rates yield

**The cap would need to be removed to allow local authorities to fully capture the value uplift.** This is because it creates a mechanism where growth is dependent on the national average. At revaluation, the multiplier is adjusted proportionally to the aggregate change in rateable value. Individual authorities that experienced a higher level of growth in rateable value than the national average therefore would see their income increase. Authorities that experienced a lower level of growth than the average would instead see their income fall, despite experiencing net growth. This is explained in more detail in Box 4.

For local authorities to be able to capture value uplift, the cap needs to be removed so that local growth is rewarded outright rather than relative to the national average.

But it is also an issue with regard to the broader redistribution mechanism. The cap artificially restricts the total amount of business rates that can be generated, which ultimately means there is less money for redistribution.

11 Collectivités-locales.gouv.fr, La réforme des valeurs locatives. https://www.collectivites-locales.gouv.fr/reforme-des-valeurs-locatives-0.

### Box 4: Impact of the cap on the growth incentive

Figure 6 and Figure 7 look at the rateable values and the amounts of business rates collected in England and in four cities – two where rateable value increased at a faster pace than the national average, and two where it increased at a slower pace – before and after the 2010 revaluation. Nationally, as a result of the 2010 revaluation, the total national rateable value increased by 21 per cent (Figure 6), but the total amount of business rates generated did not increase more than usual, because the multiplier was adjusted accordingly.[12]

**Figure 6: Rateable value change, 2008/9 - 2014/15**

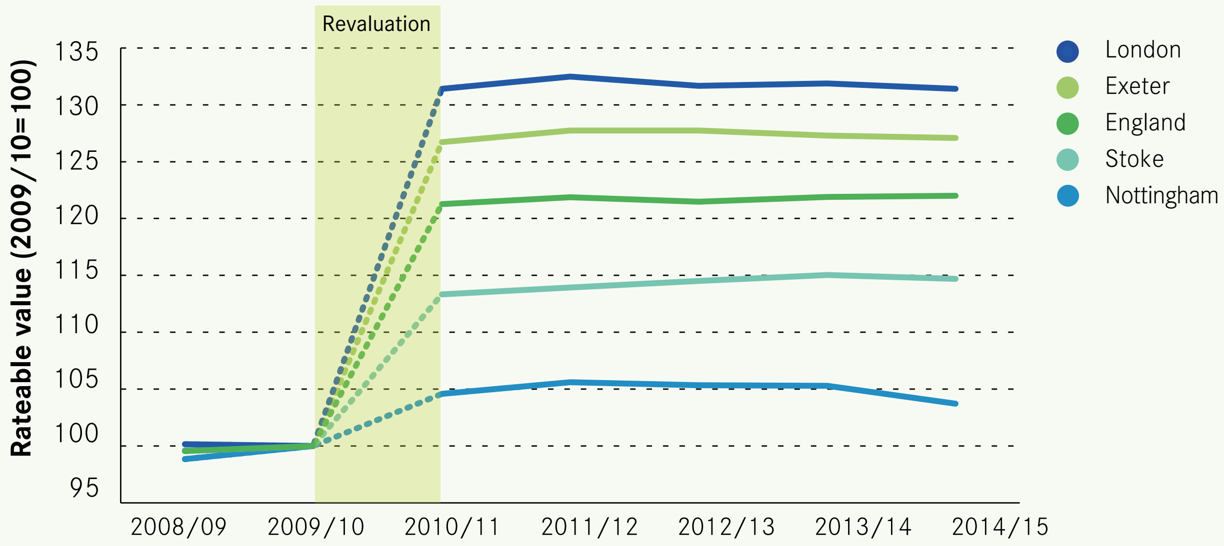
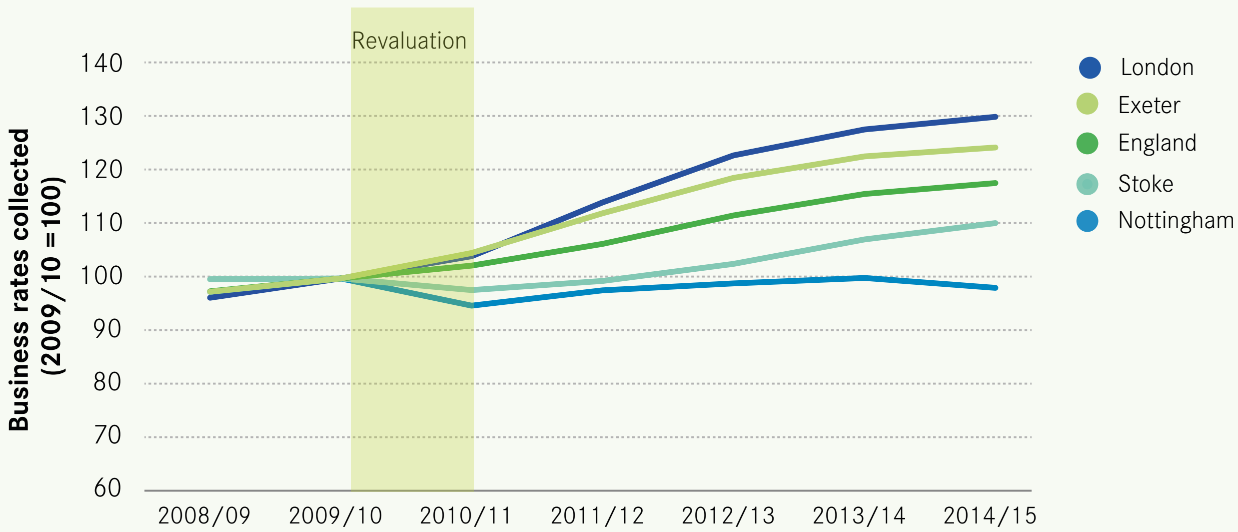



**Figure 7: Business rates collected (2008/09 - 2014/15)**




Source: VOA, DCLG Collection Rates for Council Tax and Non-Domestic Rates. Note: Values are indexed on the year 2009/10, which is one year before the 2010 revaluation.

12 The increase, which is relatively constant over years, can be explained by the net increase in floorspace between 2009/10 and 2010/11, and by inflation. The national multiplier was set at 48.9p before revaluation, and was re-adjusted at 40.7p after the 2010 revaluation.

The local picture is different. In cities where the rateable value grew at a higher rate than the national average, such as London and Exeter (31 and 27 per cent respectively before and after revaluation), the total amount of business rates collected increased after revaluation. This is because, while the multiplier decreased in proportion to how much the aggregate rateable value increased, in these cities the local rateable values grew above the national average, effectively generating more money.

In contrast, places where rateable value growth was below the national average experienced a decline in business rates collected. In Stoke, although rateable value grew at a substantial rate (13 per cent), the amount of business rates collected decreased by 3 per cent immediately after revaluation. It is worth noting that at the time these changes did not affect local budgets because local authorities are not allowed to capture any growth from rateable value, as their revenues are adjusted according to the gain or loss they experience as a result of revaluation.

### 3. Interaction with the floorspace incentive

**There is a risk that the value uplift incentive could inhibit the incentive to expand floor space.** In high-demand cities, instead of building more local authorities could restrict new developments to drive property prices up, and still make profits through business rates.

But for a high-demand authority, adopting a low-supply strategy is unsustainable in the longer term, as growing costs in rents and business rates would increasingly make the area less attractive to firms. Box 5 describes how the two incentives would work in Barnsley and London.

**Box 5: How would the two incentives play out? The cases of Barnsley and London**

**Barnsley: reward city centre improvements**

Barnsley gains most of its business rates revenues from large out-of-town space. The most well-known is the Asos Warehouse, located to the east of the city. Between the 2010 and 2017 revaluations, floorspace increased by 9 per cent outside of the city centre, while prices per $m^2$ remained almost stable. But the city centre was much weaker. During the same period, floorspace has declined by 0.6 per cent and rateable value per $m^2$ by 9.1 per cent.

Currently, Barnsley is benefitting from the system because it is expanding its total floorspace. But the system does not reward any attempt at changing its economy over the long-term, for instance by improving the quality of its built environment in the city centre.

Introducing the value uplift incentive would reward Barnsley to improve the quality of its built environment, as those improvements would be reflected in property prices. But alongside this, the city would still generate more business rates from expanding out-of-town, as the floorspace incentive would remain in place.

**London: encourage building more floorspace**

Among all cities in England and Wales, London has experienced the highest increase in rateable value per $m^2$: prices have increased by 25 per cent between the 2010 and 2017 revaluations. The total number of commercial properties has also increased by almost 6 per cent. But although London is a very high-demand market, the total commercial floorspace increased by less than 1 per cent.

This indicates that not enough additional floorspace is being built to match increasingly high demand. Under the 100 per cent retention of business rates proposed by the government, London would get more from building additional space. And although it could also make money by restricting planning permissions to drive prices up, doing so would soon reduce its attractiveness as a place to locate.

## Summary

The current system provides an appropriate incentive for successful cities by encouraging them to build more, but it does not reward other cities for improving their economy.

Introducing a value uplift component to the incentive would allow local authorities to capture any increase in business rates as a result of their efforts to improve the quality of commercial space.

This change would introduce an additional financial reward mechanism that would allow weaker cities to benefit from a growth incentive. While the floorspace incentive is most effective in successful cities – where the demand for new floorspace is high – the rateable value incentive would reward a larger range of cities to improve their economy and take long-term strategic decisions.

Local authorities that get the opportunity to allow out-of-town development would still see an increase in their business rates take. But introducing the value uplift mechanism would widen the incentives that a local authority has to improve its economy and ensure that there is an additionally rewarding alternative.

## Recognise the contribution from the rest of the country

**An implication of the geography of economic activity is that some places are much better positioned to benefit from business rates growth than others.** In 2015-16, a third of all business rates was raised in only 23 local authorities - 11 of which were in London - (Figure 8), and more than two thirds of all business rates generated in England were in cities.

**Figure 8: Top local authorities for business rates collection, 2015-2016**

| | Top local authorities for collectable rates, 2015-16 | Share of England's total (%) |
|---|---|---|
| 1 | Westminster | 7.2 |
| 2 | City of London | 3.8 |
| 3 | Camden | 2.3 |
| 4 | Birmingham | 1.7 |
| 5 | Tower Hamlets | 1.7 |
| 6 | Hillingdon | 1.6 |
| 7 | Leeds | 1.6 |
| 8 | Manchester | 1.6 |
| 9 | Kensington and Chelsea | 1.2 |
| 10 | Southwark | 1.0 |
| 11 | Hammersmith and Fulham | 0.9 |
| 12 | Bristol city of | 0.9 |
| 13 | Sheffield | 0.9 |
| 14 | Islington | 0.8 |
| 15 | Liverpool | 0.8 |
| 16 | Trafford | 0.7 |
| 17 | Hounslow | 0.7 |
| 18 | Milton Keynes | 0.7 |
| 19 | Cheshire West and Chester | 0.7 |
| 20 | Cornwall | 0.7 |
| 21 | Ealing | 0.6 |
| 22 | Wiltshire | 0.6 |
| 23 | Newcastle upon Tyne | 0.6 |
| 24 | South Gloucestershire | 0.6 |
| 25 | Bradford | 0.6 |

Source: DCLG, National non-domestic Rates collected in England, 2015-16

As a result, trying to incentivise non-commercial areas to attract more businesses and reward such behaviours is likely to be ineffective. At the same time, the expected financial reliance on business rates means that these places need to find sustainable alternative sources of funding.

Acknowledging the fact that non-city areas are less able to increase their business rates, and understanding the role these places play in the overall economy, can help shape additional specifications to the system to allow them to benefit from it.

## Pooling business rates

There is increasing recognition that urban local authorities are not individual economies but instead that each place plays a role in its wider city economy. While jobs tend to concentrate in specific areas – typically cities and city centres – workers tend to be more widely spread, with many living in surrounding local authorities. **In 2011, two-thirds of workers based in a city centre in England and Wales lived in another local authority.**

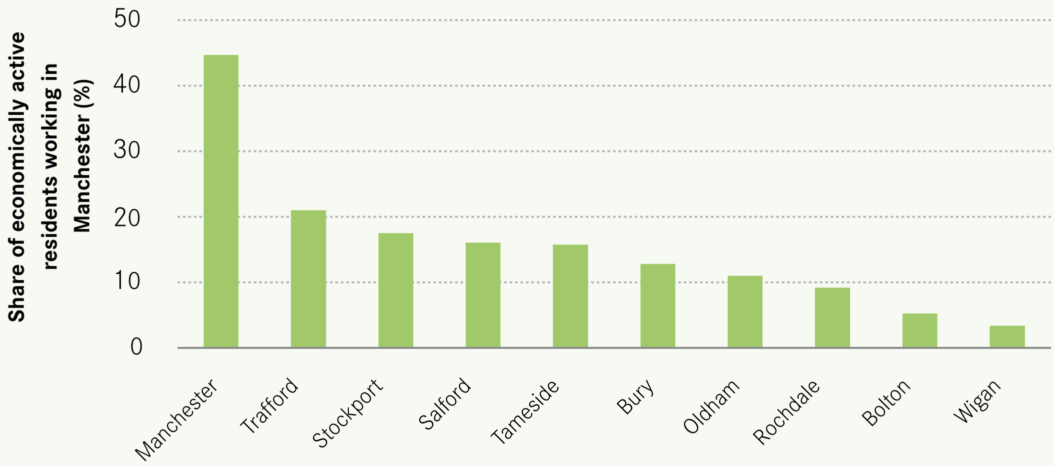
**But because business rates are a tax on commercial property, only local authorities where businesses are located get revenues.** This creates a mismatch between where the tax is generated and where revenues are spent in local services. Box 6 illustrates this with the case of Greater Manchester.

### Box 6: Business rates revenues in Greater Manchester

Greater Manchester is a good example of an integrated economy. In 2011, only 38 per cent of Manchester local authority's workers lived in the local authority and 46 per cent lived elsewhere in Greater Manchester.

As shown in Figure 9, more than 20 per cent of the economically active population of Trafford worked in Manchester, as did one in six working age residents of Salford and Tameside. But as work is located in Manchester, business rates are generated and collected there.

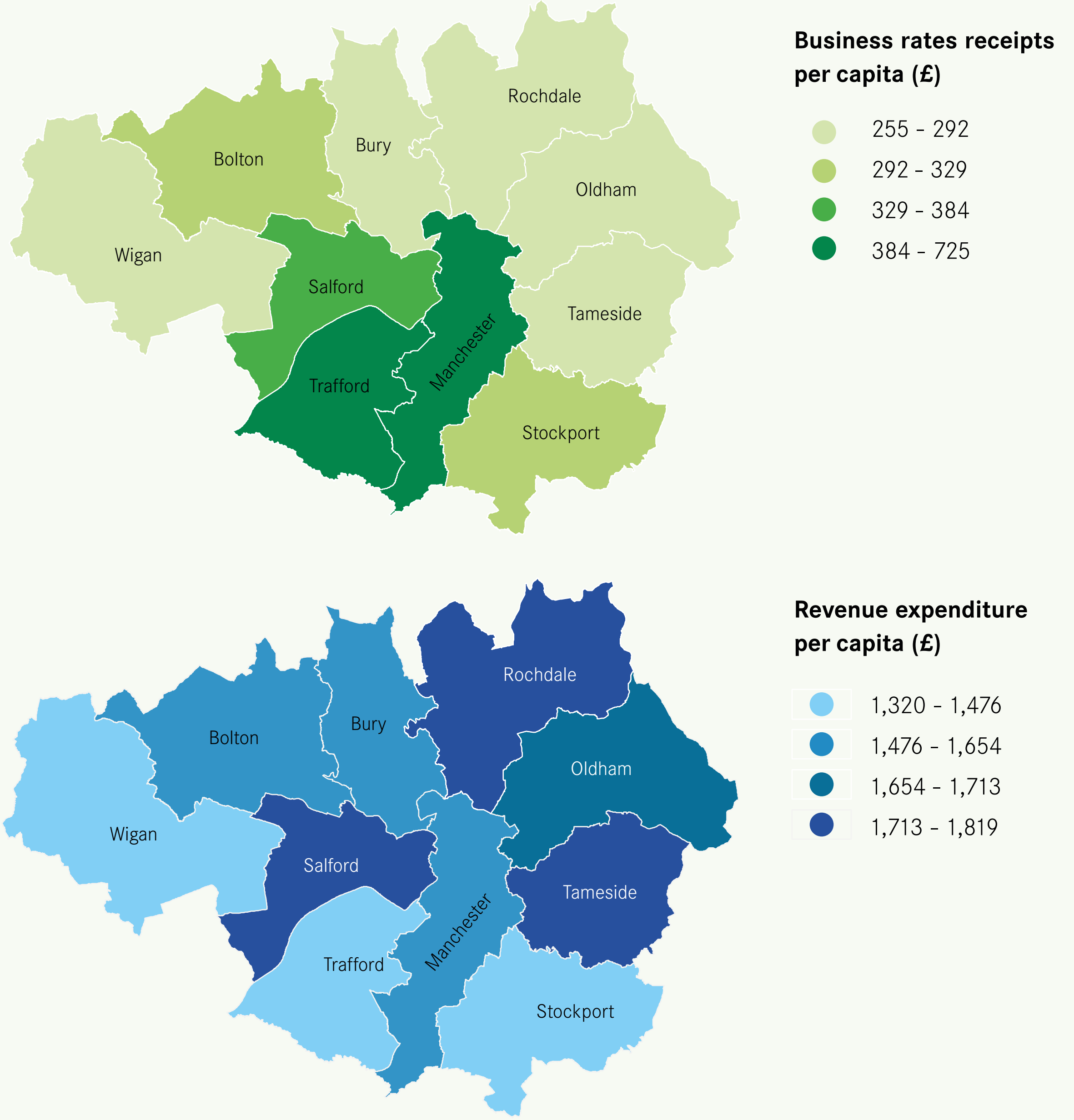
**Figure 9: Share of economically active Greater Manchester residents working in Manchester**




Source: Census 2011

And this can be an issue for local finance. As shown in Figure 10, some local authorities such as Trafford and Manchester generate large amount of business rates per inhabitant (measured by business rates receipts) and have relatively low spending needs per head (measured as revenue expenditure per capita). By contrast, Tameside, Oldham and Rochdale provide workers to Manchester's economy and have large expenditure needs, but do not generate much in business rates locally.

**Figure 10: Business rates receipts per capita and revenue expenditure per capita, 2016-2017**




Source: DCLG, NNDR1 2016-2017; Revenue Account (RA) 2016-17

**Pooling business rates revenues across city regions could help address this mismatch in tax and spend.**[13] In particular pooling would:

- Allow surrounding local authorities that contribute to the economy through the supply of workers to the central area, to benefit from the growth in the city
- Avoid negative competition between surrounding areas for investment
- Provide a better allocation of funds for growth. Pooling all funds into one pot allows investment decisions to be taken at a city-region level, rather than at a local authority one, with higher economic and financial benefits.

Local authorities' decision of whether or not to pool business rates will be affected by many factors, including local politics and the type of powers that will be on the table for devolution. But on a purely fiscal point of view, local authorities would only be willing to pool if they could get better financial or economic returns. This leaves two possibilities. The first is to ensure the pooling system has additional incentives to make it a more financially attractive solution than the status quo. This could include local rebates or the ability for authorities to have more flexibility over the multiplier. The second is for Government to enforce pooling, on the basis that it would achieve a better outcome to the wider city-region.

### Support places that can't generate enough business rates

For those places outside city-regions, the concentration of the economy in cities and their more limited ability to generate business rates growth would leave them with a high level of dependence on the system. This is why places that do not generate enough rates to cover for their services still need a national system of top-up and tariffs.

In this context of devolution, redistribution could be made more efficient by removing the cap on the business rates yield. As devolution could incentivise cities to generate more business rates, removing the cap would allow for more money to be redistributed at each reset of the system. This is why removing the cap is not only important from an incentive point of view, it can also help ensure the viability of the redistribution system.

13 Pooling currently exists but has so far mainly been used as a mechanism to allow local authorities to avoid paying a levy on disproportionate growth, rather than encouraging a more integrated redistribution of business rates. The last Government was however clear that the levy will be dropped, meaning that there would be less reason for local authorities to pursue pooling in its current form, and leaving room for new pooling arrangements.

## Conclusion and policy recommendations

To remain successful, cities must adapt their economy to changing demand – they must create the appropriate environment to help develop and attract knowledge-based services.

**But cities are in different positions when it comes to achieving this outcome, meaning that what they need to do to support growth varies.** Successful cities are already attractive to high-value activities and need to build more to sustain growth. Weaker cities are less able to attract those sectors and need to work on providing the relevant conditions to attract them in the future.

The current business rates incentive, by only rewarding local authorities which allow the development of additional property, is most relevant to only a handful of successful cities and does nothing to help weaker performers to turn around their economy.

By making a number of adjustments, the business rates incentive could help more places pursue a long-term growth strategy. To make the most of the growth incentive and maximise its impact across a wider number of places, the following changes should be implemented:

1. **Allow local authorities to capture the value uplift of commercial property.** This will encourage cities to improve their business environment to attract more high-value services and knowledge-intensive industries, rather than just expanding floorspace.
2. **Simplify the system to make it more efficient and responsive.** There are two ways to do this: (i) implement more frequent revaluations, to make the system more responsive to market change, more predictable for businesses, and easier to understand; (ii) remove the cap on the total yield generated to allow local authorities to capture real rateable value growth and for more money to be generated and redistributed.
3. **Allow places that contribute to share the rewards and the risks.** Within city-region economies, different areas play different roles, such as city-centres and industrial zones (home to businesses) and residential areas (home to workers). By pooling business rates revenues together, local authorities that are mostly residential would have an opportunity to benefit from the economic success to which they contribute.

While these adjustments can help business rates devolution to benefit a larger number of local authorities, more needs to be done to assure financial sustainability locally. The over-reliance on business rates means that not all local authorities will have the ability to increase their revenues. Therefore creating a more comprehensive local finance system, with a set of devolved taxes and redistribution mechanisms, will be necessary to support places in the future.

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