resouring London

a model for retained business rates

LONDON COUNCILS

contents

01 introduction

For years, successive governments have grappled with the question of how to improve the way in which local services are funded. Nowhere is this more pressing than in the debate around the collection of business rates. The present system, widely recognised as unwieldy and overly centralised, involves councils collecting the money from businesses in a local authority, passing the money to Whitehall, and then receiving some of the money back in the form of formula grant funding. The system is not only bureaucratic, but also creates no incentives for local authorities to engage with business to drive growth.

A window of opportunity now presents itself to reform the system. Since taking office, the government has expressed a clear desire that councils should not only be financially more self-sufficient and less dependent on central government funding, but that they should engage with business in a more proactive and collaborative way. With the government focused on delivering sustainable economic growth and enterprise[1], local authorities have an important role to play. In return, the government wants to provide a 'framework of powerful incentives'[2] to reward local authorities who regenerate their local economies and support local business.

The Local Government Resource Review (LGRR) provides local government with an important opportunity to consider its long-term funding goals and how it might best benefit from business rate retention.

1 Coalition agreement, page 7
2 *Local Growth: realising every place's potential*, page 23

Terms of reference

The terms of reference[3] for the LGRR acknowledge a number of complex issues that are associated with what would be the biggest change to the system of local government funding for 20 years. A number of these issues present some very difficult political and technical challenges, including:

- The need to have an adequate incentive and reward system for local authorities who promote growth, while 'ensuring that all authorities have adequate resources to meet the needs of their communities and to deliver the commitments set out in the Spending Review';
- The extent to which local authorities can be set free from dependency on central funding;
- The varying position of local authorities – some authorities collect significantly higher levels of business rates than their current spend while others receive far more in central government funding than they collect in business rates;
- The extent to which any reform can deliver greater transparency and localisation of the equalisation process;
- How to ensure appropriate protections are in place for business, within a framework of devolving power to the lowest level possible.

3 www.communities.gov.uk/documents/newsroom/word/1866550

Drivers for change

There is no doubt that ministers have always found the current formula grant system painful and time consuming, and a replacement must be a very attractive prospect. However, beyond the political will, a number of systemic factors exist that support reforms to the current system.

Business rates yield: Historically, local government has received an annual 'formula grant' allocation from central government to fund local services. This grant is made up of nationally redistributed business rates and revenue support grant (funded from general taxation). However, from 2013/14, current forecasts suggest that total business rate yield in England will exceed the government's formula grant funding totals; the law requires that the entire business rate yield is distributed to local government (give or take adjustments), which effectively leads to the Treasury losing control of a significant proportion of local government spending. The fact that local government will be funded almost entirely from business rates, allied with the need to change local government finance legislation, provides a real opportunity to reform a system that has forced local government to become financially dependent on funding decisions made by central government.

The formula grant 'four block' model: The potential end to formula grant also provides a real incentive and opportunity to move away from the turbulence and uncertainty of the current distribution system. As demonstrated in our report, *Four block muddle*[4], the formula grant system is complex, inherently unstable, lacks transparency and generates perverse outcomes. Local retention of business rates presents an opportunity for local government to take responsibility for devising a locally-led distribution and equalisation model. In London, one could imagine a model for the capital that reflects our unique circumstances and our diverse communities.

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4 *Four block muddle - fundamental flaws in formula funding*
www.londoncouncils.gov.uk/policylobbying/localgovernmentfinance/formula/fourblockmuddle.htm

02
a potential solution

London Councils' leaders have agreed a set of guiding principles as the basis for possible approaches to business rates retention. Using these principles, we have developed a potential retention model for all 32 London boroughs, the City of London and the GLA (as it relates to its formula grant funded police and fire functions). It is a 'shared risk and reward' pooling arrangement, whereby London retains and benefits from its business rate growth. The focus of the work to date has been to explore how a system could distribute funding across London while also providing a direct reward for economic growth driven at the local level.

It is recognised that this is one potential solution and there may be others. It has been developed to stimulate debate among our members about how London might potentially work together in a joint arrangement. The model has allowed officers and members to explore the many issues, dynamics and challenges that are inherent in a system of business rate retention, and to do this confidently; we've set up our modelling with five years of historic data and five years of forecast data to give us a ten-year span.

How does it work?

The diagram in figure A sets out the basic configuration of our model. It shows that there are three component parts:

1. Driving economic growth - an incentive mechanism to reward local success

Where an authority experiences an increase in its business rates yield above its baseline contribution to the primary pool, this amount would be treated as growth – we don't differentiate between types of growth to avoid the complexities that caused so much difficulty in the government's

LABGI system. Authorities would keep a proportion of their growth, based upon the concept of 'business rate leverage' (which we explain later), and the remainder would be fed into the secondary pool.

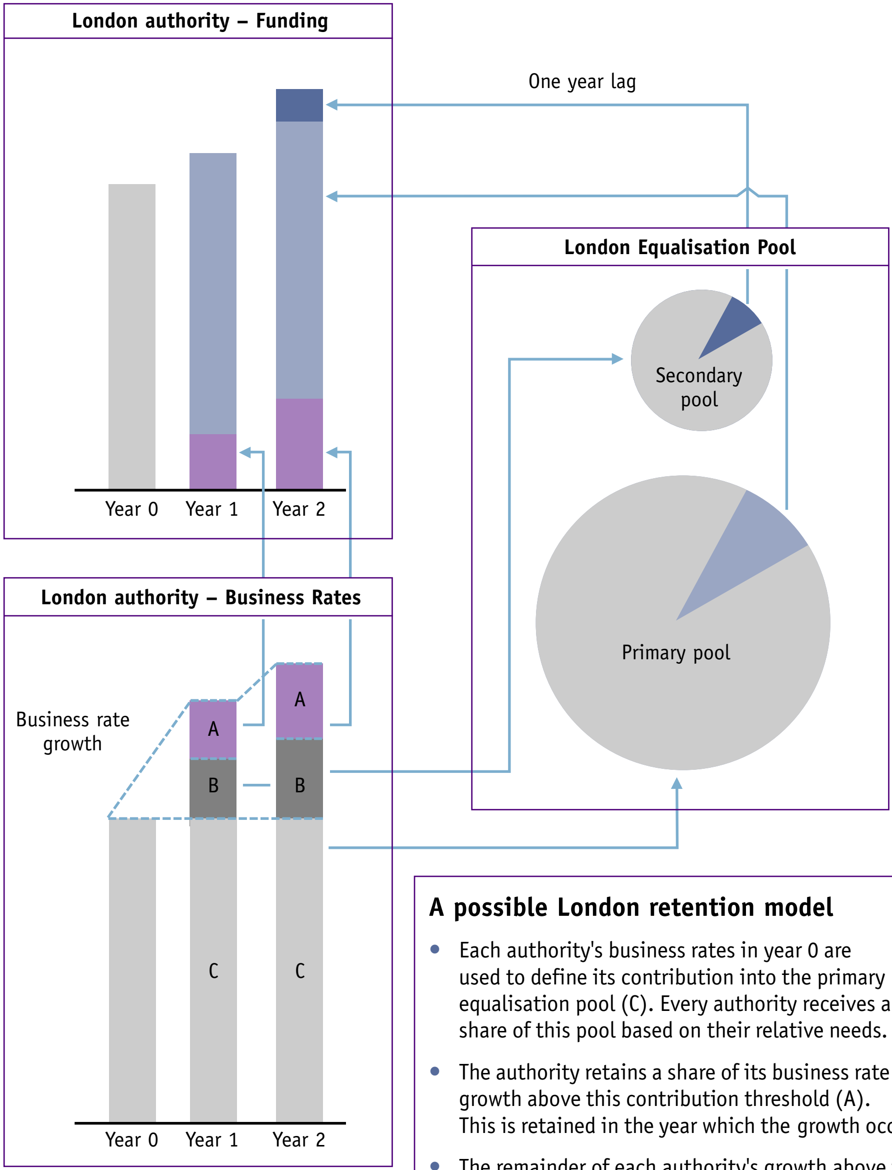
2. A primary pool – allocating London's growth

Local authorities would contribute an agreed amount of their business rate yield into the primary pool. This contribution would be set according to each authority's business rate yield in a baseline year and fixed for an agreed period of time. In turn, they would receive a funding allocation from the pool. This would initially be based upon the 2012/13 formula grant distribution.

3. A secondary pool – London-wide incentives for growth

The proportion of business rate growth that is not directly retained at the local authority level is redistributed from the secondary pool to all participating authorities using the same formula as used for the primary pool. This dynamic pool (its size will depend on the profile of growth) recognises the fact that members of the pool are part of a larger economic unit and would provide an incentive for joined-up approaches to economic development.

Figure A: *Exemplification of a possible London Retention Model*



A possible London retention model

- Each authority's business rates in year 0 are used to define its contribution into the primary equalisation pool (C). Every authority receives a share of this pool based on their relative needs.
- The authority retains a share of its business rate growth above this contribution threshold (A). This is retained in the year which the growth occurs.
- The remainder of each authority's growth above this threshold (B) is paid into a smaller, secondary equalisation pool. This pool is redistributed the following year, according to relative need.

Features of this system

Business rate leverage: If one accepts the premise that business rate retention will incentivise activity at the local level to drive economic growth, and that the result of that activity will flow through growth in business rate yield, a significant challenge presents itself – is it equitable that some authorities have significantly higher in-built growth potential than others, and that often those with low potential have high need?

Our modelling brings this dilemma into stark relief. It led us to consider ways of fully incentivising every authority while managing the likelihood of significantly asymmetric growth patterns – which we've termed 'business rate leverage'.

Our analysis shows that if authorities in London were to keep all their growth and there was a one per cent increase in business rate yield across each authority, this would provide significantly different benefits. An authority with a large business rate base could see its total funding increase by almost 10.5 per cent, while those with smaller bases could benefit by as little as 0.3 per cent. This is clearly inequitable.

To provide a consistent and fair incentive for each authority, we have developed a 'retention share' formula that is applied to the business rate growth of each local authority. It operates so that authorities with high leverage retain a smaller share of their growth and visa versa. This could range between 100 pence in the pound, for the lowest leverage authorities, to 2 pence in the pound for the highest – the formula generates a retention share specific to each authority's circumstances. Of course, the starting level could be an issue of debate, and would change over time in response to local circumstances.

The level at which the retention share is set could have a dramatic impact on the potential growth in local funding at a local authority level. Figures B and C show the potential impact on the same high base authority of a retention share set at 4 pence and 30 pence respectively.[5]

5 Based on London Councils' modelling using historic data from 2005/06 to 2010/11, and London Councils' projections from 2011/12 to 2015/16

Figure B: *High base Authority A – retention share at 4p per £* [6]

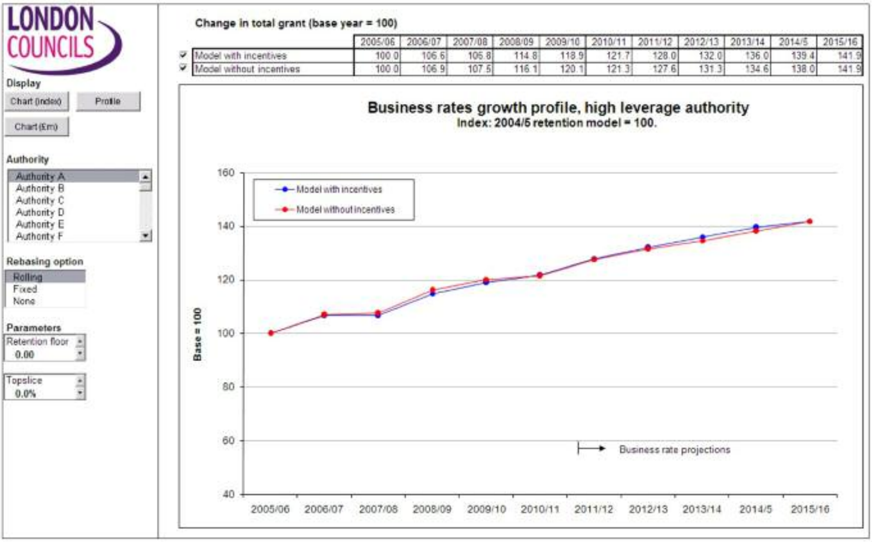
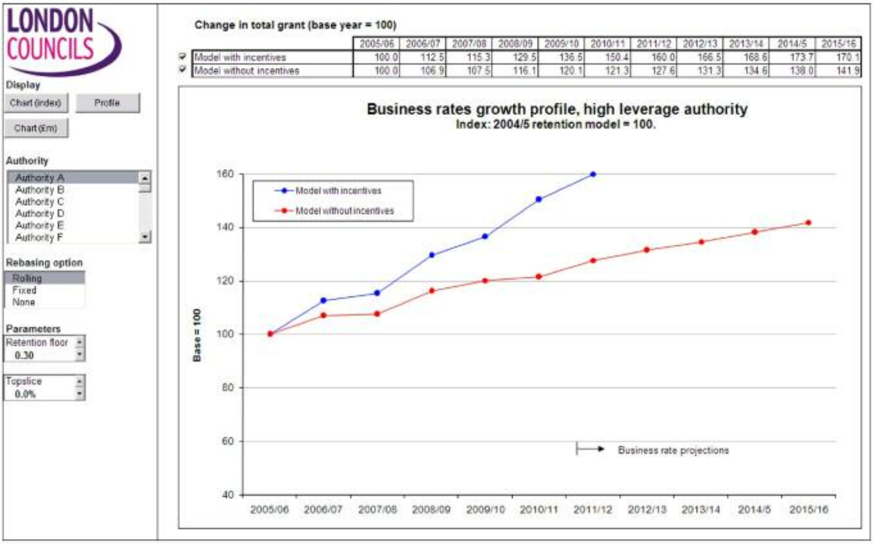


Figure C: *High base Authority A – retention share at 30p per £*



6 In Figures B, C, D and E, the blue line represents local funding in the retention model with a retention share applied. The red line represents local funding in the retention model where business rates are redistributed regionally on the basis of needs alone.

The retention share offers a solution to the problem of how to account for the varying growth potential of different local authorities when building an incentive into the business rates system. Authorities with low in-built growth potential will benefit from keeping a larger proportion of local growth but will also receive a share of the secondary growth pool.

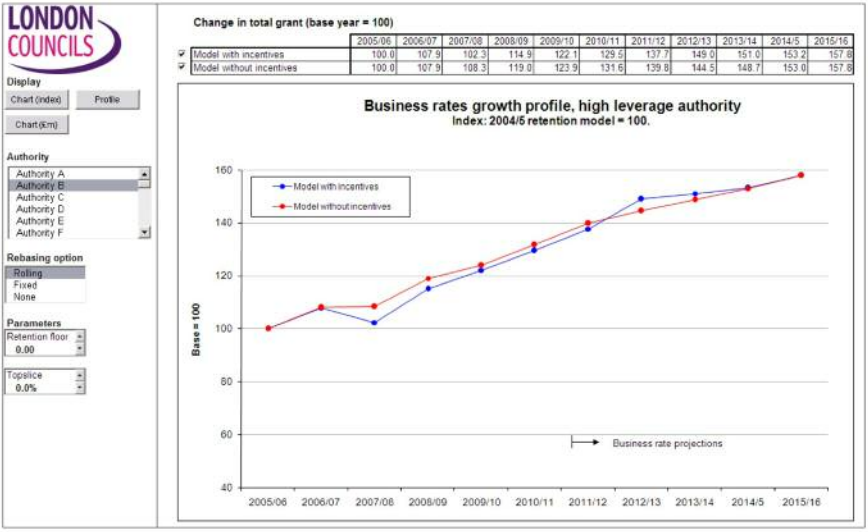
Of course, just as authorities can grow, they can also decline, and our retention share provides some level of protection for authorities with large business rate bases in times of falling business rate growth. It would do this by restricting the impact of falling growth at the authority level in the year in which the decline happens (however, as explained below, an authority's contribution to the primary pool will be fixed except in exceptional circumstances). The risk of decreasing growth would also be shared regionally via the secondary pool. This is clearly shown in Figures D and E.[7]

Figure D shows the growth in local funding for a high base authority, with a low retention share, which had a significant decline in business rate yield in 2007/08. The impact of the falling business rate yield is buffered by the low retention share.

Figure E shows the same authority but with a higher retention share being applied. The impact of the fall in business rate yield in 2007/08 on local funding is felt more intensely at the local level as the retention share is increased.

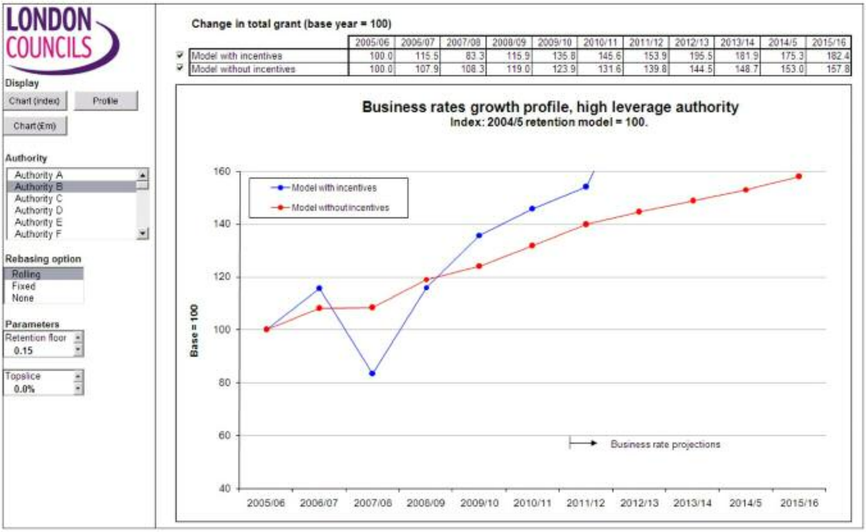
7 Based on London Councils' modelling using historic data from 2005/06 to 2010/11, and London Councils' projections from 2011/12 to 2015/16

Figure D: *The impact of the retention share on Authority B with falling business rate growth – low retention share (2p)*



	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/5	2015/16
Model with incentives	100.0	107.9	102.3	114.9	122.1	129.5	137.7	149.0	151.0	153.2	157.8
Model without incentives	100.0	107.9	108.3	119.0	123.9	131.6	139.8	144.5	148.7	153.0	157.8

Figure E: *The impact of the retention share on Authority B with falling business rate growth – higher retention share (15p)*



	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/5	2015/16
Model with incentives	100.0	115.5	83.3	115.9	135.8	145.6	153.9	195.5	181.9	175.3	182.4
Model without incentives	100.0	107.9	108.3	119.0	123.9	131.6	139.8	144.5	148.7	153.0	157.8

Retaining growth: Having addressed the issue of how much growth might be retained at the local level, the next question is, for how long should that growth be retained? The answer logically ranges from a year to forever, and is of course subject to debate and decision by the pooling authorities. Our modelling assumes a five-year rolling period after which the growth would revert to the primary pool. In other words, by year six an authority would be retaining five years of growth reward and the growth of year one would have reverted to the primary pool.

A 'carrot and stick' approach: The model has a very clear 'carrot and stick' approach. A local authority can benefit from its business rate growth. On the other hand, if an authority experiences a decline in business rate below the level necessary to make its contribution into the primary pool, it would be penalised by the requirement to pay its full contribution.

However, it is recognised that business rates yield within a local authority can be adversely affected by an event beyond its direct control, such as the recent economic downturn. Any model would need a process whereby exceptional circumstances could be taken into account.

Setting up the system

Governance: A potential London retention model would also require a local governance structure to manage the scheme. It seems to us that on a day-to-day basis the system would need a small administrative body with an equally small independent board to oversee operations. It is clearly important that any such body would be ultimately accountable to London's democratically elected leaders: the borough leaders and mayors, and the Mayor of London.

Ensuring national fairness: London has historically been a major driver of growth within the national economy and to ensure fairness across England, it is suggested that London should continue to pay a share of its business rates yield to the rest of the country. These payments could either be in the form of a share of income, or the local funding of specific grants currently funded by central government. The level of payment and the way it's measured would again be subject to political decision.

The potential for London local government to support national finances also requires recognition that in times of widespread decline or economic shocks disproportionately affecting London, London's population should not suffer funding shocks and may require national support.

Agreeing a starting point: The model assumes that services currently funded from formula grant provide the basis for any future finance settlement and that any new burden on local government would come with additional funding. No adjustments have been made to reflect the position of local authorities in respect of the formula grant funding floor – though this could be an issue for debate.

Other incentives: The model would be flexible enough to allow other business incentive schemes to function within it. In particular, government proposals to allow local authorities to engage in Tax Increment Finance (TIF) could be accommodated and the current BID legislation would be unaffected by the model. Further development work is currently underway to see how a direct house building incentive (such as the New Homes Bonus (NHB)) could work in this model.

Business rate reliefs: Both statutory and discretionary reliefs can be accommodated within the model – although, the latter would only be viable to the extent to which a local authority could meet its agreed primary pool contribution. Should London members wish to offer region-wide discounts, or to promote certain industries (eg green initiatives), this would also be possible.

The impact on business: This model assumes that day-to-day valuations and revaluations for business rate purposes will remain under the remit of the Valuation Office Agency (VOA). It is also expected that the current arrangements around control of the business rate multiplier will remain unchanged. This means that the base level of the business rate multiplier, and small business multiplier, could be set regionally, but would continue to be capped at RPI year-on-year.

Revaluation and transitional reliefs: Managing the effects of revaluation and transitional relief will be a major challenge for any retention model. London Councils' model assumes that the current business rate system will remain in place, such that the total business rate yield does not grow by more than RPI following revaluation. As pointed out in the Lyon's Review, this feature of the system means that there is no additional business rates revenue at a national level, arising from increased property values, that could be used to give local authorities a share of the benefit from any growth in the tax base that they create. The system also creates an unpredictable relationship between growth in a local authority's tax base and the business rates it collects. While London Councils' model is sufficiently flexible to include options that address this unpredictability, these parameters severely restrict the level of incentive that any retention model could provide local authorities.

Getting allocation right: It is important that funding levels reflect the service pressures faced by local authorities and 'needs' could be assessed on a periodic basis. Our published analysis shows that the existing formula grant system does not work and funding is not distributed in a fair and transparent way. A London retention model would allow the development of a more effective and flexible system, better reflecting London's circumstances. While this does not automatically lead to increased levels of funding for London overall, it could ensure that funding is better allocated *within* London.

03
from technical options to political decisions

A business rate retention model for London, based upon our set of guiding principles (see appendix), is technically possible. However, before any reforms to the system are made, central government needs to make a number of political choices, including:

1. Will the government permit a system that allows London to both benefit from its business rate growth and to contribute to the economic well-being of the rest of the country – as our leaders want to?

2. Will the government acknowledge that London's acceptance of the risks associated with pioneering business rate retention may require mechanisms to support the region, and its population, in times of wholesale economic shock/downturn?

3. Does the government agree that London leaders should be able to collectively decide how best to balance fairness and the need to reward growth within London?

4. Will ministers give us the long-term deal that allows London to adequately balance financial risk and reward across London and across the economic cycle?

5. As part of this long-term deal, will the government be willing to legislate to restrict its power to change the level of incentives on offer over a period long enough to permit investment for growth?

6. Business rate retention in London would allow London authorities to withdraw from the formula grant system. However, meeting the growing needs of London's population would require funding in addition to locally raised council tax and business rate revenues. Will the government commit to safeguarding London's share of funding from specific grants such as Dedicated Schools Grant (DSG)?

7. If a system of business rate retention is implemented, will the government undertake to fund, in full, the cost of any new burdens placed on London authorities in the future?

04 conclusion

The government is eager to reform council funding, creating local incentives to drive faster economic growth. Reform could empower local government to drive faster economic growth and better support the communities that we represent. It depends on regaining some of the autonomy that was lost when business rates were nationalised. This is a prize to be seized.

For reform to work, the incentives for growth must be strong enough and be fair to local authorities across England. London Councils' officers have developed a model that can support differing political approaches to that reform. There are opportunities, but also some very real risks, in all solutions. We hope our colleagues across local government will find this model helpful in the debate.

appendix: London Councils' guiding principles in full

London Councils' executive committee agreed the following guiding principles at its meeting on 23 May 2011. These principles have underpinned London Councils' development work to date.

a) London would continue to pay a share of its business rates yield to the rest of England, to ensure fairness across England by reflecting London's historic position as a major generator of business rates.

b) Recognising London's position as a driver of growth in the national economy, and the fact that London is an economic whole, any scheme for business rate retention in London should drive and incentivise growth by directly rewarding councils for local growth through a retention mechanism, as well as sharing the benefits of growth across the capital.

c) Any London scheme would fund the withdrawal of the London boroughs, the Corporation of London, LFEPA and the MPA from the government's formula grant system.

d) Any London scheme would pool business rates across the city and allocate them, at least at the outset, according to the 2012/13 damped formula grant distribution – i.e. the year before the government's proposed introduction year.

e) The distribution formula for any London scheme would be reviewed in the future to develop a new version, designed by those involved in London's governance, which better reflected the evolving needs of each authority area. Any such formula would:

    i. be consistent with policy goals in this area and ensure that every borough has an incentive to drive growth;

ii. recognise and improve the definition of need and take account of this in the distribution methodology;

iii. hedge risks through pooling;

iv. be subject to review and reform at regular intervals, but, recognising that there is a premium in stability, this period should be sufficiently long (say five years) to allow the proceeds of any growth to flow through. In the first phase, a review of operation after three years may be appropriate.

f) Governance and operation:

i. any London scheme should be administered by a small independent body, funded by the pool;

ii. there should be a small, independent board with 'expert' participation, to oversee and guide day-to-day operations;

iii. the body and board will be ultimately accountable to the democratically elected leaders of London;

iv. an arbitration procedure would be adopted as the route of last resort to resolve disagreements.

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