Business Rates: Consultation Briefing

28 July 2011

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1. Introduction

1.1. The Government has launched a consultation on the future of non-domestic rates which – if implemented – will have a profound effect on the funding of all upper- and lower-tier authorities. Police and Fire authorities are excluded.

1.2. For some, the proposals would mean a significant increase in resources and a strong incentive to develop local business; for others, there would be reduced resources and a substantial increase in risk.

1.3. Eight technical papers are promised for August with the consultation deadline 24 October.

2. Key Elements of the Proposals

2.1. The consultation covers the new business rates scheme and a range of associated issues. The first part of this briefing covers the main issue with other proposals (and issues for police and fire authorities) considered separately below. The key elements of the main proposals are:

- An end to the annual settlement, the last being for 2012-13
- No power for authorities to vary any aspect of the present arrangements as far as they affect businesses; in particular local authorities will have no power to vary the business rate poundage
- A business rates target for every authority from 2013-14
- Authorities collecting more in rates than they presently receive in Formula Grant will be required to pay a tariff to Government
- Authorities collecting less in rates than they presently receive in Formula Grant will continue to be subsidised
- Authorities exceeding the business rates target in any year will keep some of the excess, the rest being levied to provide a safety net and for other purposes
- Authorities failing to meet the business rates target will see a reduction in overall resources, which might be partly offset by funding from the levy
- Voluntary pooling arrangements to allow neighbouring authorities to smooth out volatility
- Continuation of the “central list”, exempt from this scheme
- Continuation of the existing set of reliefs and authority reimbursements for reliefs
- A complete “reset” every few years, possibly after ten years

- Police and Fire authority funding determined essentially as now, albeit with a revised formula from 2013-14

2.2. The consultation paper only outlines the proposed key features. The detail about how the proposed funding regime will actually work will be developed over the coming months.

2.3. These key features naturally throw-up a whole host of issues which we explore below:

- How the business rates target should be set initially and interactions with Formula Grant damping
- How the business rates target should change between years
- How tariffs and subsidies should change between years
- The extent and form of the levy on gainers
- The extent and form of the safety net and other uses of the levy
- Transition issues
- Cash-flow issues
- The appropriate frequency for resets

3. Initial Business Rates Target

3.1. The scheme revolves around the creation of a target for business rate collection and hence a target funding level. Authorities that presently collect more business rates than they receive in Formula Grant will be required to pay a tariff to Government; others will receive a top-up. This is a straight-forward concept: if a lower-tier authority collects £100m in business rates and receives £50m more in Formula Grant just prior to the new scheme its target will be based on collecting the same £100m in the first year and it can expect a similar top-up.

3.2. Adjustments to share funding between authorities in an area and to match the funding totals in the last Spending Review are essentially details (albeit important ones) and the latter point is covered in some detail in the consultation. The grant totals across local government for the first year of the scheme are only marginally lower than for 2012-13 but nonetheless there are issues about how much each authority would have received had the old scheme persisted for 2013-14 allocations – this is vital as it provides the starting point for the new arrangements.

3.3. Two options are presented: simply scale everyone down a bit to match the lower grant total or re-run the 2012-13 settlement making “minor changes as necessary” to produce a shadow 2013-14 allocation.

3.4. The key (and virtually hidden) issue surrounds the damping that is in the system: among upper tier authorities Surrey will receive £44m more in grant in 2012-13 than the formulae suggest it should, while Norfolk will receive £22m less. Clearly, how these sums will be treated in the future is very important.

3.5. The first option (scaling down) is certainly simplest. It greatly favours those that would have expected to lose had the 2013-14 settlement been run, most obviously because they receive large amounts of Formula Grant damping support that would otherwise be reduced. Authorities whose needs had reduced compared to other authorities would also benefit from no new proper settlement.

3.6. The second option (minor changes) is anything but simple, given the inherent instability in the four-block model. Compared to having a full annual settlement, however, it also favours those who presently receive large amounts of damping as they would only lose one year's damping, not all of it as would usually happen over time.

3.7. There are obvious further options – not even mentioned in the consultation – that make some attempt to erode the damping in the current system, for example increasing the rates target by 1% per year for these authorities or phasing the damping out over, say, ten years. This could well be the most contentious point politically as the authorities that presently receive large amounts of damping are overwhelmingly the ones that did best from the in-year cuts in 2010, from the 2011-12 and 2012-13 settlements, and stand to gain most from the New Homes Bonus.

4. Updating the Business Rates Target

4.1. There are a few options for changing the business rates target from year to year, two of which are outlined in the consultation. Under the first, everything would be uprated by RPI each year. For three exemplar authorities, and assuming 5% inflation, the outcomes would be:

Very high resource	Year One	Year Two
Business Rates	400	420
Top-up	-100	-105
Total Funding	300	315

High resource	Year One	Year Two
Business Rates	200	210
Top-up	100	105
Total Funding	300	315

Low resource	Year One	Year Two
Business Rates	100	105
Top-up	200	210

Total Funding	300	315

i.e. total funding also rises by inflation for all three exemplars. Any change in the business rate base would result in a change in funding for the authority concerned.

4.2. Under the second consultation option, the targets and top-ups would not be altered at all (although business rates would rise with RPI as now). The outcomes would be:

Very high resource	Year One	Year Two
Business Rates	400	420
Top-up	-100	-100
Total Funding	300	320

High resource	Year One	Year Two
Business Rates	200	210
Top-up	100	100
Total Funding	300	310

Low resource	Year One	Year Two
Business Rates	100	105
Top-up	200	200
Total Funding	300	305

This time, the authority with very high resource sees an above-RPI increase in grant, even if its ratebase remained static.

4.3. One further option (among many) would be to increase the business rates target by 1% each year on top of RPI, i.e. only reward growth in excess of what might be expected. This would effectively generate more funds for the Treasury to re-distribute to those with higher needs, or lower resources, or for something else. One outcome could be:

Very high resource	Year One	Year Two
Business Rates	400	420
Extra Target (1%)	0	-4
Top-up	-100	-105
Recycled Funds	0	3
Total Funding	300	314

High resource	Year One	Year Two
Business Rates	200	210
Extra Target (1%)	0	-2
Top-up	100	105
Recycled Funds	0	3
Total Funding	300	316

Low resource	Year One	Year Two
Business Rates	100	105
Extra Target (1%)	0	-1
Top-up	200	210
Recycled Funds	0	3
Total Funding	300	317

In this case, the very high resource authority would be penalised most for not achieving any underlying business rate growth.

5. Levies on Gainers and its Use

5.1. Perhaps the most important issue in this consultation is the need to protect authorities who suffer a fall in business rates income, particularly if that fall was beyond their control. Obviously in practice this can only come from those gaining under the new scheme.

5.2. The consultation offers few details on this, other than to justify a levy on those gaining disproportionately. Again, there are many options, perhaps involving some of:

- A set percentage of rates collected
- A percentage based on the size of an authority's rate base
- A set percentage above a target figure
- All rates above a target figure
- An amount equal to fixed percentage of an authority's budget
- Only considering one year's changes
- Considering only changes since the scheme began
- Considering both the annual and accumulated gains

5.3. Naturally, authorities will have their own views on what would be fairest and what would benefit them.

5.4. Note: new renewable energy schemes will be exempt from any levy.

5.5. The use of any levies is another difficult issue. The consultation mentions several possible uses, although offers no details:

- To offset "significant negative volatility"
- To protect the spending power of low-growth authorities
- To provide a safety net partly to offset short- and longer-term shortfalls

- To fund regeneration schemes
- To redistribute to everyone
- To hold back for future low-growth years

Clearly any additional funding from this source could not completely offset the loss for an authority otherwise the incentive effect would be severely weakened.

5.6. The use of the levy potentially gives ministers significant discretion over how funding is distributed. In contrast to the current system, the levy might not be focussed on "need" and could be targeted at other ministerial objectives. For some this will be a significant loss of future funding compared to the current system.

5.7. Ministers clearly want a simple funding system that does not rely on complex settlements every 2-3 years. For some authorities with growing population (and/or other needs), this means that these changes are not funded for many years. A compromise solution might be to use part of the levy for this purpose through a simple formula which can be updated every year or so to reflect the main changes in demography.

6. Resetting the System

6.1. The consultation paper deals with the five-yearly business rate revaluation in a simple way which appears to deal with all issues fairly. Beyond that, the plan is to re-set the system from authorities' perspective every ten years or so.

6.2. The consultation argues that the period needs to be quite long to allow investments of time or resources to bear fruit; naturally authorities seeing increased needs – either through population growth or increased deprivation – would want a much more rapid re-assessment otherwise they might face serious accumulated funding pressures by the end of the period.

6.3. The paper makes the case for a fixed re-assessment period (certainty) against a more variable period (avoids perverse incentives to delay projects until after the reassessment).

6.4. It also discusses whether the re-set should be complete or restricted only to the money in the system in year 1, leaving any growth with authorities. Authorities expecting lots of growth will favour the latter, but the reality on this (and on the period of time issues) is that political considerations at the time may trump today's intentions.

7. Voluntary Pooling

7.1. The consultation suggests that groups of authorities might voluntarily choose to pool their business rates to smooth out volatility. This sounds sensible, as does the restriction in two-tier areas to being within a county area.

7.2. Paragraph 3.47 states:

Depending on the mix of authorities in the pool, and their individual tariffs, top ups and levies, pooling could also increase the level of rates retained across the pool where it leads to a lower aggregate levy. There is a theoretical possibility that the levy may be higher, and the rates retained therefore lower if the pool consisted of only tariff authorities all experiencing positive growth. But in this scenario the collaboration benefits producing additional growth would likely offset this effect.

7.3. Not only do we not understand this paragraph, we do not understand why anything need be different, vis-à-vis Government, for authorities that have chosen to pool. Surely it would be fairest for Government to make all the calculations as if every authority were separate but allow the pools to distribute the total of the top-ups or tariffs as it had agreed?

8. Transition and Cash-flow Issues

8.1. The consultation mentions the possibility that a fixed period for re-setting the system might provide a perverse incentive for an authority to delay an investment until after the re-set. It could make the same observation about the starting point: unless the system is constructed carefully an authority might easily gain millions of pounds a year by delaying planning permission for a new development to ensure its opening was delayed from 31 March 2013 to 1 April 2013.

8.2. Any safety net system would surely operate in arrears, given the need for audited figures, but a major business closure might put pressure on a small authority's cash-flow early in a financial year. Some consideration of this issue by Government seems essential.

8.3. Authorities will have to change their financial plans to accommodate more risky income. The risks will come both from local business rate income and possibly from the way the Government handles the business rate levy. Authorities may find that they have to maintain higher balances to cope with these uncertainties.

9. Our Views on the New Scheme

9.1. The first thing to say is that this is not a scheme for the relocalisation or retention of business rates or, indeed, anything like it. Authorities are not allowed to determine for themselves how much any business is charged, or which businesses are charged, or when. Nor are there any changes in what the proceeds can be spent on. An authority that collects less in rates than they receive in Formula Grant will be given a top-up grant determined by DCLG while an authority in the reverse position will be required to hand back an amount determined by DCLG. Simply labelling this process – exactly the same as happens now - as full relocalisation takes an impressive amount of chutzpah.

9.2. What has been relocalised – in as sense – is part of the growth in business rates – perhaps 0.75% of the total yield in year one. But along with that relocalisation comes a great deal of risk; we shall only know how much when the detailed proposals for safety nets are published.

9.3. The main driver for the new scheme is to provide an incentive on authorities to boost economic growth; this is does well, provided that the levy on gains is not excessive or constructed inappropriately. The problems with the old LABGI scheme re-surface, however, and this time the stakes are much higher.

9.4. The first problem is one of luck. Many business decisions have nothing to do with local authorities and more accurately reflect the effects of UK Government policy, world economic conditions or changing tastes. This scheme gives authorities credit for any rate gains and penalties for losses however they have occurred. If your area’s large factory closes then you will suffer the effects for ten years, and at a time when your deprivation levels have suddenly increased.

9.5. The second problem is one of setting the baseline. If that factory closed just prior to the scheme’s adoption then you ought to be well-placed; if you’ve just had a shopping centre open up then you will curse your luck that it could not have been delayed until after the scheme had started. These issues will start to diminish as the scheme matures.

9.6. A related issue is that of growth trends. Business rates tend to grow at about 1% p.a. under the present arrangements. Should authorities necessarily benefit from this? And should high-resource authorities benefit many times more than low-resource ones?

9.7. Formula Grant damping is a major issue. The figures would imply that many high-resource authorities are set to gain hugely by having their damping gains locked-in for ten years. The 2011-12 settlement was pretty random, however, in many respects so a literal interpretation would be slightly misguided. Nonetheless, the fact that the gainers are also those that lost least from the 2010-11 cuts and the 2011-12 and 2012-13 settlements and are set to benefit most from the New Homes Bonus and the new business rates scheme will cause consternation in many quarters.

9.8. Will there be conflicts of interest between authorities' planning decisions and their potential gains from developments?

9.9. Do authorities understand the potential state aids implications of their attempts to attract new businesses under this scheme? In particular it seems very unlikely that the proposal at 5.4 ("the Government will also give local authorities a broad power permitting them to reduce the business rates bills of any, or all, local businesses, as they see fit") being lawful in all cases.

9.10. We see no reason – other than modest incentive to promote stability, perhaps – for authorities in a voluntary pool to retain collectively more or less rate income than had they been separate.

9.11. Transition issues concerning the timing of new developments should be addressed, as should potential cash-flow issues.

10. Related Issues

10.1. The consultation also touches on some related, though separate, issues.

10.2. Police and fire authorities are excluded from the proposed scheme. The plan appears to be to re-design the formula for these authorities for 2013-14 and to fund them by re-assigning business rates collected by other authorities. We would expect damping to continue.

10.3. The existing settlement handles changes in local government responsibilities in a complex though essentially fair way. New burdens in the future can be funded in a straight-forward way using special grants, but any transfer out of local government will be much more difficult. This latter point is not addressed at all.

10.4. The New Homes Bonus rewards increases in council taxbase and is partly funded by an increasing top-slicing of the settlement from 2012-13. Rather than make a fresh adjustment each year, the Government's plan is to top-slice enough from the business rates collections to cover the NHB immediately and return any spare funds to local government. The proposal is that this excess should be returned in proportion to baselines (akin to Formula Grant). This will favour authorities who have collected relatively little in rates and/or who have relatively high needs.

10.5. Another top-slice due from the settlement is for new academies. There will be separate discussions on this.

10.6. There are no changes to business rate supplements or business improvement districts.

10.7. The consultation has a larger section on Tax Increment Funding – i.e. borrowing money against future business rate streams. The proposal is that TIF should be covered by the existing prudential code; authorities can assess their likely additional rates income, would know how much income would be lost to a levy, and borrow accordingly. The danger is that expected growth in business rate income is lost in the reset and it not available to repay the debt that has been incurred for the TIF. TIFs are usually for 20-25 years; the reset is envisaged every 10 years.

10.8. This might have been enough, but the Government has offered a further option: stronger controls on schemes being brought forward but guaranteed revenues as a result and a promise that the income would not be subject to a levy for a defined period. The paper sets out fairly the pros and cons of the two options; the second of which does not sit well with a localism strategy but would encourage capital investment more effectively. The exclusion of TIF revenues from the reset would appear to be a reasonable alternative, though DCLG is aware of the risks that authorities will want to badge large amounts as TIF.

10.9. We have summarised the key features of TIF schemes at Appendix 1

10.10. Any *increases* in rates income from Enterprise Zones will be excluded from any levy.

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July 2011

Appendix 1 – Tax Increment Financing

11. Background

11.1. Tax Increment Financing (TIF) is a method of leveraging funding for regeneration projects.

11.2. The basic structure of a TIF project is:

- A lead agency – usually one or more local authority – works alone or with a private sector partner to invest in a regeneration project
- Boundaries to the TIF area are defined (usually to include the area that will benefit from the investment in the regeneration project)
- Upfront investment in the regeneration project is financed from borrowing
- Future growth in business rate income within the TIF area is used to payback the borrowing

11.3. The TIF concept has been developed in North America. The previous Government considered a UK-specific version through Accelerated Development Zones (ADZs).

11.4. In the UK, TIFs are being promoted most heavily by the GLA, London Councils and the Core Cities Group.

12. Legislation

12.1. Local authorities do not currently have the powers to borrow against a specific income stream. Prudential borrowing powers allow local authorities to borrow against all their income streams. TIF would allow securitisation against the increase in business rate income in a defined area.

12.2. The Government is promising to introduce primary legislation to give local authorities this power. The promise was made by Nick Clegg (22 September 2010) and restated in the recent consultation paper on business rate localisation (source).

12.3. The Government intends to introduce TIFs initially through a bid-based approach. This would allow lessons to be learned about the practical implications of implementing TIFs in the UK, and to minimise the risk to the local and UK taxpayer.

12.4. The CLG is leading on the implementation of TIFs and will consider their development as part of the Local Government Resource Review.

13. Allocating risk

13.1. Borrowing is repaid from increases in business rate income within the TIF area. Borrowing might be repaid over 20 or 25 years, depending on the type of scheme and its business case.

13.2. There is a risk that the expected growth in business rates does not happen.

13.3. It is not clear who would be responsible for any financial shortfall. If the local authority has guaranteed the debt, then its council tax payers would be responsible for making good any shortfall. Alternatively the debt could be secured on the assets in the regeneration programme – default on the debt would result in the bondholders taking possession of those assets. The local authority might share some or all of the risk with a private sector partner.

13.4. In practice a TIF has to be supported by a robust business plan. These plans will have to consider risk very carefully, and ensure that plans – especially by developers – are properly scrutinised; that there is a reasonable margin for error; and that there is sufficient correction for "optimism bias".

13.5. In the consultation paper on the localisation of business rates, the Government suggests two options: the risk on the TIF could be shouldered entirely by the local authority (and/ or private sector partner); alternatively the Government would share some of the risk with the local authority. We do not know how this second option would work in practice; no doubt the Government would want to receive some of the growth in the business rate income in return for its support.

13.6. The Treasury would enjoy the wider fiscal benefits from increases in Stamp Duty, Corporation Tax, and Income Tax.

14. Interaction with localisation of business rates

14.1. In the version of TIF considered by the previous Government, all business rate income was paid into a national pool. Growth in business rate income within the TIF would have to be reallocated back to the local authority.

14.2. The introduction of localised business rates – where most or all of the increase in business rate income is kept locally – changes the issues for introducing TIF.

14.3. Firstly the concept of retaining any growth in business rates has now been answered: almost all increases will be kept locally. There are some exceptions where growth is deemed to be excessive. In most cases, therefore, the local authority would not need permission from Government to retain the increase in rates locally. There may have to be exceptions in areas such as Westminster where a large portion of growth within the borough has to be reallocated through a national pool.

14.4. Secondly the concept of “additionality” becomes more important. Ideally TIFs should generate additional business rate income within the TIF area and should not simply transfer it from neighbouring areas (this has been a criticism of TIFs in North America). This becomes crucial when business rates are localised because the local authority is responsible for all business rate income in its area.

14.5. A key issue will be how TIFs are handled when the Government “resets” the local government finance system. The reset could be undertaken every 10 years; this might cut across a TIF arrangement which might last for more than 20 years. A local authority would want its TIF revenues excluded from any reset process.

15. Financing borrowing for TIFs

15.1. In the first instance most financing for TIFs is likely to be done by local authorities through their prudential borrowing arrangements (and possibly using their prudential borrowing powers as well). Debt would continue to be secured on all local authority revenues.

15.2. Over time, financed for TIFs could be obtained separately and could be secured on the incremental TIF revenues. Financing could be raised through the issue of specific bonds. This raises the prospect of TIFs receiving credit ratings from credit rating agencies such as Standard & Poors. There will therefore be considerable scrutiny of the business case underpinning the TIF. It might be that the credit rating agencies give lower ratings to those TIFs in more deprived areas, thus increasing the interest rates paid in these areas for their financing.

15.3. Financing could also be provided by a private sector developer.