NLGN
NEW LOCAL GOVERNMENT NETWORK

The Devil in the Detail

Designing the right incentives for local economic growth

Lily Sommer and **Daria Kuznetsova**

www.nlgn.org.uk

New Local Government Network (NLGN) is an independent think tank that seeks to transform public services, revitalise local political leadership and empower local communities. NLGN is publishing this report as part of its programme of research and innovative policy projects, which we hope will be of use to policy makers and practitioners. The views expressed are however those of the authors and not necessarily those of NLGN.

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Any errors or omissions are of the authors alone

Lily Sommer and **Daria Kuznetsova**
October 2011

Executive summary

The coalition government have introduced a package of decentralist policies to rebalance local decision making in favour of economic development. This paper will discuss one particular policy: the retention of business rates. The Local Government Resource Review will allow local authorities to retain increases in business rates generated in their area. This represents a momentous time for localism and a fundamental change in the way local government in England is financed. This paper will present our thinking and recommendations for a business rates retention model.

Any change to local government finance will have distributional implications. That is why major change is so seldom attempted. The current proposal to allow councils to retain an element of the growth in their business rate base is no exception. The government will need to recognize the significance of shifting from a system where funding is allocated primarily on the basis of need, to one in which it is based in part on a council's ability to secure economic growth.

The government must strike a careful balance between equity and efficiency. Too much redistribution could fatally weaken the growth incentive, too strong an incentive risks leaving councils in poorer areas under-funded. Even a well-designed system which balanced these two concerns would probably have the long run effect of encouraging faster budget growth in high growth areas relative to those with less growth potential. While these two groups almost certainly do not map neatly on to richer and poorer areas – there are lots of wealthy rural parts of the country with little appetite for growth – it seems likely that there will be some correlation.

The opposition is calling for the government to ensure that 'no council will be worse off in five years time' under the scheme. Agreeing to this would make the whole exercise pointless. A strong incentive will inevitably involve winners and losers, otherwise it could not possibly function. This is not a reason to avoid a bold aggregate efficiency improving reform. If the government doesn't want to alter the distribution of local government funding, why are they reviewing local government finance?

While we recognise the legitimate concerns of many councils that they may lose out because of these reforms, on balance NLGN supports the broad concept outlined in the government's consultation.

As localists, we believe that this reform represents a significant opportunity to give councils a greater degree of freedom from central government control. In addition, we recognise the potential that the growth incentive presents to stimulate the creation of new private sector jobs and prosperity,[1] helping to cushion public sector funding reductions at a time of economic stagnation. It will be important for the government to effectively communicate the national economic benefit provided by the proposals to the public and local authorities - growth in buoyant areas will be important for the health of the aggregate economy and ensuring an economic recovery.

This white paper was developed as part of NLGN's response to the government's consultation on business rate reform. It is guided by two principles. The first is that if the government is going to move to a system designed to incentivise business growth, then the system must first and foremost aim to do this. There is no point at all in changing the finance system if the result is a complicated way to replicate the current grant settlement. Secondly, we believe that a system of redistribution and equalisation remains essential, but that this system should operate outside of the business rate retention scheme. We argue specifically for a capital fund to be accessible by areas of lower business rates growth.
The government must guard against over-complicating the scheme. A system that becomes complicated and hard to understand will encourage gaming and weaken the link between council investments in growth and the returns they produce. To simplify the system we propose a lump side transfer with a flat rate tax should be used instead of redistributing and controlling for volatility through a levy and a safety net.

The breadth of options laid out in the technical papers leave the government open to questions about its intentions on a number of important details. We are particularly concerned by proposals for the Treasury to siphon off business rate income for central government purposes in the first two years,

1 See for example: Cheshire, Paul and Hilber, Christian A.L. (2008) *Office space supply restrictions in Britain: the political economy of market revenge*. Economic journal, 118 (529). ISSN 0013-0133

and possibly beyond. The business rate is a local tax, and it is our view that the growth it delivers must be returned in full to local government. Where any business rate funding is collected by the centre, for instance through the set aside, we believe ministers should set out clear principles for how this money will be returned to councils.

The proposal for forecast growth in the first two years to be used as a set-aside fund will drastically reduce the incentive effect in these years. To obtain even minimal benefit councils would have to grow their economies over and above forecast levels of growth. In a difficult context for the national economy as a whole, this is a significant challenge with limited potential gain. If the government was able to offer flexibility on the spending control totals implemented in the Comprehensive Spending Review (2010), then there would be a greater incentive in these two years, a period when the additional growth will be vital.

If the government is unable to offer flexibility on the spending control totals, we ask that after the first two years all business rate income must return to local authorities without the use of set-aside funds. Business rate income should not be used as a fungible source to replace other grants and must not be used as a basis for future devolution of powers. NLGN supports further devolution of powers, but it must be accepted that the business rates retention model is not, on its own, the correct mechanism for such change.

Finally, it will be important for both local and central government to recognise that business rate retention does not reward general growth in the local economy: it specifically incentivises growth in the number and value of rateable business premises. This means that councils will generally receive more income from large industrial and retail developments than from helping existing businesses do better or encouraging small business start-ups. Councils must continue to take a balanced approach to growth which includes skills and innovation support.

1 *Reason for change*

Britain's current local government finance system is very centralised – councils raise more than three quarters of their income from central government grants . This figure is greater than the figure for most other developed nations. Central government grants take two forms: 'specific grants' which can be ring-fenced and 'formula grant' which has no restrictions. Business rates are a large component of the latter. They are collected by local authorities from local businesses and paid into a central pool which is subsequently redistributed via formula grant using a complex formula designed to address need. These funds are then used to provide local services ranging from adult social services to police and fire services. In addition to these centralised funds, local authorities receive funding from council tax and other locally generated income.

The current system of distributing business rates is flawed for a number of reasons:

Economic health

- The UK is currently at risk of a double-dip recession[2]. An ambitious plan for growth is needed stimulate economic activity, both in the short- and long-run.
- Over the past decade the UK has had relatively low levels of public investment compared to other EU countries[3]. Central governments' current deficit reduction commitments will further squeeze new capital finance expenditures.
- Local authorities are currently keen to invest but report a capital shortfall[4] – this presents a need for new methods of local government finance to provide sufficient funds for large public investment projects

2 In September the IMF revised their UK growth forecast downwards for 2011 from 1.5% to 1.1% and warned there was a 17% chance the UK could be moving into another recession.

3 World Bank – Fiscal Policy for Growth and Development: Further Analysis and Lessons from Country Case Studies - 2007

4 In a 2011 survey conducted by NLGN on the subject of capital finance, 86% of local authorities surveyed stated they had a capital investment shortfall

Misalignment of costs and benefits

- There is a disconnection between locally raised business rates and formula grant receipts which has created an environment in which local authorities don't have direct financial incentives to encourage business growth in their areas but do so on other grounds.

- The benefits of new developments are often experienced by commuters or incomers, whereas the costs are borne by existing residents. For instance, a new housing development might promote growth by bringing a better workforce into an area, but local people may see this as harming their quality of life. Councillors generally respond to their current constituents' concerns and preferences to ensure their political survival,[5] and this tends to restrict the supply of business developments. The nationalisation of the business rate limits the ability of councils to compensate their residents, for instance with better public services.

Uncertainty, Lack of control

- A centralisation of business rates income leaves councils at the whim of central government funding decisions, reducing the scope of local decision making . This complicates the decision of long-term planning to boost local economic development - local authorities may not find it in their interest to invest in important infrastructure which require a stream of heavy investments.

High property prices

- A consequence of business development being resisted at the local level is high property prices – office costs in UK cities are very high by international standards: the UK has six of the thirty most expensive global business property markets[6]. The London School of Economics' analysis of the nationalisation of business rates found that the level of 'planning restrictiveness' increased following the changes leading to less development and subsequently higher costs for business through restricted supply of property.[7]

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5 Planning Magazine – 'Cable: Sustainability prescription at core of planning overhaul' – 26th May 2011
6 CBRE Global Office Rents – November 2010
7 Cheshire, Pail and Hilber, Christian A.L. – Office space supply restrictions in Britain: the political economy of market revenge – Economic Journal 2008 – 118 (529)

- Such high prices for commercial property will have a negative impact on economic activity.
- If the costs reflect restricted supply this could be a source of inefficiency and reduced productivity – e.g. by restricting economies of scale at the firm and industry level.

These challenges present an opportunity for government to devolve powers to local authorities to rebalance the economy. Having greater control over business rates, local authorities will be able to improve relationships with local businesses and create the right conditions for growth.

2 *Key components of the business rates retention proposals and the challenges they present*

The government has released a consultation paper and eight technical papers outlining proposals for a business rates retention scheme. It argues local authorities should have greater control over their finances, helping them to plan for the longer term: "they should see a direct link between the success of local businesses and their own cash flow". In this section we examine the key components of the proposals in detail and the role they should play in establishing a business rate retention scheme.

Tariffs and top ups

Challenge: There are strong distributional consequences which stem from allowing local authorities to retain all business rates raised in their locality. Some areas are more capable of generating business rates than others – some areas would generate business rate growth in excess of their public service requirements whereas some wouldn't be able to raise the necessary funds to deliver their core public services.

Government response: The government recognises this risk and aims to ensure a "fair starting position" for all local authorities. It has therefore proposed a re-balancing of resources at the outset of the new scheme based on a tariff and top-up system: authorities whose business rates income is higher than their baseline position (based on 2012/13 Formula Grant allocation) would pay the difference to central government in the form of a tariff, and those whose business rates are less than their baseline would receive the balance from the central government in the form of a top-up grant. Tariffs and top ups would be self-funded and fixed in future years.

The proposal is to use the 2012/13 formula grant calculation to establish the amount of grant that needs to be replaced by retained business rates. Since this is still inside the CSR period – and there are cuts still to be made – the baseline figure will be lower than the 2012/13 Formula Grant to meet the cuts required by the Treasury. How much lower will depend on each local authority's circumstances but total local government Departmental Expenditure Limit (DEL) will, at this point, only be 65% of the way towards the total reductions envisaged by the CSR, so an average real terms reduction of around 9% below 2012-13 Formula Grant Figures would be plausible.

In effect all changes in business rates would start from the same baseline and local authorities would internalise the changes in business rates above or below the set baseline. Figure 1 shows the uplift in income that comes from growing business rates, while Figure 2 shows the reverse (loss from a reduction in business rates income).

Figure 1 Uplift in a tariffed and a topped-up local authority

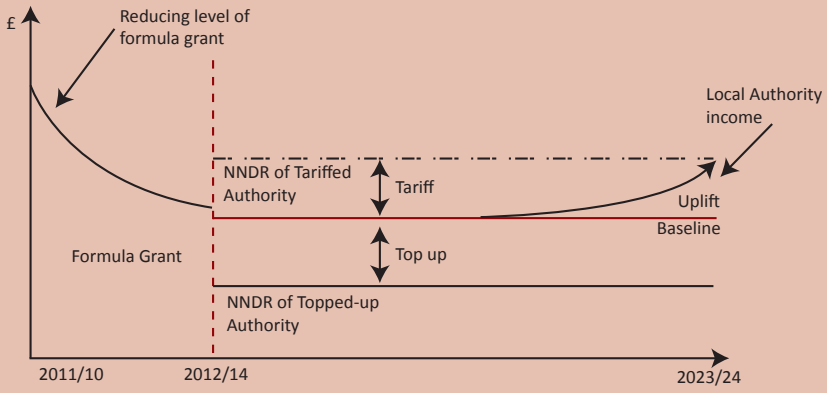
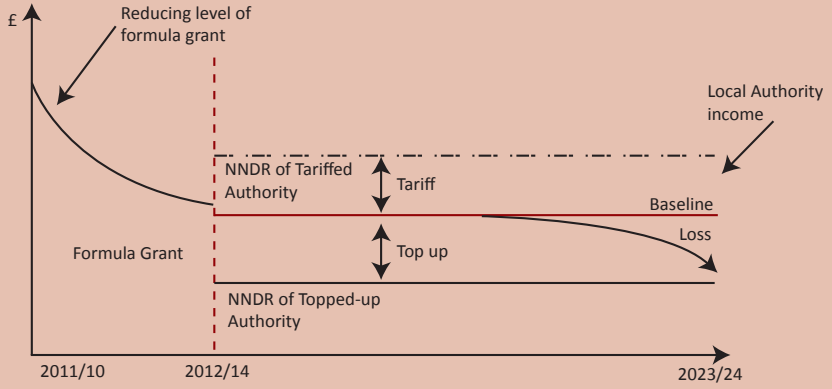


Figure 2 Downturn in a tariffed and a topped-up local authority



NLGN response: We support the tariff and top up system proposed by the government – this will ensure a fair system whereby all local authorities can meet their public service needs at the outset of the scheme.

If the government's core objective is to move to a system designed to incentivise business growth, then the system must first and foremost aim to do this. The financial incentive will have to be sufficiency large to have a noticeable impact on local authority behaviour and business development. Since incentives operate at the margin, it will be key for local authorities to be able to retain as much of the business rates generated in their areas as possible. We therefore support the government's proposals to fix tariffs and top ups at the outset of the system.

Furthermore, we favour a system of up-rating tariffs and top ups by RPI. Fixing the amount in cash terms could rapidly erode the real value of the top up to less affluent areas and would lead to pressure for more regular resets of the system. Yet we recognise that there is a risk from fixing tariffs and top ups: areas where business rate income is declining will see a significant

reduction in spending power. The government recognises this possibility and we shall discuss this later on.

2013-15: The set aside and the treatment of growth above forecast levels

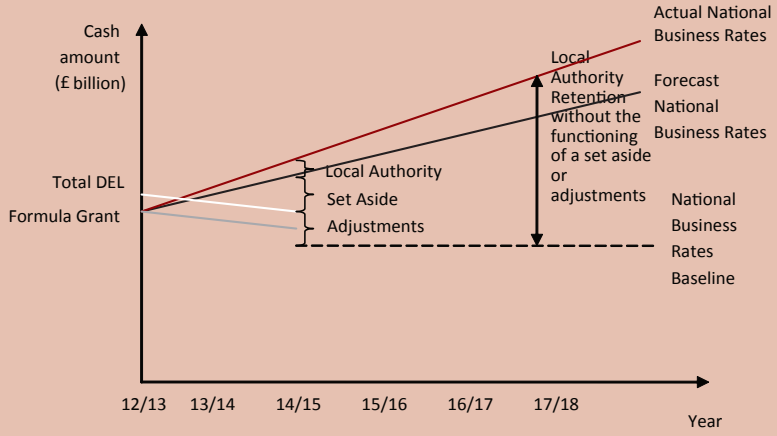
Challenge: Some argue that without checks on the total business rate growth income retained by councils there is a risk that local authority (and thus national) expenditure spirals out of control. It appears that ministers are concerned that this will place the government's fiscal position in danger, risk pushing-up government bond yields and thereby taint their international reputation as safe investments.

Government response: To ensure fiscal sustainability and to avoid jeopardising its deficit reduction program, the coalition government has proposed to ensure that the business rates retention scheme operates within the expenditure control totals for local government for 2013/14 and 2014/15. Business rates collected in England for these two periods are expected to exceed the expenditure control totals.

Since all business rates income has to come back to local government by law, the government has proposed to "set aside a share of the forecast national business rates to fund other grants to local government". The Local Government Association's calculations of the estimated NNDR yield as well as the total amount of CSR Formula Grant and Annually Managed Expenditure (AME) in 2014-15, predict the set aside to be £3.5 billion.

The functioning of the set aside means that in the first two years of the scheme local authorities will only benefit from business rates growth to the extent that their business rates actually exceed the forecast level. This is illustrated in the figure below.

Figure 3 The functioning of the set aside



NLGN's response: We disagree with the government's claim that business rate growth could jeopardise government deficit reduction plans. Business rates income only accounts for a very small proportion of public expenditure. In 2005/6, £19.9 billion was collected in business rates, representing 4.35% of the total UK tax income.[8] Given the plausible scale of any business rates growth it will therefore not have a considerable impact on achieving the deficit reduction program.

During the first two years of the scheme, we suspect that ministers will use the set aside money to substitute for other grants to local government. For instance, ministers might reduce their departmental contributions to specific grants and make up the difference with retained business rates. Equally, ministers could just roll some specific grants that are currently part of Aggregate External Finance into formula grant (by 'formula grant', we mean the proposed system of baselines and transfer payments). Either of these options would amount to a cut in central government expenditure, while still returning business rate money to councils. This is possible since set aside funds are fungible and thus freely substitutable with existing grants to local government.

8 Public Finances Databank (see section C4) - HM Treasury

There is a clear conflict here between the aim of incentivising local authorities to drive business growth, and the government's proposal to, in effect, top slice business rate income. The system proposed for the set aside means that within the first two years of the scheme councils are only able to access business rate growth in excess of the government's own forecasts of what business rate growth will be. Councils will therefore see no benefit of business growth up to this point and may be left in an even worse position should economic forces beyond their control stifle growth at a level below that which is forecast. It is unclear whether there is any genuine incentive in the first two years, but it is clear there is an element of risk for local authorities.

If the government can offer greater flexibility on its expenditure control totals for local authorities – to enable local authorities to retain more growth in the first two years – we believe that the incentive to drive growth will be greater and have a stronger possibility of resulting in a net gain for the national economy than the existing proposals.

Moreover, the government claims that in the first two years of the retention scheme, business rates income in excess of forecast business rates income will be retained by local government. Since projections suggest that by this point total NNDR income (with forecast growth, but not taking into consideration additional growth) will already be above the spending control totals, this suggests that the growth achieved above forecast levels won't operate within the expenditure control totals for 2013-14 and 2014-15 (see Figure 3).

However, the consultation claims the set aside pot will ensure that the business rates retention scheme operates within these expenditure control totals. This seems contradictory and suggests the expenditure controls totals are not immutable. Furthermore, for local government to receive a net gain within the first two years of the system, the government must guarantee that the gain from business rate growth above the forecast levels isn't cancelled out by a reduction in local government funding or grants in other areas. We seek assurance that all of the growth above forecast levels will be returned to local government, and not used to compensate for reductions in other grants to councils.

2015 onwards: The extension of a set aside pot or the devolution of responsibilities

Challenge: There is now doubt that the government's deficit reduction programme will leave the country in a materially better position by 2015, following a string of quarterly growth figures below projected levels. This means future austerity measures could be even more stringent, particularly if there is further economic instability in the Eurozone. The government will therefore need to consider the functioning of the retention system within an environment of prolonged national fiscal contraction.

Government response: The government proposals only discuss the functioning of a set aside for the years 2013/15. If the fiscal situation does not improve, and tough expenditure controls remain necessary, it is possible that ministers will choose to continue the set aside system. As we set out in the previous section, it is entirely possible that ministers will use the set aside money to cut their contributions to specific grants currently outside formula funding.

However once all these grants are phased out and essentially added to the total formula grant amount, it is possible that formula grant will no longer be able to keep pace with business rates income by replacing other grants. Moreover central government may be against using the set aside to replace all specific grants as this would remove departments' direct influence over local councils.

Alternatively, the consultation paper suggests it is more likely that from 2015/16 onwards greater responsibilities will be transferred to local government (in line with increasing formula grant and expenditure control totals) to absorb additional business rates income. The government has also already proposed "to consider, at the next Spending Review, the total spending figures for local government with a view to more closely aligning local authority functions and responsibilities with business rates income from 2015/16". Possibilities include the localisation of funding streams supporting skills and economic development. This would create a perverse system where the responsibilities of local government match the funding it raises, rather than the reverse.

NLGN's response: We are strongly against the government using set aside funds to replace existing sources of council funding. The government has already said the amounts set aside will provide funding for the New Homes Bonus. In our consultation response we asked for assurance from the government that all business rate income will be returned to local government. It is vital that this is not returned at the expense of other funding sources for local government.

While we are strongly in favour of devolving additional responsibilities to local government, we do not believe that business rates are the right mechanism to achieve this. Matching council responsibilities to the size of national aggregate business rate growth will have considerable distributional implications. In the absence of generous re-distributional mechanisms (which would negate the effect of the incentive) not all local authorities will have sufficient business rates to fund additional responsibilities. Devolving services to low growth areas would amount to an unfunded new requirement that would put additional strain on council budgets.

While growing council responsibilities would not necessarily reduce the incentive for growth – as councils will need to keep growing to fund their new duties - it would mean that a significant proportion of that growth will be captured by the centre at the expense of councils with low growth potential.

NLGN therefore proposes that the government should make a clear commitment to not impose ever decreasing expenditure control totals or transfer ever increasing responsibilities to local government. This would ensure business rates growth would result in legitimate additional discretionary cash for local authorities – so the surplus from any incentive is captured for the benefit of local communities.

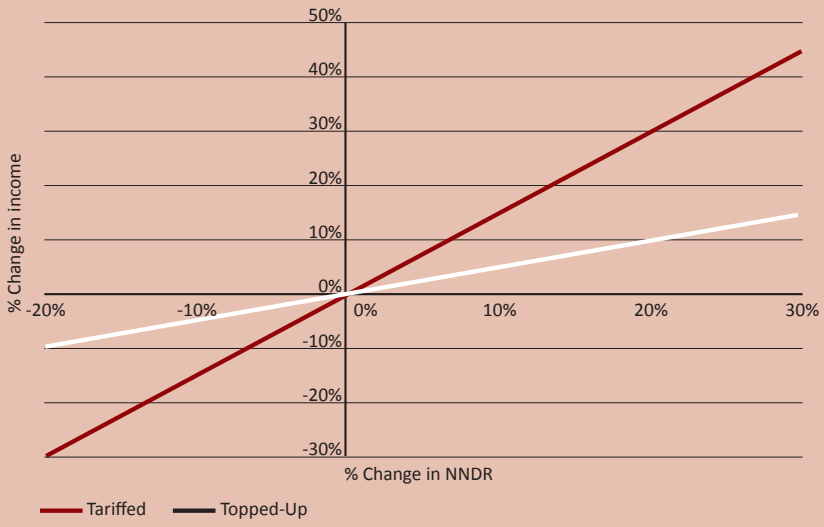
Levy

Challenge: Some local authorities with high business rates bases and good growth potential could see disproportionate financial gains. This may jeopardise the sustainability of the system in the long-run.
Differences in the relationship between an individual authority's business rates base and its baseline funding level creates a gearing effect: as a result of

fixing the tariff and top ups there will be different outcomes for different local authorities even if they grow their business rates by the same proportion.

In Figure 4 there are only two authorities (although they can be thought of as being representative of all their respective class of authorities). The tariff authority raises £150m per year in NNDR, while the topped-up authority raises £50m; as per the Review, the tariff/top-up system equalises them at £100m income each. But if we uplift their business rate income by the same percentage, the impact on the percentage change in their income is stark: no matter how close they are in financial terms the tariff local authority will always see a greater percentage increase in income than the topped-up authority. With shrinking business rate income the volatility of the Tariff authority plays in the other direction: the tariff will see bigger reductions than its topped-up counterpart even if their business rates decline by the same proportion. This means that the areas with greatest needs will not be as able to unlock the benefits of uplift, while they will have less incentive to avoid reductions in income than their tariff neighbours.

Figure 4 Effect of changing business rate growth on NNDR income



The key challenge with implementing a business rates retention policy is being able to design a scheme which optimally trades off efficiency and equity considerations. This means designing a levy schedule which responds to the gearing effect and redistributes from local authorities with high business rates income to those with low business rates income, without reducing the financial incentive to promote business growth. An optimal system would ensure the incentive to increase business rates growth is equally strong for tariff authorities as well as top up authorities.

Government response: To insure against any adverse distributional effects and associated political risks the government has proposed a levy scheme, essentially a tax on councils that see a disproportionate benefit.

The government has outlined three ways in which the levy could be calculated: setting a flat rate marginal levy; creating a banded levy; creating an individual levy rate for each authority to allow the retention business rate growth in an equivalent proportion (or a higher ration) to its baseline revenue. It seems most likely that the government will select the third option as this better responds to the gearing effect and offers a more equal incentive for business rates growth for all authorities.

NLGN response: We agree that a levy on disproportionate benefit is necessary to moderate the gearing effect and insure against any adverse distributional effects and political risk. By creating a pool of money that can be used to support slower-growth councils, the government can also reduce the political pressure for regular resets of the system (which would undermine the incentive for growth). A moderate levy and an associated safety net could therefore ensure all local authorities' needs are met without undermining the incentive effect.

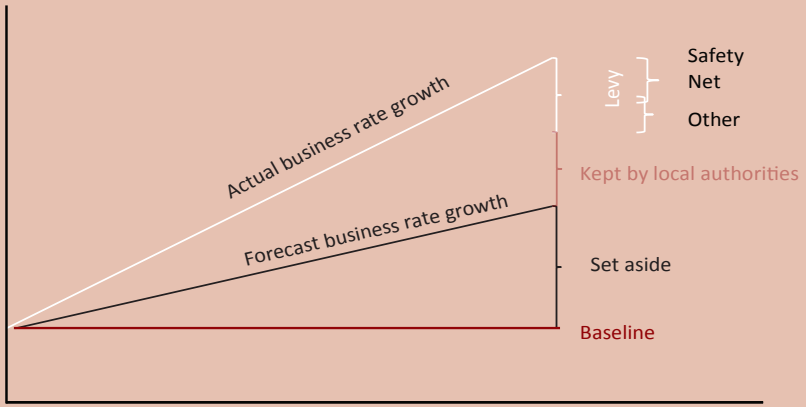
But we are concerned that tailoring the levy to each authority's baseline would introduce significant complexity and bureaucracy into the system which would risk distorting a simple and transparent financial incentive. This option would also have the unintended effect of benefiting areas that have a large formula grant relative to their business rates and experience large business rates growth – which isn't necessarily desirable. We therefore suggest three alternative levy schedules all based on the combination of a flat rate marginal tax and a lump sum transfer - these are outlined in our appendix.

Safety net

Challenge: The business rates retention system strengthens the connection between local business rates income and the financial positions of local authorities. This means local authorities which are less able to grow their business tax-base may be unable to meet their service needs and volatility in local business rates income will increase the risk associated with local government finance and investments.

Government response: The proceeds will be used to set up a safety net: a proportion of the levy pot will be used to help manage significant, negative volatility in individual authority business rates; another proportion will be used to protect the spending power of authorities who are less able to respond to the incentive. The safety net would provide financial support to authorities when their retained income fell below pre-determined thresholds, regardless of the reasons for that fall. Aside from the safety net, the government has been vague in how the rest of the money from the levy will be used.

Figure 5 End points of business rate growth



NLGN response: We are concerned that the safety net will be designed to mainly respond to business rates volatilities – so while the levy proceeds

might be raised in a fair way, the funds won't be shared in a redistributive manner. Some rich local authorities may have high but volatile business rates and some deprived local authorities may have stable but low business rate takes. We propose that any safety net should be connected to the gearing effect as well as addressing volatility.

However as previously stressed, NLGN believes the growth incentive should be sufficiently large to ensure a strong behavioural response. The government shouldn't risk diluting the incentive effects by offering strong protections – all economic policies create winners and losers.

Large transfers from a pooled levy pot could create moral hazard by reducing the incentive for councils to effectively manage their business rate income, in particular by saving money from the good times to smooth income over the business cycle. In recent years the economy has become more 'unbalanced' in favour of public sector employment in some areas than in others. It is now widely accepted that a degree of 'rebalancing' between public and private sectors is required for the sake of both local and national economies. While adjusting to this is difficult and can take time, it should remain the objective. The levy must not become a way to perpetuate dependency on central government funding, but should focus on helping 'unbalanced' economies make the transition to higher levels of private sector employment.

NLGN recommends that instead of offering strong protections and acting as a cushion, the levy proceeds should be arranged to incentivise business growth in less well off areas. This should involve transitional protection against major drops in business rate growth relative to the baseline that are clearly beyond the control of local authorities, rather than cushioning against any fluctuations experienced between resets.

The government should create a fund for cost-effective and growth promoting schemes in areas of low or negative growth. This could include early-intervention and capital projects. If the government deemed it appropriate this fund could be used as a development fund rather than a conventional capital pot. Such a fund would provide attractive rates (0.5-1%) to support capital projects in low-growth areas. This should encourage the efficient use of support funds. Local authority funding applications would

have to demonstrate a clear strategy for generating growth and considerable need for start-up support.

Beyond the safety net, NLGN is concerned by the vagueness of government's proposals about how the remainder of the levy pot will be spent. The use of a levy could result in the Treasury siphoning off some of the growth in business rates for itself, for instance to help reduce government funding in other areas. The financial incentive will undoubtedly be weakened if the Treasury attempts to siphon off a share of business rates for its own purposes.

In our consultation response we suggested the government must define clear laws against this practice to ensure the success of the policy. These laws should stipulate that all business rates must continue to be returned to local government, that all business rate growth is retained by local government and that this income is not treated as a 'set aside' fund which can be used to replace other grants.

Furthermore, NLGN supports a localist approach to good financial management. For example, local councils could encourage a diverse economic tax-base and keep a reasonable amount of business rates revenue from previous years in accessible reserves - this would enable local authorities to cope better with business displacement and significant volatility in business rates. This would encourage self-sufficiency and wouldn't risk becoming politically driven as may a centralised approach.

Adjusting for revaluation

Challenge: Every five years, the Valuation Office Agency re-assesses all business properties and assigns them new rateable values, based on their rental values for the purpose of calculating what business rates are payable. At revaluation the increase in aggregate yield is capped at RPI as in all other years, and the multiplier is reset to ensure that the overall tax burden on business doesn't increase as a result of revaluation.

Since different business properties' rateable values will change by different proportions at revaluation, revaluations can have a significant impact on

the amount of money collected in each individual council. This creates the potential for large volatilities in local authorities' budgets as a result of revaluations which are beyond their control and do not reflect local growth levels. Some areas could see the value of business property in their area increase at the same time as experiencing significant drops in income at revaluation. Only areas which experience above average growth in rental values would see their business rates increase. In turn, this may reduce the incentive linked to physical growth in the long-run.
Government response: The government has proposed "that the tariff or top up of each authority is adjusted at revaluation, so that the sum of each authority's retained rates and tariff or top up adjustment is the same after revaluation as immediately before". It is argued that this will maintain the incentive to promote physical growth and manage volatility in budgets.

NLGN's response: Contrary to the government's claim, increases in rental values are not outside the control of local authorities - it is possible to influence the price of business properties by contracting supply or improving the business environment through investments in infrastructure and public space.

The government's proposed system of readjusting tariffs and top ups at revaluation would avoid the perverse incentive for local authorities to restrict the supply of business properties (to ensure growth in local rental values was above the national average) to increase their business rates. All of the earnings from revaluation would be redistributed so the financial incentive mainly comes from growth as a result of business development.

However NLGN is concerned that the government's proposal on dealing with revaluation conflicts with the idea that the retention scheme is about improving the wider relationship between local authorities and businesses. It could remove the incentive to invest in services that contribute to improving the business environment. For instance, councils that provide better infrastructure could easily be capitalised in to business property prices. This is a problem, which must be addressed by the government to ensure the best possible outcome for its reform.

Resetting the system

Challenge: The government's proposals could over time result in some councils receiving much more money than they need to meet local needs, and others receiving much less. There needs to be a way to periodically 'reset' the system on the basis of need to counteract this. However, this must be balanced against the need to provide councils with a stable, long term funding framework. If resets are too regular, local authorities will not be able to make significant new capital investments. Councils are less likely to respond to the incentive if they fear losing out due to future rule changes.

Government response: Ministers have proposed a mechanism to "reset" the system to facilitate the realignment of resources – this would involve a reassessment of individual authorities' baseline funding levels, potentially with a completely new method for assessing relative needs and resources – and recalculating tariff and top ups accordingly. It has discussed the options of 'partial' or 'full' resets and having resets at fixed intervals or subject to government discretion.

NLGN's response: We support re-basement to ensure that individual local authorities' public service needs are met. However we are aware that there exists a trade-off in the reset decision between choosing between a system which risks manipulation by local authorities (fixed reset timings) and a system risking manipulation by political cycles (resets at government discretion). Neither of the options is satisfactory.

Taking all factors into account, NLGN supports a 'rules with discretion' approach. This would require a clear framework with clear rules on what the government can do with regards to reset policy, while retaining the advantages of discretion to respond flexibly to unexpected events and changes in local authority circumstances. Essential rules would be to prevent government from undertaking a reset less than six months prior to an election and to have a limit period of at least ten years between resets (a shorter timescale would limit the ability of councils to fund physical infrastructure by borrowing against future business rate increases).

Policy rules for reset policy should be put in place as a contingent response to the evolution of local authority's finances to ensure service needs are met for all local authorities. NLGN believes such a system will eliminate the risk of reset being dominated by political cycles and increase certainty in the system, facilitating long-term planning.

Pooling

Challenge: One of the benefits of a business rates retention model is a revenue stream to contribute to the funding of public infrastructure. Local authorities would have the capacity to fund investment in infrastructure such as schools, roads and housing. However to support medium-to-large scale infrastructure investments it may be beneficial to pool business rates revenues at the Local Enterprise Partnership (LEP) or district level. In addition, as mentioned previously, the business rates retentions system strengthens the connection between local business rates income and local authorities' financial positions. Volatility in business rates therefore increases the risk associated with local government finance investments. A well-designed pooling system may also help to smooth this volatility in local funding.

Government response: The government has proposed a voluntary pooling system with an aggregate tariff or top up and levy; pools could then decide how to distribute aggregate revenues, including any levy proceeds, among their members. This would facilitate the generation of larger revenue streams, the sharing of risk across local authorities and the creation of a large enough collateral to use to underwrite the uncertainty associated with such large development projects. Pooling business rates would create the scale needed to fund heavy infrastructure projects with large fixed costs and long development spans.

Given the considerable benefits available from a well-designed and managed pooling system, the government has considered introducing further steps to encourage the formation of pools by providing further rewards for authorities that do.

NLGN's response: We support the notion of a pooling system to support large-scale investments and manage volatilities. However we believe that

government's proposal requires a significant level of commitment from pooling authorities without creating enough of an incentive to pool.

For there to be effective rate of pooling, the process will have to be as simple and beneficial as possible. The system of pooling proposed by the government appears unnecessarily bureaucratic and complicated – agreeing each member's contribution to the pool's tariff or entitlement to a portion of the pool's top up and to the levy amount requires a great deal from pooling local authorities.

Instead, we suggest local authorities in a pool should still face their individual tariff or top up and levy payments, but should agree on how the proceeds of new business rates growth across authorities should be distributed and spent. This would require less in terms of cooperation but will give a way for local authorities with large tax-bases to assist those with smaller tax-bases through a localised formula grant type system.

An uneven distribution of business development across a potential pool would mean the incentive for a 'rich' local authority to join is likely to be weak (as with the pooling system proposed by the government) as they will initially lose business rates income. Extra incentives described below will be needed to encourage these authorities to pool so the benefits from additional increases in growth through collaborative effort (by exploiting economies of scale and working across natural economic geographies) can be achieved.

We do not agree with the government's suggestion of allowing pooling local authorities to retain a greater proportion of growth within the business rates retention system – as this would result in less funds available for redistribution. Instead we propose incentives should be linked with providing capital, infrastructure, devolving freedoms and economies of scale.

One possibility would be to match-fund payments for TIF schemes for authorities who have pooled business rates. At the same time as encouraging infrastructure investments and economies of scale, this would encourage the use of TIF, when appropriate, as a further source of funding by reducing the risk associated with TIF projects. However this would essentially take the form of a government subsidy and we are aware the funds available for this purpose would be limited during a period of deficit reduction

The most natural pooling model would be at the Local Enterprise Partnership (LEP) level and pooling business rates at this level would help support medium to large scale infrastructure investments. A 2010 SQW study shows that the priorities for LEPs are creating the right environment for business and growth – adult workforce skills topped the list, followed by the low carbon agenda, transport and inward investment[9]. Given these priorities NLGN recommends a pooling incentive based on devolving adult workforce skills funding down to the LEP level. However, NLGN would like to emphasise that any additional functions devolved to local government should be accompanied with extra funds to cover their costs, rather than additional business rates income being used to cover them.

There has also been speculation of additional government funding for more capital investment across the UK – if this goes ahead another possibility would be to use some of these resources to provide additional funding for LEPs' priority areas conditional on pooling.

Tax Increment Financing

Challenge: Tax Increment Financing (TIF) enables uplift in locally raised taxes by borrowing against the value of future uplift to deliver the required infrastructures and developments. The local retention of business rates is key to ensuring the success of TIF schemes: since local authorities aren't currently permitted to retain their rates, they can't borrow against any predicted increase in their rates. However borrowing under TIF will only take place if local authorities and developers have enough certainty about the future tax revenue streams expected from the investment and whether there are sufficient guarantees that the rates will be kept within the authority.

The scheme must therefore provide sufficient certainty to developers, banks and local authorities to ensure TIF schemes come forward – this will not be the case if the rebasing of the system takes place frequently, say every five years. Moreover, to offer certainty and a larger margin of return to generate investment, any grow in business rates income would have to be exempt from the levy. However this form of protection would mean there would be

9 SQW (2010) SQW review of LEP submissions

less money in the levy pot to manage volatilities and a potentially smaller proportion of resources would be available for rebalancing at any reset.

Government response: The government consultation paper posits two options: either allow local authorities to determine for themselves whether to invest in a TIF scheme without exempting revenues from the impact of the retention scheme, or allow business rates growth resulting from the TIF project to be retained for a defined period of time without being subject to the levy or included in any re-assessment of tariffs and top ups.

The latter offers certainty to local authorities that business rates growth in their area could be used to service debt and wouldn't be at risk of reduction from the levy and resets. But since, with no controls there may be substantial strain on levy pot resources, this approach would require government control or approval in order to limit the number of schemes coming forward and maintain resources available for re-balancing at any reset. The government would have to take a more centralised approach, possibly through a central government competition or bidding process – this creates the risk that the policy may be driven by self-interest politics.

NLGN's response: NLGN believe both options are lacking as they share the drawback of potentially restricting TIF schemes going ahead even where there may be a sound business case. We therefore propose an alternative approach to enabe local authorities and developers to take maximum advantage of TIF.

Since our alternative levy schedule features a flat rate marginal levy – unlike a tailored levy, this offers certainty to local authorities in what proportion of business rates growth in their area could be used to service debt without having to exempt TIF business rates revenues from the levy: business rates income would not be at risk of reduction from ever-increasing levy rates. We thus recommend not exempting TIF projects' business rates income from the levy but exempting the resulting business rates growth from the reset process for a defined period of time (approximately 25 years). The certainty provided should increase the number of TIF projects coming forward without putting substantial strain on the levy pot.

We recognise this creates a potential risk that a pool of rich local authorities (e.g. London boroughs) will tactically avoid reset by implementing TIF projects. However, local authorities take on a lot of risk when they participate in TIF schemes – they are faced with significant costs if the projects are unsuccessful and don't raise the necessary business rates to service the debt – this makes the possibility of local councils manipulating the reset process through implementing an excessive number of TIF projects unlikely.

Conclusion

NLGN believes the business rate retention proposals represent a unique opportunity for local growth. Through greater control of business rates local authorities will be able to establish better and more sustainable relationships with local business as well as design a local plan for growth. Nevertheless the current proposals clutter a strong incentive for growth with complex redistributional mechanisms. The reforms represent a significant step towards greater financial independence, but only if there is a clear link between the policies implemented by local authorities to drive growth and revenue. Central government will need to be bolder with its proposals to drive economic growth instead and engage in the real debate about granting local authorities greater self-sufficiency.

Appendix

We suggest three alternative levy designs all based on the combination of a flat rate marginal tax and a lump-sum transfer. Such a system would connect the collection of funds through the levy with the mechanism through which those funds are redistributed. Both are intentioned to equalise impact of business rate growth on local authorities with different baselines. An issue with all of these schedules is how to fund the initial lump-sum transfers – we think this would provide a useful and transparent purpose for the set aside funds.

Option 1: Optimal linear business rates income tax

Mirrlees (1971)[10] calculated that the optimal income tax schedule could be approximated fairly well by a tax system with a constant marginal tax rate. A linear income tax or 'flat tax' can also achieve significant redistribution. Our first option applies the optimal linear income tax methodology to business rates income.

We consider a simple linear business rates income tax schedule, where the tax revenue collected from local authority h, T^h is:

$$\mathbf{T^h = -LT^h + tq^hb^h}$$

q^hb^h is the growth in business rates income of local authority h, t is the tax rate paid per unit of growth in business rates income, and LT^h is a lump-sum transfer that the government makes to local authority h.

The lump-sum transfer must account for scale and one way of doing this is by multiplying the per capita universal lump sum transfer (LT) by a population factor (n):

$$\mathbf{LT^h = n*LT}$$

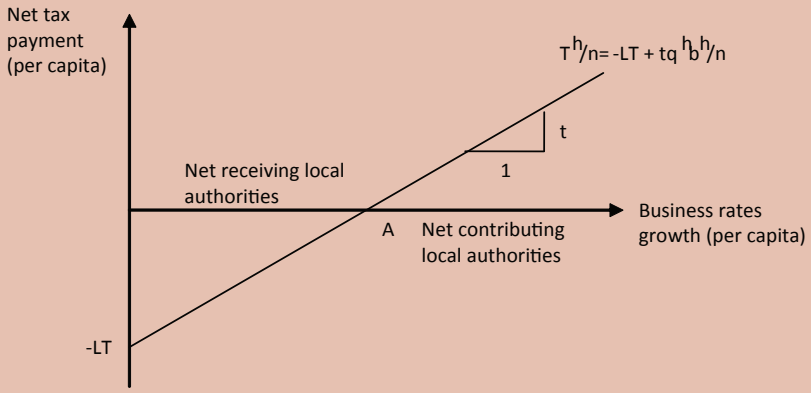
10 Peter A. Diamond and James A. Mirrlees (1971). "Optimal Taxation and Public Production I: Production Efficiency," American Economic Review

This means local authorities with large populations will receive a larger lump-sum transfer. However NLGN is aware that large populations are often not correlated with more demanding service pressures and therefore proposes a lump sum transfer based on the baseline in Option 2 of the appendix.

Two things can be said about this tax schedule. First, the marginal tax – the amount of tax the local authority pays on an extra unit of growth in business rates income – is constant, and the same irrespective of the level of business rates growth. This makes this tax schedule simpler than the banded levy option suggested by the government where a higher marginal tax rate would be levied on local authorities with high business rates growth. Second, the tax schedule implies a lump-sum transfer to local authorities – a tax credit of $-LT^h$. The value of the implied transfer depends on the taxpaying local authority's business rates growth (i.e. on local authority characteristics). This is what makes the linear business rates income tax with a lump-sum transfer a direct tax. This introduces a greater deal of progressivity into the system, than a simple flat rate marginal tax. The constant marginal rate implies that the degree of progressivity declines (but is still positive) at high levels of business rates growth. But there will be so few local authorities at this end of the distribution that additional progressivity will yield little or no extra revenue.

The schedule is illustrated in the figure below. We see that a local authority with business rates growth (per capita) at point A would break even. Local authorities with business rates growth (per capita) less than that would get money back from the levy pot, while local authorities with business rates income higher than that would pay into the levy pot. It is clear that the linear business rates income tax schedule has the potential to redistribute business rates income quite effectively.

Figure 6



We are interested in the optimal values of t and LT. The government will need to make a decision on whether it would prefer to promote greater efficiency or promote greater equity so that the aggregate sum of levy funds collected is equivalent to the lump sum transfers given to local authorities.

$$\sum LT^h = t\sum q^h b^h$$

A higher tax rate would promote greater equity but would reduce the incentive for local authorities to grow their business rates and would increase the deadweight loss associated with tax collection. However, the size of the lump sum transfer would need to substantially large to introduce a sufficient amount of progressivity into the system and ensure all local authorities meet their basic service needs.

The optimal marginal levy on business rates growth will be higher for:

- Lower values of compensated elasticity of the business tax-base
- A higher degree of concern for inequality
- Greater inequality in pre-levy business rates income
- A higher per capita lump-sum transfer

One important feature of the proposed tax schedule is that local authorities with business rates growth below the tax exemption level will receive a transfer payment from the government. It essentially creates a negative business rates income tax system of local authority social security. This feature differs markedly from a system in which local authority entitlements to safety net support are much more complex (as outlined in government proposals). It has the benefit of creating the link between the marginal levy rate paid by local authorities and entitlements to the funds collected. The flat rate marginal tax and universal lump-sum transfer also make it a less centralised approach – reducing the risk of the retention policy becoming politically driven.

Since any tax changes in this system are revenue neutral, the average local authority tax payer does not have an income effect, so only the substitution effect operates for them. An increase in the rate of the flat rate marginal tax that is used to finance an increase in the per capita lump-sum transfer will alter incentives and generally reduce the total time dedicated towards driving business growth. This will reduce growth in the business tax-base and the levy revenue will thus be lower. Thus a change that would have been revenue-neutral for a fixed tax-base, will as a result of the reduction in business premises growth, produce a revenue loss. It is this revenue loss that represents the "excess burden" of taxation. It requires an increase in the marginal levy rate to offset it; an increase that will reduce social welfare, and counteract, at least in part, the gain in social welfare from the reduction in inequality that is produced by the increase in tax progressivity created by the increase in the marginal levy rate. The requirement of a sufficiently high per capita lump-sum transfer to respond to equity considerations is therefore a drawback of our first proposed levy schedule.

Option 2 – Flat rate marginal levy combined with a lump-sum transfer linked to the baseline

One way to redistribute the gains from business rates growth (other than by increasing the value of the universal lump-sum transfer) would be to link the value of the lump-sum transfer to a local authority's need. The total revenue raised from the marginal levy rate- which we suggest should be in the range 30-50% - could be distributed in proportion to local authority's

baselines. This should provide a more equitable system without significantly diluting the financial incentive to grow business rates – all local authorities will still face the same marginal tax rate on business rates growth and since local authorities' baseline funding levels would remain fixed between resets they could not alter the amount they received via the lump-sum transfer by modifying their efforts in growing local businesses. We support this approach over option 1 – the number of people residing in a local authority is not a good measure of it's need; a local authority with a small population and high need would be better off under a system where the value of the lump-sum is linked to need rather than consisting of a universal per capita sum.

Option 3 – Flat rate marginal levy combined with a lump-sum transfer linked to the IMD

An alternative method of linking the lump-sum transfer to need would be to distribute the total revenue raised according a deprivation index, such as the Index of Multiple Deprivation (IMD). Indices of deprivation are already used to help target policies and funding by a number of Central and Local Government organisations. However such indexes are not a perfect measurement of deprivation – for example, the IMD doesn't account for elderly social care and service need.

NLGN
NEW LOCAL GOVERNMENT NETWORK

The coalition government have introduced a package of decentralist policies to rebalance local decision making in favour of economic development. This paper will discuss one particular policy: the retention of business rates. The Local Government Resource Review will allow local authorities to retain increases in business rates generated in their area.

This represents a momentous time for localism and a fundamental change in the way local government in England is financed.

This paper will present our thinking and recommendations for a business rates retention model.