St Edmundsbury
BOROUGH COUNCIL

C197

Performance and Audit Scrutiny Committee
31 October 2011

Local Government Resource Review – Commentary and Response to Consultation

"Business rates, although collected by local authorities, are subsequently pooled centrally by government and redistributed to local authorities (including police and fire authorities) through formula grant. In 2011-12, £19b of business rates are to be collected and redistributed in this way.

This dependence on central distribution of funds means that local authorities do not face a financial incentive to promote business growth in their area, as they will not receive any of the business rates receipts from additional development. Rather, authorities arguably face a financial disincentive given that if they allow development they must provide services to commercial property. This, combined with the fact that communities tend to oppose development due to misaligned costs and benefits (localised costs versus wider, more thinly spread, benefits) has meant that local authorities can be reluctant to allow commercial development and promote economic growth."

(Local Government Resource Review, p. 13)

Purpose of Report

1. To **note** the significant changes proposed to the way in which local authorities are financed, through the 'localisation' of business rates.

Introduction

2. On 18 July, the government issued its consultation paper on The Local Government Resource Review: Proposals for Business Rate Retention. A further 8 technical papers followed on 19 August, which cover the following areas:

    i. Establishing the Baseline
    ii. Measuring Business rates
    iii. Non-billing Authorities
    iv. Business rates administration
    v. Tariffs, Top ups and Levy Options
    vi. Volatility
    vii. Revaluation and transition
    viii. Renewable energy

3. The Council's response is attached at Appendix A.

4. This report considers the changes proposed and provides a view of what this might mean for SEBC.

Section 1 - The main features of the Government's consultation

5. The government's four principles for reform are as follows:

   1) to build into the local government finance system **an incentive for local authorities** to promote local growth over the long term;

   2) **to reduce local authorities' dependency** upon central government by producing as many self sufficient authorities as possible;

   3) to maintain a high degree of redistribution of resources to ensure that authorities with high need and low taxbases are still **able to meet the needs** of their areas; and

   4) **protection for businesses** and specifically, no increases in locally-imposed taxation without the agreement of local businesses.

Retention of Business Rates at a Local Level

6. This is part of the wider government agenda of devolving power to local communities and local authorities. This needs to be seen in the same context as the *Localism Bill* and the *Open Public Services White Paper*.

7. There are no proposals to change how business rates are calculated, billed and collected.

8. **HOWEVER, all is not as it may seem at face value. In securing the Comprehensive Spending Review 'control totals' (ie., ensuring that local government does not spend more than was signed off within CSR 2010), the government has created the notion of 'set-aside'.**

9. What set-aside does is take a large chunk of business rates out of the system from day 1. The table below demonstrates this:

	12-13	**13-14**	**14-15**
Estimated NNDR to be collected	£23.7b	£24.8b	£25.9b
CSR formula grant total	£23.9b	£23.7b	£22.4b
Difference = 'set aside'	(£0.2b)	£1.1b	£3.5b

b = billion

Thus, by 14-15, the government will have taken somewhere in the region of £3.5b of business rates out of the system to pay off the national debt.

Baselines, Tariffs and Top-ups

10. For 2013-14, the government will set a baseline of funding for each authority, based upon 2012-13 Formula Grant settlement. It will also set a baseline for business rates in line with the CSR settlement control totals (see above).

11. As a form of **equalisation**, the government will also calculate a tariff or top-up for each local authority.

12. Those councils with a business rate baseline higher than their funding baseline (i.e. what they would have received under formula grant) will pay a tariff to the government; those whose rates baseline is lower will receive a top-up grant from the government.

Levy on Disproportionate Benefit

13. There will be a **levy** on authorities where their business rate income generated in a year is far in excess of their Business Rates baseline, i.e. where they receive a financial benefit disproportionate to their need.

14. This is **another form of equalisation**. Most of the levy will be used to support sudden/significant shortfalls in business rates that some authorities may face (i.e. safety nets against large shifts in rateable values).

Resets and Revaluation

15. The government would have the **option to 're-set' the whole system** (e.g. recalculate baselines, top-up and tariffs) if, overall, resources no longer met service pressures.

16. The system would also have to be adjusted to take account of changes arising from the revaluation of business rates every five years. This may include the re-assessments of local authorities' needs.

Pooling

17. **Local authorities will be able to form pools, sharing income, tops-ups, tariffs and levies.** This would enable some of any disproportionate benefit from one council to be shared with others within the pool, thereby keeping more of the business rates raised in the local area. Pooling might be within counties or Local Economic Partnerships (LEPs).

Tax Increment Financing

18. Authorities will be able to borrow against future increases in business rate income.

Section 2 - Issues with what is being proposed

19. **Needs are not a prominent feature in the new system.** Increases in available resources will first be retained by councils that generate business rate growth, and then by authorities that have falls in business rate income. There are currently no plans to direct any of this money to councils with the greatest need. Fundamentally, **the system is no longer directly linked to NEED** (as it was – albeit in a flawed methodology in formula grant) but rather to **RESOURCE AVAILABILITY**. There is concern that the implementation is likely to create an even greater North/South divide, and also **significant concern at upper tier level where services such as adult social care and children and young people are need-driven services by their very nature.**

20. The existing proposals lock in the unfairness of the four block model (which is the basis on which formula grant is calculated). Authorities that suffer reductions through the damping mechanism lose money that is redistributed to other areas of the country. **Furthermore, there is clear evidence that the current model treats rural authorities unfairly, and if the baseline is to be set on this basis, then there is a very real danger that this unfairness will be locked in for at least another 10 years.**

21. As set out above, **'set-aside' means that business rates do not belong to local communities**, since a large chunk will be taken out of the system at the outset to pay off the national deficit.

22. The **complexity of the design means that the financial incentives are not at all clear**. The LGA itself has stated that it is very hard to do accurate modelling of the implications because there are too many unknown assumptions.

23. There are **big issues around fairness and stability**.

24. Currently the **risk and reward on the collection of Business rates** rests with the Government. These proposals transfer part of this to local government. In the current system, the Government announces in December how much Formula Grant will be paid to Local Authorities and this is paid in instalments throughout the financial year. This provides certainty of funding. Under the proposed arrangements should the collection of business rates fall, Districts would need to reduce the business rates payments to the County Council and to their own budgets during the year, causing a fall in income. This may require a greater level of contingency to be held or in year changes to budget plans. The LGA has raised the concern that councils might actually cut their budgets by more than is necessary, because there is not enough certainty around the funding stream (or collection rates).

25. The proposals suggest that in two tier areas, **District Councils could pool with councils or LEPs outside their county boundaries**, if they so wished, with the approval of the shire county. It is unclear whether this is constitutional, or how it would operate in practice. This has the potential to place further risks on the County Council's budget.

26. Putting these proposals together with those for New Homes Bonus, puts planning authorities in somewhat of a dilemma. Should the planning authority be favouring housing development or business growth. **Standing still will not be an option in terms of funding security,** neither in housing growth nor in business growth, since both the New Homes Bonus and Business Rates Localisation are both directly linked to growth.

27. However, early financial modelling suggests that districts would be financially better of focusing on attracting New Homes Bonus, as the potential for increased income is much greater than that likely to be secured from business rates growth.

28. The proposals do include incentives for Renewable energy schemes, but this excludes any new Power Stations. There are not, however, incentives for growth areas which are traditionally important to Suffolk – tourism and home-based businesses. And **there is little correlation between growth in these areas and business rates growth**. Cynically, the council would be financially more secure delivering large sheds with few jobs, since this is what will increase business rates growth.

Section 3 - Potential Implications for Suffolk and SEBC

29. Since 2006/07, the annual average cash increase in business rates collected in Suffolk is 3.51% per annum. This increase is below the national average increase of 4.19% over the same period. If this is discounted by the Retail Price Index (which is used annually to increase business rates), **Suffolk's real growth has been negligible in the past six years (0.15% per annum), nearly 1% below the national average.**

30. Should this situation continue, **there is the potential that Suffolk's Baseline Business rates figure will be set higher than the business rates that we will actually collect in 2013/14. Being 1% below the national average growth rate would lead to a loss of cash across Suffolk of approximately £2.5m in 2013/14 and £5m in 2014/15.**

31. **Gaining continual growth in business rates in a rural area is a challenge for reasons already mentioned.** Furthermore, Suffolk has some major business rate payers and changes to their circumstances can significantly alter the growth rate for a District. Examples include Sizewell Power Station and Felixstowe Port in Suffolk Coastal and Center Parcs in Forest Heath. Exemption from business rates caused by temporary closure of a major rate payer can have significant impact on collection rates.

32. Individual district totals for net growth since 2006/7 are as follows (note the first table is discounted for RPI):

Average Annual Real Growth in Business Rates since 2006/07 **(Discounted for RPI)**	
Babergh	1.20%
Forest Heath	0.59%
Ipswich	0.18%
Mid Suffolk	0.51%
St Edmundsbury	1.63%
Suffolk Coastal	-2.41%
Waveney	1.06%
Suffolk Average	0.15%
National Average	1.10%

Average Annual Cash Increase in Business Rates since 2006/07	
Babergh	4.74%
Forest Heath	4.02%
Ipswich	3.54%
Mid Suffolk	3.93%
St Edmundsbury	5.24%
Suffolk Coastal	0.52%
Waveney	4.57%
Overall	3.51%
National Average	4.19%

33. On the face of it, SEBC has strong growth (the strongest in the county) and **might be tempted to avoid joining a pool**. However, in a bid to encourage pooling (and therefore reduce volatility) the government has made it financially attractive to pool – so that the overall resources coming to a Suffolk pool would be greater than the sum of the resources coming to individual districts/the county. Exactly how the pool would then split its resources may be contentious, given the growth table set out above.

34. **One issue which has been little discussed is the views of businesses themselves in how all of this plays out – they should be consulted and are likely to have strong views about how any increase in income should be spent.** These may, of course, conflict with the council's (or pool's) views.

Section 4 - Conclusion

35. The proposed direction of the resource review is to be welcomed but there is much in the detail that needs further work and discussion to ensure this major change to funding local government is implemented fairly without creating unintended consequences.

Appendix A: Draft Response to consultation

Component 1: Setting the baseline

Q1: What do you think that the Government should consider in setting the baseline?

Two things:

1 The 'set-aside' is very unfair and takes out too much of the growth incentive, which is the whole premise of the review. St Edmundsbury does not believe this review of local government finance should be a reason to create an exchequer windfall (estimated at £3.5 billion). Higher than projected inflation has already increased real terms grant cuts.

2 There has been no acknowledgement of the rural penalty, which is currently built into the four-block model. We call on the Government to un-wind a small part of the Ministerial discretion that has so damaged our residents over the past decade, *before* the baseline is set. We believe that it is both fair and reasonable to ask that the funding gap (of 50%) between grant per head for urban residents compared to rural residents is closed by ten percentage points.

Q2: Do you agree with the proposal to use 2012-13 formula grant as the basis for constructing the baseline? If so, which of the two options at paragraphs 3.13 and 3.14 do you prefer and why?

Whilst we accept that the proposal would ensure that no-one loses out at the outset of the system compared to the present formulae outcomes, it would mean that rural people and communities would continue to be unfairly treated (as they have been for decades) compared to their urban counterparts in the distribution of resources to fund local government services. It may be pragmatic, as referred to in paragraph 3.12 of the Consultation Paper, but it is inequitable.

The reason that "the funding gap between urban and rural areas has grown dramatically since 1997"[1] is not because there has been a shift in needs over that time; rather it is that the previous Government used its considerable discretion in the distribution grant to favour certain types of authority. We accept that deprived areas should receive higher levels of funding than others, but do not accept that the result of this should be that urban areas generally should receive 50% more per head than predominantly rural areas.

Our argument in the preceding paragraph is all the stronger for the fact that the costs of service provision is (as a minimum) around 100% more in serving 'Village, Hamlet and Isolated Dwellings'.

Ministers, whilst in opposition, regarded the system as being "beyond its useful life". It is still that basic formula which is in operation. In the 2009 Local Government Finance debate Bob Neill MP said:-

"All of what I have said comes back to a suggestion that the grant system is creaking to the extent that it is no longer credible. It leads me to conclude that the system has gone beyond

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[1] Conservative Party in its 'Agenda for Rural Action' (published in July 2009)

its useful life and that we need a much more significant and thoroughgoing reform as to how distribution takes place".

Component 2: Setting the tariffs and top ups

Q3: Do you agree with this proposed component of tariff and top up amounts as a way of re-balancing the system in year one?

In principle, yes. This should ensure that authorities do not have problems funding their core services or find they have excess funding. However, the inbuilt unfairness set out in response to Q1 and Q2 above needs to be addressed before any system of tariff and top up could be really equitable.

Q4: Which option for setting the fixed tariff and top up amounts do you prefer and why?

Linking the tariff and top-up amounts to RPI would ensure that the status quo is maintained in periods of stagnation whilst also providing a positive incentive for growth and a negative disincentive for decline.

Component 3: The incentive effect

Q5: Do you agree that the incentive effect would work as described?

No, because the biggest share of the gain is likely to be paid to central government as set aside or taken as a levy and redistributed. It is the remainder (forecast minus "set aside") that will be used to calculate the tariff and top-up amounts. So it is clear that Government will have already assumed a certain level of growth when calculating the set aside and adjustments. Local authorities will need to exceed the Government's forecasts in order to see any true benefits from growth.

Furthermore, the issues in a rural economy as set out above dilute the incentive effect for rural authorities. Added to this, many rural businesses contribute very little to business rates growth, as they tend not to be property-based businesses (for example, home-based internet businesses). There is no correlation between growth in these businesses and growth in business rates.

The remaining concern that St Edmundsbury has is that there is a disconnect between need and growth. There is a danger of rewarding the inevitable.

Component 4: A levy recouping a share of disproportionate benefit

Q6: Do you agree with our proposal for a levy on disproportionate benefit, and why?

Yes, there should be some method of sharing excessive gains and protecting those authorities experiencing large declines. The Council would not be supportive of a levy which equated to a cap on growth.

Q7: Which option for calculating the levy do you prefer and why?

The third option, setting the levy in proportion to baseline, as it seems to be the fairest and least potentially volatile.

Q8: What preference do you have for the size of the levy?

As this is self funding this would need to be set once the government had completed its forecasts for business rates growth. There should also be an estimate of the draw on the levy pot (for example, to fund the "safety net") which should inform any decisions about the levy. This would mimic the situation in current local government finance settlements where the scaling factor and floor are set in order that they are self funding.

Q9: Do you agree with this approach to deliver the Renewable Energy commitment?

No. The incentive to deliver renewable energy should be linked to delivery of megawatts, not business rates. There is little correlation between business rates growth and green energy growth.

Q10: Do you agree that the levy pot should fund a safety net to protect local authorities: i) whose funding falls by more than a fixed percentage compared with the previous year (protection from large year to year changes); or ii) whose funding falls by more than a fixed percentage below their baseline position (the rates income floor)?

Yes.

Q11: What should be the balance between offering strong protections and strongly incentivising growth?

Undoubtedly a balance will need to be struck, but without knowledge of the estimated future growth prospects for the country, the Council feels it is unable to answer this question.

The Council is of the opinion that the baseline, for the purposes of the safety net at least, should be inflated annually by RPI. If a collection authority was dominated by one large rate-payer who suddenly closed or relocated then the authority would experience a very significant drop in that year's income. In all likelihood this would trigger the annual safety net. However, a significant loss could take a number of years to recover from – but if the closure/relocation occurs a number of years into the rates retention scheme and the baseline had not been increased by RPI then the absolute decline may not be sufficient to trigger the second safety net (falls compared to baseline) in the following years.

Q12: Which of the options for using any additional levy proceeds, above those required to fund the safety net, are you attracted to and why?

As per Q11 above, the Council considers that authorities should continue to be supported when a loss takes more than one year to recover from. Keeping a reserve of funds aside to support in years where the growth is lower would also appear prudent.

Q13: Are there any other ways you think we should consider using the levy proceeds?

Redistribute it to rural authorities who for many years have suffered from the rural penalty as set out in Q 1 above.

Component 5: Adjusting for revaluation

Q14: Do you agree with the proposal to readjust the tariff and top up of each authority at each revaluation to maintain the incentive to promote physical growth and manage volatility in budgets?

The Council understands why the consultation proposes making an adjustment to the tariffs and top-ups following a revaluation, but remains to be convinced that the proposed adjustment will work as intended.

Q15: Do you agree with this overall approach to managing transitional relief?

Yes.

Component 6: Resetting the system

Q16: Do you agree that the system should include the capacity to reset tariff and top up levels for changing levels of service need over time?

Yes. The Council is concerned that the Government are seeking to introduce a system to fund local services with no measures of need, except possibly at a reset. The Government has already admitted that there is no correlation between need and business growth and undeniably some areas of the country will struggle to achieve the kind of growth needed to continue to invest in vital local services. The Council considers it to be indefensible <u>not</u> to take into account changing levels of service need.

Q17: Should the timings of reset be fixed or subject to government decision?

The Council would support the introduction of an objective body to determine when needs and resources have diverged past a pre-determined trigger and call a reset. If need is allowed to diverge excessively the result will be that council tax payers will again bear the brunt of reductions to budgets through increased council tax bills or severely reduced services. This should not be left to ministerial discretion.

Q18: If fixed, what timescale do you think is appropriate?

See Question 17 above.

Any decision about timescale should take serious consideration of the possible risks associated with long-term borrowing against planned business rate income.

Q19: What are the advantages and disadvantages of both partial and full resets? Which do you prefer?

The Council is concerned that a partial reset would only be a halfway house to fairness, and question whether allowing achieved growth to remain with the achieving authorities could even be considered a reset. Constraining where business rates remain predetermines the outcome of the need versus resource comparison.

However, without further information as to what either a full or a partial reset would involve, the Council is unable to fully determine what the advantages or disadvantages of either system might be.

Q20: Do you agree that we should retain flexibility on whether a reset involves a new basis for assessing need?

Given that the baseline is likely to be based on a flawed measure of need the Council would strongly hope that future need assessments be based on something more accurate, transparent, agreeable and simple. The principles of this should be discussed and agreed between local and central government.

Component 7: Pooling

Q21: Do you agree that pooling should be subject to the three criteria listed at paragraph 3.50 and why?

St Edmundsbury supports the three criteria outlined in the consultation paper. However, the council believes the issue of pooling to be a particularly complex one. For example, the council is already a member of two Local Enterprise Partnerships, and it is unclear how pooling within a LEP would be practical at all. The risks around a single member of a pool withdrawing should be carefully thought through in order to ensure that no individual council can put the finances of other councils at risk.

Q22: What assurances on workability and governance should be required?

See above.

Q23: How should pooling in two tier areas be managed? Should districts be permitted to form pools outside their county area subject to the consent of the county or should there be a fourth criterion stating that there should always be alignment?

St Edmundsbury does not actually believe it is constitutionally acceptable to require county consent regarding a district pooling outside its council. If the government wishes to restrict any district from doing so, the fourth criterion (to require that pooling arrangements do not separate a district from its county) may therefore be required.

Q24: Should there be further incentives for groups of authorities forming pools and if so, what would form the most effective incentive?

The obvious incentive for authorities to form pools is the greater stability and protection offered from the rises and falls of an individual authority’s rates income. Authorities within pools will be able to decide where funding is best directed and work on a larger scale to drive further growth.

Impact on non-billing authorities

Q25: Do you agree with these approaches to non-billing authorities?

The consultation paper proposes that Police and Fire Authorities be removed from the rates retention model. The reason given is that they have more limited levers for driving business growth. The Council agrees that Police and Fire Authorities are less able to influence business growth than other types of authority. It could also be argued that Police and Fire budgets will be under greater pressure in areas where there is economic decline and/or low economic activity. It is for these two reasons that the Council agrees that Police and Fire Authorities should be removed from the rates retention system.

However, because some fire authorities are single purpose fire authorities and others are within county/unitary authorities it would be extremely difficult to remove all fire services from the rates retention system. The Council considers that all fire authorities should be treated identically and that a situation where some are exposed to the risk of local growth/decline whilst the remainder have their funding protected is unacceptable.

New Homes Bonus

Q26: Do you agree this overall approach to funding the New Homes Bonus within the rates retention system?

The introduction of New Homes Bonus does not sit particularly well with the business rates retention scheme. Districts will be more greatly incentivised by the New Homes Bonus, and counties take a smaller share of this growth. NHB is yet another complication to add to the layers of complexity around the changes in local government finance. There may be a range of unintended consequences which – as yet – have not been identified.

Q27. What do you think the mechanism for refunding surplus funding to local government should be?

Redistribute it to rural authorities.

Business rates relief

Q28: Do you agree that the current system of business rates reliefs should be maintained?

Business rate payers should be assured that the current system of reliefs will continue, so the Council supports this proposal. However, Government must ensure that there are sufficient resources available to continue to fund the system of discretionary reliefs, to the same degree as present.

Q29: Which approach to Tax Increment Financing do you prefer and why?

It is not really possible to give preference to one option or the other. The specific circumstances at the time might lead an authority to choose one or the other option. For this reason, the council believes both options should be kept open.

Q30: Which approach do you consider will enable local authorities and developers to take maximum advantage of Tax Increment Financing?

Option 2 will obviously offer greater protection for TIF investors and developers but this protection will be at the expense of the rest of local authorities.

Q31: Would the risks to revenues from the levy and reset in option 1 limit the appetite for authorities to securitise growth revenues?

Possibly.

Q32: Do you agree that pooling could mitigate this risk?

Yes, pooling could mitigate this risk, providing all members of the pool were in agreement about where capital investment should be spent and that financing that debt should be a priority.

Q33: Do you agree that central government would need to limit the numbers of projects in option 2? How best might this work in practice?

Yes. Through a transparent and apolitical process which considers only the economic integrity of any proposals.