LGA Finance Panel
14 September 2012

Item 6

Business Rates retention

Detailed issues in LGA response to consultation

Purpose of report

For discussion and direction.

Summary

This report explains the main issues raised by the Government's July consultation on the partial retention of business rates from April 2013, and seeks the Panel's direction on a number of issues that will need to be covered in the LGA's response to the consultation.

Recommendations

Members are asked to confirm the shape of the LGA response to the Government's consultation, and related lobbying work, as set out in the detailed recommendation at the end of this paper.

Action

Director of Finance and Resources.

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Local Government Association

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Background

1. The LGA Finance Panel has responsibility on behalf of the LGA Executive for consideration of the more detailed issues on the proposals for partial localisation of business rates.

2. The Local Government Finance Bill, which is expected to become law shortly, sets out the framework for what the Government now calls the Business Rates retention scheme. Within the broad framework in primary legislation, the full detail of the new business rates arrangements will emerge in part through secondary legislation but more particularly through decisions that will be made by Ministers.

3. The Government issued a 250-page consultation paper on 17 July seeking local authorities' views on a large number of detailed issues that need to be settled to enable the new arrangements to come into operation in April 2013. Moving from the present Formula Grant system, under which the Government decides how total business rates revenue is to be returned to local authorities, to arrangements in which 50% of locally raised business rates are retained, raises a lot of detailed issues. The transition has been made considerably more complicated by the Government's insistence on very precisely controlling total funding levels for local authorities. Because the business rates yield has been increasing, but the Government has been reducing overall funding, this means that more and more grants that used to be funded separately from business rates will in future be paid out of the central share of business rates that the Treasury takes. This enables the Government to fulfil its continuing legal obligation to ensure that the proceeds from business rates are fully returned to local authorities.

4. The Government consultation contains over 80 questions. Many of these cover the detail of the way in which funding baselines are initially distributed between local authorities. The LGA does not usually take positions on such matters, because different authorities inevitably take different views depending on their own position, and there is seldom an answer that benefits local government as a whole. Other consultation questions simply seek confirmation on basic points where there have to be changes – for example in the accounting arrangements as between central and local government – but where the way forward is largely a matter of common sense and unlikely to raise controversy. This paper does not discuss these matters further but seeks direction from members on a range of material issues of detail affecting local government as a whole.

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Money available for 2013-14 budgets

5. The Government consultation proposes that various amounts of money are to be held back in April 2013 when the new system comes into operation. The Government intends to keep these amounts for use for certain specific purposes, and hand back any unspent balance to local authorities after the end of the financial year.

6. The amount to be held back initially is **£345 million**. This is to fund (a) the cost of the *safety net* that the Government will use to ensure that no local authority will be at risk of loss from catastrophic decline in its retained business rates income; and (b) such *capitalisation* requests as the Government chooses to allow – these have in previous years been covered from the wider DCLG settlement, and not from the cash raised from business rates.

7. It is recommended that this proposition is robustly challenged. The proceeds of the levy on local authorities achieving real terms business rates growth are supposed to fund the safety net, but because the Government will not be ascertain and collect levy income until the year after the new arrangements begin, it will not immediately know how much is available to fund the safety net. The Government is therefore asking local authorities to pay up an amount in advance to ensure that it has sufficient money available. This appears entirely unreasonable, particularly as DCLG has not published any information evidencing that the size of the hold-back is a reasonable estimate of the safety net requirement.

8. The position on capitalization is, if anything, even worse. Here the Government is asking local authorities to pay cash in advance from their revenue budgets to offset what are essentially permissions to allow the spreading of various kinds of exceptional revenue expenditure over more than one year, granted at Ministers' discretion.

9. Taking real money from council budgets to cover what are essentially artificial quirks of government accounting is, it is suggested, something the LGA should strongly oppose, particularly at a time when funding is being heavily cut anyway.

Forecast business rates income

10. In order to commence the new arrangements, the Government has to make a forecast of the total income that local authorities might expect to raise from business rates in 2013-14. If the actual amount raised is more than the forecast, then local authorities collectively will potentially benefit by keeping 50% of the overall excess. But, if the amount raised is less than the forecast, local authorities have to cover 50% of the loss from their own budgets, and individual authorities will only get relief from the loss if it is large enough to call the safety net into operation.

11. Historically, forecasts of business rates income by the Treasury have tended to be over-optimistic, as can be seen by examining the forecasts accompanying the Chancellor's Budget over a series of past years. Forecasting is now the job of the Office for Budget Responsibility, which helpfully detaches the process from Ministerial influence but does not necessarily mean that the optimism bias will be eliminated.

12. It is understood that, within Government, officials have been looking carefully at how the forecast is constructed, and this provides some degree of assurance. However, local authorities cannot at this stage have any confidence that the accuracy of the forecast will be improved. Furthermore, to the extent that the forecast includes an estimated element of real growth in business rates, the system appears to be based on the assumption that this element of growth is entirely the Government's to keep, and not local authorities' to share.

13. It is therefore recommended that the LGA should seek two assurances from Government on the business rates forecast. First, if the new system is as Ministers have said intended to provide a strong financial incentive to promote growth, then the business rates forecast should transparently set out what part of the 2013-14 yield represents real growth, and allow local authorities to retain that growth fully, without reduction in other funding. Second, if the business rates yield for 2013-14 turns out to be lower than forecast, because of incorrect forecasting assumptions or indeed other events that are clearly outside local authorities' control, then the Government should fully compensate local authorities for losses in the local share.

Transparency of return of the business rate to local government

14. At present, business rates income gets returned to local government in two different ways. The first and most visible way is through the 'Distributable Amount' included in Formula Grant each year. This is part of the local government finance settlement determined in periodic Spending Reviews. There is, though, a second and less visible return of money, which the Government accounts for in an entirely different way. This happens when local authorities find that, for example because of appeals against rating valuations, they have to pay back business rates money already collected in respect of earlier years. In 2011-12, a total of £774 million was paid back to local authorities in this way, and the amount for 2010-11 was even higher.

15. At present, central Government has full responsibility for covering these kinds of shortfalls, and as part of the overall Spending Review Settlement, money separate from the cash-limited part of local government funding is allocated to cover them. The Treasury takes the risk on the adequacy of this amount, which is part of the Government's Annually Managed Expenditure (AME). Spending Review 2010 includes £500 million of AME for this purpose for each of 2013-14 and 2014-15, but the Government's consultation does not provide clear and transparent information about how local government is going to benefit from this. It appears that the Government intends that, from April 2013, local authorities will take 50% of the risk on all future losses on appeal, including those relating to years before 2013-14. This potentially confers a windfall gain for the Treasury at local authorities' expense.

16. It is therefore recommended that the LGA should seek from Government both a clear and transparent account of how the AME money that is included in the Spending Review 2010 settlement will be applied to benefit local government in 2013-14 and 2014-15, and a specific assurance that losses on appeals and other adjustments resulting in repayments of business rates by authorities in respect of 2012-13 and earlier years will continue to be fully covered by the Government.

Business rates proportionate shares

17. In response to earlier consultation about how each local authority's *tariff* or *top-up* should be calculated, the Government is proposing to use figures based on averaging business rates over the previous five years. The rationale for this is that the Government does not wish the way the initial arrangements for the system are set to be unduly influenced by recent one-off events.

18. Initial research by officers suggests, though, that this proposal – which in principle has much to commend it – may operate unfairly for some authorities where the current level of business rates income is, relatively, significantly lower now than at the start of the five year period. Such authorities could find that they are set a level of *tariff* (the amount by which their business rates income is structurally in excess of their normal funding level) that is considerably greater than their current capacity to fund it. In short, the new system would not provide an incentive for future growth but a penalty for the impact of, for example, a large factory closure some years ago.

19. Officers are carrying out further work to establish the potential severity of this issue and will report further on it to members at the Panel meeting. It is possible that a minor adjustment to the proportionate shares proposals could help to alleviate this problem for the authorities concerned without significantly affecting the position of others.

Funding baselines

20. The starting point for funding under the new arrangements is proposed to be determined by means of a Local Government Finance Report that includes a calculation on similar lines to the present Formula Grant arrangements. That will lock in most elements of the current formula funding and, to that extent, authorities will only be able to escape the consequences of what are perceived to be adverse effects by growing business rates locally.

21. The LGA has been developing a model to assist authorities estimate the likely baseline, and it is hoped that this can be made available to member authorities shortly. The baseline amounts can be expected to depend heavily on decisions that Ministers make about the level of floor damping, an issue on which the consultation material provides no indication of the Government's thinking. Individual authorities will have sharply divergent views on this general issue, depending on their position in relation to the grant floor, and it is not one on which the LGA can expect to reach a consensus view.

22. There is, though, a particular issue on which we have received representations and that concerns a small group of authorities whose funding for 2011-12 and 2012-13 was cut so heavily that, for those years, they received special transitional protection to limit their overall reduction in income. Members may therefore wish to consider what the LGA could do to assist authorities in this position, without detriment to the position of others. Officers will provide some further detail at the Panel meeting to assist discussion. The issue particularly concerns some Shire Districts that, until 2011, received large amounts from what was then the Working Neighbourhoods Fund.

23. A separate and much more significant issue affecting baselines of Single Tier and County Councils is the adjustment proposed to remove a total of £1,218 million in respect of funding for local authority and academy central functions. The detail of this is the subject of a separate consultation by the Department for Education, which is proposing to return part of the funding removed using a new national formula. The formula will, to put it at its simplest, return money at the current national average per pupil rate for pupils in local authority maintained schools, and at a much lower rate per pupil (£8 - £15 has been proposed) for pupils in academies. We are aware that there is a great deal of dissatisfaction with these proposals, just as there was with the original Academies Funding adjustments for 2011-12 and 2012-13. A detailed response to the DfE consultation is being prepared and a draft will be copied to members of the Panel in due course. The Children & Young People's Board has previously overseen the work on the Academies Funding transfers and it is suggested that they retain responsibility for clearance of the LGA response on the DfE consultation.

The District – County split

24. In two-tier areas, the consultation proposes that for the purposes of the *top-up* and *tariff* calculations 80% of business rates should be allocated to Shire Districts, with 20% to the county (18% in cases where the Fire and Rescue Service is run by a separate authority). The Government has said that it wishes to place the strongest incentive for growth in the hands of the lower tier, whilst providing a high degree of stability for authorities responsible for adult social care and children's services.

25. It has, though, been conclusively established through study of the detailed design of the proposed arrangements, that the impact of the Government's *levy* is such as to make the particular level of split largely irrelevant for Shire Districts <u>where they succeed in growing their business rates income in real terms</u>. In short, provided that there is real growth in business rates, a Shire District is not likely to gain any significant extra reward from an 80-20 split, as opposed to a 70-30 or 60-40 split. However, if a Shire District's business rates income declines, then its position is likely to be considerably worse, the higher the proportion of business rates allocated in the split.

26. Officers believe that the implications of this part of the design of the scheme may not have been fully appreciated by those advising Ministers, and to be fair it is a complex point to work through and understand in detail. The issue for the Panel is whether the LGA, as opposed to its Special Interest Groups, should make any particular representations for change. It is suggested that any consensus emerging between Districts and Counties for an alternative proposition should be supported but, failing that, the LGA should in its response to the consultation at least seek to ensure that the potential downside risks for both kinds of authorities are fully explained.

The safety net

27. The proposed arrangements include a *safety net* providing a floor below which its retained business rates income cannot fall. The safety net is funded by the *levy* referred to earlier, and is inflation-linked. The Government has suggested that it should

be set in the range 7.5% - 10% below indexed baseline funding.

28. Because the safety net and levy are linked (and there is the associated issue of the £345 million contingency funding that the Government wants to take out anyway), it is difficult to illustrate in simple terms the implications of striking a balance at one or other place. Officers therefore intend to run a range of scenarios setting out how the choice might be expected to operate in practice, using historic information about cases where business rates have suffered large year on year declines. A summary of the conclusions will be presented at the Panel meeting. At present, officers' inclination is to recommend that the LGA supports a safety net level giving a more generous degree of protection, but this advice would benefit from more detailed analysis before it is finalized.

The consultation response

29. The LGA's response to the consultation will need to be submitted by 24 September, so the Panel's meeting will enable members to provide direction on the overall shape of the response. The LGA Chairman and Group Leaders also have a remit, arising from the last time Business Rates localization was discussed at the LGA Executive, to set the strategy for the overall response to the consultation. Officers will report at the Panel's meeting on the results of that discussion, which is not scheduled to take place until after the deadline for preparation of this paper.

30. Subject to that, it is proposed that the LGA consultation response be submitted in draft for clearance by the Chairman and lead members of the Panel, reflecting the Panel's direction and any further views expressed by the LGA Executive.

Financial implications

31. This is core work for the LGA which is funded from existing budgets.

Recommendation

32. Members of the Panel are recommended to authorise clearance of the LGA consultation response to the Business rates retention consultation by the Chairman and lead members, on the basis that the response:

    32.1. Strongly argues for withdrawal of the proposed £345 million hold-back from 2013-14 budgets;

    32.2. Seeks assurances from Government over the reliability and transparency of the business rates forecast, and protection for local government from the consequences of incorrect forecasting assumptions or other matters outside local authorities' control;

    32.3. Demands transparency over the arrangements to ensure that AME included in the DCLG Spending Review settlement for 2013-14 and 2014-15 continues to benefit local authorities in the amounts originally envisaged, and an assurance that late adjustments to business rates yield for 2012-13 and earlier will continue to be fully funded by the Government;

32.4. Considers the possibility of representations on the business rates proportionate shares calculation and on the impact on the funding baselines of authorities previously in receipt of Transition Grant;

32.5. Together with the separate response on the new local authority central education functions funding consultation, fully rehearses member authorities' significant concerns about the level of funding removed for Academy central functions spending;

32.6. Considers, in the light of members' direction, the approach to be taken on the 80-20 District-County split and on the level of the Safety Net.