LG Group Executive
13 October 2011

Item 1

Local Government Resource Review

Purpose of report

To update the Executive on the Local Government Resource Review (LGRR) consultation and seek approval of the main points to be covered in the LG Group's response.

Summary

This paper summarises the work done in analysing the LGRR consultation and establishing the views of member authorities, and sets out an outline of the proposed LG Group response to the Government's consultation.

Recommendation

Members are asked to consider the analysis in this report, comment on the proposed outline of the LG Group response to the Government's consultation and authorise the Leadership Board to approve the full consultation response.

Action

Director of Finance and Resources

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Background

1. The Government published Terms of Reference for the first part of the Local Government Resource Review (LGRR), covering the retention of business rates, in March 2011. The Executive discussed the principles for reform and authorised publication at the annual conference of the document "Balance Transfer", setting out ten principles that we believed should underpin the design of a reformed business rates system. These principles were developed following extensive consultation with member authorities and are summarised at **Appendix A** to this report.

2. The Government issued its consultation document on 18 July and followed this up with eight detailed technical papers that were published on 18 August. We issued immediate briefings on each of these for the benefit of member authorities. The briefing on the initial consultation is available to member authorities at http://www.lga.gov.uk/lga/tio/19377920 and the briefing on the technical papers at http://www.lga.gov.uk/lga/tio/19786685.

3. As well as providing briefings on the Government's consultation material, the LGA has provided a range of detailed analysis material to member authorities through an on-line Community of Practice (www.communities.idea.gov.uk/c/11557472/home.do) to illustrate how the Government's proposals might be likely to work in practice. We hosted a one-day conference on the LGRR on 30 September, attended by around 120 officers and members. This was chaired by Cllr David Sparks and included presentations from Cllr Sir Merrick Cockell, Bob Neill MP and Barbara Keeley MP. Officers have also attended a number of meetings organised across the country to discuss the impact of the LGRR and the Government's proposals. These meetings have involved both professional networks such as the various treasurers' societies and meetings of elected members. As a result, we believe that we have established clearly where there is consensus in relation to the Government's proposals and where individual authorities' views diverge.

The Government's proposals

4. It should be acknowledged that the Government's consultation on the business rates retention scheme is clear, in most places genuinely open about the available options and very fully and professionally constructed. The consultation material in officers' view exposes all the relevant issues that need to be considered in relation to the LGRR. This has assisted detailed debate and understanding of what is being proposed, and enabled the full implications of most aspects of the reform to be fully considered. The thought that has gone into the consultation process deserves praise and recognition.

5. The extent of detail in the material makes the consultation proposals difficult to summarise. The following are the key high-level points:

   5.1 The proposed business rates retention scheme will initially work within the expenditure limits set as part of Spending Review 2010.

   5.2 Any forecast business rates income above this will be set aside and directed to local government through other grants. Local authorities will benefit from growth in business rates above forecast levels.

   5.3 Rate setting powers will remain under the control of central Government. The revaluation process will be unchanged.

   5.4 At the next Spending Review, the Government will consider 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.

   5.5 Police authorities will, for 2013-14 and 2014-15, receive guaranteed funding at the levels set in Spending Review 2010. Fire authorities may be treated in the same way, or may be brought into the new scheme from the outset.

   5.6 The detailed arrangements provide for authorities to be rewarded for growth in their business rates income subject to a ‘levy’ on growth regarded as excessive, and a ‘safety net’ where business rates income falls below a pre-determined level. The ‘levy’ will fund the ‘safety net’ arrangements and possibly other provisions that might be needed to deal with volatility in business rates income. It is recognised that periodic ‘resets’ in which local authorities’ needs are re-assessed may be required, and authorities’ views are sought on the operation of resets including, in particular, the manner and frequency at which they are triggered.

   5.7 The detailed proposals also cover how the new scheme might interact with business rates revaluation; the possibility that authorities might combine resources through pooling – which the Government wishes to encourage; and the way in which the proposals on Tax Increment Finance (TIF), New Homes Bonus and Enterprise Zones operate in the context of the new scheme.

LGA analysis

6. In analysing the proposals and discussing them with member authorities up and down the country, there has been a general welcome for the underlying objectives of putting the business rate under local control and providing clear rewards for authorities that grow business rates income.

7. The nub of the issue though is how far what is on offer in the Government’s consultation really gives us the responsibility and autonomy we seek, in a fair

and sustainable way.

8. We have identified four principal areas where we believe the Government's proposals need to be modified in order to deliver the principles that were set out in our ten point plan, published in June ahead of the Government consultation.

The set-aside

9. The Government's proposals assume a "set-aside" arrangement under which the Treasury retains part of the income from business rates, at least up to 2014-15.

9.1 Under the Government's proposals, the level of forecast business rates that it expects local government to raise in 2014-15 will be compared to the spending control total that has already been fixed for local government in the 2010 Spending Review. A similar comparison will be made for 2013-14. The amounts by which the forecast business rates exceed the spending control totals will be used to fund other grants to local government. Local government only stands to benefit from the new scheme in aggregate if the business rates yield for 2013-14 and 2014-15 exceeds the Government's forecast.

9.2 The Government's Budget 2011 documentation contains forecasts of UK wide business rates yield (and RPI inflation) from which it is possible to estimate the current view of likely business rates yield in England and the implied real terms growth in business rates. Officers' analysis of these figures is summarised below.

	2013-14	2014-15
Forecast business rates yield (£bn) (England only)	24.8	25.9
Estimated "set-aside" (£bn)	1.1	3.5
Estimated RPI inflation to previous September (per cent)	3.4%	3.5%
Estimated real growth implied in business rates forecast (per cent)	1.3%	0.7%

9.3 It can be seen that the amount of "set-aside", at more than £1bn for 2013-14 and around £3.5bn for 2014-15, is very large. Members will recall that the LGA's initial analysis of the 2010 Spending Review numbers pointed to a £2bn surplus of business rates over 2014-15 funding. This figure was calculated on a broadly comparable basis and the reason why the estimated set-aside is now much larger is mainly because the inflation figures included in the Budget 2011 estimates are higher than those used at the time of the Spending Review.

9.4 The Government's proposals to remove the set-aside are therefore doubly disadvantageous to local government. Firstly they allow the Treasury, rather than the sector, the benefit of a major slice of business rates revenue. Secondly they give the Government the benefit of extra yield attributable to higher than forecast inflation, without any recompense for local authorities which now face funding cuts that are, in consequence, larger in real terms than the 28 per cent figure set out in the Spending Review.

9.5 A possible response to the issue of the set-aside would be for the sector and the Government to agree that some additional service responsibilities, now funded directly by Government, in future fell within the scope of business rates funding. Good candidates for that transfer might include the services relating to the economy – skills and transport – mentioned in the Open Public Services White Paper as candidates for localisation. It would, though, be important to ensure that local Government was not faced with transfers of responsibility to fund services whose costs are expected to grow by more in real terms than the likely future growth in business rates.

Fairness

10. We identified through the LGA consultation that it was particularly important for the relocalisation of business rates to be achieved in a way that was considered fair across the whole spectrum of local government. This is an objective that the sector shares with the Government. In his Foreword to the Government consultation, the Secretary of State makes clear that: "We are determined that the repatriation of rates should happen in a fair and effective way. Those places with greatest dependency should, and will, continue to receive support, while being allowed to keep the products of enterprise. Those places which raise the greatest sums through business rates should expect to make a contribution. And businesses, which need stability throughout this process, will see no difference in the way they pay tax or the way the tax is set." The challenge is therefore not on acceptance of the principle but on translating it into a practical scheme for business rates retention that commands the confidence of the sector.

11. The way in which the Government's proposals aim to deliver a fair system are through:

11.1 setting a funding baseline for each authority that is likely to be reasonably close to the answer that would have emerged from the application of the present Formula Grant system for 2013-14 and 2014-15;

11.2 applying a safety net to protect authorities against temporary or long term decline in business rates yield that is largely outside their control;

11.3 using a levy, that is likely to apply particularly to authorities that enjoy both high growth and high levels of business rates relative to their funding, to fund the safety net and potentially other mechanisms to safeguard the position of authorities whose income would prove insufficient; and

11.4 periodically re-setting the system in order to ensure that levels of resourcing stay broadly in line with needs.

12. These measures are all potentially useful ones in theory. However, the Government has not made any detailed statements about the level of protection that would be delivered through the 'safety net' arrangements, or fully exemplified its likely approach to the use of the levy to fund areas in need of support. Consequently, authorities have faced genuine difficulties in understanding whether the proposed arrangements are likely to meet their needs. Legitimate concerns have, for example, been expressed about whether, over time, the system would produce results that benefitted authorities with stronger local economies at the expense of authorities entering the system from a position of historic low growth and high levels of need.

13. Analysis of the scheme by LGA officers suggests that, over the period 2005-06 to 2009-10, business rates yield raised by local authorities grew on average by just under 1 per cent p.a. in real terms. If that position continued into the future, therefore, and if the proceeds of growth were to be fully returned to local authorities, one would expect that the business rates retention scheme would produce growth in authorities' resources. Projecting the scheme over a four year period into the future, and assuming growth at an average 3.7 per cent p.a. compared with average inflation of 3 per cent, our modelling suggests that the scheme as proposed in the Government consultation papers might deliver an outcome of up to a 2 per cent p.a. above inflation increase in resources for around half of all authorities, and resource increases at a higher level for around one-tenth of authorities. By contrast, about one-ninth of authorities might receive increases in resources more than 1 per cent p.a. below inflation, and the remainder might receive increases in resources marginally below inflation. It must be emphasised that outcomes from this modelling are heavily dependent on the detailed design of the scheme, and in particular on whether top-up and tariffs are index-linked (assumed in these results) and on the rates set for the levy and the safety net.

14. Authorities will clearly have different views on what might be regarded as a 'fair' scheme. It is suggested that, in operating as a mature local government sector, our response to the Government consultation should be to encourage the development of more detailed options for business rates retention that can be properly exemplified at individual authority level for the purposes of more detailed consultation on the scheme design. Moving to a business rates retention scheme is a major change for the sector, affecting around half of non-schools funding. It is therefore vital that the detail of reform is designed very carefully, with further consultation. In a period in which the Government is seeking to constrain local authorities' resources along with other public spending, concerns about whether authorities will have sufficient resources to deliver the full range of services that local communities expect to be provided are fully justified. It is suggested that these considerations might point to a preference at the outset for adopting the more cautious options on the design of the scheme (for example, measuring growth by averaging over more than one

year) rather than going for a high risk / high reward approach to the scheme design.

15. It will, furthermore, be vitally important to the safe introduction of the scheme that the Government gives clear assurances that, beyond the current spending review period, there will be no "set-aside" and that authorities will have unrestricted use of the full business rates yield. Continuing set-aside arrangements cannot deliver a scheme that is either clear or fair.

Risk

16. The move to business rates retention is intended to be introduced alongside continuing real terms cuts in local authorities' core funding, and alongside other reforms, most notably council tax benefit localisation. The combined effect of these reforms is to increase the level of financial risk authorities have to manage, both individually and collectively.

17. To give an idea of the scale of these risks, analysis of the present arrangements for the national business pool shows that, in recent years, both the Department for Communities and Local Government (CLG) and individual local authorities have found that business rates income is not easy to predict. At individual local authority level, this has resulted in authorities needing to claim back money from CLG when yield comes in below forecast. These repayments have in aggregate typically amounted to £500m - £600m p.a. in the recent past, and CLG have run the national business rates pool at a deficit that has been as high as £2bn in recent years, although it is currently planned to bring the pool back into balance by the end of 2011-12.

18. These risks are under the present system borne entirely by the Government. Under a business rates retention scheme, the risks will transfer to local authorities. It will therefore be very important to ensure that, particularly in transition to the new scheme, the arrangements enable risks to be kept to manageable levels. It would not be a good use of the sector's resources if, because of poor or uncertain design of the new scheme, authorities found it necessary as a matter of prudent financial management to increase reserves so that, in aggregate, the amount held was more than the £0.5bn p.a. currently allocated by the Government as annually managed expenditure to cover prior year repayments.

19. Proper risk management is an important part of the overall design of the new scheme. The consultation papers include some useful provisions that will help to manage risk, such as the 'safety net' provisions and the detailed proposals for managing payments between billing authorities and other authorities. The scope that is clearly being offered (and encouraged) for authorities to pool resources for the purposes of the scheme may also assist. However, arrangements for risk management need to be developed in much greater detail before authorities can have full confidence in planning for the transition to the new scheme. It is suggested that it would be appropriate to seek assurances

from the Government that, in working up the detailed design of the reform, risk management issues will now be the subject of much more in-depth analysis and consultation, and that the Government should stand ready to transition the full risk of the scheme to the sector gradually, over a period of years, if that appears desirable.

20. In particular, the sector needs clear assurance that, if the Government continues to take “set-aside” in 2013-14 and 2014-15, then the Treasury and not local authorities will fully bear the risk that, in aggregate, business rates might fail to achieve the forecast levels of real growth in each of these years, whilst leaving the benefit from upside fully with local government.

21. A further risk management issue arises because of the possibility that, as the scheme develops, authorities’ resources from business rates and council tax might diverge sharply from underlying levels of need for funding to provide services. It is therefore suggested that the Government should maintain the capacity and evidence base for the assessment of needs, and that any decision to invoke a reset of the system should be capable of being triggered by the local government sector on the basis of evidence. Making an advance determination of the period between resets of the system, or leaving the matter entirely at Ministerial discretion and without a clear evidence base would both appear to introduce avoidable risk. It should be noted that it is not necessarily the case that resetting the system would mean loss of revenue for authorities that had benefitted from business rates growth up to the time of the reset. As happens now with the damping of formula grant, it is quite likely that any changes introduced on a reset would be phased, to avoid sharp discontinuities in individual authorities’ levels of funding. A re-determination of baselines for the calculation of top-ups and tariffs could provide a mechanism for the phasing in of change.

Incentives

22. Our earlier consultation with member authorities identified that there was clear support for the proposition that authorities that achieved real terms growth in their local economies should receive a reward for their efforts. The Government’s policy, as expressed in the Ministerial Foreword to the consultation paper, is that “Councils should … see a direct link between the success of local businesses and their own cash flow. Any council that grows its local economy will be better off under the new system. This will create the right incentives for them to work closely with local businesses, helping to create the conditions for growth, and giving local leaders reasons to celebrate their successes, not conceal them.” There is therefore broad agreement that a clear reward for growth should be part of the new system.

23. A number of member authorities have raised concerns that business rates represent an unsuitable measure of economic growth. It is said, with justification, that rewarding growth in business rates income gives disproportionate benefit to the encouragement of growth in retail space and

large distribution centres, rather than encouraging growth in small businesses (whose business rates attract substantial levels of relief) or technology businesses that operate from a small physical footprint. A number of authorities are also concerned that major changes in those parts of the public sector that operate in their areas could act as a brake on overall business rates receipts and, consequently, limit the scope for benefit from the new system. These concerns are entirely reasonable ones but it is difficult to see how they could be accommodated within the design of the new system without introducing the kind of complexity that beset the LABGI scheme that operated in the second half of the last decade.

24. A further legitimate concern is that the scheme design creates an incentive that operates in a completely different way for 'tariff' authorities than for 'top-up' authorities. The proposed arrangements have an inbuilt gearing effect that means that, in terms of the level increased resources available for each percentage point of growth in business rates yield, 'tariff' authorities have more to gain – in some cases considerably more – than top-up authorities. Earlier research by LGA officers suggested that this gearing effect could range from something like a factor of 8 for the highest 'tariff' authorities (meaning that each percentage point of growth in business rates leads to an 8 per cent increase in resources) down to a factor of only just over 0.25 for the highest top-up authorities. The proposed 'levy' arrangements deal with this issue in part, in particular the option for a 'proportional' levy – although that option leaves substantial downside risk in place for high 'tariff' authorities.

25. It is possible that a simpler and clearer scheme could be produced by building arrangements around the following two propositions:

    25.1 If an authority grows its business rates by x per cent in real terms, then it should receive a real terms increase of the same x per cent in its resources; and
    25.2 Authorities whose business rates decline in real terms then share the remaining business rates.

26. This kind of scheme would not require top-up, tariff or levy arrangements, and would provide a clear and equal incentive for all authorities. Its principal downside would be that, for authorities that do not succeed in growing business rates, there is uncertainty over what funding level would apply. However, using average growth rates for 2005-06 to 2009-10, illustrative modelling suggests that such authorities would on this basis have received funding increases at a level roughly 0.75 per cent below the rate of inflation. In other words, the incentive for growth is clear and strong but the penalty for failure might not prove massively destabilising.

27. It is suggested therefore that in responding to the consultation the LGA should encourage the Government to test whether alternative ways of presenting its proposals exist that might be expected to deliver broadly comparable results but

which can be expressed in simpler and clearer ways, so that the nature of the financial deal for authorities is as straightforward as possible.

Development of the LGA response to the Government consultation

28. The foregoing analysis has set out the main points around which officers consider that a consensual response to the Government consultation could be built. **Appendix B** sets out the broad shape of such a response.

29. Beyond that, the consultation papers raise a very wide range of detailed issues. On many of these, it will be very difficult for the LGA to develop a clear consensus as individual elements of the scheme design will affect individual authorities in very different ways. For example, the consultation raises an important question about whether tariffs and top-ups should be index-linked. Authorities that are in a tariff position will almost certainly not want this result, whereas the reverse will be true for top-up authorities. In such situations, and given that the scheme overall will need to operate within the total business rates yield available, it is suggested that the mature approach is to go back to the underlying principles that are considered to be of the greatest importance for all authorities.

30. It is therefore recommended that, in developing the detailed LGA response, officers concentrate attention on shaping the outline response in Appendix B in accordance with the steer given by the Executive – and then arrange for the final version of the outline response, and an accompanying detailed response, to be signed off by members of the Leadership Board. The deadline by which responses have to be submitted is 24 October.

Financial Implications

31. This work is core work of the LGA and is funded within existing budgets.

Appendix A

LG GROUP TEN POINT PLAN FOR REFORM PUBLISHED IN "BALANCE TRANSFER"

We believe that the following ten principles must underpin the design of any new system in order for it to be effective and sustainable over the long-term. A reformed business rates system must:

1. Be based on stability and a continuing powerful commitment to resource equalisation across the country.

There are two strengths of the current system that should be carried through into any new system. Predictability of funding provides the stability that is needed for sensible planning, whilst a robust mechanism for equalization ensures that there can be a broadly level core service offer across the country.

2. End councils' dependence from year to year on grant distribution decisions by the Secretary of State.

The current formula grant system is widely seen as being opaque and far too subject to judgement calls on the part of Government.

3. Provide a direct reward for promoting local economic growth.

Councils already see the promotion of a vibrant local economy as one of their fundamental responsibilities. The capacity to receive a direct return on their investment in local economic growth would act as a further incentive and provide a stronger platform to engage local businesses in planning for growth.

4. Have a sensible starting point.

A smooth transition to a new system is absolutely critical, and requires a starting point that provides councils with some continuity. Using formula grant allocations to councils in the pre-changeover year as a basis for the starting point seems a workable proposition.

5. Ensure that councils whose business rate income grows faster than their spending needs make a contribution to equalisation.

The new system has to do a better job of allowing councils to harness the proceeds of local economic growth for their local residents. But, because business rates growth can be very volatile, places where growth is strong should make a contribution to ensuring that all authorities have adequate resources to meet the needs of their communities. Without that, the reform would not be sustainable.

6. Provide councils whose spending needs are greater than the amount they can collect from business rates with top-up funding.

Some councils will simply not be able to generate enough business rate income or other local revenue to cover their spending needs. Moreover, many councils in areas of the country that are most deprived or face significant constraints on their growth potential have the greatest pressures for costly services such as adult social care or children's safeguarding. These authorities will need extra support to meet the needs of local people.

7. Set up an independent body that is accountable to local government, not Whitehall, to manage equalisation.

Using an independent body to manage distribution would increase the scope for transparency and challenge, while providing more credibility to equalisation decisions.

8. Allow councils to manage equalization within a sub-national pool should they so wish.

Pooling seems the best way to manage both equalisation and the risk of fluctuations in how much business rate is collected. However, pools may be more effective if they operate at a sub-national level, likely corresponding with the real economic geography of an area.

9. Review the underlying balance of needs and resources periodically.

The sustainability of the whole local government finance system relies on ensuring that every authority's resources are sufficient to meet the needs of local communities. Both spending pressures and resources can change over time, and need to be reviewed periodically so that balance is maintained.

10. Operate within the context of a more diversified local tax base.

Business rates are just one component of the funding mix for councils. True localisation would allow councils to diversify their local tax base and develop the package of taxes, charges and incentives that are right for their areas. The purpose would not be to increase tax levels on businesses or individuals, but to find a more sophisticated balance of local revenue sources for local services. A more buoyant revenue base for councils could, in fact, reduce the pressures on any individual tax mechanism.

Appendix B

OUTLINE RESPONSE TO LGRR CONSULTATION

The Local Government Association supports mechanisms which increase local decision making and accountability. We welcome the open approach that the Government has taken on its consultation about new arrangements for retention of business rates, and the full analysis incorporated in the Government's consultation paper and the accompanying technical papers.

In our publication 'Balance Transfer' we set out ten principles for the design of a reformed local government finance system incorporating business rates retention. These principles underpin our response to the Government's consultation and we believe that they constitute the appropriate framework against which to test decisions taken by Government following the consultation.

We welcome the Government's underlying objectives of putting the business rate under local control and providing clear rewards for authorities that grow business rates income.

We believe that the Government's proposals require modification or further development in a number of key areas if they are to deliver the desired objectives. In particular:

The "set-aside"

1. We recognise the decisions that the Government has taking in Spending Review 2010 but do not consider that it is necessary or desirable that the Treasury, rather than local government, should benefit from any forecast real growth in business rates yield. The benefit of above-inflation growth should be fully available as an incentive to local government.

2. We believe that it would be appropriate for the Government to agree further areas of devolution to local government, particularly in matters related to economic growth, that could be brought within the scope of business rates funding without imposing new financial burdens on local government. That would obviate the need for any "set-aside".

Fairness

3. Moving to a business rates retention scheme is a major change for the sector, affecting around half of non-schools funding. It is therefore vital that the detail of reform is designed very carefully, with further consultation. The current constraints placed around local authorities' resources over the remainder of the spending review period mean that concerns about whether authorities will have sufficient resources to deliver the full range of services that local communities expect to be provided must be fully addressed. It may therefore be preferable at the outset to adopt the more cautious options on the design of

the scheme (for example, measuring growth by averaging over more than one year) rather than potentially more volatile alternatives.

Risk management

4. Proper risk management is an important part of the overall design of the new scheme. The arrangements for risk management within the business rates retention scheme need to be developed in much greater detail before authorities can have full confidence in planning for the transition to the new scheme. The Government should, in working up the detailed design of the reform, ensure that risk management issues will be the subject of much more in-depth analysis and consultation. The Government should also stand ready to transition the full financial risk of the scheme to the sector gradually, over a period of years, if that appears desirable.

5. To mitigate the risk of authorities' resources diverging substantially from what is required to deliver services, the Government should maintain the capacity and evidence base for the assessment of needs, and any decision to invoke a reset of the system should be capable of being triggered by the local government sector on the basis of evidence.

Incentives

6. Financial incentives for local authorities under the business rates retention scheme need to be clear and straightforward. The Government should test whether alternative ways of presenting its proposals exist that might be expected to deliver broadly comparable results but which can be expressed in simpler and clearer ways.