

NLGN Response to the Local Government Resource Review: Proposals for Business Rates Retention Consultation

The New Local Government Network (NLGN) is an independent, not-for-profit think tank committed to promoting the decentralisation of power from Whitehall, transforming public services, enhancing local governance and empowering local communities. NLGN's unique networks of innovative local authorities and private companies, voluntary, community and public bodies work together with the research division of the organisation to present thought-leadership and innovative research into the future of localism and the ways it can enhance public service delivery and re-vitalise democracy in the UK.

We welcome this timely inquiry into local government finance being carried out by the Department for Communities and Local Government. We are grateful for the opportunity to present our thinking and recommendations.

Executive Summary

Any change to local government finance will have politically difficult 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 recognize the philosophical significance of moving from a system where funding is allocated 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 wealthy areas relative to poorer ones.

While we recognize 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 recognize the potential that the growth incentive presents to stimulate the creation of new private sector jobs and prosperity.¹

The government's technical papers set out a very broad range of options for the new regime. This makes it difficult for us to assess whether or not the rate retention scheme is likely to succeed. It is the detailed design of the scheme that will determine whether its overall impact is to drive growth while providing sufficient protection for the less affluent.

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

In our response to the consultation, we are guided by two principles. The first is that if the government is going to move to a system designed to incentivize business growth, then the system must first and foremost aim to do this. Secondly, we believe that a system of redistribution and equalization remains essential, but that this system should operate outside of the business rate retention scheme. We argue specifically for a mix of set aside funds, a capital pot and lump-sum transfers to areas of lower business rates growth.

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, 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 drastically reduces 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 all 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 support 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.

We have selected the questions from the government's consultation paper which we think we can constructively contribute to. To structure our ideas these will be grouped into seven sections: Setting tariffs and top ups, the incentive effect, levy and safety net, adjusting for revaluation, resetting the system, pooling, interaction with the business rates relief system, tax increment financing. In addition we have included a section on how the retention model fits with the government's deficit reduction plan – this reflects our great concern that the Treasury will top-slice local business rates growth retaining the dividends from the financial incentive provided by the scheme – and an appendix outlining our proposals for an alternative levy schedule.

Setting 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?

NLGN agrees with this component of the proposal. It is important that the government ensures a fair system whereby all local authorities can meet their public service needs at the outset of the scheme; the proposed system of tariffs and top ups ensures this.

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

We favour 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.

The incentive effect

Q5. Do you agree the incentive will work as described?

The business rates retention proposals have the *potential* to incentivise the development of new business premises. At this stage, we find it hard to assess whether the reform will achieve this.

Everything depends on the details of the final legislation. Specifically, how much weight it attaches to providing financial incentives for business growth and ensuring protection for those areas less capable of boosting their business rates tax revenue. Our view, as previously stated, is that the system requires both a strong incentive, plus strong equalisation methods outside the rate retention system.

In addition, 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.

Levy and safety net

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

NLGN believes a levy on disproportionate benefit is necessary to moderate the gearing effect and ensure against any adverse distributional effects and political risks. In addition the political outcome of a levy may be less frequent resets – a moderate levy and an associated safety net could therefore ensure all local authorities' needs are met without undermining the incentive effect (unlike regular re-basing).

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

We favour option three on the basis that it creates the fairest system – it provides a greater incentive for deprived local authorities in the north and dampens the incentive for richer local authorities in the south (who arguably require less of an incentive as they will grow irrespectively).

However, we are concerned that this option would introduce significant complexity and bureaucracy into the system which would risk distorting a simple and transparent financial incentive. This option would also have an unintended effect of benefiting areas that have large formula grant relative to their business rates and experience large business rates growth. We therefore suggest an alternative levy option in Appendix 1.

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

The key danger of the levy is that setting it at too high a rate will discourage growth.

With regards to the size of the levy there exists a key trade-off between strongly incentivising growth and building in protections. A higher marginal levy rate will reduce the incentive to grow business rates and thus is likely to reduce the total levy amount raised to redistribute after a certain point. This logic is analogous to that of the Laffer curve. For this reason, NLGN recommend the government doesn't set the levy rate at a rate which is so high it works to counter the incentive effect. In our appendix we suggest local authorities should be allowed to retain a fixed proportion of the growth (50-70%) in their business rates.

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)?**

NLGN believes that when encouraging growth every effort should be made to ensure that the growth is sustainable. A system which encourages short-termist business expansion and is prone to sharp market down-turns should not be the objective. The functioning of the safety net should work to incentivise councils to encourage business growth that is less volatile and more sustainable, even where this may not yield such high short-term gains.

NLGN therefore prefers 'option ii'. Option i may create a perverse incentive for councils to invest heavily in short term but unsustainable growth, safe in the knowledge that they are insured against a drop-off in subsequent years. For instance, available funding in Year 1 could be invested in encouraging high yield

business such as retail with no effort made to achieved a balanced and sustainable local economy. There may be large gains in the short-term, but without a vibrant local economy the retail sector may fall into decline, reversing the initial growth achieved. Under 'Option I', the council would then be compensated for this decline, which NLGN feels creates an incentive to promote any business growth rather than growth which is genuinely sustainable.

'Option ii' would encourage local authorities to take a more long-term view about business creation, while also retaining a cushion for local authorities where business decline leaves them in a position to fund the same level of services as they were able to in Year 1.

Moreover, we are concerned that the safety net will be designed to mainly respond to business rates volatilities – therefore even though the levy proceeds will be raised in a fair way (option 2 and 3) 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 the safety net should be connected to the gearing effect as well as addressing volatility.

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

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 and may prevent painful but necessary long-term adjustment for some local authorities. In recent years the economy has become more 'unbalanced' in some areas than in others. It is now accepted that a '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. Therefore, this policy should avoid creating a cycle of dependence in local economies. Instead, the policy should focus on helping those economies make the transition to possessing a healthy and buoyant business environment.

It is an underlying theme within this and much other government policy that there is an objective to foster a new culture and mind-set for local councils where they encourage greater innovation, entrepreneurialism and business growth and are able to be more responsive to market conditions. While there must be a level of protection for low growth authorities, it must be recognised that if this tilts the overall balance of the policy towards being redistributory then the policy will not have achieved its objectives.

NLGN recommends that instead of offering strong protections and acting as a cushion, the safety net 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.

In addition to a short-term centralised support mechanism, 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 would a centralised approach.

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?

NLGN supports the option for using the remainder of the levy pot to support capital expenditure in areas of lower growth or target expenditure on projects to unlock growth and prosperity. An example of such a use is a capital fund described further below. This should strengthen the abilities of lower growth local authorities in responding to the financial incentive and will be important in achieving the long term goals and sustainability of the policy.

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

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. We believe 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. There will need to be a selection of publicly transparent options for use of the left over levy proceeds. NLGN recommends the creation of an independent body, similar to the Office of Budgetary Responsibility, to manage the distribution of levy proceeds to increase the transparency and credibility of distribution decisions.

Once the safety net is funded, we suggest that 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 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.

In addition the government could prioritise projects which set out proposals to release money through schemes than can demonstrate the growth-yielding properties, such as potentially Tax Increment Financing. This approach has the advantage of establishing a link between providing assistance and supporting an environment for growth and expansion in business rate bases. Assistance would have to be short-term – to enable the start-up of schemes with considerable growth potential but to avoid long-term state dependency.

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?

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 into infrastructure and public space improvements.

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 – as 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 – since it removes the incentive to invest in services that contribute to improving the business environment. For instance, local councils who 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

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?

NLGN agrees that re-basement is required to ensure that individual local authorities' public service needs are met. However there is insufficient clarity in the government's proposals to enable us to arrive at a firm conclusion in support of any particular policy.

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

The trade-off in the reset decision is between choosing between a system which risks manipulation by local authorities and a system risking manipulation by political cycles. Neither of the options is satisfactory.

Taking all factors into account, NLGN supports a 'rules with discretion' approach. This requires 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. One essential rule would be to prevent government from undertaking a reset less than six months prior to an election.

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.

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

We suggest a period of at least 10 years between resets. A shorter timescale will limit the ability of councils to fund physical infrastructure by borrowing against future business rate increases.

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

A full reset would address distributional concerns but would reduce the financial incentive provided by the business rate retention system, as local councils would only benefit from the business growth in their area between resets.

A partial reset would provide certainty over the time period for which councils benefit from growth in their business rates, maximising the incentive effect. At the same time it would ensure that local authorities are able to satisfy their residents' needs.

For these reasons NLGN supports partial resets over full resets.

Pooling

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

We agree that pools should be voluntary as this is consistent with a decentralised approach to policy and decision-making.

Furthermore, we agree that local authorities in a pool should be subject to assurances around governance and their workability before being recognised by central government as a pool. However measures should be agreed locally rather than imposed from the outside by central government. Local authorities in the pool should be able to demonstrate cooperative methods for deciding how to distribute tariff contributions (or top up entitlements) and levy contributions, and agreeing how income from new business rates growth should be spent. We approve of London Councils' recognition of the need for a local governance structure to manage a London retention model – they suggest “a small administrative body with an equally small independent board to oversee any operations”.

NLGN agrees with the criteria that, if the pool is dissolved, the members of the pool would return to their individual tariff, top up and levy amounts. This ensures that in the event that the pool is unsuccessful or doesn't yield the desired results for a local authority – their long-term financial position isn't damaged or put at risk. Providing the option for local authorities to revert to the original system of local government finance reduces the risk from joining a pool and should encourage experimentation with pooling.

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

NLGN supports the idea of using further incentives for groups of local authorities forming pools. The proposed system requires a significant level of commitment from pooling authorities without creating enough benefits for councils to do so.

We believe in order for there to be pooling of authorities, the process will have to be as straightforward and incentivised 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 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 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 don't 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 during the period of deficit reduction the funds available for this purpose would be limited.

The most natural pooling model would be at the Local Enterprise Partnership (LEP) level – pooling business rates at this level would help support medium to large scale infrastructure investments. A 2010 SQW document studies the priorities for LEPs in creating the right environment for business and growth – adult workforce skills topped the list, followed by the low carbon agenda, transport and inward investment². 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.

Interaction with the business rates relief system

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

NLGN supports the current use of business rates reliefs, but we are concerned the business rates retention policy may create perverse incentives in this area. Business rates are an imperfect indicator of growth and could actually create the wrong incentives. The retention model could create pressures for local councils to grow businesses which generate high rateable income (e.g. power stations, supermarkets, office developments) rather than uses which generate low rateable income (e.g. small businesses, manufacturing, academic research, community and charity uses). This runs the risk of distorting local authority choices in favour of short-term fixes against the interests of local economic and social development in the long-run. At a

² SQW (2010) SQW review of LEP submissions

time when third sector organisations are facing large scale cuts, increases in business rates paid by properties used could have negative effects on individuals supported by those organisations.

We therefore strongly agree that government should include an allowance to cover partial costs of reliefs to ensure that local authorities have sufficient resources to continue to offer this important service.

Tax Increment Financing

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

NLGN prefers option two as it would enable a better fit with the time-horizon of TIF schemes. Option one would necessarily mean re-set periods of 25 years in order to enable TIF schemes, which would have marked distributional consequences.

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

Despite preferring option two, 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 enabling local authorities and developers to take maximum advantage of TIF.

In our appendix we suggest an alternative levy schedule which features a flat rate marginal 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 wouldn't 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.

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

Yes.

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?

We agree. We don't support the option of a central government competition or bidding process as this would create the risk of the policy being driven by self-interest politics. Instead, we support a commercial-venture based approach with selection on the basis of the standard of TIF applications - projects would be granted to local authorities who are more capable of delivering successful results and raising sufficient business rates to service their debts. It is important the government ensures that all TIF projects that go ahead are 'financially robust' – otherwise the public will worry that the government are taking on too much risk where conditions for TIF success may be fewer. We recognise that local authorities with higher need are likely to be those where the conditions for TIF success may be harder to achieve – the approach therefore doesn't necessarily provide opportunities for unlocking growth in lower growth areas. However, we believe need should instead be addressed using an additional capital pot funded by levy proceeds.

Deficit reduction plan

a. The impact of the set aside scheme on the incentive effect

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 therefore 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 AME in 2014-15, predict the set aside to be £3.5 billion.

During the first two years of the scheme we suspect the government will cut 'other' grants (possibly grants within the Aggregate External Finance) and use these additional funds to expand formula grant to ensure all business rates income goes back to local government – this means local government total grant income will remain unchanged. A number of special grants were already rolled into formula grant as part of the 2010 Spending Review – these include Local Transport Services funding, Supporting People funding and Housing Strategy for Older People funding) – and the government has de-ring fenced a number of grants recently which would enable their easy transferral into formula grant. This is possible since set aside funds are fungible and thus freely substitutable with existing grants to local government.

There is a clear conflict here between the aim of incentivising local authorities to drive business growth, and the government's proposal to effectively 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 which has a stronger possibility of resulting in a net gain for the national economy than the existing proposals.

b. The treatment of growth above forecast levels between 2013-2015

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. 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 as it 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.

c. Retaining local government business rates income

NLGN is concerned that the government will use set aside funds in the future to replace previous sources of funding for local government grants – the government has already said the amounts set aside will include funding for the New Homes Bonus. NLGN is strongly against the use of 'set aside funds' in the future and asks 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, as seems likely with the initial set aside funds for 2013-2015.

d. Risks associated with using the business rate retention model to channel further devolution of responsibilities

The government proposals only discuss the functioning of a set aside for the years 2013-15. It is possible that the government will prolong tough expenditure controls and the set aside system – however once all ‘other’ grants are phased out and essentially added to the total formula grant amount, it is possible 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 development. This would create a perverse system where the responsibilities of local government match the funding it raises, rather than the reverse.

Local authority roles would presumably be set on a national basis – rather than shared in accordance with ability to provide or with gains made in business rate growth. This has 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 – in these areas some functions and services would be poorly provided with others possibly not being provided at all.

Although the incentive to generate business rates on the margin isn’t diluted – as local authorities would need to drive business growth to satisfy their ever-expanding functions - the additional dividend associated with any incentive working is captured by central government and local authorities with small tax-bases stand to lose. While NLGN supports more control of functions at a local level, we believe the approach of implementing them within the business rates retention system would provide an unfair deal for local government and may jeopardise the sustainability of the scheme (we believe more responsibilities should be devolved to local government along with additional money to fund the increasing functions). NLGN is concerned that this is a significant risk for local authorities and ask for the government to clarify what additional responsibilities may be conferred to local government and pledge that any responsibilities that are devolved are accompanied by relevant funding derived independently of the business rates retention model.

It is implied that without such 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 there is a fear this places the government’s fiscal position in danger and risks escalating government bond yields and tainting their international reputation as safe investments. We would disagree

with such an analysis – business rates income only accounts for a very small proportion of public expenditure. Allowing local authorities to receive the dividends from additional business rates growth is a trade-off that must be accepted to ensure the sustainability of the scheme and incentivise much needed growth

NLGN proposes the government make a 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 by local government.

Appendix 1 – NLGN’s proposals for an alternative levy schedule

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 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.

The government has outlined three ways in which a levy could be calculated:

- Flat rate marginal levy – NLGN is against this option as it doesn’t fully respond to the effects of gearing.
- Banded levy – NLGN is against this option as it creates cliff edges
- Proportional levy – NLGN is against this approach as it introduces unnecessary complexity into the business rates retention system

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) 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:

$$T^h = -LT^h + tq^hb^h$$

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 .

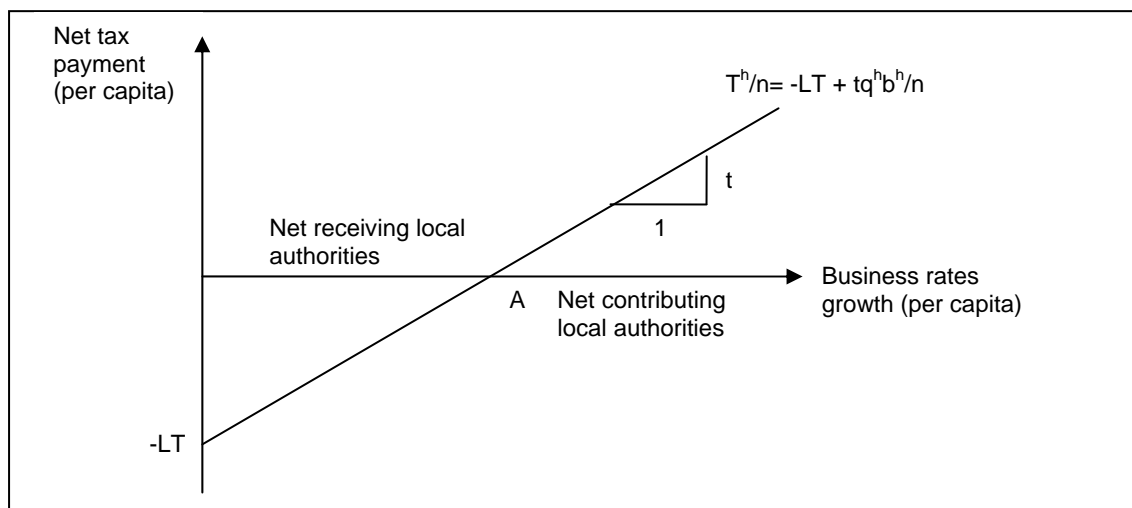
The lump-sum transfer must account for scale and one way of doing this is by multiplying the per capita universal lump sum transfer (LT) by a population factor (n):

$$LT^h = n * LT$$

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. Firstly, the marginal tax – the amount of tax the local authority pays on an extra unit of growth in business rates income – is constant, t , 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.



We are interested in what the optimal values of t and LT are. 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.

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

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 be substantially larger 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 couldn't alter the amount they received via the lump-sum transfer by altering 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.