Local Government Resource Review

Initial consultation by the LGA

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Introduction

In March, the Government published terms of reference for its Local Government Resource Review (LGRR). The purpose of the review is to consider the way in which local authorities are funded, with a view to giving authorities greater financial autonomy and strengthening the incentives to support local economic growth. It also seeks to reduce the reliance of local government on central government funding. It focuses in particular on reforms to the business rate system, including the links with Formula Grant.

The Local Government Association (LGA) has consistently called for business rates to be re-localised, and we welcome the review. The review could not be more topical. Councils currently face very large cuts in formula grant, imposed by central government. They are wrestling with the challenges of implementing those cuts while trying to protect frontline services. They face criticism of what they are doing not only from lobby groups and local political opponents, but also from some of the very ministers who imposed the cuts in the first place. Moreover – because the formula grant is financed by local business rate income that is forecast to grow even as grant falls – the Government plans to hold back centrally billions of pounds in local business rate income in order to impose the grant cuts. Business rate localisation is the obvious way to stop this situation happening again.

Re-localisation is not straightforward because the way business rates currently fund local government spending is complex and highly technical; business rate income currently funds a significant proportion of formula grant, and therefore reforming business rates would inevitably require changes to the formula grant system. As a result there is significant but unpredictable potential for very different effects on councils in different circumstances. Yet the broad issues raised by the review are of fundamental importance to how councils are funded. Our ability to work through them as a sector is central to the goals of achieving greater financial independence for councils and demonstrating our capacity to manage our own affairs.

The LGA intends submitting a response to the review by early July. Our objective is to develop specific, agreed proposals on behalf of the sector, which will concentrate on principles rather than on issues which could have a distributional impact.

This strategic discussion paper highlights the main issues to be resolved if the business rate system is to be reformed, and is intended to seek the views of a non-technical audience on the important principles at stake. It is supplemented by a more detailed paper looking at a possible model of relocalised business rates and the technical challenges associated with relocalisation of business rates.

This paper is structured into the following sections:

- the current system and key challenges
- relocalising business rates
- incentivising through reform.

Responses are requested by 20 May 2011, and should be sent to lgfinance@local.gov.uk.

Alongside this consultation, the LGA will also be working with finance advisers to further explore how reform could be implemented.

The current situation and key challenges

Business rates are one of two main sources of finance for local government, but remain almost entirely outside the control of local authorities. By law, all business rates collected by councils must be paid into a central pool, which is then redistributed to all authorities as part of formula grant. Formula Grant is calculated in line with a model which broadly:

- assesses individual authorities' relative needs
- assesses individual authorities' relative resources (eg, local council tax revenue)
- equalises these to identify the appropriate level of Formula Grant funding for each authority, ensuring every authority has a minimum floor funding increase.

The details of the model are decided by ministers, as is the proportion of the pool which is made available for distribution each year. Since the business rate system is so closely linked to formula grant allocation, it therefore follows that any review of business rates must also entail consideration of changes to the formula grant model.

Problems with the current model

The LGA, on behalf of councils, has consistently criticised the current system.

There are objections of principle:

- every single council, however strong its local resource base, is financially – and therefore politically – dependent on the government
- because the maximum increase of business rates is tied to the RPI index and revaluation is carried out to a constant yield, the proportion of local government income represented by business rates has fallen by a quarter since 1993
- councils have almost no control or influence over their income
- the system eliminates any financial link between councils' funding and local economic performance (indeed, some argue, it makes councils indifferent to the state of their local economies).

and of process:

- the formula grant system is highly opaque
- the detailed elements of the formula rest on the very contestable assumption that they genuinely model councils' 'need to spend'
- some statutory services are represented in the formulas by measures that are only very tenuously linked to the service, if at all.

Finally, since business rates are part of formula grant, councils normally can't borrow against future business rates income or take it into account in the prudential borrowing assessment. This is relevant to proposals to introduce Tax Increment Financing, where councils would be able to borrow against a future uplift in their business rates base in particular defined areas.

What the current system does achieve is:

- a thoroughgoing redistribution of business rate income between councils
- a measure of stability in resources from one year to the next, with changes to grant allocations limited through a damping mechanism and
- a measure of certainty for authorities because government, rather than local authorities, manages the risks of forecasting error on business rates yield, and of mismatches between the growth in resources allocated to local government and the growth in business rates[1].

1 These risks are significant: the Treasury currently allocates around £0.5bn a year to cover the forecasting risk, and government has in the past run a deficit of up to £2bn representing the difference between what has been raised in business rates and what has been distributed from the business rates pool.

Key challenges

Local authorities have long called for reform of the formula grant model, and for relocalisation of business rates. At a strategic level, the main issues to be resolved are:

- how, in a relocalised system, to manage any mismatches between business rate yield and the council spending it needs to finance in different parts of the country
- how to manage the risk that, over the medium term, business rates growth could be significantly different from the growth in an authority's wish to spend
- how to manage short-term local fluctuations in business rates and economic volatility without the insurance of the present pooling system and
- how to manage the transition from the present system to a radically different future system without creating significant instability.

Our accompanying paper looks in more detail at some of the technical issues this involves.

The short timescales for the review, which is due to conclude by July, makes finding ways forward on these issues all the more challenging: but the Government is clearly minded to implement reforms in 2013-14. Therefore we need to be clear on our key priorities for reform, as well as what a successful outcome would look like.

This suggests that it will be particularly helpful to focus on the principles that must underpin reform of the current system, and to test whether we can find consensus on those across the local government sector.

Principles for reform

We take as given the principles that the Government has already set for reform, namely:

1. making authorities less dependent on central government and its decisions about their funding
2. restoring the link between councils' finances and the prosperity of businesses in their local economies by allowing authorities to retain business rates income.

Alongside those principles, we think that the following ones are likely to be particularly important to councils:

3. a clear mechanism for ensuring that resources available to each council keep pace with the costs it incurs in providing services[2]
4. a mechanism (for example a pooling system) to assist authorities manage risks of fluctuation in business rates yield
5. an approach which allows for a manageable and practical transition from the present system.

Key questions

Question 1: Do you agree with this analysis of the current position?

Question 2: What principles should underpin a reformed system of business rates?

Question 3: Which key features, either of the current system or of a reformed local government finance system, are most important to you?

2 This principle is reflected in the European Charter of Local Self-Government, which requires that local authorities are given a sufficiently diversified and buoyant base of revenue systems to achieve the desired objective.

Identifying need and relocalising business rates

Local authorities generate hugely varying business rate revenue. If business rates were simply re-localised, some authorities would enjoy a large surplus of local revenue compared to existing budgeted expenditure, but others a significant shortfall; some would be roughly balanced; and some authorities, of course, do not currently set or collect business rates at all. The LGRR terms of reference make clear that any model of re-localisation would need to ensure that all authorities were adequately resourced. Therefore, it is suggested that a process of resource redistribution would still need to take place.

Looking at how a model of resource equalisation might be designed, in the light of the principles for reform discussed above, a practical approach might involve the following:

1. starting from something like the present allocations of Formula Grant (possibly excluding the Police Grant element), with resource equalisation based broadly on current differences between business rates yield and formula grant
2. keeping track of needs and available resources, not necessarily on an annual basis, by means of an assessment methodology that was either (a) owned by councils through the LGA on behalf of local government or (b) owned by an independent body acting at arms length from the LGA, but whose membership was appointed by councils through the LGA
3. providing opportunities for the collective management of risk of short-term fluctuations in business rates yield by pooling resources amongst groups of authorities associated by common local economic geography.

Key questions

Question 4: Do you agree that a reformed local government finance system needs to continue to assess authorities' needs and available resources, in order for an equalisation system to operate?

Question 5: How do you think local needs and available resources should be assessed, and by whom? Are you in favour of a 'sector owned' approach, with or without an independent body to assist with that?

Question 6: Do you think that your authority would wish to join with others in collective arrangements to manage fluctuations in business rates yield? If so, how would you envisage those arrangements operating, and at what geographic level?

Incentivising through reform

The Government's aim in exploring the relocalisation of business rates is to create an incentive mechanism whereby retaining local revenue would give councils a clear financial incentive to promote economic growth. Consideration therefore needs to be given to how growth in business rate receipts would be managed in a system that combined local retention with some level of equalisation.

Giving councils greater control over business rates income raises significant issues about how the relationship is developed between local authorities and the businesses that pay business rates. In a localised system, there is scope for authorities to promote growth through introducing local variations on business rates and discounts. This could include the ability to vary the business rates multiplier locally. It might also be appropriate to consider whether revaluation could be undertaken locally rather than nationally.

Government has already indicated its support for a number of different incentive mechanisms linked to investing in and promoting growth, including Tax Incremental Financing measures, whereby authorities are able to borrow against growth in business rates revenue in specified areas over a specific time period, usually 25 years. Budget 2011 announced the creation of 11 new Urban Enterprise Zones, where councils will be able to offer substantial discounts to businesses as well as retaining business rate revenue for investment purposes.

Consideration is needed of how TIF / UEZ frameworks would sit with a new model of business rates. In relation to council tax, the New Homes Bonus is being funded by top-slice formula grant, with allocation determined by changes to the council tax base from new and modified homes. There is therefore a key relationship between the New Homes Bonus and the relocalised business rates that constitute the source of funding for that.

It has also been suggested that there is a need to consider more explicit accountability of councils to local businesses in the context of localisation of the business rate system.

Finally, it is worth recalling that, when the 2010 Spending Review determined the overall levels of grant to be allocated to local authorities for the four years to 2014-15, LGA research suggested that it was highly likely that by the end of the period the revenue from business rates would exceed the spending total set by the government. Any incentive effect of a new system would clearly be very rapidly discredited if the government retained an unfettered power to limit the benefit local authorities took from growing business rates, for example by imposing unfunded new burdens or by cutting back on specific grant funding.

Key questions

Question 7: What reforms do you think are necessary to ensure that local government, working with business, maximises the public benefit from a new incentive to promote growth through business rates relocalisation?

Question 8: What flexibilities would you like to see around local authorities' ability to vary the business rates multiplier, amend discounts and reliefs or adopt a localised rather than a nationalised approach to revaluation?

Question 9: How important to your authority is the opportunity to use TIF. How should a TIF / UEZ system operate if business rate revenue is re-localised?

Question 10: How do you think that the funding arrangements for the New Homes Bonus should be changed to interact with a system of business rates relocalisation?

Question 11: More generally, how do you think the way in which government funds local authority spending by specific grants needs to change in order to ensure that the incentive effect from business rates relocalisation is not destroyed or weakened by the imposition of overall spending controls?

Other potential sources of revenue

This paper has focussed on localisation of the business rate because it is clear that ministers wish the LGRR to focus on that issue. In the past, however, many councils have expressed an interest in also developing a more diversified local tax base. The advantages of a more diversified tax base are not necessarily to do with increasing councils' ability to raise revenue, although that is one obvious potential effect. A more diversified – and therefore broader – tax base may also play a role in helping to provide stability and reduce councils' exposure to revenue shocks.

The local tax base might be diversified either by adding new taxes to the local resource base, or by devolving the revenue from specific national taxes which have a link to locally-driven issues such as the value of land and property or sales and registrations.

Key questions

Question 12: Is there still a worthwhile debate to be had about diversifying the local tax base?

Question 13: If so, which taxes should be part of that debate and why?

Annex: Terms of Reference

Local Government Resource Review: Terms Of Reference

Phase 1
The first phase of the review will consider the way in which local authorities are funded, with a view to giving local authorities greater financial autonomy and strengthening the incentives to support growth in the private sector and regeneration of local economies.

It will look at ways to reduce the reliance of local government on central government funding, increase local accountability and ensure that the benefits of economic growth are reflected in the resources authorities have.

The review will include consideration of changes to the business rates system, and focus in particular on:

a) the optimum model for incentivising local authorities to promote growth by retaining business rates, whilst ensuring that all authorities have adequate resources to meet the needs of their communities and to deliver the commitments set out in the Spending Review

b) the extent to which these proposals can set local authorities free from dependency on central funding

c) considering how to fund authorities where locally raised funding would be insufficient to meet budget requirements and control council tax levels, as well as councils who do not collect business rates, such as upper tier authorities, recognising that some parts of the country are currently more dependent on government funding

d) reviewing the scope for greater transparency and localisation of the equalisation process

e) the position of councils whose business rate yield would be significantly higher than their current spending

f) how to ensure appropriate protections are in place for business, within a framework of devolving power to the lowest level possible

g) how to deliver Tax Increment Financing proposals against a context of greater retention of business rate revenues

h) how various aspects of the business rate system, including business rate revaluation and reliefs, should be treated

i) examining the scope for further financial freedoms for local authorities, while standing up for and protecting the interests of local taxpayers, and

j) the wider implications of rates retention for related policies, including the work of the Commission on the Funding of Care and Support and the Government's other incentive schemes (the New Homes Bonus and the commitment to allow communities to keep the business rates for renewable energy projects).

The Review will take account of the responses made to the questions in 'Local growth: realising every place's potential'. It will also conduct extensive engagement with interested parties, including businesses of all sizes, to ensure that all views and perspectives are taken into account.

Following the announcements at the Spending Review and through introduction of the Welfare Reform Bill that Government will localise Council Tax Benefit, the Review will also consider the design of the new scheme (to be launched in 2013-14) and what flexibilities local authorities should have to help keep overall council tax levels down.

The first phase of the review will conclude by July 2011, followed by the necessary steps to implement the concluded reforms.

Phase 2

The second phase of the LGRR will commence in April 2011 and will focus on Community Budgets. It will be taken forward in parallel with the continued roll out of these Budgets. Detailed Terms of Reference will be published shortly.

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