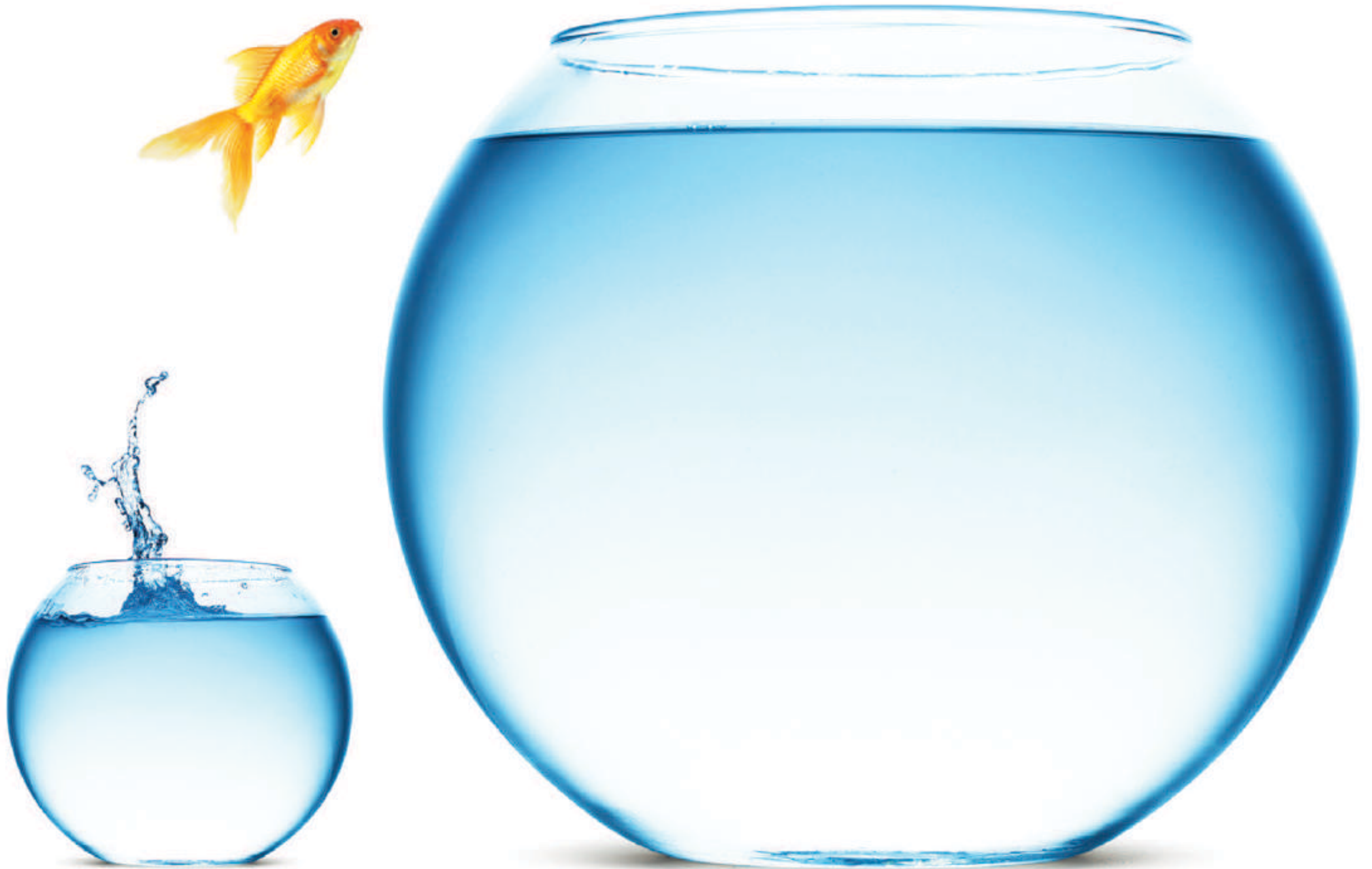

The Rate Escape

Freeing local government to drive economic growth

Tom Shakespeare and Tom Simpson
Edited by Alex Thomson

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Foreword by Sir Michael Lyons

After debate stretching at least 35 years, it can only be the most optimistic who are confident that we are at last ready to seriously address the nagging issues of how we fund local services; incentivise good government and clarify just which set of elected representatives is responsible for what. Having said that, the current signs might be promising. The Minister for Local Government, Greg Clark, promises the "new constitutional settlement" between central and local government that I called for at the end of my Inquiry in 2007 and there is serious discussion about a power of general competence for Local Authorities, Tax Increment Funding and the general case that Councils should enjoy greater freedom to raise more of their own revenue.

It is against this background that Localis publishes its thoughtful report "The Rate Escape" and introduces the suggestion that Councils should be able to buy their way out of the Formula Grant on a negotiated basis for an initial period of between three and five years, and should then benefit from the net difference from the business rates they are able to collect over the same period. After briefly reviewing the history of the debate, the case for reform and the competing options, the authors focus on the importance of the NNDR - the business rate, and establish seven tests against which possible reforms might be judged. Their emphasis on ensuring an adequate incentive effect and leaving real scope for councils to enjoy a higher degree of self determination are amongst the most important, but the reflection of the fact that any change to the system must be of benefit to all parties, including the Treasury, reflects a pragmatic approach that I particularly welcome.

This paper begins from a very similar starting point to my own work; recognising that whilst there are strong cases for improved local accountability and better tailoring of local services and expenditures to local preferences, the most pressing case for reform is the need to break down an emerging dependency culture and to provide real incentives for councils to play their potentially important role in economic growth and diversity. An argument which is likely to appeal to the current Coalition Government as they draw together a growth strategy to underpin their ambition to reshape the national economy and reduce its dependence on public expenditure.

A second strength of the Localis approach is, for me, the care they have taken to try to identify some way into the Gordian knot which frustrates so much of this debate. Over a number of years of increasing centralisation we have created a system of local government funding which, in part, harmonises resource availability between different communities; protects councils from wide swings in

income (which have marked the US system over recent years) and offers comfort to tax payers (domestic and business) that they will be protected by Government oversight. Although many can see the downsides of this constipated system with its notable lack of incentives for promoting real economic growth and poor alignment with the aspirations of local people, they are understandably discouraged by the political risks of change. My own conclusions underlined the importance of a "mosaic of changes" undertaken across the lives of more than one Government to build public confidence and to create the space for more radical change. The proposals revealed here are designed to emphasise the local choice to opt out and leave the remaining system unchanged for those who choose not to, thereby minimising opposition to the experiment. Of course, that could not continue forever and it is perhaps the dynamic aspects of this approach that most need further thought and debate. Could any but the most favoured localities expect to achieve adequate growth over the next five years to justify the opt out? How long could current equalisation arrangements continue if the fastest growing areas systematically opt out?

Nonetheless, these ideas deserve careful thought and debate and may well offer another part of the mosaic I was hoping for.

Sir Michael Lyons,
Birmingham, March 2011

Executive Summary

The Problem

In local government, money is power. The process of centralisation that took hold of central-local relations in England during the twentieth century was as much about the steady removal of local authorities' financial autonomy as structural reorganisations and centrally imposed standards. With their capacity to control their own income streams persistently eroded and revenue from central government coming with increasingly stringent spending priorities attached, councils lost some of the advantages they previously enjoyed – especially clear accountability to their residents and responsiveness to local needs.

Major issues with local government funding have been identified by a number of independent reviews since the 1970s. The tensions highlighted by Sir Frank Layfield, who chaired the first of these reviews in 1976, are even more pertinent today: central control over funding generates a disparity between councils' accountability to residents and their severely curtailed power to influence local services. Layfield's conclusion that "the only way to sustain a vital local democracy is to enlarge the share of local taxation in total local revenue and thereby make councillors more directly accountable to local electorates for their expenditure and taxation decisions" was broadly echoed in the recent Lyons Report on local government and forms a key basis for this report.

The current system of local government finance satisfies only two small groups: controlling individuals in central government who think they know what is best for communities across England, and believe these priorities can be met through convoluted and fluctuating financial redistribution; and the few council officers who have become so accustomed to central hand-outs that they have lost all confidence in their ability to manage even a modicum of financial risk. The vast majority of councils are straining to throw off centrally imposed constraints and once again be given the freedom to innovate and guide economic development in their areas. A Localis survey of local authority Chief Executives and Leaders which was carried out while researching this project showed that 99.5% agree that councils should be given greater financial autonomy.

A key facet of the problematic system is National Non-Domestic Rates (NNDR), commonly known as 'business rates'. Since their nationalisation in 1990, business rates have been collected locally but passed up to a national pool from which they are redistributed, with a top-up, through the Formula Grant system. The Formula Grant is immensely complex and subject to central government interference to ensure that specific, centrally determined areas (both geographical areas and areas of service provisions) are favoured. Moreover, nationalised business rates have left council tax and local charges and fees as the only revenue streams over which local authorities have any control. This has hampered councils' ability to raise additional revenue for projects to benefit

their local residents, and has created confusion over accountability for local services.

Nationalised business rates have also removed the incentive for councils to undertake innovative measures to lead economic development in their areas. At this time of fiscal unease, successful, locally rooted growth programmes are more important than ever. We cannot afford to carry on with local government, which should be one of the most powerful drivers of economic growth and development, having no explicit stake in the success of the economy in local areas.

The Vision

Challenging times demand radical responses – and for the local government finance system inaction is no longer an option. The funding tug-of-war between central and local government has been won by Whitehall for too long and needs to be radically reversed. We are adamant that councils should raise and control of a much larger proportion of the money they spend directly from their locality. Our long-term vision is for all councils to be entirely self-funded from a basket of locally derived income streams with minimal adjustments to take account of inequality of need. This will create a fair and transparent system for all local authorities, freeing them to be the engines of innovation and growth they ought to be, and will enabling the local electorate to once again hold councillors to account for their tax and spend decisions.

So how to achieve this change? The 'big-bang' approach, as advocated by Simon Jenkins in his seminal Localis report 'Big Bang Localism',[1] is certainly the most attractive way to achieve long-term systemic reform and deal with the multitude of issues and competing requirements in one go. But, as the Lyons Report made clear, such large-scale structural reform is not a trivial task. The competing demands of different councils, business and central government mean that there are many thorny decisions to make. And, given that any fundamental reform of the system will involve a significant period of consultation even before the legislative process could begin, to say nothing of the complex implementational questions about process and long term sustainability that will need resolving, it is clear that getting it right won't be quick. However, the parlous state of the national economy means there is a pressing need for more immediate measures that will provide councils with a real incentive to boost economic growth at the local level.

In this report we aim to show how an implementable but radical reform to allow local authorities to retain business rates at the local level will create significant new incentives that will help drive the economy forward, as well as providing a platform for a full-scale localist shift in the near future.

The Solution

Local government finance is frequently deemed too deeply ingrained and complex to change. This report goes against the prevailing orthodoxy – Layfield and Lyons excepted – that the existing system is intractable. Instead we contend that the introduction of a radical but widely acceptable option is required to liberate councils to fulfil their role as economic 'place-shapers' in their areas and to begin the process of returning financial autonomy to local government. It is clear that the few existing incentives for successful financial innovation, such as the Local Authority Business Growth Incentive (LABGI) scheme, are wholly inadequate and merely illustrate central government's stranglehold on councils' finances.

1 S. Jenkins, *Big Bang Localism: A Rescue Plan for British Democracy* (Localis & Policy Exchange: London, 2004).

This report evaluates the potential of a variety of possible reforms to address this problem. We consider the possibility of localising existing national taxes or creating new local taxes, and agree that such options be made available to councils as soon as possible. However, we make clear that in the short-term business rates (which in 2010/11 constituted almost two-thirds of the total formula grant – a proportion which, as projected in section 5.4, will increase rapidly as the Government's cuts to the formula grant are implemented and business rates income grows) are the most suitable aspect of the system with which to begin thoroughgoing reform of local government finance. Business rates not only constitute a significant portion of local authorities' revenue; they are currently collected by councils and are inherently linked to councils' success in fulfilling their vital function of promoting economic development. Furthermore, unlike many grants to local authorities which were innovated by central government to fund aspects of the welfare state, rates were, originally local taxes raised to fund specific local services.

Against this backdrop, the Government's expressed commitment to examine ways to enable local authorities to retain business rates is undoubtedly welcome. But questions remain over how exactly this should be done. Full localisation – that is, returning complete control over business rates, including rate setting, to local authorities, with no element of central involvement – would certainly suit those authorities which are currently large net contributors to the national pool. However, it has significant disadvantages, not least that those authorities which are currently large net beneficiaries of business rates redistribution would experience a devastating reduction to their funding. Another option is the Business Increase Bonus (BIB) already outlined by the Government. This allows councils to keep a proportion of any growth in a tax base over a fixed timeframe, and is undoubtedly an improvement on LABGI. However, it perpetuates the major shortcoming of only offering a small degree of financial autonomy. Another potential option – the local retention of a portion of business rates – suffers from the same drawbacks of offering only a limited incentive and a minimal increase in financial autonomy.

To assess the relative merits of the various models for reforming business rates we employ seven policy evaluation criteria:

1. **It provides a larger incentive than existing initiatives** – The extent to which councils are rewarded for doing beneficial things for their local area
2. **It provides councils with a greater degree of financial self-determination** – The degree to which councils are able to influence their own financial position through effective economic management
3. **It provides a fair incentive for all councils** – The extent to which the risk and reward are aligned for every council
4. **It retains equity** – Whether the principle of redistribution is maintained in some form
5. **It is voluntary** – The feasibility of making the system voluntary, with a particular focus on ensuring that the benefits are sufficiently attractive for everybody
6. **It is implementable** – The feasibility of implementation, including political, cultural or legislative barriers
7. **It is likely to benefit the national economy** – The extent to which the model will demonstrably benefit the country as a whole

The Buy-Out Model

Only one option successfully addresses all of these criteria: we have termed it the 'Buy-Out Model'. The Model allows councils the option of buying themselves out of the annual redistribution of the formula grant until the following business

rates revaluation. It will enable those that buy out to keep all of the business rates collected locally. Its key processes are as follows:

- Councils will be allowed to buy out of the formula grant on a voluntary basis for an initial period of three years and for five year periods from 2015
- Every council will have the option to buy out, even those who are net beneficiaries of the current system
- The buy-out will be individually determined for each local authority based on its particular circumstances, and is primarily based on its projected net contribution to the national pool during each year of the buy-out period assuming a normal level of business rate revenue growth
- The buy-out for net contributor councils can take the form of an up-front lump sum (requiring a loan or use of reserves), or can be done on a year-by-year cash-flow basis

It must be emphasised that the model does not change the way that business rates are set – with five-yearly revaluations and a national non-domestic rates multiplier – which will mitigate against the possibility of tension between councils and businesses over rates increases.

The Impact

The Buy-Out Model has a number of important advantages over other potential options. Unlike full relocalisation of business rates, this scheme does not remove current net beneficiaries from business rates redistribution. The model acknowledges that areas have differing needs and different underlying circumstances which help or hinder economic development and are beyond the control of local authorities, and therefore retains the principle of redistribution. We do not, however, see redistribution and proper incentives for economic development as mutually exclusive. Compared with reward schemes such as LABGI and BIB, the Buy-Out Model offers a considerably more substantial incentive for local authorities to focus on promoting robust economic development. As they will no longer be trapped in the formula grant system, local authorities which take the option of buying out have much greater responsibility for development in their area, much greater rewards for successfully promoting development, and much greater freedom to channel their business rates revenue towards local priorities (including further economic development). In short, the Buy-Out Model will empower local authorities and align financial freedoms with clear responsibility and accountability to local residents and businesses.

Buying out of the formula grant will, of course, entail local authorities bearing additional risk. Taking on such risk is the natural by-product of the freedoms they will receive and the additional rewards that these freedoms will afford. Full Government insurance against the impact of any reduction in the business rates revenue collected by a local authority would be problematic for a number of reasons, not least that it would create moral hazard.[2] Being exposed to greater risk implies that, on occasion, councils' business rates revenue will drop relative to what they would receive through the existing system. The buy-out itself has the advantage of creating certainty about the annual amount that local authorities will give to or receive from central government, as this amount is agreed upon during the consultation. This is an advantage for individual local authorities compared with their current reliance on revenue from the excessively complex formula grant, income from which can vary significantly from year to year (as shown in section 5.3, in recent years grant has fluctuated more year-on-year than business rates revenue has). And as the local government finance

2 'Moral hazard' describes the problems of separating risk from reward, especially the encouragement that this provides to the body that has reward without risk to act less carefully than if it is fully exposed to risk.

settlement for 2011/12 and 2012/13 indicated, receiving redistributed business rates as part of the formula grant does not immunise local authorities from drops in revenue in adverse economic circumstances.

Furthermore, taking on risk and responsibility will have the benefit of ensuring that local authorities will seek to promote economic development in the way they feel is best for their local area – a genuinely localist solution. For most, it will probably mean promoting a stable, thriving and diverse business base which has high capacity to dampen volatility. The model does include the provision of an emergency fund for shocks to the local economy that are clearly beyond the control of local authorities and which cause a slump in business rates income that would severely impact on essential services for local residents. But it must be emphasised that this will only be called upon in extreme circumstances, and its use will be heavily restricted.

The Buy-Out Model will go a long way towards solving the problem identified by Sir Frank Layfield and Sir Michael Lyons of the separation of responsibility and financial powers in local government. The current system will be greatly simplified. Councils will have more scope to innovate as they will enjoy greater control over their revenue, and will have clearer responsibility to businesses. We confidently expect that the result of this will be overwhelmingly positive. Almost all of the councils we spoke to during the extensive consultation for this project emphasised their role in local economic development, and said they are eager to be given a much freer rein to shape their areas. The Buy-Out Model combines autonomy with redistribution in such a way that councils will have considerably enhanced autonomy without being unfairly rewarded or punished for elements influencing economic development which are obviously beyond their control.

In addition, the model will have clear benefits on a national scale, as the reform will incentivise and empower local authorities to drive economic growth at the local level, which will feed into the national picture. This is even more important currently, when generating national economic growth is the number one issue facing the Government. The model should also assist the development of a rebalanced economy both in geographical terms and through providing support to private sector companies picking up the slack left by funding reductions to the public sector

The Buy-Out Model will link effectively with other financial instruments which empower local authorities. For example, Tax Increment Financing (TIF), which has strong backing from the Government and involves using projected future tax gains to act as the collateral on borrowing to finance redevelopment and infrastructure projects, would be greatly assisted by the local retention of business rates. Councils with full control over business rates revenue will be in a much stronger position make confident predictions of their business rates income, and therefore able to make more effective use of their TIF capabilities. The existing Business Improvement Districts scheme and recently introduced Local Enterprise Partnerships (LEPs) will also work well in conjunction with the 'Buy-Out Model', especially since both provide even greater incentives for local businesses and councils to work closely together. We are of the opinion that options to give local authorities much broader autonomy to raise local taxes could be considered in the near future.

This report shows that the Buy-Out Model is a realistic starting point for reform of local government finance, and the most effective mechanism for allowing local retention of business rates without unfairly disadvantaging some local

authorities. It will empower councils to undertake schemes that benefit the residents and businesses in their area, and it will help to foster a more robust and clearly accountable system of local democracy. In the future, further financial freedoms for councils could enhance these positive effects even more. We believe that the local retention of business rates not is not the end goal in itself, but the beginning of the process of giving local government genuine financial autonomy.

Structure and Methodology

Much of the fatalism towards local government finance – the belief that it cannot be changed – is predicated on the lack of understanding as to how the current system has evolved. The report therefore begins by examining the historical evolution of local government finance (Chapter 1), before setting out the key problems with the lack of autonomy in the existing system (Chapter 2). We then evaluate a number of potential options to increase financial autonomy for local authorities, and set out the case for prioritising the reform of business rates (Chapter 3). We set out councils' role in economic development and discuss the shortcomings of existing business rates incentive schemes (Chapter 4). Having built up the case for change, we then examine various options for reforming business rates and make the argument that the 'Buy-Out Model' is an effective and realistic reform to the business rates system (Chapter 5). Finally, we look at how the proposed model can link with other initiatives, and conclude with further recommendations to financially empower local authorities (Chapter 6).

The appendices include details of the current business rates system and numerical case studies projecting examples of how the Buy-Out Model might work for local authorities. They also contain the responses to a survey that we sent to the Chief Executives and Leaders of all local authorities in England. We received over 200 survey responses, and results from the survey are included at various points within the report as well as being detailed in full in Appendix 4.

A primary concern throughout this project has been to follow Sir Michael Lyons in seeking to construct a practically implementable model which will have support among the key stakeholders in the reform of business rates: central government (specifically, the Department for Communities and Local Government and HM Treasury); local authorities from across the geographical and political spectrum; and businesses. We have, therefore, consulted widely with representatives all of these groups, especially Leaders, Chief Executives and Chief Financial Officers at various local authorities. Their experiences and suggestions have shaped the model that we propose in this report. Greater local financial freedom has the potential to be a positive thing for all councils and their residents and businesses, regardless of economic base, political affiliation and geographical location. The Buy-Out Model has been designed, with the input of local authorities, to achieve this aim.

1. A Brief History of Local Government Finance in England

1.1 The Development of Local Government to its 'Heyday'

Since the United Kingdom lacks a codified constitution and its system of government has evolved through gradual and piecemeal processes, any attempt to understand the current tensions in local government financing in England must begin by outlining the historical development of local government and its financial structures. As one leading local government academic has put it, "The nature of local government has been shaped by its history".[3]

The developments of a true system of local government over the past 200 years have been marked by the emergence of a more interventionist form of central government. The 1835 Municipal Corporations Act, through creating 78 elected local authorities,[4] overhauled the local institutions which had been established in *ad hoc* and often overlapping fashion over the preceding seven centuries and were failing to meet the demands of an industrialising and urbanising country. The 1835 Act marked the beginning of a long period, up to the present day, which has featured central government's gradual but persistent appropriation of previously locally held functions and powers.

The expansion of central government's functions from the early nineteenth century onwards was inextricably connected with central involvement in funding services which had previously been locally financed. Prior to 1835, all revenue for local bodies was raised locally through a variety of taxes created to directly fund specific bodies.[5] The Municipal Corporations Act and contemporaneous reform of the Poor Law system introduced centrally controlled funding for a series of centrally controlled bodies to administer various services, including the Poor Law workhouses, education and highways.[6] The decades that followed saw the steady growth of central grants relative to the quantity of locally raised funds. The range of functions towards which central grants were directed expanded from initial limited foci on infrastructure, sanitation and public discipline to embrace aspects of "nearly all major local government services" by the turn of the twentieth century.[7]

Although the roots of centralisation reach back into the nineteenth century – back, in fact, to the very beginnings of local government as a formalised system in 1835 – the popular characterisation of the Victorian era as a 'golden age' for strong, adaptive local government in England is well-founded, especially when viewed in the light of subsequent developments during the twentieth

3 J. Stewart, *The Nature of British Local Government* (London: Macmillan, 2000), p.15.

4 D. Wilson & C. Game, *Local Government in the United Kingdom*, 4th Edition (Basingstoke: Palgrave Macmillan, 2006), p.51

5 T. Travers & L. Esposito, *The Decline and Fall of Local Democracy: A History of Local Government Finance* (London: Policy Exchange, 2003), p.19.

6 Wilson & Game, *Local Government*, p.51.

7 Travers & Esposito, *Decline and Fall*, p.23.

century. With good reason, Joseph Chamberlain's leadership in Birmingham during the 1870s has often been cited as a paragon of the powers facilitated by local authorities' financial freedoms at this time. Through innovatively using these freedoms to enable the council to provide local utilities, Chamberlain pioneered and funded a range of locally funded services and played a leading role in fashioning a robust civic identity.[8]

During this era, local authorities enjoyed the ability to undertake their own initiatives in all areas not covered by central government, which until the early or perhaps even mid-twentieth century, primarily directed its gaze outwards to imperial and European concerns rather than inwards to domestic issues. Especially in urban areas, where rapid development presented challenges and opened up opportunities for local government, municipal authorities had a wide, and largely self-defined, set of functions. Councils typically involved themselves in a range of activities ranging from the unsavoury but necessary – sanitation and public health – to the cerebral and idealistic, creating libraries and standing at the vanguard of local identity. As one historian recently commented of the mid-Victorian period, "Cities became known not just by the activities of their businesses or the culture of their civil society, but also by the reforms and rhetoric of their councils".[9]

1.2 Power Shifts During the Mid-Twentieth Century

The first significant checks from the centre on local authorities' policymaking and financial autonomy came with the 1929 Local Government Act. Its primary aims were to incorporate the increasingly outmoded Poor Law structures into councils (which would be fully completed only with the creation of the post-war Welfare State) and reorganise council boundaries to reflect ongoing urbanisation. In addition, the Act changed aspects of local government financing. It brought in block grants, calculated by central government according to a complex formula, to cover a wide range of local government spending.[10] In doing so, it signalled the beginning of the principal aspects of the system of local government financing that continues to this day – complex, centrally determined grants impinging ever more on local financial flexibility, and domestic rates constituting an increasingly large portion of those taxes which remained locally determined.

The creation of the welfare state in the post-war years had the by-product effect of further emasculating local authorities. Although in structural terms local government changed little from 1900 until the 1960s, financial reforms such as the introduction of an Equalisation Grant and myriad new grants specifically linked to particular parts of the welfare state reflected a fundamental shift in how central government viewed the role of local authorities. Having interfered little prior to the late 1920s, central government established the concept of providing uniform service provision across the country at the heart of its attitude towards local authorities. During the middle decades of the twentieth century, local government's role was swiftly eroded until it had very little to do with actual 'government' at all. Rather its function became, as one recent publication put it, "to plug 'holes' left by the inadequacies of national income redistribution policies."[11]

In short, the spate of reforms to local government finances between the 1920s and 1960s had a profound impact on the powers wielded by local authorities. This provides a pertinent reminder for the current debate over local government finance: the streams through which local authorities receive funding and the control they have over their finances considerably influences their potential

8 T. Hunt, *Building Jerusalem: The Rise and Fall of the Victorian City* (London: Phoenix, 2004), pp.313-80; House of Commons Communities and Local Government Committee, *The Balance of Power: Central and Local Government* (London: The Stationary Office, 2009), pp.6-7.

9 Hunt, *Building Jerusalem*, p.316.

10 Travers & Esposito, *Decline and Fall*, pp.33-4.

11 Travers & Esposito, *Decline and Fall*, p.32.

to administer flexible solutions to specific local issues. Financial reform, not structural change, was the driving force behind local authorities' transformation from powerhouses at the forefront of social reform and civic identity during the Victorian and Edwardian eras, to the denuded bodies of the past 50 years whose primary function has been to implement centrally imposed agendas.

The creeping centralisation of local government finance which began in this era has also meant that any reform to local government finance which is unpopular with some local residents damages central government. Accordingly, there has been a deeply ingrained reluctance on the part of central government to undertake the necessary changes to ensure that local taxation is buoyant and suited to local needs. Contrary to popular belief, this is not a problem that arose in the wake of the 'Poll Tax' (of which more below). Since the 1929 Local Government Act transferred responsibility for rates revaluation from councils to central governmental bodies, revaluation of property taxes has been so contentious that governments from both ends of the political spectrum repeatedly opted for the popular but short-sighted measure of delaying revaluation rather than fulfilling what is supposed to be a statutory obligation to undertake revaluation every five years. This has denied local authorities market value rate income and consequently increased their dependence on central grants.[12]

1.3 From the 1970s to the Present Day

Since the early 1970s, there has been broad acknowledgement that the measures undertaken in the mid-twentieth century shifted the balance in central-local relations too far towards the centre, and most national governments have expressed a desire to devolve financial powers to local authorities. In practice, however, the previous centralising trend has continued. The 1972 Local Government Act contained no devolutionary reform despite the Heath Government proclaiming that it supported such an agenda, and the squeeze on local authorities' financial autonomy continued during the Thatcher era. Motivated by the need to keep local government's spending firmly in check to ensure that the centre could control inflation through monetary policy, the Thatcher Government legislated in the 1984 Rates Act to enable central capping of rates. The failure of the subsequent rebellion by numerous Labour-led councils to overturn central capping highlighted once again the extent to which the centre held the whip hand in its relations with local authorities.

Despite the scale of the rates capping controversy, the Thatcher Government's record on local financing came to be defined by its replacement of domestic rates with the Community Charge in 1990. While the Community Charge was intended to establish a clear connection between local spending decisions and local tax bills, its regressive nature and the storm of negative publicity attached to its popular moniker – the 'Poll Tax' – made it a politically disastrous measure. As outlined earlier, the Community Charge was not the catalyst of central government reticence concerning reform of local government finance, but the severity of the public reaction against it certainly reinforced the centre's reluctance to pursue changes in this area.

The Community Charge's replacement, the Council Tax (introduced in 1992), was primarily designed to placate public opinion. Accordingly, it did not seek to resolve deep-rooted problems in the local government finance system, and was little more than a return to the imperfect domestic rates. It is a mark of the severe erosion of local government's financial powers during the twentieth century that since the 1992 reforms, the Council Tax and charges and fees were the only elements of their revenue over which local authorities have any control.

12 Travers & Esposito, *Decline and Fall*, pp.35, 38.

The impact of the ongoing financial disempowerment of local authorities during the past 40 years has been accentuated by the steady transferral of functions away from local authorities. These functions were often transferred to arms-length bodies appointed by central government (such as the Housing Corporation in the case of social housing investment and the Higher Education Funding Council in the case of further education colleges).[13] Moreover, central government's growing desire to set and enforce targets led to a host of national targets and indicators cutting across local autonomy.[14] The Labour Government under Blair and Brown did nothing to address the highly centralised system of local government financing that it inherited, and greatly accelerated the trend of central target-setting. Taken as a whole, these developments mean that by 2010, local government had less autonomy to raise funds to cater for local requirements than ever before, and less autonomy to use its revenue to provide locally tailored services.

1.4 Origins and History of NNDR

Non-Domestic rates have formed an integral part of local government finance for centuries, and the flawed system of National Non-Domestic Rates that exists today has evolved over a long period. We must consider what functions rates were initially developed to serve, and how the ratings system evolved into the defective present-day structure which no longer serves these same primary functions.

Rates were first raised in England as long ago as the late sixteenth century for the purpose of funding local services. Myriad forms of locally determined rates came into existence during the following three-and-a-half centuries. They were truly local taxes – levied from local property occupiers to be spent directly on local services. Initially rates were linked to property because the lack of sophisticated administrative techniques meant that property value was seen as the most effective approximate measure of income.[15]

In the 1920s, central government began to interfere with rates, first by legislating in 1925 to combine the various rates introduced in *ad hoc* fashion by local authorities into a single rate.[16] At this stage, local authorities retained responsibility for the revaluation of this rate. By the end of the decade, central government had reduced rates the rates levied on business properties to 25% of the amount levied on residential properties (although until 1990 domestic and business rates remained parts of the same tax).[17]

In keeping with the general trend in all areas of local government finance, the limited central initiatives of the 1920s were followed throughout the rest of the twentieth century by a spate of further centralisation. Responsibility for rates valuation passed to central government in 1948, and the Rates Act of 1984, which provoked the strong backlash from many local authorities described above, enabled the centre to cap any proposed rates increase it considered 'excessive'.[18]

It is reasonable to argue that the earliest interferences in the ratings system from the centre were justified by the need to streamline and rationalise an archaic and chaotic system, and to encourage economic development through making rates more affordable for businesses. But the continued centralisation during the mid and late twentieth century ran contrary to the initial function of rates – to collect revenue locally to pay directly for locally tailored services. Taken together, these developments significantly limited local authorities' ability to raise revenue to support services specifically designed to meet the needs of their areas and removed councils' freedom to decide how to structure its revenue streams from residents.

13 Wilson & Game, *Local Government*, pp.143-4.

14 Jones & Stewart, *Central-Local Relations*, pp.16-8.

15 Travers & Esposito, *Decline and Fall*, p.21.

16 Travers & Esposito, *Decline and Fall*, p.11.

17 Ibid, p.25.

18 Lyons Report, p.285; Travers & Esposito, *Decline and Fall*, p.12.

1.5 The Nationalisation of Non-Domestic Rates in 1990

The 1988 Local Government Finance Act took this trend of central interference in the ratings system to new levels. As explained earlier, it abolished domestic rates and replaced them with the short-lived Community Charge. Alongside this highly publicised reform was another which received considerably less popular attention, yet was arguably at least as important in terms of its impact on local government finance. This was the creation of a new National Non-Domestic Rates system (NNDR) in which all income from rates, now only levied on business properties, was pooled nationally and then redistributed by central government.

Local authorities' struggle against various central government initiatives was a major influence on the Thatcher Government's decision to take control over non-domestic rates out of local government's hands. Throughout the 1980s, central-local relations became ever more strained. Following cuts in the Rate Support Grant during the early 1980s, most councils chose to significantly raise rates rather than cut services. In 1980/81, the average rates rise was 27%, followed in 1981/82 by an average increase of 19.4%.[19] When the Government responded by introducing rates capping powers in 1984 a number of local authorities rebelled, deliberately setting illegal budgets. The ensuing impasse with a few of the more hard-line councils continued into 1985 and did much to embed Whitehall's centralising tendencies. Although the Government eventually won out, rebel councils did manage to elicit some limited concessions. Particularly notable was Liverpool City Council's receipt of an additional £20 million in funding for housing having used the threat of an illegal budget as leverage. Nationalising non-domestic rates formed a key part of the centre's policy to ensure that local authorities could not hold it to ransom in this way again, and would not have the ability to implement financial plans contrary to the strategy imposed by central government.

Although the new system of National Non-Domestic Rates retained many elements of the previous ratings system, such as its basis in the rental value of properties and local authorities' responsibility for billing and collecting the rates, it removed each council's power to decide what proportion of rateable values it would charge in its area. Instead, the NNDR system employed a single, centrally imposed multiplier through which central government has generally ensured that business rates increase by less than the Retail Price Index. The relatively small increases in income from business rates has meant that the proportion of local government revenue that they provide has declined steadily but significantly since their introduction, from around 31% in 1992/93 to 19% in 2005/06.[20] Even more importantly, the nationalisation of non-domestic rates meant that, at a stroke, the proportion of local government income over which local authorities had any control fell from over half to around a quarter.[21]

1.6 Layfield and Lyons

English local government's heavy dependence on the centre and related lack of financial control run contrary to the recommendations of a number of independent and parliamentary committee reports. The first and perhaps most celebrated of these was the Layfield Report.[22] Published in 1976 and detailing the conclusions of a two year investigation into central-local relations by an independent committee chaired by Sir Frank Layfield, a prominent barrister specialising in planning law, the report identified the existing disparity between local taxation and local accountability and responsibility. It argued that the system of local government financing meant that local authorities bore the burden of responsibility for service provision while central government essentially controlled their funding.

19 Wilson & Game, *Local Government*, p.217.

20 Ibid.

21 Ibid, pp.217-8.

22 Layfield Committee, *Report of the Committee of Enquiry into Local Government Finance*, Cmnd 6453 (London: HMSO, 1976).

Although the Layfield committee outlined two alternative models to resolve this issue – one in which the centre would maintain financial control but take on a matching level of accountability and responsibility, another in which local authorities would receive financial powers appropriate for their responsibilities – its preference was clear. It stated: "the only way to sustain a vital local democracy is to enlarge the share of local taxation in total local revenue and thereby make councillors more directly accountable to local electorates for their expenditure and taxation decisions."[23] The Government chose not only to ignore the committee's preferred localist option, but also refused to acknowledge the fundamental problem highlighted in the report: central government's failure to give local authorities financial freedoms to match their levels of responsibility and accountability. Instead, it used the rhetoric of partnership between central and local government to cover for indecision and the preservation of the status quo, and opted for a 'middle course' – the very option which the report showed to be untenable and a key driver of central-local tensions.[24]

The recommendations of the Layfield report, despite being heralded by local authorities and numerous local government academics ever since its publication, have been "decisively rejected" by a succession of national governments.[25] Despite this, the other major independent report dealing with local government finance in recent years, the 2007 Lyons Report, positioned itself as following "firmly in the footsteps" of Layfield.[26] The opening paragraph of the Lyons report spoke in similar term to its predecessor about the wide-ranging importance of local government finance:

> *"Questions about local government taxation and the funding of local services are not simply matters for technical analysis... They must be part of a broader debate about the type of country we want to live in: the balance we strike between citizen, community and government in terms of both power and voice, and how we manage the inevitable tensions between diversity, choice and a desire for common standards."*[27]

In short, the Lyons and Layfield reports both contended that local government finance was integral to the wider concern of where power is invested within the political system. Lyons also agreed with Layfield that the lack of clarity on where responsibility and accountability for local services lay was a major flaw in existing central-local relations and especially in local government financing.[28]

However, in some other respects the reports significantly diverged. Lyons differed from Layfield in premising his recommendations on accommodating the conflicting public desire "to see both national standards and local variation."[29] In essence, while Layfield insisted that compromise was not an option and a choice had to be made between 'centralist' and 'localist' frameworks, Lyons' conception of local government's role was based on a mixture of central and local control. Lyons argued that there was "no simple 'golden key' that will unlock the problems of the finance system", and accordingly advocated "a mosaic of changes, implemented over time".[30]

Although Lyons' take on reforming local government finance might appear cautious compared with Layfield's, this is a product of the increased intransigence of central government in relation to local government finance during the intervening years. Conscious of the need to outline practically viable solutions, Lyons urged revaluation of Council Tax and modifying Council Tax Benefit to address perceived unfairness, and advocated allowing local authorities to levy a local supplement on business rates. But he was concerned to maintain the principles of equity and stability as the foundations of the local government

23 Ibid, pp.300-1.

24 Jones & Stewart, *Central-Local Relations*, p.10.

25 Ibid, p.26.

26 M. Lyons, *Lyons Inquiry into Local Government: Final Report* (London: The Stationary Office, 2007), i.

27 Ibid.

28 Ibid, pp.6-8.

29 Ibid, p.2.

30 Ibid, p.21.

financial system, and accordingly discounted a number of more radical options. Not least among these was full retention of NNDR. Lyons acknowledged that this "would give local authorities a substantial new local revenue source and considerable flexibility over revenue raising". However, he argued that this was not, at that time, a viable option for local authorities, since he considered that implementing this measure would risk damaging the development of trust between businesses and local government.[31]

Lyons' recommendations reflected the spread of a fatalistic outlook on local government finance in England – the view that, for all its flaws, the existing system is too convoluted and ingrained to be altered in one major reform. As the local government academic Tony Travers commented in a publication released shortly before the Lyons Report, the extent of centralisation and the complexities of the current local government finance system means "it is easy to be convinced that virtually all change is impossible."[32]

The proposal that we outline in this report attempts to integrate the best of both Layfield and Lyons' approaches. We recognise, as Lyons did, that centralising tendencies have become considerably more embedded over the last three decades and any proposed reform must take account of the barriers to change. We therefore aim to provide a realistic and implementable reform to local government finance which will work in the short-term while also acting as an effective first step to more thoroughgoing financial autonomy for councils. It is especially important that future options for greater financial freedoms remain open as the ability for councils to act autonomously will become even more important if, as is likely, additional powers are devolved to the local level in the future.

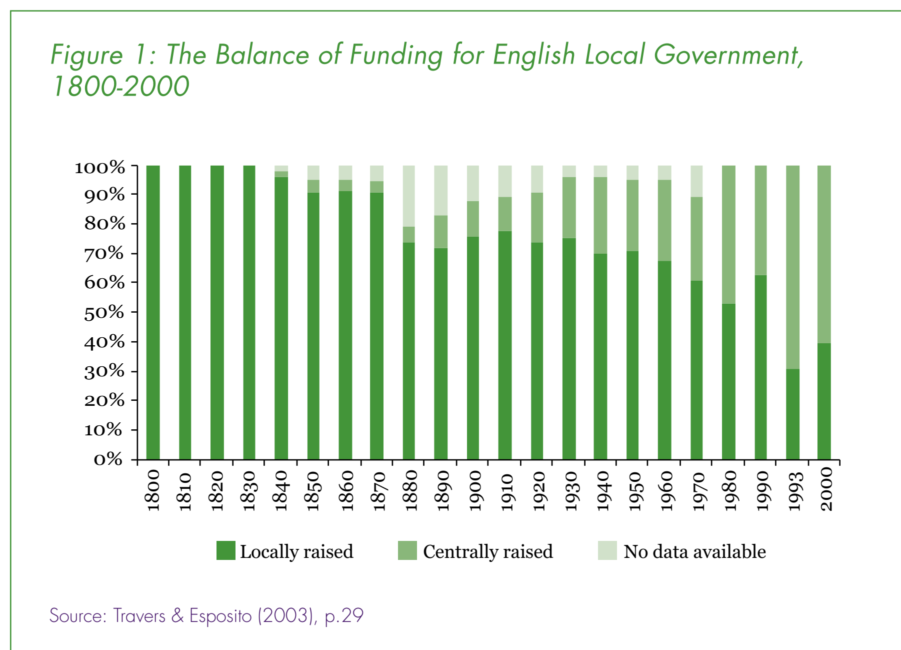
31 Ibid, pp.22-30.

32 T. Travers, *Would it be possible to re-localise the NNDR? The technicalities of achieving reform* (London: Local Government Association, 2006), p.2.

2. Why Financial Autonomy is Important

The importance of financial autonomy and the balance of funding between central and local government continues to this day. Never in the history of the UK has central government controlled so much of the country's finances, despite widespread support within the local government sector for a greater degree of autonomy (only 9% of the 195 English council Chief Executives and Leaders who responded to our recent local government finance survey believe that central equalisation is more important than local autonomy).[33] The graph below indicates how the balance of funding for councils has shifted radically from local authorities to central government.

Figure 1: The Balance of Funding for English Local Government, 1800-2000



Source: Travers & Esposito (2003), p.29

The lack of local control of the public finances disenfranchises local government and communities, and is problematic for a number of reasons.

2.1 Lack of Accountability

"All levels of government need to be accountable for their actions...[but] there is both a weak knowledge of the actual [local government] finance regime, and a poor understanding of the cost of public services".[34] This contention in the

33 For the full results of this survey, see Appendix 4.

34 Lyons Report, pp.94-5.

Lyons Report is borne out by a 2003 Government survey, which indicates that members of the public typically estimate that locally controlled revenue streams provide for 70%-80% of council spending.[35] In fact the figure is on average approximately 28%, as following the nationalisation of business rates in 1990 the only locally raised and locally adjustable sources of funding for local authorities have been local charges and fees and Council Tax (which at present also remains liable to central capping).[36] Such widespread misconceptions over the balance of funding blur accountability, often leading residents to blame local authorities for shortcomings in the provision of services over which these authorities have no financial control. Although in 1976 the Layfield Report premised its recommended options for local government funding on the need to restore a clear link between control over funding and accountability for local public services, the disconnect between the two has only increased since.

Uncertain accountability has had the notable side-effect of creating poor communication, misunderstanding and mistrust between many councils and local residents and businesses. These issues have been particularly acute in the case of businesses because councils currently have no direct incentive to fully engage with their local business communities. Although many councils already seek to communicate with businesses even without such an incentive, it is clear that major problems still exist in the relationship between local authorities and businesses.

Lack of communication between councils and business

A lack of accountability, and the resulting inadequate communication between councils and businesses, has proved detrimental to small businesses eligible for business rates relief. The Small Business Rate Relief scheme (SBRR) introduced in the Local Government Act 2003 enables small businesses that occupy properties with a value below a pre-determined level to apply for a relief scheme that eases the financial pressure of paying business rates (see appendix 1 for more details).

The FSB Small Business Rate Relief Survey 2008 showed that in one county alone, almost 11,000 small businesses were not claiming relief, with the rate of claims falling as low as 30.3% in some districts.[37] In 2009, Sutton Council reported it had sent out letters informing small businesses of their eligibility and detailing how they could make a claim. In just three weeks, 191 businesses had responded and claimed over £195,000 in the process. The Localism Bill provides for "a new small business rate relief scheme" which would be automatic, but until the Secretary of State chooses to initiate this, SBRR will remain dependent on businesses applying for relief.[38] It is therefore important, especially during the economic downturn, that councils communicate effectively to make small businesses fully aware of their relief entitlements.

When we interviewed a broad range of local councils the most frequently used terms to describe the grasp businesses had of the rates system were 'confusion' and 'misunderstanding'. This seems to stem from the lack of genuine accountability that councils have to their local businesses. For instance, during our consultation the Leader of one London Borough Council admitted that "the relationship between local government and business is one of the central

35 Office of the Deputy Prime Minister, *Balance of Funding – Minutes of the Third Meeting*, 21 October 2003 (London: ODPM, 2003), p.3.

36 DCLG, *Local Government Finance Statistics England: No.20* 2010, p.2.

37 Essex FSB Small Business Rate Relief Survey 2008 http://www.fsb.org.uk/101/assets/policy/essex%20fsb%20small%20business%20rate%20relief%20survey%202008%20league%20table%20011208.pdf (accessed 22/02/11)

38 Localism Bill, Clause 37.

challenges. Relationships could be much better". The Leader said that previous attempts by the council to institute 'consultation evenings' with business were of limited success and failed to create stronger working relationships.

In short, a lack of accountability and communication shortcomings has resulted in widespread misconceptions among businesses about the role of councils in economic development, and has meant that the relationship between local authority and local businesses is often one of mutual suspicion rather than mutual support.

The more revenue that local authorities raise themselves to deliver services and benefit their local areas, the more accountable they will be to those from whom they raise the funds. The current uneven balance of funding means that those members of the public who are better aware of where power lays within the current system of central-local relations often approach their Member of Parliament, not their local council, to address essentially local issues. The Communities and Local Government Committee recently complained of the increasing practice of "raising and debating essentially local matters in the [House of Commons] Chamber".[39] But blame for this should not be solely attached to individual MPs; central government's appropriation of control over local authorities' purse-strings, has also served to warp the public's notion of who should be held to account for local public services. In a system in which most, if not all, revenue is locally raised, residents and local businesses will clearly be able to hold councils to account for local issues, thereby stopping the existing uncertainty in this area.

2.2 Lack of Incentives

Of course, councils do already have some incentives to drive economic development in their areas, particularly avoiding the negative social consequences, such as unemployment, that result from a poor environment for businesses. However, these incentives are limited and generally insufficient to encourage councils to assign scarce resources to foster business development from which they receive no direct benefits. To be fully rewarded for efforts to promote new and expanded business activity in their areas, pioneering local authorities need to retain the financial benefits arising from such activity, not merely pass it up to central government to be redistributed to other, often less innovative, authorities. At a time when private sector jobs must be created to fill the vacuum left by a smaller state, there is an even greater imperative than usual to ensure that councils are fully incentivised to support business at the local level. Such locally led growth has the potential to have a significant positive impact on the national economic situation.

Furthermore, in typically relying on the centre for over 70% of funding and having the threat of capping hanging over the only major 'self-controlled' source of revenue, council tax, has greatly reduced the incentive for councils to innovate locally appropriate service delivery methods. Even the Audit Commission, an agent of top-down government influence, recognised that top-down pressure is a less effective driver of innovation than local political pressure or the demands of citizens.[40] In this respect, the lack of financial autonomy for local authorities is exacerbated by central inspection regimes, which undoubtedly place pressure on councils to 'play safe' and follow central prescriptions. It is difficult to disagree with the Lyons Report's statement that "decentralisation promotes innovation across a wide range of activities including economic development, service design, technology and problem solving".[41]

39 CLG Committee, *Balance of Power*, p.4.

40 Lyons Report, p.82.

41 Lyons Report, p.82.

Incentives driving innovation

While the experience of central-local relations in England has been one in which the centre has gradually but consistently eroded local authorities' fiscal powers, the reverse has been true in a number of European nations during recent decades. Among the countries that have recognised the limitations of financial centralisation and responded with thoroughgoing reforms to allow substantially enhanced local fiscal flexibilities are France, Scandinavia and Spain.

In France, François Mitterrand's Socialist Party Government undertook major structural reforms to local government in 1982 which greatly empowered hyper-local *communes*, each of which covers a village or town. Along with wide-ranging planning, development and environmental responsibilities, French local government received a broad basket of local taxes which enabled them to effectively address these responsibilities. The result of this, as judged by one recent academic assessment, has been to generate "vitality of local government and of civic participation at the micro-level".[42]

Scandinavian nations are usually cited as epitomes of centralist, social democratic government. However, by the 1980s the flaws in the 'Nordic model' of governance – especially the rising costs of large welfare states which were outstripping economic growth – had become apparent across the region. In responses to fiscal necessity, the Swedish, Norwegian, Finnish and Danish governments all undertook Free Commune Experiments (FCEs) – schemes in which a few municipalities were granted exemptions from national regulations and enhanced fiscal powers with the intention of encouraging local innovation. The details of the FCEs varied from nation to nation, but a recent DCLG report on potential lessons of the schemes for English local government noted that they "helped to stimulate a policy environment in which local authorities have been more willing and able to experiment" and "enhanced local authorities' ability to respond to local needs and priorities".[43] Referring to Sweden alone, one academic commented that among FCEs there had developed "at least five different policy models, from traditional social democracy to Thatcherite neo-liberalism".[44] Certainly, the Scandinavian FCEs show that greater local fiscal and structural flexibilities can effectively drive innovation which benefits local communities.

In Spain, Autonomous Communities (ACs) were created in the wake of Franco's demise. Although they have always enjoyed a high level of political autonomy from central government, further reforms between 1997 and 2002 enabled greater financial autonomy at the local level, with ACs allowed to raise or vary a large range of local taxes. The Spanish system among the most decentralised in Europe and is widely recognised to have not only cemented the Spanish state following the transition away from Franco's extreme centralism, but also to have provided popular and locally appropriate public services for communities.

42 H. Mendras & A. Cole, *Social Change in Modern France*, quoted in S. Jenkins, *Big Bang Localism: A Rescue Plan for British Democracy* (Localis, Policy Exchange: London, 2004), p.23.

43 Department for Communities and Local Government, *The Free Commune Experiments: lessons for policy in England* (DCLG: London, 2006) pp.7-8.

44 J. Loughlin & S. Martin, *Local Income Tax in Sweden: Reform and Continuity* (Centre for Local and Regional Government Research: Cardiff, 2004), p.10.

2.3 Distorting Behaviour

Local government's high degree of dependence on central grants has a number of perverse impacts on central-local relations and on incentives to local authorities to take on additional risk to foster growth in their areas. Local authorities' heavy reliance on grant, encourages councils to lobby ministers in order to gain additional revenue from the centre, invariably at the expense of a fellow local authority, rather than seeking to generate additional funding at the local level. While distribution systems inherently involve some element of competition between the recipients, less reliance on the centre would attenuate this element of competition in the English system which currently absorbs a significant amount of local and central government resources. Instead of competing to show why businesses should choose to locate in their area, councils are encouraged by the existing system to demonstrate how deprived, and therefore worthy of central funding, they are. As Sir Michael Lyons contended, such competition "absorbs energy amongst council members, officers, civil servants and ministers. It contributes to a sense that resources are seen not as citizens' money to be used in their best interests but somehow as the property of central government handed out by ministers".[45]

Central government has jealously guarded the share of local government funding that it controls in large part to allow it direct funding in the attempt to achieve equalisation of outcome. The OECD has correctly noted: "Full equalisation removes the incentive to increase the jurisdictional tax base by attracting new economic activity",[46] and the system in England at present certainly privileges equalisation to an extent that severely curtails such incentives. And as discussed in section 4.2, the reward provided to councils that successfully promote economic development through the existing Local Authority Business Growth Incentive scheme constitutes only a very weak incentive. In this respect as in others, the current system allows, and in fact encourages, local authorities to 'play safe' in terms of driving innovation, and requires them to remain subservient to the centre.

2.4 Gearing

A significant by-product arising from the lack of local authorities' control over their own funding is 'gearing'. 'Gearing' refers to the ratio of total revenue expenditure to Council Tax revenue, and is employed as a measure of local authorities' ability to finance increased revenue spending through altering revenue streams over which they have control. It is a somewhat imprecise measure, as councils can draw on reserves and increase charges and fees, as well as raising Council Tax, to finance increased revenue spending,[47] however it provides a reasonable and well-recognised gauge of the financial flexibility enjoyed by councils.

Across all local authorities in England in 2009/10, the gearing ratio was 4.[48] This means that, on average, Council Tax revenue accounts for only one quarter of local authorities' expenditure. Accordingly, to increase their revenue expenditure by 1% the average council must raise Council Tax by 4% (unless it funds at least part of the increase through raising charges and fees, or using funds from its reserves). In fact, there is significant variation between the gearing ratios of different types of local authorities: Shire Districts have a low ratio of 2.5, indicating relative financial flexibility, while Inner London Boroughs have a high ratio of 6.5, indicating relative financial inflexibility. Therefore, for a typical Inner London Borough to fund a modest 1% increase in its expenditure, it must increase its Council Tax income by 6.5%, which is likely to be highly unpopular with its residents and may be capped by central government.

45 Lyons Report, p.108

46 OECD Network on Fiscal Relations Across Levels of Government, *Intergovernmental Transfers and Decentralised Public Spending* (2006), p.28, see http://www.oecd.org/dataoecd/52/52/37388377.pdf (accessed 15/12/2010).

47 DCLG, *Local Government Financial Statistics England: No.20 2010*, p.31.

48 DCLG, *Local Government Financial Statistics England: No.20 2010*, p.31.

At a time of increasing devolution of power to local authorities and communities, it is arguably more important than ever that councils have the ability to influence revenue streams. While the greatest degree of influence would come from allowing local authorities the ability to vary the rate of taxation, control over tax bases would also provide a larger degree of financial autonomy than is available in the existing system. Many of the Government's localist policies risk being denuded by the lack of local financial flexibilities. For instance, the Localism Bill's provision to stop central government capping of Council Tax increases and instead allow local residents to vote on rises above the ceiling set by the Secretary of State is certainly to be welcomed.[49] However, unless councils have greater financial flexibility, those councils with relatively small Council Tax bases which wish to raise additional funds will find the necessary Council Tax increases more difficult to justify to their residents than will other authorities with larger bases.

The views of local government about local government finance[50]

Although local government finance is an extremely sensitive subject within the sector, the wide range of authorities we consulted prior to writing this report, both in face-to-face interviews and through our survey, largely agreed that the current system is weakened by the problems identified above. There is a broad degree of consensus in the local government sector on some issues:

- **Local financial autonomy is important** – There was not a single council that we spoke to that does not want more financial autonomy in some form. 99.5% of respondents to our survey also agreed that councils should be given greater financial autonomy. When asked whether they would like more control of business rates, every council we consulted in person said that they would, but they had different opinions as to how this could be achieved. 96% of respondents to our survey said that they would like more control of business rates in some form.
- **Larger incentives are needed for local government** – Whilst there was disagreement as to how this would work in practice, every council that we spoke to believed that councils should be given larger incentives to improve their local area, particularly if this enables them to carry out projects or initiatives that they would otherwise be prevented from doing. Over three quarters of those who completed our survey stated that financial incentives would make their council more innovative.
- **The current system causes tangible problems** – Whilst the barriers to development are numerous, there were several examples given of proposed initiatives that have been stymied by the current local government finance system. Many councils also highlighted that many local businesses did not understand that councils do not control business rates.

49 Localism Bill, section 56, see http://www.publications.parliament.uk/pa/cm201011/cmbills/126/11126.i-v.html (accessed 15/12/2010).

50 The consultation questions are included in Appendix 4.

- A basket of local taxes would enable full local financial autonomy – A number of councils suggested that in an ideal world, they would have access to a number of local taxes, which would provide a broad incentive to grow the local economy whilst giving a large number of councils the opportunity to be completely autonomous from central government. 96% of respondents to our survey said that, if possible, they would like to see more taxes collected and spent locally. All of the councils that we consulted in person recognised that the localisation of a broad base of taxes would take time, and a pragmatic approach, to achieve.

There are differences of opinion on other issues:

- **Councils judge economic success differently** – Every council that we spoke to also had slightly differing views as to what economic success means. For some it is about reducing unemployment; for others the focus is on promoting start-up businesses and SMEs; others still focus on a wider view of what is important to local people. Many councils were unable to provide any clear definition of economic success. (See section 4.1 for more detail on this issue.)
- **Councils prioritise incentives and equity differently** – Whilst all councils said that they would like greater financial autonomy and incentives, many also emphasised that retaining the redistributive mechanism was really important for their local area. However, in response to our survey only 9% felt that equalisation was more important than local autonomy.
- **Councils disagreed on the importance of volatility** – A few councils, particularly those dependent on a few large companies or those with a manufacturing base emphasised that the loss of a large company could have a significant impact on the accounts of a council. However, some other councils believe that the business rate revenue they collect is more stable than the grant they currently receive. Most councils told us that they could cope with the volatility through good financial management.

3. Options for Increasing Local Financial Autonomy

As we have seen, the lack of genuine local financial autonomy is a crucial stumbling block for true localism. Reforming the current finance system needs to be done in such a way as to ensure that it provides the right balance between autonomy, incentives and flexibility for local authorities, and a reasonable amount of stability and the continuation of the principle of equalisation. In a truly decentralised world councils would raise the vast majority of their income locally. So what are the options for greater autonomy in local government finance in the shorter term, and are they financially and politically feasible in the longer term?

3.1 End Capping

Council tax is, of course, at least set, collected and spent at the local level. However successive Governments have introduced and maintained council tax capping – the ability of central government to block a local authorities' proposed budget, which in practice means a block on council tax increases. As described in Chapter 1, capping was established to prevent extreme and unpopular rises in council tax. While this may be a politically popular policy, the fact remains that it is a centralised solution applied to a wide variety of individual local circumstances. If councils want to raise council tax to pay for vital services for the local area, that is a judgement for them to make, and for which they should be held accountable by their residents. Therefore the Government's policy of ending council tax capping, announced in the Localism Bill, makes sense.

However there are reasons to believe that the effect of ending capping on the overall balance of funding between central and local government will be small, particularly in the short term. Firstly, the Government is strongly encouraging councils to freeze their council tax for at least one year. Secondly, many have suggested that the Government's policy of council tax referendums will, in most cases, have a not dissimilar effect to capping on councils' revenue raising capability, especially since the Secretary of State has the power to decide which local authorities' council tax increases are put to local referendums. But most importantly (as discussed above in chapter 2.4) with council tax only accounting, on average, for a quarter of local authority revenue funding, to raise the required amount to increase in a council's budget by 1%, the average local authority would need to increase council tax by 4%. In essence, while desirable for true localism, ending central capping of council tax in all its guises will offer only a small increase in financial autonomy and will have little impact on how councils raise their money.

3.2 End Ring-Fencing

Ring fencing is the protection of grant funding for a specific policy areas identified by central government. It is based on the belief that central government knows what local government should be spending money on and that local government cannot be trusted to spend such money without strict controls. The Government is, quite rightly, already committed to ending the ring fencing of grant, which will give local authorities full control over how that money is spent, so allowing them the flexibility to spend directly for the benefit of local people. By 2011/12, the ringfencing of all revenue grants will be removed, except for health and education, with £4bn of grants rolled into the formula grant. At this stage, therefore, there is little that any further removal of ring-fencing could achieve in delivering greater local financial autonomy.

3.3 Localise Existing National Taxes

For a genuine shift in the balance of funding to take place, local authorities must be allowed to develop a much broader, more diverse and more buoyant tax base than they have at present. One of the most attractive options to address the funding problem is to partially localise existing national taxes:

- Localising a proportion of the existing income tax system has a number of advantages. It could operate through the existing PAYE system and studies within the local government sector have indicated that there would be few major practical barriers to implementation. Income tax is 'progressive' in that only those in work pay it and higher earners pay more, so it would provide local government with a strong incentive to ensure that as many people in the local area are in employment. It is also, unlike property taxes, buoyant, meaning that revenue increases without having to change the tax rate. A potential issue is that the geographical bond between residents and their council can be broken by people that live and work in different areas. However, a locally variable income tax form a central part of local government's tax base in many other developed nations, including Spain, Germany, the United States and Sweden.[51] As one in a basket of local taxes, a revenue-neutral local income tax has the potential to be an effective element of a more autonomous system of local government finance.
- Localising a proportion of Value Added Tax (VAT) has a significant advantage over a completely new local sales tax in that it could be designed to ensure that the overall burden of taxation would be neutral. But it could be for complex to implement than a localised portion of income tax, and faces similar accountability challenges to the local income tax in that there is not necessarily a direct link between sales taxation and local residence. Revenue from both income and sales taxes also tends to be more volatile than other taxes.
- Localising proportions of other national taxes, such as Vehicle Excise Duty (VED), fuel duty and alcohol duty.

A potentially simpler solution may be to localise property taxes. Property taxes account for £60bn, of which business rates is among the most notable, representing approximately 35% of all property tax revenue. Currently, Council Tax is the only localised property tax; it accounts for approximately 41% of total property taxation revenue. Aside from the two major property taxes, the remaining ones which could be localised are:

- Capital Gains Tax, which is levied on the gain in value of most assets sold for a price in excess of £6,000.
- Stamp Duty Land Tax, a percentage levy on the total purchase price of properties.

51 T. Travers & L. Esposito, *Nothing to Lose But Your Chains: Reforming the English Local Government Finance System* (Policy Exchange: London, 2004), p.42.

The localisation of these taxes is potentially feasible and would be a major step towards financial autonomy for councils. However, many councils have limited residential and business property tax bases and would therefore be unable to achieve financial autonomy through local property tax revenue alone. To enable all councils genuine financial autonomy, local authorities will have to be given the power to localise elements of other national taxes or select the most appropriate from a basket of possible local taxes.

3.4 Create New Local Taxes

Giving local authorities new tax raising powers has long been discussed as one of the best ways to enable councils to attain genuine financial autonomy. There are a number of options for new local taxes: one that is particularly popular among some councils is a tourist, or 'bed' tax – a levy on visitors staying at hotels. A 'bed' tax has the advantage that it would not face the same level of local criticism or controversy as introducing new taxes that increase the tax burden on local residents. Extra taxes on tourists could, though, have a negative impact on the size of the tourist industry, which is often the largest local contributor to the economy for some of the more deprived parts of the country. It would also benefit some areas with a strong tourist base considerably more than others.

There are also significant problems with other possible options for new local taxes. Any income tax or local sales tax that added to the overall tax bill of residents would be likely to meet with strong opposition. Innovating a local Land Value Tax (LVT) has the benefit of being clearly rooted in the local area and being relatively stable. However, if levied along with existing property taxes it would constitute double taxation and would therefore meet with significant resistance from a large portion of the local population in most areas. LVT would probably have to be considered as a replacement for existing property taxes rather than an addition to them. In addition, many more deprived areas with lower land values would find that LVT revenue constituted only a small portion of their budgetary requirements.

In addition to the specific implementational challenges that the introduction of such taxes would pose, and the likely wish of the Treasury for any redesign of the tax system to be revenue neutral, all of these options are likely to prove highly politically contentious. As such, the introduction of any new tax-raising powers for local government is not the best measure with which to begin to solve the existing problems in local government finance. It is, however, to be hoped that appropriate local taxes will form part of a robust system of financial autonomy for local authorities in the future.

The development of a broad range of local and localised taxes is undoubtedly desirable and would best promote genuine localism, but there are myriad barriers to quick change, including complex implementational issues and strong resistance from a number of key stakeholders in the local government finance system. Accordingly we believe that in the immediate future, the local retention of business rates is the most realistic option to enable a large-scale shift of financial power and begin the move towards local financial autonomy. Its advantages include that through strongly incentivising local growth it would support the urgent national growth agenda, and that business rates are already locally collected and widely perceived to be a local tax.

However, it must be emphasised that although business rates offer the most viable option in the short-term, there are clearly a number of benefits to a broad and diverse local tax base and other local taxes should be considered

in the near future. Given the need for a significant local incentive to promote economic growth, the remainder of this report will focus on the local retention of business rates. This will be a first crucial step towards genuine financial autonomy, and can pave the way for the localisation of other taxes in the short to medium term.

4. Economic Development and Business Rates

In 2008/09, business rates generated £19.9bn[52] of tax revenue, and redistributed NNDR constituted approximately 13% of total local authority income.[53] It also made up 87% of the total Formula Grant (excluding Police Grant) paid to councils in that year.[54] Local retention of business rates is therefore an option that would not only provide councils with a much greater degree of financial autonomy, but would also enshrine their important role of encouraging and promoting local economic development by giving them a direct incentive for successfully fulfilling this important role.

4.1 Local Government's Role in Economic Development

The current system of business rates not only lends itself to relatively simple local retention, but there are a number of very good reasons why councils should take much greater control. Local government has long had an important role in influencing and shaping the economic development of local areas. Formal recognition of councils' role in economic development only dates back to the Local Government and Housing Act 1989.[55] However, the Act actually served to confirm local authorities' long-running efforts to support and stimulate the local economies of the areas they govern. The example of Joseph Chamberlain's mayoral tenure in Birmingham once again provides an excellent illustration of this. The municipal council takeovers of the city's gas and water supplies were driven by the twin aims of promoting public well-being and enabling Birmingham's large corporations to enjoy secure and cheap energy supplies, thereby encouraging the city to develop.[56]

The importance of local government's role in economic development has also been recently acknowledged in the 2007 Sustainable Communities Act, which confirmed local authorities' responsibility for "encouraging the improvement of the economic, social and environmental well-being" of their areas.[57] However, a major effect of the long-term centralisation of local authorities' powers has been to remove many levers by which councils would be able to influence economic development. This trend accelerated considerably under the previous government, which vested power and responsibility for many key drivers of economic development in regional level agencies which were widely seen as arms of central government. From 1998, responsibility for economic development, including the promotion of employment, business efficiency and regeneration, has been

52 DCLG, *Summary of the Calculation of Distributable Amount for 2011-12 based on data back to 2007-08.*

53 *Local Government Finance Statistics England: No.20 2010*, p.30.

54 *Local Government Finance Statistics England: No.20 2010*, p.2.

55 Wilson & Game, *Local Government in the United Kingdom*, pp.134-5.

56 Hunt, *Building Jerusalem*, pp.342-3

57 Sustainable Communities Act 2007, section 23, 1 (2). http://www.statutelaw.gov.uk/content.aspx?activeTextDocId=3417570 (accessed 16/11/2010).

held by Regional Development Agencies rather than by local councils. And the use of Regional Spatial Strategies from 2004 to July 2010, which were developed by unelected and centrally accountable Regional Planning Bodies and approved by the Secretary of State, meant that another vital element in economic development, spatial planning, was also regionalised rather than being decided by local authorities.

Case Study: Councils taking a leading role in economic development

The spirit of 1870s Birmingham – councils innovating radical measures to support long-term economic development in their area – has continued to recent times despite the erosion of local autonomy during the intervening years.

Among the best recent examples of councils supporting economic development is the case of Manchester Airports Group plc (MAG). MAG is a holding company owned by the ten Metropolitan Borough Councils of Greater Manchester which was formed in 1986 to take control of Manchester Airport following the disbanding of the Greater Manchester County Council, which had previously run the airport. Recognising the airport's centrality to the area's economic development, the councils intervened to ensure that it would continue to develop and play a leading role in driving growth in Manchester and the surrounding region. Although national legislative provisions within the Airports Act 1986 were required for the takeover to occur, the establishment of MAG indicates the potential for councils to drive economic development in their areas. The group has subsequently expanded to operate another three airports across England and provides airport services such as baggage handling and ground services to a range of other airports. The success of MAG shows how councils can innovate to foster development of their area even within the existing stricture of the local government finance system.

Local authorities can work in very different ways to effectively stimulate economic growth in their areas. A prime example of this, and one which stands out from Manchester councils' creation of a large corporate entity to manage a specific high-value asset in the region, is Essex County Council's establishment of a supplier working group. The group seeks to review the Council's procurement processes and enable a wider range of potential suppliers to bid to provide services and goods. As a result of the group's discussions, the pre-qualification questionnaire for potential suppliers had been greatly simplified, and local businesses are explicitly prioritised for medium-sized contracts. Steps have also been taken to ensure that procurement becomes significantly more consistent and open to locally based enterprises. Such smaller scale local economic engagement may lack the newsworthiness of major schemes such as MAG, but schemes to simplify council procurement can be hugely effective at promoting and supporting a thriving local business base.

The Government's clear intent to reverse the regionalisation of economic development levers and strategies, through abolishing RDAs by 2012 and returning powers to local authorities and communities, is to be welcomed. The Localism Bill confirmed that the Government will back a planning system based on bottom-up collaboration.[58] In addition, the replacement of RDAs with Local Enterprise Partnerships (LEPs) is, in theory at least, a positive step towards returning economic development to local control, although significant questions remain over how LEPs are to be funded and governed, and how councils can be incentivised sufficiently to promote economic growth. In the future councils will be required to take on a more active role in promoting economic development, which will require them to think strategically about their role.

Local government's approach to economic development

Our consultations with councils across the geographical and political spectrums highlighted the lack of a clear definition of their role in economic development despite almost every local authority acknowledging the importance of a strong local economy to their functions as a whole. One council Leader stated: "We do not have reliable figures or relevant information at our disposal – data around business rate relief take-up and retail vacancies of course, but most information is purely anecdotal". In part, then, this is an issue of the shortcomings of performance metrics available to local authorities.

In many cases, however, it also reflects a broader problem. Local flexibility in judging economic success is to be expected and welcomed, as different areas have very different economic strengths and priorities. Some councils have robust measures of success and well defined economic priorities. For instance, Surrey County Council employs a Local Economic Assessment (LEA), which identifies a broad range of factors that affect sustainable growth and ensures that the necessary data is collected to measure performance in these areas.

Unfortunately, Surrey seems to be the exception rather than the rule. Most local authority representatives appeared uncertain as to how their council gauged economic success in its area. One Chief Executive admitted that the council did not outline indicators for economic success as clearly as it should. Some spoke of the importance of maximising employment in their area; others said that they focused on qualitative markers, such as the responses of local residents and businesses. But very few local authorities that we consulted employed indicators which represented a well-defined and broad set of economic development priorities.

Although councils clearly recognise that supporting economic development is an important element of their functions, it appears that the current system does not provide sufficient incentives for councils to define their role in economic development and use this definition as a basis for action. Such definitions would undoubtedly foster development at the local level which in turn would support growth at the national level. It is therefore imperative that councils are provided with incentives that will clearly make it in their interests to encourage local economic development.

58 Localism Bill, Part 5.

The different views of councils reflects to some degree the range of different approaches taken to economic development, but also potentially a lack of consistency in the recognition of the value of economic growth in local areas. Putting business rates revenue back in the hands of the local authorities that collect it would help to enshrine a more long-term and bottom-up approach, supporting initiatives such as LEPs, and encouraging councils to think harder about promoting business growth in their local areas. Giving local authorities a more tangible incentive to focus on business development would have the important effect of encouraging councils to contribute to the Government's programme of rebalancing the national economy. A greater focus on supporting private sector companies in their areas will mean that local authorities will have leading roles in ensuring that the national economy moves towards a stable and growth-producing basis in innovative enterprise, and away from unsustainable over-reliance on the public sector as a job provider of last resort. As we saw in Chapter 2, incentives drive innovation, and the local retention of business rates would be no exception.

4.2 Previous Attempts to Localise Local Business Growth

For the current Government's drive to relocalise the responsibility and means for nurturing economic development to be truly successful requires local authorities to have more effective incentives to drive local development. The creation of the Local Authority Business Growth Incentive scheme (LABGI) in 2005-6 was at least an acknowledgement that such an incentive is needed.

Unfortunately, LABGI proved to be highly complicated without being particularly effective. It was justly criticised for lacking transparency. It also incentivised authorities with a financial reward which in most instances constituted only a tiny fraction of the increases in NNDR revenue from their areas for which they are being rewarded.[59] The amount of rewards paid out to local authorities under the LABGI scheme in 2010/11 totalled £50 million.[60] This represented only 1.6% of the £3.04bn increase in NNDR revenue between 2005/06 and 2008/09 for which local authorities were being rewarded, and only 3.2% of the £1.58bn annual increase in 2008/09 alone.[61] In addition, the size of the pot of reward funding was set by the Department for Communities and Local Government in July 2009 without taking into account the actual national growth in NNDR revenue over the reward period. In other words, LABGI rewards bore no relation to whether or not local authorities across the country, through fostering environments conducive to business growth, helped to increase the national pool of NNDR revenue they collectively gather. It is a limited pot which fulfils the scheme's aim implied in its title – to incentivise local authorities to promote business growth – only in relative terms.

The problems with LABGI rewards were not limited to the size of the national pot. The method of distribution is also fundamentally flawed, leading to perverse incentives. Firstly, the reward is distributed to local authorities on a per capita basis, weakening its links to business growth. Secondly, the amount per capita that is distributed to each council is calculated through grouping local authorities together into 'sub-regions'. Each sub-region, the Government claims, is designed to cover a "viable economic area", in which it is equitable for NNDR growth to be pooled together to act as the basis for a shared per capita reward.[62] The sub-region concept is an attempt to account for the credible fact that the scale of increases (and decreases) in the NNDR revenue collected by each lower-tier and unitary authorities is influenced by the activity of other authorities in the economic area. However, the LABGI sub-regions, unlike true economic geographies, are inflexible. A number of sub-regions are also

59 See Department for Communities and Local Government, 'Local Authority Business Growth Incentive allocations 2009-10 and 2010-11', http://www.communities.gov.uk/localgovernment/localgovernmentfinance/labgi/labgischeme2/ (accessed 16/11/2010).

60 Department for Communities and Local Government, *Consultations on reforming the Local Authority Business Growth Incentive Scheme: Government response* (London, CLG: 2009), p.6.

61 CLG, 'Local Authority Business Growth Incentive allocations 2009-10 and 2010-11', http://www.communities.gov.uk/localgovernment/localgovernmentfinance/labgi/labgischeme2/.

62 Department for Communities and Local Government, *Consultations on reforming the Local Authority Business Growth Incentive Scheme: Government response* (London, CLG: 2009), p.5.

clearly straining the definition of what can reasonably be described a coherent 'economic area'. This is especially the case in the London sub-region, which was approved by most outer London Boroughs, whose per capita reward rises as a result of being grouped with NNDR-rich inner London Boroughs, most of which expressed dissatisfaction at the grouping.[63] It could be argued that the Boroughs of Havering in the East and Hillingdon in the West are linked by little more than the first letter of their names; certainly it is not credible to imply that each of these distant Boroughs has a sufficient impact on economic activity in the other to justify linking them together for the purpose of rewarding business rate growth. As the graph below indicates, the London sub-region has created perverse incentives, with some Boroughs receiving a far higher percentage reward for growing their business rates than others.

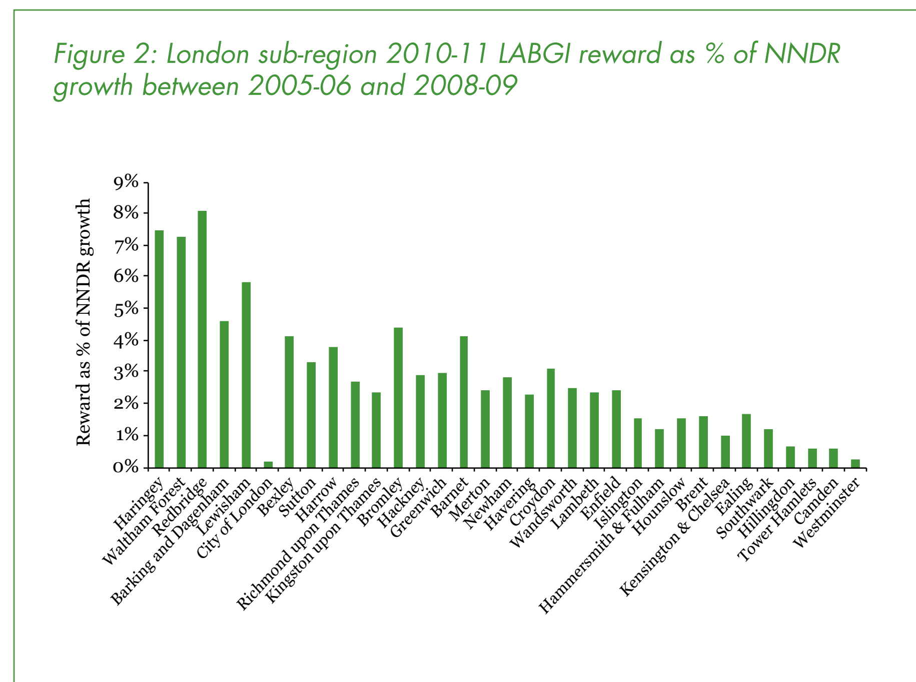


Figure 2: London sub-region 2010-11 LABGI reward as % of NNDR growth between 2005-06 and 2008-09

Other sub-regions highlight LABGI's flawed incentive structure to an even greater degree. For instance, in the LABGI settlement for 2010/11 the East Kent sub-region received a per capita reward of £0.72. This meant that two districts of similar population in the sub-region, Dover and Shepway, received similar rewards – £38,687 and £36,226 respectively. However, the gross increase in NNDR receipts in these two districts over the period 2005/06 to 2008/09, the supposed basis for the LABGI rewards in 2010/11, varied enormously. Dover's NNDR contribution to the national pool grew by over £9.2 million, or 38.6%; Shepway's contribution *decreased* by nearly £0.8 million, a reduction of 2.9%. In short, not only did Dover's LABGI 'reward' in 2010/11 represent a mere 0.4% of the increased NNDR contribution it made to the national pool over the reward period, but it also received approximately the same as a neighbouring district whose contributions to the national pool during that time fell.[64] This is not a one-off anomaly; the vagaries of sub-regional groupings mean that there are numerous other examples of perverse incentives and of councils getting a 'free ride' as the result of the efforts of neighbouring authorities.

It is quite clear that the LABGI scheme does not fulfil its stated aim to provide local authorities with strong, clear incentives "to encourage businesses in their area".[65] In fact, the incentives it provides are weak and muddled: the sub-

63 Ibid, p.23.

64 All figures calculated from DCLG, 'Local Authority Business Growth Incentive allocations 2009-10 and 2010-11', http://www.communities.gov.uk/localgovernment/localgovernmentfinance/labgi/labgischeme2/ (accessed 16/11/2010).

65 HM Treasury & Department for Communities and Local Government, Building better incentives for *local economic growth: Reforms to the Local Authority Business Growth Incentives scheme* (London: The Stationary Office, 2007), p.3.

regional groupings and calculation of reward on a per capita basis mean that, in key respects, the rewards are not truly linked to increasing business rates income in each local authority's area.

The 'Local Growth' White Paper, published in November 2010, recognised LABGI's shortcomings and stated, "The Government is clear that local authorities need a transparent, understandable and predictable set of incentives, if they are to be effective."[66] The new incentives' structure outlined in the White Paper certainly provides cause for optimism. It announced that the current flawed system of nationalised business rates is to be changed, through the introduction of a 'Business Increase Bonus scheme'. The scheme will, in the Government's own words, "reward those authorities where growth in the business rates yield exceeds a certain threshold, by allowing them to keep the increase – up to a certain level – for a period of six years".[67] The White Paper also affirmed that the Government is considering other proposals "to enable councils to retain locally raised business rates" which "go further than the Business Increase Bonus scheme" and introduced "stronger and more predictable incentives".[68] It is to be hoped that these positive proposals result in major changes that will rectify the problems ingrained in the existing system of NNDR and provide councils with local flexibility and strong incentives to pursue innovate schemes which will foster economic development in their area. The suggestions made in this report are designed to feed into this policy development process.

66 DBIS, *Local Growth*, p.28.
67 Ibid.
68 Ibid.

5. Reforming Business Rates

Perverse financial incentives, administrative inefficiency and low levels of accountability mean that the current business rates system is clearly unfit for purpose. Previous reforms have not gone nearly far enough, and there is widespread support from local government for more control of business rates. The Localis survey of English council Chief Executives and Leaders showed that 96% would like more control of business rates in some form. Furthermore, our interviews with the business community demonstrate that they too are now open to the local retention of business rates.

The views of the business community

Having consulted all the major business groups, it is abundantly clear that the business community is united in its opposition to the full relocalisation of business rates including the transfer of rate-setting powers to local authorities. The Director General of the Confederation of British Industry (CBI), John Cridland, recently stated that allowing councils to set their own business rates is a "no-go area".[69] Given the erosion of trust between businesspeople and councils prior to the nationalisation of business rates, it is understandable that many businesses fear that relocalisation would lead to substantial business rates increases. Increasing taxes levied on businesses, which have no political representation, could in many cases seem less politically damaging to councils than increasing taxes on local residents, who elect councillors. Since a major consideration in reforming the current business rates system is the need to drive economic development through strengthening the partnerships between local government and businesses, full relocalisation would be clearly be problematic in this respect. As Adam Marshall of the British Chambers of Commerce has commented, "While businesses and councils now work more closely than they did even a few years ago, taxation is still an extremely sensitive issue".[70]

The business representatives that we consulted also approve of additional incentives for councils to work in close conjunction with businesses to

69 http://www.lgcplus.com/briefings/services/economic-development/local-rates-a-no-go-cbi-chief-warns/5024910.article (accessed 16/02/2011).

70 *Local Government Chronicle*, 10/02/2011, p.11.

promote robust local economic development. Specifically, our consultations indicate that the business community is broadly happy to support innovations to business taxation as long as such measures can only be put into practice with the support of the businesses affected – the principle of taxation only with representation. In this respect, Business Improvement Districts and future possibilities, such as Tax Increment Financing, have met with business approval. There has also been an increasing amount of backing among the business community for the local retention of business rates revenue provided that local authorities are not given the power to increase business rates without local business approval.

In the wake of the Lyons Report, the CBI wrote of the need for local authorities' role in economic development to be clarified and for greater engagement between the public and private sectors.[71] A primary aim of the model that we outline (see section 5.2) is to provide stronger incentives and improved opportunities for councils to actively promote local economic development. In complete contrast to the full relocalisation of business rates, the model of local retention that we propose intends to actively promote improved relationships between local authorities and the businesses in their area. The aim is to construct a system that will provide strong incentives for councils and businesses to work together to drive local economic development.

Given the widespread support among local authorities and the business community for local retention, what can be done? The Government has already pledged to "provide incentives for local authorities to deliver sustainable development, including for new homes and businesses".[72] The 'Local Growth' white paper also made it clear that the Government intends to explore all options to allow local authorities to keep a greater proportion of business rates. The Government has also stated that the Local Government Resource Review, due to be published in July 2011, will contain details of reforms to the business rates system. In this context of forthcoming reforms to business rates, this chapter will explore how this could work in practice, and discuss the options available before putting forward a model to provide councils with increased financial autonomy and greater incentives to promote economic development.

Any prospective model will need to take account of a range of different factors. Especially important is the question of whether some authorities will have to be treated as exceptions. It is clear that local authorities have a diverse range of experiences of the current system of redistributed business rates.

The graph below shows the significant variation in current net contribution to the NNDR pool, with some councils receiving a large net benefit from the current system, while others provide a large net contribution to the pool.[73] However, it also indicates that the majority of authorities are relatively small net beneficiaries from, or net contributors to, the national business rates pool. The councils at either end of the spectrum, which either make

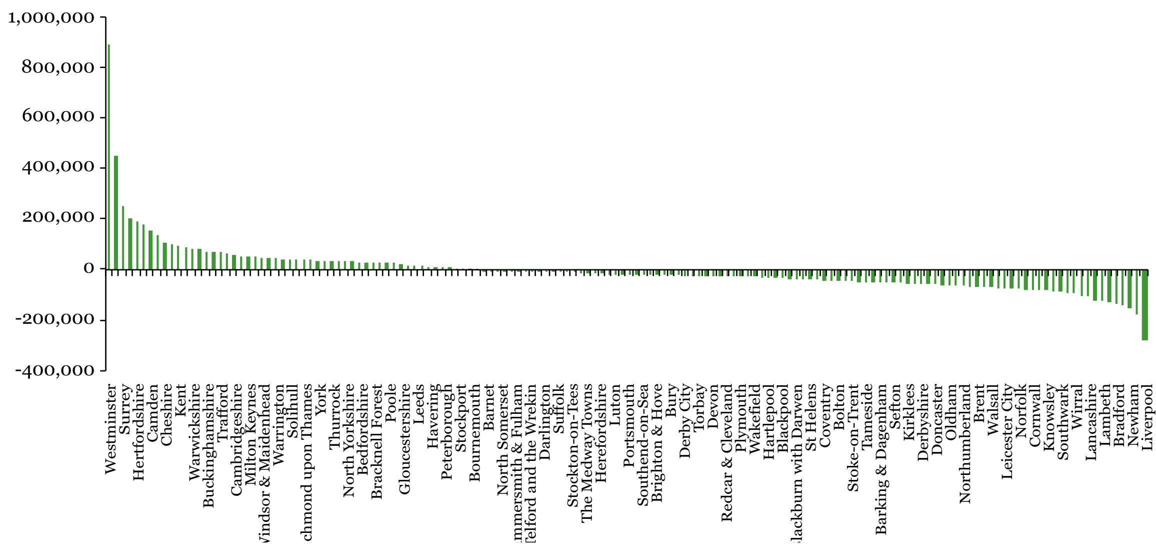
71 http://www.cbi.org.uk/pdf/cbilga1206.pdf (accessed 16/02/2011).

72 Local Growth White Paper

73 The data for two-tier areas is comprised of NNDR revenue collection by all lower tier level billing authorities within the upper tier area and redistributed NNDR to both upper and lower tier authorities

extremely large net contributions to the pool or receive a very large net sum back from national redistribution, are very much in the minority. This provides a strong indication that most local authorities could be covered by a single system, with only the few at either extreme potentially requiring exceptional arrangements.

Figure 3: NNDR Net Contribution (inc RSG) 2008/09 by Local Authority



Any prospective model will need to provide a solution which both retains the principle of redistribution from the wealthier authorities to those with greater need whilst also giving all councils a fair incentive to grow their business base.

Based on our conversations with local councils, business organisations and central government, there are seven key principles that shaped our proposed model for reforming business rates. These principles are:

1. **It provides a larger incentive than existing initiatives** – The extent to which councils are rewarded for promoting economic development in their local area
2. **It provides councils with a greater degree of financial self-determination** – The degree to which councils are able to influence their own financial position through effective economic management
3. **It provides a fair incentive for all councils** – The extent to which the risk and reward are aligned for every council
4. **It retains equity** – Whether the principle of redistribution is maintained in some form
5. **It is voluntary** – The feasibility of making the system voluntary, with a particular focus on ensuring that the benefits are sufficiently attractive for everybody
6. **It is implementable** – The feasibility of implementation, including political, cultural or legislative barriers
7. **It is likely to benefit the national economy** – The extent to which the model will demonstrably benefit the country as a whole

The following section will explore the options for reform of the business rates system, before describing our recommended model and addressing the practical considerations that this model raises.[74]

5.1 The Options

Localise all business rates directly to councils – Perhaps the most straightforward option is to allow all locally collected business rates to remain in the council. The full localisation of all business rates would provide a much larger incentive for councils, and address the balance of funding to some degree. The major problem would be that there would be insufficient funds to support those councils which are currently net recipients of business rates redistribution. Along with huge financial and political barriers, it would have a massive impact on the poorest areas of the country, and would provide an unfair advantage to those councils who already have a high business rates base due to factors that are beyond the control of councils (e.g. historical accidents of geography). It is therefore not a feasible option based on the seven key principles.

Assessment based on core principles	
1. Larger Incentive?	√
2. Greater Financial Self-Determination?	√
3. Fair Incentive?	×
4. Equity Retained?	×
5. Voluntary?	×
6. Implementable?	×
7. Benefit national economy?	~

A Business Increase Bonus (BIB) – The Business Increase Bonus is a policy put forward by the Government for local government to keep a proportion of growth in business rates collected in an area for a period of six years. This form of lagged tax base incentive mechanism allows councils to keep a proportion of any growth in a tax base over a fixed timeframe. It was one of the options considered by Sir Michael Lyons, who said it "would have some advantages in terms of transparency as local authorities should be able to identify the amount of money that they would expect to pay in to the national pot, and thus use any growth for their own purposes".[75] This approach has the advantage that it offers a much larger incentive than previous initiatives such as the Local Area Business Growth Initiative (LABGI) which was fairly limited in its scope and scale, and has been hamstrung by a series of complications (see section 4.2).

The problem with BIB is not so much its aims but its scope. It only allows for a small increase in the degree of additional financial autonomy of local councils; a much stronger incentive would have to allow local councils to operate completely outside the formula grant system altogether.

Assessment based on core principles	
1. Larger Incentive?	√
2. Greater Financial Self-Determination?	×
3. Fair Incentive?	~
4. Equity Retained?	√
5. Voluntary?	√
6. Implementable?	√
7. Benefit national economy?	~

74 All options are assessed using the seven principles. In the tables following the analysis of each option in the following section, the degree to which the option fulfils each principle is denoted by a colour; green indicates that the option meets the requirements of the principle; light green indicates that the option partially meets the requirements of the principle; and grey indicates that the option does not meet the requirements of the principle.

75 Lyons Report, p.328.

Localise a proportion of business rates – While full localisation of business rates is impractical, it is technically possible to localise a proportion of business rates to councils, with the remainder going into the redistributive pot. This would work on a rolling annual basis, with the council keeping a proportion of the business rates and the growth on that proportion, up to a fixed limit. By definition, this would give local government partial autonomy only and wouldn't allow any council to operate independently of annual formula grant redistribution. It would also lack any long term certainty, with the level of relocalised rates varying from year to year.

Assessment based on core principles	
1. Larger Incentive?	~
2. Greater Financial Self-Determination?	~
3. Fair Incentive?	~
4. Equity Retained?	√
5. Voluntary?	×
6. Implementable?	√
7. Benefit national economy?	√

All of the models outlined here fail to combine the continuation of redistribution with the provision of effective incentives to councils. One solution that could achieve this would be to allow councils to buy themselves out of the business rates system entirely.

5.2 The Buy-Out Model

The Buy-Out Model would enable local authorities to buy-out of their net contribution to business rates for specific periods of time. This is a radical option that would solve the problems outlined above in preserving the crucial re-distributional element of the current system while also providing greater incentives for local authorities. In addition, it also has notable advantages for the Treasury.

Assessment based on core principles	
1. Larger Incentive?	√
2. Greater Financial Self-Determination?	√
3. Fair Incentive?	√
4. Equity Retained?	√
5. Voluntary?	√
6. Implementable?	√
7. Benefit national economy?	√

Based on the multi criteria analysis used to assess all the options explored in this report, the Buy-Out Model is by far the most attractive and feasible solution, a position accentuated by its relative ease and speed of implementation. As discussed in Chapter 6, the model would also be compatible with the localisation of other existing taxes, which the Government may consider to ensure that every council can be entirely independent of central government funding in the long-term.

How it works

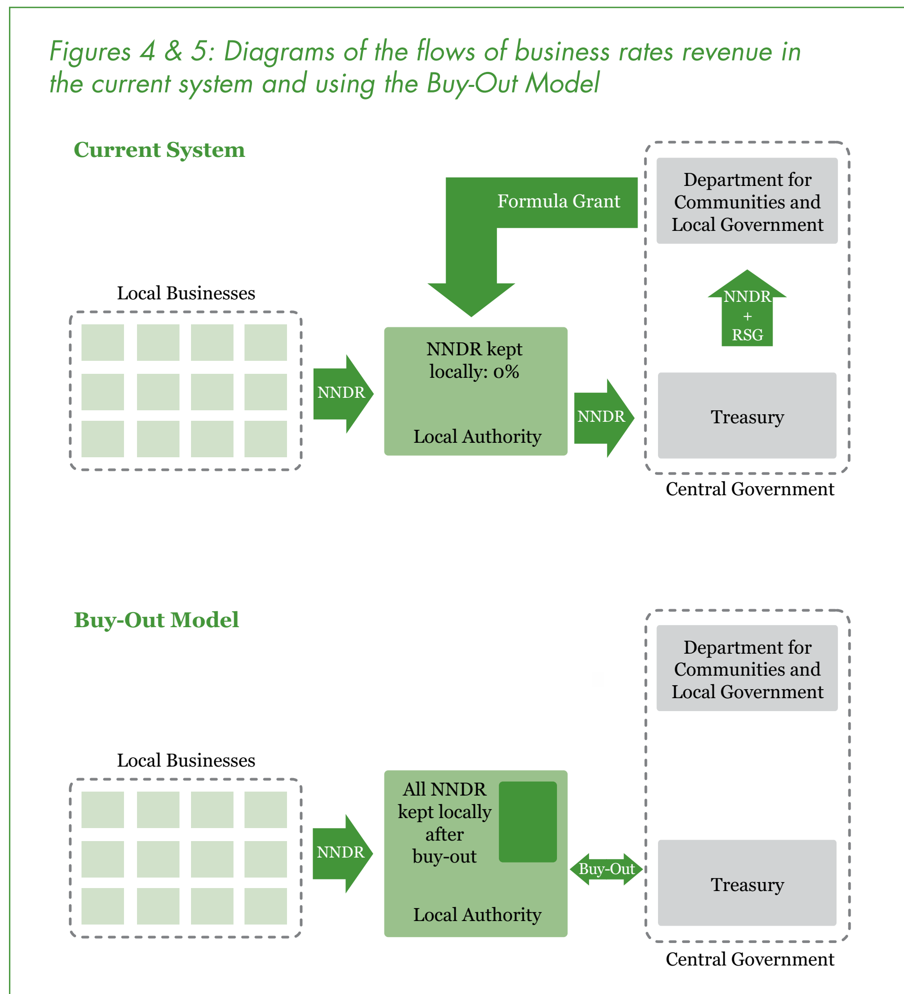
The Buy-Out Model is based on a very simple principle. Any council that believes that, with additional incentives, it can grow its business rates

revenue will be able to express an interest to the Treasury. Our consultations with councils have indicated that most are confident that robust rewards will drive further innovation: over three-quarters of the council Chief Executives and Leaders who responded to our survey said that financial incentives would make their council more innovative. Having received the expression of interest, the Treasury would then negotiate a buy-out tariff with the council, ensuring that all councils are treated fairly according to the principles outlined above.

This tariff would take the form of an agreement between the Treasury and the council for specific sums of money to be paid to or by the council in each of a specified number of years – the 'buy-out tariff' – while the council is permitted to keep all business rates collected in its area over the same period. Once agreed, the buy-out would last until the following revaluation of business properties (conducted every five years, with the next in 2015), during which time the council would keep all of the business rates revenue it collects. It is anticipated that our model could be implemented by April 2012, with the first buy-out period for three years between 2012 and 2015. Thereafter, buy-outs would be on a five-year cycle to match the revaluation cycle.

The model is designed to ensure that every council is able to significantly benefit from any growth in business rates, regardless of whether it is a net beneficiary from, or contributor to, the current system.

Figures 4 & 5: Diagrams of the flows of business rates revenue in the current system and using the Buy-Out Model



Each local authority's buy-out tariff will be designed so that risk and reward are aligned – that is, to ensure that its incentives to pursue sound financial management and promote sustainable economic development are aligned with the risks for not doing so. Equalisation will continue by using the proceeds of buy-outs from net contributor councils to ensure that those councils which are currently net recipients have a negative buy-out tariff – that is, they receive money from the Treasury as part of the buy-out. The system would work for interested councils based on the following processes:

The Buy-Out Process

- Councils will be allowed to buy-out of the formula grant on a voluntary basis for an initial period of three years and for five year periods from 2015.
- Every council will have the option to buy-out of the formula grant, even those who are net beneficiaries of the current system.
- The buy-out tariff will be individually determined for each local authority based on its particular circumstances, and is primarily based on its projected net contribution to the national pool during each year of the buy-out period assuming a normal level of business rate revenue growth.
- The buy-out for net contributor councils can take the form of an up-front lump sum (requiring a loan or use of reserves), or can be done on a year-by-year cash-flow basis.

As outlined above, the starting point for determining the price of buy-out will be a council's existing net contribution to the NNDR pool. To reflect this, the offer from the Treasury will be positive or negative i.e. during the buy-out period, it will require the council to pay money to the centre every year, or it could guarantee a certain level of top-up grant to be paid from the pool to the council every year. Crucially, however, the buy-out amount will provide certainty for each council: it will know at the start of the buy-out period exactly how much it must submit to or receive from the centre each year, and will get to keep all business rates revenue it collects during the buy-out period.

The buy-out offer will also take account of other key factors to ensure the system is fair while incentivising innovation. It is especially important to ensure that each council bears risk in line with the potential reward it can expect if it creates an environment conducive to economic development. A situation in which councils reaped the full benefits of sounds economic management but saw the Treasury compensate for any falls in business rate revenue could encourage councils to pursue unsustainable models of economic development in an attempt to maximise their financial returns – a situation of moral hazard.

Determining the level of incentive

- *Contribution* – The council's existing net contribution to the national business rate pool.

- *Prospects for Growth* – essential to projecting the total business rates take anticipated in future years, which forms the basis of the buy-out price for these years.
- *Payment* – Up-front buy-outs, which will provide additional money to the Treasury, will be incentivised by means of a percentage adjustment to the buy-out price.

Why it works
Returning to the seven policy criteria set out in section 5.1, it is clear that the Buy-Out Model fulfils all of the key requirements of a reform to the business rates system

Larger incentive – Every council that we have consulted is in favour of larger incentives. Furthermore, in our survey of English local authority Leaders and Chief Executives, more than three-quarters of respondents stated that financial incentives would make their council more innovative. The Buy-Out Model will give every council the opportunity to benefit significantly from any growth in business rates. Some 98% of billing authorities have seen growth in the amount of business rates they have collected over the last three years. With more of the benefits of growth kept locally, the level of incentive will undoubtedly help to encourage innovation and foster a stronger relationship with business that should increase each council's gains over time.

A greater degree of local financial self determination – During our consultation with local authorities, one issue that was raised repeatedly was their lack of control of the proportion of the taxes they raise and spend locally. 96% of council Chief Executives and Leaders who completed our survey said that they would like to see more taxes collected and spent locally. Respondents were also confident of councils' ability to influence economic development: 84% said that councils had a 'large' or 'moderate' impact on the local economy.

Under the model we are proposing, councils will have significantly more ability than they do currently to grow a major revenue stream. While full relocalisation of business rates and the return of rate-setting powers to local authorities, which we have ruled out on a number of grounds (see section 5.1), would be necessary to improve the balance of funding as it is traditionally defined, the Buy-Out Model significantly increases councils' responsibility and flexibility with regards to business rates revenue. For the period of the buy-out, councils will no longer receive centrally determined Formula Grant and instead will have to manage their own finances effectively to maximise the benefits they can receive. This is, therefore, an enormous opportunity for all local councils to take a long-term approach to investing in and improving their local areas.

Fair incentive – The Buy-Out Model is designed to guarantee that councils across the country, including those in the poorest areas, will have the opportunity to benefit from retaining business rates revenue locally, which in turn will allow them to invest in the long-term growth and prosperity of their area. As outlined above, a key part of the new system will be to ensure that the level of incentive in different areas is fair.

Our analysis of the model's possible consequences for councils in various positions in the current system of business rates redistribution indicates that all authorities will have the opportunity to receive significant benefits if they choose

to buy-out and successfully promote economic development. (For detailed examples and calculations of the figures that follow, see appendix 2.)

If any council manages to beat its projection growth in business rates revenue by even a small percentage, it will obtain a considerable financial reward on top of what it would have received if it had remained within the existing system of business rates redistribution. For example, exceeding the projection by a relatively small compound percentage of 1% would mean that an authority with a medium sized initial base of £120m would receive an additional £6.9m over a three year buy-out. An authority with a larger base of £320m would receive £18.4m benefit under similar circumstances. Exceeding the projection by a compound percentage of 2% would benefit these two councils by £14.7m and £39.1m respectively over a three year buy-out.

A fair incentive means that risk and reward remain aligned for each authority which buys out. Those authorities which stands to gain more by increasing their business rates base by a certain percentage above projection also risk losing more if their base falls short of projection. (For additional information on ensuring risk and reward remain fair and aligned, see 'Areas with a high business rates base to assessed need ratio' in section 5.3)

Redistribution retained – As previously described, the Buy-Out Model would ensure that the system maintains the redistribution from more affluent authorities to those with greater need. Our analysis of the potential impact on councils in a variety of situations is set out in the following table.

Council Type	**The Impact of Buying Out**
Northern and Southern councils	When establishing their buy-out tariffs, councils in the North of England will be treated no differently to those in the south, and the principle of redistribution to areas of greater need will remain. It is a fallacy to suggest that northern councils face an inexorable decline in business rates revenue, and would thereby be disadvantaged by any system of local retention. Taken as a whole, Northern Metropolitan Boroughs' business rates collection grew by more than 30% between 2004-05 and 2009-10, more than any other type of council. Furthermore, in responding to our local government finance survey, representatives of councils in the Midlands and North of England were more confident than their southern counterparts that councils had a large impact on the local economy. More respondents from Northern councils than Southern ones believe that their council would innovate further if greater financial incentives were introduced. This is not, therefore, a system merely for Southern councils, but one which is designed to reward any council which actively promotes economic development in its area, regardless of geographical location.
Rich councils	The richest councils will be given a fair incentive, balancing risk and reward, with the prospect of making up-front buy-outs more favourable. While those councils with a larger base have the potential to obtain larger rewards compared with a council with a smaller base through growing by the same percentage above projection, these councils also have to manage increased risk of larger reductions in revenue if their base falls below projection. This can be achieved through, for example, keeping a reasonable amount of business rates revenue from previous years in accessible reserves.

Poor councils	Councils with greater levels of deprivation will have fair incentives provided for growth. As outlined above, the potential gains for areas with a modest business rates base are still considerable. Furthermore, a key consideration when setting the buy-out tariff is the potential for economic growth in an area, so even those councils with legitimate concerns over future economic development in their areas should receive a fair buy-out offer. They could also benefit from support through loans for early intervention and capital investment, which could be funded by the buy-out fees of other councils (see the 'Additional Long-Term Support for the Poorest Areas' section below for details of these possible schemes).

Voluntary – We are confident that the Buy-Out Model will work as an entirely voluntary system because the potential gains are clear. Most councils claim that local government can promote business and growth better than central or regional government, and 84% of respondents to our survey indicated that their council had a large or moderate impact on the local economy. If this is indeed the case, then a voluntary model should be sufficient to ensure that the vast majority of local authorities will choose to buy-out. The attraction to such a system will be based on two main factors: increased autonomy, and a much greater reward for successfully promoting local economic development.

Implementable – The Buy-Out Model would be relatively simple to implement. In particular, the fundamental mechanism for setting business rates, including rateable value (revalued every five years) and a centrally set multiplier on rateable value, would remain unchanged. It must be emphasised that the model we are proposing does not enable local authorities to vary the business rate multiplier in their area or to take control over revaluing properties. This is especially important since it assuages the primary fear of businesses that relocalised business rates will lead to some councils imposing large rises in the rates charged to businesses in its area.

Benefits National Economy – A more dynamic, localist and accountable system is also beneficial for the entire country, and is likely to benefit the national economy as a whole – the Buy-Out Model is in the national interest, not just for local growth. It provides greater certainty to central government's financial planning, and takes some of the perceived risk – in the form of a fluctuating Revenue Support Grant – off its balance sheet. Perhaps most importantly, the country will benefit from the enhanced innovation and business growth that more incentivised local authorities will doubtless help to encourage.

At no point in the last twenty years has local government in the UK had the potential for such a large level of financial autonomy. The Buy-Out Model offers a practical solution to enable councils to take on considerable enhanced economic development functions and to benefit from these, and the local government sector must do all it can to seize this opportunity. As with any major reform, there will be certain stakeholders who believe that they will lose out. However, we have shown that the business community and, most importantly, councils from across the geographical and economic spectrums can benefit from the Buy-Out Model.

Additional long-term support for the poorest areas

Given the particular importance of ensuring that deprived areas are given the support they need to become more self-sustaining in the longer term, we have considered further options that would ensure that every area will have strong incentives to buy-out while receiving the support necessary to help vulnerable

residents. One of the concerns frequently raised about a more incentive-based system is that over time it will benefit richer areas but not poorer areas, and in so doing will exacerbate existing economic disparities. Whilst we have endeavoured to explain that our model will ensure equity of incentives from day one, it may be necessary to take additional steps to ensure that the model that we put forward is sustainable over the long-term, assisting growth in all areas.

Incentivising up-front buy-outs by councils with large business rate bases could potentially provide such support for more deprived areas. Up-front buy-outs could raise a significant amount of capital for the Treasury, which could be used to fund cost-effective and growth-promoting projects in those areas most in need. In particular, this could work through investing in early intervention projects and capital projects in more deprived areas of the country. Ideally, these funds would be controlled by a panel comprising representatives of councils from across the political and geographical spectrums which have bought out. This would have the benefit of ingraining a mentality of peer-support in the local government sector, rather than reliance on central government.

The Early Intervention and Infrastructure Investment Fund

- The fund will use money raised from councils that have opted to pay for their buy-out system up-front.
- The fund will provide loans or investment into projects that would have a clearly defined return (perhaps over long periods).
- Any council that has bought out of the formula grant and has high levels of deprivation would be eligible for the funding.
- The fund will focus on early intervention and capital investment programmes to both reduce costs in public services, and support an environment for growth.
- Councils apply to the fund, and need to produce a clear strategy for releasing cash through innovative financial products such as Tax Increment Financing and Social Impact Bonds.
- Fund investment decisions to be made by representatives of councils from across the political and geographical spectrums who have bought out.

Through the creation of an infrastructure and early intervention fund, money will be made available at attractive rates to support infrastructure projects or early intervention initiatives that provide demonstrable savings or growth potential but require start-up support. The aim of the fund would be to support those areas most in need, and provide a platform for them to build their business rate base and reduce long-term state dependency.

Recommendations

- The Government should establish a fund to support areas with high levels of deprivation to invest in Early Intervention Programmes and Infrastructure Projects.

- Up-front buy-out of the formula grant should be additionally incentivised on the basis that it raises extra money for the Treasury to invest in these funds.

5.3 Practical Considerations

The nature of the changes that we propose to the structure of local government funding generates a number of implementational issues that will need to be addressed to ensure a smooth transition from the current system to the new one.

Risk factor – There are a few authorities which are outliers within the NNDR system, and, due to their exceptional circumstances, pose a significant challenge to any reform of business rates. With regard to the Buy-Out Model, a potential issue arises for the small number of authorities whose business rates base is extremely large compared with their need as currently assessed through the formula grant system. The failure of such authorities to meet the growth projection upon which the buy-out was agreed, even by a relatively small percentage, could lead to an extreme reduction in income by the end of the buy-out period. While any authority would face income reductions if it failed to meet its growth projection, the risk is sufficiently great for a few authorities to necessitate an additional risk-sharing element to be added to their buy-out. Fewer than ten councils have a business rates base three times greater than the amount they receive through formula grant – our working definition of 'disproportionately large'. *It must be emphasised that this problem does not exist for the vast majority of councils, and it is only a very small number of councils for whom the Buy-Out Model need to be adjusted.*

The risk-sharing element must ensure that risk and reward for these few authorities will remain aligned and not place a limit on their ambition in terms of economic development. We propose that a maximum allowable ratio of three times business rates base to need should be included in the Buy-Out Model. This will directly mitigate against the potential problems associated with a disproportionately large business rates base. Councils exceeding the maximum allowable ratio will share risk with the Treasury through having their business rates bases split into a local element – projected NNDR collected up to three times assessed need – and a national element – the rest of the projected NNDR revenue. (For a numerical example of how the risk sharing system will work, see Appendix 3.)

Sharing risk with the Treasury is necessary to prevent a few authorities from realising extraordinary losses or gains from relatively small percentage shortfalls below, or gains above, projection. It is also equitable as councils with disproportionately large business rates bases are not wholly responsible for the size of their bases, which exist in part because of historical accidents of geography and depend to a significant degree on centrally determined infrastructure.

To reiterate, only a small number of authorities have a disproportionately large business rates base which requires risk sharing with the Treasury. We recommend that this special arrangement should apply to fewer than ten authorities, and it is intended to be as simple as possible while meeting the core policy criteria outlined earlier. Buying out will still give any council substantially more financial independence and strongly incentivise it to focus on developing the local economy, while continuing to support less affluent and economically developed areas.

Recommendations

- For those few councils with a disproportionately large business rates base, a special risk-sharing arrangement with the Treasury should apply to ensure that the authority will not experience dangerous income volatility.
- The arrangement will mean that these authorities will have a local element and a national element to their business rates base, which will share any above-projection increase or below-projection shortfall.

Two-tier areas – In two-tier areas, Billing Authorities at the lower tier, district level are responsible for the collection of business rates. However, both districts and counties receive a share of redistributed business rates back from central government in the form of formula grant. To reflect this situation we believe, for the purposes of this scheme only, it is right that counties and their districts are treated as indivisible groupings. In other words, neither districts nor counties will be able to buy-out on their own. Instead they will be treated collectively, with the share of business rates apportioned to each district and the county being determined locally. We expect that federated county groupings will use current relative allocations as a starting point.

This federated approach between the districts and the county council would help to engender a more collective approach to economic development, which would have both local and national benefits. Despite the attempts of previous failed initiatives such as LABGI, there has never been a substantial incentive for joint working. The Buy-Out Model would therefore be a huge step forward, and could also potentially begin to define a more collaborative approach to economic development for other areas too.

Recommendation

- Councils in two-tier areas put forward a joint 'Federal' proposal for a buy-out, with the incentive distribution decided locally.

Reaching a reasonable buy-out price – Any potential reform to central-local relations requires a reasonable spirit of cooperation between relevant central government departments and local authorities. The Buy-Out Model is no exception in this respect. However, as we have outlined above, it does provide positive incentives for the Treasury and councils to work together to negotiate a buy-out tariff based on reasonable projections. The Treasury stands to gain from the additional economic development which incentivised councils will support, while the potential benefits for councils are obvious and have already been explained in detail.

The negotiable aspect of the buy-out are the projections for the expected business rates base in future years assuming the council does not buy-out (the system will also require consideration of how the formula grant will change over the course of the buy-out). It is conceivable that the Treasury will attempt to set these projections unreasonably high in an attempt to maximise its short-term gain from councils. If this were to be the case, few councils would find the buy-out an attractive option,

with the result that most councils would have little by way of incentive to develop their business rates base and a major driver of national economic growth would be severely impaired. This approach would therefore be self-defeating, which is why we are confident that the Treasury will negotiate in a reasonable fashion, basing its buy-out offers on simple factors – particularly the authority's business rates growth in the recent past, and any forthcoming national infrastructure projects likely to impact on business rates income in the area.

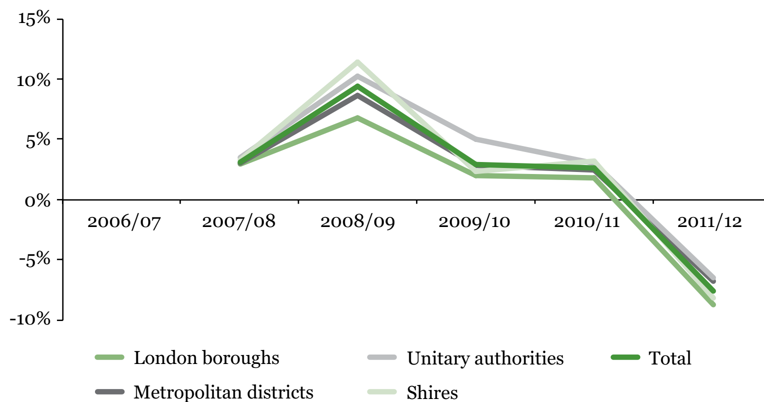
If the Treasury and councils take a realistic and mature approach, there is every reason to believe that fair projections can be agreed upon by both parties, and the buy-out system can therefore be a success for interested local authorities.

Recommendation

- The Buy-Out Model relies on the Treasury and interested councils adopting a reasonable approach to negotiations on future growth projections, but these projections should be based on a few relatively simple and transparent factors.

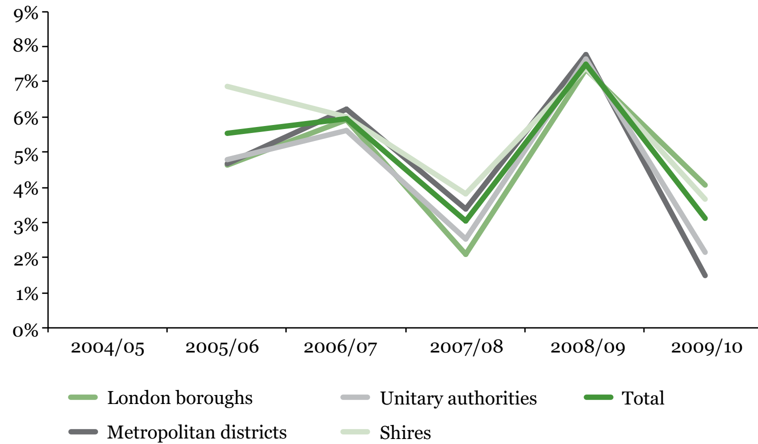
Dealing with volatility – One accusation which could potentially be levelled this system is that volatility in business rates' receipts at the local level will create instability in the financial planning of local authorities. However, this assumption is predicated on the misguided notion that central government grant, especially the formula grant, is distributed according to a consistent formula which ensures the smoothing of any volatility. In fact, the formula grant (and other funding streams for local authorities) is frequently altered to reflect prevailing political priorities: money is assigned to, or taken away from, particular groups of authorities according to the preferences of the Government. The result is that local authorities are never absolutely sure of their individual grant settlement more than a few months ahead of the start of the financial year, and the levels of revenue that they receive bears no relation to the efficacy of their economic management. The graph below indicates that central government grant in fact varies significantly from year to year.

Figure 6: Year-on-Year Formula Grant % Movement 2006/07 to 2011/12



Examining local list business rates revenue (that is, the business rates collected by local authorities) it is apparent that there is in fact less year-on-year variation at the local level.[76]

Figure 7: Year-on-Year Local List NNDR Movement 2004/05 to 2009/10



Of course, there will be occasions where negative volatility impacts directly on a local area. But good financial planning and management can do a lot to cope with the problems of volatility, and there are a number of ways that councils can ensure that stability is maintained when NNDR rates fall locally. These include:

- Keeping a sufficient proportion of resources in accessible reserves
- Managing capital and revenue accounts in such a way as to shift from one to the other where possible
- Encourage a diverse local economic base to provide protection against individual sector decline
- Ensuring that a suitable portion of the benefits of above-projection growth in business rates in one year is retained to mitigate the effects of below-projection growth in a subsequent year

Recommendation

- Councils should ensure that they put measures in place to plan for an ordinary degree of volatility in their business rates revenue.

Dealing with economic shocks – Even with sound financial management within a council, it is feasible that some areas may be disproportionately and unpredictably affected by an economic shock, for instance the closure of a major employer, through no fault of the council. However, this is relatively infrequent, even during times of general economic instability. Between the financial years 2004/05 to 2009/10, only four upper tier areas in England experienced consecutive annual declines in the amount of business rates they collected. But

76 The data for the NNDR local list graph covers a different time period from the Formula Grant data in the graph above because both contain the most up-to-date data (the Formula Grant settlement for 2011-12 has already been detailed). The pattern of year-on-year change to Local List NNDR revenue can be reasonably expected to follow a similar trend in forthcoming years as it has during the period covered in the graph.

to address such exceptional circumstances, we recommend that there is an Emergency Fund available to such local authorities to smooth out any dramatic falls in local business rates.

This should operate on a loan basis, and would be funded through a small levy on buy-out prices. There will need to be strict rules (including a minimum threshold) about how this is allocated and spent, but it must be an important part of the system to provide support for those suffering from unforeseeable shocks. Once the council has recovered from the economic shock and returns to above-projection growth, it should have to reimburse the fund to ensure that, if necessary, other councils can access it in subsequent years.

Recommendations

- A small levy should be taken from buy-out tariffs to create an Emergency Fund.
- The Fund should be used only in cases of severe and demonstrable economic shocks, and not to compensate for inadequate financial management.
- Access to the Fund should be strictly controlled, either through imposing a stringent set of circumstances in which it can be accessed, or through a process or peer review for any authority wishing to access the Fund.
- Money from the Fund should be treated as a loan to the authority in need, to be paid back when that council's business rates revenue returns to above-projection growth (possibly in the next buy-out cycle).

The Central List – As outlined in Appendix 1, properties upon which business rates are charged must be listed by the billing authority. Most properties appear on local lists; however, "network properties" – such as pipelines and telecommunications and transport infrastructure – which cross the boundaries between multiple billing authorities appear on a central list. Only 101 properties appeared on the central list in 2010, but their total annual business rate revenue obtained from these properties exceeds £1.1bn.

Currently the revenue from properties on this list is collected into the national pool and redistributed. Infrastructure on the central list cannot, by definition, fairly be classed as being within the area of one billing authority, and generally is not located in an area because of the specific efforts or initiatives of the local authority. Therefore, localising revenue from those properties on the central list is unjustifiable on grounds of both fairness and practicality. Instead, business rates revenue from properties on the central list should continue to be paid into the national pool to be used for the purpose of redistribution through subsidising the negative buy-out prices for authorities whose need exceeds their business rates base.

Recommendation

- Business rate revenue from properties on the central list should continue to be redistributed to authorities whose need exceeds their business rates base.

Making a voluntary system work in the long-term – There will undoubtedly be some councils which, despite their public pronouncements that they can influence local economic growth, will be inherently risk-averse, and do not actually think that they can grow their business rates. Such local authorities will doubtless face a political cost if they choose to turn down the opportunity to buy-out, and thereby renege on both their previous statements calling for greater local autonomy and their claims that they are able to influence local economic development.

However, after a period of time, further options may need to be considered to ensure that all areas are given the opportunity to develop, and to deal with any remaining councils left on the old system. These options will have to consider how best to deal with the specific circumstances of those councils remaining outside of the system.

Recommendation

- The Government should make the Buy-Out Model voluntary for a defined period of time before considering other options to deal with remaining councils.

Funding for fire and police authorities – While most redistributed NNDR is used to fund councils, a significant amount – £3.8bn in 2008/09 – is used to fund local fire and police authorities. Fire and police authorities cannot buy out of the formula grant system since they do not collect business rates, and a scheme to fund them using the business rates collected by councils in their area would face a number of difficulties, not least that metropolitan fire and police authorities overlap multiple upper tier authorities.

Given that fire and police authorities have a limited impact on the level of business growth within an area, there is certainly a case to be made for re-examining whether funding them primarily through revenue from business taxation is appropriate. The Government's pledge to roll out directly elected police commissioners has also opened up the possibility that further consideration could be made in the future to fund police authorities through localised taxes.

However, such future possibilities are beyond the remit of this report. We recommend that, for the time being, police and fire authorities continue to be funded through redistributed business rates and Revenue Support Grant.

Recommendations

- Fire and police authorities should continue to be funded as they are at present.
- In the future, and following the introduction of directly elected police commissioners, the Government could consider allowing local areas to charge an extra levy on local taxes to provide direct funding for policing.

Greater London Authority – As is often the case in local government, London requires additional consideration to accommodate its particular structures. The fire and police functions of the Greater London Authority (GLA) are at present partly funded by redistributed business rates. As the GLA does not collect business rates, it can be treated in the same way as other fire and police authorities.

One way in which the GLA is slightly different from fire and police authorities is that since April 2010 it has received revenue the 'Crossrail Business Rate Supplement', a levy of 2% on NNDR on properties with a rateable value over £55,000, which part-funds the Crossrail project. The Supplement is collected by all London Boroughs and the City of London and passes directly to the GLA, without going through central government. However, the Supplement is unaffected by the buy-out model and can remain in place until the Crossrail project is paid for.

Recommendations

- The GLA's police and fire functions can continue to be funded in the same way as other police and fire authorities, with buy-outs replacing business rates revenue.
- The Crossrail Business Rate Supplement currently levied by the GLA does not impact on the model we are proposing, and can remain in place.

5.4 The Impact of the Local Government Finance Settlement

The local government finance settlement, in combination with the Localism Bill, provides an opportunity to radically rethink how local government is funded. The aim of the Buy-Out Model is to provide a greater incentive for local government, and is the first step to greater financial autonomy from the complexity and bureaucracy of the formula grant. Even if the current system of local government finance remains in place, by the end of the period covered by the Comprehensive Spending Review, the financial position of every council will have changed. In particular, many more councils will collect more business rates revenue than they receive in formula grant.

If the Government does not consider radical options such as the Buy-Out Model to reform the current system, there is a real danger that cuts to the formula grant will actually make accountability more complicated. It is important that, as far as possible, the reduction in funding for local authorities as part of the Government's deficit reduction strategy is accompanied by structural changes to local government finance to make the system simpler and more transparent, and to provide a larger incentive for local areas.

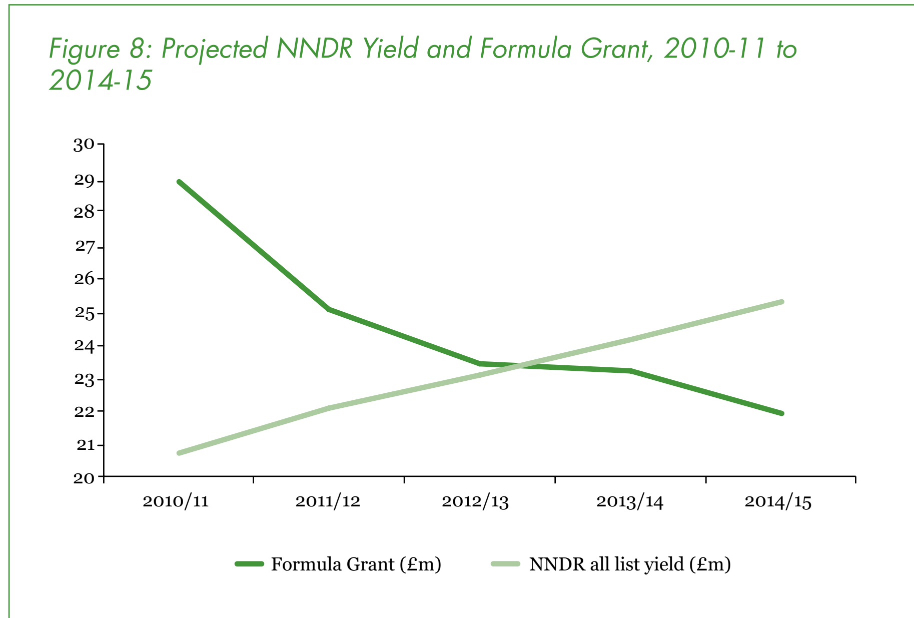
How the cuts will impact upon business rates

The forthcoming spending cuts make the full localisation of NNDR potentially problematic. Over the period covered by the Comprehensive Spending Review, the Formula Grant will be cut from £28.9bn in 2010/11 to £21.9bn in 2014/15. During this time, overall revenue from business rates is likely to increase significantly. Government figures forecast an average annual increase in business rates income from properties on local lists of 5.1% over the period from 2007/08 to 2011/12. Projecting this rate of growth in business rates revenue to the end of the Spending Review period suggests that by 2013-14, business rate revenue from properties on local lists will exceed the total amount of Formula Grant.

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Formula Grant (£bn)				28.9	25.0	23.4	23.2	21.9
Net NNDR yield from all lists (£bn)	18.3	19.9	20.2*	20.7**	22.0**	23.0***	24.1***	25.3***
Increase from prev year (%)	*N/A*	*8.5*	*1.7*	*2.4*	*6.3*	*4.7*	*4.7*	*4.7*

*Notes: all figures are to one decimal place; * denotes provisional outturn; ** denotes DCLG estimated yield; *** denotes projection based on continuation of average 4.7% annual increase in yield.*

Figure 8: Projected NNDR Yield and Formula Grant, 2010-11 to 2014-15



These figures mean that to achieve its stated reduction to the Formula Grant (which also includes the Police Grant and as of 2011-12 will have a number of other grants rolled in), the Government will have to retain a substantial amount of NNDR revenue. If this is to happen, a change in legislation will be required, as under the provisions of the Local Government Finance Act 1988 the net yield of business rates must be redistributed in full to local authorities.

How the cuts will impact upon our model

The buy-out tariffs offered by the Treasury will take account of the planned reductions to the Formula Grant. On the basis of the figures currently available, we must assume that the Government plans to change the law to allow it to retain a portion of the national business rates pool. It may be that the Government intends to use any centrally retained business rates revenue retained for the purpose of reducing the national deficit; however, we believe that any such funds should be kept in the local government sector.

We suggest that this money could provide additional money for the Early Intervention and Infrastructure Fund (proposed in section 5.2). The Fund will provide support for infrastructure which has the potential to further economic development, and will also seek to prevent instances of social breakdown through providing the necessary resources to start up early intervention programmes. It could, therefore, go some way to assuaging the problems of those areas hit hardest by recent reductions in funding from central government.

6. Linkages with Other Initiatives

We believe, for all the reasons outlined in this report, that allowing councils to buy-out of the formula grant system is a good thing in itself. But no policy exists in a vacuum, and the Buy-Out Model has the additional benefit of linking well with a number of existing and forthcoming initiatives.

The current Government and, to some extent, the previous Government have expressed their desire to support local authorities in promoting local business growth. The Government in particular has been relatively explicit in its ambition to provide councils with incentives to develop local areas, particularly for "local authorities to deliver sustainable development, including for new homes and businesses".[77] This chapter will explore how the Buy-Out model works alongside these and other existing policies, and suggest some further reforms that might be considered in the future to enable councils to promote local economic development even more effectively.

6.1 Tax Increment Financing (TIF)

How it works – TIF is a fiscal tool that uses future tax gains to finance current redevelopment and infrastructure projects. It is based on the premise that the redevelopment and provision of new infrastructure to an area will both stimulate commercial activity and increase commercial property values for that area. This in turn generates increased business rates for that area – the tax increment. The local authority can then secure financing for the proposed development against the projected uplift in business rates. The actual tax increment from the redevelopment is then used to repay the enabling finance. In the UK's case, the local authority would keep the tax increment after paying off the money it has borrowed for the TIF.

Why the Buy-Out model benefits from TIF – In the American version of TIF the council revalues the properties within the designated area during and following the redevelopment process to capture increased values and adjust business rates accordingly. The authority then uses the tax increment to repay the enabling finance. Given that in the UK current practice is to revalue every five years, there may need to be a special revaluation process for TIF areas so that the tax increment is properly captured on TIF backed redevelopments. The regular five-yearly revaluation will remain for all other areas. Thus TIF is a particularly useful tool to enable local authorities to capture additional benefits from investment due to the residual growth of property values within an area. This increase in value would not usually be captured within a five year period, and TIF therefore adds an additional financial tool for local authorities to enable new investment to take place within that time frame.

77 Eric Pickles, 10 June 2010, Speech to the LGA http://www.communities.gov.uk/statements/newsroom/localgovernmentsavings

Why TIF benefits from the Buy-Out model - Once the enabling finance is repaid via the tax increment, the TIF will be "retired" (in the US, there are often 20-30 years between area designation and retirement). In the US, TIF is often funded by publicly issued bonds that attract tax reliefs to encourage investment. It is unlikely that such tax incentives will be available for TIF in the UK.

As well as local government borrowing, the US utilises other funding mechanisms including direct developer investment and bonds raised by local authorities from private investors. Such bonds are heavily incentivised in the US, enabling direct private investment from individuals. The great benefit of the Buy-Out Model is that it potentially provides an additional source of revenue to fund TIF initiatives, which may otherwise have been funded through state subsidised private bonds.

Many in local government have long campaigned for TIF powers, and there is now a strong commitment from Government. TIF was unveiled by Nick Clegg at the 2010 Liberal Democrat Party Conference as a new mechanism of borrowing for local authorities, and was confirmed in the Comprehensive Spending Review. Even though the Government has not yet spelled out exactly how TIF will work in the UK, the Department for Communities and Local Government's business plan[78] states that it will introduce a bill for TIF powers and retention of business rates in July 2011. The expectation is that TIF powers will be introduced locally by April 2012.

The commitment by the Government to both TIF and the retention of business rates emphasises their view that both are important tools for local authorities. The model that we are proposing fits very neatly with TIF because councils with genuine control over their business rates are much better placed to use a proportion of expected growth in them to fund redevelopment and infrastructure projects. Following the retirement of a TIF scheme, the tax increment will continue to remain at the local level – therefore providing a long-term incentive for development.

6.2 Business Improvement Districts

How they work – As with TIF, the concept of Business Improvement Districts (BIDs) originated in the United States. They were introduced by the previous Government[79] to allow businesses in the same area to band together, set local priorities and raise additional revenue to execute these priorities. BIDs are established via a ballot of local businesses with membership based usually on a minimum rateable value threshold and decide on a levy which is usually around 1-2 per cent on top of business rates. A typical BID administrative team will usually consist of just a few people and be appointed to meet the objectives set out by the constituent companies. The Government has committed to the principle of allowing businesses to continue to raise an additional levy to support local investment.[80]

Why the Buy-Out Model enhances BIDs – Both the Buy-Out Model and BIDs share an emphasis on collaboration between local businesses and councils to drive economic development at the local level. In conjunction, the two schemes should underpin the development of further trust and cooperation between local authorities and businesses which will drive local economic growth.

6.3 Business Increase Bonus

How it works – Business Increase Bonus (BIB) is a policy that allows local authorities to keep any growth in business rates over a certain threshold for a period of six years, and any additional growth in subsequent years. As discussed in Chapter 3, the Government has already stated that it is developing proposals for a Business Increase Bonus.

78 Department for Communities and Local Government, *Business Plan 2011-2015*, p.7. See http://www.number10.gov.uk/wp-content/uploads/CLG_FINAL-2.pdf (accessed 20/12/2010).

79 Local Government Act (2003), Part 4. See http://www.statutelaw.gov.uk/content.aspx?activeTextDocId=819204 (accessed 20/12/2010).

80 Local Growth White Paper

How BIB and the Buy-Out Model work together - Whilst this would provide a much greater incentive for local authorities compared to the status quo, it is effectively superseded by the Buy-Out Model, which is more permanent, simpler, and potentially offers a much larger benefit to local authorities. The Business Increase Bonus could, however, provide all councils with an incentive to grow their business rates, whether they opt into the buy-out system or not. Whilst the BIB incentive is small in comparison to the Buy-Out Model, it is important for any truly localist Government that every council benefits from business rates growth in its area and has thereby has an incentive to grow its business rates base.

For those authorities that decide to buy-out, the Business Increase Bonus will not apply. The Government may need to consider how best to implement both the Business Increase Bonus and the Buy-Out Model simultaneously.

6.4 Local Enterprise Partnerships

How they work – Local Enterprise Partnerships (LEPs) are new partnerships between local authorities and businesses, led by business, to determine the economic strategy of a defined area. They were brought in to replace Regional Development Agencies, and their purpose is to encourage local councils and local businesses to work together to support economic growth over a functional economic area (i.e. beyond existing administrative boundaries). However, LEPs will not necessarily exist in all areas, and will continue to require approval from central government. As of March 1st 2011, there are 31 LEPs which have been approved by DCLG to set up boards.

These LEPs will be able to bid for a share of central funding from the Regional Growth Fund, which is worth £1.4bn over the next three years. This funding can be spent on a wide range of initiatives and projects that will support and promote economic development. In the future there is also the potential for LEPs to take on more powers, for example, in employment and strategic planning, which were previously vested in RDAs.[81]

How the Buy-Out Model can support LEPs – We believe that LEPs will be significantly enhanced by greater local control of business rates. When funding comes from the bottom up, and the benefits of growth are kept locally, there is a much greater incentive to invest in neighbouring areas for mutual benefit. Local authorities that benefit from buying out will have additional income which can enable them to work with neighbouring authorities to generate sub-regional growth. Such collaboration and joint investment is to be strongly encouraged and has a great deal of potential to drive economic success, particularly in two-tier areas and large metropolitan areas such as London and Manchester.

6.5 Prudential Borrowing

How it works – Prudential Borrowing (PB) was introduced in the Local Government Act 2003 to provide capital investment funding for local authorities. Local authorities are free to borrow to spend on capital with the caveat that they are required to remain within centrally determined limits covering overall indebtedness, capacity to make payments and minimum year-on-year expenditure increases.

How Prudential Borrowing and the Buy-Out Model work together – The problem with prudential borrowing is both the cap on the amount that can be borrowed, and the limiting rules which prevent financial innovation. The recent 1% increase in the Public Works Loan Board rates also makes PB a far less

81 Local Growth White Paper, pp.12-15.

appealing now option than it once was. PB is never going to be the panacea for greater financial autonomy in local government funding, although it may be useful in supporting the Buy-Out Model where any additional borrowing is needed, and to fund local improvements.

6.6 Big Society

What it is – The Big Society is about everyone within a community pulling together. The Government has announced various ways in which it plans to encourage individuals and neighbourhood groups to take a more direct role in commissioning, overseeing, designing and delivering public services. Of course many businesses are already deeply involved in a range of social activities in areas in which they operate, but our Buy-Out Model, by restoring clear lines of accountability between businesses and local authorities, will help to encourage more businesses to take a more active part in the communities in which they are based.

How the Buy-Out Model supports the Big Society – There is a great deal of cross-over between some of the proposals outlined in the previous chapter, and the current Government's approach to the 'Big Society', particularly around providing loans and grants for early intervention initiatives and capital investment. In theory, this could be tied to the 'Big Society Bank' that the Government has announced, providing enhanced support for community and local voluntary organisations to tackle some of the most difficult and entrenched problems in society.

6.7 Place-Based Budgeting

What it is – Place-Based Budgeting (PBB) looks at how a 'whole area' approach to public services can lead to better services at lower cost, more tailored to local needs. It seeks to identify and avoid overlap and duplication between organisations – delivering a step change in both service improvement and efficiency at the local level, as well as across Whitehall. The initiative was initiated with thirteen pilot areas under the last Government, and the current Government has pledged to roll out 'Community Budgets' – its take on PBB – by 2013/14.

How the Buy-Out Model supports Place-Based Budgeting – The impact of the economic downturn means that the whole public sector needs to find radical new solutions to not only deliver better value for money, but also better local services. Allowing councils to capture the wider benefits of their investments is an invaluable feature of the localisation of taxation. The Buy-Out Model will provide a specific opportunity for local councils to engage more comprehensively with the business community, helping to join up local services in new and innovative ways.

6.8 Providing further flexibilities on Business Rates

What they are – While the Buy-Out Model is designed to give local authorities autonomy over the business rates they collect, we are also aware of the concerns of businesses. There is an almost unanimous view amongst business representatives that increasing business rates will be damaging for the economy, "in particular in those taxes on business which bear no relation to profitability".[82] Furthermore, local authorities already have the power to allow discretionary business rates reliefs, so have some flexibility to provide some help to those local businesses it deems deserving of assistance. Similarly, councils can lead

82 Confederation of British Industry (CBI), submission to the Lyons Inquiry (2005) http://www.webarchive.org.uk/wayback/archive/20070428120000/http://www.lyonsinquiry.org.uk/submissions/Confederation%20of%20British%20Industry.pdf

on developing Business Improvement Districts, within which business rates are raised with the consent of participating businesses.

How the Buy-Out Model could support the variation of business rates – We are not proposing that the level of NNDR should be set by local authorities – the model allows for the current system's features of central control over revaluation and setting a national rating multiplier to remain. However, we welcome opportunities for local authorities to provide business rate relief to start-up businesses and smaller enterprises, and believe that an additional levy on business rates to assist targeted economic development can be used positively as long as the businesses it affects support the specific proposal. The Government has already pledged to allow local authorities to raise business rates within a defined area, as long as there is business support for the idea – in essence an extension of the concept of Business Improvement Districts.[83] As the Buy-Out Model should encourage clearer lines of accountability and closer partnerships between businesses and councils, the prospect of allowing councils to vary business rates within defined limits and with business support is likely to become less foreboding for local businesses.

83 Local Growth White Paper, p.3

7. Conclusion

The Government's localist inclinations have already been evidenced by a range of policies, from the Big Society initiative to the General Power of Competence and Neighbourhood Planning provisions of the Localism Bill. But if the Local Government Resource Review does not significantly increase financial autonomy for local authorities, there is a danger that this Government will be remembered for ignoring, rather than addressing, the undeniable need for decentralisation. Without enabling local authorities to have a greater element of financial self-determination, what they can achieve with the powers that are devolved to them will be greatly diminished.

Real financial autonomy for local government is vital for a number of reasons. The existing system of centrally determined hand-outs has meant that councils' power to generate revenue to fund locally relevant projects no longer matches their responsibility to provide services which meet the expectations of residents and local businesses. Dependence on central government has created perverse incentives, with a greater reward for the local authority which emphasises the extent of its problems than for that which backs its economic potential. But most importantly, the current system is not just flawed on the local level, it is failing to deliver the necessary results on the national level. The Government has stated its belief that local growth must drive the national economic recovery; it must follow up by providing councils with strong incentives to lead local growth. At present, such incentives are essentially non-existent.

This report has sought to provide a credible first step towards overcoming these problems through reversing the centralisation of local government finance which was arguably the dominant feature of central-local relations in the twentieth century. The scale of national economic problems makes quick reform a necessity, but the complexities of local government finance and the conflicting priorities of various stakeholders generate considerable inertia. We have adopted an approach which takes account of both the need for reform and the practical barriers to achieving it. We support thoroughgoing reform of local government finance, with the end-goal of financial self-sufficiency for all councils. However, localising aspects of existing taxes and innovating local taxes will take time and involve considerable implementational challenges.

With these practical parameters in mind, we assessed a number of potential reforms to the business rates system. All options were considered on the basis of seven criteria, which reflect the need to retain the principle of redistribution while providing councils with a much more robust incentive to promote local economic development than they have at present. Most of the reforms that we considered failed to combine redistribution and incentive: full relocalisation would severely disadvantage less economically developed areas; localising a portion of business rates or limiting reform to the introduction of a Business

Increase Bonus would provide only a limited and variable incentive. The one option that combines the principle of redistribution with a significant incentive is to allow councils to buy out of the formula grant system and thereafter retain all business rate revenue at the local level.

The Model

Buying out involves councils agreeing with the Treasury a buy-out tariff for each financial year until the next business rates revaluation. The buy-out tariff is based on the net contribution to the national business rates and Revenue Support Grant pool. Net contributors to the pool will pay the Treasury to buy out; net beneficiaries will have a negative tariff, meaning that they will receive money from central government. The tariff for each year of the buy-out is negotiated in advance of the buy-out, creating certainty for both the Treasury and local authorities. Having paid their buy-out tariff, most councils will retain all the business rates that they collect, and all will benefit significantly from fostering thriving local economies.

The Model provides a far greater degree of financial self-determination than the current system. It gives local authorities a direct incentive to focus on economic development. It also has the potential to pave the way for further reforms to local government finance: it will provide a 'kick-start' for councils to take greater control of their finances and benefit from effective economic management, and it will dovetail with further steps to enhance local financial autonomy in the future, either through the innovation of local taxes or the localisation of aspects of existing national taxes.

The Future – the end of grant altogether?

As the Government's reductions to the formula grant come into effect over the next four years, it is probable that revenue from business rates will exceed the total amount of formula grant. In effect, this means that the local government sector will generate, through council tax and business rates revenue, sufficient income to cover its non-ringfenced current spending. If business rates can be retained locally with some form of redistribution to support those areas in which self-sufficiency is not an immediately realistic prospect, then it is very possible to envisage a future without central government block grant. An even better long-term solution, as emphasised throughout this report, is to find a workable solution to enable financial autonomy for all local areas through a basket of local taxes. Following on from this report, Localis will be looking to undertake research into how such a range of local taxes can work in practice.

Ultimately the greatest barrier to the fundamental reforms that could set local government free of central financial constraints is the mindset of local government, business and Whitehall. All stakeholders must be prepared, to some extent, to look beyond narrowly defined short-term gains – an attitude encouraged by the shortcomings of the current system – in favour of backing reform that will benefit the national as a whole. Central government must be prepared to relinquish a great deal of its current control. Businesses must be prepared to work with local authorities in constructive ways. Councils must be prepared to take on additional responsibility and move away from emphasising their supposedly unique levels of need to thinking positively about the potential of their areas and how to realise it. The challenges involved in such a thoroughgoing change of mindset should not be underestimated, but it is imperative that the current broad recognition of the necessity of change translates into actual reform, not simply another missed opportunity.

Appendices

Appendix 1: How the Current Business Rates System Works

The current business rates system lends itself very strongly to local retention. This is because it is, to some degree, already a local tax. The diagram in section 5.2 illustrates how the current system operates.

NNDR are collected locally by unitary and district councils and then remitted by these councils to the Department for Communities and Local Government. This pot of money, along with a small top-up known as the Revenue Support Grant (RSG) and a Police Grant, is then reallocated to local authorities in the guise of the Formula Grant, according to a distribution model called the four block model.

The four-block model is composed of the following elements:

1. *Relative Needs* – A relative block of redistributive funding based on the needs of local authorities, as assessed by central government. It currently makes up approximately 73% of the total pot, and is allocated according to a series of extremely complicated formulae.
2. *Relative Resources* – A negative block designed to take account of local authorities' differing ability to raise their own money through council tax. The overall impact is to 'take away' approximately 27% of the total pot.
3. *Central Allocation* – This block distributes the remaining amount left over after the needs and resources allocation has been made, and so accounts for 54% of the total grant amount. It is allocated to councils on a convoluted version of a per-capita basis.
4. *Floor Damping Block* – This is a zero-sum reallocation of the totals produced by the first three blocks which ensures that authorities receive a guaranteed minimum percentage increase in grant compared to the previous year. Different 'floors' are set for different categories of local authorities. The money required to pay for a guaranteed minimum increase for all authorities is found by scaling back increases in authorities whose grant increases are above the floor. The purpose of this fourth block is to stop councils suffering significant swings in grant levels and so provide some form of financial stability.

How NNDR charges are calculated

Lists of buildings used for non-domestic purposes, and therefore liable to NNDR charges, are compiled and updated every five years. The vast majority of these buildings (over 1.7 million as of November 2009[84]) are listed on *Local Ratings Lists.*

- There is a valuation officer for each billing authority (Unitary Authority and County District) who is tasked with compiling and maintaining lists of every hereditament (property liable to NNDR charges) within the boundaries of the authority.

84 *Local Government Finance Statistics England: No.20 2010, p.45*

Local lists were first compiled on 1st April 1990, and an updated list is compiled and published on 1st April of every fifth year subsequently (the latest compilation was published on 1st April 2010).[85]

There is also a *Central Ratings List,* which "contains the rating assessments of the network property of major transport, utility and telecommunications undertakings and cross-country pipelines".[86] Examples of network property on this list include those owned by London Underground, British Telecom and National Grid Gas.[87] The NNDR revenue from hereditaments on the Central Ratings List, unlike that from hereditaments on Local Ratings Lists, is not passed through local authorities into the national pool, but instead goes directly into the pool and is subsequently redistributed to local authorities.

- The Central Valuation Officer compiles and maintains the Central Ratings List. The list was first was compiled on 1st April 1990 and is updated on 1st April of every fifth year subsequently.[88]
- In its 2010 compilation, the Central Ratings List for England contained 101 hereditaments.[89]

Each non-domestic property on the Local Ratings Lists and Central Ratings List is charged a specific amount of NNDR per annum. This is calculated by applying the *Non-Domestic Rating Multiplier* to the rateable value of each property.

The rateable value represents the open market annual rental value of a business or non-domestic property on a set valuation date.

- Current rateable values, which came into effect on 1st April 2010, represent rental values at 1st April 2008.
- Rateable values are set by the Valuation Office Agency (VOA).[90]

The Non-Domestic Rating Multiplier, also known as the Uniform Business Rate, represents the number of pence in each pound of the rateable value of the property which is charged in NNDR. It is set in England by the Department for Communities and Local Government, with the exception of the City of London, which since 2003/04 has been able to set its own multiplier.[91]

- CLG (or its predecessors) has usually adjusted the multiplier to ensure that the NNDR charged remains in line with inflation measured by the Retail Price Index (RPI).[92]
- In revaluation years (including 2010/11), the multiplier tends to drop significantly to ensure that the amount a typical businesses have to pay does not increase above RPI (since the rateable value of properties tends to increase above RPI). For example, in 2010/11 the standard multiplier in England was set at 41.4 pence in the pound to balance revaluation, down from 48.5 pence in the pound in 2009/10.[93]

Rate Relief Schemes

Having had their basic NNDR charge calculated according to the formula of applying the multiplier to the rateable value, occupiers of non-domestic properties are often eligible for one or more *Rate Relief Scheme*.

- If the rate-payer is a charity or trustees of a charity and the building is used for mostly charitable purposes, the rate charged is one-fifth of the full rate if the building were used for commercial purposes.
- If the building is a Post Office, or within an area on the rural settlement list (introduced in November 1997, it includes those settlements which have a population of less than 3,000 and are deemed by the Secretary of State to

85 Local Government Finance Act, 1988, articles 41-51. http://www.legislation.gov.uk/ukpga/1988/41/part/III/crossheading/local-rating (accessed 13/12/2010).

86 http://www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId=1086066685 (accessed 13/12/2010).

87 http://www.2010.voa.gov.uk/rli/static/HelpPages/Documents/draft_central_rating_list_for_england_2010.pdf (accessed 13/12/2010).

88 Ibid, articles 52-54. http://www.legislation.gov.uk/ukpga/1988/41/part/III/crossheading/central-rating (accessed 13/12/2010).

89 http://www.2010.voa.gov.uk/rli/static/HelpPages/Documents/draft_central_rating_list_for_england_2010.pdf (accessed 13/12/2010).

90 http://www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId=1086076412 (accessed 13/12/2010).

91 In practice the City of London has set its multiplier between 0.3 and 0.4 pence in the pound above the multiplier in the rest of England throughout the time that it has had this autonomy. See http://www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId=1086066470 (accessed 13/12/2010).

92 http://www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId=1086066503 (accessed 13/12/2010).

93 http://www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId=1086066470 (accessed 13/12/2010).

be "a rural area"), or the rate payer is a food store selling food for human consumption (excluding restaurants and purveyors of hot food), the rate charged is half of the full rate.

- There is also relief on empty properties, and 'Transitional Rate Relief' to reduce the impact of any significant changes in rateable value by spreading the change across a number of years.
- The 2003 Local Government Act introduced 'Small Business Rate Relief' in England and Wales. Currently businesses in properties of rateable value less than £18,000 (£25,000 in London) benefit from a slightly lower Non-Domestic Rating Multiplier (in 2010/11, 40.7 pence in the pound compared with the standard multiplier of 41.4 pence in the pound). Businesses in properties of a rateable value of £6,000 or less are charged half of this small business rate multiplier; those in properties of rateable value between £6,001 and £11,999 are charged on a sliding scale ranging from 50% of the small business rate multiplier for those businesses in properties of a rateable value of £6,000 to 100% of the small business rate multiplier for businesses in properties of a rateable value of £12,000. An example business in a property of a rateable value of £9,000 would be charged at 75% of the small business rate multiplier (in 2010/11, this equates to 30.5 pence in the pound).
- In total, the various forms of NNDR relief totalled just over £1.5bn in 2009/10.[94]

Although under the provisions of the 1988 Local Government Finance Act no NNDR revenue can be retained by central government, this does not mean that the total amount given back to local authorities – the Distributable Amount (DA) – is the same as the NNDR yield.[95] The DA is set in advance of the financial year to which it applies (the 2011/12 DA was set in the local government finance settlement in December 2010), and has frequently exceeded the net yield in NNDR once Rate Relief schemes (see below), collection costs and other adjustments have been taken into account. Any surplus or deficit accrued from a disparity between this net yield and the DA must be accounted for in subsequent years' DA. This explains the fluctuation in DA since 2007/08, when £18.5bn was distributed, despite the fact that the net yield increased year on year. In 2008/09, the DA increased to £20.5bn, before dropping to £19.5bn in 2009/10, and then increasing again to £21.5bn in 2010/11. It was recently announced that, owing primarily to a record £2.3bn deficit carried over from 2010/11, the DA for 2011/12 would be £19bn.[96] These fluctuations are compensated within the overall Formula Grant by changes to the Revenue Support Grant, which has varied significantly to ensure that the overall Formula Grant remains at the level desired by central government.[97]

Despite the intricacies of the current system, the way that business rates are currently collected and redistributed lends itself very well to local retention. It would be straightforward to allow councils to keep all or a proportion of the proceeds from business rates locally, whilst maintaining the most essential elements of central oversight – particularly the revaluation and rate setting elements.

Appendix 2: Detailed Illustrative Examples

These case studies do not represent specific councils, and are for illustrative purposes only. All case studies use the same assumptions. These are:

- The percentage increases in projected business rates revenue from the base in Year 0 is the same for each council (5% in Year 1; 4% in Year 2; 4% in Year 3). In reality, these percentages will vary from council to council and will be negotiated by the individual council and the Treasury.

94 *Local Government Finance Statistics England: No.20* 2010, p.48.

95 http://www.local.communities.gov.uk/finance/1112/dasummary.pdf (accessed 20/12/2010).

96 http://www.local.communities.gov.uk/finance/1112/dasummary.pdf (accessed 20/12/2010).

97 *Local Government Finance Statistics England: No.20 2010, p.57.*

- The above/below projection variations in the amount of business that the council 'actually' collects is the same for each council in each of the three scenarios (2% above projection each year for 'strong growth'; 1% above projection each year for 'moderate growth'; 1% below projection each year for 'weak growth'). In reality, these percentages would vary from council to council, and would be highly unlikely to exceed or fall short of projection by a consistent percentage across all years of the buy-out.
- The percentage reduction in the amount of redistributed NNDR and Revenue Support Grant for each council is the same as the national average reduction in the total formula grant for the years to 2014-15 (6.4% reduction in 2012-13; 0.9% reduction in 2013-14; 5.6% in 2014-15).[98]
- The Emergency Fund Levy is set at 0.2% of the council's projected business rates base for each year of the buy-out.
- The rolling buy-out adjustment is set at 0% of the council's projected business rates base for each year of the buy-out (i.e. assuming the council does not buy-out up-front).

Example 1: A large business rate base, and a significant net contribution to the NNDR pool

This council is likely to feel that because it contributes such a large amount to the pool, that it should be rewarded for its contribution. Its vital statistics are:

- In Year 0 (2011-12) it collected £320m of business rates and received £250m back from central government.
- Its net contribution to the NNDR pool in Year 0 was therefore £70m.

Scenario	*Strong Growth*				
Council	*Example 1*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		320.0	336.0	349.4	363.4
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		250.0	234.0	231.9	218.9
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		70.0	102.0	117.5	144.5
NNDR: Needs Ratio		1.3	1.4	1.5	1.7
Emergency Fund Levy	0.2%		0.7	0.7	0.7
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.2%*		*0.7*	*0.7*	*0.7*
Total Buy-Out Amount			***102.7***	***118.2***	***145.2***
Actual					
Actual NNDR Collected		320.0	342.4	362.9	384.7
Actual Growth in NNDR	*2%*		*7.0%*	*6.0%*	*6.0%*
Benefit/(Cost) to Council			**5.7**	**12.8**	**20.6**
Cumulative Benefit/(Cost) to Council					**39.1**

98 *Comprehensive Spending Review 2010*, p.51.

Scenario	*Moderate Growth*				
Council	*Example 1*				
		£m			
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		320.0	336.0	349.4	363.4
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		250.0	234.0	231.9	218.9
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		70.0	102.0	117.5	144.5
NNDR: Needs Ratio		1.3	1.4	1.5	1.7
Emergency Fund Levy	0.2%		0.7	0.7	0.7
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.2%*		*0.7*	*0.7*	*0.7*
Total Buy-Out Amount			***102.7***	***118.2***	***145.2***
Actual					
Actual NNDR Collected		320.0	339.2	356.2	374.0
Actual Growth in NNDR	*1.0%*		*6.0%*	*5.0%*	*5.0%*
Benefit/(Cost) to Council			**2.5**	**6.0**	**9.8**
Cumulative Benefit/(Cost) to Council					**18.4**

Scenario	*Weak Growth*				
Council	*Example 1*				
		£m			
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		320.0	336.0	349.4	363.4
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		250.0	234.0	231.9	218.9
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		70.0	102.0	117.5	144.5
NNDR: Needs Ratio		1.3	1.4	1.5	1.7
Emergency Fund Levy	0.2%		0.7	0.7	0.7
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.2%*		*0.7*	*0.7*	*0.7*
Total Buy-Out Amount			***102.7***	***118.2***	***145.2***
Actual					
Actual NNDR Collected		320.0	332.8	342.8	353.1
Actual Growth in NNDR	*(1.0%)*		*4.0%*	*3.0%*	*3.0%*
Benefit/(Cost) to Council			**(3.9)**	**(7.4)**	**(11.1)**
Cumulative Benefit/(Cost) to Council					**(22.3)**

Example 2: An medium business rates base, with a medium contribution to the NNDR pool

This council is likely to feel that the current system of business rate redistribution is a waste of time as they get back almost the same amount as they receive after redistribution. Its vital statistics are:

- In Year 0 (2011-12) it collected £120m of business rates and received £120m back from central government.
- Its net contribution to the NNDR pool in Year 0 was therefore £0.

Scenario	*Strong Growth*				
Council	*Example 2*				
	£m				
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		120.0	126.0	131.0	136.3
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		120.0	112.3	111.3	105.1
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		0.0	13.7	19.7	31.2
NNDR: Needs Ratio		1.0	1.1	1.2	1.3
Emergency Fund Levy	0.2%		0.3	0.3	0.3
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.2%*		*0.3*	*0.3*	*0.3*
Total Buy-Out Amount			***13.9***	***20.0***	***31.5***
Actual					
Actual NNDR Collected		120.0	128.4	136.1	144.3
Actual Growth in NNDR	*2%*		*7.0%*	*6.0%*	*6.0%*
Benefit/(Cost) to Council			**2.1**	**4.8**	**7.7**
Cumulative Benefit/(Cost) to Council					**14.7**

Scenario	*Moderate Growth*				
Council	*Example 2*				
	£m				
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		120.0	126.0	131.0	136.3
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		120.0	112.3	111.3	105.1
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		0.0	13.7	19.7	31.2
NNDR: Needs Ratio		1.0	1.1	1.2	1.3
Emergency Fund Levy	0.2%		0.3	0.3	0.3
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.2%*		*0.3*	*0.3*	*0.3*

Scenario	*Moderate Growth*				
Council	*Example 2*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Total Buy-Out Amount			***13.9***	***20.0***	***31.5***
Actual					
Actual NNDR Collected		120.0	127.2	133.6	140.2
Actual Growth in NNDR	*1.0%*		*6.0%*	*5.0%*	*5.0%*
Benefit/(Cost) to Council			**0.9**	**2.3**	**3.7**
Cumulative Benefit/(Cost) to Council					**6.9**

Scenario	*Weak Growth*				
Council	*Example 2*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		120.0	126.0	131.0	136.3
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		120.0	112.3	111.3	105.1
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		0.0	13.7	19.7	31.2
NNDR: Needs Ratio		1.0	1.1	1.2	1.3
Emergency Fund Levy	0.2%		0.3	0.3	0.3
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.2%*		*0.3*	*0.3*	*0.3*
Total Buy-Out Amount			***13.9***	***20.0***	***31.5***
Actual					
Actual NNDR Collected		120.0	124.8	128.5	132.4
Actual Growth in NNDR	*(1.0%)*		*4.0%*	*3.0%*	*3.0%*
Benefit/(Cost) to Council			**(1.5)**	**(2.8)**	**(4.2)**
Cumulative Benefit/(Cost) to Council					**(8.4)**

Example 3: A medium business rates base, with a large net benefit from the NNDR pool

This council is likely to feel that because it is largely dependent on grant that any change to the current system is unlikely to benefit them. However, our model is designed to ensure that they too receive a tempting offer to buy out.

Scenario	Strong Growth				
Council	*Example 3*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		150.0	157.5	163.8	170.4
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		240.0	224.6	222.6	210.2
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		-90.0	-67.1	-58.8	-39.8
NNDR: Needs Ratio		0.6	0.7	0.7	0.8
Emergency Fund Levy	0.2%		0.3	0.3	0.3
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.0%*		*0.3*	*0.3*	*0.3*
Total Buy-Out Amount			***-66.8***	***-58.5***	***-39.5***
Actual					
Actual NNDR Collected		150.0	160.5	170.1	180.3
Actual Growth in NNDR	*2%*		*7.0%*	*6.0%*	*6.0%*
Benefit/(Cost) to Council			**2.7**	**6.0**	**9.6**
Cumulative Benefit/(Cost) to Council					**18.3**

Scenario	Moderate Growth				
Council	*Example 3*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		150.0	157.5	163.8	170.4
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		240.0	224.6	222.6	210.2
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		-90.0	-67.1	-58.8	-39.8
NNDR: Needs Ratio		0.6	0.7	0.7	0.8
Emergency Fund Levy	0.2%		0.3	0.3	0.3
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.0%*		*0.3*	*0.3*	*0.3*
Total Buy-Out Amount			***-66.8***	***-58.5***	***-39.5***
Actual					
Actual NNDR Collected		150.0	159.0	167.0	175.3
Actual Growth in NNDR	*1.0%*		*6.0%*	*5.0%*	*5.0%*
Benefit/(Cost) to Council			**1.2**	**2.8**	**4.6**
Cumulative Benefit/(Cost) to Council					**8.6**

Scenario	Weak Growth				
Council	*Example 3*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		150.0	157.5	163.8	170.4
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		240.0	224.6	222.6	210.2
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		-90.0	-67.1	-58.8	-39.8
NNDR: Needs Ratio		0.6	0.7	0.7	0.8
Emergency Fund Levy	0.2%		0.3	0.3	0.3
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.0%*		*0.3*	*0.3*	*0.3*
Total Buy-Out Amount			***-66.8***	***-58.5***	***-39.5***
Actual					
Actual NNDR Collected		150.0	156.0	160.7	165.5
Actual Growth in NNDR	*(1.0%)*		*4.0%*	*3.0%*	*3.0%*
Benefit/(Cost) to Council			**(1.8)**	**(3.4)**	**(5.2)**
Cumulative Benefit/(Cost) to Council					**(10.5)**

Appendix 3: Risk-Sharing Examples

The following case studies use the same assumptions as the case studies in appendix 2, with the following addition:

- The maximum allowable business rates base to assessed need ratio is 3:1

Example 1: A very large business rate base, and a very large net contribution to the NNDR pool

- In Year 0 (2011-12) it collected £450m of business rates and received £110m back from central government.
- Its net contribution to the NNDR pool in Year 0 was therefore £340m.

Scenario	Strong Growth				
Council	*Risk-Share Example 1*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		450.0	472.5	491.4	511.1
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		110.0	103.0	102.0	96.3
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		340.0	369.5	389.4	414.7
NNDR: Needs Ratio		4.1	4.6	4.8	5.3

Scenario	*Strong Growth*				
Council	*Risk-Share Example 1*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Emergency Fund Levy	0.2%		0.9	1.0	1.0
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.2%*		*0.9*	*1.0*	*1.0*
Total Buy-Out Amount			***370.5***	***390.3***	***415.8***
Actual					
Actual NNDR Collected		450.0	481.5	510.4	541.0
Actual Growth in NNDR	*2.0%*		*7.0%*	*6.0%*	*6.0%*
Benefit/(Cost) to council without risk share			**8.1**	**18.0**	**28.9**
Risk share					
NNDR: Needs Ratio Threshold exceeded?	3		Y	Y	Y
Local element			308.9	306.1	289.0
National element			163.6	185.3	222.1
Percentage risk/reward for Council			*65.4%*	*62.3%*	*56.5%*
Percentage risk/reward for Treasury			*34.6%*	*37.7%*	*43.5%*
Annual Benefit/(Cost) to Council			**5.9**	**11.8**	**16.9**
Annual Benefit/(Cost) to Treasury			**3.1**	**7.2**	**13.0**
Cumulative Benefit/(Cost) to Council					**34.7**
Cumulative Benefit/(Cost) to Treasury					**23.3**

Scenario	*Moderate Growth*				
Council	*Risk-Share Example 1*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		450.0	472.5	491.4	511.1
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		110.0	103.0	102.0	96.3
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		340.0	369.5	389.4	414.7
NNDR: Needs Ratio		4.1	4.6	4.8	5.3
Emergency Fund Levy	0.2%		0.9	1.0	1.0
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.2%*		*0.9*	*1.0*	*1.0*
Total Buy-Out Amount			***370.5***	***390.3***	***415.8***
Actual					
Actual NNDR Collected		450.0	477.0	500.9	525.9

Scenario	Moderate Growth				
Council	*Risk-Share Example 1*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Actual					
Actual Growth in NNDR	*1.0%*		*6.0%*	*5.0%*	*5.0%*
Benefit/(Cost) to council without risk share			**3.6**	**8.5**	**13.8**
Risk share					
NNDR: Needs Ratio Threshold exceeded?	3		Y	Y	Y
Local element			308.9	306.1	289.0
National element			163.6	185.3	222.1
Percentage risk/reward for Council			*65.4%*	*62.3%*	*56.5%*
Percentage risk/reward for Treasury			*34.6%*	*37.7%*	*43.5%*
Annual Benefit/(Cost) to Council			**2.9**	**5.9**	**8.4**
Annual Benefit/(Cost) to Treasury			**1.6**	**3.6**	**6.4**
Cumulative Benefit/(Cost) to Council					**17.2**
Cumulative Benefit/(Cost) to Treasury					**11.6**

Scenario	Weak Growth				
Council	*Risk-Share Example 1*				
			£m		
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Projection					
Projected NNDR Collected		450.0	472.5	491.4	511.1
Growth in NNDR			5.0%	4.0%	4.0%
Total Redistributed NNDR + RSG		110.0	103.0	102.0	96.3
Growth in Redistributed NNDR + RSG			(6.4%)	(0.9%)	(5.6%)
Net Contribution to National NNDR Pool		340.0	369.5	389.4	414.7
NNDR: Needs Ratio		4.1	4.6	4.8	5.3
Emergency Fund Levy	0.2%		0.9	1.0	1.0
Rolling Buy-Out Adjustment (incentive)	0.0%		0.0	0.0	0.0
Total Adjustments	*0.2%*		*0.9*	*1.0*	*1.0*
Total Buy-Out Amount			***370.5***	***390.3***	***415.8***
Actual					
Actual NNDR Collected		450.0	468.0	482.0	496.5
Actual Growth in NNDR	*(1.0%)*		*4.0%*	*3.0%*	*3.0%*
Benefit/(Cost) to council without risk share			**(5.4)**	**(10.3)**	**(15.6)**
Risk share					
NNDR: Needs Ratio Threshold exceeded?	3		Y	Y	Y
Local element			308.9	306.1	289.0
National element			163.6	185.3	222.1
Percentage risk/reward for Council			*65.4%*	*62.3%*	*56.5%*
Percentage risk/reward for Treasury			*34.6%*	*37.7%*	*43.5%*

Scenario	Weak Growth				
Council	Risk-Share Example 1				
	£m				
		Year 0	Year 1	Year 2	Year 3
	%	2011/12	2012/13	2013/14	2014/15
Annual Benefit/(Cost) to Council			**(2.9)**	**(5.8)**	**(8.2)**
Annual Benefit/(Cost) to Treasury			**(1.6)**	**(3.5)**	**(6.3)**
Cumulative Benefit/(Cost) to Council					**(17.0)**
Cumulative Benefit/(Cost) to Treasury					**(11.4)**

Appendix 4: Consultation and Survey Questions

Consultation Questions:

1. What is the most important role for local government?
2. Do you think incentives should be built into the local government finance system? Including business growth?
3. What is the right balance between equity and incentives in local government?
4. Do you believe that businesses in your area understand that you are not responsible for NNDR?
5. Have you had any problems with local businesses due to the lack of accountability?
6. How important is stability/predictability/local autonomy in local government finance?
7. Would you like to have more control of you business rates? If so, how?
8. Do you think the scheme we are outlining might be beneficial for your area?
9. Are there any specific examples of initiatives that you have been prevented from doing because of the current system?
10. How do you judge economic success in your area?

Survey Responses

The survey was sent out to the Chief Executive and the Leader of every council in England, and 195 completed the survey. The results below are from all responses to the survey, although we also analysed the data for geographical and council type variations.

1. Should councils be given greater financial autonomy?

Yes 99.5%
No 0.5%

2. If possible, would you like to see more taxes collected and spent locally?

Yes 95.5%
No 4.5%

3. If it were possible to create a fair system for every council, would you like to be completely independent of central government funding?

Yes 77.0%
No 23.0%

4. Would financial incentives make your council more innovative?

Yes	76.0%
No	24.0%

5. What is more important for local government finance – central equalisation or local autonomy?

Local autonomy much more important	35.1%
Local autonomy slightly more important	26.7%
Both equally important	29.2%
Equalisation slightly more important	3.5%
Equalisation much more important	5.4%

6. To what extent can a council impact on the local economy?

A large amount	42.6%
A moderate amount	41.6%
A small amount	15.3%
Not at all	0.5%

7. Would you like more control of business rates in some form?

Yes	96%
No	4%

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About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities to achieve their potential.

Ernst & Young in Local Government

Ernst & Young is helping clients from across local government reach their potential through the allocation a cross-disciplinary team dedicated to the unique circumstances of local public services. Importantly we don't sell onesize-fits-all solutions; we deliver on the specific needs of our clients.

Why is Ernst & Young supporting this initiative?

Localism requires a radical shift in mindset. At Ernst & Young we pride ourselves on making difficult things happen. This often means we have to challenge the accepted norms of the environment in which our clients operate. That's what this project aims to do and we're delighted to support it.

Challenging times demand radical responses; in the current fiscal climate, new and innovative approaches are required to deliver the economic growth that the country so desperately needs. We believe that local government must be given greater local financial autonomy if it is to support this agenda more effectively. But the current system of local government finance in England is opaque, highly centralised and riven with perverse incentives.

Our long-term vision is for all councils to be entirely self-funded from a basket of locally derived income streams with minimal adjustments to take account of inequality of need. However, the parlous state of the national economy means there is a pressing need for more immediate measures that will provide councils with a real incentive to boost economic growth at the local level. In this report we aim to show how an implementable but radical reform to allow local authorities to retain business rates at the local level will create significant new incentives that will help drive the economy forward, as well as providing a platform for a full-scale localist shift in the near future.

The vast majority of councils are straining to throw off centrally imposed constraints and once again be given the freedom to innovate and drive local economic growth. This timely report - with a foreword by Sir Michael Lyons, the author of the last major review of local government finance – proposes a model that will allow them to do just that.

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