the case for consensus:

reforming local government finance

By Dan Corry and Chris Wales

THE SMITH INSTITUTE

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This publication forms part of the Smith Institute's ongoing 'policies for change' programme and builds on the work we have undertaken on localism, place making and economic geography. Whilst some of this work has contributed to the broad localism debate we have also tried to focus in on the practical delivery of policies with research on new funding tools, like tax increment financing, and reports and events on related issues, such as affordable housing and community cohesion.

With the first stage of the Local Government Resource Review reaching its conclusion, this timely report lays out the opportunities reform can bring, including a commentary on the pros and cons of retentions of the business rate and incentivising growth. As the authors make clear there are major challenges around achieving a fairer and more effective distribution of resources, and any long lasting settlement requires genuine local and national cross party support.

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Introduction

Local government finance has been a backwater for most national politicians. Since the poll tax debacle ministers have been cautious about reforming local taxation, not least because the issue was seen as divisive and complex. Local authorities have consistently stated the case for reform, but there has been no lasting consensus on how to change the system in a way which satisfies both rich and poor councils. Whilst revaluation of council tax was put on hold for fear of a public backlash, governments since the 1990s have also remained equally concerned about how business might react to changes to the business rate. Ministers have continued to commission reviews and studiously weigh up the evidence for reform, but decisions to overhaul the system have regularly been shunted into the political long grass.

Now after several false starts the Coalition government under the banner of 'meaningful localism' and 'rebalancing the economy' has pledged to "promote greater financial autonomy to local government". The objective is not only to give local authorities greater financial freedoms and flexibility, but specifically to incentivise growth in the private sector and regenerate local economies. These are similar aims to the previous Labour government, but set against a very different backdrop of public spending cuts, fiscal austerity and sluggish growth. These reforms also form part of the Coalition's wider localist agenda, which includes localising council tax benefit, reform of council housing financing (Housing Revenue Account), local enterprise partnerships and local enterprise zones, changes to the local planning system, and plans to introduce local referenda and establish more local mayors.

Although the initial aspiration of the Liberal Democrats was to conduct a no-holes barred review of the entire system of local government finance (with a view to implanting a local income/property tax), the first phase of the Coalition's Local Government Resource Review concentrates on more modest changes to the business rate system. Whilst the Review rules out the prospect of councils having the power to vary the business rate, it does provide for a new system which allows councils to retain extra income from their business rates and to borrow against that income for capital spending. To give this some context business rate receipts currently account for just under 5% of the total tax take (compared with around 7.5% for corporation tax and just under 30% for income tax).

The Deputy Prime Minister, Nick Clegg, has championed the case for financial devolution and argues that retention of business rates will make a major difference to local economies. He has stated that centralising business rates (back in 1988) was a mistake and that the reforms will allow councils to have much more control of their budgets.

Changes to the business rate system will, according to Clegg "create the conditions for communities to invest in their own success, give councils proper power over spending as well as more control over the tax they raise and keep". Furthermore, Nick Clegg has given a guarantee that the new system would be fair and "no council would lose funding….the new system will start on a level playing field. How far you progress from there is entirely up to you." The LGA welcomed the announcement, stating the reforms would be the "biggest kick-start to our economies".

How radical these reforms prove to be will not be clear until the Local Government Finance bill is introduced in the Autumn. Statements by Nick Clegg suggest that the changes will be significant and councils will have control of 80% of their budgets (up from 50%). However, this paper examines the government's claim that retention of business rates (and borrowing against extra business rate income) will support local growth overall and in all areas. Local authorities will certainly need the powers to retain extra business rate income to support new funding tools, such as Tax Increment Financing for capital projects (as they already do in Scotland). How much more of a difference the reforms will make – especially in areas of deprivation where private markets are weak and values are low- is disputable.

In this paper we examine the pros and cons of changes to the business rate system and (in light of recent government statements ahead of the Local Government Resource Review) consider: i) whether the reforms can improve the current system and support growth (notably in poorer areas); and ii) how best to strike the right balance between incentivising growth and ensuring poorer councils still have adequate resources to fund local services. Our intention is not to attack the reforms, but to contextualise them and seek to understand their scope and significance. Moreover, we have tried to set out the case for consensus so that reforms to local government finance can be sustainable and improved upon over time. Bulldozing changes through against the wishes of many councils and the opposition is counterproductive and hardly conducive to incentivising growth since it will not be assumed to be a long term settlement. Our hope is that the main political parties can reach a long term settlement on reforming local government finance.

Reforming local government finance

Any system of local government finance can have a number of objectives. According to the three-year independent Lyons Inquiry into Local Government, which reported in 2007, improving the local government finance system should seek to achieve:

- *clearer accountability* over who is responsible for what;
- *greater flexibility*, both over finances and to enable local government to manage local services in response to local needs;
- *better incentives* on local government to own and grow their tax bases;

- *tackling perceived unfairness*, in order to improve satisfaction and trust in the system of local government as a whole; and
- *continued improvements in efficiency* to help relieve pressures on council tax under the current system.[1]

However, in recent years the UK system has put two objectives above all else. One has been to try to make sure that different councils in different places get support from the centre in ways that allow in effect each council to be able to deliver broadly the same set of services for same council tax rate. So great attention is focused on the amount that a council 'needs', and how to calculate this (deprivation and the way costs vary by area being most important in this), and the amount it can genuinely raise itself. The assessments are then recalibrated through each authorities' council tax base data.[2] The second has been to devise a way of raising money at local level that causes the least disquiet with an electorate which, in general, very much dislikes the current council tax regime.

Objectives that have been relegated are: a local tax raising system that means that local people genuinely have a choice and trade-off between higher taxes and less well funded services; and the aim of giving councils – and their citizens – a financial incentive for promoting economic growth and success.

Policy makers have been aware of these two gaps over the years and have tried to address them in different ways. On the issue of a more locally focused system of raising finance, there has been a general understanding that too much money has been raised at national level relative to the local (so the 'gearing ratio' was too high) so making local government subject to too much dependency on the centre.[3] One answer to this has been to try to un-ring fence money given by the centre on the argument that the key local freedom was the ability to spend whatever you did have in the way that you (and local people) wanted.[4]

A more ambitious approach has been to move away from the current version of the council tax towards a measure that is fairer, more progressive and – ideally – does not suffer from the council tax properties of being lumpy, not changing with economic circumstances and requiring revaluations which no political party seems willing to risk (since the losers will drown out the supposedly joyous voices of the winners). This led to the Lyons Inquiry

1 *Lyons Inquiry into local government Final Report: Place-shaping: a shared ambition for the future of local government*, March 2007, The Stationary Office, London
2 See http://www.local.communities.gov.uk/finance/0607/simpguid.pdf for some background
3 OECD figures show that in 2009 only 5.31% of total taxes were raised locally (up from 3.8% in 1997), as compared to a combined state and local total of 33% in Spain, 13% in France and 29% in Germany. OECD Fiscal decentralisation Database Table 7 (www.oecd,org/ctp/federalism/stats)
4 See e.g. Corry, D and Stoker, G *New Localism* (NLGN, 2002)

which produced several reports looking at the issues and options including fairer versions of council tax (with more bands for instance), local income tax and income tax assignment. But there has been little success in turning such reports into new policy as yet.

On the incentives to growth issue, some policy thinkers, especially on the centre-right, have worried that far from encouraging growth this system of needs based equalisation positively encourages councils to have low income populations and "demonstrate how deprived and therefore worthy of central funding they are".[5] While this may be a bit far fetched in its suggestion that due to the funding system councils try to maximise the number of deprived households that they have, the basic problem off a lack of incentives to growth has been recognised and steps have been taken to add things to the current system to incentivise growth. So we saw things under the Labour government like the Local Authority Business Growth Incentive Scheme (LABGI) that rewarded councils who achieved growth. Unfortunately and for reasons well outlined in Lyons[6] this scheme turned out to reward growth in too minor, too complex, and in too unpredictable a way to have any chance of really influencing behaviour.

More recently the Coalition government has tried to use incentives to encourage house-building which historically has been seen as having only a downside for existing communities (more people) with no real financial gain. This has led to the introduction of the New Homes Bonus (in April 2011, backed by a £1bn fund), where government matches the additional council tax raised for new homes and properties brought back into use for a period of six years. The jury on how well this will work is certainly out at present, not least since it is only over a number of years that real dynamic incentive effects can be picked up.

Of course one can exaggerate the degree to which the current system does not financially incentivise councils and local areas overall to go for growth and query whether the key to getting councils to do more is to give them new incentives for so doing.

Nevertheless, much of the finance that is allocated by central government to local council areas is calculated on a per capita basis (as with schools for instance) so that more population (attracted by growth and jobs) equates to more money in any case. This has proved controversial and explains why for instance Westminster Council was so unhappy with the last census' failure to pick up their 'true' population.

5 Shakespeare, T and Simpson, T *The rate escape: freeing local government to drive economic growth* (Localis, March 2011), p.23

6 Lyons Final Report, paras 9.15-9.20. LABGI did have the advantage of basing reward on the growth of the business rate revenue base relative to an expectation which avoided only rewarding those who were going to grow irrespective of the actions of the council. (see para 9.35)

There is, however, no real evidence that local people or elected councillors are dissuaded from making moves that are good for growth and business because of a lack of financial incentives. Arguably a bigger problem is that they do not have enough powers and freedoms to promote economic growth and would do so if they did – financial incentives or not.

Indeed, the current debate and potential agenda seems to be going for a particular angle on growth in that it is looking to give incentives to local politicians (and their electorate) to make more pro growth decisions on planning and house-building (though on the former it is interesting that ministers are a bit in two minds as recent planning announcements see a return to top down influence with a presumption in favour of growth being inserted into the planning regime).[7]

Across England councils (and their electorates) define economic success in different ways, some focusing on the level of unemployment, some the number of business start ups and others more on environmentally sustainable growth. Any system that gives incentives to growth therefore is bound to tend to bias – in a very top-down way - what sort of growth councils are being asked to deliver if they want to be rewarded.

Furthermore, given that the conditions for growth are different in different places and that public funding is often enabling finance or gap funding, the incentives for growth in an area of opportunity (where land values, for example, are high or set to rise, and markets are relatively strong) contrasts with a declining area where values are low and markets are weak. Similarly, most regeneration funding mechanisms, like TIFs, local authority asset backed vehicles or the new Community Infrastructure Levy, are better suited to places of opportunity where private investors can invest at scale on the back of upfront local public funding. This is not an argument against incentivising local growth, but many of the government's local economic development initiatives favour places that are already growing or have obvious potential for growth. This is of course not new. Section 106 (planning gain) agreements have traditionally favoured councils in growth areas. It is notoriously hard to capture some of the benefits from future growth in a depressed market.

The problems facing deprived areas where there is overcapacity in labour and housing, high levels of worklessness, and little private sector interest demand a level

7 As Fiona Reynolds, head of the National Trust said recently "Planning is beginning to look increasingly vulnerable to powerful local and national interests who will only need to say the word "growth" to get the permissions they seek". http://www.guardian.co.uk/environment/2011/jun/07/environment-white-paper-economic-growth

of effort and resources beyond the budget of most councils. Previous governments have acknowledged this, with much of the policy focus of the last 10 years being on grant funding via national and regional (and sub-regional) public agencies, such as the Regional Development Agencies, English Partnerships and the Homes and Communities Agency.

What might the government's review of local government finance do?

At present and despite long held beliefs of the Liberal Democrats to move towards a local income tax, there seems to be little activity on that part of the local government finance agenda. Part of this may be because with such big cuts in central government funding over the next few years, the balance of funding naturally moves to a 'better' place and the gearing ratio looks less bad. Even were they free to do so it is unlikely that many councils would put up council tax at present given the political realities so that the salience of the issue has diminished a bit.

Indeed, despite the virtual ending of ring fencing (outside schools) there have been more restrictions on councils raising money – with a severe downwards bias on council tax rises both through the offer of money or threats of cuts if anybody went above zero this year, and with the requirement for referendums if a council ever proposes to put up council tax 'excessively'. Councils have responded to the squeeze by using the local freedoms they do have to put up charges on a variety of services (resident car parking charges being the most complained about example), but this does not quite feel like localism in action as yet.

Instead then the focus of the government's local finance reforms seems to be far more on trying to free councils from central government and give them more incentives to self-fund (including through the securitisation of long term and stable income streams from taxes and rents).

Resource Review

The Resource Review (Phase 1) is expected to be published before the Parliamentary recess in mid-July 2011. Originally the DCLG Business Plan said it would:

Deliver proposals for long term change to how local authorities are funded through the local government resource review, including local retention of business rates, giving councils greater freedoms, while retaining fairness in the local government finance system.[8]

8 http://www.number10.gov.uk/wp-content/uploads/CLG_FINAL-2.pdf

This was to start in January 2011, but was delayed several times, and when it was launched in March 2011 it began by saying that:

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

Secretary of State, Eric Pickles, gave a little more colour to that aim:

At the moment there is no motivation for councils to support local firms or create new jobs. One of the best ways we can change that is to free councils from their enslavement to Government grants and put them in control of their own destiny.[9]

The expectation and semi-explicit aim is that the government will want to see if it can make whatever changes it wants by the time of the next local government (RSG) settlement. Since the last one proposed in 2010 (for 2011/12 and 2012/13) was set for two years (not the three of previous settlements) this means getting a move on.

The government has not deemed it appropriate to in any way out-source this work to a Sir Michael Lyons type figure to try to create a wide consensus. Instead it is keeping a firm grip by having it undertaken internally with stakeholders simply being invited to send in their views. Already one important group of councils have got together to try to shape the agenda[10] and the LGA is doing its best to search for local government consensus as well.

Business rate changes – more localisation

The broad sweep of the terms of reference could lead to a wide range of issues being looked at – and there were apparently debates on this within government with Liberal Democrats wanting to look widely at a full range of new taxes.[11]

The clear priority of the Secretary of State for Communities however is to try to get at least some councils completely clear of receiving any money from central govern-

9 DCLG press release, March 17 2011

10 These are Westminster, Manchester and Birmingham. Final report is at http://www.cityfinancecommission.co.uk/db90834m/useruploads/WCC_CityFinanceCommissionLR.pdf

11 "A leaked letter from Mr Clegg to Tory prime minister David Cameron and chancellor George Osborne last week revealed the deputy prime minister wants a root-and-branch review of local tax-raising powers - including the consideration of American-style local sales and fuel taxes, reformed parking levies and wider borrowing powers .. However.... Mr Pickles and the chancellor appear keen to limit the number of new taxes and would be happier kick-starting a finance review that is more narrow in scope" (Municipal Journal 25/1/11)

ment so that they sink or swim on their own efforts. The objective for Eric Pickles, is to "free councils from their enslavement to government grants and put them in control of their own destiny".

Furthermore, his desire to achieve this is focused around the proposal to allow councils to keep all their revenue from business rates. As the Secretary of State put it:

By letting councils repatriate their business rate income you make the system more straightforward and councils more self-sufficient in one fell swoop……Scaling back central government's historic control and redistribution of this local business tax would also give councils a sudden shot of financial adrenaline and a legitimate stake in their economy with direct benefits for supporting new business and growth.[12]

Not surprisingly then the terms of reference for the Resource Review focus almost exclusively on this issue (see Annex for its terms of reference).

To localise the business rate would be a major change from the current situation. This system was brought in under Mrs Thatcher as part of the reform that led to the ending of the Community Charge (aka poll tax) in 1990. Prior to that business rates were set by local authorities alongside domestic rates as part of the same tax. In the present system all business rates are collected locally, pooled and then re-allocated out by the centre. The tax rate is also set centrally and levied at a national rate. As the Lyons Inquiry said, "It would perhaps be most accurate to call the present system of business rates not a local but a national tax, but one that is assigned to the funding of local government"; and noted that it "is actually used in great part to fund the provision of services according to national expectations and requirements.[13]

Lyons also points out that since the removal of schools funding from the Revenue Support Grant (RSG) in 2006-07, business rate receipts have become an essential source of the funding needed to allow equalisation between authorities. He was already worried that the central government grant would not be enough for equalisation.[14]

With the severe cuts in funding to local government over the next few years some calculations suggest that a growing business rate which in 2010/11 was about two-thirds of total formula grants will overtake it by 2013/14. Apart from anything else

12 DCLG press release, March 17 2011
13 Lyons Final Report para 8.6-7
14 Lyons op cit para 8.35

this means that to achieve its aims on formula grant the government cannot give all of the business rates back to local government so some change in the system is going to be needed since they are legally obliged to do that at present.[15]

Before the creation of the national business rate, business rate bases were very uneven. For instance, the City of London, Westminster, and a few other London authorities had enormous yields from a 1p rate.[16] Clearly such a switch would allow there to be at least a proportion of 'self-funded' councils (some have called them foundation or 'free' councils) who no longer need funding from the centre – in the sense that the income they would get from business rates would exceed what they currently get from the RSG. Lyons estimated that 65 councils took in more business rates than their budget requirements (with 28 in London and the South East and none in the North East, while 28 were shire counties and 19 unitaries[17]). If the government is also able to abolish most extra grants – as it seems determined to do – and fully localised the business rate then indeed there would be some councils who would not be getting any money at the say so of government but simply on the basis of the amount of business rates that they can raise.

Issues to be addressed if business rates are localised

There are many issues that arise from the attempt to localise, not least because it forms part of a wider effort by government to forge a new settlement between central government and local government. Most of the key issues are set out well in the LGA consultation document.[18] Here we focus on those which we would argue necessitate a cross-party consensus.

Retaining business rates is an attractive offer in many ways. However, the implications of such a change are enormous and will have to be teased out, addressed and solutions suggested if the government is to move forward effectively.

The overwhelming problem is what in short hand is often referred to as the 'Westminster issue' i.e. that some councils get so much business rates that they have far more than they need. In fact there are just a small number of councils in this position of having a large 'surplus' on business rates – many in the prosperous part of London and the

15 See Localis op cit pp53-54
16 See Chart 8.6 in Lyons op cit
17 Lyons tables D2 and D3
18 *Local Government Resource Review: Detailed consultation paper on local retention of business rates* (LGA, May 2011)

South East.[19] But up to now their surplus has been redistributed.

The flip side of the argument is that the amount of business rates that many other councils raise means that if they had to rely on business rate income they would be severely out of pocket. If they are not to lose out they will have to receive money from the centre so that they will continue to be 'dependent', not free, councils. This is a little ironic given the current political make-up of councils: (mainly) Conservative councils will be 'free' and Labour ones will be at the mercy of a Tory–Lib Dem government! The same logic applies if the outcome from the Resource Review is a much more modest proposal to retain (or borrow against) only extra business business rate income.

Broadly the impact of a full localisation overall is likely to be:

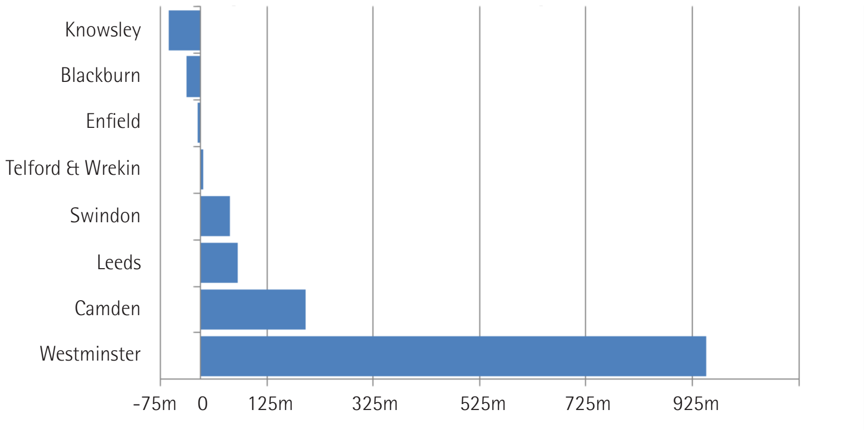
- Major gains for the City of London and Westminster;
- Gains for boroughs like Tower Hamlets, Camden and possibly some other inner London authorities;
- Probable gains for major northern metropolitan areas like Manchester and Leeds;
- Possible gains for some high tech growing authorities like Cambridge, Swindon and Reading;
- A large group for whom the change does not make a great difference either way; and
- Losses for deprived areas and authorities representing older industrial; communities – the "outer mets" - and in places like Blackburn and Hull and NE Lincs.

The impact of the localisation of business rates versus current redistribution through the central pool (payment to less money received from the central pool) is illustrated in figure 1.

This all leads clearly to the government having to decide what it really wants to do about equalisation. Ultimately this comes down to the trade off in values and practicalities between letting councils keep the fruits of their labours and giving poorer areas some help. With the explicit cross-subsidiy element removed the gap between places of opportunity and places of high need becomes more transparent and potentially more politicised (with the grant reliant 'losers' more grouped together).

19 This imbalance is well illustrated by that fact that 2010 of the 184,000 'non-domestic hereditaments' of £50k or over, 86,000 were in London and the South east. Local government Financial statistics No 21, 2011, Table 2.3a

Figure 1: Net payment to the national pool, 2009/10



Source: The Smith Institute

There seem to be several broad approaches to this problem.

An obvious one is not to let councils keep all of their business rates but only the extra above some expected or 'normal' path. This gets round the problems of 'rewarding' councils for just happening to have an economy that is attractive to business – perhaps due to location or historical investment. One view is that this was what Nick Clegg was suggesting in his June 2011 speech to the LGA, but this if far from clear and it is even less clear that all of Whitehall (and the Treasury in particular) are signed up to it.

Top slicing could be done by trying to adopt some version of the way things work in a number of the privatised utilities. That is to give incentives to councils to maximise business rate receipts – perhaps only above a normal expected amount - but then allow the system to be re-jigged every so many years.[20] In water for instance a price cap is set and then firms can keep whatever profits they can make over a set period (often 5 years) at which point the cap is re-set by the regulator. This gives incentives to efficiency and innovation but allows the system to catch up with the fact that firms may in retrospect be seen to have been able to make far more profits than was considered at the time (perhaps because cost savings and revenue

20 Lyons got close to this in his Final Report where he floated the idea of councils keeping the proceeds of growth for a fixed number of years before eventually paying it into the national pot – Para 9.48.

enhancements were possible that the regulator had not realised – partly due to asymmetric information).

This version suggests that the key component is not that all business rates are kept for ever, but that all extra business rates above what was anticipated, or considered 'normal', can be kept.[21]

The argument against this sort of approach, apart from the practical difficulties of definition and so on, is that it does not create the clean break from central government that some want, and that it is all back to a degree of assessment by central planners as to what the 'expected' business rate income is likely to be.

A valiant attempt to get round these issues has come recently from Localis.[22] The scheme they came up with has councils making an offer to central government as to how much they will pay the centre to be able to keep all their business rates for a period (in the Localis' language, they 'buy out' of the system). For surplus councils this is a payment to the centre (so we would expect it to get close to being what they would have contributed net to the pot in any case), and for deficit councils the offer would be negative (i.e. how much they would need to receive from the centre to opt out).

This option is well worth thinking through – especially if it is thought that it offers a sustainable solution (something questioned by Sir Michael Lyons in his foreword to the Localis report where he queries for instance if equalisation arrangements could continue 'if the fastest growing areas systematically opt out'.)

In theory it should end up to some degree with payments in and out of the centre of a similar pattern and scale to the current system, although that would depend on the allocation of remaining government funds undertaken on a similar basis to now. But the advantage might be that councils are free of spending constraints from the centre, and whether the net contributors or beneficiaries to the current system receive all the benefit of increased business rate revenue over that period.

21 There is also a thorny problem with business rate revaluation where there is a danger of a councils efforts to increase the value of property not being allowed to flow through if overall national business rate revenue is not to increase too much

22 Shakespeare, T and Simpson, T *The rate escape: freeing local government to drive economic growth* (Localis, March 2011)

Such a system does of course depend on detailed and undoubtedly fraught negotiations with the government (Treasury) on the exact terms of the buy-out, which makes it still feel like a servant-master relationship and does not really deal with the accountability issue (councils doing badly may say that it was government's fault for striking too tough a deal for them).

There are also less dramatic ways of going with the spirit of the reform. Surplus councils could be given a proportion of their business rates to keep. The distribution of the surplus rate back to 'deficit' councils could be made more highly dependent on their own ability to maintain or increase their business rate income so that they at least have some incentives for growth.

Spatial area[23]

One of the issues that lurks behind some of the problems and doubts over localisation of business rates is whether a typical council area is the right spatial area to allow this to happen.

Camden and Westminster get a lot of business rate receipts, but would get much less if there was not a cheap labour force in Barking and Hounslow that can service the central London offices. Burnley may find it hard to do anything that can dramatically increase its business rate revenue even over the longer run unless Manchester is thriving.

In the past, city centre authorities (Manchester, Sheffield), or some Metropolitan areas (Leeds, Birmingham) had arguably more appropriate spatial business rate bases which captured the main economic activity in their areas. By contrast, outer mets (like Knowsley, Wigan, Barnsley, South Tyneside,) and London authorities which did not benefit from even the fringe of the City/West End business activity, had very weak business rate bases. The expectation is that this pattern will not only still exist but is likely to be reinforced rather than eroded by the wider changes that have happened in the economy – the rise of finance, decline of manufacturing, increasing domination of the South East.

This may lead to thinking that larger spatial areas – like city regions or (if they work) Local Enterprise Partnerships (LEPs) – are better areas if we want to incentivise local decision makers over something that they can genuinely be held responsible for.

23 Thanks to Michael Ward for this point and several others in the next few sections

This links to the issue of whether or not councils can really influence economic development enough to make all of this sensible. It is of course not only due to geographic areas but their lack of any powers to vary other taxes (like sales and income taxes) as well as concerns over capacity and capability among smaller councils. It also concerns the ability of a small area to really do much about its economic performance acting on its own.

Equalisation

The rationale behind the creation of the current business rates system from the beginning was not to have each council for itself but to equalise out various differences (local public service needs, business rates base etc) between local authorities.

Reviewing the scene a few years ago and assuming that some equalisation would be wanted, Tony Travers concluded:

If the existing NNDR were to be re-localised, it would be necessary to institute an arrangement broadly equivalent to the London Rate Equalisation Scheme, though the new one would be more extensive and would apply to authorities throughout England.[24]

The London Rate Equalisation scheme existed pre-1990 and was used to top-slice some of the rate yield in central London and redistribute it to other London boroughs. Because the costs of education in inner London were equalised through the existence of a single Inner London Education Authority, this rate base effectively paid for education.

The capital's overall Rate Support Grant was then reduced by a sum equivalent to the amount collected from the central London authorities and redistributed so that the redistribution was effectively to the rest of the country.

Travers concludes that it is certainly possible to overcome the issues around pooling (at a regional or national level) which look simple next to the other complexities in the distribution system, but some may wonder whether if you are going to have such a complex approach it is worth the making the change at all? After all is there any hard evidence that councils strove harder for growth in the period pre-1990 than

24 LGA *Would it be possible to re-localise the NNDR?*, 2006, http://www.lga.gov.uk/lga/aio/21103

they do now? In addition Lyons rejected such an approach since rather than clarify accountability and incentives, he feared it would be confusing.[25]

London issue

London is a specific problem as the inequality between neighbouring boroughs is so marked.

One way of addressing the London problem would be to allow the GLA to use the London business rate base to fund its big spending services – namely Transport for London and the Metropolitan Police. While a neat idea this would not lead to the gains that some central London councils seek from localisation and so will hit resistance. It is a big strategic question for government too as it would encourage the (cross-party) "city state" tendency in London, with the Capital having a better tax base than Scotland.

In addition it is ominous to see gaps opening up between the London councils trade association (London Councils) – who are after regional pooling[26] – and individual councils like Westminster who do not want it.[27]

Some of the issues here and elsewhere may well be met if instead of government deciding the equalisation an independent body did this. This has been suggested by many. The LGA have floated it being the LGA itself, but it is likely that a more independent body would be needed.[28]

Is it right to move so far away from need?

A business rate retention model rewards councils for effort but at its extreme starts to downplay need. So an area that has little to attract business but has much need is now in trouble. Of course this may incentivise them to have less dysfunctional families in the area and encourage 'welfare mobility' (or 'social cleansing' as Boris Johnson called it).

But here there is a danger that the 'optimal' policy is to persuade the poor, costly and non-aspirational to move out via housing and other policies (as some would accuse

25 Lyons op cit para 8.37

26 London Councils, *Resourcing London a Model for Retained Business Rates* (2011)

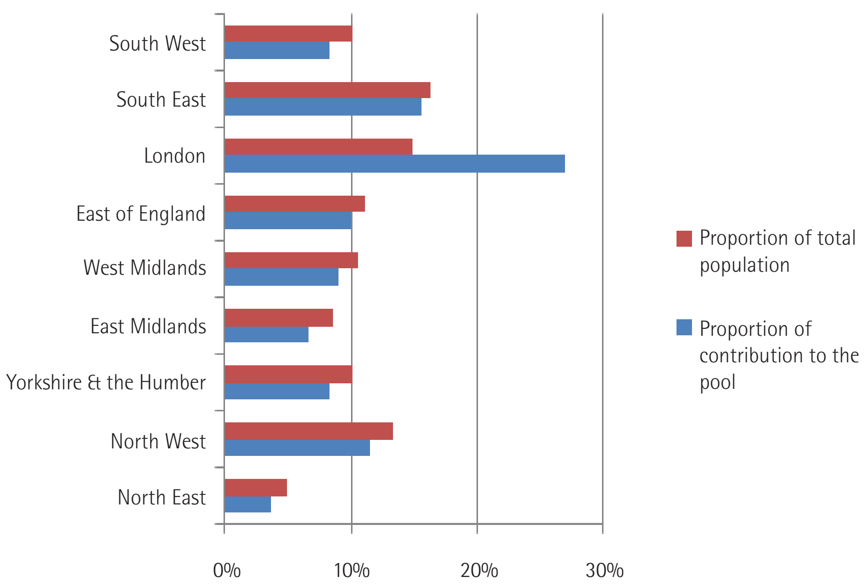
27 See eg 'Local authorities square up over business rate sharing', *Public Finance* 24/5/11 http://www.publicfinance.co.uk/news/2011/05/local-authorities-square-up-over-business-rate-sharing/?locale=en

28 LGA *Local Government Resource Review: Detailed consultation paper on local retention of business rates* (May 2011). See also McLean, I and McMillan, A *New Localism, New Finance* (NLGN, 2003) who strongly argue for a separate body

some London authorities of doing over the years) rather than work with them to solve their problems. So arguably just as many perverse incentives are set up here as are alleged to be in the current system.

This is ultimately both an issue of values but also of an understanding of incentives. Since welfare and government support based to some degree on 'need' began, there has always been a strand of thinking that says that in making up for deprivation or need the only thing that is achieved is to increase dependency. Others however maintain that it is the mark of a civilised society that it supports people – and spatial areas – most in need. In the localism debate getting the balance right is no easier than it is in welfare – but is just as important. If you put the spotlight on the regional data this issue becomes even more clear. No other region apart from London contributes a higher percentage to the national business rate pool than its share of the population (although this does not consider the impact of need).

Figure 2: Contribution to national business rate pool by region, 2010/11



Source: Department for Communities and Local Government

Implications for local and central government finances
In a world where a councils finances depend much more on the movement of business rate income within its own area there are a number of implications that will feed through into local and central government finances.

In the first place risk is transferred to local councils. It is transferred to councils as a whole – since business rates in total can vary a lot from year to year.[29] But it is also transferred to individual local councils. Now of course this is the whole point. If they raise business rates revenue they gain, if they do not, they lose.

But business rate income can fall because a major employer closes down – perhaps due to issues abroad or a reputation disaster and nothing to do with activity in the area. And more generally where the national government can smooth out these things across a whole host of council areas, when it is all up to what you bring in yourself there is no way of spreading out the risk in this way.

It would very much defeat the object of the exercise to do much about this although Localis slightly surprisingly talk about creating an emergency fund[30] - which would presumably recreate some of the moral hazard problems they were worried about in the first place.

This in turn therefore leads to an increased case for councils being allowed to borrow so that they can smooth out peaks and (especially) troughs in business rate income.

Now it is unclear how far the current system of 'prudential borrowing' allows for this. Such borrowing, brought in through the Local Government Act 2003, allows borrowing without central government grant or approval where it is prudent and affordable to do so. This is juged by having to follow rules set out by CIPFA in 2004 which is to do with the probability of being able to repay. The main aim here was to allow investment in assets that would return an income flow either (and most simply) directly but also at times through a more prosperous community. The aim of simply spreading borrowing across time to put up with the ebb and flow of business rate income is another matter.

29 The LGA (op cit p 6 footnote 2) note that Treasury currently allocated £0.5b a year to cover the forecasting risk and 'has in the past run a deficit of up to £2bn representing the difference between what has been raised in business rates and what has been distributed from the business rates pool'. As another feel of the variance in these things UK corporation tax receipts have deviated by nearly 15% from forecast values in the past decade. (See 'Should Scottish Ministers by able to borrow?': Evidence from the independent expert group to the Commission on Scottish devolution, June 2009, para 4.3.2).
30 "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..[but] this will only be called upon in extreme circumstances', Localis op cit p 9

In aggregate this may well lead to upward pressure on local authority borrowing, something that the Treasury would worry about given that such borrowing counts towards the crucial fiscal aggregates, and because whatever the rules, Treasury will feel that it is essentially being expected to stand behind such borrowing in one way or another so that contingent liabilities are being set up.

Indeed, at a macro level risk exists in the sense that it is unclear that if all business rate revenue in the country fell, central government would really be able to just let councils survive with less money (especially if other revenue streams were not so hit). It is not surprising therefore that current legislation gives the Treasury the power to prevent borrowing that it deems not prudent or for 'other' reasons.[31]

Indications from government suggest that they see retention of local business rate receipts as potentially giving a set of revenues against which major borrowing can take place to fund infrastructure and other activities. This would be a move from current ideas where most attention is on only borrowing against the anticipated extra business rates that arise from a capital investment – the so called Tax Increment Financing or TIF. The government, for now, maintains that local authority borrowing arising from self-financing "must be affordable nationally as well as locally".

More minor issues are how borrowing should work if it did become more important. For instance, are rates for borrowing sensible (PWLB rate went up recently)?

None of this is to suggest that there are not solutions to these issues. Some similar ones were faced by government as it pondered its response to the recent Calman Commission reforms for the funding of the Scottish Government.[32]

Setting the business rate?

For true localism the government could go further and let councils set the business rate itself. Indeed since there are many problems with business rates as a tax in any case if the government really wanted to get councils focused on growth they would let them set the local parameters of the tax not just the rate. Presently however the government is saying that it will not move on this aspect of localisation.

Councils can already impose business rate supplements where local companies vote for it and under the TIF proposals (in the Localism Bill) will be able to retain extra business rate income (in designated areas), but allowing councils to set their own

31 See 'Should Scottish Ministers by able to borrow?': op cit , para 6.3.5
32 Should Scottish Ministers by able to borrow?': op cit

rates in different areas appears a step too far for Westminster politicians.

Relocalisation is a definite "no go for business". According to the CBI:

Relocalisation would very likely lead to higher taxation for business with no guaranteed extra value in terms of services. It could also lead to a deterioration of the relationship between business and local authorities which has in many cases seen improvement since the introduction of the uniform business rate in 1990. In addition, relocalisation would introduce instability and complexity into local authority taxation and funding.

But if business rates are to be increasingly retained locally this agenda is surely one that will gain more momentum. The legitimate fear of business (as opposed to a dislike of the complexity of different rates in different areas) is that business becomes a cash cow subsidising councils and their councils tax payers. However, such worries can be confronted at least to a degree through ideas such as not allowing the business rate percentage increase to be more than 'x' times the rise in the council tax (where 'x' could be one – or even less).

The business lobby, and particularly the property and retail sectors, remain unconvinced of the case for reform. However, latest polling in the Spring by YouGov for the LGA suggests that the business community is now 66-34 in favour of retention, although still firmly against relocalisation of the rate setting.

Other changes

Major reform of council tax may still come back on the agenda especially as some Liberal Democrats remain keen. Local income tax featured strongly in the last Liberal Democrat manifesto ("The council tax is an unfair tax. Liberal Democrats believe that it should be scrapped and replaced with a fair local tax, based on people's ability to pay"[33]) – it will be interesting to see if it now just fades away. Assignment of tax, as discussed by Lyons, seems more likely to be a way through and may reappear in the debates especially as Labour try to look for new avenues in this area .

While any revaluation or the introduction of new bands to the current council tax system look unlikely there may be attention to some more minor tweaks to council tax – although the Lib Dem commitment in their Manifesto to "Give local authorities the power to set higher council tax rates for second homes" did not even make it

33 http://network.libdems.org.uk/manifesto2010/libdem_manifesto_2010.pdf p 90

through to the Coalition agreement.

The Government has already announced changes to the way that Council Tax Benefit (CTB) is organised. Council tax benefit aims to try to take some of the edges off the unfairness of the council tax, by helping those on lower incomes, and also to address the issues of elderly income-poor people in largish houses paying too much council tax (although some may argue that the incentive to downsize that this creates adds to efficiency in the use of the housing stock).

The main complaint over the years is that not enough people who are eligible for this benefit actually claim it and Lyons suggested making it more or less automatic.

The Coalition have rather surprisingly gone for a different approach which is to 'localise' the council tax benefit, allowing councils to determine local rules. This may be partly motivated by the fact that the CSR decision was to cut spending on council tax benefit by 10% from 2013, in itself a move that will hit councils in more deprived areas most). But the decision to abolish it as a national benefit in the Welfare Reform Bill in favour of the creation of new local council tax rebate schemes was motivated by an element of localism (and is causing some problems with the IDS proposals for a national universal benefit). Details are awaited to see how much freedom councils have on this.

In addition, and relevant to incentives for growth, and for borrowing, the Government is continuing with reforms started under the last administration to reform the Housing Revenue Account. According to PwC the reforms have the potential to generate some £50 billion of new investment.

This is a very complicated area of policy but for our purposes the key issue is that it could in theory allow councils to borrow against future council rent income. However, so far it appears that the Treasury is seeking to give itself the ability to set caps (under the 'prudential rules') on how much can be borrowed – which gives an indication of how it might behave on borrowing against future business rate income.[34]

Conclusion

A world where there are no incentives to economic success of councils would clearly be mad – even more so if there are some perverse incentives to become a deprived area to get more central funding. While that caricatures the current situation, change is certainly well worth looking at.

34 The HRA is more fully explored in the Smith Institute publication *Making the Most of HRA Reform*, June 2011

In an ideal world we would have had for many years a system with much more decentralisation in the UK, where regional and local differences had been ironed out through the innovation and creativity of localism. But apart from this being a totally idealised and unlikely outcome (after all there are big regional and local differences in countries with much more localised systems of governance and finance) we do not start from that position. We have a world where some council areas have access to great resources and some to much less. That means we do need equalisation systems.

Localising business rates is one way forward here. Exactly how it will play out depends on the details: get it right and we have an improved system with a better central–local balance. Get it wrong and we institutionalise a two tier country with well-heeled councils breaking off from their less well-off cousins – a small group of autonomous authorities with a strong tax base and a large group permanently dependent on the centre.

It depends on how in fact the economy pans out and whether in the end the Treasury is prepared to cut a bit of slack to councils even though it does carry some risk. It depends too on how councils play the system, how responsive they are to business, how much they can in reality promote growth on their own, and how much they work together to make fairness part of the system.

We must also never forget that for the more deprived areas of the country business rates are at best a marginal issue. It would be totally wrong of government to think that if it localised business rates it has in some way carried out its duty to these areas. Localising business rates will not transform Middlesbrough or Stoke. The challenge of helping such areas get on to some sort of self-sustaining growth path remains one of the great unsolved policy problems in spatial economic policy in Britain.

But trying to do something here is part of a sensible agenda, giving councils more feeling that they make their own bed to lie in, not blaming the centre all the time for what they cannot achieve.

However, to be meaningful and have the incentive effects that people hope for there needs to be some degree of cross-party consensus so that Local Government and business has some certainty to plan upon. The Coalition government would be wise therefore to try and find ways forward that command support across councils of different political control in different circumstances. If the reform is only supported by those better off councils then it will not survive a change of government.

On the other hand Labour policy makers need to think beyond the static one-off effects of some form of business rate localisation and their continuing historic commitment to equity and focus too on the need to create a dynamic in the finance system that helps councils create jobs and prosperity in their area.

In this paper we have tried to make the case for reform in a way which promotes localism and incentivises local growth without eroding vital support for deprived areas. It is a delicate and difficult balancing act to engineer a system which can meet such multiple objectives. Moreover, these are not easy decisions and rushing change without consensus might be just as ill-advised as the inertia and stasis that had characterised the lack of change in this areas for the last few decades. We need a new local government finance settlement, but if it is to work it must be one that has wide political support and can survive a change in government.

About the authors

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Annex

LOCAL GOVERNMENT RESOURCE REVIEW: TERMS OF REFERENCE

Phase 1

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Phase 2

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

Source: http://www.communities.gov.uk/documents/newsroom/word/1866550.doc

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