

POLICY DEVELOPMENT: NOT A STATEMENT OF GOVERNMENT POLICY

100% Business Rates Retention

Systems Design Working Group: 18 April 2018

Technical paper 3: Spreading the Risk of Valuation Losses across the Local Government Sector to Reduce Volatility

Introduction

- 1.1 On 5 July 2016, the Department for Communities and Local Government (DCLG), published a consultation paper, **Self Sufficient Local Government: 100% business Rates Retention**. Following this, on the 15 February 2017, DCLG published a further consultation paper, **100% Business Rates Retention: Further Consultation on the Design of the Reformed System**.
- 1.2 These set out proposals for a rates retention scheme to replace the current system, under which local authorities pay a central share of 50% of their business rates income to be redistributed as grants.
- 1.3 The consultation papers outlined the principal features of the proposed greater rates retention scheme. A summary of responses received to the Further Consultation was published alongside the 2018/19 Provisional Settlement on 19 December 2017.
- 1.4 Following the fall of the Local Government Finance Bill, MHCLG (formerly DCLG) will be developing a package of reforms, in close collaboration with the sector, that furthers the manifesto commitment to continue to allow local government greater control over the money it raises. Reforms to the design of the system will seek to make improvements to the functionality and stability of Local Government Finance.
- 1.5 A commitment was made to the Steering Group and Technical Working Group that a series of technical papers would be shared with the Technical Working Group for discussion and published on the Local Government Association (LGA) website. A suggested forward look of these was shared with the Working and Steering Groups in November 2017.

1.6 Taken together these technical papers will raise a number of questions about the proposed rates retention scheme, on which the Government is seeking views.

1.7 This is one of seven core technical papers. The full list is:

Paper 1: The Central and Local Rating Lists

Paper 2: The Safety Net, Levy & Tier Splits - Risk and Gearing

Paper 3: Appeals and Loss Payments

Paper 4: Resets, Measuring Growth and Revaluation

Paper 5: Transitional Arrangements

Paper 6: Pooling

Paper 7: Proposed Overall Short Term Package and Future Reform Using Primary Legislation

1.8 We expect that these will be supplemented by other papers in response to Technical Working Group discussions. Additional papers will be announced as need for them arises.

Overview of previous appeals reforms and the current system

2.1 Before the introduction of the current rates retention system, all business rates raised locally were paid to central government. Losses on appeal, therefore, were borne centrally.

2.2 When the 50% rates retention system was established in 2013, authorities were expected to make provisions for expected appeals losses, in line with normal accounting practice.

2.3 On setting up the 2013 system, the Government 'top-sliced' £1.9 billion in anticipation of future losses as a result of successful appeals. This figure was based on estimates of the aggregate cost of appeals outstanding against the 2005 and 2010 ratings lists.

2.4 The £1.9 billion top-slice reduced the aggregate business rates baseline and therefore was effectively apportioned between authorities proportionately to their individual business rates baselines. Because tariffs and top-ups are calculated using baseline funding levels and business rates baselines, the additional top-sliced income, above business rates baselines, was therefore left with authorities.

Overview of the impact of appeals and valuation loss within the current system

Distribution of the top-slice vs. distribution of appeals

- 3.1 It was always recognised that individual authorities' shares of the top-slice would not match their valuation losses, including those following successful appeal. Some authorities experience losses larger than their portion of the top-slice and some experience losses smaller than the portion allocated to them. Authorities whose valuation losses are greater than their share of the top-slice are affected in two major ways. Firstly, it reduces their available resources at a particular point in time and therefore their ability to spend on services relative to baseline funding level at that time. Secondly, it reduces the benefit of growth in circumstances where a large valuations loss effectively 'wipes-out' all other growth within an area because the loss is greater than the collective growth across other hereditaments. However, authorities who experience valuation losses smaller than their share of the top-slice benefit from additional income.
- 3.2 The sector has argued, both through previous working and steering groups and through consultation responses, that a reform to the current system is a desirable possibility for reform. In responding to the 'Further Consultation on 100% Business Rates Retention', 96% of respondents supported the broad principles of moving to centrally manage valuation losses, which were referred to as risk of appeals.
- 3.3 The tables and graphs on pages 4 and 5 summarise how appeals fall by region and at individual authority level across England. Figures are not available for losses by rateable value and so the tables and graphs reflect the number of appeals.
- 3.4 Table 1 demonstrates that as of 31 December 2017, the variation in the percentage of successful appeals by region is not extensive; there is a difference of 4.6 percentage points between the highest and lowest success rate. However, Table 2 shows a regional variation in the percentage of hereditaments in local lists that are subject to appeal. The greatest regional difference is between London, which has seen a challenge to 80% of valuations and the South West, where 47% of valuations have been appealed. So, whilst the percentage rate of successful appeals by region is relatively even, the number of appeals falls unevenly across the country.

Table 1: Breakdown of appeals by geography throughout the life of the 2010 list (from 1 April 2010 to 31 December 2017)

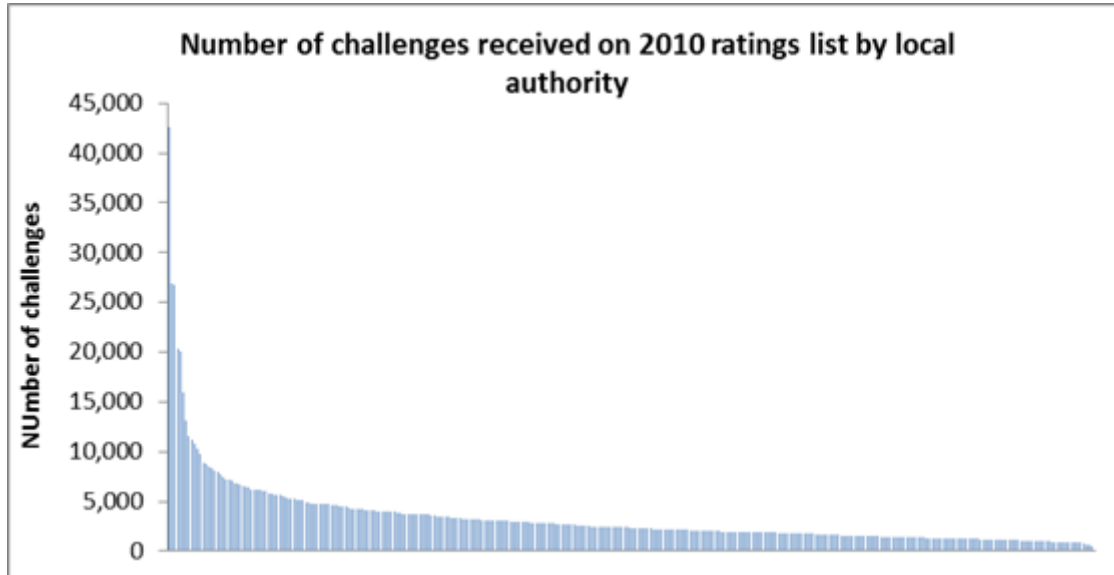
Region	Total appeals received	Percentage of England wide appeals received	Total appeals resolved	Success rate of appeals (by number)	Percentage Success rate of appeals	Total appeals resolved resulting in no change to the List ⁹	Percentage of appeals resolved resulting in no change to the List
ENGLAND	1,089,700	100	930,880	264,750	28.4	666,140	71.6
North East	47,950	4.4	39,030	11,350	29.1	27,680	70.9
North West	160,100	14.7	138,360	42,170	30.5	96,190	69.5
Yorkshire and the Humber	102,860	9.4	89,070	25,260	28.4	63,820	71.6
East Midlands	71,140	6.5	59,940	15,530	25.9	44,410	74.1
West Midlands	109,300	10.0	91,550	25,230	27.6	66,320	72.4
East England	104,470	9.6	89,920	23,320	25.9	66,600	74.1
London	244,180	22.4	205,540	59,940	29.2	145,610	70.8
South East	151,470	13.9	130,880	36,160	27.6	94,730	72.4
South West	98,330	9.0	86,600	25,810	29.8	60,790	70.2

Table 2: Breakdown of appeals by geography showing percentage of hereditaments subject to appeal (from 1 April 2010 to 31 December 2017)

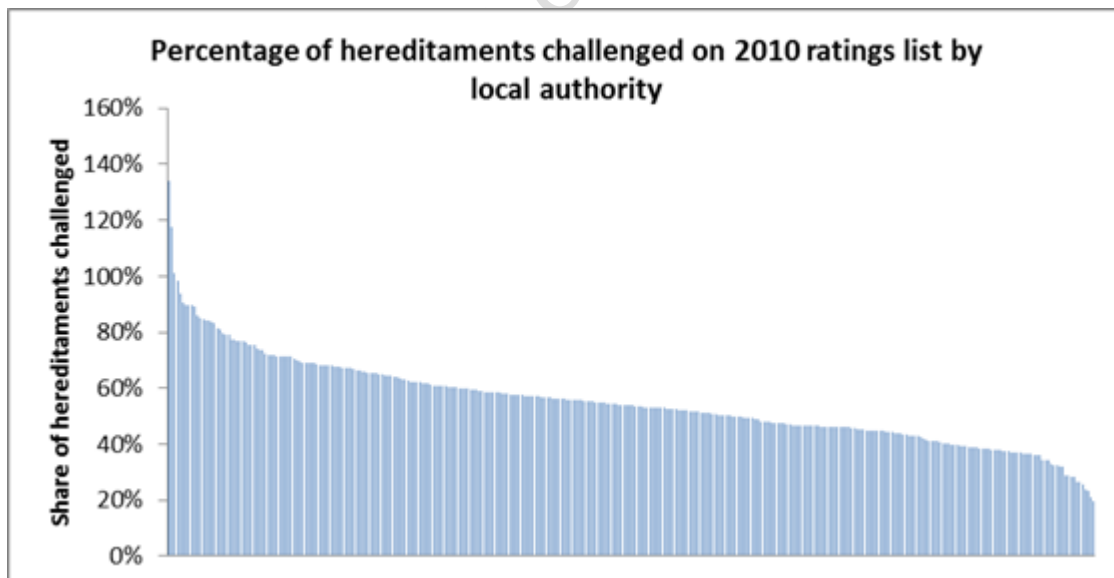
Region	Number of hereditaments in region's local lists	Total appeals received	Percentage appealed
ENGLAND	1,881,900	1,089,700	58
North East	83,485	47,950	57
North West	266,097	160,100	60
Yorkshire and the Humber	192,791	102,860	53
East Midlands	148,496	71,140	48
West Midlands	197,678	109,300	55
East England	200,187	104,470	52
London	306,592	244,180	80
South East	275,398	151,470	55
South West	211,176	98,330	47

3.5 At individual authority level, the variation is greater. Graphs 1 and 2 illustrate that some authorities have seen the number of appeals to their local list correlate to over one hundred per cent of the hereditaments in those lists. This is possible because the data includes multiple appeals on single hereditaments.

Graph 1: Appeals at individual authority level by number



Graph 2: Appeals at individual authority level by percentage



Making provisions

- 3.6 Calculating provisions is inherently difficult and both over and under estimating represents some risk to authorities' incomes and creates a degree of volatility within the system. Where an authority overestimates provisions, they will see their ability to spend decrease initially, as they defer revenue and expenditure from early to later years. Later, when they release the provision that was not needed, this will appear as growth. When an authority underestimates provisions, initially they will have greater resources to spend on services. However, when successful appeals are of greater value than their provisions they will see a reduction in income, which, if significant, may entitle them to a safety net payment. Making any kind of provision greater than their share of the top-slice can mean authorities see a reduction in their ability to spend on services as funding is allocated to mitigate potential loss.
- 3.7 Different authorities are setting aside differing amounts to provide for future valuation losses, often diverging from what was centrally estimated at the outset of the system. In some cases, the amount of provision set aside by a local authority is less than was anticipated, in others it is more. As of 31 March 2017, the stock of local authority business rates provisions was £2.6bn.
- 3.8 Authorities have also previously voiced concern about the speed at which appeals are dealt with and the added complication this adds to estimating provisions needed. Respondents to both recent consultations on rates retention highlighted the need to address the appeals backlog. Even once the VOA have cleared the majority of the current backlog relating to the 2010 list, it is likely that appeals will remain beyond this, where they are subject to litigation. Full resolution of appeals is ultimately outside of the VOA's control, relying on decisions by the independent Valuation Tribunal, or the willingness of appellants/agents to resolve cases with the VOA outside of formal litigation. Some appeals are dependent on the outcome of test cases awaiting hearings at the High Court.
- 3.9 It is too early to forecast how quickly appeals against the 2017 list will be resolved under the new Check, Challenge, Appeal system. As at 31 December 2017, the VT had registered 12,840 checks, 1210 challenges and 0 appeals under CCA. However, it is possible that this represents 'under' appealing. CCA will make provision making more difficult, for various reasons, including it being a new system with a low number of cases so far, therefore making it hard to make modelling assumptions.
- 3.10 Some types of appeal are particularly difficult to estimate provisions for, especially if they relate to a class action. Where sector wide appeals are made on a particular class of hereditament or by a ratepayer with multiple hereditaments across the country this causes uncertainty for authorities.
- 3.11 Provisions for appeals is a contributory factor towards the increase in cash balances held by the local authority sector. This increase in cash balances was highlighted as a risk by the NAO's 2016 Value for Money Report **Financial sustainability of local authorities: capital expenditure and resourcing.**

- 3.12 Some authorities may have fallen into the safety net because of provision making or because of valuation losses beyond provisions made. Although vulnerability to falling into the safety net is determined by other system design choices about tier splits and gearing and the different levels of appeals risk this causes different local authorities to carry, it remains the case that different types of hereditament, and the make up of local lists, carry different levels of appeals risk. For example, an area with a large number of ratepayers eligible for Small Business Rate Relief may experience a low level of appeals compared to other authorities with less of these ratepayers on their local lists. Even if gearing of districts were to be reduced through the reform of tier splits, this will not change the risk faced by unitary authorities. This would suggest that reforming the way appeals losses are dealt with could be worthwhile.

The reform options

- 3.13 It would be difficult to change the current distribution of the top-slice for appeals losses to make it more accurate in anticipating where valuation losses are likely to fall, because it is very difficult to establish what basis this would be on. Valuation losses do not necessarily follow previous trends and they do not work through the system at the same time. So an authority which experiences significant losses in one year, or even across the span of one list, may not experience this in the following time period and vice versa. The Check, Challenge, Appeal system is newly introduced and we do not know what the impact will be on the volume of valuation losses and their distribution over the period of a list. It would be particularly difficult to mitigate the risk posed by large hereditaments representing a significant amount of rateable value on small lists. Authorities would also still be required to make provisions against these losses.
- 3.14 It was proposed under the previous government that losses due to compiled list alterations would be centralised and so-called 'loss payments' made to compensate local authorities for the reduction in their income. This would mean that payments would be made to authorities to compensate them for valuation losses, only once those losses occurred. There could be an additional benefit in that the size of funding put aside in aggregate could be smaller than the total put aside by individual authorities.
- 3.15 The Local Government Finance Bill would have given the Secretary of State a power to make payments to local authorities for losses in income. MHCLG has established that it would still be possible to centralise valuation loss payments using Section 31 grants and adjustment to tariffs and top ups. This is the approach that forms the basis of the Department's continued work on the possibility of centralising valuations losses.
- 3.16 MHCLG has previously brought papers to the working group outlining the technical steps necessary if we were to spread the risk of valuation loss across the local government sector by centralising these losses. This paper will provide an update on these, considering: accounting reform; identifying losses; funding loss payments; and the timing of reforms.

Update on accounting arrangements

- 4.1 A previous paper presented by MHCLG to the working group, **Update on handling appeals risk under 100% rates retention**, discussed the problem of making provisions, which would remain an IAS 37 obligation, even if valuation losses were to be centralised. The paper proposed that the Department work with CIPFA to design a solution using an adjustment account, allowing the charge to the revenue account to be 'switched' into this account, in the case of losses resulting from valuation changes. This would allow funds in the General Fund to be available to spend on services, as if the provision had not been made.
- 4.2 This is still the approach the Department is scoping. We will next be meeting with CIPFA later in April. Once a model is finalised we will present it to the Working Group and make it available to the LGA to publish on their website. This will allow the sector to assess and comment on its suitability and suggest alternatives.
- 4.3 However, authorities would still need to make provisions against losses and other changes not due to valuation only changes. There is a danger of adding complexity to the system by creating this 'two-track' approach to appeals provisions.

Update on identifying losses resulting from valuation only changes

- 5.1 MHCLG and the sector previously discussed the proposal that only losses resulting from valuation changes should be compensated from a centralised fund and that those resulting from development should not be. This reflects the level of control that an authority can be seen to exercise in each case, i.e. a valuation only change cannot be attributed to the authority in question, whereas physical changes to a property or its occupation (positive and negative) can be seen to be reflective, in part, of the conditions created for growth. A small sample of authorities have indicated that this is around 80% of their total appeals against the 2010 list.
- 5.2 At present, the data received by authorities on appeals does not specifically identify the changes that are being made as a result of valuation change and the changes that result from development. It is common for ratepayers to make multiple appeals against the rateable value of their hereditament on different grounds and valuations are also subject to wider changes, such as the result of judicial rulings on other cases. Authorities are informed only of the change to the rateable value and the date to which this change has been backdated, not the varied reasons for these changes.

- 5.3 A previous paper presented by MHCLG to the working group, **Calculating compensation for valuation changes**, proposed using a proxy based on the compiled rating list for valuation changes. Under the proxy all changes backdated to the first day of the ratings list would be treated as valuation only changes and would therefore be compensated, whereas those not backdated to the first day of the list would be treated as development and so would not be compensated.
- 5.4 The working group did not endorse the proxy and a sub group thought that there might be other options.
- 5.5 MHCLG is currently carrying out scoping work to establish whether another solution is possible and would like to invite authorities to propose alternative approaches to separating losses as a result of valuation only changes from those that result from development. **These should be emailed to BRRSystemDesign@communities.gsi.gov.uk by 1 July 2018.**
- TP3 Q1: Can the working group suggest any alternative approaches to separating losses as a result of valuation changes from those that result from development?**

Funding the centralisation of appeals losses

- 6.1 The Working Group previously discussed using central list income or a new top-slice as two possible sources of funding for loss payments. The government also sought views on these options in its Further Consultation. 28% of respondents suggested that a centrally managed risk system could be funded through top-slicing, whilst 17% felt the government could fund valuation losses from business rates income that it collects through the central list.

Central List

- 6.2 The Working Group and a number of respondents to the Further Consultation have previously suggested that the business rates income from central list hereditaments could be used to fund centralised valuation losses. As central list income is already used indirectly to fund various grants to local government it would not be fiscally neutral to use it to cover valuation losses. In order to ensure fiscal neutrality, funding these losses through central list income would need to be considered at the time of the next Spending Review in 2019.
- 6.3 The central list already includes a number of risky hereditaments and the number of such hereditaments on the list may increase as we progress with 'tidying up' the central and local lists. The Treasury currently assumes all associated risk related to these hereditaments, with local government

continuing to receive all grants allocated to the sector in the last Spending Review, despite any possible volatility in central list income.

Top-slice

- 6.4 Another way to fund valuation losses under a reformed system would be to top-slice a certain amount of money from the quantum of business rates and deposit this money into a centrally managed provisions account. This money could then be used to make payments to compensate local authorities for valuation losses as they occur.
- 6.5 Fixing the amount of top-slice through a certain period of time, such as the lifetime of a valuation list (referring to the time it takes to resolve all appeals against a certain list) could also help reduce income volatility at the local level. The size of the top-slice could then be re-adjusted at set intervals to reflect the latest trends in valuation losses.
- 6.6 Upon centralising valuation losses, we would need to re-calculate the size of the new top-slice, sufficient to meet the losses expected to be compensated. A decision on the appropriate size of the top-slice, and how it will be calculated, will depend on various factors, including the outcomes of the Spending Review in 2019 and Fair Funding Review. Any final decision on the size of top-slice would also need to consider the accumulative impact of funding other system design elements, such as the safety net, through a similar top-slice.
- 6.7 MHCLG will therefore consider the methodology for calculating any top-slice, in collaboration with the sector, at a later stage of the reform programme. Discussions on multiplier adjustments will also be picked up at this stage. This will initially be discussed at the Operationalisation Sub-Working Group and then subsequently at Working and Steering Group level.

Shortfall and surplus

- 6.8 Making estimates of the impact of valuation losses across local government as a whole is more accurate than making such estimates at individual authority level because any possible valuation changes average out at the aggregate level over the period for which the estimate has been made.
- 6.9 However, even in a reformed system where provisions are pooled centrally, aggregate level estimates may prove inaccurate. As the objective of centralising valuation changes is to reduce volatility in local authorities' business rates income, the system should therefore be designed in a way that it can respond to any possible shortfall in a way that is sustainable to local government.
- 6.10 Due to the delayed impact of valuation changes on local government, it would not make sense to try and reconcile the central provisions account until the

actual impact of appeals against a certain rating list (for example the 2021 list) is known. It would be best to wait until all appeals against a certain list have been resolved and any outstanding litigation has been dealt with before an assessment on the account balance is made.

- 6.11 Most respondents to the Further Consultation argued that local government should be reimbursed if the top-slice taken was too big whilst central government should bear the cost of an insufficient top slice. However, it is our view that this proposal is undesirable as it is unlikely to be fiscally neutral.

TP3 Q2: What are your views on funding the centralisation of valuation losses through a top-slice?

Timings for introduction of loss payment reforms

- 7.1 The Government aims to introduce 75% business rates retention and associated improvements to elements of the current system in 2020/21. However, it may be desirable for local authorities to continue to handle valuation changes against 2010 and 2017 lists at local level with the provisions that they have already put aside. A centrally managed fund, to be introduced simultaneously with the next revaluation, which is proposed to take place in 2021 subject to primary legislation, could be used to cover future valuation changes against the 2021 list and other lists resulting from forthcoming revaluations.
- 7.2 Given the fact that local authorities have already made provisions for valuation changes against the 2010 and 2017 lists, centralising compensation for valuation changes before the next proposed revaluation in 2021 would add uncertainty and complexity to the system.
- 7.3 In 2020, when we aim to introduce 75% rates retention, there will potentially be appeals against the 2010 list and 2017 list and earlier lists working their way through the system at once, which would all need to be reflected in provisions alongside expected future losses.
- 7.4 One way to reduce the number of different appeals strands would be to continue dealing with outstanding appeals from the 2010 list with locally held provisions. Any valuation changes under the 2017 list could be paid for through a centrally managed provisions account. However, in order to establish a central fund to cover existing valuation changes under the 2017 list we would have to find a way of transferring some of the locally held provisions into the centrally managed fund. It is not clear what the mechanics of this would be. Additionally, appeals do not work their way through the system at a consistent rate and so some authorities may have already had the majority of their appeals resolved and so have spent their provisions and released those not needed, whilst others are likely to still be awaiting the resolution of the majority of their appeals. Therefore, attempting to centralise previously made provisions would raise questions over fairness of the process and reduction in local authorities' fiscal powers.

- 7.5 Estimates that local authorities have already made over the level of provision required are likely to differ from central estimates that take account of the level of provision required across local government as a whole. Further to this, it would also be difficult to determine how much of the money already put aside should remain in local provisions in order to cover losses for reasons other than valuation only change. This means that retrospective agreements and calculations over how much money local authorities should transfer to the centrally managed account would be very challenging. Therefore, the seeming benefit of streamlining the number of appeals strands would actually be counteracted by added complexity in the system and uncertainty for local authorities.
- 7.6 We therefore suggest that, if the government were to centralise valuation loss risk, local authorities should continue to handle valuation changes against the 2010 and 2017 lists at local level with the provisions that they have already made. Centralising valuation loss simultaneously with the next proposed revaluation in 2021 and covering losses against new valuation changes through a central fund makes most sense in terms of system simplicity.
- 7.7 Predicting any possible backlog on 2017 appeals is challenging due to the fact no challenges have progressed into the appeal stage in the first nine months of the Check Challenge Appeal system being operational. Regardless of the status of the backlog in 2021, local authorities could continue using current provisions to cover valuation changes against previous lists until all have been resolved. This would not complicate any separate contributions that local authorities may be required to make towards the central valuation loss fund from 2021 onwards.
- 7.8 We are aware that on the introduction of 75% rates retention, the need to make provisions against 75% of the rateable value of outstanding appeals against the 2017 list under the new system will be challenging for authorities. We will consider how other mechanisms within the system, such as the safety net, can be used to mitigate this in our work on transition and operationalization.

TP3 Q3: Do you agree with the proposal that were we to centralise valuation losses this should be done simultaneously with the next revaluation in 2021?

Possible future reforms

- 8.1 It is possible to centralise loss payments without primary legislation by using Section 31 grants and adjustment to tariffs and top ups. However, if we decide that spreading the risk of valuation loss across the local government sector is desirable, in longer term reforms it could be beneficial to pursue the power for the Secretary of State to make payments to local authorities for losses in income. This would allow greater certainty for local government and an administrative benefit for MHCLG.

Conclusion

- 9.1 MHCLG will need to carry out further work to establish the viability of these suggested reforms, in collaboration with the sector. This will include work on the interaction with the Spending Review, top-slicing, implementation and distributional impacts. It will be important to establish that top-slicing for valuation loss is a desirable measure to take. To do this, we will need to understand whether the necessary size of a top-slice is acceptable and that the practicalities of timing work. For example, is it possible to make a top-slice mid-way through a Spending Review period or would it be necessary to determine the top-slice at the time of the Spending Review in 2019 despite a possible 2021 implementation date for appeals reform? And if we are able to top-slice mid-way through a Spending Review period what are the distributional implications? It is important that distributional impacts are understood, so that this can form part of considerations. We will also need to scope the implementation process and resource implications for MHCLG and billing authorities.
- 9.2 Reforms will need to reflect the findings of the Hudson Review, which may make recommendations on the level of complexity that is acceptable within the Local Government Finance System. Reforms to centralise valuation losses will potentially add complexity.
- 9.3 MHCLG has always been clear that decisions will need to be made about all system elements collectively. It may be that other elements of the business rates retention system, such as the safety net and resets, could serve as better levers to address volatility within the system. In long term reform, with the use of primary legislation, it would alternatively be possible for central government to collect business rates from authorities (based on NNDRs) and then redistribute the money, reflecting growth and decline but removing the need for provisions and the impact of appeals losses. MHCLG could undertake further work to explore the desirability and viability of this option. No firm decision on whether or not to pursue the reforms in this paper will be made without further consultation with the sector.

TP3 Q4: Taking into account the considerations in this paper, does the working group currently have a view on whether other levers should be used to address volatility within the rates retention system?