

Options for reform of the levy

Introduction

- 1.1 The previous government announced its intention to abolish the levy on growth in July 2016 alongside the publication of the consultation on implementing 100% business rates retention.
- 1.2 As outlined in previous papers to the System Design Working Group (most notably the technical paper on tier splits, the safety net and levy presented to the group at the March 2018 meeting) the context to future reform of the BRR system has changed significantly since the 2016 consultation. Most significantly, the decision not to seek primary legislation to implement reform of the BRR system in 2020 means that the levy cannot be abolished as previously announced¹.
- 1.3 It should be noted that the current Government has not taken any decision on the future of the levy at this point, and the Government continues to welcome the sector's input on reform of the system ahead of any final decisions being made. It is the Government's intention to publish a consultation on options for future reform of the system at the end of 2018.
- 1.4 The working group paper from March 2018 suggested that the levy could be reformed so that it only targets 'excessive growth'. The System Design Working Group supported this as a potential option and were particularly keen to discuss how to define 'excessive growth' in more detail. The Steering Group endorsed the working group's view.
- 1.5 Members of the working group have also expressed whether the system could be reformed to address the impacts of 'gearing', and specifically the differing 'value' of growth relative to baseline funding level that gearing leads to. Reforming the levy to distribute growth achieved across the system more equitably is a potential way of doing this.
- 1.6 This paper will present options on how the levy can be reformed in line with the above steers and seek the working group's views on these options.

¹ The Local Government Finance Act 2012 s23 (1) requires the Secretary of State to calculate in relation to each relevant authority (a) whether the authority is required to make a levy payment for a year, and (b) the amount of that payment.

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Reforming the levy to target 'excessive growth'

2.1 The levy consists of two elements, both of which could be altered under current primary legislative powers. These are:

- **Levy threshold.** This is the level of growth at which any levy is applied. Under the current system the levy threshold is measured as a percentage of baseline funding level (BFL). Currently the levy is applied when growth achieved by a local authority exceeds 100% of BFL.
- **Levy rate.** This is the percentage (or pence in the pound) rate that is levied on a local authority's share of business rates income growth in any one year. The minimum levy rate is currently 0% and the maximum levy rate is 50%. The levy is calculated as below:

Levy rate = $1 - (\text{BFL} / \text{BRB})$, where the levy rate is restricted to the range 0-0.5

Levy payment = $(\text{retained rates} - \text{BFL}) * \text{levy rate}$, if retained rates > BFL

The levy is calculated for the individual local authority, or where that authority is part of a business rates pool, for the pool.

2.2 Currently, any tariff authority with a retained income greater than their baseline funding level is subject to the levy, above the current threshold of 100%. Therefore, every tariff authority's incentive effect to grow their business rates baselines is effectively reduced. By raising the **levy threshold** it is possible to focus the levy on those authorities that gain disproportionately, thereby improving the incentive for the majority of authorities who experience growth.

2.3 This could be achieved by allowing authorities to retain a greater share of their growth 'levy-free' and apply a higher levy rate for any growth above a certain threshold. Increasing the threshold would reduce the amount of levy paid by local authorities, as shown in the table below for 2016-17. It would also reduce the number of authorities/pools having to pay a levy from 76 currently to 18 if the threshold was set to 150%, for example.

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| Threshold | Levy payments (£m) | LAs paying levy |
|----------------|--------------------|-----------------|
| Current (100%) | 96 | 76 |
| 110% | 48 | 53 |
| 120% | 30 | 39 |
| 130% | 21 | 29 |
| 140% | 18 | 25 |
| 150% | 15 | 18 |
| 160% | 13 | 12 |
| 170% | 12 | 9 |
| 180% | 11 | 8 |
| 190% | 10 | 8 |
| 200% | 9 | 7 |

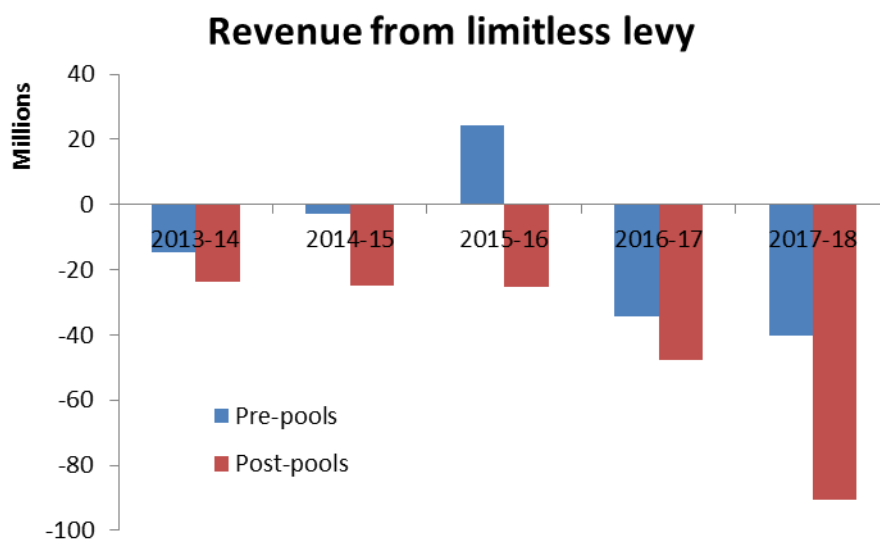
- 2.5 Increasing the levy threshold would have the impact (as demonstrated in the above table) of reducing the amount of money raised from the levy and paid into the levy account (assuming similar levels of overall BR growth going forwards). This would have implications for how any safety net is funded post-2020.
- 2.6 It could also be possible to reform the **levy rate** so that it too was focused on targeting 'excessive growth'. For example a flat levy rate (of 50% or higher) could be applied on any growth above a new higher threshold. This would have the benefit of simplifying how the levy works too.
- 2.7 The levy rate could be set at 100% and act as a **cap** on all growth above a certain level. Therefore, no local authority would receive any BR growth above a certain level of their BFL and the levy would be targeting 'excessive growth'. Introducing such a cap (100% levy) would also have the impact of raising more money into the levy account than if the levy rate was to remain unaltered, albeit from the same number of local authorities. For example, the table above shows that if the levy threshold in 2016/17 had been set at 150% with the current levy rate this would have generated £15m in levy payments from 18 local authorities. If a 100% levy was applied at a 150% threshold these same 18 local authorities would have contributed £29m in levy payments.

Q: What are the working groups' views on reforming the levy threshold and levy rate in the way? Would this target 'excessive growth'?

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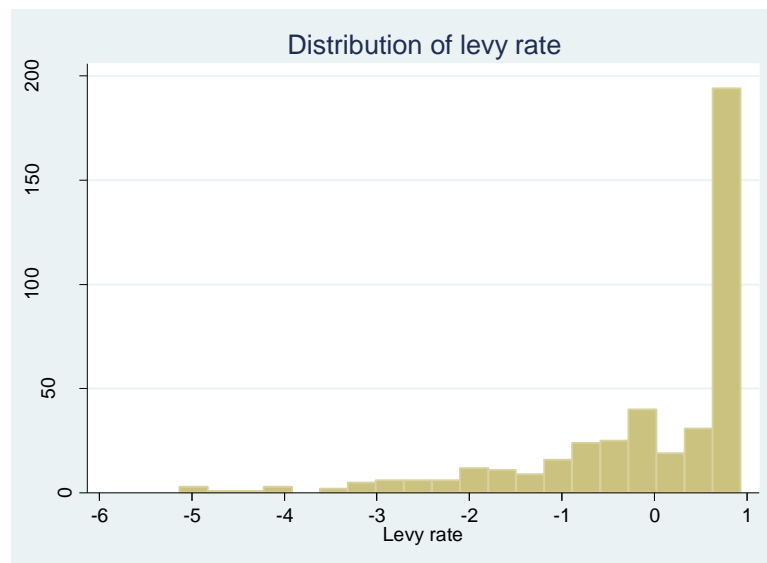
Using the levy to equalise the impacts of gearing

- 3.1 Highly geared authorities (those with a business rates baseline in excess of their baseline funding level, i.e. tariff authorities) stand to benefit more from growth in their rates receipts than lowly geared authorities (top-up authorities). Shire districts are highly geared, in large part due to their higher tier split (80%) than counties (20%). Therefore, a shire district seeing a 5% increase in their rates would see a greater than 5% increase in the business rates retention income, whereas a county would see a lower than 5% increase.
- 3.2 Members of the working group have expressed an interest in ways to equalise the opportunity to benefit from rates retention. This can be achieved by reforming the levy such that there are no limits on the levy rate. At the moment, the maximum levy an authority can pay is 50p in the £, and the minimum levy rate is 0p in the £. Removing these restrictions would mean that every authority has the same gearing and that a 5% increase in rates would lead to a 5% increase in business rates retention income. This is achieved by allowing a negative levy rate such that lowly geared authorities actually *receive* a levy payment.
- 3.3 However, this could lead to the levy running at a deficit in years with high growth. Had a limitless levy been in place over the period 2013-14 to 2017-18 the net cost would have been £70m pre pools and £210m after pools. The chart below shows the net cost of a limitless levy for each year before and after pooling.



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- 3.4 Removing the limit would mean that some authorities pay a very high levy rate. The levy rate would range from -5.13 to 0.93, with a median of 0.52 (higher than the current maximum). See table below:



- 3.5 Reform of the levy along these lines would represent a radical change from how the current BRR system works and reform of the levy cannot both target 'excessive growth' and allow more local authorities to keep all the growth achieved in their areas **and** reduce the impacts of gearing. There may be other system design reforms which could mitigate the impacts of gearing, for example by making changes to the tier split for two tier areas (although this is not applicable to all areas).

Q: What are the working groups' views on reforming the levy to equalise the impacts of gearing? How does this compare to other system design reforms that can alter the impacts of gearing?