POLICY DEVELOPMENT: NOT A STATEMENT OF GOVERNMENT POLICY

100% Business Rates Retention

Steering Group: 16 October 2018

Potential reform – the simplification or ‘alternative’ model

1. The System Design Working Group and Implementation Working Groups have considered two papers on a potential reform to the business rates retention (BRR) system that would simplify the way the system is administered, as well as potentially providing several other benefits, most notably, but not limited to, a route to mitigate the impact of appeals on local authorities. Other potential benefits would be to provide greater certainty of funding for local authorities in any individual year and to simplify the administration of the system

2. The first of these papers, produced by the local authority representatives that proposed the reform, was discussed at the July working group meeting and covered the mechanics of how the reform would work and some of the benefits of such a reform. It also provided some suggestions for how growth in business rates could be used to incentivise certain local authority behaviours. The second paper, produced by MHCLG and discussed at the September meeting, considered more broadly how reward and risk could continue to be recognised in the BRR system if such a reform was implemented.

3. For the benefit of the steering group, and at the suggestion of the working groups, this paper builds on the two previous papers. Part A summarises the key benefits and considerations to the reform. Part B sets out to a degree of detail how the alternative model could be operated. This paper seeks the Steering Group’s views on the proposed reform to the system.

<u>Questions</u>

Q1: What are the steering groups views on the potential reform outlined here? Do you endorse the reform as a potential way of delivering the objectives outlined in this paper?

Q2: Do you agree that we should seek the sector's views on this proposed reform as part of the consultation at the end of the year?

Context

4. This reform can help meet several objectives for reform of the BRR system. One of the objectives for reform of the BRR system is to tackle the impact of business rates appeals on local authorities. The Government has outlined its commitment to delivering this aim and it has been a key focus of the joint LGA-MHCLG steering and working groups.

5. The Steering Group has previously discussed work that has been undertaken on options to mitigate the impact of appeals, considering papers at the May and July meetings. The discussion at these meetings covered the potential barriers to implementing reforms to tackle the impact of appeals on local authorities. Viable options need to address two questions:
   - How provisions are dealt with through accountancy arrangements.
   - How to measure the compensation due to local authorities for valuation loss

   As the note to the July steering group concluded, solutions to these two questions are likely to be complex and challenging to implement. The Department is continuing to work on ways to address these two questions.

6. It is within the context of seeking ways to mitigate the impact of appeals that the reform outlined in this paper is proposed. As noted above, representatives from the system design working group suggested this reform which has been developed further by MHCLG.

7. In addition, the reform outlined in this paper could help to address two other potential objectives which have been raised through discussion at working groups and the steering groups:
   - **Certainty of income**. A manifestation of the current system (particularly as a result of how appeals are dealt with) is a lack of certainty around how much an individual local authority will have to spend on services in any given year.
   - **Simplicity**. The BRR system is complex and opportunities to simplify it are limited within the current legislative framework. Some potential reforms already discussed, in particularly those related to 'nationalising appeal risk', are likely to exacerbate the complexity for local authorities, for MHCLG, or for both. The system design working group has questioned the

wisdom of adding further complexity to the system even despite the problems caused by appeals.

8. This paper is divided into two sections. The first section summarises the potential benefits of the reform as outlined in the working group papers. The second explains in detail how the potential reform will work.

PART A: Potential benefits and other considerations

9. Currently we believe this proposed reform presents the best option to mitigate the impact of appeals on local authorities. It would ensure that provisions set aside by local authorities do not impact on the amount spent on local services.

10. This reform in the way the system is administered would also have several other benefits, when compared to the current way the BRR system works:
    - It would guarantee each local authority the income to spend on services as determined by the FFR (plus any growth/loss in business rates) and allows local authorities to budget with certainty;
    - Removes some of the complexity of the current system and in particular provides a way of mitigating the impact of appeals without adding further complexity;
    - Makes it easier to administer changes to the business rates system (e.g. reliefs) between resets.

11. However there are other considerations too in weighing up the viability and desirability of this potential reform:
    - We will need to establish whether the reform could have a negative impact on cash flow risk for authorities. For example, the closure of a large hereditament, leading to a significant reduction in rates collected could cause in-year cash flow problems for a local authority as the actual income from business rates would differ from the local authority's own forecast of income. We do not believe this is a large risk (and it exists to a degree in the current system as well).
    - The level of risk and reward under business rates retention would have to be built into the system. There is theoretically a lot of flexibility on how this could be done.

12. There have been two separate discussions at the joint system design and implementation working groups on options to recognise growth and decline under the reform highlighted in this paper. There are a number of ways this could be designed, although two broad choices of how growth could be treated have been considered. These are between:

- **Reward models**. Based on measuring the increase/decrease in business rates against a "baseline"; similar to the current system or
- **Behavioural models**. Based, as the paper produced by working group representatives suggested, on behaviours/choices of authorities – e.g. the correction of omissions from the rating list – that are not directly related to changes in business rates income.

Please see the previous working group papers from the July and September for a more detail on different models of reward considered.

13. Within these two broad design options there are a raft of different choices about the extent to which "growth" in a particular authority is left with that authority (and for how long), or is pooled at the local or national levels, i.e. decisions on the future approach to resets will still need to be made.

14. At this stage, we would be interested in the Steering Group's views on the following principles:
    - That the local government share of growth should match the headline level of retention (i.e. if the local share is set as 75%, authorities would keep 75% of any growth)
    - The system should recognise not only growth in BR but also decline as the current system does. It can therefore be expected that individual local authorities would bear some of the risk of business rates retention.
    - That a reward model is preferable to a behavioural model. MHCLG have investigated how this could be designed and an option is set out in Part B.

15. It should also be noted that reforming the system along the lines explained in Part B of this paper would not alter many elements of the current BRR system and decisions need to be taken as to whether and how to reform these in the future. Specifically, the options considered by the steering group in relation to resets, tier splits, the safety net and levy are all still applicable if the administration of the system is reformed in the way outlined in this paper. Similarly, any reform of the way pooling works or is incentivised is outside the scope of the reform outlined in this paper. It is still the Government's intention to consult on options for reform of these system design elements as part of the BRR consultation later this year.

PART B: How the BRR system would work under the proposed reform

16. The potential reform does not affect all aspects of the how the BRR system would be administered. In the same way as under the current BRR system:

    - we would set a central share – under current proposals this would be 25% – and local authorities would, subject to "redistribution", keep 75% of locally-collected business rates from which to fund local services.
    - Tariffs and top-ups would be set to redistribute resources between authorities taking account of their relative needs as determined by the Fair Funding Review.
    - Authorities would benefit from growth in their business rates.

17. But unlike the current model we would use current NNDR data each year to make <u>separate</u> calculations of:

    - the amount of business rates that authorities would need to retain in order to match the assessment of their relative needs;

    and

    - the amount of business rates they would retain as a result of growth, or any decline in business rates being recognised in the system

18. We would add these calculations together to produce an annual tariff, or top-up, which when added/subtracted from their share of non-domestic rating income in that year would mean that their retained business rates were equal to assessment of need + any growth/decline. These annual tariffs/top-ups would be 'floating', i.e. not fixed as they currently are, with reconciliation of the previous year's changes between NNDR1s and NNDR3s occurring in the following year's top-ups/tariffs.

19. The advantages of separating the calculations and basing them on real data are:

    - we can simplify the administration of the scheme by reducing it to a single number – the annual tariff/top-up. There would be no need for separate levy and safety net payments, or s.31 grants etc. It should be noted that a safety net and levy could still be set but these would be incorporated within in the annual top up/tariff calculations not through separate payments, i.e. all elements of the BRR system would be delivered through this system of adjusting top-ups and tariffs.
    - we can strip out the impact of appeals and provisions ensuring that the benefits of "growth" are not reduced or altogether removed by larger

than anticipated appeals or by misjudgements about the appropriate level of provisions.

20. The rest of this section looks in detail at how the reformed system would work.

21. By way of high level illustration, at a provisional settlement, two authorities might be provided with:

	£ million	
	Authority A	Authority B
SFA	10	50
Growth	2	5
Retained Income	12	55
Non Domestic Rating Income	15	35
(Tariff)/Top-Up	(3)	20

22. We will now take each of these concepts in turn and explain how they would operate under the reformed system.

SFA

23. In much the same way as envisaged under the current BRR system model, the *Settlement Funding Assessment* (or similar, depending on what it was called), would reflect an authority's share of 75% of aggregate business rates income as set out at a Spending Review.

24. Each authority's SFA would reflect its relative need as determined by the Fair Funding Review (FFR). The SFA would have the same function as the *baseline funding level* (BFL) in the existing system. Under the current proposals we anticipate that there would be no RSG post-2020-21, so the totality of an authority's Settlement Funding Assessment would be made up of retained business rates.

Growth

25. As this paper notes in Part A, there are different ways an incentive/reward in growth could be designed if the BRR system was reformed in the outlined here. This explanation presumes that, in much the same way as now, it would be preferable for individual authorities to benefit from any growth in their rates base (i.e. a reward model, not a behavioural model).

26. As the reformed model separately calculates “growth” and “redistribution”, it provides an opportunity to ensure that authorities see <u>all</u> the benefits of any growth achieved, unaffected by appeals and provisions.

27. Before considering how growth might be dealt with under the reformed model, it is worth explaining how the BRR system currently works and some of the difficulties this creates.

28. Under the current BRR system, a baseline funding level was set for each authority at the outset of the reset period, when the system was set up in 2013/14. Tariffs and top-ups are fixed so that, if the scheme correctly predicts the authority’s business rates income in the first year, the authority will have funding from business rates equivalent to its baseline funding level:

Baseline funding level (BFL)	500
Tariff	(100)
Share of Business Rates Income in year 1	600
Tariff	(100)
Retained Income	500 = BFL

29. If in year 2, if the authority grows its business rates base, its share of business rates income will grow and because the tariff is fixed in real terms, it will have greater retained income:

Share of business rates income in year 2	650
Tariff	(100)
Retained Income	550 = 50 growth above BFL

30. But, if in year 3 an appeal reduces the rates base and with it, the authority’s share of income by, say 60, the benefit of growth can be wiped out:

Share of business rates income in year 2	590
Tariff	(100)
Retained Income	490 = decline of 10 on BFL

31. Authorities, of course, have to make provisions against appeals. Because those provisions are deducted from the calculation of business rates income, in theory at least, if authorities had been able to accurately estimate future appeals losses and hence the total provision they would need to have made from day 1, their provisions would perfectly strip out the impact of appeals. In the above example, therefore, perfect forecasting of provisions would have ensured that the authority benefited from the 50 growth in each of years 2 and 3. But, in practice, accurate forecasting of appeals losses is impossible.

32. Because, the current system measures business rates income <u>after</u> accounting adjustments – and because those adjustments are always subject to uncertainty – some of the underlying growth in business rates bases is being eroded by appeals.

33. But, under the reformed system, it becomes possible to measure business rates income, <u>before</u> accounting adjustments – e.g. by measuring "net rates payable" – the sums payable by ratepayers in any year. On its own this would not solve the problem presented by appeals, because *net rates payable* will reflect appeals and backdated refunds made to ratepayers in the same way as *business rates income* and, therefore any underlying growth would still be potentially eroded by appeals.

34. But because, under the reformed system, we have divorced the calculation of any "growth" from the calculation of "redistribution", it is no longer necessary to use a fixed baseline (i.e. BFL) for calculation of growth.

35. Instead, we could use data already provided in NNDR3s (for "prior-year adjustments") to reset, each year, the baseline against which growth is measured to strip out the impact of appeals. As a result, underlying growth would be consistently measured across years and could be compensated for in the "growth" element of the settlement calculation. To illustrate simply:

Net Rates Payable (year 0 – base year)	700
Net Rates Payable (year 1)	700 – no growth
Net Rates Payable (year 2)	750 – growth of 50 over base

36. If at year 3, an appeal was heard that reduced net rates payable for the year by 60 (and produced a backdated refund of 180 in respect of years 1 and 2), the NNDR3 for year 3 would show:

Net rates payable (in year)		690 (ie 700+50 underlying growth – appeal of 60)
Prior-year adjustments:		
	Year 2	(60)
	Year 1	(60)
	Year 0	<u>(60)</u>
Net Rates Payable		460

37. By recalibrating the baseline to take account of the year 0 prior-year adjustment, we end up with an adjusted baseline of 700-60=640. Measuring net rates

payable (in year) against the adjusted baseline gives 690-640=50 growth, which is the value that would be used in the provisional settlement.

38. In year 4, because the appeal has been determined, in year, net rates payable would again be 690 and because there are no further prior year adjustments, no further adjustment is made to the recalibrated baseline and growth is again measured as 690-640=50.

39. There is more work to be done to validate this approach, which we are currently undertaking with the implementation working group and the benefit of disaggregated data from a number of authorities. But it currently looks promising and could be a way to reward authorities for underlying growth undistorted by appeals and provisions.

40. To be effective the calculations would need to be done following the availability of outturn figures at NNDR3, which would mean rewarding growth on a lagged basis – i.e. one year's growth would benefit authorities at the Settlement two years later. Whilst at first sight this might not sound ideal, as the next sub-section but one explains, it would mean that we could avoid the need for complicated reconciliation and simplify the treatment of Collection Fund surpluses and deficits by simply taking them into account in setting the redistribution element of tariffs and top-us.

Retained Income

.

41. Retained income in any year, would be the sum of an authority's assessed need and any underlying growth achieved (as measured above on the latest year's outturn figures). If there had been a decline in business rates (from physical changes to the business rates base opposed to appeals) this would also be reflected in the retained income figure.

42. Retained income would be set out at the provisional settlement and at that point, authorities would know their total retained income from business rates for the year ahead, giving certainty of funding to spend on local services.

Non-domestic rating income

43. To implement the proposed reform we would need to **bring forward the date of submission of the NNDR1 to slightly before the provisional settlement**.

44. As under the current system, billing authorities would use the NNDR1 to provide their estimate of non-domestic rating income for the year ahead and their estimate of the surplus or deficit on the previous year's collection fund.

45. Because the estimates must be of useable business rates available to the authority, they would, as now, measure an authority's non-domestic rating income after provisions, allowance for bad debt, etc.

46. Non-domestic income for the purpose of calculating tariffs and top-ups (see below) would be the authority's share of:
    - its estimated non domestic rating income for the year; plus
    - its estimated Collection Fund surplus/deficit

Tariff and Top-up

47. The tariff and top-up would be calculated anew each year in order to guarantee an authority its SFA + its underlying growth/decline.

48. It would simply be the difference between its non-domestic rating income as calculated above and its "retained income" (ie its SFA + underlying growth).