Reset 2020: Setting Business Rates Baselines – Measuring Income

Introduction

Paper IWG (18-5)1-01 looked at different approaches that could be taken when setting *business rates baselines* at the 2020-21 "re-set". Setting *business rates baselines* will necessarily depend on determining the business rates income of billing authorities and, hence, will rely to a greater, or lesser, extent, on data from NNDR returns which, in its turn, may itself dictate the best approach to setting business rates baselines.

This paper looks at the data captured by NNDRs. It considers the nature of that data, the issues raised by its use, and how data may be adjusted and adapted to overcome any inherent weaknesses.

IWG is invited to consider how best to use NNDR data to establish business rates baselines for 2020-21.

Background

1. In 2013, notwithstanding the imperfections inherent in the approach we adopted, we essentially sought to set a *business rates baseline* for each billing authority that was as close as possible to the net liability of an authority's ratepayers in the "base year", <u>after</u> making allowance for any future reduction in that liability as a result of appeals, for "bad debts and for rates income that would in future fall "outside " the scheme (eg, the rates in Enterprise Zones, or the allowance for the cost of collection).

2. For the purpose of this paper, we shall assume that, when setting business rates baselines for 2020-21, we have the same objective. Future papers will consider the extent to which the objective might need to be modified in response to the design of the new business rates retention system, for example, if the Government decided to, and could find a practical way of, "nationalising" appeals provisions.

3. Ignoring, for the moment, definitional issues, which are dealt with below, NNDRs before 2013-14 provided data on "gross rates payable", "reliefs", "net rates payable", "bad debt" "transitional arrangements" and "the cost of collection". There was no data on "appeals losses", "Enterprise Zones", or on income from "renewable energy" sites. These had to be estimated from very limited evidence.

4. Since 2013-14, very much more data is collected in NNDRs. At first sight, NNDR1s and NNDR3s appear to capture the same information at different points in the cycle – ie NNDR1s provide an "estimate" of non-domestic rating income made before the beginning of a financial year, and NNDR3s provide "outturn" figures made following the year-end. Both NNDR1s and NNDR3s, therefore, contain data on:

	<u>Gross Rates Payable:</u>	
		(less) reliefs
equals:	<u>Net Rates Payable</u>	
		add/(less) accounting adjustments
equals:	<u>Collectible Rates</u>	
		add/(less) transitional protection payments
		(less) disregarded amounts
equals:	<u>Non-Domestic Rating Income</u>	

5. However, whilst the bottom line number – *non-domestic rating income* – is directly comparable, the individual elements – *gross rates payable*, *net rates payable* etc – are not. This is because NNDR1s are designed to calculate the estimated business rates payable <u>in respect of</u> a forthcoming year, whilst NNDR3s calculate the income <u>actually due in</u> that year, including any adjustments in respect of previous years' income. What this means can be illustrated in a highly simplified form at annex A, which looks at the impact of prior-year adjustments to mandatory relief on figures for gross and net rates payable and on collectible rates. A similar impact is caused by prior-year adjustments to transitional arrangements (and hence to transitional protection payments) and to discretionary relief.

6. What this suggests is that, unless we intend to derive business rates baselines, for the base year, directly from NNDR figures for "non-domestic rating income", we need to be careful how we use individual elements of NNDR data in constructing business rates baselines.

7. The rest of this paper looks at each of the elements that comprise NNDR data, the issues raised by that data and some possible ways in which those issues could be addressed when calculating business rates baselines. Finally, drawing together the threads of papers IWG (18-5)1-01 and 1-02, the paper draws some conclusions about the design of a methodology for calculating business rates baselines at the reset.

Gross Rates Payable

8. In 2013, under a top-down approach, the starting point for the calculation of business rates baselines was a figure for (aggregate) "gross rates payable".

9. The only reason why we would need to establish a gross rates payable figure for the 2020 reset would be if, we took a top-down approach to setting baselines.

10. The obvious difficulty of using the "gross rates payable" figure in NNDR1s is that, by and large, it is constructed from the RVs for a single day. Therefore, it may, or may not, be representative of the gross rates payable over the year. The same objections apply to the way in which gross rates was forecast by Government for the purposes of EBRA in 2013.

11. On the other hand, as annex A shows, the "gross rates payable" figure in NNDR3s does <u>not</u> represent that year's gross rates liability, but instead, takes account of prior year adjustments.

12. Given that it is impossible to derive the true "gross rates payable" figure for any year from the data in NNDR3s, if a gross rates figure is needed (and NNDR1s and the 2013 EBRA approach rejected), one option would be to require NNDR3 returns (from 2018-19 onwards) to provide a breakdown of the "gross rates payable" figure between "in-year" and "prior year adjustments". This would, at least, establish the "gross rates payable" in respect of the year as a whole, instead of a "snapshot" for a single day.

Mandatory Reliefs

13. NNDRs contain figures for the amount of mandatory relief awarded by authorities in respect of transitional arrangements, SBRR, charitable relief, CASCs, Rural Rate Relief, empty property "relief" and partially-occupied "relief" ("section 44A")

14. The data provided by authorities in NNDR3s, excluding "prior-year adjustments", represent the best figures available for the cost of mandatory reliefs in respect of that year, both in aggregate and at individual local authority level.

15. However, this is only important if we adopt a top-down approach. If we seek to construct a figure for each billing authority based on its “bottom-line” figure for non-domestic rating income, we would need to take account of both the in-year and prior year adjustment figures (see annex A).

Upward Trend

16. Mandatory reliefs are on an upward trend and have been since 2013-14. But by using NNDR figures for a particular year to calculate business rates baselines, we would, effectively, be fixing the cost of mandatory reliefs at a single point in time. This would mean that authorities would bear the cost of future changes in mandatory reliefs until such time as the system was reset. Arguably, since the cost of mandatory reliefs is something over which local government has no control, this might be regarded as unfair.

17. In theory at least, it would be possible, in calculating business rates baselines, to reflect the rising trend in any figure used for mandatory reliefs. But practically, this would mean either setting different business rates baseline figures for each year of the reset period, or fixing a single figure at the outset based on a calculated value for mandatory reliefs at the mid-point of the reset period.

18. However, in practice it might be easier to address the upward trend of mandatory reliefs through the design of the system, rather than through the calculation of business rates baselines.

Discretionary Reliefs

19. Discretionary relief data raises many of the same issues as mandatory relief data.

20. There is less of a case for reflecting any “trend” in discretionary relief through the calculation of business rates baselines (or though the design of the system), since authorities themselves control the cost through the decisions they take on the amount of relief to award.

21. By 2019-20 or 2020-21 (depending on base year) – there will still be some discretionary reliefs for which authorities are compensated via s.31 grants, although most are “temporary” and may have come to an end before the next reset.

22. We will need to decide how to treat these. The choices are between:

i. excluding the reliefs from the calculation of business rates income and then compensating authorities, post-reset, for the cost of those reliefs – either through s.31 grants, or a deduction from central share; or

ii. including the reliefs in the calculation of business rates income, but then stripping them out once they come to an end – probably through an alteration of tariffs and top-ups; or

iii. dealing with them (in the same way as the "trend" in mandatory reliefs), if there is a more general "fix" through the design of the system.

Transitional arrangements and transitional protection payments

23. The transitional arrangements and how they feed through into transitional protection payments introduce a degree of complication to the calculation of business rates baselines.

24. Conceptually, we want transitional protection payments to be included in any calculation of non-domestic rating income. To do otherwise, would expose authorities to year-on year-changes in income resulting from the transitional arrangements introduced following the Revaluation.

25. However, transitional protection payments also interact with appeals and provisions. Essentially, the transitional arrangements mean that the loss of income – in the form of "refunds" – following a successful backdated appeal can be less than it would have been had there been no transitional scheme. But, in such cases, there is a compensating prior-year adjustment to the sums due under the transitional protection payments and, hence, to the amount of money due in transitional protection payments. Put simply, instead of refunding, say, £100 to the ratepayer, as might have been the case if there had been no transitional scheme, an authority can find itself refunding £30 to the ratepayer and paying £70 to Government in transitional protection payments. It is not clear to what extent, if at all, authorities make provision for the £70 that is due to central government. In extremis, the prior-year adjustment to the transitional protection payment can have a significant impact on an authority's non-domestic rating income for the year; in 2015-16, the requirement to repay £35.9 million of transitional protection payments to government, for which they had not made provision, meant that one authority had negative non-domestic rating income!

26. NNDR3s record both the “in-year” and the “prior-year” adjustments to transitional protection payments. In calculating a figure for non-domestic rating income, for the purpose of setting business rates baselines, therefore, it would be possible to exclude the prior-year adjustments. However, if the authority had previously provided for the loss and, therefore, charged it to the provision, by excluding prior year adjustments, we would be artificially inflating its non-domestic rating income.

27. The complications caused by transitional protection payments might argue for top-down approach.

Bad Debt

28. The allowance for bad debt introduces a further complication. The change in the allowance, which is a component of both the NNDR1 and NNDR3 calculation of “collectible rates”, varies significantly. It would not be a problem if the figure simply varied by authority. But, for any authority, it can also vary significantly from year to year.

29. For this reason, in 2013, the change in the allowance, together with sums written off in excess of the allowance, were excluded from the calculation of “proportionate shares”.

30. Depending on the approach we take to calculating business rates baselines, we may need to do something similar. Alternatively, in order to avoid hard-wiring “peaks”, or “troughs” into the calculation of business rates baselines, we may need to average figures over a number of years’ figures.

Accounting Adjustments

31. In order to calculate collectible rates, NNDR1s require authorities to indicate how much of the net rates payable in that year are expected, at some point in the future, to be repaid to ratepayers. NNDR3s require authorities to provide data on the amount charged to provisions during the year, plus the data on the change to provisions.

32. As can be seen from annex A, in a world of perfect forecasting, the net rates payable figure in NNDR3s plus the charge to provisions is equal to ratepayers’ net rates liability. To complicate matters, however, not all authorities provide figures for the amount charged to provisions; some simply give a net change figure. Moreover, given the limitations of some IT systems, it is not clear that the data on the “amount charged to provisions” is very robust.

33. There are also issues with the data on “changes to provisions”, not least that the figure is an “accounting estimate” made by the authority on the basis of the best information then available to it. It will inevitably change, in future, when other/better information becomes available to the authority.

34. The figure in NNDR3s for any year will, in practice, comprise two elements, even if these are not explicitly identified by authorities:

    i. An amount that represents how much of the rates collected from ratepayers in that year will ultimately be lost on appeal (effectively the “outturn” figure for the sum included in NNDR1s for “estimated repayments in respect of 20**-** rates payable”; and

    ii. Changes to the amounts previously provided for in respect of previous years. This may result in an addition to income, if the authority takes the view that its historic provision is too high – ie it overprovided for previous years’ losses. Or, a reduction to income if the latest information suggests that insufficient resource has been set side in provisions for previous years’ losses.

35. If the objective is to set business rates baselines that are as close as possible to ratepayers’ net liability, after taking account of future appeal losses (see paragraph 2 above), then we need to take account of the first of these elements, notwithstanding that it is only ever an authority’s estimate at a particular point in time.

36. But this task is complicated by the fact that NNDRs currently do not separate the two elements and that even if we required authorities to separate them, they may not be able to do so.

<u>Disregarded Amounts</u>

37. Using NNDR3 (outturn) figures for disregarded amounts as part of a calculation of that year’s non-domestic rating income is straightforward. Trying to project numbers forward for future years, however, is a lot more difficult.

38. Whilst the cost of collection is currently fixed at £84m per year and the City of London offset (if it continues to exist post-2021) can be easily estimated on the basis of the real, or anticipated change in the small business rating multiplier, the value of the amounts to be disregard for designated areas (ie Enterprise Zones etc) and new renewable energy sites is a lot more problematic. The year-on-year change in the aggregate total for both renewables and designated areas shows no pattern that could be used to

make a robust forecast and this even more true at the level of individual authorities.

Conclusions

39. The inherent weakness of some of the data and the practical limitations to our ability to make robust forecasts for future years, might suggest a methodology that:

a. So far as possible, fixes baselines on outturn data (NNDR3) for the “base year”, rather than one which forecasts non-domestic rating income for the base year, from earlier years’ data.

However, this would mean that even with a base year of 2019-20, we would be committed to revise baselines in the year after the reset because outturn data for 2019-20 will not be available until 6 months after the beginning of 2020-21.

Future work – once we have a preferred methodology (or, “lead options”), we might use historic NNDR3 data, to test the variation, at local authority level, of applying the methodology(ies) to a base year’s data, compared to a forecast based on a previous year’s data.

b. Is “top-down” – ie takes as its starting point “gross rates payable”. This would at least make use of the data in NNDR3s which is “real” eg in-year reliefs, in-year transitional protection payments. Given that we probably need to adjust the data for bad debt and provisions (see below), it may not be feasible to start from the NNDR3 figure for “non-domestic rating income” and then make adjustments for “changes to provisions” etc.

If we adopt a top-down approach, we would probably want to amend future NNDR3s to provide a breakdown of “gross rates payable” between in-year and prior-year payments.

Future work – model top-down and bottom-up approaches to determine feasibility and any difference in outcomes

c. Includes a deduction for bad debt for each authority that is based on an average of x years data for that authority.

Future work – analyse the variation in deductions for bad debt (sums written-off/written back + change in allowance) to determine the number of years on which an average should be based

d. Includes a deduction for “appeals provisions”, based on individual authorities’ data, but which excludes one-off changes (see paragraph 34ii above)

Whilst it would be possible (but difficult) to make a central estimate of the outstanding future loss as a result of appeals, and then apportion that between authorities, it probably makes more sense to use authorities’ own estimates in order to determine the disaggregated and aggregated amounts

However, under a top-down approach, we need to use only that element of that “change to provision for appeals” that relates to the net rates liability that will be lost in future years – ie the “outturn” equivalent of the figure in NNDR1s. Albeit, that this figure only represents authorities’ best estimate at that date, it is difficult to see how we might make any better estimate.

In making adjustments to tariffs and top-ups in the 18-19 Settlement, we faced the same issue and addressed it by using the “closing balance for provisions” from Part 5 of NNDR3s to work out the RV loss that this represented and then multiplied the RV figure by that year’s multiplier, to determine how much of “change in the provision for appeals” was for future loss on the current year’s liability. We might employ a similar methodology for the purpose of calculating business rates baselines

Future work – review methodology for calculating the deduction. Issues that need to be addressed are the extent to which the “closing balance” in part 5 will still be providing for 2010 list appeals that, technically, should be excluded from the calculation; whether we can/should refine the calculation to take account of the fact that provisions are made on net rates payable, not on a gross RV loss; and whether the differences made by such refinements are worth making, or simply achieve a spurious level of accuracy at the cost of greater complexity.

		1718	1819	1920
R/payer's liability (year-end)	RV	200	200	160
	m/p	0.5	0.5	0.5
	Gross Rates	**100**	**100**	**80**
	Mandatory Relief	*-80*	*-80*	*-64*
	Net Rates	**20**	**20**	**16**

Appeal determined resulting in 20% reduction in RV, backdated to Year 1718. Appeal reduces r/p liability in 1920 and requires "refund" of 2x4=8 in respect of 1718 and 1819.

		1718	1819	1920
NNDR1	**Gross Rates**	**100**	**100**	**100**
	Mandatory Relief	*-80*	*-80*	*-80*
	Net Rates	**20**	**20**	**20**
	Est. repayments (appeals)	-4	-4	-4
	Collectible Rates	**16**	**16**	**16**
	TPP/Disregarded Amounts	*0*	*0*	*0*
	Non-Domestic Rating Income	**16**	**16**	**16**

NNDR1 forecast made before appeal determined.

		1718	1819	1920
NNDR3	**Gross**			**40**
	Mandatory relief (in-year)			*-64*
	Mandatory relief (prior-year adj)			*32*
	Total mandatory relief			*-32*
	Net Rates			**8**
	charged against provision			*8*
	changes to provision			*0*
	Collectible			**16**
	TPP/Disregarded Amounts			*0*
	Non-Domestic Rating Income			**16**

Net rates is defferent from the ratepayer's actual liability. It is the accounting changes that bring it into line - but only assuming perfect forecasting. Any over- or under-provision I previous years will increase/decrease collectible rates. Hence, collectible rates is not a real-world measure of rateapyers' net liability.

Although the breakdown is not shown on NNDR3, the gross rates no. is 80 "in-year" minus 2x20=40 for "prior yr adjustments" (ie the difference between the 100 recorded in previous years NNDR1s for 1718 and 1819 and the 80 that would have been recorded if the liability were reduced in line with the appeal determination.