POLICY DEVELOPMENT: NOT A STATEMENT OF GOVERNMENT POLICY

Annex A: 100% RATES RETENTION: MITIGATION OF APPEAL RISK

1. This paper sets out that challenges that local authorities have faced from business rate appeals under the current 50% rates retention system, and considers how we could address this in the new 100% rates retention system.

2. It then considers one proposal for how this might be dealt with under 100% rates retention in order to increase acceptability of the scheme and reduce the overall cost to the public sector.

Changes in income from business rates

3. Changes (including reductions) in the business rates collected by local authorities will arise as a result of:

   i. physical changes to property – ie new build, demolitions and renovations;

   ii. changes to the mode of occupation of a property – eg "splits" and "mergers" and changes to the occupation of other properties in the area. Exceptionally this can also lead to reductions where large amounts of office space become vacant;

   iii. changes to the rateable value of property caused by an "error" in the original valuation – often identified as a result of appeals under the Non-Domestic Rating (Alteration of Lists and Appeals) (England) Regulations 2009 by ratepayers or subsequent changes to the list by the Valuation Office Agency following other such proposals or appeals. For ease of reference all these changes will be referred to as 'appeals' in the remainder of the paper.

Dealing with risk under the 50% system

4. Under 50% BRRS, a reduction in collectible business rates, regardless of the reason for that reduction, impacts on the non-domestic rating income of the authority. The safeguards available under the system are:
   i. the requirement for authorities to make an accounting provision; and
   ii. the safety net

Accounting provisions

5. A consequence of the move to 50% rates retention was that local authorities were no longer deemed to be acting solely as agents of central Government. As a result, and in accordance with proper accounting practice, they are now required to set aside part of each year's collectible business rates in a "provision". The amount set aside represents each authority's estimate of the sums that must ultimately be repaid to ratepayers as a result of "errors" in the original valuations (see para 3iii above).

6. In setting up the 50% scheme we made an aggregate estimate of the total provisions that authorities would have to make and netted this off our estimate of business rates income:

	£'000
Estimated Collectible Business rates	23,600
Adjustment	(1,800)
Estimated BR Income	21,800
50% Local Government share	10,900

7. Hence £10,900,000 became the "control" figure for business rates. It was used to set both the aggregate "baseline funding level" and the aggregate "business rates baseline" which were apportioned between individual authorities to reflect needs and resources and to set tariffs and top-ups.

Safety Net

8. Under the 50% scheme, each authority is guaranteed 92.5% of its baseline funding level. If its income from business rates (after taking account of its tariff or top-up) falls below 92.5% of its baseline funding level in any year, it receives a safety net payment in order to bring its income up to the threshold. Hence, the safety net provides some protection for the cost of all three changes to business rates identified in para 3 above.

9. We intend to consider further questions about a future safety net within the 100% rates retention scheme in later papers, so this is not explored here.

The problems

10. The large volume of appeals, the time it takes to deal with them and the lack of information made available to authorities by the VOA has made it extremely difficult for authorities to forecast their business rates income in any year. A comparison of prior year estimates (NNDR1s) and final year outturns (NNDR3s) shows that in 2013-14, authorities overestimated income by £1.2 billion; by £0.7 billion in 2014-15 and by an estimated £1.3 billion in 2015-16. A significant contribution to poor forecasting performance has been authorities' difficulty in forecasting the appeal adjustment that they should make.

11. In 2013-14, authorities made a total provision of £1.2 billion for backdated appeals and a further £0.5 billion for in-year appeals. In 2014-15 a further £1.5 billion was added to provisions and in 2015-16 it is estimated that authorities will add another £0.5 billion. In total, at 31 March 2015 (the last year for which outturn figures are available) authorities still had over £2.5 billion sitting in provisions (having "used" £0.7 billion of their

provisions over the course of the year to settle refunds on ratepayers following successful appeals). This means that authorities have set aside a significant amount of money which is therefore not being used for local services, and it is not clear whether all of that funding will be required.

12. As a consequence, in each year since 2013-14, authorities have been budgeting to spend less business rates income than their baseline funding level (for 2016-17, they will budget to spend £0.4 billion less than the aggregate baseline funding level).

13. Appeals risk adds considerably to the instability of business rates as a source of income from which to fund local services. Under 100% rates retention, the risk and financial impact will fall <u>entirely</u> on local authorities. This is likely to have a number of consequences:

   i. **Continued high provision for appeal loss** – authorities are likely to continue holding high amounts in provisions (ie making ‘prudent’ financial assessments), leaving less income to spend on local services.

   ii. **Unpredictable impact on service delivery** – because ‘appeal losses’ are inherently difficult to predict.

   iii. **Unwillingness to use “growth” in base budgets, or to make long-term investment decisions** – because business rates income is unpredictable, authorities may discount a large proportion of any growth and hold it in reserves against future losses, and will release it only to fund short-term revenue projects.

Solutions

14. Notwithstanding the appeal reforms that are currently being put in place and which may reduce the number of appeals and speed-up the time taken to deal with them, unless we are prepared to deny ratepayers the right to appeal their rateable values altogether, there will always be some (and perhaps substantial) appeal loss in the system under 100% rates retention. There are only two possible approaches to dealing with that appeal risk:

   i. **Require authorities to deal with it**

   This would mean requiring authorities to make “provisions” against appeal losses, as they do under the 50% scheme. In setting up the scheme, Government would need to build-in an amount for the aggregate provision that authorities could be expected to make.

   This will be extremely difficult, at both aggregate and individual authority level; there is simply not the data available to allow us to anticipate appeal losses accurately. Reflecting our experience over the last three years, we will also need to build-in some element for “overprovision”, or increase the risk of a major difference in Government figures and local authority budgets.

ii. **Remove the direct impact of valuation “errors”**

Effectively, authorities would no longer be required to carry the risk of valuation “errors” (see paragraph 3iii). Instead of having to make provisions for such losses, we would identify the losses post-event and compensate authorities.

Potentially, this would substantially reduce the appeal losses to be borne by authorities and, in turn, would reduce the provisions they need to hold. It would give them more stable, more forecastable, business rates income.

Can we identify “valuation errors”?

15. When the original 50% rates retention scheme was set up, Government resisted calls that it should bear the cost of “appeal losses”. This was largely on the grounds that it was not always possible to distinguish appeal losses from other changes in rateable value – a single appeal can encompass challenges to the underlying valuation; to the physical characteristics of the property; and to the nature of occupation. The outcome of the appeal is a single reduction to the rateable value that does not apportion the changes between the different elements under appeal.

16. However, given the turmoil caused by appeals and provisions under the current 50% scheme (and their potential increased impact under 100% rates retention), DCLG have been looking again with the VOA at what might be possible. Our joint conclusion is that it is not possible to devise a “perfect” system – what held true when we devised 50% rates retention holds true today. But, we think that it may be possible to devise a reasonable proxy for appeal loss.

17. To do this, it would be necessary to distinguish between value changes (both up and down) that:
    i. were backdated to the first day of the list (ie 1 April 2017); and
    ii. those that were not (ie changes that had later effect)

18. Because of the “rules” that determine the situations in which the VOA is obliged to backdate changes to the first day of the list[1], this will provide a reasonable proxy for changes made as result of valuation “errors” in the original compiled list. There will be some rough edges. Some of these could be dealt with by using the “transition certificates” that valuation officers will have to produce under the transitional arrangements that Government will be putting in place to protect ratepayers against

[1] The “rules” re contained in the Non-Domestic Rating (Alteration of Lists and Appeals)(England) Regulations 2009 (as amended) (SI 2009/2268)

large tax hikes following the 2017 Revaluation. These certificates specify the 1 April 2017 value that is to be used for transitional purposes where there has been a subsequent change to a rateable value.

Removal of valuation changes under 100% rates retention

19. In essence, removing valuation changes under 100% rates retention is operationally straightforward. The scheme might be set up in broadly the same way as now, so that each authority had a *baseline funding level* and a *business rates baseline*. The difference between the two would be the authority's tariff, or top-up.

20. At the beginning of the year, the authority would determine its business rates income in the same way as now, but it would not be expected to make a provisions for appeal loss, on the ground that it would be compensated for any such losses. It would still have to make provisions for other "losses", to the extent that these fell to be dealt with through provisions under accounting rules, but we might expect these to be small.

21. During the course of the year, the VOA would make changes to the authority's rating list, and from this the local authority would identify those changes that had effect from the first day of the list (as a proxy for valuation error) and those that were not.

22. At the end of the year, on the basis of the above, the authority would identify the loss of income in respect of valuation errors, distinguishing between on-going losses (ie those that would carry forward year-to-year as a result of the RV change) and one-off backdated changes – ie the impact of having to make refunds in respect of prior years. The former would result in a permanent adjustment to the authority's tariff or top-up. The latter would result in a one-off compensation payment. DCLG needs to test with local authorities whether this is currently possible by direct calculation from the amendments; whether it could become possible with suitable software changes; or whether it would require a further proxy adjustment.

How could this be funded?

23. If we followed this new approach, funding would need to be identified, probably from within the local government financing system, to "refund" the cost of successful appeals. Options might include:
    i. Using the revenue raised through the Central List to "refund" local authorities (noting that without further data and analysis, we don't know whether the Central List would raise enough funding for this).
    ii. Making an adjustment to the total "income" when setting up the scheme and recover this income from authorities via tariffs and top-ups.

24. For both options, the risk of the funding set aside to "refund" authorities being too high or too low will need to be considered. This might be easier to manage through option (ii)

above where the income recovered could vary from year to year (recognising that this would have some impact on the certainty of income for authorities).

QUESTIONS FOR DISCUSSION

Q1. Does the paper identify the right issues regarding business rates appeals in this paper? What's missing?

Q2. Are there other options to help mitigate the risk associated with appeals that are missing?

Q3. Would the proposed option (removal of valuation changes from local authority responsibility) work in practice? What more would be needed?

Q4. How should the proposed option be funded? Have the right options above been identified, or are there alternatives?

Q5. Should any option enable authorities to choose whether to 'opt in' to a new system, or retain the current system of provisions?