Systems Design Working Group: 25 July 2016

Resets & Growth (with data)

Paper prepared by Department for Communities and Local Government

1. At the working group meeting on 17 June, we had a discussion on 'growth and redistribution'. We agreed:
   - That fixed reset periods would give more predictability and stability to local authority income than resets triggered by a rule;
   - That there may be a benefit to the idea of 'partial resets' as a middle ground between frequent and infrequent whole system resets.
   - Even with a 'partial reset' approach, a full reset would be required at some point in the future.

2. With that in mind, we have brought back a more detailed paper, including some modelling, based on historic data, to test those agreed assumptions. We'd like to use today to test:
   a. What is meant by a 'partial reset'
   b. A scenario demonstrating how a partial reset could work
   c. Reactions from the working group about what would be acceptable in terms of modelled local authority variation from initial baseline funding levels.

3. Through regular resets of the system, our aim is to find the appropriate balance between providing a strong incentive for growth in local areas, and considering the distribution of funding between local authorities.

4. To help bring possible scenarios to life, and to test what the group finds acceptable variation from baseline funding levels, we have provided some charts at Annex A. The charts are extracted from DCLG modelling in an early stage of development, so should be interpreted as illustrative only. Key assumptions are that historic trends in business rates receipts growth will continue, starting with 2014-15 NNDR3 figures, and Settlement data has been used to create dummy Baseline Funding Levels. We have assumed a real business rates growth rate of 0.1% per annum, as per the Office for Budgetary Responsibility's forecast. Outputs are designed to illustrate the effects of design choices at a system level rather than forecast business rates growth or local authority income.

5. In order to purely test what effect the frequency of resets and partial resets have on the system, we have:
   - Assumed that tier splits remain as now
   - No changes to deal with the impact of successful business rates appeals
   - No changes to properties held on local lists
   - Not made a provision here for a safety net in order to see the full remit of variation from baseline
   - No resets to baseline funding level for changes in relative need.

6. These assumptions have been made for modelling purposes only. We will address other design elements over the upcoming working group meetings, including handling appeals and a safety net, but want to see the impact of resets at this point.

7. Similarly, the charts illustrate the impact of different resets on local authorities as a whole. For the purposes of considering the impact on the majority of authorities, these have been subdivided into bands covering 75% of local authorities. We accept that any option we model will have a number of outliers – and once we have a proposition on each element, we should look again at how to handle any remaining outliers. At this point, we'd like the working group to focus on how proposals affect the majority of local authorities.

Infrequent resets (every 20 years / never)

8. As discussed at the working group meeting on 17 June, resetting the whole system (including all achieved growth) on an infrequent basis (or never) would provide a significant incentive for local areas to grow their business rates income. However, any reduction in income over the same period would need to be managed by the local authority. Under this approach, growth achieved via increased business rates income would only return to the system for redistribution every 20 years (or – at an extreme – never).

9. **Chart one** at Annex A illustrates the impact this approach would have – in particular, it illustrates the extent to which we would expect local authorities to diverge from their baseline funding level. This chart demonstrates that:
    i. Local authorities' retained income diverges significantly from baseline funding levels, before being reset at 20 years.
    ii. This approach would appear to provide an incentive for growth but leaves authorities at the bottom of the chart seeing a significant reduction in income, which could be for an extended period of time before the reset of the system after 20 years.
    iii. As referenced above, this model makes no provision for a safety net, in order to illustrate the full impact of design choices on local authorities. But it would be reasonable to assume from this chart that the costs of a safety net under this option could be significant.
    iv. Though this approach would allow some areas to see impressive increases in income as a result of growth in business rates, it could have a detrimental impact on service delivery for the significant number of authorities that see income decrease.

Frequent resets (every 5 years)

10. By comparison, resetting the whole system (including all achieved growth) frequently – for example, every 5 years – would ensure business rates income was frequently redistributed to meet relative need. Local authorities would retain a 'growth incentive' for the years between resets, but all growth in business rates achieved by local authorities would go back into the redistribution system every 5 years.

11. **Chart two** at Annex A illustrates the impact this approach would have – in particular, it illustrates the extent to which we would expect local authorities to diverge from their baseline funding level. This chart demonstrates that:
    i. Over each 5 year period, we would expect to see a slight increase in retained income for the median. Compared to chart one, fewer local authorities would be expected to diverge as significantly from the baseline funding level.
    ii. Local authorities see growth (and loss of income) during each 5 year period, but all authorities are brought back to baseline funding levels on a regular basis, so no authority remains a significant distance from their baseline for more than 5 years.
    iii. On the other hand, no authority is able to retain longer term growth, as all achieved growth in business rates income is returned to the pot for redistribution every 5 years.
    iv. This approach reduces the incentive for sustained, longer term growth plans, as authorities return all achieved growth to the overall pot for redistribution.

Partial reset

12. As discussed on 17 June, we think there is an opportunity to have a 'partial reset'. This could work by allowing individual authorities to retain a proportion of any achieved growth in business rates income, with the other portion returned to the overall resource pot to be redistributed. C**hart three** at Annex A illustrates how this could work.

13. Under this scenario, a 'partial reset' takes place every 5 years and allows individual local authorities to retain 50% of the growth in business rates income that they have achieved during the previous reset period. At the other end of the scale, it aims to return all authorities that have seen 'negative growth' to 100% of their relative baseline funding level at each reset.

14. At a reset, all business rates income – including 50% of any growth in income since the last reset – would be redistributed according to relative need. Those authorities that had increased their business rates income since the last reset would retain 50% of that growth – ie it would remain outside the redistribution system.

15. An important point to note here is that if 50% of overall growth in business rates income is greater than the amount needed to bring all 'negative growth' authorities up to baseline level, the additional funding will return to the overall resource pot to be redistributed. Conversely, if 50% of overall growth in business rates income is smaller than the amount needed to bring 'negative growth' authorities back to baseline, there will be less overall resource to be redistributed to all authorities.

16. Key messages to be drawn from chart 3:
    i. This system appears to give an incentive for growth: local authorities that are successful in growing their business rates income continue to see reward from this over reset periods, as well as within reset periods.

ii. This system provides some assurance to authorities seeing 'negative growth' that the partial reset is reasonably frequent, and aims to bring all authorities back up to baseline funding levels.

iii. But this option does continue to contain an element of risk, as set out in para 15 above.

17. Overall this 'partial reset' approach provides a compromise between the alternatives. It does raise two issues for further discussion:

    i. Frequency of partial resets: we have used 5 year resets to illustrate the overall impact of this approach. 5 year intervals allow some element of growth to come through, but ensures no authority manages a reduced income for an extended period of time. There is interaction on this question with the Needs and Resources Working Group, who will consider how frequently the needs formula should be updated.

    ii. Proportion of growth retained: we have illustrated this system by allowing individual local authorities to retain 50% of any growth in business rates income at a reset. We will need to further consider whether the proportion of growth returned to the redistribution system at resets is 'enough' to bring all local authorities back to their baseline levels.

Does this proposal for a partial reset work?

Are the working group content for us to build these assumptions about partial resets into future modelling?

Are there additional options / assumptions that should be modelled?

Annex A: illustrative charts

Chart one	*Distribution of LA funding with full resets every 20 years*
Chart two	*Distribution of LA funding with full resets every 5 years*
Chart three	*Distribution of LA funding with partial resets every 5 years*

Annex A: Chart One – Distribution of LA income with full resets every 20 years

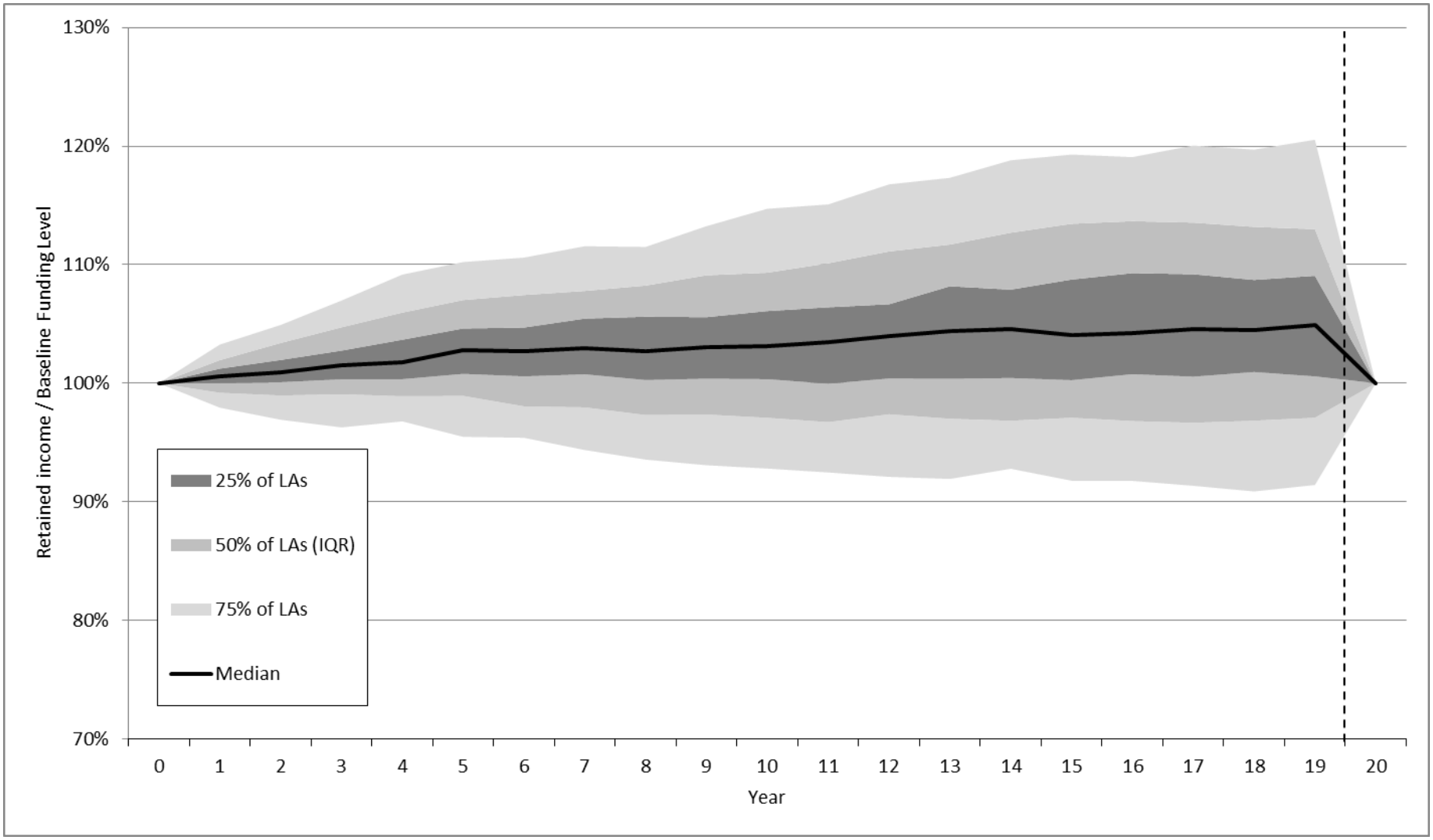

Chart Two – Distribution of LA funding with full reset every 5 years

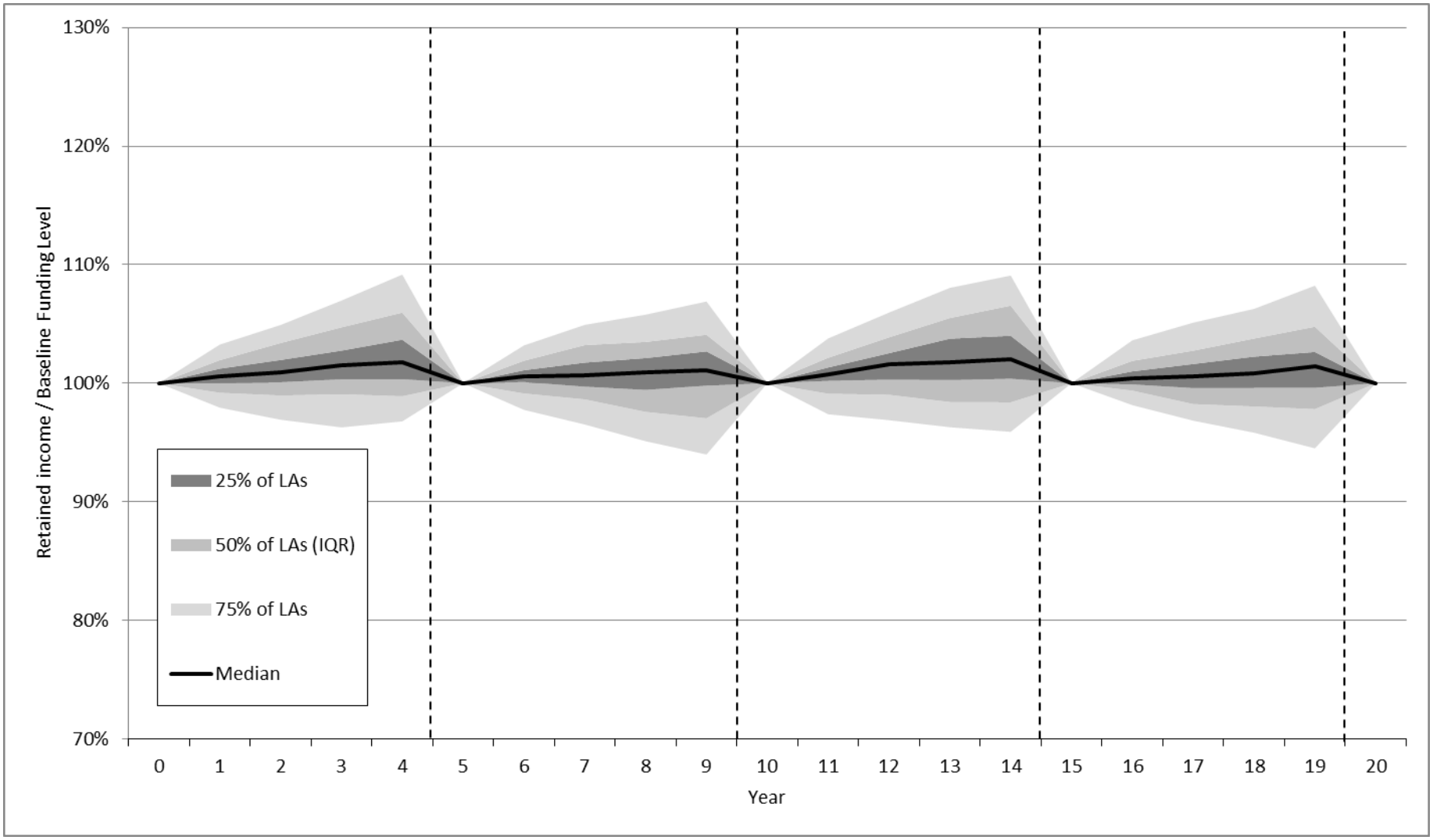

Chart Three – Distribution of LA funding with full reset every 20 years & partial resets every 5 years (50% growth retention individually)