Steering Group paper
Identifying and handling risk in the 100% rates retention system

1. Moving to 100% business rates retention is both an opportunity for the local government sector to move towards self-sufficiency, and to grow their income from business rates. To make sure self-sufficiency is not undermined, and that the sector continues to be able to provide core services – just funded through a different system – we need to consider how to manage risk within the system.

2. Experience of the 50% business rates retention system has demonstrated the importance of building the future system on a robust business rates base. We are looking at what central government can do to help manage risk, and considering how to set up the scheme to ensure councils bear proportionate risk through the handling of appeal risk, gearing and setting a safety net.

3. DCLG have been working with local government and others to consider four key ways of managing risk:
   a. Providing for appeals
   b. Gearing
   c. Ratings lists
   d. Safety net

4. These have not been discussed in depth yet with the working group, but the group currently have papers on each of these areas. Welcome the Steering Group providing any steers for particular areas to concentrate on / ideas to investigate.

a. Providing for appeals

5. Local authorities are currently required by IAS 37 to make provision against changes to a ratepayer's business rates liability, principally as a result of appeal loss. Under the 50% rates retention scheme, authorities were provided with funding for provisions. Effectively, this was done by "top-slicing" an amount - £1.8bn – from the initial calculation of the business rates that would be collectible in the first year of the scheme (and hence, every subsequent year).

6. Appeal loss varies significantly between authorities. At the end of 2014-15 (the last year for which published data is available), excluding outliers, 90% of authorities held provisions as a percentage of collectible rates ranging from 2.5% to 23.2%. The way the "top-slice" was effectively distributed to authorities under the rates retention system, has meant that some authorities' provisions have exceeded their share of the top-slice, thereby reducing their income under the scheme. Whilst for others, the share of the top-slice has exceeded the provisions they have had to make. Moreover, because forecasting appeal loss (and hence, calculating provisions) is inherently difficult, the impact of "getting it wrong", risks there being higher income volatility year-on-year than would be the case if losses were more predictable.

7. We have been exploring options for dealing with appeal losses (or some proportion of them) at national level. The basic proposition would be to compensate authorities directly for RV changes that are backdated to the first day of the rating list. The funding for compensation payments would be “top-sliced” from the quantum of business rates on the first day of the new 100% scheme, in much the same way as under the 50% scheme.

8. However, of itself, guaranteed funding for a proportion of appeal losses would not remove the IAS 37 requirement for authorities to make provisions against <u>all</u> losses that fell within the IAS 37 definitions. Unless therefore, provisions are to impact on authorities business rates income, we would need to take a further top-slice at the outset of the scheme. This would reduce still further the “quantum” of business rates in the scheme on day 1 and reduce the value of new responsibilities that are to be devolved. It would effectively “double” the value of the top-slice made at the outset of the scheme and would have a cost to government.

9. If therefore, we want to pursue the idea of centrally-funding a proportion of appeal losses, we need to find a way of operating the new system that allows authorities to recognise as “income” in any year, that part of any provision for which ultimately they will be compensated, albeit perhaps a number of years down the line.

10. A small group of local authority representatives and CIPFA met to discuss the issues, and agreed that a possible approach might be to have the charge to the revenue account “switched” into an adjustment account – leaving the general fund balance as if the provision (at least insofar as the first-day backdated element is concerned) had not been made. The amount thus debited to the adjustment account would later be credited at the point that change to the rating list was made and the compensation payment was due from “central government”.

11. This is broadly the approach that was adopted in the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2014 (SI 2014/1375) to allow authorities to spread the cost of the initial backdated appeal provisions under the current 50% rates retention scheme.

12. The group agreed that to test this further, we should
    i. Highlight this solution to the Systems Design Working Group to gather any further thoughts on this solution;
    ii. Test out how this would work in practice by working through the accounting steps required;
    iii. Highlight this favoured approach to the Accounting and Accountability Working Group to test the practical impact;
    iv. Identify the data (proxies) that would be required from the VOA and local authorities under this solution;
    v. Meet again as a small group to discuss progress.

13. We will undertake this work over the next few weeks, with the aim of consulting on a specific workable proposition in the autumn technical consultation. We will also be undertaking some work to consider how much this proposition would reduce the levels

of risk currently seen in the 50% BRR system. We anticipate that implementing this proposition would have a significant impact, ensuring that growth and loss in business rates income are more closely aligned to real life, rather than muddied by provisions for appeals. We are particularly interested to investigate the impact of implementing this proposition on likely usage of the safety net.

b. Gearing

14. The more highly geared an authority, the greater level of risk and reward they can achieve from changes in their business rates income. The lower geared an authority, the more difficult it is to achieve significant reward in their business rates income, but they also carry a much lower level of risk. Attached is a systems design working group paper covering further detail about the concept of gearing and the impact of gearing under the 50% rates retention scheme.

15. Two tier areas feel a further impact from the tier split that was set up at the introduction of the 50% business rates retention system. Through this, districts retain 80% of any increase in business rates income, with the relevant county council getting a 20% share of that increase. The system works the same for losses of business rates income – districts retain 80% of that loss, and counties only 20%. When the system was set up, Ministers felt this was the right level of tier split to both:
    - incentivise and reward districts, as the tier of government with most control over planning decisions
    - protect counties from taking on higher levels of risk as the tier of government providing high demand services in social care

16. Our opportunities to adjust gearing in single tier authorities are fairly limited. We are interested in exploring the impact of working on larger geographic areas around single tier authorities to consider how this could change the effective gearing of those authorities.

17. We are interested in exploring the impact of changing the tier splits between district and county authorities. County and district organisations are currently working together on how they would want to see this issue addressed.

18. We will take this forward with some further modelling to consider what the impact of changed tier splits would be, and whether the changes in risk to different authorities would be acceptable.

c. Ratings lists

19. The way that ratings lists operate at the moment can mean greater risk for some local authorities under business rates retention. Some local lists are may be inherently riskier than others, for example by being dominated by very large properties on local lists, such as power stations, which carry significant risks to local income from appeals, national policy changes or closure.

20. The current system can also increase volatility in local income through properties moving from a local list to the Central List. The criteria for judging these requests were developed prior to rates retention and are only applied by DCLG when a request from a ratepayer is received. As a result, there is an inconsistent picture of network properties on local lists and the Central List, and a continuing risk that some ratepayers will ask to be moved onto the Central List (often having a significant impact on a local authority's business rates income).

21. We have previously discussed with the working group the possibility of introducing 'area lists', and this option was included for Combined Authorities in the July consultation document (*Self-sufficient local government: 100% Business Rates Retention*). However, initial feedback from local government sector is that there is limited interest in this proposal.

22. Similarly, we have floated the idea of moving some 'riskier' hereditaments from local lists to the central list to help manage risk. The working group have concluded that the central list should be limited to properties which are inherently non-local and that the Government should review the contents of local and central lists to ensure the appropriate properties are assessed to the central list. The group rejected proposals to move large risky but local properties (such as power stations) out of local lists to an area or national list, suggesting that to do so would remove the incentive for local authorities to attract some of those hereditaments to their area.

23. As a result, we are actively discussing with the working group how we could better manage the current use of local lists and the central list. This is likely to involve clarifying the central list policy approach, and then refreshing the central list ahead of the introduction of 100% rates retention. This should reduce the likelihood of hereditaments moving unexpectedly between lists.

24. We continue to be interested in the opportunities for local authorities to pool their ratings lists to operate at a larger geographic area where there is appetite. We will review and adjust our thinking about ratings lists in light of responses to the business rates retention consultation.

d. Safety net

25. The local government representatives of the system design working group have suggested that they would welcome a simple, more generous, safety net mechanism. This would be based on safety net in the current 50% rates retention system, but set at a higher proportion of baseline funding levels.

26. Taking into account the other design elements above that should reduce the risk on local authorities, we are keen to test whether this ask for a simple safety net still feels right. We currently have a short paper on safety net design options out to the working group for comments. This aims to test whether a more sophisticated safety net mechanism might be useful to explore for the 100% rates retention system, including whether a future safety net could or should aim to:
    - Incentivise authorities to build business rates growth gains into their core budgets;

- Incentivise and support those authorities receiving safety net payments to grow their business rates income;
- Be more nuanced to differently geared authorities.

27. Our next steps will be to develop a more nuanced understanding of the impact of other proposals to manager risk. In particular, we would expect:
    - Introducing partial resets every 5 years to would mean that no authority remained on the safety net for longer than 5 years, and possibly fewer local authorities requiring safety net payments.
    - Changes to managing successful business rates appeals that are backdated to the first day of the list should reduce the number of local authorities relying on the safety net due to appeals losses.
    - Gearing analysis demonstrates that it is predominantly the most highly geared authorities that are currently on the safety net.

Overall picture of risk

28. We acknowledge that further work needs to be undertaken to consider the full picture on risk – ie if each of these points are addressed, what does the risk profile of the new 100% rates retention scheme look like?

29. We will also need to model the likely cost to the system of implementing proposals to help manage risk. Any cost associated with proposals to manage risk are likely to have to be managed within the wider system – for example, funded via a top slice to the overall quantum. Any top slice will mean reducing the amount of business rates funding that can be allocated to new responsibilities, and it will therefore be important to keep this at appropriate levels.

Does the Steering Group have views now on the impact of the proposals above on local authority risk under 100% business rates retention?

Does the Steering Group want to working group to focus on any particular aspects of this paper?