BETTER RATES

How to ensure the new business rates regime promotes growth everywhere

Alfie Stirling and Spencer Thompson | June 2016
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60-SECOND SUMMARY

The government has announced that it will allow the local government sector in England to keep all of the money it collectively raises through taxing businesses ('business rates'). The intention is to give local authorities a stronger incentive to support economic growth. This is very welcome.

The big question remaining is how the total pot of business rates collected nationally will be distributed between different local authorities. The government has not yet formally consulted on this question, but it has said two important things. First, the amount of funding that every local authority will get in the first year of the new scheme will be determined by its need for funding ('funding need'). Second, in subsequent years, every local authority will be able to keep every extra pound of business rates that it collects.

Our analysis shows that this approach fails on its own terms. Richer[1] councils will have much stronger incentive to grow their economies than poorer councils. Over time, this would also lead to greater concentrations of public investment and resources in richer areas of the country.

We propose an alternative system – the 'growth first' scheme – which gives all local authorities an equal incentive to increase their retained income, irrespective of whether they are rich or poor. Under 'growth first', the increase in an authority's funding would be calculated by multiplying its economic growth rate by its funding need, not by the amount of business rates it collects. This would guarantee a strong economic growth incentive for the local authorities that most need it.

KEY ARGUMENTS AND FINDINGS

The question of how to distribute the pot of overall business rates in a way that meets the government's objectives involves addressing a **fundamental trade-off: between ensuring sufficient funds for service provision while also providing financial incentives to grow the local economy.**

The government has said that the new scheme will retain the same basic framework as the current 50-per-cent retention scheme. This includes the use of a similar system of tariffs and top-ups to distribute revenue between councils, and a safety net (at an as-yet unspecified rate) to guard against some losses. **However, the government has indicated that the levy on disproportionate growth in the current system will be removed.** This means that after the first year of the new scheme, local authorities will receive 100 per cent of the growth in their business rates, irrespective of how much money they need to fund services.

Taking these announcements together, our modelling has shown that such a scheme would likely fail on the government's own terms. Richer local authorities will receive strong incentives to grow their economies, but for many poorer authorities the rewards are dampened by the likely design of the system. As a result, geographical imbalances in economic growth and public service investment will be exacerbated.

To illustrate with an example, a poorer local authority such as Barnsley, with a funding need of around £120 million in 2019/20, and local business rates collection worth around £50 million, will receive their full funding need of £120 million in the first year of the scheme. Of this, £70 million will come from a 'top-up', which is then frozen in real terms annually. This means that **a 2 per cent increase in their business rates will yield a reward of just 0.8 per cent in additional retained income.** Conversely, for a richer authority like South Bucks in Buckinghamshire, with business

1. We describe what are classified as 'tariff' and 'top-up' authorities in the present 50 per cent retention scheme as 'richer' and 'poorer' councils respectively. This is on the basis that any top-up authority has been classified as such by government because its local business rates are insufficient to meet its funding need, hence the need for a top-up. These local authorities have low economic activity relative to their social liabilities and are therefore 'poor'. The inverse is true for tariff authorities, whose tax receipts from the value of local commercial assets exceed the value of their funding need, and are therefore 'rich'.

rates worth around £30 million and a funding need worth around £1 million, **a 2 per cent increase in business rates would see retained income rise by more than 50 per cent** in a single year**.**

Moreover, **there is also increased risk of excessive losses for some local authorities.** Cancelling the levy on disproportionate growth could cost the government £170 million a year. If the equivalent amount of funds were also withdrawn from the safety net, the implication would be **a minimum funding floor of less than 70 per cent of funding need, rather than 92.5 per cent** in the current system.

In total, around 130 local authorities are likely to require a safety net payment under the government's implied plans. **However, we find that there may be scope for risk-pooling by local authorities at a sub-regional level.** Using LEP areas as a proxy, we find that aggregated local authorities at this level are unlikely to see their funding fall in real terms under the government's proposals.

RECOMMENDATIONS

We therefore recommend the 'growth first' system, which retains many of the design fundamentals of the current proposals but performs better against the government's own objectives. Under our scheme, the increase in a council's funding after the first year would be calculated by multiplying their business rates growth rate by their funding need. **This gives all local authorities an equal incentive to grow**: for example, both Barnsley and South Bucks would see a 2 per cent rise in business rates receipts translate into a 2 per cent rise in their retained income.

A further advantage of 'growth first' scheme is that it is more likely to provide funds for a safety net, without the need for an additional levy. This makes it much more likely that central government could provide adequate protection for key services in poor performing councils.

If the government does not adopt our preferred 'growth first' model, we s recommend one of two alternative options.

- **Cap and collar:** An amendment to our preferred system would see limits on the potential gains for poorer councils (by capping increases in retained income to £2 for every £1 in increased business rates) and give a minimum rate of return for the richest authorities (of 50p in every £1 in increased business rates). The balance of incentives would not be as good as our preferred system, but would still be better than those implied by the government's current proposals.
- **Retain the levy:** If the government adopts neither of our suggested alternative systems, we recommend that they do not abolish the levy. A levy on excessive growth for richer authorities, either at 50p or 80p in the pound, would not only mitigate extreme gains and losses but also provide funds for a more effective safety net.

Whether the government adopts on any of our above proposals or not, we recommend one further reform for the consultation.

- **Risk-pooling across sub-regional geographies areas:** We recommend exploring innovations that allow for risk-pooling at the level of LEP areas or similar, whether inside or outside the retention scheme itself.

BEYOND BUSINESS RATES

Although further devolution of tax and spending power is to be welcomed, our analysis shows that a system of fiscal devolution based on business rates alone has significant limitations. This is not to say that it should not be done, but that it cannot be done in isolation. Retaining a higher proportion of tax revenues derived from a wide variety of different revenue streams builds in greater flexibility and resilience.

For the full report, including all references, data sources and notes on methodology, see: www.ippr.org/publications/better-rates

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