Building better incentives for local economic growth:

reforms to the Local Authority Business Growth Incentives scheme

October 2007

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FOREWORD

We set out our continued commitment to creating strong incentives to promote economic well-being in the *Review of sub-national economic development and regeneration* earlier this year. We know that Local Authorities have a key role in enabling all of England's localities and regions to meet the challenges of an increasingly competitive global economy. The Review and Sir Michael Lyons' Inquiry into local government set out the need for stronger, clearer incentives to enable Local Authorities to fulfil their potential in taking on this role, raise prosperity across the UK and tackle disparities between regions.

In 2005 the Government introduced a three-year Local Authority Business Growth Incentives scheme (LABGI) to provide such an incentive for councils to encourage the businesses in their areas. Since the start of LABGI, many groups, including the CBI, the Local Government Association and hundreds of Local Authorities have welcomed the scheme as an innovative step in the right direction.

Building on the lessons of the existing scheme, and after wide discussion with local government and business, we want your views on how to reform the scheme to deliver our objectives to:

- **empower every council to take a lead role in encouraging economic development by strengthening the link between growth in a local area and its local business tax base;**
- **strengthen the fairness of the incentive so that all authorities – particularly the most deprived – make a greater contribution to local economic well-being by sharpening the link between financial rewards and local growth, recognising the scale of the challenge in low-income areas and delivering opportunity for all;**
- **support the plans each authority makes for the future of its local area by delivering greater certainty, simplicity and transparency in the value of LABGI; and**
- **deliver long-lasting reform by creating a permanent incentive to reward economic development that is fully integrated with the local government finance system.**

We intend to consult widely both on the core issues around a reformed scheme and, later, on detailed proposals, to ensure that we develop a scheme which provides Local Authorities with the incentive and confidence to plan for the long term well-being of their areas. In the new year we will seek your views on firm proposals with a more detailed consultation paper. To consider the options properly for how best to achieve these objectives, the new incentive will be phased in from 2009-10, with funding of £50 million doubling to £100 million in its second year, as it becomes a full and permanent part of the local government finance system.

We hope that there will be as broad a participation in the consultation as possible. Together we can work to promote regeneration and sustainable economic growth in each area and across the nation.

Angela Eagle MP
Exchequer Secretary
to the Treasury

John Healey MP
Minister of State for
Local Government

1 INTRODUCTION

PURPOSE

1.1 This issues paper seeks views on reform of the Local Authority Business Growth Incentives scheme (LABGI), which provides an incentive for Local Authorities to encourage local business growth. LABGI was introduced in 2005, following a consultation process that began in 2003. The scheme is set to end in its current form in 2008.

1.2 The Government committed in Budget 2007 to bring forward proposals to reform the LABGI scheme in light of recommendations made by the Lyons Inquiry[1] and reaffirmed this commitment in the *Review of sub-national economic development and regeneration*[2] ("the Sub-National Review"). The Government is therefore seeking views in this paper on the principles that should underlie reform of the LABGI scheme to:

- empower all Local Authorities to take a lead role in encouraging economic development by strengthening the link between a local area and its local business tax base;
- support each Local Authority's plans for the future of its local area by delivering greater certainty, simplicity and transparency in the value of LABGI; and
- strengthen the incentive for every Local Authority to take a stake in local economic well-being by sharpening the link between financial rewards and local growth, recognising the relative scale of the challenge in different places and delivering opportunity for all.

1.3 This paper discusses the rationale, policy objectives and options for a new scheme. It does not propose a way forward but is instead intended to stimulate responses on the principles of a new scheme. The Government will publish, in the spring of 2008, a consultation paper drawing on the responses to this paper with firm proposals and options, and with exemplifications of how a future scheme would operate.

COVERAGE

1.4 It is envisaged that a reformed LABGI scheme will cover all Local Authorities in England that receive formula grant, with the exception of single service Police and Fire and Rescue Authorities. These latter authorities are expected to be excluded from LABGI because the scheme only applies to authorities that have a direct role in sustainable economic growth and regeneration.

1.5 Wales have also had a LABGI scheme running in parallel to the scheme in England. The Government will be working with the Welsh Assembly Government to build on their experience of the existing scheme in order to develop strong incentives.

[1] *The Lyons Inquiry into Local Government*, Stationery Office, March 2007.

[2] *The Review of sub-national economic development and regeneration*, HM Treasury, Department for Business, Enterprise and Regulatory Reform, Department for Communities and Local Government, July 2007.

HOW TO RESPOND

I.6 HM Treasury and Communities and Local Government are releasing this issues paper jointly.

The closing date for receipt of responses is 12 December 2007.

I.7 We are providing an eight week, rather than a twelve week, window for responses since it is intended that this paper will be a precursor to a formal consultation in the Spring. With this exception this consultation is being conducted in line with the Code of Practice on Consultation, which can be found at http://www.cabinetoffice.gov.uk/regulation/consultation/code.htm.

I.8 This paper has been published on Communities and Local Government's website – http://www.communities.gov.uk. The Government would welcome your views on the options presented.

Responses should be submitted electronically to:

labgi.consultation@communities.gsi.gov.uk

Responses may also be submitted by post to:

Jasna Begum
Department for Communities and Local Government
Eland House Zone 5/H2
Bressenden Place
London
SW1E 5DU

I.9 A summary of responses to this paper will be published on the Communities and Local Government website.

I.10 In accordance with the requirements of the Freedom of Information Act 2000, all information contained in responses, including personal information, may be subject to publication or disclosure. Where respondents request that information given in response to this consultation be kept confidential, this will only be possible if it is consistent with Freedom of Information obligations. Any automatic confidentiality disclaimer generated by your organisation's IT system will not be respected unless you specifically include a request in the main text of your response.

2 Incentives for Local Authorities to promote economic development

Introduction

2.1 This section sets out the rationale for the Government's commitment to introducing and maintaining strong incentives for Local Authorities to encourage economic development. It provides background information on the original LABGI scheme, including the case for its introduction, and sets out the basis for reforming LABGI in light of the findings of the Lyons Inquiry and the Sub-National Review.

Introducing an incentive

2.2 In the 2002 Pre-Budget Report, the Government announced a new scheme that would deliver a financial incentive directly to Local Authorities that promote sustainable economic growth in their local areas, by allowing them to benefit from increases in revenue derived from business rates. In proposing the scheme the Government wanted to achieve two objectives:

- first, the scheme should give all Local Authorities an incentive to maximise local economic growth. This meant that the scheme had to be as relevant as possible to each Local Authority; and
- second, the scheme should give Local Authorities additional revenues to spend on their own priorities. This meant that revenues would be additional to, and separate from, the 2002 Spending Review settlement for formula grant and that revenues would not be ring-fenced in any way.

2.3 In order to ensure that the scheme operated in a way consistent with other Government priorities and policies, the Government proposed that the following principles should guide the way choices were made between the various options for implementing the scheme:

- the incentive should be applicable to all authorities – the scheme would align with the dual objectives of the regional Public Service Agreement growth target. This meant ensuring that the scheme did not create stronger incentives in high growth areas than in low growth areas and that Local Authorities benefit because of their relative performance rather than their relative circumstances;
- the distribution of benefits should be fair – the scheme would have a controlled impact on distribution of revenues so that benefits from the scheme represent relative performance rather than relative circumstances. This meant that a Local Authority should not receive benefits from the scheme that were out of proportion with its size. The benefits from the scheme to a Local Authority would also be commensurate with the impact of the scheme in terms of increasing sustainable economic growth; and
- the scheme should be as intelligible and transparent as possible – consistent with the above objectives the scheme would be as simple as possible and complement existing policy towards sustainable economic growth, local government and business rates.

2.4 Following a consultation the three-year Local Authority Business Growth Incentives (LABGI) scheme was launched in 2005. LABGI rewarded Local Authorities where the Rateable

Value (RV) of local commercial property increased beyond a target floor, set in relation to their historic trend growth rate.

2.5 LABGI was originally introduced to address a mismatch that can occur between the costs of economic development and the benefits that accrue from it at local level. Growth and regeneration can impose a short-term burden on Local Authorities both directly, through costs of regeneration or infrastructure investment, or indirectly, through greater strain on existing local housing stocks or environmental management. The benefits of economic development accrue to individuals through increased employment opportunities, and to the national economy through higher levels of economic activity. However, as a result of the pooling and redistribution of business rates yield through formula grant, the benefits that are accrued through growth in the value of the local business tax base as a result of economic growth are normally equalised away from the authorities where growth is strongest.

2.6 A broad range of stakeholders, including Local Authorities and business groups, has welcomed the principles and objectives of LABGI. The CBI has said:

> *"We have been particularly keen on some of the initiatives which the Government has introduced recently…(like) the Local Authority Business Growth Incentives scheme, LABGI – where we see a greater ability for bringing together the needs of the Local Authority and the business community."* [1]

2.7 Sir Michael Lyons welcomed the introduction of LABGI in his final report on local government as a step in the right direction, saying:

> *"I strongly support the Government's objective, to which the LABGI scheme is intended to contribute, to provide better incentives to Local Authorities to support economic prosperity, and the use of the business rates system as a way of doing so."*

THE CASE FOR 'REBALANCING' THE LOCAL GOVERNMENT FINANCE SYSTEM

2.8 Since the introduction of LABGI, the Lyons Inquiry and the Sub-National Review have both stressed the vital importance of the role of Local Authorities in strengthening local economic growth.

2.9 The Lyons Inquiry emphasised Local Authorities' key role in 'place-shaping' and leading the development of localities through taking responsibility for the well-being of an area and the people who live there, and promoting their interests and their future. This place-shaping function should both reflect the distinctive identity and aspirations of the people and area, and safeguard and promote their well-being and prosperity. The Sub-National Review notes that the economic trends of globalisation and technological change will make it increasingly important that places can respond quickly and flexibly to economic change if they are to increase prosperity. With their unique insight into the factors affecting growth in their area, Local Authorities are often best placed to lead and facilitate sustainable economic growth on the ground.

2.10 In order to promote well-being and prosperity and ensure that authorities respond fully to their place-shaping role, both the Lyons Inquiry and the Sub-National Review highlighted the case for strong incentives for economic growth within the existing local government finance system, arguing for a rebalancing of the system to improve incentives for local areas to grow their business tax base.

[1] Evidence to Office of the Deputy Prime Minister Select Committee, 2004.

2.11 The Lyons Inquiry accepted that two key functions of the local government finance system, stability and equity, are well supported in the system but argued that it lacks strong incentives to reward and encourage local economic growth. The Inquiry argued that, while maintaining stability and equity, space should be found at the margins to create incentives for Local Authorities to foster local economic growth. In practice this would mean striking the correct balance between the three potentially competing priorities of equity for citizens and communities, stability for local government financial managers and clear and meaningful incentives for economic growth. The Lyons Inquiry suggested that stronger incentives would:

- **deliver a more balanced decision-making process at local levels** by allowing local areas to capture the financial benefits of growth to offset the potential costs of this growth, e.g. through measures to reduce congestion or provide new services;
- **provide local authorities with levers to influence behaviour at local level** by providing a more direct relationship between Local Authority finances and the health of the local economy; and
- **provide a source of revenue**, which could be used for local investment in growth enabling measures such as infrastructure, which may need long-term planning and greater certainty over funding mechanisms.

2.12 The Government accepts that, in practice, any scheme that provides an incentive for sustainable local economic growth is likely to carry some deadweight costs and may have unintended distributional consequences. While committed to retaining equity and stability as strong principles underlying the local government finance system, the Government believes there is a compelling case in principle – as the Lyons Inquiry argues – for building stronger growth incentives to help strike the correct balance.

Consultation Questions

1. Do you agree with the need for an incentive?

2. Should it become a permanent part of the local government finance system?

3 Objectives of reform

Introduction

3.1 The previous section set out the case for introducing the original LABGI scheme in 2005, and argued the case for a scheme going forward. This section outlines some of the concerns and suggestions raised by local government and the Lyons Inquiry regarding the original LABGI. In the light of those lessons, it sets out what the Government believes should be the broad objectives of any future scheme.

Lessons from the first LABGI

3.2 Beyond the wide support for the overall principles and objectives of the scheme, the Government has received many representations from Local Authorities who, in implementing the scheme, have expressed a range of views on how it should be reformed going forwards. In general:

- Local Authorities have found the scheme difficult to understand. In particular there were concerns raised over the way the data has been used to calculate LABGI growth. In order to give effect to the stated policy of not taking account of appeals data, VOA changes as a result of expansions and contractions (recorded as "code 20") were not counted for LABGI purposes. The system has now been changed to reward positive code 20 changes through an additional payment;
- concerns were also expressed around the perceived unfairness of the targets and baseline group system. Some authorities argued that one-off growth in the tax base, or transfers of units with large RVs between different rating lists, unfairly distorted the picture of historic trend growth used to set the baseline; and
- Local Authorities have also argued that grants are unpredictable and announced too late in the budget setting process. This makes it difficult to include them in any long-term financial planning.

3.3 In addition to concerns raised directly with Government by Local Authorities, Sir Michael Lyons also took views from Local Authorities, businesses and other stakeholders, from which he suggested lessons be drawn. These included:

- **complexity in system design** – the Inquiry considered that the criteria used to allocate LABGI monies were not transparent. The complexity and changes to criteria were felt to reduce the ability of Local Authorities to predict their likely gains from the scheme;
- **short-term time horizon** – the Inquiry considered that the three year time frame of LABGI, constrained by the time horizon of central grants, limited its ability to motivate long term changes in behaviour, or influence decisions which take more than three years to have an impact; and
- **tension between fairness and complexity** – the Inquiry suggested that the attempt both to provide incentives that are applicable to all authorities, and to create a 'fair' distribution of resources, made the scheme complex and unpredictable, and so weakened the incentive effect.

OBJECTIVES FOR REFORMING LABGI

3.4 A new scheme will need to work within the context of three-year settlements for local government. As the Lyons Inquiry noted, planning, investment and development decisions at the local level, as well as relationships between authorities and business communities, are long-term issues. The Government is committed to ensuring Local Authorities have a permanent incentive for business growth that is fully integrated with the local government finance system, so that authorities can continue to be rewarded year on year for encouraging economic growth and with security necessary for making plans in the long term.

3.5 The Government is determined to learn from the current LABGI scheme and the insights of the Lyons Inquiry in establishing clear objectives for reform. Subject to responses to this paper, it considers that the broad objectives, which emerge from the lessons learnt, should be to create:

- a stronger, simpler and more predictable link between local growth and local incentives;
- fairer mechanisms for every authority; and
- a balance between the stability of funding and timeliness of rewards.

A stronger, simpler and more predictable link between local growth and local incentives

3.6 Reforms should introduce a stronger, clearer and more predictable relationship between the level of improvement in performance and the level of reward. Reforms should make it much clearer to each authority how the basic incentive mechanism works, what the relationship is between that mechanism and the rewards available, and therefore how the decisions which it takes and the policies it adopts can improve the reward received.

Fairer mechanisms for every authority

3.7 The Government is committed to creating an incentive relevant to all authorities. The simplest schemes will frequently produce a scheme that is unfair for some. Options for reform therefore include the capacity to create fairer mechanisms that provide the potential to reward every authority, and adjust for the relative scale of the challenge of economic growth in different places. In striving for fairness these adjustments can add some complexity into the incentive scheme.

Balancing funding stability with reward's timeliness

3.8 The introduction of three-year funding agreements for local government will give Local Authorities greater certainty to strengthen their financial management, forward planning and ability to use resources more efficiently. The Government is considering ways in which LABGI payments can work with three-year settlements while providing a strong incentive that rewards authorities quickly for actions that boost economic growth in their areas. In order to give full three-year certainty to LABGI payments, rewards would need to be lagged by three years. In effect, this would mean that authorities would need to wait three years before receiving the benefits of the impact of growth in their areas.

3.9 It is important to note that there are tensions between the objectives of creating certainty for financial planning and creating a responsive incentive that rewards authorities quickly for changes in economic growth in their areas. As discussed above, there is also a balance to be struck between equity and rewarding performance and between simplicity and fairness. It is clear that any effective scheme will need to attempt to find the optimum balance between these principles.

Consultation Questions

3. Taking account of the lessons learnt from the current LABGI scheme, how do we achieve an incentive scheme that achieves a good balance between:

a. stronger, simpler and more predictable incentive structures with fairer mechanisms for every authority; and

b. the stability of funding and the timeliness of rewards?

4. What do you consider to be the relative importance of the objectives and the balance to be struck?

5. Are there any other objectives that you would like the scheme to take into account?

4 DEFINING A MEASURE FOR GROWTH

INTRODUCTION

4.1 There are many ways to provide incentives to Local Authorities for business growth. The Lyons Inquiry makes reference to allocating specific reward grants to authorities on the basis of local changes, including economic growth, as one possible means of achieving this. The Inquiry, however, highlighted the particular advantages of rooting the scheme in the wider system of local government finance, particularly in the business rates system. The Government accepts the need for a stronger and longer-term link between Local Authorities' tax bases and the revenues authorities receive if local decision makers are to enjoy incentives and rewards to grow the local economy.

CREATING A BUSINESS GROWTH INCENTIVE USING 'BUSINESS RATES'

4.2 The current LABGI uses 'business rates' growth as the basis for the scheme. The specific measure is growth in the Rateable Value (RV) which is discussed in the next section. The Government believes that a business growth incentive using a measure of business rates is the simplest and most transparent basis for LABGI, rather than some other metric of business activity, such as gross value added or employment.

4.3 Other approaches could include: un/employment figures (which only capture a part of the economy, are arguably less within the control of Local Authorities and do not capture increases in value) and gross value added (which is not available at a local level, is less well understood and more difficult for authorities to influence directly).

4.4 The basic concept of an incentive based on business rates is that Local Authorities would, in effect, receive back from the National Non-Domestic Rates (NNDR) pool a proportion of the revenues raised locally, with the remainder being redistributed through the grant process as at present. In introducing such an incentive, the power to change the business rates multiplier would not be transferred from Central Government. The current system of distributing business rates through formula grant based on social and economic need dictates that, where the business rates base of a local area increases as a consequence of successful economic and business growth, that local area does not receive a direct benefit from the additional business rates.

4.5 Allowing Local Authorities to receive back a proportion of the business rates arising from growth in business activity in their area could provide a clearer and stronger incentive for growth, both as a reward for successful effort and a compensation for the wider costs resulting from growth. Importantly, this process would not involve a higher tax burden on business or property owners; the same amount of rates would be raised in each area, but part of the growth in rates yield would be shared with local communities rather than being redistributed across all authorities.

Consultation Questions

6. **Do you agree that a reformed LABGI scheme should continue to use 'business rates' as the basis for rewarding growth?**

7. **If not, what alternative measure would you suggest?**

MEASURING BUSINESS RATES GROWTH

4.6 The current LABGI scheme uses RV as the basis for measuring business rates growth. The RV used for growth calculations does not take account of the impact of appeals and is reduced by the RV of empty business premises (measured by the value of empty and partially empty property reliefs, divided by the business rates multiplier). The scheme did not initially take account of changes to the RV of existing business premises as a result of their expansion or reduction in size, but the system has now been changed so that increases in RV as a result of the expansion of existing premises are rewarded.

4.7 We accept that there remain sound arguments for using a modified form of RV as the basis for measuring growth: changes to RV as a result of successful appeals by ratepayers are likely to be outside authorities' control; including the rateable value of empty properties within the measure may reduce the incentive for authorities to bring these premises back into use and make building new business premises relatively more attractive.

4.8 On the other hand, adjusting Rateable Values on the valuation list will inevitably make the scheme more complex and harder to understand. Determining the grounds on which adjustments should or should not be made is likely to continue to be problematic, as it has been under the current LABGI scheme. The removal of reliefs on empty property after three months (or six months in the case of industrial and warehouse property) from 1 April 2008 will make reliefs granted a less reliable proxy for deriving a figure for the RV of empty properties.

4.9 An alternative to using RV, or a modified form of RV, might be to use changes in business rates yield as the basis for measuring growth. Using a 'cash' figure, for example the 'net contribution to the pool' line from National Non-Domesitc Rates returns (NNDR 3), is arguably a more immediate and readily comprehensible figure for measuring growth than RV. Alternative measures of yield, all involving a trade-off between timeliness and accuracy, might be based on NNDR 1 returns (adjusted or unadjusted for NNDR 2 returns) or NNDR 3 audited data.

4.10 Between revaluations, and assuming that nothing happens to the number or rating liability of properties in an area, the local yield from business rates will broadly increase each year in line with RPI as a result of the statutory RPI-linked increase in the business rates multiplier. The government confirmed its adherence to the RPI link on business rates yield in its response to the Lyons Inquiry. In designing a suitable incentive that rewards positive action to promote economic growth, while engaging all Local Authorities with the potential to enjoy a reward from growth in local yield, we will consider how best to balance simplicity of design against the possibility of rewarding inaction (so called 'deadweight loss') that may be involved if the increase in yield driven by RPI increases in the multiplier is not part of the calculation of base growth.

4.11 Also, as business rates yield is based on RV, similar questions about the need to adjust the headline data arise. It is likely that some adjustments, for example in respect of losses on appeal, could not be made against a cash figure without disproportionate effort. Adjusting the yield figure for costs of collection and/or losses on collection may make the measure fairer but also more complicated. Adjusting for discretionary reliefs granted eliminates a potential perverse incentive but would result in a further complication.

Consultation Questions

8. Which measure for business rates should we use?

9. What, if any, adjustments should be made?

10. Is there any other basis that we might use for measuring business rates growth?

5 OPTIONS FOR STRONGER LINKS TO LOCAL BUSINESS RATES

INTRODUCTION

5.1 The previous section outlined the rationale for basing a scheme on 'business rates' and discussed various measures upon which the incentive might be provided to Local Authorities. A number of different options, including variants of RV and business rates yield, were raised as measures of 'business rates'. All of the options outlined in this chapter are compatible with the measures in the previous chapter that are based on 'business rates' (irrespective of whether measure is RV or business rates yield). This section considers possible ways the measure could be used to calculate the incentive payment. If one of the RV variants were selected as the measure, the multiplier would be applied to the RV figure to determine each of the options below. These options include:

- basing the scheme on a proportion of an authority's overall total 'business rates' (yield or tax base);
- basing a scheme on a proportion of growth; and
- a combination of both the above (a 'hybrid model').

5.2 The first two options were considered in the Lyons Inquiry. This section sets out the strengths and risks of each of the above approaches.

DISTRIBUTION BASED ON A PORTION OF THE TOTAL

5.3 An option could be to base a scheme on a proportion of the business rates raised locally. This would meet many of the objectives of the scheme. In particular it would:

- **create the simplest mechanism** – each Local Authority would know that for every pound raised through business rates it would receive back a proportion locally, without targets, or over-reliance on growth forecasts;
- **maximise year-to-year predictability and stability** – Local Authorities would be able to predict how much they would earn through the scheme with a reasonable level of certainty in any given year. This is because most of each year's payment would be based on their overall 'business rates', rather than in-year growth. For example, in year one a 5% retention rate on 'business rates' of £100m would lead to a retention-based 'payment' of £5.0m. If in year two the 'business rates' grew by 2% (to a total of £102m) the payment would be £5.1m; if it grew by 5% (to £105m) the payment would be £5.25m. This is an increase because of the economic growth, but a marginal change from the previous year. This stability would help support local government financial planning;[1]
- **maximise the long-term benefits** – it would also give every Local Authority a genuine stake in the long-term future of their overall business rates base, locking in the rewards from previous growth for future years and allowing Local Authorities to reap long-term financial benefits. This should help to ensure that Local Authorities have the right long-term rewards and incentives to focus on development and growth with long-lasting economic benefits; and

[1] For simplicity, all examples in this document include RPI multiplier growth as 'growth'.

- **offers greatest certainty** – each Local Authority would receive at least some payment from the scheme every year. Even those with a declining 'business rates' would receive some portion of their rates.

5.4 Despite these strengths, there are nevertheless some limitations and risks with an approach that focuses on total or base revenues. These specifically include:

- **less sharp link to growth –** the price paid for longer-term predictability (as discussed above) is a potential weakening of the link between growth in any given year and the change in entitlement from the scheme. Retention payments through the scheme are unlikely to increase sharply because of in-year growth. Returning to the example of the authority with 'business rates' of £100m, receiving 5% or £5m in year one: if the 'business rates' grew by 2% it would receive £5.1m, if it grew by 5% it would receive £5.25m. So the growth rate more than doubles, but the total reward only increases by around 3%, from £5.1m to £5.25m;

- **could unfairly reward size, underlying growth or underlying wealth –** as will be discussed in Chapter 6, one of the risks of any unadjusted approach is that the largest payments could accrue to those areas with the largest wealth or tax base, based on historical performance. Such an outcome would raise questions about both equity and deadweight within the incentive scheme; and

- **risk of falling revenues** – in a scheme based on a proportion of the 'business rates', it is possible for Local Authorities to receive less money from one year to the next due to shrinking 'business rates'.

DISTRIBUTION BASED ON A PORTION OF GROWTH

5.5 Another option is to base the scheme on a portion (up to 100%) of the growth in business rates revenue, rather than the total.

5.6 Entitlements could be determined solely with reference to in-year growth, comparing business rates revenue to the previous year's total. Alternatively they could be based on cumulative growth from a designated point in time.

5.7 This mechanism captures a number of specific benefits:

- **stronger growth incentive** – this mechanism would sharpen the link between current growth and entitlements. To revisit the example above (where the business rates total is £100m), using a payment of '5% growth-based', (rather than 5% of the total 'business rates'), if the 'business rates' grew by 2% (i.e. by £2m to a total of £102m) in a given year, the payment would be £100,000 (i.e. 5% x 2m). But if the 'business rates' grew by 5% (i.e. by £5m to a total of £105m), the payment would be £250,000 (i.e. 5% x 5m). So 3 percentage points faster growth results in a 250% larger payment, compared to the 3% larger payment of the scheme based on total 'business rates';

- **increased fairness –** by rewarding increases in the 'business rates' over and above the previous year, the incentive scheme would be more heavily focussed on growth, helping to avoid the risk of payments being made on the basis of historical growth or wealth; and

- **retains simplicity** – with Local Authorities knowing that they would receive an amount of money for every pound of growth a high degree of simplicity is maintained.

5.8 Again, however, this approach raises a number of limitations and risks. In particular, relative to the total 'business rates' approach they include:

- **less predictable** – if reward payments are based purely upon growth, it would be harder accurately to predict payment size than if rewards are based upon total 'business rates'. Forecasting is difficult and changes in growth profile are amplified in percentage changes in payments – as the example above illustrates. This could reduce the ability of Local Authorities to plan with certainty;
- **less long-term in focus** – focusing on in-year growth could reduce the long-term element of the scheme;
- **less certainty** – no Local Authority is guaranteed an amount and those who did not grow, or had a shrinking base, could receive nothing from this; and
- **potential for some unfairness to remain** – without adjustment authorities with large tax bases might still receive a larger entitlement than a smaller sized authority with the same growth rate. Under a 5% growth model, an authority with 'business rates' of £100m and growth of 2% would receive £100,000, compared to an authority with a base of £10m and growth of 2% which would receive only £10,000. This might not be a fair outcome, depending on the relative circumstances of the authorities.

THE HYBRID MODEL – A COMBINATION OF BASE AND GROWTH

5.9 Each of the above approaches has its individual strengths and limitations. Another option could be to combine the approaches. This may offer the possibility of creating an incentive that, to a degree, captures the strengths, and mitigates the risks, of both schemes.

5.10 A hybrid mechanism could, for example, see Local Authorities receiving a small portion of the base revenue and a larger portion of in-year growth.

5.11 This has a number of attractions:

- **provides a strong incentive** – the growth aspect of the hybrid model could capture a strong growth-linked incentive as set out above. It may be desirable to amplify this characteristic by giving 'growth' a stronger weighting (relative to the 'total') in the hybrid;
- **provides predictability and stability** – at the same time, the base component could provide a greater level of predictability and stability than a pure growth based scheme. The base portion could ensure that, even in years where there is no growth, authorities receive some payment through the scheme, allowing them to plan with greater certainty;
- **provides long-term incentive** – as authorities' payments are partly related to their total 'business rates', increases in the base would continue to be reflected in increases in revenue from rates over time; and

- **remains relatively simple –** although more complicated than either the pure base or growth models, it remains a relatively simple approach, allowing Local Authorities a degree of certainty, whilst retaining the strong incentive aspect.

5.12 However it is not without potential risks:

- **requires balance between stability and growth –** the hybrid could be constructed as an essentially equal mix between 'total' and 'growth' or weighted to favour one over the other. Balancing the weightings is key to achieving the right incentive; and
- **adds complexity –** the advantages do come at a cost of some complexity.

Consultation Questions

11. Do you have a preference for any of the three approaches, and if so, why?

12. Do you think the hybrid approach can combine the advantages of the two other approaches, while mitigating some of the risks?

13. If so, do you have a view on the relative weighting between growth and total (if not, please state reasons)?

6 OPTIONS FOR DELIVERING FAIRNESS ALONGSIDE SIMPLICITY

INTRODUCTION

6.1 With any incentive scheme there will be a tension when balancing fairness with simplicity. The challenge is to create a scheme that acts as an incentive for growth to all Local Authorities. It is unfair to have a scheme that is significantly harder for some authorities to benefit from due to factors outside their control. However, adjusting for 'relative challenge' necessarily creates additional complexity and in turn increases uncertainty. A balance needs to be struck between creating a scheme that achieves our fairness objective and a scheme that is simple.

6.2 This chapter therefore addresses two possible additional options to achieve this balance, in a way that can be applied to any of the basic models considered in the previous chapter:

1. adjustments to strengthen incentives for all (adjusting payments to account for different authorities' relative circumstances); and
2. limiting 'excessive' payments.

ADJUSTMENTS TO STRENGTHEN INCENTIVES FOR ALL

6.3 Local Authorities differ in a number of ways that are relevant to an incentive based upon business rates. They differ in the overall total size of 'business rates', size of population, historic business rates growth rate, deprivation, and a host of other indicators that could be seen to be applicable. If these are not taken into account to reflect the relative challenges facing each authority, rewards may not be as fair as they should be, and the scheme overall will be sub-optimal as a result. Here we discuss a number of different circumstances and adjustments we could make.

Adjusting for Growth

6.4 The previous scheme took into account historic growth rates, as a way of reflecting the ease or difficulty with which different Local Authorities had been able to grow. The scheme placed authorities in one of eight groups, based on the average historic growth in their Rateable Value between 1995-96 and 2002-03. Each group was then given a different growth rate 'baseline'. Authorities began to obtain incentive payments for growth above their baseline. In this sense, LABGI was like a race with a handicap system, with some Local Authorities setting off from further behind the 'starting line' than others, because past performance suggests that they are able to grow faster.

6.5 It is broadly agreed that the aim of the handicap (adjustments to strengthen incentives for all, given relative challenge) was sound. However, the method (including approach, time-periods and adjustments) has been a cause of concern. Using historical growth to calculate 'underlying' growth is an inherently complex and uncertain process. For example, it is difficult to isolate growth that is occurring because of successful Local Authority programmes and policies, that which results from isolated one off expansion and that which would occur 'naturally'. On the other hand it is unclear that improvements that could be made to the calculation would sufficiently overcome some of the perceived problems.

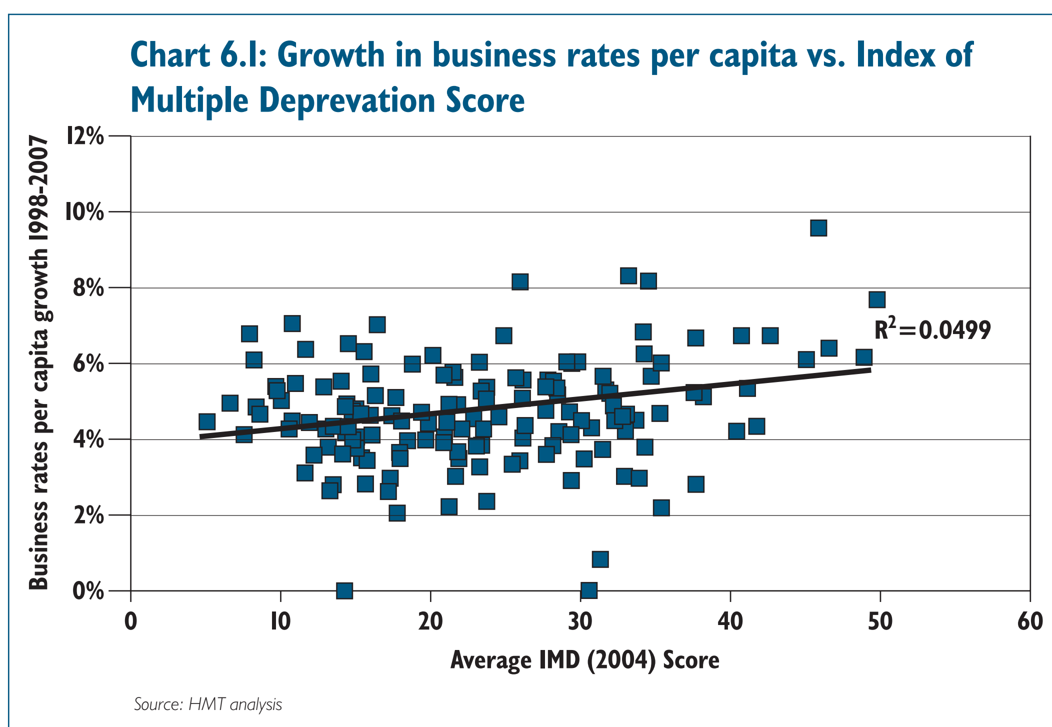
6.6 Recognising the relative scale of the challenge faced by Local Authorities in growing their local economies should remain an important consideration in scheme design. However,

it will inevitably make the scheme more complex, and the basis for differentiating between the rewards received by different authorities for the same level of growth needs to be demonstrably fair. We welcome views on whether past growth in business rates or an alternative measure does serve as a reliable proxy for the future challenge faced by authorities in achieving growth. Given some of the experience of the previous scheme in agreeing on an 'underlying growth rate' to set meaningful and fair reward rates, it would appear to be less complex to simply adjust for the tax base (see 6.9).

Adjusting for Deprivation

6.7 Analysis suggests that there is an unclear relationship between 'deprivation' and ability to grow. Some of the most deprived areas of the country have experienced the largest increases in business rates in recent years, and the chart below shows that there is little correlation between deprivation and low growth.

Chart 6.1: Growth in business rates per capita vs. Index of Multiple Deprevation Score



Source: HMT analysis

6.8 On this basis, the case for adjusting for deprivation does not appear to be strong.

Adjusting for the total size of 'business rates' tax base

6.9 Businesses are unequally distributed across Local Authorities. The current LABGI scheme takes no account of this, except through the year 1 ceilings on payments. Once authorities have crossed the starting line they are all treated in exactly the same way. What this has meant in practice is that a few authorities with very large business rates bases received very large reward payments for exactly the same rate of growth as smaller authorities with fewer businesses. In order to try and establish a level playing field the reward could be adjusted to take account of the level of business in the authority. This would be measured as the total 'business rates'.

6.10 To achieve this, instead of allowing each Local Authority to receive a consistent percentage of their rates (e.g. 1% of the total 'business rates' and 20% of in-year growth), it would be possible to adjust these percentages according to relative business rates. This would result in varying 'business rates' total and growth percentages for each authority (an authority with twice the business rates of another would have half the total and growth percentages of the other).

6.11 The effect would be that each Local Authority had a different payment rate: those with smaller underlying 'business rates' would have a higher payment rate than areas with larger underlying 'business rates'. This would ensure that, for each percentage point of growth, each Local Authority would effectively receive the same amount irrespective of underlying size.

6.12 We can show this for two imaginary authorities, A and B: Authority A has a total 'business rates' of £50m; Authority B has a total 'business rates' of £120m.

6.13 In year one, Authority A would receive 1% of its 'business rates' (£500,000) as a base payment. It would receive back 20% of its growth (£100,000 for every 1% growth). Authority B is 2.4 times larger and therefore receives 0.4% of its 'business rates' (i.e. 1% ÷ 2.4). This would equate to £500,000 (but would increase with growth in subsequent years). It would also be rewarded for growth at a different rate of 8.3% (i.e. 20% ÷ 2.4). Like Authority A, Authority B would receive £100,000 for every 1% growth.

6.14 Authority A and Authority B start with different reward rates (1% and 20% compared with 0.4% and 8.3% respectively), but the same cash rates (£500,000 plus an additional £100,000 for each one per cent of growth). If A and B grow at the same rate, they receive the same cash amount. However, if one grows faster than the other, it will receive a larger amount.

6.15 The incentive effect would thus be equally strong for each authority to the extent that the current 'business rates' size would be neutralised as a contributing factor.

Adjusting rewards on a per capita basis

6.16 The adjustments discussed above do not take into account that Local Authorities across England are of very different sizes. £5,000,000 to a large metropolitan authority with a population in the millions is likely to mean considerably less than it will to a smaller authority with a population in the hundreds of thousands (notwithstanding area or needs costs).

6.17 The Government therefore sees a case for adjusting for the size of population as well as total size of business rates.

6.18 This can be shown by again using Authority A (£50m) and Authority B (£120m), but making the adjustment for population also (1 million and 2 million respectively). Assuming Authority A continues to receive 1% of total 'business rates' and 20% of growth, if Authority B has twice the population, its total rate would double from 0.4% to 0.8% and its growth reward rate from 8.3% to 16.7%.[1]

[1] Adjusting for total business rates yield, and then adjusting for population is the same as adjusting for 'business rates per capita'. In the above example, Authority A has a business rates per capita of £50 (£50m ÷ 1m) and Authority B has £60 (£120m ÷ 2m). This means that Authority B has 1.2 times higher business rates per capita and therefore receives a yield of 0.8% (1% ÷ 1.2) and a growth reward of 16.7% (20% ÷ 1.2).

6.19 Alternatively such a payment could also be adjusted using a number of different proxies for variations in the circumstances, services and responsibilities of different authorities, for example adjusting for area cost or deprivation, as the formula grant does, but we believe that this would be both too complicated and go against the motivation of the incentive payment.

Periodical re-adjustment

6.20 Adjusting the retention rates requires determining the 'business rates' baseline for each authority. This can be done in a number of ways. It might be the chosen measure in a single year, or the average of a number of years, or set as a rolling average. Irrespective, the adjusted retention rates would have to remain fixed for a period, so that growth in 'business rates' would be reflected in growth in the amount retained.

6.21 There is an argument that the baselines should be recalculated occasionally. This would ensure that the adjusted retention rates are still appropriate, are relative to current circumstance, and that the distribution of rewards between Local Authorities does not become unbalanced. Such adjustments might take place on a similar cycle to revaluation periods, balancing the need for a long-term, predictable incentive with a position that realistically reflects current circumstances.

6.22 Occasionally the size of a Local Authority's 'business rates' changes due to national policy changes beyond its control. As these changes may have little to do with local policy, under certain circumstances, one-off adjustments to the baselines for each Local Authority could be considered if they materially alter relative circumstances. For consistency and transparency, this would need to be done from a predetermined set of criteria.

6.23 Increases in yield due to a higher rate of tax – for example as the result of a BID scheme, in the City of London where local power already exists to vary the business rate multiplier, or if Local Authorities elsewhere raise local supplements[2] – will need to be taken into account when calculating the amount of money that an authority should receive from LABGI. It is not the Government's intention that LABGI should provide an incentive to increase yield locally, other than through business growth, but in making this adjustment it will be necessary to take into account the roles played by different tiers of government and the spatial scale at which LABGI operates.

Consultation Questions

14. Are you in favour of adjusting each Local Authority's payment rate according to its total 'business rates'?

15. Are you in favour of adjusting each Local Authority's payment rate according to its business rates per capita?

16. Do you have any comments on the re-adjustment or methodology for applying this?

17. Do you believe that other differences between Local Authorities should be addressed?

18. If so, how would you suggest adjusting them?

[2] The Government published a White Paper alongside the CSR proposing the introduction of a power for Local Authorities to raise and retain local supplements on the national business rate. This power would apply across England. *Business Rates Supplements: A White Paper*, HM Treasury and Department for Communities and Local Government, October 2007.

LIMITING EXCESSIVE PAYMENTS

Ceilings on rewards

6.24 A key objective in reforming LABGI is to create a strong incentive for all authorities that rewards successful pro-growth policies by providing resources to assist in offsetting any costs of growth. However, it is possible that excessive payments could be made. Irrespective of the adjustments made to the scheme, some authorities could receive payments that still offer unjustifiably high rewards for little marginal effort. These excessive rewards can represent a sub-optimal allocation of funding, can reduce the perception of fairness (and therefore potentially decrease stakeholder buy-in to the scheme) and create financial volatility for Local Authorities. A ceiling can reduce these problems by setting an upper threshold for payments in a given year (as with all the adjustments in this chapter, ceilings could be the only adjustment made to the scheme, or they could be one of several).

6.25 On the other hand, any ceilings could complicate any incentive scheme unnecessarily and might risk placing a cap on the ambition of Local Authorities to promote growth. So the benefits of ceilings within any new LABGI scheme would need to be clear.

An absolute or relative ceiling

6.26 An absolute ceiling would consist of a maximum pound sum that could not be exceeded. This would be the same for all authorities irrespective of size, deprivation, budget, total 'business rates' or population. A relative ceiling takes into account the fact that authorities have different sizes, responsibilities and costs. The previous scheme used a modified form of the Environmental Protection and Cultural Services (EPCS) element of the Formula Spending Share. This is no longer possible as these Formula Spending Shares no longer exist. The Government has considered a number of options for relative ceilings, as detailed below.

- **a percentage of net revenue expenditure** – this ceiling is potentially attractive as it relates to the relative size, or service requirements of an authority fairly accurately, but might be seen to penalise those authorities who have achieve lower operating costs;
- **a percentage of council tax requirement** – this figure should again relate to a Local Authority's size and revenue requirements; or
- **a maximum amount per capita** – this has the advantage of being relatively simple, and accounts for different sizes and therefore expenditure requirements of authorities. However, it raises the questions of how to determine the total amount per capita, and of how to take into account different types and needs of authorities, or relative resources.

Consultation Questions

19. Do you believe a ceiling should be used to cap payments?

20. If so, in isolation, or with other adjustments?

21. Should the ceiling be absolute or relative?

22. Do you have views on appropriate measures to use as a ceiling?

23. Do you have views on where to set the ceiling to maintain the balance between the incentive effect and equity?

7 OPTIONS FOR BALANCING STABILITY WITH STRONG INCENTIVES

INTRODUCTION

7.1 The 2006-07 and 2007-08 Local Authority finance settlements marked the first multi-year financial settlement for local government. The Government is committed to full three-year certainty in settlements for Local Authorities, enabling them to plan better and to allocate resources more efficiently.

7.2 Providing resources on the basis of business rates growth needs to be reconciled with this objective. Since NNDR growth is not predictable, a strong incentive scheme may involve some element of uncertainty, and it will be important that any scheme gets the balance right between stability and incentive.

A LONG-LASTING INCENTIVE BUILT INTO THE FINANCE SYSTEM

7.3 In many instances, there is likely to be a lag between the decisions of Local Authorities that lead to improved economic outcomes, and the impact of those decisions on the ground.

7.4 The Government recognises that many of the changes necessary for economic regeneration and growth can take many years and that the Government must ensure this scheme provides the rewards for long-term change. For this reason, the Government is committed to delivering a long-term incentive for economic growth, fully integrated with the local government finance system, that rewards authorities for changes in their areas year after year.

STRONGER INCENTIVES WITH TIMELY REWARDS

7.5 LABGI can help deliver a more balanced decision-making process at local levels by rewarding performance at the local level. For the incentive to be effective, it needs to be considered during decision-making. With a permanent scheme in place, Local Authorities can make policy and planning decisions with the conviction and certainty that they will be rewarded for relevant improvements. More predictability will further improve the scheme's effectiveness as it can more accurately be considered when making decisions. Everything else being equal, the shorter the time between decision-making and reward, the stronger the incentive. This is because there are costs in many decisions; the sooner rewards are received, the more likely they are to influence decisions.

PLANNING AND ALLOCATION CONFIDENCE FROM FORWARD CERTAINTY

7.6 However there is a tension between a timely incentive that quickly rewards decisions, and forward planning for resource allocation. Although scheme design can help improve predictability (e.g. designing a scheme where authorities can accurately predict what level of reward they can expect to receive for growth in their areas), the timing of the announcement of individual authorities' incentive payments will be an important part of assisting in forward planning for authorities. One way of improving forward planning would be to announce LABGI allocations at the start of each three-year local government settlement period. This would give authorities certainty over payments for three years. This option would necessarily

require rewarding Local Authorities for their performance over the preceding three years (as the payments would have to be based upon performance data that was available at the time of settlement), which would be lagged by four years from time of payment. When authorities were considering policies to improve business growth, they would need to factor in that the authority would not be rewarded for several years after their performance was improved (due to the time lag in payments).

AN INTEGRATED, LONG-TERM APPROACH

7.7 For the scheme to become an integrated part of long-term Local Authority finance, resources will need to come from the non-domestic rates revenue. However, this would need to be done in a way that is consistent with three-year settlements. Two possible options are to embed it within the Revenue Support Grant itself, or to have a separate rebate/retention approach. The former would necessarily require the lag (as outlined above). The latter would vary year-on-year with performance (of the previous year) in a way that was outside of, but consistent with, RSG.

Consultation Questions

24. Which approach – year-on-year payments, or lagged payments given as part of three year settlements – do you prefer?

25. Is there an alternative approach that you would prefer (if so, please explain this approach)?

8 Other issues

Shares between different tiers of local government

8.1 As in the first consultation on LABGI, the Government has been clear that the incentives should apply only to those authorities who most directly influence local economic development. For this reason the Government continues to believe that single service Police and Fire and Rescue Authorities should be excluded from the scheme.

8.2 The Greater London Authority and Shire Counties, while not collecting authorities, play a key role in economic development. Currently, the payments from the LABGI scheme are split approximately 65%:35% between lower tier Districts and Shire Counties, and the GLA does not receive a share of the rewards.

8.3 The Government would be interested in revisiting these assumptions. On the one hand, one of the key motives of the scheme is to encourage a relationship between the Local Authority and its ratepayers. It would therefore seem appropriate that the incentive go to the authority that collects rates. By the same logic, however, it might be more important that the authority that provides the most services to local business, such as infrastructure and economic development, should be more reliant on revenues from business. This would imply a greater share of revenues going to upper tier authorities.

8.4 The Sub-National Review set out the case for allocating responsibilities in line with economic impacts and identified the importance of sub-regions as economic entities. In the case of cities, for example, some 63 per cent of employment is in the 56 largest urban areas in England.[1] Many lower tier authorities may be too small to take the lead in tackling economic challenges. This points towards the core resources associated with promoting economic development being aligned at the spatial level that most closely reflects real economic activity, that is, for upper tier authorities to receive the greater share of LABGI revenues.

8.5 Giving a greater share of the payments to upper tier authorities would also be consistent with the partnership working and economic development on a broader scale that the Government has been keen to encourage and that Local Authorities appear to have welcomed, through Local Strategic Partnerships and Local Area Agreements. For this reason, the Government is considering the case for reversing the shares that go to Shire Districts and Counties.

8.6 The Government is content that, as now, revenues continue to go direct to London Boroughs, given the existing funding mechanisms for large-scale development activities at the regional level.

Consultation Questions

26. How do you think that business growth incentives should be split between different tiers?

27. What should be the guiding principle for deciding this split?

[1] Sub-National Review, p49.

RING-FENCING FUNDS

8.7 LABGI funds have never been ring-fenced for economic development. The Government continues to believe that the best approach to economic development is for local areas to decide on their own priorities and how to encourage growth. For some this will be infrastructure and transport investment, for others this will be investment in skills. Ring-fencing funding would also run contrary to the broader Government policy as set out in the Local Government White Paper[2], which aims to provide Local Authorities with the freedom and space to respond flexibly to local needs and demands.

8.8 Since LABGI was first set up, however, the nature and structure of local government finance and economic development has changed, and it will be important in reforming LABGI to consider how best to design a scheme that maximises the benefit of such changes. In particular the Local Area Agreements (LAA) and their focus on local economic development and enterprise provide a vehicle by which business rates revenues might be applied in a way that is appropriate locally, but more focussed on local business growth. To align LABGI with LAA's – and to have LABGI payments within Area-Based Grant – may be attractive, as Local Authorities work increasingly in broader strategic partnerships across wider economic areas to deliver growth and economic well-being.

8.9 The Government is minded that business growth incentive payments remain without ring-fencing. However, it is interested in the possibility of aligning or committing funds within LAAs.

Consultation Question **28. What are your views on ring-fencing LABGI revenues, and what are your views on aligning or committing LABGI funds within the LAA structure?**

[2] *Strong and Prosperous Communities: The Local Government White Paper*, Department for Communities and Local Government, October 2006.

A Background on business rates and the original LABGI scheme

A.1 About £16bn is raised each year by Local Authorities from National Non-Domestic Rates (NNDR). Non-domestic rates – or 'business rates' – are collected by Local Authorities from businesses and other occupiers of non-domestic property. This money, along with contributions for properties on the 'central list', i.e. large network properties such as railways, pipelines and canals, are paid into a central pool. This pool is then distributed, through the formula grant system to Local Authorities to pay for their services.

A.21 Non-domestic rates are levied by applying a fixed national rate (the 'multiplier') to a property's Rateable Value (RV), i.e. the assessed rental value of non-domestic property. The RV of a property is recalculated every five years, when the VOA assesses what the rental value of all non-domestic properties in England would be if they were rented out. The yield from business rates can increase locally if more properties become occupied, or if properties are expanded or built, but this additional revenue is not retained locally but paid into the central pool. At revaluation years, the multiplier is calculated so that, nationally, the business rate yield does not increase as a result of revaluation, even if the total RV nationally has increased.

A.3 As local economies grow, new businesses are formed or existing businesses expand, the amount raised locally in business rates tends to rise.

A.4 LABGI is granted on the basis of business growth as measured by the increase in the RV of a Local Authority during a calendar year. In order to ensure that the incentive was available to all authorities, regardless of circumstances, each authority was assigned to one of eight baseline groups according to their historic growth rate over the eight-year period 1995-6 to 2002-3. A national adjustment factor (NAF) of 1.4 percentage points was deducted from each group's baseline, giving its 'floor' – a target level of RV growth that must be exceeded to gain LABGI grant. The NAF makes gaining LABGI awards more achievable for all Local Authorities, and more achievable still for the lower baseline groups than higher ones. A scaling factor is applied to all revenues above the target floor and in year one this amount was also subject to ceilings. Ceilings were calculated on the basis of 3% of modified EPCS FSS.

A.5 A single payment is made to each Local Authority in the final quarter of the financial year. It is based on actual changes to Rateable Values in the previous calendar year, using special RV data that removes any changes to RV that have come from successful appeals by businesses. In two tier areas, other than London, LABGI revenues are shared on the basis of the relative proportion of the modified EPCS portion of FSS received by each tier. This equates to approximately two thirds going to the upper tier and the remainder to the lower tier. In London, all rewards remain with the Boroughs. Authorities that did not reach their floor growth under the scheme have their targets re-based at the beginning of the next, to give them a fair and meaningful challenge in the next year.

A.6 Resources provided through LABGI are not ring-fenced to ensure that authorities can use them for their own local priorities.

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