Covering note: Update to the Alternative Model

This technical paper presents the latest internal thinking by the Ministry of Housing, Communities and Local Government (MHCLG) on how certain aspects of the reformed business rates retention system could work under the alternative model. The paper builds on the proposals made at the December 2018 consultation on business rates reform.

The paper does not represent Government policy.

MHCLG does not expect a substantive discussion on the paper at the Steering Group meeting of Tuesday 9 April. The paper deals with some, but not necessarily all, the ways in which the alternative arrangements could be configured. Steering Group members will have future opportunities to engage in the substantive issues.

Instead, MHCLG officials are asking the Steering Group to note the intention to discuss the details of the alternative model with the joint LGA/MHCLG Working Groups with a view to developing a detailed understanding of the arrangements that might underpin the alternative model.

MHCLG officials are happy to attend any other relevant meetings arranged by sector representative groups to discuss the ideas in the paper.

Following discussions with the sector representative groups and further analysis of responses to the recent consultation, the Government intends to develop the ideas in this paper and may formally consult on options later in 2019. None of the ideas presented in the paper represent final Government views. We are interested in the views and feedback of the Steering and Working groups and other sector representative groups before any final decisions are made.

Reforming the Administration of the Business Rates Retention System – a Technical Paper

Introduction

In our December 2018 consultation paper on Business Rates Reform[1], we discussed, at a high level, options for reforming the way in which the Business Rates Retention Scheme (BRRS) is administered[2].

Our aims were to simplify the scheme and to address the current problem of volatility in the system which is caused by appeals and other valuation changes. We noted that any reform must retain the core principles of;

- giving local authorities more control over the money they raise;
- incentivising behaviours that boost local economic growth; and
- rewarding local authorities that grow their business rates income.

The "alternative arrangements" outlined in the consultation paper would determine "tariffs" and "top-ups" by using different bases of calculation for the ***redistribution*** of resources between local authorities and for the business rates ***growth*** from which authorities benefit.

Since publishing the consultation document, we have continued to develop our thinking about how the alternative arrangements could work and discuss options with interested parties, including the Chartered Institute of Public Finance (CIPFA).

This paper sets out some possible options for the operation of the alternative arrangements. In particular, it provides further details of how the "growth calculation" could work and considers some of the potential advantages and disadvantages of different approaches.

The Steering Group is invited to note the further thinking on the alternative arrangements outlined in the paper and our proposals for future engagement with the sector.

[1] Business Rates Retention Reform - Sharing risk and reward, managing volatility and setting up the reformed system; https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/764485/Business_Rates_Reform_consultation_document.pdf

[2] Business Rates Retention Reform; Para 3.4 Reforming the administration of the system; pp 24-27

Background

The existing approach to the administration of the system

1. Currently, the business rates retention scheme (BRRS) annually redistributes a fixed amount of ***non-domestic rating income*** between authorities by means of “tariffs” and “top-ups”. The amounts are set at the outset of a reset period and fixed in real terms until the next reset. If an authority sees a real-terms increase in its ***non-domestic rating income***, it will have more revenue from which to fund local services (see figure 1).

Fig. 1

	Year 1	Year 2
LA share of non-domestic rating income (real terms)	1000	1100
Tariff (real terms)	(200)	(200)
LA Retained income	800	900

2. In order to measure ***non-domestic rating income***, under the BRRS, an authority:
   - calculates the **gross rates payable** by ratepayers (this is simply the rateable value of the hereditaments in its area multiplied by the national multiplier).
   - deducts any mandatory or discretionary reliefs awarded to the ratepayer. This gives;
   - **net rates payable**;
   - makes the necessary accounting adjustments in anticipation of valuation changes. This is done by estimating the amount of net rates payable that the authority thinks will be lost as a result of bad debt, or as a result of reductions in net rates liability following successful “appeals”;
   - by applying the accounting adjustments to the **net rates payable** amount, the authority arrives at:-
   - **collectable rates**, from which are;
   - deducted those amounts that are not “shared” under the BRRS (e.g. for Enterprise Zones, renewable energy, shale oil and gas sites and the cost of collection allowance). What is left is;
   - ***non-domestic rating income (NDRI)***. This is then shared between central government, billing authorities and major precepting authorities in accordance with the shares set down in legislation (the tier splits).

Problems with this approach

3. Under this approach, the amount of ***non-domestic rating income*** that is shared between central government and local authorities depends, in part, on the business rates collected from ratepayers, but in part on the accounting adjustments (estimates) made by LAs.

4. Because tariffs and top-ups are fixed and are not adjusted annually, any change in accounting adjustments can reduce non-domestic rating income, notwithstanding the business rates collected from ratepayers (see figure 2).

Fig. 2

	Year 1	Year 2
Net rates payable)	1000	1100
Less accounting adjustments	(200)	(350)
NDR Income	800	750
Tariff	(100)	(100)
Retained Income	700	650

5. Moreover, the business rates collected from ratepayers in any year, can themselves be reduced by valuation changes, including "appeals" losses". If the scale of these losses exceed the accounting adjustments that authorities have made, non-domestic rating income will fall. In setting up the BRRS in 2013-14, and, again, at the Revaluation, we made allowance for future appeals/provisions when setting tariffs and top-ups. LAs were provided with £1.9 billion initially (and a further £1.3 billion at the Revaluation) from which to make provisions against future appeal losses. In the absence of any better way of doing so, these sums were effectively apportioned between authorities based on their business rates bases. But actual valuation changes/appeal losses are not likely to be proportional to business rates bases. Therefore, it is possible for an authority to suffer 'losses', which are merely the effects of the difference between their appeal losses and their share of the allowances. This means that measuring "growth" on the basis of non-domestic rating income could be regarded as inherently volatile and uncertain.

Addressing this problem

6. To avoid accounting adjustments distorting the amount of **growth** that authorities enjoy, we would need to be able to measure non-domestic rating income before accounting adjustments are made.

7. However, we cannot ignore accounting adjustments when estimating non-domestic rating income for the purpose of setting the initial tariffs and top-ups. Otherwise, authorities might not have the non-domestic rating income they need to fund local services and make provisions (see figure 3).

Fig. 3

Setting tariffs and top-ups at a Reset *LA has a BFL of 1500*	Non-domestic rating income measured taking account of the adjustment for provisions	Non-domestic rating income measured ignoring the adjustment for provisions
Net rates payable	1000	1000
Authority's share of the "adjustment" for provisions	(200)	
Non-domestic rating income	800	1000
Top up	700	500
Year 1 (assuming no growth		
Net Rates Payable	1000	1000
Provision	(200)	(200)
Non-domestic rating Income	800	800
Top-up	700	500
Retained Income	**1500 (= BFL)**	**1300 (< BFL)**

8. But even if we make a forecast of provisions and other accounting adjustments for the purpose of setting the initial tariffs and top-ups, unless we also adjust those tariffs and top-ups annually to reflect the accounting adjustments that authorities actually make, accounting adjustments could continue to impact on "growth".

9. For this reason, the alternative arrangements outlined in the consultation paper proposed using different bases of calculation for "growth" and "redistribution"; and adjusting tariffs and top-ups annually. The remainder of this paper sets out some options for how the alternative arrangements might be constructed.

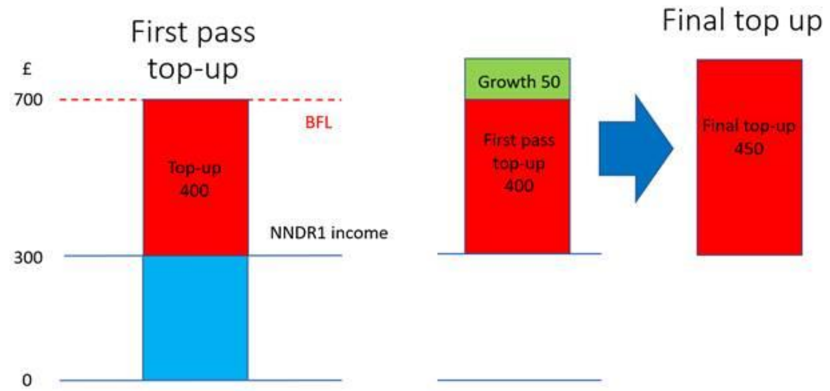
Overview of the alternative arrangements

10. As set out in the December 2018 consultation paper, the alternative arrangements rely on being able to set tariffs and top-ups for each year so that each authority would have business rates income that is equal to its baseline funding level (BFL), plus its share of “underlying growth” in business rates (ie growth measured without regard to accounting adjustments).

11. In outline:

- The Review of Relative Needs and Resources (RRNR) and the Spending Review (SR) would, taken together establish each authority’s baseline funding level (BFL)
- Separately, the government would set the shares of locally raised business rates that each local authority will keep (tier-splits).
    - A “first pass” tariff or top-up could then be calculated. This would be the difference between:
        - The authority’s share of its non-domestic rating income for the forthcoming year ; and
        - The authority’s baseline funding level (BFL); thereby ensuring that each authority would have income equal to its baseline (BFL)
    - This “first-pass” tariff or top-up could then be adjusted to take account of the underlying growth in business rates to arrive at a “final” tariff or top-up (see fig. 4).

Fig. 4



Setting the first-pass tariff/top-up

12. In order to set the "first pass" tariff and top-up for a year, the December consultation document stated that we would rely on the NNDR1s that authorities submit. The calculation would be made on the basis of the NNDR1 figure for "non-domestic rating income" – ie taking account of the accounting estimates that authorities make. This will ensure that tariffs and top-ups take account of annual changes to accounting estimates made by authorities and that those changes do not impact on authorities' retained income.

13. In the December consultation document, we also stated that, for the alternative arrangements to work, LAs would have to submit a completed NNDR1 by around September of each year, several months earlier than the current end-January deadline.[3] However, it has since been suggested that it might not be necessary to bring the completion of the NNDR1 form forward. This is because:

- There is only a statutory requirement for the provisional Local Government Finance Settlement (LGFS) to set out the '<u>basis of calculation</u>' for tariffs and top-ups, not the amounts of those tariffs and top-ups.

- the "first pass" tariff or top-up always leaves an authority with its BFL (regardless of actual tariff or top-up amounts). Therefore, as long as the LGFS sets out BFLs and the methodology for calculating them, authorities will know that their income for the year will be equal to their BFLs (other than for growth); and

- either, we will set out the an authority's "growth" in the provisional LGFS, or the authority will be able to calculate its "growth" adjustment from its NNDR1 (depending on how we calculate "growth" – see below). Therefore, authorities will know their total income from the BRRS before they set their budgets.

<u>Setting the final tariff/top-up</u>

14. A first pass tariff would be reduced by any underlying "growth". And a first pass top-up would be increased by underlying "growth" (see figures 5 and 6).

[3] Business Rates Retention Reform; Para 3.4.5 Reforming the administration of the system; page 25

Fig. 5

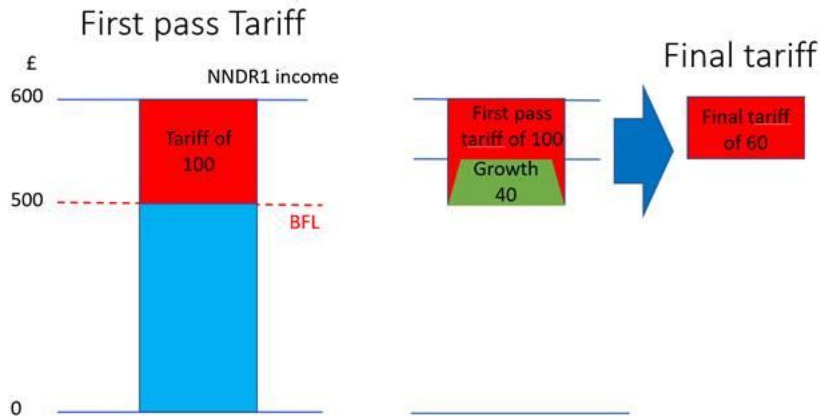
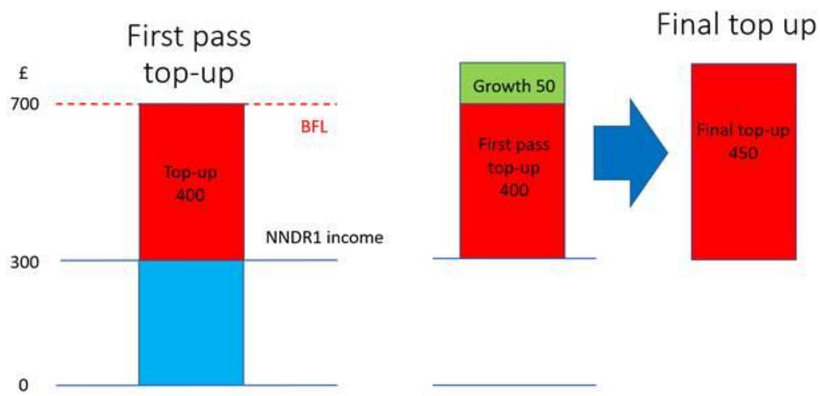


Fig. 6



<u>Measuring growth</u>

15. In order to measure underlying growth in business rates (ie disregarding the impact of accounting estimates), we would need to:
- Establish a baseline against which growth is to be measured; and
- determine the "currency" we are measuring

16. Given the order in which business rates are calculated – see paragraph 2 above – and the intention to ignore accounting adjustments, this suggests that we should measure "growth" at the level of either *gross rates payable*, or *net rates payable*. The implications of using either gross or net rates payable are considered at paragraph 28 below.

17. Having established a baseline at either gross, or net rates payable, against which growth can be measured, we would need, in practice, to be able to

adjust that baseline for any subsequent backdated changes for successful appeals, or valuation change. Otherwise, we would fail to properly measure growth (see figure 7).

Fig. 7

	Baseline	Year n	Year n+1 Following backdated appeal
Gross rates payable	1000	1000	800
Growth (GRP minus baseline)		0	-200

18. In the above example, the baseline needs to be adjusted in year n+1 to 800 to reflect the fact that the appeal change has been backdated to the baseline year. Otherwise, the growth calculation would show a loss of 200.

19. We have explored two options for calculating and adjusting the baseline against which to measure growth. The first option would use data on business rates income from local authorities' NNDR3s. The second option would use data on rateable values (RV) from the Valuation Office Agency (VOA).

Using expanded NNDRs

20. We could use the outturn data that we already collect from local authorities in the NNDR3 form to set a baseline measured at either gross rates or net rates payable.

21. The baseline could then be adjusted for "appeal losses" using data on "prior-year adjustments" that is already collected in NNDR3s.

22. However, we would need to supplement the data currently collected in order to be able to breakdown the data between years.

23. Figure 8 (assuming "zero-growth") illustrates how we could use NNDR3 data to adjust baselines for "appeal losses".

Fig. 8

			Base Year Year 1	Year 2	Year 3	
NNDR3 data	Rateable Value		1000	1000	800	
	multiplier		0.5	0.5	0.5	
	Gross Rates Payable	*in-year*	*500*	*500*	*400*	
		prior-year adj.	*-*	*-*	*-200*	*breakdown of pya = Year1 -100; Year2 -100*
		Total GRP	**500**	**500**	**200**	
	Mandatory relief	*in-year*	*-400*	*-400*	*-320*	
		prior-year adj. (pya)	*-*	*-*	*160*	*breakdown of pya = Year1 80; Year2 80*
		Total Reliefs	**-400**	**-400**	**-160**	
	Net Rates Payable	*in-year*	*100*	*100*	*80*	
		prior-year adj. (pya)	*-*	*-*	*-40*	
		Total Net Rates Payable	**100**	**100**	**40**	

		Year 1	Year 2	Year 3
Growth Calc.	Baseline	100	100	100
	adjustments	-	-	-20
	Adjusted baseline	**100**	**100**	**80**
	in-year net rates payable	100	100	80
	Growth	0	0	0

24. Assuming that we are measuring growth at the level of "net rates payable" and that "year 1" is used to establish the baseline, the baseline would be 100.

25. In year 2, because there have been no changes to the rating list, the actual "in-year" net rates payable would be 100, which compared to the baseline of 100, would mean growth of zero.

26. In year 3, a successful appeal results in a reduction in RV to 800, backdated to year 1. The NNDR3 for year 3 would (as it does now) reflect the prior-year adjustments to the year 1 and year 2 liabilities, meaning that the total net rates payable in year 3 would actually be 40. However, the in-year liability (ie the liability in respect of year 3 only) would be 80. If this were compared with the original baseline it would show the authority having incurred a "loss" of 20. But, by apportioning the prior-year adjustments (pya) to each of years 1 and 2, we can recalculate the baseline. The recalculation would be:

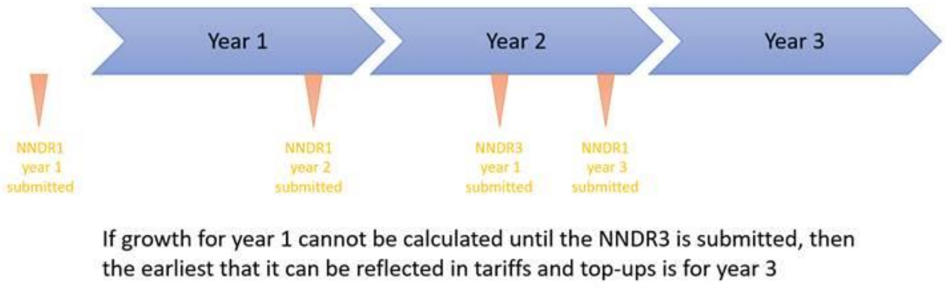
The original year 1 baseline	100
pya for gross rates in respect of year 1	-100
pya for reliefs in respect of year 1	80
Adjusted baseline for year 3	80

27. The adjusted baseline of 80, compared to the in-year net rates payable for year 3 of 80, would (correctly) show no underlying growth or decline in the authority's business rates base.

28. One potential downside of using NNDR3 data to set and adjust baselines is that adjustments to baselines could only be made once NNDR3s were completed and prior-year adjustments known. Therefore, it would be

impossible to calculate growth for any year until 6 months after the end of the year. Accordingly, it would only be possible adjust first-pass tariffs and top-ups, in any year, to reflect the growth two years earlier (see figure 9).

Fig. 9



<u>Using RV data</u>

29. The second option we have explored would set and adjust baselines using data on Rateable Values (RVs) from the Valuation Office Agency (VOA). It relies on the fact that the VOA would, at any point in time, be able to give the "up-to-date" RV of the rating list that existed on the baseline date – see figure 10.

Fig. 10

Hereditament	Baseline date (RV)	RV at Baseline date 6m later	
H1	400	400	
H2	400	300	Following RV reduction of 100, backdated to baseline date
H3	300	300	
Total	1100	1000	

30. If we were measuring growth against *gross rates payable*, we could convert the RV baseline to a *gross rates payable* figure by multiplying the RV provided by the VOA by the small business rating multiplier for the year.

31. By comparing the resulting *gross rates payable* baseline (as adjusted above for backdated appeal changes) with the "in-year" *gross rates payable* figures provided by local authorities in their NNDRs, we would be able to determine a "growth" figure by which to adjust the first-pass tariff/top-up.

32. A possible advantage of using the VOA's RV figures to calculate and subsequently adjust "growth baselines" would be that, because the VOA would be able to update the baseline RV at any point of the year, we (and authorities) should be able to work out provisional growth figures based on their NNDR1s. First-pass tariffs/top-ups could therefore be adjusted to reflect NNDR1 estimates of growth. The estimated growth figures would have to be reconciled with "actual growth" in the first-pass tariff/top-up adjustment two years later, but it could avoid having to run an entirely "lagged" system. In other words authorities would get at least some of the growth to which they were entitled in the year in which that growth happened.

Do we measure growth on gross rates or net rates?

33. When measuring growth under either the RV or NNDR options, it would be possible to measure it at the level of gross rates payable or at net rates payable, (ie after the application of mandatory and discretionary reliefs). Or we could choose to measure baselines and growth at an intermediate level ie by including some, but not all, reliefs.

34. Measuring growth at the gross rates level would mean that there would be a gap between the "growth" calculated and the actual non-domestic rating income in the system, since the latter reflects the net rates that ratepayers pay.

35. Calculating baselines and growth on *net rates payable*, would be straightforward if we were using NNDR data, since the NNDRs contain all the information that we would need. But if we were using VOA RV data, we would need a way of converting the "gross rates payable" figure (found by multiplying the VOA's RV figure by the current multiplier) into a "net rates payable" figure.

36. We have explored using NNDR3s to set an "adjustment factor" based on the ratio between gross and net rates payable. To calculate growth, we would first calculate the gross rates payable from the RV baseline and compare it with the gross rates payable figure in the NNDR1, or NNDR3. The difference would then be multiplied by adjustment factor to produce the figure by which the first-pass tariff/top-up would be adjusted – see figure 11.

Fig.11

	VOA RV Baseline (adjusted for appeal losses	From LA's NNDR return
RV	100	120
Current year's multiplier	0.5	0.5
GRP	**50**	**60**
Growth (NNDR GRP minus Baseline)	10	
Adjustment Factor (NRP divided by GRP)	95%	
Growth adjustment to be applied to first-pass tariff/top-up	9.5	

Adjustment Factors

37. If adopting the RV option for measuring growth, there would be a number of options for setting adjustment factors.

Should we set adjustment factors at the national level or set them locally?

38. We could set a single adjustment factor for all authorities, based on the ratio of GRP and NRP as measured at the national level. This would create an administratively simple system and a level playing field between authorities. It would ensure that the same RV increase in different authorities would result in the same adjustment to first-pass tariffs and top-ups.

39. However, a one-size-fits-all approach would not reflect the varying pattern of reliefs in different authorities. Therefore, instead, we could set different adjustment factors for each authority based on the ratio of GRP and NRP at the individual authority level. This would introduce further complexity into the system but would take account of local differences in reliefs.

Should we set adjustment factors once at the outset of the scheme or adjust each year?

40. There would be a further choice about whether adjustment factors should be set once, at the outset of a reset period, and then fixed for the entire period, or whether adjustment factors should change from year-to-year to reflect annual changes in the pattern of authorities' reliefs.

41. Setting factors once at the outset of a reset period would give authorities certainty about the value of any growth in their rate bases without having to wait the completion of NNDRs. But it would effectively bake-in the pattern of reliefs in the baseline year and would mean that authorities were picking up the marginal cost of changes to reliefs.

Treatment of Decline

42. One of the aims of the BRRS is to reward LAs which manage to grow the business activity in their area. However, it is also the Government' intention, as set out in the December consultation paper, that LAs should be exposed to the risk of decline in business activities in their area.

43. Under the alternative arrangements business rates decline would occur when the measure of growth in a given year was negative when compared to the baseline at the outset of the scheme.

44. This contrasts with the current arrangements where decline is experienced whenever NDRI is lower than BFL, which could happen simply because of an increase in accounting estimates - see paragraph 4 above.

45. In theory, in the same way as we would adjust the first-pass tariff/top-up for growth, we could also adjust it for decline. We could replicate the "safety net" by capping the level of decline by which we adjusted the first-pass tariff/top-up.

Next Steps

46. This paper sets out, in outline, some different options for the alternative arrangements. It does not attempt to explore all the implications of running the system, nor of measuring growth. It does not deal with all the changes that could be made – for example, dispensing with transitional protection payments – and does not discuss how we would treat resets under the alternative arrangements.

47. With the agreement of the steering group we propose to use the paper as a starting point for further discussions with the Systems Design and Implementation Working Groups and for a wide conversation with the sector, including representative bodies.