

## *Business Rates Retention Reform*

# Response to the Ministry of Housing, Communities and Local Government's Consultation

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#### **Note**

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## Summary

This note is a response to the consultation from the Ministry of Housing, Communities and Local Government concerning the reform of the business rates retention scheme (BRRS).

The key points made by this note are:

- **Valuation changes (as a result of successful challenges and appeals) are currently a significant financial risk over which council have no control. Without reform, these risks would increase when the retention rate increased from 50% to 75%. Proposals to reform the system so that these risks are handled by central government are therefore welcome.** The necessary reforms are complex but our assessment is that they will deliver on this objective. However, the way the proposals are described in the consultation and associated documentation is confusing, imprecise, and in some places seems to be inaccurate. For example, while the consultation says that the proposal will result in a 1 year lag before revenue growth is reflected, the mechanism set out would lead to a 2 year lag. For such a major reform such imprecision or errors are disappointing – especially given recent concerns about the operation and complexity of the BRRS.
- **To prevent overly large funding divergences between areas experiencing high growth and low growth (or decline) in revenues, periodic redistribution of revenue or ‘resets’ are required. Proposals for these resets to be ‘phased’ (something which we have previously termed a ‘rolling reset’) are welcome.** Such an approach means that councils will always bear the change in retained business rates income in full for a set number of years, providing consistent incentives across years. This is in contrast to the standard reset which occurs at a fixed date, and means councils bear the change in retained business rates income for different amounts of time depending on when the next reset is. Such a scheme provides inconsistent incentives across years, and can even incentivise efforts to delay the provision of new business property until after an imminent reset.
- **From the perspective of minimising funding risk and divergences, there is a case to increase the proportion of the change in retained business rates income borne by upper-tier counties in two-tier areas.** If business rates revenues continue to grow in real terms, this will also provide a small amount of additional funding, on average, to upper-tier services like social care services. When choosing the appropriate ‘tier splits’ consideration should also be given to which tier of government is expected to have most scope to respond to the financial incentives provided by the BRRS.
- **It is worth considering amending the safety net and levy schemes to avoid creating ranges of business rates income where there is no marginal financial incentive to grow the tax base.** As proposals currently stand, councils whose revenues fall below the ‘safety net’ floor will lose £1 of safety net payment for every £1 of growth in revenues until their revenues are back above the floor, which means they have no financial incentive to support the development of small properties. And councils above the revenue ceiling at which the ‘levy’ kicks in see no benefit from additional revenue growth. Amendments could address these

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issues. For instance, a safety net which compensates councils for, for example, 80% or 90% (rather than 100%) of any losses below the safety net floor would still provide significant insurance against revenue risk, but would mean councils gain something from supporting the development of small properties –10p or 20p of every £1 of extra revenue in this example.

- **Key questions asked in the consultation – including the frequency of resets and the proportion of revenue growth to be redistributed at resets, as well as safety net and levy arrangements and tier splits – can only really be answered if empirical analysis of their effects is made available. This is not currently the case.** The appropriate choices for these policy parameters will need to reflect trade-offs between providing councils with financial incentives for growing revenues on the one hand, and both insuring them against revenue risks and ensuring funding does not diverge too far from spending needs on the other. But how big are those revenue risks and how far and fast could funding diverge from spending needs under different systems? Without such information it is not possible to say what those parameters should be.
- **The MHCLG should therefore prioritise publishing empirical analysis of the potential effects of different policy choices before final decisions are made later this year.** Ideally it would have published such analysis alongside the current consultation.

**Finally, we understand that while not explicitly asked in the consultation, questions have been raised as to whether there should be a full reset in April 2020 or not.**

Ultimately, whether to do this or not is a distributional question. Undertaking a full reset will ensure that the outcome of the Fair Funding Review can be implemented in full (subject to transitional arrangements), redistributing revenues according to the new assessments of spending needs. On the other hand, undertaking a partial reset in 2020 will mean that councils' funding continues to depend to some extent on revenue growth achieved under the BRRS since 2013-14. Given that lower tier districts have tended to benefit most from the BRRS over this period they would likely benefit from making such a reset partial, while counties (with social care service responsibilities) would likely benefit from a fuller reset.

## 1. Introduction

This note is a response to the consultation from the Ministry of Housing, Communities and Local Government concerning options for the reform of the business rates retention scheme (BRRS) in England. It covers the following areas:

- The design of the periodic ‘resets’ of the BRRS (questions 1-3 of the consultation);
- The design of the ‘safety net’ to protect councils experiencing substantial falls in business rates income, and the ‘levy’ for those experiencing ‘extraordinary growth’ (questions 4-6 of the consultation);
- The relative shares of the changes in business rates income borne by counties and districts in two-tier areas (the issue of ‘tier shares’, questions 7-8 of the consultation);
- Issues related to schemes to incentivise pooling of risk/reward across councils, which may be necessary given proposed reforms of the levy (question 9 of the consultation);
- Proposed reforms to the BRRS to insure councils against the risks associated with certain types of changes in the assessed values of business property, including challenges and appeals (questions 12-13 of the consultation);
- The determination of new baselines for the implementation of the new system, due in April 2020 (question 14 of the consultation).

## 2. The design of the BRRS resets (questions 1 – 3)

### 2.1. Policy background

The BRRS is designed so that councils bear a proportion of the real-terms change in local business rates revenues, gaining when revenues increase and losing when they fall. Under the current national scheme that proportion is up to 50% by default. That default is to increase to 75% from April 2020, with some councils piloting a 75% scheme from April 2019.<sup>1</sup>

This exposure to changes in business rates revenues provides an incentive to councils to take action that could help boost local rates revenues – such as granting planning permissions and encouraging business development. However, different growth rates in different councils would mean that, over time, councils could end up with very different abilities to meet local spending needs.

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<sup>1</sup> A range of councils are have piloting 100% schemes since April 2017 or April 2018. Those starting in April 2017 will continue to pilot 100% schemes in 2019-20, but those starting in April 2018 will either become 75% scheme pilots or return to the default 50% scheme in April 2019. Our assessment of the 100% pilots can be found in Amin-Smith, Phillips and Simpson (2018), ‘100% business rate retention pilots: what can be learnt and at what cost?’, IFS Briefing Note 233, available at: <https://www.ifs.org.uk/publications/12913>.

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The government therefore proposes resetting the system at certain intervals in some way. How this reset is designed will be key in determining the balance achieved between the provision of incentives and the redistribution of funding according to need.

## 2.2. Response to consultation questions

*The consultation asks about the most appropriate approach to resets (questions 1 and 2) and the frequency with which resets should take place (question 3).*

**In relation to the first issue, a phased approach to resetting the system would be preferable to the standard approach of resetting the system in one go every few years. This is because the phased approach provides consistent incentives for growing business rates every year, whereas the standard approach provides incentives which vary according to how soon the next reset is.**

A 'phased reset' refers to a system where councils retain each year's growth (or loss) for a set number of years, before it is partially or fully redistributed between councils according to spending needs. For example, if it is chosen to allow councils to retain growth (or losses) for 5 years: growth (or losses) in year 1 would be redistributed at the end of year 5; growth (or losses) in year 2 would be redistributed at the end of year 6; and so on. Because councils know they will always retain growth (and losses) for the same period, they have consistent incentives over time to grow their business rates tax bases (by supporting the development of new and improved business property).<sup>2</sup>

This is not the case under a 'standard reset' where resets take place in a fixed year (e.g. 2020, 2025, 2030, etc.). Under such a system, councils' incentive to promote growth in their business rates tax bases progressively weakens as the next reset approaches. This is because, for example, any extra growth in the final year of a reset cycle would only be retained by councils for that one year before being partially redistributed to other councils on the basis of need.<sup>3</sup> In fact, there could be perverse incentives for councils towards the end of reset cycles: if they postpone property developments until after the reset, they would get to keep the resulting revenue growth for longer. This would be undesirable.

**Whether phased resets should partially or fully redistribute revenues according to spending need, and the appropriate time after which such resets should take effect depends on trade-offs between providing financial incentives to councils, and limiting the risk of large divergences between revenues and spending needs.**

Partial resets, which allow councils to retain a proportion of growth (or loss) beyond the normal reset period, clearly increase the incentive for councils to try to bring about such growth, but also mean that greater differences between councils' funding may open up.

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<sup>2</sup> Note: a decision would have to be taken as to whether it is only the revenue-side of resets that are undertaken on a phased basis, or whether resets on the spending-needs side (i.e. updates to spending needs assessments) are also undertaken on a rolling basis. A rolling reset of spending needs assessments would, like on the revenue side, provide consistent incentives over time for councils to take effort to reduce spending needs (e.g. by tackling poverty and ill health). But it may be more difficult to explain a phased reset of needs assessments as it would mean such assessments were never fully up to date – they would be based on needs several years previously.

<sup>3</sup> Note: full resets have been ruled out for the standard reset model.

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Similarly, longer time periods between resets mean that councils get to keep the proceeds of growth (or loss) for longer, and thus will have stronger incentives to promote such growth. The flipside of this is that there will be greater scope for funding divergences between councils to open up.

A decision over these policy parameters therefore requires judgements on:

- How beneficial the financial incentives for councils are (for example, can councils act upon them, and if they do does it generate additional economic activity or just shift activities between different council areas);
- How willing one is to see divergences between revenues and spending needs, which may be reflected in differences in services or council tax rates between council areas.

**However, it also requires empirical analysis of how far and fast divergences between revenues and spending needs could grow under different policy options. This evidence has not been made available to date by the MHCLG and should be before any final decisions are taken.** Indeed, it is unfortunate such analysis was not published alongside this consultation.

**It is also important to note that other policy choices (such as rules on safety nets and levies and tier-shares, which are discussed in more detail below) will also affect the scope for divergences revenues and spending needs. It is therefore difficult to consider choices over resets in isolation from other policy choices.** When empirical analysis is published it should therefore make clear the interaction between policy choices; and final decisions on policy should take account of these interactions.

### 3. The safety net and levies (questions 4 – 6)

#### 3.1. Policy background

Under the current set-up of the BRRS, there are two ways in which councils do not always bear the full 50% of any real-terms changes in their business rates revenues.

- The safety net: any council that sees its income from the BRRS fall below 92.5% of the amount it is adjudged to need (called its 'baseline funding level' is given a safety net payment to bring it up to that 92.5% level. This protects councils against excessive funding shortfalls.
- Levies: Councils where local revenues (before equalisation) are higher than local needs currently have to pay a levy on any real-terms growth in business rates revenues that they experience – meaning that they retain less than 50% of such growth. This is aimed at helping fund safety net payments and preventing excessive divergence in councils' ability to meet their spending needs, but also reduces the incentive for those councils to promote growth in their business rates bases.

### 3.2. Response to consultation questions

**The consultation proposes to continue the current approach to the safety net, although suggests that the level at which it will kick in will be higher relative to councils' spending need, to account for the fact that councils will be relying on business rates for a greater proportion of their overall funding. (Question 4).**

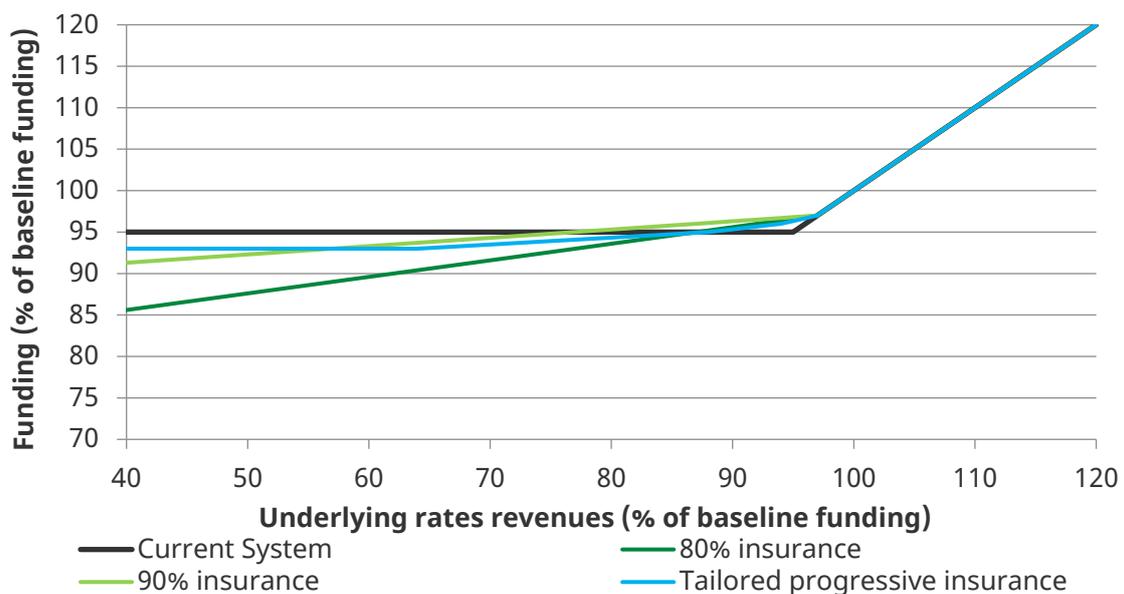
Because 75% retention will mean councils rely on business rates revenues for a greater proportion of their funding, it makes sense that the level at which safety net payments kick in should be higher, other things being equal.

**However, the current broad approach to the safety net, which it is proposed will be continued, means that councils receiving safety net payments have no marginal incentive to grow their revenues.** This is because for each £1 of business rates revenue growth they lose £1 of safety net payment until they are back above the safety net threshold. They may therefore see no benefit in terms of overall funding levels from supporting new property developments. **As it is those councils with the weakest business rates revenue performance that are on the safety net, this may be particularly concerning.**

**This problem could be addressed by a system that provided less than 100% insurance below the safety net cut off.** The flip side is that this would expose those councils seeing the biggest falls in revenues to at least a little more of those revenue falls, unless the government was willing to make the overall system more generous.

To illustrate how such systems might work, Figure 1 compares several options showing funding as a percentage of baseline funding levels after accounting for safety net payments, for different levels of underlying business rates revenue (also as a percentage of baseline funding levels).

**Figure 1. Illustration of alternative safety net options that would provide incentives to councils receiving safety net payments – unlike the current system**



Note: Authors' calculations using information in text below.

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The black line shows the current system, with the section when revenues fall below 95% of baseline funding levels showing the range where full compensation is paid but councils have no marginal incentive for revenue growth and new property developments.

The dark green line shows a system where rather than provide 100% insurance below 95% of baseline funding, 80% insurance (meaning 80p of safety net payments is provided for every £1 reduction in revenues) is provided below 97% of baseline funding. This would see councils with underlying revenues between 87% and 97% of baseline funding receiving more funding post-safety net payment than under the current system. Those with underlying revenues below 87% of baseline funding would receive less funding, but they would gain funding (20 of every £1) from increasing their underlying business rates revenues.

The light green line shows a system with 90% insurance, which would push back the 'break even' point to underlying revenues of 77% of baseline funding. Doing this would make the scheme more expensive than an 80% insurance scheme and would weaken incentives (councils on the safety net would gain only 10p rather than 20p for every additional £1 of growth in underlying business rates revenues).

More tailored schemes are also possible. The blue line shows a system where the rate of insurance progressively increases from 67% when revenues are between 94% and 97% of baseline funding; to 83% when revenues are between 88% and 94%; to 92% when revenues are between 64% and 88%; with 100% insurance kicking in only once revenues fell below 64% of baseline funding, ensuring funding could not fall below 93% of baseline funding levels. This means councils would only see losses in safety net payments fully offset growth in underlying revenues once those underlying revenues fell below 64% of baseline funding. Above that level they would get to keep between 8p and 33p of every additional £1 of revenue growth after accounting for the loss of safety net payments. This would mean more see at least some incentive to grow revenues.

**If such a system is adopted, the appropriate insurance rates and thresholds should be based on empirical analysis of the number of councils affected and likely costs, and judgements about the relative importance of incentives versus insurance.**

### Levies

*Regarding the levy, the consultation proposes that councils retain fully 75% of any growth in local revenues whilst their income remains below a certain threshold relative to their spending need. Beyond that threshold (which could be 150% or 200% of spending need) councils will retain no further growth – the levy will effectively function as a cap on retained growth. The consultation asks for thoughts on this approach, and on the level at which such a threshold should be set (Questions 5 and 6).*

**On one hand, having a levy that is only charged on growth beyond a certain level should increase the incentives most councils have to grow their revenues.** This is because up to that threshold, councils would retain the full 75% of growth they are entitled to under the BRRS, whereas presently those councils subject to levies pay them as soon as revenues exceed baseline funding levels. The higher the threshold is set the fewer councils will still be subject to levies.

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**On the other hand, any council that is or expects to be above the threshold will, under the current proposal, have little incentive to try to increase growth in its business rates revenues** since it is proposed that the levy ‘functions like a cap’ – all growth above the levy threshold is ‘levied away’.

The consultation says that this set-up is aimed to capture only ‘extraordinary’ growth, which is to say growth that ‘cannot be attributed to an authority’s management of their local economy’. However, this does mean that a council that, for example, knows it has a very large new development coming online (such as a power station or major distribution park) in a particular year will have no incentive to promote further growth in its business rates base until the next reset. In fact, it would have an incentive to postpone any such development so that the growth could instead come post-reset when the councils would be able to retain the benefits.

A separate consideration arises from the interaction of the levy with decisions taken on tier shares, and in particular the proposal that the levy threshold is set relative to councils baseline funding levels. For councils that are highly geared, i.e. where, before redistribution, their share of locally-raised revenues substantially exceeds their spending needs, even fairly modest changes in underlying business rates revenues could push them over the threshold for extraordinary growth. This could include lower-tier district councils with very large hereditaments.

**As with safety nets, consideration should therefore be given to allowing councils subject to levies to retain at least some of the resulting growth in revenues. This could be accompanied by setting the levy threshold lower (so that expected revenues from levies are the same).**

It will also be important to consider how appropriate arrangements for a possible levy might depend on decisions taken on resets. For example, if partial resets are adopted, this might suggest a lower level for the levy threshold would be appropriate than if full resets are adopted. If, as would be the case under a system of partial resets, councils are able to keep some portion of any growth indefinitely (or at least until more infrequent full resets) then having a higher threshold will allow for greater divergences in councils relative funding to persist (for longer).

## **4. County and district tier shares (questions 7 – 8)**

### **4.1. Policy background**

Business rates retention means that councils in an area retain 50% of the growth or decline in local business rates revenues, which will be 75% from April 2020. However, in areas where there is more than one tier of local government, ‘tier shares’ decide how revenue growth and losses are shared between tiers.

This means tier shares affect the distribution of risk and reward between councils in an area. Councils with higher tier shares gain more from revenue growth but lose more from revenue losses (subject to safety net payments). They therefore have more financial incentive to grow the revenues, but also see more risk that revenues will diverge from spending needs.

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At the moment, in two-tier areas, counties retain 20% of the local share of business rates growth or losses in their area (i.e. 10% of all growth or loss, given the 50% local share overall). Districts have retained 80% of the local share of business rates growth or losses (i.e. 40% of all growth or loss).

This has meant that districts have had stronger financial incentives than counties and in principle have borne more revenue risk. The system was specifically designed in this way given districts control the most direct lever in relation to development (planning control) and counties have services where statutory duties may limit flexibility over funding (such as social care services).

#### 4.2. Response to consultation questions

*The consultation expresses a hope that the decision taken on tier splits will be sector led. Failing that, it asks what a fallback position for a national tier split should be, as well as asking if two-tier areas should be able to set their own tier splits locally. (Questions 7 and 8).*

**As discussed above, there are two factors which need to be considered when deciding how to calibrate tier shares – which tiers are most able to cope with risk, and which are most able to act upon the incentives provided by retention.**

**One perhaps unintended implication of the current tier shares is that when revenues are growing in real-terms counties will tend to see their funding to need ratio fall relative to other councils.** This is because business rates top-ups – which allocate extra funding to counties to top-up their low share of local business rates revenues – are up-rated only in line with inflation, and thus fall relative to the growing business rates revenues. Conversely the ‘tariff’ payments paid by districts (who do not need all of their high share of business rates) also fall relative to business rates revenues, meaning they get to keep a higher fraction of those revenues after paying their tariffs.

**This is exactly what has happened over the last 6 years, during which there has been quite significant growth in retained business rates revenues.** Previous IFS research has shown that this means that districts have, on average, gained from the introduction of the BRRS – in some cases quite significantly – and counties have been relative losers (albeit these losses represent only a very small part of counties budgets.<sup>4</sup>

**Moreover, the safety net system (especially as it currently operates with 100% insurance below the threshold) means that the risk that would otherwise accompany districts’ high tier share is substantially mitigated.** Their high tier shares therefore look something like a one-way bet.

**Increasing the tier share for counties could therefore allow them to share more of the growth, with only a limited increase in the financial risk they face.** Indeed, other previous IFS research has shown that counties’ much bigger budgets and more larger and more diversified business rates tax bases (which cover multiple districts) means that the increase in divergence in counties funding levels when their tier-shares increase is *much* smaller than the *reduction* in divergences seen for lower-tier districts. This means

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<sup>4</sup> Amin-Smith, Phillips and Simpson (2016), ‘Council-level figures on spending cuts and business rates income’, IFS observation, available at: <https://www.ifs.org.uk/publications/8780>.

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increasing counties' tier shares would likely reduce the overall degree of divergence in service provision (or council tax) rates around the country (as variation for funding of districts' services would be much lower).<sup>5</sup>

**If the sector cannot reach agreement on the 'default' tier-share, there is therefore a case for allocating a large majority of the increase (from 50% to 75% to upper-tier counties, unless it were felt that districts would be significantly more incentivised by the extra retention.**

On the question of whether local areas should be able to set their own tier shares, it is worth noting that shares would still need to be consistent throughout each county to ensure that each district was making an equal contribution to funding county services. Since this would be similar to the forming of a pool within a county, perhaps allowing two-tier areas to set their own tier shares if in a pool could be one way of incentivising pooling in a fiscally neutral way (although, in fact, it is hard to guarantee that allowing pools to vary their tier shares will be fiscally neutral – it could affect safety net and levy payments due).

## 5. Incentivising pooling (question 9)

### 5.1. Policy background

**Since the BRRS started, have been able to group together to form pools.** Councils in a pool can decide how to allocate retained revenues amongst themselves – in particular they can decide how to share any growth in revenues. In some cases (most notably pools associated with 100% BRRS pilots), pools have set aside a certain proportion of revenues into a fund to spend collectively on projects aimed at promoting growth across the area of the entire pool.

**However, the main incentive for councils to do so has been the fact that pooling has allowed many councils subject to levies to eliminate or reduce their levy payments,** given the way levies have been calculated thus far. They have induced councils that can help them do this to join a pool, by sharing some of the 'saving'.

Looking ahead, the government plans to change the levy so that it only applies to councils experiencing 'extraordinary' growth, which if implemented would likely mean that very few councils in any given year would have to pay it. As a result there would be little direct financial incentive for councils to pool. Yet the government is keen that councils continue to pool, as it believes that 'pooling is desirable and offers many benefits'. This includes risk sharing and mutual insurance, and a forum for which joint decisions over how to promote business rates growth and spend the proceeds of growth.

### 5.2. Response to consultation

*The consultation asks what fiscally neutral measures could be used to incentivise pooling between councils within the reformed system (Question 9).*

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<sup>5</sup> Amin-Smith, Phillips and Simpson (2018), 'Spending needs, tax revenue capacity and the business rates retention scheme', IFS Report 141, available at: <https://www.ifs.org.uk/publications/10542>.

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**If the reformed system is to incentivise pooling among councils this means making aspects of the system more generous or flexible for pools relative to non-pools.** As discussed in Section 3 or 4, this could include offering more generous safety net arrangements to pools, or giving them more flexibility over tier shares.

**However, it is likely to be difficult to ensure that any financial incentive to pool is fiscally-neutral.** In the case of more generous safety-net arrangements, for example, although they could be 'offset' by less generous arrangements for non-pooling councils, the overall cost would depend on the level of take-up, which could only be known ex-post. A similar problem would afflict any attempt to design a financial incentive for pooling.

## 6. Treatment of valuation changes (questions 12 – 13)

### 6.1. Policy background

**One feature of the business rates system that is currently generating significant revenue risk for councils is that occupiers and landlords of properties can request a change to the values assigned to their properties through the 'Check, Challenge, Appeal' system. They can do so for two main reasons:**

1. A material change in the property (such as a partial demolition) or a relevant change to its surrounding area since it was valued;
2. A perceived error in the valuation of the property when it was last assessed (e.g. at the last revaluation, or when it was built if that was after the last revaluation).

A valuation change granted for the first reason is a way of recognising changes in real characteristics of a property relevant for valuation purposes. **Given that the BRRS is designed so that councils bear the cost (or retain the benefit) of any such real changes in properties or their environs – so that they have incentives to improve the local business environment – changes to valuations of this nature are something that councils should, in principle, bear the cost of.** The fact that they do is therefore not really problematic: it is a financial risk, but one which it may be desirable for councils to bear, at least in part.

Valuation changes on the grounds of initial valuation error are more complicated. **If the property has been built since the last update of a council's *Business Rates Baseline* – i.e. the amount they were assessed to be able to raise at the most recent reset of the BRRS or revaluation – then councils should, in principle, bear the cost of settling the valuation change.** That is because we want the amount a council gains from a new property to reflect its actual value – not an initial erroneous valuation.

**However if the change is backdated to at least the last update of a council's *Business Rates Baseline* – i.e. to before the most recent reset, or to the last revaluation – there is more of a problem.** That is because the council's *Business Rates Baseline* (and hence its tariff or top-up) would have been set on the basis of the initial erroneous valuation. And under the way the system works at the moment, that business rates baseline, and associated tariff and top-up is fixed in real terms (until the next reset or revaluation) irrespective of any changes in the assessed values of local properties. This means a successful challenge or appeal against a valuation will see the council's income from the BRRS fall through no fault of its own (it is the Valuation Office Agency, not the council,

which is responsible for valuation). **Such valuation changes are therefore a financial risk for councils without any upside in the form of desirable financial incentives.**

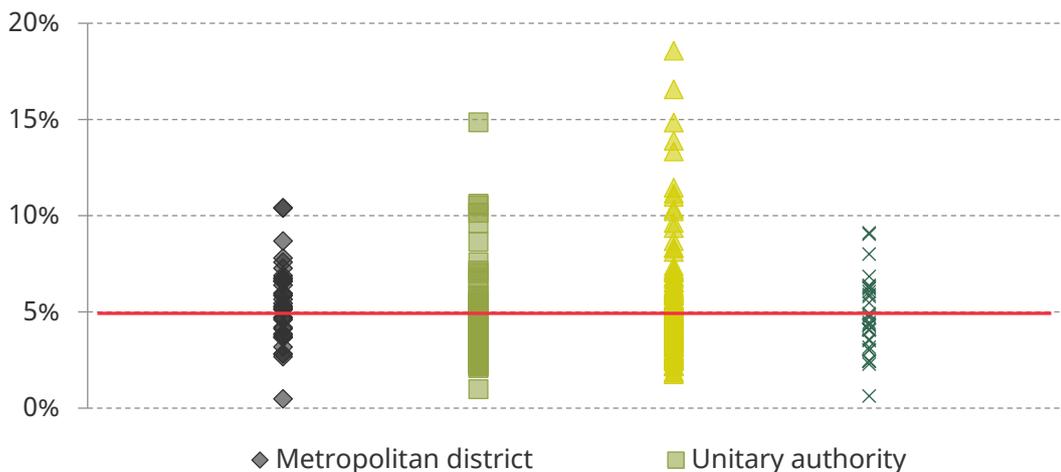
The issue of such valuation changes was recognised when the BRRS was being designed. In particular:

- **Prior to the start of the BRRS in 2013–14, the government estimated that appeals would ultimately reduce business rates bills and revenues by an average of 5.15%.** This was then incorporated into the calculation of each council’s Business Rates Baseline and tariff or top-up. In effect this gave each council a revenue buffer to deal with appeals amounting to 5.15% of local business rates revenues.
- **Rather than pay for the reductions in bills and refunds as a result of valuation changes as they arise, councils are required by law to put aside ‘provisions’ for their cost.** This means councils have to estimate how much valuation changes will cost them, and put money aside to cover those estimated costs in advance. As information about likely costs changes, provisions should be increased or reduced accordingly. Money set aside as provisions is not available to councils (or the government) to support spending on public services unless those provisions are released (e.g. if a major challenge or appeal is unsuccessful).

**There are two risks associated with this system.**

1. Even if the average revenue loss as a result of valuation changes is 5.15%, the revenue loss for specific councils may vary significantly.
2. Estimating the cost of settling approved valuation changes is very difficult, and councils may find they have put away significantly too little or too much into provisions. This can cause volatility in the rates revenues they can use to fund spending on local public services.

**Figure 2. Provisions for appeals as a % of business rates revenue, 2013–14 to 2017–18**



Note: Provisions for appeals include provisions for backdated appeal costs made in 2013–14.

Source: NNDR3 forms for 2013–14 to 2017–18.

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**Figure 2 suggests that these risks are substantial.** It shows that whilst the average provision (5.0%) was close to the assumed revenue loss from appeals (5.15%), there was significant variation in provisions across councils between 2013–14 and 2017–18. For example, one in five councils set aside more than 6% of business rates revenues in their area and around one in twenty set aside more than 10% of their business rates revenues. On the other hand, another one in twenty councils set aside less than 2.5% of revenues.

## 6.2. Response to consultation questions

**It is therefore welcome that the consultation proposes reforms aimed at removing the financial risks councils currently face as a result of changes to the valuation of properties that are backdated to the last general revaluation.** Doing this will reduce the financial risks councils face, whilst leaving the financial incentives the BRRS is designed to provide very largely intact.

**The first issue in such a reform is to identify the valuation changes that councils should be compensated for (and which they should still bear the risk of). The consultation document proposes to compensate councils for changes to valuations that are backdated to the implementation of the last general revaluation (i.e. the first day of the valuation list).**

**We agree this is a sensible approach.** The discussion in the previous sub-section shows that such backdated valuation changes are the main problem under the current system.

The consultation document seems concerned that such an approach will mean councils still bear the risk for changes to values of properties that did not exist (or did not exist in their current form) at the last revaluation. This would only be problematic if there had been a reset of Business Rate Baselines since that property had been built (or remodelled into its current form). In that case, the erroneous valuations would have been built into the Business Rates Baselines and councils will lose out when the valuations are corrected. On the other hand, if there had not been such a reset, we would want councils' retained business rates revenues to reflect an accurate value of the new/remodelled property, not the initially erroneous valuation.

Concerns about the suggested approach possibly being a poor proxy are therefore only really warranted if revaluation and reset cycles are very much out of alignment. Indeed, if revaluation and reset cycles can be aligned, the approach suggested by the government wouldn't be a proxy – it would be the conceptually correct approach. Notwithstanding other considerations, there could therefore be benefits from aligning revaluation and reset cycles.

**The second issue is designing and implementing a system that actually provides the necessary compensation to councils.** Without primary legislation, this requires a series of significant and complex changes to the operation of the BRRS.

At a high level, the proposed alternative system would work as follows:

- **Initially, a council's Business Rates Baseline and associated tariff or top-up will be set so that the amount of revenues it forecasts to retain *after deducting changes in provisions for backdated valuation changes* is equal to**

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**what it is assessed to need to retain (its Baseline Funding Level).** This means if a council is forecasting it will have to make major provisions for valuation changes, the actual revenues it retains will be unaffected – it will pay a smaller tariff or receive a bigger top-up to compensate.

- **Subsequently these forecasts will have to be reconciled to revenue outturns** – provisions and the actual cost of valuation changes are unlikely to be exactly equal to forecasts (indeed the difficulty of forecasting provisions and actual costs accurately is one of the issues with the current system). This will be done by adjustment to subsequent years' tariffs and top-ups.
- Furthermore, setting Business Rates Baselines equal to revenue forecasts mean that councils will not immediately benefit from forecast revenue growth. Higher growth, for instance, will result in a higher tariff or lower top-up. This means **growth will need to be 'added back' once data on how much growth was achieved is available** – again, implemented by changing tariffs and top-ups.

**Overall we think such an approach would remove the risk of backdated appeals from councils.** It would also mean councils still gain/lose as underlying business rates revenues grow/decline – albeit subject to a lag as a result of the initial adjustment based on forecasts stripping out impacts of revenue growth/decline. **It is preferable to the existing system – although primary legislation that allowed for central government to directly pay for backdated appeals costs would be better still.**

**However, the information in the main consultation document is at times unclear** and inconsistent with information provided elsewhere (such as Appendix B and presentations at regional consultation events).

For example, the consultation states in a number of places that estimates for year 1 will be reconciled to outturns by adjusting the tariffs and top-ups in year 2. And that growth in year 1 would also be calculated based on outturns data and allocated to councils via adjustments to the tariffs and top-ups in year 2.

Outturns data for year 1 is only available around half way through year 2 though. So this would only be possible if tariffs and top-ups for year 2 were adjusted in the middle of the year – which doesn't seem consistent with reducing financial risk and uncertainty for councils. Instead, it seems more likely that the reconciliation and growth calculations based on outturns would be reflected in the tariffs and top-ups for year 3. This means growth would be reflected with a lag of 2 years, rather than 1 year as is consistently stated in the consultation.

In Appendix B and the regional presentations there is discussion about using updated estimates for year 1 business rates revenues and provisions that councils must submit in business rates revenue estimate submissions for year 2 – which are submitted prior to the start of year 2. This would allow tariffs and top-ups for year 2 to be adjusted to take account of these updated year 1 estimates. Updated estimates of the growth in year 1 could also be taken account of in year 2 in this way. But a subsequent reconciliation would still be needed in year 3 when final outturns for year 1 become available.

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Thus, the specifics of what is proposed (or what the options are) for reconciliation and allocation of growth is unclear to us from the documentation.

**Of course, this is a complex change to the system, which we understand is difficult to explain in a straightforward way. However, given its complexity it is also important to be as precise as possible in explaining how the system will work (or the options of how it might work, where details are not yet determined). We do not feel this example that benchmark for precision and clarity.**

We would also like to highlight two further points with respect to the proposed alternative method.

**1. Under this system, the so-called 'floating' tariffs and top-ups will reflect various different factors:**

- a. Redistribution between councils where revenues (accounting for provisions and the costs of valuation change) are high relative to needs to those councils where revenues are low relative to needs. (Which is what tariffs and top-ups do currently);
- b. Reconciliations between revenue estimates and outturns;
- c. Allocating revenue growth to councils, once that growth is known;
- d. And, as discussed in the consultation, compensating councils for policy changes (such as new reliefs) and transitional arrangements that are pre-announced, rather than relying on separate grants.

**However, it is important that information is provided on how each of these various factors affects final tariff and top-up amounts in each year.** This is so councils and other stakeholders can understand their funding arrangements and are able to more easily check, if they so wish, that the calculations are correct.

**2. The consultation leaves it open as to whether the calculation of how much revenue growth (or decline) councils should bear will be based on 'gross rates payable' or 'net rates payable' in their areas.** This is an important issue that should ultimately be consulted on as it will not only affect councils' incomes, it will also affect the incentives they face.

Gross rates payable is a measure of how much rates revenues would be raised before accounting for any reliefs or transitional arrangements. Basing growth calculations on this means councils would still gain in full from the notional revenues liable on new properties (or existing properties) even if they were occupied by small businesses or charities or retailers eligible for business rates relief. This could be seen as desirable in that it would provide incentives to councils support occupation of properties by such occupiers, but it would not reflect the revenue actually raised from such properties (which would be much lower than the gross rates payable).

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Net rates revenue is a measure of how much rates revenues would be raised after accounting for reliefs and transitional arrangements. Basing growth calculations on this means councils would not gain as much from small businesses, charities or retailers eligible for business rates relief. This would better reflect the revenue actually raised from such properties, but might be seen as undesirably discouraging councils from supporting occupation of properties by such occupiers.

## 7. Setting a new baseline for April 2020 (question 14)

### 7.1. Policy background

**The government intends to undertake a full reset of the BRRS before moving to 75% retention (and potentially the new way of operation described in the previous section) in April 2020. Irrespective of whether this reset is full or partial, though, new business rates baselines will need to be calculated if the approach outlined in the previous section is not adopted.** These will form the basis against which subsequent growth in business rates is assessed against and so could have a significant impact on the revenues different councils retain.

### 7.2. Response to consultation questions

*The consultation asks for views on the most appropriate way to calculate the new business rates baselines, setting out three broad options (Question 14).*

The key issue is how to treat provisions for valuation change (and to a lesser extent, losses on collection) when deciding what each council's business rates baseline should be. The consultation suggests three main options and asks if there are any further options.

1. **The first option is to make the same proportional adjustment to each council's business rates revenues to account for provisions and losses on collection.** This is similar to what happened when the BRRS was set up in 2013-14. It is therefore feasible but means that like at the moment, councils will bear the risk of their costs of valuation changes (and collection losses) being higher or lower than that assumed average impact. Figure 2 in the previous section showed these risks to be substantial.
2. **The second and third options are based on councils' own decisions over how much provisions** to set aside as reported in their business rates revenue outturn submissions for 2018-19, or in special submissions for the purpose of setting business rates baselines (where a fixed way of determining provisions could be determined, given councils' own approaches for their regular submissions may differ somewhat. **If councils own estimates of provisions and valuation change costs are more accurate than the assumed average this could reduce financial risk – albeit not as much as under the approach discussed in the previous section**

**However, there is a risk councils could game such an approach.** They would have an incentive to overstate provisions so that their business rates baseline is set lower and they therefore pay a lower tariff (or receive a bigger top-up),

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increasing their retained revenues. Monitoring councils returns and proving such manipulation could be difficult though. Evidence from schemes like the Troubled Families programme (where payment to councils was by result, results were self-reported by councils with little monitoring, and virtually all results were deemed to have been met, despite an evaluation finding no significant improvement in outcomes) suggest such manipulation is a real possibility.<sup>6</sup>

3. **If resources at the MHCLG allow, a variant of the above options would be to have a centralised assessment of provisions and valuation cost losses for each councils, based on data from the VOA and assessments of checks, challenges and appeals not yet in the system.** This would provide the benefits of more tailored estimates for each council, without the risk of manipulation by councils hoping to boost their funding position.

**Finally, we understand that while not explicitly asked in the consultation, questions have been raised as to whether there should be a full reset in April 2020 or not.**

Ultimately, whether to do this or not is a distributional question. Undertaking a full reset will ensure that the outcome of the Fair Funding Review can be implemented in full (subject to transitional arrangements), redistributing revenues according to the new assessments of spending needs. On the other hand, undertaking a partial reset in 2020 will mean that councils funding continues to depend to some extent on revenue growth achieved under the BRRS since 2013-14. Given that lower tier districts have tended to benefit most from the BRRS over this period they would likely benefit from making such a reset partial, while counties (with social care service responsibilities) would likely benefit from a fuller reset.

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<sup>6</sup> See: <https://www.eif.org.uk/blog/five-key-lessons-from-the-troubled-families-evaluation/>.