National Audit Office

Report
by the Comptroller
and Auditor General

Department for Communities and Local Government

Planning for 100% local retention of business rates

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Key facts

£11.3bn

business rates retained locally under the 50% local retention scheme, 2015-16

£388m

additional business rates growth retained by local authorities under the 50% retention scheme from 2013-14 to 2015-16

£12.5bn

estimated additional business rates to be retained locally by 2019-20, offset against new responsibilities and by funding some existing responsibilities from additional retained rates instead of grant

5.4%	forecast real-terms reduction in local authorities' core spending power (government grant, locally retained business rates and council tax) from 2015-16 to 2019-20
27.7%	planned reduction in the Valuation Office Agency's workforce from 2015-16 to the end of the current Spending Review period
50.2%	proportion of local authorities in 2015-16 where the Department for Communities and Local Government does not have final details of retained rates income because they are members of business rates pools
£2.8 billion	local authorities' provisions in place by 2015-16 to meet the costs of appeals
39.6%	reduction in full-time equivalent staff from 2011 to 2017 working in the Department for Communities and Local Government's directorate with responsibility for delivering the scheme

Summary

1 Business rates are a charge on most non-domestic properties in England. In the 2015 Spending Review, the government announced that 100% of business rates income would be retained by the local authority sector by the end of the current Parliament. The objectives of this change are to:

- incentivise local authorities to develop their local economies; and
- enable local authorities to become more financially self-sufficient.

The move to 100% local retention builds on the process begun in 2013-14 whereby 50% of business rates income was retained by the sector.

2 The Department for Communities and Local Government (the Department), as the department with responsibility for overseeing the local government finance system, is responsible for delivering the scheme. There is also engagement from HM Treasury. This study focuses on the Department's work on planning for the 100% scheme. It examines the challenges faced by the Department, the extent to which it has learned from the 50% retention scheme, and the progress it has made to date with the 100% scheme.

3 Designing and implementing the 100% scheme will require a 'radical overhaul' of the local government finance system. The Department faces complex design issues, which need to be addressed in the context of often competing views within the sector. At the same time, the Department is undertaking a fair funding review of the sector. This will identify relative levels of needs and resources across the sector and set the baseline distribution for funding under the 100% scheme. The Department is undertaking this work having faced some reduction in staff resource.

4 There are risks in designing and implementing the 100% scheme. These include short-term risks whereby failing to deliver the scheme on time or to provide the sector with enough information in advance could undermine local financial planning. There are also more significant long-term risks whereby poor planning and design could deliver a scheme that puts local authorities' financial sustainability at risk or fails to create a mechanism that delivers local economic growth.

5 The Department has confirmed that it will introduce the scheme in 2019-20. We are engaging relatively early in the reform process and a significant amount of work remains to be done by the Department. However, engaging at this stage allows the Department time to address any issues or shortcomings before the introduction of the scheme. Early engagement will also support Parliamentary scrutiny of the Local Government Finance Bill, which entered the House of Commons in January 2017 and contains framework legislation.

Our report

6 Given the stage of the Department's work, our focus is on the arrangements to design and deliver the scheme rather than on assessing any decisions on design either taken or not taken. Our objective is to examine whether the Department has realistic plans in place to support the delivery of 100% local business rates retention by the end of this Parliament. The report addresses this question through three separate parts:

- Part One examines the challenges and issues that the Department will need to address in designing the 100% local retention scheme.
- Part Two explores the planning for and operation of the 50% local retention scheme and focuses on the extent to which the Department has learned from this experience.
- Part Three examines the progress made by the Department to date in delivering the 100% scheme.

A separate *Methodology* document is available on the National Audit Office website: www.nao.org.uk/report/planning-for-100-local-retention-of-business-rates/

Key findings

Challenges in moving to 100% retention

7 The Department's core objectives for the scheme are to promote financial self-sufficiency in the sector, and to promote local economic growth (paragraphs 1.36 and 3.2). There are significant issues to be addressed in creating a system that meets these objectives.

- **The Department is pursuing self-sufficiency through 100% local rates retention in the context of a long-term reduction in local authority funding.** Local authorities' spending power (government grant, locally retained business rates and council tax) fell in real terms by 25.2% from 2010-11 to 2015-16 and will fall by a further 5.4% by 2019-20. Service demand, not least due to an ageing population, is likely to grow. The challenge facing the Department is to assure itself that the absolute level of funding in the system at the start of the 100% scheme is enough to address both current service pressures and the additional demand to come (paragraphs 1.49 to 1.50).

- **The link between business rates and economic growth is not direct.** By allowing local authorities to retain tax base growth, the government expects that this will incentivise them to adopt pro-development planning and investment policies. This is expected to deliver economic growth in the long term. However, the scheme incentivises local authorities to increase their tax base, and tax base growth does not necessarily generate economic growth: new developments might lead to the relocation of existing economic activities rather than the creation of new ones. Equally, not all areas have the same capacity to grow their tax base. The challenge for the Department is to design the 100% system to maximise the scheme's potential to deliver economic growth rather than just tax base growth, and to ensure that the benefits of the scheme are widely spread. The Department will also need to understand the propensity and capacity for different types of authorities to use other elements of the scheme designed to support economic growth including multiplier reductions and the infrastructure supplement (paragraphs 1.37 to 1.48).

8 **Funding local services through the local retention of business rates requires fundamental design issues to be addressed, which will result in a complex system.** A key problem for locally retained business rates is that an area's capacity to generate business rates does not necessarily match demand for services. The 50% scheme addressed this through a redistribution mechanism based on 'tariffs' and 'top-ups'. Secondly, some areas have the capacity to grow their tax bases while others may see theirs shrink. The 50% scheme managed this divergence through periodic resets in which all areas' incomes were returned to a baseline. Other mechanisms such as safety nets and pools further helped to limit risk and smooth volatility. These core mechanisms from the 50% scheme are likely to continue into the 100% scheme (paragraphs 1.4 and 1.7 to 1.14).

9 **The Department will have to review and redesign the elements of the 50% scheme which will continue, and there are important new tasks to complete as well.** The Department will have to redesign existing elements of the 50% scheme such as agreeing the length and nature of resets and reviewing the mechanism to cover appeals costs. A substantial new task is to ensure that the new scheme is 'fiscally neutral' by balancing any additional funding received by local authorities against new responsibilities or by replacing existing grants. The Department is also undertaking a fair funding review to assess relative levels of needs and resources, which in turn will form the distributional baseline for the 100% scheme (paragraphs 1.15 to 1.28).

Learning from the 50% scheme

10 **The 50% scheme was introduced on time but there was significant pressure on the Department in achieving this.** The Department delivered the 50% scheme against a 30-month delivery timetable. The tight timetable meant that there were no pilots, significant decisions were taken late in the process and work on accounting arrangements was still ongoing after the scheme had started. The Department's resources were also put under pressure by the workload (paragraphs 2.4 to 2.9).

11 **The 50% scheme has allowed the sector to retain some additional funding, but there have been significant issues with aspects of the scheme.** The sector has retained an additional £388 million in the three years of the scheme. However, this has been overshadowed by the operation of the appeals system, whereby rate payers can challenge their rating valuation. Local authorities now have greater liability for meeting the costs of successful appeals. This injected volatility into the system because authorities can suffer substantial losses on appeal. Authorities have been cautious in setting the level of provisions they must make to cover appeals; by 2015-16, provisions had reached £2.8 billion. This is funding that cannot be used to support service delivery (paragraphs 2.11 and 2.20 to 2.28).

12 **The Department has learned lessons from the 50% scheme and is applying them to the 100% scheme.** As a consequence of learning from the 50% scheme, the Department has adopted a more open approach to designing the new system and has involved the local government sector more fully. The Department has also recognised the need to address accounting and accountability at the outset. It also understands that the appeals process needs addressing and is now taking steps to reform the system under the 100% retention scheme. In general, the Department has developed a body of expertise and experience that will be of value in designing the 100% scheme (paragraphs 2.32 and 2.33).

13 **The Department does not know precisely how much funding individual local authorities have retained from the 50% scheme.** The Department collects data on all local authorities' business rates income under the current 50% scheme, and how that has changed since the implementation of the scheme in 2013-14. While this includes authorities that are part of business rates pools, the Department does not have precise data on how funding has been distributed to individual authorities in pools. Consequently, potential lessons for different authorities' future finances under the 100% scheme are not easy to draw out (paragraph 2.13).

14 **The Department has not made any formal assessment of whether the 50% scheme has promoted economic growth.** The Department has not examined systematically whether the incentive in the scheme has driven different types of local authority behaviour that might promote economic growth. In the Department's view, it is too early in the life of the 50% scheme to assess its impact on economic growth and it is methodologically difficult to isolate the impact on the 50% scheme from other factors that impact local economic growth. Ultimately, however, it is not yet clear whether the 50% scheme has incentivised authorities to adopt pro-economic growth policies, and whether any behaviour change has actually supported economic growth (paragraphs 2.16 to 2.18).

Progress in delivering 100% local retention

Purpose and objectives

15 **The Department's work to date has a clear focus on the goal of promoting financial self-sufficiency across the sector, but there has been less attention on how the scheme will deliver economic growth.** The Department has a clear understanding of how the scheme will promote self-sufficiency across the sector, with devolved funding replacing grants or leading to new responsibilities for the sector. The Department's objectives for promoting economic growth are less well developed. The extent to which the scheme can best be configured to boost economic growth has not been fully explored. Equally, the local economic implications for local authorities which cannot grow their tax bases have not been examined in detail. The Department has no measurable target for additional economic growth expected from the scheme (paragraphs 3.3, 3.7 to 3.10 and 3.29).

Set-up

16 **The Department has established logical governance and delivery arrangements and has good structures to collaborate with the sector, but has fewer resources and a tight timetable.** Good governance and delivery structures are in place, and the Department deserves particular credit for its sector collaboration arrangements. The Department has also recently published a more detailed forward plan. However, at this stage of a significant and complex project we would expect to see a more thorough analysis of the interdependencies between work streams, essential requirements and contingencies. Furthermore, the delivery timetable is tight, not least because of the challenge of delivering the fair funding review. The departmental directorate with responsibility for delivering the scheme has 39.6% fewer staff than when the 50% scheme was delivered (paragraphs 3.11 to 3.22).

Delivery

17 **The Department has delivered two major milestones and made progress across a range of issues, but there has been observable slippage with some initial expectations being revised in scope or timing.** The Department has made progress, but many significant issues remain outstanding. The Department told us that this is planned and reflects its use of a flexible approach to delivery in which final decisions are taken close to implementation. This creates the potential for pressure in the late stages of the project. The Department's timescale, resources and ambitions for sector engagement leave little room for further slippage. The Department's internal assessments indicate that significant delivery risks remain, but these have reduced as the project has progressed (paragraphs 3.23 to 3.36).

Risks

18 **The Department has made good progress with a complex task, but significant short-term delivery risks and long-term outcome risks remain.** There is a risk that the pressure to deliver by 2019-20 might result in a narrowly defined scheme, or one that has not been tested enough. The Department's flexible approach, in which multiple work streams are brought together late in the process, potentially increases these risks as there will be less opportunity to deal with issues that emerge. More fundamentally, the Department needs to assure itself that the scheme will deliver its core policy objectives and that these are not overlooked among the technical challenges of designing the scheme (paragraphs 3.37 to 3.42).

Conclusion

19 The Department faces a significant challenge in implementing 100% local retention of business rates by 2019-20, a process complicated by the simultaneous delivery of a fair funding review. The Department has benefited from the experience of delivering the 50% local retention scheme and is using this experience effectively. Its highly collaborative approach to the 100% retention scheme has been welcomed by the sector. The Department has also adopted a clear and logical approach to its governance arrangements and work planning. This should now be taken forward as more detailed planning and preparatory work is required.

20 The Department has made progress in delivering the 100% scheme but, given the scale of the challenges ahead and the limited resources available, there are clear risks to delivery. Government projects such as this are prone to over-optimism, and the Department needs to avoid this. The Department needs to ensure that the design is not compromised by the pressure to deliver to a tight timetable. The Department must also assure itself that, in meeting the scheme's objective of promoting self-sufficiency, the sector's financial sustainability is not put at risk. It must ensure that the level of funding in the system at the start is sufficient to meet the sector's needs. Greater focus is also needed on ensuring that the scheme is configured to maximise economic growth rather than simply tax base growth.

Recommendations

21 We recommend that the Department should:

a Inform its planning for 100% retention by developing a comprehensive understanding of which local authorities, and why, have benefited financially from the 50% scheme.

b Routinely collect and publish data in an accessible format on the amounts retained by individual local authorities, including those in pools.

c Ensure that it is well placed to deliver the scheme by:

- reviewing its resourcing and project plans in the light of progress to date, ensuring that they are realistic given the remaining challenges;
- publishing a revised timetable setting out the critical path of inter-linkages and sequencing between the different design elements;
- reviewing its plans for modelling to support decision-making, and sharing modelling outputs with the sector; and
- examining contingency options and discussing these with the sector.

d Deepen its understanding of the relationship between business rates and economic growth to ensure that:

- the scheme design maximises the potential to deliver economic growth, not just an expansion in local authorities' tax bases; and
- consideration is given to ways of supporting economic growth in areas where the potential for tax base growth is more limited.

e Review unfunded service pressures within the sector to seek assurance that sufficient absolute funding to meet statutory responsibilities will be available at the start of the 100% system. Depending on the timing of the next Spending Review, this may require action outside of the formal Spending Review cycle.