Government proposals that local councils can retain business rates will give incentives for growth, but with some funding inequalities across councils

This week sees the launch of a government consultation on allowing local authorities to retain business rates. **Henry Overman** *looks at the pros and cons of the proposals and finds that while the proposals may give local authorities a greater incentive to provide more sites for businesses, they may also lead to some funding inequalities across councils.*

The government has launched its consultation on allowing local authorities to retain business rates. The problem: Commercial development imposes costs on local authorities (to provide services to businesses) and to local homeowners, while the benefits are spread more widely. In other words, commercial development generates benefits for others (externalities) that are ignored when making decisions on whether to allow development. This means that local government will tend not to provide enough sites for businesses. The obvious solution (if you believe in decentralised decision making) is to allow local authorities to retain some of their business rates. This will provide better incentives. But these incentives come at a cost – some councils where the business base doesn't grow will be worse off than they would be under a system which redistributes all business rate growth.

Before introducing such a change, it's important to know if these disincentive effects matter. Research by my SERC colleagues Paul Cheshire and Christian Hilber show that they do -when business rates were centralised this reduced the supply of land for commercial development.

So, in principle, business rate retention could help. Whether it will depends on the details. Two broad points to note. First, this is not a return to the old system where local authorities set rates (see my colleague Teemu Lyytikainen's post). Second, it's also part of a wider set of reforms, so assessing the effect of this one change will be difficult. Now to some details:

1) Baseline: The government will use the current formula to establish the baseline, so there are no winners and losers at the start. After that, however, the government will need to decide whether the base grows as described in the spending review (which has the benefit of providing certainty on the retention of business rates) or whether the funding formula should be tweaked over the spending review period (presumably with a view to giving more certainty on total revenues, while increasing the uncertainty on how much business rate would actually be retained)

2) Redistribution: The government will introduce tariffs and top-ups to ensure that the redistribution embedded in the baseline continues (while allowing for unevenness to develop as a result of retention). There are a couple of ways to do this one of which offers stronger growth incentives than the other.

3) Incentives: Depending on the details of (1) and (2) local authorities will retain some business rate growth providing an incentive to work better with businesses. However, they will not retain all growth because the government will impose 'levies'. The government suggests a few different options for how they might do this. The bottom line, however, is that the higher the share retained the bigger the growth incentive. Centre for Cities have some analysis which suggests this figure should be between 40-60%. That is a starting point but, in truth, I don't think anyone has good evidence on what should be the share retained.

4) Using the levy: The money raised from the levy could be used to cushion big shocks or to protect those councils that can't achieve growth. The problem with the latter, as the consultation acknowledges is that it limits the incentive effect of the changes.

5) Revaluation: One way for a local authority to increase business rate retention is actually to restrict supply and raise prices. The government wants to avoid this by redistributing all of the proceeds from revaluation so that the incentive only comes from growth as a result of new development. I think this is problematic because it conflicts with the idea that the scheme is about the wider relationship between local authorities and business. Things that local authorities do to provide better business infrastructure, e.g. through TIF, could easily be capitalised in to prices. This way of dealing with devaluation removes the incentives to do this. More thought needed on this one.

6) Reset: The government will periodically reset the system. This has huge implications for how strong the growth effects are. I don't think we have strong evidence on what would work best although full resets on a non-fixed basis would weaken incentives and appear to create incredible uncertainty for local authorities trying to make long run decisions. That leans the argument towards fixed term, partial resets. But do not believe anyone that says that we, as yet, have clear evidence on the best thing to do on this question.

7) Pooling: Local authorities would be allowed to pool resources under the new system. In keeping with the government's decentralisation agenda, all pooling would have to be voluntary. This is another difficult area, where the uneven distribution of commercial development across local authorities in the same broad geographic area could make for some very difficult negotiations.

The consultation provides more details on each of these points as well as how this will interact with other policies (e.g the new homes bonus). Some thoughts on those will have to wait for another day.

Overall, I think the tradeoffs are increasingly clear – the scheme will give incentives for growth at the cost of some equality in funding across councils. The opposition are calling for the government to ensure that 'no council will be worse off' under the new scheme. I can't see the proposal being able to deliver that in either absolute or relative terms. However, for reasons that I have discussed before, I think this is the wrong equity question. In the end, we care about people and the assessment of the fairness of this depends on how it will affect individuals. It's clear that there will be winners and losers but it is way too simplistic to imply that all the losers will be in council areas that 'lose' (what about those who can commute to new jobs created in neighbouring local authorities) nor will all the winners be in council areas that 'win' (what about homeowners near unwanted new commercial development). Don't expect constituency based politicians to see it this way…

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