RATING RETENTION

OPTIONS FOR REDESIGNING THE BUSINESS RATES RETENTION SYSTEM

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1. INTRODUCTION

Local government finances are unsustainable. We estimate that local governments will face a funding gap of £27.8 billion annually by 2024/25[1]. The lack of funding is having a severe impact on local services, particularly adult social care, children's services and homelessness support[2]. Local authorities are responding to the funding gap by draining reserves, and the Chartered Institute of Public Finance & Accountancy has warned that many local authorities are in danger of completely running out of money[3].

Local authorities are primarily funded by a combination of central government grants, council tax and business rates. However, the balance of these funding sources has changed significantly over the last decade. Grants from central government have been slashed – from £32.2 billion in 2009/10 to £4.5 billion in 2019/20[4]. Simultaneously, there has been significant reform to business rates.

Between 1990 (when the business rates tax was introduced) and 2012, business rates were collected locally and then passed on to central government who redistributed it back to councils in the form of a formula grant. However, from 2013/14 onwards, councils keep 50% of business rates collected in aggregate, as well as a proportion of any growth in business rates, through the Business Rates Retention System (BRRS). The remainder of business rates (known as the 'central share') is still redistributed to councils in the form of grants. The share kept by local government is also partially redistributed through a series of tariffs, top-ups and levies in the BRRS.

The BRRS, therefore, serves multiple functions. It determines the degree to which councils retain revenue from business rates versus their redistribution; it is a crucial source of local government revenue; and it is currently the primary mechanism by which funds are shared equitably between local authorities.

The aim of the BRRS was to give councils more control over the money they raise locally, and stronger incentives to create and support local jobs and local firms – as they would be financially rewarded for doing so[5]. However, it is open to criticism because it is highly complex to administer and understand; it has introduced uncertainty and volatility into the local government finance system as councils are more exposed to losses if business rates revenue falls; and the ability to raise business rates is geographically unequal[6]. Furthermore, although it is meant to incentivise local economic growth and activity to increase business rates revenue, there is limited evidence that the scheme has led to such activity to date.

From 2021, the government is aiming to introduce further changes to the local government finance system, including the Fair Funding Review and reforming the BRRS. As part of the BRRS reforms, government has announced an intention to allow local authorities at aggregate to keep a larger proportion of business rates receipts. Originally, it was intended that councils would eventually retain 100% of business rates, but this ambition seems to have been scaled back and the latest government announcements suggest the move will be to 75% retention. Furthermore, as local authorities are allowed to retain a higher proportion of their business rates income in aggregate, government has confirmed it expects to withdraw most of the grants it currently allocates to local government, including the Revenue Support Grant and Public Health Grant[7].

Retaining a higher proportion of their business rates revenue and its growth may give local authorities stronger incentives to grow their business rates revenue and has been welcomed by many for this reason. But there is a clear trade-off between this goal and the risk of wider divergence between councils' abilities to provide high quality services and leaving some councils behind. A key decision in the design of the BRRS (or any redistribution mechanism for local government funding) is the balance between incentives and equity.

This paper presents options for reforming the business rates retention system, assuming local tax sources remain as they are currently. Nevertheless, given the wide disparity in local economic conditions, it is likely that whatever revenue sources local government has access to, there may be a need for some form of redistribution mechanism. It must be noted that reforming the BRRS is concerned with how funding is distributed; it will not address the funding gap experienced by local authorities overall. In order to do that, we need to consider how council tax and business rates are designed and administered, which is the subject of the final report in our series on local government finances.

2. HOW THE BUSINESS RATES RETENTION SYSTEM WORKS

The business rates retention system is widely acknowledged to be incredibly complex[8].

Business rates, sometimes called non-domestic rates, are a property tax paid by occupants of non-domestic properties to local councils. This year, councils are expected to collect £25 billion, after reliefs, in business rates. They form a substantial portion of local authority funding in England, along with council tax.

Between 1990 (when the tax was introduced) and 2012, business rates were collected locally and then passed on to central government who redistributed it back to councils in the form of a formula grant. However, from 2013/14 onwards, the Business Rates Retention system (BRRS) was created. Under this system, councils kept 50% of business rates revenue (subject to tariffs and top-ups and the levy and safety net, see below), as well as an equivalent proportion of any growth in business rates in subsequent years. The remaining 50% is still pooled nationally and redistributed in the form of a series of grants. However, it is not clear which grants exactly are paid for out of this, as total business rates revenue significantly exceeds the sum of retained business rates and current grants counted in core spending power (the government's main measure of funding over which local authorities have control).

In theory, the system is reset periodically so that some councils do not experience runaway growth compared to others. But in practice the system has not been reset since it was first implemented in 2013. Nonetheless, the first reset is due in 2020 and then again periodically every few years thereafter. We refer to the periods between resets as the 'retention period'.

Since there is significant variation in the amount local authorities are able to raise in business rates, as well as variation in the amount local authorities need to provide necessary services and functions for their residents, local authorities are subject to a system of top-ups and tariffs on their local share (the portion of business rates retained locally) of business rates so that they retain roughly only the amount they need. There is also a levy to pay on any growth in business rates, which pays in part for a safety net to protect local authorities in case there is a significant fall in their rates. These various elements are described below, along with a worked example.

BUSINESS RATES BASELINE, TOP-UPS AND TARIFFS

In the first year of the system, or following a reset, each local authority is given a business rates baseline and a funding baseline. The business rates baseline is equal to the amount the local authority is expected to collect in business rates. The funding baseline is the amount of money the authority is calculated to need to deliver its services (relative to other councils and current levels of service access and quality). The business rates baseline and funding baseline are then compared. If the expected revenue (business rates baseline) is higher than predicted need (funding baseline), the council must pay a tariff. Conversely, if predicted need is higher than expected revenue then the council receives a top-up.

Top-ups and tariffs are fixed across the retention period, i.e. each top-up authority will receive the same value of top-up each year across the period, and each tariff authority must pay the same tariff (albeit tariffs and top-ups are uprated by inflation).

BUSINESS RATES GROWTH

Consider the following worked examples to show the impact of a growth in business rates for a tariff and a top-up local authority. (For simplicity we ignore inflation, as well as the levy/safety net which is described later).

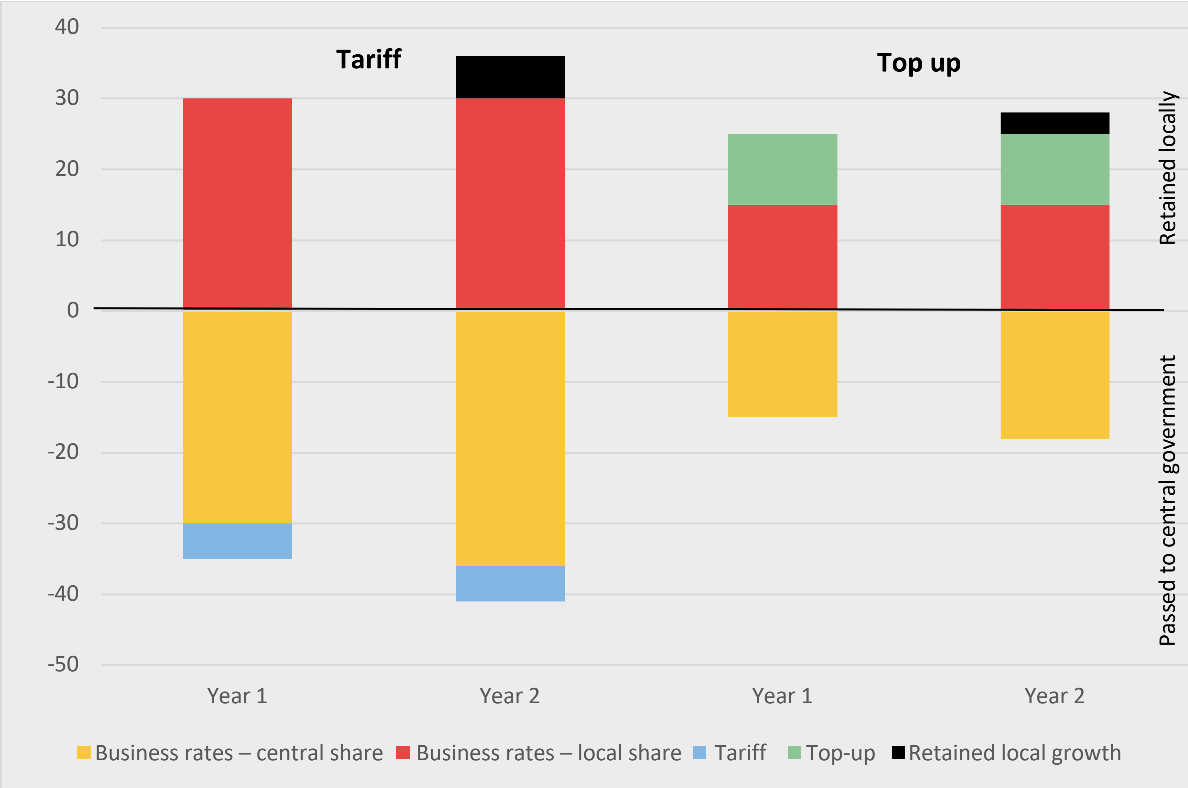
Local authority one is a tariff authority, like Camden or Wokingham. In year one, it collects £60 million in business rates. £30 million is passed on to central government, and the local share is also £30 million. The baseline need is estimated to be only £25 million, and therefore the authority must pay a tariff of £5 million. So in year 1, the authority retains £25 million from the business rates retention system.

Suppose in the second year, business rates grow by 20%. This would mean the council collects a total of £72 million in business rates, of which £36 million is passed on to central government. The authority must still pay a tariff of £5 million. That leaves £36 million for the local share of business rates – the local authority therefore has an additional £6 million (prior to the levy).

Local authority two is a top-up authority, like Middlesbrough or Northumberland. In year one it collects £30 million in business rates. £15 million is passed onto central government and £15 million is the local share. Baseline need is estimated to be £25 million, so the local authority receives a top-up of £10 million.

In the second year if business rates grow by 20%, the local authority will collect £36 million in business rates. £18 million goes to the central share. It still receives a £10 million top-up. The authority retains an additional £3 million compared to year 1 and has access to a total of £28 million in revenue (£10 million plus £15 million plus £3 million).

Figure 1: Illustrative example of tariff and top up authority business rates growth under the retention system.



The important effect of fixing top-ups and tariffs is that authorities only benefit from *additional* revenue collected from business rates beyond the initial baseline as assessed in the first year of the scheme, i.e. local authorities keep a proportion of their growth. This is intended to stop local authorities with a large business rates base from 'coasting' and relying on their already high revenue stream. However, those with a larger business rates base relative to need still benefit disproportionately.

We can see this from the worked example above, where both example local authorities successfully grew their business rates income by 20%, and both local authorities have the same predicted need. But authority one has a business rates base double that of authority two, and therefore double the additional revenue available to it.

LEVY AND SAFETY NET

In order to protect local authorities against disproportionate losses and gains, adjustments are made each year via the levy and the safety net. Authorities which experience a disproportionate growth in business rates income pay a levy on that growth, decreasing the share of growth they actually retain.

The formula for calculating the levy rate is:

1 – baseline need/business rates baseline

If baseline need is greater than the business rates baseline (i.e. the authority is a top-up authority which raises less than it needs), the levy rate will be negative. If the baseline need is much less than the business rates baseline (i.e. the authority is a tariff authority which raises more than it needs), the levy rate will be close to 1. If the levy rate is less than 0, the authority is not levied, so top-up authorities do not get levied. The levy rate is capped at a certain level (currently 0.5), so that if the levy rate formula generates a very high levy rate, councils can still keep half of their income growth.

Therefore, the maximum a local authority could gain each year under the current system is 50% of any growth in business rates, but it will be much lower if growth is large compared to need.

If an authority is subject to a significant shortfall in business rates – for example if there were several major business closures in a particular year and business properties lie empty – they are protected against disproportionate losses by a safety net. The safety net is currently set at 92.5% of baseline need, meaning that rates available to authorities will never fall more than 7.5% below predicted need (each year needs, tariffs and top-ups are uprated by CPI).

ADDITIONAL CONSIDERATIONS

The local government system in England is complex. In some places, there is a single unitary authority responsible for collecting revenue and delivering services. But in many places, there is a two-tier system, with different levels of government having different responsibilities for services and revenue collection. In places with the two-tier structure, councils that collect revenue are called billing authorities, and these authorities pass a proportion of income to higher or lower authorities (called precepting authorities).

Since the system was introduced, additional layers of complexity and uncertainty have been added due to various policy decisions. For example, the transfer of business rates revenue to local authorities was followed by additional policy announcements capping increases on rate multipliers (the rate at which tax is charged on a business property) and exempting certain types of business activity, thereby cutting the amounts local authorities can receive. A complex suite of grants have been introduced to compensate local authorities for losses arising from these.

In addition, local authorities have been encouraged to voluntarily pool their business rates into one common fund. This is meant to manage the volatility of income through business rates retention by spreading this risk across a wider geographical area. An additional incentive to pool is that the levy rate is applied to the collective pool, and it may be lower for a group of authorities than individual ones.

3. PRINCIPLES OF THE BUSINESS RATE RETENTION SYSTEM

When councils have more control over the revenue they raise locally, and are rewarded for its growth, they are incentivised to to undertake activities which grow that revenue. But some councils have a harder time growing their local tax revenue due to variation in geography and socioeconomic circumstances. The current Business Rates Retention System attempts to balance a fundamental trade-off between two goals: providing local control and incentives for local areas to boost growth, while ensuring funding is distributed equitably between areas.

Below we describe what we view as the key principles of a just and efficient business rates retention system:

- Meeting need equitably
- Pooling risk effectively
- Increasing devolved control and instilling appropriate incentives
- Achieving revenue neutrality on day-to-day spending

MEETING NEED EQUITABLY

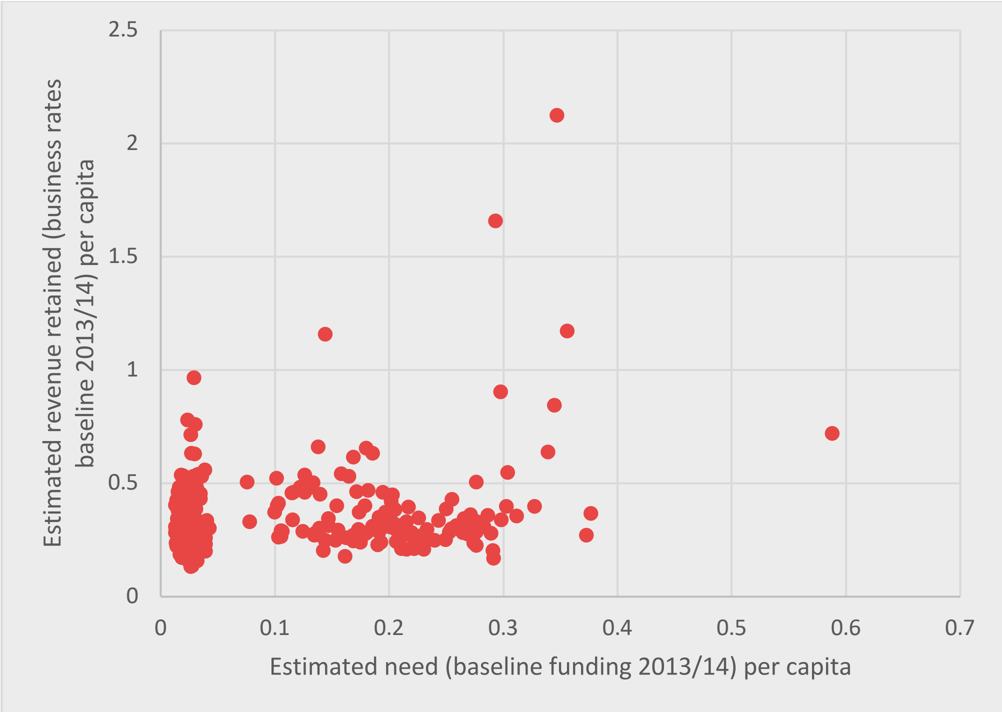
The most important policy goal for local government finance should be to ensure that all councils have sufficient resources to meet local need. There is little political or public appetite for the alternative, where people miss out on services simply due to where they live.

Prior to the introduction of the Business Rates Retention System, local government was allocated funding according to a formula, which determined how the Revenue Support Grant was distributed – the primary un-ringfenced grant to local authorities.

The ability to raise business rates is not strongly related to need in a local area as measured by central government (although it must be noted that determining need according to a centrally derived formula may not be a fair reflection of actual need either). Figure 2 below shows the mismatch between local authority need as assessed in the current system, and business rates collection per capita from 2013/14 (2013/14 is the most recent time need was estimated).

Figure 2: The link between ability to raise business rates revenue and estimated need for services is weak.

Business rates baseline versus baseline funding per capita for local (billing) authorities, 2013/14 (£00s, 2013/14 prices)



Source: Own calculations using MHCLG National non-domestic rates collected by councils in England: 2013 to 2014, available at: https://www.gov.uk/government/statistics/national-non-domestic-rates-collected-by-councils-in-england-2013-to-2014 and ONS population estimates time series dataset, available at: https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/datasets/populationestimatestimeseriesdataset

This is the justification for some form of redistributive system. In the first year of a reset, all local authorities would receive the same amount, whether under the BRRS or under a system of grants, as in either case the system essentially redistributes according to need. However, the way the system is designed with fixed tariffs and top-ups and long periods between resets means that the share of retained business rates revenue can diverge from baseline need quite significantly over time, making it harder for local authorities with lower business rates bases to meet need. The safety net currently kicks in if local authority funding falls to more than 7.5% below baseline need. However, local authority budgets are very tight. The overall amount of revenue available to local authorities to meet needs has been squeezed and squeezed, and a 7.5% fall below baseline need would have a significant impact on them.

Any reform should ensure that local authorities that can least afford losses are most protected, and that regional inequalities are removed as far as possible. The following table shows business rates capacity per person in London is more than double the revenue available from elsewhere.

Table 1: Business rates revenue per capita by region

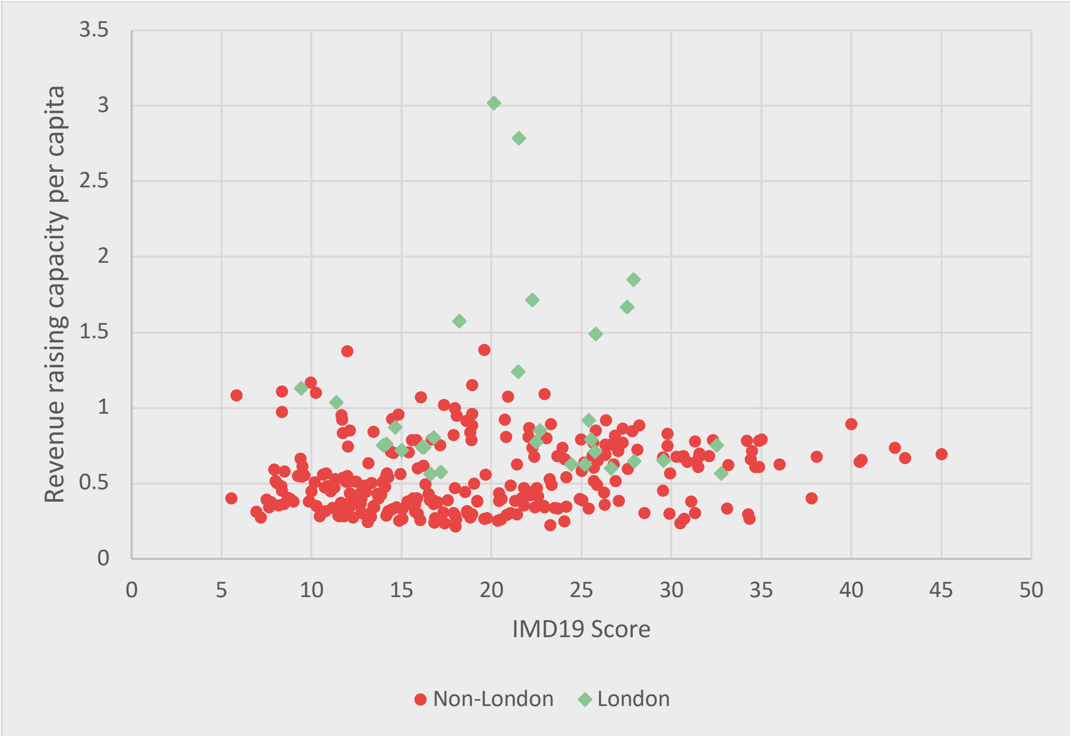
Region	Business rates revenue per capita (2018-19)
London	£940
South East	£406
West Midlands	£336
East	£363
Yorkshire and the Humber	£328
North West	£339
North East	£300
East Midlands	£319
South West	£313
ENGLAND	**£440**

Source: Own calculations using MHCLG National non-domestic rates collected by councils in England: forecast for 2018 to 2019, available at: https://www.gov.uk/government/statistics/national-non-domestic-rates-collected-by-councils-in-england-forecast-for-2018-to-2019 and ONS population estimates time series dataset, available at: https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/datasets/populationestimatestimeseriesdataset

Within regions, there is also significant variation. But in general, more deprived authorities have lower revenue raising capacity per capita.

Figure 3: More deprived authorities tend to have lower revenue raising capacity.

Revenue raising capacity in 2019/20 (£000, 2019/20 prices) compared to IMD19 score for all authorities in England.



Source: Own calculations using MHCLG Core Spending Power: final local government finance settlement 2019 to 2020, available at: https://www.gov.uk/government/publications/core-spending-power-final-local-government-finance-settlement-2019-to-2020 , MHCLG English indices of deprivation 2019, available at: https://www.gov.uk/government/statistics/english-indices-of-deprivation-2019 and ONS population estimates time series dataset, available at: https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/datasets/populationestimatestimeseriesdataset

POOLING RISK EFFECTIVELY

The system should pool risk and protect local authorities against runaway gains and losses and provide as much certainty as possible to support long-term planning. In addition, pooling income from growth across a wider, economically coherent area encourages strategic decisions about planning, development and infrastructure investment.

In 2018/19, 20% of local authorities experienced a loss in business rates income while 5% of local authorities experienced more than 10% growth[9]. The losses are particularly problematic in the context of limited funding in the system.

Under the current system the safety net and levy are applied to the pool as a whole, therefore forming a pool can reduce levy payments. Pooling arrangements are not the same as the two-tier arrangement of government described in chapter 2. Unitary authorities can be in pools, as can two-tier areas (but it is usual for all lower tier areas corresponding to an upper tier to join a pool together, potentially including other authorities).

The system of voluntary pooling is proving popular: 70% of authorities were part of some pool in 2018/19[10], providing a makeshift solution to smoothing acute gains and losses. However, authorities that are most likely to not be in a pool tend to be smaller authorities that have a longer history of calling on the safety net[11] – i.e. those most in need of support from a pool, but least likely to contribute to it.

DEVOLVED CONTROL AND INCENTIVES

It was originally intended that the rates retention system would provide a strong incentive for local authorities to promote business growth, and that allowing councils to retain a higher proportion of their business rates would lead to increased local output, job creation and prosperity[12].

However, the incentive effect is weakened by the design of the system itself. Councils have very little control over the setting of rates to attract businesses, and limited capacity to actually encourage business activity as budgets to do this have been cut. A comparison by the House of Commons Library of local Gross Value Added (GVA – a measure of economic output) and the local quantity of rateable value between 2008 and 2015 found the link to be "tenuous"[13]. Similarly, the IFS compared changes in business rates tax base to changes in local GVA and local employment between 2010-11 and 2015-16, and found no clear link between these measures[14].

Instead, the business rates system rewards the expansion of commercial floorspace, as rateable values assigned to properties are fixed for a number of years – therefore the only way to increase total tax take is to increase the amount of floorspace occupied by businesses. There is no incentive for the type of work to be highly productive or for jobs to be high quality. Centre for Cities have pointed out that this structure effectively reinforces the status quo as councils are incentivized to permit development where demand already exists: which for some areas might be low-productivity out of town premises, which may increase output, but will not necessarily lead to a more productive local economy generating better jobs[15]. Therefore the business rates system and retention system work against each other.

AFFORDABLE

Ensuring that there is enough money in the system to cover the desired level of service provision at the right tax rates is therefore vital, and this is the topic of our next paper in the series.

Government has previously indicated the move to 75% retention is intended to be fiscally neutral – that is local authorities at aggregate should not have more or less to spend overall between the year preceding and following the switch, although of course there will be winners and losers. In the long run, being able to match day-to-day spending with tax receipts is an important requirement, with borrowing reserved largely for investment or supportive spending during recession. However, in the current circumstances, the quantum of income available to councils is significantly less than they actually need[16].

In conclusion, the key problems with the current BRRS are clear.

- It fails on its own terms by providing weak incentives to increase business activity and grow revenue. Councils have very little control over the level and eligibility for business rates, and the tools available to grow revenue are weak.
- It is biased against more deprived communities with lower business rates bases. Councils with smaller business rates bases (usually poorer top-up councils) gain significantly less from the current system than councils with larger business rates bases, as councils are rewarded in proportion to the value of business property in their area.
- It exposes councils to risk and volatility in revenue without sufficient protections. The safety net is set well below the level the council needs to deliver services. With severely limited additional support now coming in the form of grants, and many councils having run down their reserves, councils are likely to be faced with hard choices in the event of a bad year or two.

4. OPTIONS FOR BUSINESS RATES RETENTION REDESIGN

In this chapter we consider key elements of the business rates retention system and assess how reforms to each can help achieve the principles set out in chapter 3.

Key elements of the BRRS:

- *The proportion of revenue retained locally rather than pooled nationally.* The current system (outside pilots) has 50% retention. Although the government has announced it is intending in the long-term to move to 100% retention, it has announced that from 2020, 75% will be retained locally. The higher the proportion retained locally, the more local authorities are exposed to risk and volatility, and the less likely all local authorities will be able to meet their needs.
- *Reward for growth.* Currently, councils receive a reward for growing their business rates, in the form of being able to keep a share of any growth in receipts. Under 50% business rates retention, councils can keep 50% of any growth and this will increase to 75% under the government's new plans. This system can lead to significant inequalities between tariff and top-up authorities. Because tariff authorities have larger business rates baselines than their baseline funding needs, they can increase their funding in the BRRS significantly from year to year. In extreme cases, income can more than double in just one or two years. Top-up authorities, on the other hand, have smaller business rates baselines than their funding need. This means they can often receive only small proportionate increases in income even if they are successful in growing their business rates baselines. In other words, there is a current systematic bias in favour of tariff authorities and at the expense of top-up authorities. One way to improve this would be to change the value of the reward so that the rate of growth in business rates is applied to baseline funding need – rather than the business rates baseline. This means no matter whether you are a tariff authority or a top-up authority, your income will increase by whatever percentage growth is achieved. This option, initially proposed by IPPR in 2016, considerably improves equitable distribution.[17]
- *Level of safety net and levy.* The safety net and levy together protect against income falling below a certain percentage of a local authority's baseline need while also capping 'extraordinary growth', respectively. Outside of a number of pilot studies, the safety net is set at 92.5% of the initial cash value of a council's

funding baseline. This means income can never fall below this level between resets. A higher safety net ensures that local authorities can meet service needs and protects against volatility, however day-to-day the safety has needed additional funding from central government because the levy has failed to cover the full the cost.

- *Pooling.* The current system of voluntary pooling of business rates income across more than one local authority, in addition to the tiered system of government in some areas, is proving popular and going some way to smoothing volatility. But not all authorities have been successful in negotiating access to voluntary pooling and are being left behind. An alternate system could see some level of mandatory pooling of income from the BRRS at a regional level; it would then be up to each region to decide how these funds could be allocated (in our illustrative modelling below we assume funds are divided up according to need within councils). This would likely require new regional government bodies to be set up but would allow for more coordinated strategic planning at the regional level.

Using a model built specially for this report, we stress tested reforms to different elements of the BRRS in order to build three indicative packages or options for reform, alongside a core scenario, which consists of the government's current expected plans. We summarise each of our final packages briefly in the bullet points and Table 2 below:

- **Core scenario – expected government plans:** In the government's plans, 75% of business rates at aggregate are retained locally through the business rates retention system, and 25% are redistributed via central government grants. There is no mandatory pooling of BRRS income between local billing authorities (other than through existing precept authorities). The government plans for a safety net of 95%, funded by a levy on retained business rates growth of 0.5 (see section 2 above). This system has been designed by government to increase incentives to local authorities to grow their business rates receipts through local economy growth. But the design sees incentives disproportionately skewed towards tariff authorities and overall there are large trade-offs with distributional outcomes across local authorities.
- **Option 1 – full redistribution:** This option illustrates the scenario at the opposite end of the spectrum to the governments' plans. We model 0% retention of business rates; all revenue is redistributed according to relative need. This option significantly dampens the risk of divergence between councils, collectivizes risk and protects councils against volatility in their revenue. But it

removes incentives for councils to grow their receipts, and greatly centralizes the current system.

- **Option 2 – moderating the current system:** This option illustrates a scenario of moderate reform to the government's current plans, with the aim of balancing out some of the trade-offs between incentives to grow business rates receipts and a proportionate redistribution of income across local authorities. In this option we model a 50:50 split between the local and central share (as in the BRRS today). However, unlike the current system, councils are rewarded for growing revenue, in proportion to their funding need. We also model an increase in the safety net to 100% and an increase in the levy rate to 0.75 to help pay for the safety net. This option softens the trade-off between incentive and redistribution compared with the core scenario, but overall there is greater centralization and less devolution in the system, with less funding retained through the BRRS.
- **Option 3 – regional pooling:** This option illustrates a new pooling mechanism at sub-national level. We model a system where 50% of local revenue is pooled regionally, subject to tariffs and top-ups and the levy and safety net. The pools are rewarded for their collective growth in revenue in proportion to their collective funding need (similar to option 2). We also include a 100% safety net to protect against loss in income. But unlike option 2 the levy is not increased, to maintain current incentive levels. An addition 25% is retained locally and subject at a local level to the same safety net and levy arrangements described. 25% is redistributed nationally. Under this option a higher proportion of revenue is retained sub-nationally than option 2, potentially maintaining current incentives (even encouraging more strategic planning and investment decisions at a regional level) and increasing devolution. But it would require new governance and administrative arrangements – for instance the creation for new regional combined authorities. Variations of this option could look into other pooling arrangements.

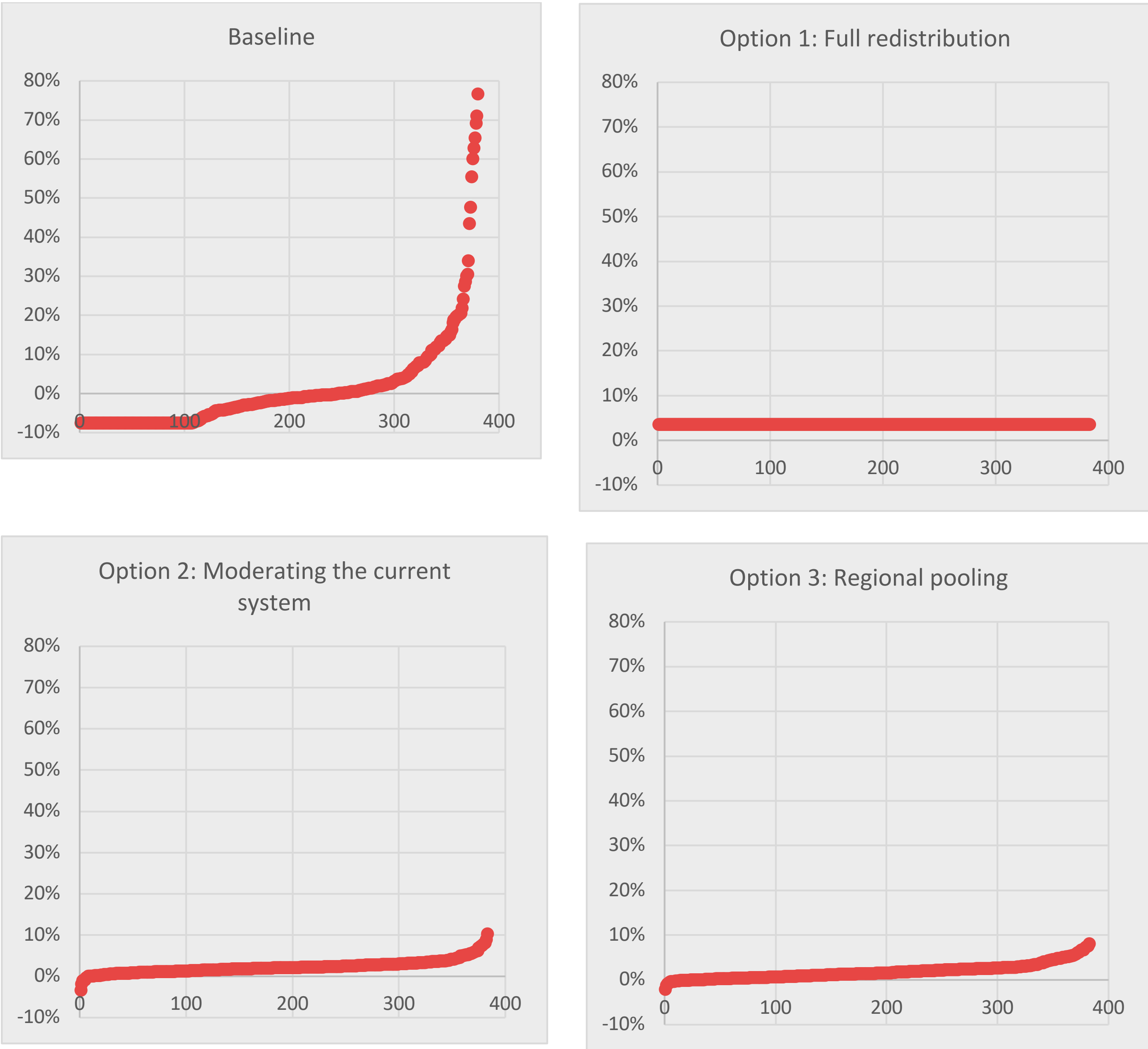
Table 2: Summarising options modelled.

	Core scenario – expected government option	Option 1 – full redistribution	Option 2 – moderating the current system	Option 3 – regional pooling
Local authority retention	75%	100%	50%	25%
Central government retention	25%	×	50%	25%
Mandatory regional pooling	×	×	×	50%
Reward for growth	Proportion of rates	×	Proportion of need	Proportion of need
Safety net	95%	×	100%	100%
Levy rate	50%	×	75%	50%
Reset	4 years	×	4 years	4 years

The packages above were run through our model to simulate the effects of each across a forecast period of 2021/22 to 2024/25, and with respect to the principles set out in Chapter 3. Figure 4 below sets out the detailed distributional results for each local authority by income growth across the forecast period, and Table 3 summarises our assessment of each package against our key principles.

The government's current plans (core scenario) are highly inequitable and would see runaway, excessive growth for the very richest local authorities (mainly in London) while almost two-thirds of authorities would see their income fall in real terms between 2021/22 and 2024/25. In contrast, retaining 100% of business rates receipts centrally and redistributing according to need (option 1) ensures that all local authorities see a real term increase in revenues of 4%. However, under this scenario, authorities would have limited control or incentive over their future revenue from business rates, and will become more vulnerable to the future political and fiscal discretion of national government. Options 2 and 3 both see a more equitable distribution of income growth compared with the government's current plans. These two options differ primarily in terms of the level of business rates receipts that would be retained and distributed directly by central government. If it is desirable to increase the level of decentralization, option 3 would be preferable.

Figure 4: The distributional impact on business rates retained by local authorities for our different scenarios, ranked by change to rates retained, between 2021/22 and 2024/25.



Source: Own calculations

Table 3: Assessment of options against principles.

	Core scenario – current government plans	Option 1 – full redistribution	Option 2 – moderating the current system	Option 3 – regional pooling
		Impact of scenario		
Meeting need equitably	**Weak**. 64% of local authorities will see their income fall by 2024/25 compared with 2020/21. Overall, the big winners are London (10% average gain), the South East and East Midlands, with all other regions losing out marginally. The biggest loser is Yorkshire and the Humber (-3%)	**Strong**. No local authorities see their income drop between 2020/21 and 2024/25. All regions and councils see their incomes rise by 4% by the end of the period.	**Strong**. No local authorities see their income drop between 2020/21 and 2024/25. Average gains across regions range from between 0% (North East) to 6% (London) overall.	**Strong**. No local authorities see their income drop. Average gains across regions range from between 1% (North East) to 5% (London) overall between 2020/21 and 2024/25.
Pooling risk effectively	**Weak.** The low safety net and high local retention exposes councils to significant risk – over a quarter of councils would lose close to 8% between 2020/21 and 2024/25 if business rates follow historical growth paths.	**Strong.** As long as business rates grow in aggregate (as they have historically), no council will lose out between 2020/21 and 2024/25.	**Medium.** A higher safety net ensures no council will lose out between 2020/21 and 2024/25, and keeping the same proportion as currently nationally redistributed ensures that councils will not be exposed to a higher level of risk under the new system.	**Medium/weak.** Pooling a relatively large proportion of funding provides protection, and a higher safety net ensures no council will lose out between 2020/21 and 2024/25. However, if a council performs poorly within a pool that performs poorly overall, they may still lose out.
Devolving control and incentives	**Medium.** Authorities retain a high proportion of income but have little meaningful control over how to increase/decrease it.	**Weak.** Authorities will be fully dependent on national government for grants.	**Medium** Authorities retain a high proportion of income but have little meaningful control over how to increase/decrease it. Authorities are awarded for growing their revenue, in proportion to their need rather than their existing base – and so those that have historically lower rates are not disincentivised	**Medium/Strong.** Authorities/regions retain a high proportion of income. It may be easier to influence businesses and decisions at a slightly less local level, and authorities can collaborate to do so. Authorities and regions are rewarded for growing their revenue, in proportion to their need rather than their existing base – and so those that have historically lower rates are not disincentivised.
Affordable/sustainable	**Strong.** Under this option, £300 million more will be collected in 2024/25 than retained/redistributed in 2020/21.	**Medium.** This option is fiscally neutral.	**Strong.** Under this option, £150 million more will be collected in 2024/25 than retained/redistributed in 2020/21.	**Strong.** Under this option, £200 million more will be collected in 2024/25 than retained/redistributed in 2020/21.

5. CONCLUSION

This paper has discussed principles of a local government redistribution scheme and assessed options for reforming the system against these principles. The principles are:

- Meeting need equitably
- Pooling risk effectively
- Increasing devolved control and instilling appropriate incentives
- Achieving revenue neutrality on day to day spending

This paper has not been concerned with the overall amount of money available to local authorities but rather how it is distributed. Nevertheless, in our current world of scarcity, the distribution is even more important as most councils cannot afford to lose out on any of the money currently available.

In analysing options for reform, we find that the expected outcomes of the government's proposed 75% retention scenario is highly inequitable and exposes authorities to significant risk.

We have presented two possible alternative packages of reform that balance the trade-off between incentivising revenue growth and keeping local control on the one hand, and preventing extreme divergence of local authority revenue and protecting public services on the other hand. One of these moderates the current system – maintaining current levels of control over revenue, and the other increases sub-national control over revenue. What these packages show is that it is possible to maintain current incentives (or even improve them), without exposing councils to significantly more risk or allowing runaway growth in a few areas.

We therefore propose the following immediate reforms to the business rates retention system to reduce geographic inequalities while still protecting local authority devolution and control:

1. Raise the safety net to 100% so all authorities are protected against large losses
2. Business rates growth should be retained by local authorities in proportion to need – i.e. using need as the denominator for the reward
3. Government should either mandate or incentivise greater regional pooling of local authority business rates, in order to improve the redistribution of business rates receipts without putting funds directly under central government control. This could be through the creation of new regional combined authorities from city region and county councils. In addition to being significant structures for fiscal devolution, such authorities could be an important commitment to

decentralising Westminster's power and making more strategic decisions at regional levels.

In forthcoming papers we will review the taxes funding local government – primarily business rates and council tax, and consider how they could be reformed or replaced to close the local authority funding gap. Reformed or replacement taxes might well have a different distributional impact (for example, they may concentrate wealth further in London and other city regions), and we will consider the design of the (re)-distribution systems and the incentives they create with respect to any new proposed taxes.

ENDNOTES

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