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DEPUTY PRIME MINISTER

# Local Authority Business Growth Incentives - A Consultation Paper

July 2003  
Office of the Deputy Prime Minister

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# Foreword

Local authorities have a strategic role to play in local economic development, the success of their regions and ultimately the prosperity of the UK. The Government is committed to supporting local authorities in this role - raising the prosperity of all communities and releasing the economic potential of every area.

The current Local Government finance structure does not fully recognise or reward local authorities' contribution to economic growth. Local authorities bear many of the costs of economic development although they do not benefit from the increased revenues it generates. Since 1990 business rate revenues have been paid into a central pool so that local authorities get no direct individual or local benefit.

This consultation sets out a scheme for reforming this arrangement by allowing local authorities direct retention of some business rate revenues. This scheme introduces incentives for local authorities to lead the economic development of their community by encouraging strong and successful partnerships with business and other local and regional players.

We are convinced that all local authorities irrespective of their economic circumstances, must benefit from the scheme. The proposals in this document therefore balance the need to maintain a strong incentive for existing high growth authorities with the need to provide greater incentives and benefits to deprived and low growth authorities. In particular, the scheme provides local authorities with a clear opportunity to tackle the enterprise gap in their areas and to integrate enterprise with the regeneration of their communities.

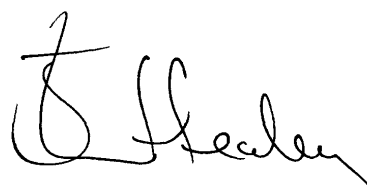
The proposals in this consultation provide a real opportunity for authorities to secure additional resources. No authority will lose, and there is no question of extra revenue from this scheme being offset against other income.

We are also committed to devolving more decision making to a local level. Therefore, benefits from the scheme will not be ring fenced and local authorities and their electorate will be free to decide whether and how to respond to the incentives created by the scheme.

The consultation document sets out the principles and concepts that will guide the design of the scheme. It represents a significant new and powerful initiative to support local economic development. We hope that there will be as broad a participation in the consultation as possible, so that together we can work to rebuild, regenerate and promote growth in local communities and the regions.



The Rt. Hon. Nick Raynsford MP  
Minister for Local and Regional Government



John Healey MP  
Economic Secretary to the Treasury



# Purpose

P.1. The consultation paper sets out the principles and concepts that the Government proposes to guide the way that a scheme under section 71 of the Local Government Bill may operate. The questions that it seeks views on are:

- Q.1) Do you agree with the principles for the scheme?
- Q.2) Do you agree with using an eight year period for setting the trend?
- Q.3) Are there models for setting the baseline that the Government has not considered that need to be considered?
- Q.4) Which of the baseline models is your preferred option and why?
- Q.5) Which of the two preferred options for floors and scaling factors (high/high and medium/medium) do you think provides the best balance between financial support and financial incentive?
- Q.6) Do you agree with using formula spending shares as the measure for determining ceilings? Do you agree that a 1% ceiling in year one of the scheme rising in line with the scheme (i.e. reaching 3% in year three) provides an adequate balance of incentive and cap on gains?
- Q.7) How do you think that benefits should be shared between different tiers of local government?
- Q.8) (If you represent a local authority) Would you like to volunteer to be part of the administrative dry run?

P.2. A copy of this consultation paper is being sent to all English Local Authorities, the Local Government Association and a number of other interested parties, including Regional Development Agencies and some business organisations. It is publicly available on the website of the Office of the Deputy Prime Minister at [www.odpm.gov.uk](http://www.odpm.gov.uk).

P.3. We invite response by **31 October 2003**. Please send paper responses to:

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London SW1E 5DU

P.4. Or email responses to:

[labgi.consultation@odpm.gsi.gov.uk](mailto:labgi.consultation@odpm.gsi.gov.uk)

P.5. Further copies of this paper can be obtained from the address on p.2 of this document, or from ODPM's website at [www.local-regions.odpm.gov.uk/conindex.htm](http://www.local-regions.odpm.gov.uk/conindex.htm)

P.6. Individual local authority baseline percentages have been published separately, and these are available from the same website.

P.7. The Office may wish to publish responses to this consultation exercise in due course or deposit them in its libraries. If so, all responses received will be published or deposited, unless a respondent specifically asks the Office to treat their response as confidential. Confidential responses will, nevertheless be included in any statistical summary of the numbers of comments received and views expressed.

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# Executive Summary

E.1. The Government's central economic objective is to achieve high and stable levels of growth and employment. Improving the economic performance of every locality in England is an essential element of that objective. This is firstly because we are committed to delivering fairness and opportunity for all in every region and community in the country. It is also because unfulfilled economic potential in every locality must be released to meet the overall challenge of increasing the UK's long term growth rate.

E.2. This document sets out the objectives, principles and concepts that will guide the Government in designing a scheme to allow local authorities retain some of the revenue from business rates. The primary legislation for the scheme is being sought in the Local Government Bill now in Parliament. This document only applies to the proposals for the scheme in England. This is a devolved matter and the devolved administrations in Scotland, Wales and Northern Ireland will be deciding policy separately.

E.3. At a local level there is currently a mismatch between the costs of economic development and the benefits that accrue from it. Economic development poses direct costs on local authorities in terms of greater congestion on local transport and impact on the local environment. Potentially it also imposes costs on other local authority services, most obviously housing, education and community safety.

E.4. In contrast, the benefits of economic growth typically accrue either to individuals, through more and better employment, or, in tax terms, at a national level. This suggests that whilst costs of economic development accrue at a local authority level, the benefits accrue at a wider level.

E.5. This scheme will change this situation. Currently, all business rate revenues are collected by local authorities and passed into a central pool. These revenues are then re-distributed on a per capita basis. This scheme will allow local authorities to individually retain some of the business rate revenues that are associated with growing the business rate tax base at a local level.

E.6. This scheme will create positive financial incentives for local authorities to work in partnership with business, Regional Development Agencies, Learning and Skills Councils and other key local and regional players to maximise economic growth. The Government's approach to economic policy is most effective when it is based on maximising growth in each locality. This approach can only be delivered by effective economic leadership from local authorities, providing what business in the area needs to fulfil its potential.

E.7. The scheme will follow the approach to Local Government set out in the 2001 Local Government White Paper *Strong Local Leadership – Quality Public Services*. Revenues from the scheme will not be ring fenced and local authorities will be free to decide whether and how to maximise local economic growth so as to benefit from the scheme.

E.8. This document is focused on the principles and concepts that will underlie the Government's approach to the scheme and the choice between options. The Government would welcome comments on these proposals by 31 October 2003. All comments will be carefully considered before the Government puts forward firm proposals for the exact mix of variables during the course of next year. The scheme will be launched on 1 April 2005.

E.9. The document is set out as follows:

- An opening chapter on objectives and principles for the scheme
- A chapter which sets the scheme in the wider policy context
- Two chapters which introduce some of the variables for the scheme and the ideas on which the Government is consulting
- A chapter setting out next steps and the timetable for introducing and evaluating the scheme
- Two appendices containing the technical working of the scheme and model baselines.

## The Policy Context

E.10. This scheme fits firmly within the Government's existing approach to economic, enterprise, local government and business rates policy.

E.11. Analysis presented in this document suggests that if local authorities successfully respond to the incentives created by the scheme, this will have a beneficial impact on local productivity and growth leading to stronger economic performance. Also, one of the key principles for this scheme is that the incentives should be relevant to all local authorities. This means that the scheme underpins efforts to reduce differentials in economic growth throughout the country whilst maximising overall economic growth.

E.12. This scheme is also a key part of the Government's new approach to local government. The revenues raised from the scheme will not be ring fenced and local authorities will be free to spend them as they choose on local priorities. The scheme provides the tools and incentives to deliver the demands of local people with regard to economic growth without prescribing what those demands should be or how to deliver them.

E.13. The scheme also complements existing business rates policy by encouraging greater co-operation with business. It is not intended in any way to pre-empt findings of the wide ranging review into the balance of funding in local government finance.

## Baselines

E.14. The key technical variable underlying the scheme is the setting of baselines. These drive the expected performance of each local authority and therefore the distribution of incentives and revenues from the scheme.

E.15. The chapter on baselines proposes five different models, each of which creates different incentives, distributional impacts and is more or less intelligible to those who need to respond to and operate the scheme.

E.16. Currently, the two models the Government favours are:

- The National Historic Growth model which groups local authorities nationally and then separates them into five sub-groups depending on relative historic performance; or
- The Sub Regional model which groups local authorities according to their Government Office for the region and then separates them into three sub-groups depending on relative historic performance.

E.17. The Government believes that these models best provide a challenging incentive to authorities with high historic growth and an achievable target for authorities with low historic growth ensuring that overall the scheme provides a relevant incentive to all local authorities. **The Government invites consultees to indicate which model they prefer and why.**

## Floors, Scaling Factors, Ceilings and Tiers

E.18. The other controllable variables for the scheme are the floors, scaling factors, ceilings and tiers. The floor denotes the level, relative to the baseline, above which a local authority will retain revenues. The scaling factor determines the percentage of revenues retained, the ceiling the maximum amount of revenue retained and the tier the relationship between lower and upper tier authorities. These factors interact to maintain equity between options and ensure a balance between an overall strong incentive and the distribution of that incentive amongst authorities.

E.19. The Government has identified two main options for delivering floors and scaling factors:

- A high floor / high scaling factor option. Under this option individual local authority floors would be set high, so that only around 50% of authorities would receive benefit from the scheme without improving performance. However, this will be compensated for by a high scaling factor, allowing retention of, say, 95% of revenues above the floor. This option creates a relatively stronger incentive to do better.

- A medium floor / medium scaling factor option. Under this option, individual local authority floors would be set so that around 75% of authorities would receive benefit from the scheme without improving performance. However, there would be a lower scaling factor with local authorities allowed to retain around 65% of revenues above the floor. This option provides greater up front support to do better.

E.20. The Government believes that overall these options provide the best match of incentives to improve and up-front support so as to enable local authorities to deliver better economic performance. **The Government invites consultees to indicate which option they prefer and why.**

E.21. Further work is needed on whether and how to distribute revenues between London Boroughs and the Greater London Authority and between shire districts and shire counties. **The Government invites consultees to indicate how they believe this should be done.**

E.22. As a ceiling, the Government proposes a restriction on gains of 1% of Formula Spending Share<sup>1</sup> per annum rising as the scheme rises and therefore reaching 3% of formula spending share in year 3.

## Administrative Requirements

E.23. The growth incentive scheme will require some changes to local authorities' existing administrative arrangements. It will also require local authorities to supply some information to central government so that it can monitor the additional revenue retained.

E.24. During the course of 2004 we will then be testing and refining these through an administrative dry run of the scheme with a group of local authorities. **As part of this consultation the government is inviting local authorities to volunteer for being part of the administrative dry run.**

## Evaluation and Revaluation

E.25. It is the Government's intention to evaluate thoroughly the operation and effectiveness of the scheme once it has been operational for two to three years. At that time the Government will review the long term design of the scheme.

E.26. The Government is determined to ensure that the 2010 revaluation does not obscure the economic effect of the scheme or result in windfall gains for certain

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<sup>1</sup> Formula Spending Share is the level of spending by each local authority assumed by central government in deciding how to distribute revenue support grant.

authorities at the expense of others. Details on how this will be achieved will be published nearer the time.

## Summary

E.27. To summarise, the Government sees this scheme as an important part of its economic policy and its approach to local government. The scheme creates strong incentives for local government to maximise economic growth in a manner that most suits the local electorate and in this way the scheme is part of the Government's new approach to Local Government building on the vision of the 2001 White Paper.

E.28. However, the scheme is also new and the Government's approach is therefore cautious. In particular the scheme includes several elements designed to ensure that the distributional impact of the scheme is fair and an incentive to all. The Government is committed to an evaluation process to assess the impact of the scheme before deciding on the long-term design of the scheme. . Nevertheless, the Government is committed to ensuring that the scheme continues for the foreseeable future so as to realise the full benefits from a culture of enterprise and partnership between local authorities and the business community.

# CHAPTER 1

## Objectives and Principles

1.1. This document sets out the objectives, principles and concepts that will guide the Government in designing a scheme to allow local authorities retain some of the revenue from business rates. The primary legislation for the scheme is being sought in the Local Government Bill now in Parliament. This document only applies to the proposals for the scheme in England. This is a devolved matter, and the devolved administrations in Scotland, Wales and Northern Ireland will be deciding policy separately.

1.2. The Government's central economic objective is to achieve high and stable levels of growth and employment. Improving the economic performance of every locality in England is an essential element of that objective, firstly for reasons of equity, but also because unfulfilled economic potential in every locality must be released to meet the overall challenge of increasing the UK's long term growth rate.

1.3. The evidence suggests that productivity differentials are currently at least as great within regions as they are between them.<sup>2</sup> With this in mind the Government has decided to increase the incentives for local authorities to work in partnership with businesses and other stakeholders, such as the Regional Development Agencies, Small Business Service and local Learning and Skills Councils, to maximise local economic growth.

1.4. The Government's intentions in this area were first announced in the Pre-Budget Report issued by the Chancellor of the Exchequer in November 2002.<sup>3</sup> The necessary primary legislation for the scheme was introduced into the Local Government Bill in February 2003 and further information was provided at that time and when the Local Government Bill progressed to the House of Lords.

1.5. This document sets out the broad principles and concepts proposed for the scheme and what they may mean in terms of the technical design of the scheme. When the Government has considered responses to this consultation it will consult on the detailed operation of the scheme. The scheme will become operational following the next business rate revaluation on 1 April 2005.

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<sup>2</sup> *Productivity in the UK: 4 – The Local Dimension*, HM Treasury and ODPM, July 2003, chapter 2.

<sup>3</sup> *Pre-Budget Report 2002: Steering a steady course: Delivering stability, enterprise and fairness in an uncertain world*, HM Treasury, November 2002, p. 143.

## Background to the scheme

1.6. The Government has set ambitious targets to raise the level of economic growth throughout the country and to minimise differences in growth between regions. This is the best way of tackling the consequences of economic failure – unemployment, poverty and inequality – and raising prosperity for all.

1.7. However, at a local level there is currently a mismatch between the costs of economic development and the benefits that accrue from it. Economic development poses direct costs on local authorities in terms of greater congestion on local transport and impact on the local environment. Potentially it also imposes costs on other local authority services, most obviously housing, education and community safety.

1.8. In contrast, the benefits of economic growth typically accrue either to individuals, through more and better employment, or, in tax terms, at a national level. This suggests that whilst costs of economic development accrue at a local authority level, the benefits accrue at a wider level.

1.9. This scheme will change this situation. Currently, all business rate revenues are collected by local authorities and passed into a central pool. These revenues are then re-distributed on a per capita basis. This scheme will allow local authorities to individually retain some of the business rate revenues that are associated with growing the business rate tax base at a local level.

## Objectives of the scheme

1.10. In proposing this scheme, the Government wants to achieve two objectives:

- Firstly, the scheme should give all local authorities an incentive to maximise local economic growth. This means that the scheme has to be as relevant as possible to each local authority.
- Secondly, the scheme will give successful local authorities additional revenues to spend on local priorities. This means that revenues are genuinely additional – i.e. there is no compensating reduction in spending totals set in the 2002 Spending Review – and that revenues are not ring fenced in any way.

1.11. However, it is also necessary to ensure that the scheme operates in a way consistent with other Government priorities and policies. We therefore propose that the following principles should guide the way choices are made between the various options for implementing the scheme:

- **The incentive must be applicable to all authorities** - The scheme must align with the dual objectives of the regional Public Service Agreement growth target to make sustainable improvements in the economic performance of all regions and to reduce the persistent gap in performance

between regions.<sup>4</sup> This means ensuring that the scheme does not create stronger incentives in high growth areas than in low growth areas and that local authorities benefit because of their relative future performance rather than their relative circumstances.

- **The distribution of benefits must be fair** - The scheme will have a controlled impact on distribution of revenues so that benefits from the scheme represent relative performance rather than relative circumstances. This means that a local authority should not receive benefits from the scheme that are out of proportion with their size. The benefits from the scheme to a local authority should also be commensurate with the impact of the scheme in terms of increasing economic growth.
- **The scheme should be as intelligible and transparent as possible** – Consistent with the above objectives the scheme should be as simple as possible and complement existing policy towards economic growth, local government and the business rate.

## Funding Guarantees and Eligibility

1.12. The Government is able to state unequivocally that:

- no business will pay more non-domestic rates through this scheme;
- no reduction in spending totals set in the 2002 Spending Review will be made as a result of this scheme;

1.13. The scheme will cover all local authorities that are responsible for economic development. That is, all shire county, shire district and shire unitary authorities, London boroughs, the Greater London Authority and Metropolitan districts. The City of London will be eligible for reward under this scheme through existing City of London offset legislation. Police and Fire authorities will not be included.

## Summary

1.14. This scheme is driven by the Government's dual objectives to maximise economic growth and to devolve responsibility and decision making to local government. The concept of the scheme has been widely welcomed and this document considers in detail how the scheme could operate.

1.15. This chapter has set out the Government's objectives and guiding principles for the scheme, the remainder of this document considers:

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<sup>4</sup> c.f. *2002 Spending Review: Public Service Agreement Targets*, HM Treasury (2002) p. 11

- The rationale for the scheme against the background of the Government's wider economic and local government policy agendas
- The options for designing the scheme
- The timetable for the introduction and evaluation of the scheme.

**Consultation questions from this chapter:**

Q.1) Do you agree with the principles for the scheme?

## CHAPTER 2

# The Policy Rationale

2.1. This chapter sets out the policy rationale for the scheme. It considers the place of the scheme in economic policy, in local government policy and in business rates policy and shows how the scheme will strongly support the Government's policy in each of these three areas.

## Economic Policy

2.2. The scheme will contribute to two of the Government's key economic targets namely:

- Make further progress by 2006 on the Government's long-term objective of raising the trend rate of growth over the economic cycle from the current estimate of 2.5% and make further progress towards increasing trend growth up to 2006.
- Make sustainable improvements in the economic performance of all English regions and over the long term reduce the persistent gap in growth rates between the regions, defining measures to improve performance and reporting progress against these measures by 2006.<sup>5</sup>

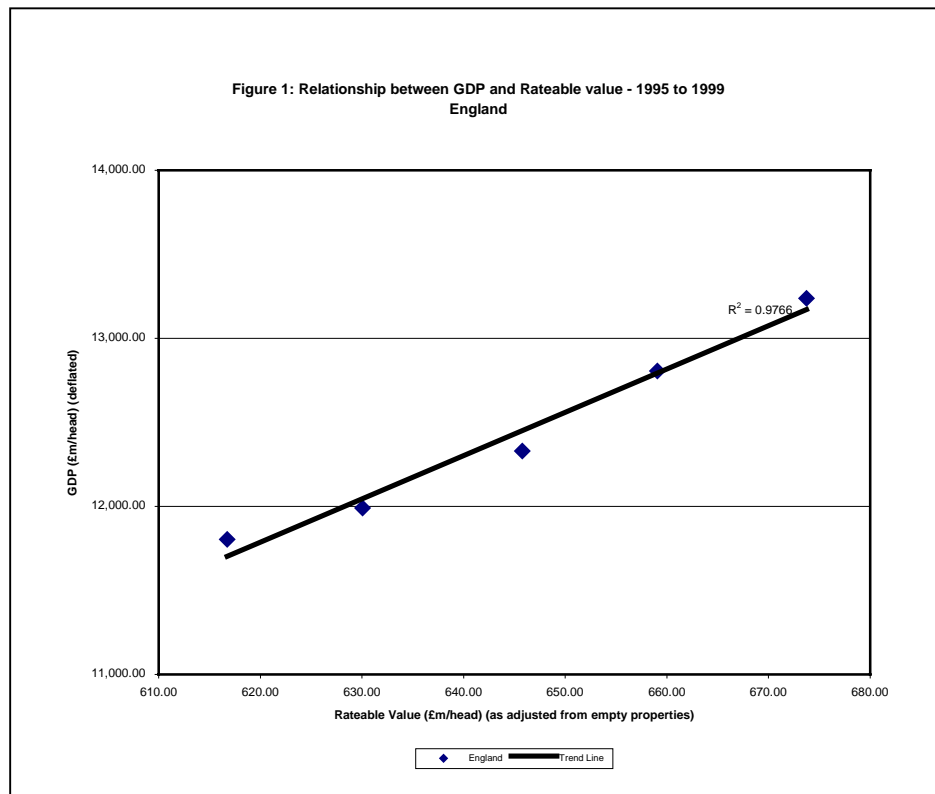
2.3. Business rates are primarily a tax on the rental value of commercial property and are therefore subject to market fluctuations as well as increases in economic growth. However, properties are only valued every five years. So between revaluations, rateable values are unaffected by movements in market price. In the period between revaluations, rateable values can only be increased by the addition and occupation of new properties, by the bringing into use of previously unoccupied properties, or by the enhancement of a property.<sup>6</sup> This means that rateable values can be used as a proxy for increases in enterprise caused by the formation of new businesses, the expansion of existing business or additional capital investment.

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<sup>5</sup> HMT PSA targets 1 & 6 (6 is shared with ODPM and DTI). These are published in *2002 Spending Review: Public Service Agreements*, HM Treasury, July 2002, p. 35.

<sup>6</sup> Strictly, rateable values are unaffected by whether a property is occupied or not. However, for the purposes of this scheme empty property relief is being included in the tax base to ensure that there is no artificial incentive towards new build over occupation of existing buildings. See Chapter 3 and Appendix A for further information.

2.4. Analysis, albeit based on a short period, shows that there is a very strong positive correlation between business rates growth and GDP growth. Figure 1 below shows the rateable value of properties in England and the English GDP during the last revaluation period.<sup>7</sup> The strength of the relationship between the two, as shown on the graph, is over 0.97. Similarly strong relationships exist for all except one of the English Government Office regions (the North East being the exception). Taken in conjunction with other evidence, this suggests that creating incentives for local authorities to increase local enterprise and, as a result, raise the business rate tax base, will have a positive impact on the wider economy and the achievement of the Government's economic objectives.



2.5. To understand this statistical relationship we need to consider how the actions which drive rises in the tax base - namely the formation of new businesses, the expansion of existing business and additional capital investment - impact on economic growth.

2.6. *Enterprise Britain* described how the rate of productivity growth in an economy depends in part upon a high net entry rate or 'productivity churn' – i.e. the rate business is entering the marketplace compared with the rate at which it is leaving it. A high net entry rate was shown to be a major driver of productivity growth because of the difference in productivity between entering and exiting firms. Furthermore, firms entering the market place typically have a more efficient capital-labour mix than

<sup>7</sup> Data limitations make it difficult to make comparisons over a longer period.

incumbents, an effect that is particularly pronounced for productivity in industries experiencing significant technological change.<sup>8</sup>

2.7. This analysis is reinforced by other pieces of research. Barnes, in his work on productivity growth throughout the OECD, estimated that around 26% of productivity growth came from new entrants challenging and replacing existing companies. The Department for Trade and Industry has cited the entry, exit, growth and decline of firms as crucial mechanisms through which economies can allocate society's scarce resources to their most productive allocation.<sup>9</sup>

2.8. As well as reflecting enterprise, rising aggregate rateable values reflect higher levels of investment in physical capital. Growth in an economy relies heavily on investment in physical capital to augment the productivity of labour. In the past, the capital stock of firms and the stock of public infrastructure in the UK has been well below that of its main competitors. *Productivity in the UK* argued that this shortfall has been a major part of the explanation for relatively poor UK productivity, and reflects years of low investment in both the public and private sectors.<sup>10</sup>

2.9. Business rate growth may also have links to the other drivers of productivity. More business coming into a locality may lead to improvements in competition as new firms challenge the old. This may lead to increased innovation as new firms introduce new techniques, products and processes. Responding to the pressures of competition may also require investment in entrepreneurial skills and the development of other skills to gain a competitive advantage. Local Authorities are well placed to support business in these improvements.

2.10. Finally, more business in a locality may mean higher levels of employment. Employment, alongside productivity, is the other key driver of economic growth.

2.11. Therefore, if local authorities respond to the incentives created by the scheme to work with business to maximise the formation of new business, the expansion of existing business and additional capital investment, then this will have a beneficial impact on local productivity and employment leading to stronger economic performance.

## Local Government Policy

2.12. *Productivity in the UK: 4* shows that intra-regional productivity differences are as large as inter-regional ones. These differences explain why the Government's approach

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<sup>8</sup> *Enterprise Britain: a modern approach to meeting the enterprise challenge*, HM Treasury and the Small Business Service, November 2002, p. 18

<sup>9</sup> *The Sources of Productivity Growth: Micro-level Evidence for the OECD*, Barnes, M and Haskel, J, available at [http://www.statistics.gov.uk/articles/nojournal/Paper\\_2\\_oecd\\_prod.pdf](http://www.statistics.gov.uk/articles/nojournal/Paper_2_oecd_prod.pdf) and *Productivity and Competitiveness indicators: Update 2002*, DTI, October 2002, p. 28.

<sup>10</sup> *Productivity in the UK: The evidence and the Government's approach*, HM Treasury, November 2000, p. 9.

to economic growth must be bottom-up, building on the indigenous strengths of individual cities and localities.<sup>11</sup>

2.13. Local authorities, in exercising their community leadership role, have a key role to play in creating the conditions for economic growth at a local level so as to maximise the welfare of their communities. They have a range of tools with which to deliver this including developing and implementing a local economic development strategy, using the planning system, providing the necessary transport infrastructure and ensuring the best educational outcomes. They also have a key role to play in developing a shared vision and partnership with other institutions, such as the Regional Development Agencies, Learning and Skills Councils and Business Links.

2.14. The Government's approach to dealing with intra-regional growth is precisely the same as for dealing with inter-regional growth. The worst-off areas must be given the opportunities to grow to the levels of the strongest, closing gaps in employment, economic activity and enterprise, while at the same time, high-growth areas must have the freedom and flexibilities to continue to grow. This is why the scheme must apply to all local authorities – both high growth areas and disadvantaged areas – if we are to deliver the best outcomes for all people.

2.15. The Government has made it clear that it sees the development of enterprise as an important part of the regeneration of disadvantaged areas, and has introduced a number of policies to support this, as set out in *Productivity in the UK: 4*<sup>12</sup>. The scheme described in this consultation document builds on this approach – the fact that the most disadvantaged areas have the lowest levels of enterprise means that the financial incentives offered by the scheme will provide local authorities with a clear opportunity to tackle the enterprise gap in their areas and to integrate enterprise into their regeneration work.

2.16. Building on the Government's drive to deliver freedoms and flexibilities to the local level and in recognition of the range of conditions faced by local authorities and tools available to them, it is not the Government's intention to prescribe a policy solution to economic growth. Instead, each local authority will be free to develop their own strategy, suited to local economic conditions, to determine how to respond to the scheme. *Productivity in the UK: 4* provides examples of the activities various local authorities are undertaking to maximise and enhance local economic growth as well as explaining the policies of central government in this area. Local authorities should be able to draw from this material in the development of their own policy response to this initiative.<sup>13</sup>

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<sup>11</sup> *Productivity in the UK: 4 – The Local Dimension*, HM Treasury and ODPM, July 2003, Chapter 2.

<sup>12</sup> *Productivity in the UK: 4 – The Local Dimension*, HM Treasury and ODPM, July 2003, Appendix.

<sup>13</sup> *Productivity in the UK: 4 – The Local Dimension*, HM Treasury and ODPM, July 2003, Chapters 3 and 4.

2.17. To help local authorities to develop their own initiatives further, the Government is committed to ensuring that all revenues generated by the scheme will be non-ring fenced. As a result, local authorities would be able to use them in the way that they and their electorate consider will best maximise local outcomes.

2.18. However, it is not the Government's intention to create another priority for local authorities and to prescribe how they should respond to it. Local authorities must make the decision about whether and how to respond to the scheme themselves. The funding provided for this scheme is genuinely additional and spending totals set in the 2002 Spending Review will not be reduced to accommodate this scheme. This means that, if local authorities and their electorate choose not to respond to the incentives, they will not be penalised and will receive the same level of central government grant as they would otherwise have done.

2.19. The Government is also clear that it does not want to distort the decisions taken at local level which must be made in the best interests of the local community. This applies particularly to planning decisions and planning committees must continue to make the decisions that are in the best interests of the local community as a whole. However, the Government would hope that revenues associated with this scheme might prove sufficient to encourage local planning committees to make decisions quicker and to make the right decision first time. This would best serve the interests of both business and the local community.

2.20. The scheme will also promote healthy competition among local authorities to attract new business to their area. However, the rewards will not be of sufficient magnitude to encourage local authorities to poach businesses from neighbouring authorities. Relocation is very expensive and state aid rules significantly limit local authority actions. Indeed, many authorities will find it mutually beneficial for groups of neighbouring authorities to work together under this scheme, as new employment opportunities will provide benefits to neighbouring authorities where the workforce is able to travel.

2.21. In summary, this scheme is a key part of the Government's new approach to local government – providing the tools and incentives to deliver the demands of local people without prescribing what these demands should be.

## Business Rates Policy

2.22. As well as being one element of the Government's vision for locally driven economic growth, this scheme also complements other reforms proposed on business rates.

2.23. Business should find the scheme of major benefit to them. The scheme does not give local authorities the flexibility to change the business rates multiplier. As a result no business will pay more tax than they otherwise would have done. However, the scheme will increase the incentives for local authorities to understand and respond to the needs of local businesses. This can only be in the best interests of local business and of the local community as a whole.

2.24. In this way, the scheme encourages local authorities to build partnerships with businesses so as to involve them in decisions affecting their local area. This complements the approach taken to the creation of Business Improvement Districts, which are funded by an agreed additional levy to the business rate.

2.25. There is already a significant review underway in the area of local government finance - the balance of funding review. This review is involving representatives from central government, local government and other interested bodies to consider whether the current balance between central government grant and local taxation causes particular problems for local authorities and to consider options for change. This scheme does not pre-judge the outcome of that review but the ongoing role of the scheme will need to be considered in the light of the findings of that review.

## Summary

2.26. This chapter has shown that this scheme is bedded firmly in current policy - be that economic policy, local government policy or business rates policy. The next chapter will begin to set out in more detail how the scheme will operate considering in particular the models for grouping local authorities and establishing baseline growth rates.

# CHAPTER 3

## Baselines

3.1. The previous chapter discussed how the Growth Incentive scheme supports the Government's policy objectives in the areas of economic policy, local government policy and business rates policy. This chapter and the next chapter consider the variables which underpin the scheme and on which the Government is consulting. This chapter focuses on the models that the Government has identified for setting baselines for the scheme.

3.2. Appendix A sets out in greater detail the technical method for calculating local authority performance within the scheme.

### What is a baseline?

3.3. The baseline is perhaps the key technical issue for the scheme. It determines the trend growth relative to which individual local authority floors are set and hence has a significant impact on the performance needed by local authorities to benefit from the scheme.

3.4. A baseline is the average growth in rateable values during a period before the scheme starts. This is then used to project anticipated growth during the operation of the scheme.

3.5. The Government proposes to use the eight year period 1995 to 2003 to set the trend for when the scheme goes live on 1 April 2005. The Government believes that this is a sufficiently long period so that the economic cycle will have a minimal impact. However, it is not so long as to use data relating to a period during which the economy was unrecognisable from the current time. The Government does not believe there is a case for extending the trend beyond the 1 April 2003. That would make it difficult to introduce the legislation in sufficient time and risk creating incentives to reduce growth in 2003-04 and 2004-05 so as to maximise benefits from 1 April 2005.

3.6. The Government has identified five different ways of grouping local authorities for determining the baseline. These are:

- National model: All local authorities grouped together with a single national baseline.
- Regional model: Local authorities grouped according to the nine English Government Office Regions.

- National Historic Growth model: Local authorities grouped into five groups of roughly even numbers according to historic growth i.e. those with historic growth in the bottom 20% appear in the bottom group, second 20% are in the second group etc.
- Sub Regional model: A combination of the Regional and National Historic Growth models with local authorities first placed into regions and then subdivided into three groups of roughly even numbers according to historic growth.
- Local Authority model: Each local authority is treated individually and against its own historic average growth.

3.7. Appendix B shows the baselines for each of the first four of these models. It also includes maps of the National Historic Growth model and the Sub Regional model to show the geographical arrangement of these two models. A separate document appears on the ODPM website which shows the baselines for individual local authorities for each of the five models.<sup>14</sup>

3.8. This section now proceeds to examine each of these models against the three principles set out in chapter one – incentive effect, distribution and intelligibility.

## Evaluating Baseline Models – The Incentive Effect

3.9. The strength of the incentive is related to two factors:

- How well does the average growth figure from each model reflect the performance of local authorities?
- How good is the average figure from each model at predicting future performance of local authorities?

3.10. Table A below looks at the first of these by considering the weighted average deviation for each model. In this table, a low number means that on, average, the baseline for each local authority more accurately reflects the authority's actual performance in the eight year historical period than a high number and is therefore a more desirable outcome.

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<sup>14</sup> See <http://www.local.odpm.gov.uk/finance/labgi.htm>

**Table A: Comparison of baseline models to reflect performance in baseline period**

<b>Model</b>	<b>Weighted Average Deviation<sup>15</sup></b>
National	1.16%
Regional	1.12%
National Historic Growth	0.90%
Sub Regional	0.95%
Local Authority	0.00%

3.11. This shows, unsurprisingly, that the Local Authority model is best at reflecting historic performance since it uses actual historic performance to set the baseline. The next best at reflecting historic performance are the National Historic Growth and Sub Regional models with the Regional and National models providing relatively poor fits.

3.12. Table B examines how well different models predict future performance. It does this by taking the baseline figure over the period 1995-6 to 1999-00 and using this to predict performance in the period 2000-01 to 2002-03. In this table, a low number means that on, average, the baseline for each local authority more accurately predicts the authority's actual performance in future years and is therefore a more desirable outcome.

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<sup>15</sup> Weighted average deviation is derived by calculating the local authority average growth in the eight year trend period and comparing this with its baseline group average. The average absolute difference is then calculated with local authorities weighted using adjusted rateable values.

**Table B: Comparison of baseline models to predict performance in future periods**

<b>Model</b>	<b>Weighted Average Deviation<sup>16</sup></b>
National	1.22%
Regional	1.34%
National Historic Growth	1.62%
Sub Regional	1.58%
Local Authority	1.72%

3.13. This shows that the National model is the best predictor of future growth, followed by the Regional model, then the Sub Regional model and National Historic Growth model and finally the Local Authority model.

3.14. The virtual reversing of the order between the two pieces of analysis reflects the underlying volatility of performance at local authority level. This volatility means that trying to be too precise in reflecting performance makes the quality of the predictions poorer.

3.15. Looking at the two tables collectively, the Government concludes that the two outlying models (National and Local Authority) do not provide a good incentive for all local authorities as they either place too much or too little emphasis on historic trend performance of individual local authorities. The remaining three models, however, provide a relatively balanced incentive to local authorities to improve local economic growth.

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<sup>16</sup> Table B uses the period 1/4/1995 to 31/3/2000 to calculate a five year baseline period which is then projected forward as a prediction. This prediction is compared with actual performance for each local authority over the period 1/4/2000 to 31/3/2002. Weighted average deviation is derived by calculating the average absolute difference with local authorities weighted according to adjusted rateable values.

## Evaluating Baseline Models – Distributional Effect

3.16. It is essential that the scheme should not only provide a strong incentive but should also distribute incentives in as fair a manner as possible across the country.

3.17. This is examined by looking at how well authorities might be expected to perform against the models. This is done in detail in the annex to this chapter and is summarised in table C below. In this table a low number means that the model has a relatively small range of outcomes between Government Office regions and is therefore more desirable than a large number which implies a relatively large distributional impact.

**Table C: Intra-Regional Range of baseline models**

<b>Baseline Model</b>	<b>Intra-Regional Range<sup>17</sup> of authorities performing:</b>			
	<b>Within 1% of baseline</b>	<b>Between 1% and 2% of baseline</b>	<b>Between 2% and 3% of baseline</b>	<b>More than 3% away from baseline</b>
National	34%	28%	18%	6%
Regional	55%	30%	42%	18%
National Historic Growth	38%	18%	14%	14%
Sub Regional	32%	19%	16%	21%
Local Authority	40%	30%	19%	15%

3.18. This table shows that the Regional model has the worst distributional fit as it has the highest range in two of the four categories and joint highest in a third category.

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<sup>17</sup> This compares performance for each local authority on each model in the period 2000-01 to 2002-03 against the predicted baseline calculated using the period 1995-96 – 1999-00. Authorities are then grouped regionally and according to how well they performed next to the baseline. The table summarises the information in the annex by showing the range between regions for each category and for each model. Note that unlike table B above there is no weighting in this table.

3.19. The Local Authority model is also not a good fit. On the plus side it has the highest number of authorities overall in the key category of 'within 1% of baseline'. However, it has the joint highest range for the 'between 1% and 2%' category and it suffers from the undesirable effect of having more authorities performing more than 3% away from baseline than between 2% and 3%.

3.20. The National model ranks third on distributional effect as it has the fewest authorities within 1% of baseline overall but this is compensated for by having the highest number of authorities between 1% and 2% of baseline. It also has the fewest authorities in the undesirable 'over 3%' category and has the smallest intra-regional range of authorities within this category.

3.21. The judgement between the National Historic Growth and Sub Regional models is finely balanced. The National Historic Growth model has the best distributional range for the 'between 1% and 2%' and the 'between 2% and 3%' of baseline categories. However, it has the undesirable effect of having more authorities in the 'more than 3%' away from baseline category than the 'between 2% and 3%' category and has the most authorities overall in the 'more than 3%' category.

3.22. The Sub Regional model, on the other hand, has the lowest range for the key 'within 1%' category. However, it has the highest range for the 'more than 3%' category going from 0% of authorities in this category in the North East to 21% of authorities in this category in London.

3.23. The Government is also keen that the scheme should benefit authorities with high levels of deprivation as it is in these areas that the biggest challenges to encouraging enterprise are often found. Government policies to tackle the barriers to enterprise and economic activity are concentrated in 2000 Enterprise Areas across the UK. An analysis of the five models weighted according to the percentage of wards with Enterprise Area status shows that these wards benefit most from the National Historic Growth and Sub Regional models.

3.24. The other key distributional issue is that of authorities facing a declining business rate. In these circumstances there may be a case for giving the authorities benefit for slowing the pace of decline. An analysis of the performance of individual local authorities in the period shows that this does not effect a significant number of authorities. In the period 1995-2000 only 5 out of 354 billing authorities faced declining tax bases. In the period 2000-2003 this number rose to 8 but overall in the eight year period from 1995-2003 only 3 authorities faced a decline.<sup>18</sup>

3.25. The only model that benefits these authorities directly is the Local Authority model as the baselines for all other models are above zero. The limited number of authorities involved does not suggest that there is a strong case for favouring the Local Authority model given the problems with this model identified above. However, the way

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<sup>18</sup> The historic growth figures for individual local authorities is available at <http://www.local.odpm.gov.uk/finance/labgi.htm>

floors are set relative to the baseline may mean that some authorities still get benefit for slowing a decline. This is discussed more fully in the next chapter.

3.26. Overall, the Government concludes from this analysis that the Regional model does not have a good distributional fit and should be ruled out at this stage.

## Evaluating Baseline Models – Intelligibility Test

3.27. The final test is the intelligibility test, that is how simple the scheme is to operate and how intelligible it is to the outside world. More than any other test this is a matter of how the models are perceived in the outside world.

3.28. Tentatively, the Government suggests the following analysis but is keen to invite views on this issue.

3.29. The National model is clearly the simplest model as it has only one baseline. It is also probably the most understandable although many authorities and local people may wonder why their authority has to perform relative to the national average given the diversity of economies at the local level.

3.30. The Regional model is also a fairly simple scheme as it only involves nine English baselines. Regional analysis is also fairly common and so many people would consider this a relatively understandable grouping. However, while many people appreciate concepts of regional economies, there is still considerable variation at regional level and so many may question the relevance of this grouping.

3.31. The National Historic Growth model is simple in that it has only five baselines. However, it is not necessarily very understandable – it uses new and previously undefined categorisations and so ignorance will have to be overcome in pursuing this option. Furthermore, it has no regional relationship, which does not match with either the Government's approach to economic policy or the way people identify with where they live. For example, it is difficult to understand why an authority in the South West is in the same group as an authority in the North East but not in the same group as a relatively nearby authority.

3.32. The Sub Regional model is more complex as it has 27 groupings. However, it is probably more understandable than the National Historic Growth model as it produces fewer options in any one region and does not create the odd situation of being in the same category as an unrelated authority hundreds of miles away. As the maps in Appendix B show, the Sub Regional produces more contiguous units than the National Historic Growth model. It also reflects better the organisation of economic policy, which has a strong regional element through the RDAs and Learning and Skills Councils. However, it has more groupings than either the National, Regional or National Historic Growth model. Furthermore, when compared to the National Historic Growth model it does produce the odd result of giving different baselines to authorities with identical historical performance.

3.33. The Local Authority model is clearly the most complex option as it involves creating a baseline for each authority. However, it is probably more understandable than either the National Historic Growth or Sub Regional model, both of which are likely to group authorities in non-contiguous groupings. This model, though, may raise serious questions in the minds of authorities about the relevance of using an historic period to estimate future performance as local economic performance is likely to be more volatile than that of a larger grouping.

3.34. The judgement on intelligibility is not clear cut. The models get more complex in terms of the number of groups as one progresses from the National model through to the Local Authority model. However, the more complex models of National Historic Growth, Sub Regional and Local Authority are likely to appear more fair as they take greater account of local authority circumstances.

## Summary

3.35. This section has outlined the five baseline models that the Government has identified and discussed how each of them operates. It has also examined each of them against the incentive effect, distributional effect and intelligibility test.

3.36. As a result of the incentive effect and distributional effect the Government does not favour the National, Regional and Local Authority models. The analysis under the intelligibility test is less clear cut. As a result the Government currently favours the National Historic Growth and Sub Regional models.

3.37. The next section will look at the other controllable variables of floors, ceilings, scaling factors and tiers.

### **Consultation questions from this chapter:**

- Q.2) Do you agree with using an eight year period for setting the trend?
- Q.3) Are there models for setting the baseline that the Government has not considered that need to be considered?
- Q.4) Which of the baseline models is your preferred option and why?

## Annex: Detailed analysis of distributional impact of different models

Model	National				Regional				National Historic Growth				Sub Regional				Local			
	Within 1% of baseline	Between 1% and 2% of baseline	Between 2% and 3% of baseline	More than 3% away from baseline	Within 1% of baseline	Between 1% and 2% of baseline	Between 2% and 3% of baseline	More than 3% away from baseline	Within 1% of baseline	Between 1% and 2% of baseline	Between 2% and 3% of baseline	More than 3% away from baseline	Within 1% of baseline	Between 1% and 2% of baseline	Between 2% and 3% of baseline	More than 3% away from baseline	Within 1% of baseline	Between 1% and 2% of baseline	Between 2% and 3% of baseline	More than 3% away from baseline
Government Office Region																				
East	65%	25%	2%	8%	67%	23%	2%	8%	46%	33%	8%	13%	52%	33%	10%	4%	54%	33%	2%	10%
East Midlands	43%	30%	18%	10%	53%	23%	18%	8%	65%	15%	15%	5%	55%	23%	18%	5%	65%	18%	5%	13%
London	30%	42%	18%	9%	21%	18%	42%	18%	33%	30%	18%	18%	45%	21%	12%	21%	36%	27%	21%	15%
North East	48%	30%	17%	4%	65%	30%	4%	0%	61%	30%	4%	4%	65%	26%	9%	0%	57%	39%	4%	0%
North West	42%	44%	9%	5%	51%	44%	0%	5%	56%	23%	5%	16%	40%	30%	21%	9%	60%	16%	12%	12%
South East	52%	30%	12%	6%	37%	31%	25%	6%	51%	24%	10%	15%	49%	28%	13%	9%	51%	30%	6%	13%
South West	56%	40%	0%	4%	62%	33%	0%	4%	49%	31%	9%	11%	53%	22%	20%	4%	60%	24%	4%	11%
West Midlands	35%	53%	6%	6%	65%	15%	12%	9%	44%	32%	12%	12%	56%	21%	15%	9%	50%	26%	9%	15%
Yorkshire & Humberside	52%	33%	10%	5%	76%	14%	0%	10%	71%	19%	5%	5%	71%	14%	5%	10%	76%	10%	10%	5%
England	48%	36%	10%	6%	53%	27%	12%	7%	52%	27%	10%	12%	52%	25%	14%	8%	56%	25%	8%	11%
Minimum Region	30%	25%	0%	4%	21%	14%	0%	0%	33%	15%	4%	4%	40%	14%	5%	0%	36%	10%	2%	0%
Maximum Region	65%	53%	18%	10%	76%	44%	42%	18%	71%	33%	18%	18%	71%	33%	21%	21%	76%	39%	21%	15%
Intra Regional Range	34%	28%	18%	6%	55%	30%	42%	18%	38%	18%	14%	14%	32%	19%	16%	21%	40%	30%	19%	15%



## CHAPTER 4

# Floors, Scaling Factors, Ceilings and Tiers

- 4.1. The previous chapter discussed the baseline models for the Growth Incentive scheme. These set the historic trend growth against which future performance is measured.
- 4.2. This chapter focuses on the other key issues for consultation – the setting of floors, scaling factors, ceilings and the relationship between different tiers of local authorities. These trade-off some of the overall incentive effect created by using trend growth in an attempt to try and increase the number of authorities to whom the scheme is relevant.
- 4.3. Appendix A sets out in greater detail the technical method for calculating local authority performance within the scheme.

## Floors, scaling factors and ceilings

- 4.4. The most significant of these trade-offs involves floors, scaling factors and ceilings. By setting a cut-in point for individual local authorities that is below historic trend, more authorities can benefit from the scheme without improving performance. The trade-off, though, is that this can only be achieved by allowing local authorities to retain less than 100% of revenues otherwise the distributional impact of the scheme is increased and the benefits from the scheme begin to outweigh its potential cost. Furthermore, it seems sensible to cap or put a ceiling on gains at some stage to stop relative benefits from the scheme becoming excessive and creating huge advantages for some authorities at the expense of others.

### WHAT ARE FLOORS AND SCALING FACTORS?

- 4.5. The floor is the percentage growth above which an individual local authority must progress to benefit from the scheme. This is related to the baseline by a national adjustment factor.
- 4.6. To take an example, Babergh district council under the Sub Regional model faces a baseline of 1.6%. Assume that the national adjustment factor is set at -1%. This means that the authority faces a floor of 0.6% and would get to retain some of

the revenue associated with growth above this point. Under the same example Leeds metropolitan district council which is in the Yorkshire & Humberside High group faces a baseline of 2.6%. This means that the floor is 1.6% and the authority would get to retain some of the revenue associated with growth above that point.

- 4.7. Scaling factors set the percentage of revenues retained locally - with the rest being remitted to the business rate pool as currently occurs. For example, if the scaling factor is set at 50% then a local authority will retain 50% of revenues above the floor with 50% being remitted to the pool.

## **THE IMPACT OF CEILINGS**

- 4.8. Ceilings determine the maximum benefit to individual local authorities from the scheme. In the interests of equity it is important that ceilings are set relative to a variable that provides a real indication of the relative size of the authority.
- 4.9. The Government believes that the best variable next to which to set ceilings is formula spending share (FSS) which is the level of local authority spending assumed by central government in determining grant allocation.
- 4.10. The main disadvantage of using formula spending share is that is not consistent with the way that floors are calculated based on rateable values. The Government has considered other variables for setting ceilings such as percentage of business rate revenues or an amount per head of population. However, using rateable values produces a very heavy skewing of the incentive towards areas with an existing high level of activity - which is not necessarily related to the size of the authority and the investment being made to improve business development. Population is a fairer indicator than rateable value but still does not take sufficient account of the relative functions of different local authorities and the relative costs imposed by additional business development.
- 4.11. The impact of ceilings is to ensure that the distribution of gains from the scheme is more measured than would otherwise occur. However, they also restrict the effectiveness of the incentive effect as once an authority is in the ceiling the incentive to do better is reduced as the benefits are reduced. A study of data over time suggests that the number of authorities affected by the ceiling reduces after the scheme has been operational for a few years. This is due to the variability of local authority performance as major developments are not delivered in a measured manner whereas ceilings grow more evenly.
- 4.12. Bearing all these factors in mind, the Government proposes a ceiling of 1% per annum of formula spending share rising as the scheme rises. The Government's view is that this represents a significant amount of resources for local authorities to benefit from, and thus reflects a sensible level of incentive, whilst keeping the distributive gains from the scheme measured.
- 4.13. A possible impact of such a ceiling is illustrated in the table below:

**Table D: Illustrative impact of a ceiling**

<b>Year</b>	<b>Minimum Local Authority gain from the scheme</b>	<b>Ceiling (Maximum gain)</b>
1	0% of FSS	1% of FSS
2	0% of FSS	2% of FSS
3	0% of FSS	3% of FSS

- 4.14. In considering options the Government is concerned to minimise the number of authorities in the ceiling. Overall, the Government believes that on historical data the maximum number of authorities in the ceiling should be around 25 to 30% of the total number of authorities in year 1 and falling thereafter.

#### **MINIMUM AND MAXIMUM SCALING FACTORS**

- 4.15. To maintain equity between options there is a trade off between floors and scaling factors – a higher floor is harder to get over but a local authority will receive a higher percentage of revenue above the floor. A lower floor will be relatively easy to progress beyond but a local authority will receive a lower percentage of revenue above the floor.
- 4.16. The scheme is primarily about creating incentives for better performance. Since low scaling factors reduce the incentive to do better the Government is concerned to ensure that scaling factors do not restrict performance too far. We therefore propose that the minimum scaling factor should be around 60%.
- 4.17. The Government also believes that there is a strong case that the maximum possible scaling factor should be less than 100%. This would ensure that some of the gains would always have to be paid into the business rates pool for the benefit of all local authorities. This would ensure a better distributional outcome from the scheme. We therefore propose that the maximum scaling factor should be around 95%.

#### **OPTIONS ON FLOORS AND SCALING FACTORS**

- 4.18. Bringing all the factors listed above together, the Government has identified two main variants for the setting of floors and scaling factors:
- A high floor/high scaling factor option. Under this option individual local authority floors will be set high so that only around 50% of authorities will receive benefit from the scheme without improving

performance. However, this will be compensated for by a high scaling factor, allowing retention of, say, 95% of revenues above the floor. Under this option around 25% of authorities may be in the ceiling in year one falling to less than 20% in year 3.

- A medium floor/medium scaling factor option. Under this option, individual local authority floors will be set so that around 75% of authorities will receive benefit from the scheme without improving performance. However, there will be a lower scaling factor with local authorities allowed to retain around 65% of revenues above the floor. Under this option around 30% of authorities may be in the ceiling in year one, falling to over 20% in year 3.

- 4.19. In setting floors and scaling factors, it would be possible to have a lower floor which, for example, ensured that 90% of authorities benefited from the scheme without improving performance. However, this could only be achieved by having a lower scaling factor of around 35% and placing more authorities in the ceiling. At this level, the Government believes that the incentive effect to improve performance becomes too weak and it is not attracted to this option.
- 4.20. Implicit in deciding between options is the need to weigh up the need for additional resources to do better and the need for an incentive and rewards for doing better.
- 4.21. The high floor/high scaling factor option means that local authorities get better rewards for improving their performance. The assumption underpinning this option would be that many authorities could spend existing resources more effectively to maximise economic growth and that therefore more resources are needed as an incentive to do better rather than as extra resources to spend on doing better. Furthermore, fewer authorities are in the ceiling in this option reflecting a better overall incentive.
- 4.22. The medium floor/medium scaling factor option means that many more authorities benefit from the scheme although the reward for doing better is reduced. The assumption underpinning this option would be that most authorities already do what they can within existing resources to maximise economic growth and what is needed are additional resources to improve performance for the majority. Nevertheless, there would be an assumption that authorities who perform poorly relative to their group could do more to maximise economic growth within existing resources. Furthermore, more authorities are in the ceiling in this option reflecting a worse overall incentive.
- 4.23. The material presented in *Productivity in the UK: 4* on Blackburn with Darwen, Manchester and Leeds show what local authorities are achieving by placing economic development at the centre of their mission and within their existing resource structure. This perhaps provides qualitative evidence that the hypothesis

underpinning the medium/medium option, namely that authorities need up front support rather than an incentive to do better, does not hold.<sup>19</sup>

- 4.24. On the other hand, chapter three shows that there are a limited number of authorities who face a declining tax base. Under a high/high option these authorities will not receive benefit from the scheme for slowing the pace of decline. The medium/medium option, however, results in some authorities getting a floor of less than 0% and therefore means that that the limited number of authorities affected do have potential to benefit from slowing the pace of decline. However, under a medium/medium option significant numbers of authorities who currently have positive growth also face a floor of less than 0%. This potentially generates a perverse result of giving benefit to these authorities despite a significant decline in the local economy.
- 4.25. An alternative viewpoint is that the authorities most in need of the scheme are not just those with a declining tax base but those with an overall poor economic record. There is a substantial gap in levels of entrepreneurship between high performing areas and the most disadvantaged. Government policies to tackle the barriers to enterprise and economic activity are concentrated in 2000 Enterprise Areas across the UK. Analysis of the high/high and medium/medium options shows that authorities with Enterprise Areas benefit more relative to other authorities from a high/high option.
- 4.26. The Government will also want to ensure that the way this scheme works in the growth areas identified in the Government's Sustainable Communities strategy, such as the Thames Gateway, is fully consistent with this strategy.
- 4.27. The Government is keen to invite opinions from all consultees on which of the medium/medium and high/high option they prefer and why. The setting, impact and interaction of floors, scaling factors and ceilings is complex. Furthermore, estimating the impact of different options on the incentive in advance of the scheme is also difficult. As a result it is likely that this will form a key part of the evaluation process mentioned in the next chapter.

## Sharing of revenues between tiers

- 4.28. The Government has been clear that this scheme only applies to those authorities that could significantly impact on economic regeneration. For that reason, Police and Fire authorities would be excluded from the scheme. This means that in metropolitan areas and some shire areas only a single authority would benefit from the scheme.

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<sup>19</sup> *Productivity in the UK:4 – The Local Dimension*, HM Treasury and ODPM, July 2003, Chapter 3

- 4.29. However, in London benefits could be shared between boroughs and the Greater London Authority (GLA). Furthermore, in the remaining shire areas benefits could be shared between a district and a county.
- 4.30. The principal argument for sharing benefits is to acknowledge the role of counties and the GLA in economic development activities and that economic growth imposes costs on these authorities. However, the business-local authority partnership that this scheme is designed to encourage may best be realised by focusing on the taxpayer relationship with the collecting authority. Shire counties and the GLA do not collect business rates and so this relationship may not be formed. Furthermore, the GLA, in particular, already receives significant resources from central government to pay for its development role through the London Development Agency.
- 4.31. If benefits are to be shared, then there are two extreme options for doing this:
- Using formula spending shares adjusted for fire and police authorities which would mean that shire counties would get approximately 85%, shire districts 15%, the Greater London Authority 0% and London boroughs 100%.
  - Using relative economic development spend over the baseline setting period. This would mean that shire counties would receive approximately 15%, shire districts 85%, the GLA 12% and London Boroughs 88%.
- 4.32. It is unclear where the balance of argument lies between these two options. Indeed the balance may be somewhere in between with, say, shire counties and shire districts sharing benefits in a 50/50 split.
- 4.33. The Government will be undertaking further work on this area before finalising its proposals. However, at this stage we would be very interested in the views of consultees on this difficult area.

## Summary

- 4.34. This section has considered the various options the Government has identified for the setting of floors, scaling factors, ceilings and tiers. The Government is inclined to set ceilings at 1% of formula spending share per annum rising as the scheme rises. The Government is unsure on the best way to share revenues between tiers and is particularly interested in comments in this area.
- 4.35. On floors and scaling factors the Government is currently unsure on the best option between a high/high and medium/medium approach as the trade off between better rewards for improvement and more up-front support is complex. We particularly welcome comments in this area.

4.36. Bringing together chapters three and four the Government has four main options that it currently favours:

- A National Historic Growth model with a high floor and high scaling factor;
- A National Historic Growth model with a medium floor and medium scaling factor;
- A Sub Regional model with a high floor and high scaling factor;
- A Sub Regional model with a medium floor and medium scaling factor.

4.37. The next section will look briefly at some of the longer term factors that will need to be considered once the scheme has been introduced.

#### **Consultation questions from this chapter**

- Q.5 ) Which of the two preferred options for floors and scaling factors (high/high and medium/medium) do you think provides the best balance between financial support and financial incentive?
- Q.6 ) Do you agree with using formula spending shares as the measure for determining ceilings? Do you agree that a 1% ceiling in year one of the scheme rising in line with the scheme (i.e. reaching 3% in year three) provides an adequate balance of incentive and cap on gains?
- Q.7 ) How do you think that benefits should be shared between different tiers of local government?

# CHAPTER 5

## Next steps

- 5.1. The previous chapters in this document have set the scheme in its wider policy content and introduced and invited comments on the variables that will control the operation of the scheme. This chapter summarises and sets out the next steps between now and introduction of the scheme and briefly considers some of the medium term issues that will need to be determined in due course.

### Consultation

- 5.2. The first step in the introduction of the scheme is the consultation, which this document initiates.

- 5.3. To summarise, the consultation questions raised in this paper are:

- Q.1 ) Do you agree with the principles for the scheme?
- Q.2 ) Do you agree with using an eight year period for setting the trend?
- Q.3 ) Are there models for setting the baseline that the Government has not considered that need to be considered?
- Q.4 ) Which of the baseline models is your preferred option and why?
- Q.5 ) Which of the two preferred options for floors and scaling factors (high/high and medium/medium) do you think provides the best balance between financial support and financial incentive?
- Q.6 ) Do you agree with using formula spending shares as the measure for determining ceilings? Do you agree that a 1% ceiling in year one of the scheme rising in line with the scheme (i.e. reaching 3% in year three) provides an adequate balance of incentive and cap on gains?
- Q.7 ) How do you think that benefits should be shared between different tiers of local government?
- Q.8 ) (If a local authority) Would you like to volunteer to be part of the administrative dry run?

- 5.4. The consultation will run until the **31 October** and consultees are invited to send their comments to:

Mr Tim Fairclough  
Office of the Deputy Prime Minister  
Eland House, 5/H2  
Bressenden Place  
London SW1E 5DU.

- 5.5. Alternatively, they could send comments by email to:

[labgi.consultation@odpm.gsi.gov.uk](mailto:labgi.consultation@odpm.gsi.gov.uk)

## Setting the Legislation for the Scheme

- 5.6. Once the consultation has concluded the Government will consider the responses and decide on the best way forward. The primary legislation for the scheme is contained in the Local Government Bill that is currently before Parliament.
- 5.7. Having considered the responses from the consultation the Government will draw up the appropriate secondary legislation and will hold a consultation on this in 2004. This secondary legislation will then be introduced into Parliament in December 2004 in time for the scheme to be introduced fully from the 1 April 2005.

## Administrative Requirements

- 5.8. The growth incentive scheme will require some changes to local authorities' existing administrative arrangements. It will also require local authorities to supply some information to central government so that it can monitor the additional revenue retained.
- 5.9. Particular issues that will need to be considered include:
- The process and timetable for issuing threshold figures each year.
  - The impact of the scheme on the estimation, by billing authorities, of contributions to the business rate pool.
  - The processes involved in transferring additional revenue from billing authorities to other local authorities.
  - The process by which amounts will be rolled forward at the end of each financial year.

- How the additional retained revenue should be taken into account in local authority budget-setting calculations.
  - How statistical returns to ODPM should be amended to monitor the amounts of additional revenue retained by billing authorities and those passed to major precepting authorities.
  - Whether changes are needed to the external audit requirements for local authorities.
  - Implications of the changes for local authority software systems, including the timescales needed for making changes.
- 5.10. Over the next few months the Government will be considering the exact form of the above administrative changes. During the course of 2004 we will then be testing and refining these through an administrative dry run of the scheme with a group of local authorities. This will not involve the retention of any revenues but will be used as an opportunity to develop the necessary systems at local level, the interface between local Government and the central pool and, if needed, the audit requirements for the scheme. **As part of this consultation the government is inviting local authorities to volunteer for being part of the administrative dry run.**

## Evaluation

- 5.11. The scheme represents an important change in principle in how the benefits of economic development are shared between central and local government. However, the Government's approach at this stage is cautious as it is unclear how big an effect the scheme will have on changing behaviour of local authorities and in improving and maximising local economic growth.
- 5.12. To help gather evidence on the impact of the scheme, the Government is committed to commissioning a detailed evaluation of the scheme. Plans for this are not yet finalised but we propose that the evaluation compares the situation immediately before the scheme was introduced with that two to three years into the scheme so as to fairly judge its impact. The intention is to measure both national indicators and do more in-depth case studies of a number of areas. These case studies would look closely at changes in how local authorities encourage business, and at the impact of the scheme on the ground. An evaluation specification will be completed by late 2004.
- 5.13. The results of the evaluation will be used to help the Government decide on the design of a longer term approach to the scheme. However, the Government is committed to ensuring that the scheme continues in the longer term so as to realise the full benefits from a culture of enterprise and partnership between local authorities and the business community.

## Revaluations

- 5.14. Business rate properties are subject to revaluation every five years. At revaluation movements in market demand and supply become incorporated into the business rate valuation of a property.
- 5.15. The Government's intention is to eliminate the impact of revaluation on the local authority gains from the scheme. This is because revaluation movements are due to a wide range of macro and micro economic effects and not simply related to movements in economic use which are picked up between revaluations. It is also because the Government is concerned to ensure that some local authorities do not make windfall gains at the cost of other local authorities. However, we are also concerned to ensure that we do not create perverse incentives around the time of a revaluation.
- 5.16. No adjustment needs to be made for a revaluation until the 1 April 2010. By then a thorough evaluation of the scheme will have been carried out and this may cause us to re-visit how baselines, floors, ceilings and scaling factors are set as well.
- 5.17. Our current thinking is that the revaluation will be accommodated by adjusting the cumulative gains to date for each local authority by the national movement in values as adjusted for inflation. This should ensure that gains as of 31 March 2010 will have the same value on the 1 April 2010 as they would have done without a revaluation. However, given the timescale until revaluation starts to take effect, it seems premature to sketch in detail how a revaluation will be accommodated. Following the evaluation of the scheme full details of how the scheme will be amended from 1 April 2010 will be published.

## Summary

- 5.18. To summarise, the Government sees this scheme as an important part of its economic policy and its approach to local government. The scheme creates strong incentives for local government to maximise economic growth in a manner that most suits the local electorate. In this way the scheme is part of the Government's new approach to Local Government building on the vision of the 2001 White Paper *Strong Local Leadership – Quality Public Services*.
- 5.19. However, the scheme is also new and the Government's approach is therefore cautious. In particular the scheme includes several elements designed to ensure that the distributional impact of the scheme is fair and an incentive to all. The Government is committed to an evaluation process to assess the impact of the scheme before deciding on the long-term design of the scheme. . Nevertheless, the Government is committed to ensuring that the scheme continues for the foreseeable future so as to realise the full benefits from a culture of enterprise and partnership between local authorities and the business community.

# APPENDIX A

## Technical Working of the Scheme

A.1. This appendix sets out in greater detail how the benefits for individual authorities will be calculated. The issues considered are:

- Baselines;
- Calculating growth beyond the floor;
- Adjusting growth for scaling factors and tiers of government;
- Applying ceilings to calculate revenue retained;
- Reliefs and appeals.

### Baselines

A.2. The steps in calculating the baseline are:

- Establishing the baseline starting value and cumulative growth in the five year period 1995-96 to 1999-00;
- Establishing the baseline starting value and cumulative growth in the three year period 2000-01 to 2002-03;
- Adjusting the period 1995-96 to 1999-00 for revaluation and adding together the cumulative growth amounts;
- For the National Historic Growth model and the Sub Regional model – comparing performance of local authorities to work out the groupings;
- Adding together all the starting values and cumulative growth for each baseline grouping and then calculating the average percentage increase in growth throughout the eight year period;

A.3. The starting rateable value on the 1 April 1995 is taken directly from the Valuation Office lists for each billing authority. To prevent the creation of an artificial incentive to favour new build over empty properties, this amount is then adjusted downwards by the amount of empty and partially empty property relief in the previous 12 months, as adjusted for the national change in tax base as a result of revaluation. This gives the starting position for calculating trend growth.

A.4. Growth itself is measured each year using the rateable value of additions to the ratings list plus the net increase as a result of enhancements less the number of demolitions. This amount is also adjusted for the movement of empty properties by comparing the amount granted in empty property and partially empty property relief for the year in question with the starting point as adjusted for revaluation. Growth for each of the five years from 1 April 1995 to 31 March 2000 is calculated in this way and added together to give a cumulative growth period. This is then annualised to give a five year growth rate for each authority.

A.5. The growth for the period 2000-01 to 2002-03 is calculated in the same way as the growth for the previous five year period.

A.6. The starting point for the baseline calculation is then worked out by taking the rateable value on the 1 April 2000 as adjusted for empty and partially empty property relief and working back five years using the annualised growth rate from the period 1995-96 to 1999-00. The difference between the adjusted 1 April 2000 rateable value and the starting point is then added to the cumulative growth from the period 2000-01 to 2002-03 to give an eight year cumulative growth amount.

A.7. For the National Historic Growth model and the Sub Regional model authorities are then ranked, either nationally or regionally, using annualised growth rates rounded to one decimal place. These rankings are then used to split authorities into five or three groups as appropriate. Authorities with the same annualised growth to one decimal place are placed in the same group this meaning that groups are not necessarily of exactly equal size.

A.8. Authorities are then grouped according to their baseline group. Within each grouping the starting points and cumulative growth for every authority are combined and then used to calculate an annualised eight year growth rate for the baseline group.

A.9. The annex to this appendix gives a worked example for the calculation of the baseline for a hypothetical local authority.

## Calculating growth beyond the floor

A.10. The starting point for the calculation of growth is the rateable value on the 1 April 2005 as adjusted for empty and partially empty property relief in the 2004-05 year.

A.11. Annual growth is defined as additions to the ratings list, plus the net increase as a result of enhancements, less the number of demolitions. This amount is also adjusted for

the movement of empty properties by comparing the amount granted in empty property and partially empty property relief for the year in question with the starting point as adjusted for revaluation. Annual growth is added together to give a cumulative growth figure since the scheme was introduced.

A.12. The billing authority floor is calculated by taking the annualised baseline figure and adjusting for the national adjustment factor. This is then factored up for the number of years since the introduction of the scheme and multiplied by the starting point.

A.13. The cumulative growth since the introduction of the scheme is then compared to the floor. The billing authority gets the benefit of growth above the floor but receives nothing if it does not manage to reach the floor.

A.14. The level of growth above the floor is then multiplied by the business rate multiplier for the year in question to give the maximum possible benefit for the billing authority.

A.15. The administrative and legal arrangements surrounding the scheme will need to take account of the difficulties of estimating future growth. This will be done so as to allow local authorities reasonable access to revenues from the scheme at the earliest possible opportunity without possibly endangering the future stability of revenues from the scheme.

## Adjusting growth for scaling factors and tiers of government

A.16. The billing authority benefit as calculated above is then reduced firstly by the scaling factor and then for different tiers of local government. The non-retained portion after the scaling factor is to be submitted to the business rate pool to be shared amongst all local authorities. The non-retained portion after the tier calculation is to be given to the upper tier authority – either the county council or the Greater London Authority. Unitary authorities potentially get the benefit of all revenues after the scaling factor has been applied.

## Applying ceilings to calculate revenue retained

A.17. Ceiling calculations are carried out for both billing authorities and upper tier authorities. For this the revenue retained after scaling factors and tiers have taken effect is compared to the ceiling which the Government proposes to calculate as a percentage of formula spending share.

A.18. The ceiling sets the maximum revenue that the local authority is allowed to retain – additional revenues have to be passed back to the business rate pool for distribution amongst all local authorities.

# Impact of mandatory and discretionary reliefs and of appeals

A.19. The most significant reliefs from business rates are for empty or partially empty properties. As explained above these reliefs will count within scheme, so as to not create perverse incentives for new build over empty properties.

A.20. Beyond these reliefs, a large range of non-domestic organisations, such as charities and sports clubs, are eligible for relief from business rates. Some of these reliefs are mandatory and some discretionary, and some of the cost of discretionary relief is borne by the Exchequer and some is shared with the local authorities. The Government has no desire to change the present structure of reliefs or change any incentives on local authorities in this respect. These other reliefs will therefore be ignored for the purposes of the scheme and the full rateable value of the property will count towards each authority's assessment under the scheme, not the rates actually collected.

A.21. Transitional relief is also available following a revaluation. Transitional relief will have no impact on the scheme until after the 2010 revaluation and exact details of how the relief will be accommodated will be published at the same time as the Government's plans for dealing with revaluation. However, the Government does not intend for transitional relief to impact on the scheme.

A.22. Since valuations for rating purposes are made by central government agencies, authorities will not see their rewards under the scheme reduced by successful appeals. To do so would be unfair to authorities and would introduce uncertainty and complexity to the scheme.

# Annex: Worked Example of Baseline Calculation

## Step 1: Calculation of starting value on 1 April 1995

- For hypothetical authority X the rateable value on 1 April 1995 was £50m.
- The empty property and partially empty relief granted in the period 1994-95 was £5m.
- The empty property relief amount is firstly adjusted by the multiplier to give an approximate rateable value amount - £5m divided by 0.423 gives £11.82m.
- The revaluation effect is given by the multipliers in 1994/5 and 1995/6 adjusted for inflation i.e. 0.423 divided 0.432 and then multiplied by 1.022 giving 1.000708. This gives an adjusted empty property relief rateable value of £11.83m
- Adjusted the baseline for empty property relief gives a revised starting point of £38.17m.

## Step 2: Calculation of annual growth in 1995-96 to 1999-00

- Authority X has additions to the rateable value list in 1995-96 of £1m. Net enhancements also total £1m whilst £0.5m was lost to demolitions. This totals to a net growth in the ratings list of £1.5m.
- The value of empty property and partially empty property relief granted in 1995-96 was £5.1m. Dividing this by the multiplier in 1995-96 of 0.432 gives a rateable value impact of £11.81m. Subtracting this from the revalued 1994/5 amount of £11.83m shows that empty properties have decreased in value by £0.02m.
- The decrease in value of empty property relief is added to the net growth in tax base to give a net increase in adjusted tax base of £1.52m or 3.99%.
- This process is repeated for each year to 1999-00 and the five years of net increase in adjusted tax base amounts are added together to give a cumulative figure. For Authority X this cumulative figure is £3.97m. Annualising this over 5 years gives an average growth rate of 2%.

## Step 3: Calculation of adjusted rateable value on 1 April 2000 and growth to 2002-03

- Steps 1 and 2 above are repeated for the three year period from 1 April 2000 to 31 March 2002.

- For Authority X the adjusted rateable value on 1 April 2000 was £45m and the average annual growth to 31 March 2002 was 2.2%. The cumulative growth to 31 March 2002 was £3.04m.

**Step 4: Recalculation of adjusted rateable on 1 April 1995 so as to adjust for the revaluation**

- The adjusted rateable value on 1 April 2000, as stated above, was £45m. This is deflated for five years using the 2% growth figure from the 1995-96 to 1999-00 period.
- For Authority X this gives a revised rateable value for 1 April 1995 of £40.76m.
- The revised cumulative growth for the five year period 1995-96 to 1999-00 is £45m less £40.76m which equals £4.24m.

**Step 5: Calculate total cumulative growth for the eight year period and annualise it using the revised 1995 starting point**

- Total cumulative growth for Authority X is £4.24m plus £3.04m which equals £7.28m.
- Annualising this over a starting point of £40.76m gives average growth of 2.1%.
- This would be the baseline under the Local Authority model. For other models the cumulative growth of all authorities in the same group as Authority X needs to be added together and annualised as a growth rate over the cumulative starting points of all authorities in the same group as Authority X.

# APPENDIX B

## Model Baselines

B.1. This appendix provides indicative baselines using the proposed methodology for four of the five models that are identified in chapter three. Information on the Local Authority model and a detailed breakdown of which baseline would apply to each local authority is provided on the ODPM website, at:

<http://www.local.odpm.gov.uk/finance/labgi.htm>

B.2. These numbers represent average growth rates over the eight year period 1995-96 to 2002-03. The data used to calculate the average growth in each of the five model is taken from data supplied by the Valuation Office Agency as adjusted for empty property and partially empty property relief. The information on empty property and partially empty property relief is taken from local authority returns to ODPM.

B.3. At the time of calculating baselines only budgeted relief data for 2001-02 and 2002-03 was available. Therefore baselines may move slightly once outturn data is available for these two years.

B.4. At the end of this appendix are two maps. These illustrate which authorities are in each category for the National Historic Growth and Sub Regional models respectively. They give an indication of relative strengths of local economies and of the inter-relationships between them.

**Table 1: National and Regional model baselines**

<b>Region</b>	<b>Baseline</b>
East	2.4%
East Midlands	2.2%
London	3.2%
North East	1.5%
North West	2.1%
South East	2.8%
South West	2.4%
West Midlands	2.1%
Yorkshire & Humberside	1.9%
England	2.5%

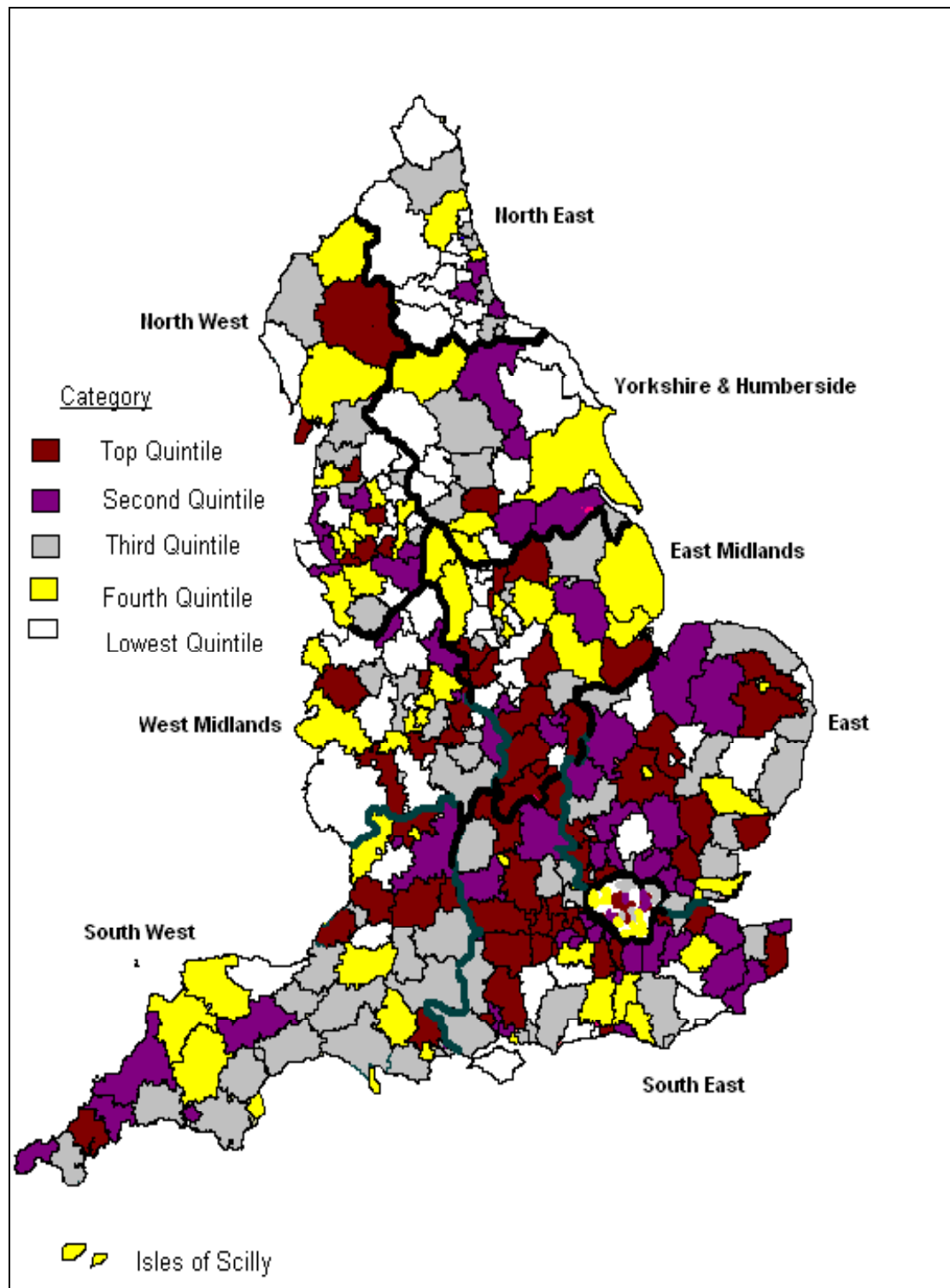
**Table 2: National Historic Growth model baselines**

<b>National Historic Growth category</b>	<b>Baseline</b>
1	0.9%
2	1.6%
3	2.0%
4	2.6%
5	4.4%

**Table 3: Sub Regional model baselines**

<b>Region</b>	<b>Sub Regional Baselines</b>		
	<b>Low</b>	<b>Medium</b>	<b>High</b>
East	1.6%	2.3%	3.4%
East Midlands	1.0%	1.9%	3.9%
London	1.2%	1.9%	4.5%
North East	0.7%	1.5%	2.4%
North West	0.5%	1.6%	3.4%
South East	1.4%	2.3%	4.1%
South West	1.4%	2.0%	3.4%
West Midlands	1.1%	1.7%	2.8%
Yorkshire & Humberside	1.0%	1.7%	2.6%

**Map 1: Illustration of Local Authority Baselines under the National Historic Growth model**



**Map 2: Illustration of Local Authority Baselines under Sub Regional model**

