Business rate supplements:
a White Paper

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CONTENTS

EXECUTIVE SUMMARY

This White Paper sets out the Government's proposal to introduce a power for local authorities and the Greater London Authority (GLA) to raise and retain local supplements on the national business rate, having examined carefully the potential benefits and costs, including economic impacts.

Building on the extensive public debate on reforms to business rates in England, the recommendations of the Lyons Inquiry and the commitment to consider options for business rate supplements in the review of sub-national economic development and regeneration, the Government's proposed model for business rate supplements involves four levels of protection for business:

- **Revenue from supplements will only be available for spending on economic development – such as infrastructure.** Plans will need to be clearly specified and committed in advance. Spending will be subject to a transparent accounting framework to ensure this.
- **A national upper limit of 2p** in the pound will be set on the level of supplements that can be levied.
- To protect smaller businesses from disproportionate burdens, **properties liable for business rates with a rateable value of £50,000 or less will be exempted from paying supplements.**
- **Where the supplement will support more than a third of the total cost of the project there will additionally be a full 'double-lock' ballot of businesses affected.**

Revenues from supplements will be locally raised and retained, with local decision-making on the duration of any supplement and the specific projects it should be spent on. The Government intends that that **only the highest tier local authority in any area should be entitled to levy supplements.** These authorities will be able to cooperate to raise supplements to fund joint projects, within the existing statutory framework. In London, the power will rest with the Greater London Authority. Shire counties will be required to consult their districts on any new supplement proposals.

The Government will **consult on technical issues before finalising detailed arrangements.**

1 EMPOWERING LOCAL AUTHORITIES TO PROMOTE ECONOMIC DEVELOPMENT

This chapter:

- **examines the case for reform through the addition of a power to raise and retain local supplements, setting out the potential benefits and risks of this approach;**
- **sets out the context for giving local authorities the ability to raise supplements on business rates, as part of the wider need to empower local authorities to work with business to promote local prosperity;**
- **highlights the considerable public debate that has taken place on business rate supplements, with contributions from local and central government, the business community and independent commentators and academics, reflecting the wide range of interests in this policy; and**
- **details the evolution of the business rates system, including the most recent reforms to introduce additional flexibility into the national framework.**

Economic growth at the local and sub-regional level

Economic performance

1.1 The case for providing local authorities with a tool to raise local revenues to invest in growth should be seen in a broader economic context of the need for a strong local authority role in economic development. The Government's overall economic objective is to raise the rate of sustainable growth and achieve rising prosperity and a better quality of life, with economic and employment opportunities for all. In order to achieve this, it is essential that every part of the UK performs to its full economic potential.

1.2 The evidence suggests that there remain substantial divergences between regions and localities in terms of their economic performance across a wide range of indicators including Gross Value Added, employment and skills levels. These differences in activity have been consistent over a relatively long historical period -at least 80 years- and reflect a wide range of factors. There is emerging evidence of encouraging progress on enhancing sub-national economic performance, reducing the persistent gap in growth rates between regions and improving outcomes in the most disadvantaged areas. However, the Government's Public Service Agreement (PSA) to improve the economic performance all English regions and reduce the gap in economic growth rates between regions remains extremely challenging. With the exception of London, English cities are also lagging behind their European counterparts.[1]

1.3 Globalisation and technological change will give further opportunities for growth, but will also create increasing pressures for specialisation and for areas to focus on their comparative advantage. This increases the risks of divergences between places, with areas with a low skills base at greater risk of being left behind. Regions and localities with clusters of sectors in high value-added manufacturing and services stand to gain from shifting comparative advantage, particularly as the importance of high value services grows. It is increasingly important that places are able to respond quickly and flexibly to economic change if they are to increase prosperity and tackle effectively concentrations of disadvantage.

1.4 The Government therefore needs to ensure that performance in sub-national

[1] *Review of sub-national economic development and regeneration*, HM Treasury, DBERR and DCLG, July 2007.

economic development and neighbourhood renewal is improved, within tight constraints on overall resources. The Government believes that a devolved approach to economic development is best able both to tackle the diverse factors that may be inhibiting growth in different areas, and to enable the different strengths of different places to be best utilised in the face of global economic competition and integration. Local authorities, in particular, must ensure that economic development is central to their mission and the policies to improve well-being in their localities.

Lyons Inquiry

1.5 The Lyons Inquiry into local government emphasised the importance of this role for local authorities. The Inquiry saw it as a part of local government's ability to work as a "place-shaper", acting as the means through which local communities can take responsibility for their development and for their future.[2] Decisions relating to the economic development of an area, including on how to remove barriers to growth, especially in the face of changes such as globalisation, are a key aspect of this.

Review of sub-national economic development and regeneration

1.6 The review of sub-national economic development and regeneration (SNR) supported the Lyons Inquiry's view of the local authority role, stating that a strengthened role is essential to enabling cities, towns and localities to work effectively with business to improve the economic potential of their areas. The SNR set out in more detail the form that this role should take. It set out a range of reforms aimed at empowering all local authorities to promote economic development and neighbourhood renewal. These reforms are based on the principles of greater local flexibility, simpler sub-national structures with strengthened accountability, stronger partnership working between public and private sector organisations, and better incentives for achieving economic growth and for ensuring disadvantaged areas benefit from and contribute to economic development.

1.7 The SNR also established a differential approach to support local authorities in all areas to work together more effectively where they so wish. For example, local authorities will be able to voluntarily pool resources, responsibilities and targets at the sub-regional level through Multi-Area Agreements (MAAs).[3] The SNR also supported the development of robust decision-making at this level, with the option to establish statutory sub-regional authorities which enable local authorities to pool responsibilities on a permanent basis.

1.8 Both the SNR and the Lyons Inquiry noted that decisions on funding infrastructure and other projects to support economic development are among those that should be made at the local or sub-regional level. However, they also noted that levers to achieve this were currently lacking, and that local authorities currently feel constrained by the lack of flexibilities and powers available to them. Consequently local authorities are limited in the extent to which they feel empowered to develop the strengths of their localities and respond to economic change. These views have also been reflected by other commentators, such as the IPPR Centre for Cities.[4]

1.9 Unlike many other comparable economies, such as the United States and Germany, sub-national government in England currently has very limited powers to adjust business or

[2] *Place-shaping: a shared ambition for the future of local government*, Lyons Inquiry into Local Government Final Report, Sir Michael Lyons, March 2007.

[3] The Government's commitment to develop Multi-Area Agreements (MAAs) was first announced in the Local Government White Paper. The principles guiding the development of MAAs were subsequently announced in the SNR. MAAs would involve a group of local authorities coming together on a voluntary basis to agree collective targets and performance indicators, rather than each having separate individual targets in separate Local Area Agreements. Local authorities and their partners would also be able to pool funding to be used to achieve these collective outcomes.

[4] *City Leadership: Giving city-regions the power to grow*, IPPR, February 2006; *City Solutions: Financing local growth. Towards a supplementary business rate?*, IPPR, August 2007.

domestic taxation to fund investment. In the US, for example, business taxation and 'tax increment financing',[5] as well as a range of domestic taxes are often used to provide resources for economic development projects.

1.10 In England, by contrast, major projects need generally to be funded through central resources in the form of grants from the Government. While Council Tax, other local resources and external resources such as EU funding can make a contribution, this is limited and these resources are predominantly directed to service expenditure.

1.11 The SNR identified other means that could be used to help address these issues, including:

- the creation of a focused statutory economic development duty for local authorities;
- reforms to the Local Authority Business Growth Incentive (LABGI) scheme to strengthen the incentive, simplify the structure of the scheme and give local authorities greater certainty over rewards;
- an expectation by Government that RDAs will delegate responsibility for spending to local authorities or sub-regions wherever possible, unless there is a clear case for retaining spending at the regional level; and
- developing options to lever in additional finance to invest in regeneration and growth, including exploring options for Regional Infrastructure Funds and Local Asset Backed Vehicles.

The Government will be taking forward these recommendations in parallel to its proposals on local business rate supplements.

1.12 Having set out the context for reform, the remainder of this chapter sets out how the national system of business rates currently operates, and the potential benefits that a power to raise business rate supplements could bring, and how any risks can be managed.

THE BUSINESS RATES SYSTEM IN ENGLAND

What are business rates?

1.13 National non-domestic rates (NNDR), or business rates, are a tax levied on occupation of non-domestic properties as part of the wider framework of business taxation in the UK.

1.14 Occupiers' liability is a function of the assessed rateable value (a hypothetical rental

[5] Tax increment financing is a tool used in the US to use future increases in tax revenue to finance current projects that will contribute to those increases. For example, a public infrastructure project such as a new road or school will generate an increase in land value and will often generate additional private investment, which in turn generate increased tax revenue. Tax increment financing dedicates that increased revenue or 'tax increment' to finance debt issued to pay for the project. Tax increment financing can therefore provide resources for public projects that may otherwise be unaffordable to localities.

value) of their property, known as a hereditament,[6] and a multiplier.[7] The last of these is a figure usually specified as a number of pence in the pound.

1.15 Until 1990, business rates were set by local authorities alongside domestic rates. In 1990 business rates were separated from domestic rates and replaced by the community charge, which was replaced by council tax in 1993. Since 1990, this multiplier has been set at a uniform national rate for England. Between revaluations, which take place every five years, the multiplier is subject to an annual increase linked to the Retail Prices Index (RPI). This framework ensures that businesses have certainty over the amount of tax they will be expected to pay. It means therefore that, in aggregate, businesses are protected from real-terms increases in business rates.

1.16 A consequence of the certainty provided by this framework is that local authorities currently do not have the power to vary the level of business rate, limiting the scope for councils to work with businesses to improve the economic prospects of a local area. The only exception to this is the City of London, which has the power to adjust the small business and non-domestic rates multipliers, in consultation with local businesses.[8] This power has been used to generate resources to invest in additional security and other measures which are considered important to the economic strength of the City.

1.17 Under the current system, local authorities do not retain business rate receipts, although the majority of business rates are collected by local authorities. Instead they surrender them to a central pool. Revenues from this pool are hypothecated for local government and are redistributed by the Government alongside Revenue Support Grant as part of the local government finance settlement.

Retention of existing national arrangements

1.18 The Lyons Inquiry recommended retaining the RPI cap, concluding that the national business rate is not at the present time an appropriate way to raise additional resources to fund general local government activity and services. The Government agrees with the Lyons Inquiry's analysis and confirmed in Budget 2007 that the current link between the Retail Prices Index and yield from business rates will be retained.

1.19 The Lyons Inquiry also considered whether to relocalise business rates. Relocalisation would allow local authorities to retain all receipts. Again, the Lyons Inquiry recommended that the existing national arrangements should be retained at present. Given the need to maintain fiscal discipline, ensure a high standard of public services in all areas and protect business from excessive tax burden, the Government also agrees that it would not be appropriate to return business rates to local control at this time.

Reforms to increase flexibility

1.20 While maintaining the broad framework of business rates, however, the Government has introduced reforms since 1997 to introduce additional flexibility into the business rates system. This has enabled and provided incentives for local authorities to work with business to maximise the growth of the local economy.

[6] A hereditament is a property which is or may become liable to NNDR, and thus appears on the rating list, complied and maintained by the Valuation Office Agency (VOA) of the HM Revenue and Customs.

[7] The NNDR multiplier is the factor by which a hereditament's rateable value is multiplied in order to calculate its business rates liability. There are two multipliers - the small business multiplier used to calculate the liability of hereditaments in receipt of small business rates relief, and the national multiplier (which includes a supplement to fund small business rate relief), which is used to calculate the liability of all other hereditaments.

[8] The limits on this power are set out in Schedule 7 to the Local Government Finance Act 1988. The power reflects the size of the City of London's permanent population – which is taken into account in the local government finance settlement – as compared to its much larger commuter population. The City also has a unique franchise.

1.21 In 2003, the Government legislated to provide for the establishment of Business Improvement Districts (BIDs). BIDs have enabled local authorities to work with local businesses to agree, through a local business ballot, to a supplementary levy on their business rates in order to fund specific, time-limited projects such as town-centre improvement or security. Each BID is operational for a maximum of five years before a new vote is taken. To date, 68 areas have developed BIDs proposals, with 56 areas taking economic development projects forward.[9] BIDs may cover an entire local authority administrative area, but so far have tended, with a few exceptions, to cover smaller areas such as an industrial estate or a town centre. These reforms have been widely welcomed by local government and business. As noted in the Lyons Inquiry, the example of BIDs shows that "with the right proposals and engagement, local authorities and businesses can develop effective relationships and mutually advantageous proposals for the improvement of places."[10]

1.22 To give local authorities a greater incentive to promote economic growth, the Government also introduced the Local Authority Business Growth Incentive (LABGI) scheme in 2005. LABGI allows local authorities to receive a proportion of increases in local business rates revenues to spend on their own priorities, creating a direct financial incentive for authorities to promote local business growth. Again this scheme has been welcomed in principle by both local authorities and business, including the Confederation of British Industry (CBI).

1.23 The Government has today published *Building better incentives for local economic growth: reforms to the Local Authority Business Growth Incentive scheme,*[11] an issues paper which sets out the Government's commitment to creating a permanent incentive for councils that encourages sustainable economic growth, fully integrated with the local government finance system. Building on the lessons of the existing LABGI scheme and after considerable engagement with the Local Government Association and local authorities, the new incentive will be phased in from 2009-10, with funding of £50 million doubling to £100 million in its second year.

Local business rate supplements

1.24 While maintaining the overall business rates framework, the Lyons Inquiry considered whether further reforms could help to improve the contribution of local authorities to economic development. Alongside its recommendations against the relocalisation of business rates, and for the retention of the RPI cap, the Lyons Inquiry proposed that the Government should develop proposals to enable local authorities to raise and retain business rate supplements. The Inquiry also recommended that these supplements should be linked to economic development.

1.25 A local business rate supplement would enable local authorities to levy a 'top up' in addition to the national business rate paid by occupiers within their areas. This differs from a wholesale return of business rates to local control in a number of ways:

- first, the national rate and the RPI cap would remain as now, with billing authorities continuing to pay national business rates into the central pool;
- second, the extent by which local authorities can vary the rate is limited to an incremental addition to this national rate; and
- third, revenue from a supplement is not a general revenue-raising power but is linked to the specific overall objective to promote economic development, and so the ability to levy a supplement may be subject to other constraints or accountability requirements.

[9] National BIDs Advisory Service, http://www.ukbids.org/BIDS/index.php

[10] *Lyons Inquiry into Local Government. Place-shaping: a shared ambition for the future of local government,* Lyons Inquiry Final Report, March 2007.

[11] *Building better incentives for local economic growth: reforms to the Local Authority Business Growth Incentive scheme*, HM Treasury and DCLG, October 2007.

1.26 A local business rate supplement also differs from the current BID levy. BIDs are designed to operate over a relatively small geographical scale – smaller than an individual local authority and in most instances significantly smaller than an economic unit such as a city or city-region. As intended, they are used for relatively short-term projects, and have to be renewed every five years. They are administered through a BID company rather than by the local authority. All of these characteristics make them difficult to use for infrastructure investments, where the benefits can be spread over a wide area, investment needs to be long-term and therefore the local authority is likely to need to take lead responsibility for financing and managing the project. BIDs are discussed in more detail in Chapter 2.

The potential benefits

1.27 The Lyons Inquiry and the SNR have made a strong case for local supplements on business rates as a means of promoting investment in local infrastructure and economic growth where they are subject to detailed consultation with, and a strong voice for, the business community.

1.28 In the SNR, the Government stated that "supplementary business rates have the potential to provide a powerful new tool for local authorities to invest in infrastructure to support long-term economic growth in their areas, backed by mechanisms to ensure that there is a strong voice for business and supplements are introduced only where they can command support from all those affected."[12] The Government committed to report back on options later this year following work with local government, business and other stakeholders.

1.29 The Government is clear that consideration of the potential benefits of local business rate supplements must take place in the context of changing long-term economic circumstances. Equally, any proposal must build on Government reforms that have already taken place. The role of local government and its relationship both with central government and with business has changed substantially since business rates were under local control. Alongside their service delivery responsibilities, local authorities have played an increasing role in the wider economic and social prosperity of their areas as economic trends have led to the increasing importance of local comparative advantage. This developing role has been supported by Government policies, for example through the introduction of the power of well-being,[13] the LABGI scheme, and BIDs. This role will be further strengthened by the reforms announced recently in the SNR, for example the inclusion of robust economic development indicators in the local government performance framework, the creation of a focused statutory economic development duty, and reforms to the LABGI scheme.

1.30 However, as the Lyons Inquiry and the SNR recommended, and as noted in the evidence to the recent Communities and Local Government Select Committee inquiry into local government finance,[14] there is a need to further develop the relationship between local authorities and the private sector. As part of this, it will be important to ensure strong accountability to business where supplements are introduced. Further, any new flexibilities should provide genuinely additional revenues to benefit local communities. In this context, the Government believes that a power to introduce a local business rate supplement could be a powerful complement to empowered, responsible local authorities with strong incentives to work with business to promote the long-term growth and productivity of their areas.

[12] *Review of sub-national economic development and regeneration*, HM Treasury, DBERR and DCLG, July 2007.

[13] The Local Government Act 2000 gave all local authorities in England and Wales a wide-ranging power to promote the economic, social and environmental well-being of their area.

[14] *Local Government Finance: Supplementary Business Rate, Seventh Report of Session 2006-07*, House of Commons Communities and Local Government Select Committee, August 2007, HC 719-1.

1.31 There would be a number of key benefits of introducing a new power to raise local business rate supplements:

- first, it puts decisions about investment and management of spending closer to local communities affected. Resources made available through a local business rates supplement would be locally owned and controlled. By contrast with centrally-administered grant programmes, decision-making would be fully devolved. Projects and programmes would be managed and run significantly closer to those with a stake in their success, who should have the best understanding of what is needed and how it can be delivered;

- second, it allows investment decisions to be made in a more joined-up way, reflecting the range of opportunities and challenges facing each area. Local communities are often better able to do this. They may be able to see the interactions and linkages between different policy challenges in a way that may be difficult for individual government departments or for central government more broadly;

- third, as noted by the Communities and Local Government Select Committee[15] and the Centre for Cities,[16] business rate supplements will provide genuinely additional revenue for investment in local projects that may have long-term economic benefits but which would otherwise be unfunded; and

- finally, this approach provides a real spur for local authorities, businesses in local areas and the wider community to work together. A local business rate supplement provides a significant opportunity for local authorities to strengthen their economic role and improve their relationship with and accountability to business.

Managing risks

1.32 However as with any reform of this type there are a number of important risks that have been identified during the discussions and analysis to date. In order to maximise the benefits outlined above, safeguards would need to be put in place that:

- protect against a disproportionate and adverse economic impact from the costs of a supplement to business. Chapter 3 sets out the key points from the evidence on the economic impact of business rates and particularly of changes in rates. The Government is committed to maintaining the competitiveness of the UK tax framework and to ensuring that it does not provide a barrier to enterprise and innovation. The costs of a supplement are in practice borne more widely than by occupiers alone, and can be outweighed by the benefits of investment. However managing the impact of these costs is essential;

[15] *Local Government Finance: Supplementary Business Rate*, House of Commons Communities and Local Government Select Committee, August 2007.

[16] *City Solutions: Financing local growth. Towards a supplementary business rate?*, IPPR, August 2007.

- secure accountability to the business community. If local business rate supplements are to promote, rather than inhibit, the development of strong relationships between local authorities and businesses in their areas then they must be administered in a way which gains credibility and legitimacy from the business community. Some businesses are worried that their concerns about the use of supplements and their impact will not be given adequate hearing by local authorities. In this context accountability is essential;
- preserve the Government's wider fiscal and economic objectives. In order to invest in infrastructure, local authorities are likely to seek to use their powers for prudential borrowing under the 2003 Local Government Act. Such borrowing increases the stock of public debt, which is subject to strict limits as a result of the Government's fiscal rules. The policy framework for a business rate supplement needs to provide the fiscal rules with adequate protection;
- ensure that revenue from supplements is genuinely additional and focused on economically beneficial purposes. The Government does not see business rate supplements as a means to pay for existing programmes, or to fund general service expenditure. The case made by the Lyons Inquiry and by the SNR is clearly focused on investment for economic growth; and
- take account of any impact on other Government policies. For instance some stakeholders have raised a concern that the introduction of business rate supplements might inhibit or undermine existing or new BIDs. Any such impacts need to be understood and managed.

Discussions with stakeholders

1.33 As part of the SNR, and since its publication, the Government has held discussions on business rate supplements with a wide range of groups. These have included the Local Government Association (LGA), the Greater London Authority (GLA), the Royal Institute of Chartered Surveyors (RICS), the Confederation of British Industry (CBI), British Chambers of Commerce (BCC), British Retail Consortium (BRC) and the Federation of Small Businesses (FSB), as well as representatives of individual businesses.

1.34 Having considered the potential benefits and risks, including potential economic impacts, and discussed these with local government, business and other stakeholders, **the Government believes that local business rate supplements could provide a valuable new tool for local authorities to help them promote economic development. Therefore the Government proposes to introduce a power for local authorities to raise and retain local supplements on the national business rate.** The rest of this paper sets out the Government's principles and proposed approach.

2 THE GOVERNMENT'S PROPOSED APPROACH TO BUSINESS RATE SUPPLEMENTS

This chapter:

- **sets out the principles guiding the Government's proposed approach to the introduction and design of a power for local authorities to raise local business rate supplements. These are: accountability to local business; local autonomy and flexibility; predictability for business; a clear focus on economic development, a positive economic impact; protection for smaller businesses and equality of opportunity for all local areas;**
- **reflecting these principles, the chapter considers the key design issues for such a power, including: accountability mechanisms; level, purpose and duration of supplements; approach to revenue retention; which authorities should levy supplements; and reliefs and protection for smaller businesses; and**
- **sets out the Government's conclusions on the key design features of a power to raise business rate supplements.**

A PRINCIPLED APPROACH

2.1 The previous chapter set out the case for introducing a business rate supplement. The Government is committed to a principled approach in order to maximise the benefits of a power to raise supplements on the business rate, and to manage the risks identified above. Reflecting the discussions held with stakeholders, this chapter sets out the principles that the Government has followed in designing a business rate supplement.

Accountability to local business

2.2 First, a power for local authorities to raise and retain a business rate supplement must be subject to robust accountability requirements to those who would be liable to pay. Local businesses should have a strong say in the decision to raise a supplement, and on how it should be spent. This is a key point that was raised by business stakeholders throughout the course of the Lyons Inquiry and the SNR, and has been reiterated in subsequent discussions. Accountability provides businesses with confidence that the impact of a supplement on them will be taken into account. Equally, it ensures that the knowledge and understanding that businesses have of the local economy can be taken into account in decisions on where and how to spend additional resources.

Local autonomy and flexibility

2.3 Second, in line with the conclusions of the SNR, this additional lever for local authorities to promote economic growth in their area must be sufficiently flexible for them to use in a way that reflects the needs and circumstances of local economies. Business rate supplements are intended as a tool for local communities to fund development in their own areas. All the revenue from supplements should be locally raised and retained. This is distinct from the main system of business rates, where revenues are pooled and reallocated nationally. The direct costs of any supplement will be borne in that area and the decision to introduce it will be made locally.

2.4 Local communities should be responsible for key decisions about whether to levy business rate supplements and how best to use the revenues to promote economic growth, giving local communities a new opportunity to take responsibility for their own economic futures. The Government intends all revenues from business rate supplements to be retained locally. For local authorities that wish to work together to raise revenues for joint projects, arrangements for voluntary pooling of retained revenues would need to be developed, which would need to be consistent with any proposals for statutory sub-regions and Multi-Area Agreements.

Predictability for business

2.5 Third, in line with the second principle above, it is fundamental that the decision on whether or not to levy a supplement, and if so at what level, is made locally. However there are good reasons for constraining the scale of the supplement. An upper limit or cap would provide assurance to ratepayers that the potential cost that they might be asked to bear will be limited. This should provide a more secure basis for discussion between local authorities and businesses. Equally it will allow other arrangements for accountability and for protecting national economic and fiscal interests to be calibrated appropriately. A potentially unlimited supplement would require stronger constraints in these areas.

Clear economic development focus

2.6 Fourth, business rate supplements are a lever to contribute to economic development, through new infrastructure projects, or support for other additional local projects whose primary focus is increasing economic growth. Business rate supplements are not intended as a new means to fund existing expenditure, or as a resource to support general service expenditure. The Government intends their use to be clearly focused on economic development, with local flexibility over what specific projects will best promote long-term economic growth in that area. As a result the purposes for which supplements may be levied will be expressly stated and restricted to additional spending to promote economic development. This does not necessarily just mean capital projects. For smaller, more short-term projects, however, the Government would expect local authorities to consider, in conjunction with local business, whether the BID model is the most appropriate financing vehicle.

Positive economic impact

2.7 Finally, it is important that the impact of the introduction of a power to raise business rate supplements on the economy is considered carefully during the design of such a power. Chapter 3 sets out the Government's analysis of the economic impact of changes in business rates in more detail. This includes consideration of the economic incidence of business rates (ie. whether the burden primarily falls on landlords or tenants of businesses), and the likely economic consequences, possible effects on different sizes and sectors of businesses, and the impact on business of a business rate supplement in the context of the overall contribution by business to general taxation. But it will be up to authorities themselves, in developing and explaining their proposals for particular projects to be funded though a supplement, to assess the impact of their proposals in their local business community.

Protection for small businesses

2.8 Smaller businesses can be disproportionately affected by changes in business rates because rates constitute a particularly high percentage of their overall costs compared to larger businesses. As part of the principle to ensure a positive economic impact and in line with the Government's commitment to promoting enterprise, protection for smaller businesses is therefore an essential part of any framework for business rate supplements.

Equality of opportunity for all local areas

2.9 Finally, to provide transparency and certainty for local authorities, local business and the wider community, the power to raise local business rate supplements will apply across England. All local areas in England will have the opportunity to use this power to contribute to long-term economic growth. Implications for the devolved administrations are discussed later in this chapter.

2.10 The rest of this chapter sets out how these principles have been applied to the practical questions associated with designing a business rate supplement.

DESIGNING A BUSINESS RATE SUPPLEMENT

The Government's approach

2.11 In developing its proposals the Government has built on the wide public debate around reforms to business rates, including:

- the recent DCLG Select Committee report *Local Government Finance: Supplementary Business Rate;*[1]
- work for the Balance of Funding Review,[2] including representations from bodies such as the LGA and the CBI;
- the public consultations carried out by the Lyons Inquiry. The Inquiry conducted a series of round-table events with businesses as well as a national conference on economic prosperity, and received submissions from a wide range of interested stakeholders;[3]
- the SNR, which examined how best to empower all local authorities to promote economic development and neighbourhood renewal through improved levers and incentives; and
- public representations and position papers on business rates reforms from interested organisations such as the British Chambers of Commerce, and from other sources such as the IPPR's Centre for Cities.[4]

2.12 In addition the Government has discussed options with business, local government and other stakeholders in light of the findings of the Lyons Inquiry and the SNR.

2.13. The Government's proposed model for business rate supplements is set out below. It includes four levels of protection for business:

- supplements will only be available for spending on economic development, local authorities will have to set out their plans in detail, and businesses will be able to participate in full statutory consultation;
- the maximum level of supplements will be capped at 2p;
- smaller businesses will receive extra protection; and
- where the supplement supports more than a third of the cost of the project the local authority will have to win a 'double lock' ballot of those businesses affected.

The remainder of this chapter sets out the model including these levels of protection and other issues such as which authorities will be able to levy supplements.

Use of supplement and requirement to consult

2.14 The first level of protection that the Government will provide is to require supplements to be used for a clearly specified economic development purpose, set out up-front, and subject to statutory condition.

[1] *Local Government Finance: Supplementary Business Rate, Seventh Report of Session 2006-07*, House of Commons Communities and Local Government Select Committee, August 2007, HC 719-1.

[2] *Balance of Funding Review-Report*, ODPM, July 2004.

[3] www.lyonsinquiry.org.uk

[4] *City leadership: Giving city-regions the power to grow*, IPPR, February 2006; *City Solutions: Financing local growth. Towards a supplementary business rate?*, IPPR, August 2007; *Budget Submission*, British Chambers of Commerce, 2007.

2.15 The power to raise supplements on business rates is not intended to provide general-purpose revenues. As set out above, this is one of the principal characteristics which distinguishes supplements from full localisation of rates. Rather it is intended to support specific investments in economic development in a transparent and targeted way.

Ensuring a focus on economic development

2.16 In order to ensure that this is how the power is used in practice the Government will specify certain constraints on how revenues from supplements can be used. The key aspects are that supplements should only be used to finance additional investment in economic development.

2.17 In principle, additionality can be simply and clearly defined. It means that supplements should only be used for investment that would not otherwise have taken place. Local authorities should not use revenues from supplements to substitute for their own resources and to support projects which they would have undertaken anyway.

2.18 This is important for two reasons. First, the Government is intending to introduce the power to levy supplements in order to provide a new tool to stimulate economic growth - not as a different way of financing existing policies. Second, without a requirement for additionality there is a risk that new revenues for economic development provided through a supplement are offset by diversion of existing resources into other service areas. This would undermine the focus of supplements on economic development and effectively turn them into a more general resource.

2.19 In practice defining and assessing additionality is much more complex. It requires comparison with a hypothetical 'no supplement' scenario which can never be fully tested in reality. There will need to be clear accounting of the revenues raised by a business rate supplement and the purposes to which those revenues are applied. A number of checks are likely to be necessary in order to provide an effective test. In particular:

- existing spending and service levels can be benchmarked in areas affected by spending from the supplement. The authority can then assess how new service provision will be additional. This benchmarking approach is used in BIDs. It can provide a useful measure of ongoing spending, where baselines can be relatively clearly established. However it is more difficult in the case of capital investment, where by definition expenditure is one-off rather than recurrent and there is no meaningful baseline;

- local authorities could be required to set out the funding routes that have been explored, and the reasons that they are not sufficient. This would provide a means of ensuring that an alternative means of funding the project is not available;

- where a local authority has set full three-year budgets, these provide a useful benchmark. If an authority is prepared to commit to given levels of service expenditure across the range of its responsibilities whether or not a supplement is levied this implies that supplement revenue is not being used to finance those services; and/or

- similarly in cases where an authority intends to use a supplement to support borrowing they could be required to set out their full borrowing plans, distinguishing between those that will only be undertaken if they levy a supplement and the remainder. The latter could then provide a binding ceiling for a given period of time. This would provide an incentive not to overestimate the additional borrowing that will be undertaken, because this would reduce the ceiling.

2.20 **The Government intends to consult on how best to deliver the additionality requirement.**

Economic development

2.21 Providing criteria which effectively focus spending on economic development also poses practical challenges. The definition of economic development used in the Best Value Accounting Code Of Practice for local authorities is extremely narrow, covering activities such as direct business support and the administration of business parks. This does not accurately reflect the range of spending undertaken by local authorities with the objective of improving local economic performance – for instance improvements in transport infrastructure.

2.22 One option would be to develop a broader definition of economic development which covered a wider range of activities. Such an approach however runs a significant risk of excluding some activities which could legitimately be claimed to have an important positive economic rationale. This applies even more strongly to narrower definitions such as infrastructure. Furthermore, following the business support simplification programme, the Government expects business support to be coordinated regionally

2.23 **The Government therefore does not intend to produce a specification of legitimate spending. Instead it will set out areas of expenditure to which revenues from a business rate supplement cannot be put.** This will include the main statutory services such as social care and children's services. However, not all statutory services will be excluded. For example, some transport improvements can clearly have a positive impact on the local or sub-regional economy.

2.24 In many cases, local authorities will wish to use revenues from business rate supplements in order to support borrowing to finance capital investment. The Government does not intend to restrict the use of supplements in this way beyond the existing requirements of the Prudential Code. If local authorities wish to use income for revenue spending or for direct capital expenditure they will retain the flexibility to do so, subject to the criteria set out elsewhere in this chapter. Borrowing under the Prudential Code will of course remain limited to capital investment.

Statutory consultation

2.25 As set out above, accountability to business is a key element of the Government's approach to business rate supplements. **In order to ensure that local authorities' proposals for supplements are transparent, they will be required to undertake a statutory consultation with local businesses and other stakeholders.** In this consultation authorities will be required to set out:

- their detailed plans for expenditure, including timescales and funding sources;
- the way in which the supplement will work, including its expected duration and any further exemptions or reliefs that they intend to apply;
- how this spending is additional to their existing plans;
- the way in which they will deal with differences between planned and outturn expenditure; and
- their assessment of the economic benefits and costs of the project and the supplement.

This consultation will provide all those affected with a good basis for assessing the merits of a project and allow local authorities to be held clearly to account.

Transparency **2.26** To ensure that revenue from supplements is only used for the purposes set out in the approval process it needs to be subject to a transparent accounting framework. **The Government will set out detailed proposals for the accounting constraints before finalising detailed arrangements.**

Duration **2.27** Under the BID model levies can only be put in place for a maximum of five years. As Box 2.1 sets out, this constraint means that it is very difficult to use BIDs for investment in longer-term and larger-scale investments. Major projects can require financing over a much longer time period than this.

2.28 Good practice for debt financing suggests that the lifetime of the debt should approximately equate to the lifetime of the asset. Taking into account construction periods, this could be as long as twenty or thirty years for many major projects.

2.29 A national maximum limit on duration of this magnitude would be unlikely to provide significant benefits to business and could also increase the cost of debt to local authorities, as they are less able to manage risk.

2.30 **The Government does not, therefore, intend to set a national maximum limit on the duration of supplements.** Instead local authorities will be expected to set out their plans as part of the vote or consultation exercise. Given that use of the supplement would be restricted to the project specified in the consultation or vote, a supplement would cease once any debt had been fully repaid.

2.31 Local authorities may wish to seek expert advice on their plans, including on the reliability of the cost-benefit analysis and the assumptions on which the plans are based. Expert input will foster local community and business confidence in those plans. **The Government will establish a national project panel to assist authorities in this respect.**

Maximum level of supplements

2.32 Under the current BID scheme there is no upper limit to the scale of supplement that can be levied. As identified by the Lyons Inquiry the highest BID levy currently in place is equivalent to 4p in the pound.[5]

2.33 However there are good reasons for providing a national upper limit for business rate supplements. Unlike BID levies, business rate supplements will not be subject to a national time limit. They are likely to operate over a larger geographical scale, affecting more ratepayers. In some cases, as set out above, they will proceed without a vote.

2.34 In this context a cap on the level of supplements would provide important security for businesses. It would also serve to protect ratepayers from the impact of cost overruns. An authority will have to absorb these overruns itself, rather than passing them on to ratepayers.

2.35 In addition, the introduction of a power to raise business rate supplements will increase local authorities' ability to borrow for capital purposes which, in aggregate, will need to be absorbed within limits determined by the Government's fiscal rules. Setting a maximum limit will ensure an appropriate level of protection of national economic and fiscal interests. **The Government therefore intends to place a national upper limit on the level of supplements that can be levied by local authorities.**

Pence rather than percentage **2.36** The level of the supplement and the upper limit could be specified in percentage terms, as a proportion of total local business rates yield, or in terms of pence, as a proportion of total local rateable value.

[5] *Place-shaping: a shared ambition for the future of local government*, Lyons Inquiry into Local Government, Sir Michael Lyons, March 2007.

2.37 A supplement specified in percentage terms would provide greater certainty for local authorities. In a situation where national rateable value falls as a result of the five-yearly revaluation process, the multiplier increases in order to keep growth in yield increasing by RPI. This means that in a situation where rental values decline, the yield stays constant in real terms. Setting a supplement in terms of percentage of yield would therefore protect local authorities from the effect of national changes in rental values. However it would not provide protection against local market changes.

2.38 This protection would be provided by transferring risk to ratepayers. A percentage supplement would vary as a proportion of rateable value as the multiplier changes. In the event of an economic downturn, a business could therefore find that the supplement constituted a significantly higher proportion of its occupancy costs than anticipated.

2.39 A supplement specified in pence would provide greater certainty to business, as it would constitute a fixed share of rateable value. While it would require local authorities to deal with a greater degree of uncertainty the Government believes that this is a fairer balance. **The level of supplements and the upper limit will therefore be set in terms of pence, rather than as a percentage of yield.**

2.40 Table 2.1 below sets out the scale of new investment that could, in theory, be provided by business rate supplements of 2p and 4p. The areas selected are intended as an illustrative cross-section by area size, type and geography.

Table 2.1: Illustrative revenues from business rate supplements in different areas

	Amount raised (£m) per year	
Local area	**2p supplement**	**4p supplement**
Greater London	177.9	355.9
Greater Manchester (10 authorities)	28.9	57.9
West Midlands (7 authorities)	27.5	54.9
West Yorkshire (5 authorities)	20.1	40.3
Lancashire	7.8	15.5
Essex	12.1	24.1
Hampshire	12.3	24.6
City of Manchester	9.0	18.0
Sheffield	5.9	11.9
Bristol	4.8	9.6
Newcastle	4.0	8.0
Nottingham	4.2	8.4
Milton Keynes	4.8	9.7

Source: RV data from VOA and DCLG data.

Maximum of 2p

2.41 As Table 2.1 shows, local areas could use the revenue from a business rate supplement to borrow significant sums of money. Particularly in urban areas, or where local authorities chose to collaborate, such additional resources could support one or two key capital projects. Examples have been given in previous reports, showing local areas will clearly have different investment priorities based on different local economic needs. Resources could be used on projects to upgrade existing transport infrastructure, for example roads or rail, as well as to support new projects, such as new bus transit or light rail, as many cities in England are considering. Beyond transport infrastructure, capital projects could support anything from business and convention centres to retail development and other infrastructure to support housing or employment. Finally, revenue from a business rate supplement need not necessarily be used to support borrowing. As with many BIDs, the resources could be used for revenue projects, from increasing the security or improving the environment of a business district.

2.42 Using a higher limit of 4p would increase the risk that spending grows faster than capacity to spend efficiently, and would not guarantee an appropriate level of protection of national economic and fiscal interests. It would also provide less assurance to businesses about the scale of potential costs. **Therefore the Government intends to limit the maximum scale of supplements to 2p in the pound.**

Box 2.1: Learning from Business Improvement Districts

Business Improvement Districts (BIDs) were set up following the Local Government Act 2003 as a means to bring together local business and local authorities to develop and finance projects that contribute to improved local economic prosperity within the local authority boundary, for example in town centres. BID proposals are subject to a vote and are funded by a levy on businesses within the specified area. The levy is ring-fenced for the area to fund the extra services and improvements identified within the BID proposal. Each BID is operational for a maximum of five years before a new vote is taken.

A preliminary evaluation of BIDs published this year showed that there is high level of support for BIDs from local authorities and that local businesses who have had experience of BIDs are generally positive about the scheme. The report acknowledged, however, that more should be done to raise awareness of BIDs among the local business community. Early evidence suggests that established BIDs are delivering in line with the expectations of business, local authority and other stakeholders.

The report also showed that, while a useful tool in promoting economic well-being within local authority areas, there are some limitations with BIDs.

The maximum level of expenditure by a single BID responding to the BID manager survey was £380,000, but the median expenditure on BID development activities is £60,000. The report also notes that BID levies usually account for around three-quarters of the total budget for a BID-financed project, with the remainder coming from other sources, usually local authority and RDA funding. Projects financed by BIDs have tended to be focused on three core areas of expenditure: marketing and promotion, safety and security, and environmental improvements. The focus has very much been on activities that will improve the area for the existing business occupants, and the report concludes that "alternatives to BIDs may be more appropriate where fundamental activities are required to transform the area."[a]

The findings of this preliminary evaluation suggest both that there is scope to learn from BIDs and that in some areas business rate supplements will need to take a different approach:

- **BIDs show that a supplementary levy can be acceptable to business and used for purposes that businesses support;**
- **the ballot system under BIDs, while it has limitations, has been shown to be practical;**
- **BIDs have not proved suitable for larger-scale, long-term investment. This is likely to be due at least in part to the need to renew the mandate every five years; and**
- **the voting can generate significant uncertainty, which would make it more difficult to align revenues from a supplement with other funding streams.**

[a] *The Development and Implementation of Business Improvement Districts*, Department for Communities and Local Government, January 2007.

Reduction of rates

2.43 While there has been a widespread debate of the issues surrounding allowing local authorities to raise a supplement on business rates, there has been less discussion of the arguments for and against permitting authorities to reduce their rates below the current national level.

2.44 Local authorities already have the power to provide discretionary hardship relief to businesses which would otherwise suffer hardship, provided it is reasonable to do so having considered the interests of Council Tax payers.

2.45 It would be possible in theory to allow local authorities a broader discretionary power to lower their local rate were this to be in the economic interests of their area. An authority might be seeking to attract inward investment, or to deal with other local economic challenges.

2.46 Given the potential revenue consequences of a reduction in rates, the authority would need to reimburse the national business rates pool for the sums foregone through the reduction. This would ensure that the local authority has to consider the consequences of a reduction fully. A similar condition that the interests of Council Tax payers must be fully taken into account would also need to be considered.

2.47 If the local authority bore the revenue consequences of a reduced rate then the size of the local tax base would have an impact on its decision. The authorities with the largest tax bases – £1 billion or more – would have to find at least £20 million per year to fund a 2p reduction in their business rates. Conversely a metropolitan district outside London with a similar size budget but a tax base of around £100-200 million would only need to find at most £4 million. Authorities with smaller tax bases would find it considerably easier to reduce their rates.

2.48 Against this case needs to be set the importance of preserving the position of both Council Tax payers and those who use local services. Business already receives protection through the RPI cap and the Government is committed to ongoing low Council Tax rises. It would clearly be unacceptable therefore were a power to lower rates to result in a significant unplanned shift in the burden of taxation from business rates to Council Tax.

2.49 State aids issues relating to allowing local authorities to forego revenue in this way would need to be explored. In light of this, the other issues raised, and the comparatively weak evidence base, the Government wishes to consider further the options here in the light of:

- the potential impact on local services;
- the extent and uses to which local authorities might use such a power;
- what safeguards might be put in place to protect Council Tax payers; and
- the implications for tax complexity.

2.50 **The Government will therefore discuss the case for allowing local authorities to reduce rates with business, local government and other stakeholders.**

Protection for smaller businesses

Exemption and smaller businesses

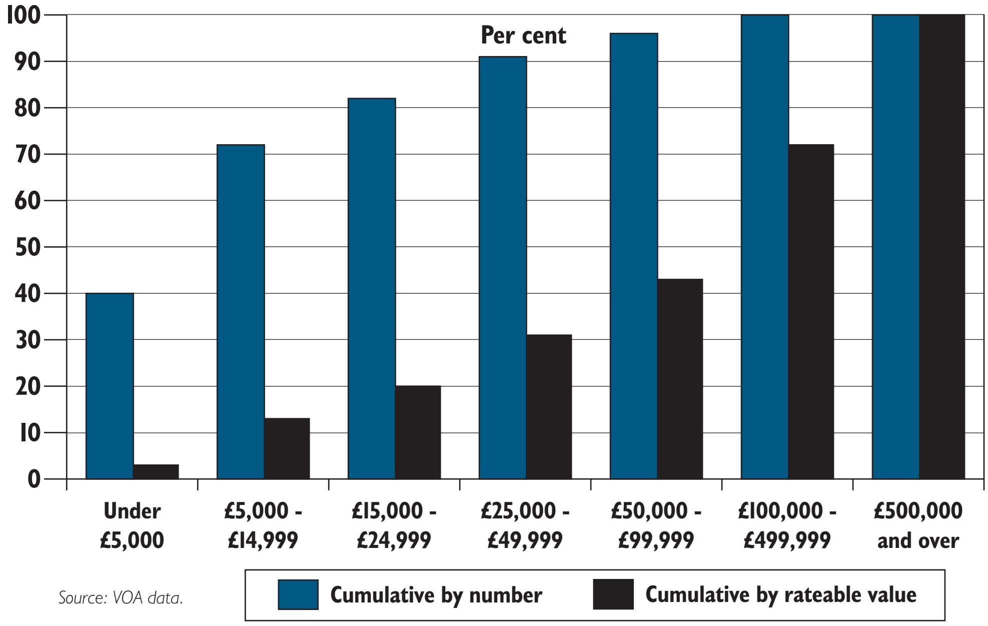
2.51 The economic evidence, as set out in Chapter 3 below, suggests that smaller businesses can be disproportionately affected by changes in business rates. In order to offer them protection, and in support of the Government's objectives for enterprise, there is therefore a case for providing additional exemptions or reliefs.

2.52 Business properties in England with a rateable value of £50,000 or less generate 31 per cent of the total yield available through a business rate supplement. As Chart 2.1 shows, protecting these businesses would therefore exempt the vast majority of business properties in England while preserving most of the yield.

2.53 **Hereditaments with a rateable value of £50,000 or less will therefore be exempted from paying the supplement.** In order to provide consistency this threshold will be standardised across England.

2.54 In some cases authorities may wish to go further and provide more generous safeguards for local businesses. Or they may wish to introduce a taper above the £50,000 threshold in order to provide a smoother transition. **The legislation will enable them to do so**.

Chart 2.1: Cumulative rateable values



Source: VOA data.

Reserve powers for Secretary of State

2.55 These conditions provide substantial protection for all businesses, and for smaller businesses in particular, to ensure that they receive a fair deal. This means that central government will not take a power to approve or give permission to supplements or projects. **However, the Secretary of State will retain a reserve power to intervene if the conditions of a supplement – such as the uses to which the supplement is put – are breached.**

Business ballot

2.56 Statutory consultation provides transparency and accountability. Businesses and other stakeholders can clearly see the costs and benefits associated with a project, and can assess the proposal fairly. They have assurance that the local authority will stick to its stated plans.

2.57 Where the public sector contribution to the cost of a project is smaller, however, the incentives on the local authority to focus on value for money and to ensure that spending is effectively targeted are weakened. With less of its money 'at risk' there is a greater chance that the authority will commit to less productive expenditure.

2.58 In these cases a ballot can provide a better alignment of incentives. Businesses can effectively weigh up the balance of costs and benefits. Unlike in situations where the authority is effectively committed to a project through its own funding decisions there is no incentive for business to attempt to 'call the bluff' of the authority in the belief that they can benefit from the investment without contributing to a supplement.

Voting arrangements

2.59 Therefore as a final level of protection **the Government will require a ballot of businesses where the contribution supported by the supplement exceeds a third of the total cost of a project.**

2.60 Voting arrangements will closely mirror those for BIDs. A local authority will need to win a simple majority of businesses affected both by rateable value and by number to levy a supplement. Entitlement to vote will be by hereditament, not by business. Only those hereditaments which would be liable for the supplement will be entitled to vote. This 'double lock' majority system will provide protection for businesses.

2.61 Ahead of a ballot local authorities will be required to set out in detail their plans to levy a supplement and the projects on which it will be spent. They will also be required to set out how they will deal with escalation or reduction in costs.

2.62 This additional level of protection reflects the success of the BIDs model and responds to contributions to the debate around business rates from a number of business representative groups calling for ballots as a key element of the accountability for business rate supplements.[6] Alongside the requirement for statutory consultation it provides a clear basis for ensuring that business receives a fair deal.

2.63 The Government will set out in detail the arrangements for assessing the proportion of costs supported by a supplement, dealing with the associated technical issues.

[6] British Chambers of Commerce news release, 5 October 2007; Confederation of British Industry news release, 6 October 2007.

Box 2.2: Crossrail

Business rate supplements can provide new potential for investment in projects to drive economic development. The Government's approach ensures clear accountability alongside a strategic role for local authorities in assessing the benefits of projects.

The proposed use, within the approach set out in this White Paper, of a supplement as part of the funding package for Crossrail provides a good example of this. Crossrail is a new railway that will link Maidenhead and Heathrow to the west of London with Shenfield and Abbey Wood to the east of London, running in new tunnels deep under London, and serving new stations that will provide direct interchanges with the Underground network. The first services are due to commence in 2017.

Crossrail will increase east-west capacity by 40 per cent, and will add 10 per cent to London's overall transport capacity, catering for a significant population and employment growth over the coming decades including an estimated 30,000 new high-value jobs. Crossrail will also open up new employment opportunities to thousands in some of London's most deprived areas, and will support new areas of housing development in the Thames Gateway.

The expected cost of up to £16 billion (including contingency and allow for inflation) has represented a considerable challenge for successive governments, and agreement has only been possible now thanks to sustainable management of the public finances. Agreement has now been reached with the Mayor of London and businesses on an equitable funding package, with passengers, businesses and general taxpayers each contributing approximately one third of the expected cost.

As part of the business contribution, the Mayor of London has announced following discussions with Government that, subject to appropriate consultation, he envisages levying a business rate supplement across the GLA area, with relief for small businesses, and with revenues to be used to service debt raised for Crossrail's construction.

In line with these discussions and the key features of the powers as set out in this document, the Mayor envisages that the supplement will be set at 2p per pound of rateable value, with businesses with a rateable value of £50,000 or less exempt from paying the supplement. The Mayor further envisages that the supplement will be introduced from April 2010, and that the supplement will cease once the debt has been fully repaid.

Arrangements for consultation will be set out by the Mayor of London in due course in order to ensure that it is possible for a supplement to be introduced to this schedule.

Eligible authorities

2.64 The system of local government in England includes a number of different layers, or tiers, of authorities. In some areas there is only one tier; in others there are shire counties and lower-tier districts; while in London the Greater London Authority operates as a city-wide, democratically elected authority alongside the London Boroughs.

The role of lower-tier authorities

2.65 Every level of authority has a role to play in promoting economic development. District councils and, in London, the London Boroughs, as billing authorities, have a key role to play through the Business Improvement Districts scheme. The BIDs scheme, which unlike the proposed busines rate supplement is not subject to an upper cap, allows a levy to be added to business rates in order to fund local improvements.

2.66 The Government is committed to the continued success of BIDs and to districts' key role in their design and delivery.

2.67 The SNR clearly identified the importance of sub-regions as economic entities. In the case of cities, for example, some 63 per cent of employment is in the 56 largest urban areas in England.[7] Equally, the Local Government Association has made strong arguments that the right economic geography to address economic issues is at the sub-regional level.[8]

2.68 Similarly, the Lyons Inquiry pointed to the additional complexity that would be created by allowing district councils to levy supplements in two-tier areas and the potential impact that this would have on businesses.

2.69 Finally, there are also fairness arguments in favour of locating the power to levy supplements at a larger geographical scale than lower-tier authorities. This has the effect of evening out some of the variation in tax bases and lessens the risk that disadvantaged areas with weaker property markets will be unable to attract the resources that they need to invest in economic improvement projects with wider long-term benefits.

2.70 **The Government therefore intends that only the highest tier authority in any area should be entitled to levy supplements.**

2.71 However, the views and input of other affected authorities in each area will clearly be important as the upper tier authority exercises this function. It is essential that the decision to levy a supplement reflects the interests of the whole area. In London, statutory arrangements already exist for the GLA to consult with the Boroughs as part of the budgeting process. Outside London, the Government recognises the importance of districts also being fully involved in consideration of whether or not to levy a supplement and if so for what purpose.

2.72 Districts have a key role in establishing partnerships, gathering information and developing policies to improve economic well-being in the towns, cities and localities they represent. To ensure that districts have the necessary voice in supplements that may affect their areas **shire counties will be required to consult their districts on any new supplement proposals.**

Multi-area supplements

2.73 In many cases, economic units go beyond individual local authorities. As the SNR set out:

> "... many local authorities are 'under-bounded' in that they cover too small a geographical area to encompass most economic markets and so are too small to tackle many economic challenges effectively. This gap between administrative and economic boundaries inhibits strategic decision-making and creates coordination challenges for economic policy-making between local authorities, risking policies that are not in the wider regional or national interest or the loss of policy opportunities that could make all places better off."[9]

2.74 The Government is developing the framework of Multi-Area Agreements to take forward sub-regional cooperation. The Government has also committed to work with interested groups of local authorities to explore the potential for establishing statutory sub-regions which enable pooling of responsibilities for economic development policy on a permanent basis. Policy on business rate supplements should operate within that framework. Local authorities, as the democratically accountable bodies, will remain individually responsible for the supplements that they set. However authorities that wish to cooperate within the existing statutory framework may do so. In particular, arrangements on

[7] *Review of sub-national economic development and regeneration*, HM Treasury, DCLG, and DBERR, July 2007.
[8] *Prosperous Communities II: vive la dévolution!*, Local Government Association, February 2007.
[9] *Review of sub-national economic development and regeneration*, HM Treasury, DCLG, and DBERR, July 2007.

consultation and voting will be constituted so that authorities can cooperate on a sub-regional basis. In these cases where the voted route is taken the requirements for majorities will apply to the sub-region involved as a whole rather than to each individual authority.

London **2.75** London's unique position in England, with a city-wide democratically elected administration, has implications for the operation of a supplement. Many of the Boroughs are substantial economic centres in their own right, and would be able to identify credible projects for investment. However there are important countervailing arguments in favour of a city-wide approach. The Greater London Authority's strategic responsibility fits well with the long-term investment which business rate supplements are intended to underpin. Differences in tax rates between the Boroughs could add unnecessary complexity. The fact that there is a democratically accountable decision-making mechanism at city level puts London in a categorically different position from other major cities.

2.76 **In London therefore the Government proposes that the power to levy supplements will rest with the Greater London Authority and not with the London Boroughs.**[10]

Other issues

Reliefs and exemptions **2.77** Business rates are subject to a system of reliefs and exemptions. The Government believes that it is appropriate to maintain consistency in the treatment of these under supplements. The mandatory exemption for smaller businesses will apply in addition to existing reliefs and exemptions. Any future changes to the national framework of reliefs and exemptions will be applied to any supplements, unless specified otherwise. Transitional relief will not be applied to supplements.

2.78 As set out in the 2007 Pre-Budget Report the Government has concluded its review of business rates reliefs and exemptions following the Lyons Inquiry recommendation to conduct such a review. The Government has acted to reform Empty Property Relief. It will bring forward proposals to simplify the current set of business rate reliefs in order to provide clarity for rate payers and certainty for those who adminster the business rate system. Subject to the results of this consultation the Government intends to legislate to introduce a simpler set of reliefs by 2010. Reform is not intended to increase funding of reliefs from the central business rates pool above the current level, will protect those enjoying existing reliefs and will not involve a change to the support offered to charities.

2.79 It proposes no further changes arising from the review at this time. However, it will continue to consider the merits of extending business rates to include derelict and vacant previously developed land. No substantive changes to Business Improvement Districts (BIDs) are proposed for the time being, though the Government will seek to take stock in the light of the introduction of the power to raise local business rate supplements, once these have been operating for some time. There will not be any substantive changes to the BIDs regime in the meantime. The Government will keep business rates policy more generally under review, as it does all taxes.

Treatment of BID levies **2.80** Business rate supplements may be proposed in areas where BIDs are already in place and businesses are already subject to BID levies. The Government supports BIDs and believes they are an important complementary policy to give local authorities a range of tools to support economic development.

[10] The City of London's unique powers, described in Paragraph 1.16, will remain in place.

2.81 The Government believes that the decision as to whether or not BID levies should be offset against business rate supplement liability should be made at a local level rather than uniformly. Local authorities, in developing proposals, will wish to consider whether or not existing or new BID levies will be offset. In some cases this will not be appropriate as the additional liability for the BID, as well as the business rate supplement, will reflect the additional benefits received by those in the BID.

2.82 The arrangements for local accountability set out above will provide businesses, including those in BIDs, to raise concerns if they feel that the proposed treatment under a supplement is not appropriate. As with BIDs, provision will be made to enable owners of occupied properties to make voluntary contributions equivalent to a business rate supplement.

Devolved issues

2.83 In line with the remit of the Lyons Inquiry and the SNR this document applies to business rates in England only. Non-domestic rates are a devolved matter in Scotland and Northern Ireland. In Wales, the rating system is governed by the same primary legislation as England, but has been devolved to the Welsh Assembly Government. The Government will consider possible implications for the devolved administrations as it takes this policy forward.

3 THE ECONOMIC IMPACT OF CHANGES IN BUSINESS RATES

This chapter presents analysis on the potential economic impact of the introduction of business rate supplements. The chapter draws on economic theory, evidence from empirical studies and rateable value data to consider the economic incidence of business rates and how this might be affected by the introduction of supplements, and impacts by size and type of business.

The available evidence suggests that:

- **although the impact of increases in the business rate is felt by the occupier in the short term, a significant portion of any change in business rates burden is passed on to the landlord over time, although this can vary depending on the operation of commercial property markets;**
- **the introduction of an exemption threshold for properties with a rateable value of £50,000 or less removes a significant majority of smaller businesses from liability for supplements;**
- **evidence on economic impact by business sector is more limited, but there is reason to believe that there may be more of an impact on businesses where property costs form a large proportion of their overall costs, such as retail. Conversely, retailers are less likely to be owner-occupiers and so should bear a smaller proportion of the eventual costs. Local authorities will need to consider this against the likely positive economic impact on these sectors;**
- **geographical areas with lower rateable value stocks will have less capacity to raise revenue from supplements, but allocation of the power to levy supplements to upper tier authorities gives all local areas the opportunity to raise significant revenues for economic development; and**
- **the most significant economic impact of a power to raise local business rate supplements of up to 2p is that it provides a substantial devolution of power over investment decisions, allowing them to more closely reflect local economic need. By comparison the impact of a supplement either on business costs or local revenues is relatively small.**

3.1 As set out in Chapter 2, one of the Government's key principles for the introduction of business rate supplements is that supplements should not have a negative or disproportionate economic impact across the country. The Government has considered carefully the potential impact on the economy of a local power to raise supplements. This chapter sets out the available analysis on economic impacts, including how different types and sizes of businesses in different regions may be affected by a power to raise supplements of up to 2p in the pound. The chapter also considers the likely economic incidence of supplements, that is, whether the cost of a supplement would ultimately be borne by occupiers or owners of business premises.

The economic incidence of business rates

Economic theory

3.2 Whilst the formal incidence of business rates is placed upon occupiers, economic theory suggests that a significant portion of any change in business rates burden is passed on to the landlord over time. This is because businesses care about the total cost of occupancy in one location rather than another, not the specific proportion made up through business rates, so an increase in business rates reduces demand for rental property at any given price. The market price of renting a property will reflect the total occupancy cost including taxation; so if occupiers in one area are faced with a higher level of business rates the landlord will have to reduce rents in order to remain competitive.

3.3 Economic theory also suggests that the portion of the burden that is passed on to landlords should only be passed on to current landlords. This is because the expected rental value of a property affects its capital value. An increase in rates would be reflected in a reduced capital value. For future landlords the two effects should balance out.

Empirical studies

3.4 Research by the Institute for Fiscal Studies on the effects of the transition to a national system of rates in the early 1990s supports this theory. After examination of a sample of 2,964 properties between 1987 and 1992 it concluded that:

> "It appears that increases in non-domestic rates put downward pressure on rents, whilst decreases in non-domestic rates put upward pressure on rents... We confidently reject the hypothesis that a £1 increase in non-domestic rates... has no impact on property rents... In the long run, we cannot reject the hypothesis that rents fall pound for pound with business rates"[1]

3.5 However this pass-through is not immediate. On the contrary, contractual constraints, five-year rent review periods and upward-only rent reviews act to impede the shift of the burden of changes onto landlords. The study concluded that the scale of pass-through after two years varies from 45p to 85p for each £1 of change in business rates. The speed of pass-through is subject to some variation, with the effect fastest in London and the South-East.

3.6 More recent unpublished work undertaken by Cambridge Econometrics, examining the effect of removing the business rates exemption for properties in Enterprise Zones, confirms this finding.[2] This research found that the majority of a change in business rates is passed through into rents, with some variation between regions and property type.

3.7 This implies that whilst in the short term a supplement increases the cost of occupying a property for tenants, over the longer term a large portion of the burden of the supplement is taken into account in rent reviews, and tenants will thus face lower rents.

3.8 The economic evidence therefore suggests that while the formal burden of taxation for business rates falls on occupiers, the economic incidence passes in whole or in part to landlords over the medium term. This has important implications for the likely economic effect of the decision to levy a supplement.

Impact by size of business

3.9 Some analysis has also assessed the impact of business rates on different sizes of business. The Government has a clear objective to promote enterprise and to encourage the development of small and medium-size enterprises (SMEs). The Government has already introduced a relief for small businesses from business rates in order to support SMEs, and the proposals set out in Chapter 2 of this document include additional protection from the impact of a supplement.

[1] *Who Pays Business Rates?*, S. Bond, K. Denny, J. Hall and W. McCluskey, Fiscal Studies vol. 17 no.l, 1996.

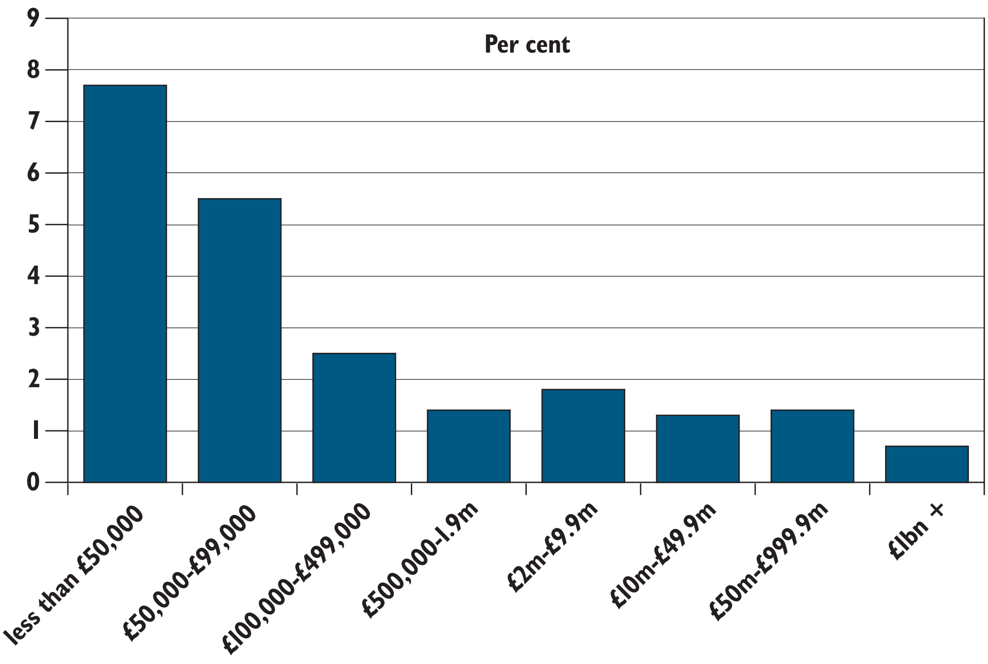
[2] *The Relationship between National Non-Domestic Rates and Rents on Commercial Property: Empirical Evidence from Enterprise Zones*, Cambridge Econometrics, forthcoming.

3.10 Research undertaken for the Government by IFF Research analysed the factors determining the extent to which rates affected different businesses. It concluded that:

> "The only group for whom the impact of rates was significantly greater [than average] was the very small primary trading companies with a turnover of less than £100,000. This was because rates, other property costs and overheads more generally were proportionally higher than for larger firms."[3]

3.11 As Chart 3.1 below shows there is a clear relationship between size of turnover and rates as a proportion of turnover:

Chart 3.1: Business rates as a proportion of turnover



Source:IFF Research, 1995.

3.12 The size of a business in terms of turnover does not necessarily directly correlate with the value of its property by rateable value. Assuming that the relationship between rateable value and turnover is approximately as found in the IFF research, however, a business with a rateable value of more than £50,000 would on average have a turnover of at least £1.1million. Office for National Statistics data report that 89.6 per cent of registered enterprises have a turnover below this level.[4] Table 3.1 below shows the distribution of properties by rateable value.

Table 3.1: Distribution of business properties

RV band	By rateable value (Per cent)	By number (Per cent)
Under £5,000	3	40
£5,000 – £14,999	10	32
£15,000 – £24,999	7	10
£25,000 – £49,999	11	9
£50,000 – £99,999	12	5
£100,000 – £499,999	29	4
£500,000 and over	28	1

Source: VOA data.

[3] *The Impact of Rates on Businesses*, IFF Research, 1995. Note that this analysis does not take account of the impacts of capitalisation.

[4] *UK Business: Activity, Size and Location*, National Statistics, 2007.

Impact by type of business

3.13 Less evidence is available on the impact of business rates on different economic sectors. In theory sectors where property costs form a particularly high proportion of turnover, costs or profit could be expected to receive the greatest propeortion of the impact of any change in rates.

3.14 This might suggest that retail would be affected more heavily than other sectors by a business rate supplement. As Table 3.2 below shows, retail properties constitutes 27 per cent of rateable value in England. These figures should be interpreted with care since they refer to the physical characteristics of the property, rather than the purpose for which it is actually used or the main business of its owner or occupier. By contrast data from UK VAT registrations suggest that only 11 per cent of businesses are retailers.[5]

Table 3.2: Distribution of business properties by type

	Per cent	
Type	By rateable value	By number
Retail	27	31
Offices	24	18
Factories	13	16
Warehouses	10	10
Othe Bulk premises	5	11
Non-Bulk premises	22	14

Source: VOA data.

3.15 At a minimum this emphasises the likelihood that a business rate supplement may have differential impacts across sectors, and that local authorities will need to take this into account in their decision-making.

3.16 Tenure patterns also vary by sector. As set out above businesses which do not own their properties are likely to bear significantly less of the cost of a supplement than owner-occupiers. VOA data show that retail properties are much more likely to be tenanted than occupied by the owner with some 78 per cent of properties by rateable value and by number rented. By contrast factories and warehouses are more likely to be owner-occupied: 53 per cent and 41 per cent by rateable value respectively. This suggests that while retail may be relatively property intensive the patterns of tenure should mitigate the impact of a supplement.

Impact by geographical area

3.17 Table 2.1 shows the potential revenues that could be generated by a selection of local areas. Those areas which have the least amount of rateable value will self-evidently be able to raise less revenue from business rate supplements than areas with large tax bases, which are often, although not exclusively, larger and more densely populated areas. However, as the power to raise supplements will rest at the upper tier, and the opportunity exist for authorities to work together on multi-area supplements, smaller areas within counties or unitary authorities with smaller tax bases will still have the opportunity to benefit from the raising of significant revenues to devote to the promotion of growth within their area.

3.18 Table 3.3 below shows how rateable values and numbers of properties are distributed across England.

[5] *UK Business: Activity, Size and Location*, National Statistics, 2007.

Table 3.3: Distribution of business properties by region

	Per cent	
Region	RV	Number
East Midlands	7	8
East of England	10	10
London	27	17
North East	4	4
North West	12	14
South East	16	15
South West	8	11
West Midlands	9	11
Yorkshire and the Humber	8	10

Source: VOA data.

3.19 Table 3.4 below sets out the potential distribution of additional supplementary revenue at a higher spatial level. Figures are based on a 100 per cent take up of a local business rate supplement power.

Table 3.4: Rateable values and potential supplement revenue by region

English Region	Total rateable value, in £bn, of premises <£50,000	Total rateable value, in £bn, of premises >£50,000	Total rateable value (£bn)	Amount raised by 2p supplement (£m)	Population share (per cent)
East of England	1.5	3.1	4.6	57.9	11.0
East Midlands	1.1	2.0	3.1	37.8	8.5
London	2.9	9.6	12.4	177.9	14.8
North East	0.6	1.1	1.6	20.4	5.1
North West	1.8	3.5	5.4	66.1	13.6
South East	2.3	5.2	7.5	97.4	16.2
South West	1.4	2.2	3.6	41.1	10.1
West Midlands	1.5	2.8	4.3	52.1	10.7
Yorkshire and the Humber	1.3	2.5	3.8	46.4	10.1

Source: HM Treasury calculations using RV data and DCLG data.

Assessing the impact of a 2p supplement

3.20 As set out above, a business rate supplement could provide local authorities, working together with business and the wider community, with an important new tool to promote growth.

3.21 The overall impact of this power on the level of spending by authorities, or the tax burden faced by businesses, will be relatively small. Annual local government spending is more than £100 billion. Even a widespread use of the new power to raise supplements would only equate to less than a quarter of a percentage point change.

3.22 Similarly the business rates multiplier has, on average, increased by 1.2p per year since 1998-99 (excluding revaluations) under the RPI cap system. A supplement of 1p would therefore be a one-off change equivalent to that faced by businesses annually.

3.23 The evidence from the IFF study cited above suggested that in 1995, for firms with a turnover of above £100,000, rates constituted 2.5 per cent or less of turnover. While this evidence is now somewhat dated, if the relationship between turnover and rates has remained approximately constant, then a 2p supplement could be expected to constitute a difference of only around 0.125 per cent to most firms' turnover.

3.24 The significance of introducing the power to levy a business rate supplement therefore lies not in the scale of the revenue involved or in the costs to business but in the potential for local authorities to take on a new role, taking key decisions with business about investment in economic development.

3.25 Each local authority's circumstances will be different and in many cases a supplement will not be an appropriate means of tackling the economic needs of the area. While the overall cost to business, especially given the £50,000 exemption, should be proportionate there may be cases where local authorities judge the impact unacceptable.

3.26 The Government believes that it is right that local authorities should be able to make this economic assessment themselves as an integral part of their decision-making process. **Therefore as part of the process of consultation or voting local authorities will be required to make an assessment of the impact of a supplement on local business and to show how this relates to the benefits that will be delivered from projects supported by the supplement.**

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