Cabinet **6th September 2011**

Report of the Cabinet Member for Corporate Services

Local Government Finance Update

Summary

1. The purpose of this report is to provide an update on a range of issues relating to Local Government Finance, including

   - the Local Government Resource Review
   - Business Rates Consultation
   - a review of alternative forms of capital finance

Local Government Resource Review

2. The Coalition Government's October 2010 Spending Review and subsequent Localism Bill announced a raft of policy changes for Local Government, both in terms of the way services will be provided and how they will be funded. Government has made clear that its priorities are to reduce the financial deficit, deliver economic growth, both nationally and locally, and reform public services. The Local Growth white paper highlighted the Local Government Resource Review and the Terms of Reference for Phase 1 were published in March 2011, focusing on the retention of business rates and council tax benefit localisation. These are attached at Annex 1 for information.

3. The current funding of the council's net budget is set out below:

	2011-12 £k	2011-12 £k
Revenue Support Grant	11,751	
Redistributed Business Rates	38,017	
Total Formula Grant		49,768
Council tax income		73,132
Collection Fund Surplus		1,000
Council net revenue budget		123,900

4. Council Tax is set locally at the discretion of local authorities based on individual need, albeit within the bounds of centrally set capping limits. Formula Grant is allocated from Central Government based on a series of highly complex formulae that is supposed to reflect each area's need. It is comprised of centrally funded Revenue Support Grant (RSG) and redistributed business rates, which leads to the issue of massive disparity in some cases between what a local authority collects and what it eventually receives back

5. The advantages of the current system are often cited as:

- stability of resources from one year to the next,
- support for poorer areas is guaranteed via the redistribution of business rates collected in more affluent areas.

6. The disadvantages of the system can be summarised as:

- disparity between total local resources and eventual settlement resulting in each local authority being financially dependent on Central Government,
- coupled with strict laws over fees and charges, local authorities have little to no control over the income they generate,
- the formulae lacks transparency and arguments persist for and against the measures used to determine 'need'.

7. The first phase of the review will consider how local authorities are funded and will include looking at ways to reduce the reliance of local government on central government funding, increase local accountability and ensure that the benefits of economic growth are reflected in the resources authorities have.

Localisation of Business Rates

8. As part of the first phase of this review, a consultation paper has been issued seeking views on the Government's proposals to introduce the local retention of business rates. It also seeks views on options for enabling authorities to carry out Tax Increment Financing within the business rates retention system. A further 8 technical papers are to be issued during August that will enable councils to calculate the actual financial impact. At the time of writing we are still awaiting sight of these

technical papers. Responses to the consultation are due by Monday 24 October 2011 and a full list of the questions asked is attached at Annex 2. The Government intends to introduce business rates retention from April 2013.

9. Business rates, although collected by local authorities, are subsequently pooled centrally by government and redistributed to local authorities (including police and fire authorities) through formula grant. The consultation paper is mainly concerned with the distribution of business rate tax revenues between individual authorities, rather than changes to the system of business rate taxation itself. Businesses will see no difference in the way they pay tax or the way the tax is set. Rate setting powers will remain under the control of central Government and the revaluation process will be unchanged.

10. The key elements of the main proposals are

i. With effect from 2013/14 there will be an end to the system whereby council's receive an annual funding settlement from central government.
ii. No changes to the system of business rate taxation itself. Rate setting powers remain under central Government control and there will be no opportunity for local authorities to set their own level of business rates.
iii. A business rates "target" for every council from 2013/14.
iv. Councils collecting more in rates than they presently receive in formula grant will be required to pay a tariff to Government, meaning that York will continue to collect much more than it eventually receives back to fund services.
v. If a council exceeds its business rates target it will keep some of the excess, the rest being levied to provide a safety net and for other purposes. Therefore gains are likely to be very modest with only a proportion of any gain being kept by the council to support local service delivery.
vi. Failure to meet the target will mean a reduction in overall resources, which might be partly offset by funding from the levy.
vii. Voluntary pooling arrangements could allow neighbouring authorities to smooth out volatility
viii. A complete "reset" every few years
ix. Police and Fire authority funding determined essentially as now with a revised formula from 2013/14.

11. The Government believes that the core components of the scheme, as set out in the following paragraphs, have been developed to
    - ensure a fair starting point for all local authorities;
    - deliver a strong growth incentive where all authorities can benefit from increases in their business growth
    - include a check on disproportionate benefits;
    - ensure sufficient stability in the system; and
    - include an ability to reset in the future to ensure levels of need are met.

12. The Government expects that business rates collected in England in 2013-14 and 2014-15 will be greater than it had previously set out in the 2010 spending review figures. Their proposals assume that this forecast increase in business rate revenues will be set aside and used to fund other grants to local government, including the New Homes Bonus. However, councils should benefit from growth in business rates above these forecast levels. It is not yet known what increase the Government is assuming and how likely it is that there will be any of this increase left for councils to retain locally.

13. Beyond 2014/15 Government will consider, at the next Spending Review, the total spending figures for local government with a view to more closely aligning local authority functions and responsibilities with business rates income from 2015-16.

14. The core components of the scheme are as follows:

    <u>Component 1: Setting the baseline</u>

15. Across the country some authorities, such as York, collect business rates in excess of current formula grant funding whilst others collect substantially less. Therefore, it will not be possible to simply allow business rates to be retained where they are paid; there needs to be a high degree of re-balancing.

16. The Government consider that the most pragmatic way to achieve this is to start from each individual councils current formula grant position and so propose to use 2012-13 formula grant as the basis for constructing the baseline in the first year of the new business rates retention system. York's 2012/13 formula grant is expected to total £44.7m, which includes £0.8m damping. This means that the grant is £0.8m higher than it would normally be without any damping mechanism. This is the amount that has been included in the Medium Term Financial Forecast and therefore nothing within this consultation changes the need to make savings of

some £20m over the next 2 years, with continued savings being required in future years.

17. Clearly, given the coalition Governments stated objectives of reducing the national deficit, they need to take into account the expenditure control totals set out in the Spending Review and the paper suggests this could be done in 2 ways:
    i. By taking individual levels of 2012/13 formula grant as the baseline position and then adjusting them in proportion to the new control totals with no further changes. This approach provides certainty and stability for the start of the business rates retention scheme. It also means that York would continue to benefit from the current £0.8m of damping included within the 12/13 formula grant allocation.
    ii. Establish the baseline position for each local authority by applying the process used to determine their 2012-13 formula grant allocations to the local government control totals and at the same time make very limited, technical updates to the formulae. This option is more risky for York as it could mean we lose the £0.8m damping within the current formula grant allocation.

Component 2: Setting tariffs and top ups

18. To ensure a fair starting point Councils (such as York) who collect more than they are currently allocated will be expected to pay a tariff. However, in an attempt to create a strong incentive and reward authorities promoting growth, the tariff amount would remain fixed so that a proportion of business rate growth in future years would be retained by the local authority in which it occurred. Again, the paper considers 2 alternative options for fixing the tariff:
    i. Uprate the year one tariff by RPI each year. This would result in the council having to achieve real growth in it's taxbase to see a real rise in spending ability. So, on the 2012/13 funding expectations we anticipate a tariff of some £43.2m (ie the difference between projected business rates income of £88m and the formula grant of £44.7m). If this were uprated by current RPI of 5% our tariff would increase by £2.1m, meaning that we would need to identify at least an equivalent amount in business rates growth just to stand still. If our gain were to be further reduced by the government raising a levy on any growth, we would need to find an even higher amount in growth or compensatory savings.

ii. Retain the year one cash amounts and not uprate by RPI, offering a stronger incentive for growth. Clearly this would be a better option for council's paying a tariff.

Component 3: The incentive effect

19. This incentive effect is at the heart of the changes that business rates retention is aiming to deliver. Regardless of how the tariff is set or uprated, the council would still stand to benefit from at least some of any increase in business rates. There would also be strong incentives for effective billing and collection of business rates. York is already a high performer in this area and as we regularly collect in excess of 98% of business rates this is less of an incentive for us.

Component 4: A levy recouping a share of disproportionate benefit

20. To manage the possibility that some local authorities with high business rate taxbases could see disproportionate financial gains, government would recoup a share of disproportionate benefit through a levy and use the proceeds to help manage large, unforeseen negative volatility in individual authorities' budgets. However, the stronger the protection, the weaker the incentive effect. Further clarity is needed as to how this levy could work and the potential impact on York. Alongside any additional resources we would also take increased risks due to volatility and therefore we would need to consider increasing the level of reserves the council currently holds.

Component 5: Adjusting for revaluation

21. The paper proposes that the tariff is adjusted at revaluation, which has the effect of removing any financial gain (or loss) from wider economic uplift reflected in rental values. It also proposes to strip out from the rates retention scheme the impact of the transitional relief on local authorities' finances.

Component 6: Resetting the system

22. Whilst, as highlighted above, the tariff would remain fixed the Government wishes to retain the option of resetting the system if it felt it necessary, eg because of population movements. The paper discusses options for a full or partial reset of the system and whether it should set a fixed period of say 10 years between resets to ensure it can achieve it's stated aim of encouraging long term growth in local economies. The

paper also states that the existing new burdens guidance will be reviewed, taking into account the proposals in this consultation.

23. As York currently is the 2nd fastest growing city in the UK this could mean that our population growth is not funded for a significant period of time. There is also some question around whether business rates yield bears any relation to the service needs of the local community. There are numerous other influences besides the council on business success and growth.

Component 7: Pooling

24. Local authorities could choose to form voluntary pools within the system whereby a single tariff or top up would be applied which would be the sum of all tariffs and top ups of individual authorities within the pool. This would help manage volatility and potentially increase growth across an area. The paper considers offering further rewards, in the form of allowing them to retain a greater proportion of growth or offering other incentives. All North Yorkshire authorities are net contributors and therefore our initial thoughts are that this would not offer any real advantages to York. There could be some merit in sharing a collection service to further improve collection rates. The table below sets out the assumed positions for all Yorkshire and Humber authorities.

	Total Formula Grant 2012/13 £m	NNDR (projected) 2012/13 £m	Contribution to National NNDR Pool in 2012/13 £m	Reliance on redistribution from NNDR Pool in 2012/13 £m
Barnsley	101.2	47.6	0	53.5
Doncaster	133.4	82.6	0	50.9
Rotherham	113.0	69.5	0	43.5
Sheffield	260.8	195.6	0	65.2
S YORKS	608.4	395.3	0	213.1
Bradford	252.3	135.7	0	116.6
Calderdale	75.0	55.0	0	20.0
Kirklees	146.2	102.8	0	43.4
Leeds	288.1	344.3	56.2	0
Wakefield	128.2	113.4	0	14.8
W YORKS	889.8	751.2	56.2	194.8
East Riding	93.7	82.2	0	11.4

Hull	145.0	90.7	0	54.3
NE Lincs	67.7	64.4	0	3.3
North Lincs	57.9	77.1	19.2	0
HUMBER	364.3	314.4	19.2	69
York	44.7	88.0	43.2	0
North Yorkshire	110.5	N/A*	40.4	0
Craven**	2.9	16.3		
Hambleton**	4.2	24.6		
Harrogate**	7.3	56.0		
Richmondshire**	2.9	11.2		
Ryedale**	3.1	15.0		
Scarborough**	8.0	29.3		
Selby**	4.7	31.6		
YORK & N YORKS	188.3	272	83.6	0
YORKSHIRE & HUMBER	2,050.9	1,732.9	159	476.9

*NYCC does not collect business rates. This is carried out by districts as billing authorities
** Until there is clarity about how any new system would work in two-tier areas, it is not possible to calculate the impact of localisation
Source: SIGOMA

New Homes Bonus

25. The Government is committed to continuing to fund the New Homes Bonus within a business rates retention system. It proposes to deliver this commitment by fixing individual authorities' tariffs and top up amounts at a level which leaves a sufficient sum aside to fund the future cost of the New Homes Bonus. This would involve making a judgement, at the outset of the rates retention scheme, about the likely sum needed to fund future New Homes Bonus payments, which would need to take into account the latest housing growth projections and the potential level of central support available (there is £250m available for each year of the current Spending Review to 2014-15).

Tax Increment Financing

26. The Government believes that the local retention of business rates will remove the most important barrier to Tax Increment Financing schemes (TIFs), namely that local authorities are currently not permitted to retain any of their business rates and therefore could not borrow against any predicted increase in their business rates. Borrowing for Tax Increment

Financing schemes would therefore fall under the prudential system, allowing local authorities to borrow for capital projects against future predicted increases in business rates growth, provided that they can afford to service the borrowing costs out of revenue resources.

27. However, clearly such borrowing can only take place if local authorities and developers have a degree of certainty about the future tax revenue streams and whether there are sufficient guarantees that they will be retained within the authority. Issues around TIFs are explored further in paragraphs 41 to 46.

Review of alternative sources of financing

28. The next section of the report contains an analysis of a number of alternative sources of capital finance that could be available to the council in the near future. Where possible, examples of projects that have been successfully developed in other parts of the country have been included. In the wider context, the Council already has power to borrow to invest in capital works and assets so long as the cost of that borrowing was affordable and in line with principles set out in a professional Prudential Code. In exploring these alternative methods of financing, the benefits will need to be clearly identified and assessed against the cost of borrowing from the Public Works Loans Board through the Prudential Code

Local Asset Backed Vehicles (LABV)

29. A LABV is a long term partnership between the public sector and a private sector partner. There is no uniform LABV but the process typically works by the Council transferring assets (that can be on a phased basis) into a joint venture with a development company who will invest cash into the vehicle. The Council assets can be surplus, investment or operational assets. The vehicle can additionally raise funding through normal commercial routes and it might be possible for the venture to attract European Regional Development Funding (ERDF).

30. Over time the vehicle works towards securing uplift in the values of the assets under its control through financing remediation, critical infrastructure provision, securing planning permission, etc. The partnership might choose to directly develop some of the properties/ land transferred to it or it may engage with other developers. The Council typically has the option to phase the introduction of assets at agreed delivery milestones giving the Council control of its asset portfolio. The vehicle would pay the running costs of the partnership, repay any

borrowings and distribute profit to the Council and private sector partner. The key advantages of a LABV are that it facilitates the pooling of both attractive and less attractive sites and that this, along with the long term relationship with a development partner who brings commercial expertise to the relationship, then allows development that would not otherwise have taken place, or the development of sites to a higher standard. The stable nature of a LABV allows a pipeline of regeneration projects and the ability to manage them under a single umbrella organisation.

31. As an example Tunbridge Wells Borough Council progressed such an option in 2008 under the header 'Tunbridge Wells Regeneration Company' with John Laing regenerating 4 town centres over a 10 year period. A number of other LABV exist including in the North and North West however there is not currently a LABV in the region.

32. LABV may offer the Council an opportunity if a suitable portfolio of sites could be identified that would be available to transfer to such a vehicle. Consideration could be given to progressing a LABV that contains a mixture of sites. Sites that are in need of regeneration/development, which alone would not pose an attractive investment opportunity, would be mixed with sites that are attractive investment proposals. The blended investment return over the whole scheme offers a good financial return.

33. **Joint European Support for Sustainable Investment in City Areas (JESSICA)**

34. JESSICA is a policy initiative of the European Commission. A JESSICA scheme would normally fund projects through an Urban Development Fund (UDF) based on funding provided from the public (normally European Regional Development Funding - ERDF) and the private sector. An UDF can support projects (that are ERDF eligible) using a variety of funding sources including loans, equity or guarantees. An UDF is a provider of funding to allow viable schemes to proceed where the risk has been too great for mainstream institutional funding. Revenues returned to a scheme can be recycled into a second round of projects making continuous growth of such areas a possibility.

35. The number of JESSICA schemes set up in the UK is relatively limited but they are more prevalent across Europe. DCLG is keen to set up a regional JESSICA.

36. As an example the Northwest Urban Investment Fund (NWUIF) is a new £100 million fund to help support urban development projects in England's Northwest. Its purpose is to restart urban regeneration projects

that have stalled due to the economic downturn and lack of finance. The project investments will include the development of employment sites, creation of new commercial floor space, reclamation of derelict or contaminated land, and provision of site servicing and infrastructure.

37. The Northwest Urban Investment Fund has been established by the Northwest Regional Development Agency (NWDA) in partnership with the European Investment Bank (EIB), which has been appointed as Holding Fund Manager, and utilises funding from the European Regional Development Fund (ERDF). The £100m fund includes £50m from the ERDF and the equivalent match of £50m from the NWDA.

38. There are issues over how a JESSICA can be set up and the traditional UK approach of using public assets temporarily to draw down EFRD funding is no longer acceptable to the EC. This is unfortunate as a JESSICA was seen as one of the few public sector led mechanisms for supporting project delivery. The UK government is challenging the setting up conditions, although this is not likely to be concluded swiftly. We will maintain a watching brief.

Local Authority Pension Funds

39. Local Authority pension funds hold a portfolio of assets that are held for a number of objectives but primarily focus on return on investment. As an example the North Yorkshire Pension Fund (NYPF) assets of £1,345m per 2010 are split between equities (including UK, global and long term growth), gilts (both index linked and fixed) and cash. Pension funds could choose to invest a proportion of the assets its holds into schemes that would serve to benefit the local area. Pension funds already do this where the commercial return justifies investment.

40. In principle pension funds will judge projects on their commercial merits. The challenge would be to put forward a sufficient critical mass of projects (as a portfolio of projects) that will interest the pension fund. Pension funds will focus on projects that are commercially viable and have an agreeable financial rate of return with an acceptable level of risk. As with any fund focused on financial return only projects that are commercially viable will be acceptable to pension funds. The obligation to protect the interest of stakeholders means that pension funds do not undertake unnecessary risks nor support projects without an acceptable rate of return. The type of project that Pension Funds could support would be equally attractive to mainstream commercial investment funds.

41. Work on assessing the opportunities for pension fund investment in local projects was led by Yorkshire Cities, and more recently by Leeds City Region, although no definite proposals have been developed.

42. The Greater Manchester Pension Fund has taken a different approach to the traditional return on investment objective. Around 20 years ago they used £25m from the pension fund to establish the Greater Manchester Property Venture Fund. This decision was taken directly by elected members who were also trustees. Using the pension fund, the Property Fund has been able to act directly as developers, taking a project from site purchase, appointing architects, finding builders and then tenants for the completed buildings.

43. With the current concerns around local authority pension funds it would be difficult to see an opportunity for pension funds to invest in projects which do not provide an acceptable rate of return. Pension funds are worth considering as an alternative source of finance should there be evidence that normal commercial sources of funding are drying up, and there is an opportunity for investors to access pension funding through local authorities bundling up projects. The Manchester property project may be worth considering if there is an opportunity to replicate it locally.

44. A further complication in using pension funds is that our pension scheme is county wide. This means that any projects would need to be agreed by all members of the scheme and as such it is likely that they would need to be significant enough for all members to see the benefits across the county, not just within York.

Tax Increment Financing (TIF)

45. Tax Increment Financing is a mechanism that generates new income streams that the local authority can then use to fund the revenue costs of new capital finance raised (normally prudential borrowing). The new income streams are generated from the forecast growth in business rates which will potentially arise following investment from a local authority in a new area / development. Specifically the increase in business rates is used to repay the cost of finance raised.

46. The risk associated with TIF is that revenues will not materialise if new investment and businesses do not materialise. This would leave the Authority with a revenue pressure to fund the cost of borrowing with no income stream to support it. The more financially viable the site or development from a commercial perspective the less risk there is associated with the revenue streams failing to materialise.

47. TIF has been used extensively in the United States. There is also evidence that in the USA TIF (known as Accelerated Development Zones) has been a powerful tool for jump-starting regeneration.

48. The Scottish government has approved the use of TIF in the waterfront area of Edinburgh. The £84m project led by the City of Edinburgh Council will use Tax Incremental Financing (TIF) in the development of a new cruise liner terminal, lock gates, esplanade and link road.

49. Previously City of York council has been supportive of TIF and has lobbied government vigorously for its early introduction. The government's proposals for TIF are set out as part of a separate consultation paper on business rates retention. As part of the consultation government is seeking views on the issue on whether government should approve TIF projects (to reduce risk and oversupply) or they should be left to local authority discretion.

50. The availability of TIF will be central to the viability of York Central initiative proceeding.

Section 106 Planning Obligations and Community Infrastructure Levy

51. A local Authority can enter into a S106 agreement with a developer as part of the planning process. The S106 agreement provides infrastructure that relates to the demands generated by the new development and which cannot be met through planning conditions. It involves enhancement to the local authority in the wider area than just the development e.g. open space provision, transport improvements, skills development, affordable housing, etc. The S106 provisions can be supplied directly by the developer or in the form of a commuted sum. S106 agreements are not a new or alternative form of finance, however from 2014 the Community Infrastructure Levy is being considered in addition to S106 agreements.

52. The Community Infrastructure Levy (CIL) will be the preferred way to fund off site infrastructure provision, although section 106 may still be used to deal with site specific issues and affordable housing. The government is still to consult on using CIL to fund affordable homes. CIL works by setting a tariff or levy charge (usually based on a sq metre of new development) for different types of development i.e. residential, offices, business, retail, etc., which will bring greater benefit to local authority areas.

53. Whilst it is early days in the CIL process, the first six councils have recently published their drafting charging schedules. Portsmouth, for example, is proposing that each additional sq metre of residential development should be charged at £105, large retail also at £105 and small retail at £53. The challenge with CIL, and section 106, is deciding the level of charge so that it can contribute to new infrastructure provision but does not deter new and worthwhile investment. There are processes in place that can be used to allow developers to pay a reduced charge if CIL or section 106 threatens the viability of a development.

Business Rates Supplement

54. The Rates Supplementary Act 2009 allows a maximum of 2 pence supplement on business rates which can be retained to fund additional projects which promote economic development of the local area. In London, the supplement is being used to support Crossrail. It is an alternative source of finance not utilised in York and is generally considered not to have a significant role as an alternative source of income for investing in new infrastructure in the future.

55. Through the Localism Bill the government is proposing to amend the 2009 Act so that all liable businesses will be able to vote on the imposition of future business rate supplements. It is expected that this will generally result in a constraint to its introduction. There is also a view in London Boroughs that the levy is acting as a disincentive to new developments.

Financial Implications

56. Whilst the proposals outlined in this consultation paper do not have an immediate impact on this council's difficult financial position it could give some potential opportunity to access limited amounts of new funding. However, along with this comes a great deal of risk and we shall only know how much when the detailed technical papers have been published and analysed. It is unlikely that the proposals currently being consulted on will generate any significant gains to the council and any potential gain needs to be set against the potential for loss of business rate income. Whilst the localisation of business rates could create some limited opportunities for the future, the need to save £20m over the next 2 years remains.

Equalities Implications

57. The proposals outlined in the consultation relate to the redistribution of business rates. Any future budgetary impact of these proposals will be subject to an equalities impact assessment in the normal way.

Other Implications

58. There are no HR, Legal, Crime and Disorder, Information Technology, Property or other implications.

Risk Management

59. The paper outlines a number of ongoing developments in local government finance. The consultation on the localisation of business rates brings some additional financial risk. A risk assessment will be carried out on the specific proposals once the full detail has been issued.

Recommendations

60. Cabinet is asked to

    i. note that officers will continue to examine opportunities for alternative forms of capital and continue to purse those options that will be beneficial for the authority.

    ii. agree to delegate responsibility to the Director of Customer & Business Support Services and the Cabinet Member for Corporate Services to agree the council's detailed response to the consultation on the localisation of business rates.

Contact Details

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Wards Affected: *List wards or tick box to indicate all* √

For further information please contact the authors of the report

Annex A – Phase 1 Terms of Reference
Annex B – Localisation of Business Rates consultation questions