

LABGI
Local Authority Business Growth Incentive



Does it do what it says on the can?

Summary

The idea of providing local authorities with incentives to promote growth is fashionable at present. If the Lyons Inquiry recommends more financial freedom for local authorities, then tax incremental financing – in which local authorities borrow to provide infrastructure and pay back their debts from future revenues – is likely to be given serious consideration. So now is a good time to look at an existing incentive scheme – LABGI. This paper looks at how it works in practice and tests whether it gives “*authorities a strong incentive to tackle barriers to enterprise, employment and growth in their areas*”.

The simple idea behind LABGI is that increases in rateable value (RV) reflect increases in economic enterprise and that local authorities should be encouraged to promote economic enterprise by allowing them to keep part of the increase in RV. Unfortunately, although the idea is simple, the practice is rather complex.

We conclude that LABGI is so complex and hard to explain it may not motivate local authorities effectively. Moreover, this complex process produces some unexpected results:

- Changes in rateable value are affected by technicalities that make them an unreliable indicator of change in the real world.
- Even if the technical problems are put right, changes in rateable value are a poor indicator of changes in enterprise and employment.
- It is difficult to show any connection between changes in these two factors and local authority endeavours, except that:
- The overwhelming winners from LABGI are local authorities that gave planning consent for new large retail, retail warehousing and distribution warehousing developments.

LABGI is a good example of a policy that looked attractively simple to begin with, but has turned out to be much more complex in practice. Our view is that the root cause of the problem is a lack of clarity about the scheme’s objectives. It is not clear whether LABGI was primarily intended to reward LA performance (as a precursor to greater freedoms following the Lyons Inquiry) or to focus resources on areas of economic growth. In fact it achieves neither.

More widely, if the effect of LABGI is capricious and random, it is hard to see how business rates can form a sound basis for Tax Incremental Financing without a reform of the system. Government should consider reforming the incentive system to make it better targeted.

1 Introduction

- 1.1 The idea of providing local authorities with incentives to promote growth is fashionable at present. If the Lyons Inquiry recommends more financial freedom for local authorities, then tax incremental financing – in which local authorities borrow to provide infrastructure and pay back their debts from future revenues – is likely to be a serious discussion topic. So, now is a good time to look at an existing incentive scheme – LABGI - to see what happens in practice.
- 1.2 The Local Authority Business Growth Incentive scheme (LABGI) was announced in the 2002 Pre-Budget Report. Legislation to introduce the scheme was passed in 2003. After a dry-run and consultation, it came into operation on 1 April 2005 and in February 2006 government announced the grant awards for the first year. The scheme will initially run for three years and then be reviewed.
- 1.3 The scheme aims to encourage local authorities to promote business growth in their area by allowing them to keep some of the annual increase in revenue from business rates and spend it as they wish. The statement on 21 July 2005 announcing the final version of the scheme said:

“Today's announcement underlines the Government's commitment to providing more freedoms for local authorities to influence local outcomes. The scheme announced today offers substantial rewards for local government. It will be for local authorities to decide how this additional money is spent- whether to provide even better public services for local communities or to reduce council tax. This is an exciting opportunity and incentive for councils to build partnerships with local business and promote long-term economic sustainability in their areas.”

“Today's announcement underlines the central importance the Government places on economic growth both nationally and regionally. Councils have a big role to play in the success of their local economies and this scheme will give authorities a strong incentive to tackle barriers to enterprise, employment and growth in their areas.”

- 1.4 It has now been announced that LABGI will continue for another year, subject only to minor changes – mainly the removal of the cap on grant.
- 1.5 This paper provides a preliminary review of LABGI. It looks at how it works in practice and tests whether it gives *“authorities a strong incentive to tackle barriers to enterprise, employment and growth in their areas”*.

2 LABGI – a technical explanation

- 2.1 Business rates are calculated by multiplying the rateable value (RV) of a property by a rate in the pound (42.2p in 2005/06). The local authority (LA) collects the business rates and transfers them into a national pool. The Treasury then redistributes this money back to local authorities through a population-based formula.
- 2.2 The Valuation Office Agency is responsible for establishing the rateable value of each business property and preparing a Valuation List of values for each LA. The rateable value is based on the annual rental value of the property. So, rateable values reflect a number of factors, including the use of the property, the amount of floorspace, the age and quality of buildings, their location and the state of the property market.
- 2.3 The Valuation List is continually updated to reflect physical changes – new buildings, additional floorspace etc - but a new Valuation List updates rental values every five years. The current Valuation List came into force on 1 January 2005, based on rental values at 1 April 2003.
- 2.4 The simple idea behind LABGI is that increases in RV reflect increases in economic enterprise and that local authorities should be encouraged to promote economic enterprise by allowing them to keep part of the increase in RV. Unfortunately, although the idea was simple, the practice is rather complex. Less technically minded readers are here advised to skip to Paragraph 2.10
- 2.5 If LABGI had been awarded simply to those LAs whose RV had increased the most over the year, it would (in theory) have rewarded those with the strongest economies. This would have reinforced existing economic disparities. So government decided to stream LAs by performance into eight bands and only reward increases in performance against average performance in the same band. Moreover, LABGI also only rewards increases in performance over the band's average for 1995-2003 – less the national average growth that could have been expected anyway. LAs that do not achieve their floor target have their actual RV used as the basis for calculating the floor target for the next year.
- 2.6 To quote from the press release:

“The starting point for measuring growth for each authority will be their rateable value at 31 December 2004.

- Each authority will have a 'floor' - the target level of rateable value growth that must be reached to gain from LABGI. An authority's 'floor' will be the baseline minus a national adjustment factor (NAF).

- Authorities' baselines have been calculated using a National Historic Growth Model (the preferred baseline model from the first consultation). This has been modified by dividing authorities into eight baseline groups based on historical growth rate, rather than seven as previously announced. The eighth group is formed by splitting groups six and seven into three equal groups.

- A scaling factor of 70% will be applied to all revenues gained above the floor to calculate the amount of revenue that can be retained locally.

- The ceiling, which sets the maximum revenue an authority can keep (in order to ensure that no local authority gains unfairly or disproportionately from the scheme), will be based on a modified form of the Environmental, Protective and Cultural Services (EPCS) part of Formula Spending Share (FSS). This will ensure that single tier and two tier authorities are treated fairly. An authority's gains in one year in excess of the ceiling will be allowed to count against the following year's target.

- The level of ceilings for the first three years of the scheme will be 3%, 6% and 9% respectively, of modified EPCS FSS.

- In two-tier areas, LABGI revenues will be shared out according to each tier's contribution to modified EPCS FSS (approximately two-thirds to the lower tier and one-third to the upper tier). In London, all rewards will remain with the Boroughs.

- Authorities that fail to retain money under the scheme will be re-based, to give them a fair and meaningful challenge in the next year, and a new lower floor will be calculated, determined from their new starting point."

A worked example

- 2.7 Knowsley had an average growth in RV of 1.6% during 1995/06 to 2002/03. This puts it in Baseline group 3 with an assumed average growth of 1.8%. From this figure the national adjustment factor of 1.4% is subtracted. So, Knowsley has to grow its RV by 0.4% during 2005 in order to gain from LABGI.
- 2.8 The rateable value for Knowsley at 31 December 2004 was £76,291,521, (allowing for any empty and partially empty properties). Knowsley has to increase its RV by 0.4% of this figure or £305,166 to reach its floor target. At the end of 2005, Knowsley had a rateable value of £79,919,958 (including any undetermined appeals but excluding empty and partially empty property reliefs which have already been granted). The difference between starting RV and end RV is £3,628,437, which is £3,323,271 above the floor target.
- 2.9 This figure has to be multiplied by 0.415 - the small business rates multiplier – to find the increase more in business rates, which is £1,379,157. Knowsley will get 70% of this increase as a grant, which is £965,410.

Now do you understand?

- 2.10 We conclude that LABGI is so complex and hard to explain, it may not motivate local authorities effectively. Moreover, this complex process produces some unexpected results. Below we look at some case studies.

3 Case Studies

Bassetlaw and the coal-fired power stations

- 3.1 Bassetlaw is a small district in north Nottinghamshire, including the towns of Worksop and Retford. According to LABGI baseline data, Bassetlaw's tax base grew by an average 3.8% annually between 1995 and 2003. This puts Bassetlaw in the second highest group by increase in rateable value in the country. (Group 7 out of 8). However, Bassetlaw includes two large coal-fired power stations, accounting for £40m of the total £99m RV in the 2000 Valuation List. These power stations do not have an open market value and are therefore evaluated according to a national formula, which is only altered at Revaluation. In 2005 this formula was changed; the rateable value of the power stations fell to £16m and Bassetlaw's overall RV fell from £99m to £84m. In other words, the apparent healthy growth in RV in the baseline period was illusory and Bassetlaw should have been placed in a lower baseline group.
- 3.2 Nevertheless, Bassetlaw was awarded £443,075 under the LABGI scheme. The reason is that in 2005 a new warehouse for the high street retailer Wilkinson and a new B&Q opened, increasing the RV by over £8m. Whether these have contributed to sustainable employment growth in Bassetlaw is an interesting question.
- 3.3 Selby (Yorkshire) and West Somerset have a similar loss of value due to a revaluation of coal-fired power stations but already had low baseline growth – both were in Group 1. Selby gained £283,000 from LABGI – apparently caused by new distribution depots opening. West Somerset got nothing.
- 3.4 Perversely, since 2003 coal-fired power stations have become much more profitable and it is likely that the national formula will be altered again at the next revaluation in 2010. This would mean that Bassetlaw, Selby and West Somerset will see their rateable value jump significantly and thus their rewards from LABGI will balloon. But what are they rewarded for?

Dartford and regional shopping centres

- 3.5 Dartford is a small local authority in North Kent included in the Thames Gateway and therefore earmarked for rapid growth – just the kind of place that could do with being incentivised by LABGI, especially since its historic employment base has shrunk in recent years. But Dartford received nothing from LABGI because its baseline growth was over 10% pa, putting it in the highest of the 8 national groups.
- 3.6 The simple reason for Dartford's high baseline growth in RV is that Bluewater Shopping Centre, the largest in the UK, opened in 1999. So, the high average rate is not the result of organic growth but the result of a one-off retail development.
- 3.7 At the 2005 Revaluation, Dartford had the highest percentage increase in RV of any LA (42.04%) of which the largest part was in retail development rising by 62.43% (£40.3m). This increase was due to the increase in rental values at Bluewater, as opposed to the addition of more space.

- 3.8 Bluewater and the retail sector now accounts for 60% of Dartford's total RV and it has little chance of beating its floor target (unless a new shopping centre opens).
- 3.9 Across the River Thames in Essex, Thurrock also has a very large shopping centre – Lakeside – but a much less demanding baseline growth of 2.2% - putting it in Group 4. The reason for this differential is that Lakeside opened in 1990, before the baseline period began, so its boost to RV is not reflected in Thurrock's baseline target.
- 3.10 Gateshead, in the northeast, has an even more anomalous history. It is home to Metrocentre, which opened in 1986 and vies with Bluewater for the title of Britain's biggest shopping centre. The opening must have caused a massive surge in the Gateshead RV. If RV is correlated with economic and employment growth, one would expect the Gateshead economy and RV to have powered ahead in later years. However, it did not. In the baseline period, Gateshead's RV grew by 0.3% pa, putting it in the lowest group in the country.
- 3.11 In another twist, Gateshead was one of the big winners from LABGI, receiving £1,325,000. There were two main reasons for the increase in RV in 2005. The smaller was the opening of the Sage – a publicly-funded arts complex. The other was that in 2004, Metrocentre opened an extension, the value of which was taken into account in 2005. If the extension had opened a year earlier, it would have been reflected in Gateshead's baseline growth, rather than in the uplift over baseline, and Gateshead would not have received any LABGI.

Central London

- 3.12 It has been the consistent view of government that the London financial markets and professional services are the powerhouse of the UK economy. These services are overwhelmingly concentrated in two LAs - City of London and Tower Hamlets (Canary Wharf). If anyone deserves to be rewarded by LABGI, you would imagine it would be these two LAs who bear the brunt of servicing the UK's most dynamic economic sector.
- 3.13 Neither authority got anything under LABGI. Their problem is that they both have very high historic baseline growth – 7.0% for the City and 7.7% for Tower Hamlets. The reason for this seems to be the upsurge in office development during the dotcom boom. By 2005, the development pipeline had eased off and the rate of completions slowed below the baseline, so they lost out.
- 3.14 Employment in the city is now growing strongly, which should be reflected in increased starts of office development in the next few years. The question is whether it is sensible to disincentivise these two LAs from planning for the next upswing by penalising them now on the basis of historic movements in the financial markets.
- 3.15 The question is even starker when you compare the City and Tower Hamlets with Westminster. Westminster had baseline growth of 2.9% pa, relatively sluggish for such an affluent area. At the 2005 Revaluation overall rateable value in Westminster increased by only 12.61%, with offices increasing by only 8.82% and shops by 22.71%. One reason for this is that Westminster is so intensively developed that opportunities to increase floorspace are limited. Moreover, in recent years the retail sector has been hit by increased competition from places like Bluewater and (retailers argue) from congestion charge.
- 3.16 However, Westminster has been awarded over £3.8m under the LABGI scheme, by far the largest payment in the country. This is partly because Westminster has by far the

largest RV of any LA - £2.45bn compared to the City of London at £1.5bn and Manchester at £600m. So a small percentage increase in RV yields a large LABGI grant.

- 3.17 However, according to the LABGI award calculations, Westminster's RV increased by £48m in 2005. We can account for over £23m increase from just two buildings – 2 Marsham Street and the refurbished Ministry of Defence main building – both occupied by government. So, Westminster is being rewarded for being home to public sector activity, not for encouraging private sector growth.

NE Lincolnshire - a poor authority

- 3.18 If LABGI is to provide an incentive for LAs to encourage growth, then there should be some correlation between LA performance and LABGI. If not, it is difficult to see how LAs could respond to an incentive. We looked at North East Lincolnshire, which performed so poorly as a local authority that it received “no star” rating in its 2005 Comprehensive Performance Assessment.
- 3.19 Yet it received a LABGI grant of £1m – because it only had to achieve more than 0.4% growth in RV to qualify. In fact, it achieved a total increase of £6m, of which about £3.8m was due to two new Tesco stores in Grimsby.

Knowsley – the best local authority in the country?

- 3.20 For our worked example in Section 2 above, we used Knowsley, a local authority on Merseyside. Knowsley was, for its size, the biggest winner under LABGI, since its award of £965,410 represents the biggest percentage of total RV in the country.
- 3.21 Knowsley, the third most deprived LA in the country, has some justification for being rewarded for its efforts in economic regeneration. Unemployment has been reduced from 22% to 4% and self-employment grew by 70% in the five years to 2005.
- 3.22 Unfortunately, that is not why the borough received such a large LABGI award. The award was based on an uplift of £3.6m RV, of which £2.8m was due to the opening of an ASDA superstore.

4 Conclusions

- 4.1 Having looked at how LABGI works in practice, we considered if this complex methodology actually provides a clear connection between changes in:
- rateable value;
 - enterprise and employment; and
 - local authority endeavours.
- 4.2 For the LABGI baseline growth, government calculated the average annual increase in RV for each LA during the period 1995-2003. This period included the 2000 Revaluation, for which it appears government adjusted by taking an average national uplift from the actual uplift in RV. Thus the RVs on which the baseline growth figures are calculated are at least 2 years out of date and based on rental values from the 2000 Valuation List – actually collected in 1998. As we have shown, this causes some problems in practice.
- 4.3 Properties valued on a national formula, because they have no market value, are a major cause of variations in RV totals. The most significant of these properties are electricity generators and ports. Changes to these assessments usually have nothing to do with the local economy.
- 4.4 The RV total for each authority is mainly based on the amount of rateable value attributable to private sector activities – but not totally. So public sector buildings also feature. It is questionable whether local authorities should receive a LABGI payment for having a public sector activity in their area – it smacks of double counting.
- 4.5 LABGI rewards changes to RV in a single year. However, those changes are normally the result of private sector investment decisions taken some years earlier. So the connection between investment and local authority intervention is difficult to prove, as is the theory that a reward now for an intervention some years ago is an incentive to intervene now to receive another reward in a few years time.
- 4.6 If the incentive were an effective reward one would expect good local authorities to respond better than poor local authorities. We could find no such correlation.
- 4.7 It was difficult to pick out much pattern from an analysis of winners and losers from LABGI but two things were clear – first, the biggest increases in RV both at the 2005 revaluation and in the first year of LABGI were due to increasing amounts of retail, retail warehousing and distribution warehousing – which are not a good indicator of economic activity overall.
- 4.8 Secondly there is a geographical bias towards the major metropolitan centres – with good shopping – and towards smaller authorities for whom a single new warehouse or food-store had a disproportionate impact on RV in percentage terms. Is this what government had in mind when it launched LABGI? Probably not.

- 4.9 We conclude that:
- Changes in rateable value are affected by technicalities that make them an unreliable indicator of change in the real world.
 - Even if the technical problems are put right, changes in rateable value are a poor indicator of changes in enterprise and employment.
 - It is difficult to show any connection between changes in these two factors and local authority endeavours, except that:
 - The overwhelming winners from LABGI are local authorities with new large retail, retail warehousing and distribution warehousing developments.
- 4.10 LABGI is a good example of a policy that looked attractively simple to begin with, but has turned out to be much more complex in practice. Our view is that the root cause of the problem is a lack of clarity about the scheme's objectives. It is not clear whether LABGI was primarily intended to reward LA performance (as a precursor to greater freedoms following the Lyons Inquiry) or to focus resources on areas of economic growth. In fact it achieves neither.
- 4.11 Going back to first principles, it seems clear to us that employment and economic activity agglomerates in the bigger urban areas and in the southeast of the country. The more the UK switches from manufacturing (which often locates near factors of production) to footloose offices, the greater this tendency. If these areas are to be motivated to create more development, they need a more targeted incentive than overall RV – perhaps RV for employment space.
- 4.12 Outside these main urban areas, employment activity forms a proportionately smaller part of the overall RV and the function of the area is more residential and less employment based. These places need a different form of incentive if they are to deliver housing growth or regeneration, in addition to or instead of employment growth. That incentive needs to be housing-related rather than related to business rates – as the government is now proposing.
- 4.13 Meanwhile, most obviously in smaller authorities, LABGI reflects the fact that consumer spending has grown far faster than GDP in recent years. So, retail development is much bigger contributor to growth in RV than employment space. Over and over again, we found that the major driver of LABGI payments is a new food-store or a shopping centre. We have some concerns about the impact of such a perverse incentive on other government policies such as the Sustainable Communities Plan.
- 4.14 In designing the rules for LABGI, government was obviously concerned not to concentrate rewards on the fastest growing authorities –so it introduced a complex system of baseline (historic) growth floors, which LAs have to beat. The upshot is that Knowsley receives the highest grant as a percentage of total RV (because a new ASDA opened) whereas Tower Hamlets (including Canary Wharf) got nothing. In terms of boosting the competitiveness of UK plc, this is hard to justify.
- 4.15 More widely, if the effect of LABGI is capricious and random, it is hard to see how business rates can form a sound basis for Tax Incremental Financing without a major reform of the system. Government should consider reforming the incentive system to make it better targeted.