Local Government Resource Review: Proposals for Business Rates Retention and Tax Increment Finance

BRITISH PROPERTY FEDERATION

A submission by the British Property Federation

Introduction

1. This submission by the British Property Federation has been prepared in response to a consultation issued by the Department for Communities and Local Government that focuses on local retention of business rates, but also sets out options for taking forward the Government's commitment to introduce tax increment financing (TIF).

2. We stress below our strong support of the Government's proposals for allowing greater local retention of rates but the focus of our comments is on the issue of TIF.

Business rates Retention

3. The BPF strongly supports the principle of allowing local authorities to retain a proportion of the rate income generated in their area, particularly that arising from new development. We believe that this would encourage more local authorities to take a more pro-active approach to promoting development and generating economic growth. It could also provide the additional funding needed to enable some projects to proceed (such as town centre improvement schemes) which are currently unviable, often because of the upfront costs of funding the infrastructure improvements and land remediation that may be necessary.

4. We recognise that business rate retention will require the setting of a baseline and adjustments for revaluation and resetting the system. Others more intimately involved with local government finance are better qualified to comment on the technicalities involved in these processes. However we would stress that if business rate retention is to have a real impact local authorities must:

   - be able to retain a substantial amount of the rate revenue arising from new development;
   - enjoy the benefit of the additional revenue over a sufficient length of time as to give them the confidence and certainty to reinvest the additional revenue in other projects (and hence create a virtuous circle); and
   - find the system relatively simple to understand and operate.

   We are, however, aware of increasing fears that the system which emerges will

   - be overly complex and cumbersome; and
   - be so concerned with maintaining the status quo that the advantage gained by those authorities who facilitate growth will be too small to have the catalytic effect intended.

   Our clear message, therefore, is that if the Government wants local rate retention to succeed, it has got to avoid the complexity that bedevilled and ultimately undermined schemes like the Local Authority Business Growth Incentive. Whatever the rhetoric, Governments usually end up trying to control every facet of such schemes with over-elaborate rules. Local rate retention will show whether this Government has learnt the lessons of previous schemes and so can avoid the same traps.

Tax Increment Financing

General comments

5. We are delighted that the Government is committed to implementing Tax Increment Financing (TIF) in the UK. However, we are concerned that progress has been slow and erratic in developing TIF. A big part of the problem lies in the way the mechanism TIF relies on (retained incremental business rates) has come to characterise it more than its fundamental purpose (unlocking investment in project-specific infrastructure to deliver the jobs, growth, productivity and social and economic renewal that entails). The way the consultation paper discusses TIF both demonstrates and exacerbates this problem.

6. It might be helpful for the BPF to supply some case studies illustrating how TIF could kick- start important regeneration schemes that are currently stalled using funding derived from a variety of quarters. We would be happy to do this and meet officials to talk through some of the issues involved.

The importance of ring-fencing

7. The essence of TIF lies in identifying and ring-fencing an anticipated future income stream so that it can be used to finance substantial upfront investment. TIF is best suited for supporting infrastructure investment which is of a sufficiently large scale (at least in the context of the relevant project) to involve financing periods of up to 25 to 30 years. Failing to ring-fence the income stream for that length of time would generally render the upfront investment unbankable, because the risks associated with it become too difficult to model, understand and price. TIF will only work with the sort of total ring-fencing proposed under Option 2 (and, indeed, in the context of Enterprise Zones and renewable energy projects).

8. The Option 1 version of TIF that the consultation paper puts forward cannot properly be described as TIF at all. Option 1 simply describes the use of prudential borrowing powers in a local retention environment. It is welcome, but it is not TIF, and it will not achieve what TIF could achieve.

9. Indeed, because of the flexibility that the Government wishes to retain in the wider business rates system, Option 1 positively discourages the sort of investments which require long term commitments. Consider a local authority that starts off in receipt of a modest top-up, which is looking at a mixed use development which is expected to generate jobs, growth and increased business rates. Let’s assume that the development requires infrastructure investment which cannot be funded without recourse to the anticipated growth in business rates over a 25 year period. If the local authority borrows under Option 1 against that anticipated growth to fund the infrastructure and allow the scheme to go ahead, it risks being worse off because resetting or changes to the local authority’s position as regards top-up and levy could

remove or restrict that business rate growth, while leaving behind the obligation to service and repay the related borrowing.

10. To be clear, it is not the fact of levy and top-up that makes TIF on the basis of Option 1 unviable; the problem is the extreme difficulty of modelling TIF cash flows over a 25 or 30 year time frame, when a local authority's exposure to levy or top-up could change, or the system could be reset, with a knock-on effect on the availability of (non-ring-fenced) TIF cash flows. Option 1 could only operate as TIF if the flexibility proposed to be built into the wider local retention scheme were abandoned.

TIF and the wider business rates scheme

11. It is also important to recognise that TIF is in no way contingent on a local retention environment, as suggested in paragraph 5.11 of the Consultation Paper. The United States, where TIF originates, has a highly localised tax system (and a very large municipal bond market). Financing substantial regeneration projects nevertheless required the invention, and has since seen the proliferation in the use of, TIF, which brings legal certainty through ring-fencing of future revenue streams (also supported by certain tax advantages). So while TIF requires ring-fencing, the design of the wider tax environment from which TIF cash flows are ring-fenced is not, in fact, important.

12. By its entirely unnecessary focus on the business rate retention element of the machinery of TIF rather than on its purpose or key characteristics, the Government has submerged TIF into its complex and ambitious reform of the entire system of local government finance. What local government and business really need is detailed proposals for how TIF will work in the UK – but Government has instead concentrated on the technical interface between TIF and a reformed business rates system. It is disappointing that the year since the Deputy Prime Minister's announcement on TIF has not been put to more productive use.

Rationing, additionality and risk

13. In discussing Option 2 (i.e. real) TIF, the consultation paper argues that the ring-fencing of TIF-committed cash flows would pose a threat to the integrity of the wider local government finance system unless the use of it were restricted. The consultation paper proposes to do that by imposing "a limit on the number of schemes". We believe that this is entirely misconceived.[1]

14. We believe that the Government should design a robust, pragmatic framework for TIF, including in particular a sensible approach to the assessment of displacement and additionality. Such a substantive, qualitative approach would ensure that most if not all TIF schemes deliver the social and economic renewal without that being at the expense of other areas. Applying quality control in this way would entirely remove any need for arbitrary limits on the use of TIF – we would not expect a large number of schemes on this basis (certainly in the early years), but even if there were, it is

[1] We would be more sympathetic to a limit on the number of schemes in the context of pilot schemes, as in Scotland for example. However, that is not what the Consultation Paper proposes.

difficult to see any sensible policy basis for blocking what are, by definition, good schemes delivering genuine additionality.

15. A good qualitative framework for TIF could contain quantitative elements. For example, US TIF regulations often place limits on the length of time for which a municipality can commit future revenue increment to a TIF scheme, and on the proportion of its budget that a municipality can place at risk using TIF schemes. The limits can be revisited from time to time, to allow flexibility in appropriate cases. We can see value in including similar restrictions in a UK TIF framework.

16. However, limiting the use of TIF on any broader quantitative basis would risk both blocking excellent schemes. An excessive focus on quantitative rationing in a generally capital constrained environment could even risk allowing poor schemes to go ahead which a more qualitative approach would stop. Limiting the number of schemes strikes us as a particularly odd approach to rationing. If TIF is used to raise £1bn, why is it better for that money to support (say) five schemes rather than ten? Wouldn't a larger number of schemes diversify risk and spread the benefits of job creation, social and economic renewal to more parts of the country?

17. Equally, limiting the number of schemes would ignore the difference between ten schemes for which an aggregate £1bn is raised (and taken out of the central business rates pot) and ten schemes which are twice or ten times the size. Finally, a limit on the number of schemes fails to apply any risk-weighting to the exposures entered into using TIF, nor does it have any regard to the benefits per TIF-enabled pound raised, even though (in the absence of a robust set of qualitative criteria for TIF) those would seem reasonable matters for Government to take into account. We would argue that schemes involving complete risk transfer to the private sector (see discussion of LTRiP below) should not count towards any quantitative caps in any event.

18. As mentioned above, we think the best approach to rationing is quality control through a sensible and robust substantive framework for TIF set by the Government (potentially including limits for individual local authority exposure to TIF). We would be happy to discuss how a flexible back-stop might be designed – but any general quantitative limitations on TIF should be no more than that.

Allowing authorities "the freedom to borrow"

19. It is very important to recognise that TIF is a flexible tool that can be used in different ways. The source of upfront finance (e.g. Public Works Loan Board, banks, capital markets, or existing developer resources) and the risk allocation (for example, as between public and private sector, lenders, borrowers and guarantors) are two particularly important questions which local authorities and their private sector partners should have the flexibility to decide in the way most appropriate to each scheme.

20. We are, therefore, disappointed that the consultation paper discusses TIF in a way that could be read as limiting it to cases involving borrowing by local authorities. While some TIF schemes would no doubt involve borrowing by a local authority,

others might involve borrowing by a local asset backed vehicle or other public-private joint venture entity.

21. Perhaps most importantly, TIF need not involve borrowing – as that term is normally understood – at all. One alternative model (based on the "pay as you go" approach in the US) is commonly referred to as Local Tax Reinvestment Programmes (LTRiP). In simple terms, this might involve the developer of a commercial or mixed use scheme agreeing to deliver the requisite infrastructure in return for payment out of the business rate increment expected to arise from the commercial development. The developer could use existing equity resources or loan facilities to fund the infrastructure work. The risk taken by the developer on delivering the infrastructure is essentially similar to the risk he is taking on the delivery of the commercial development (as business rates will be paid if rent is paid). If the developer is willing to rely on that tax increment, the local authority can achieve perfect risk transfer to the private sector: its only commitment would be to pay over a pre-agreed proportion of such increment as actually materialises (and if the scheme failed completely, the authority would have nothing to pay). Of course, the fact that the private sector is taking the full risk on the business rates increment on such schemes should operate as a further discipline on the use of TIF: while we would expect most local authorities to be responsible in the way they approach TIF, we are confident that developers would only proceed with schemes very likely to succeed.

22. We are aware that the Government considers that TIF on the LTRiP model should be treated as "borrowing" for public accounting purposes. We find that logic very hard to understand in cases where the developer's recourse is limited to the business rates increment.

23. It would be helpful if the Government could formally confirm that its proposals for TIF do not limit the sources of upfront capital, the identity of any borrower, or the way risk is allocated. It is a shame that there can still be any uncertainty about such a basic point a whole year after the introduction of TIF became Government policy.

Responses to specific questions

Q29: Which approach to Tax Increment Financing do you prefer and why?

24. Option 2, but with any rationing being implemented through qualitative criteria for TIF. Quantitative limits should be flexible and used only in exceptional circumstances. Every TIF proposal that meets sensible, pragmatic and robust qualitative conditions should be regarded as likely to deliver economic and social renewal and genuine additionality. None should be rejected simply because in a given period there are "too many" good schemes.

25. Option 1 is not TIF, it is simply prudential borrowing in the context of a local rates retention scheme with built-in flexibility – and that is very welcome, but it cannot deliver the sort of upfront investment at which TIF is aimed. Indeed, in the absence of ring-fencing as contemplated under Option 2, we would expect Option 1 positively to disincentivise authorities from entering into long-term financial commitments in relation to TIF schemes.

Q30: Which approach do you consider will enable local authorities and developers to take maximum advantage of Tax Increment Financing?

26. Option 2, as above.

Q31: Would the risks to revenues from the levy and reset in option 1 limit the appetite for authorities to securitise growth revenues?

27. As far as the sort of long term financings for which TIF is likely to be used, yes, very substantially. Option 1 could only work if local authorities knew with absolute certainty (1) how the levy and top-up regime would affect them over the life of the scheme, and (2) that the system would not be reset during the life of the scheme.

Q32: Do you agree that pooling could mitigate this risk?

28. We doubt that the impact of pooling would be material in the context of how TIF might be used under Option 1, which is not really compatible with TIF at all as currently proposed.

Q33: Do you agree that central government would need to limit the numbers of projects in option 2? How best might this work in practice?

29. No. The best way to control the use of TIF from every perspective would be to lay down clear, pragmatic and robust qualitative criteria for the use of TIF, including in relation to how additionality and displacement should be taken into account. Quantitative limits should not be needed, and could serve needlessly to limit access to a valuable tool for economic and social renewal.

30. We recognise the validity of using quantitative restrictions in the context of an initial wave of pilot schemes (as in Scotland).

31. Under a permanent regime such as is contemplated by the consultation paper, any quantitative restrictions should be flexible and should focus not on arbitrary measures like the number of schemes, but on more meaningful considerations such as the aggregate or risk-weighted exposure of TIF schemes. An even better approach might be simply to place a limit on the proportion of its budget that any local authority can risk using TIF without specific permission.

32. We think there is a strong case for excluding from any quantitative limits LTRiP schemes under which risk is fully transferred to the private sector (regardless of whether, as a technical matter, the local authority partner is deemed to have “borrowed”).

Further Comments

We would be pleased to clarify or amplify any of the above comments.

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