Business Rates Reform

Options Paper: History and Context

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Introduction

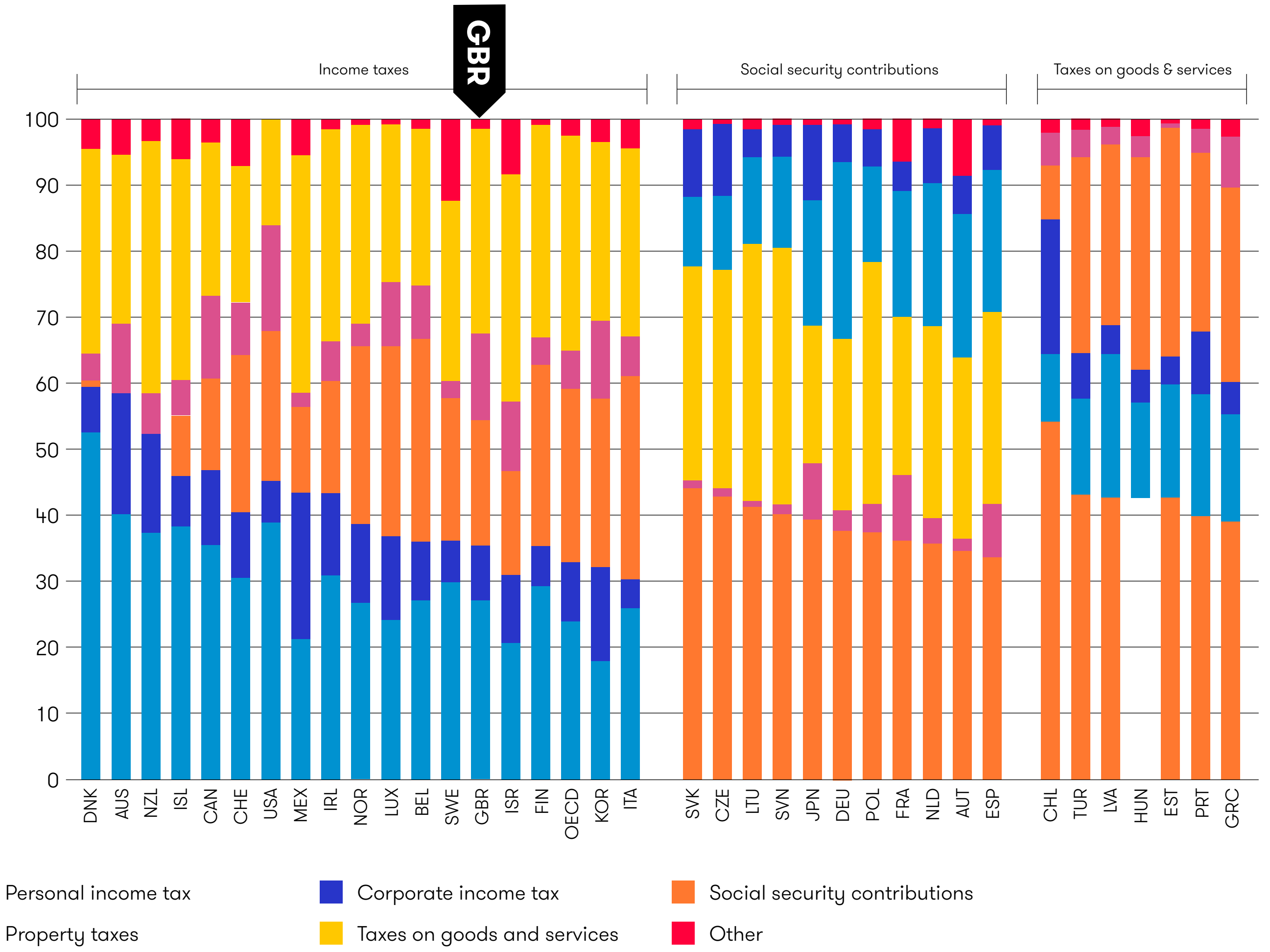
This paper has been jointly commissioned by the New West End Company and Westminster Property Association. It is not intended as a representation of either organisation's views or formal position in relation to business rates. Rather, it is an analysis of the current situation and a brief examination of the options available for reform within the boundaries set by the Treasury.

The challenge

The United Kingdom relies relatively heavily on property taxes. The OECD analysis in the table below suggests the UK's [GBR] dependence on property taxation (including domestic property taxes) is greater than in all countries apart from the United States. Moreover, the relationship between property taxes and other corporate taxes is also different: British businesses generally face a relatively larger property tax in relation to corporation tax than in many other countries. Separately, on a like-for-like basis, businesses pay more in property taxes than households. In central London, small businesses can pay £20,000 or £30,000 in NDR while multi-million pound homes nearby pay £1500-£2500 in council tax.

Main sources of tax revenues

Source: Revenue Statistics 2019 Tax revenue trends in the OECD, Paris: OECD, Figure 5



Note: Countries are grouped and ranked by those where income tax revenues (personal and corporate) form the highest share of total tax revenues, followed by those where social security contributions, or taxes on goods and services, form the highest share.

A number of official and think tank inquiries have, over the years, criticised aspects of non-domestic rates. The report of the Layfield Committee (1976) and the Mirrlees Review (2010) were among the most critical. Mirrlees concluded:

"The business rate is not a good tax. It discriminates between different sorts of businesses—agriculture is exempt, for example. More fundamentally, from an economic perspective, business property is an input to the productive process of a company. Further, it is a produced, or intermediate, input with the same economic properties as other forms of physical capital. …it is an important principle of the economics of taxation that an efficient tax system should not distort choices firms make about inputs into the production process, and hence that intermediate goods—those used in the production process—should not be taxed".[1]

Changes to the UK economy have generated pressure for reform. The decline in traditional high street retailing and, separately, changes in rural shopping habits have left some businesses facing rates bills which make them unprofitable. As the UK faces economic restructuring resulting from longer-term global trends, it is inevitable the economic distortions created by non-domestic rates will worsen. The fact that domestic property taxation (council tax) is never revalued and is seen as in need of radical reform, while Stamp Duty Land Tax is a problematic levy which creates a barrier to an efficient property market, only adds to the sense that British property taxation is opaque, distortionary and unfair.

This document is mostly concerned with non-domestic rates as they affect, in particular, central London and other major UK city 'downtowns'. It is important to recognise that in recent years business rate retention and growth incentives have increased the importance of NDR to Westminster, Camden, the City of London and other central activities zone councils. NDR started its life as a local tax and remains a key source of revenue for local government. Councils and local tax professionals operate the tax and are instrumental to its future.

Recent history

Despite the broad agreement that non-domestic rates (NDR) are not an ideal tax, successive governments have kept them. Labour did not reform them between 1997 and 2010, despite holding a review of local government finance. The Conservative-Liberal Democrat coalition government's (2010-15) then Chief Secretary to the Treasury stated:

"Business rates are a classic area where we had simply not kept up with the times. They've existed in some form or another since 1601. With 1.8 million properties in England now paying them, you might agree that they are due for a review"[2]

During the 2015 general election, the Conservatives committed themselves to reform:

"We will conduct a major review into business rates by the end of 2015 to ensure that from 2017 they properly reflect the structure of our modern economy and provide clearer billing, better information sharing and a more efficient appeal system"[3]

No substantive reform has occurred. A number of reliefs have been given to smaller businesses since 2011, though with the tax remaining broadly unchanged for all other non-domestic taxpayers. The UK NDR yield was expected (before Covid-19) to be £31 billion in 2020-21. The challenge is: such a sum would be hard to recover from other sources and/or would require a radical reform to business taxation if they were to be replaced by another levy.

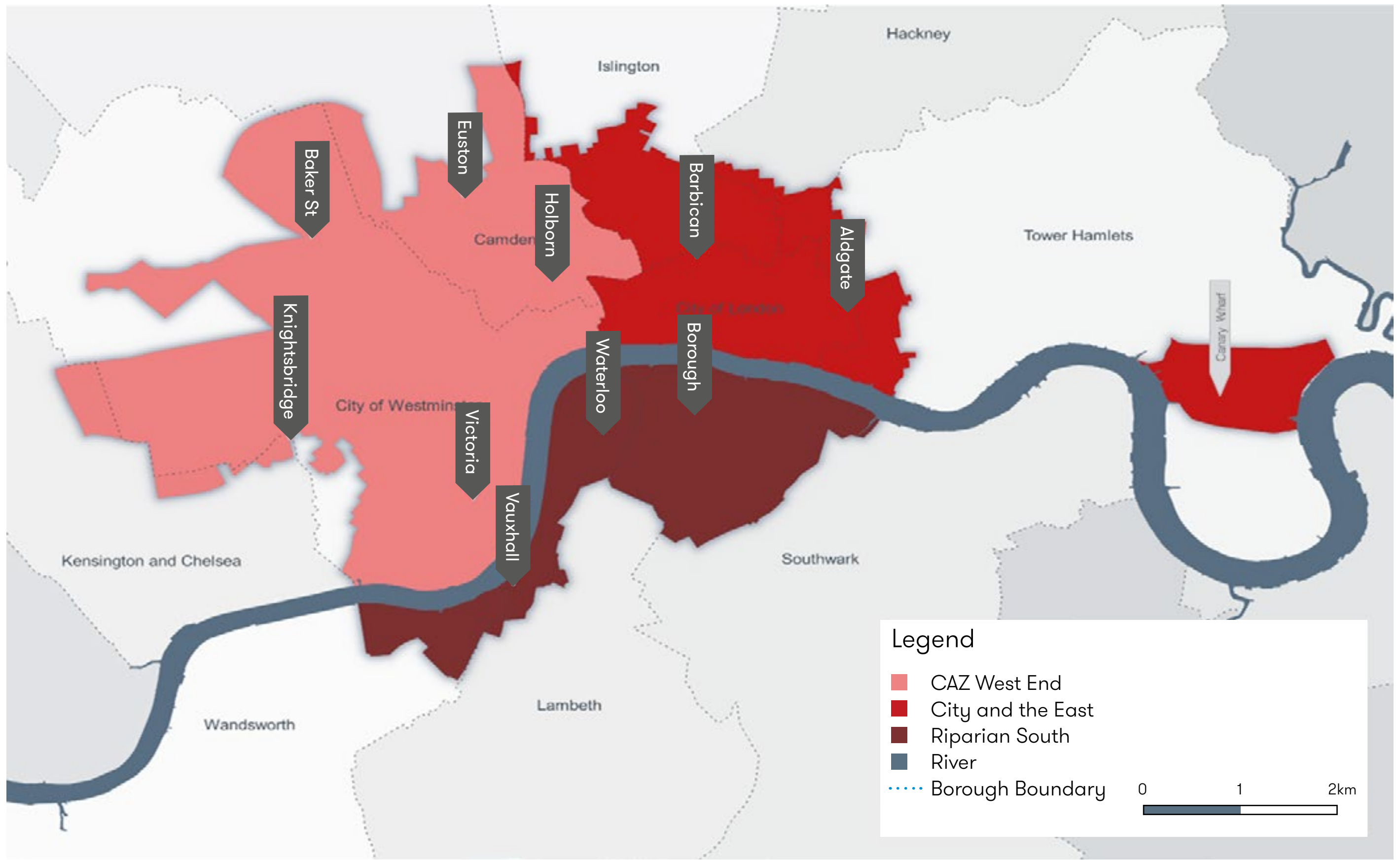
Central London's unique position

It is within this context that central London's business rate contribution can be analysed. The central London economy is largely contained in the Central Activities Zone. The area including the Northern Isle of Dogs (where Canary Wharf is located) is known as the "CAZ+". These areas are defined and referred to in the London Plan – the GLA's strategic planning document for Greater London. The figure and table below provide an overview of the CAZ+.

As can be seen, the CAZ+ takes in varying proportions of some nine London boroughs and the whole of the City of London.

CAZ+ study area

Source: Good Growth for Central London: Analysis of the CAZ+ from 2020 to 2041, London: Arup, p14



Source: Good Growth for Central London: Analysis of the CAZ+ from 2020 to 2041, London: Arup, p14

Borough	Area in CAZ+ (Hectares)	Percentage share (of CAZ+/ of borough in CAZ+)
City and the East	1,145	33%
Islington	401	16%
City of London	417	100%
Hackney	262	3%
Tower Hamlets	65	12%
CAZ West End	1,989	57%
Camden	315	19%
Kensington and Chelsea	238	5%
Westminster	1436	65%
Riparian South	364	10%
Lambeth	53	8%
Southwark	104	13%
Wandsworth	207	3%
CAZ+ total	3,498	

Analysis by the authors along with Arup for the London Property Alliance [WPA and CPA][4] estimated that the CAZ+ contains some 27.8 million square metres (299 million square feet) of commercial space (2019 figures) of which offices comprise just under three quarters of the total. For 2020 (pre-Covid), Arup estimated the total CAZ+ business rate yield was would be £4.6 billion (2019 prices).

In the context of Greater London and indeed nationally, the CAZ+ contribution is very substantial. At £4.6 billion, the CAZ+ yield is equivalent to 55% of that for Greater London as a whole or 19% of England's total.

This is a reflection of the very significant economic importance of the CAZ+. It represents 46% of London's economic output and 31% of its employment from just 2.2% of London's land area (0.01% of the UK's land mass).

Image: Bond St

The impact of Covid-19

The government's response to the Covid-19 pandemic included a nationwide lockdown of economic activity from late March 2020 which, in a modified form, is still in place. Although there was a gradual reduction in control from early June, a series of partial local constraints have been introduced since late June. Leicester, for example has been in some form of renewed lockdown continuously since 29 June.[5]

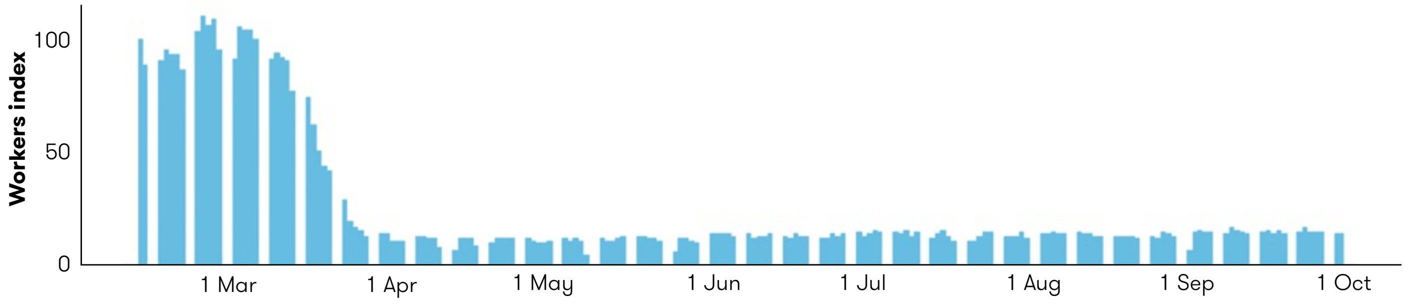
Larger city and town centres have been particularly hard hit by lockdown policies. Because central London and other major cities rely on mass public transport to move people in and out of offices, shops, cultural and leisure facilities, the initial government instruction to avoid trains and buses had a particularly dire impact on densely used business districts. Even now, with somewhat reduced restrictions in place, city centres are suffering from a significant fall in commuting and recreational travel. Both national and international tourism have been badly hit.

The Centre for Cities has analysed the impact of Covid-19 on city centre commuting. The table below shows city centre working has declined by about 80 per cent since February 2020.

Workers index

This index looks at city-centre workers in the city centre in the daytime on weekdays, compared to a pre-lockdown baseline of 100.

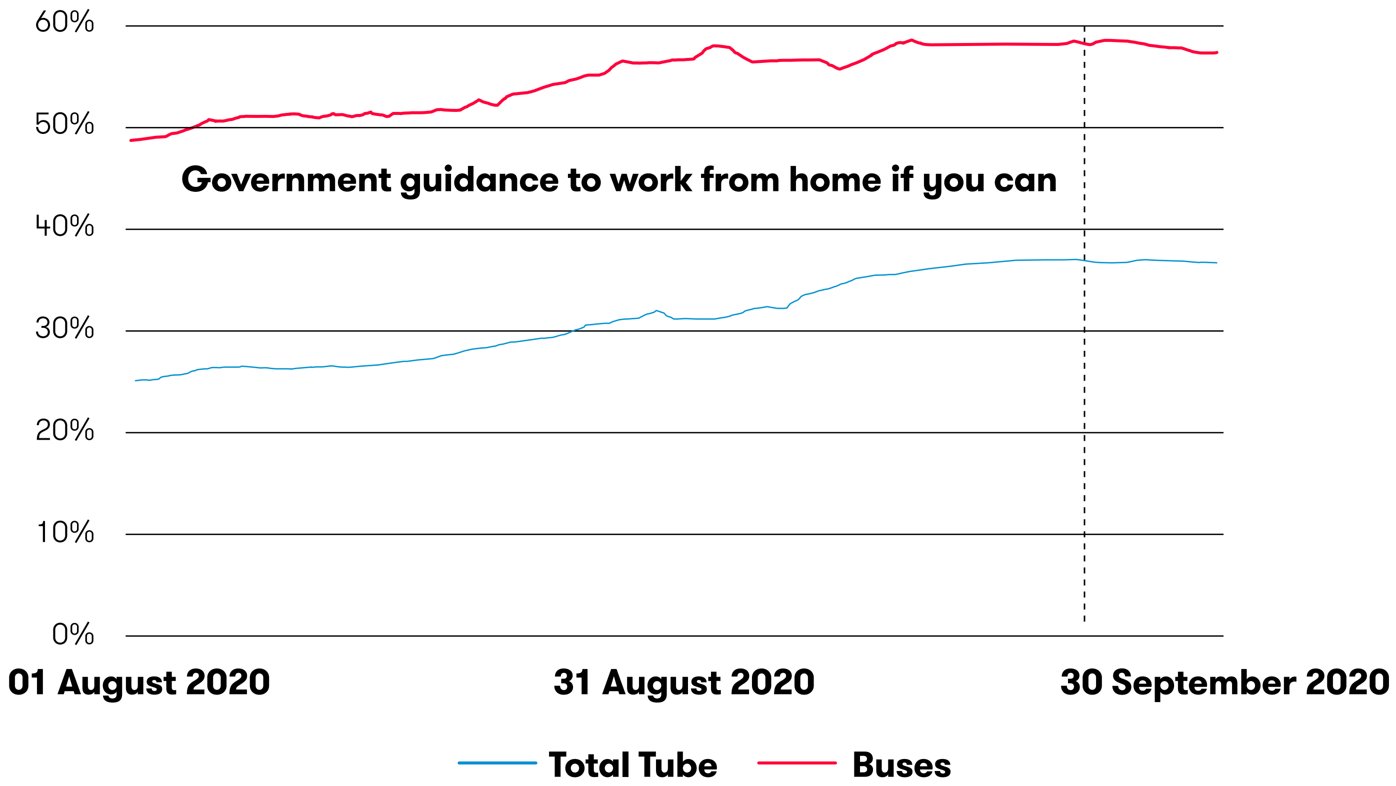
Source: Centre for Cities, https://www.centreforcities.org/data/high-streets-recovery-tracker



Reductions in commuters, shoppers and other travellers meant Underground passenger numbers fell by 95 per cent at the start of lockdown, with a modest recovery to under 40 per cent subsequently. Buses faced a smaller reduction, but still faced a huge change. Central London faced a disproportionately larger hit than these average figures.

Underground and bus ridership, August to October 2020

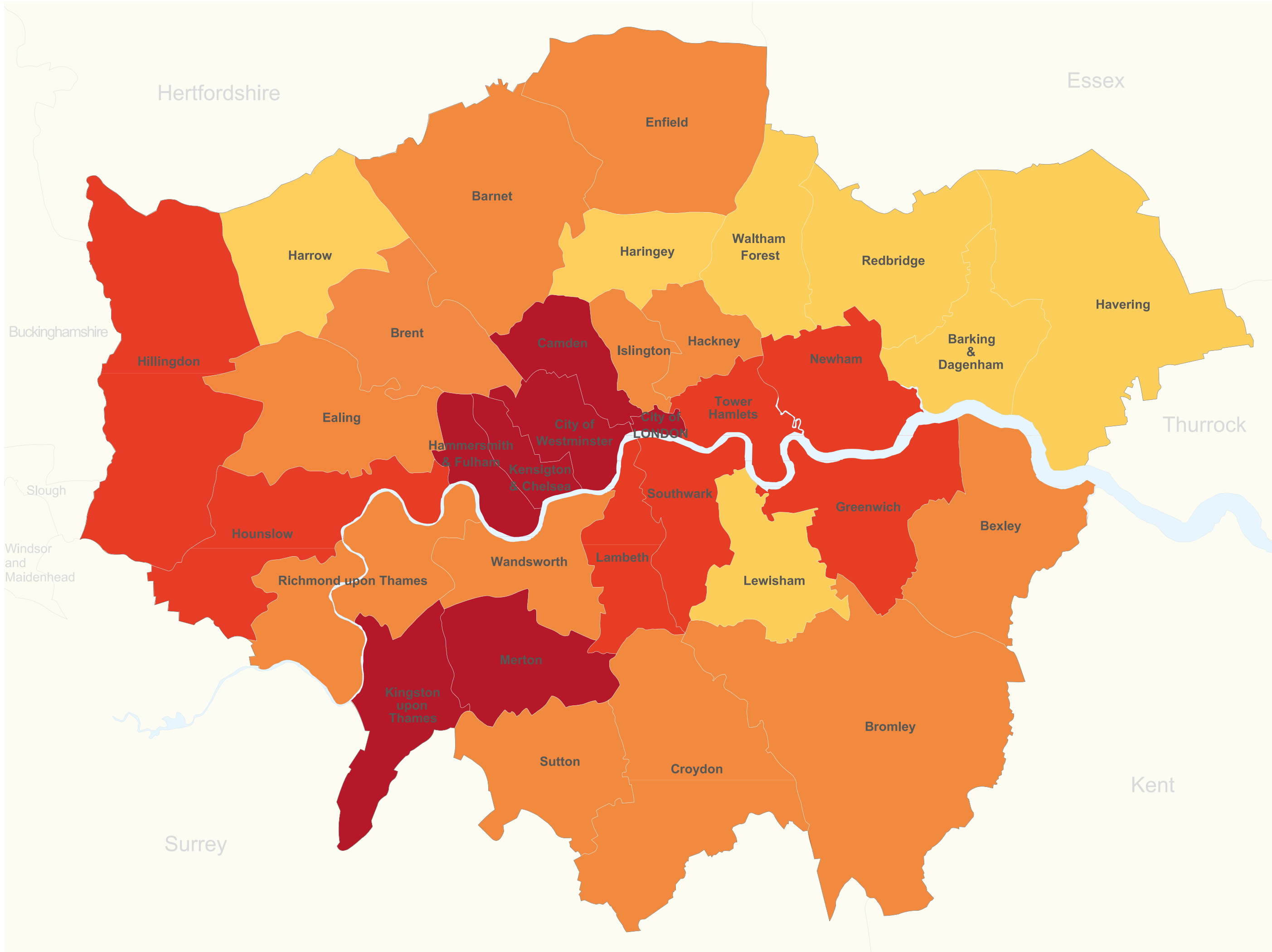
Source: Transport for London Board Papers, Finance Report, Quarter 2, 2020/21, http://content.tfl.gov.uk/board-20201021-agenda-and-papers.pdf



Nothing like this has happened to the London economy for centuries. Even the Second World War did not lead to dislocation on this scale, with virtually all businesses negatively affected. Central London shops, restaurants, hotels, bars, clubs, theatres, opera houses, cinemas, gyms and virtually all other businesses have been disproportionately affected compared to the rest of the capital.

The government offered relief to businesses in a number of ways, including a furloughing scheme to protect workers, support for the self-employed, guarantees for bank loans to businesses and 100 per cent non-domestic rates (NDR) relief for the retail, hospitality and leisure sectors.[6] While commercial NDR-payers have not received such support (beyond any such reliefs previously being paid) the relatively high rateable values in (particularly central) London have led to average reliefs paid to central London authorities being significantly above those elsewhere. The Institute for Fiscal Studies has estimated the average relief per property and per authority. The map on the following page shows the average amount of retail discount per property for councils across England.

Average amount of retail discount per property for councils across England, 2020-21
Source: Institute for Fiscal Studies, https://www.ifs.org.uk/uploads/BN293-COVID-19-support-through-the-business-rates-system.pdf [page 20]



- More than £40,000
- £30,000 - £40,000
- £20,000 - £30,000
- £10,000 - £20,000
- Under £10,000

Note: Total cost of the expanded retail discount, divided by the number of hereditaments eligible for the discount at 1 April 2020. For some authorities this includes the cost of increasing the retail discount from 33% to 50%, as announced in January 2020, as well as the further increase from 50% to 100% and significant expansion of eligibility in response to the coronavirus crisis. Source: MHCLG statistics. Additional NNDR data collection exercise, April 2020 (revised).

According to the IFS, the average payment made to a retail business in England will be £28,227 in 2020-21. Areas with high average relief payments are typically councils with major retail centres. “The highest is Westminster, however, with a mean relief of £127,400 and a total cost of reliefs of £943 million – over 9% of the total for England, despite Westminster containing just 1.3% of properties in the retail, hospitality and leisure sector (although these represent 8.2% of all rateable value)”.[7]

The scale of the relief paid to retailers in Westminster is indicative of the impact of Covid-19 on retail, hospitality and leisure businesses across central London and in other major cities. The map shows Camden, Kensington & Chelsea and Hammersmith & Fulham (also Richmond and Kingston) with high reliefs per business. Liverpool, Manchester and Birmingham are also shown in a similar position.

The government acted swiftly and decisively to protect retail, hospitality and leisure businesses in 2020-21. In parallel, many larger central London landlords have offered occupiers temporary or longer-term reliefs on rents.[8] As a result of these measures and of furlough payments and/or loans, many city centre businesses have been able to survive the last eight months despite having few customers or visitors.

Ministers are having to adjust its economic approach to the continuing Covid-19 crisis on an on-going basis. For example, the Chancellor of the Exchequer recently introduced financial support for businesses within Tier 2 localities.[9] It is now clear that the public health and economic impacts of Covid-19 are continuing to evolve and are likely to do so well into 2021-22. It is inconceivable that the UK will be ‘back to normal’ by spring next year.

There is thus a need to take policy steps to ensure that a temporary phenomenon does not inflict permanent damage on the central London economy. The same case can be made about the city centre economies of Manchester, Birmingham, Leeds, Sheffield, Liverpool, Newcastle Edinburgh, Cardiff and Belfast. One of the most important spheres for action is the non-domestic rates to be charged in 2021-22 and 2022-23. If NDR is re-imposed at anything like the full rate on retail, hospitality and leisure businesses next year, there would be a significant economic fall-out. Indeed, businesses planning ahead will need certainty about their costs very soon: any risk NDR will be fully charged in April 2021 would require shops, bars, restaurants and hotels to take protective steps in the coming weeks.

The case for reform

A continuation of full relief into 2021-22 could be agreed alongside a decision to hold a six-monthly review to reflect changing economic circumstances next year. By the second half of 2021 it should be clear whether Covid-19 is in retreat or, alternatively, that lockdowns will continue into the autumn and winter on 2021-22.

Another aspect of protecting the central London economy for recovery would be the planning system. It would be problematic if decisions were made in 2020 and 2021 which made it more difficult for the viable businesses of 2019 to be restored in the future. Central London has evolved as a complex ‘ecosystem’ of overlapping sectors. A sudden shift away from commercial, retail, cultural and related uses could inhibit future growth and productivity.

Finally, in considering the one to three-year time-horizon, policy makers should consider the importance of central London not only to the UK’s tax take, but also as a key element in the country’s ‘soft power’. If the core of the capital’s unique hub of activities is diminished, other global cities will surely gain at the UK’s expense, and not only in relation to London.

Medium term reform

The previous section considered the immediate need to protect viable enterprises and jobs in central London, particularly in relation to non-domestic rates. The government is in the middle of a consultation about the future of non-domestic rates in England. It its 'call for evidence' the Treasury stated:

"The pandemic has had a significant impact on how business is done, particularly for firms which rely on customers visiting them. The full impact of this will become clear over time. As the economy moves towards recovery, the Government will continue to support businesses as far as possible, but it must also ensure that the tax system raises sufficient revenue to fund the services that have been essential parts of the pandemic response, as well as public services more broadly. Policy changes will need to be considered in the round and particularly against the backdrop of COVID-19, as well as broader fiscal and economic considerations."[10]

This official statement makes perfect sense given the need to balance the challenges to business created by Covid-19 against the Treasury's need to protect the tax-base in the longer-term. The following section of this report considers some of the longer-term possibilities to reform NDR while ensuring the government can still raise taxation from business. The first section ('The Challenge') outlined some of the traditional objections to NDR as a good tax.

The government is at present committed to a full revaluation in England in 2023, based on "on property values as of 1 April 2021".[11] It is unlikely the economy of many city centres will be in a steady state by that date. Given the uncertainty facing both the London and UK economies, it is possible there will be a radical change in NDR bills and thus a major redistribution of the national NDR yield if 2021 is used as the basis for revaluation. A substantial fall in underlying central London rateable values would, given the way the national non-domestic rating system works, shift the burden of the tax to other businesses and areas at a time when they, too, are vulnerable. A pause, retaining 2020-21 reliefs, might be a better way forward. The economy of 2015 (when the last revaluation was based) is now an artefact of history. The economy of April 2023 will be different again.

As the UK adapts to the twin impacts of Covid-19 and Brexit, the case for more regular revaluations becomes even stronger. The government has already agreed to move from five-yearly to three-yearly revaluations, though the economic changes ahead suggest the need for even greater frequency.

The inflexible nature of non-domestic rates has been made clear by Covid-19. The government, rightly, intervened to cut the NDR impact on businesses facing the greatest loss of custom. Other, more responsive, taxes did not require interventions of this kind to avoid damage to companies or individuals. The Treasury's review needs to consider the longer-term criticisms of NDR and also the challenge they themselves now face in having to modify it for a number of years to ensure it does not cause permanent damage to an economy in transition.

It is unlikely England or the other UK nations will abolish all property taxes on non-domestic premises. Indeed, as the economy changes in the coming years, the curiosity of the zero rating of agricultural land and buildings will surely have to be reviewed as the regime of agricultural subsidies is reformed post-Brexit. Other NDR-paying businesses will doubtless be seeking a system of taxing non-domestic property which can better reflect changing economic circumstances while also treating new sectors such as on-line retailing more appropriately.

One possible way ahead would be to accept there needs to be a reduction in NDR while raising the lost amount from a new, more appropriate, business tax. This issue is considered in the following section. One thing is certain: the present system is not fit for purpose.

Longer term reform

Work by the authors with Arup for the New West End Company in 2018[12], a business improvement district (BID), focused on the advantages and drawbacks of introducing a turnover tax and a local sales tax (the latter in the form of a VAT supplement). This was primarily with a focus on thinking about an alternative to business rates for the retail sector.

Options were evaluated against a range of criteria including:

- Ease of collection
- Income generated
- Collection rates
- Equity
- Ability to pay
- Impact on the economy

A blanket rate of 1%-1.5% (1 pence to 1.5 pence in the pound) on the annual turnover of businesses would raise £28.4 billion (2017 prices); the same amount raised in business rates in 2017. Similarly, a five-percentage point VAT supplement for those businesses currently paying VAT would raise £28.4bn. Recently, it has been reported that the Treasury has estimated that an on-line tax of two percent would raise about £2 billion a year.[13] (Note, revenue from on-line activities was included in the Arup turnover tax estimate of £28.4bn cited previously.)

The figure three pages on[14] summarises the findings of the advantages and drawbacks of these two approaches, based on international case studies.

As can be seen, a local sales tax enjoys a number of advantages over the current business rate system, specifically: one point of collection in the production (or value) chain; the ability to make local changes to rates and exemptions (for example raising more or less revenue to fund public services or investment); and a correlation between tax collected and ability to pay.

The turnover tax also enjoys the advantage of being capable of being changed to reflect local requirements. It also has the advantage of being able to bring on-line businesses into the ambit of domestic tax regimes in a way that the public and "bricks and mortar" businesses might consider to be fairer and more equitable than current arrangements.

Inevitably, there are also potential disadvantages of both these alternatives to business rates.

A local sales tax

A local sales tax can carry a higher risk of evasion (as it is all collected at a single point of final consumption). It might lead to competition issues at a "cross-border" level – especially for the retail sector. The significant disadvantages of a turnover relate to the fact that it does not necessarily correlate with ability to pay and for this reason it is a comparatively distortive tax.

Furthermore, it is likely that there would be a challenge concerning how either of these taxes would work for companies with more than one place of establishment and where it is perhaps difficult to allocate on a transparent and auditable basis how much value in say a head office or "back-office" activity is being created. This might lead businesses to be tempted to use "transfer pricing" techniques to shift the assumed value from a jurisdiction with a higher sales tax rate to one or more with lower rates. Similarly, a turnover tax may be vulnerable to the same temptation with (for example) higher cost employees being notionally employed in a lower tax area or jurisdiction.

The report concluded that a local sales tax (implemented within the current VAT system) was a workable replacement for business rates but only if it is implemented on the same tax base as business rates – not just on the retail sector.

Capital value tax

One other option that could be considered is a capital value tax (CVT) or land value tax (LVT) based on the value of land and/or the buildings on it. The tax would be paid by the owner of the property rather than the business occupying it. The principal argument in favour of the shift is that there would be economic efficiency improvements in taxing those who "simply" own an asset over productive investment.[15] However, this approach is by no means a silver bullet.

First, the disadvantage that the Mirrlees Review highlighted and was noted earlier in this paper would persist – namely that an input rather than a form of economic output is being taxed with associated risks of distorting investment. Second, there is the difficult question as to who actually ends up paying this tax (the tax incidence). The Arup report cites research that indicates that at present, land-owners pay between 10% and 75% of business rates through changes to rents. There is no definitive answer to this question, but the reality is that occupiers are likely to end up footing at least part of the bill.

Given the financial stress already facing many occupiers in impacted sectors, particularly in city centres, policy makers will need to consider future economic impacts carefully when reviewing possible reform options.

Comparative findings
Source: Tax reform technical study: Report for the New West End Company, London: Arup, page 40

Criteria	Business Rates (current system)	Local Sales Tax	Turnover Tax
Collection - ease of collection	Poor transparency for businesses, complex to administer and forecast for local government, especially in relation to re-basing and re-setting years. High rates of appeals, volatility at revaluations, and complex relief / transition schemes.	One point of collection in production chain split at payment between recipient governments.	Tax collected at all levels of production chain.
Income generated – level of tax collected to spend on local services	No correlation between monies collected locally and expenditure needs of local services. Stable and reliable for local government revenue for 5-7 years.	Tax base (rates and exemptions) change locally to reflect local expenditure needs and policy direction. Represents between 10-60% of state tax revenues.	Tax base (rates and exemptions) change locally to reflect regional expenditure needs and policy direction. Represents 70% of regional tax revenues.
Collection rates – level of collection and ease of avoidance	Immobile tax base; Difficult to avoid for businesses; revenue risk for local government from appeals and discounts.	Risk of evasion relies wholly on final seller tax payments; audit trail can be obscure; preferential geographic decision for customers and businesses.	Easier to administer. Avoidance by under-reporting or vertical integration.
Equity – the spread of the tax across local businesses	Economic activity unnaturally skewed away from property development and property-intensive production activities.	Performance pressure on retailer only; localised rates can impact cross-border competitiveness	Distributional impact is indeterminate.
Ability to pay – the relationship between taxation and ability to pay	Little correlation between a business's ability to pay and properties' rateable value or multiplier used.	Direct correlation between tax collected and due, no impact on profits (ability to pay).	High turnover does not automatically imply high profits (ability to pay).
Impact on the economy – how a different basis for local business taxation would affect the local and national economy	Risk on investment and development decisions close to resetting period.	Localised rates can impact competitiveness.	Economically most distorting form of sales tax.

Note: Local Sales Tax (US case study)
Turnover Tax (Argentina Gross Income Tax case study)

Conclusions

The current non-domestic rating system is unstainable. This is through no fault of any of the key players involved: the government, councils, rating professionals, property owners, business ratepayers or their customers. Longer-term weaknesses with NDR as a tax have been exposed by Covid-19, the single biggest policy event in the UK since 1945. Short and longer-term action is now required.

If no reform takes place, economic distortions will be worsened and further economic damage will be done. The yield of NDR probably needs to be reduced and replaced (at least in part) by a new tax which would treat different businesses appropriately within the rapidly changing economy of the 2020s. Taxing businesses' land and buildings on the basis of rental values is no longer (if it ever was) fair or economically rational.

City centres and particularly the West End of London are in particular need of protection from non-domestic rates. Even before Covid-19, the burden of the tax was unusually skewed onto a small number of retailers and other occupiers in a handful of boroughs. This is not to say central London or London as a whole should pay less tax, but that the way the money is raised should reflect the contemporary economy.

The economic impacts of Covid-19 and Brexit together provide the justification for a fundamental re-set of the system.

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