Is it possible to incentivise and capture local wealth: the business rate challenge

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Abstract:

How can Government and the Treasury reconcile two often contradictory aspects of the commercial property tax model in England? On the one hand, commercial property tax is required to be responsive to economic conditions, promoting investment in property and business. On the other hand, local commercial property tax, in part, is required to fund local public services. This situation reveals a contradiction in government tax policy that has a direct impact upon local, regional and national economic activity. This Viewpoint article considers the nature of commercial property tax in England, the business rate system, the competing pressures upon the business rate system before considering the main alternative on offer in England, land value tax. Despite the undoubted economic elegance of this instrument, any move towards land value tax should be approached with caution. Any solution to the current business rates impasse should not be led by a pragmatic focus on tax collection. Nor should prevalent issues, the high street, the need for digital tax or public finance demands be considered in isolation – they should be tackled together because they are part of the same complex situation.

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How can Government and the Treasury reconcile two often contradictory aspects of the commercial property tax model in England? On the one hand, commercial property tax is required to be responsive to economic conditions, promoting investment in property and business. On the other hand, local commercial property tax, in part, is required to fund local public services. This situation reveals a contradiction in government tax policy that has a direct impact upon local, regional and national economic activity. This Viewpoint article considers the nature of commercial property tax in England, the business rate system, the competing pressures upon the business rate system before considering the main alternative on offer in England, land value tax. Despite the undoubted economic elegance of this instrument, any move towards land value tax should be approached with caution. Any solution to the current business rates impasse should not be led by a pragmatic focus on tax collection. Nor should prevalent issues, the high street, the need for digital tax or public finance demands be considered in isolation – they should be tackled together because they are part of the same complex situation.

Keywords: tax, business rates, Business Rates Retention, business growth, local government.

This Viewpoint article is designed to examine a conundrum. The conundrum can be simply stated. How can Government and the Treasury reconcile two often contradictory aspects of the commercial property tax model in England. On the one hand, commercial property tax is required to be responsive to economic conditions, fairly promoting investment in property and business. On the other hand, the local retention of commercial property tax, in part, is required to fund local public services. This is because retention of commercial property tax has affectively replaced the Central Government Revenue Support Grant (RSG).

This examination is important because it reveals an in-built contradiction within government tax policy that has a direct impact upon local, regional and national economic activity. The contradiction is between the need to support the business community during economic uncertainty (typically, this requires commercial property tax to drop) and the newer need to fund local public services (typically this requires commercial property tax to remain stable and ideally increase). The current system of commercial property tax in England cannot to both.

The timeliness of this Viewpoint article is bound up in the same central contradiction. The speed with which fiscal decentralisation (and its growing reliance on commercial property tax) is taking place, makes it imperative to understand its implications for the funding of public services and the management of local and regional economic development (Muldoon-Smith and Greenhalgh, 2015; Mor and Sandford, 2018). Concurrently, the influence of commercial property tax on businesses is also acute. Gerry Schurder (Gerald Eve 2018) has recently captured this situation arguing that commercial property tax in England has become a cumbersome, opaque albatross around the neck of businesses, stifling growth and placing too much of the burden on the shoulders of those that can least afford it. Schurder also reflected on the central contradiction in current government policy, arguing that Government needs to realise it cannot continue to use commercial property tax as a cash cow. It
is the only tax where the overall take does not change in real terms no matter what the economic conditions of the day and there needs to be more flexibility to support businesses during hard times

The contradiction at the centre of this piece, and any solution, does not relate to a simple binary between business growth and local government funding. Rather the situation reaches into the structural fabric of business activity in an era of disruption, the local fabric of differing patterns and histories of economic development and local government services and the national fabric of central government ideology and financing.

Business Rates

The modern system of business rates in England, the National Non-Domestic Rate (NNDR), replaced the local rate in 1990 (a poundage known as the uniform business rate is set nationally and is updated each year). It is a property tax derived from the rateable value (typically the amount of rent a property will achieve on the open market at the time of valuation) of non-domestic property which is traditionally assessed every 5 years by the Valuation Office Agency (VOA). Postponed by two years, the last revaluation took place in 2017 based on an antecedent valuation date of 2015. The existing business rate system has evolved since 1990 and an array of reliefs and exemptions now form part of the mechanism (Greenhalgh et al., 2016). In addition to business rates there is also a system of empty property rates that must be paid by the landlord equal to the value of the national business rate multiplier – all commercial landlords get an initial 3-month exemption period (6 months for industrial properties) while listed properties are exempt. Currently, councils in England collect nearly £30bn of business rates each year.

Business rates are calculated in relation to a given properties rateable value using the standard national business rate multiplier which currently stands at 49.3p in 2018/19 (48.00 for small businesses). This means that if a property has a rateable value of £100,000 it would have a £49,300 property tax bill. The business rate multiplier is adjusted each year according to the Consumer Price Index (CPI). It is also adjusted during the periodic national revaluation exercise to make sure that overall national property tax yield remains constant before and after national revaluation. Following the 2017 revaluation exercise the overall business rates yield has increased. However, this is largely due to the gravitational impact of the Central London property market. Rateable values in Central London have broadly increased while the rest of England has seen significant decreases in value, especially in the North.

Concurrently, local authorities in England have seen a significant cut in their financial resources. By 2020, local government in the UK will have £15.7bn less central government funding that it had in 2010, revealing a potential £5.8bn funding shortfall (House of Commons Public Accounts Committee, 2018). Partly in response to this situation, the Business Rate Retention Scheme (BRRS) was introduced in 2013. This was in order to retain more rates locally to pay for public services – affectively replacing the Revenue Support Grant. Since 2013, local authorities have been able to retain 50% of their local business rates – this will increase to 75% in April 2020. The intention was for 100% retention but this was delayed when the primary legislation fell. 75% retention is the maximum retention allowed without primary legislation (100% retention is currently only available in pilot locations).
The result now is that the business community and local authorities are both reliant on business rate decisions and income. Both interests increasingly see business rates as outdated and problematic. However, this clamour for change is not in unison. The drivers for change range from those interested in tax reduction, those interested in recovering the cost of national investment, all the way to those invested in progressive notions of local wealth building, the foundational economy and municipal socialism. Therefore, the challenge for a new system of tax involves uniting all of these interests in a virtuous relationship. Rather than the current situation which places them at odds.

**Business Rates Pressure**

The dual focus at the heart of the business rate system has resulted in a complex system that is very difficult to follow, one that is beset by administrative limitations. Businesses face various multipliers, reliefs, exemption thresholds and transitional arrangements. The incidence of the tax also falls negatively on both tenant and property owner. Occupiers, who shoulder the extra cost of business rates, have less profit and reserves to invest in their business and can pay more in property tax than corporation tax. While the business rate burden is capitalised into lower rents reducing the investment potential of property owners. In addition, it still remains the case that local authorities can potentially make more income from empty rates than business rates – this is because the empty property tax rate is set higher than the small business rate multiplier. While businesses have the potential to benefit from between 3-6 months of empty property rate relief which has incentivised an industry of empty rate avoidance and on-going vacancy.

The local government Business Rate Retention Scheme relies on a convoluted web of tariffs, top-ups, safety nets, levies. It also struggles to deal with the impossibility of retaining growth locally and redistributing income nationally amidst volatile property market conditions. This last point is partly because the adjustment for revaluation that takes place every five years strips out any increase in placed based value creation (through the adjustments in the top up and tariff mechanism). The only growth that remains is that associated with net new floor space, either derived from new build construction or repurposed floor space (Muldoon-Smith and Greenhalgh, 2015). This significantly reduces the ability of local areas to invest in their locations through place based regeneration or to secure the proceeds of local wealth building. This is because local areas cannot recover any of this investment through existing property value uplift.

The current business rate system does not work for anyone. However, in the absence of anything better, the existing system of business rates is being persevered with because, in economic speak, it is relatively fixed and hard to avoid and from a public finance perspective it is the only tax that is consistently going up. However, at the same time the business world is going through a time of disruption which is leading to administration and consolidation while local governments are entering special measures (government speak for bankruptcy). Northamptonshire County Council has recently been given the unusual permission to capitalise the sale of its headquarters to pay a £70m funding shortfall. Illustrating the gravity of this situation across the country, 80% of local authorities recently indicated that they lack faith in the on-going solvency of local authority finances (LGUI, 2019). While, the Public Accounts Committee has recently argued that the government is in denial about the state of local public sector financing (House of Commons Public Accounts Committee, 2019).
Existing efforts to improve the Business Rate Retention Scheme mostly involve complex alterations to the existing mechanism, for example re-designing the reset mechanism (when tariffs and top ups are periodically reset). Broader improvement to the existing business rates system focus on more frequent valuations (potentially aided by automated valuation tools), a more efficient appeals process (for example the Check, Challenge, Appeal process introduced in 2017) and the continuing removal of low value properties from the business rate system. However, this feels more like tinkering around the edges of a very complex system (potentially making it even more complicated), rather than fixing the underlying concerns of transparent tax and resilient public sector finance. A more comprehensive debate is needed into how England can reform its model of tax to support business and public services.

**Business Rate Reform**

A lot of the press attention for business rate reform falls upon the retail sector. However, although clearly an important consideration for retailers, business rates are not necessarily the cause of market disruption in this sector. Business rates are often relatively high for larger retailers because they have paid a premium for centrality of location. Concurrently, many smaller retailers do not pay business rates because they are below the threshold. Rather, the retail sector is currently beset by myriad structural, macro and micro concerns, which magnify the cost of business rates.

This is not to say that the retail sector is not influenced by business rates. It is an important concern in a time of clear disruption. Rather, the intention here is to argue that business rate reform should not be led by one agenda. Rather, the opportunity should be taken to take stock of the current situation and unite the various considerations and priorities that are reliant upon or demand a reformed commercial property tax in England. Creating a holistic picture of this situation will then provide the opportunity to work backwards to understand how a new system of land and property related tax could be implemented that unites the concerns of the business and public sectors. These tax considerations and priorities range from:

- Being responsive to economic conditions and fairly incentivising investment in property and business;
- Sensitivity to the new world of work that favours leaner, hybrid business models that mix bricks and mortar and digital transaction interfaces;
- The need for legibility, simplicity and transparency;
- The need to manage volatility and provide certainty in individual and overall commercial property tax yield;
- Sympathy for how business rates fall on various property sectors and locations – for example retail, leisure, office and industrial, all of which experience property tax in different ways;
- Tackling the perversity inherent in empty property rates that at times rewards vacancy more than occupation and has driven a sub-industry in Empty Property Rate avoidance techniques;
- The demand for local government financing which is only projected to increase as society lives longer;
- The need to capture the value created by public and civic spending on physical, social and knowledge infrastructure in local areas.
In facing up to the demand for business rate reform, there is a concurrent interest in land value tax as an alternative tax arrangement – currently championed by the Labour, Liberal Democrat and Green parties. In contrast to business rates, land value tax is based on location and is levied upon the value of land (with or without in situ property). The central contention is that the value of land is defined by what is happening in the immediate location and wider region. For this reason, land value tax is considered progressive because it captures value invested by society in a given location and could aid current calls for local wealth building (see for example McInroy, 2018). This model of tax certainly remedies one of the central concerns with the Business Rate Retention Scheme, that any value increase due to local investment is stripped out during the periodical national revaluation exercise – known as the ‘wash through’ (Muldoon-Smith and Greenhalgh, 2015). It also promotes the better use of land as there is an integral incentive to build out gap sites – because the landowner would be taxed on the potential value of the site if vacant. For this reason, land value tax is also known as the sustainable tax.

However, England should be wary of viewing land value tax as a panacea for concerns with business rates. The economic and ethical argument for land value tax is well made. It is an elegant economic tax that can trace its lineage back at least to Adam Smith, David Ricardo and Henry George. However, a great deal of land simply has no value and demands a certain degree of investment for development readiness. This suggests that there will still need to be a complex system of equalisation between locations and grant funding (Sandford, 2017). Indeed, research recently carried out by the Liberal Democrats (Corlett et al, 2018), into their proposals for a Commercial Landowner Levy, indicates that the tax yield will significantly decrease in certain locations. They claim that 92% of local authorities will have lower tax yields. This is particularly the case for those local areas already suffering economic blight and the worst impacts of austerity – because land values are relatively lower. Oldham, Blackburn, West Bromwich, Barrow and Middlesbrough would see average taxes cut by between 25% and 46%.

Similarly, reducing property tax will not help the high street if the demand for certain products simply does not exist anymore in conventional bricks and mortar format. In addition, any reduction in tax will likely capitalise into higher rents as property owners price in the change through time. Concurrently, it is not clear how land value tax would better deal with the new world of digital platforms that do not have physical footprints, nor the dynamic reality of commercial business that increasingly must switch between use classes in quick succession. The practicality of moving to this system is also not straightforward. It would require massive change to the English institutions of tax administration, another national revaluation exercise using a new method of site appraisal and the development of a new valuation skill base. Perhaps the biggest obstacle will be political. A switch to land value tax would shine a light on the deeply ingrained practice of wealthy property owners who may not take kindly to disturbance.

A very English compromise

Consequently, despite all of its merits, the time for land value tax may have already passed while England has persevered with a broken business rate system in recent decades. Instead, the eventual reality may be a very English compromise. For example, a semi-permanent transition that combines
elements of land value, property and turnover related tax. This balancing act would be similar to the split-rate tax (where land is taxed at a higher rate than property) seen prominently in North America. A split-rate tax model taxes land, and any buildings on it, differently. It moves the tax burden on to land by taxing it more severely. If the landowner wants to decrease this burden, they must develop land to its best use. This will result in higher taxes but also an increase in the properties market value.

The compromise could also include elements of business growth not easily captured in bricks and mortar – for example a digital sales tax. The digital sales tax, announced by Philip Hammond in the 2018 Budget aims to capture value from firms that shift sales and profits between administrative jurisdictions. The business and property world is now a hybrid mixture of commercial vehicles existing somewhere between bricks and mortar and the digital world. It makes sense for a reformed system of tax to be similarly hybrid. In this sense, rather than focusing on land and property tax – which has traditionally been considered regressive and worth avoiding, emphasis should be put on a wealth health agreement between business, property owners and local communities that creates a virtuous circle of public spending and place based tax reclamation.

During the Community Charge and Poll Tax crisis in the early 1990s, William Waldegrave (2015) described public finances as the most boring and complicated subject in all of public life. The public finance debate is no longer boring – it reaches into the very nature of local government and how we will fund the future direction of the country. However, it is certainly still complicated. English government, in asking business rates to serve so many agendas at once, has exposed the need to consider reforming the current model of commercial property tax in England. Businesses and property owners increasingly see business rates as an unfair tax. Concurrently, Central Government is mortgaging public services upon the unknown future performance of commercial property markets through the Business Rate Retention Scheme.

The situation is multi-faceted and therefore calls for a collaborative solution that brings together the world of business, property owners, the various tiers of government and those charged with administering tax. The situation should not be distilled into respective political agendas. Nor should it be examined through simplifying principles of economic supply and demand or reduced to cash flow, expenditure and finance settlements. Rather cross party consensus must be found that views land and property based tax through a dual prism of business profitability and the payment of local public services. The solution must capture the value held in the new world of work and recover the investment put into national and industrial Strategies and the bottom up civic efforts of local communities, towns and cities.

Currently, the connection between these unlikely bedfellows is the nature and performance of local commercial real estate markets. A virtuous connection would see improvements in the local economy and business performance translate into greater local tax receipts. However, the current relationship is not symbiotic, it is conflictual. The incentive to grow local economies in the Business Rate Retention Scheme does not coherently capture local economic development or wealth creation. Those locations with buoyant rental levels, that can attract new commercial development, have an advantage over areas where demand is low and viability is a challenge. There remains an implicit assumption that new property development can act as a proxy for local economic development – however, this is not borne out in reality. However, certain locations with buoyant job prospects, for example the A19 corridor dominated by Nissan in Sunderland, or the Golden Logistics
The triangle in the Midlands, do not translate into the business rate retention scheme. This is because industrial property, although space hungry, does not translate into significant business rate income due to its low rental value.

This demonstrates a clear contradiction between the tax system, models of fiscal decentralisation, and a potential place based economy that works for everyone. The challenge for those influenced by this situation is understanding how the fairly rigid administrative system of property valuation and tax, upon which the business community and public finances is reliant, can be adapted to incentivise and capture a more comprehensive account of economic value. Land value tax potentially has a role to play here. However, it will not happen overnight. An immediate improvement could be to remove the ‘wash through’ at the next national revaluation exercise. Although not as revolutionary as a land value tax, this would enable local regeneration to be reflected in, and therefore captured from, property value.

References


