Bulletin

# Taxing bricks – and clicks?

## REFORM OF BUSINESS RATES IN THE UK

Demands for government to remodel the UK's system of local business property taxation have been growing in line with the shift to online retailing, and have been sharpened by the pain of revaluation. The operators of traditional "physical" retail outlets argue that they are particularly disadvantaged by taxes on property. While some minor amendments were introduced early this year, and again in the Budget, a promise to look further at reform has opened a critical economic debate. This bulletin examines the issues and the options.

Business rates are the tax raised locally but (mostly) set nationally, as a proportion (the "multiplier") of the "rateable value" of all property used in economic activity. This value is usually the property's estimated annual market rental.

Rates paid by the occupants of business property are an important source of government income, raising £30 billion a year, or nearly 5 per cent of total taxation. This is roughly the same as the revenue from the "council tax" levied on domestic property occupiers, which - after a brief and disastrous experiment with the "community charge" (aka poll tax) - replaced domestic rates at the beginning of the 1990s.

£30

billion

**Total revenue raised through business rates**

## Hot properties

Issues with business rates have been rising sharply up the political agenda for the past few years, to the extent that each of the main parties promised a review in their election manifestos. Two principal factors lie behind these complaints:

- **Revaluation.** Once set, business rates are raised annually in line with inflation - at present, in line with the Retail Prices Index (RPI), with the promise of a move to the lower Consumer Price Index (CPI). But of course property values move at different speeds in different parts of the country and in different sectors, so there is supposed to be a revaluation for business rates every five years. The last one was in 2010, so another was due in 2015, but was only finally enacted this year. The long delay meant some businesses saw especially large jumps in their rates liability.
- **Online shopping.** Retailers paying (or facing) hefty business rates have been particularly vociferous about the fact that "clicks" businesses do not carry the same tax burden as "bricks." Both, of course, have to pay business rates on warehouses, but those distributing direct to final customers escape paying rates on retail stores.

## Rights and wrongs

Ignoring the noise of political lobbying, what are the pluses and minuses of business rates as a source of taxation? After all, the system wouldn't have lasted for so long if there weren't something going for it, and most countries have something of the kind.

On the plus side:

- Property is easy to tax: it's hard to evade as property is hard to hide and doesn't move.

- Business rates are in part a tax on land, traditionally favoured by economists because supply is fixed and taxing it encourages its efficient use. Since land value is much higher in the congested south east of the country than in the rest, a tax on land encourages the geographic redistribution of economic activity.

On the minus side:

- Business rates are a tax not only on land but also on one of the intermediate elements of economic output (physical property, such as shops or factories), and therefore reduces investment in improving or developing it. This is particularly distortionary when other intermediary elements are not taxed (such as IT or marketing).
- The tax being charged will always lag behind the actual pattern of property values, creating further distortion. Revaluation exercises try as far as possible to keep the tax in line with changing property values, but even if they are conducted as frequently as every five years, the results are likely to create large numbers of substantial (noisy) losers as well as (silent) gainers.

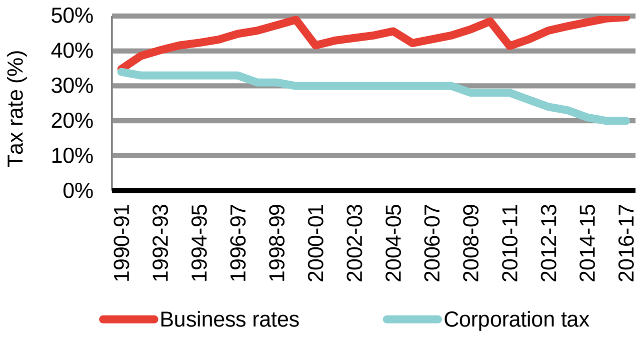
## At its limit?

It can be argued that all these difficulties and distortions simply come out in the wash. High business rates will reduce rental costs, in turn reducing rateable values. “Transitional relief” will help businesses to cope with any sharp jolts in liability. Acute pressures will encourage government not to rely too heavily on business rates for tax revenue.

However, this makes too little of the gradual shift in the burden of taxation in the UK over the past 30 years. As the left hand figure below shows, the yields from corporation taxes and business rates were roughly equal at around 34 percent of profit and rent respectively in 1990. Today corporation tax stands at 19 per cent and business rates 47 per cent. This is partly because governments have pursued a policy of maintaining the yield from rates even when property values fall, so that yield has not been linked to economic performance. By contrast, corporation tax yields reflect profits, and in addition successive governments have sought to cut the rate of tax.

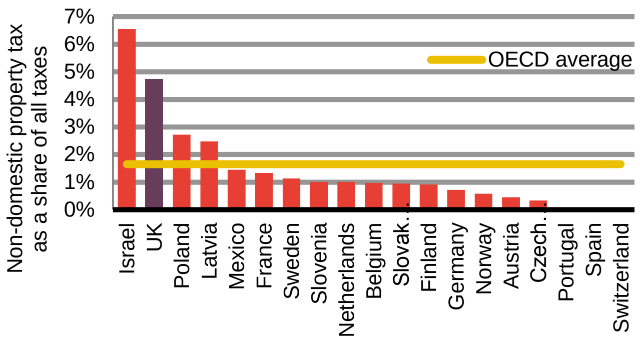
The UK has traditionally had high levels of property taxes, but these shifts mean that today, as shown in the bottom right figure, compared to most other countries the UK relies much more heavily on business property taxation for government revenue, second only to Israel (which also taxes agricultural land).

**Figure 1. Corporation tax rates have fallen while business rates have grown**




*Source: Institute for Fiscal Studies, Valuation Office Agency*

**Figure 2. UK business rates are high internationally**

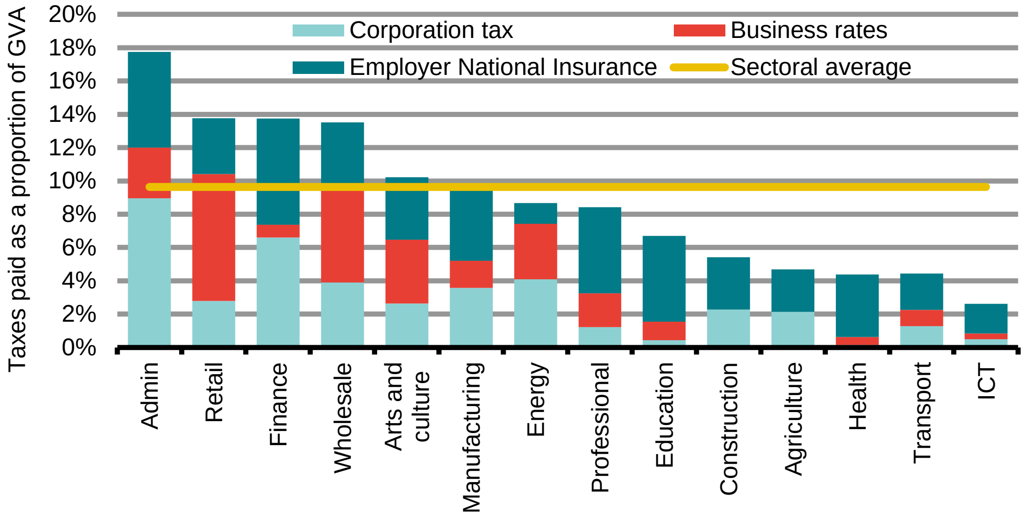



*Source: OECD*

## The retail problem

On top of all this, changes in the retail market have caused particular concerns about the long-term effect of this system of taxation. As the figure below shows, the burden of business rates falls particularly heavily on the retail sector. For “bricks” retailers, location is all-important, and with that constraint comes higher rents and business rates. Online retailers need much less property, and have greater flexibility as to where it can be located, since they do not need to rely on “footfall” or aim to be part of “clusters”.

**Figure 3. Business rates mean retail is a highly taxed sector**



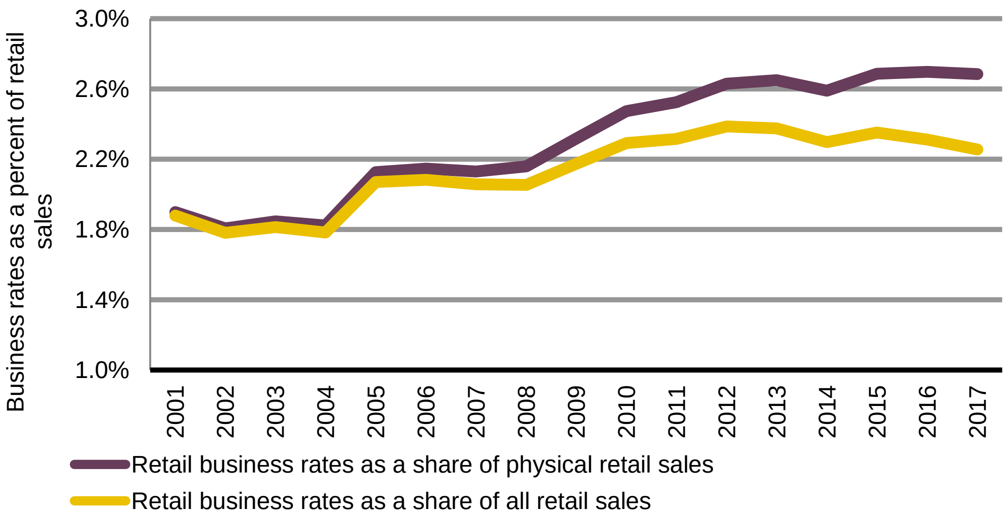

*Source: ONS Blue Book, HMRC, Valuation Office Agency*

*Note: Figures are for 2013. The 'Admin' category includes services such as car rental services, travel agencies or employment agencies, office administration and other similar kinds of services.*

Of course it can be argued that online retailers pay other taxes (more road tax and fuel tax). Or that the locational flexibility of the online retail sector is an economic advantage that should be encouraged, since it redistributes activity away from hot spots. However, fulfilment of online orders is likely to increase road congestion in richer/highly-populated areas, so the advantage is limited. And with online sales increasing from 3 per cent of the total in 2007 to about 15 per cent (and rising) at the latest count from the ONS, the question needs to be asked as to whether our reliance on business rates is creating a new distortion, and indeed driving the shift from "bricks" to "clicks".

If so, there is a risk that the Government may be relying on a dwindling tax base to provide an expected level of revenue, with predictable results. The figure below provides some illustration of this effect. It shows business rates paid by the retail sector as a percentage of all retail sales, and also of sales excluding online. We can see the burden of business rates has grown over time as a share of all retail sales. But stripping out online sales shows the burden on "bricks" businesses has risen from 1.9 per cent of sales to around 2.7 per cent - an increase of nearly 50 per cent since 2001.

**Figure 4. Business rates have increased as a share of retail sales**




*Source: Valuation Office Agency, ONS, with Frontier calculations.*

## Fair's fair?

Since many of these criticisms of business rates are not new, a number of possible solutions have been explored in the past. And a series of mitigating actions have, as noted above, already been taken or promised. These will slightly reduce the level of taxation. But they are unlikely to bring it back to the levels seen before 2005.

More frequent revaluations, more delegation to local councils, and the reform of existing reliefs have all been advocated as ways of improving the existing system. But these would not address our increased dependency on business rates, or the impact of online retail on the tax base. So a number of other options may be worth considering to reduce the burden in a targeted way:

- **Introducing new reliefs** for sectors most challenged by the digital revolution. If "bricks" retailers are seen as an important part of the high street economy, or as having social value, it could make sense to ensure that - at least - they are not disadvantaged by the tax system. Creating new cliff-edges between retailing and other industries would, however, itself introduce distortions in economic incentives.
- **Allowing offsets for other taxes.** These might include the introduction of rebates on business rates based on how much national insurance or corporation tax a business pays. This could help to rebalance the tax burden, but would add much complexity. It would be more straightforward simply to reduce business rates and increase these other taxes.
- **Gradually removing property value from the assessment of rateable value.** This would be a transition toward a land value tax, which would remove investment disincentives and should help to encourage growth outside of the south east. A number of other countries have land taxes, which are markedly better than business property taxes in terms of economic efficiency. However, valuing land also poses challenges, depending as it does on planning permission, and there could be strong opposition from those who do not gain.
- **Introducing an online sales tax.** This would ease the pressure on other taxes and address the grievance of "bricks" retailers. But designing such a tax in a way that is administratively simple, hard to evade and does not convince consumers it is not simply another addition to their cost of living would not be at all easy.

## Is all hope lost?

As the sheer range of suggestions for reform indicates, there is no silver bullet. Tax changes always create losers. But some principles remain clear. First, change should be gradual. Second, it should try to remove economic distortions. And third, it should seek to widen the tax base rather than allow it to shrink, since that is what tends to drive up rates. If the UK is to rebalance business taxation away from business rates, then these principles may point in the direction of a gradual removal of property value from business rates (as opposed to land value), and the introduction of some level of taxation on digital sales until this is achieved.


Paul Cullum

020 7031 7083

07967 640338

Paul.Cullum@frontier-economics.com

Alex Kirykowicz

020 7031 7151

07456 606495

Alex.Kirykowicz@frontier-economics.com