11. Business rates

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Summary

- Non-domestic rates – business rates – are levied on the estimated market rental value of most non-residential properties. They raised £26.1 billion in 2012–13, 4.5% of total revenue. Recurrent taxes levied on business property are higher in the UK than elsewhere in the OECD.
- Taxing business property inefficiently discourages the development and use of business property. If possible, it would be better to tax the value of the land excluding the value of any buildings on it, which would have no such effects.
- Business rates are currently based on 2008 rental values. Property valuations are normally updated every five years. As a result, bills do not rise and fall with the economic cycle like most other taxes do, and the proportion of total revenues coming from business rates has risen from 3.9% to 4.5% since before the recession.
- Average bills are limited to rise with the retail price index (RPI), a somewhat discredited measure of inflation. They therefore levy an ever-declining share of property values, which tend to rise more quickly.
- Since 2010, the government has made a number of changes to business rates. The revaluation of properties that was due to take effect in 2015 has been delayed until 2017 to avoid sharp changes in bills. This will probably delay, rather than remove, large changes in bills. Retail premises in northern England and offices in London, among others, look like being losers from this delay. It would be better to move in the opposite direction: frequent, regular revaluations would mean changes in bills were small, gradual and routine. Rateable values should also be indexed between revaluations to keep them more in line with market rents.
- Relief for low-value properties was made ‘temporarily’ more generous in 2010, and has been extended every year since. In 2014, some retail properties will also become eligible for temporary relief. These temporary reliefs lack a clear justification and add to the increasing complexity and instability of the system.
- Since April 2013, local authorities in England have been able to retain (for a limited period) between a quarter and a half of the rates revenue raised from new developments. The idea is to provide incentives to local authorities to allow business development, while preventing large disparities arising between authorities’ resources. The government could go further by allowing local authorities to retain a larger share of revenues or by giving them more power to increase business rates.

11.1 Introduction

Non-domestic rates, or business rates, are a tax levied on the estimated market rental value of non-residential properties, including shops, offices, warehouses and factories (but excluding agricultural land and buildings). Business rates raise a substantial amount of revenue – £26.1 billion in 2012–13. This is very similar to the £26.3 billion raised from the much more salient council tax and around two-thirds of the £40.4 billion raised from corporation tax. Tax raised from non-domestic properties in the UK is substantially higher than that in other OECD countries. Despite this, there has tended to be little public focus on this tax.

This has changed recently. Since the recession of 2008, businesses have raised concerns over the burden of business rates. This is largely because the tax charge does not vary with profitability or with the economic cycle and because current rateable values are based on market rents that were assessed in 2008. In January, the Prime Minister told the Federation of Small Businesses that business rates were "businesses' – particularly small businesses' – number one complaint". He pointed out that the government has responded with a number of policy changes, notably in the 2013 Autumn Statement, but also added that "I think we do need to look at longer-term reform".[1] Assessing the changes introduced recently and other possible options for reform is the topic of this chapter.

Business rates combine one of the worst taxes – a tax on the value of business property – with one of the best – a tax on land values.[2] There is a strong case against levying a tax on buildings used for business purposes. A basic tenet of the economics of taxation is that intermediate inputs to production – that is, inputs that are themselves the result of an earlier production process, such as buildings – should not be taxed.[3] The principal effect of business rates is that economic activity in the UK is artificially skewed away from property development and property-intensive production activities. Land, in contrast, is not the result of a production process: its supply is essentially fixed and taxing it (excluding the value of any buildings on it) would simply make it less valuable to its owners without discouraging any desirable activity.

Despite this, a pure land value tax (LVT) is often thought too politically difficult to introduce, partly because it would create significant losers (some current landowners) as well as winners. There would also be practical obstacles to its implementation.

Absent a move to an LVT, there are a range of options for reforming the current system of business rates, including removing exemptions, increasing the frequency of revaluations, and uprating the multiplier with reference to something more in line with the growth in property values than in the retail price index (RPI). Policy could go further in allowing local government to keep a higher share of any additional revenues, or give local governments more control over the rates or structures of business rates.

This chapter proceeds as follows. Section 11.2 describes the business rates system. Section 11.3 discusses recent policy changes and some possible alternatives. Section 11.4 discusses additional policy options going forward. Section 11.5 concludes.

All taxes are ultimately paid by households. Business rates are formally levied on the occupiers of non-domestic properties, and their mechanical effect is to reduce the profits of those businesses and thus the values of the businesses to their owners. But part of the burden of the tax might be passed on to the firm's customers (via higher prices), employees (via lower wages) or others. As we discuss in Box 11.1, in reality it seems

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[1] See https://www.gov.uk/government/speeches/supporting-small-businesses-david-camerons-qa-at-the-federation-of-small-businesses.

[2] This is a modified quote from William Vickrey; see W. Vickrey, 'Simplification, progression, and a level playing field', in K. Wenzer (ed.), *Land-Value Taxation: The Equitable and Efficient Source of Public Finance*, M. E. Sharpe, Armonk, NY, 1999.

[3] P. Diamond and J. Mirrlees, 'Optimal taxation and public production I: production efficiency', *American Economic Review*, 1971, 61, 8–27.

Box 11.1. The incidence of business rates

In the long run, the effective incidence of business rates – who is ultimately made worse off by them – depends on how sensitive the demand for and supply of business property are to changes in its price. Because demand is much more responsive to price than supply, in the long run we would expect the tax to be mostly passed on to the owners of properties via lower rents. Moreover, the effect of business rates will be felt by initial property owners, as the prices that properties command would fall as soon as the introduction of the tax is announced; people who subsequently purchase a property will pay a price that is already lower (by most of the net present value of the tax) and so, with the tax liability (or the correspondingly lower rent from their tenants) offset by that lower purchase price, they may be little worse off.

In the short run, there are likely to be rigidities in property rents (because, for example, there are contracts in place). As a result, a change in business rates will not be immediately reflected in rents and will therefore be incident on occupiers. In the context of the temporary reliefs discussed in Section 11.3, this implies that the benefits of the reliefs are likely to accrue largely to occupiers. However, if the policy were expected to be permanent, we would expect to see rents adjusting to account for any tax changes.

Empirical evidence supports this theoretical analysis. In a study of how rents changed after reforms to business rates, Bond et al. (1996) concluded that 'much of the burden of business rates is shifted on to property owners in the long run. However, the short-run impact of changes to business rates affects tenants more than landlords'.[a]

[a] See S. Bond, K. Denny, J. Hall and W. McCluskey, 'Who pays business rates?', *Fiscal Studies*, 1996, 17(1), 19–35, http://www.ifs.org.uk/publications/1562.

likely that much of the burden of business rates is passed on from the occupiers of non-domestic properties to the properties' owners (if different), via reductions in the properties' market rental values.

11.2 How business rates work

Business rates are levied on non-residential properties, including shops, offices, warehouses and factories. There are various reliefs (including for small businesses) and exemptions (including for agricultural land and buildings and for short-term empty properties). The tax is levied as a proportion (the 'multiplier') of the officially estimated market rent ('rateable value') of properties.

While revenues are collected at the local level, from 1990 business rates have been set by central government (or, since devolution, by devolved administrations in Scotland and Wales) and revenues pooled at the national (or devolved) level.[4] Section 11.3 discusses the recently introduced business rates retention scheme under which local authorities (LAs) will retain some part of the growth in revenues.

[4] The Local Government Finance Act 1988 moved the power to set business rates policy, and notably the multipliers, from local authorities to the national level. This was moved to the devolved level in 1999. Northern Ireland has a slightly different system, akin to that in place in the rest of the UK before 1990, involving regional rates (33.02% in 2013–14) and locally-varying district rates (ranging from 18.28% to 31.62% in 2013–14): see http://www.dfpni.gov.uk/lps/index/property_rating/rates_poundages_2013.htm). We do not discuss Northern Ireland further in this chapter.

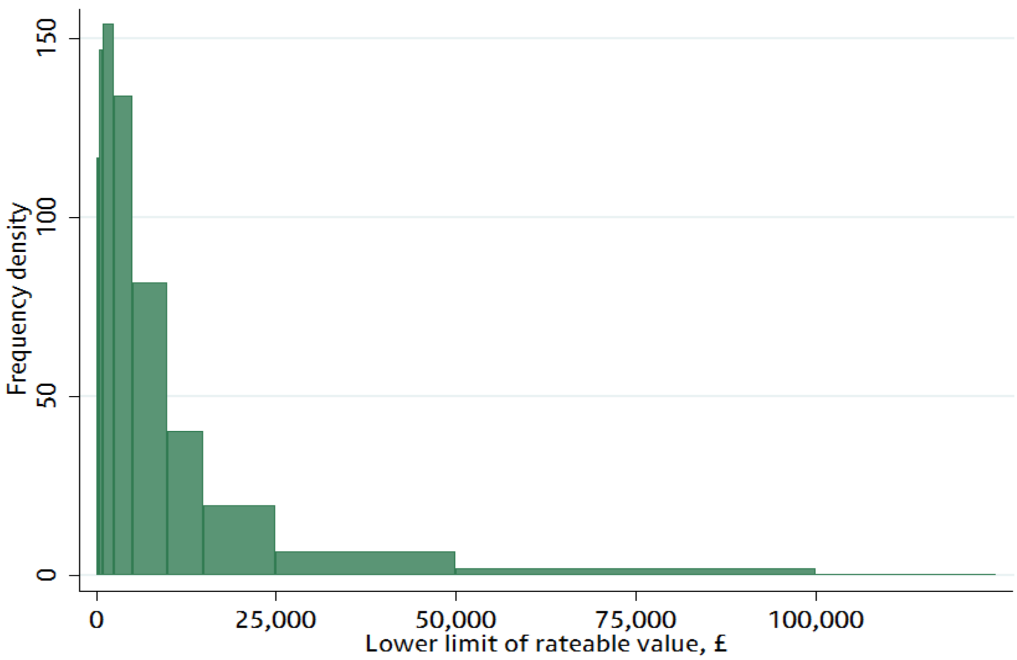
Rateable values

The Valuation Office Agency (VOA) estimates, for each (non-exempt) non-domestic property in England and Wales, an annual market rental value on a particular date, based on the property's location, physical characteristics and other relevant economic conditions. The rateable value broadly represents the annual rent the property could have been let for on the open market on a particular date, on full repairing and insuring terms. Normally, rateable values are reassessed every five years. Following a revaluation, there are transitional arrangements that work to phase in gradually the effect of any significant increases in liabilities that arise for individual properties.

The latest revaluation came into effect in April 2010, based on property values in April 2008. In England and Wales there are currently 1.9 million non-domestic properties with an aggregate rateable value of £61.7 billion, implying that the mean rateable value is £32,923. Figure 11.1 shows the distribution of rateable values for properties in England and Wales. The distribution is highly skewed: only 20% of properties have a rateable value above £25,000 yet they account for 82% of aggregate rateable value and will account for a bigger share of revenue than that because of small business rate relief (discussed in Section 11.3). The top 0.7% of properties have rateable values over £500,000 and account for 35% of aggregate rateable value. The median property has a rateable value in the £5,000 to £10,000 range and will be eligible for some small business rate relief. Table 11.1 shows how the average rateable value varies across property type. On average, offices have the highest rateable values (£38,614). This is driven by a higher density of high-value offices.

There is variation across England and Wales in both the number of properties and total rateable values; these are both highest in London and the South East, as shown in Table

Figure 11.1. Distribution of rateable values



Note: The final bin includes properties with a rateable value greater than or equal to £100,000 and less than £1 million. We have excluded properties with a rateable value of £1 million or greater, of which there are 5,538 with an average rateable value of £2,837,258. Figures refer to England and Wales.
Source: HMRC, table 17.2, http://www.hmrc.gov.uk/statistics/non-domestic.htm.

Table 11.1. Number of properties and rateable values in England and Wales as at 1 April 2013, by property type

Property type	Number of properties	Average rateable value (£)	Total rateable value (£ million)
Offices	355,064	38,614	13,710
Warehouses	218,313	37,802	8,253
Other properties	566,641	36,477	20,670
Shops	496,157	27,281	13,536
Factories	236,896	23,210	5,498
All properties	**1,873,071**	**32,923**	**61,667**

Source: HMRC, table 17.2, http://www.hmrc.gov.uk/statistics/non-domestic.htm.

Table 11.2. Number of properties and rateable values in England and Wales as at 1 April 2013, by region

Property type	Number of properties	Average rateable value (£)	Total rateable value (£ million)
London	306,231	54,028	16,545
South East	285,174	31,738	9,051
North East	54,360	31,279	1,700
East of England	184,197	28,703	5,287
West Midlands	184,507	26,071	4,810
North West	237,118	25,654	6,083
Yorkshire and Humber	190,560	25,283	4,818
South West	176,536	24,731	4,366
East Midlands	147,582	24,716	3,648
Wales	106,661	22,656	2,416

Note: The number of properties and rateable values do not sum to the total for all properties shown in Table 11.1 because 'central rating list' properties, which are not allocated to regions, are excluded here.
Source: HMRC, table 17.3, http://www.hmrc.gov.uk/statistics/non-domestic.htm.

11.2. Average rateable values are substantially higher in London than elsewhere. Indeed, London alone accounts for over a quarter of aggregate rateable values in England and Wales despite having only 15% of its population.[5]

Appeals against valuation decisions can go on for years and are one of the main administrative costs of business rates. This was highlighted in the 2013 Autumn Statement, where the Chancellor felt the need to make a special promise that the backlog of appeals from the 2010 revaluation would be 'almost all' cleared by July 2015.

The multiplier

In 2013–14, the multiplier for high-value properties (i.e. those with a rateable value over £18,000) is 47.1% in England (outside Greater London), such that a property with the mean rateable value of £32,923 will owe £15,507 a year in business rates. The multiplier is higher for properties in the City of London (47.5%) and lower for those in Wales (46.4%). In Scotland, properties with a rateable value over £35,000 face a multiplier of 47.1%. In England and Scotland, there are lower rates for small businesses – those with a

[5] For population figures, see Office for National Statistics, *Mid-2012 Population Estimates: Pivot Table Analysis Tool for the United Kingdom*, http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-319259.

low rateable value. We return to this in Section 11.3. The small business multiplier is available in cases where a firm occupies multiple small properties.

Since 2010, English LAs have had the ability to levy a supplementary business rate at up to 2 pence per pound of rateable value on properties with a rateable value above £50,000 in order to pay for economic development projects. The only authority to do this is the Greater London Authority, which levies the maximum additional rate (bringing the multiplier to 49.1%) on properties with a rateable value over £55,000 as a contribution to funding the Crossrail project.[6,7] This power is now subject to a vote among businesses that would be liable to pay the supplement.

The multiplier is usually increased each April in line with the RPI, such that the bill for every property keeps pace with RPI inflation.[8] In revaluation years, the multiplier is adjusted so that average bills (before any transitional relief) increase at the point of revaluation in line with RPI inflation: bills increase by more (less) than the RPI for properties that have seen above-(below-) average rises in value since the last revaluation.[9] As Figure 11.2 later shows, overall revenues have risen more quickly than RPI inflation only because of a growing tax base: the aggregate rental value of properties added to the tax base (for example, new developments) has been higher than that of properties that have been removed from the tax base (for example, demolished). Since property rental values typically rise faster than RPI inflation, the implication of current policy is for business rates to levy an ever-declining fraction of property values.

Exemptions and reliefs

In addition to applying lower multipliers (in England and Scotland) to properties with rateable values below a certain threshold, England, Scotland and Wales all operate small business rates relief schemes for properties beneath a somewhat lower threshold. We discuss the relief further in Section 11.3. In 2012–13, the cost of small business rates relief in England was £550 million.[10]

The business rates system also offers complete exemption from business rates to various types of properties, notably including agricultural land and buildings, and a range of other reliefs for empty properties, charities and small rural shops.[11]

In England and Wales, unoccupied properties are exempt from business rates for an initial three-month period after they become vacant.[12] In some cases, the empty property

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[6] See http://www.london.gov.uk/priorities/business-economy/vision-and-strategy/focus-areas/crossrail-business-rate-supplement.

[7] Separately, the large business multiplier also applies above a different threshold in Greater London – £25,500 rather than £18,000.

[8] Specifically, RPI inflation for the year to the previous September.

[9] Figure 11.2 later shows that revenues are usually sluggish in revaluation years and jump the year afterwards. This is presumably the effect of transitional relief, which means that businesses that see a big increase in their rateable value do not pay the full increase in the revaluation year but do pay more of it the year afterwards.

[10] Source: Table 1 of Department for Communities and Local Government, Statistical Release December 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264820/Updated_NNDR3_Statistical_Release_2012-13.pdf.

[11] The following property types are also exempted: places of religious worship, open public places (such as parks), property used for the disabled, property of Trinity House (lighthouses, buoys and beacons), sewers, property of the drainage authority, and property in enterprise zones. See Schedule 5 of the Local Government Finance Act 1988 (http://www.legislation.gov.uk/ukpga/1988/41/schedule/5).

[12] Empty property reliefs available in Scotland are broadly similar to those for England described in this paragraph, with some small differences.

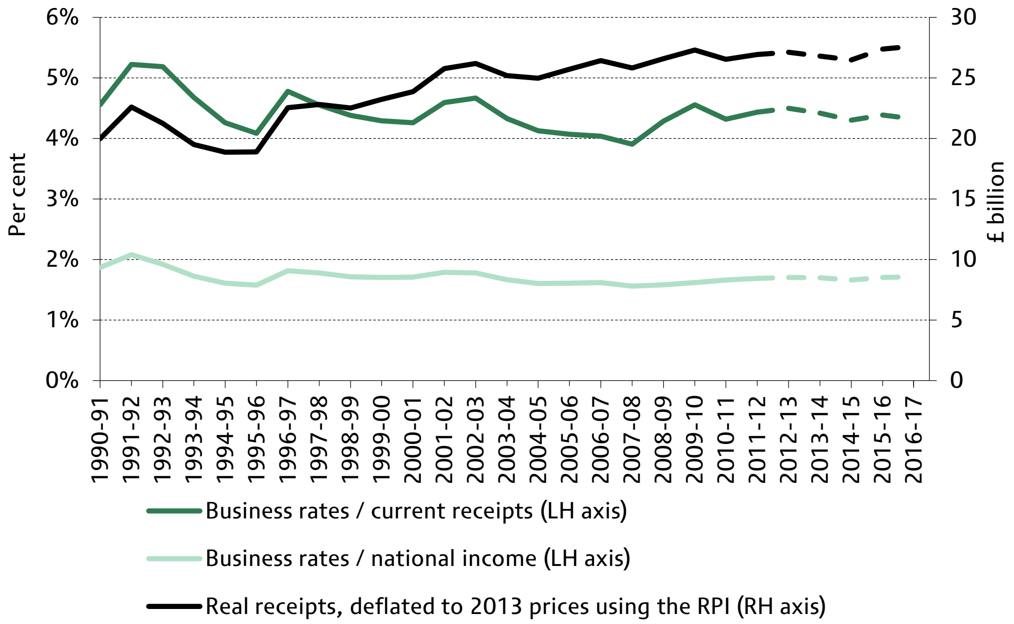
exemption is extended for longer periods. For example, industrial premises, such as warehouses, are exempt for a further three months, and listed buildings and those with a rateable value under £2,600 are exempt until reoccupied.[13] The 2012 Autumn Statement announced that properties built between October 2013 and September 2016 would be exempt from business rates for up to 18 months if empty. As at 31 March 2013, 13% of all non-domestic properties in England were empty, and the cost of empty properties relief was £957 million in 2012–13.[14] Exempting empty properties provides a tax incentive to keep properties vacant.

Land without any structures on it is not subject to business rates. As a result, there is a tax incentive faced by owners of long-term empty properties to demolish them.

Revenues

Business rates receipts for the UK in 2012–13 were £26.1 billion.[15] They represented around 4.5% of total current receipts and around 1.7% of national income: see Figure 11.2.

Figure 11.2. UK business rates receipts



Note: The figures underlying this graph are on a cash basis. They differ slightly from those in the text, which are on an accruals basis.
Source: Business rates receipts: IFS fiscal facts data, http://www.ifs.org.uk/fiscalFacts/fiscalAggregates. Figures after 2012–13 are forecasts. RPI inflation: ONS, extrapolated after 2013 using OBR RPI forecasts (December 2013 Economic and Fiscal Outlook: Economy supplementary tables, table 1.5; Q4 figures used).

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[13] Before 2008, vacant industrial property received 100% relief with no time restrictions and vacant commercial property received 50% relief after an initial three months of 100% relief. For financial year 2009–10, both empty industrial and commercial property with a rateable value of less than £15,000 temporarily received 100% relief.

[14] Source: Tables 3 and 2b respectively in Department for Communities and Local Government, Statistical Release December 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264820/Updated_NNDR3_Statistical_Release_2012-13.pdf.

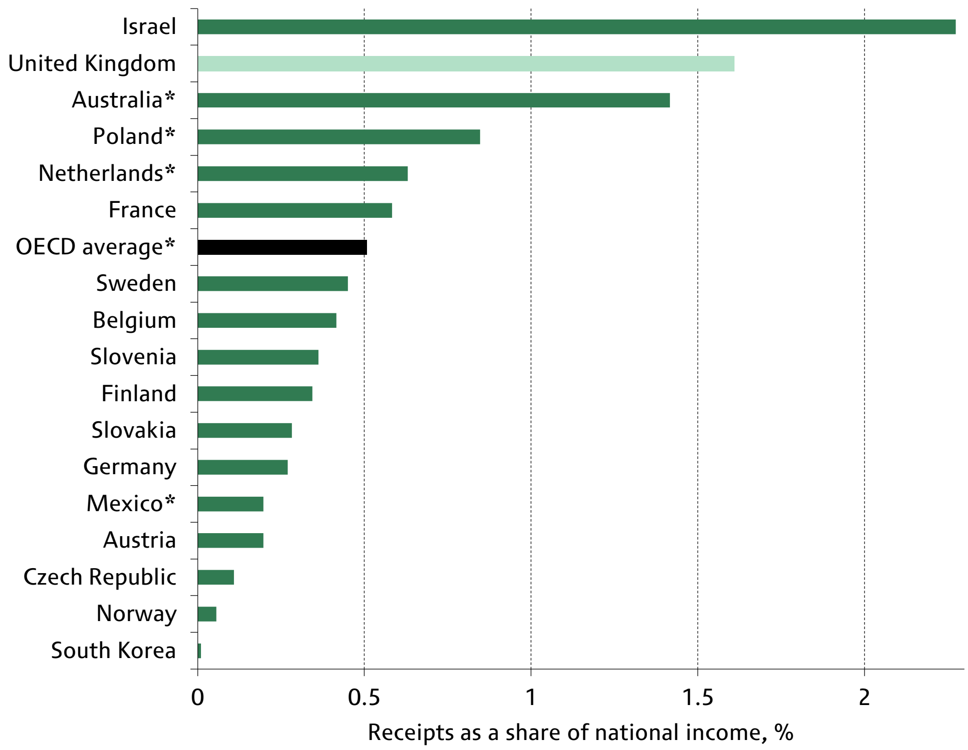
[15] See table 4.5 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, December 2013, http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf.

By way of comparison, receipts from corporation tax were £40.4 billion in 2012–13 and those from council tax were £26.3 billion. Receipts from business rates are slightly lower now as a proportion of total tax receipts than at the start of the 1990s, when they accounted for around 5% of receipts.

Since bills increase in line with RPI inflation regardless of economic circumstances, business rates are not a very cyclical source of revenue. For example, in 2007–08 they accounted for 3.9% of total revenue. In the subsequent downturn, national income and most tax bases shrank considerably while business rates were far less affected, so by 2009–10 business rates accounted for 4.6% of revenue. This helps to account for the growing concern expressed by businesses about this tax: while other liabilities such as corporation tax and National Insurance contributions shrank broadly in line with businesses' profits and payroll, firms that continued to occupy the same premises still had to pay (in real terms) as much as before in business rates. Business rates raised around half the revenue of corporation tax in 2007–08 but two-thirds by 2012–13.

Property taxation is fairly high in the UK relative to other OECD countries (see Figure 11.3). Receipts from taxes on non-residential immovable property consistently average just 0.5% of GDP across OECD countries, a third of that in the UK.

Figure 11.3. Receipts from recurrent taxes on non-domestic immovable property as a share of national income, 2011



*Data for 2010.
Source: OECD Revenue Statistics, series 4120: recurrent taxes on immovable property levied on non-households ('others'), http://stats.oecd.org/. Figure for the OECD is an unweighted average. Included countries are those that levy property taxes and for which data are available.

11.3 Assessing recent policy changes

In this section, we describe the main policy changes in England (and, where applicable, Wales and Scotland) since 2010:

- Revaluation of rateable values due to take place in 2015 has been delayed until 2017.
- Multipliers in England and Wales will be increased by 2% in 2014, rather than the 3.2% implied by the usual uprating.
- The (supposedly) temporary doubling of small businesses rate relief, initially introduced by Labour for the period from October 2010 to September 2011, has been extended by the new government on four occasions. It is now set to run until April 2015 and will now remain available for up to one year if a taxpayer acquires an additional property that would currently trigger the loss of the relief.
- For the period 2014–16, retail properties with a rateable value of up to £50,000 will be eligible for a discount of up to £1,000. There will also be a 50% relief available for 18 months for businesses that move into long-term empty retail properties between 1 April 2014 and 31 March 2016.
- From 2013–14, LAs will retain between a quarter and a half of rates revenue raised from new developments, for the period up to 2020.

Delayed revaluation

Between 1990 and 2010, revaluation of business property took place on a five-yearly cycle. The latest revaluation took effect in April 2010, based on April 2008 rental values. In 2012, the government announced that the rates revaluation scheduled for 2015 will be delayed until 2017.[16] The 2017 revaluation will be based on values as in April 2015. This is the first time since the current system was introduced in 1990 that the regular revaluation has been delayed. The stated rationale for the delay was to avoid sharp changes in bills.

If we are to have a tax on property values, it is preferable to base it on current values, or at least on the most up-to-date values possible. Revaluing rents at five-yearly intervals always implies that there may be larger changes to rental values than if revaluations happened more frequently. Delaying revaluation avoids sharp changes in bills in the short term only at the expense of even sharper changes two years later. Delay will only reduce the overall size of adjustments if changes in relative property values between April 2013 and April 2015 are such as to move back towards relative values in April 2008. We see no reason to believe that should be the case. On the contrary, we would ordinarily expect relative values to move ever further from the April 2008 position, so that the adjustment required to bills becomes bigger and bigger.

Thus, the longer revaluations are delayed, the harder they become. That has been the experience with council tax in England and Scotland, where successive delays mean that the tax is now based on 23-year-old property values yet no major political party proposes

[16] See https://www.gov.uk/government/speeches/business-rates--3 for the announcement. The delay was included in the Growth and Infrastructure Act 2013, section 29 with respect to England, http://www.legislation.gov.uk/ukpga/2013/27/contents/enacted. The Welsh and Scottish governments subsequently also chose to delay revaluation; see http://wales.gov.uk/newsroom/businessandeconomy/2013/130305br/?lang=en and http://www.scotland.gov.uk/News/Releases/2012/11/local-government-settlement-27112012 respectively.

a revaluation. It was also a major factor behind the demise of domestic rates in the 1980s and of Schedule A income tax (on imputed rental income from owner-occupied housing) in the 1960s, both of which became so out-of-date as to be unsustainable, yet both of which were deemed too politically difficult to revalue.

Delaying revaluation also adds uncertainty to a system in which, to date, everyone has known when to expect revaluations.

The way to avoid sharp changes in bills is to do revaluations *more* frequently. If revaluations happened every year, say, then adjustments in bills to reflect changes in relative property values would be small, gradual and routine. More frequent revaluations would also mean that the distribution of the tax across properties was more responsive to the economic cycle.

The decision over how frequently to revalue is effectively a trade-off between the benefit of having a tax base that is more aligned with actual value and the administrative cost of revaluing.

Who wins / loses from delaying revaluation?

The effect of revaluation is largely to redistribute the burden of business rates across properties: properties with a rental value that has increased faster (more slowly) than average will see an increase (decrease) in their bill relative to the RPI. This results from the revaluation of the multiplier (see Section 11.2).

The VOA has estimated the approximate impact of a revaluation based on predicted rental values as at 31 January 2012 (it does not provide projections of the April 2013 rents that would have been used for a 2015 revaluation). The main results are summarised in Table 11.3. A negative number indicates that tax payments would fall on revaluation, such that properties in that category will lose out from delaying revaluation. The largest losers from the delayed revaluation are offices in London, which would see a 14% fall in their average bill if revaluation based on 2012 values were to take place. Offices in the West Midlands and both offices and retail premises in northern England also lose. These changes are partly the result of offices having seen large increases in rateable values in the 2010 revaluation (based on 2008 values). The largest winners from delaying revaluation are offices in the East Midlands and retail premises in the East Midlands and London.

Below-inflation uprating of multipliers

Autumn Statement 2013 announced that multipliers in 2014–15 will be uprated by 2%, rather than the 3.2% that the usual uprating in line with RPI would have implied.[17] This reduces all business rate bills by about 1.2%. For a business with the mean rateable value of £32,923, the saving is £198.[18] The cut is estimated to cost the exchequer around £270 million per year.

In the short run, much of the cost of this move is likely to represent a tax break for the businesses occupying properties. To the extent that the lower rate is capitalised into rents in the longer term, the policy will be a giveaway to property owners. The move does marginally reduce the disincentive to develop property, but its small size and the relative

[17] See Paragraph 1.159 of HM Treasury, *Autumn Statement 2013*, https://www.gov.uk/government/publications/autumn-statement-2013-documents.

[18] Authors' calculations assuming the multiplier is increased from 0.471 to 0.480 rather than to 0.486.

Table 11.3. Estimated impact of revised rental value (as at 31 January 2012) on tax paid, by statistical region and property sector

	Retail	Office	Industrial	Other
All England	1%	–8%	0%	5%
North East	–3%	–1%	2%	–
North West	–3%	–4%	0%	–
Yorkshire & Humber	–1%	–2%	0%	–
East Midlands	6%	11%	3%	–
West Midlands	1%	–6%	–2%	–
East	–1%	–3%	–2%	–
London	7%	–14%	1%	–
South East	0%	4%	0%	–
South West	–2%	–1%	3%	–

Note: Cells show the estimated change in tax payments that would have occurred if rateable values and multipliers had been updated based on 2012 values. Negative (positive) numbers indicate that tax payments would fall (rise). The breakdown of 'other' across regions has not been released.
Source: Reproduction of part of table 2 from 'Valuation Office Agency's high level estimates of non-domestic rental and rating assessment movements for England', http://www.voa.gov.uk/corporate/_downloads/pdf/VOARevalPublication.pdf.

unresponsiveness of property development mean that it is likely to have little effect on behaviour.

'Temporary' extensions of small business rate relief

Table 11.4 describes the system of small business rates relief in place in 2013–14, including the elements of the English and Welsh systems that have been made temporarily more generous since 2010. Broadly, properties with a rateable value below a certain threshold are given relief on their business rates bill. The level of relief is largest for the lowest-rated properties, and is tapered as rental values increase. Although 'small business relief' is the terminology used, the relief is in fact provided for businesses occupying properties with a low rateable value. Firm size is not normally measured by the rental value of properties occupied.

Somewhat more than 2.7% of properties in England and Wales have a rateable value below the £6,000 threshold for eligibility for the maximum level of small business rate relief, while somewhere between 7.5% and 11.4% of properties are below the £12,000 threshold for eligibility for at least some relief.[19]

Prior to 1 October 2010, businesses in England with a rateable value below £6,000 were provided with relief at a rate of 50% (tapered to 0% at £12,000). In the March 2010 Budget, small business rate relief was temporarily doubled, such that relief was provided at 100% for rateable values below £6,000 (tapered to 0% at £12,000). The initial relief was due to be in place from October 2010 until the end of September 2011. The relief was extended for an additional year (to the end of September 2012) in Budget 2011 and for

[19] We do not know the precise distribution of rateable values. As of 1 April 2013, 2.7% of properties have a rateable value of less than £5,000, and more than that will therefore be eligible for full relief since the relevant threshold is £6,000. 7.5% of properties have a rateable value of less than £10,000 and 11.4% have a rateable value of less than £15,000, so the number eligible for at least some relief (for which the threshold is £12,000) will be somewhere between these two.

an additional six months (to the end of March 2013) in Autumn Statement 2011. Autumn Statement 2012 extended the relief to the end of March 2014 and, most recently, Autumn Statement 2013 extended it to the end of March 2015.[20] At this point, it would actually be a surprise if neither the Budget nor Autumn Statement of 2014 announced its extension until the other side of the expected date of the next general election.

Announcing temporary reliefs and then repeatedly extending them on an ad hoc basis is no way to make policy. It creates uncertainty as to how long the reliefs will last and eventually it becomes difficult to rescind what was originally a short-term policy. The structure of the tax system is permanently changed, probably inadvertently.

Table 11.4. Business rates for small properties

<table>
<tr><th rowspan="2"></th><th colspan="2">Small business multipliers, 2013–14</th><th colspan="2">Small business reliefs</th></tr>
<tr><th>Maximum eligibility threshold for small business multiplier</th><th>Small business multiplier</th><th>Maximum eligibility threshold for some relief</th><th>Level of relief (% of small business multiplier)</th></tr>
<tr><td>City of London</td><td>£25,500</td><td>46.6</td><td>£12,000</td><td rowspan="3">2010–11 to 2014–15
100% relief for rateable values <£6,000. Relief tapered on sliding scale to 0% at £12,000.
Otherwise
50% relief for rateable values <£6,000. Relief tapered on sliding scale to 0% at £12,000.</td></tr>
<tr><td>Rest of Greater London</td><td>£25,500</td><td>46.2</td><td>£12,000</td></tr>
<tr><td>Rest of England</td><td>£18,000</td><td>46.2</td><td>£12,000</td></tr>
<tr><td>Wales</td><td>—[a]</td><td>46.4</td><td>2010–11 to 2014–15
£12,000
Otherwise
£7,800</td><td>2010–11 to 2014–15
100% relief for rateable values <£6,000. Relief tapered on sliding scale to 0% at £12,000.
Otherwise
50% relief for rateable values up to £2,400; 25% between £2,401 and £7,800.</td></tr>
<tr><td>Scotland</td><td>£35,000</td><td>46.2</td><td>£18,000</td><td>100% relief for rateable values up to £10,000; 50% between £10,001 and £12,000; 25% between £12,001 and £18,000.[b]</td></tr>
</table>

[a] The multiplier does not differ for low-value properties in Wales.
[b] If the combined rateable value of all owned properties does not exceed £25,000, a taxpayer is eligible for 25% relief on each individual property with a rateable value not exceeding £18,000.
Source: For England and Wales: http://www.2010.voa.gov.uk/rli/static/HelpPages/English/faqs/faq146-what_are_the_current_multipliers.html. For the City of London: http://wwwstage.cityoflondon.gov.uk/business/business-rates/Pages/how-your-bill-is-calculated.aspx. For Scotland: http://www.scotland.gov.uk/Topics/Government/local-government/17999/11199/brief-guide.

[20] Autumn Statement 2013 also announced that, from April 2014, small business rates relief rules will be relaxed such that the relief remains available for up to one year if a taxpayer acquires an additional property that would currently trigger the loss of the relief.

If the extra relief is intended to be permanent, then the government should say so and end the uncertainty. If it is really intended to be only temporary, then the government should set out why it is temporary and under what conditions it will be continued or ended, and then stick to that policy.

This policy provides some help to businesses with low-value properties. But if it is believed to be temporary then the giveaway will do little to change behaviour.

Relief for the retail sector

Autumn Statement 2013 announced that, in 2014–15 and 2015–16, retail and food and drink premises with a rateable value below £50,000 will be eligible to receive a discount of up to £1,000 on their business rates bill.[21] The government has not yet announced the definition of retail properties or how this discount will be applied.[22] However, it has estimated that 300,000 properties will be eligible, and that the cost of the policy will be £350 million in 2014–15 and £425 million in 2015–16, implying that the average giveaway to affected properties will be around £1,170 and £1,420 respectively in those two years.[23] In the category 'shops' used in Table 11.1, which will presumably overlap heavily with 'retail', 92% (455,000) have a rateable value of less than £50,000, the threshold for eligibility. For this group, the average rateable value is £10,350.

Treating retail premises differently from other premises has obvious disadvantages. Drawing such a distinction certainly adds to the complexity of the business rates system. As noted above, the government has not yet specified how it will define 'retail' firms and, in reality, there is no clear dividing line between retail and non-retail firms. Trying to define and police a boundary that affects tax liabilities will doubtless be difficult and lead to disputes and appeals from firms judged not to be retailers as well as accusations of unfairness. As noted in Section 11.2, appeals are already one of the main administrative costs of business rates. If the classification of properties into 'retail' and 'non-retail' now also affects tax bills, more firms will have reason to dispute their classification. Treating retail properties differently might also lead to firms' changing their behaviour to fall on the right side of the boundary, and to more retailers entering the market and fewer leaving while the opposite happens among non-retailers. Other things equal, such distortions to behaviour would be undesirable.

One argument for applying lower business rates to retail premises might be that bricks-and-mortar retailers face more competition from online rivals (which do not require as much valuable business property) than other firms.[24] If that is true, then, other things being equal, demand for property will be more responsive to business rates in the retail sector than in other sectors. There is a case for levying lower business rates on sectors

[21] In addition, between 1 April 2014 and 31 March 2016, businesses that move into retail premises that have been empty for at least a year will be eligible for 50% 'reoccupation' relief for 18 months, up to EU state aid limits. See paragraph 1.162 of HM Treasury, *Autumn Statement 2013*, op. cit.

[22] An open letter from the Secretary of State for Communities and Local Government suggests that retail properties will include pubs and cafes, but exclude banks and betting offices: see https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263800/SofS_AS_Letter3.pdf.

[23] See page 11 of HM Government, 'Autumn Statement 2013: policy costings', December 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263434/autumn_statement_2013_policy_costings.pdf.

[24] In support of the policy the government cited that 'high streets are experiencing challenges as they adapt to changing customer preferences'. See paragraph 1.162 of HM Treasury, *Autumn Statement 2013*, op. cit.

whose use of property is more responsive to tax, since the associated economic inefficiency is higher in this case. We do not know whether the demand for property is more responsive overall in the retail sector than in other sectors: retail is not the only sector facing online competition and there are other factors that might also affect the responsiveness of different sectors.

A second argument for favouring retail arises if the use of premises for retail purposes brings benefits to wider society that other types of business do not. For example, such benefits might arise if there are agglomeration benefits from having many shops open on a high street (because it attracts more customers but individual businesses will not account for this) which do not arise to the same extent for other types of business. Note that any wider social value must be on top of what is reflected in people's market behaviour, since retail firms' simply being more valuable to customers will be reflected in their profitability and prevalence in the market without the need for special tax breaks. It is not clear whether such concerns are important in practice and, if they are, whether a tax reduction linked specifically to property value is the appropriate tool to address them (rather than, say, a reduced rate of corporation tax or National Insurance contributions, or a non-tax policy).

Overall, any advantages must be weighed against the disadvantages of discriminating between retail and other businesses. In addition, if the arguments in favour of the policy are considered compelling, it is not clear why they should be compelling for only two years (the announced length of the policy). Neither the value of retail-focused high streets nor the threat to high streets from the internet looks like a temporary two-year issue. Recent experience with small business relief makes one suspect that this relief might also be extended when it is due to expire. As with small business relief, the government should set out clearly what the rationale is, why it should be temporary and, as far as possible, under what circumstances it should be extended or removed.

Tax breaks for retailers that are believed to be temporary are unlikely to make much difference to the viability of different sorts of business, or to lead to significant changes in behaviour. The main effect of the policy is therefore just a giveaway to retail firms (likely to be felt in higher profits for shareholders since rents, wages and prices are less likely to change in response to a temporary giveaway). Money used to provide windfall giveaways could always be used to increase economic efficiency by making permanent cuts (of the same present value) to distortionary taxes. Whether the government instead wants to redirect taxpayers' money to the owners of retail businesses is ultimately a political value judgement, but it has done little to explain why this group should be particularly deserving of largesse.

Moves towards localisation

Business rates retention

The Local Government Finance Act (2012) stipulates that, from April 2013, English LAs are able to keep between 25% and 50% of the growth in receipts from business rates on new properties until 2020. Broadly speaking, LAs with a large business rates base get to keep a smaller fraction of the revenue from new developments. In 2020 the system will be 'reset'. It is expected that at this point the increases in business rates revenue will be redistributed across LAs and a new, 10-year, cycle will start. Box 11.2 provides further details on how the policy works.

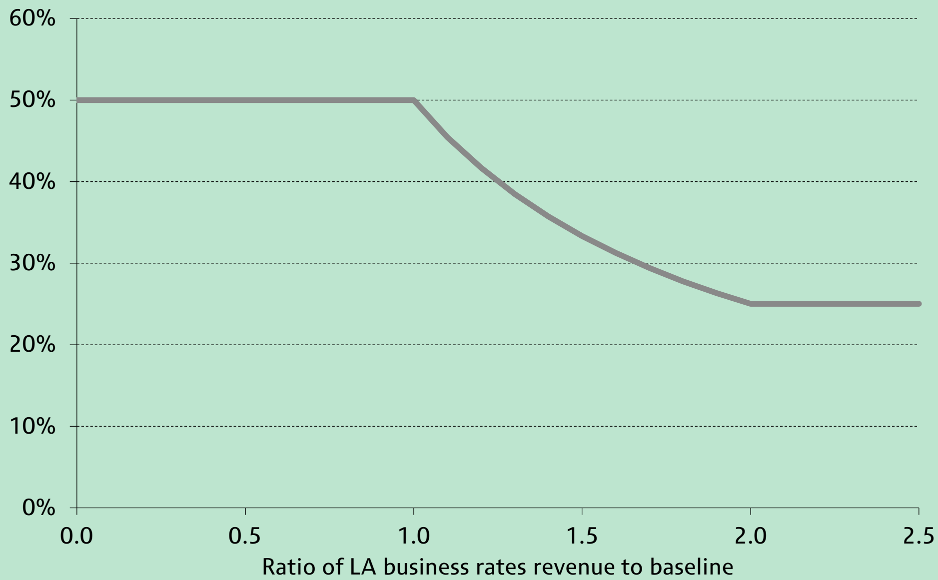
Box 11.2. Business rates retention scheme[a]

From 2013–14, LAs are able to keep between 25% and 50% of any growth in business rates revenues that comes from new developments.

Broadly speaking, LAs with a large business rates base get to keep a smaller fraction of the revenue from new developments. Specifically, the share they get to keep depends on how much business rates revenue was generated in the LA (before any new development) relative to a baseline. The baseline is what the LA's business rates revenue would have been if it were the same fraction of its block grant from central government as national business rates revenue was as a fraction of aggregate block grants.[b] If an LA's business rates revenue was lower than this baseline, then the LA keeps 50% of the revenue from new developments. If revenue was higher than the baseline, then the percentage is gradually reduced, down to a minimum of 25% for LAs whose business rates revenue was more than double the baseline.

This schedule is shown in Figure 11.4. For LAs between the 25% floor and the 50% ceiling, the effect of the gradual reduction is that LAs achieving the same percentage increase in their business rates base get to keep the same absolute amount of revenue as a result.

Figure 11.4. Share of revenue from new developments retained locally



Source: Authors' calculations.

If an LA experiences a small fall in rates revenue (because, for example, there is a fall in the number of rateable properties), then it correspondingly takes a share of between 25% and 50% of that revenue loss. However, for larger falls in rates revenue, a 'safety net' prevents LAs from losing too much. If the fall in the business rates generated in an LA is more than 7.5% of its baseline, then central government makes up the difference.

This system will run until 2020. At that point, the system will be 'reset' and baseline funding levels adjusted to account for any changes in circumstances. Details of that reset have not been determined.

[a] For further details, see Department for Communities and Local Government: *Business Rates Retention: Policy Statement*, November 2012, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/14939/Business_rates_retention_policy_statement.pdf and Department for Communities and Local Government, *Business Rates Retention: A Step-by-Step Guide*, July 2012, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/5947/2182691.pdf.

[b] Block grant is the general-purpose funding provided to LAs by central government. Broadly speaking, it is calculated as an LA's spending needs (as assessed by central government) less what is covered by grants allocated for specific purposes (principally schools) and what would be covered by a nationally-uniform 'standard' (not necessarily average) rate of council tax. It is also referred to in this context as 'start-up funding'.

Providing incentives to local authorities

The aim of the business rates retention scheme is to provide local authorities with a stronger incentive to promote business development.

Business rates mean that firms that develop valuable business property do not keep all of the commercial rewards from doing so. This weakens firms' incentives to develop business property. This weakening of firms' incentives, however, is partly offset by a strengthening of the government's incentive to encourage development, because of the extra business rates revenue such development generates.

Before April 2013, all revenues from business rates in England (except those raised from the supplements in Greater London and the City of London) were paid into a central pool. This provided central government, but not LAs, with an incentive to encourage development.

Business rates retention means that part of that incentive now applies at the local government level. Local authorities are key decision-makers over, for example, granting planning permission, so it makes sense for them to take some account of the business rates revenue at stake. But there is a difference between central government and local government having that incentive. The incentive for central government is to encourage development that would not otherwise happen at all; LAs have that incentive too, but they also have an incentive to encourage development in that LA instead of others. There is a potential downside to that, in that competition between LAs to attract new development could potentially lead to policies that are *too* business-friendly relative to what would happen if LAs cooperated or central government took decisions in the national interest. But there is also an upside if LAs are reluctant to allow new developments that could be beneficial to the country as a whole but have a detrimental impact on local households: business rate retention could help to counteract that so-called 'NIMBY' tendency.

The Department for Communities and Local Government has estimated the impact of the business rates retention scheme on national income. The main channel of effect is through a reduction in planning restrictiveness leading to an increase in the supply of business premises and a reduction in costs for business. Its central estimate is that the scheme will boost national income by £10.1 billion over the period 2013–14 to 2019–20, i.e. an average of £1.4 billion per year. However, there is significant uncertainty around this, with the published estimates ranging from £240 million per year to £2.8 billion per year.[25]

[25] See Department for Communities and Local Government, *Business Rates Retention Scheme: The Economic Benefits of Local Business Rates Retention*, May 2012, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/11472/2146726.pdf.

Redistributing resources between local authorities

Britain's current system of local government finance is predicated on a view that LAs blessed with lots of high-value business properties should not have greater funds than otherwise-similar LAs that are not so lucky. Broadly speaking, grants from central (or devolved) government are set such that, if each LA spends the amount that central government judges it needs, they will all need to set the same council tax rate to pay for that spending regardless of how much business rates are generated in the area.[26]

One might reasonably argue that, where growth in local business rates revenue reflects LAs' efforts rather than mere good luck, it is fair as well as efficient for that extra revenue to be retained locally. In practice, however, it is impossible to distinguish reliably between the consequences of effort and luck. It might over time come to be seen as increasingly unfair if areas that had experienced high growth in their business rates base – perhaps decades earlier – could spend more on local services at a lower cost to the local taxpayer than other areas. This is typical of the trade-offs that governments face in balancing a desire for decentralisation and incentives with a desire for this form of 'fairness' between LAs.

One reasonable response is for LAs to keep (some of) the revenues from any growth in the local business rates base, but only for a certain period. That combines a short-term reward for encouraging development with an assurance that long-run disparities between LAs' funding positions will not arise. The way that the government has chosen to do this, however, is peculiar. Letting LAs keep a fraction of the revenue from new developments until funding allocations are 'reset' in 2020 (and every 10 years thereafter) means that they have a relatively strong incentive to encourage development at the start of a cycle but much weaker incentives as the reset point approaches.[27] Indeed, by 2019 LAs will have a clear incentive to delay new property developments for a year, so that they get to keep the resulting revenues for 10 years rather than just 1. In light of the perverse incentives created, it will be interesting to see whether the policy is revised as 2020 approaches. It would make far more sense for LAs to keep a fraction of the revenue from new developments for a given number of years (5 or 10, say) rather than until a given calendar date.

A second response to fairness considerations is to focus on getting the baseline right: that is, the level relative to which additional development is measured. The grant system is designed to ensure that LAs do not benefit simply from having a large business rates base, only from their efforts to expand it. But if (without any unusual effort) all LAs would normally see the same percentage increase in the number of business properties each year, then letting LAs keep the resulting revenues would mean bigger funding increases for those LAs with bigger business rates bases. The ideal would be to let LAs keep (a fraction of) revenues from additional development *relative to what would happen without any particular action on their part*. Assessing that baseline is, of course, much more difficult than looking at total new development, and it would probably not be sensible for

[26] Accordingly, although the business rates retention scheme is formally set up so that each LA gets to keep half of all its business rates revenue, a system of 'tariffs' and 'top-ups' has been designed specifically to ensure that councils' overall level of funding at the start of the new regime (i.e. before any new property development) is unrelated to the business rates revenue generated there.

[27] A similar problem arises in Scotland, where the business rates incentivisation scheme allows LAs to keep 50% of revenue from additional developments until the next revaluation.

central government to make an ad hoc assessment of the baseline for each individual LA each year.[28]

The government's policy reflects concern for fairness between LAs in another way. It is designed such that (subject to a 25% floor and a 50% ceiling on the fraction of additional revenues that can be kept) LAs achieving the same percentage increase in business rates get to keep the same absolute amount of revenue as a result. That may reflect the government's perception of fairness. But it is not the simplest, and probably not the most efficient, policy: LAs that get to keep a higher percentage of business rates growth have a stronger incentive to encourage development. If LAs achieving the same absolute increase in business rates kept the same absolute amount of additional revenue – in other words, all kept the same percentage of any increase in business rates – then all development would be incentivised equally. That rather simpler approach is how Scotland's business rates incentivisation scheme, which in many other respects is similar to business rates retention, works.

In summary, business rates retention increases the incentives of LAs to promote business development, but these incentives are dampened by the mechanisms put in place to ensure that large disparities in available resources do not arise between LAs. To some extent this trade-off is inevitable, though the peculiar incentives surrounding the 2020 reset date show that it could be managed better. The effectiveness of the scheme will depend in part on how responsive LAs are to the new incentives. If the government wanted to promote a more substantial change in the incentives faced by, and therefore in the behaviour of, LAs, it would probably require a larger shift in view over the appropriate degree of resource equalisation.

Discretion over business rate reductions

Under the 2011 Localism Act, LAs in England and Wales have, since April 2012, had almost complete discretion to offer business rates discounts of any size for any property or properties in the area, at their own expense.[29] In principle, this is a sweeping power and a major step towards localisation: the government's impact assessment for the policy noted that, in principle, LAs could decide to abolish business rates entirely.[30] However, reports suggest that in 2012–13 only 18 out of 326 LAs in England offered any such

[28] One possibility would be to let LAs keep any growth in business rates revenue relative to the national average growth rate (and correspondingly lose any shortfall, perhaps subject to some limit). A strong attraction of this approach is that it would allow both central and local government to be fully incentivised to encourage development (if that were considered desirable): individual LAs could keep 100% of the revenue generated by an additional development, yet that battle for revenues would be a zero-sum game between LAs (since additional developments raise the national average, causing other LAs to lose out) with central government keeping 100% of the nationwide increase in business rates. The downside is that it would increase uncertainty in LAs' budgets since they would not know their funding position until they knew not only how much new development there was in their area, but how much there was across the country. It might also still be considered unfair if growth in the business rates base (without any unusual effort) would be predictably higher in some regions than others, for example; if that were the case, then assessing changes relative to the long-run average growth rate in that area might be appropriate, or perhaps letting LAs keep any growth in business rates revenue relative to the regional (rather than national) average growth rate. Any options along these lines might prove politically difficult, however, as they would involve some LAs losing in cash terms (though the government could cap such losses if it wished).

[29] The only limitations are that the discounts should be 'reasonable … having regard to the interests of council tax payers' and that they do not breach any wider restrictions such as EU state aid rules. Previously, discretionary discounts could be offered only in very restricted circumstances.

[30] Paragraph 19 of https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/6023/1829804.pdf. It then goes on to emphasise that this scenario is highly unlikely.

discounts, with a tiny collective value of £2.5 million.[31] This suggests that there was negligible appetite among LAs to pay for reductions in business rates – although this first year of the policy was before the introduction of business rates retention, so there would now be more incentive than there was then for LAs to offer discounts to encourage property development in the area.

11.4 Additional policy options

In Autumn Statement 2013, the government announced plans to consider possible reforms to the *administration* of business rates.[32] Given the distortions created by business rates, reform of the overall policy (rather than simply how it is administered) would be preferable. In 2012 the Scottish Government did commit to conducting a 'thorough and comprehensive review of the whole business rates system'. However, the action plan that followed the initial consultation consisted of some small administrative changes and no plans for more substantial reforms.[33]

As highlighted in the introduction and discussed below, a land value tax is superior to business rates on the grounds of economic efficiency. As such, conditional on confirming the feasibility of measuring land values, we advocate replacing the current system of business rates with an LVT.

Short of a wholesale move to an LVT, there are a range of options for reform of the current system of business rates. In addition to those discussed in the previous section, possible policy moves include:

- changes to small business relief;
- scaling back or removing exemptions and reliefs;
- changing how the multiplier is uprated between revaluations;
- changing the relative roles of central and local government: the government could go further in allowing local government to keep more of any additional revenues, or give local government more say over rates or structures.

This section discusses these options. It also discusses the Labour Party's proposal to freeze business rates in 2015–16 and 2016–17 and pay for this by increasing the main rate of corporation tax.

Land value taxation

An LVT is an annual levy on the value of land owned (excluding the value of any buildings on it). Land is not a produced input: its supply is essentially fixed and cannot be affected by the introduction of a tax. With the same amount of land available, people would not be willing to pay any more for it than before, so (the present value of) an LVT would be reflected one-for-one in a lower price of land. The owner of the land on the day an LVT is announced would see a reduction in the value of their asset, but thereafter the tax has no

[31] See 'Business rate discount schemes are shunned', *Local Government Chronicle*, 18 April 2013, http://www.lgcplus.com/topics/business-rates/business-rate-discount-schemes-are-shunned/5057427.article.

[32] It said it will 'publish a discussion paper in spring 2014 setting out the advantages and disadvantages of different options for longer-term reforms to business rates administration which maintain the aggregate tax yield' (paragraph 2.108 of HM Treasury, *Autumn Statement 2013*, op. cit.).

[33] 'Supporting Business: Promoting Growth – Scottish Government response', 4 September 2013, http://www.scotland.gov.uk/Publications/2013/09/2234/0.

effect. Taxing land values therefore does not discourage the purchase, development or use of land. In addition, an LVT would capture some of the benefits that accrue to landowners from external developments (rather than their own efforts) that work to raise the price of land.[34]

In the UK, as in most countries, there is a system of planning regulations that dictate the use of land. As such, the supply of land *for business use* is not completely fixed. A tax on land value may therefore reduce, at the margin, the incentive to apply for permission to change the designation of land. However, since there are large gains available for the development of land, this is unlikely to be a major issue. In addition, the government could relax planning regulations in response to concerns that an LVT might discourage valuable development.

There would be winners and losers from a revenue-neutral shift from to an LVT. Owners of highly developed properties would gain, while owners of undeveloped land would lose. However, in so far as the value of property is largely determined by the value of the land on which it stands, the offsetting gains and losses to owners would be close. And if the reform were introduced on a revenue-neutral basis, there would at least be no windfall gains or losses on average.

The key practical challenge involved in implementing an LVT is the need to value individual land holdings separately from any buildings erected on them. In most areas and sectors, the number of transactions in land (separate from any buildings thereon) is low and, in the absence of a sizeable market, it is difficult to determine the market price. Any inaccuracies in land valuation would not affect the efficiency of an LVT, but they would create inequities between taxpayers and might lead to more appeals – already an administrative problem for business rates. However, there are methods available to value land, including imputing the value by observing sales of comparable properties in different locations. And there are other countries – including Australia and Denmark – with experience of operating LVTs. We cannot say conclusively that the administrative hurdles to replacing business rates with an LVT could be overcome at reasonable cost. But this is such a powerful idea, and one that has been so comprehensively ignored by governments, that the case for a thorough official effort to design a workable system seems to us to be overwhelming. In particular, significant adjustment costs would be merited if the inefficient and iniquitous system of business rates could be swept away entirely and replaced by an LVT.

Short of replacing business rates altogether, however, there is a range of ways in which they could be reformed.

Changing tax rates for properties with different rateable values

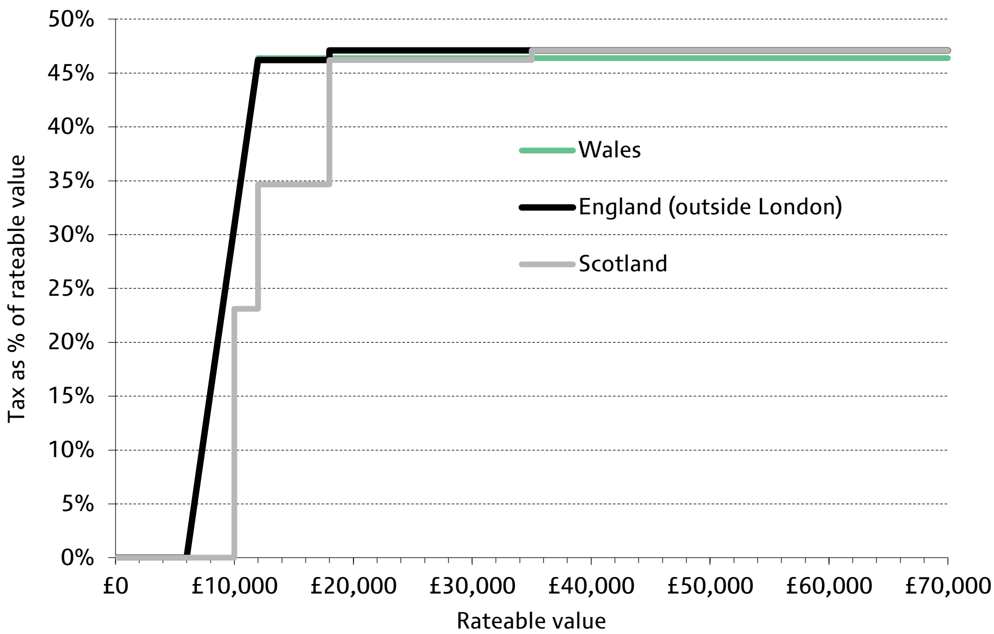
At the moment, lower rates of tax are charged on properties with lower rateable values. This is done through a combination of different multipliers for small and large properties and an explicit small business rates relief scheme. One option for reform would be to change the relationship between rateable value and tax rate.

The details of the current relationship vary across Britain. Figure 11.5 illustrates the overall schedules in Scotland, Wales and England (excluding, for simplicity, the City of

[34] For an extended discussion of the issues raised here, see 'The taxation of land and property', chapter 16 of J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *Tax by Design: The Mirrlees Review*, OUP for IFS, 2011, http://www.ifs.org.uk/mirrleesReview/design.

London and the rest of Greater London, which have slightly different schedules again) in 2013–14, including the temporary increase in small business rates relief in England and Wales. It shows that Scotland gives more generous relief for low-value premises, even allowing for the temporary additional reliefs in England and Wales. The figure also highlights that the structure of relief is different in Scotland, with a series of steps up in liability when certain thresholds are crossed. Such steps are undesirable: they mean that, for example, a property with a rateable value of £18,001 attracts a tax bill £2,080 higher than a property with a rateable value of £18,000.[35] That is clearly an absurd structure for any tax. It is particularly ironic in this case since Scotland, unlike England and Wales, is removing precisely such an anomaly elsewhere in the property tax system, with its proposed land and buildings transactions tax (which has no such jumps) due to replace stamp duty land tax (which does) from April 2015.[36] Whatever else is done, such jumps should be removed from business rate schedules.

Figure 11.5. Business rates schedules, 2013–14



Source: Authors' calculations.

But more fundamentally, the rationale for applying lower rates to lower-value properties at all is not clear. Certainly there is not a strong distributional argument. Redistributing from firms that occupy large buildings to firms that do not is not necessarily 'progressive' in the way that redistributing from rich people to poor people is. Businesses are not people; ultimately the burden of all taxes is felt by households, and the burden of 'business taxes' must be passed on to some combination of the firms' shareholders (via lower profits), customers (via higher prices), employees (via lower wages) and so on. As discussed in Box 11.1, theory and evidence suggest that the burden of business rates is mostly passed on to the owners of the premises (via reductions in property values) – although in so far as extra business rate reliefs are believed to be temporary, they are more likely to benefit the owners of the firms occupying the premises, as rents (and

[35] 34.65% of £18,000 is £6,237, while 46.2% of £18,001 is £8,316 – a difference of £2,079.

[36] Wales is also due to have 'jumps' in its business rate schedule once the temporary extra relief expires in April 2015.

wages and prices) are less likely to adjust for that short period. It is not obvious that businesses owning or occupying more valuable premises have shareholders (or, for that matter, employees or customers) who are individually better off than firms with smaller premises. The people whose pension funds invest in Tesco might not be richer than the owner-manager of a corner shop.

Lower business rates for properties with low rateable values is a distortion towards production patterns involving more low-value properties and fewer high-value properties than commercial considerations would dictate in a free market. Parallel to our earlier discussion of preferential treatment for retail properties, one could make an argument that, relative to what a free market might produce, there is an additional benefit to wider society from having lots of small business properties rather than fewer large properties. This could be to promote competition in the local market, or because people simply value the existence of (say) a variety of high-street shops even though they would rather shop in a big supermarket (note again that if people actually preferred to buy things from smaller businesses, the firms should be commercially viable even without preferential tax treatment). Whether such concerns are important in practice, and, if they are, whether a tax reduction linked specifically to low-value premises is the appropriate tool to address them, is not clear. The new employment allowance in employers' National Insurance contributions targets support at firms with low wage bills, while the small profits rate of corporation tax targets support at firms with low profits. Exactly what kind of 'small business' is it that we want to favour with this array of policies? Indeed, are tax breaks the most appropriate instrument to pursue such objectives at all, as opposed to, for example, competition policy or the planning system?

If the government believes that there is a strong rationale for preferential taxation of low-value properties, it should state clearly and precisely what that rationale is, and the exact design of the rate schedule should reflect that purpose. Otherwise, it would be simpler and more efficient to move to a single rate for all properties.

Scaling back exemptions and reliefs

Other than reduced rates for low-value properties, the principal reliefs from business rates are:

- agricultural land and buildings (cost unknown);
- charities (cost £1.3 billion in England 2012–13);
- partial relief for empty properties (cost £1.0 billion in England in 2012–13).[37]

It is hard to see any case for exempting agricultural property from business rates. It distorts land use towards agricultural rather than other purposes. The exemption seems to exist for purely political rather than economic reasons and should be ended. But the revenue cost of the exemption is unknown, and the relatively low value of agricultural land means that the tax at stake might not be large.

There may well be a rationale for the government to provide tax breaks for charities. As well as business rates relief, charities currently benefit from various reliefs from income tax, corporation tax, capital gains tax, inheritance tax, VAT and stamp duty land tax

[37] For costings, see table 2b of Department for Communities and Local Government, *Statistical Release December 2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264820/Updated_NNDR3_Statistical_Release_2012-13.pdf.

(though not National Insurance contributions). One might reasonably ask whether there are better and worse ways for government to support the charitable sector, and whether the use of all these instruments is appropriate, but we do not enter that discussion here.

At the moment, most empty business properties in England are exempt for three months and charged full business rates thereafter.[38] The three-month exemption reduces the incentive to bring properties back into use, while on the other hand charging business rates thereafter encourages the demolition of empty properties. The problem ultimately arises because land without buildings on it is untaxed. That inevitably creates a boundary where business rates start to be charged, leaving governments with an unpalatable choice between creating an incentive to demolish empty properties (if empty properties are taxed) or a disincentive to use properties (if empty properties are exempt). It would be best to tax land value irrespective of what, if anything, is built on it (see earlier discussion of land value taxation).

Changing how rateable values and multipliers evolve

We argued in Section 11.3 that regular revaluations should be conducted as frequently as administrative cost allows. In addition, if revaluations are conducted less than once a year, rateable values should be uprated in between valuations to keep them as close as possible to properties' true market rental values – for example, in line with a local rental price index for properties of a certain type.

Having a tax base that more closely reflected economic reality would help to make business rates more transparent – for example, countering the widespread misapprehension that revaluations are associated with a general increase in business rate bills not seen in other years.

Such a change would mean that multipliers no longer needed to be uprated each year in order to keep pace with inflation. If rateable values increased each year in line with true market rents, then a fixed multiplier would mean that business rate bills also increased in line with that tax base, like most other taxes do.

Current policy is that business rate bills should increase not in line with market rents, but in line with RPI inflation, which is typically lower. Having rateable values that increased in line with true market rents would mean adjusting – usually reducing – the multiplier each year if average bills are to continue to track the RPI. This would make more explicit that the implication of current policy is for business rates to levy an ever-declining fraction of property values.

Whether or not the determination of rateable values is changed in the way described, there remains the separate question of whether average bills should track the RPI at all. The RPI is a poor measure of household inflation; it has recently been declassified as a National Statistic because of concerns that the underlying formula overstates household inflation rates (Box 6.2 in Chapter 6 discusses this). If the intention is for business rates to keep pace with inflation, there are better measures of inflation that could be used.

More fundamentally, it is not clear why business rate bills should keep pace with any measure of consumer prices. For most taxes, the government sets a rate schedule which (hopefully) does not change each year, and then bills and revenues rise or fall each year

[38] Industrial premises are exempt for six months, while listed buildings and those with a rateable value below £2,600 are exempt as long as they are empty.

in line with the tax base. Business rates could be reformed along those lines. If rateable values were adjusted annually as described above, it would happen automatically with a fixed multiplier; alternatively, under the current approach of fixed rateable values in between revaluations, the multiplier would need to be uprated in line with growth in market rents. One attraction of this is that bills would then respond (at least partially) to conditions in the rental market. For example, the falls in rents following the 2008 financial crisis would have been reflected in lower bills under this type of system.

Alternatively, the government could choose to increase bills in line with a different measure, such as national income. The government can decide whether it wants business rates to remain the same magnitude (or grow, or shrink) relative to any of these comparators.

But, in any case, it is doubtful that keeping pace with RPI inflation is a sensible policy.

Further localisation

As discussed in Section 11.3, local authorities in England now retain a share of the growth in revenues from new developments, for a limited period, under the business rates retention scheme (and similarly under the business rates incentivisation scheme in Scotland). One option for greater localisation would be to increase the share that LAs can keep, or the period for which they can keep it. The pros and cons of this were discussed above.

The other main option for localisation would be to give LAs more control over the tax rate. As discussed in Section 11.3, LAs in England and Wales already have almost unlimited powers to reduce tax rates, by however much and for whichever properties they wish, although (at least in the first year of the policy) this power was little used. However, they have little power to increase tax rates. LAs can levy a supplementary business rate, but only of up to 2%, only on rateable values above £50,000, only to pay for specified economic development projects that would not otherwise take place, and only subject to a ballot of firms that would be liable to pay it. Perhaps because of these restrictions, the rate levied in Greater London to help pay for Crossrail is the only time so far that this power has been used.

Further localising rate-setting powers would increase LAs' fundraising autonomy. At present, local services are largely financed by central government. At present, council tax is the only significant tax that LAs can use to raise more money; it finances around one-sixth of total local spending (councils additionally raise around one-tenth of spending from service charges).[39] This leaves UK taxation unusually centralised, with less than 5% of tax revenues raised locally. Giving LAs the power to set business rates would be a significant change.

One concern with the localisation of business-rate-setting powers, however, is that LAs may seek to increase rates as a way of raising revenue that looks relatively painless in electoral terms. There is a danger of weak accountability: the true incidence of business rates is particularly opaque, and the individuals who ultimately bear the burden of the tax may not be aware of it or even live in the LAs concerned, leading to a lack of democratic checks on business rate increases. This concern was part of the reason for the centralisation of business rates in 1990. The ballot required to levy supplementary rates

[39] See chart 2.1b in *Local Government Financial Statistics England* 22, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/7476/2158981.pdf.

is a reasonable way to deal with this concern, and easing some of the other restrictions on this scheme might be a good way forward if further localisation is desired.

Labour Party policy

At its 2013 party conference, the Labour Party announced that, if it won the next general election, it would freeze the business rate multipliers in 2015–16 and 2016–17 for properties with a rateable value of less than £50,000. Labour estimated that this would cost £250 million in 2015–16 and £550 million per year from 2016–17 onwards.

The measure will be paid for by reversing the planned cut in the main rate of corporation tax from 21% to 20% that is due to take effect in April 2015. This has an estimated saving of £400 million in 2015–16, rising to £865 million in 2017–18.[40]

Almost 90% of properties have a rateable value of less than £50,000 and would therefore see reduced business rate bills. With the Office for Budget Responsibility's latest forecasts of RPI inflation for the relevant two years at 2.8% and 3.3% respectively, business rate bills for those properties would be 5.8% lower from 2016–17 onwards. Since the main rate of corporation tax applies only to profits above £1.5 million, firms occupying premises with rateable values below £50,000 would unambiguously see their overall tax payments fall if their profits were below £1.5 million – or if they were set up as unincorporated businesses (self-employed individuals or partnerships), which are not subject to corporation tax at all. Conversely, companies making sufficiently large profits would see the increase in their corporation tax bill outweigh any reduction in their business rate bill. Initially, these changes in business rates and corporation tax bills are likely to be reflected in firms' profits. In the longer term, however – once rents, prices and wages have time to adjust – increasing the main rate of corporation tax is likely to result (at least) partly in lower wages for employees, whereas a reduction in business rates is likely to result primarily in higher rental income for property owners.

The merits of cutting business rates and raising corporation tax rates are debatable. Business rates are the more clearly an ill-designed tax: taxing an intermediate input to production (i.e. business property) violates one of the most fundamental principles of the economics of taxation, in a way that taxing corporate profits does not. Yet business rates might nevertheless be the less damaging tax, since properties' aggregate rateable value is less responsive to taxation than corporate profits are (not least because corporate profits can move overseas whereas properties generally cannot). This is not to say that business rates should not be reduced. But if the Labour Party (or any other party) wishes to reduce business rates, there may be better places to find the revenue than increasing corporation tax.

Increasing just the main rate of corporation tax would also complicate the tax system. The scheduled reduction of the main rate of corporation tax to 20% in April 2015 will bring it into line with the small profits rate and eliminate the distinction entirely. In fact, a single 20% rate would be replacing not two separate rates but three: the small profits rate applies to profits below £300,000, the main rate applies to profits above £1,500,000 and a system of relief (in effect, a third marginal rate) operates between these two thresholds. As with business rates, the rationale for having a small profits rate of corporation tax was

[40] This estimate is based on the post-behavioural-change costing of reducing the main rate of corporation tax from 21% to 20%. See HM Government, 'Budget 2013: policy costings', March 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221895/budget2013_policy_costings.pdf.

never clear in the first place, and moving to a single rate is a welcome simplification. Labour's policy now is that it wishes to have – apparently permanently – a rate of 20% on profits below £300,000, a rate of 21.25% on profits between £300,000 and £1,500,000, and a rate of 21% on profits in excess of £1,500,000. Having three separate rates that are so similar to each other simply looks farcical. The simplification of moving to a single rate of corporation tax (whether that is at 20% or some other rate) is a real achievement of the coalition government's tax policy, and it is one that should not be reversed.

11.5 Conclusion

Tax policy should be kept as simple as possible and avoid taxing some types of firms or activities differently from others unless there are strong arguments to the contrary, in which case departures should be carefully designed. Tax policy should also be kept stable. Business rates policy currently fares badly on both of these scores.

The obvious starting point for business rates would be to levy the same tax rate on all property. In some cases, policy deviates from this with no obvious justification: agricultural relief is one example and should be abolished. There may be a stronger argument for providing permanently lower rates for retail properties or properties with a low rateable value (though not the temporary policies currently in place). But the hurdle for justifying such preferential treatment should be high; it is debatable whether there is a compelling case for these tax breaks, and if the government believes there is then it should explain its justification more clearly.

Where differential treatments are introduced, it is important that they be well designed. It cannot be sensible that, in Scotland, properties with rateable values £1 higher can attract an annual business rates bill more than £2,000 higher. And it cannot be sensible that local authorities encouraging new developments now get to keep part of the revenue for seven years whereas those doing so in 2019 may hardly benefit at all and actually be better off seeking to delay development until after 2020.

Until recently, business rates, for all their imperfections, had been one of the most stable parts of the tax system, having barely been changed at all since 1990. Recent years, however, have seen a swelling stream of new announcements and supposedly temporary policies. Revaluation has been delayed and uprating has differed from RPI inflation, both for the first time since 1990. A 'temporary' increase in business rates relief, initially announced in 2010 as a one-year policy, has already been extended four times, leaving its currently scheduled expiry date of March 2015 in doubt, to say the least. More 'temporary' reliefs have been introduced for small retail premises and empty new-build properties.

Businesses make investment decisions factoring in their expected future tax liability. If the government continually alters the tax regime, it increases uncertainty, making an assessment of the after-tax returns to an investment more difficult, and ultimately deterring businesses from investing. Repeatedly extending 'temporary' reliefs on an ad hoc basis can also make it difficult to rescind what was originally intended to be a short-term policy and can end up inadvertently changing the structure of the tax system. In any case, it has not always been clear why the temporary policies, if desirable at all, should be desirable only for a particular period. For example, why should retail properties be treated more favourably than most other business properties in 2014–15 and 2015–16 but not thereafter?

Stability is not always the decisive factor; governments should not eschew clear improvements to the system purely for the sake of minimising change. It is doubtful that all of the changes introduced recently merit the upheaval. But there are certainly worthwhile reforms available.

The ideal, subject to confirming practical feasibility, would be to replace business rates entirely with a system of land value taxation based on what each site would be worth in the absence of any buildings on it. Such a tax would remove altogether the disincentive to develop and use property that business rates creates.

Short of such a radical revamp, business rates should be reformed so that rateable values reflect as closely as possible the up-to-date market rental values of properties. There are two elements that could be used to achieve this. First, regular revaluations could be undertaken more often, though the benefits of more frequent revaluations must be weighed against the additional administrative cost. Second, if revaluations are conducted less than once a year then rateable values should be uprated in between valuations to keep them as close as possible to properties' true market rental values – for example, in line with a local rental price index for properties of a certain type. Keeping rateable values more in line with actual rental values year-to-year by these two means would make tax bills more transparent, fairer as relative property prices change, and less prone to sharp changes at revaluation than the current system. It would be possible to do all this while still restricting average bills to keep pace with RPI inflation if so desired (though better measures of inflation are available). An alternative would be to keep the tax rate (the multiplier) fixed as the tax base (rateable values) changes. That would make business rates more responsive to the economic cycle, addressing some of the recent concerns raised by businesses that saw the rental values of their properties fall in the recent recession without a commensurate fall in their business rates bills.

One of the most substantial changes in recent years has been towards greater localisation. There is a case for providing LAs with an incentive to promote business development by allowing them to retain part of the business rates revenues raised from new developments, as the business rates retention scheme in England and the business rates incentivisation scheme in Scotland do. The business rates retention scheme is, however, rather complicated. Its design has been influenced by a strong desire to equalise resources across LAs: incentives have been dampened in order to redistribute the proceeds from new developments across England. One facet of this dampening that is particularly ill-designed is the length of time for which LAs are able to retain revenues: rather than keeping extra revenues until a fixed cut-off date (which means that the incentives to encourage development weaken as the reset point approaches), it would make more sense for LAs to keep the revenue for a given number of years (5 or 10, say).

A second aspect of localisation has been to give LAs almost unlimited powers to offer discretionary business rates discounts (at their own expense) as they see fit. LAs initially made little use of this potentially sweeping power, but they have more incentive to use it now that business rates retention gives them some reward from encouraging new developments.

The case for taking localisation even further by giving LAs the power to increase business rates as well as reducing them is less compelling than the current reforms, because there might be a lack of democratic checks on LAs that are tempted to increase business rates at the ultimate expense of people who may not be clearly identifiable as local voters. The ballot of potentially liable firms now required for LAs to levy a supplementary business rate might be a useful model going forwards.

Taking the coalition government's package of business rate changes as a whole, the measures mostly lack a clear (and clearly explained) justification, make the system more complicated and have added instability. Most of the recent changes to business rates are reductions, which will no doubt be welcomed by hard-pressed businesses. But that does not mean they are necessarily the best use of taxpayers' money, even within the business rates system. Better reforms are available.