Please find below a written submission to the call for evidence into local Government Finance and the 2019 Spending Review. The submission is part of an on-going research project investigating the operation of land value and property tax and public sector finances (relevant publications are grouped at the end of this document).

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We would like to thank the Committee for the opportunity to take apart in this inquiry. We would welcome any opportunity to provide further insight at subsequent stages

1. What lessons can be learned from past changes to local government funding in England

This submission argues that while devolution and relative local government financial autonomy has been a central policy objective since at least 2010, the financial mechanisms for achieving this aim remain convoluted, unevenly allocated and do not capture well the inherent economic value in local place. A key recommendation is for a place based financial model that better captures local value. Local Council Tax is based on residential property valuations that have not been updated since 1992 (based on 1991 estimations). These valuations should be updated to present day values and consideration should be given to a new system of valuation – potentially land value based or flat rate levy based on up to date values.

The submission also draws upon recent evidence submitted to the Treasury in relation to the operation of the business rate system and its impact on the business community. This is because there is currently an inherent operational tension in relation to supporting on one hand tenants and landlords (who typically want business rates to decrease) and financing local government (who need business rate yields to remain stable and ideally increase). In its current state, this contortion does not seem possible.

1.1 Following the 2017 revaluation exercise the overall business rates yield has increased, However, this is largely due to the gravitational impact of the Central London property market. Rateable values in Central London have broadly increased while the rest of England has seen significant decreases in value, especially in the North. Concurrently, there have been successive budget announcements reducing the business rate burden on smaller businesses – assessed on the basis of relative rateable value. The consequence is that this higher business rate burden is shouldered by an ever-decreasing number of businesses with larger floorplates (found across the respective commercial sectors) and those with smaller high value properties (predominantly retail, leisure and office) in central locations.
1.2 In addition, the uniform business rate is now relatively higher than the periods immediately following previous revaluation exercises. Following the 2000, 2005 and 2010 national revaluation exercises, the business rate multiplier was reduced to between 41.6p and 42.2p in the Pound – this gave some breathing space for the business community but reduced the retained business rate yield. Following the 2017 revaluation exercise, the multiplier was only reduced to 47.9p and quickly increased to 49.3p in 2018 – one of the highest levels on record. Recent research carried out by R3Intelligence, also suggests that a great deal of rate reduction/relief seen since 2017 has been carried by subsequent business rate multiplier increases.

1.3 Proceeding sections will argue that the business rate system influences the behaviour of several business sectors:

**Business**: Orthodox economic interpretation would suggest that the higher business rate burden reduces the ability to invest in respective business growth and staff. Tenants feel this burden quickly as any increase in business rates needs to be immediately absorbed. The options for dealing with this situation are utilising reserves or reducing a burden elsewhere. It is also difficult to negotiate a rent reduction with a given landlord without lease surrender, renegotiation and agreement of new lease.

**Landlords**: Orthodox economic interpretation suggests that landlords have pressure to reduce their rents, in order to accommodate business rates, and this results in less available finance for building improvement strategies. In principle, we agree with this theory under perfect market conditions. However, the reality of market dynamics and institutional mechanisms can frustrate this e.g. upward only rent reviews and the time lags associated with market rental adjustment and the periodic national valuation exercise. The empty property rate system also leads to an underground industry of tax avoidance.

**Local authorities**: Local authorities are also considered a business in this submission. It is difficult for local authorities to incentivise business through tax cuts – as they are reliant on business rates increasing to pay for service pressures. The business rate retention scheme also incentivises local authorities to construct new commercial property. This may lead to more commercial property stock (and tax income), in certain locations. However, the result of this situation could be reduced property value (and tax income) as valuations are revised down due to oversupply over time. The relatively high empty property rate also means that local authorities can benefit more from empty properties (through empty property tax) than occupied properties (because the business rate is typically set lower).

All three interests should be considered in tandem

2. The efficiency, fitness for purpose and sustainability of the current system for funding local government

2.1 The demand for fairness, certainty and coherence and the broader requirement to support growth and encourage competition is a concern for landlords, tenants and local government. The
dual focus at the heart of the business rate system has resulted in a complex system that is very difficult to follow, and is beset by administrative entanglements and compromises. Businesses face various multipliers, reliefs, exemption thresholds and transitional arrangements. The incidence of the tax also falls negatively on both tenant and property owner. Occupiers, who shoulder the extra cost of business rates, have less profit and reserves to invest in their business and can pay more in property tax than corporation tax. While the business rate burden is capitalised into lower rents (in time) reducing the investment potential of property owners.

2.2 It also remains the case that the parallel empty property rate tax rewards vacancy more than occupation and has driven a sub-industry in empty property rate avoidance techniques. The high rate of empty property tax means that local authorities are not rewarded with any additional income from attracting new businesses into existing vacant premises. In other words, businesses often pay a lower rate of business rate taxation (often none), can receive various tax reliefs and often exhibit greater occupier churn which results in a lower business rate yield for local authorities. This means that perversely, under the current tax arrangements, local authorities gain more financial benefit from vacant commercial properties than they do those under occupation. Local authorities should be incentivised to promote indigenous economic growth by being rewarded for creating conditions whereby vacant space is reoccupied and brought back into productive use, rather than getting penalised in the current situation. This would incentivise local authorities to tackle ingrained conditions of vacancy and inertia (rather than solidifying them) and conceivably increase the rate of take up and absorption in these locations. Without change, it is very difficult to create productive value out of existing commercial real estate assets. Empty property rates should be reduced below the small business rate multiplier and consideration should be given to scrapping the scheme altogether.

2.3 The local government business rate retention scheme relies on a convoluted web of tariffs, top-ups, safety nets and levies. It also struggles to deal with the impossibility of retaining growth locally and redistributing income nationally amidst volatile property market conditions. This last point is partly because the adjustment for revaluation that takes place every five years strips out (known as the wash through) any increase in placed based value creation (through the adjustments in the top up and tariff mechanism). The only growth that remains is that associated with net new floor space, either derived from new build construction or repurposed floor space (see previous Witness Testimony to 2016 Business Rate Retention HCLG Scrutiny Enquiry).

2.4 Existing efforts to improve the business rate retention scheme mostly involve complex alterations to the existing mechanism, for example re-designing the reset mechanism (when tariffs and top ups are periodically reset). Broader improvement to the existing business rates system focus on more frequent valuations (potentially aided by automated valuation tools), a more efficient appeals process (for example the Check, Challenge, Appeal process introduced in 2017) and the continuing removal of low value properties from the business rate system. However, this feels more like tinkering around the edges of a very complex system (potentially making it even more complicated), rather than fixing the underlying concerns of transparent tax and resilient public sector finance. A more comprehensive debate is needed into how England can reform its model of tax to support business and public services (see concluding recommendations).
3. The approach the Government should take to local government funding as part of the 2019 Spending Review

3.1 This submission takes the view that the economic justification for property based tax needs to consider landlords, tenants and local government – they are co-dependent and all businesses entities. All three are influenced by or reliant upon business rates. Although a pragmatic tax, we maintain that property tax can fall negatively on both tenant and property owner. Occupiers, who shoulder the extra cost of business rates, have less profit and reserves to invest in their business and can pay more in property tax than corporation tax. While the business rate burden is capitalised into lower rents reducing the investment potential of property owners (this is covered in more detail in the previous section).

3.2 In facing up to the demand for business rate reform, there is a concurrent interest in land value tax as an alternative tax arrangement and also a digital sale tax. However, land value tax may not be a panacea for concerns with business rates. The economic and ethical argument for land value tax is well made. However, a great deal of land simply has no value and demands a certain degree of investment for development readiness. This suggests that there will still need to be a complex system of equalisation between locations and grant funding (for local government financing). Similarly, reducing property tax will not help the high street if the demand for certain products simply does not exist anymore in conventional bricks and mortar format. In addition, any reduction in tax may capitalise into higher rents as property owners price in the change through time.

3.3 Concurrently, it is not clear how land value tax would better deal with the new world of digital platforms that do not have physical footprints, nor the dynamic reality of commercial business that increasingly must switch between use classes in quick succession. The practicality of moving to this system is also not straightforward. It would require massive change to the English institutions of tax administration, another national revaluation exercise using a new method of site appraisal and the development of a new valuation skill base. In principle, the proposed digital sales tax is a move in the right direction of recognising the hybrid nature of bricks and mortar and internet trading. However, implementing this tax will also be very difficult. In other words, the business rate system is not really working but there are no immediately obvious solutions.

3.4 The eventual solution could be a compromise. For example, a semi-permanent transition that combines elements of land value, property and digital related tax. This balancing act would be similar to the split-rate tax (where land is taxed at a higher rate than property) seen prominently in North America. The compromise could also include elements of business growth not easily captured in bricks and mortar – for example a digital sales tax. The business and property world is now a hybrid mixture of commercial vehicles existing somewhere between bricks and mortar and the digital world. It makes sense for a reformed system of tax to be similarly hybrid.

3.5 In designing a new system of tax we support a system of principles that create a virtuous connection between tenants, landlords and local government (all three are businesses). A new tax system would see improvements in business growth and productivity translate into greater local tax receipts. Currently this does not happen. The opposite is true with a clear break between business, the economy and public finances. This demonstrates a clear contradiction between the tax system, models of fiscal decentralisation, and a potential place based economy that works for everyone. The
4. Conclusion

4.1 This submission argues a first base for local government finance reform should be Council Tax method remodelling. The submission also takes an unashamedly circumspect view of the business rate system. This is not because we doubt the inherent utility in taxing property (and potentially land). Rather, it is because we are worried about the current difficulties and inherent contradictions involved in providing a fair system of tax and the concurrent but not parallel demand for funding public services. A lot of the press attention for business rate reform falls upon the retail sector. However, although clearly an important consideration for retailers, business rates are not necessarily the cause of market disruption in this sector. Business rates are often relatively high for larger retailers because they have paid a premium for centrality of location. Concurrently, many smaller retailers do not pay business rates because they are below the threshold. Rather, the retail sector is currently beset by myriad structural, macro and micro concerns, which magnify the cost of business rates.

4.2 This is not to say that the retail sector is not influenced by business rates. It is an important concern in a time of clear disruption. Rather, the intention here is to argue that business rate reform (and the wider local government funding debate) should not be led by one agenda. Rather, the opportunity should be taken to take stock of the current situation and unite the various considerations and priorities that are reliant upon or demand a reformed commercial (and residential) property tax in England. The situation should not be distilled into respective political agendas. Nor should it be examined through simplifying principles of economic supply and demand or reduced to cash flow, expenditure and finance settlements. Rather cross party consensus must be found that views land and property based tax through a dual prism of business profitability and the payment of local public services. The solution must capture the value held in the new world of work and recover the investment put into national and industrial strategies and the bottom up civic efforts of local communities, towns and cities. Our main recommendations are:

- Update and reform Council Tax considering new models around land value tax and flat rate methodology
- The business rate system must be responsive to economic conditions and fairly incentivise investment in property and business;
- The business rate system should be sensitive to the new world of work that favours leaner, hybrid business models that mix bricks and mortar and digital transaction interfaces;
The business rate system should prioritise legibility, simplicity and transparency;
There should be sympathy for how business rates fall on various property sectors and locations – for example retail, leisure, office and industrial, all of which experience property tax in different ways;
The Committee should tackle the perversity inherent in empty property rates that at times rewards vacancy more than occupation and has driven a sub-industry in Empty Property Rate avoidance techniques;
In any proposals for property tax change, the demand for local government financing should be recognised. It is only projected to increase as society lives longer;
The business rate system (or any replacement) needs to manage volatility and provide certainty in individual (to help businesses plan) and overall commercial property tax yield (in order to help the local government budget setting process);
The business rate system (or any replacement) should capture the value created by public and civic spending on physical, social and knowledge infrastructure in local areas (e.g. a virtuous relationship between local economy, landlord, tenant and public services);
The co-dependent requirements for a fair tax system and funding for the public sector demands a collaborative solution that brings together the world of business, property owners, the various tiers of government and those charged with designing and administering tax;
Any new system should create a virtuous relationship between local economic growth and property tax (this is currently negated through the wash through procedure and perversities inherent in the empty property rate).

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Relevant Publications


Muldoon-Smith, K. (2019) Business rates are broken: Should we start taxing land? Citymetric

Muldoon-Smith, K. (2019) Is it possible to incentivise and capture local wealth: the business rate challenge Local Economy (forthcoming in June)


