CBI
THE VOICE OF BUSINESS

7 October 2016

Scottish Business Rates: Barclay Review

CBI Scotland welcome the opportunity to respond to the Independent Review of Scottish Business Rates led by Ken Barclay.

The CBI is the UK's leading business organisation, speaking for some 190,000 businesses, across all sectors and sizes, operating across the UK. CBI members directly employ at least 500,000 people in Scotland, which represents a quarter of the private sector workforce. This includes companies headquartered in Scotland as well as those based in other parts of the UK that have operations and employ people in Scotland.

Businesses are vital to driving economic growth and raising living standards in Scotland through investment and job creation. The environment businesses operate in is shaped by government policy, including on tax, skills, infrastructure and regulation. In order for business, government and people to get the best from each other, it is important to foster partnerships and a broad understanding of challenges and opportunities, as well as shared goals.

Non-domestic rates on commercial property is one aspect of the many ways businesses contribute to the public purse and to local services. We need to continue to maximise business investment and presence in Scotland so businesses can do what they do best – create more jobs, investment and opportunities for people in Scotland – which in return helps grow the economy and revenue for local services.

With this submission we present ways to better reflect economic reality in the rates system in order to maximise business investment and presence in Scotland. The CBI's recommendations involve a modest cost relative to potential benefits from a more competitive commercial property system. In a period of economic adjustment following the EU referendum the benefits of safeguarding investment and employment in Scotland will outweigh the modest cost of ensuring business rates support competitiveness and growth.

Taking no action risks tax revenue lost as a result of firms changing their business models to reduce their commercial property footprint or moving their operations to lower tax locations elsewhere in the UK or Europe.

Recommendations

1. **Continue to align the Scottish business rates multiplier with other parts of the UK** to avoid a deterioration in Scottish business competitiveness.

2. **Index business rates by CPI from 2017/18** to avoid unsustainable increases in the business rates multiplier for property-based businesses.

3. **Exempt new investments in plant and machinery and environmental efficiency** from business rates to encourage productive investment.

4. **Value Scottish business properties every three years** to make business rates more responsive to economic conditions and reduce tax barriers to redevelopment.

5. **Modernise billing and collection of business rates** to reduce administrative and compliance costs.

Background: The case for business rates reform

Challenging economic conditions make absorbing increase in business rates multiplier difficult

The Scottish economy has grown at an average of less than 0.9% per year since the last revaluation of business rates in 2008. This growth has been significantly weaker than average economic growth rates recorded during previous business rates revaluation cycles (*see Figure 1*). More recently, Scottish growth has been slowing sharply since 2015 Q1. In the latest available data growth was 0.6% compared to a year ago – partly reflecting the fall in crude oil prices, which has begun to affect activity beyond the production sector – meaning slower momentum going into a challenging period of economic adjustment following the EU referendum result.

In the current system of business rates, government targets a tax revenue yield that grows in line with Retail Price Inflation (RPI). RPI as a measure of inflation overestimates the official measure of inflation, the Consumer Price Index (CPI), by around 0.8% per year. Slower economic growth in Scotland makes for a more challenging business environment and means Scottish businesses will generally find the rising tax burden more difficult to absorb without an adverse impact on investment or jobs than counterparts in the rest of the UK.

Figure 1: Scottish GDP growth by business rate revaluation cycle

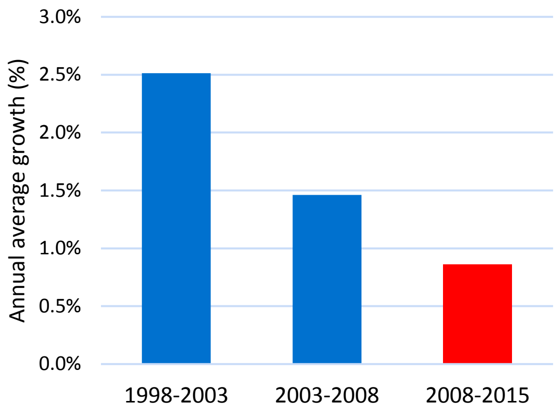
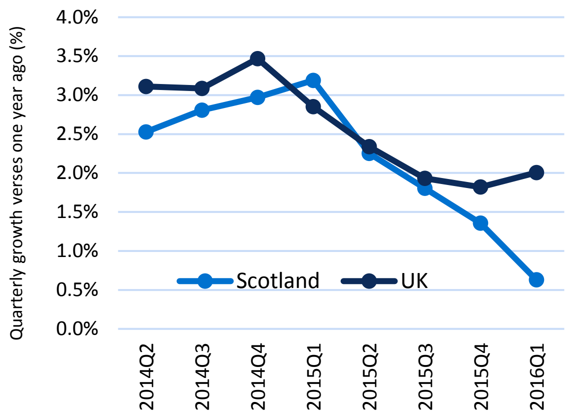


Figure 2: UK and Scottish growth since last valuation



Source: CBI Analysis of Quarterly National Accounts Scotland

Weak Scottish commercial property market will result in sharp increase in business rates multiplier

While the business rates system of taxation involves a revenue target that increases in line with RPI, other tax rates are set at a fixed rate and revenue varies according to economic conditions. Historically, this anomaly of the tax system has proven to be less of an issue because both property prices and RPI have outpaced the increase in CPI.

However, since the last valuation growth in commercial property values has been weak due to the effects of the 2008-09 financial crisis and the subsequent slow economic recovery. In the retail sector (where Scottish retail rents are unchanged since the crisis and therefore lower in real terms) weakness has been compounded by competition from internet retailers reducing the value of a physical property in business models.

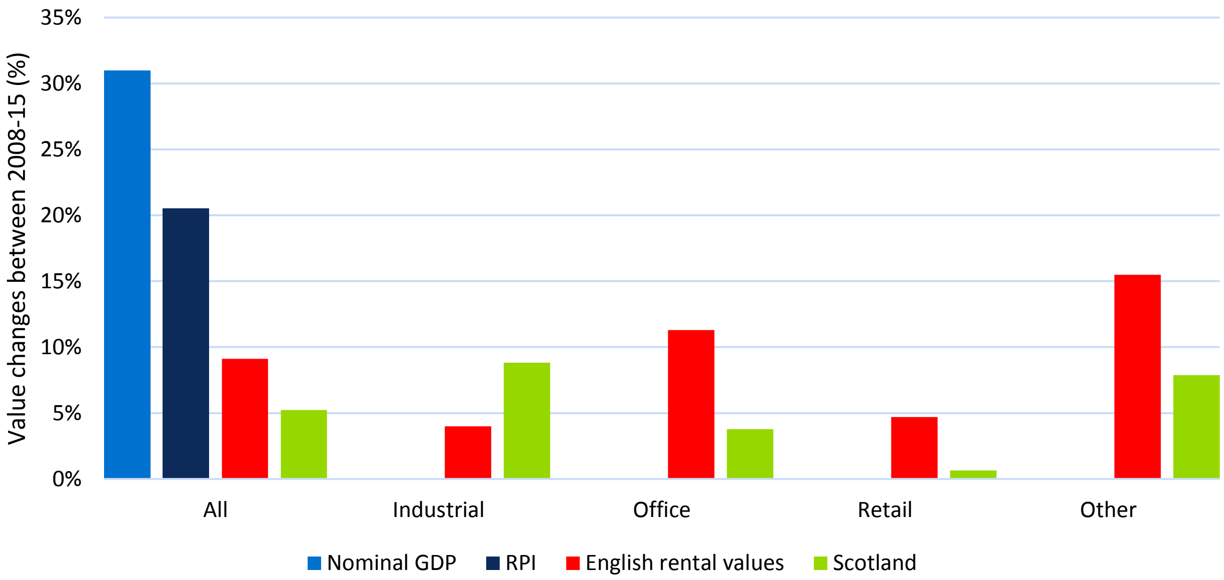
Business rates have been indexed by RPI which has risen 20.5% between 2008 and 2015 (*see Figure 3*). As Scotland shares a land border with England it is a valid comparison to make, as having business operations on both sides is commonplace. Average property values have risen by 9.1% in England[1] and are expected to have increased 5.3% in Scotland over the same period, therefore lagging inflation by an even greater margin. The uniform business rates multiplier (UBR) normally increases between revaluations but is adjusted back down when a new revaluation reflects higher rental values. In England and Scotland the UBR was 41.7p in 2010/11 (immediately after the last revaluation) and had increased to 48.0p by 2016/17. In England the recent valuations list indicates that the UBR will be cut to 46.7p (48p including the large business supplement[2]), unusually only partly reversing the increases in UBR since 2010/11.

The underperformance of the Scottish commercial property market suggests that without discretionary action the Scottish UBR will increase to 48.4p – this will be the first time since the creation of the Scottish Parliament that a revaluation will not result in a reduction in the UBR.

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/555980/Revaluation_summary_28092016.pdf

[2] https://www.ifs.org.uk/publications/8689

Figure 3: The change in English, Scottish rental values compared to RPI



Source: CBI Analysis of VOA and MSCI database

Threat to competitiveness has led to reversal of previous Scottish business rates premiums
Previous attempts to increase the Scottish UBR above the English rate have been reversed because of the negative impact on Scottish business competitiveness. 2000-01 was the first time that the Scottish UBR (45.8%) was raised in excess of the English rate (41.6%). Scottish ministers recognised the negative competitiveness effect of this divergence in 2006 and the Scottish and English UBR have been equalised since 2007-08.

In 2013-14 and 2014-15 the public health supplement was introduced for business premises with a rateable value of over £300,000 which sell both alcohol and tobacco. Although the retail of these products is less mobile than other goods and services, the punitive 13 pence in the £ supplement was deemed unsustainable as a long-term measure and was discontinued in 2015-16.

In 2016-17 the Scottish government doubled the Large Business Supplement from 1.3 pence to 2.6 pence. Although this divergence is smaller than previous tax increases, without government action, the underperformance of Scottish commercial property prices will lead to a 1.7 pence higher Scottish UBR. The combined effect of a higher supplement and UBR would more than double the competitive disadvantage faced by major employers in Scotland compared to their English counterparts from 1.3p in 2016-17 to 3.0p in the pound in 2017-18. **In order to protect Scottish business competiveness CBI Scotland have called for a reversal of the increase in the Large Business Supplement and for the UBR to match the English rate.**

The business rates multiplier is already significantly higher than other tax rates
The UBR in Scotland is already 48.4% in 2016-17 and the large businesses rate is 51%. Without policy reform the UBR could increase to a punitive 53% and 55.6% including the large business supplement in 2020-21. It is far in excess of other tax rates – for example the highest rate of income tax is 45%, VAT is 20% and employers' National Insurance at 13.8%.

In an environment where a physical property is in many cases no longer integral to business models, imposing a tax of 55.6 pence for every £1 paid in rent risks undermining the sustainability of business rates as a revenue source. Business activity could either leave to other locations or move online as a result of taxation pressures rather than underlying business reasons. There are already indications that investment in some commercial property categories in Scotland has fallen to levels that are inadequate to maintain the existing property stock.[3]

[3] There was a shortfall in 2013 in the replacement rate required to prevent the nation's business stock ageing unacceptably of around 0.84m square foot for offices and around 5.9m square foot for industrial stock. *Commercial real estate and the Scottish economy, Jones and Trevillion, Heriot Watt University (2015)*

CBI's recommendations: A modest cost relative to potential economic benefits from a more competitive commercial property system

1. **Continue to align the Scottish business rates multiplier with other parts of the UK** to avoid a deterioration in Scottish business competitiveness

CBI analysis suggests that the next valuation of business rates will result in a Scottish UBR of 48.4%. Previous administrations have recognised the negative competitiveness effects of a higher UBR in Scotland relative to south of the border.

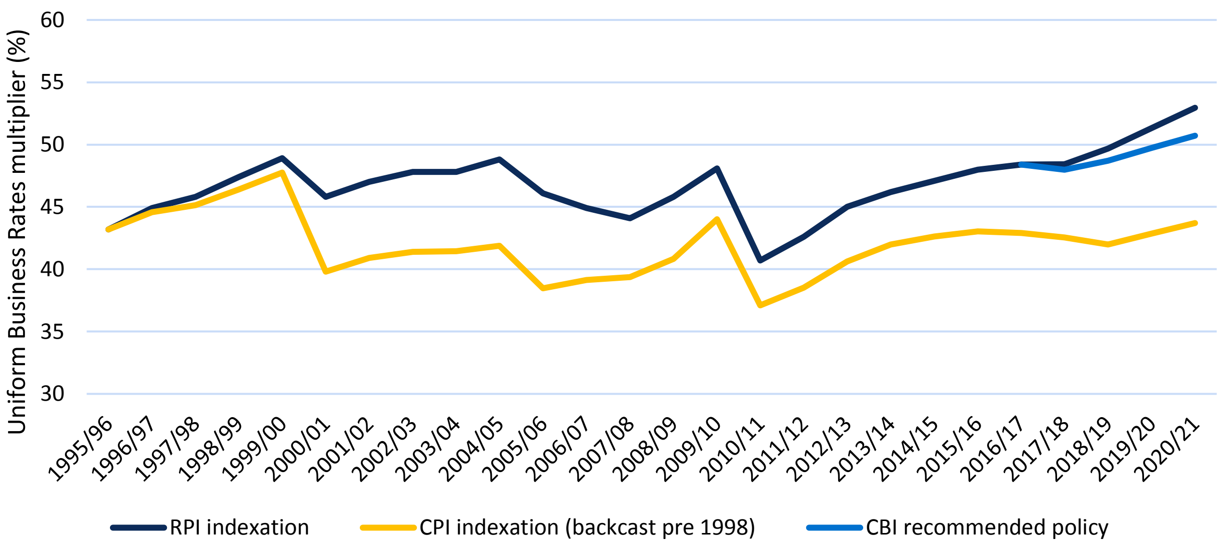
The estimated cost of matching the English UBR in 2017/18 is £95 million in foregone tax revenue. In addition, reducing the large supplement to 1.3 pence will cost £60 million. **The combined cost of £145 million per year represents less than 0.5% of the Scottish government's budget**, a modest cost relative to the benefits of safeguarding investment and employment during a period of economic adjustment following the EU referendum. Taking no action involves a risk to tax revenue if businesses take offsetting actions to reduce their commercial property footprint or move to lower tax locations outside of Scotland.

2. **Index business rates by CPI from 2017/18** to avoid unsustainable increases in the business rates multiplier for property based businesses.

When the current system of business rates was introduced in Scotland in 1995/96, the UBR was 43.2% (*see Figure 4*). Due to over-indexation of RPI the UBR is set to increase to a highly punitive tax rate of nearly 53% by 2020/21 (*Figure 4*). **If business rates had been indexed by CPI the Scottish UBR would have been a more reasonable 43.7% in 2020/21** (roughly unchanged from its 1995/96 rate).

After matching the expected English UBR of 46.7% in 2017/18 the Scottish government should index the Scottish UBR by CPI (*light blue line, Figure 4*). This would strike the balance of protecting tax revenue for the Scottish government in real terms and moderating the unsustainable rate of increase in Scottish business rates.

Figure 4: The Uniform Business Rates multiplier with RPI and CPI indexation



Source: CBI analysis

3. **Exempt new investments in plant and machinery and environmental efficiency** from business rates to encourage productive investment.

The government should consider transforming business rates into a complete property tax by removing new plant and machinery and investment in environmental efficiency, such as solar panels, from the calculation of rateable values. The current business rates system penalises such productive asset investments since doing so increases rateable values. **Businesses should be encouraged to make investments that have the potential to boost productivity**, or investment that could help meet carbon reduction commitments.

CBI analysis finds that in future if new investments in plant and machinery were exempted from business rates additional investment would be unlocked to add £1.9 billion to Scottish GDP over the next five years.[4] This reform would result in a static cost of £500 million over a five year period, however higher activity is expected to result in additional tax revenue of £670 million - exceeding the initial giveaway in business rates.

4. **Value Scottish business properties every three years** to make business rates more responsive to economic conditions and reduce tax barriers to redevelopment.

Business rates are still based on pre-recession trading conditions and are often in excess of market rents. Until the new revaluation is reflected in lower billing rates, business expansion in certain areas is often unviable, delaying private sector-led economic regeneration. **Increasing the frequency of revaluations would help make business rates more responsive to economic conditions, reduce barriers to redevelopment and also have a positive impact on appeals**.

Scottish commercial properties were last valued in 2008 and the Scottish government has continued to collect business rates based on pre-crisis values. CBI members have highlighted cases in a number of depressed commercial property markets where rents have fallen sharply, one example is East Kilbride. Tax adjustments reflecting a deterioration in commercial trading conditions would make these areas more attractive for redevelopment.

Improvements in efficiency would help to facilitate reduction of the valuation cycle from five (seven years in this cycle) to three years.[5] At the same time the delay between revaluation and billing should be compressed from two years to one year to further enhance the responsiveness of the tax system to changes in local economic conditions.

A move to a single assessor would be a way of making the system more efficient, as well as consistent. The assessment process in Scotland is currently undertaken through 14 different assessors, while in England and Wales the same process is undertaken a single assessor; the Valuation Office Agency (VOA).

Additionally, a single, transparent methodology of assessment for Scotland would ensure more consistency and fairness across valuations and avoid differences in valuations for comparable properties. Consistency and transparency in methodology would also help the appeals system reduce the number of appeals.

5. **Modernise billing and collection of business rates** to reduce administrative and compliance costs.

Modernising billing and collection by using digital technology to deliver an online one-stop shop for billing and payment of business rates can deliver a significant improvement in the Scottish business environment at no net on-going cost to government. Administrative savings can be made from moving to a more centralised digital system, which would also need to develop ways of capturing and retaining local knowledge.

The current system involves separate paper billing and collection by local councils**. Developing a central web portal for Scotland to deliver a single itemised bill that can be paid online would reduce administration and compliance costs, particularly for multi-site businesses**.

Revenue-neutrality, rationalising reliefs and responding to economic conditions

The considerable reduction in empty property relief for industrial property risks having a negative impact on regeneration and property development across a number of local communities in Scotland (*see Example below*). As the application of the relief has seen varying approaches by local authorities, an immediate term measure is to explicitly provide discretion at local level to develop mutually beneficial and collaborative solutions, which help businesses and local authorities to continue investment in their communities and ensure a consistent approach across Scotland

More broadly, business are seeking more certainty about reliefs – both knowing whether they will apply for the entirety of the revaluation period and having a set period of implementation for newly introduced reliefs would assist in addressing the need for certainty in business planning.

[4] Business Rates Reform - Rateable Plant and Machinery, Analysis of outlook and impacts, EY (2015); estimates an £8.7 billion in additional economic activity from removing P&M from business rates in the UK. CBI pro-rata analysis of suggests that £0.9 billion of economic activity could be enabled in Scotland in the next 5 years through this policy reform.

[5] Following business input the UK government has accepted the case for more frequent valuations in England.

In light of the revenue-neutrality of this review and the need to move to a system that is better set up to respond to economic conditions, rationalising reliefs and expanding the tax base could finance policy action to align the Scottish UBR with other parts of the UK and limit future increases.

Reliefs need to be carefully targeted to avoid economically harmful distortions in the commercial property market resulting in property occupation driven by tax policy rather than economic fundamentals. This is particularly the case when a tax rate is very high such as with the business rate multiplier. The Scottish government has already made some proposals with rationalising exemptions and reliefs[6]. A more comprehensive analysis of the economic rational of existing exemptions and reliefs, followed by potential reform expanding the business rates base, could finance policy action to limit increases in the UBR.

The Scottish government spent £590 million on business reliefs in 2013-14[7] accounting for 17% of potential business rates revenue. In England the corresponding expenditure on reliefs is 10% of potential business rates revenue. Reliefs have increased as a proportion of the potential tax base over the last five years in Scotland. **Reducing expenditure on reliefs could raise £250 million in tax revenue that could allow the Scottish government to align the UBR with other parts of the UK and limit future increases**.

CBI Scotland, October 2016

Example: *Rates impact on speculative development*

Speculative property developments are important to many local communities across Scotland and bring much needed investments. Following the changes to Empty Property Relief for industrial buildings businesses have amended their business plans and are reassessing speculative developments.

As a result of the reduction of relief for empty industrial buildings one company with a site in Clackmannanshire are scaling back plans for a site development – pushing back start date and end date of the project.

Another company with planning permission for three units totalling 40,000sq ft have cancelled plans due to the relief reduction and will now only start building if they have an end customer.

Both businesses and local authorities would prefer to keep companies and economic activity in their local areas but in many cases market conditions mean that it can be challenging to find tenants for many commercial properties. One company have given the example of a 33,000sq ft building they planned to make improvements to and rent out now costing £80,000 a year in rates. This means that if a tenant is not found within a year the decision will be made to knock the building down.

6 http://www.gov.scot/Topics/Environment/land-reform/LandReformProposals/prop7

7 Financial Scrutiny Unit Briefing Non-domestic Rates, Anouk Berthier (2015), SPICe Information Centre