CBI
THE VOICE OF BUSINESS

A vision for a simpler, fairer, more competitive business rates system

Policy briefing No 4

"Business rates has become a barrier to entrepreneurship, investment and productivity growth for businesses of all sizes and needs urgent reform."

Business welcomed the government's commitment to set out a business tax roadmap at budget 2016. It is critical that the government uses the roadmap to tackle the burden of the business rates system, which continues to rise disproportionately and comes on top of recent additional policy costs on business. Business rates has become a barrier to entrepreneurship, investment and productivity growth for businesses of all sizes, particularly property-based firms, and needs urgent reform, which devolution of business rates to local authorities alone cannot solve. Making the overall business rates system simpler, fairer and more competitive is a top priority for business.

This brief sets out the CBI's immediate recommendations for how the government can create a simpler, fairer and more competitive business rates system…

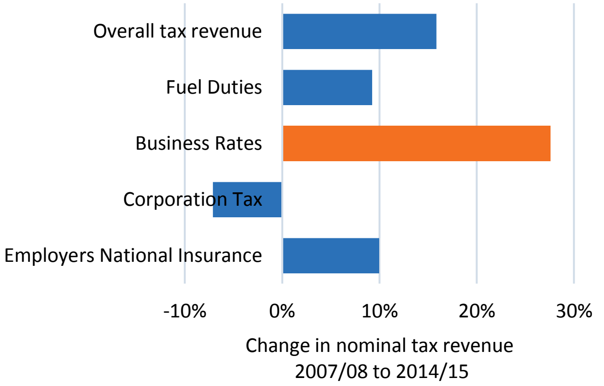
- **Simpler:** removing businesses with a 'rateable' commercial property value of less than £12,000 from the system altogether
- **Fairer:** more frequent valuations of commercial property values, which are implemented with a shorter time lag
- **More competitive:** addressing the loss of tax competitiveness from the unsustainable rate of increases in the business rates 'multiplier' (tax rate), by moving from RPI to CPI indexation – in line with the government's official inflation target.

In the longer term, more fundamental reform of business rates can deliver further improvements in the UK business environment. Using modern technology to deliver an online one-stop shop for the billing and payment of business rates can significantly reduce compliance burdens. These simplifications could allow business rates to be based on annual property valuations. Business investment and productivity improvements could be unlocked by allowing new investments in plant, machinery and energy efficiency assets to be excluded from rateable values for business rates.

1 The increasing tax burden from business rates is unsustainable

In 2003 the government changed its official measure of inflation to the Consumer Price Index (CPI) but continued to index the business rates multiplier (tax rate) to RPI, which is no longer a national statistic. This decision has led to the over-indexation of the business rates multiplier by over 8%. In the last seven years the tax burden from business rates (up 28%) has far outpaced the growth in tax revenue from other business taxes and the government's overall tax take (up 18%).

Exhibit 1 Tax revenue growth in the last seven years



Source: CBI analysis – OBR economic and fiscal outlook, November 2015

The high tax rate makes investment in commercial property unattractive

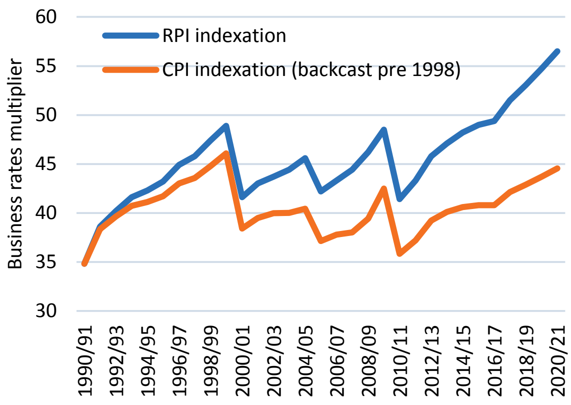
High tax burdens on commercial property, by distorting the incentive for development away from commercial property, can result in substandard and unsuitable commercial property. These factors can undermine the attractiveness of the UK to international investors as a place to do business. The lack of availability of suitable commercial property can also act as a drag on the ability of high growth and innovative medium-sized businesses to expand.

The very high business rates multiplier – which results in business property tax rates seven times higher relative to property values compared with residential property[1] – distorts property returns and creates powerful incentives for the conversion of commercial property into residential property. In 2014/15 alone there was an 80% increase in conversion from offices and shops to homes.[2]

Furthermore, punitive business rates can make new commercial property developments less viable in regions where property demand is lower and more price sensitive – such as the Midlands and the north – increasing regional imbalances. The effects of business rates therefore result in lower quality and higher cost commercial property, which are a drag on productivity.

Independent experts forecast the business rates multiplier will increase to 51.5% when the new revaluation of 'rateable' commercial property values is implemented in 2017/18 (**Exhibit 2**). Furthermore, a continuation in RPI indexation will see the business rates multiplier increase towards 60% by the end of the next five-year cycle.[3] Incremental increases in the business rates multiplier, which result in a progressively more punitive business rates multiplier, are likely to make property-based business models less viable relative to alternative ways of serving customers. As a result, the tax base for business rates will be undermined, making the tax even more distortive on those who pay it.

Exhibit 2 CPI indexation would have resulted in a more stable business rates multiplier



Source: CBI analysis – OBR economic and fiscal outlook, November 2015

[1] *The size and structure of the UK property market 2013: a decade of change* found that in 2013 residential property was worth £4,615bn, over seven times more than commercial property which was worth £645bn. Council tax and business rates revenues were both around £27bn in 2013/14 suggesting that business property is seven times more heavily taxed than residential property.

[2] http://www.ft.com/cms/s/0/a0d5bef8-8925-11e5-8a12-b0ce506400af.html#axzz3xDAg9t3f

[3] *April fools: the revaluation that never was*. GVA-Bilfinger (2015).

2 Creating a simpler, fairer and more competitive business rates system

Simpler: removing businesses with a ‘rateable’ property value less than £12,000 from the system altogether

New business formation is an important way in which new innovations are commercialised, thus helping to drive productivity improvements and economic growth. The complexity in the current business rates system can act as a barrier to new business formation. The newest and smallest business will face a greater compliance burden relative to their size. The current system imposes significant administrative burden both on government and business. Commercial properties with less than £12,000 of rateable values account for 64% of the Valuation Office Agency (VOA) caseload, yet raise only 6% of net business rates revenue.

The government has recognised the economic benefits of removing the smallest businesses from business rates. Currently, businesses with a rateable value of less than £6,000 are offered full business rate relief. Those with a rating of between £6,000 and £12,000 receive taper relief.

Small Business Rates Relief (SBRR) offers temporary rate relief, which is often extended at successive budgets. This system imposes significant administrative burdens on the smallest businesses, since SBRR needs to be applied for rather than being applied automatically. Uncertainty regarding the continuation of SBRR beyond the year ahead creates an incentive for a small business to appeal a valuation even if they qualify for full business rates relief in the current fiscal year. These appeals represent a significant cost to small business, local authorities and the courts system.

Introducing a £12,000 threshold for business rates, below which business rates do not apply, will create a simpler and more stable tax regime. The benefits of simplicity are applicable to the smallest businesses – those that face disproportionate administrative burdens relative to their size. Relative to the benefit of removing nearly two thirds of ratepayers from the onerous compliance burden of business rates, this reform has a modest fiscal cost to government of around £1bn by the end of the parliament, net of the savings to the VOA budget and abolishing SBRR which would no longer be necessary.

Fairer: more frequent valuations of commercial property values, implemented with a shorter time lag

More frequent valuations would make business rates more responsive to changing economic conditions

Commercial property rents tend to adjust to align supply with demand, encouraging the efficient use of business properties. In contrast, the business rates system is slow to respond to changing economic conditions. Under the current system, business properties are valued on a five-year cycle (extended to seven years for this revaluation cyle) with a further two year delay for tax liablities to reflect new valuations.

The unresponsiveness of business rates to fluctuations in property prices has made some commercial premises in the most depressed areas unviable and contributed to the blight of boarded up properties. Shortening the valuation cycle from five to three years and compressing the delay between valuation and new billing rates from two years to one year would make business rates more responsive to changing local economic conditions.

CBI members have commented on cases in a number of depressed commercial property markets ranging from East Kilbride in Scotland, Rochdale in northern England and Telford in the West Midlands, where market rents have declined substantially. Tax adjustment to a deterioration in commercial trading conditions would make these areas attractive for expansion. But business rates still based on pre-recession trading conditions are often far in excess of market rents and make expansion into these areas unviable and therefore delay a private sector-led economic regeneration of these areas until the new revaluation is reflected in billing rates.

Removing downwards transition will remove a significant barrier to regional rebalancing of the UK economy

Out of date business rates valuations are estimated to result in over taxation in the Midlands and north of England by £2.3bn.[4] Downwards transition – which limits the rate at which a business rates bill can fall each year when a rateable value has gone down – will compound this problem following the 2017 revaluation, since it will mean that even when the government recognises there has been a fall in relative property values, the full tax reduction is still delayed for a number of years. If valuations were more frequent, then abrupt changes in tax liabilities would be less likely to arise, doing away with the need for complex transitional arrangements (upwards and downwards).

More competitive: addressing the unsustainable rate of increases in the business rates 'multiplier' (tax rate), by moving from RPI to CPI indexation

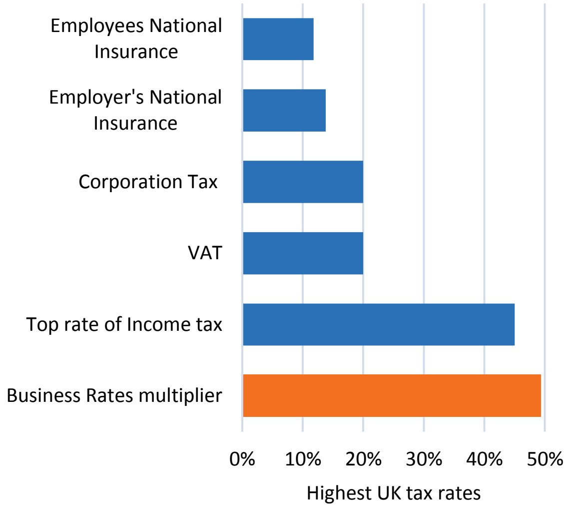
In 1990/91 when the current business rates system was introduced, the business rates multiplier (tax rate) was 34.8 pence in the pound. This rate was comparable to other tax rates at the time. For example, it was similar to the UK corporation tax rate of 34% and less than the top rate of income tax which was 40%.

Since then, the Retail Price Index (RPI) has been higher than both the Consumer Price Index (CPI) and the increase in the value of commercial property. As a result of the government's requirement for tax revenue from business rates to increase by RPI the business rates multiplier is now 49.3%, in excess of the top rate of income tax of 45% and well in excess of the UK's 20% corporation tax rate in 2015/16 (**Exhibit 3**).

CBI analysis finds that if business rates had been indexed to CPI – the government's official measure of inflation – then in 2015/16 the business rates multiplier would have been a more competitive 40.8% (**Exhibit 2, page 2**).

CPI indexation would safeguard the long term sustainability of business rates revenue, whilst ensuring business rates revenue does not run ahead of the general rise in prices in the economy, as officially measured by the government.

Exhibit 3 The business rates multiplier exceeds other tax rates in 2015/16



Source: CBI analysis

[4] *April fools: the revaluation that never was*. GVA-Bilfinger (2015)

Exhibit 4 Long-term business rates reform to further improve the UK business environment

The Northern Powerhouse agenda and the chancellor's announcement to devolve business rates to local authorities in England reflects a welcome desire to see local areas take greater responsibility for their economic development. But devolution alone does not address the many distortions created by the underlying business rates system. Without addressing the issues set out above, the business rates system will remain a barrier to the government's economic objectives – whether promoting a high-pay, low-tax economy, or boosting productivity.

While devolution offers an opportunity, it also risks an unwelcomed further increase in the administrative burden from business rates. If a business with a national footprint is required to interact with hundreds of local authorities each with their own different business rates within the existing paper based system, this would represent a significant increase in compliance burden. This compliance burden represents an opportunity cost which constrains business innovation, investment and growth. In contrast, using modern technology to deliver an online one-stop shop for the billing and payment of business rates can deliver a significant improvement in the UK business environment at no net on-going cost to government.

The government should consider transforming business rates into a pure property tax by removing plant & machinery and investment in environmental efficiency such as solar panels from the calculation of rateable values. The current business rates system penalises investment in such assets since doing so increases rateable values. Businesses are therefore discouraged from investments that have the potential to boost worker productivity and pay, or investment that could help the UK meet its carbon reduction commitments. CBI analysis finds that in future if new investments in plant and machinery were exempted from Business Rates, sufficient additional investment would be unlocked that this reform would have no net fiscal costs to the government in the first five years.

The business rates system will also need to be reviewed to ensure it keeps pace with modern business, including eventually moving to annual property valuations. Most tax liabilities are based on real time or annual estimates of economic activity. In the longer term the UK should consider implementing annual valuations of commercial property to tie business rates more closely with actual rent levels. This would follow the best practice of Hong Kong and the Netherlands that have moved to an annual commercial property valuation cycle. Annual valuations would result in smaller changes in valuations.
As businesses would no longer be locked into outdated valuations for multiple years, this would reduce the incentive to appeal against smaller disagreements between the VOA and businesses regarding the correct rateable value of a commercial property.

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