A TAX SYSTEM THAT ENABLES BUSINESSES TO INVEST AND GROW

TAKING A CLOSER LOOK AT THE BUSINESS RATES SYSTEM

In an increasingly digitalised world, it has never been a more crucial time for the Government to act and set out a path for reform to the broken business rates system. Changing business models and consumer preferences together with weak business investment and subdued growth are providing a challenging adjustment period for businesses reliant on commercial property. It is therefore vital that the tax system supports this adjustment for all sectors and regions across the economy, and not hamper investment decisions that are critical to future growth and prosperity. There are some immediate changes the Government should implement, before taking a closer look at how the business rates system is operating, with the long-term goal of developing a taxation model that is fair and effective across the whole economy.

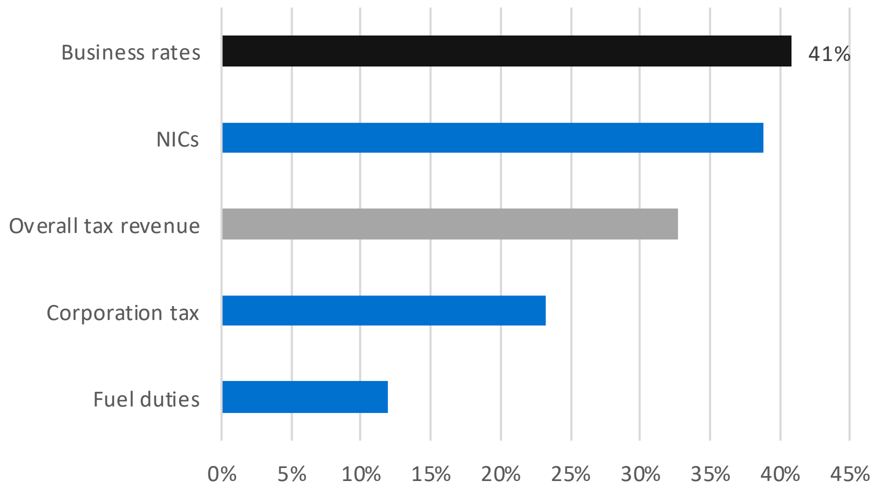
The changing environment for business rates

Business recognises the importance of business rates as a source of revenue for both central and local government, accounting for 4%[1] of total tax revenue and 16%[2] of local government revenue. In addition, their collection and administration mechanism are relatively simple for government because the tax base is immovable and therefore difficult to avoid.

Business rates reflect a significant burden on business

However, business rates represent a significant tax burden to businesses: 14 pence in every pound of tax paid by business is in business rates.[3] In 2017/18 businesses paid £27 billion in business rates, over half the revenue raised from corporation tax[4] and almost the equivalent of the defence budget that year.[5] This burden has been increasing over time, outpacing growth in overall tax revenues, as well as other business taxes.

Exhibit 1: Growth in nominal tax revenues since the financial crisis (2007/08-2017/18)



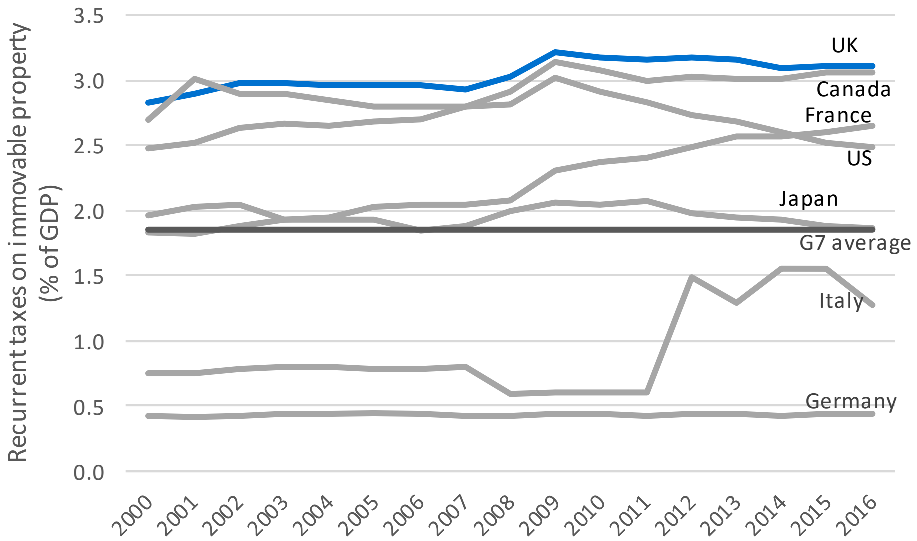
Source: CBI analysis of ONS receipts data for the years 2007/08 and 2017/18

[1] Reflects 2017/18 data, ONS receipts September 2018.
[2] Reflects 2017/18 budget data, Local authority revenue expenditure and financing England: 2018 to 2019 budget.
[3] CBI analysis on ONS receipts data published on 21st September 2018.
[4] ONS public sector current receipts, September 2018.
[5] Based on Departmental settlements set out at Spending review 2015.

The burden of property tax is the highest internationally

The UK relies more heavily on property taxes to fund public services than its international counterparts. As a percentage of GDP, property taxes are the highest across the G7 and this has been increasing over the past decade, whilst over the same period countries such as the US and Japan have seen a decline. This is making the UK less attractive to international investment, particularly when that investment includes the acquisition of commercial property.

Exhibit 2: Annual property taxes across the G7



Source: Recurrent taxes on immovable property, Global revenue Statistics Database, OECD

This issue is compounded by the lack of competitiveness of the UK's capital allowances regime. As the CBI's 'Catching the Peloton' report[6] showed, the present value of the UK's capital allowances regime is only 46% compared to an average of 64% across the rest of the G7. Much of this can be explained by the absence of allowances for industrial buildings in the UK (which make up close to 16% of total business investment in the UK). The present value of capital allowances for plant and machinery is also one of the lowest in the G7 and the current business rates system is applied to some plant and machinery as well as the building, resulting in a double hit for investors.

The burden of business rates falls disproportionately across sectors

Although not designed to target specific sectors, the reliance of certain business models on commercial property results in a disproportionate amount of the tax burden falling onto those sectors. Almost 70% of rateable properties are shops, offices, warehouses and factories[7] and therefore businesses in the retail, professional services, logistics and manufacturing sectors contribute a significant proportion to the total revenue raised from business rates.

The struggle of the retail sector

The retail sector is facing significant challenges over the short and longer term. In the short term, subdued consumer spending, because of weak real wages, is softening demand growth. In addition, cost increases are hitting retailer margins and, in part, are being passed onto the already embattled consumer. The latest CBI surveys show that these factors are driving a deterioration in sentiment and investment in the sector.[8]

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[6] http://www.cbi.org.uk/index.cfm/_api/render/file/?method=inline&fileID=2AED1099-B38E-4E43-8864FA36395E075E
[7] CBI analysis on VoA complied local ratings list 2017.
[8] CBI quarterly distributive Trades Survey, August 2018

Over the longer term, it is widely acknowledged that the retail sector is undergoing a structural change, with advancements in technology and changing consumer habits leading to a shift away from traditional business models, based on bricks and mortar, towards online and digital retailing. Retailers are changing and adapting to this but to do so requires investment and an element of business risk which is more challenging in the current trading environment.

Business rates is a significant cost to this sector - over a quarter of rateable properties are shops and some retailers have cited that their business rates bill is double their corporate tax bill.

Whilst the overall vacancy rate (the proportion of empty commercial properties) has been declining slightly over the past six years, there has been a significant shift in the type of shops seen on the high street and in retail parks. Consumer services shops such as hair and beauty salons, barbers, takeaways, coffee shops and restaurants, as well as charity shops have been replacing pubs, banks, clothes shops, newsagents and travel agents.[9] By way of example, since 2012, over 40% of women's clothing units were re-occupied by non-fashion retailers including gift shops, charity shops and beauty salons.[10] This could be partly explained by the shift towards online shopping. For the former group of businesses, it is likely to be more challenging to transition towards online retailing than the latter group, and in some cases impossible.

What is important to take from this is that shops in the first group are more likely to receive reliefs from business rates, e.g. charity shops, than shops in the second group, suggesting the tax base could be narrowing.[11] As the current business rates model requires the government to maintain the revenue it receives, the same amount of tax is being taken from fewer rates payers, increasing the burden on individual businesses.

The challenge for production industries making long term investment decisions

Manufacturing and other production industries such as utilities rely heavily on large buildings as well as plant and machinery, which are subject to business rates. Due to the nature of these sectors, there is typically a long lag between an investment decision being made and the investment becoming commercially viable, generating returns for the business. In addition, the size of the investment required up front is often significant with returns realised over a number of years. Consequently, investment decisions in these sectors are based on long-term assumptions about the tax and regulatory environment, of which business rates are a factor. For an energy storage company in the UK, business rates have played a significant role in determining the profitability of the business, as well as their investment decisions.

Case study: Energy storage company in the UK

For an energy storage company in the UK, it took 6-7 years from the purchase of the building for the facility to become commercially viable. The initial investment decision was based on the rateable value for 2009 but the 2010 revaluation resulted in a five-fold increase in their rateable value, while at the same time, the drivers of storage value fell significantly. At the 2017 revaluation, the facility saw a decrease in their valuation but due to the transitional arrangements the business has not been able to reap any of the benefits: their rateable value decreased by 59% but their business rates bill reduced by only 1%. Furthermore, in 2017, business rates accounted for 45% of their total operating expenditure and 40% of revenues, meaning the business has yet to become profitable. This has directly impacted their ability to reinvest in the facility.

Business rates directly impact business' investment decisions

The burden of business rates not only impacts significant capital investments in production industries, it affects business investment across the economy. The disproportionately high tax rate disincentivises investors from developing commercial property, encouraging a shift towards the development of residential

[9] The Local Data company collects data on the retail and leisure industry.
[10] Analysis from the Local Data Company on store openings and closures.
[11] The Local Data Company analysed the top four categories of store closures since 2012 and assessed what happened to those units.

property. Between 2015/16 and 2016/17 alone, 35% more dwellings in England were converted into residential properties.[12]

As well as affecting investment decisions in new property, business rates also impact the decisions of occupiers to further invest in their existing premises. Any capital investments in plants and machinery made by the occupier will increase their business rates bill, and sometimes this can be the deciding factor when evaluating an investment proposal. One business cited that it was more financially viable for them to deactivate a plant than to reinvest in upgrading the assets due to the associated business rates bill.

Business investment is a key enabler of productivity improvements and as a result future prosperity. However, business investment in the UK is falling behind its international peers, accounting for only 9% of GDP, compared to 13% across the rest of the G7.[13] The CBI's report, 'Catching the Peloton', found that this underperformance is only partly explained by a declining manufacturing base and uncertainty caused by Brexit, pointing to a deeper structural issue at play. Even though business has a key role in delivering investment, the Government must ensure the policy environment both promotes and encourages businesses to make investment decisions.

The tax system is one lever the Government can use as an enabler of business investment. However, under the current business rates system investing in digital, new technologies and energy efficiency such as fibre optic and solar panels increases the business rates bill and can therefore act as a barrier to investment.

Setting out a roadmap to a simpler and fairer system

It is clear from the evidence above that the current business rates system is not creating the right incentives across the economy and is in urgent need of reform. The CBI acknowledges that reforming the system to ensure it is simple and fair across ratepayers and across the economy will take time. However, there are some changes the Government can make immediately to alleviate the pressures of the most recent revaluation and help to unlock business investment in new and existing property.

Exhibit 3: Package of policy recommendations

<table>
<tr><th></th><th>Short-term</th><th>Medium-term</th><th>Long-term</th></tr>
<tr><td>Fairness</td><td>Remove transitional payments for devaluations</td><td></td><td rowspan="3">Reform the current system so that it works for everyone</td></tr>
<tr><td>Unlocking business investment</td><td>Introduce a business growth accelerator
Implement design changes to partly occupied relief</td><td>Mandate partly occupied relief
Exempt productivity enhancing investments from plant and machinery</td></tr>
<tr><td>Ensuring effectiveness</td><td></td><td>Conduct a review of the business rates system</td></tr>
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Increasing fairness and unlocking business investment immediately

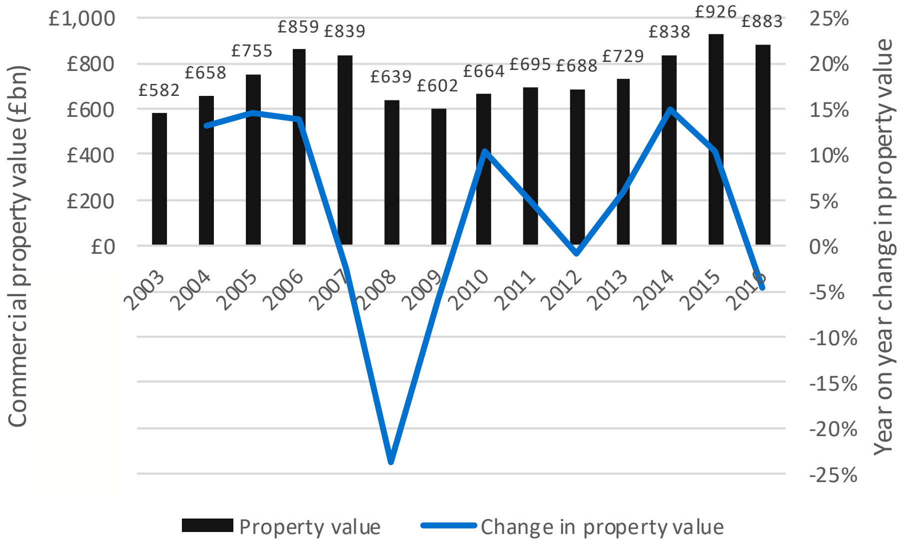
Ensure the recent revaluation is fair across rates payers

The recent revaluation has impacted many businesses across the UK. The 7-year revaluation period (2008-2015)[14] spanned the aftermath of the financial crisis, a period where property prices changed significantly. During the financial crisis, property values declined (a fall of 24% in 2008 alone), before rebounding in subsequent years as the economy recovered. However, the recovery in property values has outpaced that of

[12] Department for Communities and Local Government, Housing supply; net additional dwellings, England: 2016-17, November 2017.
[13] See the CBI's report "Catching the Peloton": http://www.cbi.org.uk/insight-and-analysis/catching-the-peloton/
[14] Properties were revalued in 2010 and 2017 based on 2008 and 2015 prices respectively.

the broader economy, an increase of 45% over the revaluation period compared to GDP growth of 8%.[15,16] As a result, businesses are not only facing tough economic conditions but also rising costs.

Exhibit 4: Aggregate value of UK commercial property (2003-2016)

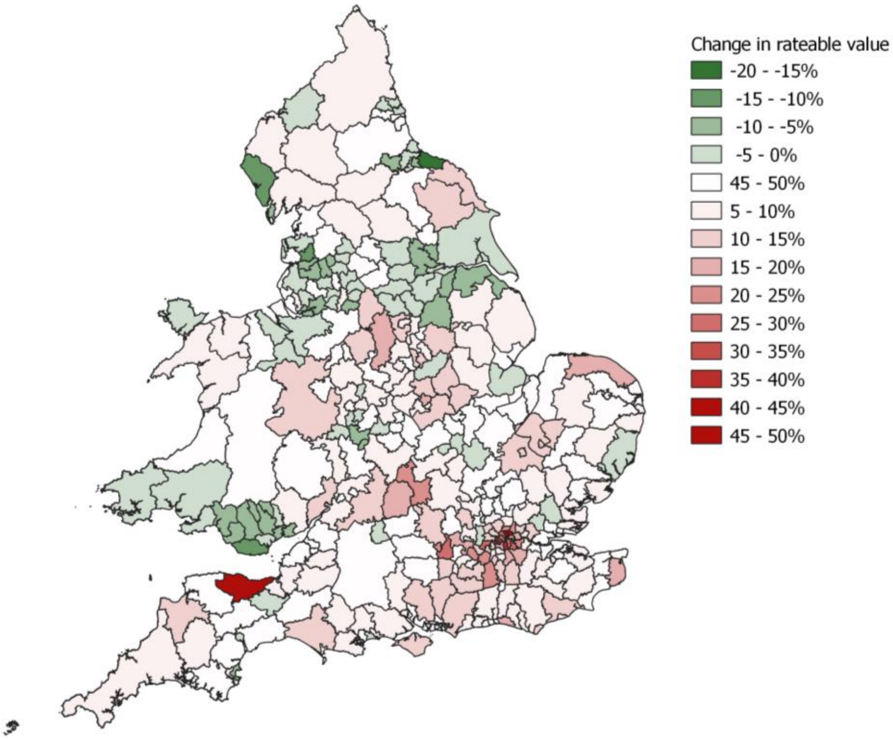


Source: Paul Mitchell estiamtes using VOA, Socttish Government and IPD data.

While on average the rateable value of properties[17] has increased by 9% over the revaluation period, the regional disparities are significant. At one end of the spectrum, Hackney saw a 46% increase in its average rateable value, whereas Redcar and Cleveland saw a 20% fall and some areas such as Wyre saw no change.[18]

[15] IPF The Size and Structure of the UK Property Market July 2017, Paul Michell estimates using VoA, Scottish Government and IPD data
[16] ONS Gross Domestic Product: chained value measures seasonally adjusted £m
[17] The total value of properties that forms the business rates tax base.
[18] Total number of Rateable Properties, Total Rateable Value and Percentage change in Rateable Value by Administrative area, VoA Administrative Data as at 31 March 2017.

Exhibit 5: Change in average rateable value by Local Authority (2010 to 2017)



Source: CBI analysis on VOA administrative data as at 31 March 2017

Businesses in areas where property prices have increased significantly have been supported by the introduction of transitional arrangements[19], enabling them to adjust to their new business rates bill gradually. However, as the transitional arrangements are also in place for those properties that have decreased in value, businesses owning these properties have taken on the burden of the overall price shift. As a result, businesses in areas where the rateable value fell are unable to benefit from a reduced business rates bill immediately. Not only are these businesses located in areas where the recovery in property values has been sluggish, these areas have also typically seen a slower recovery in economic activity, further hampering the growth or recovery of those businesses.

Consequently, downward transitional arrangements place a disproportionate burden on businesses in areas in the greatest need of investment. In addition, businesses have cited that decisions to open or close premises are considered on a site by site basis and not at the aggregate level. Removing downward transitional arrangements could help to support the Government's industrial strategy by encouraging business investment in less prosperous areas.

Recommendation 1: Remove transitional arrangements for properties whose rateable value decreased because of the 2017 revaluation. From April 2019, the rates bill of these properties should reflect the 2017 rateable value, while upwards transitional relief should be maintained.

Encourage investment in new property and improvements in existing property

Under the current system, businesses that occupy a building for non-domestic purposes are liable to pay business rates annually. The business rates bill is due regardless of whether the building is being used for commercial activities or not. Typically, there is a lag between the purchase of a commercial property and putting it to productive use, which is not reflected in the business rates system. In addition, this lag can vary

[19] Transitional relief was introduced to limit the amount a business rates bill can change as a result of revaluation. Businesses are eligible for transitional relief if the property is in England and their bill goes up or down by a certain amount.

significantly by sector and by business model, placing some businesses at a disadvantage. In some cases, business rates can be the tipping point when deciding whether to invest in a new premise.

A similar situation arises when renovating or expanding part of an existing premise. The businesses rates bill goes up immediately after the renovation is complete, regardless of whether the improvements have started to deliver value for the business. As with new buildings, it can take time for businesses to get back to full operation following facilitiy improvements, but in the interim, businesses will be hit by a potentially significant increase in their business rates bill.

Providing an exemption from business rates for new properties and property improvements will give the business the necessary time to begin commercial activity before facing the cost of business rates. By reducing the immediate burden, investing in commercial property is more likely to be financially viable.

Recommendation 2: Introduce a similar measure to Scotland's Business Growth Accelerator that enables new properties or improvements to existing properties to receive a 12-month holiday from business rates payments.

Under the current system, businesses renovating their property could benefit from partly occupied relief. This relief is available at the discretion of the local authority. Businesses can apply for the relief and if granted, their business rates bill will be apportioned based on the use of the property.[20]

When this relief was first introduced, it worked well and was welcomed by business. However, subsequently empty property relief has been introduced which makes the relief more complex as it does not take into consideration partial occupation.

Businesses benefitting from empty property relief will be disincentivised from using part of the empty space for productive purposes even when there is demand. This is because relief on partly occupied space is not guaranteed and therefore the risk of being liable for the total business rates bill often outweighs the benefit of utilising the space. This scenario is particularly typical of logistics businesses who often rent their space to multiple users.

Case study: Logistics company in the UK

A logistics company in the UK currently has 500,000 sqft of warehouse space vacant and are benefitting from empty property relief. Although there are multiple business requirements for a small percentage of the space, there is little incentive to utilise the space due to the risk of triggering the full business rates liability.

In addition, the increased localisation of business rates means local authorities do not have an incentive to grant the relief. Revenues from business rates represent a significant share of local funding needed for local infrastructure. One business cited being rejected for partly occupied relief on the basis that the low level of occupation was classified as normal business operations by the local authority.

Reviewing the interaction of partly occupied relief and empty property relief and the circumstances under which partly occupied relief is granted will help to encourage efficient use of space and the accompanying economic benefits. Setting out a strict set out guidelines for granting partly-occupied relief and reimbursing local authorities for any loss in revenue because of this relief will ensure its effectiveness.

Recommendation 3: Introduce a strict set of guidelines setting out in what circumstances local authorities should grant partly-occupied relief. This should be revenue neutral to local authorities such that any relief granted should be reimbursed by central government.

[20] Section 44a as set out in the legislation.

Ensure business rates policy is effective and supportive of growth

Research indicates that well designed taxes on immovable property are less distortive than other taxes. As the supply of property is not very responsive to its price, it is difficult to avoid and easy for the tax authority to identify the tax payer.[21] However, the approach to taxing property can be complex and as the economy modernises and becomes more digitalised, the tax system also needs to evolve. A more digitalised economy brings additional distortions from the business rates system. As property values increase and the burden of business rates rises, some businesses are more sheltered as they can move their trading online, while others that rely on commercial property are more exposed.

At a time of subdued business investment, the tax system should be looking to encourage not impede investment decisions, particularly those investments that can help to address the UK's productivity problem.

It is well cited by the business community that reform to the business rates system is crucial to ensure fairness across business models and sectors within the economy and to provide the right environment to enable businesses to invest and grow.

Longer-term reform should be considered in the context of the whole suite of taxes borne by businesses. Businesses contributed almost 30% to tax revenues in 2017/18. While the traditional large taxes of corporation tax, NICs and business rates are still the main drivers of this contribution, the list of "other" taxes has been increasing over time, more than doubling since 2009/10.[22] Reviewing taxes independently is likely to discount the interaction between different elements of the tax system and its impact on the effective tax rate, the rate that businesses base their decisions on.

Recommendation 4: Conduct a review of the business rates system in 2019/20 ahead of the next revaluation, in the wider context of business taxation. The review should do the following:

- Analyse the sectoral impact of business rates and how the design of the tax could be more supportive of key sectors as part of the UK's Industrial Strategy and remove existing distortions.
- Evaluate the long-term sustainability of the business rates tax base, including considering how changing business models and consumer preferences has led to a narrowing of this base.
- Evaluate the long-term viability of the business rates multiplier, currently around 50%, and consider options for addressing this.
- Consider the advantages of moving towards annual revaluations, which would remove the need for transitional arrangements. This should include consideration of how modernisation of tax administration, including the adoption of digital technologies as has been done as part of Making Tax Digital, could help in achieving this given the existing capacity constraints at the VoA.
- Review the current scope of the application of business rates to plant and machinery within commercial property and examine the economic impact of excluding certain types of productive and energy efficient investments.

If you would like to know more, please get in touch with CBI Principal Economist Megan Baddeley.

[21] Tax principles stipulated by the OECD, the IFS and others.
[22] CBI analysis of ONS receipts data