

8

Business taxation

Summary

This chapter argues that changes to business taxation can provide greater local flexibility for communities to invest in themselves and in the infrastructure needed to support growth, and improved incentives for the efficient use of land.

Both local authorities and businesses are keen to engage in a constructive dialogue about how best to foster economic development and growth at the local level. In order to support the positive signs of a developing relationship I recommend the RPI cap on business rates should not be removed and business rates should not be relocalised.

I also recommend introducing a power for local authorities to levy a local supplement in order to increase local flexibility and support the continued investment in infrastructure that both businesses and local authorities have called for, subject to detailed consultation with, and a strong voice for, the business community.

Better incentives for the efficient use of land could be provided through reforms to the empty property relief and by the possible taxation of derelict and previously developed land. The other reliefs and exemptions from business rates also need to be reviewed.

In taking forward a possible Planning-gain Supplement the Government should ensure it is designed as a local tax with an appropriate regional share, not as a national tax, in order to maintain the necessary local connection.

There are some arguments in favour of new taxes to reflect tourist pressures in some areas. The Government should conduct wider consultation before considering the introduction of permissive powers to allow local authorities to levy such taxes.

INTRODUCTION

8.1 Businesses are important stakeholders in the debate on local government. Over the course of my Inquiry I have received many detailed and constructive submissions from businesses and business organisations, keen to engage both with taxation issues, and also with wider questions about the role of local authorities and their potential contribution to economic growth and a successful business environment. My description of the place-shaping role of local government has been welcomed by local government and business (most notably in the recent joint statement by the Local Government Association (LGA) and the CBI, *Making 'place shaping' a reality*), and I believe that there is real potential for better and closer engagement between businesses and local authorities in the pursuit of their mutual interest in successful and prosperous places.

8.2 Taxation has, unsurprisingly, been an issue of immediate and significant concern to businesses during the Inquiry and there are some difficult and contentious issues to be addressed. Though not all will agree with my conclusions, I think it is important that we approach the subject with the objective of enhancing relationships between businesses and local authorities, and providing authorities with the tools and incentives they need to engage effectively in fostering

economic prosperity. As one business in Leeds put it, I believe we need to create “a debate on investment, rather than a debate on taxation.”¹

8.3 This chapter considers three different existing or potential local taxes which are paid, in the main, by businesses. It concentrates on business rates but also discusses the proposed Planning-gain Supplement (PGS) and taxes on tourist pressures.

BUSINESS RATES

8.4 Business rates (formally called ‘national non-domestic rates’) are an important part of the local government finance system, providing billions of pounds each year to support public services delivered by local government. They are at one and the same time both a contested part of the system – with recurring arguments over the last 17 years over whether the tax rate should be set locally or nationally – and a tax which in its fundamentals seems to be little questioned. This section:

- discusses business rates both as a tax and as a part of the local government finance system;
- considers whether the current level of tax and contribution from business is appropriate;
- assesses how changes to the business rates system could provide greater local flexibility; and
- looks at the efficiency and fairness of rates as a tax, including the exemptions and reliefs within the tax.

Business rates in local government

8.5 Property taxes on non-domestic property have been part of the English local taxation system for many hundreds of years, for most of that time as part of a combined tax on all property. This is an experience repeated in most other countries around the world including Germany, France, Denmark, Ireland, New Zealand and across the United States, where some form of business property tax (either as a separate tax, or as part of a general property tax) forms part of the local tax base.

¹Lyons Inquiry Business Engagement Events, 2006.

Business rates

Business rates are a property tax for which the occupier or owner of most non-domestic land and property is liable. This applies to shops, factories and offices, but also includes public buildings, pipelines and advertising hoardings. Some land and property, including agricultural land and associated buildings, derelict buildings or unoccupied land, and churches and other places of religious worship, are exempt from rates. Other types of property receive reliefs, including small businesses, charities and empty properties.

Each property has a rateable value based, broadly, on the annual rent that the property could command on the open market, with revaluations conducted every five years. The amount of money to be paid each year is a proportion of the rateable value, determined by a tax rate known as the multiplier. Prior to 1990 this was set separately by each local authority, but it is now set by the Government on a national basis. The multiplier for 2006-07 in England is 42.6p for small businesses and 43.3p for larger businesses. It is adjusted each year so that between revaluations the tax rate rises only in line with Retail Price Index (RPI) inflation (new properties and improvements pay this tax rate, and do therefore contribute to an increase in overall yield). At each revaluation the tax rate is recalculated to maintain the yield from the tax in real terms, taking account of likely appeals.

The vast majority of revenues from rates are collected by local authorities, though some properties are administered through a separate central list.

Full details on business rates can be found at www.mybusinessrates.gov.uk, www.voa.gov.uk and on local authority websites.

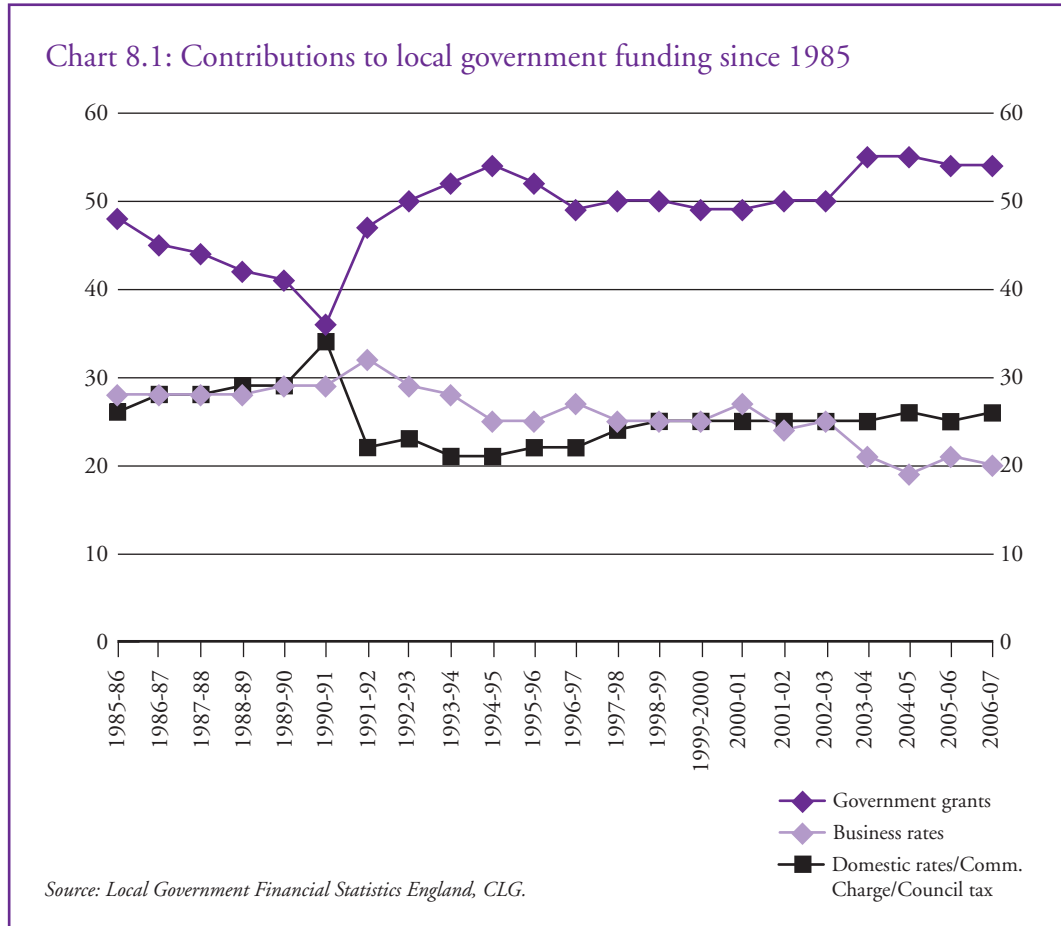
8.6 Until 1990, business rates were set by local authorities alongside domestic rates. Indeed, it does not seem to be widely understood today that business and domestic rates were actually aspects of the same tax. In principle, business and domestic properties faced the same rate of tax, though in practice central government provided resources through grant (the Domestic Element of Rate Support Grant) to reduce the tax rate on domestic properties by 18p in the pound. It is not, therefore, true to say that prior to 1990 local authorities were able to choose to place a greater weight of taxation on businesses rather than residents. This mistaken view does, unfortunately, seem to have become the accepted wisdom in debates on local business taxation.

8.7 In 1990 business rates were separated from domestic rates, and the latter were replaced by the community charge. Since then the status of business rates has become more complex. They remain fundamentally the same tax, and local authorities continue to collect the revenues. Authorities also have some discretion over the level and granting of reliefs, for example, to charities and for hardship. However, since 1990 the tax rate has been set centrally and levied at a national rate, with the locally collected revenues redistributed centrally as part of the government grant system. It would perhaps be most accurate to call the present system of business rates a national tax, but one that is assigned to the funding of local government. It does mean that there is some confusion about the purpose of the business rates system – because of its history and the way it is collected, it is still perceived by many businesses as a local tax, but it is actually used in great part to fund the provision of services according to national expectations and requirements. Since the removal of schools funding from Revenue Support Grant (RSG) in 2006-07, business rate revenues have become an essential source of the funding needed to allow equalisation between authorities for needs and resources.

The contribution from business rates

8.8 Businesses as a whole have been protected from real-term increases in rates, because of the way in which legislation lays out how the tax rate is to be calculated (as described in the above box). As local government grants and council tax revenues have risen significantly faster than both inflation, and increases in the number of business properties, business rates have provided a falling

proportion of local government spending over time. In 1990, when the national business rates system was introduced, business rates raised £9.6 billion and provided 29 per cent of local government revenues. In 2006-07 business rates are expected to provide around £17.5 billion or 20 per cent of local government spending.² The changes in the mix of funding over time is shown in the chart below.



Business rates in the wider tax system

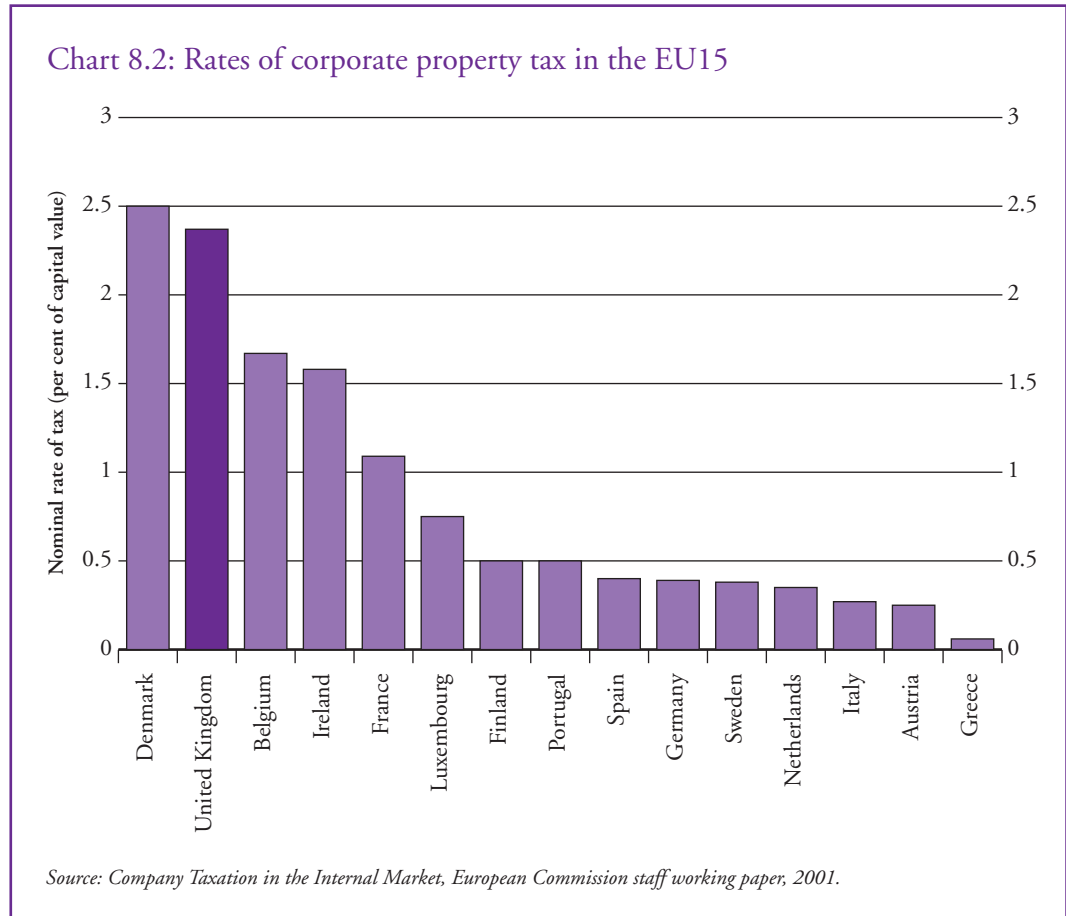
8.9 Business rates are a significant tax for businesses – in 2006-07 they are expected to raise around £18.4 billion in England (£20.3 billion across the UK), compared to £47.5 billion (net of tax credits) in UK corporation tax on business profits. Research suggests that for most businesses, rates account for around three per cent of turnover, although this can vary substantially between companies in different parts of the country and different sectors of the economy, and be much higher for small businesses.³

8.10 Some, particularly those for whom property is a substantial part of their costs, challenge the weight of taxation levied on property through business rates. In my discussions with businesses, concerns were expressed by some in the retail and manufacturing sectors about the greater burden they perceived from business rates because of their significant property usage. This was a significant issue during the 1970s and 1980s, though it has been more muted in recent years, as a result of the more prominent debate about whether the tax rate should be set nationally or locally. The growth of e-commerce retail businesses with little need for property, particularly in expensive city centre and high street locations, also raises questions about how the tax burden falls across business sectors, and how that may change in the future.

² This figure is lower than the £18.4 billion total expected yield from business rates mentioned below because of the way in which the business rates pool manages fluctuations from year to year.

³ IFF Research Ltd, *The Impacts of Rates on Businesses*, Department of the Environment, 1995.

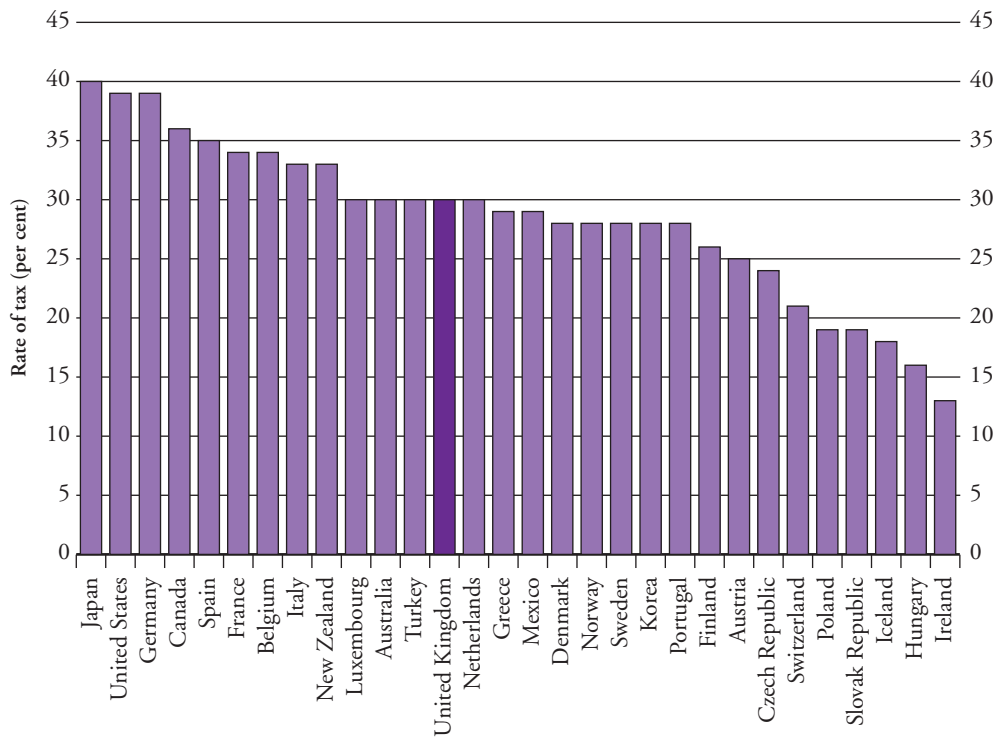
8.11 It is true that business rates are a more significant tax on business property than comparable taxes in most other European countries. Analysis in 2001 showed that the rate of property tax on business in the UK was second-highest in the EU15, as shown in the chart below.⁴



8.12 At the same time however, the UK had lower levels of corporate income taxes and social security contributions than other countries, something that clearly needs to be taken into account in assessing the overall position for business taxation in the UK. This is illustrated in the charts overleaf.

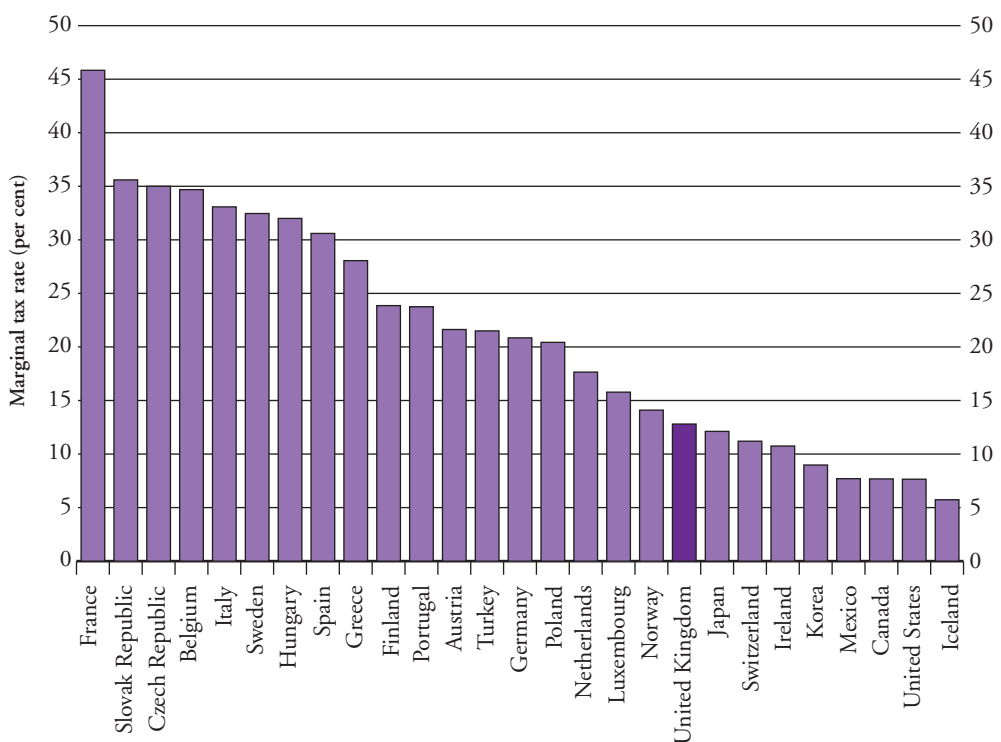
⁴ EU15 refers to 2001 at which time the European Union had only 15 members.

Chart 8.3: Rates of corporate income tax in the OECD



Source: OECD, Tax Database 2006.

Chart 8.4: Rates of employers' social security contributions in the OECD



Source: OECD, Tax Database 2006.

Reforms to business rates

8.13 Business rates are a successful and stable property tax, with a wide tax base, and while the rate can be unpopular, the principles of the tax do not excite significant opposition from ratepayers. Properties have been successfully revalued for the purposes of business rates every five years since 1990, which is a great success when compared with council tax, and with historical experience. Compelling arguments would therefore be needed to make significant reforms to the current system.

8.14 However, there have been calls for business rates to be abolished and replaced by other forms of taxation. Some believe that it would be better to tax businesses entirely on the basis of profits, a position supported by one small businessman in the regional events who argued that “you could abolish, or reduce, business rates and instead get that tax from other business taxes such as corporation tax. This would shift the burden across to those who are able to pay.” However, very few stakeholders (and none of the business representative organisations) who made submissions to the Inquiry expressed any support for this proposal. Abolishing business rates and making up the shortfall in revenues through an increase in corporation tax would require a very substantial increase in that tax.

8.15 Chapter 6 showed that other stakeholders have called for the replacement of business rates with tax on land values. As noted there, land value taxes have some clear theoretical advantages. Nevertheless, given that business rates already have some of the attributes of a land value tax, strong arguments would be needed to support a wholesale change. A consideration against the principles of a land value tax can help to suggest areas for reform and suggests that reform, rather than replacement, is the most pragmatic approach.

8.16 One significant difference between business rates and pure land value taxes are that business rates are a tax on property as well as land. As noted in Chapter 6, the taxation of property can have some distorting features, but it increases the width of the tax base, which enables a lower tax rate to be charged (and in practice many land value taxes in other countries include at least an element of tax on property for precisely this reason). Another difference is that business rates are a tax on current use value, rather than the optimum use of the land, which potentially means that they do not provide the same incentives for underused property or land to be redeveloped for another use. To change this would be a substantial alteration in the principles of business rates as they currently stand.

8.17 Not all non-domestic land and property is liable for business rates. There are a number of reliefs and exemptions which have been introduced over the years, for a variety of economic and policy reasons, which I identified in my interim report and are considered further later in this chapter. The existence of reliefs and exemptions means that, for a given level of revenue, the tax rate is higher than it would otherwise need to be. They also potentially create distortions between different types of business and uses of land. The most significant exemptions and reliefs in terms of revenue given up are empty property relief, charity relief and the exemption of agricultural land and buildings. The exemption of derelict brownfield land is also an important omission in theoretical, though not necessarily in value, terms.

8.18 Business rates differ from a purist model of property tax in the way that the rate is set. Following the 1990 reforms, the tax rate is now recalculated at revaluation to maintain the yield in real terms and increased in line with the RPI between revaluations. Although the fixed yield approach is predictable, which has advantages for both government and business, it does potentially have some negative economic consequences. In particular it means that the tax rate (expressed as a proportion of current rental value) will increase if the commercial property market weakens and rents fall, but conversely that the tax rate will fall when commercial property increases

in value. This has a pro-cyclical effect on the commercial property market – the tax take increases as a percentage of value in downswings, and falls in upswings. This is an inevitable consequence of the design of the tax, where yield is not related to property values. This also makes business rates a rather unusual tax in comparison with almost all others – not only is the tax rate set in legislation, with no flexibility for the government to alter it as part of its decisions about the overall tax system, but it means that there is no buoyancy in the yield, and increases in property values, reflecting economic growth and greater prosperity, do not lead to any additional revenues.

8.19 One further potential criticism comes from the fact that business rates are levied on occupiers rather than owners. Some of those who made submissions to the Inquiry, particularly in the context of Business Improvement Districts (BIDs) argued that it is landowners, not occupiers, who benefit from increases in the value of land that greater economic activity and public investment can create. However, economic theory suggests that the person who really ends up paying the tax is not necessarily the same as the person who hands over the money initially. In the case of property taxes, we would expect the owner to bear the final burden, because he or she will receive lower rents where taxes and other occupation costs are higher. There is some discussion on the market conditions necessary for this to happen – Kay and King argue in their classic work on the British tax system that outside city centres and areas where land is in high demand, some of the impact might fall on employment, prices or profits.⁵

8.20 However, the available empirical evidence on business rates supports the theory and suggests that it is landlords who bear the cost (or receive the benefit) of changes in rates. For example, in the Enterprise Zones (a policy introduced in the 1980s in which properties in certain areas were given a complete exemption from rates for a ten year period) the evaluation shows that rents in the zones tended to rise to reflect the absence of business rates, thus transferring much of the benefit of the exemption from the occupier to the owner.⁶ In the short term, tenants do face the cost of higher rates because their rents do not respond quickly, due to multi-year rent agreements and upward only rent reviews, but in the medium to long term almost all of the impact will fall on landlords in terms of lower rents. This means that, all other things being equal, a rise in business rates will lead to a fall in property values to reflect the reduced value of future rental streams, and that a reduction in rates will lead to a rise in property values. These are issues that I will return to later, as they are relevant to some of my proposals for the reform of the tax.

The rate of tax

8.21 I highlighted earlier in the chapter the fact that the proportion of local government spending funded by business rates has fallen over the last 17 years from around 29 per cent of local government spending before 1990 to 20 per cent in 2006-07. Some of those who made submissions to my Inquiry – particularly local authorities, but also some commentators and experts – felt that this was unfair. They pointed out that while business rates had been constrained by the RPI cap on the tax rate, council tax bills had increased substantially in real terms since the introduction of that tax. One analysis in 2004 suggested that if the contribution from the domestic and non-domestic sectors had risen at the same rate over the period since 1989-90, business rates would now raise around £1.5 billion a year more.⁷ There have therefore been calls for an increase in business rates, either to rebalance the current burden, or to spread the load more widely in the future, and thus reduce council tax increases.

⁵ Kay, J. and King, M., *The British Tax System*, 1990.

⁶ Institute for Fiscal Studies, *The Relationship between Rates and Rents*, Department of the Environment, 1993; Mehdi, N., *The Capitalisation of Business Rates: An Empirical Study of Tax Incidence in Six London Boroughs*, PhD thesis, 2003; PA Cambridge Economic Consultants, *Final Evaluation of Enterprise Zones*, HMSO, 1995.

⁷ Hale, R., *The Relocalisation of the Non-Domestic Rate – A Discussion Paper*, CIPFA & Rita Hale Associates, 2004.

The current arrangements for the increase in business rates – currently limited to RPI by law – should have been more in line with the Government’s own planned increases in council tax, thereby sharing the proceeds and burden of growth. (East Sussex County Council)

8.22 A small number of members of the public also felt the same way, including the Devon Pensioners’ Action Forum:

[our] strongly held view is that the burden of Devon County Council’s tax rises should, at the very least, be spread evenly between the business sector and private householders instead of over 80 per cent of these increases being piled onto the County’s hapless council tax payers.

8.23 Businesses and their representative organisations strongly resisted this line of argument. They felt that increases to the level of business rates would be damaging to the economy, particularly given the relatively high level of property taxation in the UK. The CBI and British Chambers of Commerce (BCC) both argued that the national tax burden on business had increased in recent years, and that they were therefore making a contribution through the government grants funded from national taxation. Finally, some argued that many of the increases in local government spending have been targeted at areas from which they perceive little benefit, such as social services and domestic waste management, while some of the services they are more concerned about, such as highways maintenance, have not been prioritised. Some business bodies, for example, London First and the Federation of Small Businesses, called for business rates to fall over time.

We propose... gradually reducing the annual increase in the national business rate i.e. by RPI minus. This would have the consequence of reducing grants to London boroughs in real terms and at the same time require them constantly to seek efficiency savings. (London First)

8.24 There are pressures on local government spending which need to be funded or managed in some way, which I discussed in Chapter 3. Raising more money from business rates, either as a one-off rise in the rate of tax, or through a gradual increase (for example, changing the way in which the tax rate is adjusted from year to year to use general growth in the economy, rather than the change in the RPI) would be a way of raising additional resources to take pressure off council tax. Using business rates would have advantages in this regard, as they are an accepted and robust form of taxation, and they apply across a wide tax base.

8.25 However, I have concluded that for the present, the national business rate is not an appropriate way to raise additional resources to fund general local government activity and services. The most pressing need is to develop much more constructive relationships between local authorities and businesses, focused on joint interests in fostering economic prosperity and investment in local infrastructure. A general national tax rise to support local government funding could put the development of those relationships in jeopardy, particularly given the high level of taxation on property that business rates represents, by international standards. Future governments might wish to review this arrangement, and consider some of the other options discussed later in this chapter.

Recommendation 8.1

The RPI cap on the national level of business rates should be retained.

Greater flexibility for local communities

8.26 Earlier chapters of this report have argued that local communities need greater flexibility over how they use existing revenues. I believe that they also need more power to choose to raise

new local revenues to invest in themselves. Businesses have identified a need to invest more in the infrastructure needed to support future growth – the CBI for example “has estimated that projects worth at least £300 billion should be initiated in the next ten years to deliver a better transport system” – and an appetite for greater engagement with local authorities on economic development, including a willingness to discuss how the revenues for investment might be found.⁸

8.27 That concern can perhaps most easily be exemplified by reference to the debate in London on Crossrail, but examples exist across the country. Rod Eddington’s Transport Study showed that there are a large number of projects – some with relatively modest overall costs – that could provide substantial benefits to local economic growth if resources could be found to support further investment.⁹ Where spending is targeted to such projects it should support an expansion in the number and success of businesses and the value of the properties in an area. Thus, combined with effective incentive for local communities – which Chapter 9 considers in more detail – greater flexibility over raising revenues to invest at the local level should allow communities to strengthen their own economies and tax bases over time.

8.28 This section considers whether business rates could provide some of that flexibility, and the ability to fund new investments, whether through existing arrangements, or through other reforms. Such arrangements need to be transparent and accountable, helping to develop greater trust between businesses and local authorities.

Existing flexibilities

8.29 Business Improvement Districts (BIDs), based on a model from the United States and introduced in the Local Government Act 2003 (but operated on a voluntary basis in a number of areas prior to that Act) do already provide some additional flexibility. Many businesses and business groups including the BCC, the CBI and the British Retail Consortium have expressed their support for BIDs. BIDs schemes have been welcomed because they are business led, have addressed business priorities and provided genuinely additional resources, alongside accountability to those paying the extra tax. In my business engagement events, the strengths of BIDs were identified as “the ability they gave local businesses to make decisions and initiate service improvements, and the clarity of the planning, delivery and benefits realisation sequence.”¹⁰

8.30 It is very positive that these new measures have been welcomed. They show that, with the right proposals and engagement, local authorities and businesses can develop effective relationships and mutually advantageous proposals for the improvement of places.

8.31 However, BIDs have a number of limitations and they are not the answer to all problems. First, their purpose is specific and limited. They are intended as a way for local businesses to raise collective contributions for specific improvements and services, and can run only for a maximum of five years without an additional vote. Although there is significant local variation, BIDs mainly spend their money in tightly defined local areas on marketing and safety and security, and sometimes on cleaning and local improvements. Even the more substantial plans for Coventry’s ‘city-wide’ BID focus on providing specific services such as information technology and crime reduction measures to tenants in a number of dispersed locations rather than on measures of general benefit to the city as a whole. Second, some concerns were raised during my discussions with businesses and BID operators that the costs of developing and administering BIDs reduced their impact and effectiveness – noted for example in the Inquiry’s business engagement events.

⁸ CBI, *Transport policy and the needs of the UK economy*, 2005.

⁹ Eddington, R., *Transport’s role in sustaining the UK’s productivity and competitiveness*, 2006.

¹⁰ OPM, *Report of Business Round-Tables*, 2006.

Third, as BIDs build on the existing structure of business rates there is a concern that their priorities can be skewed towards short-term issues rather than longer-term investments, because they can only compel contributions from occupiers (though in some cases landowners are also making contributions).¹¹

8.32 While BIDs are an important part of the package, these drawbacks suggest that other flexibilities are needed, particularly if we are to be able to address, in a locally flexible and accountable way, larger projects and needs, including infrastructure investment.

Localisation 8.33 Transferring business rates revenues and decisions over tax rates to local control has been suggested by many local authorities and some other commentators. This would give local authorities a new locally controlled revenue source (although, as business rates revenues are currently devoted to local government funding there would be no increase in available resources) and some flexibility to raise additional revenue by changing the tax rate, depending on the approach adopted to equalisation.

8.34 In principle I have considerable sympathy with this view, and am of the opinion that the nationalisation of business rates in 1990 was not a positive change. However, there are two key issues to be addressed in the consideration of this proposal. First, there are concerns in the business community about the implications for them of greater local discretion over tax rates. They fear increases in taxation without a greater say over local priorities and spending, and are concerned at the potential additional complexity of a number of different local rates. For example, the BCC said that:

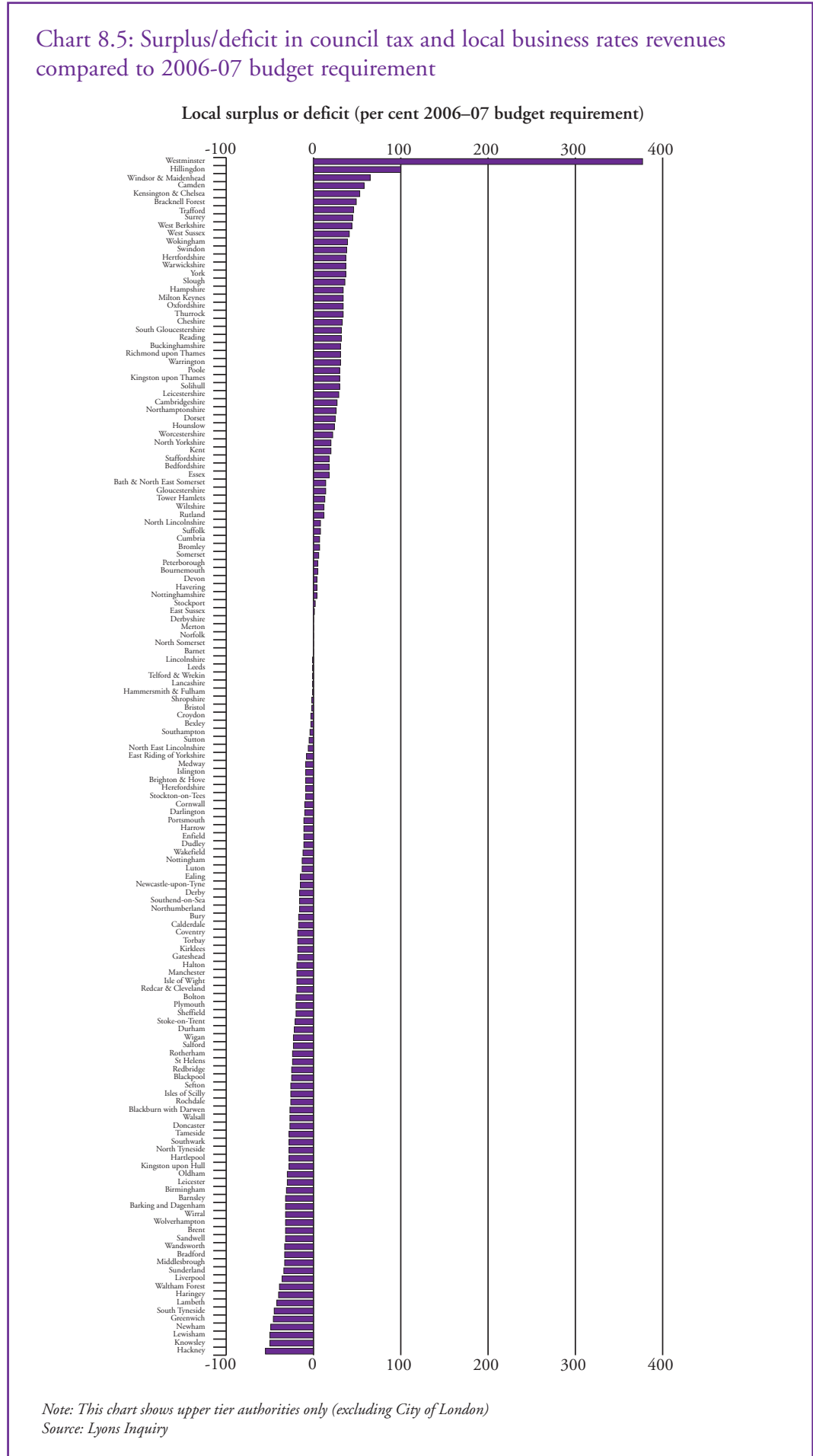
The BCC has significant concerns about this suggestion, which we fear would lead to an increase in business rates. Because business does not have a vote, the fear is that local authorities would be tempted to increase business rates, because they could enhance their spending power without enduring the political pain associated with increases in council tax.

8.35 Second, there are wider concerns about the impact of localisation on the Government's ability to equalise resources between authorities. Following the decision to move schools funding into a separate ring-fenced grant, business rates now provide the bulk of the revenues needed to equalise between authorities for differences in needs and council tax resources. To maintain current levels of equity under a localised business rates system, 65 authorities would need to pay some of their local tax revenues to central government to support other authorities with smaller tax bases and higher needs.¹² Chart 8.5, overleaf, illustrates this graphically, comparing council tax and local business rate revenues with budget requirements in 2006-07. This chart shows only upper tier authorities, as these are the authorities most affected by localisation, though in this modelling all tiers and classes of authority were allocated a share of local business rates. It shows that a large number of authorities would raise far in excess of their current spending, while others would be substantially under-funded. The limited sum of revenues available through RSG (not shown here) would not be sufficient to compensate for this.

¹¹ Communities and Local Government, *Review of the Role of Property Owners in Business Improvement Districts*, 2006.

¹² This is based on one possible way of localising business rates – there are numerous other models, which would show slightly different patterns, but a similar overall picture.

Chart 8.5: Surplus/deficit in council tax and local business rates revenues compared to 2006-07 budget requirement



8.36 Such a system can work, with richer authorities pooling some of their resources to support authorities with smaller tax bases. Some other countries, such as Sweden, take this kind of approach, and before the reforms of the late 1980s, some rates revenues were redistributed through the London Rate Equalisation Scheme in a similar fashion. As Tony Travers has argued in a recent paper for the LGA, there is little technical reason that this approach could not be used to enable business rates to be localised without reducing equity.¹³ It would require the Government – or some other institution – to decide on the appropriate level of equalisation, and therefore the amount of revenue that authorities in surplus would need to surrender for redistribution, but that is a process which (in a sense) occurs already through the national pooling and redistribution of business rates, and should not therefore pose substantially more significant technical or administrative challenges.

8.37 Despite the fact that it is technically possible to operate such a scheme, I am not attracted to this approach. I believe that it would be confusing, and would not help to create the direct and accountable relationship between local authorities and businesses needed if new local flexibility is to be used effectively. In many areas businesses would be paying taxes to their local authority that would seem to be local revenues, but would then be reallocated elsewhere in the country. Changes to the calculations for that reallocation could have effects on local taxation levels without providing local benefits. That would not be a very transparent system.

8.38 In addition, I do not think that the time is right for such a substantial change to be introduced. Local authorities and the business community still have to work on developing trust and shared objectives, and I am therefore concerned to avoid changes which could put developing that shared agenda at risk. This does not imply that full-scale relocalisation might not be possible and appropriate at a later date. However the conditions are not yet right for such a change.

Supplementary powers 8.39 An alternative option for reforming the business rates to provide additional flexibility would be to introduce a power at the margin for local authorities to levy a supplement on the national business rate within their area. The Corporation of London already has the power to raise a supplement on business rates, in consultation with local businesses, which it has used to generate resources to invest in additional security and other measures. A similar power has been discussed in the past for local authorities more generally, most notably when the Government consulted on reforms to business rates in 1998.¹⁴ While many business groups expressed concern at any change in the current arrangements, greater local flexibility is supported, subject to appropriate constraints and arrangements for voice, by a number of others.

[Subject to certain conditions] we could see the benefit to the local economy of re-localisation... we believe that i) businesses as customers will pay a fair price for a quality, efficient service ii) conversely businesses will become disillusioned as customers if they have no recourse, remedial options or leverage to counteract poor services iii) allocations of central and local funding need to be better balanced, particularly in the light of changing economic drivers. (Leeds Chamber of Commerce)

...we wish to see the return to Surrey County Council of control over the business rate. This would give the business community a stake in the running of the County and enable it to express its views about the balance between tax raising and investment. For example businesses would be empowered to argue for an increase in the business rate on the understanding that the proceeds would be invested in measures to reduce congestion. (Surrey Chambers of Commerce)

¹³ Travers, T., *Would it be possible to re-localise the NNDR? The technicalities of achieving reform*, LGA, 2007.

¹⁴ Department of Transport, Local Government and the Regions, *Modernising Local Government: Business Rates*, 1998.

8.40 A supplement would provide local authorities with a more limited flexibility to raise revenues for new investment, but it would also have a more limited impact on businesses. It would require authorities to make a transparent decision to change their local rate from the national rate, and that decision could more easily be made subject to greater consultation and constraints than a general power to set tax rates. It would also avoid the need for other complex changes to the finance system such as the equalisation noted earlier.

8.41 Given the need to develop relationships between local authorities and businesses, and my concern to ensure that any new local flexibilities provide genuinely and measurably additional local revenues, agreed with the local business community, I have therefore concluded that a supplementary power would be the most sensible step forward.

Recommendation 8.2

The existing national arrangements for business rates should be retained at present, but a new local flexibility to set a supplement on the current national business rate should be introduced.

Proposals for a local supplement

Principles 8.42 To work effectively, and to help develop trust between authorities and businesses, I think that some limitations on the new power and requirements associated with its use need to be established for both local and central government.

8.43 Getting these constraints right will be essential for the credibility of any new supplement. The business community will need to be able to have confidence that the introduction and use of the power to raise a local supplement is in their interests. Equally, the new power needs to provide genuine flexibility so that local communities can make investments in their future. The British Retail Consortium argued that:

In the event that a supplementary business rate be introduced it is vital that such a levy be clearly labelled as additional funding, ring fenced to be spent only on agreed initiatives of benefit to business, and measured against clearly defined evaluation criteria. (British Retail Consortium)

8.44 There will need to be a debate about where the balance should be struck. However, there are four key criteria that I believe need to be borne in mind in developing a supplement, drawn from business views about the basis on which a larger local contribution might be acceptable.

8.45 The supplement should be:

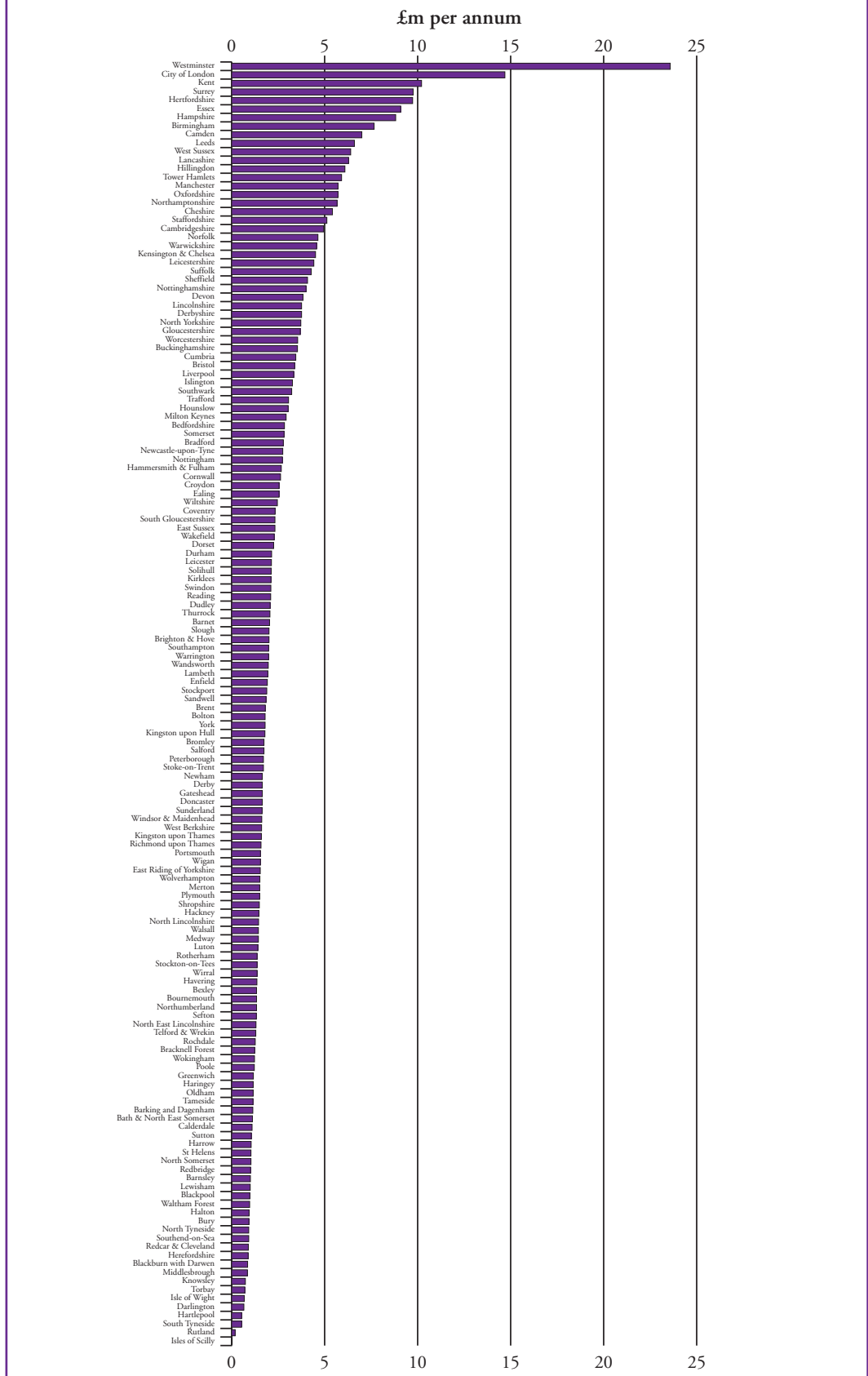
- local, both in the decision to levy a supplement and in the decisions about how it is to be spent;
- additional, with any new revenues available to spend on new infrastructure or projects rather than taken into account in central government grant allocations;
- transparent, so that businesses and other local taxpayers understand how much money is being raised and what it is being spent on; and
- agreed within the local community, with the local business community having a strong voice in the final decision on whether there should be a supplement, and the purpose to which the proceeds are put.

8.46 This proposed supplement is intended to contribute to greater flexibility for local communities – residents, businesses and their representatives – to invest in themselves and in the future. They are not intended to provide greater powers for general taxation.

8.47 Businesses have also emphasised that any reforms should, wherever possible, build on the simplicity and predictability of the current business rates system. I set out my recommendations on this subject below.

Potential size of a supplement 8.48 The potential size of a supplement is the most clear limitation that could be imposed. In doing so, a balance needs to be struck between providing sufficient flexibility to enable local communities to make a real difference to local investment, and ensuring that tax rates remain within acceptable limits. A one pence supplement across England would raise something over £400 million each year, assuming no impact from the higher tax rate on rateable values (although in practice one might expect some impact, depending on how the supplementary revenue was used). The amount that would be raised by individual authorities would vary substantially depending on the size of the authority and the number and value of properties in the area. Chart 8.6 over shows revenues at upper tier level from a one pence supplement.

Chart 8.6: Revenues from a 1p supplement on business rates for upper tier authorities



Source: Lyons Inquiry.

8.49 Different levels of supplement would enable different kinds of projects to be undertaken, and there is thus no ‘right’ answer to this question. At the upper end, some BIDs (for instance in Rugby) have levied supplements equivalent to as much as four pence. This would provide substantial local flexibility and revenues to support investment. A lower limit on the supplement would provide less revenues and less flexibility, though it might enable confidence in the new arrangements to develop more gradually. There might be a case for a lower limit to be applied in general, with a higher limit used for particularly significant projects – and probably subject to more stringent approval processes.

8.50 The table below illustrates the revenues that a supplement of one pence and one of four pence could raise in selected local areas, and the amount of borrowing for capital purposes that these revenues could support over a ten-year period.

Table 8.1: Using a supplement for borrowing

All figures £m	London	Greater Manchester	Birmingham	Kent	Cornwall
1p supplement					
Yield	109.5	20.3	7.7	10.2	2.6
10 year loan of	839.4	155.6	59.0	78.2	19.9
4p supplement					
Yield	438.0	81.2	30.8	40.8	10.4
10 year loan of	3357.6	622.5	236.1	312.8	79.7

*Borrowing figures based on a loan from the Public Works Loan Board, at an interest rate of 5.15 per cent repaid on an annuity basis.
Source: Lyons Inquiry analysis*

Decision-making processes

8.51 An upper cap on the supplementary rate is an important part of my recommendations. However, with or without it, local proposals will stand or fall on the details of arrangements and discussions between local authorities, business taxpayers and the wider community. It is therefore important that such arrangements should be introduced in a transparent and accountable way, which enables businesses to have greater trust in the desire and ability of local authorities to prioritise the issues of greatest concern to them. In my discussions with businesses I have found an appetite for greater engagement with local authorities on economic development issues, and a willingness to discuss how the revenues for investment might be found, provided there is effective and genuine discussion.

8.52 One approach would be to establish a set of national rules and ring-fences, requiring the resources only to be spent in certain ways or on certain kinds of project. However, I am wary of creating detailed formal requirements at national level for the governance and use of locally raised supplements, because of the risk of restricting genuinely additional activity that local businesses and authorities would both want to sign up to. For example, ring-fencing revenues from supplements to capital expenditure or physical infrastructure would prevent its use for the provision of services (such as security, cleaning, or town marketing) which we know from successful BID schemes are valued by businesses, and which may be an important part of making a place an attractive and successful business location.

8.53 I believe that a better focus is on bottom-up accountability to local taxpayers. This has the merit of encouraging a stronger partnership between local authorities and business. It also provides scope for a better reflection of the particular interests and needs of different types of businesses – such as the SME population. Their ability to absorb the impact, and their priorities for spending, are likely to differ from larger businesses. Local Accountability can and should take into account

these differing interests and ensure they are effectively addressed. There are two main options here for ensuring that those affected by a supplement have a voice.

8.54 The first is a voting mechanism. In discussions, many business groups highlighted the benefits they saw in the BID management and voting arrangements, and London First suggested similar arrangements on a much larger scale as the most appropriate way of funding major projects such as Crossrail. A voting mechanism has the advantage that it provides a clear mandate for an increase in taxation from those affected. The support received from the business community suggests that a model could be developed which would command consensus. It would offer a way to ensure that the projects brought forward by authorities are likely to address issues that businesses also perceive as requiring action and investment.

8.55 On the other hand, a voting mechanism could make it difficult to finance projects which may not be in the short-term interests of those affected, but which have widespread benefits in the longer-term. Such projects may well involve funding streams other than a supplement, and in such cases a voting system could add complexity and bureaucracy. Finally, it would not be consistent with the accountability arrangements for other taxes, including council tax and other, national, business taxes. I am also keen to avoid abortive proposals which burden the council tax payer, and fear that this risk would be greater with a prescriptive voting system.

8.56 The second alternative is a statutory consultation process. Such a process would require authorities to consult on raising a supplement for a specific purpose, with a clear economic assessment of its likely impact. This would provide greater flexibility to pursue projects with long-term, as well as short-term, benefits. It would allow local government a genuine freedom. However, in this proposal the control exercised by business rate payers would be weakened. This might make support among the business community more difficult to build.

8.57 On balance, I do not recommend that the use of this new power should have to be subject to a vote, though such a course should be open to local authorities if it is appropriate to the local situation.

8.58 Under either model, revenues from the supplement would be hypothecated to the approved purposes. In order to provide a contribution to infrastructure investments, which can be financed over many years, I do not propose that there should be a universal limit on the time for which a supplement can run, but the proposal to introduce the supplement should include a clear timetable. For a supplement to run beyond this period, the authority would need to gain new approval.

8.59 Whatever model is pursued, if it is to work effectively, both local authorities and local businesses will need to work hard to establish constructive and effective relationships, and to build trust and mutual understanding and respect.

Types of authority

8.60 Businesses have made clear to me that, in addition to being accountable, any new arrangements should maintain the predictability and stability of the current business rates system where possible. Retaining a standard national rate, and implementing changes as the power to set a local supplement on this rate, should aid in this. I also think that it is necessary to keep the number of different possible supplements manageable in order to minimise the administrative burden for businesses and to make the system as simple as possible.

8.61 A supplement could in theory be levied at any tier of local government – all, including parishes, used to set rates before 1990, and all charge council tax directly or via a precept. The numbers of authorities involved is set out in the table below:

Table 8.2: Number of different types of authority

Authority type	Number
Upper tier authorities (unitary, met district, county, London borough, City of London)	150
District councils	238
Police and fire authorities	67
Town and parish councils	Circa 8,700

8.62 I have reservations about giving supplementary powers to a large number of authorities, given the business community's concerns about complexity. There is an opportunity, however, to marry a concern for simplicity with an encouragement to collaborative decision-making and the coalition building that is essential to effective place-shaping. I propose that only upper tier authorities should levy supplements. In two-tier areas, those proposals should be the subject of discussion and agreement between the county and the district councils, with a joint plan for the use of the revenues raised to meet the overall needs of the area. This reduces the number of possible different rates to 150, providing a less complex system for businesses, and acknowledges the interest of all levels of elected local government in the revenues raised through the use of the supplementary power.

8.63 The governance arrangements in London are rather different from elsewhere, with a division of responsibility between the 32 boroughs and the Corporation of London, which are responsible for most local government services, and the Greater London Authority (GLA), which has various strategic powers and functions including for transport, planning and (subject to the passage of the Greater London Authority Bill) skills. The size of the business tax base varies enormously, from areas of inner London with some of the most expensive business properties in the world, to areas of more deprived outer London boroughs with among the lowest tax bases in the country. I believe that it is important that the respective roles and voice of the Mayor and the boroughs are reflected in the approach taken, but that approach must facilitate city-wide action on infrastructure issues and acknowledge the wide variations in the size of the tax base between different parts of the city. The places where infrastructure is required may well not match the pattern of revenue raising.

8.64 This need for city-wide action suggests that it would not be desirable for all powers over business rate supplements to rest solely with the boroughs, but it is also important that the boroughs are involved in any proposals. I therefore propose a more flexible and collaborative arrangement under which a single, London-wide supplementary rate would be set through agreement between the GLA and the boroughs, and in consultation with the business community, with a joint plan for the use of the revenues collected from that rate. This approach recognises the joint interest that the GLA and the boroughs have in any proposals for additional taxation and investment in London, and the need for a city-wide approach to ensure that investment is targeted in the appropriate areas. This London-wide supplement would be in addition to the Corporation of London's current powers, which should continue to operate as at present.

8.65 Although the governance arrangements in London are unique, discussions in other areas, particularly large urban areas and city regions, might come to the conclusion that a similar joint approach would also be desirable in those places.

High tax base authorities 8.66 The power to levy a supplement will not be equally valuable in all areas and the revenues that individual areas could raise would vary substantially, as shown in chart 8.6. This raises the concern that it might appear unfair to other parts of the country that these areas could raise substantially greater revenues, and in the past (for example in the Government’s consultation on supplementary rates in 1998) it has been proposed that special arrangements should apply to these areas.

8.67 However, introducing special arrangements would constrain the ability of local authorities and businesses to choose how to use resources they had chosen to raise, and reduce the accountability of local authorities for the use of locally raised money. Given that this supplement is designed to enable greater local flexibility where there is local support, it would arguably be perverse to apply an equalisation or limitation scheme to it. In addition, comparing the revenues from a supplement on a per head of population basis shows that most of the authorities with very large tax bases per head are in London, where the differences should be dealt with through the joint approach between the GLA and the boroughs suggested above. I have therefore concluded, in line with the principles I established at the beginning of this section, that all of the revenues should remain local.

Table 8.3: Authorities with largest revenues per head

Local authority	Revenues from 1p supplement (£ per head)
City of London	£1655.70
Westminster	£94.88
Camden	£31.70
Tower Hamlets	£27.69
Hillingdon	£24.01
Kensington & Chelsea	£23.32
Islington	£17.74
Slough	£17.00
Hammersmith & Fulham	£15.14
Reading	£14.45

Source: Lyons Inquiry

Small businesses 8.68 Small businesses pay a higher proportion of turnover in rates than larger businesses, and reflecting this the Government has recently introduced Small Business Rate Relief to reduce bills for small businesses. There is therefore a question as to whether small businesses should receive any discount or exemption from a business rates supplement. The smallest 90 per cent of properties only represent a little over 30 per cent of rateable value, so a discount or exemption for smaller businesses would not in most places substantially reduce the yield from a supplement. On the other hand, it might well be considered unfair by larger businesses that they should effectively have to subsidise smaller businesses, simply on account of their size.

8.69 Central government may wish to set the overall framework and how national exemptions and reliefs apply in relation to the supplement. In particular, it may wish to protect the smallest businesses through setting a threshold below which small businesses do not pay a supplement. However I think it is also important that there is flexibility to manage these issues at a local level. Local authorities and local businesses should be able to consider whether additional discounts or exemptions from a supplement are justified for small businesses, taking into account the purpose of the supplement and local economic conditions. A number of BIDs alter their levy depending on the size of the business involved. Authorities will also wish to consider whether these discounts

or exemptions should apply to all small properties, or whether to apply a more complex test (as with the Small Business Rate Relief) to ensure that only small businesses benefit by excluding smaller properties owned by larger businesses from any relief.

Borrowing powers 8.70 In order for this new flexibility to be used efficiently and effectively, it is important that local authorities have appropriate powers to use the revenues to support borrowing. The prudential borrowing powers introduced by the Government in 2003, which allow local authorities to borrow for capital purposes, provided that they are satisfied that such borrowing is prudent and affordable, have been warmly welcomed, and should provide the flexibility required.

8.71 Some authorities did raise concerns during discussions that the current Minimum Revenue Provision requirements, which require authorities to set aside four per cent of net outstanding debt out of their revenue resources to redeem their debts, are too complex and rigid and reduce their ability to use borrowing powers. However, the Government has already acknowledged this issue and is addressing it through new regulations and by taking new powers in the Local Government and Public Involvement in Health Bill.

Recommendation 8.3

Local supplementary powers should be designed in a way which can gain credibility with business and the wider community. The key issues to be considered are:

- the appropriate scale of the supplement. At the upper end, some Business Improvement Districts have levied supplements as high as four pence. A lower limit would provide less revenue and less flexibility, but might enable confidence in new arrangements to develop more gradually. In that situation, there might be a case for allowing a higher limit in some cases subject to more stringent approval mechanisms;
- retention of revenue, where I believe all revenues should be retained locally;
- the right form of accountability to business taxpayers. The most obvious options are some form of voted approval or a statutory consultation process. On balance, I propose that there should be a requirement to consult local businesses, and the wider community, before introducing a supplement, with a clear proposal and timetable. Revenues from a supplement should be hypothecated to the purposes agreed through consultation;
- how to ensure that supplements contribute to, rather than detract from, the local economy. I propose that authorities should be required to make an assessment of the impact of a supplement on the local economy, and the potential economic benefits of the spending they propose to finance from the revenues generated;
- the authority by which supplements should be levied. I recommend that supplements should be levied by unitary authorities and metropolitan districts, and in London and areas with two-tier local government, a single rate should be set through agreement between the relevant authorities, with a joint plan for the use of revenues. Where arrangements develop for collaborative working between authorities elsewhere in the country this could usefully include cooperating around supplements. Powers to introduce Business Improvement Districts should remain with shire districts and the London boroughs;
- whether authorities should have a degree of flexibility over which sizes of business pay the levy, which I would support; and
- whether there should be a threshold below which small businesses do not pay the levy.

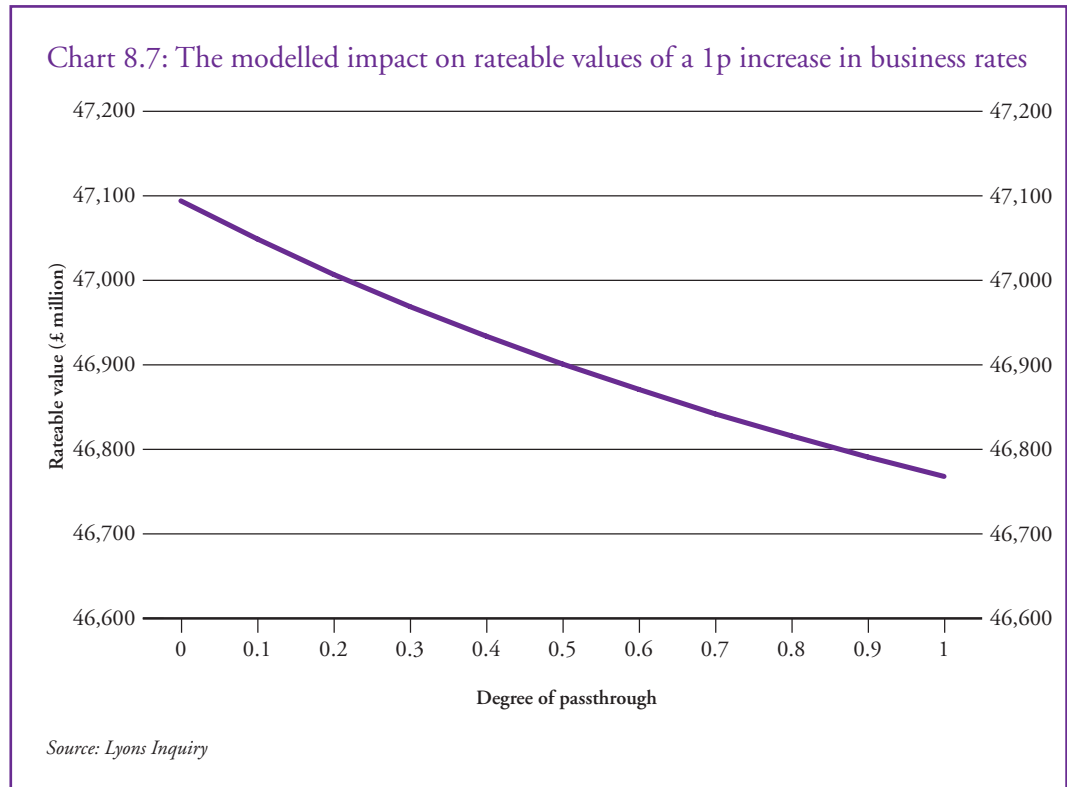
The wider impacts of a supplement

8.72 The way business rates work, and the interaction between rates and rental values, raises a number of issues that it will be important for the Government and local authorities to take into account in implementing these recommendations.

8.73 In the short term a local supplement on business rates will increase the cost of property occupation for tenants and owner-occupiers, who will have to pay higher taxes, as well as (for tenants) their current rent. In the longer term, as set out earlier in this chapter, the evidence suggests that business rates will be passed on to owners in lower rents. Depending on the use to which the revenues from a supplement are put, owner-occupiers and landlords may see some reduction in the capital value of their property compared to what would otherwise have happened without a supplement, as a result of the value of future rents being reduced.

8.74 The reduction in rental values that a supplement could lead to will have other implications for the Government and for taxpayers. I have recommended that for the present the existing method of calculating the national business rate multiplier should remain as it is. The Government will therefore continue to set the multiplier at revaluation so as to generate the same national revenue in real terms as before the revaluation. Since the introduction of local supplements may reduce rateable values compared with what they otherwise would have been, the national tax rate may need to be slightly higher than it would otherwise have been in order to continue to raise the same amount of money.

8.75 My analysis suggests that if the supplement was fully absorbed by reductions in rents, the resulting fall from a one pence supplement levied across the country would be around 0.7 per cent of total rateable value, though in practice the effect might be lost in other, more significant changes in rateable values. The chart below shows the likely impact on overall rateable value under a range of assumptions about the degree to which the increase is passed through to rental values (where zero is no impact on rents and one is where the increase in tax is fully compensated by a fall in rents). This is a potentially significant impact for property owners and investors, although small compared to recent increases in the value of commercial property.



8.76 However, it is important to remember that the objective behind introducing greater local flexibility is to enable authorities to invest in infrastructure and other activities, which enhance local quality of life and the distinctiveness of places, and support economic development and growth. Where spending is targeted well on such areas it should support an expansion in the number and success of businesses and the value of the properties in an area, offsetting the negative impact of the supplement. This makes it especially important that in proposing supplements, local authorities consider the purpose to which they intend to put the resources raised, and consult fully with businesses and other local stakeholders to ensure that they will create value in the local economy.

8.77 Changes to business rates will also have wider impacts on the public purse. Business rates are considered as a cost for tax purposes, which means that an increase in business rates liability, for a profitable company, can be partially offset against its tax bill. Public sector buildings are also liable for business rates, and public sector organisations will therefore have to pay higher rates where supplements are levied – there should not be any relief or exemption for the public sector. This will affect local and central government, as well as other public institutions such as the health service. Although no definitive figures on the rate bill of the public sector exist, a basic analysis suggests that they make up around ten per cent of the gross value of non-domestic properties.¹⁵ Local authorities will need to consider these impacts when developing their proposals on supplements.

¹⁵ The total rateable value of public sector properties as at 1 April 2006 is estimated at £4.1 billion. This is derived from information published by HM Revenue and Customs. The main components (with estimated rateable values shown in brackets) are: Local authority schools & colleges (£1.3 billion); Medical facilities (£0.8 billion); Other properties (£0.7 billion); Police stations & courts (£0.3 billion); Community centres & halls (£0.3 billion); Local government offices (£0.2 billion); and Libraries & museums (£0.1 billion).

Improving the efficiency and fairness of business rates

8.78 There are a number of different types of land and property which receive a partial relief, or are completely exempted, from business rates, for a variety of historical and policy reasons. The main exemptions and reliefs are set out in table 8.4, below, together with their cost in terms of revenue given up. Exempt land and properties are not valued for business rates, and the data on reliefs is therefore far better than the data on exemptions.

Table 8.4: Costs of business rate reliefs and exemptions

	2006-07 cost/estimated cost (£m)
Reliefs	
Empty property	1333.1
Charity (mandatory relief)	724.3
Partly occupied property relief	40.8
Community Amateur Sports Clubs	7.1
Rural shops (mandatory relief)	5.9
Former agricultural premises	0.9
Transitional relief	Revenue neutral over revaluation cycle
Small Business Rate Relief	Revenue neutral
Exemptions	
Agricultural land and buildings	300-450
Derelict/brownfield land	Uncertain
<i>Other smaller uncosted exemptions include places of religious worship, fish farms, sewers, and public parks</i>	
<i>Sources: CLG; Lyons Inquiry analysis</i>	

8.79 While there are reasons behind the existence of these reliefs and exemptions, it is sensible to cast a critical eye over them in order to ensure that they remain fit for purpose. The existence of reliefs and exemptions can create distortions, or weaken incentives to take positive actions. In addition, they represent a cost in terms of revenue foregone – money which could otherwise be used to cut the overall rate of tax or fund additional spending.

8.80 In my *Interim Report and Consultation Document* in December 2005 I noted my interest in considering areas in which business rates falls short of functioning as a full land and property tax, and I have therefore specifically considered the empty property relief and the exemption of vacant land and derelict property. These are subjects on which, in the intervening period, the Barker Review of Land Use Planning has also made recommendations.

Empty property

8.81 Empty property relief provides a substantial relief from taxation for all empty property, and full relief for some types. Most property receives 100 per cent relief for the first three months, and 50 per cent relief thereafter, and warehouses or factories receive 100 per cent relief at all times. At an annual cost in terms of revenue foregone of £1.3 billion it is the single most significant relief in the business rates system. Some stakeholders called for the relief to be reduced, or removed entirely.

Empty properties should pay full business rates as an incentive to encourage local business growth, with exceptions allowable for any property owner who can prove that they are doing all they can to fill the property and are delayed by means beyond their control. (Federation of Small Businesses)

Leeds supports the case for the reform of empty property relief...and agrees that reform could be used to encourage early redevelopment and re-use particularly in urban areas. (Leeds City Council)

8.82 There are some arguments in favour of the existence of empty property relief. It can be argued that a general relief shares the risks of a property not being able to earn a return between government and the owner.¹⁶ A relief for property that is only empty for a short time supports an active property market, as it means that owners do not pay tax while tenants move. Relieving empty property of taxation also reduces the incentive for owners to make their properties derelict in order to avoid taxation.

8.83 In the main, the prospect of commercial returns from the property should ensure full use of properties. However, the risk of not earning a return does not just result from external factors, but is also determined by the actions of the owner. For example, they might not maintain the property properly and let it fall into disrepair, be uninformed about better uses for it, or might keep it empty for speculative reasons. Empty properties can also impose additional costs on communities by rendering areas less safe and attractive, and still require some public services such as policing and fire protection.

8.84 Demand for land for development is growing as a result of economic change and household growth, and it is clear that, more than ever, need to ensure that all previously developed land is used most effectively.¹⁷ Analysis shows that vacant property is found in areas of high demand as well as in areas of low demand and former industrial areas.¹⁸ Finding ways to raise the opportunity cost of holding unused land and property in areas of high demand at such a time would be desirable. Reforming the empty property relief would help to provide this, and thus assist local authorities in their place-shaping role.

8.85 The existence of different levels of relief for different types of property distorts the market. It creates a sectoral imbalance within the system, providing a greater level of benefit to one sector than to others, and it does not provide any pressure from within the tax system to encourage the reuse of such land or the property for alternative uses, including redevelopment of the site and conversion to another use. This imbalance should be rectified by balancing the relief currently provided to factories and warehouses with that available for office and retail premises.

8.86 Changes to the empty property relief would have a number of implications for businesses. The increased taxation would encourage the owners of empty property to find ways to make better use of it, either through using it themselves, attracting new tenants (perhaps by reducing rents) or redeveloping the site for a new use. The effect across the economy would probably be a fall in future rents that would benefit property occupiers. This might be accompanied by a fall in capital values, which would have no impact on current owner-occupiers (assuming that they wanted to continue using the same or more property in the future) and a positive benefit for future purchasers.

8.87 No national breakdown exists of how much of the £1.3 billion of empty property relief is accounted for by the different elements of the relief. However, in a small sample of local authorities who were able to provide the Inquiry with data, 80 per cent of the relief was accounted for by the full relief for factories and warehouses and the partial relief on longer term empty property.¹⁹

¹⁶ Atkinson, A.B., and Stiglitz, J.E., *Lectures in Public Economics*, 1980.

¹⁷ Doing so helps to protect open spaces and the countryside, promotes urban regeneration, and supports the viability of services like public transport which rely on dense populations.

¹⁸ Office of the Deputy Prime Minister, *Commercial and Industrial Floorspace and Rateable Value Statistics 2005*, 2006.

¹⁹ Based on data for 2005-06, kindly provided by Birmingham, Stockton, Oldham, Bury, Manchester and Rochdale.

Existing data on the value of empty property in all local authority areas, and additional detailed analysis of the speed at which property falls empty, and the time it takes to be re-let or sold (currently in the process of being compiled by Communities and Local Government) paints a similar picture.²⁰ Together these sources suggest that the reforms I am proposing could raise potentially significant additional resources, alongside providing improved incentives for the efficient use of land.

8.88 Rating organisations who commented on the Barker Review of Land Use Planning's recommendations on this issue noted that measures had been introduced in the 1970s to provide better incentives for the reuse of empty property and that these had not been successful. They pointed out that when faced with penal rates of tax, owners often found it easier to make the property derelict rather than to bring it back into use. This is an instructive lesson. Any proposals for reform should seek to avoid this problem through limiting taxation to 100 per cent of liability, rather than imposing penal rates of tax. However, it remains a concern that some owners may find dereliction an attractive route to escape taxation. A tax on previously developed land, considered next, provides a possible solution to this problem.

Recommendation 8.4

The Government should reform and reduce the empty property relief by:

- retaining the existing 100 per cent relief for short-term empty property (up to three months);
- reducing the rate of empty property relief thereafter; and
- providing factories and warehouses with the same level of relief as other properties.

Derelict property and brownfield land

8.89 Land that is not 'capable of beneficial occupation' is not subject to taxation through business rates. However, the arguments set out above about the possible role of the tax system in ensuring an efficient use of land also apply to derelict property and previously developed land, and could thus support the place-shaping role of local authorities. The potential for a tax on such land to close a possible loophole in the system is also a reason for considering it seriously.

8.90 However, introducing such a tax would be a much more complex matter than reforming the empty property relief, for a number of reasons. Defining, identifying and valuing the land would be a significant task, as the land is not currently identified or taxed for the purposes of business rates. Valuation would be a particularly challenging task, given that this land does not, almost by definition, have a rental value. An approach which imputed a rent from the capital value of the land might be necessary, which would be a significant change from the normal principles of business rates, which is a tax on occupation and the consumption of property rather than its ownership.

8.91 It is difficult to calculate what the revenue from this tax would be. Although an estimated 36,500 hectares of previously developed land in England are vacant or derelict, most of this land will be worth comparatively little, and therefore the revenues from a tax on it is be unlikely to be very substantial.²¹ However, the purpose of the tax would not primarily be revenue generation, but rather to provide proper incentives for re-use and to prevent some owners exploiting the loophole in the system that would otherwise exist.

²⁰ Office of the Deputy Prime Minister, *Commercial and Industrial Floorspace and Rateable Value Statistics 2005*, 2006.

²¹ Office of the Deputy Prime Minister, *Commercial and Industrial Floorspace and Rateable Value Statistics 2005*, 2006.

8.92 These proposals are not yet fully developed, and further work will be needed to test whether this is a feasible proposition and how implementation and administration could be undertaken. The Government will need to consider a number of issues, including:

- whether it is economic to incur the costs of valuing and administering a new tax on this land given the potential yield;
- avoiding development pressure on green spaces and other public amenities. There may be a case for an exemption for such land;
- how to treat land that is uneconomic to develop (though such land should have a very low or zero value and thus little or no tax liability in any case);
- how to avoid reducing rather than increasing development because of any interaction between a new levy on previously developed land and the Planning-gain Supplement, or other aspects of the taxation system; and
- whether there are any legal circumstances or cases of reserved strategic capacity where incentives should not apply, as noted by Kate Barker.

Recommendation 8.5

The Government should develop proposals for the taxation of derelict property and brownfield land and consult on those with stakeholders.

8.93 There are myriad other reliefs and exemptions in the business rates system. The most substantial in terms of revenue foregone are the reliefs for charities, and the exemption for agricultural land and buildings. The transitional relief available to cushion the impact of revaluation and the small business rate relief are also important, though they are intended to be revenue neutral.

Agricultural land and buildings

8.94 Agricultural land and buildings have been completely exempt from business rates since 1929, although they had enjoyed some level of relief since the late 19th century because of economic difficulties in the sector. This situation no longer applies to the same extent, and there would seem in principle to be little reason to maintain the special treatment, which gives agriculture a tax benefit that no other business sector enjoys. Farms and other agricultural businesses are generally liable for a range of other taxes in the same way as other businesses (although there are some specific differences, for example in inheritance tax). That said, agriculture does have some unique characteristics, including the role of farmers in land stewardship as well as agricultural production, and the sector has been the subject of significant ongoing reforms of agricultural subsidies and support.

8.95 My analysis suggests that the exemption is worth in the order of £450 million a year in revenue foregone. This is not an exact figure as agricultural land and buildings are not currently valued for business rates by the Valuation Office Agency (VOA). In addition, we would expect agricultural rental values to fall as a result of the re-introduction of rates. If rental values fell so as to completely offset the impact of taxation, this would reduce the expected income from rates on agricultural land and buildings to around £300 million. The impact of taxation would also be to reduce the capital value of agricultural land.

8.96 There are precedents for large-scale changes in the rating system in the return of industrial property to full rating in England and Wales in 1961, having enjoyed a 75 per cent exemption from

1929, and more recently in the re-rating of industry in Northern Ireland. However, re-introducing rates on agriculture would undoubtedly be a significant step, and a tax liability of £300 million – £450 million a year would represent a substantial proportion of the income from farming (which totalled £1.9 billion in 2005 in England and Wales, as measured by the Department for the Environment, Food and Rural Affairs' Total Income from Farming assessment). Adjustment by farmers, and the agricultural sector as a whole, to a range of powerful long run economic pressures is a normal, ongoing process, but it is also the case that UK farmers are still responding to the implications of 'decoupling', and that significant further Common Agricultural Policy reform is likely over the next few years.²² Ultimately, the incidence of business rates falls on the owners of business assets, but policy on reforming exemptions to business rates needs to be sensitive to the broader economic context of the affected sectors, and in respect of farming (particularly tenant farmers) it needs to be sensitive to the realities of the agricultural adjustment process. If the Government was to re-introduce rates there would therefore certainly need to be a period of transition to allow the sector to adjust, and there might well be a case for some continuing level of relief, for example to avoid a situation where otherwise viable and environmentally beneficial agricultural business activity is curtailed. In particular, I believe that marginal agricultural land should continue to receive full relief from business rates. Other land, including that used for 'lifestyle', rather than agricultural purposes, would legitimately face taxation.

Charities 8.97 The relief for charities is the second most significant relief after the empty property relief. The 80 per cent mandatory relief was worth £724 million in 2006-07, and local authorities also provided further discretionary relief. Charities are generally not liable for tax, such as income tax, corporation tax and capital gains tax, and this relief arguably extends that approach to the business rates system. However, as we have seen earlier in this chapter, in general the evidence suggests that a fall in rates will lead to an increase in rents, and we would expect at least some proportion of the charity relief to accrue to the owners of the properties, in the form of higher rents. Some business organisations, such as the Forum of Private Business, feel that the existence of this relief helps some charities to unfairly undercut other high street businesses.

New reliefs 8.98 Some of those who made submissions to my Inquiry called for new reliefs. The Social Market Foundation have suggested new reliefs to support the environmental agenda, for example by reducing the rates payable on energy efficient buildings.²³

8.99 Such incentives might have a part to play in this country's approach to greater environmental sustainability and lower energy use. Following the publication of the Stern Review on the economics of climate change, it is clear that as a society we will have to take new steps to deal with the impact of climate change.

8.100 I do not recommend business rate based measures at this stage. It is beyond the remit of this Inquiry to consider all of the possible measures for addressing climate change, and while there is the potential to use business rates as part of an overall strategy, it is unclear whether a business rate relief would be the most effective and value for money approach. An energy efficient property will have reduced costs for the occupier, which means that there is a business case for investment in energy efficiency by owners and occupiers without public subsidy. Such a property would also therefore command a higher rent than a comparable energy inefficient property, transferring the benefit of the relief from the occupier to the owner. The concern of many of those involved in the rating system, that new reliefs would increase the complexity of an already complex system, also needs to be given some weight.

²² See for example the Government's *A Vision for the Common Agricultural Policy*, 2005.

²³ Blackwell, T. and Gough, B., *Turning business rates green: How to make the Uniform Business Rate fit for the future*, Social Market Foundation, 2006.

8.101 In the light of this, I recommend that the Government should undertake its own review of the reliefs and exemptions in the system. That review should have a number of objectives:

- to consider the current reliefs and exemptions and to judge whether they remain justified in terms of their cost, their contribution to policy objectives and the potential distortions they create to a level playing field for all property users;
- in particular, to review the case for the continuing existence of the agricultural exemption, and to consider the costs and benefits of undertaking a valuation of agricultural land at the 2010 revaluation in order to accurately assess the value of the exemption; and
- where practicable, to remove or merge existing reliefs and exemptions.

8.102 When considering any new reliefs as part of this review, the Government should consider the following principles:

- the benefits of the introduction of the relief should exceed the costs, including the costs to the Government, and to businesses, of administering a more complex system, the distortions to the property market that reliefs can create, and the fact that providing one type of property with relief might necessitate a higher tax rate on other property to maintain the overall yield; and
- since the value of any relief is likely to accrue in substantial part to the owners rather than the occupiers of the property, reliefs should only be introduced where this is a desirable end.

Recommendation 8.6

The Government should conduct a review of exemptions and reliefs to consider the scope for removing inappropriate subsidies and distortions, and to simplify the system.

Local discretion 8.103 In reforming reliefs and exemptions, there will be a choice about whether any changes should be made across the country, or whether there should be an element of local discretion. Local discretion, particularly on the empty property relief, would give local authorities new tools with which to pursue local regeneration and development, and enable them to take an approach sensitive to local economic and property market conditions. On the other hand, a national approach would have the advantage of ensuring a consistent and predictable approach across the country for property owners and developers, and it would also provide additional revenue at national level.

Use of additional revenues 8.104 Changes to reliefs and exemptions will have an impact on total yield. This will obviously be subject to the outcome of the review. However, if the net result of any changes was an overall increase in yield then this could be used to reduce business rates for all businesses. This could assist with the introduction of a discretionary supplementary power by reducing the impact of national business rates on businesses, and on the Government's other tax receipts. Final decisions on this will be for ministers to make, in the light of the wider review of reliefs, the overall fiscal position, and other calls on available revenues.

Implementation

8.105 Many of the changes I have recommended in this chapter will require primary legislation to implement them. The timescale on which they can be introduced will therefore depend on when the Government can bring forward a bill and when Parliamentary time can be found. The Government would also need to undertake further consultation with stakeholders and experts on detailed proposals and technical issues.

8.106 New powers for local authorities to levy a local supplement on business rates should be introduced as soon as possible after primary legislation, allowing sufficient time for local billing authorities and their suppliers to deal with any necessary amendments to software and information systems.

8.107 In order to remove exemptions a large number of properties which do not fall within the system at present must be valued, and it would be sensible to integrate this valuation process with the VOA's cycle of valuation work. Depending on the size and complexity of the task involved, it might be possible to remove exemptions from the beginning of the 2010 list in April 2010.

Options for future governments

8.108 The key options for the future of business rates centre on changes to the process and frequency of revaluation, and to the way in which the tax rate is set. A number of these options were considered by the Government's review of revaluation in 1999-2000. The Government will also need to keep the overall level of business rates under review, as part of its general approach to considering the appropriate level and method of taxation on businesses and on other sectors.

Revaluation 8.109 From a theoretical point of view, there is much to be said for increasing the frequency of revaluations. More frequent revaluation would mean each property paid a bill more related to its actual value (relative to other properties) – whereas in the present system property values can be almost seven years out of date (revaluations are implemented every five years, but published lists use assessments of rateable value from two years before the implementation date). This would make the tax more responsive to the actual state of the property market and could have economic advantages by reducing the burden of taxation on businesses in economic downturns. Since the changes in rateable value, and hence in tax bills, would vary less if updated each year, rather than every five years, it might also be possible to scale back or remove transitional relief, which would remove some complexity from the system.

8.110 Increasing the frequency of revaluations would have some drawbacks (including possible increases in administration costs). By updating values more frequently, it would remove some of the stability of the current system, which enables a business to calculate its likely rates bill for five years at a time. The impact of this would affect different sectors in different ways, and might be particularly challenging to sectors which are not valued using the normal rental value approach. In addition, though such a system would improve the link between business taxation and the state of the property market, this might make things harder for businesses during upturns if they had difficulty of rapidly adjusting the use of property as its price changed.

8.111 There are a variety of options for increasing the speed of revaluation. With the improvements in information technology now available it seems likely that annual revaluations would be possible in the not too distant future, though with some cost implications. Another option would be to adopt a system of rolling revaluation in which only a certain proportion of properties would actually be revalued each year, while the others were updated using statistical analyses of property price changes.

Setting a fixed multiplier 8.112 Under the current system the tax rate is set at the beginning of a revaluation cycle in order to generate the same level of revenue from the new tax base, and updated in line with RPI each year to maintain the value of the revenue in real terms. This creates a stable and predictable system for both government (which knows how much revenue it is going to collect) and for businesses (who can estimate their bills for five years in advance, subject to any appeals and the impact of transitional relief). However, as I mentioned earlier, there are potential disadvantages as it means that the weight of business rates is heavier during times of economic downturn when rents are low, and lighter during times of growth.

8.113 An alternative possibility – probably in conjunction with more frequent revaluations – would be to fix the tax rate and allow the yield from the tax to change from revaluation to revaluation depending on the state of the property market. More revenue would be raised during periods of growth, and less during periods of downturn. This system should have economic benefits as it would make taxation better linked to the market situation, helping to ease demand during growth periods and support it during downturns. It might also have advantages from the perspective of the local government finance system, as it would make it easier to provide financial incentives which would encourage local authorities to enhance the value of business properties in their area, as well as supporting growth in the number of properties. This is also noted in Chapter 9.

8.114 However, it would make business bills more variable from revaluation to revaluation, and businesses might find it difficult to renegotiate their rent or adjust their use of property appropriately between revaluations depending on the extent and predictability of fluctuations. It would also expose central and local government to greater variability in their revenues.

Setting rates at local level 8.115 My recommendation for the introduction of a local supplementary power is a limited new power for local authorities to alter the rate of tax paid by businesses in their area. In the longer term, those limits should be reviewed, taking account of how relationships evolve between local authorities and businesses, and the evidence on the economic impacts of better local authority engagement with economic development issues. The localisation of revenues and power for local authorities to set the tax rate for themselves in the light of local circumstances, including making the choice to set a lower tax rate, could be considered. Businesses have made clear their concerns about such a radical step in the short term, but it is a decision future governments may wish to consider as new arrangements evolve.

SECTION 106 AND PLANNING-GAIN SUPPLEMENT

8.116 To complete the review of local land and property taxation, it is worth a brief reflection on Section 106 (S106) contributions and the proposed Planning-gain Supplement (PGS). Both have been extensively reviewed by Kate Barker in her work on housing supply and land use planning, and the Government has set out proposals for reform, but these raise issues relevant to my remit.

8.117 These two sources provide (or could in future) a substantial source of revenues linked to development. They have two purposes – firstly, to provide community infrastructure to meet the needs of residents in new developments and/or to mitigate the impact of new developments upon existing community facilities. This is the stated purpose of S106, which is used to fund new roads, schools and so forth. Secondly, PGS is intended to capture some of the excess profits received by landowners when planning permission is granted for new developments. There are some who argue that where S106 is used to its fullest extent by local planning authorities it can in fact capture some of those profits, even though it is not strictly intended to do so, which has at times complicated the situation, and created delay and uncertainty. However, the extent to which authorities are successful in using S106 varies considerably around the country.²⁴

8.118 The Government's proposed reforms would retain a scaled back S106 to mitigate direct impacts from development and to fund immediate local infrastructure necessary to that development. It would also continue to be used to support affordable housing targets. The PGS would then be available as a general revenue source to support wider infrastructure development, and be allocated between local and regional spending with at least 70 per cent kept locally.

8.119 I support that approach in general. However, given that these revenues are linked to local planning decisions and the infrastructure needed to support and enable growth, it is important that the links to local authorities and the local community are made explicit, clear and substantial. The PGS should be seen as a local tax with a regional share, not a national tax, and the Government should not seek to direct the way in which it is spent. S106 will remain important as a source of negotiated local revenues to support development.

8.120 There is also an unresolved question about how revenues from PGS will be allocated between districts and counties in two tier areas. District authorities are responsible for making the ultimate planning decisions and engaging with developers, but it is county councils which are responsible for much of the infrastructure necessary to support development. It is also important to consider whether either tier has advantages from the perspective of ensuring that individuals and local communities perceive the financial and infrastructure benefits that development is bringing with it.

8.121 Providing appropriate infrastructure to support development is a shared issue for both tiers. I therefore think there is merit in pursuing a joint option for the management of the revenues, in which county and district councils would be jointly responsible for developing and implementing a plan for the use of the revenues from PGS in their area. That should help to give a genuine local connection, but also the opportunity to use the revenues across a wider area in order to support necessary strategic infrastructure.

²⁴ University of Sheffield and Halcrow Group, *Valuing Planning Obligations in England: Final Report*, Communities and Local Government, 2006.

Recommendation 8.7

If the Planning-gain Supplement is introduced, the Government should:

- design it primarily as a local revenue source, with a regional share of an appropriate scale, not as a national source which may or may not be allocated to authorities. It is imperative that a transparent and predictable link between local development and local resourcing exists if development is to take place, or incentive effects are to be realised; and
- consider whether in two-tier areas, it could be managed through plans jointly developed and implemented by county and district councils.

TAXES ON TOURIST PRESSURES

8.122 The Local Government Association, in its submissions to the Government's Balance of Funding Review and subsequently to me, have suggested that local authorities could be given a discretionary power to levy a tourist accommodation tax in their areas. Some interest in such taxes was expressed by a small number of authorities during the Inquiry, though on the whole local authority enthusiasm for new taxes of this kind was less than might have been expected. The proposal understandably generated significant debate within the tourism industry and beyond.

8.123 Accommodation taxes have been deployed in a number of places around the world, with varying degrees of success. For instance, an accommodation charge is levied on all overnight stays in France, with the level of the charge largely left to local determination. I also received evidence of voluntary schemes operating in England.

For over a decade the Tourism and Conservation Partnership has operated a very successful and entirely voluntary visitor payback scheme in the Lake District and more recently the wider county of Cumbria... for example, Heart of the Lakes accommodation company automatically adds £2 to every invoice they raise. Guests are given the option of opting out of paying this, but rarely do... Many guests make a voluntary contribution in excess of the requested £2. (The Tourism and Conservation Partnership)

8.124 The submissions I have received make clear the importance of weighing the merits of a tourist contribution against the costs they impose against the likely impact on the tourist industry and local economies. The impact of tourism on local communities can include tourist use of local transport networks; community safety; the local environment; local arts, sport and culture; and redevelopment activity. The societal costs imposed by tourists include pollution (for example increased CO₂ emissions), degradation of place, land use and use of public utilities (additional use of water, electricity and sewage). However, it should be noted that the evidence base relating to the economics surrounding tourist accommodation choices is still being developed; in particular there is currently insufficient data to assess the impact of a proposed local scheme at the level of individual authority areas' local economies. It is also important to remember that tax revenues are already raised from tourist activity – VAT from spending, and the business rates and other taxes from businesses which rely on tourists – and government grant to local authorities does take some account of the costs imposed by visitors.

8.125 Some submissions have articulated concerns about the likely impact of a tourist tax, including the concern that it would damage local economies by driving tourists elsewhere in the country or to other parts of the world. Local authority submissions recognised the complexity of the situation:

The economy of the Borough of Restormel is heavily dependent on tourism. Accordingly, special note was made of the concept of a tourist accommodation tax. The additional costs created by large seasonal influxes of visitors could potentially be offset by such a charge, but only if it was locally administered. However, the significant disbenefit is the potential for a loss of competitive advantage – tourists will simply go elsewhere. (Restormel Borough Council)

8.126 Many of those who wrote to me, including a substantial campaign from the hotel industry, were concerned that I might recommend a blanket tax on tourist accommodation across the country, regardless of the characteristics of the area or its economy. However, I have concluded that no single mechanism or economic instrument is likely to fit the needs of circumstances of all local authorities. I do not recommend a generally applicable ‘bed tax’. However, in some areas there may be a case for a tourist related tax, developed in partnership with local businesses and residents – possibly through an annual bed licencing scheme levied on operators, or alternatively by directly levying the tax on overnight visitors.

8.127 I do not support the introduction of any new taxation powers for the sake of it. In my view, a local accommodation tax is only likely to be acceptable if a local authority can demonstrate that:

- there is a robust evidence base that the local economy could support the introduction of the tax, including the likely start-up, collection and enforcement costs;
- existing alternatives, such as Business Improvement Districts, have been fully considered;
- there is local support for the tax; and
- the scheme has been developed in partnership with local businesses and residents, who should continue to have a voice in the evolution and review of the scheme.

8.128 In practice the impact of a levy of this kind would vary greatly between areas. A tax that would have very little impact on tourist numbers in one place might be more damaging in another, and there is not at present sufficient evidence on which to assess this at a fine-grained local level. Local authorities would therefore need to undertake rigorous analysis of the likely economic costs and benefits of levies in their areas before implementing any such scheme. Decisions about the viability of local tourism levies would need to be taken on a case-by-case basis.

8.129 It is also not clear that there is significant local appetite for new powers to tax tourists, and before extending such powers it would be important to establish that local authorities would wish to make use of them, and to undertake the necessary analytical and engagement work that would pave the way to any tax being implemented. A wider consultation with local authorities and the tourism industry would be necessary to examine this fully.

Recommendation 8.8

The Government should consult on the costs and benefits of providing a permissive power for local authorities to levy taxes on tourism, including a possible tax on accommodation, and whether local authorities would use such a power. It should use the results of that consultation to examine the case for extension of such powers to local authorities.