Tax reform technical study
Report for New West End Company

July 2018

Arup
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Much of the analysis in this report is based on analysis of data supplied by third parties. We have satisfied ourselves, so far as possible, that the information presented in our report is consistent with published information and the information provided to us, however, we have not sought to establish the reliability of the sources by reference to other specific evidence.

We emphasise that any forward-looking projections, forecasts, or estimates are based upon interpretations or assessments of available information at the time of writing. The realisation of any prospective financial information is dependent upon the continued validity of the assumptions on which it is based. Actual events frequently do not occur as expected, and the differences may be material. For this reason, we accept no responsibility for the realisation of any projection, forecast, opinion or estimate.

Findings are time-sensitive and relevant only to current conditions at the time of writing. We will not be under any obligation to update the report to address changes in facts or circumstances that occur after the date of our report that might materially affect the contents of the report or any of the conclusions set forth within.

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Limitations
We have made a number of simplifying assumptions in order to complete our work. These assumptions have been necessary in order to build upon previous work denoting the size and structure of existing tax regimes. Ultimately, the design of any future tax will have implications on the tax rate, incidence, any exclusions or exceptions, and so forth.

We have not modelled the impact of any tax reforms on the full impact on businesses, property owners or consumers. This work should be carried out at a future date, in particular in response to proposals for any changes to taxing online retail in relation to the Government’s existing White Paper.

Ove Arup & Partners Limited, July 2018
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Executive summary

England’s business rates system is arguably one of the most challenging and inefficient taxes for businesses and local government alike.

After years of slow and steady reform of the system, now is the time to drive forward with more radical change. And the New West End Company believes Brexit poses a considerable opportunity to reform the way the British government taxes business and funds local government.

UK local government is uniquely dependent on property taxes, more so than any other OECD country. A combination of poor tax design and high dependence creates a chronic problem for businesses and councils.

This report sets out the key challenges of the business rates system. It then goes on to identify eight key measures which can improve the design of the tax to support economic growth and provide a fundamentally better source of local tax revenues.

However, reforming business rates may not go far enough. The UK’s reliance on commercial property for taxes for funding local services is a source of inefficiency in our tax system and for growing firms.

Arup was commissioned by the New West End Company to assess two alternative taxes—a turnover tax and a local sales tax—as alternatives to business rates, calling on precedents from other countries.

Local sales tax (implemented with a VAT system) emerges as a potential replacement for business rates, both in terms of working for business and local government. This is true so long as the local sales tax is implemented on the same tax base as business rates, not just retailers. It can arguably tackle the challenges of a 21st Century economy, taking into account the changing nature of high streets, retail and online-businesses.

A local sales tax would link business performance to tax liability more effectively, and it could be operated within the VAT system as a tax at final sale. Looking forward, the feasibility of a sales tax and its prospective benefits present a real opportunity to make business taxes work better for government and the British economy.

Source: New West End Company
Introduction

Background and report structure

Study objectives

In July 2017, Arup, with advice from Professor Tony Travers of the LSE, produced research on behalf of the New West End Company (NWEC) to examine the relative merits of six local business tax systems as possible alternatives to the current business rates system.

The challenges of the business rates system for local government (as a funding source) and businesses (as a tax) are well-evidenced, and this research outlined options beyond business rates reform. Based on the conclusions of this work, NWEC commissioned work to explore in greater detail two specific taxes – a local sales tax and a local turnover tax.

The objective of this report is to consider how those two taxes could work in the UK, particularly whether they would be more effective than business rates in the long-term. The taxes are assessed against six criteria:

- **Collection** – ease of collection compared with a property based tax
- **Collection rates** – level of collection and ease of avoidance
- **Income generated** – level of tax collected to spend on local services
- **Equity** – the spread of the tax across local businesses
- **Ability to pay** – the relationship between taxation and ability to pay
- **Impact on the economy** – how a different basis for local business taxation would affect the local and national economy

This report provides a high-level appraisal of:

- The ease of transferring from one scheme to another
- The merits of a mixed system of business rates and either sales tax or turnover tax

The study also qualitatively examines the impact of a change from business rates on the following policy areas:

- Devolution of business rates to encourage local growth
- The funding of BIDs and TIF schemes
- The proposals of the Mayor's London Finance Commission

Structure of the report

This report is organised into three sections:

**Section one** is a review of the current business rate system as a way of business contributing to the financing of local services. This draws on analysis from the 2017 research paper, but additionally considers the impact of increasing funding requirements for local government services.

**Section two** is a high-level study of short-term, marginal changes that might improve the effectiveness, efficiency and suitability of the business rate system.

**Section three** is a detailed study of two options that were considered in the 2017 research paper: a local sales tax and a local turnover tax.
Section one
Challenges of the current system
Challenges of the Current System

Introduction

This section draws on Arup’s July 2017 research paper for NWEC which evaluated the benefits and limitations of the current business rates system. Specifically it provides:

- An international comparison of property tax’s role in funding local government
- A summary of the UK business rates system and an update on recent reforms, including the limited moves towards fiscal devolution
- An illustration of previous and current tax systems
- An assessment of the current business rate system against the principles of good tax

Source: DCLG. 2017. Local government financial statistics England no. 27 2017. Data from Revenue Outturn (RO) returns and Capital Outturn Returns (COR), 2015-16
**Challenges of the current system**

Property tax (commercial and residential) is the only tax revenue for local government funding in the UK.

### Reliance on property tax (residential and commercial) for local tax revenue

- **High (>50%)**
- **Mid**
- **Low (<10%)**
- **N/A**

Source: UN Habitat, Arup graph

### Property tax as a proportion of local tax revenue

Source: GFS 2010, computations by author.
Challenges of the current system
But only 30% of UK property tax is retained by local Government

Distribution of property taxes to local government

High (90%-100%)
Mid (89%-40%)
Low (<40%)
n/a

Distribution of property taxes to local, regional and national Government

Source: UN Habitat
Challenges of the current system

Summary

The UK relies more heavily on property tax than any other OECD country. The UK is unique in its dependence on property taxes—both as a percent of total taxation and as a percent of GDP—within the OECD. This system creates distortions in the property market and encourages and discourages certain types of development. It also decouples taxation from ability to pay based on economic cycles.

The focus on commercial property taxes in the UK is also particularly challenging. Research by the British Property Federation shows that in 2015, while business rates raise about 80 percent as much as the tax take of council tax, the asset base of commercial property has a value just one sixth of that of residential property.

The system does not work well for business, and the existing system presents particular challenges for local authorities as a funding source. Together, local property taxes account for more than 60 percent of local government funding, making them particularly vulnerable to sudden changes in the property market.

The reliance on commercial property—which is both an asset and a business input—is a burden on business and can distort incentives for development of commercial property. In areas with particularly high property values, such as London and the South East, these problems can be particularly pronounced. In places with lower property values, reliance on commercial property taxes for local income can encourage the wrong type of development rather than incentivising development in transport, business support or innovation schemes which would have a great long-term economic impact.

A “one size fits all” regime for a country with major economic disparities is no longer sustainable. While successive governments have worked to devolve business rates in various ways, wholesale reform might well be required to make the tax work sufficiently for the business community and local authorities alike.
**Overview of the business rates system**

Business rates are a levy on non-domestic property value paid by occupiers of the property. In 2016/17, £23.5bn was raised through business rates across the UK. Of this, £11.9bn was retained locally, providing 7% of total local government funding. Its objective is to ensure businesses make a contribution to funding public services in their locality, comparable to Council Tax for domestic residents. Each business’s levy is a function of the rateable value of the property they occupy and the tax rate percentage (known as the multiplier). The rateable value is similar to market value rent and is assessed by the Valuation Office Agency. The multiplier is set by Government and increases with inflation (RPI). Both are reset every five years, allowing the tax to reflect changes to property markets while ensuring the total revenue raised nationally only rises in line with inflation.

Reliefs or discounts apply to some businesses, such as small businesses and charitable organisations.

Business rates are collected by local authorities. Until 2012 all the revenue was passed to central Government which then provided funding for local authorities through the Formula Grant, a complex needs-based assessment mechanism that was designed to ensure local authorities were funded on the basis of need rather than the amount of business rates they collected.1

Almost half of local authority revenue income came from central Government in 2010/11, making the UK one of the most centralised local government finance systems in the world.2

**Reform since 2012**

The Local Government Finance Act (2012) introduced partial retention of business rates for local authorities in an attempt to “make councils more financially sustainable and give them a stronger financial incentive to promote local business growth”.2 This means that councils retain up to 50 percent of the business rates they collect, and the remaining 50 percent is redistributed based on need (similar to Formula Grant).

Partial retention was intended as a first step towards full devolution of business rates by 2019/20 target.3 This has been delayed following the outcome of the 2017 General Election,4 but the Government remains officially committed to business rates devolution.

To test the design of devolved business rates, two waves of pilot schemes have been agreed:

- From 2017/18, to the five combined authorities with ratified devolution deals (Greater Manchester, Liverpool City Region, The West Midlands, Cornwall and The West of England); plus the Greater London Authority; and
- From 2018/19 to another ten local authorities that are yet to be announced, but will include some two-tier authorities.5

Once complete, full business rates devolution will mean that less than 10% of local authority revenue funding comes from central Government.1 However, the design of the new business rates system will be key to determining how much actual control local authorities have over the revenue stream.

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**References**

1. National Audit Office, Local government overview, October 2016
3. Local Government Chronicle, April 2017
4. Office for Budget Responsibility. March 2017
5. 2018-19 pilot programme invitation, DCLG, Sept. 2017
**Challenges of the current system**

Changes in rateable values have had a dramatic impact on business rates collection in London and other cities.

**Impact of cap on business rate collection and growth incentive**

- As a result of 2010 revaluation, national average rateable value increased by 21%.
- Increase of business rates collected in local authorities which has a higher than average growth in their rateable value.
- In contrast, total business rates were reduced in areas where relative growth was below national average, despite net growth.
- The graphs to the right illustrate how some English cities see growth in their average rateable values while their total rates collected falls. This is due to the capping mechanism. It results in some cities' businesses seeing very large increases in their rates liability at revaluation.

**Figure 1. Average change in rates bills due to revaluation, by region, before accounting for adjustment to multiplier to account for expected appeals**

Source: Gal Business Rates Revaluation Consultation and VOA rateable value data.
Source: Institute for Fiscal Studies

Above: Rateable value change, 2008/9-2014/15
Below: Business rates collected, 2008/9 – 2014/15

Source: Graphs: Centre for Cities. Data: VOA, DCLG Collection Rates for Council Tax and Non-Domestic Rates.
Note: Values are indexed on the year 2009/10, which is one year before the 2010 revaluation.
Challenges of the current business rates system
Taxes should be judged against certain objectives and principles of effective design

Building on the Principles of Good Tax (Mirrlees Review), a 2013 review for the Scottish Government proposed five overarching objectives of taxation, four principles of effective design, and three methods – as shown below.\(^1\)

On the pages that follow, we consider the extent to which business rates meet three key objectives – equity and redistribution, macroeconomic stabilisation, and a particular focus on growth and competitiveness – and we look in detail at how business rates fit with the principles of effective tax design.

The impact of appeals and the timing of the initial baseline calculations have meant that there has, to date, been no real correlation between boroughs’ economic growth and business rates growth, and similarly between this overall business rates growth and retained business rate income

GLA, London Council, Consultation Response to “100% Business Rates Retention”

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Challenges of the current system

Equity and redistribution
Redistribution between local authorities on the basis of need is a fundamental principle of the business rates system, even as it moves towards 100% retention.

At the taxpayer level, however, equity issues arise when considering two consequences linked to fixed rates periods, resets and capped total yield mechanism:

i. In a fluctuating market subject to macro-economic shocks, businesses are likely to either over-pay or under-pay rates against the real rateable value of their property between two revaluations.

ii. National divergence of regional property values and exemptions for small businesses are putting an increasing pressure on a smaller number of properties in each city and on large businesses to generate national yield.

Macroeconomic stabilisation
Though business rates provide a stable revenue stream at the national level, at the local level they are unreliable for two main reasons:

i. The number of occupier appeals makes it difficult for local authorities ability to forecast revenue. It also means local authorities have to retain money in case they lose appeals which could otherwise be spent on public services.

ii. The funding stream is not aligned to demand. This creates additional cost pressures in areas of high population growth.

Growth and competitiveness
The Government’s recent reforms have partly been motivated by the need for business rates to better support growth and competitiveness.1 Underpinning this is the assumption that allowing local authorities to have more control over business rates will incentivise them to increase economic growth in order to increase their business rate income.2

However, the system as currently designed fails to achieve its goal to incentivise growth and productivity. Instead it reinforces the economic and productivity status-quo of places and fails to curb the economic productivity of weaker economies.3 There are three main reasons for this:

i. The system only rewards areas that have capacity to increase floorspace, typically where commercial demand already exists, so tends to deliver more of the same.

ii. Local authorities are incentivised to prioritise floorspace growth, but high-productivity industries tend to require less floorspace.

iii. Local authorities have no guarantee that they will retain any increase in business rates income over the long-term.

These issues can be attributed to elements of the business rates system design:

- Growth is defined on the basis of physical increase only.
- The capped total yield reduces potential for additional yield to be redistributed across the country.
- The unique multiplier that is applied nationally,4 manipulated to achieve an aggregate yield of business rates.
- The local retention rate (50%) applies to additional growth above baseline and is too low to incentivise growth.
- There is a levy on disproportionate growth for tariff authorities.
- Resets and revaluations create a cliff-edge effect.

1. Vision for the tax reform is to “reward growth and share risk.”
2. Self-sufficient local government: 100% business rates retention, Consultation Document, July 2016
3. Centre for Cities, Maximising the growth incentive across the country, Nov 2017
4. GLA, London Council, Consultation Response to “100% Business Rates Retention”

1. There are two rates set nationally: Small Businesses rate and Others. This excludes special reliefs local authorities can apply on certain types of businesses.
Challenges of the current system
The design of tax systems should be simple, stable and neutral

Principles
The Mirrlees Review provides a comprehensive view of what matters for the design of a good tax system for a "given distributional outcome", based on Adam Smith's canons of good taxation. The review concludes that "a system that is simple, neutral and stable is best placed to meet these objectives".¹

The three principles are complementary and non-exclusive, part of a self-reinforcing virtuous cycle to achieve the objectives of a good tax. Arguably the first principle (simplicity) is the most important. A tax with rules that are clear and simple for all to understand and implement improves predictability and certainty in forward planning; in turn improving efficiency, integrity and participation.

Review
The following pages provide details on the rationale underpinning the assessment of the business rate system (centralised and current) against the principles of good tax.

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Challenges of the current system
Partial retention, while yielding some benefits, has made a complex system even more difficult to understand

<table>
<thead>
<tr>
<th>Principles of good tax</th>
<th>Centralised rates - y/n</th>
<th>Centralised rates - Comment</th>
<th>Change</th>
<th>Partial retention rates – Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simplicity = Transparency (for taxpayers)</td>
<td>No</td>
<td>In principle yes: levy is a simple function (RV x multiplier) But in practice no due to a range of caveats and adjustments to “make the system work”, including: - Relief rates, discretionary relief rates, complex resetting mechanism and sudden changes in rates.</td>
<td>No change</td>
<td>Partial devolution changes hasn’t significantly improved nor worsened the clarity of the tax rules from the perspective of taxpayers. Notwithstanding revaluation periods call for complex and unclear adjustments (transition relief, revaluations open to appeal, change in rates, etc.) that add to the overall complexity for taxpayers.</td>
</tr>
<tr>
<td>Simplicity = Transparency (for local government)</td>
<td>No</td>
<td>Needs assessment makes the funding distribution opaque, and complex formula grant methodology means councils have no transparency between the level of rates they collect locally and the funding received.</td>
<td>Worse off</td>
<td>Successive changes to revenue support grant methodology make it difficult to understand whether the reform is truly fiscally neutral and whether there is a fair funding for responsibilities 1</td>
</tr>
<tr>
<td>Simplicity = Fair (ability to pay)</td>
<td>No</td>
<td>Distribution of tax burden is linked to a relative value change over a very disparate national property market. This puts an unfair burden on businesses located in areas with high property markets, and holds values down in other areas. It also means the levy for individuals isn’t linked to real economic activity of businesses or ability to pay. 2</td>
<td>Worse off</td>
<td>Marginal improvements to reliefs (i.e small business rate threshold and rate) and transitional support funds aim to ease significant uplift in bills in the successful places. But postponed revaluation period whilst previous rates were set at the height of the market has made matters worse for areas most subject to the following economic downturn.</td>
</tr>
<tr>
<td>Neutrality = fair (equitable)</td>
<td></td>
<td>Business rates tend to strengthen the competitive advantage of online retailers as well as the historical cost base of high street shops. The typical London shop is facing a 14 per cent rise in rates, and the average shop across the country a 8.5 percent rise, while online retailers operating from out-of-town warehouses will only pay an extra 2 per cent. Certain sectors—like retailers and restaurants—have particularly high business rates burdens compared to their total output. Retail contributes £7 billion business rates annually, more than any other sector. 3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. GLA, London Council, Consultation Response to “100% Business Rates Retention”
**Challenges of the current system**

Partial retention has made a complex system even more difficult to understand (contd.)

<table>
<thead>
<tr>
<th>Principles of good tax</th>
<th>Centralised rates - y/n</th>
<th>Centralised rates - Comment</th>
<th>Change</th>
<th>Partial retention rates – Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simplicity = Efficient</td>
<td>Yes</td>
<td>The 5/7-year resetting period minimises valuation and administrative costs to review funding to local authorities.</td>
<td>Worse off</td>
<td>The new system, with a growing number of reliefs, criteria changes, appeal options etc. is “opaque even for Finance Professionals”1</td>
</tr>
<tr>
<td>Minimises administrative burden</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Simplicity = Predictable</td>
<td>No</td>
<td>Opaque formula grant means there is no link between what they know business rates collected locally generate the grant funding they receive.</td>
<td>Worse off</td>
<td>Retention and redistribution formulae are even more complicated, with a split between central / local shares, alongside a system of tariffs and top-ups to share risk and ensure a level of redistribution between local authorities. Tiered authorities have another level of complexity. Complexity is added at national level when considering the pilot authorities for 100% retention scheme not to negatively impact other places.</td>
</tr>
<tr>
<td>Tax rules are easily understandable by local government</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stable = Predictable. For taxpayers</td>
<td>No</td>
<td>Rates clearly set out in the short term, but lack of predictability beyond revaluation period bears a significant impact on business’ ability to make long-term investment decisions.</td>
<td>No change</td>
<td>Possibly worse off, same as above.</td>
</tr>
<tr>
<td>Stable = Predictable. For Government</td>
<td>Yes</td>
<td>A property based tax is its preferred method of local business taxation for Government because it is easy to collect, difficult to avoid and its income (around £25 billion pa) is predictable, regardless of the state of the economy.</td>
<td>Worse off</td>
<td>Rather than rates being redistributed through a relatively predictable Formula Grant, it is not partially based on local property market performance (relative to the rest of the country). Unpredictability of appeals means Government underestimated the call of safety net in first years, creating a deficit against funding baseline in some places.1</td>
</tr>
</tbody>
</table>

GLA, London Council, Consultation Response to “100% Business Rates Retention”
Section two
How the current system can be improved in the short term
How can the current system be improved in the short term?

Introduction – These eight measures can improve the business rates system

Section two is a high-level study of short-term, marginal changes that might improve the effectiveness, efficiency and suitability of the business rate system.

The propositions put forward here reflect London Finance Commission’s and other organisations’ recommendations to improve the current system.

The eight key propositions are reviewed in turn, pulling out the impact on issues identified with the current system, as well as perspective on implementation, timeframes* and legislative deliverability. We then consider which measures would be likely to have a particularly beneficial impact in the West End.

**Make the system more flexible and responsive**

- (01) Make property value more frequent to make it better aligned to market prices
- (02) Remove the cap on total business rates yield
- (04) Devolve Valuation Office Agencies

**Reward growth of value and floorspace**

- (03) Capture value growth as financial incentive

**Prevent London’s distortion of national valuations**

- (05) De-couple London’s business rates system from the rest of the country

**Share rewards and risks within functional economic areas**

- (06) Pooling business rates across functional economic areas (city-regions, devolved authorities)

**Devolve decision making (07)**

Devolution of further responsibilities and decision-making to adapt the tax system to respond to local economies and politically accountable decisions, including:

- Ability to set their own rates
- Resets and funding baselines
- Needs Assessment
- Qualification criteria and thresholds for reliefs.

**Adapt equity to modern business models**

(08) Revise rateable value assessment for online retailers to reduce equity gap.

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1. Centre for Cities, Maximising the growth incentive across the country, Nov 2017
2. GLA, London Council, Consultation Response to “100% Business Rates Retention”
3. Ibid Centre for Cities

*Timeframes are defined as short-medium and long-term, where short-term refers to measure being implementable under the current Parliament (up to 2022), medium-term to the following Government (2022-2027) and long-term anytime following 2027.
How can the current system be improved in the short term?
The system needs to become more responsive

<table>
<thead>
<tr>
<th>Measure outline and rationale</th>
<th>Impact</th>
<th>Implementation</th>
</tr>
</thead>
</table>
| **01** Make property valuations more frequent so that rateable values are better aligned to market prices. | Medium Impact – see precedent case of impact from changes to annualised valuations study in appendices ✓ Allow cities to benefit from growth more quickly ✓ Allow to smooth changes in rateable value, business rate bills and income generated for businesses and local authorities ✓ Making rateable values more predictable and accountable, possibly reducing the number of appeals and associated costs to local government ✓ Bring more certainty to revaluation timeline | Short term
This measure does not require significant change to the current system, broadly implies resourcing or capacity constraints of Valuations Office Agencies as they currently stand.

In the United States, property values are determined annually by jurisdiction based on market value assessment.1 Devolving Agencies (06) could help deliver annual updates more effectively. The final assessment system could include a hybrid of self-assessment, annual estimates and cyclical audits (e.g. every three years).

| **02** Remove cap on national business rates yield. | High impact ✓ Reward net growth rather than relative growth to national average ✓ Increase national yield in line with economy | Medium term No legislative blockage, theoretically relatively straightforward to implement with Council Tax cap removed as a precedent. It is also aligned with Treasury’s positioning in regards in increasing fiscal revenue without changes to tax base or rates. It would require significant review of tariffs and top-ups formulas, but this is secondary to the additional revenue it could generate.
This measure has the potential for greatest impact in terms of revenue yield to local government. Benefits could be maximised if combined with (03) “Capture Value Growth”, and (05) “Decoupling London’s business rates”.

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# How can the current system be improved in the short term?

The system needs to reward other types of growth.

<table>
<thead>
<tr>
<th>Measure outline and rationale</th>
<th>Impact</th>
<th>Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>03</strong> Include property uplift in addition to floorspace increase as financial incentive</td>
<td>High impact</td>
<td>Short term</td>
</tr>
</tbody>
</table>
| Business rates growth should be measured using two mechanisms rewarding growth:  
  - Increasing value of existing properties (value uplift), and  
  - Increasing the tax base (floorspace growth). | ✓ Balance revenue stream between areas with high value growth and those with floorspace capacity  
  ✓ Incentivise local authorities to invest in their cities to improve their business environments (public realm, transport links, etc.) | Implementation would require a change in formula and secondary legislation related to uplift councils can retain above baseline growth. With long revaluation periods, assessing additional value uplift could become increasingly open to conflicts between local and central government.  
Data is already captured by VOA for revaluations, but not included in the formula base.  
This measure would be much more efficient and accountable through frequent valuations (01), but this isn’t essential.  
It would come at minimal cost compared to the potential additional revenue to local government – which would be maximised if the cap on national yield was removed (02). |

<table>
<thead>
<tr>
<th><strong>04</strong> Devolving Valuation Office Agencies</th>
<th>Low impact – nice to have</th>
<th>Short term</th>
</tr>
</thead>
</table>
| Exact process of valuation would be determined at local (combined) level, but could include a system of self-assessment or formula based, allowing more frequent valuations responsive of underlying economic conditions | ✓ Enable more frequent valuations  
  ✓ Improve effectiveness, efficiency and accountability of valuations  
  ✓ Flexibility of process determined at a sub-regional level (No impact ion local government revenue) | Easily implementable at a combined authority level with governance, funding and accountability structures already in place that could take up sub-regional VOA roles efficiently. Precedents in Scotland and Wales government implementation of regional and independent VOAs.  
This could coincide with the VOA’s plan to shut down 26 of its 52 offices by 2023 and focus its presence in big cities. |
How can the current system be improved in the short term?
The system needs to work with the UK’s economic geography

<table>
<thead>
<tr>
<th>Measure</th>
<th>Impact</th>
<th>Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td>De-coupling London’s business rates system from the rest of the country</td>
<td>High impact</td>
<td>Long term</td>
</tr>
<tr>
<td></td>
<td>✓ prevent the capital’s robust property market from continuing to distort the operation of the national system</td>
<td>This measure is one of the most politically laden with London being seen as “subsidising” the rest of the UK1. Yet it is one of the most effective ways to create significant impact in terms of local government funding for the rest of the country. In addition to being politically difficult to champion at this date, it would also require secondary legislation change.</td>
</tr>
<tr>
<td></td>
<td>✓ allow business rates baselines to increase outside of London at a rate which reflects local authorities’ own economic investment and growth</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Drawbacks / risks:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>✓ By removing London’s property market from the national portfolio (in a system with redistribution), it could increase the risk of other places</td>
<td></td>
</tr>
<tr>
<td>Pooling business rates across functional economic areas</td>
<td>Low Impact</td>
<td>Short term</td>
</tr>
<tr>
<td></td>
<td>✓ Allow places providing workers to surrounding employment areas to benefit from their contribution to the regional economy and growth in the city</td>
<td>This measure is already implemented in combined authorities on a voluntary basis, and is seen to continue to be supported as devolution trends continue to bring places under a shared governance structure. It was recently cited by Centre for Cities as a key mechanism for preventing local funding crises like Northamptonshire in 2018.</td>
</tr>
<tr>
<td></td>
<td>✓ Mitigate negative competition for investment between surrounding areas</td>
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<tr>
<td></td>
<td>✓ Provide a more strategic allocation of funds for services where they are needed at a city-region level</td>
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<tr>
<td></td>
<td>✓ Yield higher economic and financial benefits to the city-region</td>
<td></td>
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<tr>
<td></td>
<td>Drawbacks / risks:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>✓ Places that do not fall under a city-region / combined authority will remain strongly dependent on national redistribution mechanism of top-ups and tariffs.</td>
<td>There is potential for local government to lobby more strongly for the combined benefits and for Central Government to require more evidence of shared tax revenues in Devolution Deals in the future.</td>
</tr>
</tbody>
</table>

How can the current system be improved in the short term?
The system should be controlled at a local level

<table>
<thead>
<tr>
<th>Ref</th>
<th>Measure</th>
<th>Impact</th>
<th>Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Local control over rates</strong></td>
<td>Low impact</td>
<td>Long term</td>
</tr>
</tbody>
</table>
|     | Whether local government then chooses to maximise income against that tax base, or to cut rates as RV rises, should be a matter of (local) political discretion and accountability. Changes to rates above certain levels could be subject to local referendum, similar to the council tax mechanism for increasing more than 2 percent. | ✓ Could create a far stronger platform on which to increase incentives to support economic growth, promote broader policy objectives and link councils more closely to their business communities  
   ✓ Locally accountable, with direct correlation between tax characteristics and local services | These measures are strongly dependent on achieving greater devolution of fiscal and legislative powers to local authorities, implementation of the 100% retention of business rates throughout or a (full reform of tariff and top-ups system without). |
|     | **Local control over reset periods**                                    |                                                                        |                                                                                |
|     | Manage future resets of business rate and funding baselines taking into account the overall balance between spending need, council tax base, the speed of change and the desire to maintain incentives within a devolved system. |                                                                        |                                                                                |
|     | **Local assessment of needs**                                           |                                                                        |                                                                                |
|     | London Government proposes a two-stage process in which a regional needs assessment for the capital would be combined with the ability to vary a needs formula within London over time to reflect local circumstances. This concept could be applied to other combined local governments across the country. |                                                                        |                                                                                |
|     | **Qualification criteria and thresholds for reliefs**                   |                                                                        |                                                                                |
|     | Locally set qualification criteria and threshold for mandatory reliefs and/or determining new mandatory relief schemes (i.e small business rates relief threshold). |                                                                        |                                                                                |

GLA, London Council, Consultation Response to “100% Business Rates Retention”  
Centre for Cities, Maximising the growth incentive across the country, Nov 2017
**How can the current system be improved in the short term?**
The system needs to be designed fairly both for online and high-street retailers

<table>
<thead>
<tr>
<th>Measure</th>
<th>Impact</th>
<th>Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Apply Receipts and Expenditure valuation method for online retailers’ distribution centres</strong>&lt;br&gt;Some business types such as hotels as evaluated on a Receipts and Expenditure method as opposed to standard rental values.&lt;br&gt;RVs are valued based on a percentage applied on Fair Maintainable Trade; where the percentage varies upon profitability, type of business (e.g. hotel) and trading performance; and FMT based on 3-year receipts.&lt;br&gt;A similar valuation method could be devised by VOA for distribution centre / online retailers to capture better relative values in outputs against high street retailers. However, care must be given such as businesses which have an online presence for sales but also pay high street or office business rates are not essentially double-taxed.</td>
<td>Low impact&lt;br&gt;✓ Rebalance costs on businesses induced by business rates between online and high-street retailers and reduce unfair competitive advantage&lt;br&gt;✓ Modernise tax system to reflect recent changes in the economy and new disparities</td>
<td>Short-term&lt;br&gt;• No legislative changes would be required to implement this measure but would only require changes to valuation methodologies used by VOA.&lt;br&gt;• There are likely to be challenges in defining a sub-category for distribution centres specifically for online retailers as opposed to other distribution centres (e.g. serving high-street shops)</td>
</tr>
</tbody>
</table>

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**How can the current system be improved in the short term?**

Moves to yearly revaluations in other countries have led to less variation in rateable values, fewer appeals and administrative savings.

In England, revaluations currently take place every five years, moving to every three years from 2021. Since 2010, 35% of all business properties have appealed their assessment. This is expected to increase further (40%) following 2017 revaluation.

Hong Kong and the Netherlands have both reformed their revaluations system in recent years. In Hong Kong, prior to 1999 revaluations were carried out every three years or more, but are now carried out annually. In the Netherlands there was a gradual transition from a 5-year revaluation period, to two 4-year periods, then two 2-year periods, and now annual revaluations. In both cases the move to annual revaluations has led to a significant reduction in the number of challenges and appeals to businesses' rateable values. This is likely to be a result of the more gradual changes in rateable values, as shown in the charts below.

In the Netherlands in particular, there has been a decrease from 7-8% appeals under 4-year periods to 1.6% under annual cycles. The Netherlands has also seen 27% savings in property tax administration costs.

The BPF estimates that potential administrative savings from moving to an annual system in England are between £56m and £183m per annum. There would also be potential to abolish transitional relief, saving a further £230.8m per annum.

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**Source:** BPF, Arup graphs

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**Better Rates for Better Business, British Property Federation**

How can the current system be improved in the short term?
The political context has held back meaningful reform

All of these propositions have been lobbied for by the London Finance Commission, supported by think tanks (e.g. Centre for Cities, Institute for Fiscal Studies) and are broadly aligned with Treasury’s views on the topic.¹ There was a significant amount of media and public attention following the dramatic increases in business rates bills for London following the 2017 revaluation. Despite widespread support and strong arguments in favour of reform, only limited progress has been made in improving the business rates system. The previous Chancellor’s commitment to allow local government to retain all business rates by 2020 was delayed when the enabling legislation fell at the end of the last Parliament. The new Government has said it remains committed to the policy on a longer timeframe, but is currently only rolling out business rate retention on a pilot basis. The Chancellor has announced that revaluations will take place every three years, but only from 2020 and with no timeframe for moving towards annual revaluations. In Scotland and Wales, business rates have been devolved and reformed, providing a useful precedent for the English system, but one that has not yet translated into political action.

In the short-term wholesale reform of the business rates system is unlikely, particularly for changes that require legislation, as the Government remains focused on other priorities.

In this context, the ten measures that were outlined previously are assessed in terms of:

a. **Impact** – on local government funding and/or tax burden on businesses (e.g. improving efficiency, perceptions, ability to pay); and

b. **Timeframe** – in light of political context and the mechanism for change (any legislative change will require much longer timeframes than administrative measures).

¹. London Finance Commission interviews with Treasury
How can the current system be improved in the short term?

Summary – A package of priority measures could provide short-term benefits

A package of three measures would have significant impact on greater revenue retention locally whilst being implementable in the short to medium term:

- (03) Capturing growth in value as a financial incentive;
- (01) More frequent valuations; and
- (02) Removing the national cap on total yield.

The first two would be quickest to implement. They would be more efficient and effective if implemented alongside measures (04) and (06) – “Devolving Valuation Agencies” and “Pooling revenues sub-regionally” respectively. These would be relatively low impact individually but potentially important as part of a wider reform package.

Collectively the four measures that form the short-term measure would:

1. Allow cities to capture financial incentives from investments in supply and value growth;
2. Allow places providing workers to surrounding employment areas to benefit from growth (in supply and value); and
3. Increase certainty and reliability of valuations and smooth changes for businesses, reducing the need for appeals and transitional reliefs.

Benefits from the first package would be maximised if the cap on national yield were removed (02). Local revenue retention would be directly linked to net growth as opposed to relative to the rest of the country – which is likely to continue to be distorted by London’s pull on value growth.
How can the current system be improved in the short term?
West End Businesses would particularly benefit from three of the proposed measures

Each of these measures would affect different parts of the country in different ways. In the West End businesses have some of the highest rateable values in the UK and there were dramatic increases in 2015. In this context three measures are judged to be of particular potential benefit.

**Decouple London**
London’s property market has distorted the national business rates system, leading to disproportionate increases in rateable values for many businesses. Decoupling London would enable the system to take account of London’s distinct property market.

**Devolve decision making**
The West End is unique, not just for its high land values but also its mix of economic activity and particular challenges around public realm and infrastructure. Local decision making would mean the business rates system could be tailored to meet these circumstances.

**Reduce the equity gap**
High rateable values in the West End mean that its retailers are amongst the worst affected by the equity gap between online and high-street retailers. Addressing this would achieve a more even playing field.

1. **Annual revaluations**
   3-years revaluations implemented from 2022 >> Annual

2. **Remove cap on national yield**
   Allow total yield to increase faster than CPI; Reward net growth not relative growth

3. **Capture value growth**
   Change formula base to include value uplift not only quantum growth

4. **Devolve Valuations Agencies**
   Improve efficiency and accountability of valuations; enable more frequent valuations and value capture.

5. **Decouple London**
   Prevent the capital’s robust property market from continuing to distort the operation of the national system

6. **Share risks and rewards**
   Across functional economic areas

7. **Devolve decision making**
   Revise evaluation approach for online retailers

8. **Reduce the equity gap**
   High benefit

   Medium benefit

   Low benefit
Section three
An alternative solution
An alternative solution
Introduction – Brexit creates an opportunity for a wholesale review of business rates

The New West End Company (NWEC) advocates a profound transformation of local business taxes that could achieve greater benefits, equity and transparency for both businesses and local government funding. The marginal changes outlined in the last section could go some way to improving the system in the short term, but in the long term a transformational solution may be needed in the way businesses are taxed locally.

NWEC believes the current political context of both Brexit and delayed full reform of business rates creates a unique opportunity to leverage political will around the transformation of the UK tax system in a post-Brexit context, and to strongly challenge, review and transform how local business taxes are raised.

From the previous Arup research, the NWEC Board identified two forms of sales tax worth investigating further as an alternative to raising local business taxes in lieu of business rates. These two options were a local sales tax and a local turnover tax.

Indeed Brexit provides an unprecedented opportunity to review business rates as a form of VAT / sales tax within a comprehensive review of VAT following Brexit.

The objective of this research is to propose how a local sales tax or local turnover tax could work in England. The two taxes therefore need to judged against key areas of performance:

- **Collection** – ease of collection compared with a property based tax
- **Collection rates** – level of collection and ease of avoidance
- **Income generated** – level of tax collected to spend on local services
- **Equity** – the spread of the tax across local businesses
- **Ability to pay** – the relationship between taxation and ability to pay
- **Impact on the economy** – how a different basis for local business taxation would affect the local and national economy

This section will draw on lessons from international systems to analyse the potential, benefits and challenges of the two taxes against the criteria set out above.

Consumption taxes
There are three essential consumption taxes: VAT, local sales tax and turnover tax (also referred to as gross income tax on businesses).

- **Value Added Tax (VAT)**
  VAT is charged on the supply of all goods and services made in the course of a business by a taxable person, unless they are specifically exempt. All businesses must register for VAT if their turnover of taxable goods and/or services is above a given threshold.
  VAT is charged on the additional value of each transaction, and is collected at each stage of production and distribution. A business pays VAT on its purchases - known as input tax, and charges VAT on its sales - known as output tax, settling up with the tax jurisdiction for the difference between the two.

- **Local Sales Tax**
  Local sales tax is similar to VAT in principle, with the difference that the levy is applied and collected only at the final sale to the consumer and intermediary sales are exempt from collecting the tax by issue of resale certificates.

- **Turnover Tax**
  Turnover – or gross income – tax is imposed on a company’s annual gross income, defined as the total business sales less cost of goods sold.

\[ \text{Turnover Tax} = \text{total business sales} - \text{cost of goods sold} \]

A turnover tax is similar to VAT, with the difference that it also taxes intermediate and possibly capital goods. It is an indirect tax, and is typically charged based on the value of the goods or services being sold, applicable to a production process or stage.
Section three: Part one

International case studies
International Case Studies
Most countries have a value added tax, but there are some notable exceptions

Almost all countries levy an essential consumption tax, and VAT is the most common form. They form the largest part of the revenue base in the United States. Retail sales taxes accounted for 0.4% of total revenue across OECD countries in 2014, while it accounted for 7.9% of total tax revenue in the US.

Legal tax liability, legal remittance responsibility and tax incidence, Three dimensions of business taxation, OECD 2017

Map source: Arup, data from Overview of General Turnover Taxes and Tax Rates, January 2012
International Case Studies
The US sales tax is highly variable, which can encourage avoidance

US sales tax
Instead of VAT, the United States levies a consumption tax in the form of a sales tax on purchased goods. US sales tax combines local and state tax rates, both of which vary between states and within states, as shown overleaf. The highest combined rates range from 9-10% (e.g. Louisiana, Tennessee) compared to lowest which are in the range of 4-5% (e.g. Hawaii, Wisconsin) and 2% (Alaska). Five states do not have a state-wide sales tax, of which two allow local sales tax to be collected.

The role of sales tax in state and local government finance
On average tax on sales and gross receipts represents a third of state and local government tax revenue in the US (2010), as high as property tax receipts – see right. However, its importance varies around the country, for example it makes up 60% of tax revenues in Washington, compared with 10% in Oregon. This variation is driven by a range of factors: the types of taxes and fees administered within state borders, the types of resources within the state, the amount of intergovernmental transfers, and the policy priorities of state and local governments.

Sales tax avoidance
Differences in rates can encourage tax evasion from customers who choose to shop in another locality to escape higher rates, particularly where there is a significant difference between two jurisdictions’ sales tax rates. Research indicates that consumers can and do leave high-tax areas to make major purchases in low-tax areas, such as in Chicago where evidence suggests that consumers make major purchases in surrounding suburbs or online to avoid Chicago’s 10.25% sales tax rate. At the statewide level, businesses sometimes locate just outside the borders of high sales tax areas to avoid being subjected to their rates. A stark example of this is in New England, where even though I-91 runs up the Vermont side of the Connecticut River, many more retail establishments choose to locate on the New Hampshire side to avoid sales taxes. The border county of Salem County, New Jersey, can collect half state-rate (3.4%) under a policy designed to help local retailers compete with neighboring Delaware, which foregoes a sales tax.

Sales taxes are just one part of the overall tax structure and should be considered in context. For example, Washington State has high sales taxes but no income tax, whereas Oregon has no sales tax but high income taxes. While many factors influence business location and investment decisions, sales taxes are something within policymakers’ control that can have immediate impacts.

Property tax
Property tax accounts for 35% of local and state tax revenues in the US, compared to over 100% in the UK. However, like in the UK, there is a preferential treatment of residential property compared to commercial. Commercial versus home tax rates vary from 2.1 to 4.1 times higher in US cities.
**International Case Studies**

The US sales tax is highly variable, which can encourage avoidance (contd.)

*Combined State & Average Local Sales Tax Rates, Jan. 1 2017*

Source: Sales Tax Clearinghouse, Tax Foundation calculations, State Revenue Department Websites
International Case Studies
The US local sales tax presents collection challenges

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Details</th>
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</thead>
<tbody>
<tr>
<td>Collection – ease of collection</td>
<td>Single collection point in the production change: Retailers collect the taxes and remit the proceeds to the tax authority. Intermediary purchases are exempt from the charge: businesses need to provide a reseller's permit or resale certificate to their suppliers to exempt sales tax. For instance, a coffee grind supplier will not charge sales tax to the coffee shop it sells coffee to against proof of reseller certificate. Rates vary by locality and by state. Retailers must apply different sales tax on products if selling in different states. This can become complex in large distribution contexts. Online sales apply in-state sales, out-of-state sales tax vary again depending on locality and tax status of business.</td>
</tr>
<tr>
<td>Collection rates – level of collection and ease of avoidance</td>
<td>There are roughly 10,000 sales tax jurisdictions in the United States, with widely varying rates. Collected at local (City, County, or municipality) and state levels, as one combined rate applied on purchases. Tax bases between state can vary greatly: e.g. the structure of sales taxes, defining what is taxable and non-taxable. For instance, most states exempt groceries from the sales tax, others tax groceries at a limited rate, and still others tax groceries at the same rate as all other products. Cities of Long Beach (CA) and Chicago (IL) apply the highest combined state and local tax rates in the USA at 10.25%. On average, Louisiana imposes highest average combined rate at 9.25%. Neither Anchorage, Alaska, nor Portland, Oregon, impose any state or local sales taxes. Tax authorities do not get tax revenue until the sale to the final consumer and audit trails are less clear than VAT systems, especially for services. This means there is a much less redundancy built into the system to ensure local governments retrieve part of revenue if the last segment evades or under-reports on payable tax. It is extremely difficult to ensure that inter-firm purchases used to produce taxable goods and services—and only those purchases—are exempt from tax. The 'ring' (or suspension) system used to achieve this result—under which tax is 'suspended' on sales by one registered firm to another and so on and on until there is a sale to someone outside the ring of registrants—is both cumbersome to police and easy to abuse. Differences in rates tends to encourage tax evasion from customers who choose to shop in another locality to escape higher rates. Avoidance of sales tax is most likely to occur in areas where there is a significant difference between two jurisdictions’ sales tax rates.</td>
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International Case Studies
But it performs well against other criteria

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income generated</strong> – level of tax collected to spend on local services</td>
<td>The importance of sales tax in state and local government finance in the US varies by state (based on the types of taxes and fees administered within state borders, the types of resources within the state, the amount of intergovernmental transfers, and the policy priorities of state and local governments). Overall sales tax receipts represent a third (34%) of state and local government tax revenues, but can range from 60% of local tax revenues (Washington) to 10% (Oregon), or nil if no state or local sales tax apply.</td>
</tr>
<tr>
<td><strong>Equity</strong> – the spread of the tax across local businesses</td>
<td>Tax experts generally recommend that sales taxes apply to all final retail sales of goods and services but not intermediate business-to-business transactions in the production chain. These recommendations would result in a tax system that is not only broad-based but also “right-sized,” applying once and only once to each product the market produces. However, it also means that the administrative burden falls wholly on the last supplier (typically a retailer). The tax base (what is taxable and non-taxable) varies greatly between states. Different policy orientation, level of needs, competitive context with neighbours, and nature of the local economies all impact policy decisions to set the tax base and rate. This creates equity implications for local businesses, particularly the less mobile ones.</td>
</tr>
<tr>
<td><strong>Ability to pay</strong> – the relationship between taxation and ability to pay</td>
<td>Sales tax by design does not impact business’ ability to pay as there is a single and direct correlation between collected and payable tax. The tax burden falls fully on the customer’s consumption capability. The exemption of sales tax for intermediary purchases reduces the cash-flow and administrative burden of claiming tax return (as in VAT).</td>
</tr>
<tr>
<td><strong>Impact on the economy</strong> – how a different basis for local business taxation would affect the local and national economy</td>
<td>State and local governments should be cautious about raising rates too high relative to their neighbours because doing so will yield less revenue than expected or, in extreme cases, revenue losses despite the higher tax rate.</td>
</tr>
</tbody>
</table>
International Case Studies

Argentina’s turnover tax is highly distortive and contributes to high consumer prices

- In Argentina, revenue is raised by the national, provincial and municipal governments, mainly through taxes levied on income, assets and consumption. At a national level, the main taxes levied include: Income Tax, Value Added Tax, Minimum Presumed Income Tax, Excise Tax, Personal Assets Tax, and Taxes on Debits and Credits in Bank Accounts and Other Operations.

- The main provincial taxes are Gross Income Tax (or Turnover Tax), Stamp Tax and Real Estate Tax which allow them to collect enough revenue to cover, on average, approximately 40 percent of their expenses and finance the rest of their expenses through indebtedness and transfers from the central government. Provincial taxes represent 13.6% of total tax revenues.

- Turnover tax is an indirect provincial tax imposed by each of the 24 jurisdictions into which Argentina is divided on gross revenues from the sale of goods and services. Exports of goods are exempt, and certain industries are subject to a reduced tax rate. Rates, rules, and assessment procedures are determined locally.

- This tax is levied on each commercial transaction and no fiscal credits are awarded for taxes paid during the preceding periods. The rates depend on the industry and sector, ranging from 1.5% to 5% approximately. The taxes are paid throughout the year with payments made monthly or every two months, varying from province to province.

- Provincial governments are increasingly reliant on the revenue from this tax, representing 4.24% of GDP (2012) and 60-70% of provincial revenue.

- Economists say the gross income tax is one of the most distortive duties in heavily taxed Argentina because it is charged on transactions at every stage of the supply chain, contributing to high consumer prices.

- The provinces and the city of Buenos Aires have entered into an agreement to The Multilateral Agreement, under which GIT is administered, provides a harmonised definition of the tax base, uses a facts and circumstances analysis to consolidate gross income, and a two-factor uniform formula of gross receipts and expenses to apportion corporate-level gross income among the provinces of Argentina.

- Tax reforms in the 1990s were focused on efficiency gains and aimed significantly reducing distorting taxes like GIT on productive sectors, to be replaced by a retail sales tax (US model). The high dependency of Provincial governments on their turnover taxes exposed them to the risk of collecting an insufficient level of taxes to fund their services, resulting in abandoning reforms and reinforcing the imperfect tax structure of the provinces.

The country's turnover tax alone eats up nearly 90% of corporate earnings, before taxes on salaries and financial transactions South America is are taken into account. (WEF)
International Case Studies
Argentina’s turnover tax is highly distortive and contributes to high consumer prices (contd.)

Gross Income Tax has become increasingly important in subnational tax revenue: in 2001 total revenue raised through this tax totalled 2.8% of GDP (compared to subnational taxes representing 3.64% of GDP). In 2012, the tax generated 4.24% of GDP in revenue (compared to total provincial taxes at 5.63% of GDP).
### International Case Studies

Local turnover tax is in theory easy to collect, but scores poorly against other criteria

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Collection - ease of collection</strong></td>
<td>A turnover tax is in some ways the easiest to administer. ‘Tell me your turnover, and I’ll tax you on it’. The basic administrative problem is to determine and verify the turnover (sales) of a taxpayer and to collect the tax. The tax effectively is collected similarly to the VAT: All segments of the production or supply-chain collect the turnover tax on sales, and pay on purchases. Consolidated tax returns are filed annually and payment is made to the residence state. When a taxpayer does business or carries out activities in more than one province, provinces apply a facts and circumstances analysis to determine whether the gross income is derived from an economically inseparable unitary process.</td>
</tr>
<tr>
<td><strong>Collection rates – level of collection and ease of avoidance</strong></td>
<td>Turnover taxes are collected in Argentina by subnational governments which set their own rates and exemptions for industries and products. Rates range typically between 3-5%. The basic way to evade such a tax is also simple: hide (under-report) sales. The easiest way legally to avoid the tax is by integrating vertically with one’s suppliers since ‘within-firm’ sales are not taxed.</td>
</tr>
<tr>
<td><strong>Income generated – level of tax collected to spend on local services</strong></td>
<td>Gross Income tax is the most relevant source of funds for provinces. Around 70% of what the provinces collect in taxes comes from the gross income tax.</td>
</tr>
<tr>
<td><strong>Equity – the spread of the tax across local businesses</strong></td>
<td>The final tax burden borne by any particular transaction depends essentially on how many prior taxed transactions are embodied in its sales price, its distributional impact is indeterminate. Governments that impose turnover taxes have little idea of the effects of such taxes on either allocation or distribution.</td>
</tr>
<tr>
<td><strong>Ability to pay – the relationship between taxation and ability to pay</strong></td>
<td>Taxes on turnover rather than profit raise Total Tax Rates for businesses significantly. There is not necessarily a correlation between a firm’s turnover and its gross profit—a firm can have a high turnover (and tax base) and low profit margins, in particular where the whole tax burden on businesses is high like in Argentina.</td>
</tr>
<tr>
<td><strong>Impact on the economy – how a different basis for local business taxation would affect the local and national economy</strong></td>
<td>A turnover tax is by far the economically most distorting form of sales tax: discourage exports and investment and to induce firms to integrate up and down the chain of distribution and production. In comparison, by crediting taxes on inputs including capital goods, VAT avoids distorting economic choices with respect to production technology. It also eliminates taxes on exports by crediting taxes paid on inputs at prior stages.</td>
</tr>
</tbody>
</table>
**International Case Studies**
The business rates system compares poorly against other taxes that could fund local government

Sales and turnover taxes are much more common than commercial property taxes as a way of funding local government, following the trend in recent decades to reduce taxes on commercial property as an input in the production process.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Business Rates (current system)</th>
<th>Local Sales Tax (US case study)</th>
<th>Turnover Tax (Argentina Gross Income Tax case study)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Collection - ease of collection</strong></td>
<td>Poor transparency for businesses, complex to administer and forecast for local government, especially in relation to re-basing and re-setting years. High rates of appeals, volatility at revaluations, and complex relief / transition schemes.</td>
<td>One point of collection in production chain split at payment between recipient governments.</td>
<td>Tax collected at all levels of production chain.</td>
</tr>
<tr>
<td><strong>Income generated – level of tax collected to spend on local services</strong></td>
<td>No correlation between monies collected locally and expenditure needs of local services. Stable and reliable for local government revenue for 5-7 years.</td>
<td>Tax base (rates and exemptions) change locally to reflect local expenditure needs and policy direction. Represents between 10-60% of state tax revenues.</td>
<td>Tax base (rates and exemptions) change locally to reflect regional expenditure needs and policy direction. Represents 70% of regional tax revenues.</td>
</tr>
<tr>
<td><strong>Collection rates – level of collection and ease of avoidance</strong></td>
<td>Immobile tax base; Difficult to avoid for businesses; revenue risk for local government from appeals and discounts.</td>
<td>Risk of evasion relies wholly on final seller tax payments; audit trail can be obscure; preferential geographic decision for customers and businesses.</td>
<td>Easier to administer. Avoidance by under-reporting or vertical integration.</td>
</tr>
<tr>
<td><strong>Equity – the spread of the tax across local businesses</strong></td>
<td>Economic activity unnaturally skewed away from property development and property-intensive production activities.</td>
<td>Performance pressure on retailer only; localised rates can impact cross-border competitiveness</td>
<td>Distributional impact is indeterminate.</td>
</tr>
<tr>
<td><strong>Ability to pay – the relationship between taxation and ability to pay</strong></td>
<td>Little correlation between a business’s ability to pay and properties’ rateable value or multiplier used.</td>
<td>Direct correlation between tax collected and due, no impact on profits (ability to pay).</td>
<td>High turnover does not automatically imply high profits (ability to pay).</td>
</tr>
<tr>
<td><strong>Impact on the economy – how a different basis for local business taxation would affect the local and national economy</strong></td>
<td>Risk on investment and development decisions close to resetting period.</td>
<td>Localised rates can impact competitiveness.</td>
<td>Economically most distorting form of sales tax.</td>
</tr>
</tbody>
</table>
Section three: Part Two

What would an alternative solution look like in England?
Section three – An alternative solution?

The New West End Company believes Brexit provides an unprecedented opportunity to review business rates as a form of VAT / sales tax within a comprehensive review of VAT following Brexit.

The objective of this section is to propose an alternative tax (inspired from sales or turnover tax) to replace business rates.

The answers provided are illustrative and should be considered as thought experiments rather than fully designed scenarios. Further research is required into the potential design of each of these taxes to understand the potential tax rates, exemptions and burdens on citizens, businesses and property and land owners.

The options are discussed on the along following lines:

1. First, what a fully (or partially) implemented alternative tax would look like in England and Wales to be revenue neutral and raise local government funding. Here we look in particular at questions of tax base, rates, redistribution compared to business rates and revenue raised. Highlighting the potential but also drawing out further considerations that would need to be addressed. We have illustrated where possible implications for cities and individual businesses.

2. Secondly, what mechanisms should need to be considered to get there. Here we discuss questions of impact on assets or prices (tax incidence), transition period, political will, and prior financial commitments against business rates.

A key premise is tax revenues are ideally retained locally.

Risks and issues related to local sales tax and turnover taxes identified in the summary table for case studies still apply, and will need to be addressed accordingly. For turnover tax, this is broadly summarised in the economic impact as being seen by economists as being the most distortive of consumption taxes. For local sales tax, the primary issue is related to the entire revenue being collected only at one point of the chain, making it strongly subject to tax evasion, as well as consumption evasion (choosing to spend where lower rates apply).

Potential hybrid model

Both the local VAT-supplement and local turnover tax have benefits and drawbacks to be considered in the context of a full review of local business tax.

Although each tax is explored here individually on a high-level basis, a well-designed solution will most likely be a hybrid solution bringing together elements of a localised, retained business rates model with a local VAT/ sales tax option, depending on business characteristics (e.g. retail vs offices), political direction and assessment through Treasury’s model to test new taxes.

“An online sales tax might be used to level the playing field, but it does not belong within a system based largely on rental values.” (President of UK business rates at Altus Alex Probyn)
**Section three – An alternative solution?**

A local turnover tax - overview

**Concept**

*Local government levy a percentage of local businesses’ annual turnover.*

The main objective of this approach is to raise the equivalent of national business rates revenue as function of economic productivity rather than property value, widening the tax base to reduce overall rate. International case studies (Argentina) showed how business turnover is used as a tax-base for sub-national government funding, used in addition to VAT. Closer to home, a turnover-based approach is used in department stores for instance to assess rental value: retailers at Selfridges pay a rent based on 12% of turnover.

**Tax base, rates and revenue**

*A blanket rate of 1%-1.5% on annual turnover would be revenue neutral for England, raising £28.4 billion in 2017.*

- Total turnover for England in 2017 was estimated at over £2 trillion in this model.1
- In reality, different rates would likely be applied for industry, commerce and services (see Argentina Case Study), with exemptions and exclusions.
- Local government could set the rates locally. Established ranges can control for race-to-the bottom tax policies.

**Equity**

*Businesses’ contribution to tax revenue would be proportionate to and proxy of the level of local economic activity.*

The association between tax base, location and funding need isn’t correlated. A flat rate on turnover does not necessarily link to relative need in local services and associated contribution to funding these services.

A tax on turnover rather than property value would comparatively benefit small businesses in prime locations, with increased liability for businesses in lower value properties with relatively high turnover (such as online retailers and distribution centres).

**Ability to pay**

The biggest issue for taxpayers is that turnover doesn’t necessarily imply it is proportionate to a business’ profits and ability to pay.

**Impact on the economy**

Turnover tax is seen by economists as the most distortive form of taxation, as it taxes products both as an input and a product.

---

1. High level calculations, based on 2017 ONS turnover data, using business counts and mid-point of turnover bands, excluding lowest band (<£50,000). Modelling details on the following page.
Section three – An alternative solution?
Option 1: A local turnover tax – headline estimates

Winners and losers
A high level assessment of winners and losers is calculated at a local authority level, comparing receivable business rates with estimated turnover tax revenues if it were implemented as a flat rate on all business turnover.

With no equalisation process, what benefits businesses (reduced tax liability) is a cost to local government funding (reduced local tax revenue). In this context, London sees the highest reduction in local taxes raised by £1.4 billion (-20%) when the South East and East of England see a significant increase in local tax revenues by £500 million respectively. These figures denote relative ratio of business rates / relative property values to turnover rate compared to national average.

A flat rate would thus create a substantial distortion of winners and losers across the country which would call for a significant equalisation process (by either goods or location) to redistribute revenue according to need.

---

Business rates and Turnover tax revenue by region, as percent of England total

<table>
<thead>
<tr>
<th>Region</th>
<th>BR</th>
<th>TTT</th>
</tr>
</thead>
<tbody>
<tr>
<td>East of England</td>
<td>9%</td>
<td>11%</td>
</tr>
<tr>
<td>South East</td>
<td>6%</td>
<td>7%</td>
</tr>
<tr>
<td>East Midlands</td>
<td>15%</td>
<td>17%</td>
</tr>
<tr>
<td>West Midlands</td>
<td>8%</td>
<td>9%</td>
</tr>
<tr>
<td>North West</td>
<td>11%</td>
<td>11%</td>
</tr>
<tr>
<td>South West</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Yorkshire and Humber</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>North East</td>
<td>32%</td>
<td>26%</td>
</tr>
<tr>
<td>London</td>
<td>32%</td>
<td>26%</td>
</tr>
</tbody>
</table>

Source: Arup analysis

---

<table>
<thead>
<tr>
<th>Rank in BR revenue to England</th>
<th>Local authority</th>
<th>Contribution to England’s total Receivable Business Rates</th>
<th>Contribution to England’s total Turnover tax revenues (est.)</th>
<th>Rank in TT revenue to England</th>
<th>Rank change</th>
<th>Net position for local government revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Westminster</td>
<td>8%</td>
<td>5%</td>
<td>1</td>
<td>-</td>
<td>-33%</td>
</tr>
<tr>
<td>2</td>
<td>City of London</td>
<td>4%</td>
<td>3%</td>
<td>2</td>
<td>-</td>
<td>-20%</td>
</tr>
<tr>
<td>3</td>
<td>Camden</td>
<td>2%</td>
<td>2%</td>
<td>3</td>
<td>-</td>
<td>-11%</td>
</tr>
<tr>
<td>4</td>
<td>Tower Hamlets</td>
<td>2%</td>
<td>1%</td>
<td>8</td>
<td>-4</td>
<td>-39%</td>
</tr>
<tr>
<td>5</td>
<td>Birmingham</td>
<td>2%</td>
<td>2%</td>
<td>4</td>
<td>+1</td>
<td>-7%</td>
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<tr>
<td>6</td>
<td>Leeds</td>
<td>2%</td>
<td>1%</td>
<td>5</td>
<td>+1</td>
<td>-14%</td>
</tr>
<tr>
<td>7</td>
<td>Hillingdon</td>
<td>1%</td>
<td>1%</td>
<td>11</td>
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<td>-47%</td>
</tr>
<tr>
<td>8</td>
<td>Manchester</td>
<td>1%</td>
<td>1%</td>
<td>7</td>
<td>+1</td>
<td>-19%</td>
</tr>
<tr>
<td>9</td>
<td>Kensington and Chelsea</td>
<td>1%</td>
<td>1%</td>
<td>19</td>
<td>-10</td>
<td>-45%</td>
</tr>
<tr>
<td>10</td>
<td>Southwark</td>
<td>1%</td>
<td>1%</td>
<td>9</td>
<td>+1</td>
<td>-3%</td>
</tr>
</tbody>
</table>

Source: Arup analysis

---

Difference between Receivable Business Rates and estimated turnover tax revenue (1.2% rate) by region

<table>
<thead>
<tr>
<th>Region</th>
<th>Cost / savings (£000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>London</td>
<td>1,500</td>
</tr>
<tr>
<td>North East</td>
<td>-1,000</td>
</tr>
<tr>
<td>West Midlands</td>
<td>-500</td>
</tr>
<tr>
<td>East Midlands</td>
<td>-500</td>
</tr>
<tr>
<td>South East</td>
<td>-1,000</td>
</tr>
<tr>
<td>East of England</td>
<td>1,500</td>
</tr>
</tbody>
</table>

Source: Arup analysis
Section three – An alternative solution?
Option 1: A local turnover tax – approach to high level modelling

The overall local turnover tax concept is proportionality between economic activity and tax revenue contribution.

There are over 500,000 businesses registered in London, and 2.3 million in England. The majority (72%) have a turnover below £250,000 and only 1% yield a turnover over £10 million per annum\(^1\).

In comparison, Westminster businesses shift in higher turnover rates with only 54% below the £250,000 mark. In Westminster, businesses in the highest band (£50 million and above) represent 7% of England’s businesses top-band businesses, and over half of London’s in the same band (53%).

For high-level estimates purposes, the mid-range of each band was used to calculate total turnover for England, Westminster and Northampton. Northampton is included as a comparator for relatively struggling local economy which has seen reduced business rates bill following revaluation\(^2\).

Using these assumptions, central London contributes 23% of England’s total turnover, Westminster 5% and Northampton 0.1%. In comparison, central London contributes 17-21% of non-domestic tax revenues, Westminster 7.2% and Northampton 0.4%.

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1. ONS business counts and turnover bands by local area, 2017
2. Centre for Cities, Maximising the growth incentive across the country, Nov 2017
3. In 2016/17, central London accounted for 17 per cent of all business rates generated in England and Wales. In 2017/18, this will rise to 21 per cent.
5. VOA
Section three – An alternative solution?
Option 2: A Local VAT Supplement (sales tax)

Concept
Local government raises an additional levy in the form of VAT on sales and services.

The main objective of this approach is comparable to turnover tax in that it aims to raise revenue as a function of productivity.

The overarching idea is a middle ground between VAT and US local sales tax, using VAT policy and administrative framework in place to collect revenue, whilst decentralising revenues as in sales tax.

Tax base, rates and revenue
An additional 5 percentage points increase on VAT rates (replacing business rates) would be revenue neutral for the UK, raising £28.4 billion in 2017.

• Local government could set their own rates – possibly within an established variability range to control for gaming attitudes – as in US sales tax.

• The tax base and refund system are assumed to copy the VAT policy to maximise efficiency and transparency benefits. This includes exempting micro businesses with annual sales below a certain threshold from VAT registration, refund for business-to-business VAT payments, and range of rates and exemptions of products.

• Online sales of goods or services from outside and within the EU would be included in the tax base, making the tax base larger and likely increase overall revenue. However whilst business rates tax base is difficult to evade (because immovable), a VAT Supplement on online sales would suffer from high levels of tax evasion like is currently the case from sellers outside the EU.

Collection
The most efficient collection mechanism would be to fully base it on the current VAT system.

There are many benefits to using a VAT model for collection: familiarity with the tax system by tax payers (businesses and customers) including refunds and exemptions, reduced administrative burden for businesses through efficiency gains, reduced tax evasion risk compared to sales tax (see case study).

However this would not enable to easily retain tax revenues locally. VAT receipts are currently centralised and difficult to disaggregate to local areas. A large retailer might have hundreds of shops each charging VAT, but may make only a single payment of VAT every month. In the current system, it is not possible to know how much of that VAT has been collected from a particular place. This gets more complicated as many companies can reclaim VAT on goods and services they use, which might have an entirely different geographical pattern.

• One way around the problem is to consider a formula-based redistribution system based on the previous Formula Grant for business rates, with a number of issues discussed in Section 2 (lack of transparency, opaque needs assessment, etc.)

• Another option would to require businesses to comply to an fully separate payment and refund claims specifically for Local VAT Supplement. An alternative where VAT Supplements are collected and retained locally could be envisioned based on the recent EU system, however this would effectively duplicate administrative burden on businesses to comply with their liabilities.

• A third option would envision the full VAT collection system in the UK to be reviewed to allow localised retention of the supplement, avoid duplication of tax burden on businesses and possibly improve overall efficiencies.
Section three – An alternative solution?
Option 2: A Local VAT Supplement (sales tax)

Equity / distribution
Unequal geographic distribution of end-of-line businesses will be reflected in areas with supply-chain businesses not generating enough in local revenue, requiring significant equalisation processes.
A Local VAT Supplement could help rebalance unfair tax distribution between online and high-street retailers compared to business rates. With a Local VAT Supplement, though, tax receipts would be collected where consumers are located assuming EU principles apply, which is likely not related to where the distribution centre is located. This will significantly reduce local tax revenues for the local government of origin compared to that of destination (areas with highest population). This distribution issue could be overcome through equalisation processes, or through shared revenue mechanisms between origin and destination.

Ability to pay
Typically VAT and sales taxes are not considered a cost on production and therefore net of income at source of revenue.
Likely windfall gains for property / land owners in the short-medium term which will see a reduction in their tax liabilities (potentially partly captured through corporate tax increase). However evidence of tax incidence is mixed and suggests the burden of the tax will ultimately fall back to landowners and occupiers (See p. Tax incidence).
Businesses with a low net VAT payment in comparison to their business rates / value of occupied property (e.g. offices, public buildings) will benefit from reduced liability, increasing the revenue pressure on businesses (retail mostly) at the end of the supply chain.

Case study: One-Stop-Shop platform (OSS) to collect VAT receipts in EU member states from online sales and services

In December 2017, the European Commission simplified tax legislation to reduce the administrative burden of VAT for online retailers.

Instead of registering for VAT in each EU country, online retailers will only need to file a single tax return for the entire European Union, through a one-stop-shop online platform. Country specific VAT receipts will be passed on the relevant member states, based on the location of customers at the time of purchase.

Improved efficiency is estimated at €2.3 billion in savings for businesses, reducing administrative burdens for companies by as much as 95%, and a €7 billion increase in VAT revenues for member states.

The One Stop Shop for sales of online goods is due to come into effect in 2021 to give Member States time to update the IT systems underpinning the system. A similar system could be envisioned within the UK to redistribute Local VAT Supplement where goods have been purchased (including online retail in tax revenue). This system could also be extended to all VAT payments across the country, achieving overall efficiency and effectiveness in VAT payments.

2. The typical London shop is facing a 14 per cent rise in rates, and the average shop across the country a 8.5 percent rise, while online retailers operating from out-of-town warehouses will only pay an extra 2 per cent. (Rise in business rates favours online retailers over high street, Financial Times, February 2017)
3. Research suggests the tax burden of a sales or VAT taxes fall primarily on consumers, with up to 40% of the cost is supported by businesses (see ppX).
Section three – An alternative solution?
West End business application

What does this mean for local business?

Ultimately, the design of the VAT supplement (sales tax) would be critical to ensuring the effective and fair implementation of the tax. The example of a large department store demonstrates the challenge of implementing a VAT supplement in its simplest form. The tax levels in this case give an indication of the levels that would be needed to replace the revenue raised from business rates. This indicates what the size of a sales tax would need to be if it was charged in the same way as existing VAT system. Any future scheme would need to be designed to address the policy objectives that are being aimed for, including spread the rates tax burden in a different way.

For example, the “flat VAT” approach could potentially disproportionately hit businesses that sell goods to end-users (e.g., direct VAT payers) to the benefit of services providers and non-VAT payers who currently pay business rates.

More detailed analysis and modelling should be taken forward to ensure the design of a VAT supplement can be equitable from “day 1” of implementation—such that no party is better or worse off. Then the design of the tax could, based on better design, provide a basis for taxation which does not unduly tax retailers, for example.

<table>
<thead>
<tr>
<th>Snapshot – Leading Department Store</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Rates bill</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Comparison to Turnover Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover in 2017</td>
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</tbody>
</table>

A 1% turnover tax represents £9.2 million tax contribution, approximately 50% reduction in tax liability.

<table>
<thead>
<tr>
<th>Comparison to Sales Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross transaction value (before VAT)</td>
</tr>
<tr>
<td>Gross transaction value (incl. VAT)</td>
</tr>
</tbody>
</table>

A 5% uplift in local VAT supplement represents £90 million in tax liability.

Implications

The substantial reduction in tax liability for the department store under the flat turnover tax or enormous increase in sales tax liability points to two key imperatives:

1. There will be a need to tailor the tax system across goods and sectors
2. There is the potential to operate a hybrid system with business rates to mitigate such large disparities.
Section three – An alternative solution?
Transitioning to a new tax system

What needs to be considered?
Ultimately, whether a major change to the tax system will depending on political, technical feasibility and practical issues. Here we discuss questions of
1. transition period and arrangements
2. political will
3. prior financial commitments against business rates, and
4. impact on assets or prices (tax incidence)—who will bear the burden of the new tax.

These considerations are taken in turn.

Transition period and arrangements
When considering tax reform, the primary implementation issues faced by policymakers are the following.

(1) Compliance and administration:
   • How does government ensure the tax is enforceable and minimise evasion?
   • Ensure the private sector can comply with the tax without unreasonable cost
   • Administration and compliance costs increase substantially if governments exempt goods and services or use multiple rates in order to reduce the tax burden on lower income consumers
   • Define administration—manage by a central body or each local authority
   • Special treatments may be needed for small business or types of goods
   • Compliance issues also arise in terms of international and inter-authority transactions

(2) Transition:
   • Define who will be made better or worse off and how can windfall gains be mitigated or captured and reinvested
   • Determine timeframe for the transition programme. This could be tied to the length of time it takes the tax incidence to shift.
   • Decide how Sales Tax interact with SDLT and property sales
   • Treatment of services: if services are included, rules are needed to define where services actually take place and to determine whether it is taxable.
   • Treatment of intangibles (e.g., royalty payments)

(3) International issues:
   • Understand implementation in a global context
   • Manage sales of imports and exports in a localised system
   • Determine exemptions, such as tourists able to recoup the tax
   • Many countries have dealt with the above issues in some form or another. However, the list of international issues provided above should give warning that implementing a new tax is not straightforward.

(4) Central-local fiscal harmony:
   • Manage powers and relationship in the central government and local funding systems
   • Define how will needs-assessment fit within a fully localised system

Sources:
Political opportunities
Political willingness to drive change is one of the most important drivers of changes to tax laws—even more so than the design and efficiency of taxes. Brexit may represent a key milestone for unlocking political will for tax reform. But, the opportunity to drive radical reform of the local government funding system will depend on the deal reached between the UK and Europe on tax harmonisation and trade policies. Brexit provides an unprecedented opportunity to review business rates as a form of VAT / sales tax within a comprehensive review of VAT following Brexit. If the UK is no longer tied to EU VAT rules, the appetite from Government to demonstrate their ability to design a more effect and locally-appropriate tax system through the proposed sales tax may be particularly strong.

In the meantime, the political focus on Brexit and the current business rates system will likely preclude change in this Government. But, there is continued appetite within Whitehall and local government to devolve business rates in a meaningful way that supports incentive for local growth.

Impact on existing business rates-related schemes
The ability to transition from business rates system to a new tax is intrinsically tied to the long-term arrangements for which business rates are used, such as Land Value Capture and other Tax Increment Finance arrangements.

First, Tax Increment Finance (TIF) involves borrowing against a specific or general funding stream (such as property taxes) to forward funding an infrastructure project which will increase future tax revenues to help recoup the original investment. While the UK does operate some TIF schemes, like the Northern Line Extension to Battersea, the borrowing is not based solely on the business rates retained. Rather, local authorities (or transport authorities) borrow on an unsecured, non-raked basis, meaning lending and credit ratings are based on overall creditworthiness, which would likely be unaffected by a change in local tax retention policies in the short-to-medium term.

Second, a Business Improvement District (BID) is a geographical area in which the local businesses have voted to invest together to improve their environment. They are funded through an additional levy on business rates currently, but a similar mechanism could be applied to local turnover or sales tax to the same end.

Third, Land Value Capture mechanisms are based on a wide range of income streams—not just business rates. Developer contributions, like Community Infrastructure Levy and Section 2016 agreements, are paid for new developments to fund infrastructure requirements. These would be largely unaffected by a change from the business rates system.

Incidence
The question of tax incidence is of particular interest. These are explained in the following pages.
Section three – An alternative solution?
Transitioning to a new tax system

Incidence and perceptions of business rates

There is no consensus view among economists regarding how the economic burdens of many taxes are allocated. And legal tax liability often bears little relationship to who actually bears a given tax. However it is important to address the question of who ultimately bears the price in a move away from business rates, because this will be reflected in some form or another through asset or products price changes, determining winners and losers and will be a concern to political bodies.

Business Rates – research suggests that business rates costs (property tax) to businesses are redistributed to property owners through rents charged (or affordable to be charged) and to consumers through prices of products sold. There is little consensus on the proportion being shared between them and how quickly that burden changes with changes to the tax regime.

- Recent UK research has found that 75% of the value of business rate change is capitalised into rents under two to three years, although the burden in the first few years of change is borne initially by occupiers.2
- Relationship between business rate changes and rents is found clearest in the retail sector, and to a lesser degree for offices. Yet also stronger in regional market as opposed to London market.2
- A recent paper from US found that the vast majority of commercial property tax is passed on to occupiers through increased rent: 90% of incidence on businesses, with 10% falling on land / property owners.3
- A hypothesis suggests that rents fall pound for pound with business rates in the long run, but the long-run adjustment could also be lower than this. Research over two-year period shows rental values fell by 45p and 85p per square foot in response to a £1 increase in non-domestic rates per square foot, with the largest effect being seen in London.4

- Over the long-term, the full incidence could fall on landowners with rents falling in line with the tax incidence.4
- Anecdotal evidence following revaluations last year suggest part of the tax burden also falls on consumers with increased prices to consumers, although the exact amount is unknown.5

Perception - The redistribution isn’t easily visible however, hidden in the rates charged to consumers and occupiers. Any change in business rates is perceived to unequally affect businesses compared to property owners / consumers.

Timing – The shift in economic incidence could take many years, as the shift in prices for long-term leases can usually only take effect at the end of the contract.

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Section three – An alternative solution?
Transitioning to a new tax system

Incidence and perceptions of sales tax

Research suggests the incidence of sales tax of products falls predominantly on consumers, with incidence rates carrying from research and countries between 60% and 100%.

- 59% of sales tax incidence appears to fall on consumers although this would be more about tax design than direct tax incidence.
- Only very few markets show an incidence of sales tax on consumers different from 100%. The retail industry in the US is most subject to tax shifting on prices away from 100%, but with consumer share tending to be higher than 100% (over-shifted).
- Research on French VAT suggests tax incidence on consumers ranges 57-77%.

Perception - The share of sales tax attached to a transaction is typically very transparent to both the seller (businesses) and the buyer (consumers) in the way they are reported on a bill. Changes in rates would be perceived strongly by consumers, even though the impact would in principle be shared by businesses through increased pressure on prices or demand.

Example. A cup of coffee in London was priced at £2.50 including VAT (sales tax). Gross price of £2.10 is function of production costs, demand and profit margins. Should VAT increase to 25%, new price paid by consumers would range between:

- £2.50 (no change)- In an non-elastic market where demand for an increase in price would not be met and businesses would lose sales. Businesses bear the cost (10p), reducing wages and/or profits.
- £2.60 (+10p) – in a fully elastic market where demand is not affected by increased prices, and consumers are willing to pay the cost of the increased tax rate. Costs to businesses on the cup of coffee remains unchanged.
- Somewhere in between – with cost of tax shared between customers and businesses, subject to market elasticity.

Timing – In the short term, consumers could see a tax incidence reduction as the markets adjust.

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2. Besley and Rosen (1999)

Section three – What would an alternative solution look like?

Precedent case study – VAT changes in the UK

Since its introduction in 1973, VAT rates and tax base have been open to change in light of macro-economic shifts or political orientation. More recently, the standard rate has been:

- Temporarily reduced from 17.5% to 15% in 2009-2010 to incentivise spending and boost the recovery of the economy, and
- Increased to 20% from 17.5% in 2011/2012 as part of the Coalition Government’s first Budget and approach to fiscal consolidation.

The diagram overleaf illustrates the successive changes since 1973 both in tax rates and tax bases.

**Impact of increase in standard rates**

- Putting the standard rate up by 3.5% is estimated to have raised around £15.4 billion in additional revenue (1% of national income)\(^1\).
- The change in standard rate induced a spike in consumer prices by 0.76 percentage points. This means that if VAT had remained at 17.5 per cent in January 2011, the CPI 12-month rate would have been around 0.76 percentage points lower than the published figure of 4.0 per cent. Comparatively, the change from 15 to 17.5% had an impact on CPI of 0.40 percentage points (January 2010 index).\(^3\)

A proposed increase in VAT rate isn’t significantly out of political scope considering previous changes under major macro-economic influence.

The UK has had to align with EU regulation on VAT system that aim to make the “sales tax interlock effectively for the single market to function”. EU regulations require all member states to apply a standard VAT rate of 15% or more, with reduced rates no lower than 5%. Lowest rates applied in 2017/18 are in Luxembourg and Malta (respectively 17-18 per cent), highest rates apply in Hungary (27 percent) and Sweden, Denmark, Croatia (25 percent).

A change in VAT rate through Local VAT Supplements would bring the UK standard rate close to the higher limit of other European countries.

Brexit will likely have a transformational impact on the entire fiscal system in the UK in the long term, VAT included. However in the short to medium term, it is unlikely the UK will drastically move away from EU regulations to align with neighbouring markets.

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\(^{1}\) Impact of the VAT increase on the CPI, ONS, 2011

\(^{3}\) VAT rates applied in the Member States of the European Union, January 2017, European Commission
### Section three – What would an alternative solution look like?

**Precedent case study – VAT changes in the UK**

<table>
<thead>
<tr>
<th>Year</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>VAT introduced in the UK for the first time</td>
</tr>
<tr>
<td>1974</td>
<td>Higher rate introduced for the first time</td>
</tr>
<tr>
<td>1979</td>
<td>Standard rate increased to 15%, higher rate abolished</td>
</tr>
<tr>
<td>1991</td>
<td>Standard rate increased to 17.5%</td>
</tr>
<tr>
<td>2009-2010</td>
<td>Standard rate increased to 20%</td>
</tr>
<tr>
<td>2011</td>
<td>Temporarily reduced to 15% to boost recovery</td>
</tr>
<tr>
<td>1997</td>
<td>Lower rate of 8% on domestic fuel / power</td>
</tr>
<tr>
<td>1993</td>
<td>Reduced rate cut to 5%</td>
</tr>
<tr>
<td>1993</td>
<td>Extended to a small number of other supplies, including the installation of energy saving materials.</td>
</tr>
<tr>
<td>2011</td>
<td>Zero rate extended to a small number of other supplies, including the installation of energy saving materials.</td>
</tr>
</tbody>
</table>

**Chart:**

- **1973:** VAT introduced in the UK for the first time with a standard rate of 10%.
- **1974:** Higher rate introduced for the first time at 8%.
- **1979:** Standard rate increased to 15%, higher rate abolished.
- **1991:** Standard rate increased to 17.5%.
- **2009-2010:** Standard rate increased to 20%.
- **2011:** Temporarily reduced to 15% to boost recovery.
- **1997:** Lower rate of 8% on domestic fuel / power.
- **1993:** Reduced rate cut to 5%.
- **1993:** Extended to a small number of other supplies, including the installation of energy saving materials.

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**VAT: the new 20% standard rate**, House of Commons, Standard Note 2013, Anthony Seely

Over the last 25 years there have been a number of changes to the coverage of the zero rate, affecting individual supplies.
### Designing within a resilient and balanced tax system perspective

<table>
<thead>
<tr>
<th>TAX</th>
<th>Corporation Tax</th>
<th>Business Rates</th>
<th>VAT</th>
<th>National Insurance Contributions (NIC)</th>
<th>PAYE (Personal Income tax)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Base</td>
<td>Profits</td>
<td>Property (rents)</td>
<td>Output products and services</td>
<td>Earnings</td>
<td>Wages to employees</td>
</tr>
</tbody>
</table>

- ✓ Diverse tax base creates resilience in the tax system

By replacing a property-base tax revenue by a productivity / consumption tax basis already used under VAT, we loose system resilience and create greater dependency on one type of tax base (consumption of products).

http://www.bytestart.co.uk/main-business-taxes.html
Considerations for transition
Section four - Transition arrangements
Considerations within the existing tax regime and policy environment

Moving from a business-rates system in which 20 percent of local government funding comes from commercial property tax, to a new system based more on local sales or turnover, will be a step-change in policy. Brexit will open the opportunity for considering tax reform, particularly in regards to VAT. However, there are already programmes and policies set in motion that would be disrupted by this change. This disruption does not make the change technically insurmountable, but it does require consideration at this stage.

In this section, we outline three issues which will be raised in the transition to a new tax regime and propose solutions which could be considered further. These changes are:

- Devolution of business rates to encourage local growth
- The funding of BIDs and TIF schemes
- The impact on the proposals of the Mayor's London Finance Commission

Changes to Government’s programme to devolve business rates to incentivise economic growth
Evidence suggests that the nationalisation of business rates reduced the pace and scale of commercial development for many cities across the UK. This is, at least in part, due to the removal of financial (tax) benefits for local government from accepting new development, which requires investment to support (in infrastructure and local services). Arguably, the move away from a business rates system to any locally-retained tax system would provide incentives for councils to support those activities which provide further financial tax returns. Under a devolved business rates system, commercial property development increases local tax income. However, under a local turnover or sales tax, councils would be encouraged to support business more broadly, and it may encourage more emphasis on high streets and local centres.

The impact of transition on existing TIF schemes, BID funding, and local authority borrowing programmes
As referenced earlier in this section, the change to another locally-retained tax from a locally-retained business rates system would likely have minimal effects on local authority borrowing powers and TIF-style schemes. Because authorities borrow against their creditworthiness rather than an individual funding stream, it would take some time to understand the effects of any change on local authority credit and borrowing programmes.

BIDs could continue to provide the same critical services for the business community, funded in a similar precept fashion under a new tax regime.

Implications for the London Finance Commission’s recommendations
The recommendations of this report echo and progress the findings of the London Finance Commission—importantly calling for the continued devolution of powers to London to support its continued growth and contribution to the national economy.

Where the London Finance Commission does not directly advocate for either of these taxes, the principles from which they both judge the potential for great devolution and more efficient, effective and equitable tax systems is the same. Critically, these propositions do not just work for London, though; they offer a much better local business tax system for the country.
Concluding comments
Concluding comments

NWEC believes there is a profound case transformation of local business taxes that could achieve greater benefits, equity and transparency for both businesses and local government funding.

The changes to the business rates system proposed in this report could dramatically improve the business rates system in the short to medium term.

Localisation of business rates, more frequent valuations, the ability to better capture the benefits of growth and reducing the inequity between high street and online retailers could all radically improve the existing business rates system.

These recommendations should be considered alongside the proposals for full-scale reform.

However, a transformational solution could be envisaged to replace business rates.

The New West End Company believes Brexit provides an unprecedented opportunity to review business rates within a comprehensive review of VAT.

The UK’s over-reliance on property taxes in general and more specifically for funding local government creates substantial inefficiencies in the development of commercial property, the commercial decisions of businesses and the planning decisions of local government.

Looking forward, replacing business rates with a local sales tax could create a system which performs well with regards to tenets of good tax design:

- Ease of collection
- Ability to fund local services
- Mitigate against avoidance
- Equity
- Ability to pay
- Economic impact

A substantial amount of further work will be required to pursue this approach with Government. Additional studies should be commissioned to understand and estimate:

- Exact rates of any alternative tax
- Who will be legally liable for paying the tax
- Level of equalisation required, with regards to locations and sectors
- Tax evasion risks
- Minimising administrative burden and linking in with the existing VAT system
- Managing windfall gains in the transition period—and the overall design of the transition arrangement
- Designing the tax for the 21st century with online sales and digital payments.

Further work will be needed to understand how to mitigate any risks associated with this during transition. While the Government is working through the terms and conditions of Brexit, they should also keep an eye on the long-term opportunities for larger-scale tax reform. The opportunities for businesses, local government and the sustainable growth of the UK economy could be substantial.
Additional references
References

- GLA, London Council, Consultation Response to “100% Business Rates Retention”
- Macroeconomic effects and Policy issues, C.Alan Garner, Federal Reserve Bank of Kansas City, Economic Review, Second Quarter 2005

Turnover Tax
- Argentina tax summary, Corporate taxes, PWC, http://taxsummaries.pwc.com/ID/Argentina-Corporate-Other-taxes
- Unitary Taxation in Federal and Regional Integrated Markets, 2015, International Centre for Tax and Development
Supporting evidence
All business rates (adjusted to the capped and determined total) are pooled at centrally and redistributed by LA against an estimated funding baseline. This means the costs of services are not assumed to increase faster than RPI for each local authority, or the be funded through other revenue streams.

Growth in commercial floorspace and associated revenue generated are pooled centrally, and redistributed through grants. This means areas which see high development levels – and likely associated increase in service demand – do not reap additional financial benefits compared to status-quo areas.
The funding baseline is fixed for 5 years/ up to the following resetting period. 
> This means the costs of services are not assumed to increase faster than RPI for each local authority, or the be funded through other revenue streams.

Additional revenue driven by new development, but not value uplift, and only for the years in between resetting periods. Total amount of business rates that should be generated is capped and total yield is determined in advance.
Change in average business rates bill, 2016/17-2017/18, Centre for Cities

GVA and rateable value growth, Centre for Cities
In 2015-16,
- a third of all business rates was raised in only 23 local authorities – 11 of which were in London –
- More than two thirds of all business rates generated in England were in cities.

<table>
<thead>
<tr>
<th>Top local authorities for collectable rates, 2015-16</th>
<th>Share of England’s total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Westminster</td>
<td>7.2</td>
</tr>
<tr>
<td>2 City of London</td>
<td>3.8</td>
</tr>
<tr>
<td>3 Camden</td>
<td>2.3</td>
</tr>
<tr>
<td>4 Birmingham</td>
<td>1.7</td>
</tr>
<tr>
<td>5 Tower Hamlets</td>
<td>1.7</td>
</tr>
<tr>
<td>6 Hillington</td>
<td>1.6</td>
</tr>
<tr>
<td>7 Leeds</td>
<td>1.6</td>
</tr>
<tr>
<td>8 Manchester</td>
<td>1.6</td>
</tr>
<tr>
<td>9 Kensington and Chelsea</td>
<td>1.2</td>
</tr>
<tr>
<td>10 Southwark</td>
<td>1.0</td>
</tr>
<tr>
<td>11 Hammersmith and Fulham</td>
<td>0.9</td>
</tr>
<tr>
<td>12 Bristol city of</td>
<td>0.9</td>
</tr>
<tr>
<td>13 Sheffield</td>
<td>0.9</td>
</tr>
<tr>
<td>14 Islington</td>
<td>0.8</td>
</tr>
<tr>
<td>15 Liverpool</td>
<td>0.8</td>
</tr>
<tr>
<td>16 Trafford</td>
<td>0.7</td>
</tr>
<tr>
<td>17 Hounslow</td>
<td>0.7</td>
</tr>
<tr>
<td>18 Milton Keynes</td>
<td>0.7</td>
</tr>
<tr>
<td>19 Cheshire West and Chester UA</td>
<td>0.7</td>
</tr>
<tr>
<td>20 Cornwall UA</td>
<td>0.7</td>
</tr>
<tr>
<td>21 Ealing</td>
<td>0.6</td>
</tr>
<tr>
<td>22 Wiltshire UA</td>
<td>0.6</td>
</tr>
<tr>
<td>23 Newcastle upon Tyne</td>
<td>0.6</td>
</tr>
<tr>
<td>24 South Gloucestershire</td>
<td>0.6</td>
</tr>
<tr>
<td>25 Bradford</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Top local authorities for business rates collection, 2015-2016
(Source: Centre for Cities)