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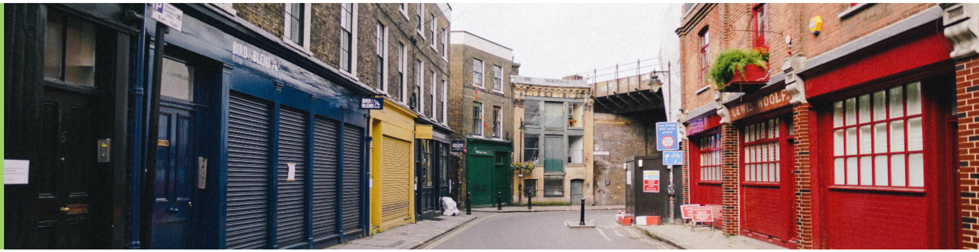


Reforming business rates

Fixing a broken system

Summary and recommendations

Business rates are a much-maligned tax. They have frequently been blamed for exacerbating economic divides across England and further disadvantaging already struggling businesses and places. Business rates are, together with council tax, one of the most important taxes for local authorities and should be designed to encourage cities and large towns to improve their business environments thereby attracting productive businesses. However, in the current system, these incentives are not always in place.

In light of these and other criticisms, the Chancellor announced a fundamental review of the business rates system for England. The review follows on from the Treasury Select Committee's 2019 inquiry into the impact of business rates, which argued that the current system is broken. The terms of reference of the Treasury's review state that the Government believes revenue should continue to be raised through the taxation of non-residential land and property.[1]

This briefing sets out what a reformed system should look like. It identifies four fundamental problems with the current structure and proposes the following solutions to address these problems:

1. Move towards annual revaluations
2. While transitioning towards annual valuations, the Government should explore how the valuation process could be devolved
3. Amend the valuation approach to take systematic account of both individual properties and up-to-date local information in a transparent manner
4. Ensure discounts and incentives are reflected in rental values through

1 While business rates are an important component of local government finance, it must be recognised that this tax alone will not be able to resolve future funding pressures emerging from issues such as social care. Nevertheless, ensuring that the tax works better for both local government and for businesses should be a key objective of public policy.

obligatory reporting and closely monitor upward-only rent reviews to assess the level of market distortion

5. The landlord should take on at least 50 per cent of the business rates liability
6. The system of reliefs should be largely abolished, while maintaining current exemptions for exempted buildings and potentially other key areas of public policy such as community sports clubs and potentially nurseries. This can be complemented by local government maintaining discretionary reliefs
7. Equalise the empty rates relief between retail and industrial units, and apply rates to empty land and potentially to listed and agricultural buildings
8. Remove plant and machinery from the valuation process
9. Implement a pooling system across the country to align business rates to local economies and allow these pools to retain 100 per cent of growth in business rates revenue
10. The cap on total business rates revenue should be lifted and the top and tariff system should be re-assessed as part of a wider reform of local government finance

Many of these recommendations are inspired by changes made to the Dutch model in the 1990s, which faced very similar challenges to those that the English system faces today. The Dutch experience, which is referred to throughout this briefing, demonstrates that it is possible to successfully reform a centralised, slow and cumbersome business rates system and turn it into a more responsive and fair tax that takes into account actual local conditions and rewards local economic growth.

Box 1: What are business rates?

Business rates are a local tax paid by businesses and other occupiers of non-residential property, based on a percentage or multiplier of the estimated annual rental value. Business rates increase annually linked to the consumer price index. There are a series of reliefs to mitigate the negative effects of the tax, including transitional relief to minimise large changes resulting from infrequent valuations. Valuations currently take place every five years, although the Government plans to move towards valuations every three years. The tax is a key component of local government finance and, since 2012, local authorities can retain up to half of the growth in revenue. The rest is distributed by central government through revenue support grants and the top-up and tariff scheme.

The four fundamental problems with the business rates system

The underlying issues – and potential solutions – associated with business rates can be summarised as relating to their timeliness, their complexity, the disincentives they provide for investment, and the disincentives they provide for local growth.

1. Timeliness: business rates do not reflect local economic realities

For business rates to be a fair and effective tax, they must reflect the real economic conditions that ratepayers experience. However, the current approach to valuing properties means this is not the case. This issue is at the root of many of the problems associated with the business rates system.

The infrequency of valuations mean that rates are paid based on valuations that can be as much as seven years out of date (or even nine years as when the 2015 valuation was delayed to 2017). And, while the Government plans to reduce the time period to a valuation every three years, the valuations used for rates will, at certain points, still be as much as five years out of date. Now, due to the Coronavirus pandemic, the 2021 revaluation has been postponed until 2022, delaying the start of for three-yearly revaluations.[2]

Recent economic history shows how out of line this can make valuations with economic reality. Between 2007 and 2012, average rents fell by between 15 and 20 per cent – but, as they are linked to inflation, business rates actually went up.[3] The pandemic has also had the rapid effect of pushing rents down in the retail sector,[4] but current valuations are based on 2017 valuations and will not be changed until 2022. So, with the link to inflation, they look set to increase over this period, when they should be falling.

This mismatch is compounded by the transitional relief scheme after each valuation. To allow businesses to manage large changes in the valuation of their property after a revaluation, changes are phased. This is good for businesses that see increases – not only have they been underpaying for years, future increases are staggered instead of being applied immediately. But it is bad news for those businesses that see a reduction. Not only have they been overpaying, but they will continue to overpay as their decrease is staggered.[5]

As Figure 1 shows, this particularly penalises businesses in weaker economies in the North of England. These businesses are effectively overpaying while businesses in the Greater South East are underpaying. This runs counter to the Government's 'levelling up' agenda. For example, in the last revaluation, businesses in Hackney saw a 46 per cent increase in valuations, while those in

2 MHCLG (2020) Business rates revaluation postponed https://www.gov.uk/government/news/business-rates-revaluation-postponed

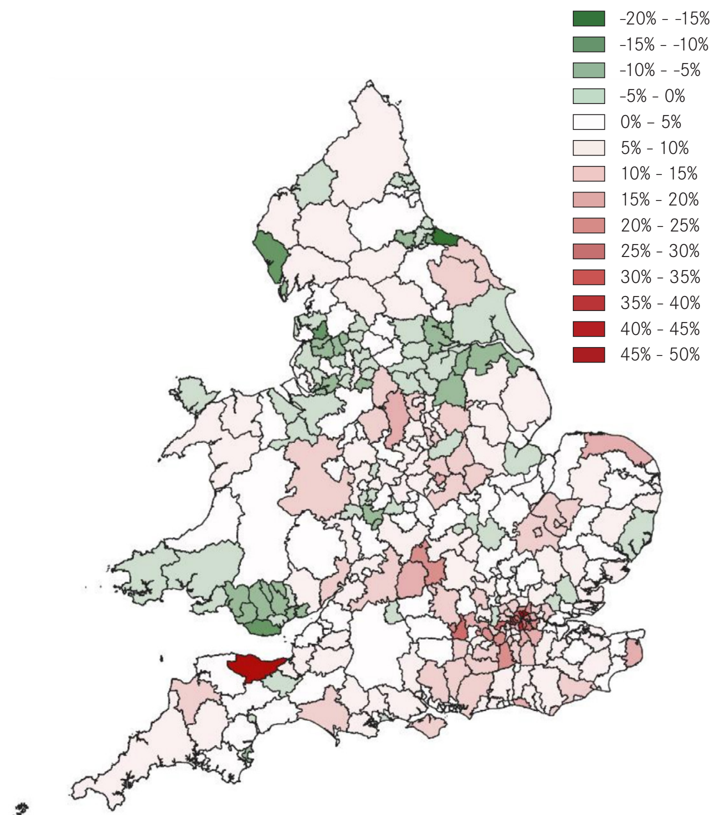
3 Commercial News Media (2013) GVA warns of business rates time bomb http://www.commercialnewsmedia.com/archives/18756

4 Hickey M, Arnold J (2020) Market in Minutes: Central London Retail https://www.savills.com/research_articles/255800/303470-0

5 A detailed analysis on how the transition scheme is compounding the mismatch of annual valuations, can be found in section 1.1 of the technical report.

Redcar and Cleveland saw a 20 per cent fall. Not only were businesses in the latter on average paying 20 per cent too much at the time of revaluation, their bills did not adjust immediately to correct this and they continue to overpay. Unsurprisingly, this system has been heavily criticised by most business groups.[6]

Figure 1: Average change in rateable value, 2008-2017



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

The system is also slow to adapt to changes in demand within particular sectors, such as the shift towards e-commerce in retail. This has further penalised the high street in favour of online retailers. Between revaluations, rising demand for logistics space for online fulfilment[7] has not been reflected in rising business rates bills because they are based on outdated and lower rateable values. At the same time, the declining demand for retail space in some areas has not resulted in a corresponding fall in rates. That Amazon would outbid for a site in north London earmarked for housing shows how valuable logistics space has become in some areas.[8] As a result, delayed valuations have in effect acted as a subsidy for online retail.

6 Treasury Select Comittee (2019), Impact of business rates on business. https://publications.parliament.uk/pa/cm201919/cmselect/cmtreasy/222/22207.htm

7 JLL (2019) Industrial market continues to outperform other property sectors https://www.jll.co.uk/en/newsroom/industrial-market-continues-to-outperform-other-property-sectors

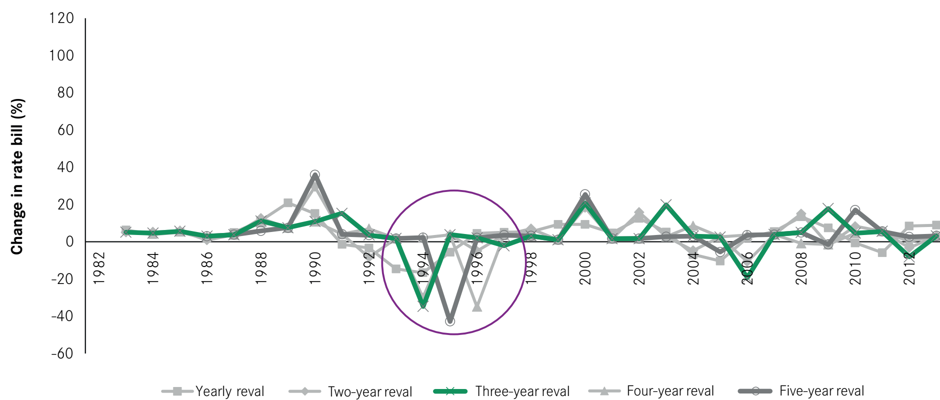
8 Roser E (2020) Amazon swoops on BTR site in last-mile logistics play. EGI https://www.egi.co.uk/news/amazon-swoops-on-btr-site-in-last-mile-logistics-play/

Recommendation 1: Move towards annual revaluations

A move towards annual valuations would enable rateable values to quickly adapt to changing economic conditions and make the tax consistent with standard commercial real estate valuation techniques. This would remove the need for transitional relief entirely and would reduce the number of appeals, as evidenced by the over 80 per cent fall in appeals when the Dutch system shifted to annual valuations.

One criticism made of annual valuations is that they would increase volatility in business rates revenues for local authorities. But analysis by the Government suggests that, rather than increasing volatility, annual valuations would merely bring forward the reduction in revenue, as shown in Figure 2. While delaying the inevitable decline in revenue for local government may have some benefits for them in the short term, it does not help firms trying to stay in business. Figure 2 suggests that annual revaluations may help businesses stay afloat due to business rate bills falling more quickly when they are experiencing greatest economic stress.

Figure 2: Business rate bill under different revaluation options (London offices, year-on-year change), 1982-2013



Source: Valuation Office Agency

Recommendation 2: While transitioning towards annual valuations, the Government should explore how the valuation process could be devolved

If business rates were to move to a system of annual valuations, the Government should consider which body should take responsibility for this process. The Government has made it clear that this cannot be achieved without reform to the valuation process itself,[9] and the Valuation Office Agency (VOA), currently responsible for valuations, has been criticised for its cumbersome, opaque and inconsistent valuation procedures.

When the Dutch moved to annual valuations, they devolved the valuation process to local authorities to draw on their superior local knowledge. This was effectively the case in the United Kingdom until 1948 when the process was centralised. In the Netherlands, devolving valuations turned out to be more efficient - the switch contributed to a 20 per cent reduction in ongoing annual costs.

The best way to do this would be as part of wider local government reform that would rationalise local authority structures in England, as proposed recently by Centre for Cities in *Levelling up local government in England*.[10] This would create enlarged and empowered single-tier local authorities that could undertake revaluations for their areas.

In the absence of local government reorganisation, there are a number of options. The first is to reform the VOA itself. A second option would be to devolve valuations to appropriate georgraphies and related authorities. This could be Combined Authorities, unitary authorities and, where they are not in place, to the upper tier of local government.[11] That would result in 46 authorities responsible for valuations. Or fire authorities, which have some knowledge of local premises, but would require additional capacity to take on this new role.

9 HM Government (2016) Business Rates: delivering more frequent revaluations summary of responses. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689236/Business_rates_revaluations.pdf

10 Jeffrey S (2020) Levelling up Local Government in England https://www.centreforcities.org/wp-content/uploads/2020/09/Levelling-up-local-government-in-England.pdf

11 Some unitary authorities may be too small for this to be an effective geography. The technical appendix sets out how these unitaries could be included within their 'ceremonial county' for these purposes, although this would require clarification on respective legal powers.

2. The system is dogged by complexity

While HM Revenue and Customs has attempted to make the UK tax system simpler, more customer focused and more efficient in recent years, business rates have become more complex. There are two main ways this manifests itself. The first is how valuations are created and the second is the complex and arbitrary web of reliefs.

Box 2: How the VOA currently values properties

Currently, to value commercial properties, the VOA collects rent evidence and sets a common value per square metre for an area, which it then adjusts using property-specific characteristics. What this means is that each type of property and its layout is factored into the valuation.

After setting the value per square metre, more information is collected about the property by dividing it into different zones. For example, in a retail store, the first zone is the section close to the shop window, the second zone is the area towards the centre of the store and the third zone is the storage area. In addition, each of these zones will have different values per square metre. Each type of industry has different relative values for each zone. For example, abattoirs have their own scale of relative values for nearly 40 different zones of the property including cold storage, office space, loading areas and food processing areas and on which floor they are located.

The valuation process is inaccurate and overly complex

Valuing properties in a systematic way is difficult because the current system requires a lot of highly-detailed information that is individual to specific properties. This has been a key argument used against moving to annual valuations, as it would make a difficult process even more burdensome. But reforms to the system can remove this stumbling block.

The main problems with the current valuation process are that:

- The VOA does not systematically consider the most up-to-date local information as part of the estimation process and instead relies more on untimely rental information from leases, which they recognise is a challenge. Although the VOA believes this to be the most recent and representative information on market values, these values may ignore crucial and more up-to-date information.

- Upward-only rent reviews embedded within long leases can result in significant distortions of the price mechanism, with rateable values kept higher than they should be. For example a 15-year lease may have rent reviews at years five and 10, however even if market rents have fallen due to a recession, the rental values for the property cannot fall below the agreed value at year one.
- Headline rents tend to get reported for valuation purposes. This is a major problem as headline rents are often kept artificially high by landlords who instead provide discounts to tenants in the form of incentives. The VOA is often not made aware of these confidential side letters and confidential agreements and so these incentives are not accounted for. This means that rents are higher than they should be and as these incentives are not factored in, rateable values are pushed higher artificially.[12]

The following recommendations address these problems.

Recommendation 3: Amend the valuation approach to take systematic account of both individual properties and up-to-date local information in a transparent manner

The VOA's focus on valuing market rents instead of actual rents is appropriate given this better represents the true value of the space. However, the current system lacks a systematic and transparent valuation methodology and fails to exploit much of the most up-to-date information that is available to them.

The current valuation methodology is extremely cumbersome and time consuming. This acts as a major barrier to moving towards annual valuations. The valuation methodology should be simplified, removing the complicated zonal methodology and replacing it with a more formula-driven approach. Such a system should adjust current property-specific rental information by the most up-to-date local information in terms of location, property type, size, state of maintenance and vacancy risk.

In addition to allowing for annual valuations, a simpler, more formulaic approach that takes into account current property-specific information and the most up-to-date local information would also have the following benefits:

- More transparency would allow ratepayers to better understand what lies behind valuations. This would reduce the number of appeals, some of which are lodged purely to extract more information from the VOA on their reasoning.

12 Financial Times (2018) The mystery of commercial rents: boom or bust? September 7 2018 https://www.ft.com/content/6ba2aee8-68d5-11e8-aee1-39f3459514fd

- Additionally, in the current system, smaller properties are disadvantaged as they have to pay more per unit of area due to the VOA's valuation approach. This has increased the tax liabilities of firms to such an extent that Small Business Rate Relief is required. A large supermarket, for example, will pay far less per square metre than a small boutique.[13]

In essence, the use of a more formulaic approach will provide greater clarity for businesses without ignoring the property-specific data. Setting up a number of pilots would test the ease of shifting to a more systematic and transparent valuation approach. Analysis of such pilots should also reflect on the operational efficiencies from this approach.

When the Netherlands decided to improve its system of business rates by moving from valuations every four years to annual valuations they successfully deployed this approach.

Box 3: How the Dutch system works[14]

In 1995, the Netherlands decided to move from four-year revaluations to an annual process undertaken by local municipalities. This shift was accompanied by a change to a more transparent valuation process and as a result, reduced the number of appeals as well as increasing efficiency. It covered both non-domestic and domestic properties.

Based on best practice valuation techniques, the valuation takes account of both property-specific information in addition to other local market information. This might include factors such as plot size, property type, location, recorded sales of properties, new leases and the level of maintenance.[15] This new approach to valuing properties ignored plant and machinery, thereby simplifying the valuation process. **As well as improving valuation estimates and reducing errors, annual ongoing costs for valuation fell by 20 per cent and appeals reduced by 80 per cent.**

As part of this process, the new valuation system has eliminated distortions to the price mechanism by requiring all incentives to be factored into lower valuations, with both the landlord and tenant required to pay a share of the tax.

The transition process was made gradually from 1997, enabling work processes to be tuned over time, rather than a 'big bang' approach.

13 Aubrey T (2015) Business rates fit for a devolved 21st century economy, HM Treasury Submission
14 A comprehensive overview on the advantages of the Dutch system can be found in annex 2 of the technical report.
15 While the Dutch approach capitalises rents to generate a capital value, a valuation adjustment process can be made to rental values instead factoring in up-to-date local information.

Recommendation 4: Ensure discounts and incentives are reflected in rental values through obligatory reporting and closely monitor upward-only rent reviews to assess the level of market distortion

Two further factors mean that rateable values may not reflect market rents, the first of these is upward-only rent reviews and the second is the use of confidential side letters which often account for incentives and discounts.

In a period of economic downturn, rents should fall, but upward-only rent reviews prevent this from happening. While the length of leases has shortened over the last 20 years, traditional upward-only rent reviews remain dominant across the UK commercial property market.[16] In these properties, during periods of economic downturn, upward-only rent reviews maintain rents artificially above market values, distorting the market mechanism and potentially increasing business rates liabilities.

The Republic of Ireland banned such clauses from commercial leases in 2010. In the UK, successive governments have opted instead for self-regulation via codes of practice to try and move towards greater flexibility. However, the evidence suggests that encouraging the use of more flexible leases through, for example the 2007 Code of Practice for Leasing Business Premises, has had little effect.

It is possible that the pandemic will result in a more flexible market for commercial space with tenants able to make more demands when signing leases. As a result, there may be fewer long leases and more leases that include open market value reviews. It is recommended that this situation be closely monitored given the potential damage upward-only rent reviews can cause through distortions to the price mechanism, resulting in firms overpaying for both rent and rates.

In addition, all confidential side letters to leases including incentives and discounts should be provided to the valuation agency so an estimate of actual rents can be made. Landlords might object to this information on confidentiality grounds given that tenants might use the information to negotiate down their rents, however, there is no reason why the valuation agency cannot keep this information confidential as is already done for pubs in the current system.[17]

Recommendation 5: The landlord should take on at least 50 per cent of the business rates liability

Currently business rates are paid in their entirety by the tenant (unless the property has become empty). As the landlord does not have to pay the rates, they have an incentive to keep headline rents high. There is therefore an argument for the landlord to pay all business rates, as this would remove this incentive which would result in a more efficient price mechanism.

While there are strong theoretical arguments to move towards this system, there

16 McCalmont-Woods N (May 7 2020) Is it time for upward & downward rent reviews? http://www.mccalmont-woods.com/is-it-time-for-upward-downward-rent-reviews/

17 Pubs are valued differently to most commercial property

is also a case for the tax to be shared between the landlord and tenant on the grounds of fairness.

Landlords are generally more interested in long-term improvements to an area while tenants tend to be more focused on shorter-term benefits. Having both parties pay would mean that both long- and short-term benefits would be encouraged to improve the local area. The landlord liability is defined as whoever has the right of occupation, as is currently the case for empty rates. There are other examples of where this type of combined approach has worked. In London, for instance, there are two Business Improvement Districts (BIDs) where the occupier and owner share the BID levy.[18] In essence, what matters for these kinds of levies or taxes is that they are used to pay for local services that also benefit local businesses.

Recommendation 6: The system of reliefs should be largely abolished, while maintaining current exemptions for exempted buildings and potentially other key areas of public policy such as community sports clubs and potentially nurseries. This can be complemented by local government maintaining discretionary reliefs.

A complex web of reliefs has emerged to address the poor performance of the current system, but ultimately makes things worse by adding to complexity. Business rates reliefs in England total almost £5 billion,[19] amounting to over 15 per cent of the overall revenue. The reasons for reliefs are diverse, but most have been introduced because valuations do not reflect market prices. These reliefs have only provided a sticking plaster to deal with this fundamental problem. Furthermore, reliefs often create new problems and distortions.

Implementing the recommendations above would deal with the reasons why many reliefs were introduced in the first place. The majority of reliefs would become obsolete and could be safely abolished. For example, annual valuations will more accurately estimate the economic conditions small firms are trading under and reduce their liability, removing the need for small business rates relief.

18This is as a part of the Business Improvement Districts (Property Owners) (England), 2014 regulations http://researchbriefings.files.parliament.uk/documents/SN04591/SN04591.pdf

19 A full table of reliefs is included in Appendix A to the technical report.

Box 4: How the abolition of the small business rates relief can benefit small businesses

Small businesses would benefit from the increased efficiency of the price mechanism due to artificial headline rents falling, from landlords paying a portion of the business rates liability, and from close monitoring of upward-only rent reviews.

Enabling rates to reflect the actual economic situation experienced by small firms will largely remove the need for small business rates relief. In addition, the current valuation methodology disadvantages smaller firms as they pay more per square metre. That would end with an up-to-date valuation methodology in place. In instances where small firms are in financial difficulty and they provide crucial local services, local authorities could continue to provide discretionary relief.

There may well be public policy objectives that the Government wants to pursue via reliefs, such as discounts for community sports clubs for public health reasons and for nurseries to reduce the cost of childcare. However, when considering which reliefs to keep, there are a few factors that should be considered:

- The charitable rates relief includes private schools and hospitals, while state schools and NHS hospitals are required to pay business rates.
- While there may be good reasons to financially support charities, the relief on land use has a knock-on effect on the allocation of land, with unfair competition in high value areas potentially crowding out both the public and private sector.
- Charities also benefit from investment made in local communities. In recognition of this, they often choose to contribute to BIDs. Business rates should also be used to invest in and improve local areas, so charities should pay a higher share than they currently do.

In addition to central government mandating some mandatory reliefs for public policy, local government should also still be able to give discretionary reliefs as they deem appropriate, which could include charities or small firms.

Recommendation 7: Equalise the empty rates relief between retail and industrial units, and apply rates to empty land and potentially to listed and agricultural buildings.

Since 2007, empty properties are liable for 100 per cent of their business rates bill after 3 months, although it is six months for industrial premises. Maintaining 100 per cent relief on empty properties for a period is a sensible approach given the time it takes to find a new tenant. It is however unclear why the comparatively outperforming industrial property sector should have double the time accorded to the retail sector.[20]

20 As more consumers shift to buy online goods, the demand for logistics centres which are a critical component for online distribution, has increased while the demand for retail space has fallen.

In the current system, empty non-agricultural land is not liable for any business rates at all. There is a strong case to rate empty, non-agricultural land at its use value given that the current system incentivises the demolitions of properties to avoid paying rates on empty properties. The Barclay Review[21] also recommended a clamp down on potential tax avoidance by ratepayers. Consideration should be given to extending the current reset period[22] for empty property relief from just six weeks to six months.

Further inconsistencies exist for agricultural buildings. As any building located on agricultural land involved in storage, drying, cleaning, grading or packing is not rateable, whereas if these activities were not carried out on agricultural land they would not be eligible for relief. An example of this is that the manufacture of cheese on a farm which provides all the milk is exempt, but a cheese manufactuer that buys in milk is not. Agricultural buildings should be made eligible for business rates.

Finally, listed buildings should not be given a blanket empty relief. This relief merely reduces the incentive for property owners to adjust rents to market values, in addition to reducing the incentive to bring properties back into use. Any relief for listed buildings should be for a shorter period of 12 months.

21 Scottish Gov (August 2017) Report of the Barclay Review of Non-Domestic Rates https://www.gov.scot/binaries/content/documents/govscot/publications/independent-report/2017/08/report-barclay-review-non-domestic-rates/documents/00523643-pdf/00523643-pdf/govscot%3Adocument/00523643.pdf

22 This is the period that a property has to be occupied and paying rates for before they can apply for another round of empty property relief

3. Promoting investment: the current system disincentivises investment

Britain's productivity record over the last decade has been poor compared to other developed countries. Lower levels of investment are one reason for this. This is not helped by the inclusion of plant and machinery in business rates, which disincentivises investment in new technologies.

Recommendation 8: Remove plant and machinery from the valuation process

Higher investment in plant and machinery increases the valuation used for business rates calculations, generating a higher liability that is, in effect, a tax on investment. This not only disadvantages manufacturing businesses (more highly concentrated in the Midlands and the North of England), but also dissuades innovation and investment in new production processes that are required to make the UK carbon neutral.

One example of how taxation of investment can affect business activity is made by Storengy, a firm that works on projects around producing and storing hydrogen. In their submission to the Select Committee on business rates,[23] they indicated that the inclusion of plant and machinery in the valuation process will most likely negatively impact investment decisions on these types of projects due to the increases in rateable value.

The Government is aware of the need to incentivise investment in machinery as shown by existing, but largely arbitrary, exemptions of plant and machinery from a small number of methods of power generation. These exemptions should apply to *all* investments in plant and machinery.

An additional problem is that the current process of estimating the value of plant and machinery is cumbersome and adds additional challenges and costs to the valuation process.[24]

Removing plant and machinery from the valuation process would address these issues. The Netherlands made a similar change when it moved to annual valuations, which reduced the cost and complexity of the valuation process.

23 Gras C (March 2019) Written evidence submitted by Storengy UK (IBR0016). http://data.parliament.uk/WrittenEvidence/CommitteeEvidence.svc/EvidenceDocument/Treasury/ImpactofBusinessRatesonBusiness/Written/97902.html

24 For example, the rating manual requires valuers, where possible, to take photos of the plant or machinery found on site, together with any identification plate showing the type, size and output of the item. The identified machines then need to be valued by assessing price information in the second-hand market to generate the replacement cost of the items

4. The system does not incentivise local growth

There are a number of problems with the structure of the current business rates system that mean it does not necessarily incentivise local growth.

First, although business rates are referred to as part of local taxation, the amount of revenue that local authorities receive from them is not directly determined by how much is raised in their area. The tax is collected locally, but then some of the revenue is sent to central government, which redistributes it back to local areas.

Second, although there have been changes in recent years, local authorities do not get to keep all of the growth in business rates, blunting incentives for growth. The cap on revenues (meaning that the total amount of business rates in the country cannot increase with a growing economy, unlike every other tax) amplifies this issue.

Third, the interaction between the structure of local government and the business rates system distorts incentives for local growth. For example, city centres often have clusters of high-skilled jobs, while suburbs provide the key input to city centre businesses – workers. The problem is that if these different parts of local economies are in different local authorities (as is the case around London, Nottingham and Newcastle, for example), authorities that may house the workers of new businesses located in neighbouring authorities do not get to benefit from any growth in business rates. This incentivises potentially unhelpful competition between authorities within one economy.

Box 5: How business rates revenue is currently raised and distributed

From 1990 to 2012, business rates were collected and passed on in their entirety to central government which then redistributed it back to councils in the form of a formula grant.

Since 2013/14, the business rates retention system means councils are able to keep 50 per cent of their business rates revenues (after top-ups/ tariffs and safety nets/levies have been applied) as well as an equivalent proportion of any growth in business rates in subsequent years. The remaining 50 per cent is sent to central government and pooled nationally before being redistributed in a number of grants. The baseline funding and need levels are reset in the system periodically every seven years, but this has not been done since it was first created in 2013 – it was intended for 2020, and has been pushed back again as a result of the pandemic to April 2022. The general idea behind the need for a reset is that over time, financial needs and revenues can change and it is important that the system responds to this.

Local authorities vary in how much they are able to raise in business rates and how much they need to provide necessary services and functions for

residents. To deal with this there are a series of top-ups and tariffs in place and a levy paid on growth in business rates that funds the safety net.

The Ministry of Housing, Communities and Local Government (MHCLG) calculates the business rates baseline and the base funding level for each local authority. A local authority must pay a tariff if its business rate baseline is greater than its baseline funding level and will receive a top-up if it is less than its baseline funding level. This means every local authority in the country is left only with a sum of money equalling its funding baseline. The amount that an authority receives or is tariffed is the same for the entire period before a reset occurs.

In some years, authorities may experience gains or losses that are disproportionate. To stop authorities benefitting too much from gains or being hit too hard by losses, their growth is adjusted by the **safety net and levy**. An authority that experiences growth in its business rates income that is disproportionate will have that growth reduced by paying a levy and, where an authority sees a disproportionate loss, this will be protected by the safety net.

One unique characteristic of business rates is the cap on the total amount of business rates that can be generated annually. This is the opposite to the situation with most other taxes - where the value of the tax base varies but the tax rate remains constant. In the business rates system, the expected yield is set and the tax rate (i.e. the multiplier) is calculated so that the predetermined yield is generated from the total of properties' rateable values.

Because of the cap, the multiplier changes at each revaluation to reflect the changes in rateable values and ensure the overall system generates the same amount as the previous year before inflation. The overall yield then is adjusted each year in line with inflation.

Box 6: Current business rates pools

Since April 2017, the Government has piloted a number of business rates retention and pooling schemes. These pilots have been primarily of both 75 and 100 per cent retention of growth in business rates revenue, an increase on the 50 per cent retention introduced in 2013/14.

In the first round of pilots, Cornwall, Greater Manchester, Merseyside, the West of England (Bristol and surrounding authorities) and the West Midlands participated. A further 10 areas then joined the 100 per cent retention pilots a year later and further areas have joined these pilots since then.

One of these retention pilots was for London's 33 local authorities and the Greater London Authority (GLA). In this pilot, participating areas:[25]

- Retained 100 per cent of the total rates collected, subject to the tariff
- Retained 100 per cent of any growth in business rates above the baseline
- Did not pay levies on growth in business rates revenues
- Saw the safety net threshold increased from 92.5 per cent to 97 per cent of the overall baseline funding level
- Forwent general grant funding via the Revenue Support Grant from MHCLG as well as some other cuts to funding
- Formed pools between boroughs, the GLA and the Corporation of the City of London, with shares of the funds distributed reflecting spending responsibilities
- Saw no detriment to joining the pilot as a pool compared to if they had not entered the pilot pool

Recommendation 9: Implement a pooling system across the country to align business rates to local economies and allow these pools to retain 100 per cent of growth in business rates revenue

Business rates should be collected at the same geography over which an economy operates. Short of local government reorganisation, the most pragmatic way forward is to create pools across the country that reflect this geography. Current pilots (see Box 6) in which pooling authorities map up to the functional economic area should be made permanent and pooling should be introduced in similar areas that did not have pilots.

25 London Councils (March 2018) Business Rates Devolution Update. https://www.londoncouncils.gov.uk/sites/default/files/Policythemes/Localgovernmentfinance/BusinessRates.pdf

To incentivise this change, authorities that partake in the pool should retain 100 per cent of the growth in their business rates revenue, as is currently the case in a number of pilots.[26]

This would also address two of the issues with the current business rates system: first, it would strengthen the incentive for local government to create favourable conditions for businesses locating in their area as they would see a greater return from this; and, second, it would provide greater control for local government over revenue.

This growth would be supported by a safety net to protect local authorities against disproportionate reductions.

This is very close to the arrangements in the recent business rates retention pilots with some differences.[27]

Recommendation 10: The cap on total business rates revenue should be lifted and the top and tariff system should be re-assessed as part of a wider reform of local government finance

The cap on total business rates yield is a key issue with business rates retention in relation to incentivising growth. This is due to the requirement for a fixed yield in the system (which then requires the multiplier to adjust accordingly). Two problems result:

1. The cap artificially restricts the total amount of business rates revenue that can be generated, which can mean there is less money for redistribution.
2. Only relative growth is rewarded, which acts as a disincentive to growth. Local authorities that have experienced a higher level of growth in rateable value than the national average see their income increase and authorities that experienced a level of growth that was below the national average instead see their incomes fall, despite experiencing net growth.[28]

Removing the cap would deal with these problems.

The system of top-ups and tariffs should remain, although it is flawed. For example, a large portion of business rates revenues would continue to be sent to national government, to be returned via a number of other grants. As well as reducing the financial freedom that local authorities have, top-ups and tariffs add complexity. In London, local authorities send nearly £3 billion of tariffs to other non-London local authorities and yet London then requires £14 billion in grants from central government. Ultimately, what is needed to simplify the system is a greater degree of fiscal devolution.

26 Note that authorities would still be subject to the top-up and tariff, as was the case in the London pilot.

27 The technical document provides further details on this recommendation.

28 Bessis H (2017) Room For Improvement. https://www.centreforcities.org/wp-content/uploads/2017/12/17-12-07-Business-rates-maximising-the-growth-incentive-across-the-country.pdf

Conclusion and next steps

The current business rates system is one that has resulted in businesses based in the North of England overpaying while many businesses in the Greater South East have often underpaid. In addition, bricks-and-mortar retailers have ended up subsidising online retailers in a system dogged by complexity.

The current business rates system also disincentivises investment in machinery thereby constraining productivity growth and distorting incentives for local growth. This is contrary to a number of the Government's core objectives, such as levelling up, supporting the high street and increasing innovation.

As the Government undertakes its review, the recommendations in this briefing have been drawn to increase the frequency of valuations, simplify the valuation process, free up the price mechanism for commercial property and ensure that incentives exist for functional economic areas to grow.

Centre for Cities is currently working with key stakeholders and institutions with interests in improving the current business rates system. Given the complexity of the system, it is important to build a consensus around what would be practical in implementing these changes.

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This report is published as part of an occasional series by guest experts to provide a platform for new ideas in urban policy. While they do not always reflect our views, we consider them an important contribution to the debate.

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