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HARMONISATION OF RATING: THE CONTRACTORS BASIS

Nicholas Ridley proposes a means of harmonising the methods used in England & Wales and Scotland for determining the rateable values of properties for which no rented market exists - for example chemical plants and steel works.

A. HOW THE EXISTING SYSTEM WORKS

For these types of property rateable values are determined by "decapitalisation":

> The valuation officer first determines the construction cost of the plant and then makes a deduction for obsolescence. He adds into this the value of land. He then applies a "decapitalisation rate" to this capital sum and finally adjusts the resulting figure if it seems out of line with other rateable values.

10 per cent of rateable value is covered in this way.

The main difference in approach between England & Wales and Scotland is in the method of calculation of the decapitalisation rate.

- In England, the assumption is made that the decapitalisation rate should be related to the rate of interest on the day of valuation. The company owning assets is assumed to borrow money to finance its construction and the interest rate to represent an annual charge for borrowed money. Following a famous judgement by Lord Denning, the resulting estimated rental value is then reduced by a third to reflect the benefits of ownership.

- In Scotland the approach is entirely different. There the decapitalisation rate is based on the average yield (in the usual property sense) from rented property.

The decapitalisation rate for commercial property in England and Wales is at present 5 per cent. In Scotland it is 7 per cent.

B. THE CHANGES PROPOSED

At present the decapitalisation rate is a matter for valuers and the Courts to determine within the terms of the relevant legislation. Nicholas Ridley and Malcolm Rifkind now have powers to prescribe for the first time a single decapitalisation rate based on the same valuation date of 1990. This will remove the issue of the correct rate from the ambit of the Courts. The Chief Valuers' Office have proposed a rate of 7 per cent (based in Scotland on the 7 per cent rate now current and two-thirds of the 10 per cent interest rate prevailing on 1 April 1988 in England and Wales). Nicholas Ridley proposes to set the rate at 6 per cent because a 7 per cent rate would lead to unjustifiably high rate increases in steel and shipbuilding. The Chief Secretary proposes that the Government should consult on a range of 6-7 per cent.

Assessment

Property rentals are normally related to capital values by yield. The yield for commercial and industrial property varies both geographically and by sector. This is to reflect different risks the landlords face and the differing prospects for capital growth. For example yields tend to be higher (because the expectations of capital growth are lower) in the North of England and Scotland. They are also higher in commercial property than retail and higher still in industrial. I understand that the yield for factory units varies from 8 per cent in the South East to 12 per cent in the North.

The aim of decapitalisation should be, as far as possible, to determine the rents that would be charged for a property were that type of property available for rent. Because of the variations in yields, a <u>single</u> decapitalisation rate crudely applied might not meet this test. 'Valuers will retain discretion to adjust the crude figure emerging from decapitalisation. It will, therefore be possible to arrive at rateable values that are a fair proxy for rentals even though yields vary.'

As to the level of the rate, there seems little point in consulting on a range between 6 and 7 per cent. Industry are likely to press for the lowest rate available (ie. 6 per cent).

C. OTHER DECAPITALISATION RATES

There are separate decapitalisation rates for local authority and Crown buildings (currently 3.75 per cent) and for Educational charities (principally public schools) (now 2.5 per cent).

Nicholas Ridley proposes to increase the rate applied to Crown and local authority property to the new standard 6 per cent.

This seems highly desirable given the increasingly blurred distinction with the private sector (eg. airports, bus companies) and the importance of ensuring fair comparisons for contracting out. It will lead to a minimal increase in the community charge (about 5p per head per week) and in central government taxation.

He also proposes to increase the rates applying to local authority schools and Educational charities to 4 per cent. This will bring them into line for the first time (ensuring equal treatment, for example, between Grant Maintained Schools and public schools).

In the case of local authority schools, this is only marginally higher than the present rate. And although the increase for educational charities will be greater, they will still benefit from a net reduction of about 50 per cent in their rates bills. This is because of the increase in charitable derating from 50 per cent to 80 per cent.

The Chief Secretary does not agree that local authority schools should be treated differently from other public sector buildings. He therefore proposes a single rate for the public sector of 5 per cent (ie below the 6 per cent rate proposed by Nicholas Ridley for all public sector buildings except schools). But he himself describes such a rate as being only "just about defensible". And it would also remove the possibility of treating Grant Maintained Schools and public schools equally.

D. <u>RATE POUNDAGE AND RSG</u>

The Chief Secretary has also raised two connected points. <u>First, rate poundage</u>. The Government has announced its intention to set the uniform business rate (UBR) in 1990 to raise the same revenue as now. The Chief Secretary is concerned that - by raising the public sector's decapitalisation rate - the proportion of this revenue met by the private sector would <u>fall</u>. He proposes therefore that the Government redefine its commitment on "business" rates to apply specifically to private business. Hitherto this commitment has been interpreted to mean <u>all</u> non-domestic ratepayers. The implication is that rate poundages in 1990 should be set in such a way as to maintain the yield from the private sector.

Second, revenue support grant (RSG). Another consequence of raising the public sector decapitalisation rate is to increase the amount the Government pays to local authorities in lieu of rates on Crown property. The Chief Secretary argues that unless RSG is adjusted accordingly, local authorities could end up receiving more taxpayers' money than they would otherwise have received.

Assessment

On these two points the Treasury appears to be putting down a marker. No decision on either point seems necessary at this stage. They can be dealt with separately in the context of settling the rate poundages and RSG for the new system.

But there are clearly important points at stake here. For example, the Treasury may be concerned that if the UBR is set too low at the start a resource gap may develop. Under the legislation (which limits increases in UBR to the RPI) this would be difficult to rectify. Whereas if UBR is set too high the Government does have the ability to adjust it downwards.

Similarly, local authorities will receive a revenue windfall from increased Government contributions in lieu of rates. This might reduce their incentive to manage their affairs efficiently.

The best way forward might be to ask Nicholas Ridley and John Major to prepare a joint paper addressing these two issues. This could be discussed at a meeting of E(LF) in the New Year.

CONCLUSION

We recommend that you:

a) agree to Nicholas Ridley's proposal to adopt a standard decapitalisation rate of 6 per cent for most types of property since it is intended that valuers should retain discretion to adjust the resulting figure;

b) agree the reduced rate of 4 per cent for local authority schools and educational charities;

c) ask the Environment Secretary and Chief Secretary to prepare a joint paper along the lines suggested above.

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