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CABINET

STEERING COMMITTEE ON LOCAL GOVERNMENT FINANCE STUDIES

DRAFT GREEN PAPER ON LOCAL GOVERNMENT FINANCE

Note by the Secretaries

Enclosed is Chapter 2 of the draft Green Paper on Local Government Finance.

This can be discussed at the meeting of E(LF)(O) on 10 December. Could any written comments be sent as soon as possible to Jill Rutter, Room N6/15, Department of the Environment, Marsham Street.

Signed J E ROBERTS
D P WALKER
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Cabinet Office
2 December 1985

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CHAPTER 2: LOCAL NON-DOMESTIC TAXES

The pattern of non-domestic rates

2.1 In Great Britain, non-domestic rates in 1985/86 contributed £■bn towards a total local authority revenue expenditure of £■bn - over ■%.

2.2 The bulk of non-domestic rate payments come from industry and commerce, including shops. But there are also very large contributions from the nationalised industries, and from public sector bodies. Local authorities pay rates to themselves and to each other for the schools and other premises they occupy. Central Government, Regional Health Authorities, Universities, etc. are also large contributors. Figure ■ shows the breakdown of non-domestic rate revenue by sector.

Figure ■: Non-domestic rates by sector (Great Britain 198■/8■)

2.3 Non-domestic rateable values are heavily concentrated in areas of commercial and industrial activity. Typically, the urban centres will have a much higher concentration of non-domestic property than rural areas. But there are many exceptions - for example, the contribution from a single power station can make up a very large proportion of the total rate income of a non-metropolitan district council. London is an extreme example of the degree to which non-domestic rates are concentrated in particular areas. The London area alone accounts for over ■% of the total non-domestic rateable value of England. And within London, over ■% of the rateable resources are concentrated in the central boroughs of Westminster, Kensington and Chelsea, Camden, and the City of London. This extreme variability of non-domesticrateable values means that different local authorities' income from non-domestic rates also varies greatly. Complicated grant arrangements have to be used to compensate for this unevenness, and these obscure for local taxpayers the true cost of changes in expenditure.

2.4 The poundages charged by local authorities also vary greatly - from ■p in the £ in ■ to ■p in the £ in ■. This means that similar businesses in similar premises can face rate bills that differ by as much as ■% just because they are located in different authorities. Obviously this will have an impact on their competitiveness.

2.5 Non-domestic rates fall to be met as an additional overhead cost of the bodies which are liable for them. Unlike domestic rates, which are a direct charge on the "consumers" of housing, non-domestic rates are charged to producers of goods and services and passed on by them to the final consumers of their products. In the case of the industrial and commercial ratepayers, their prices are higher than they would otherwise have been. In the case of the public sector bodies, central and local taxpayers have to pay more.

2.6 There is no voting right attached to the payment of non-domestic rates. However much a business might contribute to the income of a local authority, it cannot exercise any direct electoral influence over taxation decisions by councillors that can have a profound effect on its competitiveness and on its scope for investment. Of course, there are other ways - through consultation, discussion, and argument - in which an influential employer can put his views across to a local authority, and the relationships between many local authorities and local businesssmen are excellent. But the fact remains that local authorities are not <u>answerable</u> to the business ratepayers who provide a large proportion of their income. Since non-domestic ratepayers on average contribute over ■% of the total tax revenue raised locally (excluding rebates paid for by central Government), local authorities can find themselves under extreme pressure to spend more on services for their electors largely at the expense of the non-voting non-domestic ratepayer.

2.7 It is the combination of these various factors

- the very uneven incidence of non-domestic rateable values that makes complicated grant arrangements inevitable;

- the wide variation in the rate poundages paid in different areas that can distort and undermine the competitiveness of business;

- the fact that non-domestic rates are ultimately passed on to final consumers who may live far outside the authority concerned;

- the lack of any direct democratic accountability of local authorities to non-domestic ratepayers;

- the extent to which the large contribution of non-domestic ratepayers to expenditure at the margin can falsify the real costs or benefits of expenditure changes;

that has led the Government to conclude that non-domestic rates are not a satisfactory local tax.

2.8 This chapter considers what might replace them. It examines the options against two crucial tests. What will their effect on businesses be? And what effect will they have on local government?

Non-domestic rates and business

2.9 Non-domestic rates are now one of the largest taxes paid by business. Figure [redacted] compares the yield of non-domestic rates on industry and commerce in Great Britain since 1975 with the yield of corporation tax and the national insurance surcharge. The yields are not directly comparable, but they show a clear trend. Since corporation tax is directly linked to the profitability of businesses, its yield fluctuates. In [redacted], it fell to £[redacted]bn at a time when [redacted]. National insurance surcharge was reduced in line with Government policies until its final abolition in 1984. But the yield of non-domestic rates increased throughout the period. There is no correlation between this continuous growth in non-domestic rates and the level of profitability of business. This has been one of the main concerns of business representatives: that a major tax, which now produces a yield which is more than [redacted] times that of corporation tax, is completely unrelated to the competitiveness of those who pay it. It is the equivalent of a heavy overhead cost which businesses cannot control and which can vary erratically over time and in different locations.

Figure [redacted]: Taxes on business (Great Britain, 1975/85)

2.10 The impact of changes in and levels of non-domestic rates for businesses is less straightforward than that of other business costs. Normally if the price of an input - such as the cost of a particular type of material - rises, the first reaction of a firm would be to reduce its consumption of that input by switching to a substitute material or looking for another supplier. But with a change in the cost of occupying property that entails very drastic measures indeed. There are considerable costs in relocation. Until 1984 even "mothballing" empty industrial property carried no guarantee of reducing the rates bill. The business is therefore normally forced to treat a rate increase as an unavoidable increase in fixed costs and to seek to pass it on - through charging higher prices to consumers or negotiating a lower rent with the landlord - or to reduce investment and hence job creation. For some marginal firms, an increase in rates may be a factor in determining their ultimate survival.

2.11 Hard evidence on the effects of rates on business is scarce. A recent study, commissioned by the Department of the Environment, concluded that during the period 1974-81 rates could not be shown to have had a significant overall influence on manufacturing employment, although high rate burdens in London were correlated with relocation of offices outside London. At the aggregated level at which the study was conducted, and over the particular period considered, these results are plausible. But they do not provide a good indication of detailed effects at a local level. Moreover, in the period studied (1974-81), non-domestic rate poundages fell in real terms in all regions studied, except London, and in London itself there was very little manufacturing employment to provide any evidential base. The 1974 starting point also excluded the significant rate increases associated with the 1974 local government reorganisation and the effects of the implementation of the 1973 revaluation, which would have overshadowed subsequent movements in non- domestic rates.

2.12 How far business rate increases do affect the location and viability of businesses in particular areas must therefore still to a large degree be a matter of conjecture. For most firms, rates are a small cost, and a change in their level would be unlikely to have a major impact on location decisions. But employers' organisations, both in the private and public sector, report that their members <u>have</u> been influenced by rates in making decisions on employment, where rate increases have been extreme. And common sense would suggest that where a firm is struggling to stay in business a sudden increase in its rates bill can seriously jeopardise its chances of survival.

2.13 A more general concern is the impact of rates on the overall competitiveness of industry. If rates are passed on in higher prices they will damage the ability of British industry to compete with foreign businesses. If rates are absorbed by reduced investment that will, in the longer term, reduce productivity and again undermine the competitiveness of industry. If rates are passed back to the landlord there will be less incentive to develop land for business expansion.

2.14 Most costs that businesses face are fairly uniform across the country. But the rate burden can vary considerably even between neighbouring authorities. If this arises because of differences in <u>rateable value</u>, it is a reflection of the relative benefits of occupying different types of property and so is not a distorting factor - except to the extent that rateable values themslves are out of date and distorted. But differences in rate poundages are a different matter. These are purely a reflection of the spending policies of local authorities and have no connection with the resources being used by the business. Nor do differing poundages reflect different levels of benefit to non-domestic ratepayers. So sharply different rate poundages between different parts of the country will damage economic efficiency as businesses face differing cost structures which are quite unrelated to their real competitive strengths and weaknesses. Figure I shows the wide range of non-domestic rate poundages.

Figure I: Spread of non-domestic rate poundages (England, 1984/85)

2.15 On grounds of economic efficiency, therefore, there is a case for setting non-domestic rates on a basis that does not distort the competitiveness of businesses simply as a result of the chance factor that they were set up in one local authority rather than another.

The effect of non-domestic rates on local authorities' financial decisions

2.16 The government introduced a new consultation requirement in the 1984 Rates Act to promote discussion between local authorities and their non-domestic ratepayers. In many authorities such links were already well established. In others, the new arrangements represent a considerable improvement. But they still do not overcome the basic problem - that local authorities, at the end of the day, are not directly accountable to their non-domestic ratepayers.

2.17 The 1983 Rates White Paper argued in favour of domestic rates as a local tax that

"They are highly perceptible to ratepayers, and they promote accountability".

Neither argument is true of the non-domestic rate. Although non-domestic ratepayers actually write the cheques payable to the local authority, businesses do not ultimately bear the bill. As paragraph 2.5 above indicated, the final burden of the tax will rest with the consumers of the goods produced, the owners of the property occupied, the shareholders of the company, the workforce (either through lower wages or lower job creation), or the taxpayers who will pick up the bill for public sector bodies. These people will not perceive any link with the rating behaviour of the local authority. They are very likely to live outside the local authority's area altogether. So non-domestic rates fail the normal criteria for any local tax: that it should be perceptible to those who pay it as a tax imposed by the authority concerned, and that the taxpayers should be able to influence the behaviour of those who levy the tax.

2.18 In fact, non-domestic rates not only fail the test of accountability in terms of those who pay them and those who impose them. They also severely distort the link between the cost of providing local services and the costs faced by the local <u>domestic</u> taxpayers of an authority.

2.19 On average for every £1 raised locally from domestic taxpayers £■ is paid by the non-domestic sector. So the marginal cost of services to <u>domestic</u> taxpayers is reduced by the ■% contributed by non-domestic ratepayers. Most authorities that receive block grant are near this average because of the way the "resource equalisation" arrangements work (see Chapter 1, paragraph ■). In some authorities whose rateable resources are so high that they do not qualify for block grant, the marginal subsidy from non- domestic ratepayers is even greater. In Camden, for example, for every £1 contributed by the domestic ratepayer, the non-domestic ratepayer contributes £■.

2.20 As mentioned earlier, the extreme variations in non-domestic rateable values make it inevitable that there will be complicated grant arrangements to even out these differences in resources. Those arrangements in themselves make the connection between spending increases and changes in tax bills hard for local electors to understand. They may know that the expenditure of their authority and the grant it receives are in some way connected. But it is difficult to see how when the relationship depends simultaneously on the level of the authority's spending in relation to its assessed needs, <u>and</u> the level of the authority's rateable values in relation to that of other authorities. This issue of the effect of resource equalisation within the grant structure is discussed more fully in Chapter 4.

Options for reform

2.21 To summarise, non-domestic rates are not a satisfactory local tax because:

- they fall immediately on those who have no vote to influence local spending decisions;

- they are ultimately borne by people who are unaware of how these extra costs arise and may not live in the area of the authority imposing the rate;

- they reduce the apparent costs of local services to domestic rate-payers;

- they have an arbitrary and erractic effect over time and in different areas on the competitiveness of businesses.

- they make complicated and obscure grant arrangements inevitable.

2.22 There are three possible ways forward in dealing with these problems. The Government could consider the complete abolition of non-domestic rates, making up the lost revenue from some other source. It could seek ways of making local authorities genuinely answerable to their business ratepayers. Or it could look for ways of eliminating the damaging variability of non-domestic rates.

2.23 There are few taxes that could be substituted for the non-domestic rate and so make it possible to abolish it altogether. The only <u>business</u> tax with a similar coverage to non-domestic rates and capable of producing a broadly equivalent yield would be some form of payroll tax. The Government has no intention of introducing such a tax on jobs. The yield of non-domestic rates could alternatively be replaced by increasing a national tax not levied on business: for example, by adding [redacted] percentage points to VAT or increasing basic rate income tax to [redacted]. The Government is not prepared however to damage work incentives by increasing income tax. Nor would an increase in the rate of VAT be acceptable. If income from this source were paid as a grant it would increase the dependence of local government on the annual decisions of central government. If alternatively local government were simply guaranteed a share of VAT, the volatility of the yield would lead to large and unpredictable effects on local domestic tax rates year by year.

2.24 One way of seeking to make local authorities answerable to their non-domestic ratepayers would be to re-introduce a business vote or establish a separate class of membership of local authorities for representatives of bus-iness. But this approach looks to be unworkable. The previous business vote fell into disuse and was eventually withdrawn in 1969 because it was available only to sole traders or partners in businesses operating in the area. Most businesses are now carried on by limited companies, many of which are trading in more than one local authority area. It would not be practicable to devise satis-factory arrangements for voting by limited companies. For example, who would exercise the vote of the large retail chains with branches in most shopping centres? Establishing a separate class of local authority membership for busi-nesses would not resolve the conflicts in accountability which exist at the local level and would be regarded by many as an infringement of basic democratic principles.

2.25 If these approaches - abolition of non-domestic rates, or making local authorities directly answerable to business ratepayers - have to be ruled out, the unsatisfactory characteristics of non-domestic rates as a local tax will have to be tackled by retaining non-domestic rates but directly restraining their variability. This means transferring to central government the power to determine the rate poundage applying to the non-domestic rate, while continuing to distribute the proceeds of the non-domestic rate to support local government spending.

Setting the non-domestic rate

2.26 In deciding how to set the non-domestic rate central government could choose broadly one of two starting points. The existing pattern of rate poundages could be frozen. Or central government could set a single rate poundage that would apply in all local authority areas. Starting from existing rate poundage levels would ensure that individual rate bills did not change as a result of the more new system. But it would do nothing to remove the inefficiency inherent in the present arbitrary distribution of rate poundages between businesses in different parts of the country. Nor would it redress the disincentives to investment, job creation and new development in high spending local authority areas which presently exist because of the existence there of high rate poundages. Many of these are older urban areas which can ill afford to deter business in this way. As Annex E shows there is a strong correlation between the areas which would derive most benefit from a national rate and those which presently suffer the highest rates of unemployment.

2.27 Whichever approach is adopted both local government and business would require assurances about the way in which the arrangements would be operated.

2.28 Businesses will be concerned to ensure that the new arrangements do not lead to an increase in the proportion of local government spending financed by their rates. Local authorities will want to be sure that the contribution from businesses does not fall, leaving them to find more of the money to support their spending from local domestic taxpayers. The intention would be that the yield of the non-domestic rate should remain broadly unchanged as a result of the new arrangements. This is a two-part problem. How do we set the starting level? And how do we deal with subsequent upratings?

2.29 The Government would propose that in the first year non-domestic rate poundages should be set so as to maintain the real yield of non-domestic rates in the preceding year. If there is a national rate, it would be set at the average level (but see paragraphs ■ to ■ below). If existing relativities in rate poundages were to be maintained, a poundage for each authority would be set corresponding to the real value of the poundage in that area in the preceding year.

2.30 The best way of ensuring that business rates continue to meet a fair share of local spending, and that increases are predictable, so allowing businesses and local authorities to plan ahead with confidence, would be to index the initial poundages. The indexation should be provided for in primary legislation so that the arrangements could not be overturned without fresh consideration in Parliament.

2.31 There is a choice of possible indices. Some social security benefits are linked to rises in the Retail Price Index and are uprated once a year in the light of increases over a previous period. The alternative would be to use a forecast measure of inflation. The Government publish such a forecast each year in the Chancellor's Autumn Statement as required by the Industry Act 1975.

2.32 Nationally the total of non-domestic rateable value continues to grow at an average rate of [redacted]% per annum. Indexation of the poundage without an allowance for such growth would result in the aggregate yield rising faster than the rate of inflation. It would be for consideration whether, in specifying the arrangements for indexation, it would be appropriate to make an offset for such increases.

Distributing the proceeds

2.33 Whatever the basis on which the non-domestic rate were set, the total yield of the tax would be hypothecated to local government expenditure. The proceeds would be pooled and redistributed to authorities in such a way as to lower the rate of the local domestic tax by the same amount per adult in all authorities.

2.34 This simple process of pooling and redistribution would replicate the very complicated equalisation of non-domestic rateable values which presently takes place within the block grant arrangements. It would do so, however, in a very simple, straightforward and understandable way which did not lead to instability in grant entitlements within years and did not obscure the basic relationship between expenditure and local taxes. This transparency is a major benefit which will make this method of distributing the non-domestic rate an essential element in any new local government finance system.

Local dialogue

2.35 In the 1984 Rates Act the Government for the first time required local authorities to consult with representatives of non-domestic ratepayers before setting their rate or precept. That legislation was a response to the dissatisfaction of business ratepayers with their lack of a say in the spending decisions of the local authorities and to the failure by certain local authorities to enter into any serious dialogue with businesses in their areas about the services which were needed and the level of rates which businesses could reasonably afford to pay. Early experience of the first round of statutory consultation has shown that in some areas these provisions have proved extremely helpful in bringing together councils and their local employers. In other areas businesses continue to complain that their authorities are merely going through the motions. We need to consider further ways of making a fruitful dialogue between local authorities and businesses the norm in all areas.

2.36 Many commentators in recent years have also pointed out that the existing grant arrangements give local authorities no incentive to encourage development of their rateable value base. The complete compensation for variation in rateable values through "resources equalisation" ensures that, after a short time lag, authorities neither gain nor lose from changes in their rateable value. There is little or no incentive to encourage development and redevelopment.

2.37 A possible approach to meeting both objectives would be to allow local authorities to retain the discretion to levy a small rate on their non-domestic rate base, after consultation with their non-domestic ratepayers, and to retain in full the proceeds of such a rate. The poundage charged might be subject to an upper limit equivalent to, say, 5% of the national non-domestic rate (or 5% of the capped poundage if that were the method adopted).

Administrative arrangements

2.38 The non-domestic rate would continue to be collected by local authorities under the existing well-established arrangements. Of the amount collected they would be entitled to retain a sum equal to their entitlement from the redistribution of the national pool together with any entitlement to rate support grant. Any remaining surplus would be remitted to the Department of the Environment (or Welsh or Scottish Offices as appropriate) for redistribution. Where the yield of the non-domestic rate was less than an authority's entitlement to its share of non-domestic rates or rate support grant, it would receive payment of the balance. As at present, upper tier authorities will not collect rates. They will receive rate support grant and payments from the non-domestic rate pool.

2.39 Non-domestic ratepayers will continue to have the right to pay rates in instalments. The schedule of payments by local authorities to or from central government will take account of that.

2.40 If, in the light of consultation, the Government decides to proceed with the proposal for a small discretionary local non-domestic rate with a maximum limit, upper and lower tier authorities would share the proceeds.

2.41 With separate arrangements for non-domestic and domestic local taxes it will be necessary to re-draw and clarify the borderline between domestic and non-domestic property. The dividing line will fall between residential property which is occupied as a main or only residence and residential property which is not occupied on that basis. Hotels and boarding houses, therefore, will continue to be regarded as non-domestic property, like other businesses, and liable to the non-domestic rate except where the predominant use of the property is as a main or only residence for those who live there. Detailed discussions will be required to establish the boundary line. It will be a matter for the Inland Revenue Valuation Office to decide, on the facts, whether a property should be subject to a non-domestic rate and it will be necessary to provide for an appeal procedure. Existing arrangements also provide for a category of "mixed hereditaments" with both domestic and non-domestic uses. Equivalent arrangements will be necessary for the new regime.

Rates on Government Property

2.42 Crown Property is not liable for rates. The Treasury, however, through the Rating of Government Property Department, makes contributions in lieu of rates on the basis of a rateable value equivalent negotiated between that Department, the Inland Revenue Valuation Office, and the local authority concerned. There may be more efficient ways of achieving this under the new non-domestic rate arrangements - for example by a direct payment into the national non-domestic rate pool. There would, however, be a case for contributions to continue to be made in respect of local <u>domestic</u> taxes where the

English Crown Property concerned is residential in nature. The Government would wish to consult with the local authority associations about such arrangements and about which Crown Properties should be covered by them. Would it, for example, be appropriate for prisons to be treated in this way?

Non domestic revaluation

2.43 Since non-domestic rates are to continue as a major source of tax revenue it is important to ensure that they are levied on as firm and consistent a base as possible. The Inland Revenue Valuation Office has therefore been asked to start work on a revaluation of non-domestic properties with a view to preparing a new list in time for introduction on 1 April 1990. The revaluation will be based as before on evidence of rental values.

2.44 Introduction of new non-domestic rateable values would require the re-setting of the national non-domestic rate poundages so as to retain the yield of the non-domestic rate at the same level.

2.45 For the longer term, after the initial non-domestic revaluation has been completed, the Government believes it is essential to return to a regular series of revaluations in England and Wales for the non-domestic sector. These could be at five yearly intervals as presently provided for. An alternative might be to introduce a process of "rolling revaluation" for the non-domestic sector. For example, one-fifth of all properties might be revalued each year. The information obtained would be used to develop indices which could be applied to the properties which were not to be revalued that year. Such an approach could reduce substantially the degree of turbulence associated with a quinquennial reevaluation of all properties.

2.46 If such a system were to be adopted, it would be possible, instead of indexing the determined non-domestic rate poundage to the rate of inflation as discussed in paragraph █ above, to <u>freeze</u> the poundage, but instead allow the buoyancy of rateable values to cause the yield to rise in line with the increase in non-domestic property values. The Government will issue a separate consultation paper on the practical issues arising from a system of rolling revaluations.

Transition

2.47 If a national non-domestic rate poundage is adopted, that should be done at the same time as introducing new non-domestic rateable values. Both sets of changes will affect rate bills for businesses, in some cases substantially. In many cases the two sets of changes will be offsetting and so clearly should be done at the same time. In other cases the effects of the two changes will combine to give substantial overall changes in rate liability. There would be a good case for phasing in the combined effects of both changes over a three to five year period.

2.48 If existing rate poundages were simply capped, the case for phasing in changes in rate liability arising from the revaluation would be less clear-cut, since the new rating liabilities would simply reflect real changes in the value of the properties occupied.

Conclusion

2.49 The proposals in this chapter on the future of the non-domestic rate are central to the Government's proposals for the reform of local government finance as a whole. By substantially removing the discretion of local authorities to vary the non-domestic rate and by the arrangements for pooling and redistributing the yield described above it will be possible simultaneously to introduce a radical simplification of the grant arrangements and close the gaps which exist between those who vote for and those who pay for local services.

2.50 For business these proposals offer certainty about the overall speed with which non-domestic rates can be expected to grow and an ending of arbitrary variations in the sums demanded of them. This confidence should aid those making investment decisions to plan with greater confidence. The commitment to regular revaluations or a rolling revaluation will reinforce this certainty.

2.51 Local authorities, for their part, will continue collectively to secure the full benefits of the non-domestic business rate. But it will no longer be open to individual authorities to require businesses in their area to pay a disproportionate share of additional spending.