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**Research Report**

## Options for business rate reform

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# **Options for Business Rate Reform**

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## Preface

The Joseph Rowntree Foundation has supported this project as part of its programme of research and innovative development projects, which it hopes will be of value to policymakers and practitioners. The facts presented and views expressed in this report, however, are those of the authors and not necessarily those of the Foundation. Nor are they those of the Institute for Fiscal Studies, which has no corporate views.

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## **CHAPTER 1**

### **Introduction**

Business rates are a major source of tax revenues in the UK, raising some £12.7 billion in 1994–95, equivalent to some 5 per cent of total fiscal receipts. Prior to 1990, the revenues derived from business rates had accrued directly to local government, and the business rate poundage (tax rate) had been under local authority control.

In 1990, as part of the package of reforms that introduced the Community Charge (poll tax), local control over the level of business rates was removed; local business rates were replaced by a national non-domestic rate (NNDR), at a poundage determined annually by central government. The revenues raised from the national non-domestic rate are assigned to local government, and are distributed between local authorities on a straightforward per capita basis.

Since the introduction of the national non-domestic rate, there have been repeated calls for the reintroduction of some form of local control over business rates. The main issues have been summarised recently in a report commissioned by the Joseph Rowntree Foundation (Hale and Travers, 1995). This study identified arguments both in favour of and against the return of non-domestic rates to local control; whilst non-domestic rates might not be an ideal tax for local government, they can potentially allow local authorities more autonomy. In the end, Hale and Travers observed, the fate of the national non-domestic rate will be determined by political pressures; whilst government and many business representatives remain com-

mitted to the NNDR in its current form, local authorities are strong advocates of a return to local control.

If a decision is taken to return non-domestic rates to local control, there are a wide range of options for how this might be implemented. Whilst it would be possible to return to something corresponding closely to the pre-1990 system, a number of other aspects of the local government finance system have changed in the mean time. The local tax on domestic property, the council tax, based on bands of capital values, is now levied in a form that differs from that of the non-domestic rate. Also, the basis of grant distribution has changed; central government grants to local authorities no longer aim at the degree of comprehensive resource equalisation achieved prior to 1990. It might therefore be appropriate to consider a rather wider range of options for restoring some form of local business rate than simply the restoration of the pre-1990 system. A number of possible options for a new local business rate are the principal subject of this report.

The structure of the report is as follows.

In Chapter 2, we discuss the structure and operation of non-domestic rates. We recapitulate, briefly, various criticisms of the tax and the principal reasons for the abolition of locally-determined non-domestic rates.

Returning business rates to local control would have implications both for local authority revenues and for business taxpayers. Whilst the latter effect is not the primary subject of this report, the impact of local variations in business tax rates on the pattern of business competition and on business location is nevertheless an issue of considerable importance in its own right, and is also central to the choice of a system for introducing locally-varying business rates. We review the available

evidence on the effects of non-domestic property taxes on business activity and location. To the extent that these effects are large, and local variation in taxes correspondingly costly, it may be appropriate to design a scheme for local control of business rates that results in only a limited amount of variation in tax rates between authorities.

Chapter 3 describes the structure and operation of national non-domestic rates. We then consider three lines of argument for restoring local control. Some of the arguments for local control are, we think, rather weak, but they are, nevertheless, reasons that might explain why a return to some form of locally-varying business rate remains on the policy agenda five years after the introduction of the national non-domestic rate.

Chapter 4 describes a number of models that might be used to permit a return to locally-varying rates, whilst retaining the same basic structure of non-domestic rates as at present. The models differ in a number of respects: in how the burden of financing marginal local expenditure is shared between the domestic and non-domestic sectors, in the relation between the tax rates applying to the domestic and non-domestic sectors, and in the extent to which central government grant should attempt to compensate local authorities for differences in their tax bases.

Chapter 5 considers a number of other criticisms that have been advanced against non-domestic rates, whether locally or centrally determined. In particular, we discuss two alternative sets of reforms to the national non-domestic rate, each of which is compatible with either national or local control of rate poundages. The first is for a 'wider' local business tax than the current business rate, in which the tax burden is spread over a greater number of factors of production; under this scheme, which has

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some similarities with the French *taxe professionnelle*, the amount of tax paid by each business would be a function of both non-domestic rateable value and payroll, thus spreading the tax burden across labour inputs as well as capital. In the second scheme, business rates are allowed to vary across sectors; in particular, we explore the implications of ‘derating’ manufacturing and of derating retailing.

Chapter 6 summarises our results and draws conclusions.

## **CHAPTER 2**

### **Past Experience with Locally-Varying Non-Domestic Rates**

The UK property tax on the business sector, generically known as the 'rates', can be traced back as far as the Poor Relief Act of 1601. In recent years, however, the system of non-domestic rates has undergone substantial upheaval.

Until 1990, local authorities in the UK were able to set the tax rate which applied to both domestic and non-domestic properties. In 1990, a nation-wide revaluation of the tax base was accompanied by the replacement of locally-varying non-domestic rates by a centrally-determined uniform business rate (the national non-domestic rate). Whilst non-domestic rate revenues would continue to be hypothecated to local government, the tax rate would now be determined annually by central government. At the same time, domestic rates were abolished altogether, to be replaced by the ill-fated Community Charge (poll tax), and the system of grant distribution was reformed. This chapter presents the background to these 1990 reforms.

Section 2.1 provides a brief summary of the pre-1990 system of locally-varying non-domestic rates. Section 2.2 introduces a number of the arguments that were advanced in the 1980s, both in support of the existing system of locally-varying non-domestic rates and in favour of introducing a uniform business rate (UBR). The latter arguments are principally concerned with the impact of non-domestic rates on the accountability of local authorities to their electorates and the extent to which local

variations in rate poundages might distort the pattern of economic activity'. These arguments are examined in more depth in Sections 2.3 and 2.4. Section 2.5 examines a number of more fundamental criticisms that have been advanced against the system of non-domestic rates, irrespective of which tier of government is given the responsibility of determining the tax rate.

## **2.1 The Operation of Locally-Varying Non-Domestic Rates**

Rates are a property tax paid by the occupier (domestic or non-domestic) of a property. The rate bill is calculated as the product of the tax rate (known as the rate poundage and usually expressed as a number of pence in the pound) and the rateable value of the individual property. A property's rateable value, roughly defined, was intended to reflect the rental value of the property, if let in the open market for one year, on the assumption that the tenant was responsible for repairs and maintenance.

Households and businesses are presented with a single rates bill. In most areas, a number of local authorities share responsibility for the provision of local services. Shire areas have both district and county authorities (as well as parishes in some cases), whilst since 1986, metropolitan areas and London have had a single tier of multi-purpose authorities combined with a number of single-service authorities responsible for the provision of police, fire and transport services. Until 1990, the rate poundages set by each authority that provided services to a household or business were summed and collected together by the billing authority. Lower-tier authorities serve as billing

authorities in England whilst, until April 1996, the regional authorities in Scotland carry out this role.

Local authorities were not allowed to determine the share of local expenditure that was to be paid for by the domestic and non-domestic sectors respectively. The tax rates applying to the domestic and non-domestic sectors within a given local authority area could only differ by the extent of a centrally-determined (and financed) domestic rate relief. This was set at 18.5 pence in the pound in England during the 1980s.<sup>1</sup>

Local tax bases differ quite substantially, especially between district authorities. Central government has traditionally used the grant distribution system to compensate local authorities for these differences in their resource bases. The allocation of grant to individual authorities also makes allowance for variations in local needs for particular services and the unit costs of providing those services in that area.

Full resource equalisation reached its zenith with the introduction of the block grant system in 1980. Central government made an annual assessment of the cost that each individual local authority would incur if it provided a 'standard' level of service. A grant-related poundage (GRP) schedule then determined the rate poundage that each local authority could set for a given level of expenditure per head above grant-related expenditure (GRE, the 'standard spending' measure in the pre-1990 system).

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<sup>1</sup> Higher and more variable rates of domestic rate relief applied within the City of London and the City of Westminster.

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In practice, the GRP schedule represented the equalisation of notional tax bases across local authorities. Two local authorities that chose the same level of expenditure per head above GRE were able to set the same rate poundage, irrespective of any differences in their resource bases. In other words, the UK local finance system was characterised by locally-varying tax rates but not locally-varying notional (effective) tax bases.

There were a number of exceptions to this general pattern. First, a 'multiplier' was applied to the tax base in Greater London which allowed London authorities to retain some of the advantages of their high resource bases. Second, between 1981 and 1986, a system of expenditure targets and penalties was superimposed on the GRP framework so that grant also depended on annual changes in expenditure as well as absolute levels of expenditure. Third, a number of local authorities reached a position of 'grant exhaustion' as grant was withdrawn in response to higher expenditure. Since grant could not be negative, these authorities could enjoy the benefits of a larger tax base. The number of authorities in this group was initially small but increased towards the end of the 1980s.

For most authorities, one consequence of the system of resource equalisation was that local authorities had no direct financial incentives to compete with each other to attract 'footloose' businesses to the local area. For every £1 an authority gained in tax revenue from attracting additional businesses to the area, it typically lost an additional pound of grant. However, this does not mean that local authorities did not have any incentives to attract new businesses to their area, since a local authority's responsibility to its local residents is far broader than simply minimising their tax bills.

## **2.2 Criticisms of Locally-Varying Non-Domestic Rates**

The operation of non-domestic rates as a local tax was a source of considerable controversy during the 1980s. In this section, we summarise a number of the principal arguments for and against local control over the tax. In the following two sections, we evaluate the impact of locally-varying non-domestic rates on local accountability and economic efficiency in more depth.

Non-domestic rates have a number of features that recommend them as an additional local tax. The tax base is immobile (it is very difficult to physically move a building from one area to another), the process of allocating the tax base to particular local authority areas is straightforward, and there is limited scope for tax evasion.

However, at least two distinct groups of criticisms were advanced in the 1980s against non-domestic rates. The first concerns the operation of business rates as a local tax. Indeed, the 1986 Green Paper *Paying for Local Government* argued that ‘... on grounds of both economic efficiency and local accountability, non-domestic rates are not a satisfactory local tax’ (Department of the Environment, 1986, p. 15). These issues are dealt with in the following two sections. The second set of criticisms concerns the operation of business rates as a tax *per se*, irrespective of which tier of government is assigned control. These arguments are introduced in Section 2.5.

## **2.3 The Impact of Locally-Varying Rates on Local Accountability**

The Green Paper suggested a number of reasons why locally-varying non-domestic rates damaged local ‘ac-

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countability' — in other words, the effectiveness of local control over local authority tax and spending decisions.

- *Business rates fall immediately on those who have no vote to influence local spending decisions.*

The abolition of the business vote in the late 1960s could be argued to have created a situation of 'taxation without representation' in which much of the burden of high levels of local expenditure could be passed on to local businesses.

- *Business rates are ultimately borne by people who are unaware of how these costs arise and may not live in the area of the authority imposing the rate.*

It is important to differentiate between the formal and effective incidence of a tax. In other words, the business that is legally responsible for paying a tax may be able to pass on some of the tax burden to other agents in the economy. In the case of non-domestic rates, a tax on the value of property, there are a number of ways in which occupiers of the property could attempt to pass on the burden of the tax. First, firms could increase the prices they charge their customers, many of whom may not live in the local authority area in which the business is located. Second, firms may reduce the costs of other factor inputs such as wages. Third, firms may attempt to negotiate lower rents with their landlords. In each case, the burden of the tax may be passed on to individuals living in other local authority areas who have no practical means of influencing the tax burden that they bear.

- *Business rates conceal the true costs of local services, and of marginal increases in spending, from domestic ratepayers.*

It was claimed that the bulk of local spending in many high-resource areas was financed by the business sector and so the true costs of local spending decisions were hidden from the electorate. This argument is rather weak for two reasons. First, the rate poundages applying to the non-domestic sector were rigidly tied to those paid by the domestic sector.<sup>2</sup> Second, the operation of the grant system essentially ensured that high-resource authorities typically did not benefit from their resource bases. Moreover, the appropriate contribution to marginal increases in local spending will clearly depend on the distribution of the benefits of that expenditure between the two sectors.

- *Business rates require complicated grant arrangements, which further distort the impact of changes in expenditure.*

The distribution of the local tax base under a system of non-domestic rates is far more uneven than almost any alternative tax base (such as an income tax, sales tax or poll tax). This unevenness creates problems which require correction through equalisation grant arrangements. The 'nationalisation' of non-domestic rates and the simultaneous replacement of domestic rates by the poll tax allowed the abolition of resource equalisation

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<sup>2</sup>The domestic rate poundage and non-domestic rate poundage differed only by the extent of domestic rate relief, which was set at 18.5 pence in the pound during the 1980s in England.

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arrangements, but this 'transparency' in the local finance system was as short-lived as the poll tax itself. The subsequent return to local domestic property taxation has been accompanied by a return to resource equalisation, albeit less comprehensive than before and on a smaller scale than when business rates had been involved.

### **2.4 The Impact of Locally-Varying Rates on Economic Activity**

The Green Paper also suggested that business rates were damaging to economic efficiency because

- *Business rates have an arbitrary and erratic effect over time and in different areas on the competitiveness of businesses.*

There are clearly two parts to this argument. First, locally-varying business rates could impose erratic and unpredictable changes in local business tax burdens, for example if there is a change in the political control of a local authority. Second, locally-varying business rates distort the pattern of economic activity because of the differences in rate poundages between local authority areas at any one point in time. We deal with each argument in turn.

First, there are many examples of large year-to-year fluctuations in non-domestic rate poundages within a given local authority during the 1980s. Within London, for example, the rate poundage in Haringey rose by some 55 per cent between April 1988 and April 1989 whilst that in Tower Hamlets fell by over 46 per cent.<sup>3</sup> Such large variations in local tax bills make forward planning very

difficult for businesses. By contrast, rate poundages have been indexed to the retail price index (RPI) since 1990 and hence have been constant in real terms.

There may, however, be ways of reducing volatility that are consistent with local control. To the extent that large year-to-year fluctuations in local tax bills lead to uncertainty and distort the pattern of economic activity, there exists a clear case for limiting year-on-year changes to tax rates, but tax increases can be capped just as easily with local tax rates as with national tax rates. In principle, the UBR could have varied just as unpredictably as local tax rates did during the 1980s. In practice, however, annual changes in the UBR have been highly predictable since central government has limited the extent of annual increases in the UBR to the rate of inflation. There is no reason why this could not have been done to locally-varying poundages. Indeed, between April 1990 and April 1995, whilst rate poundages varied between local authorities in Scotland in any given year, they were 'frozen' in real terms over the period.

The argument that absolute differences in rate poundages across local authority boundaries may cause distortions to the pattern of economic activity is far more relevant to the debate over local or central control. It has often been alleged that high local taxes discourage economic growth by increasing the cost of capital investment. Whilst there has been much debate on this issue, the

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<sup>3</sup> Source: *Finance and General Statistics 1989/90*, Chartered Institute of Public Finance and Accountancy (CIPFA).

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empirical evidence for the existence of these effects is mixed.

Attempts to assess the impact of local business tax differentials on employment, profitability and investment have been hampered by the existence of a complex variety of institutional settings among countries that operate local property taxes. These differences make the task of generalising results determined in any one institutional setting significantly more complicated. We discuss some of the key research findings from analysis of British and American data below.

Two broad approaches have been taken to investigate the impact of differences in business rates on business profitability and business location decisions. The first has been to consider the impact of rate differences on the cost of capital. The second has been to consider the statistical association between business rate levels and economic activity measures such as the level of employment.

### *Cost of capital effects*

Bennett (1986) presented estimates of the effects of non-domestic rates on the returns to a variety of investment projects at the margin, assuming that none of the impact of changes to rates bills is capitalised into property values. He compared the impact of tax rates on the 'cost of capital' in the UK for 1980 and 1985 for a number of high- and low-tax authorities, following the method of King and Fullerton (1984). Thus he presented estimates of the 'fiscal wedge' between post-tax and pre-tax rates of return to marginal investment, discounted over the lifetime of the investment project. Local tax poundages in the six highest-tax authorities and the six lowest-tax authorities

were averaged and converted into corresponding rates of tax on corporate wealth, ranging from 1.6 per cent to 3.6 per cent in 1980 and 2.1 per cent to 4.7 per cent in 1985.

The results of applying this range of corporate wealth tax rates on corporate investments in the UK tax system were then calculated for two cases: first, the 'fixed-*p*' case in which the impact of the tax system on the post-tax real rates of return was calculated, holding the pre-tax real rate of return on the investment constant; and second, the 'fixed-*s*' case in which the effects of the tax system on the pre-tax real rate of return were evaluated, holding the post-tax real rate of return on the investment constant.

Overall, evaluated over a range of industries, assets, sources of finance and asset ownership, the variation in rate poundages between high-tax and low-tax areas generated a range of post-tax real rates of return on marginal investments of 0.5 percentage points in 1980 and 0.7 percentage points in 1985 (fixed-*p* case). Alternatively, the range of tax rates generated differences of between 0.6 percentage points and 0.9 percentage points in order for post-tax returns to be equalised (fixed-*s* case). Bennett argued that these differences are far from insignificant, once considered in the context of overall net returns to manufacturing industry of only 4 per cent in 1980. In the absence of a significant degree of capitalisation of non-domestic rates, these differences could lead to substantial effects on the pattern of investment in different locations.

### ***Investment effects***

Papke (1987) studied the influence of local business taxes on the cost of capital, and hence investment, in the US. His tax index incorporated many aspects of the tax system

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rather than simply the tax rate. It seems probable that businesses would take account of the overall tax structure (including exemptions and tax reliefs) rather than just the tax rate when making investment decisions. Using data for a large number of US states over time, Papke found that high local business taxes seemed to have a detrimental effect on the level of investment. Finney (1994) found similar results using a different methodology, although it is difficult to assess the exact size of the effects. Gyourko (1987) found that methods of production in the manufacturing industry were sensitive to tax structures. High property taxes were associated with labour-intensive methods of production, whilst there were no significant direct effects of corporate and payroll taxes.

### *Employment effects*

Crawford, Fothergill and Monk (1985) considered the impact of variations in non-domestic rates on employment growth. They reported the results of regression analysis of the change in employment in individual boroughs and districts over the period 1974–81. The study investigated a range of possible influences on employment change, including two measures of the rate burden — the rate bill and changes in rates — and considered the impact of rate burdens on employment growth in four sectors — retail, manufacturing, warehouses and offices. Crawford et al. could find no evidence that either tax rates or tax bills affected employment growth in any of the first three. Only in the office sector did they find that high tax rates were associated with lower rates of employment growth. This effect was particularly strong within London and the south-east.

### ***Business location effects***

Taylor and Twomey (1988) examined the reasons why manufacturing firms relocated between counties within the UK between 1972 and 1981. They found that regional policy had negligible effects on firm location decisions, whilst the impact of local variations in business rates was important.

Schmenner, Huber and Cook (1987) considered the locations of new manufacturing plants in the US. They modelled a firm's location decision as being a two-stage process. In the first stage, firms choose which states they should short-list as possible candidates for selection. In the second stage, they choose exactly which state they wish to locate in from the short list. Whilst different factors seemed important in the two stages of the decision process, tax variables were not a strong influence at either stage.

### ***Commercial property rents effects***

The impact of local property tax differentials on economic activity will depend on the extent to which local businesses ultimately shoulder the burden of higher tax bills. If businesses are able to pass on the burden of higher tax bills to other agents in the economy, the impact of local rate differentials on employment, investment and business location is likely to be greatly reduced.

McDonald (1993) studied a small sample of properties in Chicago but found no evidence that occupiers were able to pass on the burden of local taxes to landlords. However, he used a single cross-section or 'snapshot' of properties at one point in time and hence was unable to take account of factors such as prime locations or premium buildings

which are generally associated with both high rents and high local property taxes. A failure to control for these variables makes it very difficult to test with any degree of accuracy the extent to which occupiers pass on the burden of local taxes to landlords.

Bond, Denny, Hall and McCluskey (1995) investigated the impact that changes in local property taxes might have on commercial property rents. Their study used a sample of almost 3,000 institutionally-owned commercial properties in England and Wales over the period 1987–92. By using repeated observations of rents and rates bills for a given property, they found that rent and rates levels were often affected by the same factors, such as location and amenities. By controlling for these ‘fixed effects’, they were able to demonstrate that above-average increases in tax bills were associated with below-average increases in property rents. This process, by which the occupiers of properties pass on the burden of higher tax bills to their landlords by negotiating lower rents, was found to take a considerable period of time. However, Bond et al. concluded that, in the long run, in many sectors of the economy, the full burden of changes in business rates might be passed on from businesses to their landlords. These results imply that the long-run impact of variations in local tax rates may be significantly smaller than the short-run impact.

Overall, the empirical evidence on the economic impact of locally-varying business rates seems rather mixed. In the long run, there is some evidence that businesses may be able to pass on much of the burden of high local tax rates to their landlords in the form of lower property rents. In the short run, however, it seems likely that businesses bear the bulk of the burden of increased local tax rates.

The higher costs of production are likely to result in lower profits. There appears to be some evidence to support the view that local variations in tax rates affect investment to a greater degree than employment or location. Firms may find it relatively less costly to make adjustments to investment plans than to cut employment or relocate.

## **2.5 The Impact of Any Form of Non-Domestic Rates on Economic Activity**

A number of criticisms have been advanced against the operation of non-domestic rates as a tax, irrespective of which tier of government is responsible for determining tax rates. Whilst there are many variants of these criticisms, they basically fall into two groups.

- *Rates bills are insensitive to the circumstances of individual firms.*

This basic argument has arisen in a number of guises, such as calls for rate relief to small firms or to firms located in particular sectors of the economy. In addition, there have been calls for rates bills to vary with firm profits (Bennett, 1987).

- *Rates only tax a single input into the production process.*

As a result, rates are a particularly heavy burden on property-intensive sectors of the economy and hence may distort the allocation of resources between sectors. There have been a number of calls for rates to be replaced by a variant of the more broadly-based business taxes that exist in France and Germany.

We discuss these issues at more length in Chapter 5.

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An additional criticism of non-domestic rates is that property values are very fluid and hence the tax base can become outdated very rapidly unless there are regular revaluations of rateable values. By the late 1980s, rateable values from the 1973 Valuation List were still being used in England and Wales.<sup>4</sup> As a result, the rateable values had become far removed from the pattern of property values that prevailed across the country. This meant that businesses in those areas of the country in which property prices had risen less than the national average were forced to contribute disproportionately to the yield of non-domestic rates. Since 1990, central government has committed itself to regular revaluations every five years.

The reluctance of governments to allow regular revaluations of properties in the non-domestic sector may have been linked to the perceived political costs of revaluations of properties in the domestic sector. Indeed, the last major UK revaluation to include the domestic sector was the Scottish revaluation of 1985, which caused a wave of protest, leading eventually to the decision to abolish domestic rates and replace them with the poll tax.

However, it is not at all clear that the present system of five-yearly revaluations has successfully resolved the difficulties associated with revaluations. The 1995 Valuation List was accompanied by further measures of transitional relief as many businesses faced changes in rate bills of a similar magnitude to those experienced as a result of the 1990 revaluation. Whilst further analysis is beyond the

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<sup>4</sup>Scotland had additional revaluations in 1978 and 1985.

scope of this report, it is clear that this criticism of the rating system has not yet been resolved.

## **2.6 Conclusions**

Non-domestic rates existed as a local tax on the occupiers of business property for almost four centuries until 1990. The transfer of responsibility for setting tax rates from local to central government in 1990 must be viewed in the light of the operation of the rates as a local tax.

Non-domestic rates have some advantages as a local tax — the tax base is immobile, evasion is relatively difficult and it is very simple to allocate the tax base to individual local authorities. Despite these advantages, non-domestic rates were not an ideal local tax because they distorted the accountability of local authorities to their electorates and there is some evidence that they distorted the pattern of economic activity.

As the 1986 Green Paper argued, locally-varying non-domestic rates might reduce local accountability in a number of ways. First, business rates fall immediately on those who have no vote to influence local spending decisions. Second, business rates are ultimately borne by people who are unaware of how these costs arise and may not live in the area of the authority imposing the rate. This arises because businesses may be able to ‘pass on’ some of their local tax burden to workers in the form of lower wages, to customers in the form of higher prices and to landlords in the form of lower property rents. These individuals, whilst bearing some of the burden of the local tax, may have little or no connection with the local area. Third, business rates concealed the true costs of local services, and of marginal increases in spending, from

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domestic ratepayers since businesses ended up paying for over half of additional local expenditure which was primarily targeted towards services for the domestic sector. As a result, local electors did not face taxes reflecting the full costs of their voting decisions and inefficient levels of local expenditure may have resulted. Fourth, local variations in the non-domestic rate base required complicated grant arrangements.

In addition, business rates could damage economic efficiency because of their effects on the competitiveness of businesses in different areas. Tax differentials between local authorities may impose economic costs, to the extent that they distort firm location and investment decisions. Many studies have investigated the link between local tax rates and investment, employment and profitability, but the evidence is somewhat mixed.

Moreover, non-domestic rates as a tax have received a number of criticisms, irrespective of which tier of government is allocated the responsibility of determining tax rates. These criticisms are largely concerned with the lack of sensitivity of rates bills to the circumstances of individual firms and with the fact that rates are a tax on a single factor used in the production process.

This chapter has set the background for the introduction of the national non-domestic rate (NNDR) in April 1990. The operation of the NNDR and the reasons why, five years after its introduction, the reform of the NNDR is a subject of some controversy are discussed in Chapter 3.

## **CHAPTER 3**

### **The Case for Reforming the National Non-Domestic Rate**

Chapter 2 highlighted many of the concerns that had been raised about the effects of a system of locally-varying non-domestic rates. These concerns were largely to do with the accountability of local authorities to their electorates and the impact of local rate differentials on the pattern of economic activity. They contributed to the government decision to introduce, in 1990, a national non-domestic rate (NNDR) with a uniform rate poundage determined annually by central government.

This chapter describes the operation of the system of national non-domestic rates since April 1990. Business rates are now essentially a national tax, the revenue from which is assigned to local government and distributed to local authorities on a simple per capita basis. Section 3.1 discusses the operation of the NNDR over the last five years within the context of more general developments in the local finance system as a whole.

In addition, Section 3.2 discusses a number of arguments that have recently been advanced in favour of returning business rates to local control. These arguments have ensured that the reform of non-domestic rates remains close to the top of the policy agenda five years after the introduction of the 1990 reforms. We argue that the case for returning non-domestic rates to local control is far from proven. Much of the recent discussion about the causes of falling yields, for example, seems to have been based on a misunderstanding of how the local finance

system operates. However, to the extent that the low proportion of local authority spending that is financed from local taxation generates legitimate concerns about local autonomy, an additional local tax might be a necessary part of any long-term solution to the problems of securing meaningful local autonomy. A return to locally-varying non-domestic rates may be the quickest and simplest method of achieving this goal.

### **3.1 The National Non-Domestic Rate**

The national non-domestic rate was introduced in April 1990. At the same time, domestic rates were replaced by the Community Charge (poll tax) and the system of distributing central government grants to individual local authorities was reformed. This whole package of measures was based around the notion of 'marginal accountability' — local authorities could only be made accountable to their electorates by placing the entire burden of marginal local expenditure on the domestic sector and by spreading that burden more evenly across the electorate. According to the Green Paper, 'Effective accountability is the cornerstone of successful local government'. It was argued that local authorities would only make economically-'efficient' expenditure decisions if their electorates were faced with the 'correct' tax prices<sup>1</sup> of those decisions.

The removal of non-domestic rates from local control reduced the contribution of the business sector to additional local expenditure to zero. At the same time, the link between local expenditure and the level of grant received

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<sup>1</sup> i.e. the costs to the taxpayer of additional expenditure.

by a local authority was severed. In the future, grants were only to depend on central government's assessment of a local authority's need to spend — the standard spending assessment (SSA) — not on actual expenditure. Thus additional expenditure no longer attracted additional grant. As a result, since 1990, the full burden of any additional local expenditure at the margin has fallen on a single tax base — presently the council tax.

Local authorities retain responsibility for collecting the bulk of the revenue from non-domestic rates. This is submitted to a national 'pool' which is then used to distribute the funds to local authorities on a simple per capita basis, effectively transforming non-domestic rates from a local tax to an assigned local government revenue.

Since 1990, central government has determined the business rate poundage annually for England and Wales. In addition, since April 1995, the uniform business rate (UBR) applicable to properties in England applies to their Scottish counterparts.<sup>2</sup> However, the Local Government Finance Act 1988, the legislation that introduced the national non-domestic rate, restricted central government's discretion in determining the UBR in two ways:

- the annual increase in the UBR may not exceed the increase in the retail price index (RPI) between revaluations;
- the UBR may not increase more than is necessary to maintain real yields at revaluations, having allowed for

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<sup>2</sup>Until April 1995, rate poundages in Scotland had been 'frozen' in real terms at their 1989–90 levels.

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the likely extent of successful appeals against the new Valuation List.

These two requirements can be seen as ensuring, at the aggregate level, that the large real increases in the yield of non-domestic rates that occurred during the 1980s cannot reoccur. However, whilst individual businesses may now predict future rate bills with a considerable degree of certainty between revaluations, a great deal of uncertainty remains, due to the impact of regular revaluations.

### ***Revaluations and the tax base***

Aggregate rateable value comprises three components:

- Local rating lists. These comprise some 92 per cent of total rateable value in England.<sup>3</sup> Local authorities have retained responsibility for the collection of revenues from the local rating lists, even though they have lost the power to determine the rate poundage.
- The central list. This contains assets, such as pipelines, that are largely the property of the former nationalised industries. Revenues from the central list are collected by central government. Over time, it is expected that many of the assets included in the central list will be transferred to local rating lists. Indeed, it is likely that the central list will eventually be abolished, possibly as early as the turn of the century.
- Crown properties. Whilst Crown properties such as royal palaces and military barracks are not legally sub-

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<sup>3</sup>Source: *Inland Revenue Statistics 1994*.

ject to rates, the exchequer makes an annual contribution to the pool 'in lieu of rates' on behalf of these properties.

The first complete revaluation of non-domestic property in England and Wales since 1973 occurred at the same time as the introduction of the NNDR. This package of reforms was intended to be revenue-neutral in real terms so that, correcting for inflation, the yield of the tax in the first year of the NNDR should have been equal to the yield in the last year of locally-varying non-domestic rates.

There had been significant changes to the structure of the property market between 1973 and 1990. As a result, the introduction of the 1990 Valuation List led to considerable changes to the rates bills paid by many businesses. In the north, the average rates bills paid by factories fell by almost half, whilst the rates bills paid by shops in the south-east rose by over 30 per cent (Ridge and Smith, 1991). Outside Inner London, where various other measures in the local finance system of the 1980s, such as 'London multipliers', were being unwound, the impact of the 1990 revaluation swamped the effect of the introduction of the uniform national poundage.

Due to the scale of the changes in rates bills that many businesses faced as a result of the 1990 reforms, a scheme of transitional relief was introduced. This limited the year-on-year increases in real tax bills that businesses could face as a result of the reforms. This relief was financed by delaying tax bill reductions for those businesses (often in the industrial sector and located outside the south-east) that had gained from the revaluation. Whilst those gaining from the changes were allowed to receive the full benefit of lower rates bills from April

1993, the Treasury funded an extension of the transitional arrangements for those facing increased rates bills right up to the introduction of the 1995 Valuation List in April 1995. The provision of a further series of transitional arrangements from April 1995 has been seen as the dawn of an era of 'permanent transition'.

Contrary to expectations, regular revaluations do not seem to have ended the disruption in the pattern of rates bills that arose when revaluations were less regular. The introduction of the 1995 Valuation List has led to changes in rates bills of a similar magnitude to those resulting from the 1990 revaluation. Some of this effect may simply be the result of cyclical timing. The 1973 and 1990 Valuation Lists were both compiled when property markets were booming, whilst the antecedent date for the 1995 Valuation List was April 1993, in the midst of a recession. As a result, the pattern of gainers and losers from the 1995 revaluation is likely to reflect the relative impact of the recession of the early 1990s on different regions and sectors of the economy.

### **3.2 The Case for Reforming the National Non-Domestic Rate**

Five years after the introduction of the national non-domestic rate, a return to some form of locally-varying business rate remains on the policy agenda. Three sets of arguments have been put forward in favour of a reversal of the 1990 reforms:

- concerns about the impact of the system on the incentives to collect or enforce non-domestic rate payments have arisen because the yield of the national non-

domestic rate has fallen significantly in real terms since 1990;

- the proportion of local expenditure financed through local taxation has fallen to only 18 per cent, which may have serious consequences for local autonomy;
- the effective 'nationalisation' of business taxation has reduced the spirit of partnership between local authorities and the business community.

We shall address each of these concerns in turn.

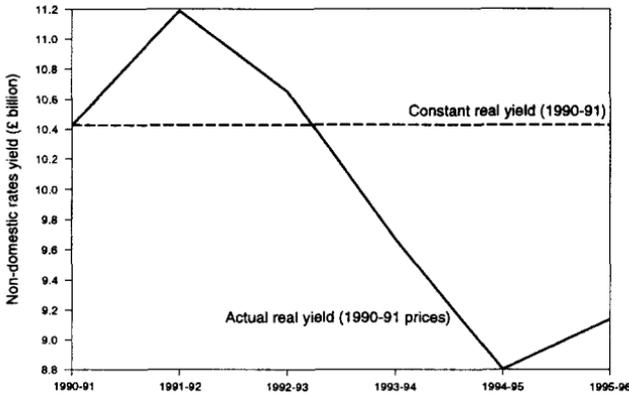
### ***The impact of the NNDR on tax yields***

Over the last few years, a great deal of attention has been given to the significant decline in the real yield of non-domestic rates that occurred in the years following the nationalisation of non-domestic rates in April 1990. The amount of non-domestic rates revenue that has been distributed to local authorities in each year of the operation of the centrally-determined tax rate is shown in Figure 3.1. The figures are in real terms, having controlled for the impact of inflation over the period.

The fall in the yield of the NNDR appears to have been partly a temporary blip and partly a permanent reduction in yields caused by an underestimation of the likelihood of successful appeals against the 1990 Valuation List. Indeed, as Figure 3.1 shows, the distributable amount of national non-domestic rates (the amount allocated to local authorities on a per capita basis) has begun to rise again for the 1995–96 financial year although it is still well below the amount distributed in the first year of operation of the NNDR. The case for the reduction in the yield of non-domestic rates since 1990 being a direct result of the removal of the tax from local control rests on two pillars.

FIGURE 3.1

**Comparison of real actual yield with yield from constant tax base**



Source: *Finance and General Statistics*, various years, CIPFA.

*Yields have fallen because local authorities no longer have an incentive to maintain collection rates since they do not directly benefit from higher local yields.*

This incentive argument is largely false. Local authorities have to contribute a fixed amount to the national non-domestic rates pool. This amount, which is agreed with central government, depends on the local tax base and the authority's provision for bad debts (which is audited) but not on actual collections. Hence, local authorities with poor collection records suffer direct financial losses. This has been reflected in high collection rates. In 1993-94, 98 per cent of the expected yield of the tax was collected. This represents 95 per cent of the total tax liability.

*Local authorities no longer have an incentive to maintain their tax base either by pursuing policies attractive to business or by challenging appeals against rateable value, again because they do not directly benefit from higher local yields.*

There has clearly been a reduction in the tax base since 1990 but not large enough to explain the decline in revenues fully. However, it is not clear that this decline in the tax base has anything to do with the loss of local control over the setting of non-domestic rates. Rather, the declining size of the non-domestic tax base has been largely due to two factors:

- The recession. Low levels of economic activity lead to both low buoyancy in the base and mandatory 50 per cent exemptions for vacant commercial and retail properties and 100 per cent exemptions for vacant industrial property. These exemptions have only been mandatory since 1990, suggesting that the impact of this recession on yields would be greater than that of previous comparable recessions. Indeed, approximately £1 billion of empty property relief has been granted in each of the last three financial years.
- A higher-than-expected success rate of appeals. Over 650,000 appeals were made against the 1990 Valuation List within the first six months. This represents approximately 40 per cent of all properties. Moreover, an additional 450,000 appeals have been made against subsequent revaluations. Since successful appeals permanently reduce the size of the tax base, it now seems likely that the cumulative effect of this appeals process will be a substantial reduction in the aggregate tax base.

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The critical issue here seems to be the accuracy with which the extent of this diminution in the size of the tax base was forecast and hence taken account of at the time of the 1990 revaluation.

However, it has been argued that there has been an excessive number of successful appeals due to lack of local authority vigilance over the appeals process. Local authorities do not have any incentives to maintain their tax bases since they do not benefit directly from increased yields. Moreover, the 1990 reforms have restricted the local authority's legal right to contest valuation appeals on properties it does not own.

Whilst it is very difficult to obtain evidence to test this hypothesis, it is not immediately obvious that the incentives of local authorities to maintain the size of the tax base have dramatically changed since 1990. An elaborate system of resource equalisation operated during the 1980s which meant that, for every £1 a local authority gained in revenue from a marginal increase to the size of its tax base, it lost £1 in grant. Hence there are only three possible reasons why effective 'nationalisation' of the tax base could have generated a structural break in local authority behaviour:

- Local authorities were 'grant-exhausted' prior to 1990 and hence could benefit from additions to their tax base since grant could not be negative. However, in all but the final years of the local finance system of the 1980s, only a handful of high-resource-base authorities found themselves in a position of grant exhaustion.
- Local authority revenues were temporarily affected by changes to the local tax base because of a delay between

the changes being made and them being reflected in changes in grant. However, the national non-domestic rate system could easily be modified to give local authorities an incentive to build up their tax bases in the short run. This would be unlikely to influence the propensity of local authorities to challenge successful appeals since the main constraint on them at present is a legislative one.

- Local authorities imperfectly understood that the system of resource equalisation that operated during the 1980s compensated them for reductions in the size of the local tax base pound for pound by increasing central government grant. Whilst it is clearly possible that a systematic misunderstanding of a highly complex local finance system might have occurred in certain cases, it would not seem sensible for the success of a policy change to depend on widespread misperceptions of the structure of the new system.

Moreover, at least part of the falling yield is likely to have been a temporary blip resulting from a temporal redistribution of tax yields for two reasons. First, successful appeals against the 1990 Valuation List have resulted in a significant revenue loss due to one-off refunds of the previous tax overpayment, with interest. This is because businesses are liable to pay the full amount of their original rates bill whilst their appeal is pending. Net repayments with interest have been in excess of £0.5 billion in each of the last three financial years. Since these refunds are likely to dwarf the impact of appeals on the tax base in the short run, we can expect a partial recovery in yields as the appeals backlog is cleared. Second, since the depth of the recession and the success rate of appeals were generally

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underestimated, anticipated collections (the basis for distributing the yield to local authorities) were over-optimistic in the early years of the tax. Poorer-than-expected collection rates do not affect the distributable amount in the year in question because the Treasury makes up any deficit in order to reduce the budgetary uncertainty faced by local authorities. This amount is reclaimed the following year. As a result, the distributable amount falls in subsequent years even if the tax yield is constant. In 1994–95, almost £1 billion of revenue was refunded to the Treasury in return for ‘bailing out’ the non-domestic rate pool in the two previous years. The effect on the distributable amount is a temporary blip which should not be used to make trend predictions.

As a result, it is far from clear that a return to locally-varying business rates can be justified on the grounds that local authorities need to be given an incentive to maintain tax yields.

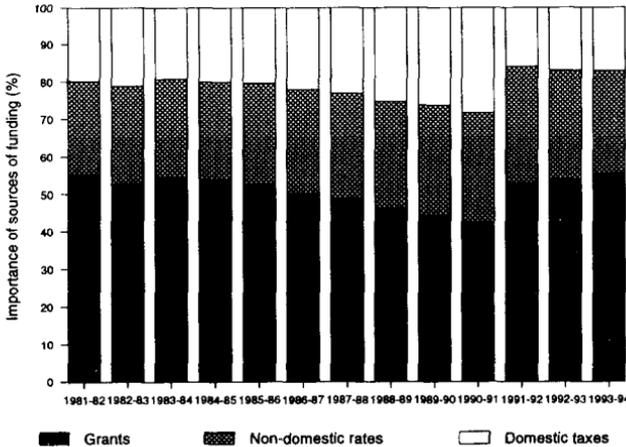
### ***The impact of the NNDR on the local tax base***

In recent years, a great deal of attention has been focused on the relatively small proportion of local expenditure that is now financed by sources of income that are under local control. This has led to concern that if ‘he who pays the piper calls the tune’, the narrowness of the local tax base may serve as a significant constraint on local autonomy in the UK.

Figure 3.2 demonstrates that during the 1980s, approximately half of local authority expenditure was funded from tax revenues that were under local control. Two major reforms to the UK local finance system led to a structural break in this pattern. First, in 1990, the non-

FIGURE 3.2

Trends in the sources of finance for local authority expenditure over time



Source: *Local Government Financial Statistics, England*, no. 4, HMSO.

domestic rate was transferred from local to national control, effectively reducing the local contribution to 25 per cent. Second, the ‘fiscal anarchy’ (Besley, Preston and Ridge, 1993) that resulted from the introduction of the poll tax in 1990 prompted an increase in the grant contribution from central government. This increase in grant effectively reduced the contribution of local taxation by £140 per Community Charge payer by increasing the national rate of value added tax (VAT) by 2.5 percentage points in 1991.

In addition, ending the link between additional local expenditure and additional grant entitlement in 1989 resulted in the entire burden of any additional local expenditure above the centrally-set standard expenditure (SSA) being borne by this relatively narrow local tax base. For the average household, a 1 per cent increase in local

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TABLE 3.1

**Range of 'gearing ratios'<sup>a</sup> for English local authorities, 1994–95**

<i>Class of authority</i>	<i>Mean</i>	<i>Standard deviation</i>	<i>Lowest</i>	<i>Highest</i>
Inner London	8.1	2.5	4.2	13.1
Outer London	5.6	1.7	3.0	10.7
Metropolitan districts	5.7	1.0	3.6	8.1
Shire counties	4.0	0.6	2.8	5.9
Shire districts	3.7	0.9	2.2	7.4

<sup>a</sup>Gearing ratios are defined as the percentage increase in local tax bills that would accompany a 1 per cent increase in expenditure above SSA, assuming no change in local authority reserves.

expenditure per head above SSA currently leads to an increase of approximately 6 per cent in council tax bills. These high 'gearing ratios' mean that not only do local authorities face an extremely high 'tax price' of additional local expenditure, but also that local tax rates may now be as responsive to changes in central government grant as to local spending decisions. Table 3.1 shows the ranges of these gearing ratios for the financial year 1994–95 by class of authority.

To the extent that high gearing ratios reduce local autonomy by restraining local expenditure to an excessive degree (an argument that remains substantially unproven), there is clearly a case for reducing gearing ratios by increasing the size of the local tax contribution. Since the council tax is a largely regressive tax, the scope for an increased rate of council tax at standard spending (CTSS) fulfilling this role seems limited. This suggests that there may be a need for an additional local tax. Such a tax would increase the proportion of local expenditure that is funded through local taxation. This would reduce the gearing

ratios applying to marginal local expenditure and hence facilitate a higher degree of local autonomy. However, it is not at all clear that this additional local tax should be non-domestic rates.

The high gearing ratios that confront marginal increases in local expenditure at present may be viewed as a significant problem in the present local finance system. If this issue is seen as being of sufficient importance to merit action within a relatively short time scale, then locally-varying non-domestic rates do hold one significant advantage over alternative local taxes such as an income tax or a sales tax: they would be relatively simple to introduce. This factor alone may tip the balance in favour of making non-domestic rates the prime candidate for an additional local tax.

However, whilst an augmented local tax base may be a necessary condition for increasing local autonomy, it is clearly not a sufficient condition. Indeed, if the present system of generalised 'capping' of local authority expenditure were retained, it is not clear that a return to locally-varying non-domestic rates would have any significant positive effect on local autonomy since the majority of the major spending authorities now set their budgets at the centrally-determined cap.

***The impact of the NNDR on the spirit of partnership between local authorities and local business***

It has been argued that the real cost of 'nationalising' non-domestic rates was the damage done to the spirit of partnership between local authorities and their local business communities. One common argument is that the reforms may have made local authorities less willing to

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devote resources to economic development and other services for the benefit of the business community, because business rate revenues are now simply distributed per capita; an authority that attracts more business does not receive any direct resource benefit from this. Whilst the 1984 Rates Act still compels local authorities to 'consult' with local business representatives when setting their annual budget, businesses may have ceased to have any meaningful influence over the local budgetary process.

The argument that locally-varying non-domestic rates would restore a greater partnership between local businesses and local authorities is, however, a misleading one, for two main reasons.

One is that the local government finance system before 1990 did not provide local authorities with any greater incentive than at present to attract business, due to the resource equalisation provisions in operation. For the large majority of local authorities, an extra £1 in local tax revenue from the location of an additional business in the area resulted in a £1 reduction in central government grant.

In addition, *locally-varying* rates are not necessary for providing local authorities with a financial interest in attracting tax base, because local authorities could be allowed to benefit temporarily from increases in their local tax base under the NNDR. This could be achieved, for example, by discounting any increase in the tax base for the purposes of calculating the grant for that authority for a number of years.

In order for a return of non-domestic rates to local control to provide an incentive for local authorities to seek to attract business, and hence tax base, to their area, it would be necessary for resource equalisation within the local finance system to be only partial — local authorities

would not be completely compensated for changes in their tax base.

However, unless a distinction were to be drawn in some way between 'old' and 'new' rateable value, a side-effect of allowing local authorities to benefit from changes in their tax base would be that those local authorities that already have very large tax bases would benefit from 'windfall gains'. The benefits to local authorities from a large existing tax base would be almost certain to swamp any changes in revenues likely to result from 'business-friendly' policies. Allowing local authorities with a large tax base to benefit from this has clear implications for the equity of the local finance system.

In addition, the argument that a local authority only cares about the state of the local economy to the extent that it benefits directly from increased local tax revenues is highly contentious. Economic growth may generate additional local jobs and amenities which affect the quality of life in the area. A local authority that wished to maximise social welfare would clearly wish to take these factors into account, whatever local finance system was in operation. Indeed, to the extent that local authority activities largely affect the distribution of economic activity rather than the aggregate level of activity, introducing a direct financial incentive for 'socially unproductive job diversion from one location to another rather than net job creation' (Jackman, 1987) would be undesirable.

The 1990 reforms may have had a larger impact on the ability of local authorities to finance business services than on their willingness to do so. The ability of local authorities to vary expenditure at the margin, in order to match the preferences of the local business community, may be significantly restricted when the whole burden of addi-

tional local expenditure falls entirely on the domestic sector. The present local finance system permits the benefits that businesses receive from local spending to differ between local authority areas whilst the costs that businesses must pay for these services do not.

A return to locally-varying rates on the basis of full equalisation might enhance the ability of local authorities to respond to the needs of local business but would be unlikely to affect their incentives to do so. Indeed, it is likely that more extensive charging for local authority services to business or some form of hypothecated local tax would be a better-targeted approach to this problem. We do not explore the forms that such a hypothecated local tax could take in this report. A residual business rate set in response to a voting process involving all business rate payers in a local area is discussed by Bennett (1987). Some alternative proposals for funding improvements to the infrastructure in London have recently been examined by Glaister and Travers (1995).

### **3.3 Conclusions**

Partly in response to concerns about the impact of locally-varying non-domestic rates on local accountability and economic efficiency, a national non-domestic rate was introduced in the UK in April 1990. From this date, central government has been responsible for setting a uniform non-domestic rate poundage each year, subject to legislation that has prevented the rate poundage from increasing in real terms.

Five years on, debate over whether or not non-domestic rates should be returned to local control remains active.

Three sets of arguments have been advanced for why the national non-domestic rate should be reformed.

First, concerns have been expressed about the impact of the NNDR system on the incentives for local authorities to collect or enforce non-domestic rate payments. These concerns have arisen because the yield of the national non-domestic rate has **fallen** significantly in real terms since 1990. We argue that much of the fall in the yield of the NNDR was a temporary blip due to the recession and refunds of previous overpayments of tax in the light of successful appeals against the 1990 Valuation List. In addition, it seems likely that central government underestimated the extent of successful appeals against the 1990 Valuation List; this has led to a **permanent reduction in tax yields**. Neither of these effects appears to have **resulted** from the nationalisation of the tax.

Second, the proportion of local expenditure financed through local taxation has fallen to only 18 per cent. This may have serious consequences for local autonomy to the extent that 'he who pays the piper calls the tune'. It also means that, on average, a 1 per cent increase in local expenditure generates a 6 per cent increase in local tax bills. The accountability of local authorities to their electorates may have been adversely affected to the extent that local tax rates are now more sensitive to changes in an authority's SSA than to local expenditure decisions. Whilst non-domestic rates may not be an ideal local tax, the return of non-domestic rates to local control might be the simplest method of broadening the local tax base.

Third, the effective 'nationalisation' of business taxation may have reduced the spirit of partnership between local authorities and the business community because local authorities may no longer be either willing or able to

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target resources at services of benefit to the business community. We argue that local authorities have many reasons to pursue business-friendly policies other than direct financial gain, and that the financial incentives have changed little since 1990. However, the ability of local authorities to pursue such policies might be enhanced by a return of non-domestic rates to local control. Consideration might need to be given to how marginal increases in local business taxes could be hypothecated towards the business sector, although this seems very difficult in practice.

It is not clear that a return of non-domestic rates to local control would necessarily provide a solution to either of the problems of falling business rate yields or to the mismatch between local expenditure on services for business and local business taxation. However, the 'narrowness' of the existing local tax base may excessively restrict the ability of local authorities to respond to variations in local preferences under the present UK local finance system. Despite obvious drawbacks, the most practical method of enlarging the local tax base, given the administrative difficulties posed by the introduction of either a local income tax or a local sales tax, might be to return non-domestic rates to local control. The practical impact on individuals, local authorities and businesses of a return to some form of locally-varying business taxation is discussed in Chapters 4 and 5.

## **CHAPTER 4**

### **Some Options for Reintroducing Locally-Varying Business Rates**

#### **4.1 Introduction**

In this chapter, we consider a variety of means by which the present national non-domestic rate could be returned to local control. If business rates were to be restored to local control, there would be a number of ways in which this could be done, with, as we show, different advantages and disadvantages.

Much of the discussion on returning to a system of business rates with locally-determined poundages has simply assumed a return to the pre-1990 system. This is perhaps to consider the issue in rather narrow and unimaginative terms. Indeed, simply restoring the pre-1990 business rate arrangements is no longer possible or logical. There are two important differences.

First, the current basis for allocating central government grants involves more limited resource equalisation than under the pre-1990 system; it provides local authorities with sufficient resources to ensure that they can all levy the same tax rate if they spend at the standard level, SSA, but does not equalise at other spending levels. The inequity that thus arises is, perhaps, tolerable where differences between areas in the council tax base are concerned, but the system has not been designed to cope with the much greater resource differences between authorities under business rates.

Second, before 1990, local household taxes were levied on the same base as business rates, and (with the exception

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of a small discount to the domestic poundage through domestic rate relief) a common tax rate applied to both business and domestic local taxpayers. The system, in effect, operated as a single local tax, and the amount that should be contributed, either on average or at the margin, by local business taxpayers was thus decided by the relative size of the business and domestic rate bases. Since domestic rates have now been abolished, there would be two separate local taxes if business rates were restored to local control, and explicit decisions would have to be taken as to the relationship between the two taxes.

Whether or not the return of some form of local control over non-domestic rates is seen as desirable, it is clear that such a reform would generate a number of practical issues which policymakers would need to address. Two key issues that require consideration in designing a scheme for locally-varying business rates are

- how the burden of financing marginal local expenditure should be divided between the domestic and non-domestic sectors; and
- what form, if any, resource equalisation arrangements should take.

The four models of locally-varying non-domestic rates discussed in this chapter involve a number of different ways of addressing these issues.

The present UK local finance system equalises local authorities' resource bases at a single level of expenditure. This is equal to central government's assessment of their 'need to spend', known as a standard spending assessment (SSA).

SSA is the level of expenditure that central government deems sufficient for the local authority to provide a given bundle of local services without any presumption that this package of local services is actually provided. Hence, central government grants depend only on SSAs and not on the actual level of local expenditure. The full cost of any marginal local expenditure is met from the local tax base, which, at present, constitutes a single tax, the council tax. In all of what follows, we shall use the term 'marginal expenditure' to mean the difference between actual local budget requirements and SSA.

'SSA-only' equalisation means that the 'tax price' of spending at SSA is the same for all local authorities but the 'tax price' of spending above or below SSA for a given authority differs inversely with the size of the local tax base. In other words, whilst all authorities that spend at SSA will be able to set the same local tax rate, resource-rich authorities with larger tax bases are able to increase expenditure beyond this level at a lower 'tax price' than less well-endowed authorities.

We consider two basic forms of equalisation arrangements. First, Section 4.2 examines various models of *full* resource equalisation in which the 'tax price' of additional expenditure is equal for all local authorities at any level of spending relative to SSA. Full equalisation would therefore involve additional redistributions of grant between local authorities in response to differences in tax bases to those that occur at present. Section 4.3 focuses on partial equalisation models in which the resource bases of local authorities are equalised at SSA only, as at present. Hence the full burden of marginal local expenditure would continue to fall on the local tax base which would be some-

what larger and more variable between local authorities than at present.

For reference, details of each of the four schemes to be discussed are summarised in Box 4.1. The following sections provide a more extensive discussion of the features of each scheme, and an analysis of the effect that

BOX 4.1

**Summary of the four schemes for locally-varying business rates**

*Model 1* — full equalisation of the business rate base, with a given percentage contribution in each local authority by household taxpayers (council tax payers). In the example shown, council tax payers contribute 40 pence per pound of extra local spending in every local authority; business rate payers in an authority with an average business rate base contribute 60 pence per pound.

*Model 2* — full equalisation of both the business and household tax bases. Marginal local spending increases the rates of council tax and business rates proportionally to the excess of the local authority's spending above SSA.

*Model 3* — partial equalisation, with a fixed business share. Resources are equalised for spending at SSA, but local taxpayers pay for additional local spending, regardless of the local tax base. In the example illustrated, the non-domestic sector pays 60 per cent of the cost of the 'overspend' and council tax payers 40 per cent.

*Model 4* — partial equalisation, with varying business share. Again, resources are equalised for spending at SSA, and local taxpayers pay for additional local spending, regardless of the local tax base. However, in this case, the contribution of business rate payers varies according to the importance of business taxpayers (measured by employment) relative to household taxpayers (measured by number of residents).

each would have on the level and distribution of the local tax burden, based on our model simulations.<sup>1</sup>

The UK local finance system consists of a complex and highly interrelated set of features. In assessing the distributional impact of the reforms discussed below, we were careful to isolate the direct impact of reforms to non-domestic rates from other, potentially complementary, reforms to the local finance system. To this end, we made a number of simplifying assumptions:

- We assume that local authorities make no behavioural response to the switch in local finance regimes involved in the reforms. This assumption is a simplification, but not necessarily an implausible one, particularly in the short term. The majority of major service-providing authorities currently set their budgets at the cap set by central government.<sup>2</sup> If some form of capping arrangements continued to apply during the transition process, (as was the case in the switch from the Community Charge to the council tax), an enhanced local tax base might not generate any additional room for manoeuvre for many local authorities.
- We assume that aggregate grant remains unchanged at 1994–95 levels (although our full equalisation models involve some redistribution of this grant between local authorities).

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<sup>1</sup> A concise mathematical summary of all the models is provided in Appendix 2.

<sup>2</sup> In 1994–95, 36 out of 39 shire counties, 31 out of 36 metropolitan districts and 20 out of 33 London boroughs set their budgets at the centrally-determined cap.

## *Options for business rate reform*

- We do not consider the possible use or impact of transitional arrangements to smooth the impact of the reforms on individual businesses or households.
- We exclude two very high-resource authorities, the City of London and the City of Westminster, from our models. The City of London, for example, has a higher share of national non-domestic rateable value than the entire northern region, despite having only 5,167 residents.<sup>3</sup> Traditionally, for this reason, special arrangements have always applied to the City and other high-resource Inner London authorities. Rather than guessing what form these arrangements may take in the future, the full equalisation models effectively 'freeze' the net contribution to the national non-domestic rates pool that is made by these two authorities.

A more complete analysis of the data used in our analysis can be found in Appendix 1.

### **4.2 Schemes Involving Full Equalisation**

The first two schemes for locally-varying non-domestic rates that we consider involve full resource equalisation for the non-domestic component of the local tax base. In other words, the schemes ensure that differences between authorities in the size of the local non-domestic tax base do not affect the non-domestic rate poundage or council tax level that a local authority would have to charge to finance any given level of spending. A local authority area with a large amount of business rateable value is not able

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<sup>3</sup> Source: *Finance and General Statistics 1994/95*, CIPFA.

to set lower tax rates on business or domestic taxpayers simply because it has this favourable resource position.

The two models we describe differ, however, in whether the full resource equalisation also applies to the local tax paid by households, the council tax. As discussed in Chapter 2, the council tax base is equalised in the present system only for spending at the standard level, SSA; if a local authority increases its spending above SSA, it has to fund this entirely from its own council tax base, regardless of the size of the base. In Model 1, this limited equalisation is retained for the council tax, whilst in Model 2, full resource equalisation applies to both the non-domestic rates and the council tax.

***Model 1: 'traditional' full equalisation***

Model 1 involves full equalisation of the business rate base, but not of the council tax base. The cost of spending above the standard level defined by central government (SSA) is divided between household taxpayers (council tax payers) and non-domestic taxpayers, on the basis that a given percentage contribution to each additional pound of spending in each local authority is made by household taxpayers.

We define the share of marginal expenditure that is paid for by the *domestic* sector in council tax as the fraction  $D$ . Higher values of  $D$  mean that more of the cost of additional local spending is borne by the household sector; lower values mean that more is borne by the business sector. If  $D$  takes a value of 1, the system is effectively the present local government finance system, in which the non-domestic sector does not make any contribution towards marginal local expenditure.

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We present the results of choosing two values for  $D$ : 0.4 and 0.85. It would, of course, be possible for other values to be chosen for  $D$ .

- $D = 0.4$  implies that council tax payers would contribute 40 pence per pound of extra local spending in every local authority; business rate payers in an authority with an average business rate base would contribute 60 pence per pound. The reason for selecting the value 0.4 for  $D$  is that it results in a system where the percentage contribution by the business sector to local-tax-financed expenditure at the *margin* is broadly equal to its *average* contribution to local-tax-financed expenditure (council tax plus national non-domestic rates) at present.
- $D = 0.85$  means that council tax payers would contribute 85 pence per pound of extra local spending in every local authority. The remaining 15 per cent of the cost of local authority spending above SSA would be financed through non-domestic rates. The logic behind the value of 0.85 for  $D$  is that a figure of 15 per cent may be a reasonable estimate of the percentage of local spending that directly benefits the local business community (Jackman, 1987). Whilst this figure is related to the percentage of spending that benefits business on average, and not to the percentage of spending at the margin that benefits business, it does not seem unreasonable as an estimate of the marginal benefit.

Most of the results shown refer to the first of these cases, where the domestic sector contributes 40 per cent and the business sector 60 per cent of the cost of marginal spending. The reason for this is that the effects of intro-

ducing locally-varying business rates are simply rather larger in this case than in the case where  $D = 0.85$ , when the business sector therefore only contributes 15 per cent. In the main, the results for  $D = 0.85$  are simply a scaled-down version of the results for  $D = 0.4$ , and results for  $D = 0.85$  are only presented where it is interesting to highlight differences between the two cases.

We present evidence on the likely effects of reforming non-domestic rates along the lines of Model 1, giving the changes in domestic and non-domestic tax burdens across a range of different classifications of authorities — by standard economic region, by class of authority and between areas of high and low unemployment. We also show how introducing locally-varying non-domestic rates would affect household incomes, through the effects that it would have on council tax levels.

At present, aggregate local authority budget requirements are 2 per cent above total SSA.<sup>4</sup> The system of locally-varying non-domestic rates, as defined in Model 1, would spread the cost of marginal expenditure across two local tax bases as opposed to one as at present. Part of the cost of extra local spending would be borne by the non-domestic sector and part by council tax payers, whereas at present the entire cost of extra spending is borne by the household sector. The effect of the reforms in authorities spending above SSA would be to increase non-domestic rates payments and reduce council tax levels.

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<sup>4</sup>Source: *Finance and General Statistics 1994/95*, CIPFA.

## *Options for business rate reform*

Over the country as a whole, the aggregate reduction in council tax payments would exactly equal the increase in non-domestic rates payments. Because of the equalisation arrangements, however, the reduction in revenue from council tax payments would not necessarily equal the increase in revenue from non-domestic rates at the level of the individual authority. The two will be roughly equal for an individual local authority with an average level of non-domestic rateable value. However, in authorities with above-average levels of rateable value, the rise in revenue from non-domestic rates payments would exceed the reduction in council tax revenue, because the equalisation arrangements ensure that the increase in the non-domestic poundage (i.e. tax rate) for a given percentage increase in spending should be the same in all authorities. Where an authority levies non-domestic rates on a large base, this will necessarily mean that it raises more revenues than an authority with less non-domestic rateable value to tax.

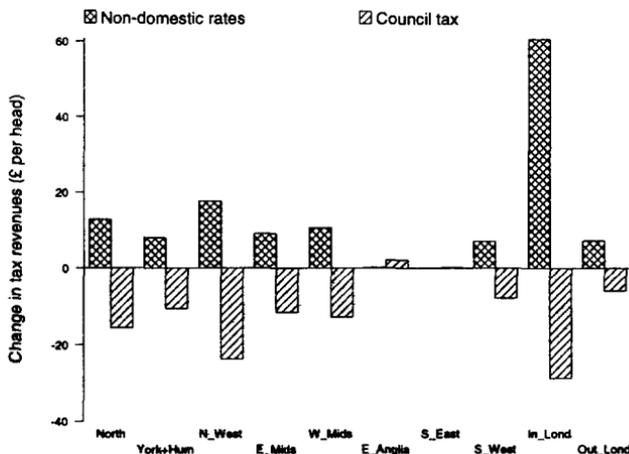
At the level of an individual local authority, the size of the effect of the locally-varying non-domestic rate under Model 1 on council tax levels will simply depend on the level of local spending in relation to the standard level, SSA. Council tax levels will fall the most where the excess of spending over SSA is greatest. The effect on non-domestic rate levels will depend both on budgetary decisions and on the relative size of the local non-domestic tax base. Large rises in business rates will tend to occur in areas where spending is high in relation to SSA, or where the non-domestic tax base is large.

These effects on revenues (in pounds per capita) from the council tax and non-domestic rates are shown in Figure

FIGURE 4.1

**Impact on local tax burdens per capita, by region, of a return to locally-varying non-domestic rates, under Model 1**

Model 1: full equalisation of business rate base; domestic sector contributes 40 per cent of spending above SSA in each authority (i.e.  $D = 0.4$ )



4.1 for each standard economic region,<sup>5</sup> for the version of Model 1 where  $D = 0.4$ .

As would be expected, because most local authorities are spending above SSA, non-domestic rate revenues rise and council tax revenues fall in most regions. The largest increases in non-domestic rate revenues per head of population occur in Inner London. This reflects both the high level of non-domestic rateable value per head of popula-

<sup>5</sup>We have divided the standard economic region of 'Greater London' into Outer London, Inner London and the City of London to highlight the differences between these three groups of authorities.

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tion in Inner London and the tendency of many Inner London authorities to spend above SSA.

The south-east and East Anglia are exceptions to the general pattern of rising non-domestic rates and falling council tax. The effects on payments of both taxes in the south-east are small, mainly because Model 1 leads to practically no changes to tax rates in the south-east, where, in many authorities, budget requirements are very close to SSA. Overall budget requirements in the south-east are within 0.1 per cent of SSA. In East Anglia, revenues from both taxes rise, because of a combination of different effects in different authorities. In general, council tax revenues rise in East Anglia because, on aggregate, local authorities there spend below SSA by some 0.5 per cent. Under the reforms of Model 1, less of the benefit from this is felt by council tax payers. However, the effect is not uniform across all authorities in East Anglia; in particular, tax rates would rise in some of the areas with the largest rateable value. As a result, the average business tax payment, as well as the average council tax payment, rises a little.

To achieve resource equalisation in Model 1, it is necessary that changes be made to the distribution of central government grant. For each local authority, and hence for each region, the following budget constraint must hold:

$$\boxed{\begin{array}{c} \text{Change in} \\ \text{council tax} \\ \text{revenues} \end{array}} + \boxed{\begin{array}{c} \text{Change in} \\ \text{non-domestic} \\ \text{rate revenues} \end{array}} + \boxed{\begin{array}{c} \text{Change in} \\ \text{grant} \end{array}} = \boxed{\begin{array}{c} \text{Zero} \end{array}}$$

Therefore the net change in tax revenues within a region represents the interregional transfers of grant that

would occur to ensure full resource base equalisation between individual local authorities. For example, in the north, non-domestic rate revenues would rise by £13 per head, council tax revenues would fall by £16 per head, and £3 per head of additional grant would flow into the region. Comparing grant redistributions between regions, the low-resource north-west would gain £6 per head in grant (this area was particularly badly hit by the 1990 reforms) whilst the high-resource authorities of Inner London would lose £32 per head in grant.

The local authorities that constitute some standard economic regions are highly heterogeneous.<sup>6</sup> 'Yorkshire and Humberside', for example, contains a combination of rural authorities with very low population densities and metropolitan authorities with high population densities. Doncaster has some 58,000 persons per hectare whilst Craven has just over 400. To see whether Model 1 has effects that differ significantly between urban and rural areas, Figure 4.2 shows the effects on local tax payments when authorities are grouped by 'class of authority' as conventionally defined (in other words, divided into Inner London and Outer London boroughs, metropolitan districts and shire areas).

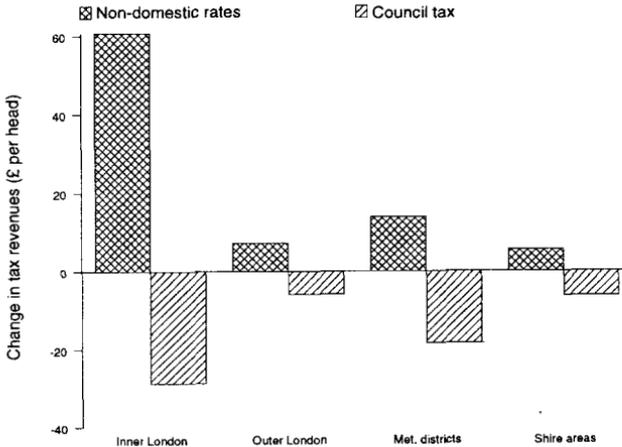
The graph shows that the largest increases in non-domestic rates bills per head would occur in Inner London, as discussed above. It is also clear that the impact of the reforms on local tax bills would be greater in metropolitan areas (where local authorities spend over 4 per cent above

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<sup>6</sup>For this reason, the standard economic region of 'Greater London' has already been divided into three subregions.

FIGURE 4.2

**Impact on local tax burdens per capita, by class of local authority, of a return to locally-varying non-domestic rates, under Model 1**  
Model 1: full equalisation of business rate base; domestic sector contributes 40 per cent of spending above SSA in each authority (i.e.  $D = 0.4$ )



SSA) than in the shire areas (where budget requirements are less than 2 per cent above SSA).

Critics of non-domestic rates have often pointed out that, unlike corporation tax, non-domestic rates bills are not sensitive to the profitability of an enterprise. The fixed-cost nature of the tax is likely to impose a greater burden on more marginal enterprises at any given point in the business cycle and on firms generally in times of recession. Indeed, more profitable firms may even enjoy a reduced non-domestic rate burden, since rates payments may be offset against their corporation tax liability. Since more marginal firms with zero or negative taxable profits may be unable to exploit this corporation tax offset (a

situation known as 'tax exhaustion'), the absolute burden of rates may be higher for less-profitable firms.

Given the fixed-cost nature of rates, we might be concerned if it was found that the move to locally-varying non-domestic rates increased rate burdens significantly in areas in which firms were already less profitable.

In the absence of local information on business profitability, we used the rate of unemployment<sup>7</sup> as a guide to the relative prosperity of an area. Unemployment rates are, of course, a very imperfect measure of business conditions for particular enterprises. Many firms in depressed areas are highly profitable. Nevertheless, better indicators are difficult to find. In addition, use of unemployment rates may be justified as a relatively accurate indicator of the economic conditions facing the domestic sector.

In Figure 4.3, we rank local authorities into deciles by unemployment, so the first decile contains the 10 per cent of local authorities with the lowest unemployment rates, and so on. The graph shows how the effects of Model 1 are distributed across areas of high and low unemployment. The gains to business actually appear to be greatest in the most prosperous areas. Non-domestic rate revenues per head would fall in the 20 per cent of local authorities with the lowest unemployment rates, because many of the local authorities with the lowest spending levels (relative to SSA) are located in the relatively prosperous regions of the south-east and East Anglia. This contrasts with an

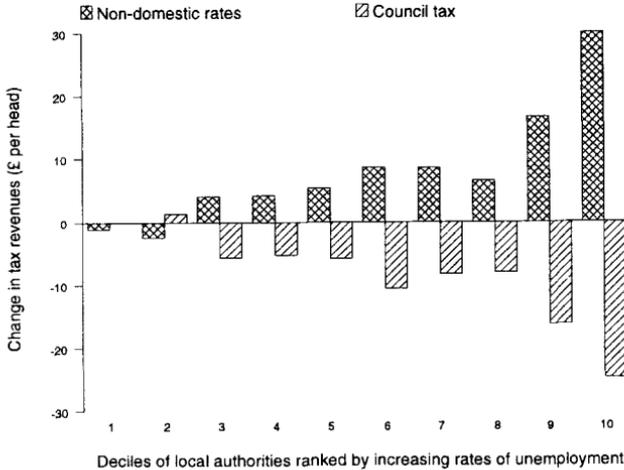
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<sup>7</sup>Rates of unemployment are expressed as the numbers unemployed as a percentage of the labour force. Data were obtained from *Regional Trends 1993*.

FIGURE 4.3

**Impact on local tax burdens per capita, by deciles of local authorities ranked by unemployment rates, of a return to locally-varying non-domestic rates, under Model 1**

Model 1: full equalisation of business rate base; domestic sector contributes 40 per cent of spending above SSA in each authority (i.e.  $D = 0.4$ )



increase in the per capita burden of non-domestic rates of roughly £30 per head in the 10 per cent of local authorities with the most depressed local labour markets.

A return to locally-varying business rates along the lines of Model 1 therefore seems likely to generate larger increases in the per capita burden of non-domestic rates in areas that are already relatively depressed than in those that are relatively prosperous. This reflects the positive correlation between high levels of local spending (relative to SSA) and local unemployment rates. A corollary of this is that falls in council tax are likely to be greatest where unemployment is highest.

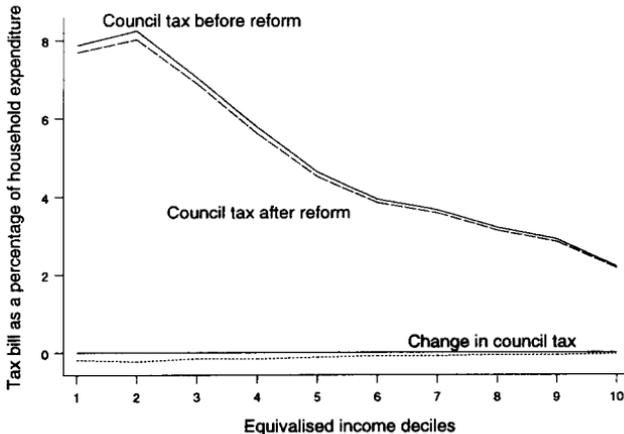
Considering the revenue implications generated by Model 1 at such an aggregated level is of limited use in evaluating the distributional implications of the reforms for individual households. To assess the incidence of the council tax rate changes resulting from the reforms, we applied the new council tax rates generated within the model to the sample of 7,000 households in the 1992 Family Expenditure Survey (FES).

Figure 4.4 shows the distributional incidence of the council tax in gross terms (i.e. before rebate), before and after the Model 1 reform, and the change in households' council tax payments that results from the reform. Figure 4.5 presents a similar analysis in terms of net council tax bills — in other words, after taking account of council tax rebates paid through the social security system.

FIGURE 4.4

**Distributional impact on council tax levels (before rebates) of a return to locally-varying non-domestic rates, under Model 1**

Model 1: full equalisation of business rate base; domestic sector contributes 40 per cent of spending above SSA in each authority (i.e.  $D = 0.4$ )



Households are classified in Figures 4.4 and 4.5 according to income deciles based on their 'equivalised income'.<sup>8</sup> The concept of equivalised income adjusts a household's income to reflect the number of household members; it thus attempts to capture the effects of household size on relative living standards. A single-person household on a given income would have a higher equivalised income than a married couple with two children who have the same total household income. Tax bills are shown in Figures 4.4 and 4.5 as a percentage of household expenditure.

Before rebates, as Figure 4.4 shows, the present council tax has a regressive distributional incidence, in the sense that poorer households pay a higher proportion of their total expenditure in tax than do richer households. Gross council tax would account for over 7 per cent of the annual expenditure of the poorest 10 per cent of households whilst it would account for less than 3 per cent of the expenditure of the richest 10 per cent.

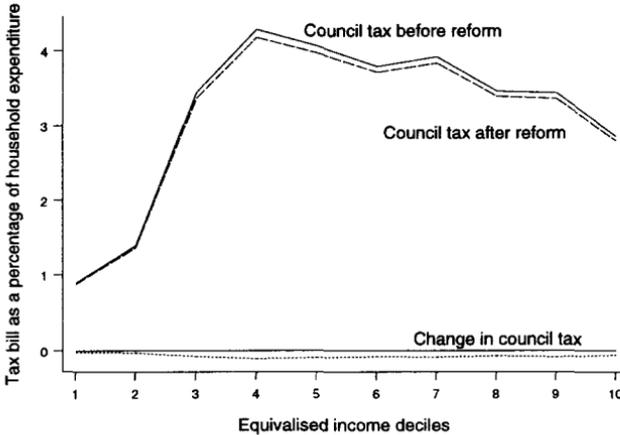
Figure 4.4 also shows how the distribution of council tax burdens would be affected by the introduction of a locally-varying non-domestic rate along the lines of Model 1. Council tax bills would fall, for the reasons discussed above, and the distributional impact of the changes to gross council tax bills would be mildly progressive: poorer households would gain more, as a percentage of their incomes, from the changes than would richer households. However, the reduction in council tax

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<sup>8</sup>The adjustment for equivalised income is calculated using standard DSS scales.

FIGURE 4.5

**Distributional impact on council tax levels (after rebates) of a return to locally-varying non-domestic rates, under Model 1**  
Model 1: full equalisation of business rate base; domestic sector contributes 40 per cent of spending above SSA in each authority (i.e.  $D = 0.4$ )



bills, and hence the impact on household living standards, is relatively minor, accounting for less than 1 per cent of household expenditure, since the reforms to the non-domestic rate only affect the financing of marginal expenditure.

The distributional analysis in Figure 4.4 is only partially informative, for two reasons.

One is that it does not take into account the impact on households of the rebate system for council tax. This is included in the results shown in Figure 4.5, which compares household net council tax bills (i.e. after rebate) both before and after the reforms. On this basis, which shows the net burden that households are actually liable to pay, the council tax is fairly progressive for the poorest 40 per

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cent of households: up to the fourth decile, net council tax bills rise as a proportion of annual expenditure as equivalised household income increases. The tax is mildly regressive thereafter. The graph shows that the reductions arising from the introduction of locally-varying non-domestic rates in the net council tax bills of poorer households are rather smaller than the equivalent reductions in gross council tax bills shown in Figure 4.4. This is because the rebate system compensates for a substantial proportion of the gross tax burden facing poorer households. As a result of rebates, the impact of Model 1 in net terms on households is largely proportional: richer households gain by roughly the same percentage of their annual expenditure as poorer households from the reforms.

A further limitation of both Figures 4.4 and 4.5 is that they do not reflect the household incidence of any resulting changes to non-domestic rates that would occur. Increases in business rates might, for example, be passed on to the domestic sector in the form of higher prices in the shops, and this would have effects on the distribution of household incomes, over and above the effects from the induced changes in council tax. A more sophisticated economic model would be necessary in order to address this limitation of the distributional analysis, and is beyond the scope of this report.

### ***Model 2: full equalisation with equiproportionate tax increases***

Model 2 involves full equalisation of both the business and household tax bases. Marginal local spending increases the rates of council tax and business rates by an equal percentage; this percentage is proportional to the

percentage by which local spending exceeds the standard level, SSA. The equalisation arrangements in Model 2 imply that the percentage by which the two taxes rise for a given percentage increase in spending above SSA should be the same in each authority, regardless of the size of the local non-domestic and domestic tax bases.

An example may explain what is involved. If we compare two authorities, A and B, both of which are spending above SSA, then Model 2 implies the following. Suppose in Authority A, spending exceeds SSA by 3 per cent; then the requirement would be that the increase in the tax rates for both taxes in Authority A should be equal and proportionate to the excess of spending over SSA. The system might, for example, operate so that there would be a 9 percentage point increase in tax rates for a 3 per cent increase in spending over SSA; the 9-point increase in tax rates would apply both to the non-domestic rate poundage and to the rate of council tax. The requirement that the percentage increase in taxation should be proportional to the percentage increase in spending would imply, in this case, that a 2 per cent increase in spending would then lead to a 6 percentage point rise in tax rates, and so on. The equalisation requirement would imply that these percentages would apply in all authorities, regardless of the size of either tax base.

It will be observed that Model 2 is very similar in spirit to the system of resource equalisation that operated during the 1980s. The rate poundages applying to domestic and business rateable value could not be varied independently of one another (although they differed by the amount of domestic rate relief). In this system, equalisation was ensured because there was a fixed relation between the spending above the standard level (GRE) and the rate

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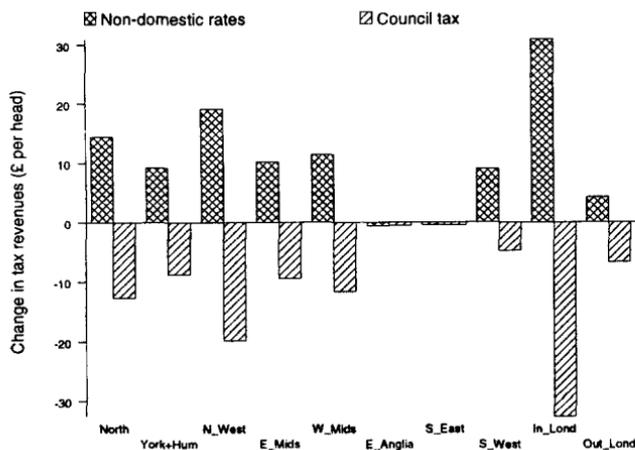
poundage levied by local authorities, which applied in all authorities; central government grant was paid to ensure that this fixed relationship would hold, regardless of tax bases. The provisions of Model 2 effectively reduce the two-tax system of non-domestic rates plus council tax to a single, fully-equalised, local tax base on which a single local tax rate is levied.

In this system, two council tax payers who lived in different local authorities with the same proportionate excess of spending over SSA would pay the same council tax in any given band. The same would apply to business rate payers located in these two areas: they would pay the same business rate poundage. Moreover, the council tax and the business rate set by a given local authority would exceed the 'standard' rates of council tax and the 'stand-

FIGURE 4.6

### Impact on local tax burdens per capita, by region, of a return to locally-varying non-domestic rates, under Model 2

Model 2: full equalisation of both business and household tax bases; equal percentage increases in rates of council tax and business rates for spending above SSA



ard' business rate poundage for spending at SSA by exactly the same proportion.

Figure 4.6 illustrates the regional pattern of the changes in local tax payments that would arise if the current system of non-domestic rates were replaced by a scheme for locally-varying non-domestic rates on the basis of Model 2. The general pattern of changes in local tax revenues generated by Model 2 is broadly similar to that of Model 1, although the scale of the changes in council tax and non-domestic rate payments per head differs. The pattern of changes arises for a combination of reasons.

For council tax, there are two reasons for the differences in tax burdens between Models 1 and 2. First, in Model 2, council tax rates in areas with below-average council tax base fall for local authorities with spending above SSA, because Model 2 has introduced resource equalisation to the domestic sector. Second, the amount of marginal spending financed by domestic taxpayers is no longer always 40 per cent, but varies, depending on the balance between business and domestic tax bases in an area.

For business rates, there are also two differences between Models 1 and 2. One is that tax burdens in individual authorities may change due to changes in the balance between business and the domestic sector in funding marginal spending. The other is that the proportion of revenues that has to be devoted to resource equalisation is reduced, since the combined tax base is less unevenly distributed than the non-domestic base alone.

Further comparisons of the changes to regional non-domestic rate poundages that would occur under Models 1 and 2 are given in Tables 4.1 to 4.3. For the case of Model 1, we present the impact of the reforms for the 40 per cent

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domestic (council tax) contribution to aggregate marginal local government expenditure shown in Figures 4.1 to 4.5, and also for an 85 per cent council tax contribution (i.e. for values of  $D$  equal to 0.4 and 0.85 respectively). Higher values for  $D$  reduce the scale of the effects, because most of the burden of paying for spending at the margin remains with the domestic sector. The impact of shifting a higher percentage of the burden of marginal local expenditure onto the non-domestic sector appears broadly to be a linear one.

Table 4.1 shows the percentage changes in average regional non-domestic rate poundages generated by each of the full equalisation models. The range of non-domestic rate poundages across authorities increases in Model 1 as the proportion of marginal expenditure financed by the non-domestic sector increases from 15 per cent to 60 per

TABLE 4.1  
**Full equalisation models:  
percentage changes in non-domestic rate poundages, by region**

<i>Standard region</i>	<i>Per cent</i>		
	<i>Model 1, D = 0.85</i>	<i>Model 1, D = 0.4</i>	<i>Model 2</i>
North	2.1	8.6	9.7
Yorkshire and Humberside	1.3	5.1	5.9
North-west	3.0	11.8	12.8
East Midlands	1.5	5.9	6.6
West Midlands	1.7	6.9	7.4
East Anglia	0.0	0.1	-0.3
South-east	0.0	0.1	-0.2
South-west	1.1	4.3	5.4
Inner London	3.5	14.1	7.2
Outer London	0.8	3.3	2.0

TABLE 4.2  
**Full equalisation models:**  
**percentage changes in non-domestic rate poundages,**  
**by class of authority**

<i>Class of authority</i>	<i>Per cent</i>		
	<i>Model 1,</i> <i>D = 0.85</i>	<i>Model 1,</i> <i>D = 0.4</i>	<i>Model 2</i>
Inner London	3.5	14.1	7.2
Outer London	0.8	3.3	2.0
Metropolitan districts	2.3	9.2	9.5
Shire areas	0.8	3.0	3.5

cent.<sup>9</sup> The greatest percentage increase in rate poundages is in Inner London under Model 1 but in the north-west under Model 2. This illustrates the differences in the equalisation arrangements implicit in each model. Inner London has the highest overspend per head — the method of scaling expenditure used in Model 1 — whilst the north-west has the highest percentage overspend — the method of scaling expenditure used in Model 2.

Table 4.2 shows the average percentage changes in rate poundages for each 'class' of local authority<sup>10</sup> for each of the full equalisation models. For each simulation, the percentage increase in business rates is higher in the relatively high-spending metropolitan areas than in shire areas. This is, of course, also reflected in a tendency for

<sup>9</sup>This corresponds to values of  $D$  equal to 0.85 and 0.4 respectively.

<sup>10</sup>The figures for Model 1 with 60 per cent of local marginal expenditure being funded by the non-domestic sector are those used in Figure 4.2.

TABLE 4.3

**Full equalisation models:  
percentage changes in non-domestic rate poundages,  
by deciles of local authorities ranked by unemployment rates**

<i>Authorities ranked by unemployment rates</i>	<i>Per cent</i>		
	<i>Model 1, D = 0.85</i>	<i>Model 1, D = 0.4</i>	<i>Model 2</i>
Lowest 10%	-0.1	-0.6	-1.2
2nd decile	-0.3	-1.2	-1.8
3rd decile	0.8	2.3	2.5
4th decile	0.4	2.3	3.3
5th decile	0.7	2.9	3.8
6th decile	1.2	4.9	5.8
7th decile	1.1	4.4	5.1
8th decile	1.0	4.0	4.4
9th decile	2.2	9.0	8.8
Highest 10%	3.2	12.8	8.8

large increases in average non-domestic tax rates in those regions that contain metropolitan areas.

Table 4.3 shows the average percentage changes in rate poundages for groups of local authorities ranked into deciles in ascending order of unemployment rates.<sup>11</sup> In each of the three cases, non-domestic rate poundages would fall for the 20 per cent of local authorities with the lowest unemployment rates, whilst those areas with the highest unemployment rates could face substantial increases in tax rates. The reasons for the differences between Models 1 and 2 in this table are difficult to interpret.

<sup>11</sup>The figures for Model 1 with 60 per cent of local marginal expenditure being funded by the non-domestic sector are those used in Figure 4.3.

### **4.3 Schemes Involving Partial Equalisation**

Local finance systems that incorporate full resource base equalisation have a number of drawbacks. One is that the amount of central government grant required for equalisation is a function of local authority expenditure or revenue decisions, and cannot therefore be fixed in advance of these decisions; this may create difficulties for central government's budgetary planning. Further disadvantages of full resource equalisation have to do with the lack of incentive that it gives local authorities to maintain their local tax base; authorities that drive tax base away through hostile policies do not lose revenue, and authorities that attract tax base do not gain any corresponding revenue benefit. As discussed in Chapter 3, the UK local finance system could be criticised for providing local authorities with little direct financial incentive to attract businesses to their areas. Schemes of partial equalisation may not have some of these disadvantages.

On the other hand, alternative reforms that only involve the partial equalisation of local tax bases may generate horizontal inequity in tax burdens between individuals and businesses located in different local authority areas. In addition, individual local authorities may be encouraged to devote an excessive amount of resources to influencing business location decisions in what is essentially a 'zero-sum game' between local authorities.

We present two models that incorporate the partial ('SSA-only') equalisation of tax bases under systems of locally-varying non-domestic rates. In these models, whilst resources are equalised so as to ensure that all local authorities can achieve the standard level of spending, SSA, at the same local tax rates, equalisation does not

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apply for spending decisions that depart from SSA. The full burden of any marginal local expenditure falls on the local tax base, as at present. As a result, any variations in the size of local tax bases will generate differences in local tax rates for any level of local spending other than the standard level.

The introduction of a partial equalisation model of locally-varying non-domestic rates would not involve any further redistributions of grant between local authorities than already occur, since the present UK local finance system already incorporates 'SSA-only' resource equalisation. Hence any change in non-domestic rate revenues available to a local authority as a result of the reforms would be matched by an equal and opposite change in council tax revenues.

We examine two partial equalisation models. They differ in terms of how the burden of paying for marginal spending is divided between the domestic and non-domestic sectors. Model 3 is similar to Model 1 in that the contribution to be made by the domestic sector is set nationally and applies in each local authority area; it differs from Model 1 in that the remainder of the resources required to fund marginal spending are raised from non-domestic rates paid by the businesses located in that area. We again assume a 40 per cent household share to the cost of financing marginal spending. In Model 3, since no resource equalisation applies to the business rate contribution, this leads directly to a 60 per cent contribution to be collected from the area's business sector. In Model 1, by contrast, the 60 per cent contribution of the non-domestic sector only applied, on average, at the national level; local proportions contributed by the non-domestic sector varied with the size of the local non-domestic tax

base. In Model 4, the relative contribution of each sector within an individual local authority area varies according to the perceived distribution of the benefits of local expenditure between sectors.

***Model 3: partial equalisation with fixed proportions***

Model 3 is a partial equalisation model in which the entire burden of additional local expenditure is financed through local taxes and there is no redistribution of grant between local authorities. We assume that the proportion of the financial burden of marginal local spending that is borne by the domestic and non-domestic sectors respectively is uniform across local authorities, irrespective of the relative sizes of their domestic and non-domestic sectors. This approach tends to generate business tax rates that are inversely proportional to the size of the local non-domestic tax base. Hence an enterprise in a suburban area with very few other non-domestic properties might face a higher 'tax price' of marginal local expenditure than an identical enterprise located in an inner-city area with a relatively large non-domestic tax base.

The relative contribution of the domestic sector to marginal expenditure is determined by the value of the parameter  $D$ . As in Model 1, it is, in principle, conceivable that we could choose any value for  $D$ . The present UK local finance system of partial equalisation could be exactly replicated by setting the value of  $D$  (the proportion of marginal expenditure financed by the domestic sector) equal to 1. As such, the council tax rates set by two local authorities with the same level of expenditure relative to SSA would be inversely related to the size of the local council tax base.

FIGURE 4.7

**Impact on local tax burdens per capita, by region, of a return to locally-varying non-domestic rates, under Model 3**

Model 3: partial equalisation, with fixed 40 per cent household share and 60 per cent business share (i.e.  $D = 0.4$ )

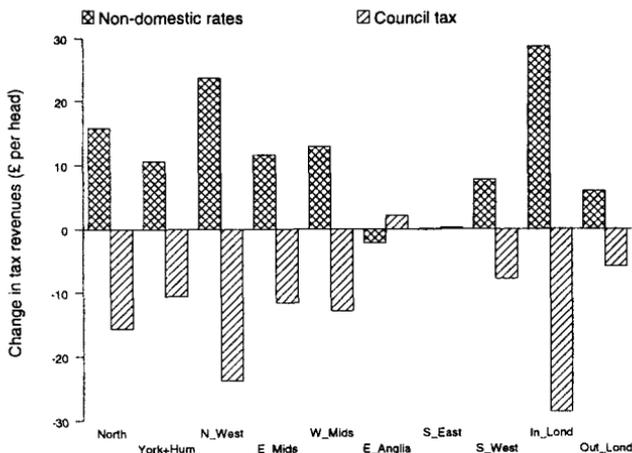


Figure 4.7 illustrates the impact on regional tax burdens of a set of reforms along the lines of Model 3 in which  $D$  takes the value of 0.4; in other words, the domestic sector makes a 40 per cent contribution and the non-domestic sector a 60 per cent contribution to local marginal expenditure. This broadly equalises the average and marginal contribution that the non-domestic sector makes to local expenditure.

Since the domestic sector makes a 40 per cent contribution to local marginal expenditure in both Models 1 and 3, an identical pattern of changes in council tax revenues per head is found in each of the two models. As in Model 1, the largest increases in non-domestic rate revenues per head would occur in Inner London under Model 3. However, the increase would be smaller in Inner London and

greater in the north-west than in Model 1. These differences illustrate how full equalisation systems may reduce local authority accountability by reducing the transparency of the local finance system. In the full equalisation system of Model 1, grant is taken from high-resource areas such as Inner London (which lost £32 per head) and redistributed to lower-resource areas such as the north-west (which gained £6 per head in grant). Model 3 eliminates these inter-authority redistributions of grant and hence brings increases in per capita non-domestic rate revenues more into line with local variations in additional local expenditure per capita.

Since there are no new equalising grant transfers in this partial equalisation model, the reductions in council tax liability are exactly matched by increases in non-domestic rate revenues in each local authority. Whilst both Model 1 (full equalisation) and Model 3 (partial equalisation) generate the same marginal contribution by the non-domestic sector on aggregate (60 per cent), Model 3 ensures that this marginal contribution also holds at the level of each individual local authority.

Again, the pattern of tax changes in the south-east and East Anglia is the opposite of that found in the rest of the country. The effect of low spending in relation to SSA is spread across two tax bases as opposed to one at present, and hence council tax rates rise to allow non-domestic rate poundages to fall below the standard level.

#### ***Model 4: partial equalisation with varying proportions***

The local finance system incorporated within Model 3 is somewhat problematic in that the percentage of local marginal expenditure financed by the non-domestic sector

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is identical in all local authorities and hence completely unrelated to the size of the non-domestic sector. To illustrate this point, consider the case of two businesses situated in different local authority areas with similar expenditure policies and similar aggregate tax bases but different mixes of domestic and non-domestic tax base. The 'tax prices' for marginal spending faced by the two businesses would differ substantially, simply because the *relative* sizes of the domestic and non-domestic tax bases differed between the authorities.

An alternative model of partial resource equalisation would be to vary the contribution that each sector makes to local marginal expenditure according to the benefits that each sector is assumed to receive from local expenditure. If we assume that the benefits received from local spending are proportional to property values (if, for example, one considered local services as primarily being services to property), then this could be done by comparing the council tax and non-domestic property bases for each local authority. A suitable weighting would be used to reflect both the different units of measurement of the two tax bases<sup>12</sup> and the share of the burden of local expenditure that would fall on each sector.

An alternative measure of variations in the benefits received from local spending might be the number of people in each sector (domestic and non-domestic) who might benefit from the services provided, rather than the value of the property that they occupy. Population might

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<sup>12</sup>Equivalent number of Band D properties for the council tax and the total rateable value for non-domestic rates.

be taken as an indicator of the benefits that residents receive from local services, and the number of people employed in an area as an indicator of the benefits that businesses derive from local spending. This is the approach we adopt in Model 4.

In Model 4, we assign a weight of 1 to population and vary the weight given to employment in the area using the parameter  $E$ . A value of 0 for  $E$  corresponds to the present system: non-domestic rates contribute nothing to the cost of local spending at the margin. Increases in the value of  $E$  would increase the proportion of the costs of marginal expenditure that falls on the non-domestic sector.

Figure 4.8 illustrates the impact of Model 4 on regional non-domestic rate revenues if  $E = 0.5$ ; that is, we assume

FIGURE 4.8

**Impact on local tax burdens per capita, by region, of a return to locally-varying non-domestic rates, under Model 4, with low business share**

Model 4: Partial equalisation, with business share given by weight of 0.5 on employment (i.e.  $E = 0.5$ )

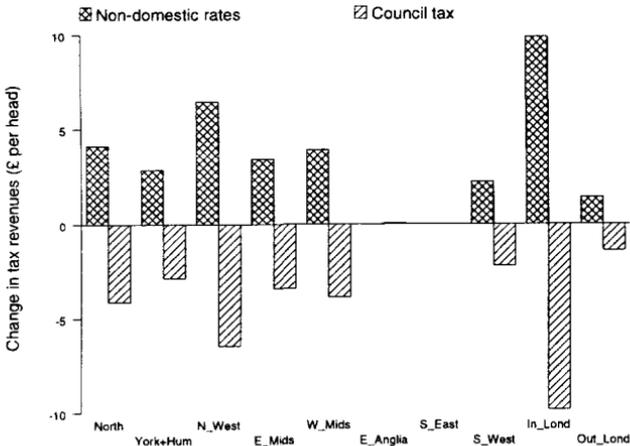
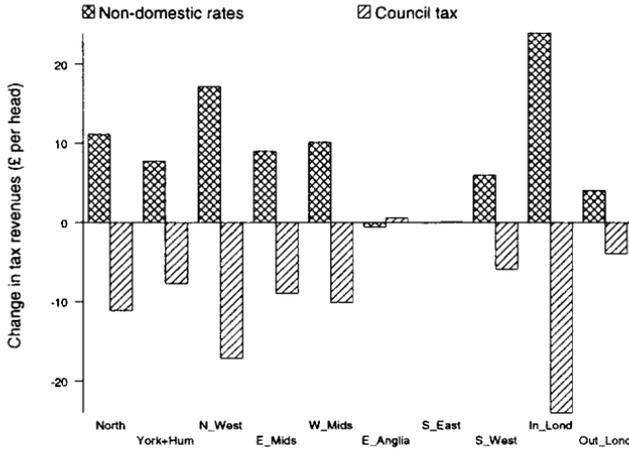


FIGURE 4.9

**Impact on local tax burdens per capita, by region, of a return to locally-varying non-domestic rates, under Model 4, with high business share**

Model 4: Partial equalisation, with business share given by weight of 2 on employment (i.e.  $E = 2$ )



that two employees would receive the same benefits from marginal local expenditure as would a single resident. As Model 4 is a partial equalisation model, changes in non-domestic rate revenues are matched by equal and opposite changes to council tax revenues. The largest increases in non-domestic rate revenues occur in Inner London as before, with insignificant changes to the pattern of local revenues in the south-east and East Anglia.

Figure 4.9 simulates the changes to local tax revenues that would be generated by Model 4 with  $E = 2$ ; that is, an employee in an area is assumed to derive twice the benefits from local marginal expenditure that accrue to a resident. The results of varying  $E$  are non-linear. This model generates a £24 per head increase in non-domestic rate reve-

TABLE 4.4

**Partial equalisation models:  
percentage changes in non-domestic rate poundages, by region**

<i>Standard region</i>	<i>Per cent</i>			
	<i>Model 3, D = 0.85</i>	<i>Model 3, D = 0.4</i>	<i>Model 4, E = 0.5</i>	<i>Model 4, E = 2</i>
North	2.6	10.5	2.8	7.5
Yorkshire and Humberside	1.7	6.8	1.8	4.9
North-west	4.0	15.9	4.3	11.5
East Midlands	1.9	7.5	2.2	5.8
West Midlands	2.1	8.3	2.5	6.5
East Anglia	-0.3	-1.2	0.0	-0.3
South-east	-0.0	-0.1	0.0	0.0
South-west	1.2	4.7	1.3	3.5
Inner London	1.7	6.7	2.3	5.6
Outer London	0.7	2.7	0.7	1.8

nues in Inner London and reductions in the burden of non-domestic rates of less than £1 per head in the 'low-spending' south-east and East Anglia.

Tables 4.4 to 4.6 show comparisons between the percentage changes in non-domestic rate poundages that would arise from the two partial equalisation models under a selection of parameter values.

Table 4.4 compares the average regional percentage changes in non-domestic rate poundages for the two partial equalisation models. It shows large rises in rate poundages of up to 15.9 per cent in the north-west and 10.5 per cent in the north compared with falls of up to 1.2 per cent in East Anglia. There are negligible changes to rate poundages in the south-east under any of the simulations, reflecting the fact that, on aggregate, local authorities in the

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TABLE 4.5  
**Partial equalisation models:  
percentage changes in non-domestic rate poundages,  
by class of local authority**

<i>Class of authority</i>	<i>Per cent</i>			
	<i>Model 3, D = 0.85</i>	<i>Model 3, D = 0.4</i>	<i>Model 4, E = 0.5</i>	<i>Model 4, E = 2</i>
Inner London	1.7	6.7	2.3	5.6
Outer London	0.7	2.7	0.7	1.8
Metropolitan districts	3.1	12.3	3.5	9.1
Shire areas	0.9	3.5	1.0	2.6

TABLE 4.6  
**Partial equalisation models:  
percentage changes in non-domestic rate poundages,  
by deciles of local authorities ranked by unemployment rates**

<i>Authorities ranked by unemployment rates</i>	<i>Per cent</i>			
	<i>Model 3, D = 0.85</i>	<i>Model 3, D = 0.4</i>	<i>Model 4, E = 0.5</i>	<i>Model 4, E = 2</i>
Lowest 10%	0.0	-0.2	0.0	0.0
2nd decile	-0.3	-1.1	-0.3	-0.8
3rd decile	1.0	3.9	1.1	2.8
4th decile	0.4	1.6	0.5	1.3
5th decile	0.9	3.4	1.0	2.6
6th decile	1.6	6.3	1.7	4.6
7th decile	1.1	4.3	1.2	3.2
8th decile	1.4	5.5	1.4	3.9
9th decile	2.3	9.3	2.7	7.0
Highest 10%	2.7	10.7	3.2	8.2

south-east budget to spend within 0.1 per cent of their total SSA.

Table 4.5 compares the average percentage changes in non-domestic rate poundages for each class of local authorities under the two partial equalisation models. In each case, rate poundages would increase most in the high-spending metropolitan areas. As for the full equalisation models, these large increases in tax bills in the metropolitan areas correspond to the regional pattern of tax rate changes illustrated in Table 4.4.

Table 4.6 compares the average percentage changes in non-domestic rate poundages generated by the two partial equalisation models when local authorities are grouped into deciles in ascending order of unemployment rates. As in Table 4.3, there is some evidence that businesses in relatively deprived areas might face larger average increases in rate poundages than those in more affluent areas, although, again, the overall pattern is not straightforward. Moreover, the increases in rate poundages faced by the 10 per cent of authorities with the highest unemployment rates are rather less than occurred under models of full equalisation.

Table 4.6 shows that the relationship between changes in rate poundages and local unemployment rates is far from uniform. However, there is some evidence that businesses in more depressed areas might face higher increases in rate poundages than those in more prosperous areas under partial equalisation models. This may reflect either political preferences for higher expenditure by authorities in more-depressed areas or the fact that SSAs underestimate the 'need to spend' of local authorities in more-deprived areas.

#### **4.4 The Pattern of Non-Domestic Rate Poundages under Each Model**

The evaluation of the four models is complex, because of the range of factors involved and their complex interactions. Whilst most of the analysis in this chapter has been concerned with averages, of tax rates or tax payments, across groups of local authorities, a further important consideration will be the impact of different systems on the pattern of tax rates levied in individual authorities. What does each imply for the level of the business rate poundage, and for its dispersion?

Table 4.7 presents some summary statistics for the distribution of non-domestic rate poundages at the level of individual authorities that would result from a return to locally-varying non-domestic rates along the lines of each of the four models. The average rate poundage rises as a greater proportion of the burden of local marginal expenditure is passed on to the non-domestic sector since, on

TABLE 4.7

**Distribution of business tax rates between local authorities (all models)**

	<i>Non-domestic rate poundage in pence</i>			
	<i>Mean</i>	<i>Standard deviation</i>	<i>Average of five lowest tax rates</i>	<i>Average of five highest tax rates</i>
Model 1, $D = 0.85$	42.7	0.7	41.0	45.5
Model 1, $D = 0.4$	43.9	2.9	37.0	55.2
Model 2	44.0	3.1	34.8	51.3
Model 3, $D = 0.85$	42.8	0.9	40.4	45.6
Model 3, $D = 0.4$	44.3	3.6	34.9	55.6
Model 4, $E = 0.5$	42.8	0.9	40.5	45.9
Model 4, $E = 2$	43.7	2.5	37.3	51.8

aggregate, local budgets are set above SSA in England. As one might expect, the dispersion of tax rates (shown by either the standard deviation or the range between the average of the five lowest and five highest rate poundages) is also greater in those cases where the non-domestic sector has to pay for a larger share of marginal local expenditure.

The dispersion of tax rates is also a little greater in models of partial equalisation than for equivalent models of full equalisation, demonstrating how inter-authority grant redistributions dampen down the dispersion of tax rates that would occur due to disparities in the tax bases available to local authorities. However, it is perhaps surprising that the partial equalisation systems do not appear to generate a much greater range in non-domestic rate poundages, compared with the systems involving full equalisation of the business rate base. It appears that the pattern of local government spending decisions in the UK is such that areas with low business rateable value per head of population also tend to have below-average spending; their poundages under partial equalisation would therefore tend to be close to the average, despite their low rate base. Whilst this suggests that introducing locally-varying business rates without the complex and opaque arrangements involved in full equalisation might be feasible without leading to excessive unevenness in the burdens of local business taxation, it should be borne in mind that this is a result that depends heavily on the current pattern of spending choices being maintained. If current low-spending authorities with low business rateable value were to wish to increase their spending, this would lead to considerable widening in the range of tax rates, and hence greater potential for locational distortions.

## **4.5 Conclusions**

This chapter has described four possible schemes or ‘models’ for introducing locally-determined non-domestic rates. The schemes differ in terms of the arrangements for resource equalisation, and in terms of the division of the cost of financing local expenditure between the domestic and non-domestic sectors.

Models 1 and 2 involve full equalisation of the business rate base, whilst Models 3 and 4 do not; in the latter models, the same ‘SSA-only’ resource equalisation applies to non-domestic rates as currently applies to the council tax.

In Model 1, whilst the business rate base is fully equalised, the council tax base is not. The council tax contributes a fixed contribution (40 per cent in the graphs) to the cost of spending above SSA. In this model, the council tax tends to fall most in areas with high spending above SSA. Business rates rise; the highest increases in the poundage are in areas where spending above SSA is greatest, but the largest amounts of extra revenue are collected in areas where there is simply a large amount of business rateable value.

In Model 2, both tax bases are equalised. Council tax rates again fall in areas where there is significant spending above SSA; in comparison with Model 1, these reductions in council tax rates are particularly large in areas where the average value of domestic properties is low, because of the extension of full resource equalisation to the domestic tax base. The effect on council tax payments, however, is less straightforward; the relaxation of the requirement that council tax payers always contribute 40 per cent benefits council tax payers in Inner London, especially,

because in Model 2 a greater proportion of the cost of marginal spending in this area is borne by non-domestic taxpayers.

In Models 3 and 4, there is only partial equalisation, and no equalisation applies to spending above SSA; this has to be financed by local taxpayers. The effects on tax payments by domestic and non-domestic taxpayers in Models 3 and 4 in each authority are equal and opposite. Model 3 has the disadvantage that it requires fixed contributions to the cost of marginal spending from the business and domestic sectors, regardless of their relative size. Model 4 divides the cost of paying for marginal spending between business and domestic taxpayers according to the relative levels of employment and population in each area. This attempts to capture the notion that the 'business' component in local spending is likely to be higher in areas with more business, and that this might appropriately be reflected in a higher business contribution to the costs of marginal spending.

Whilst it might have been expected that the partial equalisation models would have involved a much wider range of non-domestic rate poundages than the full equalisation models, and hence a much greater potential for locational distortion, this appears to be true to only a very limited extent. This is probably because those authorities with a resource disadvantage under partially-equalised non-domestic rates currently have low levels of spending; the low spending and the resource disadvantage tend to cancel out in terms of the effect on poundages. It cannot, of course, be assumed that this would continue to be the case if a system of partial equalisation were introduced.

## **CHAPTER 5**

### **Alternative Reforms to the National Non-Domestic Rate**

The debate over whether central or local government should have responsibility for the determination of rate poundages has tended in most recent policy discussion to overshadow any consideration of wider or more fundamental questions about the merits of non-domestic rates. There are, however, good reasons to look more closely at the role that non-domestic rates play within the fiscal system, and the effects that they may have on the economy. There are, in particular, some important criticisms that can be made of non-domestic rates, levied either at the local or at the national level.

Non-domestic rates are a tax on the value of certain parts of the capital stock, in particular on the value of fixed productive capital in manufacturing, commerce and public services. Judged against a number of different yardsticks, non-domestic rates constitute a substantial tax burden. Thus, for example, the revenue of some £13 billion raised from non-domestic rates in the UK in 1993–94 might be compared with the £15 billion revenue raised from corporation tax; the two business taxes are of much the same size. It is clear, also, that the level of taxation of the value of fixed productive capital under non-domestic rates is not a trivial fraction of the overall cost of fixed productive capital. Thus, for example, in the sample of commercial properties studied by Bond, Denny, Hall and McCluskey (1995), non-domestic rates were on average some £5.60 per square foot in 1992–93, compared with

average rents of £14.40 per square foot. In other words, rates in this sample amounted to about a quarter of the occupancy cost of the premises the authors studied.

These observations suggest two key objections to the use of non-domestic rates as a major source of tax revenues.

First, non-domestic rates may be criticised for being too narrowly focused on taxing a single factor of production. Whilst the introduction of a national non-domestic rate (NNDR) in April 1990 may have removed one potential distortion from the UK tax system — locational distortions resulting from local variations in the rate poundages paid by businesses — another potential fiscal distortion remains intact: non-domestic rates only tax a single input to the production process.

When firms in a given location make choices about production technology, they are essentially choosing a particular mix of inputs of land, labour, capital and property; their choice will naturally reflect the relative cost of these inputs, and where the price of one factor, relative to the others, is increased, firms will tend to substitute away from that factor towards other production inputs. Where the price of capital rises, relative to the other factors, firms will tend to choose less capital-intensive production techniques than they would have done previously. If the relative prices of factors of production reflect their relative real costs, then the cost-minimising pattern of inputs that the firm chooses will also be the most efficient from the perspective of the overall economy. However, where the relative price of one factor is increased through taxes bearing on that factor alone, then firms' production decisions will be distorted by the tax, away from the pattern of inputs that, from the point of view of the underlying

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real costs, is the most efficient. Firms will use less capital because its cost to them has been increased by the tax, even though the real cost of capital, from the point of view of the economy as a whole, remains unchanged. In this sense, a tax such as non-domestic rates, bearing on a single factor, can lead to economic costs by distorting firms' production process decisions away from the most efficient pattern of inputs.

The problem of bias away from an efficient pattern of production inputs can, however, be overstated. It should be remembered that other parts of the tax system will also affect decisions about industrial production processes, and that labour is also heavily taxed. In these circumstances, non-domestic rates may even help to correct a distortion that would otherwise arise in relative factor prices, which would otherwise bias production decisions in the direction of excessive capital-intensity.

Second, in comparison with taxes on corporate turnover, incomes or profits, non-domestic rates have the disadvantage that they are unresponsive to changes in economic conditions, both overall and in particular within different sectors of the economy.

Non-domestic rates pose a particular burden on marginal businesses for two reasons. First, the measure of taxable capacity used to assess rates liabilities does not take account of profitability. All firms pay a given poundage on their rateable value, regardless of whether or not the business is trading profitably. As a result, for a given business, rates are essentially a fixed cost, invariant to profitability, and thus more of a burden on businesses with low profits than other business taxes, such as taxes on profits or elements of variable cost such as payroll. Second, payments of non-domestic rates can be offset against

corporation tax liability. For a firm to be liable to corporation tax, it needs to be profitable in the first place. In this sense, struggling businesses may find rates to be a greater absolute tax burden as well as a greater relative burden than more successful firms. These two effects arise in relation to all sectors. However, both may be particularly severe in sectors where the fixed-cost element arising from non-domestic rates constitutes a large component of business costs.

This chapter considers two alternative sets of reforms to non-domestic rates that attempt to address aspects of these two issues. Section 5.1 considers a more broadly-based local business tax than one based solely on rateable value, as a way of reducing the bias against capital that arises in the current non-domestic rating system. The alternative, more broadly-based, tax has some features in common with local business taxes levied in France and Germany. Section 5.2 discusses the extent to which the 'fixed cost' disadvantages of non-domestic rates might be addressed by a model in which nationally-set non-domestic rate poundages might differ according to the sector of the economy in which the business operates. This is true of the agricultural sector at present (in the sense that a poundage of zero applies to agriculture), and of the industrial sector in the past (the industrial sector was partially derated in the 1928 Budget, and not reredated until some years after the Second World War). Both the reforms studied in this chapter could be compatible with either the present national non-domestic rate or a locally-varying one along the lines of the four models presented in Chapter 4.

## 5.1 A Multi-Base Business Tax

The first reform we consider is one in which the base of non-domestic rates is broadened beyond the value of non-domestic property (as reflected in rateable value), to include other aspects of the taxable capacity of businesses. In other words, we consider a tax in which the amount that a business would pay would depend both on rateable value and on other attributes of the business. We refer to this as a ‘multi-base’ business tax.

Local business taxes with a broader base than the UK’s non-domestic rates appear to operate relatively successfully in a number of other countries. In France, for example, the *taxe professionnelle* taxes a variety of factor inputs including property, machinery and payroll. Similarly, in Germany, the local business tax has a broader base than non-domestic rates.

The tax reform we model in this section is a relatively modest multi-base tax which combines two of the major bases in the French *taxe professionnelle* — payroll and rateable value — in a simple linear calculation. This is a simplification of the actual *taxe professionnelle*, in which other bases are involved and in which the tax base calculation is more complex; a more precise representation was not possible because some of the data that would be needed to model the application of the French *taxe professionnelle* are not available for the UK.

In the multi-base tax that we simulate, the base on which the tax is levied is given by:

$$\boxed{\text{Tax base}} = \boxed{\text{Non-domestic rateable value}} + \boxed{Z} \times \boxed{\text{Aggregate payroll}}$$

In the formula,  $Z$  is a weighting factor which determines the weight given to payroll in the calculation of the overall tax base.

By varying the value given to  $Z$ , it is possible to alter the relative importance of the two tax bases. A higher value for  $Z$  increases the weight given to payroll, relative to rateable value, in the overall tax base. Setting  $Z$  equal to 0 would correspond to the current system of non-domestic rates. There are no compelling reasons to prefer a particular value for  $Z$ ; a number of different values could be employed with some degree of justification. We have chosen to simulate the multi-base tax with a value of 0.1 for  $Z$ . This results, on average, in approximately equal amounts being raised from each component in the multi-base tax, because the aggregate value of payroll (£220 billion in England in 1994) is currently approximately 10 times that of non-domestic rateable value (£25 billion).

The rates-plus-payroll structure of the tax may reduce the distortion of relative factor prices, compared with a tax levied on rateable value alone. However, the effects of other taxes should also be taken into account. Introduction of the payroll element into the multi-base business tax might exacerbate the impact on employment of existing national taxes on labour inputs.

So far, our discussion of the reasons for considering the introduction of a broader-based local business tax, such as the multi-base tax, has been largely in terms of the potential reduction in the distortion in firms' production decisions that arises under non-domestic rates because they only tax a single input into the production process. There is, however, a second possible advantage from broadening the base of a business tax, when this is used as a source of local revenues. This is that a more broadly-based tax

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would spread a given local tax burden over a greater number of factors of production. This would have two possible merits. One is that it would reduce the variation in the tax rate applying to an individual factor of production across authority boundaries; as a result, there might be less tendency for firms that are heavily dependent on the particular taxed factor to relocate to areas with low local taxes. This might possibly reduce the extent to which there are significant locational distortions arising from locally-varying business taxes, if such distortions are only likely to arise where major differences in the level of taxation are involved. A second advantage is that it is possible that a more broadly-based local tax would involve less unevenness in the size of the local tax base across areas; geographical concentration of the tax base might be greater where the tax base is a single factor than where it is spread widely across a range of factors. Both of these possible advantages of the multi-base tax in the context of local taxation depend on particular circumstances, and it is difficult to assess the practical significance of the case for the multi-base tax based on either of these arguments.

Whilst chosen for illustrative purposes, payroll has certain features that recommend it as an additional component of the local tax base, particularly if it were intended to capture the demands made on local authorities by the non-domestic sector. The local services 'used' by a business may be a function of the number of employees as well as of the firm's capital stock. There are also practical advantages in the UK context. A considerable amount of the information required to operate a local tax based on payroll is already held by the Inland Revenue; this includes information on both enterprise-level payroll and

enterprise location. Whilst there would undoubtedly be additional administrative costs for the authorities in running the multi-base tax compared with non-domestic rates, and also additional compliance burdens on taxpayers, these would probably not be excessive.

Since the multi-base tax could be operated at either the national level — as currently with non-domestic rates — or as a tax under local control, we show the effects of both options. We first model a move from the national non-domestic rate to a national-rate multi-base tax raising the same amount of aggregate revenue. We then consider the introduction of a locally-varying multi-base tax, using one of the models discussed in Chapter 4.

#### ***A national multi-base business tax***

Here, we model the introduction of a multi-base tax, based on a combination of non-domestic rateable value and payroll, in which the weight,  $Z$ , given to payroll is one-tenth the weight given to rateable value. As we have already observed, this results in a tax where roughly equal amounts are raised, on average, from the ‘rateable value’ and ‘payroll’ components. The simulation assumes revenue-neutrality — in other words, it replaces the national non-domestic rate with a national multi-base tax raising the same total amount of revenue.

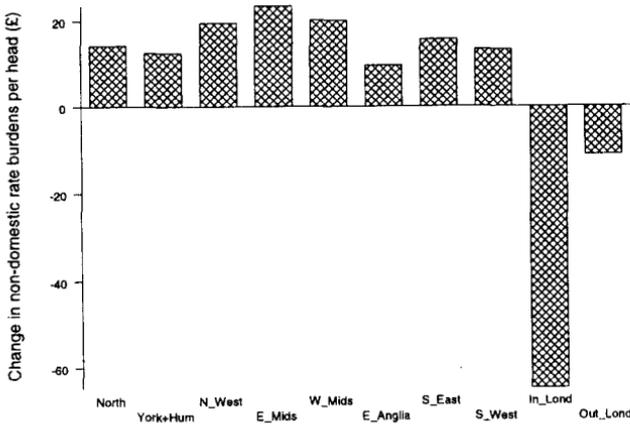
This implies roughly a halving of the tax rate (pound-age) applied to non-domestic rateable value from 42.3 pence in the pound to 22.5 pence in the pound, and a payroll-tax element levied at a rate of 2.2 per cent.

Figure 5.1 illustrates the regional pattern of changes in tax burdens per head that would result from the introduc-

FIGURE 5.1

**Change in tax burdens per head in moving from NNDR to a national multi-base tax, by region**

Payroll weight,  $Z$ , in multi-base tax = 0.1



tion of the national multi-base tax in place of non-domestic rates.

The Greater London area contains both a very high rateable value per head and a high value of payroll per head relative to the rest of the country in absolute terms. However, Greater London is also characterised by a relatively high ratio of property incomes to labour incomes compared with the rest of the country. As a result, any move to a national multi-base tax that included payroll within the tax base would generate a relative reduction in the size of London's contribution to the national 'pool', as Figure 5.1 shows.<sup>1</sup> The general pattern of redistribution

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<sup>1</sup>Figure 5.1 is likely to understate the reduction in the tax burden in Inner London because the contributions of the City of London and City of West-

of the burden of the national tax is magnified as the importance of payroll relative to rateable value is increased in the construction of the tax base (i.e. as the factor  $Z$  is increased).

### ***A locally-varying multi-base business tax***

In this section, we model the effects of allowing local authorities to determine the rate of the multi-base tax. As in Chapter 4, we are concerned with the implications of using different local government finance systems to finance a given pattern of expenditures. In other words, we assume in our simulations that local authority spending decisions remain unchanged; what changes is how the burden of paying for this spending is redistributed across different taxes and across different areas.

If the multi-base tax were employed as a local tax, it would be necessary to make the same kind of decisions as discussed in Chapter 4 about the way in which it would be integrated into the local finance system. First, the issue of resource equalisation would need to be addressed, because the tax base of the multi-base tax would vary, per head of population, between local areas. Second, it would also be necessary to specify the relationship that would hold between the multi-base tax and the other sources of local tax revenues (i.e. the council tax). In the results shown here, we have assumed that the introduction of the multi-base tax at local level would be accompanied by equalisation provisions along the lines of Chapter 4's Model 1, the first of the full equalisation models. We have also assumed

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minster are frozen for compatibility with the models in Chapter 4.

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that the proportions of the cost of marginal expenditure contributed by the domestic sector (through the council tax) and the non-domestic sector (through the multi-base tax) would be 40 per cent and 60 per cent respectively.

There are a number of different ways of analysing the consequences of operating the multi-base tax at local level. One would be to compare the effects of the multi-base tax at local level with those of the same tax at national level. Another would be to compare the multi-base tax at local level with the current system of non-domestic rates, levied at a uniform national poundage.

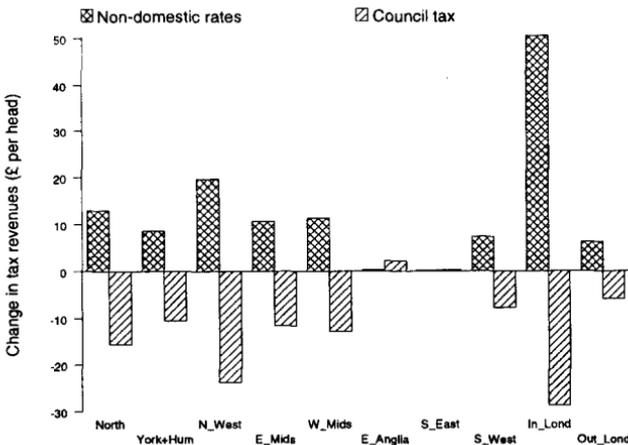
Figure 5.2 shows an analysis of the first sort — where the multi-base tax at local level is compared with the same tax levied at a uniform national rate. The graph shows the change in the regional burden of domestic and non-

FIGURE 5.2

**Impact of introducing local variation in the rates of the multi-base tax, by region**

Payroll weight,  $Z$ , in multi-base tax = 0.1

Locally-varying business rates introduced according to Model 1, with 40 per cent marginal expenditure contributed by domestic sector (i.e.  $D = 0.4$ )



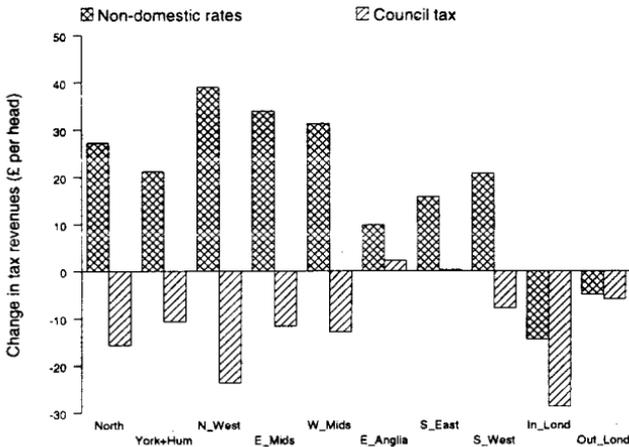
domestic taxes per head that would arise from allowing the multi-base tax to vary between areas, according to the system described above. The main changes are those also observed when the national non-domestic rate is compared with locally-varying non-domestic rates in the results for Model 1 in Chapter 4. The council tax burden falls in areas where local spending is high relative to the standard level (SSA), since part of the cost of marginal local spending is now being contributed by taxes levied on the multi-base business tax. The business tax burden correspondingly rises in areas of above-average local spending and falls elsewhere. However, it will be seen that the multi-base tax involves a smaller rise in business tax payments per capita in Inner London than Model 1 does,

FIGURE 5.3

**Effect of changing from current non-domestic rates to locally-varying multi-base tax, by region**

Payroll weight,  $Z$ , in multi-base tax = 0.1

Locally-varying business rates introduced according to Model 1, with 40 per cent marginal expenditure contributed by domestic sector (i.e.  $D = 0.4$ )



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since the proportion of the multi-base tax base concentrated in Inner London is less than the proportion of the business rate base.

Figure 5.3 shows a comparison of the multi-base tax, levied at locally-varying rates, with the current system of non-domestic rates, levied at a uniform national poundage. The effect shown in Figure 5.3 is, essentially, the combined effect of the comparisons made in Figures 5.1 and 5.2 — a change first from rates to the multi-base tax, and then the effect of allowing the tax rate to vary between areas. As can be seen in Figure 5.3, the reduction in the local business tax burden in Inner London that would result from the move to a broader-based local business tax would dominate the impact of high expenditure above SSA on tax bills in the capital. This is also true, but to a lesser extent, of Outer London.

### **5.2 Sectorally-Varying Non-Domestic Rates**

This section considers an alternative reform to non-domestic rates in which rate poundages vary according to the sector of the economy in which the business operates.

This scheme could operate within the context of a national or local system of non-domestic rates. Sectorally-varying rate poundages would also be compatible with the introduction of a multi-base tax as discussed in Section 5.1.

The idea of reducing the rate burden on particular sectors of the economy is not a recent one. Even as far back as the 1890s, central government partially derated the agriculture sector which was particularly depressed. The depression of the 1920s led to the complete derating of agriculture. In addition, the industrial sector was par-

tially derated in Churchill's 1928 Budget (Mair, 1986). In the 1950s and 1960s, manufacturing was rerated in England and Wales, but the domestic sector was partially derated in 1967 through the introduction of domestic rate relief, a relatively small discount to the poundage applied to domestic property compared with that applied to non-domestic property.

Indeed, even though the UK presently has a 'uniform' national non-domestic rate poundage, the liability for non-domestic rates is still not completely uniform between the various production sectors of the economy. For example, differential rating between sectors arises as a result of the differential provisions for derating of vacant property. Vacant commercial and retail property is liable for 50 per cent of the non-domestic rate bill, but vacant industrial property is zero-rated. There is also derating for charities and some other occupiers of non-domestic premises. In addition, of course, the agricultural sector remains completely derated.

Derating has typically been introduced in order to target assistance at struggling sectors of the economy. As argued above, non-domestic rates involve a relatively high tax burden on businesses trading at the margin of profitability, for two main reasons. One is that non-domestic rates take the form of a fixed cost, unrelated to the scale of activity (except if premises are entirely vacated) or to profitability. During periods of general recession, or for firms experiencing temporary business difficulties, non-domestic rates represent a substantial cost element, unrelated to the business's ability to pay. Second, because non-domestic rates can be offset against corporation tax liability, the amount of the tax burden imposed by non-domestic rates is actually lower for a firm trading profit-

ably than for a firm at the margin of survival earning little or no profits. For the former firm, an increase in the business rate has a net cost which is lower than the gross cost, because the firm faces a corresponding reduction in its liability to corporation tax; for the latter firm, there is no such reduction, because it has no profits and consequently pays no corporation tax. As a result of these two effects, non-domestic rates may impose both a higher relative and a higher absolute burden on less-successful businesses.

The 'fixed cost' argument might justify relating rate bills to profitability in some way. Possibilities might include a profit-related rate rebate for firms below a threshold profit level, or changing the tax base entirely, as in the multi-base tax outlined in Section 5.1, or through introduction of some profit element in the tax base.

Relating rate payments to profits (through a new system of non-domestic rate rebates) in the same way as council tax payments are related to incomes (through rebates paid through the social security system) would impose significant administrative costs, since it would require new procedures for assessment and enforcement. These would be considerably greater than the additional costs of moving to a multi-base business tax in which payroll is added as part of the tax base, for two main reasons.

One is that the current national tax system does not collect any form of data on profitability at the level of individual establishments; indeed, there are both serious conceptual difficulties in doing so and enormous practical difficulties, similar to those that arise in allocating multinational companies' profits between countries. Qualification for rebates at the establishment level would thus

involve substantial (probably prohibitive) costs. As an alternative, qualification for rebates could be considered at the firm level — at which profits are defined for corporation tax purposes. In this case, administrative costs would also be significant, since local authorities would have to co-ordinate their activities with other local authorities and the Inland Revenue (which administers corporation tax).

The second source of greater cost would arise through problems of timing; accurate information on corporate profits arises with a considerable time lag, and therefore rebates would initially have to be based on information relating to profits a year or two before the current period. Since this would largely negate any advantages to firms in temporary difficulty of a system of profit-related rebates, some system of provisional rebates would be necessary, with subsequent adjustment, when accounts relating to the firm's true profitability in the period in question became available.

If firms were required to produce accounts showing establishment-level profits, this would involve substantial extra compliance costs. In addition, the establishment-based approach would generate incentives for firms to use creative accounting procedures in order to minimise their tax liability (by, for example, allocating all the firm's profits to an establishment in a low-tax authority).

Due to the administrative difficulties and expense, targeted schemes of profit-related rate relief would seem to be an ideal, but impractical, solution to the problem of the high rate burden on unprofitable firms. As an alternative, derating sectors of the economy may be contemplated as a 'second-best' policy if more targeted approaches would generate excessive administrative and compliance

costs. If the businesses for which non-domestic rates are a particularly severe burden are concentrated in particular sectors or tend to have other easily-observable characteristics, then selective derating, according to the sector of activity or based on the other characteristics, could be a way of providing rate relief to most of the firms in need of it, at relatively low cost.

Selectively derating particular sectors of the economy may be a practical method of concentrating government assistance to struggling businesses, if some correlation exists between sectors, or other observable characteristics, and poor profitability. However, the derating of entire sectors of the economy is likely to be a relatively poorly-targeted approach for government assistance to business compared with assessments of rebate entitlement based directly on profits information. Many successful firms would benefit whilst many struggling firms would not. However generally depressed a sector of the economy is, some firms are likely to remain highly profitable. At the same time, other firms in far more prosperous sectors of the economy would escape the 'safety net'.

In essence, sectoral derating can only be justified as a rough-and-ready way of targeting assistance with low administrative costs. Similar arguments have occasionally been used to justify the targeting of rate relief on small businesses.

In this section, we analyse the regional impact on non-domestic rate revenues of two separate experiments in sectorally-varying non-domestic rates. These two experiments involve, first, derating the manufacturing sector by 50 per cent, and, second, derating the retail sector by 50 per cent. In both cases, the rate burden on other sectors

of the economy is raised to make good the shortfall in revenue.

### ***Derating manufacturing***

The manufacturing sector accounts for about 15 per cent of total non-domestic rateable value in England. Halving the rate poundage applied to manufacturing rateable value would thus reduce the aggregate revenue yield from non-domestic rates by 7.5 per cent, or some £0.9 billion.

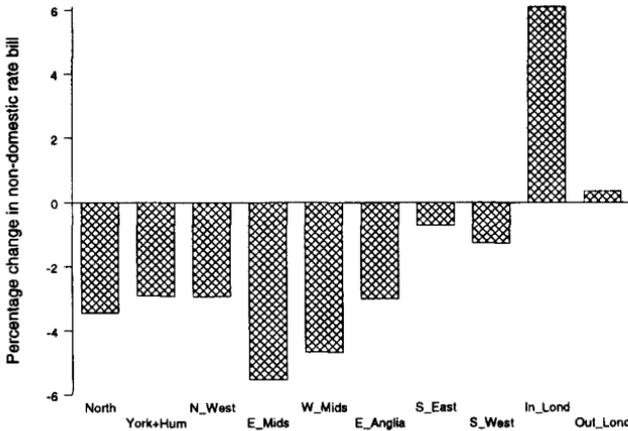
This revenue shortfall could be recouped in many different ways. Other taxes on business could be increased to compensate for the lost business rates revenue, or taxes outside the business sector, such as the personal income tax, could be raised. A relatively straightforward way of recovering the business rate revenues forgone from the manufacturing sector would be to increase the level of other business rates, so as to raise an unchanged total revenue from business rates. The total yield of non-domestic rates would thus be constant, but the burden would be redistributed between different categories of rateable value, and hence between businesses of different types.

A 50 per cent derating of the manufacturing sector would require a 7.6 per cent increase in the national non-domestic rate poundage from 42.3 pence to 45.5 pence in order to maintain aggregate business rate revenue unchanged.

There would be a geographical redistribution of the tax burden, reflecting the sectoral composition of business rateable value in different areas. Rate revenues — and hence the business rate burden — would tend to rise in those regions that contain a substantial concentration of

FIGURE 5.4

Changes to the burden of non-domestic rates, by region:  
derating the manufacturing sector by 50 per cent



manufacturing and fall in those regions in which manufacturing constitutes a smaller share of non-domestic rateable value.

Figure 5.4 illustrates the percentage changes in the yield of non-domestic rates that would occur in each region as a result of a 50 per cent derating of the manufacturing sector within the framework of the national non-domestic rate system and maintaining an overall constraint of revenue-neutrality. As the graph shows, the regions that would gain the most from the reforms are the industrialised Midlands, whilst the non-domestic rate burden would rise in Inner London, with its large concentration of shops and offices, due to the increase in the rate poundage applied to non-manufacturing rateable value in order to maintain overall revenues unchanged.

### ***Derating the retail sector***

An alternative proposal that has occasionally been advocated has been the derating of the retail sector. The justification for this may differ depending on whether it is proposed that the retail sector should be derated under a national non-domestic rate or under a system of locally-varying business rates.

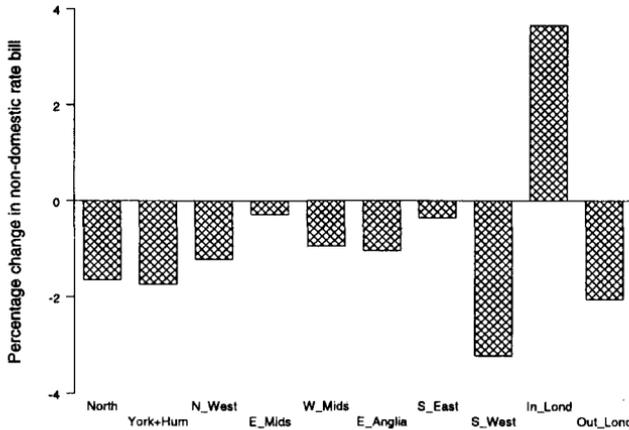
Under a national non-domestic rate, the case for the retail sector being in particular need of government assistance appears particularly weak. Large supermarkets and out-of-town developments would gain far more, in absolute terms, than would corner shops or struggling high-street businesses. One possibility might be to derate only 'small' retail businesses, although in the long term this would introduce new distortions in the pattern of retail activity. Unfortunately, we did not have access to sufficiently disaggregated data to test the implications of derating only those retail units that were considered 'small', however that was to be defined.

Under a system of locally-varying non-domestic rates, there may be more grounds for considering the partial derating of the retail sector. Systematic differences in relocation costs (both direct and indirect) across different sectors of the economy could provide a partial justification for lowering the burden of property taxes on the least-mobile sector.

Businesses in some sectors of the economy are more mobile geographically than others. At a rather simplistic level, manufacturing industry may be characterised as producing for a national market (for example, the producer of a tube of toothpaste can sell to any individual in the country) whereas retail firms typically deal with a far more

FIGURE 5.5

**Changes to the burden of non-domestic rates, by region:  
derating the retail sector by 50 per cent**



localised market, most notably in the extreme case of the corner shop.

For example, a manufacturing firm that considered the bundle of taxes and expenditure in its locality to be far from ideal might be able to relocate at relatively modest cost in another area. The costs associated with businesses 'voting with their feet' might be significantly higher in sectors of the economy where firms are less mobile. Indeed, Mair (1986) argued that sectors where rates formed a significant part of the costs — distributive trades and utilities — tended to be tied especially closely to particular localities and markets, and thus had little effective choice over location. As a result, local authorities may have an incentive to ignore the preferences of less-mobile firms in their area.

Figure 5.5 illustrates the percentage changes in regional NNDR burdens that would result from a 50 per cent

derating of the retail sector whilst maintaining the aggregate yield of the NNDR at present levels.<sup>2</sup> A 50 per cent derating of the retail sector would lead to a 12.5 per cent increase in the national non-domestic rate poundage from 42.3 pence to 47.6 pence in order to maintain yields at present levels. This reform would reduce the share of the national tax yield paid by almost all regions, with the greatest gains going to the south-west which has a relatively small retail sector. By contrast, tax revenues would increase by almost 4 per cent in Inner London as a result of the importance of the share of office property in Inner London's total rateable value.

### **5.3 Conclusions**

This chapter has considered two more-extensive reforms to non-domestic rates than those discussed in Chapter 4, which aim to address problems with non-domestic rates, levied either at the national or local level.

The first reform involves a 'multi-base' tax, which broadens the tax base of local business taxation to include a payroll element as well as rateable value. A more broadly-based tax of this form might be preferred to non-domestic rates, on the grounds that it would reduce the bias against capital that arises in the current non-domestic rating system. Our simulation of the effects of a

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<sup>2</sup>Details of the sectoral distribution of rateable value in each standard region can be found in Appendix 1. Lack of data on the sectoral composition of non-domestic rateable value at the level of individual local authorities prevented us from modelling the impact of combining sectoral derating with a move to locally-varying non-domestic rates.

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multi-base tax, levied on a base comprising both rateable value and payroll elements, shows that, in comparison with non-domestic rates, it would tend to reduce the proportion of revenue contributed by businesses in Greater London and increase the proportion contributed by the rest of the country. This redistribution of the tax burden away from London would rise as the importance of payroll relative to rateable value in the multi-base tax base is increased.

The second reform would introduce sectorally-varying non-domestic rates, through the partial derating of particular sectors, such as manufacturing or retailing. The objective behind this reform would be to reduce the heavy 'fixed-cost' burden of non-domestic rates on marginal firms, by reducing rates for sectors where such firms are particularly likely to be encountered. There would, naturally, be some significant regional shifts in the local tax burden from partial derating of either manufacturing or retailing. However, we have argued that the case for sectoral derating as a way of targeting assistance to marginal firms is weak; the help to marginal firms would be very poorly targeted. It is also clear that if the tax burden on certain sectors were reduced, then it would be necessary to raise the tax burden on other sectors, if the overall revenue yield from non-domestic rates were to be maintained.

## **CHAPTER 6**

### **Summary and Conclusions**

Local control over business rate levels was abolished as part of the 1990 reforms to local government finance. Since these reforms, a uniform business tax rate ('rate poundage') has been set nationally, and, although local authorities continue to administer business rates, the revenues are pooled and distributed to local authorities in proportion to their populations. Business rates have become, in effect, a national tax, from which the revenues are earmarked to local government.

There continues to be pressure to return to the earlier system, where the tax rate was under local control. The case for a return to local control has been advocated on three main grounds:

- *The yield from business rates has fallen sharply since the 1990 reform: could this be because the incentive for local authorities to collect the tax has been weakened, now that they simply receive a share of the pooled business rate revenues?*

This report has argued that this explanation of the fall in the yield from business rates can be discounted; there is no reason to believe that local control would have had any effect on the fall in business rate yields experienced in recent years. Much of the fall is due to the recession. In addition, local authorities still have a clear financial incentive to collect business rates, since the amount they must contribute to the business rate pool depends on local rateable value, not on the amount actually collected.

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- *The present system of local government finance in the UK generates high 'gearing ratios', so that local tax rates are extremely sensitive to small percentage differences between actual spending and the government's estimate of standard spending (SSA). These high gearing ratios may blur local authority accountability since council tax rates have become highly sensitive to changes in the grant distribution formula. A broader local tax base (with the restoration of business rates to local control) would reduce the impact of grant changes on council tax rates. If the amount of instability in council tax levels caused by grant changes is reduced, and if the dependence of local government on central government transfers is reduced, it is argued that local democratic accountability would be enhanced.*

In this report, we have suggested that other additional local taxes (such as a local income tax) might be better than business rates as a way of broadening the local tax base. However, restoring local control over business rates would be easier than introducing a completely new tax.

- *The 'nationalisation' of non-domestic rates may have weakened the partnership between local authorities and businesses. In the current system, local authorities that attract business by spending on services benefiting business do not gain any extra tax base. Also, the need for business to talk to local government has been reduced, since local spending decisions no longer feed through to taxes on business.*

We have argued that this line of argument often reflects a misunderstanding of the pre-1990 position, where, due to resource equalisation, local authorities gained no resource benefit from attracting extra business. Also,

there is no evidence that the ending of the business contribution to the costs of extra local spending has made local authorities less willing to spend on those services that benefit business.

The arguments for restoring local control over business rate levels are thus far from decisive. In addition, there are important disadvantages to local control, which prompted the 1990 introduction of the uniform business rate. In particular, differences in business rate levels between local authority areas could lead to distortions in the geographical pattern of business activity and investment.

The evidence on this in the UK — which relates, of course, to the period before 1990 — is limited. Whilst the pre-1990 system led to considerable differences in the potential profitability of locating an investment in different areas, there was little systematic statistical evidence that business rates distorted the location of business investment and employment. Considerably greater evidence exists to show such distortions in the US. One reason, however, for locational effects being hard to identify is the very long time-frame within which they would take place. Recent research by IFS (Bond, Denny, Hall and McCluskey, 1995) shows that in the short term, much of the effect of business rate differentials is absorbed in higher rents for business premises, and high business rates may thus not affect the profitability of the current occupant. Distortionary effects would then only arise in the long term, when new premises were being built. Even if the effects of tax differences were then large, they might be difficult to detect in relatively short-term data.

If business rates were to be restored to local control, there would be a number of ways in which this could be

## *Options for business rate reform*

done, with, as we have shown, widely-varying effects. Simply restoring the pre-1990 business rate arrangements is no longer possible or logical. There are two important differences between those arrangements and the present situation:

- The current basis for allocating central government grants involves more limited resource equalisation than under the pre-1990 system; it provides local authorities with sufficient resources to ensure that they can all levy the same tax rate if they spend at the standard level (SSA), but does not equalise at other spending levels. The inequity that thus arises is, perhaps, tolerable where differences between areas in the council tax base are concerned, but the system has not been designed to cope with the much greater resource differences between authorities under business rates.
- Before 1990, local household taxes were levied on the same base as business rates, and (with the exception of a small discount to the domestic poundage through domestic rate relief) a common tax rate applied to both business and domestic local taxpayers. The system, in effect, operated as a single local tax, and the amount that should be contributed, either on average or at the margin, by local business taxpayers was thus decided by the relative size of the business and domestic rate bases. Since domestic rates have now been abolished, there would be two separate local taxes if business rates were restored to local control, and explicit decisions would have to be taken as to the relationship between the two taxes.

These two differences suggest, in turn, two key areas where choices need to be made in designing a system for restoring some measure of local control over business rates:

- How much equalisation is required to offset differences in the amount of business rateable value between areas, and on what basis should the equalisation be made? Would some form of simplified partial equalisation be adequate, or is it necessary to have full resource equalisation for business rates on the pre-1990 model?
- What should business contribute, on average, and at the margin, to overall local government resources?

Whilst a wide range of possible choices might be made about these key issues, the report has explored the implications of four possible schemes for locally-varying business rates:

- *Model 1* — full equalisation of the business rate base, with a given percentage contribution by household taxpayers (council tax payers). In the main version of this model shown in the graphs in this report, council tax payers contribute 40 pence per pound of extra local spending; business rate payers in an authority with an average business rate base contribute 60 pence per pound.
- *Model 2* — full equalisation of both business and council tax bases, with the increase in the rates of council tax and business rates proportional to the size of local authorities' spending above standard spending (SSA).
- *Model 3* — partial equalisation, with a fixed business share. Resources are equalised for spending at SSA, but

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local taxpayers pay for additional local spending, regardless of the local tax base. In the example illustrated in this report, the non-domestic sector pays 60 per cent of the cost of the 'overspend' and council tax payers 40 per cent.

- *Model 4* — partial equalisation, with varying business share. Again, resources are equalised for spending at SSA, and local taxpayers pay for additional local spending, regardless of the local tax base. However, in this case, the contribution of business rate payers varies according to the importance of business taxpayers (measured by employment) relative to household taxpayers (measured by number of residents).

The report has assessed the impact of the reforms on local taxpayers, using budget data for each local authority in England in 1994–95 to estimate what the pattern of local finances and local tax rates would have been under each of the options.

Key results include the following:

- Increasing the share of marginal expenditure financed by the non-domestic sector would increase both average rate poundages and the variation in poundages between local authorities. In addition, incomplete equalisation of the resource bases of local authorities would tend to increase the dispersion of tax rates across local authority boundaries.
- If the business sector is required to finance 60 per cent of the cost of marginal local spending (i.e. of spending above SSA), non-domestic rate poundages would rise by slightly more than 1½ p in the pound — from an

average of 42.3 pence in the pound to 43.9 pence in the pound.

- Even with full equalisation of the business rate base, the range of business rate poundages would be considerable. For example, under our Model 1, with a 40 per cent domestic-sector contribution to marginal spending, the average of the five lowest local authority non-domestic tax rates would be 37 pence, whilst the average of the five highest rates would be 55 pence. Less-complete equalisation would make rather less difference to the range of non-domestic rate poundages than might have been expected. Under our partial equalisation Model 3, for example, the five lowest non-domestic tax rates would average 35 pence, whilst the average of the five highest rates would rise only to 56 pence.
- Special arrangements would be needed for the City of London. Despite having only about 5,000 residents, the City has more non-domestic rateable value than the entire northern region of England.
- Restoring local control over business rate levels would reduce council tax rates in authorities where local spending is higher than the standard level (SSA). How large the effect on council tax bills would be would depend on the contribution to marginal local spending demanded from the business sector, and on other features of the model adopted. Model 4, where local taxpayers pay the full cost of extra spending in each authority, and where the burden is distributed across authorities according to the relative 'size' of the domestic and non-domestic sectors, would give a particularly large advantage to households in areas with a large amount of taxable business.

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- In the full equalisation models, the largest reductions in council tax payments per head of population would be in Inner London (council tax bills would fall by some £30 per head) and the north-west (falls in council tax of about £20 per head). There would be little if any change in council tax levels in East Anglia and the south-east, the areas where there is least excess of spending over SSA.

In addition to the design of schemes for introducing locally-varying non-domestic rates based on the current structure of non-domestic rates, we have also considered two more-extensive reforms to non-domestic rates, which would be consistent either with a national non-domestic rate or with locally-varying non-domestic rates.

The first reform moves to a 'multi-base' tax, which broadens the tax base of local business taxation to include a payroll element as well as rateable value. A more broadly-based tax of this form might reduce the bias against capital that arises in the current non-domestic rating system. Our simulation of the effects of a multi-base tax, levied on a base comprising both rateable value and payroll elements, shows that, in comparison with non-domestic rates, it would tend to reduce the proportion of revenue contributed by businesses in Greater London and increase the proportion contributed by the rest of the country. This redistribution of the tax burden away from London would rise as the importance of payroll relative to rateable value in the multi-base tax base is increased. This redistribution would be considerable, and the multi-base tax would therefore be difficult to implement. Moreover, it is not at all clear that the present system does

indeed lead to a serious bias against capital, since other factors, especially labour, also bear heavy taxes.

The second reform would introduce sectorally-varying non-domestic rates, through the partial derating of particular sectors, such as manufacturing or retailing. The objective behind this reform would be to reduce the heavy 'fixed-cost' burden of non-domestic rates on marginal firms, by reducing rates for sectors where such firms are particularly likely to be encountered. There would, naturally, be some significant regional shifts in the local tax burden from partial derating of either manufacturing or retailing. However, we have argued that the case for sectoral derating as a way of targeting assistance to marginal firms is weak; the help to marginal firms would be very poorly targeted. It is also clear that if the tax burden on certain sectors were reduced, then it would be necessary to raise the tax burden on other sectors, if the overall revenue yield from non-domestic rates were to be maintained.

We have not attempted to draw any firm conclusions as to the desirability, in theory or in practice, of any of the reforms to the national non-domestic rate that we have discussed. If a change is to be made to the current system of national non-domestic rates, there is a wide range of possible options that could be implemented; in our view, there are no very compelling reasons to prefer one of the options to another. There are gainers and losers from each particular choice, and we are not in a position to draw a balance between these various interests. Ultimately, it is policymakers who must bear responsibility for determining whether any gains from choosing a particular model of reform can justify the effects on the domestic, non-domestic and local authority sectors.

### *Options for business rate reform*

On the more fundamental question of whether any reform at all should be implemented, we are sceptical. The theoretical and empirical evidence indicates that there would be advantages and disadvantages from restoring business rates to local authority control. Some of the arguments for change are weak, whilst the risk of significant locational distortion remains substantial. The overall case for change is far from proven.

# APPENDIX 1

## Data and Methods

### A1.1 Introduction

Appendix 1 describes both the data sources that were used in the research and the simplifying assumptions that were necessary in order to render the models described in Appendix 2 operational. Section A1.2 examines the sources of data and provides some illustrative descriptive statistics. Section A1.3 describes the simplifying assumptions we have made in the course of the analysis.

### A1.2 The Source Data

The main local choice variables modelled were those concerned with local tax and expenditure decisions. We took the discrepancy between local budgetary decisions and central government's assessment of the local authority's need to spend (standard spending assessment or SSA) as our main local choice variable. Local authority budgetary data for the financial year 1994–95 were taken from *Finance and General Statistics 1994/95* (CIPFA).<sup>1</sup>

The analysis focused on two taxes — non-domestic rates and the council tax. Local tax bases (non-domestic rateable value and equivalent Band D properties respectively) for each of these taxes were also obtained from

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<sup>1</sup>Our measure of 'variation of budget from SSA' was calculated by subtracting SSA, parish council precepts and local government reorganisation costs from each local authority's budget requirement.

## *Options for business rate reform*

*Finance and General Statistics 1994/95*. In addition, we evaluated the impact of introducing a multi-base tax. *Inland Revenue Statistics 1993* provided county-level data on payroll.

County payroll was divided amongst constituent districts according to the district's share of overall employment in the county. This approach assumes that the district's share of county employment is broadly proportional to the district's share of county payroll. This common-wage assumption might be justified if one thought that counties could be characterised as unified labour markets.

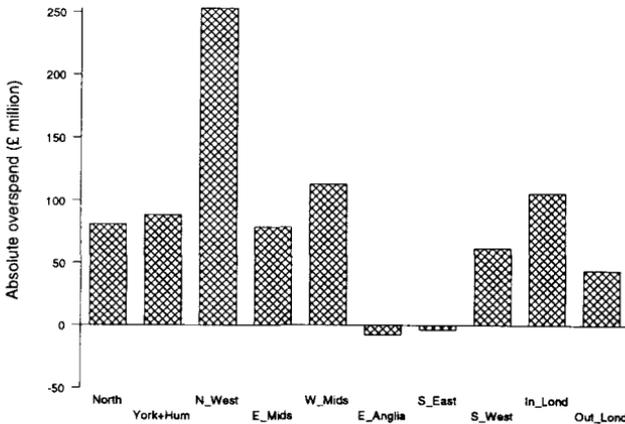
Our approach seemed least satisfactory in Greater London, where one might expect certain boroughs, in particular the City, to have higher average wages than those prevailing in other boroughs. Unfortunately, we did not have access to sufficient data to check this hypothesis.

Data on the sectoral composition of non-domestic rateable value in each standard economic region were also derived from *Inland Revenue Statistics 1994*. Unlike the other models, the sectoral analysis was only undertaken at the aggregated level of standard economic region. It is possible that this level of aggregation conceals significant differences in the sectoral composition of rateable value within regions.

### *Descriptive statistics*

This section presents some descriptive illustrations of variations in local authority expenditure and tax bases between standard economic regions. As in the main text, Greater London is separated into three subregions (Outer London, Inner London and the City) in order to highlight

FIGURE A1.1  
Distribution of absolute overspend,<sup>a</sup> by region



<sup>a</sup>Strictly, budget requirement minus parish precepts (approximately £100 million) and the costs involved in the reorganisation of local government (approximately £10 million).

the differences between these groups of authorities in the capital. In addition, to facilitate interpretation of the results in Chapters 4 and 5, the City of London and the City of Westminster are not included in the illustrations.

Figure A1.1 illustrates the distribution of 'overspending' by standard economic region. The north-west clearly has the largest absolute overspend, whilst local authorities in East Anglia and the south-east, on aggregate, spend less than SSA.

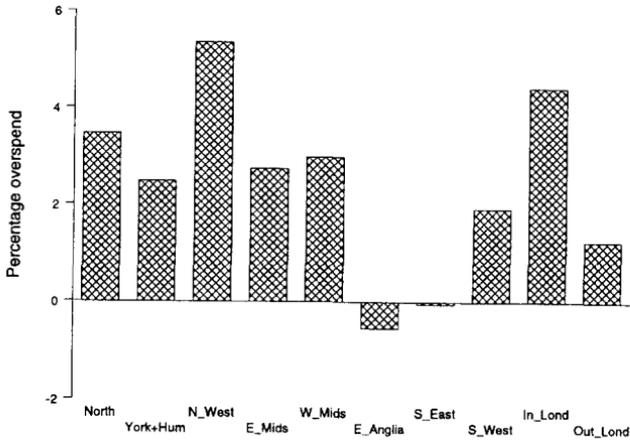
Figure A1.2 shows the percentage by which local expenditure exceeds SSA in each region. The north-west is found to have the highest percentage overspend as well as the highest absolute overspend.

Figure A1.3 shows the distribution of additional local expenditure in pounds per head between standard economic regions. This shows that overspending per head is

## Options for business rate reform

FIGURE A1.2

### Distribution of percentage overspend,<sup>a</sup> by region



<sup>a</sup>The percentage by which local expenditure exceeds SSA.

FIGURE A1.3

### Distribution of overspend per head of population

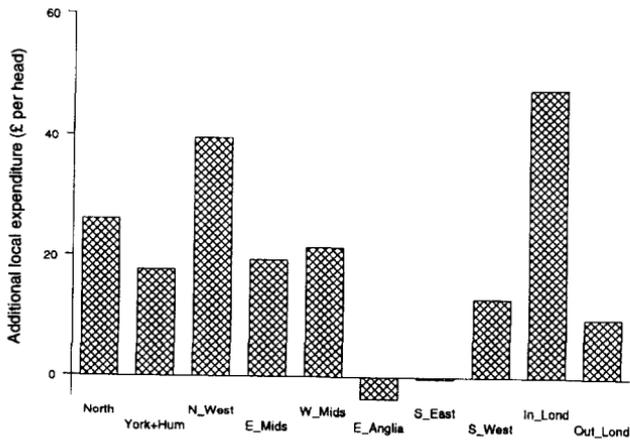
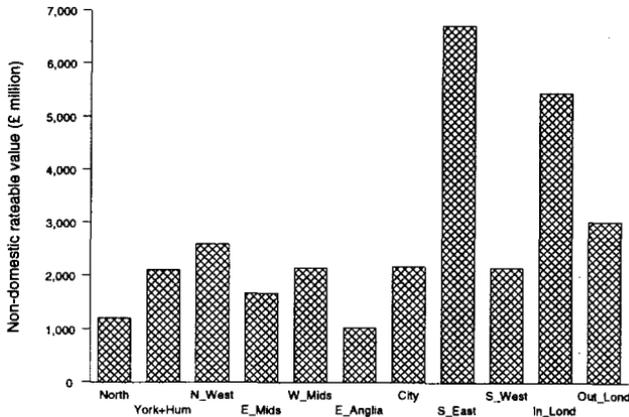


FIGURE A1.4

**Distribution of non-domestic rateable value, by region**

actually greater in Inner London than in the north-west, which has a much larger population. The percentage overspend is still higher in the north-west because Inner London has a far higher SSA per head than the north-west.

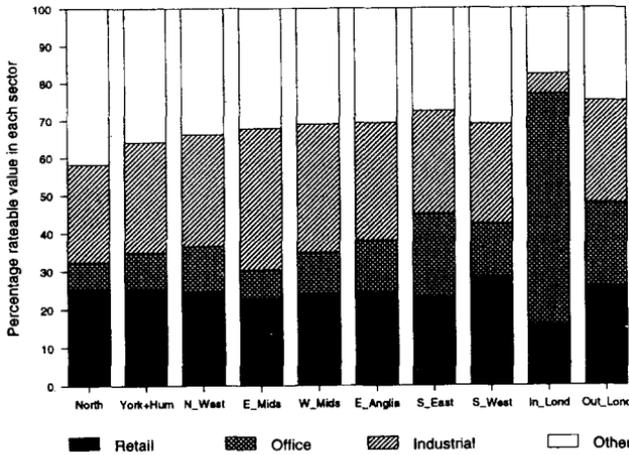
Figure A1.4 highlights the distribution of non-domestic rateable value by region. As can be seen, there is a massive concentration of the tax base in the south-east and Greater London. In particular, the City, a single local authority with only 5,167 residents,<sup>2</sup> has a higher tax base than the entire northern region with a population of over 3 million.

Figure A1.5 illustrates the sectoral composition of non-domestic rateable value by region. The sectors considered are retail, offices, industrial properties and other commercial properties. As can be seen, offices are propor-

<sup>2</sup>Source: *Finance and General Statistics 1994/95*, CIPFA.

FIGURE A1.5

**Sectoral composition of non-domestic rateable value, by region**



tionately more important in the south-east, particularly within Inner London, whilst industrial property (factories and warehouses) are relatively more important in the Midlands and the north.

### **A1.3 The Assumptions underlying the Modelled Results**

Modelling the results presented in Chapters 4 and 5 required a number of simplifying assumptions to be made. These were largely concerned with the choice of local decision variable, the treatment of 'special cases' and the assignment of tax bases to individual local authorities. The assumptions implicit in all of our modelled results are spelt out in this section.

### ***Assumptions concerning local decision variables***

The modelled results use actual local authority budget data from the financial year 1994–95 to simulate the impact of a series of reforms to the national non-domestic rate. These results will therefore be sensitive to any atypical behaviour of individual local authorities in that particular year. One set of assumptions were introduced in order to control for any particular ‘shocks’ that appeared to influence local authority behaviour during the 1994–95 financial year.

In 1994–95, the aggregate ‘overspend’ (defined as budgeted expenditure<sup>3</sup> minus standard spending assessment) of all local authorities in England amounted to some £810 million. However, this figure does not take into account the use of general fund reserves by local authorities (which amounted to an additional £819 million in 1994–95).

It is clear that such a massive run-down in reserves (constituting 29.6 per cent of general fund reserves in 1994–95)<sup>4</sup> could not continue indefinitely. Indeed, three sets of factors may help explain why such a large run-down in reserves occurred in this particular financial year. First, May 1994 was the date of the four-yearly elections in the London boroughs. In addition, a significant number of seats came up for re-election throughout the rest of the country. One might expect atypical behaviour by local authorities in election years if one makes the assumption

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<sup>3</sup> Strictly speaking, parish precepts and reorganisation costs were also deducted from local authority budgetary requirements.

<sup>4</sup> Source: *Finance and General Statistics 1994/95*, CIPFA.

that voters have short memories. Local authorities may attempt to generate a perceived 'free lunch' for voters in the form of either higher expenditure for a given level of taxes or lower tax rates for a given level of expenditure. Since almost all of the major spending authorities (London boroughs, metropolitan districts and shire counties) were setting budgets close to or at 'cap' by 1993–94, it is likely that local authorities perceived little room for manoeuvre on the tax revenues front in 1994–95. However, it was still possible to use reserves to temporarily boost expenditure. Indeed, expenditure by local authorities in England increased by 4.4 per cent between 1993–94 and 1994–95, whilst tax rates only increased by 2 per cent.<sup>5</sup>

Second, the introduction of the council tax in 1993 had gone relatively smoothly, especially considering the 'fiscal anarchy' (Besley, Preston and Ridge, 1993) of the Community Charge (the poll tax) era. As a result, in the light of the significant improvement in collection rates that occurred (from 90 per cent in the last year of the poll tax to 98 per cent in the first year of the council tax),<sup>6</sup> rational local authorities may have chosen to make a one-off adjustment to their level of precautionary reserves. There is very little evidence that this windfall was used to reduce tax rates as opposed to boosting expenditure.

Third, pre-announced revenue-capping limits have only begun to 'bite' for the majority of local authorities since 1993–94. As a result, many local authorities may have chosen to temporarily maintain higher expenditure

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<sup>5</sup> Source: *Finance and General Statistics 1994/95*, CIPFA.

<sup>6</sup> Figures from a Department of the Environment press release (May 1994).

levels in 1994–95 in the hope of a more accommodating financial settlement in future years. To the extent that this has not in fact happened, and that reserves may now be approaching an irreducible minimum for many local authorities, then expenditure levels may have to be cut to conform with the centrally-determined cap.

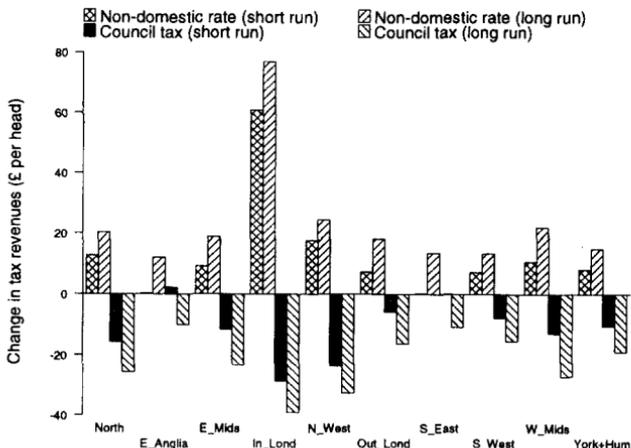
Given these factors, it is likely that in 1994–95, local authorities chose to maintain expenditure levels that were higher than those that would be sustainable in the long run, given existing budgetary caps. On the assumption that any reform to non-domestic rates would not be accompanied by any relaxation of the capping criteria, the models presented in Chapters 4 and 5 assume that expenditure would be maintained at a level compatible with existing capping arrangements.

In the longer run, however, local authorities might respond to any future relaxation of the capping criteria by choosing a level of expenditure more closely related to their expenditure levels in 1994–95, financing the balance from increased taxation rather than a continual reduction in reserves. If this were the case, the likely long-run impact of reforms to the structure of non-domestic rates may be more similar to that shown in Figure A1.6 than the results of Chapter 4 would suggest. Figure A1.6 contrasts the likely impact of reforms to non-domestic rates along the lines of Model 1 (full equalisation of business rates base with the domestic sector contributing 40 per cent of spending above SSA in each authority) both in the short run (assuming a capping regime is maintained) and in the longer run (assuming the present capping arrangements are maintained). As can be seen, the long-run impact would differ from the short-run impact more by degree than in kind.

FIGURE A1.6

**Impact on local tax burdens per capita, by region, of a return to locally-varying non-domestic rates, under Model 1 in the short run and long run**

Model 1: full equalisation of business rate base; domestic sector contributes 40 per cent of spending above SSA in each authority (i.e.  $D = 0.4$ )



***Assumptions concerning local tax bases***

The attribution of non-domestic rate revenues to local authorities presented a few additional complications for the analysis. Since actual collections are not generally equal to predicted collections due to uncertainty at the start of the fiscal year, the Treasury undertakes to maintain local budgetary stability by ‘bailing out’ the national pool in years of over-optimistic predictions and claiming the money back in subsequent years.

As a result of both a series of over-optimistic revenue forecasts in previous years and refunds of previous over-payments of tax in response to successful appeals against the 1990 Valuation List, the amount budgeted for collec-

tion in 1994–95 was substantially larger than the £10.6 billion that was available for distribution to local authorities. Whilst the figure for collections is likely to prove a more accurate indicator of long-term yields from the uniform business rate, we chose the latter figure in order to maintain aggregate external finance to local authorities at 1994–95 levels.

In addition, we have made a series of assumptions concerning the allocation of non-domestic rate revenues to individual local authority areas. The data we used were based on local rating lists, which do not take into account the following:

- the distribution of assets on the central rating list (largely consisting of the property of the utility industries, such as pipelines);
- the distribution of Crown properties (for which a contribution is made by the exchequer) between local authority areas; and
- the proportion of non-domestic property that is vacant (and hence attracts mandatory rate relief), which differs between local authority areas.

To address the first two issues, we made the essentially arbitrary assumption that the distribution of Crown and central list properties was broadly proportional to the distribution of properties included in local rating lists. This rather unsatisfactory assumption was forced on us by lack of alternative data. To address the third issue, we created an ‘effective tax base’ which reflected local variations in occupancy rates. We then proceeded on the assumption that the variation of occupancy rates between local authority areas is not compensated for by central government

## *Options for business rate reform*

(under partial equalisation models) and hence affects a local authority's effective tax base.

### *Assumptions concerning 'special cases'*

The full equalisation schemes of Models 1 and 2 were found to be highly sensitive to small variations in the expenditure decisions of a small number of high-resource-base authorities, most notably the City of London and the City of Westminster. As a result, relatively minor changes in the budget plans of these authorities were found to have a very significant impact on the distribution of grant and hence on the tax rates levied by other local authorities.

Traditionally, special arrangements such as the London Rate Equalisation Scheme have been devised to cope with this small group of authorities. Both the Greater London Council (GLC)<sup>7</sup> and the Inner London Education Authority (ILEA)<sup>8</sup> had an equalising impact over the resource bases of the London boroughs during the previous era of locally-varying non-domestic rates. In addition, special arrangements have always existed for the City of London, since this largely unpopulated single square mile contains approximately 10 per cent of all property value in England.<sup>9</sup> In view of these precedents, rather than making largely arbitrary assumptions about the future structure of such arrangements, we simply froze the net contributions of the two largest-resource-base authorities (the City of

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<sup>7</sup>Until its abolition in 1985.

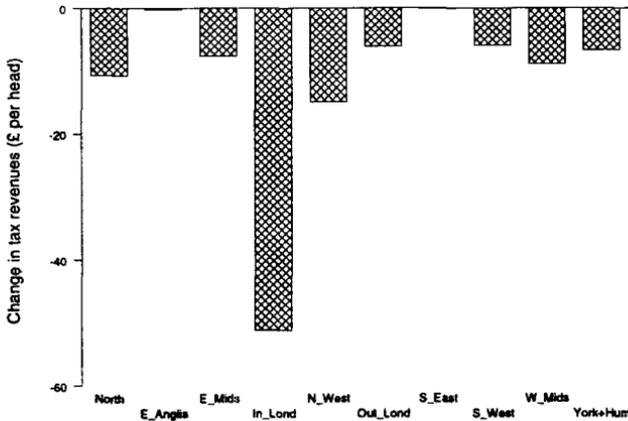
<sup>8</sup>Until its abolition in 1990.

<sup>9</sup>Source: *Local Government Financial Statistics 1994/95*, HMSO.

FIGURE A1.7

**Impact on local tax burdens per capita, by region, of including high-resource authorities within the full equalisation arrangements of Model 1**

Model 1: full equalisation of business rate base; domestic sector contributes 40 per cent of spending above SSA in each authority (i.e.  $D = 0.4$ )



London and the City of Westminster) to the national pool at present levels.

The inclusion of these two authorities within the general framework of Model 1 would generate massive redistributions of grant between local authorities, which in turn would generate significant fluctuations in non-domestic rate poundages (council tax rates would not be affected since a fixed 40 per cent of any marginal local expenditure is financed through the council tax in each local authority area). Figure A1.7 demonstrates how the inclusion of Westminster and the City within the general framework of Model 1 would generate significant changes in rate revenues per head in other local authorities. In addition, these tax rates would be highly sensitive to budgetary

### *Options for business rate reform*

decisions in the two highest-resource-base authorities. It is for these reasons that high-resource London authorities have typically been dealt with via special arrangements rather than within the framework applying to other local authorities.

### *Assumptions concerning precepting authorities*

In shire areas, there are two tiers of local authorities — district councils and county councils — with the latter responsible for roughly 80 per cent of local expenditure. Local tax rates are hence a combination of the district tax rate and the county precept.

In London and the metropolitan areas, local government consists of a series of unitary district and borough authorities together with mandatory joint arrangements for the provision of police, fire and transport services. These single-service authorities levy a precept on the lower-tier authorities in the same way as county councils. For the purposes of our model, we aggregated all joint authorities to form ‘county councils in exile’ with separate ‘county councils’ for Outer London, Inner London and the City of London to reflect different precepting arrangements and the operation of the City police force separately from the Metropolitan Police.

### *Assumptions concerning the measurement of ‘overspending’*

There are, in principle, a number of alternative methods of scaling a local authority’s ‘overspend’ in relation to standard spending assessment. Possible methods include measuring it per capita or per unit of the local tax base. The equalisation arrangements in Model 2 focus on per-

centage overspends. For the other models, we choose to scale overspends in per capita terms rather than by the size of the tax base.

Each of the two methods of scaling expenditure has much to recommend it. The tax base method might have been preferable as a method of scaling if we regarded local expenditure as being principally concerned with the provision of services to property. This was historically the case in the UK. However, the extension of local government competence to cover services such as education and personal social services during the twentieth century has rendered per capita comparisons of local expenditure more appropriate.

## **APPENDIX 2**

### **Formal Representation of Alternative Models of Business Rates**

Appendix 2 formally presents the structure of the four models of locally-varying business rates in somewhat greater detail than was possible in Chapter 4. Section A2.1 discusses some general features of the UK local finance system. Section A2.2 describes the models of full equalisation discussed in Section 4.2, and Section A2.3 describes the partial equalisation models discussed in Section 4.3. Section A2.4 provides a summary of the models used.

#### **A2.1 Some Aspects of the UK Local Finance System**

The distribution of grant from central government to local authorities in the UK serves two basic functions. First, there is a relatively straightforward per capita transfer of resources from one tier of government to another, largely reflecting a disparity between the distribution of tax-raising powers and expenditure responsibilities between tiers of government. Second, the grant system attempts to compensate local authorities for differences in their circumstances, both in terms of variations in their resource bases and in terms of variations in the demand for and the cost of providing local services.

Central government's annual assessments of the spending 'needs' (in terms of both units of service and costs per unit of service) of each local authority are known as standard spending assessments (SSAs). Central government only equalises the resource bases of local authorities

at SSA. This ensures that any local authority that budgets to spend at SSA will be able to levy a predetermined rate of council tax known as the council tax at standard spending (CTSS). For a given local authority,  $i$ , equation (1) illustrates how an expenditure level equal to the authority's SSA would be financed.

$$(1) \quad E_i^* = \bar{c} n_i + \bar{t} RV_i + \bar{g}_i$$

where

- $E_i^*$  is authority  $i$ 's SSA;
- $\bar{c}$  is the CTSS;
- $n_i$  is the number of equivalent Band D properties in authority  $i$ ;
- $\bar{t}$  is the non-domestic rate poundage at standard spending;<sup>1</sup>
- $RV_i$  is the total rateable value of non-domestic property within authority  $i$ ; and
- $\bar{g}_i$  is the level of revenue support grant (RSG) at standard spending for authority  $i$ .

At present, the burden of all local marginal spending falls on the local tax base, since grants depend only on SSA, not actual local expenditure. Hence the full burden of local marginal expenditure falls on a single tax base, the council tax. By contrast, under systems of full resource-base equalisation, spending above SSA would be funded by a combination of changes in council tax rates,

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<sup>1</sup>In the present UK finance system, this is equivalent to the uniform business rate (UBR) which does not vary between local authority areas.

### *Options for business rate reform*

changes in the rate poundages for non-domestic rates and marginal redistributions of grant between local authority areas, as is shown in equation (2).

$$(2) \quad E_i - E_i^* = \Delta c_i n_i + \Delta t_i RV_i + \Delta g_i$$

where

$E_i$  is actual expenditure by authority  $i$ .

$c_i$  is the council tax rate in authority  $i$ ;

$t_i$  is the non-domestic rate poundage in authority  $i$ ;  
and

$g_i$  is the level of revenue support grant for authority  $i$ .

Each of the four models presented in Chapter 4 incorporates resource equalisation at standard spending. That is, any local authorities that choose to spend at their SSA can set the same rate of council tax, irrespective of the size of their local tax bases. The extent to which grant responds to local authority spending levels that deviate from SSA is the key distinction between full and partial equalisation models.

## **A2.2 Models of Full Equalisation**

In Chapter 4, we considered the impact of two sets of reforms to the national non-domestic rate under systems of full resource equalisation between local authorities. We discuss these models in turn.

### ***Model 1: full equalisation***

In Model 1, the first of our full equalisation models, we assume that the proportion of each authority's spending above standard spending that is funded by the domestic

sector is given by  $D$  (at present, this proportion is 1). In addition,  $1-D$  of the *aggregate* overspend is funded by the non-domestic sector. A move to a system of full equalisation from the SSA-only equalisation inherent in the present UK local finance system would generate redistributions of grant between local authorities, reflecting differences in the size of their local tax bases.

Under Model 1,  $D$  of any marginal local expenditure will be financed by the domestic sector through the council tax. In those areas with a relatively large non-domestic tax base, the non-domestic sector will pay for more than  $1-D$  of the overspend (in which case, grant will fall), and in others, it will pay for less than  $1-D$  of the overspend (so grant rises). Whilst aggregate central government grant to local authorities remains unchanged, grant will be redistributed between local authorities in accordance with the principles of a full equalisation scheme.

The principle of horizontal equity suggests that businesses located in different local authorities that pursue similar spending policies should face the same tax rates. To impose horizontal equity at marginal spending requires that for any two authorities with the same *relative* overspend, the increase in the rate poundage is the same. In principle, one can measure the size of the overspend relative to a host of other variables such as population, number of establishments or employment. We chose to measure marginal expenditure relative to both the domestic tax base, measured as the number of equivalent Band D properties in the local authority area, and population (reflecting the benefits of additional local expenditure). In practice, there was little difference between the two bases for comparison.

### *Options for business rate reform*

The assumption that  $D$  of the overspend of each authority is met by the domestic sector of an individual authority implies that

$$(3) \quad \Delta c_i = D \frac{(E_i - E_i^*)}{n_i}.$$

The assumption that  $1-D$  of the overspend on aggregate is met by the non-domestic sector implies that

$$(4) \quad \Delta t_i = \alpha \frac{E_i - E_i^*}{n_i}, \quad \alpha > 0.$$

Substituting equations (3) and (4) into equation (2) and rearranging gives

$$(5) \quad (E_i - E_i^*) (1 - D) - \alpha \frac{E_i - E_i^*}{n_i} \text{RV}_i = \Delta g_i.$$

The assumption of grant neutrality (aggregate grant remains unchanged) implies that the sum of the changes in grant over all local authorities equals zero. In principle, Model 1 allows aggregate revenue support grant to vary by an amount  $\beta$ , although in all of the reported results,  $\beta$  is set equal to 0. This allows us to assess the regional impact of the reforms more accurately (since the regional impact of the taxes necessary to fund an increase in aggregate grant is unclear). Once  $\beta$  is determined, we can solve for  $\alpha$ :

$$(6) \quad \alpha = \frac{(1 - D) \sum_i (E_i - E_i^*) - \beta}{\sum_i \left( \frac{RV_i}{n_i} (E_i - E_i^*) \right)}.$$

In practice, central government will not be able to forecast local authority expenditure accurately in advance, so, as was the case in the 1980s, it will be unable to determine the tax schedule in such a way as to ensure that grant neutrality holds exactly in any given year. However, central government may be able to devise relatively simplistic forecasting rules to ensure that the system is approximately revenue-neutral. In practice, in estimating  $\alpha$ , central government could use lagged values of  $E_i$ , bearing in mind any likely behavioural responses to the incentives generated by the local finance system in that year. In our simulations, of course, we can abstract from these forecasting issues since we know expenditures by local authorities *ex post*. This makes a precise calculation of the required slope of the tax schedule possible.

If marginal grant is sufficiently negative, a local authority may raise more from local taxes than it chooses to spend. In this case, a local authority may receive negative grant. In the 1980s, an increasing number of local authorities found themselves in this position of *grant exhaustion*.

During the 1980s, central government determined that a local authority could not receive negative grant and so simply truncated the distribution of grant at zero. In Model 1, whilst negative grants were permitted in theory in order to preserve full resource equalisation, all local authorities were found to receive strictly positive grants in practice.

***Model 2: full equalisation with equiproportionate tax increases***

An alternative approach to full equalisation is to constrain the increase in both local tax rates to be proportional to the local authority's overspend. Model 2 is very similar in spirit to the system of locally-varying non-domestic rates that operated in the UK prior to 1990. During the 1980s, there was a single local tax rate applied to both domestic and non-domestic sectors.<sup>2</sup> Hence additional local spending led to increases in the local rate poundage in accordance with a 'grant-related poundage' schedule determined annually by central government. In this case, we have

$$(7) \quad \frac{E_i - E_i^*}{E_i^*} = \mu \frac{\Delta c_i}{c}$$

$$\text{and} \quad \frac{E_i - E_i^*}{E_i^*} = \mu \frac{\Delta t_i}{t}$$

With a little manipulation, the multiplier  $\mu$  can be shown to be

$$(8) \quad \mu = \frac{\sum_i [(E_i - E_i^*) (\bar{t} RV_i + \bar{c} n_i)]}{\sum_i (E_i - E_i^*)}$$

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<sup>2</sup> After 1967, the rate poundage actually paid by the domestic sector was lower than that paid by the non-domestic sector by the extent of a centrally-funded scheme of domestic rate relief.

$$= \frac{\sum_i [(E_i - E_i^*) (\bar{t} RV_i + \bar{c} n_i)]}{\sum_i (\Delta t_i RV_i + \Delta c_i n_i)}$$

Hence, under a set of reforms along the lines of Model 2, council tax payers in two authorities with the same proportionate overspend would face the same council tax rate. Similarly, business rate payers in two authorities with the same relative overspend would face the same non-domestic rate poundage. Moreover, the council tax and the business rate would be above the standard rate by the same proportion.

Unlike Model 1, the redistributions of grant between local authorities due to the system of full equalisation embodied in Model 2 led to two high-spending high-resource shire district authorities (both bordering Greater London) becoming grant-exhausted. Although negative grants were allowed in this model, a prohibition on negative grants would have cost the exchequer less than £3 million, compared with a revenue support grant of over £18 billion in England alone in 1994–95.

### A2.3 Partial Equalisation Models

In the two partial equalisation models, we relax the notion of strict horizontal equity and allow the ‘tax price’ of marginal spending in individual authorities to vary inversely with the size of the local tax base. This means that local authorities with large tax bases can set lower tax rates for a given level of expenditure per head relative to SSA than less-well-resourced authorities. Clearly, in such a case, there is a tendency for poundages and tax bases (both domestic and non-domestic) to vary in inverse propor-

tions, *ceteris paribus*. It is this property that is frequently regarded as a drawback to partial equalisation models, since there may be an incentive for businesses to migrate to areas that already have large tax bases. This process of fiscal migration may generate incentives for local authorities to engage in a process of tax competition. This may be inefficient to the extent that it leads to a levelling-down of tax rates. This contrasts with the inability of local authorities to exploit differing tax bases under full equalisation schemes.

Since the full burden of marginal local spending falls on the local tax base under our models of partial equalisation, there are no marginal redistributions of grant between local authorities involved in a move from a uniform business rate to a locally-varying partially-equalised non-domestic rate.

Models 3 and 4 are partial equalisation models in which resource equalisation occurs at SSA only and all local marginal expenditure is financed through local taxation, as at present. The two models differ in their division of the burden of local spending between the domestic and non-domestic sectors in each individual local authority area. In Model 3, the percentage contribution of each sector (domestic and non-domestic) is fixed nationally and applies to each individual local authority area. In Model 4, the proportion of local spending paid for by each sector varies according to the perceived pattern of benefits of marginal expenditure in each local authority area.

### ***Model 3: partial equalisation with fixed proportions***

In Model 3, the share of the burden of local expenditure that falls on the domestic and non-domestic sectors re-

spectively is set nationally and applies to all local authorities.  $1-D$  of the overspend is funded by the business community of each authority, independently of the relative sizes of each sector in an individual local authority.

$$(9) \quad (E_i - E_i^*) D = \Delta c_i n_i$$

$$\text{and} \quad (E_i - E_i^*) (1 - D) = \Delta t_i R V_i$$

The drawback of the approach of Model 3 is that the burden on the non-domestic sector implied by a given value of  $D$  will vary according to the size of the non-domestic tax base. For example, a non-domestic property in the suburbs (where there is likely to be a relatively large domestic tax base compared with the non-domestic tax base) may have to pay a far greater percentage of the total non-domestic sector contribution than one located in a city centre.

#### ***Model 4: partial equalisation with varying proportions***

Model 4 follows an alternative approach to Model 3 in that the proportion of the burden of marginal spending that falls on each sector varies between local authorities according to some measure of the relative benefits of marginal expenditure to each sector. We assume that the number of residents and the number of employees in a given local authority area give an indication of the pattern of benefits of marginal expenditure. The logic behind this approach is that local authorities that have relatively high levels of employment compared with their resident populations<sup>3</sup> are likely to devote a larger fraction of marginal expenditure to services that are primarily of benefit to the

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non-domestic sector. By definition,  $\Delta g_i = 0$  for all values of  $i$ .

$$(10) \quad (E_i - E_i^*) D_i = \Delta c_i n_i$$

$$\text{and} \quad (E_i - E_i^*) (1 - D_i) = \Delta t_i R V_i$$

where

$D_i$  is the proportion of marginal local expenditure financed by the domestic sector in authority  $i$ , i.e.

$$D_i = \frac{n_i}{n_i + E e_i};$$

$n_i$  is the domestic tax base in authority  $i$ , as before;<sup>4</sup>

$e_i$  is the level of employment in authority  $i$ ; and

$E$  is some multiplier to be determined.

The ratio of employment to number of residents may be a far-from-perfect measure of the relative benefits of local services, but the public-good nature of many of these services effectively prevents more accurate hypothecation of the pattern of benefits.<sup>5</sup> The advantage of using employment rather than alternative measures of the non-domestic sector's use of local services is, simply, that it is measured in the same basic units as resident population.

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<sup>3</sup>The 'extreme' example is the City of London, where the daytime inflow of workers is a large multiple of the relatively small number of residents.

<sup>4</sup>This is given by the number of equivalent Band D properties in the local authority area.

<sup>5</sup>See Jackman (1987).

The multiplier  $E$  can be used to introduce a degree of flexibility into the system. Setting  $E$  equal to 0 implies that the full burden of marginal expenditure falls on the domestic sector, as at present. One may believe, on the other hand, that the multiplier should be greater than 1 if employment in the area imposes greater burdens on local services than the resident population does.

Whilst the non-domestic sector in areas with high levels of employment relative to population, such as large city centres, will have to bear a larger share of the burden of local marginal spending than that in other areas, the rate bill of a particular firm will depend only on its rateable value. In this sense, Model 4 is unlike the multi-base tax discussed in Chapter 5 because it is not a tax on employment.

The changes in the council tax and non-domestic rates implied by such a model are respectively given by

$$(11) \quad \Delta c_i = \frac{E_i - E_i^*}{n_i + E e_i}$$

and

$$(12) \quad \Delta t_i = \frac{(E_i - E_i^*) E e_i}{RV_i (n_i + E e_i)}.$$

Equation (12) shows that, like the partial equalisation Model 3 which is described in equation (9), authorities will be able to exploit differing local tax bases to the full in the absence of marginal grant. Revenue support grant is determined completely by equation (1). However, this is compensated for, at least partially, by the fact that higher

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employment implies a higher burden on the business sector.

### A2.4 Summary of the Models Used

Table A2.1 summarises the consequences for the non-domestic sector of the four models.

In addition, we can derive a number of connections between these models. If  $D_i = D$  for all values of  $i$ , then Model 4 corresponds to Model 3. If  $RV_i/n_i = k$ , where  $k$  is any constant, then Model 1 and Model 3 are equivalent.

An evaluation of which of these models would be preferable is complicated since we only have rather weak priors as to the incentives that may arise within each system. Moreover, we have only very inexact measures of the benefits that the non-domestic sector derives from average local spending and none at all of the benefits of marginal local spending.

TABLE A2.1

**Comparison of the four models of locally-varying non-domestic rates used in Chapter 4**

	<i>Increase in non-domestic tax revenues as a proportion of a local authority's total marginal expenditure</i>
Model 1	$(1 - D) \left( \frac{\sum_i (E_i - E_i^*)}{\sum_i \left( \frac{RV_i}{n_i} (E_i - E_i^*) \right)} \right) \frac{RV_i}{n_i}$
Model 2	$\frac{\bar{RV}_i}{\bar{RV}_i + \bar{c} n_i}$
Model 3	$1 - D$
Model 4	$1 - D_i$

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