A TAXING PROBLEM

REFORMING BUSINESS RATES IN ENGLAND

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EXECUTIVE SUMMARY

The UK's current business rates system is not fit for purpose – it is unfair, inefficient, and overcentralised. In this paper, we propose a new business rates system that combines a land value and a business property tax. Our proposed system is fairer, more efficient, and gives more control to local authorities.

The current business rates system faces three deep-seated, overlapping issues.

First, they are **economically inefficient as they tax economically productive activity at the same rate as unearned increases in land value**. Improving a property leads to an extra tax liability, which effectively discourages property improvements.

Second, the **system of redistributing tax revenue between local areas allows a few local authorities to gain from runaway growth while leaving others short** of the cash they need to provide vital services. Meanwhile, Metro mayors, combined authorities, and the local government sector have been given greater responsibility and democratic accountability without greater tax raising and/or spending control powers.

Third, while local authorities **remain chronically underfunded, the current system does not redistribute enough to those who need it**. Between 2009/10 and 2019/20, local authority core spending power was reduced by 16%[1] and recent funding increases only plugged urgent gaps. The unfairness of the current retention system means that the overall pot of funding from business rates is misallocated, with poorer councils only protected if their business rates income in a given year falls by more than 7.5%.[2] This means that essential local services face reductions in poorer councils, while wealthier ones are allowed to benefit disproportionately.

We test our proposed new system with an illustrative revenue-neutral modelling of the following rates and policy parameters:

- **Replacing business rates with a two-rate property and land tax.** We set a higher rate of 54% on commercial rental land values, levied on land owners, and a lower rate of 35% on rental property value, levied on the occupiers of commercial property. After initial implementation, we propose that local councils are given discretion over rates on commercial property, on a similar basis to council tax today, while the central government retains control over the rates on land value.
- **Redistributing local government taxes.** We propose that business property taxes be retained locally on a similar basis to council tax, but that land value revenue be redistributed across the country according to need. This simplifies the system overall with the complicated business rates retention system no longer required.

- **Phasing in the new system**. With the Covid-19 shock followed by the energy shock and the cost of living crisis, these reforms should be gradually introduced to avoid sharp changes in bills for businesses and local government funding.

Our illustrative policy modelling shows that replacing business rates with a two-rate system would yield the following benefits:

- **Increased economic efficiency**: Increasing taxes on windfall gains from land ownership while reducing taxes on building and improving commercial property would increase the economic efficiency of taxation. Extending land value tax to unused land (based on best-permitted use) and removing empty property reliefs would incentivise more efficient use of commercial land and buildings.
- **Improved fairness for businesses**: With a higher tax rate on the share of rateable value attributable to land value, the rate on property could be set substantially lower than current business rate multipliers. This means that businesses would see liabilities from investments and improvements that increase commercial property values.
- **A fairer distribution**: With a higher tax rate on land and land value concentrated in wealthier areas, particularly London, the new system supports levelling up by reducing overall tax levels outside of London. Around 75% of local areas outside of London would see an overall fall in their business rates. Runaway growth for the richest councils is also reduced under the NEF system, as councils would retain only the growth in the property tax – a significantly smaller share of rateable value in wealthier areas with high land values – allowing for greater redistribution within the system.
- **Increased local authority control**: Local authorities would be given control over business property tax on a comparable basis to council tax, which would mean far greater control compared with business rates today. This would provide increased control over local taxation, reducing reliance on Whitehall overall. It should also come with greater control over local reliefs and exemptions, allowing councils to better target incentives at particular activities, such as revitalising high streets and supporting environmentally friendly investment, balanced with the ability to set higher rates otherwise.

1. INTRODUCTION

At the heart of dysfunctional local government finance sits the business rates tax regime and the business rates retention system (BRRS – the mechanism by which business rates are distributed to fund local services). Business rates are not considered fit for purpose by either businesses[3] or local governments.[4] There are three deep-seated and overlapping issues: (1) as a tax on businesses, rates are considered unfair and inefficient; (2) the retention system does a poor job of allocating funds to needs, worsening the chronic underfunding of local authorities; and (3) the current centralised system does not deliver on the devolution agenda, leaving unresolved tensions between greater local responsibilities and control, and equitable redistribution of resources.

In October 2021, the government published the final report of its business rates review. The Treasury's proposals for longer-term reform centre on more frequent revaluations (every three years), new reliefs for property improvements, and specific measures to support green investments but stop short of setting out a more fundamental reform.[5] Business rates were in large part suspended during the pandemic, and subsequently, the energy prices shock has led to a further round of relief. Additional reliefs provide temporary mitigation for businesses, but they also delay the fundamental reform that is needed to put the system on a more sustainable footing in the longer term.

Meanwhile, local government funding also remains in crisis. The 2010s saw the government cut funding for local authorities at precisely the same time that their responsibilities increased making it more difficult for local authorities to provide services and create thriving local economies.

The UK is among the most politically and fiscally centralised of the OECD[6]. Local government in England has very limited revenue-raising powers – every other G7 country collects a higher share of tax at a local or regional level.[7] Power cannot be meaningfully devolved without increased control by local decision makers over local taxes and investments that are most needed in their local areas.

Numerous recent reviews have examined local tax reform.[8,9,10,11,12] Many have considered a land value tax (LVT) as an option to replace business rates, council tax, or both. The theoretical benefits include supporting investment and productive activity, providing a means for recovering unearned windfalls from collective development and encouraging efficient land use by creating fewer incentives for developers to hoard undeveloped land.[13] However, these proposals focus only on the efficiency of the tax but do not address the trade-offs associated with the retention and redistribution mechanisms that balance greater devolution with the need for fairer redistribution between local authorities.

This report focuses on how business land and property taxation might be reformed to enhance fairness and efficiency for businesses, improve the distribution of local government finance, and be more decentralised, *in the same system*. We present a replacement for the current business rates tax regime and the BRRS, with a system of two-rate taxation and a simplified mechanism to allocate funds for redistribution with greater local control.

2. THE CASE FOR REFORM

There are three major issues with the current business rates tax and redistribution system: an inefficient tax design, its contribution to the local authority funding gap, and a flawed and complex redistribution system.

2.1 INEFFICIENT TAX DESIGN

Business rates account for just under half of locally collected taxes, amounting to £24.3 billion in England in 2019/20.[14] Business rates are a property tax levied mainly on commercial properties and are calculated based on a property's rateable value, which is roughly equivalent to the amount of annual rent for that property (rental value, calculated by the Valuation Office Agency). A multiplier is applied to the rental value to calculate the amount of tax due. Rateable values up until 2022/23 were based on rental estimates from 1 April 2015 (which came into effect in 2017). After several delays relating to the Covid-19 pandemic, the latest revaluation based on values as of 1 April 2021 came into force on 1 April 2023.[15]

The multipliers are adjusted each year in line with inflation (CPI), although in the aftermath of the Covid-19 pandemic, the government froze the multipliers for four consecutive years.[16] If the rateable value of the property is more than £51,000, the standard multiplier applies, which was 50.4% in 2019/20 (ie the tax bill was 50.4% of a given property's annual rent value). If the rateable value of the property is less than £51,000 but above £15,000, the small business multiplier applies, which is 49.1% (ie the bill is 49.1% of its annual rent value).[a] Properties with a rateable value below £12,000 are exempt from business rates, and those with values between £12,001 and £15,000 receive relief on a sliding scale applied to the small business multiplier.

At revaluations, the multiplier is reset such that *aggregate* tax receipts do not increase by more than the value of inflation (although revaluations by necessity mean that some businesses face increased bills and some decreased). This makes business rates unusual, as increases in the tax base that come from higher asset values (as captured through periodic revaluations [b,17]) do not directly increase the aggregate tax take in real terms, but instead, the government adjusts the tax rate (the multiplier) to deliver an expected level of tax yield.[18] However, the base can rise and fall as new properties are added or fall off the system, or through changes to the system of reliefs and allowances.

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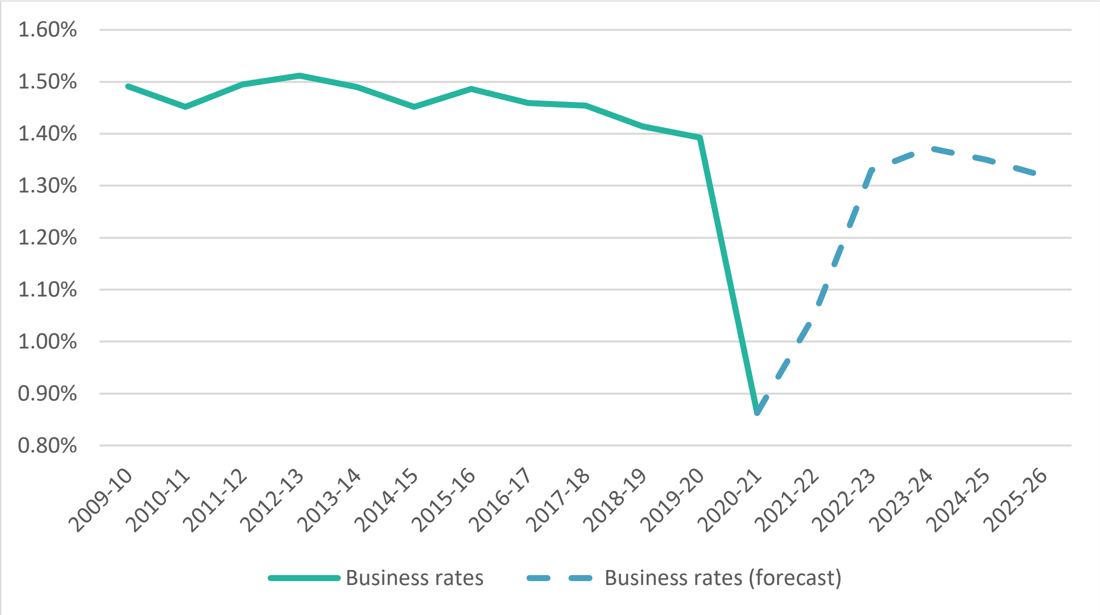
[a] Since 2020/21, the standard multiplier has been frozen at 51.2% and the small business multiplier at 49.9%.
[b] The Treasury states that revaluations are done "to maintain fairness in the system by redistributing the total amount payable in business rates, reflecting changes in the property market".

Business rates revenue as a proportion of GDP has been falling over previous decades, (from 1.8% in 1990 to 1.4% just ahead of the pandemic in 2019/20[19]). As shown in Figure 1, it is projected (after a post-Covid-19 rebound), to slowly continue falling in the coming years. Following the recent energy crisis and ongoing high prices that hit many firms extremely hard,[20] and amid projections of prolonged economic stagnation,[21] even those forecasts may prove optimistic, if more businesses fail or scale down (thus reducing tax revenue).

Figure 1: Business rates income has been gradually declining as a proportion of GDP

Annual business rates current receipts as a proportion of GDP, historical and forecast, 2008/09–2025/26



Source: IFS, Composition of UK revenue.[22]

However, business rates revenue in aggregate rose by a third in real terms between 1999/2000 and 2019/20,[c] likely driven by the increase in the number of taxable properties: between 2000/01 and 2018/19, the number of businesses nearly doubled[23] and the number of properties subject to business rates grew by 19%.[24]

Business rates contain a complex system of allowances and reliefs. During the Covid-19 pandemic, the government effectively suspended much of the system by introducing 100% rate relief for the sectors most impacted by social distancing. Besides the pandemic measures, notable reliefs include the following:

- Small business rates relief – applies to businesses in properties with a rateable value less than £15,000 and who only use one property.

[c] Author's calculations using IFS. (2022). Composition of UK revenue, and ONS. (2022). GDP deflators at market prices, and money GDP.

- Charitable rate relief – provides an 80% discount if a property is used for charitable purposes.
- Empty buildings relief – allows property owners not to pay business rates on empty buildings for the first three months a property is unoccupied, or for six months for industrial premises (such as warehouses).
- Retail, hospitality, and leisure relief (an extension of Covid-19 pandemic support) – provides up to 75% discount for qualifying types of businesses in 2023/24, up to a total value of £110,000 per business.[25]
- Certain properties are also exempt from business rates altogether; for example, agricultural buildings.

Business rates have been criticised for a range of reasons and they are highly unpopular with those who pay them.[26] Two key criticisms: (1) the recent revaluation led to unfairly sharp changes to bills and, (2) the tax itself unfairly discriminates against businesses that need a brick and mortar presence.

- **Sharp changes in bills for some businesses due to revaluations**. The 2017 revaluation led to very large changes for some businesses, particularly in London and the south-east. In London, rateable values increased overall by 24%.[27] In some areas and sectors, however, rateable values did go down on average. For example, in the north-east, overall rateable values went down by 0.9%. In the retail sector, nationally rateable values went down by 6.5%.[28] The low frequency with which valuations occur can lead to sharp changes in bills. Business properties were meant to be revalued every five years (which the government now proposes to reduce to every three), but recent revaluations only occurred three times in the past 14 years: in 2008, 2015 (effective from 2017), and 2021 (effective 2023).
- **Discrimination against brick and mortar businesses compared to online businesses.** Online businesses typically face lower business rates as they have less need for physical premises, unlike traditional retailers. Critics also note that businesses can pay proportionately much lower rates on large warehouses in low-valuation areas, compared to high-street retail businesses.[29] In response to those concerns, the government ran a consultation on a potential online sales tax,[30] although this idea met with business criticism,[31] and the government ultimately chose against pursuing it.[32] This has, among other factors, been blamed for contributing to the decline of high streets, despite the introduction of reliefs to support high-street retailers. This criticism, however, can be overstated. The pressure on the retail sector has been intensifying for over a decade as consumer expenditure on high streets falls. While business rates are paid statutorily by businesses, economic theory and the available evidence suggest that the tax incidence largely rests on landlords. Landlords charge the maximum amount the market can take allowing for businesses having to

also pay the tax. If business rates were abolished, we would expect landlords to increase rents.[33] The limited empirical evidence on the topic suggests that, in the retail sector, the majority of the burden falls onto landlords,[34] with an analysis of commercial rents in London finding that in boroughs with net increases in taxes, rents fell by similar amounts, and vice versa.[35] The British Property Federation similarly found that there is a lagged relationship between changes in rates and the level of rents, with the impact from tax bill changes largely passed on from occupiers to landlords after three to four years (through correspondingly higher or lower rent subsequently paid).[36]

Business rates are a tax on economically productive business activity. As such, they lead to an overall fall in business activity. Raising tax rates on property infrastructure increases the cost of using these properties and reduces prospective yields for owners and developers. This induces a fall in businesses occupying these properties and production.[37] This deadweight loss, however, can be more than offset by the benefits of investing those tax receipts into public services.[d]

Local authorities also criticise the tax.[38] A particular concern is that business rates policy is set by central government and administered by local government. Authorities cannot set their rates and therefore have little control over their receipts. The only way they can increase revenue is by encouraging businesses to set up in their local area. The business rates retention system (BRRS) (whereby revenue collected locally is redistributed among authorities) is also extremely complicated, reducing transparency and benefitting some councils disproportionately.

2.2 THE FUNDING GAP

Despite additional funding announcements in last year's Autumn Statement, the Institute for Fiscal Studies (IFS) estimates that local authorities will still be far short of their 2010 funding levels.[39] Councils' spending power, excluding health and social care, was reduced by about 25% in real terms between 2010/11 and 2015/16. Spending power was still 25% lower just ahead of the pandemic in 2019/20.[40]

The Local Government Association (LGA) estimates that English councils, in the context of high inflation, face a funding gap of at least £3bn over the next two years just to keep services standing still. This is likely to be an underestimate as it assumes that all councils will increase their council tax rates each year by the maximum rate allowed without a referendum.[41] Councils also face the threat of more austerity after 2024/25 when the current

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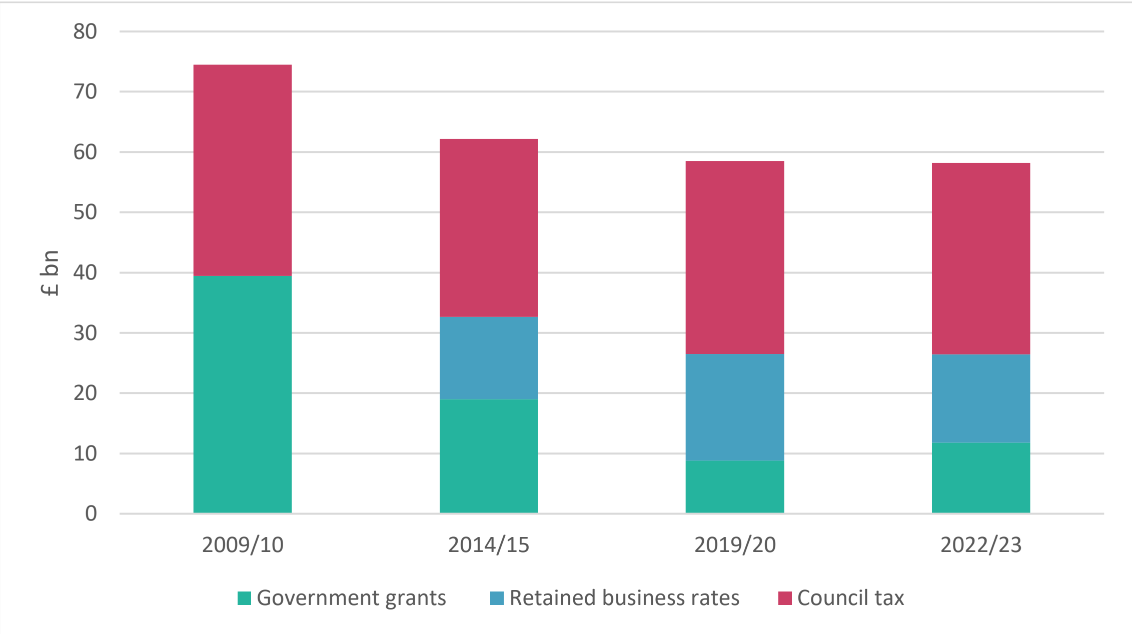
[d] Note that this argument considers the effect of the tax in isolation. In reality it should be considered in the full context of the use of the tax, and losses may be offset by other social or economic gains elsewhere.

government plans envision another round of cuts to public spending. This is likely to prove even more devastating if inflation settles at the Bank of England target of 2% rather than the government's assumptions of a deflationary dip.[42]

Previous analysis by NEF has shown how between 2013/14 and 2019/20, a large portion of central government grant funding was effectively replaced with local business rates income, which is redistributed nationally through the business rates retention system.[43] However, the overall amount of unrestricted money available to local government has been falling (Figure 2). Government non-ringfenced grant funding to councils was cut by 86% from £32.2bn to £4.5bn in 2019/20 prices by 2019/20, while the amount councils were allocated from business rates under the Settlement Funding Assessment was only £14.6bn for the same year.[44] Council tax (the other main source of local government income) rose marginally ahead of inflation over the same period, but this was not sufficient to fully cover the loss of the central government grants.

Figure 2: Local government funding has fallen significantly since 2009/10 levels

Unrestricted local government funding, including public health grants, 2009/10–2022/23, £ billion, 2022/23 prices



Source: NEF calculations using MHCLG, DLUHC, and HMT.[45,46]

Note: Grants include compensation for under-indexing business rates multiplier, public health grants, revenue support grants, other core spending power grants and equivalent funding under the 2009/10 system. Excluding the one-off 2022/23 local services grant and other government grants. Retained business rates reflect baseline funding level (including higher retention pilots). Council tax reflects core spending power.

The current business rates tax system compounds this local government funding shortfall. Within the fixed pot of money raised from business rates and allocated as local government's share, the current system exacerbates funding inequalities – giving relatively more money to richer local authorities.[47] Addressing this should be a priority for local tax reform.

2.3 FLAWED AND COMPLEX (RE)DISTRIBUTION SYSTEM

Local authorities have very different abilities to raise revenue from business rates, based on a range of historical, geographical, and other socioeconomic factors. And a council's revenue-raising ability from business rates is not related to the amount of social need.

In recognition of this, the current system redistributes local taxes through the BRRS. The majority of business rates income is redistributed subject to relative need through a complex system of tariffs and top-ups, where need is calculated according to a complicated formula. However, it allows authorities to retain a proportion (up to 50% under the current system) of the *growth* in their business rates, meaning that a small number of councils gain from runaway growth in business rates income at the expense of most local authorities. The system overall, brought in, in 2013/14, was supposed to be reset in 2020/21,[48] where all relevant baselines (relevant for calculating growth) would be recalculated; however, this has been subject to repeated delays.[49]

The government's policy on whether to increase the proportion of locally retained rates from the current 50%[e] to 75% remains unclear (having abandoned earlier plans for 100% retention). Michael Gove, as then Secretary of State for Levelling Up, Housing and Communities, previously indicated that in light of the Covid-19 impacts and the need for redistribution, those plans were likely to be shelved.[50] Most recently, while keeping the 50% system in place alongside several higher retention pilots, the government shifted to promising 100% retention of business rates specifically for mayoral combined authorities "in the next Parliament".[51]

Previous modelling by NEF before the Covid-19 pandemic suggested that a move to 75% retention would lead to just under two-thirds of authorities seeing their income fall over the first few years of the new system, while a few authorities would see a runaway growth in their retained incomes. The City of London would see a growth rate of over 100%.[52]

The move to retaining a proportion of business rates income growth has not meaningfully increased control over a significant proportion of additional income for local councils overall. To show this, we divide business rates revenue into three parts:

- **Growth in local business rates income retained locally.** A proportion of the growth in business rates (up to 50% in the baseline system, subject to a levy on excess growth, with several pilots of higher retention of 75% or 100%) is retained locally.

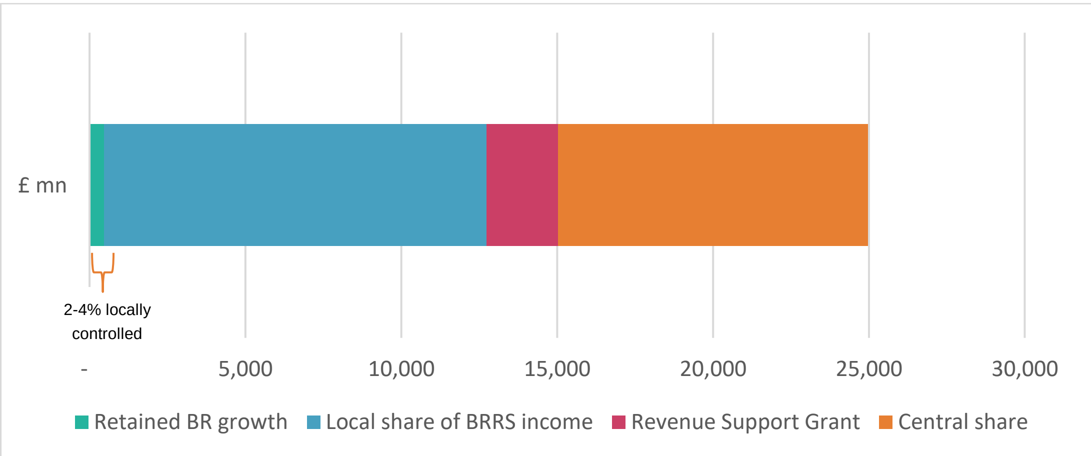
[e] Although some local areas are piloting higher levels of retention currently, we refer to the current system as 50% retention.

- **The central share**. A proportion is passed to central government (currently 50%, which would decrease to 25% under 75% retention or 0% under 100% retention), for funding other grants to local authorities. It is important to note that corresponding increases in the local share (should we move to 75% or higher retention) do not imply any extra revenue for local authorities upon initial implementation, as the central government maintains revenue neutrality by reducing other central government grants for councils with higher retention by the equivalent amount. Thus higher retention only effectively influences the share of future growth that local authorities get to keep above the baseline.
- **The local share redistributed across local authorities.** Although it is not always presented as such, the remainder of the local business rates share is redistributed across authorities. Local authorities are said to retain 50% of business rates in aggregate. The bulk of revenue is subject to central government redistribution through a system of baseline funding levels, tariffs, and top-ups before taking into account growth in business rates income. It also guarantees that revenue will be further topped up if it falls below a certain safety net threshold (currently 92.5% of baseline need), paid for through the levy on growth in business rates.

We argue that it is only over the first proportion that local councils have meaningful control in that it is not set by a central government formula (Figure 3).

Figure 3: Local government has a degree of control only over approximately 2%-4% of business rates collected

BRRS modelled as 50% retention (disregarding pools and adjusting for pilots with higher retention arrangements), with retained growth in the 2019/20 financial year, after deducting the central share and the levy where applicable)



Source: NEF analysis.[f]

[f] BRRS modelled as 50% retention disregarding pools and higher retention pilots , with RSG set so the overall total equals the 2019/20 Settlement Funding Assessment. Estimated retained growth in a single financial year, 2019/20. Council tax including parish and adult social care precepts.

Under the current system, only approximately 2%-4% of locally raised revenue from business property taxes (BPTs) is under what we would define as truly retained local control,[g] ie revenue raised locally with no chance of it being reallocated or redistributed to another place as a result of a central government formula.

In reality, therefore, only a proportion of the growth in business rates is fully retained locally. Local authorities also have no control over the formula which determines what constitutes 'growth' in their business rates, or over the specifics of the levy system. This also comes with a surprising insight that moving to a higher retention amount in aggregate will in fact not increase the proportion retained locally, because business rates growth is relatively small as a proportion of total business rates.

[g] Annual locally retained growth (the locally controlled share) varies as a share of total BR revenue, since it tends to increase year-on-year until a system is reset, which reallocates all revenues again adjusting for increases/decreases in local tax revenues and assessed local needs.

3. PRINCIPLES FOR BUSINESS RATES REFORM

Business rates need reform. They are unfair and poorly designed, notwithstanding the fact they are insufficient to sustainably fund local government. The government must replace the unfit-for-purpose tax and redistribution system.

We set out the following key principles we think tax reform should achieve:

- ***Improve economic efficiency.*** Reform should incentivise investment in productive assets while taxing economic rents resulting from mere ownership of land.
- ***Improve the progressivity of local taxes for taxpayers***. Business rates are criticised by many as being unfair for taxing businesses that are more reliant on property and the use of physical premises than others. A reformed local tax system should be fairer by reducing the burden on commercial property and improvements.
- ***Distribute resources more equitably between local places***. Different places have very unequal resources and needs. Furthermore, the link between need and ability to raise income through property taxation is weak – some of the areas with the highest need have the lowest revenue-raising capability.[53] The tax system should support levelling up by ensuring that resources are distributed between local places so that all local councils are able to meet the needs of local taxpayers and that more deprived councils do not lose out.
- ***Give councils more meaningful control over locally raised taxes.*** Local government should have a greater role in setting local tax rates. International evidence suggests that devolution can have positive effects on economic development.[54] Government efficiency may also improve because greater responsibility to generate funds increases the effectiveness of spending.[55]
- ***Improve the long-term financial sustainability of local government*. A** fully reformed system should aim to ensure that, at minimum, councils can provide existing statutory duties, obligations, and services at pre-Covid-19 (2019/20) levels of access and quality. This requires that revenues raised from local taxes are redistributed more fairly to match local needs.
- ***Improve the simplicity and transparency of the system.*** Business rates are complex and hard to understand. Any reform should simplify the system, making it clearer to councils and taxpayers how rates have been determined, and how revenues will be distributed.

There are trade-offs between some of these principles; reform needs to strike a balance between conflicting goals. Designing a system that gives places more control over the revenue they raise and how they raise it could lead to more inequality between local places.[56] By contrast, a system where all local government income is fully redistributed according to need would ensure a more equitable distribution of funding but would reduce local government autonomy and incentives to grow the tax base.

The recent trailblazer devolution deals for Greater Manchester and the West Midlands offering 100% retention for 10 years exemplify such trade-offs.[57] While they promise greater benefits to those regions from local growth in receipts (alongside greater risks from revenue falls, unless still offered a safety net by the central government), if such an approach was rolled out more widely, it would still end up concentrating benefits among the most prosperous localities, while removing a portion of funding for redistribution to poorer councils, thus replicating the main problem of the current system unless otherwise balanced by central government grants funded from other sources. Given such trade-offs, any reform needs to strike a balance in reconciling these goals.

4. A TWO-RATE TAX ON LAND AND PROPERTY

Our proposed business rates system combines both the value of the land and the value of physical capital improvements (buildings, machinery or infrastructure), into a single unit for taxation. In effect, the current lack of differentiation means that land is taxed at the same rate as the improvements upon it.

This chapter sets out the theoretical economic case behind taxing land higher than property, and why a split rate land-property tax with land taxed at a higher rate would be a good solution for England's local tax reform.

4.1 THE ECONOMIC CASE FOR TAXING LAND

A land value tax (LVT) would be superior to our current property tax system, both from a social justice and an economic efficiency perspective. Land is intrinsically different from other factors of production – it does not obey the normal rules of supply and demand. Land, as a permanent natural resource, has no cost of production and is in fixed and finite supply.

It is the location of a plot of land that determines its value, not any effort on behalf of the owner. As such, taxation of land is taxation of economic rent: a tax on unearned surplus accruing to landlords simply due to holding land in a certain location. Taxing land does not reduce its supply, unlike other factors. For these reasons, economists since the eighteenth century have recognised land as a distinct factor of production, separate from capital and labour, and have been calling for its taxation.

Taxing land value has several theoretical benefits:

- It taxes economic rent deriving from merely owning a natural resource, and not productive activity such as investment in new business infrastructure. It is therefore economically efficient as it does not deter the production of land.
- It allows society to share in gains of collectively produced wealth, by taxing locational value that land acquires from the surrounding community, including public infrastructure and the concentration of business activity in its proximity. An extreme example of this is the London Underground Jubilee Line extension through south and east London, which is estimated to have raised the aggregate value of land around the stations it connects by up to £10bn.[58]
- It discourages speculative land holding and encourages development, as land owners are incentivised to support the most efficient use of their land to recoup their tax bills through rents. Land hoarding for later use or sale becomes more expensive despite possible appreciation of land value over time with an LVT.

Criticism of LVTs is overblown. One criticism is that it could disincentivise landlords and developers from applying for permission to develop land. While it is true that the supply of land is not quite perfectly fixed due to planning regulations, there is still a strong incentive to bring land forward for development given the large gains available from converting land as shown in Table 1.

Table 1: Range of values per hectare for a comparable site across England in 2019.

	Range of values
Agricultural land	£16,000–£26,000
Industrial land	£135,000–£6mn
Commercial – edge of the city centre	£865,000–£480.7mn
Commercial – out of town	£175,000–£8.25mn
Residential land	£370,000–£161.5mn

Source: MHCLG policy appraisal estimates.[59]

Furthermore, the available research shows that LVTs lead to an increase in economic efficiency. Oates and Schwab, for example, find that nonresidential construction in Pittsburgh received a boost from two-rate taxation of land and property during the 1980s.[60] Plassmann and Tidemann found similar effects with a two-rate tax in Pennsylvania brought in between 1972 and 1994.[61] This is in line with economic theory, which suggests that a lower tax rate will lead to an increase in activity,[62] encouraging an increase in capital/land ratio, ie greater capital investment for a given land parcel.[63]

The government and local authorities should take steps to ensure that a partial LVT improves economic efficiency. They should monitor the impact of an LVT on planning applications to assess whether it results in a reduction in development applications while ensuring essential development is not impeded. To discourage conversions from commercial to residential property motivated by tax reasons (that would allow landowners to avoid the LVT), which would reduce the availability of rental space for businesses and drive up rents, the government should also consider introducing a commercial-to-residential transfers levy.[64]

Lastly, councils have been calling for powers to take action on unbuilt land with planning permission,[65] including the ability to charge council tax on approved but unbuilt developments.[66] Such reform, combined with a commercial LVT, based on best permitted use, would ensure that land awaiting development is taxed, disincentivising land holding as an asset.

4.2 SPLIT-RATE PROPERTY TAXATION

An LVT implies a substantial change to the taxation system. It has not been implemented due to real and perceived political and technical challenges. The current system fosters a sense of unfairness but there is little consensus on how it should be changed. And any changes would create winners and losers.[67] As such, introducing separate taxation of land as part of a two-rate system – with different rates of tax on land and property – has several advantages.

First, by clearly delineating between rates charged on economic rents derived from land ownership, and rates charged on business investment, a two-rate system with a higher rate on land value enables a more efficient tax system while also addressing the shortcomings of a single rate 'pure' LVT.

Second, by retaining a property tax element, the tax avoids revenue leakage and ensures that the tax system captures shifts in relative land and property values, which would smooth the transition and reduce the volatility of those relative values.

Third, the shift from the current system is more iterative, reducing the inherent risks that lie with a major reform, no matter how desirable that reform may be. It reduces the scope of potential losses to those who lose out from the reform.

Fourth, it means that the legal incidence is split between businesses and landlords. This is fairer as both gain a benefit from the property. Such a system of split taxation, where both commercial landlords and occupiers pay a share of tax, has been successfully introduced in the Netherlands (albeit on overall property valuations rather than on land and buildings separately), with landlords typically paying the higher share (56% on average).[68]

Local taxation is often thought of as a service tax, levied for the provision of local amenities, services, and infrastructure.[69] LVTs as we have described levied on landowners (who may not live locally) to capture the uplift in value resulting from the provision of these local infrastructure and services, are better thought of as a wealth tax.[70] A two-rate tax, levied at different rates on land and property, with occupiers paying the property tax, can make this clearer and be considered fairer, as those benefiting from services are directly contributing to them as well while the wealth tax proportion is redistributed.

5. REFORMING BUSINESS RATES: NEF'S PROPOSAL

In this chapter, we set out how to reform local government finance by replacing business rates with two new taxes: a land value tax (LVT) and a business property tax (BPT).

This proposal addresses the current failures in the system: an inefficient and unfair tax design, a flawed and complex 'retention' system leading to the unfair redistribution of revenues, and a lack of local government control over local taxes.

Our proposal does so by separating taxes charged on economic rents from taxes on land ownership, business property, and investments: We propose higher rates on the former and lower on the latter. It also introduces a new, far simpler system for redistribution that better matches funding to need and increases local control, by redistributing all proceeds from the LVT centrally according to need and BPT retained locally in full.

5.1 REPLACING BUSINESS RATES

We propose that business rates be replaced with a two-rate tax on land and property, with land taxed at a higher rate than property. We propose to advance the fiscal devolution agenda with this proposal as all taxes on business buildings are retained by the relevant authority, but the revenue from the land value share of the tax is redistributed according to need (taking into account the ability to raise revenue from both council tax and business properties).

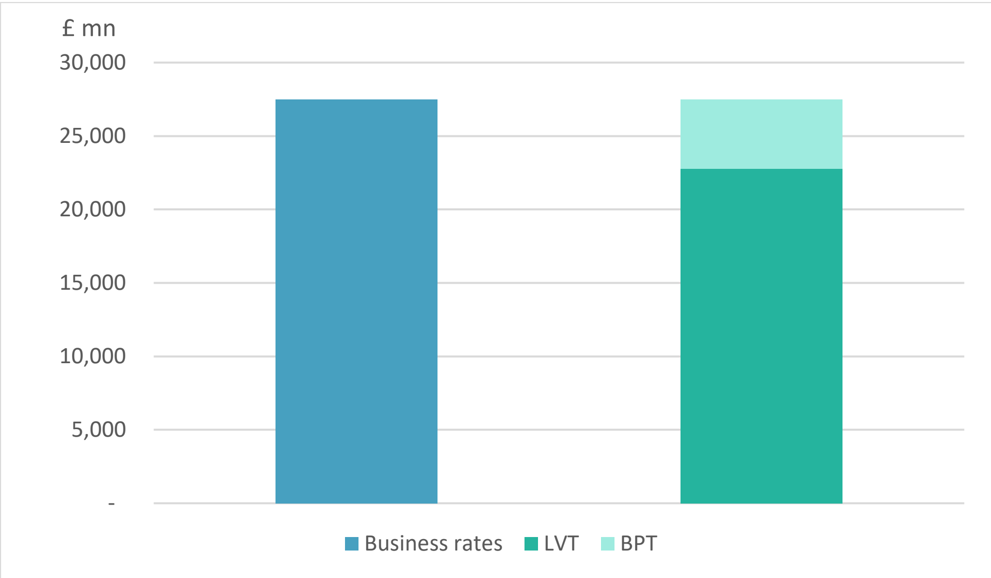
1. **Land value tax:** Land under commercial property, or with the best-permitted use being industry and commerce, would be subject to an LVT levied on the owner of the property, as opposed to businesses. Importantly, land under empty commercial property, and vacant/undeveloped land would be taxed as well, encouraging its more efficient use. Land value would be assessed by deriving a share of rateable value attributable to a parcel's location, and not the value of the structures on top of it.
2. **Business property tax:** We also propose a BPT levied on businesses renting premises. This tax would be based on a proportion of rateable value attributable to the property alone, excluding the value of the underlying land. Modelling done previously by Humphreys et al. suggests that the value of property is typically less than half of total rateable value; on average about 25% and as little as 10% in London where land values are very high.[71] This means that businesses would pay tax on what would typically be a much smaller proportion of overall rateable value than the owners of commercial property.

In our modelling, we test the results of a two-rate system compared to the baseline scenario of 50% business rates retention (adjusting figures for higher rates retention pilots for better comparability). Given the very significant disruption caused by the impacts of Covid-19 and significant uncertainty about the long-term impacts, we base the analysis on five years of data up to 2019/20 (inclusive), the last financial year before the pandemic. We set a rate of 35% on commercial property to be the same as the original business rates multiplier in 1990, and the 54% rate on land. These rates are chosen to be revenue-neutral and could be lowered or increased with the obvious implication that revenues would correspondingly fall or rise. This compares with business rates multipliers of 49.1% and 50.4% in 2019/20 (and 49.9% and 51.2% at present) for businesses in properties with a rateable value below or above £51,000, respectively.

Our rates are illustrative only and would be at the discretion of policymakers: the LVT would be set nationally while the BPT would be set locally.[h] We preserve the same allocation for rates reliefs and discounts as in 2019/20.[i] Local government should be given greater control for shaping economic activity through targeting discounts and incentives as part of controlling local BPT rates, balanced with the ability to set higher rates otherwise. This greater control over local rates could be used to, for example, help revitalize high streets and encourage environmentally friendly business investment with local BPT exemptions.

Figure 4: Revenues from business rates compared to revenues from proposed BPT and LVT

Single financial year figures, modelled for 2023/24



Source: NEF analysis using MHCLG, ONS, OBR various and Corlett, Dixon, Humphrey & von Thun (2018).[72,73,74,75j]

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[h] To limit variation and an undesireable race to the bottom, central government may want to establish a range for BPT within which local authorities could set a rate.
[i] We suggest that whether current discounts and reliefs are preserved or abolished should be determined in consultation with relevant stakeholders including local leaders, business groups, and landlords.
[j] NEF analysis using sources cited in the endnote 72-75. See the Appendix for further details on the methodology.

5.2 FISCAL EFFECTS ON LOCAL GOVERNMENT

Table 2 shows the revenue raised by our policy compared to the existing system. Our proposal was calibrated to be revenue-neutral, maintaining the same central share of rates kept by central government and the same local share that is kept locally or redistributed. Fixing the relative central and local shares in line with modelling the BRRS system (50% retention) in 2023/24, we estimate a central share of 40% of total taxes raised under both systems.[k] This implies that 49% of the LVT is returned to central government while 51% is redistributed locally. In addition, the entire BPT is kept locally.

We have chosen these modelling parameters to allow for an easier and closer comparison between our system and the current ones. Both the rates and the amount returned to central government could be altered in practice.

Table 2: Comparison of aggregate revenues distribution of 50% business rates retention and NEF proposal, 2023/24

BRRS modelled as 50% retention (adjusting figures for pilots with higher retention arrangements). NEF proposal is modelled as a two-rate tax with a 54% rate on land and a 35% rate on property (buildings and structures). Figures adjusted in line with non-domestic rating income collectable rates tables. Both systems preserve the share of rate discounts and reliefs as of 2019/20. Modelling on an illustrative basis of rateable value growth rates from 2019/20 to 2023/24 following the trend of the last five years preceding Covid-19 to adjust for the pandemic-induced variability and uncertainty in valuation changes.

Business rates with 50% retention	**£ bn**	**NEF proposal**	**£ bn**
Total revenue (business rates)	27,507	Total revenue (LVT + BPT)	27,507
of which		**of which**	
Central share	11,077	Central share (part of LVT)	11,077
Local share	16,430	Local share	16,430
of which		**of which**	
Locally retained growth	947	Locally retained BPT	4,739
Redistributed business rates and RSG	15,483	Redistributed LVT	11,692

Source: NEF analysis.[l]

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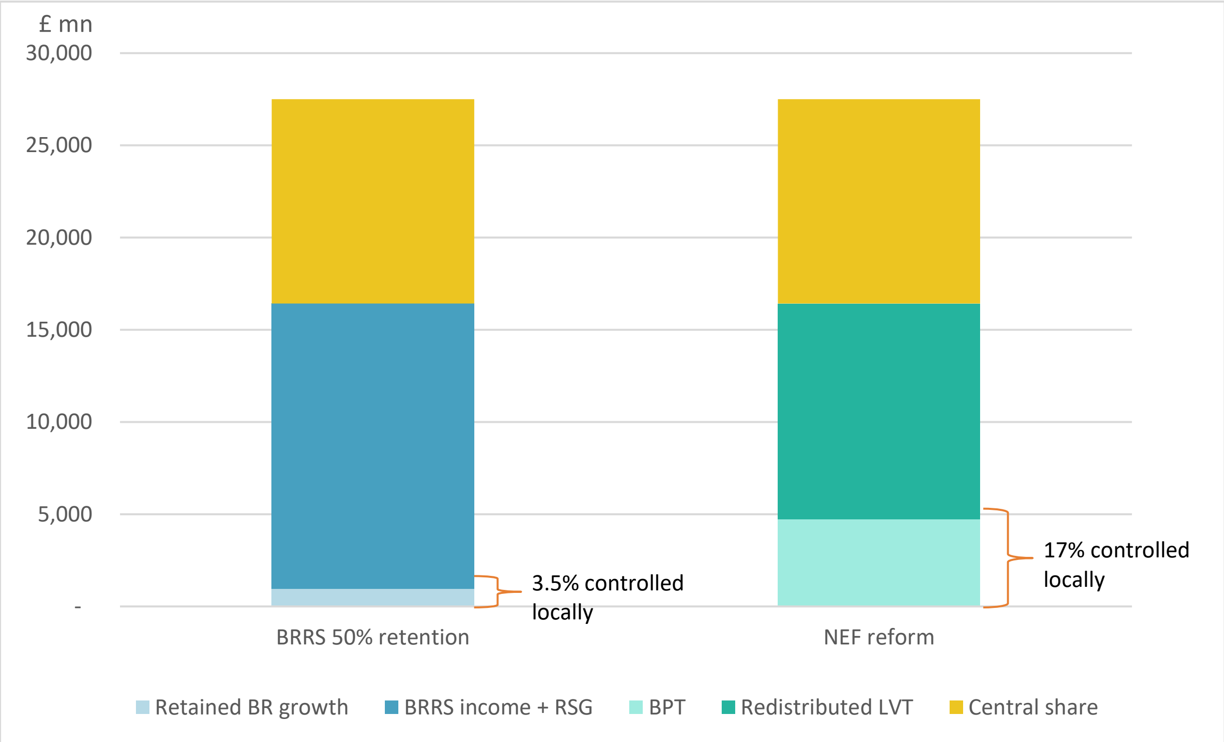
[k] This reflects the fact that in addition to 50% local share, under the current system councils also receive Revenue Support Grant funded out of business rates and a proportion of local growth in receipts above the baseline if they experience any. In line with the revenue neutrality to the central government, we assume that a sufficient proportion of LVT revenue is redistributed to equal that overall local share.

[l] NEF analysis based on sources cited in endnotes 72-75.

Currently, in addition to council tax, councils only get to keep a share of growth in their business rates (subject to a levy) and rely on centralised formula funding for the remaining share of business rates income. Under our proposed system, councils will directly keep the revenues from and gain greater control over tax rates and discounts of the new BPT, similar to council tax. This will give greater local control over the share of locally collected taxes than at present (Figure 5).

Figure 5: More revenue is truly controlled locally under our proposed system than the current BRRS system

BRRS modelled as 50% retention, disregarding pools and higher retention pilots and assuming no reset. Single financial year figures, modelled for 2023/24.



Source: NEF analysis.[m]

Our proposed reforms will also redistribute the level of taxation more equitably through a higher rate on land value (taxing economic rent from land ownership), which is more concentrated in London and the south-east (Figure 6) compared to the rest of England. This means that the overall level of tax (LVT plus BPT) will be lower for most non-London local authorities compared to current business rates. The current system, by taxing land and commercial property at the same rate, effectively penalises businesses and high streets in areas with lower relative land values[n] compared to London. Under our proposals, with land

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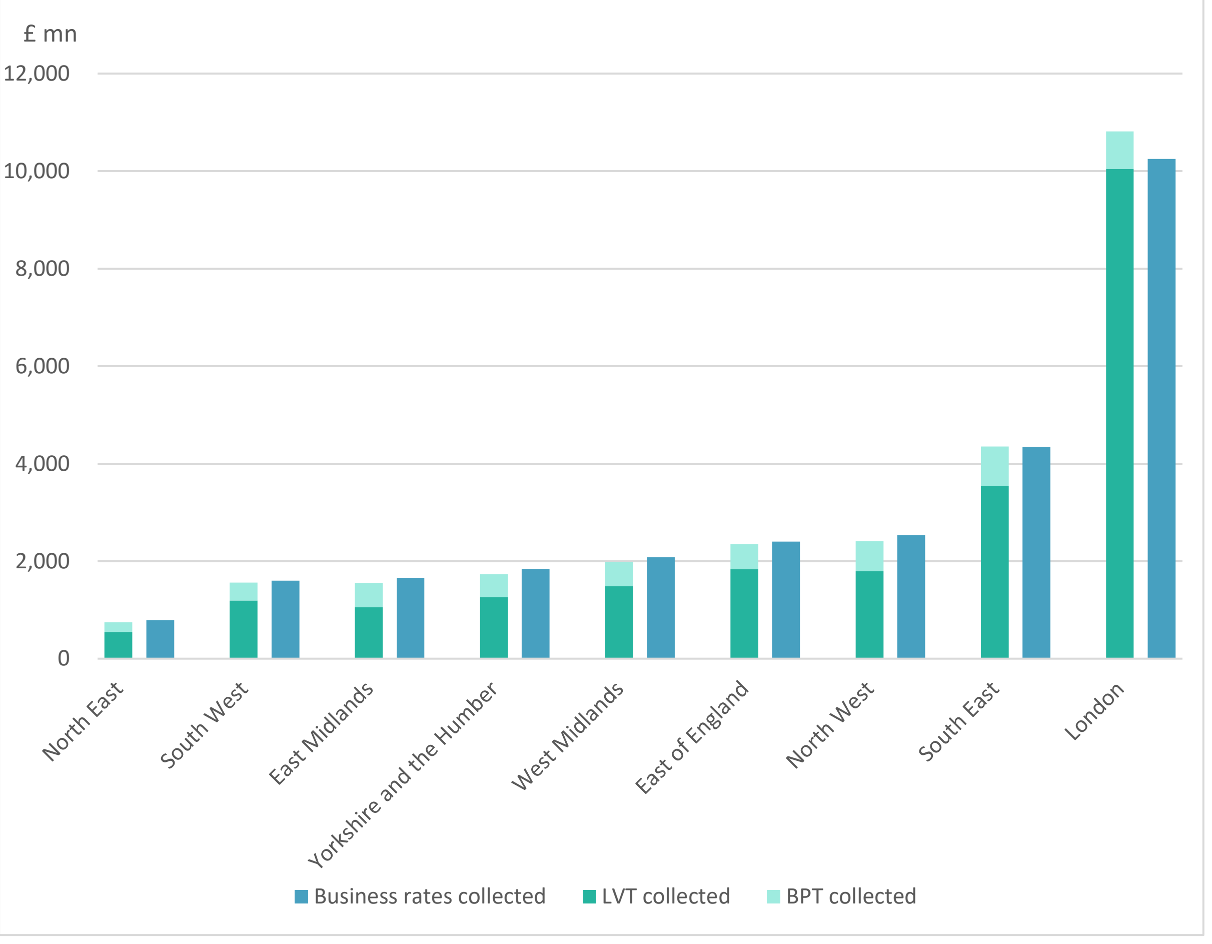
[m] NEF analysis based on sources cited in endnotes 72-75.
[n] Areas where the proportion of rateable value attributable to land - to location - is lower, which are typically outside London/wealthier parts of southern England.

value being taxed more heavily, the tax burden would be redistributed towards the most prosperous areas where the land values are the highest while reducing tax elsewhere.

Figure 6: Business rates collected compared to land and property taxes collected under NEF proposal, per region

Comparison of taxes collected in each region assuming aggregate revenue neutrality between business rates and NEF's proposal. Regional differences reflect higher tax rates on land compared to property under NEF reform affecting regional tax receipts through geographical differences in proportions of value attributable to land (location).



Source: NEF analysis.[o]

Due to huge differences in land value, total business land and property taxes collected would increase in 29 out of 33 (90%) London boroughs, by 4% on average, while they would fall in 210 billing authorities (74%) outside of London, by 4% on average. In this way, our proposed reform would support levelling up by reducing taxes in less prosperous areas and raising them in wealthier ones.

Figure 7 compares regional tax receipts after excluding the central share, with business rates revenue received locally from the retained share of local growth and the baseline funding

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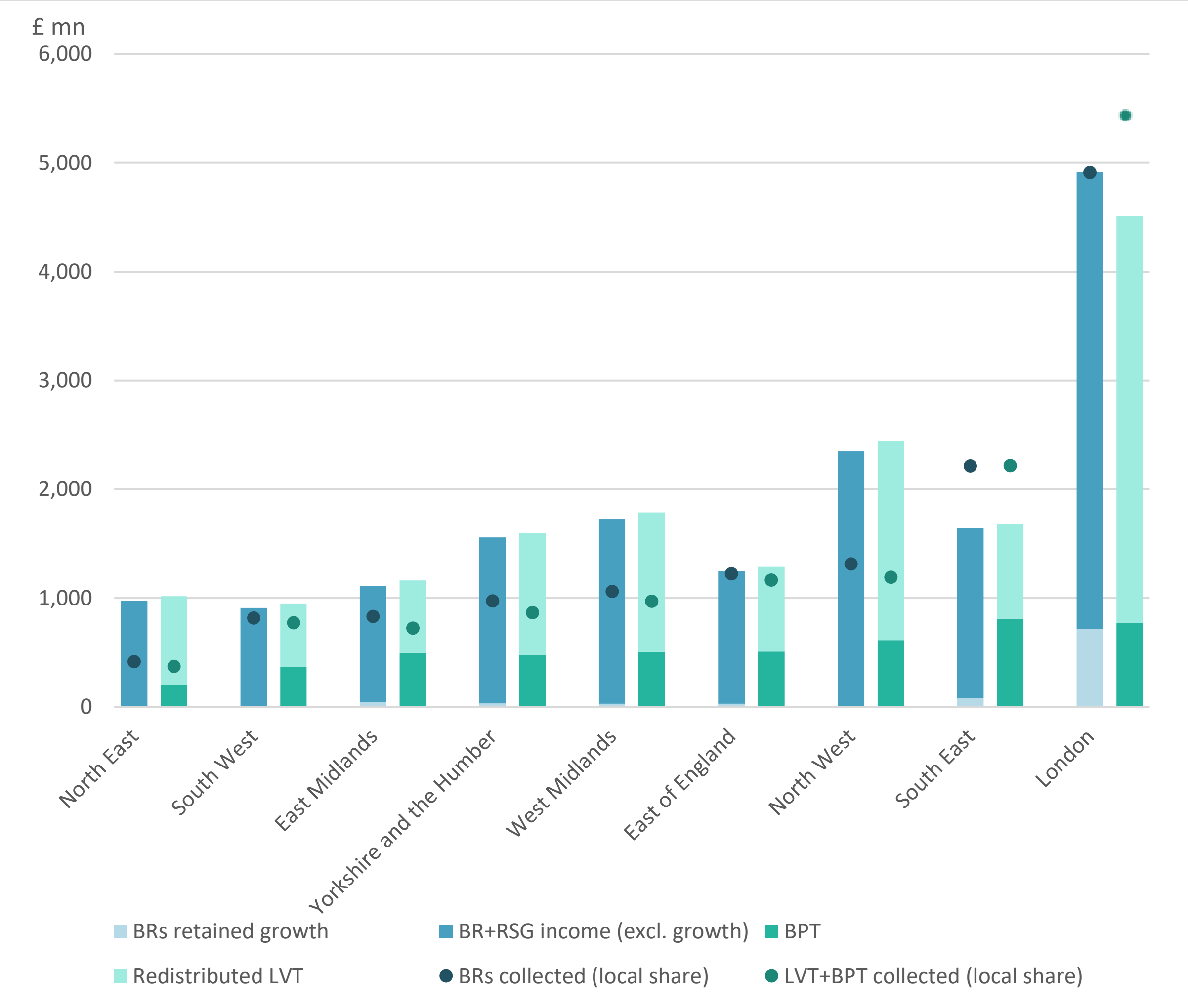
[o] NEF analysis based on sources cited in endnotes 72-75.

level in line with the government formula. This shows that local government directly keeps only a small proportion of the local share (50% of business rates growth) via retained growth, with the majority of business rates income received via a centrally controlled formula

Figure 7. Comparison of taxes collected (local share) and revenues received under the BRRS and under the NEF system

Amounts retained show Settlement Funding Assessment income consisting of retained business rates and Revenue Support Grant (RSG) where applicable. Receipts show taxes collected minus the 50% central share passed to the central government (including for funding grants to local authorities) under the BRRS, and for comparison illustrate equal central share for taxes collected under the NEF proposal. Figures modelled for 2023/24.



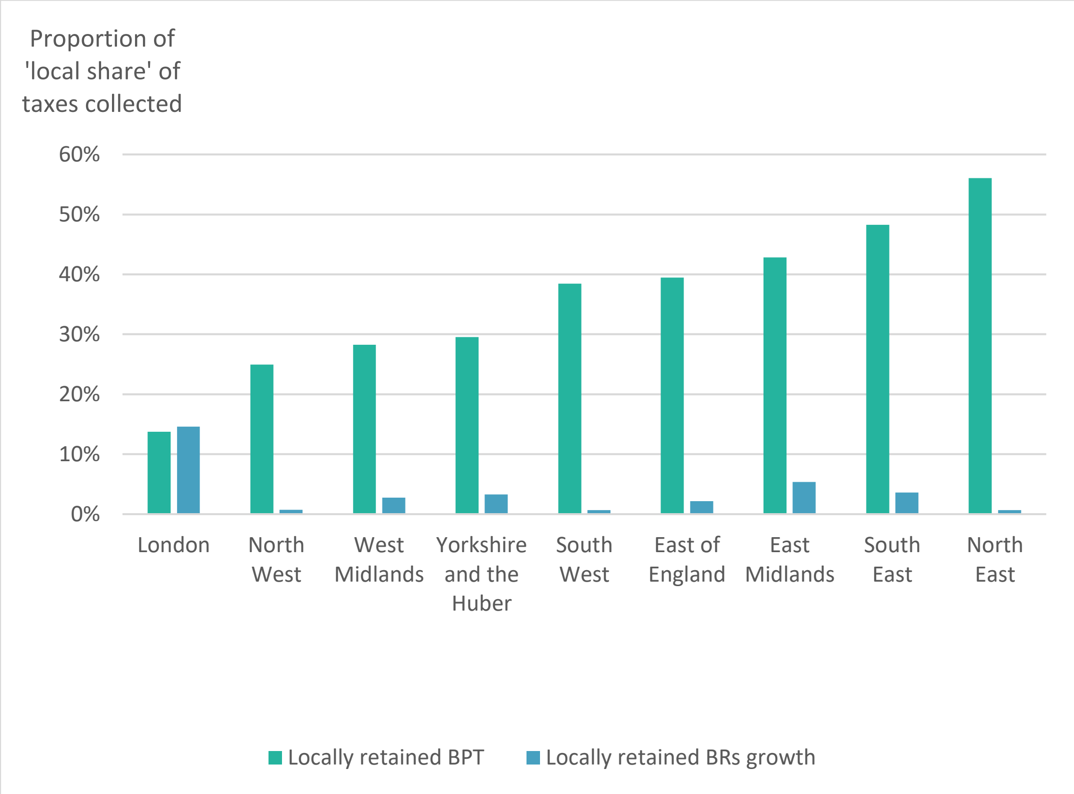
Source: NEF analysis.[p]

For comparison, under our proposal, local government would directly control a much higher proportion of tax revenue by directly retaining BPT (Figure 8).

[p] NEF analysis based on sources cited in endnotes 72-75.

Figure 8: Under the NEF proposal, local government would gain control over a greater share of business rates revenues by directly keeping and having control over all of BPT, and not just over a share of growth

Local share as defined under 50% business rates retention, and for comparison illustrating equal central share for taxes collected under the NEF proposal. Figures modelled for 2023/24.



Source: NEF analysis.[q]

Figure 9 illustrates how by allowing councils to keep all their locally collected BPT while pooling LVT centrally and redistributing it, our NEF reform would reduce the runaway growth in incomes for a few prosperous councils while enabling all councils to benefit from income growth in real terms.

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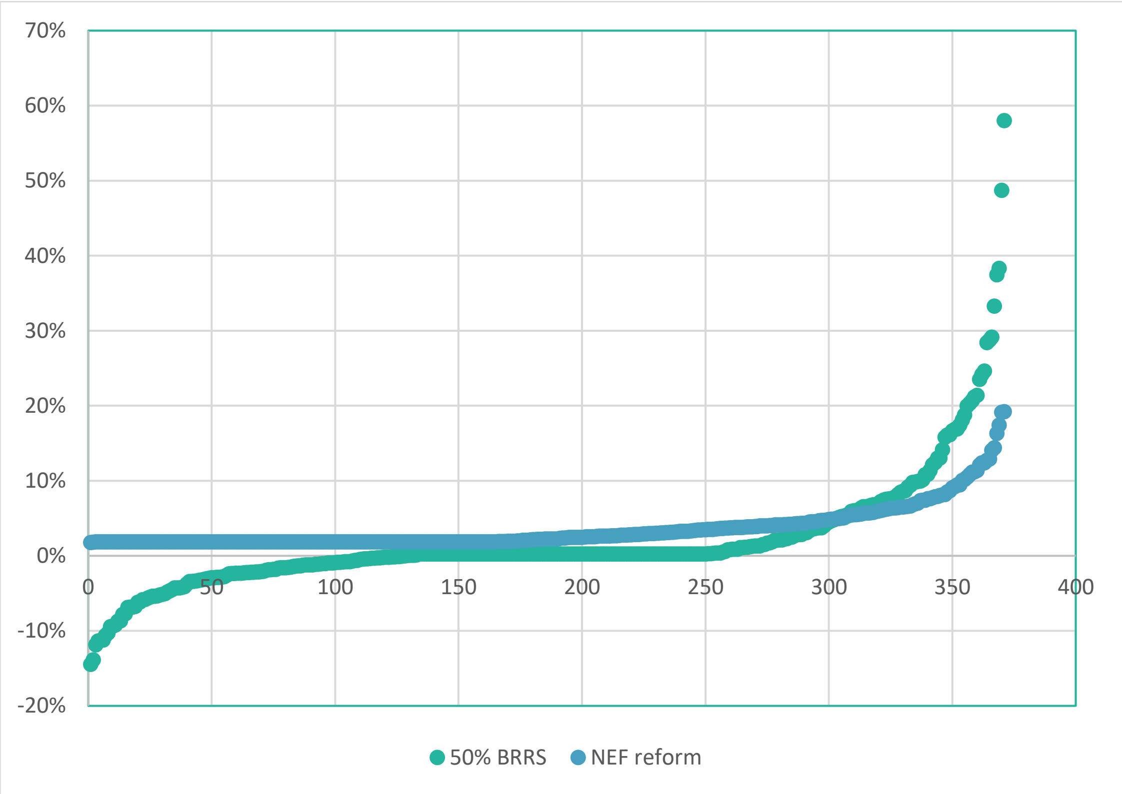
[q] Retained growth extrapolated from growth years in five years to 2019/20 (to avoid pandemic-induced distortions). Assumes no reset to the system (2019/20 FY was originally envisioned to be the last year before the reset which would've recalculated the baseline in relation to which growth is calculated).

Figure 9: NEF's proposal would curb runaway growth in income for the wealthiest councils, redistributing gains in land value more fairly to fund a minimum 2% growth in real terms (over five years) for all local authorities.

Changes in real terms over five years to locally received business land and property taxes (excluding grants) as a proportion of locally received taxes in year 1, comparing 50% business rates retention system (disregarding pools and higher retention pilots and assuming no reset) with NEF's proposal where 100% of BPT is at local authority level (including billing, fire and precepting authorities). Both series are ordered separately, excluding the City of London (out of scale). NEF's system includes a 100% safety net and additional redistribution of the LVT share of revenue growth pooled centrally.



Source*:* NEF analysis.[r]

Overall, our system will give local authorities a higher proportion of locally retained taxes over which they have the power to set rates and discounts. This strengthens the ability to grow the business tax base and shape economic activity through targeting discounts and incentives, for example, to revitalise high streets or encourage environmentally conscious business activity. At the same time, since councils have little power to change the value of land deriving from its location, pooling the LVT centrally for redistribution does not reduce local control but it helps reduce unfair gains or losses that the current system allows.

[r] NEF analysis based on sources cited in endnotes 72-75. Modelling on illustrative basis of rateable value growth rates from 2019/20 to 2023/24 following the trend of the last five years preceding Covid-19 to adjust for the pandemic-induced variability and uncertainty in valuation changes.

5.3 IMPACTS ON BUSINESSES

Our proposed revenue-neutral system will create winners and losers among the businesses affected. Our reform, by taxing land value more heavily than commercial property, will create winners in areas outside London. Our proposal supports levelling-up by reducing total taxes in regions with lower land values (mainly outside of London), even assuming a full pass-through of the LVT from landlords to business occupiers via higher rents.

Table 3 presents the maximum likely change to bills for landlords, business owner-occupiers and business renters under the rates we have chosen to test in our illustrative analysis of 35% for BPT and 54% for LVT. We consider these different stakeholders with respect to size and geographic location, comparing a small retail property in the north-west with a large retail property in the south-east.

Because we propose that the statutory incidence of the LVT falls on landlords, BPT bills paid by business renters will be significantly lower under our proposed scheme. Not only will rates for this property tax be lower than they currently are, the bill will be based on a much smaller proportion of value. On the other hand, landlords will have a new tax liability, that in many cases will be significant.

Table 3: Change in annual tax bills under NEF reform compared to business rates bills for select illustrative commercial property values and locations.

	Small retail property in Shropshire, West Midlands	Large retail property in East Hampshire, south-east	Small industrial property in Doncaster, Yorkshire	Large industrial property in Hackney, London
Current rateable value	*£15,000*	*£75,000*	*£20,000*	*£100,000*
Current business rates bill	£7,365	£37,800	£9,820	£50,400
New BPT + LVT bill (for business owner-occupiers)	£6,983	£35,991	£9,105	£51,470
New bill for landlords	£4,924	£27,685	£5,982	£46,809
New bill for business renters	£2,059	£8,306	£3,123	£4,661
% change to bill, business owner-occupier	-5%	-5%	-7%	2%

Source: NEF analysis.[76] For comparison with the rest of the modelling, business rates were calculated using 2019/20 multipliers: a standard multiplier of 50.4% and a small business multiplier of 49.1% respectively. Bills are shown before applying any discounts or reliefs.

Looking beyond the statutory incidence of the tax, while business renters would face lower tax bills, landlords are likely to try to recoup their new tax bills by raising rents, which would mean that the total costs of occupying business property (rent and taxes) would remain similar.

But to the extent that landlords do not pass on 100% of their new tax liabilities to renters, businesses could see their total occupier costs reduce. This would also be the case where landlords' tax liabilities rise due to future increases in land values. At present, when such increases are reflected in rateable values, it is businesses that directly face increases in their tax bills, but under our proposed reform it would be landlords. The extent to which these would be passed on to business renters depends on local market conditions. Anything less than a 100% pass-through would represent a gain for business occupiers relative to the current system.

Where an introduction of LVT results in an increase of total tax liability on the property (such as in London where land values are very high and the higher LVT rate we suggest would increase total tax due on average), business owner-occupiers would see increases in their tax bills. Conversely, they would see a decline in areas where combined LVT and BPT result in an overall tax bill lower than business rates currently. However, by basing part of the reform on rateable (rental) values, as opposed to capital values, our proposals ensure that any variation in bills will be mitigated, preventing the potential of a 'bill shock' that would occur if the valuation method moved away from current rental values approach.

5.4 IMPLEMENTATION CONSIDERATIONS

We propose that our new NEF system be implemented over a five-year period where the tax liabilities for land value naturally shift to landlords upon contract renewal with business occupiers before the end of the five-year period. The five-year period would, however, be a hard deadline for moving to the new system. For those whose rental contract extends beyond that period, that contract should be renegotiated.

5.5 POTENTIAL BALANCING WITH THE CORPORATION TAX

A further option to adjust business taxes is to use Corporation Tax (CT). As this is a tax on profits, it is more aligned with the business cycle, taxing firms that can afford it – whereas business rates liabilities do not depend on whether a business is profitable. The government could fund the transition period reductions in business tax liabilities with a temporary increase in the CT rate.[s] A 2.5 percentage points CT increase introduced in April 2024 could raise approximately £5.25bn in the first year or £30.25bn (in current prices) if maintained over four years,[t,77] offsetting equivalent reductions in tax liabilities of businesses during the transition. For comparison, a 1 percentage point increase in LVT would be worth approximately £460mn (in current prices).

The government could concentrate this support in year one of the reform given the ongoing impacts of the energy crisis, and reduce it over subsequent years, while the revenues from LVT on landlords begin to increase with tax liabilities shifting upon rental contract renewals. Lastly, rather than a temporary measure, the suggested CT increase could be made permanent, thus meaning the rate of commercial land and property taxation could be permanently lower.

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[s] The rate could also be increased only on larger firms (the same that since 2023-24 fall under the 25% rate), leaving smaller firms with the small profits 19% rate.

[t] In current prices. The figures are forecast to increase in nominal terms each year. Estimate for 2027/28 is calculated by applying the growth rate in total corporation tax revenues (From OBR. (2023). *Economic and fiscal outlook - March 2023*) to the 2026/27 estimate.

6. CONCLUSION

Our proposal for a two-rate land and property tax would yield the following benefits compared to the government's current business rates system:

- **A fairer distribution:** Under NEF's proposals, overall tax levels would fall in all regions outside of London and the south-east (before the removal of empty property relief for landowners). A greater share of income for redistribution would be raised from wealthier areas with higher land values. Runaway growth for the richest councils would also be reduced under the NEF system.
- **Increased local authority control:** Local authorities would also see increased control over local taxation, compared with both the current system and the proposed increased retention system, reducing reliance on Whitehall overall. Local authorities would be given control over BPT on a comparable basis to council tax today, which would mean far greater control compared with business rates today.
- **Increased economic efficiency**: Increasing taxes on windfall gains from land speculation and reducing taxes on building and improving commercial property, would increase economic efficiency across the board.
- **Improved progressivity for businesses:** Commercial property would be taxed at a significantly lower rate than land, reducing the distortionary effects of taxing investments in building improvements, while maintaining the principle that local firms should contribute towards local services through locally paid tax.

Reforming business rates in this way would give local authorities greater control over their revenues from local taxation. It would also increase fairness for businesses, which, in the context of the current difficult economic outlook, could be additionally supported through the transition phase as we describe in Section 5.4.

But reforming business rates is only part of what is required to make local taxation and expenditure fairer and more efficient. Local authorities face a vast funding gap. Council tax, too, is in desperate need of reform, to make tax proportionate to current values of residential properties, as under the proposal for a Proportional Property Tax (PPT).[78] Fundamental reforms are required to replace outdated and unfair local property taxes to make them work both for taxpayers and for local government funding. Reforming business rates as we suggest in this paper would represent a solid start.

APPENDIX: METHODOLOGY NOTES

This appendix details the methodology and data used to model our policy proposals.

- **Land coverage**: The policy options presented in this report consider a value tax on land on which property liable for business rates currently sits – ie currently developed, commercial land. This excludes undeveloped land (due to lack of data), agricultural land, and residential land.
- **Land value:** Proportions of land value as a proportion of total rateable value were based on the data kindly shared by Adam Corlett and Dominic Humphrey, an analysis originally produced in Corlett, A., Dixon A., Humphrey, D. & von Thun, M. (2018). *Replacing business rates: Taxing land, not investment*. These estimates were derived via a hedonic regression approach that produced estimates of land value as proportions of total rateable value (as currently assessed and recorded by the Valuation Office Agency (VOA) for all business properties) at the local authority level. See the paper by Corlett et al. for full details on the exact methodology for deriving land values from rateable values.
- **Baseline for comparison:** The modelling compares our proposed reform, if it were in place in 2019/20, with the baseline system of 50% rates retention (excluding pilots of higher retention to enable comparability between all local authorities). The government was previously committed to moving to a 75% retention system, but that has been repeatedly postponed and the latest indications are that a nationwide move to 75% retention has been abandoned, and instead, the government has opted for continuing some pilots and striking longer term higher retention deals with mayoral combined authorities.
- **Revenue neutrality to central government**: Our proposals are fiscally neutral from a central government perspective (the amount of business rates revenue that is set aside for the government's central share).
- **Discounts and exemptions**: We estimate the revenue raised through the proposed new taxes is reduced by the same proportion for each billing authority as it was through pre-Covid-19 reliefs in place in 2019/20.

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