<u>Reform of National Non-Domestic Rates.</u>

Consultation Paper for CEJ

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Version 6, 5th July 2010, includes comments by Dr Tony Vickers & Dave Wetzel

An outline of how the Lib-Dem policy of shifting the basis of business rates (NNDR) onto site values in a way that is revenue neutral is presented. A five year transition is proposed. The basis of valuation is considered. The effects on sites of different degrees of development are compared and the effect of a shift of incidence from occupier to owner is considered for rented sites. The outcomes predicted include the more efficient use of land and the possibility of a brake to regulate speculative property bubbles.

<u>Section I: Introduction</u>

In their 2010 election manifesto the Liberal Democrats, now a member party of the Coalition Government, included a proposal to:

> *'Reform business rates, creating a fairer system where rates are based on site values rather than rental values and are the responsibility of local authorities.'*

The policy of shifting tax from property onto sites was not unique to the Lib Dems. The manifesto of the Cooperative Party which has twenty six serving MPs contained the statement:

> *In order to prevent similar problems* [of unsustainable property booms] *emerging in the upturn, the Government should use taxation to change incentives within the property market, ensuring that it incentivises the productive use of land rather than expected capital gains in an upward market. The Government should replace council tax and national non-domestic rates with a land value tax. While this would be a new method of taxation in the UK, countries such as Denmark, Hong Kong and Taiwan utilise land values to help their economies. Local Authorities in parts of Australia, New Zealand and North America have all adopted local forms of land value taxation. This is likely to not only improve economic stability but also stimulate investment in more productive elements of the UK economy over the medium to long term.*

The Green Party which now has a representative in Parliament also made a statement about a tax shift to land values but in a more general way:

> *... In the long run we favour moving to a system of Land Value Tax, where the level of taxation depends on the rental value of the land concerned.*

This paper examines how the Lib-Dem proposal proposal for the reform of business rates (the National Non-Domestic Rate or "NNDR") by replacing them with Site Value Rating (or "SVR") could be beneficially implemented in the UK, taking into account the present state of its economy. It begins with a review of the recent literature on the taxation of land values in the UK and relevant methodologies for the valuation of land. It then looks at the present state of the UK commercial property market including the degree of indebtedness associated with it. Finally it suggests a programme for reform of business rates on the basis that authors mentioned in the review have suggested.

<u>Section II: Review of recent literature</u>

The policies advocated by the political parties noted above are consistent with recommendations for tax reform given in the Institute for Fiscal Studies' Mirrlees Review[1], a recent very extensive study of the present tax system in the UK:

> *"It would be preferable if both (i.e. council tax and business rates) could be moved to the taxation of the value of the land rather than that of the property so as to remove the distortion against improvements…*"

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Martin Weale, Director of the National Institute of Economic and Social Research, in his commentary on the section of the Mirrlees Review dealing with property taxes further endorsed this move adding the reason that such a tax would lead to increased efficiency in land use.

An extensive study of the subject of the taxation of land values in the UK up to 2004 was undertaken by Owen Connellan.[2] This contains a very useful compilation of progress made up to that date.

Since then other academics have continued to develop the case for shifting property taxes onto land. A full explanation of the historical and political background and advantages of this policy was given recently by Iain McLean, Professor of Politics at Oxford University[3].

In Ireland in 2009 Constantin Gurdgiev of Trinity College Dublin completed a very extensive comparative survey[4,5] of the relative advantages of a number of different methods of taxation using a wide range of criterion and concluded that the taxation of land values was the most effective. The Report of the Commission for Taxation in Ireland 2009[6] concluded that there were strong economic reasons for taxing land values. The only reasons given for not recommending implementation were the absence of a cadastre and a fair method of valuation in Ireland at the present time.

In 2005 Professor John Muellbauer of Nuffield College Oxford wrote a response[7] to Kate Barker's Review of Housing Supply of the previous year on which he had served as a consultant. Her interim report had advocated the taxation of land values but this was omitted in the final report. Muellbauer's view was that the remit for the report had been far too narrow to deal comprehensively with the whole issue of housing supply as it focussed only on new housing which is a very small percentage of the market. He also noted that the issues of mortgages and taxation had been reviewed separately preventing a holistic view emerging. Taking a much wider view he proposed reforming council tax, phasing out Stamp Duty and reforming business rates by shifting the tax onto land values.

A key practical aspect of the implementation of a reformed site-value based on non-domestic rates is valuation. A comprehensive study of valuation for site value rating was carried out in Whitstable Kent in 1973. In 2004 Frances Plimmer, Senior Research Officer of the College of Estate Management in Reading with Greg McGill carried out an update of the survey[8] in order to explore practical problems of valuation particularly those associated with planning.

More recently Tony Vickers in his doctoral thesis at Kingston University[9] has undertaken a useful review of the basic strategies for valuation that would be needed for taxing land values rather than property.

Section III: The present state of the UK Commercial Property Market

To set the scene a brief overview of the UK commercial property market is presented based mainly on a recent Investment Forum Report[10].

The figures are based on 2003 data. There have been considerable fluctuations in the actual asset values since then but these still gives a basic idea of what the nature of the tax base is. The main sources of data for the Report were the Valuation Office Agency (VOA) and Office of National Statistics (ONS).

The total capital value of UK commercial property is estimated as £611 billion. Table 1 shows the basic composition of the market.

Table 1: UK commercial property stock

Commercial stock	Capital value/£ billion	% of total
Retail	202	33
Office	159	26
Industrial	127	21
Other*	122	20
Total	**611**	100

*e.g. hotels, pubs, leisure, utilities,

In addition Central Government stock was estimated at £217 billion and Local Authority stock at £130 billion.

Of the private commercial sector 57% is owner-occupied and investors own the remaining 43%. The owner-occupied sector tends to be the less valuable property.

Much of it is in the hands of large corporate bodies. Only 68 retail companies between them hold £68 billion of property assets. There are 755 companies with more than £20 million of property assets who between them hold around £160 billion of property. The investment market, consisting of some 20,000 buildings, is concentrated in high value properties. Table 2 identifies the main owners of commercial property held as investments.

Table 2. Main owners of commercial property in the UK

owner	**Percentage of market by value**
UK institutions (pension funds, insurance)	29
Overseas investors	15
UK Unlisted Property Companies	15
UK listed Property Companies	14
Unitised and Pooled Funds	8
Limited Partnerships	7
Traditional estates/charities	5
Other Investors	5
UK Private Investors	3

Each year the Department of Corporate Development of the De Montfort University publishes a detailed report of the UK Commercial Property Lending Market[11]. Their figure for total lending for 2003 was £120 billion which is 46% of the capital value of the investment sector. This indicates that much of the acquisition of commercial property for investment purpose is undertaken with the assistance of bank credit.

The 2010 report has just been published. It makes unsettling reading. In the years leading up to the boom there was a large amount of lending against commercial property in the UK at high loan to value ratios. The total now stands at £228.3 billion. Following the recent falls in commercial property values it is estimated that 20% of these loans are in default or breach of covenant. Moreover £161 billion of these loans are due for repayment in the next five years. Much of the credit was supplied by banks that are now in state ownership (e.g. Lloyds supplied £62 billion and RBS, £57 billion). Any reform of NNDR needs to accommodate this delicate situation into account and increase stability rather than decrease it.

An important additional fact that is relevant to this study is the amount of vacant land in the UK. At present property that is not usable and vacant land is not on the rate register. Muellbauer estimated that if this included land with planning permission for domestic use it might add 25% to the capital value of commercial property i.e. around £150 billion. In 1985 Ronald Banks[12] made an estimate that there are 50,000 ha of land with development potential in the UK. The price of industrial and commercial land varies considerably over the country. Taking a rough figure of £1 million per hectare that would give a very rough estimate of £50 billion for its capital value but this did not include land for domestic use that Muellbauer included.

Section IV: Proposed Reforms

This paper focuses on the practicalities of the reform of business rates described in outline in the above references, particularly those of Connellan and Muellbauer. The economic and social reasons for the reform have been discussed in detail elsewhere and will not be given again here.

In the present UK tax regime there are now three distinct property taxes: non-domestic business rates, council tax and stamp duty land tax. All three are in need of reform. The proposals here only include the first. It is intended that the others will be dealt with later.

The present system of non-domestic property taxation has a long history going back over four hundred years. It is now a national tax but is administered by local authorities. Last year (09/10) it raised £23.5 billion which was 4.3% of total tax revenue.

The system of non-domestic National rates (NNDR) or business rates has the following distinct features:

1) The taxable unit is the **hereditament**. It is defined as a unit of property capable of commanding a rent. Domestic property is excluded as it is taxed in a different way.
2) From 1) it follows that derelict land, unused land, (and until 2008 unoccupied property) are exempt. Agricultural land has been exempt rates since the 1920s.
3) The tax falls on the **occupier** of the property.
4) The tax is a nationally defined proportion or **rate** of the value of the property. In 2009 the main rate was 46.2% and in 2010 is 41.4% with some reduced rates for special cases.
5) The valuation is based on the **existing use** of the property.
6) The **valuation** of the property for the purpose of taxation is not necessarily directly related to the rent the tenant actually pays. It is based on a hypothetical "reasonable" value a tenant would pay according to valuation criteria.
7) The valuation is updated every 5 years but the values are back-dated so although a new valuation came into force in 2010 it was based on 2008 values, before the significant decrease in values brought on by the crash.
8) The rateable values are open to public view and are displayed on the Valuation Office website.

In April 2008 business rates were extended to unoccupied property. In this extension the tax fell upon the owner. One of the main reasons given for the extension was to incentivise the full use of property and hence the land it occupies. However the disadvantage of the reform was that if the owner rendered the property unusable he was exempt from the tax. This has resulted in damage or demolition of significant numbers of potentially usable properties, simply to avoid rates. Owners of empty properties have also avoided rates by employing an agency to provide short-term tenants. During the period of occupation business rates are paid but when the property again becomes vacant, a three or six month rate free period again is claimed. Owners can also avoid empty property rates by "letting" rent-free to charities who are allowed to keep premises empty rate free between charitable uses. The reform proposed here could be seen as a natural extension of the previous reform and one that would overcome these problems.

The following reforms are proposed:

1) **The taxable unit to be the site only**. To put it another way, buildings and improvements would be exempt. Thus the taxable unit is defined geographically and could be identified for example, by the unique property reference number (UPRN) of every property that exists within the National Land & Property Gazetteer (NLPG). Since 2007 this has been maintained by local authorities under a central agreement involving various government agencies including VOA, OS and Land Registry. For any organisation owning several sites each would be valued independently.
2) Occupied residential land would be excluded. There could also be a threshold of site value below which land would be exempt.
3) **The tax falls on the owner**, not the occupier. Given that the occupier is much easier to identify, in the case of occupied sites the tax could be levied by billing the occupier and then the occupier subtracting the payment from their rental payments to the owner. For unoccupied land the owner would be billed directly. The ultimate penalty for non-payment could be forfeiture of the freehold.
4) **The tax is a proportion of the site value,** an annual rental value of the site, and is paid annually. For the change from the present property based system to one based on land to be tax neutral the rate would be quite a high percentage, close to 100% of the site's rental value.
5) **The valuation is based on optimum permitted use** not on existing use. This takes into account planning permissions and local development plans. Optimum permitted use is not necessarily most profitable use. There would be scope here for local communities to become much more pro-active in their planning strategies and to determine for themselves what type of use they wish to permit for the land in their localities.
6) The valuation strategy would have to be very different from that used for business rates where calculations relate to existing use and are based on the nature of the building. It would be based on the annual rental value of the land without improvements. There is a residual method of valuation where the value of the site is obtained by subtracting the value of the construction costs from the market value of the property. However, this tends to undervalue land

that is not in optimum permitted use (as any asset stripper knows). There are alternative comparative methods which would make use of both recent market transactions and a survey of the location and the surrounding factors that affect land value.[13] The recent revaluation in Northern Ireland provides an example of how this might be done. It requires the use of CAMA (computer-aided mass appraisal) methods using MRA (multiple regression analysis) and GIS (geographic information systems).

7) Values should be updated annually. Modern computerised methods are capable of maintaining land value maps in real time, making use of property transaction information, already supplied to VOA and Land Registry, to continuously update valuations.
8) The site values would be on public display. The values for each region would be recorded in a GIS and presented in the form of land value maps. The AREIS (Auditor's Real Estate Information System) of Lucas County Ohio USA[14] provides an excellent example of an existing system of this kind. In practice it was shown to have the additional advantage that the 'positive feedback' from the value maps leads to a more efficient, better informed property market.

The tax reform would need to be phased over several years as suggested by Connellan. In the transition phase there could be a two-tier scheme of property and land taxation as pertains in many US cities.

The scheme illustrated here is a five stage transition which could be introduced for example over five years. During the transition period the occupier would continue to pay the old NNDR system but with a 20% reduction each year. Meanwhile the owner would begin paying a site value rate with annual 20% increments over the transition. The rate could be set so that the overall tax take would be approximately neutral compared with the business rate.

Table 3: Payments by owners and occupiers in a proposed 5 year transition from NNDR to SVR.

Year	Occupier pays	Owner pays
0	100 % NNDR	0
1	80 % NNDR	20% SVR
2	60 % NNDR	40% SVR
3	40 % NNDR	60% SVR
4	20 % NNDR	80% SVR
5	0 % NNDR	100% SVR

Estimates of the proportion of property prices that can be attributed to land are difficult. They vary from 30 – 60%+ for commercial and industrial property. Given that the present rate is approximately 40% it would follow that the site value rate would be close to 100% of the rateable value of the land at the time of the reform.

It has been the practice with business rates that their real value, in terms of yield, remains constant so the yield only increases with inflation. Hence during a property boom the business rates yield decreases as a proportion of property values. This has prevented the possibility of NNDR being used as a tool to control speculative bubbles in commercial property values. The reformed rates would be linked to land values. If land values in general start to rise the revenue yield would follow, providing an effective brake to speculative bubbles since owners would be losing much of the 'unearned increment' from such speculation.

Section V: Illustrations

The bar charts below give some illustration of the way different sites will be affected by the reform. For simplicity the examples are of a shift from a business rate of 40% to a site value rate of 100%. The first case taken is that of owner-occupiers. The Investment Property Forum Report indicated that this covers 57% of commercial property. Here there would obviously be no change of incidence of tax. The change in the level of taxation will be determined by the ratio of site value to total value which reflects the degree of development of the site in question. There will be both winners and losers. Figure 1 compares different sites with NNDR rateable values of £100,000. In the extreme a marginal site, i.e. one whose site value rate is below the threshold would pay no tax. This would be the case of a specialised plant such as a waste disposal unit in a remote location. Sites with a site value of less than 40% of the rateable value i.e. highly developed sites would have a reduction in the amount paid. Sites with a site value of greater than 40% may pay more with the biggest change would be for vacant sites which were previously not included in the NNDR.

Figure 1: Comparison of NNDR and SVR for differently developed sites of rateable value £100,000

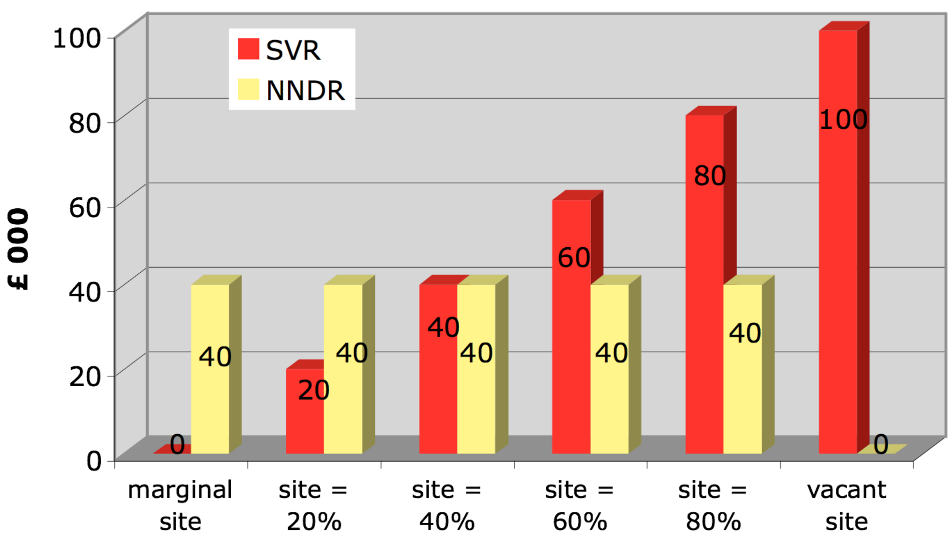
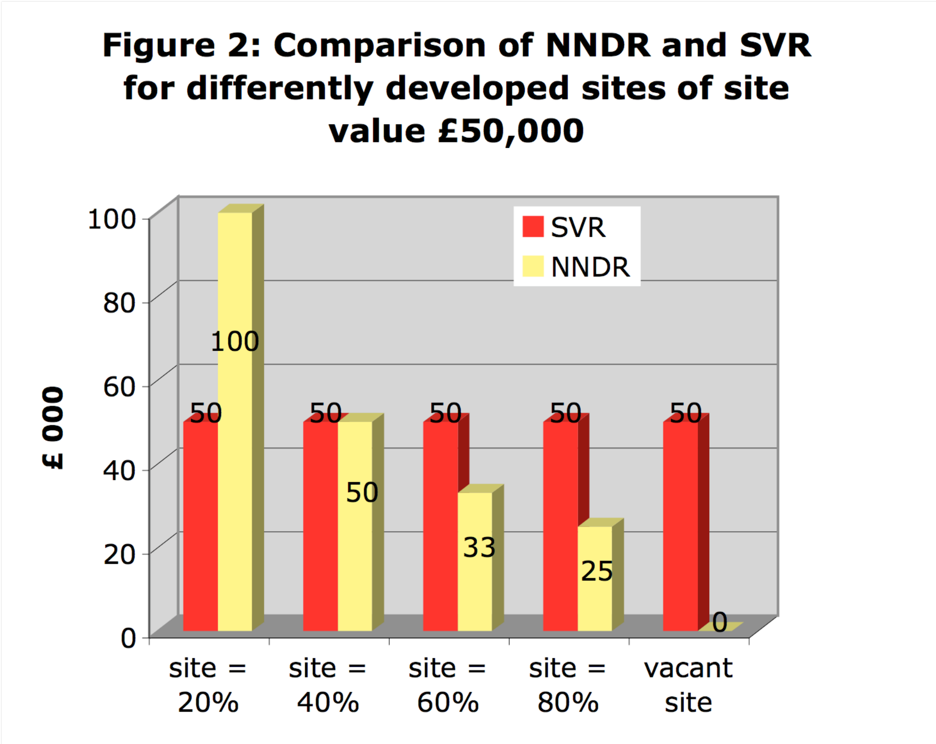


Figure 2 shows the same thing in a different way by comparing sites of the *same site-value rating* but different degrees of development. The same picture emerges, namely that the owners of highly developed sites would pay proportionately less and the owners of underdeveloped sites would find themselves paying more.



The next charts illustrate the case of sites with tenants. Here the incidence of tax changes from the occupier to the owner with the change being phased in over five years.

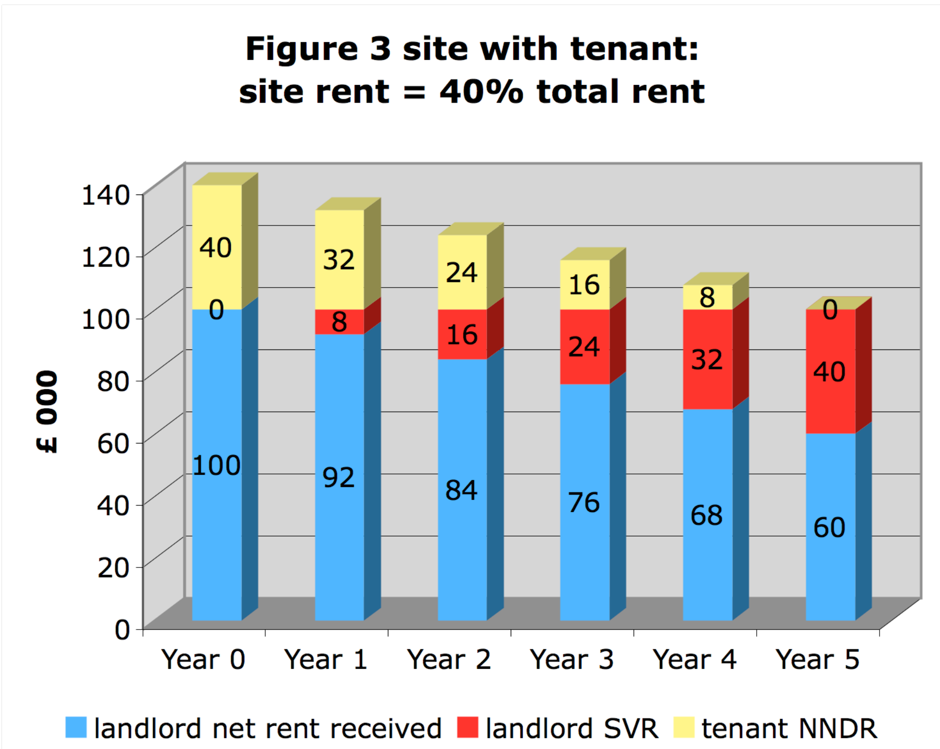


Figure 3 takes the case of a site with rateable value of £100,000. An NNDR of 40% and SVR of 100% are again. Over the transition the tax paid remains the same but is gradually transferred from the tenant to the owner.

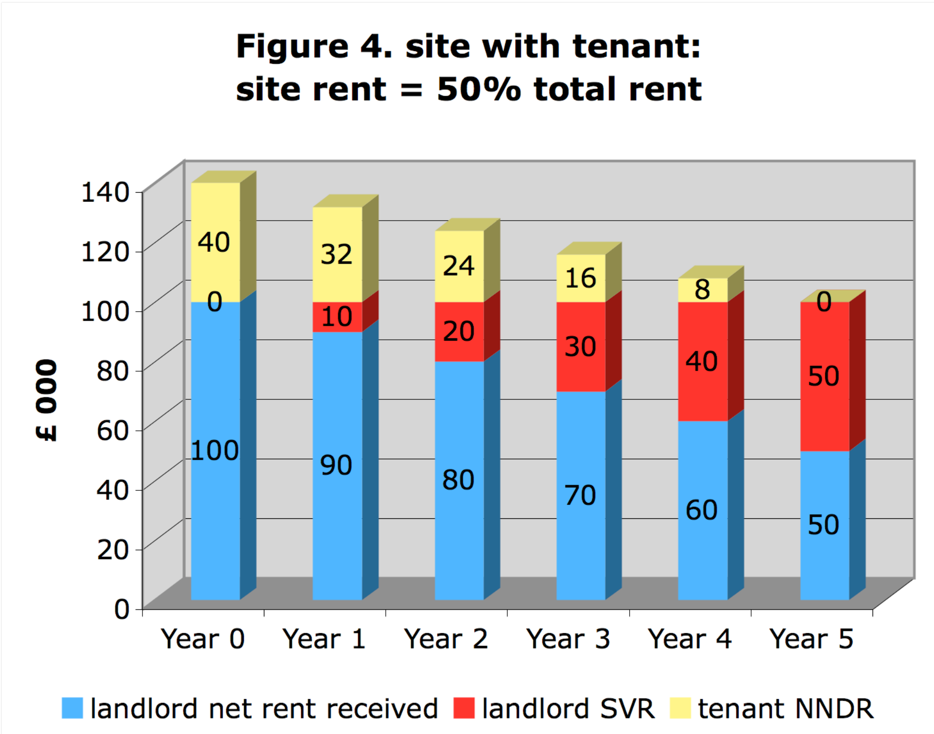
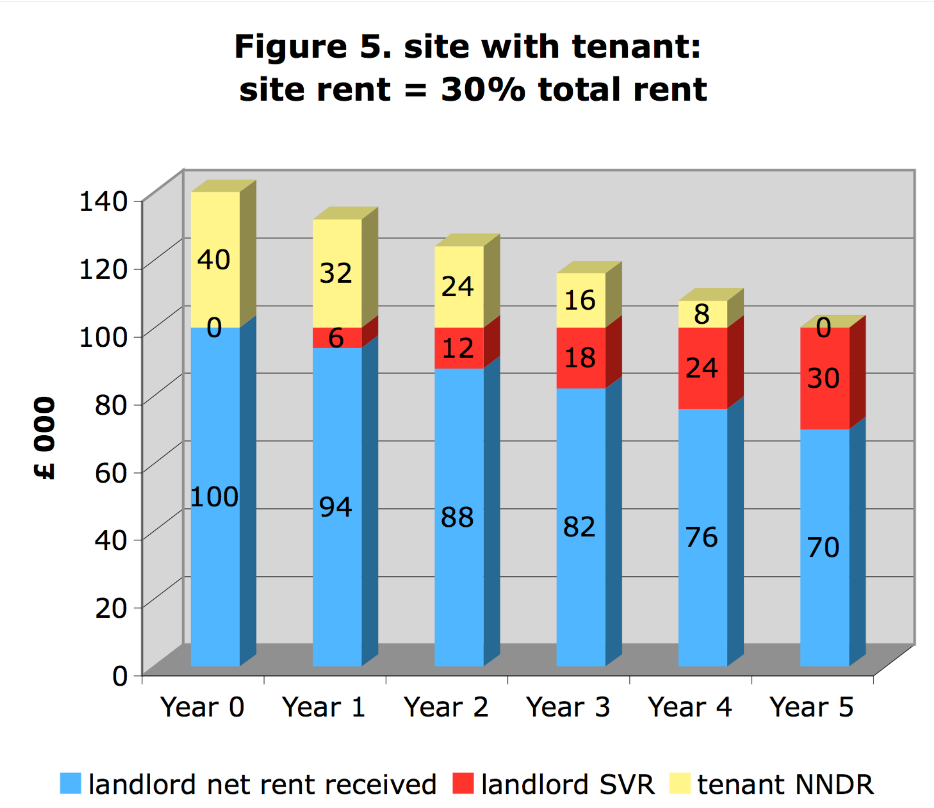


Figure 4 shows the example of a site with rateable value £100,000 and site value rate £50,000. This represents a less fully developed site of the same rateable value as the previous example. In this case there is a similar transfer of the tax to the owner but at the same time the tax paid annually increases.

The third example, figure 5, is of a site of rateable value £100,000 but with the site value only 30% of the total. This could represent a highly developed site such as a high-rise office block in a key location. It also represents the situation close to the margin where site values are low. In both cases, as the transfer is phased in there is a decrease in the tax paid annually.



Section VI: Effects of the Reform

For owner-occupiers the transfer of the business rates onto land will reward those who have developed the sites they own to the full. As Martin Weale suggested it should lead to increased efficiency of land use. For owners of unused and underdeveloped land it should act as an incentive to develop them. There is a large body of empirical evidence from the United States[15] that this type of tax shift does stimulate development. It is important to recognise that any such development must take place within the confines of "optimum *permitted* use" as determined by planning authorities.

For the tenant it needs to be recognised that rent and rates together constitute an occupational cost - the total rent plus rates payable "TRRP", which will always drift to the highest the tenant can afford. Thus if rates increase then rent decreases and if rates decrease then rents increase. The most probable response to the change to SVR will be that landlords will attempt to increase rents back to the previous level. This will only be possible where SVR is lower than the NNDR as no tenant will be able to pay more than the TRRP. Comparing the three cases illustrated in figures 3, 4 and 5 it will be seen that in the case of figure 3 (site rate = 40%) an increase in rent to restore the landlord's net income could be achieved. In the case of the less well-developed site the full previous rent cannot be reclaimed because the extra tax he pays is greater than the decreased payment of the tenant. In the well-developed site the converse is true and the owner could increase his net income as the tax burden has decreased.

Set against this is the effect of the reform on stimulating development. It would be anticipated that there would be an increase in the supply of commercial property which, according to market principle would tend to reduce TRRP. Given the time scale for property development there could well be a time lag before this became evident. If it happened the reduction in rent and rates would provide a welcome stimulus for business tenants and could enable growth of smaller traders, in the retail sector for example.

In section III the delicate state of investors in commercial property was noted. Given that investment property tends to be the high value end, containing well-developed sites, it could well be the case that these are the sites which would benefit from the reforms and could see a reduction in tax paid. The reforms could offer a respite by enabling increased rental income due to the reduction in the tax burden. If rent is able to take a larger share of TRRP, site owners benefit and should see capital values of their properties rise – if developed to optimum permitted use.

In a similar way sites that are marginal or close to marginal would also benefit through a reduction of tax paid. Rather than encouraging regional development by offering exemption from NNDR the SVR system would inherently encourage development at the margin through the lower taxation of sites of low site value.

This reform of business rates is likely to have a significant effect on the land market. The value of land, as distinct from developed in-use property, as an investment asset will be greatly diminished. Any projected increase in capital value of sites – but not of buildings - will be absorbed in increased SVR payments. This in turn would affect the basis of valuation of land for tax purposes. The complex and intimate feedback between changes in tax policy and market behaviour and the need for public accountability would make it essential to have regular (at least annual) and transparent site revaluations that are made freely available for all e.g. by publication on the internet and in local libraries.

When effective infrastructure is put in place close to a site, for example a new train line, it is well known that land values increase. With the reformed rate, using annual updates of site value, these uplifts would be captured by the tax. Thus the reformed rate could become a means of financing infrastructure development, more effective than the present system which only captures any of the uplift after at least 5 years (when the next revaluation takes effect). Conversely, if there were a change close to a site that had a negative effect on land values there would be a corresponding reduction in the tax paid.

Section VII: Conclusion.

This paper has been an attempt to flesh out the consequences of the reform to business rates proposed in the Liberal Democrat Party 2010 election manifesto and suggested by other authors. In addition to establishing the usefulness or otherwise of the proposal another purpose was to clarify what research it would be useful to undertake to establish how effective the reform would be in practice. A key piece of data that is needed to properly assess the proposal is the ratio of site value to total value for commercial properties.

The proposed changes transform business rates from a property tax into a resource levy. The reform of business rates thus needs to be seen in a wider context of establishing a "sustainable land development policy" that looks in a holistic way at the proper utilisation of this most important resource. Tax revenue is just one component of this. Planning is another aspect as is valuation and the establishment of the identity of owners of all sites.

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