No Way to Help the High Street

The Case Against an Online Sales Tax

BY TOM CLOUGHERTY & ELIZABETH DUNKLEY

Centre for Policy Studies

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Contents

Executive Summary

- The Government is consulting on whether to introduce an online sales tax (OST), which would probably be levied at 1 or 2 per cent of a vendor's total online sales over a given allowance.
- The Government has repeatedly claimed that it does not intend to discourage online shopping. Rather, the stated purpose of an OST would be to produce enough revenue to fund a modest reduction in business rates for retail premises, helping to level the playing field between online and offline retail.
- However, any plausible version of the OST would be difficult to design, costly to implement, and the source of serious economic distortions – as well as being a very inefficient way to raise additional revenue.
- What's more, even if an OST were targeted at large online sellers (it is often dubbed 'the Amazon tax' in the press), the actual burden would fall overwhelmingly on consumers and small businesses.
- Given the current high-inflation environment, introducing a new tax burden on consumers would be totally at odds with the objective of reducing the cost of living. An OST would also sit uneasily alongside the Government's levelling up agenda, since its impact is likely to be felt most keenly in the UK's 'left behind' regions.
- It is of course vital to help the high street. But by itself, an OST would do little to do that. Polling for Coadec reveals that consumers prefer to shop online for non-price reasons, including choice, convenience, and the availability of stock. An OST would have to significantly increase online prices relative to in-store ones to make a meaningful difference to the fortunes of traditional retail.
- At the same time, an OST would damage the UK's position as a leader in the digital economy. We should celebrate that success – and recognise the vital role played by online retailers during the pandemic – rather than punishing growing businesses with a new tax.
- The industries of the future do not have to choose Britain. The introduction of an OST, coupled with other ill-advised moves on technology regulation, risks establishing Britain as an inhospitable jurisdiction for innovation, and could prompt tomorrow's entrepreneurs to look elsewhere.
- The premise of an OST – that online retail is some wholly separate part of the economy, raking in bumper profits based on unfair advantages over traditional shops – is also fundamentally flawed. In reality, most in-store retailers sell online too, and e-commerce profit margins have consistently fallen as competition has increased.

- Polling also suggests that an OST would be unpopular, with opposition to the tax both more widespread and more strongly felt than support for it. Net support for an OST can only be found among Londoners and high-earners – the rest of the UK's regions, social grades and income deciles are united in their opposition to the tax. Larger businesses are more sanguine about the prospect, but even here, support quickly falls away when specific scenarios are outlined.

- None of this is to suggest that high street retailers do not need support. They do. But the problem lies not with online retail, but with the fact that we try to raise far too much money from an incredibly badly designed system of business rates. Fundamental reform is sorely needed, but it needs to be uncoupled from the unhelpful discussion surrounding an OST.

- In the short run, high street retailers would undoubtedly benefit from the kind of business rate cuts that the Government thinks an OST could fund – though such benefits would be offset to some degree by the extra tax on high street retailers' own online sales. In the longer term, both economic theory and evidence suggest that retail rents might rise to offset lower rates, meaning that in the absence of more comprehensive change, relief could be short-lived.

- A better approach would be for the Government to make good on its 2019 manifesto promise, and deliver lower business rates through a fundamental reform of the system.

- As the CPS has argued elsewhere, business rates should be based solely on underlying land values, with 'improvements' stripped out of the tax base. This would automatically cut rates bills for shops in most parts of the country, while delivering a range of other long-term economic benefits. There should also be annual revaluations of the rates.

- The business rates multiplier should also be fixed – ideally at a lower rate – rather than rising with inflation in future. Additional revenues, if necessary to fund the cuts, should come from a broader rebalancing of the tax system – not from a narrowly targeted and distortionary tax like the OST.

- The Government should also pursue a range of other policies to help the high street, such as encouraging commercial-to-residential conversions, tackling empty storefronts, and encouraging consolidated ownership – or at least joined-up thinking – on high streets across the country.

- Ultimately, the case for an online sales tax does not stack up. It would burden consumers and small businesses at a time of high inflation. It would punish innovation, undermine competition, and generate significant deadweight losses at a time when economic growth should be a primary concern. It would hit hardest (and be most unpopular) in precisely those regions the Government says it wants to 'level up'. And it would do all that without making a meaningful or lasting difference to the precarious fortunes of the British high street.

Introduction

These are tough times for the British high street. Even before the pandemic, vacancy rates had been rising steadily to an average of 13% nationwide, reaching a high of 19% in the North East.[1] Estimates suggested that between 25% and 40% of retail space across the country was no longer viable in the long term.[2] More than two thirds of the British public felt that the quality of their high streets was declining – and with it, the quality of their communities, and of their daily lives.[3]

Many people have been quick to pinpoint the culprit: the rise of online shopping. This has certainly been extraordinary. As recently as 2007, online sales as a proportion of all retail sales were a mere 3.4%. In the first quarter of 2020, on the eve of the first Covid-19 lockdown, that figure had risen to nearly 21% – a six-fold increase.[4] And the pandemic turbocharged that growth, with the UK's top 100 retailers reporting an average increase in online traffic of 52%.[5]

'Between March 2020 and April 2021, 190,000 jobs were lost in retail, with 8,700 chain stores closing in the first six months of 2021 alone'

The result was devastating for the high street. Between March 2020 and April 2021, 190,000 jobs were lost in retail, with 8,700 chain stores closing in the first six months of 2021 alone.[6]

An increasingly vocal body of opinion has argued that this is not just an unfortunate development, but an unfair one. The argument is that the rise of online retail has not been driven by any inherent superiority in its business model, or at least not just by that. It has been fostered by a business tax regime that actively discriminates against bricks-and-mortar traders. Set up a shop on a high street, and you will be taxed to the hilt. Sell the same goods from a sprawling warehouse on the town's outskirts, and the burden will be far less. Hence the decision by the Government to consult on the merits of an online sales tax (OST), which was framed explicitly as 'a means to rebalance the taxation of the retail sector between online and in-store retail'.[7]

The case for such a tax is superficially attractive. We all know how important high streets are, and why we need to protect them. There is also widespread acceptance that business rates are horrendously high – it is no coincidence that the Labour Party

1 Local Data Company, *Retail and Leisure Analysis 2020.* Link
2 Alex Morton & Jethro Elsden, *Reshaping Spaces.* Link
3 Ibid.
4 ONS, *Internet sales as a percentage of total retail sales (ratio) (%).* Link
5 TLT, *Retail IT systems straining to keep pace with heightened demand.* Link
6 Chris Walker & Jack Hutchinson, *Cutting the Shops Tax.* Link
7 HM Treasury, *Online sales tax: Assessing an option to help rebalance taxation of the retail sector.* Link

has made reform of the system one of its core promises to business,[8] or that a group of the country's best-known retailers are backing a campaign to 'Cut the Shops Tax' (a campaign the Centre for Policy Studies wholeheartedly endorses).[9] A survey by the British Retail Consortium in September 2021 found that 83% of retailers said it was 'likely', 'very likely' or 'certain' that they would close shops if the business rates burden is not reduced.[10]

But as this report will show, there are profound question marks over whether an OST will do anything to help those firms – and, indeed, whether it will be in any way practical, effective, popular or simple to implement, or raise enough to remotely compensate for the existing burden of business rates.

'A survey by the British Retail Consortium in September 2021 found that 83% of retailers said it was 'likely', 'very likely' or 'certain' that they would close shops if the business rates burden is not reduced'

It should be remembered that the woes of the British high street long predate the rise of online retail. In 2011, the retail guru Mary Portas published her recommendations, commissioned by the Government, for addressing what was already a well-established problem. Although her report mentioned the likely future growth of online retail (then less than 10% of retail sales), not a single one of her 28 recommendations was concerned with deterring people from shopping online. Instead they focused on all too familiar problems such as vacant units, a lack of joined-up thinking, overly expensive or inaccessible parking – and, of course, the burden of business rates.[11]

In short, there is a powerful need to help the high street, and an overwhelming case for doing so. But as this paper will show, introducing a new tax on online sales would not just be a sticking plaster over a gaping wound, but a retrograde step in all kinds of other ways. The best way to help the high street would be to ease the unfair burden on firms operating there – not to impose new and equally unfair burdens on others.

8 Labour Party, *Labour to Scrap Business Rates and Replace with Fairer System.* Link
9 See www.cuttheshopstax.co.uk. Link
10 Chris Walker & Jack Hutchinson, *Cutting the Shops Tax.* Link
11 Gov.uk, *The Portas Review.* Link

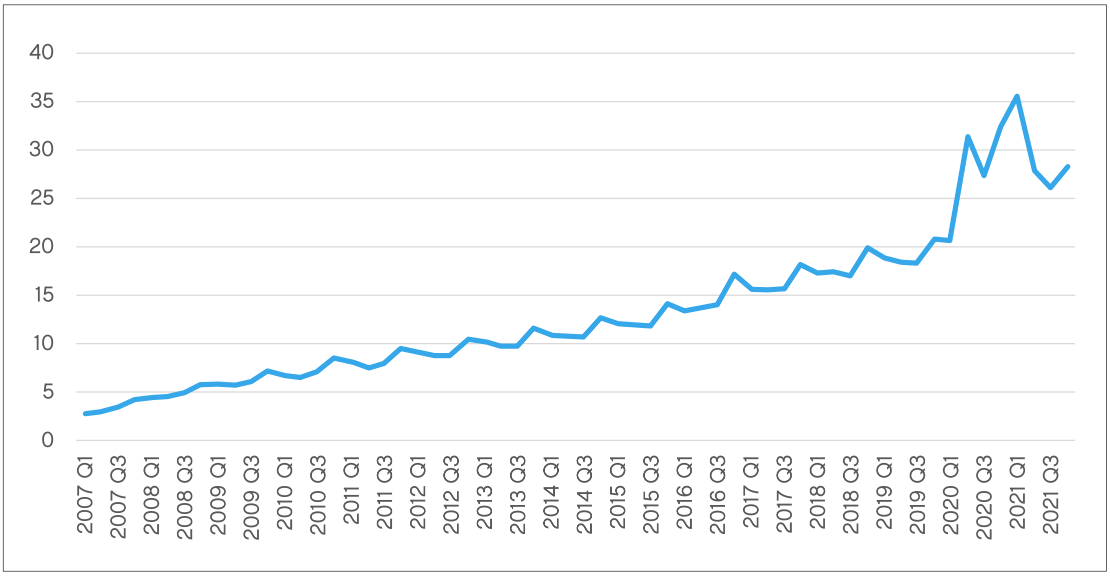
Part 1: Assessing the Case for an Online Sales Tax

The What and Why of an Online Sales Tax

Even before Covid-19 hit, there was already a long-term shift under way towards online retail and away from the bricks and mortar high street. However, this was hugely exacerbated by the pandemic. Overall in 2020, online non-food sales increased by 36.2% compared with 2019, while in-store sales of non-food items declined by 24.0%, reaching a record low.[12]

While the growth of online retail has eased off as high streets have reopened, the proportion of online purchases as a total of retail sales remains comfortably above pre-pandemic levels: 28.3% in Q4 2021 compared with 20.6% in Q1 2020.

Internet sales as a percentage of total retail



Source: ONS

This growth has not been spread evenly. Among the types of goods that people have been purchasing online, there has been a huge increase in the food and grocery sector – up by 94% since the pandemic began. Online purchasing of homeware also increased by 65%, as homeowners used lockdown to redecorate and rethink their living spaces. Lifestyle and leisure spending rose by 47%; fashion and beauty by 32%.[13]

12 British Retail Consortium, *No Christmas Respite as 2020 Hits Record Low.* Link

13 Ibid.

All this has come at a time when the high street was already reeling. Vacancy rates in 2019 ranged from 9% in London to 19% in the North East, averaging 13% across the whole country.[14] And as previous Centre for Policy Studies research has pointed out, regions with high commercial vacancy rates are correlated with areas where the Conservatives picked up more seats in the 2019 election.

Region	Conservative MPs gained in 2019	Gains as % of regional MPs	Vacancy rate
Greater London	0	0%	9.4%
South East	2	2.3%	11.3%
East of England	2	3.4%	12.6%
South West	1	1.8%	13.1%
East Midlands	7	15%	14.5%
West Midlands	9	15%	15.6%
Yorkshire & the Humber	9	16.6%	16.5%
North West	12	16%	16.5%
North East	7	24%	19.2%

Source: CPS & Local Data Company

While some consumers will return to their previous shopping habits once the impact of the pandemic fully recedes, a significant proportion will continue to shop more online, with evidence suggesting that the levels of online shopping are likely to remain elevated even as normal life resumes.[15] Almost four in 10 UK shoppers say their shopping habits have permanently changed, with the majority of consumers intending to do more shopping online than they did pre-pandemic.[16] Some 44% of people say they intend to visit retail shops less frequently than they did before the lockdowns.

All this has intensified the familiar debate about the future of the high street. Polling undertaken just before Covid hit by the Nationwide Building Centre found that over seven in 10 people found their high street an important part of their community – but as mentioned above, more than two-thirds said that it had declined over the past five years.[17] Additionally, more than seven in 10 people said that they would judge a local town by the state of the high street alone. A quieter high street means less of a community, fewer jobs, and a general degradation of the quality of life.

It has also been easy for many to pinpoint a culprit: online retailers, who benefit from lower overheads and are thus able to offer the same products at lower prices.[18] High-street retailers tend to face higher rents and higher business rates. Online retail commands a lower business rates bill: brands that are only online do not have high

14 Local Data Company, *Retail and Leisure Analysis 2020.* Link
15 Alvarez and Marshall, *The Shape of Retail.* Link
16 Ibid.
17 Elias Jahshan, *What high street shoppers want: more family-run businesses, fewer vape & betting stores.* Link
18 See, for example, LUHC Select Committee, *Supporting our high streets after COVID-19.* Link

street stores on which to levy business rates, and warehouses for storing online goods tend to have lower rateable values and therefore pay less in business rates.

All of this has sparked a policy debate about whether online retailers should be forced to pay an online sales tax (OST) in order to level the playing field. In February 2022, HM Treasury announced a call for evidence on an OST – a result of a commitment made in a wider consultation on business rates, published in October 2021.

The most obvious point to make here is that business rates are a huge source of revenue for the Government, bringing in a total of £31.7 billion in 2019-20, representing 1.4% of GDP.[19] That sheer amount of cash was one reason why the consultation on business rates rejected any fundamental reform, on the grounds that business rates funded vital local services and that no alternative commanded sufficient support to replace them.

For an OST in particular, or digital taxation in general, to replace a significant proportion of this sum, it would have to be levied at an extraordinarily high rate. The Director of the Centre for Policy Studies recently pointed out, with regard to Labour's proposal to fund a lowering of the burden on retailers by sextupling the existing levy on large tech firms, that you would need 170 more Googles to replace the full revenue from rates.[20]

Accordingly, the proposal being consulted on sets its sights relatively low, with hopes that introducing an OST will raise £1 or 2 billion annually – revenue that will explicitly be used to rebalance the tax system by funding business rates relief for bricks and mortar retailers.

‘Business rates are a huge source of revenue for the Government, bringing in a total of £31.7 billion in 2019-20, representing 1.4% of GDP’

Such a tax would be a global first, and would make the UK the only country in the world to place a sales tax solely on purchases made online. Which is among the many reasons that it needs extremely careful scrutiny.

The Government's online sales tax consultation, which ran from February 25 to May 20 this year, made it clear that the Government has not yet decided whether to introduce an OST, or determined the precise design and scope that any such tax would have.[21] Nevertheless, the Treasury's consultation document does give us some sense of what an OST would look like if it was introduced.

Unlike a typical retail sales tax, the Government envisages levying an OST on the seller rather than the buyer, and probably doing so based on some aggregated figure representing their online sales, rather than a sale-by-sale basis. In other words, we are talking here about an annual levy rather than a new form of online VAT.

19 Office for Budget Responsibility, *Economic and Fiscal Outlook March 2022.* Link

20 Robert Colvile, 'The ace up Starmer's sleeve is something the Tories can't match', Sunday Times, April 2022. Link

21 HM Treasury, *Online sales tax: Assessing an option to help rebalance taxation of the retail sector.* Link

If the consultation is anything to go by, this new tax would be levied at a fairly low level – perhaps 1% or 2% if the OST is based on revenues, or £1 per order if the tax is levied according to the number of orders a firm receives (or perhaps the number of deliveries it makes). The Government also looks likely to protect smaller firms by only levying an OST on sales above a given figure: £2m in online revenues is given as an indicative figure. An OST would likely be charged on goods but not services, and would probably aim to exclude business-to-business transactions.

It is worth stressing here that the purpose of this tax, from the Government's point of view, is explicitly not to make it harder to buy things online. The authors insist multiple times in the consultation paper that they do not intend 'to discourage consumers from shopping online'. Rather, the goal is to raise enough money from a tax on online sales to appreciably reduce the business rates burden on retailers.

'The Treasury suggests that a 1% OST, on top of a £2m allowance, would raise about £1bn – enough to replace roughly 13% of the business rates revenue from retail properties (or 9% from the broader category of retail, hospitality, and leisure property)'

The Treasury suggests that a 1% OST, on top of a £2m allowance, would raise about £1bn – enough to replace roughly 13% of the business rates revenue from retail properties (or 9% from the broader category of retail, hospitality, and leisure property). Excluding goods that are zero-rated for VAT purposes from the OST base would reduce the revenue generated – and the corresponding business rates relief – by 10-20%.

Advocates of an OST justify this potential trade-off by arguing that 'in-store retailers pay a disproportionate share of business rates', which makes 'bricks and mortar business models less competitive'. That, of course, was the problem that the Government promised to fix in its 2019 manifesto, via fundamental reform of the business rates system – which its consultation notably failed to deliver.

It is obviously true that high street retailers face high business rates. But that's not because the Government is singling them out for perverse treatment. Rather, it is because business rates are based on property values, which tend to be high in city- and town-centre locations.

There are therefore two principled objections to an OST. The first is that all businesses face the same overall tax system – just as they face, say, the same employment regulations and minimum wage laws. They must decide on that basis how to structure themselves and operate. You could argue that online retailers have simply worked out a lower-cost way to provide a service – just as a business that automates production has found a more efficient way of fulfilling its orders.

The second is that even if the current tax system does discriminate against a particular retail model, the solution should be to ease the burden on those retailers rather than increasing it on other firms. Imagine for a second that the fortunes of online and in-store retail were reversed, and high packaging and delivery costs (perhaps driven by new environmental levies to reduce packaging waste and delivery emissions) were making online retail uncompetitive. Would such a scenario justify an additional tax on in-store retail to 'level the playing field'? Almost no one would suggest that was a good idea.

Fundamentally, the problem here is that we are trying to raise far too much money from a particular tax base – namely, the rental value of commercial property. And as we will show, even if an OST were in theory the best way to address that problem, it is certainly not in practice. For even a version of the tax that sounds quite straightforward and limited at first has the potential to prove fearsomely complicated and economically damaging in practice.

Designing an Online Sales Tax

The Government's consultation on the OST is an unusual document, in that it almost reads like a carefully composed case against the introduction of any such tax.

Time and again, the consultation paper lays out the practical impediments to an efficient and effective OST coming into force, before asking respondents for ideas about how such problems could be overcome.

In many cases, the only honest answer is that they can't: the OST is by its nature a narrow and distortionary tax, and trying to square it with good economic policymaking is a fool's errand.

In particular, early in the consultation, the authors lay out five core principles for sensible tax policy. Taxes should be *sustainable* in view of long-term trends; should be *efficient*, by incentivising economic growth and minimising distortions; should be *fair*, reflecting ability to pay; should be *simple*, involving low compliance and collection costs; and should be *predictable*, allowing individuals and businesses to plan for the future.

'Time and again, the Government's consultation paper lays out the practical impediments to an efficient and effective OST coming into force'

On the face of it, an OST might seem sustainable, since online shopping is currently in the ascendant, and looks very much like the future of retail. Presumably there will be sales revenue there for the Government to tax – if it is so inclined – for the foreseeable future. But a narrow tax that generates such a small amount of revenue is always going to be something of an orphan within the tax system, imposing significant frictions for little practical gain. The most sustainable taxes are those that collect a large amount of revenue, on a broad base, according to clearly understood principles.

The proposed OST can also be challenged on the grounds of fairness. If you assume the burden of an OST will ultimately fall on consumers, is it fair to make those who prefer to shop online bear a greater tax burden than those who like to shop in person? Or that, as we show below, its burden falls disproportionately on the most deprived parts of the country? Putting another burden on consumers while inflation continues to rise also seems distinctly unfair.

As for predictability, an OST would contribute to the ever-increasing impression that Britain has an unsettled tax system, in which the Government looks to target new and innovative business models with specific taxes, rather than maintaining a neutral tax system based on big, broad tax bases, like income or consumption. As such, an OST could be seen to make the tax system rather less predictable, and therefore give people and companies less certainty as they plan for the future.

All that being said, however, the strongest objections to an OST fall under the categories of simplicity and efficiency – because as the Government's own consultation goes a long way towards showing, an OST would almost by definition be neither of those things. In fact, any plausible model for an OST would be very complicated, costly to administer, and highly distortionary – while doing absolutely nothing positive for economic growth.

To get an idea of the complexity involved in designing an OST, consider the very basic issue of defining what is being taxed here: what is an 'online sale' for the purposes of the levy? The obvious answer is a sale where the order is placed via the internet. Yet why should an internet sale be treated differently from a mail-order one, or one made by telephone? In both cases, sellers are avoiding high street premises and the business rates burden they carry. Extending the tax base to all remote sales – a possibility highlighted in the consultation – would be entirely consistent with the basic logic of an OST. But it is also rather perverse. Mail-order shopping has been with us since the Victorian era. It would be bizarre to suddenly slap an extra tax on it now.

'Any plausible model for an OST would be very complicated, costly to administer, and highly distortionary – while doing absolutely nothing positive for economic growth'

The question of where to draw the line is an extremely difficult one. An order placed on amazon.co.uk or in the Amazon app is pretty clearly an online sale. But what if Amazon allowed you to place orders via an automated telephone service? Should that be taxed differently from a sale made via instant messaging? 'Click and collect' opens another can of worms. If I place an order at marksandspencer.com but collect it from my local store, is that an online sale or not? Would it make a difference if I clicked and collected from the post office, or even an unmanned drop-off locker, rather than the retailer's own premises? Any narrow definition of an OST is bound to trigger all sorts of efforts to avoid the scope of the tax; while any broadly definition is bound to seem arbitrary and unfair.

Then there's the issue of distinguishing between goods and services. The OST consultation seems to envisage that an OST would apply to goods only. But how do you then differentiate between the value of goods and any associated service or membership fees? And how do you determine where a good ends and a service begins? Various 'delivery box' subscriptions are becoming increasingly popular. These might provide a weekly box of ingredients with associated recipes or tasting guides. How much value is in the goods themselves, and how much is in the selection, the advice, and the regular delivery? You might say that these things should all be taxed as online sales – but then what do you do about takeaways? Are they subject to the OST if ordered via Deliveroo or Just Eat, but untaxed if ordered by telephone?

Again and again as you think through the implications of an OST, you are confronted with a choice between taxing fundamentally similar activities quite differently, or broadening the scope of the tax to include all sorts of things that few people would have considered an 'online sale' at the outset.

An OST thus risks being incredibly complicated, or else logically incoherent. Either way, you are likely to cause serious distortions to business and consumer behaviour as people seek to take advantage of any grey areas to avoid the tax. That makes for poor tax policy and is bad news for the economy.

The challenge, remember, isn't just in defining the OST – it is also in making it feasible for businesses to track, report and comply with their tax liability. That means new accounting practices and software, with the associated bureaucratic burdens and transaction costs. And all this for a tax mooted to generate about as much revenue as a 0.15 percentage point increase to the standard rate of VAT.[22] It is extremely hard to see how this makes sense from a tax design standpoint.

Of course, it is also the case that even a 'perfectly' designed OST would be distortionary. The Government might not want to discourage online shopping, but it is a pretty fundamental feature of tax policy that if you tax something, you tend to get less of it. (That, indeed, is the point of taxes on sugar, tobacco and so on.)

'The distortion of business and consumer decisions is an inherent and inevitable part of introducing a narrowly targeted tax like the OST'

There is one last issue before we move on to discuss the broader economic consequences of an OST: the importance of exempting business-to-business sales. Failing to do this would lead to a 'cascade effect' of increased input prices at each step in the supply chain, potentially driving up prices for the final consumer by much more than the headline rate of the tax, and causing significant distortions to production processes. This would be very bad news from an economic standpoint.

Yet it also won't be easy to avoid. The consultation rules out a VAT-style system, whereby businesses reclaim the tax they have paid to suppliers while collecting it from their customers, as inappropriate for a narrowly targeted tax like an OST. This means that the onus will be on purchasers to prove that they are themselves businesses, on sellers to ensure that only sales to end-consumers are subject to the tax, and on the tax authorities to somehow prevent the whole system from being abused. The fact that the tax system already contains multiple different definitions of what counts as a business will only make matters more difficult.

Ultimately, while an OST sounds like a simple enough idea on paper, in reality it would be anything but. Whatever the Government's intentions, the distortion of business and consumer decisions is an inherent and inevitable part of introducing a narrowly targeted tax like the OST. The immediate economic and administrative costs of implementing such a tax would in all likelihood be completely out of line with the modest amount of revenue to be raised.

What's more, as we turn to the broader economic impacts of an OST, the case for such a tax only grows weaker.

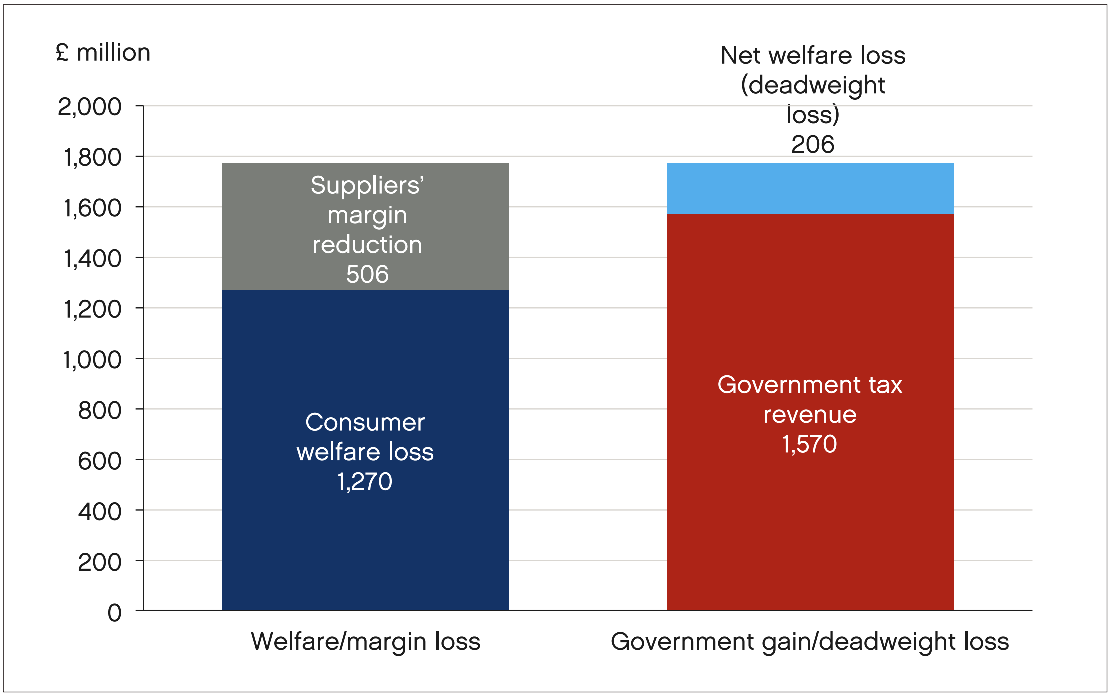
22 Based on HMRC, *Direct effects of illustrative tax changes.* Link

The Impact of an Online Sales Tax on Consumers

The most important thing to realise about an OST is that even if it is levied on vendors, the burden is likely to be felt primarily by consumers. An online sales tax will mean higher prices, and will add to an already significant inflation problem.

A study by Oxford Economics found that the introduction of a 2% online sales tax would raise around £1.6 billion for the Treasury. Their modelling suggests that the brunt of this would be borne by consumers, rather than retailers. Consumers could expect to lose around £1.3bn in welfare terms, whereas suppliers would lose just over £500 million. In other words, consumers would have to absorb around 72% of the cost of the tax.

On top of this, the increase in Government revenues would not be sufficient to compensate for the combined loss to consumers and retailers, with the net inefficiencies due to the OST being around £200m.[23]



Source: Oxford Economics

While there is a degree of uncertainty around these numbers, they are certainly a plausible estimate of the likely effect of an OST. Polling by Public First for Coadec found that 83% of businesses selling online said they were likely to pass the cost of an online sales tax on to consumers, compared with just 13% who said they were unlikely to do so.[24]

An online sales tax would be regressive

Unless the Government were to introduce a series of exemptions or thresholds – which would come with problems of its own, by further complicating the tax base and reducing the amount of revenue it would raise – all online purchases would be taxable under an OST. This would include essentials such as food, drink, clothing and footwear. As a result, the imposition of a new tax on these products would adversely impact all households.

23 Oxford Economics, *The economic impact of an OST.* Link

24 Public First, *Polling on changing trends in ecommerce.* Link

However, the tax is bound to hit the poorest and most vulnerable members of society hardest. Consumption taxes like the OST tend to be regressive: low-income households have to spend proportionately more of their income to fund their consumption, and also have lower savings.

In 2020, those in the lowest income decile spent £34.40 a week on food and non-alcoholic drinks. If 31.2% of food shopping is done online, in line with the statistics cited above, this would equate to £555.36 a year. With the imposition of a 2% levy, that spending would jump to £566.46.[25] Across all incomes, the average figure would be an extra £22.67 per year. Looking more broadly, the lowest income households spend £74 a week on food and non-alcoholic drinks, clothing, household goods and services and miscellaneous goods and services. If such a household was making all their purchases online, a 2% levy would equate to an extra £76.96 a year. Across all income deciles, the tax would equate to an additional £175.76 per year.

‘Inflation is predicted to hit 11% this year, the fastest rate for 30 years. The energy price cap means households can expect to pay 50% higher energy bills this year – an unprecedented increase’

Now, those may not seem like the biggest figures, but given the unprecedented income squeeze economists are forecasting over the next few years, any unnecessary burden that government chooses to place on ordinary households is likely to have an outsized impact. Many families have already been pushed close to or even beyond their financial limits by increases in the cost of living. Inflation is predicted to hit 11% this year, the fastest rate for 30 years.[26] The energy price cap means households can expect to pay 50% higher energy bills this year – an unprecedented increase. Then there are the increases to National Insurance contributions for companies and higher earners, and the looming corporation tax increases, which are also likely to put downward pressure on wages.[27] The Bank of England has warned of a recession later this year, and the IMF has projected that the UK will have the lowest growth in the G7 next year.[28]

The very last thing the economy, or the public, need is another inflationary tax. Indeed, the price-raising impact of an OST could go beyond the simple pass-through of the levy to consumers. For one thing, if an OST raises prices online, it will weaken competitive pressure on offline retail; further retail price increases may occur as a result. And as noted above, if business-to-business transactions are not exempted from the OST (or are only imperfectly exempted), it could lead to higher prices throughout the supply chain, further pushing up consumer prices.[29]

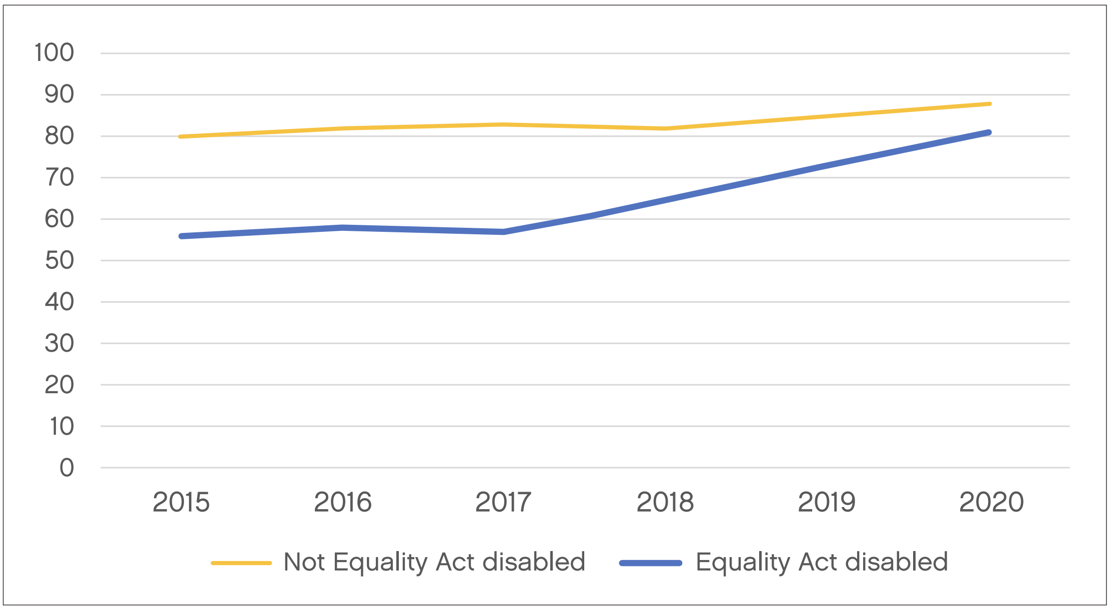
The OST is also likely to have a particular impact on elderly and disabled people who may, for mobility reasons, be more reliant on online shopping to purchase essentials. While the elderly still tend to shop less online than younger people, the Covid-19 lockdowns have clearly had an impact, with the proportion of over-65s shopping online rising especially fast in recent years.[30] Now that initial barriers (such as setting

25 Authors’ own calculations based on ONS, *Family spending workbook 2: expenditure by income.* Link
26 BBC, *UK Inflation.* Link
27 Wiji Arulampalam et al., *The Direct Incidence of Corporate Income Tax on Wages.* Link
28 The Guardian, *IMF cuts global growth forecast over Ukraine war.* Link
29 IFS senior economist Stuart Adam made this point during a CIOT/IFS debate on the online sales tax. Link
30 ONS data from Oxford Economics, *The economic impact of an OST.* Link

up accounts and entering payment details) are out of the way, we can expect this trend to continue.

The disabled have also become increasingly reliant on online shopping in recent years. The graph below, which we have reproduced from Oxford Economics' analysis, shows that the share of those with disabilities shopping online increased from 56% in 2015 to 73% in 2019 and jumped up to 81% in 2020. This rate of increase has been faster among those with disabilities than those without.

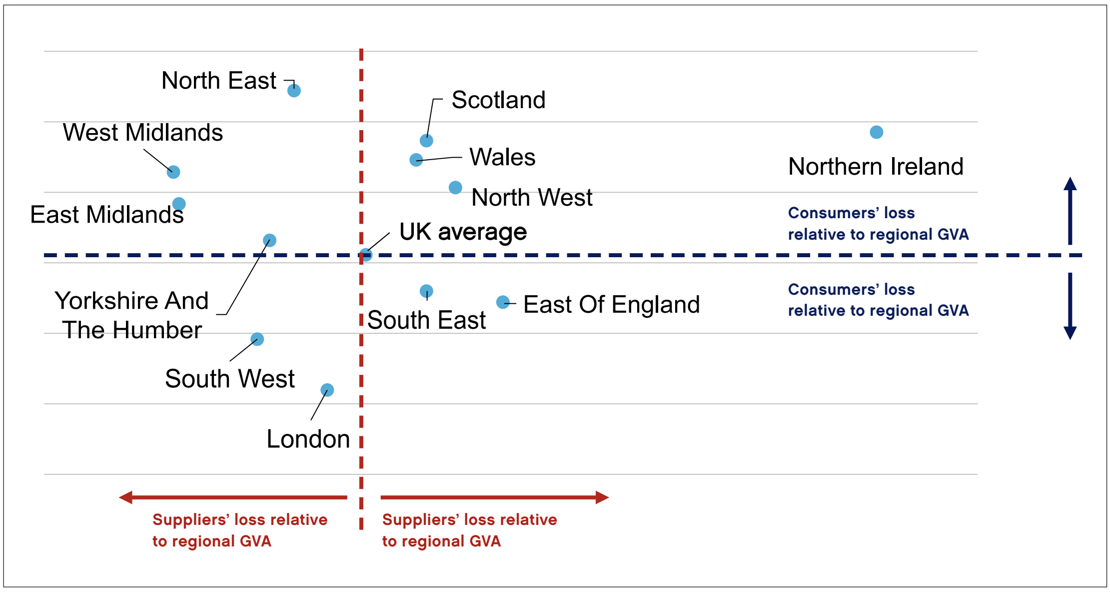
Percentage of disabled people shopping online in the last 12 months



Source: ONS

Oxford Economics' modelling suggests that there is also a regional element the Government needs to be wary of. They find that an OST is likely to disproportionately affect economic activity in regions of the UK with lower-than-average incomes, with the negative economic impacts on consumers and businesses felt most acutely in Northern Ireland, Scotland, Wales, and the North West – and relatively less severe impacts in London and the South West.

The worst affected regions are those where consumers spend a higher share of their income on products and services covered by the OST and where retailers' contribution to the regional economy is higher than the UK average. In terms of its impact on jobs, for example, an OST is likely to have a disproportionate impact in the Midlands, where delivery and warehousing jobs account for a much higher proportion of regional employment than elsewhere in the country.



Source: Oxford Economics

Introducing an OST would therefore be an odd move for a Government that is committed to levelling up, and an even odder one for a Government that claims to be focused on tackling cost of living increases. It would add to the inflationary pressure on ordinary families, and likely weigh most heavily on the least well-off households and regions. From a consumer standpoint, in short, an OST has little to recommend it.

The Impact of an Online Sales Tax on Business

When you listen to proponents of an OST, you sometimes get the impression that online retailers are raking in bumper profits at the expense of in-store retail, and that policymakers ought to step in to spread the wealth around. But this perception isn't grounded in reality.

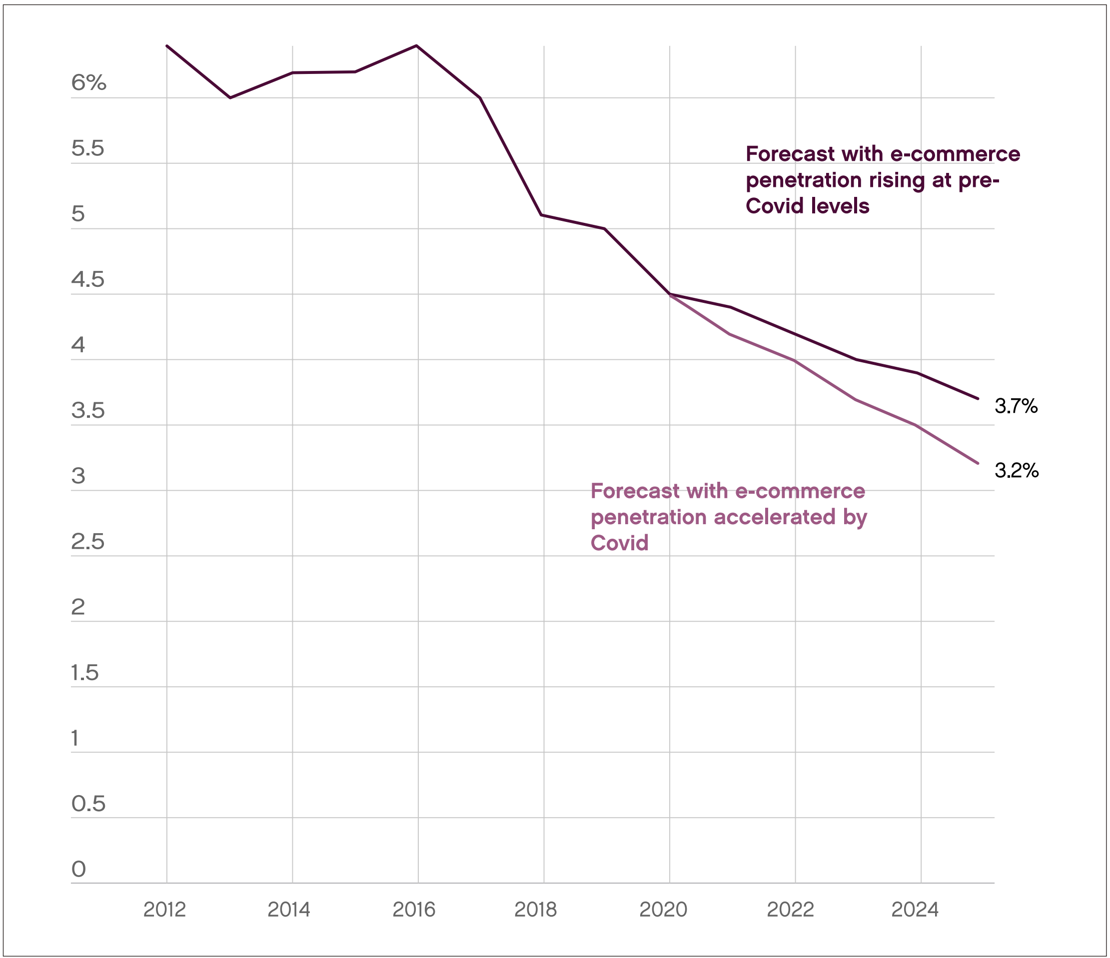
While online retail is, in many respects, thriving, it is also a highly competitive and mostly low-margin business – and one that faces significant challenges of its own.

For example, research shows that online businesses have seen a steady decline in profit margins. One analysis found an inverse correlation between the increase in share of sales happening online and profit margins: as e-commerce penetration rises, margins fall. By 2025, it forecast that pre-tax margins for online retailers in the UK will sink to just 3.2%, down from 9.2% in 2011/12.[31] Online food retail is a particularly cut-throat sector. One analyst recently told The Sunday Times that if the big supermarkets had known 25 years ago how meagre the returns would be from setting up online operations, 'they wouldn't even have bothered'.[32]

31 Alvarez & Marsal, *The shape of retail.* Link

32 Sam Chambers, 'Rapid food delivery primed to be the next victim of the 'tech wreck', Sunday Times, June 2022. Link

Pre-tax e-commerce profit margins in six European countries (inc. UK)



Source: Retail Economics and Alvarez & Marsal analysis

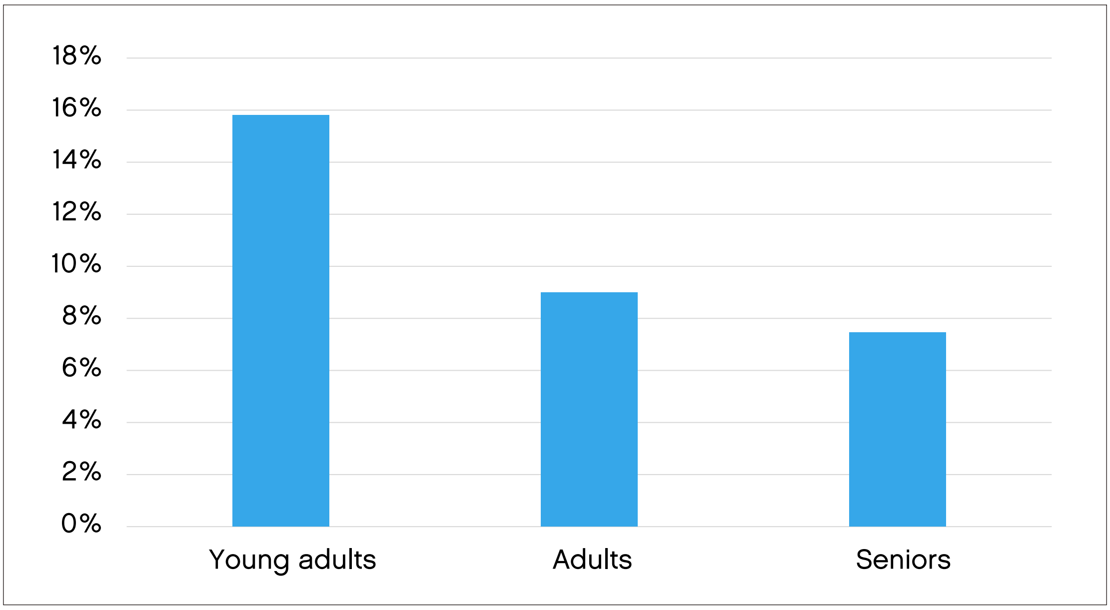
Of course, sectors such as groceries were already operating on thin margins long before e-commerce came along. But selling goods online can bring its own challenges. Most obviously, the nature of online shopping makes it easy for consumers to compare prices across retailers, creating intense competition to offer the best deals possible. In the US, prices across Amazon and other online retailers ticked downward for so long that it prompted one economist to suggest online shopping was a key driver of the country's then historically low inflation rates.[33]

The costs of fulfilling orders and handling returns can also be high. Shoppers have come to expect fast, inexpensive shipping, placing the financial burdens of delivery largely on the shoulders of retailers. Young people in particular are inclined to shop online more, yet return twice the number of items bought compared to the over-65s – another significant cost for online retailers.[34]

With the acceleration of online shopping caused by Covid and an incoming tech-savvy generation who have grown up experiencing the fierce rivalry of competing sites, there is a long-term problem for online retailers, who will have to factor in increased returns eroding their profitability.

33 Patricia Cohen, 'E-Commerce Might Help Solve the Mystery of Low Inflation', New York Times, June 2018. Link
34 Alvarez & Marsal, *The shape of retail.* Link

Percentage of online items returned



Source: Alvarez & Marsal

In response, many SME retailers are increasingly using third party platforms to sell their goods. In exchange for a fixed commission, they do not have to deal with shipping and returns themselves. The most notable of these platforms is Amazon, which is the very same company an OST is intended to target – hence the headline characterisation of the tax as 'Amazon Tax'.[35]

As of 2020, SMEs accounted for more than 60% of sales on Amazon's stores in the UK.[36] During the 12 months prior to April 2020, UK SMEs sold more than 600 million products on Amazon, up 100 million from the previous year – which equates to around 1,200 products sold per minute.

> **'A study by Deloitte and Taj found that only 5% of the tax burden from France's new digital tax was borne by the targeted companies'**

But it's worth considering whether an OST would actually target Amazon in the way its advocates suggest. When the digital services tax (DST) was introduced, in order to extract more cash from giant tech firms who were perceived to have been failing to pay their share, Amazon passed the burden on to third party sellers on its platform – the majority of which are SMEs. Similarly, Google charged its advertising clients an additional fee for ads served on Google and YouTube. The move was estimated to add about £120m annually on to marketers' costs.[37]

Similar scenarios have played out in other countries. In 2019, France enacted the first unilateral DST. The tax is a 3% levy on gross revenues from targeted online advertising, sales of users' data collected for advertising purposes, and digital interface services. A study by Deloitte and Taj found that only 5% of the tax burden from France's new

35 Sky News, 'Rishi Sunak "considering Amazon tax" to claw back pandemic borrowing from online retailers who profited'. Link

36 Amazon UK, *2020 Amazon UK SME Impact Report*. Link

37 Mark Sweeney, 'Amazon to escape UK digital services tax that will hit smaller traders', The Guardian, October 2020. Link

digital tax was borne by the targeted companies.[38] Approximately 55% was borne by consumers, while businesses that use the platforms provided by the firms affected absorbed 40%. Amazon, for example, increased the commission for SMEs selling on its marketplace from 15% to 15.45%. The tax thus clearly failed to meet its objectives, punishing consumers and smaller online retailers rather than the big multinationals. This is a pattern that has been repeated when other governments that have tried to implement similar digital taxes, such as India and various US states.[39]

While the proposed online sales tax is different to the DST, it is very easy to see the same dynamics taking shape. The Government may want to target Amazon and other large online retailers – but the reality is that smaller businesses and consumers are overwhelmingly likely to be the ones that lose out. Indeed, rather than challenging the dominance of the large multinationals, such taxes may in fact end up giving them a competitive advantage at the expense of SMEs.

An online sales tax would discourage innovation and stifle competition

One of the arguments for the OST is that it would 'level the playing field' or promote 'fair competition' between online and in-store retail. But there is every chance that an OST would prove counterproductive, by curtailing businesses' response to evolving consumer behaviour.

For example, research shows that around 80% of people now research a company online before visiting it or making a purchase, which means SMEs without a digital presence risk losing out.[40] Another survey of over 500 SMEs found that completely digital SMEs (those that use digital tools such as invoicing and payments, customer service, chat, and automations etc) take in an average of £35,000 a month more than their peers. Figures like these show how important it is for retailers to have an effective online presence, and keep up with the latest developments in the digital revolution.

> **‘In the first year of the pandemic, global e-commerce jumped to $26.7 trillion as Covid-19 boosted online sales, and in its first six months 15% of UK companies created roles specifically to cater to an increase in digital sales and boost online capacity’**

One problem with the introduction of an OST is that it will discourage and disincentivise businesses – especially smaller ones – from modernising their approach. Mike Cherry, as chairman of the Federation of Small Businesses, warned that the Government's proposals 'would achieve the polar opposite' of their intended aim,[41] cautioning that an OST could put people off starting their own business, or might mean they were deterred from creating a website. Tom Ironside of the British Retail Consortium suggested the tax would be 'another burden'[42] that would hit high street retailers with an online presence.[43]

38 Deloitte and Taj, *The French Digital Service Tax: An Economic Impact Assessment.* Link
39 TPA, *Assessing an OST.* Link
40 Sparrow, *No website, no growth for business.* Link
41 Simon Neville, 'Government launces consultation into OST', The Independent, February 2022. Link
42 The Guardian, British retailers issue warning over OST.
43 Linda Howard, 'Warning new OST plans would hit home shoppers hard', Daily Record, February 2021. Link

Proponents of an OST also suggest it would promote fairer competition in retail. But it is hard to see how retail markets would become more competitive overall thanks to an OST. SMEs and new businesses will find it more challenging to absorb the cost compared to incumbent multinationals. As noted above, an OST could actually discourage traditional retail from raising its game and adapting to new market trends. More fundamentally, an OST would also punish those businesses that have taken the risk to innovate and become more efficient by making use of the technology available to them.

It is also an odd time for the Government to consider such a measure. Online retail has become increasingly important to UK retailers and consumers. As non-essential stores were forced to close due to the pandemic, e-commerce was, and continues to be, relied upon to keep many businesses afloat. Companies who had an online presence also helped to keep the country moving, in many cases giving priority access to key workers for online delivery slots, as well as to the elderly and vulnerable – who would otherwise have had to expose themselves to increased risk by purchasing essentials in person. In Public First's polling for Coadec, some 60% of people agreed that online shopping had been a 'lifeline' during the pandemic, including the majority of those over the age of 65 (55%).

> **'Given the choice between buying the same good online or in-store, at the same price, 53% preferred to buy online versus 35% who would buy in-store'**

In the first year of the pandemic, global e-commerce jumped to $26.7 trillion as Covid-19 boosted online sales,[44] and in its first six months 15% of UK companies created roles specifically to cater to an increase in digital sales and boost online capacity.[45] Amazon, for example, created 25,000 additional jobs in 2021 while at the same time increasing salaries for its workers.[46] Supermarkets increased the number of delivery slots and were able to finally turn a profit on online deliveries for the first time in 20 years,[47] with Tesco taking on an additional 16,000 permanent workers.[48] An OST would punish and disincentivise the type of innovation displayed by those retailers who helped keep the country running during the pandemic.

It is also important to remember that the UK is a world leader in the digital economy, with a vibrant start-up scene and lots of innovation going on in both established and new businesses. This is something that we should be proud of and should seek to build upon. Punishing that dynamism is not a recipe for economic success – and may, crucially, encourage future entrepreneurs to look elsewhere. On almost every score, then, an OST would be a step in the wrong direction.

An online sales tax will hurt online retail – but it won't do much for the high street

The Treasury claims in its OST consultation that it does not want to discourage online retail. The implication is that it hopes an OST could be cost-free – a tax people don't notice or respond to, but which nevertheless raises enough money to cut the retail

44 UNCTAD, *Global e-commerce jumps to $26.7 trillion, COVID-19 boosts online sales.* Link

45 Barclays, *Online shopping growth sees surge in e-commerce roles.* Link

46 Daniel Thomas, 'Amazon adds 25,000 workers in UK to handle Covid sales boom', Financial Times, February 2022. Link

47 Ben Stevens, 'Online grocery is now as profitable as in-store shopping for the first time', Charged Retail, April 2021. Link

48 Jo Faragher, 'Tesco to create 16,000 new jobs as online sales soar', Personnel Today, October 2020. Link

sector's business rates bills. Sadly, this is a vain hope – as the analysis above has shown, any OST is bound to hurt online retailers and consumers.

Yet the OST by itself (leaving aside any associated business rates cuts for now) isn't likely to do much to revive the high street. It is important to address this point, because although the Government has avoided making such a claim, some OST advocates do tend to give the impression that a tax on online retail would send shoppers trooping back to their local high street. In reality, that is unlikely to be the case.

Polling of consumers by Public First for Coadec suggests that for those who prefer to shop online, price is just one attraction among many. Eighty per cent said that lower prices were important in deciding whether to shop online. However, the same percentage identified greater choice and ease of comparison as key factors. The most popular response, selected by 82% of those polled, was the greater availability of stock.

The point here is that online retail doesn't just compete on price – choice and convenience are big parts of its appeal. People have become used to being able to have almost anything they want delivered to them at the click of a button. So while it will inevitably have some impact at the margin, a small tax on online sales is unlikely to resuscitate high streets that are beset by a host of other structural problems, as well as changed consumer preferences.

> **'Research conducted by Visa last year showed that 87% of small high street businesses consider an online presence paramount to their commercial success'**

Interestingly, Public First also asked consumers a series of questions designed to test how price sensitive they were when it came to deciding between shopping in-store or online. Given the choice between buying the same good online or in-store, at the same price, 53% preferred to buy online versus 35% who would buy in-store. Making the online good 2% cheaper than the offline equivalent didn't make much difference to those figures (56% vs 33%). Making the online good 2% more expensive did have an impact, but only to the extent of roughly equalising preferences (46% vs 45%).

This is obviously just one opinion poll. But it does have interesting implications. First, it suggests that people tend to prefer shopping online for non-price reasons. This ought to give us pause for thought in attributing too much of the divergence in fortunes between online and in-store retail to cost issues. Second, if your goal is to sway consumer behaviour back towards traditional high streets, you would need to make online shopping noticeably more expensive than in-store shopping to have much of an impact. That is neither a realistic nor a desirable objective – and it certainly isn't one that will be achieved by the kind of OST outlined in the Government's consultation.

Furthermore, in much of the analysis above, we've talked about online and in-store retail as though they are rigidly separate parts of the economy. That, indeed, is part of the conceit of an OST – that online retail is a distinct sector that can and should be targeted with a specific tax.

In reality, of course, this view of online retail is wildly anachronistic. Public First carried out polling of businesses as well as consumers. It found that more than half of businesses now sell products online, with another third saying they are likely to start in the next 12 months. At the same time, two-thirds of firms that sold online said that physical premises will continue to be important to their business in future.

In other words, much of the UK's retail sector is 'hybrid', with the same businesses serving customers both online and in-store – a pattern which businesses expect to continue for years to come. Most high street businesses, in other words, are also online businesses: separate research conducted by Visa last year showed that 87% of small high street businesses consider an online presence paramount to their commercial success.[49] And some primarily online businesses (such as Amazon) have been experimenting with physical retail.

The point here is that it really doesn't make much sense to think of online retail as some specific, separate part of the economy. Many of the retailers that would be hit by an OST are high street retailers too. Equally, we mustn't think of online retail as just 'Amazon and co' – most businesses, large and small, all over the country, make a lot of their money selling online. You might avoid punishing the smallest by introducing that £2 million allowance. But you would still be hitting an extremely wide range of businesses.

The (Un)Popularity of an Online Sales Tax

Politics being what it is, the various objections we have raised against an OST might not count for much if the idea was an overwhelmingly popular one. However, we can say with a significant degree of certainty that the great British public are not, in fact, crying out for an online sales tax. In fact, the political case for the tax doesn't stack up any more than the economic one.[50]

‘Public First found that only 29% of consumers approved of an OST (with just 9% approving strongly). By contrast, 46% were opposed to an OST (29% strongly)’

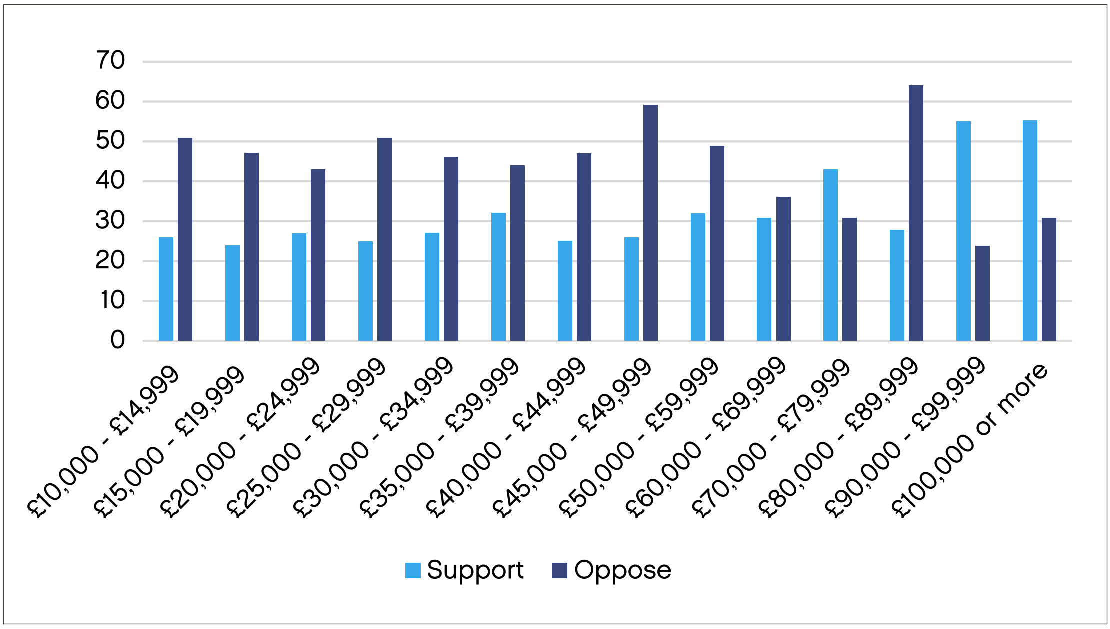
Public First found that only 29% of consumers approved of an OST (with just 9% approving strongly). By contrast, 46% were opposed to an OST (29% strongly). Put simply, opposition to an OST is both more widespread and more strongly felt than support for it.

Remarkably, given how divided the public is on many economic issues, opposition to an OST is almost universal across regions, income bands, and social grades. Indeed, every social grade (from white collar professionals to unskilled labourers) is opposed to the introduction of an OST. Every UK region (with the exception of London) is against the idea. And only the highest earners (those earning £70,000–80,000 and above £90,000) seem to be in favour of it.

49 Visa, *From bricks to clicks.* Link

50 The polling referred to throughout this section is Public First, *Polling on changing trends in ecommerce.* Link

Support for an OST by income



Source: Public First polling for Coadec

Not to put too fine a point on it, but it would certainly be odd for the current Government to pursue a tax policy that only has net support among well-off Londoners.

Public First also conducted separate surveys of micro-businesses (those with 1–5 employees) and business in general. The smallest businesses were almost as opposed to the introduction of an OST as consumers, with 41% opposed (23% strongly) and 31% in favour (with strong support at just 1%). Businesses in general were broadly supportive of an OST (44% approve, 35% disapprove) – but even here support fell away once respondents were presented with a list of particular goods and services that could be taxed.

> **‘The smallest businesses were almost as opposed to the introduction of an OST as consumers, with 41% opposed (23% strongly) and 31% in favour (with strong support at just 1%)’**

As the table on the following page shows, Public First didn’t find overwhelming approval among businesses for applying an OST to any of the products and services listed. The only scenario with net support was the first one, with 47% in favour and 46% opposed. But consumers were resolutely opposed to all the suggested scenarios. Only 18% supported applying an OST to ‘a pair of shoes bought online’ – which is about an obvious a target for such a tax as you’re likely to find. Some 40% of consumers didn’t think an OST should apply to a single one of the scenarios listed on the following page.

If the Government was to introduce a new tax on things bought online, which of the following do you think the tax should apply to?

Scenario	Consumers in favour	Businesses in favour
A new TV bought online and delivered to my door	20%	47%
Headphones ordered through an online marketplace (e.g. Amazon or eBay) delivered to my door	19%	46%
A pair of shoes bought online	18%	45%
Headphones ordered through an online marketplace (e.g. Amazon or eBay) and picked up from a parcel 'locker' at my local train station	16%	44%
A Netflix subscription	13%	34%
A takeaway curry ordered through an app (e.g. Deliveroo or Just Eat) and delivered to my door	13%	35%
Groceries ordered online and delivered to my door	12%	34%
A handmade greetings card made by an independent retailer sold through an online marketplace (e.g. eBay or Etsy) and delivered to my door	12%	35%
A hotel booked online	11%	33%
A new TV bought online but collected through a click & collect service	11%	35%
Groceries ordered online through a click & collect service	10%	29%
A drink bought in a pub through the pub's app and delivered to my table	8%	25%
A burger ordered through a QR code in a restaurant	8%	25%
Home insurance purchased online	8%	30%
A takeaway curry ordered online but paid for and collected in person	8%	26%

Source: Public First polling for Coadec

It is one thing to introduce a policy that, while unpopular, has a clear and coherent economic rationale, and is necessary for the security and prosperity of the country. But an online sales tax plainly doesn't meet that standard. Pressing ahead with its implementation in the face of widespread consumer opposition and only partial business support would therefore be a very strange move.

Conclusion

As the analysis above has made clear, an online sales tax would burden consumers at a time when cost of living pressures are one of the most important challenges the country faces. It would hurt small business and effectively punish the dynamic, innovative firms who sell online – a British success story in an economic climate that makes good news hard to come by. The negative economic impacts of an OST would also be felt most keenly in Britain's 'left behind' regions and among its poorest and most vulnerable households.

Taken together with other ill-advised policies currently being pursued on tech regulation, most notably the Online Safety Bill, implementing a narrowly targeted tax on online sales would also send a terrible message about how government views the industries of the future. It would make today's and tomorrow's entrepreneurs think twice about choosing Britain, and potentially diminish our long-term growth prospects as a result. The proposed OST is thus quite at odds with the liberalising, future-facing vision of Britain after Brexit embodied elsewhere in the Government's agenda.

'An online sales tax would be difficult to design, costly to implement, and almost inevitably the source of all sorts of perverse distortions to business and consumer behaviour'

On a basic, technical level, moreover, an online sales tax would be difficult to design, costly to implement, and almost inevitably the source of all sorts of perverse distortions to business and consumer behaviour. These unintended consequences can't be wished away – they are practically inherent to the very concept of a tax on online sales.

For all that, an OST would do little, by itself, to aid the ailing British high street. We also believe it would prove widely unpopular among British voters.

Of course, none of this is to say that the high street doesn't need more support, in particular by cutting business rates – just that the Government is wrong to tie any such changes to a fundamentally flawed new tax like the OST.

In the final part of this report, we will therefore consider the broader case for reforming and reducing business rates, along with a range of other measures that the Government should introduce to boost Britain's traditional retail sector and revive its historic high streets.

Part 2: Better Ways to Help the High Street

The Trouble with Business Rates

So far in this report we have focused on making the case against an OST, which we think would be a particularly bad way for any government to raise money.

Yet in making the case against an OST, we should not lose sight of the fact that its advocates do have half a point – namely that business rates are a bad tax that do place an unduly heavy burden on traditional retailers. The fact that introducing an OST would be a deeply problematic way to fix business rates should not lead us to leave them just as they are. On the contrary, cutting and reforming business rates is itself an important part of developing an overall tax system that better supports enterprise and growth.

The CPS covered business rates in detail in its 2020 report 'A Framework for the Future: Reforming the UK Tax System', but it is worth reviewing some of the key features of the tax – and the problems with it – in the context of the British high street.

'According to the OECD's revenue statistics database, the UK raises more as percentage of GDP from 'recurrent taxes on immovable property' than any other OECD country'

In straightforward terms, business rates are a recurrent tax on the assessed rental value of non-domestic properties. The most recent revaluation took place in 2017, and was based on rental values from 2015. The tax owed is calculated as a percentage of rateable values – the standard rate is 50.4p in the pound. A slightly lower rate (49.1p) applies where rateable value is below £51,000.

There are further general reliefs for businesses with a single property with a rateable value below £15,000. Various targeted reliefs – like the current retail, hospitality, and leisure relief, which gives eligible businesses 50% off their rates bill in 2022/23 (up to a maximum discount of £110,000) – have also been available from time to time.

There are a number of problems with business rates. Perhaps the most obvious one is that we rely very heavily on them as a source of revenue. According to the OECD's revenue statistics database, the UK raises more as percentage of GDP from 'recurrent taxes on immovable property' than any other OECD country.[51] If you look specifically at the share of such taxes paid by non-households (e.g. businesses), then only Israel raises more than us as a percentage of GDP.

51 Based on comparative revenue data from stats.oecd.org.

This matters, because what might be a relatively efficient tax when levied at a low level can quickly become an unfair burden when too much revenue is extracted.

There is a particular problem here for retailers, who pay around a quarter of business rates despite generating less than 10% of the economy's total gross value added.[52] This disproportionate impact is compounded by two further factors. First, assessed rental values are now more than seven years out of date. Over that period, market rents for the retail sector outside London have fallen by more than half in real terms.[53] Yet instead of going down in line with this dwindling tax base, rates have actually gone up.

This points to the second factor that adds insult to injury for the retail sector. While assessed values don't keep pace with market conditions, the business rates multiplier (i.e. the tax rate) does rise in line with inflation. Business rates are designed to deliver a stable revenue stream to government – but they are clearly not constructed with the interests of business in mind. And that becomes a particular problem in an inflationary environment, as we have today.

'Business rates are designed to deliver a stable revenue stream to government – but they are clearly not constructed with the interests of business in mind'

In addition to this unfairness, there's a general economic problem with business rates. While taxes based solely on land values are generally considered to be efficient, economists typically frown upon taxing 'business inputs' (things like commercial buildings and infrastructure) because doing so distorts the production process. In particular, it can actively punish you for investing in expanding or upgrading your facilities.

To give a notorious example, Tata Steel spent £185m upgrading a blast furnace at their Port Talbot facility, only to be hit by a £400,000 increase in their annual rates bill as a result.[54] That's an extreme example, but similar things happen across the economy on a smaller scale all the time – not least to retailers. The detrimental effect on business investment is not exactly hard to predict.

That flaw in the business rates base – that the tax applies to 'improvements' as well as to underlying site values – has a clear distributional impact as well. Generally speaking, business rates are higher where land values are higher – i.e. in town and city centres, in particular in London and the South-East. But compared to a more neutral tax base, the existing business rates system leads to a higher tax burden where buildings make up a higher share of total property value (i.e. where land is relatively cheap) and a lower tax burden where land is particularly expensive.

In other words, the current structure of business rates results in a relatively higher tax burden in 'left behind' regions and a relatively lower one in London and the South-East, compared to a more neutral system. It also bakes into the tax system a structural bias against capital-intensive industries, such as manufacturing.

52 Centre for Retail Research, *Business Rates and the Future of the High Street.* Link

53 British Property Federation, *Business rates call for evidence.* Link

54 Jim Pickard and Michael Pooler, 'Budget plan to exempt new machinery from rates bill', Financial Times, February 2016. Link

Reforming and cutting business rates

The reforms that ought to be made to business rates – both to help the high street and to boost the UK's overall economic performance – follow naturally from the problems inherent to the current system.

First, the tax base should reflect actual market values, with as little time lag as possible. The Government is already moving to a three-yearly cycle of revaluations. The next one will take effect in 2023, based on values from 2021. That is a start – but only a start. The aim (as the Government acknowledges) should be to get to annual revaluations as soon as possible, using values taken from the previous year.

Second, the overall burden of business rates should be reduced and the practice of increasing the multiplier in line with inflation ended. This would probably result in a significant initial fall in revenue, followed by a gradual decline in the relative importance of business rates within the tax system. Such a development might be inconvenient for the Treasury, but it makes sense: we ought to get business rates as a percentage of GDP down to more internationally normal levels.

'The overall burden of business rates should be reduced and the practice of increasing the multiplier in line with inflation ended'

Rather than attempting to fill any resultant funding gap with a narrowly targeted new tax, we should seek to raise more money in the long run from council tax on high-value residential properties (given that the tax is still charged, astonishingly, based on property values as they stood in 1991), or perhaps broad-based consumption taxes like VAT. These sorts of taxes have the smallest relative impact on economic growth, and therefore represent a 'least worst' way of raising money going forward.[55]

That said, any revenue-raising efforts must surely wait until the cost-of-living crisis recedes, and robust economic growth is restored – otherwise they risk being counterproductive.

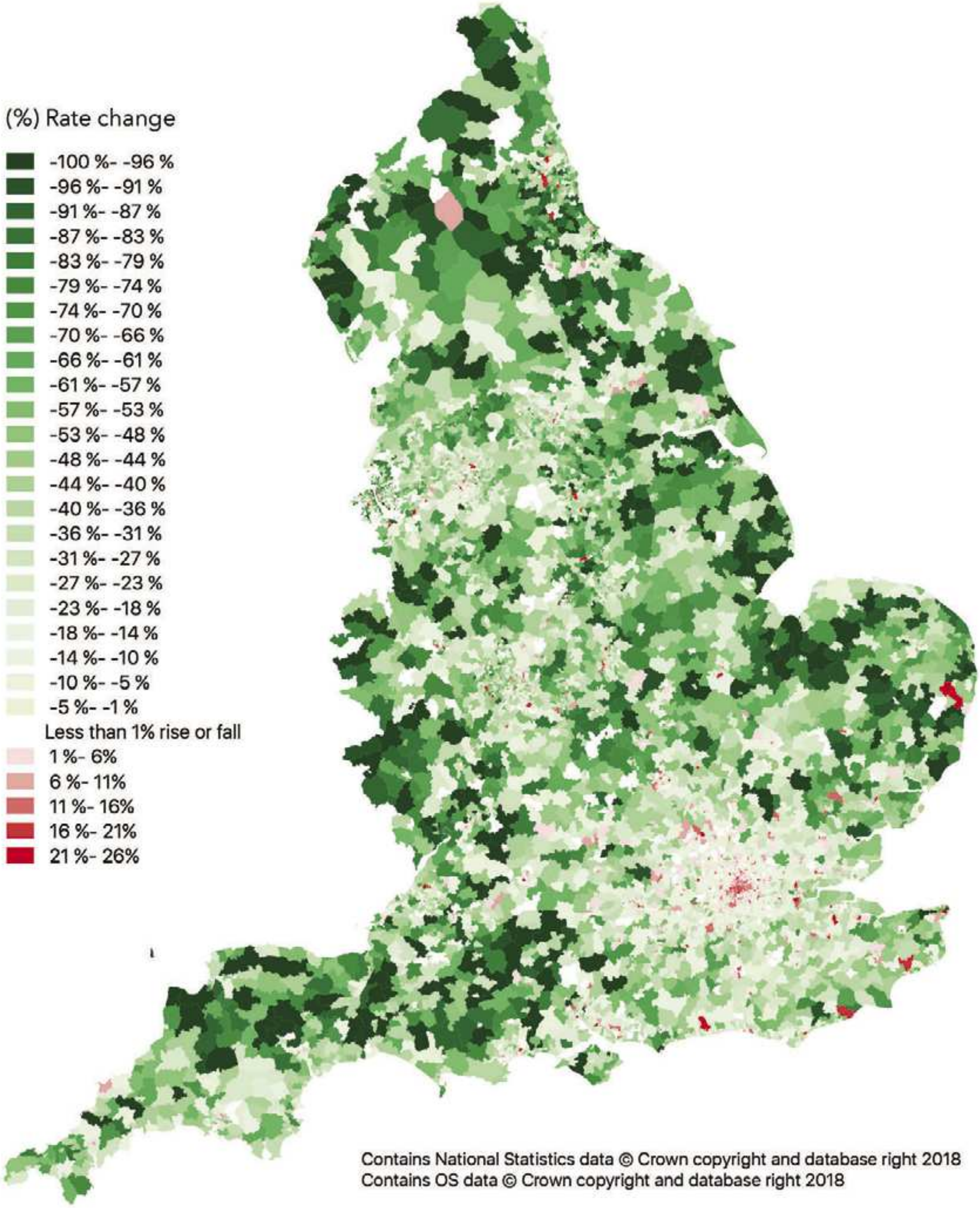
Finally, the government should remove 'improvements' from the business rates tax base, levying the tax solely on underlying site values (which would in turn reflect the legally approved use of the property in question). This, indeed, is the first way that the burden of business rates should be cut – buildings, structures, and so on should be stripped out of rateable value. By itself, this might amount to a 20% cut in the overall business rates burden, even before the multiplier was reduced (or valuations updated to reflect a depressed commercial property market).[56]

As well as helping struggling high streets (and manufacturing businesses) in the short run, reforming business rates in this way ought to boost business investment, which would have a positive long-run effect on wages and GDP, and of course tax revenues.[57]

55 Asa Johansson et al., *Tax and Economic Growth*. Link
56 Based on analysis in Tom Clougherty et al., *A Framework for the Future: Reforming the UK Tax System*. Link
57 See Adam Corlett et al., *Replacing business rates: taxing land, not investment*. Link

The chart below, which is taken from a 2018 report by Adam Corlett et al., provides a useful indication of the impact that basing business rates on land values would have for the retail sector across the country. That research actually modelled a revenue-neutral shift to a site-value basis for business rates, which means it assumed a higher tax rate as well as a reformed tax base. Even so, the authors found that such a reform would deliver large tax cuts for shops in most parts of the country. (The lower-tax approach that we have outlined here would be even more beneficial, potentially eliminating many of the localised tax increases that a revenue-neutral approach would entail.)

Change in total bills for shops by billing authority, England



Source: Adam Corlett et al., 'Replacing business rates: taxing land, not investment.'

Will cutting rates help businesses or landlords?

Before moving on to consider some of the things government could do to boost the high street that are not related to business rates, or indeed an online sales tax, there is one final issue to examine. This is the extent to which shops (and other businesses) would benefit from a lower business rates burden in the long run.

On the face of it, this might seem like an odd question to raise – since cutting taxes on retailers will surely leave them better off. But it's an important one, since economists generally believe that the economic incidence of business rates actually falls on landowners rather than occupiers.

The idea is that since the supply of land for various commercial purposes is more or less fixed, the market-clearing price is determined by demand – that is, by what tenants are prepared to pay. From the perspective of an occupying business, it doesn't make much difference whether that money is going to the Treasury or to the landlord. What matters is the overall cost of the premises (rent plus business rates). As a result, the theory goes that the main effect of raising or lowering business rates is to change landowners' revenues (in aggregate and over the medium term) by a corresponding amount.

'45% of business property in this country is owner-occupied'

However, there are a few counterpoints to make. First, 45% of business property in this country is owner-occupied.[58] Businesses operating from such premises will obviously benefit directly from lower business rates.

Second, the fact that retail rents are effectively zero in many parts of the country, owing to market conditions and changing consumer preferences, means that tenants may have much more bargaining power than has traditionally been the case – and may therefore be in a position to prevent landlords responding to lower business rates by raising rents in the medium term. Given the number of vacant shops, and the pressures on retail, there is not an inexhaustible supply of firms willing to pay whatever landlords want to charge.

There is obviously a degree of uncertainty around all this. What we can say is that retailers will definitely benefit from lower business rates in the short term, and that those benefits may prove more enduring in the current environment than economic theory and past experience suggest. Indeed, the fact that rents could eventually rise to offset business rates cuts underlines the importance of pursuing the kind of comprehensive, economy-boosting reforms we have outlined here, and putting the whole business rates regime on a fairer and more pro-growth footing, rather than solely and simply cutting the multiplier.

58 British Property Federation, *Business rates call for evidence.* Link

Other Ways to Help the High Street

The Simple Consolidated Tax

While reforming business rates should be a priority for the Government, there's another CPS tax idea that could bring immediate relief to smaller retailers: the Simple Consolidated Tax outlined by Nick King in his 2018 report 'Think Small'. The essence of this proposal was that businesses with revenues under £1m could opt in to an alternative tax system, paying a straightforward levy on turnover (the report gave an indicative rate of 12.5%) instead of corporation tax, business rates, VAT, and employers' National Insurance Contributions. Although the Simple Consolidated Tax is not a solution to the larger issues facing the retail sector, it may nonetheless be attractive to many independent shops.

Fixing the planning system

There are also several ways that a better planning system could help the high street. In their 2021 CPS report, 'Reshaping Spaces', Alex Morton and Jethro Elsden argued that local councils were often reluctant to redesignate empty commercial property for residential use – in part because the business rates retention scheme inadvertently makes it financially advantageous for councils to retain empty properties rather than allow them to be converted to residences.

'Permitting mixed use redevelopment of unused commercial property is key both to increasing the supply of housing and to revitalising ailing town centres'

Permitting mixed use redevelopment of unused commercial property is key both to increasing the supply of housing and to revitalising ailing town centres. The planning mistakes of the past have left too many town centres as inactive dead zones. The approach outlined in 'Reshaping Spaces', which begins with new local plans containing a hard-headed assessment of each local authority area's real commercial space requirements, would help to restore much-needed vibrancy to Britain's town centres. Instead, there are anecdotal examples of builders being told that their town centre developments must devote the ground floor to retail, because that is the character of the area, even though the street in question is already littered with empty shops.

Dealing with fragmented ownership and vacant property

One of the big underlying problems facing the high street is fragmented ownership. Essentially, there are often so many different landlords of different scales in relatively small places that local actors find it impossible to act strategically. Neglect ensues by default. Yet high streets characterised by consolidated ownership have bucked the national trend when it comes to high street decline.[59]

The Government should consider new ways of encouraging consolidated ownership and the joined-up, commercially led thinking it produces on high streets across the country. That may include moves to incentivise the owners of empty premises – often absentee landlords who view commercial space as a purely financial asset – to sell

59 Power to Change, *Take Back the High Street Putting communities in charge of their own town centres.* Link

up and move on. While not necessarily a policy designed to promote consolidated ownership, the Government's proposed 'reverse rental auctions' for empty shops are a welcome sign of action on this front.[60]

Even where consolidated ownership isn't possible, the Government should try to replicate some of its benefits by piloting new and improved versions of the Portas Review's 'Town Teams' concept.[61] The important thing is that someone thinks about the high street as a whole, and develops ways of making town centre shopping the kind of overall experience that appeals to today's shoppers.

Infrastructure for better high streets

Sometimes, the simplest and easiest things can help. In order to be places that people want to visit, high streets need to be accessible, attractive and safe. One of the reasons high streets have struggled while out-of-town centres have not is that out-of-town centres are able to create an environment where the shopper comes first, with wide footways and pedestrianised streets, and good transport links.

'The provision of accessible parking, within a sustainable transport plan, is integral to the success of local shops and businesses'

Local areas need to plan transport carefully to maximise the accessibility and attractiveness of high streets. In particular, our ageing population will need the same access to high streets that they have to out-of-town centres – by private car as well as by public transport (something that is too often forgotten about by contemporary town planners).

Indeed, parking remains one of the biggest frustrations for high street businesses – and one of the things most likely to deter older consumers, who are otherwise the most likely to shop in-store, from visiting their local town centre. The provision of accessible parking, within a sustainable transport plan, is integral to the success of local shops and businesses.

Sadly, too many local authorities view parking simply as a source of revenue, rather than an essential part of the high street ecosystem. Of course, pricing town centre parking appropriately can be an important (though imperfect) way of controlling congestion, and keeping traffic flowing freely. So we are not suggesting a free-for-all: just that town centre parking is planned and handled in an economically sensitive way.

60 Gemma Goldfingle, 'Government to force landlords to let out shops vacant for six months', Retail Gazette, April 2022. Link

61 Gov.uk, *The Portas Review.* Link

Conclusion

The Government is right to want to help the high street. Britain's traditional retail sector is struggling, and not just because of evolving consumer preferences or a gloomy economic outlook. Bad policies – on planning, on transport and most of all on tax – have made town centre retail so much harder and less rewarding than it needs to be.

Yet the Government's online sales tax consultation suggests that, rather than fixing past policy mistakes, it may be on the verge of making a new one. Put simply, the case for an online sales tax does not add up. Tying hopes of a fairer business rates system to its implementation is thus a hugely counterproductive move.

To be clear: introducing an online sales tax would be complicated, expensive and distortionary. Whatever the intention behind it, an OST is bound to burden small businesses and increase prices for consumers. It would be a retrograde step in the Government's campaign to fight inflation and cut the cost of living. It would also run contrary to the levelling up agenda, hitting the least prosperous areas of the country hardest.

To make matters worse, implementing an online sales tax would help undermine the Government's ambitions to boost economic growth and international competitiveness after Brexit. It is hard to argue with a straight face that Britain is serious about fostering and attracting the hi-tech industries of the future if it simultaneously slaps a new, targeted tax on online retail – one of the big success stories of recent years.

'Introducing an online sales tax would be complicated, expensive and distortionary'

The proposed online sales tax also seems to be a policy idea that pleases almost no one – except perhaps the highest-earning Londoners. The politics of an OST do not seem to make any more sense than the economics.

Ultimately, it would be an enormous shame if the manifest inadequacies of an online sales tax – which are on full display in the Government's own consultation document – were allowed to nix the prospect of reforming and cutting business rates. That is an important ambition in its own right, not just for the retail sector but for the economy and the country as a whole.

It is not too late for the Government to think more radically about business rates, to decouple efforts at reform from flawed arguments about taxing online sales, and to make good on the implicit promise of its 2019 manifesto by delivering a lower tax burden through fundamental change to the business rates system.

As the analysis in this report has made clear, an online sales tax is no way to help the high street. But sensible, pro-growth tax and planning reforms could yet make a meaningful and lasting difference – if the Government is bold enough to pursue them.

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