Business problems, land solutions: the case for land and tax reform

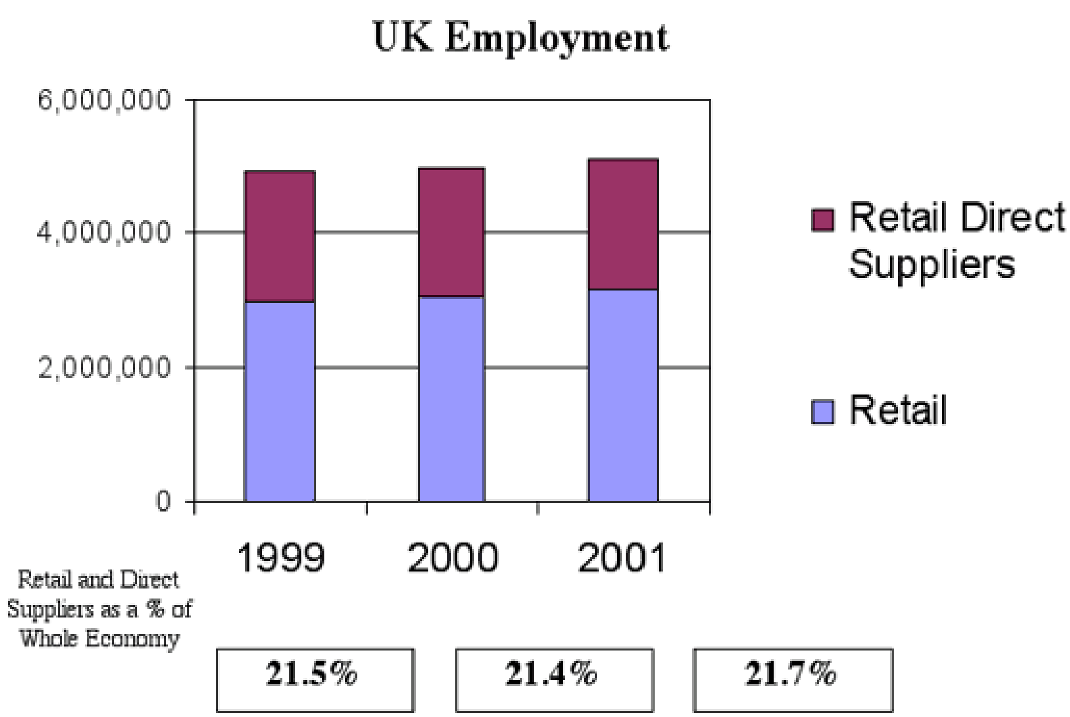
A transcript of the talk given by Albert Catterall, Head of Economics, British Retail Consortium

I think I decided a long time ago when I started coming to conferences like this one to start counting how many times people apologized, "I'm not an economist, but..." I have to say this conference has been pretty good, but I'm going to have to do a name and shame campaign and say it was actually Tom Dunne who was the first person today to say, "I'm not an economist but..."

I'm going to reverse the apology and say I am an economist, but I'm here actually to speak on business. I suppose I could also admit it is true, economists are on a power trip and we just do those equations really to fool you. Just so long as you know that now.

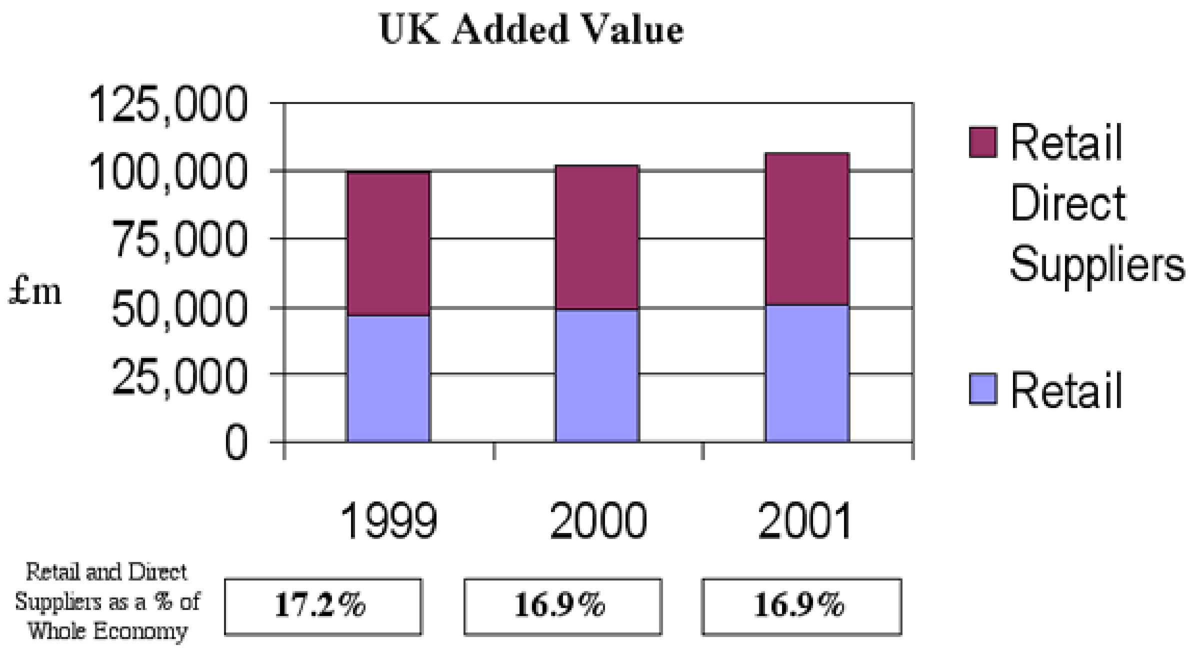
The first time I ever came to Ireland was to work on a business called Buy and Sell which produces a classified advertising newspaper and they also set up an internet site. In fact they had prices of everything, prices of farm equipment, prices of even internet dating of various sorts. I think it was Oscar Wilde, an Irishman, who said economists know the price of everything and the value of nothing. Well, I'd actually like to turn it a bit around and say in economics the end is values. The thing I noticed in Buy and Sell was behind every farmer selling his second hand farm equipment; there was a retirement fund, someone going on holiday, or setting up for a wedding: important human values behind it all.

I'm also going to do just another quick apology. Even though I'm here in Dublin the case study which I'm going to give you is actually based in the UK. It's actually based on the UK retail industry and its interaction with property. I'm going to do a few slides just explaining about the retail industry. Basically it is very big; people don't understand just how big it is. In Britain it employs close to 3 million people. Similar magnitudes in Ireland and in fact throughout the world.



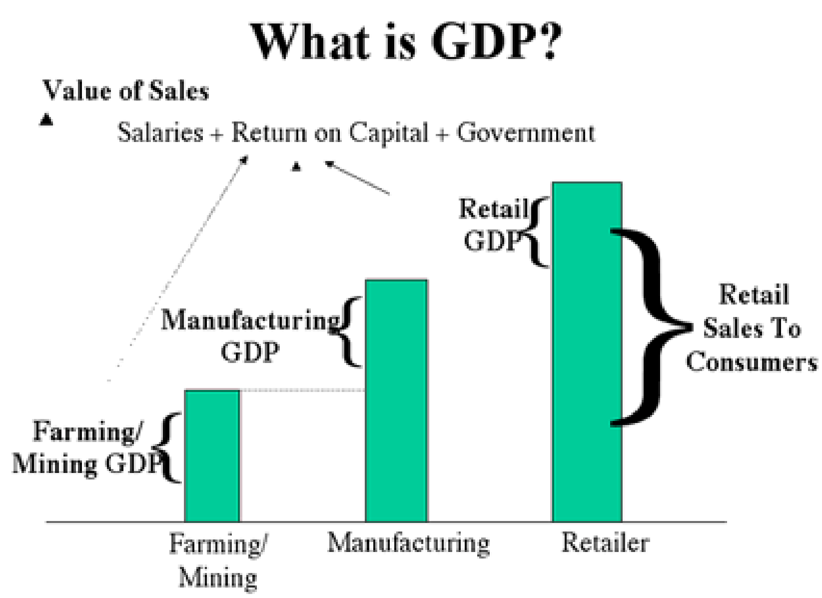
Source: ONS - assumes retail direct suppliers have same proportion of employment to sales as the rest of the non-retail community

And it's also a major part of the economy; in Britain it creates over 50 billion pounds in GDP.



Source: ONS - assumes retail direct suppliers have same proportion of employment to sales as the rest of the non-retail community

Now I say GDP, I guess that's one of those words that economists use to try and trick you and some people and some people don't quite understand what GDP is, so I'm going to present a very stylized or simplified version to explain what GDP is, and here is the idea: you have an economy which starts off with farming or mining, primary industries, they sell their produce to lets say manufacturing, and manufacturing does something to it and so sells it on at a higher price, I mean at least in this scenario it all goes for retail, and retail sells it a slightly higher price still. In each section, that little bit extra is GDP, it's the value added. So just remember GDP is not the total sales or output of any industry but just that little bit extra. And it's out of that bit extra that we actually get our salaries, the return on capital, and also the bit that the government takes for its expenditure.

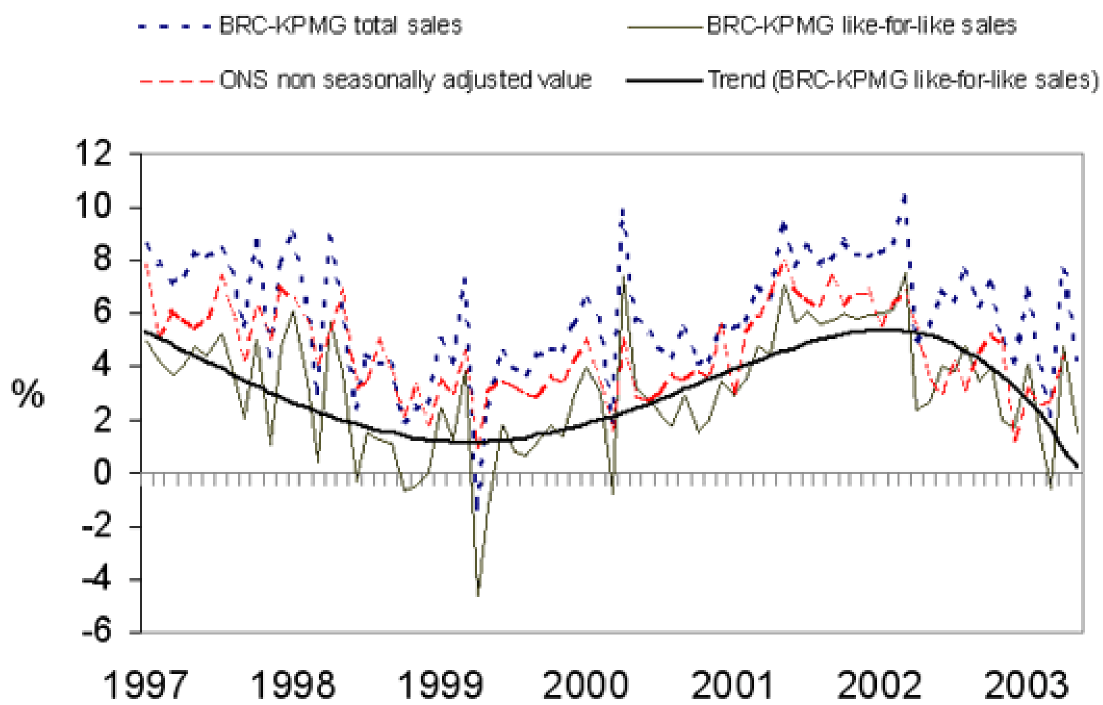


I wanted to start off by explaining what GDP is because if you look at retail, even if I said it, it's got 50 billion pounds of GDP, that's actually quite small. I don't think it measures how important it is in the economy, it's so strategically important. I think the classic example is a few years ago in Britain when there was a petrol strike. All of a sudden you couldn't go to a petrol station and get petrol and the whole country fell apart. Well, I can tell you petrol retailing is not a big part of GDP. But people soon realized how important it is. It's the bridge between production and consumption.

Perhaps the next idea I want to bring is this idea of the paradox of water and diamonds, which I learnt as an economist. The same sort of thing, water is very very cheap. It costs nothing. Diamonds are very expensive, so as far as an economist is concerned, clearly diamonds are much more important than water. I think you'd agree intuitively that's wrong, because if you don't get water you die. Water has a much greater value.

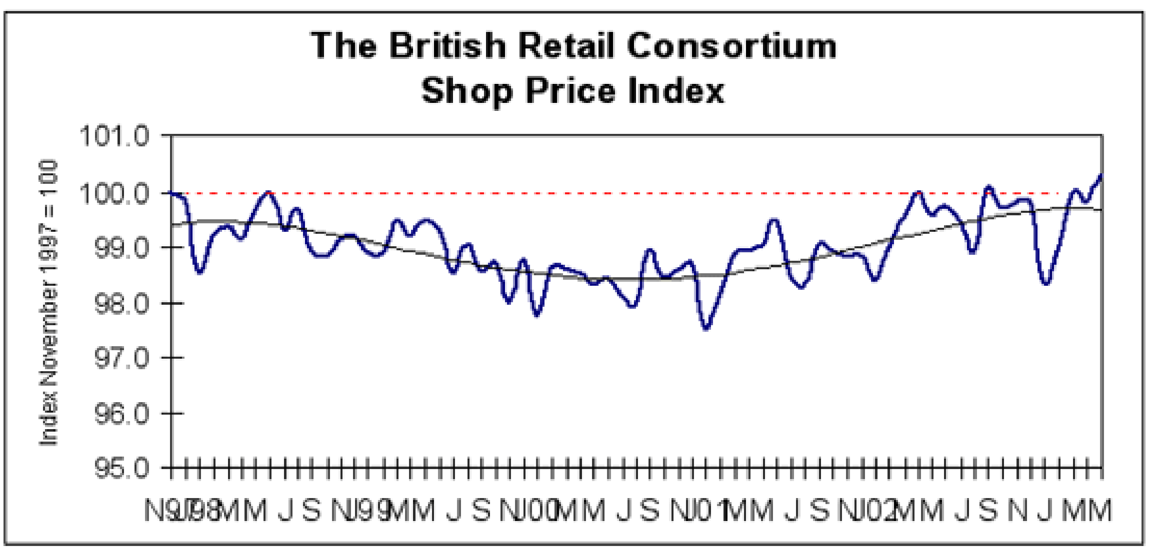
Now what I want to get to the heart of is that GDP only measures earnings, the return on capital, what you earn. It doesn't measure the consumer surplus on top of that and in fact if there was no consumer surplus, if economic activity was only worth whatever you did, it would just be an endless cycle, a sort of nightmare production for it's own sake. So just returning to the retail industry, here I've got a chart of retail sales over a number of years. Now retail sales were growing historically in the 2 to

4% range. Sometimes growing faster, sometimes slower. But certainly in the beginning of this year you started to see a very very rapid downturn; in fact it was looking very much like retail sales growth was going to go absolutely negative which is something that's never happened or rarely happened. Even in very bad downturns it rarely goes that way.



Source: BRC-KPMG

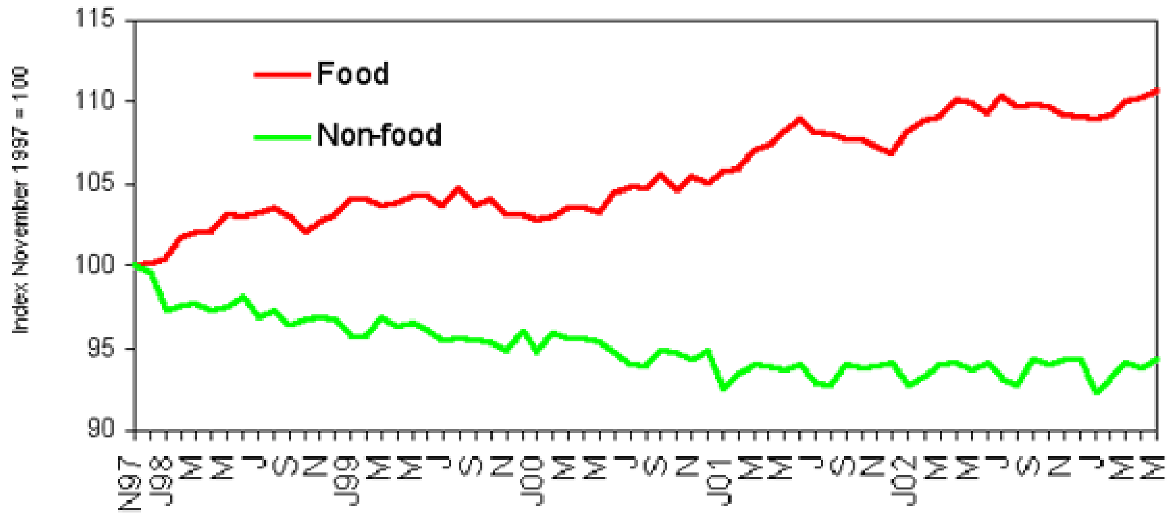
And to make things worse, actually, High Street prices, the actual money that you spend on retail in the UK I should stress are actually below the prices that you would have paid in November 97 or more than five years ago. There was a price decline, some sort of recovery, in recent years, but now prices are starting to slide again.



Source: BRC

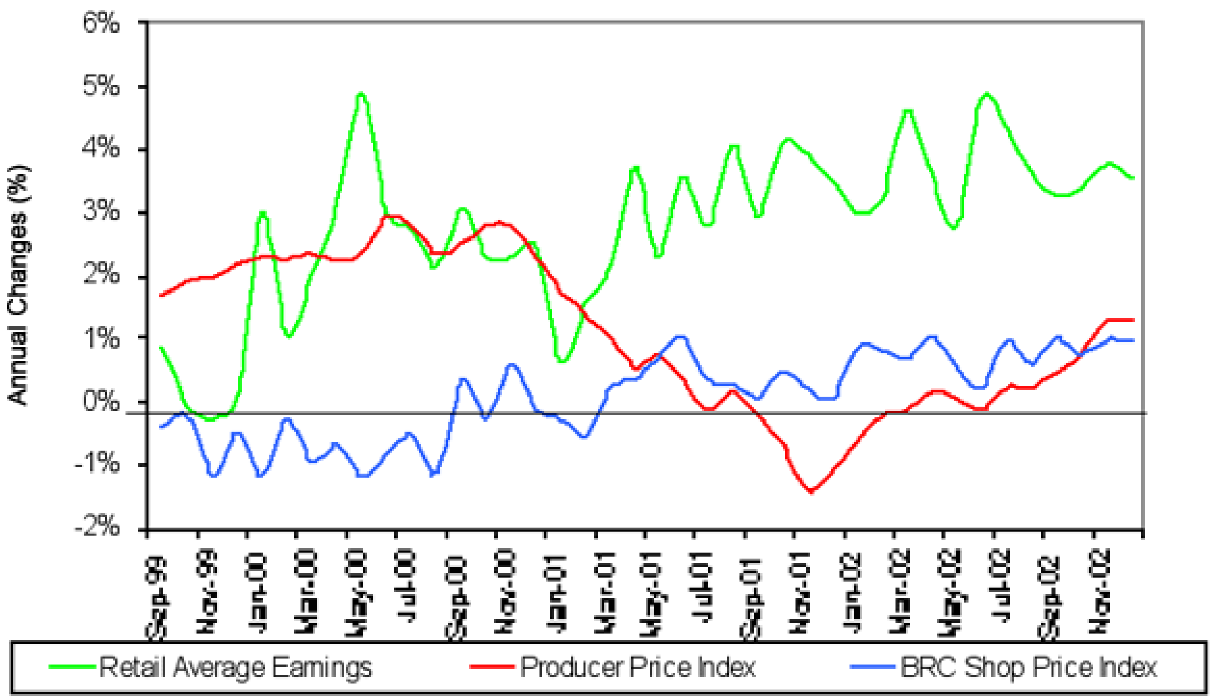
And it's interesting to actually look at the component of prices. There's a common misconception that food is going down in price. That's not true: food traditionally goes up in price, not by as much as general inflation but because of the Common Agricultural Policy it's always been steady. But that is starting to level off, and if you're a retailer in clothing or electricals you're suffering absolute price deflation. So the prices, the earnings you're getting in the shops were decreasing.

The BRC SPI: Food & Non-food split



Source: BRC

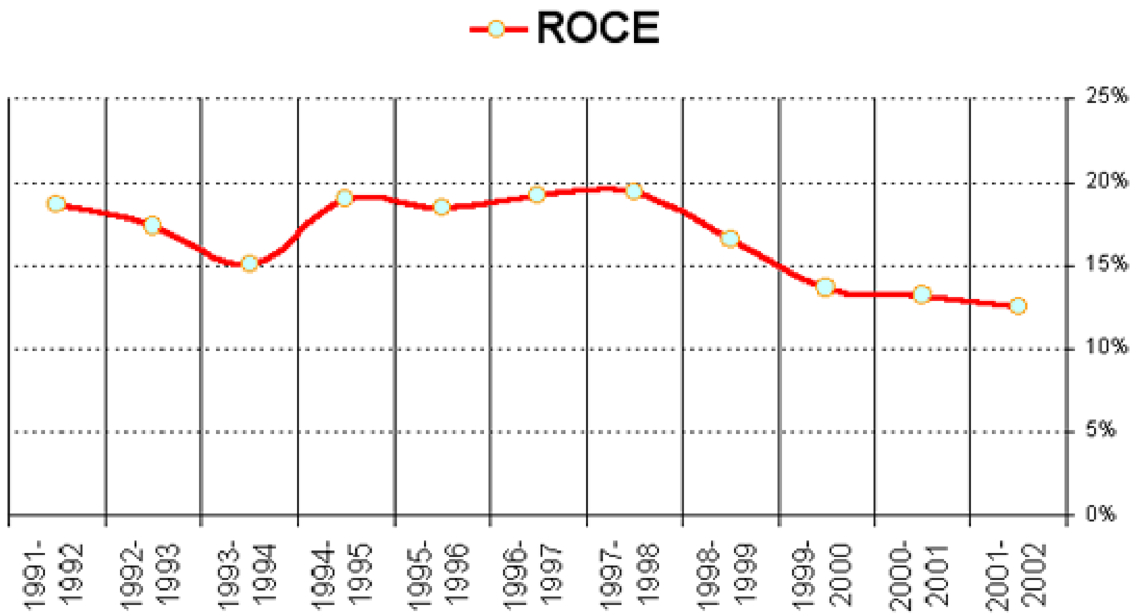
But on the other hand, if you look at the following chart: the blue line represents the growth in shop prices, the inflation for retail.



Source: ONS, BRC

As you can see, most of the time it was negative, some times slightly positive. If you look at the red line, the producer price index, how much they had to spend in actually buying the products from the manufacturer's or the suppliers in , and that historically has always raced been ahead of the shop prices, and recently has been well ahead of shop prices. There was a downturn in the middle of 2001 as the pound started to slide, and you could start to get cheaper products. You're starting to see that whole trend reverse itself and the producer price index increasing again.

Nevertheless you've still got those years of price increases, of buying in of shops, being much higher than the prices they could actually sell out at. And that resulted in retailers actually having their profit's squeezed. Here I've got return on capital employed, a sort of measure of return on investment or profit. And in fact in the UK, the returns were getting lower than ever.



Source: Datastream

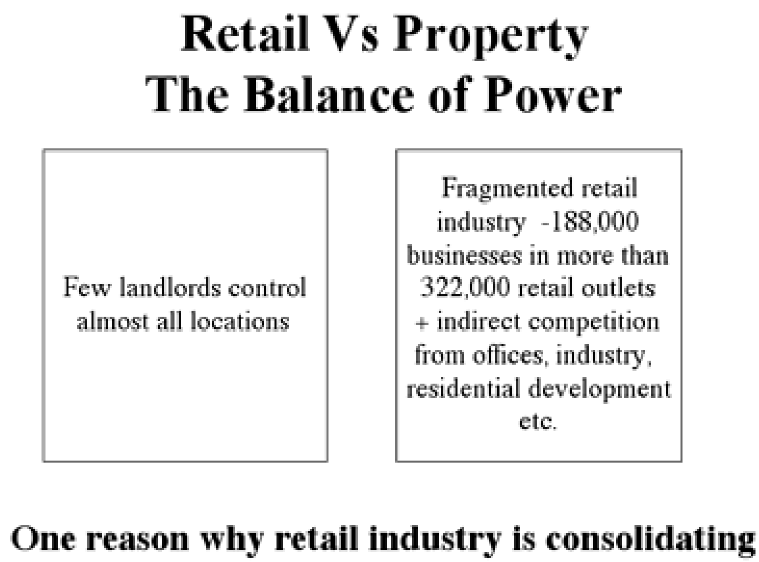
Why have I gone through all of these points about the retail trade? I suppose I wanted to come back to this idea of the water and diamond paradox. Given what I've shown you about retail, what is the impact of all of this? If the retail industry is actually producing the same quantities, getting the same number of pots, pans, whatever you want, but everything's being sold at a lower price, you actually find that GDP has decreased. The industry's earning less. That's just an economist's measure. It's not true, welfare is just the same as before, you're getting just as many things. The reason is of course that the consumers are getting more, there's more of a consumer surplus. Even though the economic measure has actually decreased.

The other thing is, what is the impact on the retail industry of its costs going up, well the result is that the component of GDP that comes from retail decreases and other industries that are supplying it, their GDP actually increases.

Now one of the points I want to come on to is property. I think it was actually Narje, if I can point you out, who gave a talk about your teashops, was it, earlier? Well this is exactly the point. You actually have property coming in and taking a part of the value that you're actually creating. But the moral I wanted to come from this was that retail, by actually getting better, by being more efficient, cheap and so on was first of all actually measured as being less and second of all, if you actually look at how the property industry reacted, property, as far as retail is concerned, is the second biggest cost component after labour.

What are they doing in a period where profits are being squeezed, retailers are going through a painful period, growth is slowing? They actually increased retail rents by over ten percent. A real hard squeeze. And how were they able to do this? Well, if you actually look at the balance of power, between the retailer, and a landlord, start off with the retail industry in the UK. There's close to 200,000 retail businesses in the UK operating over 300,000 outlets. And on top of that if you're looking for a site, you do have some indirect competition from offices, industry, residential development and so on.

If you look at the other side of the property market in Britain it's very highly concentrated. There are very few landlords who control almost all locations. Of course, one of the consequences that you're getting at the moment is that the retail industry is trying to get back some of that power, it is actually consolidating. So you're starting to see various magnates taking over all of the retail industry in Britain. Now there may be good or bad reasons for industries consolidating, or fragmenting, but this is one of the artificial reasons: they're actually trying to match the power of landlords who are highly concentrated.



There are also other ways that you see the power of property coming out and I wanted to give this example of non-price value. Something which continental retailers find amazing when they go to Britain, are its upward only rent reviews. Contractually, many of the rents that retailers face, and it's not only retail, but that's just the industry I'm most familiar with, they face contracts saying that there are periodic reviews of their rents but those periodic reviews can only push rents upwards. They can never decrease them and I should add to that the property owners insist on having long leases, they're not going to give you short leases that you can get out of and move on.

What this really means is that risk is being transferred from the landlords to the retailers. As a consequence, property businesses have become more valuable, retailers are becoming less valuable. Just as an aside to this, many of the things that we're talking about, property or land taxes or caps on value or whatever, they would not capture this transfer of value. Because because it's not based on price. I said that economists know the price of everything. Here's an example of somewhere where we can see something that isn't price based. So that's that point.

It's interesting though that you do see landlord power starting to break down where there are very few possible tenants, for example in shopping centres where you need an anchor shop tenant. In Britain it might be a Marks and Spencers in a shopping centre, otherwise you don't have one. Perhaps here it's a Dunnes or an equivalent. Those are the only places where you start to see retailers matching the power of the landlord.

I think it's that interesting, Bluewater, which is the biggest retail development in Britain, I think someone told me Europe, I'm not entirely sure about that, but they have actually given up completely on the idea of a landlord trying to copy or chase the profits of the retailers with rents. They actually just put down in the contract that their rent is a percentage of the turnover, so if a retailer does really well, or really badly the landlord will always get their cut.

What are the elements of property? I've split them into the ways that retailers normally think of them. There's always the element of construction, facilities, facilities management, there's another side which is the location and planning permission. And the thing that's certainly true, we've found, is that location and planning always create the bulk of the property cost. But that actually has the least to do with the owner.

So I come now to my plea as an economist. And that is for tax neutrality. Sounds a very opaque term but I'll start off with a point. Taxation is necessary. You are going to need to pay for your facilities many of which are necessary for business to operate in a modern economy. But you don't want taxation to discourage production. And key to that is it's better to tax people for what they do not do rather than what they do do. And one thing I can tell you is that property owners do not 'do' location. They do not create these places. They just buy into them.

I was going to make a second point about lobbying. I think someone called it 'cute' and then they corrected it to 'corrupt'. Though I'll leave it to your own interpretation of that. The lobbying that you get for planning permission is not always a desirable use of resources. Instead of having political parties being funded by builders, if the builders funded investment in manufacturing industry or something else that would be a more advantageous use of those resources And I think it's interesting that when you look at businesses, property taxes are not normally dealt with by the finance directors. All the other taxes tend to be dealt with by the finance directors. But in some sense a property tax is seen as a normal cost of business and is actually normally dealt with by the property director. An interesting exception is actually in Britain where they have development taxes where they try to tax an incremental benefit from property rather than just taxing it flat across the board. That's the only point when finance directors used to get involved in complicated avoidance schemes of the tax of one sort or another.

And now finally the businessman's plea. The businessman wants simplicity and that means including in his taxes. The whole development of business and industry over millennia is specialisation, each business or each industry breaking down tasks into simpler and simpler things. And then when you've got your bit of the process you do that really well as your core competence. That is your strength. And then along comes the government and says well you have to fill all of these forms and all of these regulations and so on and it just goes against the grain. They would rather sit down and do their bit.

I've listed some of the things that a department had to deal with in a company that I was working with. And this is a UK example: income taxes, national insurance contributions, capital gains tax, corporation taxes. Excises, VAT and others. And they were very complicated to administer. And they had to spend a lot of money on an internal administrative cost. And in fact, given that they didn't want to really deal with it, they tried to outsource as much of it as they could. And that usually went to the big audit firms like PWCand KPMG and so on with their tax departments. And I've always said if you want to have some sort of idea of the scale of cost of administration, just look at those buildings of those big firms and say what would happen if they were a manufacturer instead of processing tax forms.

I think it was Douglas North, the economist that won the Nobel Prize, he came up with an estimate, I don't know how, saying that 50% of GDP went into transactional services of some kind. Necessary, but if instead of having lawyers, accountants, and so on, you had people to just go and actually produce, just imagine the boost to the economy on that basis. Now, having said all of that, property taxes traditionally are simpler. And that's why financial directors are not traditionally the lead managers on them.

How am I doing for time, I've three minutes, that's good. So, the conclusions that I'm going to give you. First of all, GDP measures earnings. But it's surplus not earnings that actually creates welfare and prosperity so that's what we have to look towards. Second of all, if you're talking about land reform you do have to look at the concentration of property ownership. And I certainly know in specific cases this has caused an artificial consolidation in other industries. Which is not beneficial. Also you have to accept that most of the price of property reflects location and planning permission. And the owners of that have done little desirable to achieve it. Next, the value of property doesn't always only accrue to the owners in rent. Now I've given the example of upward only rent reviews. But you'll find hundreds of other examples.

As with all taxes, the more they start to bite, the more the avoidance starts to come in. which is why I'd say whatever tax you should do, if you make it as simple as possible, you'll always then avoid that issue. Taxation should be neutral.I can say as an economist, hand on heart, that a tax on location and planning permission would be. It's interesting, when I did my A level in economics, I boiled down my entire A level course, (it's the 16 to 18 qualification in Britain) to 200 lines of equations or statements that I had to learn and I got an A so I think that probably summarises it quite well. And one of those lines I actually looked up after many years and it just simply said "a tax on ineleastic items is the most efficient, for example a tax on land". I didn't realise at the time how significant that was and I think it's interesting that most economists don't either - it's just stuck in the middle there as an insignificant point. And the final thing is as I've said is that taxation should be simple. I put some caveats on this. A tax on for example rental values could be.