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It is creative destruction, not a bad tax, that is killing the high street

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Promising a "fundamental review" of a policy is invariably political code for saying: "I want to kick the can on this thorny problem."

Boris Johnson's election pledge to cut the burden of business rates and launch a review of them in his first post-election Budget falls squarely into that bucket. For the Conservatives know that this is an area where good politics and good economic policy directly conflict.

Many high street stores are having their lunch eaten by online competitors. Firms such as Amazon do not require high cost inner-town and city premises. Struggling with this creative destruction, bricks-and-mortar retailers see the apparent high cost of business rates (a tax on business property that their online competitors often pay little of) as a contributor to high street woes.

Demands for politicians to do something to "level the playing field" or "ease the burden" emanate from prominent businesses and the public. Yet economic theory and evidence suggests business rates do not, by and large, affect businesses' long-term financial positions.

To understand why, economists distinguish between "who pays the tax" on paper and "who shoulders the economic burden" in reality. Business rates are calculated using the open market rental value of the property and a government-set multiplier.

A 2017 revaluation – seven years after the last assessment – saw bills rise substantially in areas such as London, where rent and property values have soared since 2010. Though they fell in most places elsewhere, "worse off" businesses naturally reacted with horror as their bills, on paper, jumped. Yet most of that increased tax burden will ultimately fall on landowners, not tenant companies.

Why? Well, a large proportion of business rates ultimately proxies for a tax on land values. Land supply is fixed. Given strict planning laws, particularly in areas such as London, so is the supply of available commercial property.

If supply is largely constant, then the rental value of business property is determined by demand – the maximum any business is willing to pay for it. When making that calculation, businesses think about the total cost they will face, inclusive of rent payments and business rates.

The implication is that a cut in a company's business rates bill will ultimately feed through into shop and landowners receiving higher rents from tenant businesses. Any hike to business rates, conversely, results in lower rents. Overall business costs, in time, remain largely unchanged from where they would have been. The only difference is a fall in tax revenue, which has to be made up elsewhere.

Back in 1990 when business rates were introduced, places that saw their tax burden rise fell in value, and those that saw a lower tax burden rose in value. Major business rate tax cuts to "ease the burden" on high street retailers, in other words, wouldn't improve bricks-and-mortar stores' long-run bottom line, but would provide a windfall to landowners.

Now, in the short-run, reality is messier. Firms on longer fixed rental contracts who see higher business rate will indeed feel a squeeze until rents adjust.

An assessment by the British Property Foundation of previous rate revaluations found it took an average of three years for 75pc of such rent adjustment to occur. But these short-term difficulties shouldn't be confused with the high street complaints we hear. Business rate cuts will not help stave off competition from online stores, because ultimately rates are, by and large, a tax on landowners.

None of this is to say that the current system of business rates is perfect. In fact, the tax creates some clear distortions. Boris might consider, for example, having more regular revaluations, signposting revisions to allow rents to adjust before tax liabilities change, explicitly changing the legal liability to landowners to reflect economic reality, and abolishing agriculture's unjustified exemption.

A post-election review could also examine how business rates interact with council tax – the higher burden for the former encourages land being used for residential rather than commercial property, even when the latter would be more economically productive.

John Allan, the chairman of Tesco, has highlighted the biggest flaw with the current system.

By using property values, rather than underlying land values, in determining tax liabilities, the tax can deter investment in improvements to property. Business rates in practice therefore amount to an uneasy combination of an efficient tax on land values and a damaging tax on business property.

As Paul Johnson of the Institute for Fiscal Studies has pointed out, pure business rates perversely provide an incentive to demolish property in certain situations and have resulted in a time-limited vacant building relief, that still creates a wasteful incentive for some commercial property to lay empty.

To overcome these issues, we could look to adopt a commercial land value tax, targeted at the value of the underlying land absent any buildings on it. Such a tax would face its own challenges, not least how to deliver accurate valuations.

But all these issues are quite distinct from the critiques we hear about business rates from book stores, estate agents or supermarkets today. Their larger complaints are that the burden of business rates are just too high, that there's no level playing field with online firms, and that there's no link between a firm's liability and its underlying financial health.

These are all very weak economic arguments. Once we observe that business rates proxy (imperfectly) for a tax on land values, we see that they do not affect most firms' costs in anything other than the short term. It also makes no more sense to punish online firms who raise profitability by minimising the cost of property they use than punishing a business for introducing a labour-saving machine to the same end.

Boris’s future dilemma is therefore clear.

The catalyst for the business rates review pledge has been the political pressure from bricks-and-mortar businesses. But if that review is to be successful, it must ignore the simplistic economic analysis of those same high street firms.

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