Online vs physical – is there a level playing field and does it still matter?

PART I

For years, a debate has raged as to whether online or offline channels benefit from advantages over their counterparts – and if so, are retailers currently operating in what is fundamentally an unfair playing field in the fight for consumer spend?

The debate, however, is not as simple as online versus offline. Today we have traditional retailers with both physical store portfolios and digital sales platforms, global online retailers which are able to disrupt markets to sell internationally, and a consumer that is increasingly expecting a channel agnostic shopping experience. The retail sector is in a state of transition as retailers react to rapidly improving technology to keep pace with ever-shifting consumer demands.

At the latest quarterly meeting of the KPMG/Ipsos Retail Think Tank (RTT), members discussed just how ‘level’ the playing field between online and offline is. As the sector moves towards a more channel agnostic future, they questioned if that imbalance exists, whether it even matters, and what the implications of that future are on today’s retailers?

A channel agnostic future

Drawing a clear line between online and physical retailing is becoming more futile every year. The inertia that beset the sector for far too long has disappeared and business models are changing. Retailers will be required to evolve even further to meet consumer shopping demands and habits as they diverge from what has been the ‘norm’ for decades.

Retailers are on a path to change the way they work. They are striving to achieve a balance in their offline and online channels which will give consumers the choice to browse, shop and purchase at times and via channels that are convenient to them.

Paul Martin, UK Head of Retail at KPMG adds: “I increasingly believe that in the next 10 years the term ‘retail’ will become obsolete as we move towards the age of consumer commerce, in which multiple types of businesses, many that have no history in operating physical stores, will be selling products and services to consumers. The ratio of sales online vs offline will differ across categories although the fundamental point remains – successful businesses will need to deliver a customer-centric, channel agnostic proposition.”

In this channel agnostic world, the question of whether there is a level playing field will largely become redundant as online and offline shopping will both be part of ‘the same side’.

A retailer’s purpose

In order to stay competitive, the changes that are being made by retailers are not only dictated by how consumers shop, but also what motivates individuals to shop with them. Shoppers are increasingly being influenced by a retailer’s purpose, not just its products and prices.

For years a product-centric model has worked for retailers, selling the right product, at the right price in the right locations. However, a product-centric model is now not enough, and retailers must also strive to be customer-centric – and creating the right balance between these models should be at the core of every retailer’s strategy.
Regardless of whether they sell online or offline, retailers need to understand what they stand for. They need to know and embrace why they exist, what their customers like about them, and be transparent in communicating their values. The ethical sourcing of goods, employee care and the sustainability of their business operations will therefore be key considerations.

In terms of its impact on society and the environment, there are clearly challenges with the online approach. The UK consumer is currently ‘hooked’ on the convenience that online delivery brings, but it’s creating a world that brings mountains of unnecessary cardboard and plastic, and delivery vans that clog the roads and pollute the atmosphere.

RTT members agree that action needs to be taken to address the societal and environmental costs of home delivery, potentially through governmental intervention via home delivery or green taxes. Nick Bubb, Bubb Retailing Consultancy suggests: “Perhaps the answer is in devising an Environmental Protection Tax, that would focus consumers on the cost to the environment of having their streets clogged with delivery vans and surplus delivery packaging.”

**An online sales tax?**

As online and offline channels merge, the outlier is the international online platforms. The enormous power of these platforms means that the products they sell and customers they reach are not limited by international borders, and as such, they are often not subject to domestic tax laws of the countries in which they operate – disrupting the playing field and gaining huge financial advantages over their competitors.

Martin Hayward, Founder Hayward Strategy and Futures comments: “There is absolutely not a level playing field between international online players and incumbent physical retailers. If there were, governments around the world would not be grappling with multiple initiatives to urgently find better ways to ensure that international online retailers pay a fair and reasonable share of the tax burden, and account for the societal and environmental impact of their businesses. This is not proving to be easy due to the international footprint of the businesses involved.”

The COVID-19 pandemic, which brought social distancing and trading restrictions, led to an increased uptake in online shopping. James Sawley, Head of Retail & Leisure, HSBC UK, adds: “What’s worrying is that COVID-19 is making matters worse as cheap money and low interest rates are allowing bigger stronger companies to access cheap capital to expand and marginalise smaller, weaker businesses, bolstering their already dominant positions."

The path to parity and balance is not that straightforward. New taxes and increased regulation are often suggested to create a perceived balance between online and offline retailers. The UK government has introduced a Digital Services Tax that seeks to address some of the issues by taxing revenue gained through social media channels, search engines and online marketplaces - but the RTT believes that the mooted blanket tax of all online retail sales would not be a fair instrument of change.

Maureen Hinton, Group Retail Research Director, Globaldata plc, comments: “The problem with adding taxes to online shopping is that many physical retailers have invested in developing businesses that reflect consumer demand, and therefore have growing online businesses. Increasing costs for online operations will therefore penalise all retailers who have been forward thinking. Given the investment that has gone into these digital platforms, and that it is already difficult for retailers to operate profitable online operations, higher costs in the form of new taxes will inevitably be passed on to consumers in higher prices, at a time when the UK is facing a severe recession.”
Online sales are also disadvantaged by the operational costs of selling and fulfilling orders, which would only be exaggerated by further taxation. Martin Newman, The Consumer Champion, adds: “The premise of an online tax fundamentally misses the point both in relation to the cost structure of running on and offline channels. Retailers have many running costs for their online channel that makes it hard to drive profitability - from warehousing and order fulfilment to performance led marketing, data science, analytics and all of the technology ecosystem, their online business comes with a big ticket and significant on-going costs. The cost to serve is greater online than it is offline on a pro rata basis.”

Ruth Gregory, Senior UK Economist, Capital Economics, also warns that while there may be appetite for taxation of those digital operators that are benefiting from the current climate, there is a risk of stifling innovation and growth in the sector: "While there is, of course, a broader ambition within the Treasury to 'balance the books', adding new taxes won't necessarily resolve the longer-term challenges faced by the industry. As with any new tax, the scope and underlying reason for it needs to be clear – does it make sense right now to tax a selling channel popular amongst consumers and a relative bright spot in the recovery?"

Post-COVID-19, the performance of the UK-economy will be more closely connected to the fortunes and success of digital businesses. While there may be calls to level a perceived imbalance in the sector through new taxes, the truth is where there is growth in the retail sector, it’s found in online sales. Ultimately policymakers may not have the appetite to curb the growth of digital businesses which are succeeding, creating jobs and driving the recovery.

**What this means for physical stores**

The debate about the level playing field is not limited to trying to achieve balance by introducing new taxes for digital channels. Attention and comment should also centre on tax, rates and rent, and the cost pressures that are placed on operators with physical stores.

On the high street today, RTT members agree that the present tax system is placing a huge burden on offline sales. Business Rates are calculated by the value of a retailer’s property, however with online sales channels increasing in popularity, the need for so many physical stores has disappeared. Jonathan De Mello, Equity Partner, CWM Retail Consulting stresses the urgency for reform: “The necessary blurring of boundaries between online and physical retail makes the current business rates system even more ludicrous, and urgent reform is paramount prior to next April – in order to avoid a swathe of further retail business failures. If the Government considers linking rates to turnover – given rents are moving that way anyway – surely that would be a much fairer solution?"

The impact of shifting consumer habits, and calls to change the Business Rates system, are not only felt in the non-food sector. The grocers are also having to adapt their store portfolios in response to the growing popularity of local, convenience shopping and home delivery services. Mike Watkins, Head of Retailer and Business Insight, Nielsen UK comments: “From a strategic viewpoint, given that there is now an increased appetite to shop where you live (and increasingly work), providing help for food retailers with business rates, rent and other financial or tax inducements to encourage shopping at smaller stores in the community and in particular back to the high street, would lead to ‘levelling’ up for the good of society.”

The majority of sales are still made through offline channels, and while there will undoubtedly be fewer stores in the future – whether through businesses failing or the restructuring of estates - they will continue to be a vital element of a channel agnostic model. This does however raise questions not only over the future mix of real estate and the health of its community, but also how the Treasury will replace lost business rate revenue. Retailers
Currently pay 25% of the business rates that are raised in the UK, and local authorities depend on this money. The challenge will be how to reform a tax system, one that directly links rates to property value, in a world where property isn’t as essential to sectors, including retail, as it once was.

Conclusion

Whether it’s an unbalanced tax system, or discussion around the profitability and environmental impact of online shopping, the debate between online vs. offline is one that has been running since Jeff Bezos first started selling books over 25 years ago.

The perception of an unlevel playing field is well past its sell-by-date. It is rooted in a time before offline retailers knew they had to have their own online channels, and the wider societal and environmental impact of online sales was not embedded in the public conscious.

The RTT does however, agree that there is more that should be done to achieve a balanced tax system, which acknowledges a shift in how consumers shop and holds international platforms to account for the money they owe at the point of purchase.

However, imposing a new online sales tax on retailers is felt not to be the answer – it would damage traditional retailers who have invested in online services, and the increased costs would likely only be passed onto the consumer. In any case, new taxes may have to wait given that online sales are driving growth in the sector, and the performance of digital businesses will be closely tied to the UK’s economic recovery. This is not the time to dampen business growth. The broader ambition of the Treasury to balance the books will need to wait for another day. The wellbeing of the economy should be its primary concern just now.

Instead, reforming business rates, in a way that recognises the fundamental changes taking place in stores, is required, possibly linking rates to turnover. An alternative may be to turn towards Corporation Tax to fill more of the tax burden. Furthermore, the introduction of green taxes on home delivery that would create wider environmental and societal benefits, may be something that consumers come to support as part of the sustainability agenda of the future.

The retail sector is on a journey, moving at pace towards a model that is channel agnostic. In the future the terms ‘online retailer’ and ‘offline retailer’ will be one and the same, and as such, any debate around a level playing field will be largely redundant. This is an evolution that is being driven by rapidly changing consumer habits and demands, and any perceived feeling of unfairness within the sector is a product of this transition – the government and regulators just need to ‘keep up’. The pandemic acts as a good breakpoint to review matters from a regulatory and policy perspective, which is 20 years out of date.

PART II: In detail – individual views of the KPMG/Ipsos Retail Performance Think Tank members

Dr Tim Denison, Director of Retail Intelligence – Ipsos Retail Performance

In Thomas L. Friedman’s acclaimed book “The World is Flat” one premise he makes is that technological advances result in a more level playing field. This has certainly been the case for shoppers, empowered to trawl the internet to find the most competitive prices, research products, make purchases and provide experience-based recommendations. Everybody
with digital access has the same opportunity to knowledge, something that wasn’t true before the days of www.

His premise is more questionable when considering the impact of technology on the fairness of the retail channels. Traditional retailers with large store property footprints in the UK are today saddled with an unjust and crippling tax burden through business rates. It accounts for 42% of their tax burden, generating £7.9bn for the public coffers according to the British Retail Consortium. In comparison, the only properties of pure-play retailers, at the other end of the retail operating model, are warehouses and offices, which attract considerably less business rate taxes. The tax imbalance between the on and off-line retail channels is exasperated further when online retailers claim not to operate in some of their end-customer geographies and pay lower taxes as a result. Two wrongs don’t make a right.

In the USA, there have been various attempts over the years to introduce a Marketplace Fairness Act, to collect sales taxes from online purchases and redistribute to the states where the sales have been made. Compliance and red tape have prevented any such act from making its way to the statute book there. An online sales tax doesn’t necessarily seem to be the right way to go, not least because it risks supressing the growth of fledgling retailers and creating another type of competitive injustice. However, it does seem right and fair to tax businesses at the point where profits are actually generated. This, after all, was the rationale behind the business rate system, but it is no easy feat when the internet has no geographical boundaries.

There is no doubt that we need to replace the current business tax system with something that is fit-for-purpose in this digital age. The growth of the online sales channel and the shrinkage of store numbers means that the amount of tax raised by business rates from retailers will diminish substantially going forwards. This is a considerable problem for government as it is a massive tax collection vehicle for them. Currently 50% of it is retained by the local authorities, which will rise to 75% next year. There isn’t an easy solution, but government needs to develop an approach to business taxes that is fairer and will adequately finance and sustain local communities. As all retailers move towards multi-channel, the ‘level playing field’ discussion perhaps becomes a red herring and instead we should perceive one of retailers’ roles as being valued custodians of the high street, one that is acknowledged by the tax system.

Paul Martin, UK Head of Retail – KPMG

For decades, if not centuries, retail has followed the same business model. You source products, you ship them from source to point of sale and then sell them. If you are successful at this, you open additional physical locations to sell more products. Therefore, up until about 10 years ago, a high-street in Great Britain would have looked comparatively similar, to the Forum in a Roman city 2000 years back when comparing the retail business models being used. The emergence and growth of the online channel has changed this well-established equation and the pace of acceleration of this factor during the COVID-19 pandemic is increasingly changing the structural landscape of the retail sector.

Pre-COVID-19 the online penetration in the UK stood at approximately 20%. During the last six months this has grown close to 30% and by 2025 could easily reach 50%. Taking this context into consideration it is important to understand what the future of retail could look like.

During the 2010s there was a regular and emotional debate trying to answer the pros and cons of offline vs online and which model will prevail in the future. I believe the consumer has answered that question already and it is clear they want a hybrid model of both. Of
course, the ratio of sales online vs offline will differ across categories although the fundamental point remains – successful businesses will need to deliver a customer-centric, channel agnostic proposition. The key question to answer for me is ‘how to get from today’s situation to what is required in the future’? This will require many organisations to transition their Business and Operating models and failure to do this at pace will likely result in a number of familiar names going out of business. I therefore do not believe there is a requirement to create a level playing field for both routes to market as they are increasingly becoming one. A number of key factors will need addressing though and these relate to multiple stakeholders across the consumer commerce ecosystem.

- **Landlords/Real Estate** – We are already seeing a reduced demand for physical space and this will continue in the future. Repurposing retail space for alternative use is going to be imperative. The rental business model is also changing and where beneficial, turnover related rents will become the new norm. More importantly though rental levels will need to reflect this New Reality to attract potential new retail tenants. This will also likely have a profound impact on the Business model of many real estate operators.

- **Regulators/Policymakers** – With the structural changes in the sector accelerating the requirement to review and address competition rules, rates and taxation, environmental and planning legislation to name the most important has increased. The described structural changes will also have a profound impact on the shape of employment across the sector which will need to be addressed urgently.

- **Retailers** - as described in a previous Retail Think Tank white paper, I increasingly believe that in the next 10 years the term retail will become obsolete as we move towards the age of consumer commerce, in which multiple types of businesses, many that have no history in operating physical stores, will be selling products and services to consumers. In this context I do not believe the amount of disposable income we spend on consumer products and services will change significantly. I do believe, however, that the mix of what we purchase and those selling that are selling this mix could change profoundly. Therefore, embracing change and not underestimating the pace this change will occur at will be pivotal. Retailers have the choice to either buy, build or partner when deciding how to embrace this change. If the choice is made to build, I believe the business needs to already operate at a minimum 50% of the median UK online ratio otherwise the gap is too large to fill and it will be close to impossible to catch up.

**Martin Hayward, Founder – Hayward Strategy and Futures**

There is absolutely not a level playing field between international online players and incumbent physical retailers.

If there were, governments around the world would not be grappling with multiple initiatives to urgently find better ways to ensure that international online retailers pay a fair and reasonable share of the tax burden and account for the societal and environmental impact of their businesses. This is not proving to be easy due to the international footprint of the businesses involved.

The latest big push is coming from 130 countries in the Organisation for Economic Cooperation and Development (OECD), that is urging the G20 ministers to progress a digital tax reform that would allow local taxation of international players, who currently avoid their obligations through legal yet arguably immoral allocation of costs and profits to the
most favourable tax regimes they can find. This has led to profitable multi-billion pound turnover companies effectively paying minimal taxes in many of the countries that they operate within.

*Amazon’s (AMZN) UK services arm paid just £14.5m ($16.1m) in UK corporate taxes in 2019 despite generating revenues of nearly £3bn in the country, according to the company’s latest accounts.*

*The technology giant’s tax bill at the division rose by just 3% last year, even as pre-tax profits at Amazon UK Services rose by 35% to £102m:* (Yahoo Finance, Sept 2020)

Whilst there is hope for a global solution to this tax avoidance, national initiatives such as the UK’s digital services tax that hoped to provide a stop gap are under review.

The second equally important initiative to level the playing field lies in a broader review of the costs (both monetary, societal and environmental) that lie beneath the rapid increase in home delivery.

The second equally important initiative to level the playing field lies in a broader review of the costs (both monetary, societal and environmental) that lie beneath the rapid increase in home delivery.

*The Department for Transport Science Advisory Council ‘Last Mile Logistics’ positioning statement is a good place to start and is being actively considered by the chancellor. This paper explores potential options to reduce home delivery inefficiencies, congestion and pollution through, amongst other things, a tax on home delivery.*

*The Chancellor is now considering a tax on online retail sales, which could raise a significant amount of money for the government. Online shopping soared during lockdown as high street shops were forced to close. The tax could redress the balance between online retailers and the high street.*

*The Treasury, according to the Times, is considering either a two percent tax on online sales, or a charge on deliveries.* (July 2020)

It is well known across the industry that home delivery is less efficient and profitable than in-store sales, so this initiative to steer consumers towards physical stores would have both profit and environmental and societal benefits.

Otherwise, we edge closer to the dystopian future envisaged by silicon valley, where consumers, locked in to a ‘platform’ provider have their every whim anticipated and delivered without ever leaving the house, leaving them free to gorge on politically censored ‘content’ provided by the same platform, and the roads free for their fleets of delivery vans and dubious sub-contracted delivery cars and mopeds.

**Maureen Hinton, Group Retail Research Director, GlobalData Plc**

The discussion around a level playing field for retail mainly turns to imposing a new tax on online shopping to bring online costs on a par with physical retailers, whose locations incur higher rents, and therefore higher business rates.

Online has done well out of COVID-19 as it has acted as an accelerator bringing in new adopters and increasing online penetration across all sectors, as lockdowns and store closures have forced consumers to turn to online as a necessity as well as a convenience. One in three shoppers say they will continue to shop more online in the future as well (GlobalData COVID-19 weekly recovery tracker – UK). Meanwhile COVID-19 has also accelerated the demise of many physical retailers with permanent store closures.
Consequently, the government is facing reduced revenue from physical retailers at a time when it is spending billions supporting businesses and jobs through the crisis.

The problem with adding taxes to online shopping is that how we shop, even during the pandemic, is a mixture of online and offline. Many physical retailers have invested in developing businesses that reflect consumer demand, and therefore have growing online businesses, and ones where they are taking measures to reduce the carbon impact. (Even Amazon has physical stores and is investing in more with its food convenience stores). Increasing costs for online operations will therefore penalise all retailers who have been forward thinking. Already it is difficult for retailers to operate profitable online operations so higher costs will inevitably be passed on to consumers in higher prices at a time when the UK is facing a severe recession. It would be fairer to change the current retail business rate system, but the government has been dragging its feet on this despite several inquiries.

The government needs a thriving economy with consumers in jobs and spending money, bringing in higher VAT returns and tax and insurance, and healthy businesses paying corporation tax. The latter, the paying of corporation tax in the country where the profits are generated by international businesses is a real issue for online shopping. But this is an issue that must be addressed globally.

**Martin Newman, The Customer Experience Champion**

There has been much debate about the impact online is having upon physical retail. To this end, there is conjecture that the Government is considering implementing an online sales tax to create a fairer system for all retailers.

The premise of an online tax fundamentally misses the point both in relation to the cost structure of running on and offline channels as well as how consumers shop.

We live in a multichannel world. Consumers don’t see channels they only see experiences. For example, approximately 65% of consumers start their journey online but complete their purchase offline. Depending upon the category, a significant percentage of online sales would have started offline. Particularly in furniture, electricals, homewares and DIY.

The reality is that even after COVID, online only represents 26% of total retail (ONS: AUG 2020). So, physical retail still dominates.
This said, the 40% spike in ecommerce sales has meant that both multichannel retailers and online pureplays have had to make significant investments in logistics, supply chain and headcount in order to meet the uptick in demand.

Online retailers don’t have landlords, nor do they pay rent, albeit they do pay for hosting for the website. However, retailers have many other running costs for their online channel that makes it hard to drive profitability. From warehousing and order fulfilment to performance led marketing, data science, analytics and all of the technology ecosystem, their online business comes with a big ticket and significant on-going costs. Not to mention the sizeable headcount still required to run an online business successfully.

The cost to serve is greater online that it is offline on a pro rata basis.

Taking all of this into account, should online retailers pay a tax to balance things? No. Business rates are there to cover the delivery of services to the retail store and surrounding area. What we should be doing is determining how these can be set at a fairer and more affordable level.

Retailers are increasingly moving towards performance led leases. And if these can be more equitable then retailers can return to making a healthy profit from their store channel.

Offline retail also has the advantage of human interaction. And when this is effective it is a competitive advantage when it comes to customer experience.

Add to this that the pandemic has led to more people working from home and shopping locally. Physical retail is not going away and the change in consumer behaviour will be a boost for many local independent retailers.

**Mike Watkins, Head of Retailer and Business Insight – Nielsen UK**

The seismic shift in shopping behaviour during 2020 has irreversibly changed the business model of food retailers. Over the 6months from April which includes the disruptions of the early spring lockdown, overall food retail growth has been +6.6% with fmcg growth higher at +9.5%. However two channels have grown market share at the expense of all others. Smaller, local Convenience stores under 3,000 sq ft where sales have increased +10.3% and Online where sales doubled as a result of the health crisis, and share of all fmcg sales accelerated rapidly from 7.5% to 13.5%.

It is probable that these channels will continue to `outperform` for all of 2021 with Convenience stores hitting close to 28% share of all channel sales. From a strategic viewpoint given that there is now an increased appetite to shop where you live (and increasingly work), providing help for food retailers with business rates, rent and other financial or tax inducements to encourage shopping at smaller stores in the community and in particular back to the high street, would lead to `levelling` up for the better good of society. Enabling more click and collect locally - including drop of points at food stores for non food retailers - should also be encouraged.

In contrast, as Online grocery continues to grow the impact on larger Superstores is the loss of more of the biggest and most profitable, trolley shops (those of £50 and above). Which will put more pressure on the longer term viability of many big stores some of which were already structurally challenged pre pandemic. However, it is reasonable to suggest that adapting to this change is a decision for boards and management and not national or local government. The level playing field discussion in food retail is arguably more relevant when these same large, national retailers or wholesalers (who also contribute directly to local
communities with Convenience stores) compete against platform providers or new entrants from abroad with few or no physical stores. Suggested remedies such as an online sales tax could be equitable from a corporate perspective but are problematic in food retailing if any increased costs were passed onto shoppers. So in the end, it should be the behaviour of consumers who shape the future of the food retail industry and not regulators.

^Nielsen Scantrack Total Store (including General Merchandise) and Nielsen Homescan FMCG : 24 weeks to 5th September 2020.

Nick Bubb, Retailing Consultant, Bubb Retail Consultancy Ltd

If there was any serious threat to the supremacy of Online retailers in the UK during the pandemic, eg through a potential Online sales tax, the City would have sensed it and marked down the share prices of the companies likely to be affected. But there is no sign of that, as the Online retailers are still flying high: the All-Share Index is over 20% down so far this year, but, as of the close on Oct 9th, the Ocado share price is 86% up and Naked Wines is 95% up in the Food Retail sector, whilst in the Non-Food Retail sector AO.com is as much as 154% up, ASOS is up 61% and even Boohoo is 18% up (despite its well-publicised supply chain problems).

Of course, the big “pure play” Online retailers are not just dependent on the UK, as they are well diversified geographically, eg with significant revenue bases in the US and Europe. And Overseas Online sales growth has been strong as well, reflecting the common urge amongst all consumers “working from home” during the pandemic to shop Online for ease, safety and convenience.

Consumers clearly don’t think it matters whether the products and goods they want to buy from retailers come from a physical shop/collection point or from a delivery van and their expectations are now so high, in terms of supply chain efficiency, that they will take their business elsewhere if a rapid and timely home delivery service is not offered.

But it matters to the multi-channel retailer’s P&L model if so many shoppers want to order Online, given the fixed cost burden they face from their physical store portfolio and the extra distribution costs they face in getting products to the consumer’s home. And it will soon matter to Government finances, as they find the grossly inequitable but lucrative source of revenue from Business Rates (based on physical store valuations) drying up, as loss-making stores have to close down.

From the perspective of multi-channel retailers and Government finances therefore, it makes sense to explore ways of levelling the playing field by shifting the cost burden towards Online shopping.

This is, inevitably, hard to do...The Online retail lobby, eg in the form of Amazon, is strong and their arguments about the threat to Online “jobs” from penalising their success and how unfair it would be to ask Online shoppers to pay more are well-rehearsed. And there are technical issues to weigh up in terms of Online Food sales should be treated versus Online Non-Food and whether “Click and Collect” shoppers should be treated differently from home delivery orders.

Yet, where there’s a will (to tax Online sales) there’s a way. Perhaps the answer is to switch the debate from taxing Online sales to devising an Environmental Protection Tax, that would focus consumers on the cost to the environment of having their streets clogged with delivery vans and surplus delivery packaging?
James Sawley, Head of Retail & Leisure, HSBC

As a banker to Retail, I tend to judge the health of the industry and its constituent players on profitability and probability of default. Through this lens one might argue that the playing field is indeed level as pure-play online retailers are no more profitable than traditional multichannel operators, in fact they are often far less profitable! The reason being that the pure-play operators have to spend much more on technology, delivery, returns and of course marketing, when compared to their physical counterparts. Forgetting Covid for a minute, shops have millions of potential customers walking past eying the window displays every day, for ‘free’, while pure-play retailers must generate website traffic through expensive SEO, advertising, influencer marketing and fancy content generation. Also, the sheer scale of the internet means it the most competitive place to do business in the universe! If the playing field were so uneven, why then have we seen many pure-players go bust? The answer, as ever, is – it’s complicated.

I think this question of ‘fairness’ ultimately derives from the notion that 1) pure-play online retailers, through the structure of their companies and the fact they have no physical shops paying business rates, pay less tax into the UK Government’s coffers and thus are contributing less to society, and 2) as they are playing the long game, their shareholders are focussed purely on winning market share, even if this means making no profits in the short term, giving them a unfair competitive advantage. While I have some sympathy with these views, this is the force of free- market capitalism whereby old business models fail in the pursuit of industrial and economic progress. If you subscribe to this view, what's worrying is that Covid is making matters worse as cheap money and low interest rates are allowing bigger stronger companies to access cheap capital to expand and marginalise smaller, weaker businesses, bolstering their already dominant positions.

In the long run, whatever your view, this perceived advantage will disappear as a result of a force way more powerful than capitalism, that of human nature. We are social beings, we need and crave physical interactions and experiences to stimulate our senses and to satisfy our thirst for discovery. Let’s not forget that, even now, the vast majority of products are purchased in store. This feeling of unfairness is a result of what I believe is a transition period between the ‘current world’ of retail and the ‘new world’ of retail. In this new world, the terminology ‘online’ and ‘physical sales’, will be completely redundant. Every retailer on the planet will have a world class ecommerce operation, but every retailer will also need a network of awe-inspiring physical spaces to showcase products, engage with customers and build brand affinity. Falling rents, more flexible property deals, and potential tax reform will mean businesses and entrepreneurs will be able to use physical space in exciting new ways to drive footfall back to our high streets and they will flourish again. Right now, pure-play retailers are considering how, not if, physical space will be a major feature of their businesses in the not-too-distant future.

Jonathan De Mello, Equity Partner, CWM Retail Consulting LLP

I firmly believe that we are – more than ever before given COVID-19 – in the age of the ‘Channel Agnostic Shopper’ – shoppers only think in terms of a brand, not the channels it operates - and retailers would be well served to operate with the same mindset.

Clearly COVID has catalysed considerable change in all our lives – from how and where we work, to how we consume products and services. This has led to an inevitable shift in retail sales from physical stores to online, with some retailers with poor transactional websites struggling vs their more technologically advanced competitors, and others simply unable to cope with burgeoning demand due to under-investment in logistics. Pure play online retailers with
established infrastructures clearly benefited in this regard, and retailers with more of a physical store focus will have breathed a collective sigh of relief when shops were allowed to reopen on the 15th of June.

Since the shops reopened we have had circa 4 months of trading, and some clear trends have started to emerge – such as the localisation of retail and leisure expenditure given a continued high incidence of home working. This has benefited smaller towns and villages most – and has provided a much needed boost for independent retailers. Retail parks have also benefited given they are mostly located within easy reach of densely populated residential locations, can be accessed by car (with free parking) and the size of stores within retail parks enables more effective social distancing. On the flip side, major city centres have been hit hardest by a loss of both tourist and worker spend. Heathrow airport during lockdown was reporting similar passenger throughput to Southampton airport (pre-lockdown), and offices are operating at circa 25% capacity, with many workers choosing to continue to work from home in light of the continued insidious presence of Coronavirus. As a result, online channels continue to be an extremely important route to market, and many retailers are investing in improving their transactional websites, and expanding their logistics capabilities.

This has had a knock on effect on the property sector, as the investment markets have started to bounce back given the potential for over-leveraged principally institutional property owners being forced into a potential ‘distressed seller’ position as banks pressurise them to sell assets in order to avoid potential loan covenant breaches. A number of existing/newly created funds are exploring such opportunistic acquisitions, with online retail very much in mind – given the potential to acquire a retail park in its own right/acquire a park with potential for full/partial conversion to warehousing/logistics. Last mile logistics potential is particularly attractive, with parks in/around the M25 seeing particular interest. There is substantial and growing demand for such facilities from retailers – as many will be keen to bring down the cost of home delivery, given for some retailers the cost of fulfilling an online order is still very high.

Turnover-linked rents are gaining increasing traction as both retailers – and many landlords – agree that the current rental model in the UK is no longer fit for purpose. The main sticking point in negotiating such deals however is around whether and how online sales will be accounted for – with click and collect (and equally online returns) often included, though the additional ‘halo’ a physical store generates for online sales (and wholesale where relevant) is often not. This is not the case where turnover linked deals have been signed in the Leisure sector however – with home delivery via Deliveroo, Uber Eats etc.. (currently a major source of sales) included, given the food is prepared on-site.

Retailers increasingly think about stores in terms of ‘benefit to brand’ as opposed to the pure profit and loss that a particular store generates. I have worked with one fashion multiple retailer where the online ‘halo’ from new store openings in locations where they had minimal presence was 70%+. For another retailer with only a few stores in the UK online sales actually doubled on the opening of a high profile new store, given their relative lack of brand equity in the UK prior to the opening of the store. ‘Benefit to brand’ from operating stores lends itself towards high traffic/footfall locations – with the store as an alternative form of advertising vs traditional media. This is why many wholesale brands/online pure plays are considering physical store presence – given the difficulty of maintaining brand equity via a purely online presence. This is also why the argument of ‘online vs physical’ is increasingly less relevant, as many physical retailers now have a strong presence online, and more and more wholesalers and online pure plays are ‘going physical.’
The necessary blurring of boundaries between online and physical retail makes the current business rates system even more ludicrous, and urgent reform is paramount prior to next April – in order to avoid a swathe of further retail business failures. If the government considers linking rates to turnover – given rents are moving that way anyway – surely that would be a much fairer solution? Turnover linked rates could apply to the retailer’s turnover as a whole – as opposed to just physical sales – and absolutely should encompass sales made by online pure play retailers too. In terms of a level playing field therefore between online and physical retailers, I am very much in favour of making the lives of retailers with a greater physical presence substantially easier and more cost-effective – with both rents and business rates overtly linked to the turnover that retailer achieves, and the turnover rent including a consideration for the ‘halo’ a store generates for other distribution channels. This will clearly vary by retailer and by location, but to my mind represents a far more equitable solution than the rent and rates models we have in place currently.

Ruth Gregory, Senior UK Economist, Capital Economics

It’s no secret that the COVID-19 crisis dealt a heavy blow to retail spending. The bounce-back in retail sales has been impressive, with the official data suggesting that overall retail sales are already 4.0% above their pre-pandemic level. But this masks a big divergence between in-store sales and those online. Although the online contribution has declined from its spring highs, these sales values are up by nearly 50% compared with the start of the year. In-store sales are still down by almost 10%. Meanwhile, online sales accounted for 28% of sales in August, up from a fifth before the COVID-19 crisis hit.

Some of the leap in the share of retail sales that took place online has already been reversed. But as some new habits have probably been formed, COVID-19 is likely to have a lasting upward impact on the online share of retail spend. We have generated three long-run illustrative scenarios. The “medium” scenario assumes online demand stays elevated across a number of categories over the next 2-3 years. The “high” scenario assumes that COVID-19 not only pushes forward some online demand, but that online penetration reaches a higher level. (See here.) The long-term cumulative impact on physical retail sales is significant with sales roughly 10 percentage points lower on the high scenario by the end of the decade.

<table>
<thead>
<tr>
<th>Table 1: UK Retail Sales Scenarios (Values, %p.a.)</th>
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<tbody>
<tr>
<td>Total</td>
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<tr>
<td>Sales</td>
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<td>2009-13</td>
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<td>2020-21</td>
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<td>2025-30</td>
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<td>2031-35</td>
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Sources: Refinitiv, Capital Economics

This raises two questions: does it matter if the share of online retail sales continues to rise at the expense of bricks and mortar retailers? And if so, how should it be addressed?

It’s clear that the burden of business rates falls squarely on high street retailers. Viewed in this way, effective forms of government intervention to level the playing field might include...
exploring new policies, such as a revenue-based tax for online retailers, green taxes on deliveries and packaging, or a lowering in business rates and/or investment relief.

But while there may be an appetite for tax rises on those companies that have benefited from the crisis and a broader ambition within the Treasury to “balance the books”, adding new taxes won’t necessarily resolve the longer-term challenges faced by the industry. As with any new tax, the scope and underlying reason for it needs to be clear. What would it achieve? Would it prevent a boarding up of the UK’s high streets? At what cost? Would disincentivise innovation and investment online? Would the costs of higher taxation be passed onto the consumer in the form of higher prices? And does it make sense right now to tax a selling channel popular amongst consumers and a relative bright spot in the recovery?

Of course, it’s unlikely that the high street will be the same as it is today in a decade’s time. And the lines between the channels of selling are becoming increasingly blurred. After all, the rise in online sales since the start of the year has been driven by a move from physical stores to their websites. Clothing, household goods stores have seen their share of online sales more than double during the crisis, while 10% of all food sales are now done online, up from 5% in 2019. By contrast, sales at online-only stores have remained relatively flat.

Either way, the big risk now is that even tighter COVID-19 restrictions and of a no deal Brexit at the end of the year send the economic recovery into reverse. So if anything there will be pressure for the government to spend more, not less to ensure the recovery is sustained. Admittedly, government borrowing will probably reach nearly £390bn this year (19.5% of GDP), the highest budget deficit since WWII. But with borrowing costs set to stay low for many years, the concern for the economy should, and probably will, overwhelm the Chancellor’s ambition to balance the books. Overall, well-thought out retail tax reforms may be worthwhile. But for now, more support rather than less is needed. Taxing those who have benefitted from the crisis can wait for another day.