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Room for improvement:

Creating the financial incentives needed for economic growth

Kieran Larkin, Zach Wilcox & Christiana Gailey

July 2011

Executive Summary

The Government has introduced two new policies to rebalance local decision making in favour of development. The **New Homes Bonus** (NHB) offers local authorities a payment for each additional house built and the Local Government Resource Review (LGRR) will allow for the **retention of business rates**. These new financial incentives for growth are certainly a step in the right direction. Together, the reforms mark a fundamental shift in the way that local government in England is financed, incentivising local authorities to be far more pro-growth and pro-development.

In a complex world, no policy will be a catch-all for the challenge of increasing the supply of residential and commercial property. Yet, with the right design, the NHB and LGRR can create financial incentives for growth that benefit both the residential and business communities of Britain's cities, and the UK economy as a whole.

"With the right design, the NHB and LGRR can create financial incentives for growth that benefit the residential and business communities of Britain's cities"

Key policy conclusions and recommendations

Local Government Resource Review – retaining business rates

- **Our analysis suggests that local retention of business rates could create a strong incentive for growth.** This can be illustrated by the decline in the growth rate of commercial space, and increase in business occupancy costs, following the nationalisation of business rates in 1990.
- **The Government must be bold with its proposals.** In the longer term, the shift to an incentive-based system will create both relative winners and losers. Yet the majority of cities should still see growth in their local business tax base - 55 out of the 56 English cities saw their business rates tax bases grow between 1999 and 2010. We think the potential economic benefits for the country justify this trade-off between redistribution and national economic growth.
- **To be effective the incentive for growth needs to be well designed.** It needs to be large; strong at the margin; contain no thresholds; incentivise the right behaviour; target the decision maker; be simple and transparent; and long term.
- **All local authorities should be allowed to retain a fixed proportion of the growth (40-60 percent) in their business rates, indefinitely.** This would create a strong, simple, long-term incentive to support development and economic growth.
- **To ensure growth enabling infrastructure can be financed, a mechanism needs to be created to enable long-term pooling of some of the business rates revenues at the Local Enterprise Partnership (LEP) or city regional level.** Government should create an additional bonus for business rates growth committed to the LEP level for infrastructure investment.

New Homes Bonus

- **The Government's approach to incentivising additional housing delivery with the NHB is welcomed. However, as it is currently configured, the NHB looks to be too small to sufficiently increase the housing supply.** The Government's own calculations estimate that the NHB will increase supply by just 8 to 13 percent. Our analysis suggests that it will be too weak an incentive to increase house building in the areas and cities of the country where there is the highest demand.
- **To improve its effectiveness, the NHB needs to be increased in size** – preferably tripled. It should also be targeted at those residents most affected by new housing development.
- **The New Homes Bonus needs to be placed on a permanent legal footing.** To make the New Homes Bonus work properly, the amendment to the Localism Bill that allows financial considerations to be material in planning decisions should be preserved.

"The New Homes Bonus needs to be placed on a permanent legal footing"

1. Introduction

The UK economy is currently recovering from a severe recession. The pace of growth has been subdued and real incomes have been squeezed. In response to the weak recovery, the Government has set out an ambitious plan for growth,[1] targeting a range of areas – such as the tax system, regulation, business finance and planning - where it believes a change in policy can improve the performance of the economy.

The economic performance of UK cities will be vital to the recovery as well as long term growth and prosperity - 75 percent of England's private sector jobs are located in cities and their hinterlands.[2] Therefore, it is essential that the new policy environment supports urban growth and, in particular, that it encourages the expansion of our most buoyant city economies.[3]

"One important new direction of policy is the introduction of financial incentives into the planning system to try and rebalance local decision-making in favour of development"

One important new direction of policy is the introduction of financial incentives into the planning system to try and rebalance local decision-making in favour of development. For example, the Government has introduced a New Homes Bonus (NHB) – a financial reward for each new home built – and is reviewing retention of business rates – a tax on all business property – in the Local Government Resource Review (LGRR).

In combination, these reforms will fundamentally alter the way that local government is financed. One of the Government's key objectives with the LGRR is to create *"the optimum model for incentivising local authorities to promote growth by retaining business rates"*.[4] The ambition is for financial incentives for growth to enable economic factors to be given greater weight within the plan-making and development control system by providing local authorities with a direct financial benefit for enabling development.

Incentives are important and can guide us to take one stance over another. They can also help to align otherwise divergent perspectives. In the urban context, incentives could help compensate for the fact that it is often incoming residents rather than existing residents that stand to reap the greatest share of economic benefits created from new development and expansion.

Financial incentives for growth are only part of a range of measures needed to support UK cities to realise their economic potential, and must sit alongside reforms to the planning system. However, developed in the right way, they could offer significant opportunities. Incentives for growth provide a means to encourage development, particularly in the urban economies with the highest demand for housing and business property. They can also provide an income stream borrow against to fund the infrastructure which may be required to unlock this economic potential. However, financial incentives need to be well designed. To be effective, incentives need to be large, targeted at the appropriate decision maker, relatively simple and long term.

1. HM Treasury (HMT) and Department for Business, Innovation & Skills (BIS) (2011) *The Plan for Growth,* London: HMT
2. Centre for Cities (2011) *The Growth Conundrum: The importance of cities to economic growth in the UK,* London: Centre for Cities
3. Webber C & Swinney P (2010) *Private sector cities: A new geography of opportunity,* London: Centre for Cities
4. Department for Communities & Local Government (DCLG) (2011) *Local Government Resource Review: Terms of Reference*

In this report, we examine two of the Government's incentives for increasing the supply of land for development. These are the NHB and the business rate reforms of the LGRR and consider if the incentives will be sufficiently strong to change the behaviour of local decision makers for the benefit of the UK economy. We then set out our recommendations for improving these policies to create better incentives for growth.

The report is set out as follows: in the next section we review the evidence about the need for financial incentives for growth in urban development. In the third section we look at what makes an effective financial incentive for growth. In the fourth and fifth sections we look at the reforms of the LGRR and in the sixth section, we analyse the NHB.

"In this report, we examine two of the Government's incentives for increasing the supply of land for development"

2. Why we need a new approach to encourage development

This paper explores how to give local authorities financial incentives to increase land supply and encourage development.[5] Introducing incentives for local authorities to allow development has the potential to make land supply more responsive to patterns of demand across the UK, thus ensuring that areas with the most economic potential can expand. Financial incentives also offer an income stream allowing local authorities to finance much-needed infrastructure investment, further enabling growth.

In this section we set out the context for why incentives for growth are needed. We then briefly review the impact of the UK's plan-making and development control system on supply of land for development and consider the implications that this might have for the economy.

"Introducing incentives for local authorities to allow development has the potential to make land supply more responsive to patterns of demand across the UK"

Why are incentives needed?

The reforms currently being designed and introduced need to be considered as part of a package, alongside existing tools like the Community Infrastructure Levy (CIL), that will fundamentally reform the system of local government finance. The balance will be shifted towards rewarding authorities that seek to attract, deliver and enable economic growth. The changes will incentivise the development of new business premises and additional housing development. The incentives will also create a revenue stream for funding additional investment by allowing for the capitalisation of future funding streams and borrowing against these sources (Figure 1).

Figure 1: How incentives will alter the English system of local government finance

Most people or organisations respond to incentives to maximise their own benefit, whether financial or otherwise. The incentives they face influence their choices and how they act. Incentives can also align national and local interests, when they diverge. For example, it is usually in the national economic interest for places to expand and grow - particularly highly productive, buoyant cities. However, if many of the direct benefits of growth accrue to incoming rather than current residents, it may be in the current residents' interests to oppose or resist this change.

The changes made to local government finance over the last two decades have largely, and somewhat unintentionally, created disincentives to develop at the local level. Local authorities have the primary discretion over whether to permit

5. The Government is introducing a number of reforms to the planning system which the Centre for Cities will be reviewing in forthcoming work. This paper focuses on the potential for financial incentives to alter the balance of decision making and to encourage local authorities and communities to, at the margin, be more permissive of development.

development but do not benefit financially from that expansion. Residents often experience negative impacts from development - such as increased congestion, a reduced level of services, or loss of access to green space - while it is often future residents or inward commuters that stand to benefit the most from new jobs and access to cheaper or better housing. Residents' worries are usually a combination of genuine local concern and a level of self interest. Councillors quite naturally respond to their current constituents' concerns and demands through the planning system, to safeguard their own political survival. Ministers admit that it can often be in councillors' political interests to block development.[6]

While there are financial mechanisms to compensate communities for the negative impacts of development, such as Section 106 agreements,[7] local authorities still see little long-term financial benefit from supporting economic growth. This is because the majority of the resulting tax revenues are sent straight back to central government.

"Although the planning system creates benefits, in regulating and restricting the supply of land it also generates costs"

The lack of a long-term financial benefit from growth can mean that the balance of the incentives faced at a local level can lean towards resisting development. This is not true in all local authorities and some use the planning system to promote growth. In those authorities that do resolve to restrict development, this can manifest itself in planning proposals being rejected outright or in lengthy, costly delays in the time it takes house builders or businesses to secure planning permission. Developers also face considerable uncertainty during the process as to whether they will in fact receive permission, adding to their costs. We now look at the impact that this might have on the UK economy.

The implications of the plan-making and development control system for economic growth

A number of studies have argued that the UK's plan-making and development control system, henceforth referred to as the "planning system", limits the supply of land available for development.[8] The planning system clearly delivers important benefits. It is designed to deal with conflicting interests – economic, social and environmental - mitigate the negative aspects development and maximise the positive impacts. Given its arbitration role, it is not surprising that the planning system often encounters controversy. Taken as a whole, the planning system is complex. As well as local authority led plan-making and decision-taking, it also encompasses national guidance, various regulations and consents, a whole host of advisory bodies and statutory consultees and other local actors.

Although the planning system creates benefits, in regulating and restricting the supply of land it also generates costs. Evidence suggests that, in some circumstances, the costs generated by the planning system may exceed the

6. Planning Magazine (2011) 'Cable: Sustainability prescription at core of planning overhaul', published by *Planning Magazine*, 26 May 2011
7. Section 106 agreements are legally-binding agreements or planning obligations between a local planning authority and landowner in association with the granting of planning permission. They are used to secure benefits, such as the provision of infrastructure and services, that make a development acceptable.
8. For example: Barker K (2006) *Barker Review of Land Use Planning: Final Report – recommendations,* Norwich: The Stationery Office; McKinsey Global Institute (1998) *Driving Productivity and Growth in the UK Economy,* Washington: MGI; McKinsey Global Institute (2010) *From Austerity to Prosperity: Seven priorities for the long term;* Washington: MGI; OECD (2011) *OECD Economic Surveys: United Kingdom,* Paris: OECD, Evans A W & Hartwich M (2007) *The Best Laid Plans: How planning prevents economic growth,* London: Policy Exchange

benefits. Taking a prosperous city in the South East as an example, one estimate of the net welfare loss generated from restricting the supply of land is the equivalent of imposing a 3.9 percent tax on residents' incomes.[9] As this is a net figure, it accounts for most of the benefits that the planning system creates, such as access to open spaces. Overall the costs of the constraints to land supply exceed the benefits.

The same issue is true internationally. In New York, extensive building regulations have effectively excluded less well-off residents from living in certain areas of the city. On average, the people who live in the historic districts of Manhattan are almost 74 percent wealthier than people who live outside such areas, as less well off individuals have effectively been priced out of the area.[10] It is questionable whether the benefit of protecting these buildings justifies the resulting social cost.

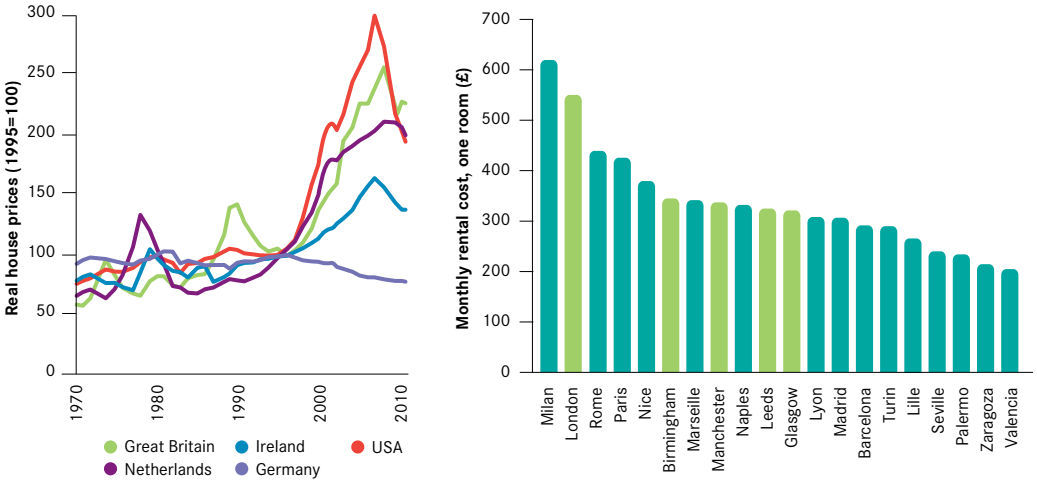
"There is now a wide body of empirical literature that demonstrates that the planning system limits the supply of housing which drives up house prices"

Impact on city housing markets

There is now a wide body of empirical literature demonstrating that the planning system limits the supply of housing which drives up house prices.[11] As a result, house prices in the UK are now among the highest in the world, despite falls in value during the recession. Similarly, the monthly rental cost of a room in many UK cities is high by international comparisons – five of Europe's most expensive rental markets are in the UK (Figure 2).

Restricted supply is only one of the factors driving up UK house prices, alongside issues like easy access to credit and a cultural attachment to homeownership. However, it is estimated that if the planning system were completely relaxed, house prices would be between 34 to 52 percent lower.[12] While this in itself is clearly an unrealistic proposition, it does indicate the impact of restricting supply.

Figure 2: House price and rents are high by international standards



Source: OECD

Source: Easyroommate.co.uk, 2010

9. Cheshire P (2009) *Urban Land Market and Policy Failures,* London: BIS
10. Glaeser E (2011) *Triumph of the City: How Our Greatest Invention Makes Us Richer, Smarter, Greener, Healthier and Happier,* Basingstoke: Macmillan
11. Hilber C & Vermeulen W (2010) *Final report: The impact of restricting housing supply on house prices and affordability.* London: DCLG; Evans A (1991) "Rabbit Hutches on Postage Stamps: Planning, Development and Political Economy." *Urban Studies* (28) 6; Andrews D et al (2011) 'Housing Market and Structural Policy in OECD Countries', *OECD Economics Department Working Paper No. 836*
12. Hilber C & Vermeulen W (2010) *The impact of restricting housing supply on house prices and affordability,* London: DCLG

Beyond the fact that high house prices mean that a larger share of people's incomes is needed to pay for housing, restricted development creates other undesirable outcomes. High house prices can restrict mobility, particularly of those with low incomes and of the unemployed. In the UK, being unemployed means that you are less likely to have moved house in the past two years whereas in the United States an unemployed person is more likely to have moved.[13] This has implications for the job-seeking behaviour of the unemployed.

Impact on property prices and business growth

There is less empirical research on the effect of the planning system on the market for business property. Local residents and planning authorities are generally less averse to commercial development than housing development because of the employment opportunities it creates.[14] Despite this, there are indications that rental prices are similarly high for businesses, that the planning system is restricting supply (see Box 1) and that this is having a negative economic impact. For example, in 2004, the occupation cost per square metre in Birmingham was greater than Manhattan and twice that of San Francisco.[15]

"There are indications that rental prices are similarly high for businesses, that the planning system is restricting supply and that this is having a negative economic impact"

Box 1: Kent International Gateway, Kent

The Kent International Gateway (KIG) is an example of a significant commercial development that met with large public opposition. The original proposal was for a large rail/road interchange near Maidstone, with extensive warehouse and office space. The development would have created 3,500 jobs.[16] Those opposing the site argued that its location in a special landscape area, the resulting increase in rail usage, proximity to historical villages and the loss in amenity value from the affected bridleways and footpaths meant that the KIG was an inappropriate development. A well organised local campaign group, STOPKIG, was set up to coordinate opposition to the development. Considering just the environmental impact, while the development was to be built on greenfield land, the hub would have actually removed 60 million km of HGV journeys from the roads each year.[17] Planning permission for the KIG was refused by Maidstone Borough Council in 2009 and subsequently rejected on appeal by the Secretary of State. The land is unlikely to be allocated as employment land in the council's Local Development Framework, ultimately reducing the likelihood of any form of commercial development in this part of the Greater South East.

The Sail Development, Wirral

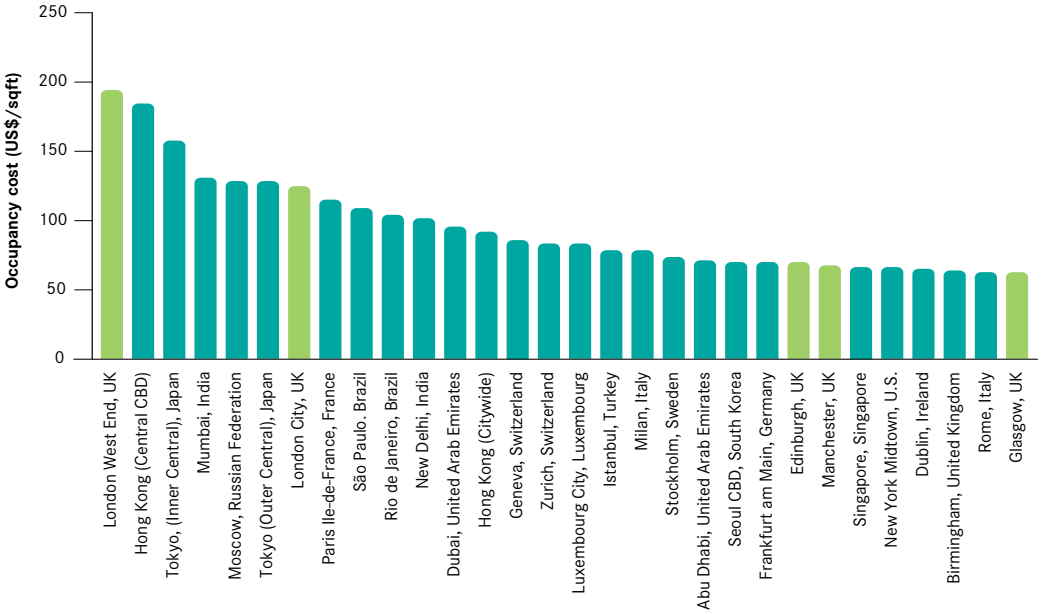
The Sail Development was a four year effort on behalf of a developer to build a new sailing school and hotel in West Kirby, Wirral. Over the course of the planning application process, the architects and developers were asked to change their plans several times, including halving the size of the hotel and providing more parking. Permission was ultimately rejected due to a lack of parking. This shows that in the absence of a direct financial benefit from growth, fairly minor issues can prevent potentially positive developments from proceeding.

13. Sánchez A & Andrews D (2011) To Move or not to Move: What Drives Residential Mobility Rates in the OECD? *OECD Economics Department Working Papers No. 846*
14. For example, In 2011, 91 of the planning applications for commercial developments (office, retail, industry and warehouses) received approval compared with 80 percent of dwellings applications.
15. Cheshire P & Hilber C (2008) *Office Space Supply Restrictions in Britain: The Political Economy of Market Revenge* London: LSE
16. BBC News (2010) 'Kent International Gateway freight depot plan refused', published by *BBC News,* 5 August 2010
17. BBC News (2007) 'Freight depot battle stepped up' published by *BBC News,* 29 October 2007

Office costs in UK cities continue to be high by international standards. Figure 3 shows the highest average rental prices for the leading 30 global office markets. UK office markets appear on the list six times, more than any other country. On the one hand, the high prices are a success story, indicating a good quality commercial property offer and a strong demand from business to locate in UK cities in what is an international market. But, as well as strong demand, high prices also reflect a restriction of the total office supply. For example, while we might expect to see office locations like London's West End appear on the list, the presence of regional cities like Birmingham is perhaps more surprising. In the top 50 office locations, UK office markets appear nine times.

"By restricting economies of scale, planning policies have reduced the productivity of specific sectors, such as retail"

Figure 3: The 30 most expensive global office rents



Source: CBRE Global Office Rents November 2010

High office prices present a significant cost to business. If these costs represent the true balance between the supply and demand for commercial space, this should not be a problem. However, if the supply of office space is being restricted,[18] despite current demand for additional office space, this could be a source of inefficiency. For example, high prices could mean that companies are unable to establish operations in their preferred location. Previous work has also identified the negative impact that the planning system may have had on competition. By preventing the most productive companies from physically expanding, and therefore increasing their market share, the planning system could have enabled less productive firms to remain in business.[19] Similarly, by restricting economies of scale, planning policies have reduced the productivity of specific sectors, such as retail.[20]

The most economically buoyant cities have not been able to expand as much as they should

The restrictions on housing and commercial space have meant that new development has not fully responded to demand. This is due to both insufficient initial allocation of land for employment and the rejection of proposals for planning permission.

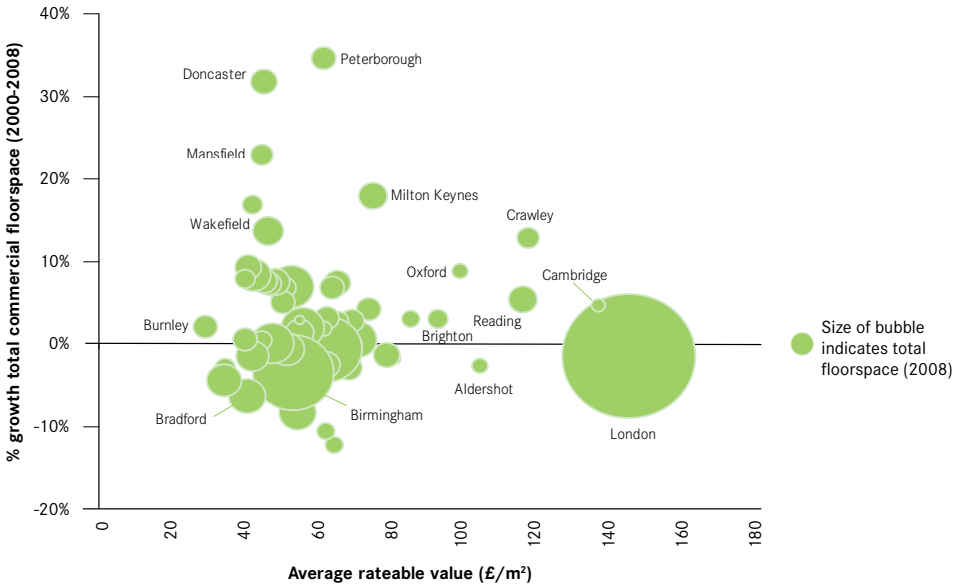
18. For example, evidenced by a large gap between full building costs and sale costs of a development.
19. McKinsey Global Institute (1998) *Driving Productivity and Growth in the UK Economy,* Washington: MGI;
20. Cheshire P et al (2010) 'Evaluating the Effects of Planning Policies on the Retail Sector: Or do Town Centre First Policies Deliver the Goods?', *SERC Discussion paper 66*

Overall, the restriction of land has constrained the growth of the UK's most buoyant local economies. Due to 'agglomeration economies' – the benefit of living in an area of high employment density – expanding the population and workforce of these areas would increase productivity, creating a national economic benefit.

In the UK, the overall picture is one of limited population growth in economically buoyant areas.[21] The supply of land for new housing and business development has been weak even in locations that are thriving economically. As a result, there has been very little relationship between the price signal (the cost of housing and rents) and level of development in both the housing[22] and commercial property markets (Figure 4).

"There has been very little relationship between the price signal (the cost of housing and rents) and level of development in both the housing and commercial property markets"

Figure 4: Little relationship between growth in commercial floorspace and average rents (2000-08)



Source: DCLG

This is also true within city regions – for example, north Manchester has increased the supply of housing faster than south Manchester, despite prices demonstrating higher demand in the south.[23] In this case it was probably an explicit policy objective as part of housing-led regeneration projects, to locate additional housing in economically weaker locations. Unfortunately, this approach to regeneration has not proved to be particularly successful.[24]

The lack of a link between, or recognition of, price signals and development in the planning system has prevented many of England's most successful cities from expanding to their full potential. Ultimately, this has probably had a detrimental impact on national growth. As we argued in *Private Sector Cities*, high growth cities, such as Cambridge, Reading, Aldershot and Brighton, need to be encouraged to expand to maximise their contribution to the national economy and to enable people to access the opportunities generated in these cities.[25]

21. Leunig T & Overman H (2008) 'Spatial patterns of development and the British housing market', *Oxford Review of Economic Policy,* Vol 24 (1)
22. Aldred T (2010) *Arrested Development: Are we building houses in the right places?,* London: Centre for Cities
23. MIER (2009) *Understanding labour markets, skills and talents,* Manchester: MIER
24. Webber C et al. (2010) *Grand Designs: A new approach to the built environment in England's cities.* London: Centre for Cities
25. Webber C & Swinney P (2010) *Private Sector Cities: A new geography of economic opportunity,* London: Centre for Cities

Price is only one indicator of the areas with the greatest economic potential and in need of expansion, but it is an important one. Although there are cases of buoyant cities which have not constrained growth – for example, Milton Keynes – and areas where it is clearly a lack of land rather than the planning system that restricts supply – for example, Westminster – in general the premise does seem to justify a policy response.

This report proceeds on the assumption that financial incentives are required to ensure that the plan-making and development control system enables growth, particularly in those areas of high demand where restrictions on land supply are more likely to be a binding constraint on growth and economic performance.

"Financial incentives are required to ensure that the plan-making and development control system enables growth"

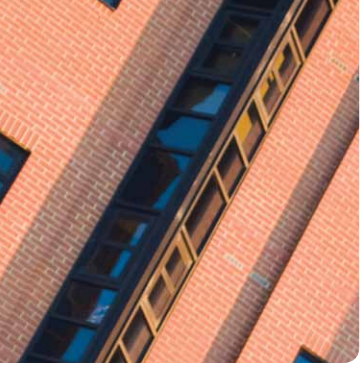
Box 2: Challenges facing the UK's housing and commercial property markets

Lack of housing supply

- Costs generated the equivalent of a four percent tax on resident incomes in some cities.
- Increased rental costs: Britain hosts five of Europe's top twenty most expensive rental markets.
- Impact on labour market mobility.

Lack of Non-Domestic Property

- High costs of property: six of the thirty most expensive global business property markets.
- Reduced business expansion and impact on business productivity.



3. How can we design effective incentives for growth?

In order to ensure that the planning system effectively takes into account the economic benefits of development, a number of studies have advocated the introduction of financial incentives.[26] The current Government appears to agree with this conclusion and so the question then becomes how to create the most effective incentive. We have identified seven factors that our review of the evidence suggests are important to consider when creating a strong financial incentive for growth.

"To change behaviour, incentives need to be large enough to generate a response"

1. Sufficiently large

To change behaviour, incentives need to be large enough to generate a response. Larger incentives generate bigger responses because they outweigh alternative courses of action. The relative size of the incentive is also important – the same size incentive will generate a larger response for local authorities with a smaller budget than for those with a larger budget.

2. Affect decisions at the margin

Incentives operate at the margin to alter the decision between doing a little bit more or a little bit less. To create a strong financial incentive for growth, all local authorities should be allowed to capture as much of the tax revenues as possible for giving planning permission for every additional house or additional commercial property, where there is demand.

3. No thresholds

Thresholds are minimum or maximum levels of performance, below (or above) which no incentive (or a different level of incentive) is received (e.g. a maximum bonus). The creation of thresholds in incentive packages will often generate undesired consequences. For example, if no payment is received after a given threshold, effort may diminish or disappear once the threshold is passed.

4. Incentivises the intended behaviour

To be effective, incentives must be designed to encourage the intended behaviour. It may seem obvious, but there is a plethora of examples of failed schemes because the behaviour the incentives encouraged was not the same as the desired outcome, resulting in unintended consequences.[27] For example, once monetised, the 13 week target for planning application decisions perversely encouraged local authorities to refuse planning permission if they thought they would miss the deadline.[28]

5. Targeted at appropriate decision maker

To affect behaviour, it is vital that the incentives created are targeted at the appropriate decision makers. While this is relatively simple to implement when designing pay schemes for individuals, policy decision making systems are complex and affected by a range of actors.[29] When it comes to planning, the majority of the

26. For example: Barker K (2006) *Barker Review of Land Use Planning: Final Report – recommendations*, Norwich: The Stationery Office; Hilber C & Vermeulen W (2010) *Final report: The impact of restricting housing supply on house prices and affordability.* London: DCLG; Evans AW & Hartwich M (2007) *The Best Laid Plans: How planning prevents economic growth*, London: Policy Exchange
27. Kerr's (1975) famous article 'On the folly of rewarding A, while hoping for B' contains many examples.
28. National Audit Office (NAO) (2008) *Planning for homes: Speeding up planning applications for major housing developments in England*, London: NAO
29. Ferrari E et al (2011) *Behavioural change approach to the housing sector Scoping study,* London: DCLG

financial benefit needs to accrue to the level at which planning decisions are made so that they affect the behaviour of councillors and local planning officers. In two-tier areas, this is primarily the district council.

6. Easy to understand and transparent

To be effective, incentives need to be easy to understand. Complexity reduces an incentive's power because people may find it difficult to predict the benefits from a course of action (see Box 3). Decisions are often made on the basis of rough guesses or known benchmarks, rather than a full analysis of the costs and benefits.[30] For this reason, a simple and clear incentive is likely to generate a stronger response.

"A simple and clear incentive is likely to generate a stronger response"

Box 3: The Local Authority Business Growth Incentive (LABGI)

Previous programmes to incentivise local authorities have failed to provide a strong financial incentive for growth. One such example is the Local Authority Business Growth Incentive (LABGI), which ran from 2005 to 2010. The scheme aimed to re-introduce financial incentives for growth into the local government finance system, but is widely considered to have failed.[31]

LABGI payments were related to the growth in business rates during the preceding calendar year. However, the Government was concerned that payments would be concentrated in only the fastest-growing local authorities and introduced a complex system of baselines for local authorities to beat. Grant amounts were determined by an authority's performance in relation to its previous growth performance and that of other 'similar' authorities.

LABGI was too complex to effectively motivate local authorities who were not able to predict the size of the reward they would receive. As a result of the complex allocation formula, Knowsley received the highest grant (as a percentage of total Rateable Values) solely because a new ASDA opened, whereas Tower Hamlets and the City of London received nothing despite the fact that they service one of the most dynamic segments of the UK economy.[32] The size of the incentive was also relatively small. In 2005-06, the average payment was just £400,000, with the largest payment being £3.8 million to Westminster which had a gross expenditure on services of over £900 million in 2005/06.[33]

The case of LABGI illustrates some of the challenges of designing a financial incentive for growth. Firstly, the desire to make the incentive work for all areas undermined its strength. Any incentive that attempts to achieve multiple conflicting objectives will probably fail. Secondly, the more complicated the allocation formula, the weaker the incentive effect. Finally, incentives need to be large enough to have the necessary impact.

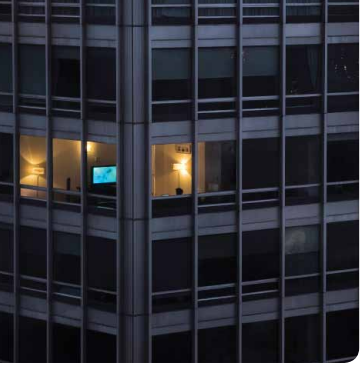
30. Thaler R & Sunstein C (2008) *Nudge: Improving Decisions About Health, Wealth, and Happiness,* New Haven: Yale University Press
31. Hewdon Consulting (2006) *LABGI: Does it do what it says on the can?,* London: Hewdon Consulting; Jones, 'Reforming the LABGI Incentives Scheme', LGA Presentation
32. Hewdon Consulting (2006) *LABGI: Does it do what it says on the can?,* London: Hewdon Consulting
33. DCLG Website archive, LAGBI Scheme 2005/6; Westminster City Council (2006) *Annual accounts 2005-2006,* London: Westminster

7. Predictable and long-term

Finally, good incentives need to be long-term – the best incentives are permanent. Payments which are uncertain have a lower value than those which people can be certain to receive. If there is a risk that an incentive might be taken away in the future the likelihood of responding to that incentive weakens. There is also evidence to suggest that changes to the planning system are likely to take a while to feed through and alter behaviour. For example, many major developments are still not covered by Section 106 agreements, despite them being in existence for more than 20 years.[34] This suggests that the reforms put forward need to have a sense of permanence about them and cannot be seen to be a bolt-on incentive.

"Good incentives need to be long term - the best incentives are permanent"

34. Crook ADH et al (2010) *The Incidence, Value and Delivery of Planning Obligations in England in 2007/08;* London: Communities and Local Government



4. The Local Government Resource Review: Making local authorities more pro-growth

The Local Government Resource Review (LGRR) will make fundamental changes to the way that local government is financed. One of the Government's key objectives with the reforms is to create *"the optimum model for incentivising local authorities to promote growth by retaining business rates"*.[35] Creating financial incentives for growth will enable economic factors to be given greater weight within the planning system by providing local authorities with a direct financial benefit for accepting development.

How local authorities choose to use these benefits will differ by area. Some local authorities may simply choose to keep council tax rates low. However, in some cities the financial incentives will also provide authorities, possibly working together via a Local Enterprise Partnership, with a real revenue stream to pay for the infrastructure required to deliver future economic growth, such as new transport investments.

"Creating financial incentives for growth will enable economic factors to be given greater weight within the planning system"

In the next two sections of the report, we review the choices the Government faces in the LGRR. In this section we outline a set of broad considerations associated with using business rates as a financial incentive for growth. In the section that follows we set out a series of options for reform in greater detail.

The current business rates system

Business rates (or nationally-set non-domestic rates (NNDR)) are a locally collected, national form of taxation. In 2010-11, business rates generated £23.8 billion, accounting for four percent of UK tax revenues.[36] The current system of business rates was introduced in 1990. The tax is collected by lower tier authorities (district or unitary) and sent to the national level. The tax is then redistributed on a needs basis to local authorities and police and fire districts and is topped up with the Revenue Support Grant to form the local authority Formula Grant. The rate of taxation (or the uniform business rate (UBR) multiplier) is also set nationally. Currently, the multiplier is 43.3p, or 42.6p for small businesses,[37] meaning that businesses are liable to pay a tax of around 40 percent on their property costs. There are also numerous exemptions from business rates, including charities, temporarily empty properties and agricultural land.

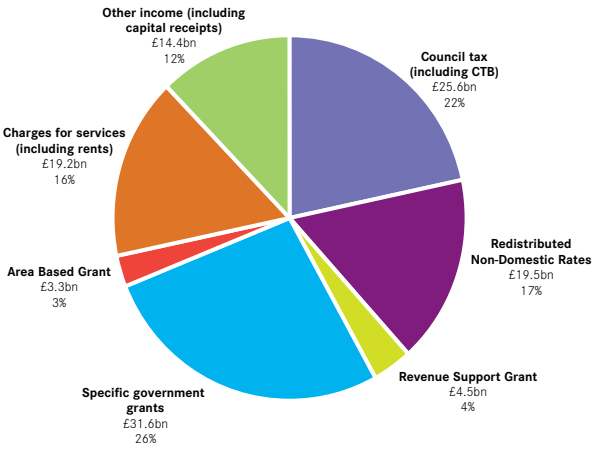
Alongside council tax, redistributed business rates account for a major proportion of local government revenues. Across the country, there is a great deal of variation in the revenues raised from business rates. In 2010-11, 27 percent of business rates revenues were raised in London. Excluding education, business rates and council tax accounted for 38 percent of total local authority revenues in 2009-10 (Figure 5a).

Given the significant cuts in central government grants faced by local government, the proportion of services paid for by council tax and business rates will rise in the future. By 2014-15, business rates revenues collected in England will exceed the amount that central government plans to distribute to local authorities via the formula grant by £3 billion (Figure 5b).

35. DCLG (2011) *Local Government Resource Review: Terms of Reference*
36. HMT (2011) *Budget 2011,* Norwich: The Stationery Office
37. Valuation Office Agency website

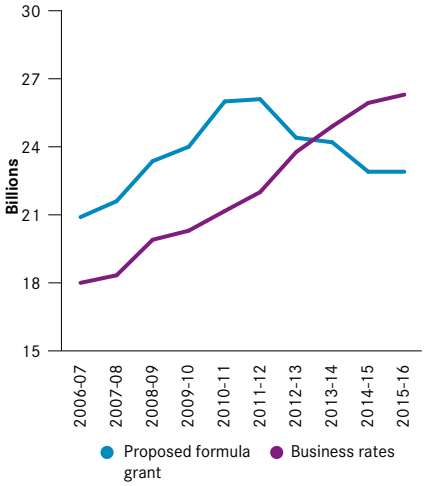
Towards the end of the current Parliament, there could be a case for looking at the level of taxation raised from business rates to ensure the tax is not inhibiting business growth.

Figure 5a: Breakdown of local government revenue sources excluding education (2009-10)



Source: DCLG

Figure 5b: Business rates will exceed formula grant (2006-16)



Source: HMT, DCLG

"In the first year, no local authority should see its budget fall by more than the forecasted decline"

Considerations for reform

Given the complexity of the LGRR and in order to guide our thinking, it is important to set out a number of key considerations for reform. These are:

- **In the first year, no local authority should see its budget fall by more than the forecasted decline:** There is a large variation in the amount of business rates that local authorities collect. In some areas, like Westminster, the business rates collected are worth substantially more than their budget. In others, the business rates tax base only covers a small percentage of their current spending needs. A full return of the business rates tax base to councils would result in an unacceptable pattern of winners and losers.

  In order to avoid creating a system that is inherently unfair to those local authorities which cannot fund themselves through business rates, there will need to be a transfer between 'surplus' authorities and 'deficit' authorities.[38] This would be a 'baseline grant'.

- **'Need' will still have to be addressed and may change:** Addressing 'social need' such as deprivation will still be of major importance for the local government finance system. The new system will have to direct resources from resource-rich local authorities, or other forms of national expenditure, to those local authorities currently considered to be in need. However, this should be addressed outside of the mechanism to create an incentive for growth.

38. Local authorities where their combined collected business rates and council tax receipts exceed their budget in the final year of the current system (2012-13), will be able to retain a proportion of their locally collected business rates up to their current budget requirement. Revenues beyond this will need to continue to be collected by the government and distributed to those authorities where the collected business rates combined with the council tax take fails to meet an authority's budget requirement.

- **It will not be politically acceptable for there to be a *"winner takes all"* approach:** It is socially undesirable and politically unlikely that all local authorities will be able to keep the full growth in their business rates. This would mean that some local authorities would retain large amounts of money and new sources of funding would need to be found for lagging authorities. A system will need to be implemented to redistribute funds from very strong performers, and the design of this "tax on growth" matters critically for the strength of the incentive created. We return to this matter in more detail in the next section.
- **The incentive needs to be thought of as a share of a future stream of payments:** In the case of business rates the size and strength of the incentive, at the margin, is best thought of as how much of the future stream of tax payments related to an extra new development that a local authority gets to keep for the last development it grants planning permission. As such, it does not make sense to only consider the tax revenues a local authority would get in the short term. Instead it is the share of future revenues captured that needs to be considered.
- **The focus is on the potential for business rates retention, rather than relocalisation** – where local authorities set the rate of taxation locally. This is because, while local government will be able to retain locally raised business rates, concerns from business groups such as the Confederation of British Industry (CBI) and British Chambers of Commerce (BCC) make it unlikely that central government will allow local government to alter the UBR, which will continue to be nationally set.[39]

"A system will need to be implemented to redistribute funds from very strong performers, and the design of this 'tax on growth' matters critically for the strength of the incentive created"

Which cities would benefit most from retaining the growth in business rates?

One way to analyse the effect of allowing local authorities to retain the growth in business rates is to understand how it would have changed the financial position of different cities in the past. For the purposes of this paper, we define cities as Primary Urban Areas (PUAs), unless stated otherwise. This enables us to analyse the impact of the reforms at a city-wide level, although some cities maybe over- or under-bounded.[40] Using data on non-domestic rates collectable by each local authority between 1999-2000 and 2009-10, we can estimate the financial implications of a system that would incentivise growth.[41]

Almost all cities over the past decade have increased their business rates tax base in real terms, suggesting that a financial incentive for growth could work positively for almost all cities. Only Bradford, which saw a two percent decline, would have experienced a fall in its budget as a result of retaining the growth in business rates. This picture is also similar if we consider all local authorities, with only six percent of local authorities seeing a real decline in business rates over the period 1999 to 2010.[42]

39. As part of the Localism Bill, local authorities will be able to offer business rates discounts to companies, if they are able to fund the shortfall in their budget from their own sources.
40. It should be noted that most reforms would actually be made at the local authority level and we are not advocating a PUA level solution.
41. Important to note here is that these projections show what would have happened financially if local authorities operated on a growth model for retaining NNDR revenues; it does not model how local authorities' behaviours would have changed, which may alter the patterns. Some of the growth is accounted for by the transfer of Crown properties to the local lists.
42. "Net collectable debit" has been used as the business rates tax base definition, assuming that incentive would cause collection rates to increase. High collection rates (England: 97.8%) means there is little difference if receipts are used. The tax base has been deflated by the GDP price deflator and is in 2009-10 prices. Using the Retail Price Index measure would increase the number of cities that had seen negative growth.

Over the past decade the cities that saw their collected business rates grow the most in percentage terms were Milton Keynes (57 percent), Cambridge (46 percent) and Preston (45 percent) (Table 7). Unsurprisingly, London also saw a big increase. Growth, however, was not limited to those places one would expect. For example, Newcastle and Liverpool both saw big increases in their business rates tax base over the last decade. In these cities, it seems that the growth in business rates was in part related to the successful regeneration efforts that took place in these cities.

"Over the past decade the cities that saw their collected business rates grow the most in percentage terms were Milton Keynes, Cambridge and Preston"

Table 1: Cities which have seen the biggest growth in their collectable business rates tax bases (1999-2010)

Rank	City	Real growth* in business rates (1999-2010) (£000s) (2009-10 prices)	%	Rank	City	Real growth* in business rates (1999-2010) (£000s) (2009-10 prices)	%
1	Milton Keynes	53,000	57%	46	Stoke	10,300	10%
2	Cambridge	25,600	46%	47	Warrington	9,200	10%
3	Preston	34,400	45%	48	Birkenhead	4,800	8%
4	Oxford	24,700	45%	49	Grimsby	4,200	7%
5	London	1,670,000	40%	50	Ipswich	2,500	5%
6	Liverpool	70,800	40%	51	Middlesbrough	5,900	4%
7	Newcastle	82,600	40%	52	Southend	1,800	3%
8	Southampton	39,800	38%	53	Hastings	400	2%
9	Derby	23,400	38%	54	Blackpool	1,200	1%
10	Mansfield	16,000	37%	55	Bradford	-2,800	-2%

* Deflated using the GDP price deflator (2009-10 prices)
Source: DCLG

The growth in business rates in cities is due to both additional development and an increase in the rateable value of existing premises. The latter of these can be influenced by local authorities - if they improve the business environment - but many of the factors that affect the rateable value are outside of a local authority's control.

Given that this was a very buoyant period for the UK economy, it is reasonable to expect business rates growth over the next decade to be less pronounced. For example, one of the themes of the cities that saw high levels of growth is that many of them had new shopping centre developments. With future consumption widely expected to be subdued, there will probably be less retail-led growth during the next decade. Due to the recession, the next revaluation is also likely to reduce commercial property values. If this is the case a larger number of cities might experience real declines.

How big an incentive would relocalising the business rates create?

It also important to consider how big an incentive retaining business rates would create. Scale is important, the size of the response and the national benefit it creates may outweigh negative aspects of the reforms, such as less redistribution.

One way of thinking about this problem is *"how did behaviour change as a result of the nationalisation of business rates in 1990?"*. Specifically, what impact did the nationalisation of business rates have on the growth rate of commercial floorspace - as this would seem to be a reasonable proxy for how much development was being permitted by local authorities and whether their attitude towards development changed.

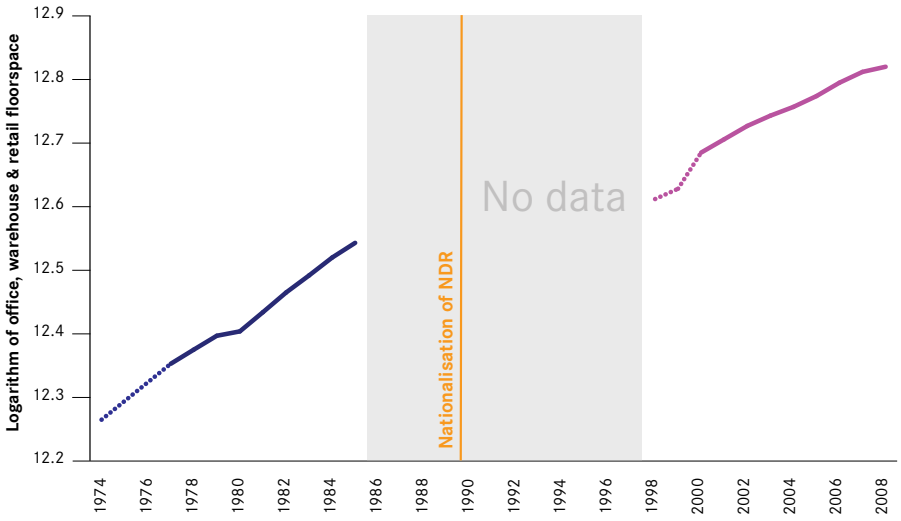
We can then estimate what effect reversing this policy change[43] might have on future levels of commercial development and by implication on supporting economic activity.

The government data that is available over this period allows us to look at the growth in commercial floorspace between 1974 and 1985 and between 1998 and 2008, across the English regions and Wales (Figure 6). Unfortunately, there is a big gap in the series during the period in which business rates were nationalised. Accordingly, any estimates have to be interpreted very cautiously.

Our modeling has also excluded factory/industrial floorspace as this declined between 1974 and 2008 – declining at a faster rate in the later period, accentuating the overall trend. We consider this decline a result caused by a structural shift in the economy rather than government policy.

"The rate of development was slower between 2000 and 2008 than between 1977 and 1985"

Figure 6: Growth in non-factory floorspace (1974-2008)



Source: DCLG

Comparing a consistent sub-set of these two periods[44] we notice a reduction in the rate of growth of floorspace at the national level from 2.4 percent to 1.7 percent, despite stronger economic growth and a higher level of business formation during the recent period. The rate of development was slower between 2000 and 2008 than between 1977 and 1985 (Table 2).

Table 2: Summary statistics for growth in non-factory floorspace

	Growth rate of non-factory floorspace	Floorspace added per year	Average GDP growth	Average annual Increase in business stock*
1977-1985	2.4%	6,100	1.8%	22,300
2000-2008	1.7%	5,800	2.2%	31,700

* Years of data available. First period: 1980-85, Second period: 2000-07
Source: DCLG; ONS; NOMIS

43. Although arguably the Government is not considering at this time going as far as reversing the policy decision of the early 1990s, we think that the major incentive element of business rate reform would be captured by the retention of business rates rather than setting the tax rate. As such, the nationalisation in the 1990s can act as a useful proxy.
44. There is no data for 1976, so 1974 is excluded from the first period. Methodological changes in 2000, added a significant amount of additional floorspace (including crown properties, e.g. central and local government offices). Therefore, the years 1998 and 1999 are excluded from the second period.

Significant uplift in the growth rate of floorspace and office space

As the floorspace data is available at the regional level, we can also undertake more sophisticated regression analysis, controlling for a number of variables, to attempt to estimate how big an effect the nationalisation of business rates had. However, while we are able to account for the strength of the economy, the level of unemployment and the number of employees in each region, other factors clearly influence the difference in the pace of development between these two periods.[45] As such, to attribute all of the variation the analysis identifies to one policy change, is likely to be a considerable overstatement. Nevertheless, the analysis does shed some light as to how large an incentive might be created by allowing for local retention of business rates revenues.

"Relocalising or retaining business rates would create a strong pro-development incentive"

The main finding from the regression analysis is that relocalising or retaining business rates would create a strong pro-development incentive. Comparing the two time periods, our business rates variable suggests that a policy change would increase the growth rate of non-factory floorspace by one percentage point. This finding requires us to attribute the change in the growth rate of floorspace between the two periods, not accounted for by the other explanatory variables, to the change in the business rates policy.

Given that the standardised annual growth rate of floorspace during the most recent period was 1.8 percent, a one percentage point increase is the equivalent of a 50 percent increase in the growth rate. These figures differ from the summary statistics presented above as additional factors have been controlled for.

If this estimate is correct, it would imply that over a 10 year period, following a future policy change and providing there is sufficient demand from developers and the private sector, we would see a 10 percent increase in the total amount of floorspace in England, or the equivalent of an additional 50 million square metres of floorspace (Figure 7a). While we expect this to be an overestimate of the probable benefit, it does suggest the possibility of creating a strong incentive for growth.

Figure 7a: Impact of policy change on rate of floorspace growth

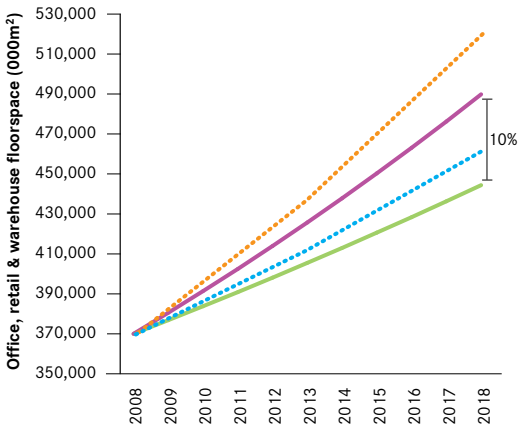
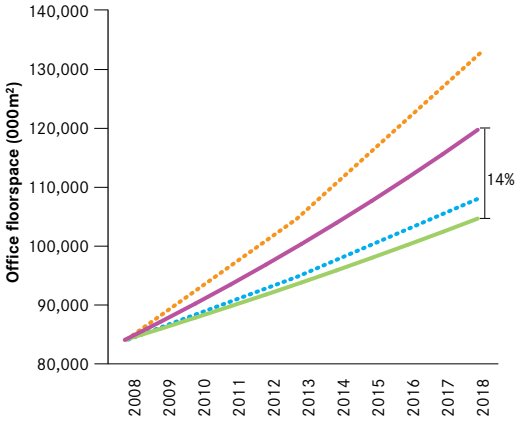


Figure 7b: Impact of policy change on rate of office space growth



Baseline
Business rate
Upper confidence interval
Lower confidence interval

Source: Centre for Cities modelling

45. For example, there has almost certainly been a shift towards more floorspace-intense ways of working. This has occurred both as a result of sectoral shifts (although the decline in manufacturing is accounted for), productivity increases within sectors and rise in home working

Our analysis also suggests that the impact on office space could be even more significant. Here the data suggests that the policy change could result in an increase in the annual growth rate of office space of 1.4 percentage points, although our estimates are less precise. After 10 years, this higher growth rate would mean that in total in Great Britain there would be 14 percent more office space (Figure 7b). This is the equivalent of an additional 20 million square metres of office space[46] or perhaps more comprehensibly 140 Canada One buildings – the flagship Canary Wharf skyscraper. If there was not sufficient private sector demand for this amount of commercial space to be built we would instead expect the cost of office space to fall as supply would be acting as less of a restriction.

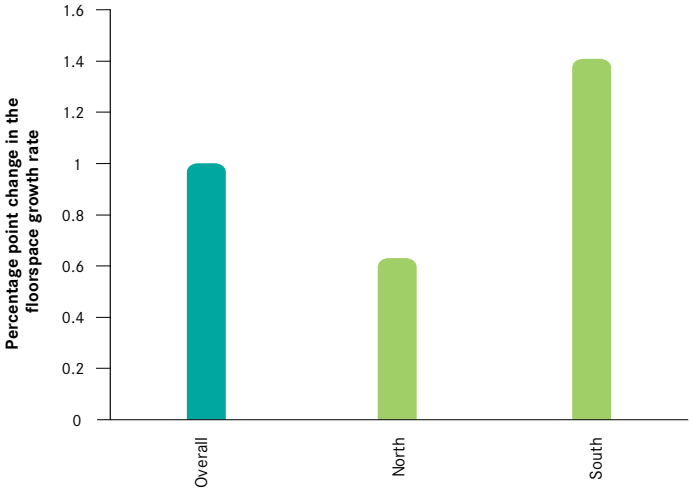
"If a proportion of this growth could be achieved, it would represent a major economic benefit to the national economy"

Again this is likely to be an overestimate of pure effect of the nationalisation of the business rate. **But if a proportion of this growth could be achieved, it would represent a major benefit to the national economy by providing more affordable office space to businesses across the country.**

Incentivising development in the areas of greatest demand

Finally, our analysis looks at how the impact of business rates retention might affect development rates in different areas of the country. This is important because the planning system - while only being one of the factors that influences the performance of a city's economy - is more likely to act as a constraint on economic growth in certain parts of the county, particularly London and the South East of England.[47] Due to a range of political motives and spatial realities, planning restrictions are more likely to be a barrier to growth in cities like Cambridge and Reading than in cities like Blackburn and Hull.

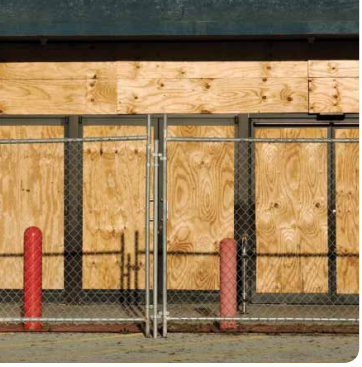
Figure 8: Policy change has a greater impact in areas where planning is a barrier to growth



Source: Centre for Cities modelling

Because of data availability, we are only able to compare the effect of the policy change on the North (including Wales) relative to the South. However, interestingly our analysis suggests that a business rates policy change may have a larger positive impact on the rate of development in cities in the South compared with cities

46. This would not be in addition to the 50 million square metres of floorspace already identified, but instead a subset.
47. Hilber C & Vermeulen W (2010) *The impact of restricting housing supply on house prices and affordability,* London: CLG



in the North. The modelling finds that the growth rate in non-factory floorspace might increase by 0.6 percentage points in northern regions, compared with 1.4 percentage points in southern regions as a result of the policy change (Figure 8).

The findings point to the potential to create a strong incentive for growth, although due to the limitations of the available data, significant caution is required in their interpretation. Yet the result that the nationalisation of business rates reduced development in the UK commercial property market is not without precedent. Previous rigorous academic work has looked at the impact on office space costs of nationalising the business rate, finding a significant effect.

"The result that the nationalisation of business rates reduced development in the UK commercial property market is not without precedent"

A study by Cheshire and Hilber (2008) found that by removing the incentive for local authorities to support development, nationalising the business rate unintentionally reduced the office supply increasing what the author's call a 'regulatory tax' on development.[48] The increase in business occupation costs associated with the nationalisation of the business rate is larger than the approximate business rates revenues for that property (~£48,000) in all of the major office markets (Table 3). For example, in Reading the annual occupation cost for a medium sized office firm[49] is estimated to have increased by over £71,000 as a result of the nationalisation of the business rate.

Table 3: Increase in annual occupation costs associated with the nationalisation of the business rates, for a medium sized firm in UK office markets

Office Market	Increase in annual occupation costs (2005 £)
Croydon	94,000
London West End	90,000
Newcastle	85,000
Manchester	73,000
Reading	71,000
Bristol	68,000
Leeds	63,000
Birmingham	62,000
Glasgow	57,000
Edinburgh	55,000
Average (all markets)	**72,000**

Source: Cheshire and Hilber (2008)

The reforms will create winners and losers

Changes to the system of local government finance will have distributional consequences. Incentives are by their very nature designed to reward those places that alter their behaviour in the desired way. The reverse is also true: those cities that do not alter their behaviour will be relatively worse off.

Although the incentive will function even in those places which have lower rates of growth (as they will be rewarded for any growth they do see) this may be less than the increase in revenue they would have received under the current system.

48. Cheshire P & Hilber C (2008) *Office Space Supply Restrictions in Britain: The Political Economy of Market Revenge* London: LSE
49. Medium sized firm is defined as firm of 200 people, using 1,500 m2 of office space

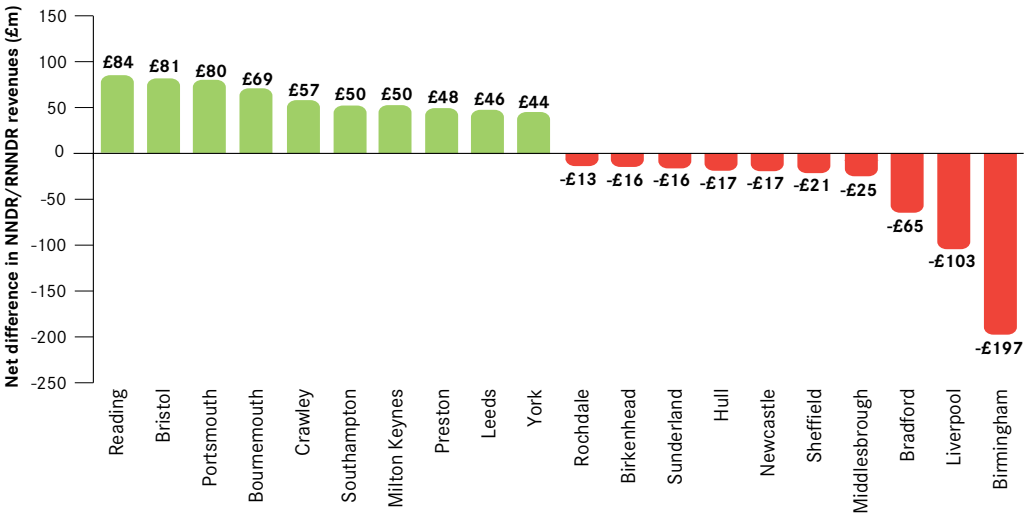
Similarly, cities that see a decline in their business rates base would, under most circumstances, be expected to experience a decline in their budget. As business rates form an substantial part of local authorities' funding, this will have spending implications. It also is important to remember that the growth in business rates is influenced by many economic factors that are not within a local authority's control.

Analysing the potential distributional impacts of an incentive-based system is difficult.[50] One method is to compare the growth in business rates collected by local authorities against how much they received from the central government over the last decade in the form of redistributed rates. Those areas that have benefited from the redistributive system would have a negative balance, while those that would benefit from an incentive system would have a positive balance.

"The LGRR reforms will shift the system of local government finance from an almost solely equity-driven needs-based system to a system where potential for economic growth is given a greater weighting"

Our analysis shows that if England's 56 cities, defined by PUAs, were allowed to retain growth in business rates, 66 percent would actually be 'better off', in terms of the total growth in their retained receipts in absolute terms between 1999 and 2010 compared with the growth in the received redistributed rates over the same period. Cities that would do particularly well under an incentive system relative to the current redistributive system include London (not shown), which would see its total take increase by £735 million, Reading (£84 million) and Bristol (£81 million) (Figure 9).

Figure 9: Relative winners and losers in the move from a redistributive to an incentive based system (1999-2010)



Source: DCLG

In contrast to the analysis which purely looked at business rates growth, this analysis indicates that there are cities that would do less well financially, relative to the current redistributive system - for example, Birmingham (-£197 million), Liverpool (-£103 million) and Bradford (-£65 million). This is because, although the majority of cities have seen their business rates base grow, under the current redistributive system the increase in the amount that they got back from central government was greater. The case of Liverpool is interesting and informative. As shown in Table 1, it saw a 40 percent (or £70 million) increase in its business rates base from 1999-2010.

50. A range of changes have occurred in the funding of local government over the past ten years and it if difficult to untangle all of these trends. For example, the removal of the Dedicated Schools Grant from the Formula Grant generated a significant shift in the way that resources were allocated.

However, compared with the growth in redistributed business rates revenues it received back from the central government over this period, it would still be a net relative loser under an incentive-based system.

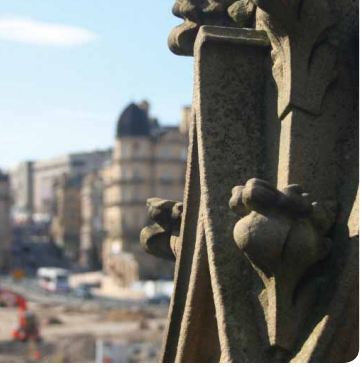
Essentially, the LGRR reforms will shift the system of local government finance from an almost solely equity-driven needs-based system to a system where potential for economic growth is given a greater weighting. In this shift, there is an inevitable trade-off between equity and efficiency. This being said, few would advocate a complete switch from the first approach to the later, and that is certainly not what is being recommended in this paper. Whichever system is introduced, it is likely that the central government will maintain considerable control over the distribution of resources and it will be able to make a decision on the basis as to the criteria that it choses to do this by (see Box 5, page 29).

"The reforms will create winners and losers. Government needs to be bold, creating a strong incentive, and explain why the changes will bring about national economic benefit"

The policy choice that the Government faces is ensuring that the incentive works while recognising that a strong incentive will result in losers as well as winners, relative to the current arrangements. Government also needs to be wary of the fact that measures that reduce the number of losers or size of losses, will also dampen the strength of the incentive. This is not a technical choice, but a political one, based on an assessment of the upsides and downsides of the different outcomes.

Policy implications

- **Business rates retention should generate a sizeable incentive for growth, providing the incentive is not dampened.** This incentive means that local authorities would directly benefit from development as well as providing a revenue stream that allows cities to fund the infrastructure that this growth may require. Given the potential benefit that could be created it is critical that Government gets the design of the incentive right and does not weaken the reforms by introducing excess complexity or uncertainty.
- **The reforms will create winners and losers. Government needs to be bold, creating a strong incentive, and explain why the changes will bring about national economic benefit.** While our analysis has identified that the reforms have the potential to boost the rate of development - which should create a national economic benefit - there will clearly be winners and losers.
- All cities will be incentivised to support economic growth, and most cities should continue to see an increase in their business rates revenues, but some cities stand to do less well than they did under the previous more redistributive system - although substantial redistributive elements will remain. Being bold with the reforms is the only way that the Government will be able to avoid creating a small incentive that is unlikely to impact on behaviour or increase the supply of land and commercial premises.



5. The Local Government Resource Review: options for reform

Having set out the principles for the LGRR to accomplish and key considerations for reform, we now turn to specific options the Government faces. While a number of reports have started to outline in significant detail the various systems of local government finance that the LGRR might implement,[51] our objectives are narrower. Rather than try to propose a complete package of reforms we concentrate on the mechanism that we think the Government needs to introduce to create the strongest possible incentive for growth within a practical set of technical, social and political limitations.

"Excluding the big winners would be the most radical solution as it would create a strong incentive for growth in almost all cities"

We then consider how the revenues generated by the incentive might be used. How practical an incentive is to decision makers will impact on its strength. We look at the role of pooling and how business rates revenues might be used to fund new infrastructure investments.

Implementing a strong business rates growth incentive

If the Government is unlikely to allow all local authorities to capture all the future growth in local business rates, then the design of the mechanism it introduces to limit this will be vital to the incentive's effectiveness. We consider five options for reform to decide which would provide the strongest financial incentive for growth. These are: **(1)** excluding the big winners, **(2)** a fixed rebasing system, **(3)** a rolling rebasing system **(4)** a fixed percentage of growth or **(5)** introducing a cap or sliding scale of deductions. Our preferred incentive is the fourth of these, the fixed percentage of growth.

All of these options would be altered by decisions made about the frequency and arrangements for ratings revaluations. Although we do not believe that any of the options are invalidated by the different revaluation systems. To create a more effective incentive, **our preferred solution would be more regular revaluations of commercial property and a fixed tax rate that does not increase with RPI.** We leave this topic for a later research note.

1. Excluding the big winners

The first option would be to allow almost all local authorities to retain 100 percent of their business rates growth, but to remove a few local authorities from the system. These "big winners" have very large business rates tax bases relative to their current total expenditure and are considered to have overly buoyant rates growth. In these authorities even a small percentage increase in their local business rates, could lead to substantial growth in the authorities' total available budget.

Excluding the big winners would be the most radical solution as it would create a strong incentive for growth in almost all cities. The local authorities that would be excluded from the system are likely to be Westminster, City of London, Tower Hamlets and Camden (Figure 10). These four local authorities would continue to see their business rates collected and distributed in the same method as under the current system.

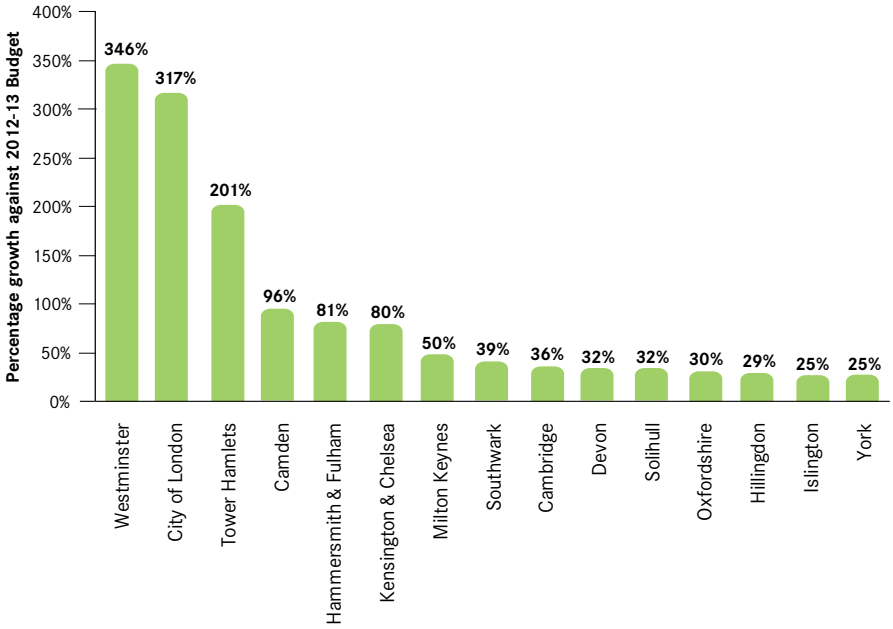
51. Shakespeare T & Simpson T (2011) *The Rate Escape: freeing local government to drive economic growth,* London: Localis

- **Advantages:** A very strong incentive is created in most cities as they capture 100 percent of the future business rates growth. The mechanism is also politically palatable, as it redistributes wealth from areas which receive significant benefit due to their location and historical factors over which the local authority has little influence.
- **Disadvantages:** The downside of this option is that it would effectively create no incentive to encourage development in some of the most important office locations in the centre of London. However, given the past reasonably pro-development attitudes of these councils, the reality is that this may not prove to be a sizeable problem.

"To offset the negative incentive created for these councils we would recommend extending the precept powers that the City of London enjoys to the other big winner local authorities"

To offset the negative incentive created for these councils we would recommend extending the precept powers that the City of London enjoys to the other big winner local authorities that are excluded from the new system. The City of London is currently able to levy a discretionary increment on top of its business rates that it retains locally to pay for services. In 2011-12 this was set at 0.4p. This has proved to be a reasonably strong incentive in favour of development in the City of London and thus could offset the negative impact of not including these authorities in the wider incentive mechanism.[52]

Figure 10: A few local authorities could see their total budgets grow by a very significant level



Source: DCLG

2. Fixed Rebasing mechanism

While the option of *"excluding the big winners"* is attractive, it seems likely that Government will want to place constraints on the growth in business rates retained locally beyond a few exceptional authorities. If this is the case, a more extensive mechanism will be required. This would alter the size of the incentive faced by all local authorities.

52. Cheshire P & Hilber C (2008) *Office Space Supply Restrictions in Britain: The Political Economy of Market Revenge* London: LSE

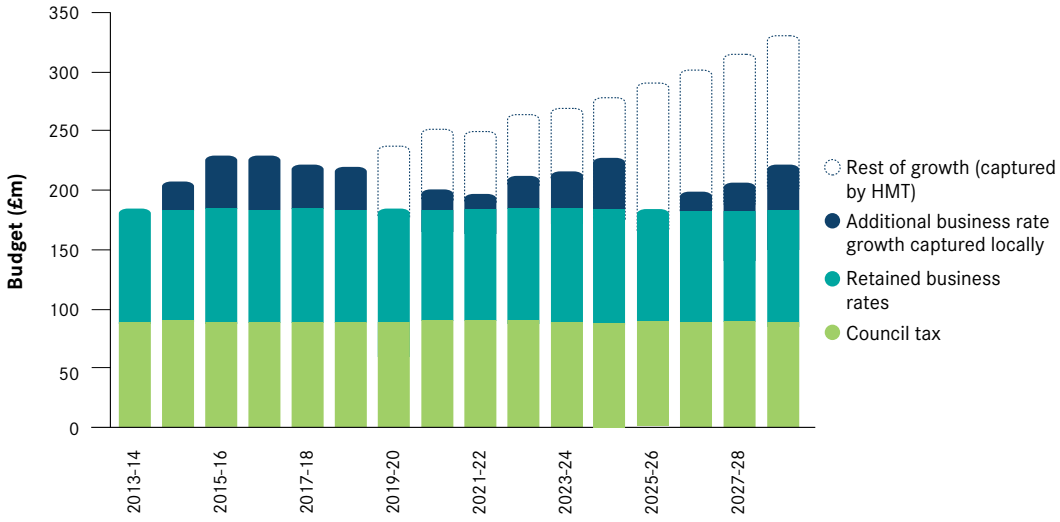
The first of these options is the fixed rebasing option whereby each local authority is able to keep all of the growth in business rates over a baseline for a fixed period of time, for example, five years. At this point all local authorities are "rebased" and brought back to their starting level, or a new baseline based on a set of government criteria.

Figure 11 shows how the mechanism would impact on the budget of Milton Keynes. Council tax and retained business rates are held constant at the 2012-13 level (in real terms). Under the "no local authority losers" principle the city, a surplus authority, would be able retain 62 percent of its locally collected business rates. The increment then shows the growth in local business rates Milton Keynes would retain. The growth in business rates captured by the Treasury is also indicated.

"Rebasing local authorities to a given budget baseline, would allow central government to keep all local authorities' resources in line with its estimation of their spending needs"

- **Advantages:** Rebasing local authorities to a given budget baseline, would allow central government to keep all local authorities' resources in line with its estimation of their spending needs. This system is predictable since it designates a specific period for rebasing, which would make it easy to administer.
- **Disadvantages:** The major drawback of this system is that, in the later years, perverse incentives against development are created. In year five, only a small proportion of the potential stream of business rates revenue would be captured. This would create an incentive to defer the approval of developments until the beginning of a new rebasing period. This is a highly undesirable feature.

Figure 11: Milton Keynes: five year rebasing mechanism (indicative)



Source: DCLG

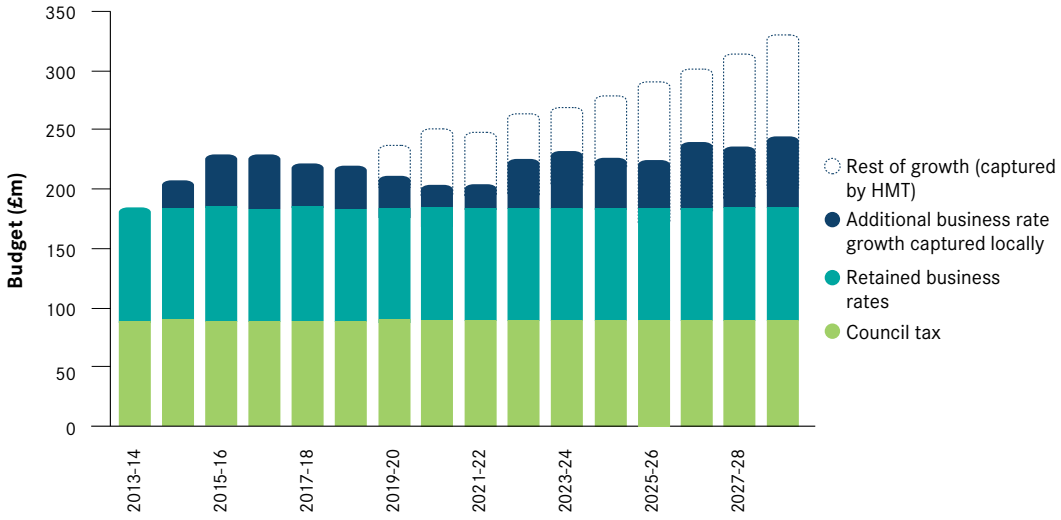
3. Rolling Rebasing system

In the first instance rolling rebasing would work similarly to the five-year rebasing system. However, in year six, rather than being rebased back to the baseline, the authority would lose the growth increment gained in year one but gain the increment associated with year six (Figure 12).

- **Advantages:** The fact local authorities always get to keep five years of growth makes the incentive large and strong at the margin, an attractive feature. The design gets around the perverse incentives created in later years under a fixed rebasing model. Central government would still be able to exercise control over authorities' resources.

- **Disadvantages:** It could be complex and lose out on the transparency and easy-to-understand principles of a good incentive. Central government may also be drawn into discussions with local authorities every year regarding their budgets and this could create unnecessary bureaucracy.

Figure 12: Milton Keynes: rolling rebasing mechanism (indicative)



Source: DCLG

"Compared to a system of rolling rebasing, we think allowing local authorities to retain 40 to 60 percent of the growth would provide a similar, or stronger incentive"

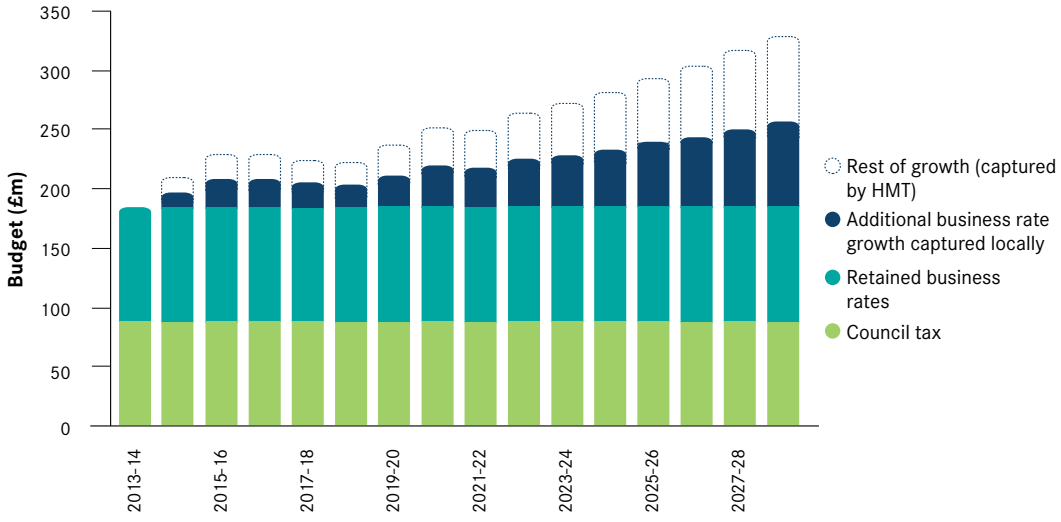
4. Fixed proportion of growth

One way to get around the problems posed by a rebasing mechanism is to allow local authorities to retain a fixed proportion of the growth in their business rates from the baseline onward (Figure 13).

- **Advantages:** The biggest strength of the fixed proportion of growth is the clarity of the incentive, its predictability and long-term nature. Allowing local authorities to retain a fixed proportion of business rates growth indefinitely also recognises that new development has ongoing costs associated with it, in the form of the delivery of additional services to business. The long-term stream of payments generated would also be beneficial for authorities hoping to fund new infrastructure as they would have a reliable source of revenue. The same incentive would also be created by allowing local authorities to retain 50 percent of all locally raised business rates and 100 percent of the future growth.
- **Disadvantages:** To be effective, this mechanism would require the Government to make a firm commitment to not rebase local authority budgets in the future. Central government's ability to oversee and direct the resources that each local authority has would be diminished.

Whether the incentive created by the fixed proportion of growth mechanism is stronger, at the margin, than that provided by rolling rebasing depends on what proportion of the growth in rates local authorities are allowed to keep and the assumptions used about the value that councillors attach to future income streams. Compared to a system of rolling rebasing, where local authorities get to keep all of the growth for a five year period, we think allowing local authorities to retain 40 to 60 percent of the growth would provide a similar, or stronger incentive (see Box 4).

Figure 13: Milton Keynes: Fixed proportion (50 percent) of growth retained mechanism (indicative)



Source: DCLG

"Capping the amount of growth that local authorities can capture or reducing the proportion of growth retained would create undesirable incentives for growth in high demand areas"

Box 4: What proportion of growth is needed for a strong incentive?

The best way to evaluate the fixed proportion of growth incentive against the rolling rebasing incentive is to compare the "present value" of the future stream of payments and consider this as a proportion of present value of the total possible revenue stream. It is common practice to "discount" future revenues to account for the fact that money received in the future is less desirable than money received today.

If we assume that councillors have a seven percent discount rate (double the usual Green Book[53] rate - the standard guide used for evaluating policies) and that they value 10 years' worth of payments, allowing local authorities to keep 60 percent of the growth in rates permanently would be a stronger incentive than allowing them to keep 100 percent of the growth for five years. If more generous assumptions are used a lower fixed proportion is required to provide the same incentive.

5. A growth cap or sliding scale of deductions

A final option would be to introduce a range of caps or an increasing scale of deductions. For example, it could be decided that local authorities only get to keep the first £5 million of business rates growth or that after a certain amount of growth the proportion that an authority would get to keep would fall, perhaps from 60 to 20 percent.

- **Advantages:** Central government would be able to retain greater control over the individual budgets of local authorities. A system with a sliding scale of deductions would be analogous to the progressive taxation of personal income, where a higher level of income tax is paid by high earners.
- **Disadvantages:** Capping the amount of growth that local authorities can capture or reducing the proportion of growth retained would create undesirable incentives for growth in high demand areas. It would reduce the incentive to permit the marginal commercial development in those areas where rental costs are likely to be highest and new premises most beneficial. Incentives would be stronger in less buoyant city economies, where planning restrictions are less of a barrier to growth.

53. HMT (2003) *Green Book: Appraisal and Evaluation in Central Government,* London: HMT

Box 5: What should be done with the growth captured by central government?

All models and solutions that do not allow local authorities to retain 100 percent of the locally generated business rates growth will result in a growing pot of business rates revenues hypothecated to central government. How Government decides to distribute these funds will impact on the strength of the incentive created. If the funds are used to top up local authorities' budgets that have fallen below a notional budget requirement, the strength of the incentive for growth will of course be reduced.

To create a stronger incentive, it would be better for the distribution of this money not to be linked to the budget position of local authorities. Instead it could be used to automatically increase the amount of money received by all 'deficit' local authorities in receipt of a baseline grant, or could be linked to a measure of deprivation, such as the IMD. The money could also be used to fund an enlarged New Homes Bonus (NHB) (see Section 6).

"Allowing local authorities to retain a fixed proportion of growth indefinitely would provide a strong incentive for growth"

Policy recommendations

- **Allowing local authorities to retain a fixed proportion of growth indefinitely would provide a strong incentive for growth.** This provides the best incentive for ensuring that more commercial development is permitted in expanding places, supporting economic growth. It is the simplest and clearest solution, and provides a compelling and direct incentive to decision makers. We believe that allowing councils to retain 40 to 60 percent of business rates growth would create the strongest financial incentive for growth possible. However, it does require the Government's firm commitment not to rebase at some point in the future.
- **If Government cannot commit to not rebasing, a system of rolling rebasing would be best.** Fixed periods should be avoided, and rebasing should happen on a longer term basis if it must occur. However, this mechanism is inevitably more complicated. This lack of transparency may reduce the ability of the mechanism to provide a clear and predictable incentive.
- **Do not introduce a growth cap or sliding scale of deductions.** A total cap on growth or increasing scale of deductions would reduce the share of future payments a local authority is allowed to keep. This is likely to reduce the effectiveness of the incentive in the very cities where additional development would generate the biggest economic return and planning restrictions are most acute.
- **Consider how the distribution of other resources will impact on the business rates incentive.** Under most options for reform, substantial business rates revenues will still be captured by central government. These should be distributed on a needs basis, or used to pay for an enlarged NHB. However, Government should avoid linking the distribution of these funds to the budget position of local authorities as this would weaken the incentive.

Using business rate reforms to fund cross boundary infrastructure investments

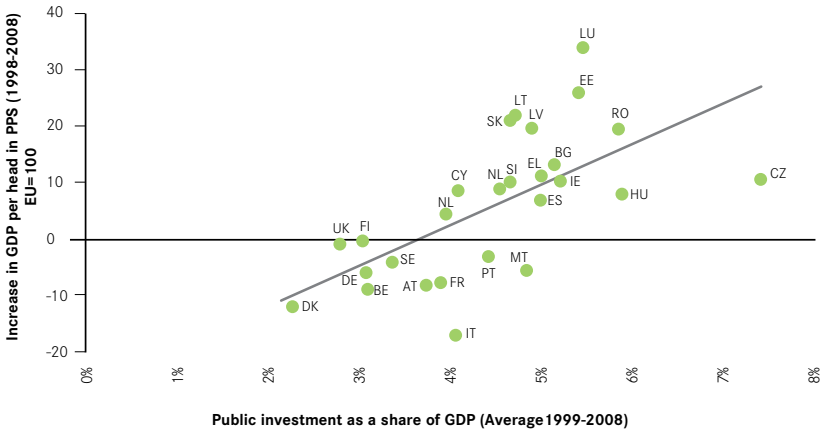
As well as the goal of incentivising behavioural change at the margin to encourage more development, a secondary goal for business rate reforms is to provide a revenue stream to fund public infrastructure. Incentives need to be useful to decision makers if they are to be effective. Investment in the infrastructure that supports economic growth is an important part of enabling urban expansion and securing future prosperity (see Box 6).

"In order to support medium-scale city infrastructure investments it would make sense to allow local authorities to pool business rates revenues at the LEP or city-regional level"

Box 6: Financial incentives can further increase growth by enabling new investment

The UK economy has been characterised by relatively low levels of public investment, with spending in this area further squeezed by the spending cuts.[54] Public spending on infrastructure, education, and health is generally thought to have a positive effect on economic growth, although the relationship is complex.[55] The figure below shows the strong association between levels of public investment and GDP growth in the European Union (Figure 14).

Figure 14: Public investment can boost economic growth (1999-2008)



Source: http://ec.europa.eu/regional_policy/sources/docgener/work/2010_03_patterns.pdf

Increasing the level of public investment could contribute to long term economic growth. However, despite the need for additional investment, the current environment of fiscal austerity will constrain the ability of central government to finance new capital expenditure. At the local level, cities are keen to invest but lack a sufficient revenue base. This underscores the importance of implementing new methods for funding public investment that enables economic growth.

In order to support medium-scale city infrastructure investments that support economic growth, it would make sense to allow local authorities to pool business rates revenues at the Local Enterprise Partnership (LEP) or city-regional level.[56]

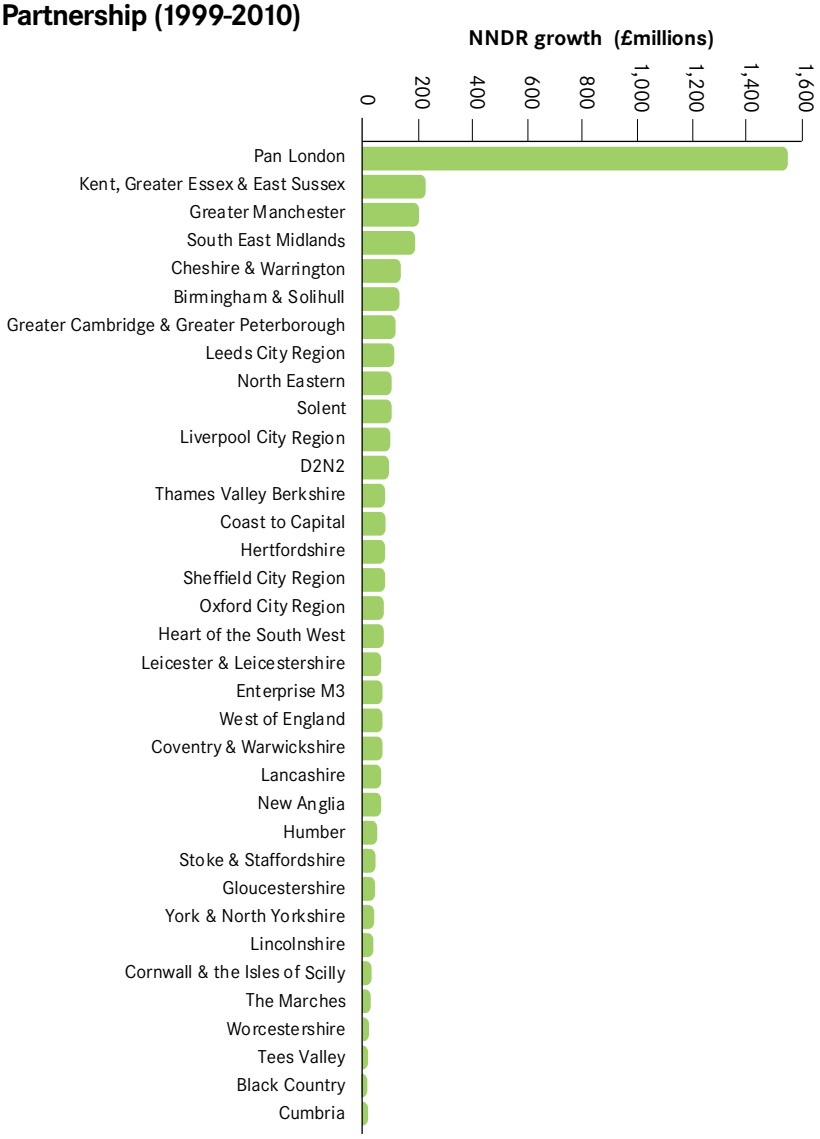
54. OECD (2011) *OECD Economic Surveys:* United Kingdom, London: OECD; Helm D et al (2009) *Delivering a 21st Century Infrastructure for Britain,* London: Policy Exchange; Clark T et al (2001) *Twenty-Five Years of Falling Investment? Trends in capital spending on public services,* London: IFS
55. World Bank (2007) *Fiscal Policy for Growth and Development: Further Analysis and Lessons from Country Case Studies,* Washington: World Bank
56. The important proposition is that the growth in business rates can be pooled at the same level, and across the same spatial area, as the benefits from investment accrue. While many LEPs fit well with their functional economic area, others are less well aligned. Similarly, the capacity of these predominantly new organisations to deliver these types of proposals differs.

This would enable larger revenue streams to be generated, risk to be shared between local authorities and sufficient collateral to be put forward to underwrite the uncertainty associated with development proposals. One way that business rates growth could then be used would be, alongside other revenue streams, to fund Tax Increment Financing (TIF) proposals. Although in reality, funding for TIF type proposals will often be linked to the growth of business rates from a specific scheme.

Pooling could unlock the scale required to fund infrastructure improvements. Due to LEPs' size, the future growth of local business rates revenues will be greater at this level. For example, between 1999 and 2010, annual business rates revenues increased by £230 million in the Kent, Greater Essex and East Sussex LEP, £200 million in the Greater Manchester LEP, £180 million in the South East Midland LEP. Across the Pan London LEP, revenues increased by £1.6 billion (Figure 15).

"Due to LEPs' size, the future growth of local business rates revenues will be greater at this level"

Figure 15: Real growth in annual business rates revenues by Local Enterprise Partnership (1999-2010)



Source: DCLG

The figure also demonstrates that borrowing against future business rates revenues to fund infrastructure projects may be more viable in certain LEPs than others – the four LEPs with the largest growth generated more revenues than all the other LEPs combined. Finally, while these figures are impressive, it needs to be remembered

that the majority of the revenues will be required to fund existing services rather than new infrastructure commitments.

The Government could decide to implement a complete LEP based solution to the LGRR, such as the model that has been advocated by London Councils, redistributing business rates resources within an LEP area.[57] While this view has merits, ultimately it is not the most attractive option for creating a strong incentive. We recommend a voluntary, rather than formal, LEP-level business rates system. As identified in Section 3, to be effective financial incentives need to be targeted at decision makers or critical decision shapers. As LEPs do not currently have plan-making or decision making powers it would weaken the incentive if the LEP was to see the majority of the benefit from the incentive in the form of a revenue stream.

"We recommend a voluntary, rather than formal, LEP-level business rates system"

Instead, local authorities that take planning decisions should see the majority of the benefit of financial incentives for growth, but should be able to pool available funding, if that is what their situation requires. In two tier areas it should be at the district level – the level that takes planning decisions - that the incentive for growth is strongest. Beyond this the reforms need to introduce a mechanism that groups of local authorities could use to commit a proportion of future business rates growth towards - or growth from a specific scheme and other revenue streams, such as the NHB. This shared revenue stream could then be used to borrow against in order to fund new infrastructure projects.[58]

Strategic infrastructure investment could be further incentivised by allowing authorities that choose to pool their revenues for infrastructure expenditure to receive match funding from the Government. This could be in the form of an increment of the proportion of business rates growth that we have identified, which would be allocated back to central government. However if, as seems likely, borrowing were to add to the national debt, it would need to be overseen and ultimately rationed by the Treasury.

Policy recommendations

- **The pooling of business rates revenues at the LEP or city region level should be on a voluntary rather than a formal basis.** The majority of the benefit associated with the new financial incentives for growth needs to be targeted at the level of planning decision makers. In two-tier areas, this means that district councils must see a large amount of the increase in revenue associated with accepting new development. In cities where economic growth will require significant new infrastructure, a mechanism will be needed to allow local authorities to pool funds to create a large, long term revenue stream to fund infrastructure investments.
- **Government should match pooled growth in business rates to incentivise infrastructure investments that support economic growth.** Government could encourage local authorities to pool the proceeds of business rates growth at the LEP or city-regional level to pay for infrastructure investment, by offering to match hypothecated funds with a share of the growth that would otherwise be retained by central government.

57. London Councils (2011) *Resourcing London: a model for retained business rates,* London: London Councils
58. Having entered into this type of mechanism, a local authority would not be able to exit during a given period, and authorities' assets would be subject to claims from any shortfall in revenues needed to meet infrastructure payments.

6. Building more homes: the New Homes Bonus

Since coming to power, the Government has announced a series of reforms related to boosting the housing supply in England. Alongside an extensive reform of the planning system and abolition of Regional Spatial Strategies, a key element of these changes is the New Homes Bonus (NHB), a fiscal incentive given to local authorities to encourage development. The use of incentives as a mechanism for engendering a more supportive attitude towards growth is certainly to be welcomed.

However, despite this positive step, there are concerns that the current NHB is insufficient to increase the housing supply significantly and encourage supply to respond to demand spatially. This is particularly important in buoyant cities, and their surrounding areas, where employment opportunities are growing most rapidly. In such cities, new housing creates opportunities for individuals to move to these locations and access employment. This section argues that, in order to be an effective incentive, the NHB needs to be reformed. In particular, to have a sufficient impact we think the NHB payments need to be larger in size.

"The use of incentives as a mechanism for engendering a more supportive attitude towards growth is certainly to be welcomed"

Why do we need more housing?

As outlined in Section 2, the planning system has restricted land supply in the UK and this has had the effect of increasing house prices. Greater demand due to rising incomes has resulted in falling housing affordability as the average house price to salary ratio has risen. Experts suggest that 270,000 net additions per year would be required to stabilise current affordability levels, although these estimates are uncertain due to the unknown long term impact of the financial crisis on the housing market. The previous Government adopted a target of 240,000 net additions per annum.[59]

It is also important that additional housing is built where there is the greatest demand from people to live. Not only does this meet people's preferences, but it also allows for the agglomeration economies associated with densely populated productive locations to be captured. Over the past decade government policy has led to a large number of houses being built in areas of the country where there did not seem to be huge demand.[60]

What is the New Homes Bonus?

The NHB is designed to correct the disincentive for new housing development that exists within the current system of local government finance. Currently, growth in the resident population increases the burden on local public services. Yet this development provides few direct financial benefits to the existing residents. While Section 106 agreements are used to cover some of these requirements, they are costly to agree and are only arranged on 51 percent of major residential developments.[61]

59. Nickell S (2011) "Too Many People in Britain? Immigration and the Housing Problem", speech delivered at LSE, 21 June 2011; NHPAU (2007) *Developing a target range for the supply of new homes across England,* Fareham: NHPAU
60. Webber C et al (2010) *Grand Designs? A new approach to the built environment in England's cities,* London: Centre for Cities
61. Crook A et al (2010) *The incidence, value and delivery of planning obligations in England in 2007-08,* London: DCLG

Although new residents generate additional council tax revenue, any growth in local council tax receipts is usually mitigated by the adjustment of central government grants. This is because the population numbers used to determine these grants are retrospective. Milton Keynes has calculated that the addition of 1,000 new houses leaves it underfunded by £3 million over a two to three year period.[62] Although in the case of Milton Keynes, it remains positive about new housing development, this loss of funding is one of the reasons that local people and their elected councillors might object to new development, with the funding mechanism acting as a disincentive for growth.

The NHB corrects for this by providing a six year incentive equal to the average national council tax band property equivalent. For a band D property, this was £1,439 in 2010-11, which over a six year period amounts to £8,634. Net additions and empty homes brought back into use are eligible for the payment, and affordable houses will receive an additional yearly enhancement of £350. In two tier areas, the incentive will be split 80:20 between the district and county levels respectively.

"The NHB will clearly have a differential impact on cities across the country - those cities that build houses will do well, whereas cities that have a low number of net additions will do relatively poorly"

The Government will primarily fund the NHB via a top slice from the existing Formula Grant, redistributing money from areas that do not build houses to areas that do. However, in the first four years of the NHB's operation the Government has committed £200-250 million per annum to smooth the transition.

Which cities will do well out of the New Homes Bonus?

The NHB will clearly have a differential impact on cities across the country. Those cities that build houses will do well, whereas cities that have a low number of net additions will do relatively poorly. On a per capita basis, the cities that will receive the biggest payment based on the first year of the scheme's operation are Milton Keynes, followed by Gloucester and Cambridge. In these cities, over a six year period, the net additions in 2009-10 will result in a £50 payment for each resident of the local authority area (Table 4).

Table 4: Which cities will see the biggest reward from the first NHB payment?

Ten cities with highest NHB payment per capita in 2011-12

Rank	City	NHB per capita (£)
1	Milton Keynes	63.7
2	Gloucester	50.0
3	Cambridge	48.7
4	Swindon	43.8
5	Peterborough	39.0
6	Bradford	32.7
7	Northampton	31.3
8	London	30.9
9	Crawley	27.5
10	Bristol	27.3

Ten cities with lowest NHB payment per capita in 2011-12

Rank	City	NHB per capita (£)
47	Preston	10.9
48	Hull	10.2
49	Liverpool	10
50	Rochdale	9.8
51	Portsmouth	9.1
52	Newcastle	8.7
53	Doncaster	8.3
54	Burnley	7.3
55	Birkenhead	5.1
56	Blackburn	4.7

Source: DCLG

62. Email exchange with Milton Keynes Council

In contrast, in the cities building few houses, such as Burnley and Blackburn, the per capita payment will be less than £10 per person. In the cities receiving small payments, the reduction in the Formula Grant from year five onwards may be larger than the NHB payment they receive. This is how the incentive would be expected to work, reallocating resources from those areas that do not build house to those that do.

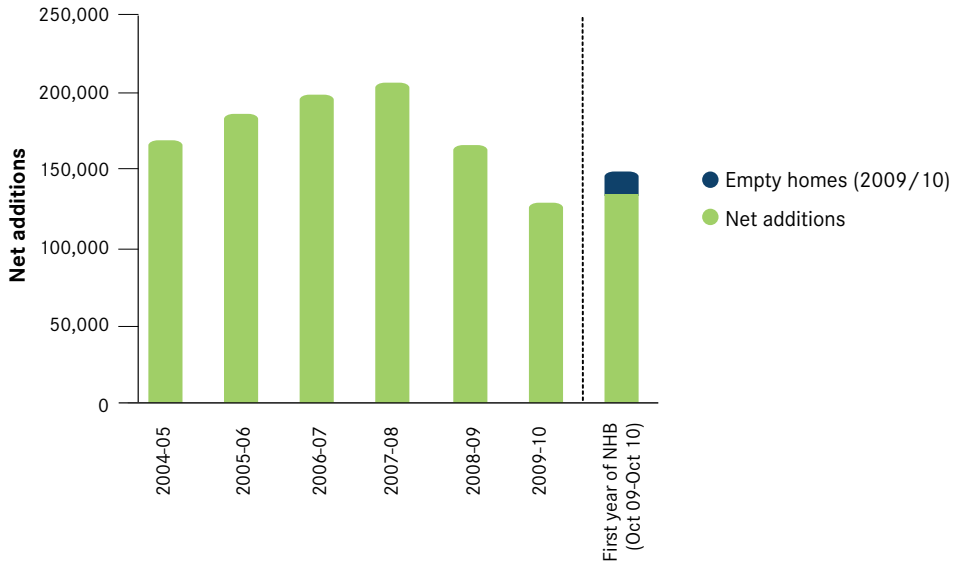
Early signs of a positive impact are not promising

The introduction of the NHB appears to have had a minimal impact on the number of net additions in year one of the programme (October 2009-10). The total increase in the effective housing stock announced by the Government in April 2011 was 150,000 homes, but this comprised of both net additions and empty homes brought back into use.[63] When the empty homes are excluded, actual net additions are closer to 133,700. As Figure 16 shows, net additions have in fact fallen against 2008-09 levels.

"The introduction of the NHB appears to have had a minimal impact on the number of net additions in year one of the programme"

The reality is that we probably would not expect a significant response at this early stage. Much of the period covered by the first payment covers a time before the Coalition came to power (October 2009 – May 2010) and the policy was only announced in full in September 2010 and launched in February 2011.[64] The housing market is also still suffering from the effects of the recession, house builders are finding it difficult to borrow, and it can be difficult for changes to be made to housing delivery, given the time required to make planning decisions and the current system of five-year local development plans.

Figure 16: First year response of local authorities to the New Homes Bonus



Source: DCLG

A slightly more positive picture is portrayed by the house building statistics. These measure the gross additions to stock rather than net additions, but are available on a more contemporary basis. Between 2009-10 and 2010-11, housing starts grew by 22 percent, although completions continued to fall (7 percent).

63. DCLG (2011) 'Grant Shapps calls on communities to decide how to spend the rewards of growth', *DCLG press release,* 4 April 2011
64. DCLG (2010) *New Homes Bonus Consultation,* London: DCLG

A more worrying indicator that the incentive is failing to have the desired effect is that, over the past 12 months, a substantial number of local authorities have actually reduced their housing supply targets against Regional Spatial Strategy (RSS) levels, rather than increase them (see Box 7).

Box 7: House building in Bristol

Bristol is one of the fastest growing cities in the UK, having added nearly 63,000 people over the last decade.[65] It is also one of the biggest winners of the first round allocations of the NHB at £19 million (paid out over six years).[66] Bristol's current policy is focused on intensification of the urban area, rather than expansion into surrounding green space. This means that, even with the introduction of the NHB, planned housing supply in Bristol has actually dropped by 10,000 since the abolition of the Regional Spatial Strategy. The Council is currently in the process of producing and updating an integrated investment plan to take account of the new policy environment.

"Over the past 12 months, a substantial number of local authorities have actually reduced their housing supply targets against Regional Spatial Strategy RSS levels"

One study found that 12 percent of local authorities have lowered their housing targets, reducing the target by an average of 20.6 percent with the largest reductions being in the South East and South West (Table 5). The impact on annual housing delivery is estimated to be 31,000 fewer homes per annum being built.[67] Research by the National Housing Federation concluded that the total number of planned homes has fallen by 200,000 since the abolition of the RSS.[68]

Table 5: Change in housing targets by region since the abolition of Regional Spatial Strategies

Region	Average reduction in housing targets	Local authorities yet to decide on allocation	Estimate total housing loss p.a.	Average house price (2010)
South West	-26.5%	34%	5,822	£214,985
Greater South East	-18.2%	50%	16,712	£279,968
North West	-17.9%	20%	1,616	£152,555
East & West Midlands	-6.0%	26%	3,838	£165,799
North East and Yorkshire & Humber	-1.9%	45%	3,419	£147,448
England	**-20.6%**	**37%**	**31,407**	**£216,036**

Source: BNP Paribas Real Estate; DCLG

Overall this analysis raises two issues. Firstly, at this early stage, the NHB does not appear to be having a tremendously influential impact on supply. Evidence from individual authorities suggests many cities are planning to build fewer homes than had been set out under the Regional Spatial Strategies and while there has been an increase in housing starts, overall housebuilding is still at a very low level.

65. Centre for Cities (2011) *Cities Outlook 2011,* London: Centre for Cities
66. Based on Bristol PUA: Bristol UA: £14 million; South Gloucester UA: £5 million
67. BNP Paribas Real Estate and Tristan Fitzgerald Associates (2011) *Housing the Nation: the impact of localism on housing supply,* London: BNP Paribus
68. Tetlow King Planning (2011) 'Updated Research on the Impact of the Intended Revocation of Regional Strategies on Proposed Local Housing Targets in England', *Supplementary Evidence to the House of Commons Communities and Local Government Committee Inquiry on the Abolition of Regional Spatial Strategies,* submitted by National Housing Federation, January 2011

Secondly, it seems likely - particularly in its first year of operation - that the NHB is being paid out irrespective of its role as an incentive to actually encourage additional housing development. In light of these findings, the Government might want to review whether it can claw back NHB payments made to areas that had already given planning permission for new residential developments. And in the future, areas which refuse planning permission, which is subsequently accepted on appeal, should not receive the NHB allocation.

What will happen in the future?

Having looked at the limited impact during the first year of the NHB, we now turn to how it might affect future behaviour. To do so, we've created a model of how local authorities might respond to the NHB in light of recent budget cuts. A full explanation of the model is provided in the appendix. It is based on a similar approach to that used by the Government to model the NHB in its impact assessment.[69] We assume that in reaction to budget cuts, local authorities seek to increase the housing supply in order to maintain spending per capita at 2010-11 levels. It should be recognised that trying to model the impact of an incentive like the NHB is inherently difficult and subject to considerable uncertainty.

"We estimate that the NHB will increase the housing supply by 6 to 16 percent. This would not be sufficient to increase house building to the level needed"

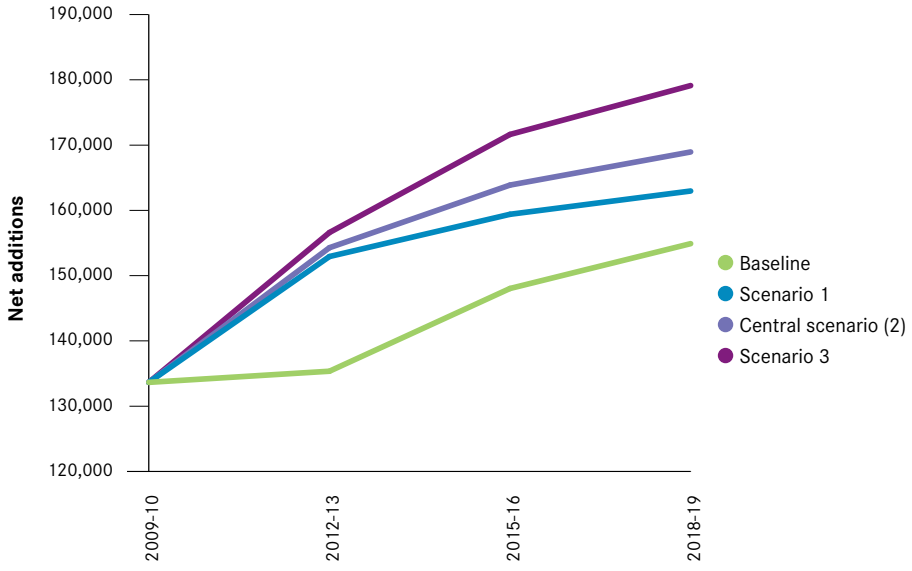
We estimate that the NHB will increase the housing supply by 6 to 16 percent (Figure 17). This would not be sufficient to increase house building to the level needed, or to deliver enough homes in the places with the highest level of demand.

The central scenario – the estimate we think is most likely - sees a 10 percent increase in the housing supply relative to the baseline, or around 15,000 extra homes per year. The baseline reflects an estimate, based on historical housing market recoveries, of what might happen to the housing supply in the absence of a policy intervention. The supply response is stronger during the spending cut years, when local authorities are expected to try and compensate for budget cuts by increasing the number of net additions. By 2019-20, net additions are projected to reach 170,000, slightly below the average for 2004-10 (176,000).

We recognise that different local authorities will adopt different strategies. Therefore, we also model two other scenarios where a greater proportion of local authorities adopt a more positive or more negative approach to the NHB. Under scenario 1, where local authorities may reduce housing supply in their area, the NHB results in only a six percent increase over the baseline. Under scenario 3, where a greater proportion of the local authorities "go for growth" we see a stronger supply response with a 16 percent increase in net additions. **Overall, our projected outcomes are similar to the Government estimates, which forecast an 8 to 13 percent increase in the housing supply.**[70]

69. DCLG (2010) *New Homes Bonus Consultation,* London: DCLG
70. DCLG (2010) *New Homes Bonus Consultation,* London: DCLG

Figure 17: New Homes Bonus generates a small but positive supply response



Source: Centre for Cities' modelling

"It is important to consider where new homes will be built. Our modelling suggests that the strongest supply response will be in London"

Regional and spatial impacts

As well as the question, *"Will the NHB sufficiently increase the housing supply?"* – which we have argued that it will not – it is also important to consider where new homes will be built. Our modelling suggests that the strongest supply response will be in London (a 21 percent increase over the baseline). This can be attributed to the relatively steep spending cuts experienced by London Boroughs and that, with a high affordability ratio across the capital, most authorities are not constrained by a lack of demand. The second strongest supply response is in the West Midlands (10 percent) (Figure 18a).

By contrast a far weaker response is seen in the East of England (5 percent), Yorkshire and Humber (6 percent), East Midlands (6 percent) and the South East (6 percent). Given that, except for London, it is in the South East and East that the greatest requirement to increase the supply exists based on price signals, this is a disappointing prediction.

Figure 18a: Regional impact of New Homes Bonus

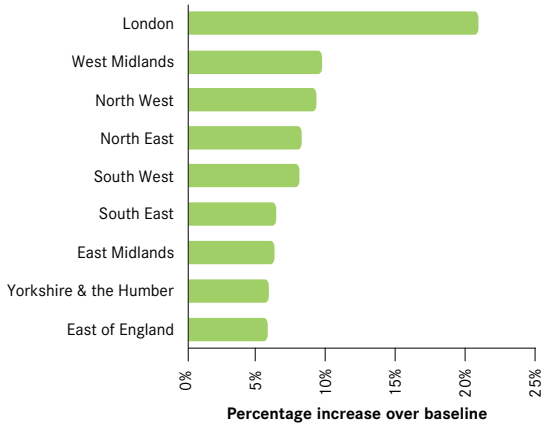
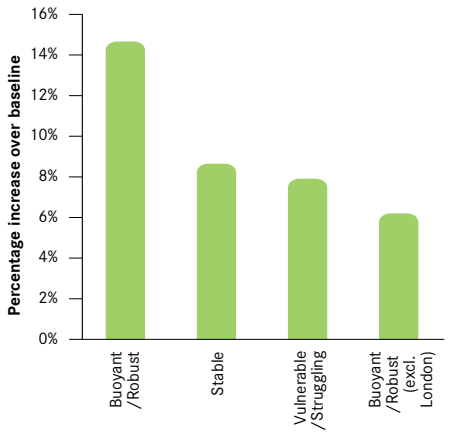


Figure 18b: Supply response to New Homes Bonus by city type



Source: Centre for Cities' modelling

These regional results are also reflected in our analysis of how the NHB might have an impact on the housing supply by city type (Figure 18b). While a strong supply response is predicted in the cities we have identified as having buoyant and robust economies (15 percent) this is almost entirely accounted for by the supply increase in London. Once London's effect is removed the supply response in buoyant and robust cities falls to six percent. In stable cities the supply response is nine percent, while in struggling cities the response is eight percent.

Overall the indications are that, if our modelling assumptions are correct, not only will the NHB fail to raise the housing supply adequately across the country as a whole, it also will not ensure that new housing is delivered in the cities where there is most demand.

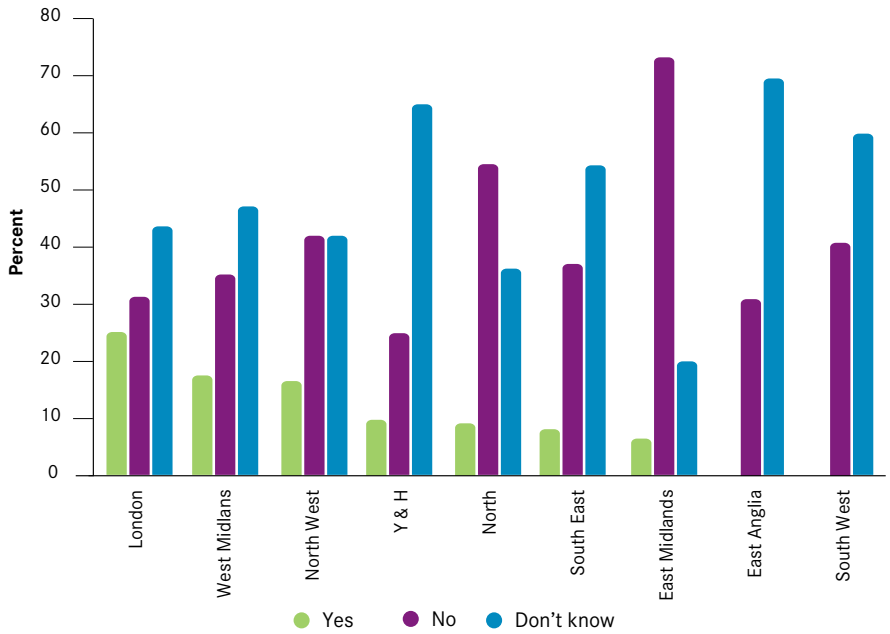
"Our survey found that almost 50 percent of respondents thought that the NHB would not have an impact on levels of house building"

Stakeholders are unconvinced of the New Homes Bonus' impact

The final piece of evidence which suggests that the NHB is unlikely to have a sufficient impact on the housing supply is the negativity of local authorities, developers and other regeneration stakeholders when asked about its potential effectiveness. Across three separate surveys, almost half the respondents thought that the NHB would have no impact.

First, our own survey on the impact of the new package of financial incentives for growth found that almost 50 percent of respondents thought that the NHB would not have an impact on levels of house building.[71] This result was replicated in a survey by CBRE, where almost half the surveyed councillors and 40 percent of industry insiders responded by saying that the NHB is not sufficiently generous to increase the level of house building.[72] Finally a survey by RICS found that 40 percent of its members believe that the NHB will have no effect at all on new development.[73]

Figure 19: Stakeholder views on the effectiveness of the New Homes Bonus by region



Source: RICS

71. Centre for Cities survey, April 2011, 68 respondents.
72. CBRE/Com Res survey, March 2011, Councillors: 400 respondents; Industry: 200 respondents
73. RICS UK Housing Market Survey, January 2011, 217 respondents

The survey by RICS also broke down respondents by region (Figure 19). Interestingly, we see a very similar pattern to that estimated by our NHB model. Respondents from London (25 percent) and the West Midlands (18 percent) were the most likely to think that the NHB would change behaviour, whereas respondents from East Anglia (0 percent) and the South West (0 percent) were the least likely.

What are the challenges of the New Homes Bonus?

The NHB has a number of positive attributes – it is a financial incentive for growth, simple to understand and reasonably predictable. However, against our principles for an effective incentive (Section 3), it also contains a number of flaws:

- The NHB will alter behaviour, but it is **not big enough** to encourage local decision makers to accept sufficient development to address housing affordability issues and support national economic growth.
- Although the NHB will reward cities for building homes, it does not seem to be **targeted at those places where house prices are highest** or at the groups of individuals most resistant to new housing.
- While the NHB is predictable, it is **yet to be considered a permanent feature** of the local government finance landscape.
- The operation of the NHB may result in a number of **unintended consequences**, such as the treatment of empty homes.

"It is unlikely that the NHB will encourage those cities where prices indicate there is the greatest shortage of housing to increase their plans for development"

We believe that these elements can be fixed to make the incentive a more powerful feature of housing policy. We now address these issues in turn, setting out our recommendations for reform.

1. The New Homes Bonus is too small to affect behaviour

The main problem with the NHB is that it is generally agreed to be too small to alter behaviour on the scale that is needed. Previous estimates of the number of net additions required to stabilise current levels of housing affordability range from 240,000 to 270,000 net additions per annum. The weight of the evidence presented above from the initial response to the incentive, the modelled response of local authorities to the incentive over a 10 year period and the views of the relevant stakeholders in a variety of surveys all suggest the NHB will not have a large impact on supply.

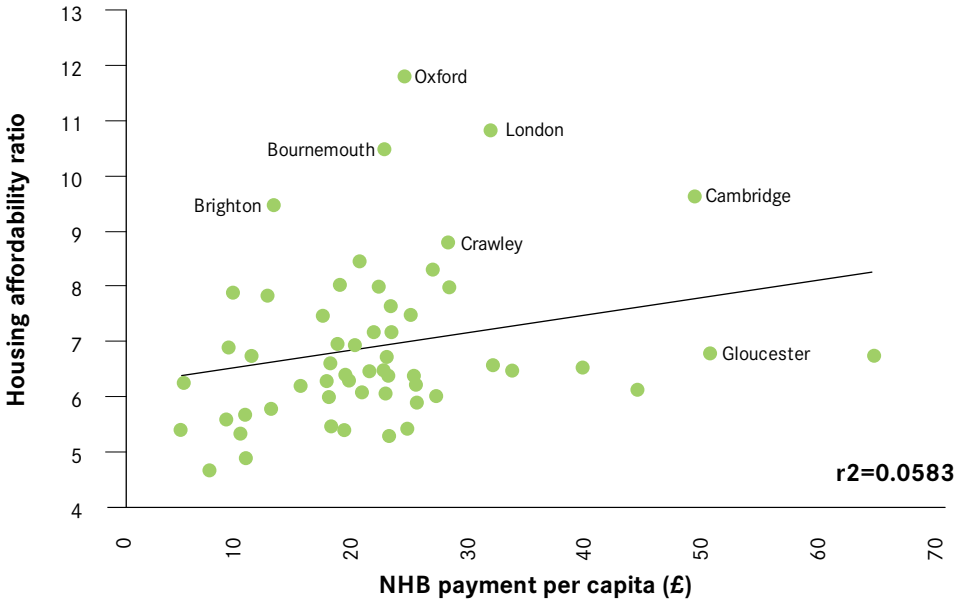
2. Not targeted at delivering houses where there is greatest demand

It is unlikely that the NHB will encourage those cities where prices indicate there is the greatest shortage of housing to increase their plans for development. For example, the link between the cities which receive large NHB payments based on the first stream of payments made in 2011-12 and cities in which property is unaffordable is fairly weak (Figure 20).

This finding is not altogether surprising. It's already been shown that net additions in the UK have generally not occurred where housing is in greatest demand.[74] It is possible that the introduction of the NHB will strengthen the link between low affordability and the number of net additions, with more homes being built in less affordable cities. However, as the NHB is not a targeted incentive (except on the basis of Council Tax bands) it is not completely clear that this alignment will take place.

74. Aldred T (2010) *Arrested Development: Are we building houses in the right places?,* London: Centre for Cities

Figure 20: Weak relationship between housing affordability ratio and New Homes Bonus payment per capita



Source: DCLG

"Focusing the NHB on the groups of individuals most resistant to housing development could be a simple way of ensuring that the NHB delivers new homes where there is the greatest demand"

While most privately funded additional housing is beneficial for the economy,[75] the greatest need is for extra housing in those cities that housing is least affordable. Mechanisms that seek to target NHB payments at the areas where new housing is most required or at the groups of residents most resistant to new development could strengthen the NHB's effectiveness. For example, this might be done by providing a bigger incentive to those areas that are less affordable.

The desire to target the NHB at those areas most in need of additional housing has to be balanced against increasing the complexity this adds to the incentive, which would reduce its effectiveness. Currently, the simplicity of the current NHB is one of the incentives strongest features.

Rather than trying to target the NHB at the places where housing affordability is worst, it might be simpler to target the benefits of the NHB at the residents, or groups of residents, most affected by new housing development. This is particularly relevant as we know that local residents' objections can be a big factor in influencing local decision makers and by consequence, the outcome of planning decisions.

Once operational and accountable, this targeting could be done via neighbourhood forums, which will be an important element of the plan-making process. Groups of residents, as defined by all those that live within an area set out in a neighbourhood development plan, might be less opposed to new housing if in return they were to get a discount on their council tax or increased funding for local services. Focusing the NHB on the groups of individuals most affected by housing development could be a simple way of ensuring that the NHB delivers new homes where there is the greatest demand.

75. Glaeser E (2011) *Triumph of the City: How Our Greatest Invention Makes Us Richer, Smarter, Greener, Healthier and Happier,* Basingstoke: Macmillan

3. Predictable but not permanent

Another factor that may reduce the impact of the NHB on raising the housing supply is that currently it is not viewed as a permanent feature of the local government finance system. Despite indications by the Government that the NHB is intended to be a long term incentive[76] many cities are hesitant to believe that this is the case. As Section 3 outlined, the perceived permanence of an incentive can have a big impact on its effectiveness, this is because uncertainty as to whether a local authority will receive a payment in future years reduces a payment's value.

Local authorities' fears that the NHB might be scrapped after six years are not without reasonable grounds. In particular, subject to the findings of the LGRR, the money from which the NHB is currently top-sliced will effectively cease to exist. Under current legislation it is also illegal for the NHB to be treated as a material consideration in planning decisions.

"Despite indications by the Government that the NHB is intended to be a long term incentive many cities are hesitant to believe that this is the case"

4. Unintended consequences

In addition to the NHB failing to sufficiently increase the housing supply, a number of unintended consequences of the scheme have also been identified. These are the possibility that commercial property will be prioritised over new housing and that local authorities may be able to overstate the number of empty homes brought back into use.

Balance between commercial and residential incentives

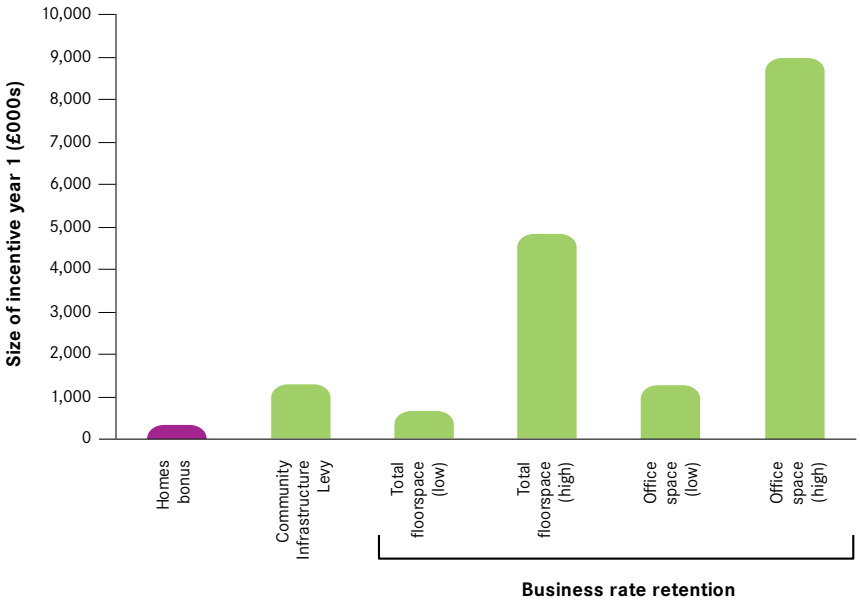
Ideally, equivalent incentives would be faced by local authorities looking to choose between a commercial and residential development, so that ultimately the decision would be based upon what the local demand was for. Currently, the reforms planned as part of the LGRR, which will enable local authorities to retain growth in business rates revenues, look set to create a set of incentives that encourages them to favour new commercial development over new housing.

If a comparison is made between the financial incentives associated with two comparable projects, i.e. that would require the same amount of land – a 250 homes development and commercial development on a 58,000 square metre plot of land – the commercial development seems a lot more financially attractive to a local authority. Based on the current NHB, such a scheme might attract a payment of £350,000 in year 1.[77] Depending on the assumptions used a commercial project on a similar site might attract an annual payment of £700,000 to £9 million.[78] The lower bound is almost double the NHB payment.

Figure 21 shows the expected payout of the NHB compared with two types of commercial development: one with general-use floorspace, and one solely with office space (which would receive a higher business rate payment per square metre). While the NHB payment would also be received in a further six years it would be expected that some additional form of business rate payment would also be received, so we use the incentive in year one for comparability. The Community Infrastructure Levy has also been included for illustrative purposes. CIL would be available on both residential and commercial developments.

76. BIS (2010) *Local Growth: realising every place's potential,* London: The Stationery Office
77. We assume that all homes are Band C properties and 30 percent of properties qualify for the affordable homes top up.
78. The assumptions used have big impact on the size of the incentive created. Our low estimate is based on a space to plot ratio of 0.42:1, while our high estimate uses a ratio of 3:1. The rateable value per square metre of total floorspace is taken as £64, with £119 used for office space (2008 values). The multiplier used is 43p taken for the value in 2011/12.

Figure 21: New Homes Bonus dwarfed by business rates incentive



Source: Centre for Cities estimates

"The imbalance between benefits from the NHB and business rates enhances the case for increasing the size of the NHB such that the incentives faced by local authorities are more equal"

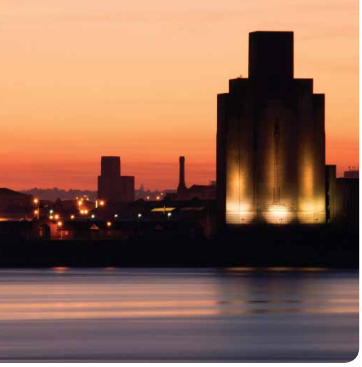
Clearly, in many circumstances it is unrealistic to expect local authorities to face this choice in such a clear cut manner. Some development sites will naturally be more appropriate for housing or commercial use and the expected rateable value and thus the incentive a local authority faces would reflect this. However, at the margin, the imbalance between these two incentives is likely to encourage local authorities to pursue commercial developments over housing. Given that the problems faced by a shortage of housing are arguably more acute, evidenced by the fact that on average land for residential use commands a significant price premium over land for commercial use,[79] this does not seem sensible. While the exact effects are unclear, this may also interact undesirably with the new policy of relaxing the rules for changing use class orders.[80]

In our view, this imbalance between benefits from the NHB and business rates enhances the case for increasing the size of the NHB such that the incentives faced by local authorities are more equal. It also justifies the fixed proportion of growth mechanism recommended in Section 5.

Other potential unintended consequences

Another unintended consequence of the NHB is that it seems likely that local authorities may be able to take advantage of the empty properties incentive, receiving a payment for bringing a long term empty home back into use without increasing the actual effective housing stock. They may be able to do this when updating the local empty homes register by declaring previously unoccupied homes occupied, without deducting newly unoccupied homes, through a process known as "data cleansing".[81] In effect, this is measuring the gross change in empty homes rather than the net change.

79. There are examples where commercial property attracts a greater premium, e.g. in the central business district of major cities.
80. DCLG (2011) *Relaxation of planning rules for change of use from commercial to residential: consultation,* London: DCLG
81. Conversation with Empty Homes, a charity that campaigns to bring empty homes back into use. See: www.emptyhomes.com



As outlined in Section 1, it is important that new measures incentivise the desired behaviour - this requires behaviour to be tracked and assessed accurately. The Government needs to ensure that it minimises the unintended consequences created by the NHB and acts to mitigate the risks of this behaviour as much as possible.

Recommendations

- **Increase the size of the New Homes Bonus payment.**
  The NHB does not appear to be large enough to encourage behaviour change on the scale required and its size should be increased. For example, based on the estimated response to the current NHB, we expect that tripling the size of the payment could trigger a supply response of between 20 to 30 percent. This could be revenue-neutral paid for by a proportion of the funds retained by Government from business rates growth. Efforts should also be made to ensure any population based allocations of government grants keeps up with the actual population of a city, fully removing the disincentive currently faced.

"The NHB does not appear to be large enough to encourage behaviour change on the scale required and its size should be increased"

- **Ensure the NHB is viewed as being a permanent feature of the local government finance landscape and that the incentive has a strong legal basis.**
  This should include allowing local finance considerations to be material in planning decisions. The NHB will only work if planning authorities can actually treat the incentive as part of the planning process, balanced against the other relevant considerations. Therefore, the amendment to the Localism Bill which allows this to occur is necessary for the NHB's success and Government should ensure that the amendment is retained in the final legislation.[82] Placing the NHB on a legal footing and indentifying a long term source of funding for the incentive would also increase its credibility and sense of permanence.

- **Aim to target New Homes Bonus payments at the groups of residents most affected by housing development.**
  Part of the rationale for financial incentives for growth is to compensate all residents that are affected by the real costs created by new housing. These costs, in the form of increased congestion or a negative impact on the value of the existing housing stock, take place at a relatively localised scale. It is arguable that they are generally not felt across the whole local authority but within neighbourhoods. Compared with commercial development, there tends to be greater local resistance and lobbying to oppose new housing development.

  While the details would need to be worked out, efforts should be made to target the NHB payments at smaller groups of residents directly affected by housing development, perhaps via neighbourhood forums. Clearly this would only make sense after local authority costs and liabilities are accounted for and if these neighbourhood forums are sufficiently robust and accountable.

- **Reduce the potential for unintended consequences by ensuring the empty properties payment incentivises the right type of behaviour.**
  To ensure it is an effective incentive, the unintended consequences of the NHB need to be dealt with. For example, it is important that the empty homes

82. House of Commons (2011) *Localism Bill, Notices of Amendments: 10 May 2011*

payment reflects the net change in empty homes rather than a gross change. The current method for collecting the data for empty homes means local authorities might be able to exaggerate the number of homes brought back into use. If this cannot be dealt with in a satisfactory way the Government should remove the empty homes element of the NHB.

Beyond the New Homes Bonus

A sufficiently large incentive may be too big for the public purse

While the NHB is a welcome introduction to the UK policy environment, it must be recognised that even a larger NHB may not be sufficient to change behaviour on the scale that is required. This is because incentives work at the margin to affect the decision of those that are "sitting on the fence" as to whether to accept an extra home or not. Dramatic realignments in response to a changed set of incentives, particularly when they are relatively small in size, should not be expected.

"While the NHB is a welcome introduction to the UK policy environment, it must be recognised that even a larger NHB may not be sufficient to change behaviour on the scale that is required"

It seems probable that the Government will not be able to fund a sufficiently large financial incentive from the public purse. As such, the Government will need to look once more at the revenues that could be captured from land value uplift – the financial value created from granting planning permission. One approach currently being looked at by the Government is land auctions.[83]

In the 2011 Budget, the Government committed to launching a set of land auction pilots, but it intends to start piloting auctions on public land. As we have previously recommended,[84] to test the model properly a full programme of trials on private land also needs to be carried out.

Finally, other funding approaches will also be needed to deal with financing larger scale city expansion. While the NHB is a good incentive for growth, it will not deliver resources on the right scale or at the right time to support very large housing expansions in fast growing cities. CIL is also likely to be insufficient for these purposes. Additional funds may need to be made available to support this type of expansion in a small number of rapidly growing cities.

83. Aldred T (2010) *Arrested Development: Are we building houses in the right places?,* London: Centre for Cities
84. Larkin K (2011) *It's the little things: What does the 2011 Budget mean for cities?,* London: Centre for Cities; Aldred T (2010) *Arrested Development: Are we building houses in the right places?,* London: Centre for Cities

7. Conclusion

The new financial incentives for growth set out by the Government are certainly a step in the right direction. The Local Government Resource Review (LGRR) should strengthen the relationship between local development and local tax revenues, while the New Homes Bonus will ensure that local authorities benefit from accepting additional housing. These reforms could fundamentally shift the way the local government in England is financed, incentivising local authorities to be far more pro-growth and pro-development.

It is positive that policy is tackling the issue of land supply. The evidence indicates that, in the absence of financial incentives for growth, the plan-making and development control system has raised the price of housing and commercial property. There has also been a very limited relationship between prices and new development, which has constrained the growth of our most buoyant city economies. To address this problem, when implementing new financial incentives for growth the Government needs to design them in a way that ensures they have the appropriate impact.

"The task at hand is to ensure that incentives encourage places to respond to demand, minimise negative side-effects, and provide a permanent and transparent structure for local decision making"

With both of the new incentives our analysis has identified room for improvement. As part of the LGRR, the Government must be bold in designing the new system for allocating business rates. This report has found that business rate retention could create a sizable incentive for growth, but the Government should avoid 'watering down' the incentive by trying to achieve multiple objectives. A strong incentive will inevitably create winners and losers, but the overall benefits to the national economy make this trade-off acceptable. These national benefits need to be emphasised. To create a strong, simple and permanent financial incentive for growth we recommend allowing all local authorities to get a fixed proportion of business rates growth indefinitely.

At the same time, structures need to be created to allow local authorities to pool revenues across their city region or Local Enterprise Partnership. This will give them the financial strength needed to fund new infrastructure investments. The Government could even encourage this behaviour by creating an additional incentive to commit business rates growth to the level on the functional economy to invest in infrastructure for growth.

In the housing market, the NHB provides a positive incentive to support additional house building. However, our research suggests that the current NHB will only induce a reasonably small supply response. Given that the NHB is a good incentive, its scale should be increased. To increase its effectiveness, it should be targeted at groups of residents at the neighbourhood level, as they have a significant influence on whether development occurs. Additionally, the NHB also needs to be placed on a sound legal basis.

In a complex world, we recognise that no policy will be a catch-all for the challenges of increasing the supply of residential and commercial property. However, the new financial incentives for growth can shape behaviour of councillors and constituents in a manner that will be more pro-growth. The task at hand is to ensure that incentives encourage places to respond to demand, minimise negative side-effects, and provide a permanent and transparent structure for local decision making. With the right design, the NHB and LGRR can create financial incentives for growth that benefit both the residential and business communities of Britain's cities and the UK economy as a whole.

Authors

Kieran Larkin, Analyst at the Centre for Cities.
k.larkin@centreforcities.org / 020 7803 4310

Zach Wilcox, Economic Researcher at the Centre for Cities.
z.wilcox@centreforcities.org / 020 7803 4323

Acknowledgements

We are grateful to CB Richard Ellis and SNR Denton for the financial support that made this report possible and for the advice and input of Sarah Whitney and Jennet Siebrits (CB Richard Ellis), and Stephen Ashworth and Stephen Webb (SNR Denton).

The authors would like to thank the following individuals who provided opinion and comment on this research: Tom Aldred (DCLG), Paul Cheshire (LSE), Peter Cosmetatos (British Property Federation), Christian Hilber (LSE), Adam Marshall (British Chambers of Commerce), Michael Salmon (DCLG), Jerry Schurder (Gerald Eve), Geoff Snelson (Milton Keynes Council) and Dominic Williams (Hewdon Consulting).

Special thanks also to Paul Swinney at Centre for Cities for his technical assistance with the business rates modelling.

All views expressed in this report are those of the Centre for Cities and do not necessarily represent the views of those we interviewed. All mistakes are the authors' own.

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July 2011

Centre for Cities
Enterprise House
59 - 65 Upper Ground
London SE1 9PQ

020 7803 4300
info@centreforcities.org
www.centreforcities.org

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