All Party Urban Development Group
promoting sustainable development and urban renewal

Regeneration and the recession

Unlocking the money

About the All Party Urban Development Group

The All Party Urban Development Group (APUDG) is a cross party parliamentary body of MPs and Peers committed to progressing urban renewal and sustainable development in the UK.

The group was formed to raise the profile and understanding within Parliament of the regeneration process and the role that can be played by the private sector, particularly the property investment community. The group's remit is to take a holistic approach in the examination of all constituent elements that bring about truly sustainable communities, and to review policies that will increase the quality and pace of urban renewal and sustainable development nationally.

Officers
Clive Betts MP (chairman)
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About this inquiry
This report draws on written and oral evidence received during the inquiry from regional development agencies, urban regeneration companies, local authorities, developers, regeneration experts, retailers and other relevant stakeholders. It considers regeneration in the context of the economic recession, and what policy changes and tools are necessary to ensure regeneration can continue.

Further information
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Executive summary

The recession has brought an end to the long property investment boom that has helped revitalise many city centres and run down urban areas in the UK over the past decade. The boom was fuelled by cheap credit, a bubble in the property market and large increases in public spending. Property development and regeneration over the next ten years is expected to be very different, and cities will need to step up and play a bigger role in regeneration. In order to do this, greater devolution of decision making and financial powers will be needed so that cities have the flexibility to raise, pool, and decide how to spend resources locally.

This report highlights the need for cities to have additional financial tools and revenue raising options, and argues that accelerated development zones (ADZs) – a UK variant on tax increment financing (TIF), which funds infrastructure from future increases in tax revenue caused by new development – should be introduced as a key step towards achieving this objective.

Based on the oral and written evidence submitted to the group's inquiry, this report recommends that:

1. In the next Pre-Budget Report, the government should pilot a significant yet manageable number of TIFs/ADZs.
The government should sanction a number of TIF/ADZ pilots in different cities. Five or six pilots would be both manageable and would provide a robust evidence base from which to launch a larger national ADZ scheme. Pilots will provide an opportunity for other potential users of TIFs/ADZs to understand how the model can work in practice and demonstrate to HM Treasury how the risks and rewards can be actively managed, in combination with other funding tools.

2. The next government should use these pilots to push through a fully national TIF/ADZ scheme from 2011.
The TIF/ADZ pilots should be used to speed up the creation of a full scheme from 2011, when public sector finances come under increasing strain. Legislation will need to ensure that TIFs/ADZs are only used for unviable regeneration schemes and that there is appropriate strategic oversight over where and how they are used.

3. All cities need to adopt a more proactive approach to working with the private sector, and take on more risk.
There will need to be a step change in the way cities and city regions work with private sector partners through the use of joint ventures and equity sharing arrangements. Cities will need to use these investment vehicles to take on a bigger share of the risk, but also a bigger share of the long term reward.

4. The Homes and Communities Agency (HCA) should establish a specialist regeneration funding team to support local authorities with the practical challenges of implementing different funding models in the current climate.
The specialist funding team should be tasked with providing comprehensive guidelines and expertise on a) risk management for implementing TIFs/ADZs; b) alternative funding options and how they can be adjusted to fit the new environment; and c) support in navigating the credit market and in structuring funding agreements.

Introduction

Over the past decade, significant progress has been made in the revitalisation of many of the UK's city centres and run down urban areas, but the recession has now brought much of this investment to an abrupt halt. The lack of liquidity has been at the heart of the crisis, but the fall in property values and wider economic downturn have also played a part. As Professor Parkinson's report to the Department for Communities and Local Government (CLG) found, marginal sites in the north and the midlands have been hit the hardest[1]. Some economists are now arguing that the worst of the recession is over[2], but property developers continue to struggle and the recovery is expected to be slow.

After bringing forward capital spending to ease the impact of the recession, the 2009 Budget announced that net annual capital spending will fall from £44 billion in 2009-10 to £22 billion by 2013-14[3]. Property development and regeneration actors should expect further downward pressure on capital budgets as central government attempts to reduce public sector debt over the long term.

Significant cuts in public sector capital spending means that cities will have significantly less resource to partner up with the private sector to fund regeneration. It will also mean that public sector actors will be less able to fund the infrastructure investment that is often crucial to the viability of development sites, particularly marginal sites in deprived areas.

The combination of tighter credit conditions, slower capital growth, lower public spending and weaker economic performance poses serious questions about the viability of the UK's existing property development and regeneration funding models. This report examines what the recession means for these funding models, and what new ones could be brought to the table. It draws on evidence from an expert inquiry session held at the House of Commons in May 2009, and 41 written submissions from public and private sector organisations across the UK.

The report is split into four sections.

- **Section 1** examines the impact that the recession is having on property development and regeneration and takes a forward look at what the longer term impact might be, as well as what changes might be introduced after a general election.
- **Section 2** explores the extent to which existing regeneration models, such as local asset backed vehicles (LABVs), remain viable tools for leveraging investment and explains some of the steps that should be taken to improve their economic viability.
- **Section 3** analyses the key arguments surrounding new investment options, such as ADZs – a UK variant of TIFs – and regional infrastructure funds.
- **Section 4** draws together the report's key policy recommendations.

1 Parkinson M, Ball M, Blake N & Key T (2009) The Credit Crunch and Regeneration: impact and implications: an independent report to the Department for Communities and Local Government London: CLG
2 National Institute for Economic and Social Research (2009) Estimates of Monthly GDP London: NIESR
3 HM Treasury (2009) Budget 2009: Building Britain's Future London: HM Treasury

Section 1

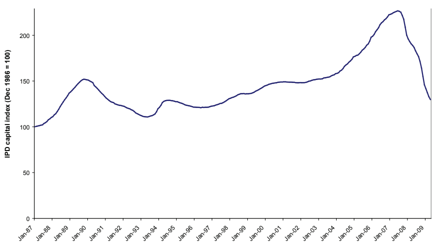
The impact of the recession on property development and regeneration in the UK

The recession's impact on property development and regeneration

Professor Parkinson's (2009) report sets out how the fall in property values and restrictions on credit availability have impacted on property development and regeneration during the recession[4]. Here are the key points from the report[5].

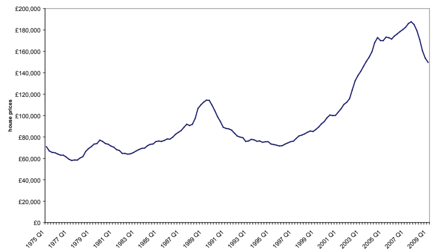
- The commercial property market experienced a bubble between 2001 and 2007 with capital values rising by 53 per cent, while rental values rose by only 9 per cent. Since 2007, commercial property values have dropped by 43 per cent and there are few signs of recovery as yet (see figure 1). In the residential property market, real house prices rose by 162 per cent between 1995 and 2007, and have since dropped by 20 per cent (see figure 2).

Figure 1: Commercial property values 1987-2009



Source: Thomson Datastream

Figure 2: Real house prices (1975-2009)



Source: Nationwide

- While property values were rising there was a clear incentive for the private sector to invest in new property. As previous inquiries from this group have shown, problems with England's planning system have contributed to an undersupply of new housing, which has contributed towards greater volatility in the housing market[6].

- When the credit crunch started to hit in the second half of 2007, there was a sharp contraction in the supply of credit. This has left property companies struggling to finance new schemes. Added to this, falling commercial and residential property prices greatly discouraged investors from starting new projects. This has resulted in a large amount of the planned commercial and residential property investment being shelved or cancelled altogether.

4 In this report, regeneration refers to physical development in disadvantaged areas, which has explicit economic and social objectives. Property development refers to investment that is less risky to the private sector than regeneration schemes.

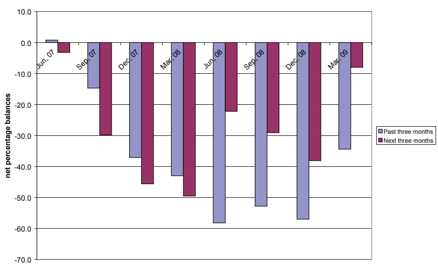
5 Parkinson M, Ball M, Blake N & Key T (2009) The Credit Crunch and Regeneration: impact and implications: an independent report to the Department for Communities and Local Government London: CLG

6 All Party Urban Development Group (2008) Delivering Urban Homes: the role of the public and private sectors London: APUDG

- The impact of the recession on property development and regeneration has varied from city to city, with London and the south east faring better than smaller cities in the north and the midlands. Disadvantaged areas, such as the housing market renewal pathfinder areas, have been particularly badly affected. Property investment returns in regeneration areas[7] fell by 6 per cent during 2007 compared to a 3.7 per cent fall nationally.

The situation has deteriorated further in the six months between Professor Parkinson's report and this inquiry, with commercial and residential property prices continuing to decline (see figures 1 and 2). Meanwhile, lenders have only marginally improved the supply of credit to commercial real estate actors over the past six months (figure 3).

Figure 3: the supply of credit to commercial real estate



Source: Bank of England[8]

The medium term impact of the recession
Looking forward, what impact will the recession have on key public and private sector regeneration players?

- **Private sector** property developers and regeneration companies will be constrained by a weaker supply of credit, relative to the past ten years, and higher risk premiums, particularly for more marginal projects. Added to this, with the property market and wider economy less buoyant, returns will be less certain and developers will be less able to fund enabling infrastructure.

  Not all private sector partners will be impacted in the same way. Food stores, for example, are still developing despite current difficulties. Sainsbury's has recently announced a £450 million capital raising programme to secure new floor space. In some cases, it is possible that smaller property or regeneration schemes could be built around new food/convenience store developments. Meanwhile, house builders are likely to continue to struggle with funding for the foreseeable future and are much less likely to be able to fund infrastructure in support of new development.

  Overall, as a way of sharing some of the risk, and the upfront costs, private sector appetite for long term partnership with the public sector is likely to increase.

7 Defined as those areas which receive money from government regeneration programmes.
8 To calculate aggregate results, each lender is assigned a score based on their response. Lenders who report that credit conditions have changed 'a lot' are assigned twice the score of those who report that conditions have changed 'a little'. These scores are then weighted by lenders' market shares. The results are analysed by calculating 'net percentage balances' – the difference between the weighted balance of lenders reporting that, for example, demand was higher/lower or terms and conditions were tighter/looser. The net percentage balances are scaled to lie between ±100.

As Peter Vernon, the chief executive of Grosvenor (Britain & Ireland), noted in his evidence to the inquiry, we need to find "mechanisms whereby the allocation of risk between public and private sectors is adjusted so that the downside risk for the developer is controlled."

- **Local authorities (and regional development agencies, or other regional bodies)** will have to take on stronger partnership roles with the private sector, shifting from grant providers to equity shareholders. This will require a more proactive approach and greater willingness to take on risk – bearing more of the burden for land assembly, remediation and infrastructure costs.

  Local authorities with significant cash reserves and investment holdings can take advantage of lower property values to buy and parcel up land for private developers. This will help to get investment going more quickly when economic growth does return, and facilitate the uptake of public private funding models such as LABVs. For most local authorities, however, regeneration plans and housing targets will need to be reassessed to reflect what can realistically be achieved in the new economic climate, and re-prioritised to take into account changing economic needs and demand following the recession.

- **The Homes and Communities Agency (HCA)**, the government's housing and regeneration arm, has seen the receipts from its property and regeneration activity fall substantially. As Trevor Beattie from the HCA explained at the inquiry, "the downturn has had a very profound impact on our business. Fundamental to it has been a loss of liquidity."

  Looking forward, the HCA will have a key role in regeneration, given its expertise and annual budget (£5 billion up until 2011, in addition to the £600 million cash injection from the 2009 Budget). The HCA's ability to act, however, will depend on the severity of cuts to its budget post-2011, and the level of flexibility the HCA has over its remaining spending. With the majority of the HCA's current budget earmarked (2009-11), its ability to respond to the recession has been limited. The HCA has, however, started to take up equity stakes to restart development plans with some success.

  The overall cuts in public sector capital investment will also have a significant impact on infrastructure provision. This will, in turn, affect the viability of regeneration schemes that the HCA is able to fund. This increases the urgency for new tools that will forward fund infrastructure and help to de-risk sites. It also suggests that there may be a need to switch away from larger schemes to smaller projects that are more easily funded and less risky for all parties concerned.

What might happen after the next general election?

The other potential source of change will be the possibility of a new national government coming to power after next year's general election.

The Conservatives' *Control Shift* green paper[9] made clear their ambition to devolve more financial and planning powers to local

9 The Conservative Party (2009) Control Shift: Returning Power to Local Communities London: the Conservative Party

authorities. An important part of their proposal is the shifting of all regional planning and housing powers from regional government to local councils, and the creation of local incentives for growth. Local authorities would be encouraged to lead economic recovery and growth by allowing them to retain the increase in local tax take arising from business and housing growth for six years. These proposals are a positive development towards greater flexibility for cities, but do not by themselves give cities sufficient financial flexibility to jump start regeneration and infrastructure projects.

More recently, the Labour government has also been shifting power back to local government, evidenced by the forthcoming business rate supplements, community infrastructure levy, and the endorsement of city regions. The housing minister, John Healey, has pledged to further empower local government by increasing their financial independence and allowing them "to do more to meet the economic and housing needs in their areas" [10].

Whichever party is in power, the next administration must continue on the path toward giving local government more freedom and flexibility. Also, the new government will be faced with the overriding need to get public finances back in order. Questions regarding how best to prioritise scarce public sector resources for maximum economic impact become all the more apparent, and tough choices will have to be made. The group believes that by giving local government more freedom and flexibility, public finances can be used more effectively.

Overall implications

We have, for the time being at least, seen the end of city centre regeneration driven by short term speculative gains and cheap credit. The next wave of regeneration will be different.

- The private sector will need to accept longer term investment vehicles.

- The public sector will have to be less risk averse and more proactive in partnering with the private sector. In return, the public sector will benefit from a more significant share of the rewards.

- Whichever party is in power after the next general election, devolved funding will be important if local authorities are to take on a more significant role in levering investment into regeneration, and ensure that limited budgets are utilised for maximum benefit. This will need to include greater flexibility in their ability to choose from a suite of funding tools.

10 Inside Housing (19 June 2009) "Healey: freedoms for councils within a month"

Section 2

Are existing regeneration models still viable?

The recession has led to much debate in the property development and regeneration industry about whether existing models of partnership and investment between the public and private sectors, such as LABVs, are still viable. The report of this group's first inquiry, *Loosening the leash: how local government can deliver infrastructure with private sector money*, provides a useful summary of the range of financing options that were available to local authorities at the height of the boom, in early 2007 – including roof taxes, regional infrastructure funds, and land pooling[11].

These kinds of partnership models have been valuable in enabling the upfront infrastructure investment – in roads, electricity, sewerage systems and others assets – that are often essential to de-risking marginal sites and attracting private sector investment. In a more cautious investment environment, finding ways to share risk will be increasingly important.

Are existing models broken?

Existing property development and regeneration models – such as LABVs and public private partnerships (PPPs) – are not broken. Evidence from the oral inquiry revealed that the underlying principles of partnership working – in particular to share skills, expertise and risk – remain valid. Nevertheless, in an environment where lending is unlikely to return to pre-credit crunch levels, and capital growth is expected to be slow, these models will need to adapt to the changing economic landscape, and new tools will have to be brought to the table.

These views were reflected in the written evidence submitted to this inquiry.

- "Those PPPs and LABVs already established by the RDAs have not experienced any significant adverse effects during the downturn; however, the ability to create new risk sharing delivery partnerships such as joint ventures, PPPs and LABVs in the current climate is clearly diminished due to increased risk, reduced expectations of value uplift and falling land values, which are a disincentive for all parties" (ONE North East, written evidence).

- "PPPs and LABVs are still feasible provided that the public sector takes most of the risk in the next couple of years. Adjustment may need to be made to shares of return to take account of this risk allocation" (Royal Institution of Chartered Surveyors, written evidence).

Box 1: Local asset backed vehicles

In LABVs, local authority land assets are used to lever investment from the private sector. They "bring together a range of public and private sector partners in order to pool finance, planning powers, land and expertise; to ensure an acceptable balance of risk and return for all partners; and to plan and deliver projects more strategically"[12].

LABVs are a valuable model, but they are relatively new and are not yet used widely around the UK, particularly in the north. One of the problems is the requirement for a significant set of land

11 All Party Urban Development Group (2007) Loosening the leash: how local government can deliver infrastructure with private sector money London: APUDG

12 Harrison, B and Marshall, A (2007) City Solutions: Delivering Local Growth – Local Asset Backed Vehicles London: Centre for Cities

assets for the proposal to be attractive to the private sector.

One of the furthest developed LABVs is in Croydon, where Croydon Council and property developer, John Laing, signed a £450 million partnership deal in December 2008. The deal will regenerate four town centre sites, including the construction of two 40 storey towers with 650 new flats and a new headquarters for the council. The council is using its land assets to act as a partner in the deal and will receive a 50-50 share of the profits, providing it with enough money to pay for its new headquarters.

The written and oral evidence submitted to this inquiry in particular stressed the need to adjust the distribution of risk in the design of LABVs and PPPs – through the public sector taking on a greater proportion of the upfront risk. In return, the private sector will need to shift away from a short term profit to a steady long term income business model. Different options for achieving this were presented to the inquiry. These are discussed below.

- Reducing upfront risks: one of the most effective ways of reducing private sector risk is by the public sector taking on more of the associated site acquisition and infrastructure costs. Given the significant and long term financial constraints facing local authorities, the TIF model might be one way of raising finance for this type of investment. Other alternative, or additional, options include the joint European support for sustainable investment in city areas (JESSICA) scheme. Both models are discussed in section 3.

- Minimising transaction costs: as previous reports from this group have shown, the hidden administrative and legal costs of coordinating and agreeing development plans between the public and private sector can be very high[13]. There is now an increasing urgency to reduce these costs – in particular for smaller schemes, where coordination costs often represent a larger share of the overall development cost.

  The Killian Pretty Review highlighted some of the ways in which planning procedures could be reformed to minimise transaction costs, including increasing the emphasis on pre-application discussions with elected members, and the wider use of planning performance agreements[14]. With regards to LABVs and similar partnership models there will be a need for greater simplicity and standardisation of partnership arrangements. This, however, needs to be balanced against the continued need for tailored development agreements to suit local conditions.

  Another practical step that can be taken is to ensure that there is absolute clarity on the European Union's Roanne judgment[15] and what this means for the process of striking development agreements

13 All Party Urban Development Group (2007) Loosening the leash: how local government can deliver infrastructure with private sector money London: APUDG

14 Killian J and Pretty D (2008) The Killian Pretty Review: Planning Applications – a faster and more responsive system London: CLG

15 The European Court of Justice's Roanne judgement (2007) says that local authorities should tender for development partners on public procurement projects within the Official Journal of the European Union (OJEU), or else be in breach of EU procurement regulations.

between the public and private sectors. Uncertainty about this issue has already led to the cancellation of development projects, in Rochdale for example, and is still creating problems and delays for the public and private sector partners across the country. With many procurement processes now needing to go through the Official Journal of the European Union (OJEU), consideration needs to be given to how the costs of this process can be minimised for all parties.

- Phased development: private sector witnesses at the inquiry suggested that the public sector can reduce risk by permitting staged phasing of large development sites through the planning system. This can, however, increase the risk for the public sector, for example, by leaving a multi phase project with only one phase completed, if private sector partners delay or cancel the less profitable follow-up phases. Trevor Beattie of the HCA argued that this problem can be overcome: "we are doing quite a bit in terms of phasing… but we are only doing that in return for some very clear undertakings from the private sector in terms of the quality that is being provided, commitments to start and commitments to build out."

  Linked to this, another option for partners is to reduce the overall scale of developments projects. Switching the emphasis from large, expensive and complex schemes to smaller more manageable projects is one option for minimising risk for all concerned. The funding limitations for new development over the coming years are likely to force this change in many circumstances.

- Tailoring and re-prioritising projects to local need: as Land Securities noted in its written evidence to this inquiry: "Instead of analysing the regeneration needs of an area and trying to identify a way of addressing those needs, too often the financial models are adopted as a solution without enough thought being given to whether they are appropriate to the circumstances… care needs to be taken to ensure that there is continuing flexibility of approach" (Land Securities, written evidence).

  Related to this, reviewing investment plans and reprioritising projects will be important if limited public sector capital funding is to be effectively allocated. Sunderland City Council, for example, is adopting a policy of prioritisation, with a focus on developing a city centre site around a proposed investment from Her Majesty's Court Service. The HCA is also undertaking a review to reprioritise and consider "more flexible tailored packages of funding" (Trevor Beattie, oral evidence), possibly using national affordable housing programme money.

- Strong leadership role for the HCA: the HCA needs to adopt a proactive role in encouraging local authorities to enter into joint ventures and equity sharing arrangements with the private sector. Local authorities need to share in a greater proportion of both the risks, and longer term rewards, but there will be a learning curve. The HCA's expert advice and guidance will be even more important in a more uncertain environment. Other skills that already exist at the city level, such as within urban regeneration and city economic development companies, could usefully be co-opted. This could be particularly valuable in northern cities, where regeneration schemes have been hit the hardest and the risks to the private sector may be the greatest.

- More financial and decision making autonomy: as this group has previously argued, more decision making and financial powers for local authorities is fundamental if cities are to maximise the economic impact from limited public sector funds. The urgency for this has now increased. Cities need the flexibility to pool housing, regeneration and related funding streams, and ensure resources are not spread too thinly. Financial incentives to invest in regeneration and development (such as the freedom to retain the longer term increase in business rates) will also become increasingly important as councils have less resource available to cope with the short term costs. This is discussed further in the following section.

Overall implications

The concepts of cost, risk and viability will be crucial to determining whether investment can go forward in the current, and future, economic climate. If PPPs are sufficiently flexible, the costs and risk can be shared over the long term in ways that can increase viability.

- Existing models, such as LABVs, can help achieve the above. But with limited credit availability and slower capital growth, they will need to be flexible and adapt. Practical options include phasing development, re-prioritising projects, and using LABVs in conjunction with new tools, such as JESSICA and TIF/ADZ financing models.

- For funding models to adapt, and be tailored to local development scenarios, more financial and decision making autonomy for local authorities will be required. Cities need the flexibility to raise, pool, and spend resources locally.

- The HCA has an important role to play in helping local authorities to step up to this role, and in providing them with the expertise they need to create joint ventures and enter into equity sharing arrangements in a more uncertain investment environment. Other skills at the city level, such as within city economic development companies, could also be usefully co-opted.

Section 3

New financing tools

The need to empower local leaders and introduce new funding tools has been clear for some time, as we argued in the report from our first inquiry in 2006[16]. Progress on devolution has been slow, however, with the introduction of local and multi area agreements and the business rate supplement (BRS) only representing small scale reform. As the previous section showed, the current economic difficulties in the UK create the need for more urgency on the devolution of decision making and financial powers.

The options local authorities have to enable property development and regeneration are discussed below, with the focus on what new tools need to be brought to the table, such as ADZs – the UK variant of TIFs.

Expanding and combining the financing toolkit

One of the key messages that came through in the written evidence to this inquiry was the idea of switching from a "rules based to a tools based" approach to regeneration in the UK (Igloo Regeneration, written evidence). Such a switch would involve two main steps.

First, local and regional actors would need the flexibility to select between a range of financing tools, or to use different tools simultaneously, in order to lever sufficient funding to pump prime a property development and/or regeneration project. Tools, such as business rate supplements and the community infrastructure levy, are unlikely to be able to provide sufficient resources to fund urban infrastructure needs alone. Adding new ones, such as ADZs, to the toolkit could be vital to bridging the funding gap.

Secondly, local and regional actors would need more financial and decision making power to create tailored approaches to different development scenarios. The major parties need to follow through on their commitments to devolve power to local authorities, for example through giving local authorities the flexibility to raise and spend resources locally, and pool funding streams within the multi area agreements framework. The Manchester and Leeds city region pilots provide a ready made opportunity to experiment with different types of financial devolution.

Business rate supplements and the community infrastructure levy

The BRS Bill should be an Act by the time this report is published, or not long after. BRS will allow local authorities to levy up to an additional 2p per pound on the business rates of firms with a rateable value over £50,000, for a set time period. The revenue stream can be used to invest in infrastructure projects for their areas.

Businesses are unlikely to favour higher business rates in the current economic climate, but the tool will be a useful option for some cities in the longer term. There are, nevertheless, some concerns that the tool may only be suited to large cities and large scale projects, such as London's Crossrail. Elsewhere in the country, particularly in some northern areas, the scale and type of businesses may not create a sufficient revenue stream to finance major investments. Where projects are smaller, it is unlikely that the wider business community would be willing to pay a business rate supplement that would benefit only one area.

16 All Party Urban Development Group (2007) Loosening the leash: how local government can deliver infrastructure with private sector money London: APUDG

The community infrastructure levy (CIL) involves levying a set charge on different types of development to invest in infrastructure; however, this alone will not solve funding for infrastructure[17]. The 2009 Budget delayed the implementation of CIL until 2010, but even this is likely to be too soon given the expected slow economic recovery.

Quantitative analysis conducted by PricewaterhouseCoopers (PwC) found that even a combination of these two funding sources would be insufficient to fund the scale of infrastructure associated with regeneration projects[18].

JESSICA

One of the investment options given most emphasis in the written submissions to this inquiry was the European Union's (EU) JESSICA scheme. JESSICA has been set up for the 2007-13 programming period of the EU structural funds. It allows RDAs to use a proportion of their EU structural fund allocations to create an urban development fund for use as equity, loans or guarantees, rather than as grant money[19]. In this way, the funds can be recycled over time – as equity investments can be cashed out and reinvested in new projects.

To take advantage of this opportunity, national government should adopt a stronger leadership role to ensure that the scheme is utilised to its fullest possible extent by RDAs. JESSICA could support a number of regeneration schemes in the midlands, north and the devolved countries – all of which have significant structural fund allocations.

Regional infrastructure funds

Regional infrastructure funds (RIFs) would be an alternative option, which would complement JESSICA and other instruments, if widely adopted. The South West Regional Development Agency (SWRDA) has recently established the first of these and allocated £80 million. Other RDAs, including the East of England Development Agency, are also assessing the case for their introduction.

RIFs could work in a variety of ways. In the case of the SWRDA RIF, money has been top sliced from other budgets, such as the south west's regional funding allocation, and is being used as a loan facility to help fund private sector contributions to development projects. In some cases the loans made are only partly repayable so the fund value is set to erode over time. Another option would be to use a RIF as a way of guaranteeing other loans. As in the Leeds example in box 2 below, RIFs could also be used to pump prime investment in an ADZ to reduce the level of upfront risk.

In the future, the principle of pooling money from different public sources to create a more effective use of scarce funds will be key. This concept is similar to a Centre for Cities proposal to create a dedicated urban transport investment fund – which would pool resources from the Department of Transport, the private sector and cities – to boost investment in urban public transport in the medium term[20]. A dedicated transport fund would be larger than the existing RIF, and potentially more useful to enabling regeneration.

17 Core Cities and PwC (2008) Unlocking City Growth: Interim Findings on New Funding Mechanisms London: PwC
18 ibid
19 BPF (2008) Tax increment financing: a new tool for funding regeneration in the UK? London: BPF; BPF (2009) Regeneration Manifesto London: BPF
20 The fund proposed would loan out resources to member cities seeking to undertake transport infrastructure projects. Repayment of these loans – alongside further injections of capital from investors – would replenish the fund and allow it to make additional commitments over time. See Marshall A (2009) Keeping the wheels from falling off London: Centre for Cities

Tax increment financing / accelerated development zones

TIF, which has long been part of the infrastructure financing toolkit in the US, works by allowing local government to raise money by borrowing against the expected increases in tax revenue associated with a new development. The evidence presented to the inquiry demonstrated the strength of the public and private sector appetite for the adoption of TIFs in the UK, which are known here as ADZs.

- "This method of funding regeneration and infrastructure is particularly attractive in the current financial climate, enabling developers to build based on the more predictable future revenues of a project and helping overcome the current shortfall in lending. In effect, this approach can help smooth out the investment cycle" (Merseytravel, written evidence).

- "The concept of new fundraising models… is something that the private sector welcomes… Taxes that are seen as being raised locally and spent locally enjoy a much greater level of support… [and] offer the right incentives to local authorities to focus their activity on supporting economic development" (Manchester Chamber of Commerce, written evidence).

Much analytical work has been conducted by the Core Cities Group (with the support of PwC), the British Property Federation and others into the case for trialling TIFs/ADZs[21]. The UK model would involve one or more local authorities having the freedom to retain business rates over and above the existing receipts of the area caused by new development. These rates would be securitised to pay for upfront infrastructure, with the debts repaid over a period of 20 plus years. According to PwC, the use of ADZs could generate a much larger source of revenue to support local infrastructure investment, and would help to fill the infrastructure funding gap left by other sources of finance (including BRS and CIL). Box 2 explains how an ADZ might work in Leeds.

Box 2: The Aire Valley regeneration project, Leeds

Leeds City Council is exploring the potential for an ADZ in the Aire Valley, an area of manufacturing that has suffered industrial decline. The regeneration project aims to reclaim and redevelop 180 hectares of brownfield land, enhance the river/canal corridor and reconnect the area to surrounding communities.

The project has secured a public sector funding commitment of £32 million. However, this leaves an infrastructure funding gap of £250 million for the planned work. Projections suggest that the additional business rates generated through the scheme would be around £289 million over a 13 year period. With an ADZ, this projected increase could be harnessed to borrow much of the money needed to finance the upfront infrastructure investment needed to get the scheme started.

21 PwC (2008) Unlocking City Growth: Interim Findings on New Funding Mechanisms London: Core Cities

PwC conducted an analysis of the economic impact of the regeneration project, comparing an ADZ with a 'no ADZ' scenario, and taking leakage, displacement, substitution and multiplier effects into account. The study found that the net additional employment effect of completing the project could generate 14,000 additional jobs, and stimulate 2.5 times more gross value added (£1 billion to the local economy), compared to the 'no ADZ' scenario, over a 15 year period. Over a 30 year period, the ADZ would result in a net benefit for the Exchequer.

If an ADZ was implemented, the risk would be highest during the early stages of the project. In order to mitigate this, a RIF could be used to pump prime the investment. Once the project receives an income stream from the growth in business rates, the ADZ would repay the RIF. If the ADZ were used in conjunction with income from a BRS, RIF and CIL, the term of the ADZ would be shortened, and the risk would be lower.

Source: Leeds City Region Partnership (2009) Impact, innovation, leadership: the Leeds city region forerunner plan, Leeds: Leeds City Region Partnership; PwC (2008) Unlocking City Growth: Interim Findings on New Funding Mechanisms London: Core Cities

Reasons to be cautious about ADZs

In addition to presenting a strong economic case for the introduction of ADZs, the inquiry also raised some valuable notes of caution.

Similar to the US model, local authorities could finance ADZ projects using prudential borrowing powers to raise money either in the capital markets or from central government sources. This could add to public sector debt, and pose a risk if the development is delayed, costs overrun or if forecast revenue is unable to cover the debt. Nevertheless, the cost of private finance may be prohibitively high if there is no central government guarantee, particularly in the current climate.

In particular, the inquiry stressed the importance of additionality – permitting the use of ADZs only to fund investment that would not otherwise go ahead and having regard to the impact on tax revenues. The evidence presented showed the merit of ADZs as a powerful regeneration tool in the US, but stressed that the model had been overused (see box 3). In particular, the US experience has suffered from the lack of any strategic oversight to monitor the use of TIF, and limit competition between zones seeking to benefit from it.

- "The reason [some] TIFs have gone very badly wrong in the States is that property developers come along and say 'My scheme is going to generate $100 million' and not saying that it is just being sucked from elsewhere. The key thing about

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TIFs is that you have got to… have a very coherent basis for rationing" (Chris Brown, Igloo Regeneration).

- "The whole principle upon which TIF is predicated needs to be looking at additional investment and acceleration of investment, and the incremental revenues are the gap between those revenues that would otherwise have been created and the ones that will be created as a result of enabling infrastructure" (Dave Anderson, Edinburgh City Council).

Box 3: Tax increment financing – lessons from the US

TIFs were first introduced in the US in the 1950s, but their use has been expanded significantly since the 1970s. For example, Illinois, which had one TIF district in 1970, now has over 900.

Until the 1990s, most states reserved TIFs for areas that could be described as blighted. However, the definition of blight has been dramatically expanded over the years for purpose of TIFs. In 1999, for example, Baraboo, Wisconsin, created a TIF for an industrial park and a Wal-Mart centre to be built on farmland. The definition of blight in this case was met by a single house in the district that was uninhabited.

The reasons for loosening the criteria for establishing TIFs appear to include competition between states and neighbourhoods for development, and the fact that municipal bodies have realised that areas with higher property values can generate more tax revenue to pay off development bonds.

Source: BPF (2008) Tax increment financing: a new tool for funding regeneration in the UK?

The avoidance of harmful regional competition is therefore critical and would need to be addressed, for example through the use of national strategic oversight by an appropriate government agency. It would be important to have clear rules and guidance about the use of ADZs.

Rationing ADZs to only the most critical property development and regeneration projects would ensure that the tools genuinely stimulate additional investment that would not otherwise have occurred. The use of ADZs would be much less widespread than in the US, and the pitfalls of unmanaged regional competition could be avoided.

One of the biggest challenges, however, will be determining whether a new development facilitated by an ADZ is likely to generate additional tax revenues on a national level. It is unrealistic to assume that all the new businesses attracted into the TIF district or ADZ, and associated job creation, would be additional. Some may have simply been displaced from outside the zone. Nevertheless, according to analysis conducted by PwC, the level of displacement would need to be substantial for it to be more financially beneficial for HM Treasury to retain all business rates rather than implement a ADZ. The Treasury will, however, need to ensure that the additional business rates created by the ADZ are discounted when calculating the national uniform business rate.

The expected net benefit to the Scottish Government is reflected in the Edinburgh example (see box 4), where an upfront investment of £50 million would be funded out of an anticipated increase in business rate receipts of £310 million over 25 years.

Box 4: Edinburgh ADZ trial

Edinburgh is one of a number of cities around the UK that is developing proposals for an ADZ trial. Edinburgh City Council's plan is one of the furthest advanced and would help lever over £450 million of investment in the Edinburgh waterfront. According to the plan, this would require funding a number of upfront infrastructure investments worth £50 million in, for example, a lock gate, a new pier and a new road. Edinburgh City Council is planning to fund these investments by borrowing against the expected increase in business rates revenues arising from the realisation of their long term plans for the area. The council's projections suggest that they would receive as much as £310 million in additional business rates over the next 25 years, leaving them with sufficient resource to repay the loan.

The most effective way to work out details of implementation would be for national government to sanction a number of ADZ pilots – to fund different types of infrastructure and development, in different cities. The pilots would provide the opportunity to work through the remaining issues and assess the benefits of possible wider ADZ regime. In a fully national scheme, however, it will be necessary to set out a strict set of pre-conditions to ensure there is appropriate strategic oversight over where and how ADZs are used.

Overall implications

If local authorities are to have the capacity to enable the property development and regeneration in the future, the financing toolkit will need to expand and adapt to new economic conditions. The tools currently available to cities do not have the financial capacity to de-risk regeneration sites. If combined, however, the financial tools identified here represent important revenue raising options that would enable local authorities to pay for an ADZ, or similar financing vehicle, with the potential to make an unviable regeneration project viable.

- TIFs have proved to be a powerful tool in the US in jump starting regeneration. ADZs could be key to bridging the funding gap in the UK, learning from the experience of US cities and states.

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- In implementing ADZs, establishing clear principles as regards additionality and appropriate strategic oversight will be critical.

- If these plans go ahead, the HCA could play an important role in providing expert advice to local authorities in terms of practical implementation, particularly as regards risk analysis and mitigation.

- A key challenge will be determining the extent to which a new development, facilitated by the use of ADZ, generates additional tax revenues on a national level rather than merely displacing revenues within the UK. Nevertheless, the level of displacement would need to be substantial for the use of ADZ to be positively unattractive, even on purely fiscal grounds.

- The most effective way to work out details of implementation would be for national government to sanction a number of ADZ pilots.

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Conclusions and recommendations

Physical regeneration and property development has an important role to play in the future economic recovery of UK cities. With limited public funds, however, devolved responsibility for pump priming regeneration and enabling infrastructure will be critical to attracting private sector investment. Without the political will to proceed with devolution and new funding tools, Britain's regeneration industry could remain dormant for years to come.

The recession has changed regeneration from short term profit to long term public private partnerships. Central government needs to work with local authorities and experiment with different funding models that will strengthen the links between the immediate costs and risk of investment on marginal sites, and the longer term benefits of regeneration. These longer term benefits need to be both captured and shared locally. This inquiry has presented ADZs as one of the most viable ways of achieving the above.

1. **In the next Pre-Budget Report, the government should sanction TIF/ADZs pilots.**
   The government should sanction a significant number of ADZ pilots (five or six, at least) in different cities. This will provide an opportunity for other potential users of ADZs to understand how the model can work in practice and demonstrate to HM Treasury how the risks and rewards can be actively managed, in combination with other funding tools.

2. **The next government should use these pilots to push through a full national ADZ scheme from 2011.**
   The ADZ pilots should be used to speed up the creation of a full scheme from 2011, when public sector finances come under increasing strain. Legislation will need to ensure that ADZs are only used for regeneration schemes that would otherwise be unviable and that there is appropriate strategic oversight over where and how they are used.

3. **All cities need to adopt a more proactive approach to working with the private sector, and take on more risk.**
   There will need to be a step change in the way cities and city regions work with private sector partners. Local authorities need to adopt a more proactive and entrepreneurial approach to working with the private sector through the use of joint ventures and equity sharing arrangements. "It is down to the public sector to set the agenda in a practical and deliverable way" (British Council of Shopping Centres, written evidence). Cities will need to take on a bigger share of the risk – bearing more of the burden for land assembly, remediation and infrastructure costs – but also share in the longer term reward.

4. **The HCA should establish a specialist regeneration team to help local authorities with the practical challenges of implementing different funding models, such as assessing and allocating risk.**
   The specialist team should be tasked with providing comprehensive guidelines and expertise on a) risk management for implementing ADZ pilots; b) alternative funding options in the new economic environment; and c) support in navigating the credit market and in structuring funding agreements. The aim should be to increase the number of joint ventures and equity sharing arrangements, which are particularly underutilised amongst northern cities where the recession has hit schemes the hardest.

Annex

Acknowledgements

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Witnesses at the APUDG inquiry session, House of Commons, 14 May 2009

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British Council of Shopping Centres
Birmingham City Council
British Property Federation
City Region of Birmingham, Coventry and the Black Country
Core Cities Group
CPR Regeneration
Cushman & Wakefield
CB Richard Ellis
DLA Piper
DTZ
Equalities and Human Rights Commission
Greater Manchester Chamber of Commerce
Greater Norwich Development Partnership
Heritage Lottery Fund
Housing Market Renewal Chairs
Hull City Council
Igloo Regeneration
John Laing and Denton Wilde Sapte
King Sturge
Land Securities
Liverpool City Council
London Councils
London Thames Gateway Development Corporation
Manchester City Council
Merseytravel
Newcastle City Council
NewHeartlands Housing Market Renewal Pathfinder
Network Rail
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