

Economic Growth in Cities: Issues for Central Government

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This note is concerned with the role of cities and urban policy in growth. Decentralisation from central to local government may help city leaders raise economic performance. It also generates new policy choices for *central* government – especially in policy areas where local leaders are unwilling or unable to take actions that benefit growth. Policy decisions in this area will also impact on geographical concentrations of firms that are located outside cities.

This note summarises evidence emerging from SERC research (www.spataleconomics.ac.uk) as well as from the wider urban economics literature. SERC will publish further notes on these issues over the coming months.

Introduction

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Cities and Growth¹

Cities allow geographic concentration of firms and households. Proximity enables collaboration in the production of goods and ideas, increasing productivity and innovation. Structural shifts are increasing the benefits of proximity. Proximity benefits services more than manufacturing. Ideas matter more in a world where globalisation and ICT increase the rewards to innovation. Rising skill levels increase the benefits of larger labour markets with many job opportunities and a greater availability of appropriately skilled workers.

Costs offset these benefits. As activity concentrates, the price of resources, such as land, increases. There is greater congestion, increased pollution and higher crime. It is the trade-off between these changing costs and benefits that determines which areas are rich and which are poor; which grow fast and which grow slowly. These changes are not playing out evenly resulting in growth in some cities, decline in others. The previous government tried to address these disparities by spending heavily in declining areas but this expenditure failed to create private sector jobs, leaving some cities reliant on the public sector. At the same time, crucial questions about policies to help successful cities have been neglected. What policies might help cities grow and ensure that as many people as possible can access the benefits?

Decentralisation and Growth²

Decentralising fiscal and political powers from central to local government is a key element of the ‘localism’ agenda. There is no clear evidence of a *direct* link between decentralisation to local government and improved economic outcomes, nor between decentralisation and rebalancing (a narrowing of spatial disparities). Theoretically, decentralisation may benefit local wellbeing or economic growth – for example, by encouraging policy innovation, economies of scope or the tailoring of policy to needs. More evidence is needed on these channels. There is also a broad consensus that *if* economic policy is devolved this should be to functional economic

¹ See Rice and Overman (2008) ‘Resurgent Cities and Regional Economic Performance’, SERC policy paper 1 <http://www.spatialeconomics.ac.uk/textonly/SERC/publications/download/sercpp001.pdf> for more evidence and references. Leunig and Overman (2008) ‘Spatial patterns of development and the British housing market’ Oxford Review of Economic Policy, provides an introduction to urban economics with a focus on the changing economic geography of the UK. Glaeser (2011) ‘Triumph of the City’ provides further discussion on many of these issues. Ioannides, Overman, Rossi-Hansberg and Schmidheiny (2008) ‘The effect of information and communication technologies on urban structure’, Economic Policy, provides evidence on the role of ICT.

² Steeples (2010) ‘City-Region Governance, Policy Variation and Economic Performance’, SERC policy paper 5 <http://www.spatialeconomics.ac.uk/textonly/SERC/publications/download/sercpp005.pdf> summarises the available evidence on the link between governance of city-regions and their economic performance.

areas. When these cut across boundaries, new leadership models (e.g. elected Mayors) may be needed.

Passing powers to city leaders limits *central* government's ability to affect urban economic performance. The coalition's approach to this is to combine decentralisation with incentives for growth. Fundamentally, if we want successful cities to grow the balance between decentralisation and pro-growth incentives has to be right. We highlight six areas where it is not clear that we yet have the right balance.

Planning³

The planning system co-ordinates the expansion and redevelopment that is crucial for city growth. Unfortunately, as recognised in the Government's local growth review, in many areas the current planning rules work primarily to *constrain* not coordinate. Ministers aim to tackle these issues with a presumption in favour of sustainable development, incentives for councils to adopt pro-growth planning frameworks, dropping brownfield targets and piloting land auctions. However, the extent to which these changes will be successful is not yet known and a number of issues remain outstanding. For example, it is not clear that the Business Increase Bonus will provide enough revenue to affect council's economic development stance. Ministers have also retained Greenbelts, which prevent cities from expanding out. In London, height restrictions prevent developers from building up. Heritage restrictions, planning delays and uncertainty further increase the costs of development, while building and other regulations add substantially to the costs of permitted development. Of course, these policies have benefits, but they impose important costs for firms, particularly in terms of high prices for land.

Housing⁴

Planning also affects the supply and cost of housing. In successful cities, low levels of house building mean that prices rise quickly as the local economy expands, choking off growth and preventing people from sharing in the benefits of that growth. Unfortunately home owners, who lose when local prices fall, have few reasons to say yes to local development. Past regional plans tried to force local areas to build more housing. The Coalition favours decentralisation, coupled with incentives to permit new house building. But, giving residents more say in planning decisions (e.g. through neighbourhood plans) may reinforce anti-development tendencies they can already express via the ballot box. These tendencies are likely higher in successful areas and there is, as yet, little evidence on whether New Homes Bonus-type incentives will be sufficient to outweigh them.

³ See Cheshire, Hilber and Kaplanis (2011) Evaluating the Effects of Planning Policies on the Retail Sector: Or do Town Centre First Policies Deliver the Goods?' for evidence on the impact of planning on retail productivity. <http://www.spatial-economics.ac.uk/textonly/SERC/publications/download/sercdp0066.pdf>. See chapter 6 of Glaeser (2011) 'Triumph of the City' for discussion about the effect of restrictions on development. A number of these issues were also addressed in the Barker Review.

⁴ Cheshire (2009) 'Urban Containment, Housing Affordability and Price Stability - Irreconcilable Goals', SERC policy paper 4 <http://www.spatial-economics.ac.uk/textonly/SERC/publications/download/sercpp004.pdf> provides further discussion on the link between planning and housing prices. See Leunig (2007) Not In My Back Yard for further discussion on whether NHB incentives will be enough to overcome objections to new housing (<http://www.centreforum.org/assets/pubs/in-my-back-yard.pdf>)

Local Government Finance⁵

The structure of local government finance provides a further barrier to development. Grant formulas are slow to respond to population changes, meaning that local authorities lose in the years following development. The problem is more severe for commercial development where local authorities incur costs that are never returned through changes to funding. The government is trying to address these issues through the New Homes Bonus, TIF, changes to business rates and a review of local government finance. It is unclear whether these changes will remove the fiscal disincentives – and the electoral disincentives remain large.

Education⁶

There is strong evidence that more skilled cities grow faster, so to be successful cities need to be able to attract or educate and retain skilled workers. The provision of housing and other amenities will affect the decisions of mobile skilled workers. The urban school system also influences educational mix (both directly and indirectly). Cities house a disproportionate share of poor families, placing considerable stress on urban school systems. As teachers get low real wages in cities this means the most challenging schools are often unable to employ the best teachers. To avoid these stresses, more mobile parents often move to non-urban areas where they can avoid mixed communities and schools. Of course, it may not necessarily matter if skilled people live outside cities but work in them, but the interplay between education and success raises crucial questions for cities.

Innovation⁷

Innovation – the successful exploitation of new ideas – is an important driver of cities' long term economic development. Conversely, evidence suggests urban environments enable innovative activity. Do cities need their own policies to boost private sector innovation? Those sceptical about the capacity to develop such policies advocate spatial neutrality and a focus on rewarding entrepreneurship and business success as the best means of encouraging innovation. This doesn't mean there are no questions to address regarding innovation policy and cities. For example, if innovation policy focuses on formal R&D it may not apply to much of the innovation in cities that occurs in services through process improvements (e.g. in retail), or investment in intangible assets such as design. In addition, other policies may be negatively affecting innovation in cities. For example, high rents limit proximity (which benefits innovation) and constrain entrepreneurs from starting new businesses.

⁵ Recognition of these problems is reflected in the government's decision to undertake the Local Government Resources Review.

⁶ On the link between education and economic performance, see the report from SERC on 'The Case for Agglomeration Economies, published as part of the Manchester Independent Economic Review' <http://www.manchester-review.org.uk/download/?id=685>. Glaeser (2011) 'Triumph of the City' provides further discussion (c.f. particularly chapter 1).

⁷ See Duranton, Martin, Mayer and Mayneris (2011) The Economics of Clusters for evidence and further references. These issues are also discussed further in The Case for Agglomeration Economies, published as part of the Manchester Independent Economic Review <http://www.manchester-review.org.uk/download/?id=685>.

Transport⁸

Growing cities need to invest in transport and to consider other ways to limit congestion, particularly through the introduction of charging. Unfortunately, in most cities, local referenda have been unable to deliver congestion charging. Political leaders tend to prefer light rail and trams over buses, despite evidence that the latter are more cost-effective. At national level the decision-making process often leads to the funding of high-visibility, high cost projects (the Humber Bridge, HS2) at the expense of within-city projects that have better expected benefit-cost ratios. All of this raises questions about the appropriate governance arrangements for transport policy.

Conclusions

Decentralisation from central to local government has the potential to help city leaders raise urban economic performance, and help their citizens improve economic wellbeing. Decentralisation also raises important questions for central government – which needs to set frameworks and incentives that will help cities drive future economic growth in the UK. We have identified six areas – planning, housing, local government finance, education, transport and innovation – where these issues will be crucial. SERC intends to provide further evidence on these six areas over the coming months.

⁸ See the 2006 Eddington report for further discussion on these issues.

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