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The Economic Impact of the British Planning and Fiscal System: Business Rates Devolution and other Policy Options

Christian Hilber
London School of Economics

19 September 2016



Overview

1. The key policy issue – some stylized facts
2. Features of the British system of land use planning (and taxation) and testable implications
3. Empirical evidence: Impact of planning constraints on house prices
4. Assessment of policies in light of existing institutional setting
 - a) Business rates reform
 - b) Other proposed policies
5. Conclusions

Overview

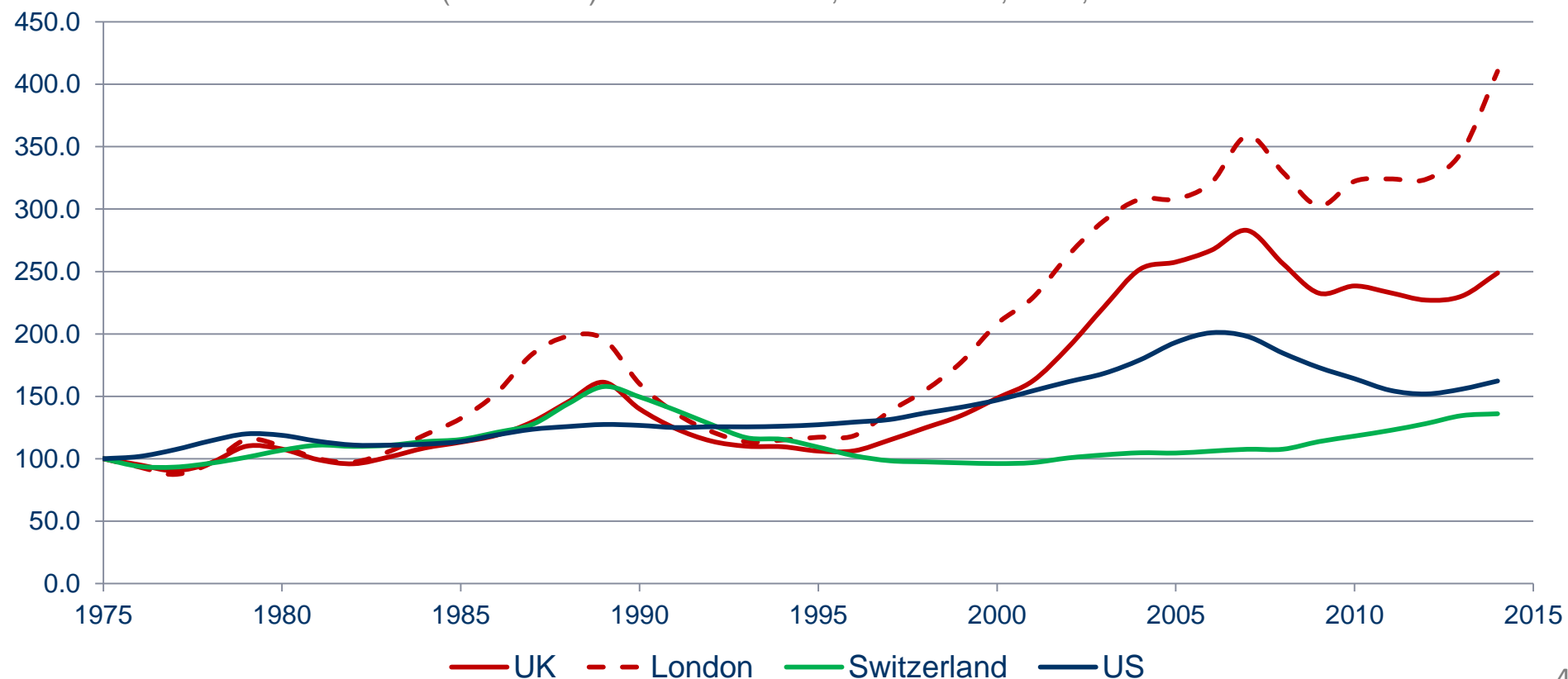
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Stylized fact 1

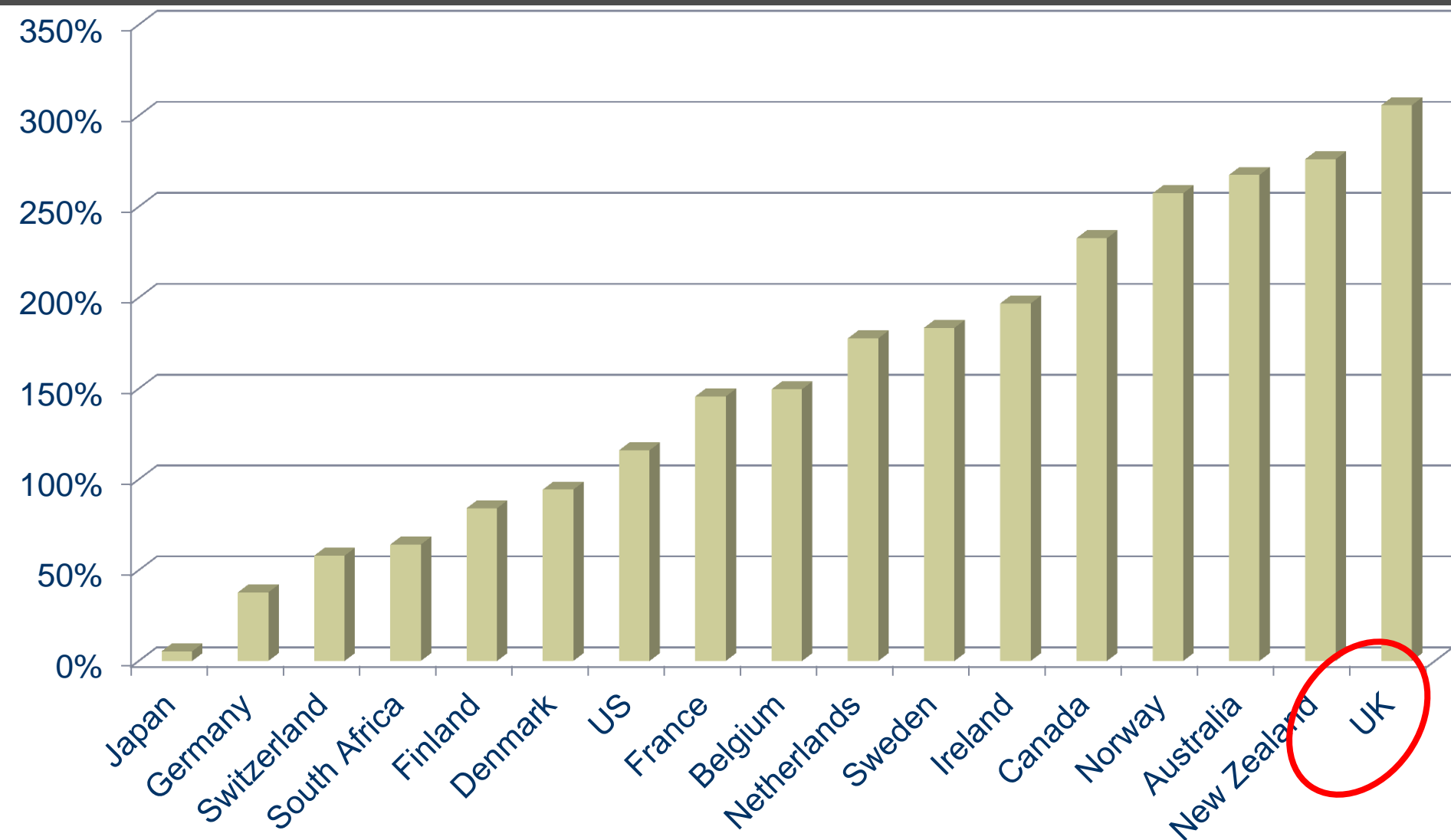
- Real HP growth in UK over last 40 years has been extraordinarily high by international standards...

Real house price growth in UK vs. US & Switzerland

Rebased (1975=100) – Sources: ONS, Nationwide, SNB, St Louis Fed



Accumulated real house price growth in % 1970 – 2015 for selected OECD countries



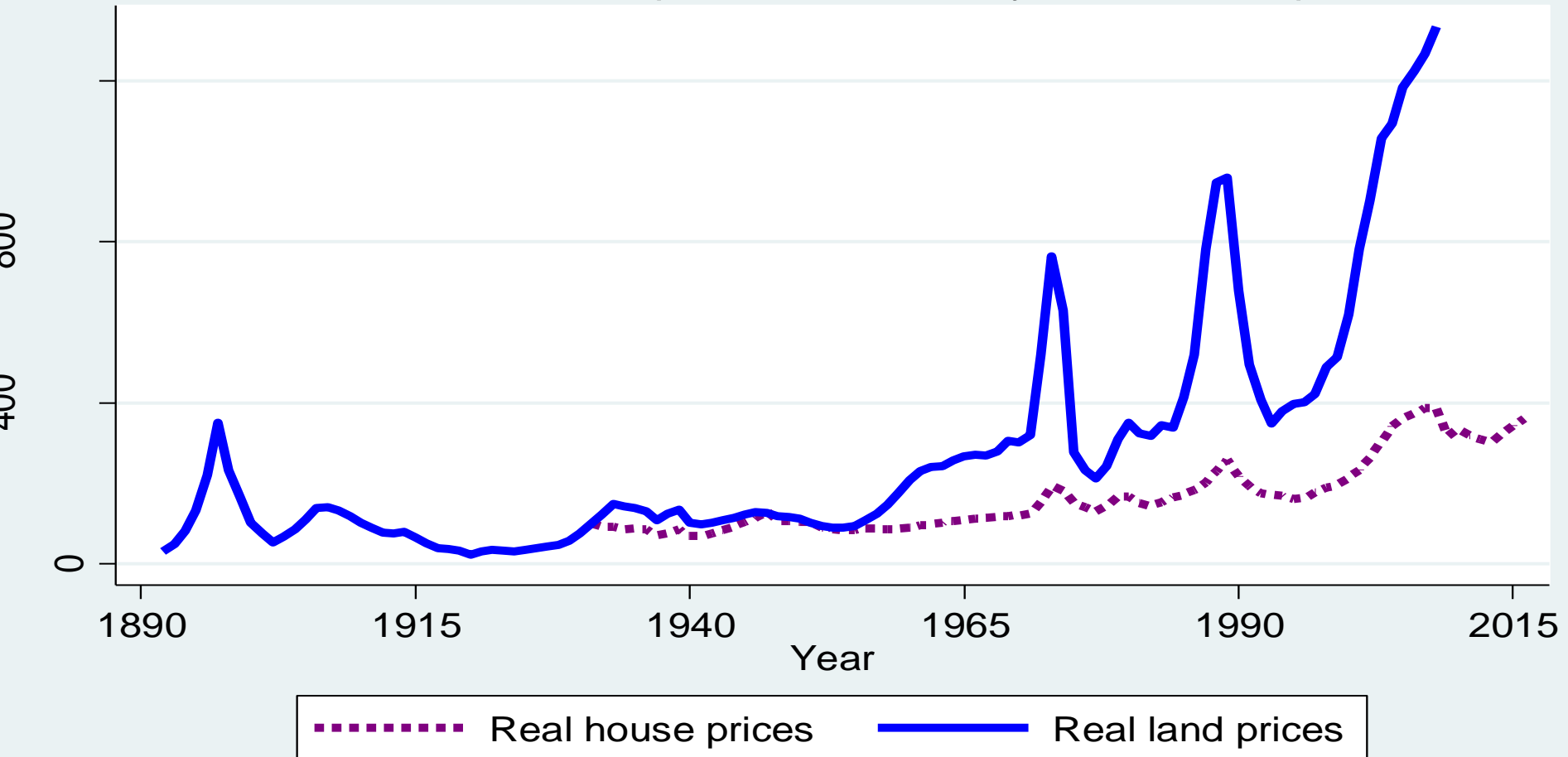
Sources: Bank for International Settlements (BIS), World Bank, Bank of England

Stylized fact 2

Volatility has increased in recent decades...

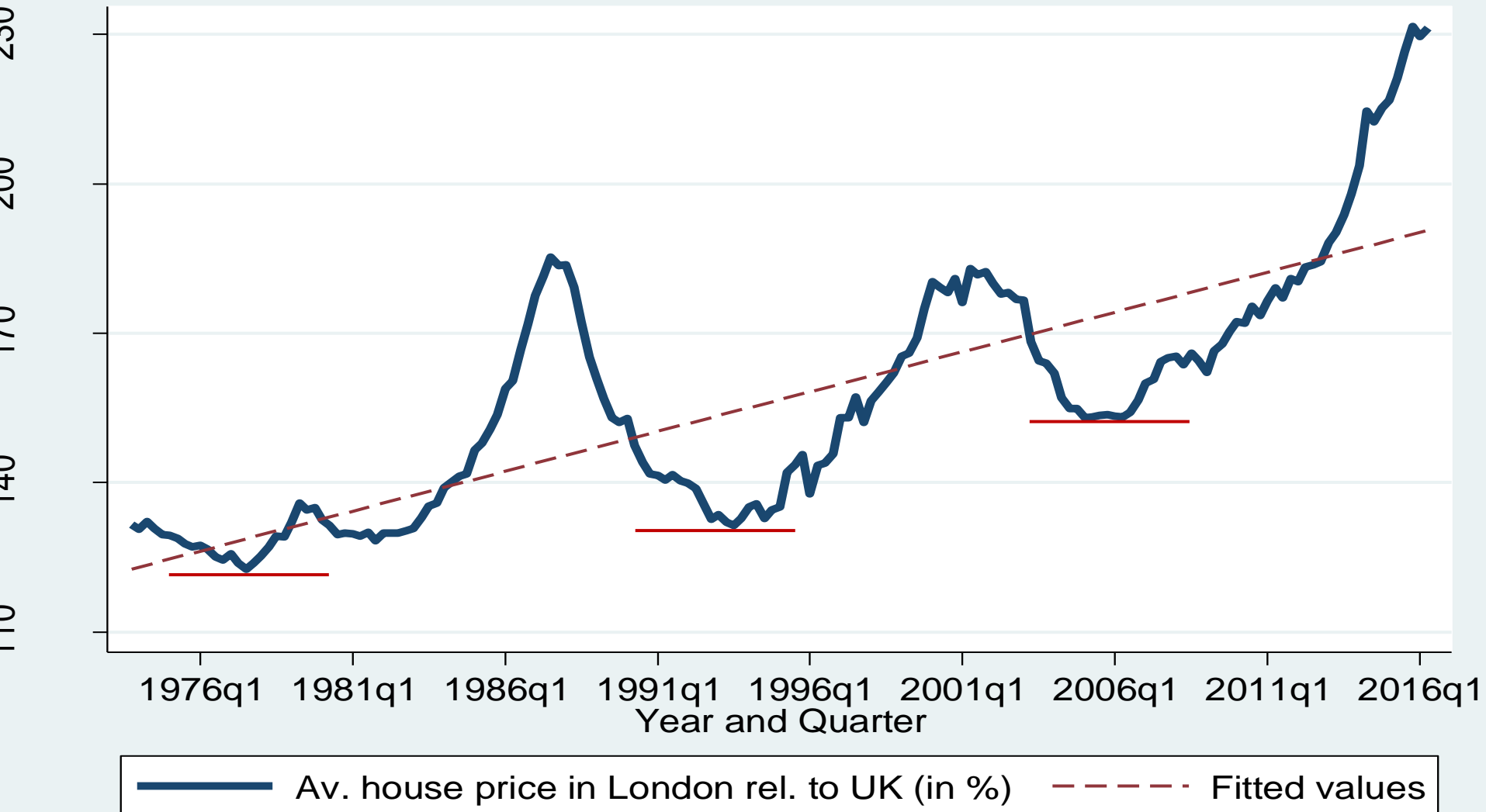
Real land and house price indices (1931=100)

Note: House and land price data for war years are interpolated



Source: Cheshire (2009) and own calculations for 2008 onwards / Land Registry & Nationwide

House prices in London increase more strongly and are more volatile (1973q4-2016q2)

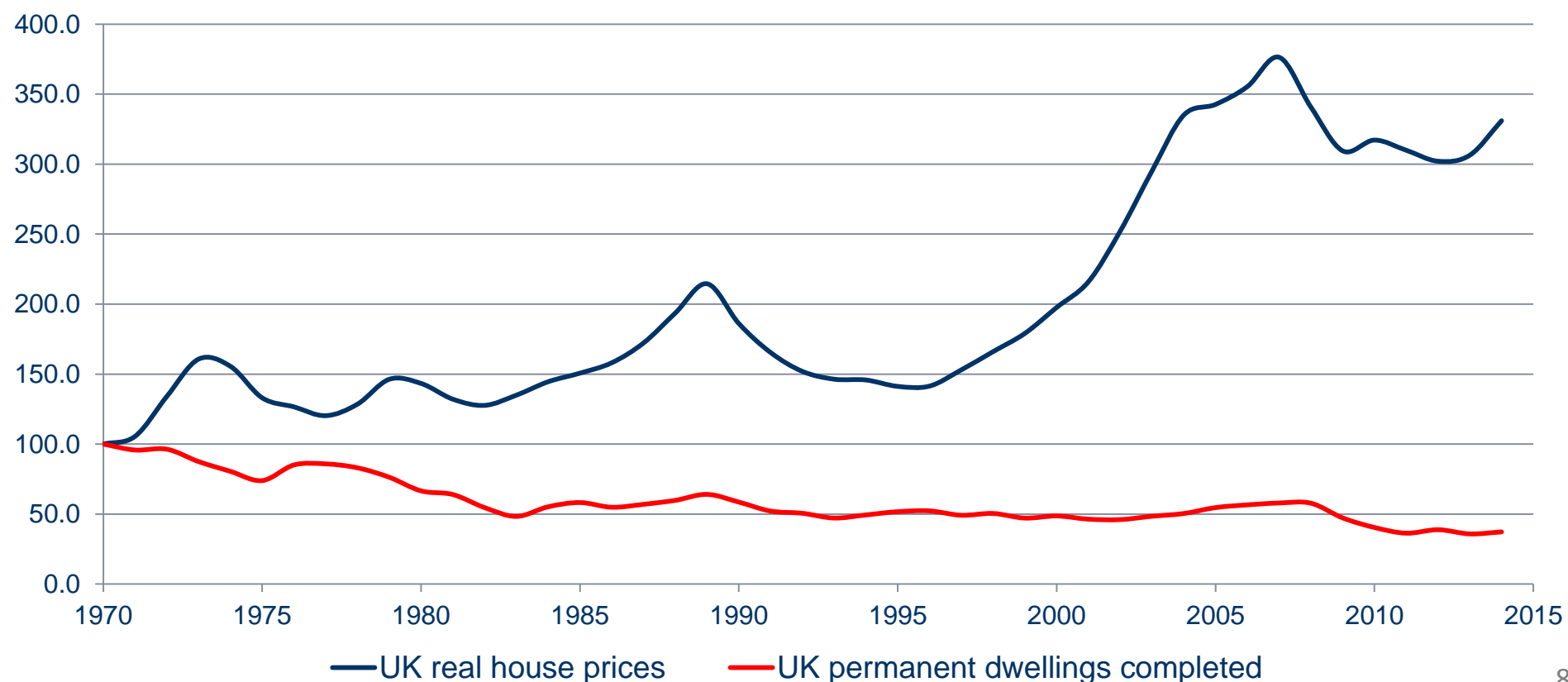


Source: Nationwide, own calculations

Stylized fact 3

- **Despite extraordinary price growth since 1970, construction has been in continuous decline...**

UK real house prices vs. UK permanent dwellings completed
Rebased (1970=100) – Source: ONS, DCLG



Stylized fact 4

- **There are not only fewer new-build homes but these are also extremely small by international standards**
 - ▶ A new-build house in UK is **38% smaller** than in densely populated Germany and...
 - ▶ **40% smaller** than in the even more densely populated Netherlands (Statistics Sweden 2005)
- **And houses are built in the wrong places: very little construction in the prosperous South**
 - ▶ Very little new housing in e.g. Oxford & Cambridge (compared to say Doncaster or Barnsley)

Derived research questions

- **What factors constrain housing supply** (and thereby cause the corresponding high level and volatility of prices)?
 - ▶ Might the **British system of land use planning** be a – or the main – culprit?

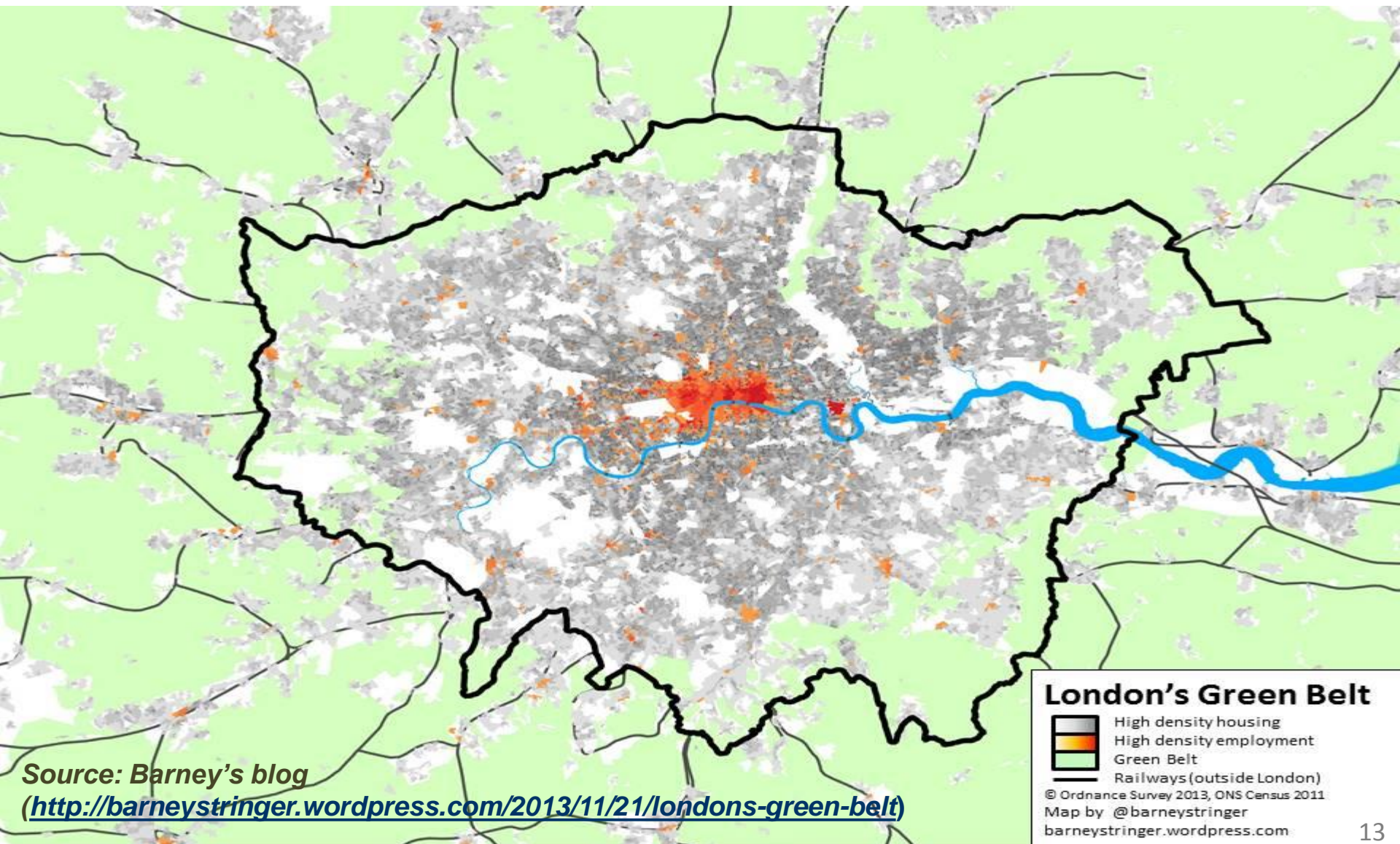
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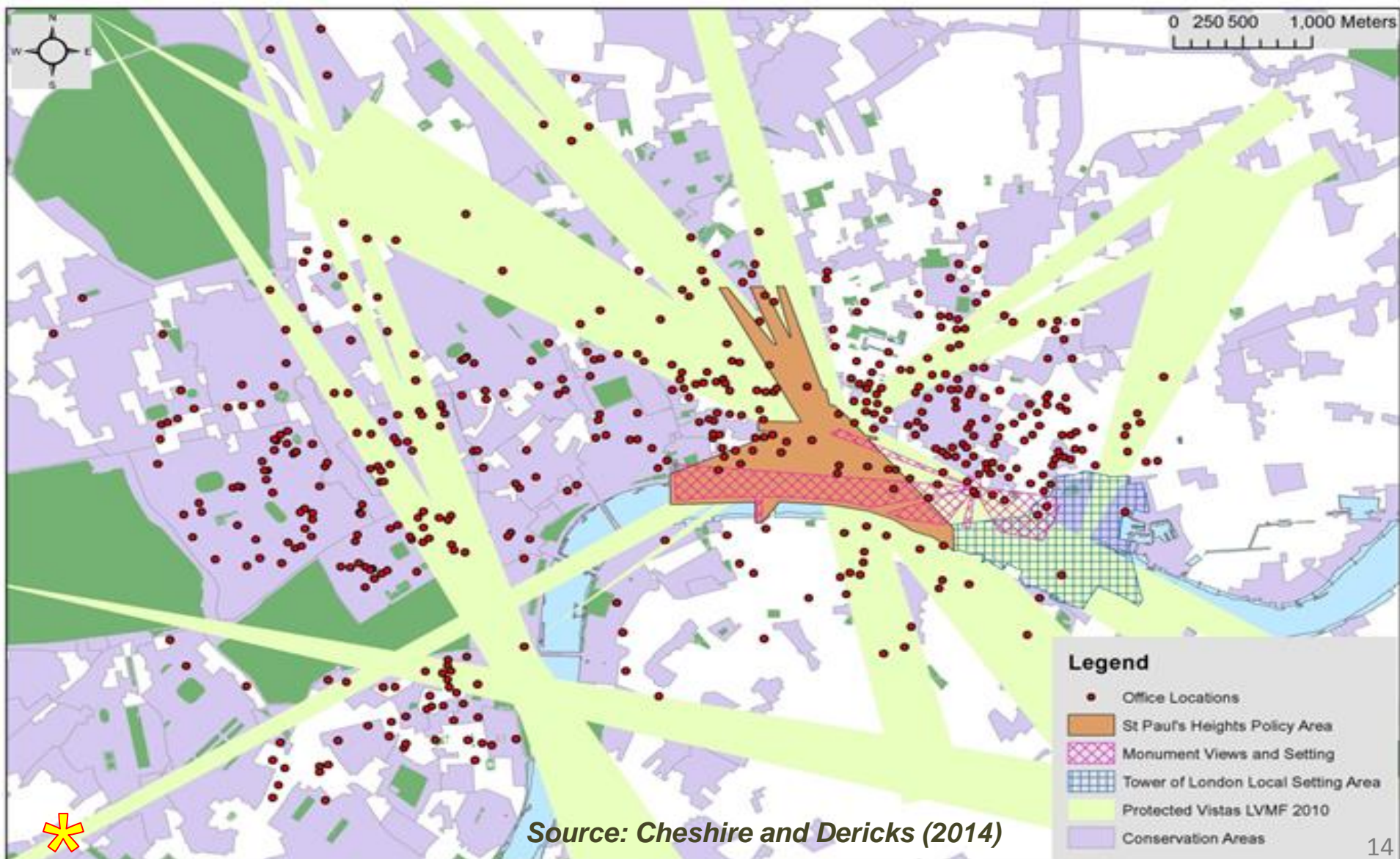
Some background: The British system of land use planning

- Today's planning system established in 1947 through **Town and Country Planning Act**
- Key features
 - ▶ Expropriated development rights of land owners
 - ▶ Designated 'use' classes, whereas any change of 'use' requires **development control permission** (granted at local level)
 - ▶ Aim is 'development control' or 'containment'

The London green belt



But not just green belt containment – many other planning constraints...



* Protected view from King Henry VIII's Mound (Richmond Park)—*created in 1710*



Backdrop:
Liverpool Street
Station area

Distance to...

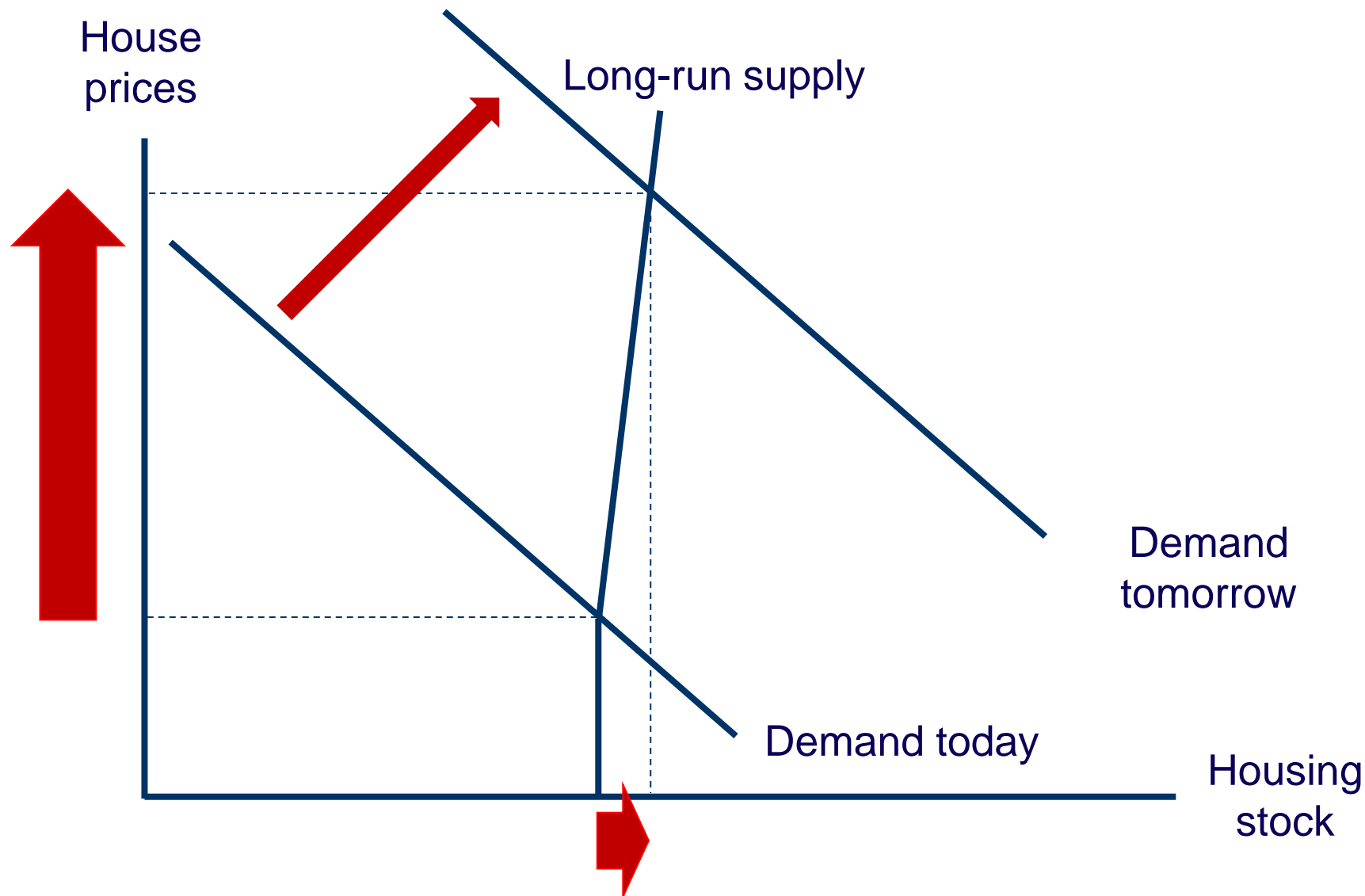
- Silicon roundabout: 850m
- BoE (City): 600m
- St. Paul's: 1km

16km

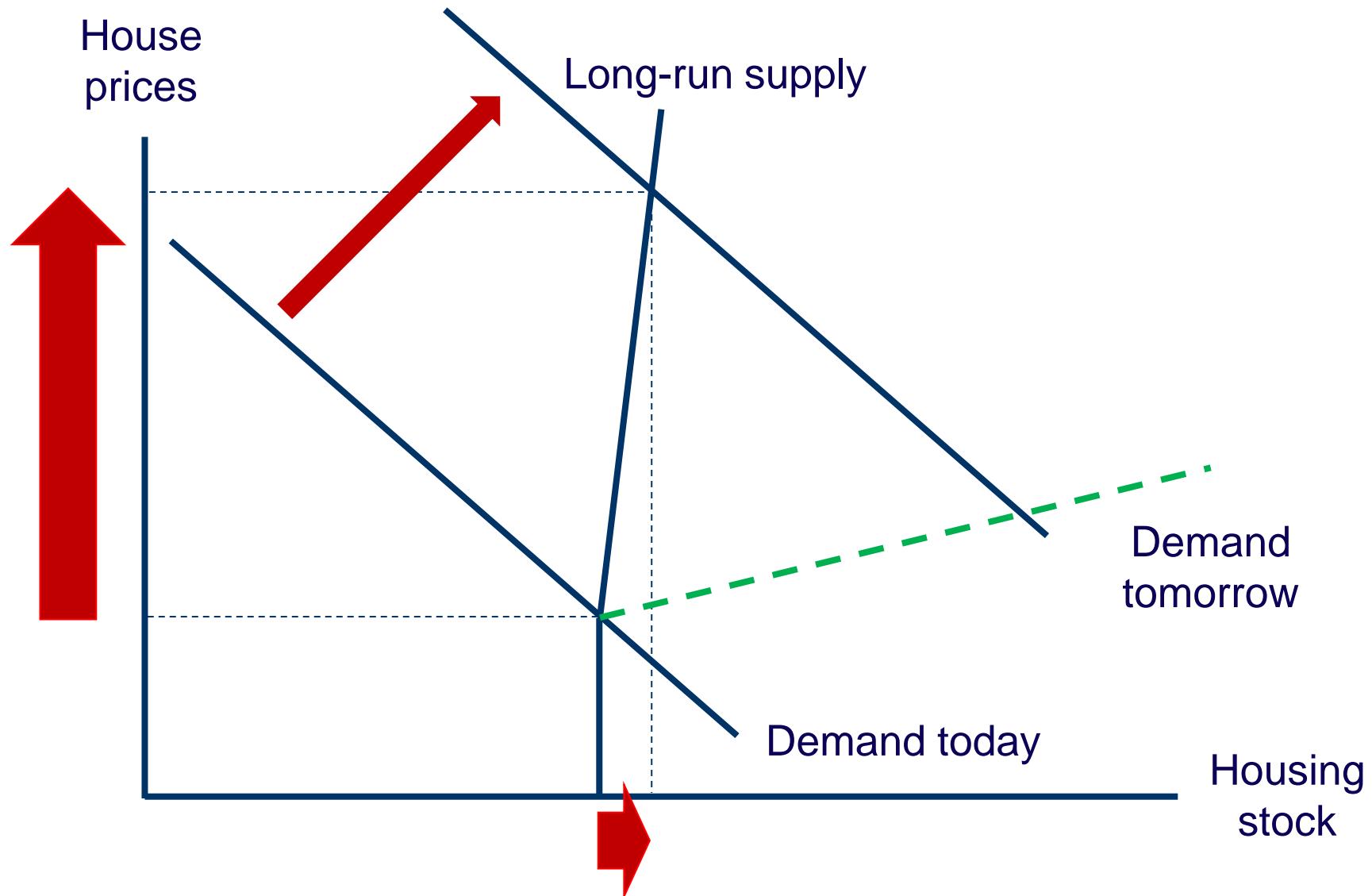
Who decides in UK?

- Local Planning Authorities (LPAs) grant or reject planning applications
 - ▶ Problem: Since 1947 **virtually no fiscal incentives** at local level to permit development (costs far exceed benefits)
 - ▶ Central **government grant equalisation system** in medium-term more or less eliminates any revenue gain for LPAs that permit more development
 - Underlying causes?
 - ▶ UK = highly centralized country, virtually no fiscal power at local level
 - ▶ Planning system tilts political power towards homeowners (NIMBYs)
- ⇒ Local long-run supply curve nearly vertical...

Theoretical prediction...



Theoretical prediction...



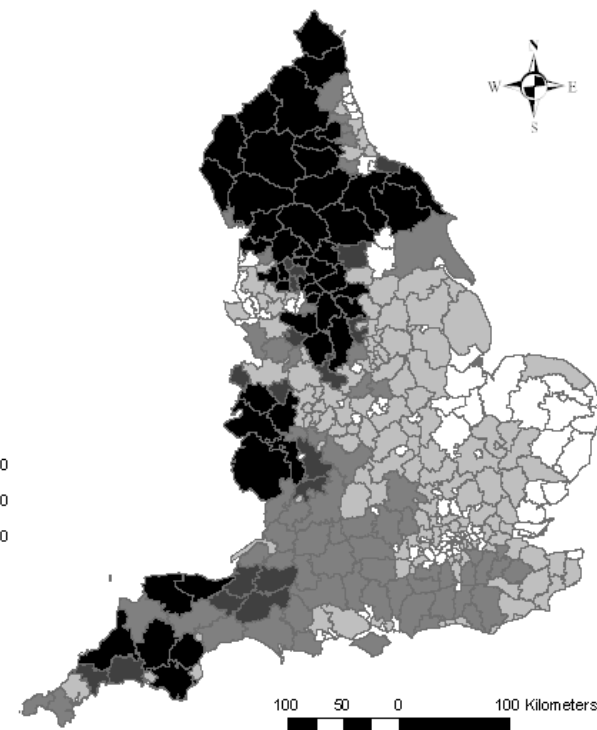
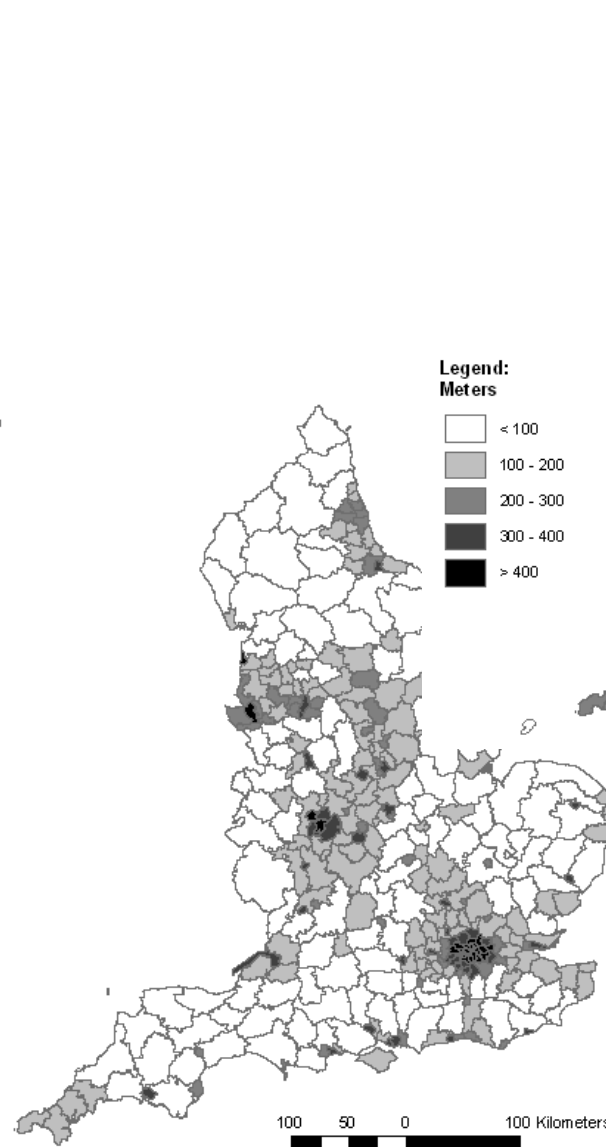
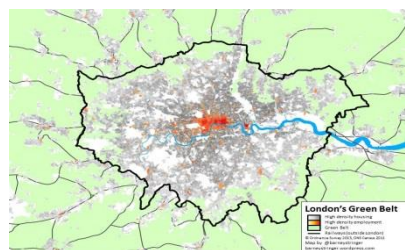
How to test?

- Hilber and Vermeulen (2016)
 - ▶ Exploit spatial variation in three different types of supply constraints: **regulatory, scarcity of developable land and topography**
 - ▶ Interact supply constraints with demand shifters (local earnings; labour demand shock)
 - ▶ Use instrumental variable technique to identify **causal effect** of local supply constraints measures on local house prices

Average refusal rate
(major residential
projects) 1979-2008

Share developable
land developed,
1990

Elevation range



Source: Hilber and Vermeulen (2016)

Main findings

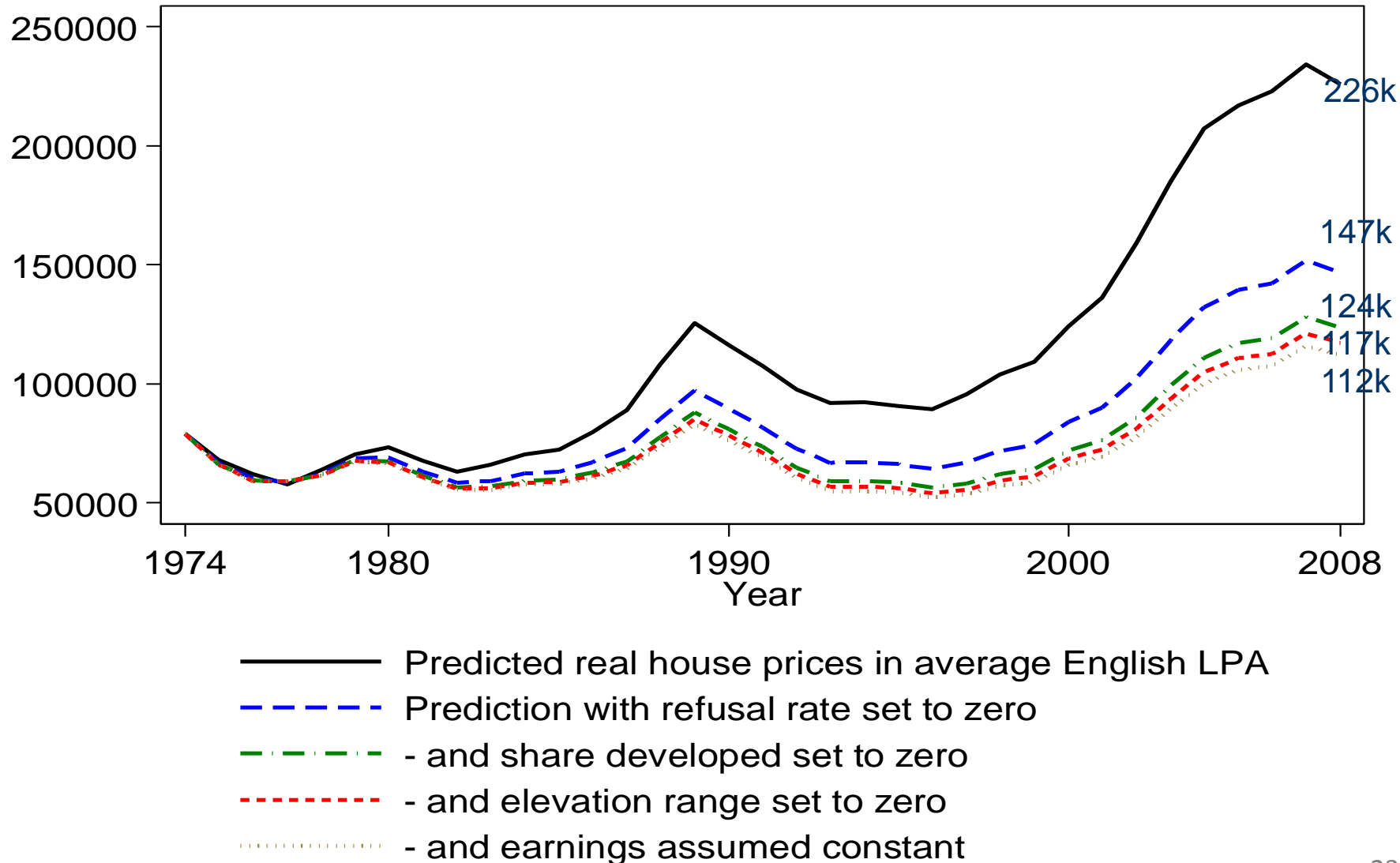
- **Tight local planning constraints** in parts of England (in conjunction with strong demand) are to a large extent responsible for extraordinarily high house prices
- **Local scarcity of developable land** matters but very non-linearly (only in most developed locations)
- **Topography** matters in statistical sense but very little in economic (quantitative) sense...

Quantitative effects (based on IV with *all* instruments)

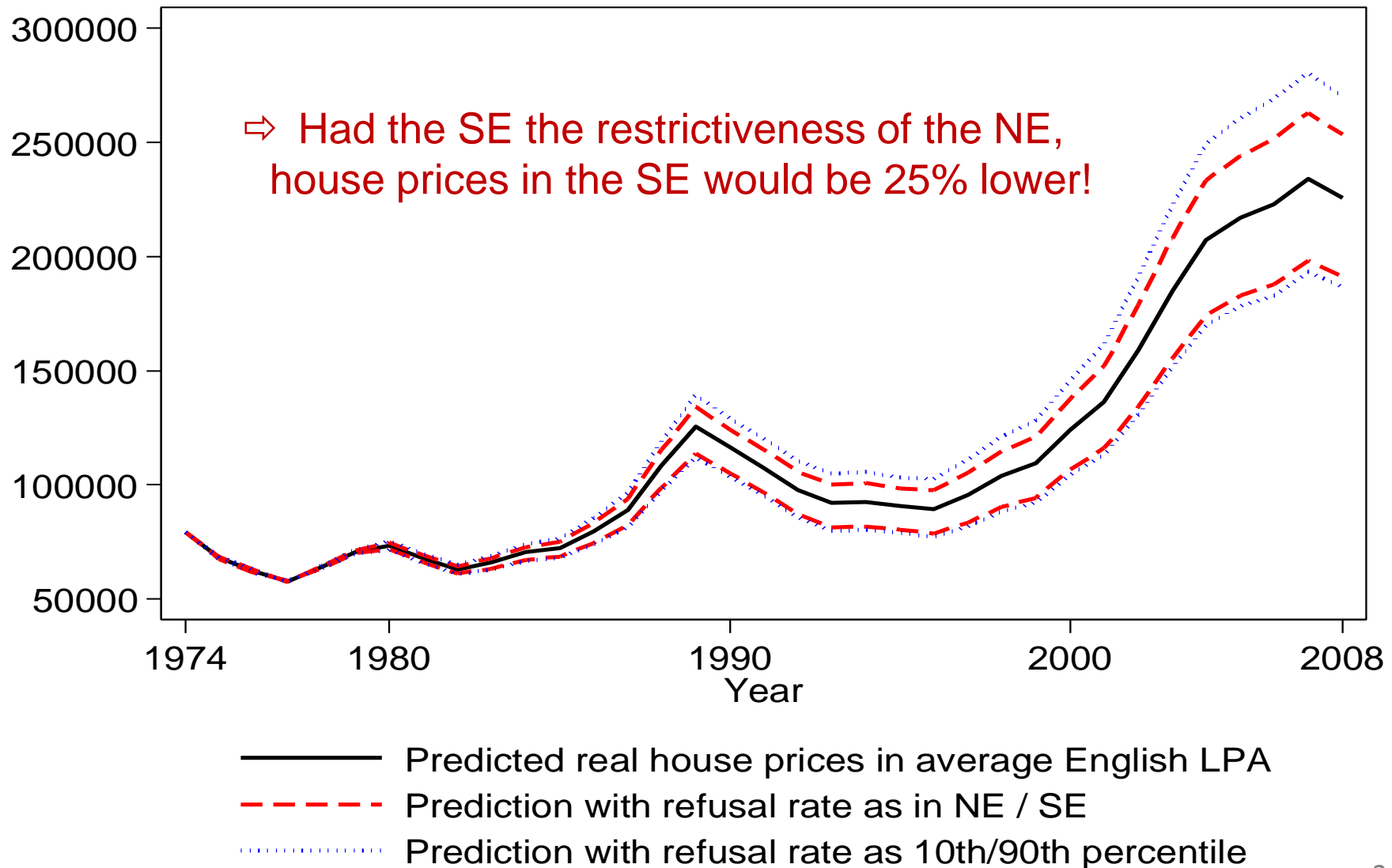
- If planning were completely relaxed in *average LPA*:
 - ▶ House prices in *average LPA*: -35%
- *and* developable land were abundant:
 - ▶ House prices in *average LPA*: -45% ($\Delta = -10\%$)
- *and* LPA were completely flat:
 - ▶ House prices in *average LPA*: -48% ($\Delta = -3\%$)

*Note: These are likely lower bound estimates for a number of reasons
(see Hilber and Vermeulen, 2016, for details)*

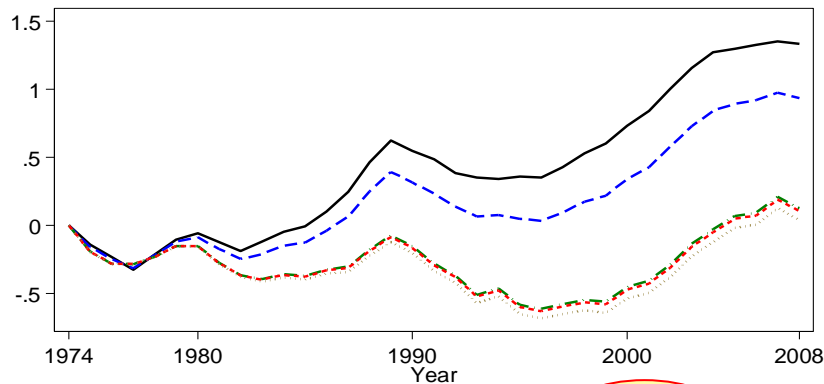
What would house prices in average English LPA be if...



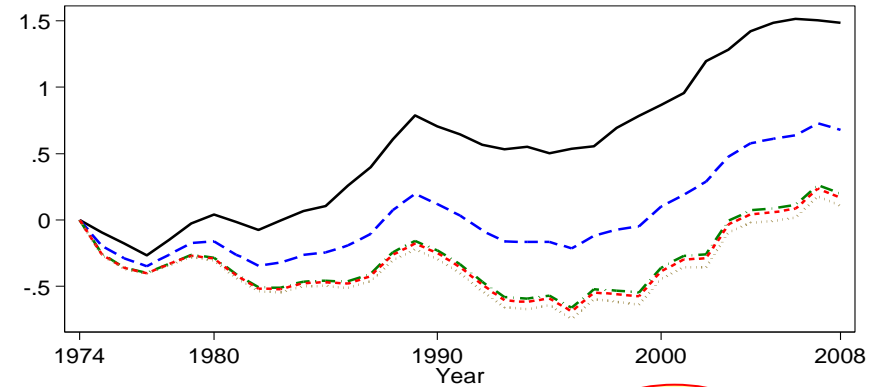
North East vs. South East & 90th vs. 10th percentile



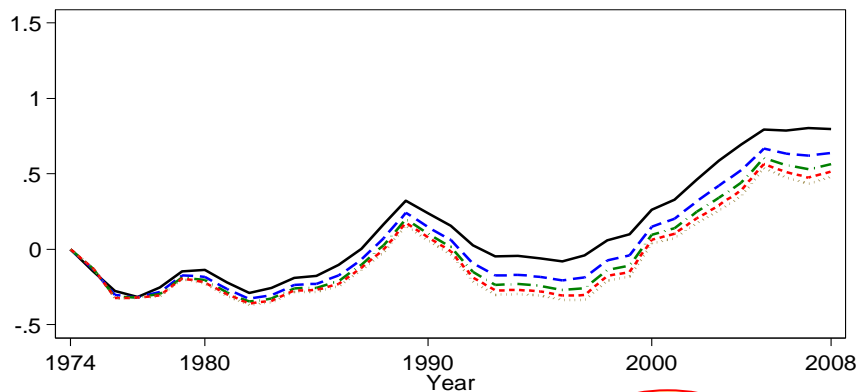
But large variation across locations...



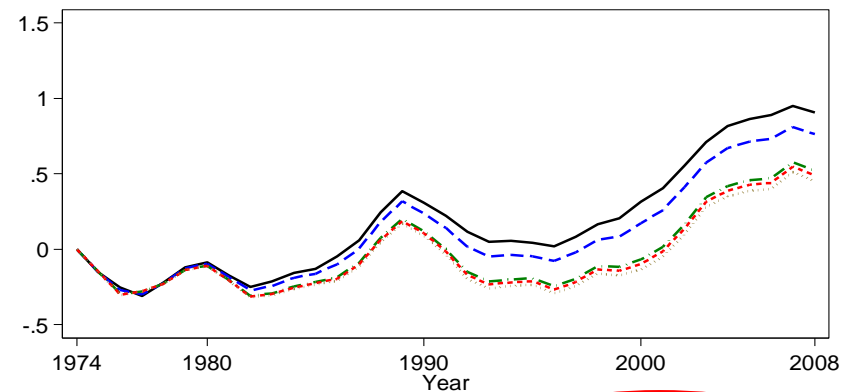
- Predicted log real house prices in Westminster
- - - Prediction with refusal rate set to zero
- . - and share developed set to zero
- . . and elevation range set to zero
- ... and earnings assumed constant



- Predicted log real house prices in Reading
- - - Prediction with refusal rate set to zero
- . - and share developed set to zero
- . . and elevation range set to zero
- ... and earnings assumed constant



- Predicted log real house prices in Darlington
- - - Prediction with refusal rate set to zero
- . - and share developed set to zero
- . . and elevation range set to zero
- ... and earnings assumed constant



- Predicted log real house prices in Newcastle upon Tyne
- - - Prediction with refusal rate set to zero
- . - and share developed set to zero
- . . and elevation range set to zero
- ... and earnings assumed constant

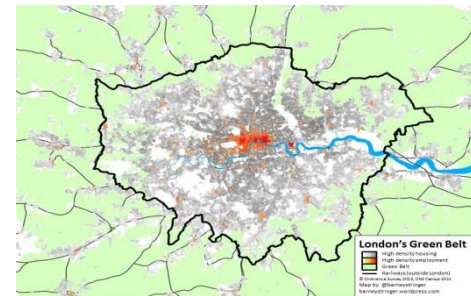
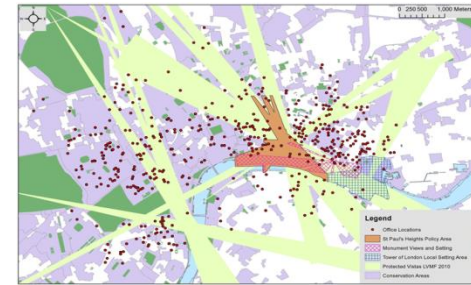
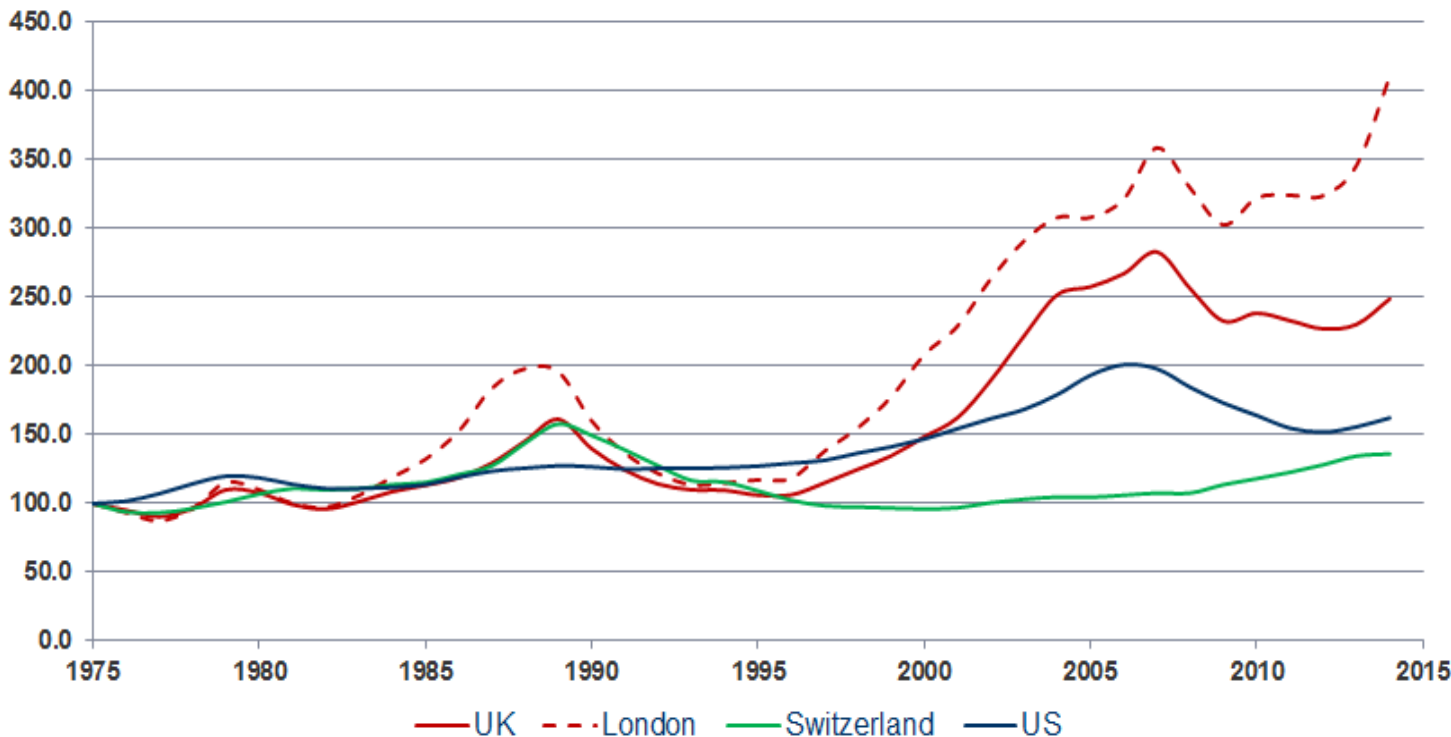
Preliminary conclusions:

There are two fundamental issues...

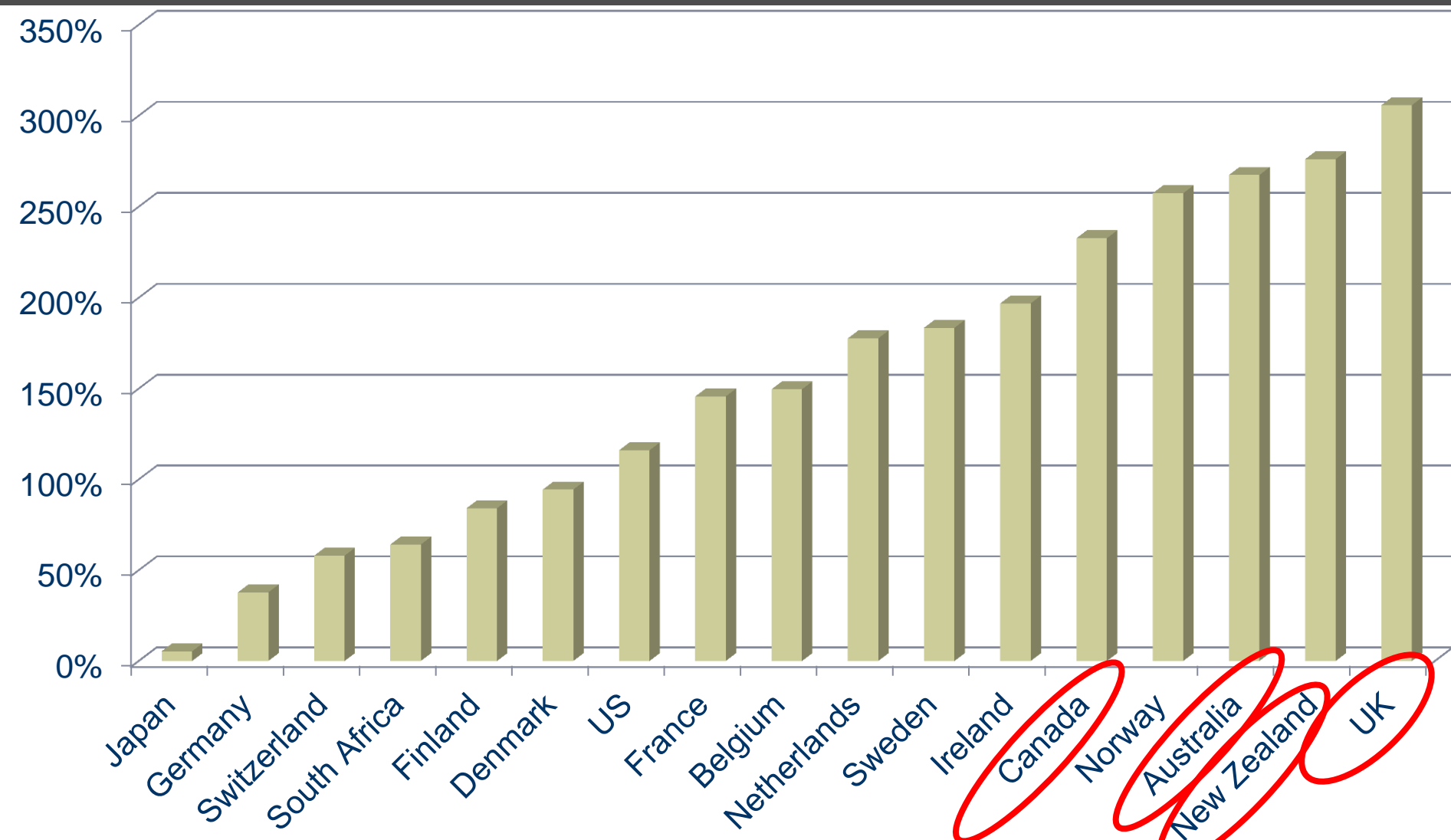
1. Planning system effectively assigns development rights to local policy makers, planners & NIMBYs
 - ▶ In contrast: In most other countries, development is rule based – if land is zoned as residential, presumption is in favour of development
 2. Lack of fiscal incentives to develop at local level
 - ▶ Discourages local authorities to permit development (most costs – little benefits!) – NIMBYism reinforces
 - ▶ Creates incentives to impose horizontal restrictions (Green Belt) and vertical ones (height restrictions etc.)
- ⇒ **1. + 2. jointly cause affordability crisis!**

The planning and tax system determine housing affordability

Real house price growth in UK vs. US & Switzerland
Rebased (1975=100) – Sources: ONS, Nationwide, SNB, St Louis Fed

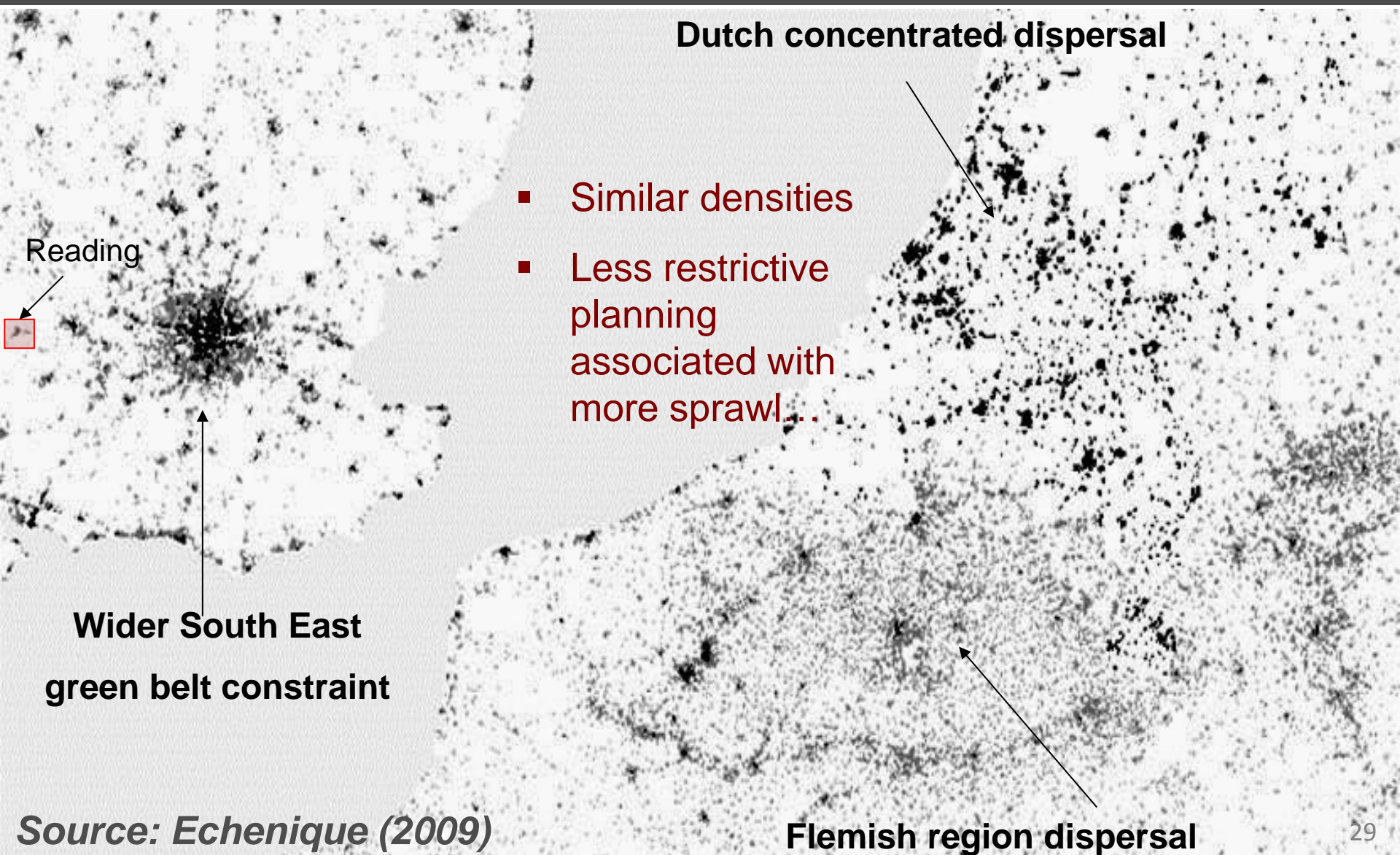


Accumulated real house price growth in % 1970 – 2015 for selected OECD countries



Sources: Bank for International Settlements (BIS), World Bank, Bank of England

...And urban form



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Business rates reform

- Idea
 - ▶ Devolve fiscal power to tax businesses to Local Authorities
 - ▶ Aim: Boost enterprise and economic activity
- Proposal
 - ▶ By 2020 LAs retain 100% of revenue from business rates (~£26 billion) replacing current retention scheme
 - ▶ Replaces core grant funding for LA services

Key concern

- If LAs can indeed keep all revenue this should provide more incentives to permit commercial development on brownfield land, **great but...**
- **Problem:** May divert brownfield land away from housing (substitution effect) so probably **even less new housing, reinforcing affordability problem!**
- (If central government grants were to offset business rate revenue, then no effect at all)

Empirical evidence

- Cheshire and Hilber **for UK (2008)**
 - ▶ (Reverse) Reform of business rates in April 1990: creation of **Uniform Business Rate** (except for City of London)
 - ▶ Reform generated strong fiscal **disincentive** for LAs (except City of London) to permit commercial development
 - ▶ Created huge “Regulatory Tax” making British office space (some of the) dearest in world

	<u>Average 1990-2005 in % of MCC</u>
■ London West End	809%
■ City of London	488%
■ <u>Canary Wharf</u>	<u>327%</u>
■ Paris La Defence	167%
■ Brussels	68%
■ NYC	0-50%

Empirical evidence (cont.)

- Quigley and Raphael (2005) **for California**
 - ▶ Jurisdictions in California can benefit from sales tax revenues, whereas property taxes are limited to 1 percent of the transaction price
 - ▶ California's tax policies created fiscal disincentives to build new housing in favor of expensive retail buildings!
- Various other studies with similar findings
 - ▶ Burnes *et al.* (2012) for Florida
 - ▶ Jacob and McMillen (2015) for Chicago

Other problems

- Which public services are funded with local business rates?
 - ▶ Can't be social welfare (redistribution)
 - ▶ Not education or police
 - ▶ Public infrastructure (transport, electricity, gas, water, broadband)? Garbage collection?
 - ▶ How to ensure revenue and spending are congruent?
- Further incentive-issues
 - ▶ LAs may focus spending on services that attract businesses rather than residents
 - ▶ LAs may try to outsource new housing developments to neighbouring LAs (free-riding), increasing commute distances

Other proposed policies

1. Housing construction targets
2. Help-to-Buy and other demand subsidies
3. Increase in stamp duty on buy-to-let properties & second homes (Autumn Statement)
4. Limit on increase of rents for social tenants (Chancellor announcement)
5. Allowing local authorities to build starter homes on Green Belt (DCLG consultation document)
6. Expansion of Right-to-Buy (Autumn Statement)

1. Housing construction targets

- **Idea:** Announce housing construction targets to encourage development
- **Problem:** Targets alone neither tilt development rights in favour of development nor do they provide fiscal incentives

⇒ **Expected effect: Nil!**

⇒ **Evidence:** Construction in decline since 1970 despite ever increasing targets by all parties and consecutive governments of different colours

2. Help-to-Buy & other subsidies to homebuyers

- **Idea:** Subsidise demand for owner-occupied housing
- **Problem:** Local supply extremely price inelastic, in particular in London & South East
- ⇒ **Expected effect:** Policy raises prices but does not spur development
- ⇒ **Evidence:**
 - ▶ House prices in London rose by 25.8% b/w 2013Q2 and 2014Q4 & there was no housing construction boom!
 - ▶ Evidence from US: In tightly regulated cities demand subsidies are counterproductive (Hilber & Turner 2014)

3. Increase in stamp duty on buy-to-let properties & second homes

- **Idea:** Discourage buy-to-let & second homes
- ⇒ **Expected effects:** Makes buy-to-let and second homes less attractive compared to owner-occupation
 - ▶ **Buy-to-let:** Increase in stamp duty will reduce supply of private rental homes ⇒ Increase in private rents & possibly slight reduction in price of owner-occupied homes
 - ▶ **Second homes:** Might increase supply of primary homes in short-run and slightly reduce house prices (good!) but may provide even fewer incentives to add new housing (bad!)
- **Overall:** Likely zero sum; private rental will become less affordable and owner-occupied housing slightly more affordable

4. Limit on increase of rents for social tenants

- **Idea:** Make social housing more affordable by limiting social rent increase (to e.g. 1% p.a.)
- **Problem:** Reduces book value of social rented housing stock ⇒ reduces ability of housing associations to finance additional social housing development
- ⇒ **Expected effects:** Less new social housing ⇒ few lucky social tenants but even greater affordability crisis for all other young and low income households

5. Allowing local authorities to build starter homes on Green Belt

- **Idea:** Relax (somewhat) constraints to build starter homes at edge of green belts & on brown-field land within green belts

⇒ **Expected effects:**

- ▶ Tiny fraction of green belt is brownfield
 - ▶ Only possible if local authority wants it!
- **Problem:** Local authorities still have no fiscal incentives to develop, especially not in green belt, so at best ‘a drop on a hot stone’.
 - ▶ **But** does send signal that low-amenity-value land in green belts *may no longer be sacrosanct*!

6. Expansion of Right-to-Buy

- **Idea:** Expand RTB to housing association tenants

⇒ **Expected effects:**

- ▶ Incentivises owner-occupation – *may or may not be welfare increasing*
- ▶ But in any case: at huge cost to taxpayer because housing associations must be compensated for losses
- ▶ **IF** they are not: Policy will endanger ability of associations to finance new homes, *so may reduce new construction*
- ▶ Also creates more ‘homevoter’ NIMBYs, which in turn *may further reduce new housing construction!*

Conclusions

- Planning serves important purpose - in principle it can improve welfare through correcting market failure such as externalities and public goods
- But British planning and tax systems have serious “design flaws”:
 - ▶ ‘Development control’ blindly favours containment and generates great degree of uncertainty
 - ▶ Lack of local fiscal incentives reinforces problem
- Existing and proposed policies do not tackle these flaws – policies are, at best, ineffective but often counterproductive

So what ought policy makers do?

Some guiding principles...

- Radical reforms needed that simultaneously address flaws of **planning and tax system**
- Planning system ought to...
 1. **Focus on correcting market failures:** Designate parks, areas of natural beauty, historic buildings etc. that are off hands from (re-)development *and*
 2. **Change to rule based zoning system:** Introduce presumption in favour of development in areas that are not protected

So what ought policy makers do?

Some guiding principles...

- Tax system ought to...
 1. **Align fiscal incentives to develop:** Local residents & neighbours who bear costs also ought to be able to reap benefits
 2. **Move** away from stamp duty & demand subsidies **towards impact fees** (reflecting marginal social costs) and **genuine local property tax or LVT**
 3. **Consider** permitting **private compensation payments**

Q & A

Thank you!

*Presentation with references & hyperlinks
will be downloadable from:*

<http://personal.lse.ac.uk/hilber/>

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