Spatial Economics Research Centre

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The law of unintended consequences: business rate retention and house prices

Posted by Dr Christian Hilber, LSE and SERC

Most analysis of Monday's local government finance proposals has focused on the shiny new stuff – retained business rates and Tax Increment Financing (TIF) – and the winners and losers reform might create. That's not surprising. But it's also not the whole story. Changes to business rates are also likely to affect local house prices – in ways that are actively unhelpful for Ministers' housebuilding agenda.

Imagine a country where local government gets most of its funding from central government. There are two local areas, A and B, which are identical ar receive the same amount of money. Now imagine that for some reason Ministers decide to double A's cash. A can either improve local service quality, invest in infrastructure, or decrease local taxes. In each case, A becomes more desirable than B and demand for housing rises. If there are planning constraints, house prices in A go up.

SERC colleagues and I test this empirically for England, using council grant data for 2001 – 2008. (Our paper's just been published here.) We exploit t fact that grant settlements sometimes change for reasons other than local need. We find that changes in grants are largely capitalised into local house price changes.

To see what business rate retention might do, repeat the thought experiment with a couple of changes. Ministers are essentially gifting some local area with more money by allowing them to retain the local business tax take. Even if no local authority is directly worse off from this change – as Nick Clegg has promised – some areas will be better off than others.

For better-off councils, that translates into better services or lower taxes. That makes the winners more attractive places to live in – putting upward pressure on house prices and rents.

In turn, that creates further winners and losers. In 'winning' areas local property owners (homeowners and landlords) are better off as the value of their assets rises. Renters enjoy better local services and/or lower local taxes but they will have to pay for these via higher rents. Overall, therefore, there is effect on renters – unless, as seems likely, many are frustrated would-be homeowners. Immobile would-be-homeowners are likely the main losers amc the group of current renters. For renters with an attachment to their place of residence, owner-occupation becomes even less affordable. Also, some immobile renters may not value the improved services but they may still need to pay for them via increased rents. Other losers will be the property owners in the 'losing' areas as the value of their assets will decline.

In theory, developers should step in to build more houses in the 'winning areas'. But there are obvious reasons for local homeowners to resist new development – not least since the value of their homes partly depends on relative scarcity. The political power of NIMBYs and BANANAs on local councils can be very strong.

To sum up – localising business rates creates an incentive for local authorities to approve commercial developments. This is desirable in itself. But it al produces a disincentive effect on residential development, via house price shifts.

So the interaction with planning rules and incentives is crucial. The last government's reliance on top-down targets was ineffectual in increasing housin supply. However, the Coalition's New Homes Bonus also seems too weak to generate any significant positive effects on the supply side.

So while there are many reasons to cheer moves to give councils more financial freedom, the unintended consequences could make the UK's housing supply shortage even worse. This Autumn's Local Government Finance Bill needs to make sure business rate reform and TIF properly joins up with th wider package of growth incentives. Doubling or even tripling the size of the New Homes Bonus and making it permanent, as the Centre for Cities recommends, would be one helpful step.

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