Bridging the infrastructure gap

Financing infrastructure investment to unlock housing

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Centre for Progressive Capitalism

dynamic markets, inclusive societies

Contents

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The small quantity of land therefore which is brought to market and the high price of what is brought thither prevents a greater number of capitals from being employed

Adam Smith, The Wealth of Nations

Executive summary

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Infrastructure is a key element of the enabling environment to increase economic growth. Access to infrastructure such as energy and transport greatly influences the productivity of private investment and an economy's competitiveness. Moreover, physical infrastructure plays a central role in fulfilling the ambitions of citizens including the ability to live in an affordable, good quality home that is reasonably close to their place of work.

However, the UK's infrastructure investment record is poor. Investment levels have been consistently lower than those recommended by the OECD, and crucially with far lower rates of housebuilding compared to similar economies. This is in spite of the fact that there remains huge pent up demand and need for housing in the UK.

The recent foundation of the National Infrastructure Commission is a welcome step to reverse these chronic levels of underinvestment. It also signals a much needed shift in the political consensus for the state to intervene in order to drive investment in our physical infrastructure. However, a key issue remains as to how new infrastructure investment, particularly for transport, is to be funded? This is critical as new infrastructure unlocks more land for residential housebuilding.

One approach that is widely used to fund infrastructure investment in many other European and Asian countries is land value capture. This is where land is acquired by a public authority at values close to existing (typically industrial or agricultural) use value. The resulting uplift in land values due to infrastructure investment is then captured by the public authority by either: selling houses directly after contracting with construction firms, selling the land at residential use value to construction firms, or generating rental income from tenants. Critically, it is the ability of the public authority to capture the uplift in land values that permits the initial infrastructure investment to be financed.

In England and Wales, this approach is largely precluded as landowners are guaranteed the uplift in land values as set out in the 1961 Land Compensation Act. This means that there is less financing around for large-scale infrastructure investment to open up new areas for housing. Moreover, the ability of a small number of landowners to generate windfall profits from the productive work of others is undermining the legitimacy of our economic system. Recent polling by Populus for the Centre for Progressive Capitalism suggests that the majority of Britons believe that the economic system is set up mainly to reward the wealthier sections of society. This is clearly not a sustainable path.

The Land Compensation Act should be reformed so that land, designated in a strategic plan for transportation and housing by a combined authority, would not take account of any prospective planning permission with regards to compensation. This would permit combined authorities to capture the uplift in land values from public infrastructure investment instead of landowners.

Besides opening up land for housing, there are also four economic arguments for amending the 1961 Land Compensation Act. It would:

- **Free up £172bn over the next 20 years for increased capital expenditure on infrastructure:** This is the result of capturing an incremental annualised uplift of £8.6bn which is currently being channelled to landowners. This would increase the viability of many new large-scale housing projects.

- **Open up opportunities for smaller housebuilders and generate up to 77,000 jobs:** This could potentially lead to a fourfold increase from 3,000 housebuilders in the UK to levels last seen in 1990 of around 12,000. As well as adding jobs, the increased levels of infrastructure investment of £8.6bn per year could add £16bn in output each year to the UK economy.

- **Shift investment patterns away from existing assets towards productive assets:** The effect of eliminating profits from rising land and house prices would lead to an increase in output and productivity growth, driving up real incomes for a wider section of society.

- **Alleviate pressure on the housing benefit bill:** Spending 1.4 per cent of GDP on housing benefit is incredibly wasteful when comparative data implies that a well-functioning housing market requires housing subsidies in the region of 0.4 per cent of GDP.

In addition to ensuring that public authorities are able to capture the uplift in land values from new infrastructure projects, public policy should ensure that business rates and council tax are also capturing the benefits from public investment. This will require business rates to be based on more regular valuations, for property valuations to exclude plant and machinery, and for the tax to be applied to vacant land.

Council tax should move towards a flat tax on the value of houses to end the regressive nature of the current system. Combined authorities should also have greater control of the tax devolved to them. Moreover, the incentive structures within government need to be altered with those responsible for housebuilding also having some responsibility for housing benefit.

All major political parties have shown an increasing appetite for reform on this critical issue. Britain urgently needs to shift towards a higher investment, higher productivity economy. To do this will require the public sector to lead by example. A jump in infrastructure spending will not only help increase the new supply of housing, but it will also support greater productivity growth, driving up real incomes for all of society.

Chapter 1: The UK's infrastructure deficit

The central importance of transport and housing

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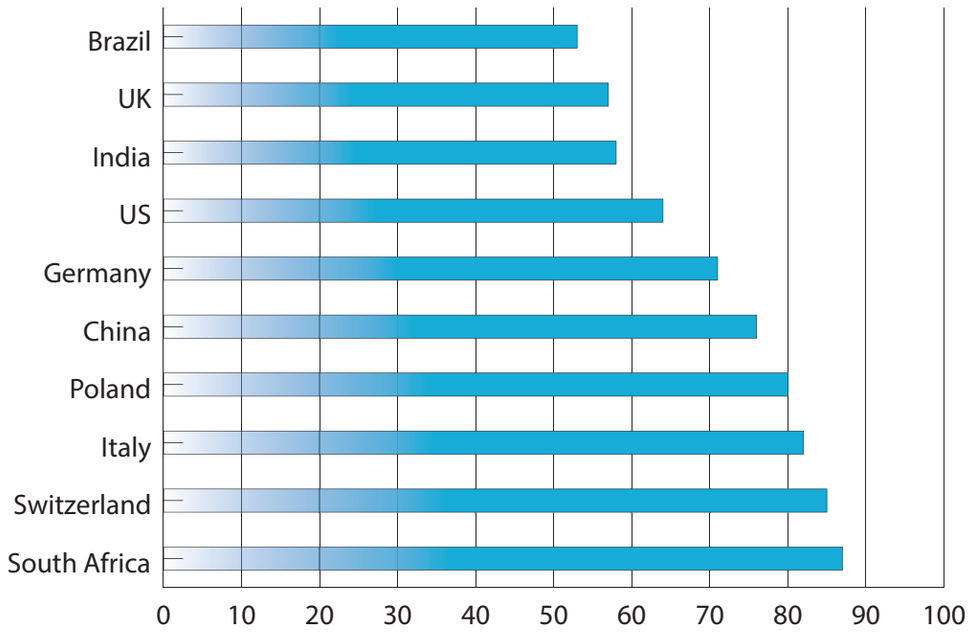
Infrastructure is a key element of the enabling environment to increase economic growth.[1] Access to infrastructure such as energy and transport greatly influences the productivity of private investment and an economy's competitiveness. According to the ratings agency Standard & Poors, infrastructure investment in the UK generates a multiplier of 1.9 for the wider economy.[2] So for every £1bn spent, it generates almost £2bn in output. Furthermore, the jobs multiplier effect for infrastructure projects is just over three jobs for every infrastructure job created.[3] The physical infrastructure also plays a central role in the fulfilment of the ambitions of a country's citizens including their ability to live in a good quality home that is affordable and within reasonable commute of their place of work.

Lack of competitiveness due to low investment

The UK's infrastructure has for generations lagged behind its peers. A study by the management consultancy firm McKinsey estimated that the UK's total infrastructure stock was only 57 per cent of GDP compared to 71 per cent in Germany.

Chart 1.1: Total infrastructure stock as a proportion of GDP, 2013[4]



This infrastructure deficit is also undermining the economic competitiveness of the UK. The World Economic Forum's Global Competiveness Report ranked the UK 24th out of 148 countries for quality of overall infrastructure.

1. See for example: World Bank Group (2014), Strong, Sustainable and Balanced Growth: Enhancing the Impact of Infrastructure Investment on Growth and Employment: Background note for the G20 prepared by Staff of the World Bank Group

2. Global Infrastructure Investment: Timing Is Everything (And Now Is The Time) Standard & Poors 2015

3. Civil Engineering Contractors Association (2013), Securing our economy: The case for infrastructure

4. Mckinsey (2013), Infrastructure productivity: How to save $1 trillion a year

Table 1.1: World Economic Forum's global rankings for quality of overall infrastructure, 2015-16[5]

Country	Ranking for quality of overall infrastructure
Switzerland	1
United Arab Emirates	2
Hong Kong SAR	3
Singapore	4
Netherlands	5
Finland	6
Japan	7
Austria	8
Iceland	9
France	10
Germany	11
United States	13
United Kingdom	24

According to the Civil Engineering Contractors Association, this lack of investment in infrastructure is costing the UK around £78bn per year in lost output.[6] In the CBI's recent infrastructure survey, 94 per cent of businesses said that the quality of infrastructure is a decisive factor when planning future investment. Although the government has established the National Infrastructure Commission, the majority of firms (53 per cent) are not confident of seeing tangible improvement in the coming five years. Moreover, 62 per cent of firms are unhappy with the pace of progress.[7]

Low residential construction rates

Besides the major issue of not being able to build sufficient transport and energy infrastructure, housing has also significantly underperformed in terms of investment in the UK. Indeed, the infrastructure deficit in housing is even more acute. The UK has one of the largest pre-1945 housing stocks in Europe,[8] as well as some of the lowest rates of dwelling completions per population.[9]

Table 1.2: Comparison of European residential housing construction in the long and short run, 1975-2014

Country	Dwelling completions per 1000 population 1975 - 2014
France	6
Netherlands	5.9
Sweden	4.6
Denmark	4.3
Germanay	3.9
United Kingdom	3.5

Country	Dwelling completions per 1000 population 2010 - 2014
France	5.2
Netherlands	3.1
Sweden	2.6
Denmark	2.5
Germanay	2.4
United Kingdom	2.2

The recent poor performance of housing construction between 2010 and 2014 is of particular concern given the current concerns on future housing affordability. The median earnings to house price index has reached new highs of 7.4 as shown in chart 1.2. It should be noted though that this ratio does not take account of mortgage costs - which have fallen as a result of looser monetary policy - government subsidies, nor the difficulties of obtaining a mortgage since the financial crisis due to tighter regulations.

5 World Economic Forum, Global Competitiveness Index 2015-16

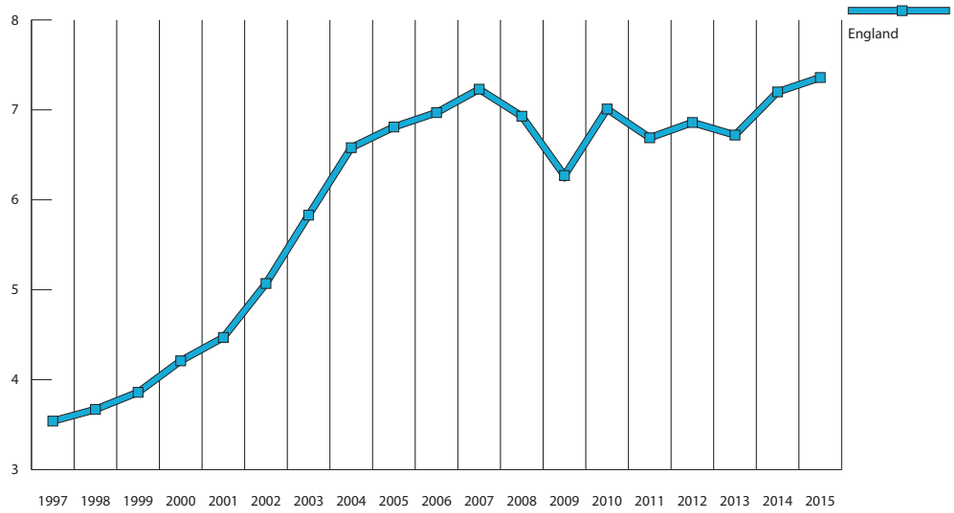
6. Civil Engineering Contractors Association (2013), Securing our economy: The case for infrastructure

7. Turning Momentum into Delivery CBI/AECOM Infrastructure Survey 2015

8. Delft University of Technology (2010), Housing Statistics in the European Union 2010, Tables 2.4 and 3.12;

9 Source Policy Network from European central statistical offices. France data is for starts. An analysis of the relationship between starts and completions suggests around a 10 per cent difference implying figures of 5.4 and 4.7 for long and short run.

Chart 1.2: House price to median earnings ratio in England, 1997-2015[10]



A critical challenge for many parts of Britain is that the population is expected to grow in the next few years, and the projections for household formation are well above the present rate of housing completions. In England alone, the forecast over the next ten years for new household formation is on average 221,000 per annum.[11] This figure does not take into account the backlog from prior years where housing supply has not sufficiently met demand. Even if construction levels could reach 221,000 per year, it would do little to improve housing affordability. It has been estimated that for house price growth to fall to levels of 1.1% per annum, housebuilding would need to rise to 250,000 per annum.[12]

The net result of failing to increase the rate of housebuilding to meet demand has for the first time in a generation pushed housing up the priority list for political parties. Recent polling by Populus for the Centre for Progressive Capitalism highlighted that a shortage of housing that is affordable was considered to be the biggest barrier for the younger generation to achieving their aspirations in life. 59 per cent of respondents felt that housing was the major barrier to achieving their aspirations, even more than skills and jobs that were at 52 per cent and 55 per cent respectively.

Importance of infrastructure investment to increase housebuilding

The reasons for this lack of investment in infrastructure and housing in the UK are numerous and long standing. However, one crucial factor is that lower levels of transportation investment tend to be closely linked to lower rates of housebuilding. Large-scale local housing developments require the appropriate transportation investment to be in place to ensure that people living in these new houses have reasonable access to jobs and local civic amenities. This kind of investment would also have substantial positive benefits for existing home owners by improving connectivity and the quality of local amenities.

As the Royal Town Planning Institute (RTPI) has recently argued:[13]

> *Transport infrastructure can play an important role in unlocking land for development through connectivity, making sites viable and thus providing either the private or public sector with the opportunity to deliver developments where there is demand.*
>
> *However, it is rare that strategic planning is adopted as a tool to help the infrastructure / development relationship to flourish. The existing model for provisioning sites for housebuilding,*

10. http://data.london.gov.uk/dataset/ratio-house-prices-earnings-borough

11. https://www.gov.uk/government/statistical-data-sets/live-tables-on-household-projections

12. See Housing Market Note 14th December 2015, New build supply Savills referencing Barker Review 2004

13. Transport Infrastructure Investment: Capturing the Wider Benefits of Investment in Transport Infrastructure 2014 RTPI

whether small or large-scale, sees key infrastructure provision, often the cornerstone for whether a development will go ahead or not, as a bargaining tool between stakeholders, who all recognise its crucial importance, but are often not prepared or able to meet each other's expectations. This is a significant failure of the system as it mismatches the allocations of cost and benefits between communities.

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Things are however changing with the creation of the new National Infrastructure Commission. The recent review of the case for large-scale transport investment in London by the new commission makes the specific link with how transport investment can unlock greater levels of housebuilding. The report also develops coherent arguments on how these projects might be funded in spite of the current fiscal constraints.[14]

The report stresses that "planning and transport infrastructure consenting strategies therefore need to be aligned", including making sure that appropriate land use changes are applied. The report also highlights how such an integration of transportation and planning can support funding from land value capture as well as property taxation. The UK's persistent lower level of investment in infrastructure suggests that funding remains a key policy challenge that needs to be resolved. Given the current limited scope for central and local government to invest in expanding these kinds of projects due to fiscal constraints, the challenge of how to kick start transport investment remains a key issue.

According to a recent parliamentary briefing,[15] the UK government forecast for public investment in infrastructure is expected to be around 1.4 per cent of GDP in 2019/20. This is well below the OECD's target of 3.5 per cent of GDP. Moreover, the expected investment in transportation as set out in the infrastructure pipeline of investment is expected to fall every year from 2015 to the end of the parliament from around £17bn in 2015/16 to around £11bn in 2019/20.

In terms of the sources of this finance, 62 per cent of the investment in transportation is expected to be public investment. Pure private investment plays a very small role in financing transport projects in the UK at around seven per cent. The residual of around 31 per cent is therefore expected to be provided through a mix of public and private funding. But without incremental public funding in place, it is highly unlikely that the private sector financing will materialise. Thus in order to double the investment levels to reach the OECD's 3.5 per cent benchmark, the state would have to play the major role in bridging the financing gap. But this would need to be undertaken in a way that does not impact the deficit. Resolving this challenge should be an urgent priority for public policy.

14. Review of the Case for Large Scale Transport Investment in London, National Infrastructure Commission 2016

15. http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN06594#fullreport

Chapter 2: Bridging the infrastructure funding gap

Fiscal constraints and how other countries fund infrastructure

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The UK's general approach to financing transportation investment has been either through central government expenditure or a form of public-private partnership. The chancellor appears to have recognised that these mechanisms alone are unlikely to be able to bridge the significant shortfall in transport investment, which needs to be doubled to reach the OECD target of 3.5 per cent of GDP.

Bound by fiscal constraints

The chancellor of the exchequer has been clear that his ambition is to have a budget surplus by the end of the current parliament. In order to achieve this surplus, fiscal constraints have been placed on public finances, which in turn limits the amount of public investment that can be made in infrastructure. As a consequence, he has been looking at how the private sector might be able to finance the shortfall.

In October 2015, George Osborne announced two measures to support increased financing. One was to pool the Local Government Association's pension funds to enable greater infrastructure investment. The other policy was the introduction of an infrastructure levy for city region authorities. Under the new initiative, a rise of two pence in the pound for infrastructure investment was permitted as long as the local enterprise partnership – which jointly represent employers and local government in 39 local economies across England – had agreed to the levy. There has long been data that has shown that the private sector is willing to pay higher business rates if that incremental revenue is all invested locally to improve the economic environment for firms.[16]

However, these measures on their own are unlikely to bridge the funding shortfall. But there are other alternatives. The recent report by the National Infrastructure Commission, which assessed the potential funding options for the proposed Crossrail II rail line, argued that infrastructure funding should look more closely at how transportation investment can influence housing delivery. It also argued that more attention should be paid to how land value capture can play a role in funding investment. The report stated that:[17]

> *Higher density development will usually yield greater profit and therefore higher land values. Land-values will also be increased by increased demand to live in an area that has improved public transport, especially large-scale infrastructure such as the national rail network. Such infrastructure can significantly improve journeys to work and promotes more sustainable forms of living by placing more people within easy access of public transport modes and important shops and services – thereby enhancing quality of life.*
>
> *Public transport can therefore help to remove viability constraints through increasing land and property values, promote changes of use e.g. industrial to residential and support increases in the density of development thus increasing efficiencies in the use of land. Secondly, the uplift in value can have revenue implications for the public sector, which can in turn help raise funding for transport schemes. Public revenue sources such as the community infrastructure levy, stamp duty, and council tax all have a link back to values.*

This shift in thinking about the funding of infrastructure projects is to be welcome. It highlights that the UK is increasingly interested in learning from international best practice to seek alternative sources of finance to bridge the funding gap. Land value capture is in many respects the most widely used and

16. See for example London Chamber of Commerce & Industry 2012 Driving local growth: the business case

17. Review of the Case for Large Scale Transport Investment in London, National Infrastructure Commission 2016

successful mechanism to fund projects. This is the case both in dynamic cities, which already have rising land values, and in areas that need regeneration since they are able to reverse the decline in land values. The following case studies highlight the central importance in using land value capture to finance the investment in transport infrastructure which in turn accelerates housebuilding.

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Lessons from Hong Kong, Hamburg, Amersfoort and Cambridge

The Hong Kong Metro [18]

The ability of the Hong Kong metro system to capture revenues from the uplift in land values due to the network played a significant role in the financing of the network itself. Between 1996 and 2000, annual revenues generated from public land leasing were more than enough to cover the costs of all infrastructure. For the Hong Kong Metro System, land value capture represented a financial windfall. It facilitated an increase in the building of residential properties that were connected to places of employment through the metro links.

Hamburg's Hafen City, Germany [19]

In 1996, Hamburg set out a plan to expand the city using adjacent brownfield sites in order to dramatically increase the housing supply in conjunction with a new container terminal. While around 70 per cent of the land to be developed was already under the ownership of the city-state, the agency responsible for the project, Hafen City Hamburg GmbH, was tasked with bringing the remainder of the privately owned land into public hands. The infrastructure for the project was financed by borrowing against the land assets and included building roads, bridges, public spaces and flood defences. The total public expenditure of €2.4bn was subsequently complemented by private investment totalling €8.4bn. Sales of land that have captured the uplift in land value due to the infrastructure investment has permitted the agency to finance its operations and also to pay back the loans needed for investment.

Amersfoot, Netherlands [20]

The Vathorst Development Company (OBV) was set up in 1998 in Amersfoort to expand the housing supply. OBV was a 50:50 joint venture between the local authority and a consortium of private landowners and developers who had pooled their land holdings. The development company was responsible among other things for land acquisition and commissioning infrastructure. Financing the development of 11,000 homes, a shopping centre and business park amounted to €750m, of which half was used to fund infrastructure. Borrowings with a maturity of 15 years are to be repaid out of the proceeds from land sales.

The North West Cambridge Development, UK [21]

Cambridge University has become increasingly concerned that the inexorable rise of house prices will make it much harder to attract the best lecturers and researchers from around the world to join the university staff. The university therefore decided to use its own land and raise money from the bond market to invest £70m in infrastructure in order for 3,000 homes to be built. The bond holders are to be paid back through the process of land value capture. The agricultural land that the university owned with a nominal book value of around £24,000 per hectare will jump to around £2.4m per hectare as a result of the strategic planning and infrastructure investment. Cambridge University expects to sell off half of the plots to developers and then keep half of them to rent out to staff. If the university had had to acquire the land at market rates, the project would most likely have failed at the viability stage. The value of residential land in Cambridge for 3,000 units is estimated at around £384m, which is considerably more than the £350m the university borrowed from the bond market to finance the entire project.

Assembling public and private land

18. Land value capture as a funding source for urban investment: The warsaw metro system, Ernst & Young / UCL 2010, See also, Financing transit -oriented development with land values overview, Hiroaki Suzuki, Jin Murakami, Yu-Hung Hong, and Beth Tamayose Adapting Land Value Capture in Developing Countries World Bank 2015

19. Planning as 'market maker': How planning is used to stimulate development in Germany, France and The Netherlands RTPI

20. Making Eco-towns Work: Developing Vathorst, Amersfoort NL Dr Nicholas Falk 2008

21. http://www.nwcambridge.co.uk/

As the above case studies highlighted, public land often plays a vital role in large-scale infrastructure investment. However, a single public authority rarely owns all the land upon which the major infrastructure project and large-scale housing development are constructed. Hence, such large-scale projects are generally viable when private land is able to be acquired at values close to use value in addition to using public land.

This was the case with Letchworth and Welwyn Garden City, which were new towns constructed in the early 20th century. Their development corporations acquired agricultural land and used the uplift in land values to finance infrastructure investment. The development of Milton Keynes in the 1960s followed a similar path.[22]

In recent years, there has rightly been a greater focus on how public land can be better utilised for housing development. An analysis by Savills based on their proprietary data suggests that the public sector owns around 15 per cent of land in the pre-planning pipeline.[23] The challenge for any large-scale infrastructure project however is that these land holdings are owned by numerous public sector organisations or government agencies. Moreover, public sector organisations are required to maximise the value for the public when land is being sold. The 1972 Local Government Act (section 123) states that councils shall not dispose of land for a consideration less than the best that can reasonably be obtained.

The current framework to assemble private and public land for large-scale infrastructure investment has major drawbacks, which significantly reduce the viability of many projects. Given this backdrop, in addition to the costs of financing large-scale infrastructure, it should perhaps not be surprising that rates of housebuilding in the UK have been so much lower than in other countries.
Despite parts of Britain having had some exposure to using land value capture to finance infrastructure investment, it remains the exception rather than the rule. As a result, the traditional approach to financing infrastructure has been to rely far more on government grants. In an age of austerity, this approach is not only limited in scope, but it is also an expensive way of undertaking such investment from the taxpayers' viewpoint, as it comes out of tax receipts, rather than being funded by the uplift in land values. The funding of Crossrail is a good example of the UK approach, which also highlights that it is landowners who often benefit most from large-scale infrastructure investment.

Funding Crossrail

The funding of Crossrail amounted to £14.8 bn and was largely dependent on a central government grant covering around a third of the costs. A business rate supplement was agreed to finance 28 per cent of the costs, but only four per cent of the funding was raised from using section 106 / community infrastructure levy (CIL), which is the approach used to capture the financial gains made from planning in the UK. According to the property advisers GVA, Crossrail could help create additional residential and commercial value of as much as £5.5bn along the route, more than a third of the total cost of the project. GVA predict that commercial office values around Crossrail stations in central London will increase by 10 per cent above a rising baseline projection. They also predict significant increases in residential capital values immediately around stations in central London of some 25 per cent and in the suburbs of some 20 per cent.[24]

In order to capture the full increase in land value from large-scale projects, particularly those that use tunnelling – and therefore increase the values of existing property assets – a more refined approach to property taxation including council tax and business rates is also required.[25] This is a clear example of how in the UK, property owners are able to capture the uplift in land values due to public investment. Arguably, the failure of local economies to capture this unearned increment has resulted in lower amounts of public expenditure in physical infrastructure, given the uplift in land values would provide the necessary financing mechanism.

22. TCPA New Towns Act 2015

23. UK Residential Development Land February 2016 Savills

24. Crossrail property impact study GVA 2012

25 This is discussed in detail in chapter 4

Landowners and the law

The examples in Hong Kong, Germany and the Netherlands demonstrate the importance of land value capture for financing large-scale infrastructure, which subsequently can lead to an increase in the housing supply. The legal arrangements for how local authorities in Germany and the Netherlands are able to assemble land for large-scale projects including acquiring land compulsorily where necessary, provide the necessary support for the process to function effectively.

In Germany the planning law freezes the value of the land when the local municipality decides to specify an area for residential construction. Under the German building codes 165-171, the urban planning law enables the speedy procurement of unused land designated by the local municipality for development. The freezing of land values means that the municipality effectively acquires the land at use value with the uplift in values from the sale of housing plots paying for the necessary infrastructure required for the development. This planning law has limited the differences between use value and market value as there is almost no scope to profit from land speculation.

The Netherlands is similar in certain respects in that the municipality has a central role in the local development plan, effective control of how all land can be utilised and land assembly. The ability of the municipality to change land use results in less land speculation given that landowners who are not willing to cooperate with the municipality might see their land designated as a park. However Dutch municipalities do not have the power to freeze land values as in Germany.

The arrangements between the Dutch municipality and local landowners in terms of acquiring land are determined by the market. The difference between use value and market value being determined by the institutional arrangements of how the market is set up. Besides the local authority being able to leverage its ability to change land use, it also has the ability to proceed with compulsory purchase orders (CPOs). Although this additional power is rarely used, the threat of it has enabled local authorities to acquire land at a very small premium to agricultural values. According to one report, land values for agricultural land designated for development can be acquired by local authorities at around €50 per square metre- as opposed to €5 per square metre for agricultural land. Prepared residential land plots sell in the region of €400 per square metre.[26] The premium is sufficient for the local authority to benefit from the uplift in land values for residential plots to pay for the necessary infrastructure investment and to increase the number of viable projects.

In the UK, it is clearly possible to use land value capture to finance infrastructure as the North West Cambridge Development case study demonstrates. But why was Crossrail, which is a good example of transportation infrastructure investment, unable to benefit from land value capture and be self-financing like most of the other mentioned large-scale projects?

It has been estimated that Crossrail will support the delivery of 57,000 new homes, but it only generated around four per cent of the funding needs from section 106 / CIL, and required a hefty grant from central government to cover a third of the cost. Clearly the tunnelling aspects of Crossrail, which have been estimated to add £5.5bn to the value of existing property assets, would need to be captured via other means such as business rates and council tax. However, the uplift in land values in London from industrial to residential values for 57,000 units would add as much as £19bn to land values over the entire length of the project.

One reason why land value capture for large-scale transportation and housing projects is seldom used in the UK is that it is rare for a landowner to be in control of the entire area needed for the plan. This has been further impacted by the lack of strategic planning across functional economic areas. Most development remains small scale and dependent on the initiative of landowners. For large-

26. http://www.pbl.nl/sites/default/files/cms/publicaties/De_grondmarkt_voor_woningbouwlocaties.pdf

scale transportation and housing projects to be carried out, the landowner needs to have the desire to pursue the project and crucially must be capable of raising large amounts of money from the capital market to invest in the initial infrastructure. In Germany and the Netherlands this is largely undertaken by public authorities who acquire private land as part of their planning process at values close to use value, assemble it with public land, and then use the uplift in land values to pay for the infrastructure.

The challenge for UK local authorities is that when they acquire land for residential construction, they are forced to pay the landowner the full amount of the value including the increment that would be paid had planning permission been granted on sites that do not yet have permission. This is set out in the 1961 Land Compensation Act.

Section 14 makes it clear that landowners who have gone through the planning permission process should be compensated at full value in the event of a CPO. Given they have taken the risk of acquiring the land and pushed it through the planning process, this would appear to be reasonable. But the 1961 Land Compensation Act also stipulates that full compensation should be paid out if "planning permission for any development could in any particular circumstances reasonably have been expected to be granted".

This section implies that if the CPO is to acquire land in order to build houses, then the landowner should be paid as though it had planning permission on, resulting in the land owner rather than the local authority capturing the uplift in land values to finance infrastructure. This is why Crossrail was able to obtain such a limited amount of its funding from CIL / section 106 agreements. In effect, the land owner is guaranteed a windfall profit by primary legislation for just owning land in an area where there is demand for land for housing.

This anomaly in the UK, which benefits land owners at the expense of capital and labour was central to progressive politics during the late 19th and early 20th centuries. The debate was perhaps best summed up by Winston Churchill in his 1909 book The People's Rights, which was a summary of the speeches he had made that year on the 1909 budget, free trade, land and welfare. In the book there is a section entitled "unearned increment", where Churchill lambasted landowners for being rewarded for doing nothing. The section is quoted in full.

> *Roads are made, streets are made, railway services are improved, electric light burns night into day, electric trams glide swiftly to and fro, water is brought from reservoirs a hundred miles off in the mountains – and all the while the landlord sits still. Every one of those improvements is effected by the labour and at the cost of other people. Many of the most important are effected at the cost of the municipality and of the ratepayers. To not one of those improvements does the land monopolist as a land monopolist contribute, and yet by every one of them the value of his land is sensibly enhanced. He renders no service to the community, he contributes nothing to the general welfare; he contributes nothing even to the process from which his own enrichment is derived. If the land were occupied by shops or by dwellings, the municipality at least would secure the rates upon them in aid of the general fund, but the land may be unoccupied, undeveloped, it may be what is called 'ripening' – ripening at the expense of the whole city, of the whole country, for the unearned increment of its owner.*
>
> *Roads perhaps may have to be diverted to avoid this forbidden area. The merchant going to his office, the artisan going to his work, have to make a detour or pay a tram fare to avoid it. The citizens are losing their chance of developing the land, the city is losing its rates, the State is losing its taxes which would have accrued if the natural development had taken place; and that share has to be replaced at the expense of the other ratepayers and taxpayers, and the nation as a whole is losing in the competition of the world – the hard and growing competition of the world – both in time and money. And all the while the land monopolist has only to sit still and watch complacently his property multiplying in value, sometimes manifold, without either effort or contribution on his part; and that is justice!* [27]

27. W. Churchill The People's Rights 1909

Any society that is based on the principle that landowners should be rewarded for doing nothing, while firms and workers engaged in productive activity get no direct reward for raising demand, is likely to incur legitimation issues due to numerous negative social and economic impacts. These issues include a rising inequality of wealth which has been unearned, low levels infrastructure investment due to the inability of local economies to finance the projects, low levels of housing supply and low productivity rates due to higher input costs.

It should therefore not be surprising that British voters believe that the current economic system is geared towards supporting the aspirations of the wealthy, leaving the middle and working classes behind. According to a recent Populus Survey for the Centre for Progressive Capitalism, 74 per cent of people felt that the economic system was effective at supporting those from wealthy backgrounds in achieving their aspirations, versus only 23 per cent for the middle classes and 5 per cent from poorer backgrounds.

Chapter 3:
Why it is finally time to amend the 1961 Land Compensation Act
The unfairness principle and the economic case

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The legal backdrop to the 1961 Land Compensation Act emerged in the 19th century as Britain embarked on its period of railway construction. As much of this infrastructure investment came from the private sector, it was deemed that the landowners should be fully compensated from the uplift in land values. However, by the time the Attlee government came to power in 1945, public authorities had become central to investing in infrastructure and housing. The issue of land compensation was subsequently raised in the 1947 Town and Country Planning Act which stated that land acquisitions should be at existing use value.

But the new system introduced in 1947 did not work well in practice. Land was still being bought at prices including the full development value despite having to pay the 100 per cent development charge due to the increase in the value of land. This was largely due to the severe restrictions imposed on building.[28] This legislation was repealed by the subsequent Conservative administration, with the new rules on land compensation being enacted in 1961.

The approach to land compensation set out in the 1961 Act did not initially constrain the economy because high levels of housebuilding meant that house prices rose roughly along with wages. During the 1980s, the link between wages and house prices decoupled. Construction rates fell, increasing the returns to landowners. Furthermore, as the British economy has shifted towards more knowledge-intensive industries, city regions have become the major engines of economic growth. This has put increased pressure on demand for housing in growing city regions, particularly as construction levels have remained well below required rates.

A key challenge for the UK to address remains how it can increase its investment in transportation to unlock greater housing supply. These regional infrastructure projects are best undertaken by local authorities covering a functional economic area, since they have the detailed understanding of the local economy. However, given the current fiscal constraints, one of the few options that remains open to local authorities to finance the infrastructure investment is using land value capture.

Since the coalition government of 2010 to 2015 began the process of devolution, it has become increasingly clear how local authorities can combine together to have scale. Most of the devolution deals that have been completed have led to combined authorities developing across all parts of England, including the devolution of transport and housing. Recent proposals by the Treasury and the Department for Communities and Local Government to put mayoral development corporations on the same footing as new town and urban development corporations are another positive development in this process. [29]

In order for combined authorities to acquire land close to use value, the 1961 Land Compensation Act needs to be amended to bring the UK in line with international best practice. This would then permit infrastructure investment to be funded by borrowing against the future uplift in land values. The basic tenet of clauses 14-16 of the 1961 Land Compensation Act guarantee that the uplift in land value flows to the owner of the land even when no planning permission has been granted if it would be likely that this would be granted if permission was requested. The fact that landowners are currently entitled to substantial windfall profits due to the productive work of others has had two significant negative economic and social impacts.

28. Cullingworth, J. B., and V. Nadin. 1994. Town and country planning in Britain

29. Consultation on further reform of the compulsory purchase system, DCLG, HM Treasury 2016

First, it has largely prevented public authorities from utilising land value capture as an effective means of financing infrastructure projects. This is one of the main reasons why investment, productivity and housebuilding levels are lower in the UK than in most other developed economies. Second, the process whereby a tiny percentage of the population benefits financially at the expense of those who increase productivity growth has not only reduced the incentives to invest in productive enterprise, but it is also undermining the legitimacy of our economic system, as demonstrated by the recent Populus survey.

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How to amend the Act

In order to address these two issues, it is recommended that section 14 of the 1961 Land Compensation Act be amended so that:

> **1. No account is taken of any prospective planning permission in land designated by combined authorities for infrastructure including housing**

In addition, within these designated areas, section 106 obligations or the community infrastructure levy would no longer apply, thus making the whole development process far simpler. Once the combined authority's strategic plan for transport and housing has been agreed and published, the mayoral development corporation would assemble the necessary public and private land across the multiple sites.

The practical implication of amending the act in this way is that landowners sitting on land without planning permission would no longer be able to benefit financially from the fact that their land appeared in a strategic plan for development. Given the inability to pocket unearned income, there would be little value in land speculation and attempting to make money from 'hope value'. Hope value is determined by the hope that planning permission would be granted at some point in the future, and therefore the landowner is compensated for this speculation at a later date.

Hence, the market value principle as set out in section 5 of the 1961 Act would still determine the value of the land, but as landowners would no longer be able to benefit from the uplift, the market value itself would remain at levels close to use value. It is possible that land sales under this proposed system will end up clearing at levels higher than use value given that combined authorities would most likely be willing to trade the potential cost of undertaking a CPO as a premium for the landowner. This new framework for the land market will not only make the process of land transactions more efficient, but it may well lead to fewer CPOs actually taking place.

The mayoral development corporations, acting on behalf of the combined authority, would then be able to raise long-term financing using the bond market to invest in the necessary infrastructure, and preparing the sites for residential construction. Mayoral development corporations would then decide whether to sell off land to developers for construction or contract directly with building firms. The bond holders would be paid back by the mayoral development corporations from revenue streams including land sale receipts at residential use value, sales of completed residential units or from rental income from social housing.

> **2. Section 17 is amended so certificates of appropriate alternative development would cease to apply in those areas designated by combined authorities for development**

Section 17 of the Act permits a landowner to litigate against a local authority acquiring land who they feel has not compensated them fully as part of a CPO process. The compensation levels are generally assumed to be at levels akin to land with planning permission as set out in section 14-16.

This legislation is often used by litigants who believe that there could have been an appropriate alternative development instead of the one that has been proceeded with. This threat of litigation has made local authorities wary of embarking on CPOs when attempting to pay less than the full compensation to the landowner based on the view that planning consent has been given.

Development sites outside of these designated plans would, however, continue to be built out using the current approach.

The London 2012 Olympics and legal disputes

During the construction phase of the London Olympics a great deal of industrial land was acquired by local authorities using CPO powers. This was part of a wider project to build new infrastructure, sports and leisure facilities, as well as residential housing. Many landowners decided to contest the compensation levels as they argued that they should have been compensated at residential land value and not industrial land value. They argued that if the Olympics had not gone ahead their land could have been used to build houses, and they proceeded to use section 17 of the Act to argue their case.

A legal case that epitomises why many local authorities have been reluctant to proceed with CPOs was Rooff Limited vs Newham Borough Council/London Development Agency. Rooff argued that they should have been compensated at residential use value as at some stage the area would have been developed even without the Olympic Games having taken place. Newham argued that there was no policy at that time to support residential development in that area. Mr Justice Blake agreed with Newham and dismissed the case in July 2010. However, on appeal this ruling was overturned in April 2011 and the case was referred back to the secretary of state. The landowner was subsequently awarded full compensation.

In this instance, the CPOs went ahead with the backing of the London Development Agency, London mayor and the government, stemming from the 2006 Olympics Act. The viability of the Olympics project was clearly not at stake as the government was committed to financing it. However, in the event of a CPO for local infrastructure or housing, it is clear that a local authority or development corporation would most likely need to acquire vacant land at residential housing levels to avoid having to fight expensive legal cases which they would need to pick up the bill for. This is precisely why CPOs are so rarely undertaken, and ultimately this means that very few large-scale housing and infrastructure projects are financially viable.

The government has unsurprisingly become increasingly concerned that landowners are benefiting financially from large-scale public investment and are questioning whether compensation levels are set at appropriate levels. This has resulted in the government proposing to use a 'no scheme world' approach to compensation whereby an acquiring public authority should not pay more for the land it is acquiring by reason of its own (or someone else's) public investment. A key example would be where there has been recent and substantial public investment in adjoining or nearby transport infrastructure.[30]

The problem with the government's 'no scheme world' proposals

Although the spirit of this suggestion is to be welcomed in that the uplift in land value due to public sector investment should not flow to the landowner, it is unclear how this might work in practice. For example, the proposal makes it clear that the valuation of the land must disregard the project impact on the site. But how will such land values be estimated? It is quite feasible that numerous land transactions have been undertaken and generated profits based on hope value, prior to the project having been announced. So what is the "true" no scheme world value? Is it the underlying use value? Or is it the value of the last land transaction made prior to the scheme announcement

30. Consultation on further reform of the compulsory purchase system, DCLG, HM Treasury 2016

which may have anticipated the development?

Furthermore, the ability of landowners to use a section 17 certificate of alternative appropriate development to challenge the compensation levels highlights the complexities involved. The Rooff vs Newham Council case demonstrated that despite the large-scale public investment made by the state for the London Olympics, Rooff was still able to claim residential land value compensation based on the premise that the land could have been used at some point in the future for the construction of houses.

Lord Justice Carnwath, who overturned the decision of Rooff vs Newham on appeal, highlighted some of the issues with the section 17 regime stating that it, "requires the planning status of the land to be determined in the abstract, isolated from market consideration which in the end will determine value for compensation purposes."

These legal issues suggest that the government might need to rethink its approach to ensuring that public authorities are able to capture land value as a result of public investment.

Human rights law and public interest test case

One potential barrier preventing reform of the 1961 Act is that civil servants across a number of government departments have suggested that such a reform would be in breach of Article 1 of the European Convention on Human Rights – which is related to peaceful enjoyment of possessions. This view was conveyed to us informally by former ministers. The view that the European Convention on Human Rights might prevent public authorities from capturing land values is misguided.

First, the European Court of Human Rights has made itself clear that the notion of the public interest is extensive and takes precedent to individual claims – as long as appropriate compensation is provided. [31] The public interest case is strongest when development is carried out at scale, hence the need for plans to be drawn up at the combined authority level that covers a functional economic area. Second, most other countries across Europe use the process of land value capture as a central funding mechanism for infrastructure investment, and this has been supported by the European Court.

A reasonable compensation would be determined by market value. In a world with an amended section 14 of the 1961 Act, market values of land within designated areas would fall to levels just above use value, assuming that authorities would be willing to pay a premium equivalent to the cost of undertaking a CPO. As such, these new market values would be a reasonable approximation of an appropriate level of compensation.

The main obstacle to implementing such a reform in the past has been political. However, the political landscape, since the foundation of the National Infrastructure Commission, has clearly changed with both major political parties now committed to using the state to intervene in order to increase the rate of infrastructure investment. Clearly, if further reforms are to be made in this area, a strong and coherent economic argument also needs to be developed. The following sections will look in more detail at the economic case.

The four economic arguments

Amending the 1961 Act would:

1. Free up £172bn over the next 20 years for increased capital expenditure on infrastructure

Detailed empirical analysis of data from the local government department suggests that in England

31. See Practitioners' Guide to the European Convention on Human Rights, Karen Reid.

alone, local authorities acquiring land for residential housing at the current rate of housebuilding would be able to generate around £8.6bn per annum from land value capture. This £8.6bn would be able to fund a significant number of extra transportation projects, which in turn would unlock greater housing opportunities thereby increasing the supply of homes to levels that are required.

Using estimates of the value per hectare of residential land by each of the 326 local authorities in England in conjunction with regional estimates per hectare for agricultural and industrial land, density data, units built, as well as the split between greenfield and brownfield land, we can estimate the difference for England between use value and residential land value. The figures for 2014/15 demonstrate an uplift of £12.4bn.[32]

It is worth emphasising that this figure is likely to be an underestimate. Due to a lack of data, it excludes residential units that have been modified from another use such as commercial property to residential property. Land value capture has also been ignored for commercial property itself due to insufficient data, although the values are likely to be smaller than for residential housing. However, the data does not take account of affordable housing residential land values, although the income streams for affordable housing from section 106 agreements are captured.

Local authorities already capture some of this uplift through section 106 agreements and the community infrastructure levy. The section 106 planning obligations negotiated between landowners, developers and local planning authorities generate obligations for developers to make contributions towards affordable housing, transportation and other public services or spaces. Based on local government department estimates for 2007-08 and 2011-12, we estimate that the 2014-15 value of planning obligations generated from residential housing (75 per cent of the value) was £2.8bn.[33] Local authorities and other public bodies also sell land at market value. Although no data has been collected by government for this – resulting in the National Audit Office producing an extremely critical report – government forecasts are for around £1bn of public land sales per annum during this parliament.[34]

Subtracting the section 106 payments and estimates of public land sales generates an estimate of £8.6bn derived from land value capture per annum based on current building rates. In terms of forecasting future revenues, we have assumed a constant building rate at current levels for the next 20 years[35] which would generate an additional potential £172bn to invest in transport infrastructure, and unlock greater levels of housing. This would finally provide the necessary foundations to enable the housing supply to reach levels of well over 250,000 per year.

A change in the Land Compensation Act is not going to immediately magic up an extra 100,000 houses in annual construction rates. It will take time for combined authorities to develop their plans and start the land assembly process, for funds to be raised to finance the transportation infrastructure, for new housebuilding firms to come into the market, and for sufficient numbers of workers to be trained up. This shift towards combined authorities driving the housebuilding process may also require support from central government to provide the necessary human capital for land assembly and financing. However, reform of the 1961 Act remains a necessary condition to permit expansion at much higher rates.

2. Open up opportunities for smaller housebuilders and generate up to 77,000 jobs

An economy with a greater number of housebuilding firms has greater potential to adjust to higher rates of construction. However, in England the operation of the land market has effectively precluded this from developing. England is unique in having a handful of large construction firms dominating the sector.

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32. Please see appendix for more detailed methodology

33. See: Section 106 Planning Obligations in England, 2011-12 DCLG 2014, & The Incidence, Value and Delivery of Planning Obligations in England in 2007-08

34. https://www.nao.org.uk/report/disposal-of-public-land-for-new-homes/

35. Assuming current construction levels is likely to be a significant understatement given that changes to the Land Compensation Act will lead to higher rates of housebuilding.

One of the main reasons behind this difference is that the need to acquire land at high prices significantly increases risks for small building firms, in addition to planning risk. In the event of a downturn, the land price can fall leaving the firm with a loss-making asset, potentially forcing the firm into bankruptcy proceedings. During the early 1990s downturn an estimated £2.5bn was written off the value of the industry's land holdings.[36]

According to a recent report by Shelter, the top 10 housebuilders in the early 1960s contributed to only eight or nine per cent of total production, however by 2006 they were responsible for almost half of all homes built. Since the financial crisis, diversity has narrowed further with the number of builders producing fewer than 30 units per year declining by a half while the number of medium sized builders has shrunk by 60 per cent.[37]

The dominance of housebuilding by larger firms can also be seen in the data on individual commissions. A high level of individual commissions as a percentage of total housebuilding highlights a greater diversity of the housebuilding sector. Although data is difficult to compare across countries, it is estimated that the UK procures only around seven to eight per cent of houses in this way, compared to around 60 per cent for Sweden, France and Germany.[38] This is further evidence of the lack of diversity across the housebuilding sector.

In a world where local authorities are assembling land for construction firms to build on, managing land prices would no longer be part of the business model of building houses. Construction firms will be able to bid for construction work based on a more traditional quality / price pay-off. This reduces the risks to small firms engaging in the housebuilding sector, and therefore should lead to an expansion of firms in the sector.

According to the NHBC Foundation, there are now only around 3,000 housebuilding firms in the UK.[39] Based on the assumption that a significant increase in transportation infrastructure investment will increase the availability of sites, there is no reason why the market could not return to its late 1980s levels of around 12,000 firms in the medium term. This increase in the number of firms will be critical in being able to scale up output of housebuilding.

Besides bringing greater competition to the housebuilding sector, an increase in the level of investment in infrastructure by £8.6bn will generate an increase in output of £16.3bn based on the 1.9 multiplier effect. Although each project would clearly be different, it is expected that the infrastructure investment would mainly flow to transportation in a typical large-scale project:

Table 3.1: Estimate of type of infrastructure investment for a large-scale project [40]

	Type of infrastructure work	Percentage of value of work
1	Transportation (roads, railways, transportation systems)	63 %
2	Education	12 %
3	Health	8 %
4	Utilities	8 %
5	Open Space	7 %
6	Land / site preparation	2 %

According to the labour forecasting model of the Construction Industry Training Board (CITB), an incremental investment of £8.6bn in infrastructure across the above areas has the potential to generate 77,000 jobs in construction.[41]

36. Callcutt Review of housebuilding delivery 2007

37. Shelter/KPMG: Building the homes we need

38. https://fullfact.org/economy/self-build-britain-uk-lagging-behind-other-countries/

39. http://www.insidehousing.co.uk/journals/2014/10/15/f/d/p/NHBC-FOUNDATION-REPORT-OCT-2014.pdf

40. Based on estimations from the North West Cambridge Development, the Stratford redevelopment for the Olympic Games and Milton Keynes

41. Estimates of jobs arising from infrastructure investment, April 2016. CITB & Whole Life Consultants

3. Shift investment patterns away from existing assets towards productive assets

One other economic impact of increasing the supply of housing is likely to be on the flow of capital across the UK economy. According to Bank of England estimates, of the £144bn of mortgages raised in 2014 to purchase houses, £125bn was used to acquire existing assets, excluding re-mortgaging, with only £19bn invested in acquiring new builds. In essence a significant portion of the savings pool is used to acquire existing assets, which in turn has a limited impact on output and jobs.[42]

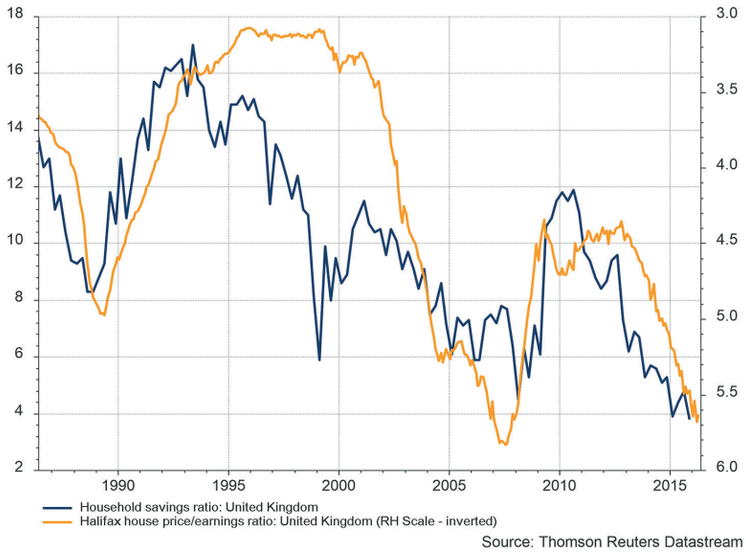
Although the benefit to home owners from rising house prices is limited unless the householder decides to sell up and live somewhere else much cheaper, there have been significant financial benefits for investors. According to the Wrigglesworth Consultancy, investors in residential housing have generated outstanding annual returns of 16.2 per cent on average since 1996, compared to 6.9 per cent for gilts and 6.5 per cent for UK equities. Buy-to-let mortgages now account for a quarter of all new house purchases. As demand for this asset grows, it is likely to have an ever-increasing impact on supporting rising house prices. Hence the Bank of England's increasing concern with the destabilising impact this could have on the UK economy.

In a world with higher rates of building, future returns to residential housing as a financial asset would be less likely to continue to rise at current rates. This may well have a knock-on effect with less financial capital flowing into existing housing assets. Given this capital needs to flow somewhere, there are possibilities that some of this capital might be rechannelled back into the economy and used to finance productive assets which generate higher levels of output. Indeed, recent research by the National Institute of Economic and Social Research (NIESR) suggests that high house prices require higher levels of expenditure and are diverting investment away from productive uses.[43]

Another macroeconomic benefit of an increase in housing supply is that housing costs relative to disposable income may start to fall. Recent analysis by the National Housing Federation suggests that 39 per cent of income is spent on rent in the UK versus only 25 per cent in Germany.[44] Such a shift in supply will possibly have two other positive effects on the economy. First, some of the increase in disposable income will be consumed boosting aggregate demand. Second, some of it will be saved. This will boost the savings ratio, which in turn will boost the propensity to invest.

Indeed, as the house price to earnings ratio rises – signifying rising unaffordability – the household savings ratio falls, as an ever larger portion of household income is deployed to acquire existing housing assets, which is suggested by the NIESR research.

Chart 3.1: Household savings ratio vs house price/earnings ratio



Source: Thomson Reuters Datastream

42. http://progressive-capitalism.net/2015/09/how-george-osborne-could-stop-the-next-financial-crisis/

43. http://www.ft.com/cms/s/0/51976728-1044-11e6-91da-096d89bd2173.html#axzz47wrQtj4z Housing policy is hitting savers, says NIESR

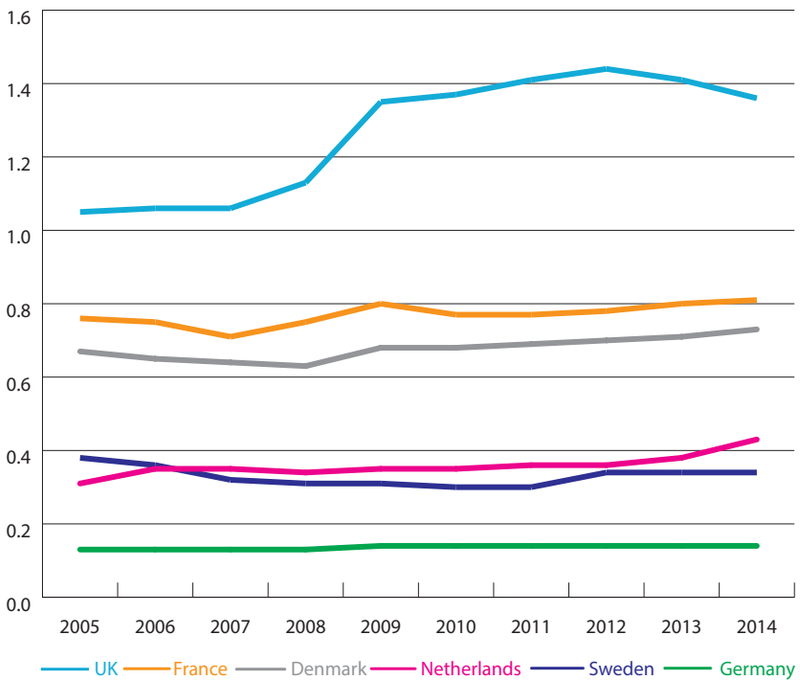
44. http://www.housing.org.uk/blog/private-renters-in-uk-pay-double-the-european-average/

4. Alleviate pressure on the housing benefit bill

The UK's dysfunctional land market is responsible for generating one of the largest housing benefit bills as a percentage of GDP across the EU. This is around 10 times that of Germany and more than three times the level in the Netherlands. By 2020, the Office for Budget Responsibility (OBR) forecasts that the housing benefit bill will have reached £23bn.[45] Such high levels of benefits are an incredibly wasteful use of precious resources. It would be far better to make sure the market functions efficiently in the first place by improving outcomes, rather than redistributing taxpayers' money due to the poor outcome of a dysfunctional market.

Although this level of housing benefit will take some time to fall, there is no reason why over the next decade or so housing benefit as a percentage of GDP should not fall to similar levels found in continental Europe leading to considerable savings.

Chart 3.2: European comparison of housing benefit, 2005-14 (percentage of GDP) [46]



One other area of welfare policy that also needs to be looked at is who should be responsible for paying housing benefit. This is currently under the remit of the Department for Work and Pensions (DWP). Given that the DWP has no control over housing policy, the government has created a totally misaligned system of incentives. The current push of devolution to combined authorities, particularly for transport and housing, is welcome. However, it would create an extra incentive for these regions to build sufficient houses if they were also in control of the housing benefit budget. In Germany, 50 per cent of housing benefit is paid by local government, which acts as an incentive to ensure that a sufficient number of houses are built.

In instances where combined authorities decided that they did not want to expand housebuilding to meet supply, this would then lead to higher rates of local expenditure on housing benefit. This would require the combined authorities to request from their population higher taxes to finance this benefit. If the democratic will of the local population is to finance this benefit through increased taxation, then construction rates will not rise, but this will come at a cost to the local population. However, for those populations who do not wish to see local taxation rise to pay for housing benefit, then higher rates of housebuilding would be able to prevent housing benefit levels from rising.

45. http://budgetresponsibility.org.uk/docs/dlm_uploads/July-2015-EFO-234224.pdf Table 4.19

46. Britain's dysfunctional housing market: a European comparison, Thomas Aubrey http://www.policy-network.net/pno_detail.aspx?ID=4985&title=Britain%E2%80%99s+dysfunctional+housing+market%3a+a+European+comparison

Who might be most affected from the changes?

While the arguments for amending the 1961 Act are compelling from an economic perspective, it is clear that making £8.6bn available in investment a year is capital that would have been flowing to landowners' profits. Hence, it is necessary to understand what impact this may cause.

Land owners and investors

Clearly developers who have great ideas will always be able to generate good profits by the value added they provide. But land owners and investors whose investment strategy has been to capture the uplift in land values will no longer have any returns to speak of, with the potential exception of a CPO premium. According to a recent report by the GLA, just under a quarter of plots with permission in London are held by organisations not associated with the construction process.[47]

Reform of the 1961 Act will also impact the revenue collected by HMRC. Assuming that landowners and investors are buying and selling land through companies, and are paying tax at the appropriate levels of 20 per cent of their profits, then HMRC would incur losses. It remains unclear to what extent land transactions are all carried out by limited companies, but clearly a portion of them would be paying less tax due to lower profits. However, this loss will more than be made up for by the increase in output, jobs, investment, lower benefits and higher tax revenues.

Some landowners would see some financial gain as they may be able to sell land for which there was previously no demand due to limited infrastructure and lack of connectivity. As such, this new approach would be able to generate earlier and more certain returns for some landowners.

Large housebuilders

Besides landowners and investors, it is likely that the amendment of the 1961 Act would also have an impact on the balance sheets of the large housebuilding firms. In order to mitigate the effect of volatile land prices, large-scale housebuilders have tried to manage their businesses to ensure they are shielded from the worst effects of volatile land prices. As such, the business model has become increasingly linked to rising land prices. Some large building firms are willing to take the risk and acquire land without planning permission or acquire options on land. They are betting on permission being granted at some point in the future so that they can benefit financially from the uplift in land values. Clearly business plans that have been predicated on such windfall profits will be unsustainable in the event of an amendment to the 1961 Act.

Companies that have acquired land without planning permission but at hope value are required to record the value of that land at the lowest of either what they have paid for it or its net realisable value (NRV). Hence a fall in the value of that land would lead to a lower NRV, impacting the balance sheet of the company. A fall in the fair value of options would also need to be accounted for on the balance sheet. To mitigate these effects there may be good reasons to stagger the process, giving time for large building firms to build out their remaining land holdings. This would need to be subject to further discussion with the industry.

47. Barriers to Housing Delivery Update GLA Table 9 (non-builder + prior approval)

Chapter 4: Taxing the rise in unearned land values

A closer look at business rates and council tax

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Reforming the Land Compensation Act would enable combined authorities to use land value capture to invest and build out the necessary infrastructure to increase the viability of housing projects. However, the owners of existing assets are also benefiting from windfall profits if they sell their commercial or residential property at inflated values due to this increased investment. But there is no reason why any economic agent should benefit from a free ride in relation to rising land values.

The two mechanisms that are used to capture this uplift in land values are local property taxes, which include business rates and council tax.

A business rates system fit for the 21st century

The coalition government in March 2015 published a consultation paper in response to concerns that the system of business rates is in need of reform to make it fit for a 21st century economy. This step, although long overdue, is welcome. Business rates – a tax based on property rental values charged on shops, offices and factories – generate around £24bn per year in England to help pay for local services.

Since 2012, local authorities in England have been able to retain up to 50 per cent of incremental revenues generated from business rates, with Manchester and Cambridge now able to retain 100 per cent of incremental growth. The basis for this devolution is that it will provide an extra incentive for local authorities to drive growth. In 2015 George Osborne announced that business rates will be completely devolved to local authorities by the end of this parliament. Although this is a welcome step, there still remain central government constraints on the tax particularly on increasing the multiplier upwards.

Devolving business rates in their current form would however not be a sensible option as it is becoming increasingly clear that the business rate regime has had a number of substantial negative economic effects on the British economy. Recent responses from the Treasury though suggest that there is far less appetite to make the necessary changes to make the tax fit for the 21st century. If this ends up being the case, it will be a huge missed opportunity to fully capture the effects of rising land values.

Issues with the current system

The business rates system has at least four major issues that require reforms to improve the efficacy of the tax. The current system:

1. Leads to higher levels of unemployment and insolvencies as rates do not track rental values

One of the most pressing issues with business rates is that tax levels are not related to actual rental values. Valuations take place every five years, and business rate multipliers during the interim period constantly rise as they are linked to inflation. Although this reduces the volatility of business rates revenue, such a rigid approach has undoubtedly led to higher levels of business defaults including the spike in unemployment during the financial crisis.

According to a property research company,[48] average rents fell between 15 and 20 per cent between

48. GVA (2013), The Business Rates Time Bomb

2007 and 2012, but business rates went up, not down, due to the 2008 revaluation. Although central London retail rents increased by 11 per cent, values declined in the rest of the country, with 51 local authorities seeing rental values fall by more than 20 per cent.

The idea of basing a system of taxation predicated on the assumption that rents will rise over the subsequent five-year period is without empirical foundation and is economically damaging. This particularly hit the retail sector, which is not only the largest contributor to business rates (38 per cent versus 31 per cent from offices and 25 per cent from industrial properties) but is also by far the largest employer in the UK providing 2.7 million jobs. Estimates during the crisis suggested that over a quarter of retail businesses were at risk of failure due to a combination of falling demand in conjunction with high business rates – and in some areas high rents as upward only rent reviews did not allow rents to adjust to their new market levels.

2. *Penalises smaller businesses above the relief threshold who pay a far higher amount per square metre than larger firms*

Another major issue with business rates is that it penalises those firms who use less space and who tend to be smaller and less profitable. In cities where there is increasing pressure on land values, it makes little sense to reward those firms who use more space with lower rates per square metre. Moreover, entrepreneurs trying to establish new business models and services end up paying far higher rates per square metre which makes business rates a regressive tax. The recent increase in the relief threshold does nothing to prevent this, but only creates further distortions to the tax system itself.[49]

The introduction of reliefs for certain sections for the economy can also have a distorting effect on a local economy. For example, the relief threshold for small businesses may be set so high that low rates of tax are collected in certain areas, or creates large jumps in costs for firms that want to expand above the threshold.

3. High administrative costs

A fundamental issue with the current system of valuations is that they are expensive to do. This work is undertaken by the Valuation Office Agency (VOA). The VOA is already one of the largest employers of chartered surveyors in the country, and according to the government, it finds recruiting sufficient chartered surveyors challenging. The VOA receives in excess of 8,000 appeals per month and has 3,500 staff. Its gross operating costs are £195m and 72 per cent of these are staff costs. The current system is expensive to administer largely because rateable values are undertaken at the individual property level so it is necessary for personnel to check measurements on-site if the reason behind appeals are related to measurement errors. As the rateable value of a retail unit is disproportionately driven by the width of the shop window, it is common for businesses to appeal to try to reduce business rates by ensuring these measurements are accurate. However, over 70 per cent of all the challenges on the 2010 rating list have resulted in no change although most do not state the basis for the appeal.[50]

The Treasury's response to the business rates review published in March 2016 was to accept that valuations needed to be more regular – at least every three years. However, it has completely failed to address how this might be done more efficiently. The Treasury's response to more regular valuations has been that this will increase costs. A preferable approach would have been to think about the nature of the tax itself and see how more regular valuations could be generated more cheaply than under the current system.

49. Business rates fit for a devolved 21st century British Economy, Policy Network 2015

50. Ibid

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4. Taxes investment in plant and machinery but not vacant land

Business rates are levied on rental valuations that incorporate plant and machinery investment. Given the low rate of investment in the UK this is clearly a poor incentive if the objective is to raise investment levels. Indeed, a key effect of business rates is that economic activity in the UK is artificially skewed away from development and productive activity.

Land without any structures on it is not subject to business rates at all, which has led to some instances of owners demolishing structures to avoid paying the tax. This is problematic as it creates no incentive for vacant land to be used efficiently, which given the current constraints on housing supply and office space in growing city regions is clearly sub-optimal.

Recommendations

In response to these four issues, it is recommend that the following three principles are used as the foundation for an effective business rates tax for the 21st century:

1. Conduct valuations annually at the post code level

The lack of regular valuation means that firms are either paying too little or too much depending on the direction of the local economy. To keep the administrative costs to a minimum this can be achieved by moving away from costly individual valuations towards post code valuations which capture average rents per square metre. By digitising the VOA and ensuring that all properties are connected to the system, rental values can easily be updated by firms. Annual valuations will also reduce the number of appeals, greatly reducing costs further. In the Netherlands, the introduction of annual valuations led to a drop of 80 per cent in appeals.[51] Finally, to avoid the regressive nature of the tax, those who use more land should pay a proportionate amount of tax. As such the zoning rules should be dropped in favour of a simpler system where firms pay a fixed percentage for the space that they use, rather than lower rates on larger spaces.

2. Apply business rates to vacant land and remove plant and machinery from the tax

Business rates should be applied to vacant land, as land can be rented out for business purposes. Once sufficient data are collected on land it should become easier to remove plant and machinery from the current regime. Such an approach is in keeping with the Mirrlees Review of taxation recommendations.[52] However, any move towards removing plant and machinery from valuation estimates will most likely require a two-stage process.

3. Give combined authorities greater control

Combined authorities need to be given full control over the rate at which it can set its multiplier, both up and down. Moreover, decisions on which groups benefit from business rates relief should be determined by each combined authority and not by central government. To date, more than £3bn has been removed from the tax. This leads to distortions in local economies, as different geographic locations have different business drivers.

Critically, as the devolution process unfolds over this parliament, greater consideration should be given to devolving business rates fully to combined authorities with sufficient scale. Devolution of business rates to individual authorities makes little sense given that they are not coterminous with a functional economic area. For the tax incentive to generate higher rates of local economic growth, investments that benefit the entire local economy need to be made, permitting rising land values to

51. http://www.booksellers.org.uk/BookSellers/media/SiteMediaLibrary/IndustryNews/Adminstration-of-Business-Rates-in-England-BA-Submission-to-HM-Treasury.pdf

52. Reforming the Tax System for the 21st Century: The Mirrlees Review

pay back the funds to finance the initial investment.

A fairer flat-rate council tax

The way in which domestic properties are taxed also needs a fundamental reassessment, although this appears unlikely to be a priority for this parliament given the political challenges it brings. Council tax is charged to all occupiers of domestic property in England, who are placed into one of eight bands (A to H). Each band attracts a different rate of taxation – with the higher the band, the higher the council tax paid. The valuation bands are based on the estimated market value of each house on 1 April 1991. There has been no revaluation of properties at all in England since the tax was introduced. In 2014, council tax raised in England was just under £23.6bn excluding local precepts.[53]

House prices since 1991 have risen by nearly 200 per cent across the UK, but they have risen by nearly 350 per cent in London, and only 150 per cent in the north west.[54] Despite this rise in values for Londoners, the wealthiest property owners in the most exclusive parts of London actually pay less in council tax than an average worker does across many parts of the country. For example, a £140m luxury apartment in Westminster (band H) is liable for £1,338 in council tax, whereas a two bedroom flat costing £650 per month in rent in Weymouth (band C) would pay 17 per cent more in council tax at £1,559. Property owners not only have to pay less tax, but they have also benefited substantially from the rise in London land values.

This clear lack of a relationship between council tax and rising house prices has not only led to great inequalities of wealth between home owners and renters, but also inequalities between home owners in different cities. It has even led to inequalities between different areas in the same city as there is evidence that housing is constrained most in the areas which are most desirable to live in, which in turn increases values further.[55] Rising house prices have also significantly increased intergenerational inequalities with recent polling by Populus for the Centre for Progressive Capitalism highlighting that the lack of housing that is affordable is now seen as the greatest barrier for young people in achieving their aspirations.

The data set collected by Thomas Piketty demonstrates that rising land and house prices have been largely responsible for increasing inequality over the last three decades.[56] A further dissection of Piketty's dataset highlights that the returns from productive wealth, which excludes housing, have risen only weakly relative to income over the last few decades. And when the capital to labour income ratio is calculated excluding housing, there has been no long-run trend away from the returns to labour towards capital.[57]

Given that governments in most countries tax land and housing at substantially lower rates than income, the owners of land have benefited most – through no effort of their own – from the productive work of others. In essence, the current economic system discriminates against productive members of society in favour of those who benefit from unearned income.

As the Mirrlees Review of tax in the UK argued, council tax has three fundamental flaws. First, properties are heavily concentrated in the lower bands, with 81 per cent of all houses in the lowest four bands. Second, average council charges rise more slowly than values themselves making the tax regressive. Finally, the highest band covers all properties worth more than £320,000 in 1991, including those worth many times more. The Mirrlees Review recommended a tax on housing services, which bears a closer resemblance to one of council tax's predecessors: domestic rates. These were charged as a percentage of the estimated rental value of properties.[58]

53. Local Government Financial Statistics England No.25 2015 DCLG

54. Calculated from the Halifax Price Indices

55. Housing Inequality David Albouy Mike Zabek 2016

56.Thomas Piketty, Capital in the 21st Century, p.116 (UK)

57. Does housing capital contribute to inequality? A comment on Thomas Piketty's Capital in the 21stCentury Bonnet, Bono, Chapelle & Wasmer, May 2014

58. Tax by Design, Mirrlees Review 2011

Table 4.1: Distribution of housing stock in England by council tax band [59]

Council tax band	A	B	C	D	E	F	G	H	Total for all dwellings
# of dwellings by band	5,814,551	4,648,289	5,154,689	3,642,444	2,241,807	1,184,996	828,442	137,902	23,653,120
% of dwellings by by band	25%	20%	22%	15%	9%	5%	4%	1%	

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The principle of moving towards a flat tax on local property is to be welcome for numerous reasons. First, a flat tax is much fairer than the current regressive tax which sees those occupying the most valuable land having to pay a lower proportion of tax on those values. Second, it is simpler to levy given that it would avoid band challenges. Third, should a combined authority wish to ask its electorate to increase or decrease council tax it would be able to make the necessary adjustment to the flat rate.

In practice such a reform could be achieved relatively easily by levying a fixed percentage on the value of each house based on a revenue neutral calculation. Our estimates imply that this would be in the region of 0.5 per cent of the value of the house price, which would be revenue neutral or beneficial for around 80 per cent of households. Using house prices rather than rental values is a more straight-forward approach to achieve the Mirrlees Review's goal, given that the dataset already largely exists.

Although new technology and data would permit automatic annualised valuations, it should be noted that this does not mean that each combined authority would adjust their 'new council tax' up or down based on house prices. Each combined authority would able to adjust the multiplier based on its revenue needs, which is the approach that the government is taking with respect to business rates, albeit within certain fiscal constraints. This devolution to combined authorities would allow the local electorate to vote on budgets and ensure that council tax is more responsive to those plans.

For the small percentage of individuals who are asset rich but income poor, and are unable to pay the increase in rates, all tax could be deferred until the owner sells the house where the combined authority has the first claim on the proceeds of the sale of the house.

59. Source: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/505139/CTB_Form_October_2015-_drop_down_-_revised_Feb_2016.xlsx

Conclusion

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Britain urgently needs to increase its level of infrastructure investment to unlock new areas of land if it wants to increase the supply of new housing. This can be achieved by utilising land value capture to finance a new wave of investment.

To pursue such a policy will require the 1961 Land Compensation Act to be reformed whereby land designated in a combined authority plan for infrastructure and housing would not take account of any prospective planning permission with regards to compensation. As a result of this change the combined authority would be able to capture the uplift in land values. This would permit the funding of large-scale infrastructure projects, most likely via the bond market, with the bond holders paid back from income streams generated by the uplift in land values. This approach to land assembly and investment would also ensure that public land is effectively utilised in unlocking land for new housing.

The result of this shift in policy would generate a significant boost to the British economy in four major areas.

- **It would free up £172bn over the next twenty years for increased capital expenditure for infrastructure investment, which in turn would increase the viability of many large-scale housing projects.**

- **By removing high and volatile land prices from the construction process it would pave the way to increase the number of building firms fourfold, as well as the potential to generate 77,000 jobs, and an increase of £16bn in output per year.**

- **The elimination of profits from rising land prices would shift investment patterns away from existing assets such as land and property towards productive assets, thereby increasing output and productivity growth.**

- **The ability to increase the viability of new large-scale housebuilding would mean that the pressure on the housing benefit bill could be alleviated by up to two thirds of the current levels of 1.4% of GDP.**

Besides ensuring that combined authorities are able to capture the uplift in land values from new projects, a more concerted effort needs to be made to ensure that business rates and council tax are also capturing the benefits from investments which increase land values. This will require business rates to be based on more regular valuations, plant and machinery to be removed, and the tax to be applied to vacant land. Council tax should be directed towards a flat tax on the value of houses. This would end the regressive nature of the current system. Greater control of the tax should also be devolved to combined authorities.

It is clear that there is an increasing appetite for reform from all major political parties on solving the housing crisis. The recent foundation of the National Infrastructure Commission is a welcome step to reverse these chronic levels of underinvestment. It also signals a much needed shift in the political consensus for the state to intervene in order to drive investment in our physical infrastructure. However, without the ability of combined authorities to use land value capture, it is hard to see how the wave of infrastructure investment that Britain needs will be financed given the current fiscal constraints.

Britain urgently needs to shift towards a higher investment, higher productivity economy. A jump in infrastructure spending will not only help increase the new supply of housing, but it will also support greater productivity growth, driving up real incomes for all of society.

Appendix – methodology for estimating land value capture

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The local government department provides data on the following data sets, which form the foundation of the analysis:

- estimates of the value per hectare of residential land by each of the 326 local authorities in England;[60]
- estimates per hectare for agricultural and industrial land by region;
- the number of units built by each of the 326 local authorities in England adjusted by average difference of housing output between table 209 and table 120
- the density of house construction by each of the 326 local authorities in England;
- the split of brownfield vs greenfield land used for residential housing.

From these datasets we can therefore determine the following:

- Number of hectares of land used for residential construction per annum by authority. (Number of units built divided by the density per hectare)
- Total land value of new builds (number of hectares of land multiplied by the land value per hectare)
- Summing up the land values of new builds for all 326 local authorities we can estimate the total value of land for new builds at £14.759bn for 2014-15.

  Note: This figure is an underestimate of the final land value calculation as it excludes residential units that have been modified from other uses such as commercial property which in 2014 2015 amounted to 20,650 residential units. This has been excluded as we do not have data to ascertain what the land value may have been originally. Commercial property has also been excluded from the calculation due to lack of data.

According to land use statistics, 59 per cent of new residential addresses were constructed on previously developed land and therefore has been allocated an industrial land use value. 41 per cent of addresses were developed on greenfield land that was allocated agricultural use value. We have assumed that 100 per cent of land in Greater London is industrial land, which leads to an adjustment for the rest of England of 52 per cent industrial land and 48 per cent agricultural land. Using these ratios for original use value we can determine that total initial land use value for 2014-15 was £2.383bn.

Therefore, the total land value uplift is estimated at £12.375bn.

Local authorities already capture some of this uplift through section 106 agreements and the community infrastructure levy. The section 106 planning obligations negotiated between landowners, developers and local planning authorities generate obligations for developers to make contributions towards affordable housing, transportation and other public services or spaces. The local government department has estimated the quantity and financial value of planning obligations in 2007-08 was £4.9bn and in 2011-12 was £3.7bn.

In 2011-12 section 106 generated an incremental £3.7bn from the following sources:

- **Affordable housing** £2.3bn (31,000 – 33,000 affordable housing dwellings)
- **Direct payments** £1bn (Education and transport account for nearly 60 per cent of direct payments)
- **Payments in kind** £0.1bn
- **Land contributions** £0.3bn

60. Data sourced from Land value estimates for policy appraisal December 2015, DCLG – Although there remain data issues with these values, they remain the only consistent national available dataset and therefore provide a reasonably solid foundation for the analysis

In seeking to estimate the value of section 106 for 2014-2015, we have taken the average of the ratio of house completions to the local government department estimates for 2007-08 and 2011-2012 and computed an estimated value based on this ratio. Hence for 2014-15 we get an estimate of the value in planning obligations of £3.725bn.

The local government department has stipulated that 75 per cent of this value is generated from residential buildings, resulting in £2.79bn of value already being captured.

Public authorities also sell land at market prices and hence generate incremental income streams from the uplift in land values. Although there is no data on the value of these income streams, which was the subject of a critical National Audit Office report, the government has set a target of £1bn per year from the public sales of land. Although this is likely to be an overestimate we have taken this into account in the final figure.

Subtracting £2.79bn from section 106/CIL income streams and £1bn of land sales leaves the amount of uplift in land values not captured of £8.585bn.

Given that the local government department has stated that 75 per cent of section 106 obligations is derived from residential property, it is plausible that the actual figure of land value uplift is significantly higher than the estimated £8.6bn.

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