incentives for growth

Edited by Paul Hackett

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Preface
Wilf Stevenson, Director, Smith Institute

The Smith Institute is an independent think tank which has been set up to undertake research and education in issues that flow from the changing relationship between social values and economic imperatives. In recent years the institute has centred its work on the policy implications arising from the interactions of equality, enterprise and equity.

This monograph takes a hard look at what needs to be done to meet the government's ambitious housing and growth targets. In advance of the next comprehensive spending review (and related reviews on transport, planning and local government), the essays examine the barriers to investment and propose a menu of new incentives to address housing shortages in the South and underinvestment in areas of deprivation in the North.

Incentives for Growth is a timely publication that takes forward the discussions the Smith Institute has sponsored in recent years on public-private finance and housing policy. It draws on past experience from the UK and the US and debates the use of new, more localised policy tools such as housing tax credits, tax incremental financing and regeneration infrastructure funds. Proposals are also put forward to boost social investment and support the emerging community finance sector.

The authors consider the chequered history of tax breaks and discuss the demand for a more sophisticated and market-sensitive approach to social investment and financing regeneration. There are no easy answers in this ever more complex area of funding major projects, but each chapter suggests how incentives could work more effectively with conventional grant funding to secure higher and better-quality investment – especially in the core cities and "Northern Way" areas.

The government faces an enormous challenge in securing sufficient investment for sustainable growth and is looking for new approaches and new ideas. We hope these contributions, by leading experts in the field of regeneration, economic development and public-private finance, will provide a valuable resource for government and the host of other organisations and individuals involved in helping fund sustainable communities.

The Smith Institute thanks Paul Hackett for agreeing to edit this collection of essays, and gratefully acknowledges the support of PricewaterhouseCoopers and Yorkshire Forward towards this publication and the associated seminar.

Foreword
Rt Hon Stephen Timms MP, Chief Secretary to the Treasury

The central economic objective of this government is to build a strong economy alongside a fair society, with opportunity and security for all. Enabling everyone to contribute and share in that economic prosperity is key to achieving this goal. I therefore welcome the valuable contribution that this monograph of essays makes to the debate, and look forward to continued progress as we promote regional and local growth.

We need to build up the right local and regional incentives for growth and for investment. Over the last 10 years we have taken important steps to develop these. Locally, new approaches have begun to pay dividends. The local authority business growth initiative encourages local authorities to work with the private sector to promote economic growth. The local enterprise growth initiative goes a step further, specifically targeting business growth in the most disadvantaged areas.

Regionally, strategies to encourage investment vary to reflect local needs and resources. The regional development agencies have been given considerable budgets, over £2 billion this last year alone, as well as great flexibility and autonomy to find the most effective ways of stimulating growth in their region. This funding reflects different opportunities and needs, enabling less well-off regions to spend substantially more per head than more prosperous areas – contributing to narrowing the disparities in economic performance.

Nationally, English Partnerships, the national regeneration agency, provides real incentives to support high-quality sustainable growth across England too. That ranges from brokering agreements with the private sector to co-ordinating investment; from creating incentives for development through gap funding, through to tackling dereliction and supporting affordable housing.

More widely still, we can make a considerable difference through our tax system, which provides important incentives for growth. For example, disadvantaged areas relief was introduced in 2001 to provide relief from stamp duty land tax on residential transactions in the most disadvantaged areas. Looking ahead, we are committed to introducing a business premises renovation allowance, which would provide 100% capital allowances for the costs of bringing empty business properties in disadvantaged areas back into use, following state aids approval from the European Commission.

In addition, the government is undertaking a fundamental reassessment of current incentive structures for economic growth in preparation for the comprehensive spending review. The policy review of subnational economic development and regeneration will be assessing how best governance, incentives and accountability can be arranged to support economic growth and tackle spatial disparities.

In parallel, the policy review on supporting housing growth will determine the social, transport and environmental infrastructure implications of housing growth, establish a framework for sustainable and cost-effective patterns of growth, and ensure that departmental resources are best targeted to support housing growth.

We have set out our ambition to address, through the comprehensive spending review, the challenges that will face the UK in the coming decade. The realities of technological and demographic change and the globalisation of economic activity demand flexible and responsive incentives for growth. Addressing these challenges will require us to ensure that all citizens and communities, wherever they are located, can make the most of their potential and share fairly in our national prosperity. And it is this prosperity that will underpin the diverse, cohesive and strong communities that are central to our future success. These essays are an important contribution to the debate on how best to achieve that, and I welcome their publication.

Introduction
Paul Hackett, former Government Special Adviser and Public Policy Consultant

The funding framework for housing and growth is changing, with more emphasis on integrated policy making, public-private partnerships and private finance. This new approach has spawned a growing menu of new tools and incentives – including tax relief in deprived areas, shared equity housing schemes, regional venture capital funds, community investment tax credits, and more recently real estate investment trusts, the local authority business growth incentive scheme, infrastructure tariffs, and business improvement districts.

Against the backdrop of a tighter public spending round, ambitious delivery targets and growing demand for public funds, the government is now considering further incentives, such as a planning gain supplement and tax incremental financing. Local authorities and public agencies, including housing associations and regional development agencies, are being encouraged by ministers to find new ways of attracting private finance and know-how. The money markets, meanwhile, are showing a greater appetite for investing in government-sponsored programmes – like affordable housing and infrastructure – that were traditionally the preserve of the public sector.

However, according to PricewaterhouseCoopers, the high levels of liquidity in the financial markets have so far not been translated into significant new investment into regeneration. The major institutional investors remain cautious, despite mounting evidence of healthy returns from public-private regeneration programmes. Moreover, stakeholders often prefer to stick with the conventional grants system they know rather than support new incentives that demand a change in approach.

Investors, on the other hand, often claim that investment incentive schemes are badly designed, undersold and poorly targeted. There are also concerns about governance arrangements, capacity and expertise in the public sector (and the not-for-profit sector), all of which feed a perception of uncertainty and high risk.

Despite these difficulties, there is a growing body of research (much of it from the US) to show that incentives (packaged with public grant and other instruments) are an effective way of attracting large-scale additional funding in housing, regeneration and infrastructure. This monograph seeks to put that evidence to the test by providing a critical review of what has been achieved so far under Labour and what may work better in the future.

The following chapters examine the pros and cons of incentives for growth in respect of private investors, public agencies and the so-called "third sector". The authors discuss the key issues surrounding the government's agenda for regeneration and renewal, investigate the options for change and put forward new ideas and proposals.

In different ways, the chapters seek to connect the debate on incentives for growth with the government's comprehensive spending review (due in 2007) and related policy reviews, such as the Barker review on land use planning; the Lyons inquiry into local government finance; the housing and regeneration review; the Eddington transport review; and the cross-cutting reviews on infrastructure and growth.

A "Northern Way"

Incentives for growth and renewal are at the heart of the government's strategy to lift the economic performance of the North. Although all the Northern regions have seen improvements (especially in the large cities), the relative prosperity gap with London and the South East remains stubbornly wide and continues to pose a threat to long-term national economic success.

Tom Riordan, chief executive of Yorkshire Forward, says in his chapter "Financing the Northern Way: incentives for regeneration in the North" that the North's economy is improving but has not been transformed. He argues that the Northern Way initiative (led by the three Northern regional development agencies) and the city-region approach (championed by the large Northern local authorities) are making a difference, but that existing incentives need to be pushed to the limit.

Riordan observes that past financial incentives and interventions were too centralised, lacked a real understanding of how the local economy worked and were rarely joined-up. He claims times have changed and that the common barrier to growth is, almost without exception, infrastructure costs. For Riordan, the issue is less a case of creating new incentives, rather more an argument about how to get public and private actors singing from the same hymn sheet. He also notes that changes to the way public bodies such as the regional development agencies have to account for their assets would be a positive move.

According to Riordan, addressing all the risk issues (including planning, land assembly, infrastructure and so on), not just the financial aspects of regeneration, is essential to creating investor confidence. Financial incentives can be important, but they are just one part of addressing private developer and investor risk. Summarising the views of investors in the North, Riordan concludes that the real key and priority is to introduce greater financial freedoms and flexibilities for Northern local authorities. "Devolving business rate responsibility back to local authorities – perhaps Northern local authorities in the first instance would provide a real boost to economic growth," he suggests.

Land banks and house building

Joe Docherty, chief executive of Tees Valley Regeneration, emphasises – in his chapter "Maximising private investment in housing and growth" – the need to understand and work with the financial markets. He argues that there has been too much reliance on planning policy and conventional public funding, and not enough focus on market mechanisms.

Docherty claims that the behaviour of house builders, for example, has remained unchanged for more than 20 years despite government interventions. He suggests the time is right for a more ambitious strategy, including more flexible planning and giving the public sector more financial freedoms and flexibilities – not least, greater powers to utilise physical assets. In areas of high housing demand, Docherty suggests that public agencies might also be given the powers and resources to buy (and bank) land. He notes that such a dramatic change in approach would require some safeguards, but argues that maintaining the status quo will make it impossible for Labour to meet its ambitious housing targets.

Housing tax credits and the American experience

The UK, of course, is not alone in seeking new programmes and incentives for housing and growth. In the US, for example, the affordable housing sector has seen a variety of new incentives, many of them at state and municipal levels and targeted at both the for-profit and the not-for-profit sectors. According to David Smith, founder of the American Affordable Housing Institute and a leading expert on international housing markets, "the essence of a public-private partnership model is incentives, shaping behaviour and market through rewards rather than commands".

For Smith, US experience suggests that there is constant demand for new and judicious incentives: "no sooner is one initiative added to the repertoire than another market niche appears, another funding gap arises … Government is constantly hoping for the universal programme that can simply be created and then funded increasingly thereafter, but this is impossible because ecosystemic complexity continuously increases … Indeed, the success of older programme creates demand for new ones."

Smith describes how the affordable housing market has evolved in the US, and draws some interesting parallels with the UK. He argues that the UK can learn from the US experience (particularly in respect of funding systems, project finance and delivery structures) and makes some insightful recommendations. Smith suggests the UK is ripe for a more radical policy shift, centred on the idea of adapted housing investment tax credits.

Drawing on some 20 years of experience, Smith makes the case for low-income housing tax credits, which have helped fund more than 1.2 million homes in the US and have become the motor for investment in affordable housing (the credits are worth US$7 billion a year). The credits system offers a cost-effective alternative to conventional housing grant and brings America's largest financial institutions into close contact with local community (and housing) organisations.

According to Smith, the UK has all the preconditions in place for a scheme of this type: "Tax credits would find a ready take-up and would provide immediate benefits, including stimulating the two other desirable trends – stock transfer from local authorities and greater involvement by for-profit developers."

Incentives for local economic development

Smith also comments that the locus of decision making and funding for affordable housing in the US has shifted to the states (with the federal government's encouragement), and that new incentives must be modified to suit local conditions. This point is developed further by Chris Leslie, director of the New Local Government Network and former government minister, in his chapter on incentives for local economic development.

Taking up the agenda set out by the Lyons inquiry into local government, Leslie looks at how the local state can influence private institutions and companies to hire more people. He argues for a more proactive, locally driven approach towards tackling regional disparities, and calls for a fundamental change "that helps councils to learn new skills and take on new responsibilities, and to mature in their willingness to tackle thorny issues, generate their own resources and solve their own problems".

Leslie examines the key conditions for endogenous growth, and comments on the way in which Whitehall continues to impose constraints on local government. According to Leslie, for new incentives to work at the local level, local democracy requires much greater freedoms and flexibilities and a new culture of rewarding local independence.

In particular, Leslie calls for a move away from a grant-giving regime towards a system of assigning tax as grant. This would leave unaltered the national tax system, but "the incentive to take a greater interest and role in shaping local economic development would be instant and significant". Leslie also questions the effectiveness of a possible planning gain supplement, and instead advocates development of infrastructure tariffs and new flexibilities for capital financing. He also comments on the need for more "multi-area agreements" on cross-boundary working, such as the Regional Cities East coalition.

Enabling investment and regeneration infrastructure funds

Leslie proposes that councils should be freer to use future revenue streams against which to raise capital. This issue is taken up by Ray Mills and Rosalind Rowe, partners of PricewaterhouseCoopers, who provide an insider view of how the private sector perceives government incentives to invest in underserved markets. In their chapter on "Financing solutions for growth and renewal", Mills and Rowe set out the case for tax incremental financing, which involves capturing increases in local taxes to fund (and co-fund) local regeneration. They claim that tax incremental financing could perform a vital function in "creating an investment bridge between the requirement to forward fund infrastructure investment and subsequent development".

According to PricewaterhouseCoopers, the TIF model (tried and tested in the US) should form part of the toolkit for enabling investment, alongside other new approaches such as strategic section 106 infrastructure tariffs ("roof tariffs") and new public-private partnerships such as Blueprint in the East Midlands, which receives stable revenue streams from investment assets transferred into the partnership as part of the initial equity investment.

Mills and Rowe comment that these types of regeneration partnerships, which provide long-term and secure income streams, are attractive to private investors but can be difficult to set up. They also make the point that instruments such as roof tariffs, where contributions are not captured until development gets under way, cannot provide a workable solution unless government is willing to act as initial banker and invest in advance.

They say there are no simple solutions, but establishing new regeneration infrastructure funds – with the right to capture future income streams generated by tariffs or local taxes, and use that income to repay debt borrowed in advance to fund up-front enabling investment – could complement existing schemes and unlock new resources. Mills and Rowe explain how regeneration infrastructure funds would work and suggest that they could provide "significant scope for leverage of private-sector investment and the potential for sharing and recycling financial returns".

They say experience suggests that, while new structures and investment vehicles are important innovations, if we are to secure large-scale additional funding for enabling infrastructure (which is the critical platform for regeneration) then a greater focus is required on the challenge of improving the trade-off between risk and return on investment.

They also comment on the use of tax breaks (such as real estate investment trusts) and tax-transparent vehicles, such as the new limited liability partnerships. According to PricewaterhouseCoopers, new tax incentives also often fail to close the yield gap between returns on regeneration investment and competing offers in the marketplace. Unless this test is passed, initiatives intended to be fit for purpose all too often quickly become fit for failure.

Investing in the third sector

The social enterprise sector has expanded dramatically over the past decade, contributing more than £8 billion a year to the national economy and employing half a million people. Not-for-profit enterprises, like Cafédirect and community development trusts, are now playing a significant role in the regeneration of local communities across the UK. However – as Jonathan Bland and Lisa Knowles from the Social Enterprise Coalition show in their chapter – the third sector has enormous potential and is being constrained by a lack of access to private finance.

According to the Social Enterprise Coalition, part of the problem is that investment incentives such as enterprise capital funds (designed to bridge the equity gap for investment in new companies) encourage mainstream investors to prioritise conventional profit-maximising businesses, leaving social enterprises over-reliant on philanthropy. The initial response to overcoming these funding barriers was to scale up investment through new community development finance institutions, backed by the now defunct Phoenix fund. CDFIs were also supported by the community investment tax relief scheme, which was recommended by Sir Ronald Cohen's social investment task force in 2000.

For Bland and Knowles, CDFIs and the tax relief marked a positive turning point for the sector, but both initiatives have fallen short of expectations. There have been other improvements since (not least the introduction of a legal framework for social enterprises and expansion of alternative forms of investment), but stronger incentives are needed to tackle the deep-rooted market failures holding back social investment. The Social Enterprise Coalition calls for extra support for CDFIs – perhaps through a new social investment bank, using some of the £2.4 billion lying unclaimed in UK banks (a proposal made by the Commission on Unclaimed Assets, also chaired by Cohen).

With an eye on the government's on-going review of the third sector, Bland and Knowles argue for more help to boost the investment readiness of social enterprises and recommend recalibrating existing tax breaks to attract more social investment.

Dermot Finch, director at the Institute for Public Policy Research's Centre for Cities, also reviews the barriers to growth in the third sector in his chapter, "Tax incentives for social investment". Finch, who as a Treasury adviser was responsible for following up the social investment task force report, provides a well-argued and incisive critique of the community development finance sector. Like the Social Enterprise Coalition, Dermot notes the success of the third sector, but claims that the impact of community investment tax relief since its introduction in 2003 has been somewhat disappointing. The scheme has only raised around £50 million so far (against a target of £1 billion by 2008), with less than half on-lent to social investment entities and little corporate involvement.

Finch suggests that the sector suffers from limited demand and weak capacity, and considers whether community development finance institutions could compete with the major banks. He argues that the time is right for a reform package that builds on experience since the social investment task force report, including beefing up the community investment tax relief. He also explores the more radical option of introducing something similar to the US Community Reinvestment Act (introduced in 1977, and revamped under President Bill Clinton), which would effectively mandate banks to provide services to low-income communities and disclose their lending and investing activities in those areas.

Sustainable communities

Finally, John Callcutt, the new chief executive of national regeneration agency English Partnerships, in his chapter suggests that clearer national standards and longer-term delivery arrangements can achieve the double dividend of speeding up housing supply and promoting sustainable development. Callcutt argues that while a great deal is being done, to reach the tipping point "requires the public sector to start investing in projects in a different way so that private-sector partners have more clarity on standards and objectives before and after being engaged in projects".

The environmental footprint of our housing fabric is poor (homes account for nearly a third of the nation's carbon dioxide emissions) and the UK trails behind other countries, like Denmark, which has introduced new incentives and building regulations to deliver zero-carbon homes. Callcutt identifies the barriers to sustainable housing and sets a clear trajectory towards carbon reduction, including incentives for energy savings, improved planning and more joined-up delivery. Although optimistic about inter-agency co-operation to implement the Code for Sustainable Homes, he warns that "in moving forward we may need to resolve a growing tension between the proliferation of clever and detailed technical standards set locally by ambitious local authorities and what is, and should be, led nationally".

Chapter 1

Financing solutions for growth and renewal

Ray Mills and Rosalind Rowe, partners of PricewaterhouseCoopers

Financing solutions for growth and renewal

The government is constantly on the search for new and better ways to attract greater levels of private finance to regeneration. The recent cross-cutting review into supporting housing growth, for example, looks at investment incentives to deliver investment in housing-related infrastructure. The subnational economic development and regeneration review meanwhile examines the value for money and effectiveness of interventions for encouraging economic growth and regeneration at the local and regional levels. Such consultations, ahead of the 2007 comprehensive spending review, seek to put public-private funding centre stage in delivery of the government's economic productivity and prosperity agenda.

This debate has taken place at a time when an abundance of private capital has been available to invest. Disappointingly, the high levels of liquidity in the financial markets have not been translated into significant new investment in regeneration, although the commercial and residential investment markets have thrived on the back of significant injections of new money.

The major barrier to securing significant new investment in regeneration has been the perception of uncertainty and risk in regeneration areas, which has been sufficient to deter major institutional investors. This remains the case, despite an increasing evidence base that suggests that investment returns from regeneration property have exceeded the Investment Property Databank UK benchmark. This paper further explores this issue and proposes a new approach for attracting investment to regeneration areas, and in particular to addressing the perennial issue of forward financing, enabling investment in land remediation and infrastructure.

Enabling investment and property finance

The public sector has, over the years, proposed various interventions to stimulate regeneration investment – particularly in underserved areas that are in need of regeneration – with varying degrees of success. The scale of the challenge created by the South East growth areas, the 2012 Olympics and the continuing focus on improving the economic performance of the UK regions means, however, that there is an unprecedented pressure and focus on delivering regeneration projects.

The scale of investment required to deliver the government's regeneration ambitions is such that the public sector does not have available resources for the scale of investment needed in land remediation, infrastructure and other enabling investment, which it has traditionally been expected to meet. Furthermore, the challenge is not limited to the amount of funds required. It also, increasingly, involves the timing of any investment, and particularly the need to forward fund infrastructure as a necessary catalyst to commercially viable and productive regeneration programmes.

There is concern that the public sector cannot meet the pressures of unprecedented demand for regeneration and forward funding of infrastructure across the UK. Therefore, if the government's ambitious plans for growth and renewal across the nation are to continue, there is an increasingly urgent need to further explore new opportunities and approaches to accessing private finance for infrastructure investment.

In considering opportunities to access additional private finance for regeneration, a distinction needs to be made between enabling investment (such as land assembly, site remediation and infrastructure) and property finance of commercial, leisure and residential development. This distinction has typically marked the boundary between public- and private-sector investment, with the public sector primarily meeting the enabling investment requirement, thus creating a platform for property or development finance to complete the regeneration process.

The reason for this distinction is the high level of risk and uncertainty as to delivery and financial returns, as well as the potentially long-term time horizons associated with enabling investment. Clearly, this reliance on the public sector to fund enabling investment can, when government resources are limited, act as a barrier to development and the achievement of sustainable communities objectives.

There are other factors to take into account in determining the nature of any infrastructure financing solution. In particular, we would highlight the point that enabling investment such as infrastructure lends itself more to longer-term funding mechanisms (such as bonds) rather than shorter-term bank debt, which is typically used in property development finance. This is because of the different timescales, risk profiles and financial returns associated with infrastructure finance and investment in property development. Any solutions for stimulating private investment in regeneration need to recognise that the investment opportunities offered must reflect the requirements of different sources of finance.

Furthermore, there is little merit in expecting financial institutions to invest in long-term infrastructure requirements unless the overall return for investors is sufficient to compensate for the perceived uncertainty and risk. In contrast, experience demonstrates that securing private finance for property development is relatively straightforward, assuming appropriate investment in enabling infrastructure and the right market conditions. It follows therefore that if new financing mechanisms (and incentives) can be developed to accommodate investors and investment in enabling infrastructure, then a key barrier to growth and development would be removed.

The task of creating new funding mechanisms, able to accommodate long-term infrastructure investment while offering an acceptable rate of return to private-sector investors, is not straightforward. In this regard, the major challenge in designing new funding mechanisms is how to capture sufficient revenues from regeneration activity to offer the financial returns demanded by investors. If government is unwilling or unable to provide the financial returns demanded, say under PFI-type arrangements, then alternative means of capturing revenues from development need to be explored. Our view is that these alternative revenues are likely to relate to tariffs or local taxes on users or beneficiaries of the planned development, whether developers, residents or corporate tenants.

Tax incremental financing

A comparison here would be the tax incremental financing (TIF) approach used in a number of cities in the US. This approach involves establishing special-purpose vehicles with the right to capture increases in local taxes such as real estate taxes. These revenues are then used to fund infrastructure and other mechanisms to enable regeneration, such as incentives to encourage developers to invest.

Typically, the TIF will raise bond finance, secured by guarantees from the municipality and repaid by the tax receipts raised by the TIF vehicle. TIFs are now commonplace in nearly all American states and have raised billions of dollars of investment for regeneration in US cities. The TIF model is essentially a securitisation approach, underpinned by the hypothecation of revenues realised through regeneration.

While hypothecation is not generally supported by the UK government, it seems an equitable solution to capture local revenues, generated from either the public or private sectors, and to apply them to investment in the same locality. Indeed, there are signs in recent policy developments that the principles underlying localised hypothecation of state revenues are beginning to take root. The question is whether those principles can encompass the opportunity of raising private investment secured on those revenues.

Innovation in regeneration financing

Within the UK, there have recently been some positive developments in new approaches to capturing future revenues for financing regeneration. Those developments include initiatives such as the strategic section 106 tariff for Milton Keynes (the "roof tax"), the local authority business growth incentive scheme and the proposed planning gain supplement. All of these new initiatives share some similarities with TIF principles, in that they aim to capture from developers and businesses a proportion of new revenues generated by development and growth and to apply those funds towards further regeneration activity in the locality.

So far, the potential for using these revenue streams to attract private funding has not been fully tested, although there are some examples where the public sector has contributed towards enabling investment predicated on receipts from future development. To illustrate, the Milton Keynes tariff promises to generate somewhere in the region of £300 million towards housing and infrastructure provision, the forward funding of which will be met by government. Wider roll-out of the approach adopted in Milton Keynes, where government acts as banker for the forward funding element, would, however, significantly increase the burden on the public purse.

At the same time, new forms of funding and partnership vehicles between the public and private sectors have proven to be an effective means of leveraging in additional investment in regeneration. Partnership models such as Blueprint in the East Midlands (a 50/50 public-private partnership led by English Partnerships and the East Midlands Development Agency) and the £100 million English Cities fund (an initiative, run by English Partnerships and AMEC/Legal & General, to invest in deprived neighbourhoods) provide clear evidence that regeneration can be attractive to private-sector investors.

However, there is little evidence of the establishment of new public-private partnerships with the objective of investing primarily in enabling infrastructure – hardly surprising, given the uncertain returns, complexities and risks involved. It is instructive to note that the more successful examples of regeneration PPPs, such as Blueprint, receive stable revenue streams from investment assets transferred into the vehicle as part of the initial equity investment. This echoes the TIF approach, where the offer of a relatively secure, long-term income stream has proven a potent attraction for private-sector investment into public-sector-led regeneration initiatives.

Experience so far suggests that, while new structures and investment vehicles are important innovations, if we are to secure large-scale additional funding for enabling infrastructure (which is the critical platform for regeneration), then a greater focus is required on the challenge of improving the trade-off between risk and return on investment.

Enabling investment – regeneration infrastructure funds

As previously identified, enabling investment in a regeneration context relates to land assembly, infrastructure investment and public realm. The cost of these fundamental requirements has traditionally been financed from public-sector resources. There is little doubt, however, that the level of funds needed to meet the requirements of the UK's regeneration ambitions is so high that this traditional approach can no longer be relied upon in all circumstances.

Traditional PFI or PPP solutions will be an option for certain elements of infrastructure requirements, such as transport links, schools and health facilities. Other solutions need to be developed, however, that bring in substantial new injections of private finance into enabling infrastructure, if regeneration is not to be stifled and delayed.

A further major challenge in considering enabling investment is that, by its very nature, it is often required early in the development process – often before commercial development of any scale can take place. Therefore new or proposed approaches such as the strategic tariff, planning gain supplement or the local authority business growth incentive scheme, where contributions from developers or business are not captured until development gets under way, cannot provide a workable solution – unless the public sector provides funds for enabling investment, in the expectation that future contributions from the private sector will repay this commitment.

There is nevertheless widespread unease about how a planning gain supplement would be applied. Where section 106 agreements are sought from a developer, it has some control over delivery. Many in the regeneration industry fear that this control will be forfeited and that planning gain supplement may not be applied for its intended purpose, nor will delivery occur at the required time.

While public funding of enabling infrastructure is an obvious solution, can we be confident that the substantial funds required will be made available in the right amounts and at the right time to meet projected demand? How, therefore, can we harness additional private-sector investment, either to replace or to invest alongside scarce public-sector resources?

One solution could be to establish regeneration infrastructure funds (RIFs) with the right to capture future income streams generated by tariffs, planning gain supplement, local authority business growth incentive schemes, uniform business rates or council taxes, and use that income to repay debt borrowed in advance to fund upfront enabling investment. This approach reflects the TIF approach used in the US, referred to earlier.

The RIF would be long-term and likely to be funded through a combination of bonds, equity and debt. Investors would be repaid both their initial investment and a suitable coupon, through a combination of hypothecated tax/tariff revenues, contributions from developers and land sales; and in the initial stages before revenues are realised, the required coupon could be met from the capital raised.

A fund could also take on a development role, taking a stake in commercial or residential projects that are unlocked by the infrastructure investment. These investments could then be sold on or held within the fund as income-generating assets that may, in the longer term, serve to reduce the requirement for hypothecated government revenues to support fund returns.

The proposed RIFs could cover a region or, preferably, be area-specific, covering for example a city or town. An area-based fund would also give rise to the possibility of transferring income-generating assets into the fund, providing greater leverage for raising investment funds as well as reducing risk. In a similar vein, government funds injected as equity into the RIF would facilitate the raising of finance. In this instance, government regeneration funding schemes such as the community investment fund could be used as equity, rather than grant across a number of RIFs, providing significant scope for leverage of private investment and the potential for sharing and recycling financial returns.

It is likely that RIFs would require some form of government or local authority guarantee to underwrite their financial performance. This would ensure that the bond or debt issue and fundraising is successful, and would have a positive impact on pricing of the funds raised. The requirement for a government-backed guarantee would appear reasonable, given the direct economic benefits that would accrue from the associated regeneration activity.

A government-backed guarantee would also provide the opportunity to use higher proportions of shorter-term bank debt, which is likely to offer more flexibility for refinancing the RIF at a future date. This ability to refinance at a time when risk profiles are clearer and uncertainty is reduced may offer a chance to secure better pricing on debt terms, as well as releasing government from its obligations.

In terms of timing, an RIF could be set up for a specific period – say 20 years – or could be permanent, with proceeds being reinvested on an on-going basis and equity investors receiving dividends accruing from investment activity, in addition to the coupon offered to finance providers.

REITs and tax incentives for regeneration

As the RIF model becomes established, it may also be possible to establish the vehicle as a real estate investment trust. REITs – real estate investment trusts – offer tax incentives to investors, with no tax levied on the investment vehicle's rental income nor on gains from the sale of investment properties. Clearly, should a regeneration-type REIT emerge based around the RIF model, it would offer a further incentive to increase investment in regeneration, by improving returns to investors.

The key question will be whether fund returns, along with the tax incentives offered, are sufficient to bridge the yield gap between returns on regeneration investment and competing offers in the marketplace. If this gap can be closed, then RIFs could make a significant contribution towards funding sustainable communities.

Given that regeneration is not a homogeneous process, we see the RIF as part of a package of solutions. Other options would be to have tax-transparent vehicles that would enable the private sector to invest alongside the public sector – a good example is the limited liability partnership. An LLP can enter contracts without making its partners joint and severally liable (a potential hazard for the construction industry). The LLP affords exemption from tax at the vehicle level and is therefore tax-transparent, enabling the public sector to receive income gross rather than after tax. The public-sector bodies can consider whether to reinvest their tax-free returns from a regeneration site or use them for some other project.

For some sites that need pump-priming, tax incentives can play an effective role in attracting private money. However, such incentives work when there is full consultation and thorough market testing. A number of recent fiscal measures to encourage redevelopment of brownfield sites have not been fully effective, because the implications of their introduction had not been thought through.

Stamp duty relief in disadvantaged areas, for instance, became abused because it was not sufficiently focused. Similarly, contaminated land relief failed to live up to expectations, in part because investors are treated differently from property traders (investors get relief when they incur the cost, whereas traders/developers only get relief when they sell or write down the value of the property) and because complications in the definition of "contamination" led to misunderstandings.

The way forward

Clearly, some significant challenges would need to be to overcome in order to establish and implement infrastructure funds as described in this paper, not least in establishing the mechanisms by which a local authority could ringfence and advance future revenues generated by planning gain supplement, section 106 tariffs and others. We recognise that this is a measure considered and rejected by the government in the past.

On the plus side, however, the government's commitment to ensure that initiatives such as planning gain supplement and local authority business growth incentive schemes are local measures, with proceeds recycled through grant to the local level for local priorities, suggests a willingness to reconsider the hypothecation question in the field of regeneration. If this is indeed the case, then designing and implementing a mechanism to allow recycling of wider revenue streams, generated locally to repay finance raised in the public sector, should not be insurmountable.

The implementation of any RIF-type initiative would probably be best achieved through a number of pilot projects aimed at high-priority regeneration programmes, for example in the Thames Gateway. In advance of any pilot, it should be possible to assess the potential impact of a RIF approach in terms of the net additional gross added value that would be generated by this approach, compared with alternative delivery models.

The alternatives in this instance are likely to be zero-intervention and traditional intervention approaches. In the zero-intervention approach, government would essentially do nothing, and the traditional approach would involve pump-priming development through grant and other measures.

Governance will also be a key issue to consider and address if RIF activities are to be aligned with local regeneration priorities and strategies. The potential, however, to establish the funds as public-private partnerships should enable the establishment of acceptable governance strategies and procedures.

In conclusion, the establishment of new measures to support the creation of area-based regeneration and infrastructure funds – similar to TIFs in the US – could perform a vital function in creating an investment bridge between the requirement to forward fund infrastructure investment and subsequent development. If RIF-type funds can unlock new resources for enabling investment, and government can take the lead in their establishment, then the positive economic and regeneration impact that would follow would represent a real and scalable incentive for sustainable growth.

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Chapter 2

Incentives for change: local leadership, local prosperity

Chris Leslie, Director of the New Local Government Network

Incentives for change: local leadership, local prosperity

Finding the magic ingredients for successful local economic development isn't rocket science – it is more difficult than that. While every local authority in Britain now has an economic development strategy and a team of officers whose task is to "get results", there is an opacity here, more than in most other policy disciplines. The truth of the matter is that the role of the state (both local and national) in shaping economic growth and prosperity is far from a precise science – to many it is more of an art.

Local growth and prosperity are caused by higher levels of employment and income, which in turn are a product of institutions hiring more people within a community. While we cannot discount the importance of a thriving public sector using tax revenues as a means of employing local residents in socially useful tasks, for the purposes of this chapter, I want to focus instead on how the local state can influence private institutions and companies to hire more people.

Local economic development

Ask most businessmen or businesswomen whether their decision to hire employees was as a direct result of the actions of the local council, and I have no doubt that a resounding "no" will be heard. Yet when reading those glowing annual reports of many public bodies, these days you will often trip across claims extolling "1,000 more jobs created" by council X or agency Y. In reality, these statistics are hard to prove or disprove. They would have greater validity if they claimed a hand in *laying down the conditions* in which businesses created those thousand new employees. Because when the rhetoric is stripped away and the target culture set aside for a moment, it is blindingly obvious that local councils *can* help foster the right circumstances for private enterprise to thrive and succeed.

Although some businesses may think that they are independent and isolated from the public realm at large, in reality the state can have a massive impact on whether company chief executives can or cannot afford to hire more local employees. Most important, of course, are the fiscal and monetary policy frameworks which govern our financial circumstances as a society. These remain largely determined by national government, though globalisation has established implicit norms on both, and European treaties increasingly make explicit margins of flexibility.

We cannot ignore the importance of healthy national tax revenues as a direct driver of job creation in many local schools, hospitals and local community facilities. Outside the public sector, the tax regime can historically be highly beneficial or highly detrimental to corporate decisions on employment. Coupled with the role of the state in determining monetary policy and the affordability of capital, it is certain that the public realm is of great significance.

But what is the role of the local state in determining fiscal or monetary policy? It is marginal in the first case, non-existent in the second. So if local government is a mere pawn on the chess board of financial policy, is it any wonder that business is unclear about the role councils can play in economic development?

There are two points to make here. First, although local councils must be realistic about the scale of their significance, there are many non-financial areas where they can make or break a company's decision to employ. Second, perhaps it is time for local government to consider how it could become a bigger player in a financial sense, providing incentives to greater local employment and inward investment.

Capitalising on natural advantages

We are fortunate to live in an era where there are good examples of local prosperity and economic success dotted around the country, albeit far too few, but frequent enough to see what factors have made a big difference. Proximity to the capital city appears to be a major advantage for many communities, as any map of the distribution of wealth in Britain will show. This can, of course, be a double-edged sword, with the wealthiest communities (such as Canary Wharf) living side-by-side with some of the most deprived neighbourhoods in the country (Bethnal Green or Poplar). This is often the product of more and more people chasing aspirations of a better future, in turn crowding an already overheated patch.

But if well managed and appropriately regulated, communities within striking distance of busy centres of commerce can reach near-full employment, as the sheer demand for every available skill draws away all physical supply. Geography is a major advantage to many communities, and it is here that local government can make a big impact: removing barriers to reaching the workplace and helping commuters and traders with mobility. Technological improvements to mass public transit now mean that people can travel hundreds of miles to and from work, and traders can get goods and services to market just in time for their customers' convenience.

Each passing year sees the reach of "commutability" extend further and further – which means that local communities in Yorkshire and Lancashire, even in the North East, need to use their powers to help residents tap into the wealth of the capital city. It is no surprise that city-regions policy has come on to the agenda recently, prompted in part by the reality that councils can succeed in arguing for better road and rail links if they team together and argue strategically – but still they need to win London's consent, often, to gain fair access to London.

Community leadership, national reform

Yet geography is also a disadvantage for some communities, excluded and isolated from the burgeoning capital city. So is it possible for local councils to generate home-grown centres of commerce and enterprise, rather than relying on exporting their residents as commuters to London? I believe this has to be the key to a sustainable, long-term approach. Feeding more and more fuel to the already energetic capital city may bring short-term benefit, but it will store up imbalance and dysfunction for UK society as a whole. Britain needs a more balanced approach to economic development, and local government is vital in this endeavour.

The Lyons inquiry into the future role and finance of local government is addressing many relevant questions here. The British constitution sees localities highly dependent on grants and resources determined from on high, a culture that ensures that efforts – and blame – are focused always on Whitehall, and ministers are held as the sole saviours of many local problems. Unless a fundamental change of approach takes place, the chances of independent and creative economic development activity being led endogenously will diminish further still. Instead we need an approach that helps councils to learn new skills and take on new responsibilities, and to mature in their willingness to tackle thorny issues, generate their own resources and solve their own problems.

Do-it-yourself: laying down foundations

Not all efforts to encourage economic growth require finance or investment – sometimes what is required are new attitudes to regulation, relationships and presentation. As Kate Barker's review of housing supply suggests, the lighter-touch risk-based approach to planning and building control permissions can make a world of difference for the responsible business seeking to grow or diversify, just as an intransigent or faceless bureaucracy can deter for life any dealings in some localities. An upbeat, can-do attitude from local officials, inspired by positive political leadership, can engender a spirit of co-operation that is conducive to doing business, as is evident for instance in Manchester city's leadership team. A willingness to face head-on the prejudices that deter visitors or business location is also not as common as it should be, including attention to black spots that drag down the standing of some towns and cities (be they a reputation for gun crime, or litter, or even managerial incompetence).

We should not underestimate the importance of tourism and foreign expenditure in the UK as a generator of jobs and business start-ups – an industry highly dependent on skilful marketing and careful presentation of an area to the outside world. In its approach to skills training, town-centre facilities, even cultural events, arts and recreation, local government – as a multi-functional leader of a community – can use its influence more ingeniously to boost its economic prospects. Yet this non-financial policy approach cannot, on its own, answer all aspects of the challenge.

Economic development requires community investment in road and rail improvements, environmental and urban design changes to improve quality of life, solutions to draw custom efficiently into marketplaces and shopping centres, and available premises for office and retail facilities. Businesses today need help to make it easy and painless to locate within the community, help that removes obstacles and bureaucracy from the process of moving offices or affording decent, well-serviced accommodation.

In a world that looks set to see the UK economy lead on financial services, technology, research and white-collar trade, councils need to become familiar with the latest broadband, wifi or better communications infrastructure. The news that some local authorities are piloting whole-city wireless IT zones is a great example of helpfulness for job creation from the public realm.

Each of these initiatives can cost a local authority a considerable sum of money. It can sometimes feel as though there should be a higher priority afforded to speculative expenditure over immediate necessitous expenditure on basic services, which makes for difficult political choices. And there are other problems.

The pressures on resources available for discretionary spend by English local government have been so strong for more than a generation that we are now entirely unaccustomed to councils making decisions that go beyond those policies explicitly sanctioned by Whitehall. Councils have had constraints on their capital expenditure preventing many public works – especially social housing – from construction under their auspices, and while welcome relaxations have occurred in recent years, they have been offset by the lure of greater freedoms available in non-state investment vehicles, with their own set of constraints, permissions and limits.

Public-realm creativity has become largely unaffordable for local government, where a stifled ability to raise and spend capital has pretty well snuffed out the in-house engineering and architecture departments that were once the hallmark of a local state with the ability to determine its own destiny. Certainly, councils are occasionally able to commission external teams to design, build, finance and operate new local facilities. But if a local community wishes to acquire one of the building blocks necessary to attract business investment – a new road link, railway station, an educational establishment – it may only do so if the scheme can leap through hoops designated by decision makers in Whitehall.

At the New Local Government Network, we have urged Sir Michael Lyons and the Chancellor to take a "whole systems" approach to reform, including reforms as they seek to boost local economic development activity. Unless localities have the ability and nous to control and determine their own destiny, we will lose our enterprising edge as a nation and drift into a way of life reliant on top-down governance.

Social justice and economic development both require a healthy and vibrant local democratic leadership capability. The tentative steps in the direction of greater freedoms and flexibilities for local democracy in recent years are welcome, but barely scratch the surface of what is required. Whitehall is keen to see councils that show initiative and drive, yet is simultaneously addicted to a performance management regime that can appear to treat local government as a baby brother, not really aware of the risks or the caution required to act independently.

Next steps for freedoms and flexibilities

Local public services have a major impact on economic performance, their fate resting on the fortunes of the economy itself. Success breeds success, and growth can release new resources to further boost talent and productivity. So why is it that managers of local public services see no incentive to grow their community's economic base, in order to generate those extra resources to reinvest in better provision? If government chose to move away from a grant-giving regime, replacing it gradually with a series of assigned sources of revenue directly from taxes accumulated at a national level, local authorities would see for themselves the cause and effect of their policies on revenue generation.

If, for instance, the first incidence of income tax – namely the 10% starting rate – were assigned to local rather than national government in exchange for a commensurate diminution of revenue support grant, then council leaders would know for sure that the fate of their budgets was absolutely intertwined with the fate of their local economies. The incentive to take a greater interest and role in shaping local economic development would be instant and significant.

A strategy of assigning tax as grant need not involve locally variable tax rates, and could therefore avoid perverse incentives and cross-boundary anomalies. It would also leave unaltered the national frameworks of fiscal policy management, as yields would remain the same. The benefits would be felt in the greater maturity of local leadership, who would need to acquire the actuarial skills necessary to forecast long-term trends in the local economy, to predict likely income levels over time, and to understand better the relationship between local policy and available resources. This basic first step on the road to greater localism would go largely unnoticed by the general public, but it would create a seismic shift in the quality and capability of local authority leadership.

New freedoms are also needed to allow localities to benefit from the financial inventiveness that national government has delivered over the past decade. Not only should private finance be more available to local authorities to deliver major capital projects of benefit to the local economy, within more permissive yet better-defined guidelines, but councils should be freer to use future revenue streams against which to raise capital.

The possible advent of a planning gain supplement poses serious questions about the destination of the revenue generated as a result; if revenue is held locally, will this disadvantage those parts of the country where development is slower? But if revenue is accumulated nationally, will this stifle the incentive for local agents to generate and foster such investment in the first place? The alternative notion of infrastructure tariffs, as a predictable source of income available after construction and therefore allowing reasonable leverage on available capital in advance of development, is strong and should be piloted locally as soon as possible.

The additional latitude allowed by the 2003 Local Government Act through the system known as the prudential borrowing framework has still to be properly exploited by councils, perhaps because of a remaining cloudiness about the detailed rules. The local government community should come together to insist on new flexibilities for capital financing.

There are other vehicles at a local level that may provide new opportunities for capital finance or economic development. Business improvement districts are starting to emerge in more and more cities, providing an interesting new arm of local co-ordination and prospects for revenue. Furthermore, collaborations springing up between like-minded towns and cities – for instance, the Regional Cities East coalition in the East of England (including Peterborough, Norwich, Ipswich, Luton, Southend and Colchester), or the looser federation known as the South East Diamonds to the west and south of London (including Reading, Milton Keynes and Brighton) – are challenging the government to respond with multi-area agreements designed to ease urban regeneration and remove barriers to growth and prosperity.

Together with potential city-region initiatives, which might become stronger alliances around financial joint working on cross-boundary projects, there are some interesting and thoughtful examples of institutional change.

Policy opportunities

Coming months will see an array of policy direction papers and statements paying homage to the now widely accepted virtues of localism, though whether they will deliver significant or incremental change remains to be seen. Ideally, the local government white paper and its subsequent legislative enactment will contain measures to broaden the financial competence of councils still further, though it is more likely that many of these aspects will wait for the inquiry report from Sir Michael Lyons. Alongside these, the Treasury-led subnational review of economic development and regeneration must also surely conclude that a localist approach is key to achieving the best results.

If the government waits to respond to Lyons until the comprehensive spending review, the chances are that the 2007 Local Government Bill will have passed by, meaning that a further legislative slot will be required – and will need to be keenly fought for, especially in the last part of the parliament.

The fight is worth having, however, especially if new powers on economic development are seen as part of a wider package of steps towards stronger local democracy and local responsibility. The chance for government to create new allies for its approach to growth and stability, rooted in real communities up and down the country, is a tremendous prize to be won; but it requires trust and bravery and a whole-systems shift in the way policy decisions are made. If local leadership is to blossom, it will take real leadership and confidence at a national level to achieve it.

Chapter 3

Financing the Northern Way: incentives for regeneration in the North

Tom Riordan, Chief Executive of Yorkshire Forward

Financing the Northern Way: incentives for regeneration in the North

Let's not run away with the idea that the North is in dire straits while the South prospers! There are some amazing successes in the regeneration of the North's economy, driven in part by impressive progress in the renaissance of the region's core cities – Leeds, Manchester, Sheffield, Liverpool, Newcastle and Hull – and in part by the equally impressive renaissance of other major urban centres as the massively negative impacts of the collapse of heavy industry and manufacturing in the 1970s and 1980s are gradually consigned to history.

And the same goes for that important part of the North's economy that happens in rural settlements and settings – the knowledge-based economy can happen in market towns and coastal towns too!

The North also has incredible strengths and assets, including more than 14 million people, whose character, skills and assets offer huge potential to support economic growth; more than 700,000 successful businesses; cities and towns with some of the finest historical architecture in the country and some of the best contemporary urban districts in Europe; vibrant and diverse culture; magnificent countryside and coasts; eight universities in the *Times Educational Supplement*'s top 30, the busiest UK ports, in the Humber; and, spatially, the North sits at the cross-roads of nationally strategic east-west and north-south transport corridors.

But, in terms of economic performance, while we are moving in the right direction through the woods, we are certainly not out of them yet. The region's economy is improving but it has not been transformed. And the North, like the South, still has too many areas, both urban and rural, of deprivation. Our city centres are beginning to blossom and boom, but extending that success to the rings around the centres remains problematic.

The North is home to 24% of the UK's population, but only 19% of its businesses, producing just 20% of the UK's gross value added (GVA). There is still a multibillion-pound output gap between the economies of the North and the rest of the UK. If the three Northern regions improved their productivity to that of the English average, the UK would be better off by some £35 billion a year.

The Northern Way

The Northern Way initiative is a response to the output gap. It is led by the three Northern regional development agencies (Yorkshire Forward, One North East and the North West Development Agency), and focuses on those barriers to economic growth where the RDAs can bring added value by working together and with key partners – particularly transport, innovation and inward investment marketing. The key partners are the three Northern assemblies, the chair of English Partnerships, representatives from the core cities, the housing sector, universities and developers.

It is important to understand, too, that the work of the Northern Way initiative does not replace, displace or subsume the regional economic strategies, the regional spatial strategies of the three Northern regions or the evolving city region development plans for the eight city-regions in the North – it is a tool to enhance delivery of certain aspects of those strategies and plans.

Financial incentives for regeneration in the North

Is it necessary to introduce new financial incentives for regeneration to succeed in transforming the North's economy? And, if such incentives are necessary, who should they be for – the public sector or the private sector?

(a) How do places and their economies work?

Consideration of financial incentives in isolation makes the huge assumption that we all understand how places work, how their economies work, and what incentives will trigger the right outcomes for those places. Economies stand a better chance of working successfully when the three components of the triple bottom line are given equal attention – the economic, social, physical (natural and built) aspects of "place"; economies don't work without the right social and physical assets in place.

More recently, the triple bottom line has become the quadruple bottom line, with the inclusion of culture as a key contributor to economic activity. A recognition that labour markets and supply chains do not respect administrative boundaries is also important, and consideration of appropriate financial incentives stands a better chance of yielding the right outcomes if there is an understanding of the differences between each place – one size does not fit all, nationally, regionally or even locally.

Historically, financial incentives such as enterprise zones and the more recent but short-lived stamp duty exemption, and initiatives such as the single regeneration budget and its predecessor schemes, have tended to be parachuted into the regeneration of particular spatial areas in towns and cities and, certainly initially, focused primarily on physical regeneration. There was little real understanding of how the economy of the whole place worked (or was not working), and no overall economic vision or masterplan for the town or city. The rules and processes for each incentive and initiative were centrally set without any recognition of the differences (economic and otherwise) of each place, let alone each region and locality.

Refreshingly, the times they are a-changing. Some central government policies, particularly those of the Department for Communities & Local Government, are beginning to embrace the idea of place, of economic masterplanning and of differences between places. It is clear from the interim report of the Lyons review of local government finance that understanding place-based economic development, and the points of responsibility for it, is vitally important to national economic performance. The Treasury-led review of subnational economies and regeneration is also especially relevant to this agenda – as are the impending Eddington report, commissioned by the Treasury and the Department of Transport, on the relationship between transport and productivity, and the next Barker review on land use planning, following Kate Barker's housing supply review in 2002. It will be important to co-ordinate the outcomes of all this work to ensure that any implementation of their recommendations has a constructive and effective impact on the different economies of the different regions and localities.

This change in central government thinking is welcome, but there is a long way to go given that the policies of other departments and their agencies, such as education, transport, work and pensions, and trade and industry have equally important impacts on the economies of place.

(b) Whose job is it anyway?

The interim Lyons report makes it very clear that responsibility for the economic development of places rests first and foremost with the appropriate local authority. That has to be right, given their direct accountability to their communities and their statutory responsibility for the well-being of those communities and various public services. In reality, delivery is through partnerships – with the regional development agencies, the business, community and voluntary sectors – and increasingly with neighbouring authorities, as greater understanding of labour markets and supply chains is gained.

The question of whether local authorities, after 15-20 years of resource pressure and centralisation of decision making into Whitehall, have the capacity and skills to deliver the emerging Lyons vision – and how that can be addressed quickly – is a nationwide issue, not just a Northern issue.

(c) What are the options for financial incentives to achieve regeneration in the North?
There is, of course, the "big bang" option that one or two countries in Europe are pursuing –the abolition of all grant regimes and incentives in favour of lower corporation tax. Assuming that England is not a natural adopter of such options, it almost goes without saying that the shadow of state aids and the requirement for all public bodies to achieve market value for physical assets underpin, and to some extent limit, any debate about financial incentives for regeneration.

With that in mind, the key questions here are:

- Are the existing incentives and tools working well enough?
- Does the private sector need new financial incentives?
- Does the public sector need financial incentives?
- Should either of them be any different in the North to the rest of the country?

The simple answers are: mostly, maybe, yes and probably not, respectively.

Existing incentives and tools nationally provide a surprising amount of flexibility. Regional development agencies, English Partnerships and local authorities can enter into joint venture and development arrangements of varying kinds, they can front-fund or cash-flow certain infrastructure, they can set up companies (such as urban regeneration companies, of which there are 11 in the North) as special purpose vehicles, they can take equity stakes in projects, they can gap fund projects in certain cases, they can transfer assets into special purpose vehicles, they can undertake compulsory purchase orders and they can acquire strategic development sites.

And central sponsoring departments (particularly the DCLG and the Department of Trade & Industry) plus the Treasury are always open to considering proposals for different ways of using physical assets in public ownership. In most cases the bureaucracy involved in any of these options can be daunting, but given a common vision, purpose and commitment between public and private sectors, it is possible to achieve regeneration in difficult markets through these existing options.

In the present economic climate it is relatively easy for private developers to borrow, and the amount of investment (national and international) available for private, commercial and retail development is probably as high as it has ever been, given the attractiveness of property-based returns versus stock market returns. It may be that returns are higher in London and the South East, but as available development land there becomes tight and as economies elsewhere pick up, the inward investment and public agencies in the North need to grasp the opportunity to sell the benefits of the North. This is one of the priority areas for the Northern Way initiative.

Developer and investor concerns tend to centre on the limitation of risk rather than financial incentives – particularly risks attaching to midway changes in scheme requirements (the proverbial movement of the goalposts by the public sector), risk attaching to the planning process and section 106 requirements, risk attaching to land assembly (including compulsory purchase), and risk attaching to infrastructure provision (transport, utilities and services such as schools and doctors' surgeries). Addressing *all* of these issues, not just the financial aspects per se of regeneration, is absolutely essential to create the confidence that developers and investors, and communities, need for regeneration to happen.

Some popular suggestions

Financial incentives are often, therefore, just one part of addressing private developer and investor risk. This (together with financial disincentives) is reflected in the results of a quick call for views from private developers and investors in the North for this Smith Institute monograph:

- Large-scale projects could benefit from cash-flow assistance at the beginning – there is often a large public-sector wish list, and if a project takes 15 years to complete it is only at the end that many of the wishes are delivered, but public cash-flowing could bring them forward. For example, a good school increases the likelihood of prosperity by attracting people to the area and enhancing values, but there is no incentive to put the school in first.
- There is a risk that much government policy is driven by the housing pressures in London and the South East. The planning gain supplement seems to be an example, and to be driven by windfall gain to landowners from the sale of land for residential use. However, any generally applied planning gain supplement must consider the implications for commercial development and the implications for the North, where housing pressures, albeit of concern, are less severe than in London and the South East.

- The proposed lower planning gain supplement levy on brownfield land again fails to recognise particular regional and local circumstances, and the much tighter economics of regenerating certain brownfield sites. The risk is that brownfield sites – of which there is still a fair supply in the North – are not brought forward for redevelopment where existing use can provide an adequate return to the owner.
- Reintroduction of enterprise zones, with their attendant business rate and capital gains tax allowances, is strongly supported for targeted areas of the North.
- Encouragement and help for local authorities to pool section 106 income to enhance transport infrastructure and public realm are called for, but also recognition that both are public good provisions and should be adequately funded through general taxation, with developers potentially contributing to enhancements rather than basic provision.
- VAT could be removed on refurbishments in targeted areas.
- Revisiting the removal of stamp duty, but with clearer thinking about targeting, is also called for.
- Tax incentives could be provided for developers that commit to and deliver local training and employment schemes in targeted areas – not just construction-related training and jobs.
- The bureaucracy attaching to existing financial support (especially European funding) hinders regeneration, and requires private developers/investors to lay out significant sums on professional fees with no guarantee of a positive outcome. Even when funding is made available, the relationship between the two parties tends to be one of conflict (with threats of grant withdrawal) rather than one of mutual support. Both sides need to have a better understanding of the other's processes and timetables without losing sight of delivering the development.
- Local authorities need to be proactive and their services joined up – not just in respect of planning.
- Various aspects of regeneration benefit from guidance such as building design, sustainable construction, highways and road infrastructure, but too often this guidance is held up as the "rules". It is imperative for all sectors to work together on delivering schemes and to be prepared, on both sides, to be pragmatic.
- New means of energy provision (localised CHP, bio fuels, renewables) suggest that not every development will need to allocate the same amount of space and investment to substations and in-building plant. The saving that these developments will produce could be used elsewhere in the scheme to support public benefit outcomes.

While the government could consider introducing a national framework menu of financial incentives for private development, from which regional and local bodies could pick and mix in order to achieve regeneration, the one issue that gets everyone's vote is that local authorities need greater financial autonomy. This is the only way that regional and local solutions to regional and local barriers to regeneration and economic performance can be addressed effectively. These barriers are, almost without exception, infrastructure costs.

A range of possible measures is under discussion: tax incremental financing, where local authorities can borrow infrastructure funding against future tax (business rate) uplifts, with those uplifts paying off the borrowing – this works well where the economy is buoyant but not so well where business rate uplifts are slow to materialise; a return of business rate control to local authorities and/or ringfencing a spatial area from which business rates would be kept by the local authority; new forms of deadlocked joint venture with private investors/developers, where local authorities transfer their property assets into the company, the private sector invests equity, there is an agreed business plan and regeneration programme, receipts are recycled and profits are shared; and specific prudential borrowing rights for infrastructure.

The London lobby – against that city subsidising the rest of the country by being a net contributor to the Treasury through business rates – applies elsewhere too. Interestingly, more than one Northern city is also a net contributor to the Treasury! Devolving business rate responsibility back to local authorities – perhaps Northern local authorities in the first instance – would provide a real boost to economic growth.

The government's initiative to introduce local area agreements with local authorities offers the opportunity for these authorities to win more freedoms and flexibilities, in support of their economic development responsibility. However, there is a real need for government to recognise the overarching nature of that responsibility and not to see it as an add-on, and a real need for it to flow from and join up with the regional economic strategy.

Sometimes the issue is not about lack of available financial options and tools, but more about how public bodies, such as the regional development agencies and English Partnerships, have to account for their assets. For example, any end-of-year reductions in the market value of land assets have to be, literally, paid for from the regional development agency's government grant that year. Similarly the regional development agencies, also literally, have to pay for the cost of capital of land holdings from their grant each year. When these costs are added to the initial acquisition cost, the economic case for direct acquisitions to support regeneration in areas of market failure is significantly diminished. The ability for regional development agencies in the North to recycle all land receipts to support economic growth in defined areas would also be a positive move.

Conclusions

The transformation of the North's economy requires quality and committed leadership and vision in all sectors, but particularly in local government and its assemblies and in the regional development agencies, given, in particular, their responsibility for the regional economic strategies. The Northern Way initiative is one manifestation of such leadership; others include the work that local authorities in the North are undertaking to develop city-region approaches to sustainable economic development.

It also requires the skills and capacity within those organisations (and within all departments of central government) to understand how economies work in places and to understand that alliances with other places (possibly in different administrative areas) can be of mutual economic benefit. Each place should have an economic masterplan that is both spatial and sectoral and that dovetails into the social, environmental and cultural strategies and plans.

New ways of working with the private sector need to be pursued. "Partnership" is an overused word and only delivers meaningful outputs and outcomes for its members when there is strong leadership, truly joint commitment to one vision for any particular project, and a willingness to share risk, and when there is openness and honesty about where individual partners can or cannot bend.

Existing financial and other tools to deliver regeneration need to be pushed to the limit. While there is a range of new financial incentives that could encourage greater investment and quicker development in areas whose economies are lagging, the real key and priority is to introduce greater financial freedoms and flexibilities for Northern local authorities.

There is no one-size-fits-all answer to economic transformation; each place in each region is different and each region is different. Central government can set a framework and a menu of interventions to protect national economic growth, but decisions about which particular intervention and financial incentive work best for individual places and regions, and how the all-important infrastructure can best be funded, must be for the local authorities and the relevant regional partners to decide.

The North could be a pilot or test-bed for this approach. The government has welcomed the Northern Way as an initiative, led by the three regional development agencies working closely with local government and others, to transformation the North's economy for the benefit of everyone who lives, works and invests in the area. The North is ready to embrace change.

Chapter 4

Maximising private investment in housing and growth

Joe Docherty, Chief Executive of Tees Valley Regeneration

Maximising private investment in housing and growth

If public policy is aimed at establishing sustainable development, or increasing the rate and quality of development, it needs to work with the basic driver of the private sector. Clearly, capital will seek to invest funds where it can maximise the return for a perceived level of risk. All attempts to bend private capital towards public policy goals have to address this fundamental issue. If the reliance is placed instead on merely the goodwill of the private investor, the sums invested will be minimal – reduced to the level of corporate alms giving or barely concealed public relations, and even this can be subject to the individual views, values or, dare it be said, whims of passing senior executives.

So, if the question for the private investor boils down to one of risk and return, then the challenge to the public policy maker is simple: either reduce the perceived level of risk to the private investor or increase the level of financial return – or if possible do both.

The public company – a basic reminder

The basic driver of the publicly quoted company is to maximise the value of the investment under control of the organisation. This ultimately is reflected in the share price, that is, the total value of the company in the market; indeed, the board of directors has a legal duty to consider the interests of the shareholders.

Of course share price is a short-term indicator of value, more often a barometer than a thermometer, and is only one method by which the management of a company can track performance. They can pursue market share, return on capital, margins and so on, all of which will to some extent dictate the short- to medium-term behaviour of the company.

It is also true that there are often trade-offs in seeking policy objectives, which need to be understood in advance. However, the board of directors will ultimately measure the success of the company by its market value, as reflected by the share price. And this means they will ultimately measure the success of the managers they employ in the same way.

Therefore it follows that the managers in charge of a company will not behave in a way that is to the long-term detriment to the share price. Rather – before students of such British commercial triumphs such as Barings, GEC Marconi, Maxwell Communications and MG Rover object – managers will not *deliberately* behave in a way that is to the long-term detriment of the share price.

Public-sector interventions

Traditionally, the major public-sector interventions to increase development have centred on the alleviation of physical barriers to investment – assembling a site, decontaminating land, the guarantee of sufficient infrastructure and so on. Where the cost of mitigating these risks results in the land being worth less than the sums invested, the public sector has traditionally intervened; through compulsory land assembly, capital interventions to clean land, using direct grant to produce infrastructure and the like.

This can serve to create a profitable platform and a degree of certainty for the investor, and by reducing the time private capital would need to be employed in a development, the turnaround of that capital is improved and hence the return is increased. The public sector relies on traditional grant-funding regimes to pay for the work. It is only in the relatively recent past that the public sector has been able to rely in the medium term on predictable levels of public investment to meet these demands and, importantly, this cannot be guaranteed in the future.

Another instrument of public policy objectives is the planning regime, which (through planning guidance) gives priority to the development of brownfield, town-centre sites. This has meant that in the past nine years, the percentage of homes built on brownfield sites has increased from 56% to 74%.

The above is very much the basis for most physical regeneration interventions. It has been for a long time, regardless of who carries out the public-sector intervention. Perhaps unusually, these interventions are common to areas in both the North and South of the country.

The type of tools cited can be successful in taking unattractive sites to the market, and drawing investment to areas that in an open market without intervention would continue to sit idle. It could be argued that this deliberate distortion of the market squeezes out "commercial" development elsewhere, and in some respects that is the point.

However, where interventions have been singularly unsuccessful is in working creatively to maximise the value from public investment, relying as they do on traditional grant-funded mechanisms. In the case of house building especially, this approach has been unable to increase the overall level of investment carried out by the private sector, which – despite an array of incentives and rising demand – has stayed relatively stable over 25 years.

The private sector has in fact delivered, consistently and through every political, planning and economic cycle, around 150,000-160,000 homes a year. Where housing output has been significantly higher than this, it is because the government, in a rather unfashionable way, built the rest for rent.

Therefore the challenges to increase the rate of investment in the 21st century are three-fold: as now, it is necessary to bend investment to areas that for public policy reasons are a priority; in an environment where the population and the economy are predicted to continue to grow, there is an imperative to maximise the value from what may become increasingly limited public-sector funds; and clearly there is a need now to increase the overall level of investment.

A financial detour

If the government is to be serious about achieving the goals it has set itself for house building in the South East, then there will need to be a significant increase in the supply of housing being created, which in the present climate is taken to mean an increase in the supply of housing being developed by the private sector. Yet we have seen that this has been very difficult if not impossible to do using traditional tools.

Efforts to innovate with the market include the creation of investment funds with a mix of private and public funding, usually with the private sector taking a priority return and possibly first loss capital being attributed to the public sector. However, the scale of these funds and the pace at which they have invested is so small, compared with the overall property investment market, as to be immaterial. For the pension funds involved, the amounts invested, although welcome, could almost be considered alms giving.

Some other mechanism needs to be found. There are numerous solutions, none of which will be free to the public purse. The recreation of a vibrant private rental sector, the return to mass public investment in public housing, a land tax – all could be relevant.

As stated, capital has a choice; for the modern house builder, that choice is which project will, when complete, provide a target level of return on capital. Should the analysis of a development, following all the traditional interventions listed above, fail to reach the target return, the investment will not be made.

However, it is also true that those investors, even the largest companies, have a finite amount of capital. They work in a market Adam Smith would still recognise: one where supply and demand feed straight through to price (although clearly they are not the only factors). It is commonly thought that supply in this instance means sites with available planning permissions.

It is also a fact, revealed by London Residential Research, that no single development within London has built homes at a rate of more than 300 a year. Not one. Even those that have built at this rate are very rare, and 200 units a year is in reality top-quartile performance in terms of volume. In other words, even if you have a site with permission for 2,000 homes, it will take 10 years to deliver. Companies set rates at which they plan to sell, linked to their target return on capital, and this dictates their behaviour.

Doing otherwise would have unfavourable market consequences. By illustration, were a house builder to radically increase the rate at which homes were built, and the overall planning regime remained static, the price of land available on which to build would go up; either the company land bank would be depleted, or the price of new available sites would increase, or both; the price achieved per unit sale could be damaged and margins would be depressed. Ultimately the long-term future of the company could be placed in doubt.

New thinking – new flexibility

The public sector must have the freedom and financial flexibility to create best value out of limited public funds in a way that meaningfully increases development.

As stated, the traditional tools of regeneration (such as gap funding) rely on continued and stable flows of public money, rather than utilisation of public assets. Public agencies, especially local authorities, have considerable physical assets, including land and property. They should be given the freedom to place these assets in suitable vehicles and leverage in private investment, possibly retaining a stake in the life and profits of a development.

As well as providing funds, private investment ensures there is a market test to the outcomes – matching a public policy outcome with a sustainable market-led solution, while maximising the outcome of public assets.

Clearly there are value-for-money issues here. Will a local authority resist the temptation of selling today for cash rather than hanging on for the long term? The basis of any net present-value calculation would be a material factor, but this could pale into insignificance when faced with short-term cash pressures.

So achieving such a solution is easier to talk about than to carry out. However, it will become increasingly necessary to increase the flexibility with which public agencies, especially local authorities, maximise the value from their asset base. Where asset values do not produce income, or – in the case of land, for example – have a negative value, there will still be a requirement to use the traditional toolbox. However, the overall outcomes from a given level of public funds will be increased.

This will require flexibility from, among other places, the Department for Communities & Local Government and especially HM Treasury, and a confidence in partners, particularly local government, that has not obviously been present in the last 20 years.

You can lead a horse to water ...

Even if local delivery vehicles or agencies are given more flexibility, and even if the planning regime frees up permissions in the South, there is still the issue of persuading house builders to build more.

As already cited, there is a limit to the rate at which developers appear to be willing to build, at both macro and micro levels. We have seen that simply granting more and more planning permissions in the South East will not guarantee a further increase in house building. Put more simply, were the major house builders in the country each to be given substantially more greenfield permissions, it is a moot point how many more houses we would see built than at present.

So how can we guarantee that new planning permissions result in more homes? As a rule of thumb, the price of a house can be allocated as follows: a third on the land, a third on construction and a third profit to the house builder (less central overheads, cost of capital and so on). This is of course a generalisation; in the South East the land can account for a far higher proportion of the price of a property.

So the greatest proportion of capital, tied up for the longest period, sits in the land. House builders with a large land bank may be able to make a profit in the land, as values increase over time. However, most house builders have to turn the asset round, given the cost on their balance sheet of carrying it. This significantly affects the return to be obtained on each site.

At present, if a public agency purchased a site it would normally sell on to a house builder, who then carries the cost on balance sheet. However, if the public sector, on the largest of projects, purchased the land (or indeed used land already in the public sector) on the house builder's behalf, and only took a receipt from the developer *as each house were sold*, there would be no call on the house builder's capital for the land. It is this last fact that will be of *crucial* importance to the private house builder.

This has a number of impacts. The house builder has more capital freed up to be employed elsewhere. It can make its target return in the traditional way – building homes at a profit. As it has freed up capital, and still has a requirement to meet a target return, it has an incentive to build more, making a profit per unit as it does so. The project is considerably and materially de-risked as well. Given that the house builder has never purchased the land in the first place, it is not cannibalising its own land bank and can therefore significantly increase the rate of build without damaging its future.

Given certainty and a commitment from house builders, the public-sector party could even borrow funds to buy the land, reducing the costs involved to interest, which can be at a lower rate than for the private sector. Given that the public sector does not hold the land, if the value drops because of the increased rate of development, that is not its concern. The overall cost of this is far less than perhaps the only other sure-fire method of creating an extra 400,000 new homes in 10 years – having the public sector build them direct.

Clearly, such a dramatic change in approach would need some safeguards. There needs to be a guarantee that the company will not simply return the unneeded capital to shareholders, either through a share buyback or by taking the company private.

It could be argued (and no doubt would be by house builders) that by reducing their risk (and implicitly, reducing the required return), their role is relegated to that of contractors. This ignores the fundamental market-led role they would maintain – which is crucial – although it throws open the question of others getting in on the act. If one thinks of long-term government relationships, your thinking can move towards Serco-type organisations, rather than George Wimpey.

There have been some small experiments along these lines, but none on a transformational level. The approach could be seen as a gift to house builders by the public sector, which, to a degree, it is. However, if increased growth in the South is to be reliant on commercial house builders building for sale, there remains little reason to expect any real progress to be made without a significant departure from current practice. A classic symptom of madness is, after all, to keep doing the same thing and expecting a different result.

Conclusion

We clearly need new incentives for growth that protect the renaissance in the North, while encouraging the growth (and release of land) required in the South. Traditional regeneration tools have an important role to play, but much more needs to be done to help draw investment and maximise value from public assets.

An asymmetric and more flexible planning regime and a publicly funded land bank are just two proposals that might make a difference, if designed and implemented properly. In advance of the next three-year spending review, the ball is clearly in the government's court. What is clear to all in the regeneration business is that keeping on doing the same thing is not going to produce the step change required to meet Labour's ambitious housing and growth targets.

Chapter 5

Incentives for affordable housing: learning from the American experience

David A Smith, Founder of the Affordable Housing Institute (USA)

Incentives for affordable housing: learning from the American experience

Even though the affordable housing ecosystems of the US and UK may appear quite different at the outset, their structural similarities make some of the lessons learned in the US transferable to the British context. However, any new incentives must be properly adapted to build on the established UK ecosystem and value chains.

So, what can we learn from the American experience, and what initiatives might be transferable? Useful US lessons can be grouped into the following four categories. I have attempted to profile each, with a view to understanding what might work best in the UK housing market.

Public-private partnerships: The US and UK have both embraced the public-private partnership model, but how best to deliver such partnerships remains an on-going design and administrative challenge.

Participant motivations: Because market actors move more quickly and decisively than government, in the long run it is impossible to regulate them to excellence; regulatory control stifles innovation. Instead, market actors become excellent in an outcome-based environment: substantial rewards for success, brisk penalties for failure.

Evolving incrementally: Ecosystems are both constantly evolving and interdependent. Wise public policy adds innovations sequentially, even strategically, building on what works by identifying the next additive to address an unmet need. Revolutionary changes often fail dramatically, whereas strategically chosen incremental steps can reinvigorate the whole ecosystem.

Filling the toolbox: Although one wishes for a universal financial tool, in reality the more tools, the better, because market requirements vary so dramatically. The one-size-fits-all tool is an impossibility. In reality, the toolbox should always be expanding, preferably including tools at national, regional and municipal levels. New US-styled housing-based investment tax credits, such as the proposed housing and regeneration tax credit, could make a major difference in the UK.

Public-private partnership

After 30 years of the pure public model (1934-65), for the past 40 years the US has committed itself unequivocally to using private-sector partners to accomplish government housing goals. The UK's embrace of the private sector is of slightly more recent vintage, dating from the late 1980s stock transfer programme.

When creating rental affordability, especially for its lowest-income citizens, governments tend as their first intervention to create purely government housing (council housing in the UK, public housing in the US, *habitations loyer moyenne* in France). Over time, the pure public market succumbs to government's inaptitude for enterprise and management, giving way to a public-private partnership model involving three parties: government, the private sector and residents/community.

Government is the designer and initiator. It identifies target populations to be served, designs the regulatory structure it seeks to impose and offers financial incentives to attract the private sector.

Private-sector participants are the activators. They *choose* to participate, submit proposals or schemes for consideration, if selected build and operate the properties, and are the properties' visible local face.

Residents/community are not just consumers but also play a critical role in quality control. As government's eyes and ears, if given proper incentives and empowered (by choice), they will do a better job of holding the private-sector owner accountable than any legions of government administrators.

Delivering effective public-private partnership remains an on-going challenge and is never easy. US practice over the past 30 years offers four portable lessons:

i) Transfer risk to the private sector. In an efficient capital marketplace, risk always migrates to the party best able to minimise its occurrence and mitigate its cost. Such a transfer takes many forms, including pay after performance, not before; private equity contributions that remain at risk; clawback collectible against the owner, not the property; and quick-take or quick-eject enforcement.

All of these elements have been added, bit by experienced bit, into US affordable housing programmes and incentive packages. Not coincidentally, all of them are embodied in US investment tax credit schemes.

ii) Tie subsidy to affordability use, not predetermined physical locations. Markets move faster than governments, so any programme that circles a particular physical property type discovers that the price rises even before the programme escapes its consultation period, let alone is enacted and goes into regulation. Likewise, if the financial incentives or subsidies are attached to a particular physical property or its financial instrument (for instance, a hard first mortgage), then severing the subsidy imperils the property.

Conversely, if the subsidy assistance is paid out over time and ceases should the property fall out of compliance, then government holds some options and is better able to enforce against a non-performing owner, or attract a better candidate if the bad apple is replaced.

iii) Let localities make funding decisions subject to a cap. Capital is global or national, and government programmes and housing ecosystems are national, but real estate markets are metropolitan and local. All real estate decisions should be made as locally as possible.

In the US, multi-tiered governmental infrastructure – federal, state, and municipal governments – has a long-established hierarchy, so there is effectively an installed nervous system that distributes resources. Creating effective regional or local government is more of a challenge in the UK, where even regional and city-wide devolution (such as the promise to delegate housing powers and spend to the Greater London Authority) is only now proceeding, and local authorities rebate a substantial portion of their rates to the Treasury. Nevertheless, some initiatives could be adopted almost immediately; in any case regionality is worth building over time, and housing is a great first initiative to use.

iv) For-profit versus non-profit is a false duality. In the US, which has a much larger permanent professional rental sector than the UK, for-profits and non-profits have long existed side by side, although until 15 years ago, teaming between them was infrequent and fraught with scepticism and suspicion on either side. Today that has changed: non-profits compete toe-to-toe with for-profits for resources; and teaming is now an accepted practice in low-income housing tax credit properties and mixed-use, mixed-income developments. Even more profoundly, each has embraced the other's best features:

For-profits now understand that affordable housing is a goal in its own right, not just a mantra to mouth; that conversion to market use is not essential if properties are solidly economic within the affordability structure; that specialisation and resident service are competitive advantages; and that good residents add value.

Non-profits meanwhile no longer disdain profit (now they seek to reinvest it in new developments). They endorse rent increases that fund capital improvements, and they fight to pay their staff market-comparable salaries so they can recruit and retain the best talent. They no longer fear financial control, nor scale and breadth of scope.

The differences between best-in-class US for-profits and non-profits will continue to narrow. In the UK, affordable housing has long been almost exclusively the province of non-profit housing associations. Many UK housing associations have grown to a large size and world-class professionalism. Indeed, as in the US, larger-scale housing associations are probably more effective owners and managers.

Even so, some of the UK's better for-profit developments would arguably make welcome additional participants, bringing a new sensitivity to the importance of project finance and positive cash flow in each development, vertically integrating additional services beyond mere housing, and adding the flexibility of larger, mixed-use, mixed-income developments in town centres.

Motivating participants: private developers and private renters

The essence of a public-private partnership model is the use of incentives, shaping behaviour and markets through rewards rather than commands. This thinking must apply to all three participants: private owners, residents and even government.

Housing demand is elastic: no matter how many studies government undertakes, no matter how many rules it writes, housing customers will seek to consume what they want and go to considerable lengths to trade commodities they do not want for those they do. In the US, this has led to discovery of the following guidelines:

- Vary tenures, apartment mixes, room configurations, and rent levels as much as possible within any given property, and certainly within neighbourhoods. Make it as easy as possible for people to change how much they pay and how much housing they consume without leaving their job, family or friends.
- Any in-kind benefit (for instance, a rent voucher such as housing benefit) can be traded in a secondary market, and those doing the trading are unlikely to call themselves to government's attention. The closer incentives can approximate cash in their utility for residents, the more transparent the markets will be.

Furthermore, public policy making today seeks to give everyone a choice. Most early-stage US systems presumed that "government knew best", assigning residents particular home sizes, configuration alternatives, and even where to live. Over the past 20 years, the trend has been consistently towards greater resident choice, including conversion of section 8 assistance (akin to housing benefit) to resident portability, symbolically renamed housing choice vouchers. Resident choice has also encouraged developing more types of tenure and home configuration within the same neighbourhood, so residents can change homes without changing neighbourhoods and social networks.

Any time government mandates an activity, if the result is to cut economic value, the government is wise to match the mandate with a compensatory financial incentive. The incentive need not precisely equal the cost, but it should represent a material offset, a monetary pull to ease the pain of government's push.

The most successful US example is the historic tax credit (see box).

The historic tax credit: a short description

- Eligible properties are certified historic structures, or located in a historic district.
- Renovation or rehab must be approved by the state historic preservation commission, which can specify virtually all aspects of exterior facade.
- Every dollar of certified rehab cost (including interiors and new construction) earns the sponsor a credit – direct reduction of net tax payable – of 20 cents.
- The historic credit is realised upon completion of rehab and its placement in service, including a post-construction approval by the preservation commission. So long as adding historic designation increases costs by less than 20%, it is a net benefit to the developer.

The historic tax credit has been single-handedly responsible for preserving hundreds of listed buildings throughout the United States. In contrast, the UK – rich in listed buildings worthy of renovation and restoration, many of them located in city centres desperately needing retail and consumer landmarks – has no historic tax credit.

A second example, designed to overcome local opposition (nimbyism), is locally mandated minimum proportions of affordable housing (for instance, 10% per town) coupled with inclusionary zoning (development permission, density bonus) that can override local codes. (Massachusetts's chapter 40B is one of the oldest and most effective examples.)

With the density bonus, the affordability subsidy is "paid" through increased land value from the higher-density rezoning. As a result, negotiations between localities and developers are positive-sum games.

In the UK, section 106 is zero-sum, pitting developers squarely against communities, even as the contested property languishes undeveloped. However, the UK uses planning gain and brownfield investment tax credits, both of which use these principles and are working well.

Strategic incremental evolution

Systems evolve in the context of and interdependently with other systems. Innovations, if introduced, must be modified to suit local conditions, *and* calibrated to build upon rather than conflict with existing programmes and participants.

The US experience encourages the best to specialise. Programmes and resources by themselves are not enough. Affordable housing is a complex, difficult business that mixes social and economic objectives and has very low margin for error. Sponsor capacity must always continue to rise.

In addition, it is widely seen as important to introduce new resources through proven channels to proven performers. Over the past 20 years, the state housing finance agencies have grown from modest risk-averse loan conduits into large, multi-divisional financial institutions with vast net worth, great political strength, and broad effective arrays of state-customised financial resources and programmes. Because of this, the locus of decision authority has shifted to the states, with the federal government's encouragement, and to its great relief!

In Britain, the system's strength is its housing associations, its large-scale financiers, and its world-class mixed-use, mixed-tenure private developers. If these entities can be properly harnessed in pursuit of new incentives, offered efficiently and with regional variation, the results will be impressive indeed.

Continuously filling the toolbox with new tools

All ecosystems, including financial ones, start out simple and become more complex. For governments working in affordable housing this is exasperating; no sooner is one initiative added to the repertoire than another market niche appears, another funding gap arises, another stakeholder group presses a valid claim. Government is constantly hoping for the universal programme that can simply be created and then funded increasingly thereafter, but this is impossible because ecosystemic complexity continuously increases.

The more types of tools, the better and more efficient *each* becomes. US experience shows that at least once a decade a new national programme is needed, even if all preceding programmes are operating successfully. Indeed, the success of older programmes creates demand for new ones.

Moreover, resources must vary regionally. Market dynamics vary dramatically by region and metropolitan area. What works in Boston is pointless in Boise, a failure in Baton Rouge. Additionally, the willingness of taxpayers to fund housing affordability likewise varies based on economic growth, availability of "first responders" or "key workers", land and home prices, and overall affordability. The result is that every US state has a housing finance agency, a housing strategy, and a small handful of custom-designed programmes funded by state and not national revenues.

It is important to consider subsidising both capital and operations. Subsidies for affordable housing are either capital (they reduce the cost of financing property development or acquisition) or operational (they cover operating expenses or resident rents). While these are mathematically interchangeable, they are distinct politically and in practical financing terms.

As the UK expands its range of housing choices to include intermediate housing, key worker housing, and section 106 affordable set-asides, it may wish also to create other operating alternatives to housing benefit.

The role of investment tax credits[1]

There are different types of tax credits (see box), some of which are appropriate to affordable housing. In the US the focus has been largely on investment tax credits, which have several enormous advantages over appropriated funds.

1 In 2002, the author worked with roughly 30 UK stakeholders, public and private, in a Liverpool symposium whose report endorsed tax credits. One of these was later designed into a legislative proposal, the housing and regeneration tax credit, about which information may be found at www.hartcredit.org.uk.

Three species of tax credits

- **Social benefits transfer.** Some tax credits are simply a disguised social benefit programme that government thinks can be efficiently delivered through tax filings. The US has an *earned income tax credit*; the UK has *child tax credit* and *working tax credit*. These are not genuine tax credits, in the sense that they are simply a government rebate using the tax system as their delivery vectors.
- **Direct consumption.** Some tax credits are intended to be consumed by the sponsor as an ex post facto rebate for a particular investment. *Weatherisation credits* and Washington DC's *home ownership tax credit* are two examples.
- **Investment tax credits.** Some credits, such as the *low-income housing tax credit* and *historic tax credit*, are fiscal instruments; they are intended to stimulate a particular investment and depend for their success on syndication – that is, the sponsor selling the future tax credit to an investor for present cash.

One of the principal benefits of investment tax credits is that they transfer risk: government pays only after performance, and the up-front capital is also provided by a private entity. Moreover, compliance is easy to monitor (every business deals with HM Revenue & Customs), and clawback is collectible (ditto). All of these features mean that in the real world (as opposed to econometric models), investment tax credits are much more cost-effective than grants. There is much less wastage, inflation of development costs, and uncollectible non-compliance. This conclusion is hard to prove abstractly, but is demonstrated by US experience,[2] which found low-income housing tax credits to be 13-32% cheaper than grants, net of all costs and even without quantifying the considerable value of risk transfer.[3]

The US low-income housing tax credit: areas for improvement

By all standards including longevity (20 years), support (85% co-sponsorship), and impact (more than 1.2 million homes created), the US low-income housing tax credit has been enormously successful. But it is validly criticised for the following (correctible) flaws:

- **Overly specified.** It consumes 34 pages of small-print internal revenue code statute, far more than required.

2 All information is derived from GAO-02-76: *Comparing the Characteristics & Costs of Housing Programs.* The full GAO report is available at www.gao.gov/new.items/d0276.pdf.
3 Calculated by the Affordable Housing Institute in an eight-page report available at www.hartcredit.org.uk/News/library/HART_US_GAO_040804.pdf.

- **Tenure limited.** It is limited to affordable rental, and excludes home ownership, shared ownership, and similar schemes.
- **Delivered too slowly.** It is paid out over 10 years (though clawback applies for 15), and it would be more efficient (higher price per dollar of taxes foregone) if paid out more quickly.
- **Hard cap on income limits.** It is capped at 60% of area median income, which is below the affordability level in many US cities.

An investment tax credit in Britain could build on US lessons learned. Such a tax credit has been designed, as a public service, by a small group of US and UK professionals and dubbed the housing and regeneration tax (HART) credit.

HART credits are capitated (finite allowance each year), allocated (through regional allocating bodies), and competed for (many sponsors vie for award, only the best receive it). These features control government expenditure and allow both precise targeting and virtuous-circle evolution. An eligible sponsor developing an eligible property secures an allocation of (future) HART credits from a government allocator (for example, the regional development agency or English Partnerships) via a competitive process. The sponsor then factors the allocation (sells it for cash) to an investor (probably a large tax-paying financial institution) and uses that cash as soft equity gap funding to develop or regenerate the property. Once the property is fully developed and placed in service, the allocator issues a HART credit chit that the investor attaches to its tax return. The HART credit is thus a pound-for-pound reduction in taxes payable. (More details are available on www.hartcredit.org.uk.)

The HART credit has been endorsed by the National Housing Federation, and officials at the Department for Communities & Local Government are known to be broadly sympathetic. The general view among housing professionals, following an informal consultation on the implementation of HART credit a few years ago, was that the scheme could complement existing affordable housing programmes and bring new players into the affordable housing market. An independent study by Abros (co-funded by English Partnerships and the Housing Corporation) in 2003 concluded that the HART credit would be cost-effective and give value for money compared with conventional grants.

It is to be hoped that the successful introduction of new tax initiatives in the UK and the need for additional private finance will encourage ministers to revisit the idea of a HART credit scheme, perhaps on a region-wide basis.

What next?

In conclusion, three broad structural reforms stand out as candidates for possible transfer to the UK:

i) Accelerate stock transfer from local authorities to housing associations. As discussed elsewhere,[4] the US public housing delivery system is breaking down, imperilling more than a million properties – excluding those that have been revitalised through HOPE VI and similar initiatives – and an even faster stock transfer to public-private partnership is essential to save that system from potential collapse. US experience suggests very strongly that private entities are better owners than direct government agencies, and the UK has a rich heritage of capable non-profit housing associations that are equal to the challenge.

ii) Bring more for-profit developers into affordable housing. Whereas once in the US we thought for-profits and non-profits were two species, they have evolved towards one another: for-profits are becoming complete specialists in affordability; non-profits are growing in scale, business savvy and financial efficiency.

In the UK, even as the best housing associations are embracing entrepreneurial principles and expanding the range of services they provide and income bands to whom they provide them, larger property companies are developing multi-use, mixed-income down-town revitalisations. Letting housing associations tap the private finance initiative[5] is one step towards convergence, allowing private developers to compete for grant another. Real estate investment trusts will further motivate for-profit involvement, although their affordability value is questionable.[6] The next stages will probably be sophisticated for-profit/non-profit teams and greater consolidation and specialisation among housing associations.

iii) Add investment tax credits as a resource. In the US, tax credits have gone in 20 years from almost an after-thought palliative in the 1986 Tax Reform Act to the dominant, omnipresent, essential resource, a $7 billion annual industry that brings the nation's largest financial institutions into close contact with its smallest community development organisations.

4 See Web Update 55: *Public Housing, the Ghost of Christmas Yet to Come*, available at www.recapadvisors.com/pdf/wu55.pdf.
5 Whether PFI is optimally designed or could be made more efficient are topics beyond the scope of this paper.
6 REITs, soon to be introduced, will actually increase the competitive advantage for-profits enjoy relative to non-profits, even as they will widen the affordability gap. See George Bull and David Smith, *REITs: What in the Box?* (Social Housing, February 2004).

Almost unique among the world's nations other than the US,[7] the UK has all the preconditions in place: entrepreneurial housing associations, a broad array of appropriated financial tools (grants and loans), active and interested capital markets, and large public investors eager to participate in affordable housing and urban regeneration. In this context, tax credits would find a ready take-up and would provide immediate benefits, including stimulating the two other desirable trends: stock transfer from local authorities and greater involvement by for-profit developers.

7 Canada is also an environment suitable for investment tax credits, and conceivably Australia, although this conclusion is tentative.

Chapter 6

Social enterprise and the potential of private investment to regenerate communities

Jonathan Bland, Chief Executive, and Lisa Knowles, PR Manager, of the Social Enterprise Coalition

Social enterprise and the potential of private investment to regenerate communities

Until recently, social enterprises were one of Britain's best-kept secrets. Now people are starting to realise that this growing movement could be uniquely positioned to help solve some of the major social and economic challenges of our times. The latest government figures[8] suggest there are 55,000 social enterprises in the UK, with a combined annual turnover of £27 billion. They employ more than 500,000 people and contribute £8.4 billion a year to national GDP. And that is without putting a value on the wider social and environmental benefits they provide.

The question is: how can the right level of investment be leveraged to ensure the continued growth of social enterprise? And what can government do to tackle market failures in accessing private investment from individuals, to help make this happen?

Social enterprises operate right across the economy. Well-known examples include *The Big Issue*, *Café Direct* and the *Fifteen* restaurant chain. What they all have in common is they are in business to achieve explicit social and environmental aims. And they are playing an increasingly important role. In the context of regeneration, social enterprises can provide a powerful vehicle for local communities to play a direct part in shaping their local environment, creating wealth and employment that is embedded in the community and developing services that are attuned to local people's needs.

All around Britain, communities in rural villages are taking over local shops, post offices and cafés – or all three in the case of the Tackley Centre in Oxfordshire, which provides a wide range of important community services, local jobs and, just as importantly, social capital. In Scotland, the residents of Gigha bought back their island and, through the Gigha Heritage Trust, have revitalised their community through enterprise – developing, for example, a profitable, community-owned wind farm. These impressive examples demonstrate how communities can empower themselves when they are able to access finance to buy local assets.

Social enterprise-led regeneration is also transforming urban neighbourhoods such as the Coin Street complex on London's South Bank. As large businesses moved into the South Bank in the 1970s, the community declined, with many smaller shops and schools being

8 Issued by the Small Business Service, May 2006.

forced to close. Coin Street Community Builders turned the area's fortunes around by demolishing the derelict buildings, developing riverside parks and housing co-operatives and paving the way for the regeneration of local shops and services. Income generated from commercial activities at the Oxo Tower and Gabriel's Wharf has allowed Coin Street to grow and local people are being empowered to develop new services that meet the community's needs, including a new school.

Despite a natural fit with community needs, the creation and scaling up of social enterprises to further social and economic regeneration has been constrained by a lack of access to appropriate types and levels of finance. Sometimes it is an issue of securing debt finance. Banks still seem to lack an understanding of social enterprise business models and, as a result, heightened perceptions of risk may contribute to an unwillingness to lend. In addition there are issues on the demand side, with some social enterprises reluctant to take on debt finance.

For many social enterprises, however, debt finance is inappropriate as they look to start up or scale up, and there is a growing understanding that social enterprises need access to the kind of equity-equivalent products used by the private sector. The issue was explored in a Bank of England report published in 2003, which identified several potential barriers, including the level of financial return, problems with exit strategies, and ownership and governance issues. There was evidence of demand for some form of "patient finance", particularly at the start-up or expansion stages in the development of a social enterprise, in which investors are willing to accept a lower financial return in exchange for a social return on investment – at least in the short term. This kind of finance would enable greater levels of risk and play a venture capital/equity role.

But existing barriers to private finance have meant that the growth of social enterprises engaged in regeneration has tended to be dependent on investment from government programmes or philanthropic institutions, or reliant on the transfer of public assets, rather than communities raising finance to buy them for themselves. So how can private risk capital in social enterprise be scaled up?

Over recent years, there has been increasing interest in harnessing the support of social investors. In contrast to traditional charitable giving, social investors want the option of getting their money back and some level of financial return, although they are willing to accept a lower return because they want their money to make a difference to society.

There are two primary ways in which social enterprises can secure social investment in the UK: by connecting directly with individual investors or working through specialist finance institutions.

Direct investment by individuals

There is increasing interest in social investment by high-net-worth individuals, as well as from less well-off people looking to invest modest sums in local communities and ethical causes. The key to encouraging private investment is being able to connect would-be social investors with social enterprises that can offer a reasonable return on investment, a social return and an acceptable level of risk.

The Bank of England's 2003 report recommended that the financial sector promote suitable investment opportunities in individual social enterprises and investigate the possibility of establishing a "social angels" network to match investors with social enterprises, in the manner of business angel networks for traditional venture capital. Philanthropy UK's overview of giving[9] characterises a new breed of philanthropist as "young, self-made and socially conscious – giving rise to new ways of giving".

One social angel, Gordon Roddick, supports several social enterprises, which he describes as commercially successful ventures that are "ethically sound and dedicated to serving society".[10] This included co-funding *The Big Issue*,[11] which is now 15 years old and continuously breaks new ground in providing opportunities to people facing homelessness. Social angels are engaged and pioneering, setting ambitious goals for the organisations they nurture; they want impact and accountability and look for a balance of social and financial returns.

But the potential of social investors is being hampered by market failures. This includes a lack of mechanisms to connect social investors with social enterprises, and a failure to use tax incentives for investment, to reward the positive externalities of social and environmental dividends that come from running a business with a multiple bottom line (for example, savings in social security payments).

9 *Guide to Giving* (Association of Charitable Foundations – Philanthropy UK) (www.philanthropyuk.org/print/overview1_main.asp).
10 Ibid.
11 www.bigissue.co.uk.

Moreover, the experience of Triodos Bank suggests that the primary concern of social investors is guaranteeing invested capital,[12] whereas mainstream investment incentives – such as enterprise investment schemes and enterprise capital funds[13] – are not working to guarantee the capital of the investor, but are instead aimed at investors who want to maximise their profits. There is a double disincentive at work: the social investor is unlikely to enter a scheme without a guarantee on the investment, while mainstream investors are unlikely to use their enterprise investment scheme allowance on a social enterprise when they could get a better return from investing in a profit-maximising business.

An alternative approach, pioneered by a few social enterprises, is securing private investment by issuing shares to the general public. For example, *Cafédirect*'s share issue on Ethex[14] – the alternative matched bargain share trading system – attracted more than 4,000 individual ethical investors and raised £5 million. The issue was fully subscribed in less than four months. The internet could also play a role in the social investment revolution, with websites such as www.zopa.com providing new virtual communities of people who want to lend and those who want to borrow.

New co-operatives have seen a resurgence of community investment in recent years. For example, the Phone Co-op raised £1.2 million from its members,[15] and, in Cumbria, a group of local beer enthusiasts formed a co-operative to keep alive the village brewery when the owners decided to retire. The normal option would have been to sell out to private interests, with uncertain social and economic consequences for the community. The co-operative was formed of people who lived locally or had local connections, who paid £1,500 each for an equal share in the enterprise. And it worked out so well that they formed a second co-op to buy the local pub – preserving the local post office, shop and guesthouse in the process.

Cumbria's Baywind Co-op[16] – the country's first community-owned wind farm – carried out two share offers and raised more than £1.9 million, giving preference to local investors and using the enterprise investment scheme to enable qualifying shareholders to benefit

12 Moreland, J *Encouraging Investment in Social Enterprise* (Triodos Bank).
13 Enterprise capital funds were set up by the government's Small Business Service in an attempt to bridge the equity gap for investment in new companies, with the initial model offering debt at a favourable interest rate and enabling public money to be drawn down at up to twice the private capital in the fund.
14 Ethex is a matching service developed by Triodos Bank, which enables investors to trade in ethical shares and bonds.
15 www.Phonecoop.com.
16 www.baywind.co.uk.

from tax relief. More than 40% of Baywind's 1,350 shareholders live in the North West of England. They have received an average annual return of 7%, while funding a subsidiary Energy4All,[17] which is owned by community co-operatives, and working to develop six further renewable energy co-operatives around the country.

Such examples show that individuals can be highly motivated to invest in social enterprises in their communities, or enterprises that share their commitment to an ethical cause. They want to play a role in owning and shaping their local economic and social infrastructure, and in addressing particular social or environmental problems.

Investment through institutions

In recognition of the need to boost private social investment in deprived areas, and acknowledging that direct investment by individuals is not always the most effective method of financing enterprises, a social investment task force was established. Its report of 2000[18] explored how to lever in private finance at scale to support sustainable regeneration in some of the UK's more deprived areas, and had a significant impact on government policy. A new kind of financial intermediary, known as the community development finance institution, came into being. Based on a US model, CDFIs aim to scale up investment in enterprises in disadvantaged areas.

The creation of CDFIs was supported with development funding from government through the Phoenix fund,[19] and community investment tax relief (CITR) was rolled out to help lever private capital into investment funds managed by these intermediaries that could then go into social and conventional private enterprises established in disadvantaged areas.

To date, a few established specialist banks have been accredited for CITR, and some new CDFIs have been established. According to the Community Development Finance Association,[20] CDFIs have provided more than £180 million in investments. They have financed more than 18,000 businesses and people, sustained 88,000 jobs and created 11,000 more. They have also made a real difference to the setting up, growth and replication

17 www.energy4all.co.uk
18 *Enterprising Communities* (Social Investment Task Force, October 2000).
19 The Phoenix fund was launched in November 1999 in response to the policy action team's enterprise and social exclusion report, published by HM Treasury. It encouraged enterprise in disadvantaged communities and groups underrepresented in terms of business ownership. Financial support for the fund is channelled through business support advisers and financial intermediaries, and includes CDFIs, the Community Development Venture Fund and City Growth. The Phoenix fund closed on 31 March 2006.
20 Inside Out (CDFA 2005).

of social enterprises. For example, Co-operative & Community Finance[21] pioneered this approach to investment over the past 20 years and has provided financial assistance to many social enterprises, such as a recent investment in Sunderland Home Care Associates, which was looking to replicate its £1.5 million business model across the North of England. BIGinvest (part of the *The Big Issue*), one of the UK's first wholesale funds, also provides loans ranging from £50,000 to £200,000 to social enterprises, and in addition invests in other CDFIs.

However, although the Community Development Finance Association reports that more than 50% of CDFI lending by value goes to social enterprises,[22] this equates to less than 6% of lending by volume. This suggests that the social enterprise market is polarised, with a few national CDFIs lending large sums to a small number of established social enterprises, and local CDFIs providing non-property, unsecured, working capital lending.

Moreover, while the amount raised through CITR doubled from £18 million in 2004 to £38 million in 2005, it still falls far short of the £1 billion aspired to by Sir Ronald Cohen in the social investment task force report. Charity Bank had a notable success – raising approximately £23 million – but for many, the potential of CDFIs and CITR has not been fulfilled.

In addition to CDFIs, there are an increasing number of vehicles for institutional venture philanthropy that fill the funding gap. For example, Venturesome[23] combines private funding with funds from trusts to provide mezzanine finance to social enterprises and other third-sector organisations. The Impetus Trust,[24] the UK's first general venture philanthropy organisation, provides an integrated investment package of capacity-building, long-term funding and hands-on management support. While these bodies do not seek a return for social investors, they are testing out some useful ways of introducing equity-type products to support social enterprise growth.

Taking stock and looking ahead

The government has already taken steps to improve the legal frameworks for social enterprise in order to make it easier for them to attract finance. It updated legislation on industrial and provident societies and created a new legal form specifically for social enterprise, the community interest company.[25]

21 www.icof.co.uk
22 CDFA, op cit
23 www.cafonline.org/default.aspx?page=6903
24 www.impetus.org.uk
25 www.cicregulator.gov.uk

Among other benefits, this structure allows share investment in social enterprises, with the security of a built-in asset lock and the flexibility of a light regulatory touch. In community interest companies limited by shares, the asset lock is enforced through caps on dividends and performance related loans. In the case of a loan where the interest payable is related to performance, the rate is capped at 4% above the Bank of England base rate. Dividends are capped so that the percentage of the paid-up value of the share cannot be higher than 5% above the Bank of England base rate at the time any shares are issued, and aggregate dividends must not be greater than 35% of the company's distributable profits.[26]

The government is now looking for social enterprises to play a much greater role as a dynamic and growing part of a wider third sector.[27] An office of the third sector has been created within the Cabinet Office,[28] and HM Treasury is carrying out a review of the sector, linked to the comprehensive spending review for 2008-11.[29] Social enterprises look set to play a bigger role in the delivery and reform of public services, and in a more local, people-centred approach to regeneration that puts communities in control. This includes exploring the ability of local communities to acquire assets and take a much more direct role in shaping regeneration.

So to build on this work, what might government do to tackle the market failure holding back social investment in social enterprises? Broadly, there are five areas where action is needed.

Scaling up CDFIs

First, CDFIs need support to develop so that they can operate effectively at scale without disproportionately high back office costs, and have the capacity to promote and market social investment opportunities (like CITR) to individual investors. They need to develop sustainable investment portfolios and, as many social enterprises have high transaction costs, there is a strong case for subsidising the support and investment readiness work that CDFIs do.

26 *Keeping it Legal* (Social Enterprise Coalition).
27 HM Treasury defines the third sector as follows: "[The] 'third sector' encompass[es] voluntary and community organisations, charities, social enterprises, mutuals and co-operatives. The defining features of the sector are independence from the state, a motivation derived from values and social purposes rather than the pursuit of profit, and the reinvestment of surpluses principally in pursuit of these values rather than for private distribution." (www.hm-treasury.gov.uk/media/34C/1D/vcs_thirdsector210205.pdf)
28 www.cabinetoffice.gov.uk/thirdsector
29 www.hm-treasury.gov.uk/documents/public_spending_and_services/third_sector/pss_thirdsector_consultations.cfm

CDFIs are increasingly striving to generate income from investment, but according to the Community Development Finance Association's 2005 figures,[30] at the moment only 72p is raised by investment for every £1 levered from grants. The Phoenix fund was the largest single contributor to revenue and capital income for the sector, but is being wound down. And with operational self-sustainability for CDFIs averaging just over 36%, do such institutions really present an attractive investment opportunity for individuals? The original vision for CDFIs based on community investment in the USA needs to be taken forward.

A new social investment institution

Second, a new national social investment institution is required – one that can manage the largest deals and act as an independent wholesaler to CDFIs (and possibly other specialist fund managers). This reflects the vision of the Commission for Unclaimed Assets,[31] which proposes using the £2.4 billion lying unclaimed in Britain's banks and savings institutions to provide an equity base for investment.

This equity base would allow the institution to attract private investment and channel capital into social enterprises and the wider third sector through a variety of financial tools – whether grants, equity, quasi-equity or bonds. As part of its work, the institution could help improve the self-sustainability and coverage of CDFIs and refinance their loan books to extend lending capacity. Crucially, any new social investment vehicle must enable high-value risk investment, which is something that banks have traditionally avoided.

A review of existing tax incentives in relation to social enterprise

Third, the government must look at tax incentives in relation to social enterprise. The positive externalities that exist where social enterprises offer a lower financial return to investors in exchange for a higher social return and related savings to the taxpayer should be recognised, and rewarded. The key to encouraging higher levels of social investment is to increase the level of returns for investors and, consequently, reduce the level of risk. Providing tax relief on investment in social enterprises would help to compensate for the current failure of the market system to internalise the social benefits of this way of doing business.

The government should review its tax incentives for business in relation to social enterprise, along with measures such as the loan guarantee scheme, to see how they might better

30 CDFA "Inside Out" report 2005.
31 "A Social Investment Bank Consultation Paper" (http://www.unclaimedassets.org.uk

encourage social investment. This might be done through tailoring existing measures, such as: extending enterprise investment schemes and venture capital trusts to include investments in bonds issued by social enterprise or relaxing the enterprise investment scheme restriction on property; offering a tax break on real estate investment trusts; allowing ISA investment in social enterprises; or establishing a guaranteed social investor portfolio.[32]

In the case of CITR, HM Treasury should consider loosening some restrictions and regulations – allowing, for example, investment in all regulated social enterprises (industrial and provident societies, community interest companies and charities) operating in any part of the UK. Secondly, existing CITR legislation rules out lending on property, whereas many social enterprises want to raise finance so as to buy or refurbish property; and an asset base can be a crucial factor in empowering local communities and paving the way for regeneration. According to a recent study by the London social economy task force,[33] for example, many social enterprises experience a catch-22 situation of being unable to scale up without having more space to work in, but being unable to secure finance for larger premises without any guarantee of growth.

Connecting social investors with social enterprises
Fourth, work should be taken forward to develop the ideas set out in the Bank of England report on connecting social angels with social enterprises seeking investment. And the government should help to develop a market for social investment by addressing the lack of information mechanisms that link investors with social enterprises.

Building the capacity of the social enterprises to take investment
Finally, government should support work to spread know-how regarding the business models and financial instruments that are being successfully used by social enterprises, and resources should be allocated for boosting the investment readiness of social enterprises. The role that CDFIs and other specialist support bodies play in this must be recognised and supported as part of the business growth programmes funded by government. In addition, support should be given to develop the knowledge and expertise of managers and the boards of social enterprises to ensure that risk is managed appropriately and investors get the best possible combination of financial, social and environmental returns.

32 Moreland, J, op cit
33 www.sel.org.uk/news_detail.aspx?nid=6d06ff03-ad5e-4b40-b5e7-ffb3c26e3496

Conclusion

The social enterprise sector is already playing a significant role in the regeneration of communities right across the UK. However, as the government has rightly recognised, there is the potential for it to do much more. Finance is the motor for growth for all businesses, and social enterprises are no different. New and exciting forms of investment are emerging, but the government must act to stimulate these so that more social enterprises are able to start up and grow, and more people and communities reap the social, environmental and economic benefits.

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Chapter 7

Tax incentives for social investment

Dermot Finch, Director of the Centre for Cities at the Institute of Public Policy Research

Tax incentives for social investment

This chapter examines the legacy of the social investment task force, set up in 2000 by the Chancellor to encourage more private investment in disadvantaged communities. In particular, it explores the emergence of the community development finance sector and the impact of one of the task force's key recommendations, community investment tax relief.

Three years after going live, CITR has raised £38 million of new investment. But its potential is far greater than that. This chapter identifies the barriers facing CITR and what more needs to be done – by the government and by the community development finance sector – to maximise its impact.

Social investment task force

The social investment task force was set up in 2000 under the leadership of Sir Ronald Cohen, founder and former chairman of Apax Partners. It was initiated by HM Treasury at the request of the UK Social Investment Forum, the New Economics Foundation and the Development Trusts Association.

I was a policy adviser in HM Treasury at the time, and sat as an observer on the task force. I was also responsible for following up the task force report, and helped push through the early implementation of its five key recommendations. Incidentally, the task force had the good sense to make only five recommendations. This provided real focus and should serve as a model for the future.

The remit of the task force was "to set out how entrepreneurial practices can be applied to obtain higher social and financial returns from social investment … and to unleash new sources of private and institutional investment". The task force was also asked to explore innovative roles that the voluntary sector, businesses and government could play as partners in this area.

The task force's five recommendations to the Chancellor in October 2000 were a package of interlocking initiatives. They were designed to create a system that could drive investment in underinvested communities and encourage entrepreneurial growth and financial inclusion. The government responded to the recommendations very swiftly and positively.

The recommendations were:

1. To introduce community investment tax relief (CITR).
2. To help set up community development venture capital funds.
3. To encourage disclosure by banks of their lending in underinvested areas.
4. To provide greater latitude and encouragement for charitable trusts and foundations to invest in community development finance.
5. To provide support for community development finance institutions (CDFIs).

Progress since 2000

The task force's recommendations have made a significant impact in a short time. But as this summary of progress shows, there is still more to do.

1. In just over three years, CITR has raised £38 million of private investment in CDFIs, for on-lending to businesses in disadvantaged communities. But the potential of CITR is much greater than this. The rest of this chapter discusses the challenges facing CITR in more detail.
2. The UK's first dedicated community development venture capital company, Bridges Community Ventures, was set up in 2002 and has now invested its first £40 million fund. Bridges recently announced it had raised £33 million for a second fund. This emerging community development venture capital sector is perhaps the most impressive achievement since the task force made its report in 2000.
3. Some banks have voluntarily started to disclose information about their lending activities – for example, Barclays, HSBC and NatWest/RBS. But not all have done so. This has led some to press for legislation compelling banks to disclose, along the lines of the US Community Reinvestment Act.
4. Charities have been active in developing new financial instruments such as Futurebuilders. But there is still more to do, to promote community development finance among the charitable sector.
5. The Community Development Finance Association was launched in 2002. It has 73 members, representing the vast majority of the UK's community development finance institutions, and has been key to the recent growth of the sector.

Community development finance sector

The community development finance sector is now worth £450 million. It has supported more than 18,000 businesses and households. According to the Community Development Finance Association, it has created 11,000 jobs and sustained 88,000 more. This finance, which is delivered by CDFIs, has levered an extra £285 million of funding from other sources into businesses and households in the UK's most disadvantaged communities.

CDFIs are specialist finance providers that serve deprived areas. One of the key aims of the task force was to increase these bodies' access to capital; that is why they were earmarked as the initial recipients of CITR investments. CDFIs are therefore critical to the tax credit's successful delivery. But as this chapter shows, they do not yet have the capacity or volumes to trigger a step change in the economic and social revitalisation of the communities that they serve.

Community investment tax relief

Community investment tax relief is a relatively new tax incentive. It was enacted in the 2002 Finance Act, and went live in April 2003, when the first CITR deposits were raised by Charity Bank. CITR aims to encourage individuals and corporate investors to invest in accredited CDFIs, which then provide finance to enterprises that operate in or for disadvantaged communities.

The tax relief is generous. It comes in the form of a reduction in the tax liability of individuals and corporations, totalling 25% of the capital provided, spread over five years (5% a year).

For example, an investment of £100,000 would entitle the investor to a reduction in tax liability of £5,000 each year for five years. This is worth 8.33% a year gross for higher-rate taxpayers, 6.41% a year for standard-rate taxpayers and 7.14% a year for main-rate corporation taxpayers.

Investments may be in the form of loans, equity investment (either shares or securities) or deposits (for those CDFIs that are banks). Since all CITR investments are committed for five years, they can be recycled again and again, resulting in a much greater impact than single donations.

Take-up of CITR

So far, the take-up of CITR has been quite limited – in terms of investment raised, the type of investor, the number of active CDFIs and the amount of on-lending.

First, CITR has raised £38 million of private finance (spread over five years). But in 2000, the task force estimated that it would raise £1 billion over that period. This was clearly overambitious, and now makes the £38 million look disappointing. The Community Development Finance Association says that a further £15 million to £20 million could be raised by the end of 2007, bringing total CITR investments to around £55 million.

Second, most of the £38 million has been raised from individuals, rather than corporate investors. The tax relief has so far failed to engage fully with the corporate sector, and needs to be more actively promoted and targeted at corporate investors.

Third, only a minority of CDFIs are actually using CITR. Of the Community Development Finance Association's 73 members, 23 are accredited to use the tax relief, but by September 2005 only 11 of those had actually raised CITR investments.[34] It is the more mature institutions that have been most successful at raising finance under the scheme. For example, the vast majority of the total £38 million has been raised by just one institution – Charity Bank. The many younger CDFIs must now work hard to get to the stage where they can also raise private finance. The Community Development Finance Association is working hard to increase demand for CITR among these bodies, but progress is slow.

Fourth, not all of the £38 million raised by CITR has actually been invested in disadvantaged communities. By the autumn of 2004, less than half of CITR funding had been on-lent to social investment entities. This is because, in many cases, there can be limited demand for CDFI investment – partly because there simply are not enough businesses on the ground for them to invest in. We highlighted this problem in our city markets report *Business Location in Deprived Areas* (2006), which looked at some 30 areas.

Challenges

The Community Development Finance Association has identified these key challenges facing CDFIs and CITR:

- Implementing and embedding a new scheme: Clearly, it takes time for a new tax incentive scheme like this to take hold. This is especially true of the CITR.
- Raising the profile of CITR among individuals and companies: Awareness of the relief is growing, but the sector must find new ways to boost awareness if the scheme is to reach its potential – especially among corporate investors.

34 The 11 CDFIs using CITR are: Charity Bank (£25 million), Triodos (£3.8 million), Social Investment Scotland (£2 million), Big Invest (£1 million), Co-operative & Community Finance (£1 million), Business Finance North West (£600,000), Enterprise Fund (£600,000), Black Country Reinvestment Society (£63,000), Aston Reinvestment Trust (£58,000), Aspire (£50,000) and London Rebuilding Society (£16,000).

- **Growing capital demand:** CDFIs must increase their ability to deploy capital effectively, and do more to identify enterprises to invest in. Increasing the demand for CDFI finance will take time, as younger institutions achieve investment readiness.

Another key challenge is the funding position of the CDFI sector. For CITR to succeed, the CDFI sector needs to be secure. Until recently, the Phoenix fund has been the primary means by which the government supported the sector. Following the formal wind-up of this fund in March 2005, the government allocated £11 million of transitional support to the sector for 2006-08, but the long-term funding position is still uncertain.

I wrote to the Treasury about this in December 2005. The official Treasury reply (January 2006) stated:

In the long term, the government wants to see the CDFI sector generally building toward a more sustainable platform – including leveraging private finance. The government is reviewing – along with RDAs, banks and other investors – what long-term options may help in progressing this.

This suggests that CDFIs will have to become less reliant on public funding, and use tools like CITR to diversify their funding options. Only then will the community development finance sector become truly self-sustaining. However, these institutions are still in their infancy and the tax relief scheme is complicated. This combination is particularly difficult, and means that progress towards sustainability will probably be quite slow.

Barriers to sustainability: CDFIs
There are several key issues facing CDFIs, which together explain their position. These issues will need to be addressed, if they are to secure their long-term sustainability.

- First, most CDFIs are new. Community development finance is an emerging sector. Nearly half of these institutions (42%) have been financing for less than two years. This means that many do not have an established track record, and are seen as very risky.
- Second, CDFIs are typically very small, run by one or two people. Their capacity is very limited, especially when it comes to dealing with complicated tools like CITR. Most will need to grow further in order to become investment-ready. The Community Development Finance Association is developing a programme of capacity-building for specific institutions, to help develop their investment strategies. This will take time.

- Third, many CDFIs have been overly reliant on capital grants. This is unsustainable. As the sector consolidates and grows, more institutions will need to raise investment from a variety of sources – not just grants and loans, but private investment too. The CITR can help them do this, so they need to make more use of it.
- Fourth, CDFIs are not well-known. This is partly because of their small scale, but also because of their branding and marketing. Basically, these institutions are bad at promoting themselves. Few people have heard of them. Interestingly, in the US, where the model was born, the sector is considering a rebranding. Perhaps CDFIs should rename themselves "community banks"?
- Finally, the terminology around CDFIs can be unhelpful, and could explain the limited take-up by corporate investors. For example, potential investors are confused by terms like "ethical investment", "social investment" and "venture philanthropy". This tends to marginalise CDFIs, placing them in the framework of corporate social responsibility rather than mainstream commercial investment. Instead, CDFIs should market themselves more commercially, and present CITR proposals as a sound financial investment – with low but sustainable rates of return, and a social return too.

These five factors help to explain why most CDFIs have been unable to make more significant use of tax relief. Let's now turn to some of the specific problems related to CITR.

Barriers to sustainability: CITR

These factors help to explain the limited impact of CITR so far:

- CITR is a very niche, narrow and specialist tool. Its design has prevented it from becoming a major, mainstream finance vehicle.
- Its range of applications is too limited. CDFIs cannot use CITR money for property-backed investment, equity investments in profit-making businesses, home improvement loans or personal loans.
- It does not have a champion within government. For example, there is no adequate resource in central government to deal with CITR queries, which can take months to handle.
- It has been poorly marketed. Such a specialist tool needs smart marketing. An effective marketing campaign would target independent financial advisers, for example – a key audience if CITR is to take off. It would also tell the tax relief story more clearly and simply. How does CITR benefit people directly? Why does it matter? How can investors get involved?

Proposed changes to CITR

The Community Development Finance Association has proposed a number of changes to the design of the tax relief. For example:

- allowing CDFIs to invest a proportion of their portfolio in social (residential) housing;
- extending the period of tax relief for investments from five to 10 years; and
- extending CITR to include equity investments in for-profit companies.

Extending the tax relief to personal finance could also be a big potential market. The Treasury consulted in 2005 on extending CITR to include this market. There was a good deal of support at the time, but the consultation also raised some issues that are still being examined by the Treasury and HM Revenue & Customs. In the 2005 pre-budget report, the Treasury said:

The government has consulted on extending CITR to the personal lending activities of CDFIs. This indicated support for an extension and highlighted a range of practical issues that need addressing. The government will continue to consider the case for, and practicalities of, this extension.

It would appear that the government is in no rush to extend CITR to personal finance.

The US Community Reinvestment Act

As mentioned above, a much more radical option would be to compel the banks to disclose their lending activities in underinvested communities. During its initial work, the social investment task force found that the US Community Reinvestment Act had been a significant driver in identifying banks' activities in underinvested areas.

The act was passed because of concern that banks were taking deposits from, but not lending to, deprived communities. It effectively mandates banks to provide services to low-income communities, and to disclose their lending and investing activities in those areas. Introduced in 1977, and revamped under President Bill Clinton's tenure, the Community Reinvestment Act is loved and loathed in equal measure.

Although its impact on financial exclusion is not clear-cut, it does seem to have brought banks into areas they would otherwise not have entered – and once they are there, they soon realise they can make a profit. It has encouraged US banks to acknowledge the importance of CDFIs. And it is credited with causing an additional $1 billion to flow into some of the US's poorest communities.

The social investment task force recommended that UK banks disclose information on their lending in under-invested areas. If banks did not do this voluntarily, the task force said such disclosure should be made mandatory, along the lines of the Community Reinvestment Act.

Some banks have disclosed some information about their lending activities – for example, Barclays (2001), The Co-operative Bank (May 2002), Unity Trust Bank (2003), NatWest/RBS (2003) and HSBC (2004). But not all have done so. This makes meaningful comparison between banks' activities very difficult. Last year, the National Consumer Council and others proposed a universal service obligation – along the lines of a Community Reinvestment Act – that would mandate the banks to do more.

So far, the government has avoided going down this road. And on balance it remains an unlikely outcome, given the government's broader concerns about excessive regulation on business.

Conclusion

When Gordon Brown agreed to Ronald Cohen's proposals for a CITR in 2000, we always knew it was going to be an experiment. The risk of low take-up was higher than the risk of excessive demand. The success of the tax relief was going to rely to a large extent on the ability of the CDFI sector to adapt and grow. We knew this would be a big challenge.

Six years on, the experiment is working. CITR is taking hold, and the CDFI sector is growing. CDFIs got a major boost when the Treasury agreed to CITR. But the tax relief scheme has also asked CDFIs some challenging questions, about their market penetration, their track record and their capacity. The sector is still in a process of transition. It is still too marginal, and too specialist. It needs to become more mainstream, and more commercial. The CITR is also too specialist, and niche. It needs to be expanded and made more flexible.

Meanwhile, the mainstream banks present CDFIs with a real challenge. They are now getting better at serving traditional CDFI markets. This is good news on one level, as we all want to see increased access to mainstream banks. But it could also lead to reduced demand for specialist vehicles such as CDFIs. To survive, they will increasingly need to seek out new, and potentially riskier, investment opportunities. This will be difficult for such a new and emerging sector.

On a brighter note, the Commission on Unclaimed Assets, also chaired by Sir Ronald Cohen, offers the prospect of additional future funding for CDFIs – although this new stream will not become available for at least another 18 months, and the demands on it will be significant. Nevertheless, with Sir Ronald at the helm, CDFIs are in a good position to benefit.

So there is plenty more to do, to safeguard the community development finance sector and to make the case for an improved CITR. As the comprehensive spending review approaches, that case needs to be made more strongly than before.

Chapter 8

Incentives for sustainable communities

John Callcutt, Chief Executive of English Partnerships

Incentives for sustainable communities

Climate change is a serious threat facing the world today. Our government's goal is to reduce carbon dioxide emissions in excess of the Kyoto treaty to 60% of 1990 levels by 2050. While a great deal is being achieved in some quarters against this target, many of our homes and communities are a long way from being sustainable.

Clearer national standards and stronger, longer-term local delivery arrangements can achieve major improvements in housing quality. Greater consensus on measurable standards, combined with better pre-project planning and delivery by the public sector, will allow the private sector to gear up for change by adapting supply chains, changing processes and speeding up delivery. Mainstream sustainability provides efficiency gains on the supply side that will reduce demands on the public sector for grants or free land. To reach the tipping point where this starts to happen requires the public sector to start investing in projects in a different way so that private-sector partners have more clarity on standards and objectives before and after being engaged in projects.

Are our homes sustainable?

The environmental footprint of our housing fabric is poor. We consume 150 litres of water a day in our homes, yet only 10% of household water consumption is accounted for by drinking or cooking. About half of household waste is reusable, although only 17% actually gets recycled. At the current rate we will run out of landfill sites for household waste in the next decade.

Houses account for 30% of the UK's total energy use and 27% of carbon dioxide emissions. The government's standard assessment procedure for energy rating scores homes at between 1 (poor) and 120 (excellent) for their energy use, cost and likely carbon dioxide emission: the average home scores 50 and over a third score below 20. Only 17% of new homes are deemed to be of good design by the Commission for Architecture & the Built Environment, the government's own architecture watchdog. Construction costs are set to rise by 5% a year, but 10% of materials are wasted on building sites. After years of investment in neighbourhood renewal and the upgrading of social housing to decent standards, there are still many failing estates that are not truly mixed and viable communities.

Does sustainability create or destroy value?

In recent years housing policy debates have tended to focus on issues of housing supply and affordability. The important role that quality can play has not been given the prominence it deserves. An illustration of what could be achieved is the EcoHomes accreditation run by the Building Research Establishment. At its "excellent" level the standard typically achieves a 17% reduction in carbon emissions. If most of the homes built to the regional planning growth targets were to be set at the EcoHomes "excellent" standard, a benefit to society of £1.5 billion from mitigation of environmental costs could be achieved over 10 years, each new home contributing £8,000. The additional build cost of building to EcoHomes "excellent" standard is no more than £7,000 per home, or half that for well-positioned sites near existing infrastructure.

A similar equation can be applied to other industry standards, such as the Lifetime Homes scheme. If all homes were made to be potentially accessible for the elderly and disabled, rather than just those homes built as specially designed units, the annual cost of adaptations to homes for people in old age or with a disability would be avoided, saving millions a year, mostly for the Exchequer, which currently bears 60% of the cost of such adaptations.

Similarly, people living in new communities accredited by the police under the Secured by Design scheme have been shown to be half as likely to be burgled and much less prone to suffer car crime compared with those living in comparable new housing schemes without the in-built surveillance features of good urban design. The maths is simple but such development standards are not commonplace, other than on English Partnerships and housing association sites.

In order to give pre-competition clarity to developers, last year English Partnerships adopted quality/price standards, all independently verified by industry agencies. This has radically improved the quality of all bids we receive and we are now helping many local authorities to include these standards in their planning briefs for major growth sites.

Rising demand and high land prices seemingly weaken the incentive to build to a higher sustainability level. There is, however, some evidence that this might not necessarily be always true. A recent study found that high-density sustainable housing projects with better design features attracted higher land values. Not all of this is being achieved through public subsidy: only 13 of the 20 projects achieving gold in the Building for Life awards scheme were in receipt of public grant.

Another barrier to the ratcheting-up of standards is that public-sector landowners need to show "best value" and some authorities fear that higher sustainable standards will require their public land to be given away to meet the higher cost faced by developers. While there are undoubted costs for high sustainability objectives, it is possible to get innovation without giving away free land.

For example, the Design or Manufacture (£60,000 home) competition run by English Partnerships for the Department for Communities & Local Government will generate phased land payment receipts for the 10 sites made available to bidders, well above the value of the portfolio originally set. For one site in Merton, London, the developer will provide a 72% reduction in the carbon footprint against current building standards, exceeding the council's ambitious low-carbon housing targets and comfortably meeting the market receipt for the land English Partnerships required.

Construction cost efficiency and remarkable energy savings came about through a judicious mix of architects designing to maximise solar gain opportunities and the use of off-site modern construction processes that provide high thermal performance as well as cutting waste. What also contributed was that the brief that English Partnerships and the London Borough of Merton issued was clear and unequivocal, provided lots of detail on what was required, and took out much of the information risks that so often dampen land values for prospective housing projects on public land.

The ultimate test, however, is getting house buyers and tenants to care about the quality of the environment they are planning to move into. We are a long way from having a consumer-driven market for sustainable homes but there are early signs of an awakening that we need to encourage. A survey by WWF and the Halifax found that 84% of respondents would be willing to pay up to 2% more for sustainability features. House purchasers take into consideration cavity wall insulation and efficient boiler systems when buying homes, so the precedent is there for the next generation of environmental components. In the USA and Canada a market premium is common for homes with higher energy performance, partly because of the availability of green mortgages that allow a higher level of borrowing for sustainable homes.

English Partnerships' seven Millennium Communities demonstration projects also provide evidence that efficiency in construction and environmental performance pay dividends. Countryside Homes reported that 40% of residents buying at Greenwich Millennium Village cited the sustainability quality as a major factor in the purchase decision. As a result, these homes have been sold faster than those on standard housing sites, translating into higher return on capital employed.

A leap forward in consumer demand for more sustainable homes could also be achieved through more tenure diversity and by supporting vehicles that encourage more private and institutional investment. Because rental and other housing with capital growth potential is valued for its long-term growth potential, rather than its sale price, protection against energy crises and societal change is likely to be sought, including by the lenders. In the commercial property sector, the environmental agenda of the major pension funds has started to drive office design and building specifications toward major energy efficiency savings. We could draw through some of these gains by encouraging more long-term investment opportunities in the housing sector, where the stock is held as an asset and cared for as such.

Sustainable communities

While we can set standards that affect future house building, there remains a major challenge to regenerate many existing housing estates. We are demolishing huge concrete structures built only three decades ago, generating massive carbon dioxide outputs. At the inception of the decent homes policy nine years ago, 7.6% of our national housing stock was deemed unfit, costing £3 billion in healthcare, £1.8 billion in crime and £120 million in cost to the fire services. Failing yet refurbished estates remain with us. The recent DCLG paper *From Decent Homes to Sustainable Communities* shows that there is real political will to break the cycle and try to link together social, economic and environmental sustainability solutions.

To make the change, we need to shift whole communities in these failing places out of the welfare box into which they have been placed. We need to look forward in all our housing projects to envisage how the homes might function in the marketplace without major on-going public subsidy.

In a paper for the Town & Country Planning Association, *Cities & Regions of Sustainable Communities – New Strategies*, Julie Cowans has argued that we can see sustainability before our very eyes in places where good "liveability" features are present, including well-performing schools, good shopping and civic amenities, a sense of safety and quality green space. Not surprisingly, these places also maintain healthy land market values over long periods, and so it follows that buoyant, healthy land and property markets should be the legacy for all our housing projects. In other words, we should not exit from interventions unless we can leave this legacy. It is acceptable to place economic value at the core of our definition of successful sustainable places, alongside the social and environmental features we aspire to.

With such thinking in mind, English Partnerships is creating a new public-sector investment model to assist those local authorities that have taken the bold step of looking for comprehensive regeneration.

The Ferrier Estate in Greenwich is an example of this new approach. Built in 1974 to house council tenants, Ferrier is home to 5,000 people in an unsightly mix of high-rise and low-rise apartment blocks, a no-go area at night. Deprivation is high, teenage pregnancy is double the national average, educational attainment is dismal. The community feels let down. Much public money, for example from the EU single regeneration budget, has been spent in the past to no avail, even though the estate is cheek-by-jowl with some of the most vibrant parts of the housing market in south London.

English Partnerships has helped the London Borough of Greenwich to establish a strategic relationship with developer Berkeley Homes that rejects the refurbishment option that for many years lay on the table. The objective is to place Ferrier in the context of a wider new community area of Kidbrooke, so that it will no longer be an estate defined by its social housing label. We will introduce 2,488 homes for private sale and replace the 1,906 social housing with mixed affordable-housing options, including social rented and shared ownership. A library, a health centre and a new secondary school on a new education and leisure campus are part of the integrated plan, with long-term stewardship vested in a community trust.

The central business model gives the developer confidence to invest £700 million, because it can see when the public sector will deliver each phase. We have agreed with the Housing Corporation that social housing grant should be reserved for the project when it is needed in future years, rather than be subject to the usual bidding timetable. The benefit of such a joined-up approach for the public sector is that, like the developer, it can make a single investment against a proper development cash flow and maximise the recycling of development receipts back into the project. This project promises to reduce the net (present value) cost to the public purse to £21,890 per home, far less than the £40,577 per home that the refurbishment option would have cost. A truly sustainable option is frequently the economic one as well.

Learning from Europe

We recently accompanied Yvette Cooper, the Housing Minister, on a trip to Amsterdam, Rotterdam, Malmo and Copenhagen to look at sustainable housing projects. It is remarkable how strong and confident local authorities are in these countries and how they have the mandate to set out long-term plans with clear sustainability goals. They appear to have a mature and devolved relationship with central government that enables ambitious new communities to be created quickly.

Their plans are unified, with transport links in place before homes are completed, and land supply is controlled by the local town hall (or else by agreement with state agencies) and usually with an economic dimension. This gives certainty to the private sector, which can know for sure what is expected before project-level plans are drawn up. Planning there is light-touch and speedy, with long periods for dialogue to achieve consensus. Once on site, the projects deliver at three times the rate in the UK, with integrated wind, solar and district heating and state-of-the-art domestic waste treatment. Energy utilities are also involved in the fine grain of planning and providing supply for these European schemes.

There are differences at the national level in Europe. Denmark had new building regulations last year and the industry already knows what the regulations are going to be in 2010 and 2015, with a pretty good idea that 2020 will require zero-carbon homes and 2025 homes that provide net additions to the national grid (as some homes in Germany are already achieving). The Danes can now confidently plan the materials and technology required for their current and future communities.

Strong local delivery

There was nothing we saw on the European trip that could not be done in the UK today if we were to put greater skills and best practice into effect at the local level. There is a role for central government and its agencies to enable this delivery to happen at the local level. We have recently developed some good UK vehicles, such as the Milton Keynes Prospectus and other ringmaster projects, where long-term business plans and local area agreements are co-ordinated with subregional and national infrastructure planning.

An example of such a co-ordinated approach is Northstowe in Cambridge, which will be a completely new settlement of 10,000 homes on a surplus airfield that English Partnerships purchased from the Ministry of Defence. Starting from scratch on such a big scale has given English Partnerships an opportunity to help the local partners to build carefully on existing infrastructure, skills and opportunities rather than create a dormitory town.

We have created a sustainability brief that aims to allow individual site developers to plan for very clear sustainability objectives, including 50% reductions in energy and mains water supply, micro generation of energy, and solar sources for half the hot water requirement. By creating a knowledge pool, all parties can learn from best practice and integrate sustainability features into their bids. Rather than place the policy burden straight on to developers, we need to help local authorities and planners to bring the private sector with them.

Energy savings companies

The other big change we need is in how we provide energy to the sustainable housing projects of tomorrow. There is a limit to what good house design and materials can do alone. Most carbon reduction will come from changes in the main energy source. That requires local authorities and central government to join forces in linking sites, locally and regionally, to get economies of scale from development.

There has been a major move toward micro and small-scale energy generation options for sustainable housing. The trend has come about because decentralised combined heat and power schemes are far more energy efficient than the more conventional centralised supply of energy. This is because 60% of the energy used to create electricity in large power stations is lost in heat, while around 5% is lost in transmission. Biomass-based combined heat and power systems, such as those using biodiesels, biogas, solid fuel or waste, are also likely to be carbon neutral and appear very attractive to local authorities pursuing environmental objectives.

Such small-scale solutions have their place for small sites but there are greater advantages and savings to be had by public authorities joining up development sites and growth areas to achieve real purchasing scale. In response to the climate change agenda and the drive for energy and water efficiency, a number of companies are restructuring their offer. This has allowed small, entrepreneurial companies to enter the market to provide new housing developments with energy, water, waste and telecoms services that are structured in a completely different way from conventional utility provision.

Service companies can be either multi-utility service companies (MUSCOs), water and energy service companies (WESCOs) or energy savings companies (ESCOs). They are offering to make a contribution to the capital costs of utility provision, including generation, distribution, supply, management, maintenance and service charges, in return for long-term supply (heat, water, telecoms) under contractual purchase agreements. Such companies can take from the shoulders of the developer and the local community the responsibility for financing, maintaining and renewing these systems. These schemes are typically cost-neutral for the developer, because the service company picks up any extra costs as part of the contract. Every scheme has its own business model and payback period. The role of the public sector is to provide security and surety, not subsidy.

One of the most successful initiatives to date is the London ESCO, which is a joint venture between the Greater London Authority/London Development Agency and EDF Energy, in which the LDA tendered through competitive dialogue for a utility partner to supply major projects in the London area with low-carbon energy services. Another example is the multi-utility joint venture set up by Land Securities in partnership with EDF Energy and Thames Water to create a utility company that would meet the capital costs for primary water and energy connections in return for 40-year power and water supply agreements. English Partnerships is currently investigating how this emerging solution to cheaper and more efficient energy supply can be rolled out more widely to help local authorities and others to use such business models to realise low-carbon sustainable housing.

National standards and local delivery?

The government is doing a great deal to support sustainable development. In housing policy, we have had some welcome improvements in the Part L building regulation reform, which sets the trajectory towards carbon reduction. The planning system is also about to contain clearer guidance on climate change. The government is encouraging all regional and local planning bodies to introduce a requirement for developments of over 10 units to incorporate on-site renewable energy technologies to supply a minimum of 10% of the total energy demand. The Department of Trade & Industry and the Treasury have created an energy transformation fund, which is expected to apply both to sustainable communities projects and to the massive retrofit of the existing housing stock that we face.

In moving forward we may need to resolve a growing tension between the proliferation of clever and detailed technical standards set locally by ambitious local authorities and what is, and should be, led nationally. With so many local authorities going carbon neutral yet such as variety of fine-grain solutions proposed on the ground, there is a danger that developers will not be able to gear up properly to provide solutions.

It would undoubtedly help to have a clear timetable for the implementation of the Code for Sustainable Homes, to provide easily digestible steps toward zero-carbon homes at each level without trading between elements that other schemes have allowed. The code would cover energy efficiency in the building fabric as well as use of metering to encourage the use of A-rated appliances and use of solar heating, water efficiency, water management, construction site waste reduction, household waste reduction and use of materials from sustainable sources. This would give greater clarity for the planning process to ensure that the right environment, ecology and local infrastructure are in place to support these high-performing homes guaranteed by national standards.

Above all, we need a clear link between the case for mixed and economically healthy communities and the environmental agenda, so that truly sustainable communities are just that, in every sense of the word.

The Smith Institute

The Smith Institute is an independent think tank that has been set up to look at issues which flow from the changing relationship between social values and economic imperatives.

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