What can urban policy do to improve the economic performance of Britain's cities? **Henry Overman**, director of the Spatial Economics Research Centre (SERC), surveys the evidence on potentially effective responses to the challenges of the recession and longer-term structural change.

The economic future of British cities

The growth of British cities over the past 15 years or so represents a significant turnaround from the period between the Second World War and the mid-1990s. London, for example, lost two million residents in the half-century after the war, only to see that loss completely reversed more recently. Positive population growth in Birmingham, Manchester and Newcastle during the 2000s represented an even more recent turnaround: these cities all had declining populations in the 1990s.

The turnaround has not been uniform across the country: for example, Liverpool and Sunderland have continued to see their populations static or declining. It is also unclear the extent to which the resurgence of some cities will be hit by the continued economic downturn.

The recent economic performance of British cities is essentially driven by two interconnected phenomena. First, the structure of the economy has shifted towards activities that tend to benefit more from urban locations – this is true of both the general shift from manufacturing to services and of shifts within those broad areas. Second, at the same time as cities have become more important as places of production, they have also become more important as places of consumption.

The fact that the structural shift has tended to benefit more skilled workers means that these two changes have reinforced one another: successful cities have attracted higher skilled workers, who in turn have made those places more successful. Indeed, these two factors explain not only the resurgence of British

Planning restrictions make our more successful cities very expensive

Cities have become more important as places of production and as places of consumption

cities, but also their resilience to the downturn and their likely economic future. That is confirmed by the evidence we have been gathering at CEP and SERC on what drives the underlying performance of cities.

For example, one of our studies followed hundreds of thousands of workers as they moved around the country (Gibbons et al, 2010). This allowed us to decompose area differences in wages into an 'area effect', driven by where people live, and a 'people effect', driven by the kind of people that live in an area. We found that people effects were the most important factor underpinning area differences in wages.

But area effects do play some role and our research seeks to understand what underpins those area effects. Why is it that workers are more productive when they locate in some places rather than others? The evidence suggests that the pure size of a place plays the most important role.

Bigger places make it easier to interact with other firms and other people (be that buying and selling from them or exchanging ideas with them). Such 'agglomeration economies' (benefits from size) tend to be self-reinforcing. As a place becomes more productive, it attracts more people and firms, which, in turn, makes it more productive.

If a place itself isn't big, the next best thing is to be well connected to places that are big and successful – such as commuter towns around London. It also helps to have lots of skilled workers because higher skilled workers earn even more when they are surrounded by lots of other higher skilled workers.

Finally, it helps if an area has one of the industries that do well in cities (advertising, for example) or is doing well nationally (for example, management consultancy). These issues are discussed more extensively in our work for the Manchester Independent Economic Review (http://www.manchester-review.org.uk).

Can urban policies make a difference to the productivity of a place? The research we have done so far suggests that it is very difficult for policy directly to target and improve area-level productivity. Area-based policies, such as the 'single regeneration budget' and the 'local enterprise growth initiative', appear simply to shift employment around relatively small areas.

Giving money directly to firms – for example, through 'regional selective assistance' – does seem to be able to create some additional employment at larger spatial scales, but it doesn't seem to have any measurable effect on productivity (Criscuolo et al, 2012). That is troubling because increasing employment in smaller low productivity firms will tend to drive down area-level productivity.

Improving road links has a similar impact: it clearly affects the location of employment, but in our research to date, measurable effects on productivity have proved elusive (Gibbons et al, 2012).

Since the evidence suggests that it is very hard to affect area-level productivity, are there other things that urban policy can do to help improve the economic performance of British cities? First, it is important to note that while there are many benefits from urban growth, there are also costs – and as cities grow, so too do the costs of living and doing business in a city. Policy can have a very large effect on these costs and this, in turn, can have a big impact on urban economic performance.

The weight of evidence shows that policy in Britain works to increase the costs of living. One key figure is that between 1970 and 2006, real house price growth in Britain averaged an incredible 4.5% *per annum*, the highest rate in the OECD. In contrast, the Netherlands experienced 3.5% growth, the United States a little over 2% and Germany saw house prices stay constant in real terms.

Two things might explain this phenomenal increase. One is that we experienced a house price bubble as increases in supply were unable to keep up with speculative increases in demand. This is what happened in Spain and Ireland, which experienced similar price increases while building many more houses.

But Britain's story is fundamentally different because most of the increase in prices was a result of building too few houses in areas where people want to live. This, in turn, is down to the fact that our planning system strongly constrains the supply of land.

Two of my SERC colleagues have attempted to quantify the role of the planning system in driving high house prices in Britain (Hilber and Vermeulen, 2012). According to their estimates, a local authority that moved from the average level of 'restrictiveness' to no restrictions would have houses that were about 35% cheaper. That might seem extreme, but even moving from the average restrictiveness in the South East to the restrictiveness of local authorities in the North East would see housing 25% cheaper.

These are significant costs of the planning regime – and they are not just limited to housing. Another study has looked at the impact of supply restrictions on the cost of office space (Cheshire and Hilber, 2008). This was done by comparing the cost of renting space with the cost of developing it (using the idea that large mark-ups of revenues over costs should be arbitraged away by commercial developers unless they are constrained by planning policy). The research gives a rough measure of the regulatory 'tax' imposed by the planning system: in the West End of London, the tax is around 800%; in Canary Wharf, it's around 320%.

When people see these figures, they tend to argue that London is 'beautiful' and needs protecting. But central Paris is attractive too and the estimated regulatory tax there is 305% (and around 160% in La Defense). The other typical objection is that London is already crowded, but downtown Manhattan (which is very crowded) manages a tax rate that is somewhere between 0% and 50%.

This isn't just a problem for London: Birmingham imposes a 250% tax rate. To put this in perspective, towards the end of the boom years, office rents in Birmingham were comparable to office rents in San Francisco. With rents like that, is it any wonder that Birmingham might struggle to attract private sector employers? SERC research also suggests that planning restrictions reduce supermarket productivity by about 20%: in other words, planning increases the price of our weekly shop (Cheshire et al, 2011).

Does any of this matter? I think that there are two important implications. First, these restrictions make our more successful cities very expensive. In fact, the productivity effect of living in our more successful cities is far outweighed by the cost of living effect. People who choose to live in those cities are compensated by the urban amenities. But the amenities aren't sufficient to compensate the many people who are priced out of more successful areas: posh restaurants are cold comfort for the urban poor.

What about the economic performance of British cities? Here too, there is a case to be made that planning restrictions are having a major impact on the urban system as a whole. In particular, they make some of our 'second-tier' cities too small, which has important implications for their economic performance given the link between city size and productivity.

This is shown by an empirical regularity called Zipf's law. Applied to cities, Zipf's law suggests that the second largest city should be half the size of the largest, the third largest city should be a third the size of the largest, and so on. To a reasonable approximation, this law holds for the relative sizes of cities in

Cities like Manchester are smaller and less successful than they should be

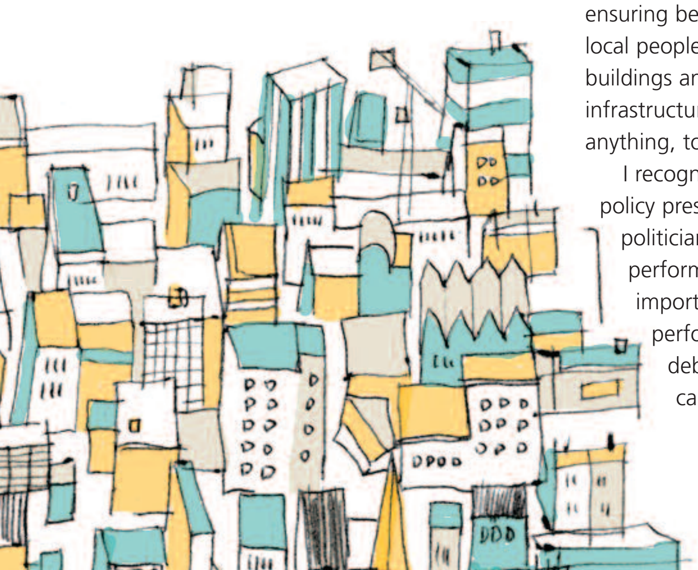
most countries. But it does not hold in Britain where our second-tier cities appear to be too small.

Most people infer from this statement that London is too big. But it turns out that London is about the right size relative to Britain's smaller cities (say those ranked from about 25th and lower). The issue is that the rest of our urban population tends to be 'spread out' across a number of moderately large cities. Zipf's law would require some of those cities to become much larger and some to become much smaller.

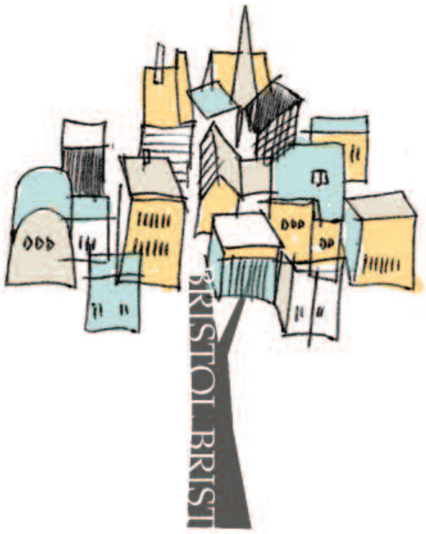
What stops that from happening? Part of the problem is supply restrictions. Take Manchester, one of the recent urban success stories, which has seen the fastest growth in population outside London and the South East. As documented in the city's independent economic review, supply constraints meant that this rise in population was accompanied by steep increases in house prices and office rents (at least in the more successful parts of the city). This, in turn, will have choked off further growth.

Planning constraints are not the only problem. Our larger cities struggle to provide good schools, accessible open space and safe streets. All of these things discourage more mobile households (particularly families) from living in our more successful cities. Concentrations of higher skilled workers are important for cities, so if higher skilled workers are first attracted to cities only to be 'forced' out as their children get older, this has implications for urban economic performance.

More controversially, I would argue that our relatively successful cities have also been hampered by the fact that 'place-based' interventions tend to involve a lot of 'jam-spreading'. Spending money in a city like Manchester on new transport



London is not too big; Britain's second-tier cities are too small



links, reclaiming land and improving parks is seen as 'unfair' if we don't pursue similar policies in less successful urban areas. As a result, what money is spent gets spread around rather than trying to build on the successes.

In short, I believe that the policy mix of supply constraints and jam-spreading has led to cities like Manchester being smaller than they otherwise would have been. This has fundamental implications for the economic performance of those cities and the wider British economy.

Focusing more on our relatively successful cities would raise very difficult questions about what happens in the places 'left behind'. Of course, they should not be 'abandoned', but the policy mix in these areas needs to be more realistic about their prospects. The balance of spending should be strongly tilted towards ensuring better education and training for local people and away from shiny buildings and expensive new transport infrastructure that will do little, if anything, to turn these places around.

I recognise that this is a very difficult policy prescription for constituency-based politicians. But the economic performance of Britain's cities is vitally important – and improving that performance requires a serious debate about what urban policy can and should do better.

Henry Overman is director of SERC, professor of economic geography at LSE and a research associate in CEP's globalisation programme.

For more commentary on urban and regional policy issues, see the SERC blog: http://spatial-economics.blogspot.co.uk

Further reading

Paul Cheshire and Christian Hilber (2008) 'Office Space Supply Restrictions in Britain: The Political Economy of Market Revenge', *Economic Journal* 118(529): F185-221.

Paul Cheshire, Christian Hilber and Ioannis Kaplanis (2011) 'Evaluating the Effects of Planning Policies on the Retail Sector: Or Do Town Centre First Policies Deliver the Goods?', SERC Discussion Paper No. 66 (http://www.spatialeconomics.ac.uk/textonly/serc/publications/download/sercdp0066.pdf).

Chiara Criscuolo, Ralf Martin, Henry Overman and John Van Reenen (2012) 'The Causal Effects of an Industrial Policy', SERC Discussion Paper No. 98 (http://www.spatialeconomics.ac.uk/textonly/serc/publications/download/sercdp0098.pdf).

Stephen Gibbons, Teemu Lyytikäinen, Henry Overman and Rosa Sanchis-Guarner (2012) 'New Road Infrastructure: The Effects on Firms', SERC Discussion Paper No. 117 (http://www.spatialeconomics.ac.uk/textonly/serc/publications/download/sercdp0117.pdf).

Stephen Gibbons, Henry Overman and Panu Pelkonen (2010) 'Wage Disparities in Britain: People or Place?', SERC Discussion Paper No. 60 (http://www.spatialeconomics.ac.uk/textonly/SERC/publications/download/sercdp0060.pdf).

Christian Hilber and Wouter Vermeulen (2012) 'The Impact of Supply Constraints on House Prices in England', SERC Discussion Paper No. 119 (http://www.spatialeconomics.ac.uk/textonly/SERC/publications/download/sercdp0119.pdf).