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## Viewpoint

# *Planning and the economy: a complex relationship*

The diplomat thought that he had won the first prize in his foreign ministry's lottery. Having spent the past few years in his country's capital in Central Europe he received an attractive offer. For the next three years he could work at the embassy in London, a vibrant city in a country that had seen more than one and a half decades of uninterrupted economic growth. The prospect was so good that he did not hesitate to pack his suitcases and move.

But unfortunately, his original excitement soon started to wear off when it came to house hunting. After a long search, he found a small house in Chiswick for his family. Altogether about 120 square metres – but disappointingly no cellar – it was quite a bit smaller than his home back on the continent. The building standard was also much lower, and, much to his surprise, the monthly rent was higher than his net income: £4600. Luckily for him, the foreign ministry has a policy in place by which he only has to pay what a comparable home in his country's capital would have cost, so he pays only £800 a month – the rest is covered by the embassy.

When I met this diplomat a few weeks ago, he was still trying to work out why housing in London was so expensive and yet often so substandard. But above all, he could not understand how it was that after the longest period of economic growth in recent history many Britons find it harder than ever to afford decent accommodation. Shouldn't a rich country be able to offer its inhabitants a much better quality of life?

What sounds like a paradoxical experience may not be so much of a paradox after all. House prices, quality of life and economic growth are very much interlinked in Britain's recent history, and it is not always easy to disentangle the three. However, if we want to understand why they are connected, it is necessary to subject them to an economic analysis, and that means analysing the way Britain's built environment has been planned.

The acknowledgement that planning and the economy are closely linked is relatively new. For many decades, economists have preferred to deal with other factors when analysing the British economy. They examined interest rates, money supply, regulation or labour markets – and with very good reasons, too – but the economics of planning simply did not appear on the radar of many economists (and they probably did not know much about the subject either). So when it came to identifying the factors that

were determining economic growth, it was frequently overlooked as an issue. It was a bit like the joke of the drunkard who had lost his keys in a dark street and then started looking for them under a remote lamp-post where the light was better.

On the other side of the fence were planners, and they were not that much interested in economics either. It was for them to plan and for the market to follow, so many thought. The response of a planner, asked whether land price data could be useful, was unequivocal: 'We would not see the point of looking at price data ... Planning should lead, not prices. Land price should reflect planning, not the other way round' (Evans and Hartwich, 2005a, 18). The history of planners and economists was for a long time one of mutual lack of interest and probably even a degree of prejudice.

Things have changed in the past decade or so. The Department of the Environment first commissioned research into land prices and land supply in 1992 (Eve, 1992). The McKinsey Global Institute named planning as one of the obstacles to productivity growth in 1998 (McKinsey Global Institute, 1998). Furthermore, there have been two HM Treasury/ODPM/DCLG enquiries into housing supply and land use planning undertaken by Bank of England economist Kate Barker (2003; 2004; 2006a, b). Undoubtedly, all these voluminous reports have altered the tone of the debate towards an open recognition that economics can tell us something about planning and its effects.

Since the introduction of the modern planning system in 1947, the main effect – at least from an economics perspective – has been the restriction of land supply. This was not an unintended consequence. The Town and Country Planning Act was meant to bring an end to the 'sprawl' many English cities had experienced in the 1920s and 1930s. Over time, planning increasingly became part of an explicit policy to limit the spatial extent of cities and protect the countryside.

Translated into the language of economics, this meant that supply failed to keep up with demand. What happened then could have been predicted by any first-semester student of economics. Where demand for housing increases through a combination of population growth, a changed demographic structure and smaller household sizes, and where the supply of new land for development is limited, the price of land will go up. Indeed, the real price of residential land went up markedly after 1947 while it had been virtually stable over the preceding six decades (Evans, 2004). And it was not only residential land prices that increased but also prices for industrial and commercial land.

Clear economic evidence of the distortions caused by restrictive land supply can be found in the price differential between different categories of land. Whereas residential land in England (excluding London) is worth more than £2.5m per hectare on average, the price of agricultural land is only £10,000 (Evans and Hartwich, 2007). Such huge differences could not occur if land supply were not heavily restricted, and

everyone knows what happens to land prices once planning permission is granted on previously undeveloped land. Nowhere are the distortions in the land market as visible as in such cases.

We can thus reasonably assume that our land and property prices are far higher than they would have been in the absence of tight planning controls and there is some prima-facie evidence for this. If we compare occupation costs for prime industrial space, no place on the planet is as expensive as Heathrow adjacent to the UK's main international airport. While Heathrow may not be the most typical place in Britain, it is still interesting to note that industrial space in British cities is always more expensive than in continental European cities of broadly comparable size: Birmingham is more expensive than Barcelona and Manchester more expensive than Munich. The same story applies to office space as well. London is a considerably more expensive place to do business than other big international cities, and even smaller cities such as Glasgow and Bristol are more expensive than Zurich, Amsterdam or Singapore (Evans and Hartwich, 2007).

In one sense, these higher prices could be interpreted as a sign of success: after all, a place's attractiveness would have to justify them. Equally, it is easy to imagine what such prices do to a city's ability to attract new business: they become a deterrent. In deciding where to open a new factory or a new office, high land prices are just one among many factors, but they undoubtedly play a role. In the worst case, companies may even decide to relocate if office space and accommodation become too high. This was one of the reasons given when Kraft Foods announced they would be moving their European headquarters from London to Zurich last spring.

Higher land prices also have an effect on the general price level in the economy. This is easy to understand as land prices are passed on from businesses to consumers who, ultimately, have to pay the bill. For example, both restaurants and hotels are in the business of letting space (i.e. 'land') to their customers for a specified time. In other sectors, too, land costs play a role. When we had a look at the prices that IKEA charges its customers in different countries, IKEA UK came out the most expensive despite the fact that its products were identical and, probably, imported from South-East Asia (Evans and Hartwich, 2007).

The one area where high land prices are perhaps most striking is housing. We know that our houses have now become the most expensive in the developed world, but unfortunately their quality is far from being world class. Yet here comes the paradox: although high housing costs may have become a burden on society, especially the younger generation, they helped to boost the UK's economic performance over the past 15 years.

House prices have increased dramatically over this period. In real terms they have more than doubled. This had a number of effects. First, it made savings look less and less like a good investment. The property market promised much better returns

in comparison, especially as interest rates were low. On the other hand, as it became more expensive to become a homeowner, households could save less and had to borrow more. This further reinforced the decline of the UK's savings rate. Second, high house prices combined with falling savings rates contributed to the rise of private debt. Part of that debt went straight into the property market. Another part, however, represented equity withdrawn from people's homes to bolster their consumption. From 2001 to 2006, a total of £256bn in equity (in current prices) was extracted from UK property values in this way. Rising house prices did help to support economic growth – but they only did so at the expense of the country becoming more and more indebted (Hartwich et al., 2007).

That rising house prices have had a positive effect on economic growth is not disputed, but it means that any weakening of the property market now ranks high on the list of potential dangers to the UK economy. Rampant house price inflation is not a stable foundation for an economy. On the contrary, it appears that high house prices can only temporarily 'supercharge' the economy by creating an unsustainable wealth illusion. In the long run, planning-induced land and house price inflation can slow down growth as they become a competitive disadvantage in many ways. So a stable property market would be preferable to continued house price inflation. The question is, how such stability can be achieved?

The first thing to do is to realise that planning, land supply and land/house prices are interconnected. We can no longer deny the link between restrictive planning and high house prices (Evans and Hartwich, 2005a). This is not to say that demand factors did not play a role – undoubtedly they did, but very similar demand factors (economic growth, population growth, increased longevity, changing household formation, etc.) were present in all developed countries around the world, and other countries have managed to keep their property markets stable and avoid the boom-and-bust cycles without becoming dependent on the development of house prices for their economic growth.

Two such countries are Germany and Switzerland. Both are building new houses that are considerably larger than their UK equivalents and both have enjoyed three decades of stable real property prices. The key to their stable property markets is this: planning is mainly managed at the local level, where budgets depend on factors such as population figures, tax revenue generated, or even, as in Switzerland, on local income taxes. It is precisely because of these factors that local planners are keen to support their councils by making their cities attractive places in which to live and thus attractive to new inhabitants. People get the houses they want and the politicians are the masters of their own fiscal fate (Evans and Hartwich, 2005b).

What was clear from our research is that the planning systems that work best are not only decentralised but are also incentivised. Local decision-makers need to face the full costs and benefits of their planning policies; in this way more, better and

larger homes that remain stable in price (Evans and Hartwich, 2006) can be built in their areas. On top of these already pleasant outcomes, both Germany and Switzerland have maintained a far healthier savings culture than Britain and their economies are not at the whim of the ups and downs of the property market.

The above is not to say that planning in Germany or Switzerland was a complete free-for-all. Quite the contrary, both countries operate planning systems which are comprehensive and often complex. In Germany, for example, local planners have to consider long lists of legal requirements under the Federal Building Act when it comes to drawing up development plans. This process ensures that planning decisions have to give due weight to different goals such as housing requirements, social needs, the protection of the environment and the protection of historic buildings. However, in contrast to the situation in the UK, the availability of fiscal incentives for successful planning for development equally ensures that negative side effects of planning are considered against a positive incentive. So, while planning may be a complex and demanding process, it is nevertheless a process that delivers outcomes in the form of a housing supply responsive to local demand.

The continental diplomat who arrived in Britain a few weeks ago was startled at the combination of a long-term economic boom coupled with high house prices and widespread affordability problems. It is argued here that these things have more in common than he might initially have thought. Artificially inflated land prices have temporarily supported Britain's economy, while they were simultaneously eroding the foundations of long-term growth and creating big social problems on the first rungs of the property ladder. The big boom that made Britain look so attractive from the other side of the Channel may turn out to be much more of a mirage than a true economic miracle.

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