Reimagine regeneration

Using our best disruptive thinking to achieve public policy goals

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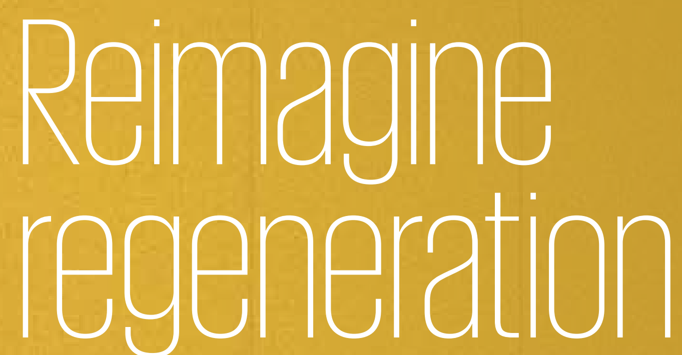

Zoe Davidson and Louise Sunderland

Traditional approaches to regeneration give public bodies the responsibility for identifying and funding effective investments; but this is exactly what the private sector does best. Zoe Davidson and Louise Sunderland suggest a new model, handing investors both the risks and the rewards of shaping and pursuing regeneration programmes.

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In 1934, the UK government sent a roving commissioner with £2m in his pocket to distribute to industrial areas badly hit by the Great Depression. Two years later, the Spectator magazine argued that this early example of economic development intervention by central government had achieved little. Its editorial concluded that the measures taken were "mere palliatives of unemployment; they have done little or nothing to create employment".

Initiatives aimed at cushioning the impact of industrial decline have grown more sophisticated over the years, but their impact is still disrupted. While enterprise zones, city grants, regional development agencies and holistic, area-based initiatives have had some success, the country retains areas of concentrated and persistent poverty. These 'social mobility cold spots' continue to require large amounts of public money in the shape of benefits bills for low-income workers and the unemployed.

Parts of Britain – particularly some of the former industrial heartlands and coastal towns – can often feel left behind, with low revenues from council tax and business rates creating a vicious cycle of underinvestment. Given the patchy legacy of previous central government attempts to attract investment and reverse these communities' fortunes, is it time to try a fresh approach?

After all, many national and international companies are sitting on huge reserves of capital on which they seek modest returns. Rather than facilitating investments and subsidising businesses – either directly, or indirectly through tax breaks – to invest in deprived areas, the government could try a different approach: giving businesses both a share of the rewards generated by their investments, and the direct responsibility for helping to boost local economies.

This could both encourage businesses to sink their capital into the areas which need it most, and pass the task of stimulating and attracting investment to the organisations which best understand how business decisions are made: investors themselves.

A fiscal swap solution

Under this model, HM Treasury could offer a 'fiscal swap' – inviting private consortia to bid for the right to take on the task of planning and delivering regeneration strategies, along with the risks and rewards of investing to turn around deprived areas. If the winning bidder succeeded in driving down the benefits bill within their patch by generating jobs and boosting the local employment rate, they could receive the savings that would otherwise accrue to the Department of Work and Pensions; and, of course, if the benefits bill increased, the consortium would have to hand the difference to government.

The bidders' tenders would be based on their forecasts of how programmes they introduced could help reduce the benefits bill. These interventions could, for example, include work programmes, training courses, investment in infrastructure, or the direct creation of employment space such as factories, offices or distribution hubs. The money to fund this work would be put in by the consortia, with the goal of reaping the benefits of the resulting reductions in benefits spending.

Contracts could last five years and be awarded after a competitive auction, similar to those used to award contracts to Train Operating Companies.

Predictions relating to the wider economic climate would play a part in helping consortia formulate their bids, with any suspicion that dark clouds were looming over the economy being priced into the tenders submitted to central government.

The winner of the auction would be the consortium making the lowest bid. Bid too high, and you might lose the competition. Bid too low, and you would face lower returns and the risk of making a loss; benefits payments would be underwritten by the government in such a scenario, removing the risk of hardship among benefit recipients.

The winning consortium would be required to raise enough money to cover a worst case scenario – such as the huge rise in the benefits bill that would result from a one-in-100-years slump. To cover the additional benefit payments in this event, a 'backstop reserve' held in escrow would be required – ensuring that winning consortia could meet their commitments to cover any rise in payments, even if key members went bust. The consortia could raise this money through share offers, with the number and price of shares defined within the bid. Shareholders would make their investment based on the confidence in the consortia reducing the benefits bill.

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Risks and rewards

Let's take an example. One deprived local authority saw benefits totalling £45.5m paid to the unemployed and low paid in the last financial year. The highest annual benefit bill since the financial crisis was £50m. Doubling that difference to £9m could create a safety net for a worst-case scenario. If the benefits paid out by Treasury each year were fixed in real terms at the previous year's bill then the consortium would then need to raise £45m as a safety net (five x £9m), roughly one year's payments.

In this local authority, the lowest annual previous bill since 2008 was £41m. So if the consortium succeeded in keeping benefits at this level for five years in a row, the total return on investment over five years for shareholders would reach £22.5m (five years of £4.5m savings). This would equate to an annual real internal rate of return to shareholders of over 8%.

Conversely, five years of a sum equivalent to the worst bill over the past decade (£50m) would lead to payments to Treasury of £4.5m a year for shareholders. This would equate to a loss of half the investment if the downturn was sustained over the whole period of five years. Shareholders would be taking a risk – with a downside broadly comparable to the broader equities market under such an economic crash.

The transparency of markets

A secondary market in the shares would also be created, allowing shareholders to buy and sell shares throughout the period of the initiative. If a consortium failed to reduce the benefits bill in the first two years, the price of a share could slip. However, if the consortium subsequently did enough to put 1,500 people into work, then the share price could rise considerably.

These share prices would create transparency to inward investors. A multinational looking for a location for a new office park would be able to spot an opportunity to buy shares when they were low. With the confidence that their investment would reduce unemployment over coming years, they would stand to benefit from the increase in the share price resulting from their investment. This secondary market would effectively allow investors to receive a subsidy for investing in an area.

Market mechanisms would prevent companies from 'playing the system' to manipulate the price of shares. For example, large companies owning shares which misleadingly hinted at big investments in order to reap the resulting share price rises would suffer a big hit to their reputation. Smaller companies' announcements wouldn't be likely to have a significant impact on share prices, though if they did go through with successful investments they might see some uplift.

The scheme would not require the creation of any new bureaucracy. Benefits and assessments would continue to be carried out by existing government agencies and offices. The consortium would merely have to settle up with the government at the end of each year, either receiving a payment or paying the government – depending on the total benefits paid.

Let investors shape investments

Transferring the risk and rewards associated with regional economic development initiatives to the private sector via a fiscal swap would provide a number of gains for the policymakers. Companies would have a direct stake in the welfare of their local economies and citizens, and could become valuable partners to local authorities in the place-making agenda.

Just as importantly, the model passes the responsibility for assessing and pursuing viable regeneration and economic development projects to the investors and businesses which are expert in this process, replacing the more process-led approach of the public sector – which by definition has limited experience of judging the financial sustainability of capital investments and a poor track record of delivery.

The scheme would also have a major advantage over some of the current government initiatives which attempt to transfer some of the risks of service provision to the private sector. Payment-by-results and social impact bonds often require complex measurements of outcomes before the government pays its private sector partners. Here, the market provides the transparency necessary to reward the consortia for their efforts. And whilst the government wouldn't see its benefits bill fall over the five-year period as a result of successful regeneration programmes, it would receive plenty of other benefits – including lower medium- and long-term benefits bills, lower demand on public services such as policing and health, and rising revenues from income tax, business rates and corporation tax.

Society as a whole – citizens, government and businesses – stands to gain much from a system where the private sector has a greater stake in the welfare of local communities. And poor economic growth is fundamentally a markets problem: the market may be best placed to identify the solutions, focusing businesses on what they do best. Allowing the private sector to take on the risks and rewards of economic interventions could allow the market to succeed where the public sector has often struggled to make a long-lasting difference. Nearly a century after the government's first attempts at urban regeneration, we could have a policy mechanism to genuinely reduce unemployment – rather than simply providing a palliative.

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