LONDON FIRST

Infrastructure Funding and Financing Working Group

Squaring the circle

Funding London’s transport pipeline and levelling up

Introduction

London First has been considering alternative ways of funding London's transport infrastructure needs for some time and this paper draws on a workshop held in partnership with KPMG in January 2020.

The current coronavirus pandemic is likely to have enduring and transformational effects on London's transport infrastructure. There will, of course, still need to be significant investment in London's transport networks in future, but some of the drivers of this investment may change. Priorities may shift towards housing, economic regeneration and decarbonisation. This means that while the capacity case for capital-intensive schemes, such as Crossrail 2, is likely to remain strong, the focus may shift to the broader benefits arising from better connectivity. And Transport for London (TfL) will also still need to renew some of its older assets, and the costs of doing so will be no less after the crisis than they were before.

We know that there will be further strain on potential sources of funding to maintain and expand London's transport network. Central Government's response to the pandemic will lead to a large increase in the UK's debt to GDP ratio, meaning that future resources for infrastructure are expected to be constrained. Within this constraint, the Government will still want to meet its objective of levelling up productivity between UK regions; an ambition that London First fully supports. And, of course, before the lockdown, TfL's business plan was already projecting a looming long-term funding shortfall of almost £50bn over the next 20 years. Since then, TfL's revenue has already fallen dramatically as a result of the coronavirus crisis and it is now unlikely to recover to pre-crisis levels in the short to medium term.

Recent events mean that the case for re-thinking how we fund London's transport pipeline has, if anything, strengthened. This will involve, in the first instance, addressing questions about where new transport funding should come from, what the right mix of local and national contributions is, and how funding approaches should differ between different parts of the country.

To contribute to this objective, as part of our Infrastructure Funding and Financing Working Group, London First, supported by KPMG, consulted with the capital's business community along with senior officials from the Treasury (Infrastructure Projects Authority), TfL, local authorities, and public sector officials from bodies representing regions across the country to examine how London should seek to overcome challenges in securing the necessary funding for its transport pipeline in the 2020s and beyond. Rather than recommend specific mechanisms to raise money to fund London's transport projects – a matter we will examine at a later stage – we sought views on the key fundamentals that should be used to inform future decisions about how its transport pipeline should be funded. This paper reflects initial thinking from this discussion.

The London Funding Challenge

In September 2019, London First research revealed that meeting the capital's transport ambitions was likely to require new sources of funding[1]. Subsequently, TfL published its business plan[2], which highlighted numerous essential projects that are not currently funded. This includes improvements to existing infrastructure – for example, upgrades to the Piccadilly Line signalling system – as well as new projects such as Crossrail 2, the Bakerloo Line extension and the DLR extension to Thamesmead.

Prior to the social distancing measures and the drop in economic activity caused by the pandemic, many of the capital's existing transport routes were overcrowded at peak times. New investment was necessary to address expected economic and population growth[3], and to unlock much-needed new housing supply.

While the long-term consequences of the pandemic on transport demand and supply are uncertain, it is reasonable to assume that London will continue to need a mass transit network; that the network will need to be maintained and modernised over time; that population growth will continue; and that policy objectives around housing delivery, economic regeneration and decarbonisation will become increasingly important. Taken together, this will mean significant investment is required in London's public transport systems.

1 *London First, The role of private capital in securing London's future infrastructure, 2019*

2 *Transport for London, Business Plan: 2019/20 to 2023/24*

3 *National Infrastructure Commission, Annual Monitoring Report 2020, 2020*

GLA Economics, in January 2020, set out some of the issues in comparing investment in London with the rest of the country including:

- London's unique geographic characteristics are reflected in unique transport patterns. It is, for example, the only UK region which is entirely an urban area.
- London is much more reliant on public transport than the rest of the country (which, incidentally, makes it in some ways more exposed to the spread of coronavirus than other parts of the country) and it is over-simplistic to see transport investment as a zero-sum game between regions.
- London pays substantially more in taxes than it receives.

GLA Economics went on to estimate that London needs approximately £445bn of investment in transport by 2041, and that there is a projected public sector transport funding gap of £32bn in real terms (2018 prices) over this period[4]. This analysis is also reflected in TfL's latest business plan, which suggests that it faces a long-term funding shortfall of £50bn in nominal terms over the next 20 years[5].

There are, of course, some caveats. For example, the projected funding gap cited by GLA Economics (Arup's analysis[6]) is based on a variety of assumptions about expected funding

4 *GLA Economics, Transport expenditure in London, 2020*

5 *Transport for London Business Plan 2020/21 to 2024/25*

6 *See Greater London Authority, The cost of London's infrastructure requirements to 2041 and the funding gap, 2019*

from central government, including that the Department for Transport will fund 50% of the cost for Crossrail 2. And, of course, the current underutilisation of TfL's transport network – and any future changes in travel patterns that may come about from the pandemic – has not been taken into account. Nonetheless, it is clear that there is a major funding gap for London's transport pipeline.

There is no right answer as to how this gap should be addressed.

The National Infrastructure Commission's National Infrastructure Assessment makes it clear that it is possible to deliver TfL's long-term investment needs (including Crossrail 2) within its remit of 1.2% of GDP[7]. The Government looks set to exceed this percentage over the course of this Parliament, judging by plans set out in the 2020 Budget: although these were, of course, announced before the fiscal pressures of dealing with the costs of the pandemic had been taken into account. However, while this shows that, at least pre-pandemic, London's transport investment needs are affordable within the remit of public sector spending of 1.2% of GDP on economic infrastructure, it does not establish how exactly they will be funded.

There is an argument that London's historic tax surplus is such that its future transport investment needs should simply be met by the Treasury. However, central government's balance sheet will be increasingly strained following the Coronavirus pandemic and the case for levelling up productivity across the rest of the country remains.

In practice, a broad range of investment sources will be required to fulfil the capital's transport needs. Like other parts of the country, London should receive a reasonable baseline level of funding from central government, but it should also be prepared to raise supplemental revenues locally; and in return, must have the powers from central government to do so sustainably and equitably.

7 *National Infrastructure Commission, National Infrastructure Assessment, 2018*

The capital already has experience in raising local funding to deliver major schemes. For example:

- **Crossrail** has received only a third of the funding cost from central government. Other contributions are coming from London's business community, including a business rate supplement (BRS) levied on large London businesses that will contribute over £4bn of funding to the scheme, as well as the farebox; and
- the **Northern Line Extension (NLE)** has received no direct grant from central government. Two thirds of the funding will come from localised business rates retention[8]. The remainder of the funding will come from developers via Section 106 agreements.

While London has managed to pay for these two major projects at the same time, these funding mechanisms would not on their own be able to deliver the future pipeline. Crossrail's delay means that some of the funding initially planned for Crossrail 2 via the BRS and the Mayoral Community Infrastructure Levy (MCIL) is now funding the overrun; and the localised retention of business rates funding around two thirds of the cost for the NLE is only possible due to the exceptional transformational regeneration occurring at Nine Elms.

In short, if London does not have access to newly devolved flows of existing taxes, coupled with some revenue raising powers, the capital's transport system will either be unable to cope with expected growth and the challenges of post-pandemic recovery, or we will have to accept the degradation of existing assets.

8 *The Business Rates Retention element of the NLE's funding is effectively a mixture of local and national funding. Since 2013-14, London's locally-retained share of business rates growth (above a pre-determined baseline) has varied between 50 and 100%. Even without the specific agreement relating to the Vauxhall Nine Elms area, a significant proportion of business rates growth revenue arising from new development would have been retained in London.*

Funding London's transport pipeline in the levelling-up era: the workshop's key findings

1 "Levelling up" is supported as an objective, but this must not lead to London's investment being levelled down

The Government's levelling-up agenda means boosting investment in other regions, but this should not lead to London being starved of the funds for new transport investment. The rest of the UK is London's biggest trading partner and the capital provides a large net contribution to the Treasury, giving the UK as a whole an economic interest in the enduring success of the capital. Moreover, intra-regional equity issues are important: London, for example, has areas of high deprivation and the levelling-up agenda should equally apply to these areas.

Accordingly, central Government should provide London a reasonable baseline level of investment; although the scale of the funding challenge associated with both levelling up and delivering on London's investment requirements means that this will need to be accompanied by broader funding reforms.

2 Fair funding means ensuring a wide range of beneficiaries contribute proportionately to delivering London's future transport pipeline

In recent times, local funding contributions towards London's transport projects have mostly come from the business and developer community through mechanisms such as the BRS and the MCIL.

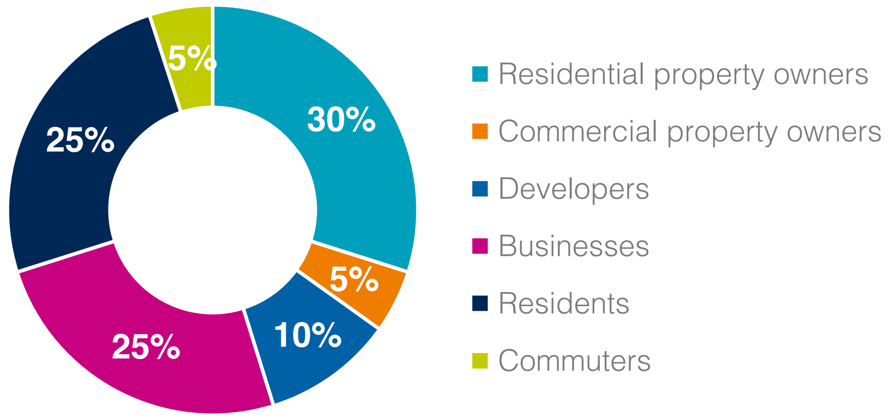
However, for reasons already stated, these existing methods will not produce enough cash to support the delivery of London's future transport pipeline; nor would they fairly or proportionately target the full range of financial beneficiaries of new transport projects. For example, the majority of increases to land value from new transport projects in London are likely to go to existing residential properties[9], but current mechanisms do not capture a significant portion of these uplifts.

Critical to achieving fairness in funding London's transport pipeline is developing a robust understanding of how and when projects will generate financial gains, and for whom.

9 *TfL Corporate Finance, Land Value Uplift Capture, November 2018*

There has already been some analysis on the proportion of financial benefits going to different beneficiaries for new transport projects in London. For example, the Independent Affordability Review for Crossrail 2 developed an 'equity map' (figure 1 below), estimating which groups are projected to benefit financially from the project, and the relativity of benefit between them.

Figure 1: Equity Map for Crossrail 2 – shares of post-tax financial gains (indicative values only)



Source: Analysis supporting the Crossrail 2 Independent Affordability Review
Note: See Annex for further details

The overall funding package for London's transport pipeline should seek to ensure proportionate contributions from the full range of beneficiaries. The equity map analysis provides a useful foundation for debate as to whether particular groups are making a fair funding contribution to the costs associated with new projects.

3 Land Value Capture mechanisms can play a role in closing the transport funding gap, but there are important design details to resolve about how they would work in practice

Land Value Capture (LVC) mechanisms such as a transport premium charge on properties near to new stations would aim to divert a portion of the land value uplift arising from new transport schemes (associated with both existing properties and new development) and apply them towards the funding of the project. Previous estimates by TfL suggest that future transport schemes in London are likely to produce significant land value uplift. A sample of eight prospective TfL projects (including Crossrail 2, the Bakerloo line Extension (BLE) and the DLR extension to Thamesmead) were estimated to have the potential to produce land value increases of nearly two and a half times the costs associated with the schemes[10].

10 *TfL, Land Value Capture, 2017*

However, existing tax mechanisms are able to extract only a small fraction of these gains, particularly those accruing to residential property[11], and do not directly fund London's transport projects as they simply go straight into the Treasury's coffers.

While LVC mechanisms clearly have the potential to help fund investment in infrastructure, there are two key challenges: how could LVC mechanisms work in practice and what is a fair way of raising revenue from different beneficiaries?

Practical challenges include the potential instability of revenue streams (which could make the revenues hard to borrow against too far in advance) and problems around how charges would be calculated. There are also political difficulties in making funding obligations equitable and treating people differently depending on where they lived and when they bought or sold their property.

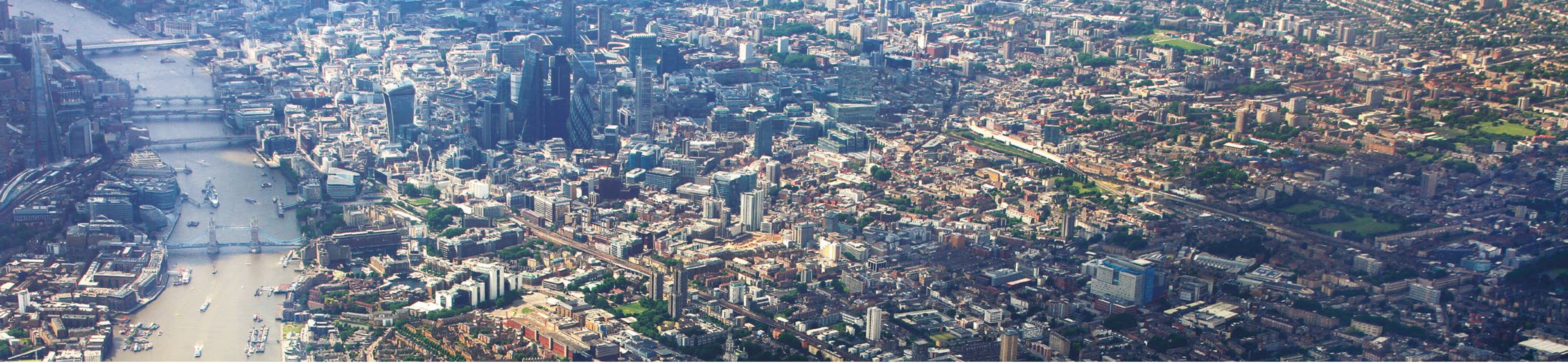
Through the Infrastructure Funding and Financing Working Group, London First plans to undertake further work to understand these issues and consider the design of potential LVC approaches for London that might form part of the funding package for the capital's future transport pipeline.

4 Making funding decisions on a project-by-project basis is inefficient, and there should be a mix of London-wide and locally-targeted mechanisms

Typically, making the case for new transport projects in London is done on a scheme-by-scheme basis, meaning that funding packages are agreed for specific projects with little consideration about the future transport pipeline. This is a myopic and highly inefficient way of delivering transport investment in London.

Instead, funding for London's transport pipeline should be agreed at a programmatic level over a long period. This programme should then be part-funded by central government grant along with a mix of London-wide and more locally-targeted funding mechanisms. It is important for locally-targeted mechanisms to be part of this mix so that beneficiaries receiving large benefits from new transport projects make a proportionate contribution. Indeed, London's transport pipeline should be funded equitably from all direct beneficiaries – including businesses, developers, residents and commuters.

11 Existing mechanisms capture minimal amounts of land value uplifts. SDLT, for example, would only typically capture around 3% of the uplift.



5 Funding London's transport pipeline will require a more joined-up approach between the GLA area and the wider South East

It is estimated that, during normal times, around two million people commute into London from the wider South East every day[12]. This highlights the importance of improving political co-ordination between the GLA area and the wider South East.

Many of these commuters, along with those within the GLA boundary, will be benefitting from London's transport projects and should therefore also make a fair contribution to the funding costs. An increase in fares on certain routes in and out of London is potentially the easiest mechanism to achieve this, but any such fare increases must not lead to modal shift away from public transport; must remain equitable with other beneficiaries; and must also take account of existing fare distortions (for example, between TfL and National Rail). There is also scope for changing the structure of fares, for example TfL zones, and in order to ensure London's transport strategy aligns with the Government's net zero ambitions, a coherent road pricing strategy is also likely to be needed.

12 *GLA Economics, Transport expenditure in London, 2020*

6 City regions should be responsible for determining and delivering intra-regional transport projects, and this requires further devolution

It is of course theoretically possible for central Government to both determine the transport programme that London should follow and then provide equitably sourced funding from grant and direct beneficiaries. However, in practice, this is unlikely to happen. Central government has already given most operational responsibilities for transport policy to London government through TfL – recognising that it is best placed to develop projects that are tailored to local needs. However, while there is substantial devolution of transport policy to the GLA, TfL is reliant on short-term periodic funding agreements with central government. This creates inherent uncertainty, prevents long-term planning and creates a mismatch between policy and resources.

For London to deliver on its objectives there needs to be greater fiscal devolution. This would give London control over the existing tax revenue streams raised in the capital, supporting long-term planning, coupled with some tax varying powers to capture value and increase investment. Such an approach, based on devolving property taxes and reducing central government grant to ensure fiscal neutrality at the point of devolution, was proposed by the London Finance Commission created by the Prime Minister when Mayor of London.

Conclusion

To support the delivery of its transport investment needs, London will require certainty from the Government on an adequate funding regime. This could be from a long-term funding agreement with the Treasury; or, more likely, from a combination of devolution/grant and new powers that can equitably tap the beneficiaries of investment. These new funding mechanisms must:

- ensure a broad range of beneficiaries pay for new projects and that there should be a mixture of London-wide and locally targeted mechanisms;
- support a programme of investment, as opposed to project-by-project schemes; and
- join up the interest and resources of the GLA with those of the Greater South East.

The forthcoming English Devolution Bill provides a good mechanism to create the appropriate new powers.

Other city regions have different devolution frameworks to London. The Government will, quite rightly, want to devolve further decision-making powers to the regions of the UK in the upcoming Bill, but this should not mean the capital's need for more locally-held powers and further fiscal devolution should be ignored.

Fiscal devolution should be a combination of control over the rates of existing property taxes (subject to appropriate checks and balances that ensure businesses are not treated as a "cash cow") with the ability to implement new revenue raising mechanisms, potentially such as Land Value Capture (again, subject to checks and balances that ensure no group is disproportionately affected and that new development remains viable) that could be developed with central government, and then the powers to implement them devolved accordingly.

Control over revenues arising from property taxes would also provide greater long-term funding certainty as opposed to the uncertainty associated with the current system, reliant on periodic agreements with central Government. It would have the added advantage of incentivising London government to grow its tax base: currently local authorities, particularly in central London, bear many of the political costs of growth with few of the benefits.

And it would also incentivise London government to ask the hard questions about the relative value of different transport projects, which would encourage policymakers to take the most efficient investment decisions. Inevitably, there will be political challenges locally in implementing new mechanisms to fund transport projects. But these challenges should be faced up to at a London level, and the capital needs the powers to make its own decisions about how to close its transport funding gap.

Fiscal devolution and funding reform in London would also help other regions. It could help free up resources and London could potentially act as a test bed for new funding mechanisms, which, if successful, could be rolled out to other parts of the UK. London has been a leader in the past – for example, through the innovative funding package for Crossrail – and can be again with the right kind of overall funding regime and powers.

Next steps

In the next phase of London First's Infrastructure Funding and Financing Working Group, we will examine the specific mechanisms that should be used to fund the capital's transport pipeline and the devolution settlement London will need to implement these mechanisms. We plan to set up a workshop to examine this issue once there is further clarity about the future direction of infrastructure policy following publication of the National Infrastructure Strategy and the Spending Review – as well as further information on when the Government will publish an English Devolution Bill

If you would be interested in participating in London First's Infrastructure Funding and Financing Working Group – or in any of the specific roundtable opportunities – please contact Daniel Mahoney at dmahoney@londonfirst.co.uk (Programme Director for Economy and Infrastructure).

Annex – Equity map

The 'Equity Map' analysis was undertaken as part of the Independent Affordability Review of Crossrail 2 and examined the share of potential post-tax financial gains between the project's different beneficiary groups, as follows:

Beneficiary group	Nature of benefit
Residential property owners	Impact (after stamp duty) on residential property values for existing dwellings within station footprints. Based principally on Savills analysis with spatial modelling in support. Three-quarters of this is within London.
Commercial property owners	Impact (after corporation tax) on existing commercial property values within station footprints. Based on Savills analysis. Only London effects included.
Developers	Net land value estimates on new residential and commercial development within station footprints. Mix of Savills analysis and spatial modelling.
Non-property businesses	Off-route and London only (to keep separate from station footprint rent effects above). Reflects additional post-tax profits based on additional employment and productivity forecasts derived from spatial modelling, including high-skilled international migration, and the ability of London to continue to attract more than its share of the most productive people and businesses.
Residents	Off-line of route estimate only (to avoid overlap with residential impacts above) and London only. Reflects additional post-tax wages generated by additional employment and productivity forecast for the project derived from spatial modelling, including high-skilled international migration, and the ability of London to continue to attract more than its share of the most productive people and businesses.
Commuters	Commuter belt equivalent of "Residents" gains reflecting commuters' share of London wage gains. Based on spatial modelling.

These estimates focus only on London and the South East commuter belt, being the primary post-tax 'winners' from the project. Losses elsewhere in the country are not reflected in the figures.

Separate estimate, consistent with the above, was made of net Exchequer gains (i.e. after the impact of losses in other parts of the country on Exchequer receipts and gains in London and the commuter belt).

The analysis highlighted similarities in the relative scales of impacts on existing property, to non-property businesses (via higher profits) and residents (via higher post tax wages). On a proportionate basis, it implied a very different mix of local funding from that used to date (e.g. on Crossrail), including through new mechanisms capable of targeting impacts on existing property values.

London First is a membership group which campaigns to make London the best city in the world to do business.

Our membership comprises over 200 leading employers across a wide range of sectors. We convene and mobilise business leaders to tackle the key challenges facing our capital.

We have been instrumental in establishing a **Mayor of London**, pioneered **Teach First**, driven the campaign for **Crossrail**, lobbied for government action on airport capacity, leading to the approval of a new **Heathrow** runway and achieved a win for business when Government announced a review of the **Apprenticeship Levy**.

Now we are focusing on key priorities to keep our capital working for the UK: **people, place, competitiveness** and **connectivity**.

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