UK City Deals – adapting new thinking to Australia's growth and funding challenges

Paul Low[1] and Praveen Thakur[2]

[1]KPMG Brisbane, 71 Eagle Street, Brisbane QLD 4000

[2]KPMG Melbourne, 147 Collins Street, Melbourne VIC 3000

Email for correspondence: thakurp@kpmg.com.au

Abstract

Central and local government in the United Kingdom (UK) have collectively developed and implemented a new model for infrastructure funding and delivery. The City Deal model has provided the foundation for a growing number of city regions (such as Manchester, Glasgow, Leeds/York) to secure a more financially sustainable approach to prioritising and funding infrastructure through a "long term rolling investment" programme underpinned by 10 year funding agreements between the UK's 'second capitals' and central government.

A core tenet of the City Deal model has been the prioritisation of infrastructure investment on the basis of the capacity of that infrastructure to deliver productivity improvement and jobs growth. This reflects a shift in accepted transport assessment methodologies in the UK, whereby the growth benefits associated with infrastructure become the central focus for the value for money assessment. In practice, this also means focussing on the outcomes that generate tax revenues that pay for publicly funded investment.

The foundations for the City Deal model rests on three pillars:

- Real economy prioritisation;
- Establishing governance and metrics; and
- Establishing funding parameters.

Many of the challenges that were the catalyst for action in the UK are present in Australia. This paper will consider these challenges, outline the key drivers for changes in the UK and examine the application of the core concepts that underpin the City Deal model and the potential to adapt the model for the Australian context.

City Deals – Adapting the UK Experience

1. Introduction

Infrastructure, along with urban form, is a key enabler of the modern economy, underpinning the efficiency with which it operates. Infrastructure and urban form are the biggest factor in our lived experience. Despite the important role played by infrastructure, Australia faces a number of challenges in prioritising and funding the infrastructure.

Rapidly growing population is generating significant demand for trunk and local infrastructure, negatively impacting on the economic growth and productivity. Data on historical productivity growth shows that multifactor productivity in Australia has been declining since the early 21st century (ABS, 2014). A number of studies, including a study by the Productivity Commission (2014), have examined the role of infrastructure and productivity and have concluded that inefficient infrastructure is a contributing factor.

The continued decline in the productivity growth in Australia over the last decade, and the tangible impact it has on the standard of living, has contributed to increased policy focus on the approaches to reverse the trend.

Conversely, governments in Australia at Federal, State and local levels are increasingly constrained in their ability to invest in social and economic infrastructure projects.

Faced with similar pressures, the Central and local governments in the UK collectively developed and implemented a new model for funding and delivery of infrastructure. A core tenet of the 'City Deals' model has been the prioritisation of infrastructure investment on the basis of the capacity of that infrastructure to deliver productivity improvement and jobs growth.

This paper outlines the key drivers for change in the UK, examines the application of the core concepts that underpin the City Deals model and assesses the relevance of the model in the Australian context.

2. Background to City Deals model

Prior to the development of the City Deals model, the approach to funding and delivery of major infrastructure projects in the UK was similar to that currently adopted in Australia. This included development of detailed funding submissions entailing project-by-project bids. All bids were evaluated using traditional Cost Benefit Analysis (CBA), with local authorities in the UK being responsible for making the case for investment. Appraisals would be scrutinised by the Central Government and Ministers would periodically clear projects to move up an "approval ladder" – programme entry through to final approval, with the last stage only being possible when the budget headroom became available.

Notwithstanding the benefits of the approach to project-by-project funding submissions, it also posed a range of challenges, including lack of transparency at the city/ region level, about the total budget a city might expect to receive in terms of infrastructure investment for the next year. This approach also did not provide certainty of funding over the medium or long term, and is counter to the approach adopted in infrastructure and land use planning that, by necessity, requires a long term view.

Key drivers for city-based reform and change to the City Deals model were:

- Realisation that cities were asking for almost 20 times the available budget for infrastructure funding (total of project-by-project funding submissions in the pipeline), turning investment decisions into a huge source of tension and conflict between central and local government;

- Recognition that a combination of project-by-project traditional CBA and lobbying was a very costly and inefficient allocation mechanism, particularly against the background of Central Government's balanced growth objectives and cities' ambitions to grow their economies;
- Specific acknowledgement of the role of infrastructure in driving productivity and economic performance, leading to questions about the traditional CBA approach to appraisal; and
- Increasing interest in alternative funding mechanisms (value capture etc) and questions about how to maximise incentives to develop and deploy these funding mechanisms.

Faced with these challenges and drivers, the Greater Manchester (GM), comprising 10 local authorities, developed and negotiated the first City Deal model with the Central Government in the UK. The model enabled a more financially sustainable approach to infrastructure financing through the implementation of a *'long-term rolling investment'* approach that draws on new sources of committed funding. This has provided greater certainty around infrastructure investment, a commitment to prioritisation of infrastructure around productivity and economic growth outcomes, and the capacity to fund a greater scale of infrastructure than has historically been feasible.

The Greater Manchester Deal, signed in 2012, spurred a number of other regions to reconsider their approach to infrastructure prioritisation and funding (including Glasgow, Leads City, West Yorkshire and Greater Cambridge to name a few). City Deals have now become a central feature and a reform for local devolution.

The next section discusses the key elements of the City Deal approach to infrastructure prioritisation and funding.

3. Key features of City Deals

The City Deal model was developed to achieve two clear objectives:

- to cause ***a step-change in the level of infrastructure being delivered***; and
- to ***maximise the productivity and economic growth realised*** as a product of that investment.

The key elements of the City Deals can be summarised by three key pillars:

- 'Real economy' prioritisation;
- Funding parameters; and
- Governance.

Each of these three pillars are discussed in the following pages.

3.1 Economic prioritisation

A core tenet of the City Deal model has been the prioritisation of infrastructure investment on the basis of the capacity of that infrastructure to deliver productivity improvements and jobs growth.

This reflects a shift in accepted project prioritisation methodologies in the UK, whereby the productivity benefits associated with infrastructure investment become the central focus for the value for money assessment. In practice, this also means focusing on the outcomes that generate the tax revenues that pay for publicly funded investment. This has helped to capture the productivity and employment growth that can be attracted and incentivised through sound infrastructure investment.

Key issues that need to be considered in implementing the real economy prioritisation include upfront agreement on metrics and programme prioritisation.

- **Metrics definition** – The City Deal model requires metrics to be agreed up front that provide for a real economy focus (e.g. productivity at the level of the whole city region and net impact on jobs), combined with supporting metrics that ensure sufficient balance in terms of benefits across an area to sustain local agreement. Selecting metrics that focus on economic productivity and jobs has been the defining feature of the model. .

  The UK experience is that generating consensus around initiatives reliant on significant levels of 'self-help' (explained below) requires more than a single headline economic metric. It requires delivering balanced growth, particularly in terms of the distribution of the benefits that focusing on the real economy can bring, e.g. the distribution of improved employment and earnings opportunities, both geographically across a city region and between communities. In practice, this kind of balance is more likely to be delivered at the programme level as opposed to individual project level. This has resulted in the establishment of what is referred to as "programme minima" – minimum outcomes that the programme as a whole needs to deliver.

  This approach results in the lead economic metric (typically Gross Value Added, a measure of Gross State Product or Gross Domestic Product) being maximised subject to the minima (environmental and social equity considerations) also being delivered. The UK experience is also that it is prudent to focus on a 10-year view, providing scope to build in balance whilst avoiding the risk of projects being too far away into the future to generate stakeholder buy-in.

- **Programme prioritisation** – Once metrics are agreed, the list of potential projects is prioritised based on these metrics by an independent party acceptable to all stakeholders. The outcome of this process is a programme of projects, ranked from highest to lowest priority against the lead metric. A number of potential funding scenarios are applied to the prioritised list and the emerging programmes are assessed to determine if they comply with the programme minima. Where the programme fails, its contents are adjusted until it complies, with projects being swapped in and out with a view to minimising the impact on the headline metric. The approach ensures that the potential list includes projects that are cost effective against the lead metric and against the programme minima.

  In the City Deal model, significant effort is put into getting the programme metrics right at the outset, before the prioritisation is undertaken. The aim is to minimise the attempts to redefine the criteria, after the prioritisation, in order to change scheme rankings. A clear real economy lead metric (productivity and jobs) is critical. This minimises the risk of stakeholders arguing for an approach that reduces employment and growth outcomes. Arguments about fair shares are also more difficult to counter which is why in the City Deal model substantial effort is put into determining the programme minima.

3.2 Governance

The governance structures employed to implement a deal are just as important as the mechanical details of the deal itself. It is important to establish a suitable structure for the specified geography, to ensure that all stakeholders are held accountable to responsibilities and that benefits from the deal are realised and shared across the combined region.

Effective governance arrangements are critical to ensuring that the terms of the other two pillars can be negotiated. This is about both the initial decision-making – e.g. around the important decision criteria – but also in downstream delivery.

The agreed governance structure will take into consideration the specific social, economic and environmental characteristics as well as local legislative and/or any existing governance and collaboration arrangements.

In the case of GM, it established a Combined Authority, accountable to the 10 leaders of the GM authorities, to deliver and/or make changes to their programme. The GM model operates under Quality Majority Voting rules (seven of the 10 leaders have to vote in favour) and has the right to levy the 10 authorities (pro rata to population) to deliver its agreed programmes and is accountable to a cabinet of the 10 elected leaders.

3.3 Funding parameters

The delivery of infrastructure ultimately is dependent on funding. Funding for the delivery of infrastructure under the City Deal model generally comprises *baseline funding, self-help* and *earn-back funding*.

- **Baseline funding** refers to the funds contributed to a centralised funding pool by the Central Government and any locally sourced funding. Together with the real economy prioritisation, this helps cities understand the scale of 'self-help' that might be required to deliver the prioritised infrastructure and make the cities more productive.
- **Self-help** is any additional locally sourced funding over and above standard budget allocation. It may incorporate additional sources of revenue to maximise the total funding pool and includes sources such as re-prioritisation of existing budget/revenue, tolls, value capture levies, developer contributions and any dedicated local taxes that are not committed to projects in the usual course of events. The concept of self-help is about the lower tier of government making difficult decisions and adding to the total investment pool as a result. Self-help is critical to receiving the earn-back, securing the City Deal between the Central Government and the lower tiers of government and creating a long-term infrastructure investment fund.
- **Earn-back/payment by results** – A city is rewarded by the Central Government for its self-help as (and when) it delivers additional economic growth by returning a portion of increased tax receipts collected by Central Government due to economic growth delivered by the infrastructure funded through self-help. This means the local self-help contribution is returned to the region, as long as the initial investment delivers what is promised i.e. additional economic growth and resultant increase in tax receipts. This reinforces the incentives created by the initial move to baseline budgets and real economy prioritisation. The earn-back imposes the discipline on local decision makers and stakeholders to follow through on the logic of the approach, whilst at the same time ensuring that the city receives its fair share of the fiscal benefits its extra efforts ('self-help') create for the Central Government in increased tax receipts.

3.4 Benefits of UK City Deals

Key benefits of increased devolution offered by the City Deals approach include:

- Transparency and certainty on the investment pipeline and priority;
- Clear and quantified investment decision making based on agreed prioritisation metrics;
- Maximisation of infrastructure led economic growth to achieve positive productivity, employment and financial outcomes;
- Greater collaboration and accountability between stakeholders, including shared local decision-making; and

- Investment accountability enabled through increased transparency and shared contribution to infrastructure funding in exchange for a share of any increase in tax receipts realised by the higher tiers of the government.

Most importantly, the benefit of the City Deal approach is that it enables the creation of a long-term infrastructure fund providing a ‘step-change’ in infrastructure investment that maximises economic growth outcomes and also delivers social and environmental benefits that are incorporated through the programme minima.

4. Relevance of City Deals model to Australia

Similar challenges faced in the UK that contributed to the development of the City Deal model is currently evident in Australia. This includes:

- Constrained funding for infrastructure investment at all levels of government – infrastructure deficit facing Australia is estimated at around $800 billion (Australian Financial Review, 2015);
- Recognition of the critical role infrastructure plays in enhancing economic productivity and societal well-being – refer to Productivity Commission, 2014, Lowe, P, 2013 and Infrastructure Australia, 2015; and
- A broader acknowledgement that the traditional approach to infrastructure prioritisation and funding is unable to address the scale of the infrastructure deficit facing.

These challenges are leading to the Governments at every level and increasingly peak bodies in Australia:

- Sharpen their **economic narrative**;
- Deepen their conversations with the community around **trade-offs and long term futures**;
- Seek ways to allocate diminishing funds – or **leverage private funding sources** – with greater impact; and
- Embrace more assertive **governance models** to cut through regulatory or jurisdictional burdens.

These issues and relevance of the City Deal concept to Australia are discussed below.

4.1 The economic narrative

The Australian policy makers have now accepted the rationale for inclusion of Wider Economic Benefits (WEBs) for prioritising transport and land (re)generation projects, some 10 years after the UK first introduced the concept for transport appraisals. The revised National Guidelines for Transport System Management in Australia will include detailed guidance on the approach to assessing WEBs in Australia (Commonwealth of Australia, 2015). WEBs are additional benefits that are not captured within the traditional Cost Benefit Analysis (CBA) framework. These additional benefits arise from the presence of market imperfections. WEBs refer to benefits arising from:

- The capacity of a project to ***unlock new opportunities*** to deliver new products and services by more effective leveraging of the benefits infrastructure can provide;
- The capacity of projects to ***more efficiently deliver*** existing products and services through:
  - **Agglomeration benefits** of bringing people, employment and supply chains closer together; and

- Improvements in **human capital** through the provision of the right mix of enabling infrastructure in the right location with the optimal supporting mix of social infrastructure.

A key observation here is that the traditional approach to project prioritisation often has a bias towards narrowing the scope of a project to align with funding sources, to control project costs and delivery and to limit opportunities relating to project interdependencies (for example, creating barriers to realising land use transition at a corridor level). This is particularly evident when the 'affordability envelope' is placed over a project.

The central tenet of the City Deal approach is that it focusses on a package of infrastructure projects to lift a region's economic capacity over the medium to long-term. The prioritisation of projects based on productivity and economic growth outcomes, together with a set of social and environmental minima, creates the capacity to deal with competing priorities because projects are sitting within a wider productivity and growth frame of reference. In doing so, it also shifts the focus from getting single projects up, to taking a more programmatic view to managing growth challenges across longer-term horizons.

4.2 Trade-offs, long term futures and alternative funding sources

As discussed above, the concept of 'self-help' is a key theme permeating the City Deal's framework. The model was borne out of the need for Manchester (and subsequently other city regions) to 'do something different' and to think more laterally about its future. Similarly, the fiscal constraints faced by Central Government in the UK contributed to the Treasury accepting that it had a lot more to gain by enabling city regions to prioritise and fund the infrastructure from 'self-help'.

Similar debate to that held in the UK about 5-6 years ago is currently gathering pace in Australia. The issue of vertical fiscal imbalance and options for addressing these, including raising the GST rate, is explored in the Draft Green Paper on Federation recently released by the Department of Prime Minister and Cabinet. Australia is also engaging in debates around the need for broadening the funding envelope and including a wider set of considerations to inform the funding and taxation debate. This includes, for instance, the examination of alternative funding mechanisms on road pricing and value capture undertaken by a range of agencies such as the Henry Review (2010), the Australian Competition Policy Review (2015b) and the Tax discussion paper (2015c).

The City Deal concept also offers the opportunity at the local government level to explore infrastructure funding models for enabling or trunk infrastructure as an alternate or complementary mechanism to developer contributions. The debate in Queensland, Victoria and New South Wales is about striking the right balance between infrastructure charges to:

1. Ensure local government financial sustainability; and
2. Support development feasibility.

The key historical challenge is that the lens of cost apportionment that traditionally drives reform in this space is firmly predicated on a narrow affordability question. In contrast, the City Deal model is predicated on applying a wider and deeper focus on the beneficiaries of growth. It is focussed on understanding and facilitating the multipliers that come with economic development and leveraging these more effectively to generate and distribute funds within a collaborative regional infrastructure prioritisation process.

The debate on trade-offs in available budget and long-term futures and alternative funding sources are ripe in Australia, suggesting that the City Deal-type approach is worthy of detailed investigation.

4.3 Governance models

Partnerships and a rigorous governance model is fundamental to the success of the City Deal model. The cornerstone of each Deal is a regional governance model that has 'internalised' the trade-offs around project selection and prioritisation through engagement at the local level on an agreed set of metrics. This has enabled a united front for political engagement with Central Government around a region's long-term infrastructure and funding priorities.

The debate on long-term infrastructure priorities and the service delivery responsibilities between the three tiers of government in Australia is also ripe. The Green Paper on federation also investigates this matter.

The City Deal model that enables devolution of decision making and funding to the lower tiers of government, and a partnership approach with higher tiers and stakeholders, therefore warrants investigation.

5. Conclusions and further research

The City Deal model explicitly recognises that infrastructure is an enabler, and has a catalytic impact on the economy. The catalytic impact of infrastructure is well accepted by the policy makers and practitioners in Australia, particularly those involved in infrastructure and land use planning and prioritisation.

For instance, Infrastructure Australia (2013) requires that all infrastructure proposals submitted for inclusion in its priority list demonstrate that it aligns with the seven strategic priorities set by Infrastructure Australia, five of which are focussed towards enhancing the economic capacity and productivity:

- SP1: Expand Australia's productive capacity;
- SP2: Increase Australia's productivity;
- SP3: Diversify Australia's economic capabilities;
- SP4: Build on Australia's global competitive advantages; and
- SP5: Develop our cities and/ or regions.

This in turn suggests that effective planning and prioritisation of infrastructure is critical to maximise the return on infrastructure investment to the community and economy. However, the prioritisation process adopted in Australia does not always explicitly consider the economic outcomes of infrastructure investment.

The explicit incorporation of these impacts in Australia's prioritisation framework is more likely to sharpen the focus on productivity and urban form outcomes. This in turn can invite greater community engagement and, ultimately, management of political issues. It will also enable Australia to sharpen the focus on the real trade-offs that underpin funding allocations.

The funding constraints faced by all three tiers of government in Australia also suggests that a broader debate about approaches to funding infrastructure and the associated trade-offs is needed. Greater devolution, combined with appropriate governance mechanisms, may address some of the challenges facing Australian cities and regions.

In summary, the City Deal model offers a number of lessons that may be relevant in the Australian context. The review of the City Deal model provided in this paper suggests that further detailed research should be undertaken to assess:

1. If the City Deal framework could be adapted to create a more effective infrastructure prioritisation and funding model to meet the infrastructure challenges facing Australia;
2. Whether a more explicit productivity focus in the infrastructure prioritisation and funding process would solve some of the traditional barriers; and
3. Whether an adapted City Deal model would deliver better governance that buttresses and supports more effective implementation of Australia's growth management strategies for Australian cities and regions?

References

Australian Bureau of Statistics (2014) *Estimates of Industry Multifactor Productivity*, publication 5260.0.55.002, ABS, Canberra, ACT

Australian Financial Review (2015), *Superannuation all set to bridge infrastructure funding gap,* Brett Himbury, 11 June 2015.

Blunden, W R and Black, J A (1984) *The Land-Use Transport System* (2nd ed) Sydney: Pergamon Press

Commonwealth of Australia (2015a), National Guidelines for Transport System Management, Wider Economic Benefits, https://ngtsmguidelines.files.wordpress.com/2014/07/ngtsm2015_t3_-_webs.pdf

Commonwealth of Australia (2015b) *The Australian Government Competition Policy Review*, Final Report.

Commonwealth of Australia (2015c) *Re:Think – Tax discussion paper,* available from http://bettertax.gov.au/publications/discussion-paper/

Commonwealth of Australia (2010) *Henry Tax Review*, available from http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm

Infrastructure Australia (April 2015) *Australian Infrastructure Audit*

Infrastructure Australia (2013) *Reform and Investment Framework,* available from http://infrastructureaustralia.gov.au/projects/files/Infrastructure_Priority_List_Submission_Template_for_Stages_1_to_6.pdf

Lowe, P. (2013) Productivity and infrastructure, presented at IARIW-UNSW *Conference on Productivity Measurement, Drivers and Trends*, Sydney

Productivity Commission (2014) *Public Infrastructure*, Inquiry Report No. 71, Canberra, ACT

Property Council of Australia and KPMG (2014), *Introducing City Deals A smart approach to supercharging economic growth and productivity*, Sydney, New South Wales.