Levelling Up: Making Investment Appraisal Fit for Purpose

Introduction

The new Government has committed itself to stimulating a more balanced UK economy and of the need for inclusive growth to play a role in every part of this process. So far as the Government is concerned, the emphasis must both be on the development of its own proposals for a more widely shared form of growth for the UK and responding to proposals from others too.

This paper is a contribution to meeting that objective. It arises from a project which has looked at how the system for evaluating projects works at present. It has concluded that if the Government is to achieve its levelling up objective, the implementation of policies needs also to be accompanied by an evolution in the way in which investment appraisal works. The key means for doing this is through modifications to the HM Treasury Green Book and the way in which Government, and indeed everyone else, uses it.

This submission is designed to help the Treasury and other government departments in reworking these processes to ensure government investment meets its rebalancing objective with funding being more distributed whilst representing value for money in the use of public funds. The ideas set out in this paper aim to ensure that investment appraisal supports sound projects of different kinds in every part of the country. It has been put together by Metro Dynamics, sponsored by Peel Group and the North West Business Leadership Team (NWBLT). In putting together this report, we have reviewed a wide range of literature and had discussions with a wide variety of people in Government, industry and in academia.

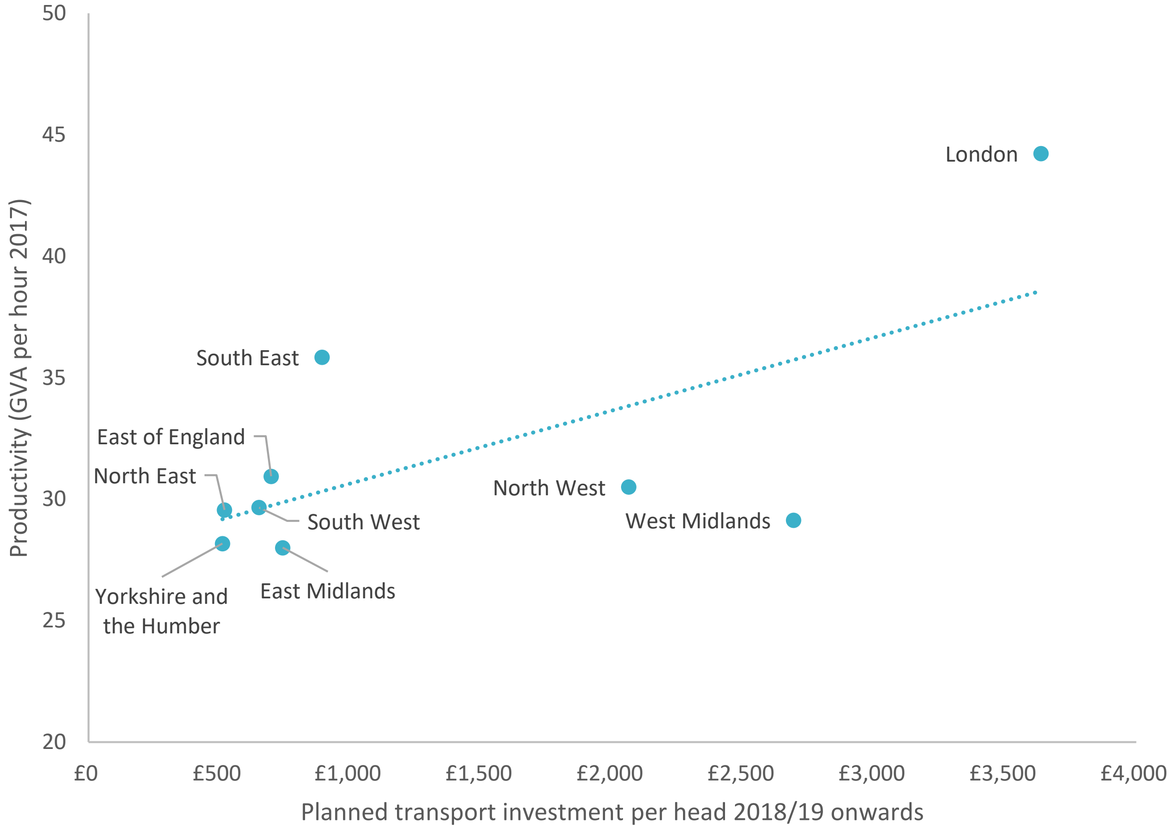
The key issue: A long-term trend of underinvestment in places

The role of investment in promoting long-term growth is highly contested in the literature[1]. The role of investment in alleviating supply constraints in the shorter term is clearer. But the evidence has mounted that the effects of investment on relieving immediate capacity constraints can be short-lived, often bringing about the need for further and more costly investment later. The question to which this has led us is whether there is a better balance that can be obtained as between investments which allow the more productive parts of the economy to grow further, while also bringing into economic use more spare capacity so as to create a longer term process of sustainable and inclusive growth.

If, as is sometimes argued (but also contested, as discussed below), projects in the North tend to produce lower benefits than those in the South on a case by case basis, the outcome of the process of policy, its application and of scheme prioritisation over the past decades has tended to become self-reinforcing. The chart below examines output per head by region with planned public transport spending. Whilst we would argue that the sole purpose of transport isn't and shouldn't be to level up growth, it also seems that in the absence of an intentional countervailing influence, more productive regions attract more of this spending. This is inconsistent with the Government's stated policy objectives.

[1] For a helpful summary (focused on transport) see: https://whatworksgrowth.org/policy-reviews/transport/why-transport/. The author concludes: "In short, while infrastructure investment may be vitally important for growing cities, its role in stimulating growth is not as clear-cut as assumed by many decision makers."

Figure 1. More productive regions in general receive more transport investment per head



Source: Analysis of ONS Regional Accounts and IPPR North analysis of Public Expenditure

The issue this has led us to focus on is that of process: how can policy development and investment appraisal support better investment that both promotes sustainable growth in the more successful parts of the economy whilst prioritising schemes which deliver the same elsewhere too.

What role do appraisal practices play in the distribution of investment spending?

The pattern of infrastructure investment has shown signs of strong regional differentiation over a long period. There are many possible reasons as to why this might be so: risk aversion can lead to backing projects where the prospect of a return is more self-evident, it is often easier to bring in private sector investment in more prosperous parts of the country, and decision makers are generally based in London, meaning they may have a greater awareness of the need for key projects in that area.

We believe it is plausible that the current system of appraisal processes in the UK also contributes to skews in investment. This includes both the formal appraisal guidance (which centres on the Green Book), but also the manner in which it is applied, and the surrounding culture of infrastructure appraisal.

What are the issues with the current approach?

Drawing upon our own experience and conversations with stakeholders from across the project appraisal process, we have identified the following challenges:

1. **The Green Book is a toolkit too often confused with a decision-making guide**. It is, even when fully and correctly used, a technical tool, and even then has a great deal of latitude in its application (for example in relation to the inclusion or otherwise of different variables in the measurement of both costs and benefits). It therefore occupies a challenging role of being used as a technical solution to inherently strategic decisions. Its robustness would be improved by recognising this fact. The Green Book does not currently provide clear strategic guidance.

2. **The Rebalancing Toolkit, introduced by the Government in December 2017, is an attempt to rectify this with regard to strategic rebalancing considerations.** At present, it fails to do so. It currently a) lacks teeth, with a lack of clarity about when it needs to be applied, leaving it as a "nice to have" rather than a "need to have" for a business case, and b) is insufficiently detailed to fulfil its aims. This is a specific instance of a more general point considered below.

3. **The Strategic Case element of appraisal is often under-developed and generally undervalued.** This means that the long-term benefits of key projects are often not recognised, and there is insufficient rigour around strategic objectives. In the absence of clear policy objectives (such as those concerning left-behind places), the economic case tends to predominate, something that is aggravated by the simple measurability of benefit-cost ratios (see point 4 below). Consequently, market-evidenced needs (such as heavy current demand on a busy transport corridor) will generally take precedence over social needs (such as reinstating a train link in a town which has become isolated) – whereas in fact, both need to be attended to. Social impact is generally harder to measure than economic impact, which exacerbates this problem.

   Furthermore, in an economy where proposals are needed to change the trajectory of productivity and growth, many projects will have an element of newness. The track record of similar projects may be limited or non-existent. Quantification may be difficult if the likely efficacy of a project can only be established *a priori*. The absence of a counterfactual can and often is used to kill off potentially valuable as well as less robust projects alike.

4. The underdevelopment of the strategic case both contributes to and is a result of **an overreliance on benefit-cost ratios (BCRs) in decision-making**. BCRs (part of the

Economic Case) are useful guides, but are often significantly different *ex ante* a project and *ex post*, and they can be subject to manipulation to make a project appear better than it actually is. They will also naturally favour projects where return is more certain – if only because of the track record of similar projects. However, these projects tend to be found more in areas which are already economically successful. Value for money is, of course, a vital consideration in all public spending – but there is a risk that in the absence of clear strategic directives, it becomes the *only* consideration.

5. **Relatedly, the benefit-cost ratio, even when accurate, is blind to geographical considerations because it sums all national gains and losses into one figure**. This makes sense as far as recognising value for public money is concerned: however, from the point of view of places it means that, for major regeneration schemes, the benefits side of the equation often has to be dampened down by the assumption of displacement from elsewhere. While displacement *is* a genuine cost, it is normally an inevitable one in any successful scheme to transform a place – with research showing that the biggest impact on any place's development path is its stock of skilled labour. In the short to medium term, this can only be increased by the movement of people (indeed, the continued economic success of places like London is fuelled by the ongoing displacement of skilled individuals away from other parts of the country). The fact that the BCR has to dampen local gains by reflecting losses elsewhere compounds the problem of putting the economic case before the strategic case[2].

6. **There is a lack of transparency around the infrastructure appraisal process.** Business cases are not routinely published, meaning the public cannot scrutinise how effectively Government is using the process which exists. Data around benefit-cost ratios of projects, and whether they are approved or not, is not collated by departments, let alone shared, as Freedom of Information Requests we have encountered in the course of this research have revealed. This makes it difficult to establish the facts. The only data available, from the Eddington Review in 2006[3] suggest that in at least one case, projects in London and the South East which had lower BCRs than equivalent projects in Leeds were nonetheless chosen ahead of those projects. Some claim that the Green Book itself inevitably makes it harder to gain approval for projects in less prosperous areas, while others claim these projects often can stand up on their own but are "overlooked". The facts with which to back up or refute these claims are simply not known as are the details of how plausible or otherwise the BCRs for funded (and not funded) projects are.

7. **Complex Investment Appraisal processes, without adequate support, can act as a barrier to market entry. The expertise to use the Green Book to develop value for**

[2] Recent progress has been made to recognise the benefits of agglomeration in adding to productivity benefits of bringing economic activity together in a place. This therefore does help to capture the additional economic benefits which can arise from the movement of economic activity. However, these are generally minor, and may serve to further channel investment towards successful places.

[3] Available at: https://webarchive.nationalarchives.gov.uk/20081230093524/http://www.dft.gov.uk/about/strategy/transportstrategy/eddingtonstudy/

money and compliant proposals is often lacking, particularly in areas that have a limited track record. Whilst we accept that it is the responsibility of project sponsors to make arrangements for the development of their projects, the fact remains that many, including those for whom the Government is making funds available, do not have in-depth strategic capacity or even ready access to it. To take an example, in many places where Government has made available multiple funding streams for town development, there is a gap between the capacity of councils (with less than £20m budgets) and the sums available (for some as much as £75m). It seems unlikely that these areas are well placed to develop effective proposals. In areas of historic underinvestment there has often been seen to be little value in developing proposals, meaning that there is not much in the way of "shovel-ready" projects – and few staff, if any, with the ability to change this. If the Government is committed to rebalancing, this is a problem about which it too needs to be concerned.

Proposals to improve the investment appraisal process

To help respond to these challenges, and ensure that public sector investment is used to effectively stimulate economic development across the UK, we propose the following six changes to how appraisal is conducted in the UK.

1. **Introduce a clear strategic framework for assessing projects into the Green Book**. We propose that the first modification should be that long-term policy objectives are made explicit in the Green Book. The Government objectives of raising growth levels across the country, reducing carbon emissions and rebalancing the economy should be made clear and prominent within the Green Book, to emphasise that investment appraisals need to incorporate and address the Government's policy aims and not just generate a high BCR.

2. Alongside stating the policy aims, **there should also be a clear framework as to how these aims will be achieved and what success might look like, along with metrics which can be used to evidence it**. One option, which the Green Book already makes provision for, is setting out a *local-level* BCR which only captures benefits and costs in the local area. It therefore ignores displacement effects from elsewhere. This would form part of the *strategic case*, as it helps to make the argument for why a particular place needs a particular scheme, rather than why the nation as a whole needs the scheme. The use of local-level BCRs in the strategic case, alongside national BCRs in the economic case, should be mandated for all local schemes, meaning that Ministers (and indeed local leaders) can have a clearer view of both the national *and* local reasons for carrying out a project (along with any accompanying trade-offs).

   Additionally, the Green Book should make clear provision to articulate where the particular project fits within a wider place-based series of interventions to drive re-balancing. This will enable the wider benefits to be captured, and help sharpen thinking about the delivery of schemes in relation to each other.

3. **As part of this we propose formally incorporating (with changes) the Government's Rebalancing Toolkit into the Green Book**. The Rebalancing Toolkit is supplementary guidance to the Strategic Case with the ambition of "help[ing] authors of strategic cases assess how a programme or project fits with the objective of spreading growth across the country"[4]. Nonetheless, we concur with the views of the Transport Select Committee: "We are concerned that the toolkit's status as supplementary guidance will limit its effectiveness; we recommend the Department initiate discussions with HM Treasury about how economic rebalancing can be made an intrinsic consideration in transport scheme appraisals, putting it at the heart of investment decisions rather than being merely an add on."[5] The Committee's recommendation seems to us an appropriate next step.

   All of the above would make the strategic goals of investment as clear as the economic goals and put a greater emphasis on the social impacts of a project, as will be required to rebalance the economy.

   This would help address issues 1 – 4 in the list above.

4. **A review of discount rates and time horizons**. The Green Book discount rate of 3.5%, which is applied to most projects, should be reviewed. Higher discount rates will tend to favour projects which deliver more immediate returns, and therefore deprioritise longer term strategic projects. In addition, it is rare for a project's appraisal period to go beyond sixty years. However:

   a. There is an argument that long-term transformational projects, which seek to regenerate areas through the growth of employment and trade should have lower discount rates, and/or longer time horizons for appraisal. Much of our Victorian rail infrastructure is still in major use – but this would not have been reflected in the original appraisal at the time if current processes had been applied. A project designed simply to relieve short-term pain perhaps ought, conversely, to be subject to a higher discount rate.

   b. The discount rate currently doesn't reflect the real interest rate, being based on pure social time preference. Therefore, the low cost of government borrowing (which many economists believe is set to be a long-term trend) is not automatically reflected in an increase in the number of economically viable projects.

   These are complex issues, and warrant further consideration, drawing in the views of relevant departments and the Office for Budgetary Responsibility (upon whose projections many of these figures are based) and others. A formal Review mechanism is warranted and an immediate and urgent review to start the process.

   This would help address issue 3 in the list above.

[4] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/669043/supplementary-guidance-rebalancing-toolkit.pdf

[5] https://publications.parliament.uk/pa/cm201719/cmselect/cmtrans/582/58206.htm

5. **A commitment to transparency**. In order to practically start identifying the points of failure in the appraisal process, it needs to be opened up to scrutiny. A new Government is the ideal time to do this – as previous decisions made were not on its watch. We propose that full business cases are published as a matter of course ex ante (except where this would cause security issues, e.g. for defence projects, or breach commercial confidentiality). In addition, the data should contained in business cases should be collated by departments and published in a way which makes it easy to compare between projects – with tables of BCRs and other figures put together. Where possible, it will help to provide locational data (region, local authority) to enable scrutiny of value for money as well as the identification of any systemic barriers facing projects or indeed certain parts of the UK.

   This would help address issue 5 in the list above.

6. **A programme of capacity building to support business case development**. Lack of capacity has been identified as a major issue in bringing forward quality projects in lagging regions of the UK. If the UK is, as a whole, to become more seriously engaged in the long-term process of renewing the economic and social fabric of its towns, cities and regions, real effort needs to be made to grow the capacity of everyone involved. We propose the government invests in training local authorities, local enterprise partnerships, and even businesses in struggling regions in how to develop compelling business cases which can command policy support, be deliverable and present sound uses of public funding. The Government should also consider setting up a taskforce to directly support with the development of these business cases.

   This would help address issue 6 in the list above.

Conclusion

In conclusion, we believe that the existing infrastructure appraisal processes acts as a barrier to aligning the Government's stated policy objectives of levelling up growth across the country and the more equitable distribution of investment. We believe that the issue could be addressed by building a clearer strategic framework into the Green Book itself, reviewing discount rates and time horizons for different types of project, increasing levels of transparency surrounding investment appraisal, and developing capacity across the country. All these will support the creation of good quality schemes that can deliver genuine sustainable and inclusive growth for places, their residents and businesses across the UK.

This submission was produced by Metro Dynamics, with the sponsorship of Peel Group and the North West Business Leadership Team.

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