

Urban Economics: Implications for Policy

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Overview

- Failure of urban economics to play any (substantive) role in the formulation of urban policy
- Even most basic ideas poorly communicated to or understood by policy makers.
- So what are the key lessons from urban economics for urban policy?

Two spatial policy “myths”

- Two “clear” justifications for dealing with spatial disparities
 - “It’s just not fair”
 - “Everyone’s a winner”

Equity and efficiency

- At the heart of debates over *economic* justification for spatial policy
 - Equity
 - Efficiency
- “It’s just not fair” → equity role
- “Everyone’s a winner” → efficiency role
- Much urban/regional policy claims both
- [But for reasons that I don’t understand hardly ever talks clearly about either]

e.g.: PSA on regional disparities

- Make sustainable improvements in the economic performance of all English regions by 2008, and over the long term reduce the persistent gap in growth rates between the regions, demonstrating progress by 2006 (*Joint target DCLG, DTI, HMT*) [, including by establishing Elected Regional Assemblies in regions which vote in a referendum to have one.]

Theory I: Neoclassical growth models

- Output per worker a function of supply of factors of production
 - Physical capital (private or public)
 - Human capital (“skills”)
 - Technology

Predictions

- Decreasing returns \rightarrow Convergence
- Long run differences driven by
 - Technology
- Factor mobility reinforces convergence
 - Capital flows to capital scarce regions
 - Labour flow to labour scarce regions
- With factor mobility long run differences driven by technology

Adjustment: Leave to markets but....

- “The persistence of these differentials [...], points to significant market failures in underperforming [...] localities. If the economic processes driving growth were working effectively, we would expect these differences to disappear over time.” [HMT Productivity 3]
- Market failures
 - Capital mobility
 - Indigenous investment
- Would urban economics agree?

Theory II: Economic geography

- Evidence of increasing (not decreasing) returns to geographical concentration
- Location outcomes are a balance between
 - Agglomeration forces (benefits of proximity)
 - Dispersion forces (costs of proximity)
- What are the implications for spatial disparities?

Simple diagrammatic framework

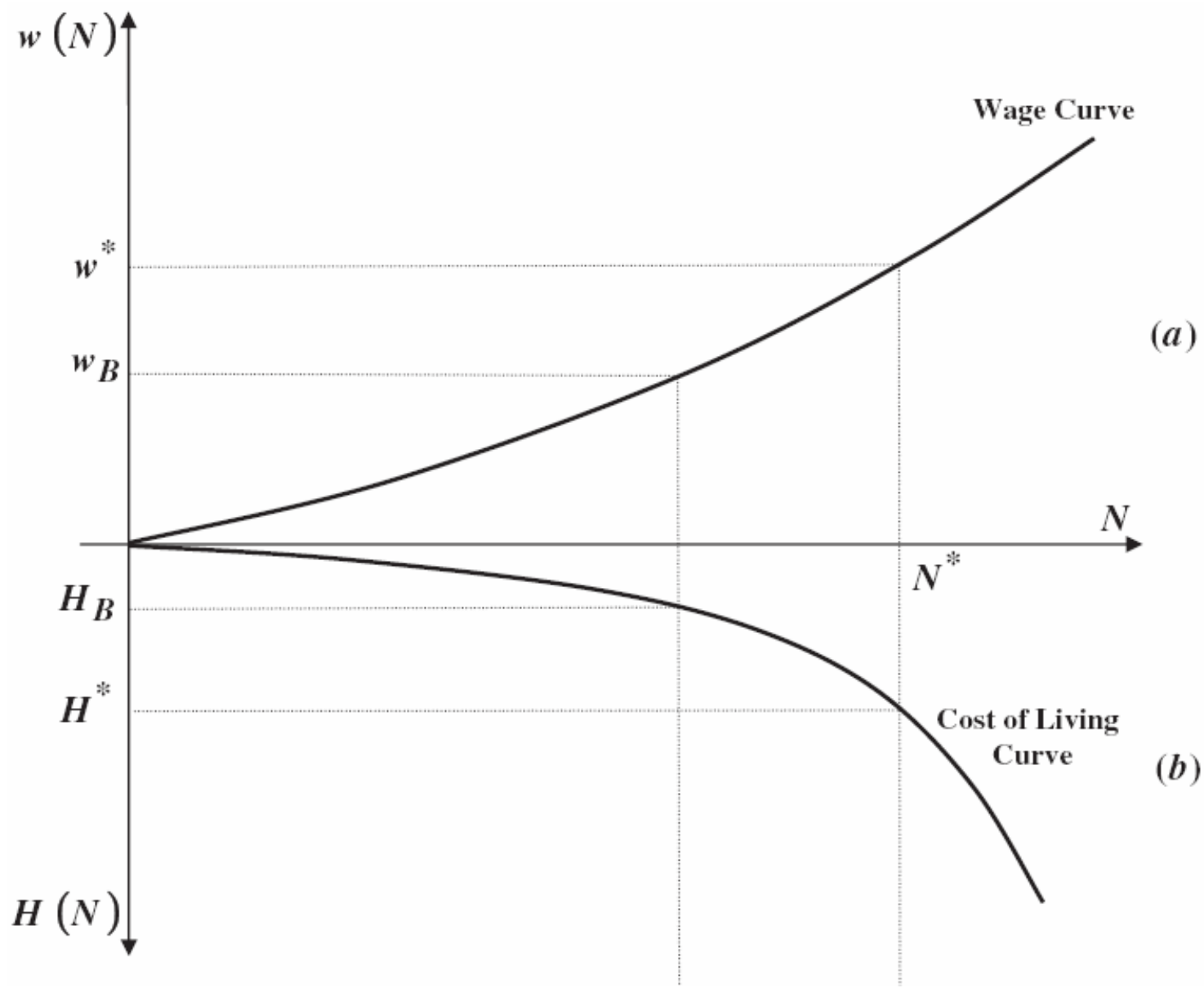
- Can demonstrate forces in simple diagram
- Wage curve
 - How wages change with city size
- Cost curve
 - How costs change with city size

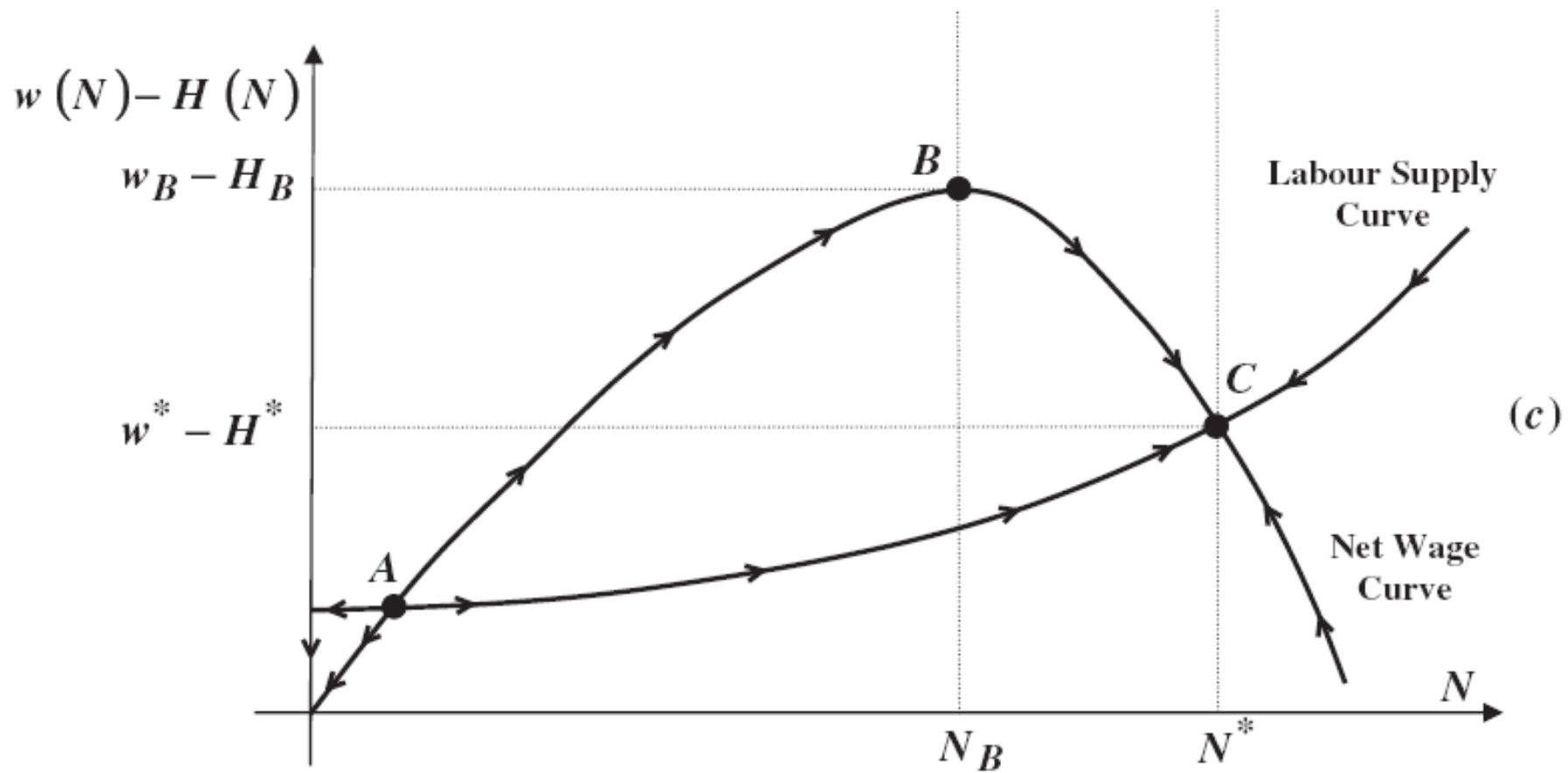
The wage curve

- Wage increases with city size
- Aggregate increasing returns consistent with lots of micro-economic foundations
 - Shape depends on exact model
 - Good for description, but actually bad for policy prescription
 - Which forces matter most?
 - What are the market failures?

Cost of living curve

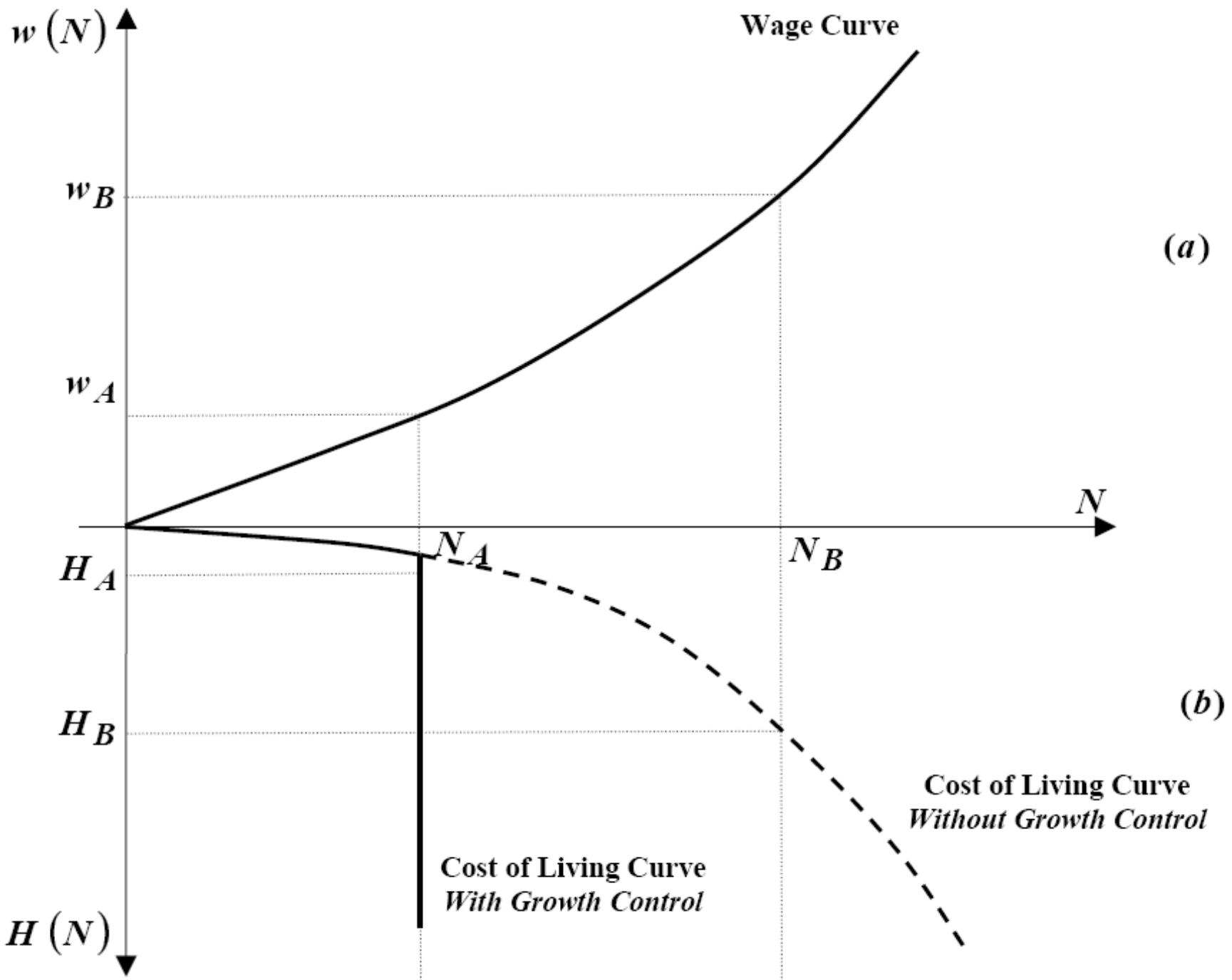
- Components
 - Commuting (increasing with N)
 - Housing (increasing with N)
 - Other (tradable) goods (ignore for the moment)
- “Second order” effects
 - Wage to cost of commuting
 - Wage to demand for housing

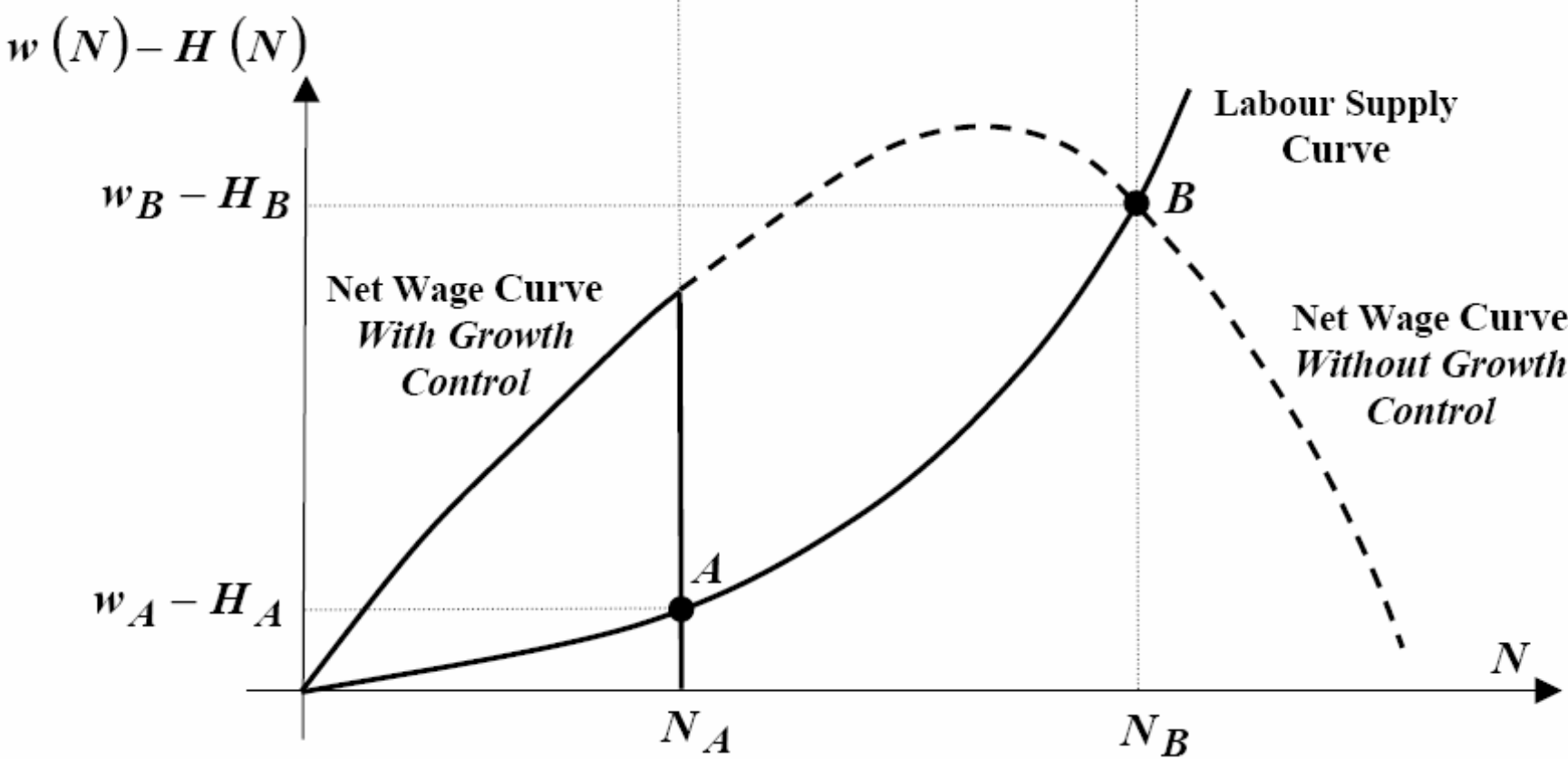




Implications for policy

- Coordination problem means that markets deliver “too much agglomeration” (compare C to B)
- Even worse – there are un-priced congestion externalities that the market ignores
- This is the urban economics argument for “balanced development”
- Policy response = planning constraints
- But urban economics did not play much of a role in reaching this conclusion because ...





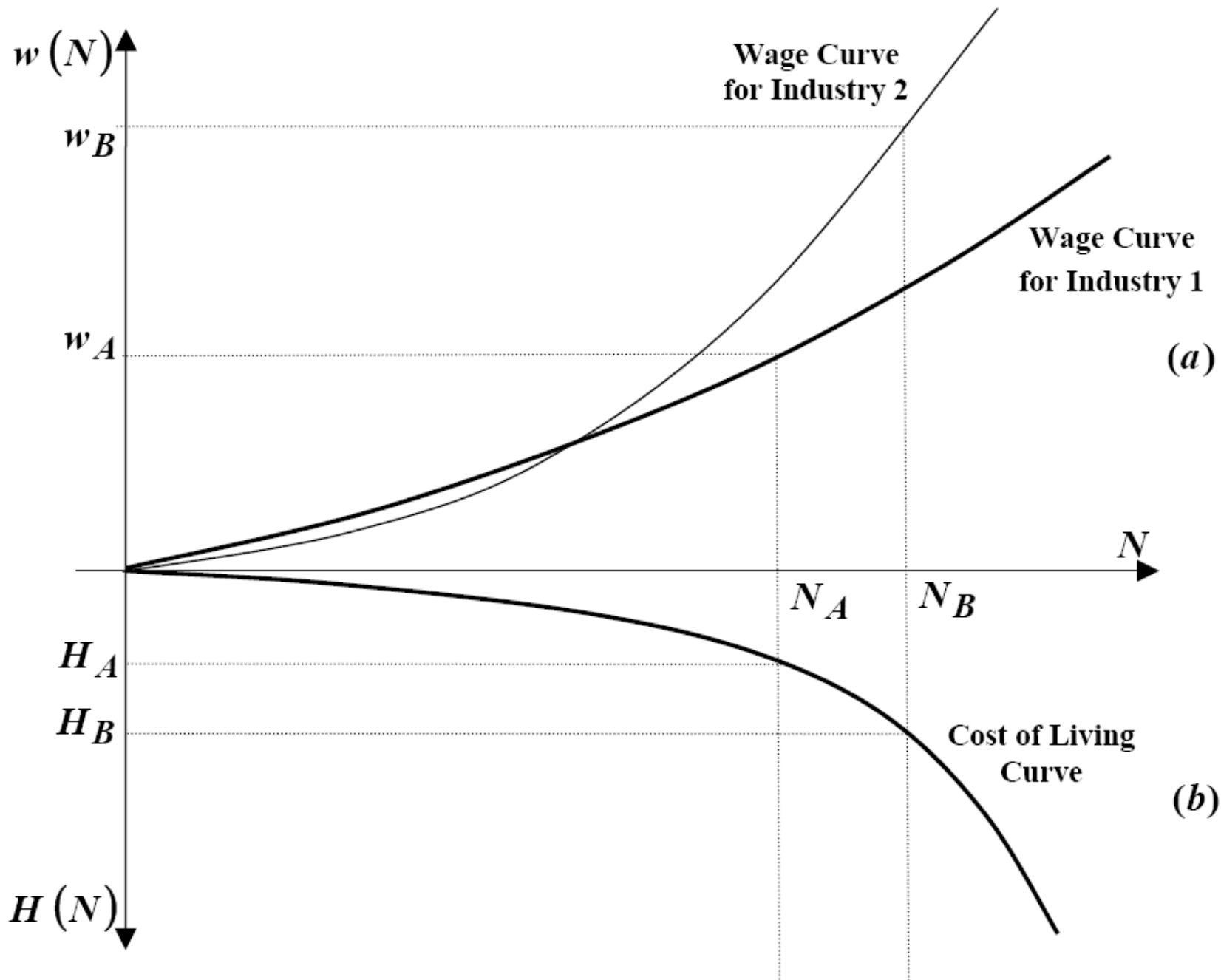
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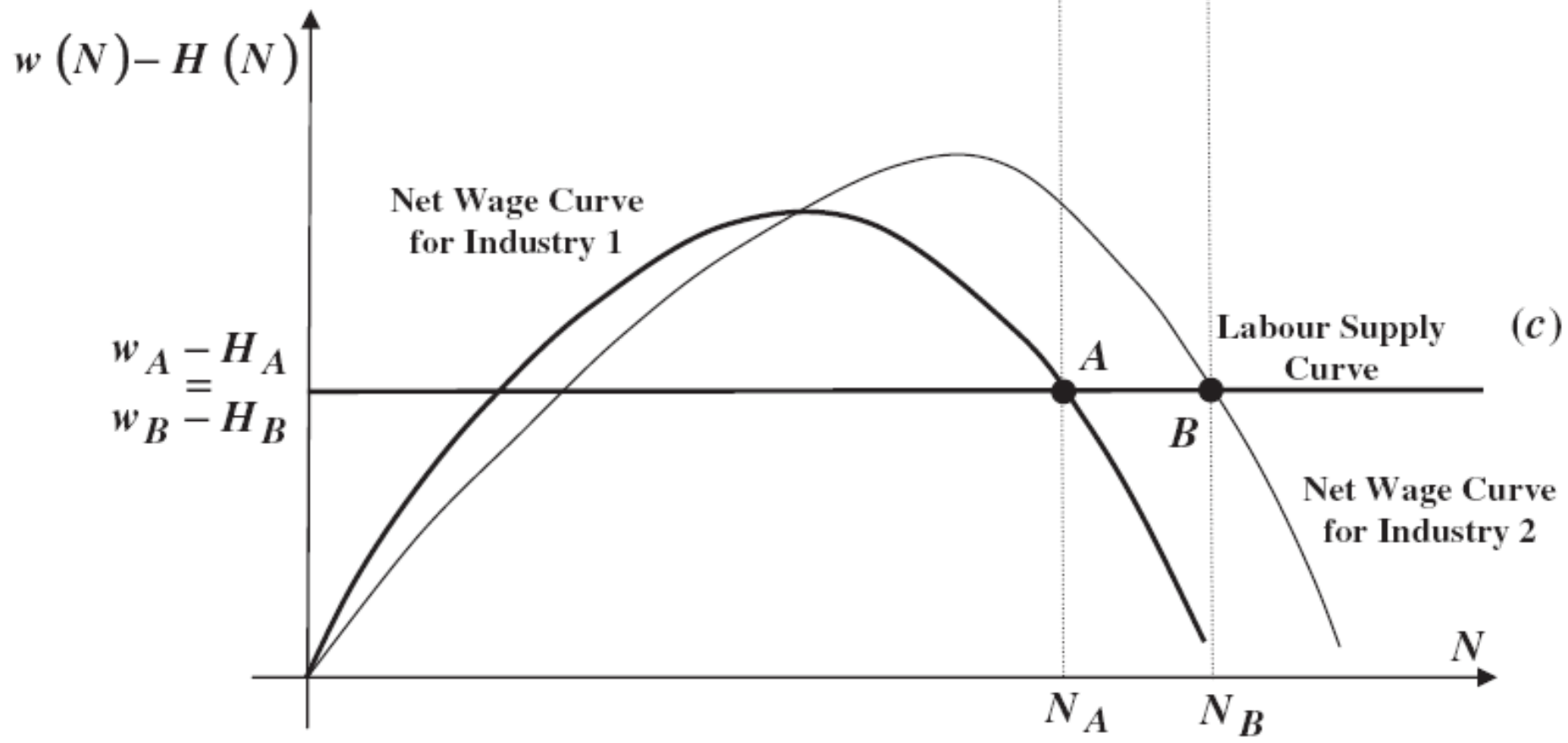
Planning: Land use

- Getting land use constraints wrong can be very costly
- Developers responding to price signals can help deal with oversized places (providing we allow new “large places” to emerge)

Activities are different

- Different types of activities
 - Financial services and manufacturing
- Empirically, agglomeration externality stronger for financial services than manufacturing
- This has implications for spatial differences (places *should* be different)





An aside: Real vs. nominal wages

- People care about *real* not *nominal* wages
- Extreme assumption that people perfectly mobile \rightarrow *real wages equalised*
- Strength of agglomeration externality determines city size
- Places are *different sizes* with *different nominal wages*

Planning constraints as a solution for the optimal city size problem

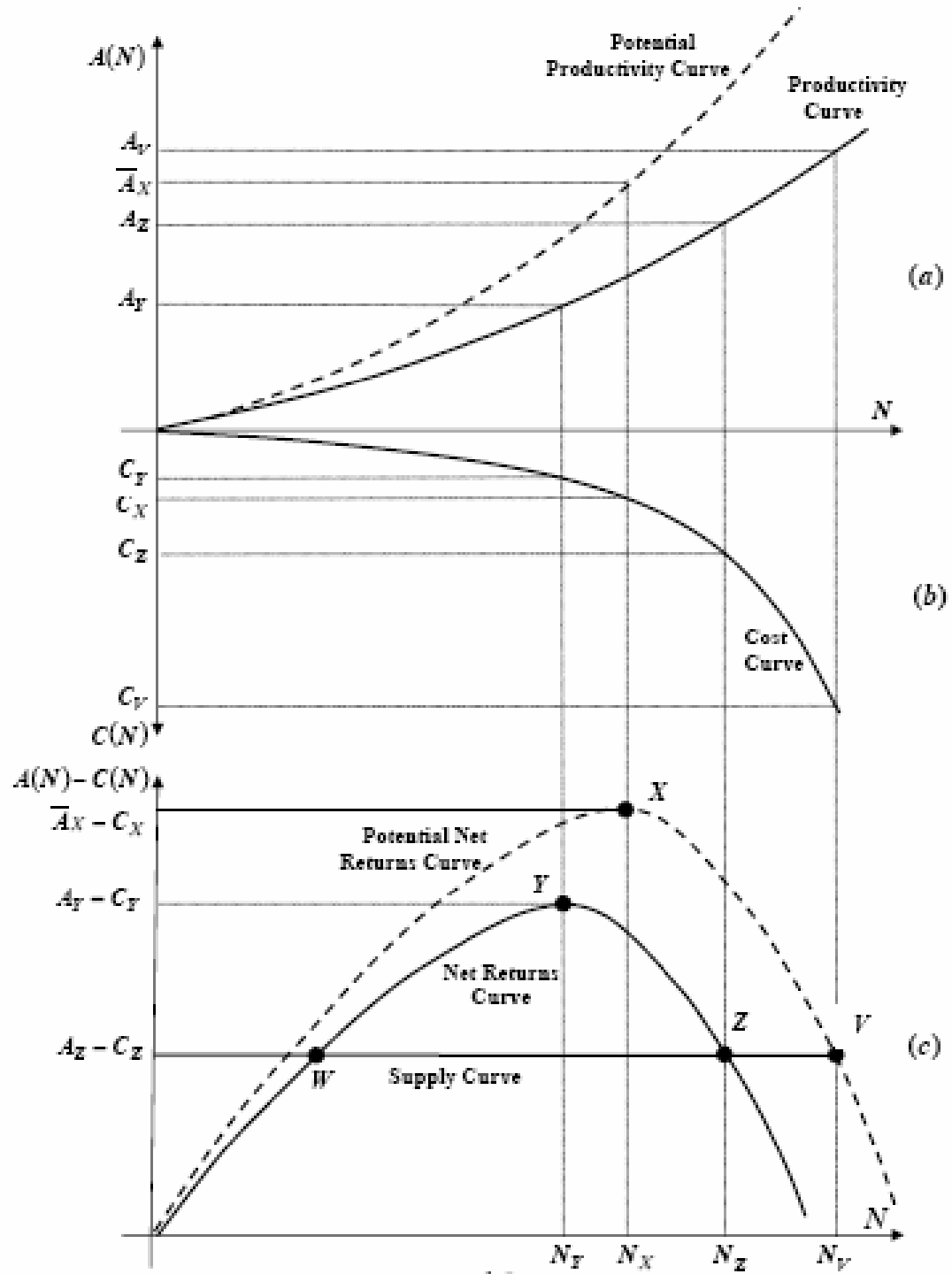
- We have no idea where the optimal city size might be
- The optimal city size may differ considerably depending on what kind of activities occur
- There is some (limited) evidence that the costs of being too small may far outweigh the costs of being too big (Henderson 2005)
- There are un-priced positive externalities

Cluster policies

- Porter 2003 “A cluster is a geographically proximate group of interconnected companies and associated institutions in a particular field linked by commonalities and complementarities”
- Criticised for lack of clear definition (Martin & Sunley 2003)
- Empirically problematic
- ... but theoretically pretty close to the urban economics literature

The case for clusters policy

- Porter's diamond does not actually make an economic case for clusters policy because it only focuses on one inefficiency
- Two inefficiencies
 - There are un-priced positive externalities
 - ➔ clusters should be larger
 - There are coordination failures
 - ➔ clusters should be smaller

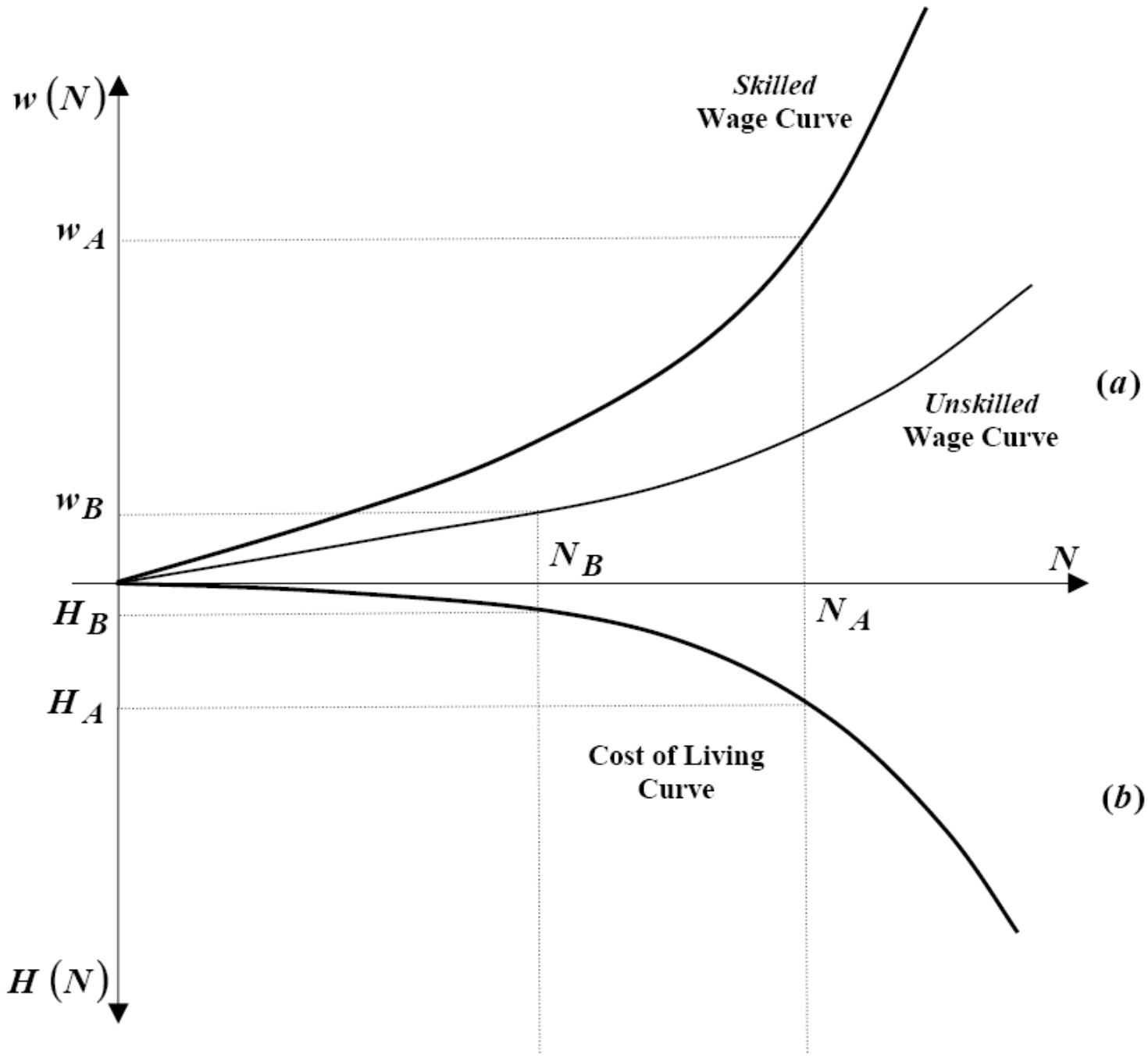


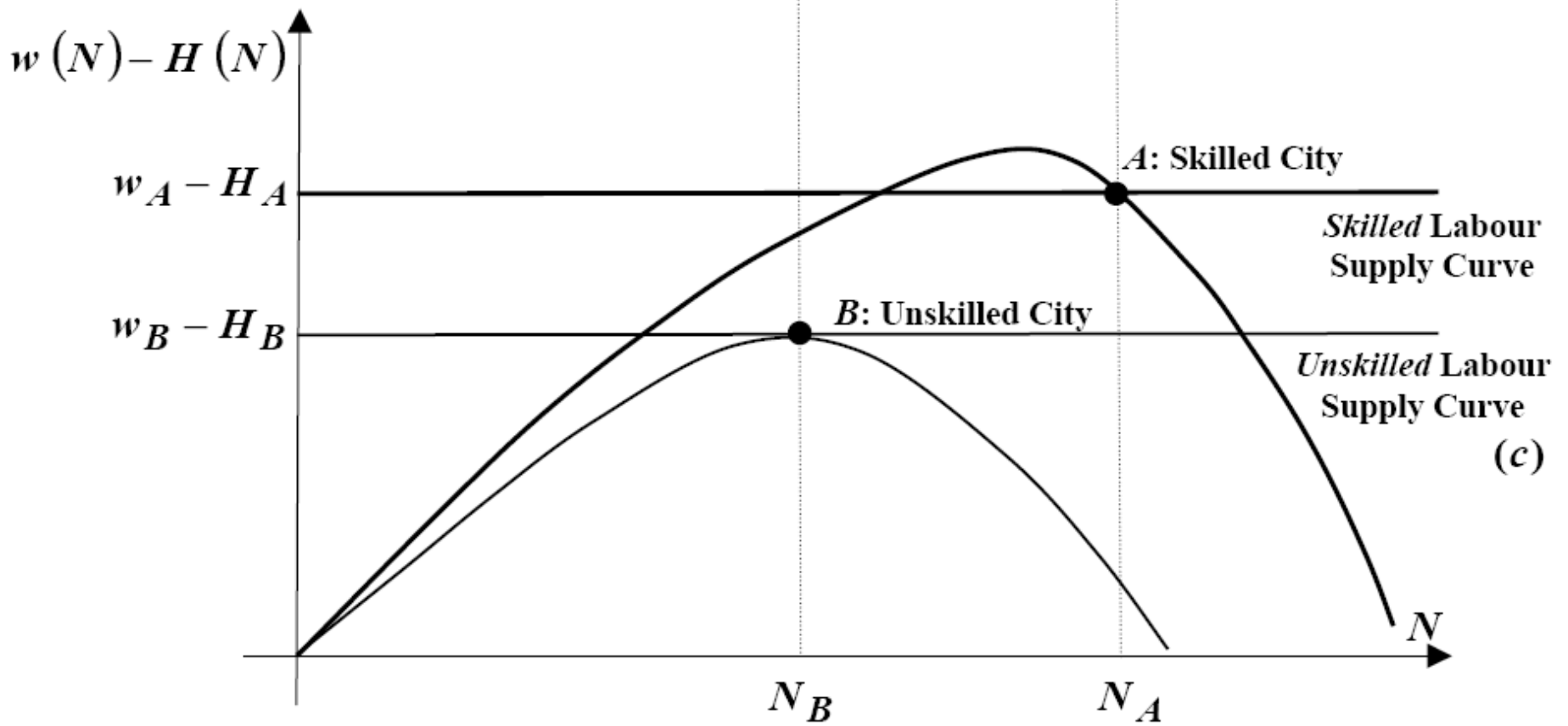
The contradictory roles for policy

- On the basis of very little evidence the status quo appears to be that
 - For cities: un-priced negative congestion externalities plus coordination failure outweigh un-priced positive externalities
 - For clusters: un-priced positive externalities outweigh un-priced negative congestion externalities plus coordination failure
- [Ignoring a third inefficiency from immobility]

People are different

- Earlier in the presentation – failure to recognise that there were different types of activities led to problems
- Policy much more likely to recognise that people are different
- Take a stylised e.g. different types of workers
 - Skilled and unskilled workers
- Empirically, agglomeration externality stronger for skilled than unskilled
- Work through the implications for spatial differences and policy





Implication for spatial disparities: Composition effects

- Workers *sort* in response to costs and benefits
- Differences in outcome for skilled and unskilled workers reflects equilibrium sorting *not* market failures
- Implication for spatial disparities
 - Big efficiency *and* equity cost to making all places look similar

Shifting scales: Mixed communities

- Equity arguments for mixed communities
 - Externality from high skilled to low skilled ...
 - ... that outweighs the additional cost for low skilled of living in higher skill neighbourhood
 - [Response to “right to buy” suggests these conditions may not often be satisfied in practice?]
- Efficiency arguments for mixed communities
 - Benefit to low skilled more than offsets cost to high skilled (i.e. there is a non-linearity)
- Recent MTO evidence pretty dismal on this (nothing for mums, bad for boys, good for girls)

Some conclusions

- Urban policy is tricky
 - Coordination failures
 - Externalities
 - Activities are different
- But even the simplest policy messages (real wages, role of price signals, places will be different) from urban economics are not consistently translated in to practice.

FAQ's follow

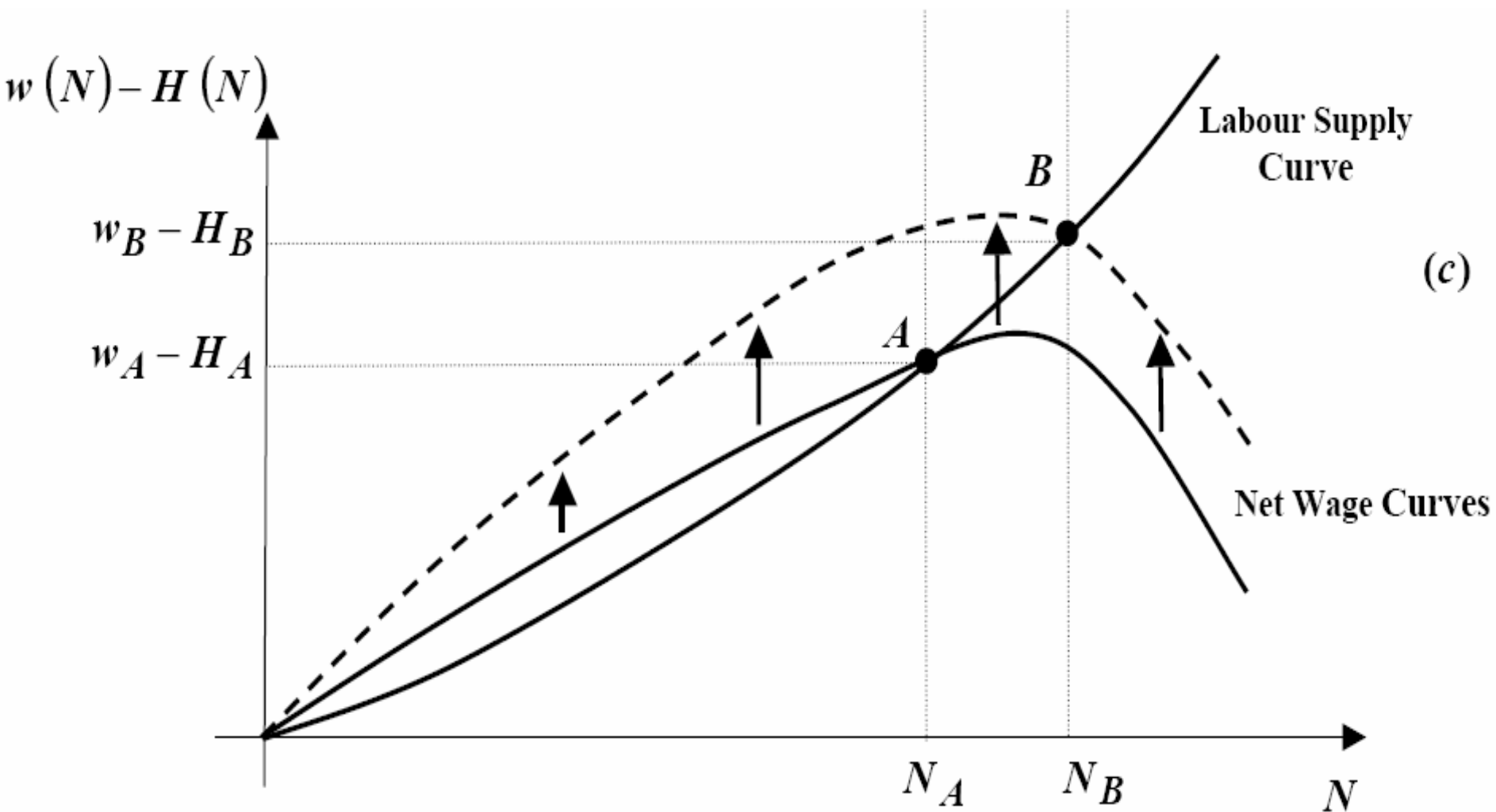
Market failures

- There are inefficiencies here
 - Places are too big relative to the optimum
 - “Coordinating” role?
 - There are externalities
 - Fix externalities

Externalities

- There are externalities so *optimal* wage curve may be higher or lower
- Constrained (no fix externality) versus unconstrained (fix ext) optimal city size
 - E.g. knowledge spillovers; encourage firm entry; unconstrained larger
- Externalities on cost curve too
 - E.g. Pricing congestion shifts curve up

Fixing externalities



Linkages between places: NEG

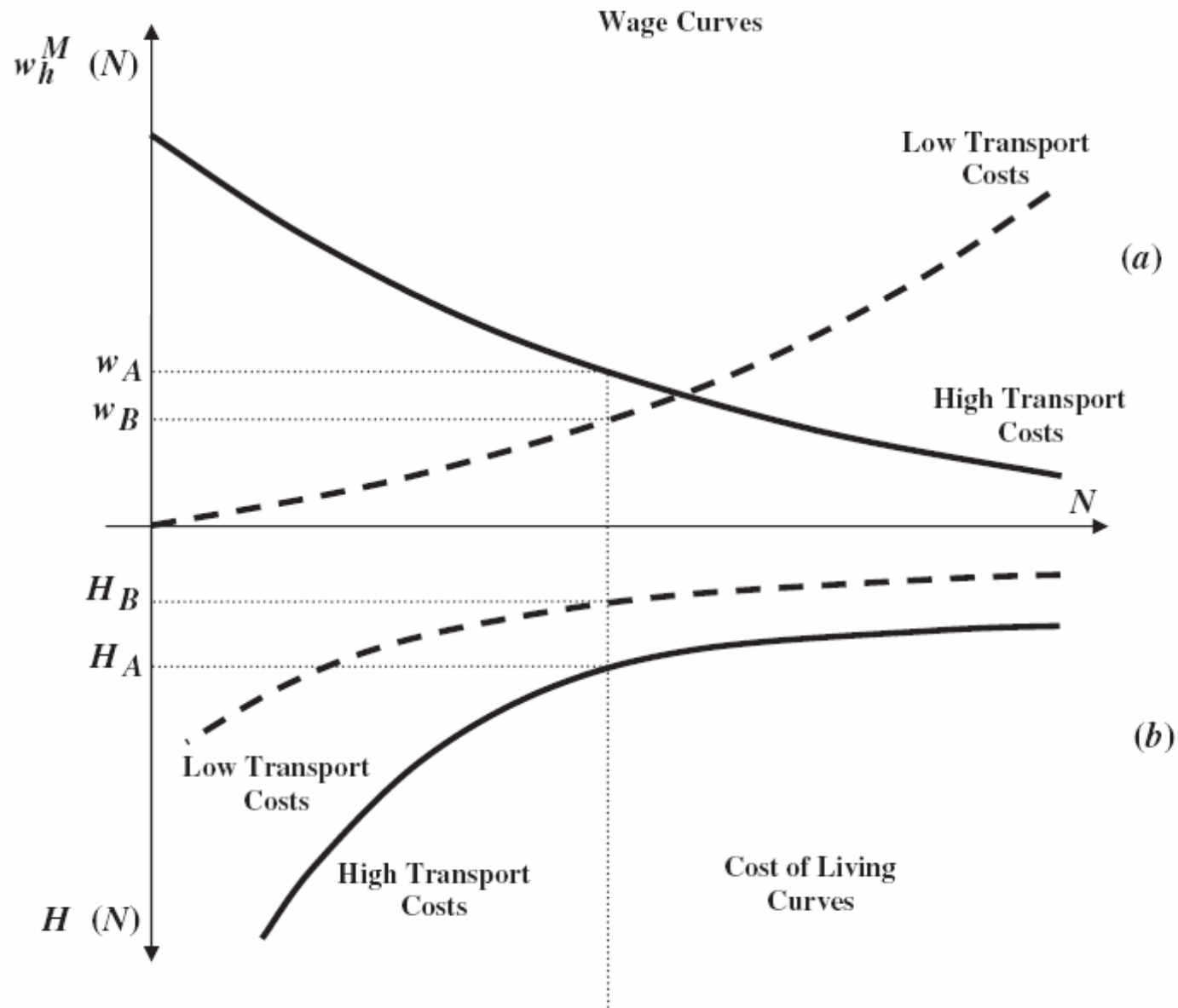
- NEG:
 - Increasing returns to scale
 - Transport costs between regions
 - Some workers/consumers dispersed and tied to particular places

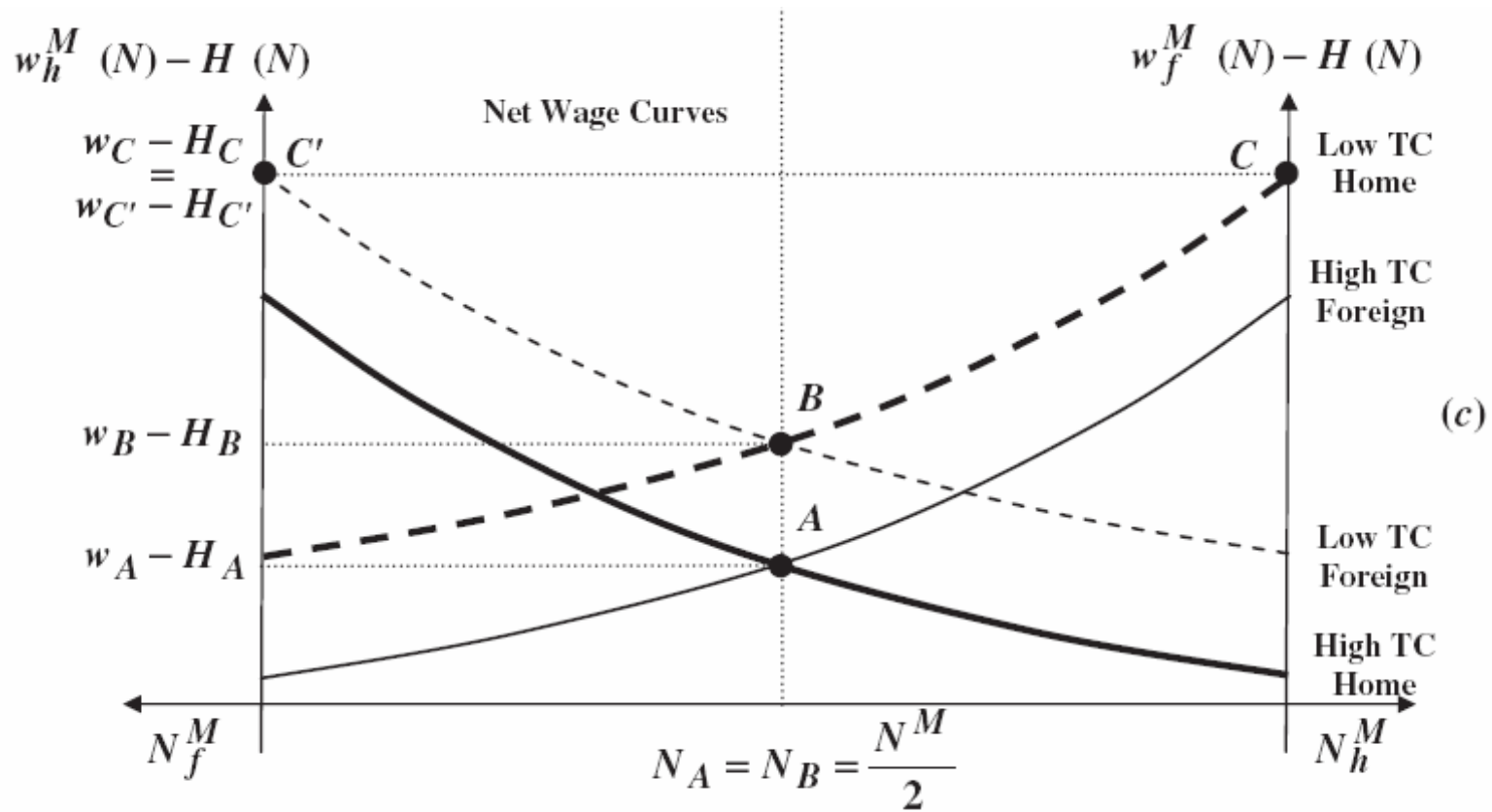
Intuition

- With IRS, prefer to build one plant
- Benefits of locating in large market
 - Cost linkages
 - Demand linkages
- Costs of locating in large market
 - Product market competition
 - Factor market competition

The role of transaction costs

- Changing transport costs changes balance of agglomeration and dispersion forces
- Key - product market competition from the *other* market increases as transport costs fall
 - High transport costs, firms in small markets protected from competition; in large markets more competition
 - As transport costs fall, firms everywhere face more competition → dispersion force less strong
- Agglomeration as transport costs fall



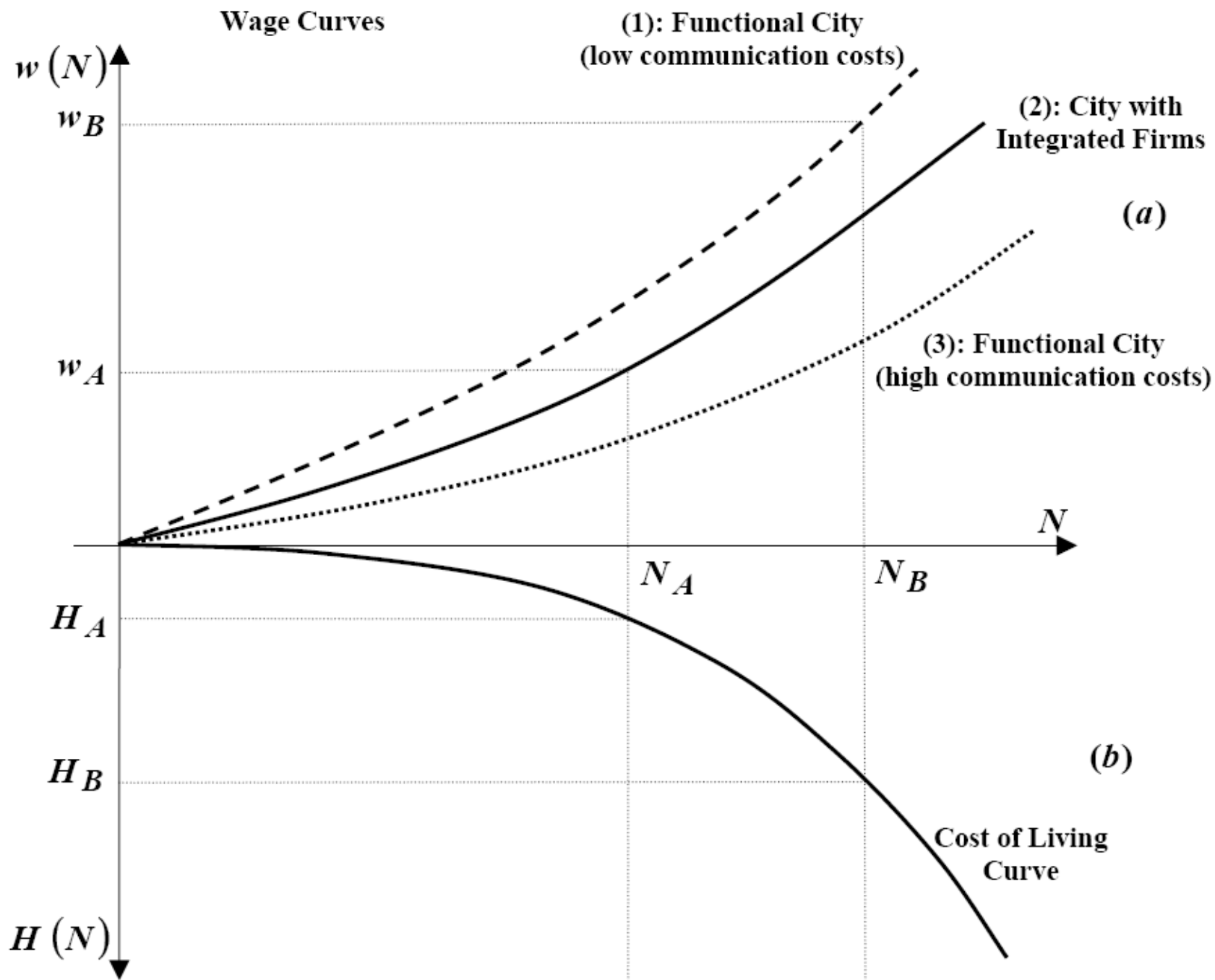


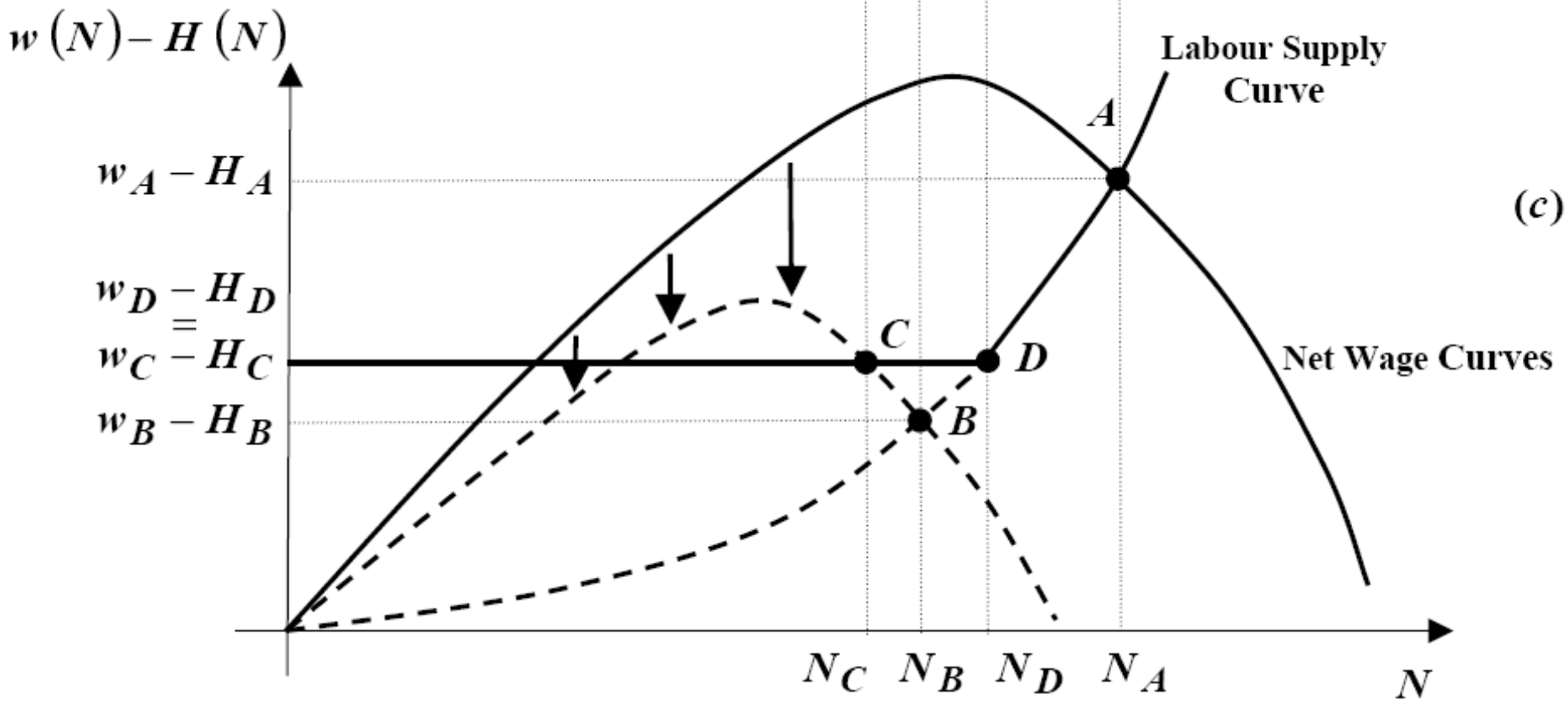
People versus places

- Difference between people and places
- The mobile gain from spatial concentration
- No market failure here – so you are making a straight redistributive choice
- Once allow for traded goods, may not even be an equity basis for spatial policy
- It is even possible that policy should encourage more uneven development not less!

Conclusions

- More thought / evidence needed
 - Nature of increasing returns
 - Composition effects
 - Mobility
 - Land use constraints
 - Externalities





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