Housing Affordability

Summary version of draft report – December 2011

The New Zealand Productivity Commission

The Commission – an independent Crown Entity – completes in-depth inquiry reports on topics selected by the Government, carries out productivity-related research, and promotes understanding of productivity issues. The Commission's work is guided by the *New Zealand Productivity Commission Act 2010.*

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What this 'Summary version' is

This 'summary version' provides the key points, findings and recommendations from the Commission's housing affordability inquiry draft report. It is designed to give you a quick route into the key insights from our examination of housing affordability in New Zealand.

The draft report itself follows the release of an earlier issues paper (June 2011); consideration of about 60 submissions on that paper; a large number of meetings with interested parties; and the Commission undertaking its own research and analysis of issues central to housing affordability. Submissions on the draft report are invited by 10 February.

We are keen to hear from you over the remainder of the inquiry period – as part of ensuring we deliver a high-quality final report by 16 March. To see the full version of the draft report – including information on how to make a submission – please visit our website www.productivity.govt.nz or call us on 04 903 5150.

Format of the summary version

Key points

- The key points box at the start of each chapter is a summary of the main considerations and findings on each topic.

F **Findings** are shown in numbered order at the end of each chapter.

R **Recommendations** are shown in numbered order at the end of each chapter.

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Overview

Why is this inquiry important?

The Government has asked the Commission to evaluate the factors influencing the affordability of housing in New Zealand (both rental and owner-occupied) and to examine potential opportunities to increase affordability.

The context of this inquiry is a recognition that stability of the home environment is important for social cohesion and family stability. There is a concern that real (inflation-adjusted) house prices in New Zealand are markedly higher than they were a decade ago and that this has been associated with general declines in housing affordability and home ownership rates. These declines have contributed to increased demand for rental accommodation and additional pressure on the social housing sector.

The aim of this report is to suggest policy improvements that could enhance the performance of the housing market and the effectiveness with which it meets the needs of New Zealanders. This would be important at any time, but is particularly so in the aftermath of a house price boom between 2001 and 2007 that was unprecedented in recent history and one of the longest and steepest since data began (House prices, real and nominal). Real house prices almost doubled over this period, which equates to an average increase of 12% per year. The boom has started to unwind but house prices remain above long term levels.

House prices, real and nominal

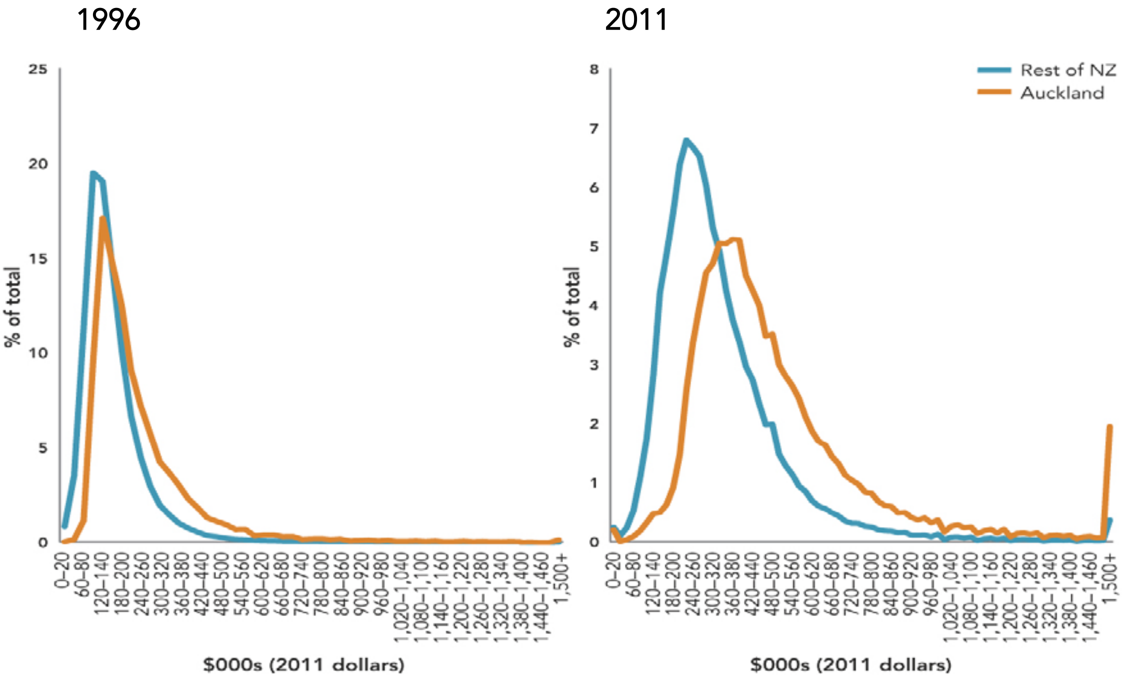
Source: Quotable Value and Statistics New Zealand

Notes:

1. Real house prices are measured as the ratio of actual house prices to the CPI.

The house price boom was more widely dispersed across the country than previous house price expansions. However, there were important exceptions to this trend – in the Queenstown Lakes District and metropolitan areas in Auckland and Wellington, houses were among the most expensive in the country in the early 2000s, but these regions still experienced strong real house price appreciations over the boom. In Auckland – home to around one third of New Zealand's population and 31% and 41% of its housing stock by number and value respectively – this continued a well-established trend of strong real house price increases relative to the rest of the country. As a consequence, the distribution of house prices in Auckland is now markedly different to that in the rest of New Zealand, particularly at the lower end of the Auckland housing market. For example, between 1995 and 2011, the gap between lower quartile house prices in Auckland vis-à-vis the rest of the country increased by over 260% in real terms. The analogous figures for median and upper quartile house prices are 230% and 150% respectively (Distribution of house prices in Auckland and the rest of New Zealand).

Distribution of house prices in Auckland and the rest of New Zealand



Source: Productivity Commission calculation based on QV data

Notes:

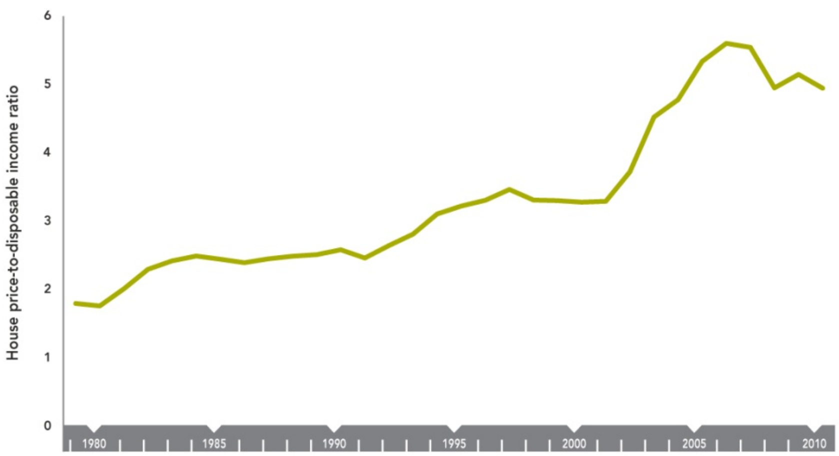
1. House price distributions are shown in constant (2011) dollars (deflated by the CPI).

What has happened to housing affordability?

House buyers

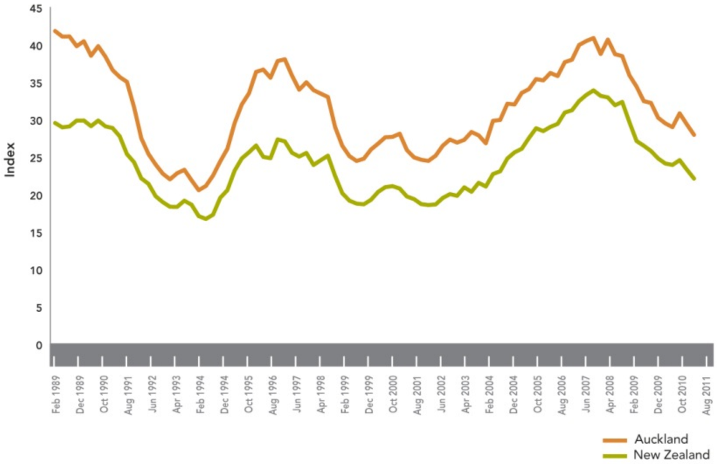
Ten years after the surge in house prices began, national measures of house price-to-disposable income ratios remain elevated and would require sharp falls in house prices to return to long-term averages (House price ratio). Affordability measures that include financing costs are currently closer to longer term averages, owing to interest rates that are low compared with earlier times (Massey home affordability index). This latter assessment, which properly includes financing costs, is often over-looked.

House price ratio



Source: Productivity Commission calculations using Reserve Bank of New Zealand data.

Massey home affordability index



Source: Massey University Real Estate Analysis Unit.

Notes:

1. A low index indicates improved affordability.

These aggregate measures do not necessarily indicate what is happening to affordability for different types of households. Disaggregated measures indicate that:

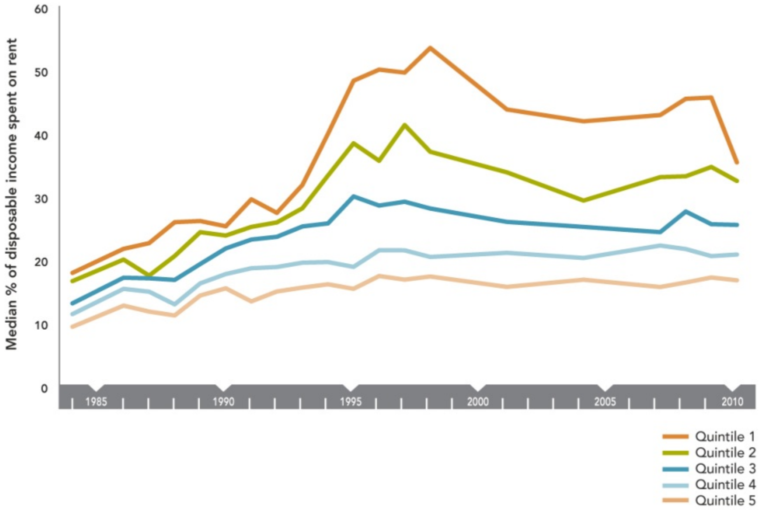
- Affordability pressures are particularly evident in Auckland, reflecting that city's higher house prices.
- Housing affordability is lowest among those who are younger, single, have lower income and wealth or belong to an ethnic group other than New Zealand European.
- During the last house price boom, housing affordability became a constraint for some middle-income groups, whereas it had previously mainly been an issue for those on lower incomes. It is not yet clear if this is a cyclical phenomenon or a structural trend.

Renters

During the house price boom, rents in aggregate increased at around the same rate as generalised inflation. Even across the territorial authorities, rents grew in a relatively tight range of 2.3% per year (in Dunedin City) to 8.2% per year (in Buller District). In all cases, rent increases were significantly less than real house price inflation and the ratio of house prices to rents increased markedly, a departure from the long term broadly stable relationship.

This apparently benign aggregate situation disguises a more difficult position for renters on lower incomes. In particular, people in the lowest two income quintiles spend a much higher proportion of their income on rent than people on higher incomes (Median rent-to-household disposable income by disposable income quintile). Even though the situation appears to have improved since the late 1990s, those in the two lower income quintiles still spend, on average, more than 30% of their disposable income on rent, after allowing for government assistance.

Median rent-to-household disposable income by disposable income quintile



Source: Productivity Commission and Treasury calculations using Statistics New Zealand Household Economic Survey (HES) data.

Notes:

1. HES was not conducted in 1999, 2000, 2002, 2003, 2005 and 2006. Data for these years was interpolated.
2. Income quintiles are based on the entire HES sample.
3. There is some uncertainty about the reliability of the figures for 2010 for quintile 1.

When house prices increase, people who have to spend a large proportion of their income on rents will find it hard to save for a deposit for a house. Between 2001 and 2006, as rising house prices pushed the affordability constraint further up the income distribution, the number of 'intermediate renters' - people who cannot afford to buy a dwelling at the lower quartile price, assuming standard bank lending criteria - increased by over 150% to 187,400 households or 58% of all private renters. Driven in part by declining interest rates, the share of intermediate renters is estimated to have declined since 2006. One in three renters - and a large proportion of the intermediate renters - lives in Auckland.

What are the key features of the housing landscape?

Many features of the housing landscape influence housing affordability, which implies that opportunities for improving housing outcomes are likely to be found through small contributions in many places, rather than in any single large 'solution'. As a backdrop to the Commission's suggestions for improving housing affordability, the report outlines key features of the landscape that influence the demand for housing, the supply of housing and the institutional framework within which it operates.

Housing is a house/land package

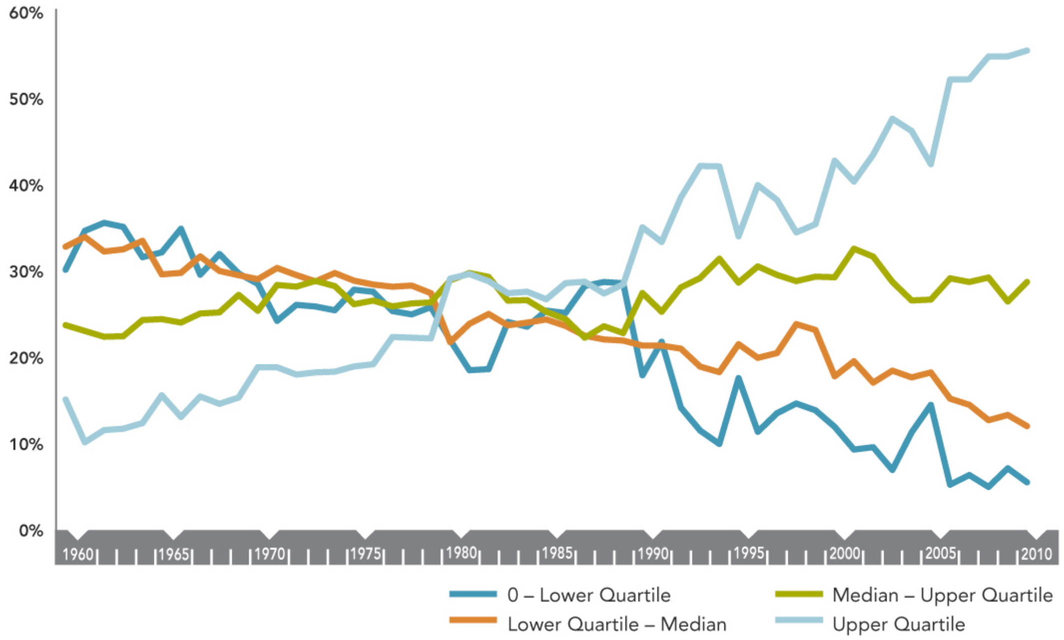
Housing is of course a house/land package, as land has to be developed and serviced with infrastructure before it is usable for housing. This inquiry therefore examines the determinants of the cost of land, of the infrastructure needed to service that land, of building materials, and of the costs of assembling those materials to build the house.

Section prices have grown more quickly than house prices over the last 20 years, indicating that appreciating land prices have been a key driver of house price inflation in New Zealand. This suggests a shortage of residential land in places where people want to live. Land price pressures have been particularly acute in Auckland, where section prices now account for around 60% of the cost of a new dwelling, compared with 40% in the rest of New Zealand.

Although much of New Zealand's land area is unsuitable for residential development, the country's low population density is such that the potential supply of raw land is relatively abundant. While pressure on land prices in the biggest and fastest growing centres is expected, the movements in recent years seem excessive. This implies that policy and planning practices may be constraining the supply of residential land. For example, strong land price pressures in Auckland raise questions about the impact of policies aimed at increasing density – such as the metropolitan urban limit and other planning restrictions – on housing affordability. A major challenge ahead is to improve land release and planning approval processes so that affordability considerations are integrated fully into spatial planning.

A distinctive feature of residential investment in New Zealand, which may be linked to rising land prices, is that new supply has tended to come in the form of large and relatively expensive houses or, to a lesser extent, apartments that are targeted at the top end of the market (New housing investment, value distribution). As such, the majority of new dwellings are currently not targeted at the affordable end of the market, adding to the difficulties faced by intermediate renters seeking to buy a home.

New housing investment, value distribution



Source: Productivity Commission calculation using QV data

Notes:

1. For each year, the data show the share of new houses that are valued within each quartile of the value distribution for the existing housing stock.

Underlying demand has been strong and is projected to continue increasing

Responsive land release and planning processes are likely to be particularly important given projections that underlying demand for housing will be strong, driven by household formation, which in turn depends on population growth and factors that determine household size. New Zealand's natural population growth has been strong, while migration flows have been highly variable and often focused on Auckland. Population growth has been unequally distributed across the country, largely as a result of internal migration patterns and the regional preferences of international migrants.

Demographic changes – such as population ageing, cultural and ethnic diversification and a radical transformation in family structures – have also been a feature of recent years. Changes in New Zealand's ethnic structure have increased average household size while the ageing population structure has tended to reduce it. The net effect has been an overall fall in average household size and an associated increase in household formation.

Looking to the future, net household formation in New Zealand is expected to continue to increase as the population continues to grow and households become yet smaller. While the extent to which this underlying demand for housing becomes effective depends on whether households have the capacity to pay for housing, demographic projections suggest a need for home construction volumes to increase.

The housing market is segmented

Housing growth will not, however, be uniform across the country. There are stark regional differences between housing markets. Statistics New Zealand's projections suggest that Auckland will have the largest increase, accounting for 60 % of New Zealand's population growth and for almost half the number of new households, followed by Wellington and Canterbury. Auckland is also expected to have the highest growth rate in household formation.

One consequence of this segmentation is that adjustments to changing housing needs and preferences will create market and price pressures that are likely to differ across New Zealand. While a complex web of demographic influences are at work in New Zealand, the outcome overall is that household formation is concentrated in and near Auckland and is likely to remain so for the next few decades. For that reason, the challenge of providing adequate housing is largely an Auckland one. A small number of regional centres will also face challenges, albeit to a lesser degree.

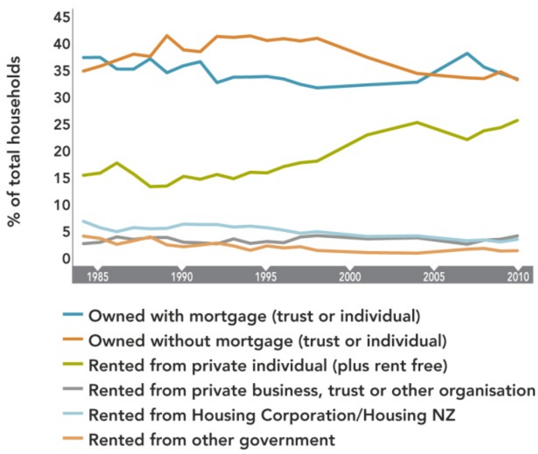
The rental market is important

The stability of rents while house prices were rising over the 2000s boom allowed the rental market to act as a 'safety valve' in the face of rising house prices. As house prices increased rapidly, the rental market expanded to accommodate an increasing number of households that favoured renting over home ownership given increasing (relative) affordability in the rental market.

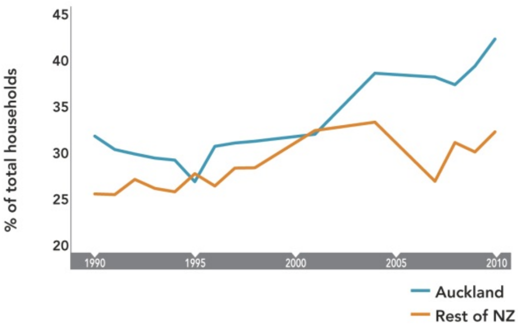
This large swing in tenure choice exacerbated the growth of the rental sector and decline in the extent of home ownership that had been underway for some time (Tenure choice in New Zealand). Home ownership peaked in the late 1980s/early 1990s, when around 75%of private dwellings were owned by their occupants. Since then, ownership levels have dropped to around 65% – which is about average for the group of OECD countries for which data is available. Currently, around 408 000 households are estimated to live in private residential rental accommodation. The decrease in home ownership since the end of the 1990s has been particularly marked in Auckland, where around 40% of households now rent.

Tenure choice in New Zealand

Tenure choice[1]



Regional profile of tenure type



Source: HES, OECD, NZ Census

The owner occupier and rental markets have been performing differently

Most investors in New Zealand's rental market are relatively small scale. Landlords have been prepared to accept low yields on their rental properties, in part because of expected capital gains in housing and lack of confidence in other investment markets. Although estimates vary, the net cash yield on rental properties over the 2000s house price boom is estimated to be well below 4%. In contrast, capital gains have been relatively strong until recently and New Zealand homeowners have, on average over the 2000s, enjoyed superior returns compared to investing in the share market.

However, since the end of the 2000s boom, capital gains on rental properties have diminished significantly. Although difficult to judge, demand pressure may already be working to increase rents in the bigger cities, with recent data indicating that rental households are spending an increasing share of disposable income on rent.

Outside of student accommodation and retirement villages, large-scale landlords have a very limited presence in the New Zealand market. A low cash yield is likely to be one important reason why institutions have been reluctant to enter the rental property market. In effect, they have been crowded out by small scale private investors. The large scale of investment required to assemble a suitably diverse portfolio of rental properties in different locations with different demographic exposures is also often cited as a barrier to institutional investment in the sector. Challenges around capturing any construction scale economies in the sector may also be inhibiting large-scale involvements. Reflecting these barriers, the share of people living in rental properties owned by private businesses, trusts or other organisations has remained low at under 5%, indicative of a very low level of institutional involvement in the sector.

Because of the burgeoning group of small-scale investors in the rental market, Housing New Zealand Corporation (HNZC) and other local and central government agencies have accounted for a declining share of the market. HNZC currently plans to upgrade or divest 27 000 of the 69 000 dwellings it currently owns. HNZC has introduced reviewable tenancies for its new tenants. This is to help HNZC focus more closely on those in greatest need.

Shifting housing and other services from HNZC and other central government agencies to a range of community and related non-government providers has been suggested. While commonly and successfully done in a number of countries, 'third sector' provision of not-for-profit or not-for-dividend community-based housing is underdeveloped in New Zealand. Instead, policy settings have focussed on demand side assistance in the form of the Accommodation Supplement to increase the affordability of private rental accommodation, together with provision of state housing.

There is a challenging transition ahead that will potentially have significant impacts on the behaviour and performance of the housing sector in terms of delivery of fit-for-purpose housing for low income groups.

The residential building industry is fragmented with low productivity growth

In a typical year, the residential building industry builds about 24,000 new homes and renovates about 32,000 homes. The industry is essentially a fragmented 'cottage industry' dominated by very small independent builders constructing bespoke homes. Sole traders (with no employees) are the most common firm size and businesses employing more than 20 employees constitute only 9% of total sector employment. Most builders construct one house at a time: in the year to May 2010, 4,604 firms built just one house during the year. In contrast, only thirty firms built more than thirty homes, while just five firms built more than 100 houses. As noted earlier, most new homes are being built for the upper end of the market.

Productivity growth is below other industries and submissions also pointed to problems such as: projects exceeding both budget and agreed timeframes; non-compliant or defective work; and reliance on lower quality materials which have a shorter life-span and require higher levels of maintenance.

The building materials industry is concentrated but still small scale

Manufacture and distribution of building materials is relatively concentrated in New Zealand, which has prompted claims that the market suffers from a lack of competition. The firms concerned nevertheless appear unable to reach the scale necessary to match international product prices.

The small size of New Zealand's market, the corresponding small scale of New Zealand material manufacturers, and high domestic transport costs mean that materials are relatively expensive in New Zealand. Building costs for a standard home (including materials, labour, sub-contractor and other administrative costs) have increased by 30% in real terms in the nine years to 2011, with large increases recorded over the 2000s house price boom. The cost of residential construction in New Zealand is significantly higher than in Australia, with negative implications for housing affordability. For example, putting the land cost aside, the cost of building a new house in Auckland is around 25% more expensive than building a house of comparable size and specification in Melbourne.

Councils perform key roles in the housing market

Councils have a major influence on all stages of house construction, as they are responsible for urban planning, including the release of land for development and zoning decisions; providing or arranging for the provision of infrastructure to land that is to be developed; for issuing building consents that are required before buildings are demolished, removed, constructed or altered; and for ensuring compliance with the Building Code.

The Commission's analysis indicates that the construction and land development sectors are more responsive to changes in housing demand in some parts of the country compared to others. There is also some evidence that, in areas of the country where housing supply is more responsive, an increase in housing demand results in relatively more houses and smaller increases in real house prices, with beneficial implications for housing affordability. Although difficult to show conclusively, differences in supply responsiveness at the territorial authority level may, in part, reflect the efficiency with which local councils implement and enforce regulations governing the land development and building sectors.

Where has the Commission found opportunities to improve affordability?

The Commission has reviewed these features of the housing landscape in order to identify opportunities to improve the housing sector's capacity to meet consumers' preferences for housing that is safe and comfortable, while also affordable. While housing is largely a private market, the way in which the market operates is heavily influenced by its regulatory and institutional framework. Hence the Commission has focused on ways to improve this framework. While many of the Commission's proposals apply nationally, there is a particular focus on Auckland, given that the challenge of providing adequate housing is largely one for Auckland, although a small number of regional centres will also struggle. The Commission has also concentrated on ways to increase affordability for those on lower incomes, where the biggest social issues are found.

Planning

Urban planning today requires consideration of a wide range of objectives, including environmental management and economic development goals. Planning practices have not sufficiently adapted to be able to adequately manage and balance these multiple objectives.

The prevailing approach to urban planning in New Zealand has a negative influence on housing affordability in our faster growing cities. The widespread planning preference for increasing residential density, and limiting greenfield development to achieve this, places upward pressure on house prices across the board. Constraints on the release of new residential land create scarcity, limit housing choice, and are increasing prices across the market. These impacts may be disproportionately felt by particular sub-markets. Prices are also likely to be reflecting the significant transaction and compliance costs associated with housing development. These costs include hefty impacts associated with delays encountered in releasing land and through the consenting process.

An immediate release of land for residential development will ease supply constraints and reduce the pressure on prices. This should include a combination of significant tracts of both greenfield and brownfield land catering to a variety of sub-markets, with an immediate focus on Auckland. Any such release should be contingent on meeting requisite geophysical and environmental standards, favour land that can be readily connected to existing urban areas and amenities, and provide for a variety of housing markets. The aim would be to identify, assemble, and develop substantial parcels of land for housing and associated uses of such a scale that it leads to a rapid easing of current supply constraints and consequently a reduction in price pressures.

The long delays associated with bringing both brownfield and greenfield land to the market suggest that a fifteen or even twenty-year pipeline written into plans is likely to be inadequate in practice, particularly if subject to short-term constraints through plan-based staging of land release. Sufficient competition in the supply of construction-ready sections is required to exert downward pressure on prices. Expensive sections encourage a concentration on construction of high cost houses.

The effect of adopting these policies will be to substantially reduce the opportunity for land banking by individual land owners and developers. While it may take some time to implement, commitment to a less constrained planning environment could have an early positive impact on housing in Auckland.

More generally, the Commission recommends that territorial authorities:

- take a more active approach to the identification, consenting, release, and development of land for housing in the inner city, suburbs, and city edge, both with respect to volumes of consented land and the time taken to achieve consents;
- adopt a strategy that allows for both intensification within existing urban boundaries and orderly expansion beyond them; and
- develop strategies that promote adequate competition with respect to the sale of construction-ready sections.

In New Zealand, the task of planning is challenged by the complex array of planning-related legislation and the diverse nature of institutional responsibilities for land use and infrastructure planning. In the longer term, a more fundamental review of the related legislative frameworks may also be required, with a view to considering the long-term rationalisation of the local planning and policy environment.

Infrastructure charges

There are two forms of infrastructure charge against new developments in New Zealand: financial and development contributions. The former focuses on the environmental effects of particular developments, the latter are intended to compensate councils for capital expenditure associated with development on such facilities as reserves, networks and community infrastructure.

These charges are applied widely across New Zealand and collected $267m in 2008 (June year), amounting to 4.5% of total local government income (equivalent to 7.5% of rates income). Water supply and waste water services are funded through development contributions by more councils than other types of infrastructure, and tend to attract the highest charges.

The level of charges varies considerably between councils and between types of infrastructure, but can be significant. While some councils do not apply these charges, in other cases they can exceed $40,000 per developed section. Overall, the increase in development charges is not enough to explain the surge in house prices in the early 2000s (for example, one survey of 10 regions suggested that development contributions made up between about 1% and 10% of median section prices, whereas prices doubled during the boom, as noted earlier), but they affect affordability and oblige households to take on larger mortgages.

Charging for infrastructure, if implemented well, encourages efficient choices in the development of housing in ways and places of greatest value. It requires considerable skill and information, however, to design and implement charges that accurately reflect costs. The Commission has been made aware of concerns about the way in which these charges are applied in New Zealand and is suggesting some ideas for addressing them.

The Commission considers that the Government should encourage development of a set of best practice development contribution guidelines that would help councils to improve the clarity of their decision making with respect to these charges. These guidelines would cover when development contributions should be used, how they should be calculated, and how costs should be recovered. If necessary, the principles in such guidelines might be incorporated into Schedule 13 of the Local Government Act.

A range of measures would both help councils to implement the Guide and strengthen their incentives to do so. These include training about how to implement the Guidelines; monitoring councils' performance in implementing the Guidelines, combined with public reporting of the outcomes; and external auditing of councils' compliance with the Guidelines.

The Government could also consider further strengthening the incentives for good practice by making decisions about development contributions contestable through changes to the Local Government Act. These changes would enable a merit-based test that would cover matters such as whether the charges are based on the actual costs incurred as a result of development, and whether the revenue generated is directed at the capital expenditure incurred.

These proposals should reduce the burden of upfront charging for infrastructure on the cost of new residential development, and improve the quality of decision-making around infrastructure funding. They are, however, a small part of the governance framework within which councils operate, and would not fully address issues that have been raised around how councils arrive at the overall level, composition and timing of infrastructure that they seek to fund through infrastructure charges. Effective governance of infrastructure assets is critical. Analysis of these broader issues would include matters such as:

- the appropriate role for councils in planning and providing infrastructure such as the three waters (which in some jurisdictions are not provided by councils);
- the appropriate corporate form for the entities that provide infrastructure when this remains within councils; and
- reporting and accountability arrangements.

Building regulation

Regulations relating to building construction can affect the cost of building or renovating a house in six main ways.

1. Imposing standards that buildings must meet with respect, for example, to durability and safety, which exceed levels that consumers would otherwise choose.
2. The additional costs in administering the regulatory framework, some of which are passed on to homebuyers. Inconsistent or slow enforcement of regulatory requirements can delay project completion or otherwise increase project costs.
3. Inconsistent or slow enforcement of regulatory requirements can delay project completion or otherwise increase project costs.
4. Regulation can affect the incentives to innovate with new materials or processes.
5. Regulation can influence how risks are shared between different parties – home owners, architects and engineers, builders and subcontractors, material suppliers and building consent authorities.
6. The structure of the building consenting and inspection service can influence costs. Small building consent authorities (BCAs) may suffer from diseconomies of scale or be unable to take advantage of efficiency-enhancing technology, adding to the costs of administering building regulations.

There are incentives for BCAs to be risk averse, and this can add to building costs. The Government intends to change the industry's regulatory arrangements, in part to alter the allocation of risks in the building sector. The Commission endorses the direction of these changes. Given the inherent difficulties in predicting the effects of these reforms, the Department of Building and Housing should report on its evaluation of the reforms five years after introduction.

The Commission has suggestions for additional reforms.

- To reduce delay costs with issuing building consents, Building Consent Authorities (BCAs) should report on the number of occasions that they use the 'stop the clock' provision during the assessment of consents, their reasons for doing so and the total time taken between receiving applications and granting consents. External auditing would strengthen incentives for good performance.

- To reduce the costs faced by builders seeking approval for an innovation as an 'alternative solution', the Department of Building and Housing should provide more specific guidance for BCAs about what is required for an alternative solution to comply with the Building Code.
- Achieving approval for an alternative solution is further complicated by the site specific requirements of the Building Code. This has contributed to the low uptake of the "Multi-proof Building Consent" — a scheme introduced in 2010 to produce time and cost savings for volume builders by removing the need for the same or similar building designs to be repeatedly assessed for compliance by individual BCAs. The Department of Building and Housing 2012 review of this process should identify the barriers to its uptake, and suggest ways to overcome these barriers.
- Increased effort on data collection about the quality of the housing stock and consumers' experience of the building industry would generate information that would inform policy making and assist assessment of the performance of the industry and of the regulatory framework. Statistics New Zealand is the most obvious agency to collect this information, and is well placed to compare the costs and benefits of improving the data in this area with other priorities.

The Commission is seeking further information in two areas:

- Rapid and effective feedback mechanisms to enable emerging deficiencies in building standards to be identified, diagnosed and remedied promptly.
- Opportunities to drive greater national consistency and efficiency in the building regulatory system through consolidation of building consent functions or from a contestable market for building consenting and inspection services, either publicly or privately provided.

Taxation

In New Zealand, as in many countries, there is a long-standing perception that housing is 'tax-favoured'. The Commission's general sense, however, is that housing is not as tax favoured as appears widely to have been considered to be the case and that tax distortions per se were not a significant driver of the surge in house prices.

There is a tilt in favour of owner-occupied housing, but only to the extent that owner-occupied houses are financed by owner-equity. Even there, property taxes (rates) levied by territorial government, and GST, act to level up the playing field. Also, to the extent that housing – owner-occupied as well as rental housing – is financed by debt, that debt is taxed quite heavily. This arises since tax is applied to the full amount of nominal, not just real, interest. On the other hand, capital gains on housing are generally outside the tax net. Clearly, those gains were substantial during the price boom. However, there are questions about how 'real', and/or permanent, those gains really are, and thus questions about the nature and extent of any tilting of the tax system in favour of housing that stems from their exclusion from tax assessable income.

In the case of rental housing, the high rate of house price inflation and leveraging up of rental investments during the 2000s created opportunities for rental investors to achieve positive economic returns, including capital gains, whilst reporting tax losses. However, investors appear to have traded away some portion of those gains by accepting lower rents. It is possible that over the longer term the capital gains and 'tax breaks' may come in below what was being anticipated (particularly now that depreciation deductions have been eliminated). If that proves to be the case, the economics of the rental market could look different in the decade ahead, with less investment and higher rents than in the last decade.

Against this backdrop, the Commission does not see a pressing need for changes to the taxation of housing. The current taxation of housing is not ideal, but addressing particular anomalies would further complicate the system and could have unintended effects.

In these regards, the Commission notes that the two most recent major tax reviews to report, the McLeod Committee in 2001 and the Tax Working Group (TWG) in 2010, ventured beyond looking at how to 'adapt' the measurement of income to better cope with asset price inflation. They recognised that adjustments required to achieve that within the existing income tax framework are unavoidably complex, and saw merit in moving to taxing housing capital more directly, and more simply, in particular by applying a 'risk-free rate of return' to the assessed value of the housing investment. The 2010 TWG report additionally explored the application of a 'capital charge' and of a land tax. These approaches would all involve a shift toward taxing property, including but not limited to housing, in a manner more similar to how local government rates are struck.

Potential advantages of these kinds of approach, over applying further patches to address anomalies and inconsistencies in the existing tax system, would appear to be their comparative simplicity, certainty, stability and neutrality in the face of inflation, whether in asset prices or more generally. But they also involve much broader issues, including the appropriate balance overall amongst taxes on income, consumption (GST), and property, and as such, are beyond the scope of the Commission's current Inquiry.

The building industry

There is scope to improve the productivity of the residential building sector and so reduce construction costs. Key barriers to productivity growth are the industry's small scale, low levels of innovation, skill issues and the "bespoke" nature of our homes. Little can be done about market characteristics which reflect consumer preferences and New Zealand's smallness. As such, the Commission advocates a multi-faceted approach which includes greater innovation and measures to raise skills levels.

First, the small size of most firms prevents them from taking advantage of scale economies that could lower their costs. Some barriers to expansion, such as the small size of some regional markets and consumers' preferences for bespoke designs, are inherent in the New Zealand market. Little evidence has been presented to the inquiry about regulatory impediments to the growth of firms, although it is possible that the Commission's proposals for freeing up the consent process will enable new housing developments on a greater scale.

Second, the industry is fragmented vertically and relies on an increasing number of different sub-trades. Sub-contracting, or outsourcing services is common. Houses are often built using a staged step-by-step approach, with individual trades working sequentially in isolation from each other. This can result in time delays and associated holding expenses caused by sub-contractors not being on site when required, as well as the need for re-work. Improved management skills and practice, together with greater uptake and implementation of collaborative working principles could help increase the efficiency of building processes and improve industry productivity.

Third, industry procurement practices exacerbate the disconnection between main contractors and sub-contractors. The establishment of best practice guidelines, appropriate to the New Zealand context, would be beneficial. The Building and Construction Sector Productivity Partnership would be well equipped to undertake this work.

Fourth, inquiry participants raised a number of issues relating to low skill levels in the industry. The Building and Construction Sector Productivity Partnership has developed a skills strategy document for the industry that matches closely the issues raised by inquiry participants in this inquiry. The Commission supports the findings of the Partnership and their strategy for addressing skills issues in the industry.

Government housing assistance

For those on lower incomes, the steep increase in real house prices over the 2000s has significantly decreased the likelihood that they will be able to purchase their own home. The current annual cost of government support for housing is estimated at a total approaching $3 billion – this includes an estimated 'opportunity cost' (calculated at the same rate as other government capital charges) of $883 million on HNZC's state housing portfolio. Over the past nine years, government housing expenditure (excluding the opportunity cost) has grown at an annual rate of around 7% per year.

The Government's initiatives fall into four broad categories:

- State housing: government owns 69,000 houses with a total value of around $15 billion. Most are rented to tenants who pay a subsidised rent which is capped at a certain proportion of their income (income-related rent). The difference between market rents and income related rents (the income-related rent subsidy) cost a total of $564 million in 2010/11. Additionally, government invests significant amounts in maintaining, upgrading and managing state houses. HNZC forecasts a $64 million dividend in 2011/12.

- Accommodation Supplement (AS) and other support: AS is a weekly payment to 320,000 individuals who struggle to meet accommodation costs, most of whom are in the private rental sector (around half of all renters receive AS). AS expenditure for the 2010/11 year was $1.2 billion.
- Home ownership assistance schemes: There is a range of initiatives aimed to reduce the barriers to home ownership. Expenditure on these schemes is relatively small compared with AS and state housing.
- Community Housing: Community Housing is the provision of affordable housing to lower and moderate income groups by non-government, not-for-profit organisations. Government has provided funding to Community Housing providers through a range of mechanisms since 2003 with $35.35 million budgeted for the 2011/12 year.

The Commission heard mixed views about these initiatives. State housing is not always matched to those individuals or areas where there is the greatest need and the stock is old and needs upgrading. The Accommodation Supplement has eased affordability issues for many households. Some suggest the benefits of the Supplement are partly captured by landlords, but evidence of such capture is difficult to distil. Participants questioned the effectiveness of home ownership assistance programs.

The Government has established the Social Housing Unit (SHU) within the Department of Building and Housing as an interim measure to provide advice that will enable the Government to increase the amount of social housing. The Commission agrees that developing the community sector is an important task. To be effective, the SHU needs to be either wholly separate, or fully integrated with another relevant social service agency.

Community housing organisations in other countries have shown that they can deliver better outcomes to tenants than government, council housing departments, or private landlords. A key part of their advantage lies in the ability to offer a complete "wrap around" package of support that extends beyond just the provision of housing into other needs of the client households. In many countries this has been achieved through the large-scale transfer of council or state housing to housing associations. With a strong equity base and the safeguard of rigorous public audit, housing associations elsewhere have proved able to attract loan and equity capital.

Growing the community sector in New Zealand will, however, be a big challenge. Any transfers of state housing to the sector would need to be designed with consideration to the risks associated with the housing, so that the community provider can be viable in the long term. Transferring obsolete houses in the wrong areas to the community sector will not readily lead to growth in their portfolios. The Commission's view is that the social housing fund will need to be increased if community housing provision is to increase significantly and contribute to resolving the anticipated shortfall in the housing market.

The private rental market will also continue to play a very important role in meeting the needs of those at the lower end of the housing market. During the recent housing cycle, the private rental market expanded rapidly to provide housing for an increasing number of households who could not (or did not want to) keep pace with rapidly increasing house prices. The rental market delivers good outcomes for a number of tenants, particularly those who are relatively well off, require flexibility and those who seek transitional accommodation due to changing life circumstances. However, the growth in the private market presents a number of challenges with regards to housing affordability in the coming years. Affordability is already an acute issue for lower-income renters, and this situation has potential to be exacerbated if rents rise back to the longer-run house price-to-rent ratio. In addition, this may generate further demand for the AS, implying significant fiscal risks for the years ahead. Because there is no fixed cap on the AS, annual payments are projected to grow to between $1.7 and $2.2 billion by the year 2015.

The available evidence suggests that greater numbers of households will be relying on private rental accommodation over the long-term. A range of issues including poor quality, insecure tenure and inadequate income in retirement all indicate that the market is not currently equipped to deliver the volume or quality of housing necessary for well-being in the long term. These issues appear to have been exacerbated by the dominance of small-scale investors, whose primary focus is on investment returns rather than provision of housing services. The Commission is concerned that the private rental market will be unable to scale up to provide better and more affordable outcomes for a growing market. A model where institutional investment is used to deliver long-term leases, where the tenant has some ownership interest in the property and the landlord is focussed on a sustainable on-going yield appears to be the best approach, but has not developed. The Commission is seeking further information about options that would enable the private rental market to deliver better outcomes, particularly for those tenants who are likely to rely on the rental market for long-term accommodation.

Rural Māori housing

Generally rural Māori value housing more for keeping whānau connected to land, tradition, tūpuna, and their whanaunga, than as a financial investment. It is "about building communities, rather than building houses." Sustaining rural communities poses a challenge for some Māori in maintaining a connection to their land and the cultural practices that centre on marae (which have required a stable and continued presence). The fear that dwindling populations in rural communities may lead to an irreversible culture loss is for many whānau a real one.

A lack of certainty about future saleability of homes on Māori land (due to the limited market) reduces prices, and places those homeowners at financial risk. It also reduces the security value of the home from a lender's perspective.

The Social Housing Unit has opened its funding round for 2011/12, and will be providing grants for up to 50% of the capital costs of a housing development. This is a significant step forward for making housing on Māori land accessible and affordable.

The relatively small amount of money available ($3m in the Māori fund, and $5m in the Rural fund), and the intent to use that money to access private money for housing may make it difficult for trusts with few assets to access these funds. They would not be available at all to individual home buyers.

The Commission has reviewed three models to see whether they could provide the necessary security for banks to lend: Trust guarantees, a financial options system, and mutual insurance schemes. Under the right circumstances each of these shows some promise. As well, the Commission has reviewed two models of housing where there is an element of common ownership. These are licences to occupy (as used by retirement villages) and unit titles, under the Unit Titles Act 2010. The Commission has concluded that each of these models could form robust ways to manage housing on Māori land.

The Commission is keen to explore these models further with Māori, and invites further submissions and korero.

There will be a considerable adjustment period between the Rural Housing Programme and the Rural Community Regeneration Programme. During this time whānau living in damaged or dangerous homes will be at risk. The Commission recommends making some seed funding available to local Māori organisations or Whānau Ora provider collectives to deliver loans for essential repairs using a microfinance approach.

Concluding comments

The entry costs of home ownership increased over the course of the 2000s house price boom for some groups in society. This has had an important impact on the journey of some households up the housing ladder, particularly those living in Auckland.

It is difficult to predict the likely balance between the fundamental drivers of demand, the supply responsiveness of the land development and construction sectors and the associated house price and tenure dynamics. One plausible scenario is that in the absence of improvements in land delivery and the performance of the construction sector, we can expect to see land prices and the costs of new houses continuing to increase, as rapid household formation, especially in the upper North Island, continues to outstrip construction of new houses.

In this scenario, the size of the rental market would increase further as the proportion of families owning their own homes continues to decline, particularly in Auckland. Compromises in housing provision would become more pressing, especially with respect to overcrowding for low income households, as the available housing stock is utilised more intensively. Indicative of missing rungs on the housing ladder, intermediate renters would find it ever more difficult to make the transition into home ownership. In addition, a growing shortage of both private rental and affordable housing would expose the government to increasing fiscal risk in the form of an escalating accommodation supplement and growing state house rental subsidies. This risk would grow significantly if rents move back into line with still elevated house prices, ending the recent and historically unusual period of disconnect and increasing the level of financial distress for many low-income renters.

An alternative scenario is that the housing market continues to be subdued. To date, New Zealand's house price correction post the Global Financial Crisis has been modest in international comparison. Given the prospect of a volatile global economy with considerable recessionary risks, there may be more price falls to come. In this scenario, supply constraints in the construction and land development sectors bite to a lesser extent and real house prices continue to fall. The market would settle at lower house prices and the affordability issue would recede. However, the continuing pressure from increasing numbers of households seeking accommodation is likely to moderate future reductions in house prices, even in the setting of a weak economy.

On top of the range of possible cyclical outcomes, the New Zealand housing market faces a number of additional challenges. The shift in tenure choice outlined above indicates that the housing needs of New Zealanders are changing rapidly and that the rental market needs to be able to provide secure long-term quality rental housing on a much larger scale than it has done previously.

Although the future direction of the New Zealand housing market is difficult to predict, the policy recommendations outlined in this report are not contingent on a particular outlook. These recommendations focus on improving the supply responsiveness of the land development and construction sectors and hastening the development of a third sector for the provision of social housing. Impediments and lack of development in these sectors have had a negative effect on affordability that has accumulated over the years and goes well beyond the impact of house price cycles, including the house price boom over the 2000s. As such, these policy recommendations are welfare enhancing, even in a low-growth scenario.

Perhaps more importantly, the policy improvements outlined in this report are aimed at improving the performance of the housing market and the effectiveness with which it provides housing for New Zealanders. The objective is a housing market capable of meeting changing demands for housing in a cost effective and affordable way over the long term and well beyond the length of a typical house price cycle.

1 The housing affordability inquiry

Key points

- The Government has asked the Commission to evaluate the factors influencing the affordability of housing and identify potential opportunities to improve affordability and reduce impediments to home ownership.
- Housing plays a central role in individual and community health, family stability and social wellbeing, in the operation of the labour market, productivity and development. As such, the issue of housing affordability is at the core of the Commission's mandate.
- Sitting behind the level of house prices is a complex set of supply and demand forces that ultimately determine the level of affordability in the housing market.
  - At its simplest, housing affordability is a function of income, house prices and the day-to-day costs of home ownership, or rents and income in the case of rental affordability. Change in any of these factors has a direct impact on affordability.
- Housing affordability needs to be understood and examined from a holistic perspective. Therefore:
  - Housing affordability, even at entry level ('starter homes') cannot be understood without considering how the entire housing market works.
  - Affordability is relative: the experience of affordability is very different between existing home owners, first home buyers, rental tenants and across different localities and household types. Different segments have quite different housing needs and ability to pay.
  - There are multiple impacts on housing costs that suggest that issues around land, construction, labour, and capital and their regulation contribute individually and jointly to affordability problems – resolving one in a way which compounds another may not enhance affordability.
  - It desirable that the housing market work in such a way as to maximise the options available for quality housing for all New Zealanders regardless of income or tenure choice. This means a housing market that has both depth and diversity.
  - Affordability is influenced by the costs of accessibility – to work, schools, friends and family, recreation and entertainment.

2 The New Zealand housing scene

Key points

- Reflecting a confluence of global and domestic drivers, New Zealand experienced a house price boom over the 2000s that was widely dispersed across the country. Although unprecedented in recent history, this boom was not out of line with the experience of a number of other OECD countries.
- Over the course of the 2000s boom, house price increases tended to be stronger in areas with relatively low house prices initially. However, despite houses being among the most expensive in the country, the Auckland market continued a well-established trend of relatively strong house prices increases. This 'divergence' in Auckland house prices *vis-à-vis* the rest of the country was especially pronounced at the lower end of the Auckland housing market.
- The responsiveness of housing supply in New Zealand is around average in international comparison, but about half as effective as in a number of better-performing OECD countries. As such, demand increases are estimated to lead to proportionately larger increases in house prices than in new house construction.
- Supply responsiveness varies across the country, with implications for house price dynamics in regional housing markets. This may be related to the efficiency with which local councils implement and enforce regulations governing the land development and construction sectors.
- Land prices are a large and increasing share of the price of dwellings, particularly in Auckland. Available evidence suggests that construction costs have increased and are high in international comparison. This highlights land release and other regulatory hurdles, along with a poor performance in the construction sector, as impediments to a more effective supply response.
- Reflecting a number of factors including high land prices, most new housing supply is directed at the top end of the market, with very little new supply aimed at affordable housing.
- The available evidence indicates that the quality of the New Zealand housing stock is poor, particularly for rental dwellings.
- Over the 2000s boom, rents increased by significantly less than house prices, allowing the rental market to act as a 'safety valve'. This exacerbated a tenure shift away from owner-occupied dwellings to rental. Indicative of missing rungs on the housing ladder, the share of "intermediate renters" – who have at least one member in paid employment but still can't afford to buy a house –increased markedly, particularly in Auckland.
- The rental sector is populated by numerous small-scale landlords, rather than institutional investors. This raises questions about its capacity to provide secure long-term quality rental housing on a much larger scale than it has done previously. In addition, Housing New Zealand is reducing its role in the rental market to focus on 'high-needs tenants'. In its place, the third sector is expected to play a greater role in the provision of social housing. However, this sector is very underdeveloped in New Zealand.
- Impediments to the efficient functioning of the housing market have a negative effect on affordability that accumulates over the decades and goes well beyond the impact of house price cycles, including the house price boom over the 2000s. By the same token, even if supply responsiveness can be significantly improved, the New Zealand housing market will still experience house price cycles to some extent, with attendant implications for affordability.

3 Macroeconomic factors are important

Key points

- Housing matters for the macro economy. The housing market is both an important driver of, and is importantly influenced by, developments in the wider economy. This interdependence has the potential significantly to amplify economic disturbances that originate both within and outside of the housing market.
- The housing market boom in the 2000s was not unique to New Zealand. A number of other OECD countries had a similar experience, pointing to a confluence of global influences as having been at play. These included the emergence of global economic and financial imbalances and innovations in financial policy frameworks (both monetary and prudential) that turned out to be destabilising.
- New Zealand-specific factors were also at work, some of which amplified the housing boom and others that helped to soften the subsequent ‘bust’.
- Overall, the housing boom over the 2000s created significant complications in moderating the business cycle and mitigating the associated economic and welfare costs. One such complication was a tendency for monetary policy responses to amplify the exchange rate cycle, to the detriment of the tradables sector of the economy and, as a consequence, productivity performance overall.
- In the future, one of the central challenges is how better to manage house price inflation expectations and monetary/credit expansions. The emerging development of macro-prudential policy frameworks and instruments provides one, if not the main, way forward.

4 Housing affordability: distribution and trends

Key points

- House price increases have significantly reduced housing affordability over the past decade, but this has been at least partially offset by lower interest rates.
- Housing affordability differs across New Zealand, with dwellings in Auckland typically the least affordable.
- Most indicators suggest that housing affordability has improved in recent years from the peak of the 2000s house price boom. However, house price-to-income ratios remain elevated and would require sharp falls in house prices to return to long-term averages. Affordability measures that include financing costs are currently closer to longer term averages.
- During the last house price boom, housing affordability became a constraint for some middle-income groups, whereas it had previously mainly been an issue for those on lower incomes. It is not yet clear if this is a cyclical phenomenon or a structural trend.
- Housing affordability is lowest among those who are younger, single, have lower income and wealth, live in Auckland, or belong to an ethnic group other than New Zealand European.
- Over the last decade, rents have increased far less rapidly than house prices and the share of income that households spend on rent has fallen in most years since 1996. This apparently benign aggregate situation, however, disguises a more difficult situation for those on lower incomes. Also, the most recent data suggest that upward pressures on rents may be beginning to emerge.

5 Population and demographic change

Key points

- Over the last 30 years New Zealand has experienced: population growth well above the OECD mean; volatile immigration; an ageing population; cultural and ethnic diversification; and a radical transformation of family structure. All these changes have driven a large increase in underlying demand for housing.

- Since 1971, population growth has resulted in roughly 450,000 new households and the decrease in average household size has created an additional 350,000. Between 2001 and 2006, 22,000 additional households were being formed on average each year.

- Demand pressures have differed markedly by region. This is driven by cross-regional differences in external and internal net migration and age, family and ethnic structures. Auckland has accounted for roughly 40% of New Zealand's net household formation over the last 10 years.

- As well as influencing underlying demand for dwellings, population growth and demographic changes have also influenced tenure choice, with some groups in New Zealand more likely to rent than own their homes.

- Looking to the future, in nearly all parts of the country, the average household size is likely to continue falling, implying increased housing demand. New Zealand's population is also likely to continue growing strongly. Much of this growth will be focused on the Auckland region, putting pressure on the regional housing market. For example, the Department of Building and Housing currently projects a shortfall of 90,500 dwellings in Auckland alone over the next 20 years (although a surplus is projected in other regions).

- The impact of underlying demand on house prices ultimately depends on the responsiveness of housing supply in the context of other demand drivers, such as income growth.

6 The role of taxation

Key points

- The Commission is not persuaded that taxation issues were a principal driver of the recent surge in house prices. The present tax position is long-standing and any tax benefit can be expected to have been capitalised into house prices long ago. Absent *change* to the tax regime, a tax bias that has already been factored in should not cause *movement* in prices.
- Housing is less tax-advantaged than is often suggested. This conclusion rests primarily on the following factors:
  - that part of the income provided by the house that is paid over to a lender as mortgage interest is taxed, in the hands of the lender, leaving untaxed only the imputed return on the owner's equity.
  - the application of GST to both rental and owner-occupied housing
  - the universal application of a property tax (local body rates) as the principal revenue source for local government
  - capital gains on housing are already taxed when those buying and selling houses are 'in trade'.
- The deductibility, and assessability, of the inflation component of interest is a tax distortion. The former favours borrowing to invest in real assets, including for investment in rental properties, and the latter encourages investment in these kinds of asset over financial assets. However, this is a general flaw in the income tax system and would be best addressed as such, rather than specifically in the context of housing.
- The Commission would not support taxing capital gains from housing alone:
  - taxation should be approached in a principled way across the economy – an ad hoc regime for housing would risk significant costs
  - designing a regime to bring capital gains and losses more generally within the tax system presents a number of difficult, conceptual and practical, challenges, such as how to define and keep track of capital gains and losses, including how to limit assessable capital gains to 'real' gains rather than merely 'inflation gains'.
- The government should monitor the impact of the removal of depreciation allowances on commercial properties – which includes rental housing – to check that the absence of depreciation deductions in a falling market (if or when that occurs) does not result in resources being diverted away from the rental sector in the same kind of way that depreciation deductions in a rising market drew resources into the sector.

F6.1 The tax bias in favour of equity invested in owner-occupied housing is not as large as is often suggested, once GST and territorial government rates are taken into account.

F6.2 A decision on whether to adopt a capital gains tax on housing should be based on a coherent set of principles that have general application, not just to housing – a wider matter that runs beyond the scope of this inquiry. There are a number of difficult issues associated with a capital gains tax that would also need to be further considered. This is a complex matter that is sometimes overly simplified by commentators. These questions suggest that the design of a regime for bringing capital gains and losses from changes in the relative price of assets – including houses – into the tax net would depend importantly on the policy objectives (revenue raising, stabilisation, equity and efficiency); and that there may be more to – and less in – it than initially meets the eye.

F6.3

- The elimination of depreciation allowances for houses (and other buildings) can be seen as a pragmatic balancing of a number of considerations in the light of a particular set of circumstances – the housing market boom of the early 2000s. Its aptness going forward, in what could be different circumstances, should be monitored; ideally in the context of establishing an approach that is durable across a range of different circumstances.
- The full deductibility of interest expense for business borrowers (and assessability for savers), including of that component that is not 'real', is a tax distortion that favours borrowing to invest in real assets, including for investment in rental dwellings. However, it is a general flaw in the income tax system that best would be addressed as such, rather than specifically in the context of housing.
- No changes, to ring-fence losses on residential rental investments from other taxable income, are called for.

R6.1

That the Government monitor the impact of the removal of the depreciation allowance on commercial properties, including rental properties, for evidence that expenditures relevant to the proper upkeep and safety of buildings are being sustained.

F6.4

The existing GST treatment of housing, which applies equally to rental and owner-occupied housing, is appropriate.

Territorial rates, which also apply equally to rental an owner-occupied housing, are also an efficient form of tax.

F6.5

With respect to housing affordability:

- GST is front-loaded into the acquisition price of a house, which can raise the hurdle to first home ownership, offset at least in part by the availability of Kiwi Saver and Welcome Home assistance for first home buyers.
- Rates can cause strains for those who are 'housing rich but income poor'. The (government funded) rates rebate scheme, and rates postponement arrangements offered by local authorities, are available to ease these strains. There may be a growing need for these, particularly the latter, uptake of which has been low, as the community ages.

7 Urban planning and housing affordability

Key points

- Urban planning today requires consideration of a wide range of objectives, including environmental management and economic development goals. Planning practices have not sufficiently adapted to be able to adequately manage and balance these multiple objectives.
- The prevailing approach to urban planning in New Zealand has a negative influence on housing affordability in our faster growing cities.
  - The widespread planning preference for increasing residential densities and limiting greenfield development to achieve this places upward pressure on house prices across the board.
  - Constraints on the release of new residential land creates scarcity, limits housing choice, and increases prices across the market.
  - These impacts may be disproportionately felt by particular submarkets. Supply constraints are also encouraging speculative property investment (land banking), which further fuels prices.
  - Prices are likely to be reflecting the significant transaction and compliance costs associated with housing development. These costs include those associated with delays encountered in releasing land and through the consenting process.
- An immediate release of land for residential development will ease supply constraints and reduce the pressure on prices. This should include a combination of significant tracts of both greenfield and brownfield land catering to a variety of submarkets, with an immediate focus on Auckland. The Commission considers that collaborative models for the process of identifying, assembling and releasing large scale tracts of land have merit.
- More generally, the Commission recommends that territorial authorities:
  - take a less constrained approach to the identification, consenting, release, and development of land for housing in the inner city, suburbs, and city edge
  - adopt a strategy that allows for both intensification within existing urban boundaries and orderly expansion beyond them
  - develop strategies that promote adequate competition between developers for the sale of construction-ready sections.
- In New Zealand, the task of planning is challenged by the complex array of planning-related legislation and the diverse nature of institutional responsibilities for land use and infrastructure planning.
- In the longer term, a more fundamental review of the related legislative frameworks may also be required, with a view to considering the long-term rationalisation of the local planning and policy environment.

F7.1 The prevailing principles and practice of urban planning have a negative influence on housing affordability in our faster-growing cities. Through their plans, councils may directly facilitate or impede residential development by constraining the amount of land they allow for the construction of new stock. Where and when land is provided influences the private and public costs of development and therefore directly influences housing prices. The widespread planning preference for increasing residential densities and limiting greenfield development to achieve this places upward pressure on house prices across the board.

R7.1 Auckland Council should show in its final Auckland Plan how it has considered and reconciled affordable housing alongside its other priorities.

R7.2 Bring significant tracts of greenfield and brownfield land to the market in Auckland – identify and assemble land that could be quickly released and identify significant tracts of land with the potential for (say) 50 years' development, with at least 20 years' worth under preparation for development.

R7.3 Auckland Council should look to collaborative models for the process of identifying, assembling and releasing large scale tracts of land.

F7.2 Promoting greater affordability of land and houses, providing for diverse demand, encouraging home ownership, and reducing the negative impact of land banking can be addressed by:

- An active approach to the identification, consenting, release, and development of land for housing in the inner city, suburbs, and city edge.
- Adopting a strategy that allows for both intensification within existing urban boundaries and orderly expansion beyond them to promote efficient urban development, offer a range of lifestyles, and avoid imposing unreasonable and costly constraints on individual segments within the housing market by recognising the benefits of advancing multiple forms of development.
- Identifying substantial areas of brownfield and greenfield land for development, with provision for more efficient use of existing suburban areas through infill where practical and acknowledging the likelihood that greenfield development also provides an opportunity to achieve medium density settlement.
- Promoting competition between developers for the sale of construction-ready sections.

R7.4 Territorial authorities:

- Take a less constrained approach to the identification, consenting, release, and development of land for housing in the inner city, suburbs, and city edge.
- Adopt a strategy that allows for both intensification within existing urban boundaries and orderly expansion beyond them.
- Develop strategies that promote adequate competition between developers for the right to develop land.

F7.3 Current legislation does not appear to provide a framework either within or between the Resource Management Act and Local Government Act whereby councils (and other government agencies) might test the trade-offs among objectives and outcomes associated with the four well-beings to reach a position which clearly establishes defensible priorities. The Acts both jointly and individually have purposes which may be difficult to fulfil without recourse to such frameworks.

8 Charging for infrastructure

Key points

- Development and financial contributions for infrastructure are applied widely in New Zealand to recover some infrastructure costs. The level of charges varies considerably, but can be significant. They are not large enough to explain the surge in house prices in the early 2000s, but have impacted on affordability and led to many households taking out larger mortgages.
- Designing and implementing charges for infrastructure that accurately reflect costs is difficult, and there is considerable concern about the way these charges - particularly development contributions - are applied. These concerns relate to issues such as their efficiency, impacts on housing affordability, whether they should be levied up front or over time, the transparency of the processes through which they are determined, and the capabilities of councils to set charges.
- The user pays principle is an important mechanism for shaping the choices made by citizens and encouraging an environment in which private choices are compatible with the public interest. Linking the benefit received and the payment made for some types of additional infrastructure helps efficient resource allocation and to ensure that the level of investment in housing reflects its opportunity cost and that efficient locational choices are made.
- To help improve the calculation and application of infrastructure charges so that they are more efficient, equitable, transparent, and do not unduly penalise new development, the government should update the Best Practice Guidelines to Development Contributions, incorporating principles set out in this chapter.
  - The process for developing the Guidelines should be based on consultation with both councils and the industry, covering matters such as when the contributions should be applied, how they should be calculated and how costs should be recovered.
  - Consideration could be given to conferring legal status on the principles in the Guidelines.
- Conformity with the Guidelines would be encouraged by enhanced training and better reporting by councils of how they are complying with them. External auditing of these reports would help.
- Increasing the scope for merits-based challenges of development contributions is worth considering.

F8.1 Infrastructure charges, especially development contributions, can be difficult and costly to implement. While housing affordability may be diminished, infrastructure has to be paid for. If implemented well, the charges will reflect the incremental costs of necessary infrastructure, and can encourage more efficient investment and location decisions.

R8.1 That the Government update the Best Practice Guidelines to Development Contributions, based on a process that takes account of the experience of both councils and the industry. The principles in the guidelines might be given statutory status by being incorporated into Schedule 13 of the LGA.

F8.2 Development contributions are most likely to be justified only for major items of infrastructure, especially network infrastructure, where closed or partially-closed access enhances the ability to charge the beneficiaries, and which justify public supply. Observing these criteria mean that offsite water, wastewater, stormwater, and roads are the categories best suited for funding through development contributions.

R8.2 That the Government leads training to enable councils to enhance their skills in implementing the proposed Best Practice Guidelines for Development Contributions.

R8.3 That as part of the process of updating the Best Practice Guidelines to Development Contributions, the Government:

- identify information that councils would need to provide in regular reports to demonstrate compliance with the Guidelines
- develop a process for regular auditing of councils to assess their adherence to the Guidelines.

9 Building regulations and affordability

Key points

- The regulatory framework can affect the cost of building or renovating a house by imposing standards that exceed what home owners would otherwise choose. The process through which the regulations are set is extremely important in ensuring that standards do not require more expenditure than is justified by the benefits.
- The costs of administering the regulatory framework are to a large extent passed onto home buyers. The Commission is interested in further information on the potential for more contestability in the market for consenting and inspection services.
- The costs arising from slow and uncertain administration of building regulations and inspection services can be substantial and deserve greater attention from building regulatory authorities.
- Local authorities administering building regulation face challenges in acquiring, retaining and supporting the necessary technology, skills and judgements to perform these tasks to a high standard.
- Concerns regarding the quality, timeliness, cost and consistency of building regulatory functions were common in submissions and consultations during the course of this inquiry. Also evident was the poor state of relationships between building practitioners and building consent authorities in some areas. These tensions are likely to impede the success of an effective performance-based building regulatory system.
- Building consent authorities face strong incentives to regulate in a risk averse manner, especially given the liabilities they have incurred in the wake of the leaky homes experience. Reforms designed to reallocate risk among the parties to building work should be evaluated to assess their effectiveness.
- There is a need for central and local regulators, in concert with representatives of the residential construction industry, to devise new fit-for-purpose processes to reduce compliance costs and facilitate innovation, while improving the performance of inspection services with respect to cost, timeliness and capacity to deal with building innovations.
- Achieving greater scale and better use of available technology, to ensure faster dissemination of information, greater consistency and quality, and faster processing of residential building consenting and inspection services, is both feasible and desirable.
- The development of rapid and effective feedback mechanisms which enable emerging deficiencies in building practice to be identified, diagnosed and remedied promptly is required to improve the performance-based regulatory system.
- There is little quantitative or qualitative information on the quality of the New Zealand housing stock. Such information could be included as a component in Statistics New Zealand surveys and would provide a source of data for policy development and monitoring purposes which is currently missing.

R9.1

- The Department of Building and Housing publish for each BCA, the total time taken between receiving applications and finally granting consents and the number of occasions where each BCA has used the 'stop the clock' provision.
- The Department of Building and Housing audit the 'stop the clock' information from a

sample of BCAs.

R9.2 The Law Commission give regard in its review of the application of joint and several liability on the incentives faced by regulators.

R9.3 The Department of Building and Housing report on its ongoing evaluation of the reforms on the allocation of risks between parties to building work five years after introduction.

R9.4 The Department of Building and Housing should provide more specific guidance for Building Consent Authorities about what is required for an alternative solution to comply with the Building Code.

R9.5 The Department of Building and Housing should review the Multi-proof building consent process with a focus on identifying barriers to its application, and suggesting ways to overcome these barriers.

R9.6 Statistics New Zealand consider collecting more information about the quality of New Zealand's housing stock and consumer satisfaction with the residential construction industry.

10 The performance of the building industry

Key points

- The performance of the building and construction industry plays an important role in the supply, quality and cost of new housing. Industry performance is also important for the improvement, alteration and maintenance of existing rental, social and owner-occupied housing.
- Industry productivity performance is flat-lining, and this is reflected in growing building costs, and evidence of poor building quality. During the recent housing boom building costs increased above the general rate of inflation, and residential building costs are higher than in Australia.
- Building materials are more expensive in New Zealand than they are in Australia.
  - In part, this can be explained by the small size of the New Zealand market and the small scale of major material manufacturers.
  - It is unclear whether additional competition in the materials industry would reduce the costs. The Commerce Commission investigates concerns about the behaviour of material suppliers and has found no breaches of the Commerce Act.
- The trend in New Zealand toward larger and higher specification housing increases building costs.
- The small scale and fragmented nature of the New Zealand building industry contributes to high costs.
  - The industry is dominated by small firms which build one house at a time, are unable to generate economies of scale, and often lack management capability.
  - The industry is fragmented vertically which presents difficulties in the management of the supply chain.
  - New houses tend to be bespoke one-off designs. Building costs can be reduced through greater uptake of standardised designs and building techniques.
- The industry is subject to significant demand cycles, making investment in firm expansion and the recruitment and retention of skilled staff difficult.
- The industry suffers from a number of skill issues, particularly at the management level. The misalignment between industry business cycles and industry training can result in skill shortages during booms and excess staff during periods of downturn.
- The construction industry and government have identified productivity growth as a priority and have established the Building and Construction Sector Productivity Partnership to develop practical proposals to address productivity issues.

F10.1

- During the recent housing boom, the cost of building a standard house has increased at a greater rate than inflation.
- The cost of both building materials and building a standard house is substantially higher than in Australia.
- A trend toward larger and higher specification houses is also contributing to

increased costs. Factors driving this trend include changing consumer preferences, the use of covenants, and a desire to avoid under-capitalising given current section prices.

F10.2 Industry productivity performance is flat-lining, and this is reflected in growing building costs and evidence of poor building quality. Evidence suggests that the productivity performance of the construction industry over the past thirty years has been poor relative to other New Zealand industries, and relative to other jurisdictions.

F10.3 The lack of scale in the New Zealand residential construction industry presents a significant barrier to productivity growth.

- Small builders are less able to generate economies of scale.
- Scale home builders can reduce construction costs through the delivery of standardised housing, but scale building firms occupy a comparatively small share of New Zealand's building market.
- A lack of available land can present a barrier to productivity through inhibiting the development of group home builders and scale developments.

F10.4 The fragmented nature of the residential construction industry supply chain presents a number of management difficulties which can result in lower building quality and higher construction costs.

R10.1 Given that the Productivity Partnership has a number of relevant workstreams in progress, and has an established membership of relevant representatives, the Commission considers that it is well placed to develop practical initiatives to improve industry productivity. In particular, the Partnership should develop, in consultation with the sector, practical responses to the supply chain issues outlined in section 10.4.

F10.5 The National Infrastructure Plan represents a good mechanism for providing, where possible, forward visibility of government investment which is reliant on the residential construction sector.

F10.6 Skills issues, particularly at the management level, require attention in order for the residential construction industry to better respond to industry cycles and to improve productivity performance. The Productivity Partnership Skills Strategy is focussing on a number of skill issues, which, if addressed, would enable better industry productivity growth.

11 Where housing affordability bites

Key points

- Government provides a range of housing assistance programmes, from providing a state house through to home ownership schemes. The total cost of these programmes is about $3 billion, and has grown substantially over recent years.
    - There are a number of known issues relating to the suitability, performance and use of many of New Zealand's 69,000 state houses.
    - Expenditure on Accommodation Supplement has increased significantly since 2004. Although the supplement has helped make housing more affordable for many households, inquiry participants questioned its effectiveness. With the exception of KiwiSaver, inquiry participants also questioned the effectiveness of current home ownership assistance programmes.
- Community housing has made an important contribution to affordable housing, but increasing the scale of the sector faces a number of challenges:
    - Because much state housing is obsolete, 'stock transfers' will need to be judiciously managed to avoid setting back the development of the community housing sector.
    - Given that private landlords already accept relatively low yields, community housing providers may struggle to cover their costs through reduced rents, without additional financial support.
    - Because the Social Housing Fund is only a moderate amount, it is unlikely by itself to deliver significant increases in the amount of affordable housing.
- The Social Housing Unit (SHU) is a Semi-Autonomous Body operating in the Department of Building and Housing. In the Commission's view the SHU needs to be either wholly separate, or fully integrated with another relevant social service agency.
- The Commission supports local service delivery through community housing organisations but seeks further suggestions about how to increase the capacity of the sector.
- During the recent housing cycle, the private rental market expanded rapidly to provide housing for an increasing number of households that were unable to keep pace with increasing house prices.
- Despite rents increasing at only a modest rate during the recent housing boom, rental affordability remains an acute issue for lower-income households. Any future decline in rental affordability is likely to place additional pressure on low-income households and generate further growth in Accommodation Supplement expenditure.
- The Commission projects that increasing numbers of households will rely on the private rental market for long-term housing. The traditional first step into home ownership – lower-priced homes – is closing, with high land prices and new building concentrated on higher-priced homes.
- The rental market is well equipped to respond to those who value flexibility or require transitional housing, but the current market provides limited options for those who seek secure long-term rental accommodation.
- Rental markets internationally have a number of features that raise the quality of accommodation and tenure security. Most of these do not appear to be present in New Zealand. The Commission seeks further suggestions about how to generate better outcomes for those who rely on the private rental market to meet their long-term housing needs.

R11.1	The final structure of the Social Housing Unit should be a Crown Entity with an arm's-length relationship to the Minister of Housing.

F11.1	The state housing stock available to be transferred is not so much surplus, as obsolete. Transferring the problem of modernisation and low demand to the community housing sector will hold back growth in this sector.

R11.2	We recommend that the Social Housing Fund be increased to better meet the expectations of future social housing provision through the community housing sector.

12 Rural Māori housing

Key points

- Housing is valued more for keeping whānau connected to land, tradition, tūpuna, and their whanaunga, than as a financial investment. It is "about building communities, rather than building houses."
- The affordability and sustainability of rural housing poses a challenge for some Māori in sustaining a connection to their land and the cultural practices that centre on marae (which require a stable and continued presence). The fear is that dwindling populations in rural communities may lead to an irreversible culture loss for many whānau.
- The Social Housing Unit has been established within DBH, and responsibility for housing policy and non state-housing programmes transferred from HNZC to DBH and the SHU respectively. Being a social housing provider, though, may not align well with some of the aspirations Māori have for housing on their land. Aspirations to keep whānau connected to the whenua, their tūpuna, their marae, and the associated traditions are only indirectly related to providing social housing.
- The SHU has a focus on building new stock of social or affordable housing. The focus on building new houses takes a very narrow view of housing needs, particularly for rural Māori, where there is an identified issue with the quality of the existing housing stock in many rural Māori communities.
- A lack of certainty about future demand for particular homes on Māori land (due to the limited market for some homes) places home owners at quite some financial risk. Despite this, many Māori are willing to borrow to buy or build a home because of the value they place on a home on their whenua. However, concern about future saleability and security value can undermine the confidence of lenders to lend, because if they have to take possession of the house, on-selling it might not recoup the cost of the loan.
- The Commission has reviewed three models to see whether they could provide the necessary security for banks to lend: trust guarantees, a financial options system, and mutual insurance schemes. Under the right circumstances each of these shows some promise.
- The Commission has reviewed two models of housing where there is an element of common ownership. These are licences to occupy (as used by retirement village developments) and unit titles, under the Unit Titles Act 2010. The Commission has concluded that each of these models could form robust ways to manage housing on Māori land.
- There will be a considerable adjustment period between the Rural Housing Programme and the Rural Community Regeneration Programme. During this time whānau living in damaged or dangerous homes will be at risk. The Commission recommends making some seed funding available to local Māori organisations or Whānau Ora provider collectives to deliver loans for essential repairs using a microfinance approach.

Terms of reference

The Government has asked the Productivity Commission to undertake an inquiry into housing affordability.

New Zealand Productivity Commission Inquiry into Housing Affordability

Issued by the Minister of Finance, the Minister for the Environment, the Minister of Housing, the Minister for Building and Construction, and the Minister for Regulatory Reform ("the referring Ministers").

Pursuant to sections 9 and 11 of the New Zealand Productivity Commission Act 2010, we hereby request that the New Zealand Productivity Commission ("the Commission") undertake an inquiry into housing affordability.

Context

Stability of the home environment is widely considered to be important for social cohesion and family stability. Real house prices in New Zealand are markedly higher than they were a decade ago. The rise in real house prices has been associated with general declines in housing affordability, as indicated by a number of different measures, and in the rate of home ownership. These declines have contributed to increased demand for rental accommodation and additional pressure on the social housing sector. The debt accumulation and wealth effects associated with the rise in house prices may have also exacerbated New Zealand's last economic cycle. Interest rates and exchange rates were arguably higher than they otherwise would have been during the upturn and there has been greater contraction in demand during the recession. Debt accumulation may also be a factor in ongoing economic risks.

Scope

Having regard to the context outlined above, the Commission is requested to undertake an inquiry to evaluate the factors influencing the affordability of housing (both rental and owner-occupied housing), and to examine potential opportunities to increase housing affordability. For the purposes of this evaluation the Commission should:

- Identify and analyse all components of the cost and price of housing.
- Identify mechanisms to improve the affordability of housing, with respect to both the demand and supply of housing and associated infrastructure.
- Identify any significant impediments to home ownership, and assess the feasibility and implications of reducing or removing such impediments.

Particular attention should be given, without limitation, to the following matters:

a) factors influencing the supply of land and basic infrastructure for residential construction;

b) factors influencing the cost of residential construction, including the effect of standards, specifications, approval and title requirements on the cost of new housing construction;

c) the level and growth of productivity in the land development and residential construction industries, and the effect of government regulations on productivity in these industries;

d) the efficiency of taxes, levies and charges imposed at all stages of the housing supply chain;

e) the efficiency of the tax treatment of owner-occupied and rental housing;

f) the influence of changing consumer housing preferences, willingness to pay, and financing costs on housing affordability; and

g) the operation of the overall housing market, with specific reference to the availability of a range of public and private housing types, the demand for housing, and the efficiency of use of the existing residential housing stock.

Consultation Requirements

In undertaking this review, the Commission should consult with key interest groups and affected parties.

Timeframe

The Commission must publish a draft report and/or discussion paper(s) on the inquiry for public comment, followed by a final report, which must be submitted to each of the referring Ministers by 1 February 2012.

BILL ENGLISH, MINISTER OF FINANCE
NICK SMITH, MINISTER FOR THE ENVIRONMENT
PHIL HEATLEY, MINISTER OF HOUSING
MAURICE WILLIAMSON, MINISTER FOR BUILDING AND CONSTRUCTION
RODNEY HIDE, MINISTER FOR REGULATORY REFORM

30 MARCH 2011