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Treasury University Challenge 2014 - Quality of rental housing

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Introduction:

The poor state of New Zealand's rental housing stock (Barton, 2013) challenges this country's ability to provide the essential human right of a standard of living adequate for health and wellbeing (Human rights commission). This poor state means indoor temperatures in the majority of New Zealand houses rarely reach the world health organisation's prescribed healthy range of 18-24 degrees Celsius (Isaacs, Camilleri, French, Pollard, Saville-Smith, Fraser, Rossouw, & Jowett, 2006). Consequently, Issacs and Donn (1989) identified a link between New Zealand's poor housing stock and high rates of seasonal mortality.

Important aspects of housing quality include energy efficiency, health, and safety. Regulating the quality of New Zealand's rental housing can improve our social infrastructure, equity, and sustainability (based on New Zealand Treasury definitions). Possible benefits include energy savings, better occupant health and safety, and increased equity (through raising minimum living standards). This regulation would impose compliance and renovation costs, the level of these costs and who is likely to bear them are key factors in policy setting.

This essay assesses the possible benefits of regulating the quality of New Zealand rental housing, the costs and who will pay them, and other possible market implications.

Current state:

The 'heat smart' programme was a government initiative to improve New Zealand housing quality. The programme offered subsidised insulation and heat pumps on a voluntary basis (Ministry of Economic Development, 2011) and resulted in warmer and healthier homes. Despite the programme's success, uptake from rental home owners was low (Fitzpatrick, 2010).

Internationally, the United Kingdom is leading the way in regulating rental housing quality. Their 'decent homes' programme requires rental housing to be bought to a 'reasonable standard'¹. The programme has had a positive impact on the country's social infrastructure with reduced health care costs, tenancy failure, and crime rates (Nicol, Roys, Davidson, Summers, Ormandy, & Ambrose, 2010). The Republic of Ireland introduced regulation in 2009 requiring landlords to ensure their properties meet minimum physical standards including heating, sanitary facilities, and secure storage (Citizens information Ireland).

¹ This programme involved bringing all social housing up to a 'decent standard' (judged by being in a reasonable state of repair, free from health and safety hazards, insulated, and with reasonably modern facilities (United Kingdom Government). In 2011 these requirements were applied to the private sector – with compliance being necessary by 2018 – if owners have access to 'green loans' – a finance initiative aimed to ease the burden of improving the houses (Barton, 2013).

Energy Use:

Quality housing is energy efficient, meaning it can be heated affordably. A study by Lawson and Williams (2012) shows that 24% of New Zealanders have foregone the use of heating because they felt they could not afford it. With electricity (New Zealand's predominant source of domestic heating) prices increasing 3 times faster than general inflation since 2002 (Statistics New Zealand, appendix A), and prices able to continue increasing (National business review), a rental housing stock which costs less to heat, or requires less heating, would improve equity and sustainability in New Zealand.

Houses upgraded under the heat smart programme had higher indoor temperatures but only reduced electricity use by 1%. These results – and the results of other New Zealand studies (Lloyd, Callau, Bishop, Smith, 2008) – indicate better housing quality results in similar energy use but better performance. The improved performance increases equity through increasing living standards, but is unlikely to save tenants money, and has little impact on (environmental) sustainability.

Health:

Poor housing conditions, such as damp, mouldy, and cold (<18 degrees Celsius) indoor environments, are major causes of respiratory health issues (Keall, Baker, Howden-Chapman, Cunningham, & Ormandy, 2010; Lloyd et al, 2008). A quality home means one that is healthy i.e. warm and dry.

The heat smart programme increased indoor temperatures and subsequently reduced hospital omissions and mortality rates. The value of these improvements was conservatively estimated at \$560 annually per home (Ministry of Economic Development, 2011). This represents a social return of 16% per annum for a 30 year investment². These results highlight the health benefits of improving housing quality through adding insulation and heating.

Safety:

A quality house is one which is safe and free from hazards, such as slippery paths and dangerous stairways. The social cost of household injuries in New Zealand is \$13 billion annually, the equivalent of 3.5 times the cost of road injury (White, 2013). Both international (decent homes scheme) and local New Zealand studies have shown that improving housing quality reduces this cost (White, 2013). During the New Zealand 'healthy housing index' pilot study, each additional hazard around the pilot study homes increased the likelihood of occupant injury (requiring treatment) by 22% (Keall, Baker, Howden-Chapman, Cunningham, & Cunningham, 2007).

² Improvements last 30 years and cost \$3,500 on average (Beacon, Ministry of Economic Development, 2011)

Improving the quality of housing by reducing the prevalence of these hazards, has the scope to significantly reduce the \$13 billion annual social cost of household injuries in New Zealand.

Cost:

The method of regulating the quality of rental housing will impact the cost of the scheme and determine who bears this cost, which will directly influence the living standards framework. One method which has featured in popular discussion is the adoption of a warrant of fitness scheme for rental housing. During feasibility testing of this method, compliance inspectors estimated they would charge \$200-\$300 per assessment (Bennett, Chisholm, Hansen, Howden-Chapman, 2014), which equates to 1.5%-2% of average annual rental income and a total burden of \$90-130 million³. The bearer of this compliance cost will impact equity, specifically it seems inequitable to burden the owners of good quality housing with this extra cost.

Another method is to amend the building code so items critical to improving housing quality are treated as urgent safety issues in a manner similar to earthquake strengthening, and dangerous, or unsanitary buildings and environments. This would mandate upgrading items such as insulation in existing buildings to meet current building code levels, rather than just requiring this of new buildings (Barton, 2013). Currently, items critical to improving housing quality such as insulation are not considered urgent safety issues (Barton, 2013). However, the evidence (e.g. results of the heat smart programme) indicates their influence on health and safety impacts, and their potential benefits supports that they should be.

The renovations required to improve rental housing quality are the other major cost. In the warrant of fitness feasibility-tests, only 8% of houses passed the initial conditions – this would increase to 36% by fixing low cost items like smoke alarms (Bennett et al, 2014). That leaves 64% of rental houses requiring potentially costly improvements like installing insulation, heating and balustrades. Housing New Zealand is currently trialling a housing warrant of fitness with reduced requirements to lower renovation costs (New Zealand Government), this will be a useful policy tool when complete.

Who pays?

Who will pay, and who should pay, for compliance and renovation costs will influence policy setting. Rental housing owners generally accept the importance of improving housing quality but argue it is unfair to expect them to fund renovations without financial assistance (tax breaks,

³ Based on average rents of \$275 per year and 453,000 rental houses in NZ (Stats NZ).

subsidies, etc.), and they should not have to pay compliance costs (New Zealand property investors federation). Another argument is that businesses (including rental home owners) must ensure their premises are safe. If substandard properties are affecting the health and safety of tenants, rental home owners can be expected to fund improvements in these houses.

If extra costs are imposed on house owners, they may attempt to increase rent, with two possible justifications:

They are passing on additional business costs to their customers

They are renting out a higher quality asset, therefore they can demand a higher price.

Tenants in these houses are generally living in low cost rentals, increasing their rent burden may force them to forgo other necessities (or any luxury goods they had been enjoying), or force them out of private rental housing – increasing the strain on social housing.

Warrant of fitness feasibility-testing found 12% of house owners intended to increase rent prices after incurring the cost of improving their properties (Bennett et al, 2014)⁴. Whether this 12% are able to increase rents remains debatable. Some practitioners believe low end rentals have a price ceiling – tenants simply can't afford higher rents (Meadows, 2014). Others believe improving housing quality does not lead to higher rental prices – this is why housing quality has not improved under market circumstances (Barton, 2013). Unfortunately few studies have assessed the real world impact of regulating housing quality on rent levels. The Republic of Ireland is an appropriate case study, however they do not make low cost rent price data publicly available, so we cannot assess the impact their regulation has had on rent prices. This assessment would be a strong policy tool, so this data should be requested from the Republic of Ireland central statistics office.

Central funding for compliance costs and financial assistance for renovation (tax breaks, subsidies, or low interest loans) may avoid imposing potentially inequitable costs on rental home owners. These also remove the 'passing on costs' justification for increasing rents thus reducing risk of vulnerable tenants facing increased costs. This risk could be reduced further by making financial assistance conditional on rent increases being tied to the CPI – however this would add further administration costs.

The United Kingdom 'decent homes' programme used subsidised loans to reduce the burden on house owners. A graph of rental price changes (Appendix B) does not show a definitive link between rental prices and the programme becoming enforceable in the private sector (in 2011)⁵.

⁴ This is likely to be an understatement of the total market as the sample was selected from willing participants (unwilling participants may be more likely to increase rents).

⁵ This data is at an aggregate level, so further research – particularly on the impact on low end rents – is needed to strengthen this analysis.

Further options which could be considered to ensure regulation is fair to home owners and tenants include:

A declaration warrant of fitness scheme i.e. ratings must be displayed, rather than pass/fail. This would improve transparency and subsequently reduce the likelihood of high rents being paid for substandard housing.

Offering guaranteed purchase of housing which landlords do not want to (or cannot) fund improvements for. This would risk creating distortions in the housing market and would rely on valuation accuracy.

Subsidising rent increases faced by low cost renters. This would carry risk of house owners increasing rent in the knowledge it will be government funded.

Other market impacts:

Possible market implications of regulating the quality of rental housing include reducing the supply of rental housing. If properties become too expensive to improve, they may be removed from the rental housing stock. This would increase pressure on the current rental housing stock, but may increase the supply of houses available for purchase, consequently improving home affordability. Having fewer rental properties and more houses available for home ownership may be beneficial in the current climate of high house prices (although this could be debated further).

Renovation work to improve the rental housing stock will boost economic growth (using GDP measure) and employment. Analysis shows the installation of insulation and heating in 50,000 homes under the heat smart programme in 2009-10 added 400 FTEs and \$135m of producer surplus to the economy (Ministry of Economic Development, 2011)⁶.

More new houses may be built to replace any that were too expensive to improve, creating an initial boom in housing construction. This would stimulate economic growth (by the GDP measure), however it would put extra strain on the construction sector which is currently coping with the Christchurch rebuild. If regulation was timed to coincide with the Christchurch construction slow down, it may provide an avenue to move construction resources. Once houses are improved or replaced, there is likely to be a bust in the construction sector as home owners will be reluctant to replace houses they have recently made improvements to.

⁶ It should be noted that there is significant margin for error in these calculations.

Conclusion:

Regulating the quality of rental housing in New Zealand is likely to improve our social infrastructure. The main benefits are major reductions in health and safety costs associated with home occupant accidents, and illnesses. Energy savings, traditionally considered an important part of improving housing quality, are likely to be insignificant.

This regulation is likely to create significant costs. Careful consideration must go into assessing who pays these costs, ensuring the answer is equitable for stakeholders. To do this, further assessment is required to determine real world evidence which indicates who is likely to bear these costs. Contact should be made with internationals who have regulated their rental housing markets (United Kingdom, Republic of Ireland) so assessments can be made on how their regulation influenced rent prices, and how other policies (such as subsidising renovation costs) impacted these prices.

While the regulation is likely to promote economic growth, careful consideration must be paid to the timing of the regulation to restrict pressure on the construction industry.

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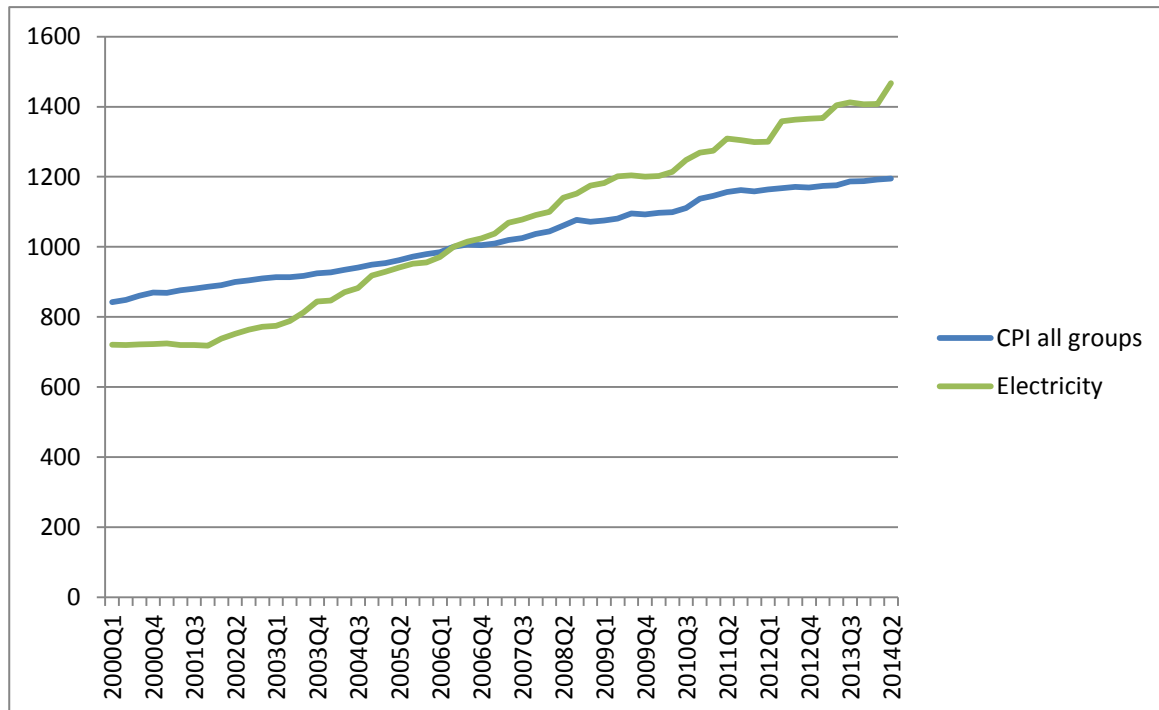
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Appendices:

Appendix A:

Electricity and CPI quarterly index figures (source Statistics New Zealand – www.stats.govt.nz)



Appendix B:

United Kingdom annual rental price change (source Office of National Statistics – www.ons.gov.uk)

