NEW ZEALAND
PRODUCTIVITY COMMISSION
Te Kōmihana Whai Hua o Aotearoa

Housing affordability

Issues Paper
June 2011

The Commission aims to provide insightful, well-informed and accessible advice that leads to the best possible improvement in the wellbeing of New Zealanders. The submission process is an important method that the Commission will use to gather ideas, opinions, and information to ensure that inquiries are well-informed and relevant.

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THE NEW ZEALAND PRODUCTIVITY COMMISSION

The New Zealand Productivity Commission is an independent Crown Entity. We complete in-depth inquiry reports on topics referred to us by the Government, carry out productivity-related research that assists improvement in productivity over time, and promote understanding of our work to increase support for improving productivity. The Commission's independence is underpinned by an Act of Parliament — The *New Zealand Productivity Commission Act 2010*. Our research and advice is guided by our statutory purpose to improve the wellbeing of the community as a whole.

Information on the Commission can be found on www.productivity.govt.nz
or by contacting (04) 903 5150

Contents

The Issues Paper

This issues paper is intended to assist individuals and organisations to prepare submissions to the inquiry into housing affordability. It outlines the background to the inquiry and the matters about which the Commission is seeking comment and information.

This paper is not intended to limit comment. The Commission wishes to receive information and comment on any issues which participants consider relevant to the inquiry's terms of reference.

KEY INQUIRY DATES

Receipt of terms of reference:	1 April 2011
Due date for initial submissions:	3 August 2011
Release of draft report:	October 2011
Draft report submissions due:	December 2011
Final Report to Government:	February 2012

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WHY YOU SHOULD MAKE A SUBMISSION

The Commission aims to provide insightful, well-informed and accessible advice that leads to the best possible improvement in the wellbeing of New Zealanders. We strive to be 'in touch' so our advice is relevant, credible and workable in practice. In keeping with these principles, the Commission recognises the significant amount of existing research, knowledge and skills which will be relevant and beneficial to our work. The submission process is an important method that the Commission will use to gather ideas, opinions and information to ensure that inquiries are well-informed and relevant.

HOW TO MAKE A SUBMISSION

Anyone can make a submission. It may be in written, electronic or audio format. A submission may take a number of forms, ranging from a short letter on a single issue to a much more substantial document covering a range of issues. Where possible, you should provide relevant facts, figures, data, examples and documentation to support your views. While every submission is welcome, multiple, identical submissions do not carry any more weight than the merits of an argument in a single submission. Submissions may incorporate material made available to other reviews or inquiries that are relevant to this inquiry.

Submissions may be made electronically (preferred) or by post. Electronic submissions should be in Microsoft Word or Adobe PDF format, and submitted via the form provided (from mid-July) on the Commission's website (www.productivity.govt.nz). Postal submissions should include your name and contact details, and the details of any organisation you represent. Where possible, an electronic copy of postal submissions should also be sent to housinginquiry@productivity.govt.nz. In circumstances where the content of submissions is deemed inappropriate or defamatory, the Commission may choose not to accept such submissions.

WHAT THE COMMISSION WILL DO WITH SUBMISSIONS

Submissions will play an important role in shaping the nature and focus of this inquiry. Submissions will be used to gauge the position and preferences of relevant stakeholders with regards to aspects of the inquiry. Where relevant, such information, along with other evidence (such as facts, figures, data or examples) may be cited or used directly in the inquiry report.

The Commission seeks to put as much information as possible on the public record. Submissions will become publicly available documents once placed on the Commission's website. This will occur shortly after receipt of the submission. 'In confidence' material can be accepted only under special circumstances. You should contact the Commission before submitting such material.

The context of this inquiry is a recognition that stability of the home environment is widely considered to be important for social cohesion and family stability. There is a concern that real 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 debt accumulation and wealth effects associated with the rise in house prices may also have exacerbated New Zealand's last economic cycle with interest rates and exchange rates arguably higher than they otherwise would have been during the upturn and consequently greater contractions in demand during recession.

1 What has the Commission been asked to do?

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

Specifically the Government has asked the Commission to:

- 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; and
- identify any significant impediments to home ownership, and assess the feasibility and implications of reducing or removing such impediments.

These tasks can be synthesised into three questions:

- What are the key (demand and supply) components of housing affordability?
- How can the housing market work better to improve housing affordability?
- What can be done to remove impediments to home ownership?

In particular, the Government has asked the Commission to give particular attention to:

- factors influencing the supply of land and basic infrastructure for residential construction;
- factors influencing the cost of residential construction, including the effect of standards, specifications, approval and title requirements on the cost of new housing construction;
- 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;
- the efficiency of taxes, levies and charges imposed at all stages of the housing supply chain;
- the efficiency of the tax treatment of owner-occupied and rental housing;
- the influence of changing consumer housing preferences, willingness to pay, and financing costs on housing affordability; and
- 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.

2 The Commission's approach

UNDERSTANDING AFFORDABILITY

The context of this inquiry is a concern about distortions in the New Zealand housing market that have led to rising house prices and declining housing affordability. While there is widespread use of the term 'housing affordability', there are different views about its meaning and measurement. The Commission views affordability as reflecting both the up-front cost of purchasing a home (accessibility) and the capacity of an individual or household to meet the ongoing costs of housing out of current income. Both depend on housing costs (including finance costs) and income.

Housing affordability also spans the full range of tenure types, including private home ownership, private rental and social housing. Affordability tends to be more of a problem for lower quartile income households, who are buyers or are renting, where volatility and fluctuations in the housing market have a disproportionate impact. The Commission considers 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.

However, sitting behind the notion of housing affordability is a complex set of forces that ultimately determine the level of affordability in the housing market (APC, 2004):

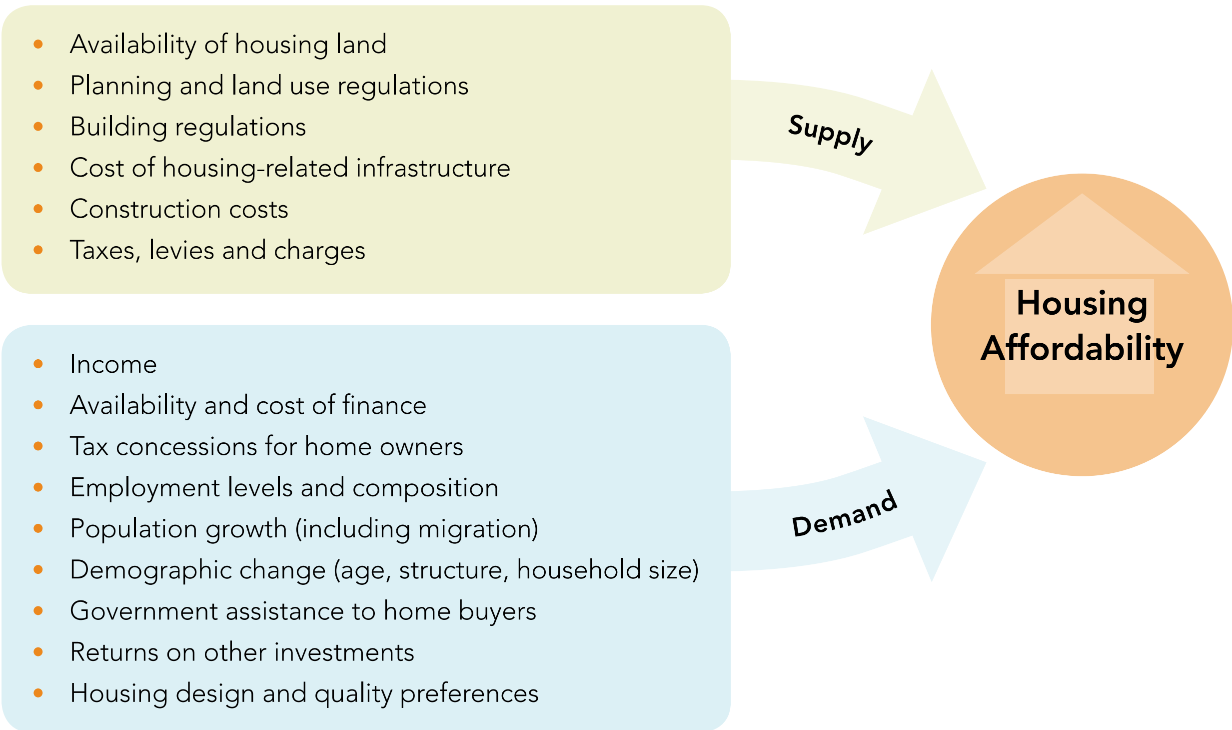
- House prices and affordability are the outcome of various determinants of the demand for housing and the cost of supply.
- Some demand and supply factors are cyclical in nature, with their effects felt primarily in the short term. Others are structural and influence prices over the medium to longer term. Demand and supply factors can also vary from cycle to cycle and between different regional markets.
- The ultimate effect on housing affordability will depend on how demand and supply interact — for example, the less responsive is supply, then the greater will be the price increases arising from an increased demand for housing.
- The expectations generated by price rises may themselves stimulate further price rises — the so-called 'bubble' phenomenon.

A stylised illustration of the multiple determinants of housing affordability is provided in Figure 1. A key focus for the Commission in this inquiry is to identify any factors that may be distorting demand and supply with adverse effects on the efficiency of the housing market and housing affordability.

A COMMUNITY-WIDE PERSPECTIVE

In keeping with the purpose set out in our legislation, the Commission will examine housing affordability from a community-wide perspective. This means that policy settings for improving housing access and affordability will be considered in terms of what will deliver the best outcomes for the New Zealand community over time. This includes the wider social benefits of home ownership that may not be fully recognised by the market, for example, greater family and social stability, community connectedness, and improved health and education outcomes.

Figure 1 **Multiple determinants of housing affordability**



Q1 *How should the Commission think about the concept of housing affordability – its meaning and measurement? Should the Commission focus its work on affordability as it impacts on lower income households or should the focus be broader and examine the market as a whole?*

Q2 *Does this stylised framework (Figure 1) capture all the important determinants of housing affordability? Are there others that are important?*

Q3 *Is there a more appropriate framework for examining the housing market and issues of affordability?*

3 The importance of well-functioning housing markets

New Zealand has always had a strong culture of home ownership, with studies showing that it is an important aspiration for many New Zealanders (DTZ, 2005). The desire to own a home is commonly linked to benefits such as greater security, flexibility to adapt the dwelling as needs or preferences change, and as a store of wealth.

Housing is the single biggest expenditure for most New Zealand households and comprises the main share of both household assets and debt.

The housing sector can usefully be thought of as a large complex system characterised by market and non-market sectors, local boundaries and global drivers, and significant links to markets for land, labour and finance. Housing markets are also inherently sticky with spillovers, lags and repeated effects across a range of different sectors and systems (Maclennan, 2008). This underlines the importance (and challenge) of better understanding housing markets and the potential impact of policy intervention.

Housing market outcomes can have significant ramifications for the wider economy as evidenced by the recent global financial and economic crisis. The interaction of housing, housing finance, and economic activity is of central importance to the workings of the economy as a whole (Bernanke, 2007). Instability in the housing market can be transmitted to volatility in economic activity due to the links between house prices, credit constraints and household consumption and indebtedness.

Given that roughly 86 per cent of the New Zealand population lives in an urban centre, and over one third of New Zealanders live in Auckland, thoughtful urban planning and design is critical to realising the economic and social benefits from the housing market. Research in spatial and urban economics suggests that if our cities or towns are larger or smaller than optimal, in the wrong place, or poorly designed, productivity, employment and wages will be lower than they might otherwise be (Muellbauer and Murphy, 2008). How well our towns and cities are planned also affects energy consumption and carbon emissions. For example, travel distances can be reduced only if communities are designed to maximise connectivity with work, amenities, schools, community facilities and open space (Kamal-Chaoui and Robert, 2009).

Home ownership also contributes to positive social outcomes in society (through the building of social capital). For example, studies have shown a strong link between home ownership and better educational outcomes and future income prospects for resident children (e.g., Haurin *et al*, 2001), more civic engagement, higher trust in others and a positive sense of community (Roskruge *et al*, 2011), family and social stability (e.g., Glaeser and Shapiro 2002), and higher average living standards in retirement (Ministry of Social Development, 2006). The quality of housing is also closely linked to health outcomes (e.g., Maani *et al*, 2006, and Howden-Chapman *et al*, 2007). Affordable, high quality rental housing could also be expected to provide such social benefits, although there is evidence that home ownership provides greater benefits (e.g., Rohe, *et al*, 2000).

Access to affordable and quality housing can therefore enhance both economic performance and social capital. However, housing markets may not deliver efficient or appropriate outcomes for the following reasons:

- Demand may become excessive if people develop unrealistic expectations about the returns from housing relative to other investments. Although people eventually adjust their expectations to market realities, such adjustment can be very disruptive and can take a long time with long lasting effects.
- The demand for housing may be inflated or distorted by government policy settings — for example, the taxation treatment afforded to housing compared to other assets or services.
- The supply of new housing may be unduly slow to adjust to increases in demand due to, for example, any inefficiencies in the building and construction industry or any deficiencies in government regulation (or its administration) such as insufficient and delayed land release or planning and consenting constraints.
- Poor productivity in the housing supply chain resulting in more expensive housing than otherwise would be the case.

4 Analysing housing markets

The housing market has some distinctive features which are relevant to the analysis of price trends and affordability (APC, 2004).

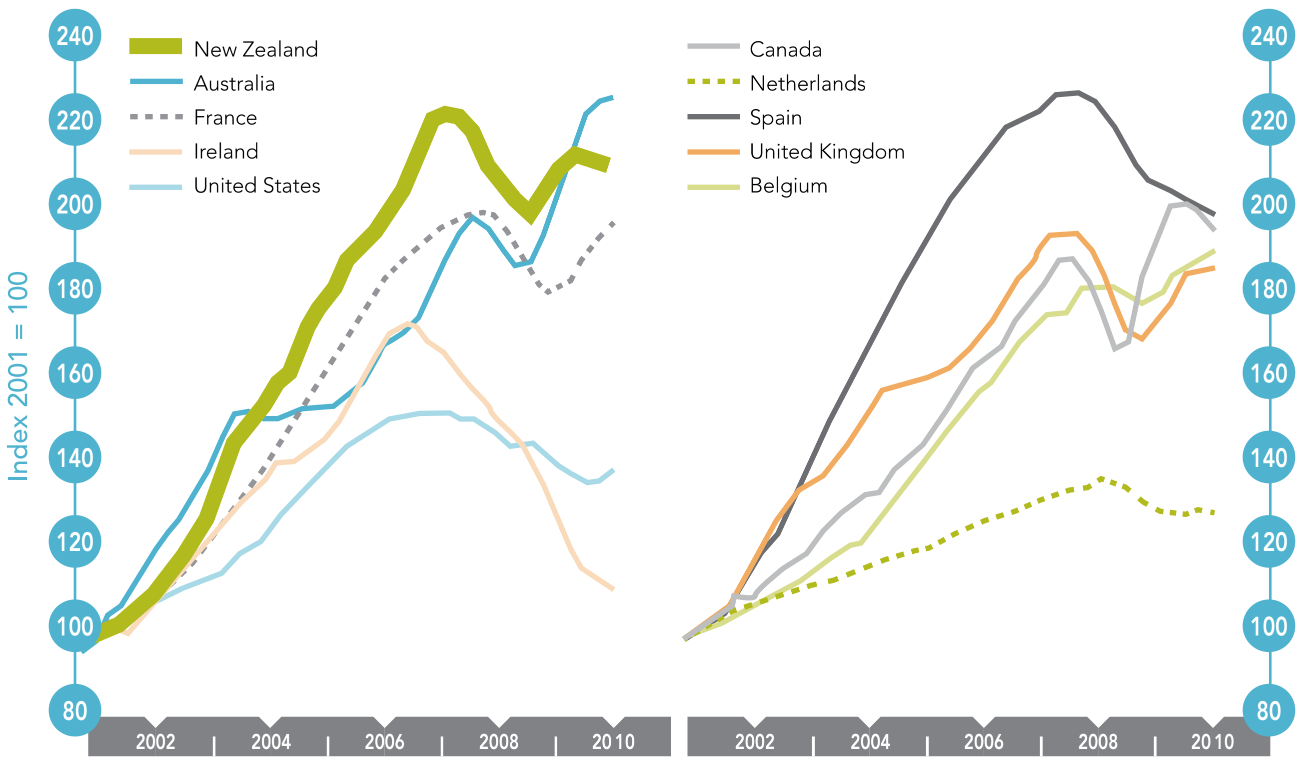
- *The nature of the asset* — Houses are assets that provide a stream of consumption (a place to live) and investment services (an asset that can be treated as a store of value and can be sold for a subsequent gain or loss). This dual function adds considerable complexity to the analysis of housing markets as it introduces greater tenure choice for households. Formally, the price of a house will implicitly reflect the discounted 'present value' of that stream of services and depend on expectations about future demand and supply, as well as current market conditions. The value of a house represents the combined value of the dwelling and the land on which it is sited. In New Zealand, significant changes in house prices in the last decade have mainly come about through changes in the value of land (House Prices Unit, 2008).
- *Price volatility* — While there is an upward trend in real house prices in most countries, there is much fluctuation such that, at its extreme, it can result in booms or busts. The cyclical nature of housing demand is responsible for much of this price fluctuation. Because most house purchases are financed by debt, this makes demand sensitive to the accessibility of finance and movements in interest rates, as well as to income and employment trends. Investment in rental housing is influenced by the returns available on alternative investments such as equities, which similarly fluctuate over time.
- *Supply lags* — Short-term constraints on the responsiveness of supply make it difficult to accommodate cyclical surges in demand. It can take several years to transform basic housing land to a construction-ready state (including the supporting infrastructure). At the same time, there are high search and other transaction costs (such as legal, commission and administrative costs) associated with buying and selling houses that make them much less liquid assets than, say, equities. This can delay and thereby accentuate adjustments to changing market conditions. Likewise, depending on circumstances, households may take years to modify their housing requirements in response to changes in prices, incomes and borrowing costs.
- *Segmentation of the market* — There are multiple segments making up the housing market. The market is split geographically, by dwelling type and by price/quality bands. It can also be divided into owner-occupied and rental housing. These submarkets are not unconnected, with substitution occurring across them in response to changes in relative prices and rental yields. The linkages and flow on effects between market segments in turn mean that prices in each segment (and therefore affordability) are influenced by broader market trends. It also means that the analysis of any policy intervention should consider not only its expected impact on the targeted submarket but also its ripple effects to other submarkets.

5 Recent trends in housing markets

HOUSE PRICE TREND

A principal task for this inquiry is to identify what has been happening to housing prices and why, and the implications for affordability over time. Between 1990 and 2001, national average house prices had appreciated at an annual rate of only 2% in real terms and even fell in a number of districts. However, from around 2002 house prices increased in concert across all regions and local districts, and since then, cumulative growth in the national house price index has exceeded that of most other OECD countries (Figure 2) (OECD, 2011). New Zealand house prices hit their peak in 2007. They had risen over 180 per cent in real terms relative to 1990 levels, and all local districts experienced at least an 85 per cent increase. Notably, the largest price increases exceeded 200 per cent in real terms and were concentrated in major urban centres and holiday locations. Since the global financial crisis nominal house prices have fallen around 5 per cent.

Figure 2 **Housing price indices across countries**



Source: OECD, 2011.

A combination of both supply and demand factors have been identified in explaining the surge in real house prices. These include a sharp inflow of migrants during the cycle, favourable credit conditions, a rise in average incomes, declining nominal interest rates, very low unemployment, strong gains in the terms of trade during the period (with dairy prices driving up rural land values), response lags of residential construction, increases in the costs of building homes and shortages in materials and skills. These factors likely inflated expectations of future house price increases, though it is difficult to determine whether a housing bubble had formed (OECD, 2011).

An issue for this inquiry is whether the recent experience with housing prices is merely a recurring and transient phenomenon, with a corresponding short-term effect on real prices and affordability, or whether it is the consequence of more fundamental changes in housing markets.

Q4 *What factors have caused recent housing price increases? Are some of them temporary?*

Q5 *What evidence is there that there was a 'bubble' in housing prices? Were house prices previously undervalued?*

Q6 *What effects have price rises in housing had on the affordability of home ownership?*

Market-wide median or average price increases may not be representative of changes occurring in particular locations, for particular types of housing (such as established or new separate houses, flats and apartments), or housing with particular quality attributes. Owner-occupied housing price movements may also be influenced by developments in rental markets, and vice versa.

Q7 *Are median price trends representative of trends within housing sub-markets?*

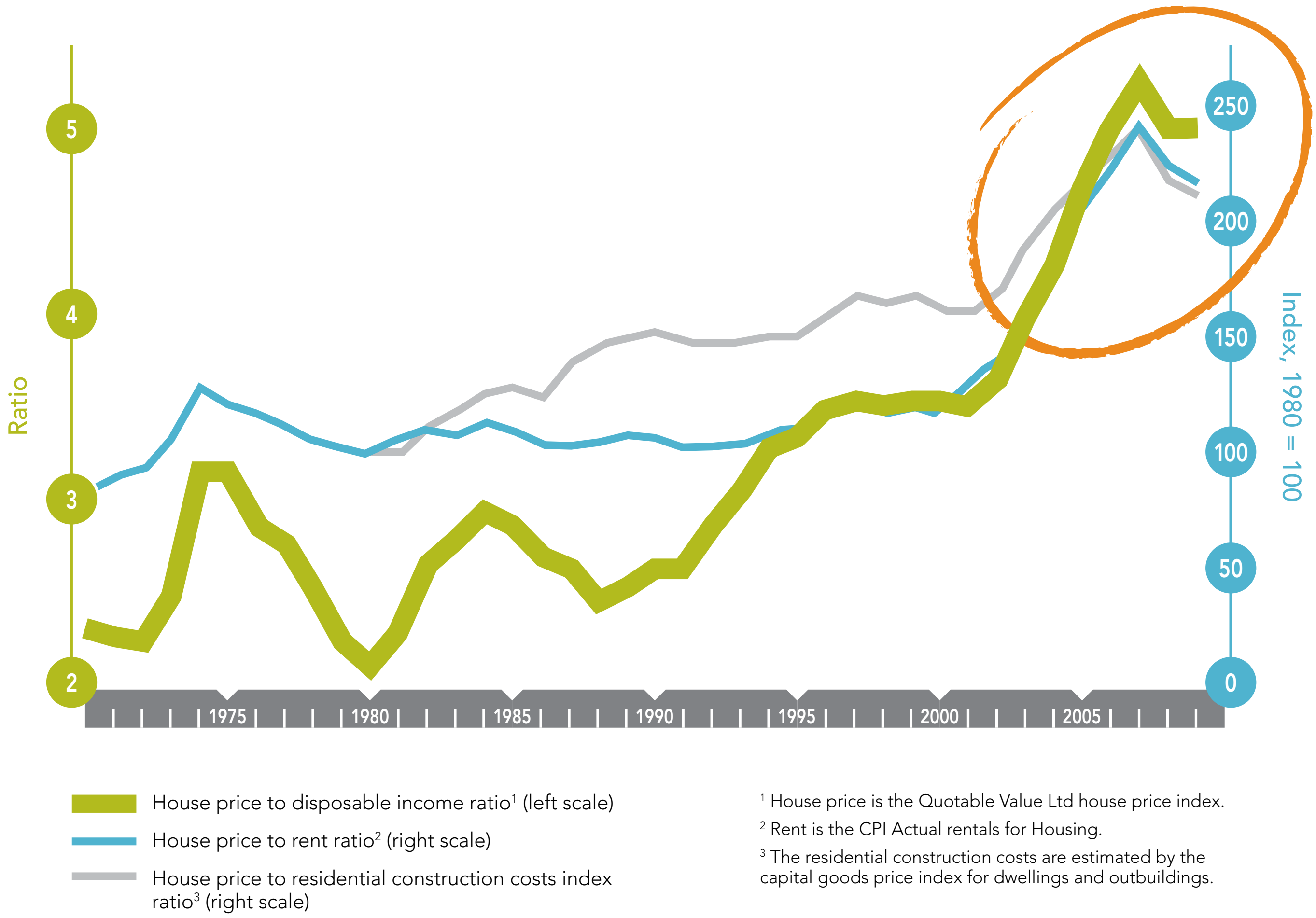
Q8 *What is the best way to segment the market, and are there significant house price variations confined to specific market segments?*

Q9 *Why have different parts of New Zealand (cities and regions) experienced different trends in housing prices?*

AFFORDABILITY TREND

There is some evidence that the surge in house prices in the last decade has been associated with general declines in affordability. A commonly used measure of affordability is 'price to income' ratio as shown in Figure 3. This shows affordability steadily declining since late the 1980s, a sharp drop in affordability during the 2000s housing boom and, more recently, slight improvement.

Figure 3 **Housing price ratios**



[1] House price is the Quotable Value Ltd house price index.
[2] Rent is the CPI Actual rentals for Housing.
[3] The residential construction costs are estimated by the capital goods price index for dwellings and outbuildings.

Source: Statistics New Zealand; Reserve Bank of New Zealand; Girouard et al. (2006); OECD Main Economic Indicators database; OECD calculations.

But price to income ratios are only partial measures of affordability trends as the cost of housing finance is not taken into account. Some measures aim to relate mortgage repayments to household income while others measure the extent of the 'deposit gap' that must be funded by home buyers ('accessibility indices').

Affordability measures that link average house prices to interest rates and some measure of income can present a blind spot to what is actually happening to affordability. For example, indices based on average income measures fail to capture what is happening in those households with below-average incomes. Such affordability indices also do not account for improvements in the quality of housing over time.

That said, while different measures of affordability can yield different conclusions about trends, with a healthy level of caution, they can provide useful insights as to what is happening with affordability in the aggregate and over time.

Q10 *How should affordability for home buyers/owners be defined and measured, both in principle and in practice (taking account of data availability)? Is it possible to assess affordability using a single measure?*

Q11 *What has happened to affordability over time and what has caused this? Is it lower now than at times in the past? Does it reflect different influences to previous episodes of declining/increasing affordability?*

Available measures of affordability can be useful for providing a broad assessment of trends. However, they might not adequately capture the problems facing different groups.

Q12 *Do affordability trends differ for first home buyers with different income and household characteristics?*

Q13 *Do they capture adequately, the problems facing those on lower incomes or those in particular locations (such as the urban fringe or rural areas)?*

AFFORDABILITY OF RENTAL HOUSING

Relative to the movement of New Zealand house prices in the 2000s, increases in the cost of renting have been muted (OECD, 2011). Between 2001 and 2006 the rent index of the consumer price index (CPI) increased by an average of 2.4 per cent per annum. Data from tenancy bonds – which cover new rental agreements – show stronger growth with average rents increasing by an average of about 6 per cent per annum. However, both measures show that the growth in rental prices is considerably lower than that of house prices, which averaged 11 per cent per annum (Reserve Bank of New Zealand, 2007). As a result, the past ten years have seen a significant increase in the price-to-rent ratio (see Figure 2).

In part, this trend is can be explained by the significant growth in the supply of private rental properties at the same time that housing prices grew so rapidly. Between 1996 and 2006, the number of households who paid rent increased by 33.8 per cent, from 290,124 to 388,272 (Statistics New Zealand, 2011). The upsurge in private rental households and corresponding rental affordability trends may also have been influenced by perceptions of favourable tax treatment for investment properties and by landlords accepting relatively low rent returns in anticipation of significant capital gains (McKinlay Douglas, 2004).

The current trend in rental and housing affordability creates difficulties for tenants in that if house prices continue to grow, their chances of saving the deposit required to purchase a home may worsen, even if net rentals do not keep pace with house price increases. Conversely, if the housing market flattens, landlords may seek increased rentals to minimise the reduction in their overall returns hence reducing the capacity of renters to save (McKinlay Douglas, 2004). Deterioration in rental affordability is also likely to increase the level of dependence on the government's accommodation supplement. The supplement is designed to assist New Zealanders with the cost of rent, board or a mortgage, however the majority of recipients are private renters. At the end of 2009, just under 323,000 people were receiving the supplement (Housing Shareholders Advisory Group, 2010).

A by-product of the apparent disjunct between the affordability of renting and home ownership has been the growth of the "intermediate" market segment. Broadly, the intermediate segment is defined as those households in the private rental market with at least one household member in paid employment, who cannot afford to buy a house at the lower-quartile house price under standard bank lending terms (DTZ, 2008). Between 1996 and 2001, the size of the intermediate housing market remained relatively constant (70,300 in 1996 and 72,300 in 2001). In the following five years, the size of the intermediate housing market more than doubled from 72,300 to 187,300 households, or 58 per cent of all private rental households, primarily as a result of the significant surge in real house prices (DTZ, 2008).

The government has responded to the growth in the intermediate sector with a number of programmes designed to make home ownership more accessible for low- to moderate-income households (Box 1).

Box 1 **Government assistance with home ownership**

The government provides various programmes to assist low- and moderate-income households to purchase their first home. A recent review of some of major options that are currently available has shown that they have a low take-up rate and are reaching only a small proportion of those who aspire to own a home (Housing Shareholders Advisory Group, 2010).

- The Welcome Home Loan scheme enables borrowers with a maximum yearly income of $85,000 to borrow up to $350,000 without a deposit. Since its inception in 2003, an average of 931 households have made use of the programme each year.
- Also funded from Welcome Home monies, Kāinga Whenua is a Housing New Zealand Corporation (HNZC) programme that began in February 2010. It enables those with a license to occupy Māori land to obtain a loan of up to NZD 200 000 to build, purchase or relocate a house there. Eligibility is based on the same income criteria as for Welcome Home Loans.
- The KiwiSaver programme is administered by HNZC and provides assistance to first home buyers who have been members for more than three years. The KiwiSaver First Home Deposit Subsidy programme allows individuals and couples with a combined gross annual income of no more than $100,000 a subsidy of $3,000 to $5,000 depending on the duration of their contribution to the scheme. Additionally, all Kiwisaver members may also withdraw all personal and employer contributions and all returns to purchase a first home.
- Gateway Housing makes Crown land available to first-time buyers with payment for the land deferred and capped for 10 years. Gateway Housing opportunities are available primarily through partnerships with community housing organisations and HNZC.
- The Housing Innovation Fund provides community housing providers and Iwi/Māori organisations with funding to build or buy community rental housing and to provide for affordable home-ownership opportunities through either a term loan or a grant.
- The New Zealand Housing Foundation is a charitable trust that develops pathways to home ownership for households who would otherwise be long-term renters. Products include a shared ownership scheme which enables easier access to a mortgage, and a home equity creation scheme for people with no deposit and previous credit issues.

Sources: Housing Shareholders Advisory Group, 2010; OECD, 2011.

Q14 *How should affordability for renters be defined and measured, both in principle and in practice (taking account of data availability)? Is it possible to assess rental affordability using a single measure?*

Q15 *What has happened to rental affordability over time in relation to both house purchase prices and household incomes? Do rental affordability trends differ across different locations or for certain household characteristics?*

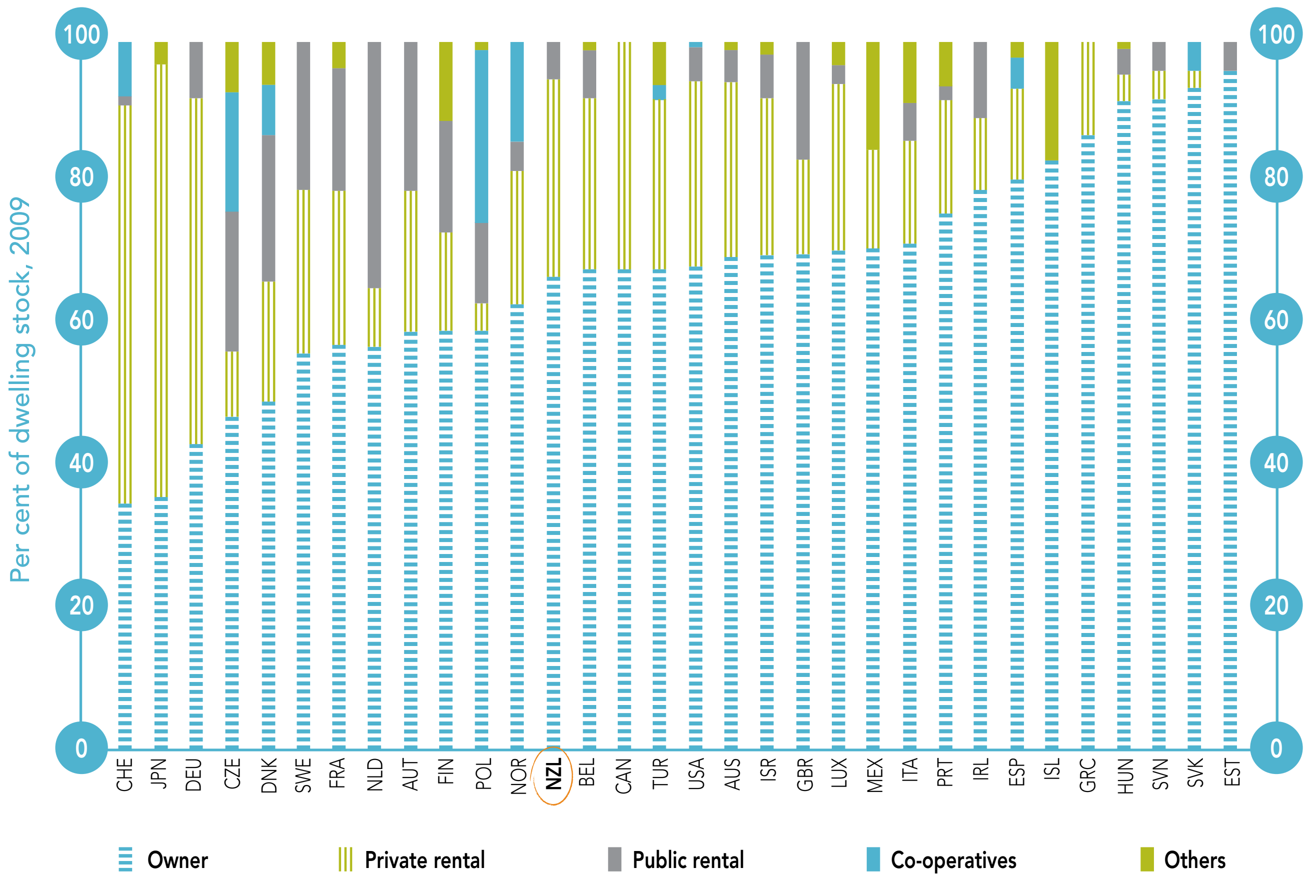
Q16 *What factors have influenced the price of renting relative to house purchase prices? Are the current rental affordability trends likely to persist, or are they temporary?*

Q17 *What has been the impact of existing government programmes to assist first home buyers?*

HOME OWNERSHIP TREND

Another important trend is that home ownership rates in New Zealand have declined as a proportion of total households from around 75 per cent in 1991 to 67 per cent in 2006, with 27.5 per cent renting and 5.5 per cent living in social housing (2006 Census). The level of home ownership in New Zealand is slightly below the OECD average (Figure 4).

Figure 4 **Tenure structure across countries**



Source: Andrews, D. A. Sanchez and Å. Johansson (2011).

The declining home ownership trend may be associated with the rise in real house prices and general decline in housing affordability. Other partial explanations include a trend towards postponing household formation until later in life. This has accompanied the increasing uptake of tertiary education (often with student loans), and later marriage and childbearing which are often identified as the dominant drivers of the propensity to own (Morrison, 2008). The most significant falls in home ownership are in the 25-40 year old age groups (House Price Unit, 2008). The extent that this fall is explained by deferral of home ownership by this particular group remains an open question.

The decline in New Zealand of home ownership rates contrasts with the trend of increasing owner occupancy rates observed in most other OECD countries (OECD, 2011).

Q18 *What are the key drivers of the decline in home ownership rates?*

Q19 *To what extent are changes in home ownership levels explained by changing tenure preferences? Have changes in the New Zealand rental market been a factor in explaining declining home ownership rates?*

6 Markets for housing

Evidence on housing price trends suggests that the New Zealand housing market is comprised of a number of regionally based markets. There is also a series of sub-markets within these regional markets. Sub-markets might be distinguished by location, dwelling type and quality. Price trends in these markets may differ as demand and supply shifts occur.

The extent to which price trends in housing sub-markets differ depends on the linkages between them. Over time, all sub-markets may be connected by people moving between them or investing across them. For example, people shift locations for work or other reasons and typically upgrade their home as their needs change.

Q20 *How should housing markets be defined in New Zealand? What are the key factors that distinguish housing sub-markets?*

Q21 *Do housing price trends for the various sub-markets differ? Are such differentials sustained or temporary?*

The dual role of housing as both a consumption and investment good heavily influences its affordability and price. There is evidence that investors have become more prominent in the New Zealand housing market, particularly during the housing boom and that this property investment was important in driving housing demand. Data from the *Household Economic Survey* and other sources suggest that by 2007 investment properties accounted for up to 40 per cent of all residential mortgages (Brooks and Cubero, 2009).

Analysis by Scobie, Gibson and Le (2007) of data from the *Survey of Family Income and Employment* found that 15 per cent of all households in New Zealand owned investment property. Interestingly, the rental property market is characterised by numerous small-scale first-time investors rather than institutional investors (DTZ, 2004). Moreover, it has been suggested that a feature of housing demand during the boom in New Zealand was the extra demand for second homes and rental investment generated by well-off baby boomers. Indeed, figure 14 shows the high level of debt that is borne by the top income quintiles. Analysis of housing booms in other countries also emphasises the significance of this component of demand (see for example, Shiller, R.J., 2005).

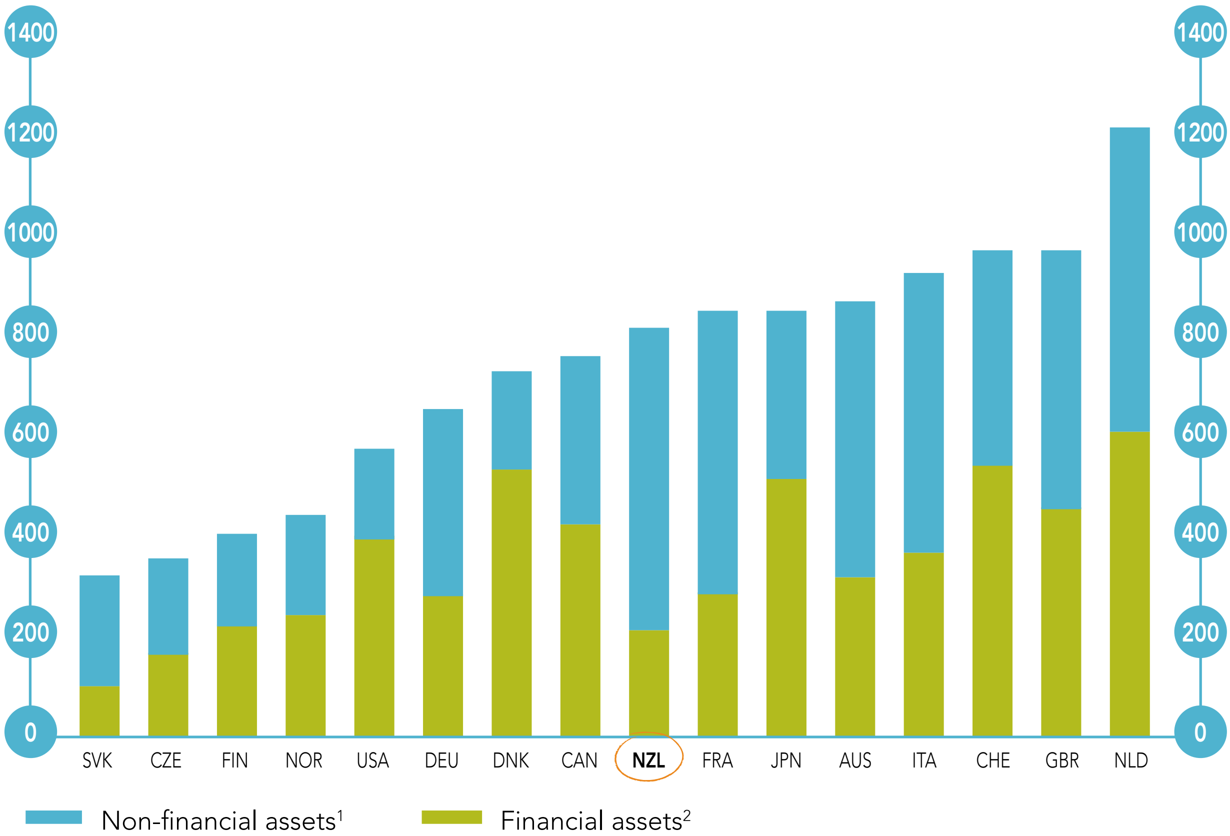
The level of investor activity in housing markets may be influenced by factors such as the taxation treatment of housing and expectations about returns (derived from rents and capital gains), and the prospective returns from alternative forms of investment (such as shares).

While somewhat dated now, a revealing survey of landlords in New Zealand found that they identified the following benefits from investing in property (Centre for Research, Evaluation and Social Assessment, 2003):

- Capital gains – 38 per cent
- Regular income stream – 32 per cent
- Retirement investment income – 25 per cent
- Tax advantages – 9 per cent
- Rent paying off mortgage – 8 per cent.

The question arises as to whether household investment portfolios in New Zealand are too concentrated in housing and land assets. When compared with other OECD countries this does appear to be the case (Figure 5).

Figure 5 **Financial and non-financial assets (as a percentage of net disposable income 2009 or latest available year)**



1. Include dwellings, land and consumer durables. Dwellings only for Denmark, Finland, Norway and Slovakia.

2. Balance sheet consolidated for Australia, balance sheet non-consolidated for the other countries and Reserve Bank of New Zealand data for New Zealand.

Source: Reserve Bank of New Zealand; OECD National Accounts database and OECD Economic Outlook 88 database.

The strong preference for New Zealander's to invest in residential property may also be partly explained by perceptions of risk associated with property compared with other types of investments. There is some evidence that New Zealander's invest overwhelmingly in property because they feel more confident and 'trust' property investment more than other forms of investment (Braithwaite and Kemp, 2007).

Q22 *What are the characteristics of investors in housing? How much of the recent activity in housing is coming from small, first-time investors? Has offshore investment been a feature in the New Zealand housing market? What market segments have seen the most investment activity?*

Q23 *What are the major factors that have influenced recent investor activity in housing markets? Is the perceived risk associated with property investment different to that of other types of investments?*

Q24 *What effect has investor activity in housing markets had on housing prices and affordability? Has investor activity influenced prices and affordability in all housing sub-markets, or has the effect been concentrated in particular areas such as apartments and medium-density housing in the cities or particular locations?*

Q25 *Why is there little institutional investment in the private rental market in New Zealand?*

Given the high transaction costs associated with buying and selling a house, including search costs, fees and commissions, the cost of buying and selling housing could also be influenced by any changes in practices of real estate agents.

Q26 *What practices of real estate agents impact on housing prices and affordability? Has the effect been significant? Has the recently introduced Real Estate Act 2008 and stronger regulation of agents made a difference to the influence of real estate agents?*

Q27 *Is there scope to improve the practices of the real estate sector? If so, how? What would be the effects on housing prices and affordability?*

7 Urban planning, design and land use policies

Well-designed cities and towns can more effectively support our quality of life, economic growth aspirations and the integrity of our environment.

As mentioned earlier, research in spatial and urban economics suggests that if our cities or towns are larger or smaller than optimal, in the wrong place, or lack the right infrastructure, then productivity, employment and wages will be lower than they could be (Muellbauer and Murphy, 2008). A country's international competitiveness relies on the competitiveness of its major cities which in turn depend on how, and how well, they function.

Planning and land-use policies are important because land use generates externalities that may not be included in the market price, for example congestion and environmental degradation. Land-use planning systems aim to correct for such market imperfections. But land-use and planning policies can also restrict supply responsiveness which has wider implications for house prices and affordability. At the same time, positive externalities or spillovers can arise from planning and public investment decisions where schools, community facilities, parks, and transport development are capitalised in the value of private property (the so-called 'unearned increment').

The supply of land can be increased by re-zoning 'green-field' land to allow development for housing construction on the fringe of towns and cities (expansion). Land can also become available through 'brown-field' re-zoning of existing inner city and non-residential land to allow higher density housing (intensification). There are strong arguments made in favour of both approaches (Box 2). New Zealand cities have historically grown by expanding the land area that they cover through new suburbs. This has resulted in population densities that are below many other cities in the world but closer to densities in most Australian cities (Housing Prices Unit, 2008).

In better understanding the demand drivers in the housing market, the Commission is interested in the preferences of home buyers in New Zealand for particular housing development models and why this is the case. For example, one survey of new home buyers showed that detached suburban living with a commute was preferred over medium or high density housing nearer work (Page, 2007). As much floor space as possible given their budget constraints and a double garage were identified as the top priorities.

Box 2 **Intensification versus expansion**

Arguments for intensification:

- More efficient utilisation of land in urban areas through the creation of higher-density land-use patterns that encourage a mix of uses (including residential, business and retail).
- Using less land per dwelling, through a greater use of terraced and apartment-style dwellings along with in-fill subdivisions, which can reduce housing costs.
- The clustering of people and economic activity in larger, denser urban settlements, with good access to amenities and transport thereby achieving greater business productivity and increased economic growth.
- More efficient movement of goods and services, along with reduced car dependence, with subsequent savings in overall energy demand and carbon emissions.
- Revitalisation and reinvestment in existing developed areas.

Arguments for urban expansion:

- Mitigating the effects of increasing land prices and thereby improving housing affordability.
- Allowing consumer choice and market response to preferences, with a suburban location seen as the preferred lifestyle choice of the majority of people.
- Reducing traffic congestion in low density suburban development and, as a result, increasing traffic speeds and lowering pollution emissions.

Source: House Prices Unit, 2008.

Q28 *What are the relative costs and benefits of intensification and expansion (greenfields development) to urban planning? What research literature and overseas developments are most relevant to New Zealand?*

Q29 *How do these different approaches to urban planning support competitiveness and economic growth?*

Q30 *To what extent do these different approaches to urban planning support environmental objectives?*

Q31 *In New Zealand, do home owners prefer living in dense urban settlements or less dense suburban developments? What are the reasons for this preference?*

There are large differences in the development strategies adopted by major cities such as Auckland, Christchurch and Wellington, and regional cities like Napier and Tauranga. Regional cities generally accommodate growth through outward expansion, greenfield development and the conversion of farmland and rural lots to residential land (Fairgray, 2009). Conversely, major urban areas tend to promote growth through brown field development and densification within existing urban boundaries with limited outward expansion or greenfield development (OECD, 2011). For example, in Auckland city, urban development is contained within Metropolitan Urban Limits (MULs) or growth boundaries aimed at controlling urban expansion and limiting adverse environmental effects. But this is not to say that such boundaries are static. In practice, residential land supply can be expanded by extending the MUL, and this has happened in the Auckland region. The Commission understands that, since 1999, the MUL has been extended by 2000 ha, with five areas rezoned around the city fringe: Long Bay, Hobsonville, Flat Bush (in Manukau City), Takanini, and Hingaia (CHRANZ, 2010).

There is evidence that MULs have driven up land and housing prices within (and just beyond) the containment area and that they have become an increasingly binding constraint on land supply over time (see for example Grimes and Liang, 2007). It should be noted that land availability and release does not appear to be an issue in all regional markets in New Zealand. For example, there is anecdotal evidence of ample subdivided land on the market in Northland and Central Otago.

There are also claims of undesirable instances of 'land banking' in Auckland where owners of land within MULs have restricted land release, or placed restrictive covenants, either to prevent certain developments proceeding on the land or to ultimately prevent the land from being purchased by certain household and social housing providers (Commerce Select Committee, 2008). Moreover, where the price of bare land within the MUL is rising, there is an incentive for land owners to bank land in anticipation of future price increases.

Q32 *Has there been a reduction in the rate of land release, either at the urban fringe or in in-fill areas? If so, why?*

Q33 *Are local authorities' land release policies enabling or constraining the supply of land for development?*

Q34 *What is the likely minimum lead time for release and development of new land and housing?*

Q35 *Is land release delayed unnecessarily either by inadequate supply of infrastructure services or a lack of responsiveness on the part of infrastructure service providers? If so, to what extent is this affecting development costs?*

Q36 *Are the planning policies that are designed to encourage higher density housing consistent with, and flexible enough to accommodate, changing community preferences?*

Q37 *Is there evidence of 'land banking' by some developers? Is this a problem?*

THE URBAN PLANNING SYSTEM

The planning system that regulates housing supply in New Zealand is governed by the following legislation.

- The Resource Management Act 1991 (RMA) provides for the sustainable management of land and land-use development based on environmental impacts.
- The Local Government Act 2002 (LGA) provides guidance for local authorities infrastructure and investment plans and the power to impose development levies.
- The Land Transport Management Act 2003 (LTMA) provides a framework for national and regional transport strategy, planning and funding.
- The Historic Places Act 1993 also plays a role in urban areas.

This statutory framework governs the development of national policy statements, national environmental standards, regional policy statements, and regional and district plans implemented by local authorities. Thus, the planning system is complex.

Criticism of the New Zealand planning system has focussed on the complexity and fragmentation of the regulatory framework governing the system. This arises because each of the three different statutes has different legal purposes, timeframes, processes and criteria that are not designed to work together (Ministry for the Environment, 2010). Development proposals are broken down into economic, infrastructure and environmental components and examined separately according to the relevant legislation. This disconnect can make it difficult to achieve quality integrated urban development. It can also create uncertainty for developers over whether appropriate infrastructure and services complementary to housing will be installed to support new residential construction (OECD, 2011). This uncertainty is exacerbated to the extent that there are different interpretations and application of the relevant legislation across different local authorities.

With multiple participants and decision-makers, there is no single mechanism for facilitating engagement, securing agreement among participants and providing information for robust decision-making. Rather, there is the tendency to focus on specific single elements of the urban environment covered by any particular Act. For example, the Ministry for the Environment (2010) note that the effects-based nature of the RMA, as the primary land-use planning legislation, means there is limited capacity to adequately consider the value created by urban development, and good urban design, beyond effects on amenity value. Fragmented regulatory responsibilities and decision-making can make it difficult for the private sector to engage effectively with the planning system (and can make engagement costly, uncertain and risky).

Q38 *Is the current planning regulatory system more complex and fragmented than it needs to be? Does the planning system include elements that detract from quality urban development and impose unnecessary costs and uncertainty on developers?*

Q39 *How could urban planning and development be improved to better integrate strategies for land use, economic development, transport and infrastructure?*

Planning controls affect the sub-division of land and can also dictate the type of buildings constructed on a particular piece of land. These controls are designed to protect a host of legitimate public and private interests by ensuring that certain conditions are met before a planning consent is granted by the local authority.

Q40 *Do local authority planning schemes and approval processes create unnecessary costs? If so, how could they be improved?*

Q41 *Do external or third-party appeal mechanisms unnecessarily delay planning approvals?*

8 Infrastructure charges

Making more land available for housing will not necessarily result in a corresponding increase in housing construction. The conversion of undeveloped land to residential use requires the construction or augmentation of infrastructure and network services.

There are broadly two types of infrastructure:

- *Economic* infrastructure provides services such as water, sewerage, drainage, electricity, gas, telecommunications, refuse and recycling facilities, public transport, and roads. This can be either on-site (private) and specific to a development or off-site (shared) and service other developments.
- *Social* (or community) infrastructure is used to provide a range of community and recreational services; for example, public libraries, schools, community centres, sports grounds and parks.

There are two pricing mechanisms (infrastructure charges) currently used by local authorities that aim to capture the full economic and social infrastructure costs of land development: *Financial contributions* and *development contributions*. Financial contributions are levied by regional and territorial local authorities under the RMA to fund capital expenditure necessary to limit the environmental effects of developments. *Development contributions* are levied by territorial and local authorities under the Local Government Act 2002 and commonly used to fund capital expenditure on infrastructure needed to accommodate growth (where there is a direct causal link between the need for such capital expenditure and a development).

By requiring developers to internalise environmental externalities and share the costs of new infrastructure investment, a charge on users better reflects the true economic costs, promotes efficiency by discouraging excessive development and helps ensure efficient locational decisions are made. Conversely, infrastructure charges may discourage worthwhile development if set too high. There are well established principles for when and how infrastructure charges should apply (Box 3).

Box 3 **Principles for infrastructure charges**

Developer charges, and charging for infrastructure generally, should be:

- *necessary* – with the need for the services concerned clearly demonstrated
- *efficient* – justified on a whole-of-life cost basis and consistent with maintaining financial disciplines on service providers by precluding over-recovery of costs
- *equitable* – with a clear nexus between benefits and costs, and only implemented after industry and public input
- *accountable* – revenues need to be spent on the infrastructure for which it was collected.

Source: APC, 2004, Victorian Government, 2004.

The impact of developer charges on housing affordability has long been the subject of debate. Local authority infrastructure charges are a sizable component of new housing construction costs (Box 4). There is also a view that these charges have been rising in recent years as Councils increasingly charge developers for general infrastructure services rather than funding them from local authority rates or central government funding from general taxation (House Prices Unit, 2008). The House Price Unit calculated that section prices increased by 115 per cent between 2001 and 2008 as a result of development levies, increased interest charges and developers' margins. The Shand Inquiry reported that development contributions alone are expected to increase from an aggregate of $224 million in 2006/07 to $447 million in 2015/16 (Shand, Horsley and Cheyne, 2007). There also appears to be considerable variability between local authorities as to when the charges apply and how much they should be (House Prices Unit, 2008).

Concerns expressed (by, for example, the Local Government Forum and Property Council New Zealand, 2010) about the role of infrastructure charges have included the following:

- Development and financial contributions lack transparency and weaken the accountability of elected representatives.
- Infrastructure charges being inappropriately imposed on individual developments, when they should be spread more widely.
- Upfront infrastructure charges or standards for infrastructure provision that are excessive for their given purpose, sometimes because of 'gold plating' to minimise future maintenance costs for local authorities (which are generally funded from rates) and the tendency to front load infrastructure charges rather than spreading them over the life of the asset.
- The level of spending on infrastructure is often determined politically or administratively, without regard to the willingness of users to pay. As such, it is claimed that infrastructure charges are a selective tax rather than a price charged for goods and services supplied.
- Residents of developments effectively paying twice for some infrastructure through both upfront charges and rates or on-going charges (double charging).
- Funds not being spent on the designated purpose.
- Lack of scope for, or excessive costs in, appealing against particular charges or requirements.

Box 4 **Case study of development contributions**

Development levies vary across the country. Case study evidence obtained from the Department of Building and Housing provides the following examples of charges:

- Porirua City Council recreation and civic development contribution of $5,228 for each new dwelling in 2006/07.
- Tauranga City Council charges between $11,850 (plus 5.9 per cent of land value) and $32,750 (plus 3.4 per cent of land value) per subdivision lot.
- Auckland City increased charges from $7,000 in 2006 to potentially up to $40,000 per unit from July 2007, including higher charges for central city residential developments.

Source: House Prices Unit, 2008.

Q42 *What infrastructure costs should be recovered through infrastructure charges? Should the costs of providing services such as schools, parks and libraries be recovered via infrastructure charges?*

Q43 *Are current infrastructure charges justified by the efficient cost of providing services? Is there evidence of over-recovery of infrastructure costs?*

Q44 *Is the basis for calculating infrastructure charges transparent? Is it subject to undue discretion by local authorities?*

Q45 *Are there different regional or local features that justify different approaches to when and how to apply infrastructure charges?*

Q46 *Are infrastructure charges an equitable and efficient way of funding infrastructure services?*

Q47 *Do infrastructure charges become fully capitalised into the value of the land?*

Q48 *What alternative methods of funding could deliver fairer and/or more efficient outcomes?*

9 Building controls

Local authorities have an important role in regulating the quality, safety and amenity of buildings, as well as their environmental impacts.

The construction of dwellings is therefore subject to a variety of building controls and regulation affecting how dwellings are designed, built and maintained. The Building Act 2004 introduced a new regulatory framework for building. This new regulatory framework was in large part a response to a system failure of the building control system (including design, construction and inspection) to prevent leaky buildings.

The new regime has the potential to increase costs of building. One study of the regulatory impact of the Building Act estimated that the new regime would add about 2.9 per cent to the cost of building a new dwelling (PricewaterhouseCoopers, 2003). Obviously any assessment of the framework needs to account for the potential benefits in order to judge the overall impact on housing affordability. For example, the potential for better quality construction with fewer defects and lower ongoing maintenance and repair costs. This recognises that setting higher initial requirements for building can result in lower whole-of-life costs. There may also be possible indirect benefits such as improved health outcomes.

Q49 *What effect have the 2004 changes to Building Act had on housing prices and affordability?*

Q50 *What evidence exists of unnecessary or inappropriate regulation of building? Is there evidence that such regulation is adding unnecessarily to building costs and that the cost of building regulation exceed the benefits?*

Q51 *Compared with overseas, are there specific New Zealand conditions or peculiarities that necessarily require additional or more costly building controls and standards? For example, New Zealand's geography, topography, seismic activity, wind conditions, water quality, etc.*

Q52 *To what extent does the building code encourage or accommodate medium to high density housing?*

The House Prices Unit (2008) reported that developers consider building consent approval times have increased in recent years. Factors affecting the delays include innovative development proposals being treated more cautiously by authorities, due to the leaky homes problems. There have also been claims of inadequate local authority staffing, lack of experienced staff and recruiting difficulties.

Q53 *Is there evidence of unnecessary delays in approving building consents? If so, what factors are causing any delays and how could the approval processes be streamlined?*

10

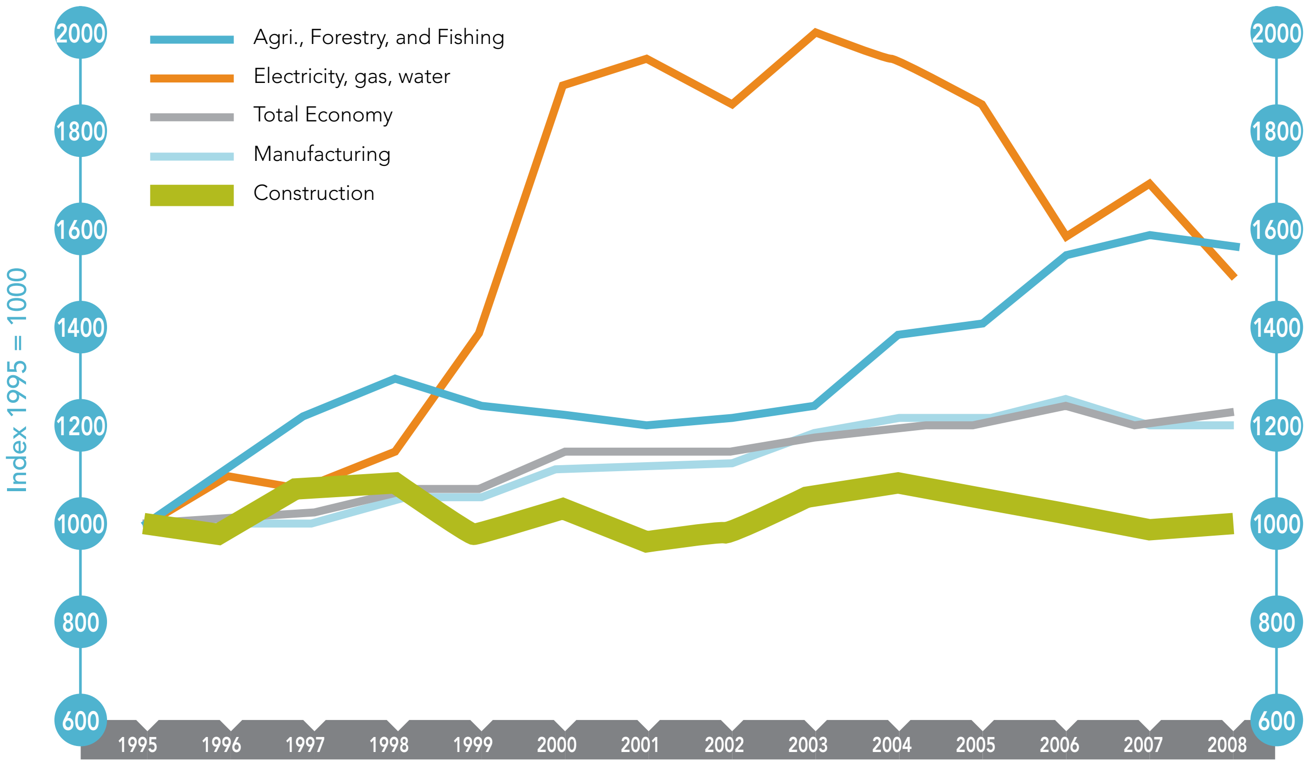
Performance of the building and construction industry

The productivity performance of the building and construction sector matters to the affordability of housing in New Zealand and the wider economy.

In a typical year, the building and construction sector builds about 24,000 new homes and renovates approximately 32,000 existing homes; builds $4 billion worth of non-residential building; employs about 178,000 people (as at December 2008); and contributes approximately five per cent to New Zealand's GDP (about the same as the agriculture, on-farm, sector), with spillover (multiplier) productivity effects to other sectors and industries (Building and Construction Sector Productivity Taskforce, 2009).

Productivity in the building and construction sector is low, relative to other countries and other sectors of the New Zealand economy, and labour productivity has been flat over time (Figure 6) (Building and Construction Sector Productivity Taskforce, 2009).

Figure 6 **Labour productivity by industry**



Source: Building and Construction Sector Productivity Partnership, 2011.

Low productivity in the construction sector translates into higher than necessary construction costs. Indeed, work by the House Prices Unit (2008) shows that construction costs, and building costs more generally, have increased significantly since 2001 therefore putting upward pressure on house prices. Specifically, since 2001:

- the cost of building a new house has generally increased in line with house prices;
- the cost of labour and builders' margins increased by over 88 per cent;
- the cost materials increased by around 50 per cent; and
- the cost of sections has more than doubled (115 per cent).

Furthermore, recent work by the OECD (Caldera Sanchez and Johansson, 2011) suggests that increasing construction costs in New Zealand are an important factor in explaining housing supply rigidities (Figure 7).

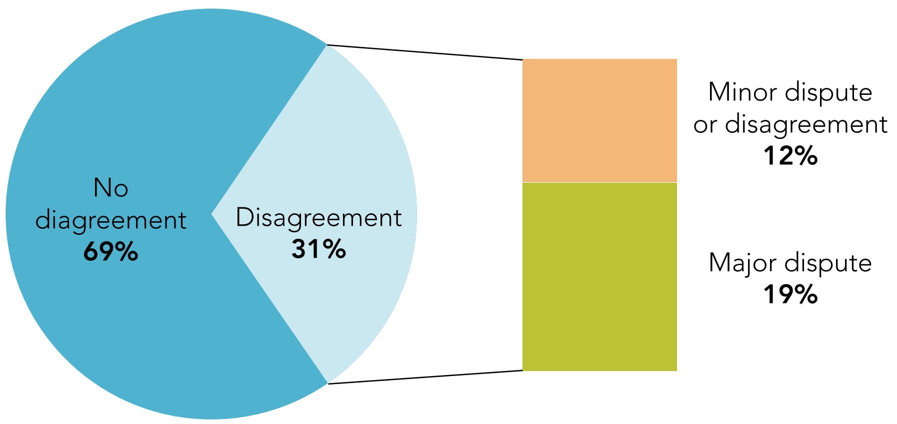
Figure 7 **Housing supply has fallen below long run levels (percentage)**

Source: Statistics New Zealand, QVNZ, OECD (2011) calculations.

A number of reasons have been suggested for low productivity in the New Zealand building and construction sector:

- Shortage of necessary skill (important in labour intensive industry), high job churn, very low innovation (by and large, construction is done the way it has always been done), procurement practice (for example, buildings being unnecessarily complex to build due to design issues), poor management capability (many small businesses and owner operators) and inefficient regulation (see Building and Construction Sector Productivity Taskforce, 2009).
- It is difficult to take advantage of economies of scale as New Zealand has a highly customised and labour intensive approach to residential construction. This means builders tend to be small businesses dealing with individual clients, with most construction individualised and most work carried out on site, rather than by assembling prefabricated materials that have been manufactured off site (House Price Unit, 2008).
- Geographic dispersion of local markets tends to raise unit costs for most construction materials relative to other countries (OECD, 2011). High transport costs result in more separated plants of a smaller scale, at a level well below world scale, thereby resulting in higher unit costs for most material compared with overseas and less local competition (Page, 2009). The competitive environment for building materials was also raised as an issue by the Commerce Committee in their inquiry into housing affordability. The Committee noted that while the level of competition is fierce among merchant chain businesses, submissions raised concerns that the market structure for building material suppliers was less competitive (Commerce Select Committee, 2008). For many materials there are just one or two manufacturers within New Zealand and this lack of competition may be influencing prices (Page, 2009).
- There is evidence of major rework in the building sector due to disagreement between homeowners and builders on the quality of work completed (Figure 8).

Figure 8 **Proportion of homeowners commissioning building work who experience a disagreement**



Source: Department of Building and Housing (2010).

Q54 *Are construction costs higher than they need to be? If so, why?*

Q55 *Have rising construction costs contributed to rising housing prices and affordability in New Zealand? Have construction costs increased because the level of building activity has risen more rapidly than supply capability? What other factors are relevant?*

Q56 *To what extent is the market structure and lack of economies of scale in the New Zealand market a factor in driving the costs of building materials? What are the barriers to achieving greater economies of scale in New Zealand?*

Q57 *Are there any concerns with the level of competition in the building materials market or any other part of the building and construction supply chain?*

Q58 *Why is there not more standardisation in New Zealand's building and construction sector? Is this driven by consumer preferences or industry approach?*

Q59 *Have skill shortages in the housing and construction industry contributed to rising housing prices and reduced affordability? Are such shortages temporary or are there long-term issues? Have the costs of skills shortages been more significant in particular regions? What impact will the Christchurch rebuild have on skill shortages in the housing and construction industry nationally?*

Q60 *Are there differences in productivity between residential and commercial construction sectors? If so, what is driving these differences?*

Q61 *Why does there appear to be a high level of rework in the building sector? To what extent is poor quality due to poor design, low skill levels or poor supervision?*

11 Population and demographic change

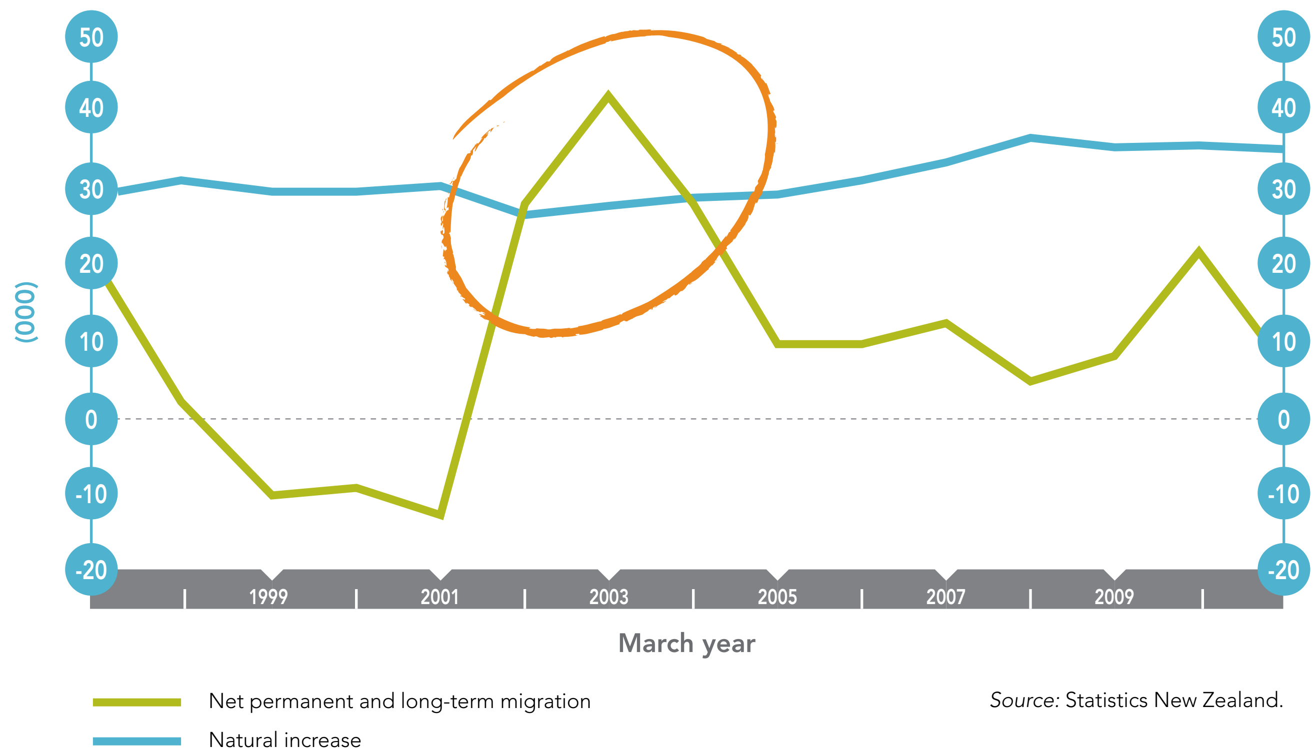
Population and demographic trends influence housing demand and prices.

Population growth occurs through natural changes in the population (births and deaths) and through patterns of inward and outward migration.

The population of New Zealand has been steadily rising and is forecast to continue, with the size of the population expected to reach five million within the next 20 years, underpinning demand in the future (House Prices Unit, 2008).

A significant driver of population growth in New Zealand is migration flows (Figure 9). Migratory flows can be large and volatile in New Zealand thereby placing significant pressure on housing demand. For example, net inflows in 2002 and 2003 combined to almost 2 per cent of the entire New Zealand population and have remained positive every year since (OECD, 2011).

Figure 9 **Components of annual population change**



Source: Statistics New Zealand.

The effect of population growth on housing demand will depend in part on where this growth has been concentrated and what impact it has had on demand for housing in different cities and regions (both recently and in the longer term). At the same time, domestic migration can change the impact and pressures on housing demand in particular locations. For example, the House Prices Unit (2008) note that, between 2001 and 2006, the growth in the population of Auckland accounted for 47 per cent of the population growth of New Zealand as a whole. However, during this period, 76,000 people moved out of Auckland to another region of New Zealand. Over the same period, around 59,000 people moved into Auckland from another New Zealand region, giving a net loss of population for Auckland from internal migration.

Q62 *To what extent has immigration influenced overall housing demand? Has it been a significant factor in the recent surge in housing prices? Has the influence of immigration on housing prices been uniformly distributed?*

Q63 *Where has population growth contributed most to rising housing prices?*

Q64 *Has population growth been concentrated in the major regional cities? If so, why? Is this changing?*

Changing household characteristics and preferences such as age, size and structure can also have long-term effects on demand, and therefore housing prices. For example, a decline in the average size of households will generally require an increase in the housing stock. This has been the case in New Zealand where the average number of persons per dwelling has fallen and the growth in the number of households has increased at a faster rate than population growth. According to the House Prices Unit (2008), the increase in household formation is a result of a decline in the proportion of households made up of couples with children and an increase in both the share of one-person and couple-only households. These trends are projected to continue as we see an ageing of the population in New Zealand which contributes to more people living for longer periods on their own.

Q65 *What are the major demographic and social changes that have influenced housing demand? Have these impacted on affordability for first home buyers or affordability more generally?*

Q66 *To what extent have changes in household composition affected the demand for housing?*

Q67 *How have household preferences for housing changed? What future demographic trends will be important in influencing housing demand?*

Q68 *Does the apparent mismatch between the increasing average size of dwellings being added to New Zealand's housing stock and the projected shift to smaller households raise any market or policy issues?*

12 The role of taxation

The tax system has an important influence on the housing market primarily through affecting the returns to housing vis-à-vis other assets.

If the tax system favours housing relative to other types of assets, then demand for housing will be artificially inflated, pushing up house prices. If different types of tenure are favoured over other types, then taxation may influence tenure decisions towards or away from home ownership (Davis and Hunn, 2007).

For owner occupiers, the tax system in New Zealand exempts imputed rents (where the implicit rental benefits derived from owning one's home are taxed) and capital gains from taxation. Mortgage interest is also not tax deductible (Table 1). However, investors in rental housing in New Zealand enjoy generous tax treatment because of the absence of a capital gains tax and the extent that rental losses can be offset against other income (OECD, 2011). It is commonly suggested that excessive investment in housing has been caused by the concessional treatment of capital gains and by the tax advantage of negative gearing, thereby distorting the allocation of resources. (Although the tax arrangements for rental property investors also equally apply to investment in other asset classes.)

Table 1 **Taxation of housing in New Zealand**

Form of taxation	Owner-occupier	Rental property investor
Tax on rental income or imputed rent	No	Taxed at marginal tax rate
Capital gains tax	No	No
Mortgage interest tax deductibility	No	Deductible at marginal tax rate
Property/Land tax	Yes	Yes, deductible at marginal tax rate
Inheritance/Estate Tax	No	No
Transfer taxes or stamp duties	No	No
GST	No GST on imputed rent. GST is imposed on the cost of building new houses.	No GST on rent. GST is imposed on the cost of building new houses.

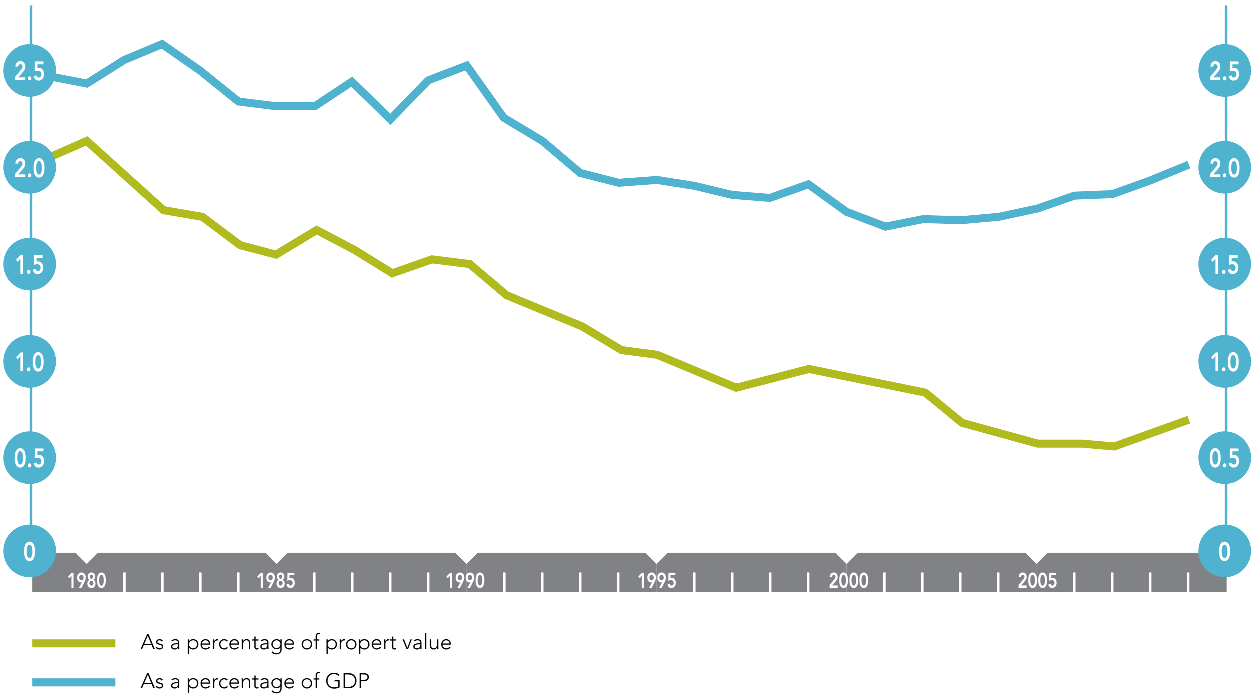
Source: Inland Revenue Department.

The Commission will need to look at the effects of different taxes on trends in the cost and affordability of housing, as well as on the efficiency of housing markets and the wider economy. For example, some argue that the favourable tax treatment of rental housing has driven a significant increase in investor demand which, in turn, has exacerbated other factors increasing the demand for housing and crowding out marginal first home buyers from the market (Davis and Hunn, 2007).

Estimates prepared by the House Prices Unit (2008) suggest that the ability to deduct losses from rental properties increases the value of a medium-price house to the investor by $25,000.

Rates are a form of tax on property. Local authorities have the discretion to set rates in order to cover costs. The imposition and level of property tax does not appear to be impacting on the New Zealand housing market. Revenue from local authority rates averages 2 per cent of GDP as of 2008 (about the OECD average) but has declined as a percentage of housing values — from 2.2 per cent in 1980 to 0.65 per cent in 2008 (OECD, 2011). See Figure 10.

Figure 10 **NZ average local property taxes (2008 or latest available year)**



Source: IBFD (2009), Reserve Bank of New Zealand and OECD calculations.

Q69 *How have taxes affected price and affordability outcomes in the New Zealand housing market, especially for first home buyers?*

Q70 *To what extent, and in what way, is the tax treatment of investment housing concessional relative to other income earning assets? If so, has this contributed to inflated demand and prices?*

Q71 *Does the New Zealand tax system influence tenure decisions towards or away from home ownership?*

Q72 *What is the impact of local property taxes (rates) on housing demand? How does the overall burden of taxation on housing in New Zealand compare with other countries?*

13 Macroeconomic influences

General macroeconomic factors are known to be important determinants of housing demand and, in turn, real house prices and affordability.

For example:

- House prices rise strongly with increases in household disposable income. A rise in incomes means people have more financial capacity to purchase a first home or upgrade to higher quality housing, thereby pushing demand up leading to price rises (OECD, 2010).
- Reductions in unemployment, to the extent that household incomes rise permanently, affect housing demand and lead to price increases. Low unemployment is also likely to raise confidence levels and peoples' willingness to take on high levels of debt.
- Real interest rates are on average, negatively related to house prices. Lower interest rates make housing more affordable and increase demand for houses resulting in higher house prices (Andre, 2010).
- The impact of an increase in (consumer price) inflation is ambiguous and can generate either a negative or positive impact on demand (Andrews, 2010).

Conversely, as the recent global economic and financial downturn illustrates, the housing market can have serious impacts for the wider economy. This is because instability or volatility in housing markets is transmitted to the wider economy through its link to house prices, credit constraints and household consumption and indebtedness.

Until the recent global financial and economic downturn, New Zealand experienced an unusually long period of sustained economic growth. During the house price boom, real GDP increased 19.4 per cent between December 2001 and June 2007 (House Prices Unit, 2008). This period of economic growth has been associated with an increase in average household incomes, rising employment and labour force participation, lower unemployment and low inflation. Real interest rates were also relatively low for a sustained period, although rates increased near the end of period. Together, these factors have helped to lift demand for housing from both owner-occupiers and investors.

Q73 *Has growth in household incomes been a major factor affecting housing demand, prices and affordability?*

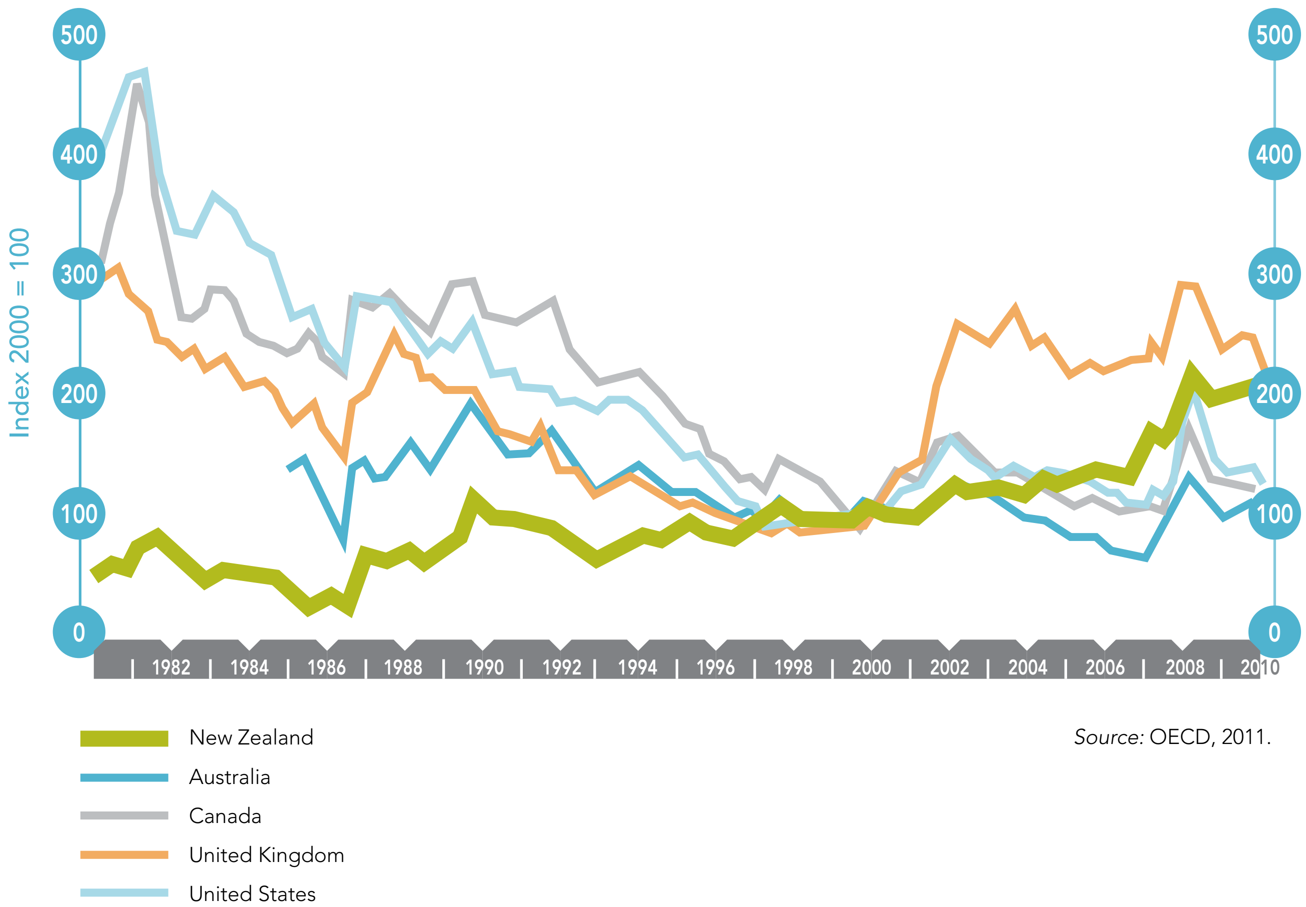
Q74 *To what extent have changes in real and nominal interest rates over the last decade stimulated demand and increased housing prices?*

Q75 *To what extent have housing prices been affected by labour market developments including relatively low unemployment rates during the housing boom period and increases in casual employment?*

Q76 *What other macroeconomic factors have influenced housing prices and affordability?*

Investor and overall activity in housing markets might also depend on the returns available from other types of investments and asset, such as equities. A cross country analysis by the OECD of housing prices relative to equities across three decades shows no tendency for property to systematically outperform stocks over the long term (Figure 11). However, in New Zealand's case, homeowners would, on average, appear to have received superior returns compared to equities over the late 1980s and most of the 2000s (OECD, 2011).

Figure 11 **House prices relative to share prices**



Source: OECD, 2011.

Q77 *To what extent have housing prices been affected by the recent performance of equity markets?*

Q78 *How have returns on investment in housing moved over time and relative to other assets?*

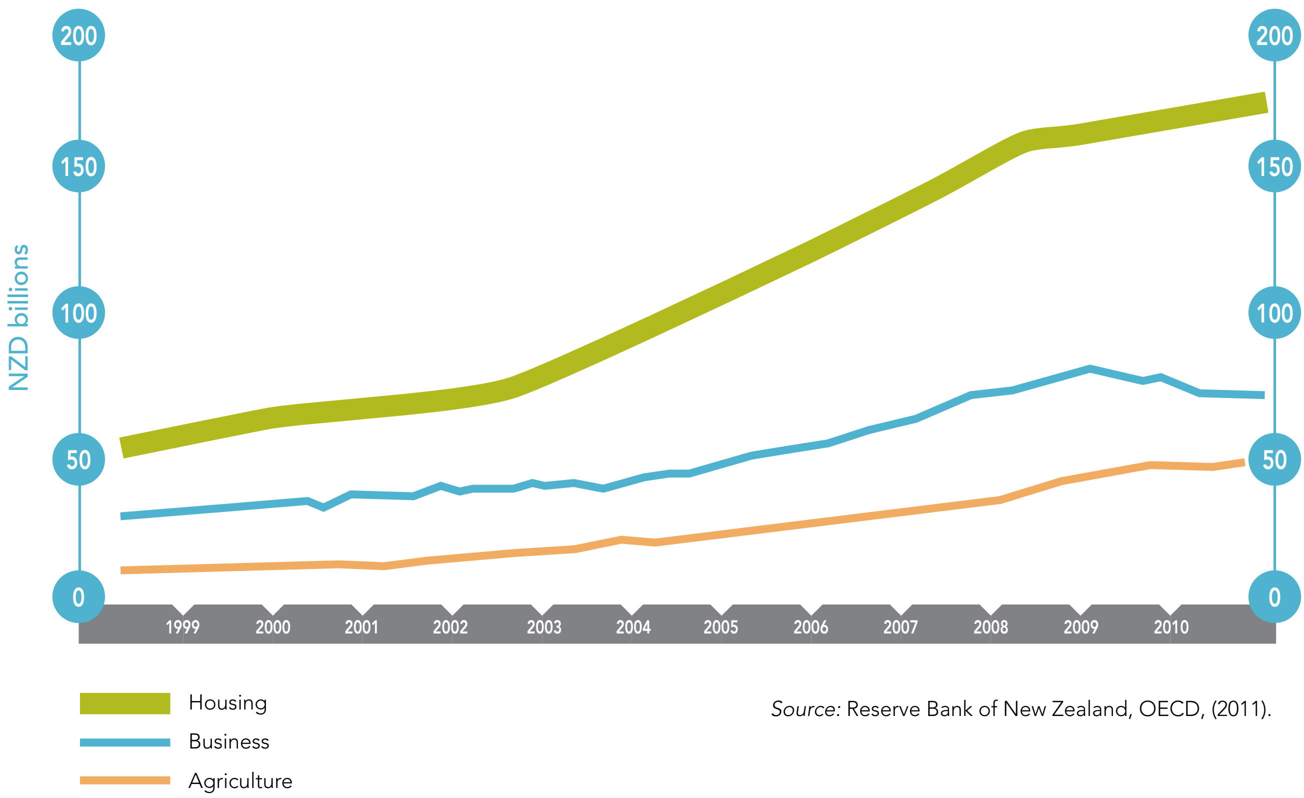
14 Availability of finance

The deregulation of capital markets in New Zealand has made mortgage finance for housing much more attainable and competitive.

For example, previously it was often necessary to have a substantial savings record with the bank from which finance was sought. Banks would generally not lend more than 75 per cent of the value of the house and impose limits on the size of repayments relative to income, generally 20-30 per cent (Coleman, 2007). Deposit requirements and borrowing limits were also far more restrictive.

Greater competition among housing lenders (including the advent of mortgage originators and brokers) has made it much easier to obtain loans, and may have contributed to lower interest costs by reducing lending margins. Increased competition has also resulted in many new finance products and services, expanding the scope for borrowing and contributing to increased demand for owner-occupied and investor housing. There has also been an increase in lending by the financial sector for housing, with residential mortgages accounting for over 50 per cent of total bank and non-bank financial institution loans (Figure 12).

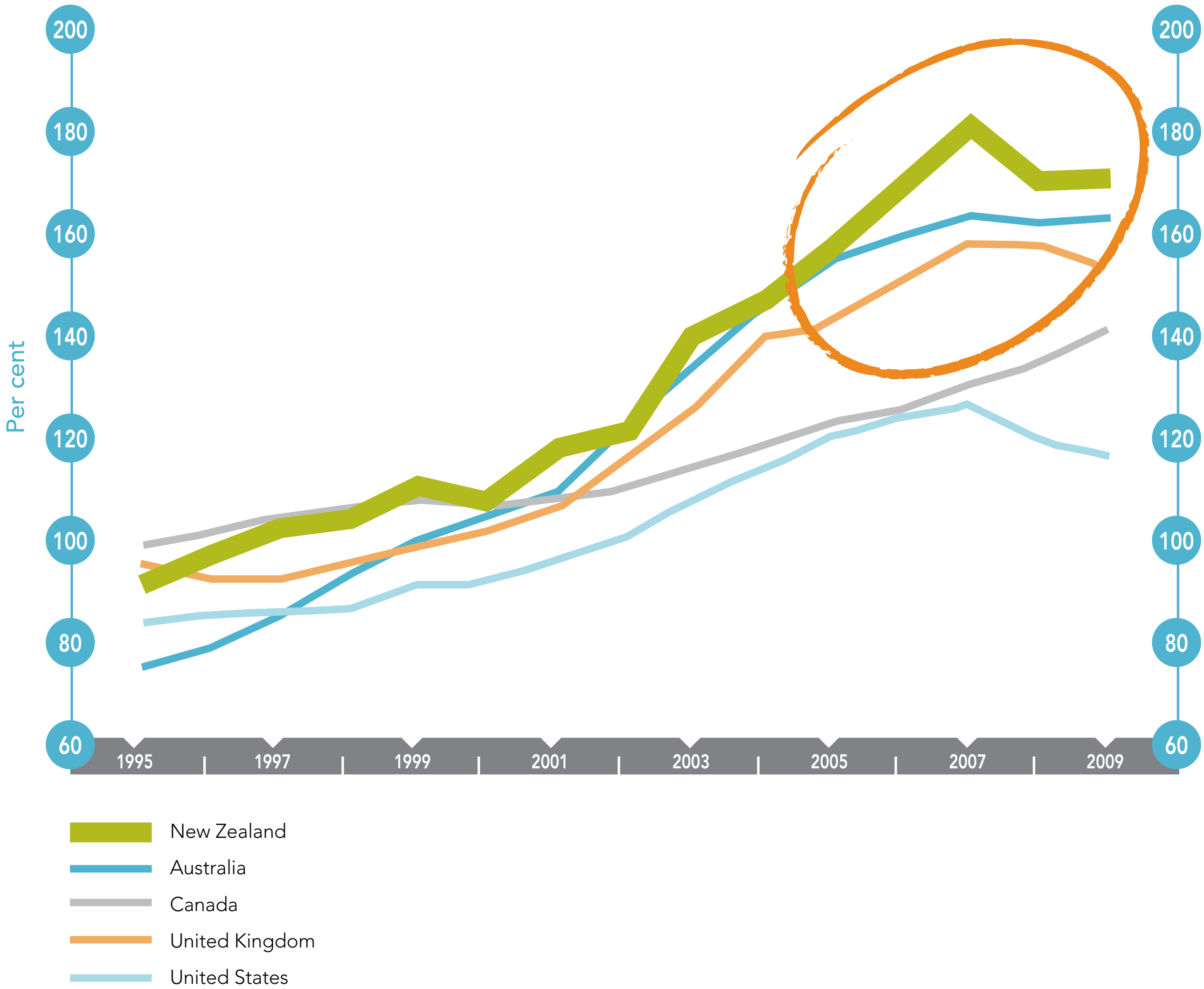
Figure 12 **Lending by financial institutions to housing, business and agriculture**



Source: Reserve Bank of New Zealand, OECD, (2011).

Cheaper and more accessible housing finance effectively increases the purchasing power of home buyers through increasing the mortgage potentially obtainable as well as elevating the price of a home that can be 'afforded' for a given budget or income. Home owners could choose to 'trade up' to an improved (larger, nicer, better located) house, or upgrade their existing home. It also means aspiring first home owners could buy sooner (APC, 2004). Certainly, household debt levels have accelerated since the early 2000s and remain close to 170 per cent of disposable income, which is high by OECD standards (OECD, 2011) (Figure 13).

Figure 13 **Household debt[1] as a percentage of gross disposable income**



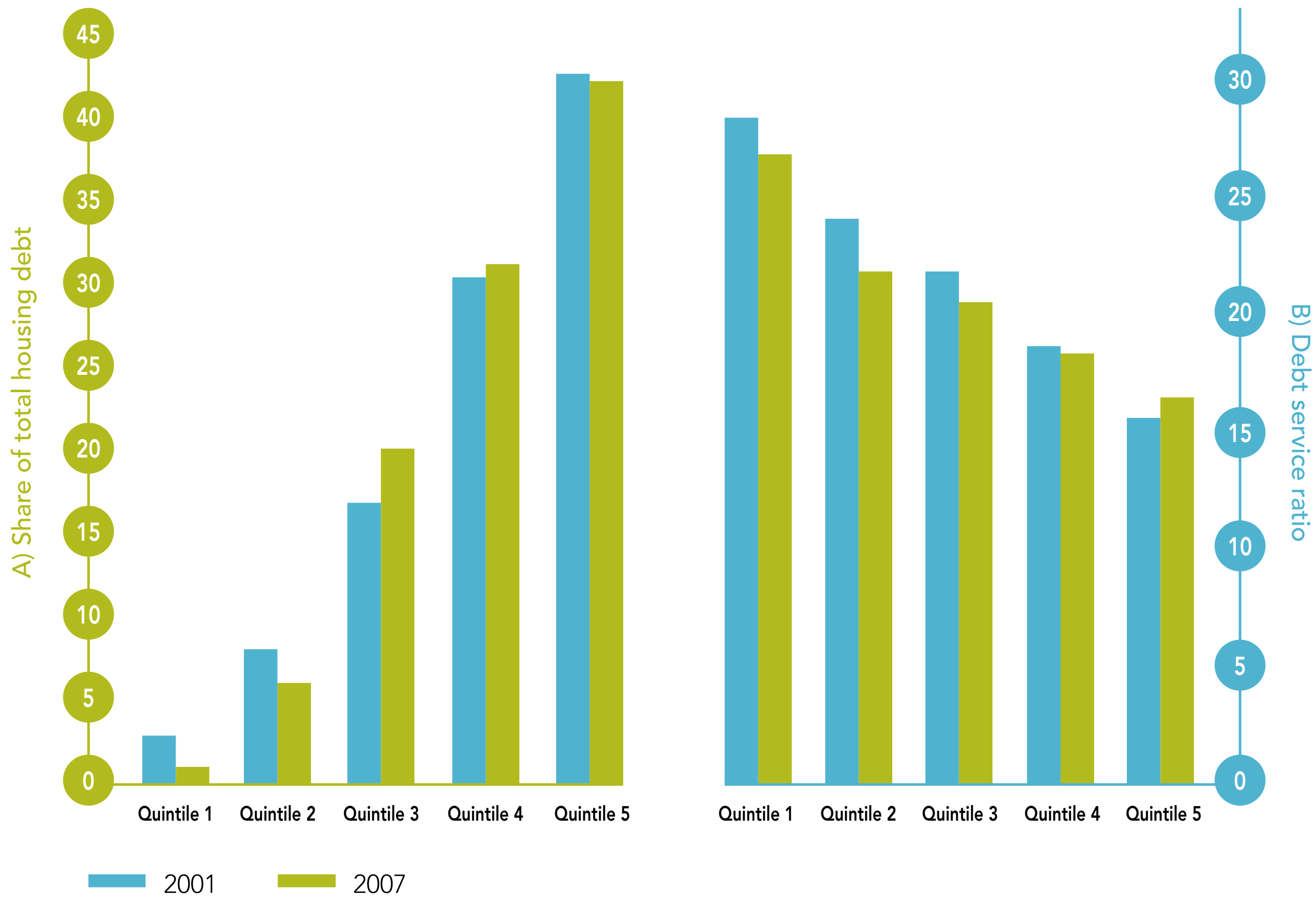
1. Short and longterm loans.

Source: Statistics New Zealand and OECD National accounts database.

In order to get a complete picture of New Zealand household indebtedness, this average trend needs to be unpacked to determine both the level of household debt by income quintiles and debt-service burdens by income quintiles. Figure 14 shows that most mortgage debt in New Zealand tends to be held by higher income households, with the top two income quintiles accounting for almost three quarters of the total debt levels (Kida, 2009).

Analysis by the Reserve Bank shows that declining house prices would most affect those with elevated loan-to-value ratios, who tend to be high-income households (Figure 14, Panel A). On the other hand, a shock to interest rates or income would impact those with high debt-service burdens that are concentrated among low-income households (Figure 14, Panel B).

Figure 14 **Household debt across income quintiles**



Source: Reserve Bank of New Zealand.

However, the indebtedness picture may be overstated. Analysis of data from the 2007 Household Economic Survey suggests that only 50 per cent of homeowners have a mortgage, representing only 35 per cent of all households (Kida, 2009). In addition, only 0.1 per cent of indebted households (in 2007) would be considered highly vulnerable, as defined by having loan-to-value ratios above 80 per cent or debt-service ratios above 55 per cent. In any case, mortgage delinquency rates in New Zealand have remained relatively low at 1.3 per cent in the first half of 2010, as compared with 10 per cent in the United States (OECD, 2011).

Q79 *How has financial product innovation in home lending, and changes in lending practices, contributed to increasing demand for owner-occupied and investor housing, and house prices? Have the levels of financial product innovation and lending practices changed since the economic downturn?*

Q80 *Are capital markets meeting the needs of home buyers, in particular first home buyers?*

Q81 *To what extent is the financial sector overly exposed to property markets? Should this be a problem? Has the cooling in the housing markets since the economic downturn made a difference to exposure levels?*

Q82 *Are household debt levels in New Zealand a concern? Given household debt levels, what vulnerabilities present the greatest risk to capital markets?*

15 Relative costs of renting versus owning

New Zealanders have always had a strong culture of home ownership.

While many people may have a strong preference for home ownership, demand at a particular point in time will also be influenced by the relative cost and availability of rental accommodation.

For example, a reduction in rents brought about by an increase in the supply of rental properties will cause some households to delay moving into owner-occupied housing, all other things being equal.

The relative cost of renting and ownership (for a similar level of 'housing service') may be influenced by a number of factors. Examples include, differences in risk, transaction costs, tax treatment, interest rates, depreciation and maintenance costs, anticipated capital gains and vacancy rates in the case of rental properties. Tenure decisions are also influenced by borrowing constraints (the ability to obtain an adequate mortgage) and accumulated wealth (to pay the necessary deposit on a house). Households' perception and preferences for risk are also important drivers of tenure choice. For example, the desire for security of tenure is a key driver of home ownership (OECD, 2010a).

In New Zealand, while house prices increased sharply relative to disposable income during the housing boom, rent increases remained relatively muted, at roughly the pace of CPI inflation. As a result the price-to-rent ratio increased dramatically from 2001 to 2007 (OECD, 2011). See Figure 15 which can be interpreted as the cost of owning relative to renting a house.

Rent allowances provided by government also affect demand for rental housing and affordability. Almost 70 per cent of government expenditure on social housing assistance is provided to people living in private accommodation through the Accommodation Supplement, with more than half of private renters receiving the Accommodation Supplement and 4 per cent of homeowners (OECD, 2011).

Q83 *What are the benefits of owning rather than renting a home, and visa versa? Given the choice, is the preference for renting over home ownership becoming more common in New Zealand?*

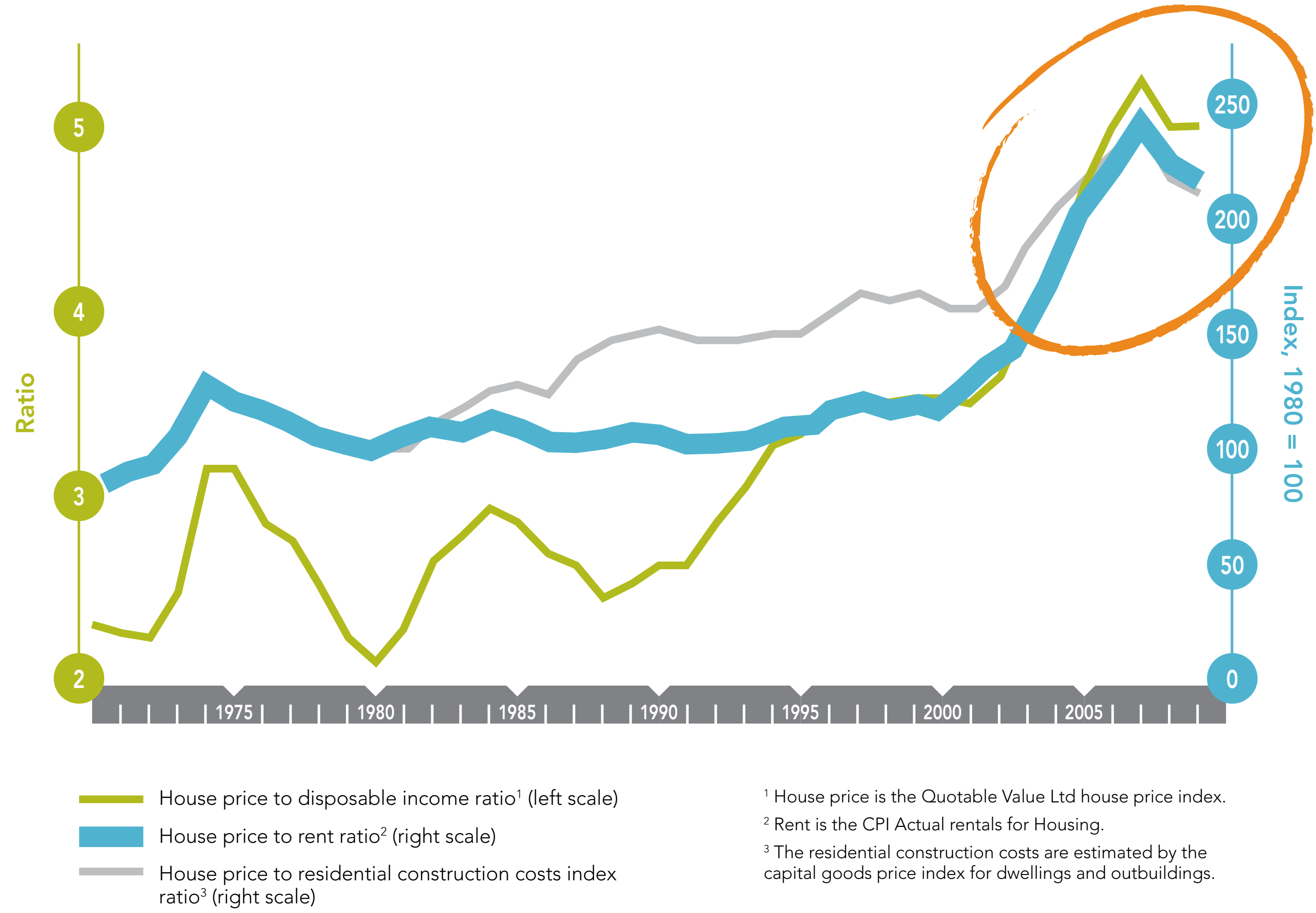
Q84 *How responsive is the demand for owner-occupied housing to changes in rental costs? Do other factors such as borrowing and wealth constraints have a greater influence on home buyer decisions?*

Q85 *Have changes in the costs of renting and ownership caused changes in the level of first home ownership?*

Q86 *Has investor activity influenced the relative cost of renting and home ownership?*

Q87 *To what extent does the design and administration of the Accommodation Supplement influence housing consumption, tenure choices or affordability?*

Figure 15 **Housing price ratios**



[1] House price is the Quotable Value Ltd house price index.
[2] Rent is the CPI Actual rentals for Housing.
[3] The residential construction costs are estimated by the capital goods price index for dwellings and outbuildings.

Source: Statistics New Zealand; Reserve Bank of New Zealand; Girouard et al. (2006); OECD Main Economic Indicators database; OECD calculations.

What are the key drivers of the decline in home ownership rates?

What effect has investor activity in housing markets had on housing prices and affordability?

What factors have caused recent housing price increases?

A summary of the questions

The Commission's approach

Q1 How should the Commission think about the concept of housing affordability – its meaning and measurement? Should the Commission focus its work on affordability as it impacts on lower income households or should the focus be broader and examine the market as a whole?

Q2 Does this stylised framework (Figure 1) capture all the important determinants of housing affordability? Are there others that are important?

Q3 Is there a more appropriate framework for examining the housing market and issues of affordability?

Recent trends in housing markets

Q4 What factors have caused recent housing price increases? Are some of them temporary?

Q5 What evidence is there that there was a 'bubble' in housing prices? Were house prices previously undervalued?

Q6 What effects have price rises in housing had on the affordability of home ownership?

Q7 Are median price trends representative of trends within housing sub-markets?

Q8 What is the best way to segment the market, and are there significant house price variations confined to specific market segments?

Q9 Why have different parts of New Zealand (cities and regions) experienced different trends in housing prices?

Q10 How should affordability for home buyers/owners be defined and measured, both in principle and in practice (taking account of data availability)? Is it possible to assess affordability using a single measure?

Q11 What has happened to affordability over time and what has caused this? Is it lower now than at times in the past? Does it reflect different influences to previous episodes of declining/ increasing affordability?

Q12 Do affordability trends differ for first home buyers with different income and household characteristics?

Q13 Do they capture adequately, the problems facing those on lower incomes or those in particular locations (such as the urban fringe or rural areas)?

Q14 How should affordability for renters be defined and measured, both in principle and in practice (taking account of data availability)? Is it possible to assess rental affordability using a single measure?

Q15 What has happened to rental affordability over time in relation to both house purchase prices and household incomes? Do rental affordability trends differ across different locations or for certain household characteristics?

Q16 What factors have influenced the price of renting relative to house purchase prices? Are the current rental affordability trends likely to persist, or are they temporary?

Q17 What has been the impact of existing government programmes to assist first home buyers?

Q18 What are the key drivers of the decline in home ownership rates?

Q19 To what extent are changes in home ownership levels explained by changing tenure preferences? Have changes in the New Zealand rental market been a factor in explaining declining home ownership rates?

Markets for housing

Q20 How should housing markets be defined in New Zealand? What are the key factors that distinguish housing sub-markets?

Q21 Do housing price trends for the various sub-markets differ? Are such differentials sustained or temporary?

Q22 What are the characteristics of investors in housing? How much of the recent activity in housing is coming from small, first-time investors? Has offshore investment been a feature in the New Zealand housing market? What market segments have seen the most investment activity?

Q23 What are the major factors that have influenced recent investor activity in housing markets? Is the perceived risk associated with property investment different to that of other types of investments?

Q24 What effect has investor activity in housing markets had on housing prices and affordability? Has investor activity influenced prices and affordability in all housing sub-markets, or has the effect been concentrated in particular areas such as apartments and medium-density housing in the cities or particular locations?

Q25 Why is there little institutional investment in the private rental market in New Zealand?

How much of the recent activity in housing is coming from small, first-time investors?

Are construction costs higher than they need to be? If so, why?

Why is there little institutional investment in the private rental market in New Zealand?

In New Zealand, do home owners prefer living in dense urban settlements or less dense suburban developments?

Do local authority planning schemes and approval processes create unnecessary costs?

Q26 What practices of real estate agents impact on housing prices and affordability? Has the effect been significant? Has the recently introduced Real Estate Act 2008 and stronger regulation of agents made a difference to the influence of real estate agents?

Q27 Is there scope to improve the practices of the real estate sector? If so, how? What would be the effects on housing prices and affordability?

Urban planning, design and land use policies

Q28 What are the relative costs and benefits of intensification and expansion (greenfields development) to urban planning? What research literature and overseas developments are most relevant to New Zealand?

Q29 How do these different approaches to urban planning support competitiveness and economic growth?

Q30 To what extent do these different approaches to urban planning support environmental objectives?

Q31 In New Zealand, do home owners prefer living in dense urban settlements or less dense suburban developments? What are the reasons for this preference?

Q32 Has there been a reduction in the rate of land release, either at the urban fringe or in in-fill areas? If so, why?

Q33 Are local authorities' land release policies enabling or constraining the supply of land for development?

Q34 What is the likely minimum lead time for release and development of new land and housing?

Q35 Is land release delayed unnecessarily either by inadequate supply of infrastructure services or a lack of responsiveness on the part of infrastructure service providers? If so, to what extent is this affecting development costs?

Q36 Are the planning policies that are designed to encourage higher density housing consistent with, and flexible enough to accommodate, changing community preferences?

Q37 Is there evidence of 'land banking' by some developers? Is this a problem?

Q38 Is the current planning regulatory system more complex and fragmented than it needs to be? Does the planning system include elements that detract from quality urban development and impose unnecessary costs and uncertainty on developers?

Q39 How could urban planning and development be improved to better integrate strategies for land use, economic development, transport and infrastructure?

Q40 Do local authority planning schemes and approval processes create unnecessary costs? If so, how could they be improved?

Q41 Do external or third-party appeal mechanisms unnecessarily delay planning approvals?

Infrastructure charges

Q42 What infrastructure costs should be recovered through infrastructure charges? Should the costs of providing services such as schools, parks and libraries be recovered via infrastructure charges?

Q43 Are current infrastructure charges justified by the efficient cost of providing services? Is there evidence of over-recovery of infrastructure costs?

Q44 Is the basis for calculating infrastructure charges transparent? Is it subject to undue discretion by local authorities?

Q45 Are there different regional or local features that justify different approaches to when and how to apply infrastructure charges?

Q46 Are infrastructure charges an equitable and efficient way of funding infrastructure services?

Q47 Do infrastructure charges become fully capitalised into the value of the land?

Q48 What alternative methods of funding could deliver fairer and/or more efficient outcomes?

Building controls

Q49 What effect have the 2004 changes to Building Act had on housing prices and affordability?

Q50 What evidence exists of unnecessary or inappropriate regulation of building? Is there evidence that such regulation is adding unnecessarily to building costs and that the cost of building regulation exceed the benefits?

Q51 Compared with overseas, are there specific New Zealand conditions or peculiarities that necessarily require additional or more costly building controls and standards? For example, New Zealand's geography, topography, seismic activity, wind conditions, water quality, etc.

Q52 To what extent does the building code encourage or accommodate medium to high density housing?

Q53 Is there evidence of unnecessary delays in approving building consents? If so, what factors are causing any delays and how could the approval processes be streamlined?

Performance of the building and construction industry

Q54 Are construction costs higher than they need to be? If so, why?

Q55 Have rising construction costs contributed to rising housing prices and affordability in New Zealand? Have construction costs increased because the level of building activity has risen more rapidly than supply capability? What other factors are relevant?

Q56 To what extent is the market structure and lack of economies of scale in the New Zealand market a factor in driving the costs of building materials? What are the barriers to achieving greater economies of scale in New Zealand?

Where has population growth contributed most to rising housing prices?

What are the benefits of owning rather than renting a home, and visa versa?

What impact will the Christchurch rebuild have on skill shortages in the housing and construction industry nationally?

What future demographic trends will be important in influencing housing demand?

Q57 Are there any concerns with the level of competition in the building materials market or any other part of the building and construction supply chain?

Q58 Why is there not more standardisation in New Zealand's building and construction sector? Is this driven by consumer preferences or industry approach?

Q59 Have skill shortages in the housing and construction industry contributed to rising housing prices and reduced affordability? Are such shortages temporary or are there long-term issues? Have the costs of skills shortages been more significant in particular regions? What impact will the Christchurch rebuild have on skill shortages in the housing and construction industry nationally?

Q60 Are there differences in productivity between residential and commercial construction sectors? If so, what is driving these differences?

Q61 Why does there appear to be a high level of rework in the building sector? To what extent is poor quality due to poor design, low skill levels or poor supervision?

Population and demographic change

Q62 To what extent has immigration influenced overall housing demand? Has it been a significant factor in the recent surge in housing prices? Has the influence of immigration on housing prices been uniformly distributed?

Q63 Where has population growth contributed most to rising housing prices?

Q64 Has population growth been concentrated in the major regional cities? If so, why? Is this changing?

Q65 What are the major demographic and social changes that have influenced housing demand? Have these impacted on affordability for first home buyers or affordability more generally?

Q66 To what extent have changes in household composition affected the demand for housing?

Q67 How have household preferences for housing changed? What future demographic trends will be important in influencing housing demand?

Q68 Does the apparent mismatch between the increasing average size of dwellings being added to New Zealand's housing stock and the projected shift to smaller households raise any market or policy issues?

The role of taxation

Q69 How have taxes affected price and affordability outcomes in the New Zealand housing market, especially for first home buyers?

Q70 To what extent, and in what way, is the tax treatment of investment housing concessional relative to other income earning assets? If so, has this contributed to inflated demand and prices?

Q71 Does the New Zealand tax system influence tenure decisions towards or away from home ownership?

Q72 What is the impact of local property taxes (rates) on housing demand? How does the overall burden of taxation on housing in New Zealand compare with other countries?

Macroeconomic influences

Q73 Has growth in household incomes been a major factor affecting housing demand, prices and affordability?

Q74 To what extent have changes in real and nominal interest rates over the last decade stimulated demand and increased housing prices?

Q75 To what extent have housing prices been affected by labour market developments including relatively low unemployment rates during the housing boom period and increases in casual employment?

Q76 What other macroeconomic factors have influenced housing prices and affordability?

Q77 To what extent have housing prices been affected by the recent performance of equity markets?

Q78 How have returns on investment in housing moved over time and relative to other assets?

Availability of finance

Q79 How has financial product innovation in home lending, and changes in lending practices, contributed to increasing demand for owner-occupied and investor housing, and house prices? Have the levels of financial product innovation and lending practices changed since the economic downturn?

To what extent have housing prices been affected by the recent performance of equity markets?

Q80 Are capital markets meeting the needs of home buyers, in particular first home buyers?

Q81 To what extent is the financial sector overly exposed to property markets? Should this be a problem? Has the cooling in the housing markets since the economic downturn made a difference to exposure levels?

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Q85 Have changes in the costs of renting and ownership caused changes in the level of first home ownership?

Q86 Has investor activity influenced the relative cost of renting and home ownership?

Q87 To what extent does the design and administration of the Accommodation Supplement influence housing consumption, tenure choices or affordability?

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Terms of Reference

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 on-going 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:

1. factors influencing the supply of land and basic infrastructure for residential construction;
2. factors influencing the cost of residential construction, including the effect of standards, specifications, approval and title requirements on the cost of new housing construction;
3. 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;
4. the efficiency of taxes, levies and charges imposed at all stages of the housing supply chain;
5. the efficiency of the tax treatment of owner-occupied and rental housing;
6. the influence of changing consumer housing preferences, willingness to pay, and financing costs on housing affordability; and
7. 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

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