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Getting land use incentives right

- To overcome Auckland's housing shortage, we need to incentivise the most efficient use of land, and to accurately price the cost to developers of new infrastructure across different parts of the city.
- This means it is important to remove distortions in the infrastructure costs are recouped and the way rates are levied on properties.
- Auckland Council is currently reviewing Development Contributions (DCs), the money that developers contribute to infrastructure to serve new developments.
- There are several further steps to better incentivise efficient use of land with infrastructure in place.
- These include greater use of targeted rates for infrastructure, a switch from rates based on capital value to land value and from land use to land zoning, and using a value-maximising approach to determining what and where infrastructure goes.

We estimate that Auckland is short about 44,000 dwellings and growing (50,000 according to a year-old Reserve Bank estimate, and 45,000 according to MBIE). To reduce this shortage, it is important that two economic principles are satisfied with regard to land use: land must be used efficiently, and land development and holding costs must be priced accurately.

There are at least five ways to improve how well the Auckland land market satisfies these principles. The first is already underway through Auckland Council's DC policy review. Another is being considered by the Mayor's housing taskforce recommendations. But there is still work to do to incentivise efficient land use to tackle the housing shortfall.

One: Price the cost of new infrastructure accurately

For years, existing general ratepayers have subsidised development of new building in Auckland, as DCs have not covered the full cost to ratepayers of installing infrastructure. The subsidy can reach as much as \$50,000 per new dwelling when we consider the expected price of greenfield development under the Future Urban Land Supply Strategy against what developers currently pay.

This subsidy has encouraged development of more distant greenfield areas, which is inefficient for a number of reasons, including the congestion costs it imposes on other transport network users. Land owners [receive the value gain](#) that comes from servicing raw land with infrastructure, without paying for all of it.

Auckland Council is currently reviewing DCs to align them more accurately with the actual cost of delivering infrastructure, so that existing general ratepayers don't continue to subsidise new infrastructure.

As our recent [Insights paper](#) points out, the empirical evidence shows that by and large when DCs are set at a price that more accurately reflects the costs of infrastructure, that cost is passed upstream to the land owner, not downstream to house prices. In the current system, the land owner is profiting from infrastructure being delivered on that land, subsidised at large cost to existing general ratepayers.

Two: Switch to targeted rates

We have [written before in detail](#) about the uncertain timing of funding that hobbles a DC-funded model of infrastructure growth. We advocate that once a more accurate estimate of the cost of infrastructure per new dwelling or business is established, we use targeted rates rather than DCs to recoup those costs. Importantly, the targeted rates collected would need to be the same as the DC lump-sum figure in net present value terms.

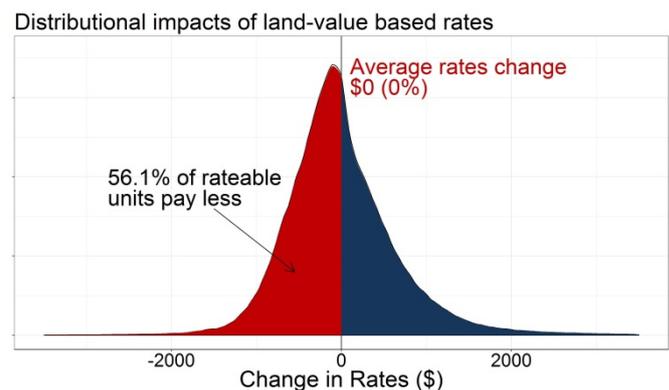
The benefits of a targeted rates approach include:

- greater incentive to develop, as land owners will not avoid paying for infrastructure by delaying development.
- greater certainty about when the money to pay for infrastructure will be collected, ensuring infrastructure development can be advanced more confidently.
- intergenerational fairness, as the cost of new infrastructure is spread over several years on properties that directly benefit from it.

Three: Rate on land value, not capital value

Most councils in New Zealand, including Auckland, charge rates based on capital values (which is land plus the value of improvements) not just land values. Yet legally, and historically, land values have been used. The disadvantage of the current approach is that it penalises development; putting houses on your land means you pay more rates than if you kept the land vacant.

That doesn't help deliver houses any faster. A switch to rating based on land value as much as possible would incentivise people to use land more efficiently, as land value is the major source of growth in property values. The Mayor's housing taskforce recommended examining the implications of switching to rates based on land value. The Chief Economist Unit has run the numbers, and a switch to rates based exclusively on land value for residential properties would reduce rates for 56% of ratepayers. Meanwhile, those with highly valued land, who are not using it efficiently, would see their rates increase, providing an incentive to use land better.



Four: Rate on zoning, not use

A further anomaly of the ratings system in some parts of the country is a rates discount or rebate (of up to 20% in the case of Auckland) on residentially-zoned properties used for rural purposes. The rationale behind the approach is that if someone is using their residentially-zoned land for sheep or carrot-growing, they're probably not accessing council services like swimming pools or libraries to the same extent.

But the large windfall gain in value that the property owner gets from residential zoning or access to infrastructure (as we [pointed out here](#)) is not based on whether they use that infrastructure or not. It is the property owner's choice if they take advantage of the available infrastructure or zoning that their property value has benefitted from. By discounting, inefficient use of land zoned for residential development is rewarded.

In Auckland, fewer than 1,400 properties are zoned "residential", but used for farming or lifestyle purposes. But this small share of the total number of residential properties (around 0.3%) accounts for 3,900 hectares (more than 8%) of available residential-zoned land.

Five: Build infrastructure for maximised value

Infrastructure should in general be in a form and location that maximises the increase in total property value in its catchment area. The economic rationale for this is that if infrastructure adds maximum value to property prices, the value of that infrastructure to the catchment area was maximised. This is because people have paid more in purchase prices or rent to live or operate businesses where they are serviced by that infrastructure.

This approach has two advantages. First, it requires councils to thoroughly evaluate if the proposed infrastructure will genuinely benefit properties around it. Second, it provides a strong empirical basis for why property owners in the infrastructure catchment area should pay for the infrastructure – their property values have directly benefitted.

Committing to this approach may mean, for example, placing a train station 300 metres further north or south on the proposed light rail route so as to maximise property value increases, but then recouping those costs through a targeted rate on properties that will benefit.

There is one caveat. At times, the objectives of a project may be different, such as optimising access to jobs via public transport for lower income households. In such cases, there may be a case for putting a station somewhere that does not maximise property values. This decision needs to be made consciously and explicitly alongside a financial case for funding from beyond the households that directly benefit from improved access.

A basket of solutions

We have pointed out that there are several steps to incentivising the most efficient use of land, and to accurately pricing the cost to develop across different parts of the city. Achieving this will go some way to eating into the housing shortage by encouraging development where it means more efficient use of land, and where the cost of development is borne by those who benefit from it.

Auckland Economic Commentary

Harshal Chitale

Senior Economist, Chief Economist Unit

- Mixed indicators reinforce our long-held view of a growing, but slower economy.
- Unemployment remains low and nominal wages have grown somewhat, while building consents have reached the highest level since January 2005.
- But tourism is flat lining, annual retail sales growth has come off its high, and house prices remain in a soggy middle ground.

Key economic trends

Net long term migration into Auckland was 34,450 for the year ended March 2018 ensuring another twelve months of strong population growth. However, the trend for net migration is one of slow decline, and we expect a further slow decline through the end of the year.

GDP growth has been strong over the past four years, driven by population and house price growth, but now but the steam may start to come off a little going ahead as net migration declines. If interest rates start to increase, particularly as US bond yields start to rise, affecting international markets, this may further weaken growth.

Strong net migration, along with strong nominal wage growth and house price rises drove demand for goods and services, including housing and infrastructure. However, flattening house prices and declining net migration mean growth in demand for goods and services is moderating.

Both residential and non-residential consents continued to increase. Non-residential consented floor area was up 24% for the year to March 2018. And the \$28 billion transport funding package announced for Auckland over the next decade will provide some longer-term confidence in the infrastructure construction pipeline. The building sector reported a solid pipeline of construction work according to NZIER's QSBO and hiring has been buoyant over the quarter. Shortages of both skilled and unskilled labour continue being felt by the sector.

Annual retail sales growth for March 2018 year was 3.8% in nominal terms or about 2.7% in real terms. Flat house prices are contributing to the continued slowdown in retail growth.

Annual guest nights in Auckland were marginally lower in the March 2018 quarter compared to a year earlier. While international guest nights increased 5.2%, domestic guest nights fell 4.6%. However, the data does not include services like AirBnB which may have increased their market share over this period.

As we reported in our previous quarterly, the profile of international visitors has changed - a sharp decline in the growth rate of visitors from China and slower growth in visitors from Japan, Korea and the US. This has been partly offset by increased growth rate of visitors from the UK over this period but not enough to negate the slowdown from other markets.

Employment and wages

Auckland's unemployment rate increased to 4.5% for the March quarter which is higher than the previous quarter but in a historical context, still low. We should also point out that regional numbers bounce around a lot more than the headline national figures, so there may be a larger margin of error here. Still, the labour force participation rate stayed high at 71.1% and 3,000 jobs were added during the quarter, down from 12,000 in the last one. There is some seasonality in job creation though and this pattern is not unusual for the first three months of the year.

Nominal wages in Auckland increased about 4% for the year to March which translated to a real wage increase of about 3%. The Labour Cost Index, which corrects wage and salary increases for productivity gains and for the changing industrial composition of the economy, was up 1.8% for the same period. Businesses, particularly in the building sector, are facing difficulties finding both skilled and unskilled labour, according to NZIER's QSBO. If and when net migration does start to fall significantly, these shortages could intensify.

Underemployment – defined as those with the desire to work more hours but unable to find those hours – reduced this quarter, which means that spare capacity is being better utilised.

Inflation (measured by the Consumer Price Index) was lower than in the last quarter, at just 1.1% for the year to March, well below the Reserve Bank's mid-point target of 2.0%. The Reserve Bank has kept the Official Cash Rate unchanged at 1.75% and the OCR is as likely to go up or down in the next few months.

Housing

Residential building consents continued their upward trajectory and at nearly 11,200 for the year to March 2018, were the highest since January 2005. Attached dwellings made up more than 50% of this number. However, this growth in consents was still not enough to keep up with the increase in the demand for housing due to population growth over the last twelve months.

The median house price in Auckland in April 2018 was \$850,000, almost unchanged since a year ago,

according to the REINZ. Along with rising household incomes and flat to falling retail interest rates, this means houses are the most affordable they have been since September 2014. Rents increased 4% for the year to March 2018, matching the growth in nominal wages one-for-one, and growing much faster than inflation.

We expect house prices to remain steady for the rest of the year for reasons discussed in our previous Quarterly. There has been a slowdown in the growth in the number of new listings, according to the REINZ and this trend, along with the shortfall.

Data analyst

Ross Wilson - Analyst, RIMU

Indicator	Latest quarter	Last quarter	12 months ago	5-year average	Rest of NZ latest
Employment indicators					
Annual employment growth (%pa)	3.8%	3.4%	7.3%	4.8%	2.7%
Unemployment rate (%)	4.5%	4.1%	5.0%	5.4%	4.7%
Unemployment rate among 20 to 24 year olds (%)	9.3%	9.2%	9.7%	10.2%	8.4%
Unemployment rate among 15 to 19 year olds (%)	20.1%	17.5%	25.6%	22.0%	18.4%
Earning and affordability indicators					
Annual nominal wage growth (%pa)	4.0%	3.6%	1.8%	2.3%	3.8%
Annual geometric mean rent growth (%pa)*	4.0%	5.1%	3.1%	4.6%	4.6%
Geometric mean rent to median household income ratio (%)*	27.8%	28.6%	28.4%	29.1%	26.5%
Annual median house price growth (%pa)*	-2.2%	0.7%	7.8%	9.3%	1.8%
Mortgage serviceability ratio (relative to Dec-06)	-4.7%	-7.0%	-11.3%	-5.1%	NA
Construction					
Annual new residential building consents growth (%pa)	9.7%	8.4%	6.6%	18.6%	-1.1%
Annual m2 non-residential building consent growth (%pa)	24.1%	25.8%	-19.1%	5.4%	4.4%
International connections					
Annual guest night growth (%pa)	-0.2%	-0.9%	3.2%	2.6%	4.9%
Annual net migration	34,448	36,152	35,772	28,454	33,536
Confidence					
Annual retail sales growth (%pa)	3.8%	4.5%	7.6%	6.3%	4.1%
Quarterly Survey of Business Opinion (net optimists)	-14.8%	-9.3%	4.5%	22.6%	-8.3%
Westpac Consumer Confidence*	109.4	107.5	115.1	116.2	111.2

Sources: Chief Economist Unit, Auckland Council; Statistics New Zealand; Ministry of Business Innovation and Employment; Real Estate Institute of New Zealand; New Zealand Institute of Economic Research; Westpac; Reserve Bank of New Zealand. * Rest of New Zealand figures are for all of New Zealand including Auckland. Data is not seasonally-adjusted.

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