

Attachment E: Impact of development contributions on house prices

Theory and evidence on development contributions lack of propensity to impact house prices

Economic theory on the pricing of goods and services is based on buyers and sellers' willingness to pay and accept, respectively. This applies to the market for housing in the form of the maximum price that a seller/developer can charge for a dwelling.

In the current Auckland housing market, with prices at record highs and affordability under considerable strain, buyers' willingness to pay is arguably equivalent to the current market price. In economics terms, this means the consumer surplus is effectively zero. In a market where the consumer surplus is zero, a developer will be unable to affect the market price. In short, house prices cannot increase to accommodate increases to development contributions (DCs).

Observations of house price movements over recent years indicate that home buyers are paying close to their maximum willingness to pay and hence there is no room for developers to raise prices in response to higher DCs. From October 2016 through to February 2020, Auckland's median house price was flat, even as there was a housing shortage. As soon as interest rates dropped sharply in response to COVID-19, house prices immediately increased. The amount of the house price increase can be entirely explained by the fall in interest rates. That is, median loan repayments before and after the interest rate changes are the same.

However, even in cases where buyers of houses are not at their maximum willingness to pay, it is debatable whether increased DCs could be passed through to the buyer. New housing is a small fraction of all housing. In Auckland, the housing stock is approximately 550,000 dwellings, and the number of new dwellings consented per year over the past few years has been between 10,000 and 18,600 dwellings. Thus, it is likely that new housing is a "price taker" in the housing market. That is, developers have little influence over:

- construction costs and the price paid for materials or labour
- house prices
- home buyers' willingness to pay.

The only price that developers can influence is the price of raw land through the bidding process. Over time, the bids placed by developers on raw land translates into the value of that raw land.

Therefore, the developer's decision works backwards from what they think the final price they can get for the dwelling, as illustrated in Figure 1¹. They figure out (through an often rigorous process) how much they can pay for the raw land by working backwards from the final price, subtracting out their costs and desired profit (this is relative to what can be earned with the next best investment alternative), and are left with a residual land value. If the price of the land is too high to make development feasible, they will not develop or wait until housing prices are high enough to make a development commercially feasible.

¹ Murray, C. (2020, July 24). Feasibility Guide for Town Planners. <https://doi.org/10.31219/osf.io/62wsn>

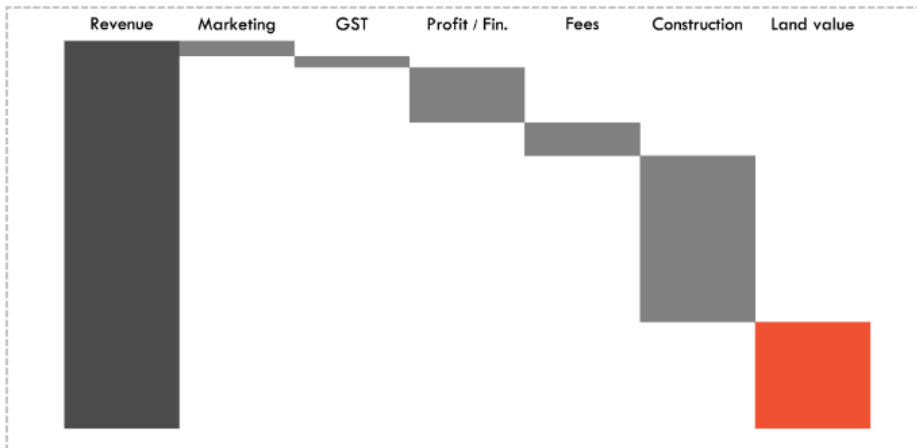


Figure 1 Developers' Decision Logic

Based on this residual land price logic, whenever the market price of housing goes up (say, because interest rates fall), but the developers' costs are otherwise roughly the same, this means that the residual land price will increase. That is, developers can afford to pay more for the land while still making a profit.

Similarly, when any costs go up for the developer – for instance, increased construction costs, labour costs, or DCs – the residual land value will decrease. That is, given that they cannot raise the price for housing just because their costs go up, the only way to adjust is to pay less for raw land. These two relationships are illustrated in Figure 2² below.

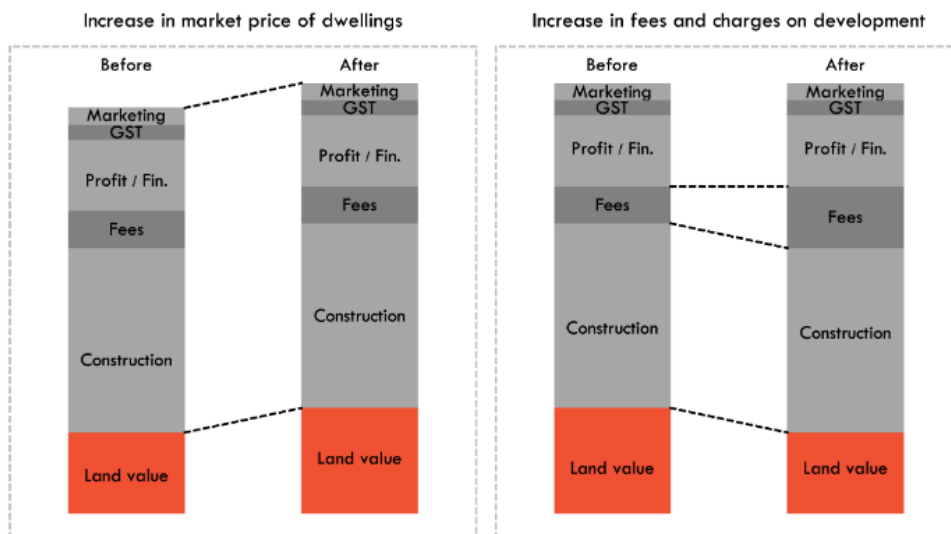


Figure 2 Residual land value reactions

The most important aspect of this is that the price for housing is not determined by costs. If this were the case, houses that were first bought ten years ago would not be selling for more than double their purchase price. Similarly, developers who started projects and incurred their land costs prior to 2019, before house prices rose by more than 30 per cent, are not selling their housing at last year's prices. Most of the land in the Drury area, more than 90 per cent by area and value, was purchased prior to 2019.

² Ibid.

International evidence

Despite theory being clear that when developers are price takers, all changes in the market ultimately flow through to land value, the international evidence is relatively mixed. Several studies (a few of them referenced below)³ from around the world show that increasing DCs can increase house prices. However, the main criticism of almost all work in this area is that it is out of date and the methods used for analysis were inadequate⁴.

Previously, the Chief Economist Unit has written⁵ about this issue and given a literature review. In the New Zealand context, evidence⁶ from the old Waitakere City Council suggested that a 25% increase in DCs had little or no impact on house prices (or rents) and a small negative impact on building consent growth, after controlling for other variables that might affect these indicators.

In Australia, research⁷ points to Queensland and a surprise policy change in 2011. This work found that the new charges had zero impact on house prices and a slight positive effect on the rate of development. This research also shows that previous studies are likely to have methodological deficiencies in how they identified the effect of DCs on prices.

Evidence from Hamilton

Though it is quite recent, there is also some evidence from Hamilton that supports the view that increases in DCs do not flow through to house prices.

Hamilton City Council introduced higher development contributions prices in 2018 with increases ranging from 30 to 100 per cent. While development slowed in the next two years in some areas it progressed in others and all the development areas are now experiencing strong growth. The slowing of development in some areas was a result of timing issues in the delivery of infrastructure required to allow development to proceed. In addition, some developers accelerated development prior to introduction of the 2018 policy to avoid the higher charges with a consequent slow down immediately after the new policy was introduced

Conclusion

International literature on the matter is mixed, though newer research suggests that increased DCs are not passed through to the price of housing but rather on to the landowner. It is our view that this is likely to be the case for Auckland for several reasons.

- the latest international evidence suggests this will be the case
- evidence from NZ of past DCs increases shows this is the case
- there is little to no room for house prices to increase as housing prices approach the maximum willingness (and ability) to pay.

³ <https://doi.org/10.1016/j.regsciurbeco.2003.11.002>;
<https://journals.sagepub.com/doi/pdf/10.1177/0739456X13494241>;
<https://doi.org/10.1007/s10901-016-9527-0>

⁴ <https://thebradentontimes.com/ImpactFeeHousePrice.pdf>

⁵ <https://www.aucklandcouncil.govt.nz/about-auckland-council/business-in-auckland/docsoccasionalpapers/how-fund-greenfield-infrastructure.pdf>
<https://www.aucklandcouncil.govt.nz/about-auckland-council/business-in-auckland/docsoccasionalpapers/unshackling-growth%20-%20April%202018.pdf>

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<http://web.archive.org/web/20100515145810/http://www.waitakere.govt.nz/AbtCnl/pp/pdf/devcont/economic-impactstudy2008-CovecRpt.pdf>

⁷ <https://doi.org/10.1016/j.cities.2017.10.019>