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Government Policy and the Residential Rental Market

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Abstract:

This paper examines the impact of New Zealand Government housing policy on the movement in residential rents over the period 1993-1998. During this time state house rents were moved from being income related to being set at market levels. At the same time a government funded accommodation supplement was introduced for low-income renters in both the private and state sectors. The present government has gone back to income related rents for state houses but maintained the private sector accommodation supplement policy. Private sector property investors are concerned that the new policy setting will cause rents to fall in the private sector thereby discouraging investment in rental housing. Analysis of the data confirms that rents did rise during the period 1993-1998 with lower quartile rents in cities with a high percentage of state houses rising at a faster rate than upper quartile rents in the same cities. Moving state rents away from market levels is likely to cause private sector rents and rental property values to drop. Thus the concerns expressed by the private sector appear to be valid.

Government Policy and the Residential Rental Market

Introduction

The election in November 1999 of a Labour/Alliance coalition government resulted in a major change in New Zealand's rental housing policy. In particular, the Labour Party (1999) had pledged to introduce income related rents for government owned state houses, to reverse the previous policy of selling off state houses to the private sector, and to begin building more state owned rental houses. To a large extent these policies are a return to previous government housing policies during the period 1930-1984.

During most of the 1990's New Zealand had a National party led government and the housing policy was orientated to the private sector provision of rental housing, moving state house rentals to market levels and the sale of surplus state houses. To offset the movement of state house rentals to market, the Ministry of Housing, Luxton (1991) introduced an accommodation supplement (AS) for low-income people. The AS is administered by the Department of Social Welfare (1994) and available to renters, owners and boarders. The AS replaced a previous scheme called the accommodation benefit (AB) which was limited to beneficiaries. The AS initially paid up to 65% of rental costs above 25% of income, subject to regional limitations. According to Kelsey (1997) the AB was established in the early 1990's to offset significant cuts to other benefits.

Although the new government has pledged to maintain the AS private sector, landlords are worried that rents will fall once the policy of income related rents for state houses is re-introduced. This paper will analyse movements in private sector residential rents over the period 1992-1998 with the objective of determining the impact of the previous government's policies on the rental market. If it can be shown that moving state house rents to market increased private sector rents, then it is likely that moving state rents down will also reduce some private sector rents.

Previous Housing Studies

Previous studies to isolate the influence of government rental subsidies have often been inconclusive. For example, Bradbury and Downs (1981) examined the effect of US government rental subsidies on residential rents, and concluded that the housing allowance supply experiment caused no measurable increase in rents in the relevant housing markets. According to their research occupancy rates, not rents, absorbed most of the short run effects of rent subsidies. Monro (1998) came to a similar conclusion with respect to the Australian situation.

Smith (1970) pointed out the dual nature of housing in that in most countries the state and private sector are very interdependent in the housing decision making process. Smith said this feature makes economic analysis of housing both more difficult and more necessary. There is a tendency for the private sector to argue against any sort of regulation and to point out the mistakes being made by the government sector. Similarly, the government sector will tend to argue that the private sector is not catering for the needs of low-income people. Hence the need for direct government intervention by providing some low income housing and perhaps regulating rents in the private sector.

A difficulty with pricing housing at below market rents is that it can result in inefficient resource use and discourage private sector investment. For example, the circumstances of long stay tenants in a 3 bedroom house may change from a family with children, to "empty nesters" and then ultimately a single person householder. There are strong political and social pressures against the state forcing tenants to move houses so as to achieve better utilisation of housing stock. Past experience indicates that pricing state houses at below market results in a dramatic increase in the waiting list for state houses and this is used as an argument to build more state houses. Gelting (1967) pointed out that the post World War II effect of rent controls in most Western European countries was to intensify housing shortages. Setting state rents below the market is a form of rent control. However, Wendt (1962) conceded that housing policy, in the final analysis, is a political decision and there are a number of possible state and private sector combinations that can be used to raise national housing standards.

Rothenberg et al (1991) discuss the complexities of both rental and ownership housing markets and sub-markets. They emphasize that housing is spatially immobile, highly durable, physically modifiable and multi dimensioned, heterogeneous, good. They suggest the concept of a housing-quality sub-market as a good basis for building a theory of urban housing markets. The concept of quality is seen as including spatial aspects as well as individual housing attributes such as house size, house age, facilities, number of bedrooms etc.

Critics of the emphasis on housing privatisation during the 1990's point out the problem of poverty in New Zealand society. Waldegrave and Frater (1996) claimed the high cost of rental housing was a significant factor contributing to poverty. Campbell Roberts (1992) was also critical of the AS pointing out that it did not do enough for people at the lower end of the socioeconomic scale and did little to overcome discrimination. The New Zealand Council of Christian Social Services (1999) showed that in the year to March 1998, Auckland households in the lowest income quartile were spending about half their income on housing costs. On a national basis, the comparable figure was 32%. Thorns (2000) says his research suggests the level of the AS has been insufficient to contain housing related poverty. Thorns contends that the AS may have simply raised rents and thus landlords' profits.

New Zealand's Rental Housing Stock

According to Statistics New Zealand (1996) (1998) the private sector rental housing stock comprised 20.6% of the total housing stock and the public sector rental housing 5% of the total housing stock. At the 1996 census privately owned households were 70.5% of the total housing stock. Since 1996 the trend in New Zealand has been for the number of rental houses to increase at around 1% per annum with this increase being exclusively in the private sector. Housing New Zealand (1999a) reported the number of state rental units reduced from 61,718 (June 1998) to 58,303 (October 1999). Further, that 41,800 of their tenants were in receipt of the AS.

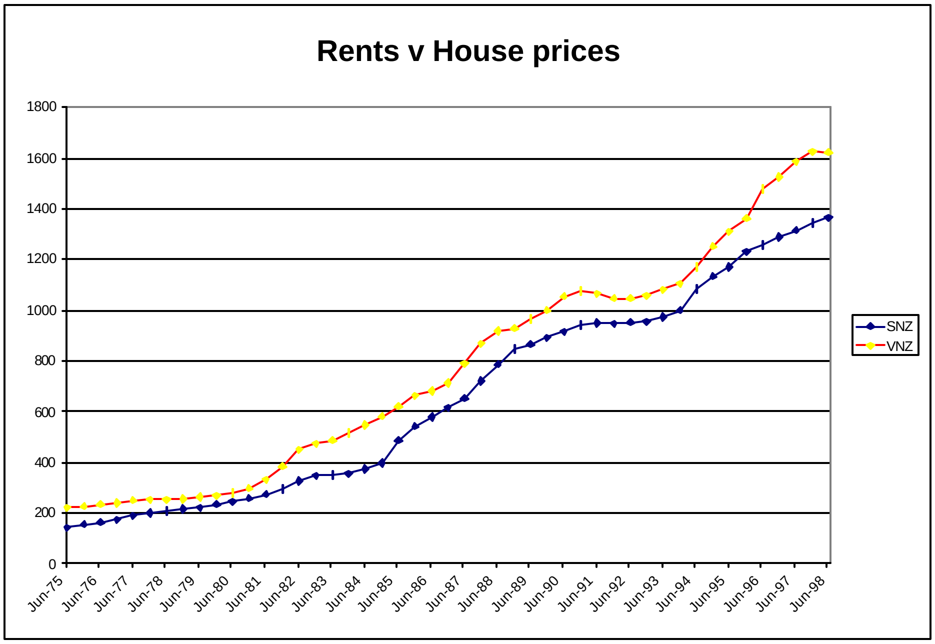
By and large the rental housing stock is not purpose built but rather second hand housing converted from an owner-occupier to a rental arrangement. The median rental property is a 3 bedroom detached bungalow situated in the suburbs. This means that the highest and best use of an existing rental property may alternate between the ownership and rental markets. This will depend on factors such as rental levels, expectations about future changes in property values, the replacement cost of the house and redevelopment opportunities.

Rents and Property Values

In general increasing rental levels will make renting more profitable and introduce a greater supply of private sector rental houses. Conversely, rent reductions will result in some rental housing being sold to owner-occupiers. In theory the price of rental housing should decrease when rents drop since the present value of the future cash flows will decrease. The complicating factors are firstly, the housing market is dominated by the owner-occupier sector, and secondly, existing house prices are also influenced by the replacement cost of new houses.

The relationship between rents and property values over the period June 1975 to June 1998 is shown in Figure 1.

Figure 1



The rental information is taken from the Statistics New Zealand Residential Rental Index series and house price data from Quotable Value (1999). Clearly, there is a strong relationship between these two series with increases in house prices generally exceeding increases in rents. In theory the value of a house now is the present worth of the future income stream. Future income is a function of rents and changes in property values over time. The difficulty with this approach is that around 70% of houses are owner-occupied and investment decisions in the owner-occupier sector are driven by somewhat different criteria to the investor-renter market. For example, from an income stream perspective it may make economic sense to add another bedroom to a house rather than spending an equivalent sum upgrading the kitchen and bathroom.

Figure 2 shows the same data converted to half-yearly percentage changes over time. Remembering that the AS was introduced during 1993, then the upward spike in the percentage change in rents during the first half of 1994 is likely to be directly related. The rental spike in 1985 was due to a relaxation of a previous short-term rent control policy. According to the Department of Social Welfare (1998) the weekly cost of the AS as at 30 June 1994 was $NZ8.5m. The majority of AS recipients live in rental accommodation (59%) and of these 67% are in private sector rental housing. By 30 June 1997 the weekly cost of the AS had risen to $12.29m. The annualised amount of AS relating to the rental sector rose from around $260m in mid 1994 to around $467m by mid 1998.

Figure 3 shows the total annual per person benefit from the AS graphed against the Auckland lower quartile rents over the period 1993-1998. This reinforces the data in Figure 2 showing a spike in rents at around the time the AS was introduced.

Figure 2

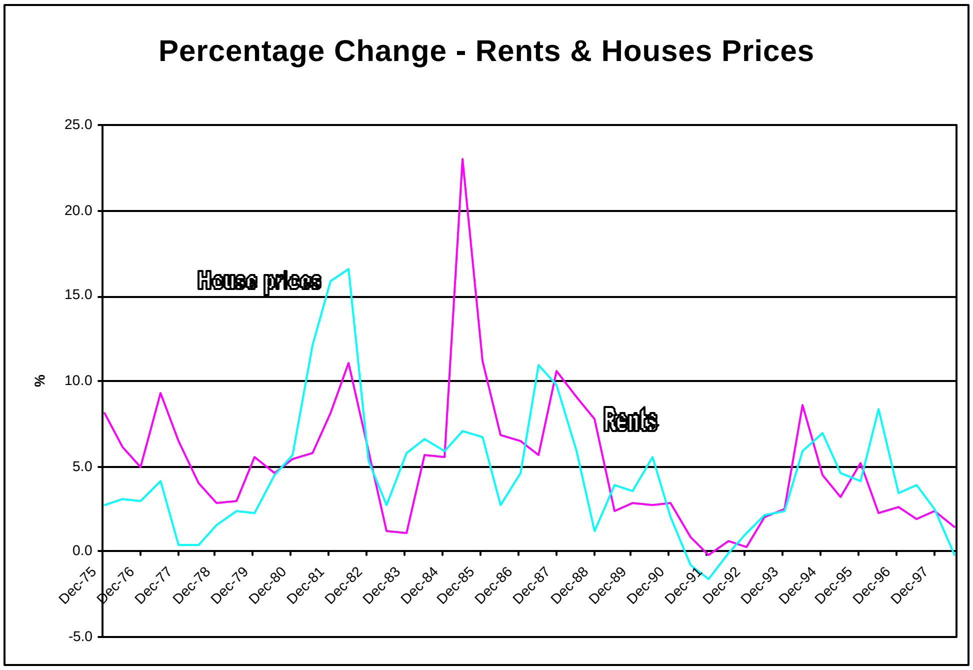
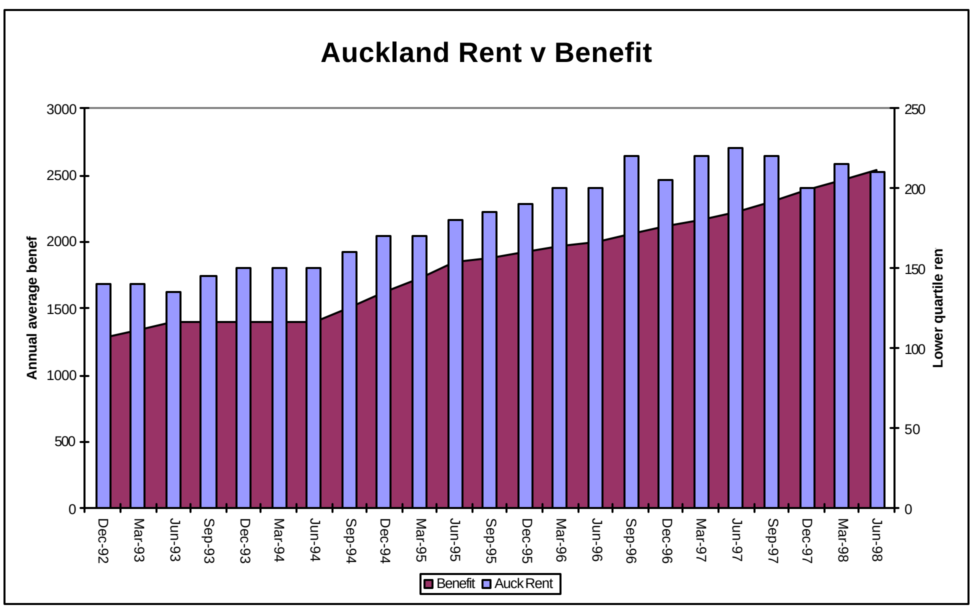


Figure 3

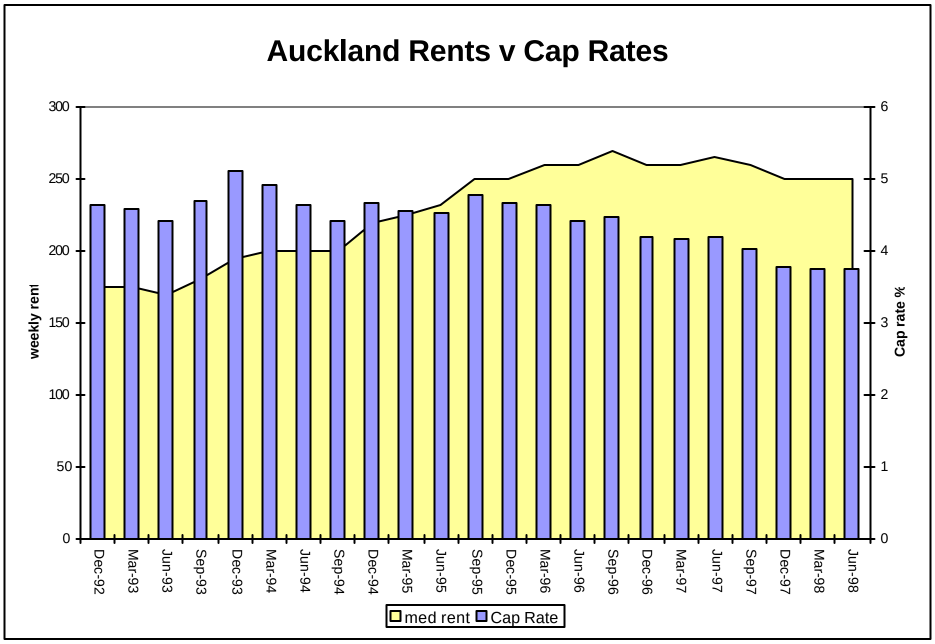


In a sense the introduction of the AS represented a windfall gain for the owners of rental properties. This gain was realised by those landlords who sold out during the upturn phase but somewhat eroded when rents and house prices remained static while ownership costs continued to increase. Certainly, there had previously been a scheme called the accommodation benefit (AB) but this scheme was limited in application and confined just to beneficiaries. At the same time as the AS was introduced the government embarked on a scheme to move rents on state houses to market levels. The experience was that significant numbers of tenants moved out of the state houses because they preferred houses in private sector neighbourhoods. This resulted in higher than normal vacancy rates in the state housing sector and made it easier to rationalise the sale of state houses to the private sector.

At the same time the number of private sector rental properties continued to increase. Just by how much will not be known until the next census in 2001 but over the period 1993-1998 the annual volume of private sector tenancies recorded by the Ministry of Housing (Bond Centre) (1999) from 89,515 (1993) to 127,278 (1998). This represents a 42% increase. To some extent these figures overstate the overall position because during this time at least 5,000 state houses moved to private sector administration and an increasing percentage of private sector landlords lodged bonds with the Bond Centre.

The relationship between the income from a rental property and the sale price is defined as the capitalisation rate (also referred to as the yield or return). As net income information was not available, gross income figures have been derived for several New Zealand cities. Figure 4 shows the gross capitalisation rates for Auckland against median weekly rents.

Figure 4



Auckland gross capitalisation rates peaked at 5% in December 1993 and steadily declined to 3.7% in June 1998. It appears that increased rental profitability for property owners was quickly capitalised into increased house prices so that the main benefits accrued to owners who sold their properties.

The trends for Waitakere City (8% in December 1993 to 6.3% in June 1998) and Manukau City (8% in December 1993 to 6.3% in June 1998) are similar. However, in Porirua City (6.1% in June 1993 to 5.4% in July 1998) the decline is much less, possibly because of static house prices due to a declining population.

Vacancy and Turnover Rates for State Houses

The impact of income related rents (IRR) for state houses on the private sector rental market will depend on the ability of private sector tenants to obtain state rental houses. If the IRR policy simply creates large waiting lists for state houses then the impact will be minimal. The availability of state houses will be a function of the current vacancy rate and the annual movement of tenants out of IRR state houses. Vacancy rates are currently low. Housing New Zealand (1999b) reported that by June 1999 their vacancy rates were at an “all time low” of 2.03%, down from 4.23% in September 1998. If this vacancy rate improved by 1% then this would free up around 580 houses. However, it turns out that the annual turnover rate for state houses is much more significant then the vacancy rate. In 1999 under the market rents policy 47% of state house tenants moved in 3 years or less and only 23% of tenants stayed for 10 years or longer.

Under the previous IRR policy Housing New Zealand reported annual turnover rates ranging from 9.5% to 11.4% over the period 1987-1991 with an average rate of 10.7%. During this period there was a significant waiting list for state houses. Applying the 10.7% churn rate to the present stock of state houses would free up around 6,200 houses each year for private sector tenants. This number is significant and will almost certainly result in increased vacancy rates and lower rents in the private sector. The application of our IRR policy will also force some existing state house tenants into other housing as their income levels will be too high to meet the new state housing criteria.

The people that move on from state houses will not necessarily move back to private sector rental housing. Some will purchase a house, others will move overseas, some will board, and others will move into retirement accommodation with onsite medical facilities.

Rental Changes 1992-1998

To analyse the effect of moving state house rents to market levels on private sector rents it was decided to select four cities with significantly different percentages of state housing. Table 1 compares upper and lower quartile rents for the cities of Auckland, Manukau, Wellington and Porirua. In addition, Table 1 also includes the comparable all New Zealand figures.

Table 1

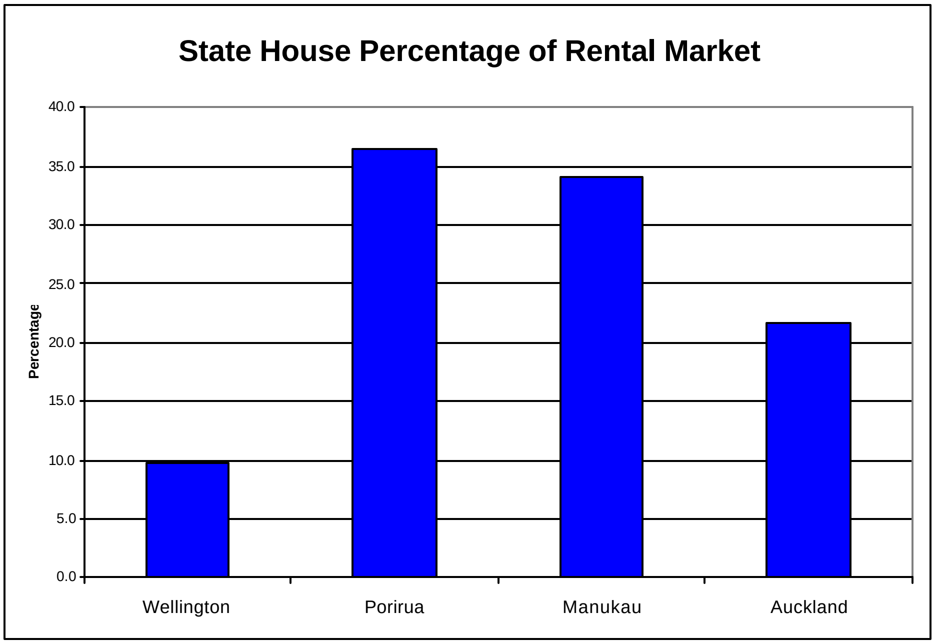
Lower Quartile -- Upper Quartile Rental Indices										
Date	**Auckland**		**Manukau**		**Wgtn**		**Porirua**		**NZ**	
	LQ	**UQ**	**LQ**	**UQ**	**LQ**	**UQ**	**LQ**	**UQ**	**LQ**	**UQ**
Oct 92	100	100	100	100	100	100	100	100	100	100
Oct 93	103	108	100	98	103	97	106	91	100	105
Oct 94	110	121	100	104	107	107	112	93	104	111
Oct 95	131	139	122	113	114	108	124	100	112	127
Oct 96	151	152	140	130	121	126	110	91	116	138
Oct 97	144	152	140	126	128	126	104	90	125	138
July 98	144	143	137	126	135	134	117	100	125	138

The numbers in the table are indexed back to a common basis in October 1992.

In Auckland and Wellington lower quartile rents and upper quartile rents moved in tandem, but in Manukau (9%) and Porirua 17%) lower quartile rents moved up appreciably faster than upper quartile rents.

Figure 5 shows the state houses as a percentage of the residential rental market in Auckland, Manukau, Wellington and Porirua cities.

Figure 5



Thus, in cities with a high percentage of state houses there appears to be greater pressure for upward rental movement on the lower end of the rental market. The flip side of this analysis is that moving state house rents away from market and back to income related will place downward pressure on lower quartile rents in Porirua and Manukau.

Rents and Rental Subsidies

At first glance there does appear to be a strong relationship between increases in rental subsidies and increases in rents over the period 1993-1998. Figure 3 shows movements in the average per head level of subsidy and lower quartile rents for Auckland City. Increases in the AS for the 1993-1995 period do coincide with rental increases but later rents flatten out while the AS continues to increase. To broaden the scope of this study a statistical analysis using multiple regression analysis was undertaken on lower quartile rents for the cities of Auckland, Waitakere, Manukau, Wellington and Porirua. The data was arranged in quarterly periods and had 115 rental observations. The variables used in the study are shown in Table 2 and the results of the initial regression equation in Table 3.

Table 2

Variables Used for Study	
Name	**Comments**
Lower Quartile Rent	Dependent variable in dollars per week
Auckland City	yes/no
Waitakere City	yes/no
Wellington City	yes/no
Porirua City	yes/no
Per person benefit	Average annual amount in dollars
Percentage change in house prices	Quarterly percentage change in average house price

Table 3

Variable	Regression Coefficient	Standard Error	TStat	Sigt
Constant	-12.94	3.78	-3.46	0.00
Auckland City	-2.16	3.76	-0.57	0.56
Manukau City	-29.65	3.78	-7.83	0.00
Wellington City	-37.02	3.85	-9.59	0.00
Weekly per person benefit	2.63	0.70	16.74	0.00
Percentage change in house prices	1.231	0.09	2.20	0.03
Adjusted R Square = 79.9%	Standard Error = $12.67			
Number of Cases = 115	F Statistic = 76.55			

The overall structure of the equation seems logical. The coefficient for the per person benefit is positive. The weightings for the various cities are more or less in line with what was expected. The actual coefficient of 2.631 for the weekly per person benefit means that increasing the AS by $1 per week would raise rents by $2.63 per week on average. Such an increase in rents seems unlikely suggesting this variable may be acting as a proxy for other variables not included in the initial equation. The next step was to express the house price variable in a different way. The particular form used was the log of house prices. When this variable was added to the equation then the variable for weekly per person became much less statistically significant as shown in Table 4.

Table 4

Variable	Regression Coefficient	Standard Error	TStat	Sigt
Constant	-1444.64	-107.45	-13.44	0.00
Auckland City	-25.31	-3.80	-6.65	0.00
Manukau City	30.88	2.27	13.56	0.00
Waitakere City	52.01	2.71	19.16	0.00
Porirua City	28.71	3.46	8.29	0.00
Weekly per person benefit	1.49	0.004	0.037	0.97
Log house price	304.46	21.58	14.10	0.00
Adjusted R Square = 92.6%	Standard Error = $7.68			
Number of Cases = 115	F Statistic = 239.15			

However, the sign for the per person benefit remains positive and the coefficient suggests that adding a $1 per week in benefit will increase lower quartile weekly rents by 49 cents on average. Not much can be read into the actual coefficient but the fact the sign is positive helps to back up the indices developed in Table 1.

Summary and Conclusions

This research shows the effect of government rental housing policies during the period 1992-1998 was most pronounced in those cities with a high percentage of state rental houses. The effect of raising state rentals to market and broadening the scope and amount of the AS subsidy also increased private sector rents, particularly those in the lower quartile of Manukau and Porirua cities.

Because increases in the AS coincided with general house price inflation it is more difficult to quantify the overall effect of the AS rental subsidies on rents. The issue is further complicated by the fact that the private sector substantially increased the supply of rental houses during the period studied. The AS resulted in short term increased profitability for owners of rental properties. The analysis of gross capitalisation rates shows this increased profitability was quickly capitalised into increased house prices, particularly in the Auckland region.

Moving state house rents away from the market and back to income related will almost certainly exert downward pressure on private sector rents. This downward pressure will first be felt in lower quartile rents but may spread into median and upper quartile rents. The turnover rate for state houses will decrease to around 10% per annum freeing up over 6,000 houses per year for private sector tenants. The actual impact on rents will be a function of demographic changes on the demand side and private sector profitability on the supply side. The residential rental market is dominated by the private sector (over 80%) and government has both financial and physical constraints on the amount they can increase state housing. Therefore housing policy settings that disadvantage the private sector are likely to result in a reduction in private sector investment.

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