Submission to the New Zealand Productivity Commission

on

Housing Affordability

by

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Origins of State Housing in New Zealand

The origins of State Housing in New Zealand can be traced back to the First World War and this genesis ought to be acknowledged because of the impact it still has. At that time a political concern arose about the plight of soldiers who had left farms to fight and then found that their family could not meet mortgage payments and faced foreclosure. Legislation was enacted to prevent any such foreclosures and, although intended to be a temporary measure, it was retained and extended, culminating in the Mortgagees and Lessees Rehabilitation Act 1936.

This Act provided a mechanism that enabled a mortgagee to have mortgage payments suspended or cancelled without any compensation to the lender. Many lenders lost their entire life's savings as a result of decisions made in camera under this Act.

Naturally, as lawyers became aware of this happening they advised clients not to lend money on mortgage and many older lawyers remember this[1]. Banks would have reached the same conclusion. This, naturally, lead to an acute shortage of finance for housing and the post-World War II housing shortage. Having first created the problem, the government of the day then set to work to solve it by building State houses and setting up State lending institutions.

It has something of a “Yes Minister”, flavour doesn't it? More seriously, we think it is a relevant example of the unintended consequences of misguided policy settings and is worthy of note in your investigations. Incidentally, the legislation is still extant and could be reactivated should a government so decide.

Size of Rental Portfolios

Interestingly Antony Jay, one of the writers of “Yes Minister” also put forward a concept that we think is relevant to the private rental market. He noted that the ancient Roman Army had cohorts of only about 500 men rather than 1000 which would have seemed logical in a decimal system. His hypothesis was that 600 is the maximum number of people that can be addressed directly by one person without electronic aids and it is also about the maximum number of faces and names that one person can recall. Maximum motivation and control of troops could therefore be exercised by units not exceeding 600 men.

At the time of the Wairarapa transaction described below, we did some checking and our recollection is that no private landlord (individual or corporate) had a portfolio of more than 1000 units. A quick Google check produced the following reports which seem to be consistent with this:

http://www.york.ac.uk/inst/chp/publications/PDF/lha4_landlords.pdf

1 Neil Gray now retired from Chapman Tripp is one who recalls this. He started work in the late 1940s as I recall.

http://www.scotland.gov.uk/Publications/2009/03/23153136/4

The conclusion of these reports is that most landlords preferred to invest in their home area, for two main reasons. First-hand knowledge of an area was thought to be essential to making rational and well-informed investment decisions - investing in other areas was considered risky. Secondly, they wanted to be nearby for ease of management and maintenance.

This is also consistent with the "Jay" hypothesis that there are management advantages in operating units where the owner has a direct personal relationship with all the tenants.

Our suggestion is that when the number of rental units gets above about 600, there has to a management structure that removes the direct involvement of the principal and necessitates operating rules, procedures and other bureaucratic paraphernalia. This has additional administrative costs and we believe that it has indirect costs as well. The indirect costs arising from the lack of a direct principal-tenant relationship will manifest as increased maintenance costs, increased tenant turnover, more rent defaults and the like.

The Wairarapa "Experiment"

In 1989 Peter Farley, acting on behalf of Housing New Zealand, negotiated the sale of all State housing in the Wairarapa-Bush region to Trust House Wairarapa. Trust House has developed from the Masterton Licencing Trust and has trustees elected by ratepayers in the Trust area. We use the term "experiment" because such a large scale transfer of ownership of State houses had never been done before.

The Wairarapa "experiment" has, we understand[2], been very successful for all parties:

> The Crown received a substantial cash sum for a financial liability – the portfolio would not have generated a net annual cash inflow to the Crown accounts;
>
> Trust House Wairarapa has gained an asset that is producing a respectable net annual cash inflow and enabled them to improve social capital by upgrading the housing stock; and
>
> Tenants have gained a dependable, fair local landlord with a "face".

Bernard Teahans (Chief Executive) of Trust House thinks that it would be possible for them to handle up to about 1000 units without losing their current advantages.

The Implications

If our belief that this type of structure is optimal for the management of rental housing is correct, then that raises two further questions: why has there been so little institutional investment in housing in New Zealand when the Wairarapa experience suggests it is viable; and what does it imply for Housing New Zealand.

We preface our answers by first noting that, contrary to popular belief and much public comment, people in in New Zealand do not generally have "housing problems". What are presented as housing problems (over-crowding, cold, leaking, damp, unhealthy, etc.) are just the manifestation of underlying problems.

2 Pers comms, Bernard Teahans to Peter Farley, August 2011.

These underlying problems can include one or more of health problems, education deficiencies, drug problems, relationship problems, employment problems, income problems etc. Simply providing an adequate house will not solve the underlying problem, it just puts a temporary band-aid over it. Worse, the implication that provision of a "cheap house" is somehow a solution to these difficulties is illusory.

Issues related to welfare (usually expressed as "affordable" housing) need to be separated from issues concerning the supply of housing at competitive price. If this is not done, then it is impossible to identify what is a welfare cost, what is a necessary and competitive cost, and what is inefficiency and waste.

The issue really concerns competitive prices for housing services – in this case rental housing services. If supply is competitive it must *by definition* be affordable. Accordingly, to be affordable it must be competitive. At a competitive price landlords will invest and tenants will consume.

Even so, a local landlord such as Trust House is sometimes well placed to address or ameliorate the underlying problems. It can coordinate with appropriate government agencies and implement tailored solutions that fit an individual situation without having to worry about precedents, policies or politics. A focus on beneficial end outcomes rather than actions which are simply politically defensible becomes possible.

Housing New Zealand, on the other hand, must have serious regard to all these things. Further, with the best will in the world, coordinating inter-departmental action in respect of individual tenants is virtually impossible. An attempt at this level of coordination would be very expensive (and thus difficult to justify) and would still be ineffective because of the imperative to act consistently and in compliance with each departments' procedures.

This precludes most "tailored" solutions because of the wider impact of precedents and exceptions.

Returning to the two questions raised above:

1. Why has there been so little institutional investment in housing in New Zealand when the Wairarapa experience suggests it is viable?

   We think it is a straightforward example of "crowding out" by State housing activities. By the time the private sector had recovered from (or forgotten about) the effects of the Mortgagees and Lessees Rehabilitation Act, State housing was so widespread and so extensively subsidised that no rational institution would risk entering the market.

2. What does it imply for Housing New Zealand?

   Split it up into units of not more than 1000. Transfer ownership to local trusts (existing or new) at a price based on the existing net cash flow of units excluding HNZ's corporate overhead. This provides a means for significant scale supply, in a portfolio of demonstrably manageable size which generates housing services which are affordable and able to cover their cost of capital thus allowing replacement and improvement.