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# Rental and Housing Affordability

## Submission to the Victorian Legislative Council's Legal and Social Issues Committee

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17 July 2023



**Committee Secretary  
Legislative Council Legal and Social Issues Committee  
Parliament House  
Melbourne Vic 2600**

**Submission to the Inquiry into the rental and housing affordability crisis in Victoria**

The Centre for Independent Studies (CIS) appreciates the opportunity to provide a submission to the Legal and Social Issues Committee's Inquiry into the rental and housing affordability crisis in Victoria.

The CIS is a leading independent public policy think tank in Australia. It has been a strong advocate for free markets and limited government for more than 40 years. The CIS is independent and non-partisan in both its funding and research, does no commissioned research nor takes any government money to support its public policy work.

Researchers at the CIS have done substantial work on many of the issues relevant to the current inquiry. However, this submission focusses on what we consider to be the most important issue, the role of planning restrictions on housing affordability.

We would be happy to provide further information if this would assist the Committee.

Yours sincerely,

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Chief Economist  
Centre for Independent Studies  
17 July 2023

# Rental and Housing Affordability in Victoria

Submission by Centre for Independent Studies

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## 1. Summary and Introduction

The cost of housing in Victoria is too high. The main reason is that planning restrictions limit supply, driving up prices and rents. This submission describes the evidence of large planning effects, including estimates for Melbourne and effects on renters with low income. It then discusses various objections to this research finding. It concludes by recommending that the Victorian government set and enforce high housing targets for local councils.

## 2. Evidence that planning restrictions make housing expensive.

The evidence that planning restrictions make housing expensive is very strong. However, it is not well understood by the public. So, opponents of housing developments do not realise the harm that they do. That is a major obstacle to policy reform. Accordingly, a description of that evidence is important.

A mountain of academic research finds zoning restricts supply, and this increases prices and rents. More specifically, researchers find: less building in jurisdictions with tight planning restrictions; more building when restrictions are eased; lower prices and rents when restrictions are eased; prices exceed marginal costs for both detached houses and apartments; substantial economic harm from zoning restrictions; and so on. The research uses a wide variety of data sets and empirical approaches. For surveys and summaries see Gyourko and Molloy ([2015](#)), Hamilton ([2021](#)), Been ([2018](#)), [Furman \(2015\)](#), Glaeser and Gyourko ([2018](#)), Schuetz ([2022](#)), Phillips ([2020](#)), Schleicher ([2021](#)), Gray ([2022](#)), Erdmann ([2019](#)), Beyer ([2022](#)) and, for a UK focus, Hilber and Vermeulen ([2015](#), Section 2). Tulip ([2020](#)) discusses Australian research. We present representative examples of this research in Section 3.

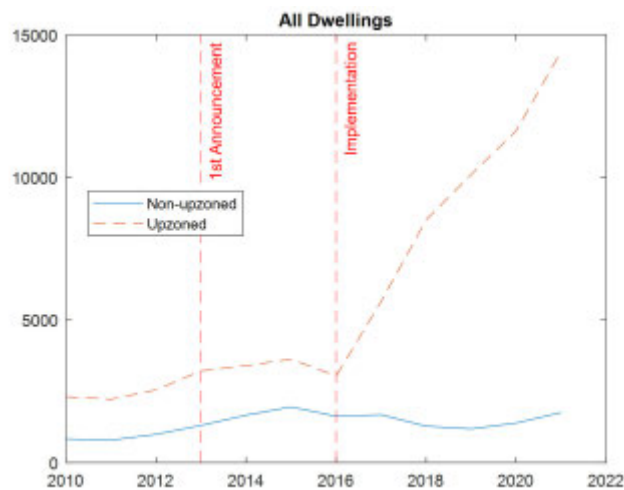
Most of these overviews are by eminent urban economists. The individual papers cited in these surveys typically contain shorter literature reviews with the same conclusions, as do numerous government reports from many different countries. In Australia, the most recent official reports are the Commonwealth Productivity Commission's [Report on housing](#), the [Falinski Inquiry](#), and the NSW Productivity Commission's '[Rebooting the economy](#)' and '[Building more homes where people want to live](#)'. The Economist magazine ([2021](#)) has complained that "no one needs any more papers showing that stringent zoning regulations raise housing costs. It is time for solutions."

The research could be described as "mixed" or "contested" if one gave a substantial weight to badly-designed uninformative studies. However, the surveys above place more weight on research that is robust to criticism. The simple misunderstandings one sees in social media (discussed in Section 6) are not taken seriously in the research literature.

This substantial research should be the basis of public policy. However, it is also useful to reinforce the point with some simple but telling examples.

Auckland's planning reform of 2016 removed many restrictions on medium density development. This was an unusually large-scale reform, conducted in a well delineated area, with less-affected regions nearby forming a good comparison group. The reform was followed by a boom in construction in upzoned areas (about three-quarters of the city) relative to non-upzoned areas.

Chart 1: Dwelling consents in Auckland; 2010-2021

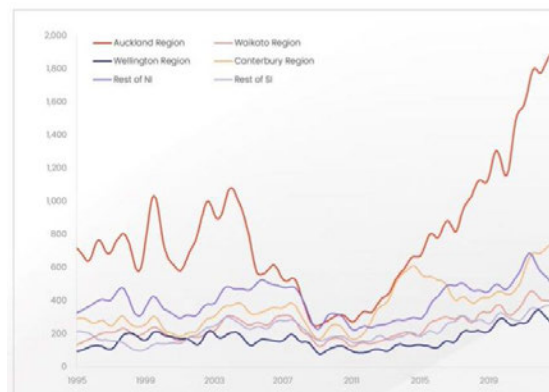


Source: [Greenaway-McGrevy and Phillips \(2023\)](#)

This boom cannot be attributed to favourable macroeconomic or financial factors given that construction in Auckland boomed relative to history and other NZ cities.

Chart 2: Dwelling Consents; New Zealand Cities

### Building Consents



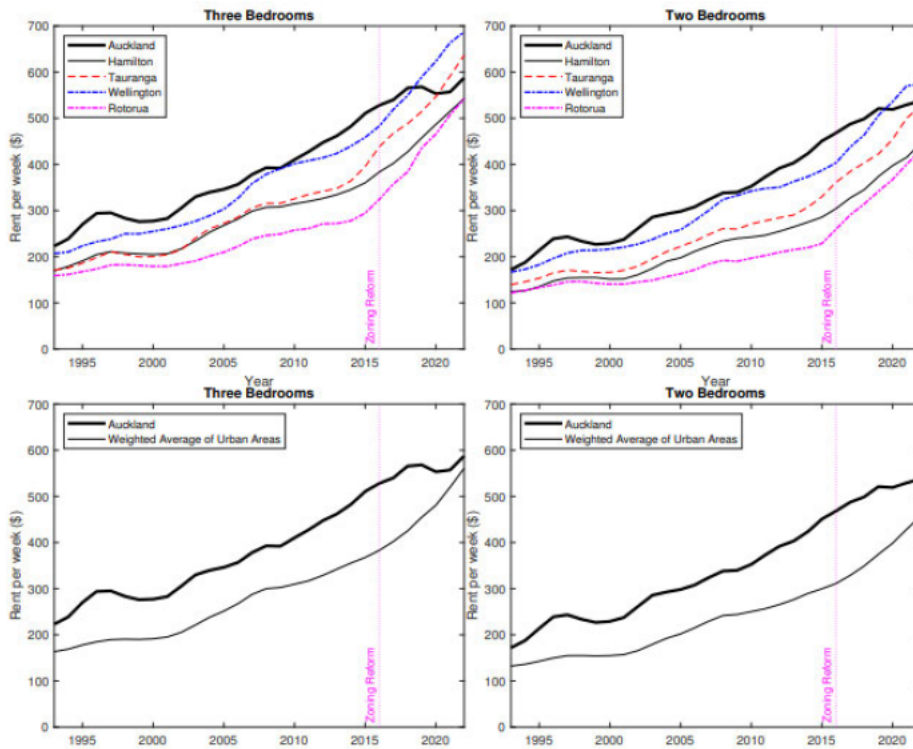
Source: [Phillips \(2023\)](#)

In a thorough econometric study, [Greenaway-McGrevy and Phillips \(2023\)](#) estimate that these reforms approximately doubled the rate of construction in Auckland, adding 5% to the dwelling stock (not allowing for demolitions) over 5 years.<sup>1</sup>

The planning reforms reduced rent relative to other New Zealand cities, as shown in Chart 3. [Greenaway-McGrevy \(2023b\)](#) estimates that rents in Auckland fell by 14% to 35% relative to what they would have been otherwise.

<sup>1</sup> Those estimates have been challenged by [Murray and Helm \(2023\)](#) but their objections have been addressed in subsequent work by [Greenaway-McGrevy \(2023a\)](#), leading to stronger conclusions (see also [Maltman, 2023](#); [Phillips \(2023\)](#)).

Chart 3: Rent in NZ Metropolitan Areas; 1993-2022

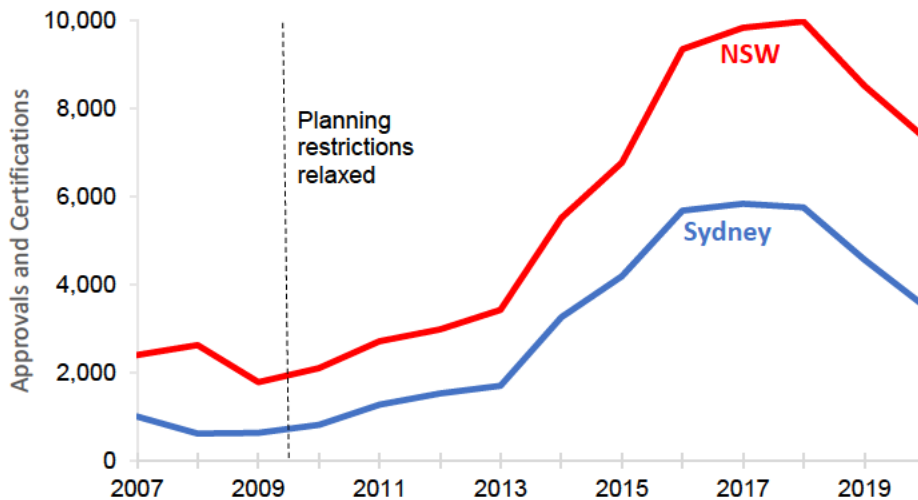


Notes: Geometric mean rents for selected urban areas. Weights based on 2018 census populations.

Source: [Greenaway-McGrevy \(2023b\)](#)

There are many other examples where lifting planning restrictions has been followed by huge increases in construction. One, closer to home, is New South Wales lifting of restrictions on ‘granny flats’ in 2009. As shown in Chart 4, this led to a five-fold increase in construction, or about 49,000 extra dwellings by 2020. Discussions with industry participants suggest reforms in Victoria would have a similar effect.

Chart 4: Granny Flats in NSW following 2009 liberalisation



Source: <https://pp.planningportal.nsw.gov.au/local-development-performance-monitoring-ldpm>

Large effects of planning restrictions can also be easily seen in the huge increases in land values that accompany upzonings. For example, in 2014 a property at 661 Chapel St, South Yarra was sold for \$20 million when it was zoned for 13 storeys. It was then rezoned for 31 storeys and sold later that year for \$56 million ([Lucas 2017](#)). Loosening restrictions added \$36 million in value. For similar examples see [Millar, Vedelago and Schneiders \(2015\)](#), [Kendall and Tulip \(2018, Appendix A\)](#) or the stream of corruption allegations that plague local politics. These examples are representative, as can be seen in Valuer-General valuations or the site values of apartment buildings, discussed in Section 3.

Large land revaluations are analogous to the high market value of quantity restrictions in other industries such as taxi licences, pharmacy licenses or import quotas. They show that legal permission to build is scarce and valuable. Developers will only pay these large sums if the new permission is expected to be profitably used and if building is not possible without it. That is, the absence of permission is a binding constraint on construction.

Simpler, more direct evidence is to ask people involved in new construction. For example, the Lord Mayor of Sydney explains the level of new housing in her jurisdiction is essentially determined by the State government's planning controls: "The city's housing targets are set by the state, and we are on track to achieve them" ([Moore 2023](#)). Mayors and councillors from many other municipalities, including [the Hills](#), [Woollahra](#), and [Mosman](#), have made similar statements. Ask a builder, developer or architect why their apartment building wasn't taller, and the most common answer is that they built as high as they were allowed. People in the industry want to build more but their routine experience is that the planning system stops them. Our understanding is that submissions to the inquiry from industry participants will expand on this.

### 3. Estimates of the excess demand for housing

One common approach to estimating the "housing shortage" is to project forward assumptions of household formation (labelled "demand") and of construction (labelled "supply") and to describe the gap between the series as a "shortage".

While this approach helps to communicate simple ideas to the general public, it does not provide an adequate basis for policy. Among other problems, it requires an assumption about average household size, typically a recent value. However, current household size is constrained and too large: because we have not built enough, prices have risen so people overcrowd into the available dwellings.

A more rigorous approach is to calculate the excess demand for housing as the gap between prices and the marginal cost of supply. This is the leading approach in the academic literature.

For example, the NSW Productivity Commission ([2023](#)) estimates that the average new Melbourne apartment sold for \$672,000 in 2022 but only cost \$544,000 to supply, implying a gap of \$128,000 or 19% of the price. This looks like a highly profitable transaction, raising the question of why it doesn't occur. The answer is that the planning system prohibits it. Estimates for detached houses and other Australian cities are in the first two columns of Table 1.

**Table 1: The Wedge Between Sale Prices and the Cost of Supply**

	<u>Estimates of the Contribution of Planning Restrictions to Property Prices</u>		<u>Site Values</u>
	<u>Detached Houses, 2016</u>	<u>Apartments, 2022</u>	<u>Apartments, 2020</u>
Sydney	\$489,000 (42%)	\$357,000 (37%)	\$180,000
Melbourne	\$324,000 (41%)	\$128,000 (19%)	\$130,000
Brisbane	\$159,000 (29%)	\$17,000 (3%)	\$40,000
Perth	\$206,000 (35%)		\$50,000
Adelaide			\$40,000
Gold Coast			\$80,000
Canberra			\$80,000
Hobart			\$100,000
Darwin			\$50,000
Source:	Kendall and Tulip ( <a href="#">2018</a> )	NSW Productivity Commission ( <a href="#">2023</a> )	Knight Frank ( <a href="#">2021</a> )

The sources in the last row of the table give details of how the estimates are constructed. The NSW Productivity Commission estimates for apartments are an update of Jenner and Tulip ([2020](#)) where the approach is documented. Tulip ([2020](#)) discusses the estimates in the first two columns and notes that similar effects have been estimated in many cities overseas, using a wide variety of data sets and testing sensitivity to many other factors, so the estimates are qualitatively robust.

The ‘site values’ in column 3, sometimes called the ‘residual land value’ of apartment buildings, provide a cross-check. Site values, like the effect of planning, reflect the per-apartment difference between sales prices and costs. As such, they provide independent corroboration of the estimates, though there are differences in coverage, definitions, weighting and timing. The site values in Table 1 are compiled and updated by [Knight Frank](#), one of Australia’s leading property consultancies.<sup>2</sup> Site values like these are commonly discussed within the industry on a ‘per apartment’ basis, consistent with land values being roughly proportional to the number of apartments that are allowed to be built on a site.

Estimates in table 1 are for sale prices of housing, as that is most directly comparable to the cost of supply. However, rents are approximately proportional to prices (given interest rates and other components of the user cost of housing; see [Fox and Tulip, 2014](#)). So, findings that prices of houses and apartments in Melbourne are 41% and 19% excessive due to planning implies that rents are similarly excessive.

Planning restrictions increase housing costs in two ways. First, they increase administrative costs and delays. The Centre for International Economics ([2013](#)) and Deloitte Access Economics ([2016](#), Section 3.1.1) estimate that the most easily quantified “red tape” like this might increase supply costs by about \$2,000 to \$6,000 per dwelling. Second, planning restrictions simply reduce the supply of housing. The estimates in Table 1, many of which are in hundreds of thousands of dollars, suggest that this by far the bigger effect. This has important policy implications: speeding up and

<sup>2</sup> The estimates in column 3 and column 2 are conceptually similar except estimates in column 2 use marginal cost and apply after building approval is granted, whereas those in column 3 use average cost and apply at an earlier stage in planning (so incur a larger risk premium).



streamlining planning decisions is worthwhile but it is not the priority; the important challenge is to turn “no” into “yes”.

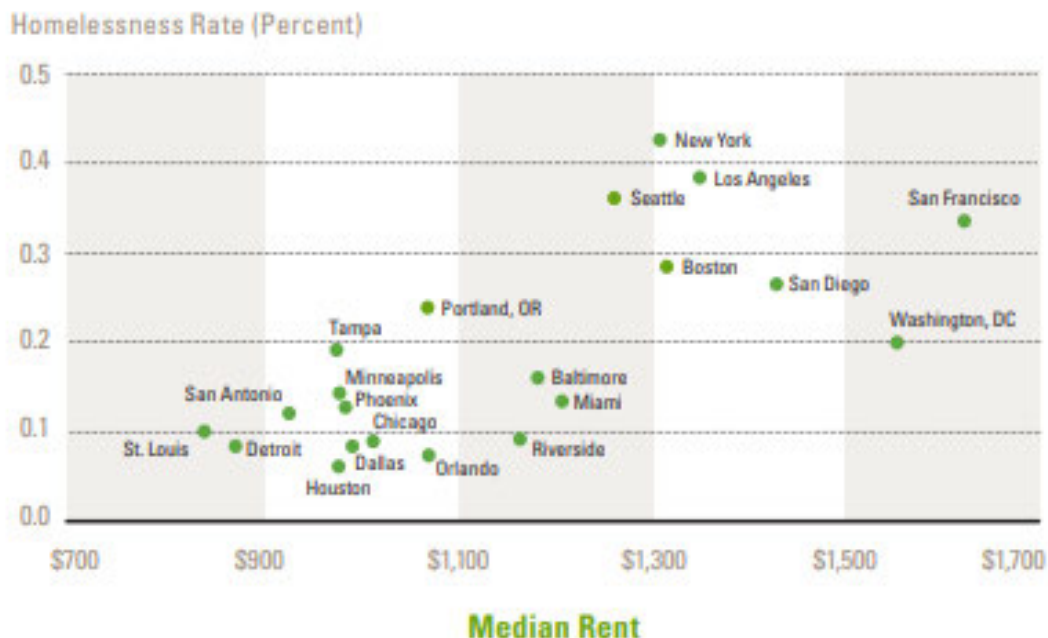
#### 4. Housing for those on lower incomes

While evidence that planning restrictions affect the overall affordability of housing is overwhelming, affordability for renters on low incomes is a special concern.

Newly constructed housing is often more expensive than old housing, giving rise to concerns that extra construction will primarily benefit the wealthy. However, this concern is misplaced, because it does not take into account the indirect “filtering” or “cascade” effects of increased supply. When wealthy residents occupy new housing, they vacate other housing, which falls in price. Those vacancies are filled by those on moderate incomes, who vacate other housing. That increases supply and lowers prices for those on lower incomes. And so on. Researchers in [Australia](#), the [United States \(twice\)](#), [Germany](#) and (most persuasively) [Finland](#) have all documented these “moving chains”, finding them to be fast and strong. As the [Commonwealth Productivity Commission](#) (2022, Section 12.5) concluded, based on its survey of the research, “More supply — in any segment of the market — can improve affordability for low-income households”

A shortage of housing is like a game of musical chairs. Regardless of who is playing or the quality of the chairs, if there are not enough then the weakest will miss out. As shown in Chart 5, there is a strong relationship between rents (determined by overall supply) and homelessness. Indeed, average rents are the most important determinant of rates of homelessness – more so, for example than poverty rates, unemployment or drug abuse – as documented in the aptly named *Homelessness Is A Housing Problem* by [Colburn and Aldern, 2022](#).

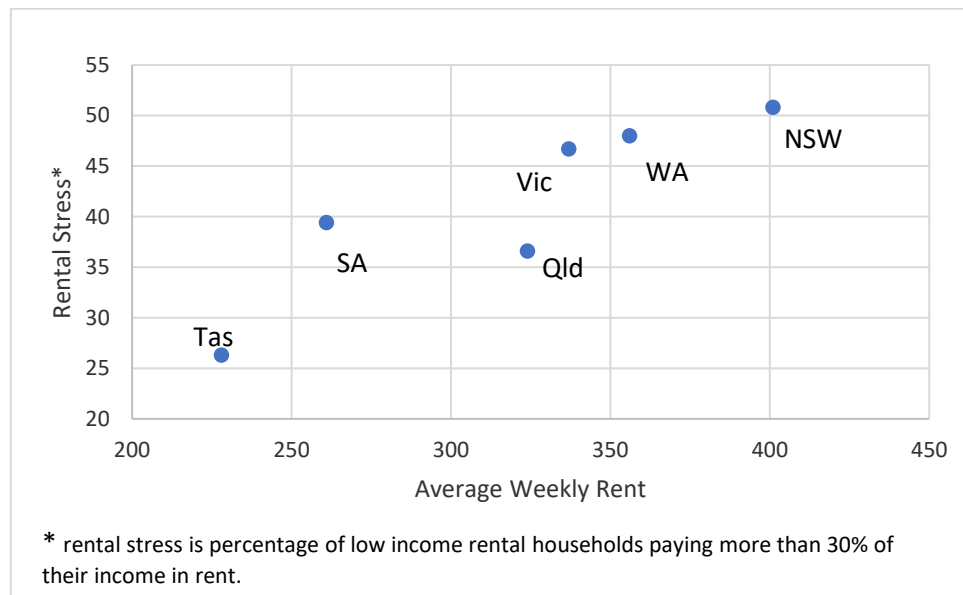
Chart 5: Homelessness and Rent; US cities



Source: [Harvard Joint Center for Housing Studies](#) (2017; Figure 35)

Similarly, average rent in a city is strongly correlated with measures of rental stress among low-income earners.

Chart 6: Rental Stress Increases with Average Rent



Source: ABS 41300, Housing Occupancy and Costs, 2015–16, Tables 13.1 and 22.1

[Nygaard and coauthors \(2022\)](#) find that filtering “on its own” does not lower rents for those on lower incomes. However, contrary to what is suggested by [Pawson and coauthors \(2022\)](#), this is perfectly consistent with the other research on filtering. Filtering lowers rents for those on lower incomes when it is combined with increased supply. In contrast, properties “filter up” (become more expensive) when supply is inadequate. In practice, the latter has often predominated. That is consistent with the finding that a policy of boosting supply would make housing more affordable for those who need it the most.

## 5. Amenity

The strongest argument for zoning restrictions is that they preserve local amenity. Some people find tall buildings ugly, they dislike congestion on local roads, and they consider that increased density impairs the character of their neighbourhood. These are value judgements on which reasonable people should agree to disagree.

However, it is doubtful whether these views are as widely or strongly held as the noise generated by their supporters might imply. When new high-rise apartments have been constructed, as for example, in Box Hill, South Yarra or Footscray, nearby house prices have not changed relative to adjoining suburbs ([Lanigan and Tulip, 2021](#)). This suggests that local amenity has not been impaired. While some neighbours may dislike new buildings, that has been offset by other homebuyers who like a lively walkable neighbourhood and the new shops, restaurants and transport that accompany higher density.

Similarly, econometric studies of special character overlays (elsewhere called heritage protection) in Auckland find that they increase housing values by about 4% ([Greenaway-McGrevy and Jones, 2023](#); [Fernandez and Martin, 2020](#); [Bade, Castillo, Fernandez and Aguilar-Bohorquez, 2020](#)). In economic terms, this quantifies the value of the externality in a way that can be directly compared with a Pigouvian “zoning tax”, which [Lees \(2018\)](#) estimates to be 54% in Auckland.

If one did consider that opposition to new development was widespread, society would face a trade-off. Elected representatives would need to weigh the desire of wealthy neighbours for easy parking and to avoid shadows against potential residents' need for shelter. Current institutional arrangements make this trade-off by giving those wealthy neighbours a say, via their local councils, while the views of potential residents from outside the area are ignored. State politicians representing wider electorates would place more weight on the latter group and make different trade-offs. Broader social welfare is advanced by making these decisions at State level.

## 6. Misunderstandings

Whereas concerns about neighbourhood amenity reflect differing values, most other objections seem to reflect simple misunderstandings. These other objections are not taken seriously in the research literature. For example, they are barely mentioned in the summaries of the research cited in Section 2. Nevertheless, they may appear in other submissions.

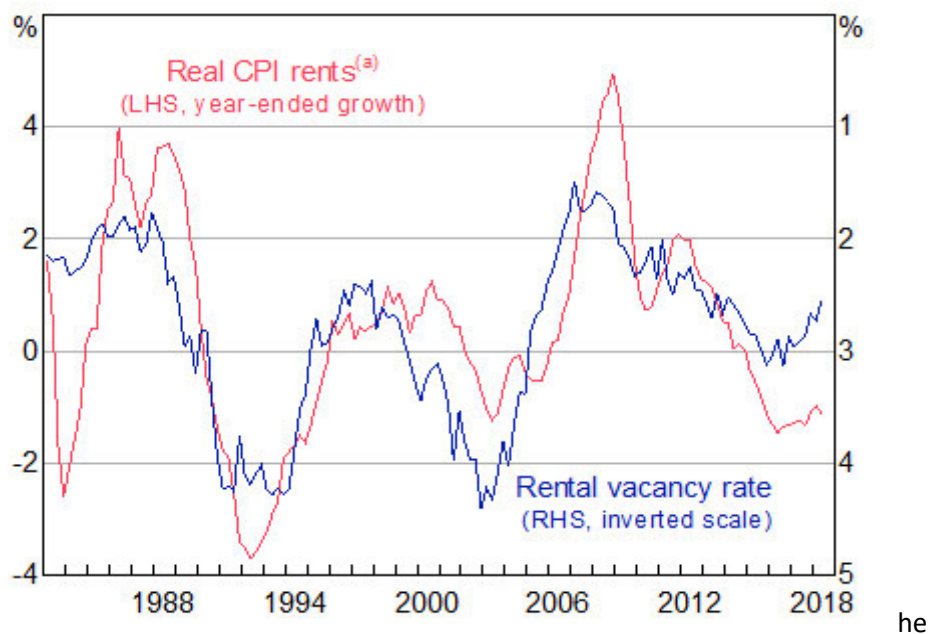
### The role of supply and demand

It is sometimes suggested that, in contrast to other markets, extra supply of housing does not reduce rents or prices. This argument is often based on observations where both supply and demand increase, but that is not relevant to a policy that increases supply for a given level of demand.

Part of the confusion occurs because a small, isolated increase in supply, for example by one builder or in one suburb, will not materially affect prices. That is because it is small relative to the overall market and it competes with nearby housing, to which its prices are tied. In the same way a farmer doubling his crop will not affect his price or his neighbour's price.

However, if all builders or suburbs increase supply, so the change is substantial relative to the level of demand, prices move strongly and clearly. This can be seen in Chart 7, which shows that when the vacancy rate, a measure of the gap between supply and demand, is low, rents rise quickly. The same close relationship between the tightness of the housing market and rental growth is evident in [Canada](#) and the [United States](#).

Chart 7: Vacancy Rate and Change in Real CPI Rents; Australia



Source: [Saunders and Tulip \(2019\)](#)

As an aside, this relationship explains, in a proximate sense, the recent growth in rents in Victoria. The Department of Families, Fairness and Housing's [Rental Index for Victoria](#) (based on all new rental lettings in the State) increased by 13.3 per cent in the twelve months to March 2023, the fastest increase since this series began in 2000. This can be attributed to the very tight housing market, with [REIV's](#) vacancy rate for Metropolitan Melbourne, at 2.1%, near its lowest levels since 2005 ([Hanmer and Marquardt, 2023](#), Figure 1).

The effect of excess supply on the cost of housing is verified and quantified in econometric work. Studies at a local or city level ([Phillips, Manville and Lens, 2021](#); [Hanushek and Quigley, 1980](#); [Albouy, Ehrlich and Liu, 2016](#)) find extra supply has a small but clear effect, reducing the cost of similar housing. Studies at a national level find that an extra 1% increase in the housing stock reduces the cost of housing by about 2-3% ([Abelson, Joyeux, Milunovich and Chung, 2005](#); [Girouad, Kennedy, van den Noord and André, 2006](#); [Oxford Economics, 2016](#)). The most recent study for Australia, by [Saunders and Tulip \(2019\)](#) estimates that a 1% increase in the housing stock reduces rents and prices by 2½%.

[Pawson and coauthors \(2022\)](#) dispute these well-established empirical regularities on theoretical grounds. They say that it would be irrational for builders to increase supply, reducing prices. Their mistake is assuming that the housing market is monopolistic. In a competitive housing industry like Victoria's, which has thousands of builders and developers, if one firm withholds supply, its competitors will take its business. To be clear, competitive firms have an incentive to *time* the market – selling when prices are unusually high. But that smooths prices, it does not increase them.

[Pawson and coauthors \(2022\)](#) also say that were supply to increase due to a relaxation of planning, then other supply would contract. Zero evidence is provided in support, nor is any plausible mechanism suggested. Capacity constraints have been important recently as the unemployment rate has fallen below 4%, however conditions are loosening quickly, and those constraints are unlikely to bind again for many years. Some advocates of this view (for example, [Farrelly, 2023](#)) assume that housing supply is highly price-elastic, but that assumption is clearly rejected by econometric studies such as [Saunders and Tulip](#), (2019, Section 4.1) or the RBA's MARTIN model ([Ballantyne et al](#), section 4.3.1) which find a modest and short-lived response to prices.

Technically, many residents are relatively indifferent between housing in nearby neighbourhoods, so demand at a local level is highly elastic. In contrast, moving to a different city requires the whole household to change jobs, schools and social networks, so demand at a city or higher level is highly inelastic. So isolated increases in supply have a small effect on prices whereas widespread increases have large effects. This has important policy implications. It means that one local council, by itself, can do little to overcome the housing affordability crisis. Were it to increase supply, residents would move from nearby. A co-ordinated city-wide increase in supply, organised by the State government, is needed.

## Other misunderstandings

Several other misunderstandings can be simply addressed. Quotations are representative of arguments frequently made on social media.

*“Zoning is not an important determinant of housing prices because other factors, such as interest rates, immigration, taxes or location premiums, are more important.”*

These other factors are not alternative explanations but complements. It is the *interaction* between these factors and planning restrictions that inflates prices. In economic terms, zoning makes housing supply inelastic; that is, the supply curve is steep. In contrast, these other factors boost demand, shifting the demand curve to the right. A well-functioning housing market would respond to the higher demand by building more dwellings. Instead, because planning limits supply, we get higher rents and prices.

Moreover, there are usually good reasons, or reasons outside the Victorian government's control, for demand to increase. For example, rising income and population. So, demand should usually be taken as given. In contrast, reasons for not allowing supply to respond are weak and within the Victorian government's power to change.

*"Planning restrictions cannot explain recent high prices because those restrictions have been eased."*

Again, this ignores the interaction. It is true that restrictions barely change — despite demand increasing with increases in population, incomes or lower interest rates — that is the problem. With higher demand, the constraint becomes more binding.

*"Recent construction levels have been high"*

Recent construction levels have not been high enough to clear the long-term accumulated backlog, nor to meet growing demand. Those who point to the flow of new housing are simply ignoring the research (discussed in Sections 2 and 3) finding that the stock of housing is inadequate. The relevant shortage is the level.

*"Some developers are allowed to build but they choose to withhold supply"*

The importance of this is contested but the more important response is "So what? Why is that an argument for stopping the many builders and developers who do want to build?"

Tulip ([2021](#)) discusses further objections to estimates of a large zoning effect.

## 7. Public and Social Housing

Policy towards public housing has been thoroughly studied by the [Henry Review](#), the [McClure Review](#) and the [Productivity Commission](#). We endorse those reviews' recommendations with respect to public housing and do not repeat their material here.

In summary, there are compassionate grounds for providing temporary shelter to refugees, victims of domestic violence and others with emergency needs. Furthermore, there are paternalistic reasons for providing longer term housing assistance for those suffering from disability or mental illness. However, the large majority of public and social housing tenants and potential tenants would be better off if they were given the subsidy in cash and allowed to choose housing that best suited their changing individual circumstances.

If public and social housing takes the form of new construction, then it increases housing supply and improves affordability. However, it comes at a prohibitive fiscal cost. For example, the Federal

government's HAFF costs \$10 billion to provide 30,000 new dwellings. That represents a 0.2% increase in the national dwelling stock. Using the estimates discussed in Section 6, it would reduce the average cost of housing by about 0.5%. Compared to the estimates in Table 1, that is tiny, if not trivial. For another relevant comparison, the liberalisation of granny flats in NSW shown in Chart 4 led to 49,000 extra dwellings at zero cost to the taxpayer.

## 8. Policy

We need to relax zoning restrictions to allow more housing.

At a society level, this requires more acceptance of higher density and less opposition to new development. We need to put more weight on the interests of renters and future home buyers and less weight on the interests of nearby residents. This rebalancing will shift the incentives for elected governments to act. Societal pressure over the issue of housing affordability is growing, but needs to be encouraged.

Were the Victorian government inclined to do something to improve housing affordability, there are several measures it could take.

One increasingly popular and effective approach is for the State government to set conditions that apply across local plans. For example, NSW removed limits on the construction of granny flats, as discussed in Section 2. New Zealand's 'Medium Density Residential Standard' requires large cities to permit up to three storeys and three dwellings on all existing residential parcels of land ([Greenaway-McGrevy, 2022](#)). California's AB 2011 allowed medium-density residential development to proceed by right in commercial zones. [Schuetz \(2022b\)](#) lists dozens of similar reforms.

Minimum standards can prevent the worst restrictions. However, their uniformity is a limitation: different levels and forms of density are appropriate in different areas. Granny flats are not efficient in the inner suburbs, while high-rises are not efficient on the outskirts. In practice, blanket over-rides such as Auckland's Unitary Plan have tended to increase density most on the outskirts ([Lynch and Lees, 2021](#)); whereas Melbourne arguably most needs development in inner suburbs.

A more flexible approach is for the State government to set and enforce construction targets for local councils, allowing each council to decide how the target should be met. Councils could choose a small number of high-density developments or a larger number of medium density developments. Either choice improves housing affordability. The important thing is that councils need to allow more housing. The quantity should be decided centrally; the type can be decentralised. An approach like this is followed in NSW and many foreign jurisdictions, including England, California and some Canadian provinces.<sup>3</sup> However, most of those targets are too low and inadequately enforced.

The rationale for the State government over-riding local councils is that the councils are biased against development. They represent nearby residents, not the direct beneficiaries — the newcomers moving into the area — nor the indirect beneficiaries, the renters and future home buyers who pay lower housing costs. Local governments will act like a cartel, restricting supply and driving up the price of housing. That benefits local property owners, but this is more than outweighed by the harm done to potential residents from outside the area and future generations.

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<sup>3</sup> For England see [UK Department for Communities and Local Government \(2017\)](#); for California, see [Schneider \(2022\)](#); For [British Columbia, Office of the Premier \(2022\)](#); For Ontario, see [Hughes \(2022\)](#) or [Moffatt et al \(2022\)](#).

Closely related, housing affordability can be seen as a public good, subject to a free-rider problem. There is little that one council, acting alone can achieve. But if all councils allow more building, housing costs will fall substantially. So, it is rational for individual councils to contribute if, and only if, other councils are also required to contribute.

The above rationales support central control of the quantity of housing, though not necessarily of its kind, which can be left in local hands. [Tulip \(2023\)](#) discusses how targets for local councils can be calculated. The important point is that the targets should require an increase in construction.