"Making Room for Growth" – a strategy founded on poor economics

By: Dr J D M Fairgray, 25 June 2019

In a recent address to the NZ Initiative, Housing Minister Phil Twyford laid out his new planning approach to urban development - **Making Room for Growth**[1].

His reasoning is revealing. The Minister's objective is "*..to bring down urban land prices by flooding the market with development opportunities.*" He wants to "*break the current land market model*".

Blaming planning and infrastructure financing for creating an "*artificial scarcity of land … preventing efficient land use....blocking … more affordable housing options", and creating an* Auckland market characterised by "*land banking and speculation*", he seeks to get rid of *"a planning system based on urban containment"* and instead "*replace the Urban Growth Boundary with a more expansive approach to spatial planning"* – aiming squarely at Auckland's urban growth boundary.

The basis of the inefficient market stance is clear – housing prices are too high. The critical evidence for this inefficient land market is that urban land values (per ha) are far higher than rural land values.

The Minister's views echo and further extend the views in Treasury, MBIE, MHUD and elsewhere that housing prices are too high because the land market is inefficient. That premise of market inefficiency had a strong influence on urban policies under the previous National government. It was a critical driver of the NPS on Urban Development Capacity (NPS-UDC, 2016), which now sits atop New Zealand's urban planning framework. Efforts to "fix" the market are dominated by this view – the favoured solution is to create a "competitive urban land market" by removing constraints on growth and allowing cities to spread further into their rural surrounds. The belief is that adding to the supply of land for future growth – "*flooding the market*" - will drive down urban land values, across all existing and future urban properties. That would make the land market efficient - irrespective of the economics of urban expansion.

Unfortunately, that premise of an inefficient land market is flawed. It arises from misinterpretation of how the land market functions which is at odds with fundamentals of land economics and valuation principles, particularly how urban economies expand into their rural surrounds. As a consequence, the much higher values for urban land have been misinterpreted as showing the land market is inefficient, when instead those large differences in value reflect efficient urban growth patterns.

[1] Address to NZ Initiative Members' Retreat, April 2019

The belief that urban land prices will be brought down "*..by flooding the market with development opportunities* " highlights the flaws in the economic rationale. It implies that the land market can be understood according to some Economics-101 demand-supply diagram for a factory's widget production, rather than understanding that the market has a complex dynamic structure where location, time and scale are critical influences, especially around the urban edge as cities expand and displace rural activity.

How has this arisen? An analysis by M.E identified flaws in how the inefficient market premise has been examined and identified, and found that the premise of an inefficient land market around the urban edge is not sound (NZ Planning Quarterly[2], March 2019). One key reason is that the premise of the inefficient land market is driven by a backward-looking focus on the price of rural land - akin to a cost-accounting approach - instead of considering how the market itself places value on urban land according to its potential uses.

The critical evidence relied on to show that the land market is inefficient is the large differences observed between urban and rural land values per ha. The theory which is relied on - the *Marginal Opportunity Cost* (MOC) concept, adopted for the NPS-UDC and the Urban growth Agenda (UGA) - is that urban land values should be not much higher than rural land values. In an efficient market, the theory is that urban values would be higher than rural values only by the costs of infrastructure and land development, plus the convenience value of an urban location and value for rare amenity. If land value differences are greater than this MOC, then the market is deemed inefficient.

However, the inefficient market premise relies on the MOC concept which contains two key assumptions. One assumption is that land value is not influenced by potential land use. Unfortunately, that position conflicts directly with economic theory and key principles of valuation.

The second assumption is that land value is not influenced by location. That position too is at odds with economic theory and knowledge of how the land market functions, especially at the rural-urban interface.

In our view, those critical assumptions mean there are significant flaws in the economic rationale for assessing how efficiently the land market is functioning. The misinterpretation is clear in expectations of what land values "should" be – that is, no more than its value if it were still solely rural, plus the costs of infrastructure and some allowance for the convenience of being close to urban activities and amenities.

The MOC approach simply ignores two very major influences on urban land value, and excludes potential land use and location from the value equation. As a consequence, the expectations of what land values should be are substantially distorted. Excluding potential land use and location from the mix means that the differences between rural and urban values, are inevitably larger than 'expected'. Those big differences in value are then interpreted as critical evidence of that the market is inefficient – rather than recognising that

[2] Inefficient Markets — the Basis for New Zealand's Urban Policy NZ Planning Quarterly March 2019

in an efficient economy, those differences reflect that the market places much higher value on urban land than rural land.

The omissions create a major difficulty when it comes to developing sound urban policies.

If those two critical assumptions in the MOC approach are relaxed, then the 'evidence' of market inefficiency falls away. That is because when the market is functioning efficiently there should be substantial differences between rural and urban land values - an outcome which is consistent with how the market operates, and how urban spatial economies function.

The misinterpretation appears to result from incomplete understanding. The notion that urban land values should be rural values plus infrastructure costs plus convenience values does not adequately take account of the workings of urban economies, and how the land market operates. Urban land is more valuable than rural land because it can be used more intensively and so can generate much greater returns, and because it incurs substantial costs to sustain that urban activity. That direct relationship between potential land use and land value is a fundamental of economics. It is encapsulated in the valuation sector's principle of *highest and best use of land*, where valuation is based on probable use, taking account of physical and legal attributes and feasibility[3]. Location too is always a core influence, especially because of its major effect on potential use. Markets typically recognise differences in potential returns, and reflect these in prices. In Auckland, for example, for urban residential land both housing capacity per ha and values per ha are around 30 times those of rural land – quite simply, higher intensity of use generates higher returns and land value.

However, rather than recognise this, the MOC theory relied on for the NPS-UDC and the UGA, and now being further promoted in the *Making Room for Growth* initiative, is that urban land has much higher value than rural land mainly because of some failure in the market, and not because of its capability to generate much higher returns than rural land. Hence the repeated references to the inefficient land market - especially at the urban-rural interface where most of the new capacity for growth arises, and where the difference between expected and actual land values is most obvious.

Closer attention to why and how cities form, and the core economic processes which drive land use change and associated land value change, lead us to quite different expectations of what urban land values "should" be, and a different appreciation of how efficiently the land market is working.

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[3] "*The most probable use of a property which is physically possible, appropriately justified, legally permissible, financially feasible, and* ***which results in*** *the highest value of the property being valued*" Australian and New Zealand Valuation and Property Standards, 2009, http://www.google.co.nz/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&ved=2ahUKEwiD4cGF3PXeAhUGEnIKHdHIBi4QFjACegQICBAC&url=http%3A%2F%2Fpropertyinstitute.nz%2FFolder%3FAction%3DDownload%26Folder_id%3D4%26File%3D06-11-09_Valuation%2Band%2BProperty%2BStandards_2008%255B1%255D.pdf&usg=AOvVaw0CrAuu7nwKo8bh033JGBoT

Cities form because there are major economic benefits from co-location of economic and social activity. Geographic concentration of activity drives efficiencies and agglomeration benefits, enhancing urban efficiency and sustainability. Achieving those efficiencies typically incurs substantial costs, especially for the built infrastructure needed to sustain the concentration of economic activity. Land values reflect both these urbanisation costs and earning potential, with urban values highest in the city centre as the most efficient location and decreasing toward the urban edge. At that edge, the returns from using the land drop significantly to reflect the lower intensity of use possible on rural land.

As cities expand outward (and upward), land at the edge transitions from rural to urban use, and land values transition as well to reflect the greater potential returns as land becomes urbanised, and the infrastructure, subdivision and development costs are incurred to sustain that greater intensity of use. The increase in land value commonly has several steps – as the urban edge expands outwards, the still-rural land close to the edge increases in value in anticipation of the much greater returns which can be realised once it is in urban use. The degree of value uplift depends on its location relative to the edge, and the anticipated time lag before urbanisation is a reality.

That value uplift is strongly affected by location. Land close to the current edge is most valuable, it will be urbanised sooner and is attractive as the closest still-rural land to the city centre. Land further distant is less attractive at the moment as a place to live or do business, it has higher holding costs because of the time lag until the urban edge arrives, and is costlier to service than land right at the edge. The main uplift in its value will occur later, as the urban edge continues to move outward.

Landowners around the edge are generally well aware that the value of their undeveloped rural land will peak when the urban edge is very close, and the start of the urbanisation process is imminent. To achieve the best price for their land, there is obvious incentive to wait until it reaches maximum value. The timing of their decisions to sell or develop reflects this. Selling earlier – when the urban edge is some distance and time away – simply invites a lower price.

This is a key reason why simply adding more land to “flood the market” on the notion that increasing potential supply would boost competition among those landowners and cause a price drop, would have minimal effect on urban prices. More land will increase total potential supply but it is further from the urban edge, and adding less attractive land to the mix now provides no strong reason for the owners of the most attractive land right at the edge to lower their prices - they know their land is the most valuable for development because of its location, irrespective of the total potential supply. Location and timing are the critical influences. Which is why it is rather naïve to claim that increasing land supply well beyond the edge will materially affect the values right at the edge.

And this is quite apart from the fact that the price of still-rural land is a small component of the final value of fully urbanised land.

The characteristic uplift in land value as the urban edge approaches has been seen in some quarters as being the result of speculation and land-banking to artificially constrain land's release to inflate prices. While this certainly does happen, the uplift in value is predominantly a direct effect of the urban advance, and occurs irrespective of land ownership patterns, and timing reflects rational behaviour by owners of still-rural land to maximise their returns – in the same way that property owners, of lifestyle or rural land outside the urban edge, or households and businesses within urban economies generally seek to maximise their returns from property sale. Where one or a few owners have a large share of the total resource, they may certainly act to inflate prices by constraining release. However, in a market where there are multiple owners each holding very small shares of the total resource, it is difficult to conclude that significant land banking occurs. Around Auckland, the still-rural land in the 12,000 ha or so of Future Urban zone has approximately 2,600 land owners owning on average 4-5 ha, or about 0.04% of the total resource, which suggests there is quite limited potential for any level of market control.

Part of the problem is that the MOC interpretation of the land market seems to ignore the effects of location and time and how these in combination affect land values as a city expands. While a strategy to "..*bring down urban land prices by flooding the market with development opportunities"* may have the appealing simplicity of the Economics-101 demand-supply graph, it simply does not capture the dynamics of the land market where conditions and values change with the advance of the urban edge.

Which is why a strategy based on simply "*..flooding the market..*" rings so many alarm bells – it is likely to be ineffective, it is likely to undermine soundly thought out growth strategies for urban containment to deliver more efficient and more sustainable cities.

These matters highlight the need for a different interpretation and approach, which focuses on how urban markets function and grow, and not the rural sector which urban growth displaces. For a city, an efficient urban growth pattern will result in clear differences between urban and rural land values, which accurately reflect the higher earning potential of urban land over rural land, and its advantages as a place to live. The benefits of co-location and concentration of economic activity, and the high costs of infrastructure, subdivision and development, mean that cities are relatively efficient and sustainable when the activity is concentrated on the land. A compact urban form is relatively efficient and sustainable, with land utilised efficiently. A city expanding in a land-efficient manner will take up only the minimum extra land needed for economic growth, with that land transitioning quickly to full urban activity. Land values adjust in anticipation, and in response, including the characteristic increase in rural land values with the approach of the urban edge.

That is why efficient urban expansion will usually result in significant differences between urban and rural land values. And why substantial differences in land values should be interpreted as showing that urban growth is occurring efficiently, and not some failure of the land market. An efficient urban growth pattern is important, because over 90% of our population growth is urban.

These matters highlight the importance of having our urban policies based on sound understanding of how our urban economies really work, rather than misinterpretations of what drives our land markets, and supposed market inefficiency.

Attempts to "fix" the land market without fully understanding it will lead us to poor policy responses - which will have minimal effect on housing prices, but will come at the cost of undermining key higher order objectives for sustainability and urban efficiency. This is an especially important consideration for the NPS-UDC and the UGA, with many of their big positives at risk of being hamstrung by failure to understand critical aspects of how urban economies grow and expand.