The Persistent Puzzle - Speculative Vacancies 10 *by Karl Fitzgerald*

Key Findings

• Water usage data finds 69,004 properties vacant, a ratio of 4.1% in 2019.

• Vacancies recorded in 2019 could house 185,000 people at current household averages.

• Vacancies increased 13.3% between 2017 and 2019.

• Properties using zero litres per day on average over 12 months totalled 24,042, a ratio of 1.4%.

• When added to the short term rental rate, some 4.7% of properties were likely vacant.

• Up to 16.1% of investor owned residential properties were potentially vacant.

• Just 12.3% more properties were sold as were likely vacant.

• These findings do not include 370,000 vacant land lots, largely within master planned communities.

• The Valuer General's quantification of residential property 'assessments without buildings' equates to approximately 63,314, a similar volume to our findings.

• Three times the amount of non-residential property stood vacant as was sold in last year's vibrant industrial market.

• The state government's Vacant Residential Land Tax was levied on only 2.6% of absolute vacancies. No fines have been recorded against non-declaring landholders. Water consumption has not been used as a vacancy indicator. Weak enforcement has cost the taxpayer at least $160 million a year.

• Vacancy rates in the gentrification belt of the inner north, alongside the cultural hotspot of mid eastern suburbs such as Box Hill and Glen Waverley, increased markedly in 2014 remaining >5% over five years.

Housing supply has been the centrepiece of national and state government affordability policy for over twenty years. Prosper has spent a decade advocating for more accurate, timely vacancy data, so those properties withheld from use could be added to advertised vacancies to deliver a holistic analysis of land use.

Land and housing supply is recognised as a key ingredient to affordability, yet we fail to effectively gauge inefficient land use.

Meanwhile, industry bodies regularly call for more land supply in the form of rezoning, or deregulation of existing land supply.

Such advocacy occurs even when the development lobby aggressively cuts supply in response to falling demand or weak market conditions.

Housing Industry Australia (HIA) Economist Angela Lillicrap stated in October 2019:

"A shortage of land is one of the factors that has driven home prices to increase over the past decade. The process of making land 'shovel ready' can often last a decade, therefore, responding to shortages cannot be met with increased supply in the short term. An adequate supply of land is required to avoid a deterioration in affordability."

A more objective take was presented by the Urban Development Institute of Australia (UDIA):

"Developers responded to the subdued market conditions by releasing lower levels of stock to market in 2019, with a total of 11,964 annual lot releases which was 35% lower than 2018 and 48% lower than 2017."

The most recent Urban Development Plan - Broadacre report found available land supply averaged 21 years across our growth areas. Plan Melbourne states 15 years supply as a sufficient public policy aim. Melton has 42 years and Hume-Mitchell 30 years available land supply.

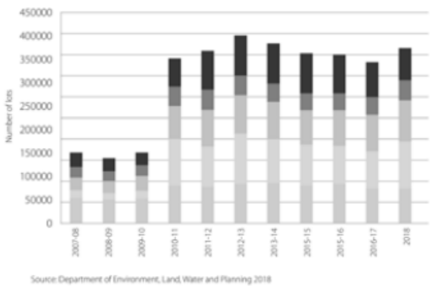

Figure 11. Broadacre land supply

has more than doubled the broadacres supply from the pre 2010 era of 150,000 lots to some 350,000 lots over the following 8 years.

This supply pipeline has not rectified affordability concerns or reduced the price of housing.

"While land prices have come down during 2019, over the last decade the price of new residential land per square metre in Sydney has doubled and more than doubled in Melbourne," stated HIA Economists Angela Lillicrap.

The HIA press release then continues to counsel that land prices are the sole responsibility of limited land supply.

Furthermore, greenfield median lot sizes have fallen by 23.5% since 2009. Per metre costs have increased by more than double, from $327 per metre to 837 p/m - up 256%.

Let's turn our attention to the relationship between pricing and supply responsiveness in three growth area suburbs:

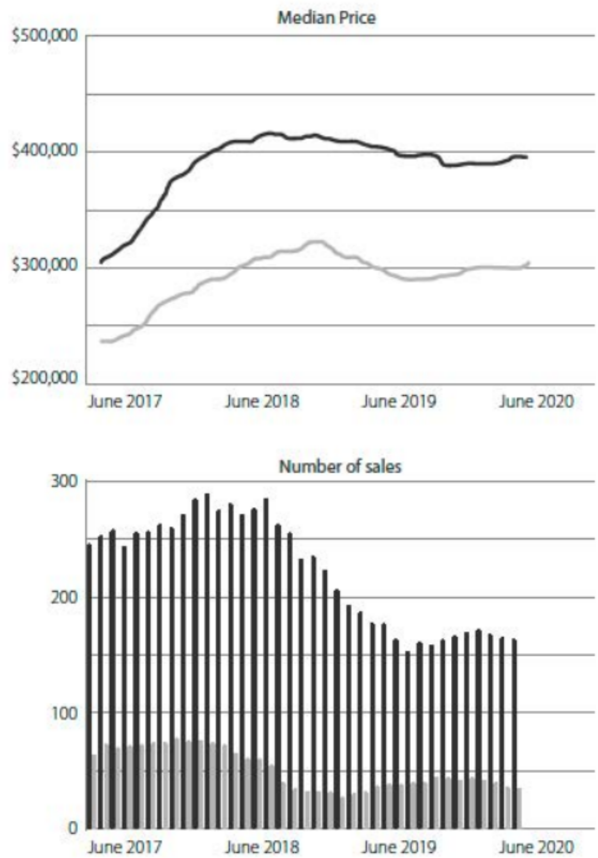

Figure 12. Suburb profile for Melton South VIC (3338)

House
Unit

Figure 12 shows recent pricing trends in the suburb of Melton South. We can see immediately above that sales reduced from 2018 and throughout 2019 whilst prices have stayed fairly constant.In a softening market, reduced stock acts to maintain prices.

Mernda, in the Whittlesea district (with an available land supply of 22 years), has also seen supply trending downwards.

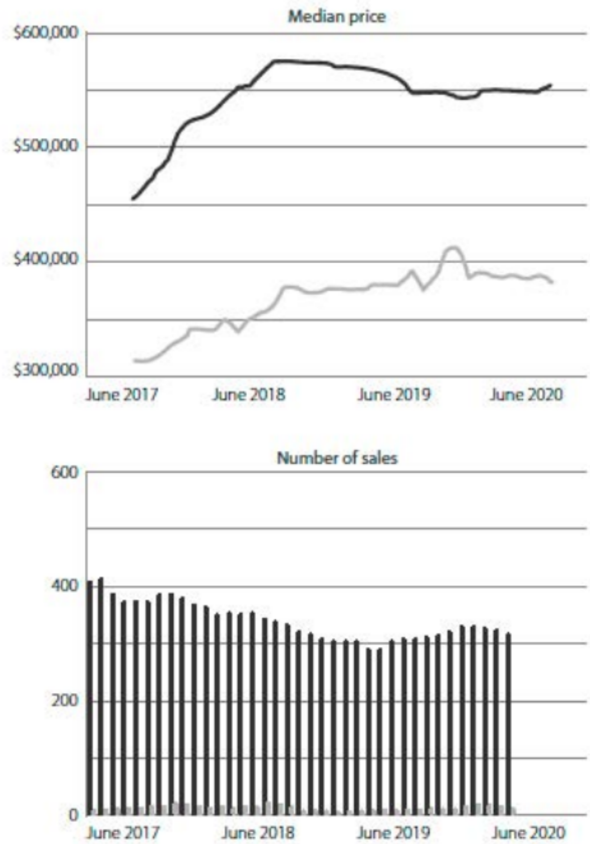

Figure 13. Suburb profile for Mernda VIC (3754)

House
Unit

A similar theme repeats in Mickleham, one of the growth area suburbs within the Hume-Mitchell catchment.

Figure 14 shows how supply appears to lag housing pricing trajectory. Despite more than 30 years available land supply (double the amount of supply Plan Melbourne sees as appropriate to enable affordability), prices continue to head northwards in Mickleham, home to some of the nation’s largest master-planned communities. The slight pricing downturn in early 2020 was immediately followed by the countervailing change in supply, indicative of price preservation.

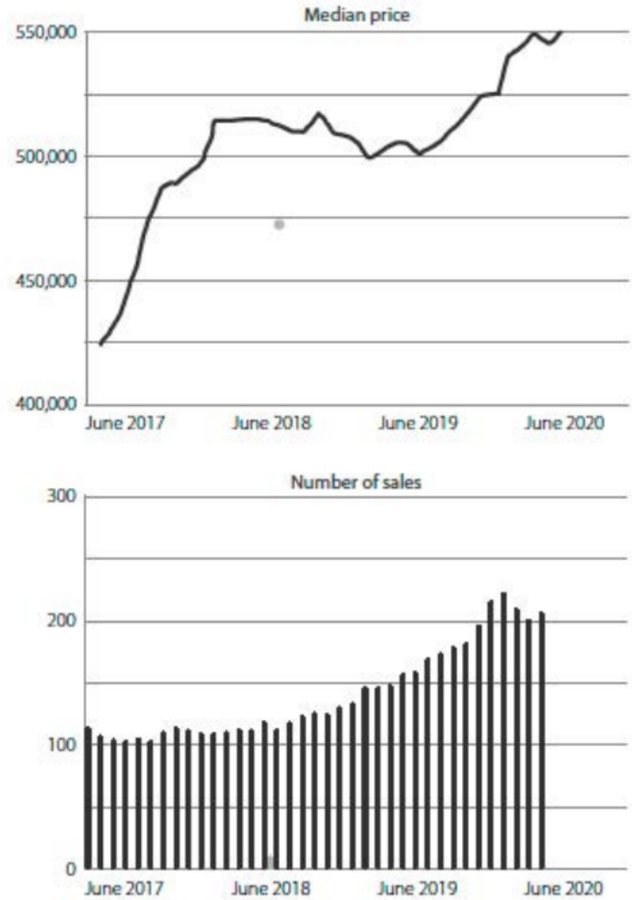

Figure 14. Suburb profile for Mickleham VIC (3064)

House
Unit

We highlight these examples because urban economic theories, upon which much housing policy has been based, claim that private housing markets will continue to supply equilibrium homes until a new, affordable equilibrium is reached.

This overlooks the market signals private developers must adhere to in order to remain in business. It is as if developers are expected to be pro-cyclical in the good times but when challenging market conditions change, are expected to behave as good samaritans, holding production steady to provide housing for all.

This only exists in theoretical models with questionable assumptions.That’s not how it plays out in reality.

Private markets act rationally to maintain land and housing prices by reducing supply. Financiers deter land price discounts in order to preserve their balance sheet, reducing the impact on credit creation. Lobbyists move quickly to create a distraction: be it the shortage of labor, the ubiquitous planning delays, or the need for yet more supply.

Similar behaviour is apparent in many markets where a scarce number of producers can influence market prices with their monopoly power.

Government must step in to ensure there is adequately affordable housing. Only government can repair the market failure generated by land's status as a monopoly resource. And it is the government who can ensure that everybody shares the benefits of urban economic development.

All the way along, the absence of accurate data on the time taken for housing to reach the market is overlooked. Inaccurate vacancy figures have allowed these "supply-side" narratives to dominate the public debate.

Questioning the theoretical assumptions of supply-side narratives

One of the criticisms the economics profession faces centres around static models. These are models calculated at a 'given point in time'. This limits its ability to address how behaviour changes over time.

In the past it was seen as too difficult. Dynamic equilibrium modeling makes use of larger data sets over time to evaluate market behaviour.

As a measure of how widespread static modelling and the assumptions behind it are, a widely critiqued paper by the Reserve Bank of Australia found that zoning controls added $355,000 to apartment prices in Sydney, but only $97,000 to Victorian prices.

Dr Cameron Murray (University of Sydney) applied the predominant Glaeser and Gyourko modeling to 'find a high "regulatory tax" even in the absence of regulatory constraints using both simulated data and historical land sales data from colonial Australia and ancient Mesopotamia.' The model used to justify land market deregulation failed the counter-factual of application in periods prior to the existence of planning controls.

Building on this research, Murray has developed an alternative theoretical approach based on property options, which helps to explain why developers are motivated to hold land vacant over time.

In his dynamic equilibrium model, the return to not developing i.e. leaving a property vacant or underutilised, comes from the changing value of the option to develop as society grows.

This model sees land not only becoming more valuable over time, but as development sites become relatively scarce, or market conditions tighten, a higher return for waiting occurs due to increasing options i.e. higher density development becoming more feasible/allowed.

This helps explain why prime corner blocks or sites near train stations are left vacant in the hope of an apartment rezoning.

Further, "*return-maximising developers will limit new housing supply per period independently of the optimal or allowable development density. They will increase supply in rising markets, but decrease it in falling markets. This means there are no private incentives to generate market supply-led price reductions*." The end result is that price falls are stymied by rapid supply constraints when pricing trajectories are threatened.

Macroeconomic drivers of vacancy trends

Monetary policy has been a key driver of housing price rises and construction rates. Low interest rates contribute to the spread of speculative vacancies.

In mid 2013 the Australian property boom was re-ignited with three interest rate cuts from 3.25% to 2.50% (Dec 2012 - Aug 2013). With the northern hemisphere already enjoying an interest rate differential with Australia, it became apparent that rates would continue their downward trajectory.

'Jawboning' was used by central bankers to

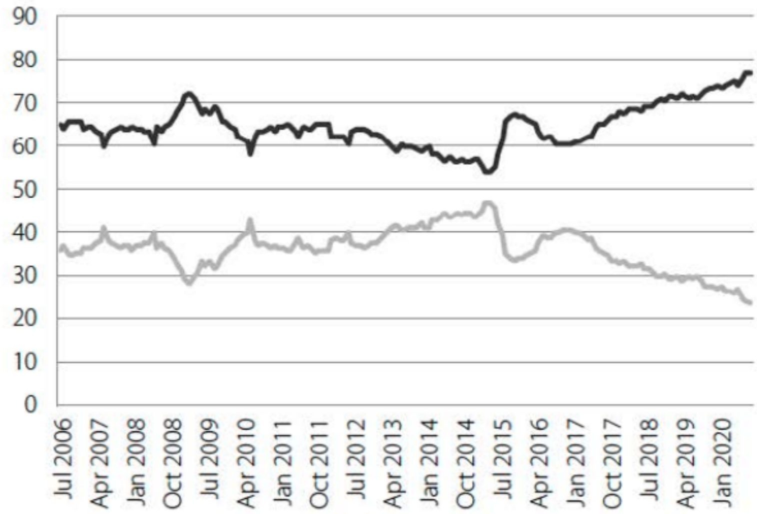

Figure 15. Investors, Owner Occupiers as % Total Loans

telegraph future intentions and push the currency further southward to support export growth. Policymakers responded inadequately to the impact this was having on housing affordability.

Figure 15 reflects the growth in national housing loans to investors between mid 2013 and late 2015. Investors grew from 37.4% of all loans (Jan 2013) to a peak of 46.4% (April 2015). APRA's December 2014 announcement of a tightening in lending conditions, with the 10% cap on investor loans per annum,started the process of winding back investor influence.

Further deterrents included the announcement of the Royal Commission into Banking, alongside the looming Federal election where the ALP opposition was favoured to sweep into power to deliver on their promise of negative gearing and capital gains tax reform.

Interest rates are a significant holding charge for property investors. With their recent cut to 0.10%, holding charges on property are at an all time record low. Melbourne's median house value was $730,000 in 2019.

Assuming that the land component equated to 60% of the median house price, a typical investor with a single investment property would be liable for $650 in land taxes. In our opinion, when combined with low interest rates, these are insufficient holding charges to encourage highest and best use of land.

With investor share of credit falling, the combination of government responses to vacancy may have been having the desired effect. At the state level, the VRLT and the foreign investor surcharge, plus existing land tax on investors targets speculative behaviour. At the federal level, macroprudential lending controls and absentee surcharges on foreign investors may have worked to counteract what might otherwise be an alarming level of vacancy.

We expect Speculative Vacancies to significantly increase if these policies are wound back. Treasurer Frydenberg has recently announced the Commonwealth's intention to remove responsible lending obligations from the National Consumer Credit Protection Act 2009 (Cth). This has been criticised as encouraging risky lending behaviour.

The Victorian Government has waived the Vacant Residential Land Tax in response to the COVID crisis, and has not signalled if or when it will be reinstated. These developments take us backwards.

Whilst record low inflation of 1.3% was heralded in March 2015, house prices increased 18.4% (Sydney) and 11.5% (Melbourne). Such a disparity alludes to another key statistical indicator that needs further reform to reflect the reality of daily living. With many spending significant amounts of their weekly budget on housing costs, a more accurate weighting within the basket of goods used to calculate inflation is required.

In summary, it appears vacancy rates will remain a consistent constraint on affordability under current policy settings.

Read the full report with footnotes:
https://www.prosper.org.au/4tl