City of Sydney Affordable Housing Levy: Peer Review

PREPARED FOR

City of Sydney Council

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1. EXECUTIVE SUMMARY

The City of Sydney (the City) has recognised the emerging need for an urgent and substantial increase in the level of affordable housing and has initiated a multifaceted strategy to provide an additional 8,612 social housing or affordable housing units by 2030. Most of this increase will be in the affordable housing area. The City is currently investigating the provision of 2,000 affordable housing units through a levy on development within the City.

The City has developed a methodology for computing and applying the levy and has completed a preliminary computation of the rate. This study reviews the methodology used to set the levy rate. The proposed levy rate was computed by estimating the floor area and cost of the proposed affordable housing target (2,000 units) using assumptions of the gross floor per unit (100m^2) and average unit price ($280,000). This was compared to the undeveloped capacity in the City being 6,140,480m^2. This suggested a contribution in kind of 5% of developed floor area or a money contribution of $140/ m^2 based on the initial capacity estimate.

Hill PDA considers that the capacity estimate should be adjusted to subtract the content of future development that will be for social and affordable housing, an amount of some 861,200m^2. When this is applied to the revised capacity estimate the floor area upon which the levy will be placed becomes 5,279,280m^2. This suggests an in kind levy of 3.8%.

Hill PDA also suggests that some consideration be given to the possibility that the levy may constitute a second layer of affordable housing encumbrance on private development space that is connected with other assisted housing supply strategies, such as Council incentive schemes. It may be deemed inappropriate to apply the levy in these cases and if so this would further limit the developed space over which the levy would apply. This possibility was not precisely quantified, but could increase the in kind levy at least to 4%.

Hill PDA considers that the cost per unit of affordable housing should be taken as the acquisition price of affordable housing units, not their construction cost as funds raised through payment of the levy in money would be used to purchase (or develop) affordable housing dwellings elsewhere and this would be effectively at market prices, or market price equivalents. The median strata dwelling price, which was $480,000 in March 2008, is recommended as the reference dwelling price for affordable housing units on the basis that it would be most prudent to target dwellings for affordable housing that were neither at the high or low end of the residential spectrum. Using this price and the adjusted capacity suggested a levy of $182.40/ m^2 that could be rounded to $185/ m^2.

The means of applying the in kind levy suggested by the City was supported by Hill PDA, but the strategy for obtaining a money contribution was considered suboptimal. Applying a fixed money levy, say of $185/m^2, on developed space in any market in any part of the City will create a significant imbalance in the burden between developments due to their potentially different values. In general it will mean that developments that have a developed value per square metre greater than that applicable to the median residential strata unit would be burdened less than those with floor areas less valuable than the median. Several approaches were considered for the money levy with a levy on either the total developed costs or the developed value of new space being recommended. If the median strata dwelling represented the mean development value, this would suggest a money levy of 3.8% on developed value, or about 4.5% on total development costs, though its precise computation would require an estimate of the value of the development capacity in the City. This was beyond the scope of this study.

A critical aspect of the levy is that regardless of whether it is paid in kind or in money it must represent sufficient resources to supply the desired 2,000 dwellings. Closely related to this is the importance of making the various forms of the levy equivalent and an equal burden across the development spectrum.

All rates considered have been net of administrative and acquisition costs, which could total in the order of $48,000,000. If Council does not intend to carry these costs the levy rates suggested should be increased by a margin of perhaps 3%-5%. Adopting a 5% overhead, this would suggest a levy rate of $191.50/m^2 of GFA, or 4.0% of space in kind, or 4.7% of development costs.

The introduction of the levy was considered in terms of its economic impact on development and the property cycle. Hill PDA considers that comparable levies have been introduced in circumstances somewhat different to the present and the magnitude of the levies may be resisted, especially within the current financial conditions. Conversely, the levy will have beneficial long term impacts on the property market and initiating the levy at this part of the property cycle will make it part of the development equation as confidence and construction activity are reignited.

2. INTRODUCTION

The City of Sydney LGA area (the City) was home to 156,572 people in 2006 occupying 90,000 dwellings. The resident population has risen 21% since 2001 compared with only 4.2% for the Sydney Statistical District.

The City of Sydney Council recognises the importance of providing an adequate level of affordable housing in order to ensure the reasonable local accommodation of key workers for the City. It has completed studies of the demand for affordable accommodation in the light of employment demands and demographic forecasts and resolved to aim for a total of 20,100 units of social housing and affordable housing by the year 2030. This represents a five fold increase in the level of affordable housing or about 19% of new dwellings being directed to assisted[1] housing objectives.

The realisation of this goal will involve a coordinated approach that will utilise a number of strategies for the provision of affordable housing and the engagement of several organisations. In particular, the Council recognised that its role is to facilitate the establishment of the stock of affordable housing, and not to be involved in its management. In this capacity, the City is prepared to undertake a range of planning and regulatory activities to encourage the development of affordable housing stock and its effective transfer into the hands of responsible management organisations.

There are no less than thirteen initiatives that will contribute to the provision of housing for various challenged groups within the community. These initiatives represent about ten identifiable strategy channels and rely on various systems of funding, including developer contributions and planning concessions and various systems of supply, including direct in kind development contributions and varied management structures.

Of the funding systems, most involve some sort of contributions derived from the private development of unrelated space. Within this framework, one approach the City intends to implement is a levy on development that will be used to provide affordable housing space to be placed under the management of a community housing provider. The levy is intended to provide 2,000 affordable dwellings, or 10% of the total growth in affordable housing to 2030. This study is a review of the methodology used to set the levy.

[1] Assisted housing in this report refers to any housing that fulfils either social housing or affordable housing objectives

3. QUANTIFICATION AND POLICY FOR AFFORDABLE HOUSING.

The City of Sydney Council has relied on several data and policy sources to identify the level of need for affordable housing and the appropriate policy response. These include the Sydney Metropolitan Strategy, Sustainable Sydney 2030, City of Sydney Social Plan 2006-2010 and the City of Sydney Affordable Housing Research Paper (the research paper).

Two issues arise in connection with the identification of the need for affordable housing. Firstly, the physical profile of housing need and, secondly, policy commitment to take an active role in the local provision of affordable housing.

The research paper has provided detailed profiles of current affordable housing initiatives in the City of Sydney and the households that make up the City. In particular it has identified that although the City's inhabitants enjoy a relatively high average income, with correspondingly higher average residential prices types compared with the wider metropolitan area, there exists a significant income polarisation. This polarisation is evident as a substantial number of lower income households often composed of the younger occupants. This is consistent with the apparent gentrification of the City that has seen the City become attractive to higher income earners who can afford higher housing costs, but it does cramp out lower income earners who have a vital role in the life of the City. These factors combine to form a profile of housing prices generally moving away from affordable levels for lower income households. In 2006 69% of very low to moderate income households were paying in excess of 30% of their incomes towards housing costs.

Sustainable Sydney 2030 is a 25 year strategic document to guide the growth of the City. It sets a policy target of 7.5% of all housing in the City to be social housing and 7.5% to be affordable housing to be managed by recognised affordable housing providers. This will mean an additional 8,612 affordable dwellings be provided by 2030, or about 20% of all new dwellings. Of these 7,959, or 92%, will be for affordable housing and only 653 will be social housing.

The policy response to the emerging need is not automatic. The undertaking by the community to support affordable housing rests on the belief that the social vitality as well as the economic functionality of the City will be enhanced by a local diversity of incomes and households and the commitment to contribute resources to its realisation. It could be possible to allow the residential markets to find their own levels and in so doing push lower income households out of the City. Lower income households would then incur greater travel costs given the persistence of employment for key workers in the City. It would also place additional strain on transport infrastructure.

These effects would intensify their disadvantage and weaken the City due to the greater difficulty of reliably filling key worker positions. The weight of these costs has been recognised to be so great as to justify intervention in the housing market. The level of intervention has been related to estimates of the level of need and the policy goal of reducing housing stress in lower income households as socially desirable.

4. Affordable Housing Levy Rationale

A levy on all new development has been proposed as one strategy for realising the affordable housing target. The objective of the affordable housing levy for the City of Sydney is the provision of 2,000 affordable housing units. This represents 23% of the total social & affordable housing growth target, or about 5% of the total new dwellings.

A levy on new development can be considered as a development tax aimed at funding the public good that follows from the provision of local affordable housing. As such it may be merely an arbitrary impost on development and perhaps other taxes or funding strategies may be more appropriate. Several considerations inform this issue including the following:

- It could be claimed that a levy constitutes an arbitrary additional development cost and would be passed on as higher housing costs that would make residential prices in the City even less affordable.
- A counter claim is that under conditions of robust demand, house prices are set by demand and not supply cost. This is supported by the conventional method for valuing development land that begins with the price of developed space as a market fact from which development costs are deducted to arrive at the value of undeveloped land. Under these conditions a levy will have the long term effect of moderating land price growth and will not adversely affect house prices.
- The need for affordable housing in any particular locale is the result of house prices in that locality becoming dysfunctionally high, hence it warrants strategies to contain excessive local property market growth. A levy has the capacity to deliver on this objective and solves a local problem locally.
- Development approval usually results in a value uplift that is connected more with the community's decision to permit development and higher densities than with any positive act on the part of land owners or developers. A levy is a mechanism for retaining some of that value uplift for the community that created it.
- Affordable housing cannot be provided within the residential market without generating costs that must be borne by either the community or the subject households.
- Funding affordable housing through other taxes, say income tax or GST, places part of the burden of payment on the very households that the initiative is meant to assist and most on persons totally separate to the whole situation. By contrast, a levy will have the effect of moderating the local capital gains on land which is the fundamentally linked to the origin of the affordability problem itself.
- A levy on local development will have a secondary effect of controlling local capital gain in land and thereby contain the likelihood of growth in the future costs of supplying affordable housing. This would suggest that a levy would contribute to limiting future blow outs in the costs of meeting future affordable housing targets.

On consideration of the above, the balance of the argument supports the use of a levy as a strategy for funding affordable housing and recognises distinct advantages it has over alternate funding strategies.

5. THE AFFORDABLE HOUSING PROVISION SPECTRUM

The supply of affordable housing for the City of Sydney will be provided from the following sources:

Council in Partnership:

These are initiatives where the City of Sydney Council engages in partnerships with others to provide affordable housing. The Glebe Affordable Housing Project is an example of this strategy. Combined they will contribute 6% of the target in assisted housing. They rely on resources being provided from partners, such as land contributions from the State Government as in the case of the Glebe project.

Council incentives:

These involve planning and development incentives, such as bonus FSR, in exchange for private developers constructing and contributing affordable housing units. Implicitly FSR bonus' usually increase development profitability and are already in operation in areas where planning changes have permitted greater FSR than existing maximums in planning instruments. These incentives are expected to contribute about 4% of the assisted housing target.

Public Housing, Community Housing, Crisis Housing and Aboriginal Housing:

This is funded by other levels of government and is expected to contribute a total of 8% of the assisted housing target.

Student Housing:

Sydney University and the University of Technology Sydney are both engaged in the provision of subsidised student housing. This represents 17% of the target growth in assisted housing.

State and Commonwealth incentives:

These take the form of direct support to not-for-profit providers of assisted housing. They will account for 16% of the target for assisted housing.

Affordable housing in RWA, Barrangaroo and CUB:

Contributions from development in these areas are expected to supply 4% of the target growth in assisted housing.

Demonstration of successful financial models:

The Glebe Affordable Housing Project is expected to provide a model for the alternate financing of affordable housing for not-for-profit and other providers that may be taken up by other parties. These are expected to provide 14% of the target in assisted housing growth.

Future State and Commonwealth Government incentives:

A further 14% of the target growth is expected to be provided through incentive programmes from NSW and Commonwealth governments in the future. These may include government grants or tax incentives.

The proposed levy approach will provide the remaining 23% of affordable housing. As such it will be the largest single provision channel. However, its operation must take into account the operation and logic of the other initiatives. Especially, it should be noted that many of the other approaches to assisted housing involve development contributions, with or without incentives. This would suggest that the proposed levy will be an additional charge to the existing regime. This may create complications and resistance in application.

6. CONTRIBUTION RATE METHODOLOGY

The methodology suggested by the City of Sydney Council consists of identifying the size and cost of the intended affordable housing to be provided by the levy and expressing this as a proportion of the magnitude of anticipated development. It may be summarised as follows adopting the values for parameters supplied by Council:

Table 1 - Levy Computation Methodology Suggested by the City of Sydney

Levy Computation Proposed by City of Sydney		
Target Affordable Housing	2,000	dwellings
Total floor area (at100m^2 per unit)	200,000	m^2
Cost of Development	$280,000	per unit
Total cost of supply	$560,000,000	
Forecast Development Capacity	6,140,480	m^2
In kind contribution rate	3.3%	
Payment in lieu	$91.20	/m^2

Source: City of Sydney Council

The 2,000 units of affordable housing are expected to cost $280,000 each and they are to be provided within the environment of 6,140,480m^2 of developed floor space. This equates to an in kind contribution of 3.26% of gross floor area, or $91.20/m^2.

This is one of several possible straightforward methodologies that would represent a sound approach to establishing a levy rate, however it is highly dependent upon the precision of the parameters. The cost of development and the forecast development capacity are two key parameters that deserve attention as follows.

Cost of Development

The adoption of $280,000 as the cost of development for an affordable housing unit in the City appears very low and inconsistent with the stated dwelling prices. Given that the money income from the levy will be used to buy or build affordable housing stock, the price of comparable dwellings should be considered as the basis for the levy.

There is growing evidence that current residential markets are entering a period of uncertainty which makes the setting of a reliable current purchase price difficult. In March 2008, the median price in the City of Sydney LGA for a strata unit was $480,000 and $780,000 for a non-strata dwelling. Affordable housing may be targeted at strata units suggesting the lower price be adopted. Generally across Sydney the last quarter has seen a dramatic change in property values which wiped away most of the price growth of the last year. If this trend continues, and some commentators believe that it may eventually wipe about 20% off current prices before stabilising, current prices may not be a reliable indicator for the longer term. For this reason this study will adopt $480,000 as the reference price for acquiring affordable housing units, though close monitoring of this figure is recommended. This would suggest that the development value[2] per square metre gross to a developer for new residential space may be adopted as a minimum of $4,800/m^2 given the likelihood that new space will attract a premium above the median. This will be comparable to the cost the City is likely to have to pay for affordable housing units and somewhat above the $2,800/m^2 implied in the contribution estimate.

For this reason it would be unlikely that a developer would consider a contribution in kind as it would constitute at least a 50% premium on cost of the contribution in money. Likewise, it would appear unlikely that affordable housing units could be obtained for $280,000 per unit at any reasonable standard. This suggests that the number of units of affordable housing that would be obtained from the levy would be below the target of 2,000. If the money raised was used to purchase median priced units it would only obtain about 1,166, or 58% of the target.

The adoption of a cost per unit for affordable housing across the City ignores local differences due to specific location within the City and variations in cost to develop due to various scales of construction. It may be argued that affordable housing stock does not need to be acquired new, at comparable quality levels to all private offering, or at in the same spatial distribution within the City as private housing. These are complex policy questions. On one hand opting for simpler, older dwellings in less sought after parts of the City will maximise the quantum of affordable housing that may be obtained for the City, but this may be considered unpalatable as public policy and could create undesirable concentrations of affordable housing. It would appear that the current pricing assumption could only be realised through using the money contribution to buy the cheapest offerings in the City.

A separate issue to be considered is the possibility of a developer preference not to have affordable housing within a development on the basis that it might present marketing difficulties for the private dwellings. For this reason, even if the money contribution was exactly equal to the sale value of units, it could be expected that developers would prefer the money contribution in preference to contributions in kind. As it stands the mispricing of affordable housings units adds to potential developer preference away from 'in house' affordable housing providing a double disincentive to contribute in kind. A rational economic approach to contribution alternative pricing would be that the contribution alternatives should present equivalent total cost options to developers (not the City) and this would suggest a money equivalence at least closely related to the value of the private developed space.

Four solutions exist to overcome this problem as follows:

1) <u>Raise the estimated cost per unit:</u> Adopting the median strata unit price as the average cost for an affordable housing unit, this approach yields a levy rate of $156.34/m^2.This solution does not alter the in kind contribution rate which would remain at 3.3%, however it would raise the equivalent payment to be comparable with the developed value of residential space. The contribution rate would need to be escalated in some manner to keep pace with development and acquisition costs. This could be done by reference to either unit values or total development costs, however unit values would be the recommended option. A shortcoming with this approach is that it would create a greater relative

[2] Development value in this report refers to the sale price of developed space

contribution burden for lower priced developments as the contribution is expressed as a constant dollar rate per square metre regardless of the end value of the development.

2) Insist on contribution in kind: This solution overcomes the valuation of the contribution and also ensures a better distribution of affordable housing across the City. It may offer some practical shortcomings due to the lumpiness of the contribution which would have to be equated into a whole number of affordable units. It may raise objections from developers in view of their expressed preference evidenced in both Green Square and Ultimo-Pyrmont away from contributions in kind, though this may have been partly complicated by the pricing equivalence problem. There may also be cases where the type of product being developed is unsuitable for affordable housing. This could be the case where the development consists of luxury dwellings in exceptional locations that would be hard to justify as affordable housing.

3) Express the money contribution as a rate on development costs: Starting with the computed in kind rate of 3.3% for floor area contributions, which could be applicable if all else were equal, the money contribution could be expressed as a rate on comparable total development costs. Total development costs here refer to all development costs, including land, but excluding developer profit and risk. The money contribution would need to include the implicit effect of the developer’s profit and risk that bulks up the development costs into the end sale price. Typical developer margins would suggest that a 3.3% participation in developed floor area would likely become a 4.0% levy on total development costs if the money were to be sufficient to purchase affordable housing equivalent to the same floor area. The advantage of a contribution rate levied on total development costs is that it would provide a high level of contribution equity and would escalate in line with property values to preserve the long term affordable housing objectives with respect to private development. It provides the flexibility to deploy affordable housing better across the City. The setting of the levy rate is simple and transparent.

4) Express the money contribution as a rate on construction costs: In practice, contribution rates computed on construction costs are more manageable as the land and profit and risk components can be difficult to identify and adequately compute. This may make them more attractive than option 3 above. A rate levied against construction will also tend to escalate in time with the costs of acquiring alternate affordable housing space, however it may suffer from changes in the relative proportions of land and construction in the cost structure of developments. Like option 3 above, it also has the advantage of participating more uniformly in the scale and value of developments while maintaining flexibility in how the funds generated are allocated. This could be used to create a more equitable contribution that also provides the flexibility to deploy affordable housing better across the City. The setting of the levy rate is simple and transparent, though it does require some global assumptions regarding the balance between land and construction costs. It has the disadvantage that it disengages the levy from land values which tend to carry the bulk of property value growth. For this reason it may prove less adequate in latter years.

Forecast Development Capacity

A second consideration arises from the choice of parameters in the levy computation. This is the estimated quantum of space to be developed to 2030. The 6,140,480m^2 of existing development capacity appears to ignore the anticipated floor area of the space to be dedicated as social and affordable housing. Adopting the target of 8,612 dwelling units, this equates to about 19% of the expected total development. It would seem counterproductive to levy affordable housing contributions on this floor area and SEPP 70 explicitly exempts these developments. This would suggest that the target for the contribution levy should only include private development not intended for social or affordable housing. This infers a discount in the floor area to be subject to the levy of about 861,200m^2.

The most recent estimate of actual development capacity is 6,140,480 m^2 which suggests a net private capacity of 5,279,280 m^2. This leads to a contribution rate of about 3.8% as shown in the figure below:

Table 2 - Levy Computation with Adjusted Parameter Values

Levy Computation Proposed Using Amended Private Housing Capacity		
Target Affordable Housing	2,000	dwellings
Total floor area	200,000	sqm
Cost of Development	$480,000	per unit
Total cost of supply	$960,000,000	
Total Forecast Capacity	6,140,480	
Less social & affordable development	861,200	
Forecast Private Development Capacity	5,279,280	sqm
In kind contribution rate	3.79%	
Payment in lieu	**$181.84**	**psm**

Source: Hill PDA

It is also possible that other development will also be involved in mechanisms aimed at affordable housing provision. For example, 359 dwellings are forecast to be provided as the result of Council incentives, most likely bonus FSR agreements. In these developments the affordable housing contribution is likely to only represent a small percentage of the total development. If, say, they represent a 10% dedication for affordable housing due to a FSR uplift, the 359 affordable units will be on the back of 3,590 private units accounting for perhaps 359,000m^2 of floor area. Assuming this private space is exempt from a second layer of affordable housing contribution this alone represents further 5% loss of capacity on which the levy could be raised which would raise the levy rate to about 4.0%. A clear policy regarding the possibility of a double layer of affordable housing contribution is required to dispel this possibility.

Given that Green Square currently operates under a 3% contribution on residential land, an increase to 3.8%-4.1% would appear to have precedent, though the former's introduction was part of a complex change in planning situation. Often when significant additional contribution rates have been introduced they accompany planning changes that include implicit value uplifts including FSR increases or changes in permissible uses. The affordable housing levy as currently conceived does not appear to be attended by any specific incentives, indeed the supply of affordable housing through council incentives (such as FSR increases) is mentioned as a separate category of affordable housing source apparently only anticipated to realise about 359 housing units. The issues surrounding the imposition of a levy will be dealt with in a later section in this report.

Combined Impact of Cost of Development and Forecast Development Capacity Parameters

The imposition of contributions for affordable housing have been accepted in the City of Sydney as evident in the current successful affordable housing initiatives at Green Square, Ultimo-Pyrmont and Redfern-Waterloo. The level of contributions in these areas have been between 1%-3% depending upon the location and development type. These levies have been adopted fairly recently and respond to the growing awareness that the provision of affordable housing is a growing community concern. It is also possible that the evident preference by developers to make money contributions, rather than in kind contributions, may suggest that there has been an imbalance in the relative value of the two options. If this has been the case then the effective contribution may have been significantly less than the apparent 1%-3%. The contributions have also been associated with planning changes that simultaneously created land value uplifts that may have more than outweighed the contribution costs. For these reasons the apparent precedent in the introduction of contributions for affordable housing may be misleading.

In addition to this, the usefulness of money contributions is likely to be lower than contributions in kind. The UK experience has been that it is more costly to pool, coordinate, and manage money contributions towards the realisation of alternate affordable housing space than it is to acquire an in kind contribution directly. For this reason in the UK a premium is applied to the rate for money contributions.

Administrative Overheads

The acquisition process will carry costs that do not appear to have been incorporated into the levy rate computations. While it may well be that the City Council is prepared to carry these costs, it should be recognised that the actual cost to the community will be greater than the simple purchase price of the housing units. In this case an acquisition cost of between 3%-5% would not be unlikely, suggesting an overall cost of up to about $48,000,000. If Council considers that the acquisition overheads should be included in the levy, then the amounts suggested in this report should be increased accordingly.

7. ECONOMIC CONTEXT

The use of the proposed levy will have economic impacts on the profitability and perhaps viability of development. The significance of these impacts will be largely affected by the interplay between the underlying property economics of land value and the property cycle.

In the long term, any development cost will be paid out of land values. This is usually evident however more in diluting land price growth than causing an immediate land value correction, as the latter is usually resisted by the market. A contribution levy operates in the opposite direction to planning relaxations, such as FSR increase, as the latter increase land values. The increase often occurs rapidly making it strategically important to match serendipitous FSR increases with simultaneous contribution increases in order to capture for the community what the community creates. This does not appear possible in this case.

The property cycle is currently an issue that appears to be straining the development industry with residential prices in Sydney suffering a fall in the last quarter not seen since 1979 and a very uncertain near future outlook. The policy goal of the levy is intended to operate over the next two decades, which is over a period well in excess of the usual property cycle, however the cycle has a strong hold over the immediate behaviour of the markets and the psychology of the industry.

These economic aspects of the levy should be considered as they have the capacity to significantly affect the popular acceptability of the levy, despite its other merits.

7.1 Property Cycle Issues

The reception of the levy, particularly since it is substantial, will be affected to some extent by the position of the property cycle at the time of its introduction. The historical acceptance of levies for affordable housing were most likely influenced by attitudes formed within different parts of the property cycle. Green Square was facilitated by the South Sydney Local Environmental Plan 1998 which was finalised at a buoyant phase in the property cycle. The City West Affordable Housing Program and Redfern-Waterloo Affordable Housing Policy were both affected sufficiently near the beginning, and close of that buoyant phase, to be acceptable within a general mood of market optimism. This is not the case at present.

Given the current understanding in growth of the need for affordable housing, the current targets for affordable housing are reasonable, but the level of contribution may be considered objectionable from the perspective of development viability. This is particularly the case where demand is weakening despite persistent higher land prices. Shane Oliver[3] of AMP Capital Investors is amongst the prominent economists who consider that housing prices are currently abnormally high. This is supported by research completed by Hill PDA[4] that suggests house

[3] Shane Oliver, 2008, The Outlook for Australian House Prices, http://www.amp.com.au/retail/2column/0,4764,CH41075%255FSI4305,00.html

[4] Garrick Small, 2008, Long Term Property Prices: Implications for Sydney Residential Development, ICTC annual conference, Sydney.

prices are out of line with key household parameters and the widespread concern regarding housing affordability. Under these conditions it is the land component that carries the capital gain and will be affected by likely corrections. The land value is also what is primarily affected by the imposition of development costs and contributions.

This would suggest that the current malaise in the development industry is largely due to inappropriately high land values and until they are corrected the industry will be slow to move. Within this environment, compounded by the international financial turbulence, additional development contributions, even for causes as worthy as affordable housing, will likely be resisted.

Conversely, planning and policy decisions should be to some extent aloof from the current vicissitudes of the market and focus on the longer term efficacy. The policy is intended to direct the provision of affordable housing over the next twenty two years and that will likely include up to two complete property cycles. The current general financial instability will likely precipitate a correction to land values. This is evident in the most recent sales figures that show a 7.6% fall in median dwelling values in Sydney SD over the last quarter[5] and considerably greater falls in other parts of the Greater Metropolitan Region. It is too easy for the prevailing difficulties in the market to be fallaciously used as an argument against a particular policy, though it is prudent to avoid introducing burdensome innovations at the weaker parts of the cycle.

Also, the rate of development will tend to follow the cycle and while it may be constrained at present, the probable gains that will occur once optimism returns, will likely soften or negate the burden of the proposed levy. This would suggest that in the longer term the levy will work and permit expansion of the affordable housing stock in line with the general rate of development, once the latter has regained momentum. There are two separate issues involved: the current malaise in the development sector and the need to provide affordable housing. Once the fundamentals have returned to a favourable orientation for development, the levy will be tolerable. However, this may not be evident at this point in time.

The importance of incentives or offsets, such as FSR bonuses should be carefully considered as a strategy to avoid unnecessarily burdening an already stressed development sector that is currently unable to meet physical demand. Conversely, it has been the aggressive growth in property values to unaffordable levels that is partly responsible for the current crisis in affordable housing for key workers. Following this argument it may be concluded that the current land values are unsustainable and do not warrant the implicit support that shying away from an affordable housing levy constitutes.

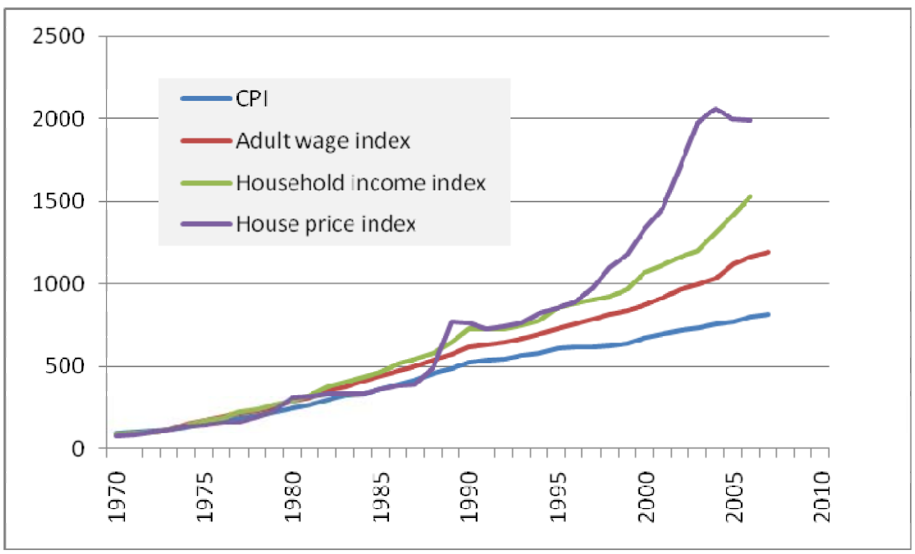
[5] NSW Dept of Housing, 2008, Rent and Sales Report, No.84

7.2 Impacts on Land Values

It is a common misconception that development costs impact on the prices of the developed property. While in some transitory cases they may appear to push prices higher, there are always more robust explanations for price movements. In a stable property market the end value of the developed product is adopted from the property market directly. The development costs are deducted from the total expected revenue from the market to the value of the raw development land. This is consistent with the widely accepted residual land valuation method for the appraisal of development land which implicitly follows this exact logic.

While the value of undeveloped land is impacted by development costs in a stable well functioning economy, the price of developed property is by no means static. The diagram below shows how house prices have risen against other relevant economic indicators over the last generation. Economic thought generally supports the view that the change in house prices is the result of forces that do not include construction costs (Small 2008).

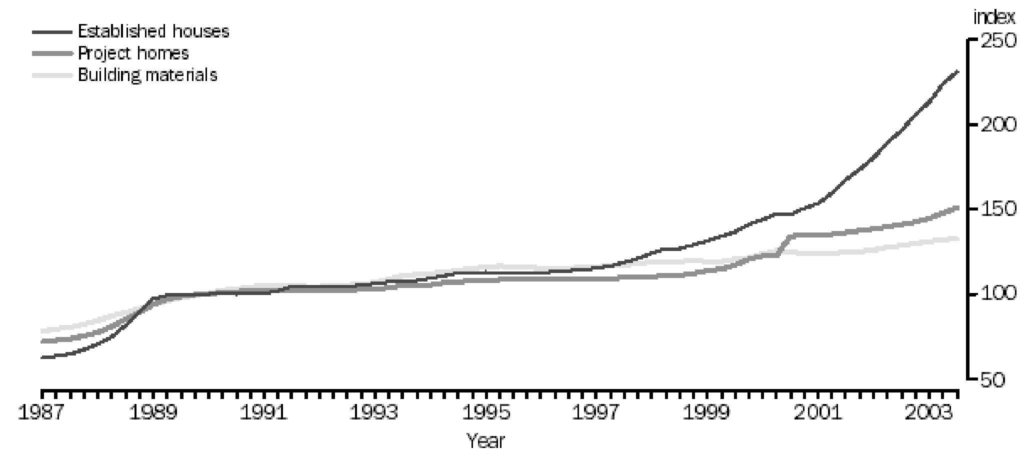
Figure 1 - House Price Index and related household variables.



Source: ABS and Saunders (2005)

This is evident in the data on building costs and residential housing prices as shown in the relevant ABS indexes in the figure below taken from the 2006 ABS Yearbook. This illustrates how recent residential price growth has substantially exceeded both growth in building materials and growth in project homes. Since residential prices include land, whereas the others do not, it is evident that changes in building costs are not responsible for the majority of house price change.

Figure 2 - House Prices compared to Building Costs.



(a) Base year 1989–90=100.

Source: House Price Indexes: Eight capital cities (ABS cat. no. 6416.0).

House prices follow complex causes largely originating in demand. Where prices are rising, it is often convenient to justify them on the basis of rising costs, but this ignores the mechanics of the valuation of development land. The only situation where costs may influence price is in the case where land prices are stuck at a high level and the developer's cost structure is such that development is not feasible. At that point development will simply not proceed until demand strengthens sufficiently to support the higher cost structure. Demand is the explanation in this case also, though the delay in the provision of space may not be considered acceptable for other reasons.

For these reasons it is unlikely that a levy will affect house prices, at least in the long term. This does not mean that the imposition of an additional levy will not create a discouragement for development in the short term, or that it may not contribute to a modest correction to land values.

Similar conclusions can be drawn regarding commercial property where there are rising concerns that recent valuations have been unrealistically high[6]. This would suggest that commercial values will be written down and development discouraged regardless of the imposition of any new levies.

[6] Harley, Robert, 2008 , "Valuations worth nothing at this point" Australian Financial Review, Thursday 20 November

7.3 Conclusions on Economic Implications

The residential property cycle has been at a sluggish point for some time. Physical demand for residential space is high and growing, but this has not been converted into effective demand evidenced by comparable price growth. There appears to be sound reason to believe that property prices are currently on the verge of a significant correction. In addition the wider economic uncertainty has discouraged the development industry and may have catalysed the start of that correction. This forms the immediate economic environment into which the levy will be introduced. Once the correction has passed and land values have returned to their underlying economic value, the levy will operate as anticipated. While introducing the levy at this point in the cycle will provide a further impediment to immediate development, its existence as part of the matrix that forms land values, will be an important element in its successful operation through the cycle's recovery phase.

The stapling of the levy with to an incentive, such as a FSR uplift, does not appear possible at present, but it would provide a balancing force to negate the adverse impact on land values. Part of current land value may be the result of irrational over speculation in recent times, but it is a psychological component of the current property landscape. Had property prices not escalated to be disproportionate to household incomes the urgency of the need for affordable housing would not be present and the levy itself superfluous, but this is not the case.

The commitment by the City of Sydney Council to set a target that will increase the stock of affordable housing by 480% over the relatively short span of twenty two years will necessarily require a costly commitment. There are sound arguments to suggest that land values are closely connected with the affordability problem and this leads to the conclusion that any loss of the inappropriately high current level of land prices due to the imposition of a levy is not unreasonable or unjust.

8. RECOMMENDED LEVY METHODOLOGY

The target level of 2,000 affordable housing dwellings is to be provided by the levy on the entire remaining capacity of residential development in the City. Assuming the levy will not be made against development of social or affordable housing, this means that it will be made against a total of about 5,279,280m^2 of potential development. Any of the four suggested methodologies could be applied to levy this future development to return the resources necessary to provide the affordable housing target.

The contribution in kind rate appears to be between 3.9%-4.1% and its final computation may follow the approach already used with some tightening of the precision of the parameters. It may also be used as a base for the other methods.

The money equivalent levy may follow the computation methodology suggested, but needs to use a unit value per affordable housing unit that is comparable to the market cost for space. This would suggest a unit cost currently of $480,000 which leads to a per square metre levy rate of $181.84, say $182/m^2 using the current parameters. This rate should be expressed in a form that will respond to changes in the market. Escalation could be in the form of a function of current property values, or subject to an escalation index, say the ABS house price index.

Computing and applying the levy on this basis will lead to inequities in the burden of the levy due to the differing relative cost of the levy to any particular development. A levy on construction cost is an approach that has been found practical to apply but is likely to create long term levy underperformance. A levy on total development value would overcome this, although it could introduce complications related to the valuation of the land component. It would however be superior in terms of overall equity.

Establishing the rate for a levy on total development value would require estimation of the total development value of undeveloped land capacity and relating this to the anticipated cost of the required quantum of affordable housing. As development costs are net of developer profit, the rate would have to be grossed up by a factor to cover the development margin. For example, for an in kind levy of 3.8% and a 20% development margin the levy rate on total development costs could be computed as follows:

Table 3 - Levy Computation for Money Rate on Total Development Costs

Levy Computation Based on Development Costs	
In kind contribution rate	3.8%
Anticipated Development Margin	20%
Levy on Total Development Costs	4.5%

In summary, the methodology for establishing an in kind contribution levy rate suggested by the City is supported, subject to the refinement of the value of the parameters. On the available values it appears to suggest a levy rate of 3.8%, assuming it is to be applied as an independent layer of affordable housing contribution that may add to other affordable housing initiatives.

The money equivalent levy per square metre as suggested by the CPWG could also be workable, subject to the refinement of its parameters, however it will not produce an equitable burden on all developments across the City.

At present it appears that this suggests a levy rate of $182/m^2$. However, a superior money equivalent methodology would be to charge on the basis of the total development value of the in kind floor space levy. This could be done by inflating the total development costs by the anticipated developer margin. Using the current parameters this would suggest a levy of 4.5% of total development costs. On balance this latter approach for a money equivalent levy would be preferable. A precise computation of the levy rate will require an estimate of the development value of available capacity and may result in a reduction of the actual supplied if other development types display an overall greater value than pure residential.

Lastly, if Council does not intend to carry the acquisition and administrative costs associated with obtaining the affordable housing units, the amounts suggested should be increased accordingly. Quantification of this increase will require separate investigation, but is likely to increase the levy rates suggested above by perhaps 3%-5%.

9. Conclusion

The imposition of a levy on all development for affordable housing has the capacity to provide a significant amount of affordable housing. It will have the long term effect of moderating the growth in the value of development land and in so doing return to the community some of the value that has originated from planning changes and market growth.

The ability of the market to tolerate the proposed new levy will not necessarily follow the experience gained in circumstances where contributions have been imposed concurrently with rezonings that implicitly offset the land value diminution effect of contributions. In the medium and long term the levy will have the beneficial effect of moderating the growth of total housing costs of private land by avoiding the necessity for affordable housing to be funded from future tax or rates income.

Ultimately the realisation of the ambitious but necessary target for affordable housing envisioned by the City of Sydney will require significant funding from some source. Since the cause of the need for affordable housing can be ultimately traced to excessive growth in land values, using a levy that will be ultimately paid from land valued to fund the solution to the problem is equitable as well as returning other economic benefits.

The proposed methodology for the computation of an in kind levy is supported, subject to the refinement of the parameters. The methodology for the computation and imposition of a money equivalent levy is considered to be reasonable but suboptimal and a money equivalent based on development value is suggested as the most efficient, equitable and responsive to possible future price changes.