

## Formal residential markets in urban areas

This case study draws on research that examined the formal urban housing market in South Africa. The research study was carried out by Genesis Analytics on behalf of Urban LandMark. This case study draws extensively on that work, which is gratefully acknowledged. See Sheet 5 for Reference details.

An introduction is given below. On the back of this sheet some learning and reflection activities based on the case study are provided. You can do these activities on your own or in groups, as appropriate for your learning session. Look carefully at these activities before you read the case study so you know what to look for while you are reading.

The next part of the document (Sheets 2, 3 and 4) examines the logic of the formal housing market, how it works and why it fails poor people. It also examines how the legislative environment has been operating counter to the logic of the market and points out that working in synergy with market forces would assist in achieving pro-poor outcomes. The final component of this document (Sheet 5) includes a summary of the key points that were covered in the case study and recommendations arising from it.

### Learning outcomes:

By the end of this session participants will be able to:

- Explain why the formal urban housing market does not meet the needs of all people in South Africa
- Describe recent trends in the housing market, especially at the lower end
- Suggest ways that the state could harness the energy of the market to achieve pro-poor housing outcomes.

### Introduction to the case study

This case study examines the formal urban land and property market in South Africa, its institutions, "rules of the game" and functioning. It shows that the market functions well for those who are able to participate in it, but poorer people are excluded from participating because affordability is a critical requirement and thus represents a barrier.

The case study then presents recent trends in the formal housing market, particularly what has been happening in the gap between the lower end of the market and the segment where the state is the major provider of housing. It shows how there was a narrowing of that gap prior to the global economic crisis, and that this trend, if it continues, represents a significant opportunity for the state to influence the market towards pro-poor housing outcomes. Ways that the state can intervene at this end of the housing market are examined. These involve changing the "rules of the game" through instruments such as incentives and targeted subsidies so that market players are encouraged to involve themselves in this "gap" market, in line with state policies to bring about the desired pro-poor housing solutions.

Photo: Kevin James



Many people cannot afford to buy in the formal housing market

Part of a series of case studies developed as a teaching and learning resource for studies in urban land markets. Urban LandMark Tel: 012 342 7636 Fax: 012 342 7639 email: [info@urbanlandmark.org.za](mailto:info@urbanlandmark.org.za) • [www.urbanlandmark.org.za](http://www.urbanlandmark.org.za)  
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## Learning activities

### Before you start

Before you read the case study, spend a couple of minutes noting your response to this question: Since democracy in South Africa many changes have taken place in the formal housing market. What are some of the trends that you think might have emerged with regard to poor people gaining access to the formal housing market?

### After reading Sheets 2 to 4 of the case study

In small groups, discuss these questions:

1. Identify state housing policies and strategies that run counter to market forces.
2. Make recommendations that would help the state harness market forces for pro-poor outcomes, for example, the production of more middle- to low-income housing and more opportunities for small traders. Include options from your own experience that might not have been commented on in the case study.

### Reflection

- What new, or surprising, insights have you gained as a result of this activity?
- To what extent will you be able to adopt what you have learned in your daily work? What do you need to do to overcome barriers to adopting these new learnings?

Photo: Urban LandMark



Affordability excludes these people from the formal housing market



## The urban land market is dominated by a financial logic

The urban property market functions effectively in South Africa. It responds predictably to the forces of supply and demand and follows the normal market “rules of the game”. The framework of the market – its institutions, drivers, rules of the game and players – represents a powerful mechanism which governs formal sector property transactions in urban areas of South Africa.

However, there are significant limitations in the market’s ability to address the deeply rooted income, access and spatial distortions in South Africa’s urban property market. It is not able to address the backlog of supply and access at the poorest ends of the property spectrum. Fundamentally, this is because the formal property market cannot operate effectively without the basic requirement of affordability. Where affordability is below the ability of market players to supply accommodation options for a competitive return and at an acceptable risk, the market will cease to operate. The “risk and reward” element of the market, which is a basic “rule of the game”, cannot operate at this end of the market, and so the game ends.

*Where affordability is below the ability of market players to supply accommodation options for a competitive return and at an acceptable risk, the market will cease to operate.*

Photo: Urban LandMark



**Direct state involvement in the provision of housing is inevitable**

In the South African context, and given the country’s legacy of racial discrimination and exclusion, the market currently excludes large numbers of people from participating in and benefiting from it. Their inclusion will depend on national economic growth in ways that are pro-poor, and the extension of employment levels and income levels to a much larger proportion of the population. There is, therefore, an inevitable role that the state must play, both directly (investments and subsidies) and indirectly (regulation and incentives).

Nevertheless, although there are limits to the market’s ability to bring about pro-poor outcomes, the formal housing market does have a role to play. The delivery of pro-poor market outcomes can be significantly enhanced where there is alignment between the operating and regulatory environment created by the state and the formal housing market. Where there is no alignment, market activity will be compromised and its overall effectiveness and potential as a supplier of pro-poor housing solutions will decline.

Thus it would seem that the state’s ability to address the scale of the urban housing backlog effectively and sustainably depends on the extent to which its investment and regulatory frameworks operate with the housing market rather than in isolation of it.

This does not suggest that market-based approaches to pro-poor housing challenges are the only basis for state intervention.

Widespread poverty and the skewed structure of incomes and employment fundamentally disable the market from directly contributing to meeting the housing needs of significant sections of the population; typically those who exist outside of the formal economy. It is inevitable, therefore, that the state will have to (continue to) provide a significant injection of state resources into the low end of the housing market. The aim of this should be twofold – to increase the supply of housing and to improve poorer households’ access to a range of housing options, whether through ownership, rental or settlement upgrading. Given the scale of the backlog, direct subsidisation of poor people’s access to housing will likely remain a continuing core function of the state for the foreseeable future.

*The state’s investment and regulatory frameworks need to operate with the housing market rather than in isolation of it.*

However, the power of markets to leverage state resources and outcomes, even at lower levels of affordability and in an incremental fashion, remains significant. This case study outlines ways in which the formal housing market might be harnessed to extend the reach and impact of the state in bridging the housing gap and addressing the shortfall.

## The state needs to harness the market for pro-poor outcomes

The market essentially consists of an intricate network of rules, conventions and relationships that together represent the system through which property is used and traded. Over time the rules of this system become codified into laws which are needed to guard against abuse by certain players or interest groups which may seek to create and exploit unfair advantages through collusion and anti-competitive practices.

Through regulation and legislation the state can readily change the “rules of the game”.

Depending on their impact on incentives, risks and rewards for different players, economic outcomes can be expected to change in any number of ways and will ultimately manifest in increases or decreases in demand and supply.

The state’s planning function influences and directs the market in relation to social and economic objectives. These interventions can be highly effective in enabling market activity and in incentivising the fulfilment of social outcomes.

Equally, where planning interventions are not aligned with the market (or regulatory inaction occurs), market activity may be reduced. This will tend to compromise market-based activity and result in the withdrawal of market players, causing increased reliance on state resources and institutions for delivery. To some extent, this trend has manifested itself in many inner city areas as private developers and rental providers experienced lengthening delays, uncertainty and increased enforcement costs associated with their development and letting functions. The fact that developers are less involved in the affordable housing market in more recent times, for reasons outlined above, is not a market failure so much as a state failure.

To anticipate and influence such outcomes, it is suggested that policymakers need to have a good understanding of the particular logic, institutional arrangements and the “rules of the game” that govern the property market and its various segments. This will help to maximise the impact of state interventions and will facilitate the design and delivery of effective incentivising instruments and regulations. By contrast, interventions which are not founded on an understanding of the market’s logic can have sub-optimal outcomes – either because they underestimate the market’s willingness and ability to undertake activity, or because they may discourage market activity which would support the fulfilment of the state’s objectives. It is important, therefore, for policymakers to understand the market’s logic, so as to be able to help determine the extent of its operation and the nature of its outcomes. The challenge for policymakers thus lies in changing “the rules of the game” to direct market activity into new areas and population segments without compromising the principles under which these markets function.

And so this is the focus of the case study – the market operates by certain rules, the state can influence these rules, but the state can also work with the rules to achieve enhanced pro-poor outcomes. The next section examines opportunities for state interventions that are emerging at the low end of the property market.

Photo: Angela Rivers/AFCHO



Inner city residential redevelopment

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## Some recent trends in the residential market in South Africa

What has been happening at the lower end of the housing market since democracy? What trends exist that the state can work with?

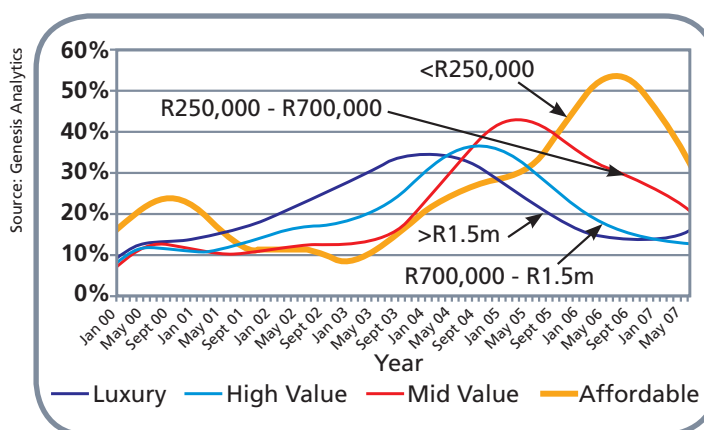
Across the major cities surveyed in the research used for this case study (Johannesburg, Durban, Bloemfontein, Cape Town and Nelspruit), house prices had not grown in a uniform way. Certain suburbs experienced stronger price growth than others, with some suburbs experiencing growth below inflation or even in the negative. Notwithstanding the many possible reasons for negative price growth, the upshot is that over the past ten years these suburbs have become more affordable in real terms. Figure 1 shows this clearly in that the line representing affordable housing (less than R250,000) increased significantly more than the other three lines during the period mid-2003 to mid-2007.

These affordable suburbs thus represent a point of formal market entry for households who have been historically excluded from access and ownership. The only exception to this pattern is Nelspruit, where relatively few suburbs have declined in price, largely as a result of the sustained strong economic growth the city has experienced up to about 2007 (mainly as a result of the Maputo Corridor).

In addition, there is evidence of a significant overlap in the property prices of different suburbs and townships, across all metropolitan areas. This suggests that people who currently live in former apartheid “non-white residential areas” are increasingly able to afford better located property. There were therefore, at least until the beginning of the global economic crisis, increased opportunities for mobility between former ‘township’ areas and formal suburbs as access to employment and income opportunities have begun to normalise. The household income needed to purchase housing at the lower end of the market is well within the upper limit of the Financial Sector Charter affordability bands (which in 2007 had an upper limit of R8,800 p.m.), and in some cases is as low as R5,500 p.m. Such households now also enjoy a relatively broad choice of residential accommodation opportunities at these levels, across a variety of suburbs and locations. However, these types of affordable housing are often in short supply.

This information is significant in that it indicates the downward extension, at least until 2007, of the private residential property ‘ladder’ in South Africa’s main cities. However, despite the increased affordability of some suburbs, many urban South Africans do not qualify for mortgage finance and therefore cannot afford to enter the formal housing market, even at the bottom end. The general shortage of suitable affordable housing is a further limit. But for those who can, both the affordability of metropolitan housing and the range of residential suburbs from which to choose are improving – without any obvious direct state intervention. The ability to move up this ‘ladder’ will be influenced by the access which new entrants have to market information, the availability of appropriate financing from the formal financial institutions and the availability of properties. This is an area where targeted public-private partnerships should be explored and are likely to have a significant impact in terms of deepening and widening the entry points to the bottom end of the formal property market.

*Since about 1998 many suburbs in South African cities have become more affordable.*



**Figure 1: House price growth across different bands of the residential property market**

*People who currently live in former apartheid “non-white residential areas” are increasingly able to afford better located property.*

*The residential property ladder was extending steadily downwards before the global economic crisis.*



It appears at this stage that historically excluded households are beginning to gain entry into formal suburbs through greater incomes and greater affordability in certain suburbs. It is not clear whether this trend extends to all cities in South Africa. The research findings used for this case study suggest that until 2007 the gap between former townships and former white suburbs did narrow through an extension of the housing ladder, leading to greater integration in some residential areas. However, at this stage, inadequate supply of affordable housing means that integration remains limited.

Source: Genesis Analytics

Suburb	2007 income required to buy average priced property	1996 income required to buy, converted to 2007 values
Meadowlands	R6,904.74	R4,833.10
Yeoville	R7,012.63	R6,320.21
Berea	R7,890.48	R4,461.33
Bellevue central	R7,983.61	R6,803.52
Jeppeshtown	R8,199.38	R26,210.29
Wilfordon (Roodepoort)	R10,572.88	R16,953.04
Bellevue East	R10,572.88	R7,807.32
Lombardy West	R11,004.43	R7,398.37
Rabie Ridge	R11,220.20	R37,177.71
Paarlshoop	R11,522.29	R4,349.79
Marlboro South	R11,587.02	R18,588.86

**Table 1: Residential housing transition in Johannesburg**

The information shown in Table 1 shows that some suburbs in previous township areas (e.g. Meadowlands) have increased in value, allowing those residents to gain access to the formal housing market, while others (Jeppeshtown, Wilfordon, Rabie Ridge and Marlboro South) have become more affordable, providing significant entry points for people moving up the housing ladder.

In 2007 there was every reason to anticipate that this trend would continue with further economic growth and formal employment creation. However, the global economic crisis has prevented this. At the time of the research, the evidence indicated that the price barriers or ‘cliffs’ which historically hindered mobility between townships and residential suburbs were in the process of being eroded. Whether this will continue once markets have recovered remains to be seen. This emphasises the need for the state to promote general economic development and, in particular, to seek ways of enabling growth in this “gap” element of the formal housing market.

One learns from these trends in the formal housing market that the state has not had to make direct interventions in order for the market to respond. The beginnings of housing normalisation simply paralleled the beginnings of social and economic normalisation. Therefore continued support for economic advancement by previously disadvantaged people is an important role that the state needs to play. The market responded in kind and began to contribute to the housing backlog. However, given the many barriers, including low levels of supply of affordable housing, the stimulatory role of state economic policy remains significant and should be explored.

But the low end of the formal housing market does not represent a solution to the housing backlog where a lack of affordability remains a factor. The state’s role as a subsidiser and provider of housing for poor people remains an important one. This leads one to ask whether there are indeed ways that the state can mobilise market forces at this low end of the housing ladder?

*Continued support for economic advancement by previously disadvantaged people is an important role that the state needs to play.*

## The legislative and regulatory framework

*So, the formal housing market operates by rules, poor people are mostly not able to participate in it, yet it did begin to extend downwards, and the state can play a role. How has the state been playing a role, and how could that role change?*

Government's land and housing policy are both being used to influence and shape delivery in line with specific targeted outcomes. A common set of themes and outcomes are therefore woven throughout the state's policy documents. These include:

- spatial integration of cities and towns
- reduction of economic inequalities
- transformed patterns of ownership and asset creation
- participatory planning processes
- creation of 'sustainable human settlements'
- promotion of urban densification and 'social inclusion'.

Each of these themes is reflected in an increasingly complex policy framework, which can give rise to policy contradictions, conflicting priorities and market confusion, especially at local level. Concerns now exist around a number of issues where this growing legislative complexity may be hampering rather than helping government achieve its social development objectives in housing delivery. These are summarised as:

- contradictory and competing roles and responsibilities across spheres and tiers of government, which result in inefficiencies
- confusing policy and legislative prescriptions (for example Land Use Management legislation, the Public Finance Management Act, the Municipal Finance Act and Environmental Impact Assessment requirements), which add to uncertainty and development costs
- unclear and in many cases contradictory development priorities (house the poor vs. protect the environment), which result in conflicts that slow down delivery and raise costs
- untested proposed interventions which could lead to the displacement of private players and the erosion of the market's investment, development and supply capacity
- poorly capacitated and increasingly burdened local authorities already unable to keep up with the core planning and development processes, which lie at the heart of the market's ability to function effectively.

*Growing legislative complexity may be hampering rather than helping government achieve its social development objectives in housing delivery.*

Photo: Angela Rivers/AFCHO



Private sector affordable inner city housing within the Johannesburg Urban Development Zone

It is evident from the above that up to the end of 2009, government housing policy had become more interventionist. In the early days it relied on a relatively simple policy, the Housing Subsidy Scheme, to address the housing backlog in the country. Unhappiness with the location of public and private sector-delivered housing projects led government to look at housing delivery in a much more deliberate manner. It required local authorities to develop more explicit guidelines around future development, especially around housing location and land usage.

However, this more prescriptive approach did not necessarily result in the achievement of government's transformation aims. As a result there were concerns that proposals at the time, for example, a broadening of expropriation legislation and a legislated 'inclusionary' housing policy would lead to the withdrawal of market players and a weakening of the market's capacity to contribute to urban development solutions. More recent policy changes and debates have allayed some of these fears.

With respect to land issues, government is responsible for land administration, which includes all the normal processes of township establishment, land titling and so on. Ensuring that land is properly administered is one of the state's fundamental roles, as it is key to the effective functioning of the property market. Government should be highly concerned that land administration has become less efficient over time, which, unless addressed, will eventually negatively affect the operation of the property market.

The increasing complexity and lower levels of efficiency have resulted in a slow-down in the urban planning, investment and development process, with negative consequences for the nature and scale of continued private sector participation in this market.

*There have been concerns that government's more prescriptive approach was leading to the withdrawal of market players and a weakening of the market's capacity to contribute to urban development solutions. Recent policy changes have allayed some of these concerns.*

### Alternatives that incentivise the market

There are important examples of government pursuing approaches that have incentivised rather than 'compelled' actions on the part of the private sector. Specifically, government's Urban Development Zone (UDZ) tax incentive has been effective in encouraging the private sector to carry out government's aim of urban regeneration. This represents an important example of the government's capacity to leverage the market's power in the fulfilment of its social objectives. It is a prime illustration of the value of government, in its dealings with the private sector, being guided by the principle of incentivising actions, rather than prescribing actions that might be at odds with the logic of the market, and hence its ability to function effectively.

Government is currently exploring initiatives such as mortgage default insurance, which gives greater confidence to lenders and opens up housing financing to poorer people, and also to reviewing and strengthening individual housing subsidies (for example, those which applied to RDP houses).

#### Urban Development Zones

Inner city areas around the world experience urban decay, derelict buildings and impoverishment. To reverse this economic decline the South African government has followed international trends and intervened by introducing a tax incentive known as the urban development zone tax incentive. This is an incentive scheme aimed at encouraging inner city renewal across South Africa. It takes the form of an accelerated depreciation allowance to promote private sector investment in construction, extensions, additions and improvement or refurbishment of buildings in the specified urban development zones.



## Summary sheet

### Formal residential markets in urban areas

This case study has examined the formal urban land and property market in South Africa. It shows that the market is functioning well for those who are able to participate in it, but for poorer people, for whom the critical requirement of affordability is a barrier, the formal market is not easily accessed.

By examining recent housing trends the case study reveals how the affordability gap between poorer people and houses at the lower end of the formal market has been closing; the 'housing ladder' has extended downwards. This is a result of democratisation, the opening up of the economy to previously excluded and disadvantaged South Africans, and of a growing economy prior to 2008. The state has a role to play at the lowest end of the housing ladder by direct means such as housing subsidies and indirect means such as incentives and an enabling regulatory environment. The case study makes a case for the state to understand the "rules of the game" in the formal housing market and to find ways of working in synergy with those rules, to harness the energy of the market to achieve pro-poor outcomes.

### Selected recommendations

#### Overall recommendation

The state should direct resource transfers, incentives and enabling regulatory interventions toward the lower end of the residential market. The focus should be on market-related interventions that bridge the gap between the bottom end of the formal property sector where the market works relatively well, and those segments which lie immediately beyond the market's operation. In order to extend downwards the base of the housing ladder in South Africa, there is also an urgent need for policies and incentives that improve affordability and expand supply at this, the entry level, of the housing market.

#### Recognise the power of the market – and its limitations

Government is attempting to align its policies and interventions in the market to work with the market, rather than seeking to work in isolation from it. Policies and interventions that are contrary to the market's logic and its "rules of the game" will tend to undermine existing institutions, compromise sustainable delivery and enhance reliance on the state for delivery. Policies that harness the power of the market and which reflect institutional and incentive arrangements that target previously marginalised groups stand to provide better outcomes than those relying exclusively on the state for delivery.

This shift requires a systematic review and assessment of policies, regulations and interventions, to evaluate the extent of their market compatibility and their likely impact on its ability to deliver on government's property market goals.

Photo: Housing Association East London



Social housing in East London – a form of state intervention through subsidies

## Review the legislative and regulatory environment

The overall aim of reviewing legislation would be to bring about greater coherence and less complexity. Some of these changes are already underway, for example the proposed mortgage default insurance and the finance linked individual subsidy. At present, the proposed amendments to the Expropriation Bill, the proposed inclusionary housing policy and others create a degree of uncertainty in the market which is not conducive to investment and long-term planning. As uncertainty increases, so risks and costs for developers and other players increase.

At a legislative level, the simplicity and coherence promised by the much-delayed enactment of the Land Use Management Bill would mark a major improvement in the contradictory and overlapping legislative environment that has until recently characterised the urban development market.

## Further review recommendations include

- Verify the extent of the operation and downward reach of a residential property market ladder, the affordability and income bands this extends to, and the extent to which this reflects the operation of an active upward market-filtering process across metropolitan areas.
- Explore the scope for and features of a financing mechanism aimed at bridging the gap between informal housing and the bottom rung of the formal housing market.
- Explore the feasibility and likely impact of rates- and/or tax-rebates as instruments for incentivising the densification and transformation of urban residential areas.
- Explore the relevance and impact of applying established mainstream investment facilitation instruments (such as debt securitisation) to the low end of the formal mortgage market with a view to lowering the risks and costs associated with bank lending in these market segments.
- Together with the appropriate statutory authorities, conduct regulatory impact assessments of key policies and legislation in place or in prospect, to assess their impact on the market's ability to function effectively and to contribute to meeting the needs of the urban housing and accommodation backlog.

## Recognise that incentives are more powerful than prescriptions

Market-compatible incentives are likely to be more effective in shifting market behaviour than a potentially prescriptive policy such as enforced inclusionary housing requirements. For example, in pursuing the goal of densification and improving the efficiency of South African cities, instead of a prescriptive policy such as 'inclusionary housing' the research suggests that incentivising property owners would be more effective. This will encourage them to take the initiative in densifying their properties, for example, by building or converting a second dwelling for rental or sale, in exchange for a tax or rate rebate. This would go further towards achieving the goal of densification and, in time, integration of residential suburbs, than onerous investment regulations that are likely to displace investors and distort markets.

## Local authorities should prioritise the fulfilment of their core functions

Local authorities need to focus on creating an environment conducive to private investment, development and letting activity whilst also making it possible for new entrants to enter the market. This involves ensuring that planning approvals are processed efficiently, that by-laws are enforced and bulk services installed within a reasonable period, and that there is regulatory certainty.

### Reading

Primary source document for this case study:

Zille P, Viruly F, Tomlinson M, Hobden T, Erasmus M (2008) *The dynamics of the formal urban land market in South Africa: A report prepared for Urban LandMark by Genesis Analytics*. Urban LandMark, Pretoria.