

# Chapter 12

## Regulating the Building Industry – A Case of Regulatory Failure

---

*Brent Layton\**

### 12.1 Introduction

#### 12.1.1 *Change in regulatory regime for buildings*

In the early 1990s, New Zealand replaced its prescription or standards-based regulation of buildings with a performance-based system. This was achieved through the passing of the Building Act 1991 (the Act) and the promulgation of a performance-based building code in a schedule to the Building Regulations 1992. The new building code came into force on 1 January 1993.

The purpose for adopting a performance-based building code was to improve the economic performance of the New Zealand economy by facilitating greater innovation and efficiency in the building sector.<sup>1</sup> The building sector is a significant component of the economy in its own right and provides important inputs into most other economic activities. Its efficiency and rate of productivity improvement are important to the performance of the whole economy.<sup>2</sup>

The principal means of fostering innovation and efficiency was by complementing the prescriptions or standards mandated under the former regime by permitting “alternative solutions”. These were to be acceptable under the legislation provided they were judged on the basis of comparisons with approved documents, tests and expert advice to meet the requirements of the new code.

---

\* Chair of the Electricity Authority.

<sup>1</sup> Peter J Mumford “Enhancing Performance-Based Regulation: Lessons from New Zealand’s Building Control System” (PhD Thesis, Victoria University of Wellington, 2010) at 26.

<sup>2</sup> As to the issues around labour productivity and foreign direct investment see Daniel Kalderimis “Regulating Foreign Investment in New Zealand” in this volume (ch 16).

The change to a performance-based approach to building regulation in New Zealand had been a long time in development; it was not a regulatory change developed in haste. Mumford has traced its origins back to at least the late 1970s, when the building industry started to react against what it saw as heavy-handed regulation. This led to the establishment by the Government in 1982 of the Office of the Review of Planning and Building Controls (ORPBC) and finally to a report by the Building Industry Commission in 1988. This report provided for the new regime introduced by the Act.<sup>3</sup>

The change to a performance-based approach was also not novel to New Zealand, or to the building industry. Similar changes were made in Britain, Japan and Australia around the same time as the change in New Zealand.<sup>4</sup> The Resource Management Act 1991, the Health and Safety in Employment Act 1992, the Electricity Act 1992 and the Hazardous Substances and New Organisms Act 1996 were also performance-based.<sup>5</sup>

The Act had other key objectives. These were to improve the quality of services provided to those requiring building inspections by introducing competition from private building certifiers to what had previously been a local authority monopoly and to provide a more accessible building control regime through a single building code for the country and a one-stop-shop for compliance.<sup>6</sup>

### **12.1.2 *Developments in house design***<sup>7</sup>

From the mid-1990s onwards a new style of dwelling based on Mediterranean design became popular in New Zealand, especially in the major metropolitan

<sup>3</sup> Peter J Mumford “Enhancing Performance-Based Regulation: Lessons from New Zealand’s Building Control System” (PhD Thesis, Victoria University of Wellington, 2010) at 21–22.

<sup>4</sup> Peter J Mumford “Enhancing Performance-Based Regulation: Lessons from New Zealand’s Building Control System” (PhD Thesis, Victoria University of Wellington, 2010) at 23.

<sup>5</sup> Peter J Mumford “Enhancing Performance-Based Regulation: Lessons from New Zealand’s Building Control System” (PhD Thesis, Victoria University of Wellington, 2010) at 22–26.

<sup>6</sup> Peter J Mumford “Enhancing Performance-Based Regulation: Lessons from New Zealand’s Building Control System” (PhD Thesis, Victoria University of Wellington, 2010) at 26.

<sup>7</sup> For descriptions of weathertightness problems see Weathertightness Overview Group *Report of the Overview Group on the Weathertightness of Buildings to the Building Industry Authority* (2002) Department of Building and Housing [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011); Weathertightness Overview Group *Report of the Overview Group on the Weathertightness of Buildings to the Building Industry Authority: Addendum Section 3* (2002) Department of Building and Housing [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011); Peter J May “Performance-based Regulation and Regulatory Regimes: The Saga of Leaky Buildings” (2003) 25 *Law & Policy* 381; The Government Administration Select Committee *Weathertightness of Buildings in New Zealand: Report of the Government Administration Committee’s inquiry into the weathertightness of buildings in New Zealand* (2003); and Peter J Mumford “Enhancing Performance-Based Regulation: Lessons from New Zealand’s Building Control System” (PhD Thesis, Victoria University of Wellington, 2010).

areas, where land prices were higher, as the style allowed a larger house size relative to plot area than traditional styles. The features of these houses were no eaves and outdoor terraced areas and balconies surrounded by exterior cladding. They often had more than one level.

These dwellings had monolithic external cladding – usually fibre cement, stucco or plaster-coated polystyrene – installed over timber framing, which from 1995 onwards was often untreated. It was also common for these dwellings not to have a drainage cavity between the cladding and the materials to which it was attached.

New Zealand has a wetter climate than the Mediterranean where the design originated and much of the heavy rain comes with winds that drive the water into cracks and joints. The result was that water was able to ingress many of the buildings of this type of construction, especially if they had not been well constructed in terms of flush joints and appropriate sealants being applied. Because of the absence of a drainage cavity, water which had penetrated the cladding was not able to egress. The retained moisture softened and rotted the material with which it came into contact, and was especially damaging for untreated timber framing.

### 12.1.3 *The extent of weathertightness problems*

There have been a range of estimates of the extent of the problem and the costs of remediation.<sup>8</sup> The most comprehensive and extensively researched is a report prepared by PricewaterhouseCoopers (PwC) for the Department of Building and Housing (DBH) in July 2009.<sup>9</sup>

PwC estimates the total number of New Zealand dwellings built between 1992 and 2008 with weathertightness problems falls within the range of 22,000 and 89,000. The degree of failure of these buildings varies, as does the expected cost of repair, but according to PwC “for the consensus forecast of 42,000 failures, the total economic cost (i.e. repair and transactions costs) of remediation to all dwellings affected by weathertightness failures, is estimated as \$11.3 billion (in 2008 dollars)”.<sup>10</sup>

---

<sup>8</sup> See for details of the earlier estimates Peter J Mumford “Enhancing Performance-Based Regulation: Lessons from New Zealand’s Building Control System” (PhD Thesis, Victoria University of Wellington, 2010) at 30.

<sup>9</sup> PricewaterhouseCoopers *Weathertightness – Estimating the Cost* (prepared for the Department of Building and Housing, 2009).

<sup>10</sup> PricewaterhouseCoopers *Weathertightness – Estimating the Cost* (prepared for the Department of Building and Housing, 2009) at 3.

## 12.2 Issues

### 12.2.1 Net public (dis)benefit

PwC's consensus forecast of the economic cost of remediation as \$11.3 billion in 2008 dollars is a strong indicator that the economic consequences of weathertightness failures were serious. However, PwC's cost estimate is not a calculation of the costs and benefits of the Act or of the shift to a performance-based approach to building regulation in New Zealand.

Consideration of the costs and benefits is a core component of regulatory impact statements.<sup>11</sup> These are required for most papers to Cabinet, if they propose legislation or regulation.<sup>12</sup> Moreover, some consideration of costs and benefits is required to support most decisions by specialist regulators, such as the Commerce Commission, Gas Industry Company and the Electricity Authority.<sup>13</sup>

In 2011, the Regulatory Standards Bill 2011 was introduced to Parliament with the support of the government. One of the requirements of its cl 7 is that responsible regulation should "produce benefits that outweigh the costs".<sup>14</sup> If the Regulatory Standards Bill is passed into law, it will ensure that all regulatory decision makers – Parliament, the Executive Council and specialist regulators – will be careful to undertake and publish what economists refer to as a net public benefit (NPB) test of their proposals.<sup>15</sup> Failure to do so may mean that the regulatory decision could be declared by a court to be incompatible with this legislation.<sup>16</sup>

PwC's purpose was to work out in constant 2008 prices the financial liability to remediate dwellings suffering from weathertightness failures. It was not to evaluate the pluses and minuses of the change to performance-based regulation or the introduction of competition for local authorities in the Act in 1991 on either an *ex post* or *ex ante* basis.

<sup>11</sup> See Derek Gill "Regulatory Management in New Zealand: What, Why and How?" in this volume (ch 7).

<sup>12</sup> The Treasury *Regulatory Impact Analysis Handbook* (2009) at 5–6 available at [www.treasury.govt.nz/publications/guidance/regulatory/impactanalysis](http://www.treasury.govt.nz/publications/guidance/regulatory/impactanalysis) (last accessed 23 September 2011).

<sup>13</sup> See Commerce Act 1986, ss 52A and 61; Gas Act 1992, s 43N (1) (b); and Electricity Industry Act 2010, s 39(2).

<sup>14</sup> For discussion of other relevant elements of cl 7 see Petra Butler "Rights and Regulation" (ch 9), Derek Gill "Regulatory Management in New Zealand: What, Why and How?" (ch 7), and Dean Knight and Rayner Thwaites "Review and Appeal of Regulatory Decisions: The Tension between Supervision and Performance" (ch 8) in this volume.

<sup>15</sup> A critical discussion of the appropriateness of this mechanism can be found in Dean Knight and Rayner Thwaites "Review and Appeal of Regulatory Decisions: The Tension between Supervision and Performance" in this volume (ch 8).

<sup>16</sup> Regulatory Standards Bill 2011 (277-1), cl 12.

Although PwC's estimate of \$11.3 billion is not an estimate of the net public (dis)benefit of the changes in building regime initiated by the 1991 Act, those not fully familiar with economic concepts are likely to think the figure is comparable with other net public benefit estimates for policy changes. There is good reason to believe that the net public (dis)benefit of the regulatory change was significantly less than PwC's \$11.3 billion. In fact, it is not totally inconceivable that the regulatory change generated a positive net public benefit when compared with the maintaining the *status quo* regime. This is despite the very expensive weathertightness problems experienced in New Zealand in the period from 1993 until 2005.

Given this and the likelihood of increasing emphasis on NPB estimates in regulatory discussions in the future if the Regulatory Standards Bill is passed, it would be useful to explain, and roughly quantify, how an estimate of the NPB of the regulatory change in 1991 would differ from PwC's \$11.3 billion figure.

### 12.2.2 *Regulatory decision making processes*

In recent years several improvements to the processes for the evaluation of regulatory proposals have been introduced in New Zealand:<sup>17</sup>

- a requirement that most Cabinet papers proposing regulatory change be accompanied by a Regulatory Impact Statement (RIS) was introduced in 2008 and expanded in 2009;<sup>18</sup>
- a Regulatory Impact Analysis Team (RIAT) was established in Treasury in 2009 to assist Treasury and other government agencies to decide whether a full analysis was required and to assist in its preparation and quality assurance if it was;
- a guide for undertaking Regulatory Impact Analysis was published by Treasury in 2008 and replaced by a more comprehensive handbook in November 2009;
- a revised version of the primer for the preparation of cost benefit analysis was published by Treasury in December 2005; and
- the government issued a Government Statement on Good Regulation in August 2009 and updated it in August 2010.

The questions for policy-makers and regulators are:

- have all the lessons from the weathertightness failures been incorporated into these improved processes?; and

---

<sup>17</sup> See The Treasury *Regulatory Impact Analysis Handbook* (2009); The Treasury *Cost Benefit Analysis Primer* (2005) and Hon Bill English MP and Hon Rodney Hide MP "Government Statement on Regulation: Better Regulation, Less Regulation (press release, 17 August 2009).

<sup>18</sup> See Derek Gill "Regulatory Management in New Zealand: What, Why and How?" in this volume (ch 7).

- are the current procedures sufficient to catch and quickly address any similar issues with regulatory proposals should they arise?

### **12.2.3 The political economy of wealth losses**

Legislation recently passed by Parliament provides for an enhanced financial assistance package to those with an eligible claim in respect to a dwelling house suffering from weathertightness failure.<sup>19</sup> Under this legislation, the Crown and a territorial local authority participating in the scheme each provide a 25 per cent direct payment to the building owner to cover approved repair costs.<sup>20</sup>

If an eligible homeowner opts into the scheme, the homeowner must agree not to take legal action against the participating territorial local authority or the Crown in relation to the weathertightness failure. The homeowner is, however, able to pursue legal action against other parties that may have liability, such as a non-participating local authority, designers, architects, builders, private building certifiers and former owners of the property. Other parties can agree to participate in a contribution scheme for a particular homeowner, in which case if the homeowner agrees to their contribution the homeowner loses its ability to take legal action against these parties for weathertightness damage to its dwelling.<sup>21</sup>

In addition, under the proposal, the Crown can provide assistance to eligible homeowners in accessing finance for the balance of the repair costs in the form of a limited Crown guarantee or indemnity of the loan.<sup>22</sup>

This legislation was developed following a decision of the Court of Appeal in March 2010 that territorial local authorities owed a duty of care to owners, whether occupants or not, to make sure that buildings were habitable. This meant that territorial local authorities faced very considerable liabilities, as in many cases they were the only parties left for homeowners to sue as others had either been liquidated or could not be located.<sup>23</sup> The Crown agency under the Building Act 1991 for accrediting building industry products and processes and approving building certifiers, the Building Industry Authority, has not been

---

<sup>19</sup> Weathertight Homes Resolution Service (Financial Assistance Package) Amendment Act 2011.

<sup>20</sup> See Department of Building and Housing "Eligibility" [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).

<sup>21</sup> Department of Building and Housing "Eligibility" [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).

<sup>22</sup> Weathertight Homes Resolution Services Act 2006, s 125I.

<sup>23</sup> *North Shore City Council v Body Corporate 188529* [2010] NZCA 64, [2010] 3 NZLR 486 [*Sunset Terraces*]. For a discussion of this cases and the legal decisions relevant to weathertightness see Geoff McLay "Legal Doctrine, the Leaky Homes Crisis and the Limits of Judicial Law Making" in *Leaky Building – A 360° View* (Thomson Reuters, New Zealand, forthcoming 2011).

found liable for defective work.<sup>24</sup> Therefore, the government's recently enacted financial assistance package amounts to a decision to relieve local authorities of some of the liabilities they could otherwise bear and to place some liability on taxpayers instead.

This is only one of several recent instances where the government has decided taxpayers should bear costs that would otherwise fall upon more directly affected or responsible parties because the sums involved seem "too large" for the parties to bear and the numbers of affected parties is significant. Other instances are:

- the repayment of depositors of South Canterbury Finance and some other finance companies under the retail deposit guarantee scheme;<sup>25</sup>
- the special grants for Canterbury employers following the September 2010<sup>26</sup> and February 2011 earthquakes;<sup>27</sup>
- the government assistance to homeowners in the "red zone" in the form of an offer to buy them out at rateable valuation following the February and June 2011 Christchurch earthquakes;<sup>28</sup>
- the proposed assistance to Christchurch City Council for the repair and replacement of infrastructure damaged in the recent earthquakes;<sup>29</sup> and
- the proposed support to AMI Insurance to manage its exposure to damage incurred in the recent Canterbury earthquakes.<sup>30</sup>

The government's decisions in these instances may be understandable, especially in a small economy like New Zealand, because many have close relationships with those adversely affected and the number of directly and indirectly affected parties is not insignificant relative to numbers of electors in some areas. In a sense, in these instances the government is acting like a very large mutual insurance co-operative.

<sup>24</sup> *Sunset Terraces* [2010] NZCA 64, [2010] 3 NZLR 486 and *O'Hagan v Body Corporate 189855* [2010] NZCA 65, [2010] 3 NZLR 445 [*Byron Avenue*].

<sup>25</sup> See Treasury "Retail deposit scheme guarantee" [www.treasury.govt.nz/economy/guarantee/retail](http://www.treasury.govt.nz/economy/guarantee/retail) (last accessed 6 October 2011).

<sup>26</sup> See Work and Income "Earthquake support subsidy" [www.workandincome.govt.nz/about-work-and-income/news/canterbury-earthquake/employer-subsidy.html](http://www.workandincome.govt.nz/about-work-and-income/news/canterbury-earthquake/employer-subsidy.html) (last accessed 6 October 2011).

<sup>27</sup> See Work and Income "Earthquake support subsidy" [www.workandincome.govt.nz/business/earthquake-recovery/ess.html](http://www.workandincome.govt.nz/business/earthquake-recovery/ess.html) (last accessed 6 October 2011).

<sup>28</sup> See Canterbury Earthquake Recovery Authority "Offer to red zone residents" [cera.govt.nz/land-information/offer-to-red-zone-residents](http://cera.govt.nz/land-information/offer-to-red-zone-residents) (last accessed on 6 October 2011).

<sup>29</sup> See Canterbury Earthquake Recovery Authority "Budget funds new earthquake recovery authority" [cera.govt.nz/news/budget-funds-new-earthquake-recovery-authority-19-may-2011](http://cera.govt.nz/news/budget-funds-new-earthquake-recovery-authority-19-may-2011) (last accessed on 6 October 2011).

<sup>30</sup> See New Zealand Government "Back up support for AMI policy holders" [www.beehive.govt.nz/release/back-financial-support-ami-policyholders](http://www.beehive.govt.nz/release/back-financial-support-ami-policyholders) (last accessed 6 October 2011).

The government using its ability to borrow at lower cost than other parties because of its ability to tax to meet commitments may lower costs of funding repairs and remedial work and therefore be more efficient. However, a decision to relieve parties of liabilities they have willingly incurred, or accepted in the normal course of events, and place them on tax payers means a reallocation of risks and returns which has a high potential to generate inefficient outcomes over time. This is because, if such interventions become widely anticipated, parties are likely to alter behaviour so they take on more high-risk activities than they would if they bore all the risks of their own actions. In short, socialising risks creates what economists refer to as “moral hazards”. The outcome is more risks are taken on by the community than it would be efficient to do, given the likely costs of incurring these risks. The allocation of resources towards risky activities becomes inefficiently high in the sense that economic welfare could be improved if fewer risks were taken.

Does the apparent propensity of New Zealand governments to “socialise” to tax payers the wealth losses of significant minorities when they become “too large” have any implications for those designing regulatory regimes? Are there elements in the design of regulatory regimes which could inhibit this tendency for political responses to create a moral hazard, and thereby avoid the inefficiency it engenders in relation to risk taking?

### **12.2.4 *The role of local authorities and the policy problem***

New Zealand local authorities have provided building consents and undertaken building inspections for a very long time. The Building Act 1991 introduced contestability into providing building consents and inspections; it allowed for them to be carried out by both local authorities and private sector building certifiers.<sup>31</sup>

Under the Building Act 2004, territorial and regional authorities carrying out building consent, inspection and approval work must be accredited by a building consent accreditation body against standards and criteria laid down in regulations. The council must also be registered by the Department of Building and Housing (DBH). International Accreditation New Zealand (IANZ) has been appointed as the building consent accreditation body. A council which does not wish to be accredited or registered as a Building Consent Authority (BCA) can transfer these functions to another council which is accredited and registered.<sup>32</sup>

---

<sup>31</sup> Peter J Mumford “Enhancing Performance-Based Regulation: Lessons from New Zealand’s Building Control System” (PhD Thesis, Victoria University of Wellington, 2010) at 27.

<sup>32</sup> For a description of the scheme see Department of Building and Housing “Building consent authority (BCA) accreditation and registration” [www.dbh.govt.nz/bofficials-bca](http://www.dbh.govt.nz/bofficials-bca) (last accessed 23 August 2011).



Accreditation involves IANZ assessing technical competences, resources, equipment, procedures, systems and processes of the BCA.<sup>33</sup>

The legislation also enables private organisations to seek accreditation and registration as BCAs, but places considerable emphasis on ensuring consumer protection arrangements are in place before a price organisation may be registered.<sup>34</sup>

In practice, 69 councils are accredited and registered as BCAs. There are currently no private organisations accredited and registered.<sup>35</sup> Between them BCAs process approximately 70,000 building consents per year and conduct inspections on roughly the same number of buildings. This is approximately 1,000 per council on average. Since the major metropolitan councils handle many more than 1,000, the average number of applicants for a non-metropolitan council is usually well less than 1,000 per year.

A council which provides a consent is jointly and severally liable with other parties, such as the builder, designer, architect, and sub-contractors, in the event that they contributed to a problem with a building by not doing their jobs properly or meeting other obligations. The same situation prevailed under the 1991 legislation and its predecessors.

Because liability is “joint and several”, if one or more of the parties found to have been negligent is not able to contribute their share of the costs, the other parties found to have been negligent have to contribute to the defaulting parties’ shares as well as bear their own share. Since councils have the ability to levy rates, they have access to considerable financial resources. As a result they have tended to carry a significant share of the costs of settlements; they have often been the “last person standing”.

In 2009, the Government conducted a review of the Building Act 2004.<sup>36</sup> This found that “the current system is more costly than necessary and less efficient than it could be, and does not provide incentives to improve productivity”.<sup>37</sup> It also found that “where problems arise it is difficult for homeowners to hold those responsible for the problems to account”.<sup>38</sup> It also found that many designers and builders do not believe they are responsible

---

<sup>33</sup> Department of Building and Housing “Building consent authority (BCA) accreditation and registration” [www.dbh.govt.nz/bofficials-bca](http://www.dbh.govt.nz/bofficials-bca) (last accessed 23 August 2011).

<sup>34</sup> Department of Building and Housing “Building consent authority (BCA) accreditation and registration” [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).

<sup>35</sup> See Department of Building and Housing “Register of Building Consent Authorities (ss 191 and 273(1)(a) of the Building Act 2004)” [www.dbh.govt.nz/buildingactreview](http://www.dbh.govt.nz/buildingactreview) (last accessed 23 August 2011).

<sup>36</sup> See Department of Building and Housing “Building Act review results and next steps” [www.dbh.govt.nz/buildingactreview](http://www.dbh.govt.nz/buildingactreview) (last accessed 23 August 2011).

<sup>37</sup> See Department of Building and Housing “Building Act review results and next steps” [www.dbh.govt.nz/buildingactreview](http://www.dbh.govt.nz/buildingactreview) (last accessed 6 October 2011).

<sup>38</sup> See Department of Building and Housing “Building Act review results and next steps” [www.dbh.govt.nz/buildingactreview](http://www.dbh.govt.nz/buildingactreview) (last accessed 6 October 2011).

for meeting the Building Code. Designers think this is the responsibility of the builder and builders think it is the responsibility of the BCA.<sup>39</sup>

As a result of the review, the government decided to amend the Building Act to:

- make it clear that builders and designers are accountable for making sure buildings and building work meet the minimum requirements set out in the Building Code;
- make it easier for homeowners getting building work done to hold building contractors to account through mandatory written contracts, supported by information disclosure, clearer legal obligations and remedies and improved dispute resolution options;
- make it quicker and easier to get a building consent for low-risk work provided quality assurance measures are met; and
- exempt a broad range of minor work from needing a building consent.<sup>40</sup>

The Building Amendment Bill (No 3), which will implement several of these policy outcomes of the 2009 review, is currently before Parliament. According to the commentary on the Bill when reported back from the Local Government and Environment Committee:<sup>41</sup>

This Bill seeks to amend the Building Act 2004 by introducing a risk-based approach to the administration of building consent and inspection requirements, to align the role of the building consent authorities with the risk involved. The Bill is intended to signal more clearly the accountabilities of those involved in building design and construction, and enhance accountability under the licensed building practitioners regime.

The Bill proposes a number of changes designed to improve and clarify the building warrant of fitness regime [...]. The Bill also seeks to provide for an owner-builder exemption from the restricted building work provisions of the Building Act.

One thing the Bill will not change is the central role of councils as BCAs. In this role they will be responsible for:<sup>42</sup>

- checking to ensure that an application for a building consent complies with the Building Code;
- checking to ensure that building work has been carried out in accordance with the building consent for that work; and
- issuing building consents and certificates.

---

<sup>39</sup> See Department of Building and Housing “Update on implementing the Building Act review” (2011) [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).

<sup>40</sup> Department of Building and Housing “Update on implementing the Building Act review” (2011) [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).

<sup>41</sup> Building Amendment Bill (No 3) 2010 (253-2).

<sup>42</sup> Building Amendment Bill (No 3) 2010 (253-2), cl 10.

The issue of whether the liability of councils as BCAs, and other parties, should remain joint and several is still under review,<sup>43</sup> but in the meantime councils acting as BCAs will continue to bear significant risk from these activities. Another issue still under review is the design of the building consent process.<sup>44</sup> Officials have developed and analysed two options for improving the administration of the building consent inspection and enforcement process:<sup>45</sup>

- a regional option – this would result in the establishment of a small number of regional hubs that would provide management and back office support for the local delivery of building consent inspection and enforcement services; and
- a centralised option – this would result in a central government-controlled single national entity supported by its own regional service centres.

Neither of these models, however, has been adopted as government policy.

These matters raise the wider issue of the nature of the problem the consenting and inspection arrangements in the Building Act are trying to address.

This section identified four areas where the weathertightness regulatory failure has raised issues worthy of further investigation. Each of these issues is explored in turn in the next four sections.

## 12.3 Net public (dis)benefit

### 12.3.1 *The purpose of PwC's estimates*

DBH commissioned PwC to estimate the financial cost, in constant 2008 prices, of the remediation of the weathertightness failures to New Zealand dwellings built between 1992 and 2008. This estimate included the design, legal and other costs. It fulfilled this brief in a thoroughly competent and professional manner.

What PwC was not asked to do was to calculate the net public (dis)benefit (NPB) created by the Building Act 1991 changing the building consent and inspection regulatory regime in such a manner that the number of dwellings in New Zealand which have, or will, suffer weathertightness failures increased. It is likely, however, that many will equate PwC's estimate of \$11.3 billion with an *ex post* calculation of the cost benefit of the 1991 regulatory change, or at

<sup>43</sup> See [www.dbh.govt.nz/UserFiles/File/Building/Building%20law%20and%20compliance/fact-sheet-BAR-results-next-steps.pdf](http://www.dbh.govt.nz/UserFiles/File/Building/Building%20law%20and%20compliance/fact-sheet-BAR-results-next-steps.pdf) at 2 (last accessed 26 August 2011).

<sup>44</sup> See [www.dbh.govt.nz/UserFiles/File/Building/Building%20law%20and%20compliance/fact-sheet-BAR-results-next-steps.pdf](http://www.dbh.govt.nz/UserFiles/File/Building/Building%20law%20and%20compliance/fact-sheet-BAR-results-next-steps.pdf) at 2 (last accessed 26 August 2011).

<sup>45</sup> Department of Building and Housing "Building Act review: Proposals and options for reform" (2010) [www.dbh.govt.nz/ris-building-act-review](http://www.dbh.govt.nz/ris-building-act-review) (last accessed 23 August 2011).

least consider it to be a reasonable approximation of such a figure. This is, however, not the case.

### **12.3.2 The counterfactual**

The NPB of a regulatory change is the final summary figure produced by a cost benefit analysis of the change. A key part of any cost benefit analysis is to determine the correct counterfactual. This is the specification of what the world would be like if the change being evaluated (the factual) had not occurred. The reason this is important is because it is the difference in the costs and benefits under the factual from the costs and benefits under the counterfactual that have to be estimated and evaluated. Costs and benefits that are common to the factual and counterfactual are not relevant to the evaluation of the factual and calculation of the NPB of the change.

For an evaluation of the Building Act 1991, it will be assumed the appropriate counterfactual is the situation that would have prevailed if the previous legislation and regulations relating to building consent and inspection had remained in place.<sup>46</sup>

### **12.3.3 Adjustments to PwC's costs**

#### *(a) Conversion to 1991 prices*

There are a number of reasons why the NPB of the changes will be significantly less than PwC's figure. The \$11.3 billion is in constant 2008 prices whereas the NPB calculation should measure costs and benefits in constant prices of the same year. The costs and prices should also be discounted so they are measured from the same point in time, it is usual to use the year of the policy change or legislation implementing it for this. In this case, the legislation was passed in 1991. Between 1991 and 2008, the residential building component of the New Zealand capital price index increased by 102 per cent. On this basis, the \$11.3 billion in 2008 prices converts to only \$5.6 billion in 1991 prices.

#### *(b) Discounting to achieve present values*

The costs of remediation of weathertightness failures resulting from the 1991 Act will be spread over the period from 1 January 1993 – the date the change came into force – until 2020, and possibly beyond. It is standard when undertaking NPB calculations to standardise (constant price) values spread over time to values at the time of evaluation by using a (real) discount rate.

---

<sup>46</sup>

An alternative counterfactual would be to assume that the provision relating to consent and inspection in the Building Act 2004 had been adopted in 1991. This alternative is considered at the end of this section.

PwC's calculations do not involve any discounting. At a real discount rate of eight per cent, which is the rate recommended by Treasury, expenditure of \$100 in 2020 has a present value of only \$9.94 in 1991.

Clearly, taking into account discounting would reduce the costs of remediation of weathertightness considerably. If the remediation expenditure were spread evenly over the years from 1993 until 2020, the present value of the \$100 in 1991 would be merely \$33.84, or roughly one-third. So, if it is assumed for simplicity of calculation, the remediation cost of \$5.6 billion in constant 1991 prices was spread evenly over the period 1993–2020, the present value of the cost in 1991 would have been only \$1.9 billion.

### *(c) Weathertightness failure under the counterfactual*

PwC's estimates relate to all weathertightness failures between 1992 and 2008, not just those attributable to the changes made in 1991. However, weathertightness problems are not unique to the period when the 1991 regulatory regime was in place. The costs of remediating the failures that would have occurred anyway should be deducted because they would be common to both the factual and the counterfactual.

In a 2003 article reviewing the leaky home saga in New Zealand, Peter May explicitly considered whether the building crisis would have occurred had the previous, prescriptive regime remained in place. In his opinion, "other experience suggests that the problems would still have arisen but very likely would have been identified and addressed before becoming a crisis."<sup>47</sup> He backed up this conclusion by pointing out that problems with new building materials and moisture have arisen in completely different regimes, like British Columbia and the United States.

If May's view is accepted, and it is assumed there would have been a three-year lag in recognition under the previous regime, the corollary is that only the remediation costs from dwellings constructed from 1 January 1996 onwards should be included in the calculation. Assuming, for simplicity of calculation, that the problems were uniformly incurred over the period from 1993, when the Building Act 1991 came into force, and 2006, when the Building Act 2004 became effective, the three years would amount to a 23 per cent reduction in costs. \$1.9 billion reduced by 23 per cent is \$1.46 billion.

### *(d) GST and other transfers*

The amount of GST and income taxation the government collects from the remediation costs can be considered as a transfer payment among sections of the community. Transfer payments should not be included in NPB calculations as they are a cost to one group of the public and a benefit to another and the

---

<sup>47</sup> Peter J May "Performance-based Regulation and Regulatory Regimes: The Saga of Leaky Buildings" (2003) 25 *Law & Policy* 381 at 396.

two cancel one another out. PwC's cost estimates are based on market prices<sup>48</sup> and so are inclusive of GST. To adjust for this factor, PwC's costs could be conservatively reduced by 12.5 per cent or one-eighth. \$1.46 billion reduced by 12.5 per cent is \$1.30 billion.

*(e) Non-dwelling building costs*

PwC's estimates relate to single and multi-unit dwellings only. Most buildings that suffered from weathertightness failures were dwellings because the construction techniques which gave rise to them were largely used in this segment of the market. However, there were some non-dwelling structures affected. Ronald McDonald House in Wellington is one that is well-known; it was so badly afflicted it had to be pulled down and reconstructed within a few years of its construction. An allowance of ten per cent for these structures would appear generous, given that most of the problems were with dwellings. \$1.30 billion increased by ten per cent is \$1.43 billion.

*(f) Fungal and other health costs*

The fungal growth that occurred in some leaky homes and the stress and the financial strains it created had adverse health effects on occupants and other, and these are social costs that would have been avoided under the counterfactual. These costs are hard to quantify but should be included in a comprehensive NPB calculation.

### **12.3.4 Addition of benefits**

The other component that needs to be taken into account to arrive at the NPB of the 1991 reforms is the benefit that arose due to the increase in innovation that occurred as a result of the relaxation of consent requirements. This is hard to quantify. However, over the period 1993–2005, inclusive, the total value of buildings put in place in New Zealand in constant 1991 prices was \$77.44 billion.

If the unquantifiable social costs discussed above are neglected, provided the benefits of the improved productivity due to the greater innovation made possible by the 1991 reforms over this period were on average more than about 1.8 per cent, it is plausible that the reforms generated a positive NPB, despite the weathertightness failures they created. Such an increase in average productivity is modest; it is consistent with a very modest increase in the growth rate in building sector productivity over the period.

---

<sup>48</sup> PricewaterhouseCoopers *Weathertightness – Estimating the Cost* (prepared for the Department of Building and Housing, 2009) at 74.

### 12.3.5 Summary

It would be wrong to conclude from these rough calculations that the weathertightness problem does not matter, or was not a regulatory failure, or should not be treated seriously. For many of the individuals affected, the damage to their residences and investment properties was a major financial and emotional blow. Moreover, New Zealand would have been much better off if it had captured the innovation benefits but avoided the weathertightness issues. The difficulties identified in 2009 with the operation of the Building Act 2004, however, highlight that achieving both these aims is not easy.

What the calculations do highlight is that to evaluate a policy or proposed policy it is important to compare apples with apples and to try to enumerate all costs and benefits on a common basis. Just looking at the costs will inevitably give a one-sided perspective.

## 12.4 Regulatory decision making

### 12.4.1 Regulations as experiments

One of the insights contained in Peter Mumford's study of the weathertightness issues arising from the Building Act 1991 is that the introduction of new economic regulation almost always involves experimentation, to a greater or lesser degree. Legislators and regulators should factor this into their design and operation of regulatory regimes.<sup>49</sup> The limitations of our ability to analyse complex systems mean there is the risk that new regulatory interventions will give rise to unintended consequences as the various parties respond to the changes in the incentives they face.<sup>50</sup>

Although Treasury's recently published *Regulatory Impact Analysis Handbook* does not explicitly refer to new regulations as experiments it does clearly identify the underlying issue and provides guidance on how to manage it:<sup>51</sup>

It is important that new policies (including regulation) are monitored and evaluated, to ensure they are working as expected (delivering the anticipated benefits at expected costs), that there have been no unforeseen consequences and they continue to be necessary as circumstances change and evolve.

...

<sup>49</sup> Peter J Mumford "Enhancing Performance-Based Regulation: Lessons from New Zealand's Building Control System" (PhD Thesis, Victoria University of Wellington, 2010) at 222–225.

<sup>50</sup> See Kate Tokeley "Consumer Law and Paternalism: A Framework for Policy Decision-Making" in this volume (ch 10).

<sup>51</sup> The Treasury *Regulatory Impact Analysis Handbook* (2009) at 16.

On-going or periodic consultation with stakeholders may be appropriate, in which case the arrangements for this should be agreed. It may be appropriate to establish a feedback mechanism (eg, a way for stakeholders to ask questions or lodge complaints). Regular public reporting on the effectiveness of the regulation may also be considered.

Plans should be made for how and when the regulation will be reviewed, and reviews should consider the following issues:

- Is there still a problem (and is it the one originally identified)?
- Are the objectives being met?
- Are the impacts as expected? Are there any unforeseen problems? Are there any indirect effects that were not anticipated?
- Is intervention still required? Is the current intervention still the most appropriate, or would another measure be more suitable?

## **12.4.2 Are there other gaps?**

A review of the various guidelines and handbooks that have been issued<sup>52</sup> did not reveal any lessons from the weathertightness experience which are not now incorporated into the advice, apart from the absence of a clear discussion about how to determine whether an entity is an appropriate party to be a regulator. This issue is addressed further at [12.6].

## **12.5 The political economy of wealth losses**

### **12.5.1 Insurance schemes**

One element of regulatory design in response to the propensity of politicians to “socialise” to tax payers the wealth losses of significant minorities when they become “too large” is to facilitate (or compel) parties to take out insurance against the risk.

The EQC fund to cover the dwelling, contents and (to some degree) land assets of households against earthquake and some other risks is an example of a scheme of this kind.

Experience following the September 2010 earthquake in Christchurch showed EQC could be effective at limiting the pressures on politicians to “socialise” losses. The pressure on politicians following this event mainly related to the restoration of infrastructure and to support employment and small businesses disrupted by the events; these are risks not covered by EQC.

Events following the February and June 2011 earthquakes in Christchurch have, however, shown that there is a limit to the effectiveness of EQC in this

---

<sup>52</sup> The Treasury *Regulatory Impact Analysis Handbook* (2009); The Treasury, *Cost Benefit Analysis Primer* (2005); Hon Bill English MP and Hon Rodney Hide MP “Government Statement on Regulation: Better Regulation, Less Regulation (press release, 17 August 2009).



regard. The government has felt compelled to provide owners of homes in the “red zone” with the option to sell their property or just the land to it at current rateable valuations as an alternative to accepting any pay-out from EQC and private insurers to which they are entitled.<sup>53</sup> In essence, the government has acted to protect the equity of the owners of dwellings in the “red zone”, even though this was a fully insurable risk prior to the earthquakes. The number of parties potentially affected and the potential sizes of the losses were such that the government could not withstand the pressure to “socialise” these losses.

### **12.5.2 Compulsory insurance and “moral hazard”**

One of the dangers of compulsory insurance is that it can create its own “moral hazard”. This is economists’ standard argument against compulsory deposit insurance for banks and financial institutions. The presence of insurance reduces depositor scrutiny on the performance of banks, as they know their deposits are guaranteed, and the result is that banks can take on more risky propositions than they would if there were no deposit insurance scheme.

In the case of EQC, the existence of the scheme can have no effect on the frequency or location of the natural disasters it covers, but it may affect the riskiness of the building designs and sites chosen by households for their dwellings. There is a provision in the legislation under which EQC operates that allows it to refuse to cover some property but this constraint is quite weak.<sup>54</sup> No research into whether the EQC scheme has resulted in New Zealanders adopting more risky house designs or building in more risky locations has been identified. But there are no obvious indications it has to any material or noticeable degree. EQC only covers up to \$100,000 for land and buildings and up to \$20,000 for contents. As a result of these levels of cover having not been revised for the effects of inflation for quite some time, households still need to bear (or privately insure) significant risk. Moreover, district planning and Building Code requirements also constrain the risks households can take in terms of dwelling design and location.

### **12.5.3 Facilitation of private insurance**

The facilitation and encouragement of parties to take private insurance so that most choose to do so will generally avoid the “moral hazard” that arises with a compulsory insurance scheme because the private insurers have strong incentives to monitor risks and reject from coverage those deemed unacceptable, or at the least charge them premiums commensurate with the risks they create.

---

<sup>53</sup> See Canterbury Earthquake Recovery Authority “Offer to red zone residents” [cera.govt.nz/land-information/offer-to-red-zone-residents](http://cera.govt.nz/land-information/offer-to-red-zone-residents) (last accessed 6 October 2011).

<sup>54</sup> Earthquake Commission Act 1993, Sch 3, d 3.

Encouragement of private insurance is the approach proposed as a result of the recent review of the Building Act. Some of the proposals are:<sup>55</sup>

- to require a written contract between contractors and consumers for all projects above \$20,000;
- every contract will have to include the warranties that the building work is fit for purpose, meets the Building Code, and has been undertaken with reasonable care and skill;
- building contractors will be required to “put things right” for up to 10 years;
- during the first 12 months the building contractor normally will be expected to remedy any defects (or replace faulty material) – as a matter of routine. The onus will be on the contractor to fix the defect, or prove the request was unreasonable, rather than on the consumer; and
- consumers will have to be given information before the contract is signed. This will inform the consumer about the skills and background of the contractor and the surety backing and insurance they have to cover the costs of fixing any faults.

The intended effect is to make it easier for consumers to check on the surety backing and insurance of builders and thereby encourage them to take out adequate insurance in order to win work.<sup>56</sup> The insurers will have a strong incentive to ensure that they match the premiums charged with the risks associated with insuring each builder. Poor quality builders and those with limited skills or experience will find it either expensive or impossible to obtain adequate insurance cover and this will inhibit their ability to compete in the marketplace.

It is intended that these consumer protection proposals will be introduced into Parliament during 2011.<sup>57</sup>

For the facilitation of voluntary insurance to be effective in reducing the pressure to “socialise” wealth losses, it must result in cover of an adequate level relative to potential losses being held by a significant proportion of the parties likely to be affected at any one time. If there is low coverage of the parties potentially affected, or inadequate coverage relative to total exposure, the pressure on politicians will still arise. Events subsequent to the February and June Christchurch earthquakes illustrate this risk.<sup>58</sup>

---

<sup>55</sup> Department of Building and Housing “Building Act Review: Consumer Support” [www.dbh.govt.nz/buildingactreview-consumer-support](http://www.dbh.govt.nz/buildingactreview-consumer-support) (last accessed 23 August 2011).

<sup>56</sup> Similar disclosure requirements exist in the context of consumer financial contracts. See Graeme Austin “The Regulation of Consumer Credit Products: The Effects of Baseline Assumption” in this volume (ch 11).

<sup>57</sup> Graeme Austin “The Regulation of Consumer Credit Products: The Effects of Baseline Assumption” in this volume (ch 11).

<sup>58</sup> See Work and Income “Earthquake support subsidy” [www.workandincome.govt.nz/business/earthquake-recovery/ess.html](http://www.workandincome.govt.nz/business/earthquake-recovery/ess.html); Canterbury Earthquake Recovery Authority “Offer

If high voluntary coverage cannot be achieved by encouragement and facilitation, the policy choices appear to be to accept the fiscal risk or introduce a compulsory scheme. If a compulsory scheme is adopted, the options are to either live with or manage by other means any resulting “moral hazards”.

## 12.6 The role of local government and the policy problem

### 12.6.1 *What is the problem?*

The Treasury’s *Regulatory Impact Analysis Handbook* identifies that one of the early tasks in designing and assessing potential regulatory actions is to identify the root cause of the problem, and not just its symptoms.<sup>59</sup> More specifically, Treasury advises to consider whether the problem arises because of market failure, regulatory failure, unacceptable hazards or risks, or social goals and equity issues.<sup>60</sup>

There are two potential market failures that the consenting and inspection arrangements in the Building Act might be designed to address. The first is a potential market failure due to the externalities that could arise because the owner of an unsafe or unsound structure may not bear all the potential costs which result from the status of the building but would bear all the costs of ensuring that it is safe and sound.

If the owner does not reap all the benefits of ensuring safety and soundness but bears all the costs there is a difference between the private costs and benefits and the social costs and benefits; there is an externality. The outcome will be that the level of safety and soundness determined in the market, where decision makers respond to only the costs and benefits they bear and enjoy, will be lower than the socially optimal level.

The second potential market failure arises because of the asymmetry of information between builders, designers, architects, and such on the one hand and building purchasers on the other. In general, the builders, designers, architects will know the safety and soundness of a building better than their buyers. This is partly because of the relative inexperience and lack of knowledge and expertise of buyers, many of whom will buy infrequently, compared with professionals engaged in construction on a full-time basis. It is

---

to red zone residents” [cera.govt.nz/land-information/offer-to-red-zone-residents](http://cera.govt.nz/land-information/offer-to-red-zone-residents). See also “Budget funds new earthquake recovery authority” [cera.govt.nz/news/budget-funds-new-earthquake-recovery-authority-19-may-2011](http://cera.govt.nz/news/budget-funds-new-earthquake-recovery-authority-19-may-2011); and New Zealand Government “Back up support for AMI policyholders” [www.beehive.govt.nz/release/back-financial-support-ami-policyholders](http://www.beehive.govt.nz/release/back-financial-support-ami-policyholders) (all last accessed on 6 October 2011).

<sup>59</sup> The Treasury *Regulatory Impact Analysis Handbook* (2009) at 9.

<sup>60</sup> The Treasury *Regulatory Impact Analysis Handbook* (2009) at 9.

also partly because of the difficulties buyers have monitoring all inputs into a building process as they occur or determining them after construction. If not corrected, this asymmetry could lead to buildings being less safe and sound than optimal because buyers will not pay for a level of quality they are not confident they are receiving. They will assume all buildings for sale, whether new or second-hand, are “lemons”<sup>61</sup> and bid accordingly.

### **12.6.2 Safety and quality for motor vehicles**

The same two potential market failures occur in relation to motor vehicles,<sup>62</sup> and it is instructive to consider the regulatory and market arrangements in New Zealand in this case.

The government imposes warrant of fitness obligations on cars and vans, and certificate of fitness obligations on other motor vehicles. It also certifies and oversees the parties authorised to issue these documents, including prescribing the aspects of the vehicles which need to be checked.

The checks focus on whether the vehicle presents a safety, emission or noise hazard to other users of the road, or the public. In other words, the checks focus on aspects which may lead to a potential difference between the private costs of the owner and operator and the social cost of the vehicle being operated on the road. The checks focus on reducing externalities. If the vehicle is not driven on a public road it is not required to have a warrant or certificate of fitness.

The checks do not test whether the ride is comfortable, the panels and paint are bent or scratched, the engine and gearbox are in good condition, the expected longevity of the vehicle, or whether the roof and sides leak and retain water when it rains. The requirement is for the warrant and certificate of fitness checks to be carried out and the vehicle found to comply when the vehicle is new and periodically thereafter.<sup>63</sup> In most circumstances, the check is also required to be passed by the vehicle within one month of it being sold.<sup>64</sup>

The government (or other regulatory bodies) has limited involvement in checking the quality of motor vehicles for aspects which do not give rise to externalities. In addition to laying down the warrant or certificate conditions, the government sets requirements in relation to emissions, noise and some

---

<sup>61</sup> The seminal article on information asymmetry and how it affects market efficiency is George Akerlof “The Market for ‘Lemons’ Quality Uncertainty and the Market Mechanism” (1970) 84 *The Quarterly Journal of Economics* at 488.

<sup>62</sup> Motor vehicles were a principal example in Akerlof’s analysis of the problem.

<sup>63</sup> See New Zealand Transport Authority “The Warrant of fitness process” [www.nzta.govt.nz/vehicle/warrants-certifications/getting-wof/about.html](http://www.nzta.govt.nz/vehicle/warrants-certifications/getting-wof/about.html) and New Zealand Transport Authority “Getting a certificate of fitness” [www.nzta.govt.nz/vehicle/warrants-certifications/getting-cof.html](http://www.nzta.govt.nz/vehicle/warrants-certifications/getting-cof.html) (last accessed 6 October 2011).

<sup>64</sup> See [www.nzta.govt.nz/resources/factsheets/41/buying-and-selling.html](http://www.nzta.govt.nz/resources/factsheets/41/buying-and-selling.html) (last accessed 6 October 2011).

minimum safety features for new vehicles,<sup>65</sup> and requires certain information disclosures by vehicle dealers relating to quality, such as year of registration and current odometer reading. The government also requires disclosure of whether a vehicle being sold has been a taxi or rental vehicle. In addition, the government runs a webpage that allows prospective buyers to check on the ownership of the vehicle and whether it is encumbered.<sup>66</sup> Most aspects of the quality checking of motor vehicles, however, are left to the market and to private sector providers, such as the Automobile Association (“AA”). Prospective buyers of used vehicles can seek the seller’s permission to obtain a check of the quality of the vehicle by AA or some other private provider of the service. Buyers of new vehicles consult specialist motoring magazines and newspapers for reviews of new vehicles by motoring journalists. They also rely upon the reputations of the brands of the vehicles and the quality of the warranties they provide.

The most appropriate means of dealing with asymmetric information – one party to a transaction having more or better information than the other – are signalling and screening. Signalling involves the party with the informational advantage acquiring characteristics which give the buyer assurance that the information they provide is accurate. Certificates and educational qualifications are common signalling devices used in labour markets to provide assurance about ability and knowledge of the applicant, but acquiring a reputation for straight dealing which is valuable and would be lost if the party provided misleading information is another option. Screening involves the party with the informational advantage being incentivised to reveal the true quality. For example, demanding a lengthy warranty requires the vendor to reveal how long the article will last and how prone it will be to failure needing repair.

### **12.6.3 The externality problem reconsidered?**

The consenting and inspection arrangements in the Building Act are poorly designed if their prime purpose is to address the market failure which gives rise to safety and health externalities. Regular periodic inspections would seem essential to fulfil this purpose and not just inspections at the time when major construction is being undertaken. Failures which could give rise to these externalities are likely to arise at other times, due to the effects of the building aging or external events.

The New Zealand building legislation recognises the need for periodic reviews to deal with health and safety externalities. The owners of most buildings with “specified systems” must ensure the building has a compliance

---

<sup>65</sup> See [www.nzta.govt.nz/vehicle/index.html](http://www.nzta.govt.nz/vehicle/index.html) (last accessed 6 October 2011).

<sup>66</sup> See The Companies Office “Buying a motor vehicle” [www.ppsr.govt.nz/cms/consumer-information/buying-a-motor-vehicle](http://www.ppsr.govt.nz/cms/consumer-information/buying-a-motor-vehicle) (last accessed 6 October 2011).

schedule and a current warrant of fitness relative to that schedule.<sup>67</sup> “Specified systems” are “systems or features that contribute to the proper functioning of a building”. These specified systems “require ongoing inspection and maintenance to ensure they function as required, because if they fail to operate properly, they have the potential to *adversely affect health or life safety*” [emphasis added].<sup>68</sup> Building owners are required to engage approved Independent Qualified Persons (IQPs) or Licenced Building Practitioners (LBPs) to undertake the inspection, maintenance and reporting procedures listed on the compliance schedule.<sup>69</sup> A building warrant of fitness has to be renewed annually. It is a statement supplied by a building owner to the territorial local authority in which the building is located, confirming that the specified systems in the compliance schedule for the building have been maintained and checked in accordance with the compliance schedule for the previous 12 months, and that they will continue to perform as required.<sup>70</sup>

The principal group of buildings exempt from the requirement to have a warrant of fitness is single residential dwellings, although these are required to have a warrant if they have a cable car installed.<sup>71</sup> Presumably, the basis for this exemption is that the compliance costs will exceed the benefits, given that most of the health and safety issues arising in relation to single dwellings will fall upon the owner and his or her family directly as occupiers or on the owner through negotiation with his or her tenants.

The requirement for buildings to have warrants of fitness suggests the role of the consenting and inspection arrangements in the Building Act in relation to dealing with potential health and safety externalities is to ensure that when major construction is undertaken it conforms with minimum health and safety requirements and to assist drawing up and amending the compliance schedule for the building warrant of fitness obligations so that it covers all relevant “specified systems”.

## **12.6.4 Regulatory response to information asymmetry**

Consideration of how motor vehicles are regulated raises the question of why any regulatory body should be involved in dealing with the problems arising

---

<sup>67</sup> See Department of Building and Housing “Guidance on building warrants of fitness and compliance schedules” (2010) [www.dbh.govt.nz/building-warrant-of-fitness-guide](http://www.dbh.govt.nz/building-warrant-of-fitness-guide) (last accessed 6 October 2011).

<sup>68</sup> Department of Building and Housing “Guidance on building warrants of fitness and compliance schedules” (2010) [www.dbh.govt.nz/building-warrant-of-fitness-guide](http://www.dbh.govt.nz/building-warrant-of-fitness-guide) (last accessed 6 October 2011).

<sup>69</sup> Department of Building and Housing “Building warrant of fitness (BWoFs) [www.dbh.govt.nz/bofficials-building-warrants-of-fitness](http://www.dbh.govt.nz/bofficials-building-warrants-of-fitness) (last accessed 23 August 2011).

<sup>70</sup> See Department of Building and Housing “Building warrants of fitness (BWoFs) [www.dbh.govt.nz/bofficials-building-warrants-of-fitness](http://www.dbh.govt.nz/bofficials-building-warrants-of-fitness) (last accessed 23 August 2011).

<sup>71</sup> Department of Building and Housing “Guidance on building warrants of fitness and compliance schedules” (2010) [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).

from asymmetric information of the contracting parties in relation to building transactions. Why is this problem not left to the market? The solutions to asymmetric information are screening and signalling and there is usually no need for the involvement of a regulator for these to happen.

Prospective buyers of used buildings concerned about the quality of a building could contract experts in assessing building quality to provide them with a report. The buyers of new buildings could rely on the reputations of the builders, designers, architects and so forth, and/or hire agents to monitor construction to ensure quality is maintained throughout the process.

In practice, many prospective buyers of used buildings do contract to obtain expert advice on quality and there is a thriving market in the provision of this service. Brand assurance devices, such as Registered Master Builders and Certified Builders, are features of the construction sector, and these organisations provide insurance to cover the quality of the work undertaken by their members as signals of their quality. Branded building franchises like Lockwood and Signature Homes are another feature of the sector. The franchisor has strong incentives to ensure the quality of the work of all its franchisees or else the businesses of all of them suffer as does the value of the brand to the franchisor. Moreover, one of the core services provided by an architect is to monitor construction for the building's owner and other organisations also offer this service.

The question is, therefore, why is there both a private market response and a regulatory response to the information asymmetry problem? Why is the regulator providing any assurances relating to aspects of the quality of buildings, such as its weathertightness and durability? Why is the regulator not sticking to identifying and preventing things that may give rise to material health and safety externalities?

### **12.6.5 Reduce confusion**

One possibility is that there is concern that the buyers of buildings may be confused if the regulatory entity only deals with issues that will give rise to health and safety externalities. They may assume that the regulator is also dealing with other quality issues. As a result, buyers may fail to take adequate steps to have the other aspects of a building's quality assessed.

However, buyers of motor vehicles are not confused by the regulatory arrangements and generally do not think that a warrant or certificate of fitness tells them anything about the quality of the engine, the gear box, the upholstery or even the weathertightness of the vehicle. The public understands that a warrant of fitness of a car is about safety, noise and exhaust emissions only and if they want to know about the other features of the quality of a used vehicle they should contract with a private sector entity that provides this service and preferably with one with clear signals and screening devices to back up its work. There is no obvious reason why the

public should be confused if regulation of buildings was similarly restricted to focus on potential externalities, leaving the private sector to deal with the asymmetric information issues.

### **12.6.6 *Relative value of buildings***

Another possibility is the value of a building is generally much greater than the value of a car and this justifies more regulatory involvement for the building. If this were the logic, however, one would expect that the need to have consent and inspection would be restricted to buildings above a certain value. While certain categories of minor works are exempt from consenting and inspection it is clear that this is on the basis that they are unlikely to give rise to any material health or safety externalities, not on the basis of their value.

### **12.6.7 *Efficiency***

A further possibility is that the current arrangement is more efficient than leaving asymmetric information to be managed by private sector contracts. This is not plausible as an explanation. First, there is the inefficiency implicit in the duplication in the current system due to both private sector providers and BCAs having input into providing assurances regarding non-externality related aspects of building quality.

Secondly, there are 69 local authorities currently registered as BCAs.<sup>72</sup> On average, they process about 1,000 building consents and associated building inspections per year. This means most BCAs are too small to capture the economies of scale that arise because there is a high fixed cost in maintaining databases, IT systems and personnel with sufficient expertise to cover the full range of consent and inspection requirements.

Thirdly, local councils do not face commercial pressures as they have the ability to impose rates on property owners and relieve any financial constraints they may face. So there are no market pressures on them to be efficient in the provision of services. Moreover, that any liability arising from this activity is spread across all ratepayers proportionate to their contribution to rates means that there will be little accountability for poor performance in practice. Few individual ratepayers will have enough at stake to warrant seeking redress and, short of selling their property, ratepayers have no choice but to meet rates demands and the realisable value of property will reflect any increase in rates anyway.

In short, the current arrangement is inefficient. This has been recognised by government as a result of its review of the Building Act. It estimates that stream-lining administration of the consent and inspection process could reduce the costs of consent production by 40 per cent and “achieve estimated

---

<sup>72</sup> Department of Building and Housing “Register of Building Consent Authorities ss 191 and 273(1)(a) of the Building Act 2004” [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).



consumer benefits and operational savings around \$250m over five years ([this equates to] one year's total operating costs every five years)".<sup>73</sup> These estimates do not count the gains to be made from removing duplication of effort and improving incentives and accountability.

### 12.6.8 *History and inertia*

The most plausible reasons for the current arrangements are history and inertia. In other words, inadequate consideration of the nature of the core problem and the justification for any regulatory intervention. What has been done for a long time and who has done it has unduly influenced what should be done in future.

The regulatory impact statement which accompanies the proposed policy response to the issues identified in the 2010 Review of the Building Act illustrates this point. Its problem definition reads:<sup>74</sup>

The foregoing discussion suggests that the market for building services is characterised by market failure due to:

- limits to and asymmetries of information
- misallocation of risks and responsibilities, and the level of effort undertaken not being commensurate with the level of risk involved, and
- institutional (both private and government institutions) failure to efficiently correct these imperfections.

The combination of these factors means that there is suboptimal competition on quality and price from suppliers, and hence suboptimal consumer welfare. There is, therefore, a *prima facie* case for intervention.

The next section in the statement outlines the objectives of the reform package and the section following it sets out the regulatory impact assessment of the key elements of the package.<sup>75</sup>

The underlying reason for the market failure identified as the problem is not considered and there is no analysis of whether the market failure could be overcome by non-regulatory means, such as education or facilitation of the market. Indeed, there is no recognition that there is already a comprehensive market response to the asymmetry of information between builders, designers, architects, etc, on the one hand, and building buyers on the other. That a package of regulations is required is assumed, and its scope is shaped

---

<sup>73</sup> Department of Building and Housing "Building Act Review: Proposals and Options for Reform" (2010) [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).

<sup>74</sup> Department of Building and Housing "Building Act Review: Proposals and Options for Reform" (2010) [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).

<sup>75</sup> Department of Building and Housing "Building Act Review: Proposals and Options for Reform" (2010) [www.dbh.govt.nz](http://www.dbh.govt.nz) (last accessed 23 August 2011).

largely by what has gone before and perceived problems with the current regulatory regime.

The question of whether local councils should be BCAs, or be replaced by a smaller number of regional hubs or a central government controlled single national entity supported by regional service centres is on the agenda, but has not yet been resolved.

What is not being considered, but should be, is whether these entities should restrict themselves to providing consents and undertaking inspections focussed on ensuring that:

- the building meets the minimum standards necessary to deal with any safety and health externalities; and
- the list of “specific systems” to include in the compliance schedule for building warrant of fitness checks in future is compiled and updated.

If they were so restricted the market would be required to provide buyers with assurances regarding the other facets of the quality of buildings.

## **12.7 Summary**

The negative NPB resulting from the weathertightness failures that arose from the changes in building consent and inspection under the Building Act 1991 appears to have been significantly less than PwC’s \$11.3 billion estimate of fiscal liability.

If the increased productivity in the building sector and the value of the health and other unquantifiable social costs generated are taken into account, it is not inconceivable that the changes in 1991 generated a positive NPB when compared with maintaining the pre-1991 regulatory regime.

New Zealand would have been better off without weathertightness failures and the costs they impose but the economic cost of the regulatory change was well less than \$11.3 billion.

The weathertightness failures highlight that almost all new regulation is to some degree an experiment and this should be recognised in the regulatory design by factoring in scope for monitoring and reviews.

Treasury’s handbook for analysing regulatory impacts recognises this, even though it does not explicitly refer to new regulations as experiments.

Apart from not providing guidance as to the parties most appropriate to be regulators, the recent official publications on regulatory practice appear to reflect the lessons from the weathertightness failures.

In situations in which significant wealth losses to a reasonably sizeable group can occur there is a danger that politicians will “socialise” the risks by shifting losses to taxpayers. This will tend to be inefficient.

The incorporation of incentives or compulsion to insure into regulatory design can reduce the propensity to “socialise” losses, although compulsory insurance can give rise to its own form of “moral hazard” and inefficiency as a result and may not be adequate if the losses are large and well-spread.

The regulatory impact assessment of the policies arising from the 2010 Review of the Building Act has not adequately identified the nature of the problem being addressed by the provision of consenting and inspection arrangements in the legislation. As a result, why the market should not be left to manage the provision of information about the aspects of quality not related to safety and health externalities has not been considered.

In stage 2 of this project, the framework for investigating the implications of the case study on the building industry will analyse the following questions:

- What was the underlying problem that each stage of building regulation was, and is, intended to address? Was this well understood and consistent with the selected regulatory processes? When is such an intervention worth doing – in terms of being better than leaving outcomes to the general actions of market forces and legal processes?
- Were the (necessarily uncertain) assumptions that underpinned the choice of regulatory structure reasonable in the light of the risks inherent in the industry, particularly given its history? What might be done to address the inevitable uncertainty about the new environment associated with any regulatory innovation – is better monitoring/review an answer?
- Would appropriately designed appeal/review/dispute settlement mechanisms have played a part in reducing the losses?
- What should influence the assignment of regulatory roles among the various possible parties? How would this change with different incentives and regulatory structures?
- How much influence did public beliefs about the regulatory environment have on the final outcome?
- How do regulatory structures interact with political economics when moral hazard is present? Is it possible to design or manage around such difficulties?



<b>12.1</b>	<b>Introduction .....</b>	<b>311</b>
12.1.1	Change in regulatory regime for buildings .....	311
12.1.2	Developments in house design .....	312
12.1.3	The extent of weathertightness problems .....	313
<b>12.2</b>	<b>Issues.....</b>	<b>314</b>
12.2.1	Net public (dis)benefit.....	314
12.2.2	Regulatory decision making processes.....	315
12.2.3	The political economy of wealth losses.....	316
12.2.4	The role of local authorities and the policy problem .....	318
<b>12.3</b>	<b>Net public (dis)benefit .....</b>	<b>321</b>
12.3.1	The purpose of PwC's estimates .....	321
12.3.2	The counterfactual.....	322
12.3.3	Adjustments to PwC's costs.....	322
(a)	Conversion to 1991 prices.....	322
(b)	Discounting to achieve present values.....	322
(c)	Weathertightness failure under the counterfactual .....	323
(d)	GST and other transfers .....	323
(e)	Non-dwelling building costs .....	324
(f)	Fungal and other health costs .....	324
12.3.4	Addition of benefits .....	324
12.3.5	Summary .....	325
<b>12.4</b>	<b>Regulatory decision making .....</b>	<b>325</b>
12.4.1	Regulations as experiments.....	325
12.4.2	Are there other gaps? .....	326
<b>12.5</b>	<b>The political economy of wealth losses .....</b>	<b>326</b>
12.5.1	Insurance schemes.....	326
12.5.2	Compulsory insurance and "moral hazard" .....	327
12.5.3	Facilitation of private insurance.....	327
<b>12.6</b>	<b>The role of local government and the policy problem ..</b>	<b>329</b>
12.6.1	What is the problem?.....	329
12.6.2	Safety and quality for motor vehicles .....	330
12.6.3	The externality problem reconsidered? .....	331

12.6.4	Regulatory response to information asymmetry.....	332
12.6.5	Reduce confusion .....	333
12.6.6	Relative value of buildings.....	334
12.6.7	Efficiency .....	334
12.6.8	History and inertia .....	335
<b>12.7</b>	<b>Summary .....</b>	<b>336</b>