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Some thoughts on a National Housing Strategy

Steve Pomeroy

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Steve Pomeroy, Senior Research Fellow, Carleton University Centre for Urban Research and Education (CURE)

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Caledon Institute of Social Policy
1356 Wellington Street West, 2nd Floor
Ottawa, ON K1Y 3C3
CANADA

Tel.: (613) 729-3340

E-mail: caledon@caledoninst.org
Website: www.caledoninst.org
Twitter: @CaledonINST

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Executive Summary

After decades of lobbying by advocates of affordable housing, the federal government has agreed to develop a national housing strategy. Given the multi-jurisdictional aspect and shared responsibilities of housing in Canada, such a comprehensive coordinated approach is a welcome initiative. Provided that it is appropriately funded and supported, a national strategy can make an effective contribution to overcoming historical issues of both market failure and administrative public policy failure in Canada's housing system.

The strategy must be broad in scope, embracing all elements of the housing system – the non-market low-income part, the intermediate rental sector and access to ownership, especially for millennials and first-time buyers.

In the affordable core need segment, greater attention must be paid to the role of provincial/territorial income assistance and housing allowances to complement housing programs.

Similarly, social housing providers must expand supports to proactively enable labour market reattachment and thereby improve both tenant income and ability to pay rents.

A distinct federal role remains as financier and funder of capital programs to complement provincial/territorial income assistance roles and to directly address Aboriginal housing need.

The rental sector is a critical component of the housing system but its role in the intermediate market has been largely overlooked, resulting in the erosion and undersupply of needed moderate rate rental options.

At the same time, ensuring access to the ownership ladder for millennial and other first-time buyers is critical to manage excess demand in the under-supplied rental sector.

A thoughtful, well-designed and proactive national strategy could go a long way to strengthening Canada's housing system and generating better outcomes, especially for those currently priced out of the market.

Introduction

Jean-Yves Duclos, Minister of Families, Children and Social Development and the federal minister responsible for the Canada Mortgage and Housing Corporation (CMHC) recently announced a consultation process on the development of a national housing strategy. This commentary outlines some issues and opportunities for consideration.

Discussion and framing for a national housing strategy for Canada must recognize that:

- housing is an interdependent and highly complex ecosystem
- the system has many parts, all interacting and influencing others
- ultimately, issues of housing need and housing affordability are an outcome and consequence of an ineffective and inefficient or disconnected system
- issues of housing need and affordability, which are manifest mainly in the lower reaches of the market system, cannot be addressed without considering the larger system and how it works (or does not)
- low-income affordability issues require a concurrent policy response through income assistance – housing measures alone cannot properly address these challenges.

The Canadian housing market works relatively well and fully addresses the needs of 80 percent of households who fulfill their housing requirements with no assistance. An additional 5 percent are directly supported through some form of housing assistance program, including publicly supplied social housing or some form of housing allowance to help cover market cost.

The remaining 15 percent of Canadian households are underserved. Most have housing, but are challenged by one or a combination of problems: Their housing requires them to spend over a norm threshold of 30 percent of income, the home is in poor condition and in need of major repair, or the home is too small relative to the number of persons in the family. Among these three, affordability is by far the most pressing concern.[1]

A very small but visible group completely lacks housing and exists either on the street or in the emergency shelter system – Canada's homeless. There are two primary contributing causes of this residual underserved population: market failure and public policy failure.

Market failure occurs when markets fail to produce and allocate scarce resources (e.g., land) in the most efficient way and/or fail to produce enough merit goods, such as education or basic affordable housing. Market failure is often seen in the form of externalities wherein consumption by some households crowds out or precludes production for others (e.g., distribution of lower-cost housing). It is also reflected in the lack of construction of certain types and tenures (renting and owning), and in the worst-case demolition and replacement of existing homes with higher rent/cost housing, which act to erode available stock of lower-rent homes.

Policy and administrative failure is reflected in our inability and lack of sufficient public resources to manage issues of market failure. It is also manifest in actions that exacerbate market failure. An example of this occurred in 2006, when amortization periods were extended, allowing increased capacity to pay at a time when home prices were already rising substantially. If anything, policy at that time should have:

i. let the marginal increase in mortgage rates that was in play continue and thereby dampen demand and price pressure or
ii. enacted policy change to reduce access to credit, with a similar effect.

Ideally, a proactive purposeful policy framework or national housing strategy will seek to minimize both market and administrative failure. In thinking about how to frame and shape a national housing strategy, we might start with the overall housing system and separately examine how well – or not – the market is functioning, and the forms of market failure that it generates. Concurrently, we would examine traditional and current program and policy initiatives and the outcomes that they have generated (or failed to generate).

In so doing, we should seek to optimize the reach of the market such that the need for residual public interventions is reduced or closer to the limited resources available.

AN ILLUSTRATIVE EXAMPLE

A useful illustrative case is the dramatic shift in housing markets in Canada between 1996 and 2006. Over this decade, the national home-ownership rate increased substantially. Following more than 25 years at roughly 63 percent, it jumped to almost 69 percent by 2006. This change represented a shift of more than 700,000 renter households into homeownership in a single decade. By contrast, construction of newly-built rental was between 7,000 and 19,000 units per year over the same decade.

In 1996, one-third of households were renting and the homeownership rate sat at 63 percent. Annual housing starts were hovering around 125,000 and fewer than 7,000 of these (6 percent) were intended as purpose built rental. By 2006, total starts had increased strongly and exceeded 227,000 nationally, but with rental accounting for only 25,000 of these housing starts. While close to one-third of households were renters, starts still comprised less than 10 percent of all new housing construction.

Nationally, the weighted average rental vacancy rate was 4.3 percent with ten of 33 metropolitan areas below the benchmark 3 percent of a healthy rental market. In 2006, the national average was down to 2.7 percent with 16 cities under 3 percent.

Despite very low levels of rental construction, rental vacancies were not very low and there was no excessive pressure on rent levels. Nationally, the average monthly rent rose only 27 percent from $593 to $755, an average of 2.7 percent annually, just above the rate of inflation.

Over this period, two primary factors minimized the requirement for a specific housing policy response. First, the Bank of Canada pursued an active monetary policy to stabilize inflation with the result that mortgage interest rates fell substantially from over 8 percent to under 5 percent. Second, lower financing costs were abetted by strong economic growth, with per capita disposable income up 33 percent over the decade.

The combined effect of declining mortgage rates and rising incomes was a substantial increase in capacity to access homeownership, despite the perception that rising prices were making ownership less affordable. The 700,000 renters moving into homeownership is strong evidence that, for many, buying a home was not actually a problem.

The size of the shift from renting into ownership (1996-2006) also removed any pressure from the rental part of the housing system. In short, market-based capacity to buy was an effective valve in releasing pressure from the rental part of the housing system.

Over this same period (1996-2006), core housing need, which is predominantly a problem of affordability and is much higher among renters, also declined.[2] Over the decade, 140,000 fewer renters were deemed to be in core need. And this was a decade that immediately followed the termination of federal funding for new social housing in 1994. Although a modest new affordable housing program was introduced in 2002, it was much smaller in scale and very few units were completed and occupied prior to 2006. So the improvement in core need among renters took place despite an absence of programs or funding.

Arguably, the number of households in need would have declined further had funding been in place. But the fact that it declined at all is a testament to the broader effects of changes in the larger housing system.

LESSONS LEARNED

What insights and lessons does this brief historical review suggest as we seek to frame a discussion about a national housing strategy?

While the advocacy for a national housing strategy originated with and was carried largely by the affordable housing sector, this assessment reveals that a strategy must be more than just funding for social or affordable housing. What occurs in the ownership and private rental parts of the housing system can have a much larger impact than direct investment in the much smaller affordable part of the system.

For example, without these two external influences, neither of which was a function of housing policy, what policy levers and level of investment would have been needed to emulate that dramatic and largely positive change in housing outcomes (a 6 percent increase in ownership and a 5 percent reduction in renter need)?

Perhaps none would be required. But careful monitoring of the market conditions as a basis to inform policy decisions that could have significant impacts (e.g., the initial extension of amortization periods for insured loans and subsequent retraction thereof) would be highly desirable, and should be part of any national strategy framework. CMHC is already active in collecting and publishing market intelligence; it simply needs to be more effectively harnessed.

This illustrative decade also reveals that remedies to high and persisting levels of affordability, both in terms of low-income need as well as middle-class access to ownership, may lie outside of the housing sector. Again, policies that influence mortgage rates, terms and incomes are very significant.

Looking to the future, with mortgage rates now effectively bottomed out and income growth stagnant, this pattern of tenure shift is extremely unlikely to repeat itself.

In the absence of large-scale transitions into ownership, pressure will mount on the rental part of the housing system and be evident in rising rents and increased renter core need (i.e., declining renter affordability). It is notable that the number of core need renters increased between 2006 and 2011, in part a consequence of an economic slowdown with more people out of work and less income.

So the policy challenge for the next decade will be how to manage residual and growing demand in an undersupplied rental sector.

While focusing on the rental part of the system, it would be short-sighted to overlook potential actions in the ownership part of the system. These could include, for example, measures to preserve and enhance access to ownership for young families and millennials, many of whom are now being precluded both by increases in home prices (a market effect) and constrained access to credit (a macro-prudential policy effect).[3]

PARSING THE RANGE OF CRITICAL ISSUES AND ASSOCIATED ROLES AND RESPONSIBILITIES

Based on the foregoing assessment, any discussion of a national housing strategy must encompass the full housing system and may require engagement and different actions across stakeholders.

To begin some discussion around how well the market functions, evidence of market failure and potential remedies and options must be gathered. The overall goal of a national housing strategy should be to effect a healthy, well-functioning housing system in which the market extends its reach to address as much demand as possible. By so doing, the residual need for social policy interventions and funding can be reduced, ideally to a manageable scale. Purposeful proactive interventions should be designed to complement and offset the limits of the market.

MARKET POLICIES

An important aspect of market-related policy and strategy is in-depth and current intelligence on market conditions. This information can be built on CMHCs existing market analysis activity. Beyond simply providing data and insight, this approach requires a proactive policy review lens to examine and advise on any proposed policies with market impacts.

The framing should explore two key areas of market housing: access to ownership for first-time buyers and millennials, and investment and provision of rental housing, especially in the "intermediate rent" – range 100-140 percent of the CMHC average market rent (AMR).[4]

It should also examine the current distribution of housing including the large number of singles or couples occupying larger homes, which could be more efficiently used to house larger families – if an appropriate mix of incentives and alternate options were available to aging occupants.

In particular in the context of an aging population and potential impacts on health care costs, the role of housing in a residential-based health support system as an alternative to a more expensive institution-based health care system must be considered.

AFFORDABLE/SOCIAL PART OF SYSTEM

In the area of low-income affordable housing, it is crucial to recognize two vital characteristics of this part of the housing system.

First, as suggested earlier, the predominant problem is affordability. This problem arises at the confluence of housing cost (rent) and incomes. Affordability is exacerbated both by a lack of lower-rent housing as well as the prevalence of low income. For this segment of need, the greatest challenge is low income. As shown in the 1996-2006 decade, employment and economic policies to increase earnings can be more effective than housing subsidies acting alone to address low-income affordability issues.

Building or acquiring housing and then setting rents on a rent-geared-to-income (RGI) basis (i.e., charging only 30 percent of income for rent) does not necessarily change housing consumption. It simply reduces the portion of income that people allocate toward paying for their housing – relative to food, clothing and transportation. Many already live in appropriate and adequate housing; they simply pay more than they are deemed able to afford. Adding the cost to move in order to access subsidy via new supply social housing is an inefficient policy.

By allowing a maximum of 30 percent of income for rent, the policy is reserving 70 percent of income for non-housing consumption. As such, RGI rents are *de facto* a form of income assistance. A more direct approach is to accept this reality and pursue housing-linked income support. Given the provincial and territorial primary role in income assistance, this is a logical role for this order of government.

Allocating primary responsibility and expenditure for RGI-income-related subsidy to the provincial/territorial (PT) level, however, creates and exacerbates an already existing and evolving fiscal imbalance. As federal agreements expire, provinces and territories (and municipalities in Ontario) take on a larger share of the costs ($6:$1 provincial/territorial: federal) by 2025.

SO WHAT CAN OR SHOULD THE FEDERAL GOVERNMENT FUND?

If the provinces and territories assumed responsibility for income assistance and support, how can fiscal responsibilities be balanced out? A federal role can be matched to the second critical issue: the need for capital investment, both via grant and low-cost financing, to support retrofit and renewal of aging social housing assets. Federal grants similar to those under the 2009-11 stimulus package can have an important impact in extending the useful life of existing social housing and can help balance the share of spending if provinces and territories take on income support/RGI.

In addition to funding new construction, it is critical to monitor the ongoing loss and erosion of relatively affordable rental stock. This is lost via demolition and redevelopment, conversion to condominiums and by inflating rents, which move units out of affordable ranges.

In the decade from 2001 to 2011, the number of units renting for less than $600 per month nationally declined by 860,000. This represents a "loss" of one-fifth of Canada's moderate affordable rental stock (many units still existed but at higher, less affordable rents). An effective way to preserve such units is to enable community-based non-profits to acquire existing rental properties in the same way that institutional investors tend to acquire existing units rather than build new (because it is more cost-effective). If the objective is to address and preserve affordability, federal capital funds should embrace strategic acquisition as well as new build.

Another way is to allocate capital funding to develop some new social housing, especially in the area of supportive housing for chronic homeless persons, as part of a Housing First strategy.[5] Low-rent units are simply too limited to support a Housing First strategy and cities like Calgary have developed small-scale models (20-25 units) to meet the supported needs of formerly chronic homeless persons. Capital funding is required to develop these options and, in Calgary, this includes acquisition as well as new construction.

When using capital funding to develop affordable housing, the lower the rent level the larger the amount of grant that is required. Setting rents very low (by using large grants) has a perverse effect in generating very low rental income, which makes it hard to cover basic operating costs and to maintain the asset well. Very low rents also limit the total number of units that can be built with a fixed capital budget. To manage this issue, it is better to set rents at the average market level or just below (e.g., 90 percent AMR) and then separately draw on supplements or housing allowances to make them affordable. This action ensures that properties have sufficient income to be well operated and sustained as real estate assets, rather than having very low rents, which undermine sound asset management.

Another appropriate federal role is in the area of mortgage financing. CMHC returned to direct lending in 1992 for social housing loans and, drawing on the Crown borrowing facility, is able to secure the lowest rate financing available. While this has no cost impact on the federal treasury, it can effectively extend the impact of grants to further support low-rent development. With maturing of social housing operating agreements and related mortgages, there is new room in this CMHC (re)financing capacity for retrofit and additional development.[6]

Potentially, the new low rate financing initiative announced in Budget 2016 can help support mixed-income, mixed-market/affordable rents. This type of blended rent structure can generate a more sustainable income while also help to address demand in the intermediate rental market – an important aspect of linking housing to labour market mobility and productivity.

A further federal role is in the area of tax policy and its impact upon potential investment in much-needed new rental construction. Tax reforms in the early 1970s and again in the 1980s have made rental investment less attractive. This is one of the factors, but not the only one, which have contributed to low levels of rental development.

Careful examination of how tax policy impacts incentives to invest is an important part of a national housing strategy. Simply reverting to old tax policies may not necessarily be effective, as this action would create a very large expenditure over the entire rental sector of four million units. However, specific targeted tax measures may have a place. Options include some form of tax credit to vendors of existing, relatively affordable rental assets as an incentive to transfer ownership to a non-profit housing corporation in order to preserve existing affordability – and likely at a far lower cost than building new dwellings.

HOUSING AS A STRATEGIC INVESTMENT IN A PRODUCTIVE ECONOMY

Housing investment in federal budgets has frequently been associated with economic stimulus and employment generation – e.g., John Turner 1984, Jim Flaherty 2009 and Bill Morneau 2016.

Budget 2016 noted that the consultation on a national housing strategy is to "ensure that these affordable housing investments are most effective and to help the social housing sector achieve self-reliance." The Budget further added: "Investing in affordable housing will provide targeted support to those who need it most and create good jobs that help grow Canada's economy in a clean and sustainable way."

Accordingly, the consultation will also need to determine what form of housing assistance and investment will best contribute to growing the economy. The investment may not necessarily include traditional social housing construction programs. These can provide short-term employment stimulus (via multiplier effects) but don't necessarily contribute to long-term increased productivity.

Productively is increased only if the social housing assets and related services enhance labour market participation or have positive health effects in the case of the elderly and people with long-term disabilities. Traditional programs in which rents have been based on a percentage called rent geared to income (RGI) have been clearly associated with income assistance and work disincentives.

With a 30 percent RGI model, for example, each incremental dollar earned is clawed back by a 30-cent increase in rent, a very large effective tax rate. Enhancing rental assistance to low-income households on an RGI basis may have negative productivity effects and undermine the longer-term strategic intent of social infrastructure investment.

A critical question is how should housing policy be (re)designed in order to achieve such longer-term strategic objectives?

CONCLUDING COMMENTS

Housing is a complex and highly interactive system. This paper argues that greater attention should be paid to the role of provincial/territorial income assistance and housing allowances to complement housing programs. Social housing providers must expand supports to proactively enable labour market reattachment and thus improve both tenant income and ability to pay rents. A clear role remains for the federal government as financier and funder of capital programs as a complement to the provincial/territorial role in income assistance.

While the rental sector is a critical component of the overall housing system, its importance has largely been overlooked. The result has been an erosion and undersupply of moderate-rate rental options. Equally important in a national housing strategy is the need to ensure access to the ownership ladder for millennials and other first-time home buyers.

ENDNOTES

1. Housing affordability is generally defined as spending more than 30 percent of gross rent for shelter costs (rent or mortgage plus utilities).

2. Core need means a household experiences one of three problems – the dwelling is in poor repair, it is overcrowded or it requires the household to spend over 30 percent on housing. In the specific measure of "core housing need" developed by CMHC, affordability is further refined by adding an income benchmark, calculated at the income required to pay the local rent for an appropriate size dwelling without spending over 30 percent (e.g., if rent is $800, the income benchmark is $800/0.30 x 12 months = $32,000). A household is in core need if it pays more than 30 percent on housing or experiences condition and crowding problems AND has an income below this level.

3. Macro-prudential policies refer to the rules and practices that regulate lenders in order to manage large-scale risk in the financial system and mortgage market.

4. Average market rent (AMR) is measured through an annual survey conducted by CMHC of all rental properties of three or more dwelling units. The average is heavily weighted by older units built in the 1960s and 1970s when rent construction peaked. Thus the AMR is well below the market rent for a newly-constructed rental apartment. CMHC data suggest that new units have rents at roughly 140 percent of the AMR.

5. Housing First is an approach that is premised on first finding and settling a homeless person into permanent housing, then commencing other treatment and interventions to address underlying issues, such as mental health problems and addiction. Previous policies required a person with mental health problems and/or addiction to address these before accessing permanent housing, which simply perpetuated the cycle of homelessness.

6. Historically, social housing was funded with long-term agreements that paid an operating subsidy and were matched to the mortgage amortization period, usually 35 or 50 years. Many of these agreements started in the 1960s and are now maturing.