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INCREASING THE AFFORDABILITY OF RENTAL HOUSING IN CANADA: An Assessment of Alternative Supply-side Measures*

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ABSTRACT

Homelessness is a serious social problem that is unlikely to be solved by grand proclamations or a single policy initiative. It is, more likely, to be solved by the introduction of innumerable changes both in how we understand the problem and how we approach its solution. In this paper we examine the costs and benefits of tax measures that would promote greater involvement of the private sector in the provision of affordable housing. We also examine the costs and benefits of a variety of regulatory initiatives. In an earlier era, centrally directed federal-provincial grant programs for housing run by governments and non-profit organizations were the means of providing affordable housing. Most of the proposals in this paper, in contrast, aim to harness the energy and the efficiency-promoting competition of the private sector. The focus is on decentralized decision-making. Some measures would depend heavily on individual entrepreneurs and non-profit organizations. Others would depend on municipal governments, whose program capacities have grown greatly in recent decades and whose closeness to their constituencies makes them well-placed both to develop and to deliver supportive measures. Our assessment of possibilities suggests that a low-income housing tax credit best balances effectiveness with the need to minimize costs on strained government budgets. Tax measures aimed at investors in multi-unit rental buildings are also likely to meet these criteria.

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EXECUTIVE SUMMARY

Housing affordability and homelessness are major problems in most Canadian cities, and are exacerbated in urban areas whose economies are driven by commodity price booms that drive rents higher and vacancy rates lower. Added to this cyclical problem is a long-term structural problem: a remarkable decline in the size of the multi-unit rental sector, which has made it difficult to reduce homelessness and make housing more affordable for lower-income families.

Affordable housing, as currently financed by federal, provincial, and often municipal governments, relies on large, up-front capital grants, which put undue pressure on current government budgets. There is thus a need to consider alternative financing mechanisms, particularly tax expenditures, and other supply-side measures to encourage an increase in the stock of multi-unit rental accommodation and to make such housing more affordable.

Targeted tax expenditures might seem at odds with the desirable policy goal of neutrality in taxation, but housing is a special case in that the tax system is heavily biased in favour of owner occupants. Possible measures on the tax side to increase the stock and affordability of rental housing include:

- reducing the taxes landlords pay in the early years of ownership by increasing the amount of capital cost allowance (CCA) that they are permitted to deduct from their rental income;
- reducing the taxes new landlords pay by relaxing restrictions on rental losses that are deductible against non-real estate income;
- reducing the taxes existing landlords pay by allowing, with restrictions targeted to protecting and increasing the affordable housing stock, rollover which would postpone capital gains tax on the sale of a property where another one is acquired;
- reducing the taxes existing landlords pay by allowing, with restrictions targeted to protecting and increasing the affordable housing stock, postponement of taxes due on the sale of a property, of accumulated depreciation deductions – that is, postpone tax on the recapture of CCA;
- eliminating capital gains taxes on donations of property for affordable housing; and, most important;
- implementing a housing tax credit modeled on the US Low Income Housing Tax Credit (LIHTC).

In addition to tax expenditures, other possible supply-side measures, primarily regulatory, could help to both maintain and enhance the stock of multi-unit rental accommodation. Such measures include:

- changing zoning to permit home owners to rent out a portion of their home as a secondary suite;
- controlling demolitions and the conversion of multi-unit rental buildings into condominium units;

- implementing “inclusionary” zoning, based either on the “mandatory” model, whereby the provision of affordable units is required in *all* residential developments or on the “voluntary” model, whereby as-of-right developments are exempt from affordable housing requirements and developers can avoid including affordable units simply by not seeking re-zoning;
- instituting second-generation rent control, a milder version of classic rent control that, for example, would allow rent increases according to a guideline equal to the rate of inflation plus two percentage points;
- for affordable housing, reducing development charges— one-time levies that municipalities impose on new development to offset the costs of additional necessary public infrastructure;
- allocation by municipalities of local tax revenue to support the development of affordable housing; and
- transfer of land by municipalities to social housing agencies or other affordable housing developers on non-market terms.

In an earlier era, centrally directed federal-provincial grant programs for housing run by governments and non-profit organizations were the means of providing affordable housing. Most of the measures in this paper, in contrast, aim to harness the energy and the efficiency-promoting competition of the private sector. The focus is on decentralized decision-making. Some measures would depend heavily on individual entrepreneurs and non-profit organizations. Others would depend on municipal governments, whose program capacities have grown greatly in recent decades and whose closeness to their constituencies makes them well-placed both to develop and to deliver supportive measures.

INTRODUCTION

Rental housing markets in major Canadian cities have experienced a deterioration of affordability in recent years. In part this is an effect of the income tax reform of the 1980s, the shutdown of social housing programs by the federal government in the 1990s, and the inadequacy of the federal-provincial Affordable Housing Initiative to compensate fully for these earlier moves. While the 2008–09 recession loosened rental housing markets, with full recovery there will be tightness again. In addition, there is a structural problem: there has been a shift in the composition of the rental housing stock toward forms that, by and large, are less suited than multi-unit rental property to providing housing for the elderly and for other less resourceful tenants. Landlords of single detached rental houses and apartments in converted houses often have no one on site to attend immediately to problems such as a furnace breakdown or disruptive neighbours, and rental condominiums do not have anyone on site to repair en suite equipment. Furthermore, years of booming housing markets have reinforced a major motivation for owning such properties: the expected capital gain when the property is sold. This motivation — and the possible sale to an owner-occupant — intrinsically jeopardizes the tenant's security of tenure.

These problems underscore the importance of considering measures to increase the supply of multiple-unit rental buildings, especially affordable ones, which would help most would-be renters but particularly those who are homeless or at risk of homelessness.[1] People who are somehow managing — but only just — to pay their rent are apt to lose their home when markets are tight. If their rent increases and they cannot pay it, or if they are displaced by demolition or conversion, they will find it difficult to find a new place to live. Tight markets mean that landlords can pick and choose among applicants, and successful applicants tend to be those perceived to be low cost to serve — that is, those who are resourceful and easy to house. Increasing the supply of affordable housing, particularly of multi-unit forms, would especially help households who do not fit into this class.

In this paper, we set the context for considering affordability measures and discuss specific proposals for increasing the supply of affordable housing — namely, tax deductions and deferrals, a Canadian version of the US Low Income Housing Tax Credit, and a variety of regulatory changes.

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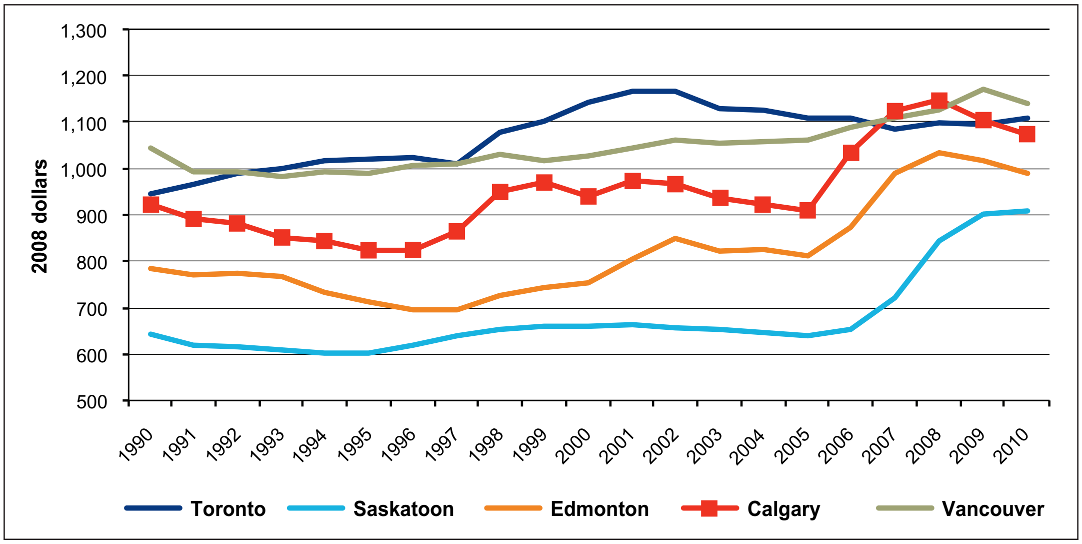
[1] While the terms of reference for this paper were to investigate tax and regulatory measures affecting the supply side of the housing market, we recognize that the demand side is also important. Our position is that a full analysis of both supply- and demand-side options is needed. One particularly desirable demand-side program is a modest housing allowance that would be open to all tenants who satisfy defined rent and income criteria; see Marion Steele, "Canadian Housing Allowances," in *Housing Allowances in Comparative Perspective*, edited by Peter Kemp (Bristol, UK: The Policy Press, 2007). Such an allowance would ameliorate affordability problems and tend to reduce the flow into homelessness. It also would reduce the inequity associated with the large subsidies that households in social housing receive because it would assure low-income households in the private market of subsidies as well. However, a housing allowance would have such a slight effect on the housing market that subsidies on the supply side would still be needed to induce an increase — or stem a decline — in the quantity of housing units, especially affordable ones. For a useful review and toolkit for affordable housing that covers housing allowances, other demand-side measures, and a range of supply options, see Conference Board of Canada, "Building from the Ground Up: Enhancing Affordable Housing in Canada" (Ottawa: Conference Board of Canada, 2010).

THE STATE OF THE RENTAL HOUSING MARKET IN SELECTED CITIES

How severe is the rental market problem in Canadian cities? Figure 1 shows that the behaviour of rents in Saskatoon, Edmonton, and Calgary is markedly different from that in Toronto and Vancouver. In all five cities, real rents rose between 1990 and 2010, but the increase was far greater in the commodity-boom cities than elsewhere, and was concentrated in dramatic increases over 2006 to 2008 as migrants flooded into the booming western cities and severely strained their housing markets. Low-income renters — and indeed some moderate-income renters — must have had a difficult time in these years. Some who could afford their accommodation when they moved in found they could not a year or so later, after an unmanageable rent increase. Those simply unable to pay the new rent might have found themselves living on the street, using shelters, bunking in with friends, or moving to another city.

FIGURE 1: Average Rent for a Two-Bedroom Unit in a Multi-unit Rental Building, Selected Cities, 1990-2010

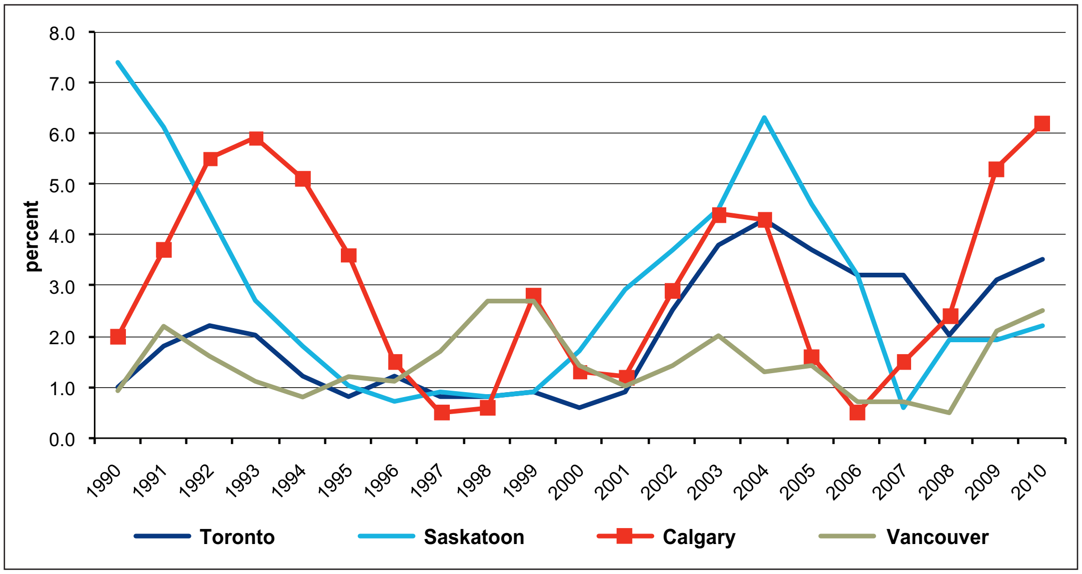


NOTE: The figure shows rents in 2008 dollars—actual October rents except for 2010, which is forecast using data for April for two-bedroom apartments in multi-unit rental buildings (excluding rental condominium units) with three or more units, which Canada Mortgage and Housing Corporation terms "conventional" rental structures, divided by the consumer price index for the Census Metropolitan Area, then multiplied by a factor to allow for building depreciation, offset in part by land value appreciation, of 0.25% per year. The rationale for this factor is that, when there is little addition to the stock, wear and tear and obsolescence mean account should be taken of building deterioration, likely in the range of 1% to 3% per year; see David M. Geltner and Norman G. Miller, *Commercial Real Estate Analysis and Investments* (Upper Saddle River, NJ: Prentice-Hall, 2001), p. 221n.. A considerably higher rate is found in a study using US data; see Jeffrey D. Fisher et al., "Analysis of Economic Depreciation for Multi-Family Property," *Journal of Real Estate Research* 27 (4, 2005): 355-370. For Canada, however, a rate of 2% is implicit in George Fallis and Lawrence B. Smith, "Tax Reform and Residential Real Estate," in *The Economic Impacts of Tax Reform*, edited by Jack Mintz and John Whalley (Toronto: Canadian Tax Foundation, 1989).

SOURCES: Canada Mortgage and Housing Corporation, Canadian Housing Observer*, various issues; idem,* Rental Market Reports*, various issues; and authors' calculations.*

Vacancy rates in the commodity-driven cities of Calgary and Saskatoon have also been more volatile than those in Toronto and Vancouver, reaching levels of over 5% in the early 1990s, in the same range about a decade later — and, in the case of Calgary, again in 2009-10 — but falling to less than 1% at times (see Figure 2). Commodity-driven Edmonton's vacancy rate (not shown) has been similarly volatile. In contrast, the peak Vancouver rate was under 3% and that of Toronto topped 4% just once, in the fallout from Ontario's move to intertenancy rent decontrol — that is, no limit on the amount by which a landlord may raise the rent of a unit when one tenant moves out and another moves in. These two cities, however, are subject to second-generation rent control — rent regulation that permits rent increases under specified conditions — and are not so affected by commodity prices. Vacancy rates and rent changes are intimately connected, and the increases in vacancy rates over the 2007-2010 period in the prairie cities show that rent increases overshot demand. Despite a decline in the prices of oil and other commodities, an increase in unemployment and an associated jump in vacancies, the decline in rents in Calgary and Edmonton has been modest, while Saskatoon rents have actually risen.

FIGURE 2: Vacancy Rates in Multi-unit Rental Buildings, Selected Cities, 1990-2010



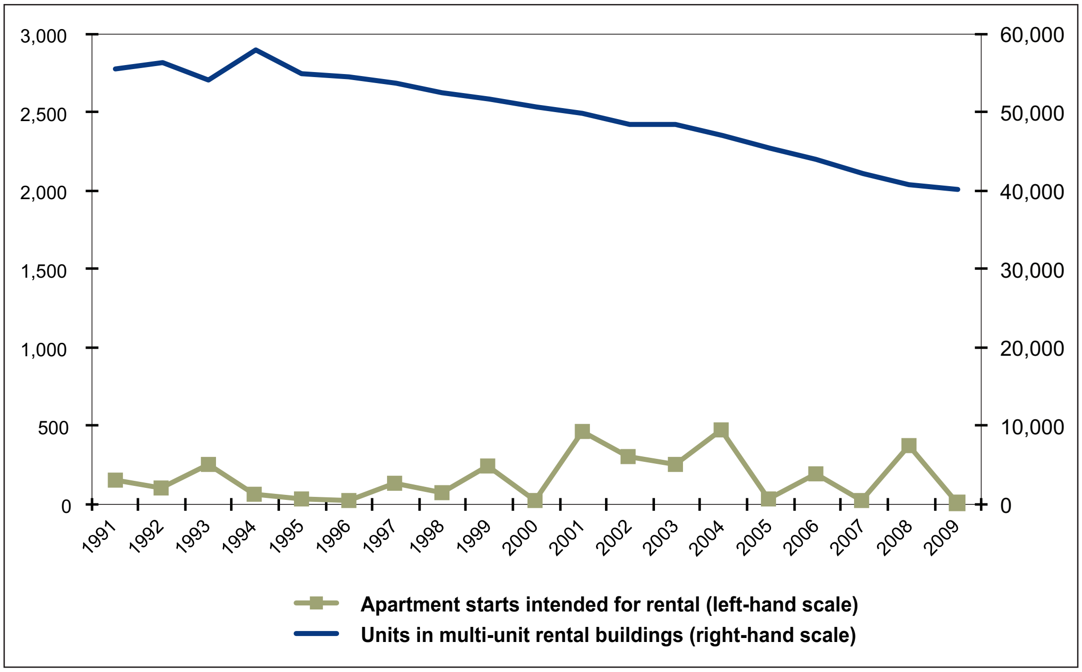
NOTE: Vacancy rates are as of October each year except those for 2010, which are forecast using data to April. The rate is the headline rate — that is, for apartment units of all sizes in rental structures (excluding rental condominium units) with three or more units.

SOURCES: Canada Mortgage and Housing Corporation, Rental Market Reports*, various issues.*

In Calgary, the oil boom and rising rents have been associated with a remarkable decline in the size of the multi-unit rental stock, which was well under way in the late 1990s and accelerated in the 2000s (see Figure 3). This decline is the outcome of very little multi-unit rental construction, combined with conversions to condominium and other uses and demolitions. Calgary's rate of decline between 2000 and 2008 was almost matched by that in Saskatoon; there was also a decline, although a much smaller one, in Edmonton and Vancouver, while in Toronto and Montreal there was some, albeit minimal, growth.[2]

[2] Canada Mortgage and Housing Corporation, *Canadian Housing Statistics*, various issues; idem, *Rental Market Reports*, various issues; and authors' estimates.

FIGURE 3: Changes in the Stock of Multi-unit Rental Housing, Calgary, 1991-2010



NOTE: Multi-unit rental stock is defined as the number of rental units in apartment and row structures with three units or more (excluding condominiums). Numbers for 1991 estimated from data on apartments only. Rental starts include social housing, but the stock data do not.

SOURCES: Canada Mortgage and Housing Corporation, Canadian Housing Statistics*, various issues; idem,* Rental Market Reports*, various issues; and authors' estimates.*

Some analysts say this decline — in what Canada Mortgage and Housing Corporation (CMHC) calls the "conventional" rental sector — does not matter because attention should focus on vacancy rates and rents. After all, *total* rental supply is much greater than just that in multi-unit rental buildings. Home owners attracted by rising rents and low vacancy rates in some years have put secondary suites on the market, the income from which has helped them meet their own housing financing costs. Also, stimulated by rising house prices and expected capital gains, investors have bought condominiums and other small properties and rented them out.[3]

Multi-unit rental buildings, however, occupy a unique position, for several reasons. First, they are generally professionally managed — often with an on-site superintendent who can attend to problems ranging from maintenance needs to mislaid keys without delay – and they typically have the security assurance of controlled entry. Second, for tenants who pay rent on time and abide by the rules, such buildings deliver more security of tenure than do most other rental forms (although the high rate of decline in Calgary has lessened this advantage recently), making them more suitable for long-stay tenants, particularly the elderly, than is a single-detached house.[4]

[3] In fall 2009 in Calgary there were an estimated 22,895 rental single detached houses, more than half the number of conventional rental apartments plus rental townhouses. (Canada Mortgage and Housing Corporation, *Rental Market Report, Calgary CMA*, Fall, 2009). Numbers for Edmonton are similar.

[4] Life lease housing delivers the same kind of package but is more similar to ownership than rental insofar as occupants need to make a large financial contribution.

Third, only these buildings have the administrative apparatus and scale to enter into a contract for rent supplements, a subsidy for social housing clients who live in private sector buildings. It is also true that, in the recent economic environment, multi-unit rental properties are almost certainly greater contributors per housing unit to income tax revenues than are small properties.[5]

We now turn to proposals that might improve the situation, beginning with income tax measures.

INCOME TAX MEASURES: DEDUCTIONS AND DEFERRALS

The current state of the multi-unit rental sector suggests that the tax reform of the 1980s went too far in reducing incentives to build such housing.[6] Understandably, in the high-inflation environment of the late 1970s and 1980s, there was concern over the erosion of federal tax revenues due to the deduction of high interest expenses as well as tax expenditures — subsidies through the tax system — for rental housing. Indeed, at least one tax provision — the large tax break that wood-frame buildings received compared with other types of construction — distorted even the physical nature of apartments built. Accordingly, most of the measures we discuss below would reverse, in part, the changes implemented during the 1980s tax reform, and all would impose costs on the federal and provincial governments in terms of forgone revenues.[7]

Some might question our focus on tax expenditures rather than on direct expenditures, since the former seems at odds with the desirable policy goal of neutrality in taxation. But this is not the case where housing is concerned. Since the tax system's bias in favour of owner occupancy is a given and is likely to remain so for the foreseeable future,[8] tax expenditures targeted to rental housing would provide a partial offset, potentially with a positive impact on neutrality. While the tax expenditures we discuss here conceivably could be replaced with expenditure-side equivalents, experience with such equivalents is too limited to able to judge their effectiveness.

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5 See Marion Steele, "Capital Gains Rollovers and the Two-Sector Rental Housing Market: A Simulation Study of Toronto," *Canadian Tax Journal* 57 (3, 2009): 460-488.

6 See George Fallis and Lawrence B. Smith, "Tax Reform and Residential Real Estate," in *The Economic Impacts of Tax Reform*, edited by Jack Mintz and John Whalley (Toronto: Canadian Tax Foundation, 1989).

7 Here we are not considering very costly changes, such as the write-off of soft costs for new construction, which would bring back tax expenditures of the scale of those in the late 1970s. Our proposals are considerably less expensive.

8 The chief bias is the non-taxation of capital gains when a principal residence is sold; this tax expenditure is estimated to have been more than $4 billion for 2007. See Canada, Department of Finance, Tax Expenditures and Evaluations, 2007 (Ottawa: Department of Finance, 2008), table 1; available online at www.fin.gc.ca/toce/2007/taxexp07_e.html. Another key tax expenditure is the non-taxation of the imputed net rent of owner-occupiers — the rent, net of expenses, that the homeowner would receive if the home were rented out to others — estimated to be worth in the order of $2 billion or more; see Marion Steele and François Des Rosiers, "Building Affordable Rental Housing in Unaffordable Cities: A Canadian-Low Income Housing Tax Credit," *C.D. Howe Institute Commentary* 289 (Toronto: C.D. Howe Institute, 2009). A third, much smaller tax expenditure is that due to the Home Buyers' Plan; see Marion Steele, "The Canadian Home Buyers' Plan: Tax Benefit, Tax Expenditure, and Policy Assessment," *Canadian Tax Journal* 55 (1, 2007): 1-30.

We would target our proposals at affordable housing (which we define as housing that has rent and tenant-income limits), at multi-unit rental housing,[9] or at housing that fits both categories. The partial overlap of affordable and multi-unit rental is a key factor to keep in mind: since simply increasing the number of multi-unit rentals would confer a benefit on low- to moderate-income tenants, we would expect cost-benefit analysis to support such housing per se, even if it did not qualify as affordable. Clearly, however, the current fiscal climate requires some prioritization. Giving fiscal priority to affordable housing means responding to the greatest need. One way to do this would be to limit the application of some provisions to affordable housing. In addition, rental single houses, rental condominiums and houses that have been converted into two or three units would not receive the proposed tax relief. Excluding these kinds of units would shift the weight of incentives to multi-unit rentals from the kind of short-term and highly leveraged investments that are most destabilizing to the housing market and that provide relatively little security of tenure to those most at risk of homelessness.

Specific Tax Measures

Among the many possible changes to the tax system that have been proposed to increase the construction and affordability of multi-unit rental housing, the ones we regard as most justifiable are making the capital cost allowance (CCA) more generous, relaxing rules on rental loss, permitting capital gains rollover for multi-unit rental properties, permitting postponement of recaptured CCA, and eliminating capital gains taxes on property donations; a number of other measures could also be useful, as we describe below.[10] All the proposals face the problem of a loss of some government revenues,[11] and some also might require intergovernmental cooperation.[12]

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[9] Targeting multi-unit rental housing necessarily would entail the agreement of building owners not to apply for condominium conversion for a specified period.

[10] For some additional changes, see Greg Lampert and Steve Pomeroy, "Options for Changes in Federal Taxes to Encourage New Rental Construction," paper prepared for the Research Subcommittee, Housing Supply Working Group (Toronto: Ministry of Municipal Affairs and Housing, 2002); and Canadian Home Builders' Association, "Focusing on Housing Priorities: Pre-budget Submission" (Ottawa: CHBA, 2005).

[11] For an estimate of the loss of tax revenue per housing unit, in the case of a few of the changes, see Lampert and Pomeroy, "Options for Changes."

[12] Except for Quebec, which collects its own taxes, all the provinces would have to ask the Department of Finance for permission to deviate from the federal definition of taxable income. An increased willingness by the department to consider such flexibility makes this more likely than might have been the case in the past; see Rebecca N. Warburton, "Takeup of Income-Tested Health-Care Premium Subsidies: Evidence and Remedies for British Columbia," *Canadian Tax Journal* 53 (1, 2005): 1-28.

MAKE THE CAPITAL COST ALLOWANCE MORE GENEROUS

Owners of real property are permitted to deduct from their rental income an amount, called the capital cost allowance, in recognition of the depreciation their building suffers over time, since depreciation because of physical wear and tear and obsolescence is an expense of operating the rental property just as maintenance is. The CCA is 4% of the value of the building per year, substantially more than actual depreciation, so that this deduction is, in part, a subsidy to building owners.[13]

An advantage of the CCA write-off is that its biggest effect on cash flow is early in the property ownership period, when it is most valuable to investors and when owners are most likely to need it.[14] Just as home owners find that the financial burden of home ownership, notably the mortgage payment, is biggest right after purchase of a house, so investors experience the biggest financial pressure — and have the thinnest protection from failure — early in their years of holding the property. An increase in the CCA would make mortgages for investors less risky for lenders and increase the ease of obtaining financing. It would also have a positive effect on the rate of return and increase the incentive to invest in rental housing.

One possible reform would be to implement a moderate increase in the CCA — to, say, 5% from the current 4% — for purchases of existing multi-unit rental buildings. Such an increase would increase the likelihood that purchasers of multi-rental buildings would keep them in rental use rather than convert them to condominiums. It would also be desirable to have the increased rate apply to the properties of existing owners.

A measure to encourage renovation and additions to the existing stock is to implement a large increase in the CCA for capital expenditures on existing multi-unit rental buildings. Owners of older buildings, faced with the need for major replacements and renovation, might defer such work, conclude it is financially optimal to do the work only in the context of a condominium conversion, or demolish the building. A large increase in the CCA to, say, double the current applicable rate for capital expenditure would help keep existing buildings in rental use, encourage green renovation, and assist such initiatives as the Mayor's Tower Renewal in Toronto.[15] At the same time, to encourage additions to the existing stock of housing units, the CCA could be increased substantially for new multi-unit rental buildings — for example, an increase to 6% would boost by about half the CCA deductible in the early years of a new building.

Still another possibility is to treat, for CCA purposes, the year of purchase of a multi-unit rental property (or the year a capital expenditure is made) in the same way as subsequent years — that is, to abolish the "half-year" rule. Currently, the CCA rate is half as great in the first year of ownership as in later years. On strict consistency grounds, this makes sense because purchases take place throughout the year — on average, halfway through, if there is no gaming

[13] David M. Geltner and Norman G. Miller, *Commercial Real Estate Analysis and Investments* (Upper Saddle River, NJ: Prentice-Hall, 2001) give the typical depreciation rate of built property in the US as 1% to 3% (p. 221n).

[14] This is true because the value of the building for tax purposes declines the longer the property is held, so long as the owner writes off CCA each year. For example, if a building is worth $1,000,000 at the beginning of the second year of ownership, then the CCA is $40,000. Assuming this is deducted from rental income in year two, the building value for tax purposes is $960,000 at the beginning of the third year and the CCA that can be deducted in year three is 4% of this, or $38,400; the write-off declines similarly in later years. (The example starts with the second year for reasons that will become clear below.)

[15] For details of the Toronto initiative, see www.towerrenewal.ca/about.php.

of the system — so it seems unwarranted to allow, in the year of purchase, deduction of a whole year's depreciation. The current provision, however, hurts owners just when they need the cash flow the most, in the early years of ownership when they might be new to managing property and cash is tight. Eliminating the half-year rule would give investors a bonus up front for making a socially desirable investment. Its encouragement of purchases just before yearend seems a reasonable price to pay for its advantages.

One might ask why we do not suggest lowering the cost of capital through investment tax credits rather than these CCA rate changes – although we do in fact suggest a credit for affordable housing (see below). The advantage of credits is that their generosity does not vary with the tax rate of the investor; moreover, their status as tax expenditures is more transparent than an increase in the CCA because *some* CCA is warranted on economic grounds and is not a tax expenditure. Our proposal to make changes to the CCA rate instead, however, is based on the pragmatic grounds that such changes are more likely to be perceived as marginal and not requiring a rethinking of the current default CCA rate for buildings.

RELAX RENTAL LOSS RULES

All the CCA-related proposals noted above would encourage additional investment in multi-unit rental buildings by real estate investment trusts (REITs) as well as by current owners of *profit-making* real estate. In contrast, relaxing restrictions on rental losses that may be deductible against non-real estate income would provide a major incentive for the entry of new investors. It would also increase the effectiveness of the preceding CCA proposals. (The effect on tax revenues of changes in rental loss rules could be reduced by limiting applicability to only a few years after purchase.) Currently, an owner who has a rental loss cannot take the CCA deduction but instead must defer it unless the owner has another rental property with net positive rental income.[16] If the rules were relaxed, an owner would be able to deduct a loss increased by the CCA[17] from other income — in the case of an individual, usually professional or employment income.[18]

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[16] More precisely, the CCA cannot be used to create or increase a rental loss deductible against non-real estate income. For example, if net rental income is, say, $30,000 prior to the deduction of the CCA, then $30,000 is the maximum CCA that can be deducted even if the 4% rule gives a CCA of $40,000. As another example, if net rental income prior to the deduction of the CCA were a loss of $10,000, none of the CCA could be deducted. This restriction on the use of the CCA deduction does not apply to corporations with principal business in real estate-associated activities. It should be noted that, under standard conditions, use of the CCA defers payment of tax rather than eliminating it.

[17] The taxpayer always has the option to deduct less than the permitted CCA, in which case the CCA deductible in future years is increased. It might be advantageous to take less than the permitted CCA where the future marginal tax rate is expected to be higher than it is for the current year.

[18] Even if a landlord has no taxable income (rental or other), the proposal to allow a rental loss to be created or increased by the CCA would still be valuable. In particular, a landlord who expected to have substantial positive income within seven years would find it advantageous to carry forward the loss created by the CCA. (A taxpayer is allowed to carry forward a loss for up to seven years.)

In the 1970s and early 1980s, such a rule was permitted for new buildings under the multi-unit residential building (MURB) provision, but was widely considered, along with other MURB provisions, to have encouraged excessively creative financing and, accordingly, investments costly in forgone tax revenue. More generally, most MURBs were judged to be inefficient investments. However, MURBs were not restricted as is suggested here, in the number of years for which the provision could be used. The MURB provision also permitted so-called soft costs — such as architects' fees and interest expenses during construction — to be deducted as an expense, rather than capitalized. When soft costs are expensed, there is an immediate deduction, giving a big boost to cash flow in the first year of ownership. When soft cost are capitalized, as is the case currently, they are treated as part of the cost of the building and are thus deducted over many years via the CCA. Furthermore, restrictions on the use of the CCA might mean that there is no deduction whatsoever in the early years. Thus, the soft-costs provision would greatly increase valuable cash flow at the beginning of ownership.

A tax change of this nature would reduce the risk for new investors in rental housing because the tax relief provided by the CCA would not be reduced in the event of operational losses at the start of a period of ownership — a surgeon who invests in a multi-residential building would be able to deduct a loss against surgical income. A loss might be caused by unexpected vacancies, rent delinquency, repairs and other expenses, and, more fundamentally and predictably, by the tilt in net income resulting from a nominally fixed (for a period) mortgage payment along with rising nominal rent. Essentially, the tax system would share any loss.This measure would ensure that any increase in the CCA has the desired effect on the after-tax cash flow of *new* new investors as well as established ones. First-time landlords, including corporations not principally in the real estate business, are especially likely to make management errors resulting in unexpected losses. Established landlords — particularly those who own other, profit-making properties — would not benefit because they already are able to fully deduct the CCA;[19] neither would real estate corporations. Pension funds also would not benefit because they are not taxable, nor would REIT unit holders because REITs rarely incur losses, and when they do, they usually cannot pass them through to unit holders.

IMPLEMENT A CAPITAL GAINS ROLLOVER FOR MULTI-UNIT RENTAL PROPERTIES

Generally, when a property is sold, one-half of the gain in its value is counted as taxable income and is taxed at the taxpayer's income tax rate. While this means that capital gains are tax favoured compared with ordinary income, there is a timing problem: because the gain is taxed when the property is sold, rather than annually as the gain accrues, the tax paid at sale is ordinarily large. The tax can be avoided, however, by retaining the property, which is a powerful disincentive to selling. The investor thus is said to be impeded by the phenomenon of "lock-in": equity is locked into the property and cannot be used to buy another one.[20] Capital gains rollover, however, would postpone the capital gains tax on the sale of a multi-unit rental property so long as the proceeds of the sale were used within a specified period to acquire another such property.[21]

[19] This assumes that the other rental properties are sufficiently profitable. More precisely, so long as the net rental income (before deduction of the CCA) from *all* properties is more than sum of available CCA for all properties, there is no restriction. For example, an owner of one property with net rental income of $50,000 after deducting the CCA who buys another property with (a) net rental income before the CCA of -$5,000 (that is, a loss of $5,000) and (b) CCA available of $40,000 may deduct the latter to get a loss of $45,000 on the second property. This is possible because the sum of net rental income of the two properties is $50,000 plus -$45,000 = $5,000.

[20] This characterization is, in part, a distortion: an investor usually can refinance the property and use the equity withdrawn in that way to purchase other investments. But the investor in this situation is not released from risks associated with ownership, and these risks increase as the debt on the property increases. Furthermore, taking equity out of any property increases the overall leverage of the investor — which makes further funds more difficult to obtain.

[21] The effect of a rollover is shown by the following example. Suppose an individual acquires property A for $1,000,000 and sells it for $1,500,000, so that the capital gain is $500,000. (Assume for simplicity that no CCA is taken and there are no selling or buying costs.) Then suppose the individual acquires property B for $2,000,000, and a capital gains rollover takes place so that the individual pays no tax on the $500,000 gain from the sale of property A. If the individual later sells property B for $3,000,000, and this time there is no rollover into the purchase of another property, then the deferred tax on the $500,000 gain on the original property must be paid, as well as tax on the $1,000,000 gain on the second property.

This proposal would provide an incentive for an investor such as a REIT to sell one property and buy another, which could be operationally advantageous and contribute to efficiency.[22] For instance, there could be an increased clustering of buildings, leading to increased economies of scale — one site supervisor might look after two or more buildings. A disadvantage of the proposal is that it could result in large losses in tax revenue,[23] the scale of which is indicated by Canada Revenue Agency statistics that show that, for the 2006 tax year, real estate gains declared by individual landlords were $3.6 billion, more than half of which was accounted for by taxpayers with total income of over $150,000 and with a mean gain of $250,000. In the same tax year, corporate landlords declared capital gains in real estate of $2.3 billion.[24] Clearly, substantial tax revenues would be in play.

Another disadvantage of capital gains rollover is that it would permit the owner of a rental property to sell it and perhaps use the rollover to purchase a limited partnership in an existing building, thus achieving relief from management duties while deferring capital gains taxes without adding to the multi-unit rental stock. Currently, the owner-manager of a rental property, upon reaching retirement age and not wanting to continue managing, might sell the property, enriching government coffers with the capital gains tax paid.

A further disadvantage of this proposal is that, while it potentially would defer and reduce taxes substantially for existing holders of real estate, it would do little to induce investment by first-time investors.[25] For new investors expecting to hold their property for many years, the tax benefit would have only a small effect on their internal rate of return – it would be so far in the future as to be worth little.[26] For investors currently holding rental real estate, rollover would remove a disincentive to trading in the existing market, but it is not clear that it would result in substantial additions to the multi-unit rental stock.

Still another disadvantage of rollover is that, because it would increase the incentives to sell, it would tend to increase the risk that an old building would be sold to a new owner who would renovate and implement steep increases in rent, which would be tantamount to economic eviction for many tenants.[27]

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[22] See Jack M. Mintz and Thomas A. Wilson, "Removing the Shackles: Deferring Capital Gains Taxes on Asset Rollovers," *Backgrounder* 94 (Toronto: C.D. Howe Institute, 2006).

[23] See Steele, "Capital Gains Rollovers."

[24] An individual is assumed to be a landlord if he or she has more than $10,000 in rental income. The average gain is for those individuals who declare any gain. Total taxable income includes taxable capital gains (that is, 50% of capital gains). A breakdown by income class shows that 840 individuals with total taxable income between $140,000 and $150,000 had average real estate capital gains of $97,000, implying total taxable income net of taxable capital gains of about $96,000 The distribution of individuals with income of less than $150,000 suggests that the average taxable total income of individuals with total income of more than $150,000 is at least $250,000, and that their average total taxable income net of taxable capital gains is at least $125,000 (=$250,000 - 0.5($250,000). A corporation is assumed to be a landlord if it has any rental income from real estate.

We are indebted to Jason Jacques of the Parliamentary Budget Office (PBO) for the spreadsheets from which both individual and corporate data are taken; the aggregates were computed by Statistics Canada to the PBO's specifications.

[25] Of course, at death, capital gains are realized and taxes paid, but a tax delayed is a tax reduced.

[26] See Steele, "Capital Gains Rollovers."

[27] See, for example, the business model discussed in Terry Deutscher, *Mainstreet Equity Corp.* (London, ON: University of Western Ontario, Richard Ivey School of Business, 2001). The model consists of purchase and "value creation," a process that typically reduces the affordable stock.

IMPLEMENT A ROLLOVER OF RECAPTURED CCA

When a rental property is sold, there is ordinarily a tax to be paid not only on capital gains but also on the "recapture" of the depreciation (the CCA) that was deducted. This tax easily can be a heavier burden than that on capital gains — in fact, the lower the rate of inflation the more likely this is the case. The way recapture works is as follows: if the sale price of the building is no less than its value when it was acquired, then any CCA taken earlier would be regarded as unwarranted and the seller would have to pay back the tax relief gained earlier.[28] Furthermore, the tax rate would be the income rate, which would be twice the effective rate on capital gains.

Implementing rollover of recaptured CCA would reduce lock-in, especially for old rental properties, and, less obviously, it might prevent the demolition of older, more affordable buildings. When a property is sold under the current system, it is possible that the Canada Revenue Agency will attribute more of the total selling value to the building (which affects the CCA recapture) than the owner believes it is worth. If the building is demolished, however, there can be no argument about recapture, because the value at sale has to be entirely the property's land value: there is nothing to recapture. Rollover would eliminate demolitions to avoid recapture, and some affordable rental buildings might be rehabilitated rather than demolished. Another attractive feature is that highly levered investors who have held their rental unit for only a few years and have declared rental losses would benefit much less than those who have held their property for a long time.[29]

REITs would be particularly advantaged by a rollover of recaptured CCA. Their core investor clientele consists largely of income investors, especially retirees, for whom the cash yield is probably far more important than capital gain — as demonstrated by the fact that REIT distributions typically are made monthly, rather than quarterly. Of course, it is *after-tax* yield that matters. The CCA is valuable because it reduces taxable net income – and the tax owed by investors[30] – but not cash available to the REIT for distribution. In particular, the CCA part of a REIT's cash distribution to investors is classed as return of capital — an untaxed item. The other two components of distributions are net earnings (which are fully taxable) and capital gains (which are taxed, in effect, at half the income tax rate). The overall rate of tax on distributions tends to be much less than the taxpayer's marginal tax rate. It clearly would be advantageous to a REIT to maintain this low effective rate of tax, especially in the context of the recent increase

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[28] More fully and precisely, the taxpayer would have to declare as ordinary income the total amount of CCA taken over the period the property was held, so long as the current value of the *building* was greater than its original value. To understand the relation of recaptured CCA and capital gain, consider the following example. Suppose a property is purchased for $1,000,000, of which the building accounts for $800,000, and that it is then sold for $1,800,000 (of which the building is estimated to account for $1,200.000). Moreover, suppose for simplicity there are no selling or purchase costs. If the CCA taken, summed over the whole period the building is held, is $500,000, then the recaptured CCA is $500,000. The capital gain of $800,000 is the selling price, $1,800,000, minus the purchase price, $1,000,000. If the taxpayer is in the 50% tax bracket, the tax paid on the recaptured CCA is 50% of $500,000, or $250,000. The tax owing on the capital gain is 25% of $800,000, or $200,000, and total tax paid is $200,000 + $250,000 = $450,000.

[29] See the examples in Steele, "Capital Gains Rollovers."

[30] The statement is true for taxpayers holding units outside a registered retirement savings plan or other tax-exempt vehicle.

in the dividend tax credit, which reduces the effective rate of tax on dividends paid by corporations and in turn, increases pressure on REIT unit prices as some investors switch from REIT units to corporate stock. In Alberta, for example, the top marginal tax rate on income is 39%, while on dividends the rate is now less than half that, or 15.9%; for middle-income earners in the $70,000 range, dividends are even more tax advantaged.[31]

The role of the CCA in maintaining a low effective tax rate on cash distributions, however, would present the managers of REITs with a problem: the longer a property is held the lower is the CCA amount, since it is 4% of a declining balance. Over time, if a REIT's portfolio of property does not change, its CCA will decline, its taxable income will increase, and the effective tax rate on its cash distributions will increase. Rollover is a way to overcome this problem. Because of inflation alone, the market value of the building increases over time so that even if a property purchased is identical to the one sold, the investor would be able to claim a larger CCA than if there were no trading at all.[32] Thus, a major tax expenditure associated with such a rollover might well be the additional CCA claimed on the properties purchased relative to the CCA that could have been claimed on the properties sold.

ELIMINATE CAPITAL GAINS TAXES ON PROPERTY DONATIONS

An intrinsically targeted tax change would be to eliminate capital gains taxes due on the sale of property donated to registered public charities for the purpose of providing affordable housing. This would be consistent with the treatment of donations of art to cultural institutions.

ADDITIONAL RESTRICTIONS AND TARGETING OF SELECTED INCOME TAX MEASURES

To address concerns about tax revenue loss, a limit could be imposed on the number of years in which a rental loss increased by the CCA could be deducted against non-real estate income. For example, it might be set at five years for any single property. To target rollover more narrowly, it might be permitted only when the net proceeds of the sold building are invested in a new or substantially renovated multi-unit rental building where, for a set period (say, 15 years), the building is affordable — that is, it has rents that are below market and has income restrictions on incoming tenants[33] — or the sold building is reserved for affordable use. We expect the latter alternative would be quite attractive to some current owners of multi-unit rental buildings, and would be consistent with the notion that affordable housing should be more modest than market housing.[34] Rollover would be an immediate large benefit to existing owners — unlike other suggested changes, which would deliver benefits over a longer period — making it a good candidate for further targeting.

[31] Of course, the gross amount of earnings available to be distributed to stock holders as dividends is reduced by the corporate tax; this does not happen in the case of REITs because they are flow-through entities with no tax at the trust level.

[32] If a rollover rule required that the initial value of the second building be reduced by the accumulated CCA on the first building, the advantage would be reduced.

[33] For example, one might copy the requirements for tenant income and rent employed in federal-provincial affordable housing programs or in the US LIHTC program.

[34] Affordability conditions would reduce the price the sold building would fetch, but the reduction might be small if the sold building already had affordable rents and tenants with moderate or low incomes.

If the possible loss of tax revenues from rollovers is still considered too great, a limit could be set on the dollar amount of rollover in each province, and the provinces could allocate this amount among competing developers.[35]

No proposal to target low- and moderate-income tenants would be complete, however, without mention of the so-called filtering argument against targeting. Filtering refers to the shift of housing accommodation occupied by higher-income tenants into use by lower-income tenants. If new apartments attract-high income tenants, the units they vacate increase the supply of existing apartments available to lower-income tenants, tending to lower the rents and increase the vacancy rates of the latter. Thus, it is argued, all that really matters is to increase the total supply of rental housing, which would increase the availability and affordability of housing for low-income groups, thus rendering targeting needless. A counterargument, however, is that when high-income tenants vacate existing apartments, the softening of the market provides an incentive for middle-income young singles to leave their parents' home and rent their own place or for tenants to move in from another city; in other words, the apartments so released might go to new households, rather than to low-income households. Another view of filtering is that it relies on the deterioration of middle-income housing,[36] but if municipal policy or gentrification slows or reverses deterioration, the process might not take place or might take too long to solve an urgent homelessness problem. Both views suggest that filtering cannot be depended on to provide affordable housing. The empirical evidence, in fact, is mixed, with some studies finding that filtering works, while others, including a recent Canadian study, finding it does not.[37]

Summary of Proposed Changes in Deductions and Deferrals

A significant attraction of using income tax measures as a lever to increase the construction and affordability of rental accommodation is that they are easy for investors, accountants, and the building industry to understand, as the changes we have discussed here all involve only marginal modifications to the existing tax system. What is more, the revenue and incentive effects of these changes are, in most cases, relatively easy to gauge, as they were part of the tax system in the 1980s.

Turning to particular changes, increasing the CCA would help investors early in the life of the investment when cash flow problems are most likely, and the front loading that is inherent in this deduction means that it would have a significant impact on investors' rate of return. Allowing rental losses to be increased by the CCA would encourage new investors to enter the rental housing industry. Allowing a capital gains rollover with restrictions would encourage REITs to sell some of their properties to affordable housing providers. It might even increase the price REITs and other investors are willing to pay for new units sufficiently to induce

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[35] There could be a limiting mechanism at the individual taxpayer level, as suggested by Mintz and Wilson, "Removing the Shackles."

[36] See Brendan O'Flaherty, *Making Room: The Economics of Homelessness* (Cambridge, MA: Harvard University Press, 1996).

[37] For citations, see Steele and Des Rosiers, "Building Affordable Rental Housing in Unaffordable Cities."

builders to sell properties planned for the condominium market to investors who would own them as multi-unit rental properties. If the condominium market became distressed, implementing rollover might be a particularly effective policy. A disadvantage of allowing capital gains rollover, however, is that it could have a significant cost in terms of forgone tax revenue — indeed, this would be a problem to a lesser degree for all tax measures — but revenue losses could be minimized by using tax measures that are targeted only at providing affordable housing.

Finally, eliminating taxes on capital gains on property donations intended for affordable housing would have the attraction of treating such donations on the same basis as donations of securities to charities. Encouraging the provision of land and possibly buildings surely would speed up the provision of affordable housing. While determining fair market value so as to arrive at a valuation might be problematic for infrequently traded real estate, we suspect it would be no more so than for other in-kind donations, such as works of art. A possible drawback of donated property is that it might be poorly located — perhaps far from public transportation, employment, and social services — to meet the needs of low- and moderate-income tenants.

A LOW-INCOME HOUSING TAX CREDIT PROGRAM

The tax changes we have discussed so far deal with deductions and deferrals that would reduce the amount of tax owing and whose value would depend on the taxpayer's marginal tax rate. A different kind of tax benefit is a non-refundable, low-income housing tax credit, which would reduce tax owing in any year only for those taxpayers whose tax liability is at least equal to the tax credit they receive and which does not depend on the taxpayer's marginal tax rate. In addition, it might be possible for a province to establish its own tax credit program while continuing to use the federal tax collection agency. A key advantage of such a program is that, because it is independent of tax rates, it would be easy to cap the tax expenditure.

In the United States, the Low Income Housing Tax Credit has been in existence since 1986 and is regarded as highly successful.[38] Although the recent financial crisis hit the program hard, it still survives and is being used as a platform for housing stimulus measures. It funds most US low-income housing, and about a third of the units provided under the program are developed by non-profit organizations.[39] It has funded a great variety of housing, from Anishinabe Wakiagun, a single room occupancy development for 40 homeless alcoholics in Minneapolis to the for-profit Anson Park apartments for families in Abilene, Texas. The housing credit provisions were added to the US *Tax Reform Act* because of concerns that the act's tightening up of taxes on rental housing would hit low-income renters disproportionately. The credit has turned out to be politically robust: introduced under the Reagan administration, when the Democrats were a majority in Congress, it has survived through Democratic and Republican administrations and Congresses, and has been strengthened and enriched over that period.

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[38] See, for example, Joint Center for Housing Studies, *The Disruption of the Low-Income Housing Tax Credit Program: Causes, Consequences, Responses, and Proposed Correctives* (Cambridge, MA: Harvard University, 2009). For a contrary view see EL Glaeser and J Gyourko, *Rethinking Federal Housing Policy: How to Make Housing Plentiful and Affordable* (Washington, DC: American Enterprise Institute Press, 2008)

[39] Steele and Des Rosiers, "Building Affordable Rental Housing in Unaffordable Cities."

In contrast, Canadian tax reform, which took place in the same era, made no special provision for low-income renters, an oversight that might be remedied by a housing credit patterned on the US experience, which we now examine, with appropriate modifications for the Canadian context.[40]

Key Provisions of the Program

In the United States, tax credits provided every year for ten years to owners of certain low- and moderate-income housing projects.[41] Buildings must be new or substantially renovated, and developers may be either for-profits or non-profits. The cost of the credits to the government is ordinarily 70% of the building cost but is 91% in high-cost cities such as Boston (using US criteria, Calgary, Toronto, and Vancouver probably would qualify as high cost). If construction represents 80% of project costs in a high-cost city, the credits amount to about 73% of the total development cost of a unit. For example, if the total development cost of a two-bedroom unit is $200,000, where the cost of land per unit accounts for 20%, or $40,000, and the cost of construction is 80%, or $160,000, the cost of the credits to the government would be 91% of $160,000, or $145,600. This is close to double the federal maximum contribution per unit under the Canadian federal-provincial Affordable Housing Initiative (AHI), although this amount is beefed up with a matching provincial-municipal contribution. If a Canadian credit program were to follow the US precedent there would be no required provincial contribution whatsoever.

As the name suggests, the US program has an income requirement whereby prospective qualifying tenants are those whose income is at or below 60% of the median income in the area for a given household size. A Canadian program could use either a similar criterion or the income maximums under the AHI. In the United States, rents are set at no more than 30% of income for tenants at the *top* of the eligible income range.[42] Again, a Canadian program might follow this example, or the maximum rent could be some percentage of the market rent — for example, the 80% used in at least one agreement under the AHI — or simply the market rent of modest-quality units, thus explicitly targeting the credit to affordable housing. Furthermore, rent changes are restricted under the US program because rents are able to rise only insofar as median incomes do; in Canada, allowable rent increases could follow the US rule or increases in the market rent, as under an AHI rule. We note, however, that the US rule protects tenants better in situations of high increases in market rents such as were experienced in Alberta and Saskatchewan over the 2006-2008 period.

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[40] Versions of a possible credit are analyzed in ibid.

[41] If a project receives credits worth $1,000,000 in total over the ten years, the annual credit is found by determining the amount that is equivalent to $1,000,000 when received each year for ten years and discounted — because the credits are not worth as much in the future as they would be if received immediately. At a discount rate of 4% — slightly less than the rate on Government of Canada long-term bonds as of March 2010 — the annual credit would be $123,291. Developments that receive the credits must comply with program requirements for a minimum of 30 years; the penalty for non-compliance involves repayment of the credits to the Internal Revenue Service.

[42] Tenants actually in the units usually would have an income below the maximum, leading to average rent-to-income ratios well above 30 percent. For example, if the median annual income for a two-parent, one-child family in a given area is $60,000, the housing credit maximum income for such a family would be $36,000, and the maximum rent for a unit of suitable size would be $900 per month. If the family actually living in the unit has an income of $30,000, it would pay 36 percent of that amount in rent.

Another affordability provision in the US program is the requirement that LIHTC units accept housing voucher recipients; this assures these recipients that at least LIHTC landlords are willing to accept their voucher. An analogous provision in Canada would require LIHTC projects to set aside some units for Rent Supplements if requested by a government agency. We see no reason why a building might not be a mix of LIHTC and non-LIHTC units, with the credits going only to the former. This is permitted under the US program, but almost invariably LIHTC units there account for 90% or more of total units in a building. A mix, however, would help achieve mixed-income objectives, might make it easier to fund condominium units under the program, and would provide funding to support some inclusionary zoning initiatives, as we discuss below.

Under the US program, there is a limit on the credits issued in any year and they are allocated by states' housing agencies. Agencies are required to publish allocation plans so that applicants know the selection criteria their agency uses. Legislation stipulates that 10% of the credits must go to non-profit developers, although some states mandate more than that. In the Canadian context, credits likely would be allocated by provincial agencies — although, in principle, there is no reason they could not be allocated by CMHC instead — and could have a similar set-aside for non-profit developers as in the United States; preference also might be given to projects that house the homeless.

Developers who are successful in the competition for credits almost always have to market them to investors, since the program provides non-refundable tax credits, not grants. The credits are attractive, however, only to investors who would otherwise pay tax — and who expect to continue to have a tax liability over the ten years credits are received. To sell the credits, syndicators are almost always used as intermediaries and they negotiate with and advise developers before an application is made. In this way, developers are able to predict how much equity they likely will receive from investors and, accordingly, how large a mortgage they will need. If the developer's application is successful, the syndicator typically sells the credits to many investors, usually in the form of a share in a fund financing several developments.

Fees charged by the many syndicators who now handle the US program have dropped considerably since the program began, partly as consequence of its becoming permanent in the 1990s. In Canada, at least some real estate syndicators, who currently focus on commercial property, might shift their attention to a LIHTC, although any new program involving the private sector is likely to take time to become efficient, as the experience of the MURB and the US LIHTC show, and should be announced as permanent.

The Low-Income Housing Tax Credit: Summary

Whereas all the tax measures discussed earlier would cost governments an uncertain amount of tax revenue, a significant advantage of an LIHTC is that its forgone tax revenue is set. Indeed, it is possible that program costs might be matched to declining CMHC expenditures as 40 and 50-year commitments that it made decades ago expire. A major attraction for cash-strapped provincial governments is the absence of any requirement that they provide matching funds.

Another significant advantage of an LIHTC is that, in contrast to programs such as Rent Geared to Income housing, it would not affect tenants' marginal effective tax rate. Unless tenants also receive Rent Supplements, their rent would not increase when their incomes do, and so the LIHTC would not create a work disincentive. Furthermore, housing security would be enhanced for tenants whose income rose above the maximum eligible amount because the maximum would apply only upon entering the unit. Moreover, a unique property of a housing credit is that it would allow non-profit developers to obtain the benefit of the capital cost allowance (CCA) tax deduction that for-profit developers already enjoy, which would help attract private equity into non-profit projects.

Any public program to enhance affordable housing must address the issue of administrative costs. On this front, an LIHTC would perform well. After establishing a minimum set of conditions for the operation of the program, the role of the federal government essentially would be limited to dealing with non-compliance, a function the Canada Revenue Agency would handle efficiently. A province's administrative costs would be under its own control and would depend on the complexity of its criteria for the allocation of credits, which, unlike arrangements under the AHI, would have the advantage of being flexible from year to year. Learning-by-doing might inform governments as to which criteria are most important.

Perhaps the most potent advantage of an LIHTC is that its efficiency and effectiveness would rely on the competitive allocation of funds and on efforts by the private sector to minimize costs. In the United States, those involved in the LIHTC program believe the pressures exerted by private investors, and their oversight, have been highly valuable.[43]

The most significant disadvantage of an LIHTC is that inefficiencies likely would be high in the early years of the program because Canadian developers, syndicators and investors would need time to learn and assess the degree of risk associated with the program.[44] This was the experience in the United States and syndicator fees were high in the early years. But high initial fees are akin to the high administrative costs in the early years of a government grant program. The functioning of an LIHTC also would be sensitive to the state of financial markets and to the incomes of potential investors: in the United States, the recent financial crisis resulted in a significant fall in the demand for, and the price of, credits; in Canada, the apparent greater stability of the financial system would make this of less concern.

Another disadvantage of an LIHTC is that it would crowd out some investment in unsubsidized rental housing — largely rental condominiums and other small rental properties, however, a sector currently so well supplied that the disadvantage is slight.

[43] See Joint Center for Housing Studies, *The Disruption of the Low-Income Housing Tax Credit Program*. To increase the appeal of the credit to private investors one proposal is to shorten the period over which credits are paid out.

[44] The learning curve would be reduced for some by related experience in the US market; for example, RBC Capital Markets is a big investor in this market (Northeast Regional Report, *Affordable Housing Finance* July-August (http://www.nxtbook.com/nxtbooks/hanleywood/ahf_20090708/#/0).

REGULATORY CHANGES

An increase in the supply of affordable rental housing in Canada also could be encouraged through regulatory changes. Most such changes are under the control of municipalities usually under an umbrella of provincial regulation. Among the changes that could be considered are allowing homeowners to rent out secondary suites, controlling the demolition or conversion of affordable multi-unit rental housing, implementing inclusionary zoning, and instituting second-generation rent control.

Permit Secondary Suites

Should home owners be permitted, as of right, to rent out part of their house as a separate apartment? Effectively, by old definitions, they would be converting a single-family house into a duplex, which traditionally has been prohibited in single-family zones. But a "secondary suite" is distinctly different from the second unit in a duplex: it is subsidiary to the main unit and usually inferior in both size and facilities.[45]

There has been mounting pressure to allow secondary suites. As roomers other than students have become almost extinct and the demand for privacy has militated against sharing arrangements, increasing numbers of homeowners want to rent out excess space as a separate unit. Empty-nesters often would prefer to rent out some of the space their children once occupied rather than to move to a smaller home. In some places, home prices are so high that many first-time buyers cannot carry their mortgage without the income from a secondary suite. It seems no accident that two of the Census Metropolitan Areas where house prices are among the highest contain municipalities that already permit secondary suites across residential zones — namely, the City of North Vancouver and the City of Toronto; about a fifth of the rental housing stock in these places is estimated to be secondary suites. Permitting secondary suites as of right, subject to necessary health and safety standards, could increase the supply of affordable housing, as well as increase population density, potentially making more efficient use of infrastructure.

Secondary suites can be inexpensive to create as long as they are treated by building codes as merely a cordoning off of part of the original unit, so that they do not require expensive renovations such as separate hot water tanks and furnaces. Where secondary suites are legal only if such renovations are undertaken or where they are not permitted as of right, they often exist as illegal units, whose elimination by ruthless law enforcement would result in the loss of a significant part of the affordable housing stock. For its part, Alberta has attempted to tread a fine line between too much building regulation, which would discourage legal units unnecessarily, and too little regulation, which would permit legal but unsafe units.[46]

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[45] In Calgary, for example, a secondary suite must be 70 square metres of floor space or less; see City of Calgary, "Secondary Suites: Alberta Building Code Requirements" (Calgary: City of Calgary Development and Building Approvals, July 2010), p. 1; available online at www.calgary.ca/DocGallery/BU/dba/brochures/secondary_suites_abc_requirements.pdf. Calgary, 2009

[46] See Alberta Municipal Affairs, MLA Review Committee on Secondary Suites, *Final Report* (Edmonton: Alberta Municipal Affairs, 2005); available online at www.municipalaffairs.alberta.ca/documents/ss/MLA_Final_Report_Secondary_Suites.pdf. The province allows single mechanical systems, for example, but demands interconnected smoke detectors in both the main and secondary suites.

As important an obstacle to secondary suites as regulatory controls is neighbourhood and political opposition. Property owners tend to oppose as-of-right legislation because of concerns about parking, traffic, and noise: while voters might approve of increasing city-wide population density they often oppose increases in their own neighbourhood. One way of dealing with this, as Calgary and other cities have done, is simply to permit secondary suites only in special zones while having a passive bylaw enforcement policy with regard to illegal suites.[47] Calgary also has implemented a generous capital grant pilot program to help create legal suites in the existing stock, although it seems unlikely that this program will have much effect, given zoning and other regulatory obstacles.[48] Many houses in Calgary, however, are now being built with legal secondary suites, which seems likely to become the city's dominant source of this stock: the future might be one of legal secondary suites in suburban areas and illegal ones in the core. Another interesting option would be to make secondary suites as of right the default option and to require neighbourhoods to initiate a vote to prohibit them.[49]

Control the Demolition and Conversion of Affordable Multi-unit Rental Housing

Another way to maintain the supply and affordability of rental accommodation is to enact bylaws to control the demolition and conversion of multi-unit rental buildings, as various municipalities in British Columbia have done. For example, four municipalities in the Victoria region have bylaws blocking conversions unless the rental vacancy rate is over 4%, and owners who are given approval are required to supply replacement units.

During Toronto's long residential boom that began in the late 1990s, many rental building owners considered more profitable uses of their land. Condominium conversion became especially attractive due to the ability to sell the units individually to owner occupants[50] and to a tax rate anomaly in that the city's rate on non-condominium rental buildings built before 2000 is more than three times the rate on condominium buildings.[51] The city taxes a condominium unit at the same rate as a single-family home, even if a tenant resides in the unit. Assessed value typically goes up following conversion (reflecting the owner's motivation to convert), but not by enough to offset the lower tax rate; thus, the net effect is to reduce taxes on the property.

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[47] As the City of Calgary itself notes, "The City's Development & Building Approvals investigates illegal suites on a complaint-only basis"; see www.calgary.ca/portal/server.pt/gateway/PTARGS_0_0_780_237_0_43/http;/content.calgary.ca/CCA/City+Hall/Business+Units/Development+and+Building+Approvals+and+Land+Use+Planning+and+Policy/Home+Building+and+Renovations/I+Want+to+Build/Basement+Suite/Secondary+Suites.htm.

[48] See City of Calgary, "Secondary Suites: A Guide to Developing a Secondary Suite" (Calgary: City of Calgary Development and Building Approvals, 2009), available online at www.calgary.ca/DocGallery/BU/dba/brochures/secondary_suites_brochure.pdf; idem, "Secondary Suites: Alberta Building Code Requirements"; and idem, "Secondary Suites 101: Getting Started" (Calgary: City of Calgary Development and Building Approvals, 2009), available online at www.creb.com/public/education-and-careers/registration/information/Secondary-Suites-Grant-Program.pdf.

[49] This is the policy in Maple Ridge, British Columbia; see www.remembernow.com/Vancouver-Hot-Spots/secondarySuites.html.

[50] See Steele, "Capital Gains Rollovers."

[51] Education rates levied on the two property classes are equal, but residential education taxes — in dollar terms — are substantially lower than residential municipal taxes. Toronto does not apply the higher municipal rate to new multi-residential buildings, and plans to reduce the rate premium on existing buildings over the next eight years. After the reduction program ends, however, the rate premium will still be 2.5:1.

An alternative to conversion is to build a new condominium on the site, an option usually requiring demolition of existing rental buildings. Many sites occupied by older rental buildings are in locations that affluent condominium purchasers regard as desirable.

Prior to 2007, Toronto lacked absolute veto power over conversions and demolitions, but it could negotiate with property owners to mitigate their negative effects on tenants. Property owners had at least some motivation to reach a deal with the city, since appeals to the Ontario Municipal Board can be costly, but the board's ultimate authority limited the city's leverage. The passing of the *City of Toronto Act*, however, gave the city significantly increased authority. As the act states, "The City may prohibit and regulate the demolition of residential rental properties and may prohibit and regulate the conversion of residential rental properties to a purpose other than the purpose of a residential rental property." Where demolitions are concerned, Toronto now generally requires that units in a replacement building be available to displaced tenants. These units are to be provided at rent levels "similar" to those paid prior to demolition, with future rent increases controlled by the city for ten years. Accommodation for tenants during construction must also be satisfactory to the city. In the case of condominium conversions, Toronto currently prohibits them except in cases where units in a building rent for more than 1.5 times average rent levels in the city. Such controls appear to have been effective in protecting Toronto's affordable multi-residential stock, the attrition of which has been far less than in Calgary. However, some new investment in Toronto may have been deterred by the controls, and – in some cases – buildings could become rundown.

Implement Inclusionary Zoning

Increasing the stock and affordability of rental housing could also be accomplished by implementing "inclusionary" zoning. Such zoning could be based either on the "mandatory" model, whereby the provision of affordable units is required in *all* residential developments — although perhaps with cash or land contributions as alternatives — or on the "voluntary" model, whereby as-of-right developments are exempt from affordable housing requirements and developers can avoid including affordable units simply by not seeking re-zoning.

THE MANDATORY MODEL OF INCLUSIONARY ZONING

Mandatory inclusionary zoning, rarely used in Canada, is common in the United States. A US urban economics text describes inclusionary zoning in these terms: "Under an inclusionary zoning program, the local government forces local developers to build dwellings for low-income households. The dwellings are typically sold to low-income households for less than the cost of construction."[52] Although the reference here is to affordable housing for ownership tenure, a similar description would apply in the case of rental tenure. The underlying intent of US inclusionary zoning programs is to have developers, rather than property taxpayers, bear the costs of affordable housing development. Indirectly, however, these costs may be shifted to others — for example, to purchasers of market-priced units — in a manner similar to shifts in tax burden.

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[52] Arthur O'Sullivan, *Urban Economics*, 5th ed. (Boston: McGraw-Hill/Irwin, 2003), p. 238.

At least in the case of major Canadian cities, mandatory inclusionary zoning programs have not come to our attention, but at least one smaller city — Langford, British Columbia — has a mandatory program on most of its development land.[53] Only a small part of the land supply available for development is "pre-zoned"; elsewhere, as-of-right housing development is not an option. Since only the pre-zoned land is exempt from inclusionary zoning, virtually any larger subdivision (more than ten units) is covered by it. The Langford requirement, however, benefits owner occupants rather than tenants. Of units in a subdivision, 10% must be priced at or below a city-imposed ceiling (currently about $165,000). The city estimates the average market value of these units to be $360,000, which reflects both a minimum floor area and minimum lot area set by the city. There are restrictions on buyers' income and assets, as well as on the length of time buyers have lived or worked in the city. To prevent windfall gains, the city controls re-sale prices.

THE VOLUNTARY MODEL OF INCLUSIONARY ZONING

An objective underlying the voluntary model of inclusionary zoning is to produce a win-win outcome by giving developers benefits sufficient to outweigh the cost of providing affordable units.[54] In Ontario, for example, the Ontario Planning Act empowers municipalities to exact community benefits in exchange for allowing added height and density via re-zoning. For Toronto, securing affordable housing in exchange for re-zoning is a key priority. In the case of larger sites (more than five hectares), the city's Official Plan requires that 20% of additional units — that is, units added by re-zoning — be "affordable," defined as renting for less than city average levels reported by CMHC. The Official Plan does give a developer an alternative to building the affordable units, but the alternative (conveyance of part of the site to the city for affordable housing development) still results in on-site affordable housing. Off-site land conveyances (preferably nearby), or cash-in-lieu are also cited as possible alternatives, but available only at the city's discretion.

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53 See City of Langford, "Affordable Housing Program — City of Langford" (Langford, BC, February 2008); available online at www.cityoflangford.ca/documents/brochures/AffordableHousing/Affordable%20Housing%20Program%20Case%20Study.pdf. BC legislation, on its face, allows developers to avoid an affordable housing requirement by avoiding re-zoning; however, it also allows municipalities to make re-zoning mandatory, thereby making affordable housing production mandatory.

54 The term "density bonusing" is also used to describe the voluntary model. If the bonusing option is initially attractive enough, it will cause an increase in land values, possibly making the as-of-right option no longer economically viable. Ultimately, sellers of land might be the largest beneficiaries, as developers' profit moves to long-run competitive levels. In effect, the land market could transform a "voluntary" program into a mandatory program.

Toronto's 2009 report on affordable housing indicates the city's intent to expand the use of inclusionary zoning:

> Private sector developers seeking increased density on individual large residential sites of five hectares or more will continue to be expected to incorporate affordable housing as a condition of the City's planning approvals. But most residential development in Toronto is on sites of less than five hectares. Such applications are not required by the Official Plan to include affordable housing when they apply for zoning changes to permit an increase in the new housing to be built.
>
> To further encourage these and other opportunities, the City will work with the Province to advocate for innovative approaches such as tax increment financing and inclusionary zoning policies related to the provision of affordable housing within a broader range of new buildings and new communities….
>
> [It is recommended that] the provincial government provide Toronto with new powers to implement an inclusionary housing program and tax increment financing to increase affordable housing opportunities in new developments.[55]

The report does not expand on how tax increment financing might be used in conjunction with inclusionary zoning, but Ontario legislation permitting the use of such financing could be applied, with provincial government agreement, to the financing of affordable housing, although it has not been used for this purpose to date. Toronto's inclusionary zoning policies have been aimed so far at affordable rental housing, but the city's 2009 report suggests possibly extending them to affordable ownership housing. To limit windfall gains on re-sale, the report recommends that "The Province provide Toronto the option of implementing statutory covenants to secure ongoing affordability where City benefits have been provided."[56] These covenants might be similar to the re-sale restrictions in Langford, BC.

The principle attraction of inclusionary zoning is that it might increase the supply of affordable housing at no cost to taxpayers. This outcome is not certain, however, since some developments might not be viable with affordable units, causing developers to look to other local jurisdictions. The adoption of inclusionary zoning within a municipality's affordable housing policy primarily might reflect the community's wish to have an income mix within neighbourhoods.

[55] City of Toronto, Affordable Housing Committee, "Housing Opportunities Toronto: An Affordable Housing Action Plan 2010-2020" (Toronto, 2009), pp. 29-30; available online at www.toronto.ca/affordablehousing/pdf/hot_actionplan.pdf.

[56] Ibid., p. 38.

Institute Second-generation Rent Control

Another option to increase the affordability of rental accommodation is to institute what has come to be called "second-generation rent control," a mild, liberal version of rent control with only some of the deleterious effects of a simple rent freeze.[57]

There are various versions of second-generation rent control. In Ontario, for example, there have been no controls since 1998 on raising the rent of a unit as one tenant moves out and another moves in (referred to as intertenancy decontrol), but once a new tenant is in place, the maximum allowable rent increase is set by the rate of inflation, with some provision for above-guideline increases justified by cost increases.[58] (Buildings used for rental accommodation only since the early 1990s are not covered by rent control.) Los Angeles has a similar version in place, but with a more generous guideline. Quebec has no formal guidelines, but a sitting tenant may have a rent increase rolled back on appeal, and in some cases a new tenant may be able to get the contract rent reduced.

Economists are almost universally opposed to classic rent control – a simple rent freeze – and are apt to support second-generation rent control only if the politically feasible alternative is more stringent control. Classic rent control is much more inefficient and inequitable than the second-generation variety, the effects of which depend on the details of the regulation. For example, while building deterioration because of a lack of investment in major repairs is an oft-mentioned outcome of classic rent control, the opposite — overinvestment in major renovations and replacements — tends to occur when costs may be passed through generously onto rent increases.

In outlining the pros and cons of second-generation rent control, we assume a rent control regime with maximum rent increases for units with sitting tenants — say, the rate of inflation plus one or two percentage points, with provision for higher increases in the case of exceptional cost increases — but no control over increases when tenants change.[59] Such a regime would not have permitted increases for sitting tenants as large as those that occurred on average in the 2006-2008 period in the Edmonton and Calgary multi-unit stock.

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[57] See, for example, Richard Arnott, "Time for Revisionism on Rent Control?" *Journal of Economic Perspectives* 9 (1, 1995): 99-120.

[58] Prior to 1998, Ontario made no legal distinction between rent increases permitted for incoming tenants and those for tenants in place, but there was evidence that landlords often increased rents between tenants above the legally permitted level.. See Michael Mascall and D.M. Lang, "Report on the Ontario Rental Housing Market," Research Study 22 (Toronto: Ontario Commission of Inquiry into Residential Tenancies, 1985).

[59] An example is the "rent stability guideline" (the rate of inflation plus two percentage points) recommended for a two-year period by the Alberta Affordable Housing Task Force, in *Housing First* (Edmonton: Alberta Municipal Affairs and Housing, 2007). British Columbia has a similar guideline, but not intertenancy decontrol; it also has a market rent escape hatch in that rent increases may be above the rate of inflation plus two percentage points if the rent is significantly lower than comparable units in the same geographic area.

The greatest attraction of second-generation rent control is the protection it offers sitting tenants against a severe deterioration of housing affordability caused by high rent increases — in effect, it prevents economic eviction. It also is apt to reduce the waste caused by periodic excess vacancies — which, like high unemployment, represent excess capacity — by making it less likely that rents in times of economic boom overshoot a sustainable level. Moreover, the fiscal cost to government of second-generation rent control is low and, when all is said and done, rent control tends to find favour with voters, be they renters or homeowners.

The major disadvantage of any kind of rent control is its possibly significant negative effect on investors' willingness to invest in multi-unit rental housing.[60] Control tends to increase the rate of conversion of multi-rental units to condominiums and to divert real estate investment into commercial property. In addition, the introduction of second-generation rent control might prove to be the thin edge of the wedge that encourages poverty activists to wage a campaign for tighter control.

MUNICIPAL FINANCIAL MEASURES

Individual municipalities themselves could undertake a number of financial measures to increase the construction and affordability of multi-unit rental accommodation. The significant advantage of such support is that a municipality can use this tool independently of its provincial government, and so tailor it to the municipality's specific circumstances.

One such measure would be to reduce development charges — one-time levies on new development, both residential and non-residential, to offset the costs of additional necessary public infrastructure and other facilities such as sewage and water treatment, libraries, and fire stations. Development charges vary considerably from one municipality to another — for example, in 2005, charges for a typical single detached house were $25,000 in Surrey, British Columbia, and $27,000 in the Toronto suburb of Vaughan but only $10,000 in Edmonton and in Saskatoon, $9,000 in Calgary, and $5,000 in Winnipeg and Prince George, British Columbia.[61] Furthermore, developers are typically responsible for providing and paying for all on-site infrastructure.

There is continuing debate among economists about who actually bears the costs of development charges (as contrasted with who writes the cheque — usually the developer or builder). Almost all theorists come down on the side of the owners of land — that is, the development charges are effectively paid by the landowners, since developers are not willing to pay as much for land if they also have to pay the charges. Empirical economists, however, almost invariably find that the charges are passed on to purchasers, at least in the short run,[62] which would be consistent with the cost-markup pricing behaviour often found for other goods.

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[60] That factor outweighs, in the view of one of the authors (Tomlinson), any possible favourable effects of any sort of rent control.

[61] Canadian Home Builders' Association, "Focusing on Housing Priorities."

[62] See the discussion in SHS Consulting et al., *Development Cost Charges and the Societal Costs and Benefits of Greenfield and Infill Residential Development* (Ottawa: Canada Mortgage and Housing Corporation, 2008).

In the case of rental housing, the cost of development charges is likely to fall on prospective tenants in the form of higher rents,[63] so that reducing these charges on multi-unit rental projects would help meet affordable housing objectives – although account should be taken of a partially offsetting negative impact where a municipality makes up for the loss of revenue from reduced development charges by a general increase in property tax rates.

In Canada, affordable housing is primarily a provincial responsibility, with funding help from the federal government. Municipalities thus might see themselves as facing a disincentive to spending local taxes on such housing. Indeed, increasing the supply of affordable housing might attract households from other municipalities, limiting the benefit to local residents in need. Notwithstanding this disincentive, many Canadian municipalities, including Calgary and Toronto, do spend local property tax revenue on affordable housing.[64] Both Calgary and Toronto also reduce property taxes on new affordable housing, with Calgary reducing the municipal portion of the tax on eligible properties by 50%. In Ontario, municipalities can confer “municipal capital facility” status on affordable housing projects — potentially on privately developed affordable housing projects as well as on non-profit projects — which exempts them not only from municipal property taxes but also from education property taxes.[65]

Yet another policy tool available to municipalities is to transfer land that is surplus to their requirements to social housing agencies or other affordable housing developers on non-market terms, rather than selling the site to the highest bidder. Since the municipality thereby would incur an opportunity cost — the revenue forgone by not selling to the highest bidder — the attraction of this approach would depend on whether the municipality would benefit more from the development of affordable housing or from the revenues that would be gained by selling to the highest bidder. Both Calgary and Toronto, for example, have land-transfer programs along these lines, and both cities also provide pre-development grants to affordable housing developers.

[63] See Enid Slack, “Alternative Approaches to Taxing Land and Property,” in *Perspectives on Fiscal Federalism*, edited by Richard M. Bird and François Vaillancourt (Washington, DC: World Bank, 2006).

[64] Provincial legislation compels Ontario municipalities to spend local taxes on the legacy social housing stock, the costs of which have been almost entirely downloaded to the municipal level, but there is no requirement to build *additional* social housing.

[65] Education tax exemptions for social housing should be viewed as provincial support, not local, because education property taxes are provincial revenues.

CONCLUDING REMARKS

A number of regulatory and tax measures could be undertaken to reduce rental housing affordability problems. Tax measures all carry with them a cost to taxpayers as a whole: they are tax expenditures. At the same time, currently renters are relatively disadvantaged vis-à-vis the tax system because of the large tax expenditures from which owner-occupiers benefit. While this justifies some new tax expenditures for renters, the key question is, which tax expenditures should be chosen?

On the basis of our assessment of possible changes to the tax regime, we give first priority to a low-income housing tax credit. An important lesson from the US experience with its housing credit is that it is crucial that any such program not be merely a temporary measure: only after the housing credit had been in effect for many years in the US did it become efficient. If a housing credit should prove politically infeasible, we would give top priority to a pair of measures. First, to encourage new investors to supply needed housing: relax the rules for investors in multi-unit rental buildings on the use of the capital cost allowance when there is a rental loss. Second, to provide an incentive to existing owners of multi-unit rental housing: put in place capital gains rollover – that is, postpone the collection of capital gains tax on the sale of a property where the proceeds are used to acquire another one – with restrictions targeting the benefit to affordable housing.

Our assessment of other, primarily regulatory, measures is that controls on demolition and condominium conversions — where they are not already in place — could merit priority status. While these controls might not be sustainable indefinitely, where applied they have been effective in maintaining existing multi-unit residential units.

In an earlier era, centrally directed federal-provincial grant programs for housing run by governments and non-profit organizations were the way to provide affordable housing. Most of our proposals, in contrast, emphasize harnessing the energy and efficiency-promoting competition of the private sector. The focus would be on decentralized decision-making: some measures would depend heavily on individual entrepreneurs and non-profit organizations; others would depend on municipal governments, whose program capacities have grown greatly in recent decades and whose closeness to their constituencies makes them well placed both to develop and to deliver supportive measures.

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