

THE ECONOMICS OF RENTAL HOUSING SUPPLY AND RENT DECONTROL IN ONTARIO

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What is the rationale for residential rent controls?

I was asked this question back in 1983 by the Ontario Commission of Inquiry into Residential Tenancies and I wrote Research Report #6 for the Commission, entitled *Market Imperfections and the Role of Rent Regulations in the Residential Rental Market* (December 1984). The major change I would make to that report is its title. It should refer to 'market failure,' not the economic jargon of 'market imperfections.'

A market fails when supply and demand do not and cannot function normally. We have had market failure in the residential rental market in Ontario for more than two decades. Changing a set of regulations enacted in response to market failure does nothing to address the underlying macroeconomic dynamics causing the problem.

When there is inadequate market demand and thus little new supply in the rental housing sector vacancy rates remain low and tenants require adequate regulations to provide some degree of balance in the landlord/tenant relationship. The normal market dynamics of supply and demand no longer protect tenants from rent gouging or widespread discriminatory behaviour. There are no 'normal' market dynamics. Bill 96 is based on the assumption that there are normal market dynamics waiting to be unleashed once the shackles of inefficient regulation are removed.

Given this failure of the residential rental market in the early 1970s in Ontario's larger metropolitan areas there are four rationales for rent regulations. These are discussed in my 1984 report for the Ontario Commission of Inquiry. They are:

1. Security of tenure (protection from economic evictions);
2. Maintenance of the affordability of the existing rental stock;
3. Prevention of a regressive income redistribution; and
4. Mediation of conflicts relating to rental tenure (including protection from discrimination).

This is essentially what the current landlord/tenant and rental housing stock legislation seeks to do.

There is nothing inherently good nor inherently bad about rent controls. They are a regulation. All aspects of our life are governed by various types of regulations.

Rent regulations are a *response* to market failure. Ending rent controls will have no positive impact on the rental housing *supply* problem – which is the lack of effective market demand. Macroeconomic factors, not a set of regulations, have caused the rental supply problem.

I find it interesting how some people try to rewrite history to suit their own interests. For example, which came first: rental market failure or rent controls?

Ontario's Rent controls were introduced in July 1975. This government's 1996 consultation paper (*Tenant Protection Legislation: New Directions for Discussion*) contains an appendix with some helpful graphs explaining why a Conservative government in 1975 had no choice but to respond with rent regulations.

- Vacancy rates fell dramatically between 1971 and 1974, from about 3.5% to close to 1%.
- Private rental starts fell from a peak of about 40,000 per year in 1972 to a few thousand in 1975.
- Ontario's consumer price index climbed dramatically throughout the 1970s peaking at close to 12% in 1981 with interest rates reaching 21% in August 1981.

These negative trends began for both tenants and investors *before* rent controls.

The early 1970s saw the beginning of 'stagflation.' The old economic rules for rental supply, as for many key sectors of the economy, were rapidly changed. Condominiums were also introduced in the early 1970s for the first time, allowing higher income tenants to own their apartments (thus decreasing market demand for new rental units).

Again I must point out that there is nothing inherently good nor bad about rent regulations. I know of no researchers who support rent controls *in principle*. If conditions in particular rental markets require them, fine. If not, fine. It is an empirical research question. For some, I know, it is a matter of ideology, a set of beliefs, and/or economic self-interest. The evidence about real housing markets and real tenant households does not matter for some. The objective public policy question, however, is whether a *particular* set of circumstances requires a *particular* set of regulations.

The answer is always debatable *until* evidence is brought to bear – *evidence* not ideology or self-interest – and a policy choice is made through a democratic process. No set of regulations can ever be perfect. Any system has its complexities and inefficiencies and the contextual conditions are always changing. Change to Ontario's set of rental regulations must be based on an identification of what is *specifically* wrong and on what *specific* measure will likely address the problem. The government's proposed legislation does neither.

The rental sector problem in Ontario is the near total lack of private sector rental housing construction. Last year 931 private sector rental units were built in Ontario. Ontario has about 1.3 million renter households. The 931 units are just 2% of total housing starts, while renter households comprise about 36% of Ontario's households. Social housing starts were also 2% of total housing starts last year, down from a peak of 28%, a figure which will soon be zero thanks to the termination of social housing construction by this government.

Most private sector rental starts over the recent decade were either investor condo units (which may only temporarily be rental) and 'life leases,' a form of tenure and financing for senior citizens. Rental apartment buildings built in the late 1970s and early 1980s were almost all subsidized by programs such as the Assisted Rental Program (ARP), the Canada Rental Supply Program (CRSP), and the MURB tax incentive.

The problem, once again, is that construction of new private sector rental apartment buildings is not economically viable. This is why last year 96% of Ontario's housing starts were for home owners. Home owners in the province have enough income and wealth to generate market demand for housing; most renters in the province do not have the income to generate market demand in either the rental or ownership sector.

My message today is a very practical and pragmatic one. We must pay attention to the economic realities of *new investment in rental housing* and to the economic realities of what *tenant households are able to pay* for their housing. These two do not match. There is a very big gap between the two and the gap has grown since the early 1970s. The former is too high, the cost of building new rental apartments, and the latter is too low, the household income of many tenants.

It is important to make two distinctions relating to the gap when considering legislation of the type we have before us.

The first distinction is between the *existing* stock of rental housing and the potential for *new supply* of rental housing.

The second distinction is between the *market demand* for rental housing and the social need for rental housing.

These two distinctions need to be considered *before* we throw away a quarter of century's worth of experience with working out a reasonably fair set of regulations given market failure in the rental supply mechanism. This includes all the experience with:

- the evolution of legislation relating to landlord/tenant rights and responsibilities;
- the evolution of rental housing stock protection given the lack of new unsubsidized supply;
- the evolution of regulations on the allowable rent given the low vacancy rates (i.e., the imbalance in the relationship between landlords and renters); and
- the discrimination protections contained in the Ontario Human Rights Code.

We need to build upon this experience not throw it away with a one sided piece of legislation.

The Existing Rental Stock and the Potential for New Supply

There is virtually no relationship between the current owners of the *existing* rental stock and potential new investors in rental housing. The gap between the risks and the profitability of investment in *existing* rental stock and *new* construction of rental housing is huge. They are two different types of investment.

In terms of the existing and now ageing stock of rental apartment buildings the regulations over the past twenty five years have succeeded in maintaining these buildings as an excellent investment for those with the money and inclination to buy and manage rental properties. There is a very strong market for these buildings as medium and long term investments.

A recent report by the firm N. Barry Lyon Consultants Limited (*The Impact of Rent Arrears on the Viability of Residential Landlords' Businesses*, for the Ontario Human Rights Commission, 1995), for example, found that, compared to most investment options, investment in *existing* rental apartment buildings is a relatively favourable one. There is solid demand, a predictable income stream, and compared to other sectors even within the real estate industry, residential rental businesses weathered the recession of the early 1990s relatively well.

A recent study for the Metro Toronto Council's Housing Stakeholders Panel, *Prospects for Rental Housing Production in Metro* (by Greg Lampert, Steve Pomeroy and Helyar and Associates, March 1997), compared the economics of existing and new rental buildings. The study found that returns are substantially higher for existing buildings and, compared to the new rental project, there are fewer risks. For new projects, the risks associated with construction and occupancy "are significant risks which must be reflected in the rates of return required to make new rental investment attractive" (p.13).

The report states very clearly that

- "there appears to be little prospect of new rental housing development"
- "there are concerns that severe shortages could occur – with attendant negative consequences for tenants, particularly those with lower incomes"
- "the potential returns from investment in new private rental properties in Metro are extremely poor" (pp. i-ii)

The main point is that:

- "Without changes which result in higher returns from new rental projects, there will be little new private rental investment in Metro."

What kinds of changes will result in higher returns? The consultants provide a list of necessary actions which include a combination of fairer tax treatment, special treatment in various ways, and direct and indirect subsidies. The list includes:

reduction in property taxes;

- interest-free second mortgages;
- land leases (free land or delayed payment for the land);
- reductions in municipal charges and regulations;
- mortgage guarantees; and
- zoning bonuses.

These are focused on municipal action. There are also provincial and federal measures. Rent regulations are at best a 'psychological' barrier. The economic barriers are primary. If a good return on investment could be made it is highly unlikely that investors will let a 'psychological concern' interfere with the well being of their bank accounts.

In short, there is no private sector rental housing development sector in Ontario today and there will no private sector investors interested in rental housing construction – unless massive subsidies are made available and a variety changes in the treatment of rental housing are made. The problem with rental supply is first and foremost an economic problem. The financing numbers do not work.

The Difference between Market Demand and Social Need

Why do the financial numbers not work?

Markets respond to market demand. Market demand means there are potential customers with enough money in their pockets to encourage some enterprising entrepreneurs to supply what they are demanding. If there is *market demand* then the supply side of that market will function. If there is no market demand, it will not function.

In rental housing markets low vacancy rates are a signal that demand is high and supply is not adequate. Rising rents, increases that far exceed inflation, are a sign that there is inadequate supply. Landlords are able to take advantage of tenants because they have few choices in terms of moving.

Social need, in contrast to market demand, on the other hand, is where people must have something basic in order to survive – food, clothing, shelter – but do not have enough money to generate demand in the market place.

Many tenants, perhaps a vast majority throughout the province, have difficulty paying rent on their existing older, lower rent, apartment units. About one-third of all tenants in Ontario

are receiving social assistance. The median income of tenant households is about half that of owners. Using the Toronto CMA as an example, where about half of all renter households in Ontario live, the real income of tenant households has declined by 8% between 1971 and 1991 while that of owners has increased by 20% (1991 constant dollars). In 1991 tenant households in the Toronto CMA had a median income of \$33,500 while owners had an income of \$64,000 – a gap of \$30,500.

When the negative macroeconomic conditions for rental investment are combined with the growing lack of effective market demand – the very low and falling median income of renter households in the province – market failure is the result. The ‘demand’ for rental housing is not effective market demand. It is social need. There can be and will be no supply response from the private sector under these conditions. The market does not respond to social need.

Discrimination by Landlords

When a market fails in something as essential as housing there are many negative impacts on tenants caught in that market. Unfair increases in rent is one. Discrimination is another.

Ontario’s *Human Rights Code* states that: “Every person has a right to equal treatment with respect to the occupancy of accommodation without discrimination because of race, ancestry, place of origin, colour, ethnic origin, citizenship, creed, sex, sexual orientation, age, marital status, family status, handicap or the receipt of public assistance”

Many of the larger landlords and property management firms in Ontario have been engaging in what is known in the economic literature as statistical discrimination. This is a term used to describe the judgement of individuals based on group averages instead of their own individual characteristics. Some alleged propensity of a group is applied to all members of that group.

The use of minimum income criteria is a very simple, convenient and easy to use excuse for screening out individuals some landlords consider to be from “inferior groups” – on the basis of negative stereotypes and prejudice. When properly used, measures assessing the individual merit of a potential tenant, on the other hand, such as credit checks, rental history and the like, assess the individual, not the group he or she belongs to.

If there was any validity to the simple rent-to-income ratio as a determinant of risk we need to ask why, on a continual basis, for as long as such data has been collected, a substantial number of Canadian renter households have managed to spend a *huge* percentage of their cash incomes on rent and not default on their rent?

The 1991 Canadian census reports that one third of Ontario’s renter households, or 430,000 out of the 1.3 million renter households, paid more than 30% of the household income on rent. Fifteen percent (195,000 renter households) paid more than 50% of their income on rent. How can they manage to do this if the only resource these households had to meet their needs was their cash income? They would either starve or be evicted. If the housing expenditure-to-income rule of thumb, based as it is on 30% or 35% of income, is a valid and

reliable measure of housing affordability and ability to pay rent, why is Ontario not facing a crisis of historic proportions – close to 200,000 households facing eviction for inability to pay rent (i.e., the 195,000 households paying over 50% of their income on housing)? Close to a third of all homeowners with mortgages are paying over 30%, with 10% (115,600) of these households paying over 50%. Why are these 115,000 owners not defaulting on their mortgage? How do they manage to ‘violate’ the ‘rule of thumb’?

The reason for the absence of massive defaults is abundantly known. The rent-to-income ratio is not a valid predictor of risk.

Further, it is important to note that the risk of default is relatively small even though so many current tenants are paying well above 30% of their income on housing. The report by Barry Lyon Consultants that I refer to earlier points out that risk of tenant default was found to be “relatively insignificant as a determinant of the viability of a residential rental business.” Bad debt was found to be less than 1% of gross revenue which is normal for most wholesale and retail businesses. The cost and inconvenience of evicting tenants for arrears is also relatively insignificant. Court fees and eviction service fees represent about 0.1% of gross rental income and arrears in these cases represents about 0.3% of gross rental income. “There is no apparent justification for suggesting any greater exposure to the risk of bad debt” in the apartment renting business, the report concluded, “than in most others” (44-45).

The issue before us in Sections 36 and 200 of Bill 96 is not financial risk but the freedom to discriminate. Some landlords do not like the protections offered to certain groups by the Human Rights Code and the use of income criteria in selecting tenants lets them exclude most individuals from the groups the code protects.

The selection and use of an arbitrary ‘rule of thumb,’ such as 30% of income, applies a statistical measure to all members of a group, in this case people with lower incomes. These people with lower incomes in Ontario just happen to also be from many of the groups the human rights code protects. The use of minimum income criteria constitutes the use of an easy to use measure to discriminate against many of the groups protected by our human rights legislation. It is a convenient loophole that some landlords use and some want to continue using.

The available evidence indicates that it is the larger landlords and property managers who selectively use income criteria. They arbitrarily select a rent-to-income ratio (e.g., 25%, 30%, 35%) and selectively apply it to some households but not to others. Since most groups protected by the Human Rights Code ‘flunk’ the minimum income criteria test, its use allows landlords to discriminate against whomever they want. Smaller landlords, those with just a few units, tend to have no idea what ‘income criteria’ are. My research indicates that it is after the Human Rights Code was amended in the early 1980s prohibiting discrimination against people on social assistance in Ontario that the use of income criteria became an increasingly common practice by the larger owners and managers of rental housing. If its use was good business practice there would be much research demonstrating its validity and it would have been much more commonly used *prior* to the strengthening of the anti-discrimination clauses in the Human Rights Code.

My research on this subject is contained in the following reports and papers:
Discrimination in Ontario's Rental Housing Market: The Role of Income Criteria, a report prepared for the Ontario Human Rights Commission, March 1994.

How Households Obtain their Basic Needs: The Shifting Mix of Cash and Non-Cash Resources, a report prepared for the Ontario Human Rights Commission, March 1994. Co-author: Joseph H. Michalski.

The Use of Percent of Income "Rules of Thumb": Origins, Evolution and Implications, a report prepared for the Ontario Human Rights Commission, March 1994.

"The Concept of Housing Affordability: Six Contemporary Uses of the Housing Expenditure-to-Income Ratio," *Housing Studies*, Vol 10, No 4, October 1995, pp. 471-491.

The inclusion of an amendment to the Human Rights Code in Bill 96 – the two words 'income information' in Sections 36 and 200 – is particularly offensive and those responsible for this and those who support it should be ashamed of themselves.

In Summary: Bill 96 is 'Dehousing' and Discriminatory Legislation

Throughout the 1996 consultation paper that this legislation is based upon there are numerous assertions that certain rules or regulations or legal protections do not work, are harmful, are inefficient, provide barriers, and so forth.

Where is the evidence for any of these assertions?

Where is the analysis that the proposed new regulations will be better than the existing ones?

The assertions are followed by proposals that benefit owners of existing rental stock, mainly the large corporate owners. There is no conceivable way that tenants will be any better off. There will be no significant supply of new rental units because the problem – the lack of effective market demand – is not even recognized. The number of tenants forced out of housing altogether will continue to grow as a result of these proposals.

There is already a process of "dehousing" taking place in Ontario's cities. Growing numbers of individuals and families who cannot afford to pay rent any longer find themselves doubling up with others for a while and/or finding themselves in rooming houses, emergency shelters or on the street. Bill 96 will harm the most vulnerable tenant households in the province. It will result in greater homelessness.

The certain impacts of the government's proposals include:

rent gouging – the transfer of a huge amount of money from tenants to owners with very little if any benefit in exchange.

For example, if only 20% of Ontario's 1.3 million renter households pay an extra \$50 per month as a result of this legislation, a transfer of \$156 million from tenants to landlords will take place. What will tenants receive in exchange for this massive transfer of wealth – this reverse income redistribution?

'dehousing' – the harassment of some tenants by some landlords so as to obtain a vacant rent-decontrolled unit.

discrimination – providing a loophole for those landlords who want to violate the protections offered by the Human Rights Code.

demolition and conversion of rental stock – even tighter vacancy rates will result due to the loss of rental stock once the *Rental Housing Protection Act* is abolished.

glutting the condo market – for a few years at least, there will be construction job losses, a potential decline or stagnation of property values for condo owners, and a potential loss of new municipal tax base as existing rental units are converted to condominiums (i.e., units which can be sold for less than the cost of new construction).

To arrive at these conclusions we need simply to examine the patterns of *rational economic behaviour* which will result under the proposed legislation.

Bill 96 is a one-sided caving in to one special interest group – owners of existing rental buildings. It will mainly harm low income Ontarians. Bill 96 is yet another example of mean spirited treatment by this government of people whose apparent crime is having a low income. This legislation will hurt many young adults, older people, immigrants and refugees, single mothers, people with disabilities, and all people on social assistance. These low income households have no choice but to rent in the private sector. This government is not building more social housing, and as I have pointed out today, this government is not addressing the economic realities of why rental housing construction is not taking place.

In summary, the rent control system and the related tenant and rental stock protections that currently exist are a *response* to the problem of inadequate rental supply, they are not the *cause* of the problem.

This committee should recommend that this legislation be scrapped and that new proposals for rental housing *supply* be brought forward. The system of regulations affecting the existing rental stock does need to be reviewed and amended but such amendments must be based on a careful assessment of contemporary realities.

Table 1

Rental Housing Starts in Ontario, 1988-1996

	Total Housing Starts in Ontario	Private Rental		Assisted Rental		Total Rental		Assisted Rental as a % of Total Rental
		Private Starts	as a % of Total Starts	Assisted Starts	as a % of Total Starts	Starts	as a % of Total Starts	
1987	105,213							
1988	99,924	10,838	11%	5236	5%	16,074	16%	33%
1989	93,337	9,789	10%	4650	5%	14,439	15%	32%
1990	62,649	6,971	11%	6897	11%	13,868	22%	50%
1991	52,794	5,407	10%	12400	23%	17,807	34%	70%
1992	55,772	2,273	4%	15667	28%	17,940	32%	87%
1993	45,140	2,023	4%	7195	16%	9,218	20%	78%
1994	46,645	1,366	3%	3805	8%	5,171	11%	74%
1995	35,818	550	2%	2945	8%	3,495	10%	84%
1996	43,062	931	2%	794	2%	1,725	4%	46%

Source: Canada Mortgage and Housing Corporation, Ontario Region.

Table 2

Percentage of Household Income Spent on Housing

Owners and Renters in Ontario, 1991 Census

1990 Household Income	Owners without mortgages	Owners with mortgages	Renters
Less than 20%	88%	38%	39%
20 - 24.9%	5%	18%	16%
25 - 29.9%	3%	14%	12%
30 - 39.9%	2%	14%	12%
40 - 49.9%	0%	6%	7%
50% and over	2%	10%	15%
	100%	100%	100%
Average Income	\$58,894	\$66,393	\$34,971
Number of Households	1,100,900	1,156,475	1,298,620
Total spending 30% or	5%	30%	33%

Source: Statistics Canada, Housing Costs and Other Characteristics of Canadian Households,