ASSESSMENT REPORT
EVALUATION OF FEDERAL
RENTAL HOUSING PROGRAMS

PROGRAM EVALUATION DIVISION
CANADA MORTGAGE AND HOUSING CORPORATION

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1. INTRODUCTION:

During much of the 1970's, factors such as high and rising inflation and interest rates coupled with the introduction of provincial rent controls, created large gaps between the rents that landlords were able or permitted to charge and the rents that were necessary to make it feasible to invest in rental housing. As a result, periods of excess demand for rental accomodation persisted in many areas across the country, which in turn resulted in increased efforts by the federal government to stimulate the construction of rental housing units. Because the lack of rental construction activity coincided with downturns in economic activity, the MURB tax measure, the Assisted Rental Program (ARP) and the Canada Rental Supply Plan (CRSP) were also intended to increase employment.

Although federal government intervention in the rental housing market expanded steadily during the 1970's, its influence in the rental market began in 1946 with the introduction of the Limited Dividend Program. For approximately three decades the Limited Dividend Program was the instrument that the federal government used in order to stimulate the production of moderately-priced rental accomodation. The philosophy underlying the Limited Dividend Program was that of providing a middle ground between subsidized public housing on the one hand, and fully private unassisted rental housing on the other.

The federal rental programs under examination are now terminated, however their evaluation can provide evidence on the ability of the tax system and direct subsidy programs to stimulate investment in the residential rental sector. This information would be valuable in providing guidance should the government consider the re-introduction of such a program in the future.

The purpose of this Assessment Report is to propose a range of potential strategies for an evaluation study of federal programs used to stimulate the private production of rental housing: Limited Dividend housing; MURB tax measure; the Assisted Rental Program; and the Canada Rental Supply Plan. In so doing, the Assessment Report develops an understanding of how the rental market operates; it reviews relevant literature and evaluation work; it determines the program-specific evaluation issues which could be considered in the evaluation study; and it determines, analyses, costs the evaluation options and recommends an appropriate evaluation approach.

1.1 Reasons for the Evaluation:

There are several reasons for conducting an evaluation of federal rental housing programs at this time:

First, the role that the federal government has played in the rental market has been the subject of some debate in recent years. Most recently, the federal Task Force on Program Review recommended that "ideally, a federal response to the problem of rental housing should deal with the underlying factors rather than attempt to deal with the symptoms...any future measures related to rental housing production should be more stable, less expensive to government and better controlled than previous stimulative initiatives."

Second, the 1987-1991 Strategic Plan, in setting out the Corporation's directions for market housing, indicated that CMHC would "evaluate past initiatives...to determine the most effective means of using housing measures to support economic objectives; and be prepared to advise the government on preferred policy options should it wish to consider housing stimulant measures again in the future." The 1988-1992 Strategic Plan also highlights this direction as a priority.

Third, because the MURB (Multiple Unit Residential Building), ARP (Assisted Rental Program) and CRSP (Canada Rental Supply Plan) were instruments used by the government to stimulate the economy as well as increase the production of rental housing, the ability and effectiveness of rental housing programs in generating employment needs to be examined.

Fourth, concern has been raised by some analysts regarding the extent to which operating agreements under the Limited Dividend Program have been enforced, and whether continued control is required over the administration of the operating agreements in order to achieve the program's objective of providing low-rental housing for moderate-income households.

Fifth, the <u>Report of the Auditor General of Canada</u> (31 March 1986), in a review of housing related tax measures, recommended that "since CMHC has the analytical capability and is set up to administer, monitor and evaluate housing programs, it would appear to be the best agency to deal with the interrelationships among direct and tax programs in this sector".

Finally, the perceived market problem that these programs were designed to alleviate still persists in some areas. For example, in October 1987, the vacancy rates in 9 out of 24 metropolitan areas stood at one percent or less.

The 1988 Evaluation Work Plan includes the evaluation of federal rental programs (for completion in 1989) to be conducted in accordance with the principles established by Treasury Board. The Evaluation Study is expected to commence in August 1988.

1.2 Uses of the Evaluation:

The Limited Dividend Program, MURB tax measure, the Assisted Rental Program, and the Canada Rental Supply Plan have all been discontinued. For this reason, this evaluation will exert little immediate impact upon the Corporation's current operations. However, given historically low vacancy rates in many areas across the country, there exists a variety of potential uses for the evaluation of federal rental housing programs. For example, rental stimulus programs may be needed again in the future and at that time Cabinet will require advice on the appropriateness of the available options. In this respect, the evaluation can be used to:

- o assist in re-assessing the federal role in rental housing markets given current and prospective conditions;
- o provide evidence to CMHC management on the relative cost-effectiveness of varying types of federal rental initiatives;
- o assess the impacts and effects that the programs may have exerted upon the rental housing market; and,
- o identify viable program alternatives and provide a framework to assess them.

1.3 Scope of the Evaluation:

The evaluation of federal rental housing programs will be restricted to those programs which were designed to promote the privately-initiated construction of new rental housing units. These programs were essentially meant to leverage private-sector investment in order to increase the supply of rental housing. This was the basic objective common across all four initiatives, although specific features unique to some of the programs were also designed to achieve social objectives such as the provision of affordable housing.

The major federal rental market programs over the past 30 years have been the Limited Dividend Program, the MURB (Multiple Unit Residential Building) tax measure, the ARP (Assisted Rental Program) and CRSP (Canada Rental Supply Plan).

In the case of ARP and CRSP, subsidies were provided in order to offset the difference between economic rent (the rent necessary to cover costs on new rental properties and still provide a reasonable rate of return on equity) and market rent (the actual rent prevailing in the market) on new rental projects and thereby enhance their economic feasibility. In the case of the MURB tax measure, the depreciation allowance provided equality to the treatment of rental investment vis-a-vis investments in other areas of real estate by allowing investors to apply a depreciation loss against other income. The implicit subsidies available under the Limited Dividend Program were intended to provide rental accommodation to families and individuals with limited means.

As previously mentioned, all four federal rental programs have been discontinued. There is currently no active federal government subsidy program aimed at the stimulation of new private rental construction.

2. BACKGROUND

2.1 Rental Housing Production: The Institutional Setting:

This section of the report will briefly describe the operation of the residential rental sector with a view to identifying the principal participants and their interrelationships in the market.

In general, the return on investment in the residential rental sector must be competitive with the returns on alternative investments, taking into account the risk, liquidity and short/long run nature of the assets being compared. Investors will not put their money into new rental construction unless they anticipate an overall return on their investment which is at least competitive with the return available on alternative investments in terms of anticipated yield (including capital appreciation) and risk for comparable short and long term investments.

While the quantity supplied of rental housing is driven primarily by shifts in demand, it is constrained by various factors such as the yields offered on alternative investments, construction and financing costs, and by the actions of government.

At the municipal level, government intervention usually takes the form of enforcing building codes, zoning requirements and land use controls. For example, delays involved in transforming unserviced land into urban use can often create periods of artificial scarcity of land, increasing its cost to the builder.

At the provincial government level, land banking is a method which has been used to control urban development, stabilize land prices, and to promote a more equitable distribution of profits from land. By withdrawing land from the private market, however, land banking can also have the effect of raising the cost and therefore the price of land. Provincial controls over condominium conversions is another factor which influences rental investor preferences. Rental construction is also influenced by the existence of rent controls in some form or another (currently, only British Columbia, Alberta, New Brunswick and both Territories do not have rent controls).

At the federal level, intervention in the rental market over the past 15 years has been in the form of direct and indirect subsidies as well as taxation programs in order to stimulate rental construction and ease conditions in the rental market (the provinces as well have been involved in loan subsidy programs to developers, but the major thrusts have come from the federal government). Federal government action also affects investment in rental housing indirectly through the use of monetary and fiscal policy, influencing investors' decisions via changes in interest rates and inflationary expectations.

The long-term demand for rental housing is determined principally by demographic factors, and in this sense federal government immigration policy also can also affect the operations of the rental housing market. In addition, differentials in inter-regional economic conditions which influence migration patterns across housing markets can exert a significant effect on rental housing demand.

The rental market operates in a dynamic fashion whereby rents respond to changing supply/demand conditions. The factor which links supply/demand conditions is known as the 'vacancy rate' (the ratio of the vacant rental stock to the total rental stock). As vacancy rates rise (indicating a situation of supply outpacing demand), rent increases tend to moderate and return on investment falls, thereby reducing the incentive to invest in the rental market.

In reality, however, rental rates are not entirely free to move in response to changes in vacancy rates and supply/demand conditions, particularly due to provincial rent controls. Although there still exists an inverse relationship between rents and vacancy rates under controls, the extent to which the relationship can affect rent levels is limited by the rate of rent increase stipulated by the controls scheme. Other imperfections in the market include imperfect information on market conditions (particularly for smaller investors) and the existence of 'staggered contracts' in which rents can often only be adjusted once per year for a given unit or building.

During the 1970's and early 1980's, the viability of investing in new residential rental construction was weakened at least in part due to the the combination of adverse economic conditions and legislative factors (eg. rent controls) which prevented the market adjustment process from working effectively. Particularly due to the inability of supply to respond adequately to shifts in demand, the federal government introduced a series of initiatives to assist in restoring the viability of investment in residential rental accomodation.

Inasmuch as federal government actions in rental housing markets were attempts at correcting market distortions at least partially created by other levels of government, it is important to note that residential rental markets do not operate in a vacuum; rental accommodation represents but one of the many interrelated sub-markets which co-exist in the housing market.

For example, although the federal government concentrated much of its efforts in the 1970's and early 1980's to stimulate the supply of rental housing, simultaneous programs such as AHOP and CHOSP were also introduced to encourage homeownership. These incentives to induce households to switch tenure from rental to homeownership (or condominium) during the 1970's and 1980's may also have had the indirect effect of easing the downward pressure on vacancy rates.

2.2 The Evolution of Federal Involvement in Rental Housing:

This section of the Assessment Report provides an historical summary of the federal government's involvement in rental housing. In particular, the focus of this background material is on supply-side intervention in the rental housing market, including a brief review of the factors which precipitated these actions.

2.2.1 Rental Programs Prior to 1974:

(i) The Limited Dividend Program:

Prior to the introduction of the MURB, ARP and CRSP programs, the instrument that was extensively used to encourage the construction of private rental housing was the Limited Dividend Program offering direct long term high ratio loans to Entrepreneurs at preferential rates of interest. The purpose of the program was to provide low rental housing to families and individuals with low and moderate incomes.

Although Limited Dividend housing existed in legislation as early as 1938, activity under the program did not commence until 1946. This was mainly due to the fact that between 1938 and 1946, government actions in housing, and in the economy in general, were directed primarily towards the War effort. Other factors accounting for the initial inactivity include the difficulty in organizing Municipal Housing Authorities and Limited Dividend Corporations, and the slow response of some of the provinces in passing an essential piece of legislation allowing them to guarantee the principal and interest on all municipal borrowings under the National Housing Act.

Although activity under the program (which commenced in 1946) was initially not very significant (43 loans accounting for 3,784 units from 1946 to 1949), the program was characterized throughout its existence by tremendous volatility in its annual production of rental units -in part because of shifting program policy and in part because entrepreneurs were at different times faced with superior alternative investment opportunities.

Although the program experienced significant take-up, (approximately 100 000 Limited Dividend units were built across the country under all of Section 15) by 1975 total apartment starts fell dramatically to 70 361 -- the lowest level in almost a decade, despite the existence of the Limited Dividend Program.

For many years, the Limited Dividend Program had been exposed to criticisms from various sources concerning faulty program design, the lack of enforcement of the Operating Agreements, the poor maintenance levels in some of the projects, the high default rates experienced under the program arising either from overbuilding in 'soft' markets or inexperienced management of some limited dividend projects. These difficulties, together with shifting priorities of the Corporation from the social aspects of Section 15 (particularly since the introduction of public rental housing) to the stimulation of private moderate rental housing production at slightly below market rates, led in part to the replacement of the Limited Dividend Program with the Assisted Rental Program in 1975.

(ii) Capital Cost Allowance for Residential Construction:

Prior to 1972, all investors were permitted to claim capital cost (depreciation) allowance on buildings to create or increase a rental loss which could be used to reduce taxable income from any other source. This was in addition to allowable deductions of such items as property tax, mortgage interest payments, and repair and maintenance expenses which could also be used for this purpose.

The Capital Cost Allowance system has always required that the excess depreciation which is claimed be 'recaptured' and taxed as income when the property is disposed of (usually when sold or when a 'deemed disposition' occurs such as change in property use). At the time of disposition, the excess CCA shows up as the difference between actual depreciation and that which was claimed for tax purposes. However, before 1972, capital cost allowance provisions also allowed all rental buildings to be 'pooled'. This meant that real estate investors could effectively avoid taxation on recaptured depreciation upon disposition of a property, by investing in another property in the same class. This meant that taxes could be deferred until a much later date-- often indefinitely.

Prior to tax reform in 1972, the acquisition of rental buildings was a popular tax deferral and avoidance technique, particularly by professionals and high-income individuals. At that time, the Income Tax Regulations divided buildings into 2 classes for depreciation purposes. Class 3 (with an allowable depreciation rate of 5%) included concrete and steel reinforced structures, while Class 6 (with an allowable depreciation rate of 10%) contained wood frame, stucco on frame, and brick veneer buildings. In both cases, CCA was claimed on the basis of the diminishing balance.

Beginning in 1972, Canadian tax regulations severely restricted the ability of real estate investors to apply losses for tax purposes from a property investment against non-real estate income. First, investors could use capital cost allowance to create a loss against rental income, but not against income from other sources. The limitation restricting the deductibility of CCA losses did not apply to corporations whose principal business was leasing, rental, development or sale of real property (such corporations could continue to offset rental losses created by capital cost allowances against miscellaneous other income).

Other 1972 tax reforms terminated the 'pooling' of real estate projects. Each rental building with a capital value of $50 000 or more was placed into a separate class for depreciation purposes. Upon sale of the building, any recapture of capital cost allowances arising would be immediately subject to tax, rather than deferred by being credited against the undepreciated capital cost of other buildings by the taxpayer.

The net effect of this package of tax changes on the economics of investment in rental real estate was, of course, negative. Although the restrictions applied generally to all rental real estate, the negative effect was felt primarily in residential rental accommodation (few individuals have ever invested in commercial real estate). The 1972-73 taxation years saw relatively little tax shelter investment activity in the real estate market, attributed by some as being due to the inability to claim depreciation losses.(1)

2.2.2 <u>The Introduction of MURBs</u>:

In response to public pressure and a dramatic reduction in apartment starts between 1971 and 1974 (106,000 to 74,000), the federal budget of November 1974 introduced a new category of real property known as the Multiple Unit Residential Building (MURB). This was a tax measure inducement to entice individuals to invest in rental housing through the relaxation of the capital cost restrictions of the Income Tax Act (thereby allowing CCA to be deducted against any income). Similar to the tax treatment of all real estate prior to 1972, the attractiveness of a MURB investment stemmed from the ability to defer taxes.

Although initially the MURB program was intended to remain in effect only until the end of 1975, subsequent changes to the Income Tax Act extended it on an annual basis until the end of 1979. The program then recommenced in late 1980 with a termination date of December 31, 1981. The federal budget announced in November 1981 indicated that the MURB program would not be continued beyond 1981.

The enactment of the MURB provisions did not exert much of an immediate effect on the market for the construction of new apartments. In 1975, apartment starts dropped to roughly 70 000, and the average national vacancy rate remained at an historically low 1.2 percent. This was at least partially due to the length of time it took investors to become familiar with the changes to the Income Tax Act. But even when the effect was felt by the market, the Canadian economy entered into an inflationary state following the recession of 1974, which resulted in an escalation in building costs across the country to the point where the costs of operating newly constructed apartment units exceeded the revenues that could possibly be expected. While the index of construction costs rose by over 20 percent between 1974 and 1975, the rent component of the CPI lagged severely behind with an increase of less than 6 percent. As a result, many proposed apartment projects had projected negative cash flows, so that cash requirements to keep the project operating exceeded any advantages to be gained from the relaxation of the CCA restrictions. (3)

In January 1978, the CCA on woodframe MURBs was reduced from 10 to 5 percent annually. The reasons for the change were twofold. First, there was concern among housing officials that the two allowable depreciation rates were resulting in a bias in the market, especially in western Canada, toward the construction of wood frame buildings. One reason for this is that building codes in western provinces permit 4-storey wood frame buildings whereas in Ontario, wood frame can be used for one or two storey structures only (4). Secondly, since 1972 the probability of rot, fire, or heaving in a wood frame building was no longer high because of improved building materials. (5)

The rules regarding deductibility of soft costs were changed effective January 1, 1979, so that such costs could only be deducted in the period to which they related. Previously, soft costs could be deducted as paid, regardless of the period to which they related. This change exerted a significant impact upon MURB investors since if the investor did not get into the project at an early enough stage, he/she could miss some of the write-offs which would subsequently have to be added to the capital cost of the project. In addition, the first year write-off amounts would be less to the extent that soft costs would have to be spread across three or four years or longer.

2.2.3 The Introduction of ARP:

For a number of reasons, the profitability of investing in the residential rental sector was hindered during the early-mid 1970's. The widely perceived adverse influences on rental real estate at that time were: the rapid escalation in the price of development land in virtually all areas of Canada, in part due to government action through stricter zoning requirements (6); generally rising interest rates and construction costs associated with inflation; and rent controls were established in all of the provinces by October 1975.

The net effect of the above influences was to make the economics of rental investment relatively less attractive vis-a-vis alternative investments. The normal market response to a decline in relative profitability in the rental construction sector is, of course, a decline in rental construction itself. Such a decline in new supply inevitably leads to 'tight' markets, reflected in lower vacancy rates and higher market rents to the point that investment in the rental market becomes equally attractive and rental construction resumes; hence the dynamic nature of the rental market. The rental market operates in this fashion in theory, but in fact, the market rigidities discussed above prevented the rental markets throughout Canada from working in this way in the 1970's.

Subsequent to the enactment of the MURB tax measure a month earlier, the (original) Assisted Rental Program was introduced in Parliament in December 1974 in order to stimulate the economy and to encourage the construction of modest rental accomodation, by eliminating negative cash flow on new rental projects. The ARP eventually replaced the previous Limited Dividend

Program, thereby eliminating the use of direct government funding in favour of an insured loan supplemented by grants of up to $75 per unit per month provided that owners of new rental projects maintained rents at a reasonable level for a period of up to 15 years.

The 1975 ARP subsidy constituted interim assistance required to maintain the viability of a given rental project until market rents rose to economic levels. The subsidy payments were reduced gradually over a period of up to 10 years as market rental rates increased. In other words, the program was premised on sustained rental inflation over the period of assistance, for if market rents did not increase, federal assistance levels would have to be maintained over longer periods than expected.

While this original version of the Assisted Rental Program produced roughly 358 projects representing approximately 22 000 units in 1975 (accounting largely for the surge in apartment starts from 70 361 to 89 324 between 1975 and 1976), the average vacancy rate by 1976 was still at a low 1.3 percent, indicating that a one-year expedient measure was not sufficient to alleviate the gap between the rents that had to be charged for newly constructed units and the rent levels that could be charged in the rental market.

Changes to the Assisted Rental Program introduced as part of the FHAP package in late 1975 attempted to make it conform to the AHOP regulations (in terms of price per unit) and to reduce the direct subsidy costs to the federal government. The major change consisted of replacing the grant with an interest-free assistance loan to bring economic rents down to market levels.

ARP 1976 represented a significant departure from other rental housing programs in the past. For the first time, financial subsidies were offered for private rental construction with no constraints on the income of the tenants (under ARP 1975, there was an income entry requirement). The efforts of the federal government were reinforced by various provincial government initiatives that also provided financial assistance by way of grants to the owners of newly-constructed apartment units. Under the 1976 program, 98,000 rental units were approved and financed by $2.7 billion in insured lending. This escalation in program activity was in part attributable to the objective of generating employment.

The final version of the program, ARP 78, was introduced in March 1978 (the companion provincial programs terminated in 1977), and featured an interest-bearing second mortage assistance loan similar to the Graduated Payment Mortgage. The Assisted Rental Program terminated in 1978. A total of 2 239 ARP projects representing 122 791 units were constructed under the program -- accounting for approximately 31 percent of all multi-family starts during the 1976-78 period.

With the combination of the MURB tax incentive and the assistance available under the Assisted Rental Program, the level of public assistance was quite high. These incentives coincided with a significant increase in the supply of new privately-initiated rental housing, averaging over 86 000 per annum between 1976 and 1978 -- well above the 70 361 level in 1975. In addition, vacancy rates increased gradually to 3.2% by 1978. However, it was the cost of these incentives and their apparent success which led in part to the termination of ARP in 1978.

2.2.4 The Return of MURBs and the Introduction of CRSP:

The result of the expiry of the ARP subsidy and the changes to the MURB tax measure was a dramatic decline in rental construction from 77 327 apartment starts in 1978 to 48 329 in 1980. During the same period, rental markets tightened considerably as the average vacancy rate fell from 3.2 percent in 1978 to 2.2 percent by 1980. As mortgage rates soared to unprecedented levels in late 1979, the discrepancy between market rents and the rent necessary to cover the costs of construction and financing (and still provide a reasonable rate of return on invested capital to rental investors) became exacerbated.

In response to the reduced levels of unsubsidized new rental construction, the MURB tax measure was reinstated in 1980 because "...the vacancy rate is negligible and, because of a low rate of return on investment, rental construction was inadequate". (7)

By 1981, the economic situation prevailing in the rental market worsened as evidenced by the fall in the average national vacancy rate to 1.2 percent. The situation was particularly acute in the Vancouver, Calgary and Toronto markets where vacancy rates approximated zero.

In the 1981 federal budget (November 12) the MURB provision was terminated, and was replaced by the Canada Rental Supply Plan Plan -- in an effort to boost the supply of rental housing at an affordable cost.

In defending the move of the Minister of Finance not to extend the MURB tax measure in the face of tight rental markets, the Minister responsible for CMHC told reporters: "One reason for ending the MURB program was the birth of the Canada Rental Supply Plan, with a stronger emphasis on the provision of rental housing units. In many cases, the MURB program was used as an investment rather than a housing vehicle." (8) By the time CRSP was terminated in 1983, it had produced 20 670 rental units (an additional 3 452 units in 1984), resulting in a rise in the national vacancy rate to 2.7 percent.

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(5) The Capital Cost Allowance, Ottawa: Program and Market Requirements Division, CMHC, June 1977, mimeo.

(6) Clayton Research Associates, Op. Cit., page 7.

(7) Speech by the Hon. Paul Cosgrove to the Annual Conference of the Housing and Urban Development Association of Canada, Montreal, 2 February 1981.

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3. PROGRAM PROFILE

3.1 Limited Dividend Program

3.1.1 LD Program Objectives

The 1953 CMHC Annual Report described the Limited Dividend Program as a loan scheme for the "construction of moderate rental projects." Although the program had social connotations in-as-much-as rents were controlled and units were restricted to low and moderate income households, the historical objective of the program can be viewed as **increasing the supply of moderately priced private rental housing to lower income people**

Although the program was terminated in 1975, there are many Limited Dividend projects still subject to the terms and conditions of their Operating Agreements. In this context, the CMHC Guidelines and Procedures Manual describes the current objectives associated with the program. They are to ensure:

- compliance with the terms of the Operating Agreement
- that the low rent character of the project is maintained
- that the project is being adequately maintained
- that accommodation is provided to households for which the loan was intended.

3.1.2 LD Program Description

Between 1946 and 1975, the Limited Dividend Program represented the main instrument used by the federal government to stimulate the production of modest-cost private rental housing for moderate and low income households. Under the program, private developers were offered high-ratio mortgage loans (usually between 90 and 95 percent), with an amortization period of up to 50 years. The loans were directly provided by CMHC at a preferred rate of interest, approximately two percent below conventional mortgage interest rates available from private mortgage lenders. This preferred rate of interest was roughly equivalent to the federal government's borrowing rate.

The Limited Dividend Housing Program changed many times after its inception in 1946 and the Operating Agreements were amended from time to time to reflect both policy changes and more efficient administration of the agreements involved. Over the years, Limited Dividend Housing Loans have been made under Sections 9, 16, 16A and 15 under the National Housing Act (due to the re-numbering of the NHA at different times). Under these sections of the Act, a limited dividend company is defined as a company incorporated to construct, hold and manage a low-rental housing project with dividends limited to five percent or less of its paid-up share capital.

In return for the favourable financing conditions offered under the program, private developers were required to adhere to a number of conditions stipulated in an Operating Agreement. The Operating Agreement outlines the conditions under which the borrower must operate the project in order to continue to benefit from the low interest rate and the extended amortization period offered under the terms of the program. The CMHC branch managers were provided with a large degree of discretion and flexibility in enforcing the terms and conditions in the Operating Agreements.

The first condition stipulated in the Operating Agreement was to limit the return on the developer/builder's paid up capital (the annual dividend) to approximately five percent, by charging below market rents approved by CMHC for loans made before 1968. For post-1968 limited dividend loans, borrowers have not been required to show proof of their equity and return on equity became negotiable.

The limited dividend company is required to seek CMHC's approval for any rent adjustment, and is restricted to making one adjustment to rents for every 12 month period except when an increase in rent is necessary to cover an increase in certain operating costs. Where provincial rent control legislation exists, the maximum rent which can be charged is the lower of the provincial rent review guideline or CMHC's authorized increase.

The second condition in the Operating Agreement stipulated the type of tenants that limited dividend rental units were geared towards. Building owners were required to ensure occupancy of units by households with low and moderate incomes. A household could not move into a unit unless its gross annual income was less than four times the annual rent. If a household occupying such a unit experienced an increase in gross annual income to a level exceeding five times the annual rent, it no longer was eligible to live in the unit. If after a reasonable length of time the landlord demonstrated that he/she was unable to find acceptable tenants, then the income limits could be increased. In 1985, outgoing tenant income thresholds were eliminated and the ingoing requirements were modified. The new limits are set annually at the upper bound of the second quintile of family income for each province as determined by Statistics Canada.

Owners of limited dividend projects were originally required to perform income checks annually; however this was later amended to once every three years. Additionally, landlords are required to have annual maintenance inspections performed by CMHC. The rental records of all new tenants from the date of initial occupancy or the date of the last inspection are to be reviewed to determine that the following are in accordance with the Operating Agreement:

o allocation of units;
o income declarations;
o income limits;
o leases; and
o rental rates.

There are two distinct categories of Limited Dividend projects:

o projects approved prior to 1968, where the mortgage did not provide for pre-payment privileges but required a lock-in period of between 40 and 50 years; and

o projects approved after 1968, where the mortgage documentation allowed a pre-payment privilege after 15 years with concurrent cancellation of the Operating Agreement (essentially a "buy-out" clause). Investors who chose this option would in effect be trading off the favourable financing terms available under the program in return for freedom from CMHC control over the rents that could be charged for their units.

In order to streamline administrative procedures and because many Agreements were not being enforced, the Corporation in 1982 permitted owners of pre-1968 projects the privilege of repaying the mortgage loan in full, commencing in January 1983 (since post-1968 projects with a 15 year lock-in would begin to expire on that date). Where the borrower decided not to exercise the repayment privilege, the terms and conditions of the Operating Agreement with CMHC continued to remain in force for the remainder of the term. This provision was subsequently rescinded in 1983 due to the negative public reaction and was replaced in 1985 with the Accelerated Repayment Option and Supplementary Agreement. This option is offered to both pre- and post-1968 projects and allows rents to rise to market levels subject to the condition that they not rise above 25 percent of a tenant's income.

Prior to the approval of the loan, the limited dividend company had to agree to furnish efficient management at all times; to keep the project in a satisfactory state of repair throughout the term of the loan; and to maintain books, records and accounts in a form satisfactory to CMHC. The physical condition of the project and the limited dividend company's financial records are expected to be open to inspection at all times. These inspections are required to ensure that there is no impairment to CMHC's mortgage security, that is, that the project is well-maintained, especially in view of the unusually long-term nature of the mortgage loan. The examination of financial accounts is to ensure that the bookkeeping is adequate for the accumulation of operating data and that the project is being operated in accordance with the terms of the Operating Agreement. To this end, the borrower is also required to submit two copies of its annual financial statements.

In addition to the requirements outlined above, the borrowing company had to pledge itself to maintain the low-rental character of the project throughout the entire term of the loan; had to agree not to sell (or otherwise dispose of) or make any additions or alterations to the project during the term of the loan except with the consent and under the conditions stipulated by CMHC; and had to agree in advance on how much surplus earnings would be set aside for reserve, maintenance, repairs, possible decline in rentals and other contingencies.

There are several ways a borrower may be considered in breach of the Operating Agreement. To the extent that the Agreements have been monitored, the following are the most common breaches:

- o further encumbering the project without CMHC approval;
- o failure to rent the units in accordance with the terms of the Operating Agreement;
- o failure to repay the mortgage account on the agreed terms;
- o failure to submit financial statements;
- o paying a dividend in excess of the amount allowed;
- o introduction of a rental increase without CMHC approval; and
- o failure to maintain and manage the project efficiently.

Because of the different wording used in the different forms of Operating Agreements, some actions on the part of borrowers may or may not constitute breach. Whenever such a situation is discovered in a project, its Operating Agreement is to be reviewed to determine whether the borrower's action constitutes a breach.

If the above circumstances are deemed to constitute a breach then the Corporation has the right to take legal action to enforce the terms of the Agreement or to declare the outstanding part of the loan due.

Finally, the members of the limited dividend company were required to present specific evidence that conditions of shortage, overcrowding or substandard housing existed in the district before the company would be accorded a loan under the LD section of the Act. With respect to the location of the project, it was necessary that planning and zoning requirements be adequate to ensure the suitability of the area through the term of the loan. The Corporation also required evidence that municipal services such as roads, sidewalks, street lighting, sewer and water lines be supplied immediately to the project. Additionally, in keeping with the economical character of the proposed project, the applicant's plans had to provide a sufficient number of family housing units to assure reasonable economies in construction and operation.

Although the return on profits under Limited Dividend housing was restricted by the operating agreement, the program was particularly attractive to entrepreneurs for three reasons.

First, during periods of 'tight' money when interest rates rose, builders consequently found it unprofitable to build new rental housing units. For instance, in periods when building firms expanded their size and assumed a larger staff, higher overhead costs would likely be incurred. In most cases, the builder would then continue to build in order to write-off those overhead costs against individual projects. This would likely create increased pressures to find additional funds in times of tight money, and the funds which were made available for limited dividend housing projects frequently assisted builders in maintaining construction levels.

Second, until 1972, owners of depreciable rental properties (such as limited dividend housing) could deduct their Capital Cost Allowance from other non-rental sources of income. After tax profits in excess of the stipulated limit could be achieved by reducing taxes on the entrepreneur's earnings from other sources.

Third, in the calculation of lending value of a post-1968 limited dividend project, CMHC used the lower of two appraisals (one submitted by the builder, and one by CMHC). As CMHC based its appraisal on average cost figures, a developer with access to building materials for less than their average market price could overestimate his actual costs in his submission to CMHC. Hence, the entrepreneur could theoretically be left with zero equity -- a riskless investment.

3.1.3 LD Program Delivery

To become eligible for a loan under the Limited Dividend Program, the proponent was required to:

- o assemble evidence of project need, particularly with respect to intended tenants;
- o submit a drafted instrument of incorporation for CMHC review;
- o submit a description of the proposed site, including drawings;
- o submit a preliminary cost estimate;
- o prepare a statement of available funds, other than NHA; and
- o submit the formal Application for Limited Dividend Loan with the application fee.

Applications were reviewed at the Branch Office, although National Office retained authority to approve projects.

The limited dividend corporation was also required to satisfy CMHC that its organization and management would be sufficiently competent at planning, constructing and administering the project throughout the term of the loan. The applicant was also required to prove that it possessed the equity, when added to the loan, to cover the entire cost of construction

The first loan advance from CMHC became available when the proponent had sunk all equity into the project. Additional advances would then be forthcoming throughout the course of construction. Proof of construction costs was required before the final loan advance was payed. CMHC periodically inspected the construction site to verify that approved plans were being conformed to, and to check the progress of construction for the purpose of making loan advances.

3.2. Assisted Rental Program

3.2.1 ARP Program Objectives

According to the CMHC 1985-86 Operational Plan, the objectives of the Assisted Rental Program have been:

> "to provide assistance directly to entrepreneurs to promote the construction of new, moderately priced rental housing...and to encourage Approved Lenders to make available funds to finance reasonably priced rental projects."

Another objective of the ARP program as contained in a Submission to Cabinet by CMHC was to increase the level of employment in Canada. In fact, job creation was a major objective of the 1975 Federal Housing Assistance Plan of which ARP was a component.

Although ARP underwent a number of design changes in the form of the incentives it offered, the common thread throughout the program was to stimulate the construction of moderately-priced rental housing.

3.2.2 ARP Program Description

The Assisted Rental Program was enacted in April 1975 under the legislative authority of the National Housing Act, Section 14 Part 1. The legislation was introduced in combination with the extension of tax sheltering for MURBs as part of an overall housing package to stimulate the production of rental housing. Under NHA Section 14(1), CMHC is authorized to provide assistance directly to entrepreneurs to promote the construction of new, moderately priced rental housing.

Three separate versions of the Assisted Rental Program were introduced by the federal government between 1975 and 1978, each of which provided a different form of assistance (1975, 1976 and 1978). Although each rental scheme differed in terms of design and levels of assistance, in order to receive assistance under each program, the landlord was required to enter into an Operating Agreement with CMHC. The agreement required the recipient to:

- o Provide annual audited financial statements;
- o Limit the return on equity to an amount stipulated in the Operating Agreement; and
- o Limit rents and rental increases to an amount stipulated in the Operating Agreement.

ARP 1975:

ARP 1975 was designed to encourage the production of moderately-priced rental accommodation by providing federal non-taxable grants of up to $75 per unit per month. The purpose of these grants was to supplement rental income to the extent necessary to generate a stated return on investment. The non-repayable subsidy constituted interim assistance required to maintain the viability of the project until market rents rose to economic levels.

In return for the subsidy, the owner entered into an Operating Agreement with CMHC which established the base-year market rents and operating expenses. Increases in rents were not permitted to exceed the sum of the annual reductions in the subsidy contribution plus the increase in operating expenses over the base year. The maximum ingoing tenant income at the time of occupancy was five times the annual rent. In this sense, ARP 1975 was similar to the previous Limited Dividend Program in providing modest-rental accomodation to low-income households. The financing of ARP 1975 was facilitated through the use of private (approved lender) sources.

The level of subsidy was reduced by equal amounts over a period of normally 10 years (a minimum of 5 years and under exceptional circumstances, up to 15 years), on the premise that offsetting increases in rent levels could be achieved, so as to eliminate the subsidy by the end of the term. The basic philosophy underlying this scheme was that inflation in net rental income would offset the annual decrease in the monthly contribution and eventually the project would stand on its own without financial assistance.

Only approved lender loans, insured either privately or under Part 1, NHA, were eligible for 1975 ARP assistance. The required range in the term of the first mortgage loan was between 5 and 15 years, while the loan amortization period had to fall between 35 and 40 years.

ARP 1976:

The introduction of ARP 76 as part of the Federal Housing Action Program replaced the $75 per month non-recoverable grant with a repayable assistance loan. The 'modified' program was aimed at encouraging the construction of rental accomodation financed through private investment by providing interest-free loans which would bridge the gap between economic and market rents.

The basic features of the new Assisted Rental Program were:

- An assistance loan of up to $100 per unit per month ($1200 annually) in the first year was given to the entrepreneur of new rental accomodation to bring rents down to market levels. A policy amendment was introduced in 1977 which established a working limit of $75 per unit per month in all areas except the high-cost markets of Toronto and Vancouver. During the period of high interest rates (1980 to 1982), the maximum assistance was increased to $180 per unit per month. The actual assistance loan was determined by the size of the project, the cost of construction, the mortgage rate of interest, operating costs, and the average cost for similar accomodation in the area in which the builder proposed to construct the new units.

- Assistance was paid directly to the entrepreneur and secured by a second mortgage. These loans were normally free of interest for ten years, and were reduced by 10 percent each year. The ARP 76 program was therefore founded on the premise that rents would roughly increase at the same rate as the rental assistance diminished. The loan became repayable after 10 years at which time it attracted interest and was then amortized at the prevailing NHA rate.

- If market rents increased at a faster rate than originally anticipated, the assistance reduction process was accelerated. The ARP 76 operating agreement set a dollar amount which was to represent the borrower's guaranteed return on equity (which was allowed to vary between 5 and 10 percent, depending on local market conditions). If rents increased without an increase in cash outflow, the level of assistance would fall accordingly.

- Units were required to be 'modest' in size and had to be priced at or below the AHOP maximum price limit for that market area.

- To qualify, a new rental project would have to contain normally a minimum of 8 units and have an insured mortgage for up to 90 per cent of the value of the project (while privately insured mortgages could qualify, the project was required to meet NHA standards of appraisal, construction and inspection).

- There were no restrictions on who could rent units built under the program.

- The entrepreneur was required to submit an annual audited financial statement along guidelines established in the operating agreement with CMHC. If the entrepreneur did not earn a fair return on equity (5 to 10 percent per year depending on the individual agreement), assistance could be continued at the same level as before. If the yield was above this stipulated fair rate of return, assistance could decline more rapidly than one-tenth, although the interest-free period would remain ten years.

- Rents were established in the first year by agreement between CMHC and the entrepreneur. Thereafter, rent levels were set by market conditions, although assistance remained tied to return on equity.

ARP 1978:

The final version of the program, ARP 1978, was introduced in March 1978. ARP 1978 offered a payment reduction loan, designed to encourage the production of new moderately priced rental housing in appropriate markets (i.e. locations where a reasonable level of demand for rental housing exists) . The program was implemented largely to facilitate the transition to Graduated Payment Mortgages (GPM), thereby allowing the industry to understand and adopt the new GPM concept without creating interruptions in production, while phasing out direct public subsidies.

The payment reduction loan (advanced monthly) constituted an interest-bearing-second-mortgage-assistance-loan with a level of assistance and a phase-out arrangement. Assistance to the landlord in the first year was the lesser of:

(a) the actual amount needed to make market rent equate with economic rent (ie. to provide a 5 percent return on equity);

or

(b) $2.25 per month for every $1000 of the first mortgage amount.

Assistance in the second and subsequent years was reduced by five percent of the previous year's payment for principal and interest on the first mortgage debt minus the previous year's PRL (Payment Reduction Loan) assistance.

The term of the PRL mortgage was either 10 years or equal to the term of the first mortgage, whichever was lower. At the end of this maximum 10 year period the PRL becomes due and payable. The rate of interest on the Payment Reduction Loan was the same as on the first mortgage. The first mortgage had to be insured under the NHA, represent a maximum 90% of project cost, have a term of at least 5 years and have an amortization period of between 25 and 35 years.

As with ARP 1976, initial rents were established under agreement with CMHC. Thereafter, rent levels were allowed to be set by market conditions with the requirement that higher net revenues would go towards reducing the amount of assistance in subsequent years.

SUMMARY CHART OF ASSISTED RENTAL PROGRAM

	ARP 1975	ARP 1976	ARP 1978
FIRST MORTGAGE LOAN	Approved lender; insured	Approved lender or CMHC direct; insured	NHA insured
TERM OF AGREEMENT	5 to 15 years	10 years	Lesser of 10 yrs or first mtg term
TENANT INCOME	max 5 times rent	N/A	N/A
RENTS	Rents controlled for life of Agreement	Rents controlled in first year only	Rents controlled in first year only
RETURN ON EQUITY (ROE)	ROE limited to dollar amount originally agreed to and shortfalls cannot be recaptured in future	ROE limited to dollar amount originally agreed to and shortfalls can be recaptured in next year	Maximum 5 percent ROE each year
ASSISTANCE	Maximum $75 per unit per month non-repayable subsidy; declines by 10% per year	Repayable loan up to $100 per unit per month (later $75); interest free for 10 years; declines by 10% per year	Repayable Payment Reduction Loan with interest; max. $2.25 per month per $1000 of first mrtg; reduced by 5% P&I annually
SECURITY	N/A	Loan secured by second mortgage at 5.5 times first yr assistance	Loan secured by second mortgage at 50 times first month assistance
INTEREST RATE	N/A	Interest-free until assistance ends then Section 58 rate	First mortgage interest rate
LOAN REPAYMENT	N/A	Repayment starts 13 months after assistance ends	Repayment starts one month after assistance ends

3.2.3 ARP Program Delivery

The delivery process under ARP began with an application by the builder for an NHA rental loan to the local CMHC branch office. CMHC would then perform an appraisal of the rental project, and would approve only those applications that could produce modest rental accommodation by local market standards.

Once an application was approved, an Operating Agreement was signed between the entrepreneur and CMHC, stipulating the rents and operating expenses for the first year, the terms of the assistance and the Return on Equity allowed. The mortgage was then signed between the builder and the lender; data pertaining to the assistance was recorded on CMHC's files; and a copy of the Operating Agreement was sent to Mortgage Administration. A MURB certificate was usually issued once the footings were in place. Once the project had been completed and had achieved 80 percent occupancy, CMHC released assistance funds.

CMHC had complete discretion in disbursing the assistance. A builder did not have a statutory right to ARP funding. For example, if market saturation was identified in a certain area, assistance may not have been made available to a particular applicant.

3.3 MURB Tax Measure

3.3.1 MURB Program Objectives

Since the authority for the MURB program rested with the Department of Finance, the primary source used to determine the program's objectives consists of statements made by the Ministers of Finance while the program was in operation:

> "I am particularly anxious to provide a quick and strong incentive to the construction of new rental housing units... I am quite confident that this measure will attract a significant amount of private equity capital into the construction of new housing". (John Turner, Minister of Finance, Budget Speech, 18 November 1974, p. 19)

> "...to help reduce shortages of rental accommodation and provide a needed stimulus to the construction industry". (Department of Finance, Budget Papers, 28 October 1980)

Unlike the other rental programs, the MURB program was a measure implemented solely to encourage investment in rental housing construction. Given its design, it is evident that MURB's could not be targetted to tight rental markets, to the creation of moderately priced units or toward low-income households. But because the program was explicitly designed to stimulate the construction industry, a related objective of the MURB program was to increase employment in the residential construction sector.

3.3.2 MURB Program Description

The Multiple Unit Residential Building (MURB) tax measure program was first introduced in the November 1974 federal Budget as a measure to stimulate the construction of rental housing by offering favourable tax advantages to such an investment. The MURB provision of the Income Tax Act created two new classes of properties for income tax purposes: Classes 31 and 32. Investors in residential rental properties which were conferred with MURB status were then allowed to use the Capital Cost Allowance associated with these classes of property to create or increase rental losses which could be used to 'shelter' income from any other source. It was this tax benefit which represented the essential attractiveness of MURB's to investors and, it was hoped, would create a sufficient incentive to stimulate the construction of residential rental housing.

The two new classes of depreciable property which were created for the purpose of designating the applicable rate of depreciation (Capital Cost Allowance) paralleled existing property classes. The new MURB classes of property were given the same CCA as that enjoyed by non-MURB's. Class 31 MURB properties were equivalent to a Class 3 property (concrete/steel reinforced) with the same 5 percent annual declining balance CCA depreciation rate. Similarly, Class 32 MURB's were equivalent to a conventional Class 6 property (woodframe or brick veneer) with the same 10 percent CCA. The more favorable 10 percent CCA was terminated in 1978 and so all MURB's where construction commenced in 1978 or later were automatically designated as Class 31 properties.

A building qualified as a MURB if all of the following eligibility criteria were met:

o it contained at least two residential dwelling units;

o construction commenced during the time periods November 18, 1974 to December 31, 1978 or October 28, 1980 to December 31, 1981 (construction had commenced if the footings were installed);

- o at least 80 percent of floor space was used for residential purposes;
- o the developer was in possession of a CMHC certificate certifying the above conditions were met.

The MURB provision also entailed much wider use of what can arguably be called other tax expenditures. First, the Capital Cost Allowance itself represents an accelerated rate of depreciation which exceeds the true rate of actual economic depreciation. When this CCA is applied as an expense, an operating loss can result for tax purposes even though a real loss may not exist.

The second type of tax deduction whose use was further encouraged by the MURB provision was the immediate deductibility of developers' soft costs. These are the expenses incurred by the developers of new rental property which are not directly related to the actual acquisition of this property. Examples of soft costs include mortgage insurance and legal fees, landscaping, and interest charges and property taxes incurred during construction. The deductibility of these soft costs in the year they were incurred rather than forcing them to be capitalized into the value of the project and thus subject to gradual write-down via the CCA represented a distinct tax advantage for three reasons:

- o the present value of earlier write-off exceeds the present value of later write-off because of the discount factor;
- o if capitalized, the full cost will rarely be completely written-off since only a small fraction can represent the annual write-off;
- o excess CCA is subject to recapture at disposition (a concept explained below);

This benefit was frequently passed on to individual MURB investors by developers by signing up the investors before construction had started.

The introduction of the MURB tax measure partially restored the pre-1972 tax rules where the Capital Cost Allowance could be used to induce a rental loss thus offsetting other taxable income. The implementation of Tax Reform in 1972 rescinded a number of tax advantages afforded to rental housing investors including:

- Measures to reduce opportunities for deferring the taxable 'recapture' of CCA were promulgated. The recapture of CCA occurs when the building or a respective interest in the building is disposed of in some way (usually by selling it). When the disposition occurs, the excess depreciation claimed in previous years is realized as the difference between the claimed depreciation and the actual depreciation revealed by the disposition. This excess depreciation becomes taxable as income at the time of recapture. The 1972 Tax Reform Package significantly reduced opportunities for avoiding or deferring this recapture.

- The ability to apply an operating loss induced by CCA to other non-rental income was terminated for everyone except land development corporations. It was this provision of the 1972 tax law which was 'temporarily' suspended in 1974 and constituted the MURB tax measure.

Much of the attractiveness of MURB's from the investor's perspective derived from the ability to leverage the investment where a substantial proportion of the project cost was financed by borrowed funds. Since the investor could claim the entire CCA and/or soft costs associated with the project, the magnitude of the deductible loss relative to the size of the initial investment could be large.

There were virtually no restrictions on who could qualify as MURB investors, as long as they were Canadian citizens. In general, there were three types of MURB ownership available to investors:

1. **Undivided ownership** -- an investor could purchase a share of an association or partnership which held a MURB as an asset.

2. **Divided interest** -- an investor could purchase an eligible unit and hold the title to the unit itself.

3. **Limited partnership** -- an investor could become a limited partner in the ownership of a MURB with a general partner who would operate the property.

3.3.3 MURB Program Delivery

Given the nature of the MURB program as a tax measure, it was primarily delivered by Revenue Canada(Taxation) within the existing structure of the federal income tax system. However, for a rental project to be eligible for MURB status, a certificate had to be obtained from CMHC verifying that the necessary requirements had been met.

Copies of these certificates were sent to Revenue Canada, where they were filed for future reference in case of a tax audit. Copies of these certificates were also retained by CMHC to recover administrative expenses from Revenue Canada.

3.4 Canada Rental Supply Plan

3.4.1 CRSP Program Objectives

The justification used to introduce the Canada Rental Supply Plan (CRSP) to replace the MURB tax measure was "to encourage the construction of rental housing" (Hon. Allan J. MacEachen, Minister of Finance, Budget Speech, 12 November 1981).

The government of the day was concerned "about the effects of current high mortgage interest rates on the availability of rental units. New rental housing investment is uneconomic... this threatens to lead to serious shortfalls in the availability of rental units, particularly in certain markets" (Department of Finance, The Budget in More Detail, 12 November 1981).

The objective of CRSP was also described by a CMHC General Memorandum: "To prevent further deterioration of vacancy levels in tight market areas by assisting in the construction of as many as 30 000 additional units of rental accomodation" (GM B-1738, 23 December 1982).

There was also an employment objective attached to CRSP: "...the rental supply plan and the social housing programs have a dual purpose...to create new jobs which are so sorely needed at this time" (Speech given by the Hon. Paul Cosgrove, Minister Responsible for CMHC to the Metropolitan Hamilton Real Estate Board, 13 September 1982).

3.4.2 CRSP Program Description

The Canada Rental Supply Plan represented a special initiative to assist in the production of rental housing. It was introduced in the Federal Budget of November 1981 and extended in the Budget of June 1982. Under this program, interest-free second mortgage loans were made available to builders to help bridge the gap between the first mortgage loan and the equity the builder was willing to put into the project.

The program was originally intended to generate up to 15,000 rental housing starts when it was announced in the Budget on November 12, 1981. The allocation was later increased on March 23, 1982 to generate 30,000 rental housing units in targetted market areas where the vacancy rate indicated tight rental market conditions.

Assistance under the CRSP program took the form of an interest-free loan calculated as the difference between:

- o 75 percent of project cost and GPM first mortgage financing (Graduated Payment Mortgage); or
- o 80 percent of project cost and EPM first mortgage financing (Equal Payment Mortgage).

The maximum loan amount was set by Order-in Council at $7500 per unit, although in "exceptional circumstances" CMHC was authorized to consider CRSP loans in excess of this prescribed limit.

The loans were in the form of second mortgages with a 15 year term, during which time no principal was payable and no interest was attracted. After 15 years, the owner could opt to either repay the original loan as a lump sum or amortize the repayment with interest (at the prevailing Section 58 interest rate). Full repayment of the CRSP loan was required before the end of the 15 year term if:

- o project was being used not as residential rental;
- o default under the first or second mortgage;
- o selling or transferring the title or beneficial interest without CMHC approval;
- o fragmenting or demanding the fragmentation of the first or second mortgage;
- o failing to complete construction of the project.

CMHC advanced one-half of the loan when the work in place represented at least 15 percent of the total project construction cost. The balance was disbursed at the interest adjustment date (the date on which the first mortgage term begins).

Eligibility Criteria:

- o Only new rental construction was eligible for the CRSP loan. The construction start date for the project had to be on or after 1 June 1982.
- o The proponent had to offer 33 percent of the units to the Provinces for rent supplement tenants.
- o Projects had to be private rentals. A project did not qualify for CRSP assistance if:
  -it received Section 56.1 assistance;

-it possessed a MURB certificate;
-construction had progressed past the footings;
-it received similar provincial assistance.

- Access for the disabled had to be provided and a minimum 5 percent of the units had to be designed for the disabled unless it could be demonstrated that the market could not support this number.

- Financing had to be by way of an insured mortgage. If the first mortgage was insured privately, the rental project still had to comply with the technical requirements for obtaining NHA mortgage insurance.

- The first mortgage loan plus the CRSP loan could not exceed 85 percent of project cost.

- The proponent had to demonstrate financial capability and technical expertise to successfully complete and manage the project.

- There were no restrictions on the size or type of units built nor were any ceilings placed on rents.

3.4.3 CRSP Program Delivery

When CRSP was introduced in the November 1981 Federal Budget, CMHC requested that interested proponents submit proposals for rental housing projects to be constructed in tight market areas characterized by low vacancy rates. The selection criteria were based on the following factors:

- amount of loan required;

- types of units proposed;

- location of units;

- construction, financial and management capabilities of the proponent;

- speed in which the project could be completed;

- overall quality of the project;

Upon approval of a project for the CRSP loan, successful applicants were issued a Letter of Intent indicating that CMHC would also be conditionally prepared to insure the first mortgage under the NHA. A CRSP loan commitment was made on acceptable projects subject to CMHC's receipt within 60 days of final working drawings, and a lender's commitment letter with certification of mortgage insurance. Construction had to commence within 120 days of the loan commitment date.

3.5 Program Activity:

The table on the following page of this Assessment Report presents preliminary estimates of the total number of units assisted under each of the four federal rental housing programs from 1969 to 1986. Also indicated are the total number of apartment construction starts each year. Although the precise incidence is not currently known, it is generally accepted that virtually all buildings whose construction was supported under the ARP program also received a MURB certificate.

3.6 Program Logic:

The logic charts shown in Figures 1 to 4 link program activities to outputs and also identify direct and indirect impacts for each of the four rental programs.

Activities describe the activities taken by the Corporation in delivering each program. In the case of the Limited Dividend and Assisted Rental Programs, this involved the formulation of the operating agreement with the entrepreneur and processing the application for the assistance; for capital cost allowance write-offs, this involved the issuance of the MURB certificate; and CRSP activities included the designation of target market areas experiencing low vacancy rates by CMHC, and the processing of approved applications.

Outputs indicate the actual products of the program. With respect to the Limited Dividend Program, the major output was the provision of loans at a preferred (below market) rate to aid in the construction of low-rental housing projects. Other outputs involved the restriction on rent increases by explicitly limiting the rate of return on invested capital, and the targeting of units to low-moderate income households. For ARP, outputs consisted of the various forms of assistance provided by the different programs (ARP 1975, ARP 1976 and ARP 1978), controlling the rent and rate of return via the operating agreement and in the case of ARP 1975, the provision of moderate income rental housing. AHOP maximum price limits and maximum floor areas were outputs directed towards the construction of 'modest' rental units. In the case of the MURB tax measure, the major output was the deductibility of capital cost allowance from non-rental income. For CRSP, outputs consist of assistance in the form of interest-free second mortgage loans and housing for disabled and Rent Supplement households.

Federal Rental Program Activity

	DWELLING UNITS				
Year	Apartment Starts(1)	LD	ARP(2)	MURB(3)	CRSP
1969	110 917	7 364	-	-	-
1970	91 898	19 609	-	-	-
1971	106 187	11 507	-	-	-
1972	103 715	8 797	-	-	-
1973	106 451	4 526	-	-	-
1974	74 025	2 544	-	-	-
1975	70 361	10 895	22 351	8 517	-
1976	89 324	-	25 151	35 219	-
1977	92 327	-	57 053	82 265	-
1978	77 327	-	18 198	80 089	-
1979	58 387	-	-	76 550	-
1980	48 329	-	-	-	-
1981	61 607	-	-	61 500	-
1982	53 162	-	-	-	10 405
1983	44 124	-	-	-	10 265
1984	37 342	-	-	-	3 452
1985	51 576	-	-	-	-
1986	61 020	-	-	-	-

Notes: (1) Apartment starts do not distinguish intended markets (ownership versus rental) and exclude row and semi-detached, but such units were eligible to receive a MURB certificate.
(2) Virtually all ARP units also possessed a MURB certificate but precise extent of stacking is currently unknown.
(3) CMHC's MURB figures represent issued certificates and are currently incomplete.

Direct Impacts consist of those outcomes which can be specifically and directly attributed to the program outputs described earlier. The main direct impact of the Limited Dividend Program was to increase the production of moderately-priced rental accommodation subject to borrower compliance with the terms of the Operating Agreement (that the low rental character of the project is maintained; that the project is being adequately maintained; and that accommodation is provided to those households for which the loan was intended). The Assisted Rental Program's main direct impact was to promote the construction of new, moderately-priced rental units by bridging the gap between market and economic rents, while moderating rent increases and stimulating employment. The MURB tax measures' direct impact was the stimulation of the residential rental construction sector, both in terms of new rental production and the employment of labour. Finally, the primary direct impact of the Canada Rental Supply Plan was to encourage rental housing construction in areas with low vacancy rates and simultaneously increase the level of employment.

Indirect Impacts are those outcomes which are not directly linked to the program outputs, but are secondary in nature. They are specific outcomes which are a result of the direct impacts. Impacts upon rents and affordability, the quality of rental housing construction, the impact upon building materials costs, and the indirect costs incurred by the government are indirect impacts common to all four rental programs. Additional indirect impacts under the federal rental housing programs potentially include a reduction in the need for public housing, the impacts the programs may have exerted on cyclical instability in rental construction, the potential for units constructed under the programs to outpace the demand for such units, and the subsequent potential impact upon default rates and hence the Mortgage Insurance Fund.

Figure 1: Limited Dividend Program Logic Chart

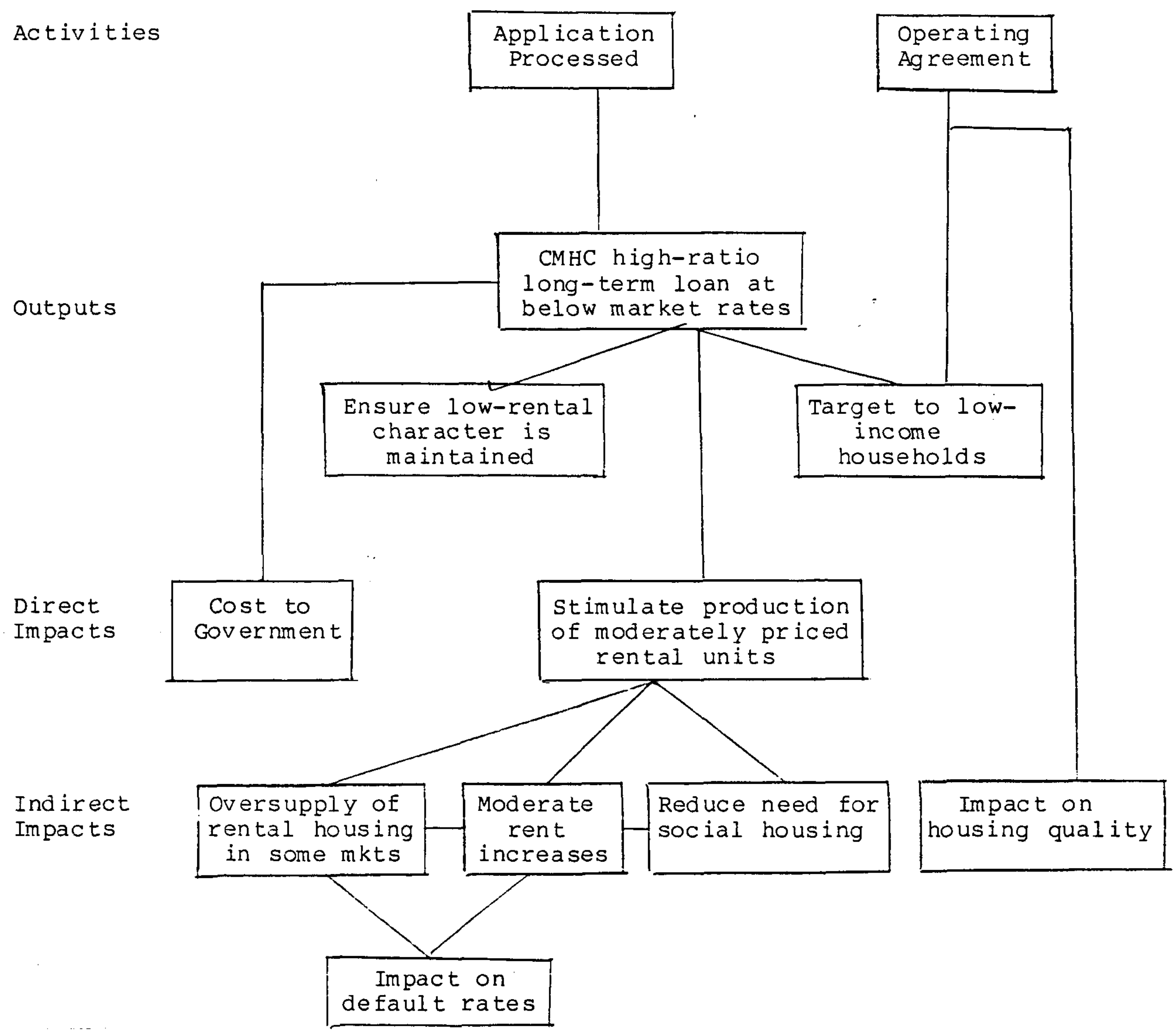


Figure 2: Assisted Rental Program Logic Chart

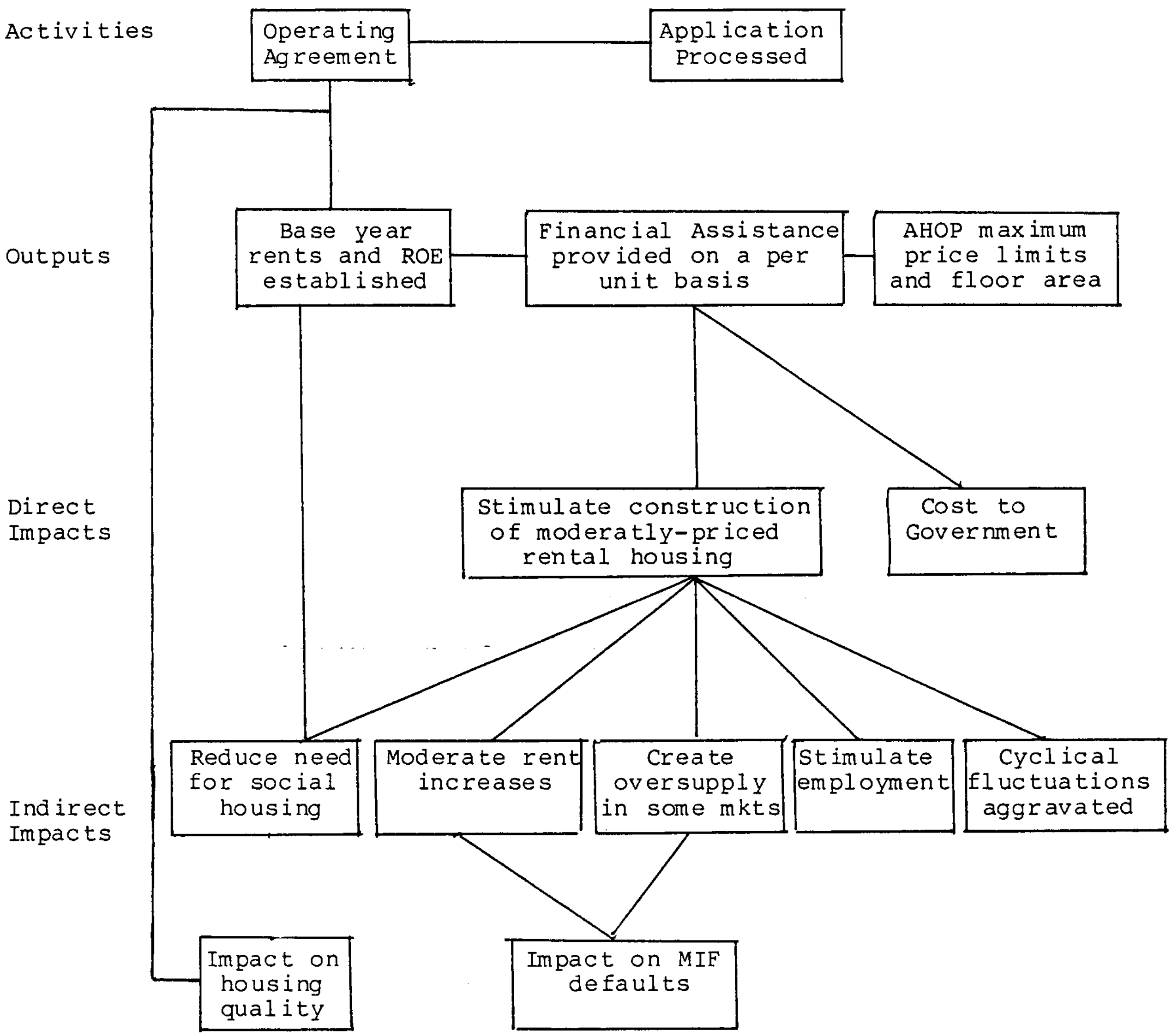


Figure 3: MURB Logic Chart

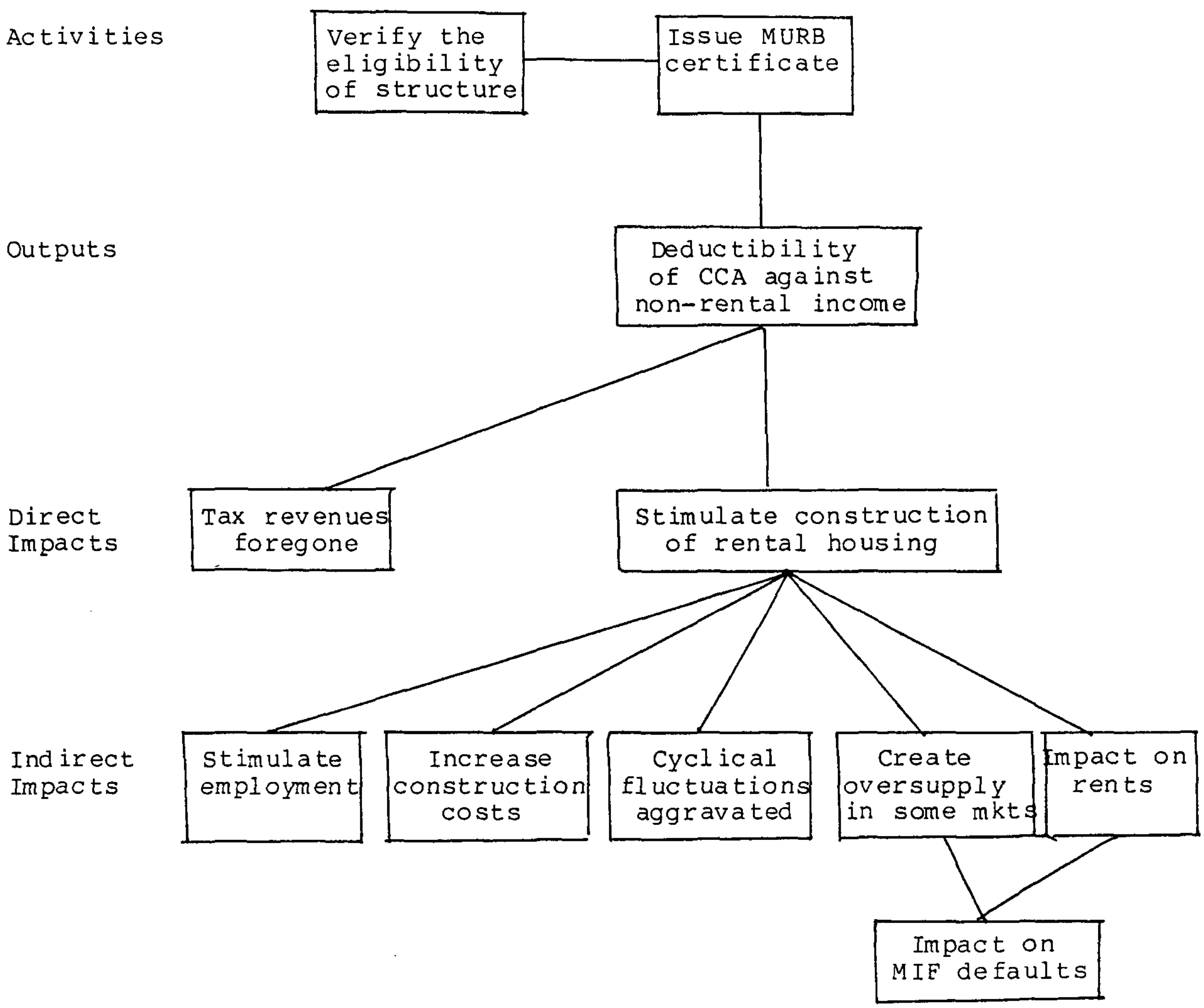
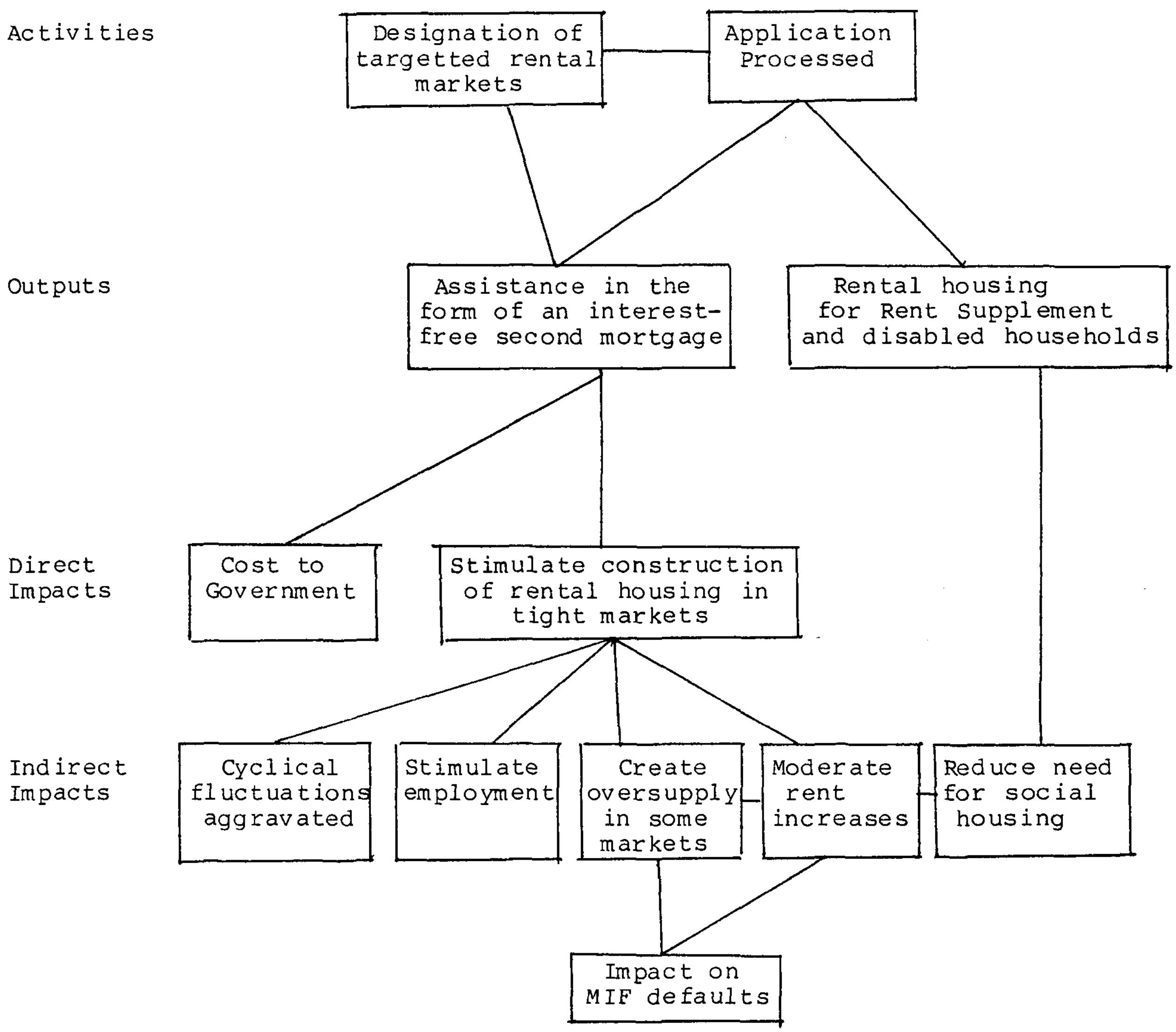


Figure 4: Canada Rental Supply Plan Logic Chart



4. EVALUATION ISSUES

This section of the assessment report develops evaluation issues under five different categories. The first set of issues deals with Program Rationale which:

- o examines the role of the federal government in stimulating the rental housing market; and,
- o analyzes the problems which have existed in the rental housing market during the past 15 years, and whether these problems created a need for government intervention.

The second set of issues on Objectives Achievement relates to the manner and extent in which the objectives of the programs were met. The third section on Impacts and Effects identifies both the intended and unintended effects resulting from the existence of these programs. The Program Design and Delivery issues focus on the specific features of the programs as they relate to the achievement of objectives and cost-effectiveness considerations. Finally, issues are discussed which would investigate the feasibility of alternative policy measures available to the federal government if intervention should be contemplated again in the future.

4.1 Program Rationale

1. What have been the causes of ongoing supply-deficiency in rental housing?

A number of explanations have been advanced for the chronically low vacancy rates experienced in many parts of Canada since the early 1970's. These included the existence of rent controls instituted in all ten provinces in 1974-75; the reduced attractiveness of rental housing as an investment due to tax reform in 1972; and high financing and land costs as inflation and interest rates increased.

2. Has supply in fact been persistently insensitive to changing demand conditions thereby constituting a market failure (a situation in which demand exceeds supply)?

During the 1970's there was a perceived need for government involvement in the rental housing market. Much of this perception stemmed from the rapid decline in rental construction combined with a reduction in vacancy rates in many markets. During the peak of their involvement, governments became preoccupied with seemingly 'unacceptably' low vacancy rates. This issue is therefore concerned with whether falling vacancy rates were a direct reflection of the deteriorating attractiveness of rental investment or whether, as some observers have suggested, the vacancy rate was merely adjusting to a lower equilibrium in response to structural change in the housing market (for example, more efficient search behaviour by landlords and tenants).

3. What has been the long-term role of the federal government in the rental housing market?

The period between 1974 and 1983 was marked by increasing efforts by the federal government to improve the financial viability of rental construction. However, the presence of market distortions induced by the activities of other levels of government, such as rent controls and municipal approval processes, may represent obstacles which offset any effective federal policy response to insufficient supply.

4. Have rental housing construction programs been an appropriate means of stimulating employment?

In the mid-1970's, the growth of the Canadian economy slowed, followed by increasing rates of inflation and unemployment. Given the sensitivity of the general economy to housing starts, the ARP and CRSP programs were also used by the government to generate employment in the construction industry. However, the use of a single policy instrument may not be an efficient method of attaining multiple economic objectives if there is little relationship between unemployment and shortages of rental housing. In fact, there are reasonable grounds for believing that the opposite situation may prevail: that tight rental markets are more likely to be geographically associated with more favourable labour market conditions.

4.2 Program Objectives Achievement

5. To what extent did the LD, ARP, CRSP and MURB programs each result in net additions to the rental housing stock?

Given that the primary objective of each of these federal rental housing programs has been to stimulate the construction of new rental units, estimates of their net contribution to the stock represent an important component of the evaluation. This will entail producing estimates of the number of rental units which would not have been constructed in the absence of these programs, including the extent to which these subsidized starts displaced unassisted rental construction. These estimates would also provide direct estimates of the programs' impact on vacancy rates. Because ARP benefits were usually 'stacked' onto the favourable MURB tax advantages, statistical measures will be required to disentangle the effect of ARP from that of the MURB provision. Similar recognition will be required for the stacking of ARP benefits with provincial subsidy programs in Ontario and British Columbia.

6. Were the ARP, MURB and CRSP programs successful in generating incremental employment?

In addition to increasing the supply of rental housing, these programs had the objective of creating jobs both directly in the residential construction industry and indirectly in other sectors of the economy. The volumes of employment generated by these programs are directly linked to the net rental housing starts directly attributable to the programs' existence. Also at issue is whether the jobs created were simply brought forward from future time periods.

7. Was assistance under CRSP directed to targetted areas experiencing excess demand as reflected by low vacancy rates?

As a replacement for the MURB tax measure, CRSP was explicitly targetted to Selected Market Areas with very low vacancy rates, and its success should be judged largely on the extent to which it alleviated shortages in areas where the problem was most profound.

8. Did the LD, ARP75 and CRSP Programs adequately target units to low and moderate income households?

Under the Limited Dividend and ARP75 Programs, units were to be provided to households of low and moderate incomes with specific rent-to-income thresholds which determined the eligibility of a tenant. Since 1985, ingoing LD tenant income thresholds have been set at the upper bound of Statistics Canada's second income quintile. Under CRSP, builders were free to build the size and type of units they wished, but under the terms of the loan, one-third of the units had to be offered to the Provinces for Rent Supplement tenants. However, the lack of controls on the types of units constructed may have discouraged provincial housing authorities from accepting the offer.

9. Did the LD and ARP programs encourage the construction of moderately-priced rental units and have these units remained moderately-priced while their Operating Agreements were in force?

Both of these programs offered ongoing financial assistance to projects as part of their Operating Agreements in exchange for the maintenance of moderate rent levels. Also at issue is whether introducing the 15 year Limited Dividend Supplementary Agreement has resulted in the loss of the moderately-priced nature of these units.

4.3 Program Impacts and Effects

10. What have been the costs to the federal government of the LD, ARP, MURB and CRSP programs and how do per unit costs compare across these different programs?

The measurement of cost must be consistent across programs to ensure that comparisons are valid. Direct program disbursements, indirect subsidies and administrative costs will all be included in the 'present value' calculation of program costs. In addition, estimates of net losses to the MIF arising from ARP, MURB and CRSP should be captured in the cost equations. The measurement of costs associated with the MURB program may be particularly challenging since it largely consists of deferred tax revenues. Therefore, a number of assumptions regarding alternative investment decisions will have to be made.

11. To what extent did the ARP, MURB, and CRSP programs result in lower overall rent levels?

If these programs were successful in stimulating a net increase in the supply of rental housing, then increases in market-wide rent levels should have been moderated as a result of these programs. This issue would also address whether the benefits conferred on MURB investors were capitalized into the value of the property or passed through to tenants in the form of lower rents.

12. To what extent did the ARP, MURB and CRSP programs exacerbate cycles in rental residential construction activity?

During their existence, the ARP and CRSP programs underwent changes in the levels of subsidy they offered. When combined with the 'on-again off-again' MURB program, some observers have suggested that these programs exacerbated fluctuations in residential construction activity. It is also possible that some of the construction that was induced by these programs was brought forward from the future.

13. Did the LD, ARP, MURB or CRSP programs lead to an overproduction in certain markets, thereby increasing mortgage default rates?

A major concern with the rental programs has been their possible effect on mortgage default rates. By producing more units than a market can absorb, vacancy rates are likely to rise, possibly leading to future defaults and/or arrears on mortgage repayments. This issue would specifically examine the impact of ARP, MURB and CRSP on the Mortgage Insurance Fund, and the extent to which subsequent changes in ARP payment/repayment schemes were used to protect the MIF.

14. Did the LD, ARP, MURB and CRSP programs reduce the need for or delivery of social housing programs?

If the production of Limited Dividend, ARP and CRSP units increased supply thereby reducing the rate of increase in overall rents (increasing affordability in general), then a corresponding reduction in the need for social housing can be expected to occur. This issue would also review whether increased funding for market housing programs occurred in place of social housing delivery.

15. What impact did the federal rental housing programs exert on the quality of rental housing?

This question addresses the extent to which subsidized rental projects meet NHA housing quality standards, and whether there are any differences in quality between assisted and unassisted projects.

4.4 Program Design and Delivery

16. Were the terms of the LD and ARP Operating Agreements consistent with program objectives?

The terms and conditions of the Operating Agreements under LD and ARP included restrictions on Return on Equity, rents, tenant incomes, and further encumberances on the project (in the case of LD). Limited Dividend and ARP75 Operating Agreements set specific income limits for tenant households which should be reviewed in terms of their consistency with program objectives. Program design would also be reviewed to determine whether sufficient incentive was provided for owners to adequately maintain the property. An additional issue related to LD is whether the option given projects to terminate the Operating Agreements or to take up the Supplementary Agreements after 15 years is consistent with the program's objective of providing modestly priced rental housing to low and moderate income households.

17. Was there an incentive under the rental programs to inflate claimed costs?

Assistance under the LD, ARP and CRSP programs was tied to the cost of the project. However, the post-1968 LD program did not require proof of actual costs since assistance was based on appraised value. In the case of the MURB tax measure, higher front end costs resulted in a larger tax saving since these costs could be written off immediately as soft costs and did not have to be capitalized and thus subject to amortization.

18. Were the eligibility criteria and assistance levels associated with the rental housing programs consistent with the programs' objectives?

All four of the federal rental housing programs were designed to improve the financial attractiveness of constructing rental housing, by offering direct or indirect loans at preferential terms (amortization period and/or interest rate). In the case of MURB's, the incentive was in the form of a tax deduction whereby personal income tax liability could be reduced. While LD, ARP and CRSP provided for specific eligibility criteria, access to the MURB tax measure was virtually unrestricted which provided for no control over specific targetting.

4.5 <u>Program Alternatives</u>

19. Under what market conditions, if any, would the re-introduction of a rental housing stimulation program be appropriate?

As noted in the Consultation Paper on Housing, the construction industry generally opposes government intervention and regulations which distort the normal functioning of the market. It has also been suggested that a policy of non-intervention might result in the return of long run market stability. As a result of the Consultations, the federal government has adopted a policy of refraining from direct stimulation of the rental housing market except as a last resort. On the basis of evaluation results collected for issues 1 to 19, an analysis would be undertaken of what conditions might constitute a "last resort."

20. What form of intervention would be advisable to correct "last resort" circumstances if they should occur in the future?

A review of relative cost-effectiveness and ability to leverage private sector investment decisions of each of the evaluated programs would provide a sound basis for recommendations on a future course of action should the Corporation be called upon to offer recommendations. On the basis of conclusions drawn from the evaluation of these previous methods of intervention and from a review of the past rationale for intervention, the positive and negative features of these alternatives should be assessed. In addition, estimates of the impacts of these rental programs on employment and on rental vacancies can be compared with results obtained in the recent evaluation of the CHOSP homeownership program.

21. What other alternatives would be available to the federal government to encourage the production of rental housing?

A number of other alternative measures open to the government can be identified and assessed. An analysis of such alternatives would be restricted to a comparative review of existing programs put in place by other levels of government in Canada or abroad. For example, a comparison could be made of the cost-effectiveness of past federal initiatives with that of Ontario's current rental conversion incentives program.

5. EVALUATION OPTIONS

In the previous section, specific issues were identified which could be addressed in an evaluation study of federal rental housing programs. This section of the assessment report identifies priorities associated with these groups of issues and presents three alternative options for consideration.

5.1 Option 1: Minimum Evaluation Package:

The minimum effort which should be expended on this evaluation would address all issues relating to Program Rationale and Objectives Achievement and also the issue which derives cost estimates of the rental programs. Specifically, the issues which would be addressed in the minimum evaluation package can be outlined within the following areas:

- The rationale for government intervention in the rental housing market and the rationale for using such intervention to stimulate employment. **[Issues 1-4]**
- The net contribution of each of these programs to the rental housing stock. **[Issue 5]**
- The net effect of ARP, MURB and CRSP in generating employment. **[Issue 6]**
- The extent to which the targetted programs were actually delivered to areas(CRSP) or households (LD, ARP75 and CRSP) which were specifically intended. **[Issues 7-8]**
- Affordability of rent levels for units constructed under LD and ARP. **[Issue 9]**
- The net cost to the government of each of the four rental housing programs. **[Issue 10]**
- Alternatives **[Issue 20]**

Program Rationale:

The program rationale review will consist of an historical analysis of the rental housing market in Canada in order to examine the rationale for supply-side intervention in the past. The focus of this analysis will be on the rental housing market since the early 1970's and will also include a review of the rationale for using such measures to generate employment.

Over the past decade, the role of the federal government in the rental housing market has shifted from intervention in the form of tax incentives and direct subsidies to a more passive role.

The federal government has also committed itself to avoiding such direct stimulus programs in the future without consulting with the industry. The results of this rationale review will provide a clearer understanding of the nature of the market problem and will provide Management with a firm basis with which to offer advice to the government in the future.

Impacts on Rental Housing Starts:

The second important task for the Evaluation Team will be to estimate the net contribution of the four programs in adding to the stock of rental housing. A determination of the incrementality of these programs will require estimating the proportion of units built under these programs **which would not have occurred in their absence.** However, there is also a time dimension to consider. The derived estimates of incrementality must also take into account that some construction may have been brought forward from a future time period, in order to take advantage of the program before it was phased out.

The main approach which will be strongly relied on to determine the impact of the programs on rental housing construction will be econometric models and simulations which make use of observed statistical relationships between rental housing construction and its postulated determinants (including levels of program activity). The development of a national-scale regression model of multiple-unit housing construction activity would enable the Evaluation Team to estimate through statistical inference the numbers of units constructed as a direct result of each program.

In addition, a survey of MURB developers would collect basic information on the nature of the projects which CMHC already possesses for the other programs. For example, such a survey would be relied upon to provide estimates of the proportion of MURB projects in which construction was completed and the proportion in which the units were ultimately used as residential rental properties (to simply have a certificate issued did not necessarily require either of the above conditions to hold). As part of this data collection exercise, indicators of the extent to which the MURB tax measure affected their decision to build would be gathered. This component of the evaluation study would require the automation of a large sample of MURB project data in order to provide detailed tabulations of when and where MURB certificates were issued since existing information sources are either non-existant or incomplete.

Impacts on Employment:

The evaluation will examine the extent to which ARP, MURB and CRSP increased employment in the construction sector and in related industries. This will require estimates of the statistical relationship between rental housing construction and the resulting employment which this generates, using such methods as existing Input-Output models and a macroeconomic model of the Canadian economy. The net effect of these programs on rental housing construction would represent the first stage of this analysis, while the second stage would involve the determination of the quantitative relationship between construction activity and employment.

Achievement of Other Objectives:

The extent to which CRSP program activity actually occurred in rental housing markets which were experiencing the most profound rental shortages will be analyzed with existing program and housing market data.

One of the objectives of the Limited Dividend Program and the Assisted Rental Program was to encourage the construction of moderately-priced rental housing. Existing program data and the Rental Market Survey System can provide indicators of the rent levels which have been charged on these units as part of the minimum evaluation package.

Program Costs:

The final important task to be included in the minimum evaluation package will be to estimate the total cost to the government of each of the four federal rental housing programs. The measurement of program cost should include both direct disbursements and indirect administrative costs incurred in delivering these programs. Estimates of net losses to the MIF would also be included in the calculation of cost.

The determination of government costs associated with the MURB tax measure will require the cooperation of the Departments of Finance and National Revenue. MURB costs will include revenue deferred as a result of the program and will also take account of the following:

- Assumptions on the types of alternative investments which would have been considered by MURB investors and their respective tax treatment if the program had not existed.
- The extent to which related tax expenditures such as soft cost deductibility and the Capital Cost Allowance itself were used as a direct result of MURBs.
- Assumptions on the likely timing and amount of recapture of excess Capital Cost Allowance claimed under the MURB program.

Alternatives:

On the basis of conclusions arrived at relating to program effectiveness and costs, a general analysis can be undertaken of the advantages and disadvantages of each of the past rental programs in order to generate alternatives if such intervention is contemplated in the future (Issue 20).

5.2 Option 2: Intermediate Evaluation Package:

This evaluation option builds on the issues which were outlined as part of the minimum evaluation package. In addition to the proposed coverage of Option 1, this intermediate evaluation package would also address program design and delivery issues, examine indirect program impacts and undertake surveys of tenants currently residing in Limited Dividend and ARP units. These surveys would provide much stronger evidence on the achievement of program objectives for these two programs in terms of providing moderate cost housing for low income households. They would also provide subjective indicators of the quality of the current Limited Dividend stock and of the units built under the Assisted Rental Program.

It is proposed that tenant surveys be carried out for only Limited Dividend and Assisted Rental Program units. It is recommended that no such tenant surveys be undertaken for MURB or CRSP buildings on the following grounds:

- LD and ARP were the only two programs in which the financial incentive required the owner to comply with the terms of an Operating Agreement. The tenant surveys would therefore provide evidence of the owners' compliance in terms of rents charged, tenant income requirements and building maintenance. No such Operating Agreements were required for MURB or CRSP buildings.

- There was no objective, either explicit or implicit, that MURB and CRSP units be directed to low or moderate income households, or that the units be moderately-priced. This did not even enter into the proposal selection criteria for CRSP, probably to minimize the risk of future mortgage loan defaults as occurred under ARP. Instead, proposal review teams were only mandated to analyze 'market demand for type of units proposed'. The selection criteria generally emphasized the economic viability of the projects.

- It is planned that data be collected by other means (such as the existing Rental Market Survey) on current rents being charged for units whose construction was supported by all four programs. Such other means would be much more cost-effective and would still be capable of addressing the issue of the affordability of the units produced. Since the very large majority of rental units constructed from 1975 to 1981 were issued MURB certificates, a variety of other data sources could be used to estimate the rents and income levels of tenants occupying MURB units (Census, HIFE, FAMEX, etc).

- It is estimated that a minimum cost of $50 will be incurred for each returned tenant questionnaire using a mailout survey. Because all results must be analyzed separately for each program, we would in effect be carrying out four separate surveys. In order to provide results which are at least significant by region of Canada, a minimum of 1,000 completed survey questionnaires would be needed for each program.

- Given that the overall emphasis of the evaluation is to be on the stimulative effects of rental housing programs, it would be difficult to justify devoting such a large proportion of the Evaluation's resources in examining issues which are of a peripheral nature for the MURB and CRSP programs.

The additional issues outlined under Option 2 are considered to be important but not as crucial as the issues outlined for Option 1. Evaluation Option 2 therefore consists of:

- All issues covered in Option 1.

- The impacts on cycles in residential construction activity market-wide rents, the need for social housing and the overproduction of rental housing in some markets **[Issues 11-14]**

- Program design and delivery. **[Issues 16-18]**

- Program Alternatives. **[Issues 19,21]**

Impacts on Construction Cycles and Overproduction:

Option 2 would extend the analysis of the rental programs' basic effects on new construction to further determine how the timing of construction activity was affected (issue 12). For example, some observers have suggested that the annual decision to extend or terminate the MURB tax measure for each year may have played a role in destabilizing an already cyclical industry.

Other Indirect Impacts:

If these rental programs were successful in generating net increases in the supply of rental housing then some general market-wide pressure should have been exerted on 'equilibrium' rent levels. This analysis would largely consist of estimating price elasticities associated with rental housing in order to determine the effect of an increase in supply on rents which can be attributable to MURB, ARP and CRSP. Although different estimation techniques would be explored, limited past work in this area suggests that it is the differential between the 'natural' and the actual vacancy rates which represents the key transmission mechanism between a change in supply and its effect on market-wide rents.

This issue is severely complicated by the fact that distortions exist in the rental housing market and such regulations as rent controls probably prevent the market from fully adjusting toward the clearing price structure.

To address the issue of the extent to which these programs reduced the need for social housing, the Evaluation Team would use a survey of tenants currently occupying the units built under the rental programs. This data collection instrument would produce detailed socio-economic profiles of the tenants. The analysis would also rely on a comparison of the rents these tenants currently face against the rents they would most likely have to adjust to in the hypothetical absence of these rental programs.

A potential issue for the evaluation study to address concerns the extent to which the federal rental programs produced more units than the market could absorb (as described under issue 13). The Evaluation Team would analyze the impact of these programs on selected housing markets, quantifying the relationship between supply and demand for rental accommodation across various metropolitan areas via the vacancy rate. A related task would include an examination of the extent to which losses on insured rental projects incurred by the Mortgage Insurance Fund can be attributable to the overproduction of rental housing under these programs.

Program Design and Delivery:

This group of selective issues focusses upon the extent to which the design and delivery aspects of the four programs were consistent with the achievement of their objectives. The analysis of these issues will be carried out by the Evaluation Team using in-house program and market data.

Specific data related to the enforcement of Limited Dividend and ARP Operating Agreements would be collected through discussions with CMHC Branch Officials and with the tenant surveys. The sample of tenants would be drawn from those households currently occupying units which are subject to the terms of an Operating Agreement.

A survey of Branch Offices will be undertaken to obtain indicators on the extent of non-compliance with Operating Agreements and to review monitoring and enforcement procedures. Branch Offices will also be asked to supplement existing project address information which is not fully available at National Office. Complete addresses (including apartment numbers, if applicable) would be required to undertake the mailout tenant surveys.

The LD and ARP tenant surveys would provide information in three main areas. Tenant household incomes, actual rents and subjective indicators of housing quality would be derived from these surveys. This would provide basic information on whether Operating Agreements are being adhered to (for example, whether rents are within the approved range and whether the building is adequately maintained) and the extent to which low/moderate income tenant households are in fact being served by these programs.

Program Alternatives:

Alternative forms of federal government action will be reviewed in light of the government's current policy of avoiding active intervention in the rental housing market, as set out in the Strategic Plan.

These issues essentially build on the other findings of the evaluation and a significant input to the examination of program alternatives will therefore already exist as described under Option 1. However, under Option 2, the review of program design and delivery would provide a stronger basis for determining the most efficient design and delivery mechanisms if such a program is again contemplated in the future.

5.3 Option 3: Comprehensive Evaluation Package:

The Comprehensive Evaluation Package encompasses all the issues identified in Section 4. It therefore consists of the strategy outlined as Option 2 in addition to the Impacts and Effects not already discussed:

o All issues covered in Option 2.

o Impacts on the quality of rental housing through the use of physical inspections **[Issue 15]**

A rigorous analysis of the impact of the programs on the quality of rental housing would require the implementation of physical inspections of a sample of subsidized rental projects. The results of this survey could then be compared against a control group of non-subsidized projects with similar characteristics.

6. RECOMMENDATION

Option 2 is recommended for the conduct of the evaluation of federal rental housing programs. This option would address all but one of the evaluation issues identified in this Assessment Report. The inclusion of a rigorous examination of the impacts of these programs on the quality of rental housing, which is the one issue not in the recommended option, would require detailed physical inspections of a large sample of the stock. This data collection exercise would be time-consuming and costly to complete, while addressing an issue which is not identified as a high priority for this evaluation as expressed in the context of the Corporation's Strategic Plan.

CMHC's Strategic Plan identifies the evaluation of the stimulative effects of housing programs as a priority area. The recommended evaluation option includes an analysis of the economic impacts of the federal rental housing programs on rental housing markets and other selective areas of the economy. Statistical measures will be derived to estimate the impacts of the programs on rental housing starts, market rents, construction cycles and employment.

As part of the recommended evaluation option, a survey of tenants in Limited Dividend and ARP housing projects will be carried out. This survey will provide important evidence on the types of households being served by these two programs, and on the extent to which they have benefitted. A survey of MURB developers will provide a deeper understanding of the stimulative effects of that tax measure.

ISSUES ADDRESSED BY EVALUATION OPTIONS

Evaluation Issues	Evaluation Options		
Program Rationale	Option 1	Option 2	Option 3
1. What have been the causes of ongoing supply-deficiency in rental housing?	*	*	*
2. Has supply in fact been persistently insensitive to changing demand conditions thereby constituting a market failure?	*	*	*
3. What has been the long-term role of the federal government in the rental housing market?	*	*	*
4. Have rental housing construction programs been an appropriate means of stimulating employment?	*	*	*
Objectives Achievement			
5. To what extent did the LD, ARP, CRSP and MURB programs each result in net additions to the rental housing stock?	*	*	*
6. Were the ARP, MURB and CRSP programs successful in generating incremental employment?	*	*	*
7. Was assistance under CRSP directed to targeted areas experiencing excess demand as reflected by low vacancy rates?	*	*	*
8. Did the LD, ARP75 and CRSP programs adequately target units to low and moderate income households?		*	*
9. Did the LD and ARP programs encourage the construction of moderately-priced rental units and have these units remained moderately-priced while their Operating Agreements were in force?	*	*	*
Impacts and Effects			
10. What have been the costs to the federal government of the LD, ARP, MURB and CRSP programs and how do per unit costs compare across these different programs?	*	*	*
11. To what extent did the ARP, MURB and CRSP programs result in lower overall rent levels?		*	*
12. To what extent did the ARP, MURB and CRSP programs exacerbate cycles in rental residential construction activity?		*	*
13. Did the LD, ARP, MURB or CRSP programs lead to an overproduction incertain markets, thereby increasing mortgage default rates?		*	*
14. Did the LD, ARP and CRSP programs reduce the need for or delivery of social housing programs?		*	*
15. What impact did the federal rental programs exert on the quality of rental housing?			*
Program Design and Delivery			
16. Were the terms of the LD and ARP Operating Agreements consistent with program objectives?		*	*
17. Was there an incentive under the rental programs for builders to inflate costs?		*	*
18. Were the eligibility criteria and assistance levels associated with the rental housing programs consistent with the programs' objectives?		*	*
Alternatives			
19. Under what market conditions, if any, would the re-introduction of a rental housing stimulation program be appropriate?		*	*
20. What form of intervention would be advisable to correct "last resort" circumstances if they should occur in the future?	*	*	*
21. What other alternatives would be available to the federal government to encourage the production of rental housing?		*	*

APPENDIX 1

Evolution of Government Involvement in Rental Housing

APPENDIX 1

EVOLUTION OF GOVERNMENT INVOLVEMENT IN RENTAL HOUSING

1917	- first depreciation allowance in Canada inroduced as part of the Income Tax War Act
1938	- Limited Dividend Housing Program introduced as part of the National Housing Act
1946	- activity under the Limited Dividend Program commences
1954	- 'book' value method of calculating depreciation allowance replaced by a declining balance basis according to a pre-determined rate
1962	- loans to Limited Dividend companies allowed to be made for the purchase or conversion of existing buildings into low-rental developments
1964	- Section 15.1 added to the NHA to provide high-ratio loans to non-profit organizations
1968	- removal of limited dividend (5 percent rate of return) condition for Section 15 loans - entrepreneurs allowed to pay off the limited dividend loan after 15 years, subsequently releasing them from the conditions stipulated in the Operating Agreement
1972	- Income Tax Act revised, eliminating the ability to offset tax losses stemming from CCA on rental properties against non-rental income
1974	- MURB tax shelters introduced as part of the Federal budget, largely restoring the pre-1972 CCA provisions (extended annually until the end of 1979)
1975	- termination of the Limited Dividend Program - introduction of ARP 75 under the Federal Housing Assistance Program

1975 - the introduction of provincial rent controls as part of the federal government's anti-inflation policy

1976 - the direct subsidy scheme under ARP 75 replaced by ARP 76 interest reduction loan. The regulatory maximum assistance was set at $100 per unit per month

1977 - policy amendment for ARP was introduced, establishing a working limit of $75 per unit per month in all areas except Toronto and Vancouver (subsequently increased to $120 per unit per month <u>but</u> only for Toronto and Vancouver)
- Ontario and British Columbia stacked provincial assistance with ARP

1978 - ARP 76 replaced by the ARP 78 payment reduction loan
- CCA on woodframe MURBs reduced from 10 to 5 per percent annually
- rules regarding deductibility of 'soft' costs changed so that they could only be deducted in the period to which they relate, as opposed to being deducted when they are paid
- the ARP program was not extended past 1978, and was replaced by the Graduated Payment Mortgage which carried no subsidy.

1979 - the MURB program expired and was not extended for 1980

1980 - the MURB program was reinstated for 1981

1981 - the MURB program was discontinued, and replaced by the Canada Rental Supply Plan for 1982 (extended to 1983)

1983 - termination of the Canada Rental Supply Plan

APPENDIX 2

Analysis Plan for Federal Rental Programs Evaluation

ISSUES	POTENTIAL METHODS	DATA SOURCES
Program Rationale		
1. What have been the causes of on-going supply-deficiency in rental housing?	Determine the extent to which rental housing investment became unprofitable. Assess the relative importance of such factors as rent controls, interest rates and the income tax system in contributing to declines in rental housing starts.	° Market data on investor revenues (rents), operating costs(such as debt carry charges), and real estate prices from existing sources (e.g. RMSS and Statistics Canada). ° Data on alternative investment yields (e.g. Bank of Canada Review). ° Literature review. ° Consultations with industry experts.
2. Has supply in fact been persistently insensitive to changing demand conditions thereby constituting a market failure?	Review of whether existing vacancy rate measures are both an accurate and valid indicator of excess demand in the rental housing market. Analysis of units not covered in the vacancy rate survey. Assess whether the long run decline in vacancy rates may reflect a more efficient operation of the rental housing market.	° Discussions with housing market experts and CMHC officials. ° Documentation on procedures/survey methodology used to calculate vacancy rates. ° Statistics Canada data on size, distribution and characteristics of the rental housing stock.

ISSUES	POTENTIAL METHODS	DATA SOURCES
3. What has been the long-term role of the federal government in the rental housing market?	Review of current and past federal government objectives in the rental housing market in particular and all housing markets in general. Review of specific program rationale for each program and market conditions which precipitated each intervention.	° Review of Canadian literature and government documents on the long-term role of the federal government in the rental market. ° Discussions with housing policy experts.
4. Have rental housing construction programs been an appropriate means of stimulating employment?	Analysis of the correlation between areas experiencing high unemployment with areas experiencing particularly severe rental housing shortages. Compare the employment generated by investing in rental housing with alternative job creation strategies.	° Statistics Canada data on local unemployment rates. ° CHS data on local vacancy rates. ° Statistics Canada/Employment and Immigration Canada data and literature review on employment generated by rental housing construction and other activities.

ISSUES	POTENTIAL METHODS	DATA SOURCES
Objectives Achievement		
5. To what extent did the LD, ARP, CRSP and MURB programs each result in net additions to the rental housing stock?	Estimate statistically the net new rental construction which resulted from each program using several alternative econometric models. Analysis of the likely financial viability of individual projects in the absence of these programs. Review of the findings of other studies providing comparable estimates.	° Time series database of the Canadian economy and housing markets. ° Quarterly/annual program data on loan amounts, numbers of approvals and numbers of rental units constructed. ° Individual project files. ° Survey of MURB developers. ° Literature review.
6. Were the ARP, MURB and CRSP programs successful in generating incremental employment?	Estimate the relationship between rental housing construction and resulting person-years of employment generated based on net new construction occurring because of these programs.	° Existing input-output models of the housing construction industry and a macroeconomic model of the Canadian economy.
7. Was assistance under CRSP directed to areas experiencing excess demand as reflected by low vacancy rates?	Examine the relationship between share of program disbursements and vacancy rates across local housing markets.	° Housing market data (RMSS) and program activity data by local housing market.

ISSUES	POTENTIAL METHODS	DATA SOURCES
8. Did the LD, ARP75 and CRSP programs adequately target units to low and moderate income households?	Review of the adequacy of program control and enforcement procedures to ensure tenant household incomes have met requirements. Determine provincial take-up of Rent Supplement under CRSP. Comparison of LD tenant incomes with occupants in non-financially supported rental stock.	° Discussions with program officials at National and Branch Offices. ° Project files and documentation. ° Surveys of LD/ARP tenants. ° Statistics Canada data on household incomes.
9. Did the LD and ARP programs encourage the construction of moderately-priced rental units and have these units remained moderately-priced while their Operating Agreements were in force?	Compare the average rents charged on these units with rents in the non-financially supported stock.	° Existing program data on CMHC-approved rents. ° Survey of LD and ARP tenants. ° Market data on average rents in the subsidized and unsubsidized stock (RMSS). ° Discussions with CMHC Branch Officials.

ISSUES	POTENTIAL METHODS	DATA SOURCES
Impacts and Effects		
10. What have been the costs to the federal government of the LD, ARP, MURB and CRSP programs and how do per unit costs compare across these different programs?	Calculate total and per unit direct program disbursements for LD, ARP and CRSP, including implied subsidies (usually through an interest subsidy). For MURB's, calculate direct and indirect tax revenues deferred resulting from deductions by MURB investors. Estimate the costs of operating and administering these programs. Derive and compare the total Net Present Value (NPV) cost of each program.	° CMHC and Department of Finance program data. ° Survey of MURB developers (to help develop assumptions for calculating MURB costs.) ° Time series data on market interest rates.
11. To what extent did the ARP, MURB, and CRSP programs result in lower overall rent levels?	Derive estimates of the price elasticities associated with the stock of rental housing. Apply these estimated elasticities to the net increase in the stock caused by these programs. Determine whether rent controls have been "binding" in terms of holding market-wide rents below equilibrium levels.	° Extensive market-wide data on the stock of housing, tenure, rent levels and vacancies. ° Literature review. ° Consultations with housing market experts. ° Rental Market Survey System (RMSS).

ISSUES	POTENTIAL METHODS	DATA SOURCES
12. To what extent did the ARP, MURB and CRSP programs exacerbate cycles in rental residential construction activity?	Statistically determine whether the federal rental programs increased the variability in rental construction activity using models described in Issue 5.	° Market data on vacancy rates, rents and construction activity. ° Survey of MURB developers. ° Consultations with industry experts.
13. Did the LD, ARP, MURB or CRSP programs lead to an over production in certain markets, thereby increasing mortgage default rates?	Analysis of the behaviour of vacancy rates and property values in markets which experienced heavy program activity. Examine the secondary effect in creating mortgage defaults in both the subsidized and unsubsidized sectors.	° Vacancy rate and property value data. ° Data on arrears and default under these programs from the MIF files. ° Program activity data. ° Review of previous CMHC studies on this issue.

ISSUES	POTENTIAL METHODS	DATA SOURCES
14. Did the LD, ARP and CRSP programs reduce the need for or delivery of social housing programs?	Compare socioeconomic profiles of project households with the general population. Determine the proportion who would be deemed eligible for social housing. Compare rents currently faced by project tenants with general market-wide rents.	° Program data. ° Consultations with Branch Officials. ° Survey of tenants. ° Market data on rents (RMSS). ° Statistics Canada demographic data on household incomes.
15. What impact did the federal rental housing programs exert on the quality of rental housing?	Determine whether subsidized rental projects are in superior condition to non-subsidized projects using physical condition survey instruments. Compare the proportion of subsidized projects which are NHA-insured with non-subsidized projects to infer differentials in housing quality.	° Physical inspections instrument ° Survey of LD and ARP tenants. ° Existing databases on overall rental housing quality in Canada. ° NHA Mortgage Insurance File (MIPS).

ISSUES	POTENTIAL METHODS	DATA SOURCES
Program Design and Delivery		
16. Were the terms of the LD and ARP Operating Agreements consistent with program objectives?	Comparison of the specific terms and conditions of the Operating Agreements with the stated program objectives to assess consistency. Review of enforcement policy and procedures. Comparison of terms of the Operating Agreements with situation currently faced by tenants.	° Program data (AGRSH). ° Survey of LD and ARP tenants. ° Consultations with Program Portfolio Management Division and Branch Officials. ° Statistics Canada demographic data on household incomes.
17. Was there an incentive under the rental programs for builders to inflate costs?	Review of the specific guidelines used to calculate assistance levels/tax deductions. Gather views of experts. Compare costs of NHA-insured projects which were subsidized to those which were not.	° Survey of MURB developers. ° Consultations with CMHC program officials. ° Mortgage Insurance Approvals data (MIPS).
18. Were the eligibility criteria and assistance levels associated with the rental housing programs consistent with the programs' objectives?	Determine the extent to which assistance levels were sufficient to leverage private investment, and whether eligibility criteria were focussed toward projects not likely to proceed without program assistance. Determine whether LD, ARP and CRSP encouraged the production of affordable rental units.	° Review of progam guidelines. ° Program data. ° Consultations with CMHC program officials. ° Surveys of LD and ARP tenants. ° Rental Market Survey System (RMSS)

ISSUES	POTENTIAL METHODS	DATA SOURCES
Program Alternatives		
19. Under what market conditions, if any, would the re-introduction of a rental housing stimulation program be appropriate?	Review the performance of the rental housing market since the abandonment of direct federal government intervention in 1984. Review effectiveness results of each of the rental programs.	° RMSS rental market data on starts, rents, vacancy rates and interest rates. ° Literature review. ° Survey of MURB developers. ° Expert opinion. ° Program effectiveness data.
20. What form of intervention would be advisable to correct "last resort" circumstances if they should occur in the future?	Review of the advantages and disadvantages associated with each of the four rental housing programs.	° Program cost-effectiveness ° data. ° Expert Opinion. ° Literature review.
21. What other alternatives are available to the federal government to achieve its objectives in the rental housing market?	Identify potential alternative measures. Assess the viability of these alternatives.	° Consultations with CMHC officials. ° Literature review. ° Expert opinion.

APPENDIX 3

Review of the Literature on Federal Rental Housing Programs

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Since the early 1970's, concern has periodically been raised about a growing 'crisis' in rental housing. This concern has been triggered by a number of factors: both vacancy rates and annual private rental construction simultaneously fell to unprecedented levels during much of the 1970's and early 1980's.

There exist numerous reports which have been written over the years concerning the effects of the 1974 federal budget as it relates to rental housing (the introduction of Multiple Unit Residential Buildings) and of the impact that the Assisted Rental Program exerted upon Canadian rental markets. However, because the Canada Rental Supply Plan terminated relatively recently, this program has not been extensively reviewed.

This Appendix highlights the main conclusions from various studies pertaining to federal government actions in the rental market, with a view to identifying potential issues that could be examined in the evaluation of federal rental housing programs. In most cases, the literature suggests that short-term federal government initiatives themselves have been at least partially responsible for the economic malaise experienced by the rental housing sector.

A3.1 Review of Canadian Literature on Rental Housing Markets:

The Crisis in Rental Housing: A Canadian Perspective:

This article was written by Professor L.B. Smith (University of Toronto) in January 1983. The article concludes that a variety of factors have combined during the past decade to make investment in the residential rental sector unfeasible. While indicating that a major disincentive for investment in rental housing lay in the "perception that inflation was becoming institutionalized in the Canadian economy", Smith regards government intervention in the housing market as being the primary discouragement to rental investors:

"By subsidizing...private rental housing...government policy restrained rents in the private sector, created an unfavourable atmosphere for housing investment, and clearly discouraged the private ownership of and investment in rental housing". (Smith, Annals of the American Academy, January 1983, page 70)

Smith clearly favours a diminishing presence of the federal government in the rental housing market. With the existence of rent controls coupled with increasingly unfavourable demographics, Professor Smith acknowledges that recent federal government efforts to allow market forces in rental housing to operate may be nullified.

A Critical Review of Tax Shelters:

This article was written by Robert D. Brown for the Canadian Tax Foundation in February 1982. Brown is very critical in his personal commentary on the effects of the MURB tax shelter, particularly the manner in which the program was repeatedly extended, year after year:

"These extensions illustrate a fundamental and recurring flaw in the governmment structuring of tax incentives...as the MURB program was initially announced as a short-term program, and then was extended fitfully on a year-to-year basis, investors and developers could never be confident that it would still be in existence when long-term projects were finally brought to fruition. As a result, the program was substantially less effective in encouraging rental real estate than might otherwise have been the case". (Brown, in Tax Policy Options in the 1980s, February 1982, page 130).

In discussing the effects of the Assisted Rental Program, Brown asserts that the program was characterized by design problems in the sense that when the benefit period terminated, owners of ARP units did not possess the economic means to continue with them, "the net result being that some of the projects have been financial disasters". In concurrence with Smith, Brown suggests that government actions made it uneconomical to invest in most types of rental housing across Canada in the long-run by preventing market forces from operating.

Project Land:

In June 1982, Woods Gordon Management Consultants prepared a report for the Market Forecast and Analysis Division (CMHC) concerning land prices and rental construction in Metropolitan Toronto.

The study process largely involved interviews with planning departments In Toronto and surrounding municipalities, developers, appraisers and real estate brokers. The results of the study indicate that the removal of the MURB provision at the end of 1981 was one of the primary reasons for the reduction and stabilization of land prices in downtown Toronto.

Shortage of Rental Housing: Overview and Recommendations:

This report was performed by C.I.P.R.E.C. (Canadian Institute of Public Real Estate Companies in April 1982) and was submitted to the Minister Responsible for CMHC in order to review its recommendations.

The report cites the many difficulties which prevailed in the rental market in the early 1980's, primarily the unprecedented high rates of interest, the lack of flexibility in CMHC's mortgage underwriting, provincial rent controls, and the combination of provincial and federal rental housing programs. The report justifies government intervention in the rental market only to minimize the adjustment period or the social costs of any abrupt change in the market:

"Our governments' extensive involvement in the housing industry has not only proven to be expensive, but unfortunatley nurses its continued involvement to maintain an adequate level of rental housing...the industry's sensitivity to political intervention has discouraged many potential lenders and investors to participate in the industry". (page 12)

The study recommended to the Minister that in encouraging the gradual reduction of government involvement in the rental housing market, "rental rates and operating returns will hopefully gradually increase to levels deserving of these developers' and financial institutions' rental housing participation and ownership". (page 13)

The State of the Rental Housing Market: Implications for CMHC and Federal Government Housing Policy in the 1980's:

This paper was prepared by Professor Lawrence D. Jones (University of British Colombia) in May 1983 for CMHC. The paper focussed primarily upon an examination of the proposition that the price or supply response mechanism has malfunctioned in the rental housing market, and the implications for federal housing policy.

In response to the assumptions that are usually made that declining vacancy rates imply an excess demand disequilibrium situation, Jones suggests that an alternative explanation is that the 'natural' or equilibrium vacancy rate is lower in most Canadian housing markets than used to be the case. In his analysis, Jones contends that lagging rents and low vacancy rates do not necessarily imply market failure.

In describing the problems experienced by the rental housing market in the 1970's, Jones cites several forms of government intervention that were responsible:

"...the on-again/off-again posture of the federal government with regard to the eligibility of 'MURBS' for special tax shelter status diluted any positive impacts on anticipated returns and added to the unusually high degree of uncertainty faced by investors". (page 39)

In discussing the Assisted Rental Program, Jones concludes that "assistance policies of the ARP form run the particular risk of inducing supply of the wrong form in the wrong location; such units are vulnerable to market price declines, subject to undermaintenance, deterioration and even abandonment and consequently are much more exposed to mortgage delinquency...reflected in the extraordinarily high loan delinquency rates experienced by ARP loans". (page 41)

In conclusion, Jones asserts that the combination of projected reductions in the growth of renter households with the risk attached to rental housing stimulus programs in the sense that in the past they "have all tended to induce production of units that failed to match the composition of demand (the likelihood of this is much greater in a smaller low-growth market)", casts much doubt as to the appropriateness for rental housing programs in the latter half of the 1980's:

"It would be unfortunate if policy actions of the Eighties produced a chronic excess supply housing crisis in the Nineties generating pressures for federal government and CMHC intervention to design and implement policies to reduce the size of the housing stock". (page 52)

Impact of the ARP and MURB Programs on the Vancouver Housing Market:

This research study was carried out by George Gau and Anne Wicks in January 1982 for CMHC (under the terms of the External Research Program).

The study attempts to determine the extent to which the ARP and MURB programs encouraged the construction of rental housing units in the Vancouver market, or whether investors responded to the programs by merely capitalizing into property values the benefits available under the incentives.

The analysis consisted of measuring actual operating cash flows and capital gains received by owners of assisted and non-assisted projects in order to calculate and compare after-tax rates of return between the two types of project investments. The results:

"...do not support the proposition that the ARP and MURB programs create superior rates of return for real estate investors...the findings indicate that the tax-shelter subsidies of the program are fully capitalized into property values...MURB is an expensive subsidy policy that is ineffective as a housing assistance program". (page 11)

Tax Expenditures - Housing:

This paper was prepared for CMHC in March 1981 by Clayton Research Associates Limited. The report discussed at length the costs and benefits of selected tax expenditures in the housing area, with much emphasis placed on the MURB tax shelter.

With respect to the rationale of the MURB provision -- that being the stimulation of private rental construction -- the program is judged in the report as being a success particularly in "attracting private investment capital from sources which had been cut off with tax reform in 1972".

In terms of its relevance for the 1980's, the MURB program is not considered to be suitable to meet the rental investment of the 1980's. Clayton outlines three major problems with the program:

- "Instability -- MURBs are an attempt at a short-term, stop-gap answer to a long-run, structural problem in the rental market..."
- "Costs -- at a present value cost of $2 000 - $3 000 per unit, MURBs are a significant draw on the federal treasury..."
- "Inefficient subsidy allocation -- because investors are primarily interested in MURBs as a no-cost tax shelter, and are frequently ignorant in real estate matters, they are prime candidates for exploitation by developers/promoters who are highly proficient in real estate matters. Exploitation does not occur in all MURBs, but the situation is ripe...". (page 35)

With regard to the problems inherent in the MURB tax shelter provision, the report suggests three potential alternatives which could more efficiently meet the intended objective:

- "Replace the MURB and soft cost tax shelters with direct construction grants...more rental units should be produced out of a given amount of grant revenue since builders/developers (none of the benefits are passed along to syndicators or investors) would be recipients of larger subsidies". (page 43)
- "Replace the MURB and soft cost tax shelters with investment tax credit for builders/developers...(it) has the same advantage as the direct construction grant...(except) it would be administered through the tax system".
- "Replace the MURB and soft cost tax shelters with interest subsidies for builders/developers...the need to subsidize syndicators and individual investors is again eliminated".

A Longer-Term Rental Housing Strategy for Canada:

This report was prepared for the Housing and Urban Development Institute by Clayton Research Associates Limited in Februrary 1984. This study is a more recent review of the problems permeating the rental market combined with an assessment of federal rental housing programs and a presentation of a longer-term strategy for the rental market.

In terms of stimulating rental construction, MURB tax shelters, ARP and CRSP are all judged as a success in the report in addressing the problem of a lack of construction in the short-run, although "they were costly and also did little to address the fundamental (long-term) problem...that market rents are too low to support the construction of unsubsidized new rental projects".

In assessing their effectiveness, the report emphasizes the programs' indirect impact in encouraging developers to inflate their costs:

"Both the MURB and CRSP encouraged many developers to inflate to varying degrees their costs - at least on paper. MURB benefits were related to the soft costs and the capital cost of the improvement; the larger the costs (on paper), the larger the tax write-offs...(for CRSP) the higher the cost, the higher the economic rent and the larger the gap which CRSP interest-free loans were designed to bridge". (page 45)

In discussing the long-term strategy needed to overcome the problems in the rental market (in terms of the lack of attractiveness of new rental investment in many Canadian rental markets), Clayton concurs with the majority of housing analysts that there should be "a resolve on the part of governments not to interfere unduly in the operation of the private rental market".

Programs In Search of a Policy:

This study was commissioned by CMHC to provide background information for revisions of the National Housing Act in 1972. The study was conducted by M. Dennis and S. Fish. The research was divided into 4 areas: economic; institutional-administrative; production and design; and the social aspects of housing policy.

The study found that the Limited Dividend Program had been unsatisfactory in terms of the poor locations that projects were situated; lack of amenities; poor design and construction; small non-family units; poor maintenance and project management; and high-grading in tenant selection.

Given the "unsatisfactory" results of the program found by the authors, several recommendations were made to ensure that further flaws inherent in the program's design would not be repeated:

- The legislation should be amended to require that projects be reasonably located with respect to community facilites, transportation and employment.

- Administrative regulations must require suitable amenities, site planning and design.

- An increased emphasis must be placed on the provision of larger, low-rise units.

- Income limits and utilization of family units must be policed more closely.

- Loans should be conditional on the tenants being offered a lease, for a minimum period of one year, the terms of which are at least as favourable as those in the public housing lease.

Allowance should be made in the loan amount for the cost of training competent, socially-oriented housing managers. Tenants' associations should be encouraged and funded.

- Since the advantages of a rental lock-in (when matched with incomes) does not evidence itself until between the eighth and tenth years of operation, the terms of the lock-in should be extended to 25 from the present 15 years.

The authors concluded this section of the study by stating that "once the non-profit sector has mobilized sufficiently and is responsible for a major portion of the annual social housing production, little justification remains for retaining the full recovery entrepreneurial housing program....once non-profit housing gets fully underway...there is the further long-term advantage that, at the end of the mortgage term, the project will be paid for in full and will still be available as low income housing, with no mortgage payments and even lower rentals". (page 243)

Report of the (Ontario) Commission of Enquiry into Residential Tenancies, Volume II:

The final report of the Commission of Enquiry was completed in April 1987 and released in January 1988. Some of its more pertinent findings include:

- It is estimated that rent control in Ontario has held actual rents 7.5 to 10 percent below average market levels. However, they have led to higher rents in the uncontrolled sector than would have been the case in the absence of controls. Furthermore, a disproportionately small part of the monetary benefits of lower rents extend to lower income tenants. Most of the benefit accrues to tenants who could afford market rents.

- The Commission recognizes that conclusive evidence is unavailable in terms of the effects of rent control on the supply of rental housing. However, they do note that total rental starts in Ontario have been much lower in 1975 and later years as compared to the years before the imposition of rent controls. In addition, the composition of rental starts shifted dramatically after the imposition of controls, with 72 percent of starts being private and unassisted in the six years before rent controls, compared to 38 percent in the six years after controls were adopted.

- The Commission makes 25 recommendations which essentially form their proposal for a Fair Market Rent system combined with a shelter allowance program for Ontario.

Report on the Impact of Limited Dividend Housing on the Demand for Subsidized Public Housing in Metroplitan Toronto:

This report was prepared by the Metropolitan Toronto Planning Board in January 1963 in response to a request by the Metropolitan Toronto Interim Housing Committee to "prepare a report on the impact of the private limited dividend housing programme and its effect on the demand for subsidized public housing in the Metropolitan Toronto area".

One of the Board's findings was that the Limited Dividend Program was providing shelter for tenants who were roughly in the same low income market as those served by public housing. Although the Board found that 4/5 of the limited dividend tenants would pay higher rents (due to higher incomes) for public housing, 95 percent of limited dividend tenants qualified for admission to public housing projects.

This was not to say that limited dividend and public housing were perfect substitutes, however, as the Board also found "several rather serious shortcomings in most limited dividend projects...there are significant differences which show that limited dividend cannot do the job as completely or as well as public housing" (i.e. higher densities, less adequate social and recreational facilities, smaller management staffs, et cetera).

However, the Board also concluded that the Limited Dividend Program served a useful purpose in times of housing shortages in Metro in providing shelter to low-income large-family households, thereby "attempting to play a public housing role for which it was not intended". (page 23)

The Role of the Limited Dividend/Entrepreneurial Program in Canadian Social Housing Policy:

This report was prepared by Doris Schwar in May 1987 under the CMHC Scholarship Program. It provides detailed historical research findings on the origins and evolution of the Limited Dividend Program. According to Schwar, Limited Dividend housing was premised on "a strong belief in the private housing market, and on an equally strong distaste for direct government intervention and subsidization" (p. 135).

As part of her study, Schwar conducted a small survey of 132 tenants, including personal visits to 125 Limited Dividend projects and the report concedes that the results should not be considered representative. However, some of the survey findings included:

- "Most of the projects surveyed are in relatively good condition, and apart from Toronto and Montreal, unsatisfactory projects appear to be the exception rather than the norm."
- "Half of those [tenants] surveyed have lived in their units for more than three years, and one-quarter indicate a relatively

high degree of efficacy and community participation."

- "The majority of tenants in the projects surveyed are low to modest income earners, and one in four might qualify for public housing, while one-fifth reported incomes in excess of $25,000 per annum."

- "About one-third (32%) of the tenants surveyed were very satisfied with their housing, and an additional 45% were at least satisfied. Areas of concern focus primarily on maintenance related issues."

A3.2 Review of Evaluation Studies on Federal Rental Housing Programs

The Assisted Rental Program (ARP), 1975-1978: An Evaluation:

This evaluation report was produced by David Hulchanski (Centre for Urban and Community Studies of the University of Toronto) for the Co-operative Housing Foundation of Canada in December 1982. The following results flowed from the report's analysis:

- The direct cost of the ARP interest-free loans to the federal government amounted to $555 millions between 1975 and 1979 (approx. $4 500 per unit); the cost of the interest forgiven on the interest-free ARP loans was $29.7 million between 1976 and 1981.

- The high rate of default under the program was due to the combination of imbalances between supply and demand in local markets with provincial stacking (in Ontario and British Columbia) of ARP benefits.

- Annual cost of Capital Cost Allowance to the federal government estimated at $95 million; the annual federal tax losses resulting from deductions for soft costs in 1979 was estimated at $65 million.

- The average ARP (with all the subsidies attached to it) unit provides an estimated 15 percent yield on equity to the investor; with just the interest-free loan assistance, the investor could earn a yield of 3.8 percent; CCA alone would yield 3.8 percent; and without any program, the difference between economic and market rents would have yielded a negative return on equity of -8.3 percent.

- An estimated 40 percent of ARP units would have been built without the program.

- Some low vacancy areas received a relatively small number of units under ARP; Montreal was the main beneficiary of the program although classified by CMHC as an area which lacked demand.

- Most ARP units are low-rise due to the bias of CCA provisions, and are two-bedroom or smaller -- not what is commonly classified as family-oriented housing.

- Maintenance levels in ARP projects are affected by inexperienced investors; ARP projects are characterized by poor quality of construction.

- Floor area restrictions have functioned effectively as constraints on builders under the program.

- AHOP maximum prices have been ineffective as a mechanism to ensure affordability; flexible assistance loans have not kept rents down in the majority of ARP units.

- The administration of annual audited financial statements was expensive; and program revisions greatly complicated the administration of ARP.

Due to the findings outlined above, Hulchanski concludes that

"by most standards of evaluation, the effort must be viewed as a failure. The federal government's decision to discontinue the program...was a good one". (page 27)

An Evaluation of the Federal Assisted Rental Program (1976-77):

This evaluation study was conducted by Irwin Lithwick (Program Evaluation Unit: CMHC) in February 1978. The study assesses the program's effectiveness of achieving its goal of increasing the supply of rental accomodation at the national level, and does not evaluate the impact of ARP market by market. The results of the study are outlined below:

- It is estimated that 60 percent of all units built under ARP would not have been built in the absence of the program.

- It is estimated that in 1976, the program generated 16 263 man-years of employment: 3 753 in complementary industries and 12 510 in employment directly related to new construction.

- The imposition of AHOP price limits exerted minimal impact upon the quality of units built under ARP.

- ARP created a situation of over-supply in many Canadian rental housing markets.

Housing-Related Tax Expenditures: An Overview and Evaluation:

This study was conducted by Robert G. Dowler (Centre for Urban and Community Studies -- University of Toronto), and published in co-operation with the Co-Operative Housing Foundation of Canada in February 1983.

The evaluation focusses specifically upon tax expenditures related to housing policy, and reviews and assesses the advantages and limitations of using the tax system to influence decisions in the housing market. The results of the evaluation, outlined below indicates that the "program has not been altogether successful in fulfilling its goals":

- A large number of projects would have been built with or without the program.
- In tight markets, the subsidy would not be passed on from landowner to investor to renter, instead, the value of the subsidy tended to be capitalized into the price of the land or the unit (exerting little impact on supply or affordability).
- MURB units tend to be priced in the high end of the market (depending on the degree of tightness in the market).
- MURB investors were largely unskilled in real estate leading to a number of inefficiencies -- projects of inferior quality were frequently purchased.
- There is little evidence suggesting that either investors or tenants benefited a great deal from the program.
- MURBs tended to be cheap to administer but offered extremely low levels of government control. As a result, MURBs possessed relatively low levels of accountability which detracted from program efficiency.

NHA Policies and Programs for the Seventies: Low Income Housing Policy (Volume V):

This report was prepared by the joint officials of Policy Planning and other Operating Divisions of CMHC and the Low Income Housing Task Force in 1971. The report dealt specifically with the development of a low income housing policy wthin CMHC.

With respect to the Entrepreneurial Limited Dividend Housing Program, many findings of the report were consistent with the results found in much of the other related literature, these being:

- poor, marginal locations
- inadequate site planning and facilities
- a propensity for one and two bedroom, high-rise units in what is nominally a family housing program
- underutilization of existing larger units, and 'creaming' out of undesirable units
- increased income limits

- 'heavy-handed' management over which CMHC management exercises no control
- funding at a level which does not begin to meet the need
- a big-city bias, similar to that found in the public housing program.

In recommending options for a supply strategy, the authors of the report cited a system of shelter allowances as a superior method of "subsidizing people rather than units". Among the advantages (of a shelter allowance program) listed was that it would be "universal and meets the entire need; it does not lock in the government into subsidies for 50 years; it does not depend on the willingness or ability of government or non-profit intermediaries to construct new stock..." (page 14, Appendix A)

Evaluation of The Administration of Section 15 NHA-Entrepreneur Operating Agreements:

This evaluation was performed for CMHC by Henry Sourial, (Chartered Accountant) and was completed in July 1980. The evaluation seeks an answer to one broad fundamental question: Has the Limited dividend programme achieved its objective of providing low-rental housing for families and individuals of modest means? Sourial relied heavily upon discussions with CMHC officials at the National office, Quebec, Ontario and Prairie Regions in analyzing the problems encountered in the administration of the Limited Dividend operating agreements.

Sourial concluded in his analysis that the problems of the program are more "perceived than real" and "stem only from the lack of commitment by local management (which filters down to the operation level) to the continued administration of the program". (page 10) Sourial also found that despite the fact that some tenants possess incomes in excess of those permitted by CMHC formulae it "does not diminish, too much, the success of the program..." however, "...it should be clearly pointed out to local office that this element of the programme should be monitored to ensure the implementation of the operating agreement". (page 18)

Sourial formulated a series of options, recommending one which would "continue with the Limited Dividend agreement administration as at present but with a much strengthened staff where needed", citing the following reasons: (page 28)

- For a cost of $496,080 now being incurred in the administration of Limited dividend projects, the administration of the programme is cost-effective.
- Great progress has recently been made in developing training programmes for Limited Dividend agreement administrators which should continue.

- The major part of the agreements (for some 542 projects with a 15 year lock-in period) will start to 'die a natural death' since the 15 year periods expire commencing in 1983/84, and by 1990 all will have expired.

- CMHC would be left with control under the operating agreement of the most socially valuable portion of the portfolio (those with 40-50 year lock-in periods). CMHC should develop flexible policies in dealing with owners of some of these projects who wish to redevelop or upgrade them having regard to its social responsiblities to the tenants for whom alternate accomodations could be found in the interim.

- There is no need to tamper with the administration of a programme that has largely succeeded in providing low-rental accomodation for low-modest-income tenants.

- Vacancy rates indicate that rental markets are generally tight and it is not wise to experiment with unproven new approaches at the risk of jeopardizing what the projects offer to its tenants at present.

A3.3 Review of U.S. Literature on Rental Housing Markets:

Given that the rental housing problems in the United States during the 1970's was similar to the Canadian experience (an inflationary economy, the advent of rent controls in many markets, and a persisting gap between economic and market rents), the debate among U.S. housing analysts as to the appropriate role for government in the residential rental sector is relevant for the evaluation of Canadian rental housing initiatives.

In addition, unlike France, Great Britain or the Netherlands (or the majority of Western nations) where private rental construction has virtually ceased, the majority of the American and Canadian rental housing stock is privately-owned and not in receipt of direct subsidies (although indirect subsidies through the tax system have been used as a vehicle to attract investment into residential real estate). In this light, much of the debate in the U.S. has also focussed primarily upon methods to stimulate the unsubsidized production of rental housing.

The Coming Crunch in Rental Housing:

This article was written by Anthony Downs (a senior fellow at the Brookings Institute in Washington, D.C.) in the Annals, AAPSS January 1983. Downs claims that the ability of private rental investors to channel funds into the residential rental sector depends upon the future profitability of investing in this market. Downs favours a complete elimination of rent controls combined with "a federal housing voucher entitlement program focused on low-income renters", as opposed to expanding publicly subsidized housing.

"If the federal government responds to future pressures to do something about rental housing shortages by subsidizing more public housing, the private rental inventory may shrink enormously...as it has in Great Britain". (page 85)

Federal Tax Incentives and Rental Housing:

The House Committee on Banking, Finance and Urban Affairs instructed the U.S. Department of Housing and Urban Development in 1982 to "conduct a study of the impact of Federal taxation law on rental housing". The report (which was completed in December 1982) provides a frame of reference for how tax incentives in the U.S. affect the rental housing production process; and focusses on the specific provisions of the U.S. Federal Tax Code that impact and affect investor decisions in the market. Unlike the findings of some of the literature pertaining the Canadian experience, the report concludes that:

"on the surface...it is likely that most of the benefits of rental specific tax provisions accrue to renters. In the short-run, owners of rental property may benefit from a favourable change in rental provisions, but the enhanced rate of return will attract more investment...and lead to lower rents". (page 85)

Report of the President's Commission on Housing:

This report, which was submitted to President Reagan in April 1982, contains a section which describes the conditions that exist in the U.S. rental market, projects future trends in the market, and formulates proposals that address the major problems confronting the rental housing market.

The Commission suggested that primary emphasis should be placed upon private market solutions to the problems of the rental market. In this light, the Commission made two important recommendations on the role of government in the rental residential sector, these being:

- eliminating or minimizing of the extent of rent controls and
- tax incentives for construction...to provide for more equitable treatment of rental housing in the tax code. (page 89)

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