Private Rental Policies and Programs:

Review of the International Experience

Final Report

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Purpose

The purpose of this research report is to develop a thorough understanding of the programs and policies that governments in other countries have employed to improve the quality or increase the supply of private rental housing.

While this study was conducted for Canada Mortgage and Housing Corporation under Part IX of the National Housing Act, the analysis, interpretations and recommendations are those of the consultants and do not necessarily reflect the views of Canada Mortgage and Housing Corporation or those divisions of the corporation which assisted in the study.

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Executive Summary

Introduction

This report examines the experience of ten countries from Europe, Scandinavia, North America and the Pacific Rim in supporting a private rental sector as part of their respective national housing systems. The purpose was to examine the extent to which other governments have developed policies and programs specifically to encourage the production or rehabilitation of the private rented stock.

The private rented sector is defined here to include the part of the housing stock that is owned and operated by private individuals or corporations with the intent to generate a profit. It excludes non-profit and publicly owned rented properties.

The International Context

Across the ten countries, there has been a significant decline in the relative importance of the private rental sector. In most countries, private rental housing approximated half of the total housing stock in the early post war period. Until the 1970s, housing policy focused on major construction initiatives emphasizing public or social housing and homeownership - with the result that the private rented sector declined in relative size.

Since the 1970s, the private rental stock has continued to contract, as a proportion of the total stock in all countries except Germany and Japan. Initially, this relative decline in size was due to high levels of production in the social and homeownership sectors of the housing market - private rental production continued but was dwarfed in volume by these two other housing sectors.

Since the 1980s however, the cause has shifted. Now it reflects weakened demand for rental housing in most countries. This is due to both demographics and historically low mortgage rates that enhance ownership affordability and a consumer shift to this tenure. There is demand for units at the low end of the market, but affordable rents cannot economically support financially viable new rental production without financial assistance.

Associated with weak effective demand, the inability to compete with subsidies in the social rented sector and the tax advantages of homeownership, the fundamental cause of limited private rental investment across almost all countries is the lack of a competitive rate of return, especially in light of the risk inherent in rental investment.

The general feeling expressed by a variety of analysts and authors is that this problem is worsening as the financial markets continue to offer a plethora of relatively high yield (and relative to private rental, lower risk) investment vehicles. Investors are simply not attracted to rental housing. Accordingly, the rate of new construction in the private rented sector has been very low in many countries

Notwithstanding low rates of investment and production, the private rental sector is not regarded as a serious policy issue in most countries. Even though the literature occasionally refers to a rental housing crisis, the evidence of a policy response in the form of specific remedial initiatives is very limited. Overall, the government response has been laissé faire - market forces and the underlying attractiveness of investment have been left to determine the level and type of private rental new production and rehabilitation.
Only in France and Germany have authorities identified low production levels as a serious concern. In France the policy response has tended to favour investment in the social rented sector.

The revival of a private rented sector has been a significant part of the policy debate in the U.K, but here it relates to ownership of the stock rather than new production.

In most countries, the policy response has been very limited. Housing policy has tended to focus more on promoting homeownership, and on reforming social housing - with an overall emphasis on containing or reducing government expenditures.

Comparative Framework and Policy Responses

In order to identify and assess the policies and programs developed in the selected countries, a typology of policy approaches was developed and used as a framework for the analysis. Three categories of policy response, or measures were identified:

- tax measures (including depreciation, tax exemptions, tax credits and tax-based investment funds);
- subsidy measures (including preferred rate loans as well as grants); and
- facilitative measures (including deregulation, and mortgage insurance).

The review focused on major programs and policy initiatives primarily at the national level. Although they were not explored in detail, a number of smaller scale policies also have some influence on rental investment. Typically developed and implemented at the local level, for the most part, these fall within the facilitative category and involve relaxation of land use regulations, density bonussing or fast tracking development applications as an incentive to stimulate certain types of development - often affordable housing. [1]

[1] The focus of the research was on national, and where applicable state levels, therefore these local regulatory initiatives were not included.

The major policies that have been implemented have been primarily in the form of facilitative measures, notably deregulation of rent controls, with the expectation that this would create greater opportunity for profitability and thus encourage investment.

The impact of regulation and rent control in particular must be viewed in the context of relative investment opportunities. The rate of return on an investment encompasses the investors' perception of risk. Constraints or uncertainty about future income streams directly impact and increase the required rate of return. In this regard, rent control and review policies have been seen as a significant area of risk, increasing the required rate of return. Risk is influenced more by uncertainty than the mere existence of controls - it is uncertainty about their future imposition or revision that creates a serious element of risk for the rental investor, and accordingly constrains investment.

Thus an important precondition for investment appears to be a consistent system that seeks to balance opportunities for investors to earn a fair return with tenant protection against inordinate increases. Compared with no controls, but a fear that they could be reintroduced, such a balanced system may provide greater comfort to landlord/investors, especially after they are exposed to the system for some time.

Almost all countries have also used tax measures at some point, typically in efforts to improve investment through more attractive after-tax rates of return on rental investment. Depreciation allowances and associated book losses are a common measure, often combined with the ability to deduct losses on rental investment against other income sources for tax purposes.
Only three countries have used direct subsidies - small capital grants in The Netherlands (replacing a previous system of longer-term subsidies), and interest rate subsidies in Japan and Sweden. In both of these latter countries, these subsidies are a legacy from previous decades - they were not implemented as a policy response to more recent declining investment. Moreover, they were not unique to the private rental sector - they were

concurrently used to support homeownership production.

The grants used in The Netherlands since 1984 were discontinued in 1995. Meanwhile, Sweden is in the process of phasing out its' interest rate subsidy. In general, direct subsidy programs in these two countries appear to have been both financially and politically unsustainable.

The review found that facilitative measures in the form of market deregulation (e.g. reducing or phasing out rent controls), in and of itself, was a necessary but not a sufficient condition to stimulate private investment in rental rehabilitation or production. At the same time, tax incentives acting alone were also found to be less than effective in cases where some level of rent regulation persisted.

Thus, it is extremely difficult, and perhaps misleading, to isolate the impact of a single policy initiative. The specific context in which a policy or program was implemented, and the dynamic interaction with other policies have a critical bearing on the outcomes generated by the specific initiative under review.

The only countries that appear to have maintained a healthy investment environment without direct subsidies are New Zealand and Australia. Notably, neither have rent controls and both permit depreciation and deductibility of rental losses (including non-cash book losses caused by depreciation) against other sources of income.

Germany, and to a lesser degree France, have maintained some levels of rehabilitation and new production but the investment incentives in these two countries are somewhat more generous than those in the South Pacific countries reviewed. It is concluded that in the European nations a residual system of rent control has increased the need for compensating incentive measures. For investment to be attractive it must first overcome the impacts of the regulatory framework, which imposes some degree of risk - actual or perceived, and may suppress rent levels.

This suggests that the precondition to private investment is not a single policy, but a critical balance across the range of measures - subsidy, taxation, regulatory and facilitative.

Lessons for Canada

The most significant finding is that a variant of virtually all of the policies and programs used in the other countries has been attempted in Canada sometime during the past three decades. The only exceptions are the tax credit and tax exempt bonds utilized in the U.S. These mechanisms are used in the U.S. primarily to stimulate private investment in affordable housing production and involve significant levels of public expenditure - the 1997 appropriation for the Low Income Housing Tax Credit, was U.S. $2.8 billion. Despite the improvement in Canada's fiscal position, programs involving substantial expenditures are unlikely to secure political support at this time.

In the context of rental housing the most critical issue facing several governments is not simply the lack of private rental housing production, but the problem that many low-income households do not have access to rental housing at a cost they can afford - mainly a function of low income. This is the primary issue in France and the U.S. and is evident in a number of other countries.

Over time the available existing affordable stock is reduced as units are either converted to condominium or luxury rental, or may be demolished and replaced. This has been the case in Canada as well as all other countries. Without new investment, pressure on the existing stock, especially the lower priced units is increased.

In addition, almost all countries have implemented shelter allowance programs specifically aimed at the affordability issue. However, shelter allowances depend on the availability of a sufficient reasonably priced private rental stock. Without this base, the effectiveness of shelter allowances is diminished, and overtime they become expensive. The evidence from other nations suggests that it is not enough simply to

implement shelter allowances - parallel measures must exist to encourage new investment and development.

Overall, the lessons from abroad are quite limited, because Canada has already had some experience with almost all forms of policy initiative and programs identified. As such, areas for future research on the private rented sector relating to the international arena are not readily apparent. Some possible areas for consideration are however identified. These include:

1. a detailed analysis of the factors underlying the apparent health of private rental markets in Australia and New Zealand;
2. monitoring the sufficiency and affordability of the existing private rental stock, relative to affordable housing need;
3. an exploration of Real Estate Investment Trusts (REITs) and the necessary policy environment which might facilitate investment in new private rental housing production and rehabilitation.
4. assessment of the private rental rates of return in Canada relative to returns on alternate investment vehicles.

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Introduction

CMHC has commissioned this study to review methods that federal and state governments in other countries have used to support privately-owned rental housing with the objective of enhancing the understanding of the role of rental housing as a integral sub component of the housing system. [2] The project focuses on programs and policies aimed at improving the quality, increasing the supply, and prolonging the life of the private rental housing stock in selected countries.

In Canada, the private rental sector has traditionally played a significant role in responding to the housing needs of Canadians, one-third of whom are renters. Rental tenure is typically the tenure of newly formed households. It is also home to many seniors. For some households, rental is a transitional tenure (either from the parental home or, in the case of immigrants, from their previous country); for others, especially those of more modest income, it is often the only tenure choice available. Steele (1984) has characterized rental as a default tenure.

With the cessation of new funding for social housing programs at the federal level, and in almost all provinces, in the past few years the importance of a viable and well-maintained private rented sector is becoming more important. Of the almost 4 million renter households in Canada, 85 percent live in private rented properties; social rented housing accounts for only 15 percent of renter households. Although the private rented sector has been the largest source of affordable rental housing, the long-term affordability of this resource may be under threat in the face of low production levels, and persisting demand.

In Canada, federal policy with respect to the private rental market has remained essentially unchanged since the 1985 policy statement *A National Direction for Housing Solutions* (CMHC 1985). The 1984 Consultation Paper on Housing, which preceded this policy statement, noted that the construction industry generally opposed government intervention and regulation that distorts the market. Thus the federal government adopted a policy of refraining from direct stimulation of the rental market, except as a last resort (CMHC, 1988). With no subsequent policy announcements since, this essentially remains the policy context for the 1990s.

As a key component in the housing system of all countries, the private rental sector is subject to both market and policy influences. It seems likely that other countries have experienced challenges and, in response, developed policies and programs to address these concerns.

The terms of reference directed the research to examine the programs and policies developed and employed in the U.K., Scandinavia, Western Europe, the U.S. and Japan. The specific countries selected are:

U.K	Netherlands
Sweden	USA
Finland	Australia
Germany	New Zealand
France	Japan

[2] In this study the term private rental housing is used to include only rental properties owned by private for-profit investors. Private not-for-profit (non-profit) associations, which receive ongoing supply assistance subsidies, are excluded. Some of the private properties included in this definition may have been, or are, in receipt of some form of explicit program assistance.

Report Structure

The report is structured to consolidate an overview of findings in the main body while a substantial level of detail is located in the appendix.

Part 1 presents a conceptual framework for comparative review of the experience in each of the 11 countries (ten selected countries plus Canada).

Part 2 extracts information from the detailed country overviews to present some comparative information on the market context for each of the countries reviewed.

Part 3 overviews the issues that have arisen in regard to the private rental sector in each country and identifies the specific policies and programs that have been implemented or adapted to respond since the early 1980s.

Part 4 concludes by assessing the relevance and implications of the programs and policies for Canada.

A detailed Appendix provides context and background information on each country as well as more detailed descriptions of specific policies and programs introduced. The analysis covers details on the policy and economic environment within which the private rental sector functions and provides essential background context behind each country's policies and programs. This background is important for those who are interested in understanding the influences that have shaped the policies and programs in each country.

Part 1: Comparative Framework

The objective of this study is to examine programs and policies that have been developed and adopted specifically to improve the quality or increase the supply of private rental housing. However, it is important to recognize the broader influences that bear on the housing system and the rental market in particular in order to provide a context for these public initiatives.

Public policy impacts are direct and indirect, deliberate and inadvertent. Direct influences include targeted regulatory measures, and specific housing programs. Monetary policy is an example of an indirect influence - it is not conceived solely for the purpose of the rental market, but nonetheless has an important impact on the market.

More specific to housing policy, initiatives that seek to increase access to home ownership have an indirect and sometimes inadvertent impact on the rental sector as they inevitably shift demand in favour of homeownership. While reducing rental demand may be a desirable way to address a tight rental market without building new rental supply, this may be only an inadvertent consequence of the desire to promote homeownership. It could also have the effect of reducing the population of tenants mainly to those on low incomes, a relatively less desirable group for rental investors to target (Pomeroy 1988).

Taxation policy is perhaps one of the most significant influences on rental investment. Again, this may be direct and intentional, as was the case in Canada with the Multiple Unit Residential Building (MURB) capital cost provisions between 1974 and 1981. Alternatively, it may be indirect and unintentional. For example, in the mid and late 1980s, the $100,000 lifetime capital gains exemption provided a valuable stimulus that reinforced the speculative purchase and rental of condominium units as investment properties by individuals - although it was not introduced specifically with rental investment in mind.

The GST (and more recently the HST) [3] is an example of a general tax provision that illustrates how more general policies can have different effects on sub components of the housing system. In implementing the GST, specific exception was made for ownership units and for non-profit development, but not for the costs of development of private rental housing.

Investment in rental housing will be affected by monetary policy (interest rates and availability of mortgage credit), fiscal policy (i.e. program spending constraints), and to a lesser degree, immigration policy which impacts housing demand. These are all general policy domains that, by their broad nature, do not (and often cannot) necessarily consider their impact on specific sectors.

More specific to the rental sector, the relative availability and rate of return on other investments is an important influence. Without a competitive rate of return, investment in rental properties is less attractive. The rate of return encompasses investors' perception of risk so constraints or uncertainty about future income increase the required rate of return. In this regard, rent control or review policies have been seen as a significant area of risk in relation to rental investment. It is not just the existence of controls, but uncertainty about their imposition or revision in the future that causes risk. By comparison, selling a unit as a condominium removes this particular risk, often making this a relatively more attractive option for developers

[3] Harmonized Sales Tax - this has been implemented in three Atlantic Provinces and integrates both the provincial sales tax and the GST. Effectively this broadens the provincial tax base to encompass services - as such it has a significant impact on rental housing development.

Looking more specifically within the housing system, the range of possible influences can be generally grouped into a typology of tax provisions, subsidies, facilitation and regulatory measures. Each of these can be identified separately with respect to demand and supply influences. Measures that impact demand are those that stimulate (or suppress) demand by increasing (or decreasing) the ability to pay - for example, mortgage interest deductibility leaves more after tax income in a consumer's pocket, increasing their effective demand for ownership.

Specific supply stimulus programs, such as the Assisted Rental Program in Canada, are an example of a supply side approach. Here by reducing production expenses the intervention is directly focused on the producer, rather than the consumer of housing. There may be an indirect benefit for consumers in that the units may not otherwise have been built. Further, the stimulus adds supply and, in sufficient quantities, will impact on overall market rent levels.

This typology is summarized in Figure 1.1. The purpose of presenting this typology is to show that specific housing programs and policies designed to stimulate either supply or reinvestment and renovation of rental housing are only one component of the typology. The functioning of the rental part of the system is often more a factor of the broader public policy influences - especially those relating to regulation, taxation and fiscal policy. For this reason, in preparing overviews for each country, the researchers went beyond specific rental policies to provide a perspective on the broader investment and policy conditions and trends in each country. With this appreciation of the broader context, the subsequent assessment of specific policies and programs in each country is more meaningful.

The assessment framework used to examine specific rental policies and programs in each country focused on five critical questions:

1. What stimulated the introduction of the program? How do the conditions that underpinned the initiative relate to those that prevail in Canada in the late 1990s (i.e. to what degree is the approach relevant and transferable)?
2. What was the intended (explicit) objective of the program? To what extent did it meet its objective?
3. Did the program or policy generate any unintended or auxiliary impacts? Were these positive or negative and what does this suggest in the way of lessons for Canada?
4. What was the duration and level of funding allocated to the program? Has this been revised over the duration of the initiative?
5. Does the measure remain in place today? Has it undergone modification and, if so, in what way? If no longer in place, why was the measure terminated?

The Appendix contains profiles for each country in which detailed responses to each of these questions are provided. The country profiles set the context, identify the recent trends relating to private rental housing and discuss the regulatory framework, tax environment and subsidy programs that have an impact on rental production and rehabilitation. Because the relative treatment of competing sub-sectors (ownership and social renting) indirectly impact the private rental sector, some reference to relevant measures in these other parts of each countries housing system are included.

The country profiles also detail the policies and programs in each country relating specifically to private rental housing. The appendix includes a chapter on Canada in order to provide context for international readers and for the comparison of policies and programs in each country.

Figure 1.1: Typology of Public Interventions that Affect the Rental Market	
Supply Oriented:	
Taxation	Property tax treatment Income tax provisions on rental investment
Subsidies	Supply incentive programs including grants and loans Renovation assistance (e.g. RRAP) Mortgage subsidies, grants and loans to investor/developers Conversion programs (to rental) Land zoning and banking
Facilitation	Mortgage insurance
Regulation	Land development fees and charges Maintenance and occupancy bylaws Tenant protection legislation (also demand impact) Rent regulation and Control (also demand impact)
Demand Oriented:	
Taxation	Mortgage interest deductibility from income tax (for homeowners) Tax exempt homeowner saving plans (incl. RRSP withdrawal) Treatment of capital gains on principal residence Homeowner property tax grants
Subsidies	Renter tax credits Shelter allowances Mortgage or other subsidies (for owners)
Facilitation	Tenant advocacy and counselling centres
Regulation	Tenant protection legislation (also supply impact) Rent regulation and Control (also supply impact)

In reviewing the policies and programs in each of the countries the focus was on major programs. It

should be acknowledged that a range of small-scale local initiatives also exists. These can have some impact of private rental production. These fall within the facilitative and regulatory categories of the typology.

These smaller local measures are not generally included in the detailed country profiles or in the overview. For the most part they involve relaxation of land -use regulations, density bonusing or fast tracking development applications as an incentive to stimulate certain types of development. They have become particularly prominent in the U.S. where they are typically linked to affordable housing production (including affordable homeownership and rental). Another measure, used in both the U.S. and in Germany (until 1990), is exemption from property taxes for some specified period.

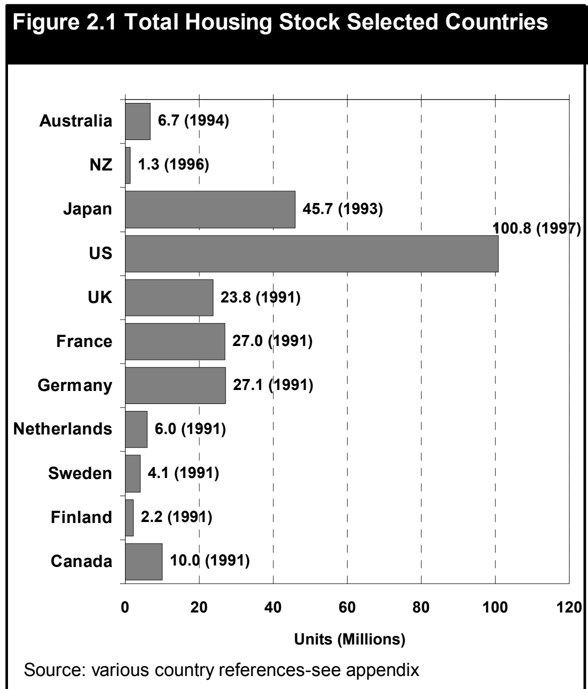
In the next section of the report we provide an overview of the detailed findings, beginning with some general context on the relative size and nature of the private rental sector. The specific major policies employed are overviewed and the possible lessons for Canada are summarized.

Part 2: The International Context

The ten countries selected for analysis here are a mixture of large and small nations, with vastly different sized private rental sectors (Figure 2.1).

The U.S. dominates in terms of the size of the total occupied housing stock – over 100 million units in 1997. The other nine countries combined have a total stock of roughly 145 million units. Four of the other countries (Japan, Germany, France and the U.K.) have total housing stocks in the 20 to 47 million unit range, while the remaining five each have a total housing stock of less than 7 million units. Canada falls between these two latter groups with a total stock approximating 10 million units.

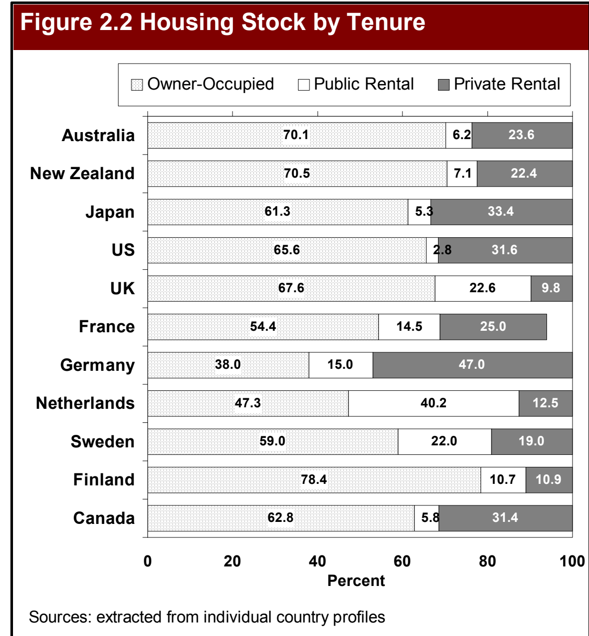
Figure 2.1 Total Housing Stock Selected Countries



Source: various country references-see appendix

The countries also differ significantly in terms of the relative importance of the private rental stock versus the public rental stock and owner-occupied housing. These variations are illustrated in Figure 2.2.

Figure 2.2 Housing Stock by Tenure



Sources: extracted from individual country profiles

Highlights of housing tenure differences among the ten countries include: [4]

- The private rental sector represents only a minority of the housing stock in all ten countries. In fact, except for the continental European countries (Germany, France, the Netherlands and Sweden), over 60 percent of the total housing stock in each of the countries is owner-occupied. The highest rate of owner occupation is in Finland at almost 80 percent.

[4] Some caution is necessary in allocating dwellings to a specific tenure for this type of comparison since there are subtle variations in many countries, especially in Europe. Various co-operative tenures exist including non profit and equity co-ops. Occupants are variably described as tenant owners and collective owners. These have generally been assigned to ownership. Employee housing, which is technically outside of the market as it is only available to employees, is typically rented and for the purpose of this discussion is identified as private rental.

Germany has the lowest rate of owner-occupants at 38 percent.

- The countries with relatively low ownership rates all have significant publicly owned housing stocks. The Netherlands has the highest publicly owned share of the total stock (over 40 percent). A substantial public or social stock is more typical of the European countries. With the exception of Finland (10.7 percent), all have public/social sector housing stocks that account for roughly 15 percent or more of the total stock.

- Conversely, in the countries that have a high ownership sector, the public or social sector is typically very small. In the U.S., the publicly owned share of the total stock is only 2 percent. In Australia, New Zealand and Japan, the publicly owned share of the total stock is in the 5-7 percent range (similar to Canada).

- The U.K. is the exception; it has both a large owner occupied sector, and a significant public sector. Notably, the private rental sector in the U.K. is among the lowest of all the countries.

- The privately owned rental stock in each of the ten countries ranges in relative importance from almost half of the total stock in Germany (47 percent) to less than 10 percent in the U.K.

- Finland (10.9 percent) and the Netherlands (12.5 percent) also have relatively small private rental stocks – though for different reasons since Finland has a relatively small publicly owned rental stock while the Netherlands has a large public sector.

- In Australia, New Zealand, and Sweden, the privately owned rental stock accounts for between 20-25 percent of the total stock while in France, Japan and the U.S., it accounts for roughly one-third of the total.

- Canada belongs to the latter group – with the second highest proportion of private rental housing (31 percent).

The current proportions illustrated in Figure 2.2 above do not reflect longer-term trends. A longer-term perspective is provided in Figure 2.3.[5]

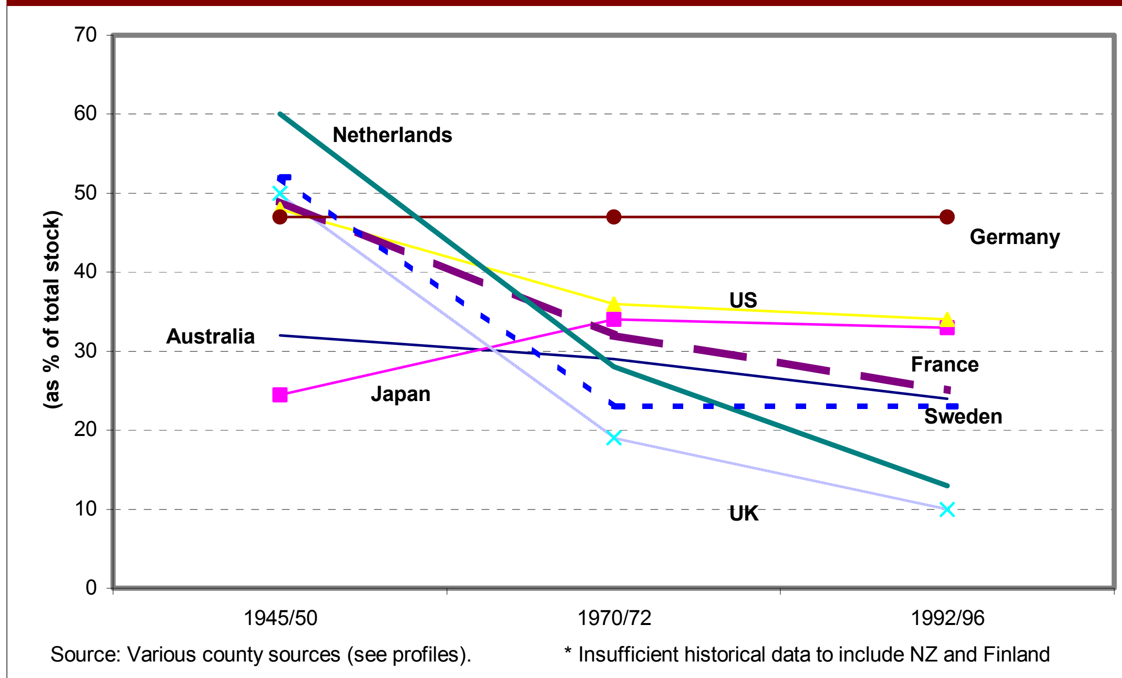
In most counties, the private rental stock in the immediate post war period either exceeded, or was close to half of the total stock. The relative size of the private rented sector has declined since 1945/50 in all countries except Germany and Japan.

In Germany this sector has remained relatively constant around 47 percent (reflecting both favourable tax policies and ongoing strong rental demand in the face of high ownership costs). Japan was the only country to see its private rented stock increase in relative size during the 1950s and 1960s - abetted by a public financing framework that provided low-interest loans. Since 1960 Japan's private rented sector has maintained its share. Beyond 1960, there are no countries in which the private rental sector has expanded.

Among the countries that have seen a contraction in the market share of the private rental stock, there have been two general patterns. The first is an almost universal expansion in the owner occupied sector (largely supported by pro-active policies). The second trend, more limited to just a few countries, is an expansion of the social sector, especially through to the 1970s (most particularly The Netherlands, Sweden and the U.K.). This has contributed to a reduction in the relative size of the private rented sector.

Much of this change occurred between 1950 to 1970 and was the consequence of growing consumer affluence (in the case of ownership) and facilitative government policy, which in a number of countries involved large scale public spending on social housing provision, and in others encouraged and facilitated homeownership.

[5] Due to the changing size of the category referred to as "Other", which includes free accommodation and employer rented stock in various countries, and the different treatment of these categories by different sources, it has been difficult to identify precise comparable data for the full post war period. Figure 2.3 does, however, reveal the general trends.



Since the 1980s, a widespread retrenchment in public spending has resulted in a gradual decline in the relative size of the social rented stock, especially in those countries where this sector was large - U.K., Sweden, Finland, Germany and France. However, the gains were primarily in the private owner-occupied sector - the private rented sector did not grow.

The only country that has seen any expansion in the social rented sector has been The Netherlands, and here this was largely a consequence of the commercialization of public housing companies enabling them to use their large existing assets to lever financing for new development. Although owned by local government these public companies function like private rental corporations.

Part 3: Specific Policies and Programs Introduced to Encourage the Production and Improvement of Private Rental Housing.

The overall finding from the search for policies and programs in other countries is that the private rental sector has not generally been identified as a serious policy issue. While the relative size of the private rented sector has contracted in most countries reviewed, and the economic viability of private rental development has weakened, there has been only a very limited policy response.

A number of countries have maintained or modified programs that already existed prior to the 1980s but, outside of the U.K. (and to a much lesser extent Finland), none have introduced significant new programs directed at the private rental sector. However, a number of countries have revised regulatory and tax policies that have impacted the private rental sector - some positively and some in a less favourable way. The policy responses and initiatives that were identified generally fall into one of three general categories:

- tax measures (including depreciation, tax exemptions, tax credits and tax based investment funds);
- subsidy measures (including preferred rate loans as well as grants); and
- facilitative measures (including deregulation, and mortgage insurance).[6]

The extent to which each country has employed these various mechanisms is summarized in Figure 3.1

Figure 3.1: Summary of Policy Responses *

	Tax	Subsidy	Facilitative
U.K.	✓		✓
Sweden		✓	✓
Finland	✓		✓
France	✓	✓	✓
Germany	✓	✓	✓
Netherlands	✓	✓	✓
U.S.	✓		✓
Australia	✓		
New Zealand	✓		✓
Japan		✓	

* Reflects policies used since 1980. These may not remain in place in 1998

A detailed country by country review of the policy context and an assessment of specific programs developed in relation to the private rented sector are provided in an appendix. Here we briefly overview the situation in each country and highlight the main mechanisms or policies employed.

United Kingdom

The United Kingdom (U.K.) stands out as the only country where the private rented sector has been explicitly identified as a serious policy concern. This sector has been in a state of decline throughout the 20th century, declining in size from over half of the stock at the turn of the century to less than 10 percent in the late 1980s.

In the latter half of the 1980s, the U.K. government expressed a desire to revive and expand the private rental sector, arguing that it was a good option for people who needed mobility and did not want the ties of homeownership

[6] In the conceptual framework, presented in Part 1, we identified regulatory measures and facilitative measures separately. Here they are combined for convenience.

(Department of the Environment, 1987). In part, this policy direction reflected the government's ideological view that strongly favoured privatization and promoted the free market. Given the long-term decline of this sector, the focus of attention was primarily on reviving private ownership of rental housing, not necessarily stimulating new production.

The approach in the U.K. has been mainly in the form of facilitating investment and tax measures. Although tax measures involve an indirect subsidy through lost tax revenues, there have been no direct subsidy approaches.

The three principal measures employed in the U.K. have been:

Deregulation of the Rental Market
A series of legislative measures have been enacted since 1980 with the aim to decontrol rent regulation. Specific legislation was enacted in 1980, with various refinements in 1986 and 1988 that gradually reduced constraints on rent setting, and provided a stronger role for the market to determine rents.

Business Expansion Scheme
The Business Expansion Scheme (BES) is a tax shelter measure providing tax relief to individual investors in companies established under this initiative. Initially established in 1983 to raise venture capital for manufacturing companies, the BES was expanded in 1988, on a 6-year demonstration basis (1988-93), specifically to include investment in private rental housing.

Housing Investment Trusts (HITs)
Housing Investment Trusts were created in 1996 as a vehicle to attract indirect investment in rental housing from financial institutions, and thereby to revive and expand the size of the private rented sector. Somewhat similar to Real Estate Investment Trusts (REITs) created in North America, HITs enable large scale, primarily institutional, investors to invest in a trust set up to own and manage private rental property. Under the Finance Act 1996, HITs are exempt from paying capital gains tax and pay corporation tax at the lower, small company rate (24 percent versus 33 percent in 1996).

The overall impact of these initiatives is at best marginal. The private rented sector has increased in its proportionate size but analysts attribute this as much to the property market slump as to these specific policies. In the face of falling house prices, many individual homeowners that were relocating for employment have elected to rent out their homes rather than sell at a loss.

The Business Expansion Scheme had a short-term impact, accounting for the acquisition of some 81,000 properties. However, when it ended in 1993, many BES companies folded. The government's hope that the BES would ignite sufficient interest to maintain investment without the tax subsidy has not materialized. The more recent HIT has been singularly unsuccessful - no HITs have yet been established, and appear unlikely to be.

Sweden

Policy and program initiatives in Sweden have been primarily subsidy and facilitative measures.

Historically, Sweden has had a highly subsidized housing construction and rehabilitation system, based, since 1975, on a system of interest rate subsidies. Overtime, escalation in expenditures under this program has confronted growing concern about the costs, prompting reform and phasing out of the interest subsidy mechanism.

The key policy issue relating to the private rental sector in Sweden is the size and monopolistic influence of the public sector. Although, in the aggregate, municipal housing companies account for only slightly more of the total housing stock (22 percent) than private companies (19 percent) they tend to be very large and, individually, dominant local markets.

Policy reform has revised the regulatory and rent setting framework to encourage a more market oriented process. However, the monopoly power of the municipal housing companies (as well as

access to capital and economies of scale) has left private rental companies at a comparative disadvantage. The phasing out of interest rate subsidies will impact both the private and municipal sectors and, as such, will do little to shift this imbalance.

Interest Rate Subsidies
Since 1975, the subsidization of mortgage interest rates has been the principal vehicle in support of both new construction and rehabilitation of housing in Sweden. This subsidy mechanism is not exclusive to the rental sector but applies equally to all sectors of the housing system. These subsidies are established in the initial year of operation and effectively reduce the interest cost to a low "guaranteed interest rate" (4.9 percent for owner-occupants and 2.45 percent for private rental developers).

Phasing out of this mechanism commenced in 1994. Although two commissions have investigated the subsidy system and have made recommendations about reform, including a partial replacement for the interest rate subsidies, these have yet to be approved or implemented.

In short, there have not been any new initiatives focused explicitly on encouraging private rental production or rehabilitation in Sweden. The rental sector has been impacted by broader based reforms but as highlighted above, these have not been focused on improving the output of this system - indeed they may have the effect of constraining new private development activity.

Finland

As noted earlier, due to the predominance of homeownership, Finland has the smallest rented sector of all countries reviewed. Following a downturn in house prices (1989-92), there has been increasing demand for rental options. Increasing government concern about urbanization and labour mobility has paralleled these, such that government policy has recently sought to encourage investment in and expansion of the private rented sector. In pursuing this policy, initiatives have encompassed both facilitative measures - in the form of deregulation - and a specific investment vehicle - real estate funds (somewhat analogous to North American REITs).

Deregulation of Rents
Prior to 1990, rents were effectively set by government, through a rent control board, which included both landlord and tenant representatives. Starting in 1992, regulations were gradually relaxed. By May 1995, rents in the private sector were completely deregulated, although rents in the social rental sector are still limited to cost recovery levels.

Real Estate Funds
The Finnish Act on Real Estate Funds (REF) came into force on March 1, 1998. Any funds created under the legislation will be limited liability companies under the Companies Act, listed on the Helsinki Stock Exchange. The funds are intended as a vehicle to encourage investment in residential or commercial real estate, including private rental housing production.

Unfortunately, the REFs have been created primarily as a conduit for investment and rely solely on the deregulated environment to encourage investment. Unlike direct investment in properties, REF investors are removed from property management issues so it was hoped that the REF might be more attractive and stimulate investment. However, observers have suggested that without some tax breaks the REFs are unlikely to be successful (a similar plights as HITs in U.K.).

Germany

With its total rental sector comprising approximately 60 percent of the housing stock, Germany is the one country where rental housing has remained squarely on the policy agenda. The reunification with the former federal republic has imposed serious challenges to German housing policy. This, to some degree, may explain the special prominence of housing policy in general and rental housing in particular, although policy interest in the private rented sector pre-dates unification.

The distinction between the social and private rented sectors are quite blurred in Germany, giving private investors a prominent role in development but often with requirements to house low-income households and to restrict rents. The large size of the combined rented sector is a direct result of a proactive policy environment.

Over the past two decades, Germany has maintained a full array of programs and policies designed specifically to encourage rental construction and rehabilitation. These have included some relaxation of rent controls (although rent levels remain regulated), direct subsidy in the form of interest rate subsidies (linked to targeting conditions for modest income households), and tax provisions largely in the form of depreciation allowances. Rehabilitation has also been promoted through a special program of accelerated depreciation that allowed costs of rehabilitation and additions to be fully deductible over a five year period (20 percent annually).

Depreciation Allowances
The concept of depreciation is similar to the capital cost allowance in Canada. The amount of depreciation is based on the property cost (construction or acquisition) and a depreciation rate. Depreciation can be claimed for a maximum period of 50 years. Rates are graduated to provide greater relief in the early years and thereby enhance after-tax rates of return. In addition, any net loss created by depreciation can be deducted against income from other sources.

Under revisions in 1989 (which were rolled back in 1996), depreciation rates for new construction were 7 percent of the value of the building each year for the first 4 years, 5 percent per annum for the next 6 years, 2 percent per annum for the following 6 years, and 1.25 percent in each of the final 24 years.

German housing policy has also been somewhat responsive in using various policy instruments, particularly depreciation allowances, as a counter cyclical policy tool. In the face of housing shortages in the latter 1980s, depreciation allowances were increased (possibly too much as overbuilding resulted). In addition, the accelerated depreciation of renovation expenditures was introduced to stimulate renovation. Subsequently, following a period of oversupply that coincided with a recession and weakening demand (1993/94) the depreciation rates were rolled back in 1996 to pre 1989 levels. [7]

France

Like many other countries profiled here, France has seen its private rental stock diminish in size over the post war period. The contraction of this sector in France has been seen as a serious policy issue as demand has remained quite strong, especially in the context of high migration from northern Africa. The imposition of a new tenant protection and rent control system in 1982 is identified as a pivotal event in France, which acted to substantially reduce new investment.

At the same time, the existing stock was eroding as small individual investors, the predominant type of rental property owner in France, are aging and their heirs tend to be uninterested in continuing to operate rental properties with very marginal returns. Consequently, a large number of older private rental units have been lost either to demolition or to condominium conversion. Over one million dwellings were lost (on a base of 7 million) from the private rental stock through demolition and conversion between 1975 and 1990.

The view that the rental sector is generally unprofitable is widely shared by many investors and has led to serious declines in the construction of new rental housing. In 1974, 54,000 new private rental dwellings were constructed; in 1984, only 5,000 units were built. Government responded with a range of measures including relaxation of the 1982 rent controls and various tax measures. The result was a modest recovery in

[7] Current rates are 5% for the first 8 years, 2.5% for the next 6 years, and 1.25% for years 15-50. These rates are the same as those that prevailed through most of the 1980's.

new construction activity to some 20,000 units in 1990 - still substantially below levels in the 1970s.

The measures implemented in France fall primarily within the tax measures category of our typology. In overview, these measures include tax reductions that can be used to reduce taxable income, the exemption of net rental income from income tax, and depreciation allowances. It is important to note that the vast majority of rental property owners (87 percent of the stock) are small individual investors. Institutions comprise only 13 percent of ownership in France, so these tax provisions are directed primarily at the small investor.

Tax Reductions
In 1984, tax reductions were introduced for individuals investing in new private rentals. Tax reductions were provided on the first FF40,000 [8]of an investment in housing if the landlord bought or built a new dwelling and rented it for more than six years. This was replaced with a new tax reduction in 1989.

Under the new system (still in place) the tax reduction rate, based on the original construction cost, is 10 percent for individual investors and 7.5 percent for institutions. There is a limit on the property cost of FF300,000 for individuals and 600,000 for couples (increased to 15 percent and FF900,000 in 1997). The reduction is taken over two years.[9]

Exempting Net Rental Income from Income Tax
Before 1987, 15 percent of net rental income was tax-free for a period of 10 years. The government raised the tax-free amount to 35 percent in 1987.

Capital Cost Depreciation Allowance
Similar to Canada, owners/investors in rental properties can claim depreciation in the value of the property. Since 1993, capital cost depreciation rates and the extent to which losses caused by depreciation can be written off against other income sources have been progressively increased. From 1986 to 1993, the annual capital cost depreciation allowance for rental properties was 8 percent of construction cost. This rate was then increased to 10 percent in 1993 and to 13 percent in 1996.

In addition, depreciation can be used to create losses. Landlords were allowed to deduct rental losses from other income, up to an annual upper limit. This maximum has similarly been raised from FF50,000 in 1986 to FF70,000 (1986) and to FF100,000 in 1996).

As indicated earlier, these measures have had some impact in restoring levels of new investment and production, but, despite relatively strong demand, starts remain quite low compared to the 1970s. Rather than further enhance measures to stimulate private rental production, the government of France has elected to pursue a policy of investing directly in the social rented sector. In combination with ongoing conversions from rental to condominium ownership, the contraction of the private rental sector is expected to continue.

The Netherlands

Although there has been a very marked decline in the size and importance of the private rental sector in The Netherlands, this does not seem to be a particular concern to the government or to the society (Oxley and Smith 1996). Government policy favours both homeownership and the social rented sector, although, in the latter case, social landlords are now required to become entrepreneurial - they must operate on a self sufficient basis, but a housing allowance enables them to address affordability concerns and to house low income households.

Given the lack of interest in the private rented sector, the government policy response to private rental housing has been, at best, muted. The principal approach used in The Netherlands has

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[8] Current exchange is 0.2880, so FF40,000 is just over Canadian $10,000

[9] So, for example, under the pre 1997 FF600,000 maximum, a couple could claim FF30,000 in each of two years (10% x FF600,000, spread over two years)

been one of direct subsidy, although this was directly tied to rent controls.

In The Netherlands, the subsidy mechanism has been revised on three occasions (1975, 1989 and 1993). Prior to 1975, a system of operating subsidies was provided. In 1975, this was replaced by a mechanism that predetermined annual subsidies based on projected increasing rents and rates of return. However, rents did not increase as anticipated, leaving investors with unsatisfactory rates of return - investors (mainly pension funds and insurance companies) inevitably became uninterested.

In 1984, a new capital grant program ("Sector C") was introduced. This provides small capital grants to both the ownership sector and private rental developers.

Sector "C" Grants
Available to private rental investors as well as homeowners, grants of Dfl 2000 per year (approximately Can $1,700) were available for five years (total Dfl 10,000, equals Can $8,500) were provided for the development, improvement, or major maintenance of dwelling units costing below certain limits. Most of the housing built using these grants was in the owner occupied sector.

Generally, "Sector C" grants could be used in mixed income rental developments comprising units subsidized under Sector C as well as non-subsidized units. The grant was based only on the number of units falling below cost limits. This led to cost manipulation where certain costs were allocated entirely to "unsubsidized" units in order to bring the cost of the remaining units within the price guidelines for grant eligibility.
Although this program is credited with stimulating some production in the unregulated private sector (total of 4,000 units over 5 years), the price controls and eligibility criteria associated with the rental grants were very limiting, to the point that the grants effectively became obsolete even before they were formally discontinued in 1995.

USA

Policy issues around private rental production and rehabilitation in the U.S. are for the most part a legacy of previous decades, characterized by high levels of direct subsidy, very generous tax provisions and a policy emphasis on private development. Privately developed properties were the primary means of supplying a stock of housing on which shelter allowances could then be used to address affordable housing need.

Measures used in the U.S., particularly in the first half of the 1980s tended to over stimulate private production and caused a substantial oversupply that prevailed through the past decade. With the worst of the 1980s overbuilding finally worked off, the multifamily rental market is only now approaching equilibrium (Joint Centre for Housing Studies 1998).

With high rental vacancy rates in many metropolitan areas and relatively weak demand there has been no basis for concern over the supply of private rental housing. The more pressing issue in the U.S. has been the growing level of need for affordable housing. It is only in the context of affordable housing need that any new rental production and rehabilitation policies have been pursued.

Historically, policies and programs to facilitate or stimulate private rental development in the U.S. have included both direct subsidy programs and indirect subsidies in the form of tax measures (with associated expenditure costs to the federal treasury). Facilitative measures have also been an important tool, primarily in the form of mortgage insurance and more recently credit enhancement.

The following programs - all with affordable housing objectives - are the major initiatives that have supported private rental production and rehabilitation since 1980.

Section 8 Low Income Rental Assistance [10]

[10] The common reference in the U.S. is to section numbers of the U.S. Federal Housing Act.

A direct subsidy program for private rental production, this program was a carry over from the 1970s. The Section 8 project based rental assistance program provides ongoing assistance to bridge the gap between low- income rents (based on 30 percent of income) and approved project rent. New funding under this program ceased in 1986.

Federal Mortgage Insurance
HUD's National Housing Act Section 221(d) (3) and (4) are the primary programs used to insure multi family (five or more units) housing loans. By providing protection to lenders in the event of default, mortgage insurance encourages lenders to provide financing and, depending on underwriting criteria, to increase the percentage of project development costs that they are willing to finance. Underwriting criteria permit loans up to 90 percent of project development costs. The program provides insurance both for new construction, substantial rehabilitation and refinancing.

Tax Exempt Bonds
Tax exempt bonds have been used extensively in the U.S. since the 1930s to finance various municipal capital programs, including the construction and rehabilitation of housing. Legislation in 1980 specifically expanded the scope of these bonds to permit their use in financing affordable housing. They are used to finance both non-profit and private for profit development (providing the project targets low-income households).

Bonds can be issued by state and local housing authorities and the interest on the bonds is exempt from federal taxation. As a result the after-tax yield is enhanced and the bonds are issued at favourable rates to reflect this factor. The result is a source of lower interest financing for rental development.

Federal Tax Incentives
Tax measures (in addition to the bonds just reviewed) are one of the most significant measures used to stimulate rental production in the U.S. During the early 1980s, accelerated depreciation coupled with the liberal use of soft cost deductibility were the primary motivators for large-scale investment in rental housing. These advantages were significantly reduced in 1986. Since that time, the single most important program responsible for rental development and rehabilitation has been the Low Income Housing Tax Credit (LIHTC) - however this is directed to low and moderate income households (although projects may be mixed income).

Essentially, the LIHTC provides a 10-year series of tax credits that can be used to reduce income tax payable by the investor (primarily corporations). Investors purchase the stream of credits, usually in installments over the construction period. This provides equity and reduces the level of debt financing required by the project - thereby enhancing viability and ability to keep rents affordable.

The LIHTC equity typically makes up one third of project financing, another third is covered by conventional debt financing and the remaining third by a variety of other preferred rate financing and grants. Most of these are a function of ongoing federal block grant programs that provide cash resources to local government who in turn have spawned a wide variety of locally designed assistance programs incorporating grants and loans - again with low-income targeting objectives but for which private rental developers are eligible.

Even though there is a strong emphasis on affordable housing outcomes, the private rental sector continues to play a prominent role in the U.S. Throughout the 1970s and early 1980s private rental development was an important platform in a strategy to address affordable housing need, supplying modest quality rental housing that could be combined with shelter allowances. In the 1980s the role of the private rental developer shifted. Now they are often one of many partners in public-private partnership ventures - a model that has emerged as the primary vehicle for rental housing production in the U.S. [11]

[11] For a comprehensive assessment of public private partnerships in the US see Pomeroy et al 1998.

Australia

Among the countries reviewed here Australia is relatively unique - it appears to have a well functioning private rental sector. A recent report by the Commonwealth Government reported "there is little evidence of chronic failure in the private rental market".[12] This system is characterized by the absence of any rent controls and a healthy level of investment, facilitated by modest provisions relating to depreciation and the ability to write off losses (both actual losses and book losses) against other sources of income.

This is not to say that there have been no policy initiatives. In 1985, the Commonwealth government introduced a capital gains tax, which encompassed new rental housing development, among other capital assets. To balance the capital gains tax, depreciation allowances were concurrently introduced - also for the first time.

A third component of the 1985 tax reform was the imposition of a moratorium on the provision to write off rental losses against other sources of income ("negative gearing"). The immediate impact was a decline in new rental investment and tightening vacancy rates. Consequently the moratorium was lifted after 2 years (1987) and construction rebounded. Since that time, the rental market has performed well, without any intervention beyond a reduction in the depreciation rate from the 4 percent implemented in 1985 to 2.5 percent in 1995 - the 4 percent rate was seen as excessively favourable.

There was an unsuccessful attempt at the State level to create a new tax based incentive scheme in response to low vacancy rates in the late 1980s - the New South Wales (NSW) Rental Property Trust. The Trust raised funds from individuals to invest in new rental housing projects. The investment vehicle combined the use of rental property losses (including depreciation) to provide investors with a guaranteed tax-free real rate of return on investments in a property trust comprised of new rental buildings. On the redemption of their units, the investors were also guaranteed a capital gain equal to the inflation rate over the investment period. An unfavourable court ruling on tax grounds curtailed the initiative.

New Zealand

As with many of the countries involved in this analysis, the private rental sector appears to have been regarded largely as a "residual" sector in New Zealand. Government policies have generally favoured and promoted homeownership.

At the same time, a reasonably healthy investment environment has been in place and has facilitated sufficient levels of production to meet demand. Like Australia, New Zealand does not have rent controls and permits the deductibility of depreciation both against rental income and, where a property incurs a loss, against other sources of income.

There is no evidence of under supply and private rental investment does not appear to have been an area of particular interest to New Zealand governments. This is reflected in a lack of specific programs or policies directed at the private rental sector.

Japan

Housing issues in Japan relate primarily to replacement of an obsolete housing stock. Much of the older stock was built to a low quality - largely as the preoccupation through the post war period into the 1970s was more on addressing an absolute shortage of accommodation in the face of expanding demand. Due to the combination of poor existing quality stock and extremely high land prices, the value of existing improvements tend to be low. Most activity is therefore focused on replacement, rather than rehabilitation of the housing stock.

The private rental sector figures prominently in this strategy. Representing one third of the total

[12] Commonwealth Department of Social Security, *Submission to the Senate Community Affairs References Committee – Inquiry into Housing Assistance*, May 1997, page 62.

existing stock, private rental construction has also accounted for 35 to 50 percent of annual starts since the mid 1980s.

This volume of activity represents a continuation of an existing pattern of development - it was not stimulated by any specific program or policy initiatives. Tax measures have been relatively neutral - they have not been designed specifically to stimulate private rental development. Similarly, the regulatory framework has remained consistent since 1980 when Wartime rent controls were finally relaxed. The major factor supporting housing production (both rental and ownership) is the availability of low rate government loans. As such, the primary approach to encouraging rental production in Japan is one using a direct subsidy.

Low Interest Government Loans
Although not specific to the rental sector, a system of direct low interest government mortgages is a mainstay of Japanese housing policy. These loans are below the rates charged by commercial lenders and typically cover 40-50 percent of total building costs - with commercial loans and investor equity covering the remaining costs. Loan terms vary to reflect the type of project and loan applicant - more preferable terms are granted for loans on modest housing, serving lower income households.

Summary of Policy Responses

Regulatory Framework

Many analysts have argued that the regulation of the private rental market, and particularly controls over establishing and increasing rent levels, have been a critical determinant in the declining production of private rental housing (Gyourko 1990, Smith 1996, Oxley and Smith 1996). Others have suggested that this is an unfair indictment of rent control (Harlow 1985, Kemp 1988. McLennan 1995). McLennen points out that investors are attracted to certain assets based on the anticipated rate of return and the level of risk involved. There is some agreement that the regulatory environment is a contributing factor, but is not solely responsible for the lack of investment. It could equally be argued that the more important consideration is the degree of risk about future changes in the regulatory system.

For example, countries with a history of no controls (Australia and New Zealand and Japan since 1980) seem to have healthy ongoing levels of rental development. Meanwhile, in countries that have gone through a process of deregulation (The Netherlands, Sweden, Finland, U.K., France and to a lesser extent Germany), but have a history of frequent changes in rent control policy, there is less evidence of an active level of new production, without other compensating incentive measures.

Thus an important precondition for investment appears to be a consistent system that seeks to balance opportunities for investors to earn a fair return with tenant protection against inordinate increases. Compared with no controls, but a fear that they could be reintroduced, such a balanced system may provide greater comfort to landlord/investors, especially after they are exposed to the system for some time.
Deregulation has also extended to the public and social sectors - with policies in NZ and the U.S., The Netherlands, Sweden and Germany moving social housing rents to market levels (many effectively creating public rental companies that operate like a private for-profit entity). In these cases, the previous project-based subsidies (most often in the form of low interest loans) have been replaced with forms of shelter allowance to address tenant affordability - these are generally available to both private and public sector tenants, and in some cases to low income owners.

Tax environment

Tax policy has a critical impact on the relative attractiveness of rental investment. Here policies are often of a more indirect nature, but capture rental investment within their net. A number of countries have undertaken tax reforms with both positive and negative impacts on rental investment.

Australia, NZ, France and Germany have implemented reforms of the tax system that have tended to make new private rental investment more attractive. While these four countries have all employed depreciation as the instrument of policy, and all permit losses on rental properties to be deducted against other sources of income, in the two European countries the depreciation rates and periods were relatively high. In Australia and New Zealand, depreciation allowances are more modest. As noted above, the two South Pacific countries have no rent controls so depreciation allowances influence the relative attraction of rental investment; they are not required to first overcome what might be perceived by investors as negative influences of controlled markets. Conversely in the two European examples the depreciation rate may have had to be higher in order to overcome the (perceived) negative influences of rent controls .

The trend in the U.S. has vacillated between tax measures that directly stimulated new rental production in 1981-86 (notably accelerated depreciation) to reform that removed these benefits and made rental investment much less attractive in 1986. There was an offset for this in relation to targeted affordable housing development in the form of the Low Income Housing Tax Credit. However, these provisions are not available to developers that are not targeting low-income households.

In The Netherlands and Japan there have been no significant changes in tax treatment since the 1980s. In the U.K., Sweden and Finland there has been an indirect impact on rental demand as reduced mortgage interest relief for owner occupants lessens the relative attractiveness of ownership.

Direct Subsidy Measures

Specific subsidies (as distinct from indirect tax expenditures) to encourage private rental production, have existed in only three countries -- the Netherlands, Sweden and Japan. Those in Sweden and Japan are subsidies on loan interest rates and these predate the 1980s, with those in Sweden now being phased out. In the Netherlands the subsidy was in the form of capital grants but this was cancelled in 1995.

France and Germany also provide subsidized loans, for which private landlords are eligible. However these are linked to provision of accommodation for low-income households, so rents are regulated and held well below market. In Germany this results in very substantial transfers (2 million units 1984-95) of subsidized stock into the unsubsidized private sector.

Part 4: Assessment of the International Experience and Implications for Canada

Context is Important

In reviewing the international experience, and in assessing the relevance of the policy responses in various counties it is important to keep the different contexts in perspective. There are significant differences in the:

- traditional role of the private rented sector in each country;
- physical form of the stock;
- nature of investors (individual, versus institutional and corporate);
- traditional and recent levels of regulation; and
- long term perspective of investors.

General macroeconomic factors (such as the Europe-wide property market recession in the late 1980s) and mortgage interest rate declines have also impacted the relative levels of investment.

Constitutional differences and division of powers can have some bearing on the policy environment. Most countries reviewed are unitary states; only three (Germany, Australia and the U.S.) are federations like Canada. In these three countries, the federal government has traditionally played a strong role on the implementation of policies and programs, as well as having primary responsibility for tax policy. In the U.S. and Australia, the federal government is the primary source of funding. In Germany, this was at one time shared with the Lander (states) - but the Lander are now responsible for grants, while the federal level supports the rental sector through tax relief.

Temporal differences also have an important bearing on the demand for rental housing. The Post War period through to the 1970s was characterized in most countries by high levels of population and household growth, major housing shortages, and a subsequent need to improve housing conditions. There was a high degree of direct government intervention and high levels of government spending on a wide range of programs - including general production of rental housing. Strong economic growth and greater affluence facilitated the trend toward higher levels of owner occupation through the 1960s to the 70s, and often this involved the upgrading of existing rental properties and conversion to the ownership stock. In such cases, the decline in the size of the private rented stock is not necessarily a problem. As demand shifts to the ownership sector there is less pressure on the rental market.

International Policy and Program Initiatives

In reviewing policies (since the 1980s) it has been found that most direct subsidy and indirect government tax expenditure initiatives were implemented in earlier decades, prior to the almost universal onset of government spending restraints in the 1980s. While some countries have managed to preserve existing measures (notably Japan), most have not.

Generally (there are exceptions), the gradual disappearance of direct subsidy and taxation measures does not appear to be linked to formal evaluations and the assessed failure of certain policies. More typically, the issue is that the related expenditures are not politically or financially sustainable. In part, this is related to relative weak demand - a function of demographic trends (the growth rate of typical first-time renter households is lower in all countries) as well as a policy emphasis on access to home ownership.

Regulatory Initiatives

In the face of spending constraints, the predominant rent control and review policy is one of deregulation of the market. Historically, there is a long tradition of rent control in rental housing in most countries, which has been identified as a deterrent to investment. No doubt reflecting limited fiscal resources, almost all countries reviewed have moved away from intervention (and spending) in the rental market and are making an active transition to an unregulated environment. Legislation continues to provide some degree of tenant protection, but generally leaves the matter of rent increases to market forces.

Tax Initiatives

Internationally, tax reform since 1980 has had mixed impacts - either directly or indirectly impacting the investment environment.

In some countries, tax reforms have lessened the attractiveness of rental investment, compared with previous regimes. General tax reforms have often (inadvertently) affected the private rental sector. In the U.S., a 5-year period (1981 to 1986) of very favourable tax treatment was introduced as part of a broad set of economic stimulus measures following the recession of 1980-81. Subsequent 1986 tax reforms significantly removed these advantages and created a tax environment that was far more restrained (except for affordable housing with income targeting conditions).

Australia also changed their tax policies with respect to rental investment in the mid-1980s – only to change them back in the face of reduced rental investment.

For other countries, notably Germany and France, tax reform has enhanced the treatment of rental housing to explicitly encourage investment (with some degree of success in the form of increased output (Van der Heijden & Boelhouwer, 1996). Here again, however, tax reforms were a counteractive measure to overcome the negative influence of other policy actions - in France the imposition of stronger rent control, and in Germany the introduction of tax measures that stimulated conversion to ownership (with a dramatic contraction in the rental stock).

Subsidy Initiatives

The decline of the private rented sector in a number of European countries over the post-war period arose as government policy strongly favoured public and social production. This had the effect of undermining demand for private rental housing, as social sector rents were cheaper. Recent reductions in social funding initiatives have largely removed the competitive advantage of this sector (except in France).

Together with tax reform and the liberalization of the regulatory environment, there has been a discernable international trend toward demand side subsidies. Many countries already had shelter allowance programs prior to the 1980s (all except NZ, Australia and Japan). These have generally been retained or amended, often in parallel with deregulation.

New Zealand is perhaps the most notable, in implementing a major reform in 1991, essentially privatizing the existing public housing stock through a state owned corporation, Housing New Zealand. Rents moved to market and both tenants in this stock and renters in general became eligible for a new shelter allowance - the Accommodations Supplement.

Australia is in the midst of a review of its assisted housing program, which seems likely to result in some form of shelter allowance type of program.

In contrast, there have been no initiatives to create new supply subsidies for the private rented sector. In fact, as noted earlier, most direct supply initiatives related to private rental production have been, or are in the process of being, phased out.

Weak Investment Return is the Fundamental Issue

Across almost all countries, the fundamental cause of the low level of investment in private rental production and rehabilitation is the lack of a competitive rate of return, especially in light of the

risk inherent in rental investment. The general feeling expressed by a variety of analysts and authors is that this problem is worsening as the financial markets continue to offer a plethora of relatively high yield (and relative to private rental, lower risk) investment vehicles. Investors are simply not attracted to rental housing.

Even though there is demand for rental housing, this is increasingly at the low end of the market, at rents that are not economically viable without public assistance.

In reviewing the U.K. experience, it was noted that in and of itself deregulation of rental markets (softening or removal of rent controls) appears to have been a necessary though not sufficient condition to improve the economic viability of private rental investment. Similarly, in a number of countries, the experience with stimulative tax measures aimed at improving rates of return on investment suggests that these may not be sufficient to encourage investment in rental production or rehabilitation if the underlying market fundamentals will not support sufficiently high rents. The beneficial effect of tax measures may be undermined by either actual rent controls that continue to limit returns, or by perceptions of a risk that future controls may erode anticipated returns.

This suggests that the precondition to development is a critical balance across the range of measures - subsidy, taxation, regulatory and facilitative.

The only countries that appear to have maintained a healthy investment environment without direct subsidies are New Zealand and Australia. Notably, neither have rent controls and both permit depreciation and deductibility of rental losses against other sources of income (including non-cash book losses caused by depreciation).

Lessons for Canada

In terms of the specific implications for Canada of rental housing policies and programs in other countries, the most striking finding is that variants of almost all the identified policies used in other countries have, at some time in the past two decades, been employed and evaluated in Canada. Evidently, other countries have not discovered a panacea to encourage the production or rehabilitation of the private rental stock.

Canada, at various, times has used:

- low interest loans (Limited Dividend program with direct loans at below market rates);
- operating subsidies in the form of interest free loans or grants to enhance the rate of return on investment (ARP and CRSP);
- favourable tax provisions including accelerated depreciation (MURB program); and
- tax induced investment funds (to the extent that tax provisions facilitated syndication).

In terms of rent controls, many provinces have already deregulated or softened their policies - or are in the process of doing so.

The only mechanisms used in the other ten countries that have not been attempted to date, in Canada, are the application of favourable depreciation rates to encourage expenditures on upgrading the stock and tax-exempt bonds (as used in the U.S.).

With respect to improving the existing private stock the preference in Canada has remained direct assistance in the form of forgiveable loans under the RRAP program and similar provincial programs.

Tax exempt bonds would clearly involve new government expenditure and would require a new administrative framework to create. If there were any appetite for a tax expenditure mechanism specifically to encourage private rental development, a better option may be deductibility of losses on rental investment against other sources of income - the mechanism used in New Zealand and Australia.

Conclusions

The private rental sector is not regarded as a serious policy issue. Even though the literature, in

most countries, occasionally refers to a rental housing crisis, the evidence of a policy response in the form of specific remedial initiatives is very limited. Some policy attention is focused on the affordable rental subset of this market and on affordable homeownership stimulation. Although not yet manifest in policies and programs, there also seems to be a growing concern about labor mobility and about changing employment patterns leading to a need for tenure flexibility. This is expressed most often in Europe in conjunction with the increasing integration of economies. In this light, greater attention and development of new policies related to private renting may emerge in the near term.

Another driving factor that may elevate policy attention on private rental housing is the retrenchment in social and affordable housing programs. Arguably, the contraction of the private rented sector over the post war period was associated with the emphasis on both ownership and the social rented sector. Together, these two components of the housing system crowded out the private rental sector in many of the countries covered in this analysis. As direct provision of affordable housing through publicly supported supply programs has been universally curtailed, it is likely that some revival of the private rental sector may occur.

The issue at hand is whether certain types of public policy intervention are either necessary or desirable to guide this revival. As long as the risk-weighted rates of return on rental investment remain inferior to other investment options - both within and outside of the housing sector - private investment is likely to be limited.

While there has recently been a significant level of acquisition by Canadian Real Estate Investment Trusts (REITs - some of which specialize in multiple unit residential properties), this activity has been exclusively in relation to the existing stock. This has resulted in some modernization and upgrading, but could also act to diminish the stock affordable to lower income households. To date REITs have not invested in new multiunit residential development (Lampert and Pomeroy, 1997). In the US, however, REITs have been involved in some new rental production initiatives, and discussion with REITs in Canada suggests that in the face of an improving investment environment they may now be considering this option (Lampert 1998).

It is interesting to note that, distinct from the U.K. Finland and Australia, REITs have developed in North America primarily through the creativity of the real estate finance and investment community, not as an explicit action of government.[13] The government sponsored funds in other countries are relatively recent and it remains to be seen whether they are successful. Initial indications from the U.K. (HITs) and from Finland (REFs) suggest that without specific tax relief features they will not attract capital. Australia's attempt at government-sponsored rental housing trusts was unsuccessful due to a court interpretation, which eliminated much of the tax advantage of the vehicle.

The public policy question is whether governments believe that the low levels of rental production (relative to demand) [14] might ultimately threaten the goal of ensuring that all citizens have access to adequate and affordable housing. If this is deemed to be an issue, then policy analysts will have to determine the best approach to enhancing the attractiveness (e.g. increasing the potential rate of return or reducing risk) associated with this type of investment.

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[13] Legislation that enabled REITs to be established was enacted in the 1960s. After booming in the late 1960's REITs fell dormant and have only re-emerged in the 1990's as the investment community has sought out new ways to attract capital investment. The key feature is the ability for the corporate entity to be tax exempt, provided that it distributes 95% of taxable income to share holders - who are then liable for taxes as individual investors. For a detailed discussion of REITs see Wellman 1998.

[14] Only Germany and France have experienced high demand for rental housing, largely related to immigration.

The international experience offers little in the way of assistance in this regard since the policies and programs in other countries all involve either direct or indirect (e.g. tax based) subsidies which, as evidenced by their phasing out, are difficult to initiate or maintain in periods of fiscal constraint. Moreover, a sound foundation of analysis, involving the same types of responses already exists in Canada.

In almost all countries (as in Canada), shortages of private rental housing tend to be regional or local in nature - while other areas have an abundance of vacant stock. This suggests that a more targeted, flexible response removing impediments that may exist in the local market would be more appropriate than those traditionally provided through broad national programs. This might include addressing inconsistent property tax rates between rental and condominium properties, and reducing development fees and levies.

This is not to say that there is no need for a national perspective and policy in relation to the private rental sector. CMHC retains an important lever over investment in the form of the Mortgage Insurance Fund. Mortgage insurance was identified as a policy tool only in the U.S., where the experience has not been overly positive. However, ongoing efforts to reinvent HUD, including FHA multi-family insurance products may provide some future lessons for Canada. These activities should be monitored.

Suggestions for Future Research

Overall, this review has concluded that there may be few lessons from other countries. As such, areas for future research on the private rented sector relating to the international arena are not readily apparent. Some possible areas for consideration include:

1. The apparent health of the private rental housing sector in both Australia and New Zealand has been highlighted. There may be some benefit in developing a more detailed assessment of the success in maintaining a healthy ongoing rate of private rental production in these two countries.

2. As in the U.S., the emerging issue in Canada is not a problem of absolute supply but more specifically one of affordable supply, and the gradual erosion of affordable stock within the private sector. Some research effort should be directed to monitoring the sufficiency and affordability of the existing private rental stock, relative to affordable housing need.

3. A positive opportunity to increase investment in the private rental sector is emerging in the form of REITs. It is not clear whether the current policy framework is either conducive or restrictive to this emerging form of investment. Some exploratory research in this area may be appropriate.

4. Coupled with a review of the environment for REITs, it would be beneficial to undertake an assessment of the relative return (compared with alternate investment vehicles) and future outlook for rental investment, in Canada. This could provide some foresight on future issues that may emerge with respect to the long-term viability of the private rental sector.

Although the potential lessons from other countries are limited for Canada, the U.K. provides a sobering one. It reveals, albeit in the U.K. context, that it is difficult to revive a private rental sector once it has experienced long-term decline, such as it has in the U.K. Thus the key lesson for Canada should be the importance of ensuring that the private rental sector remains viable and competitive, and is not permitted to enter a spiral of decline through policy neglect, from which it might become equally difficult to resurrect a well functioning sector. A thoughtful research agenda is an important element in averting such a dilemma.

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Appendix: Detailed Country Profiles

This part of the report presents a profile of each of the ten countries reviewed, together with an overview of the situation in Canada. This is provided both to inform international readers and to establish a basis for comparison of the international experience.

The profiles provide some general background on the relative size of the rental stock and changes in the market share overtime. Each profile overviews the regulatory framework that exists and how housing is treated within the tax system. This review includes the treatment of ownership because the relative attractiveness of other parts of the housing system has an important bearing on the size and consumer demand for private rental housing.

A brief discussion on policy issues affecting the private rental sector highlights some of the key challenges and response pursued in recent years. A description and assessment of each of the specific programs identified is provided at the end of each profile.

The reviews begin with Canada then move through Europe, the U.S. and subsequently to the Pacific Rim:

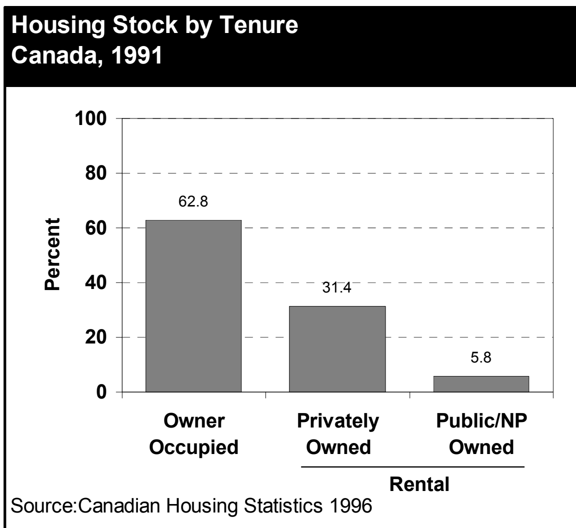
Canada A-32
U.K. A-39
Sweden A-50
Finland A-56
Germany A-60
France A-68
The Netherlands.............................. A-74
USA A-79
Australia A-92
New Zealand................................... A-98
Japan A-102

Canada

Market Context

In terms of size of the private rental stock, Canada is close to the high end of countries profiled. The total rental stock in Canada accounts for just over one-third (37.2 percent) of all dwellings, with the remaining two thirds being owner-occupied housing.

Consistent with most counties profiled, in Canada, the size of the privately owned rental stock overshadows the social and publicly owned stock (the U.K. and Netherlands being the notable exceptions). The private rental stock in Canada is 31.4 percent of the stock. Meanwhile, assisted housing, owned by public agencies (municipal housing corporations or public housing authorities) or non-profit and co-operatives comprise just under 16 percent of the rental stock (5.8 percent of the entire stock).



Unlike many of the other countries reviewed, the distribution between tenures has remained relatively constant over time, fluctuating only mildly since the 1960s.

Most of Canada's rental housing was built over 25 years ago during periods when there were strong demographic demands and a number of incentive mechanisms in place.

Trends in the Private Rental Sector

There are dramatic differences between the investment environment that exists today and that, which prevailed, in the late 1960' s, and early 1970s. Three decades ago, rental development was attractive due to the continuing process of urbanization, high demand from the baby boom generation just entering the rental market and, in the face of this high demand, low rental vacancy rates.

During the 1960s through to the early 1970s, the income tax regimes that applied to rental investment were also very favourable for investors (non-taxation of capital gains, and favourable income tax treatment). This translated to a noticeable shift in housing starts in favour of multi-family apartments - the form of building most often associated with rental in Canada.[15]

During the 1970s, a number of successive factors gradually eroded this favourable investment environment for private rental production. These included:

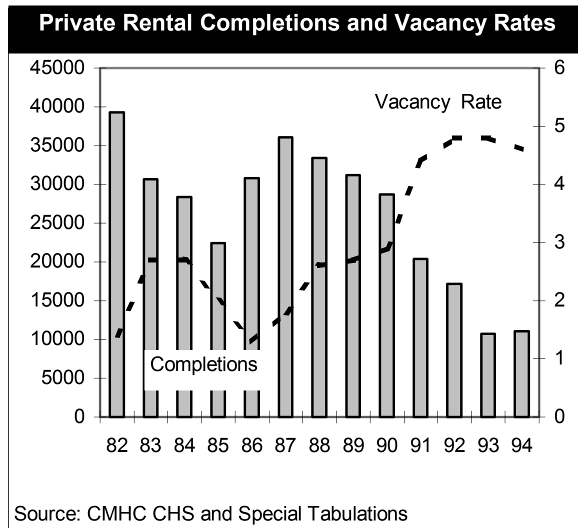
- the impact of rising inflation on both development costs and mortgage rates (rates rose from 7-9 percent in the late 1960s to over 11 percent by 1975);
- the imposition of rent controls in all provinces in 1975 (a control/review regime already existed in Newfoundland and Quebec); and
- the 1972 tax reform which introduced a 50 percent capital gains tax rate and removed tax

[15] Although rental is typically associated with multifamily housing there is a very significant proportion of stock in smaller properties, including rented homes, semi-detached houses and apartments in homes. The CMHC rental survey universe of purpose-built rental structures of 3+ units, including row projects totaled 1,839,000 in 1991 (CMHC). This compares with a total rental stock reported in the Census of 3,701,950. Allowing for some 550,000 social housing units excluded from the "private rental universe" still leaves 1.3 million units. These are either in smaller properties or rented condominium units (which fluctuate between rental and owner-occupation).

shelter arrangements open to private rental investors.

These negative influences were however concealed in the statistics of total output by a number of production stimulus programs, largely responsible for the secondary peaking of total construction in the mid 1970s. These programs included both the Assisted Rental Program (ARP: 1975 to1978) and a favourable tax measure (MURB 1974 to 1979, 1980 to 1981) that permitted rental losses to be written off against income from other sources.

In addition, the non-profit and co-operative housing programs were introduced in 1974, and overlapped with ongoing new construction of public housing (although public housing was being phased out), to further increase the level of multiple completions. While maintaining relatively high levels of rental construction, the reality of the mid- to late-1970swas that the level of unassisted rental development dramatically declined.

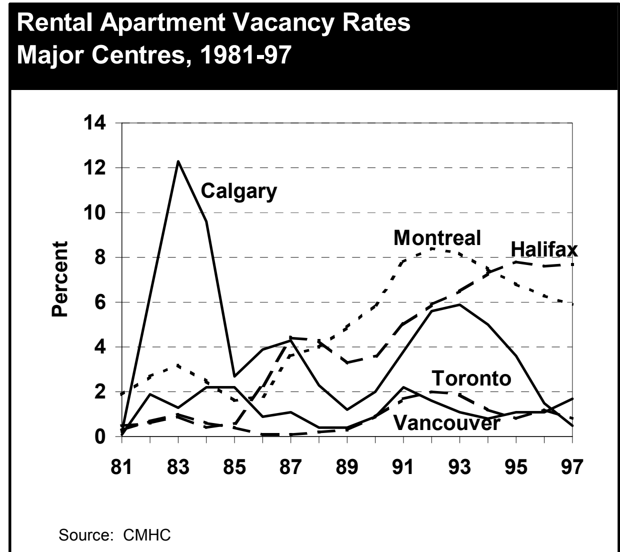


By the early 1980s, rental development had declined substantially from over 100,000 units annually to less than 40,000 units. A short-term stimulus was provided by the temporary reinstatement of the MURB program (1980 to 1981) the Canada Rental Supply Plan (1983 to 1985); both of which contributed to private rental supply.

Thereafter, there is a noticeable decline in rental completions, as illustrated in the Figure above.

A deep recession in most of Canada in 1990 to 1991 suppressed house prices, which had been surging in the late 1980s. These more affordable prices coincided with declining interest rates, which reached 30 year lows in the mid 1990s. Together these two factors contributed to a significant improvement in access to ownership and a concurrent weakening in rental demand (also related to demographics).

Weakening demand is reflecting in a significant rise in the overall rental vacancy rate, although demand remained strong in some specific larger centres - notably Vancouver, Toronto and more recently, Calgary).



Regulation

Provincial legislation which establishes the rules governing rent increases in the private rental housing stock were initiated in all provinces as part of the wages and price control program in the mid 1970s. Some provinces had rent controls before this – Quebec has the longest tradition of rent regulation in Canada, having a form of rent review in place since the 1950s.

Rent regulation has undergone many changes over the years. At present, six provincial governments continue to maintain rent regulation systems,

while three provinces – Alberta, New Brunswick and Saskatchewan have eliminated rent controls. Nova Scotia passed a regulation in 1993 exempting all rental housing from the province's *Rent Review Act* – although the act has not been repealed.

There are many similarities in the rent regulation systems in place across the country. Each of the six provinces permit rent increases only once per year, and typically require landlords to provide tenants with three months notice of an increase. Several provinces have also exempted new rental construction from rent regulation for a period of five years as an incentive for new construction.

When tenants challenge proposed rent increases, the provinces typically use similar criteria for determining the appropriateness of such rent increases. Considerations typically include: whether the proposed rent is fair in the context of the local market; the extent and nature of change in the projects operating expenses; need for capital repairs; and improvements in the building. Several provinces also consider a landlord's ability to obtain a fair and equitable return on investment as a consideration when reviewing proposed changes in rent levels.

The six rent regulation systems in Canada can be categorized into two groups:

- In British Columbia, Quebec and Newfoundland, rent regulation is primarily a complaint-driven system with no prescribed restriction on the ability of landlords to raise rents, provided there is agreement from tenants. Tenants that oppose a proposed rent increase may apply to provincial rent review boards to challenge the proposed increase.

- In Ontario, Manitoba, and PEI, rent regulations include prescribed caps or guidelines on the permitted annual rent increase that can be imposed by landlords. For 1997, the rent increase guidelines were 2.8 percent in Ontario, 1 percent in Manitoba, and 1.5 percent in PEI.

Ontario is currently in the process of implementing a new *Tenant Protection Act*, which replaces the existing *Rent Control Act*, adopted in 1992. Under this legislation, landlords will continue to be subject to the annual rent increase guidelines established by the province for "sitting" tenants, however, they will be free to set new rents when a unit is vacated. When a vacant unit is occupied the provincial rent increase guideline are in effect for as long as the tenant resides in the unit.

Income Tax and Subsidy Treatment

The income tax system in Canada tends toward neutrality with respect to tenure. The deduction of mortgage interest by homeowners is not permitted in Canada, nor is imputed rent subject to taxation. Homeowners do, however, benefit from exemption from capital gains tax on sale of a principal residence.

Rental owners are treated as businesses and income is taxed at the corporate or individual investor 's personal tax rate. All operating expenses are deductible from income and there is some allowance for depreciation. Any capital gain on disposition is subject capital gains tax.

The treatment of rental housing has been the subject of various tax reforms beginning in 1972. These cumulative reforms have resulted in:

- a reduction in the amount of soft costs that can be deducted up front (they must now be depreciated over the life of the building), a reduction in the Capital Cost Allowance (CCA) from 5 percent to 4 percent (and only 2 percent in the first year of operation);
- the termination of the pooling of properties, which allowed investors to avoid recapture of depreciation upon sale of the building (now each property is established in a separate category); and
- increased tax rates for capital gains.

Relative to the tax environment that prevailed in the early 1970s, and the beneficial tax treatment provided temporarily by the MURB program, the tax situation for investors in the 1990s is far less attractive than the case twenty years earlier.

This situation was made worse by the introduction, in 1991, of a new federal goods and services sales tax, the GST. Relative to the previous federal sales tax (FST) which was hidden within retail prices, it has been estimated that the taxes under the GST taxes on new rental housing production are up to three times higher than the previous FST (Lampert 1995). In addition, rental housing is impacted more than ownership where purchasers of new properties under $350,000 receive a rebate effectively reducing the GST to 4.5 percent. Private rental developers, however, are not eligible for any rebate so must bear the full cost of the GST and pass this onto tenants in the form of higher rents. The GST also broadens the categories subject to tax, notably services, so the fees for professionals used in the development process are taxed, increasing development soft costs.

Policy Issues

For a variety of reasons, very little new private rental housing has been built in Canada for some years now. Tax reform has removed almost all the favourable provisions that stimulated rental housing investment and production in the past (Clayton Research 1991, Fallis 1993, McNiven 1993, Lampert 1995).

Changes in the policies of mortgage lenders and insurers (notably the increase in mortgage insurance premiums in 1996 - implemented to reflect underwriting losses on rental insurance) have effected the economics of rental development by increasing the level of equity investment. Meanwhile demographics coupled with the general economic climate have combined to reduce rental demand
.

Policies and Programs Affecting Private Rental Investment

A variety of policies and programs have been used in Canada over the past two decades, with intended or untended impacts on the rental market. The major programs introduced at the national (federal) level included:

- The Limited Dividend (LD) Program (1946-1974)
- The Assisted Rental Program (1975-1979)
- The Multiple Unit Rental Building (MURB) program (1974-79, 1981)
- The Canada Rental Supply Plan (1981-83)

Each of these programs was introduced with more than one objective - typically coupling employment stimulation with housing supply. Each is briefly reviewed below.[16]

The Limited Dividend (LD) Program (1946-1974)

The LD program was introduced in an attempt to stimulate the provision of moderate rental housing to serve lower income households. Essentially the program provided high ratio direct loans (90-95 percent loan-to-value) with long amortization periods, up to 50 years.

Benefiting from the federal government's borrowing rate, the loans were provided at rates approximately 2 percent below conventional mortgage rates. Property owners agreed to limit their required return on invested equity to 5 percent or less and to operate within conditions imposed by an operating agreement. Rents had to be approved by CMHC, and were generally below market levels, and units were to be provided to households with incomes below specified thresholds.

Although subject to administrative oversight, the LD program was attractive to investors especially in times of tight money. Owners could take advantage of favorable interest rates and tax benefits related to deductibility of capital cost depreciation allowances (paper losses) against other sources of income.

Developers were also able to undertake development with minimal equity investment. Program guidelines established loan maximums based on lending values, not actual costs. This meant that developers with land, or with lower than average construction costs could effectively

[16] These descriptions are drawn partly from the CMHC Assessment Report - Evaluation of Federal Rental Housing Programs (1988).

secure financing on 100 percent of the actual cost - requiring zero cash equity.

Between 1946 and 1974, approximately 100,000 units were constructed under the limited dividend program. Despite the availability of the LD program, rental production fell substantially between 1971 to 1974, largely due to the aforementioned 1972 tax reform and inflationary pressures on interest rates.

The Assisted Rental Program (ARP)

The ARP was introduced as a component of the 1975 Federal Housing Assistance Plan in the face of weak economic conditions and low levels of rental development. ARP combined three objectives: to stimulate employment in the construction trades; to produce rental stock to meet growing demand; and to encourage private lenders to finance moderately priced rental housing.

ARP was a significant policy shift from earlier programs that hitherto had involved direct government lending. Like the LD program, an operating agreement imposed some conditions - restricting return on equity to a specified amount and limiting annual rental increases. Unlike LDs, however, rent levels were *at* rather than *below* market and, after the first year, reflected market conditions. Affordability objectives were pursued separately through the optional contracting for rent supplement commitments - which few owners exercised (CMHC 1994).

Over the 4 years of the program, three versions of ARP were used:

- The 1975 ARP initiative provided a non-taxable grant up to $75 per unit per month. The grant amount was set initially at the level necessary to generate a stipulated return on investment, and reduced gradually over 10 years.

- The 1976 version replaced the reducing grant with an interest free loan of $75 per unit/per month ($100 in higher priced markets of Vancouver and Toronto; and increased to $180 during the interest peak of 1980 to 1982). The amount of the annual loan was similarly reduced by 10 percent per year with the accumulated advance becoming repayable in the 11th year at the prevailing National Housing Act (NHA) rate.
- The 1978 program revised the funding mechanism to utilize a graduated payment mortgage. The introduction of this new mortgage instrument was intended to eliminate public subsidy by shifting the burden of mortgage payments into the future when, based on historic patterns, cash flows were higher. A Payment Reducing Loan (PRL) second mortgage provided a monthly payment established in year 1 at the lesser of the amount necessary to generate a 5 percent return on investment; or $2.25/$1000 of the first mortgage amount. Like the earlier versions of ARP, the annual payments reduced annually and were fully phased after 10 years. At this point the PRL became repayable.

In total, the three versions of the ARP program resulted in the production of some 122,000 units between 1975-79.

Multiple Unit Residential Building (MURB)

The MURB program was a tax provision, rather than an expenditure or pure housing supply program. Introduced as part of the 1975 Federal Housing Assistance Plan, it was intended to stimulate construction and employment. It partially reinstituted tax benefits available prior to 1972 tax reform. Initially a one-year tax measure, it was renewed annually from 1974 through to 1979, and again for the 1981-tax year.

The provision permitted investors to use CCA depreciation deductions (paper losses) to create or increase losses associated with rental properties that could then be used to shelter income from other sources. This provision facilitated the syndication of investment pools and generated a new source of investment for rental development.

Many MURB developments also benefited from assistance under the ARP initiative. In total, 344,000 MURB units were certified between 1974 to 1981.

Canada Rental Supply Plan

In 1982, the MURB program was replaced with a more direct approach to encourage private rental housing production - the Canada Rental Supply Plan (CRSP). The government of the day was concerned about the impact that historically high interest rates were having on economic viability of new rental production. With the Canadian economy in the midst of a recession, there was strong incentive to introduce measures that would create new employment.

The subsidy measure used in CRSP was an interest free second mortgage. A maximum loan was established at $7,500 per unit with a 15-year term. The actual loan amount, up to this maximum, was calculated as the difference between the first mortgage and 80 percent of actual cost (75 percent in the case of a Graduated Payment Mortgage).

Rents were at market levels, with no restrictions on tenant eligibility; however, proponents were required to offer one third of the units to the province for use in rent supplement programs to ensure some potential affordability for lower income households. Provinces were not obligated to enter into contracts with landlords and very few units were contracted under the rent supplement program - between 1982-84 a total of 1,526 rent supplement commitments were made so at most 6 percent of the 24,000 CRSP units were stacked with rent supplements.

Renovation and Repair Programs

In addition to supporting new construction, there has been an ongoing effort to upgrade and rehabilitate housing in general, including the private rental stock. Federal funding has supported this approach since the 1950s (Home Improvement Loans Program). Rental rehabilitation has been encouraged since 1974 by the introduction of the federal Residential Rehabilitation Assistance Program (RRAP). Many provinces have either piggybacked their own initiatives on RRAP (by adding additional funding and sometimes program criteria), or have established separate rehabilitation programs - especially in Quebec.

Although the parameters of the Rental RRAP program have been revised from time to time, over the past 25 years, the general program mechanism has been the provision of forgiveable loans to landlords who undertake repairs. The amount of loan available is determined on the basis the pre and post rehab rent levels, relative to average market rent for comparable units. Since 1986, the assistance under rental RRAP has been targeted to projects serving households below core need income thresholds. Since inception in 1974, more than 500,000 units have been rehabilitated through rental RRAP.

In the 1990s the federal government has continued to provide funding to support rehabilitation – but, like the programs of the 1970s, it is more often than not justified as an employment program as much as a housing initiative (Throne Speech 1994; CMHC Press Release 1998).

Impact of Federal Programs

In total, the four major supply federal programs contributed to the production of as many as 500,000 new rental units, while the RRAP assisted in the renovation of a further 500,000 units. In the 1970s, a decade in which the private rental stock increased by some 885,000 units, at least 300,000 rental starts were associated with federal stimulus programs.

Clearly, these programs had an impact on the level of private rental production. However, analysis indicates that net contribution of each program to rental starts is less than the actual number of commitments. A 1989 study by the University of Toronto Institute of Policy Analysis (Fallis et al 1989) concluded that, while these temporary programs initially stimulated starts, they also resulted in a contraction of activity following the end of the program.

In the short term, the programs generated an excess supply and acted to suppress rents, lessening subsequent starts. Fallis et al (1989) estimated that as a proportion of actual starts under each program only 19 percent (ARP) and 46 percent (LD) of starts can be attributed to the programs. Over the longer term, the remainder would have occurred regardless. Similarly, Smith

(1995) suggests that these supply programs appear to have increased housing starts during the 1970s by only 12 percent.

The argument that these program interventions had a distorting and undesirable effect on the rental market provided strong support to the government's desire to minimize expenditures in the face of rising government deficits. The 1985 Federal policy statement, New Directions, essentially placed a moratorium on any stimulus interventions. Although some provinces did continue to initiate programs, these were generally small in scale and relatively short-lived.

These four major federal programs were conceived in a period very different from that, which exists in the 1990s. Through the 1970s and early 1980s, demographic factors generated high levels of new household formation and rental demand, inflationary pressures were high, federal (and provincial) expenditures were growing, deficits were deepening, and a combination of high house prices and high interest rates constrained access to ownership.

The imperative to address a shortfall in the rental supply was more evident in these earlier decades than it is in the 1990s - when Canada enjoys historically low interest rates, vastly improved access to ownership, and lower levels of new renter household formation and renter demand.

Provincial Initiatives

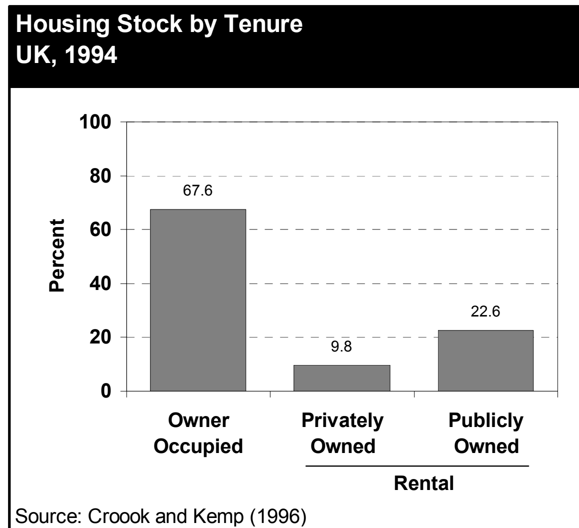
While the federal stimulus programs have been by far the most significant in terms of the volume of units produced, a number of provinces have also introduced a number of short term programs aimed at encouraging private development. These have generally been focused on higher cost centres with low rental vacancy rates. Examples of these programs included:

- Ontario Rental Construction Grant Program, which supplemented ARP with direct grants to reduce economic rents on new rental development (in place for 1977).
- Ontario Rental Construction Loan Program (1981) which provided interest-free second mortgages to private developers of rental housing.
- Renterprise (Ontario) which similarly provided interest free second mortgages up to $15,000 per unit to developers of rental housing.
- Ontario Convert to Rent Program (1983) which provided interest free loans (up to $7,000 per unit) provided to encourage installation of rental units within single family dwellings (subject to zoning compliance).
- Ontario Low-Rise Rehabilitation Program (1986) which provided loans to improve the physical condition of low rise apartments and rooming houses while ensuring that the remain affordable for low and moderate tenants.
- Quebec Rental Building Renovation Program (1990) which promoted the renovation of deteriorated rental units and rooming houses.
- Quebec Central Neighbourhoods Revitalization Program (1997) a cost shared program between the province and city to fund targeted revitalization of identified neighbourhoods. Private landlords are eligible for rehabilitation grants.
- BC Rental Supply Program, which used an interest rate write-down to reduce financing, costs for private development. Some 6,200 units were created under this program between 1989 to 1993.

U.K.

Market Context

The privately rented housing sector in Britain is one of the smallest among all of the countries reviewed, comprising just less than 10 percent of the total housing stock. It is significantly dwarfed by the social rented sector, which after peaking in the late 1970s at around 35 percent of the stock, has fallen to 22.6 percent due to the sale of local authority housing and reduction in new funding for non profit housing associations.



The characteristics of the private rented sector are an important distinguishing feature of the U.K. stock. Most properties are small, involving detached and attached (semi and terraced) houses, or houses converted to apartments - as distinct from large multi-unit properties which come to mind in the North American or even European context.[17]

Trends in the Private Rental Sector

The private rented sector has experienced almost continuous decline since the early years of the century. Very little private rental housing has been constructed since the Second World War and much of the existing stock has been sold into owner occupation or demolished in slum clearance programmes.

With new production efforts in the post war period focused on public housing and homeownership, the private rental stock continued to decline in relative terms - from 90 percent of the total stock in 1919 to less than 10 percent by 1989.

Those households that rented from private landlords tended to be low-income non-family households with weak demand. With poor returns, landlords were reluctant to invest in maintaining the stock. As it fell into disrepair and poor management, the private rented sector and private landlords became negatively stereotyped (Crook and Kemp, 1996).

Since the late 1980s, however, the privately rented housing market and the context within which it operates has begun to change. Most particularly, funding for new social housing has been increasingly constrained and the ownership sector entered a deep recession, especially in the South. Thus the traditional crowding out effect of these other two sectors is lessening.

Many owners who have had to relocate for employment were unable, or unwilling, to sell and have turned, temporarily at least, to renting their homes. The consequence is that the number of privately rented homes has increased slightly in recent years, although not because of new production.

Regulation

In Britain, rent-controlling legislation was introduced in 1915 and has remained in one form or another.[18] However, the 1988 Housing Act

[17] In part reflecting the small scale of properties and the migration between tenures, there is no formal annual survey of rental vacancy rates.

[18] England and Wales have a different legal system from that in Scotland, but in practice the two are very similar. Moreover while some legislation covers

deregulated the rents of new tenancies (lettings). Since then, rents have increased in real terms (i.e. in excess of the consumer price index and the increase in average earnings).

There are three broad categories of rental tenancy

First, there are "lettings" created since January 1989 (under the Housing Act 1988), which are free from rent controls. Rents are set by agreement between landlord and tenant. These lettings are either assured tenancies or assured shorthold tenancies (in Scotland, the latter are called short assured tenancies). Assured tenancies give the tenant security of tenure provided they pay the rent and adhere to the other conditions of the lease. There is no restriction on the minimum length of an assured tenancy. Assured shorthold tenancies are similar to assured tenancies but they must be for a fixed period of at least six months, after which the landlord has the right to possession.[19] The new Labour government has pledged to retain the tenancy arrangements introduced by the former Conservative government. Moreover, the new government has made it clear that it will not re-introduce rent regulation.

Second, there are regulated tenancies created under the 1977 Rent Act. Regulated tenancies give the existing tenant strong security of tenure and the right (which also extends to landlords) to have a 'fair rent' registered.

Since January 1989, it has not been possible to grant new regulated tenancies; however, existing tenancies remain grandfathered under this regime until the tenant leaves. At this time the property becomes decontrolled.

Third, there are tenancies to which the rent acts do not apply or which are exempt under the 1988 Housing Act. These include licence to occupy agreements, 'restricted contract' agreements made by resident landlords, holiday lettings, lettings where the landlord provides meals and support and lettings made by universities or by employers to their employees, by virtue of their employment. Although the details differ, tenants in all of these forms of exempt letting have relatively little security of tenure. The rents are set by agreement between the landlord and tenant.

In 1993, just four years after deregulation, assured and assured shorthold tenancies accounted for 55 percent of the total tenancies. This reflects the very high degree of tenant mobility with the sector. The remaining pool of (pre-1989) regulated tenancies is shrinking as existing tenants die or leave for other accommodation.

Income Tax and Subsidy Treatment

The income tax system in the U.K. tends to favour ownership tenure. Home-owners are not taxed on imputed rents, are exempt from capital gains tax and benefit from mortgage interest tax deductibility, although the ceilings on the levels subject to relief has gradually been reduced in the face of arguments that it is an unwarranted expenditure.

Landlords are taxed on their net rental and pay tax on real (post inflation) capital gains. Mortgage interest and other cash operating expenses can be used to determine net income but landlords are not eligible for depreciation allowances (i.e. non-cash paper losses).

Developing new rental housing remains financially unattractive because rent revenues do not support debt and operating expenses to provide a competitive return on equity. This has led to calls for the introduction of supplier subsidies to close the gap. Bricks and mortar subsidies to private landlords have proved to be politically controversial (though they do exist on a small scale in Scotland), but tax incentives to attract financial institutions to invest in the sector are more readily accepted.

Two specific schemes have been developed in the context of tax measures - the Business Expansion Scheme (BES) and Housing Investment Trusts

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England and Wales only, other measures affect Britain as a whole

[19] Assured tenancies are analogous to the month to month tenancy typical in Canada; assured shorthold tenancies are similar to a fixed lease period, such as those that prevail in Quebec.

(HITs). Each of these is described in some detail at the end of this profile.

Rehabilitation Grants

Grants administered by local authorities, but funded nationally to improve and rehabilitate housing have been available in one form or another since 1949. Landlords have generally been eligible for these improvement grants but rental properties account for a minority of recipients (most grants go to homeowners).

In the early 1990s, improvement grants had been available on a mandatory basis if a dwelling was deemed by the local authority to be below the "fitness standard" and on a discretionary basis if above the standard, but still in need of some remedial repair. This generated difficulties for local authorities, as they were obliged to fund landlords whose properties they condemned as unfit, even if the budget was fully expended. Concerns arose over landlords deliberately letting properties fall into disrepair and thereby qualifying for a mandatory grant.

In 1996 these grants were amended to be available only on a discretionary basis. Currently, few seem to be paid to private landlords on the basis that since deregulation government feels that landlords have the capacity to fund repairs through rent increases.

Policy Issues

In the late 1980s the Conservative government was committed to reviving the privately rented sector, premised largely on ideological grounds, but also a realization that a balanced housing system required a viable private rented sector. The 1988 Housing Act deregulated rents on new tenancies ("lettings" in U.K. terms) and made it easier for landlords to get possession (thereby improving asset liquidity). The Government also extended the Business Expansion Scheme (BES) to companies providing accommodation on assured tenancies (see section on regulation, below for discussion of assured tenancy). The tax shelter provided under this scheme to individuals investing into qualifying companies was made available from 1988 to 1993 in order to give a 'kick start' to new investment in private rental housing.

A key question is to what extent the small rebound in the size of the private rented sector was a response to:

i) rent deregulation provided under the 1988 Housing Act
ii) the temporary incentives provided by the Business Expansion Scheme;
iii) a short-term bubble created by the slump in the owner-occupied housing market

All three of these developments occurred at about the same time. In practice, it is difficult to disentangle the separate influence of each.

Prior to being returned to office in May 1997 following 18 years of Conservative rule, the Labour Party accepted that private rental housing can play some important roles within the housing market, particularly in respect of new and young households, job movers and others who require the flexibility that this tenure can provide.

The new Labour Government promised to retain the rent deregulation and tenancy measures introduced under the 1988 Housing Act by the previous government. However, it has signalled an intention to address the question of poor conditions at the bottom end of the privately rented sector by, for example, introducing a mandatory licensing scheme for landlords of houses in multiple occupation. This will force the physical improvement of existing dwellings through regulation, rather than subsidy.

Significantly, the number of dwellings lost from the rental sector increased sharply during the house price boom of the mid to late 1980s. The subsequent growth in the size of the sector occurred during the slump in the housing market and began to tail off as house prices started to recover. About half of the increase in lettings was a result of the property slump. This suggests that many, but by no means all, of the extra dwellings will be sold back into owner occupation as house prices recover from the recent slump.

Policies And Programs Affecting Private Rental Production

In a series of ongoing efforts to revive a private rental sector, the U.K. government has focused first on reforming the regulatory environment for rental housing and secondly on introducing programs to ignite investor interest.

Detailed assessments of three policies are presented below:

- Deregulation of the Rental Market
- The Business Expansion Scheme (BES); and
- Housing Investment Trusts (HITs).

U.K.: Deregulation of the Rental Market

Description of the program/ policy:

A series of legislative measures have been enacted since 1980 with the aim to decontrol rent regulation. Specific legislation was enacted in 1980, with various refinements in 1986 and 1988, which gradually reduced constraints on rent setting:

Housing Act 1980

- Deregulated rents on newly constructed privately rented dwelling let by approved landlords on a new form of letting (assured tenancies). Assured tenancies could be let at market rents and gave the tenant the right to remain in possession (except in certain, specified situations) provided they adhered to the terms of the tenancy and paid the rent.

- Introduced shorthold tenancies whereby the landlord could regain possession of the property after a defined term of between 6 months and 5 years. The landlord had to issue a notice at the outset of the tenancy informing the tenant that it was to be a shorthold. This provided landlords with greater certainty over their ability to regain vacant possession, and implement rent increases.

Housing and Planning Act 1986

- Extended rent deregulation to include newly refurbished properties let by approved landlords.

Housing Act 1988

- Extended deregulation to all new lettings and removed the need for landlord approval.

- All new lettings (except for certain exempt categories) now have to be assured or assured shorthold tenancies (known as short assured tenancies in Scotland). Tenancies were to automatically be assured tenancies unless the landlord issued a prior notice that it was to be an assured shorthold.

- Made it easier for landlords to regain possession of the dwelling.

Housing Act 1996

- Made assured shorthold tenancies the default tenancy. Landlords therefore no longer had to issue a notice at the commencement of the tenancy that it was a shorthold.

Background Context:

By North American standards, the private rental sector in the U.K. has been heavily regulated since 1915, when rent controls and a regulatory regime were imposed and have since prevailed. Policies that have supported public supply and those that favoured and facilitated home-ownership have concurrently weakened demand and potential rates of return in the private rented sector. These are important factors underlying the long-term decline in size of the private rental stock. However, the system of rental regulation has been seen as a contributing impediment to investment and revival of this sector.

The regulatory regime that existed prior to the 1980s extended strong security of tenure to existing tenants - an increasing number of whom were elderly and had been long-term tenants. Relatively low rents and quite restrictive policies on eviction and repossession of the property impacted both rent revenues and potential to liquidate the asset. The regulatory legislation, not only impacts levels of rent increase, it has created different types of tenancy, the earlier versions of which tended to encumber the property.

As detailed earlier, three broad categories of tenancy currently exist in the U.K.:

1. *Regulated tenancies* created under the 1977 Rent Act
2. *Assured tenancies or assured shorthold* tenancies under the Housing Act 1988
3. Tenancies to which the rent acts do not apply or which are exempt under the 1988 Housing Act

In 1993, just four years after deregulation, assured and assured-shorthold tenancies accounted for 55 percent of the total. The remaining pool of grandfathered regulated tenancies is shrinking as existing tenants die or leave the rental sector.

Specific Purpose/Objectives

The objectives of deregulation were to allow rents to be set by market forces with the expectation that this would provide more attractive investment and stimulate greater interest in the private rented sector.

Duration and level of funding

The new regulatory framework established in 1988 remains in place in 1998 although tenancies that had commenced under previous legislation are grandfathered under the earlier legislation. As a regulatory measure, there is no funding component.

Impact and success of the initiative

Policies to deregulate the rental sector have been introduced within a package of other policies and have also coincided with a very significant boom and bust period in the U.K. property market. Consequently it is impossible to distinguish individual cause and effect impacts among a number of factors, nor to attribute any specific impact to deregulation (Crook and Kemp 1996).

Conceptually, for rent deregulation to have an impact on investment in existing properties or to stimulate new rental construction, rent levels would have to increase substantially. Since 1988/89, rents have increased faster than either the rate of increase in average earnings or the consumer price index.[20]

Analysis of official data indicates that the number of private dwellings that are rented increased between 1988-93 by 14 percent, from 1.8 million to 2.05 million dwellings. However, most analysts

[20] This may be a reflection of a shifting pool of renters coupled with significant reform to the shelter allowance program (Housing Benefit) that on the one hand increased the benefits for lower income renters but also restricted eligibility.

attribute this increase more to the collapse in the property market than to rent deregulation. [21]

The tax incentives under the Business Expansion Scheme (discussed separately) were also a minor factor during this period, explicitly contributing 81,000 dwellings to the increase.

Private (largely small-scale) landlords are reported to have a greater level of comfort with the new regulatory environment, compared with the 1980s and 1970s. The regime allows them to charge what they feel are more reasonable levels of rent to cover maintenance and to generate a small return. However, while long term, small-scale landlords express a more positive view, compared to the past; the rates of return remain inadequate to attract new investment - except that linked to tax shelter schemes, such as the BES.

Current Status

The change in government in the U.K. has not resulted in a reversal in the policy of rent deregulation. The "New Labour " government has acknowledged the desirability of a well functioning private rented sector to complement the social rented and ownership components of the housing system.

Lessons for Canada

The overall conclusion drawn from the research of the private rental sector in the U.K. is that rent deregulation appears to have been a necessary through not a sufficient condition for improving the economic viability and attractiveness of the private rental sector (Kemp and Crook 1996).

Because the U.K.'s private rented sector has experienced an extremely long and gradual decline, this observation may be less applicable in Canada, though uncertainty about future regulatory reforms, and (in some provinces) constant tinkering with the regulatory mechanism may tend to leave investors wary of this sector. Clearly rates of return would have to exceed those available from other investment options which enjoy greater predictability and are perceived as lower risk in relation to investment in rental properties.

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[21] Crook and Kemp (1996) estimate that approximately half of the increase in lettings between 1988 and 1993 was accounted for by ‘property slump’ landlords letting accommodation that they could not, or were unwilling, to sell because of the fall in house prices.

U.K.: Business Expansion Scheme

Description of the program/ policy:

The Business Expansion Scheme (BES) is a tax shelter measure providing tax relief to individual investors in companies established under this initiative. Initially established in 1983 to raise venture capital for manufacturing companies, the BES was expanded in 1988, on a 6-year demonstration basis (1988 to 1993), specifically to include investment in private rental housing.

Individual investors were permitted to invest up to £40,000 in a tax year. Tax relief involved tax deductibility of income invested in BES shares and any real capital gains remained untaxed, provided that the investment was held for a minimum of 5 years.

A company engaged in providing rental housing was permitted to raise a maximum of £5.0 million in any tax year under the BES. At least 80 percent of the capital raised through the BES had to be invested in assured tenancies and the properties had to remain as rental for at least four years. The properties acquired had to be valued to no more than £125,000 per unit in Greater London and no more than £85,000 per unit elsewhere.

Background Context:

In the U.K., the private rented sector is a very small-scale enterprise dominated by individual investors rather than companies. Rental investment is seldom the core business of the investor; it is a sideline used to supplement income.

In the latter half of the 1980s the U.K. government expressed a desire to revive and expand the private rental sector, arguing that it was a good option for people who needed mobility and did not want the ties of homeownership (Department of the Environment 1987). In part, this policy direction reflected the government's ideological view that strongly favoured privatization and promoted the free market. Given the long-term decline of this sector, the focus of attention was primarily on reviving private ownership, not necessarily stimulating new production.

A number of earlier efforts, beginning in the 1960s had sought to revive investment in private rental housing by decontrolling rents (see separate analysis of rent deregulation policies). However, the outcome of these efforts suggested that that removal of rent controls might be a necessary but not sufficient condition to revive the sector. The critical problem was still the lack of a competitive return on investment, which was associated with weak effective demand, the inability to compete with subsidies in the social rented sector and the tax advantages of homeownership.

The government's rationale and intentions were articulated in the 1987 white paper *Housing: The Governments Proposals*. The mainstay of this policy position was that it was not enough to simply decontrol rents and expect market forces to remedy the longstanding weakness in private rental investment. The white paper proposals, and subsequent enactment, coupled decontrol with a subsidy stimulus (BES) to get this sector onto a more viable footing (Crook et al 1991).

There were no restrictions or targeting on the income levels of tenants to be housed in projects undertaken through the BES. Moreover, the BES was introduced in concert with rent deregulation and with a set of policies that were aimed at creating a more market-oriented framework. Subsidies to Local Authority (public housing) and Housing Associations were reduced with a consequent increase in rents. Rising rents in the social sector, and the portability of Housing Benefit (a shelter allowance) were intended to enable the deregulated private sector to better compete for tenants.

Specific Purpose/Objectives

The principal objective of the BES was to raise capital to support start up enterprises - this covered a range of activities but initially excluded rental investment. Specific amendments to the Finance Act 1988 added companies whose principle business would be the provision of rental housing. The goal was to promote the establishment of companies providing private rental housing on an

assured tenancy basis (i.e. it excluded short-hold tenancies).

The objective of the demonstration was to overcome investor concerns about investment in rental housing. It was hoped that once the BES demonstration period expired, investors would be sufficiently assured that they would continue to invest in this sector, even without tax advantages.

Although eventually new investment should lead to new production, the initiative was not designed to stimulate new construction - its focus was solely on encouraging private investment in a sector that had for some time been seen as an unattractive investment.

As noted above, there was no targeting or restriction on tenant income levels.

Duration and level of funding

The BES demonstration was in place from 1998 through 1993, just under 6 years. Because it was a tax expenditure initiative there was no explicit budget or subsidy flow. Estimates by Crook et al (1995) have assessed the total lost tax revenue as £1.7 billion; £20,874 per unit (44 percent of the cost of the average unit), assuming that the invested capital was diverted from tax generating alternatives. [22]

The tax expenditure cost per unit fell over the term of the demonstration due to the slump in real estate markets (and lower acquisition costs) as well as the emergence of university-linked and mortgage repossession BES companies in the later years of the initiative.

Impact and success of the initiative

Over the course of the demonstration 903 BES companies were launched, notably almost one third of these in the last nine months of the initiative. Two types of companies were created:

i) entrepreneurial companies which offered return in the form of rental income and unlimited capital gain or loss; and

ii) "contracted-exit" companies, which provided a fixed return at the end of the BES period. These were typically linked to a long term owner such as universities, housing associations or mortgage lenders who contacted to purchase the BES companies property, providing an exit for the shareholders (individual investors).

The majority of BES companies were sponsored by a financial services company - that is, they were in the business of tax syndication, rather than real estate. With a deep recession in property markets in the late 1980s the attractiveness of the entrepreneurial companies was limited and there was considerable uncertainty about the liquidity of the investment and real capital gains. The contracted exits did much to overcome this liquidity constraint, and were primarily responsible for the large number of BES companies established in the final nine months of the program.

The companies raised capital through a variety of mechanisms including the issue of a public offering prospectus or memorandum (to buy shares in the company or shares in a fund, which would then invest in properties) or through private placements. The public issues generated a total of £2,975m, which was augmented by private share placements of £440m for a total of £3,415 million. The issue costs (underwriting fees) amounted to some £185million yielding a net of £3,278m.

This capital was invested in the purchase of properties containing some 81,000 existing units. One-quarter were repossessed properties held by lending institutions; 40 percent were university accommodations, 10 percent were housing association projects and the remaining 25 percent involved entrepreneurial companies. The average per unit acquisition cost was £56,900 in Greater London (35 percent of properties) and £40,000 overall.

The total number of companies (903) as well as the number of units (81,145) indicate that the BES companies were quite small - average holdings of only 90 units. Although in the context of existing investors in the U.K. they are quite large; most

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[22] During this period the exchange of the pound fluctuated around Can$2.00

investors in rental properties own less than 10 units.

An unintended consequence of the BES scheme was the opportunity for universities (facing increased enrollment and need for student housing) and housing associations to expand their portfolios of rented properties. It also enabled mortgage lenders to move repossessed properties off their books. In each case, the third parties sold property to the BES company and contracted to buy back the property (or shares in the company) after 5 years. The universities and housing associations gained access to cheap capital and during the five years were able to invest the proceeds from the sale, until they used to funds to repurchase the units.

Crook and Kemp (1996) report that only 37 percent of properties were acquired primarily as investments for rental income or capital gains - more than half were purchased by "investors" such as socially oriented housing associations, universities or employers providing employee housing. These purchasers were not motivated by the opportunity for a commercial rate of return. So only a minority of investors were likely to respond in a commercial way to market signals like rents and changing liquidity.

Overall, the BES was not successful in demonstrating that a competitive rate of return can be generated through investment in the private rented sector. BES company directors felt that the returns on investment remained inadequate, and without tax incentives, new investment was unlikely - in short the government failed in its objective to increase future investment, without subsidy.

A survey of BES investors determined that individual investors and companies still wish to see easier repossession, less troublesome tenants and higher rents (Crook Hughes and Kemp, 1995). They also wanted to see less tax on rental income and capital gains (for non-BES properties). Financial institutions remained lukewarm to investing in this sector. They were not overly interested in equity investment without some form of intermediary property management company - and in the absence of sound financial returns, the emergence of a corporate property management infrastructure seems unlikely.

Current Status

The BES period ended, as planned at the end of 1993. Companies are required to maintain their operations only for 5 years (i.e. those created in 1993 are now, in 1998 fulfilling their BES requirements) and can sell the assets and dissolve the company. Due to the recession in property prices many of the initial entrepreneurial companies are likely to hold their properties until prices recover more. However, over time it is possible that many of the properties could be sold either to new investors, or converted for ownership occupancy - most are expected to wind -up operations once the qualifying period has expired (Crook and Kemp 1996).

Lessons for Canada

This experience in the U.K. has limited application to Canada, largely because the context was so different. The primary issue was the very small size of the private rented sector, a long-term disinterest on the part of investors in this sector and an ideologically motivated desire on the part of government to rekindle private investment. The emphasis was on investment (largely focused on existing properties) rather than new production.

Context notwithstanding, even within a comprehensive framework of change that incorporated tax reform and rent deregulation, this implicitly subsidized tax expenditure mechanism was still insufficient to have any significant impact in stimulating greater ongoing interest in private rental investment. The potential yields on investment were simple not sufficiently attractive.

Perhaps the most significant lesson is that it reveals, albeit in the U.K. context, that it is difficult to revive a private rental sector once it has experienced such a long-term decline. Thus the key lesson for Canada should be the importance of ensuring that the private rental sector remains viable and competitive, and is not permitted to enter a spiral of decline through policy neglect, from which it might become equally difficult to resurrect a well functioning sector.

U.K.: Housing Investment Trusts

Brief Description

Housing Investment Trusts were created in 1996 as a vehicle to attract investment in rental housing from financial institutions, and thereby to revive and expand the size of the private rented sector (in 1993 still only just over 10 percent of the total housing stock in the U.K.).

Somewhat like a Real Estate Investment Trust (REIT) created in North America, HITs enable *an institution* to invest in a trust set up to own and manage private rental property. Under the Finance Act 1996, HITs are exempt from paying capital gains tax and pay corporation tax at the lower, small company's rate (24 percent versus 33 percent in 1996).[23] This more specific investment objective and fact that they retain some tax liability distinguishes the HIT from REITs.

Background Context:

Within the overall strategy to revive the private rental sector, government policy has sought to make rental investment more attractive and to professionalize this sector. This has involved stimulating financing from financial institutions and encouraging the formation of property companies (distinct from the predominant small-scale individual ownership), largely via the BES discussed earlier.

Following the end of the BES demonstration period, in 1993, and the assessment of its limited success (see separate review of the BES), analysts and commentators maintained that if the goal of reviving the private rental sector was to be pursued, a greater level of direct investment from the financial institutions was crucial (Best 1992, Crook et al 1996). On this basis, the government's 1995 Housing White paper proposed Housing Investment Trusts (HITs)

[23] The small company and corporate tax rates were further lowered to 21 percent and 31 percent in 1997. In addition the government has announced its intent to lower these rates still further in 1999, to 20 percent and 30 percent respectively.

Specific Purpose/Objectives

In light of reluctance among private institutional investors to take a direct ownership and management role it has been necessary to create an institutional framework of professional property management companies (the BES assisted this pre-requisite goal). HITs were established as a vehicle through which financial institutions could invest indirectly in rental properties, to capitalize new companies and to facilitate property acquisition (new development is also possible, but not the primary goal).

Impact and Success of the initiative:

HITs are a recent measure and it remains early to asses their impact. However, analysts are skeptical about their potential (Coppers Lybrand 1998). No HITs had been established by March 1998.

In order for HITs to achieve their goal of increasing corporate investment, competitive rates of return will be necessary to induce new investment. Although actual experience is limited by the recent implementation of this measure, it is possible to simulate the impact of the HIT related tax advantages. Crook et al (1996) undertook such an assessment, using data obtained from a 1993/94 survey of landlords. The analysis compares the rate of return that would be generated by investing in a HIT compared with direct ownership. As an owner the investor as owner would pay corporate tax at the full rate and be subject to capital gains; as a HIT investor they would earn and be taxed on dividend income).

The analysis by Crook et al (1996) determined that the rate of return on the alternate property investments would be marginally better under the HIT. But, returns are unlikely to reach a comparable hurdle rate (as represented by returns on commercial properties or on much lower-risk median-term government securities).

The minimum size of HITs is £30m compared with a maximum of £5 million for property companies established under the BES. Some potential for more favourable returns was suggested if HITs are able to achieve economies of scale in their management and maintenance costs

(Crook et al (1996). The analysis found that the achievement of economies would have a larger impact on the rate of return than the tax advantages built into HITs. However, even with this advantage, investment in residential rental property would only match returns available in the commercial sector, which have a more established track record and are less vulnerable to regulatory regimes, and thus perceived to be lower risk.

Coopers and Lybrand undertook a more recent assessment in 1998. This study examined the creation of HITs, interviewed a wide range of potential participants and partners and identified barriers and necessary steps to make HITs sufficiently attractive to generate investment. The study attributed the slow start in initiating these investment vehicles to onerous, and uncoordinated, administrative and oversight measures.

In addition, the study suggested that HITs should be tax transparent (i.e. tax-exempt) in the same way that REITs are treated in North America (i.e. the income is taxed in the hands of the investor not the conduit).

The consensus of opinion in the U.K. is that, in their current form, HITs are not sufficiently attractive to financial institutions. The fact that after two years no HITs have yet been successfully created attests to this reluctance.

Duration and level of funding

HITs were only introduced in 1996, there is current no sunset clause - they are indefinite in duration. There is no explicit funding - the more favourable tax provisions do however impose a tax expenditure cost on the treasury.

Current Status

Active - but none yet created.

Lessons for Canada

HITs are an inferior investment vehicle to the REITs that are now proliferating in Canada. Compared to REITs, HITs retain some tax liability and have also been constrained by quite onerous structural requirements imposed by tax authorities and the Stock exchange.

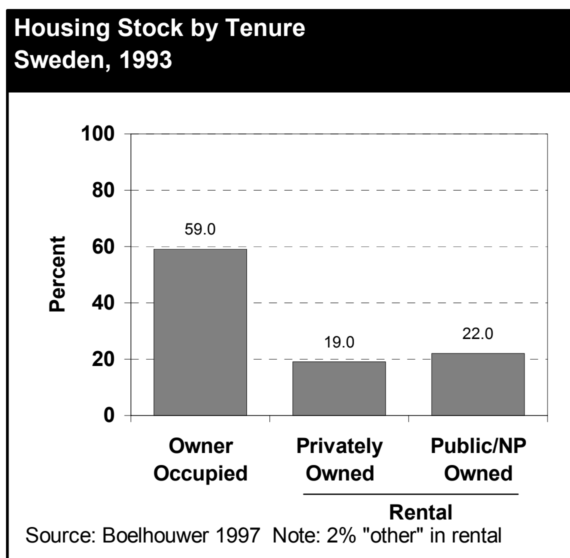
Given the availability of REITs there is no merit in considering HITs in Canada.

Sweden

Market Context

Among the countries reviewed, Sweden has the second largest rental sector, after Germany. In total 41 percent of Swedish households rent their dwellings with just over half of these renting in the social-rental sector. Some households rent from employers (total of 2 percent) and here these are included with private rental). The ownership sector is comprised of both individual owner occupants (44 percent of all households and collective ownership in the form of cooperatives (15 percent of all households).

Only a very small proportion of single detached dwellings are rented, and multi-unit properties are exclusively rental or co-operatives.



Beyond the nature of ownership and age of the properties, there is very little difference between the rent levels and type of accommodation provided in the private and social rented sector. Social housing is owned and operated by municipal companies and rented out to anyone - there are no specific eligibility or targeting criteria, nor any allocation mechanism to place lower income tenants in the publicly owned stock. The income distribution of tenants in each sector is also relatively similar, although there is a higher incidence of lower income households in the public rented stock (e.g. 36.5 percent of tenants in the municipal public are in lowest three income deciles; versus 30.7 percent in the private rental sector).

A housing allowance subsidy system provides relief to lower income households but is independent of tenure or type of ownership. In practice, however, most recipients are renters, as owners require high incomes to access this tenure. Consequently, few owners qualify under the income targeting of the housing allowance.

The relative cost of renting and owning appears to favour the rental sector, where monthly rents tend, on average, to be about half of the costs of owner occupation. However this is due to differences in size and amenity of dwellings. Owned homes are, however, generally considerably larger and based on a cost per square metre are much closer to renting. The larger size and absolute costs both for downpayment and carrying costs, constrains access to the ownership sector, while maintaining strong demand for rental and co-operatives.

Trends in the Private Rental Sector

The relative size of these four components of the housing stock has shifted considerably between 1960 to 1980, with private rental housing experiencing the most significant decline from 43 percent in 1960 to 21 percent in 1980, where it has stabilized through to the 1990s. Between 1960-80, the most significant change was in the size of the public rented sector (e.g., from 14 percent to 24 percent), while the proportion of coop and individual owners saw small gains. Since 1980, the size of each component has fluctuated only marginally.

Just over half (54 percent) of the private rented stock was constructed prior to 1950, while most of the public stock began production after 1950. Although 86 percent of the public stock was completed before 1975, it tends to be newer, and thus more marketable than the private stock.

Regulation

Sweden also has a unique system of rent regulation - essentially a collective bargaining process, driven by the large municipal housing companies and the equally large tenants union, which most tenants join. Until the market based reforms in the early 1990s, this system had the following features:

- Each year a level of rent increase was negotiated between these two parties. Rent increases in the public sector (municipal companies) were premised on a breakeven non-profit rent, derived from pooled properties, so that older properties averaged down higher new costs. Once established through this negotiated process, rents in the social sector set the standard for the private rented sector.

- These negotiated rents were then used as an upper limit on comparable private rented units, where rent levels were negotiated on an individual basis between landlord and tenant. Where they could not agree on a rent, recourse was to an arbitration process through the courts.

The negotiating process set uniform rents for an entire municipal housing company (these are typically large with holdings of 4,000-6,000 units). More recently (1990) this system has been reformed to move to a more market based approach. Rents are now determined at a project/neighbourhood level which takes age, amenity and location into account. Rental law has been amended to remove the leading role and effective ceiling rents negotiated in the social rental sector - and municipal housing companies are being encouraged by their municipal shareholders to generate profits.

Thus, while, in theory there is no rent control, in practice, this process effectively means that rents are tightly controlled, albeit not by legislative edict. Until the recent reorientation to a more market based approach by the municipal companies, the attractiveness of private rental investment has been limited by this social sector imposed limit on rent increases. In addition, the size of the municipal companies and their consequent ability to carry losses on new development through cross-subsidization has given them a competitive advantage over the typically smaller private investors.

In summary, the relative attractiveness of private rental investment has been diminished by the strong influence of the public rented sector. This has suppressed rents and the viability of private investment in new production. Recent regulatory reform has responded to this problem and may lead to new private investment.

Tax and Subsidy Treatment

Among all countries reviewed, the tax system in Sweden comes closest to tenure neutrality - in fact this is an explicit objective of Swedish housing policy - the Swedes seek to maintain freedom of choice in housing tenure such that comparable dwellings cost the occupant the same, regardless of tenure. In the various subsidy mechanisms that have been implemented, specific provisions are made to balance the combined effect of measures to maintain neutrality - for example because owners benefit from mortgage interest deductibility, the shelter allowance benefits for renters versus owners are adjusted to take the owners interest deduction into account. Similarly with regard to the interest subsidies for new construction the basis for calculated assistance is adjusted to first neutralize the tax impact of the mortgage interest deductibility.

- Housing is treated as an investment good for owners and rental investors alike. Both benefit from mortgage interest deductibility (30 percent of interest cost is deductible - this was 100 percent until 1982 tax reform when it was reduced to 50 percent; and subsequently to 40 percent in 1990 and 30 percent in 1991). In the case of owners this is identified as a tax subsidy; however, for rental landlords, interest expenses are seen as a legitimate business expense, not a subsidy.

- As one of the few counties where this complicated practice is used, owner-occupants are subject to tax on imputed rent.

- Individual owners and property investors are similarly subject to capital gains tax. The capital gains rate slightly favours rental investors (gains are taxed at 28 percent) over owners (30 percent).

- An annual real estate tax was introduced in 1982. Following a rate increase in 1992, tax is levied against owners at a rate of 1.5 percent of the assessed property value (75 percent of market); the real estate tax on rental is higher at 2.5 percent of assessed value.

- A housing allowance subsidy is paid directly to low income households (tenants and owners - although it favours families as the number of children is a factor in determining the level of the allowance).

- Since 1975, an interest subsidy has been available to encourage the construction of both rental (social and private) and owner-occupied housing. Because owners benefited from mortgage interest deductibility, the interest subsidy to the ownership sector was smaller than that in rental. This specific program is discussed in greater detail below. In 1992, in response to escalating subsidy costs, it was announced that the interest subsidy system would be phased out over a ten-year period.

Overall, Sweden is unique in its efforts to maintain tax neutrality between the different tenures. This has tended to complicate both subsidy mechanisms and tax reforms as the indirect impact on the neutrality objective must be taken into consideration.

Policy Issues

Given the size of the public rented sector and the fact that the stock characteristics and rents are similar to those in the private sector, there is direct competition between these two sectors.

To some extent, however, there is unfair competition, as the municipal housing companies tend to be larger than the owners of private rental properties. The public landlords have an almost monopolistic influence on the local market. Their large size and geographic extent affords them the potential to cross-subsidize their portfolios - using surplus from older properties to subsidize the rents in new developments. Thus the large public sector companies have cost advantages in new production, relative to private owners, who by comparison have smaller holdings and would be required to carry negative cash flows in order to maintain rents at a competitive level.

The system of interest subsidies, owner-occupant tax deductibility and housing allowances that have been in place since the mid 1970s have led to escalating levels of government expenditure on housing. To address this expenditure problem, a series of reforms were proposed between 1989-91, as part of a broad tax reform.

The first (and only reform measure implemented) was the reduction in basic housing subsidies implemented through the phasing-out of interest rate subsidies on new construction (all tenures) and the reduction in marginal tax rates that impact on deductibility of mortgage interest for owner-occupants.

Two other proposals focused on potential replacements for the phased out interest rate subsidies, however, these were not implemented.

Policies and Programs Affecting Private Rental Production

The primary vehicle encouraging rental production and rehabilitation has been the system of interest subsidies, which apply to all tenures, not just private rental - these are described in detail at the end of this country profile. There have not been any other initiatives specifically targeting private rental production.

The Commission on Housing (1996) has proposed a further set of reforms. The key element of these new proposals (still under consideration) is the introduction of a new subsidy system that would convert the annual interest rate subsidy expenditure into a one time capital grant paid to the owner/developer. The Commission has proposed a grant based on 10 percent of acceptable construction costs.

The phasing-out of interest rate subsidies is generally expected to result in overall lower levels of new construction for both owner-occupied and rental housing (Englund, et al 1996). This may be offset by some form of replacement measure, such as those noted above by the Commission, however these are yet to be finalized or implemented.

Sweden: Interest Rate Subsidies

Brief Description

Since 1975, the subsidization of mortgage interest rates has been the principal vehicle in support of both new construction and rehabilitation of housing in Sweden. This subsidy mechanism is not exclusive to the rental sector but applies equally to all sectors of the housing system - including owner- occupied, social (municipal) rented, co-operative and the private rented sectors.

New Construction:
These subsidies are established in the initial year of operation and effectively reduce the interest cost to a low "guaranteed interest rate" (4.9 percent for owner-occupants and 2.45 percent for private rental developers). The interest subsidy is reduced each year by .25 percent (0.5 percent for owner-occupants) such that it gradually decreases and is fully phased out once the annual adjustments cause the effective rate to equal the actual contracted mortgage rate. Generally this occurs after 13-15 years, depending on prevailing interest rates at time of construction. In 1992 the annual step out for rental properties was raised to .35 percent. Because of the gradual adjustment, the subsidy on older properties is lower than that on new development ones.

Rehabilitation and improvements
In 1982, a similar subsidy mechanism was implemented as part of a 10-year plan to encourage upgrading of properties- but only for the rental and co-operative sectors. Under this initiative, the guaranteed interest rate for private rental properties was 5.1 percent with the annual step-out set at .25 percent. High rates of economic growth and household formation in the mid 1980s increased pressure for new construction and led to a 50 percent reduction in the interest subsidy on rehabilitation, as more subsidy was required to keep up with demand driven new construction.

As noted previously reforms announced in 1993 are directed at gradually phasing out this system.

Background Context

Permanent financing for residential construction in Sweden is financed with a joint loan from the private lender, covering 70 percent of the eligible costs, and a second mortgage from a government financial institution, covering 25 to 30 percent of the cost - depending on tenure. In total, municipal housing companies can borrow up to 100 percent; co-ops - 99 percent and owner-occupants and rental investors - 95 percent of the eligible cost, with the remainder coming from their own equity. The full combined loan is eligible for the interest rate subsidies, which also vary by tenure in order to compensate for other subsidies, notably tax subsidies for owner-occupants.

The system of interest rate subsidies was introduced in 1974 as part of a series of reforms in housing policy. This subsidy system combined with strong demand to propel high levels of construction. The result was a surplus of housing in many cities. Government policy consequently shifted from a focus on new construction to addressing problems of housing condition.

Concurrently, the new policy framework sought to equalize levels of assistance and choice across tenures. Mortgage interest deductibility for owner-occupants had been in place for some time and it was not politically attractive to eliminate this benefit. The reforms consequently pursued a goal of tenure neutrality by customizing specific subsidy and finance measures to take other tax subsidies into consideration.

When the system of interest subsidies was implemented in 1975 mortgage interest rates were in the region of 7 percent with the subsidy bridging the difference between this and the initial guaranteed rate for private rental construction of 2.25 percent. Subsequently, through the late 1980s interest rates rose to the 14 percent level, substantially increasing the subsidy cost. This escalation in subsidy costs underlies the pressure for reform (and the current policy of phasing out the system).

A second important factor impacting the policy context is the integration in the European Community - Sweden is required to bring itself more in line with other countries, which requires reform of the country's tax and subsidy systems. With Sweden still maintaining a policy of tenure neutrality, tax reforms that impact the value of the mortgage interest deductibility of owner-occupants reverberate through the system and will require revisions to the rest of the subsidy framework.

Specific Purpose/Objectives

Within the overall housing policy reforms of 1974, the interest rate subsidy was introduced with the specific objectives to:

i) limit capital costs (affordability objective);

ii) harmonize capital costs across the housing stock built in different periods (parity objective)

iii) To harmonize the effects of financial regulations across different tenure classes

Impact and Success of the initiative:

Because of the policy of tenure neutrality, the impact of this measure specifically on rental production is not possible to ascertain. The availability of the mortgage interest subsidies, as well as the relatively high ratio mortgages (requiring minimal equity investment) previously made housing a less costly investment than non-housing investment (Turner and Berger 1993). Conversely, phasing out of the subsidy is expected to make housing a comparatively less attractive option.

In undertaking projections on the impact of phasing out the interest rate subsidy, Englund Hendershott and Turner (1995) have determined that total housing output declined by 10 percent as a result of tax reforms in 1991-92. The phasing out of subsidies commencing in 1993 was assessed as likely to decrease demand by a further 3-4 percent.

These estimates relate to overall housing output (they did not explicitly assess the rental sector). As such it is difficult to isolate the impact of the subsidy reduction specifically on rental production. It appears however that investment will fall.

On the other hand, the subsidy cost borne by government has mounted over time, first due to rising interest rates through the 1980s; but also as each new year of interest subsidies are layered on.

Through an economic boom in the later 1980s housing starts grew strongly to 64,000 before falling precipitously since 1990 to less than 11,000 in 1994. This decline is attributed in part to the announced phasing out of subsidies, but also reflects a deep economic recession in the early 1990s, high unemployment and weak demand, high real interest rates and over investment in the late 1980s.

Duration and level of funding

In place from 1975 to 1993 - now gradually being phased out. At its peak in 1992 the expenditure was some 35 billion Swedish Krona. By the year 2,000 the annual expenditure will be below 5 Billion SEK.[24]

Current Status

As above - being phased out

Lessons for Canada

The interest rate subsidy significantly lowered the effective cost of housing for Swedes, regardless of tenure. It has, however, proven to be politically unsustainable, due to the mounting costs, especially in periods of high interest rates. Such a costly mechanism is unlikely to have any appeal in the fiscal environment that prevails in Canada in the 1990s.

A range of other reforms that impacted tax rates and credit influenced this specific initiative. As such, it is extremely difficult to isolate the impact of a single initiative. The specific context in which a policy or program was implemented and used are extremely important to understanding specific policies. This is an important case in point - the lesson being that the transferability from one country, and one particular context to another country with a totally different context may be limited.

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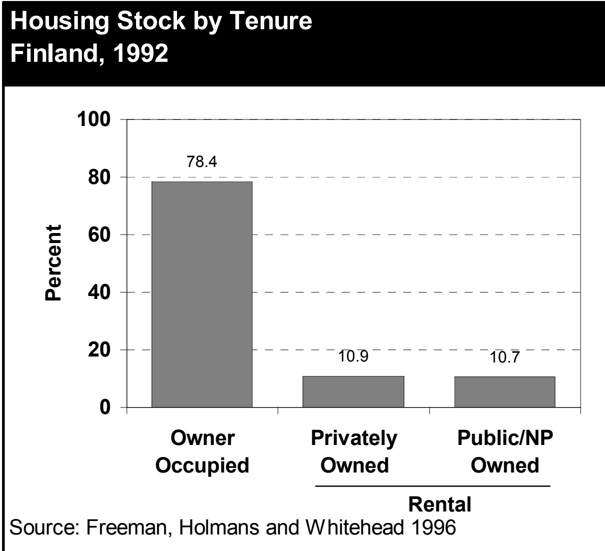
[24] The current exchange on the Swedish Krona is Can$0.2058

Finland

Market Context

Finland has one of the highest rates of homeownership in the western world – 78.4 percent of all households.[25] The private rental sector comprises less than 10 percent of total households. Even among young, childless households, only one in four households rents in the private sector[26].



There are two major reasons for the historic dominance of homeownership. The first is tax support: capital gains resulting from the sale of an owner-occupied dwelling are not taxed; imputed rental income is taxed only slightly; and interest payments on housing loans are deductible (first time buyers can deduct 30 percent of their interest payments while others can deduct 28 percent.[27]) In addition, first time buyers under the age of 30 may receive an interest rate subsidy over the first six years of loan repayment, an incentive that undoubtedly explains much of the evident lack of appeal of renting among young households. Owners may also qualify for housing allowances if their income is low enough.

The second reason for the dominance of homeownership is rent control, now largely abandoned but for many years a prominent feature of Finnish housing policy. Some observers have suggested that while they existed, rent controls functioned as an effective impediment to a larger rental sector.[28]

The Finnish government has historically been a major player in the housing sector. During the last few years, state subsidized building has accounted for about 70 percent of total housing activity, an objective accomplished primarily through the operation of the Housing Fund of the Republic of Finland.[29] The Housing Fund has several roles:

- it operates subsidized lending and repair grant programs;
- it supervises construction costs and the quality of subsidized housing; and
- it analyzes the housing market in order to avoid excess supply and consequent credit losses.

In an effort to reduce the amount of direct spending provided by the Housing Fund, the government securitized a portfolio of existing multi-family rental loans in late 1994. This was the first public securitization sponsored by an agency of a European central government.

Regulation

Rent control existed in Finland between 1967 and 1991. The government set annual rent levels for

[25] According to Finland's 1992 Census. When calculated on a dwelling unit basis (rather than on a household basis), the ratio is somewhat lower (67 percent) because some dwellings are not in residential use.

[26] This may be something of a chicken and egg situation. Booth and Glascock (1995) point out that "young families' efforts to obtain housing are seriously hampered by undeveloped rental markets, a problem that produces more pressures to provide aid to first-time buyers of owner-occupied dwellings.

[27] Freeman et al.

[28] See Booth et al.

[29] Ministry of the Environment, May 1998.

different types of accommodation based on the recommendations of a rent control board, which included both landlord and tenant representatives.

Starting in 1992, regulations were gradually relaxed. By May 1995, rents in the private sector were completely deregulated, although rents in the social rental sector are still limited to cost recovery levels.

Many industry observers (Booth for example) believe that the relaxation of controls has led to an increased interest among investors in the private rental sector, although definitive proof of this assertion is not available. Certainly the government hoped that this would happen.

Tax and Subsidy Treatment

Housing is treated as a consumption good in Finland – investors' pay no capital gains tax and homeowners do not pay tax on imputed rental income. However, homeowners receive mortgage tax relief, although the relief was reduced in 1993, and they are also eligible for interest subsidies, guarantees on loans from commercial lenders, and shelter allowances.

Private landlords pay income tax on their net rental income (although they receive no depreciation allowances), but they do not pay capital gains tax. Some landlords, referred to as "organizations which provide housing on social grounds", are able to access the state-run ARAVA loan scheme, which provides interest subsidies. Tenants of these private landlords are eligible for housing allowances.

There are no special tax provisions affecting the private rental sector. Finnish landlords are not even able to claim depreciation allowances for tax purposes, although other cash costs are deductible from rental income for purposes of calculating income taxes. This inability to claim depreciation allowances is very unusual among Western countries (although this is also the case in the U.K.).

In recent years, the Finnish government has sought tenure neutrality in its tax treatment of housing, as evidenced by restrictions placed on the mortgage tax relief program as well as the cessation of rent regulation in the private rental sector. The government hopes these policies will help to rekindle interest in the private rental sector among investors.

Policy Issues

Although quite small, the private rental sector has undergone something of a revival in recent years. Severe declines in house prices over the 1989 to 1992 period resulted in capital losses for many owners, a situation that has led to an increased interest in renting. In addition, migration to urban centres is strong in Finland, which has underscored the desirability of a more vibrant rental sector. The government is also concerned with efficient labor markets and believes that a healthy rental sector is a necessary accompaniment to an efficient labor market. [30]

Coincident with these events, the gradual relaxation and subsequent abandonment of rent controls made investment in the rental sector more attractive.

The government would like to build on the momentum created by the confluence of these factors and encourage new institutional landlords to become active in the private rental sector. Currently, most owners in the private rental market are individuals with small properties.

To that end, a government bill on real estate investment funds has recently been introduced into the Finnish parliament. New legislation that would enable the funds to invest in commercial and residential real estate was passed in March 1998. Additional detail on these funds is discussed later in this chapter.

Policies and Programs Affecting Rental Production

The principal initiatives directed to the private market have been various relaxations in the Tenancy Act (1990, 1992) followed in 1995 by the

[30] Analysis provided by Sirpa Tully, Ministry of the Environment, Helsinki, November 26, 1997.

complete deregulation of rents in the non-subsidized, privately financed rental sector.

A very recent initiative, enacted only in March 1998 is the creation of Real Estate Funds, discussed in the next section.

Finland: Real Estate Funds

Description

The Finnish Act on Real Estate Funds came into force on March 1, 1998. Any Funds created under the legislation will be established as limited liability companies under the Companies Act, listed on the Helsinki Stock Exchange. The Funds, which can invest in either residential or commercial real estate, are subject to more stringent information disclosure requirements than other listed companies.

Background Context

In an effort to encourage private rental investment and development in Finland, the government would like to encourage new institutional landlords to become active in the private rental sector. Rent controls have largely been abolished, but additional measures are deemed necessary. The creation of Real Estate Funds was expected to increase the flow of funds into the sector.

To date, no funds have been established under the Act,[31] and it appears unlikely that any will be unless changes are made to the legislation.

The reason for this somewhat gloomy prognosis is that in spite of advice to the contrary from the industry, the government decided to tax the funds the same as any other limited liability company, which puts the REFs at a competitive disadvantage relative to mutual funds, which are not so taxed. The Ministry of Finance has been asked to make changes but appears disinclined to give any major concessions to the funds.

If the funds ultimately fail to take root, it will be regarded as a pity by housing industry observers, who believe that they have the potential to attract institutional investors into the private rental market. [32]

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[31] Information provided by the Ministry of the Environment, May 8, 1998.
[32] Comment of Sirpa Tully, Ministry of the Environment, Finland.

Duration and Level of Funding

Not applicable

Specific Purpose/Objective

The passage of the Finnish Act on Real Estate Funds was intended to attract new investment into the private rental sector.

Impact and Success of the Initiative

The Act has only been in force for a few months. No funds have been established so far.

Current Status

Although it is far too early to determine if the creation of real estate funds will result in a more vibrant private rental sector in Finland, the early signs are not encouraging. If investors avoid the funds because of tax disadvantages relative to mutual funds, the government will have to decide whether the encouragement of private rental housing is worth the cost in tax losses.

Lessons for Canada

While the idea of the Finnish Real Estate Funds has some parallels to REITs in North America, the REF seems to suffer from a far less advantageous tax structure (a similar problem plagues HITs in the U.K.). The limited companies that create REF will be subject to income tax. This is fundamentally different than REITs, which are tax exempt and act as a conduit for investments with returns taxed in the hands of investors.

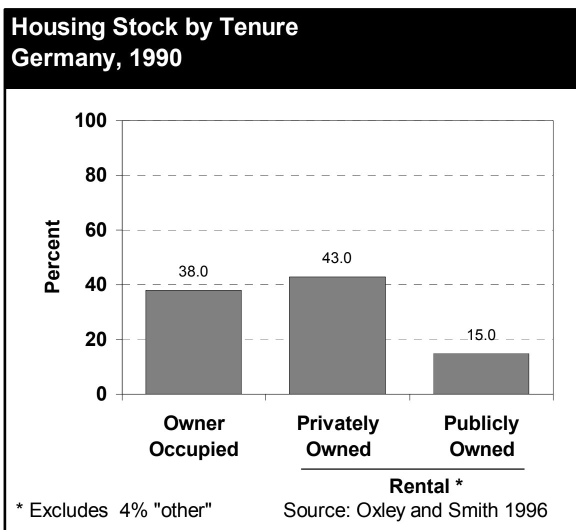
As in the U.K., it seems clear that investors will not generally invest in new construction in the private rental sector unless there are clear advantages to be gained from their investments. In both countries, investors are signalling that they do not believe such advantages exist - rental investment does not provide a competitive rate of return for investors.

Given the establishment and more advantageous structure of REITs in Canada, the Finnish experimentation with the Real Estate Funds offers no new lessons to Canada.

Germany

Market Context

Germany is one of the few countries in Europe where the home ownership sector does not dominate the rental sector. In fact, for many reasons, including massive post-war reconstruction, Germany is generally considered to have the largest private rental sector in the European Union.[33]



Notwithstanding this description, in practice it is difficult to draw precise boundaries between private renting and social renting in Germany. There are several definable components such as the private sector, the non-profit sector, the public sector and so on. However, tenants in any of these sectors are eligible to receive similar subsidies. With regard to private renting, private landlords qualify for reduced interest loans as long as the units so created are rented at below market rates during loan repayment. Once the loan is repaid, units revert to the unsubsidized private rental sector. Thus, both private and social landlords can rent subsidized and unsubsidized dwellings, although due to regulation, rents in the social rented sector are generally lower than those in the private rental dwellings. This also reflects a higher incidence of lower income households in the social sector.

Due to the obligations related to reduced interest loans, rental units are always somewhere in transition between the social and private parts of the market. In recent years there has been a growing concentration of the lowest income groups in social rented dwellings, particularly those owned by municipal housing corporations.

Importantly, at least from a North American perspective, the physical differences between new social housing and new private rental housing are minor. Tenants in any kind of rental building may qualify for housing allowances, as may homeowners under certain circumstances.

In spite of definitional problems, most housing market analysts consider the current German housing market to comprise 40 percent owners and 60 percent renters,[34] which together with Switzerland is by far the highest proportion of renters in Europe, and approximately double the ratio in Canada. Over the last 10 years there may have been a slight reduction in the proportion of tenants in the German housing market.[35]

Among the reasons for the significance of the private rental sector in Germany are the following:

- The private rental sector has always been regarded as an important component of the housing market – it is regarded as quite normal to rent.

[33] Switzerland also has a large private rental sector that is sometimes described as proportionately larger than Germany's. In this Chapter, the discussion reflects the former West Germany, prior to unification, as historical texts and data related primarily to this previous state.

[34] See, for example, Hubert, Franz, Private Rented Housing in Germany, FUB, December 1994. Professor Hubert estimates that in 1998, the ratio of owners to social renters to private renters is 40/10/50.

[35] For example, Whitehead estimates the proportion of tenants in 1987 as 62 percent of the total.

- The price of owner occupation is high and large down payments are required.[36] Transaction costs for homeownership are also high. They may amount to 10 percent of the value of the property: 6 percent real estate fees, 1.5 percent legal fees, 2 percent tax on the land value. In addition, home ownership is subsidized by depreciation allowances that can only be obtained once in a lifetime. The tax benefit increases with the value of the house and with marginal tax rates, which encourages buying later in life and renting earlier on.

- Unlike many other west European countries, new dwellings are being built for the private rental market, largely because of generous taxation incentives.

- Rent levels are relatively very affordable.[37]

Over time, investor interest in the rental sector has waxed and waned as rent regulations and incentives in the competing ownership sector have come and gone. Beginning in the 1970s, landlords began to perceive that the development and operation of rental housing was becoming less profitable than it once was, partly because of rent regulation and other legal requirements governing tenancies. At the same time, tax subsidies for first time owners were extended in 1976 to include the existing stock, resulting in a wave of condominium conversions.

Alarmed at the loss of rental stock in the early 1980s, the government introduced accelerated depreciation allowances for new rental construction. The new rates were not enough to halt the loss of rental stock and by 1989 net additions to the rental supply were insufficient to counter losses caused by demolitions and conversions. Net additions fell from 70,000 in 1980 to negative 10,000 in 1989, when the number of demolitions and conversions exceeded the number of completions.

With the continued net loss of rental units, a problem exacerbated by German reunification, the government introduced enhanced tax incentives in 1989 that once again encouraged greater investment in the rental sector.

The supply of new rental units peaked in 1993/1994, just as Germany was entering a recession characterized by growing unemployment. Reflecting the combination of oversupply and weaker demand vacancy rates increased dramatically. [38] Government used this opportunity to lower the depreciation allowance schedule to the level of the early 1980s.

Current market disequilibrium aside, Germany is the best European example of a rental market that meets all three major needs for rental accommodation from:

- newly forming and mobile households where emphasis is on easy access, low transaction costs, limited commitment to the property;
- households who even though they could afford to own do not want to, but still want long term secure accommodation; and
- lower-income households who cannot afford adequate accommodation without some form of assistance.

It is not certain what direction German housing policy may take in the future, although like most European countries Germany has become less interventionist in recent years, partly as a matter of philosophy and partly as a matter of financial exigency.

[36] In 1987, average house prices in large West German towns were estimated to be between 7 and 8 times the annual gross income of industrial workers. Estimate quoted in Oxley, Michael and J. Smith, Housing Policy and Rented Housing in Europe, E & FN Spon, London, 1996, page 165.

[37] Rental expenditures relative to the cost of homeownership range from 39 percent to 56 percent depending on household type. In comparison, relative rental expenditures in Canada range from 65 percent to 105 percent. Freeman, Holman and Whitehead, 1996, page 22.

[38] Information provided by Professor Franz Hubert, Free University of Berlin, March 1998. There is no formal rental vacancy survey in Germany - these are anecdotal comments.

Regulation

There is essentially a two-tier rent regulation system. The first tier results from the construction subsidies that are available to all landlords, whether private or social, for new construction. During the 25 or 50 year repayment period units are rented at cost-recovery levels (limited return on equity).

For the rest of the market, the primary legal instrument regulating the private rental sector in Germany has been in place since 1971.[39] The Rent Regulation Act is based on three major components: security of tenure for tenants; limitations on rent increases for sitting tenants to the level reached by comparable accommodation (Vergleichsmiete); and free negotiation of rents in new tenancy situations.

In terms of the security of tenure component, the 1971 Rent Act specified that tenants observing all the requirements of their tenancy could only be evicted if either the landlord or a member of the landlord's close family moved into the unit. In 1983 these provisions were relaxed somewhat in response to landlord concerns, but many landlord organizations still consider the provisions unfair to landlords.

The rent control provisions of the Act were clarified in 1982. Comparable rental contracts used to limit rents were specified as those that have been agreed upon during the preceding three years. If these comparable local units were renting at higher levels, or if operating costs had increased, or if improvements to the property had been made rents could be increased (although by not more than 30 percent in 3 years),

More recently, the restriction of rent increases within three years was lowered from 30 percent to 20 percent for dwellings built before 1981. In addition, relevant rent contracts were defined as those agreed to within the previous four years, rather than three years. However, these tightened constraints have had little real impact due to the current weak state of the market, which by its very nature is inhibiting rent increases.[40]

In terms of the third component of the Rent Act, the free negotiation of rents in new tenancies has resulted in a growing gap between old rents and new rents, a situation that is of concern to authorities. Renter mobility has been reduced as people become trapped in unsuitable accommodation that they cannot afford to leave because of the much-increased costs of a new lease elsewhere. In 1993, steps were taken to reduce the free negotiation of new rents by explicitly stating that a new rent more than 20 percent higher than the Vergleichsmiete (comparables) was an administrative offense, subject to stiff fines.

Overall, the general thrust of rent regulation in Germany is actually quite relaxed compared to many other countries in Europe. However, when housing markets began to tighten in the late eighties, rent control and rent regulation became highly political issues, with one side opposing any interference with the market and the other in favor of protective measures for tenants. Notwithstanding the polarization, there is a broad political consensus that the system of rent regulation should be maintained.

In summary, the regulatory framework in Germany has remained relatively consistent, with some variations over time. It has been used to fine tune investor returns and the extent of tenant protection. Although landlords have objected from time to time about perceived unfairness, the overall regulatory structure has been subject to calls for fundamental reform. As discussed below, the relatively generous tax measures have been more significant in encouraging investment than any negative impact of regulation.

Tax and Subsidy Treatment

Housing is treated as a consumption good in Germany. For homeowners capital gains and imputed rental income are not taxed, and there is no mortgage tax relief, although home ownership

[39] Until the end of the sixties and the substantial completion of post-war reconstruction, rent controls were very strict, much stricter than those contained in the Rent Regulation Act.

[40] Professor Hubert, March 31, 1998.

is subsidized by depreciation allowances that can only be obtained once in a lifetime. The tax benefit increases with the value of the house and with marginal tax rates, which encourages buying later in life.

Private rental housing has always been treated the same as any other investments as far as taxation is concerned. All costs are deductible and in addition, losses are deductible from other sources of income, although this has become more restrictive over time.

Rented property is exempt from capital gains tax if held for more than 2 years. More detail on these aspects of the German housing market is presented later in this chapter.

Germany is one of the few European countries that provides subsidies to private landlords. Landlords can apply for subsidized interest loans under the social housing scheme, on the same basis as social housing landlords (this is analogous to the former Section 15 Limited Dividend program in Canada for which for-profit and not-for-profit landlords were equally eligible).

While the subsidized loan is being repaid, which may take up to 50 years, the rents are controlled at below market rates but thereafter, market rents prevail and no further assistance is available to the landlord. As a condition of the loan, landlords must house tenants of with incomes below specified income limits. Depending on income, the tenant may qualify separately for a housing allowance subsidy.

Since 1981 accelerated repayments of subsidized loans have been allowed. By 1995, estimates suggested that half of the 4 million subsidized private rental units that existed in 1994 had reverted to the unsubsidized sector.

In 1989, a program was introduced whereby the cost of extensions or renovations to existing buildings could be deducted from income for tax purposes for 5 years at a rate of 20 percent per year. This program was in force for 5 years, from 1989 to 1994. Some observers have expressed the concern that this program did not limit the cost of extensions or rehabilitation with the result that previously affordable housing could be renovated and become less affordable (the full deductibility acted as an inducement to spend more).[41]

Housing allowances, called Wohngeld, are available in both the private and social rental sector and in the ownership sector - they are tenure neutral. Over 60 percent of allowance recipients are in the private rented sector. Housing allowances are narrowly targeted with respect to income. In 1990 for example, only 10 percent of all tenants were in receipt of a housing allowance. Most recipients are either on social assistance or are pensioners.

In general, the Lander (states) are responsible for grants; the federal government for providing relief through the tax system. This general observation holds true regardless of tenure.

Overall, Germany has a very favourable tax and subsidy environment that encourages rental investment and production. Much of this system has been in place for some time, prior to the 1980s, although since then, some adjustments have been made to rent regulation levels and to depreciation rates, as detailed at the end of this chapter.

Policy Issues

Because of accelerated repayments, of the 4 million subsidized private rented dwellings that existed in 1987, only 1 million are projected to remain in the year 2000. Combined with significant reductions in the level of new construction in the latter 1980s (social and private) the transition of these units to the open private market will cause a lack of social housing. This is expected by many housing market observers to become an important issue.

Concerns over the low rate of home ownership may impact on the rental market. Moves are afoot to make home ownership easier for young households. But on the other hand, Germany has been suffering from housing shortages and this may create some opportunities for the private

[41] Ibid page 144.

rental sector, particularly from high-income individuals and from the growing number of elderly households (although for most high income group's ownership will remain the preferred choice).

The rent gap between older and newer dwellings has been increasing, More important, the gap between rental rates of new and old leases is increasing, which significantly affects the operation of the rental market. People are reluctant to move which means inefficient utilization of the existing stock, there are landlord/tenant conflicts (because landlords have incentives to get rid of current tenants); and affordability problems are created.

Condo conversion has become a major issue. To protect tenants, freeze periods have been instituted during which rental contracts cannot be terminated. Freeze periods range from 5 to 10 years depending on locality. In the late 1980s condominium conversion was blocked in most large cities by administrative measures, but these measures were ruled unconstitutional in 1992.

It is not certain what direction German housing policy may take in the future, although like most European countries Germany has become less interventionist in recent years, partly as a matter of philosophy and partly as a matter of financial exigency.

Policies and Programs Affecting Private Rental Production

Over the past two decades Germany has maintained a full array of programs and policies designed specifically to encourage rental construction and rehabilitation. These have included some relaxation of rent controls (although rent levels remain regulated), direct subsidy in the firm of interest rate subsidies, (linked to targeting conditions for modest income households); and tax provisions largely in the form of depreciation allowances. As the economy and housing market have moved through market cycles, the government has adjusted depreciation rates and permissible levels of rent increase.

Germany's system of depreciation allowance and the various revisions to this system are detailed in the next section.

Germany: Accelerated Depreciation Allowances

Description and Background Context

Depreciation allowances have been a feature of German housing policy for many years, in both the rental and the ownership sectors. First introduced in the 1960s, depreciation allowances for landlords were based on straight-line calculations related to the anticipated life of the building. For buildings constructed prior to 1925, depreciation was based on 2.5 percent of the building's value per annum. For buildings constructed after 1925, annual depreciation was based on 2 percent of the building's value. However unlike other capital assets, every time a building was sold the rate of depreciation began again at year zero, based on the resale value of the building, not the original value.

To encourage the construction of new private rental buildings, depreciation rates were raised in the early 1980s to 5 percent for the first 8 years; 2.5 percent for the following 6 years; and 1.25 percent for the final 36 years.

In 1989, depreciation rates for new construction were raised again to provide landlords with an additional incentive to invest in the sector. The new rates were 7 percent of the value of the building each year for the first 4 years, 5 percent per annum for the next 6 years, 2 percent per annum for the following 6 years, and 1.25 percent in each of the final 24 years. These graduated rates of depreciation were designed to provide greater relief in the early years and thereby enhance after tax rates of return

In addition to the standard depreciation allowances, the 1989 reforms introduced additional allowances for owners who rented units at a preferential rate for a minimum period of 5 years to low income households. This enabled depreciation of a total 85 percent depreciation over the first 10 years.

The tax system was also used to encourage renovation and the addition of new units to existing properties to creating additional rental units. Between 1989 and 1994, renovation and addition expenditures could be deducted from income at a rate of 20 percent per year for 5 years. To further enhance the impact of these tax measures, losses from housing investments can be deducted from other sources of income. As well, many private German landlords are in receipt of interest rate subsidies (as long as they are willing to accept rent controls during the debt repayment period). Until 1990, they were also exempt from land tax for the first 10 years of ownership.

In 1996 depreciation allowances were reduced in the face of growing oversupply and rising vacancy rates. They are currently 5 percent for the first 8 years, 2.5 percent for the next 6 years, and 1.25 percent for years 15 to 50. These rates are identical to those that prevailed prior to the 1989 increase.

Specific Purpose/Objectives

Accelerated depreciation allowances are intended to increase the supply of rental housing by enhancing its attractiveness as an investment via favourable tax advantages. That is, to the extent that accelerated depreciation rates exceed actual depreciation rates, deductible operating expenses are inflated, thus reducing tax payable.

The impact of accelerated depreciation for both new construction and rehabilitation is magnified by the ability to use depreciation induced losses in real estate to shelter income from other sources and by the availability of interest rate subsidies for landlords that are willing to accept rent controls during loan repayment.

Duration and Level of Funding

Depreciation allowances have been a feature of German housing policy since the 1960s with various degrees of accelerated depreciation in effect for almost 20 years.

It is difficult to obtain detailed estimates of the cost of the policy to taxpayers, although it is known that the cost of the 1989 enhancements

increased tax losses from 362 million DM in 1989 to 960 million DM in 1992.[42]

Impact and Success of the Initiative

While Germany is unique in maintaining the relative size of its private rented sector over the post war period, there have been periods when the level of new production has declined. Oxley and Smith (1996) observe that the legislation introduced in 1989 rekindled investor interest and resulted in a rebound in production levels.

Thus from the point of view of direct results, the depreciation allowance tool has been effective in stimulating investment and construction. Rental completions increased from 26,700 units in 1988 to 66,800 units in 1991.

There have however been large swings in production levels, clearly associated with the changes in depreciation rates. With this evidence, it is difficult to determine whether these policies have contributed to net new additions as distinct from simply accelerating construction.[43]

As Hubert comments: "Unfortunately there are neither official data nor serious estimates of the tax benefits obtained through high depreciation of renter property. But there is no doubt that the favourable tax treatment is a very important motive for investment in private rented housing."[44]

Whether it is the most efficient way of encouraging private rental construction is another question. Unlike other countries Germany has retained a stronger system of rent regulation - a feature typically cited as a disincentive to investment. Fairly favourable tax benefits have been used to offset this impact. It is not possible to determine whether these tax expenditures might have been lower in the absence of the rent regulation, although economists would suggest that this should be the case.

Unfortunately serious evaluation has not been undertaken to examine whether oversupply has been created in some markets, whether land prices have been inflated, or whether any other unintended consequence might have occurred.

Current Status

As previously indicated, a new, less generous, depreciation allowance schedule has been in place since 1996.

Lessons for Canada

In Canada, the use of depreciation allowances to influence investor behaviour has a long history. However, it has been the ability to use depreciation allowances as the means to shelter income from other sources that has provided the main attraction to new investors, not the existence or the level of depreciation allowances per se. This observation is also true of Germany.

There are close similarities between the German use of depreciation allowances and tax shelters and the Canadian experience with MURB's. It is somewhat ironic that the German approach is widely credited with achieving a much more vibrant private rental market in that country than in other European countries, while the Canadian experience with rental tax shelters is generally viewed in a very negative light (Brown, 1982, Jones, 1983, Gau and Wicks, 1982, Clayton Research, 1981 and 1984, Hulchanski, 1982, Dowler, 1983).

It is possible that these differing views are related to the magnitude of the housing problem that needed to be addressed in the two countries. Over the post-war period Germany has experienced serious housing shortages, due to the war and to recent reunification. Canada has never experienced housing shortages on this scale.

It is also possible that program differences, rather than similarities, account for the positive view of

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[42] Oxley and Smith, page 142. The current exchange rate on the DM is 0.9997 so the dollar is almost equivalent to the DM

[43] As discussed in the Canadian profile, Smith and Fallis have articulated this impact in the Canadian context. Developers may hold off development in anticipation of incentives, and then overbuild when they are available.

[44] Hubert, December, 1994, page 23.

German initiatives and the negative view of Canadian ones. For example, one of the recurring criticisms of the MURB program was its short-term and uncertain nature – investors never knew how long the program was going to last. The German approach has been more permanent and consistent, although elements of their approach have changed from time to time as well.

However, the major difference between positive and negative perceptions of this particular policy instrument may be cultural, reflecting different views of the proper role of government in the economy and in the management of the housing market.

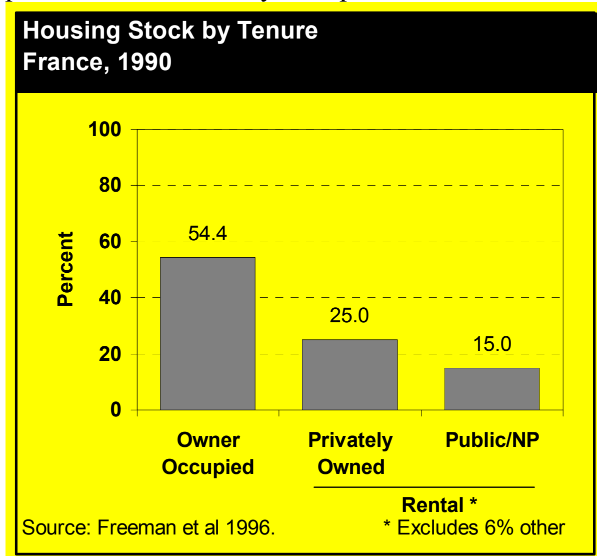
In addition, it appears that evaluations of the depreciation allowance policy have not been undertaken in Germany and it is not known whether there might be other, more effective ways of stimulating investment in the private rental market.

In Canada, the German approach to tax-based incentives for private rental construction and rehabilitation has been in place for many years, with varying degrees of support, but has not been as generous as the German system and has not stimulated the same degree of investment.

France

Market Context

In spite of the fact that government policy has favored the owner-occupied sector for more than two decades, France still has a comparatively large private rental sector by European standards.



Although the sector has gradually declined in prominence in the post-war era, renters currently occupy some 40 percent of the total housing stock. About two-thirds of renter households rent privately; the remainder live in social housing of one type or another, most owned by non-profit HLM (Habitation a Loyers Moderes) organizations.[45]

The proportion of private rental dwellings in France has declined from a post-war high of 50 percent to somewhere around 38 percent currently.[46] Of course, as is the case in most European countries, the distinction between social and private renting is not entirely clear. There are varying estimates of the size of each component.[47] There are actually four types of rental housing in France:

- The rent controlled sector: mainly pre-1948 units owned by individuals (institutional investors own the newest stock);
- The private subsidized sector;
- The free sector: post-war rented housing not subject to controls; and
- The social sector: owned mainly by non-profit societies (HLM's).

Individual investors own almost (3.6 million units, 87 percent) the entire private rental stock, encompassing first 3 categories above, although institutional investors own the newest stock (500,000 units). Much of the privately owned stock is old, small, and occupied by low-income households. There is some concern in France that when many of the individual owners die, their heirs will prefer to sell off the properties rather than continue to operate them. They believe alternate investments will be more profitable than rental housing.

A view that the rental sector is generally unprofitable is widely shared by many investors and has led to serious declines in the construction of new rental housing. In 1974, 54,000 new private rental dwellings were constructed; in 1984,only 5,000 units were built. A loss of rental units to condominium conversion and the demolition of poor quality units have exacerbated the decline in new construction.

In reaction to this decline the government introduced new initiatives[48] that stimulated the recovery in private rental starts to 20,000 in 1990 (from levels of around 5,000 in the mid-1980s). However, many observers believe that the rental market is still not creating enough units to meet the need arising from young single-person households, divorced people, the working poor, and transient professionals. Investors simply do not see rental housing as a profitable place to put

[45] Freeman, Table 1.

[46] Oxley, M. and J. Smith 1996.

[47] Freeman et al (1996) for example put the rental sector at 40 percent, but estimates that 2/3 of the rental stock is private and 1/3 social.

[48] Oxley and Smith. (Discussed at greater length later in this chapter)

their money, a perception that has been supported as valid by research studies.[49] Similarly, landlords are not willing to invest in modernization or repair, as they do not see returns sufficient to compensate them for the investment.

Regulation

Although through the 1960s and 1970s various governments sought to freeze rents as part of a policy of social control; the vast majority of private rental units remained outside of controls. Only those build prior to the 1948 Rent Act (i.e.12 percent of 1982 stock) were controlled. This changed dramatically in 1982 with the enactment of the Quilliot Law (also known as the 1982 Rent Act). This significantly strengthened tenants' rights and introduced rent controls across the entire stock. Investors argued that the controls were too tight and made investment in rental housing unprofitable. Rental construction levels plummeted.[50]

In the face of very low construction, rent controls were relaxed in 1986 with the adoption of the Mehaignerie Law. This freed the rents of new and vacated units and allowed them to be revised annually in line with the construction price index.

Although construction of rental units increased significantly from 5,000 per annum in 1984 to 20,000 in 1989, rents also increased dramatically in some areas following the passage of the 1986 law (e.g. Paris rents increased between 51 and 180 percent).[51] The government felt it necessary to reintroduce stricter controls and did so with the passage of the Mermaz-Malandain Law in 1989, which allowed the imposition of one year rent freezes. Such freezes were imposed in Paris several times beginning in 1989.

The 1989 law remains as the primary arbiter of rent control in France although there are still some (probably fewer than 400,000) rental units controlled under the terms of the 1948 Rent Act. Tenants in these units, which are generally of relatively poor quality, have security of tenure and rents are tightly controlled.

In summary, rent regulation has been a significant influence on the private rental sector. A dramatic decline in rental production coincided exactly with the introduction of a fairly rigorous new system of tenant protection and rent control in 1982.

Tax and Subsidy Treatment

Notwithstanding its continual decline in the post-war period, the private rental sector in France has always received some form of subsidy or tax assistance. However, subsidies for home ownership have typically been larger than subsidies for the rental sector. In part this explains the relative contraction of the rented sector. Homeowners are assisted with special downpayment savings plans - when a home is purchased government provides a bonus payment equally to the amount of interest received on these savings plans. In addition, subsidized loans are available to low and moderate income households. Finally, owners receive an annual tax credit equal to 25 percent of mortgage interest paid.

Assistance for the private rental sector is provided in various ways:

- State funded financial institutions will provide below-market interest rate loans for private investors in rental housing, as long as they adhere to certain conditions. These loans, known as PLA loans,[52] are available for both new construction and renovation.[53] PLA loans are available to cover a maximum of 65 percent of construction costs. Interest rates are fixed for 25 years or variable for 30. In return for these below-market rate preferential loan terms, investors must accept below-market rents and tenants must have incomes below certain levels.

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[49] Oxley and Smith page 138.

[50] Boelhouwer and van der Heijden, page 222.

[51] Ibid, page 226.

[52] Prets Locatifs Aidés

[53] Although available to private investors, PLA loans are mainly used by social developers.

- Subsidies from the National Agency for Habitat Improvement (ANAH) are available in the form of grants to encourage modernization and improvement of the older (15 years plus), private rental stock as well as improved energy efficiency. Normally, subsidies are equal to 25 percent of costs but this limit can be increased to either 35 percent, if units are rented to certain qualified tenants, or up to 70 percent if a unit is rented to a particularly disadvantaged tenant. The minimum rental commitment for a landlord is 10 years and during this period rent levels are limited. Agency funds were successful in reducing the number of pre-1949 dwellings lacking basic facilities from 37 percent in 1978 to 19 percent in 1988.[54]

- Although private rental housing is generally treated as an investment good for tax purposes in France, landlords who own only one rental property are exempt from capital gains tax on disposition of that property.

- New rental dwellings are exempt from property taxation for either two years in the case of unsubsidized dwellings, or from 10-15 years in the case of dwellings financed with subsidized loans.

- Private landlords pay income tax on rental income after expenses and a depreciation allowance are deducted. As detailed in the review of tax provisions at the end of this chapter, depreciation allowances have been steadily increased over the past decade in an attempt to enhance the attraction of rental investment.

- Tax reductions for investing in private renting were introduced in 1984. Immediate tax reductions were provided on the first FF40,000 of an investment in rental housing if the landlord bought or built a new dwelling and contracted to rent it for more than six years. In 1989 this provision was revised to a percentage of the capital cost (15 percent in 1997 with a maximum cost ceiling of FF900,000)[55] with the reduction taken equally over two years).

- If a private landlord qualifies for a PLA loan, tenants below certain income limit are entitled to a housing allowance (called an APL). However, these income limits are set at relatively high levels, such that in 1988 for example, 24 percent of private rented households were in receipt of an APL.

In summary a variety of tax concessions and subsidies have been implemented in attempts to improve the relative rates of return on rental investment. Overall, however, returns are at best barely competitive and investment has remained limited.

Policy Issues

The decline in production of rental housing has been a serious concern to government. Exacerbating low production levels, over one million dwellings were lost from the private rental stock through demolition and conversion between 1975 to 1990.[56] The government is trying to boost investment in the sector because it is considered important for new households in transition to home ownership as well as for social housing.

Initiatives such as relaxing rent controls and enhancing tax reductions for rental investment have resulted in some increases in the private rental housing stock but not enough to compensate for losses of small private rented dwellings. This has implications for low income and minority households who are not always accepted into the social rental sector. As the stock of relatively affordable housing private accommodation erodes they have fewer shelter options.

Investors do not believe, possibly with some justification, that investment in the private rental housing sector (either new or in modernizing the existing stock) will be profitable. Incentives that

[54] Oxley and Smith, page 136.

[55] Current exchange rate against the franc is .288 so FF40,000 is approximately $10,000 and FF900,000 approximates $225,000

[56] Op cit, page 137.

have been provided by the government are not as generous as incentives provided for other sectors of the economy. The result has been under investment in rental housing. [57]

Government concerns have been echoed in various reports, including one by the Counseil Économique et Social (CES 1989). There are calls for additional investment in the rental sector, not only in new construction but also in maintenance of the existing stock. Some of the suggested remedies for inadequate investment include:

- reducing fluctuations in short term inflation and interest rates;
- making income earned from rent-controlled units tax free; and
- introducing more generous depreciation allowances similar to those available in Germany[58]

With the exception of the first suggestion, which would be difficult for the government to implement, these policy alternatives would involve significant government expenditures.

Policies and Programs Affecting Private Rental Production

As suggested above, there has been a general policy thrust toward a more deregulated market as well as specific tax provisions designed to enhance the attractiveness of rental investment. The key tax measures are now reviewed.

France: Tax Provisions

Description

An ongoing series of tax measures have been implemented or amended in France since 1984, specifically for the purpose of encouraging private rental production and improvement. These have generally involved tax deductions, the exemption from taxes on some portion on rental income, and depreciation allowances.

In 1984 tax reductions were introduced for individuals investing in new private rentals. Reduced tax rates were provided on the first FF40,000 of an investment in housing if the landlord bought or built a new dwelling and rented it for more than six years. This was replaced with a new tax reduction mechanism in 1989.

Under the new 1989 system a tax credit is provided and spread equally over the first two years following the investment. The amount of the tax credit, based on the original construction cost, is 10 percent for individual investors and 7.5 percent for institutions.[59] There is a limit on the property cost of FF300,000 for individuals and 600,000 for couples (increased to 15 percent and FF900,000 in 1997).

In 1986 the government complemented tax measures with revisions to the Mehaighnerie Act, which relaxed rent controls.

In 1987 the government took further steps to increase the attractiveness of private rental housing to investors. Before 1987, 15 percent of net rental income was tax-free for a period of 10 years. The government raised the tax-free amount to 35 percent in 1987.

In a similar measure, implemented for one year only in 1996, capital gains realized on money and bond market funds and on stocks were exempt from tax as long as the transfer proceeds were invested within two months in the purchase,

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[57] Geindre cited in Oxley and Smith p 138

[58] Boelhouwer and van der Heijden, 1992, Oxley and Smith 1996

[59] So, for example, under the pre 1997 FF600,000 maximum a couple could claim FF30,000 in each of two year (10 percent x 600,000 spread over two years)

construction, or repair of a private rental dwelling. This provision applied only to transactions between January 1 and December 31, 1996.[60]

Since 1993 capital cost depreciation rates (sometimes referred to in France as the standard deduction rate on real estate gross income) and the extent to which losses caused by depreciation have been progressively increased. From 1986 to 1993 the annual capital cost depreciation allowance for rental properties was 8 percent of construction cost. This rate was then increased to 10 percent in 1993 and to 13 percent in 1996. In addition, landlords were allowed to deduct rental losses from other income, up to an annual upper limit. This maximum has similarly been raised from FF50,000 in 1986 to FF70,000 (1993) and to FF100,000 in 1996). [61]

Background Context

The stimulus for tax measures has come largely from a concern about low levels of production attributed to the negative impacts of rent regulation, especially as implemented in 1982, and the relatively poor levels of return on rental investment compared with other options - such as bonds and equities. There has been a parallel concern about disinvestment as older individual investors leave rental properties to heirs who may not have not be interested in continuing to hold the property.

Duration and Level of Funding

Tax provisions of one kind or another have been used in France for decades to stimulate the private rental sector. Unfortunately, only partial information is available about the cost of these measures. A 1994 summary of public housing expenditures in France indicates that of a total budget of 134 billion francs, 34 billion was attributable to "fiscal expenses". [62] More than two-thirds of these fiscal expenses favored homeowners (24 billion francs) while landlords accounted for 7.3 billion francs. Miscellaneous fiscal expenses accounted for the remaining 3 billion francs.

Specific Purpose/Objective

The intent of each of these tax provisions was to stimulate investment in private rental housing. The increased supply so induced, coupled with assumed pass-through of some of the tax credit benefits to tenants, were hypothesized to lead to lower rents. Some specific measures were designed to incite investment in upgrading the older stock.

An ancillary objective has been the stimulation of the construction industry.

Impact and Success of the Initiative

The rebound in the level of rental construction is one indicator that these measures have had a positive impact. Production of rental housing recovered from a low point of 5000 units annually in the mid 1980s to over 20,000 units by 1990.

Current Status

The new Socialist government has chosen to meet emerging housing needs by relying on the construction of new social housing as the central plank of its policy, unlike previous governments which have been more inclined to rely on the market. The various tax provisions described in this chapter still exist, but they are not the major focus of the government's housing policy - large scale spending on production in the social rented sector dominates.

Lessons for Canada

Generally speaking, in comparison with Canada, the French model of housing policy is far more directive and interventionist, certainly in the 1990s. In France, tax-based incentives are only one part of a complicated web of programs aimed at all components of the housing sector.

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[60] ibid

[61] Ministry of Public Works, Transportation and Housing, Housing Policy in France, November 1997.

[62] ibid, page 32. The budget breakdown was as follows: 23 billion francs on direct budget assistance (subsidized loans and so on); 70 billion in personal support (shelter allowances); 34 billion in fiscal expenses, and 7 billion in other categories.

Clearly these mechanisms have worked in France, at least to some extent. However, the private rental housing sector has continued to decline, although it would undoubtedly have declined faster in the absence of the various tax incentives that have been introduced over the years. Investors do not regard the current investment environment or the incentives that exist as a sufficient inducement to become more active in rental housing than they already are. For its part, the government has chosen to address current housing needs mainly through the social housing sector.

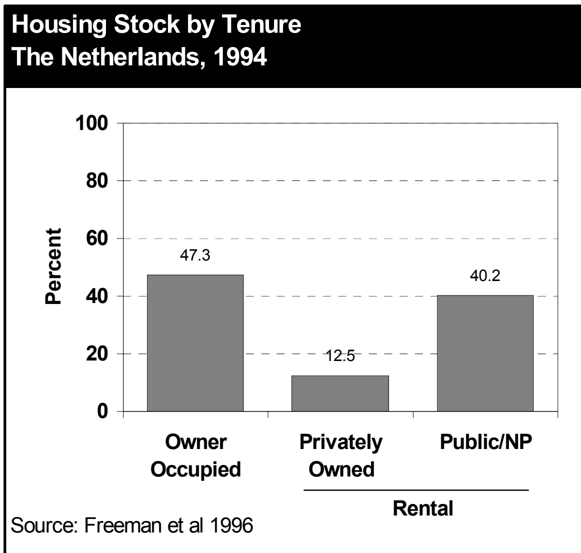
Overall it seems very doubtful that there are any lessons to be learned for Canada from this particular aspect of French housing policy, especially if the objective is to seek approaches that do not involve large levels of government expenditure.

Canada has previously employed similar measures - specifically depreciation allowances at different levels and allowed investors to shelter non-rental income with rental losses - and similarly stimulated inflows of capital to the rental housing sector. Moreover, in Canada these measures have been subject to evaluation and critical assessment and provide an existing base of knowledge, which reduces the need to examine how the same types of measures have functioned in France.

The Netherlands

Market Context

At the end of World War II the private rental market in the Netherlands accounted for 60 percent of the housing stock, a European high. But after the end of the war, the share of the private rental sector declined sharply and continuously, to 57 percent in 1960, 28 percent in 1970, 17 percent in 1980, and 13 percent in 1990.[63] Judging from recent construction statistics, this already low share will continue to shrink. Between 1988 and 1994, private rental housing starts declined from 10 percent of total housing starts to 7 percent.[64]



Source: Freeman et al 1996

The social rental sector on the other hand is very large, in fact at 40 percent of the stock the largest in Western Europe by far. The next largest social rental sector in Europe is in the U.K., where it accounts for 22.6 percent of the stock. By way of North American comparisons, Canada's social rental sector accounts for less than 6 percent of the stock, while in the U.S. the social rental sector accounts for a mere 2 percent share of the total housing stock. [65]

The table below illustrates quite dramatically the rate and the magnitude of the decline in new construction in the private rental sector in the Netherlands over the last 30 years.

Year	Private rental units completed
1970	28,942
1975	24,231
1980	11,087
1985	20,210
1988	11,319
1990	8,949
1992	6,500

One of the major reasons for the decline of the private rental sector in the Netherlands has been the advent of formal pension plans. In the pre-war period, individuals would buy houses to rent and use the income so realized as pension income. In the post-war period, conventional pension plans replaced this approach to retirement incomes, offering lower risk and more reliable sources of retirement income.

A further reason for the decline of the private rental sector was the already noted significant expansion of the social rental sector, which was intended by the government to house both low income and middle income groups. Being of generally better quality than stock in the private rental sector, the social rental stock gradually attracted more and more tenants from the private rental sector.

Another blow to the private rental sector fell in 1975 with the introduction of a rent setting system known as the dynamic cost-price rental system (DCPR). The DCPR, which is explained at greater length later in this chapter, was viewed as a

[63] van den Heijden, H. and Peter Boelhouwer, The Private Rental Sector in Western Europe, Housing Studies, vol. 11, no. 1, 1996.

[64] van den Heijden and Boelhouwer, quoted in Balchin, P. (ed.) Housing Policy in Europe, page 89.

[65] Freeman et al, page 11.

significant disincentive by private landlords, and is considered by some housing market analysts to be the main reason for the decline of the private rental sector in the Netherlands.

The private rental stock in the Netherlands forms two distinctly different sub-markets: the pre- war stock, which is comprised of small properties that are generally less expensive and lived in primarily by the very young or the very old. In contrast, the post-war stock chiefly owned by institutional investors, is of good quality and concentrated in areas of the Netherlands where there is strong demand for housing (typically the big cities). Occupants are mobile and have relatively high incomes, and rents tend to be higher.

Regulation

There has been a long history of rent regulation in the Netherlands, however, this has been inextricably linked to an offsetting subsidy system (discussed below under tax and subsidy treatment). Between 1975 and 1989 the Dynamic Cost-Price Rental (DCPR) system was used to control rents in both the private and the social sectors. Essentially it fixed rents and provided an ongoing, but declining subsidy - which turned out to be insufficient to fully compensate for the low fixed rents.

Since the removal of the DCPR in 1989, rents at the top end of the market are now freely determined. However, below certain thresholds, rents continue to be controlled according to a maximum rent increase set by government. A new subsidy system, sector "C" grants was introduced as the offset although this was discontinued in 1995.

The legal position of tenants is the same in the private sector as in the social sector Owners of subsidized dwellings must adhere to increases set by national rent policy. Security of tenure is strong: indefinite term tenancy agreements are common.

In summary, the rental market in The Netherlands has been characterized by a high degree of regulation. Although this has lessened in the 1990's, it remains highly regulated by Canadian

Netherlands

standards. Tax and subsidy measures have been used largely to compensate for the impact of this regulatory regime and should be viewed within this context.

Tax and Subsidy Treatment

The Netherlands is one of the few countries where housing is treated as an investment good (as distinct from a consumption good) for tax purposes. As a consequence, homeowners' imputed rental income is taxed and mortgage interest is fully deductible, however, capital gains are tax-free.

In terms of the rental sector there are two classes of landlord and two approaches to taxation. Private individuals pay normal income tax on the income from their rental investments, which is included in their taxable income after deducting expenses (including depreciation). Private organizations in theory pay corporation tax, but the majority of those who own private rental housing are exempted from paying (Freeman Holmans and Whitehead 1996).

Normal capital depreciation is a permitted deduction for rental investment properties. There is no special or accelerated depreciation allowance for rental properties in the Netherlands

Like Germany, there has been a close link between loan subsidies and affordable rents. For many years, private landlords in the Netherlands were eligible for subsidies from the government, as long as they agreed to adhere to rent controls. Until 1975, the subsidy was an annual one that simply subsidized operating costs. However, the procedure changed with the advent of the DCPR system in 1975.

The DCPR was both a rent control mechanism and a subsidy program. It replaced this earlier "open ended" subsidy system with a predetermined annual subsidy based on a 50 year forecast of break-even rents and contract (achievable) rents.

The DCPR subsidy was paid on an annual basis, but it was withdrawn over time in anticipation of achievable rents increasing over time at a faster rate than break-even rents. In fact, the reverse

occurred and subsidies were withdrawn faster than the extent to which rents actually increased. Because of the significant losses so created, the DCPR system is widely credited with driving investors from the private rental sector.[66]

In recognition of the damage the DCPR system was doing to the private rental market (in terms of reducing investment in the sector), the system was abandoned in 1989. The government will continue to pay subsidies on previously committed units until the 50-year subsidy period expires for all projects approved while the system was operational.

Following the abandonment of the DCPR system in 1989, the government reverted to a grant system. For private rental landlords, the grants were called Sector "C" grant (these are described in greater at the end of this country profile). However, these grants were discontinued in 1995 and since then, neither subsidized loans nor grants for private rental housing have been available in the Netherlands.

Local authorities (municipal housing companies) are the primary providers of social rented stock. They have decentralized subsidy budgets (from the national government) that can be used to promote housing production or improvements of pre-war rental dwellings.

Tenants in both the private and social sector are eligible for publicly funded housing allowances as long as they have low incomes. The objective of current policy in the Netherlands is to create a financially independent social rented sector employing housing allowances as the principal subsidy instrument (which enables lower income households to afford market rents).

In an effort to reduce supply subsidies (prompted by the fact that many moderate and higher income households live in stock to which supply subsidy is linked) government policy in the 1990s has required rents to increase at 1 percent above the rate of general price inflation.

[66] See for example Oxley and Smith, page 149.

Overall, as suggested under the review of regulation, the subsidy mechanisms used in The Netherlands have been developed in concert with the regulatory framework. Subsidies, in the form of the DCPR and more recently the capital grants are a quid pro quo to landlords for holding rents down. This experience has not been positive - rents have remained affordable but at the cost of weak incentive for developers, so new production has stalled. With limited ability to maintain subsidies, the more recent trend is toward deregulation - allowing rents to rise at a greater rate than inflation.

Policy Issues

Although there has been a very marked decline in the size and importance of the private rental sector in The Netherlands, this does not seem to be a particular concern to the government or to the society (Oxley and Smith 1996). In large part this lack of concern for the state of the private rental sector is due to the very significant stock of good quality social rental housing.

The solution to current housing shortages is sought in the social rental sector and in the owner-occupied sector for higher income earners. The government is also interested in "social entrepreneurship for social landlords", which means they are trying to encourage them to become financially self-sufficient, albeit with the support of housing allowances.

Current public policy also encompasses increasing the proportion of homeowners in the Netherlands from about 44 percent to about 55 percent by the year 2000. Some of this shift will result from the sale of non-profit rentals to sitting tenants, and some from simple arithmetic – 75 percent of new housing built in the early nineties was ownership housing.[67]

Private rental housing does not appear to figure, to any degree, in the current policy framework, except in pushing rents up to a level that reflects the real cost of providing housing. This may enhance potential returns and stimulate some

[67] Boelhouwer and van der Heijden, Housing Systems in Europe, page 77.

investment. However the basis of the policy is more focused on reducing the level of ongoing supply subsidies (a legacy of older programs) than it is on stimulating new construction.

Policies and Programs Affecting Private Rental Production

The primary programs and policies affecting the private rental sector in the Netherlands have been a series of linked rent control and subsidy initiatives. However these have been phased out and currently there remain no specific initiatives directed to this sector other than pushing rents to market levels and deregulating controls. The most recent subsidy initiative, capital grants, were in place from 1989 through 1995. They are reviewed here in greater detail.

Netherlands: Sector "C" Grants

Description

Available to private rental investors as well as homeowners, Sector "C" capital grants paid Dfl2000 per unit per year for five years for the development, improvement, or major maintenance of dwelling units costing below certain limits.[68] Most of the Sector "C" housing built was in the owner occupied sector. Generally, Sector C units were part of mixed developments comprising units subsidized under Sector C as well as non-subsidized units.

Background Context

For many years, private landlords in the Netherlands were eligible for subsidies from the government, as long as they agreed to adhere to rent controls. Until 1975, the subsidy was an annual one that simply subsidized operating costs. However, the procedure changed with the advent of the DCPR system in 1975. Following the abandonment of the DCPR system in 1989, the government reverted to a grant system. For private rental landlords, the grants were called Sector "C" grants.

Specific Purpose/Objectives

The purpose behind the grants was to encourage the construction or improvement of rented and owner occupied housing in the cheaper, unregulated sector of the housing market. The government was also anxious to avoid the long-run nature of the subsidies involved in the DCPR system. Additionally, an element of decentralization was introduced, with the devolution of decision-making capability from the central government to local authorities (responsible for determining project eligibility and allocation of the grants).[69]

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[68] The current exchange rate on Dfl (Dutch Guilders) is 0.85 Canadian. As such, these grants approximate $1,700 per unit annually.

[69] Analysis provided by Marietta Haffner, OTB Research Institute for Housing, Urban and Mobility Studies, Delft University of Technology.

Duration and Level of Funding

Sector C grants were available between 1989 and 1995. In 1990, Dfl990 million was paid out in grants, of which Dfl123 million (12 percent) was allocated to the rental sector [70] (at $Can exchange rate of $1.38 the total of the rental grants approximately $170 million). Available information indicates that in 1989, 1990, and 1991, just fewer than 4,000 rental units were completed using Sector "C" grants.[71]

Impact and Success of the Initiative

Sector "C" grants were discontinued because they were viewed as expensive and inefficient. The only way the eligible price limits of the scheme could be met was by in effect cross-subsidization within a project. That is, part of the land and construction costs of Sector C units were attributed to the non-subsidized units in order to keep costs down. Over time the price difference between Sector C eligible price ceilings and non-subsidized units became too large. Even with cross subsidization within a project, costs remained above eligible price ceilings. An additional complicating factor arose when interest rates increased and the only households who could afford the Sector C units were considered to have incomes too high to be part of the target group. [72]

These problems suggests that eligibility and program criteria were not adjusted to reflect reasonable costs - perhaps an indication that the government preferred to phase out this expenditure - which they did in formally discontinuing the program in 1995.

Current Status

Sector "C" grants were discontinued in 1995.

Lessons for Canada

Although the private rental sector is not seen as an attractive investment and has consequently contracted in relative terms this has not been identified as a serious policy concern. The Netherlands removed a strong deterrent (the DCPR) in 1989 but this action was premised more on a policy shift to a more market oriented system (including the social rented sector).

One of the leading Dutch experts on housing policy forecasts the future as follows:
"On account of changing ideas about the task of the government and the need to reduce and curb government expenditure, it seems that government influence will remain limited in the years to come. In this situation, the owner occupied sector in particular will increase in importance. This is at the expense of the private rented sector, which will probably waste away further."[73]

The Netherlands experience does reinforce lessons from other countries - the critical issue is whether the investment environment is sufficiently attractive. Government policy in the Netherlands did more to reduce than to enhance the attractiveness of rental investment.

When they did implement a subsidy mechanism to stimulate construction, it was not exclusive to the rented sector; in fact the allocation to the private rental sector was only a small fraction of the program. Moreover, the program appears flawed in terms of a "designed obsolescence" (i.e. phased out after only five years). The obvious lesson here is that if government is sincere in promoting an outcome (e.g. private investment in rental development or rehabilitation) the eligibility criteria in the specific program must be set on a realistic basis and adjusted overtime to remain meaningful.

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[70] Oxley and Smith, page 151. (At $Can exchange rate of 1.38 this is approximately $170million)

[71] Boelhouwer and van der Heijden, Housing Systems in Europe, page 48.

[72] Marietta Haffner.

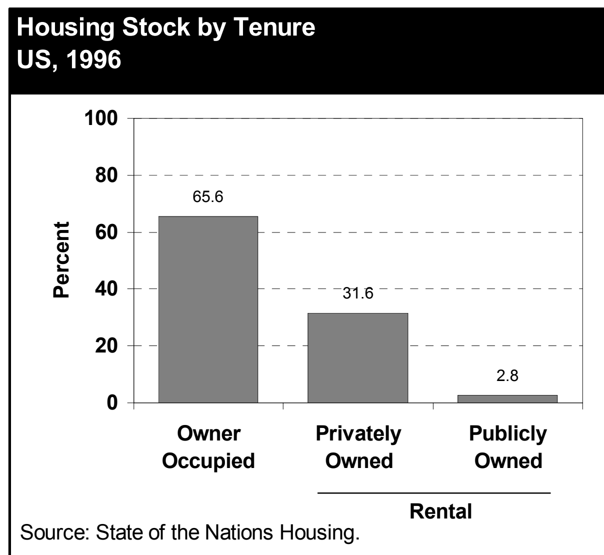
[73] Boelhouwer, Peter, in Balchin, P. (ed) Housing Policy in Europe, Routledge, 1996.

United States of America (USA)

Market Context

The profile of the U.S. housing stock is very similar to that of Canada. Just less than one third of households rent while two thirds (1996: 65.6 percent) are owner occupants.[74]

Within the rented sector the majority of units are owned and operated by private investors. Only a small number (2.8 percent are publicly or community owned. Although non-profit corporations have become the primary vehicle for the production of affordable rental housing since the mid 1980s they still account for less than .03 percent of the total stock (7 percent of the federally assisted stock).



An important feature of the U.S. housing system is the strong reliance on the private rental sector as a vehicle through which to deliver demand side affordable housing assistance (shelter allowances in the form of certificates or vouchers - these account for 29 percent of the assisted households). To a degree, this distorts the pure distinction between the private and social rented sectors, as the private stock targeted to low income households is typically counted as part of the country's assisted housing stock. In this review it is included in the private rental count.

With a reliance on private rental units to facilitate the shelter allowance approach, beginning in the early 1970s, the U.S. developed programs to stimulate private rental supply. The rational, in part, being that by encouraging supply the government would avoid a mis-match between demand and supply and mitigate rent increases and windfall gains to landlords. [75]

The result is that while identified as private rental housing, 12 percent of the total rental stock involves subsidized units (typically both a shelter allowance and a supply subsidy to a private landlord). In this sense, and similar to a number of the European countries profiled in this report, it is difficult to discuss initiatives supporting private rental production without also discussing more general policies related to the provision of affordable housing

In comparison with rental tenure, there remains a policy and program bias favouring ownership. There has been a particular concern around access to ownership among young and minority households (The National Homeownership Strategy, 1996). The ownership rate in the U.S. achieved a record high of 66.0 percent in 1997. This is attributable both to low mortgage rates but also aggressive ownership policies and underwriting provisions for lower income and minority households. Data through third quarter of 1997 shows higher homeownership among younger households. Rates among blacks went from 42.3 percent in 1994 to 44.1 percent in 1996; for Hispanic to 42.8 percent from 41.2 percent over same period.

[74] Under the national Home-ownership Strategy announced in June 1996, the Administration has established a goal of raising the ownership rate to 67.5 percent by the end of the century.

[75] (Burke 1993, p 55).

The perceived failure of public housing as a way to address low income housing need has reinforced a policy pre-occupation on promoting and facilitating ownership among low and moderate income households, as an alternative to low income rental programs.

Trends in the Private Rental Sector

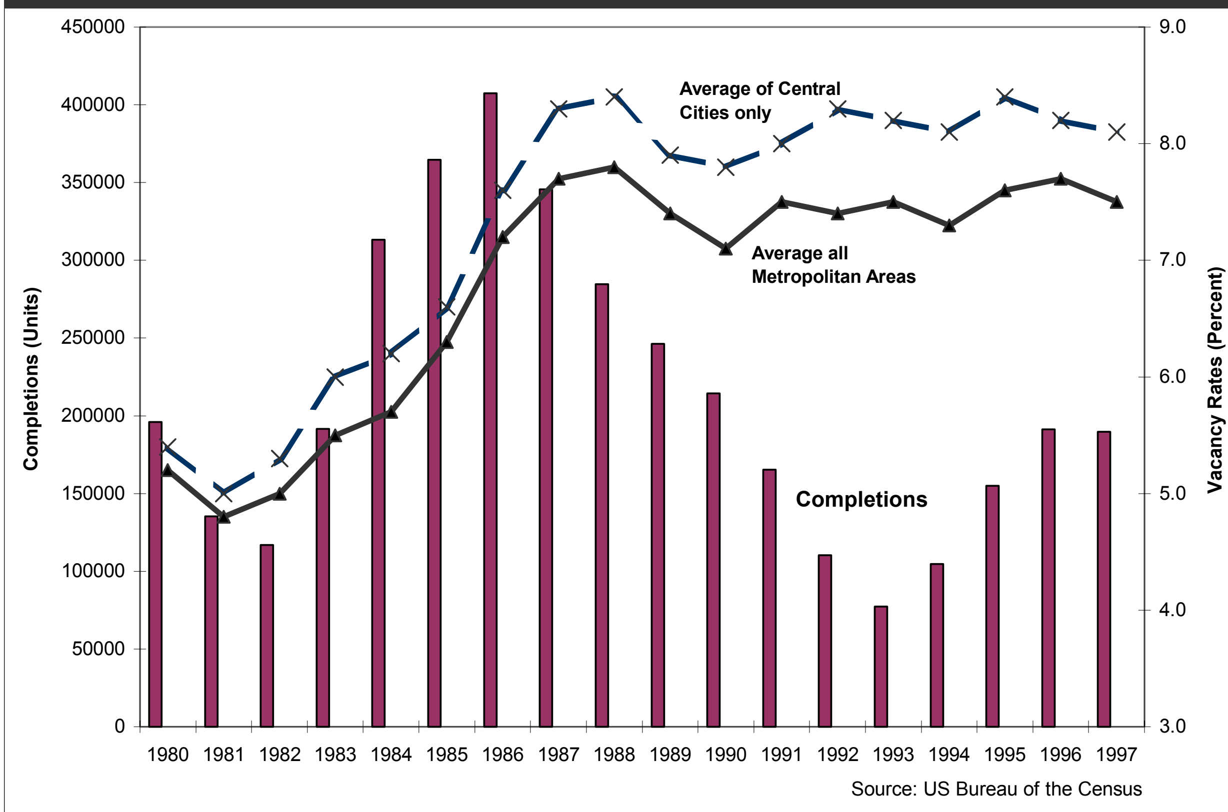
The supply of private rental housing has traditionally been stimulated by various mortgage credit and tax policies with the vast majority of the existing stock of rental housing was built under favourable tax regimes between the post war period and 1986.

The chart of completions and vacancy rates, below, illustrates the declining level of new rental housing construction since the 1980s. In 1986 over 400,000 rental apartments were completed; starts diminished thereafter with completions falling to only 77,000 in 1993, their lowest point since 1959.

A number of factors underlie this decline: one of the most significant was the 1986 tax reform; which significantly removed very attractive tax provisions that had been introduced in 1981. The 1981 to 1986 tax regime had contributed to overbuilding of multifamily units (including many condominiums that were also rented).

The impact of overbuilding is reflected in the upward trend in vacancy rates in the first half of the 1980s. It is notable, however, that despite a very significant decline in new rental construction, rental vacancy rates have remained quite high, persisting above the 7 percent level on average across metropolitan areas. This weak demand reflects demographics (the baby boom was well into the ownership cycle) and has been facilitated by favourable interest rates enabling home purchase as well as strong tax benefits associated with home ownership in the U.S.).

Rental Completions and Vacancy Rates 1980-1997



Overbuilding in the mid 1980s preceded a weak economy in the early 1990s and structural changes in the housing finance system that have constrained the availability of multifamily mortgage credit and thus limited new development (Federal Housing Act [FHA], 1995). In addition, new funding under for the private development of low-income rental projects (Section 8 project based assistance) ceased in 1986.

The subsequent recovery in rental starts through the mid-1990s (back up to 191,000 in 1996) corresponded with strong economic recovery. The increase in rental starts involved primarily production of units at higher rent levels.

Although overall vacancy rates have remained high, the availability of a sufficient supply of lower rent affordable housing has continued to be an issue in the U.S. Recent policies in this are have emphasized the use of public private partnerships and involve a number of subsidy and tax credit programs. [76]

Since the mid 1980s there has been little direct intervention at any level of government, to stimulate private rental development other than initiatives related to affordable housing production (which are estimated to account for about one quarter of all rental starts (Lea and Wallace 1996).

The lack of stimulus for private rental development is in part related to the absence of effective demand (as distinct from affordable housing need). As discussed earlier, rental vacancy rates have remained soft.

Regulation

Tenant protection and rent regulations are legislated through the state but are generally implemented at the discretion of local government.

[76] For detailed analysis on partnerships see separate report the Role of Public Private Partnerships in Producing Affordable Housing (Pomeroy et al 1998). The tax measures and specifically the Low-Income Housing Tax credit are briefly discussed in a later section of the current report.

While many cities have some form of tenant protection regulation, most have deregulated the control of rents. Tenancy is typically on a one-year leasehold basis.

Typically, local rent regulation approaches involve some benchmark formula indexed to inflation or to savings interest rates. Increases above these benchmarks are either prohibited or subject to review. Regulations generally require adequate maintenance as a condition of rent increase and have appeal procedures both for landlords (to exceed the allowable increase) and for tenants to appeal increases. New rental construction is usually exempt from these controls.

A serious problem with discrimination against minorities and low income households has been evident in U.S. housing markets (both ownership and rental) prompting enactment of specific legislation, notably the Community Reinvestment Act (1977) and the Fair Housing Act (1988). These legislative actions have tended to stimulate private lender investment in affordable housing, much of which is rental.

Overall, although regulatory regimes exist in many cities, these tend to focus on creating some security of tenure for renters and prohibiting excessive levels of rent increase. Relative to the tax system, rent controls have not been seen as a serious impediment to new investment, particularly since most systems have exempted new construction from the controls.

Tax and Subsidy Treatment

Preferential federal tax treatment has traditionally been the primary policy tool affecting private rental investment and was significantly enhanced in 1981. The Accelerated Cost Recovery System of the Economic Recovery Tax Act (ERTA) 1981 provided a strong stimulus for private rental production. This is clearly reflected in the high levels of completions in the earlier chart (note that completions data lag the initiation of the project development process, so the effect of ERTA are more evident in the chart beginning in 1983).

This tax change accelerated the period of depreciation (from 30 to 15 years) and permitted a

one-year write-off of soft costs (all taxes and interest carrying costs paid during the construction period could be written off immediately).

The 1986 Tax Reform Act subsequently removed the advantageous provisions of the 1981 ERTA (again, this change is clearly reflected in the chart, with a substantial decline in completions after 1987).

The 1986 reform extended the depreciation period from 15 to 27.5 years, increased the capital gains tax rate, and imposed restrictions on tax sheltering of passive investments (i.e. those typical in a syndication). This later action removed the attractiveness of the investment for investors not directly involved in real estate.

The 1986 Act introduced a new tax credit for investors in housing projects that serve low-income households - the Low Income Housing Tax Credit. The LIHTC has become the primary tool in stimulating affordable new rental activity as well as rehabilitation (this mechanism is discussed at in more detail at the end of this profile).

In sum, tax measures coupled with subsidy programs that encouraged the private production of rental housing (but with low- income tenant targets) have been a major influence on the volume of private rental investment in the U.S.. In particular the ERTA regime (1981 through 1986) had a substantial influence on investment and construction levels.

Policy Issues

Beyond concerns about a sufficient supply of affordable housing, the historically low level of unassisted rental production (reflected in the preceding figure) does not appear to be a serious issue in the U.S.. There is no evidence of efforts to stimulate or enhance private rental production outside of the affordable sector. With vacancy rates in the rental sector remaining very high there is no basis to pursue the stimulation of the market - except in specific cities where these high rates do not prevail. [77]

The primary issues in the U.S. revolve more specifically around meeting affordable housing need. Private rental production is, however, a component of this overall strategy, most particularly in the form of incentives to rehabilitate or build mixed income or low-income projects. These incentives take the form of direct subsidies through block grant programs - Community Development Block Grants (CDBG) and HOME - and indirect subsidy through tax expenditures measures notably the Low Income Housing Tax Credit and tax exempt mortgage bonds. These measures are described in more detail at the end of this profile.

Similarly related to production of affordable multifamily rental housing, access to mortgage credit has been a serious issue. "Thrifts " (Savings and Loans Institutions) were a major source of private multi-family debt financing prior to their collapse in the mid-1980. As a result of this collapse, the thrift industry was downsized with no other institution stepping forward to provide multifamily financing. In response to the Thrift collapse, the 1989 Financial Institutions Reform, Restructure, and Enforcement Act (FIRREA) imposed substantial risk-based capital requirements on multifamily lenders.

These new requirements significantly restricted the flow of mortgage credit, since multifamily loans held in a lender's portfolio are given the maximum (100 percent) risk weight for capital reserve requirements, effectively discouraging lenders from holding these assets.

Changes in the Federal Housing Authority (FHA) mortgage insurance underwriting criteria have been another factor that has reduced the

[77] A number of Cities have developed land use policies specifically linking new commercial development to a requirement to produce housing, premised on the fact that the commercial enterprise generates new employment and thus housing demand. These policies are not necessarily linked to private rental production, although cities such as Boston and San Francisco use these programs to encourage affordable housing.

availability of mortgage financing for rental production. Following significant loses in the mid-1980s (related to weak underwriting and a collapsing market) FHA underwriting criteria were tightened and as a result the FHA presence in multi-family lending contracted.

With a strong policy focus on increasing the homeownership rate, especially among minority and lower income households, there has been a strong focus on developing new underwriting and credit enhancement programs in the ownership sector. Similar measures have been much slower to develop in the multifamily sector - for example the development and expansion of a secondary market for multifamily loans is far less advanced, compared with single family lending sector.

Compared with single family lending, in multifamily underwriting there is less standardization of loan products, a pre-requisite to secondary market syndication. In addition, rental loans are generally large and impact on the MBS pool cash flows. These feature make multifamily lending less attractive with the result that private mortgage insurers do not participate in multi family credit enhancement.

Without access to a liquid secondary market to move multifamily loans off their books, traditional multifamily mortgage lenders are discouraged by the FIRREA requirements from making new loans.

Restricted access to capital for multifamily development is partially offset by the emergence of Real Estate Investment Trusts (REITs - especially in relation to higher rent properties). There has been considerable REIT investment in rental apartment properties over the past two years - however this is focused largely on existing properties and has only recently begun to translate into investment in new rental production - primarily upscale development in strong housing markets.[78]

In summary, private rental production has not, in and of itself, been a serious policy issue since the early 1980s (even then the focus of ERTA was more on economic recovery than on rental production). Policy initiatives have focused much more strongly on the other components of the housing system- the ownership sector and affordable rental production. It is only in the latter context that recent policy initiatives have impacted on private rental activity.

Policies and Programs Affecting Private Rental Production

Historically policies and programs to facilitate or stimulate private rental development in the U.S. have included both direct subsidy programs and indirect subsidies in the form of tax measures (with associated expenditure costs to the federal treasury). Facilitative measures have also been an important tool, primarily in the form of mortgage insurance and more recently credit enhancement.

Subsidy programs to stimulate supply were a key feature of the 1960s and 1970s (continuing into the 1980s), but are no longer active. For reference, these included financing subsidies (interest rate subsidies under Section 236 of the U.S. National Housing Act, 1934)[79]; and Section 8 (of the US Housing Act, 1937) which essentially provided subsidies to cover the difference between 30 percent of income and market rent.

Tax measures related to the treatment of capital expenditures on housing - include the 1981 ERTA and 1986 Tax Reform Act (which established the Low Income Housing Tax Credit).

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[78] For more detailed discussion on the emerging US experience with REITs and their potential impact see a forthcoming CMHC External Research Report titled *Examination of the Prospects for, and the Potential Impacts of Real Estate Investment Trusts on the Multi Family Rental Market in Canada*, (Tony Wellman, 1998 forthcoming)

[79] Section 236 below market interest rate Program was used between 1968-73 but cancelled in the moratorium imposed by the Nixon Administration in 1973. Effectively, it provided low interest rate project financing in exchange for project operators meeting certain conditions in relation to housing low-moderate income households. Generally it was also stacked with Sec 221 FHA mortgage insurance. Since it has been inactive since the early 1970's it is not profiled in detail.

The primary facilitative measure has been mortgage insurance underwritten by the FHA (private mortgage insurers are a significant player in the single family market but have left the riskier multifamily insurance sector to the FHA (under various authorizations of the FHA, but primarily Section 221).

FHA mortgage insurance, and two tax provisions remain in place and are profiled in more detail in the next section.

U.S. - Federal Mortgage Insurance

Description of the program/ policy:

HUD's National Housing Act Sections 221(d) (3) and (4) are the primary programs used to insure multi family (five or more units) housing loans. By providing protection to lenders in the event of default, mortgage insurance induces lenders to provide financing and, depending on underwriting criteria, to increase the percentage of project development costs that they are willing to finance. Underwriting criteria permit loans up to 90 percent of project development costs. The program provides insurance both for new construction, substantial rehabilitation and refinancing.

Background Context:

Through the Federal Housing Administration (the mortgage insurance arm of HUD) the federal government provides a range of mortgage insurance products intended to facilitate the provision of private lender housing finance. Sections 221 (3) and (4) of the national Housing Act were enacted in 1954 and 1959 respectively.

Currently, Section 221 (d) (3) permits insurance of loans up to 100 percent of replacement cost for public, non-profit and co-operative borrowers; meanwhile, Section 221 (d) (4) limits the loan amount to 90 percent irrespective of the type of mortgagor. The introduction of mortgage insurance (in both the U.S. and Canada) was premised on the desire to reduce the direct lending activities of government but ensure that affordable financing is available.

Section 221 loans are intended to stimulate production of affordable rental housing and as such HUD regulated the rents of insured projects - they were not permitted to exceed rents for comparable projects in the same market area. In 1983, HUD removed this restriction along with requirements that HUD approve rents, charges and fees provided that owners agreed to limit their cash distributions from project operations.

The primary program that existed (under Section 221) through the 1980s was the FHA co-insurance program. Under this program the FHA delegated

authority to lenders to originate, process and underwrite mortgage loans and subsequently to service the loans and where necessary manage the disposal of defaulted properties. Lenders assumed the first 5 percent of any loss on loans that they originated under this provision. Losses in excess of this amount (after disposal proceeds) were split in the ratio of 15 percent and 85 percent to the lender and FHA respectively. Lender fees for processing these services were paid upon loan approval. Much of the co-insurance activities in the 1980s related to refinancing under a separate section of the FHA (Section 23 (f), however some 61,000 new units in 314 projects were produced.

Specific Purpose/Objectives

As noted above, the purpose of mortgage insurance is to pool risk and thereby encourage origination of loans by private lenders. Section 221 was focused specifically on supporting investment in multi-family development. By reducing the lender's risk, mortgage insurance encourages lenders to raise the loan to value ratio on loans, a key factor lowering the amount of developer (or investor) equity in the project. Depending on the mortgage interest rate, this enhances the return on investor equity. In turn, this helps to make rental housing investment competitive with other investment alternatives.

Duration and level of funding

Section 221 has been available since the 1950s. Unlike the FHA's single family insurance programs, which were required to be self-supporting (through premium revenues), multifamily insurance programs have required regular congressional appropriations.

Impact and success of the initiative

FHA mortgage insurance has been an important factor in encouraging multi-family financing. In 1980, FHA insurance accounted for 30 percent of multifamily rental mortgage loans - however by 1990 the market share had fallen to only 6 percent of all multifamily loans (the majority are financed on a conventional basis with sufficient levels of investor equity to avoid mortgage insurance.

The decline in FHA insurance is explained in part by a shift in public policy which halted the Section 8 project based rental assistance program - Section 8 projects were all FHA insured. The decline was also a result of very substantial loses incurred by the FHA, particularly related to the co-insurance product. As reported by the GAO analysis of multi family finance (1994) the program generated losses in excess of $2.8 billion, which were attributed to poor program design and weak administration (GAO 1994).

The consequence of these large losses (which through co-insurance the lenders shared) was that lenders and investors perception that multi family loans are very risky was heightened. In addition, this experience made the FHA wary of developing new credit enhancement products for multifamily lending.

Many of the loans originated through the co-insurance program had been purchased and securitized by Freddie Mac, one of the secondary mortgage market conduits. In the face of high defaults, Freddie Mac suspended its cash purchase program (that provided liquidity to the multi family mortgage market).

By the mid 1990s FHA volumes rebounded somewhat, aided primarily by the imposition on the two secondary mortgage market Government Sponsored Enterprises (GSEs - Freddie Mac and Fannie Mae) "Special Affordable Housing Goals". These goals are legislated targets and require the GSEs to purchase specified volumes of affordable housing multi family loans from individual lenders. In many cases, the insured loans are part of multi layer financing packages with substantial layers of public subsidy through subordinated loans funded under the HOME and Community Development Block Grant programs (see Pomeroy et al 1998 for details of partnership projects).

Current Status

Section 221 (d) (3) and (4) of the NHA remain active although current volumes remain very low. In 1996 and 1997 some 124 and 147 projects were underwritten totaling just over 23,000 units in each year.

Lessons for Canada

Like the U.S., Canada already has a public mortgage insurance program, which includes rental products. Unlike the U.S., CMHC has generally sought to maintain premiums at a level that makes the Mortgage Insurance Fund self-sustaining. This objective notwithstanding, the rental insurance part of the MIF has incurred losses (a premium deficiency).

The economics of rental development in many Canadian markets are such that new development is barely economically viable, especially in the short term. The lending value of rental properties is typically only 60 percent-80 percent of actual cost so that even with an 85 percent insured loan (this is 85 percent of lending value, not actual cost) potential rental developers are required to provide very significant levels of equity (often 30-40 percent of development costs). With returns on rental investment relatively low and risks high, such investment is extremely unattractive so that little investment is forthcoming.

Given the well established and seemingly better managed mortgage insurance system already in place in Canada it is unlikely that the U.S. experience with mortgage insurance can provide any lessons for Canada. However, the encouragement of an active multi-family secondary mortgage market might be beneficial in increasing liquidity of loans to support the private rental sector.

U.S. - Federal Tax Incentives

Brief Description

Tax measures are one of the most significant tools used to stimulate rental production in the U.S.. During the early 1980s accelerated depreciation coupled with the liberal use of soft cost deductibility were the primary motivators for large-scale investment in rental housing. Since 1986 the single most important program responsible for rental development and rehabilitation has been the Low Income Housing Tax Credit (LIHTC).

Background Context:

Under the tax laws in effect prior to 1981, investors in rental properties were allowed to choose among a number of methods for depreciating project costs and in most cases 33 years were recognized as the allowable tax life. This effectively permitted large amounts of development costs to be written off and used to reduce taxable income.

The 1981 Economic Recovery Tax Act (ERTA) shortened the depreciation period for rental investments to 15 years and permitted accelerated depreciation. Substantial rehabilitation of a low-income property could qualify for full depreciation over 5 years. Rehabilitation of historic structures qualified for a 25 percent investment tax credit - encouraging the rehabilitation of these structures. Moreover, these tax provisions also applied to passive investors, permitting losses to be applied against income from other sources.

The enactment of the LIHTC in the Tax Reform Act of 1986 supplanted previous tax measures and is significantly more effective in targeting production to affordable rental housing. [80] The measure, authorized under Section 42 of the Internal Revenue Code provides a ten-year stream of tax credits to be used against federal income tax liability for investors in qualifying rental projects - these are a dollar for dollar credit against federal tax payable, not merely a deduction against taxable income.

[80] Section 167(k) of the Internal Revenue Code was ended with the Tax Reform Act of 1986. There is still a historic rehabilitation tax credit of 20 percent and, for commercial and industrial developments (but not residences) a 10 percent rehabilitation tax credit (Section 47).

Specific Purpose/Objectives

Both the ERTA and LIHTC tax measures were intended to enhance the after tax return on equity generated by investors in rental housing and thereby attract such investment.

The ERTA provisions were created as part of a post recession economic recovery package intended to stimulate employment in the construction trades. These tax-related equity proceeds were often combined with various forms of project based rental assistance (under Section 8 of the U.S. Housing Act), that provided direct subsidies reduced rents to 30 percent of income). However, use of the tax provisions was not tied to affordable housing, and much market rate housing was developed.

In contrast, and as the label suggests, the LIHTC was directly linked to the production of low-income affordable housing. Projects qualify to use the LIHTC by providing a minimum of 40 percent of the units to households with incomes under 60 percent of local family median income (or 20 percent of units to households below 50 percent of median income) and affordable at no more than 30 percent of income for rent - in practice, there is limited income mixing, most projects have 100 percent of the units within these criteria.

Owners must commit to maintain affordable rents for a period of 30 years (initially 15 years but later extended to 30 years in 1989). Private developers (just over two thirds of LIHTC are developed by for profit general partners) will likely seek to sell the project to a non-profit after they have received the 10 year flow of tax credits. Owners can notify the state credit agency as they near the 15th year of their intention to sell.

The value of the tax credit is calculated from the eligible basis of the project (development costs including fees, net of land), the proportion used to accommodate target households, and a discount

rate to reflect the fact that credits are received over a period of 10 years. Two levels of credit are available:

1. for new construction projects without federal subsidies (such as CDBG, HOME or an FHA insured mortgage), the annual credit is approximately 9 percent of the depreciable base of the project;
2. for acquisition, substantial rehabilitation and new projects where federal subsidies are involved, the credit is 4 percent per year.

The equity investment generated by the prospect of 10 years of tax credits typically covers about one-third of total development costs. Alone, it is not sufficient to achieve affordable rent levels without some other form of assistance as net revenues from rents (limited to be affordable to low-income tenants) supports mortgage debt of only about one-third of total costs - leaving one third as an "affordability gap" (Wallace 1995). This final third must be assembled from a variety of other sources and results in a layering of many financing sources - see Pomeroy et al 1998).

Impact and Success of the Initiatives:

The tax provisions enacted under ERTA had a significant impact in stimulating rental production. Multi-family rental starts rebounded from a low of 379,000 in 1981 to over 600,000 annually between 1983-1986, a boom characterized by many analysts as overbuilding. In most cases, the projects developed during the 1981 to 1986 period were insured under the FHA coinsurance program - discussed earlier. In the context of overbuilding, softening markets and the previously discussed weak underwriting practices of this program, a high level of mortgage default resulted.

In 1985, the U.S. General Accounting Office conducted a review of incentives used to encourage private investment in the production of multi family rental housing. The analysis modeled the effect of different measures on the after tax rate of return (premised on an initial hurdle rate of 15 percent). In summary, the review reported that:

- the ERTA tax treatment increased the rate of return from 15 percent to 16 percent;
- the financial leverage benefits of accessing federal mortgage insurance (to reduce equity) increased the rate of return from 16 percent to 25 percent; and
- the below market interest rate benefits from direct financing subsidies (available for elderly housing under Section 202) further raised the return from 25 percent to 29 percent.

It was already recognized that the tax provisions of the ERTA were extremely advantageous (this applied to many of the measures, not just those relating to housing), especially when coupled with other programs, such as Section 8 project based assistance or Section 202 below market interest rate loans. Thus the tax Reform Act of 1986 set out to eliminate many of the tax benefits introduced only five years earlier.

In the case of housing, an unlikely alliance of financial institutions, the real estate industry and affordable housing advocates lobbied successfully to retain some tax measures with specific targeting to enable the production of affordable housing. Thus the LIHTC was enacted - initially on a year by year basis, but recently signed into permanency by President Clinton.

Since its inception, the LIHTC has contributed to the production or of approximately 70,000-90,000 affordable multi family rental units annually.[81] These account for somewhere between all rental starts (in the recession related low production year of 1991) to perhaps one-third of rental completions in recent years. Precise data are not available as the new method of producing affordable housing involves multiple layers of financing and program funding so units produced under a specific program can be double or even triple counted (see Pomeroy et al 1998).

[81] LIHTC facilitates both new development and rehabilitation. In 1994, new construction units totalled 74,000. Another 20,000 involved substantial rehabilitation and 23,000 acquisition and rehabilitation (Lea and Wallace 1996).

Duration and level of funding

The 1981 ERTA provisions were in effect from 1981 to 1986. No explicit funding was provided but there was an implicit tax expenditure cost.

The LIHTC was introduced in 1986 with annual credit allocations on a formula basis ($1.25 per capita, totaling some $315 million annually. Because credits are used by investors annually over a ten year period, and due to the layering of each years credits, the total expenditure in the tenth year of the measure approximates $3 billion (10 x $315 million). Since units were under construction and the credits could not be taken until units put into service, there is a slight time lag before the full tax expenditure impact of this program is experienced. The 1997 expenditure cost reported was U.S.$2.8 billion, reflecting ten years of layering (HUD 1997).

Current Status

The 1981 ERTA has been supplanted by the 1986 Tax Reform Act;

The LIHTC measure remains in place. A proposal is currently in Congress to increase the annual allocation from 1.25 per capita to $1.75 per capita

Lessons for Canada

Like the U.S., Canada has also utilized tax measures to stimulate rental production - in the form of the MURB program (1974-81). This program mirrored some of the provisions of the ERTA, most particularly the provision allowing passive investors to apply write-offs against other income.

The consensus from research (both in Canada and in the U.S.) suggests that much of the impact of these measures is in the form of accelerated construction activity, rather than net new production. The program benefits are often capitalized into development costs (i.e., as developers anticipate higher returns the valuation of the property increases, usually reflected in higher land prices). Meanwhile large tax expenditures are imposed on the treasury. Many economists generally argue in favour of an explicit, direct subsidy, over such opaque tax measures.

U.S. - Tax Exempt Bonds

Brief Description

Tax-exempt bonds have been used extensively in the U.S. since the 1930s to finance various municipal capital programs, including the construction and rehabilitation of housing. They are used both for non-profit and private-for-profit development where there is some low-income targeting provision. State and local housing authorities can issue bonds. The interest on the bonds is exempt from federal taxation (and at the will of the State also from State income taxes). As a result, the after-tax yield is enhanced and the bonds are issued at favourable rates to reflect this factor. The result is a source of lower interest financing.

Background Context:

Tax-exempt bonds have been used in the U.S. since the 1930s. State and local housing finance authorities are authorized to issue the bonds under Section 103 of the Internal Revenue Code. Until 1968 there were few restrictions on the use of the bonds, and unlimited authority for their issuance - leaving the federal treasury exposed to an unknown level of tax expenditure loss. In 1968, in the face of expanding use of the bonds, Congress amended Section 103 to make bonds taxable, but permitted exemptions for specific purposes - including the construction and rehabilitation of housing.

In 1980, the legislation was amended further, requiring the bonds to be used to assist the production of affordable housing - 20 percent of the units produced must be targeted to low-income households. The Mortgage Subsidy Bond Act of 1980 also set annual caps on the total bond volume for each state.[82]

Bonds were used both as new money issues to finance new development, and to refinance older issues with bond financing at better rates. In addition, the finance agencies are also authorized to issue tax-exempt bonds on behalf of charitable organizations (referred to Section 501 (c)(3), after the section of the Internal Revenue Code authorizing charitable status.

[82] For multi family housing, State Finance Agencies issue both tax exempt and taxable bonds but only the tax-exempt bonds are subject to the caps.

Specific Purpose/Objectives

The objectives of the legislation supporting tax-exempt bond issues was to provide state and local government with a means of raising capital for a variety of public works and housing initiatives. By exempting the bonds from federal taxes, states and localities were able to access lower cost financing - as such this is tantamount to a federal subsidy of local borrowing. This was not an initiative created specifically to encourage private rental development, however, the 1980 legislation extended this provision to rental housing - providing the project so financed is targeted to eligible low income households.

Impact and Success of the Initiative

Tax-exempt bonds have become a common feature in financing local initiatives. In terms of housing, and in the context of the timeframe being reviewed in this report, the volume of bonds has fluctuated. There was a dramatic increase in the use of tax-exempt bond financing in the early 1980s, (from $1.1 billion in 1981 to $5.1 billion in 1982 - a level that prevailed through the mid 1980s. (GAO 1986)

This increase followed the ERTA reform and coincided with the dramatic rise in interest rates, the reductions in direct subsidies for affordable housing production, and significantly, constraints on the availability of multi-family credit from conventional sources.

With the introduction of the LIHTC in 1986, the use of the bonds declined. This reflected the fact that the level of the tax credit was reduced from 9 percent to 4 percent of eligible capital costs in a project that combined the LIHTC with ongoing federal subsidies or tax exempt financing. Accordingly affordable housing developers tended to use one or the other, not both together.

In 1994 the multi-family bond issue to fund new development totaled $0.432 billion and was associated with the production of some 8,185

units. Meanwhile refinancing issues totaled a much larger $1.387 billion (22,260 units).[83]

Due to the targeting restrictions imposed in the 1980 legislation, most tax-exempt bond financing of multi-family housing is associated with affordable housing production (although the developer may be a non-profit or for-profit organization).

Duration and Level of Funding

Tax-exempt bonds have been authorized since the 1930s. In recent decades, as noted previously, issues of multi-family bonds have totaled as much as $5 billion but have since fallen to less than $2 billion annually (including refunding).

Current Status

Tax exempt bond financing remains active, but volumes for multi-family housing continue to be quite low relative to the peak years of the early 1980s.

Lessons for Canada

While there is an equally long tradition of bond and debenture financing among Canadian municipalities and provinces, to date, none have involved any federal tax-exempt status.

The practice in Canada has traditionally been to direct federal provincial cash transfers, or to cede tax points under federal-provincial fiscal equalization measures, rather than the more indirect federal subsidy that would be incurred through tax exempt bonds. The efforts of the U.S. Congress to establish caps and criteria over the use of this financing source suggest that unlimited exposure of the federal treasury to such expenditure "losses" is untenable.

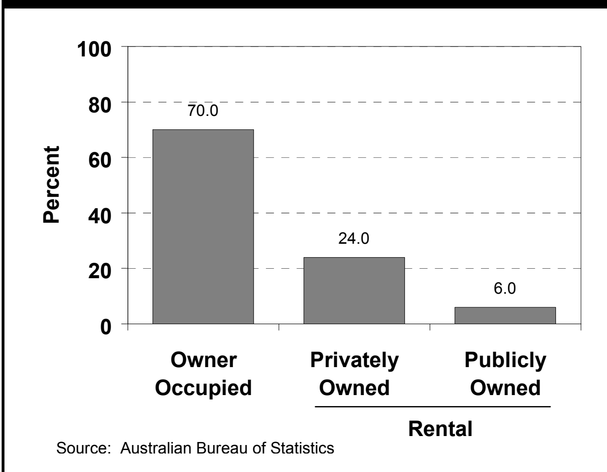
Until very recently, tax reform in Canada has focused on disentangling the tax system (i.e., removing tax incentives and loopholes). On a number of occasions municipalities have suggested tax exempt bonds but the federal government has persistently resisted such measures.

[83] A much larger volume of bonds are issued to support development and financing of single family housing - in excess of $10 billion in 1994)

Australia

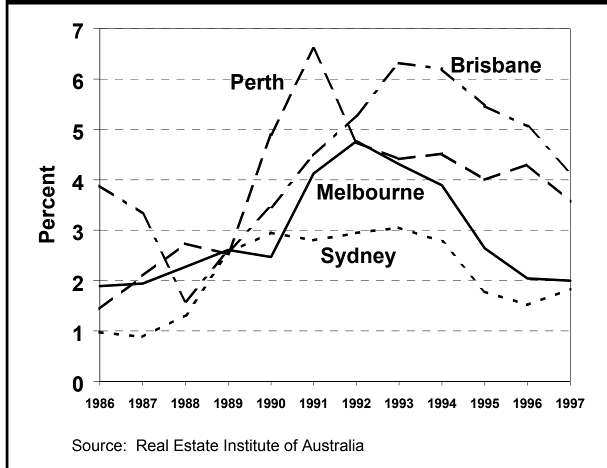
Market Context

Owner-occupants accounted for an estimated 70 percent of all households in Australia in 1997. This is among the highest rates of owner-occupancy among the countries covered in this analysis. Tenants of publicly owned rental housing accounted for 6 percent of all households. The remaining 24 percent were renters in privately owned rental housing. Most of these private renters were in units owned by individuals and companies; however, roughly 5 percent of private renters and 1 percent of all households) were living either rent-free or in dwellings owned by "other" types of landlords (e.g. employers, cooperatives, etc.).



The relative shares of owner-occupants, and public and private renters have remained relatively stable throughout the period since 1980.

As illustrated in the chart, the vacancy rates in major cities are relatively high. According to data from the Real Estate Institute of Australia, the rental vacancy rates in all state capital cities peaked in the first half of the 1990s. By 1997, vacancy rates in Sydney and Melbourne had fallen to roughly 2 percent – all other state capitals had higher vacancy rates of 3.5 percent or more.



Australian data do not disaggregate new housing activity by tenure. Projects built specifically for rental do not appear to account for a large share of the private rental market. Most landlords in Australia have relatively small holdings – typically, individuals purchase single houses, or dwellings in a block of "home units" (condominiums in Canadian parlance), or high-income earners purchase small blocks of flats (either individually or in partnership) from developer/builders who build mainly for the tax shelter market.

Roughly half of the private rental housing stock in Australia is comprised of single-detached houses – the comparable number for Canada is 15 percent.

An analysis of the characteristics of landlords in New South Wales indicated that almost two-thirds were individuals – which accounted for over half of the rental stock.[84] Of the remaining landlords, 30 percent were partnerships and only 6 percent were companies. Companies held less than 20 percent of the total rental stock – almost half of

[84] Commonwealth Department of Social Security, *Overview of the Australian Private Rental Housing Market*, Policy Research Paper No. 72, October 1996.

these companies held only one property. Another survey (cited in the same report) indicated that 78 percent of Australian rental landlords owned only one property.

Regulation

State governments have the legislative authority in the area of landlord/tenant legislation. While all states have landlord and tenant legislation, the scope of the legislation varies significantly. In particular, some states have rental bond boards that hold bonds paid by tenants (damage deposits in Canadian parlance), and which may arbitrate in the case of disputes concerning damage and the return of bonds.

Other than during and immediately following World War II there have been no rent controls in Australia.

State and local government policies governing the rezoning of land for residential development have been a subject of criticism in some quarters since they are perceived as a significant factor behind periodic shortages and high costs of multi-unit development land in the major cities – especially Sydney.

In summary, the regulatory environment in Australia is much less prominent as a negative influence on rental investment than is the case in most other countries reviewed.

Tax and Subsidy Treatment

There have been significant changes in the income tax treatment of rental properties over the period since the early 1980s.

In 1985, the Commonwealth (federal) government introduced a capital gains tax – on *real* gains (i.e. those above the rate of inflation) only. Owner-occupied property is exempt from the capital gains tax. Owners of rental properties acquired prior to 1985 are also exempt from the provisions of the capital gains tax.

Along with the introduction of the capital gains tax which applied to rental housing acquired in 1985 or later, the government introduced a depreciation allowance (of 4 percent) for *newly constructed* income-producing properties only – including rental projects. Previously, depreciation was not an eligible expense for income tax purposes.

As part of the 1985 tax changes, “negative gearing” was “quarantined” (i.e., a moratorium was imposed). Negative gearing describes the practice of utilizing the losses incurred on rental properties (in cases where there was a deficit between rental income, versus interest and operating costs) as a deduction from other income for tax purposes. Despite the fact that negative gearing involved actual operating losses (distinct from book losses), there was no depreciation allowed on pre-1985 buildings. This practice was commonly cited as a tax shelter for high-income taxpayers.

The "quarantine" (moratorium) on negative gearing was lifted in 1987 in an effort to stimulate the supply of new rental housing. According to representatives of the housing industry, the 1985 changes had caused a reduction in new rental supply as evidenced, in part, by low vacancy rates in some centres, especially Sydney. As part of the same package, depreciation allowances (which still apply only to newly constructed properties) were reduced from 4.0 percent to 2.5 percent.

The Australians consider that their tax provisions “provide a very favourable investment environment for rental investment, in particular for those with high marginal tax rates”.[85] To the extent that depreciation can be used to create losses against other income for tax purposes, this appears (from a Canadian taxation perspective) to be true; however, the use of depreciation is restricted to new rental properties only.

State taxes on rental housing can be a significant factor in investment. Australian states do not have a substantial independent source of revenues – they do not levy income or sales taxes but instead obtain most of their revenues in the form of grants from the Commonwealth government. With no

[85] Commonwealth Department of Social Security, 1996.

independent income taxes or sales taxes, the states are forced to rely on land taxes and "stamp duties" (effectively transaction taxes) – both of which impact on the cost of operating rental housing. The rates for these taxes vary by state but they can be a significant cost for landlords. These state land taxes are in addition to local government property taxes.

State land taxes are levied annually on the value of properties. Land taxes typically average 1-3 percent of median dwelling value (owner-occupants are exempt). The rates of tax are higher for taxpayers with higher values of properties owned – some states have marginal rates for their annual land taxes in the 2-4 percent range for taxpayers with high value properties. In some states, the total value of an investment portfolio is treated as a lump sum, generating higher effective tax rates on large investors than if their properties were taxed individually. These state land taxes have been cited as a major impediment to rental investment in anything other than small rental properties (where the taxes are less onerous).

State stamp duties are also payable on tenants rental leases (1 percent or more of annual rent in some states) and on property transactions (3-5 percent on property sales of $300,000+) and mortgages. The stamp duty rates vary by state.

In sum, there are no subsidy programs directed to the private rental sector. From a tax perspective there are a number of tax burdens imposed by the states but, to a large degree, these are offset by quite favourable income tax treatment of rental investment. The impact of negative gearing (allowing rental losses to be written off against other sources of income) has however become an important feature in making the rental market attractive to investors - as evidenced by a production decline when this measure was temporarily suspended.

Policy Issues

Most analysis and policy development in Australia is concentrated in the promotion of home ownership – or, for those requiring assistance, on publicly owned rental housing. The supply of private rental housing appears to have been left largely to market forces to sort out.

There appears to be little concern in Australia regarding the adequacy of private rental supply. Indeed, a recent report by the Commonwealth Government indicates that "there is little evidence of chronic failure in the private rental market".[86] The report indicates that none of the problems associated with a failure of supply (low levels of housing satisfaction, queues, greater use of low-cost housing on the urban fringe, overcrowding, and chronic homelessness) are evident in Australia.

The report goes on to say: "For the majority of low-income tenants, it would therefore appear that access to housing should be possible in the private rental market, assuming it is affordable to people on low incomes." The report concludes that "the supply of rental housing, though complex by nature, responds to demand over time" and "affordability problems are a function of low incomes". Consequently, there is little interest in programs or policies designed to stimulate the supply of private rental housing.

Australia appears to be in the midst of re-thinking of its social housing system, with an apparent shift toward increasing reliance on the private sector - using shelter allowances to address affordability issues, but relying of the proven ability of the private rental sector to supply a sufficient stock of rental housing. Another objective is to enable low-income tenants to access private sector housing rather than remain on public housing waiting lists.

Policies and Programs Affecting Private Rental Production

There has not been a great deal of interest in programs or policies to encourage the production of private rental housing in Australia. With the exception of a few periods of high demand in major centres (especially Sydney), the supply of

[86] Commonwealth Department of Social Security, *Submission to the Senate Community Affairs References Committee – Inquiry into Housing Assistance*, May 1997, page 62.

private rental housing has generally been considered adequate to meet demand.

Negative gearing – allowing rental landlords to deduct operating losses (plus depreciation on new buildings) from other income – is considered a significant benefit to landlords in Australia. While this provision was discontinued for a short period in the mid-1980s, it was relatively quickly reinstated and both major political parties have reiterated their support for its continuation – on the grounds that changes would negatively affect the supply of private rental housing.

Other than this "tax benefit", there has been little in the way of initiatives directed at encouraging new rental investment. One initiative, which was planned in the late 1980s, but did not come to fruition, involved a program to direct investment to low-cost rental housing through a Commonwealth government direct rental subsidy scheme. An up-front subsidy was to be offered to supplement private finance directed towards providing affordable rental housing. Despite invitations to states to submit proposals for such projects, none were received and no funds were ever appropriated for the scheme. Discussions with Commonwealth housing officials failed to turn up any evidence of interest with respect to this initiative.

There have been programs to support the supply of public rental housing using public-private joint venture arrangements. Several ventures involve head-leasing private rental projects for use as public housing. One innovative venture, the Public Equity Partnership (PEP) scheme, undertaken in New South Wales in 1991 entailed the purchase of dwellings in Sydney by a private financial institution which then leased the dwellings to the NSW Department of Housing as public housing. Under the arrangement, the financial institution provided funds to acquire 1,000 units that were leased to the Department of Housing for a period of 21 years; the Department manages the units and lets them out to public housing tenants.

Under the PEP scheme the financial institution receives a guaranteed *real* (post inflation) return of 7 percent per annum (4.5 percent in cash and 2.5 percent through tax concessions). After 21 years, the units are to be sold, with the proceeds accruing to the financial institution, except that the Department of Housing receives 75 percent of any increase in the value of the dwellings above the Consumer Price Index. This program is designed to encourage the provision of public rental housing rather than private rental housing and does not, therefore, relate to the raison d'être of this study – encouraging private rental investment.

Another initiative, which did relate to the provision of private rental housing, was the New South Wales Rental Property Trust launched in 1988. This initiative, while seemingly promising, was short-lived - a victim of an unfavourable tax ruling.

Australia: NSW Rental Property Trust

Brief Description

The NSW Rental Property Trust was an initiative to stimulate the supply of new rental housing during a period of low vacancy rates. The Trust raised funds from individuals to invest in new rental housing projects. The investment vehicle combined the use of rental property losses (including depreciation) to provide investors with a guaranteed tax-free, real-rate of return on investments in a property trust comprised of new rental buildings. On the redemption of their units, the investors were also guaranteed a capital gain equal to the inflation rate over the investment period.

The Trust was a partial success in that initial offerings were over-subscribed by investors. However, it was ultimately a failure due to an unfavourable tax ruling, which reduced the effective return on the investments. While the trust was structured to pass on tax benefits to the unit holders, the Australian Tax Office ruled that the investment was not equity but a loan – so the investors were not entitled to the tax benefits accruing to rental property owners.

Background Context

In the late 1980s, rental vacancy rates were very low (by Australian standards) in Sydney, the capital and major city of the state of New South Wales, due in part to an economic upturn which stimulated the demand for rental housing. On the supply side, the use of "negative gearing" (allowing operating losses from rental projects to be deducted from other sources of income for tax purposes) had been curtailed by Commonwealth Government tax changes between 1985 and 1987 and this appears to have led to reductions in new rental investment. Other tax changes at the same time included the use of depreciation on new projects – for the first time in Australia.

The perceived lack of new private rental supply, plus the opportunities offered by the new taxation arrangements for newly-built rental housing, appeared to offer an opportunity to structure a rental housing investment trust which would be attractive to investors.

Specific Purpose/Objectives

The purpose of the Trust was to stimulate the supply of new rental housing by utilizing the tax benefits available from depreciation on new rental buildings to encourage investments from individual taxpayers.

Impact and Success of the Initiative

The Trust was initially successful at attracting investors because of the generous guaranteed returns. However, following the unfavourable tax ruling, new offerings ceased and the existing properties holdings are being wound up. [87]

Duration and Level of Funding

New investments by the Trust covered only a relatively short period in the late 1980s.

Current Status

The Trust is still in existence in the sense that some of the dwellings acquired at the outset are still held by the Trust. However, the Department is attempting to wind it down as quickly as possible since, under the terms of the prospectus, the Department is committed to make up the difference between the terms advertised to investors and those flowing from the investment.

There appears to be little prospect of a similar venture in the future.

Lessons for Canada

Canada has little to learn from the NSW Rental Property Trust. The use (by individuals) of depreciation losses to offset income from other sources has not been allowed in Canada since the early 1970s (with the exception of MURB

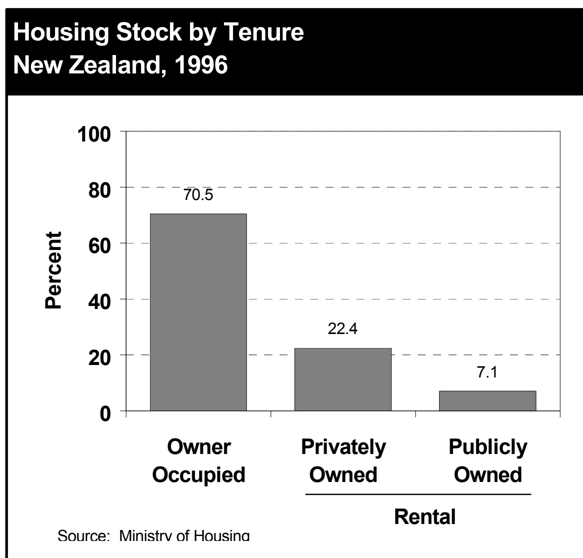
[87] Determined attempts to ascertain details about the Trust were unsuccessful since none of the officials in the NSW Department of Housing who were responsible for the scheme apparently remain with the department. Researchers in the Commonwealth government and the private sector also have little interest in the scheme because it not considered workable

projects). The attempt by the NSW Rental Property Trust to package new rental investments as tax shelters appears to echo the MURB tax shelter projects which were common in Canada during the late 1970s and early 1980s. The difference in the Australian case, however, was that the returns to investors were *guaranteed* by the government.

New Zealand

Market Context

As with Australia, rental housing, particularly private rental housing, comprises a relatively small share of New Zealand's housing stock. In 1996, over 70 percent of the stock was owner-occupied – well above the share in Canada, and second only to Finland among the countries covered in this analysis. The publicly owned rental stock comprises 7.1 percent of the total stock. The privately owned rental stock accounts for just over 22 percent of the total housing stock, representing over three-quarters of the total rental stock. The occupied housing stock in New Zealand in 1996 totalled 1.3 million units.



Although no data are available, according to the New Zealand Ministry of Housing, most private sector rental housing is provided by small-scale investors who own only one or two properties. Rental investment is generally seen as a long-term investment (often for retirement) with returns from both rental income and capital gains. There continues to be a significant growth in the private sector rental stock. Data on private rental vacancy rates are not available for New Zealand.

As with many of the countries involved in this analysis, the private rental sector appears to have been regarded largely as a "residual" sector in New Zealand.[88] Government policies have generally promoted homeownership, and until recent changes, the construction of state -owned rental housing. Private rental investment does not appear to have been an area of particular interest to New Zealand governments – and this is reflected in a lack of specific programs or policies directed at the private rental sector.

In 1991, there was a dramatic shift in housing policy in New Zealand. The 1991 Budget, in fact, marked an important watershed in re-fashioning the country's entire welfare state. Key elements of the welfare reforms included a shift away from universal provision of benefits to the targeting of benefits based on individual household circumstances, and a reduction in the provision of government services in favour of income assistance measures.

The Accommodation Supplement, a shelter allowance, was a major part of the reforms – it was introduced as the principal instrument for delivering housing assistance. Tenants in both private and publicly owned rental housing, as well as low-income homeowners, are now eligible for income-based assistance through the Accommodation Supplement. The publicly owned rental housing, previously established on a rent-geared-to-income basis, was commercialized – with rents set at market (although ownership is retained by the N.Z. Housing Corporation). Tenant assistance is now provided solely through the Accommodation Supplement – though there were some transitional measures for a small group of public housing tenants with special needs who would find it difficult to move.

Prior to the introduction of the Accommodation Supplement, the publicly owned rental stock provided accommodation at relatively low rents.

[88] Most of the content here is based on information provided directly by officials of the New Zealand Ministry of Housing through exchanges of correspondence.

In addition, the Accommodation Benefit, a cash subsidy similar to the broader Accommodation Supplement, which replaced it, was available for those in privately owned rental housing as well as to homeowners receiving government assistance.

During the post 1980 period there have been no specific programs directed at the private rental sector, nor is private rental housing eligible for low-interest loans, tax breaks or other forms of assistance.

Regulation

Rent freezes were in effect in New Zealand prior to the election of the new reforming Labour government in 1984. Since then, there have been no controls on private sector rents.

The Residential Tenancies Act defines the rights and obligations of landlords and tenants. A dispute resolution service has been established within the Ministry of Housing to deal with landlord/tenant disputes. The Ministry operates a tenancy bond centre and trust account which processes all tenancy bonds (similar to damage deposits) collected by landlords – which, by law, must be deposited with the Ministry of Housing. Interest on the bonds is used to defray the costs of operating the centre as well as part of the cost of operating the Disputes Resolution Service, which mediates and resolves disputes between landlords and tenants.

Tax and Subsidy Treatment

Rental property net income is subject to tax in much the same way as in Canada. Operating expenses and depreciation are deducted from rental income in determining taxes payable. Depreciation was introduced in 1993. Prior to that time landlords could not use depreciation in determining income taxes payable on income from rental housing. The depreciation rate for buildings purchased after March 31, 1993 is 4 percent of diminished value or 3 percent of cost.[89] "Paper losses" from the use of depreciation can be used to offset taxpayers' income from other sources.

There is no capital gains tax in New Zealand. Upon the sale of a rental property, excess depreciation (beyond the sales value of the improvements) is recaptured and taxed but gains above the original purchase price are treated as a tax-free capital gain. Only for properties where the owner is considered to have purchased with the intent of resale (i.e. the taxpayer is in the business of trading property), is the increased value taxable as income.

Property taxes are set by individual cities in New Zealand. There is no national agreement on either the way of rating properties (both commercial and private) or on how property tax rates are set.

Policy Issues

Prior to the 1991 introduction of the Accommodation Supplement, there were two government programs to assist private renters:

- The Accommodation Benefit, a cash subsidy for both private renters and homeowners who were in receipt of public assistance (similar to the Accommodation Supplement): and
- The provision of publicly owned and managed rent-geared-to-income housing.

The public housing program was aggressively pursued during the second half of the 1980s – the stock of Housing Corporation state houses rose from roughly 55,000 units in 1984 to 70,000 units in 1990 using heavily subsidized government loans. In addition, the Housing Corporation advanced low interest (3.5 percent) loans to local authorities – mainly for housing for pensioners.

With the introduction of the Accommodation Supplement in 1991, the rents on publicly owned and leased housing were moved in four stages to market levels. Housing New Zealand (HNZ) is now expected to pay dividends to the government through the efficient management of its portfolio. Nonetheless, in allocating housing to tenants, HNZ still promotes the government's social objectives through various measures, including allocating

[89] If taxpayers switch to the cost rate after using the diminished value rate, then cost is deemed to be the diminished value at the date of transfer.

tenancies primarily to those on low incomes, and within that group, to those with special needs (e.g., those in overcrowded or substandard housing, those with health problems, etc.). To further these goals in areas where they do not have sufficient stock, HNZ leases dwellings from the private sector – though this program is still relatively modest (i.e., a total of 869 units by October 1997).

Since 1991, there has been a decline in the stock of publicly owned housing. Under the "Right to Buy" scheme, started in 1994, public tenants who purchased their units could receive a 10 percent (up to $12,500) "suspensory" (i.e. deferred) loan which was written off progressively over 7 years. To date, 1,650 units have been sold to tenants. In addition, there have been sales of vacant units in areas with low housing demand.

The Accommodation Supplement is now the principal instrument for delivering housing assistance. According to the Ministry of Housing:

> "This cash demand subsidy was considered preferable for a number of reasons, including effective targeting of assistance; greater transparency of costs; equity between state tenants, private-sector tenants and home owners; and better management of the state's housing assets. The increased emphasis on demand subsidies also reflected wider changes in the social security system, which reduced base benefits and increased targeting through second- and third-tier benefits such as the Accommodation Supplement."[90]

The Accommodation Supplement is delivered through the Department of Social Welfare. It is calculated by a formula that considers income, housing costs and "cash assets". For renters and boarders, the current formula subsidizes 70 percent of rental costs in excess of 25 percent of net income, up to a set maximum (e.g., $150 per week for a 3+ person household in Auckland – the highest in the country). For boarders, the formula assumes that 62 percent of board payments are for rent (the remainder is for other services, such as meals). There were a total of almost 300,000 recipients of the Accommodation Supplement in 1997 – the Ministry of Housing estimates that 65 percent of eligible households (includes owners and renters) apply for the Accommodation Supplement. Almost 85 percent of recipients are tenants and boarders:

- Housing New Zealand tenants 46,000
- Local authorities tenants 3,000
- Private tenants 113,000
- Boarders 70,000
- Home owners 46,000
- Total 298,000

Policies and Programs Affecting Private Rental Investment

The Accommodation Supplement appears to be the only significant policy or program related to rental housing in New Zealand. The government has not sought to specifically encourage new private rental investment through any policies or programs targeted at the sector. However, the existing policy framework - which provides both depreciation allowances and the ability to deduct losses generated either by cash loss or book loses (depreciation) against other sources of income, is sufficiently attractive to enable a healthy and viable private rental sector - with ongoing unsubsidized production.

For Canada, the Accommodation Supplement, and its success in expanding choice to tenants with low incomes and/or special needs and ensuring that housing is affordable to them, could be of significant interest. The number of beneficiaries of assistance has expanded well beyond the numbers of units of publicly owned assisted housing previously available.

However, for the purposes of this study, which examines the methods used by governments in other countries to support private rental housing, the Accommodation Supplement is of little relevance. It was conceived not as a means of stimulating interest in private rental housing – but as a method of directing assistance to those in need.

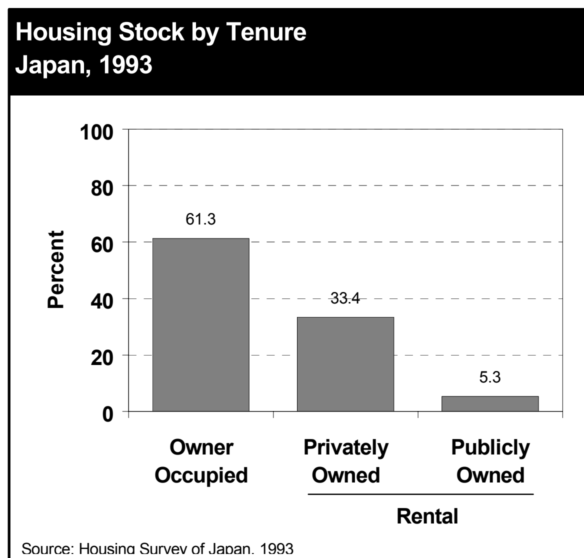
[90] Ministry of Housing, Post-Election Briefing, 1996, page 37.

New Zealand

Japan

Market Context

Most Japanese households (over 60 percent in the latest national housing survey) own their home. Private rental housing comprises one-third of the total housing stock while the publicly owned sector comprises just over 5 percent. The proportion of renters has increased since the 1960s as more of the population has moved to large urban areas – where homeownership rates tend to be low. In Tokyo, for example, only 39 percent of households own their home.



To facilitate migration of their workers to employment in the large cities (and to retain employees), many Japanese employers have traditionally offered rental housing as part of the employment arrangements. Employer-owned housing accounts for roughly 4 percent of the total Japanese housing stock, but roughly 10 percent of the private rental stock. Companies receive accelerated depreciation allowances for providing such rental housing. The demand for company housing is reportedly much higher than the supply, although it is generally relatively low-quality dormitory style accommodation.

Housing units in Japan are relatively small by Canadian standards – especially rental housing. The average size of a unit in the rental stock in Japan was 45.1 square metres in 1993 (485 square feet). The average floor area for owner-occupied dwellings was 122.1 square metres (1,314 square feet). However, while there has been a progressive increase in the average size of owner-occupied dwellings over the past few decades (up from roughly 90 square metres in the early 1960s), there has been relatively little change in the average size of rented dwellings (an average of roughly 40 square metres in the early 1960s).

Total rental construction has comprised between 35 percent and 50 percent of total new housing construction in each year since the mid 1980s.

Regulation

In terms of specific regulations relating to rental housing, there are no rent controls in Japan. There were controls imposed during World War II, however, these were repealed in 1980. The government has also relaxed regulations, which appeared to offer extraordinary protection for tenants from eviction.

As a result of these (now relaxed) regulations, landlords apparently often resorted to harassment of tenants (often by gangsters called yakuza and jiageya) in order to obtain vacant possession of properties either for redevelopment or for occupancy by other (higher-rent) tenants.

Land prices are very high in Japan due to a shortage of suitable land for development. In the mid-1990s, land costs represented over 60 percent of total housing costs in heavily urbanized regions and much higher proportions of cost in parts of Tokyo and Osaka. The chronic land shortages have been traced to government policies which distort land use (in particular policies which favour retention of agricultural land, even in urban areas), rather than an actual shortage of land.

In the late 1980s, the national government directed local governments to relax existing zoning restrictions. The result was increases in the ratio of building volume to lot size, the conversion of residential areas to commercial uses and elimination of the requirement that developers obtain the consent of residents displaced by planned developments. This has helped to free up land for development. In addition, changes in the

leasehold laws freed up land in major centres, though leaseholds are used more for ownership than rental housing.

Most important in terms of its impact on land prices, however, has been the bursting of the real estate "bubble" in Japan – land prices are currently well below the levels of the late 1980s and early 1990s. In Tokyo, for example, residential land prices have fallen by more than one-third since the peak of 1991.

Restrictive building regulations and licensing requirements for contractors have been cited as another cause of high dwelling prices.

In summary, the regulatory environment for rental operations is quite conducive to viable investments. The critical regulatory issue is an adequate supply of developable land.

Tax and Subsidy Treatment

Both ownership and rental housing are treated as an investment good for income tax purposes with capital gains being taxed. Private landlords can deduct all of their costs (mortgage interest, repairs, management and depreciation) against income (from all sources) for income tax purposes. [91]

There are government tax incentives to promote the construction of specified "high-grade rental housing". Rental housing built with a longer than normal projected useful life is granted additional depreciation for the first five years.[92] Similarly, "high-grade rental housing" receives a reduction of two-thirds of property taxes for the first five years after construction.

Rental housing built by employers for the use of their employees is eligible for accelerated depreciation allowances. This is, no doubt, a major factor behind the significant volume of employer-owned rental housing in Japan – as noted, this comprises over 4 percent of Japan's total housing stock.

There are significant taxes involved in property transactions, as well as a national land value tax and local property taxes. The taxes payable for agricultural land are typically much lower than for land on which residential or commercial buildings are located. These taxation differences reduce the incentive to develop the land and negatively impact the viability of both new construction and ongoing operation of rental properties.

Much of the rental housing built has been subsidized through below-market rate low-interest loans from the Government Housing Loan Corporation (GHLC). [93] Typically, GHLC low-interest loans account for only a share of the total financing for housing – the remainder is financed commercially with private lending institutions at higher interest rates.

In addition to the GHLC financing for private rental investment, low-cost financing is also available for public sector rental programs and loans to private developers who agree to maintain low rents in their projects to accommodate low-income tenants.

In sum, tax measures have been relatively neutral - they have not been designed specifically to stimulate private rental development. However, subsidized loans have been a significant impetus to the rental sector.

Policy Issues

Japanese housing policy is established in Five-Year Programs, which set targets and establish

[91] Similar income tax deductions are allowed for home purchasers in an effort to facilitate the acquisition of a home. These are attempts to offset the barriers represented by the very high prices of homes in Japan.

[92] It appears ironic that housing which will last a longer time is granted greater *depreciation* rate than housing which is not anticipated to last.

[93] Similar low-interest loans are also available for ownership housing, which in fact accounts for 90 percent of the GHLC financed units - rental only accounted for 10 percent of GHLC financed units.

policies to meet these targets. The current, seventh, program (1996-2000) seeks to improve the housing standards of Japanese households – particular emphasis is placed on the following four issues:

- increase good quality housing stock to meet the needs of the people;
- promote safe and comfortable urban life and improve the housing environment;
- Improve the environment for the aged to enjoy a healthy and comfortable life; and
- Improve housing units and environment to revitalize communities.

As part of this seventh year program, a total of 7.3 million dwellings are targeted to be built – with 3.6 million dwellings to be financed (at least partially) with government funds. Most of the government funding will be provided through the GHLC employing the below-market interest rate loans. The plan does not specify tenure but it is expected that rental housing will continue to maintain its market share

Policies and Programs Affecting Private Rental Investment

Programs targeted at encouraging new rental investment consist mainly of low-interest financing through the GHLC. These are described in greater detail below.

The public housing programs have similarly been funded with low interest loans but also benefit from ongoing government rent subsidies. In the existing public housing, the rents for units are based on cost rents minus the government subsidy. A new subsidy method is being used to fund social housing units being built under the "Specially Qualified Rental Housing System". Under this social housing program, units are rented at market rent but the tenant receives assistance covering the difference between market rent and what the tenant can afford – this assistance will be decreased by 5 percent each year for 20 years.

Quite different from the pattern in many other countries reviewed here, there has been no attempt to use private sector units as a base for affordable housing through a shelter allowance. In Japan, there are no housing allowances available to assist low-income tenants to afford private sector accommodation.

The rents on the social housing stock are well below those of private rental units – they are allocated on a lottery system because of the excess demand for social housing units.

Japan: Low-Interest Loans

Brief Description

The Government Housing Loan Corporation (GHLC) in Japan offers below-market-low-interest rate long-term loans for both ownership and rental housing. Typically, the GHLC loans comprise a share of the total loans required to finance a dwelling; the interest rates on these loans are generally below the prevailing market interest rate for mortgages.

The GHLC is the largest single mortgage lender in the world. It accounts for 30-40 percent of outstanding housing loans in Japan. The GHLC was established in 1950 as part of the post-war reconstruction effort, in order to provide long-term capital at a low rate of interest for the construction and purchase of housing. Since it was established, the GHLC has been involved in the financing of over 15 million units – roughly 30 percent of the total dwellings built in the post-war period.

GHLC loans are available for both ownership and rental housing – the lion's share of the funding goes to ownership housing. In 1996, loans to entrepreneurs for rental housing comprised 56,000 units (less than 10 percent of the total units financed by the GHLC).

The size and terms of the low-interest loans available from GHLC are determined by a number of factors. In establishing loan size, term and the interest rates, consideration is given to factors such as modest homes, homes in particular areas, and homes which are designed specifically for the needs of the elderly and/or for energy efficiency. Loans from the GHLC typically account for 40-50 percent of the financing for a dwelling – the remainder is obtained from private sector lenders.

Background Context

The GHLC was established in 1950 as part of the post-war reconstruction effort in Japan and appears to have continued to fulfill the same role throughout the second half of this century. Its purpose is to "make loans for the building or purchase of homes in order for Japanese people to lead a healthy and fulfilling life in circumstances which make it difficult for private financial institutions to make a loan".[94]

Specific Purpose/Objectives

The purpose of the GHLC low-interest rate loans is to provide low-cost financing for housing consumers (owners) and landlords. Preference is given to low-income homebuyers who might not otherwise be able to obtain financing to acquire modest homes.

While rental housing is eligible for GHLC funding, owner-occupied housing appears to be the main focus of the program (accounting for 90 percent of the units financed).

Impact and Success of the Initiative

The GHLC is an intrinsic and important part of the Japanese housing finance system. By providing low-interest loans to finance part of the acquisition cost of a dwelling, the program facilitates access to homeownership and reduces the costs for rental housing. Although the main focus of the GHLC loans is on homeowners, over 1 million rental housing units having been financed by the GHLC since 1950. The GHLC low interest loan mechanism is clearly a major factor in rental investment.

Duration and Level of Funding

In July 1998, GHLC financing was available at a rate of 2.75 percent for the first 10 years of the loan and 4 percent thereafter. In contrast, bank financing for 10-year term mortgages was available at 3.5 percent. GHLC loans are long-term, typically for the full normal amortization period of the mortgage on the dwelling.

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[94] Japan International Cooperation Agency, Housing Bureau, Ministry of Construction, and the Building Centre of Japan, *Housing Loans*, part of a series on Housing Policy, 1997, page 3.

Current Status

The GHLC continues to be a significant part of the Japanese housing finance system.

Lessons for Canada

There appears to be little that Canada can learn from the GHLC low-interest rate loan program. Both the federal and provincial governments in Canada have, in the past, used low- or zero-interest second mortgages to encourage new rental investment. Since the GHLC program is available for both home purchasers and rental investors, and since it provides long-term low-interest financing, it appears to be less targeted and likely more costly than the past Canadian programs.