

A Home to Call Our Own:

**A Federal Strategy for Affordable and
Responsible Homeownership**

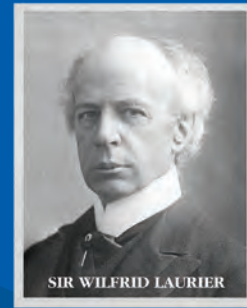
Sean Speer and Jane Londerville



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Executive Summary

The federal government is soon expected to release its much-awaited National Housing Strategy. It comes at a key moment for Canadian housing policy given serious housing affordability challenges in key centres such as Toronto and Vancouver.

The details of Ottawa's strategy can either help to improve the conditions for affordable and responsible homeownership or put homeownership further out of reach for Canadians. This study seeks to put forward ideas and recommendations with the latter outcome in mind.

Remember policy-makers and the public have been debating the sources of our housing affordability challenges and what governments ought to do about them for several months. There have been various provincial and local policy responses thus far with a particular focus on "demand-side" factors such as foreign investment.

Ottawa has generally been removed from this debate. There is some basis for this. Most of these issues are localized and outside of federal control. But it is wrong to assume that there is no federal role in enabling the conditions for affordable and responsible homeownership. Ottawa touches on the housing file in several ways - including monetary policy, mortgage insurance, financial regulations, tax policy, and social housing spending.

“Policy-makers and the public have been debating the sources of our housing affordability challenges and what governments ought to do about them for several months.

Federal housing policy lacks coherence. Policy changes are regularly enacted with little focus on their consistency or compatibility with other housing-related policies. One example: successive cases of mortgage rule tightening have taken place while Ottawa has concurrently expanded incentives and subsidies for first-time home buyers. It often seems like the left hand and the right hand are not speaking.

A National Housing Strategy that looks holistically at federal housing policy can address this incoherence problem. Federal housing policy should start to look like it was purposefully designed rather than a mishmash of disparate initiatives and measures. Policy-makers should aim to replace the bride of Frankenstein with a carefully conceived strategy. This could be a major step in the direction of enabling the conditions for affordable and responsible homeownership in Canada.

To this end, this study has set out some clear principles and recommendations to inform the government's thinking and policy development. These include:

- The National Housing Strategy must be rooted in a clear understanding of the difference between *affordable housing* and *housing affordability* and ensure that it is placing equal focus on the latter.
- The federal government should actively promote affordable and responsible homeownership given its broad-based benefits, including its key link to inclusive growth.
- Ottawa should put new or pending changes to mortgage and financing rules on hold until the impact of recent changes on the housing market can be determined.
- The government should rethink how it delivers mortgage insurance - including lowering mortgage insurance fees.
- The government should consolidate and augment existing tax policies to promote and support homeownership - including reconfiguring current housing-related tax expenditures into a new, single pro-homeownership tax credit and creating a new matching funds mechanism in Tax-Free Savings Accounts (similar to Registered Education Savings Plans or Registered Disability Savings Plans) for the purposes of supporting higher down payments

Affordable and responsible homeownership carries with it considerable economic and social benefits and ought to be a major part of the federal government's vision of inclusive growth. Adopting the principles and recommendations set out in this paper would help to ensure that the National Housing Strategy can be a key plank in such an agenda.

SOMMAIRE

Le gouvernement fédéral devrait prochainement lancer sa très attendue Stratégie nationale sur le logement. Elle vient à point pour la politique canadienne du logement puisque le pays continue toujours de faire face à de graves problèmes d'abordabilité dans les centres urbains clés comme Toronto et Vancouver.

Les détails de la stratégie d'Ottawa peuvent ou bien contribuer à favoriser la propriété abordable et responsable pour les Canadiens ou bien rendre l'accès à la propriété encore plus hors de leur portée. Des idées et des recommandations sont proposées dans cette étude en ce qui concerne ce dernier point.

Il convient de rappeler que les décideurs politiques et le grand public discutent depuis des mois des sources du problème d'abordabilité et des mesures gouvernementales à adopter. Jusqu'à maintenant, les interventions politiques se sont tenues aux paliers provincial et local et se sont attachées tout particulièrement aux enjeux liés à la demande, notamment l'investissement étranger.

Ottawa a généralement été exclu de ce débat. Cela s'explique. La plupart de ces questions sont locales et ne font donc pas partie des champs de compétence fédérale. Toutefois, il est faux de supposer que le gouvernement fédéral n'a aucun rôle à jouer pour favoriser la propriété abordable et responsable. Ottawa intervient dans la filière du logement de multiples façons - de la politique monétaire et fiscale à la réglementation financière, en passant par l'assurance hypothécaire, sans oublier les dépenses en logements sociaux.

En réalité, la politique fédérale en matière de logement manque de cohérence. Ses changements d'orientation ont régulièrement été mis en œuvre sans souci d'uniformité ou de convergence avec les politiques connexes au logement. Un exemple : la réglementation sur le crédit hypothécaire a été

resserrée plusieurs fois d'affilée au moment même où Ottawa a renforcé ses mesures incitatives et ses programmes de subvention à l'intention des acheteurs de première maison. Il semble que la main gauche ignore souvent ce que fait la main droite.

“Une Stratégie nationale sur le logement élaborée à partir d'un examen global des politiques fédérales en la matière pourrait résoudre ce problème d'incohérence.”

Une Stratégie nationale sur le logement élaborée à partir d'un examen global des politiques fédérales en la matière pourrait résoudre ce problème d'incohérence. Il est temps que la politique fédérale du logement se rapproche de sa mission originale et qu'elle prenne donc ses distances par rapport au ramassis d'initiatives et de mesures hétéroclites qui la définissent actuellement. Les décideurs politiques doivent tenter de remplacer la « fiancée de Frankenstein » par une stratégie conçue avec soin. Cela constituerait une mesure importante pour favoriser l'accès à la propriété au Canada.

À ces fins, les principes et les recommandations dans cette étude pourront éclairer la réflexion du gouvernement et l'élaboration de la politique. Les voici ci-dessous :

- La Stratégie nationale sur le logement doit émaner d'une compréhension claire de la différence entre « logement abordable » et « abordabilité du logement » et mettre un accent égal sur la deuxième notion.
- Le gouvernement fédéral doit favoriser activement la propriété abordable et responsable, compte tenu de ses bénéfices étendus et notamment de ses retombées vitales sur la croissance inclusive.
- Ottawa doit mettre sur la glace les modifications nouvelles et en attente qu'il souhaite apporter aux règles de financement hypothécaire jusqu'à ce que l'impact des changements récents sur le marché du logement soit connu.
- Le gouvernement doit revoir la façon dont il offre l'assurance prêt hypothécaire – notamment en ce qui a trait à la baisse des frais d'assurance hypothécaire.
- Le gouvernement doit consolider et compléter ses politiques fiscales existantes visant à favoriser et soutenir l'accession à la propriété – en transformant notamment les dépenses fiscales actuelles liées au logement en un crédit d'impôt nouveau et unique et en créant un nouveau mécanisme qui lui permettrait de verser, aux fins des mises de fonds, des cotisations de contrepartie dans les comptes d'épargne exempts d'impôt (semblable au régime enregistré d'épargne-études ou au régime enregistré d'épargne-invalidité).

L'accession à la propriété abordable et responsable comporte des avantages économiques et sociaux considérables et doit être pleinement intégrée à la vision du gouvernement fédéral à l'égard de la croissance inclusive. Adopter les principes énoncés et les recommandations formulées dans le présent document peut contribuer à faire de la Stratégie nationale sur le logement un élément déterminant d'un tel programme.

Introduction

Housing issues have climbed to near the top of the public policy agenda in Canada. Just check the newspapers. There are regularly headlines such as “Canadian home ownership inches further out of reach” (Perkins 2013) or “Are homeownership dreams out of reach for millennials?” (CTV News 2016) or “How Canada’s housing market went totally insane” (Castaldo 2017).

These questions about housing affordability have particularly bedeviled provincial and local governments who have responded with a mix of policies including new taxes on foreign residents and vacant homes, incremental spending on social housing, and expanding rent controls. The jury is still out on the utility of these policy changes and their long-term effects on housing affordability.

Ottawa has generally been removed from this debate. There is some logic to this, given that the underlying issues – including land-use policies – tend to be localized and thus outside of federal control. But it is wrong to assume that there is no federal role in creating the conditions for affordable and responsible homeownership. Ottawa touches the housing file in a number of important ways, including mortgage insurance, financial regulations, tax policy, and social housing spending.

Yet there has been limited analysis of the interaction between these various federal policy levers and how they fit in a broader housing policy and pro-homeownership framework. Policy changes are regularly undertaken without a careful eye to broader coherence including clear and consistent policy objectives. Governments have, for instance, tightened mortgage rules at the same time as they have expanded incentives and subsidies for first-time home buyers. It can regularly appear as if the left hand and right hand are not speaking.

The Trudeau government’s impending National Housing Strategy has the potential to bring greater coherence across the country to federal housing policy and in turn support housing affordability and homeownership across the country.

This study seeks to help in this regard. It aims to outline the key aspects of federal housing policy, how these policies interact, and concrete recommendations on how to improve federal housing policy in the name of affordable, responsible homeownership.

It has four sections. The first describes the current state of the housing market and the growing affordability challenges in our major urban centres. The second considers the role for public policy in promoting and supporting homeownership. The third analyses the evolution and scope of federal housing policy. The fourth contextualizes the impending National Housing Strategy. The final one sets out our recommendations to strengthen federal housing policy.

“Federal housing policy should start to look like it was purposefully designed rather than a mishmash of disparate initiatives and measures.”

The study's principal observation is that Ottawa can and should support homeownership but it must start with a clear, evidence-based understanding of how its policies work, how their effectiveness is measured, and how federal policies interact with one another and those of lower levels of government. Federal housing policy should start to look like it was purposefully designed rather than a mishmash of disparate initiatives and measures.

Key recommendations include:

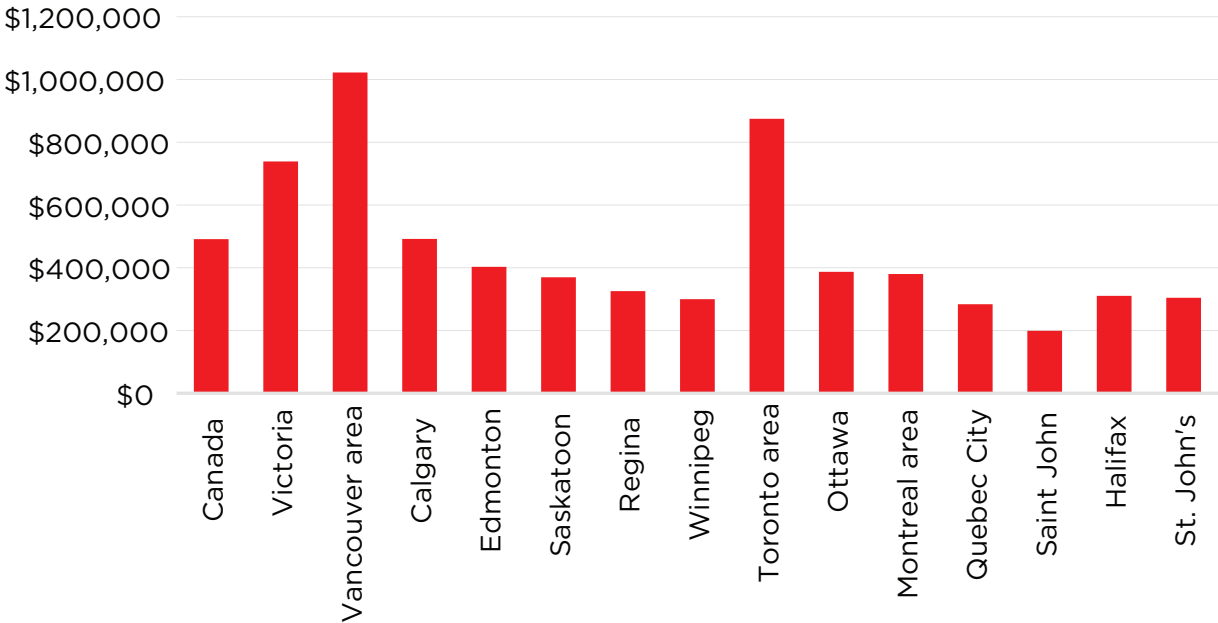
- The National Housing Strategy must be rooted in a clear understanding of the difference between affordable rental housing (which includes social housing and affordable housing units built with government assistance and other rental units affordable to lower-income groups) and housing affordability (which refers to the affordability of market-based housing - both rental and owned).
- The federal government should actively promote affordable and responsible homeownership given the broad-based benefits associated with homeownership including its key link to inclusive growth.
- Ottawa should put new or pending changes to mortgage and financing rules on hold.
- The government should reconsider how it delivers mortgage insurance, including investigating models that are lower cost for the borrower.
- The government should consolidate and augment existing tax policies to promote and support higher down payments and more home equity.

Ultimately the goal of the study is to (1) illuminate the role of the federal government in housing policy given it often seems excluded from the policy debate and (2) set out ways to improve Ottawa's role in housing policy with the goal of promoting and supporting affordable, equitable, and responsible homeownership.

Growing Concerns about Rising Housing Prices

Ongoing concerns about housing affordability have placed renewed emphasis on the role of housing policy. The problem does not seem to be going away. Toronto and Vancouver are now among the least affordable cities in the world (Canadian Press 2017). Just consider that Toronto’s housing prices jumped nearly 33 percent in 2016 alone. The average home now costs roughly \$875,000 and average detached homes have reached nearly \$1.6 million (Bloomberg News 2017). A recent RBC report finds that housing affordability has hit its worst level in 27 years (Ligaya 2017). Vancouver has faced similar pressures and is now the only Canadian city with average home prices exceeding \$1 million (see chart 1).

CHART 1: AVERAGE HOME PRICES IN CANADA, Q2 2017

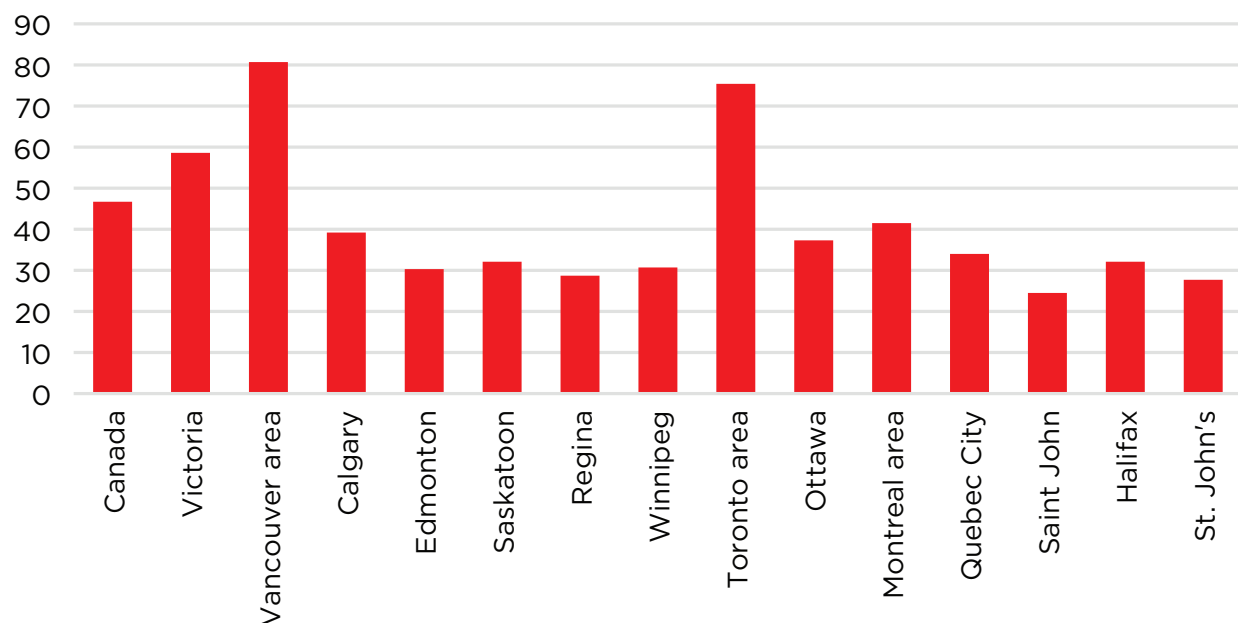


Source: Wright and Hogue 2017.

These trends have put considerable pressure on policy-makers to produce solutions. Thus far most of the attention has focused on provincial and local policy-makers for two key reasons.

The first is that housing affordability challenges are mostly a localized matter rather than a national one (see chart 2).¹ There are limits to making judgments about housing affordability by simply examining national prices. National policies provide limited scope for targeted solutions. By this we mean that a one-size-fits-all response from the federal government would likely produce different and possibly harmful outcomes in different markets. The policy response to affordability questions for the Vancouver market is of course different from the St. John’s one. Nationalizing the problem is thus an unwise policy response that can produce inadvertent consequences in different regional or local housing markets.

CHART 2: AFFORDABILITY INDEX, Q2 2017



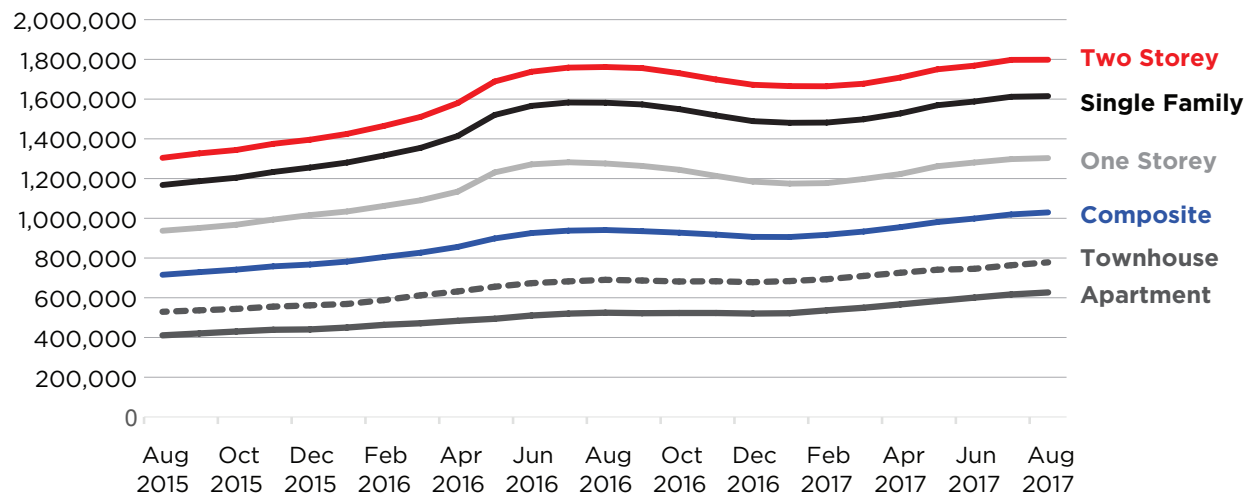
Source: Wright and Hogue 2017.

The second reason is that the federal government mainly affects housing demand and has only a minimal effect on housing supply. The provinces and cities, by contrast, influence the housing supply and its composition by designating where new homes can be built through land-use regulations, the cost of new homes through development fees and other levies, and the scope of renovations and additions to existing homes through building codes and city permits. These policy levers play a key role in shaping market dynamics. The federal government's only role in supply-related issues might include national parks, defence bases and training properties, and federal Crown lands.

The BC and Ontario governments have recently acted in response to growing concerns about housing affordability in their respective provinces. These policy responses have tended to focus on demand-side issues, including concerns about the inflationary pressures caused by foreign investment. Both have enacted 15 percent foreign buyers' taxes in the past 20 months in order to discourage non-resident speculation. The jury is still out on the utility of these policies. It is notable that BC's foreign buyers' tax has had a minimal effect on pricing trends besides a temporary adjustment (see chart 3). Some Ontario-based data show that sales to non-residents have decreased but it is not clear that this has had an impact on overall demand and prices (Ministry of Finance 2017; Giovannetti and Mahoney 2017).

These developments seem to buttress the argument on the part of some commentators (including scholars affiliated with the Macdonald-Laurier Institute) that the role of foreign investment in driving up prices is overstated (Crowley and Speer 2016). There has been an element of policy-makers searching under a proverbial streetlight on this issue, with no hard data on the percentage of foreign buyers in each market or their role in contributing to affordability challenges.

CHART 3: GREATER VANCOUVER HOUSING PRICE COMPOSITE, AUGUST 2015 TO AUGUST 2017



Source: Canadian Real Estate Association, “MLS Home Price Index.”

By contrast, the potential for supply-oriented reforms has largely been ignored. We have seen no real progress on liberalizing zoning or revisiting urban containment policies that limit supply. NIMBYism continues to be an obstacle to these types of reforms (Speer 2017a). Failing to address the role of policy in limiting supply means that policy-makers are neglecting a key part of the housing equation.

This is regrettable given the growing body of research and emerging political consensus in favour of such reforms in the United States. Economists and policy experts ranging from progressive economist Jason Furman to conservative economist Ed Glaeser have drawn attention to the role of land-use regulations in driving up housing prices (Speer 2017a).² What makes this US-based analysis so powerful is the extent to which it is rooted in concerns about equity and opportunity. Brookings Institution scholar Richard Reeves (who also serves on the Canadian government’s advisory panel on poverty reduction) has gone so far as to describe exclusionary zoning policies as a case of “dream hoarding” by present homeowners at the expense of aspirational ones (2017).

Surely there is room to review provincial and local land-use policies to make judgments about their effects on housing supply and consider the trade-offs between housing affordability and other policy objectives such as environmental or aesthetic considerations – particularly given the present political focus on inclusivity and opportunity. A Canada Mortgage and Housing Corporation (CMHC) memo to Minister Jean-Yves Duclos on this topic was obtained via access-to-information in October 2017. The analysis found that “supply challenges including land supply and zoning regulation emerge as factors that contribute particularly to high priced markets” (Quinn 2017). The significant proportion of a new house price that is attributable to ever-rising development charges is another area of concern.

We recognize of course that land-use changes or restructuring development fees will neither immediately solve nor fully address housing affordability in Toronto and Vancouver for a host of reasons including: (i) creating additional supply involves a time lag, (ii) the problem is not just insufficient supply but also the composition of supply including the so-called “missing middle” between de-

tached homes and high-rise condos (Canadian Centre for Economic Analysis 2017; Kalinowski 2017), and (iii) it is also probably the case that “irrational exuberance” is part of the problem and no amount of policy changes can fully address these impulses.

“There is an important distinction between smart pro-homeownership policies and dumb ones.”

Still, there is scope for greater ambition in addressing the relationship between public policy and housing supply. Demand-side reforms have thus far failed to produce meaningful progress with regards to improved affordability (see chart 3). That only provides more evidence that a greater focus on housing supply on the part of provincial and local governments is justified. It certainly cannot hurt.

We would also add that while the affordability challenges are localized – that is, it is principally a problem in Toronto and Vancouver and their surrounding areas – they can have national implications. These are our two most dynamic, job-creating cities and home to more than half of all home sales and a disproportionate

share of jobs. If low- and middle-income Canadians cannot afford to relocate to or live in these cities, the opportunity costs in the form of less economic activity and fewer jobs are national in scope. This does not change the fact that many of the solutions must come from provincial and local governments. But it does affirm that housing affordability in two major centres is rightly seen as a national problem.

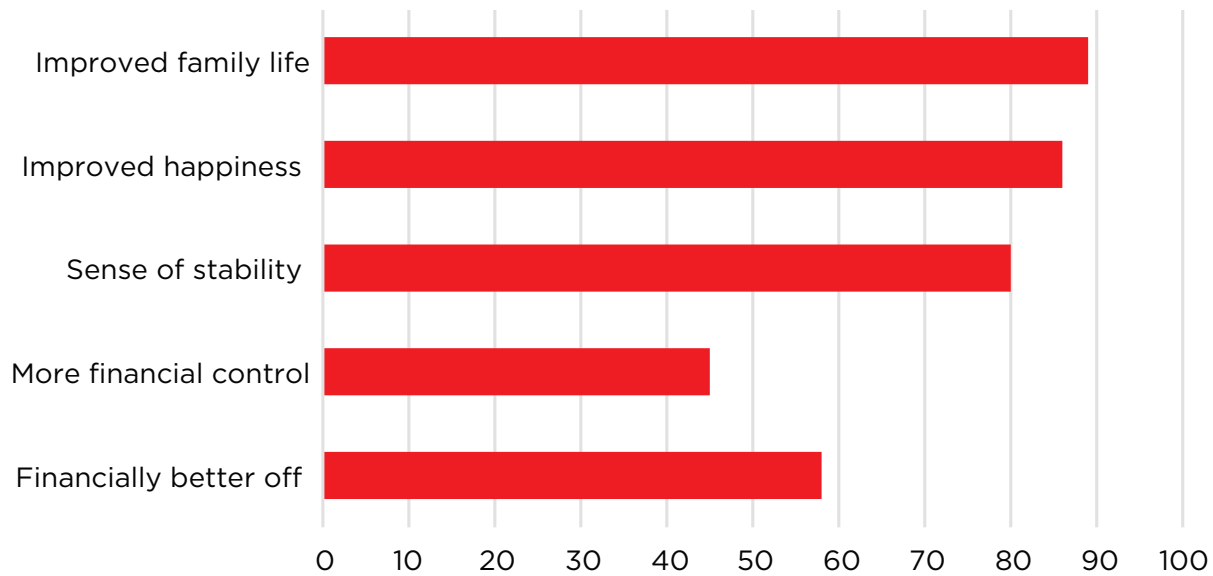
Homeownership, Housing, Affordability, and the Role of Public Policy

We believe that there is a sound policy case for the federal government to incentivize affordable and responsible homeownership. It is worth developing this point before examining federal housing policies since we recognize some commentators would prefer the federal government to adopt a neutral position on homeownership.

Homeownership is a basic part of middle-class aspirations. It has been seen for decades as the quintessential step on the path to financial security and personal stability. Previous MLI scholarship has surveyed the social science research on the topic and finds that homeownership is positively associated with a raft of economic and social benefits that extend beyond the individual to

society as a whole (Crowley and Speer 2016). Ottawa’s own discussion papers for its consultation on the National Housing Strategy cite this research and highlight positive findings related to homeownership based on a survey of those who have transitioned into it (see chart 4).

CHART 4: FEDERAL DISCUSSION PAPER ON BENEFITS AND IMPACT OF HOMEOWNERSHIP (%)



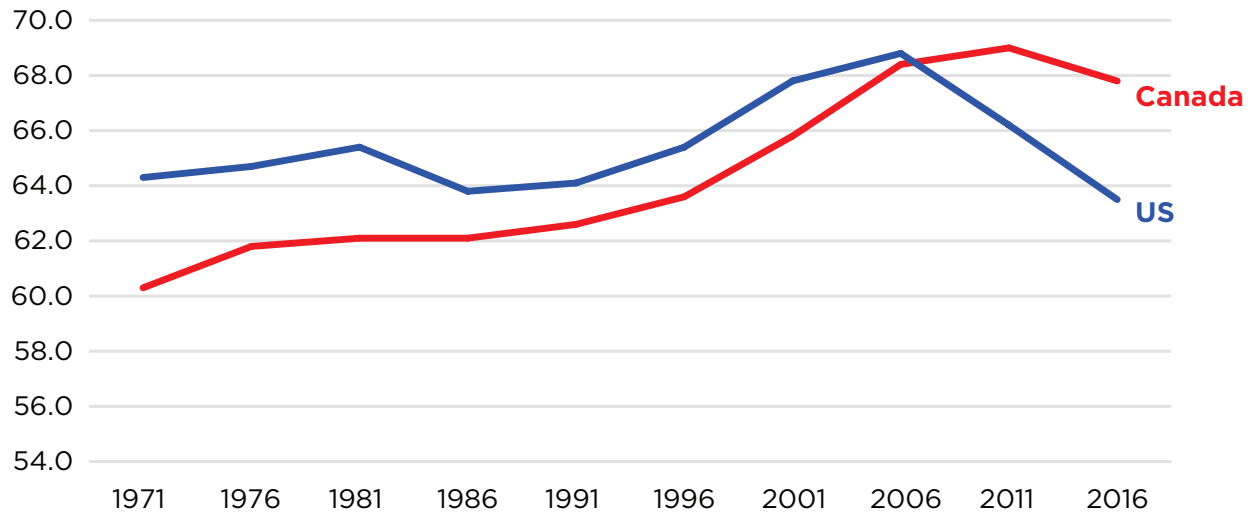
Source: Government of Canada, “Let’s Talk Housing: Socially inclusive housing for a better society.”

These broad-based economic and social benefits are what economists call *positive externalities*. The list ranges from better health, better educational outcomes, and stronger families to higher rates of civic engagement. This is a critical point: the evidence shows that the benefits are not just limited to homeowners. Society benefits when families have access to affordable and responsible homeownership.

As US policy thinker Reihan Salam (2016) writes: “Homeownership is an important engine of economic growth and provides a path to prosperity for low- and middle-income families.” Hence the basis for public policy to promote and support homeownership.

The good news is that Canada’s homeownership rate now exceeds the US rate. This is a departure from most of the 20th century and coincides with median income levels in Canada also exceeding US levels. Canada’s homeownership rate has gone from 60.3 percent in 1970 to nearly 70 percent in 2011 to 67.8 percent in 2016. This steady rise in the country’s homeownership rate stands in contrast with the United States, which has recently experienced a drop in its overall rate (see chart 5).

CHART 5: CANADA AND US HOMEOWNERSHIP RATE, 1971 TO 2016



Source: Statistics Canada 2015; US Census Bureau 2017.

The bad news is that pro-homeownership policies have fallen somewhat out of favour since the 2008–2009 financial crisis. This is mostly based on the role that government policies to induce higher levels of homeownership played in contributing to the US banking crisis. It has come to be seen as an indictment of such policies and evidence that government should be neutral on encouraging or promoting homeownership.

There is no question that the 2008–2009 experience is a lesson about the pitfalls of poorly-conceived government policy. But, in our view, it does not follow that government should be neutral on homeownership. It simply means that government policy to support homeownership should be designed to minimize possible negative effects. There is an important distinction between smart pro-homeownership policies and dumb ones. We should adopt smart policies and avoid dumb ones. But that does not change the fact that there are good reasons for public policy to support homeownership. Most jurisdictions in fact use various policies to promote and support homeownership (Desilver 2013). It is entirely possible to support homeownership without creating a US-style housing bubble.

It ultimately comes down to policy objectives and design.

“The result is a sort of a bride of Frankenstein.”

Which brings us briefly to Ottawa’s role in promoting and supporting homeownership, something it has done for decades. The *Dominion Housing Act* was enacted in 1935 to create more housing and promote recovery from the depression (CMHC 2011). The Central Housing and Mortgage Corporation (the precursor to the Canada Mortgage and Housing Corporation) was established in 1946. Ottawa has been involved in housing issues ever since.

Federal policy comes in various forms ranging from mortgage insurance through the CMHC to financial sector regulations to subsidies and tax incentives to direct spending and transfer payments on social housing. The totality of federal spending on housing is significant. The cost of tax-related measures alone was \$6.1 billion in 2015 (Department of Finance 2017b). Yet there has been limited strategic thinking about how the various federal policies fit together or are attached to clear objectives. There has been an evolution since the era before the Second World War based in part on new policy thinking, in part by different preferences of various governments, and in part by political expediency. The result is a sort of a bride of Frankenstein. We will describe the various aspects of federal housing policy and their lack of coherence in subsequent sections.

But the current Minister of Families, Children and Social Development's mandate letter from the Prime Minister provides a sense of the wide-reaching and non-strategic ways in which the federal government has engaged in housing issues (Trudeau 2015). It states:

In your role as Minister responsible for the Canada Mortgage and Housing Corporation, work with the Minister of Infrastructure and Communities to develop a strategy to re-establish the federal government's role in supporting affordable housing, including:

- o prioritizing infrastructure investments in affordable housing and seniors' housing, including finding ways to support the municipal construction of new housing units and refurbishment of existing ones;
- o providing support to municipalities to maintain rent-geared-to-income subsidies in co-ops;
- o providing communities the money they need for Housing First initiatives that help homeless Canadians find stable housing;
- o working with the Minister of Finance to encourage the construction of new affordable rental housing by removing all GST on new capital investments in affordable rental housing;
- o working with the Minister of Finance to modernize the existing Home Buyers' Plan to allow Canadians impacted by sudden and significant life changes to buy a house without tax penalty;
- o working with the Minister of Finance to ensure that the new Canada Infrastructure Bank provides financing to support the construction of new, affordable rental housing;
- o working with the Minister of Public Services and Procurement to conduct an inventory of all available federal lands and buildings that could be repurposed, and making some of these lands available at low cost, or no cost, for affordable housing;
- o undertaking a review of escalating home prices in high-priced housing markets and considering all policy tools that could keep homeownership within reach for more Canadians;
- o bringing forward a proposal to prevent mortgage fraud; and
- o using the restored mandatory long-form census to ensure that decisions on housing are made using the best and most up-to-date data available.

There is a lot here. But most of it is focused on social (or affordable rental) housing rather than housing affordability. It is not to say that social housing is not important. But it is to say that there is a key distinction between the two. It may seem like semantics but it is essential that we properly define the problem before we can determine the right policy solution.

Social housing typically involves public subsidies for construction and/or operation and is geared towards low-income households. Roughly 6 percent of Canada's housing market is social housing

(Housing Service Corporation 2014). Adding more social housing units in the form of affordable rental housing (as the minister's mandate letter prioritizes) may or may not be justified. There are certainly voices - including the Federation of Canadian Municipalities - arguing for major new federal spending on social housing (Gerbas and Iveson 2017). But it is unlikely to have a demonstrable effect on the broader housing market.

“Most of Trudeau government's pronouncements have tended to emphasize 'affordable housing' over 'housing affordability.’”

Housing affordability refers to the rising costs of market-based housing - both rental and owned. There are various measures of “affordability” produced by Statistics Canada, private banks, real estate organizations, and non-profit groups (Luffman 2006). But the key point is that it is focused on the affordability of market-based housing which affects some 94 percent of Canadians (Canadian Home Builders'

Association 2016). Questions about housing affordability therefore tend to affect larger numbers and in turn can be assumed to be the subject that people refer to when raising “housing affordability” in polling or public commentaries.

Most of the Trudeau government's pronouncements have tended to emphasize “affordable housing” over “housing affordability.” A July 2017 interview of Prime Minister Trudeau by *Macleans*'s journalist Paul Wells, for example, focused on affordable housing investments rather than policies to enable improved housing affordability. But the prime minister has recognized the extent to which these issues are mostly localized and the risks of blunt federal action. As he said in a March 2017 interview:

We recognize the tools of the federal level are necessarily pan-Canadian, and there are tremendous differences and variances between the housing markets in Vancouver and Toronto and housing markets in other cities. So we're working very closely with provinces and municipal authorities to ensure that the impacts that we need to have in certain areas of the country don't result in unwanted impositions or negative impacts on other parts of the country. (Reuters)

This caution is justified. Nationalizing these policy questions would be a mistake for precisely the reasons that the prime minister sets out. It is worth noting however that he cited federal interventions to tighten mortgage financing rules in the same interview. It is a recognition that Ottawa cannot fully wash its hands of the housing issues and a powerful example of the federal government's tendency to intervene in incoherent and non-strategic ways.

Federal Role in Housing Policy

While the prime minister is correct that there are limits to Ottawa's role in housing policy, he is also right to point out that "we [the government] do have levers" as he did in the same interview (Wells 2017). The federal government has been involved in the housing file in a number of ways dating back to the depression era. The evolution of federal housing policy reflects an interaction of evolving policy thinking, politics, and ideology. Policies have been added, subtracted, augmented, and refined without much coherence or strategic thinking. This section of the paper describes the key elements of federal housing policy and how they have evolved over time. It mostly excludes on-reserve housing in First Nations communities, which is sufficiently complicated and different that it requires its own inquiry and analysis.

Monetary policy

The first way in which the federal government affects housing and homeownership is through the Bank of Canada's monetary policy. The bank's responsibility for interest-rate setting affects borrowing costs for mortgage holders and in turn contributes to household decisions in the housing market.

Think of it this way. When the interest rate is lower, people are generally able to borrow more as doing so will cost them less than at another time. Conversely, when the interest rate is higher, borrowing becomes more expensive. This principle applies to loans that come in the form of mortgages. When mortgage rates are lower, purchasing a home becomes more affordable. Consequently, the sales of homes tend to rise as more households can take out a low-cost loan. Similarly, in periods of low interest rates, more houses are often built as demand rises, and developers are able to borrow money at a cheaper rate to finance construction (Painter and Redfearn 2001).

Canada has gone through a period of low interest rates since the global financial crisis. Mortgage rates have been historically low as a result. Rates fell as low as 1.49 percent for five-year fixed rates in April 2015 (Marr 2015). This has invariably contributed to a rise in housing demand and increases in our homeownership rates, as well as to households buying more expensive homes than they would if rates were higher.

Monetary policy interacts with other housing-related policies to affect the housing market. Some analysis indicates that the federal government has opted to tighten mortgage rules in part because of concerns about how low interest rates are affecting the housing market (Freeman 2016). How monetary policy evolves in 2018 and beyond will affect the government's National Housing Strategy's outcomes.

The Bank raised interest rates most recently in September 2017. There is considerable debate and speculation about when we will see future rate increases. But it is important to note that various factors go into the Bank of Canada's interest-rate setting beyond housing issues. So, while we recognize the role of monetary policy and its interaction with other housing-related policies, we do not intend to focus on it as part of a prospective agenda to promote affordable and responsible homeownership.

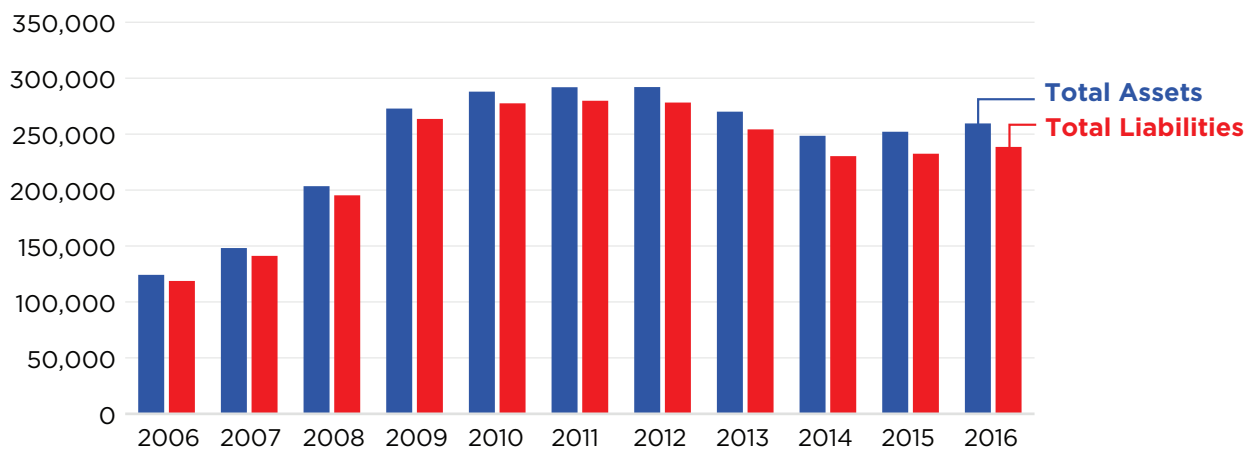
Mortgage insurance and mortgage securitization

Ottawa's primary form of support for homeownership is the Canada Mortgage and Housing Corporation (CMHC)'s role in the mortgage insurance market. CMHC was created 70 years ago to provide low-cost mortgages and support the construction of social and rental housing for veterans returning from the Second World War. Today one of its main functions is to sell insurance to Canadian residential mortgage lenders to protect them against mortgage defaults.

The introduction of mortgage insurance in 1954 was extremely beneficial in creating a well functioning housing market. It allowed first-time buyers of homes to enter the market with a small down payment; the banks were willing to lend to people with little equity because the loans were backed by this federal insurance. This was essential in unlocking private financing for the purposes of promoting and supporting homeownership.

Because fees are charged for this insurance, CMHC does not lose money offering the insurance - in fact it has made a healthy surplus each year for many years and has accumulated more than the required amount of reserves to cover expected losses in case of a market downturn (see chart 6). The Crown corporation in fact has started to pay a considerable dividend to the federal government (Marr 2017).

CHART 6: CMHC, TOTAL ASSETS AND TOTAL LIABILITIES, 2006 TO 2016 (\$MILLIONS)



Source: CMHC 2017b.

Any residential loan for more than 80 percent of the value of the property must be insured if it is from a federally-regulated financial institution. The lender takes care of this transaction by choosing the insurer and paying the fee and then passing the cost on to the borrower, typically as part of his or her overall loan.

Mortgage insurance fees (MIF) in Canada are paid on the whole loan upfront. These fees are not small and were increased by CMHC in March 2017 (despite years of positive cash flows prior to the increase). As an example: A 95 percent loan on a \$400,000 property would incur a fee of \$15,200. Even as a borrower's loan balance falls below 80 percent of a home's value through repayment of principal and appreciation in house prices, the borrower must still pay the entire MIF over time -

either through monthly mortgage payments or when the loan is repaid on the sale of the house. The following table shows the impact of the recent increases in MIF on borrowers, even at the historically low interest rates in the current market.³

TABLE 1: LOAN-TO-VALUE RATIO AND THE COSTS OF MORTGAGE INSURANCE

Loan-to-Value Ratio	Previous premium		Premium as of March 17, 2017	
80.01% - 85%	1.80%		2.80%	
85.01 - 90%	2.40%		3.10%	
90.01 - 95%	3.60%		4.00%	
90.01 - 95% non-traditional down payment	3.85%		4.50%	

Standard down payment between 5.00% and 9.99% with 3% interest rate and 25-year amortization				
Loan amount	\$250,000	\$350,000	\$550,000	\$850,000*
Increase to monthly mortgage payment	\$4.73	\$6.63	\$10.41	\$16.09

* requires 10% down payment on loan over \$500,000

Source: Data from CMHC and author calculations.

The case for raising its fees at the time was that this would help cool overheated housing markets. But it is not so easy to identify the cause and effect here. Because MIFs are added to the loan after the borrower has purchased a home and the transaction is largely invisible to the borrower, it is unlikely that raising the fees by less than 1 percent would have much effect on the market. Instead the principal effect is more likely its positive impact on CMHC's bottom line and mortgage insurers more generally. Given that CMHC issues about half the mortgage insurance in Canada (a lower market share from previous highs) it tends to be a price setter for MIFs and thus private insurers such as Genworth and Canada Guarantee tend to adopt the fees as set by the Crown corporation.

As mentioned, CMHC's business activity has grown substantially and the result is that its net income has in turn increased. Its net income after tax reached almost \$1.4 billion in 2016. This is folded back into general revenues for the federal government.

But, as mentioned above, in light of CMHC's growing revenue levels it announced in June 2017 that it would pay the federal government a special \$4 billion dividend over the next two years (beyond what it already sends Ottawa from net income). This is a return of capital that the corporation has decided is not required to safely insure against a major market downturn. It is not clear whether the government will use these funds for affordable housing programs or just consolidate it into general revenue to be spent on non-housing priorities or to reduce the budgetary deficit. It is important to emphasize that these profits are mostly earned through mortgage insurance fees charged to first-time home buyers who have smaller down payments. It is difficult to justify why this group should be essentially subsidizing other government spending or deficit reduction through higher-than-necessary mortgage insurance fees.

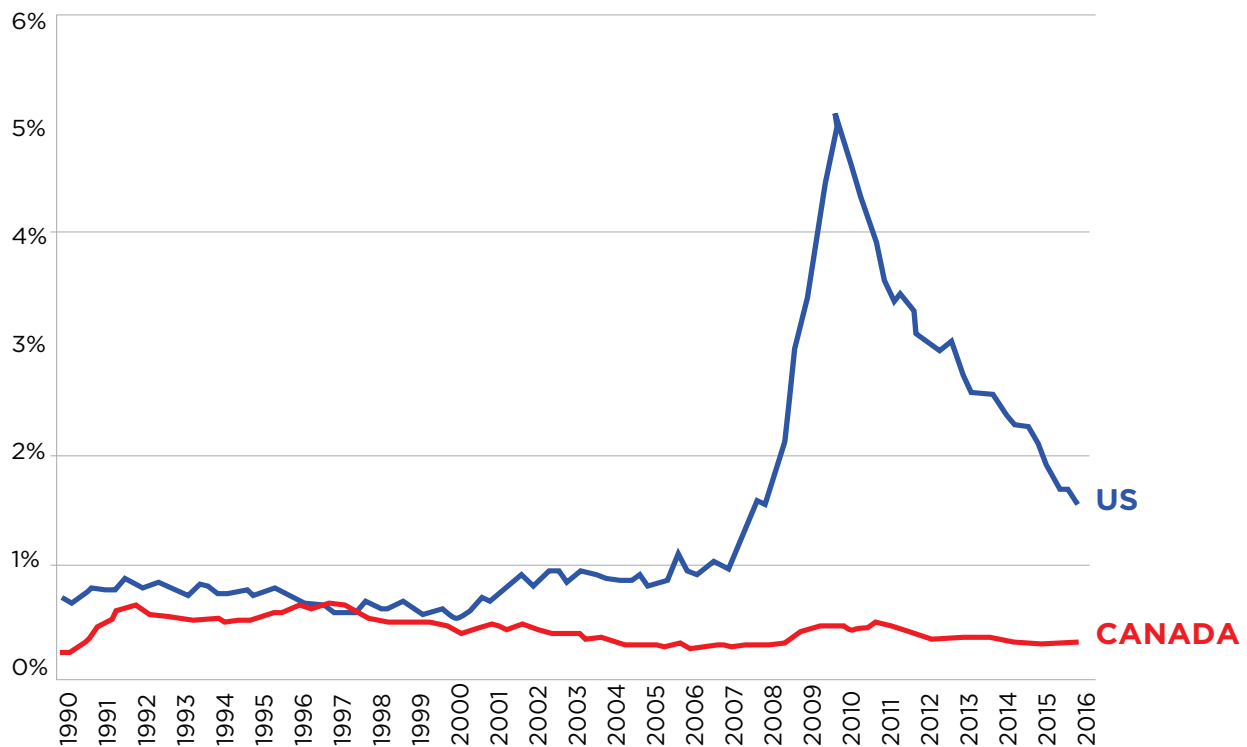
Other countries handle mortgage insurance in different ways. In Hong Kong, for instance, mortgage insurance is paid on the amount by which the loan exceeds 60 percent LTV up to a maximum loan

of 90 percent. Banks are protected on only this portion of the loan (Standard Chartered Bank 2017). The Federal Housing Administration's mortgage insurance in the US alternatively charges a smaller upfront fee of 1.75 percent of the loan amount and then a monthly fee of .45 percent to 1.05 percent depending on the price of the house and length of term. Once the loan-to-value ratio for the property reaches 78 percent, the monthly fee is no longer required (Galante 2013).

Either of these systems would result in much lower premiums for the borrowers without having a large impact on their repayment viability if properly implemented. It is not clear whether CMHC has ever considered an alternative mortgage insurance program after the initial one was set up. The fiscal incentives for cash-starved governments certainly do not point in the direction of such reforms.

The following chart shows mortgage arrears⁴ rates for Canada for the past 26 years (see chart 7). The strength of our careful underwriting is clear in the low and steady levels of mortgage arrears. Even during the financial crisis, arrears rates were less than half a percent, which of course stands in stark contrast to the US arrears rate which peaked at more than 4 percent in 2009. Canada's arrears rate was its highest in 1983 when interest rates hovered around 20 percent and still it was only 1.02 percent at the time (McIister 2011). In 2010 CMHC reported that 87 percent of their insured borrowers had at least 10 percent equity in their properties. Average equity levels are of course even higher. It is a reminder that public comments about a debt crisis or runaway housing catastrophe require a considerable degree of pessimistic assumptions.

CHART 7: RESIDENTIAL MORTGAGES IN ARREARS, 1990-2016



Source: Canadian Bankers Association 2017.

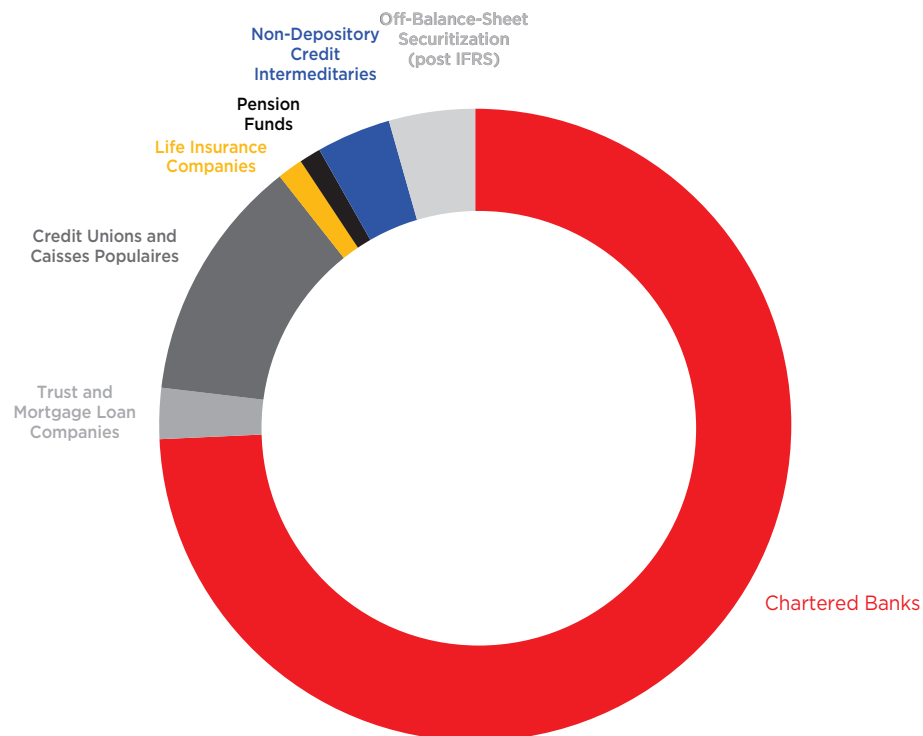
Mortgaged backed securities

CMHC introduced mortgage backed securities (MBSs) in 1986. These enable financial institutions to bundle similar mortgages together and sell them to investors, thereby increasing the supply of mortgage funds to be lent to home buyers. The result is a more efficient secondary mortgage market and reliable mortgage financing for Canadians. During the financial crisis, CMHC used the Insured Mortgage Purchase Program to buy mortgages from banks and put them into MBSs to increase liquidity of the banks, which greatly reduced pressure in financial institutions and the negative effects of the global financial crisis.

CMHC also manages Canada Mortgage Bonds, which are a simple investment vehicle for lenders particularly small ones that have limited funding channels. This enables them to compete more effectively with larger financial institutions with more liquidity and in turn fosters greater competition for consumers. Canada Mortgage Bonds are similar to MBS except that there is no early prepayment of principal allowed making them more analogous to bonds. The minister has authorized guarantees of up to \$40 billion for Canada Mortgage Bonds.

As mentioned, these investment and liquidity vehicles play a useful role in Canada's mortgage market. Still securitization is a much smaller part of the market in Canada than in the US. Banks do the lion's share of mortgage lending in Canada - almost three-fourths of all mortgage loans (see chart 8). They do not have a huge incentive to move these loans into MBSs because of the typically short terms on mortgage loans (relative to the US) and the coverage provided by mortgage insurance. Mortgages can thus be an attractive investment for banks to hold by matching maturity of the loans to savings instruments and earning a favourable spread on the interest rates. As a result, the proportion of mortgage loans in Canada sold into MBSs is much smaller than for the US.

CHART 8: RESIDENTIAL MORTGAGES OUTSTANDING, BY FUNDER, AS OF 2013Q2



Source: Crawford, Meh, and Zhou 2013, chart 1, page 54.

One result has been that the introduction of MBSs has allowed banks to offer borrowers a longer term on their fixed-term loans – seven or even 10 years rather than three or five years. But this has not had a major effect on the market in part because the penalty costs for breaking a loan term early (much higher than in the US) has deterred customers.

While the Canadian mortgage system is robust, one weakness is that interest rate risk resides with the borrower. If rates rise dramatically, as they did in the early 1980s, the borrower has to renew at the rates then offered when the term of his or her loan is up for renewal. The potential for an interest rate spike to erode a borrower’s capacity to manage his or her mortgage has been a concern for policy-makers in recent years. It has been cited in fact as one of the principal reasons for policy changes including the recent proposal to stress test borrowers for interest rates as much as 2 percentage points higher than they are currently paying.

The US by comparison has 15- or 30-year term mortgages with the ability to get out of the loan for relatively low fees if interest rates drop. This leaves most interest rate risk with the lender – and is a large reason why the US needed to develop the large MBS system it has in place. A very convoluted insurance program to protect borrowers against rate increases was developed in Canada after the early 1980s scare. But, because of its complexity and the limits to its coverage, it was rarely used. There is value in revisiting this policy question as part of a pro-homeownership agenda.

Mortgage rules

Ottawa is responsible for setting out the mortgage rules and standards followed by federally regulated financial institutions. These include: minimum down payments on purchase of principal residences and investment properties, equity requirements for refinancing, and maximum amortization periods. Also included are the guidelines for borrower maximum debt ratios (gross debt service, or GDS, and total debt service, or TDS) and the interest rates at which these need to be measured. This

“regulatory sandbox” has been updated several times in recent years and speculation continues to mount that the government may make further changes to curb the market.

“Minimum down payments have also been adjusted. This policy lever has moved up and down over years.”

The purposes of these financial regulations related to mortgages is principally about financial stability and reflects the federal government’s responsibility for systemic issues concerning the financial services sector. Policy and regulatory responsibilities rest with the Department of Finance and the Office of the Superintendent of Financial Institutions (OSFI). Generally speaking, the department sets out the policy and regulatory framework and OSFI’s role is execution and oversight. It is important to note however that the line between the two can be somewhat blurry. A new, controversial proposal to stress test borrowers based on higher interest rates, for instance (which is discussed in more detail below),

would be an operational change from OSFI rather than a new proposal from Finance. Understanding the different roles and why and how new policies or oversight initiatives originate can be difficult for industry and the public.

Minimum down payments have varied over time in Canada. Historically they were 10 percent but were lowered to 5 percent in 1992 to make it easier for first-time buyers to save enough to buy a house and enter the housing market. While Canada's underwriting on residential loans was never close to as lax as it became in the US in the mid 2000s, there have been periods of regulatory relaxation in the name of promoting higher levels of homeownership. It evolved to a point that, by 2007, buyers were permitted to purchase a house with a zero down payment and amortization periods of up to 40 years irrespective of one's age or the characteristics of different housing markets.

When the global financial crisis hit, the Canadian government reined in these rules. By mid-2008, the maximum amortization rate for high ratio insured mortgages was reduced to 35 years; by mid-2012 this had been reduced twice more to 25 years. Reducing the length of the amortization period has of course led to higher monthly carrying costs and thus a significant impact on the maximum loan amount borrowers would qualify for.

Suppose a borrower has a household income of \$80,000 and no other debts. The lender requires a maximum gross debt service (GDS) ratio⁵ of 35 percent. If property taxes on the house are \$3000, the maximum mortgage he or she would qualify for at a 35-year amortization period is approximately \$517,000. The same financial circumstances but at a 25-year amortization limit produces a \$420,000 maximum mortgage. This means the house such a borrower can buy at a 25-year amortization period is \$100,000 less than at 35 years.

In markets like Vancouver and Toronto, this may mean not entering the housing market at all. Now, one can argue that such a policy change is justified on the grounds of protecting against household debt or systemic risk. But it also conflicts with the intent of other policies, such as the current government's pledge to significantly increase the Home Buyers' Plan and to make it more flexible for first-time buyers. This is the type of policy incoherence that we see across federal housing policy.

Changes have also been made to minimum equity levels on purchase and refinancing. Concerns about debt levels for consumers led to an increase in required equity for purchases and refinancing in the aftermath of the global financial crisis. In early 2010, Canadians who sought to refinance their homes were restricted to a 90 percent LTV down from 95 percent; this was further lowered to 85 percent in January 2011 and to 80 percent in 2012. Those buying an owner-occupied investment property with three or four units can now borrow only 90 percent; if the purchasers are not living in the property the maximum loan is 80 percent.

These changes may make sense in theory. Higher thresholds for non-residential purposes have an intuitive aspect. But, for many purchasers in higher priced cities, the only way to buy is to have an extra unit(s) in the property to rent to others - as a means to provide income to help make the

“The extension of stress testing to all uninsured mortgages may have a significant impact on the housing market - especially since as many as 46 percent of mortgages outstanding in Canada are uninsured.”

mortgage payments. These higher equity requirements therefore may not just affect commercial landlords. It can also make the initial purchase difficult for first-time buyers and for those who plan to draw on extra units to defray their mortgage costs.

Minimum down payments have also been adjusted. This policy lever has moved up and down over years. The most recent changes occurred in October 2016. Now we have a graduated model based on home prices. The minimum down payment for homes below \$500,000 is 5 percent. It rises to 10 percent for the amount a home's price exceeds \$500,000, which means that buyers must now contribute 10 percent of the value over \$500,000 up to \$1 million. As an example: a \$900,000 would entail a down payment of \$65,000 versus \$45,000 at 5 percent on the total price. It then climbs to 20 percent for homes exceeding \$1 million because a home buyer is no longer able to purchase mortgage insurance on these properties.

This model may not affect prospective purchasers in some regions and cities, but it can have significant implications in our high-priced markets. Remember the average housing price in Vancouver now exceeds \$1 million. The result is a prospective home buyer must have a minimum down payment that reaches beyond \$200,000. The risk is that such a down payment is out-of-reach for a large share of the population in these major cities.

Rules on the interest rates used for qualifying borrowers for loans have also changed over time. Lenders post interest rates on their websites but borrowers can negotiate rates much lower than the posted rates – generally about 2 percent currently. In 2010, borrowers were permitted to draw on variable rate loans or one to four-year term loans but only if they qualified for the loan at the Bank of Canada conventional posted five-year rate (posted rate) rather than the negotiated rates. This restriction essentially produced a policy-induced trade-off in favour of a fixed-term mortgage over a variable one. Taking a 5-year term loan may have been a good choice given low interest rates but it has limited flexibility because of the penalties associated with early repayment. This disproportionately affects those experiencing employment changes or other household developments by the government choosing stability over flexibility with little or no room for choice.

In 2016, the government closed this last so-called “loophole” by requiring all borrowers with insured loans (those with less than a 20-percent down payment) to qualify at the posted rate. This provides a cushion for the lender and the borrower if rates rise significantly when the term of the mortgage ends and renewal involves higher rates. However, it also significantly reduces the home prices for which a borrower can qualify.

Just think: If a home buyer negotiated a five-year mortgage loan at 2.4 percent, the lender would calculate his or her affordability ratios (GDS and TDS⁶) with a mortgage payment based on the posted rate – in the range of 4.65 percent. On an \$800,000 home, with 10 percent down, the borrower would need to qualify on GDS and TDS calculations at a mortgage payment almost \$900 per month higher than they are actually paying.

This point is worth emphasizing: policy measures to protect against undue household debt or financial risk is now imposing significant costs, particularly on first-time buyers in major urban centres.

These costs are bound to be exacerbated by OSFI's new policy to further tighten mortgage underwriting. The biggest change is the implementation of a stress test for all uninsured mortgages (those with a down payment of more than 20 percent). Under current rules, only insured mortgages, variable rates, and fixed mortgages must be qualified at a higher rate. That rate is the Bank of Canada's posted rate (currently 4.64 percent). Going forward, it will be replaced by a 200-basis-point buffer above the borrower's contract rate. Using a million-dollar home as an example, buyers looking to

secure a mortgage with a 20 percent down payment at a 3 percent interest rate will have to prove that they could pay up to \$4652 per month instead of \$3786 on their contract – a difference of \$866 per month.

Other proposed changes include:

- requiring that loan-to-value measurements remain dynamic and adjust for local conditions when used to qualify borrowers; and
- prohibiting bundled mortgages that are meant to circumvent regulatory requirements. The practice of bundling a second mortgage with a regulated lender's first mortgage is often used to get around the 80 percent-plus loan-to-value limit on uninsured mortgages.

The extension of stress testing to all uninsured mortgages may have a significant impact on the housing market – especially since as many as 46 percent of mortgages outstanding in Canada are uninsured. There is a real risk that it effectively shuts many borrowers out of the market, drives them into less suitable housing, or sends them into the arms of credit unions or sub-prime lenders that are not federally regulated. One estimate suggests that these changes will depress housing demand by 5 percent to 10 percent, another that they will reduce the volume of home sales by 10 percent to 15 percent annually, resulting in 50,000 to 75,000 fewer home sales per year when compared with previous rule changes (McFarland and Bradshaw 2017).

OFSI has defended its changes on the grounds that the regulator has to occasionally enact policies that are “bold and unpopular” (Bradshaw 2017). This does not strike us as a basis for sound public policy – particularly in light of the evidence in favour of pro-homeownership policies and the government's own pro-homeownership rhetoric. Simply put: prudence and coherence seem like a better policy basis than boldness or popularity.

“This is regulation-making in search of a problem.”

One gets the sense that this overemphasis on household indebtedness in bureaucratic circles is partly a result of looking at the Canadian market through a US lens despite our clear differences, and partly about a risk aversion based on the regulatory failures elsewhere in the lead up to the global financial crisis. It is one thing to act before a problem emerges and another to search for a problem where it does not exist. OFSI head Jeremy Rudin's observation that “We are not waiting to see those [housing] risks crystalize in rising arrears and defaults” is telling (Bradshaw 2017). This is regulation-making in search of a problem.

Many borrowers who have repaid their mortgage loans subsequently take out a line of credit secured against their principal residence – often called a home equity line of credit (HELOC). Borrowing against real estate is usually the cheapest way for a household to acquire needed funds for various purposes. Households use HELOCs to:

- invest in other assets such as stocks and bonds,
- pay for secondary education for children,
- pass on an early “inheritance” to children to allow them to enter the housing market or for other purposes, and
- consolidate other debt (credit card debt and others).

Concerns about the growing amount of HELOC debt in 2012 led a restriction by the federal government against allowing these to be insured through CMHC. This effectively limits them to maximum 80-percent LTV. OFSI's more recent changes restrict these HELOCs (which are non-amortizing) to 65 percent LTV.

The government has made smaller changes to the underwriting criteria for GDS and TDS. These ratios have been used for decades as a method of assessing whether the borrower can afford to make the payments on the loan. For much of this time the maximum ratios were 32 percent for GDS and 40 percent for TDS. Many financial advice web sites still recommend these levels (National Bank 2016). However, CMHC currently permits GDS/TDS of 35 percent/42 percent if the borrower's credit score is less than 680 and 39 percent/44 percent for those with credit scores above 680. The 44 percent limit was recently lowered from 45 percent.

“Different households are in different tax situations.”

While these are standard measures of affordability, they are far from perfect. The numerator does not include all the costs of homeownership that differ from renting. Insurance is not included; the utility estimate is often low relative to what is actually paid; there is no allowance for maintenance costs; and so on. As well, the numerator does not consider other fixed costs faced by the borrower such as daycare costs or the cost of a monthly commuter pass that can affect the ability to make mortgage payments.

The denominator in both the ratios is gross income not net income. Different households are in different tax situations and have different at-source deductions for benefits for example. Sometimes the income is from one person and sometimes from more than one earner leading to very different after-tax income. This results in quite different disposable incomes for the same gross household income. It is take-home pay that households have available to make debt payments and an argument could be made that these affordability ratios should be based on net income rather than gross.

As well these ratios are the same regardless of income level. Households with an income of \$80,000 who borrow to a GDS level of 32 percent, would have about \$49,000 of gross income (much less net income) left for all household expenses - food, clothing, transportation, and so on. A household earning \$200,000 would have \$136,000 remaining at a 32 percent GDS ratio - a much healthier amount.

Tax incentives

The federal government also promotes and supports homeownership through the tax-and-transfer system. These policies are principally designed to help first-time home buyers save for a down payment or to cover closing costs or to encourage homeowners to build up equity in their primary residences. The total cost of these measures was roughly \$6.1 billion in 2015 which is the equivalent of more than 2 percent of total program spending (see table 2).

TABLE 2: FEDERAL TAX INCENTIVES FOR HOMEOWNERSHIP, 2010–2017 (\$MILLIONS)

	2010	2011	2012	2013	2014	2015	2016	2017
First-Time Home Buyers' Tax Credit	105	110	110	105	115	120	120	120
Non-taxation of capital gains on principal residences	4105	4700	3900	4160	5100	5920	5320	4975
Home Buyer's Plan	75	75	75	75	75	75	75	75
Total	4285	4885	4085	4340	5290	6115	5515	5170

Source: Department of Finance 2017b.

These measures exclude other housing-related sales tax policies including a GST exemption for certain residential rent (\$2.1 billion per year), a GST rebate for new housing (\$505 million per year), and a rebate for new residential rental property (\$100 million per year) (Department of Finance 2017b).

The capital gains exemption on the sale of one's primary residence dates back to the early 1970s when the taxation of capital gains was first enacted. The government opted to exempt housing. It is now the most significant federal incentive, representing 97 percent of total direct federal initiatives related to homeownership.

This tax treatment has been criticized by some commentators for disproportionately benefiting high-income earners or disadvantaging renters (Lee and Ivanova 2013; Shapcott 2002). It has even been characterized as “winning the lottery” for wealthy homeowners (Lee 2016).

This type of narrow distributional analysis fails to recognize that taxing capital gains on principal residences amounts to double taxation since home equity is built up through after-tax payments (which is a broader problem that Tax-Free Savings Accounts are beginning to remedy) rather than from pre-tax sources as is the case elsewhere.

It also neglects the advantages of the current tax treatment in encouraging equity-based homeownership relative to the US. MLI has written elsewhere about how Canada's non-taxation of capital gains is a far better option than the US government's provision of mortgage interest deductibility to promote and support homeownership (Crowley and Speer 2016). This differing tax treatment is one of the reasons that Canadians own greater equity in their homes than Americans and mortgage arrears are eight times lower here (Crowley and Speer 2016).

The other two federal incentives are focused on helping first-time home buyers save for a down payment or cover their closing costs. The First-Time Home Buyers' Tax Credit was enacted in 2009 by the previous government to help first-time buyers defray the costs associated with closing a transaction. The Home Buyers' Plan was established in 1992 to enable individuals to borrow up to \$25,000 from their Registered Retirement Savings Plans for the purposes of buying a home without incurring penalties, as long as they repay the loan over 15 years. An average of approximately 190,000 tax filers utilized this provision each year. These measures are more minor in cost and the Home Buyers' Plan

may become less relevant in the future as more Canadians rely on Tax-Free Savings Accounts as a vehicle for saving for a home rather than their RRSPs (Carrick 2011; Marr 2012).

The Liberal Party (2015) platform proposed enhancements to the First-Time Home Buyers' Plan but these changes were excluded from the 2016 budget and it is unclear if or when the government will fulfill this outstanding commitment. It has been criticized for its inaction on this commitment especially in light of the series of changes tightening mortgage rules. Instead government spokespeople cite its "significant investments in affordable housing" (Harris 2016). This response highlights the tendency to conflate social housing spending and policies to support homeownership in market-based housing.

Affordable housing

The federal government supports affordable housing principally through transfer payments to other levels of government (CMHC 2017a). The Trudeau government has placed a significant emphasis on funding more affordable housing including providing an additional \$1 billion per year (Young 2017). This renewed investment has received considerable support from municipalities and non-profit organizations who were critical of the previous government's perceived lack of commitment on the file.

Most of this criticism was unfounded. The truth is that successive federal governments have consistently supported social housing since the Second World War. The federal government and the provinces and territories have created and maintained a portfolio of social housing units through various programs and initiatives. There are now about 550,000 units in the social housing portfolio that are receiving long-term subsidies from the federal government. The federal contribution to these subsidized housing units is approximately \$1.7 billion annually including for on-reserve housing. This does not include CMHC's Investment in Affordable Housing initiative that provides \$238 million for affordable housing per year. The recent federal budget doubled this amount for 2016 to 2018. The upshot is Ottawa spends about \$2 billion per year on social housing (Government of Canada "Let's Talk Housing – CMHC's Role in Canada's Housing System").

But some of these long-term federal subsidies are beginning to sunset and will fully expire by 2039 (Falvo 2017). Ottawa has yet to signal whether it will renew or replace them with some kind of long-term funding mechanism. It is likely that the Trudeau government's National Housing Strategy will speak to these questions in one way or another.

Approximately 50 percent of social housing units are owned by provinces and cities. These public housing units tend to house low-income tenants who pay rents that are heavily subsidized by governments. Non-profit housing providers, including housing co-operatives, generally own and operate the remaining social housing. Most of this housing supports households with a mix of low- and moderate-income levels. This network of social or affordable rental housing is partly self-financing but there are minimal resources available for major capital financing.

As mentioned, roughly 6 percent of Canada's housing market is social or affordable rental housing. It is not to diminish its importance or the need for new thinking on the file. The potential for federal funding to shift from operational costs to a housing benefit or voucher would be a positive step that would enable more inclusivity and less housing segregation (Zon and Nelles 2017). Requiring new housing developments to include more low-income housing in conjunction with market-based projects would also be worth considering. It would not only help maintain and grow the supply of

social housing, but also ensure that these units are not segregated and instead part of market-based housing complexes.

But more generally the government cannot lose sight of housing affordability in the market-based share of the market. The minister's mandate cited earlier suggests that there is room for a policy and political rebalancing as part of the National Housing Strategy.

National Housing Strategy

The Trudeau government has to its credit committed to a National Housing Strategy in the name of bringing greater coherence to federal housing policy. National consultations began in June 2016. Feedback was set out in a preliminary report titled *What We Heard: Shaping Canada's National Housing Strategy*, in November 2016. Expectations are the final strategy will be released in the coming weeks.

What goals and objectives underpin this work? Nineteen discussion documents that the government released to shape and inform the consultation provide a bit of insight. Topics include: "Socially inclusive housing for a better society," "Rethinking affordable housing for low-income Canadians," and "Market housing in Canada, homeownership and rental."

The preliminary report provides some insight into the government's thinking and priorities. Its vision as articulated in the report - "Canadians have access to housing that meets their needs and they can afford. Housing is the cornerstone of building sustainable, inclusive communities and a strong Canadian economy where we can prosper and thrive" - is by and large right. But its key findings have some strengths and weaknesses that are worth addressing before setting out our own recommendations.

The report's strengths are (1) an emphasis on First Nations housing which is a core federal responsibility in serious need of rethinking and new models, (2) its focus on funding following people rather than moving people to geographically-concentrated social housing, and (3) a commitment to greater measurement and data collection.

Its principal weakness is its under-emphasis on market-based housing. The phrase does not appear once in the 66 pages. "Homeownership" appears 8 times. Talk of a "furthering the progressive realization of the right to housing" seems to supersede more practical questions about how we promote and support homeownership in Canada and the proper role of the federal government. It is difficult not to read the materials as a manifesto on social housing at the expense of new thinking on how to support homeownership in the market-based part of the housing market.

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This is especially important given the emphasis that the Trudeau government has placed on “the middle class and those looking to join it.” This idea is at the heart of Ottawa’s focus on “inclusive growth” which we at the Macdonald-Laurier Institute have enthusiastically supported. The research in our view is decidedly clear: promoting and supporting homeownership is one of the best ways for the federal government to help the middle class and those Canadians looking to join it. Thus the omission of the importance of housing affordability and homeownership in the market-based share of the market in the preliminary report is a major gap that will need to be addressed in the impending strategy.

Recommendations for a Coherent, Pro-Ownership National Housing Strategy

The federal government’s National Housing Strategy is an opportunity bring coherence to federal housing policy. The goal should be to put forward a positive policy framework for affordable and responsible homeownership. Doing so would represent a major step in the direction of the Trudeau government’s vision of inclusive growth. Here are five key principles and recommendations that ought to inform the National Housing Strategy.

1. Affordable housing and housing affordability are different and require different policy responses

Social or affordable rental housing represents only 6 percent of the market. Yet it has seemed to consume a disproportionate share of the government’s attention on the housing file. The Prime Minister’s July 2017 interview and the substance of the National Housing Strategy’s consultation documents certainly suggest so.

It is not to diminish the importance of social housing or the potential for new thinking on how the federal government can more effectively support those who require social housing. Speculation that Ottawa is considering a new housing benefit, for instance, would be a major step forward (Press 2017).

But it is to remind federal policy-makers that a singular focus on social housing will neglect the principal housing concern for most Canadians, which is whether they can afford a home that meets their need in the market-based share of the housing market.

The National Housing Strategy must put a major emphasis on a pro-homeownership agenda to help those struggling with affordability to buy homes in market-based housing. This is the pressing issue reflected in polls and surveys as well as its potential effects in terms of enabling people to relocate and live in our most dynamic, job-creating cities. There is a considerable body of US evidence, for example, that high housing costs in more urban centres are a drag on the economy and ultimately a source of inequality (Calder 2017; Furman 2015).

The government must also recognize that affordable housing and housing affordability require different thinking and different policies. This should be self-evident but at times spokespeople for the government have tended to cite support for affordable housing when questioned about housing affordability. An effective National Housing Strategy will need to speak to both issues and present specific and distinct policies that make progress on each front.

2. Promoting and supporting affordable and responsible homeownership is key to inclusive growth

We recognize that some economists are critical of using public policy to encourage homeownership. They see it as distorting the market and nudging people into homes that they cannot afford when savings might be put to better use elsewhere. These are legitimate objections.

But we do not believe that it is a basis to eliminate housing-related incentives – especially in light of the overwhelming evidence that homeownership is associated with a raft of economic and social benefits. The focus for policy-makers must be on getting the incentives right, and economists can help craft such programs to be effective. The US mortgage interest deduction is a prime example of poorly-designed policy that gets the incentives wrong. Encouraging homeownership fueled by debt rather than equity makes buying a house a source of instability – not the foundation of the middle class.

The question, then, in our view, is not whether government policy should promote and support homeownership but how?

The first step is for Ottawa to remember that it is establishing a national policy framework for several disparate markets. Vancouver’s market is of course different from the St. John’s one. Federal policy-makers must be more cognizant of the fact that top-down, national policy changes will have different effects in these different markets.

The solution is to focus on a coherent national policy framework with clear, predictable rules and incentives for savings, higher down payments, and equity accumulation. Provincial and local governments can then make policy adjustments to address unique regional or local issues.

The second is to think about the design and interaction of federal incentives related to housing and homeownership. We believe that there is room for policy innovation and new ideas rooted in the basic idea that homeownership is associated with broad-based economic and social benefits and that there is a role for public policy to promote and support it.

3. Ottawa should put any new or pending changes to mortgage and financing rules on hold

The so-called “regulatory sandbox” has been disrupted several times since 2009/10 and this does not even account for recent provincial and local regulatory and policy changes related to housing. The market has experienced considerable policy volatility. This cumulative burden of successive changes is still playing itself out.

Few sectors or markets have experienced similar levels of policy uncertainty and regulatory change over this period. It seems sensible therefore to hit pause on any further changes to the mortgage rules until we have a better sense of how past policy adjustments are affecting the market. This layering of new rules and policies should have some time and space to work itself out before we can

make judgements on the state of the market and what is working or requires reform. As stakeholders indicated in the federal government’s consultations on the National Housing Strategy: “Any changes to the housing finance system (tightening or loosening) should be thoughtful, deliberate, and gradual” (Government of Canada 2016, 65). We agree.

This “regulatory pause” ought to be extended to OSFI’s recent plan to stress test non-insured mortgages. We are concerned that this new operational change may do more harm than good – particularly if it pushes people into unregulated lenders or higher debt levels. OSFI should put this idea in abeyance and focus on long-term trends rather than short-term impulses.

One immediate step that Ottawa might consider is incorporating public analysis and reporting on past regulatory and policy changes in the name of transparency and evidence-based policy-making. The annual report on tax expenditures can serve as a bit of a model with some adjustments to reflect the inherent policy differences. This type of public-facing, evidence-based analysis would enable stakeholder engagement, knowledge transfer and exchange, and better designed policy along the lines set out in the quotation above.

The provinces and cities should also adopt a similar model of public reporting – particularly on the effects of current land-use policies on housing supply. The public may decide that land-use restrictions are justified to fulfill other objectives such as environmental considerations. But these trade-offs can only be evaluated when the information is available. Open-source data on the benefits and costs of existing urban planning policies would enable such an evidence-based debate.

4. There is room to rethink mortgage insurance – including investigating alternative models of insurance that are less costly to borrowers

As mentioned elsewhere, Ottawa’s principal role in market-based housing is through CMHC’s mortgage insurance activities. It is a huge portfolio. CMHC’s insurance-in-force has a legislated limit of \$600 billion. At the end of the second quarter of 2016, its total insurance-in-force was \$523 billion (CMHC 2016).

Successive governments have taken some steps to curb the growth of its mortgage insurance activities in part because of the potential risk for taxpayers and in part because the private insurance market has become more mature. It is notable that CMHC’s total insurance-in-force has fallen by approximately \$3 billion since 2015. But these modest efforts to rein in the growth of its mortgage insurance however sensible do not represent fundamental thinking about how CMHC participates in the market.

Three ideas that are, in our view, worth exploring are: (1) possible changes to the method of charging MIFs (mortgage insurance fees) with the goal of reducing the burden on aspiring home buyers, (2) measures to reduce interest rate risks for borrowers, and (3) gradually shifting from relying solely on a mortgage insurance model for first time buyers to one that incentivizes higher down payments and more equity.

The first strikes us as a more straightforward and less contentious policy change. CMHC is collecting significant revenues for its mortgage insurance activities and is now in a position to increase its dividend to the federal government. The Crown corporation’s role is to fill a market gap and support homeownership. It is not to be an indirect source of revenue for the federal government’s bottom line – especially since its fees are disproportionately collected from young families. One option would be a reduction in MIFs for first-time home buyers. Another would be to establish a semi-regu-

lar fee-setting mechanism to ensure that CMHC was only collecting sufficient fees to cover its costs and risks.

The second has been previously tested in Canada but was not ultimately widely adopted. But other jurisdictions have had more success with such policies. The US, for instance, allows mortgage holders greater flexibility to get out of a loan if interest rates fall, as mentioned above. We should consider whether a similar policy would fit in the Canadian context given the government's rightful emphasis on lowering household debt levels and the risks of interest rate exposure.

The final option would represent more substantive reform. It could come in the form of shifting a portion of its resources to a pilot program that provides means-tested matching contributions into Tax-Free Savings Accounts for the purposes of higher down payments (Gyourko 2015). This could be done through a simple system in which qualified households pay into a TFSA and receive some type of match from the government. These funds would accumulate on a tax-free basis until they were large enough to provide a 20 percent down payment on a home. Such a policy mechanism would support equity accumulation and could, over time, result in a smaller share of insured mortgages in circulation. This idea is not totally far-fetched. It has similarities to the current Registered Education Savings Plans or Registered Disability Savings Plans models. One of us has also written elsewhere about the potential to leverage the TFSA model for the purposes of incentivizing savings for specific purposes such as health-care costs or housing down payments. Similar ideas have been advanced in the United States (Gyourko 2015).

5. There is room to consolidate and augment existing pro-homeownership tax policies

The Liberal Party's 2015 election platform committed to a comprehensive review of federal tax expenditures comprised of credits, deductions, and other special preferences. This exercise was supposed to ensure that the federal tax code was efficient, simple, and fair. MLI has written positively of these goals and set out recommendations to help the government achieve them (Crowley and Speer 2016).

The review process has to date not been very productive. Small changes enacted in the 2016 budget have been overshadowed by the recent controversy surrounding the government's proposed changes to the small business tax regime. A lack of transparency and poor execution on the part of the government is mostly to blame.

But that does not mean that the basic premise was wrong or that there is no opportunity for tax reform including as it relates to homeownership. The federal tax code presently includes tax expenditures related to homeownership that total roughly \$5 billion in annual foregone revenue. This is substantial. It amounts to nearly the equivalent of three quarters of a GST percentage point.

Some of these tax expenditures have gone unchanged for decades or have been enhanced without much thinking towards to the broader federal housing policy framework. There is room therefore for more creative and ambitious thinking about how the federal tax system can support affordable and responsible homeownership.

One option would be a revenue neutral reconfiguration of the existing tax expenditures in the form of a generous, means-tested tax credit to defray the costs associated with a home purchase. The Trudeau government's consolidation and redesign of the caregiving-related tax credits and deductions in the 2017 budget is a good example (Department of Finance 2017a).

A more ambitious one would be to replace these tax expenditures with a large-scale program to match savings in TFSAs for the purposes of incentivizing larger down payments as described in recommendation #4.

Irrespective of which option the government was to choose, the authors of this report believe there is room for a rethink of how the federal tax code promotes and supports homeownership as part of a National Housing Strategy and the ongoing review of federal tax expenditures.

Conclusion

Housing issues have climbed to near the top of the public policy agenda in Canada. The principal focus of this policy debate has been the provinces and cities. And for good reason. These levels of government play the lead role in affecting the supply-and-demand dynamic of regional and local housing markets.

But Ottawa also has a role to play in housing policy. The federal government in fact has been involved in the housing market for more than 70 years. It touches housing issues through monetary policy, mortgage insurance, financial regulations, taxes and subsidies, and social housing spending.

Federal housing policy has evolved over the decades with little coherence or strategic thinking. It frequently shows. Successive governments have often enacted policies that can work at cross-purposes. Think for instance of richer subsidies for first-time home buyers and restrictive mortgage regulations (such as higher minimum down payments or shorter amortization periods). This paper has described the resulting housing policy framework as the equivalent of the Bride of Frankenstein.

The Trudeau government's impending National Housing Strategy has the potential to bring greater coherence to federal housing policy and in turn support housing affordability and homeownership across the country. This study has sought to help in this regard. Its key observation is that Ottawa can and should support homeownership but it must start with a clear, evidence-based understanding of how its policies work, how their effectiveness is measured, and how federal policies interact with one another and those of lower levels of government. Federal housing policy should start to look like it was purposefully designed rather than a mishmash of disparate initiatives and measures.

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Endnotes

- 1 This affordability metric captures the proportion of median pre-tax household income required to service the cost of a mortgage on an existing housing unit at market prices, including principal and interest, property taxes, and utilities; the modified measure used here includes the cost of servicing a mortgage, but excludes property taxes and utilities due to data constraint in the smaller CMAs. This measure is based on a 25 percent down payment, a 25-year mortgage loan at a five-year fixed rate, and is estimated on a quarterly basis.
- 2 A more detailed literature review on the relationship between land-use restrictions, housing affordability, and income inequality can be found in Brian Lee Crowley and Sean Speer, 2016, *A Home for Canada's Middle Class*, Macdonald-Laurier Institute.
- 3 A non-traditional down payment may be a gift from a parent or some other form of funds not saved over time by the borrower.
- 4 A mortgage is considered to be in arrears if the borrower has missed 3 or more payments.
- 5 $\text{GDS ratio} = \frac{\text{(mortgage payment} + \text{property taxes} + \text{utility allowance} + \text{(50\% of condo fee if applicable)})}{\text{gross income}}$ is one measure of the borrower's ability to make mortgage payments.
- 6 $\text{TDS} = \text{total debt service} = \frac{\text{(mortgage payment} + \text{property taxes} + \text{utility allowance} + \text{(50\% of condo fee if applicable))} + \text{all other debt payments}}{\text{gross income}}$.



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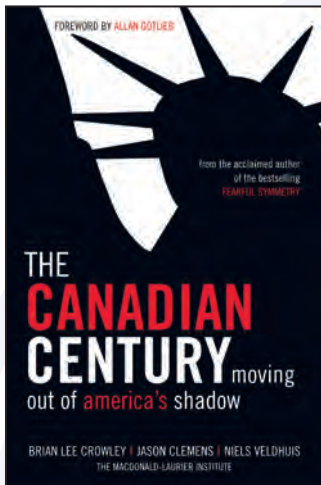
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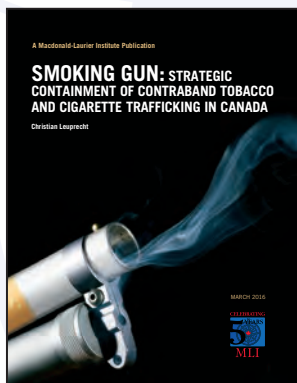


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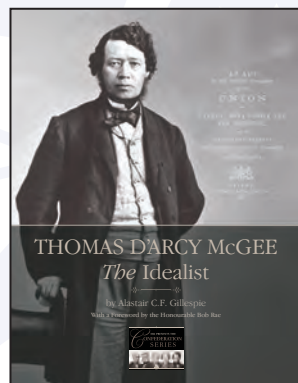
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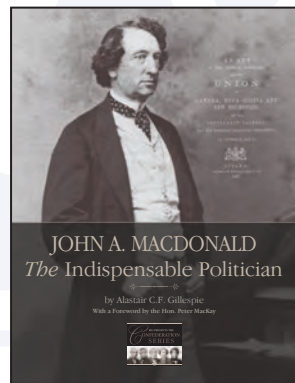
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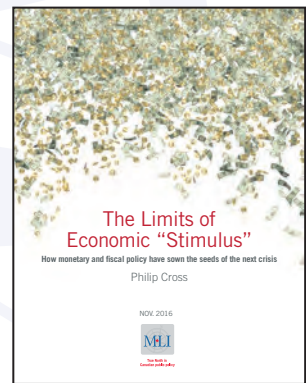
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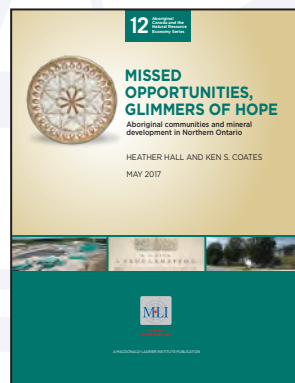
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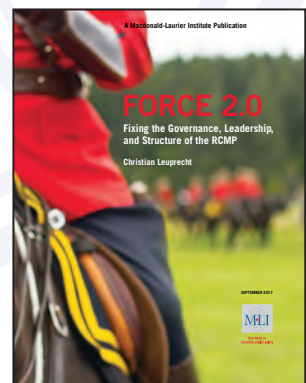
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