The private rental market and the move-up effect
By John Dickie, Chair, EOLO

The rental housing system is largely a set of inter-connected markets. A market is:

- an actual or notional place
- where buyers and sellers interact
- to trade goods or services for money
- thereby setting prices.

In the rental market, renters interact with landlords to rent accommodation and related services, thereby setting rents. Markets:

- Provide choice
- Match effective demand with supply
- Allocate resources efficiently.

The rental market matches demand with supply:

- Of the total number of rental units
- Of different sizes
- At different locations
- With different amenities
- In different styles (high-rise vs. low rise vs. ground oriented).

Since some people and some dwellings can go back and forth between owner occupation and rental occupation, the housing market as a whole matches those five factors of demand and supply, and in addition a sixth factor, namely the desire of people to owner-occupy as opposed to rent.

In each city, the “rental housing market” is in fact many sub-markets linked together. There are sub-markets based on:

- price, for high-end vs. standard vs. affordable units
- housing style, for high-rise vs. low-rise vs. ground oriented units
- location
- unit size, mostly bedroom count.

For governments, trying to dictate prices, rents or quantities always fails. However, market outcomes will change with:

- changes in demand (tastes, and willingness and ability to pay)
- changes in supply (especially with costs going up or down for units in different parts of the market, or overall).

Governments can significantly affect the demand for and/or supply of various types of housing. In making any changes, governments need to consider the unintended consequences of program, tax and policy changes.

Governments are particularly concerned with the availability of housing which is affordable, but local government action has its biggest effect on the supply of new housing for first time home buyers, on the supply of subsidized housing and on the ability of low-income people to pay for their housing.

Filtering, the “move-up effect”

A major impact in housing markets is “filtering,” which can also be called the “move up effect.” “Filtering” is the process whereby households move up a step in the housing chain, leaving the older and more economical housing to be occupied by less well-off families. As households move up to more desirable units or leave the rental market for ownership housing, lower rent units are made available for move-up renter households, or at the bottom of the rental market to new, low-income renters (including people who would share or continue to live at home if that housing were not available.)

If government takes advantage of it, the move-up effect has a major advantage for public policy. The move-up effect happens without requiring any government funding. Households with higher incomes pay for the higher cost of new housing, and leave behind housing that may be less desirable than the new stock, but is most often good quality housing which lower income households will gladly occupy.

To ensure an adequate supply of low cost housing, what is most important is to ensure that there is an abundant supply of housing, regardless of its price. Many studies have shown that the supply of lower-quality, lower cost housing is primarily dependent upon the quantity of new, higher-cost and higher-quality housing supplied in any given market. Most new supply is higher in cost than the existing stock.

There is growing evidence that a primary cause of affordable housing problems was a breakdown in the filtering process. Problems with housing affordability are greatest in those areas where there are barriers to new supply generally (for example, unfair tax treatment, rent controls, municipal fees, land use restrictions, etc.) Rent control is problematic because of its effects on demand. When rents are held below market level, renters find their existing units a bargain. That inhibits moves to starter homes, and inhibits all the moves through the chain, making filtering less effective that it would be absent binding rent control.

As well as working cost-effectively, the move-up effect works fast. Whenever new housing is added at any level of the market, it frees up housing at the lower end of the market through filtering. A lack of filtering is a sign that a particular market is not functioning properly, due to the barriers to new supply or rent controls.

For more on the filtering, or the move-up effect, see:

“The Affordability of Housing In Ontario: Trends, Causes, Solutions”, by Vincent Brescia, January 13, 2005 (esp. pages 25-28), available at www.cfaa-fcapi.org in the section on Housing and Tax Research;

“Is Housing Unaffordable? Why isn’t it More Affordable?” By John M. Quigley and Steven Raphael, Journal of Economic Perspectives, Winter 2004 (esp. page 205); and

“Filtering and Housing Markets: An Empirical Analysis”, by John Weicher and Thomas Thibodeau, Journal of Urban Economics, 1988 (esp. pages 21-22 and p.37).

An understanding of housing markets and the move-up effect suggests a different approach to increasing housing affordability may be more effective than the approaches which have been used for some time in the past.

Social housing construction vs housing benefits or repair subsidies

For example, one major US study found that in many market environments new subsidized housing production does not increase the supply of housing occupied by low-income people. Instead of increasing housing supply, new social housing crowds out private development by using up available land, labour supply, contractors and by taking the effective demand. Even if an additional new rental unit is built, the new unit usually crowds out an existing unit by making rehabilitation not cost-effective, so that an existing unit is demolished. In his research on the United States, Murray (1999) found that in many market environments new subsidized production crowded out private supply one-for-one.[1] Additional subsidy expenditures may have may have produced no additional housing at all. (It may have produced newer, better housing, but it did not produce more housing, once the crowding out effect is considered.)

At the least, Murray's results suggest that subsidies to new social housing construction should be matched with increases in housing benefits in order to increase the ability of other low-income households to pay for housing, and thus to keep the low-end rental units in the market through continued repair and rehabilitation. As well, an adequate amount of sufficient repair and rehabilitation subsidies (grants or loans) may be of great help to keep that low-end supply in the rental market.

Government charges and inclusionary zoning

Another example is to pay attention to the rising government- imposed costs and delays in new housing construction. The impediments to new housing construction include:

1. Development charges;
2. New taxes like the GST/HST;
3. A complex and burdensome planning and approval process;
4. Disproportional influence afforded to NIMBY and other local opposition stakeholders;
5. Policies aimed at preventing or slowing down conversion or demolition; and
6. Inclusionary zoning.

Decades ago new housing was constructed without development charges. New infrastructure was paid for by borrowing, which borrowings were repaid over time by all residents of the city. In recent decades, development charges have been levied on new housing. In economic theory, those charges should be borne by the sellers of development land or by developers. (Leaving aside the equity of

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[1] Michael P. Murray. 1999. "Subsidized and Unsubsidized Housing Stocks 1935 to 1987: Crowding out and Cointegration." Journal of Real Estate Finance and Economics, 18 - 1 107 - 124.

taxing those people specifically, they were thought to be well off, and to be able to bear the costs.)

However, empirical economic research strongly suggests that in the real world, development charges are passed through into the sales prices of new housing. Apparently, land owners hold out for the same price they obtained before, and developers as a whole do not have excess profit from which the development charges can be extracted. Instead, new home buyers have to pay the development charges through the prices they pay for new housing.

In addition, since the price of new housing rises, less of it is produced than would otherwise be the case, and the value and price of existing housing rises. The price effects of higher development charges work their way through the whole housing continuum by reducing the positive impact of the move-up effect. Simply put, higher development charges make housing cost more for everyone, and that includes making rental housing for low-income people cost more.

Inclusionary zoning is seen as a way to combat the higher cost of new housing by forcing developers to provide some of the new housing at a lower price. That reduces the developers' revenue from some percentage of the new units. If cities or senior governments provide sufficient off-sets so that developments achieve the same level of profitability as before, then that should not have a negative effect on housing supply. However, if there are no offsets, or insufficient offsets, then inclusionary zoning acts like a tax, raising developers costs, and reducing the quantity of new housing which they will supply at a given price (for the balance of the units.)

Making new housing more costly reduces the amount produced, and through the reduction in the move-up effect that makes housing cost more for everyone, including making rental housing for low-income people cost more.

Conclusion

In evaluating its existing housing policies, and possible changes to those policies, the City needs to look carefully at the unintended consequences of policy changes, and especially at the impact the changes will have on the rest of the housing market through the impacts on the working of the move-up effect.