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RETHINKING CANADA'S TARGET FOR 5.8 MILLION NEW HOMES BY 2030

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Introduction and summary

Canada Mortgage and Housing Corporation (CMHC) has been publicizing a report that says we need 5.8M new homes by 2030 in order for supply in the market to restore affordability. This brief reviews how CMHC came up with the 5.8 million number and seeks to clarify what the CMHC analysis is suggesting and whether this presents a sound or realistic basis for policy.

I argue that a supply focus alone is insufficient and misleading. To address the fundamental issue of affordability, complementary policy action is also required to better manage demand. The brief concludes by enumerating several complementary demand side measures.

Rather than relying on the CMHC theoretical analysis, and an expectation that the stakeholders in the housing system will agree to flood the market with new supply, more realistic estimates of housing requirements (demand) must be determined, including estimates of suppressed demand.

Revised minimum supply targets should be established and used in both provincial-municipal planning as well as in federal initiatives like the Housing Accelerator Fund (HAF). Currently there is a complete disconnect between the HAF targets and the CMHC 5.8 million home ambition.

But any recalibration of supply targets must also be supplemented and complemented by policies to better manage demand factors, especially immigration levels.

Recommendations

- To better manage and calibrate demand, especially for rental housing, implement a more carefully managed process for international students and temporary workers.
- To address the erosion of low rent properties, the National Housing Strategy (NHS) must be augmented with a funding mechanism to enable non-profits to acquire and preserve existing low-moderate rent properties – an approach that is more cost effective and quicker than new supply.
- An expansion of income assistance and housing allowances (Canada Housing Benefit) can be more effective in directly and quickly addressing high shelter cost burdens for many renters that are already adequately and suitably housed (88% of core need have only an affordability problem – we don't need to build them a home, we just need to help pay their current excessive rent).
- Alongside expanded housing allowances, the risk of escalating costs caused by excessive rent increases must be managed through stronger rent regulation. This should include a review by provinces of the prevailing policy to permit vacancy decontrol. Introducing, at least temporarily while supply catches up, some limit on increases for vacant units (including exempting recent and newly constructed properties to avoid creating a supply disincentive) can provide critical relief to renters required to move.

- To manage excessive home price escalation caused by existing owners with windfall equity gains, introduce a federal property transfer tax on home sales. A federal transfer tax should tax the vendor's windfall gain and reduce their excess purchasing power. The property transfer tax should then be used to support additional affordable housing programs. This would redistribute those windfall gains, dissuade speculative behavior, and provide the federal government with much needed revenues to fund additional targeted affordable housing initiatives.

Background

In June 2022, CMHC published a research paper (updated September in 2023) proposing that in order to restore housing to an affordability level it would be necessary to build 5.8 million new homes by 2030, including an increment of 3.5 million homes over and above the total already anticipated.

The CMHC analysis seeks to determine what level of supply would be required to have a significant impact on home affordability. It makes an important distinction between the number of homes required to meet anticipated household growth and an additional number designed to restore affordability (at least for ownership). To improve affordability, it proposes to oversupply the market with new homes, which is then expected to drive prices down to a specified affordable level.

Projecting to 2030, it proposes that recent levels of construction are generating an estimated 2.3 million homes (230,000 per year, although this subsequently bumped up). The CMHC modelling determined that a further 3.5 million (550,000 per year) would be required to restore housing prices to 2004 levels.

The key point here is that the 3.5 million target is simply a theoretical estimate, proposed to generate support for the notion that increasing new home construction to flood the market with excess supply will drive prices down by over 30% from their 2022 level. For example, to reduce prices in Ontario from $871,000 to $499,000; and in BC from $929,000 to $679,000.

In fairness to the authors, they acknowledge that this is a theoretical analysis and seeks "proof of concept" for determining affordability.

Unfortunately, the overall 5.8 million, and additional 3.5 million increment, have been taken out of context and is widely repeated by industry, the media, and politicians as fact and the most desirable, if not the only, basis for designing policy.

How the estimate was generated

The analysis defines affordability using the relationship between household income and home prices. Based on a review of past affordability trends, it benchmarks affordability at 2004 levels, the period in recent history when housing costs were low relative to average incomes. The 2004 benchmark for house prices produces ratios of around 30% of household income for most provinces but 37% in Ontario and 44% in British Columbia.

It then targets a reduction in this housing cost-to-income ratio (and implicitly to home values) down to equivalent levels that existed in 2003/04. This involves first projecting household incomes forward to 2030. Then, given where they expect disposable income to be in 2030, the Maximum Affordable Price Level (MAPL) is determined. They then ask the model, “what is the supply required so that demand is satisfied and house prices equal MAPL?” Next, they compare the resulting total supply required, as generated by the model, to the level of supply anticipated at recent levels of production.

This modelling predicts that, to restore affordability, a total of 5.8 million homes will be required by 2030. With 2.3 million homes expected under “business as usual,” the additional increment specifically needed to lower prices and restore affordability is 3.5 million homes.

It is also noted that the modelling does not examine deep affordability or the requirements for affordable (social) housing. And the analysis makes an important simplifying assumption that homes can be purchased or rented so it uses the median home price as a proxy: “we are effectively treating all the housing system as one market. Implicitly, we are assuming that increases in house prices will be passed on into the rental system over time”(CMHC 2022). This is a substantial simplifying assumption that may significantly undermine the value of the analysis for policymaking.

The 2023 update of CMHC’s analysis notes some small changes in immigration, current levels of construction and some regional population shifts, but does not materially change their estimate that, nationally, the required excess supply remains around 3.5 million homes by 2030.

Note that this means building an additional 500,000 homes per year, over and above the 230,000 anticipated at recent construction levels – i.e. a total of 730,000 per year.

To put this in context in the decade 2011-2021, Canada added an average of 204,000 (this surprisingly increased during the pandemic averaging 265,000 in 2021-22, a level which appears likely to be replicated in 2023).

How will much higher levels of construction improve affordability?

The CMHC modelling is premised on the well-established micro-economic principle that an increase in supply will shift the supply curve and, all things being equal, will then trigger a shift in the demand curve, resulting in a reduction in price. The CMHC analysis inverts this to start with a desired price level, determined from a projected future income level, and a lower price-to-income ratio (as existing in 2004). Having set that price (by province) and the target affordability ratio works backwards to determine the associated level of supply to solve this equation.

CMHC explains that a substantial increase in overall supply will drive down prices in several ways, including a process of filtering and adding many lower priced units at higher density.

While not explicitly stating it this way, the CMHC aspiration requires a large amount of excess supply which, if achieved, would flood the market and cause prices (and rent) to fall.

How reality conflicts with CMHC's aspiration

A key element of the argument is the process of filtering, where higher income consumers will buy the newer, usually more expensive homes, leaving their existing home at a lower price for the next lower band of incomes and so on. This assumes the vacated property does not, or has not already, significantly increased in price. The economic literature confirms filtering helps in cities that have experienced depopulation or slow growth and have high vacancies. In such cases, the benefits of new construction trickle down to poorer households, although population growth often attenuates much of this effect.[1] The same literature also notes that in a situation of constrained supply and high demand, it is more likely that the older property will also inflate in price (filter upward), especially if in a well-located desirable area. This means for oversupply and some form of filtering to work we need to significantly slow down population growth (i.e. migration). And a Canadian analysis of filtering (Skaburskis, 2006) noted that the most important finding shows the reversal in the direction of filtering in all Canadian metropolitan areas since 1981.[2]

Another important factor the analysis ignores is the presence of vacancy decontrols in many provinces" When an existing renter moves from a rent-controlled unit, the vacancy decontrol regulation permits an increase in rent to current market levels. So, on turnover, rather than filtering to lower incomes, landlords adjust rents to prevailing market levels, making rents less affordable through turnover. This is confirmed in a 2023 Statistics Canada report comparing rents among renters that moved in the past year to those that had not moved. While the CMHC analysis uses a simplifying assumption that median house sale prices are a reasonable proxy for all housing prices, including rentals, here the evidence on filtering is not favourable. In a context of vacancy decontrol and high rental demand, we are seeing double digit year-to-year rent increases, as reported in rentals.ca.

Second, it is expected that the increased new demand will include substantial intensification, and the new units will be smaller and at lower prices, compared to the replaced home so this

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[1] See for example Charles G. Nathanson, 2020, "Trickle-Down Housing Economics", Northwestern University working paper; Evan Mast, 2019, "The Effect of New Market-Rate Housing Construction on the Low-Income Housing Market", Upjohn Institute Policy and Research Briefs, No. 7-23-2019.

[2] Andrejs Skaburskis (2006) Filtering, City Change and the Supply of Low-priced Housing in Canada. Urban Studies, Volume 43, Issue 3 https://doi.org/10.1080/00420980500533612

will pull the overall average home price down. The target average 2030 prices presented at provincial averages in the CMHC 2022 report are roughly 30% below the 2022 values.

In reply to a question on how existing owners might react to a proposed 30% reduction in their home value (i.e., the CMHC target price for restored affordability), the author of the CMHC report responded:

> "*With respect to price declines, note that this is the average price of the entire housing system, not necessarily in the resale market. So, replacing four large single-detached houses on a lot worth millions of dollars with a multi-unit apartment structure will result in a decline in average price. This will not necessarily harm anyone.*" [CMHC Deputy Chief Economist]

Although they never say so explicitly, CMHC has promoted the 3.5 million number to stimulate actors across the system to up their game – municipalities to approve faster, builders to build more, skilled trades to grow the construction labour supply, immigration officials to similarly target skilled labour and industry to innovate to lower costs and improve efficiency.

Unfortunately, despite the rhetoric that we need a massive increase in supply and an "all hands-on deck" level of effort, there are warnings of slowing and stalling of new construction (Globe and Mail Nov 1). Total housing starts in 2023 fell 13% from a recent peak in 2022. This is contrary to what is prescribed as necessary, but reflects the behavior of markets. A wide range of industry stakeholders have identified considerable friction in the housing system: insufficient supply of construction labour, recent inflation in materials costs, higher interest rates and high land costs (caused by recent price escalation flowing back into land values). Even the CMHC author admitted in a radio interview that it's unrealistic: asked if he believed building an additional 3.5 million housing units by 2030 is possible, the report's author responded, "No, but it's the right question to ask."

And these stalling behaviors capture a critical area of friction – developers and builders are not motivated to flood the market with excess supply that would reduce potential sales profits; indeed, their inclination is the opposite – to stall until there is greater certainty and potential for new supply to be absorbed at a higher rate of return on investment.

A further aspect of friction is in the financing part of the system. For builders developing new sub-divisions and multi-unit condo developers, lenders require a minimum level of pre-sales before they will advance construction financing. And CMHC itself, in its loan insurance underwriting, imposes similar constraints on construction financing loans. These policies and practices act to prevent flooding the market with product for which there is no potential purchasers.

What Government should do

The critical drivers of excessive price increase and rents were:

- A combination of extremely low mortgage rates and large windfall gains from increasing prices (which together massively fueled capacity to bid up prices); and

- Unmanaged population growth dominated by temporary foreign workers and international students, populations that almost always rent and create excessive rental demand.

The issue of insufficient supply is a by-product of excessive demand, and the inability of supply to react quickly. Housing supply is inherently inelastic and takes a long time to ramp up and respond to changes in demand, so managing the issue dictates a parallel response to address these demand pressures.

Addressing demand from international students and temporary foreign workers

- Foremost among this is a more carefully managed process for international students and temporary workers. The sheer volume of such immigrants (which is over and above to managed permanent resident target) has overwhelmed the rental sector, so must be recalibrated with efforts to expand rental construction. Notably while home prices have subsided over the past year, rents have continued to rise at double digit levels – fueled by this excessive demand.

Impact of appreciation in fuelling price escalation

In the ownership part of the housing system recent actions by the bank of Canada to manage inflation by raising the bank rate have helped to stop and reverse the trajectory of price change. This may be a temporary pause, and the market is expected to resume an upward trend once interest rates begin to fall.

The other critical element causing price escalation was the enhanced capacity to buy, drawing from appreciation and equity (windfall) gains for existing owners. Two thirds of home purchases come from existing owners (either upscaling, downsizing or buying investment properties). Armed with this extra equity from selling or borrowing against an existing home these buyers are driving up prices, and first-time buyers are unable to compete. Improving the potential for renters to buy will remove some of the pent-up demand from the rental sector, which further adds to rent pressures.

- To level this playing field, part of the windfall gain should be taxed. Such gains are unearned incomes that undermine economic productivity and the public interest. This could be achieved by introducing a federal property transfer tax on home sales. All provinces have already implemented such a tax – but tax the purchaser, adding additional costs for first time home buyers. A federal transfer tax should tax the vendor, and erase part of their excess purchasing power. Even better would be a combined Federal-Provincial land transfer tax on the vendor, and elimination of the provincial taxes on purchasers. This would redistribute those windfall gains and provide the federal government with much needed revenues to fund new targeted affordable housing initiatives.

Addressing erosion of existing private rental affordable housing

While subsidies can assist in adding new targeted affordable supply, it is critical to concurrently manage the ongoing loss of lower rent units. The distribution of renters by income band against equivalent rent bands (i.e., incomes of $20,000-$30,000 who can afford $500-$750) identifies an absolute lack of lower rent homes. The ongoing erosion at the lower end of the rent distribution due to excessive rent increases, as revealed in the rentals.ca data and reported by Pomeroy 2023, exacerbates this shortage.

- To address this erosion the National Housing Strategy must be augmented with a financing and funding mechanism to enable non-profits to acquire and preserve existing low-moderate rent properties – an approach that is more cost effective and quick than new supply.

Addressing rental affordability more directly

- Expansion of income assistance and housing allowances (Canada Housing Benefit) can be more effective in directly and quickly addressing high shelter cost burdens for many that are already adequately and suitably housed (88% of core need have only an affordability problem – we don't need to build them a home; we just need to help pay their current excessive rent).
- Alongside expanded housing allowances, the risk of escalating costs caused by excessive rent increases must be managed through stronger rent regulation. This should include a review by provinces of the prevailing policy to permit vacancy decontrol. Introducing, at least temporarily while supply catches up, some limit on increases for vacant units (including exempting recent and newly constructed properties to avoid creating a supply disincentive) can provide critical relief to renters required to move.

Updating and generating more realistic targets for supply

Given recent high levels of immigration, particularly from students and temporary workers, we need to increase supply. But this requires a more realistic and meaningful approach to estimating housing requirements – including a sufficient surplus beyond demographic and migration estimates to enable mobility and choice. Given that the 3.5 million homes number is a theoretical and unrealistic number, it should be refined and clearly repositioned.

Rather than relying on the CMHC theoretical analysis, and an expectation that the stakeholders in the housing system have the capacity and motivation to flood the market with new supply, more realistic estimates of housing requirements (demand) must be determined.

High prices, alongside other labour market and economic factors, have acted to suppress new household formation (adult children "forced" to remain in parental home), so additional homes at affordable prices/rent will be required to enable young cohorts to transition into independent housing careers. The number of new homes required must also consider demolition of existing homes due to an emphasis on intensification.

Some level of additional supply should also be quantified to restore health and balance to the housing system. In the rental sector there has been a well-established guideline (although of uncertain origin) that a 3% vacancy rate is a useful benchmark for a balanced market: moderating excess rent pressure but still incentivizing investment. A similar benchmark of balance could be estimated for the ownership part of the system. And some proportion of new construction directed to deeper affordability needs is necessary, including an expansion of funding initiatives to support construction of permanent supported housing and deeply affordable options which are critically needed to address homelessness and the recent phenomenon of encampments.

These are all quantifiable amounts and as a first step this work should be undertaken, and realistic minimum targets established as **minimum supply targets** – and these should be used in both provincial-municipal planning as well as in initiatives like the Housing Accelerator Fund (HAF) – currently there is a complete disconnect between the HAF targets and the CMHC ambition.

But any recalibration of supply targets must also be supplemented and complemented by policies to better manage demand factors, especially immigration levels, as outlined above.

As leading bank Economists Douglas Porter, Robert Kavcic both of BMO articulated following the Sept 2023 CMHC update:

> *It's good to have lofty aspirations for homebuilding given the tightness in Canada's housing market and rapid-fire population growth. But we can't be led down a blind alley of wildly unrealistic targets; then, expect a major push to build will alone solve affordability strains. If demand is allowed to continue to run amok, then even torrid supply will simply be quickly swallowed whole.*

It is unfortunate that, governments at both the federal and provincial levels, reinforced by the CMHC supply analysis, have bought into the chronic undersupply argument, and responded only with a strong supply side bias (e.g. the Housing Accelerator Fund, removal of GST from new rental construction). They have indeed been led down this blind alley by the theoretical but unrealistic CMHC supply estimate. It's time to revisit and update that assessment to develop realistic targets and actions to facilitate appropriate expanded supply together with a range of complementary measures to better manage demand.