

# Research Note I – Low Income Housing Series: Financial Implications of Different Housing Tenure Arrangements

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by Terry Partridge  
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The Institute of Urban Studies





THE UNIVERSITY OF  
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**RESEARCH NOTE I – LOW INCOME HOUSING SERIES: FINANCIAL IMPLICATIONS OF DIFFERENT HOUSING TENURE ARRANGEMENTS**

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The Institute of Urban Studies is an independent research arm of the University of Winnipeg. Since 1969, the IUS has been both an academic and an applied research centre, committed to examining urban development issues in a broad, non-partisan manner. The Institute examines inner city, environmental, Aboriginal and community development issues. In addition to its ongoing involvement in research, IUS brings in visiting scholars, hosts workshops, seminars and conferences, and acts in partnership with other organizations in the community to effect positive change.

RESEARCH NOTE I - LOW INCOME HOUSING SERIES

Financial Implications of Different  
- Housing Tenure Arrangements.

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October 1972

A Note for Study on the Financial Implications  
of Different Housing Tenure Arrangements.

I. Introduction

Over the past three years, the Institute of Urban Studies has helped in the formation of two non-profit housing corporations operated by Kinew Incorporated, and The People's Committee for a Better Neighbourhood. Both organizations arose from low cost housing needs identified as top priorities in the course of action research with citizen groups. The non profit provisions of the National Housing Act were seen as the best available means of meeting these needs at the time.

Since its inception, Kinew has grown rapidly, now handling some 75 units with as many more planned for the coming year. Kinew has thus far, however, fallen short of its original objective, which was to provide transitional housing and social assistance for the more needy native people about to establish their first residence in the city. In spite of preferential interest rates, the annual rents required to cover mortgage, tax, and maintenance costs have initially restricted the homes to families with incomes above \$5,500 many of whom have already adjusted to city life.

The People's Committee housing program is more in its formative stage. They too, have, however, encountered the problem of catering for the lower income members of their community. In the course of discussions with the Institute, a number of other management issues have arisen, such as means of selecting tenants, provision for future purchase by the tenant, rent and cost, pooling, security of tenure etc.

With the prospect of new National Housing Act Legislation creating a major expansion of non profit housing, together with Manitoba's

accelerated Public Housing program, issues concerning the financing and management of housing through different institutional forms take on provincial and nationwide importance. It is hoped that an examination of these questions now might assist governments in achieving the maximum potential from their programs.

The purpose of this note is to outline some fundamental issues regarding the financing and pricing of urban housing services under different tenure arrangements.

Some general evidence on practices in the different tenure markets is presented, that suggests a case for policy initiatives of some form. The precise policy implications are, however to some extent open to dispute, depending on the relationships between the markets. A number of testable alternative hypothesis concerning these relationships are proposed, and methods of empirical verification are suggested.

The issues or questions I propose to deal with are as follows:

## II. The Issues

1. Are there real financial advantages in home ownership?
2. If so, what explains the large number of households who continue to rent on the private market?
  - a) Are there specific situations where renting is a better financial prospect?
  - b) Are there benefits to renting, such as general management services, that make the extra costs worthwhile for some persons.
  - c) Are the costs of renting as low as they could be, or are there ways to lower them!
  - d) Are there institutional constraints that preclude some persons from the financially preferable choice of home ownership?
3. What are the advantages for consumers of public non-profit, co-op, and limited dividend housing, in comparison to the private ownership and rental markets?
  - a) Do the consumers receive the benefits of home ownership as in no.1?
  - b) If so, is the role of these institutions to provide a means of overcoming the constraints to ownership mentioned in 2d, plus the advantages of renting as in 2a and 2b.
  - c) Is the government subsidy through preferential interest rates the chief advantage?
  - d) If so, what are the reasons for administering the subsidy in this form?
4. Given the dual, ownership rental role of non-profit housing, what are the implications for establishing rents?

### III. The Arguments

Figure 1 below illustrates the time stream of mortgage payments for a home owner purchasing in year zero, with a mortgage fixed in equal annual money payments. Aspects such as downpayment, and reversion value are omitted for the time being to simplify the exposition.

FIGURE 1

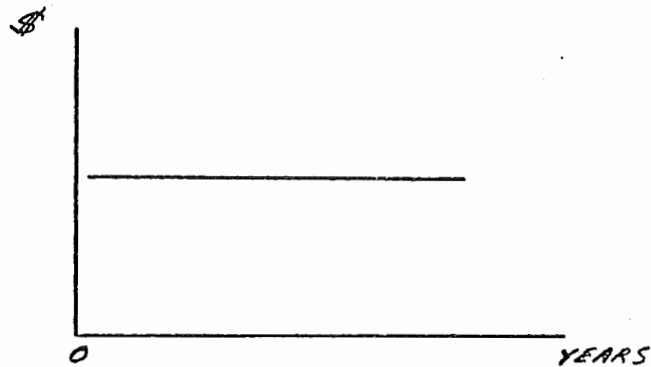
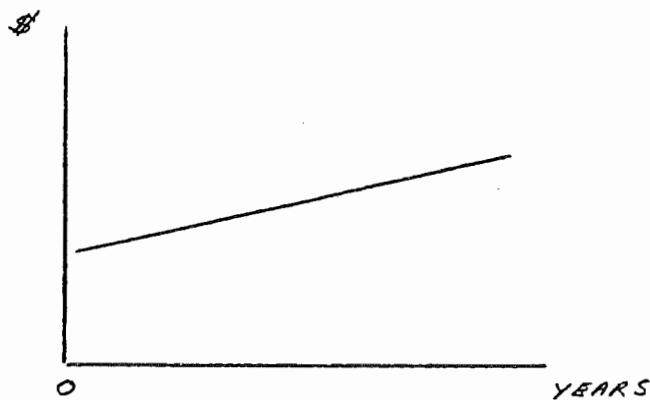


Figure 2 represents the time stream of rents facing a tenant in the private market.

FIGURE 2



The upward slope reflects the commonly observed inflation in the housing and rental markets. The slopes of the two payment schedules are clearly different. The significance for policy depends, however, on the relative heights of the two schedules. Two alternative possibilities are illustrated below in Figures 3 and 4.

FIGURE 3

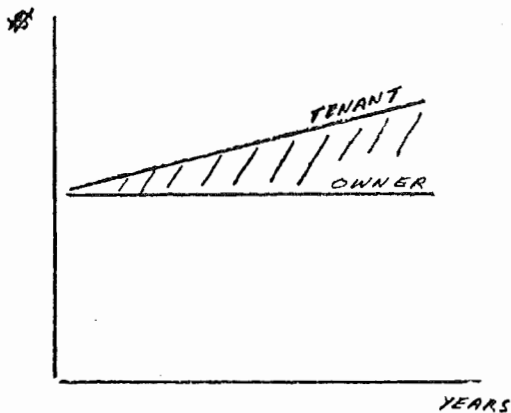
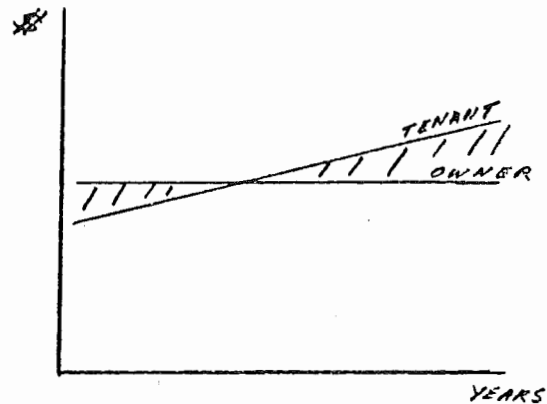


FIGURE 4



If we assume for the moment, that items such as management, operating costs and tax differences have been netted out, then the owner in Figure 3 would clearly be financially better off than the tenant, and the landlord would be receiving above average profits represented by the shaded area.

Some would argue that such a situation of excess profits could not be maintained over the long run. Competition should insure that more funds would come into the rental market until yields in the residential real estate market were exactly as good as investments elsewhere. (Marcuse P., "Homeownership for Low Income Families: Financial Implication", Land Economics May 1972; and Muth, R.F., "Cities and Housing", University of Chicago Press 1969, p. 19).



If the latter view is correct, and prospective investors do in fact forecast rising future incomes, then the payment profiles would look something like those shown in Figure 4. In other words, the capital element of rents in any year should be less than the mortgage payments on similar properties bought in that same year. The financial differences for homeowners and tenants could be explained by different rates at which they discount future consumption relative to the present.

Reasons why this may not happen are as follows. First, investors in income properties may not believe that prices will rise. Investment decisions may therefore be based on the assumption that current rents will prevail, in which case many landlords will experience unexpected positive returns over the long run. It is also possible that future predictions are based on experience of the recent past, rather than a long run view. This could lead to very perverse short-term behaviour in a cyclical situation such as exists in Canadian Housing Markets.

It may also be possible, that while the price trend of properties in the aggregate is definitely up, there may be considerable variability among individual properties. In such a situation, with a large number of small investors, very high yields may be required to offset risk. With a smaller number of large investors, average risks could be considerably reduced, thereby reducing the yield required. While the required risk might be reduced in such a situation, the emergence of locational monopolies could well be used to keep returns at a high rate. Some policy that recognizes these related problems could well bring down average rental prices.

Whether the views illustrated by Figure 3 or Figure 4 are correct is essentially a matter for empirical verification. There is certainly some indirect evidence that the situation outlined in Figure 3 may be what now exists. An American study by Richard V. Ratcliff called "Current Practices

in "Income Property Appraisal - A Critique, 1966-1967", showed that of 79 appraisal reports by real estate analysts, in only 10 cases was the initial income raised or lowered to represent the stabilized level of an expected rising or falling income. And in no case, did the appraiser forecast an increasing or decreasing income in step or curve form.

In spite of the record over the past 20 years, there is still a feeling in many quarters that future price increases are by no means inevitable. A report prepared for the Hellyer Task Force on Housing, by KPM Nov. 1968, began with terms of reference stating that policies aimed at increasing housing supply could stabilize or even decrease prices. A prevalent view of this sort could certainly lead to the high returns of Figure 3.

An empirical study comparing rents and prices for similar properties could go a long way towards establishing whether the situation in Figure 3 or Figure 4 has been historically correct. For the future, policy must depend to some extent on what will happen. I believe there are very strong theoretical reasons for saying that prices will continue to rise under the current system in urban areas, whether there are increases in supply or not. The argument is based on increasing returns to a scarce factor, land. This argument will be developed further in a later paper.

The above discussion describes the basic framework for a study of the issues described in II 1, and II 2. From this no doubt several avenues for policy initiatives will follow. Possible examples are; ways to reduce returns to "normal" levels in the rental markets; and ways to overcome constraints to home ownership for low income groups.

The relationship between the ownership and private rental markets also has relevance for the role of public, and non-profit housing.

Consider first an unsubsidized non-profit housing scheme. If the situation as depicted in Figure 3 holds, then initially there is no advantage over home ownership or renting. As time goes on, however, the tenant receives the advantages of home ownership, provided the rents are held constant. The advantage would appear to be through elimination of technical constraints to home ownerships. In relation to the rental market, such a program would be able initially to offer little improvement on what now exists. As time goes by, however, the rents would become within the means of progressively lower income groups.

This raises an important issue regarding the regulation of non-profit organizations. Should tenants be allowed to eventually buy their homes, and if so, at current market price, original market price or outstanding principle? The issue concerns the respective welfares of the individual tenant, and the organization, as a representative of low income people generally. Permission to buy or remain as a permanent tenant could contribute to social stability for the tenant and the neighbourhood. If the tenant is allowed to pay off outstanding principle only, then he makes a capital gain, and the organization starts off again at square one. If he buys at market price, the tenant would immediately increase his own annual payments for the same accommodation, but the organization would be able to purchase another home and let it to another low income family at a rate well below the market.

In the willow park co-op, the capital gains are left with the organization when a tenant moves on. In Limited Dividend Housing, tenants are required to vacate when money incomes rise, hence the scheme caters for progressively lower income groups at the cost of stability and security of tenure.

Consider now an unsubsidized non-profit scheme when the situation depicted in Figure 4 holds. The same basic comments apply as for homeowners and tenants. Non profit housing would provide an opportunity for quasi ownership for those now restricted by non financial barriers, whose time preferences make a constant payment schedule preferable. The difficulty here, is that in the first years they would be paying over the odds going in the rental market. In order to be on a financial par with homeowners, they would have to remain tenants for a very long time or alternatively they would require the option to purchase based on payment of outstanding principle.

The same two cases, but with preferential interest subsidies are depicted below.

Figure 5

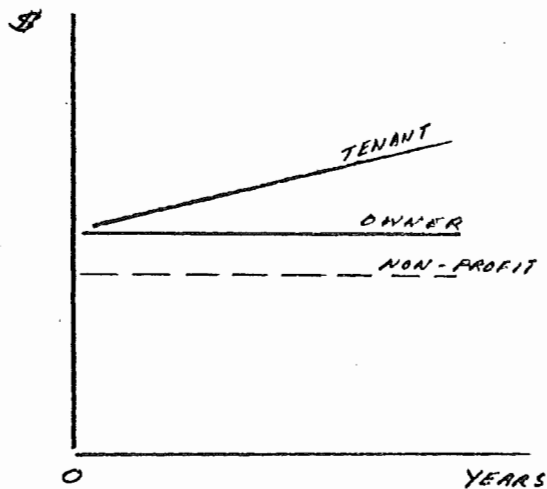
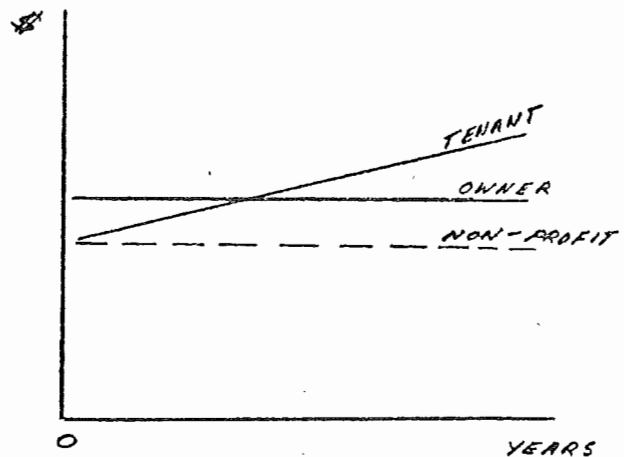


Figure 6



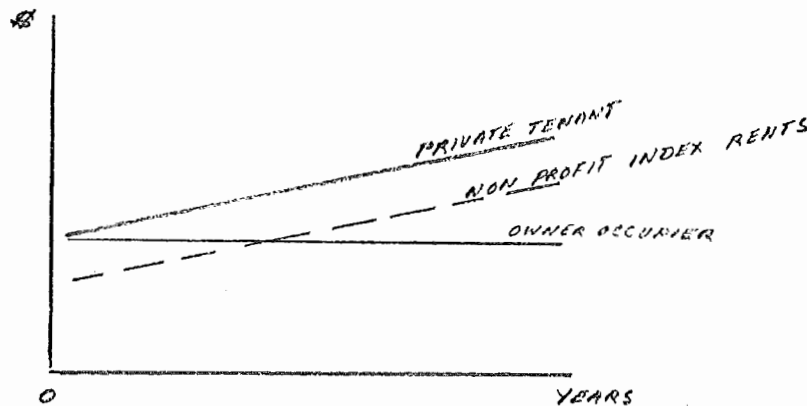
In Figure 5, the subsidized non-profit rents are financially better than either the homeownership or private rental payments. In the Figure 6 situation, the subsidy is sufficient to compete with the private rental market in the initial years. An ever increasing advantage is then realized through the years.

#### IV. Policies

The above discussion leads us to the question posed in II 4. What implications does the above have for the financing and a pricing of non-profit housing? One method, which can initially bring non-profit rents within the means of a lower income group than is now possible, and at the same time establish a more stable relationship with the rest of the market is a system of rent indexing. The principle is illustrated below in Figure 7, for a non subsidized non-profit organization where external market conditions as described in Figure 3 hold.

For discussion see I. Stahl "Some Aspects of a Mixed Housing Market" in "The Economic Problems of Housing" A.A. Nevitt, ed.

Figure 7

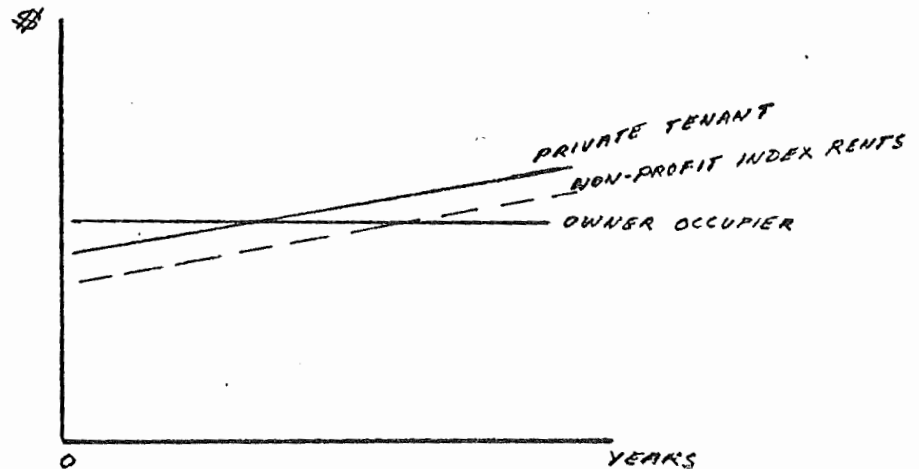


The present value of the rents paid by the non-profit tenant and the mortgage costs of the owner occupier are identical. Only the time stream is changed. The system requires first a forecast of rent increases in the general market, and secondly a method of financing deficits in the early years as shown by the shaded area. There is nothing peculiar about such

a process. This form of calculation is often the basis for investment analysis in commercial and industrial sectors. Indeed, if the private rental market behaves in the rational competitive manner described earlier in Figure 4, then this is exactly what they are doing now. In this event, rent indexing in the non-profit sector would serve primarily to bring non-profit prices into a less disadvantageous position vis-a-vis the private market.

The absence of nominal competitive profits, and the introduction of subsidized interest rates would of course give non-profit housing an overall advantage even in this case. This situation is shown in Figure 8.

Figure 8



Up to now, the discussion has been primarily concerned with comparisons between dwellings purchased in year zero, and then offered for sale or rent. What should be the pricing strategy for a non-profit or public housing corporation with a heterogeneous stock purchased over a period of years?

Different possibilities without rent indexing are illustrated in Figure 9. The upward sloping line R represents the trend in market prices for units of a given quality. The horizontal lines M0, M1, M2, etc, are the annual fixed money mortgage payments for homes bought in years 0, 1, 2, etc. Prices can be set either according to the historical costs of the dwelling in question or the total costs could be pooled and averaged over the entire

stock for rent purposes. Alternatively, rents could be determined on the basis of tenants incomes in such a manner as to cover aggregate costs without reference to the historical costs of individual dwellings. With pooled averaged rents, the trendline would follow a curve like MA.

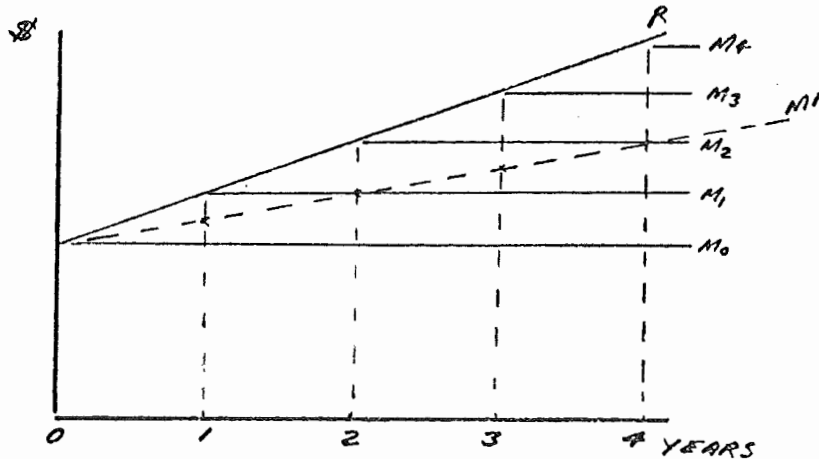
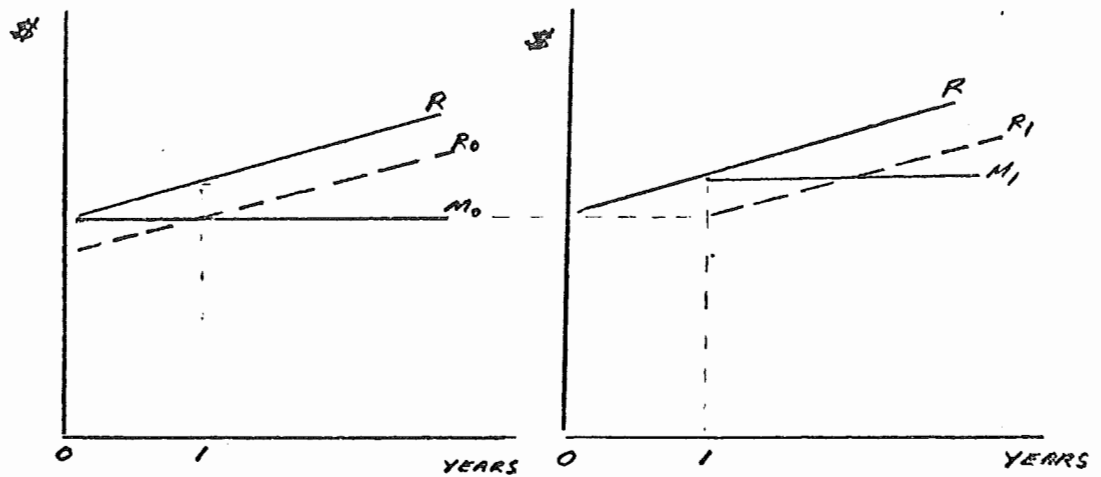


Figure 9

With a system of rent indexing, the pooling feature would be taken care of almost automatically as shown in Figure 10. For instance, a house bought in year 0, with nominal mortgage payments of  $M_0$ , could have an indexed rent schedule like  $R_0$ . A home bought in year 1, with nominal mortgage payments of  $M_1$  could have an indexed rent schedule of  $R_1$ . As these are the same line, further pooling would be unnecessary. Note that this schedule is lower than MA in the early years, and rises above MA in later years.

Figure 10



Some of the hypothesis described above, that apply to the historical experience of existing Limited Dividend, non-profit, public, and co-op housing should be possible to demonstrate by empirical study of costs and rents over time compared to the private market.

An interesting opportunity to illustrate some of the issues may soon be available at the Willow Park Co-op. This co-op has been operating for some time now in homes built 8 or 10 years ago. They now intend to add some further housing units. Comparison of cost covering rents on existing units with the new units will be possible. It will also be interesting to see how rents for the whole system are in fact determined. Without pooling, considerable rent differentials with consequent excess demands in the existing units may exist. A straight pooling system initiated now, might be unpopular with existing tenants. On the other hand it might be possible to institute a gradualist pooling system, by raising rents on the existing units when they become vacant, and using this additional revenue to lower rents on the new units.

Finally, a word about forecasting market price for purposes of establishing a rent index. Earlier, it was suggested that private enterprise



may require a substantial premium for risk due to wide variations in price changes for individual dwellings in the context of consistent and predictable average increases. The same could apply also to a small non-profit organization particularly with all of its units confined to a limited segment of the market geographically or otherwise. The usual principles of size and diversification might be a requisite for such a system. Government is probably well placed to do this in the context of a public housing system. It might not be so easy for government to act as some form of guarantor for non-profit organizations. It is not hard to understand groups being willing to accept compensation for short falls in expected value increases for their own properties. It is harder, however, to envision organizations making above average gains, surrendering them to the common pool.

To some extent, the guaranteed CMHC mortgage insurance program does a similar thing for homeowners. Thinking futuristically, perhaps guaranteed index loans could be extended to cover the whole housing market, including non-profit, owner occupier, and private rental accommodation.

## V. Conclusion

This paper has suggested a number of issues and ideas for discussion. Specific research projects have only been hinted at. There does, however, appear to be adequate scope here for developing a number of avenues for empirical research, and perhaps some selected field experiments with the innovative ideas suggested. The time dimension of most of the issues will of course limit immediate monitoring of action research to an analysis of the implementation process. Evaluation of the programs' success or failure would have to await the passing of time.

The single most important question posed above concerns the issue of house price inflation at rates higher than prices generally. This essential, and I submit inevitable feature of private urban housing markets has received far too little attention in housing analysis of the past.

Non profit rents, now tied to fixed annual money mortgage payments, offer little initial advantage over the private market, but become increasingly competitive as time goes on, and rents rise elsewhere. There appears to be considerable scope here for a new form of loan based on a rising schedule of payments. Initial payments could begin below the existing fixed annual rate, and rise with the market, paying back the differences in later years. This would immediately bring the program within the financial means of lower income groups than heretofore. The same relative advantage would remain through time although it would not increase as under the fixed payment method. The lower initial prices would, however, increase demand now leaving a larger stock of housing priced at reasonable rents for the future. While such a scheme may appear radical in contrast to existing Canadian practices, variations on the idea are now in operation in Germany, Denmark, and Holland.

Terry Partridge  
October 13, 1972.