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# Development of the Rental Housing Market in Latin America and the Caribbean

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## **Abstract**<sup>\*</sup>

Experience in northern and developed countries suggests that a well functioning rental sector (potentially including both social and private renting) is an important component of a complete and effective housing system, offering more solutions to meet a full spectrum of demands and needs. As such, it is appropriate to explore the opportunities for the Bank to support the rental options alongside the traditional lending and program focus that has generally favored homeownership. This paper seeks to outline the existing tenure patterns across Latin American and Caribbean (LAC) countries, identify the prerequisite features of effective rental sectors—based on experience in developed OECD countries—, and outline the necessary steps to develop and expand the rental sector in LAC countries. This includes consideration of both the private (private investors) and community rental sector (community based nonprofit and cooperative ownership).

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## Table of Contents

1	Introduction.....	1
2	Setting the Context.....	2
2.1	Bank’s Intervention in the Development of the Housing Sector in Latin America	2
2.2	Current tenure patterns.....	3
3	Rental Market Development in Developed Countries .....	8
3.1	Lessons from this historical background. ....	10
4	Sustaining a viable rented sector.....	13
4.1	Elaborating on Prerequisite and Ancillary Conditions .....	14
4.2	Developing a private rental market: policy approaches.....	23
4.3	Some Policy Implications .....	25
5	Consolidation: some proposed options for consideration in LAC countries. ....	34
6	Conclusions and Possible Directions .....	37
6.1	Suggestions for short-term strategy development.....	37
6.2	Recommendations for Medium-Longer term development.....	38
	Bibliography .....	40

# 1 Introduction

The Inter-American Development Bank (IDB) wishes to identify and help implement opportunities to nurture and expand formal rental tenure across the Latin American and Caribbean (LAC) countries in an effort to expand shelter opportunities for lower income households, especially in urban markets. The rationale for the Bank's involvement includes the following:

- To advise government authorities on policy implementations and supports them throughout a lending program for the development of rental housing for lower-income households.
- To enable a more integrated approach, incorporating elements of the current Bank's strategy for the development of the housing sector (i.e., urban development, land title, sites and services, slumps upgrading, housing finance, etc).
- To enable the Bank to provide technical assistance to help government authorities in establishing an appropriate regulatory environment in which to plan the development of rental market projects that will be delivered by the private sector.

***This paper will help LAC countries to better understand the implications of developing a rental housing market as an integrated part of the overall housing system.***

Traditional development and shelter assistance programs have focused on either large scale public housing development, which have largely fallen out of favor, or on homeownership assistance. Even though 20 to 40 percent of people in the LAC region rent their dwellings, only a negligible proportion of any subsidy is directed to renters (Sunil, 1996; Buckley and Kalarickal, 2006). Rental tenure rates also appear to be somewhat lower in the developing countries in Latin American and the Caribbean when compared with other developing countries in Africa and Asia (Andreasen, 1996; Gilbert et al., 1997).

Experience in northern and developed countries suggests that a well functioning rental sector (potentially including both social and private renting) is an important component of a complete and effective housing system, offering more solutions to meet a full spectrum of

demands and needs. As such, it is appropriate to explore the opportunities for the IDB to support the rental options alongside the traditional lending and program focus that has generally favored homeownership.

This paper seeks to outline the existing tenure patterns across LAC countries, identify the prerequisite features of effective rental sectors—based on experience in developed OECD countries—, and outline the necessary steps to develop and expand the rental sector in LAC countries. This includes consideration of both the private (private investors) and community rental sector (community based nonprofit and cooperative ownership).

## **2 Setting the Context**

### **2.1 The IDB's Intervention in the Development of the Housing Sector in Latin America**

The IDB's knowledge in housing is significant. Between 1998 and 2008, the Bank approved approximately US\$3.8 million in housing programs and technical cooperation. The operational experience and knowledge in this sector has been focused mainly on slum upgrading programs (58 percent of all housing programs approved by the Bank), direct demand subsidies, and the development of mortgage markets (with a focus on mortgage loans for homeownership, not for investor lending).

These programs have improved the housing stock in the LAC region, and have expanded access to new houses for families with moderate income. However, they have had limited results in the provision of policy alternatives to prevent the formation of new slums and to accommodate the demand for new houses for low-income families. The prevalence of informal settlements in the region has affected not only housing market outcomes, but also the sustainability of cities.

The policy response to housing problems (quality and affordability) in the LAC region has, in most cases, ignored rental housing as a vehicle to provide adequate housing solutions for low- and moderate-income families. This is however not unique to LAC countries or other developing countries; the political and financial support in most developed countries over the

past six postwar decades has similarly emphasized the social rented sector and the owner occupied sector (Whitehead 1996).

Most countries in the LAC region have negligible or inexistent rental housing policies and programs. The Bank's main policy response in the region has been towards improving the informal housing stock with slum upgrading programs and improving affordability through direct or indirect subsidies to low- and moderate-income families for the purchase of a new housing unit. Recent evaluations of housing programs in Latin America and the Caribbean have shown that slum upgrading programs, although important, are too focused on solving the problems of the housing stock and are doing too little to prevent new informal developments (Rojas, 2009).

Subsidy programs (emphasizing improved conditions) have been less effective in reaching low-income families and have encountered problems such as the unsustainable levels of subsidy requirements, the lack of private mortgage financing for the targeted groups, the greater distance and segregation of social housing developments, the increased pressure on public services and infrastructure, and the limits on social and work mobility (Ruprah, 2009). There are several Bank studies underway focusing on public housing policies, housing finance, land markets, and municipal provision of housing services, but the studies of the rental housing market are limited.<sup>1</sup> The Bank wants to fill an important gap in this sector and support its housing and urban development niche by identifying barriers and opportunities to develop the rental housing market in general, and affordable housing alternatives in particular. This conceptual paper presents some policy and program instruments that could help LAC governments to support and expand rental housing markets and make it affordable for low-income families.

## **2.2 Current Tenure Patterns**

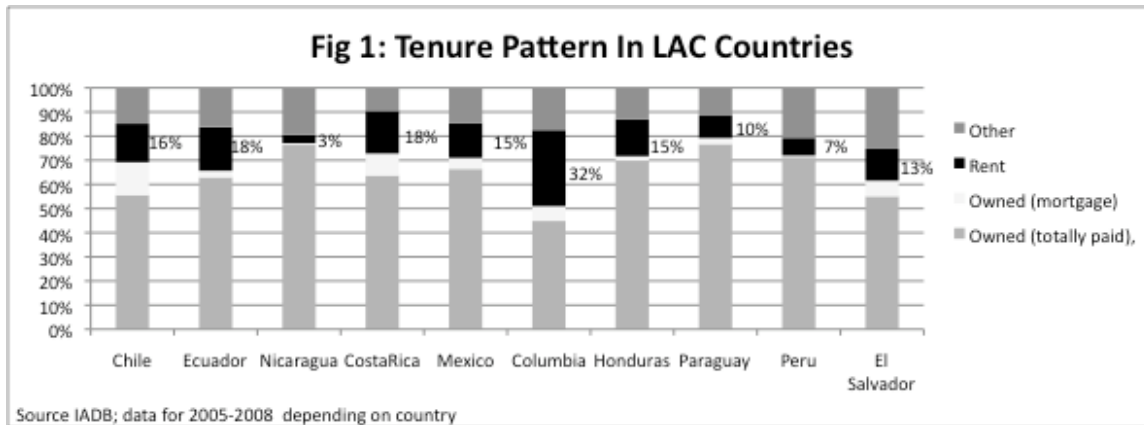
Data on tenure reveal that the rental sector in most LAC countries is small; typically less than one-fifth of all households rent (Figure 1). Moreover, this proportion is either stagnant or

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<sup>1</sup> For example, (RG-K1099) Public Housing Policies; (RG-K1125) Housing Finance; (RG-K1154) Land Markets; and (RG-K1153) Municipal Provision of Housing Services.



contracting.<sup>2</sup> Unlike the situation in developed northern countries, either there is little formal regulation and many tenants do not enjoy secure tenure or there are overly restrictive occupancy regulations that discourage investment and create an illegal secondary market as original occupants sell their occupancy rights (Buckley and Kalarickal, 2006). Even when contracts do exist between owners and tenants, they are typically short-term contracts and tenants remain vulnerable to sudden and significant increase in rents (Environment and Urbanization, 1997).



Data also reveal that on average two-thirds of the households own outright and do so without outstanding debt, while a minority of owners (under 10 percent) carry mortgage debt. In part, low levels of mortgaged households reflect constrained access to financing, possibly related to absence of or a weak land registry system (fundamental to registering mortgages) as well as an underdeveloped housing finance system. The ownership data presented in Figure 1 include informal ownership, wherein dwellings are occupied without a title deed or services, and which the household members design, finance, and often build with their own hands. The term “informal housing” is used synonymously with self-help and spontaneous housing. The label “other” includes categories such as invaders (squatters), people who live in a dwelling of their company (employee housing), a friend, or a family. Also included in “other” in Figure 1 are households that declare ownership of the house but not the land on which it is situated.

<sup>2</sup> Official statistics provided here by the IDB, compiled by Inder Ruprah and Nadin Madelin with data from national housing surveys, identify formal rental tenure; however this may under-represent the total as many may rent their homes on an informal basis. Such households are recorded here in the category “other.”

International development programs typically focus on building infrastructure, establishing mechanisms to register and formalize land ownership, and removing slum conditions. These frequently incorporate homeownership assistance as a way to stabilize the population, a factor that may contribute to the size and growth of the ownership sector. However, many assisted ownership programs have not been effective in reaching low-income households.

In some cases international development funding has been used to develop public housing, albeit with limited success, as is the case in northern countries. Public housing often suffers from design issues, misses the main segment of the population in need, and does not encourage resident contributions. In others it over concentrates low-income households, exacerbating poverty issues. There is need for an ongoing administrative regime and large subsidies (Buckley and Kalarickal, 2006). Meanwhile, few development initiatives have explicitly identified or tried to establish a strong rented sector, other than via public ownership. In addition to being small, the rented sector in many LAC countries displays a very different profile than that in older developed nations.

In most northern countries, housing systems have emerged with a mix of tenures and continuum from public or social renting through private renting to ownership. The size of each sector varies considerably, reflecting both cultural differences and policy approaches. Regulatory regimes have been established to provide some degree of security of tenure, to establish tenant rights, to protect tenants from eviction or excessive rates of rent increase, and to create a framework and process to mediate disputes between tenants and landlords (Fraser Institute, 1975; Whitehead, 1996).

Generally, in the developed nations, household incomes increase along this continuum (social renting-private renting-ownership), as both social and private renting perform the role of transitional tenures. Renters tend to be younger, reflecting people leaving the family home and forming a new household, either with friends or as a result of marriage.<sup>3</sup> Many renters are at the

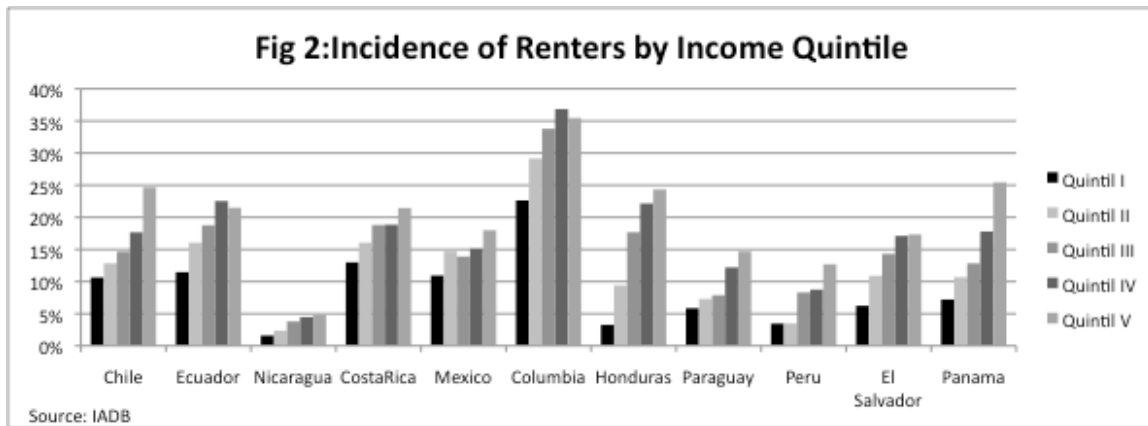
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<sup>3</sup> Historically senior households (65+) were also highly represented in rental stock as many sought apartments as they downsized from family homes. However, in North America at least, the introduction of strata titling, known as condominiums, has enabled many to move to an apartment form while retaining ownership status.

beginning of their careers, and have not accumulated the wealth necessary to purchase a home. Some also tend to seek greater mobility, a feature offered by rental options (Leal, 1994). So, while renting is a transitional stage of lifecycle tenure for many, for some, notably those of lower income, it is a lifelong tenure.

Historically, rental housing expanded in the northern countries during periods of industrialization and urbanization. The growth of rental sectors was a natural market phenomenon, not initially policy driven. Policy and regulatory frameworks were later additions to the system, largely in response to the emergence of tenant rights organizations, as well as traditions in civil law. Increasing regulation levels are often associated with contraction of the private rented sector (Fraser Institute, 1975; Whitehead, 1996). A similar tendency is occurring in LAC countries, with rapid urbanization causing an absolute deficiency in housing supply in growing cities, which in turn imposes price pressure on the existing stock. The unregulated response to unmet demand and need is an increase in invaders and slum development. In the context of rapid urbanization in developing countries, the housing shortage constitutes one of the greatest challenges to social and economic development.

In developed northern countries, renters tend to have a lower income than owners, and the incidence of renting tends to be very high in the lowest-income quintiles and very small in high-income quintiles (CMHC, 2010). As shown in Figure 2, the situation is different in LAC countries. In all cases the proportion of the population that rent their homes is higher in the highest-income quintiles and very low in the lowest quintiles. This is the inverse of the case in developed northern countries, suggesting both different institutional arrangements and different cultural norms.



In LAC countries rental options have not been developed as a shelter option for lower-income families, and rental tenure is more associated with wealth. For example, in Bolivia a widely used feature of the rental system is large lump prepayments or loans (*anti-credito*). In return for this payment or loan, the renter secures a right to occupy for a fixed period, often up to two years. This *anti-credito* became popular in periods of inflation, as it is a source of capital to owners. The effective rent is the foregone interest and depreciated value of the lump sum when repaid. However, because this requires a large capital sum, it tends to favor wealthier middle-class renters over those with lower income.

In short, the rental market in the LAC region is not very developed. The policy response to housing problems (quality and affordability) has, in most cases, ignored rental housing as a vehicle to provide adequate housing solutions for low- and moderate-income families (UN-Habitat, 2003). As a result, most countries in the region have negligible or inexistent rental housing policies and programs. Arguably, the small and stagnant rented sector in LAC countries reflects an incomplete housing system. Strengthening the rental sector may be an option to increase opportunities to address housing demand and concurrently help in managing poverty issues. A larger more effective rental sector can also enhance labor mobility and productivity. This paper first examines the characteristics of rental markets and systems in developed countries, and then draws on these experiences to provide options for developing LAC countries

### **3 Rental Market Development in Developed Countries**

Across most developed countries the level of rental tenure expanded as part of the rural-urban migration through the latter part of the eighteenth century and through the mid-1900s, mainly in response to demand by a new urban labor force. This was supported, in part, by employer sponsored housing, although demand also prompted the emergence of commercial landlords, initially on an informal and unregulated basis. Over time, the rental sector gradually became subject to regulation, initially based on health and safety concerns, but subsequently to control rents and protect tenant occupancy rights. In most European countries, as well as in North America, rent restrictions were imposed during the two periods of world wars and in many countries persisted beyond (Fraser Institute, 1975).

With suppressed rents and rising costs due to new postwar demand, a large gap emerged between cost-based rents and regulated rents (Hayak, 1975; De Jouvenal, 1975). While control regimes were adjusted in some countries, in most the fear of massive increases to market based levels and the politicization of this issue was a strong deterrent to deregulation. This was the beginning of unfavorable conditions for rental investment, a situation that has persisted over much of the postwar period in many northern/western nations.

The postwar policy response to an undersupply of new rental construction generally took the form of direct public investment and the emergence and expansion of public and social housing sectors, particularly in European countries. Here the public/social stock legacy is generally much larger than is the case in the former dominions in North America and the South Pacific (New Zealand and Australia), countries where there was no destruction of stock, a more liberal form of postwar welfare state and less pressure to regulate postwar rents. In these less regulated environments an active private investor sector became the primary source of new rental construction and provision.

The United States and Canada also implemented specific policies and financing mechanisms to support and enable private rental investment for new rental development and also enacted (or temporarily re-enacted) favorable tax legislation—policy levers that contributed to

the emergence of large-scale developer-investors that constructed and operated large portfolios of multiunit apartment buildings.<sup>4</sup> These stimuli persisted through the 1980s.

Since 1978, notwithstanding the initial growth of rental housing, in most industrialized countries there has been a gradual decline in the size of the rental sector, and more particularly in the size of the private rented sector (Whitehead, 1996; Van der Heijen and Boelhouwer, 1996). Since the 1970s, the private rented sector has contracted in most OECD countries, Austria, Germany, and Japan being the exceptions (Lampert et al., 1998; Italian Housing Federation, 2006). This reflects demographic factors, shifting demand levels and consumer preferences, the relative viability of ownership versus rental options as well as the regulatory taxation and subsidy regime in each country (Boelhouwer, 1996; Whitehead, 1996; Lampert et al., 1998).

A public policy shift occurred in the 1980s and 1990s, from bricks and mortar (new housing construction, supply side) to consumer-oriented subsidies (focused on demand side). The rental market for low-income households was viewed as an income problem and the response was thus to institute rent assistance programs (as opposed to rental supply programs). In this case, governments strived to complement private sector initiatives (as opposed to competing). However, research and analysis showed that rent assistance programs were not sufficient to induce an adequate supply of low-income rental housing (Fraser Institute, 1975; Kemp, 1990; Husle, 2001).

The question of what constitutes the optimal balance between income-related assistance and other forms of subsidies is still a major component of housing policy debates in many countries (Kemp, 1990; Pomeroy 2008). With the size of the private rental sector contracting, a number of countries have explored ways to reverse this trend and some have developed and implemented policies and programs to stimulate private investment (Crook and Kemp, 1996).

One study (Lampert et al., 1998) examined the experience across 10 developed OECD countries to determine what approaches have been effective. This report focuses on policies

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<sup>4</sup> This included favorable lending rates, incentive grants, loans, and tax measures—in the United States accelerated depreciation and in Canada a temporary measure to allow passive investors to deduct losses against other (nonrelated to real estate) income.

developed at the national scale, although it also notes some instances where ancillary initiatives were added at the local scale (essentially facilitative measures, such as fast-tracking development approvals relaxing land use regulation). The study finds that the most extensive approach involves facilitative measures with a strong emphasis on deregulation of rent controls and implementation of reformed regulatory systems that seek a balance between tenant protection (security of occupancy) and a fair return to investors. The need to minimize uncertainty is highlighted as a critical precondition to private investment. A number of countries have also employed tax provisions to enhance after tax yields as a way to encourage investment. Direct subsidy expenditures are found in only three of the ten countries—the Netherlands employs small capital grants while Japan and Sweden sustain pre-existing interest rate subsidies (a mechanism used in the 1960s and 1970s in both Canada and the United States).

Lampert et al. (1998) also find that only two countries, Australia and New Zealand, have implemented and maintained healthy investment environments without direct subsidy. Notably, neither country has onerous rent controls, both permit depreciation and deductibility of rental losses against other income (an incentive to small, noncorporate investors), and both involve a common structure, mainly detached dwellings which fluctuate between ownership and the rented sector. They are distinct from the structures with multipurpose units that are more typically associated with rental tenure in North America.

### **3.1 Lessons from this Historical Background**

It terms of exploring opportunities to strengthen and expand the rented sector in developing LAC countries, some insights can be drawn from the experience in the developed OECD countries, both during periods of expansion and subsequent contraction of the private rented sector.

Perhaps the most critical lesson is that as governments in developed countries have increased their level of intervention, private investment and expansion of the private rental sector has contracted. That is not to say that regulation is bad, but sometimes, regulatory frameworks create uncertainty and impose barriers to investment. Others have introduced a level of competition that is too high for many private investors. The challenge is to find the right balance to achieve regulatory objectives (e.g., establish reasonable security of occupancy) without penalizing potential investors. Shlomo (2000) describes a well-functioning housing system as

one in which investors and producers of housing stock are indifferent to building properties for owner occupancy or rental use and consumers are similarly indifferent to owning or renting. This is clearly not the case in most developed countries. Together, housing subsidies, tax treatment of investment income, and regulation contribute to a distorting effect on housing markets and consumption patterns and generally favor home-ownership.

Another major failure of housing policy and programs in developed countries is a segmented intervention rather than a systemic intervention. Policies in many countries, notably the Anglo-speaking ones including Australia, the United States, and the UK and, to a lesser extent, Canada, have emphasized encouraging and facilitating homeownership (as an almost singular policy goal). This is reflected in the more favorable tax treatment of homeowners, such as exemption from capital gains tax, nontaxation of imputed rent, and, in some countries, tax deductibility of mortgage interest. The United States has adopted specific policies to increase the rate of homeownership (under both the Clinton administration between 1992 and 2000 and subsequently the Bush administration between 2000 and 2008), and generally has provided favorable below-market interest rates and underwriting mechanisms to increase access to home financing.

Similarly, in developing countries, international multilateral and bilateral organizations have centered most of their interventions on increasing homeownership levels, but it is not clear as to whether this policy has had a positive impact. There are rising concerns in developed countries that promoting high rates of ownership can be counterproductive. Rates have peaked and declined (for example in New Zealand, Australia, and more recently under the global financial crisis in the United States). The UN-Habitat (2003) has suggested that it is not possible to achieve or sustain high rates of ownership on a universal level.

Against these proactive efforts to promote ownership, levels of new rental construction have suffered as demand is diverted into the ownership sector and rental yields decline. These policies reinforce cultural beliefs and perceptions that it is better to own than to rent, and have the effect of stereotyping renters as second-class citizens. Other countries, such as Austria, Germany, and Sweden, have sought to maintain a more tenure neutral framework (including regulation, subsidy, and taxation) to achieve and sustain more balanced housing systems with a



wider choice across social renting, private renting, and homeownership. Policy initiatives in developing countries should seek to emulate these more balanced and complementary approaches. However, in the short term it may be necessary to emphasize and favor policies and incentives that enable and encourage growth of the rented sector, as a way to compensate for previous imbalance in favor of ownership.

Housing is an inherently expensive good and requires a significant capital investment. Ideally, housing systems should enable and encourage private investment to the greatest extent possible to avoid large and unsustainable levels of public investment. It should be noted that while discussed here in a generic fashion, the characteristics of the rental sector vary substantially across countries. This includes significant differences in:

- The characteristics of consumers, encompassing only the lowest-income populations versus a broader range of incomes;
- The physical form of the rental stock—individual homes or attached houses versus multiunit apartment blocks; and
- The characteristics of landlords, including both social and private operators as well as a significant variation between small individual investors (usually renting a single dwelling), corporate professional developer-landlords (that create purpose built rental stock), and institutional investors. The latter are more common in North America and tend to invest in existing properties rather than participate in development.

The regulatory, taxation and subsidy regimes may have different influences depending on the characteristics of the consumer and investor groups. Across the LAC countries these characteristics will also vary. Accordingly, there is no single prescription that can or should be applied across all countries; rather it is necessary to examine the current conditions and existing institutional and regulatory arrangements, and then design policy interventions to either optimize or correct existing conditions. It is also important to examine and define the nature of the housing problem. Is there an absolute lack of supply, in which case measures may be required to stimulate construction? Why is there a lack of supply; are there land constraints, labor constraint, or lack of financing? Is there a group of investors that is willing to participate in creating purpose

built rental supply? If there is sufficient supply (stock) but also difficulties in terms of access and affordability, rental assistance, rather than supply stimulus, may be necessary. It could also involve acquisition of existing stock by special purpose corporations, such as community-based nonprofit entities with a mandate and mission to provide and preserve rental housing at affordable prices.

In short, it is possible to create and implement policies to influence and manage issues related to both supply or demand. However, to do so it is important to define policy issues, objectives, and priorities.

#### **4 Sustaining a Viable Rental Sector**

Based on the comparative analysis of Lampert et al. (1998), the critical elements of rental systems include both a set of prerequisite conditions as well as a set of ancillary features that help sustain and enhance the private rental sector.

##### **Prerequisite conditions:**

- Established and effective urban land market
- Effective land title registration and regulatory framework (to facilitate registration of mortgages and secure property rights)
- Effective housing finance system (including mortgage insurance)
- Regulatory framework to balance security of occupancy rights against reasonable returns for investors

##### **Ancillary conditions:**

- Taxation framework that avoids inequitable treatment of rental investment relative to alternate investments and may include incentives for rental investment
- Subsidy system that stimulates and encourages private investment and supports non-profit community based development and ownership

- Planning system to facilitate rental options (Linkage and inclusionary requirements).

#### **4.1 Elaborating on Prerequisite and Ancillary Conditions**

##### **Established and Effective Urban Land Market**

The issue of well functioning land markets is fundamental to housing supply and a broad concern beyond the narrow scope of this conceptual paper. To the extent that a supply issue exists in any country, there is a need to enable production and this may be in the form of either owner occupation or rental, but either case requires an underlying system of land management and servicing.

Even with effective land management, in liberal market systems there is an ongoing challenge in promoting or stimulating a full range of housing options. In the Anglo countries, planning and zoning provisions do not generally provide for specification of tenure or value of the dwellings constructed. These outcomes are increasingly left to market forces, albeit typically skewed by policies that tend to favor the ownership sector. Historically, multiunit designation (apartment structures) in zoning codes was synonymous with rental tenure, mainly because it was not possible to legally separate one structure into multiple ownership parcels. However, the introduction of three-dimensional “strata titling” has enabled the creation of legal parcels and thus the ability to sell parts of buildings as individual properties (commonly labeled as *condominiums* in North America, referring to the “strata titling” legislation). Thus the notion of a “purpose built” rental sector does not really exist in many countries—notably Australia, New Zealand, and the UK. Moreover this system is disappearing in North America as condominium apartments now dominate multiunit apartment construction.

What is emerging, however, is a transformation in the type of supply, which is now often constructed as tenure neutral stock. Sweden prides itself on a tenure neutral system (Van Heiden and Boulhouwer, 1996; Connelly et al., 2010). Properties, including detached homes and apartments in multiunit structures, are sold on the free market and may be purchased by an owner occupant or by an investor seeking a rental property. This is much closer to the approach that prevails in Australia, New Zealand, and the UK, which usually involves detached and semidetached dwellings rented out through a large number of small investors. The key point here

is that a well functioning planning and development system must be established to address demand for new supply in the rental market.

## **2. Effective Land Title Registration and Regulatory Framework to Support an Effective Finance System**

Housing (and indeed all real estate) is a capital-intensive commodity. Even in northern developing countries, it is unusual for people to purchase dwellings with cash, especially for those consumers with low and modest income at the market entry level. Over much of the past century, housing finance systems have been developed to provide the capital necessary to fund the purchase of properties. The housing finance system is premised on a sound system of land titles and registration in order to clearly identify ownership and concurrently to enable registration of deeds and liens against these titles as a basis of security for the capital loans provided to purchasers. Policies to facilitate access to mortgage finance have favored the ownership sector, but in some countries the benefits of a sound housing finance system have extended to the rental sector—both for private investors and in the public and social rented sectors. This was especially the case in Canada, where initially direct government loans (1964–1978) and subsequently public mortgage insurance enabled developers of rental properties to readily access mortgage financing.

To promote and sustain development and investment in existing assets, it is critical to have a formal system to recognize and catalogue land and property ownership as a way to facilitate registration of mortgages and secure property rights

## **3. Regulatory Framework to Balance Property Rights and Security of Occupancy**

As renters in all developed countries include a lower-income population, there has traditionally been a strong regulatory framework to provide some protection and security of occupancy. Many analysts have associated high levels of regulation with the steady decline in rental tenure. Most Western European countries experienced a dramatic decline in the postwar period, with the private rented sector declining from over half of all housing to less than one-fifth (Van Heiden and Boulhouwer, 1996). The key to an effective rental sector is a balanced regulatory framework

that protects occupancy rights of tenancy without imposing excess risk on investors or suppressing rent levels to the point that return on investment to property owners is unattractive.

Rent regulation typically includes two main elements. The first is security of occupancy, which essentially establishes duration of occupancy as well as limits opportunities for landlords to remove tenants except for specified and usually limited reasons. The closely associated second element is a control on levels of rent increase, intended both to preserve affordability and to preclude de facto economic eviction, which would occur if rents increase well beyond the tenant's ability to pay.

These rent control regimes tend to establish the amount and frequency of rent increase (typically limited to a single annual increase) and the rate of increase often set by regulation and linked to some measure such as the consumer price index. In some jurisdictions, restrictions on rent increase are maintained only during a sitting tenancy, but once a unit is vacated there is no restriction and rents may be adjusted to a level that the market will bear (vacancy decontrol); however the controls are put back into place once a new tenant occupies the unit/dwelling. Few jurisdictions have found a way to balance efforts to protect tenant rights with the necessity to concurrently enable investors to generate a sufficient rate of return to remain invested in this sector, and more important, to invest in additional production.

Canada provides a useful contrast of rent regulation regimes wherein some provinces have progressed through a period of deregulation, yet this has not resulted in significant levels of rental housing production (e.g., in the provinces of BC and Ontario) mainly because of the uncertainty people have about whether future governments will reintroduce more restrictive controls. Ontario in particular has gone through five sets of new legislation and related regulatory reform since 1975. Those of the late 1990s were specifically intended to deregulate and thus encourage investment, although this has not yet occurred.

Quebec, meanwhile, has retained a consistent and well-established regulatory system with a reasonable balance between protecting tenants and encouraging investment. Because Quebec's regulatory system has been in place for a prolonged period with minimal revision (or threat of increase to levels of regulation), it is accepted by and capitalized into the market. In contrast, the system in other provinces, where there have been ongoing revisions to the

legislation and a general trend to deregulation, there is lingering doubt and concern that controls will be reintroduced. This uncertainty in the market has resulted in a highly cautious, if not disinterested, rental investment community. The key insight from this experience is that it is not only controls and regulation that discourage investment, but uncertainty and risk of a potentially changing regime also affect investment decisions.

As part of its regulatory regime, the province of Quebec has established a quasi-judicial board, the Regie du Logement (RDL), to help manage the regulatory process (see Box 1). Other provinces have followed this approach, but as noted, the role and regulations of these boards have been subject to reform (e.g., Ontario introduced a tribunal in 1998, and subsequently revised its mandate under the 2006 Residential Tenancies Act).

### **Box 1. Regulating the Rental Market: The Case of “Regie du Logement du Quebec (RDL)”**

The “Regie du Logement du Quebec (RDL)” was adopted in 1980 (L.Q. 1979 c. 38). The Quebec Government introduced a new mechanism to regulate the relationships between “landlords and tenants.” The latter modified the civil code and formalized the regulatory framework for the rental market. RDL is an administrative tribunal governed by the civil code and as a “quasi-judicial” specialized tribunal. Its main mission includes the following:

- Promote conciliation between landlords and tenants;
- Resolve disputes between landlords and tenants by deciding the applications that have been submitted within the framework of simple rules of procedure dictated by the civil code;
- Inform citizens about their rights and obligations related to the lease.

Since 1996, the use of a standardized lease form is mandatory for any residential lease, whether it involves a room, a separate suite in a house, an apartment, or an entire house, among other types. Once the form is signed, it is binding.

An important role of the RDL is to provide an annual rent increase guideline that determines the level of increase landlords are allowed to request and can usually impose on tenants. These rent increases are based on a methodology developed by the RDL, reflecting general inflation and other factors that impact the rental market. However, landlords may also seek an increase above the guideline. If the tenant thinks the increase is unjustified, he or she can contact the RDL to request an assessment on whether the increase is justified. The RDL will convene a hearing for both parties, and will render a decision on whether the rent increase is appropriate. In addition, RDL hears cases in which tenants or landlords are seeking to settle a dispute, such as wrongful eviction or failure to pay rent. Based on a RDL court order, the landlord can evict a tenant after three months of nonpayment of rent. In 2009, it took five weeks to get a RDL court order. Also, the RDL can decide on any application pertaining to the conservation of dwellings and the protection of tenants, such as the following:

- Demolition of a dwelling where there is no municipal regulation that provides for it;
- Sale of a rental building within a building complex; and
- Transformation of residential buildings into divided co-ownership.

#### **4. Taxation Framework**

The tax treatment of rental investment income has proven to be a critical factor in either stimulating (Australia, France, Germany, Netherlands, New Zealand, ) or conversely discouraging (United States, Canada) private rental investment. Typically, more favorable regimes permit accelerated depreciation and the ability to use both cash and paper (depreciation) losses to reduce taxable net income for passive investors whose income is generated from outside of the property sector. This tends to have a more significant impact on small investors compared to corporate and institutional investors, although in the 1980's the syndication of tax sheltering opportunities effectively created opportunities for developers to assemble investment from numerous high-income individuals and produce multiunit apartment developments.

Both Canada and United States significantly reduced and constrained tax advantages for rental investors in the early to mid-1970s, although in both countries temporary measures restored attractive tax regimes and helped to temporarily stimulate investment (augmented by subsidy initiatives). These typically included restoring and accelerating depreciation allowances as well as permitting actual as well as paper losses (notional depreciation) to be deducted from non real estate income.

Over the past decade in some developed countries, such as Canada and Australia, there has been great debate over the introduction of targeted tax measures to help investors or landlords in the private rental market. In 2002–2003, the Canadian Ministry of Finance and provincial finance ministries conducted an analysis on this matter to determine whether new tax measures could help landlords/investors produce and maintain an affordable housing stock for low-income households. They concluded that the structure proposed by most of the market participants was an inefficient (the loss of tax revenues for the government outweighed the economic impact) and inappropriate solution for maintaining a sustainable stock of affordable rental units.

More recently, researchers in Canada (Pomeroy, 2006) and Australia (Brotherhood and CEDA, 2004) have considered the introduction of a tax measure based on the American Low-income Housing Tax Credit (LIHTC) program. The LIHTC provides tax incentives for investors in affordable housing. The target audience of the LIHTC program is households with incomes at



or below 60 percent of the area median family income, and preference is given to households earning only 50 percent of the area median income. The main purpose of the tax credit is to induce private equity investment and thereby reduce debt servicing costs to ensure a sustainable stock of affordable housing for low-income households. However, while tax credits can effectively influence investor behavior, such tax credit mechanisms do not generate affordable housing without subsidies. Tax expenditures, but not collecting tax revenues otherwise payable, are simply a different way to structure subsidies and still impact the fiscal positions of the governments.

In addition to the tax treatment of rental investment, how other investment options are treated also has some influence on the rental sector. For example favorable treatment of the ownership sector (including nontaxation of capital gains and mortgage interest deductibility) encourage households (especially modest-middle income earners) to become homeowners. The residual rental sector then tends to be dominated by lower-income households with more limited levels of effective demand, and lower rent levels, undermining the attraction of rental investment.

## **5. Subsidy System**

Most developed nations have, at various times, sought to encourage expanded housing supply specifically through rental development. This includes a wide range of mechanisms directed to stimulate private rental investment as well as direct funding support for the development and expansion of the social rental sector.

In the private rentals sector, when subsidies have been used, this has taken the form of preferable (below market) interest rates (Canada, Germany, Japan, Sweden, United States), forgivable loans and outright grants (Canada, Netherlands). In most cases the quid pro quo for this support has involved some form of agreement to maintain rents at some defined affordable level over a prescribed duration (e.g., Germany, Netherlands).

In the initial post war period, most countries, and especially those of Western Europe faced with massive rebuilding, employed direct subsidy for public and social housing. The trend from the 1980s on has been away from these direct supply subsidy expenditures. Approaches have shifted to a combination of rent deregulation coupled with person based shelter allowance approaches.

The (former) significant level of subsidy support for the public and social sectors was in a negative influence on private investment in many countries. The social sectors were initially not targeted only to low-income households, yet they provided general rental supply and competed with the private sector for tenants.

One of the interesting approaches in a number of European countries is a rental subsidy system (mainly via reduced interest programs) that does not distinguish between social and private developers/owners, and thus seeks to avoid the crowding out competition that prevails in countries where direct subsidies are provided only to social landlords. In the Netherlands and Sweden, these subsidy systems promote general rental supply while a separate system of housing allowances is also neutral and low-income tenants are accordingly distributed across both the private and the social (municipal) stock.

The US has implemented a sustained a production program that creates units at modest affordable rents (generally limited to rents affordable at 30 percent of income to households earning between 50 and 60 percent of median family income in each locality). It too includes for profit and nonprofit sponsors. While premised on a set of tax incentives, these are targeted on

**Box 2. Canada Rental Supply Program (CRSP)**

This program was introduced in 1981 with the objective of stimulating private rental investment in cities with tight rental vacancy rates. It targeted the production of 30,000 new rental dwellings over three years (1982–1984). The result of the program was actual production of roughly 24,000 rental units over the three years (CMHC, 1988).

The mechanism used was an interest-free loan that was designed to reduce the amount of investor equity required for the development to be viable. The maximum assistance was calculated at the difference between 80 percent of cost and the level of mortgage financing the project could carry at market rents, after allowing for approved operating expenses and a fair return on equity to the investor. The maximum amount of the loan was \$7,500 per unit.

The loan was secured as a second mortgage on title and no payments of either principal or interest were required for 15 years. After 15 years, the property owner had the option of repaying the original capital amount as a lump sum or amortizing the amount with ongoing interest payments at the then prevailing government direct lending rate.

There was no restriction on rent, but owners were obligated to offer 33 percent of the units to provinces for rent supplement tenants (a separate contract to provide a subsidy lowering net rent to eligible low income tenants (see box 4 ). As such, the primary objective was to stimulate supply/construction of rental units.

potential corporate investors that purchase tax credits, such that for project developers the form of assistance is effectively a grant (with an extensive conditions and compliance regime).

Boxes 2 and 3 illustrate two ways to either stimulate construction or both support construction and address an affordability objective. A third approach is rental assistance (Box 4), which operates separately but is connected to general supply initiatives. The advantage of rental assistance is that it can address affordability issues without incurring the cost to build. As such, this option is effective only where a large stock of existing rental housing already exists (as in the United States and Canada), but is not affordable to lower-income individuals and families. As Box 4 shows, rental assistance can be tied to specific properties (rent supplements) or managed as a general income supplement linked to excess housing expenditure (housing or shelter allowance).

## 6. Planning Systems to Facilitate Rental Options

Although not a major feature of rental systems, various jurisdictions have sought to use planning and development approval processes to encourage rental development (usually with some affordability objectives). This is widespread in the UK, where inclusion of affordable housing is almost mandatory as part of the development approval process, and more often than not is associated with development partnerships between private developers (building for the ownership market) and social landlords (via linkage and inclusionary requirements). In most

### Box 3. Nonprofit Housing Program (1978–1985)

This is one of a number of programs introduced in Canada. The objective was twofold: to generate supply of rental units and to ensure they are made available at rents affordable to low-moderate income individuals and families. Eligible developers were nonprofit corporations and cooperatives, in which the distribution of net operating surplus for personal gain was prohibited. Thus these corporations have no incentive to generate profit and instead tend to minimize any increase in rent levels to an amount necessary to cover break-even costs.

Project sponsors/developers were eligible to obtain insured mortgage loans covering 100 percent of capital cost. The resulting operating expenses, plus debt servicing expenses, were well above the level that could be covered by low affordable rents. Accordingly, an ongoing operating subsidy was provided (with a 35-year duration, matching the amortization period of the mortgage) During the 1978–1985 period, the form of the operating subsidy was finite, calculated as the difference between the amortizing mortgage payment calculated at the prevailing mortgage rate and the amount calculated at 2 percent. The nonprofit owner would then charge rents sufficient to cover an effective mortgage payment at 2 percent plus operating expenses.

A minimum 15 percent of units were required to be provided at rents set at 25 percent of tenants gross income (this was raised to 30 percent in 1991), although in practice most nonprofit owners significantly exceed the minimum proportion of rent geared to income basis (RGI) units (averaging around 40 percent of all units). The remaining units were rented at a “low end of market (LEM) rent, typically about 95 percent of market rate, so that there was a mix of low and moderate income (avoiding issues of concentrated poverty and stigmatization of rental properties).

countries planning legislation does not authorize tenure preference, so support for rental development is indirect under the guise of affordability inclusion.

**Box 4. Rental assistance (to separately address affordability issues)**

**A. Rent Supplements**

Rent supplements have been used in Canada as a contractual arrangement with landlords to allocate certain units to eligible low-income households. The contract specified the market rent and rate at which this rent can be annually increased (usually an inflation linked rent index). Households pay partial rent based on 30 percent of income, with the program then paying the difference between this 30 percent RGI payment and the market rent. These supplementary payments are made directly to the landlord.

**B. Housing Allowances**

Unlike a rent supplement, a housing allowance does not involve directly contracting with a landlord. It leaves recipients to freely choose where they live and to select their own unit. It is possible to have minimal condition or size standards in order to ensure the program is not supporting poor quality housing. The subsidy payment similarly uses a percentage of income, such as 30 percent but adds a further formulaic element, a “percentage of gap” between the 30 percent level and actual market rent.

So if the market rent is \$500 and 30 percent of income is \$375, the gap is \$125. The percentage of gap covers a specified percent of this gap such as 60 percent (so \$75) or 75 percent (\$93.75).

The percent of rent in programs in British Columbia and Manitoba varies, starting at 90 percent for the lowest-income recipients declining linearly to 60 percent in Manitoba and 65 percent in British Columbia, while in Quebec the payment is only two-thirds of the affordability gap (Steele, 2006). This approach requires the recipient to pay part of the gap and thus induces an element of consumer control so that the recipient that is paying part of the cost has incentive to select a lower cost unit. The cost is also managed by imposing a maximum rent for eligible assistance.

## **4.2 Developing a Private Rental Market: Policy Approaches**

As Figure 3 shows, past interventions have been channeled through taxation, direct or indirect subsidies, and facilitation or regulation of the market through complementary measures or programs. These types of approach can be supply oriented, targeting investment in the rental sector, or demand based, focused on rental consumers via shelter allowances and mechanisms to improve affordability.

Indirect mechanisms, such as those favoring ownership, also affect the rental sector; for example, tax advantages provided to the ownership sector may undermine demand for rental. At the same time, in the absence of any significant new rental supply (the case in most northern/western countries in the last two decades), policies, and mechanisms that favor and

encourage access to ownership have had a beneficial effect on rental markets by removing demand that without supply would cause rent inflation and exacerbate affordability concerns.

It should be noted the research and the associated analytical framework developed by Lampert et al. (1998) focused on measures governments have used to *promote and expand the private rental sector*. Thus this framework speaks only to the task of establishing and maintaining *a private rental sector*; it does not address the corollary matter of a social rental sector, nor the basis and rationale for creating a parallel social rental sector.

<b>Figure 3. Public Interventions that Affect the Private Rental Market</b>		
<b>Type of interventions</b>	<b>Supply Oriented</b>	<b>Demand Oriented</b>
Taxation	<ul style="list-style-type: none"> <li>- Property tax treatment</li> <li>- Tax credit to investor</li> <li>- Income tax provisions on rental investment income</li> </ul>	<ul style="list-style-type: none"> <li>- Mortgage interest deductibility from income tax (for homeowners)</li> <li>- Tax exempt homeowners saving plans</li> <li>- Treatment of capital gains on principal residence</li> <li>- Homeownership property tax grants</li> <li>- Renter tax credit (to improve affordability)</li> </ul>
Subsidies	<ul style="list-style-type: none"> <li>- Supply incentive programs including grants and loans</li> <li>- Renovation assistance</li> <li>- Mortgage subsidies, grants and loans to investors/developers</li> <li>- Conversion programs (to rental)</li> <li>- Land zoning and banking</li> </ul>	<ul style="list-style-type: none"> <li>- Shelter allowances</li> <li>- Mortgage or other subsidies (for owners)</li> </ul>
Facilitation	<ul style="list-style-type: none"> <li>- Mortgage insurance</li> </ul>	<ul style="list-style-type: none"> <li>- Tenant advocacy and counseling centers</li> </ul>
Regulation	<ul style="list-style-type: none"> <li>- Land development fees and charges</li> <li>- Maintenance and occupancy bylaws</li> <li>- Tenant protection legislation (also demand impact)</li> <li>- Rent regulation and control (also demand impact)</li> </ul>	<ul style="list-style-type: none"> <li>- Tenant protection legislation (also supply impact)</li> <li>- Rent regulation and control (also supply impact)</li> </ul>

In examining the existing context in each country to determine which, if any, of the prerequisite conditions exist, it is also useful to identify the components of the housing system that policy initiatives are intended to influence. In particular:

- What segment of consumers – the low-income segment only, low- to moderate-income or a broad spectrum across income bands?

- Is the policy objective (based on an assessment of the housing problem(s) to stimulate only investment and promotion of rental options within the existing stock, or is there a need and policy desire to stimulate new construction of housing (i.e., a supply objective)?
- If the policy objective is focused primarily of encouraging rental investment (and is indifferent to new or existing stock) is the potential target small individual investors or larger scale corporate or institutional investment? And do such corporate and institutional investors exist?

### **4.3 Some Policy Implications**

This brief review of experience in developed countries provides some insight into a number of key questions that underpin the development and expansion of a rental-housing sector, and how a rental sector might be expanded in LAC countries. In developing LAC countries, the development of the rental market is of critical importance, as the poor cannot always attain homeownership. Developed countries have centered most of their interventions to increase homeownership in the developing countries, but it is not clear as to whether this policy has had a positive impact in developing countries. The following are important questions to consider when developing policies to expand the rental sector in these countries.

#### **1. To what extent is a rental sector important to a healthy housing system?**

Experience across a range of countries has revealed long-term trends that promote a social housing sector and owner occupation in favor of renting. In almost all countries this has been followed by declining production of housing allocated for renting or general decline in rental tenure rates. The 2008 global financial crisis is attributed by many as a result of overzealous promotion of owner occupation and excess ease in obtaining credit to purchase. In addition to impacting international and national financial systems, this has had dire consequences for many owners, with some losing their home to mortgage default and others faced with negative equity that will burden them with a long-term liability. In a well functioning housing system, producers of housing should not have an overwhelming preference for producing homes for owner occupants in favor of homes for renters; similarly, consumers should be indifferent to tenure options.

A further benefit of an effective rental sector is that it creates choice and opportunities as a transitional stepping stone for younger households; it supports and enhances labor mobility and thereby productivity. Provided that appropriate management companies exist, rental ownership and operation can be an effective management structure for larger multiunit properties, which are more common in large urbanizing LAC cities. As such, the development of a rental sector is an important component in rebalancing national housing systems. A well-functioning rental sector, ideally with both private renting and social components, is critical to a sustainable and well-functioning housing system. There does not appear to be any perfect ratio of owner occupation, private renting, and social renting (or other tenure alternatives)—as this is a function of cultural norms and preferences—, but some mix of each component seems essential.

Public policy in developing countries should therefore not favor homeownership over the development of the rental market for low-income households. Governments should use balanced and complementary approaches. Also, they could use any instrument (i.e., tax incentives and/or subsidies) to respond efficiently and adequately to the housing needs, especially concerning the development of a sustainable rental market for low-income households.

## **2. What types of initiatives are necessary preconditions to successfully nurture the rental sector?**

Much of the experience of the OECD and northern countries, discussed in the previous section, reveals the consequences of the lack of or poorly designed policy and programs, as well as the inadvertent outcome of well-intentioned policy. Thus, they offer lessons and insights on what not to do rather than exemplary evidence of effective housing systems. To the extent that apartments are typically smaller and less expensive than individual attached dwellings, if the intent is to nurture a rental sector to address housing needs among lower-moderate income households, the planning system must both permit and encourage construction of apartment structures. These do not need to be large structures; rather smaller structures can be highly effective to enable the participation of smaller investors.

In the province of Quebec, Canada for example, much of the housing stock in urban areas like Montreal is in the form of three- and fourplexes, with an owner occupant in one unit and the other units provided as rentals. These types of units are mainly purchased by small investors.

Most of these investors are moderate and low-income workers that choose this vehicle to save and build an asset. In other areas, small structures of 4-20 units are also quite common, especially those built in the 1950s and 1960s. It should be noted that this form of rental supply is not an outcome of explicit intentional policy or programs. These are simply outcomes derived from motivated investor behavior that are responding to demand and, to some degree, driven by a cultural behavior in which households want to remain mobile. =

For larger structures it is necessary to attract the interest of corporate or institutional investors, so rates of return must be sufficient and competitive relative to alternate investments. Rents generated on lower-income targeted properties are typically insufficient to attract such investors; their involvement is more realistic at mid- to upper-market rent levels and in larger multiunit structures. This also requires the availability or nurturing of property management firms with appropriate expertise to professionally manage these larger assets. It is likely to be a greater challenge to attract the necessary investment to produce large structures. The experiences in North America suggest that institutional owners seldom produce new properties; rather they seek out existing buildings with established and predictable cash flows, avoiding development risk. Much of the stock that such investors are now acquiring was built under the stimulus programs of the 1970s and 1980s.

As discussed above, either type of investor—small or large—requires access to financing (and attendant security of a land registration system). All investors will be discouraged by regulatory systems that have the effect of suppressing potential rent levels and rates of return. A system that permits vacancy decontrol (rents readjust to true market) is preferable to stringent controls on levels of rents.

### **3. Does it matter whether the rental sector is driven by public or private investment and ownership of assets?**

If the main objective is supply, governments should be indifferent to public (community-social) versus private ownership of assets. The experience in OECD countries reflects both approaches. Many western European countries took advantage of large-scale public investment to create substantial public or community sector rental sectors in immediate post war periods. This was



augmented in a few countries (notable Germany, Netherlands, and Sweden) with favorable loans to encourage private development.<sup>5</sup>

Both Canada and the United States utilized the private sector to expand rental supply in the 1960s and 1970s, providing a positive investment environment and range of incentives. This helped to expand the private rental sector to one-fourth of all housing. In exchange for low interest rate, financing was a form of property specific rent control, a constraint in place for 20 years. All of the stock built under that specific program has now emerged from this constraint and an “expiring use” problem has emerged. Rents are no longer restricted and owners are gradually moving rents to market rates, well above affordable levels. If affordability is a parallel or primary objective, the public or community sector can be a valuable mechanism to avoid these types of expiring use issues and ensure long-term affordability (a legacy of public investment)

All countries have used public supply (initially in the form of public housing), and all have experienced difficulties, such as excessive public bureaucracies, concentrations of poverty, and inability to manage rising expenditures. A number of countries have shifted from public housing to nonprofit and cooperative “social” housing. Smaller scale, income-mixed properties that are less bureaucratically managed have proven to be better vehicles. This new policy was intended to shift the responsibility from the government to the group, insuring a better management of the project, such as people in cooperatives that own collectively and are responsible for their unit or nonprofit local boards that are more in control of insuring quality of the housing stock. Most significantly, the nonprofit status preserves long-term affordability, avoiding such problems as the private sector use issue and the public housing ghettoization concern.

Two studies in Canada (Ekos, 1997; Pomeroy, 2006) have examined the long-term cost effectiveness of private rental (with rent supplements) versus nonprofit housing. The analyses

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<sup>5</sup> That said, reviewers have suggested that the record of public ownership (particularly in LAC countries) is not generally positive. The public sector has not proven to be a good producer or operator of housing. The more successful cases in developed countries appear to be those engaging nonprofit, cooperative, or local municipal ownership and management. That is not to say that private operators necessarily generate better outcomes (in terms of quality and maintenance, security of occupancy, and affordability).

examined actual data for pairs of market and nonprofit properties constructed at the same year using data back to mid 1970s. The nonprofit option creates supply as well as addressing affordability. To simplify the analysis and remove any bias of a specific program design, it was assumed in both cases that a rent supplement was used to address the affordability aspect. In the private market case, the rent supplement cost is based on the difference between actual contracted market rent and 30 percent of household income. In the nonprofit option, it is calculated as the difference between a breakeven rent (including operating costs as well as debt service on 100 percent of construction costs). The analyses found that the long-term average rate of increase in breakeven rents in the nonprofit projects was roughly half the rate of increase of the market rents in the private properties. Thus assisting an identical household (same size and income) paying 30 percent of income rent with a rent supplement then covering the difference between this 30 percent and either the contracted market rent or nonprofit breakeven would become increasingly less expensive over time. These studies assumed new build at the outset for both market and nonprofit options. In today's market, and with the increasing costs of construction, if an existing rental property at average market rent were selected for placement of the debt supplement, it would be significantly less expensive than the breakeven rent on a newly constructed nonprofit property due to the higher development cost and associated debt servicing expense. With a wider initial gap the long run advantage of breakeven operation in the nonprofit would take longer to catch up, usually beyond 35 years. Thus while nonprofit models can be less costly than private market when both initially involve new construction, nonprofit provision with new construction is more cost effective than placing rent supplements on existing older rental that operate close to average market levels.

A key challenge in concurrently supporting and promoting both private sector expansion and community (social) renting is avoiding the creation of unfair competition. For example, providing subsidy to the community sector and not to the private investors, while both provide accommodation to similar tenants and thus compete for tenants. This can, and has been, achieved by maintaining equal levels of support (access to low rate direct financing, or partially forgivable loans) to both the private and community sector. This is often described as a unitary rental system, a single set of production incentives often coupled with a separate affordability subsidy that does not distinguish private or social sector. Countries with separate and competing social

and private sectors are identified as dualist systems with differentiated levels of support and arguably unfair competition between the sectors. Promoting an integrated rental system is preferable.

**4. If a private rented sector is desirable, what barriers to investment have been evidenced to date in countries with an established rental sector?**

As already noted, the most critical deterrent to a sustainable private rented sector is an uncertain regulatory regime. This is often a more significant barrier than weak rates of return, although these too will be an important factor. Imbalance in the overall housing system, with preferential treatment given to the social rental sector or to the owner-occupied sector, will also discourage private rental investment.

In North American markets, emphasis on homeownership (especially nontaxation of capital gains, and in the United States, mortgage interest deductibility) makes the ownership sector more attractive. Where strata title (condominium) systems have been adopted (most countries) to enable ownership of apartments or flats in multiunit structures, this in turn drives land values beyond those that allow economically feasible rental development.

**5. What type of environment (combined incentive, regulatory and facilitative measures) can help create an interest in a rental sector?**

In an ideal world, it would not be necessary to establish a policy framework to encourage and promote a viable rental sector. The nature forces of consumption (demand) would generate supply. Investors seeing opportunity as rental providers would purchase property and provide this at competitive rental rates to consumers. However, past policy interventions that have favored other sectors has built distortions into the market such that rental housing is both unviable and unattractive to potential investors. So the primary policy response should be to examine existing competing policies and remove or minimize their distorting effects. As suggested a balanced regulatory regime that concurrently provides security of occupancy for tenants, but allows investors a fair rate of return (inflation based rent index and vacancy decontrol), is required.

The second condition is an opportunity for investors to generate a reasonable rate of return. Typically because real cost of debt service tends to decline over time as incomes and thus rents inflate, rates of return become more favorable over the longer term. For this reason, many stimulus programs have tended to provide assistance over the initial years of operation (e.g., first 5 to 10 years) to supplement otherwise low and unattractive rates of return. This includes interest free or forgivable loans, which effectively reduce initial investor equity, required and thus improve return on equity. From a post tax perspective, permitting deductibility of both cash losses and artificial loss via depreciation allowances (as used successfully in Australia and New Zealand (Lampert et. al., 1998) helps to overcome weak rates of return, both during initial years and beyond. Potential return on equity is also impacted by ability to access financing (leverage) and thus minimize direct equity investment; thus a well-functioning housing finance system is important.

#### **6. Establishing and nurturing a community-based rental sector.**

Many LAC countries continue to experience low levels of new housing production, and thus have a supply constraint, which impacts overall housing affordability. While mechanisms to stimulate private investment and production are possible, another approach is to follow the early postwar emphasis in many western countries of direct state support for housing supply (although this was a broad scale approach, not solely focused on low-income affordable supply).

In countries where prerequisite conditions to enable or expand private rental are weak, this public/social model may yield faster results. This would entail creating a publicly-owned development corporation to assemble and expand capacity in development and construction. Once constructed assets can either be sold to private sector investors or to community nonprofits to operate these properties.

A community-based sector can be created in parallel with encouragement of private sector expansion, provided it does not receive preferential treatment and put the private sector at a disadvantage. The U.S. model under the Low-Income Housing Tax Credit (1986–present) is a good example of an integrated system allowing both private and nonprofit sponsors to compete for credit allocations and develop assets.

While the postwar approach in many countries emphasized direct public ownership and created large public housing bureaucracies, in some countries this took the form of community-based nonprofit and cooperative corporations or hybrid organizations, publicly owned but operating at arms length including the municipal housing corporations in Denmark, Netherlands, and Sweden (and now, through stock transfer, the housing associations that dominate in the UK and are being considered in Australia).

Canada also undertook a public housing model initially but refocused its approach to affordable housing provision in the early 1970s to help create a community housing sector. As a new model, it was necessary to build capacity and for the national government to provide funding to create technical assistance “resource groups” who could take on development activities for an array of community based nonprofits, including faith organizations, ethnic groups, and service clubs. So each housing provider did not need to have specific skills in housing development, but was required to retain or develop a property management capacity internally.

While identified generically here, there are different variants of nonprofit community housing providers. These can include NGOs, such as nonprofit corporations with a specific mission to provide and operate affordable housing; cooperative housing associations, which have a similar mission by all residents are members and internally create a board for self governance; and quasi municipal agencies, with board and governance structures related to local municipal councils but also augmented with outside board members. Regardless of type, in Canada funding was provided to produce new housing (and also permitted acquisition and rehabilitation, where feasible), initially in the form of low-rate financing. As land and development costs inflated and breakeven rents moved above desired affordable rent levels, separate rent supplements were introduced to reduce rents for low-income tenants (with rent set initially at 25 percent of gross income). Subsequently, social housing assistance was revised to combine supply and affordability assistance in a single ongoing operating subsidy together with publicly secured mortgage financing at 100 percent of cost (using insured lending provisions of the national housing agency, Canada Mortgage and Housing Corporation). The ongoing subsidy then helped cover related debt servicing expenses while also ensuring affordable rents affordable to low-income tenants.

Over the subsequent 30 years, Canada's social housing stock expanded to reach 6 percent of total stock with a network of cooperative and nonprofit housing providers owning the assets, providing ongoing management services, and ensuring preservation of long-term affordability via their nonprofit status. Their mission—to provide affordable housing—was enabled by government-funded subsidy programs. One consequence of this model in Canada is that while accounting for 6 percent of total stock, the structure of the community-based sector is characterized by a high level of fragmentation with many single project (multiunit) providers. Few have over 500 units, and there is insufficient scale to generate economies of scale in operations or to build expertise and capacity. The key lesson here is that community-based provision can be an effective vehicle, especially for preserving ongoing affordability. However, it is critical to create community-based operators at scale (e.g., ultimately operating 500–3,000 units).

Nurturing and sustaining a sound community rental sector also requires the availability of volunteers to sit on boards and provide appropriate level of governance. This too has emerged as an issue over the longer term. Many were happy to become involved during planning and construction, motivated by the challenge and excitement of building an asset. However, lack of recruitment and board renewal and a perceived lower interest level in asset management versus construction has resulted in challenges in retaining and renewing boards, and, in some cases poor governance (at least in small single project providers). The important lesson is to focus on ongoing management and governance with appropriate capacity building support.

A partnership with the community could play a vital role for the success of the development of rental markets in developing countries. Studies of Multilateral Development Banks (MDBs) have shown that efforts to stimulate community driven development have grown rapidly and that involvement of community-based organizations and NGOs can yield strong positive effects on MDB-supported projects (Buckley and Clerical, 2004). The government's role in bolstering rental markets would therefore be to help build partnerships among all concerned public agencies, private sector, NGO representatives, and community-based organizations, and to give each cooperative or nonprofit organization an opportunity to create and apply their own housing solutions in conjunction with their partners. This would build long-

term capacity in the development of a community rental market for low-income households (Buckley and Kalarickal, 2004).

The UK has followed a different model, especially in transferring social housing stock from local authorities (public housing) to housing associations. These tend to be larger, generally with portfolios of 1,000-5,000 dwellings and staff levels are sufficient to build specialized expertise. Recently, the UK government took this one step further and restricted approval for new build to a few larger designated “development partners” – Housing associations with the necessary skill and expertise to effective management procurement of new construction.

A critical distinction between a community-based rental sector and private sector is that most community-based entities have limited assets and capital. Thus they are highly dependent on a subsidy regime and impose ongoing and often rising expenditures on government; the private sector tends to utilize high levels of financial leverage in combination with direct equity investment. This requires rents at a sufficient level to service debt and to yield a return on invested equity, but usually require less subsidy assistance. Of course, underlying this difference is the fact that public and social housing seek to serve the lowest-income population, and thus require much deeper subsidy assistance than average market renters.

The municipal housing companies established in postwar Western Europe were initially publically funded, but have amassed a sufficient pool of assets, most with retired debt, such that they can now lever the rental cash flows for expansion. This takes a full generation of investment before assets provide this opportunity. These corporations, while nonprofit in nature, are also a source of general supply with a good mix of market rate tenants, thus improving their financial viability. In the UK, the stacking of a shelter allowance (housing benefit) as a separate form of revenue subsidy has enabled housing associations to similarly leverage financing for refurbishment and expansion.

## **7. Consolidation: some proposed options for consideration in LAC countries.**

Prior to prescribing particular approaches in any LAC country, it will be important to review and analyze the existing context in each. This should include the following:

- A review of the land market;

- State of the current supply issue and housing industry capacity;
- Existence and state of social security and income assistance (potentially including housing allowances or conditional income assistance linked to housing expenditure)
- Existing of a community nonprofit sector capable of developing and managing housing assets and possibly related subsidies.
- Availability and capacity for housing finance (via private lending institutions or via direct government loans);
- The extent to which small scale investors (distinct from informal family renting) are already present and active;
- The presence and potential for larger corporate or institutional investors to take an active role in the rental market; and
- The existing regulatory regime (degree to which it balances consumer protection and security of occupancy with rent setting policies and constraints).

In the absence of detailed country level assessments, it is expected that smaller scale investors in the informal rental market and the community nonprofit rental sector may present the least difficult approach and more fertile areas for initial attention. Encouragement and support for larger scale corporate or institutional investment is likely a more challenging proposition requiring more mature rental systems and institutional frameworks (both the UK and Australia have in the past implemented initiatives to attract institutional investment as a way to grow the rental sector, and both have met with limited levels of interest or investment—and coincidentally both have rental systems currently dominated by small scale investors).

## **8. Clearly defining the nature of the housing issue**

It is important to distinguish supply problems and policies from affordability issues (even when they coexist). The latter reflect weak capacity of households to pay rent (a function of low incomes) and are irreconcilable with the economics of production on a for profit investment basis (rental revenues are unavailable to sustain debt servicing costs). If a particular country has both a supply shortage and affordability issues, it is more fruitful to segregate these issues and promote



supply as a separate objective targeting working class and middle income consumers with capacity to pay reasonable (and viable) rents.

Affordability issues fundamentally reflect inadequate income and are better addressed via conditional income assistance, such as a housing allowance. Countries with large social or quasi-social housing sectors (e.g., Sweden) often have parallel housing allowances (Germany, Sweden, UK) that effectively address affordability while properties operate at market rents (supported by the housing allowance). This generates the necessary cash flows to make production and operations viable. However, in most LAC countries such universal shelter allowance programs are unlikely to exist, and would be expensive to implement, so it is more likely that direct investment in new supply initiatives will be more practical. If the priority issue is lack of sufficient new supply, as it more often is in LAC developing countries, appropriate policies are those that encourage production. Here the private development sector (if one exists) is the ideal target for policies and capacity building initiatives. Fully developing such a policy framework is outside the scope of this paper, but the private development sector will build if there is a firm market for their product (at a price that covers cost and profit). Thus rental policy needs to create an investment environment to acquire properties once constructed, essentially an outlet for the product of builder/developers.

While the community nonprofit sector has played an active role in developing affordable housing in some countries—notably France, Netherlands, and the UK and, at a smaller scale, Canada—the true benefit of the community nonprofit sector (potentially including cooperatives) is in owning and managing assets. Because they do not have a profit motive, they can help to preserve affordability over the long run. It is possible to “purchase” development expertise in the private market, which in turn helps to expand capacity in the production part of the housing system. Rather than nurture the community sector as developers, it may be more effective to focus their efforts and build their capacity in asset and property management (and possibly, if addressing the needs of the low-income population, rental subsidy administration). Moreover, to the extent that large-scale property management expertise is lacking, building this expertise in the community nonprofit/coop sector may be useful.

The other possibility is that small investors will purchase newly produced housing not for occupancy themselves but as an investment as a rental asset. In the many countries where small-scale investors are active, their involvement tends to focus much more on acquiring existing assets. Most lack the expertise and inclination to take on new development, so an alternative vehicle is needed to generate production (possibly a public development corporation, or where in place, private sector development).

If the land registration, financing and regulatory frameworks are not in place or not fully implemented, it may be more difficult to attract private investment, even at small scale (other than on an informal basis). In such circumstances, promoting and supporting the growth of community housing associations and cooperatives as the legal entities to own and manage assets may be a more expedient approach, as regulatory matters can be more tailored and included in funding and operating contracts.

## **5 Conclusions and Possible Directions**

The appropriate course of action will depend on the actual context in any country and can only effectively be developed following an assessment of the various factors noted in Section 4 herein.

### **5.1 Suggestions for Short-Term Strategy Development**

Following an assessment of country context, in the short-term policy initiatives should focus on both the informal small-scale investor and the social-community nonprofit sector:

- The small private investors can be a primary mechanism to provide rental accommodation, mainly via investment in the existing housing stock, as experience in developed countries suggests that such investors do not typically take on the more complicated (and risky) task of building the dwelling. This can be encouraged by preferential tax treatment of rental income and also provides a way for middle-income families to build assets for retirement income.
- The social-community nonprofit sector can play an important parallel role in helping to expand rental options, and as a way to sustain and preserve affordability of this stock in the long term.

In countries where an investor class is small or nonexistent, it may be more expeditious to create and build capacity in the community sector. This might include both traditional nonprofit corporations, ideally with a mixed housing and community development social enterprise mandate, as well as self-build and managing cooperatives. The advantage of cooperatives is that ongoing management capacity can be built internally through community based technical assistance agencies. These technical assistance groups can also undertake the more skilled development process on behalf of coops and nonprofit owners.

For both small private investors and community sector investment, access to financing (secured by anticipated rental revenues) is a critical prerequisite. Lending policies will need to be reviewed and possibly developed to ensure such access. A set of incentive mechanisms is required to encourage and promote small-scale investment. In many developed countries this has come through the tax preference conveyed to rental investment income (with Australia, New Zealand and, pre-1973, Canada being notable examples). This includes ability to deduct losses from rental investment against other sources of income, as well as exempting all or part of the capital gain from income tax. Investment can also be motivated via mechanisms like interest free loans that reduce the investors out of pocket equity requirements (effectively lowering the investment threshold).

Compared to large corporate investors, small-scale investors generally seem less cognizant of the regulatory regime. Many have a long-term investment perspective and are “patient investors.” However, the regulatory regime does impact willingness to invest or incentives to disinvest (Pomeroy, 1998). It is critical to review and, where appropriate, reform regulatory regimes to ensure a balance regime, and then minimize ongoing “tinkering” so that the effects of the regulatory regime can be capitalized into the market.

## **5.2 Recommendations for Medium-Longer Term Development**

The other potential investor segment is the corporate and institutional investor. The former played a significant role in the North American expansion of rental stock through new construction during the 1960s and 1970s. The growth largely preceded the widespread acceptance of condominiums tenure (condominium legislation was introduced in the 1969–1971 period in Canadian provinces), such that multiunit apartment construction through the 1970s and

early 1980s continued to be predominantly for rental. This sector emerged as governments created incentive mechanisms including below market and interest free loans and in some cases grants and traditional builders transformed their business from subdivisions and building detached homes for sale to constructing multiunit apartment structures. Certain corporations developed expertise in rental housing and property management and created large portfolios of income producing properties. Advantageous tax treatment of rental property income also provided additional incentives. As noted previously, many such producers and owners have subsequently refocused their efforts on producing apartments for sale (condominiums), and have sold their rental portfolios to institutional investors and real estate trusts (REITs), which are specialized tax exempt investments that effectively acquire and manage larger portfolios and distribute all net income to investors, where the investment is taxed as investment income.

To the extent that LAC countries wish to expand the rental sector at scale, such large-scale corporate actors can be valuable vehicles, as they are sufficiently large to have the specialized skills and capacity to develop property and multiunit structures, as well as undertake ongoing asset management. Conversely, small-scale investors, while effective in operating investments of detached homes or small apartment buildings, lack the specialized expertise and capacity to develop and manage larger-scale undertakings.

To stimulate participation of such large-scale investors, corporate tax structures will be required (in this case for principle business corporations engaged in real estate development and management). Again, access to financing will be important, although such corporations have broader options in addition to property specific mortgage finance. They can issue corporate debt and leverage their corporate balance sheet.

In the event that potential rates of return are insufficient to make rental investment attractive (even after favorable tax measures), additional incentives may be required. If the primary objective is to create rental supply, it may not be imperative to attach targeting or tenant eligibility conditions to these financial incentives. However, as noted previously, if the primary objective is long-term affordability, it may be more feasible to invest in nonprofit corporations, where the long-term affordability objective is not in conflict with profitability.

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