

THE ECONOMIC REASONS FOR THE SHORTAGES OF RESIDENTIAL
RENTAL ACCOMMODATION IN GREATER VANCOUVER

by

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Abstract

In the last three or four years a shortage of residential rental accommodation has been developing in Metropolitan Vancouver. This shortage has been brought about by a continuing decrease in the annual number of apartment completions since 1969.

To determine the cause of this shortage, this thesis concentrated on defining the reasons for the continuing decreases in the annual number of apartment completions since 1969.

Information on apartment land costs, construction costs, financing costs and operating costs were collected for the period commencing in 1964 and ending in 1972. Annual percentage increases for each of these costs were calculated and compared with annual percentage increases in apartment rents over the time period.

It was found that the capital costs of producing apartment buildings (construction and land costs) have been increasing at a faster rate than rents in most areas of Metropolitan Vancouver between 1964 and 1972. More rapid increases in capital costs than in rents reduce the yield that is available from apartment investment and thus reduce developers' incentive to produce new apartment rental units.

An analysis of apartment operating costs indicated that they have been increasing at the same rate as rents for buildings of similar ages operating between 1964 and 1972.

Thus, operating costs have not been responsible for the recent reduction in construction of apartment rental units.

Investigations were also carried out to determine what effects the amendments to the Income Tax Act have had on the continuing production of apartment rental units. It was found that the amendments destroyed many of the advantages that apartment investment had over other forms of investment. They have reduced the profitability of apartment investment and have discouraged the individual investor, who was largely responsible for the tremendous growth in apartment construction during the 1960's, from investing in new apartment buildings.

An examination of the procedures, costs and the lengths of time required to obtain municipal approval of apartment development applications was carried out for the Cities of North Vancouver and Vancouver and the District of Surrey. It was found that municipal regulations often substantially increased the costs of apartment development and delayed the initiation of apartment construction for lengthy periods of time. This was found to be especially true where land use contracts were used.

An analysis of the expected future demand for multi-family accommodation to the year 1991 was conducted. It was discovered that approximately 10,000 additional units per year will have to be provided in Metropolitan Vancouver until 1991. With the present rate of apartment completions, this demand will not be met.

Only if rents rise high enough to make apartment investment attractive relative to other forms of investment will this demand be met. Increasing rents could cause governments to implement some form of rent control. A study of rent control systems in the United Kingdom and New York City indicated that they do little to solve housing problems and aggravate the shortages that exist.

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CHAPTER I

Introduction

Between the years 1960 and 1972 there was a rapid expansion in the number of multiple family housing starts in Metropolitan Vancouver. During this period approximately 65 per cent of the current total multiple dwelling stock was constructed. This rapid expansion was brought about by increased demand for rental accommodation on the one hand, and by the large increase of funds flowing from professionals into apartment investment on the other.

The strong demand was created partly by the migration of other Canadians and foreigners to B.C., and the Lower Mainland in particular; partly by the rising costs of land, construction and financing in the home ownership sector which squeezed some potential home buyers into the apartment market; and partly by the increasing affluence of the population which allowed young, single people to enter the apartment market and significantly increase non-family household formation.

The supply of apartment units was greatly aided by the entrance of the professional with a very high income and high marginal tax rate who was more concerned with his personal after-tax cash position than with the before-tax profitability of an investment. Apartment investment until recently allowed him to trade off a reduction in the return

on his investment for a large tax saving. The professional brought about an expansion of the market because he was willing to accept a lower return and lower rents which resulted in a misallocation of resources towards apartment investment and away from other types of housing.¹

Table 1 shows that the peak of apartment investment was reached in 1969 when 12,525 units were constructed. Since then the number of apartment completions have fallen off dramatically. The extent of the reduction in apartment investment since 1969 is minimized in Table 1. Since 1966, when the Strata Titles Act was passed by the Legislature allowing ownership of individual units in multi-family dwellings among other things, the number of apartment units constructed for outright sale have increased dramatically. Table 1 does not differentiate between units constructed for ownership and units constructed for rental. It is therefore necessary to refer to Table 2 which presents the number of units designed for ownership between 1968 and 1972. Subtracting the total units constructed per year in Table 2 from the corresponding totals in Table 1 demonstrates that the drop-off in the supply of rental accommodation is more significant than appears from Table 1 alone. Assuming that all those units in Table 2 are new multi-family construction,² then the total amount of apartment units constructed for the rental market are 7,697 in 1970, 7,969 in 1971 and 5,512 in 1972.

Table 1

Multiple Family Completions* In Selected Areas
Of Metropolitan Vancouver, 1966 to 1972

<u>Location</u>	Number of Dwelling Units Completed						
	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>
Vancouver City	2359	3649	4626	6106	1290	2716	1936
Burnaby	600	1310	1628	1320	2116	2124	1119
Coquitlam	94	241	503	837	516	482	555
Delta	45	6	104	131	549	337	96
New Westminster	587	914	1106	673	344	133	149
North Vancouver	412	713	1270	1449	884	868	943
Port Coquitlam	4	59	130	231	140	426	64
Port Moody	--	102	158	134	370	75	--
Richmond	154	--	69	696	1424	845	996
Surrey	91	10	379	596	469	1575	1420
West Vancouver	327	217	133	163	340	197	183
White Rock	<u>--</u>	<u>72</u>	<u>26</u>	<u>189</u>	<u>159</u>	<u>95</u>	<u>347</u>
Total	4673	7293	10032	12525	8601	9873	7808

* Includes both apartment and row housing.

Source: Central Mortgage and Housing Corporation staff.

Table 2

Multiple Family Dwellings Registered as Strata Lots
In Selected Areas Of Metropolitan Vancouver, 1968 to 1972

	Number of Dwelling Units Registered				
	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>
Vancouver City	--	--	38	222	793
Burnaby and Richmond	--	181	301	920	755
Coquitlam, Port	102	44	162	44	4
Coquitlam and Port Moody					
Delta, Surrey and White Rock	--	295	211	451	233
New Westminster	--	--	--	--	62
North Vancouver	--	78	182	172	399
West Vancouver	<u>--</u>	<u>--</u>	<u>10</u>	<u>95</u>	<u>50</u>
Total	102	598	904	1904	2296

Source: Mr. Ron Roberts (U.B.C.) unpublished information.

That the lack of investment in rental accommodation in recent years is severely affecting the rental market is illustrated by Table 3 which presents the vacancy rates for Metropolitan Vancouver between 1963 and 1972. Since 1970, except for a brief period in the summer of 1971, the vacancy rate has been falling steadily to the record low of 0.6 per cent in December, 1972. For all practical purposes six empty apartment units per thousand surveyed is a zero vacancy factor. All indications are that the Metropolitan area will experience a critical shortage of rental accommodation in the next few years.

One of the goals of this dissertation is to examine those factors responsible for the large decline in the construction of rental accommodation since 1969. Greater land, construction and financing costs helped to curtail the market since rents were dragging behind these increases. The increased costs reduced net return on investment so that many investors were unwise to continue in further construction.

Supplementing the effects of increased costs was the passage of the new income tax law which destroyed the tax shelter that initially attracted many professionals into the market. The tax shelter feature was more important to many apartment purchasers than the actual yield on investment. Many purchasers were prepared to pay high prices for frame apartment buildings and many of them were built because they were profitable for builders. With the loss of the tax

Table 3

Overall Vacancy Rates In Multiple Family Rental
Accommodation In Metropolitan Vancouver,
1963 to 1972

	<u>Metro Vancouver</u>	
	<u>June</u>	<u>Dec.</u>
	%	
1963	4.2	--
1964	4.8	--
1965	4.0	--
1966	1.5	--
1967	1.0	--
1968	1.3	--
1969	1.2	0.8
1970	2.7	2.1
1971	4.1	2.8
1972	2.4	0.6

Source: Central Mortgage and Housing Corporation. Apartment Vacancy Survey. Metropolitan Vancouver, December 1972.

shelter, apartments have to sell strictly on the basis of their yield as investments. With the present level of rents it is no longer attractive to build such apartments if they have to be sold on a yield basis.

Obstacles placed before the apartment developer by municipal authorities and tenant organizations have also contributed to the decline in the number of rental starts. The "red tape", delays and high municipal processing and other charges involved in obtaining municipal approval for apartment projects have further soured the investment climate. New landlord and tenant legislation has made it increasingly difficult for the landlord to reduce his bad debts, evict problem tenants, and recover the cost of damages done to suites. Tenant activism has also re-introduced the possibility of legislation aimed at controlling rent levels.

All of the above factors have contributed to the reduced activity in the construction of rental accommodation in recent years. The flow of funds is being diverted into other forms of real property. The passage of the Strata Titles Act has aided the diversion of funds away from rental accommodation. As Table 2 shows, the importance of condominiums in the market is increasing steadily. Condominiums are more attractive to developers because they can be sold at higher prices per unit since the purchasers are buying living accommodation not investments. Commercial and industrial properties, although faced with many of the same cost increases as in the

residential sector, are more attractive investments. There is little tenant activism, increased costs are more readily passed on, and generally the relationship between landlord and tenant is on a more business-like footing.

Besides the examination of factors responsible for reduced apartment construction, the paper concentrates on two other areas associated with the operation of the rental market.

Firstly, demand forecasts for rental accommodation to the year 1991 are presented in order to give some dimensions to any shortage of rental accommodation that may be experienced in the future. Secondly, an analysis of operating costs and yields of 48 apartment properties, originally researched by R. Dale-Johnson,³ was carried out with the intention of isolating the reasons why some blocks were profitable while others were not.

Throughout this study the author was continually hampered by his inability to obtain correct and sufficient data on apartment construction, operation and profitability. The major reasons for this appeared to be that those developers, builders and lenders contacted (the majority of the larger operators in Vancouver) considered the information requested to be confidential and therefore not suitable for publication; unknown; or too difficult and time consuming to discover. Consequently, the observations and conclusions drawn from the study are not statistically valid, but it is

the belief of the author that they do indicate the general direction in which the apartment market is heading. In some aspects of the study the lack of suitable data was so great that it was necessary to fall back on indexes and averages at the national and regional levels, published, most notably, by Central Mortgage and Housing Corporation, Statistics Canada, and the Greater Vancouver Real Estate Board. The following paragraphs give a brief outline of the topics covered in each chapter and the sources of data used.

Chapter II presents demand forecasts for multiple family housing in Greater Vancouver. The forecasts are based on material published by Statistics Canada;⁴ an unpublished consulting report prepared for a leading Vancouver developer by Acres Western Limited;⁵ and a report prepared by the Planning Department of the District of North Vancouver.⁶ The purpose of presenting this data is to give some dimensions to the expected future shortages in rental accommodation.

Chapter III, the first chapter to examine factors responsible for reduced apartment construction, initially investigates the average annual percentage increases in rents for bachelor, studio, one- and two-bedroom suites in selected areas of Greater Vancouver during the period 1964 to 1972. The data were obtained from Real Estate Trends published by the Greater Vancouver Real Estate Board⁷ and from Statistics Canada.⁸

Similar average annual percentage increases in construction, land and financing costs were calculated for the period 1964 to 1972. When researching these trends in costs, it was originally planned to present a compilation of data obtained for specific apartment projects constructed during the time period in Metropolitan Vancouver. It was found, however, that not enough, sufficiently accurate data could be obtained to present informative results. Consequently, a Statistics Canada price index was used to convey the extent of increasing construction costs.⁹ Increases in land prices for apartment blocks were obtained from Real Estate Trends¹⁰ but were not strictly comparable with the construction cost index. The construction cost index is a national index, while land price increases were obtained from local data. Trends for changes in financing costs were established by using information drawn from quarterly reports of the Financial Post¹¹ and from Canadian Housing Statistics.¹²

Increases in rents were compared with increases in construction, land and financing costs between 1964 and 1972. The purpose of this exercise was to demonstrate that one of the reasons for the recent slow down in the construction of rental accommodation was due to the fact that faster increases in capital costs (construction and land costs) and financing costs than in rents were reducing the returns on investment available from renting and thus decreasing the attractiveness of apartment investment. As capital and financing costs

increased, a greater amount of equity had to be supplied by the investor. Since rents were not increasing as fast as equity requirements, the net return on investment fell.

Chapter IV examines the most important amendments to the Income Tax Act, which became law in 1972, as they affect real estate transactions. Prior to 1972, it was advantageous for professionals with high marginal tax rates to invest in residential rental property because paper losses created by the use of capital cost allowances could be applied against other income to reduce taxes. This advantage increased the flow of funds into apartment properties. With the changing of the Tax Act, the desirability of apartment investment for professionals has greatly diminished.

Chapter V investigates a third group of important factors which have been partly responsible for the reduction in the number of apartment starts since 1969. These are the obstacles placed before the apartment developer by municipal authorities. The "red tape", delays and high processing and impost charges involved in obtaining municipal approval for apartment projects have had the effect of discouraging and/or increasing the cost to the investor of apartment investment.

The chapter examines the procedures used in the Cities of North Vancouver and Vancouver and the District of Surrey for processing development applications in order to determine the extent of the bureaucracy involved and the time required to complete processing. Suggestions are made as to how this

bureaucratic process can be speeded up and thus aid in reducing costs to the developer. Charges levied directly against developers by the three municipal governments are itemized to indicate the costs that a developer incurs at the municipal level.

Chapter VI examines the effects that costs of operating apartment buildings have had on the profitability of apartment investment in the last few years in Metropolitan Vancouver. Average operating costs as a percentage of gross income that were presented in Real Estate Trends between 1964 and 1972 were analyzed to determine if the ratio of operating costs to gross income had increased, remained constant, or decreased with time.¹³

To further understand the trends that operating costs of Vancouver apartment blocks have been taking, data originally collected by Dale-Johnson for his thesis were examined.¹⁴ This data consisted of operating statements for 48 apartment buildings collected for several years of operation. They too were analyzed to determine if the profitability of apartment investment has been affected by these costs.

The dramatic decreases in apartment construction since 1969 in Metropolitan Vancouver have led to a shortage of rental accommodation as verified by Table 3. It is expected that rents will rise partly because of the shortage and partly because of the low returns that are now available from apartment investment. Already, some rent increases and

the current shortage of rental dwellings are beginning to stimulate tenant unrest and pressure is being applied on local and Provincial governments to consider some form of rent control legislation.

Chapter VII is a study of rent control policies in New York City and the United Kingdom where controls have been in existence for many years. The purpose of the study is to review the adverse effects that such policies have had on the rental housing market in the hope that the lessons learned will discourage any form of rent control in B.C.

Chapter VIII is a study of the yields obtained by a sample of 48 apartment blocks located in various municipalities of Metropolitan Vancouver. The sample was obtained and the yields calculated by Dale-Johnson and the results were presented in his thesis.¹⁵

The sample of apartment buildings was broken up into two groups--those having an average rate of return of less than 10.0 per cent and those having an average rate of return of more than 10.0 per cent excluding capital gains or losses. Various physical, financial and operating characteristics of the two groups were then calculated and analyzed to determine the fundamental reasons for the differences in profitability of the two groups of buildings.

Chapter IX presents the conclusions drawn from the study that have a bearing on the continued supply of new rental accommodation in Metropolitan Vancouver.

CHAPTER II

Demand Forecasts For Multi-Family Rental Accommodation

Population Analysis

As was shown in Table 1 in the last chapter, the number of multiple family housing units being constructed in Metropolitan Vancouver has been declining since the peak of 1969. This is leading to a serious shortage of rental accommodation, as evidenced by the declining vacancy rates presented in Table 3. To determine if these shortages will increase, remain the same or decrease in future years, it is helpful to predict the future demand for rental accommodation.

Table 4 summarizes the population projections for selected areas of Metropolitan Vancouver. It is conservatively estimated that the population of the Vancouver Metropolitan Area will increase from 1,032,000 to 1,761,000 during the 1971 to 1991 time period. This projection is based on an annual growth rate of 2.7 per cent per annum. A less conservative projection using historical rates of migration and survival indicates the population of the Vancouver Metropolitan Area will increase to 2,126,000 by 1991.¹⁶

Based on the conservative rates of growth, the combined population of Surrey, Delta, Richmond and White Rock (South Shore) will increase 2.5 times from 213,500 to 525,600. The population of Coquitlam, Port Coquitlam, and Port Moody (Northern Burrard Peninsula) will increase by nearly two times from 82,500 to 150,800.

Table 4
Population Growth Trends
Metropolitan Vancouver and Selected Areas
1966-1991

	<u>1966</u>	<u>1971</u>	<u>1976</u>	<u>1981</u>	<u>1986</u>	<u>1991</u>
V.M.A.	892,384	1,032,000	1,176,000	1,335,000	1,524,000	1,761,000
Vancouver	410,375	444,000	467,000	488,000	510,000	533,000
South Shore	160,958	213,500	267,500	339,800	423,500	525,600
Richmond	50,460	65,000	84,200	108,400	134,000	166,000
Delta	20,664	39,000	55,000	75,000	100,000	130,000
Surrey	81,826	100,000	118,000	145,000	177,000	216,000
White Rock	7,787	9,500	10,300	11,400	12,500	13,600
Northern Burrard Pen.	50,058	82,500	99,500	116,000	133,300	150,800
Coquitlam	40,916	53,300	63,300	73,300	83,300	93,300
Port Coquitlam	11,121	17,800	21,800	25,300	28,600	32,100
Port Moody	7,021	11,400	14,400	17,400	21,400	25,400

Source: Statistics Canada, Census of Canada, 1966, Vol. 1 and Acres Western Ltd., Residential Market Opportunity Study, unpublished, 1971, pp. 6-7.

An attempt has been made to identify the characteristics of the anticipated future population. It is on the basis of such considerations as age, households and income composition that the requirements for the various housing types can be determined.

The future age composition of the Lower Mainland population is presented in Table 5, which reveals the population in relevant age groups for the period 1971 to 1991. There will be a major increase in the population between the ages 25 and 44 and decreases in the population between the ages 20 and 24 and over 65 by 1991. Despite decreasing family size, the larger number of families will result in an increase in the 0 to 14 group.

Average household sizes are expected to decline during the 1971 to 1991 period. Projected household sizes for Metropolitan Vancouver and various sub-areas are illustrated in Table 6. Although all major areas of "Metro" are expected to reflect the trend towards smaller families, not all will experience this trend to the same extent. The average number of persons per household in Vancouver City will decline from 2.8 in 1966 to 2.6 in 1991, while family size in the South Shore municipalities will be expected to decline from 3.6 to 3.2 persons during the same period. The Northern Burrard Peninsula region, which experienced an increase in average household size between 1951 and 1966, is also expected to decline from 3.9 to 3.4 persons by 1991. These changes can

Table 5
Projected Population By Age Groups
Lower Mainland, 1971-1991

<u>Age</u>	<u>1971</u> %	<u>1976</u> %	<u>1981</u> %	<u>1986</u> %	<u>1991</u> %
0-4	8.3	9.2	10.1	10.5	10.2
5-14	17.9	15.1	14.6	15.7	16.7
15-19	8.8	9.1	7.4	6.3	6.6
20-24	8.5	9.2	9.3	7.9	6.7
25-34	13.8	16.3	18.3	19.1	18.2
35-44	12.6	12.3	13.1	14.8	16.6
45-65	20.7	20.1	18.7	17.6	17.2
65-	9.4	8.7	8.5	8.1	7.8

Source: Statistics Canada, op. cit. and Acres Western, op. cit., p. 8.

Table 6
Average Household Size
1951-1991

	<u>1951</u>	<u>1961</u>	<u>1966</u>	<u>1971</u>	<u>1976</u>	<u>1981</u>	<u>1986</u>	<u>1991</u>
M.V.A.	3.3	3.3	3.2	3.2	3.2	3.1	3.1	3.0
Vancouver	3.3	3.1	2.8	2.8	2.8	2.7	2.7	2.6
South Shore	3.6	3.6	3.6	3.6	3.5	3.4	3.3	3.2
Northern Burrard Peninsula	3.5	3.8	3.9	3.8	3.7	3.6	3.5	3.4

Source: Statistics Canada, op. cit. and Acres Western, op. cit., p. 10.

be compared to the overall decline in Metro from 3.2 to 3.0 persons during the 1971 to 1991 period.

The future income distribution pattern is shown in Table 7. The Economic Council of Canada reports in its Sixth Annual Review¹⁷ that the real growth rate was 2.7 per cent per annum for the years 1950 to 1967. To reduce the possibility of over-estimating, Acres Western used an average annual increase in real income of 2.5 per cent.¹⁸ This growth rate will also be used in this report. On this basis, 57.0 per cent of the Metropolitan Vancouver population will have incomes in the \$10,000 to \$14,999 group by 1991.

Residential Demand Analysis

During the 1951 to 1966 time period, the total number of single-family dwellings increased from 114,510 to 182,575 units in Metropolitan Vancouver, an increase of almost 60 per cent. During the same time period multi-family dwellings increased from 32,320 to 88,602 units, an increase of 175 per cent.¹⁹

Examination of these historical housing statistics shows the rapid growth of single-family accommodation in suburban areas and the shift from single-family to multi-family housing that is occurring in Vancouver City.

Based on previously mentioned population projections, the projected decline in average household size, and allowing for some replacement of existing housing, estimates of future housing requirements have been made for Metropolitan Vancouver

Table 7
Income Distribution By Households*
Metropolitan Vancouver

	<u>1951</u>	<u>1961</u>	<u>1971</u>	<u>1976</u>	<u>1981</u>	<u>1986</u>	<u>1991</u>
Less than \$3,000	51.7	17.4)	40.5	30.6	20.7	10.8	0.9
\$3,000-\$5,999	45.3	42.9)					
\$6,000-\$6,999	3.0**	12.3	8.9	7.2	5.5	3.8	2.0
\$7,000-\$9,999	--	17.9	19.1	19.7	20.3	20.9	21.6
\$10,000-\$14,999	--	6.4	23.2	31.6	40.0	48.4	57.0
\$15,000+	--	3.1	8.3	10.9	13.5	16.1	18.5

* Real household income projected at 2.5 per cent per annum.

** Above \$6,000 in annual income.

Source: Statistics Canada, op. cit. and Acres Western, op. cit., p. 11.

and various municipalities. It is estimated that the total housing stock in Metro will have to increase by approximately 310,000 units during the next 20 years.

To translate expected future population size, age distribution, average household size and income into generalized housing requirements, it is necessary to rely somewhat heavily on historical trends. This is an obvious weakness to the approach. In addition, it is difficult to assess accurately future changes in taste, and to ascertain the effects of changes in building costs, land costs and financing costs.

As presented in Table 5, the percentage of people in the 25 to 44 year age groups are expected to increase significantly over the next 20 years. Since it is from these groups that the main demand for single-family housing occurs, it would be expected that the predominance of this type of housing would increase. Correspondingly, the percentage of those in the 20 to 24 age group and the over 45 groups are expected to decrease considerably signalling a decrease in demand for multi-family housing.

However, the reasoning is not as simple as this would suggest. Increasing building costs, land costs and financing costs are placing greater pressure on the need for more efficient land use, that is, multi-family housing instead of single-family. It is therefore expected that the total housing stock will more than ever in the future be made up of multi-family housing.

Table 8 presents estimates of future single-family and multi-family housing units required for growth and replacement. The division of total housing requirements into single- and multi-family housing needs is based on historical trends and the expectations that scarcity of land, increased construction costs and higher financing charges will persuade more families to switch to cheaper multi-family housing. It also assumes that historic rates of development will continue unaffected by future municipal development policy decisions.²⁰

Table 9 shows that the multi-family units required will be expected to increase over time as a percentage of total housing units required.

The South Shore municipalities (Richmond, Surrey, Delta, and White Rock) will increase their share of total new housing starts from 21.4 per cent during the 1971 to 1976 period to 37.0 per cent by the 1986 to 1991 period. Multi-family housing units will increase from 27.1 per cent of additional new housing in the 1971 to 1976 period to 52.6 per cent in the 1986 to 1991 period. The North Burrard Peninsula will be called upon to supply at least 23,000 new units over the next 20 years, 39.7 per cent of those supplied in the 1971 to 1976 period being multi-family, rising to 63.6 per cent in the 1986 to 1991 period. The City of Vancouver will require 80,000 to 100,000 new units and the majority of these will be multi-family dwellings. In terms of new

Table 8

Estimated Single-Family* and Multi-Family Units Required
For Growth** and Replacement By Sub-Area+
1965-1991

	<u>1965-70⁺⁺</u>		<u>1971-76</u>		<u>1976-81</u>		<u>1981-86[^]</u>		<u>1986-91</u>	
	<u>S.F.</u>	<u>M.F.</u>	<u>S.F.</u>	<u>M.F.</u>	<u>S.F.</u>	<u>M.F.</u>	<u>S.F.</u>	<u>M.F.</u>	<u>S.F.</u>	<u>M.F.</u>
Vancouver City	3,398	22,009	1,900	17,000	1,600	17,400	1,400	18,800	1,100	20,400
North Burrard Peninsula	5,143	2,359	3,200	2,100	3,000	2,600	2,600	3,400	2,400	4,200
South Shore	12,268	2,841	12,900	4,800	16,000	8,300	16,800	12,400	17,700	19,600
Metro Vancouver	27,596	42,830	23,400	36,800	26,100	41,700	27,900	53,000	30,200	70,500

* Includes only single detached dwellings.

** Assumes an overall Metro. Vancouver population of 1,761,000 by 1991.

+ Replacement rates: Vancouver City - 5%; Metro. Vancouver - 3%; all other areas - 1%.

++ Covers 5½ year period (January, 1965 - June, 1970).

Source: Acres Western, op. cit., p. 15.

Table 9
Multi-Family Units Demanded As A Percentage Of
Additional Total Housing Required
1965-1991

	<u>1965-70</u> %	<u>1971-76</u> %	<u>1976-81</u> %	<u>1981-86</u> %	<u>1986-91</u> %
Vancouver City	86.7	90.0	91.6	93.1	94.9
North Burrard Peninsula	31.4	39.7	46.5	56.7	63.6
South Shore	18.8	27.1	34.2	42.5	52.6
Metro. Vancouver	61.9	61.6	61.6	65.6	65.9

housing starts single-family detached dwellings in Vancouver will decline from 10.0 per cent between 1971 and 1976 to 5.1 per cent by 1991.

The relative availability of land in Surrey, Richmond, and Delta will permit these municipalities to provide the majority of single family detached dwellings constructed in the Metro area during the next two decades. It is expected that these municipalities will sustain a relatively balanced housing mix, but that they too will feel the increasing pressure towards multi-unit housing developments in order to provide accommodation at reasonable prices.

Analysis Of Future Apartment Shortages

It is expected that a total of 202,000 units of multi-family housing will have to be constructed during the next twenty years to meet projected demand in Metropolitan Vancouver. Some of these units will be for sale to homeowners, while the remainder will be retained in the rental market.

It is difficult to divide the projected demand for multi-family units into those required for ownership and those required for rental. Generally, it can be assumed that the higher income groups will prefer ownership of their units to rental but it would be very misleading to estimate what the proportion of condominiums to rental units demanded would be, since there are few statistics available on which to base such an estimate. Instead, an examination of the overall picture, that is, of both condominium and rental

units demanded, will be conducted.

A demand for 202,000 multi-family units in twenty years requires that approximately 10,000 units must be constructed per year. Based on the number of completions of multi-family units in 1972 (Tables 1 and 2), this demand will not be met. During the year only 7,800 units were constructed. Furthermore, 1972 was a year of considerable flux in the trends of apartment construction. The number of multiple dwelling completions decreased 20.7 per cent from the previous year and represented only 62.3 per cent of the completions achieved in the peak year of 1969. In addition, an increasing proportion of those completions were for sale to individual homeowners rather than for rental to tenants. 29.4 per cent of multi-family completions were registered as strata lots in 1972 as opposed to 20.0 per cent the previous year and only 5.0 per cent in 1969.

It is expected that the construction of multi-family units for rental purposes will continue to decrease over the next few years until rents are at such a level as to make rental development profitable to the developer-investor. Correspondingly, the supply of multi-family condominium units should increase at a greater and greater rate.

It is foreseen that as long as present conditions continue there will be extensive shortages of units for rent. The beginning of the shortage is already being seen, as the announced vacancy level of 0.6 per cent in Metropolitan

Vancouver for December, 1972 demonstrates.²¹ Many developers, at present, are discontinuing rental construction and concentrating on condominium development where the profits are considerably greater.

Condominium and rental development together, may meet the goals of 10,000 new units per year but, if this is the case, it is likely that it will be due to the construction of a large proportion of units for individual ownership and a small proportion for rental. This will lead to a shortage of rental units and a possible over-supply of condominiums.

Summary and Conclusions

A population and demand analysis indicates that 202,000 multi-family units will be demanded in Metropolitan Vancouver over the next twenty years. An examination of present and future trends in the supply of units indicates that the demand will probably not be met but if it is, it will only be in total since expectations of an over-supply of condominiums and an under-supply of rental units are foreseen.

The succeeding chapters examine the reasons for the unprofitable nature of rental units which are resulting in reduced construction and consequently, increasing shortages.

CHAPTER III

Rent Levels, Construction, Land And Financing Costs

It has been stated that because rents have been dragging behind increases in land costs, construction costs and interest rates, the net return on investment that an investor can obtain from apartment blocks has slowly been decreasing with the resultant effect that the number of apartments being produced per year has been declining.²²

The purpose of this chapter is to determine if the statement is true by comparing increases in rents with increases in construction, land and financing costs between 1964 and 1972.

Before doing this, however, it should be emphasized that larger increases in capital costs (land and construction costs) and financing costs than in rental rates will only reduce the yield on new apartment blocks coming into operation for the first time and not on blocks that are already in existence, unless they are re-financed. Once a block is constructed, its capital cost is fixed at that point of time and it does not matter how capital costs change subsequently, they will not affect the yield of the existing block.

Another point worth noting is that several authorities²³ have discovered that as a block gets older, operational costs increase faster than rents thus reducing profits and yields; the main reason for loss of profitability being increased

repairs and maintenance. However, this section is not concerned with how a property's profit margin declines as the block gets older but only with why the yield on a block constructed, say, in 1970 is lower at a particular point in time of its operation than a block constructed, say, in 1966 at a similar operational time point.

A study of some apartment properties, the results of which are presented in a later chapter, indicates that operational costs as a percentage of gross income have remained fairly constant for a given year of operation (first year, second year, et cetera) regardless of when the block was constructed. For example, it was found that blocks constructed in 1968, in 1969 and in 1970 all had similar operating costs during their first and second years of operation. Consequently, operational costs do not play a role in this section of the analysis.

Rent Increases, 1964 to 1972

Two sources of data were used to determine the average annual percentage increases in rents in Metropolitan Vancouver between 1964 and 1972. The first source is from information published by the Real Estate Board of Greater Vancouver²⁴ and the second is from the Residential Rent Index published by Statistics Canada.²⁵

The Real Estate Board publishes lists of typical rents in selected areas of Metropolitan Vancouver every second year. From 1966 onwards the rents published were for suites of

average quality in recently constructed, modern apartment buildings. The suites were on the third floor and of average size and quality for the area surveyed. No special premiums were attached for orientation or view and parking charges were not included.

The 1964 rental survey, however, differed from that in succeeding years. Instead of surveying suites on the third floor of modern buildings, the survey was conducted on second floor suites of buildings of all ages. Since older buildings tend to have lower rents because of reduced amenities, the typical rents reported in 1964 tended to be deflated relative to rents reported in succeeding years. Also, second floor suites generally rent at lower rates than third floor ones because of the poorer views available. These two factors meant that the survey conducted in 1964 was not strictly comparable with those done in later years. Thus, the large percentage rent increases reported in Table 10 for the period 1964 to 1966 are due more to changing sampling techniques than to actual rent increases.

Table 10

Average Percentage Rent Increases In Metropolitan
Vancouver By Suite Type, 1964-1972

<u>Suite Type</u>	<u>1964-66</u>	<u>1966-68</u>	<u>1968-70</u>	<u>1970-72</u>
	%	%	%	%
Bachelor	25.4	12.9	--	--
Studio	--	--	--	9.4
One Bedroom	15.4	13.5	13.5	10.3
Two Bedroom	17.0	19.9	11.3	10.1
Average	19.3	15.4	12.4	9.9

Source: Real Estate Trends in Metropolitan Vancouver,
Greater Vancouver Real Estate Board, 1964-1972.

Table 11 presents the average annual percentage increase in rents for selected areas of Metropolitan Vancouver by suite type between 1964 and 1972.

The overall average annual rent increase in Metropolitan Vancouver, taken as a whole, was approximately 6 per cent. Bachelor suites led the way with an average annual increase of 8.7 per cent, followed by two bedroom suites at 6.3 per cent, one bedroom suites at 6.1 per cent and studios at 4.7 per cent.

The areas showing the greatest annual rent increases were the East Hastings area of Vancouver, Burnaby and New Westminster, with increases of 9.3, 9.6 and 9.0 per cent, respectively. Richmond had annual rent increases of 1.4 per cent, by far the lowest for Metro.

Comparing the rent increases reported by Real Estate Trends with those published by Statistics Canada in the Residential Rent Index, it is found that the Index reports lower annual percentage increases than Trends. Between 1964 and 1971 the Residential Rent Index for Vancouver rose from 100.1 to 124.6.²⁶ This represented an average increase of approximately 3.5 per cent per annum.

The discrepancy between the annual increase of 6.0 per cent calculated from Trends and the 3.5 per cent of the Index appears to be due to differing sampling techniques used in the two surveys. The Index is compiled by sampling a broad but specific group of urban families and reflects the price

Table 11

Average Annual Percentage Increase In Rents For
Selected Areas Of Metropolitan Vancouver
By Suite Type, 1964-1972

<u>Area</u>		<u>Bach.</u>	<u>Studio</u>	<u>1-Bdrm.</u>	<u>2-Bdrm.</u>	<u>Average</u>
Vancouver City						
West End	highrise	5.3	4.0	6.3	4.8	5.1
South Granville	frame	2.8	6.5	6.7	8.6	6.2
	highrise	--	4.0	6.9	7.5	6.1
Kitsilano	frame	8.5	4.4	7.6	9.5	7.5
	highrise	--	2.0	5.8	6.8	4.9
Kerrisdale	frame	1.1	2.2	4.6	6.4	3.6
	highrise	--	4.0	4.9	6.0	5.0
Marpole	frame	5.6	6.8	6.5	5.9	6.2
East Hastings	frame	13.9	4.6	9.3	9.4	9.3
Burnaby	frame	18.6	4.4	7.5	7.7	9.6
New Westminster	frame	14.3	7.5	7.1	6.9	9.0
North Vancouver	frame	12.9	4.4	7.7	8.6	8.4
West Vancouver	highrise	4.2	6.5	5.1	6.4	5.6
Coquitlam	frame	--	--	4.2	4.2	4.2
Port Coquitlam	frame	--	--	4.4	5.3	4.9
Richmond	frame	--	--	2.0	0.8	1.4
Surrey	frame	--	--	7.4	2.7	5.1
Average		8.7	4.7	6.1	6.3	6.0

Source: Based on data from Greater Vancouver Real Estate Board, op. cit.

changes experienced by that "target group". The "target group" is composed of families ranging in size from two adults to two adults with four children. They have annual incomes ranging from \$2,500 to \$7,000. Thus, the Index does not emphasize as much as Trends, increases in rents due to better and more amenities. The Index samples rental rates on a broad basis and does not differentiate between older buildings with fewer amenities and more modern blocks with more amenities. Trends, on the other hand, concentrates only on modern blocks (except in the 1964 survey) which usually rent at premium rates.

For the forthcoming comparisons of rental increases with capital cost increases, it will be more appropriate to use the Trends survey as a basis because it reflects rents on recently constructed blocks. Since this study is only interested in contemporary trends in capital costs, the comparisons with modern rents will be more effective.

Land Costs

Land costs for apartment projects have increased at a phenomenal rate in Metropolitan Vancouver over the last eight years, although there now appears to be a levelling off occurring.

The data for this section of the study were obtained from average figures published in Real Estate Trends between 1964 and 1972. The apartment site values presented in Table

12 are extracted from Real Estate Trends. They were based on sales occurring in the year they were reported. Sales occurring well above or well below the average were eliminated.

Real Estate Trends divided some apartment areas into smaller sub-areas for presentation. For example, the West End was divided into three sub-areas--North of Davie, South of Davie and West of Denman. For purposes of Table 12 the sub-areas have been eliminated. The range presented for site values consists of the lowest value reported of all sub-areas and the highest value reported of all sub-areas.

When examining the land prices presented, it must be remembered that they have to be considered along with the amount of land needed per apartment unit. This depends on the floor space ratio and the permitted maximum site coverage. The floor space ratio and maximum site coverage differ from apartment zone to zone. Thus, although land was the most expensive per square foot in the West End, the land component needed for one apartment unit is less in dollar terms than for other parts of Metropolitan Vancouver.

In 1972 land was selling in the West End for \$13.00 to \$14.00 per square foot and the land cost per unit varied between \$2,000 and \$2,400. In South Granville the land cost per unit was \$4,400 to \$6,500, but the price per square foot was between \$9.00 and \$10.50; in Kitsilano the land cost per unit was \$3,800 to \$4,500, while the cost per square foot varied between \$6.30 and \$8.00; the land cost per apartment

Table 12

Apartment Site Values In Selected Areas Of
Metropolitan Vancouver, 1964-1972

	<u>1964</u>	<u>Price Per Square Foot</u>			<u>1972</u>
	\$	<u>1966</u>	<u>1968</u>	<u>1970</u>	\$
		\$	\$	\$	
Vancouver City					
West End*	4.1-6.5	5.5-8.0	7.0-12.0	9.5-12.0	13.0-14.0
South Granville	4.5-5.5	4.5-5.9	7.0-8.0	7.8-10.0	9.0-10.5
Kitsilano	3.6-3.7	3.3-5.0	5.0-6.3	6.3-8.0	6.3-8.0
Kerrisdale	3.3-3.8	4.0-5.0	--	--	--
Marpole	1.7-2.7	2.0-3.0	4.0-5.0	4.7-6.0	6.0-7.5
East Hastings	--	--	4.0-5.0	4.2-5.0	4.2-5.0
New Westminster	1.1-1.6	1.5-3.0	3.3-4.5	3.5-4.5	3.5-4.5
North Vancouver	1.2-1.7	1.8-2.0	3.0-4.5	3.4-6.3	6.0-7.5
Surrey	--	--	1.0-1.3 ⁺	--	2.0-2.2 ⁺
West Vancouver	2.0-3.9	3.0-4.0	3.5-4.7	5.3-7.0	5.3-7.0
Coquitlam	--	--	1.0-1.8 ⁺	3.0-3.8	3.3-3.9
Port Coquitlam	--	--	0.9-1.3	1.8-2.0	2.3-2.5
Richmond	--	--	0.9-1.3	1.0-2.7	2.8-3.0
Burnaby	1.0-1.9	1.2-2.0	1.8-4.4	2.5-4.2	2.5-5.0

* Land prices for sites along English Bay and near Stanley Park have been omitted because they are considerably higher than other parts of the West End.

⁺ Estimated.

Source: Greater Vancouver Real Estate Board, op. cit.

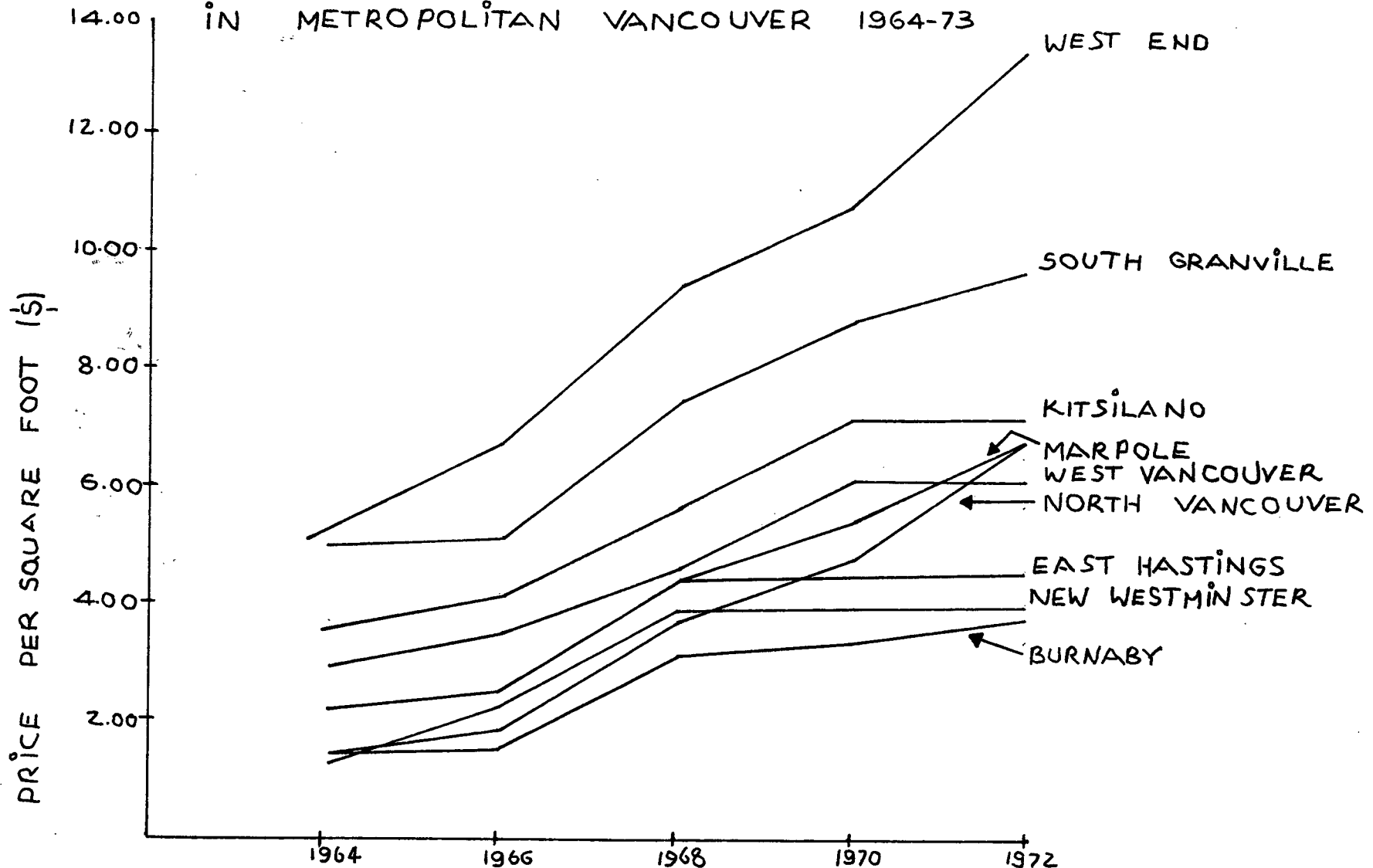
unit in Marpole was \$3,500 to \$4,000, with a cost per square foot of \$6.00 to \$7.50; and in the East Hastings area land sold for between \$4.20 and \$5.00 per square foot, with a resultant cost per apartment unit of \$2,200 to \$3,000.

In the suburban areas of Vancouver land was generally less expensive per square foot and per apartment unit than that found in the city. In New Westminster one apartment unit required \$2,000 to \$2,300 worth of land at a cost of \$3.50 to \$4.50 per square foot; a per square foot cost of \$2.50 to \$5.00 was experienced in Burnaby, with a cost per unit of \$2,500 to \$3,300; in North Vancouver the cost per unit was \$2,000 to \$4,500, with a corresponding per square foot cost of \$6.00 to \$7.50; West Vancouver experienced land costs per unit of \$2,200 to \$3,000 or a cost per square foot of \$5.30 to \$7.00; in Coquitlam the land component per unit was between \$2,000 and \$2,500, while the per square foot cost was \$3.30 to \$3.90; Surrey experienced the lowest land costs in 1972, with a cost per square foot of \$2.00 to \$2.20 and a cost per unit of \$1,800 to \$2,000; and Richmond also had low land costs of \$1,800 to \$2,500 per unit or \$2.80 to \$3.00 per square foot.²⁷

Land prices are greatly affected by the supply of and demand for sites. Looking at Figure 1 and Table 13,²⁸ it can be seen that within Vancouver City, the West End and Marpole have shown the greatest increases in land costs between 1964 and 1972. Land prices increased between 14.4

FIGURE 1

APARTMENT SITE VALUES FOR SELECTED AREAS
IN METROPOLITAN VANCOUVER 1964-73



SOURCE: TABLE 12

YEAR

Table 13

Percentage Changes In Apartment Site Values In Selected Areas Of
Metropolitan Vancouver, 1964-1972

	<u>1964-66</u> %	<u>1966-68</u> %	<u>1968-70</u> %	<u>1970-72</u> %	<u>Average Annual Change</u>
Vancouver City					
West End	23.1-35.8	27.3-50.0	0.0-35.7	16.7-36.8	14.4-27.6
South Granville	1.1-6.3	36.8-55.6	10.7-25.0	5.0-16.1	11.4-12.8
Kitsilano	(10.8)-35.1	25.0-53.8	25.0-28.0	0.0	9.2-14.5
Marpole	13.2-17.6	66.7-100.0	17.5-20.0	25.0-27.7	22.9-31.6
East Hastings	--	--	0.0-3.8	0.0	0.0-1.0
New Westminster	42.9-89.4	48.5-116.7	0.0-7.7	0.0	22.7-29.2
North Vancouver	17.6-50.0	66.7-125.0	11.7-40.0	19.0-79.1	42.7-50.0
West Vancouver	2.6-50.0	16.7-17.5	48.9-50.0	0.0	9.9-20.3
Coquitlam	--	--	110.7-200.0	2.7-8.3	29.1-56.3
Richmond	--	--	11.1-112.0	13.2-180.0	35.0-45.0
Burnaby	2.6-20.0	50.0-125.6	0.0-38.9	0.0-20.5	18.8-20.4
Average	11.5-38.0	42.2-80.5	21.4-51.0	7.4-33.5	19.6-22.6

Source: Based on Table 12.

and 27.6 per cent in the West End during that time period, while in Marpole they increased between 22.9 and 31.6 per cent. The smallest increases in land costs were recorded in East Hastings (0.0 to 1.0 per cent) and in Kitsilano (9.2 to 14.5 per cent).

In the suburbs, North Vancouver, Coquitlam and Richmond demonstrated the largest increases in land costs, increasing at an average annual rate of 42.7 to 50.0 per cent, 29.1 to 56.3 per cent and 35.0 to 45.0 per cent, respectively. The lowest price increases were recorded in West Vancouver and Burnaby, where prices rose at an average annual rate of 9.9 to 20.3 per cent and 18.8 to 20.4 per cent, respectively.

To correlate the increases in land costs with greater demand for sites relative to supply, it is worthwhile to examine Table 14 where the percentage increases in the total apartment stock between 1966 and 1972 are presented as an indication of demand for nine areas in Metropolitan Vancouver.

Comparing the average percentage increases in total stock from 1966 to 1968, 1968 to 1970 and 1970 to 1972 with the average percentage increases in land prices for the same time periods, it is seen that in the 1966 to 1968 period, when the greatest percentage increases in total stock were registered, there were correspondingly large increases in land prices. Similarly, in the 1970 to 1972 period when the percentage increases in total stock were at their smallest, land prices rose at their lowest rate.

Table 14

Apartment Completions As A Percentage Of Total Stock
In Selected Areas Of Metropolitan Vancouver, 1966-1972

<u>Area</u>	<u>1966-68</u> %	<u>1968-70</u> %	<u>1970-72</u> %
Vancouver City			
West End	11.5	11.9	7.4
South Granville	16.5	16.0	0.0
Kitsilano	34.8	21.0	2.6
Marpole	28.3	9.2	6.6
East Hastings	33.6	23.2	31.4
North Vancouver	39.7	71.3	27.0
New Westminster	43.2	38.0	11.3
West Vancouver	31.7	25.6	7.2
Burnaby	44.8	55.6	20.2
Average	31.6	30.2	12.6

In the 1970 to 1972 time period land prices levelled off in four areas of Metropolitan Vancouver--Kitsilano, East Hastings, New Westminster and West Vancouver. For all of these areas except East Hastings, the levelling off is readily explained by greatly reduced demand for sites as evidenced in Table 14 by the reductions in the numbers of completions of apartment units. The East Hastings phenomenon, where completions continued at a steady pace, while land prices remained constant, is best explained by a finding

from a 1968 survey²⁹ which discovered that only 25.0 per cent of the available apartment sites in that area were developed. Thus, despite the large percentage increase in the completion of apartment suites there was still a ready supply of sites which held land prices down.

In the West End, South Granville and Marpole land prices continued to rise between 1966 and 1972 despite only marginal increases in demand. This peculiarity is explained also by considering the supply of available sites. The 1968 survey³⁰ reported that only 46.0 per cent of the apartment sites in the West End were unoccupied. In South Granville and Marpole only 35.0 and 37.0 per cent, respectively, of the sites were unoccupied. Although the number of completions was small in these areas, the lack of apartment sites allowed the small demand to influence prices significantly.

In North Vancouver and Burnaby the demand for sites was fairly heavy between 1966 and 1972 and consequently, land prices rose unabated.

Construction Costs

Attempts to obtain construction costs for specific apartment projects in Metropolitan Vancouver resulted in dismal failure. Over a three week period every major developer in Vancouver, twenty major construction firms and a variety of mortgage lending institutions were contacted in efforts to obtain accurate cost information.

Of those firms who were unable to supply cost data, the major reason appeared to be that they were unknown or so entangled with other factors that they were useless. One major developer who provides about 800 apartment units per year in Metro was unable to provide cost data because cost accounts did not exist for individual projects. Instead, accounts were set up by materials and labour used. For instance, they purchased \$50,000 worth of glass in 1971 but they could not allocate costs to specific projects. Similar accounting problems were encountered with other firms, thus raising doubts in the author's mind that developers themselves knew how profitable their projects were.

It was found that the cost data that were obtained were often misleading and inaccurate. Problems were met where apartment projects differed drastically in the quality of materials used and in the types of amenities supplied, both factors which affect costs significantly. In some projects for which data were obtained, construction strikes and bankruptcies during development severely affected costs. The end result was that many of these problems could not be resolved and so a withdrawal to the use of national construction cost indexes had to be made.

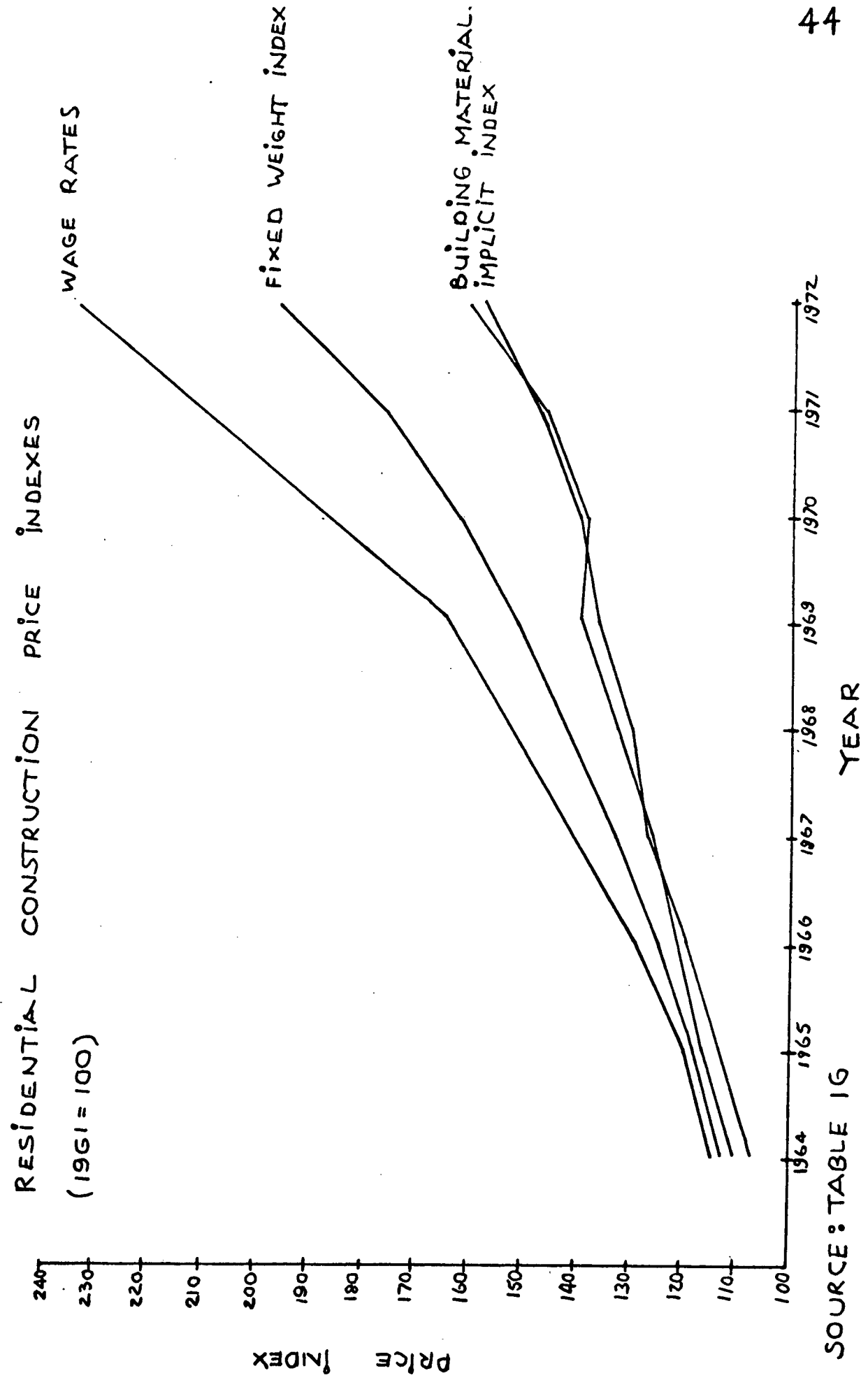
The use of Residential Construction Price Indexes³¹ is unfortunate because data are only available at the national level and there are no allowances for local variations. The Indexes are also based on costs of materials and labour

associated with all forms of residential construction and not just apartment units. They also have an unfavourable bias against highrise concrete structures mainly because the Building Materials Index does not apply as well to high-rises as it does to frame apartment buildings and single family dwellings. In computing the Materials Index lumber and lumber products are weighted 42.64 per cent, while concrete is only weighted 7.61 per cent.³² These proportions may be fairly accurate for frame apartments and single family units but for highrises it is probable that the proportions of lumber and concrete would invert. Since, in 1972, the Lumber Price Index stood at 176.8 while Concrete was only 138.2,³³ it is likely that the increases in construction costs are being overrated for highrise apartment blocks.

Despite these weaknesses in the data it was decided to utilize the Residential Price Indexes since they were the most reliable source of information and gave a fair indication of how costs had increased in the last decade.

Figure 2 and Table 15 present the Residential Price Indexes between 1964 and 1972. The Building Materials Index is based on price movements of materials used in construction. Changes in Federal sales tax charges are reflected in the Index. Between 1964 and 1972 the Building Materials Index rose 51.3 per cent or at an average annual rate of 6.4 per cent. During the same time period the Wage Rate Index, which is a composite of wage rates obtained by the various

FIGURE 2



SOURCE: TABLE 16

Table 15
Residential Construction Price Indexes
(1961 = 100)

<u>Year</u>	<u>Materials</u>	<u>Wage Rates*</u>	<u>Fixed Weight Index**</u>	<u>Implicit Index⁺</u>
1964	109.5	113.1	111.3	106.9
1965	115.8	118.6	117.1	112.3
1966	120.5	128.1	124.2	119.2
1967	125.3	140.8	132.8	126.6
1968	132.1	152.8	142.0	129.2
1969	139.2	164.5	151.4	136.0
1970	137.6	188.7	162.2	138.0
1971	145.3	210.4	176.6	146.4
1972	160.8	234.0	196.0	158.3

* Includes non-residential construction.

** Composite of Columns 1 and 2. Materials weighted 62.5 per cent and wage rates 37.5 per cent.

+ Adjusted by changes in profit margins and productivity for national accounts "Implicit Index for Business Gross Fixed Capital Formation".

Source: Statistics Canada, Prices and Price Indexes,
December 1972 and February 1973.

trades in the building industry, rose 120.9 per cent or at an annual average of 15.1 per cent. The Wage Rate Index is based on minimum rates given to workers on Federal Government construction contracts. Fringe benefit costs are not included and no adjustments are made to reflect the quantity and quality of work.

The Fixed Weight Index combines price indexes for materials used in building construction with price indexes based on wage rates in construction. The impact of changing profit margins and productivity are not reflected in the Index movements and for this reason, it is thought to have an upward bias as an indicator of price changes in building construction. Between 1964 and 1972 the Fixed Weight Index rose 84.7 per cent, for an average annual increase of 10.6 per cent.

The Implicit Index is the most useful one for this analysis. Like the Fixed Weight Index it is a composite of material price and wage rates but unlike the Fixed Weight Index, it accounts for changes in profit margins and productivity. It is the most realistic index available that traces price movements in building construction and will thus be the one used for the analysis of changing yields from apartment investment, that is presented later in this chapter. Between 1964 and 1972 the Implicit Index rose 51.4 per cent which is equal to an annual average of 6.4 per cent.

Construction costs, unlike land costs increased at a modest rate between 1964 and 1972. While rents rose at an average of 6.0 per cent per annum in Metropolitan Vancouver, construction costs rose 6.4 per cent and land costs climbed 19.6 to 22.6 per cent per annum.

Financing Costs

Since the 1964 to 1965 period mortgage rates have risen rapidly in Canada. This has been mainly due to economic expansion and increased consumer borrowing. Higher capital investment and increased consumption have had an inflationary effect on borrowing rates for all purposes, especially the financing of real property. Between 1964 and the peak year of 1970 prime conventional rates rose from 7.0 per cent to 10.5 per cent. After 1970, when the Federal Government changed its monetary policy to reduce economic expansion, rates fell by about 1.0 per cent.

Up until recently the majority of apartment financing has been conducted through the use of conventional mortgage loans.³⁴ Conversations with officials of some Vancouver lending institutions indicated that generally most soundly constructed apartment projects were able to obtain the prime conventional mortgage rate. It was also discovered that prime conventional rates in British Columbia differ only slightly from those prevailing in the rest of Canada.³⁵ Accordingly, Table 16 presents average prime conventional mortgage rates in Canada between 1964 and 1972 and also

Table 16

Interest Rates On Conventional Mortgage Loans*
In Canada, 1964-1972

<u>Year</u>	<u>Mortgage Rate</u> %	<u>Percentage Increase Of Mortgage Rates Per Period</u> %
1964	6.97	0.72
1965	7.02	9.12
1966	7.66	5.35
1967	8.07	12.40
1968	9.07	8.49
1969	9.84	6.20
1970	10.45	(9.76)
1971	9.43	(2.38)
1972	9.21*	

Average Annual Increase In Mortgage Rates is 3.77 per cent.

* Average of prime conventional mortgage interest rates.

Source: Central Mortgage and Housing Corporation, Canadian Housing Statistics, 1972, p. 62.

shows by how much these rates have increased from year to year.

Mortgage rates rose most dramatically between 1965 and 1966, 1967 and 1968 and 1968 and 1969, when rates increased 9.12, 12.40 and 8.49 per cent, respectively. Since 1970 lending rates have decreased by about 12.0 per cent. Between 1964 and 1972 prime conventional mortgage rates increased at an average of 3.77 per cent per annum.

Capital Costs, Financing Costs, Rents And Yields

If rents increase at a slower rate than construction, land and financing costs, then the yield that an investor can expect to obtain from apartment investment will be reduced assuming that the purchase price he pays reflects the increased capital costs.³⁶

In the preceding sections it has been assumed that construction costs have increased at the same rate regardless of location in Metropolitan Vancouver. This is also true for financing costs or interest rates.³⁷ Land costs and rents, in contrast, rise at different rates in different locations. Thus, although increased construction costs and increased financing costs will have similar effects on yields in any location, increases in land costs and rents, which differ from location to location, will have the effect of rendering some apartment districts more profitable than others, everything else being equal.

It is assumed in the following analysis that the yield obtained from an apartment investment is equal to total revenues minus interest charges on debt and divided by the capital cost of the investment. It is also assumed that the loan to value ratio has remained constant for new apartment buildings over time. With these assumptions the result of greater increases in capital costs and financing costs than in rents is that yields will decline.

Normally, to determine yield one must know what the operating expenses, depreciation charges, debt amortization, and investor's equity are for the investment. Since there has been a lack of suitable data to analyze how yields have actually changed over time for new apartment projects, it has been assumed that these factors do not have a role in determining yields. Thus, the definition of yield used in this analysis will only give an indication of how the profitabilities of apartment investment in the various areas of Metropolitan Vancouver have declined relative to one another.

Table 17 which is a summary of the findings of this section presents the average annual percentage increases in construction, land and financing costs and rents in eleven areas of Metropolitan Vancouver. To aid in the comparison of increases in capital costs with increases in rents, construction costs and land costs have been combined in Table 18 to produce an overall rate of increase for capital costs. The analysis of some of the more accurate construction and

Table 17

Average Annual Increases In Construction Costs, Financing Costs, Land Costs, And Rents In Selected Areas Of Metropolitan Vancouver, 1964-1972

<u>Area</u>	<u>Average Annual Increase In:</u>			
	<u>Construction</u>	<u>Financing</u>	<u>Land</u>	<u>Rents</u>
	<u>Costs</u> %	<u>Costs</u> %	<u>Costs</u> %	<u>Costs</u> %
Vancouver City				
West End*	6.4	3.77	14.4-27.6	5.1
South Granville	6.4	3.77	11.4-12.8	6.2
Kitsilano	6.4	3.77	9.2-14.5	7.5
Marpole	6.4	3.77	22.9-31.6	6.2
East Hastings	6.4	3.77	0.0-1.0	9.3
New Westminster	6.4	3.77	22.7-29.2	9.0
North Vancouver	6.4	3.77	42.7-50.0	8.4
West Vancouver*	6.4	3.77	9.9-20.3	5.6
Coquitlam	6.4	3.77	29.1-56.3	4.2
Richmond	6.4	3.77	35.0-45.0	1.4
Burnaby	6.4	3.77	18.8-20.4	9.6
Average	6.4	3.77	19.6-22.6	6.6

* The data is for highrise buildings only.

Table 18

Average Annual Increases In Capital Costs, Financing
Costs And Rents In Selected Areas Of
Metropolitan Vancouver, 1964-1972

<u>Area</u>	<u>Capital Costs⁺</u> %	<u>Financing Costs</u> %	<u>Rents</u> %
Vancouver City			
West End*	7.6-9.6	3.77	5.1
South Granville	7.7-8.0	3.77	6.2
Kitsilano	7.1-8.4	3.77	7.5
Marpole	10.5-12.7	3.77	6.2
East Hastings	4.8-5.1	3.77	9.3
New Westminster	9.0-10.0	3.77	9.0
North Vancouver	12.2-13.4	3.77	8.4
West Vancouver*	6.9-8.3	3.77	5.6
Coquitlam	10.0-13.4	3.77	4.2
Richmond	11.0-12.6	3.77	1.4
Burnaby	8.4-8.6	3.77	9.6

⁺ For an explanation of how capital cost increases are computed see accompanying text.

* The data is for highrise buildings only.

land cost data supplied by various developers and contractors indicates that for apartment blocks constructed in 1964, the land component as a percentage of total cost was approximately 25.0 per cent within Vancouver City for frame apartment buildings; for highrise blocks, land made up about 15.0 per cent of total cost. In the suburban municipalities in 1964 the land cost represented about 16.0 per cent of total costs for frame dwellings and about 14.0 per cent for the concrete ones in West Vancouver. Using these weights for land costs and construction costs, it is possible to determine by how much overall capital costs of apartment properties increased annually between 1964 and 1972.

From Table 18 it would appear that Richmond apartment blocks which had cost increases of 11.0 to 12.6 per cent and rent increases of 1.4 per cent annually have suffered from the greatest erosions of yield on investment of all the areas studied. Richmond was followed closely by Coquitlam as one of the more unprofitable areas. In Coquitlam capital costs rose at an annual average of 10.0 to 13.4 per cent, while rents only rose 4.2 per cent between 1964 and 1972. Apartment buildings coming into operation in Richmond and Coquitlam during the late sixties and early seventies would be considerably less profitable than their counterparts commencing operation in the early sixties.

Marpole and North Vancouver had similar increases in capital costs as Richmond and Coquitlam, but fairly high

annual increases in rents of 6.2 and 8.4 per cent, respectively, served to reduce the erosion of yields to some extent.

In the West End, West Vancouver and South Granville intermediate annual increases in capital costs of 7.6 to 9.6 per cent, 6.9 to 8.3 per cent and 7.7 to 8.0 per cent, respectively, helped to make these areas relatively more profitable than some others. However, the annual rent increases were not high enough to offset the higher capital cost increases and thus a small loss in profitability probably occurred.

The high annual rent increases of 7.5 per cent in Kitsilano, 9.0 per cent in New Westminster and 9.6 per cent in Burnaby helped to maintain yields from apartment investment in these areas at a fairly stable level.

East Hastings is the only apartment district in Metropolitan Vancouver which may have experienced an increase in yields through the 1964 to 1972 period. This is because the annual increases in capital costs were lower than the annual increases in rents, 4.8 to 5.1 per cent as opposed to 9.3 per cent.

In Metropolitan Vancouver between 1964 and 1972 it appeared as though the yields from new apartment investment have been steadily declining, as evidenced by greater increases in capital costs and financing costs than in rents. This is believed to be one of the major reasons why the number of apartment starts for rental have declined since

1969. To support this conclusion, it would be worthwhile to attempt an in-depth study of yields from actual apartment projects constructed over the 1964 to 1972 time period. For this author that study was not possible owing to the limited amount of suitable data that could be obtained.

Summary and Conclusions

Average annual increases in rents, construction costs, land costs and financing costs were calculated for the 1964 to 1972 period in selected areas of Metropolitan Vancouver. Comparisons of rent increases with cost increases indicated that in most areas of Metro yields on new apartment investment have been declining since 1964. Yields have been declining because rent levels have not been keeping pace with the costs of apartment investment. The areas apparently suffering the greatest declines in yields were the suburban municipalities of Richmond and Coquitlam. East Hastings was the only area studied where yields may have increased since 1964.

Reduced yields from apartment investment are thought to be one of the major reasons why new apartment construction for rental purposes has been declining over the last three years; another major reason, the changes in the Federal Income Tax Act, will be studied in the next chapter.

CHAPTER IV

The Impact Of The New Federal Income Tax Act
On The Residential Rental Market

Since January 1, 1972 when the new Federal Income Tax Act was introduced into law, the whole character of the real estate market has been changed. This chapter proposes firstly, to outline and compare the more important amendments brought in by the new Act, which affect real estate transactions, with those regulations that applied under the old Act. The second goal of the chapter is to analyze the effects that the new income tax regulations are having, or will have on investment in residential rental property.

The New Tax Regulations As They
Affect Real Estate Transactions

The new Income Tax Act introduced two major amendments affecting capital cost allowances (C.C.A.) on real estate which destroyed most of the advantages that many doctors, lawyers and other individuals with high professional incomes had obtained from investing in real estate. These amendments are:³⁸

1. Losses created by capital cost allowance on rental property cannot be deducted from non-rental income.
2. Each rental building costing \$50,000 or more must be placed in a separate capital cost allowance class.

The first amendment ends the practice used by many individual investors whereby a property producing a positive cash

flow but a tax loss (through deducting C.C.A.) was purchased so that the loss could be used to reduce non-rental income and thus taxes paid. An example will help clarify this point:

Suppose an investor owns a concrete apartment building with an undepreciated capital cost of \$100,000, an annual gross income of \$20,000 and expenses of \$17,000. The tax treatment under the old and new legislation is:

	Old System	New System
Rental Income	\$20,000	\$20,000
Expenses	17,000	17,000
C.C.A. (5%)	<u>5,000</u>	<u>5,000</u>
Taxable Income	\$(2,000)	NIL

Under the old Act the investor could apply the \$2,000 loss to other income thus reducing his tax. The new Act only allows the capital cost allowance claim to be used to the extent that it reduces rental income to zero.

Where an investor owns more than one rental property, any unclaimed C.C.A. on one property may be transferred over to another property to reduce that property's rental income. If there is an overall loss from all rental properties, the loss cannot be deducted from other income but must be capitalized in effect, by reducing the claim for C.C.A.

Corporations, whose principal business involves the rental, development or sale of real estate, can use losses

created by deducting C.C.A. from rental income to reduce other income from operations that do not involve the rental of real estate.

The second amendment to the Income Tax Act, which applies to both corporate and individual investors, is that "pooling" of properties in the same depreciation class is no longer allowed. Each building acquired after 1971 and worth \$50,000 or more must be put in a separate depreciation class for tax purposes. This means that the recapture of depreciation can no longer be postponed. Under the old tax system recapture of depreciation could be postponed indefinitely by "pooling". For example, suppose an investor sold an apartment block for \$50,000 more than the undepreciated capital cost. If, within the same taxation year, he purchased another building in the same depreciation class for \$150,000, he could apply the excess depreciation of \$50,000 to the new building and thus reduce its undepreciated capital cost to \$100,000, thus postponing repayment of the tax on recapture. If the investor continued this practice of "pooling" throughout his lifetime, then he and his estate could avoid all recapture of depreciation because the old Act allowed property to pass to heirs at fair market value with no recapture.

The new Act provides that where a property is sold, the amount by which the selling price exceeds depreciation deducted up to the original cost is brought into income. This

is called recapture of depreciation and is fully taxable. Suppose, for example, an investor purchased an improvement at a capital cost of \$100,000 which is depreciated to \$75,000 by the time of sale. If the selling price is \$100,000, then the recapture of depreciation will be \$25,000 and will be taxable at full rates.

Another major amendment to the Income Tax Act is that capital gains received on the disposition of property will be subject to taxation after December 31, 1971 (V-Day). A capital gain is defined as the excess of proceeds over the greater of original capital cost of the property or V-Day value. Capital gains which accrued before December 31, 1971 go untaxed. Capital gains are taxed at half the normal rate.

To illustrate how the new tax rules concerning capital gains and recovery of depreciation function, consider the case of an investor who purchases an improvement valued at \$100,000 in 1972 and which he depreciates to \$75,000 before selling for \$125,000.

	Old System	New System
Capital Cost	\$100,000	\$100,000
Undepreciated Capital Cost	<u>75,000</u>	<u>75,000</u>
Recovery of Depreciation	\$25,000	\$25,000
Taxable Amount Due to Recovery of Depreciation	---	\$25,000
Selling Price	\$125,000	\$125,000
Original Cost	<u>100,000</u>	<u>100,000</u>
Capital Gain	\$25,000	\$25,000
Taxable Amount Due to Capital Gain	---	\$12,500

Although capital gains are taxable, there are few opportunities to obtain capital losses except perhaps on the sale of undeveloped land. Under the terms of the new Act capital losses are not available on the disposition of depreciable property. In order to obtain a deductible loss from the sale of depreciable property, there must be a "terminal" loss. A terminal loss arises when a depreciable asset is sold for an amount less than its undepreciated capital cost. For the individual investor a terminal loss on one property is first applied to capital gains realized on other properties sold within the same taxation year; half of any loss remaining thereafter is deductible from other income to a maximum amount of \$1,000 per taxation year. Any residual loss remaining, after deducting the maximum amount from other income, can be carried back one year or forward indefinitely until used up. Under the old Act terminal losses were not deductible. A corporation can deduct all terminal losses accrued from other income within the taxation year.

The capital gains tax rate only exists for those individuals and corporations who are not considered to be "traders" in the field. Where an individual or company's activity involves the frequent buying and selling of real property, capital gains are taxed at full rates.

The new Income Tax Act has provided two methods for determining capital gains on disposition of assets, either method may be used by the individual but the corporation

must use the second method. The two alternatives are:

1. The election method. The capital gain is the excess of net proceeds of disposition over V-Day value.
2. The tax free zone method. The capital gain is the excess of net proceeds over a certain amount. This certain amount is the middle value of original cost, V-Day value and net sale proceeds.

As a general rule, if assets are worth more on V-Day than they cost, then the election method should be used. In these circumstances an investor would not be paying more tax than if he had used the tax free zone method and may pay less if the value of the investment falls after V-Day. If assets are worth less on V-Day than the original cost, then the tax free zone method should be used. Otherwise the investor will pay tax on any gains in value achieved after V-Day.

The new Act prevents end-of-the-year tax selling which often occurs in the United States. In order to avoid "superficial" losses, it is impossible to sell assets at the end of a taxation year which have fallen in value to record the loss for tax purposes and immediately thereafter buy them back again at the beginning of the next taxation year. There must be a thirty day time lapse between the selling of an asset and re-buying it.³⁹

There are special rules in the new Income Tax Act for determining proceeds of disposition of investments where the

investor dies; gives the property as a gift; sells in a non-arms length transaction; where the property is destroyed or expropriated; and where the property is taken out of an income-producing use. The rules for deemed dispositions are adequately explained in several publications,⁴⁰ and so, except for deemed dispositions that occur on the taxpayer's death, will not be dealt with here.

Under the old Act when the taxpayer died, depreciable property passed to the heirs without recapture of depreciation. The heir received the property at fair market value and could start depreciating from that value. If, as was frequently the case, fair market value was substantially higher than undepreciated capital cost, this gave the heir an attractive "step up" in capital cost. The regulations in the new Act now allow for recapture of depreciation and capital gains taxation when the death of the taxpayer occurs. The estate of the deceased is considered to have sold the property at an amount halfway between undepreciated capital cost and fair market value at time of death. The beneficiary is considered to have acquired the property at the same amount. If the sale-purchase price arrived at by this method is less than the deceased originally paid for the property, the beneficiary's original cost is the same as the deceased's. The difference between the two amounts is treated as though it were C.C.A. claimed by the new owner in previous years. The capital gain is considered to be the

difference between the deemed proceeds and the original cost. Where the property is willed to the deceased's spouse, a tax-free rollover occurs.

To ease the effect of double taxation which the new Income Tax Act and provincial death taxes create, it is thought that recapture of depreciation and capital gains tax will be subtracted from the net value of the properties before computations are made for provincial death taxes.⁴¹

Before leaving this section it might be suitable to discuss the tax status of small private companies set up by individuals to hold their real estate. The new low rate of 25 per cent for small Canadian-controlled private corporations applies only to income received from an "active business" and only on the first \$50,000 of active business income earned each year, until the aggregate exceeds \$400,000. Otherwise, income is taxed at the basic corporate rate of 50 per cent in 1972. Although the Act contains no definition of "active business", it appears from the National Revenue's Interpretation Bulletin IT-72⁴² that rental income would not likely qualify as coming from an active business unless it was a hotel-type of business.

A private Canadian corporation, taxed at the 50 per cent rate on all non-active business income and property income, will receive a refund of tax equal to half the amount of income paid out to the shareholders as dividends. Where the tax rate of the shareholders is less than 50 per cent, the

greater tax saving can be achieved by holding the real estate directly as an individual. If the shareholder's tax rate is greater than 50 per cent, more tax can be saved by holding the real estate through a privately owned corporation. These points are illustrated by the following example which compares the tax treatments for corporations and individuals at different rates.

	<u>Tax Rate of Individual</u>		
	<u>40%</u>	<u>50%</u>	<u>60%</u>
<u>Property held directly by individual:</u>			
Net income from property	\$40,000	\$40,000	\$40,000
Tax payable	<u>16,000</u>	<u>20,000</u>	<u>24,000</u>
After-tax income	\$24,000	\$20,000	\$16,000
<u>Property held through corporation:</u>			
Net income from property	\$40,000	\$40,000	\$40,000
Tax payable (50%)	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>
After-tax income	\$20,000	\$20,000	\$20,000
Dividends paid to shareholders	\$20,000	\$20,000	\$20,000
Tax refund to corporation (50%)	\$10,000	\$10,000	\$10,000
Dividends received by shareholder	\$20,000	\$20,000	\$20,000
Tax payable	<u>8,000</u>	<u>10,000</u>	<u>12,000</u>
After-tax income	\$12,000	\$10,000	\$8,000
Income retained by corporation	\$10,000	\$10,000	\$10,000
Income retained by shareholder	<u>12,000</u>	<u>10,000</u>	<u>8,000</u>
Total after-tax income retained by corporation & shareholder	\$22,000	\$20,000	\$18,000
Advantage in holding property directly through individual	\$2,000	---	\$(2,000)

The individual investor must be wary of holding real estate through a corporation because of the risk of double-taxation of capital gains after his death. If the property has increased in value, the value of the deceased's shares in

the corporation will have increased too and will be deemed to be disposed of on his death. His estate must pay tax on half of the gain accrued by his shares. Ultimately, when the corporation disposes of the real estate, it will also be subject to a tax on the capital gain accrued by the property. The new Act provides for relief from this double taxation if the estate sells the corporation's assets within twelve months of the individual's death. The stripping of the corporate assets will effectively reduce the value of the shares to zero. The Act provides that the capital loss that is sustained when the worthless shares are disposed of, can be offset against the capital gain that is deemed to be realized by the deceased's estate at time of death.⁴³ Such action requires that the executors of the estate must be able to act speedily.

Another disadvantage of holding real estate through a corporation is that when the shareholder dies, his estate loses the advantage of the deemed realization rule which applies to depreciable property, whereby the assets are deemed to be disposed of at an undepreciated capital cost plus half the difference between that and fair market value. His estate will be deemed to have disposed of his shares at full market value.

The Impact of the Income Tax Act on
Investment in Residential Rental Property

Of the major amendments to the Income Tax Act, the loss of the tax shelter which allowed rental losses to be deducted from other income and the introduction of separate C.C.A. classes for each apartment building will have the greatest impact in re-shaping the investment nature of the residential rental field.

Throughout the 1960's much of the tremendous growth in apartment starts was due to the influx of investment funds into the market from doctors, lawyers and others with high professional incomes. Their interest in acquiring residential rental property was not so much to increase their total income but rather to achieve paper losses from C.C.A.'s which could be applied to their other income and so shelter part or all of it from taxation. These investors cared less about the economics of apartment investment and more about the tax savings they could obtain. They wanted investments which produced a positive cash flow and a loss for tax purposes. This type of investment was usually a small- to medium-sized frame apartment block. Frame properties with a maximum C.C.A. of 10 per cent were more desirable than concrete ones which only have a maximum C.C.A. of 5 per cent.

Because professional men who invested in apartment properties were willing to take a lower than normal rate of return and were desirous to obtain a tax shelter, they purchased apartment blocks at a higher price than that justified

by yield and rented them at lower rates than normal, since they were usually only concerned with meeting mortgage payments and expenses.

Now that the new tax regulations are in effect and the tax shelter no longer exists, apartment buildings have to sell strictly on the basis of yield as investments. With the present level of rents it is no longer attractive to build such apartments if they have to be sold on a yield basis. This is quite apparent from the number of multi-family completions constructed in Metropolitan Vancouver since 1969. This opinion was borne out by interviews with two of Vancouver's leading developers.⁴⁴ In the past these developers have built many frame apartment buildings which were immediately sold at high prices to professionals as tax shelters. However, they are now finding that with the removal of the tax shelter that they cannot sell buildings for as high a price, nor can they rent them out at economical rents because of the higher capital and financing costs and thus, they have ceased to develop apartments for the rental field. This reduction in construction has checked the trend of rising land prices to some extent (Table 13).

As the shortage of rental units increases, it is expected that rents will increase until apartment values and yields are restored to an economic level; only then will construction resume in rental accommodation. When this happens, it is expected that the trend will be towards larger projects

of concrete construction which are more economical to run.⁴⁵ These apartment investments will probably be retained by larger real estate companies rather than sold to individual investors. This is because corporations receive a more favourable tax treatment under the new regulations than individuals.

To demonstrate how the capital gains tax and the regulations governing capital cost allowances can affect the return from apartment investment consider the following example.

Assume the following conditions:

1. Original cost of apartment block

Land	\$100,000
Improvements	<u>\$1,000,000</u>
Total	\$1,100,000
2. Original mortgage \$700,000 for 25 years at 10.0%.
3. Original equity \$400,000.
4. Capital cost allowance 5.0%.
5. Property sold at end of the 5th year for \$1,600,000.
6. Outstanding mortgage at the end of the 5th year is \$667,064.
7. Assumed tax rate for the investor 50.0%.
8. The investor has other professional income in excess of the loss on the property.
9. Funds are assumed to be reinvested in a similar property in year of the sale.

The tax and net cash flow calculations are shown below:

<u>Tax Calculation</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Net operating income	\$85,000	\$85,000	\$85,000	\$85,000	\$85,000
Less interest on mortgage	71,750	71,200	70,593	69,924	69,187
Less C.C.A.	50,000	47,500	45,125	42,869	40,725
Taxable income	\$(36,750)	\$(33,700)	\$(30,718)	\$(27,055)	\$(24,912)
Tax saving (50%)	\$18,375	\$16,850	\$15,359	\$13,528	\$12,456
<u>Net Cash Flow Calculation</u>					
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Net operating income	\$85,000	\$85,000	\$85,000	\$85,000	\$85,000
Less principal and interest	77,118	77,118	77,118	77,118	77,118
Cash flow	\$7,882	\$7,882	\$7,882	\$7,882	\$7,882
Plus tax saving	18,375	16,850	15,359	13,528	12,456
Net cash flow	\$26,257	\$24,732	\$23,241	\$21,410	\$20,338

Rates of return:

1. Rate of return for 5 years under old tax regulations:

Annual net cash flow - see above
 Residual cash value: Sales Price \$1,600,000
 Outstanding mortgage 667,064
 Available to re-invest \$932,936

Average rate of return on equity including capital gain 29.5%

2. Rate of return for 5 years under new tax regulations:

Annual net cash flow - \$7,882*
 Residual cash value: Sales price \$1,600,000
 Outstanding mortgage 667,064
 Tax on capital gain 125,000
 Tax on recovery of C.C.A. 36,173
 Available to re-invest \$771,763

Average rate of return on equity including capital gain 18.1%

* No tax saving.

The result of the new regulations has been a reduction in the returns on apartment investment. In this example, the average rate of return on equity has been reduced from the 29.5 per cent that could be obtained under the old tax legislation to 18.1 per cent under the new regulations. To regain the return on equity that was possible under the old legislation, either rents will have to increase, or equity (selling price) will have to decrease.

A further effect of the new legislation is that it may reduce the liquidity of the capital markets. Consider the case of an investor, with a 50 per cent marginal tax rate, who owns an improvement costing \$200,000. At the time he wishes to sell the improvement, he has an outstanding mortgage of \$150,000, equity of \$50,000 and has depreciated the building to \$160,000. If the investor sells the property for \$210,000, he will receive net proceeds, after taxation of capital gains and recovery of depreciation, of \$37,500. This is less than the equity of \$50,000 which he had established in the property. Thus, if he sold his property at the stage described, the investor would see an erosion of his capital through taxation.

The new tax laws raise a new problem for the investor. He now not only has to worry about a return "on" his capital but also a return "of" the sum invested. The first is a payment of interest or yield and the second is a repayment of his equity. If and when the equity is returned and it is

reduced in value measured in constant dollars through inflation and taxation, then part of the yield must be set aside as a sinking fund to make up the difference so that, at term, the capital sum is constant. The residual, after allowance for the sinking fund, is the true yield. Thus, the new Income Tax Act may not only reduce yields by taxing the income stream but also by taxing the capital as well.

The overall effects of the amendments to the Income Tax Act are thus, a decrease in construction of rental units and a reduced mobility of capital within the market. Construction has been reduced because those with professional incomes no longer find it advantageous to invest in apartments and because landlords are finding that an economical return cannot be obtained from renting. The dangers of the taxation of capital has or will result in a decrease in apartment sales and a freezing of investments within the market.

The combined effects of the tax changes, plus the rapid increase in capital costs seen in the previous chapter, indicate that rents will have to climb fairly steeply to return the investment in rental housing to an economical footing. In the meantime developers are turning away from the rental market to the development of condominiums, commercial and office space where the profits are considerably greater than in rental housing.

Summary and Conclusions

This chapter was the second to consider factors affecting the reduced construction of rental housing in Metropolitan Vancouver since 1969. A general outline of the new Income Tax Act was presented and a brief discussion of the effects of the new regulations on apartment investment was conducted. It was concluded that the new Act will force professionals out of the rental field because of the loss of the tax shelter. In addition, yields may be reduced due to taxation of capital gains and recovery of depreciation. The reduction in yields caused by taxation, combined with increased capital and financing costs, will keep additional supplies of rental units at a low level until rents increase to a point high enough to produce economic returns.

The following chapter considers the municipal bureaucracy and costs involved in the processing of applications for apartment projects. This aspect is being deliberated because it is felt that bureaucracy and the costs involved have been partly responsible for discouraging developers from supplying new apartment rental units.

CHAPTER V

The Processing of Apartment Development Permits
by Municipal Authorities

In recent years much criticism has been levelled at municipal authorities for the time delays and red tape involved in processing the plans and documents that are required prior to the granting of development permits. In addition, the increasing popularity of land use contracts with their necessary public hearings has left the feasibility of many apartment projects to the whims of the public and their elected representatives. These factors have had the effect of discouraging apartment development, especially since they are one of the less desirable real estate investments.

The purpose of this chapter is to examine the procedures used in several municipalities for processing development applications to determine the extent of the bureaucracy involved and the time required to complete processing. It is hoped that this methodology will throw light on ways processing can be speeded up and so reduce the costs that developers have while holding land awaiting for municipal approval to construct. These costs include optioning land, interim financing and future higher construction costs.

Besides the costs associated with delays created at the municipal level, developers also have to pay directly to the municipality monies for processing documents, impost charges

and other levies imposed by municipal authorities. In some municipalities these costs have been approaching astronomical levels in recent years. An outline of the charges in three municipalities will also be included in this discussion.

The District of Surrey and the Cities of Vancouver and North Vancouver were selected for examination in the above context. These areas were chosen because in the past few years almost 50 per cent of all apartment completions have taken place within their boundaries and thus, their policies regarding apartment development will have a significant impact on the whole residential rental field.

North Vancouver--Outright Use⁴⁶

North Vancouver City's procedure for processing plans for building permits is probably the most efficient of the three areas studied.

Until fairly recently all developments were carried out under existing zoning and building by-laws but in June, 1972 Council passed a resolution which provided that all developments costing \$600,000 or more or occupying more than one acre of land would only be given approval via the use of land use contracts.⁴⁷ The procedures for obtaining land use contracts will be examined later, firstly, the processing of building permit applications under existing by-laws will be inspected.

Before making an official application for a building permit,⁴⁸ a developer may elect to submit preliminary drawings

to the City officials for examination to check if they are in accordance with existing zoning by-laws. This is a good procedure because if the use proposed fails to meet the by-law standards, the plan can be rejected before any expensive detailed site drawings are prepared and before any monies are expended for processing.

To make an official application for a building permit, the applicant must first request, in writing, building grades and services information from the City Engineering Department. He then must submit two complete building plans plus three site and drainage plans and fill out a building permit application. The site and drainage plans must show all building grades and distances involved and the location and grades of all existing and proposed service lines and the direction of flow.

Once these plans have been filed, a quick review is made by the City officials to see if they are adequate. The applicant is notified at this time if they are not. At the time of application two copies of the site and drainage plans are passed to the City Engineering Department.

The plans are checked for compliance with the building, zoning and plumbing regulations by the Building Inspector and a list is made of by-law infractions. The Engineering Department also lists any by-law infractions they detect and pass these along to the Building Inspector. All infractions are brought to the attention of the developer. The process is repeated until all plans are completely corrected.

Once these approvals have been obtained, the City Engineering Department keeps one copy of the site and drainage plans and returns the others to the Building Inspector, who returns one plan to the applicant and gives the other to the Plumbing Inspector.

After all plans are found to have complied with the relevant by-laws, the Fire Warden is asked to examine them to see if they meet fire safety regulations. If the plans are in order, he signs them, if not the developer is asked to rectify the fault.

Where any City streets or lanes must be occupied during construction, a Street Occupancy Permit is needed. Permits are also needed for plumbing, electrical, sewer, water and swimming pool connections.

Once all these conditions have been met and all approvals obtained, the building permit is issued. Normally all the processing required to issue a building permit will take two to three weeks if all plans and drawings are in order. Where the plans are not correct, the processing, of course, is longer; it pays in time and money for the developer to ensure that the plans submitted are correct. Occasionally, during busy construction periods, processing may take a couple of weeks longer than normal.

As was mentioned, the City of North Vancouver's processing procedures for development plans are the most efficient of any municipality studied. The efficiencies appear to be due

to the fact that the Building Department and the City Engineering Department, the two departments where the majority of processing occurs, examine and process the plans simultaneously. Further, the lack of a Planning Department reduces the amount of processing to be done. In other municipalities (see the City of Vancouver below) processing is done in a chain-type manner, that is, through one department and on to the next. This is an inferior system because it takes much longer to advance through approval stages one department at a time than to advance on a broad front through several departments simultaneously. Where municipal departments suggest modifications or changes in the proposed development, it is easier to evaluate them when all departments are working on the development at the same time and are thus aware of the nature of the development proposed, than where one department in a chain-type process suggests changes to the plans and has to refer them back through those departments that have already completed processing.

In North Vancouver the Building Inspector is responsible for the overall supervision of processing in all departments. He is aware of all problems in the development plans and is thus able to communicate the problems to the developer and the municipal departments concerned in an effective manner.

Fees in the City of North Vancouver for processing and building permits are fairly reasonable. The processing fee, which is non-refundable, is 50 per cent of the Building Permit

Fee up to a maximum of \$50.00.⁴⁹ The Building Permit Fees, which are payable only if the building permit is granted, are based on the value of works to be constructed. The fee schedule is:⁵⁰

When the cost of works does not exceed \$1,000....	\$6.00
For each additional \$1,000 or part between \$1,000 and \$15,000.....	\$3.00
For each additional \$1,000 or part between \$15,000 and \$50,000.....	\$2.50
For each additional \$1,000 or part between \$50,000 and \$100,000.....	\$2.00
For each additional \$1,000 or part over \$100,000.....	\$1.50
Plus an additional inspection fee of \$50.00 per unit	

On a 35 suite apartment block costing \$315,000 the Building Permit Fee would be \$2,308.00. Nominal fees are also charged for Street Occupancy Permits and permits required for the connection of water, sewer, electricity, et cetera.

Any off-site works required by the development must be paid for by the developer. These include all service connections and any additional charges that may be levied for construction of off-site works. Normally any off-site construction is done by the City at cost and charged to the developer.

The impressions obtained of North Vancouver's processing procedures were that there was a minimum of red tape and that permission to commence construction was forthcoming within a reasonable time from the initial application date.

The fees charged were not excessive and probably represent fairly, the cost of the City's input required for processing and inspection. The procedure used in North Vancouver is one which could be better followed by other municipalities.

Land Use Contracts

One of the reasons why so many municipalities are turning to the application of land use contracts for development purposes, is that it is thought that major developments have a significant impact upon the community and consequently, the inhabitants should be allowed to express their views and opinions of any such developments. They have this opportunity at public hearings which must be held prior to the conclusion of any agreement between the municipality and the developer.

Land use contracts, although admirable in principle, do not work as well in practice. Often a development will be cancelled because a few political activists, with more power than their numbers justify, create strong opposition to the proposed use. It is not often that a broad spectrum of the community are represented at these hearings since usually only those who oppose the development will attend the public hearing.

Land use contracts also tend to greatly increase the costs involved in obtaining municipal approval for construction. The developer faces costs of presentations of the proposed development to the public; costs of holding land;

costs of interim financing; future higher construction costs attributed to the much longer period of time required for municipal approval; costs of concessions to the municipality, such as deeding of recreational land, expansion or provision of public facilities, et cetera; and legal costs attributed to the drawing up of the actual contract. These factors are partly responsible for reducing the desirability of development from an entrepreneurial viewpoint, especially in apartment development where the gains are limited.

From the developer's point of view land use contracts are very costly, somewhat of a gamble and should not be entered into unless there is a considerable gain to be made. For apartment rental units this gain does not exist. The costs associated with land use contracts can run into the hundreds of thousand dollars, especially where land must be deeded to the municipality. The gamble is great because there is a substantial possibility that the proposal will be rejected at some point along the approval process or that the concessions the Council requires will be too burdensome to allow for an economic development. This gamble is increasingly being recognized by developers; where the outright purchase of a site was once the common method, options are now sought as an insurance against project rejection.

North Vancouver--Land Use Contracts⁵¹

In the City of North Vancouver developments costing \$600,000 or more or occupying more than one acre require employment of a land use contract. To obtain a contract, an application outlining the type and size of development must be submitted to the City Clerk, the Planning Consultant and the Advisory Planning Commission. These bodies study the application and report their recommendations to Council. If Council accepts the application, it authorizes the preparation of a land use contract and designates the site as a development area.

The Planning Consultant obtains comments from the City staff, especially the Engineering and Building Departments, and draws up the contract based on these comments and those of the Advisory Planning Commission and Council. He negotiates with the developer to arrive at an acceptable contract and development plan. If during this process major changes to the development are made, they must be re-submitted to the various advisory groups for approval. The draft contract is then submitted to Council for review. A date is set for a public hearing if Council accepts the application. No public hearing is held if the Council rejects the application. If the public hearing is favourable to the development, Council signs the contract and has it registered in the Land Registry Office. The developer now follows the normal procedure for obtaining a building permit.

The time taken from the date of initial application until final approval can vary between two months to a year or longer. This is because of all the additional bodies and boards that must be consulted prior to entering into the contract. In addition, the absence of guide-lines to aid in the preparation of the contract leaves much room for negotiation which can take a considerable period of time.

Since Council and the various advisory bodies have other tasks besides reviewing new development proposals, they often do not have the time to study a proposed land use contract in a continuous fashion through its formulation. This results in long delays before overall approval is obtained.

The costs to the developer of developing through the medium of land use contracts have already been pointed out in a generalized form in the previous section. The specific costs he must bear in North Vancouver are the application fee and the Building Permit Fee. The application fee is \$300 for developments on sites up to one acre and an additional \$100 per acre or part above one acre.⁵² The Building Permit Fee is the same as that outlined for outright uses.

In North Vancouver it would greatly aid the developer if guidelines could be established which indicated the probable terms and conditions which would be incorporated in a land use contract. In this way, before the developer finalized a development scheme, he would have some idea of the costs involved in obtaining a land use contract. In addition,

time limits should be set up within which the various advisory bodies must make their recommendations.

To give the community a voice in the approval of proposed developments, there seems to be no other way than through a public hearing. Council, however, should be on the lookout for those groups who have a greater influence than that justified by their numbers and ensure that no segment of the community is over-represented.

City of Vancouver⁵³

In Vancouver land use contracts are not used, however, a special type of zoning, called Comprehensive Development Zoning, serves the same purpose. Since this zoning is rarely used for apartment developments, it need not be considered. Only the procedures for processing apartment development plans that meet existing zoning by-laws will be referred to.

To apply for building and development permits in Vancouver, site plans, elevation plans, floor plans and roof plans must be submitted in triplicate to the Building Department. This Department checks for completeness of the plans. The plans are then sent to the Engineering Department. This Department examines the plans as they affect sewers, water, street crossings, air pollution control and highways. If the Department approves them, they are returned to the Building Department. Generally approval takes two to three weeks but can be much longer.

The Building Department re-routes the plans to the Planning Department where it is ensured that the proposed development is not in an area required for schools, parks or highways or is under consideration for rezoning, re-subdividing or re-development. If in such an area the plans are left for clearance. In some cases where matters of design of the structure are involved, the plans are referred to the advisory Design Panel for approval. Otherwise, the Planning Department approves the plans. This stage of the processing procedure may take between two days and several weeks.

Once Planning Department approval is obtained, the plans return to the Building Department where they are checked in detail for compliance with the Zoning and Development By-Law and with the various building by-laws. This may take from one hour to several weeks. In the majority of cases, the plans do not wholly comply with the by-laws and the developer is required to alter them. Considerable time is spent in explaining and discussing the various items and also in checking any amendments to the plans.

When the plans are approved by all the departments concerned, the building and development permits are issued.

Where a proposed use does not and cannot meet existing building and zoning and development by-laws, the plans are referred to the Technical Planning Board for approval. The Technical Planning Board may refuse approval if the development will create a traffic hazard; be injurious to amenity;

cannot be properly drained; or does not conform to an amendment to the Zoning and Development By-Law which is under consideration by Council. If Technical Planning Board approval is needed, a further two weeks of processing is added.

In Vancouver the processing and building permit fees are quite nominal. To have development plans for an apartment use processed, a non-refundable fee of \$18 on the first 5,000 square feet of gross floor area to be constructed is charged. \$1.50 for each additional 1,000 square feet is added until the maximum processing fee of \$300 is reached.⁵⁴ The Building Permit Fee is \$160 per \$100,000 of works to be constructed.⁵⁵ Any off-site works that the developer requires will be constructed by the City at the expense of the developer.

In Vancouver processing can take a few days or several months, often the latter. The time necessary to approve a set of development plans and issue a building permit, is generally longer in Vancouver than in North Vancouver. The reason for this appears to be in the different organizational structure of the departments involved in processing in the two cities. Plans are processed in Vancouver in a chain-type manner; when one department has studied and approved the plans, they are passed along to the next department, never does more than one department work on the plans at any one time. This means that the speed at which plans move through a department is very much dependent on the staff of that department.

Even assuming that a chain-type processing procedure is the most efficient, it would seem that the order in which departments study plans is inefficient. Before it is even known if the proposed use would comply with building and zoning and development by-laws, a relatively simple thing to confirm, the Engineering Department has to process the plans. This Department has to study the plans in considerable detail to determine if such things as the location of sewer and water lines are correct. This takes a lengthy period of time and it is completely wasted if it is subsequently found that the proposed use does not comply with the relevant by-laws. The proposal would then have to be re-designed and the Engineering Department would have to re-examine the amended plans. It would be more logical and efficient if departments such as Planning and Building who have a more general and less time-consuming function in the processing procedure were to examine the plans initially. In this way Engineering's time would not be wasted in examining plans that don't meet zoning requirements.

District of Surrey⁵⁶

In June, 1973 the District of Surrey adopted a new municipal development policy which requires that all apartment developments be carried out under the terms of a land use contract. As has been mentioned, a considerable period of time is needed to approve land use contract applications, with the result that the developer's costs increase

significantly. The processing procedure in the District of Surrey varies little from that found in North Vancouver and so only a general outline of it will be given. The main reason for including a study of Surrey is that their new development policy specifies exactly what the terms of any land use contract for apartment development will be. The terms are heavily biased in favour of the District and increase the cost of development considerably.

To apply for a land use contract in Surrey the developer must fill out an application and include:

1. a sketch showing the location and use of all buildings on the property and approximate location and use of the nearest buildings on adjacent land;
2. a perspective drawing indicating landscaping and the general appearance of buildings, parking lots, et cetera; and
3. a brief description of the project with an indication of the number and mixture of suites, and an outline of the amenities provided.

The application and plans must be submitted 16 days prior to the meeting of the Advisory Planning Commission, to be considered at that meeting. The Advisory Planning Commission studies the plans for the proposed development and makes recommendations to Council. Council may or may not decide to hold a public hearing depending on whether they reject the proposal immediately or decide to let the community express its views. The development cannot be granted permission to proceed without a public hearing. As a result

of this public hearing Council may or may not decide to pass the necessary by-law.

If approval in principle is given by Council after the public hearing, plans must then be submitted for examination to the Planning Department and the Advisory Design Panel. Once the development plans are approved, based on Council policy and by-law requirements, engineering design drawings are submitted to the Engineering and Building Departments for study and approval. Once this is done development can proceed.

The District of Surrey's municipal development policy, which became effective in June, 1973, states that the following impost charges will be an integral part of any land use contract:

1. \$650 for each apartment unit constructed where the development abuts a roadway not constructed to municipal standards and where the developer does not improve the roadway to these standards;⁵⁷
2. \$200 for each apartment unit constructed for the upgrading of all municipal highways;⁵⁸
3. \$300 per apartment unit constructed for the improvement of municipal drainage facilities;⁵⁹
4. \$150 for each apartment unit constructed for the improvement of the waterworks system; and⁶⁰
5. \$1,295 per apartment unit constructed for the acquisition of lands for public use.⁶¹

The impost charges that a developer has to pay amount to \$2,595 per unit. In today's market the construction cost of building one unit in a frame apartment block varies between

\$8,000 and \$14,000;⁶² adding these impost charges to the cost would raise this level to between \$10,600 and \$16,600. This means that impost charges represent between 15.7 and 24.5 per cent of the total cost of development excluding land and financing costs. This is an enormous and unreasonable cost of development and it is expected that the charges will severely reduce the number of apartment units constructed in the District.

In addition to the impost charges, the developer is responsible for the installation of all water, and sanitary and storm sewers needed to connect his development to existing works.⁶³ He is also responsible for placing all existing and proposed utility wires underground both on roads abutting the development and on site.⁶⁴ On top of this, a charge of four per cent of the cost of all works excluding impost charges and the cost of placing utility wire underground, is extracted from the developer for administration, engineering, legal and inspection services.⁶⁵

The District of Surrey has surely helped to discourage apartment development for rental purposes, as much as the increases in capital costs and financing costs and the changes to the Income Tax Act. The charges it has decided to impose on developers must seriously reduce the attractiveness of investment in that area. Developers should be charged certain costs for improving municipal services since their developments are the partial cause of the need for

such improvements, but to levy charges to the extent that the District of Surrey has determined, must be looked upon as an excessive use of their delegated powers.

Summary and Conclusions

It has been demonstrated in previous chapters that the changes in the Income Tax Act and the higher costs of construction, land and financing have reduced the desirability of apartment investment. This chapter continues the inquiry into those factors which are causing reduced levels of construction of rental units. The factors examined in this case are the delays encountered at the municipal level in processing proposed development plans and the costs of such delays. Municipal levies on proposed developments are also considered as a factor in discouraging development of apartments. Ways are examined by which municipal processing time can be lessened.

It was discovered that the processing procedures in the City of North Vancouver were the most efficient. This was because all the municipal departments involved in the approval process simultaneously received the plans to determine if they were appropriate. In Vancouver the processing was carried out in a chain-type manner; plans were received by one department and when approved were passed to the next. This took a considerably longer period of time than where the plans were received by all the concerned departments at once.

Where land use contracts were used, the processing procedure was much more complicated and time consuming and the costs of such contracts to the developer were much greater. It is advised that developers do their utmost to avoid land use contracts because they are more expensive in time and money and are more uncertain than an outright approval procedure.

The District of Surrey has laid down policies which will give it the maximum advantage in the negotiation of land use contracts. The costs of contracts to the developer are so great that it is expected that apartment development will all but cease in that municipality.

It is hoped that municipalities will try and simplify the processing procedure for apartment development plans so that developers may be given approval in the fastest possible time. The longer processing takes, the greater are the costs of development and the less likely that apartment units will be constructed for rental. A major step that would simplify processing would be to scrap the land use contract concept and the need for separate negotiations for each development and provide guidelines by which all developments would be judged, so far as levies and concessions to the municipality are concerned.

The succeeding chapter analyzes the role that apartment operating costs have played in reducing the desirability of new apartment investment.

CHAPTER VI

Operating Costs

Previous chapters have discussed the major reasons for the reduction in the number of apartment starts in Greater Vancouver in recent years. No mention, however, has yet been made of the role operating costs have taken in affecting apartment investment.

Operating costs are defined to be all those costs which are necessary to maintain apartment blocks as income-producing investments. They include the costs of utilities, maintenance and repairs, administration and property taxes.

A major study of the Vancouver apartment market conducted by Dale-Johnson indicated that one of the reasons why new apartment construction was falling off was because inflationary pressures were forcing operating costs up at a faster rate than rents.⁶⁶ The purpose of this chapter is to test the validity of this statement by analyzing operating expense statements for apartment blocks. Data were obtained from Real Estate Trends in Metropolitan Vancouver⁶⁷ and from the Dale-Johnson dissertation.⁶⁸

When it is said that greater increases in operating costs than in rents have adversely affected the provision of new apartment units, the statement does not mean that the inevitable increases in operating costs that occur as a building becomes older are the reasons for the decline in

apartment construction. What is meant is that, if operating expenses as a percentage of gross income are higher on newer buildings than on older ones at similar timepoints in their lifecycles, then the profitability of the more recently constructed apartment buildings will be less than older ones at similar stages and some investors will either postpone or cancel their decisions to construct new apartment buildings.

Assume, for example, that most blocks constructed in, say, 1965 had operating costs as a percentage of gross income during their first, second and third years of operation of 30, 32 and 35 per cent, respectively. If most apartment blocks constructed, say, in 1970 also had operating costs of 30, 32 and 35 per cent during the same periods of operation, then investors contemplating construction of new blocks would not have their decisions unduly influenced by the level of operating costs, anymore than investors did in 1965. If, however, the trend was to have operating costs of 40, 42 and 44 per cent during the first, second and third years of operation of 1970 apartment blocks, then today's investor would possibly cancel any plans for the construction of a new apartment building because his profit would be lower than what he could have obtained in 1965. This chapter hopes to discover if profits have been reduced by increased operating costs in newer apartment buildings compared to those built several years ago.

To test the validity of Dale-Johnson's reasoning that operating cost increases are partially responsible for the reduction in the number of apartment starts in recent years, it has to be demonstrated that operating costs as a percentage of gross income are higher on newer apartment blocks than on older ones during similar periods of operation.

Operating Costs as Presented in Real Estate Trends

The Greater Vancouver Real Estate Board publishes average annual operating costs as a percentage of gross income for frame and concrete apartment blocks. Statements are published every two years.⁶⁹

Operating statements from 1966 to 1972 were analyzed. The statements present a range of costs for newer buildings and thus, represent operating costs during earlier years of operation. The buildings analyzed offer contemporary amenities and are located in the more central regions of Greater Vancouver.

Since the statements were not strictly comparable between years, estimates of certain expenses had to be made to make them more uniform. The 1970 operating cost statements did not include a provision for management expenses which all the other years analyzed had; therefore, 5 per cent of gross income was added to the total percentage operating costs presented. The 1968 statements included a provision for replacement reserves. Since no other years' statements

had this provision, it was deducted from the 1968 statements.

Table 19 presents the summary of total operating costs as a percentage of gross income for frame and concrete apartment buildings located in Metropolitan Vancouver.

Table 19

Total Operating Costs As A Percentage Of Gross Income
For Frame And Concrete Apartment Blocks In
Metropolitan Vancouver, 1966-1972

	Operating Costs As A Percentage Of Gross Income			
	<u>1966</u> %	<u>1968</u> %	<u>1970</u> %	<u>1972</u> %
Frame Apartments				
Range	--	34.9- 47.3	--	35.0- 46.0
Median of Range	40.0	41.1	39.0	40.5
Concrete Apartments				
Range	--	32.9- 46.1	--	34.5- 44.0
Median of Range	39.0	39.5	40.0	38.1

As Table 19 indicates, operating costs as a percentage of gross income have not increased nor decreased substantially for concrete and frame apartment buildings during their earlier years of operation between 1966 and 1972. This is significant because if the Real Estate Trends' data is representative of the apartment market as a whole, then operating costs cannot have had any meaningful effect on the profitability of apartment investment. If this is the case, then the reduction in apartment construction in recent years cannot be tied to inflationary increases in operating costs.

Operating Costs Presented in the
Dale-Johnson Dissertation

To further test the conclusion reached above, an analysis of operating expense statements of several dozen apartment blocks was conducted. The data were first presented in an appendix to the Dale-Johnson study.⁷⁰ They have some severe limitations.

Firstly, the data do not represent a statistical sample. Many owners of apartment buildings view information about operating expenses as highly confidential and are unwilling to donate it for research purposes. Consequently, data could not be obtained by statistical samples and were taken from whoever was willing to supply them. The result was that a high proportion of the apartment blocks studied were owned by professional men and thus, may not represent normal investments in real estate. The apartment blocks sampled were primarily held as tax shelters rather than as long-term investments.

Secondly, operating expense statements are only available for the years 1968 to 1970. It would have been desirable to have statements for a greater number of years in order to produce a more effective test of whether operating expenses are increasing enough to discourage apartment construction.

Thirdly, not enough data are available to analyze apartment cost increases for each area in Greater Vancouver. Operating costs as a percentage of gross income are a function of the rents being charged amongst other things.⁷¹ The rents

in the outlying municipalities are lower than in the more central parts of the City of Vancouver and thus, these apartments have higher operating costs as a percentage of gross income. It was thus necessary to eliminate those apartment blocks whose rents varied considerably from the majority of apartment blocks in the sample. This excluded most frame apartment blocks in the more central regions of Vancouver. It also excluded all concrete apartment buildings, for their rents were found to be too diverse to properly compare them.

Finally, not enough data were available to analyze operating costs by size of apartment block. If all the available data were lumped into one group, the analysis would produce misleading results because apartment blocks with a relatively large number of suites generally have lower operating costs as a percentage of gross income than smaller ones. It was necessary to either analyze the apartment blocks in groups, according to the number of suites each had, or to eliminate the extremes in size and analyze the remainder as one group. Not enough data were available to accomplish the former and so the latter approach was followed.

Those apartment blocks remaining that were older than eight years in 1970 were excluded from the analysis because there were too few of them to compare with each other. Buildings having extraordinary expenses were also excluded.

The final sample, which was analyzed, consisted of 39 frame apartment blocks. For these blocks, operating expense statements were available for a total of 63 years of operation, or an average of 1.6 years of operation per apartment block. Tables 20 and 21 present the characteristics of the sample regarding location and size.

Table 20

Location Of Frame Apartment Blocks In The Sample

<u>Location</u>	<u>Number of Blocks</u>
East Hastings	5
Burnaby	8
New Westminster	20
Surrey	2
Coquitlam	1
North Vancouver	3

Table 21

Size Of Frame Apartment Blocks In The Sample

<u>Number of Suites</u>	<u>Number of Blocks</u>
18 - 37	14
38 - 57	17
58 - 89	8

The nature of the apartment blocks constituting the sample is relatively uniform as Tables 20 and 21 testify. Rents do not differ appreciably among the six areas from which the sample was drawn. Accordingly, operating expenses as a percentage of gross income are not unduly influenced by the location of the buildings. Apartment building sizes encountered in the sample appear to be uniform enough to

make sure that no buildings have significant operating economies of scale relative to other buildings.

For the analysis each annual operating expense statement was categorized according to the calendar year in which it occurred. The statements were further subdivided for each calendar year into three groups, according to whether they occurred in the first and second years, third and fourth years, or fifth to eighth years of the building's operation to which they refer.

By categorizing operating statements in this manner, increasing operating costs with building age are taken into consideration. Optimally, this table should have further been subdivided by area and by size of property, however, there were not enough data available to do this and still retain categories with enough members to analyze.

If, as the Real Estate Trends' data indicate, operating costs as a percentage of gross income have remained constant over the past few years, then the average operating costs as a percentage of gross income in each sub-category of each calendar year should be equal to the corresponding sub-category in every other calendar year. For instance, the average operating costs as a percentage of gross income for the third and fourth years of operation in 1968 should be equal to the average operating costs as a percentage of gross income for the third and fourth years in 1969 and 1970.

Table 22 presents the results of the categorization of operating statements.

Table 22

Operating Costs As A Percentage Of Gross Income For Frame Apartment
Buildings In Metropolitan Vancouver Defined By Building Age

	<u>1st and 2nd Years of Operation</u>			<u>3rd and 4th Years of Operation</u>			<u>5th to 8th Years of Operation</u>		
	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>
Number of operating expense statements in each category	7	17	16	2	6	9	1	1	4
Average operating expenses per category (%)	37.3	38.2	36.9	40.4	40.9	39.6	40.1	43.7	40.7

The table shows that frame apartment buildings, operating during their first and second years, had operating costs as a percentage of gross income of 37.3, 38.2 and 36.9 per cent. Those apartment buildings, operating in their third and fourth years, had average operating costs as a percentage of gross income in 1968, 1969 and 1970 of 40.4, 40.9 and 39.6 per cent respectively. Buildings in their fifth to eighth years of operation, had average operating costs as a percentage of gross income of 40.1 per cent in 1968, 43.7 per cent in 1969 and 40.7 per cent in 1970.

These figures tend to support the conclusion reached from the Real Estate Trends' data that operating costs as a percentage of gross income have not increased over the last few years. Dale-Johnson's statement that inflationary pressures were forcing operating costs up at a faster rate than rents appears to be incorrect. Operating costs as a percentage of gross income would increase within each period of operation with time, if operating costs were increasing faster than rents. The fact that these increases did not take place indicates that rents have been increasing as fast as operating costs. Therefore, the reduction in the number of apartment starts cannot be attributed to increased operating costs.

Summary and Conclusions

An investigation was carried out to determine if operating costs have been increasing faster than rents over the

past few years, enough to discourage new apartment construction. Operating expense data obtained from Real Estate Trends were analyzed for frame and concrete apartment blocks between 1966 and 1972. These data indicated that operating expenses have been increasing at about the same rate as rents over the time period. This conclusion prompted a further analysis of operating expense statements for frame apartment buildings which were originally presented in the Dale-Johnson dissertation. The analysis of these statements supported the conclusion reached from the analysis of Real Estate Trends' data.

The fact that operating expenses as a percentage of gross income have not increased in the past few years, indicates that operating expenses have not been responsible for the reduction in new apartment construction.

The present shortage of rental accommodation in Greater Vancouver will remain until rents increase enough to make apartment construction and investment a more economical proposition. Increases in rents will probably stimulate tenant unrest and could result in pressure being applied on the Provincial Governments to implement some form of rent control. The implications of rent control are the subject of the next chapter.

CHAPTER VII

Rent Control: Is It A Solution Or Aggravation
Of Pricing Policies In The Housing Market?

The combined effects of high capital costs, financing costs, low rents, changes in the Income Tax Act, and the costs and time delays associated with obtaining municipal approval for proposed apartment dwellings, are reducing the number of multi-family rental units completed each year. The small number of rental units supplied coupled with the high demand for such units will result in higher and higher rents. Rents will continue to increase until the return on investment is attractive enough to stimulate increased construction.

Increasing rents generally create tenant unrest and demands are made to government authorities to stop the increases. Although, for the present, the B.C. Provincial Government has ruled out any attempt at controlling rents, it is expected that as rents continue to rise and the shortage of housing becomes more acute, tenant groups will bring increasing pressure on the Government to implement some form of controlling legislation.

This chapter's purpose is to study rent control policies in two areas where controls have been in existence for many years, the United Kingdom and New York City, in the hope that the lessons learned there will serve to discourage any form of rent control in B.C.

The United Kingdom Experience⁷²

In response to the severe housing shortages and resultant rent increases in the United Kingdom during World War One, Parliament placed controls on rents by passing the Rent and Mortgage Interest Restriction Act of 1915. This Act fixed rents on the cheaper housing types that were rented unfurnished; provided security against eviction; and halted rising mortgage interest rates. At the time of its conception, the Act was considered to be a temporary measure which would be abolished with the return of peace. Unfortunately, this was not the case and rents have been controlled to a greater or lesser extent ever since.

Since the 1915 Act rent control in Great Britain has been an entanglement of contradictory social and economic policies. In some periods the legislation was aimed at reducing the range of controls, while in others it increased them. Constantly changing rent controlling laws have created severe inadequacies in the British housing market.

The 1915 Act was extended in 1920 to include "middle" class dwellings; however, in 1923 it was decided that too large a sector of the housing market was under control and so dwellings were allowed to become decontrolled if tenants voluntarily moved. The same year a Committee was set up to study the rent control system. No conclusive results were produced by this Committee and another was organized in

1931. In the meantime, annual legislation between 1924 and 1933 was allowing decontrol to continue where tenants moved voluntarily. The 1931 Committee recommended that the more expensive dwellings be released from the scope of rent control. This was given approval by Parliament in 1933 and again in 1938. The 1938 legislation, although it allowed the decontrol of more expensive residential units, tightened the controls on the cheaper ones.

The beginning of the Second World War in 1939 created the necessity for extending rent controls over a larger range of properties. Between 1939 and 1954 rent control policies remained static. In 1954 the levels of controlled rents were increased to try and encourage landlords to better maintain the housing. This legislation was unsuccessful in achieving its goals. Accordingly, in 1957 the Rent Act was passed which freed those dwellings with higher rateable values in London and Scotland from rent control. The reason for choosing these areas for partial decontrol was that there was a critical housing shortage and it was hoped that this action would stimulate new investment in housing. At the same time rent ceilings were raised on all controlled stock remaining, to try and further encourage better maintenance.

The 1957 Act was unsuccessful in achieving better maintenance and more investment. In 1963 a Committee of Inquiry was established to revamp the whole rent controlling

legislation. Their report resulted in a new Rent Act in 1965. This Act was meant to be so designed that it would encourage investment in rental housing. It was revolutionary in that it did away with rigid forms of rent control and allowed landlord and tenant the opportunity to negotiate a rent together. Where agreement was not achieved, the Act provided that a "fair rent" would be established by a Rent Officer. Fair rent was basically considered to be the revenue a landlord would obtain from his dwelling if the scarcity of housing was discounted so that it would not be taken into account. Once fair rent was determined, it would be registered for three years and could not be altered.

The 1965 Rent Act extended some forms of rent control over a large part of the field of private rental housing. Dwellings brought under the provisions of the new Act had their rents determined by the fair rent approach and were called "regulated tenancies". Those dwellings which were subject to control under previous Acts remained in that status and were called "controlled tenancies". Once they became vacant, they would be evaluated as regulated tenancies. The 1965 Act was the first legislation which did not fix rents according to a strict formula but it did preserve the security of tenure that tenants enjoyed under previous Acts.

In order to further shift tenancies from controlled to regulated status, the Housing Act was passed in 1969. This

allowed landlords who added standard amenities (bath, wash basin, sink, toilet and hot water) to controlled tenancies, to have them shifted into regulated tenancies subject to fair rents.

Also, in 1969 another Committee, commonly known as the Francis Committee, was organized to evaluate the effects of the 1965 Act on the housing market. This Committee reported that little or no new unfurnished accommodation was being rented because the fair rent scheme had been unsuccessful in providing a large enough return for landlords to encourage them to continue renting.⁷³ They also communicated that there was a large amount of transferring of tenancies from unfurnished (controlled or regulated) to furnished (non-controlled) uses. The reasons for this, according to the Committee, were:⁷⁴

1. Mortgagees will not permit their borrowers to let unfurnished because unfurnished tenancies, being protected, depreciate the value of the security to a substantial extent;
2. Landlords of furnished accommodation obtain a better return on their investment; and
3. It is easier for landlords to obtain possession of furnished premises.

The Francis Committee recommended that more properties be switched from controlled to regulated tenancies. It suggested that rent increases be spread over two or three years and that increased investment in housing could be achieved by reducing the classes of property that came under

regulation or control. In 1972 the Housing Finance Act was passed to implement some of these recommendations.

One of the major changes, which the new Act introduced, was that tenants, who could not afford to rent in a free market, be subsidized directly by the Government, instead of using the old procedure of controlled rents and indirectly forcing the landlord to subsidize the tenant. The Act also specified that all dwellings still subject to control be phased into the fair rent sector by 1975.

The conclusion to be drawn from the above history of British rent control experiences is that fixing of rents, below the level that would exist in the free market, discourages new investment in housing and may dissuade landlords from carrying out necessary maintenance. Since 1954 it would appear that the Government has recognized these points, as witnessed by the Acts of 1954, 1957, 1965, 1969 and 1972 which all reduced controls to some degree.

The New York Experience⁷⁵

Restrictions on rents were enforced throughout the United States during the Second World War. In all areas of the country except New York City the restrictions were abolished soon after the War's end.

In New York there are rent controls on most lower class dwellings. These include all accommodation built before 1951 and run-down properties inhabited by more than one family. In the 1960's rents in controlled properties were

set by the Office of Rent Control. Base rents were established as of April 30, 1962 and any increase above the base had to be approved by the Office. Increases were granted where facilities were increased or capital improvements carried out; where there was an increase in the number of occupants in a dwelling unit; where the landlord's annual net return fell below six per cent; where the rent charged was less than $32\frac{1}{4}$ per cent above that charged on March 1, 1943; and where labour costs increased. Conversely, rents were reduced for a reduction in services and where the base rent was judged to be higher than that for comparable housing.

These measures were found to distort the rental housing market in a serious manner. There was a critical housing shortage, too rapid deterioration of existing dwellings and very high rents in the uncontrolled sector. It was estimated that the number of multi-family units which were structurally sound but had been abandoned because of poor returns were approaching 30,000 per year.⁷⁶

A new procedure was initiated in 1969 which was designed to make rental housing a more economic venture for landlords and increase new investment in housing. This procedure established a system of rent control in which building rents (called maximum base rents) reflect the costs of properly operating, maintaining and financing buildings. It applied to a much broader range of accommodation than previously covered by rent control. Rent increases, to a maximum of 7.5 per cent per annum, were allowed.

New York, like Great Britain, has found that rigid forms of rent control do not work to alleviate housing problems. In New York the trend has been to move away from rent control per se into a more flexible system which allows the landlord to recover some profit from his investment and to have a greater incentive to maintain his buildings.

The Case Against Rent Control

Rent control is a statutory limit on the amount of rent which can be charged, with the result that controlled rents are less than the rents which could be obtained in the free market.⁷⁷ Governments embark on systems of rent control when housing is in short supply and there is a danger that low income groups may be priced out of the market.

Rent control results in tenants being subsidized by landlords. It is intended to secure to low income families a larger proportion of the total housing stock than they would be able to command in a free market.

Rent controls are introduced at times of housing shortages and rising rents. Rent control, however, is no solution to these problems. It can be nothing more than a short-term partial solution to the problem of soaring rents. It is detrimental to housing production because developers are unlikely to enter a field in which their profits are certain to be limited. Furthermore, it could give landlords an excuse to neglect maintenance and repairs in order to offset

their limited profits. Difficulty in establishing criteria for fair rent or fair profit, makes rent control hard to administer.

In areas where rent controls have been introduced, the controls have not been placed on the whole range of rental housing but only on certain classes and types. Experience has shown that, with the passage of time, the number of controlled premises diminish as landlords convert to non-controlled uses. This has been found in Great Britain where many landlords converted from unfurnished to furnished, as premises became vacant. Controls aggravate the housing shortage in areas where the statutory rent limits apply. Lack of controlled housing reduces the mobility of tenants since they are reluctant to move if the possibility of finding another controlled dwelling is small.

A survey carried out in Greater London for the Francis Committee demonstrated that 60 per cent of tenants of furnished (uncontrolled) accommodation moved in an 18 month period while only 17 per cent of tenants in unfurnished (controlled) accommodation moved in the same period. Furthermore, the people living in unfurnished premises, who had lived in London since birth, exceeded those who had lived in London since birth in furnished tenancies, by more than four to one.

When tenant mobility is reduced, the use of the housing stock declines in efficiency. Older tenants continue to

occupy accommodation larger than they require because the rent is not associated to the amount of use and because it is difficult to find smaller premises in the controlled sector. The survey conducted for the Francis Committee indicated that 78 per cent of furnished tenancies had household heads under the age of 35 while only 39 per cent of unfurnished tenancies had household heads under 35. In addition, only six to seven per cent of tenants in furnished accommodation were over 60, as opposed to 22 per cent in unfurnished accommodation.⁷⁹

Where rent controls exist, black markets often develop for rent controlled premises. Unscrupulous landlords have been known to charge "key" money to new tenants seeking controlled accommodation. This is an "under the table" payment to the landlord over and above the controlled rent, for the privilege of receiving a key to enter the premises. It is often the poor and uneducated who are the victims of black marketeering, the very group for whom rent controls are designed to help.

Prices and rents in the uncontrolled sector often rise to levels considerably higher than would have been the case if rent controls had not been introduced. This is because virtually all of the new demand is directed to this part of the market and exceeds supply.⁸⁰

When rent controls are introduced in selected segments of the housing market, tenants in uncontrolled housing are

discriminated against. They are not given the benefit of reduced rents which their counterparts in the controlled sector enjoy and, in fact, they may find rents increasing at a faster rate than would otherwise have been the case in a free market. Landlords of controlled premises are also discriminated against because they, in effect, are ordered to subsidize their tenants and accept lower returns than those landlords in the uncontrolled sector.⁸¹

Experience has shown that governments that embark on systems of rent control find it difficult to abandon the practice. This is illustrated in both New York and the United Kingdom. Rent controls were introduced as temporary wartime measures yet they are still in existence in a modified form today.

In present day society, there will always be some people who cannot afford to pay free market rents. Instead of penalizing the whole system to benefit the minority of tenancies, only those who need to be protected from free market rents, should be protected and at the expense of the community, rather than at the expense of the landlord. Rents should be allowed to find their own levels in the market place and those that cannot bear the burden should be subsidized by society.

At the present time in the Lower Mainland of British Columbia, the supply of rental accommodation is small relative to the demand. Previous chapters in this critique have

attempted to explain why the shortage exists. The most effective way to overcome the shortage is to allow rents to rise to a level that will justify new investment in rental housing. If rent control is introduced, it will serve to delay the attainment of economic feasibility for further rental housing development and further increase the shortage situation. If the B.C. Government feels that rising rents will hurt certain segments of society economically, it should subsidize the rents of those groups and leave the free market rents to find their own level.

Summary and Conclusions

The chapter concentrated on examining the history of rent control in two areas--New York and Great Britain--in order to determine what effects government interference has had on the operations of the housing market. The case histories illustrated that rent controls increased the shortage of housing by discouraging new investment; they reduced maintenance of existing dwellings; opened the door for black market operations; reduced mobility of tenants; and increased the prices in the uncontrolled sectors of the housing market. Subsidization of the rents of the needy is preferred to broad, sweeping policies that control rents in large segments of the market place.

CHAPTER VIII

A Study Of The Profitability Of Some Greater
Vancouver Apartment Buildings

Up until this point, this dissertation has concentrated on examining those factors which have contributed to the reduction in construction of new apartment units in recent years. This chapter moves away from the study of supply and investigates those physical, operating and financial characteristics of apartment buildings that determine the degree of profitability that can be achieved from apartment investment.

The main point of this study is to illustrate why some apartment buildings produce profitable returns for their owners while others do not.

Method of Analysis

The sample used for the analysis of the profitability of apartment investment was chosen from the data in the Appendix of the Dale-Johnson work.⁸² Dale-Johnson calculated the return on investment for several dozen Greater Vancouver apartment buildings. He used two parameters to measure return--the average rate of return excluding capital gains or losses and the internal rate of return including gains or losses. The average rate of return is, for any given year of operation, the total cash flow of that year as a percentage of the original equity. Where average rates of

return were available for more than one year of operation, the mean of these returns was calculated and used in the analysis.

The internal rate of return is the return in any one year based upon the equity in that year summed with the returns in other years based upon the equity positions in each of the corresponding years. Each year's component is then compounded by a per cent factor to arrive at a value equivalent to the equity value at the sale date or date of valuation.

To calculate the internal rate of return including capital gains and losses, Dale-Johnson, in many cases, had to predict hypothetical sale values. To arrive at his prediction, he considered the rate of capitalization the market demands for apartment properties; the condition of the block with respect to quality and repair; the rental demand; gross income; the level of expenses; the interest rates on mortgages; and personal judgement.⁸⁴

For the analysis that is to be conducted in this chapter, the actual and hypothetical capital gains and losses are not important because the primary emphasis will be on the returns on investment obtained excluding gains and losses. Whether a capital gain or loss did or might occur was, however, noted for each apartment block in the sample.

The apartment buildings for which Dale-Johnson calculated average rates of return excluding gains or losses were

divided into two groups for the analysis; the first group was made up of those apartment blocks that achieved an average rate of return excluding capital gains or losses of less than 10 per cent; the second group consisted of those buildings that had average rates of return of more than 10 per cent.⁸⁴ Physical, operating and financial characteristics of the two groups of apartment buildings were examined to determine what factors appeared to influence the levels of profitability that were being obtained by both groups. Before presenting the results of the analysis, the limitations of the sample will be discussed.

Limitations of the Sample

A major limitation of the Dale-Johnson data was that approximately 58 per cent of the apartment buildings analyzed were owned by professional men.⁸⁶ As has been mentioned before, professionals tended to buy into apartment buildings for tax reasons rather than for pure investment reasons. They were willing to trade off a reduction in returns for tax savings. Thus, the returns on investment achieved by apartment buildings in this sample were probably lower than would be found in a proper statistical sample.

Another problem with the sample obtained from Dale-Johnson's work was that returns on investment were only available up to 1970. Since 1970 several factors, which have been discussed in previous chapters, have altered the level of returns that can be obtained. Among these, are the

amendments to the Income Tax Act and rising construction, land and financing costs.

Despite the fact that the two groups of apartment buildings studied do not reflect current investment returns, they are still useful in that comparisons of certain characteristics demonstrated by the two groups shed some light on the factors that affect their profitability.

The Results of the Apartment Investment Analysis

Various physical, financial and operating characteristics of the two groups of apartment buildings are presented in Table 23.

The first point to note is that only three properties out of the seventeen analyzed in the group having average returns on investment of less than 10.0 per cent sold or would sell for a capital gain. In the group of properties having returns of greater than 10.0 per cent, twenty-six out of the thirty-one properties sampled sold or would sell for a capital gain. This is not a surprising result for a rational purchaser would consider the ratio of expenses to income, the amount of debt service, the level of rentals, the location and quality of the block and other factors to arrive at a capitalization rate to determine value. Since these components also determine average return on investment, if they are detrimental to the successful financial operation of an apartment building, they will produce a low average return on investment, a high capitalization rate

Table 23

A Comparison Of The Profitabilities Displayed By Two
Groups Of Greater Vancouver Apartment Buildings(a)

Item No.	Average Rate of Return Excluding Capital Gains or Losses	
	<u>Less than 10.0%</u>	<u>Greater than 10.0%</u>
1. Number of properties in sample	17	31
2. Number of properties that sold or would sell for a capital gain	3	26
3. Number of suites per property(b)	11 (40) 89	11 (47) 154
4. Property age in 1970	1 (3.3) 17	1 (7.5) 45
5. Median property age in years	2	5
6. Operating expenses as a percentage of gross income	30.1 (39.7) 46.2	28.8 (36.4) 46.2
7. Percentage of pro- perties in high rent areas(c)	17.6	16.1
8. Percentage of pro- perties in average rent areas(c)	41.2	29.0
9. Percentage of pro- perties in low rent areas(c)	41.2	54.9
10. Percentage of pro- perties judged to be renting at below mar- ket rent given their location and condition(c)	25.0	24.0
11. Debt service (prin- cipal and interest) as a percentage of gross income	42.6 (57.6) 72.5	28.8 (51.7) 64.3
12. Loan/value ratio(d)	68.3 (74.0) 91.5	40.4 (76.2) 99.9
13. Term of:		
- first mortgage(e)	20.0 (23.4) 30.0	20.0 (24.3) 50.0
- second mortgage(e)	2.0 (14.3) 20.0	5.0 (14.7) 20.0

Table 23

A Comparison Of The Profitabilities Displayed By Two
Groups Of Greater Vancouver Apartment Buildings^(a)

Item No.	Average Rate of Return Excluding Capital Gains or Losses	
	<u>Less than 10.0%</u>	<u>Greater than 10.0%</u>
14. Weighted interest ^(f) rate on all mort- gages	8.50 (9.46) 12.45	7.00 (8.44) 9.88
15. Percentage of pro- perties having more than one mortgage	82.4	66.7
16. Purchase price per suite	\$8,545 (\$11,237) \$13,442	\$6,957 (\$10,113) \$15,547

(a) Based on data presented in R. Dale-Johnson, Returns On Apartment Properties (University of British Columbia: Master's thesis, 1972).

(b) Where three numbers are presented alongside an Item, the number within the brackets is the average for the group and the numbers on either side represent the lowest and highest values in the range.

(c) See text for explanations.

(d) The loan amount is all financing received by the blocks. It includes mortgages and agreements for sale.

(e) The term of mortgages is the period of years over which the mortgage is amortized.

(f) The weighted mortgage interest rate was calculated by multiplying the interest rate of each mortgage charged against an apartment building by the ratio of the original amount of funds borrowed under that mortgage agreement to the amount of funds borrowed through all the mortgage agreements on the building. The resulting interest rate factor was added to the interest rate factors for all the other mortgages on the building. Agreements for sale were included in these calculations.

and consequently, a possible capital loss.

Item 3 in Table 23 demonstrates that the less profitable apartment blocks (those with an average return of under 10.0 per cent) had fewer suites on the average than the more profitable ones (those with an average return of greater than 10.0 per cent).

The average property age (Item 4) and the median property age (Item 5) for each group of apartment buildings are presented in Table 23. Use of the median age as a means of comparison between the two groups is preferred because the average age is unduly influenced by the extremes in age of each group. Those buildings with average rates of return of under 10.0 per cent were newer than those with average returns of over 10.0 per cent; a median age of two in 1970 for the "under 10.0 per cent" group, as opposed to a median age of five in 1970 for the "over 10.0 per cent" group.

Item 6 presents the average operating expenses as a percentage of gross income for each group of apartment buildings. The less profitable group of buildings had average operating costs of 39.7 per cent, while those with a return of over 10.0 per cent had costs of 36.4 per cent.

Higher operating costs as a percentage of gross income in the less profitable group of apartment buildings than in the more profitable group appear to be one of the reasons why the former group of buildings did not achieve such good returns on investment. These higher operating costs may be

due to the fact that the less profitable buildings had a fewer number of suites per block than the more profitable ones. Dale-Johnson indicated in his study of apartment operating costs that the more suites, to a point, that a building had the lower would be the operating costs as a percentage of gross income. This was because economies of scale were captured as buildings increased in size.⁸⁷ However, Dale-Johnson also found that operating costs as a percentage of gross income tended to increase with building age.⁸⁸ Table 23 illustrates that, despite the more profitable class of buildings being older than the less profitable class, they had a lower ratio of operating costs to gross income. From studying Dale-Johnson's results of the operating cost analysis, it is not felt that an average of seven more suites per building, which the more profitable group had over the less profitable group, would be enough to outweigh the effects of increasing building age on operating cost ratios.⁸⁹ For this reason it is concluded that the major cause for the less profitable group of apartment buildings having a higher operating cost ratio than the more profitable group, must lie in the efficiency of management of the buildings. It would appear that the less profitable group were having serious mismanagement problems.

Since the level of operating costs as a percentage of gross income is dependent on the amount of rent being charged, it is possible that the high ratio of expenses, demonstrated

by the less profitable group of apartment buildings, was due to the fact that lower rents were being charged by them, relative to those being charged in the more profitable group. To determine if this was the case, all the apartment buildings comprising each group were categorized according to location and divided into three classes. The three classes were those areas of Greater Vancouver considered to be areas where high rents were charged; average rents were charged; and low rents were charged. Apartment buildings in the South Granville area, Kerrisdale, the West End and West Vancouver were considered to be in high rent areas. Average rent areas were Marpole, East Hastings, North Vancouver and Burnaby. Low rent areas were New Westminster, Surrey, Mission and Coquitlam.

Once the apartment buildings had been categorized by area, their rents were examined to see if they were below market value for the areas in which they were located. It was found that 25.0 per cent of those buildings in the "less than 10.0 per cent return" group were renting at levels below the market rent for the areas in which they were located. 24.0 per cent of apartment buildings having average returns of greater than 10.0 per cent were renting at below market levels (Item 10, Table 23). Since approximately the same percentages of apartment buildings in each group were renting at below market levels for their locations, the effects of low rents on operating cost ratios will be similar for each group and can thus be ignored.

Table 23 illustrates in Items 7 to 9 the categorization of the apartment buildings into high, average and low rent areas, respectively. There were approximately the same percentages of apartment buildings having returns of less than 10.0 per cent as those having returns of more than 10.0 per cent in high rent areas, 17.6 per cent compared to 16.1 per cent. 41.2 per cent of the less profitable group of apartment buildings were in average rent areas, while only 29.0 per cent of the more profitable group were in such areas. 41.2 per cent of the less profitable group of buildings were located in low rent areas, as opposed to 54.9 per cent of the more profitable group.

These results demonstrate that lower rents were not being charged in the less profitable group of apartment buildings than in the more profitable group and thus, the high ratio of operating costs experienced by the former group were not due to lower rents. In fact, as Item 9 illustrates, it would appear that rents were generally lower in the more profitable group than in the less profitable one. Everything else being equal, it would be expected that the more profitable group would have higher expense ratios because of this factor. The fact that they did not, reinforces the idea that the less profitable group were experiencing inefficiencies in management.

To continue with the search for factors influencing the profitability of apartment investment, Item 11 in Table 23

demonstrates that those apartment buildings having an average return of less than 10.0 per cent had paid an average of 57.6 per cent of their gross income toward repayment of the principal and interest on mortgage loans. Those apartment buildings having an average return of greater than 10.0 per cent had paid an average of 51.7 per cent in combined principal and interest payments.

Referring back to the previous discussion on the effects of rent levels on operating cost ratios, it was concluded that rents were lower in those buildings with average returns of greater than 10.0 per cent. Because of this factor, it is likely that the debt service ratio for those buildings is exaggerated relative to the debt service ratio for the buildings with average returns of less than 10.0 per cent.

Item 12 in Table 23 presents the average loan to value ratios for the two groups of apartment buildings. The less profitable group of apartment buildings had a slightly lower loan to value ratio than the more profitable group, 74.9 per cent as opposed to 76.2 per cent.

The average length of the terms for first and second mortgages in the less profitable group of apartment buildings were 23.4 and 14.3 years, respectively. For the more profitable group, the corresponding terms of the mortgages were 24.3 and 14.7 years, respectively (Item 13).

Since both groups of apartment buildings had approximately the same loan to value ratios when purchased and

similar lengths of terms for first and second mortgages, it is clear that the reason for the less profitable group of apartment buildings having to pay a higher percentage of gross income towards principal and interest payments than the more profitable group, is because of higher interest rates on their mortgage loans, higher purchase prices paid, or a combination of both of these factors.

The average weighted mortgage interest rate for each group of apartment buildings is presented in Table 23 as Item 14. It can be seen that those buildings having a return of less than 10.0 per cent had an average weighted interest rate of 9.46 per cent; those buildings with a return of greater than 10.0 per cent had an average weighted interest rate of 8.44 per cent. It thus appears that another reason for the less profitable group of buildings being in that financial condition is because of higher financing costs on mortgage loans.

A partial reason for the less profitable group of apartment buildings having higher financing costs than the more profitable group is that they were of more recent construction (see Item 5). From 1965 to 1970 interest rates on mortgage loans had climbed steadily. Since the less profitable buildings were newer than the more profitable ones, they were faced with higher borrowing costs.

Increased borrowing costs for the less profitable group of apartment buildings were also due to the larger percentage

of blocks in the group that had to resort to higher priced secondary financing. 82.4 per cent of this group had more than one mortgage while only 66.7 per cent of the group, made up of more profitable buildings, had more than one mortgage (Item 15).

Despite the fact that a much smaller percentage of the apartment blocks in the more profitable group than in the less profitable group had more than one mortgage, the two groups had similar loan to value ratios. This indicates that lenders have been becoming more reluctant to give high ratio first mortgages than they have been in the past.

As was mentioned previously, the higher average debt service ratio experienced by that group of apartment buildings having average returns of less than 10.0 per cent was partially due to higher interest rates on mortgage loans. It was also due to the fact that that group had paid higher purchase prices per suite than the group having average returns of more than 10.0 per cent. The average purchase price per suite for the less profitable group of buildings was \$11,273 and for the more profitable group, \$10,113 (Item 16).

Since the loan to value ratios for both the more profitable and less profitable groups of apartment buildings were approximately the same and since the lengths of the terms for the first and second mortgages in both groups were also similar, then the higher purchase prices per suite paid

by the less profitable group meant that larger mortgage loans had to be obtained by the group. These larger loans required greater periodic payments of principal and interest and consequently, a higher portion of gross income had to be set aside to service the debts.

The question arises as to what was the reason for the less profitable group of apartment buildings being bought for higher purchase prices per suite than the more profitable group. Purchase price is dependent on many factors including the location of the property; the time purchase was made; the age, quality and condition of the block; and the types and sizes of suites and amenities provided within the block. Not enough data were available to properly compare the purchase prices for both groups of apartment buildings. To conduct a proper comparison, it would be necessary to have enough data to classify the buildings into various sub-groups according to the myriad of characteristics which they possessed that affected the purchase prices paid for them. Since the sample size was so small, such a classification here could not readily be accomplished without having as many sub-groups as there were buildings. With only one building in each sub-group, comparisons would not be possible.

There were a few apartment buildings, however, from the less profitable and more profitable groups which had similar characteristics and thus, allowed a reasonable comparison of their purchase prices. In the East Hastings area of

Vancouver one frame apartment building of 35 suites, which had an average return of less than 10.0 per cent, was purchased in 1968 for an average of \$10,080 per suite. A similar building of 21 suites with an average return of greater than 10.0 per cent was purchased in the same year for an average of \$9,790 per suite. In New Westminster two frame buildings from the less profitable group were purchased in 1968 for \$11,548 per suite and \$10,759 per suite. The building to which the former purchase price refers, had 42 suites and the latter had 29 suites. Three similar buildings from the more profitable group were bought in 1968 in the same area for \$10,160 per suite (25 suites), \$10,692 per suite (26 suites), and \$11,111 per suite (63 suites).

From these results it would appear that those buildings in the less profitable group were purchased at higher prices than similar buildings in the more profitable group. This indicates that a possible reason for some buildings having lower average returns is that the investors who bought the buildings paid too much.

Since there were very few buildings in the sample for which purchase prices could be realistically compared, it cannot be fairly concluded without much more extensive research that the unprofitability of some apartment buildings was partially due to investors paying more for them than they were worth. It is, however, quite possible that this was the case, for many apartment blocks purchased prior to 1970

were used as tax shelters rather than as long-term economic investments. Premiums were often paid for the tax shelter benefits.⁹⁰

Summary and Conclusions

The purpose of this chapter was to determine the reasons for some apartment buildings obtaining good returns on investment, while others received poor returns.

A sample of 48 apartment buildings was obtained from the data provided in the Appendix to the Dale-Johnson dissertation. The sample was divided into those buildings with average returns excluding capital gains or losses of less than 10.0 per cent (the less profitable group) and into those buildings with average returns excluding gains or losses of more than 10.0 per cent (the more profitable group). Physical, operating and financial characteristics of the two groups of apartment buildings were calculated and compared. These characteristics threw light on the reasons for low returns on investment in some apartment blocks and higher returns in other blocks.

Return on investment excluding capital gains or losses is a function of several variables. It is dependent on the cash flow obtained from the operations of the building; the amount of principal repaid; and the initial amount of equity.

A comparison of the average purchase prices paid per suite for each group of buildings, demonstrated that the less profitable group of apartment buildings generally had

paid a higher purchase price than the more profitable group. Since the loan to value ratios of both groups of apartment buildings were approximately the same, higher purchase prices in the less profitable group meant that the equity requirements for that group were also higher than in the more profitable group. Everything else being equal, higher equity positions result in lower average returns.

Higher purchase prices in the less profitable group of apartment buildings than in the more profitable group also meant that a greater amount of interest was paid on mortgage loans by the former group compared to the latter. Calculations also showed that interest rates on the mortgage loans received by the less profitable group were higher than those received by the more profitable group. This was partly attributable to the greater amount of secondary financing obtained by the less profitable group and partly due to the newness of these buildings. Between 1964 and 1970 interest rates had climbed steadily, so that the newer a building, the higher the interest rates on loans. Since interest payments are deducted from cash flow prior to rate of return calculations, the larger the amount of interest paid, the smaller the cash flow and the lower the return on investment.

Preliminary analysis indicated that the higher purchase prices paid for apartment buildings in the less profitable group than in the more profitable group were due to investor ignorance. Too much money was paid for some apartment blocks given their physical and economic conditions.

Comparisons of operating cost ratios in each group demonstrated that the less profitable group were paying a higher proportion of gross income in operating expenses than the more profitable group. Operating costs are deducted from gross income before calculating cash flows. Therefore, higher costs in the less profitable group lowered the level of cash flows and thus the return on equity.

Despite the facts that the less profitable group of apartment blocks had higher rents and were newer than the more profitable group, their operating cost ratios were also higher. This indicated that the less profitable group of buildings were being managed inefficiently.

To conclude, the major reasons for low returns on investment on some apartment buildings were due to:

1. High purchase prices;
2. High interest payments on mortgage loans; and
3. High operating costs.

CHAPTER IX

Findings And Conclusions

Since 1960 Metropolitan Vancouver has experienced a rapid expansion in its stock of multiple dwelling units. The expansion reached its peak in 1969 when 12,525 units were completed. Between 1969 and 1972 the number of additional units constructed declined annually so that by 1972, fewer were completed than at any time after 1966.

One of the main goals of the dissertation was to explain the reasons for the decline in apartment construction after 1969. These reasons fell into three main groups:

1. Larger increases in construction, land and financing costs than in rents;
2. Amendments to the Income Tax Act which destroyed many advantages that real estate investments had over other forms of investment; and
3. Obstacles placed before developers by municipal authorities and the costs of such barriers to developers.

Rents and Construction, Land
and Financing Costs

In Metropolitan Vancouver, rents increased at an average rate of 6.6 per cent per annum while construction costs increased at a rate of 6.4 per cent, financing at 3.77 per cent, and land costs between 19.6 and 22.6 per cent per annum between 1964 and 1972.

It was assumed that the yield from apartment investment was equal to total rent minus interest charges on mortgage loans, divided by the capital cost of the investment, and it was further assumed that loan to value ratios were the same for all areas of Metropolitan Vancouver, and had not changed over time. These assumptions meant that greater increases in capital costs (construction and land costs) than in rents would result in yields being less on newly constructed buildings than on older apartment buildings at any given point in time.

For these assumptions on yield calculations, only interest charges and not operating expenses were deducted from total rent. This was because further research whose results were presented in Chapter VI of this thesis, demonstrated that operating expenses expressed as a percentage of gross income had remained constant for new buildings in the last few years, thus indicating that they had been increasing at the same rate as rents.

In Table 18 in Chapter III, average annual increases in capital costs and financing costs were compared with average annual increases in rents between 1964 and 1972 for selected areas of Metropolitan Vancouver. On the basis of the above assumptions for yield calculations it appeared that new buildings in Richmond and Coquitlam had suffered the greatest erosion in yields because of greater increases in capital and financing costs than in rents. In East Hastings and

Burnaby where rents often increased faster than capital costs and financing costs, yields have become greater. All other apartment areas of Metropolitan Vancouver fell between the extremes established on the one hand by Richmond and Coquitlam and on the other by East Hastings and Burnaby.

To illustrate with a hypothetical example how the level of yields have been affected by changing costs and rents, consider the following data for apartment buildings constructed in Richmond and the East Hastings area of Vancouver:

Buildings 1A and 2A were completed and operating in 1964; Buildings 1B and 2B were completed and operating in 1965. Rents, capital costs and financing costs are assumed to have increased between 1964 and 1965 at the average annual rates calculated for Richmond and East Hastings and presented in Table 18. Since the annual change in capital costs has been presented as a range of values, the median of this range will be used for this example. The loan to value ratio is assumed to remain constant in Richmond and East Hastings in 1964 and in 1965; it is assumed to be 50 per cent. The mortgage interest rate is assumed to be 10.0 per cent in Richmond and East Hastings in 1964. In 1965, this would have increased to 10.377 per cent if it increased at the average annual rate of 3.77 per cent presented in Table 18.

With these assumptions, the following changes in yield would occur:

	<u>Richmond</u>		<u>East Hastings</u>	
	<u>Bldg. 1A</u>	<u>Bldg. 1B</u>	<u>Bldg. 2A</u>	<u>Bldg. 2B</u>
Capital cost of buildings	\$1,000.00	\$1,118.00	\$1,000.00	\$1,050.00
Gross rent	\$100.00	\$101.40	\$100.00	\$109.30
less interest	<u>50.00</u>	<u>58.01</u>	<u>50.00</u>	<u>54.48</u>
Net income	\$50.00	\$43.39	\$50.00	\$54.82
Yield	5.0%	3.9%	5.0%	5.2%

In the hypothetical case for Richmond the apartment building going into operation in 1965 would achieve a 1.1 per cent lower yield than its counterpart which began operating in 1964. This decline in yield is due to the fact that capital costs were increasing faster than rents.

In East Hastings yield on the building which began operating in 1965 increased by 0.2 per cent over its counterpart building operating in 1964. The reason for this was due to the fact that rents increased at a greater rate than capital and financing costs.

If these examples were calculated on for more periods, yields from Richmond apartment buildings would continue to decline, while yields from East Hastings buildings would increase. In 1966, yield from new apartment buildings in Richmond would fall to 3.1 per cent; in 1967, they would fall to 2.1 per cent. Similarly, in East Hastings yields would increase to 5.6 per cent in 1966 and 5.8 per cent in 1967.

In reality, however, changes in construction, land and financing costs and rents do not affect yields in the direct manner that was assumed in the above illustrations, except in the case of the developer of the apartment property who also becomes the long-term investor. More common, especially prior to the amendments to the Income Tax Act, is the case of the developer who builds an apartment block and then sells to an investor.

The investor normally pays the fair market value for an apartment building and this is usually determined by a capitalization of the income obtainable from the property. The capitalization rate chosen is not affected by increases in construction and land costs and should be the same for two buildings in the same physical and economic conditions regardless of the cost of constructing them.

With a capitalization rate which is independent of the capital cost of an apartment building, it is found that in a time when capital costs are increasing at a faster rate than rents that the capitalization rate of the investor will not change proportionately to the capital costs of the developer. The result is that the developer cannot sell his apartment building at a price high enough to cover his capital costs, development costs and profit margin. Consequently, he ceases to construct apartment buildings.

No matter whether an apartment building is constructed and operated by a developer or constructed by a developer

and sold to an investor, the results of greater increases in construction, land and financing costs than in rents have the effect of reducing new apartment construction by reducing the yields either directly or indirectly. As the data in Chapter III demonstrated, this is what has happened in Metropolitan Vancouver between 1964 and 1972.

In addition to the rapid increases in construction and land costs, the passing of the Strata Titles Act in 1966, which allowed individual ownership of apartment units, has encouraged developers to move away from the construction of rental units into the condominium market. Tables 1 and 2 in Chapter I illustrated the construction trends in the rental and condominium markets.

Condominiums remain economical ventures for developers because they can pass all their increased costs on to the purchaser. This is because they are being sold to people desiring living accommodation rather than investments.

The Income Tax Act

Besides those cost factors which have played a role in discouraging apartment construction, amendments to the Income Tax Act have also had considerable effects.

Prior to the amendments of the Income Tax Act which became law in 1972, many apartment investors were characterized by having high incomes and high marginal tax rates. These investors were prepared to trade off a reduction in return on apartment investment for a large tax saving. This

philosophy resulted in a rapid expansion of the rental housing market throughout the 1960's, particularly for three storey wood frame blocks.

The amendments to the Income Tax Act destroyed the possibility for many investors of obtaining large tax savings from apartment buildings. This was mainly due to two amendments:

1. Losses created by capital cost allowances on rental property cannot be deducted from non-rental income; and
2. Each rental building costing \$50,000 or more must be placed in a separate capital cost allowance group.

Return on apartment investment was reduced by these amendments. The first amendment reduced the annual cash flow that was available to those with high professional incomes who invested in apartment buildings, by disallowing the deducting of rental losses from other income and thus, decreasing tax savings to zero. The second amendment increased the taxation that occurred upon the sale of the apartment building by taxing at full rates all depreciation that was recovered.

A third amendment to the Tax Act allowed for the taxation at half normal rates of all capital gains that were forthcoming upon the sale of the investment. This further reduced the investor's after-tax return.

In addition to the reduction in the return on investment by taxation of recovery of depreciation and capital gains and the loss of tax savings obtainable from the use of C.C.A.'s, the return on investment can often be reduced by the need of the investor to establish a sinking fund to maintain the level of his equity throughout the life of his investment.

When an investor sells his apartment building, taxation of recovery of depreciation and capital gains can reduce his after-tax equity to a level which is lower than that which he had when he first purchased the building. To prevent this, the investor must contribute to a sinking fund each year to be used for maintaining his equity at a constant level. Since contributions to this fund are similar to other expenses, they reduce income and hence return on investment.

Before the introduction of the new Income Tax Act, the nature of the rental market was such that many investors in apartment buildings were, in effect, subsidizing their tenants' rents by seeking tax losses from their apartment buildings in order to offset their other income. In striving for these losses, rents were often set at uneconomic levels to the benefit of the tenants. Now that the new Income Tax Act is in effect, apartment investments have to be economic ventures in themselves because they cannot provide any benefits to other income. This means that rents will have to

rise to restore the economic viability of apartment buildings.

The amendments to the Income Tax Act will likely change the types of investors who invest in residential rental property. It is expected that professional men, who heavily invested in apartment properties for tax shelter purposes, will turn to other forms of investment. Their place will be taken by large companies whose business is the provision of rental accommodation. Companies have an advantage over individuals in the rental market because they can deduct rental losses from other income.

New apartment buildings will probably be of a larger, more economic size than many that exist today. Frame apartment buildings which offer an advantageous C.C.A. will decline in importance because the benefit of their C.C.A. rate is less important and because they are more uneconomic to operate relative to concrete buildings.

Municipal Approval for Apartment Developments

The third major set of factors which have interfered with the provision of new apartment buildings for rental purposes are the long and costly delays involved in obtaining municipal approval for apartment developments. The increasing use of land use contracts by municipalities is also increasing the risk that developers have to face in initiating a project and trying to obtain municipal and public approval. Land use contracts also add to the cost of developments because the developer often has to grant expensive concessions to

the municipality to obtain the contract.

The delays and costs found when trying to obtain municipal approval are, of course, faced by every developer no matter whether he is going to produce an apartment block, office tower or industrial park. However, the return on investment available from non-residential rental projects usually far exceeds that which can be obtained from residential rental uses. Thus, developers are willing to take the time, costs and risks to obtain approval for these other uses but they find that the return from apartment investment does not warrant the trouble.

In this dissertation, three municipalities were studied to determine the procedures followed in granting approval of apartment developments under existing by-laws and under land use contracts. The length of time involved and the costs of approval were also examined.

The City of North Vancouver was found to have the most efficient and least time-consuming process for approval under existing by-laws of apartment developments. It appeared that the reasons for the efficiency were due to two factors. Firstly, only one body had responsibility for guiding development proposals through the processing procedure--this was the Building Inspector. Secondly, all the departments concerned in the approval simultaneously processed the documents. This avoided time delays since each department did not have to wait for approval by the previous department before processing could begin.

The organization of the City of North Vancouver was established in such a manner that processing for a building permit could be accomplished in a minimum of time, usually three weeks. Where developers did not submit plans and documents complying with the City's by-laws, processing took longer.

The approval procedure in the City of Vancouver was much more complex and time-consuming than in North Vancouver. This was partly due to a larger number of municipal departments involved in the approval process; partly due to the apparent lack of an overall authority to guide the developer's application through the bureaucratic procedures; and partly due to the organization of the approval process.

Unlike North Vancouver, the City of Vancouver only processed plans and documents through one department at a time. This was a longer procedure than one where several departments were studying the development proposal simultaneously.

The amount of time necessary to obtain development approval in Vancouver varied between a few days and several months, the latter time period being quite prevalent. This added significant costs to the development by increasing the developer's holding costs, interim financing and future construction costs.

The time delays involved in obtaining municipal approval for developments were not entirely the fault of civic officials,

however. It was often the case that those who were applying for approval were not familiar enough with city by-laws to ensure that their developments complied with zoning by-laws and building codes. Also, the plans and sketches submitted with the development proposal were sometimes not of sufficient detail nor contained all the required information that was necessary to grant approval.

The actual processing fees and fees for development and building permits were a reasonable amount in North Vancouver and Vancouver, and added little to development costs.

More and more today, municipal governments are regulating the development of land by land use contracts rather than by zoning by-laws. Initially, the reason for employing land use contracts was that some development concepts could not be approved under existing by-laws because they encompassed a multiple use of land which rigid zoning by-laws did not legally allow.

Today, the increasing popularity of land use contracts for the regulation of development is primarily due to three reasons:

1. The municipal government is able to gauge the reactions of the community to a proposed development at public hearings which must be held prior to the granting of a land use contract.
2. The public is given a voice in the approval of a proposed development.

3. The municipality can extract concessions, such as the deeding of land, from developers which it cannot do under existing by-laws.

The procedures, time required and some of the costs to the developer involved in processing development applications under land use contracts in the City of North Vancouver and the District of Surrey were examined in this dissertation.

In the City of North Vancouver, land use contracts must be used for all developments costing \$600,000 or more or occupying more than one acre. It was found that a much longer period of time was required for approval where land use contracts were involved than where development could proceed under existing by-laws. It could often take a year or longer from the initial date of the developer's application for a land use contract until permission was finally granted.

There were several reasons for the much longer period of time required to obtain municipal approval with land use contracts than with existing City by-laws. Firstly, several additional bodies were involved in the approval process where land use contracts were used than where development approval was authorized by existing zoning by-laws. These bodies were the Planning Consultant, the Advisory Planning Commission, City Council and the public. All of these groups act in an advisory capacity to the proposed development with Council having the final decision on the approval of the project.

Secondly, negotiations must take place between the Planning Consultant and the developer to reach agreement on the terms of the contract. Since there was an absence of guidelines outlining the terms and conditions which the City would seek to be included in the land use contract, the negotiations could often be very lengthy and time-consuming.

Finally, the proposed development must be presented to the public at a hearing before permission could be granted to the developer to proceed. The primary purpose of a public hearing was to give Council a chance to gauge the community reaction towards the development. This process of determining public opinion could often continue long after the public hearing had been held, especially if the views of the community were not clear.

The considerable amount of time expended in processing development applications where land use contracts were involved was directly attributable to the nature of such contracts. It was necessary for all the various advisory boards on land use and City Council to become involved in the approval process because only they could decide if a proposed development which did not come under existing zoning by-laws would be beneficial for the community. It was also necessary under the Municipal Act for the public to be allowed a hearing before approval was given. Thus, much of the delay in obtaining approval was directly related to

the nature of land use contracts rather than to inefficiencies within the municipal government. However, in the City of North Vancouver, some changes could be made to speed up the approval process.

Much of the delay in obtaining municipal approval centered around the negotiations between the Planning Consultant and the developer. No guidelines had been published on which these negotiations were to be based and they could thus become quite drawn out. In addition, the developer was faced with considerable risk because he had no idea of what terms and conditions he would be required to meet until the negotiations began. The developer often had to deed land to the municipality or contribute to the improvement of other municipal services, both of which could be very costly.

It would ease the developer's risk and speed up the negotiating of land use contracts if there were some published guidelines outlining the basic policies to be followed during negotiations and the probable costs of the policies.

In the District of Surrey, land use contracts must be used for all apartment developments. The procedure for obtaining development approval was much the same as in North Vancouver. However, Surrey Council had introduced a development policy which specifically outlined all the charges that a developer had to pay before being granted municipal approval to proceed with the construction of his project. These charges were an integral part of all land use contracts and amounted to \$2,595 for each apartment unit.

The developer who wanted to build in Surrey, unlike his counterpart in North Vancouver, was well aware of the costs of his land use contract before negotiations began. However, the costs of such contracts were so high that often they could make an apartment development uneconomic.

Operating Expenses

Besides the study of the effects of construction, land and financing costs, the amendments to the Income Tax Act and the inefficiencies of municipal processing procedures on new apartment construction, a fourth factor was also examined. This was the effect of operating expenses on apartment profitability.

It has been stated in several publications that operating costs have been increasing faster than rents. An analysis of data presented in Real Estate Trends and in the Dale-Johnson thesis demonstrated that while operating costs do increase as a percentage of gross income as a building increases in age, they have been remaining relatively constant for buildings of the same age when compared in different years. For example, a comparison of buildings between one and two years old in 1968, one and two years old in 1969, and one and two years old in 1970 showed that all groups of buildings in the same age bracket had similar operating expenses as a percentage of gross income, regardless of the year in which they occurred. This indicated that the profitability of more recently constructed apartment buildings has not

been reduced by greater increases in operating expenses than in rents relative to older apartment buildings.

Future Demand for Apartment Units

While the supply of additional apartment units for rental is gradually dwindling, demand is continuing unabated. Demand is growing partly because of the migration of families into B.C.; partly because of the increasing affluence of people in their late teens and early twenties who are able to leave home at an earlier age and compete for shelter in the rental market; and partly because of rising costs of land, construction and financing in the home ownership sector which are squeezing some potential home buyers into the apartment market.

It is expected that the population of the Vancouver Metropolitan Area will increase by 70 per cent between 1971 and 1991, an increase of 729,000 people. Applying estimates of average household size and replacement rates for the existing stock of dwellings, it is calculated that there will be a need for an additional 310,000 units of single and multi-family dwellings by 1991. Using historical rates of growth for single and multi-family units, it would appear that 202,000 units will be needed to accommodate the multi-family sector.

Between 1971 and 1991 an average of 10,000 additional multiple dwelling units per annum will be needed to meet forecasted demand. Since 1969, the number of multiple

family completions per annum has been declining and at no time since 1969 have the number of completions exceeded 10,000 units. Thus, while demand is increasing the provision of additional supplies of multi-family units has been declining, with the result that the shortage of apartment housing will increase.

Only when rents rise to a level high enough to provide investors with a sufficient return on investment will apartment construction pick up and ease the shortage of housing. Already, increasing rents are creating tenant unrest and pressure is slowly mounting on the various municipal governments and the Provincial Government to consider some form of legislation to control rental increases, or halt them altogether.

Rent Control

Studies of rent control systems in the United Kingdom and in New York City indicated that rent controls aggravated housing shortages by reducing developers' and investors' incentive to provide new rental dwellings. This was because construction costs, land costs, financing costs and operating expenses continued to increase while rents were held constant. The result was that the investor's return continued to decline and new construction became increasingly unprofitable.

Rent controls also discouraged the proper maintenance of existing buildings because operating costs continued to increase and reduced the margin of profitability for the

landlord. In some cases, buildings which still had some economic life were abandoned because the margin of profitability became very low.

Experiences in both New York City and the United Kingdom demonstrated that the following consequences were felt when rent controls were introduced:

1. Housing construction for rental purposes was reduced partly because landlords could not obtain a sufficient return on investment and partly because mortgagees were reluctant to finance rental projects where they would fall under the jurisdiction of rent control.
2. Maintenance of existing controlled dwellings declined.
3. The mobility of tenants was reduced because the demand for controlled tenancies usually far outweighed the supply and thus the tenant who vacated a controlled premise had much difficulty in locating in another.
4. Those tenants in the uncontrolled sector were discriminated against because they did not receive the benefit of lower rents that those in the controlled sector enjoyed and because all new demand for rental housing was channelled into the uncontrolled sector forcing rents above that which would have prevailed if rent controls had not been introduced.

5. With time, the number of controlled tenancies was reduced because landlords tried to convert those premises that were controlled into uncontrolled dwellings.
6. The efficiency of the housing stock was decreased because tenants in controlled premises who occupied more space than they required were unwilling to relocate to smaller dwellings because of the difficulty in finding other controlled housing.

Rent controls were also difficult to administer because it was almost impossible to find criteria for establishing fair rents or profits and thus rents were set at a level which was unrealistic when compared to those that would prevail in the free market with the result that serious inadequacies were introduced into the market.

In both New York and the United Kingdom the consequences of rent controls have been realized and major efforts are now being made to abolish strict rent controls and introduce systems whereby those who cannot compete in a free market will be subsidized by the state, rather than by the landlord.

In B.C. those who will not be able to meet the increased rents that will be charged by landlords should be subsidized by the government rather than by the owners of rental property. Only if rents are allowed to increase freely will

apartment investment become economic again and stimulate new construction and reduce the housing shortage.

A Comparison of the Profitabilities
of Some Vancouver Apartment Buildings

The final study conducted for this dissertation was an analysis of the physical, financial and operating characteristics of some apartment buildings operating in Metropolitan Vancouver. The sample was split into two groups--those buildings with an average rate of return on investment of less than 10.0 per cent excluding any capital gains or losses and those with an average rate of return of more than 10.0 per cent excluding gains or losses.

It was found that the more profitable group of apartment buildings (those with a return of more than 10.0 per cent) had a higher median age in 1970 than the less profitable group, 5 years old for the former and 2 for the latter.

The more profitable group of apartment buildings used a lower percentage of gross income to pay principal and interest on mortgage loans than the less profitable group despite both groups having similar loan to value ratios. This was due to two factors.

Firstly, the weighted interest rate on mortgages of the more profitable group was almost 1.0 per cent lower than for the less profitable group. The difference in interest rates was due to the differing ages of the two groups and due to the higher percentage of buildings in the less

profitable group having high interest second mortgages. Since the buildings in the more profitable group were older, they obtained financing earlier and thus at lower interest rates than the less profitable group.

Secondly, higher purchase prices per suite were paid for buildings in the less profitable group than in the more profitable group. This meant that the amounts borrowed by the less profitable group were larger than the amounts borrowed by the more profitable group since the loan to value ratios were approximately the same for the two groups.

These two factors tend to indicate that investors who owned buildings in the less profitable group were generally misinformed in the purchasing and financing of their apartment buildings. As was mentioned, the less profitable group of buildings had a higher percentage of its members carrying second mortgages than the more profitable group and yet the loan to value ratios in the two groups were similar. An examination of the data in Dale-Johnson's thesis did not indicate any valid reasons for this and therefore it could only be concluded that some investors were not aware of the amount of financing that might be obtained with first mortgages or that mortgagees were less willing to give high ratio first mortgages.

Relative to those investors who purchased apartment buildings which belong to the more profitable group, the investors in the less profitable group paid too much for

their buildings given the level of rents and operating expenses of their purchases. This was indicated by the poorer returns that the more expensive buildings obtained.

An analysis of operating expenses lent further support to the hypothesis that the investors in the less profitable group were poorly educated in the ways of the apartment investment market. It was found that the less profitable group of buildings had higher operating expenses as a percentage of gross income than the more profitable group despite the facts that they were newer and in higher rental areas. This indicated that buildings in the less profitable group were being mismanaged.

The Future of the Apartment Rental Market in Greater Vancouver

As has been shown, rents in Metropolitan Vancouver have not been increasing as fast as construction, land and financing costs and thus, yields from apartment investment have fallen in recent years. The amendments to the Income Tax Act have further reduced yields by taxing capital gains and recovery of depreciation and outlawing tax shelters in rental property. Municipal bureaucracy has slowed down the processing of development proposals and the increasing popularity of land use contracts has increased the costs and risks of development.

To offset these factors and reduce current and future shortages of rental accommodation, rents must increase

substantially in the next few years to return apartment investment to an economic footing. Increasing rents will face stiff opposition from tenants and if their implementation is to be successful, landlords must go out of their way to explain to tenants the necessity of these increases.

Apartment investors of the future will have to become more knowledgeable and more sophisticated than their counterparts in recent years. Increasingly, landlords will become larger companies specializing in the rental of residential real estate; projects will become larger and more economic to operate.

Public involvement in the planning process is certain to increase with the result that land use contracts and public hearings will become more frequent. Developers, therefore, will have to design their projects so that they are more amicable to the community and will have to communicate more effectively at public hearings if their projects are to succeed in gaining approval.

Governments should be prepared to step into the rental market and subsidize those tenants who cannot compete in the market of increased rentals. Legislation should also be produced to limit the time allowed for municipal approval of development proposals and to limit the powers of municipalities in the negotiating of land use contracts.

FOOTNOTES

Chapter I

¹R. Dale-Johnson, Returns On Apartment Properties (University of British Columbia: Master's thesis, 1972), p. 1.

²This assumption is not strictly correct. Some of the units in Table 2 were created by the conversion of existing rental accommodation into condominiums rather than being newly constructed. CMHC staff have indicated that probably no more than 20.0 per cent of condominium units were created by conversion.

³Dale-Johnson, op. cit., Appendix.

⁴Statistics Canada, Census of Canada (Ottawa: Queen's Printer, 1966), Vol. 1.

⁵Acres Western, Ltd., Residential Market Opportunity Study (Unpublished, 1971).

⁶Corporation of the District of North Vancouver, Planning Department, Apartment Report (May, 1968).

⁷Greater Vancouver Real Estate Board, Real Estate Trends in Metropolitan Vancouver, 1964-1972.

⁸Statistics Canada, "Residential Rent Index," Prices And Price Indexes (Ottawa: Queen's Printer, Dec., 1972), p. 49.

⁹Statistics Canada, Prices and Price Indexes (Ottawa: Queen's Printer, Dec., 1972 and Feb., 1973), p. 73 and p. 75.

¹⁰Greater Vancouver Real Estate Board, op. cit.

¹¹Financial Post (Toronto: MacLean-Hunter Ltd., 1964-1972).

¹²Central Mortgage and Housing Corporation, Canadian Housing Statistics (Ottawa: Queen's Printer, 1972), p. 62.

¹³Greater Vancouver Real Estate Board, op. cit.

¹⁴Dale-Johnson, op. cit., Appendix.

¹⁵Ibid.

Chapter II

¹⁶Acres Western, Ltd., Residential Market Opportunity Study (Unpublished, 1971), p. 5.

¹⁷Economic Council of Canada, Sixth Annual Review (Ottawa: Queen's Printer, 1969), p. 22.

¹⁸Acres Western, Ltd., op. cit., p. 9.

¹⁹Greater Vancouver Real Estate Board, Real Estate Trends in Metropolitan Vancouver (1970), p. B-11.

²⁰Recent provincial legislation has brought forth new policies for the management of land which may mean that historic rates of development will no longer continue. The major impact of the legislation is that the rate of transformation of agricultural land into urban land will decrease, especially in the South Shore municipalities. This means that land will not be available to accommodate all the new demand for single-family dwellings. The excess demand will be channelled into additional demand for multi-family housing with the result that the projections in Table 8 for multi-family housing may be underestimated.

²¹Central Mortgage and Housing Corporation, Apartment Vacancy Survey, Metropolitan Vancouver, Dec., 1972.

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Chapter III

²²"Future Apartment Development," Apartment Owners Journal, (August, 1972), p. 8.

²³Most notably R. Dale-Johnson, Returns on Apartment Properties (University of British Columbia: Master's thesis, 1972), p. 40.

²⁴Greater Vancouver Real Estate Board, Real Estate Trends in Metropolitan Vancouver (1964-1972).

²⁵Statistics Canada, "Residential Rent Index," Prices and Price Indexes (Ottawa: Queen's Printer, Dec., 1972).

²⁶Statistics Canada, op. cit.

²⁷Greater Vancouver Real Estate Board, op. cit., (1972), p. B-3.

²⁸It was mentioned previously that land costs must be examined in the light of the applicable zoning regulations as they refer to floor space ratios and maximum site

coverage. Since 1964, there have generally been only minor changes in F.S.R. in the various Greater Vancouver municipalities. Consequently, comparisons of land cost increases on a square foot basis among the various municipalities is fairly valid since the land cost per apartment unit has been unchanged by zoning regulations. The exception to this generality occurs in the West End where new multiple dwelling densities were imposed in 1973. The new RM-4A zoning reduces F.S.R.'s to 1.4 with bonuses, from 2.6 with bonuses. This change, however, does not affect the analysis presented here, as it is very recent.

²⁹"Vancouver Urban Renewal Study: Apartment Districts," Technical Report No. 2 (1968), p. 2.

³⁰Ibid.

³¹Statistics Canada, op. cit., p. 73.

³²Statistics Canada, op. cit. (May, 1970), p. X.

³³Statistics Canada, op. cit. (Feb., 1973), p. 73.

³⁴Central Mortgage and Housing Corporation, Canadian Housing Statistics (Ottawa: Queen's Printer, 1971), pp. 35-36.

³⁵This information was obtained from officers of the following firms on July 3, 1973: Metropolitan Trust Co. Ltd.; Canada Permanent Trust; and North American Life Insurance Co.

³⁶This is, in practice, an unrealistic assumption because in the apartment market properties sell on the basis of yield and not on the basis of capital costs. Since yields are not increasing as fast as capital costs, developers of apartment buildings cannot sell their apartments to investors at a high enough price to cover the increasing capital costs. Consequently, fewer apartment buildings are constructed.

³⁷Construction costs and financing costs do vary significantly from region to region. Within a region construction costs only vary because of the transportation costs involved in moving materials. Financing costs can vary according to the lender's view of the profitability of a project. Since Metropolitan Vancouver is such a small area, it is assumed that construction and financing costs are uniform regardless of location.

Chapter IV

³⁸ Benjamin Swirsky, "The Income Tax Treatment of Depreciable Property," Papers on Real Estate and Income Tax (The Real Estate Institute of Canada, 1972), p. 13.

³⁹ Bernard Shinder, "Capital Gains and Real Estate Transactions," Papers on Real Estate and Income Tax (The Real Estate Institute of Canada, 1972), p. 3.

⁴⁰ See especially Swirsky, op. cit., pp. 11-18 and Shinder, op. cit., pp. 1-10.

⁴¹ David A. Ward, "Forms of Ownership of Real Estate," Papers on Real Estate and Income Tax (The Real Estate Institute of Canada, 1972), p. 22.

⁴² Department of National Revenue, Taxation, Interpretation Bulletin No. IT-72 (Ottawa: Queen's Printer, 1972).

⁴³ Ward, op. cit., p. 24.

⁴⁴ Interviews were conducted with officials of Block Bros. Realty Ltd. and Wall and Redekop Corporation Ltd. in June, 1973.

⁴⁵ "Future Apartment Development," Apartment Owners Journal (August, 1972), p. 8.

Chapter V

⁴⁶ Much of the information presented in this section was obtained from the Building Inspector for the City of North Vancouver at an interview on July 6, 1973.

⁴⁷ City of North Vancouver, Resolution of Council (June 12, 1972).

⁴⁸ Development permits are not required in the City of North Vancouver.

⁴⁹ City of North Vancouver, Building By-Law No. 4361 (1972), Subsection 1.9.3.

⁵⁰ Ibid., Appendix A.

⁵¹ See footnote 46.

⁵² City of North Vancouver, Resolution of Council, op. cit.

⁵³Most of the information concerning processing procedures was obtained from officials in the Building Department in July, 1973.

⁵⁴City of Vancouver, Zoning and Development Fee By-Law No. 4188 (September, 1965).

⁵⁵Ibid.

⁵⁶Most of the information concerning processing procedures was obtained from the Planning Department in the District of Surrey in July, 1973.

⁵⁷District of Surrey, Municipal Development Policy (June, 1973), p. 3.

⁵⁸Ibid., p. 3.

⁵⁹Ibid., p. 4.

⁶⁰Ibid., p. 7.

⁶¹Ibid., p. 9.

⁶²These figures were obtained from some developers who were interviewed during efforts to obtain construction cost data.

⁶³District of Surrey, op. cit., p. 14.

⁶⁴Ibid., p. 14.

⁶⁵Ibid., p. 10.

⁶⁶

Chapter VI

⁶⁶R. Dale-Johnson, Returns on Apartment Properties (University of British Columbia: Master's thesis, 1972), p. 18.

⁶⁷Greater Vancouver Real Estate Board, Real Estate Trends in Metropolitan Vancouver, 1966-1972.

⁶⁸Dale-Johnson, op. cit., Appendix.

⁶⁹Greater Vancouver Real Estate Board, op. cit.

⁷⁰Dale-Johnson, op. cit., Appendix.

⁷¹Ibid., p. 57.

Chapter VII

⁷²The British history of rent control has largely been drawn from Adela A. Nevitt, The Nature of Rent Controlling Legislation in the United Kingdom (London: Centre for Environmental Studies, 1970), 22 pp. and Michael Audain and C. Bradshaw, "Rent Regulation," Is There a Case For Rent Control (Canadian Council on Social Development, 1973), pp. 13-37.

⁷³H. M. S. O., Report of the Committee on the Rent Acts, Cmd. 4609 (1971), p. 82.

⁷⁴Ibid., p. 83.

⁷⁵Michael Audain and C. Bradshaw, op. cit., pp. 13-37 was a valuable source of information for this section.

⁷⁶"New York Eases Rent Controls," Apartment Owners Journal (February, 1972), p. 10.

⁷⁷Philip H. White, The Case Against Rent Control (Toronto: Canadian Council on Social Development, 1972), p. 1.

⁷⁸H. M. S. O., op. cit., p. 132.

⁷⁹Ibid., p. 131.

⁸⁰White, op. cit., p. 7.

⁸¹Ibid., pp. 6-9.

Chapter VIII

⁸²R. Dale-Johnson, Returns on Apartment Properties (University of British Columbia: Master's thesis, 1972), Appendix.

⁸³Ibid., pp. 71-72.

⁸⁴The data was drawn from Dale-Johnson and is summarized in that work in Table 14, p. 66; Table 15, p. 74; and Table 16, p. 77.

⁸⁵Many of the limitations were previously discussed in Chapter VI.

⁸⁶Dale-Johnson, op. cit., p. iii.

⁸⁷Ibid., p. 48.

⁸⁸Ibid., pp. 39-42.

⁸⁹The results of Dale-Johnson's analysis of operating cost ratios in relation to number of suites are presented in Table 6 of his thesis. Those results show a weak correlation between decreasing operating cost ratios and increasing building size. For this reason, it is doubtful that an apartment building with seven more apartment suites than another building would have a significantly lower operating cost ratio. Table 5, however, in Dale-Johnson's thesis shows a clear relationship between increasing operating costs and building age. The fact that the more profitable group of buildings are older and have lower operating cost ratios than the less profitable group must indicate some management problems in the latter group.

⁹⁰Dale-Johnson, op. cit., pp. 8-11.

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