

Intelligence MEMOS



From: Benjamin Dachis
To: Steve Clark, Ontario Minister of Municipal Affairs and Housing
Date: April 1, 2022
Re: SUPPLY CONSTRAINTS DRIVE HOUSING PRICES SPIKES

This week's [announcement](#) from the Ontario government of their planned actions on housing shows more is still needed to truly solve the housing cost crisis. And the Union of British Columbia Municipalities issued a [report last week](#) putting the blame for high housing costs on everyone but themselves. It is the lack of housing supply, largely driven by municipal governments slowing down approvals, that is behind this problem.

Ontario made some incremental moves to reduce delays in housing development. For example, fiscal consequences to cities for [lengthy delays](#) in approval is a good start. But most action has been deferred [to a consultation](#) the government will start after the election to inform future rounds of housing red-tape reduction.

Here's why governments need to keep the focus on increasing supply. In a world without any impediments to building, housing development is a simple business like any other. Developers need to sell what they build for more than what it cost them.

What are their costs? Construction workers, naturally. Lumber and other physical products, of course. And a loan from the bank to cover their costs until they sell what they've built. The cost of all these key ingredients of a house – labour and capital – depend on supply and demand factors. When there is more demand for construction workers, a developer must pay more for them. Lumber [costs](#) have risen and fallen like a yo-yo. The results affect construction costs and therefore buying prices.

Housing gets built when it's profitable to do so. Greedy developers aren't the core of the problem. If profits for building housing rise as demand goes up, more and more developers enter. A core lesson of economics is that the profitability of the building sector will come down if there are no barriers to entry and fierce competition.

In many places in Canada and in [many parts of the United States](#), even booming places like [Atlanta](#) or [Orlando](#), these basic economics determine the cost of housing. In [Edmonton](#), prices are the same as they were in 2015. The final purchase price of housing in Edmonton is in [line](#) with the cost of building.

But in other places like Toronto or Vancouver there has been a persistent gap between construction costs and sales prices. A key reason: Builders in big cities face added costs beyond what it costs to build. For example, many proposed developments in Canada's major cities undergo lengthy community consultation. After that, projects need government approval. That's no sure thing. Developers must increase their prices to cover the instances when their efforts are stymied.

Process delays are a big part of the problem. That makes it hard to build up. There are barriers to growing out as well. There is also a lack of transit infrastructure to make land useable. And a lack of municipal water supply to service new subdivisions. The list of barriers is long.

It is this lack of places to build that drives up the cost of the limited amount of land that can be most easily built on. That rising land cost is driving housing cost increase, not construction costs. One [study found](#) that 80 percent of the increase in home prices across 14 advanced countries since the Second World War has been due to increasing prices of land.

How much are these extra land costs on top of construction costs in Canada? As of 2018 (meaning these figures are surely higher now), homebuyers in Vancouver saw an extra cost of \$644,000 for the average new home because of supply limits. It's an extra \$168,000 in the Greater Toronto Area. Sale price increases in both places far outstripped increases in construction costs over recent history.

Governments seem to have still bought into the argument that high demand, not supply, is the root cause of high prices. And, as a result, we get policies that either make buying easier for domestic borrowers, or make demand harder for foreign buyers. Indeed, Ontario announced increased taxes on foreign buyers as of March 30. Unfortunately, this won't solve the problem.

Increases in price caused by foreign buyers only occur because of a lack of supply. What would happen if housing developers could increase supply to match even extreme increases in demand from foreign buyers? Yes, they would pay more dearly for lumber or concrete for high-rises, which would increase input costs, and, ultimately, the cost of housing, but only incrementally. They don't explain the doubling of housing costs.

Using the same economic logic as housing builders seeing fierce competition and lower prices if there are no barriers to entry, the best cure for high prices is more supply. Restrictions on supply are what keep prices high when we have high demand, such as from foreign buyers.

It's time for the Ontario government to get serious about tackling the housing supply problem as the root cause of high home prices.

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