CANADA—U.S. FREE TRADE PACT MAY BENEFIT COUNSELORS

by Robert B. Hulley, CRE

The Canada–U.S. Free Trade Agreement, "once approved by your Parliament and our Congress, will throw open the doors to the world's largest free trade area," said President Ronald Reagan in his farewell speech to Canadians following the Summit Conference held in Toronto.[1] The Free Trade Agreement (FTA) will create new opportunities for trade in service, giving both Canadians and Americans the right to do business on either side of the border. Counselors, however, seem unaware that real estate is among the service industries covered by the agreement.

"The key element in the FTA pertaining to trade in services is a commitment by both countries to national treatment in all new policies. National treatment means that foreign firms are treated the same under laws and government policy."[2] The obligation, however, to extend national treatment does not mean that treatment has to be the same in all respects. Article 1403,[3] for example, specifies that either government remains free to license and certify providers of specific services, such as real estate, but must ensure that the licensing requirements do not act as a discriminatory barrier for persons of the other nation to meet. Not only will it be easier for Canadians to work on assignments in the United States, but also, it will be easier for firms to sell and accommodate specialized services in the United States, or for Americans to do the same in Canada.

Counselors, whether in Canada or in the U.S., often work together informally, referring clients and assisting one another. Now under the FTA, "temporary entry by business visitors, professionals and intercompany transfers will be liberalized between Canada and the United States . . . Both Countries have restrictive temporary-entry regulations now, but the U.S. restrictions have been particularly troublesome recently."[4] The challenge, therefore, for those preparing the agreement was to ensure that immigration regulations would complement the rules governing the movement of services, but would not compromise the ability of either government to determine who may gain entry.

Free trade already has prompted some Canadian and U.S. professionals to consider joining forces. And, although lawyers are excluded from the FTA, the legal firm of Day, Berry and Howard (Hartford, Connecticut), who "have represented both Canadian and U.S. corporations, is now looking to joint venture with Canadian law firms to provide business clients with legal advice from both sides of the border."[5] According to Robert Siegal, partner, Day, Berry and Howard, they are arranging working relationships—that could mean more business for both entities.

Real estate counselors should be aware of the agreement's possible ramifications, opportunities and limitations. For example, while real estate agents, brokers and managers specifically are included in the agreement, the Standard Industrial Classification (SIC) index, does not include real estate counselors. This could lead to misinterpretation since real estate counselors are not listed as an occupation in either the Canadian or American SIC manuals.[6] However, this may not be a problem, since counselors would probably qualify under the real estate broker or management consultant categories. Counselors on both sides of the border should, however, work toward having this classification amended. After all, trade in service is considered the frontier of international commerce in the 1980s.

"The new, general rules adopted for trade in service are a trail blazing effort and could lay the foundation for further work multilaterally. Applying these rules prospectively will insure that new discrimination will not be introduced. This constitutes a major step toward ensuring that open and competitive trade in services continues between the two countries."[7] And, the process of the agreement becoming law in both countries moved closer when both the House Ways and Means and the Senate Finance Committees unanimously approved the legislation. In signing the implementary legislation, President Ronald Reagan said, "I am sending to Congress what will be one of the most historic pieces of legislation during my Presidency."[8]

Both Canadian and American members of the American Society of Real Estate Counselors are in a preferred position to benefit from the FTA since many already have worked together. Now, the real estate service industries on both sides of the border can profit from the new opportunities and challenges. As stated by Prime Minister Mulroney at the Toronto Summit meeting, "It will promote new ideas and develop a common sense of purpose."[9]

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NOTES

1. Remarks by the President of the United States of America, to the members of the Empire and Canadian Clubs, June 21, 1988, Royal York Hotel following the Toronto Economic Summit.
2. Smith, Murray G., Free Trade—The Real Story, Institute for Research on Public Policy.

Gage Educational Publishing Company, Toronto, 1988.

3. The Canada – U.S. Free Trade Agreement, Chapter 14, Articles 1401-1407, 1988.

4. Ibid.

5. Free Trade May Prompt Lawyers to Join Forces, The Financial Post, July 8, 1988.

6. Standard Industrial Classification (SIC) fourth edition, Department of Supply and Services, and United States Office of Management and Budget, Standard Industrial Classifications, 1987.

7. The Canadian Free Trade Agreement Synopsis, External Affairs Canada.

8. Senator Breaks Ranks Over Free Trade Tactic, The Financial Post, July 26, 1988.

9. Quote from Prime Minister Brian Mulroney's Economic Summit Leaders Final Communique, The Toronto Star, June 22, 1988.

Another Viewpoint

HOUSING AFFORDABILITY INDEX — WHAT IT IS AND ISN'T

by Glenn Crellin

During the period of soaring mortgage interest rates in the early 1980s, the NATIONAL ASSOCIATION OF REALTORS wanted an understandable measure that could be used to compare the affordability of housing over time. The result was the development of the housing affordability index. A brief explanation of why specific measures were chosen as components of the index may aid in understanding the application of the affordability index.

Development History

The objective of the index is to measure the affordability of housing to middle-income Americans. Middle-Americans generally purchase typical houses, and there is no better way to measure typical than through the median sales price, the price at which half the homes sold for more and half sold for less. Too often analysis used average home prices, but those values are significantly influenced by the sale of comparatively few, but very expensive properties. This upward bias is suggested by the fact that the average price in 1987 was 24.2 percent higher than the median of $85,600.

The second component of housing affordability is mortage interest rates. We chose to use the average effective interest rate on existing homes as reported by the Federal Home Loan Bank Board. This was a difficult decision. Intuitively we would have preferred to match our home prices, which are measured at the point of contract rather than closing, with the interest rates consumers were facing in the market place at that point in time. The Bank Board's commitment rate series would have satisfied this condition. However, when the index was being developed loans were actually being made at rates well below what the financial institutions were advertising, using techniques such as buydowns. Moreover, the closing rate allowed the index to be calculated using mortage rates exclusively for resale homes.

Finally, assumptions were required on downpayment and term of mortage. According to the Bank Board's data, the average downpayment on existing homes was 20 percent, leading to the choice of that percentage for the calculation of the index. It is further assumed that the loan is amortized over a 30-year period.

From these two components (median price and mortage interest rate) and two assumptions (20 percent down, 30-year term) a monthly payment can be calculated. However, knowing how much the house costs and how much the payments would be tells only part of the story. Income is the other factor. Exactly how much income is required to carry that mortgage? Clearly, there is no easy answer. It depends, of course, on the other housing costs in an area, especially homeowners insurance and property taxes, not to mention the other debts of the purchasing family. While each financial institution sets its own qualification standards, the realities of the marketplace require that most mortgages be *conforming loans* (they conform with Fannie Mae guidelines on what can be sold in the secondary market). Generally, this means the housing cost cannot exceed 28-30 percent of the purchaser's gross income. For simplicity it was decided to avoid the problem of property taxes (the largest remaining portion of housing costs) by dropping the proportion of income which could be devoted to paying principal and interest costs to 25 percent. Subsequent analysis has determined this is consistent with a 1.0 to 1.5 percent *effective* property tax rate (that is, as a percent of market value or sales price rather than assessed values). Accordingly, an annual *qualifying income* is calculated based on four times the monthly mortgage payment times 12 months.

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Now for the critical question. How does this qualifying income compare with incomes available to home purchasers? As usual, choices were required among imperfect measures.

Once again a median measure was preferred, but what median? The Census Bureau produces the two most likely candidates, both derived from the annual Current Population Survey—Median Family Income and Median Household Income. Choice between the two is far from trivial; it amounts to thousands of dollars. While any household may choose to purchase a home, the traditional (and current) home purchases are predominantly families, both married couple and single-parent families. This difference in the characteristics of the housing market led to the selection of the family income measure. Put simply, the purpose of the index was to measure the ability of a typical potential buyer to afford the purchase—and that typical purchaser is part of a family household.

Accordingly, the index is constructed to measure the ability of this middle American family to afford the carrying cost of the purchase of a median price (typical) home. Mathematically:

$$\frac{\text{Median Family Income}}{\text{Qualifying Income}} \times 100 =$$

Housing Affordability Index

Note that the index does not measure the affordability of housing at the present time relative to some previous point in time. It has no base year as does a consumer price index. It is simply an index of the potential for current purchase by the typical family.

Similarly, it does not measure how many American families can or cannot afford to purchase a home. Trying to develop that number requires a myriad of assumptions. For example, the number of households (families) that can afford to purchase a house are not only those with enough income to qualify for a home loan but those who also possess the required downpayment. Moreover, a household which could not qualify for a loan on the median price home with a 20 percent downpayment, if they have the liquid assets, might choose to qualify by increasing their downpayment.

The Future Of The Affordability Index

The mere fact that the Houing Affordability Index has existed in its current form for several years does not imply the analysis of affordability is stagnant. Two enhancements are currently under development.

First, we have recently developed an affordability index for first-time buyers. Several factors make the current index unsatisfactory for first-time buyers.

- They typically buy smaller, less expensive homes.
- They have not had the good fortune to ride the housing market to an equity position which allows a 20 percent downpayment.
- They are younger and therefore lower on the income ladder.

The first-time buyer index is computationally similar to the existing index in that it assumes a starter home price at 85 percent of the median price. This agrees with observed behavior from our research with recent homebuyers. It assumes a 10 percent downpayment (still a real hurdle) and adjusts the mortgage rate to include a PMI premium. Finally, it compares the resulting qualifying income to the median income of families in their mid-20s to mid-40s who are currently renters, because these are the primary first-time buyers. Preliminary results indicate that, as expected, housing is much less affordable for first-time buyers *and* that the gap between the housing haves and have nots is growing wider.

The other primary enhancement is localization of affordability estimates. While incomes tend to be higher in the same areas where housing prices are higher, the value of the relationship is not well known. The problem we have faced is finding an appropriate measure of income. Census Bureau unpublished data has been reviewed for the 20 largest metropolitan areas. Unfortunately, the development of this data is such a low priority at the Bureau (in large part because the samples do not meet the publication criteria) that the data is computed using 1970 Census geographic definitions. Less satisfactory unpublished family income data at the state level may be used, except in some of the largest urban areas, where the metro income data does meet publication standards. Although the mortgage market has become national, variations in mortgage rates between areas must be considered. The biggest remaining stumbling block relates to the necessity to factor in property taxes which are more nearly standardized across a metro area than they are across the country. Fortunately, data from the Government's Division of Census along with local government trade associations will permit reasonably accurate estimates.

Summary

What is the Housing Affordability Index? A statistical measure of the ability of Americans to buy homes.

Why was it developed? As a tool to communicate the problems with housing affordability to the public policy makers who were creating the environment in which the housing sector operates.

Is the Housing Affordability Index intended to influence buyers/sellers? Originally no, but more recently it has been used to convince clients that widely publicized price increases have not pushed housing beyond the limits of most Americans. It is not expected to significantly influence the direction of home prices, home sale volumes or time on market.

Is the Housing Affordability Index perfect? Of course not. It is based on assumptions, but it provides a good general overview of the housing market. Enhancements are currently underway that will make the index more widely accepted and understood.