

**ECONOMIC SURVEY OF SPAIN 2005:  
STABILISING THE HOUSING MARKET**

This is an excerpt from the OECD Economic Survey of Spain, 2005,  
from chapter 2, “Preserving Macroeconomic stability and competitiveness”.

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**Stabilising the housing market**

1. Stabilising the residential construction market is another crucial challenge. A continuation of the steep rise in house prices is increasing the risk of a marked fall in the medium term, while at the same time accentuating social problems, because housing services become increasingly unaffordable. The continuing rapid increase in households’ residential investment and borrowing is making the economy more vulnerable to a rise in interest rates (Chapter 1).

***The stabilisation of the housing market should involve structural reforms***

2. The policy response should depend on the relative importance of the supply and demand factors responsible for the surge in house prices (**Annex 2.1**). The sharp rise has been accompanied by a substantial increase in the supply of housing, in contrast with some other OECD countries. Recent research has stressed the importance of demand pressures which have been underpinned by low real interest rates (García-Montalvo, 2003; Martínez Pagés and Llanos Matea Rosa, 2003). Demand is also boosted by distortions caused by housing policy. They limit both the supply and the utilisation of the housing stock. Housing policy is designed to guarantee all Spaniards access to adequate housing. It has had mixed results despite a budgetary cost of 1% of GDP in 2004, which seems high in international comparison.<sup>1</sup>

***There are still some problems with access to housing, but they do not seem to be widespread***

3. The main aim of housing policy has been to facilitate home ownership through several measures: *i*) income tax relief on the purchase of a main residence, without any means test, granted both by the central and many regional governments; *ii*) assistance to help the least well-off households purchase a home via housing plans; *iii*) the application of a reduced value added tax (VAT) rate on residential construction; and *iv*) no taxation of the imputed rents of owner-occupiers.<sup>2</sup> Justified in part by the very high level of interest rates until the late 1990s, these measures have contributed to increase the proportion of owner-occupiers in recent decades (**Table 2.4**). The proportion reached 85% in 2001, the highest in the OECD. In recent years, it was also stimulated by the sharp fall in interest rates, longer-term mortgage loans and the growing proportion of households with two incomes. The latter has reduced the cost of home ownership as a proportion of the average household’s income to a moderate level, despite the rise in property prices (**Figure 2.8**). While accessibility seems to be less of a problem than in the other European

countries for a large part of the population,<sup>3</sup> difficulties persist for less well-off population groups (Pareja and San Martín, 2003) and the problem varies a great deal from region to region (CES, 2003) (**Box 2.3**).

**Table 2.4. Tenure and availability of housing**  
2001

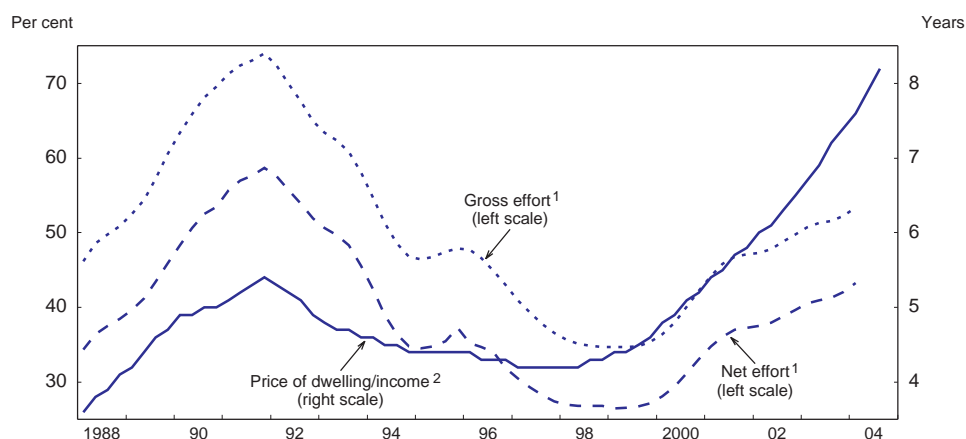
	% of the stock of main residence			Dwellings per 1 000 inhabitants	1991 Vacant dwellings (% of total stock)
	Owner-occupied	Rented	Other		
<b>Spain<sup>1</sup></b>	84.8	10.1	5.1	..	..
Census 2001	82.0	11.5	6.5	510	15.5
Census 1991	78.3	15.2	6.5	436	14.8
Census 1981	73.1	20.8	6.1	390	16.3
Austria	55.3	37.3	7.4	465	4.6
Belgium	73.9	23.4	2.7	456	..
Denmark	66.6	32.9	0.5	469	4.8
Finland	68.1	30.7	1.2	483	6.9
France	63.4	31.3	5.2	477	7.2
Germany	43.8	52.6	3.6	473	1.8
Ireland	81.9	16.5	1.6	358	..
Italy	76.2	17.5	6.3	459	7.2
Netherlands	55.3	44.0	0.7	416	2.2
Portugal	66.7	23.5	9.8	489	10.5
Sweden	59.8	40.1	0.1	483	0.4
United Kingdom	71.8	26.8	1.4	433	4.5
EU average	64.2	31.9	3.9	468	5.0 <sup>2</sup>

1. Eurostat source.

2. Unweighted average of the above European countries for which data are available.

Source: Banco Bilbao Vizcaya Argentaria (BBVA), *Situación Inmobiliaria* (various issues) and Eurostat, New Cronos database, September 2004.

**Figure 2.8. Indicators of housing accessibility**



1. These indicators show the efforts (relative to the annual income, gross and net of tax) required for the reimbursement of a 15-year mortgage, to finance 80% of the acquisition cost of a 93.5 m<sup>2</sup> dwelling.

2. Number of annual incomes to afford a house.

Source: Ministerio de Fomento and Bank of Spain.

### Box 2.3. Low-cost housing policy seems ineffective

Low-cost housing policy consists mainly in building subsidised houses which are then sold to poorer households, contrary to most other OECD countries which have developed a sector of subsidised rented dwellings. The problems that households with modest incomes face in gaining access to the housing market have worsened in recent years in Spain partly as a result of the reduction in the construction of subsidised housing. After falling by half between the 1980s and the first half of the 1990s, the supply of this sort of accommodation has remained low, accounting for only some 10% of total annual housing construction. Because the bulk of this type of property is built by the private sector, the increase in real estate prices makes such projects less attractive to promoters, which results in a crowding out effect when the market overheats. In addition, the high budgetary cost of subsidised housing also tends to impede its expansion, with the result that strong demand has given rise to frequent irregularities in the way such homes are allocated to the targeted population: for example, sales sometimes take place at above the recommended price or such homes are purchased as secondary residences (Rodríguez López, 2004). The effectiveness of these measures is also called in question by the lack of control over subsequent transactions of low-cost housing (López-García, 2003). The construction and sale of low-cost homes are not a very effective way of solving the issue. Government assistance takes account of households' current income rather than their permanent income, and its irreversibility makes it impossible to adapt to changes in situation or to household's often transitory needs (Ruiz and San Martín, 2004).

Furthermore, the stock of subsidised rented dwellings is too small to meet demand. In the early 2000s, it accounted for just 6.3% of all main residences, compared with 13.7% for the European average, while the number of low-cost dwellings being rented covered only 35.4% of poor households, as against 72.8% on average in Europe (Pareja and San Martín, 2003). The low supply of low-rent housing,<sup>1</sup> is liable to cause growing problems in the future, because of the probable rise in captive demand for this type of accommodation due to the increase in immigration. Seventy per cent of immigrants rent their homes and most of them live in large towns where real estate prices are the highest (CES, 2003).

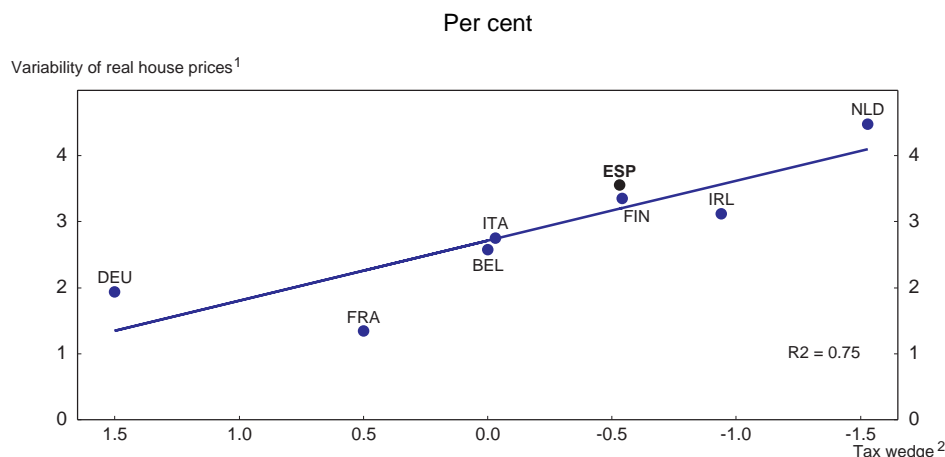
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1. According to the 2002-05 housing plan, only a little over 10% of subsidised housing construction was intended for rental in 2003.

### *Measures to encourage home ownership push prices up,...*

4. Tax incentives in favour of home ownership have contributed to stimulate housing demand and to push prices up. As shown by van den Noord (2005), tax incentives for house purchases can also reinforce house price volatility (**Figure 2.9**). According to Domínguez Martínez (2004), income tax deductions reduce the effective interest rate by 2 percentage points on average and real after-tax interest rates have been negative since 1999. The scale of the subsidy, which varies with the size of the loan, the depreciation rate and the level of interest rates, allows buyers to increase their borrowing and the price of the home purchased by 15% to 20%. In view, however, of the strong pressure of demand and the rigidity of housing supply, it is likely that these tax deductions are largely capitalised into prices. López-García (2003) estimates that, without these concessions, property prices would fall by between 15% and 30%.

**Figure 2.9. Correlation between the tax wedge and variability of house prices**



1. Root mean square deviation of real house price from trend, 1970-2001.
2. Difference between after-tax and pre-tax real interest rate on mortgage loans; 1999 tax rules, interest rates and inflation.

Source: P. van den Noord (2005), "Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence", *Économie Internationale*, CEPII (Centre d'études prospectives et d'informations internationales), Paris, forthcoming.

***... their redistributive effect is debatable and they tend to distort resource allocation***

This assistance can hardly be justified by positive externalities and their redistributive effect is debatable. As these tax deductions probably increase house prices, they result in a redistribution in favour of owners and hence between young and older people. Taking a longer-term perspective, they also create distortions by channelling a large share of savings into construction instead of other, more productive activities. According to Domínguez Martínez (2004), the taxation of real estate purchases and financing, measured on a net basis, amounts to only some 5% of the purchase price and is even negative if only central government taxes are included. The low level of taxation compared with other investments undermines the neutrality of the tax treatment of saving, a phenomenon accentuated by the tax relief on capital gains from selling main residences. Those older than 65 years benefit from this in particular (Antón Perez, 2003). All told, the tax system makes investing in property especially attractive to build up and transfer wealth, but it distorts resource allocation, as illustrated by the large share of this sector in the economy.

***The effect of demand pressures on prices is exacerbated by the rigidity of housing supply***

Demand pressures on prices are accentuated by supply rigidities. The rise in the cost of building plots has accounted for a rising share of house prices, mainly because of restrictions by the municipalities regarding the classification of areas that can be built on.<sup>4</sup> Since the mid-1990s there have been various reforms<sup>5</sup> and, according to the Ministry of Housing, the availability of building and developable land is no longer a problem. However, this assessment, which is difficult to confirm because of a lack of statistical information,<sup>6</sup> is not shared by many observers. The latter underline the persistent restrictive role of local governments, which control the supply of building land and are interested in keeping prices high by using arbitrary criteria to issue building permits since they benefit from the compulsory transfer of 10% of land when it is reclassified as developable. The importance of this phenomenon is however difficult to quantify. In any case, the likely restrictive effect on the supply of building land is reinforced by the length and complexity of the town planning procedures needed to build the necessary infrastructure, such as water and electricity. These procedures, which in the majority of regions are the landowners' responsibility, can last between 7 and 10 years.

### *The private rental market has declined because of weak demand...*

Housing policy is also harming the development of the private rental market. The rental market accounted for only 11½ per cent of the stock of main residences in 2001, which is one-third of the EU average. The trend decline of this market, which was much more marked than in the rest of the OECD because of rental regulations that for a long time were tilted in favour of tenants (García-Montalvo, 2003), was not halted by the 1985 reforms.<sup>7</sup> The private rental market is still suffering from a chronic shortage of demand due, in part, to the tax deductions for house purchases. Because of them, non-captive demand from households with sufficient resources to choose the type of housing they want is turning into a decision to purchase. The discounted present value of the assets accumulated by a household buying a home very soon outstrips the capital built up by a tenant who systematically invests on the financial market the saving resulting from the difference between his rent and what he would have spent on a house purchase (OECD, 2003). This strengthens the public's traditionally negative attitude towards renting, which is seen as "a waste", and thus pushes private sector rentals down.

### *... and the supply of rental accommodation restricted by regulatory impediments*

Private rental supply is also small, despite the large share of real estate in households' wealth (Chapter 1), due among other factors to the high underlying returns on investment if one allows for capital gains.<sup>8</sup> The result is a very large number of unoccupied homes. They account for some 14% of the total housing stock in 2001, which is about double the total stock of rental accommodation. This proportion is well above the average for other countries (**Table 2.4**), even though it is probably overestimated. It is partly the result of demographic factors<sup>9</sup> but is due above all to regulatory obstacles which encourage owners to keep their property unoccupied. With rent levels low, the return that owners can obtain from letting their accommodation would seem insufficient to offset the associated costs resulting, in particular, from damage to the premises and the risk of unpaid rents. The relationship between owners and tenants is complicated by the existence of a variety of different legal situations in a small market.<sup>10</sup> Moreover, the actions of the courts are often very slow to resolve flagrant abuses benefiting tenants (Martínez Pagés and Llanos Matea Rosa, 2003). Furthermore, the minimum five-year period for rental contracts, which was introduced in 1994, could well act as a major constraint for investors to sell, particularly when demand is high, which is no doubt why they leave their property unoccupied.

### *Measures have been adopted to resolve the difficulties of the housing market*

To resolve these problems, the government has created a new Housing Ministry, whose resources have surged in 2005 (by 32%). They will be used to increase the subsidies in favour of home purchases by young people with low incomes. These measures come on top of an emergency plan costing € 1 billion. It has three main objectives:

- *First*, the plan increases the supply of low-cost housing by 65% (from 110 000 to 180 000 homes in 2004), with the maximum price of low-cost dwellings being raised by 4% to make the sector more attractive to private promoters. The bulk of the increase (40 000 houses) is for the rental market.
- The *second* objective is to expand the rental sector by boosting demand and supply. Assistance will be made available to tenants aged under 35 and with limited means for a maximum of two years.<sup>11</sup> In addition, subsidies are also being granted to firms and public bodies purchasing property for the purpose of letting it,<sup>12</sup> and also to private individuals letting accommodation for a minimum period of five years so as to cover their insurance costs against unpaid rents and the cost of repairing their property. In 2005, a public rental agency will be set up to ensure the transparency and development of the rental market, while a committee of experts will investigate improvements in the legal relations between tenants and owners.

- *Third*, to limit the rise in real estate prices the auctioning of public land will be abolished and replaced by “beauty” contests,<sup>13</sup> while an inter-ministerial commission will look into the possibilities of increasing the supply of public land for the construction of subsidised housing.

### *Assessment*

Although moving in the right direction, these reforms further increase public spending on housing, the opportunity cost of which is high in terms of higher taxation or foregone revenues. They only partially correct the factors distorting the real estate market. The measures adopted under the emergency plan to expand rental demand are inadequate, for example; they only concern captive rental demand and appear to be narrowly targeted on demand by young people to solve the problems of access to housing. An increase in total rental demand is required<sup>14</sup> and this means gradually doing away with home ownership assistance, with its high budgetary cost and tendency to push property prices up. Abolishing this assistance would also improve the allocation of savings, a high share of which is channelled into the construction sector.

While measures to stimulate rental supply are needed, they should focus on eliminating the regulatory obstacles rather than granting further tax expenditure. In this respect, the plan to improve the legal safety of relations between tenants and owners is a sensible initiative which could be supplemented by a reduction in the minimum five-year duration of rental contracts. Once the regulatory framework of rental supply has been improved, the usefulness of the recent tax incentives in attracting private rental supply will need to be reconsidered. On the other hand, the cost-effectiveness of the current system of subsidies to social housing, which still relies largely on selling subsidised housing, should be reassessed. A less costly and more effective way of solving the problems of access to housing for disadvantaged population groups could be for example to let rather than sell subsidised housing. It is important, though, that such measures should be properly targeted, including periodic reassessment of the situation of the beneficiaries (OECD, 2004a). Alternatively, it might be preferable to ease the access of disadvantaged population groups through the introduction of a tenant-based voucher system. This approach would broaden the choice of the beneficiaries and would reduce the risks of creating “ghettos” that develop because of the lack of maintenance of rented houses (Olsen, 2003). In general, a policy that focuses on measures to encourage renting will have beneficial effects not just on the housing market, but also on workers’ geographic mobility, which is currently very limited. Taken as a whole, these measures should reduce public expenditure on housing and ought to be accompanied by the relaxation of town-planning regulations. Removing the compulsory transfer of 10% of building land to the municipalities should also be considered in the context of a local tax reform (Chapter 4) to eliminate the incentive of the municipalities to keep prices high.

## NOTES

1. In the late 1990s Spain was devoting more resources to housing policy (1.4% of GDP) than were other European countries (0.8% of GDP). Such international comparisons are, however, difficult to make and need to be interpreted with some caution (ECB, 2003).
2. Applying the reduced VAT rate of 7% to residential construction, instead of the normal rate of 16%, amounts to a revenue shortfall of € 2.7 billion in 2005. Income tax relief on the purchase of a home amounts to € 4.4 billion (including tax relief granted by regions). Housing plan assistance, which takes the form of direct grants or subsidised loans subject to a means test for the purchase of homes having specific characteristics in terms of size and price, represents about € 1 billion.
3. Expenditure on housing as a proportion of household incomes is lower on average than in Europe. Although more Spanish households are owners and their financing costs are similar to those in other European countries, a larger proportion of them has finished paying for their homes (65.9% of households in Spain compared to 38.6% in Europe). Also, there are fewer people renting and average rents are lower as a percentage of income than in Europe (Pareja and San Martín, 2003).
4. The linkage between trends in the price of land and house prices has been emphasised, since the former cannot be mechanically identified as the cause of the rise in real estate prices. The price of land depends in fact on house price expectations, bearing in mind the amount of building that town-planning regulations allow on the plots in question. This interaction does not, however, call in question the central role played by the market for land (the supply of which is neither reproducible nor homogeneous, which gives landowners a certain monopoly power) in ensuring a flexible supply of housing.
5. In 1996, for example, the authorities simplified the method used to classify urban land and reduced from 15% to 10% the amount of the land that private promoters had to transfer to the municipalities for the construction of low-cost housing and amenities.
6. Some statistics suggest a recent easing of building land prices, the increase of which slowed substantially in 2002-03 after it had exceeded 30% per year on average in 2000-01 (Bank of Spain, 2004). There are however some doubts about the quality of these data.
7. The Boyer Act liberalised post-1985 rental contracts. In 1994, the minimum length of rental leases was set at 5 years. Nowadays, rents are initially negotiated freely and then indexed on the CPI for the life of the contract.
8. Bank of Spain estimates suggest that, between 1988 and 2003, the average return on property investment was 13½ per cent, which was higher than on stock market investments (9%) measured on the basis of the IBEX-35 index.
9. The proportion of empty dwellings is higher in provinces where the population has declined (Martínez Pagés and Llanos Matea Rosa, 2003). However, the high proportion of empty dwellings is probably somewhat overestimated in Spain because of the difficulty of distinguishing secondary from empty houses with the data collection techniques used for the census.
10. A far from negligible share of the housing stock let before 1985 is still subject to constraints requiring the extension of contracts and to rules limiting rent levels by comparison with market prices, even though the latter are progressively updated. According to Trilla and Carreras (2001), 50% of rental housing in Barcelona is subject to these rules.

11. This assistance is available to persons signing a new rental contract who are aged under 35 and earn less than € 15 792 per year; it cannot exceed 40% of the person's annual income or € 240 per month. The aim is to reduce the housing expenses of the target population by some 20%.
12. Individuals receive assistance worth € 6 000, while firms and public bodies enjoy subsidies which take the form of preferential loans amounting to between 12% and 16% of the purchase price of the rented housing. These measures are additional to those adopted in 2002 to stimulate the supply of rental accommodation, which included a reduction in tax on the net rental income declared by households and a substantial decrease in tax on corporate profits granted under certain conditions to firms providing property to let.
13. Contrary to the auction system, "beauty" contests do not rely only on the price criteria for determining the successful bidder but take also into account parameters such as the architectural quality, the conception, the construction lag or environmental aspects.
14. A 50% reduction in the proportion of unoccupied homes, which would leave Spain with a vacant housing rate above the European average, would represent additional housing service supply of 1.5 million dwellings, or the equivalent of three years' production.