

Making the housing market work: A proposal for structural reform

14 October 2009

A housing market that is not working

The inadequate regulatory framework of the property market in Spain has produced significant economic distortions, such as the artificial shortage of rental housing, an excessive share of productive investment devoted to this sector and, indirectly, low productivity growth. However, much more important are its social consequences, such as the excessive household indebtedness, the decline in housing affordability or the distortions to labor mobility. For this situation to be corrected, a far-reaching change in the regulation of this market is required.

The Spanish property market displays a set of features which differentiate it from other European countries. The most notorious is the high rate of owner-occupation, which exceeds 85% of total primary residences and implies a very weak rental market (around 13%). This rate is especially low when compared to that of other European countries such as Germany and France (with rates over 40%) or the United Kingdom (around 30%).¹ At the same time, the rate of empty dwellings is over 16%, an extraordinary figure.²

Given these features, the Spanish economy has experienced a sharp increase in housing prices, which doubled in real terms between 1999 and 2007, a rise comparable only to that observed in the United Kingdom over the same period. Consequently, the number of dwellings built has been very high: two-thirds of the homes built in the European Union between 1999 and 2007 are located in Spain.

Furthermore, Spanish citizens' housing affordability has been notably reduced in recent years. The effort required from households to gain access to housing has increased continuously, without social housing policies or tax incentives having produced any positive effects. In December 1997, average house prices were 3.6 times the average gross disposable household income, while ten years later they represented 7.7 times such income.³ This reduction in affordability is especially marked for first-time buyers. The fact that this difficulty is currently disguised by low interest rates does not change anything: nobody can imagine that the Euribor can continue indefinitely at around 1%.

The current situation of crisis has made even more evident the negative socio-economic implications which these characteristics of the housing market have for Spain:

(a) The weakness of the rental market restricts the mobility of workers, who cannot quickly find accommodation in other provinces in which they could find employment or better working conditions. By contrast, can be observed that the European economies with the highest rates of rental housing, such as France or Germany, also display greater geographical mobility.⁴ Likewise, the economic literature has shown that low labor mobility is associated to higher unemployment.⁵ This is especially

important in a context in which the unemployment rate in Spain has reached 18% of the labor force.

(b) The rental market has not been an efficient alternative to the owner-occupied market, due largely to its institutional characteristics. As a result, it has neither managed to attract empty dwellings nor provided a buffer against the sharp increases in housing prices.

(c) Many citizens cannot find an adequate place to live. In particular, young people trying to gain access to their first home have borne a large part of the burden created by the abovementioned disequilibria. It should be stressed that more than 65% of Spaniards aged 25 to 29 years old live with their parents, compared to 20%-22% in France, the Netherlands or the United Kingdom.⁶

(d) At the same time as young people cannot find a place to live, there exists an enormous excess of dwellings for sale. Although it is difficult to know precisely how many new homes are unsold, a conservative estimate gives a figure of slightly more than one million, equivalent to the number of dwellings normally sold in three years.⁷ This is an extremely high figure. For example, despite the excesses experienced in the United States property market, the total number of homes for sale in that country is lower than yearly sales (approximately 9 months).⁸ The excess supply in Spain constitutes a significant obstacle to economic recovery, which is difficult to imagine if the construction of non-subsidized housing is halted for three years.

The paradoxical coexistence of a large excess supply with a large potential demand from many young people with low salaries and insecure jobs is an unequivocal sign of a market which is not functioning properly -prices are not falling enough.

Thus, we consider that some measures must be urgently taken to resolve this situation. Firstly, because such measures could help to overcome the crisis, by contributing to end the excess of unsold dwellings and to speed up the price adjustment. Secondly, because they would dramatically improve the affordability of housing, especially for young people. Thirdly, because they would foster an increase in the income of small landlords and a reduction of the effects of the crisis on households. Lastly, because they would contribute to the fall in unemployment.

Proposed measures

Measure 1: Strengthen the rental market by liberalizing contracts, increasing legal protection for owners and reducing obstacles for renters

The rental market in Spain is regulated by the Law on Urban Rentals (LAU), which restricts the contractual freedom of the parties in two ways.⁹ On the one hand, it imposes a minimum duration of five years for rental contracts. On the other, it limits increases in the rent paid to the variation in the Consumer Price Index (IPC), which does not necessarily reflect the evolution of the rental market. Moreover, this market suffers from a serious lack of legal protection, largely due to the slow pace of judicial proceedings faced by landlords in cases of non-payment of rent.¹⁰ Unfortunately, the

reform of the civil legal procedure in the year 2000 did not produce noteworthy advances in this area.¹¹

Numerous studies have signaled that both the restrictions on rental contracts and the lack of judicial safeguards negatively affect the market, reducing the number and quality of housing for rent.¹²

Contractual restrictions and the underdevelopment of the rental market reduce labor mobility, thereby diminishing economic efficiency and increasing the unemployment rate.¹³ Moreover, the weakness of the rental market prevents it from constituting an efficient alternative to the owner-occupied market and from mitigating price increases.

Consequently, in order to stimulate the rental market in Spain, a reform of the restrictions introduced by the LAU is necessary, bringing them closer to those in force in other European countries with higher rates of rental housing. Thus, we propose the reduction of the compulsory minimum duration of rental contracts, which is among the highest in Europe, establishing it at one year, to bring the Spanish situation closer to that of other European countries.¹⁴ We consider that a period much shorter than the one currently in force in Spain would still provide the necessary stability to tenants, without in turn producing an excessive burden on landlords.

Furthermore, increases in legal protection and in the speed of proceedings for the resolution of contracts and for evictions in cases of non-payment of rent are needed. To do this, improvements are required in both the legal regulation (the Law on Civil Procedure) and the resources available to the courts, to allow them to speed up this type of proceedings. We also propose a legal reform to permit notaries to certify the non-payment of rent and order the vacation of the dwelling if the parties have so agreed in the rental contract, in a process similar to that employed in foreclosures of mortgages or pledges. Should the tenant refuse to vacate the dwelling, the intervention of a magistrate would be inevitable, but the duration would be significantly reduced; the magistrate would simply approve the affidavit and give the order for its execution.

The increase in legal protection would discourage landlords from adopting self-protection measures such as demanding excessive deposits. In particular, we believe that the law must not impose obligatory deposits.¹⁵

Measure 2: Abolish immediately all tax incentives for home purchase

In Spain there currently exists a deduction from personal income tax (IRPF) for the purchase of the primary residence; this involves a reduction in tax liability for payment of both capital and interest.¹⁶ The maximum deduction from the tax payable is 1,352.27 euro per year. Moreover, the Autonomous Communities (CCAA – regional governments) have progressively added in recent years other deductions to home purchase, applicable according to diverse circumstances but of lesser importance.¹⁷ The general deduction for housing may be considered as generous and has a high impact on revenues, which is extremely burdensome in the current situation of a large budget deficit in Spain.

By contrast, tax incentives for home rental have been few in recent years. Although there exist some very limited deductions in the CCAA,¹⁸ the only noteworthy incentives for renters were introduced in 2008, with the application of the “basic moving out allowance” (210 euros monthly for young people between 22 and 30 years old, for a maximum period of four years¹⁹) and the approval of a deduction from the IRPF, aimed at taxpayers with incomes below 24,020 euros per year, with a maximum of 10% of the rent paid.²⁰

Taking the system as a whole, the evidence shows that tax incentives in Spain have benefited owner-occupied housing rather than rented housing, with the above-mentioned negative effects.²¹ A numerical simulation of the elimination of the deductions for home purchase indicates that this would reduce both housing prices and the number of dwellings available.²² Such deductions, in addition to having encouraged the taking of excessive risks, have been clearly regressive insofar as they have not taken into account home purchasers’ income (at least in the case of the deductions from the IRPF for home purchase).²³

Consequently, we propose abolishing subsidies for home purchase and dedicating the resources thereby obtained to temporarily finance a tax deduction for home rental. In this respect, we welcome the initiative proposed by the President of the Government in the last debate on the State of the Nation (12/05/2009), namely to eliminate, at least partially, the deductions for home purchase.²⁴

Measure 3: Abolish owner-occupied social housing and reorient social protection towards the rental market

In Spain, the provision of housing with some degree of protection has traditionally been oriented towards owner-occupied housing.²⁵ Thus, public rented housing constitutes only 1%-2% of total dwellings,²⁶ far below France or the United Kingdom, which have rates of over 15%.²⁷

Insofar as the allocation of owner-occupied social housing is very limited and the demand for it extremely high, it takes the form of a lottery in which very few beneficiaries receive a very high subsidy.²⁸ Furthermore, once the dwelling has been obtained, changes in household income do not mean the loss or repayment of the subsidy enjoyed. In fact, the protection afforded to public housing has a fixed period of 30 years (as a general rule), after which the dwelling can be derestricted. This system is, moreover, the source of abundant fraud, which has only recently been subjected to attempts at control, by recording the circumstances of the dwelling in the property register.²⁹ Furthermore, it is not obvious that social housing helps to moderate free market housing prices.³⁰

The reorientation of social housing from the owner-occupied market towards that of rental is still very recent and limited.³¹ The State Plan for Housing and Renovation 2009-2012 proposes as an objective that 40% of the new supply of social housing should be rented. However, it renounces in part this objective by including the possibility of renting with the option to purchase.

Due to the factors described, we believe that the creation of new owner-occupied social housing should be suppressed, especially in the current situation of excess supply, and the resources freed by it dedicated to financing subsidies to free market rental housing for people with low income.

Measure 4: Abolish or strongly reduce the property transfer tax for home purchases and sales

The Spanish tax system includes, in addition to the deductions from the IRPF, other taxes which affect housing. Thus, the real estate tax (IBI) is collected by town and city councils and taxes housing ownership. In turn, others tax the transfer of dwellings: the value added tax and the property transfer tax (ITP), collected by the Autonomous Communities.³²

At a time when transactions in the housing market are falling considerably (between 2006 and 2009 the total number of purchases witnessed by notary has fallen by over half³³), we propose the elimination or strong reduction of the property transfer tax. This measure would boost home sales and would thereby favor the geographical mobility of owners, without provoking a significant fall in tax revenues. We suggest, furthermore, that the loss of revenue caused by the disappearance of this tax could be counterbalanced by an increase in the IBI, which could have a regional tranche to compensate for the reduction in revenue suffered by the Autonomous Communities as a result of this measure. The IBI is an optimal tax from an economic point of view, since it affects an asset which is completely inelastic, i.e. property ownership.

Conclusion

We believe that a reform of the regulation of the property market is a necessary condition for the beginning of a new period of sustained growth.

This reform should strengthen the rental market via the liberalization of contracts and increased legal protection for landlords, eliminate tax incentives for home purchase, reorient social housing policy towards the rental market and abolish or strongly reduce the property transfer tax for home sales and purchases. These measures would contribute to the achievement of a more sustained growth of the Spanish economy and to the exit from the current crisis.

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NOTES:

¹ Taking into account only rentals by private persons, the figure rises to 49% in Germany and to 20% in France (Whitehead and Scanlon, 2007).

² Data from the 2001 census (coherent with the information derived from the Continuous Survey of Family Budgets, ECPF).

³ Synthesis of indicators, Banco de España.

⁴ Maclennan *et al.* (1998) and Barceló (2006).

⁵ Layard *et al.* (1991).

⁶ Becker *et al.* (2009).

⁷ *Situación Inmobiliaria*, Banco Bilbao Vizcaya Argentaria (June 2009).

⁸ National Association of Realtors: "Housing inventory in the US was 3.62m units for sale, which represented an 8.5 month of supply at current sales", press release 24 September 2009.

⁹ Law 29/1994, 24 November, on Urban Rentals.

¹⁰ Djankov *et al.* (2003).

¹¹ Law 1/2000, 1 January, on Civil Procedure. See Mora (2009a) for a comparison of civil rental proceedings in the Law on Civil Procedure of 1881 and the Law on Civil Procedure of 2000.

¹² See Olsen (1972), Alston *et al.* (1992), Weiss (1995), Early (1999) and Sims (2007) for the effects of rent control, and for legal protection see Casas-Arce and Saiz (2006) and Mora (2009b).

¹³ Layard *et al.* (1991), Ault *et al.* (1994), Hardman and Ioannides (1999), Munch and Svarer (2001), Svarer *et al.* (2005) and Barceló (2006).

¹⁴ Mora (2008) offers a comparison.

¹⁵ Article 36 of the LAU.

¹⁶ Law 35/2006, 28 November, on Personal Income Tax and on the partial modification of the laws on Company Taxation, on Non-Residents' Income and on Wealth.

¹⁷ Arising from the regulatory changes introduced by Law 21/2001, 27 December, which regulates the fiscal and administrative measures of the new system of financing of the Autonomous Communities under the common system and Cities with a Statute of Autonomy.

¹⁸ Royal Decree-Law 2/1985, 30 April, on economic policy measures.

¹⁹ Royal Decree 1472/2007, 2 November, in regulation of the basic emancipation allowance for young people.

²⁰ Law 51/2007, 26 December, on the General State Budget for the year 2008.

²¹ López García (1996) and García-Vaquero and Martínez (2005).

²² López García (2004).

²³ Sanz (2000) and Bilbao Terol *et al.* (2006).

²⁴ Speech by the President of the Government in the Debate on the State of the Nation. Congress of Deputies, 12 May 2009.

²⁵ Making no distinction by programme, social housing represents 11.52% of the housing stock in Spain (average for the period 2001-2008, according to Ministry of Housing data).

²⁶ Inurrieta (2007) and European Liaison Committee for Social Housing (CECODHAS) for 2007.

²⁷ Trilla (2001) and Whitehead and Scanlon (2007).

²⁸ García Montalvo (2007).

²⁹ Royal Decree 2066/2008, 12 December, in regulation of the State Plan for Housing and Renovation 2009-2012. In the same respect measures were introduced in the new Law on Land (Law 8/2007, 28 May, on land).

³⁰ Green *et al.* (2002) and Ellen *et al.* (2005) provide some evidence for the United States.

³¹ Renting with the option to purchase appears for the first time in Royal Decree 801/2005, 1 July, which approves the State Plan 2005-2008 for promoting citizens' access to housing.

³² Royal Legislative Decree 1/1993, 24 September, which approves the Revised Text of the Law on Property Transfer Tax and Stamp Duty.

³³ The maximum was reached in June 2006, with 251,649 transactions, while the latest figure, for March 2009, was 104,703.