HOUSING MARKETS AND THE ECONOMY: POLICIES FOR RENOVATION

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POUR UNE VIE MEILLEURE

Introduction

Housing markets affect economic performance through several channels. Governments intervene to enhance housing opportunities available to citizens.

- Do policies achieve their objectives in an efficient and equitable way?
- Do policies have any adverse side effects?

A cross-country study offering governments a roadmap for sounder housing policies in a number of areas such as housing finance, housing supply, taxation and mobility.

The study also contains a range of new cross-country indicators of housing policies in OECD countries.

Released in 2011 as part of Going for Growth 2011

Roadmap

Some stylised facts

Demand factors

Supply-side factors

Housing taxation policy

Rental market regulations and social housing

A sharp increase in housing prices across OECD

Table 1. **Change in real house prices**[1]

1980 (or earliest year available)-2008

Very large increases (90% or more)	Moderate to large increases (20% to 90%)	Stable or declining (less than 20% increase)
Australia	Austria	Chile
Belgium	Canada	Germany
Finland	Denmark	Hungary
Ireland	France	Israel
Netherlands	Greece	Japan
New Zealand	Italy	Korea
Norway	Slovenia	Portugal
Spain	Sweden	Switzerland
United Kingdom	United States	

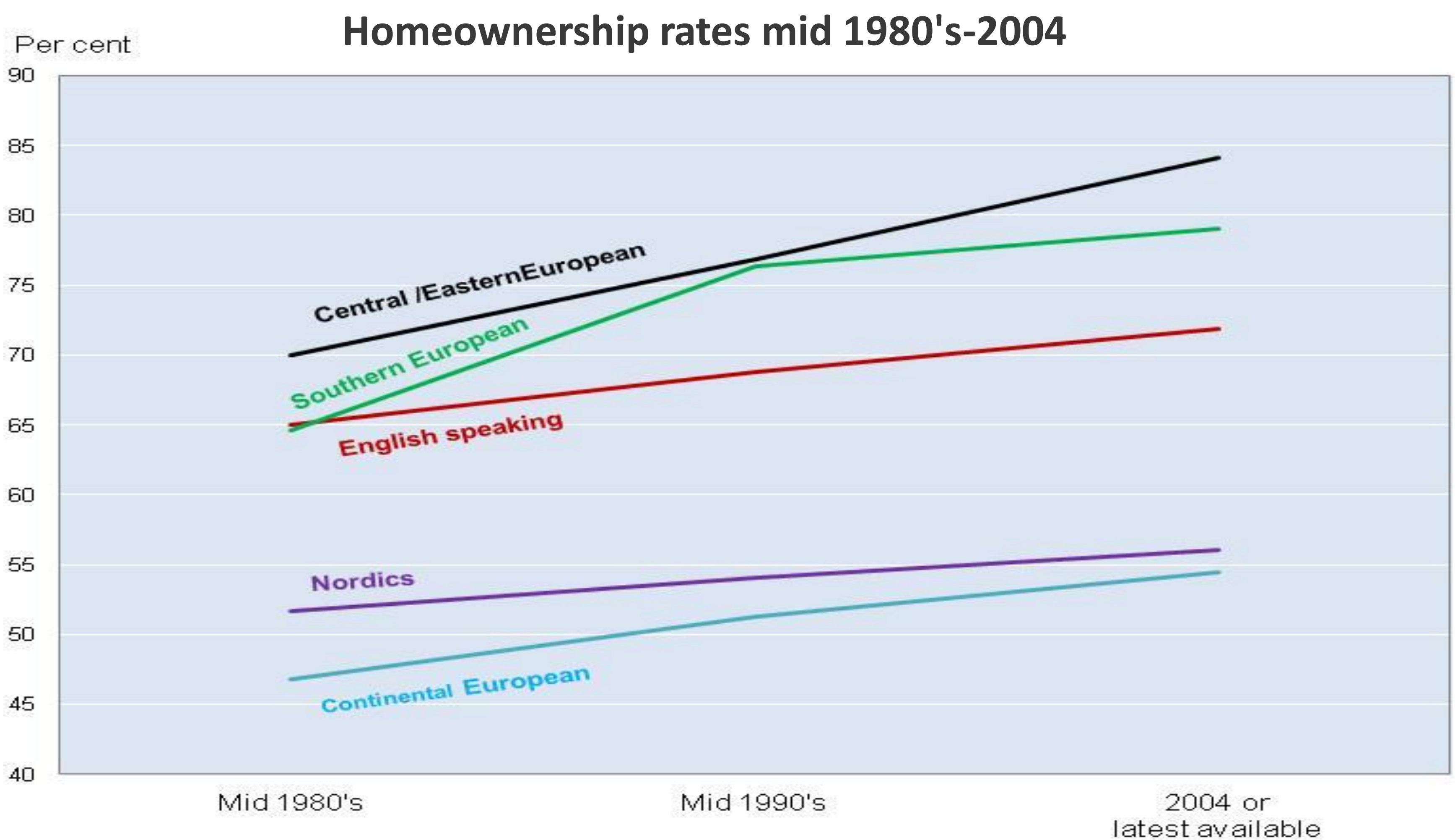
1. Nominal prices deflated by the consumer price index.

Source: National sources and OECD Economic Outlook No. 87.

Since 2008, real house prices declined by an average of 6% across the OECD, but there is significant cross-country variation:

- *Double-digit declines in crisis countries, Eastern Europe, UK.*
- *Sizeable price rises in AT, CA, DE, CH, NO*

..was accompanied by rising homeownership



Source: Andrews, Caldera-Sanchez and Johansson (2011).

Demand factors: financial liberalisation lowered borrowing costs but carried risks

1. Lower down-payment requirements associated with an increase in homeownership among previously constrained households
2. Financial liberalisation estimated to have increased real house prices as much as 30% in the average OECD country over recent decades …
3. … and led to greater house price volatility, which can pose risks to macro stability
   - Innovation in mortgage markets should be coupled with appropriate regulatory oversight and prudent banking regulations

Lower LTV ratios and stronger banking supervision lowers house price volatility

Real house price volatility can be reduced by…	Policy experiment
25%	A further improvement in banking supervision equivalent to that observed on average in OECD over the 1990-2005 period.
20%	Reducing the maximum loan to value ratio by 10 percentage points.[2]
19%	Increasing the estimated supply elasticity from the level observed in Ireland to the level in Canada.
11%	Reducing the tax relief on mortgage debt financing costs from the level observed in Netherlands to the level in Sweden.

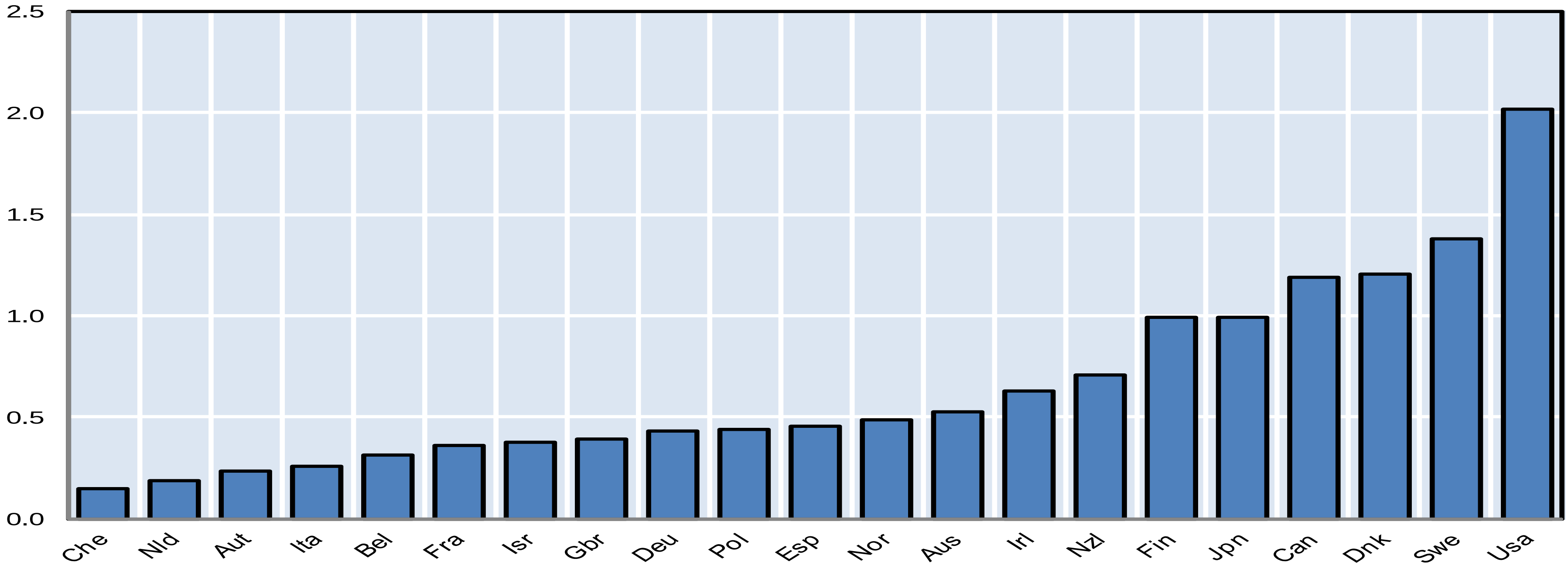
1. The policy experiments are roughly equivalent to the impact of a one standard deviation change in the policy variables of interest on real house price volatility. Estimates are based on random effects panel regressions for between 16 and 20 OECD countries, over the period circa 1980-2005. The dependent variable is the standard deviation in annual real house price growth and the model also controls for macroeconomic volatility and time fixed effects (see Andrews (2010) for details).

2. Over the sample period, loan to value ratios range from a minimum of 56% to a maximum of 110% in OECD countries.

Source: Andrews, Caldera-Sanchez and Johansson (2011).

Variations in responsiveness of new housing supply to changes in prices

Estimates of the long-run price-elasticity of new housing supply, 1980's - 2007



1. Estimates of the long-run price elasticity of new housing supply where new supply is measured by residential investments. All elasticities are significant at least at the 10% level. In the case of Spain, restricting the sample to the period 1995-2007, which would reflect recent developments in housing markets (such as the large stock of unsold houses resulting from the construction boom starting in 2000 and peaking in 2007-09), only slightly increases the estimate of the elasticity of housing supply from 0.45 to 0.58. Estimation period early 1980s to early 2000s. See Caldera Sánchez and Johansson (2010) for details.

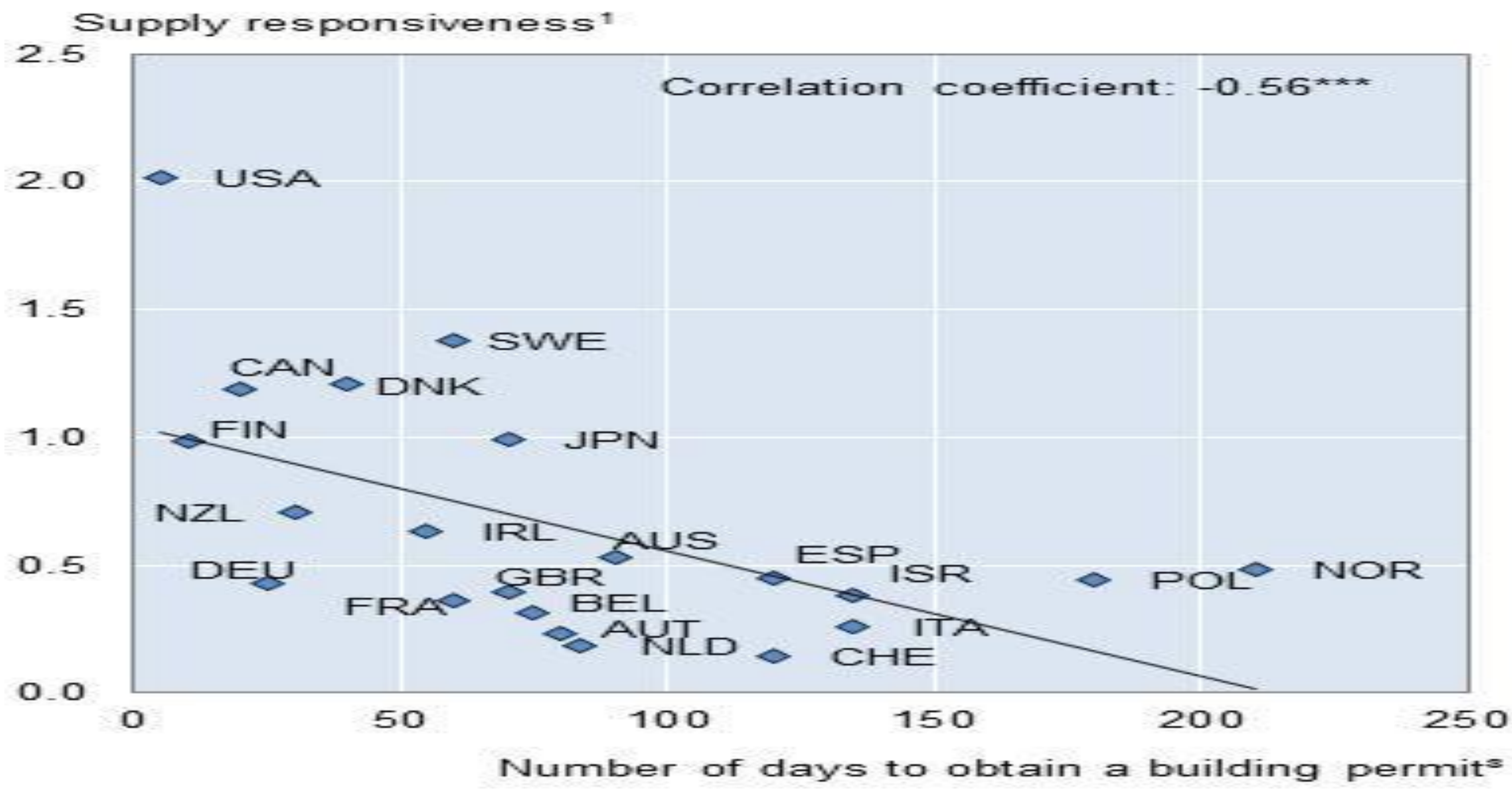
Source: Andrews, Caldera-Sanchez and Johansson (2011).

Improving the responsiveness of housing supply to demand

1. Streamline cumbersome construction licensing procedures

Cumbersome land-use regulations are associated with weaker supply responsiveness

Supply responsiveness and land-use regulation



Source: OECD estimations, World Bank Doing Business (2009)

Improving the responsiveness of housing supply to demand (continued)

1. Streamline cumbersome construction licensing procedures
2. Encourage a better use of land by linking the assessment of property values for tax purposes to market values
3. Provide complementary infrastructure and other public services
4. Ensure the adequate provision of social housing
    - But caution is required to avoid volatility in residential investment

How should housing be taxed?

Favourable tax treatment for housing is often justified on the basis that homeownership gives rise to positive spillovers for society BUT credible evidence in favour of this hypothesis is lacking.

Housing and alternative investments should be taxed in the same way:

- **First best**

  Tax imputed rents and allow mortgage interests to be tax deductible.

- **Second best**

  If taxing imputed rents is not politically feasible:

  – Remove mortgage interest deductibility.

  or

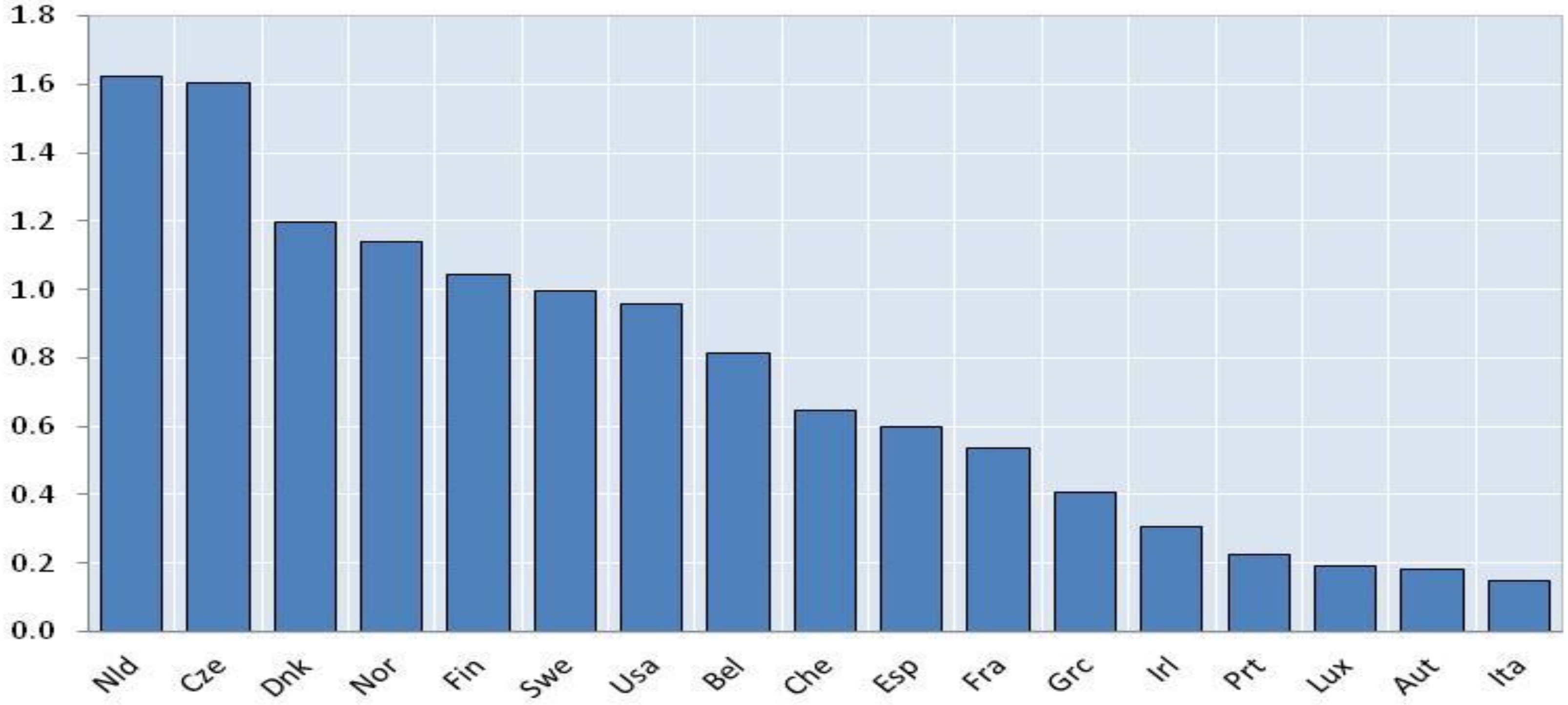
  – Scale-up recurrent property taxes.

BUT housing is tax favoured in OECD countries

- Tax exemptions are common:
  - **Imputed rental income:** is generally not taxed
  - **Capital gains:** on the primary residence are tax exempt (albeit after some holding period in some countries)
- Many countries allow **tax deductibility of mortgage interest payments.**
- Most countries use **recurrent property taxes** but these are:
  - Not large enough to offset the mortgage subsidy
  - The property value for tax purposes lags behind the market value

Tax relief on mortgage debt financing is often high, 2009

Estimated wedge between the market interest rate and the after-tax debt financing cost of housing; increasing in the degree of tax relief



This indicator takes into account if interest payments on mortgage debt are deductible from taxable income and if there are any limits on the allowed period of deduction or the deductible amount, and if tax credits for loans are available. For countries that have no tax relief on debt financing costs, this indicator takes the value of zero.

Source: Andrews, Caldera-Sanchez and Johansson (2011).

Consequences of favourable tax treatment

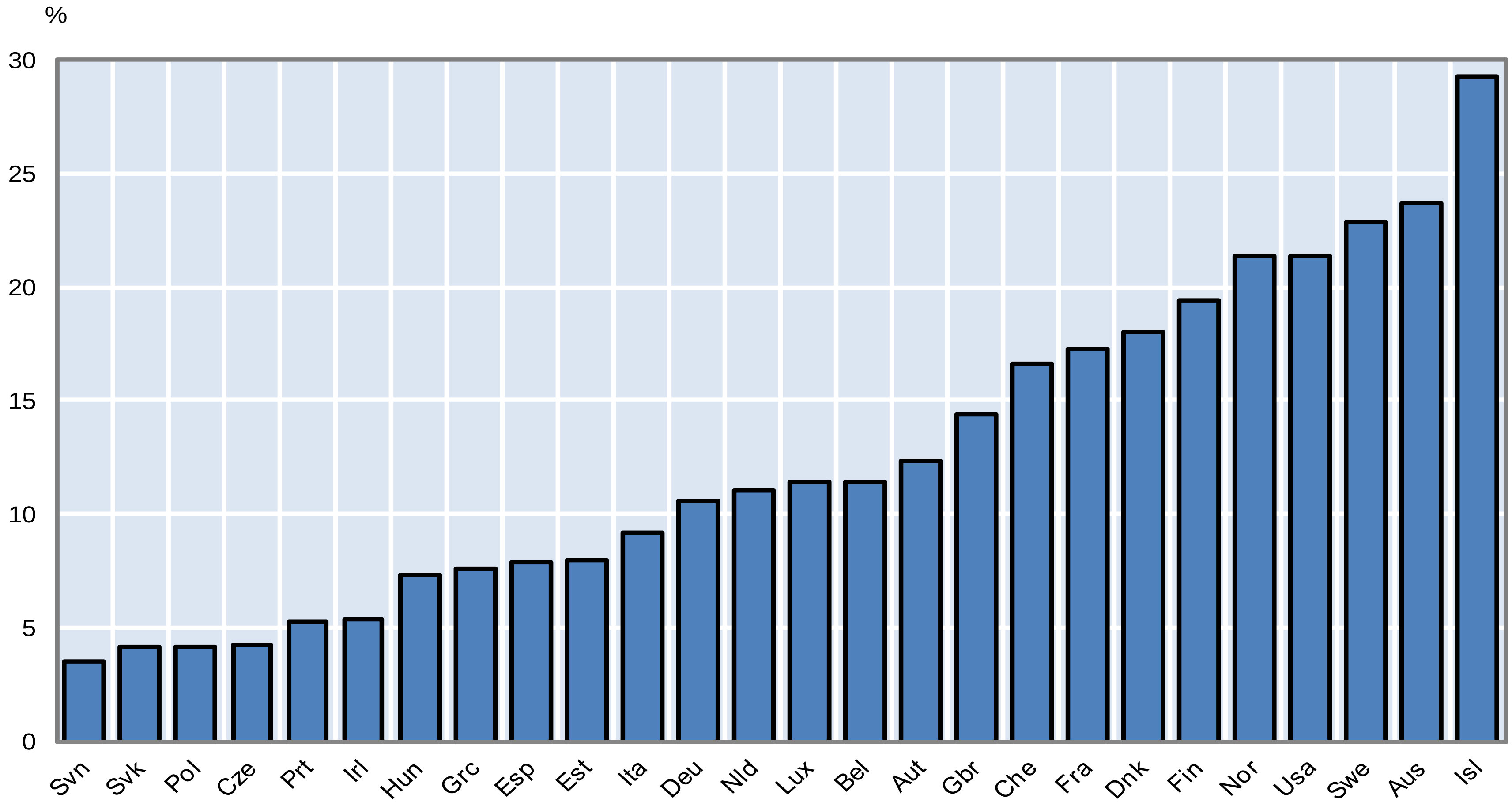
1. **Adversely affects growth**: through excessive investment in housing crowding out more productive investments.

2. **Adversely affects macroeconomic stability**: by encouraging excessive borrowing and speculative behaviour by lowering the cost of mortgage finance and raising house price volatility

3. Tax reliefs for mortgage debt tend to be **regressive.**

Housing market policies carry implications for labour mobility…

Percentage of households that changed residence within the last 2 years



Source: Andrews, Caldera-Sanchez and Johansson (2011).

How policies affect residential mobility and in turn labour mobility?

1. Homeowners are less mobile than renters and social housing tenants are less mobile than private market tenants

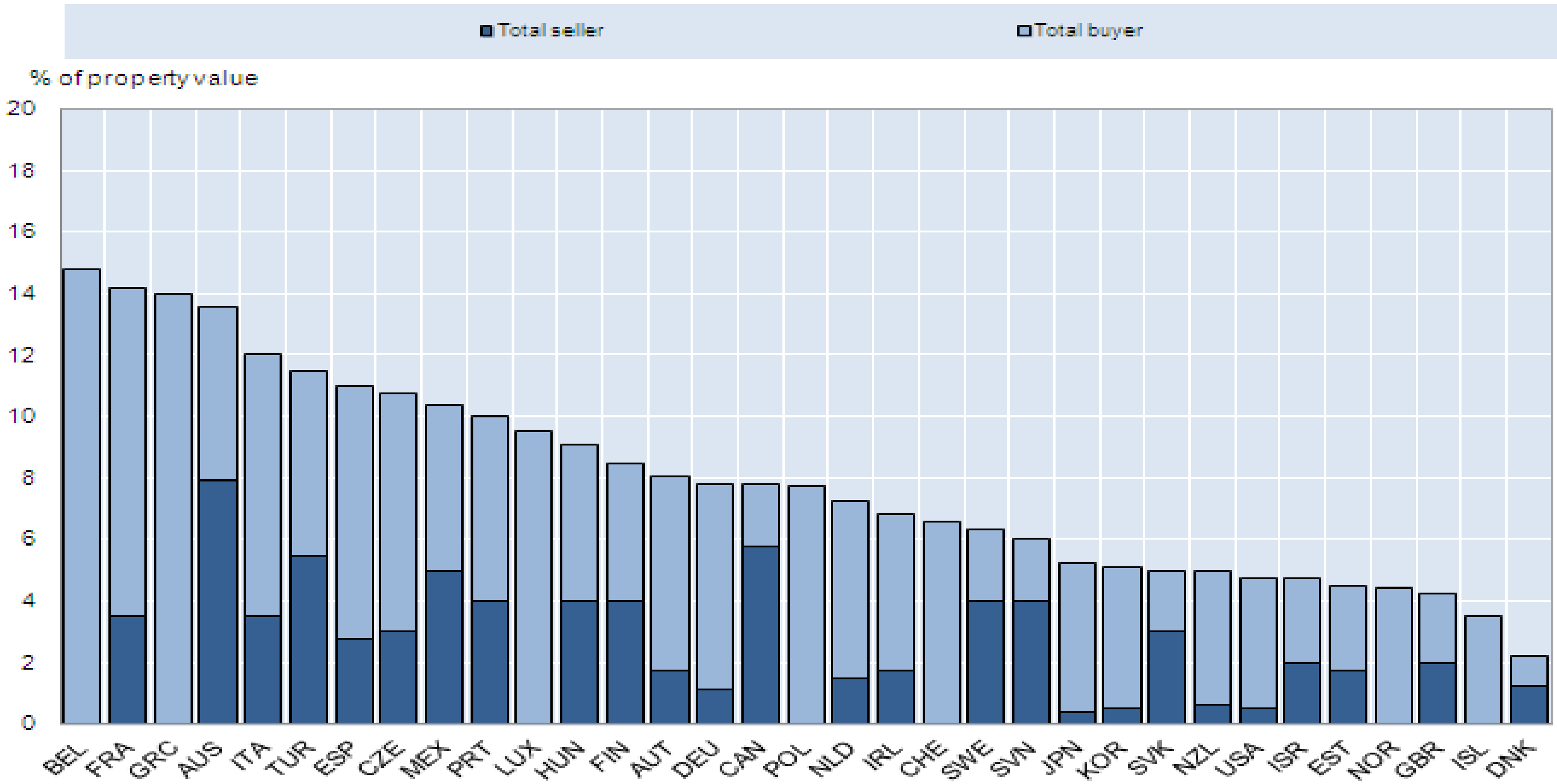
   - Housing taxation should aim at being tenure neutral.

   - Well designed portable housing allowances may be preferred to direct provision of social housing.

2. High transaction costs in buying and selling houses may reduce residential mobility

3. Tight rent controls/tenant protection can lead to high transaction costs and lower mobility

Transaction costs of purchasing property vary across OECD countries, 2009

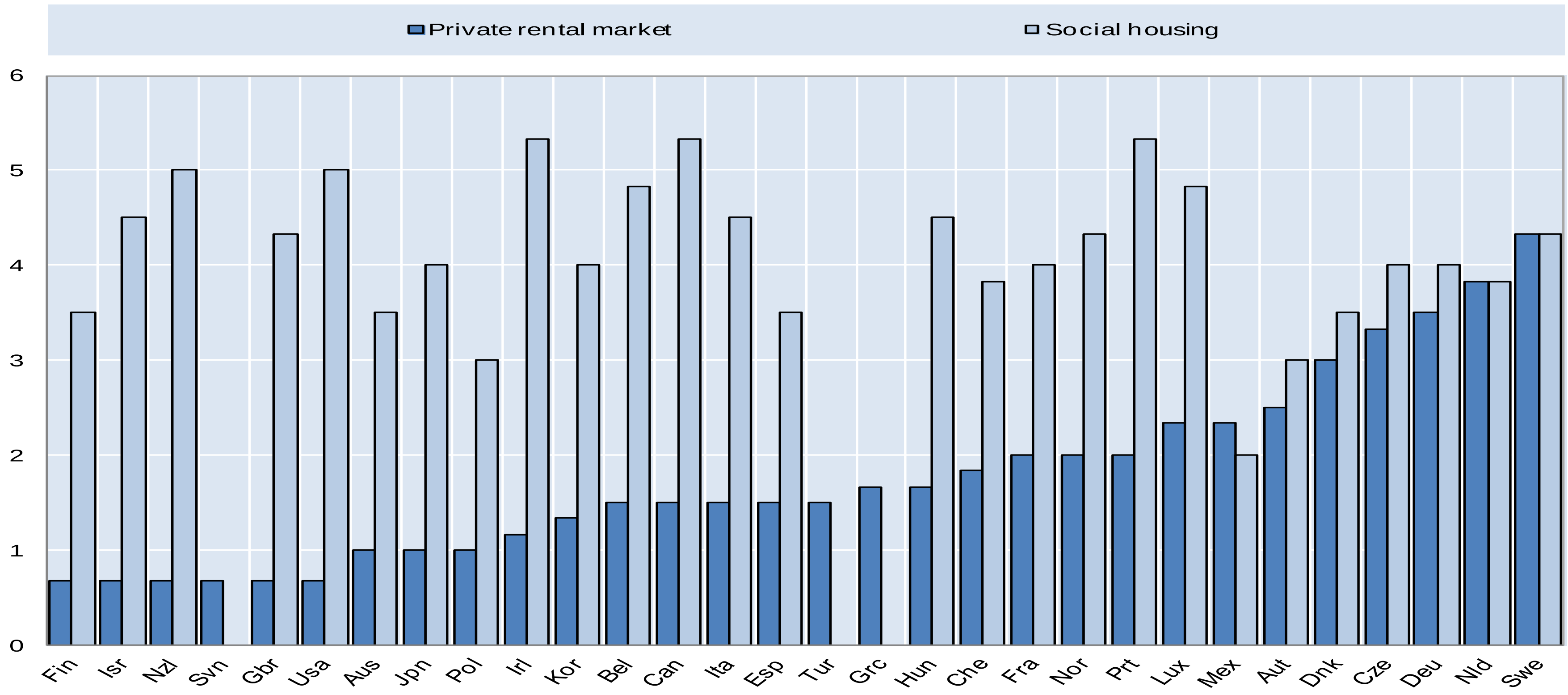


Transaction costs refer to average costs. The estimates do not take into account the various tax breaks that exist in countries for certain dwellings implying that the estimated cost may overestimate the actual cost in some countries (for example in Italy) where such tax breaks are frequent. In addition, VAT when applied to certain costs is not included due to data limitations.

Source: Andrews, Caldera-Sanchez and Johansson (2011).

Strict rent controls can hinder mobility

Scale 0-6: Increasing in degree of rent control[1]



1. This indicator is a composite indicator of the extent of controls of rents, how increases in rents are determined, and the permitted cost pass-through onto rents in each country.

Source: Andrews, Caldera-Sanchez and Johansson (2011).

How do policies influence residential mobility? (continued)

4. A more responsive supply increases residential mobility.

5. Greater access to credit facilitates residential mobility

<u>but</u> too high leverage ratios can undermine mobility as demonstrated by recent experience in the United States

Housing policies influence residential mobility: summary

How policies can increase residential mobility

The probability of moving each year can be increased by...	Policy experiments
2.3 percentage points...	Increasing the estimated price-elasticity of housing supply from the level in the Netherlands to the average level in the OECD
1.4 percentage points...	Decreasing the rent control from the level in Germany to the average level in the OECD
1.4 percentage points...	Decreasing the down-payment constraint (i.e. increasing the loan to value ratio) by 20 percentage points from the level in Switzerland to the average level in the
1.1 percentage points...	Increasing access to credit (i.e. increasing the share of private credit to GDP) from the level in the Slovak Republic to the average level in the OECD.
0.6 percentage points...	Decreasing tenure security (i.e. tenant-landlord regulations) from the level in Portugal to the average level in the OECD
0.5 percentage points...	Decreasing transaction costs from the level in Greece to the average level in the OECD

Memorandum item: Average annual probability to move in OECD countries = 6%.

1. Policy experiments are roughly equivalent to the impact of a one and a half standard deviation change in the policy variables of interest on residential mobility. Estimates based on probit regression of household probability to move controlling for age, tenure status, education, employment, income and squared income, cohabitation status, total income and the national urbanisation rate.

Source: Andrews, Caldera-Sanchez and Johansson (2011).

Key policy implications

1. Combine innovations in mortgage markets with appropriate regulatory oversight and prudential regulations
2. Improve supply responsiveness of housing by improving land-use, planning regulations and tax incentives
3. Remove favourable tax treatment of housing
4. Consider rent allowances to enhance housing opportunities
5. Redesign rent controls that bring rents far out of line with market values.

Thank you!

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OECD, Housing and the Economy portal:

http://www.oecd.org/document/50/0,3746,en_2649_37671049_47333810_1_1_1_1,00.html

Selected references:

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