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**Finland's Housing Market:
Reducing Risks and
Improving Policies**

Laura Vartia

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Laura Vartia

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Abstract

Finland's housing market: reducing risks and improving policies

While pronounced cycles in house prices have been a major cause of macroeconomic instability in the past, current house price developments do not yet suggest an overheating of the housing market. However, several important concerns are related to both direct effects of housing markets on overall activity and to more structural and regional issues. A factor making housing markets and the macro economy vulnerable to interest-rate shocks is the high share of mortgage loans linked to variable interest rates. Tax subsidies to housing may largely be capitalised in higher land prices rather than increasing housing availability to the extent that slow planning procedures and municipalities' unwillingness to provide building land have limited the growth of the housing stock in growth regions. This would argue for improving municipalities' incentives to provide building land, speeding up planning procedures and a phased removal of the tax advantage associated with housing. Furthermore, the provision of social housing and the housing allowance system should be better targeted on those most in need of affordable housing.

This paper relates to the 2006 Economic Survey of Finland (www.oecd.org/eco/surveys/finland).

JEL classification codes: E2; E44; H71; R31.

Key words: house prices; mortgages; housing wealth; property tax; social housing; housing support.

* * * * *

Résumé

Le marché du logement en Finlande: réduire les risques et améliorer les politiques

Si, par le passé, les cycles marqués qu'ont connus les prix des logements ont été un facteur majeur d'instabilité économique, l'évolution actuelle des prix des logements ne donne pas encore à penser qu'il y a surchauffe sur ce marché. Toutefois, les effets directs des marchés du logement sur l'activité globale et des problèmes plus structurels et plus régionaux sont des sujets de préoccupation importants. L'un des facteurs de la vulnérabilité des marchés du logement et de la macroéconomie aux chocs de taux d'intérêt est la part importante des prêts hypothécaires à taux d'intérêt variable. Les aides fiscales au logement peuvent être largement capitalisées dans la hausse des prix des terrains au lieu d'accroître le nombre de logements disponibles dans la mesure où la lenteur des procédures de planification et la réticence des communes à offrir des terrains constructibles ont limité la croissance du parc de logements dans les régions en expansion. Cela plaide en faveur de politiques visant à inciter davantage les communes à offrir des terrains à bâtir, à accélérer les procédures de planification et à supprimer progressivement l'avantage fiscal dont bénéficie le logement. En outre, l'offre de logements sociaux et le régime de l'allocation logement devraient être davantage ciblés sur les personnes ayant le plus de besoin de logements à un prix abordable.

Ce document de travail se rapporte à l'Étude économique de la Finlande 2006 (www.oecd.org/eco/etudes/finlande).

Classification JEL : E2 ; E44 ; H71 ; R31.

Mots clés : prix des logements ; emprunts hypothécaires ; richesse ; impôt sur la propriété ; logement social ; aides au logement.

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TABLE OF CONTENTS

Introduction.....	5
The current housing system and dwelling stock: an overview.....	8
The housing market and overall activity	9
The current state of the housing market	9
The link between the housing market and consumption appears to be strong.....	11
Housing investment and the construction sector	14
Raising the effectiveness of housing policies.....	15
The planning system and supply of building land	16
Taxation of property	17
Other tax policies.....	20
Housing finance and support systems.....	24
Regional dimensions of housing markets	27
Summing up	30
Notes	31
Bibliography	32
<i>Annex A. Housing wealth and consumption</i>	<i>34</i>

Boxes

1. The house price bubble and banking crisis of the early 1990s	7
2. Housing policy objectives.....	9
3. The government guarantee for mortgages	14
4. The fiscal equalisation system	19
5. The determination of assessment values for property taxation.....	20
6. Housing taxation and tax neutrality	21
7. Recommendations concerning the housing market	30

Tables

1. Housing wealth effect on consumption.....	13
2. Correlation between house price cycles.....	13
3. Taxation of residential property.....	23
A.1. Detailed estimation results.....	35

Figures

1. Real house prices: average annual increase and variability.....	6
2. Correlation of private consumption growth with real house price changes.....	7
3. Dwelling stock.....	8

4.	Price-to-rent and price-to-income ratios	10
5.	Household mortgage debt	12
6.	Dwelling completions	15
7.	Trends in housing related price indices	16
8.	Property tax revenue	17
9.	Municipal finances	18
10.	Impact of tax deductibility of interest payments.....	22
11.	Housing subsidies	24
12.	Dwelling completions by type of financing.....	27
13.	Trends in housing prices and rents.....	28
14.	Regional mobility rates	29
15.	Dwellings by tenure	29

FINLAND'S HOUSING MARKET: REDUCING RISKS AND IMPROVING POLICIES

by Laura Vartia¹

Introduction

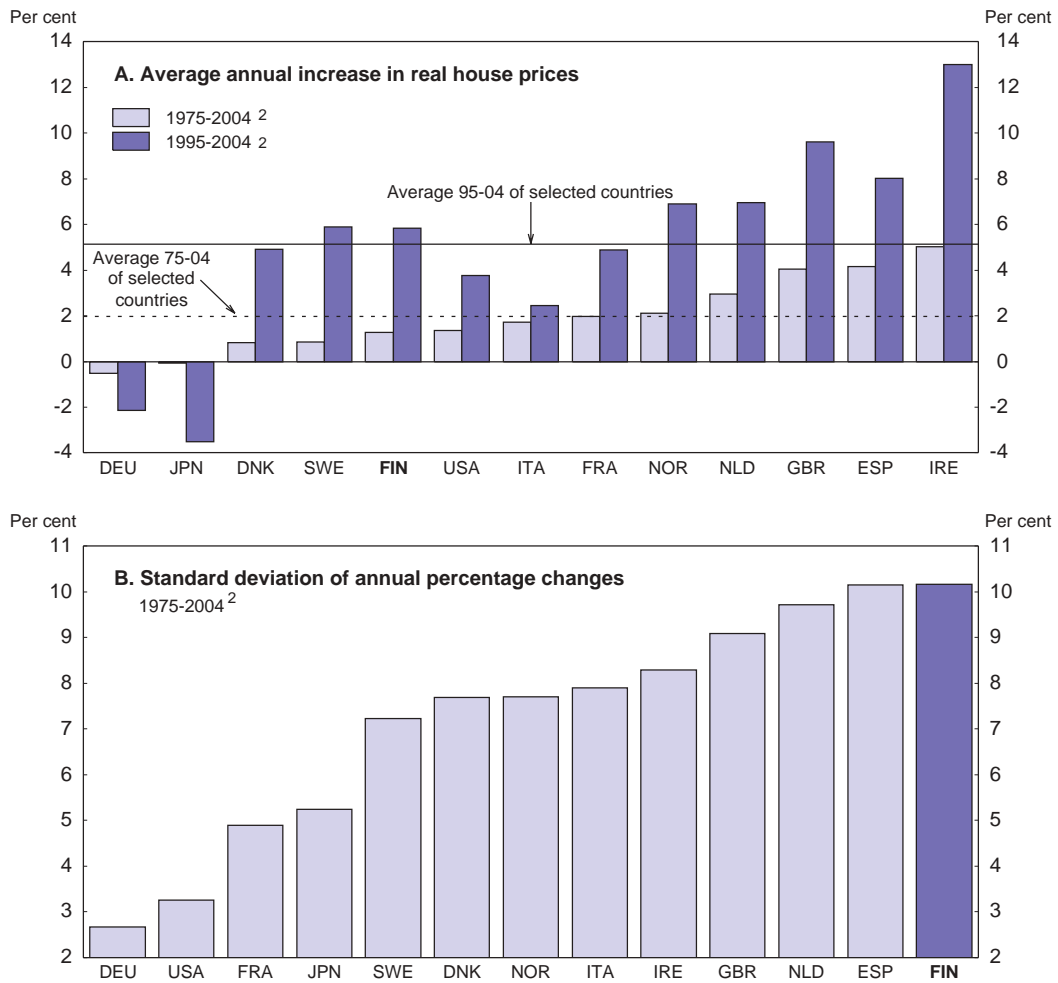
House prices in Finland have been amongst the most volatile in the OECD over the last three decades (Figure 1) although their trend growth has been close to the OECD average. Much of this volatility is accounted for by the housing bubble that emerged in the late 1980s and its dramatic collapse in the early 1990s (Box 1). Generally, price changes have been strongly correlated with both the business cycle and consumption (Figure 2). In recent years annual house price increases have, however, remained in single digits, though they have accelerated recently, especially in the Helsinki region. Overall, there is no strong evidence that houses are currently overvalued. This suggests that now is an opportune time to consider the reasons for the strong links between economic activity and the housing market and whether there is a case for policy action to reduce the risk of macroeconomic instability in the future.

In 2002 an international panel of experts (Ministry of Environment, 2002a) concluded that, despite the volatility of the housing market, housing policy and well-functioning financial markets have underpinned the provision of an adequate supply of affordable housing: The stock of dwellings *per capita* is high in international comparison and has been growing faster than in the other Nordic countries (Figure 3). Housing standards, in terms of basic amenities, have increased considerably; around 50% of apartments have their own sauna, and homelessness has halved since the late 1980s.

Nevertheless, there are signs of shortages in some of the main metropolitan areas and the housing stock falls short of the population's aspirations in some respects, notably the average dwelling size is smaller than in other Nordic countries. The remainder of this paper reviews the functioning of the housing market and considers a wide range of related policy issues including: the links between the housing market and economic activity; whether there are more efficient ways of achieving the government's objectives, while making the housing market more responsive to people's aspirations; and whether the mix and overall burden of taxation and subsidies on housing is optimal.

1. This paper was originally prepared for the *OECD Economic Survey of Finland* published in May 2006 on the responsibility of the Economic and Development Review Committee. The author is grateful to colleagues at the OECD, especially Christophe Andre, Andrew Dean, Jorgen Elmeskov, Michael Feiner, Nathalie Girouard, Peter Hoeller, Åsa Johansson, Val Koromzay and David Turner for their helpful comments. Special thanks go to Isabelle Duong for her statistical assistance. Finally, thanks to Kari Takala and Risto Herrala (Bank of Finland) for the data and information. The author can be contacted at laura.vartia@oecd.org.

Figure 1. Real house prices¹ : average annual increase and variability



1. House prices are deflated using the private consumption deflator.

2. 2003 for Denmark.

Source: Table III.4 in OECD, *OECD Economic Outlook*, No. 78, December 2005.

Box 1. The house price bubble and banking crisis of the early 1990s

The collapse of the house price bubble in the early 1990s ushered in one of the most severe recessions experienced by any OECD country.* The housing bubble and the following banking crisis were preceded by a housing and financial market boom and overheating of the economy. During the boom period in the late 1980s, real house prices increased more than 60%, but plummeted by almost 50% between 1990 and 1993, while housing completions in 1996 were only one-third of the peak in the early 1990s.

The boom can be partly explained by the liberalisation of financial markets and inadequacies in prudential supervision of the banking sector. In addition to the deregulation of interest rates, competition between banks was raised by foreign banks entering the domestic financial market and the freeing up of foreign capital movements. The increase in asset prices made it easier to apply for a loan as the value of collateral also increased. The boom peaked in late 1988 when credit expanded by almost 30%. However, bank lending continued to grow until 1991. After that the domestic credit stock declined for four years and it took until 1996 for bank lending to recover.

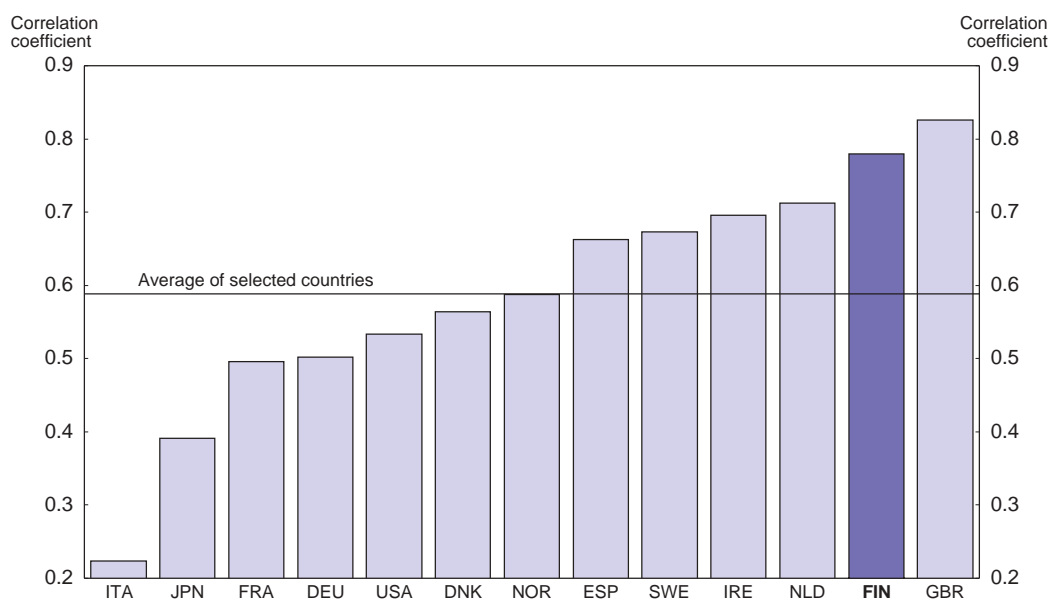
During the crisis, the share of non-performing bank loans grew rapidly, with the proportion of non-performing loans rising to 9% when the banking crisis was at its worst (IMF, 1998). This caused huge credit losses to banks, and it has been argued that they were an essential factor contributing to the severity of the crisis. Most of the credit losses, however, came from corporate loans. While credit losses from housing loans were minimal, households reacted to excess indebtedness and declining collateral values by accelerating the pay-pack of loans. The resulting increase in the saving ratio made the situation even worse by reducing domestic demand, increasing the number of bankruptcies in the non-tradable sector and thereby the credit losses of banks.

The total costs of the banking crisis are calculated to have been 8-10% of GDP. The crisis was also costly for the government which provided the banks with around € 16 billion of support. All in all, the net cost to the government was half of this amount.

The crisis did, however, trigger a vast improvement in the productivity of the banking sector. The improvement is partly explained by a considerable reduction in the number of bank offices and personnel. The rapid adoption of new technologies and increased international competition have also contributed to the increase in productivity.

* See Honkapohja and Koskela (1999) and Kiander and Vartia (1998) for a review of the recession.

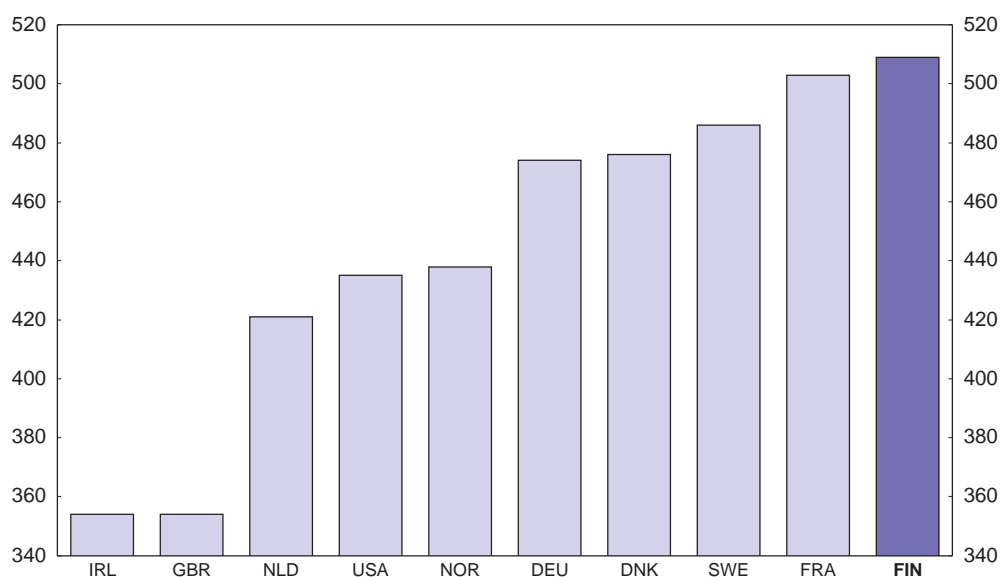
Figure 2. Correlation of private consumption growth with real house price changes 1975-2004¹



1. 2003 for Denmark.

Source: Table III.4 in OECD, *OECD Economic Outlook*, No. 78, December 2005.

Figure 3. **Dwelling stock**
Per 1000 inhabitants, 2003¹



1. Or latest year.

Source: Statistics Finland, *Construction and Housing Yearbook*, 2005 ed., Chapter 19, Table 1.

The current housing system and dwelling stock: an overview

Housing policy has focused on providing housing with decent standards for all Finns. The housing situation was very difficult after the Second World War as housing standards were low in international comparison, internal migration extensive and financial markets underdeveloped. In view of the difficult starting point, housing policy has thus been fairly successful in reaching its objectives (Box 2).

The national and local authorities affect housing supply as they are responsible for the zoning of land, whereas private companies and co-operatives build houses, including the construction of social housing. Most of the financing is provided by banks. However, as in many other OECD countries the state provides considerable support to housing, in total about 1% of GDP in 2004. The state subsidises the financing of housing production and renovations through preferential loan schemes. Furthermore, it provides tax deductions for interest payments for owner-occupied housing and a housing allowance for low-income households.

Owner-occupied housing is predominant even though the share of owner-occupation fell from 67% in 1990 to 58% in 2004 following the bursting of the housing bubble and the liberalisation of the private rental market in 1995.¹ Moreover, social rental housing production was promoted through government programmes. More than half of the rental dwellings are owned by non-profit institutions providing social housing (17% of the housing stock).

The average age of the housing stock is relatively low, with more than 60% of the dwellings built after 1970 and less than 4% built before 1920. Housing standards, in terms of average floor area per person, have risen significantly from 15 square meters in 1970 to 37 square meters in 2003. However, the average size per person is still relatively low in international comparison and the lowest in the Nordic countries (Lujanen and Palmgren, 2004). The housing stock does not seem to meet households'

aspirations: according to a survey by the Ministry of Environment, 76% of households would prefer living in detached or semi-detached houses but less than half of the households participating in the survey actually lived in such dwellings (Ministry of Environment, 2004b).

Box 2. Housing policy objectives

The central objective of housing policy is to enhance the affordability of decent homes for everyone. Based on the indicators discussed above, housing policy has been successful in promoting this objective. However, housing policy is facing a number of challenges that emerge from regional imbalances, the ageing of the population, volatility in housing markets and environmental and quality issues. The government has issued a 2004-06 housing policy programme (Ministry of Environment, 2004a) and a programme for construction policy (Ministry of Environment, 2002b).

The main objectives of the programme for housing policy are the following:

- Enhance housing production in growth centres by improving planning and land policies, increasing social housing in these regions and promoting the supply of private rental housing.
- Encourage maintenance and repair of the housing stock, taking into account the needs of the elderly for living at home.
- Smooth the problems related to housing in regions where out-migration is large, for example by reducing the sale restrictions on dwellings built with government subsidies.

The programme for construction policy includes the following major goals:

- Further improve the quality of housing and the living environment by developing the training and education system and R&D in the construction sector as well as by specifying required qualifications of professionals and by agreeing on common standards.
- Enhance ecological and life-cycle aspects in the construction sector.
- Promote competition and productivity in the construction sector by using more calls for tender in public building, facilitating co-operation between public and private parties in the sector and improving conditions for international activities of the construction sector.
- Improve the resilience of the construction sector to business cycle fluctuations.
- Develop planning and building permit systems to shorten the process between planning and the start of building projects.
- Develop co-operation between the state and municipalities in providing urban infrastructure.

The housing market and overall activity

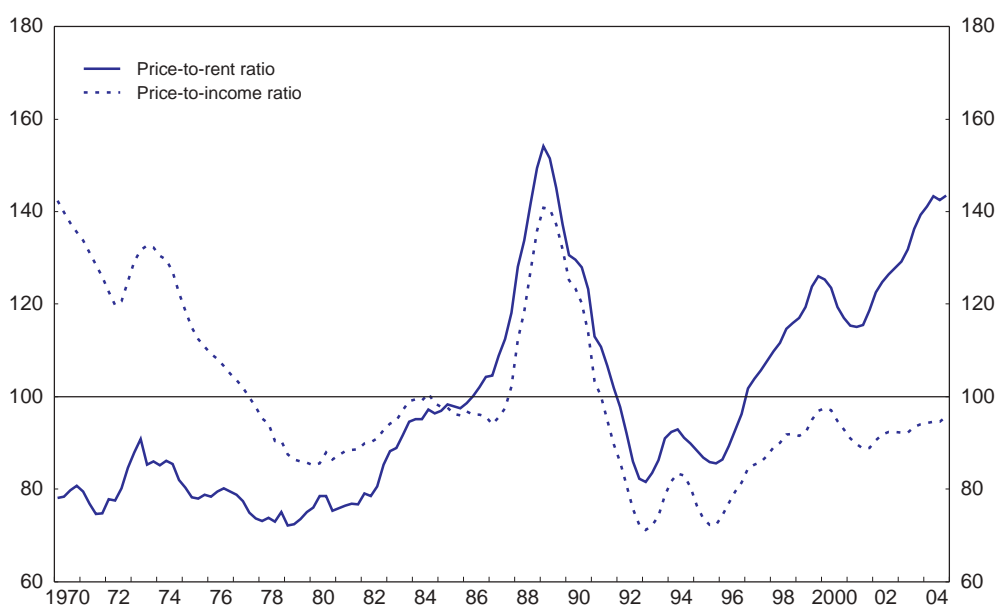
The current state of the housing market

As in most other OECD countries, house prices have increased over the last decade. Real house prices have risen by more than 80% in general and by 100% in the Helsinki metropolitan area since the first quarter of 1995. However, the price increases have been less pronounced than in some other OECD countries, such as Ireland, Spain or the United Kingdom. As strong house price increases are not necessarily evidence of an overvaluation, it is important to relate the house price increases to their underlying fundamentals in order to assess whether markets are overvalued.

Recent research (Girouard *et al.*, 2006; Herrala, 2005; Oikarinen, 2005) suggests that the current house price level is largely in line with the fundamental drivers. For instance, the price-to-income ratio, which is an indicator of the affordability of housing, is below its historical average (Figure 4). In many

other OECD countries this ratio is above its long-term average (Girouard *et al.*, 2006). However, the ratio of prices to households' disposable income alone may be an insufficient measure to evaluate housing affordability as it does not capture the sustainability of households' mortgage debt service payments. The study by Herrala (2005) shows that, although the size of mortgage loans has risen, lower interest rates and longer loan periods have compensated for the increase in house prices and mortgage indebtedness.

Figure 4. **Price-to-rent and price-to-income ratios**
Long-term average = 100



Source: OECD, *OECD Economic Outlook*, No. 78, December 2005, Figure III.4.

One way to assess the over or undervaluation of houses is to compare the price of owner occupation and rental accommodation using price-to-rent ratios (the nominal house price index divided by the rent component of the consumer price index). The price of owner-occupied housing has risen more rapidly than rents in recent years and is currently higher than the long-run average, as in many OECD countries (Figure 4).² This development can, however, be justified by the low level of interest rates since a decline in interest rates reduces the relative cost of owner-occupation as compared to renting.

Based on econometric work that links house price changes to fundamentals, Oikarinen (2005) shows that the current house price level is roughly in line with the long-run drivers of house prices. In particular, the growth in real disposable income and the decline in the real mortgage rate have justified a substantial part of the increase in house prices in the Helsinki metropolitan area over the last ten years. Even though house prices do not currently seem to be overvalued, a sudden change in fundamentals could have a severe effect on the ability of households to meet their mortgage payments. Van den Noord (2006) shows, for instance, that although the probability of a downturn in the housing market is currently small, the probability would rise rapidly if real house prices were to continue to rise and there were an increase in interest rates from their current low level. Indeed, the most recent figures on house prices confirm that this may become a concern, in particular in the Helsinki area where the annual increase in house prices was close to 10% in the last quarter of 2005.

The link between the housing market and consumption appears to be strong

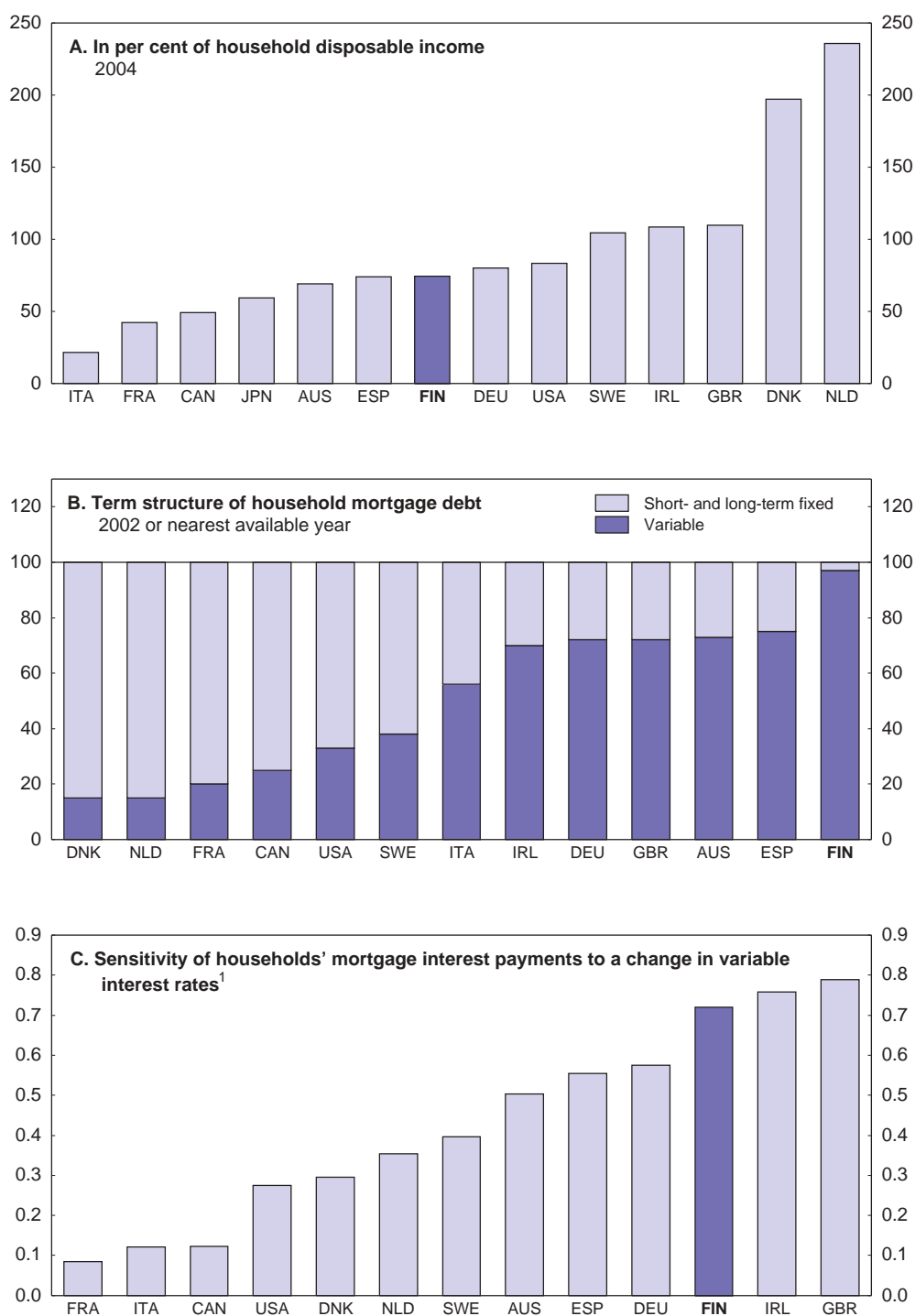
The housing market acts as an important transmission mechanism between monetary policy and consumption. A rise in mortgage interest rates affects consumption through their direct effects on disposable income as the burden of interest payments increases. The housing market may also have an indirect impact on consumption through wealth effects.

Mortgage debt and wealth effects

The level of mortgage debt is important in determining the magnitude of the direct impact of interest rate changes on mortgage debt service and hence consumption. In international comparison mortgage debt as a share of disposable income is relatively low (Figure 5, panel A). However, debt has been increasing rapidly in recent years, even though it is still below the 1989 peak when it reached 90% of households' disposable income. If indebtedness continues to rise rapidly, the debt ratio will exceed the previous peak in a few years. The effect of an interest rate change on mortgage debt service depends not only on the level of debt but also on the term structure of mortgage interest rates: the more short-term variable rates are used, the greater the sensitivity. As reported by Miles (2003) fixed and variable-rate mortgage products have very different risk and cost characteristics. Fixed-rate mortgages are not without risk, but they give a certainty over the profile of households' monthly debt service payments. Variable-rate mortgages do not provide such a certainty. However, due to the term premium fixed-rate mortgages may often *ex post* turn out to be more expensive. How attractive these products are from the view point of households depends to a significant extent on the costs of the option to repay the mortgage early and re-mortgage. The attractiveness of fixed-rate mortgages depends also on the risk aversion of households. While variable-rate mortgage products may be a good alternative for some households, fixed-rate mortgages are clearly a less risky alternative for some households, in particular first-time house buyers, households with long maturity or large mortgages. In this respect Finland is an extreme case with a surprisingly high share (95%) of the mortgage loans based on variable interest rates (Figure 5, panel B), which are usually tied closely to the 12-month Euribor rate.

A crude measure of the effects of interest rates on of the mortgage debt service (Figure 5, panel C) suggests that the sensitivity of Finnish households to interest rate changes is high compared with most other OECD countries due to the large proportion of variable rate mortgages. A 1 percentage point increase in short-term interest rates could lead to a 0.7 percentage point rise in the interest payment-to-disposable income ratio. Increasing the length of the maturity of mortgage loans would be one way to smooth the effects of interest rate increases on households' debt servicing payments. Indeed, banks have started to offer loan contracts where an increase in interest rates automatically leads to a lengthening of the maturity so that debt servicing remains constant. While the average maturity of mortgages has traditionally been relatively short and is currently around 17 years, in recent years the maturity of new mortgages has risen³ so that there may be less room now to increase the length of the maturity further.

Figure 5. Household mortgage debt



1. Estimated effect of a 1 percentage point increase in short-term interest rates on gross mortgage interest payments (as a per cent of households' disposable income). The effect is calculated as the product of the share of mortgages subject to variable rates and households' outstanding mortgage debt.

Source: European Mortgage Federation, *HypoStat 2004*; OECD, *OECD Economic Outlook*, No. 78, December 2005, Table III.1.

Housing is a major wealth component and house prices may influence consumption. Housing wealth in relation to financial wealth is relatively large compared with other countries. Changes in housing wealth may also affect borrowing constraints as it can be used as collateral for loans with more favourable conditions than other forms of household borrowing (mortgage equity withdrawal). Econometric analysis (Annex A) suggests that the short-run effect of a change in housing wealth on households' consumption is relatively large as compared with most other OECD countries and is larger than the short-run effect of financial wealth. The short-run effect of housing wealth is also considerably larger (as well as being statistically better determined) than the long-run effect (Table 1).

Table 1. Housing wealth effect on consumption

Estimated short-term marginal propensities to consume out of real housing wealth

Australia	0.02
Canada	0.03
Japan	0.01
Netherlands	0.02
Spain	0.01
United Kingdom	0.08
Finland	0.05

Source: Catte, P., N. Girouard, R. Price, and C. André (2004), "Housing Markets, Wealth and the Business Cycle", *OECD Economics Department Working Papers*, No. 394 and OECD calculations.

How should policy respond?

The heavy use of variable-rate mortgages largely reflects the preferences of households as banks are not much constrained in the products they can offer. Hence, there is no clear sign of failure in the Finnish mortgage market. However, the sensitivity to the interest rate changes should be a matter of policy concern. Finland no longer has an independent monetary policy and wealth effects appear to be much stronger than for the major euro area countries. Furthermore, variations in house prices are not strongly correlated with that of most other euro area countries (Table 2).

Table 2. Correlation between house price cycles

Correlation of house price changes, 1975-2004

	DNK	FIN	FRA	DEU	IRL	ITA	NLD	ESP	SWE	GBR
DNK	1	0.06	-0.25	-0.32	0.27	-0.65 ¹	0.4 ¹	-0.04	0.21	0.13
FIN		1	0.23	-0.36 ¹	0.23	0.04	-0.1	0.35	0.41 ¹	0.73 ¹
FRA			1	0.1	0.31	0.6 ¹	0.25	0.64 ¹	0.63 ¹	0.53 ¹
DEU				1	0.17	0.39 ¹	-0.03	-0.07	-0.09	-0.06
IRL					1	0.17	0.34	0.19	0.49 ¹	0.36 ¹
ITA						1	-0.06	0.36 ¹	0.33	0.21
NLD							1	0.38 ¹	0.49 ¹	0.02
ESP								1	0.64 ¹	0.59 ¹
SWE									1	0.53 ¹
GBR										1

1. Statistically significant at 5% level.

Source: OECD calculations.

The government currently operates a mortgage guarantee scheme available to all borrowers. While this scheme is intended as an insurance against default risk arising from possible discontinuity of income and is not likely to be the cause of the high share of variable-rate mortgages, it may be one factor diminishing the risk awareness of households and banks and thus inhibiting the development of fixed-rate mortgages. Such mortgage guarantee schemes are relatively rare in OECD countries and so it is unclear what particular rationale there is for one in Finland. Furthermore, they are usually targeted on low-income households in countries where there exist similar schemes, *e.g.* in the Netherlands (Waarborgsfonds Eigen Woningen, WEW). The government should, therefore, consider phasing out or better targeting this scheme. While this would leave households and banks at an increased risk from a rise in interest rates, it might strengthen their incentives to insure against the risk by using fixed-rate mortgages (Box 3).

Box 3. The government guarantee for mortgages

A government guarantee scheme is available to all borrowers buying a home or building a house since 1996. It was designed to facilitate the guarantee and collateral arrangements of borrowers and to replace the personal guarantees that led to large losses during the recession. Many households lost their homes as they were used as a collateral or as a basis for personal guarantees during the debt-defaults in the early 1990s.

The banks grant government guarantees as part of their housing loan decisions, and borrowers do not need to apply for a guarantee separately. The Housing Fund of Finland (ARA) supervises the banks' guarantee operations. A government guaranteed loan cannot exceed 85% of the purchase price of the house. The state guarantee provides a secondary collateral. If the prospective homeowner receives an interest subsidy, the loan guarantee is not subject to a charge. Otherwise the loan applicant may obtain the guarantee against a 2.5% premium. In the case of default, losses are covered after the primary collateral is liquidated by the lender and if the lender has not been able to recover the full amount of the receivables due from the collateral. The guarantee covers a maximum of 20% or € 25 250 of the outstanding loan balance and additionally, a maximum of 20% of the interest and penalty interest on the principal.

Statistical facts:

In 2004 banks granted 35 000 mortgage loans with government guarantees.

Currently, more than 150 000 government guarantees exist.

About € 10 billion of the households' mortgage loan stock (€ 42 billion) is partly covered by the government guarantee.

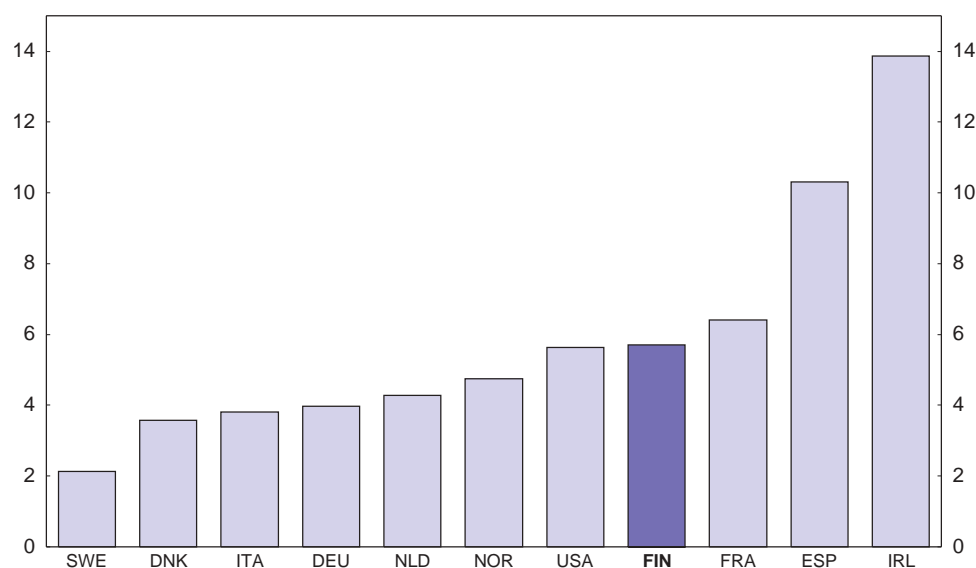
The total value of the government guarantees is currently € 750 million.

Losses covered by the guarantees have been relatively small at € 175 000.

Housing investment and the construction sector

The impact of house price developments on the construction sector forms an important additional channel through which housing markets affect macroeconomic stability. For instance, OECD (2006a) suggests that construction booms and busts may have large macroeconomic consequences. The Finnish construction sector accounts for nearly 10% of the total value added in the non-agricultural business sector. In international comparison the construction sector is relatively large, even though dwelling completions per inhabitant are considerably smaller than in countries where housing is booming, such as Spain and Ireland (Figure 6).

Figure 6. Dwelling completions
Per 1000 inhabitants, annual average 2000-03¹



1. Or latest year.

Source: Statistics Finland, *Construction and Housing Yearbook*, 2005 ed., Chapter 19, Table 5.

Compared with house and land prices, construction costs have increased only moderately over the last decade. However, there may be future pressures on construction costs if the sector continues to grow rapidly. In particular, labour costs could rise more sharply. Unemployment in the construction sector has fallen below the national average and the number of unfilled vacancies exceeds the level found in the boom period of the late 1980s.

One explanation of why there has not been more pressure on construction costs may be the increased share of foreigners working in residential construction, particularly in southern Finland. Their share of total hours worked in housing construction is estimated to have been around 5-8% in 2004 (Lith, 2005). Foreign workers (mainly Estonians) have been able to work in Finland despite the restriction on the free movement of labour from the new EU member countries, mainly because they have not been hired directly by Finnish firms but by foreign-based contractors or subcontractors. Under the freedom to provide services, the employees of such companies are not required to have a work permit if they are working temporarily in Finland whereas foreigners directly hired to work in Finland need a work permit. The requirements on work permits were originally set for a transition period of two years until the beginning of May 2006 in most "old" EU countries. These restrictions were removed in Finland in May 2006 which should help in overcoming labour shortages in the future.

Raising the effectiveness of housing policies

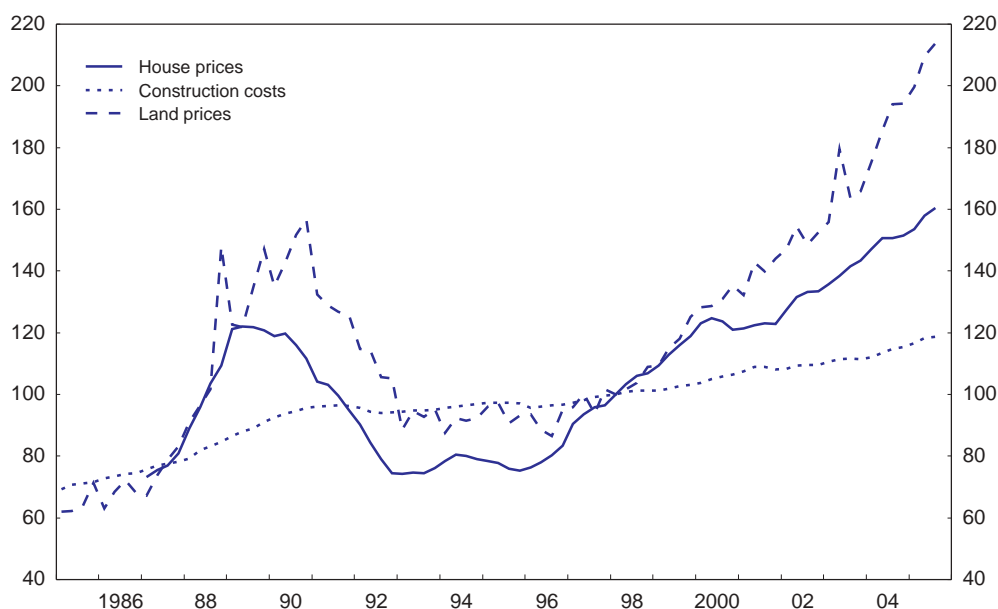
While housing policy has been fairly successful in achieving its goals, there is scope for improvement. Housing support should be better targeted and housing supply in growth areas should become more elastic. Furthermore, there is a good case for reconsidering the role of property taxes in municipal finances. This section first assesses the problems related to planning and shortages of building land. It then considers different tax policy aspects related to housing, in particular property taxes and tax advantages associated with housing and home ownership. This is followed by an assessment of the housing finance and support system. Finally, the regional dimension of housing and labour mobility are discussed.

The planning system and supply of building land

The main factor driving up house prices has been the price of land. From the beginning of 1998 to the later part of 2005, land prices rose by 114%, while house prices increased by 54% (Figure 7). This feature is astonishing as Finland is a sparsely populated country and there is land available even around the metropolitan areas. The sharp rise in land prices signals a mismatch between the availability of and demand for building land. In a survey by the Finnish Local and Regional Authority (Laine, 2004) the shortage of building land is listed as one of the major bottlenecks limiting housing construction, particularly in the rapidly growing areas. According to the survey, this problem has worsened since the early 2000s. The survey lists the diversity of interest groups related to planning, lack of resources, problems in financing local infrastructure and the slowness of appeals on planning decisions as the most problematic issues.

Figure 7. Trends in housing related price indices

Index 1998 Q1 = 100



Source: Statistics Finland.

The new *Planning and Building Act* was enacted in 2000. All government levels are involved in land use planning. The government sets general national planning guidelines and a regional plan is prepared and approved by a regional council where municipalities are represented. This plan is ratified by the Ministry of Environment. The municipalities are responsible for the local master plan and the local detailed plan. They thus have a strong role in planning and no ratification of their planning decisions is required by other government levels.

The sluggish response of house building to the increase in prices in rapidly growing regions is partly due to the slow planning process. There are, for instance, multiple possibilities to appeal over decisions on building permits and local plans. The applicants and third parties have the right to challenge the decisions in both the regional and supreme administrative court. In 2004 the average length of proceedings in regional courts was 12.6 months, special permits took 9.7 months and building permits 7.9 months. If the parties appeal to the Supreme Court the length increases on average by an additional 11.9 months. 12% of planning and building decisions were appealed to regional courts and 26% were appealed to the Supreme Administrative Court (Korkein hallinto-oikeus, 2004).

Since municipalities are responsible for providing the costly infrastructure in urban areas, such as roads and sewage, they may also have a disincentive to allocate sufficient building land for housing construction. In addition, they are responsible for providing schools and children day care, health care and other services for the new residents. The government has recently decided to provide earmarked grants (maximum 35% of total expenses) to municipalities to support the provision of infrastructure in the growing regions.

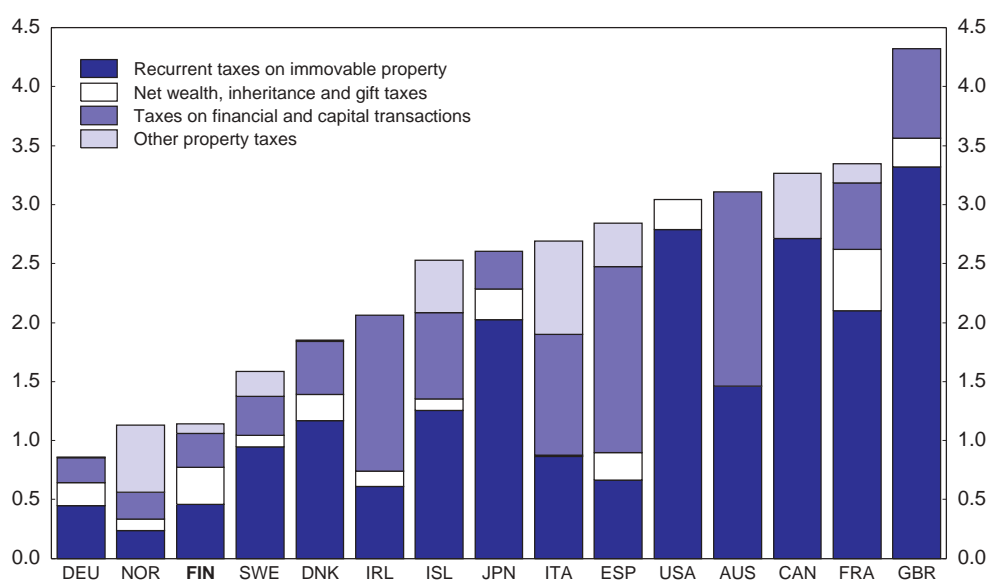
The issues related to planning and municipalities' incentives to provide building land have been cited as major problems in discussions and reports.⁴ The government is tackling these issues in the national construction and housing policy programmes by proposing to improve planning procedures and co-operation between the state and municipalities in providing infrastructure and services to new urban areas. Recently, a working group appointed by the government released its report on whether the *Planning and Building Act* should be revised so that municipalities' duties laid down in the Act to provide housing plots could be better enforced.⁵ The working group also considered how the planning process could be speeded up. One of the conclusions of the report is that forcing municipalities to provide housing plots in all circumstances is not appropriate in the current system. Several recommendations concerning better planning procedures are, however, proposed in the report. In particular, the report considers limiting the multiple possibilities to appeal over planning decisions.

Taxation of property

Tax policy is often used to alter housing market developments. In particular, the tax treatment of housing in Finland has played an important role in favouring home ownership. Mortgage interest payments are tax deductible, capital gains and imputed rental income are not taxed and property taxation is very low compared with many OECD countries (Figure 8).⁶

Figure 8. Property tax revenue

As a percentage of GDP, 2004¹



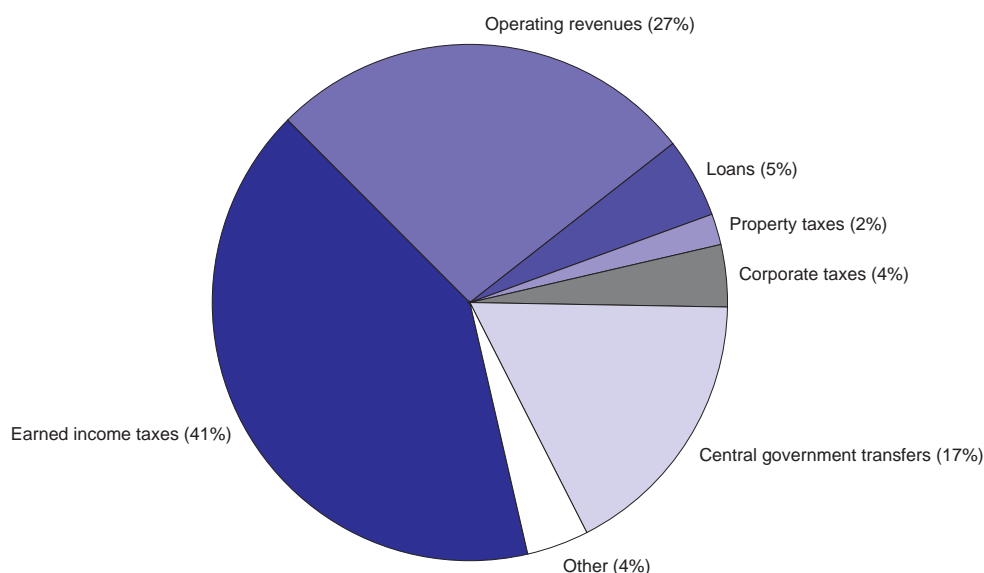
1. 2003 for Australia.

Source: OECD, *Revenue Statistics, 1965-2004*, 2005 ed.

Municipal level property tax

One way to encourage municipalities to provide more building land and speed up planning processes would be to widen their possibilities to levy property taxes and to extend the tax base to undeveloped land, particularly in urban areas, which is currently not taxed. The property tax was introduced in 1993 when a major tax reform of the income tax system was implemented.⁷ However, the role of property taxation as a revenue source has remained limited. While municipalities are free to decide on their own income tax rate without any upper threshold, the property tax rate is only allowed to vary within narrow limits. Currently, the general property tax rate can vary between 0.5 and 1.0%, but residential buildings are taxed at a lower rate (0.22-0.5%). The share of property tax revenues in total municipal revenues was around 2% in 2004, whereas the revenues from earned income and corporate tax accounted for 45% of total revenues (Figure 9).

Figure 9. **Municipal finances**
2004, in per cent of total revenues



Source: Ministry of Interior.

Some changes towards a wider use of property taxation are underway: land that is earmarked for house building but remains without construction activity will be taxed above the normal property tax rate. However, there is clearly room for further changes, most notably raising the lowest threshold and removing the upper threshold on the property tax rate. The major advantage of the use of property taxes at the local government level is that the tax base is more stable than the personal income and especially the corporate income tax. Property tax revenues are also relatively predictable (Joumard and Kongsrud, 2003). Moreover, higher property taxation would mitigate the upward pressure on labour income taxation that several municipalities are currently facing.

In order to further enhance the incentives of municipalities, property tax revenues could be exempted from the fiscal equalisation system. Currently all municipal tax revenues are taken into account in the equalisation of central government transfers. The system basically implies that municipalities with a smaller tax base relative to the average receive compensation whereas municipalities with a large tax base will receive less central government transfers (Box 4). The incentives could also be promoted by allowing municipalities to tax the increase in the value of building land provided for housing or by encouraging them to use their preferential right to buy land and to charge building developers for the costs of new infrastructure.

Box 4. The fiscal equalisation system

Since municipalities are responsible for many functions that involve redistribution (from the rich to the poor and from the working-age population to the young and the old), some equalisation of resources is necessary. The tax equalisation scheme aims to reduce disparities among municipalities in their capacity to raise revenues while the state grant scheme contributes to the funding of the local provision of statutory services.

The tax equalisation system is based on a comparison between a municipality's potential tax revenues per inhabitant and the country average (potential tax revenues are defined as those that the municipality would get if it adopted the average tax rate). If the potential tax revenue of a municipality falls below 90% of the country's average, then the tax equalisation scheme raises this municipality's financial resources by redistributing tax revenues collected from wealthier municipalities (in 2004, more than three fourths of the municipalities were below this threshold). If it exceeds the 90% threshold, the municipality contributes to the tax redistribution scheme (40% of its tax revenues, starting from the 90% threshold). In 2006 the 90% threshold was raised to almost 92% and the 40% share was reduced to 37%. These changes are related to reimbursing municipalities the additional costs due to the labour market support reform and loss of revenues due to some other reforms.

Municipalities also receive block grants, based on notional expenditure needs, from the state. Notional spending on social welfare and health care is based on the age structure of the municipalities' population and some geographic criteria. Social welfare grants also take into account the level of unemployment, and health grants take into account a morbidity factor. State transfers for education are based on the number of students. Every year, state transfers are adjusted to reflect price and public sector wage developments. State grants were cut significantly in the mid-1990s. However, in recent years the share of state grants has been increasing, representing 5.2% of GDP in 2004.

No formal relationship exists between grants and taxes, creating uncertainties over the availability of municipal financial resources. In the second half of the 1990s, booming corporate income tax revenues led to cuts in state grants, *de facto* preventing excessive spending. However, there is no automatic mechanism leading to higher grants in periods of falling tax revenues. Furthermore, despite the recent reduction to two years, the delay in redistributing tax revenues through the tax equalisation scheme creates additional uncertainty on the resources that will accrue to them.

The exclusion of property tax from the equalisation system has been discussed (Ministry of Interior, 2004), but was not adopted, in part because such a reform would benefit most those municipalities that have a large industrial tax base. As an intermediate alternative, the reform could relate only to residential property. This would also strengthen the link between municipalities' incentives to supply building land for housing and property taxation, as efforts to improve the local infrastructure are likely to be reflected in property values, increasing the tax yield for municipalities. This link between property taxation and municipal incentives does not exist, however, if the property values in the tax assessment are not market based.

Currently, the assessment value of property is not closely linked to recent price developments (Box 5.). The assessment value of buildings is based on the repurchase value set annually by the Ministry of Finance. The rise in the repurchase value has been much slower than that of house prices. For example, house prices increased by about 30% in Finland from 2000 to 2005 whereas the repurchase value increased by less than 10%.⁸ Similarly, assessment values of land lag behind the development in land prices. For example, the assessment values of land in the Helsinki city centre have not been changed since 1997.

Box 5. The determination of assessment values for property taxation

The amount of property tax is determined by the tax rate and the assessment value of land and buildings. The assessment value of land is based on wealth tax law and annual decisions by the tax authority. The government has proposed to abolish the wealth tax from 2006. The assessment value will be determined by a new law on the valuation of assets. Until now, the calculation of this value was determined by municipal maps including information about site prices in a region and assessment guidelines. The site prices in the maps reflect the price of raw land sold in the region as well as the planning situation and land policy of the municipalities.* Region-specific current values are determined for sites with residential buildings, offices, shopping malls and industrial buildings. The target of the tax authorities is to have the assessment value of land at 73.5% of the value indicated by the site price maps and assessment guidelines.

The property tax assessment value of buildings is determined by the repurchasing value of the buildings and by deductions related to their age. The repurchasing value of a building is based on the assessment of the construction costs of a similar new building. This assessment does not take into account differences in construction costs by region. The Ministry of Finance sets annually the repurchase values of different types of buildings. These values are 70% of average construction costs and reflect the changes in the construction cost index. The tax assessment value is obtained by subtracting annual age deductions from the repurchase value. Thus, the tax assessment value often does not reflect the market value of buildings. The total assessment value of a property is obtained by summing the assessment value of the building component with that of the site.

* The difficulty in updating the assessment values of land, e.g. in the Helsinki area, is that there are few land transactions which could be used as a basis for updating the assessment values of land in the area.

If the assessment value of property were linked directly to recent house prices, property taxes would affect house price developments. Muellbauer (2005) argues that it is crucial to link the property tax to current or recent house prices throughout the house price cycle, so that property tax would be a constant proportion of capital values. This would tend to dampen house price cycles since higher house prices have an immediate effect on tax payments and thus on households' income. Furthermore, if households extrapolate house price rises into the future they will also anticipate the greater tax burden. This will lead to more cautious spending and portfolio decisions.

Other tax policies

As in many other countries, taxation is geared towards facilitating households' access to home ownership via the deductibility of mortgage interest payments from income tax, while the imputed rental income and capital gains from home ownership are not taxed. Taken together these tax advantages form a complex taxation structure which departs from the principle of tax neutrality and strongly favours home ownership instead of renting (Box 6).

Box 6. Housing taxation and tax neutrality

The main purpose of any tax is to raise revenues, but the tax system is also used to promote various economic and social objectives. This can be done through tax exemptions, low tax rates, and special reliefs affecting incentives. Taken together these elements create complex structures which may depart from the principals of tax neutrality and create distortions.

One problematic issue in analysing housing taxation and tax neutrality is that housing is a special good: it may be considered as an investment and a consumption good.* As housing provides a flow of services consumed by people, it should be taxed so that the costs of different housing tenures, basically owner occupation and rental housing, are equal. The tax advantage of homeowners is that they do not pay taxes on the service income provided by housing (often referred as imputed rental income) and they are allowed to deduct the mortgage interest payments from income tax. According to the tax neutrality principal, the imputed rental income should be taxed, but homeowners should be allowed to deduct their mortgage interest payments and operating costs from this income. On the other hand, as an investment good housing should be taxed such that it would not distort incentives to invest in different assets. In this case, the additional tax advantage of investing in housing relative to other forms of investment is that capital gains from housing are often exempt from taxation.

In practice, the set-up of current tax systems in many OECD countries does not follow the tax neutrality principle between different forms of investment and housing tenure. In Finland taxation is used to promote home ownership, through the deductibility of mortgage interest payments and the non-taxation of imputed rental income and capital gains. Achieving the neutrality principle would not only require a reform of housing taxation but also of the whole tax system, for example to ensure that capital gains are taxed in a similar way to other forms of income.

An additional type of housing taxation is that on property values. This tax can be seen as a means to raise revenue to finance local services provided by the municipalities, but it can also be seen as a mean to tax gains from the increase in value of property due to the changes in the zoning of land. Furthermore, a property tax may be considered as a tax on location. The property tax differs from the tax on imputed rental income in that it does not involve taxation of the service income provided by housing and hence does not necessarily affect the tax neutrality between rental housing and owner occupation.

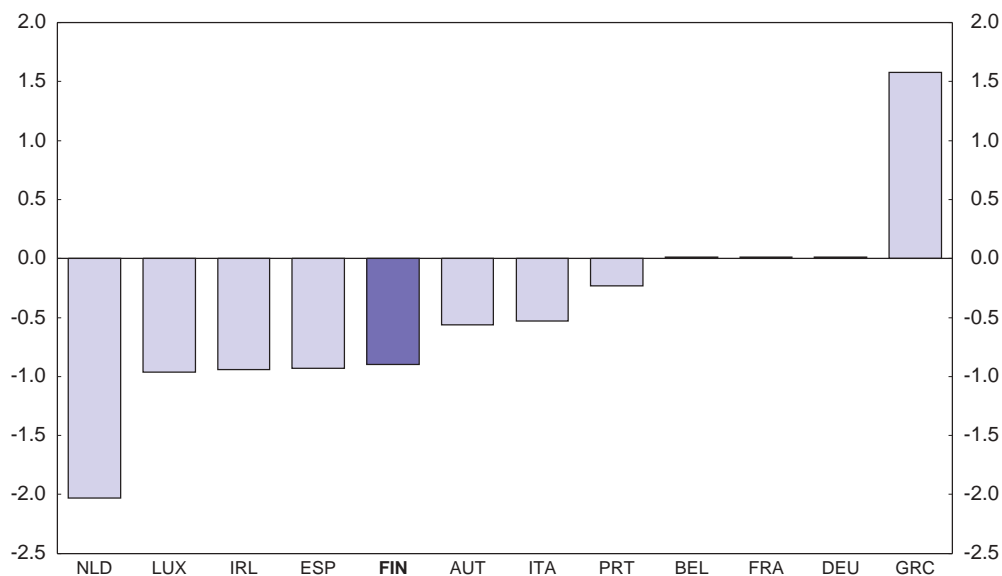
* Furthermore, home ownership is often thought to have positive externalities.

Finland has a dual tax system where capital and labour income are taxed at different rates (van den Noord and Heady, 2001). The deductibility of interest payments is determined by the intended use of the debt. The right to deduct interest payments concerns interest on mortgages, government-secured student loans and interest expenses accrued from producing taxable income. The interest payments are primarily deductible from capital income. If interest payments exceed capital income, it is possible to deduct the rest from the labour income tax liability in the form of a tax credit (Saarimaa, 2005)⁹ in which case they can be deducted at the capital income tax rate.¹⁰

The favourable tax treatment of owner occupation is often justified by the specific nature of housing and the positive externalities for society associated with its consumption (OECD, 2005). However, the deductibility of mortgage interest expenses may be an inefficient policy instrument to promote home ownership since it also affects house prices. This is the case, in particular, when housing supply does not respond swiftly to increasing demand. In addition, the tax relief leads to higher demand for mortgage loans at any given interest rate which may amplify the housing cycle. Although the deduction was shifted from the progressive income tax to the flat capital income tax rate in 1993, it still plays an important role, accounting for 0.25% of GDP. In international comparison, the tax treatment of mortgage interest payments in Finland is more favourable than in many other OECD counties (Figure 10.). Tax deductibility should be scaled back, possibly in the context of a more comprehensive reform of housing policies.

However, to the extent that a more general reform involved a substantial increase in property taxes the urgency of phasing out the mortgage deductibility would be reduced. In the current environment of low interest rates, the decision to phase out the tax relief would be more acceptable to the public and easier to carry out since the subsidy is smaller in such circumstances.

Figure 10. **Impact of tax deductibility of interest payments**¹
1999, per cent



1. Difference between after-tax and pre-tax real interest rate on mortgage loans.

Source: Van den Noord, P. (2005), "Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence", *Économie internationale*, No. 101.

Another type of tax incentive, present in many OECD countries, is that gains from sales of owner-occupied housing are exempt from capital gains tax (Catte *et al.*, 2004). In Finland these gains are exempt from taxation if the owner has lived in the dwelling for more than two years. Taking all tax elements together, policy in Finland gives an especially favourable status to home ownership (Table 3).

Table 3. Taxation of residential property

	Imputed rental income taxed	Tax relief on mortgages		Capital gains on housing assets taxable	Inheritance tax
		Interest	Principal repayments		
Austria	N	Y (up to ceiling)	N	Y	Y
Belgium	Y (with fixed deduction)	Y (up to imputed rental income)	Y (within limit)	Y (if sold < 5 years) POOD are exempt	Y
Canada	N	N	N	Y (on 50% of gains) POOD are exempt	N (but subject to capital gains tax)
Denmark	N	Y	n.a.	Y POOD are exempt	Y
Germany	N	N	N	Y (if sold <10 years) POOD are exempt	Y (lower than for financial assets)
Finland	N	Y (up to a ceiling)	n.a.	Y POOD exempt if sold > 2 years	Y
France	N	N	N	Y POOD are exempt	Y
Ireland	N	Y	N	Y POOD are exempt	Y
Italy	N (for POOD)	Y (for POOD)	N	Y (50% for POOD)	Y (until 2001)
Netherlands	Y	Y	N	N	Y (above tax free threshold)
Norway	Y	Partly (as other interest expenses)	N	Y	Y
Spain	N (for POOD)	Y	Y	Y (exempt if reinvested)	Y
Sweden	Y	Y	N	Y (exempt if reinvested)	N
United Kingdom	N	N	N	Y POOD are exempt	Y
United States	N	Y (up to ceiling)	N	Y (until 2002) (deduction for POOD if held > 2 years)	Y (to be phased out)

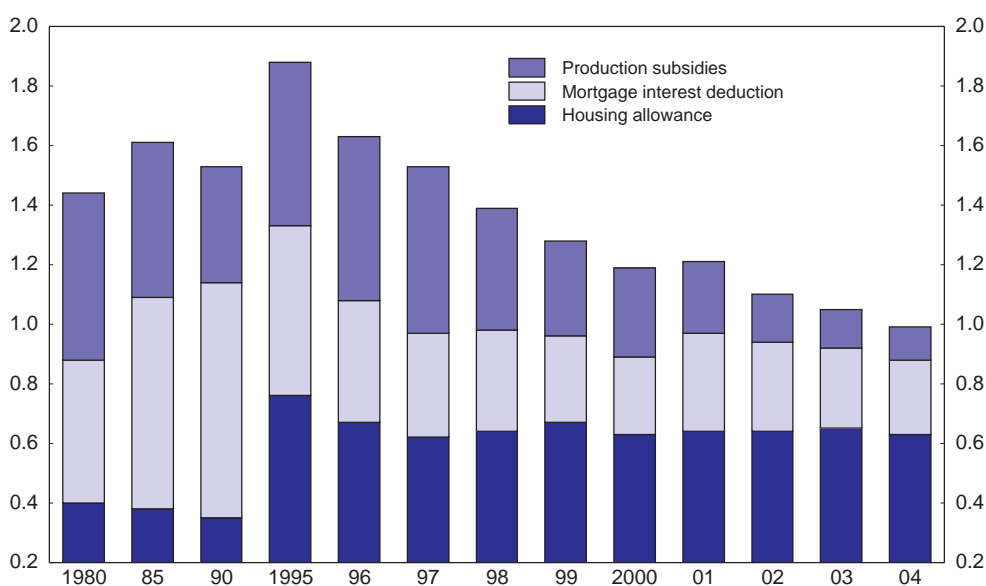
Note: POOD = principal owner-occupied dwellings.

Source: Catte, P., N. Girouard, R. Price, and C. André (2004), "Housing Markets, Wealth and the Business Cycle", *OECD Economics Department Working Papers*, No. 394; Baunkjoer, C.F. (2004), "Housing Taxation", *Housing and Housing Policy in Nordic Countries*, M. Lujanen (ed.), Nordic Council of Ministers.

Housing finance and support systems

In addition to tax policy, government housing finance and subsidies play an important role in shaping the housing market. These subsidies can be divided into different programmes depending on whether they are intended to support housing supply or to subsidise housing demand. In total such subsidies amounted to 1% of GDP in 2004 (Figure 11).

Figure 11. **Housing subsidies**
As a percentage of GDP



Source: Ministry of Environment.

Housing allowances

The housing allowance accounted for two-thirds of these subsidies in 2004. A general allowance is granted to low-income households irrespective of the type of housing tenure (social rental, private rental, “right of occupancy”¹¹ and home ownership). 159 000 households received this assistance in 2004. In addition, more than 300 000 people were included in separate housing allowance programmes for pensioners and students. Overall, around 20% of all households receive a housing allowance.

The amount of the general housing allowance is linked to households’ income through a so-called “deductible amount”. The size of the “deductible amount” (the amount of rent paid by the household) is determined by family type, number of children, and geographic location and it increases in small steps as the gross income of the household increases. The amount of housing allowance that households receive covers 80% of the difference between the actual housing costs and the “deductible amount”. The actual housing cost includes expenses such as rent, water and heating payments for tenants and water, heating and maintenance costs as well as 55% of personal or 80% of a household’s total mortgage interest payments for home-owners. Although the majority of claimants for housing allowance are tenants, the possibility to obtain the allowance to cover mortgage interest payments favours housing investment over other types of investment.

The housing allowance system allows the eligible households to raise the magnitude of the allowance by moving to higher quality housing. Thus, the system not only reduces living expenses but also increases the quality of housing of low-income households. The system thus promotes the principal housing policy objective of providing good quality housing at an affordable price. However, the fact that the housing allowance depends on the actual rent paid may increase incentives to move to a more expensive accommodation, at least within the limits of the housing cost ceilings¹² covered by the housing allowance. Indeed, Kangasharju (2003) argues that the system over-compensates low-income households for their low rent-paying ability since an average household receiving housing allowance typically lives in more expensive and higher quality housing than an average household without housing allowance after controlling for many household and dwelling-specific factors.

If instead of depending on the actual rent, the housing allowance were a lump sum determined by the average rent in a region, households' income and size, the household would choose the quality and price of the accommodation. For example, households could choose between paying more than the allowance and living in more expensive accommodation or living in less expensive housing and keeping the difference. Such a reform in the housing allowance system would increase the choice of households and be less costly for the government. A reform along these lines was undertaken in a pilot programme in the United Kingdom in 2004.¹³

While housing allowances can form an important source of revenue for low-income households, when taken together with other features of the tax-benefit system they may create unemployment and poverty traps. Such traps arise when individuals have little incentive to move from unemployment to full-time work or to increase their hours worked as the increase in net income is relatively small due to the combined effect of increased tax payments and the withdrawal of income-tested benefits. The extent to which additional gains from work are "taxed away" can be measured by the marginal effective tax rate (METR). In international comparison the housing allowance component plays an important role in Finland. In 2002, Finland had the sixth highest housing allowance component in the OECD.¹⁴ The government has taken some action to alleviate the negative effects of the housing allowance on unemployment traps: in the 2006 budget proposal, the government suggested that when long-term unemployed return to work their higher income will not reduce their housing allowance in the first three months.

Loan subsidies

The tax deductibility of mortgage interest payments is one important subsidy promoting housing demand. An additional form is the ASP scheme (saving system for young people) intended for first-time homebuyers. This scheme subsidises interest payments. However, in the current environment of low interest rates this form of subsidy is negligible as there is a minimum threshold for the interest rate below which there is no subsidy. As with mortgage interest deductibility this scheme should be abolished, and with interest rates low this is a good time to do so.

The main forms of support for housing supply are government provided, subsidised loans (ARAVA loans) and privately provided loans with a government interest subsidy (interest subsidy loans). These subsidies are granted by a governmental agency (ARA) and are intended mainly for municipalities or non-profit corporations. While ARAVA loans can only be used to finance social rental and "right of occupancy" dwellings, interest subsidy loans are also available for financing the construction and acquisition of owner-occupied dwellings.

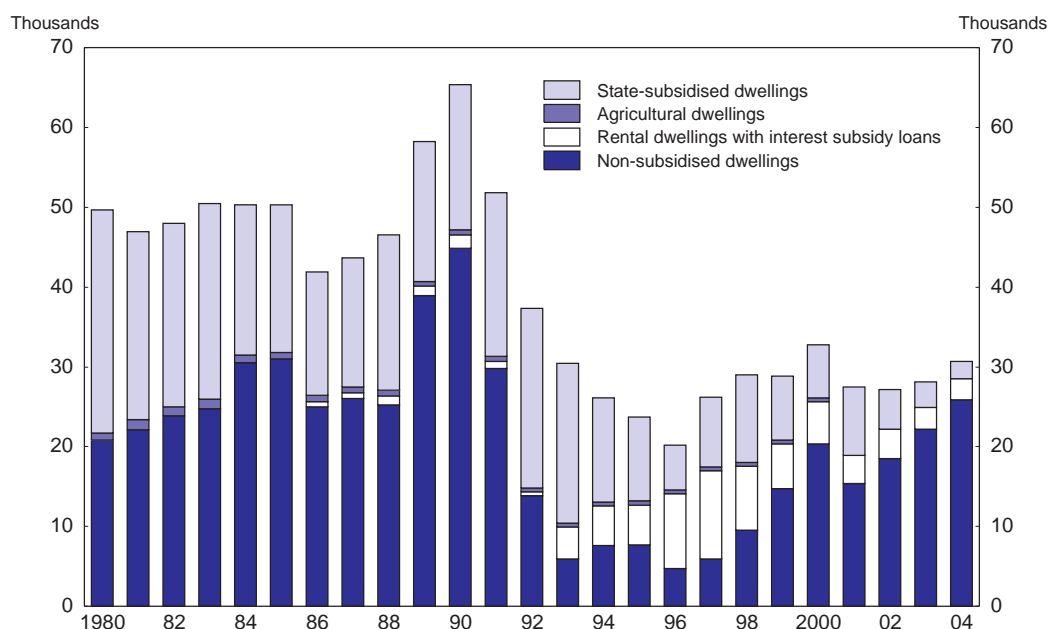
Government subsidised loans for social housing are subject to regulations concerning tenant selection and providers of social housing:

- The selection of tenants is based on social criteria and financial need. Specific criteria are set annually by the government, including the urgency of housing needs, level of income and wealth. Tenant selection procedures are controlled by the local authorities. Tenants for social housing are means-tested at the time of taking up a tenancy and local authorities are obliged to carry out random checks to ensure the selection criteria have been respected.
- Only certain borrowers are allowed to obtain ARAVA and interest subsidy loans: *i)* local authorities or public corporations; *ii)* non-profit corporations that fulfil certain preconditions and are accepted by ARA; and *iii)* limited liability companies in which one or more of the organisations mentioned are dominant.
- Social rental housing is subject to cost and quality control. ARA approves buildings to ensure standards of architectural design and quality as well as geographic and social integration criteria. It also monitors cost and quality and ensures the use of competitive tendering.
- Social rental dwellings are to be used as rental dwellings for 40 years. The rent is based on capital and maintenance expenditure (cost recovery principle). The dwellings intended for social housing can only be sold to a buyer who is accepted in the regulations, *i.e.* some of the organisations mentioned above, and the price should not exceed the maximum amount determined in the regulations.

A typical characteristic of highly volatile housing markets is that housing construction also has strong variations. Indeed, the government housing policy, through ARAVA and interest subsidy loans, has played an important counter-cyclical role in supporting construction and dampening fluctuations in housing production, in particular, maintaining a minimum level of production during the crisis period in the early 1990s. Since then, subsidised loans have lost in importance. In 2004 the number of dwelling starts subsidised by these loans had declined to one-third of those in the mid-1990s (Figure 12) and the share of such subsidies relative to total government subsidies for housing has diminished from around 30% to only 11%.

While the share of government-subsidised housing production has decreased, more than 50% of rental housing is provided through social housing and almost 100% of new rental production is government-subsidised implying that the role of private rental activities and especially production is rather small. This is surprising since Finland has a relatively liberal rental market. For example, since 1995 no rent controls have been in operation, when entering a rental contract, though there are some limits to raising the rent afterwards. One explanation could be that the high level of social housing provision and the wide possibilities to apply for social housing programmes has crowded out private providers of rental housing. It is striking that 73% of Finland's population is eligible for the social housing programme. In addition, private providers may find it difficult to profitably invest and compete with high quality social housing. This high level of eligibility for social housing reflects the government's objective of social cohesion, in particular that there should be a mix of households from a range of income backgrounds using social housing. On the other hand, this objective could alternatively be pursued by building social housing in the same region with private housing. At the same time limiting eligibility to social housing would reduce the cost for the government and encourage the private rental market with probably little implication for this objective.

Figure 12. Dwelling completions by type of financing



Source: Statistics Finland.

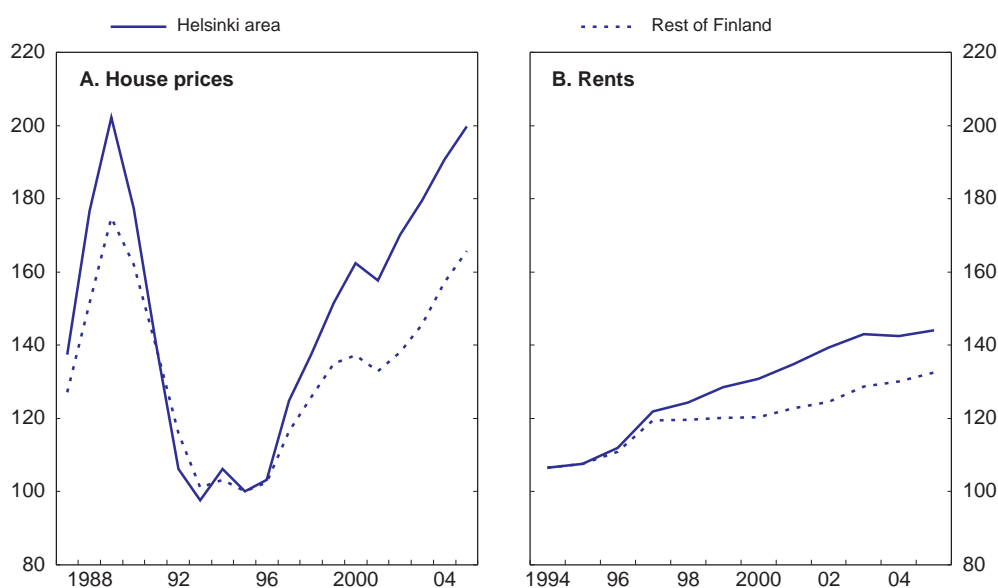
Regional dimensions of housing markets

Regional developments in housing supply

There are wide regional disparities in house prices (Figure 13). For example, the average real house price in the Helsinki metropolitan area was almost double the price in the rest of Finland in 2005, while the average rent in the Helsinki metropolitan area was 33% higher. Moreover, the divergence is increasing as house prices and rents rise faster in the growth centres relative to other regions. During the past decade real house prices in the Helsinki metropolitan area grew annually by more than 7% whereas in the rest of Finland the annual price increase was around 5%.

In a well-functioning system house building should respond to increases in house prices. However, in some regions building activity has decreased recently, while house prices have increased. For example, in the Uusimaa region (including the Helsinki area) the annual growth of real house prices has been on average 5% in 2000-04, whereas the number of building permits has *fallen* by around 3%. As discussed above, this may partly reflect the slow planning procedures and municipalities' disincentives to provide building land.

Figure 13. Trends in housing prices and rents
In real terms¹, index 1995 = 100



1. Deflated by the CPI.

Source: Statistics Finland and OECD, Economic Outlook database.

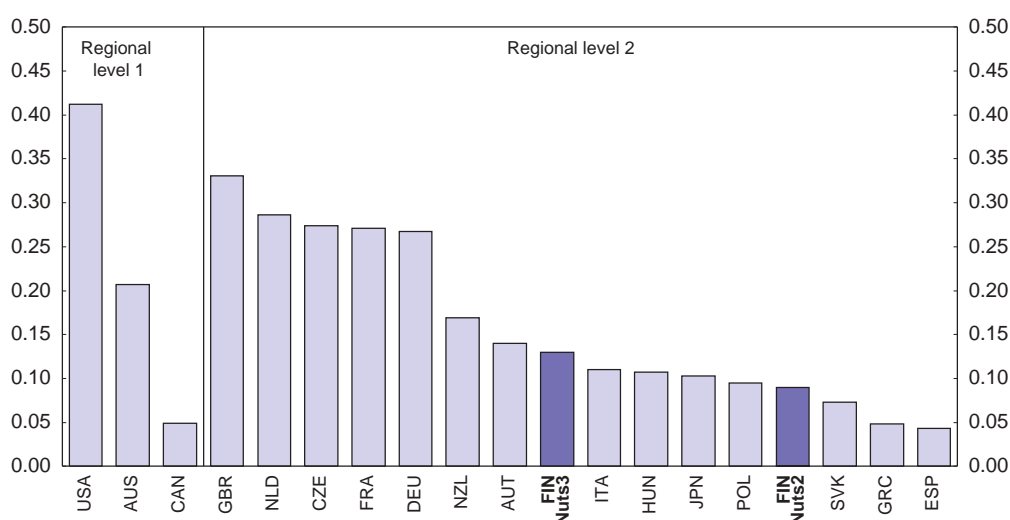
The regional dimension is also an important factor in the planning and supply of social housing. The demand for housing has been concentrated in a few growth areas, such as metropolitan Helsinki and the surrounding area, and the Turku, Tampere, Jyväskylä and Oulu areas. This creates pressures on supply of social rental housing in these areas, whereas in other regions social housing faces opposite challenges with empty social rental dwellings. There were 87 000 applicants queuing for social rental housing in 2004 of which 70% were in the growth centres. Over one fourth of these applicants were in urgent need of housing, whereas in other regions less than 10% of applicants were in urgent need of housing. The housing market situation has been most difficult in the Helsinki area, where less than one fifth of the applicants have obtained a dwelling.

Mobility and housing markets

As highlighted in OECD (2006b), there are large disparities in regional labour market performance and these disparities have increased over time. A low level of geographic labour mobility may be one explanation. Local factors, in particular housing market conditions and policies, are likely to influence decisions to change residence to take up a new job. For example, considerable regional disparities in house prices may hinder migration and internal migration in Finland is low in international comparison (Figure 14).

Home ownership is often seen as a barrier to labour mobility. Home owners are less likely than others to move to a new location, due to transaction costs and potential capital losses. Similarly, social housing may form a barrier to mobility, if there are queues for social housing in the new location. Both probably undermine mobility in Finland: home ownership is the dominant tenure type and social housing accounts for around 50% of rental housing (Figure 15). Furthermore, social housing may create obstacles for moving to growth areas as there are bottlenecks in the supply of social housing in these areas.

Figure 14. **Regional mobility rates**
Net flows as a percentage of the population aged 15-64¹, 2003²

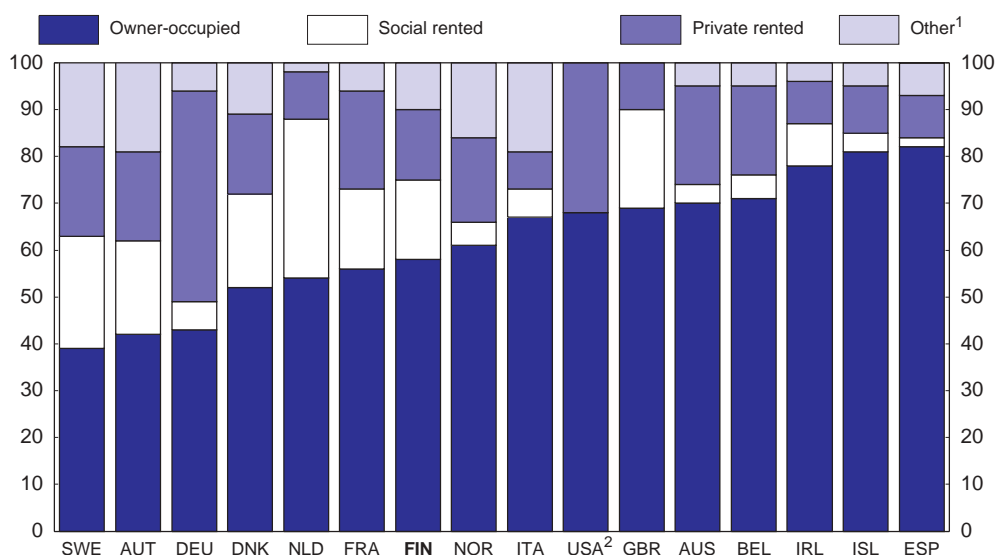


1. For Australia and Italy, the population of reference is the total population; for Japan, it is the population aged more than five years and for Finland, it is the population aged more than 15 years old. The net migration rate is calculated as the ratio of the sum of the absolute values of regional in and out flows divided by two, to the total population aged 15-64.

2. 1999 for the Netherlands; 2001 for Japan; 2002 for France and Italy.

Source: Statistics Finland; OECD (2005), *OECD Employment Outlook*, OECD, Paris, Chart 2.7, panel B.

Figure 15. **Dwellings by tenure**
2004 or latest available year



1. For Finland, it is the unknown type which is included here while for most of the other countries, it includes the cooperative housing, employer-provided housing, etc. On the other hand, for Finland, these categories are included in the private rentals.

2. For the United States, it was not possible to split rented housing into private rentals and social housing.

Source: Department of Housing of the Direction General of Planning, Housing and Heritage (2002), *Housing statistics in the European Union*, <http://international.vrom.nl/Docs/internationaal/housingStats2002.pdf>; Karlberg, B. and A. Victorin (2004), "Housing Tenures in the Nordic Countries", Chapter 4, *Housing and Housing Policy in the Nordic Countries*, M. Lujanen (ed.), Norden 2004:7, Nordic Council of Ministers, Helsinki; Ball, M. (2005), "European Housing Review 2005", RICS; Economic Council (2001), *Danish Economy, Spring 2001*, Copenhagen; OECD (2005), *OECD Economic Surveys: Spain*, OECD, Paris.

Indeed, econometric analysis by Hämäläinen and Böckerman (2002) confirms that both the high dispersion of regional house prices and the high level of home ownership reduce net migration between regions, particularly by discouraging in-migration. International comparisons (OECD, 2005) suggest that home ownership significantly reduces the probability of regional migration, while social housing also reduces the probability, but to a lesser extent. This in turn suggests that policies strongly favouring home ownership and social housing over other types of tenure should be reconsidered.

Summing up

To sum up, housing policy and the financing system have succeeded in their primary objective of providing affordable and high quality housing for all Finns. There is, however, scope for improving the functioning of the housing market and the efficiency of housing policies (Box 7).

Box 7. Recommendations concerning the housing market

- Consideration should be given to phase out or better target the state loan guarantee scheme in such a way that it will not undermine the risk awareness of home buyers.
- Begin scaling back mortgage interest deductibility, possibly in the context of a more comprehensive reform of housing policies and taxation.
- Shift taxation away from labour towards property by further easing the limits on municipal property tax rates and extending the tax base to undeveloped land, which is currently not taxed. The property tax on housing should be excluded from the equalisation system so as to encourage housing development and the tax assessment of residential properties should be more closely aligned with market values.
- Speed up the planning process by reducing the possibilities to appeal over the decisions concerning building permits and local plans.
- Limit eligibility to social housing to reduce the cost for the government and encourage the private rental market.
- Reform the housing allowance system to improve efficiency and to allow households to exercise choice by linking the magnitude of the allowance to the average rent in the region and by allowing households to choose the quality and price of the housing.

Notes

1. Some of the decline in home-ownership may be due to statistical reasons since almost 10% of the dwelling tenure is listed as other and unknown.
2. It should be noted that the long-run average of price-to-rent ratio may be affected by the abolishing of the rental control in 1995. However, the effect is probably relatively small since rents have been increasing only at a relatively moderate pace since 1995.
3. Currently, banks are offering loans with 30 or even 60 years maturity.
4. See, for example, the report written by a group of experts appointed by the Ministry of Environment.
5. This working group was headed by Mr. Tarasti and more details about the report can be found in the web page of the Ministry of Environment (in Finnish): www.ymparisto.fi/default.asp?contentid=174640&lan=FI (accessed 10 April 2006).
6. The revenues from taxing immovable property (buildings and land) accrue to municipalities, but that of other property taxes, such as taxes on financial and capital transactions and net wealth, inheritance and gift taxes, accrue to the central government.
7. At the same time the tax on imputed rents was abolished.
8. The repurchasing values are set down in the annual statutory regulation by the Ministry of Finance (1155/2000 & 1126/2004). These values concern the whole country and do not differ between regions.
9. There is a ceiling for the deductible amount (€ 1 400 for an individual and € 3 600 for a two-adult family with two children) in the case where interest expenses are deducted from labour income. In contrast, the interest expenses are fully deductible from capital income.
10. The tax rate on capital gains is currently 28%, but first home buyers are allowed to deduct interest payments at the rate of 30%.
11. The right of occupancy is a form of housing tenure that falls between owner-occupancy and renting. Residents buy into the scheme by paying a percentage (15%) of the value of their home. Residents also pay a monthly charge which is based on the cost recovery principle. The right of occupancy dwellings cannot be transformed to owner-occupancy.
12. The maximum ceiling for housing costs is determined by geographic location, size of housing, building year and heating system.
13. See www.dwp.gov.uk/housingbenefit/lha/.
14. The comparison of the marginal effective tax rates (METR) was carried out by decomposing the METR and by examining the housing allowance component of the METR for individuals moving from unemployment to full-time work and for individuals deciding to work longer hours or moving to jobs offering higher wages. Two types of family situation were considered: a single parent with two children and a one earner married-couple with two children. For further details see OECD (2006c).

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Annex A

Housing wealth and consumption

This annex reports the results of the analysis of housing wealth effects on consumption. The analysis is based on the life cycle and permanent income hypotheses suggesting that households smooth their consumption over time so that in the long-run their consumption depends on their life-time income and wealth. However, in the short-run, consumption may diverge from the long-run trend. Building on earlier OECD work the short-run dynamics is estimated using an error correction approach that estimates the long-run relationship between consumption, income and wealth and that at the same time allows for a temporary deviation from the long-run trend.

The long-run relationship between consumption, income and wealth is estimated using disaggregated components of households' net wealth, *i.e.* housing and financial wealth, using annual data spanning 1979-2004.¹

$$\ln C = \alpha_0 + \alpha_1 \ln FW + \alpha_2 \ln HW + \alpha_3 \ln Y + ect \quad (6.A.1)$$

where C is real consumption, Y is households' real disposable income, FW and HW denote real net housing and financial wealth, respectively. Net financial wealth is determined as financial assets minus financial liabilities except mortgages whereas net housing wealth is determined as housing assets minus households' mortgages. The coefficients related to households' income, financial and housing wealth in equation (6.A.1) are the long-term elasticities with respect to these variables. Finally, ect represents the residual from the regression capturing the difference between actual and long-term values of consumption.

The short-run dynamics are estimated using the following equation:

$$\Delta \ln C = \beta_0 + \beta_1 \Delta UN + \beta_2 \Delta \ln FW + \beta_3 \Delta \ln HW + \beta_4 \Delta \ln Y + \tau ect_{-1} \quad (6.A.2)$$

where Δ indicates first-order differences and ect_{-1} is the error-correction term capturing deviations from the long-run trend. The larger this coefficient is, the faster the adjustment to the equilibrium. In addition to households' income and wealth, the short-run dynamics are explained by the unemployment rate (UN). It was also tested whether the short-run specification should take into account additional explanatory variables, such as interest rates and inflation. However, these variables did not have a statistically significant effect on consumption.

Table A.1 presents the estimation results for both the long-run relationship (panel A) and the short-run dynamics (panel B). The estimates were first conducted without any restrictions on the long-run relationship and then the long-run elasticities with respect to income, financial and housing wealth were restricted to sum to one. This restriction is, however, rejected at the 1% significance level. In the specification without the restriction, the sum of elasticities is close to 0.8. This implies that the long-run relationship between consumption, income and wealth is not homogeneous or that it is not well determined which may be due to the boom and bust in the late 1980s and early 1990s. It is worth noting that the results of the short-run dynamics are relatively robust to the inclusion of the restriction on the sum of elasticities.

1. The data are obtained from Bank of Finland and OECD Analytical Database.

The magnitude of short and long-run effects of housing wealth on consumption is of special interest when assessing the effects of housing markets on consumption. The short-run consumption elasticity is clearly higher than the long-run elasticity. Furthermore, the short-run elasticity with respect to housing wealth is larger than that with respect to financial wealth, whereas in the long-run the elasticity with respect to financial wealth is higher.

Instead of examining the elasticities with respect to housing wealth, it is also interesting to analyse the marginal propensity to consume out of housing wealth, *i.e.* the amount that consumption changes in response to incremental changes in housing wealth. A convenient way to approximate the marginal propensity (*MPC*) is to use the expression for the elasticity of consumption with respect to housing wealth:

$$\varepsilon(C/HW) = \frac{\Delta C/C}{\Delta HW/HW} = \Delta C/\Delta HW * HW/C = MPC * (HW/C). \text{ In international comparison the short-run marginal}$$

propensity is relatively high in Finland, while the long-run propensity is around the OECD average (0.03). This result is also consistent with the findings of Clapham *et al.* (2002).

Table A.1. Detailed estimation results

	Panel A	
	Long-run relationship	
	Unrestricted specification	Restricted specification
Constant	5.186 (5.14)	0.041 (1.46)
Real financial wealth	0.164 (8.25)	0.096 (4.51)
Real housing wealth	0.071 (2.80)	0.004 (0.14)
Real income	0.555 (7.90)	0.899 (32.00)
R ²	0.99	0.98
	Panel B	
	Short-run dynamics	
	Long-run unrestricted specification	Long-run restricted specification
Constant	0.013 (3.75)	0.013 (3.91)
Δ real financial wealth	0.059 (2.69)	0.033 (1.82)
Δ real housing wealth	0.104 (3.88)	0.107 (3.84)
Δ real income	0.219 (2.41)	0.239 (2.11)
Δ unemployment rate	-0.006 (-0.55)	-0.008 (-4.10)
ect(-1)	-0.366 (-2.00)	-0.258 (-1.57)
R ²	0.91	0.90

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