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The German Private Rented Sector

- A Holistic Approach

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- A Holistic Approach

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PREFACE

This working paper intends to provide the reader with an overview of the German private rented market. It describes why the rented sector is so large, why many households opt to stay in rented dwellings, and why the rent prices increased so little over time. To properly understand these issues, the report further considers the rented sector in relation to the home-ownership sector and the social sector. It shows the private rented sector as being highly embedded within the microeconomic situation of households and the macroeconomic structure of the German social market economy.

The German private rented market is gaining wide-ranging interest from investors, academics, economists, policy-makers and journalists from abroad; due to the role it has played in the stability of the German housing market and the question of whether there will be a boom in German housing market. The mainstream argument for the structure of the German housing market is that the large rented sector balances the fluctuation of the owner-occupied sector due to the availability of tenure substitution. The logical conclusion is to copy German housing policies to replicate this structure and stability. However, this paper concludes that it would be inaccurate to extrapolate policies from the German private rented sector without understanding how it fits into the rather unique myriad of institutions in the German housing market and general economy.

The paper initially reviews the legalistic characteristics of the rented sector, including tenancy law and rent regulation. In particular it evaluates the effects of the security of tenancy, the *Mietspiegel* and the rent increase ceilings. The normative effect of these laws and institutions are assessed, and it is shown that there is no significant impact on market rent price, and therefore there are other characteristics as to why the rented sector in Germany is so large and house prices remain very stable.

A detailed review of the supply and demand determinants for both the rented and owner-occupied sectors is carried out in Chapters 4 and 5 respectively. It shows that the shape and stability of the housing market can be explained due to long term characteristics and policies, which have culminated in a large supply of dwellings, a more regulated mortgage market, private rented dwellings inherent within households' life cycle, and other macroeconomic stabilizers.

The paper does not conclude that policies from Germany are unable to be introduced in new countries, where for example the rent regulation instrument called the *Mietspiegel* (Rent Mirror) can be seen as an effective instrument to insure reasonable market rents can be easily set for a dwelling in the negotiation between the landlord and the tenant. In relation to increasing the energy efficiency of dwellings in the private rented sector, the German policy can be seen as strongly in favour of the modernisation process over the additional costs to the tenants.

The regulation of the private rented sector conforms to the German economic model of a 'social rented economy', whereby intervention is only undertaken when there would be a market failure and that social objectives are best carried out through the private sector. In housing this means that the rented and owner-occupied sectors are regulated in order to avoid unsustainable price increase bub-

bles, either through rent price increase caps or mortgage lending restrictions. Furthermore, the preference of achieving the social aim of affordable housing through the private sector can be seen in both the policy of 'publically subsidized dwellings' rather than the provision of many social dwellings and the policy of providing tax incentives for small landlords in the private rented sector.

The Knowledge Centre for Housing Economics, an independent and impartial research group within the Danish foundation Realdania, has commissioned this working paper at the start of 2013. An expansive comparative report is being made by the Knowledge Centre for Housing Economics together with DELFT University, the London School of Economics, the Copenhagen Business School and the Cologne Institute for Economic Research, and is expected to be finished at the end of 2014.

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CHAPTER 1: INTRODUCTION

The private rented sector (PRS) in Germany has been growing in interest from academics, policy makers, the media and investors across the world since the downturn in the housing markets in many OECD countries forged the foundations of the financial crisis. This report gives a holistic analysis of the German PRS, including legal, fiscal, macroeconomic, microeconomic and political considerations. The report shows how the PRS is an embedded part of the German social market economy structure, where rent regulation, tenancy law and investment incentives are enacted with the aim to ensure the private sector is the leading supplier and that market failures are mitigated. In understanding the life cycle of households in Germany, this report follows the necessary approach in reviewing both the social rented sector and the owner-occupied sector as alternative tenure choices.

The tenancy law and rent regulations which shape the German PRS are elaborated upon in Chapter 2. Furthermore, there is an outline of the dispute settlement procedure. Although this section is descriptive, the aim is to show that tenancy law, rent regulations and the court system are all generally favourable towards the tenants, offering them a security of tenure, ability to make the dwelling a "home" and ensures the rent price will be restricted against large scale volatility. The rest of the report refers back to this chapter to support the claims of tenure decision making in the life cycle of households, thus it is important to outline the complete field.

Chapter 3 elaborates in detail the rent regulations which were introduced in chapter 2. Specifically it looks into the development, operation and use of the *Mietspiegel* (Rent Mirror). The *Mietspiegel* is a document prepared for by the local governments which shows the comparative local rent for each area in order to give the landlord and tenant a clear understanding of what the market rent should be and thus appropriate for the contract. In Germany the initial rent price in practice will be the market price, thus unregulated. The regulations thus focus on the rent increases, where the *Mietspiegel* and two other forms of rent increase can be used by the landlord. Furthermore, this chapter reviews rent increases due to modernisation of the dwelling and the right to rent reduction due to defects. The essential finding of this chapter is that the rent regulation is not designed to control the rent price in the market, but ensure that there is no extreme volatility. The *Mietspiegel* is actually a device to ensure that there is an accurate finding of the market price, so that rent increase can be carried out amicably and that market efficiency is enhanced.

Chapter 4 reviews the PRS in terms of size, composition and the determinants of supply and demand. It also describes the "publically subsidised" rented sector, which encourages the private market actors to supply social housing. We find that the large demand is encouraged by the large share of the market the PRS has with varying quality, the favourable tenancy laws and regulations, the role rented dwellings play for mobile and young households, and the support of social security provisions. On the supply side, there are considerable tax advantages, subsidies for energy modernisation, several governmental subsidies and the investor understanding of stable rental income. The chapter concludes that the PRS embodies

the core characteristics of the German social market economy: it balances between encouraging private investment and ensuring socially acceptable rent price levels, and intervenes in the market where there is failure such as vacancy rates in East Germany, extremely high growth in rent prices and improving the energy efficiency of the housing stock.

Chapter 5 shows how the PRS is crucially embedded within the complete housing sector of Germany. There is a review of the history of house prices, the characteristics of the stock, construction analysis, the supply determinants, and the demand determinants, including mortgage lending, demographics and tax. The home-ownership sector impacts the PRS most influentially through two channels. First is that with rent regulation ensuring "market price", the general housing market will impact on the house prices, including dwellings in the rented sector, and thus an effect on the rental prices. In other words, while the rent prices are somewhat correlated to the house prices, we need to analyse the determinants of supply and demand on house prices. Second, the user cost of home-ownership needs to be analysed to review the household tenure choice between home-ownership and the PRS. This gives us a greater understanding of the role of the PRS within the life-cycle of households tenure. It finds that there are no tax advantages for home-ownership, the mortgage market is highly regulated and the macroeconomic conditions of Germany has given rise to an expectation of the home not generating capital gains, which combined makes the market difficult to access. German households will therefore stay in the PRS until they can access the home-ownership market, explaining part of the size and popularity of the PRS.

CHAPTER 2: GERMAN TENANCY LAW AND THE LAW OF RENT REGULATION

This chapter sets out the tenancy law and rent regulation in the German PRS. It is largely descriptive, giving the report a basis upon which to refer to in order to substantiate the later understanding of user cost, rent price development, life-cycle of households, investor constraints, and interaction with challenges such as energy modernisation and vacancy rates. The first section introduces the legal authority, showing the sources and concepts around which the law is shaped. The second section then describes what is enacted for practical reasons.

INTRODUCTION AND LEGAL AUTHORITY OF TENANCY LAW AND RENT REGULATION

1. Introduction and Principles of German Tenancy Law

1.1 The vast majority of German tenancy law is found within the German Civil Code (*Bürgerliches Gesetzbuch* = BGB). The rules of tenancy law are found within its Book II (Law of Obligations).

1.2 Although there are traces of Roman Law, the BGB is structured upon the liberal philosophy that when the individual is freed from the traditional constraints and authorities of a feudal, political or religious nature, he is a reasonable, rational person capable of defining his own fate. He can decide whether or not to make a contract, to whom he makes this with, and under what terms.

1.3 This principle of private autonomy leads to the creation of contracts with no tenancy protection, and still has influence on the freedom of new contracts from rent regulation.

1.4 A brief history of rent regulation shapes the understanding of the current market and regulative schema. The housing shortage following WWI led to regulation to increased distributive allocation of housing. These merely served to distribute available housing, and failed to attract investment into the housing market. The Third Reich enacted the Law on Price Freezes (*Preisstoppgesetz*) of 1936 which prohibited rent increases. Post-WW2 policies introduced for housing shortages and refugees. The 1960s marked a period of gradual liberalisation in the housing market due to greater understanding of the interconnectedness of the economy and monetary policy with the housing sector. The legislative aims were:

1.4.1 To ensure sufficient housing without anti-competitive cartels

1.4.2 To give sufficient returns for landlords to encourage investment

1.4.3 Supply sufficient housing for the population.

1.5 Since the 1960s legislation has been enacted to foster private house building with public funds, the rent control regime was loosened, and social elements of tenancy law aimed at protecting the tenant were strengthened.

1.6 The 2001 Tenancy Reform Act (*Mietrechtsreformgesetz*) aimed to simplify the existing tenancy law into a systematic structure of rules. It was structured:

1.6.1 General Rules of All Lease Contracts (§§ 535-548 BGB)

1.6.2 Lease of Housing Accommodation (§§549-577a BGB)

1.6.3 Lease of other objects (§§578-580a BGB)

1.7 Furthermore, it was structured according to the legal remedies:

1.7.1 Specific Performance

1.7.2 Damages

1.7.3 Termination

1.8 Enacted a Uniform Concept of a Breach of Duty

1.9 The reform modernisation was necessary to adapt tenancy law to changes in society: increased mobility of tenants, new forms of co-habitation, and the conservation of energy.

1.10 The Reform Act 2001 codified most of case law, thus reference to previous jurisprudence provides examples of how the BGB should be work in practice.

1.11 The changes in the new tenancy law were promoted by the Act to Modernise the Law of Obligations (*Schuldrechtmodernisierungsgesetz*). The new law was inspired by the rules in the UN Convention on the International Sale of Goods (CISG). In the last stage of debate the Principles of European Contract Law (PECL) were taken into consideration.

1.12 Institutional Structure of Housing Legislation and Responsibility:

1.12.1 Most of the legislation is decided at the national level by the Federal Government with its majority in the German *Bundestag* (Parliament)

1.12.2 The *Bundesrat* (representatives from the 16 *Bundesländer* (States, referred to as *Länder* for this report) has an important role because it has to formally approve more than half of the bills.

1.12.3 The *Länder* have legislative powers for a number of areas, including housing and social assistance. Together with the

municipalities, they are the main financing bodies for housing, although the Federal government still plays some roles.

1.12.4 For implementation of laws and public social administration, the municipalities are the most important bodies, apart from corporatist agents.

2. Constitutional Influences on Tenancy Law

2.1 The Principle of Autonomy of the private party has been converted to a publically regulated social owner-and-user relationship. This marks a development in German Basic Law (*Grundgetz = GG*) or Constitution.

2.2 The development of the GG has significance on private law. In the Federal Constitutional Court (BVerfG) decision of 1962 in *Lüth* they held that fundamental rights were "objective principles" which would be given effect throughout the legal system, thus deployed in an indirect horizontal effect through private law.

2.3 Some of the main constitutional rights found within tenancy law include:

2.3.1 A14(I) GG: Guarantee of Private Property

2.3.2 A2(1) GG: Guarantee of Private Autonomy

2.3.3 A14 II GG: Property Rights are limited in the Social Interest

2.3.4 A14(I) GG: Protection of the tenant as a possessor of the premises although not the owner

2.3.5 A5(I) GG: Freedom of Information (e.g. ensuring antenna dishes)

2.3.6 A3(I) GG: Principle of Equal Treatment (allocation of shared costs)

2.3.7 A6(I) GG: Protection of Marriage and the Family

2.4 Some of these principles, such as recognising cohabitees inheritance under A6(I) GG, were also codified in the 2001 Reform Act.

3. Acts and Regulations Structuring Current Tenancy Law

3.1 Since the 2001 Reform, most of the private laws on the law of lease can be found in §535 ff BGB. However, this does not contain all private law rules.

3.2 The Regulation on the Calculation of Heating Costs (*Verordnung über Heizkostenabrechnung* – HeizkostenVO): sets forth rules on the calculation and distribution of costs for heating and warm water for premises with more than one apartment.

3.3 The Regulation on the Housing Costs Calculations, called II. Calculation Regulation" (II. *Verordnung über wohnungswirtschaftliche Berechnungen* = II. BV): contains a full set of rules on calculation of costs, charges, encumbrances etc. with regards to financing of housing.

3.4 The Law on Regulation of Estate Agencies (*Gesetz zur Regelung der Wohnungsvermittlung* = WoVermittG): rules on the contractual relationship between a tenant and the estate agent

3.5 Regulation on Personal Chattels (*Hausratsverordnung*)

3.6 Law on Apartment Ownership (*Wohnungseigentumsgesetz*)

3.7 Public law norms mainly on government funding of housing, rent calculation or rent increase control for social housing, and tax law regulation to support the construction of housing accommodation.

3.8 Some public law provisions also have important effects on private law, such as §5 Economic Criminal Law (*Wirtschaftsstrafgesetz*), which declares profiteering to be a regulatory offense.

3.9 Local authorities can also enact regulations, such as prohibiting the alienation of premises.

4. Influence of European Community Law on National Tenancy Law

4.1 Council Directive 93/13/EEC on Unfair Terms in Consumer Contract has been transposed into §§305 sqq. BGB. For example, clauses on professional renovation are deemed void as it is contrary to the requirement of good faith since it puts an unreasonable disadvantage on a tenant.

4.2 A3(II)(a) Council Directive 85/577 to protect the consumer in respect of contracts negotiated away from business premises.

4.3 In some cases German law has gone beyond what is required in European law in consumer protection, such as §312(I) BGB extending beyond what is required in A8 of Directive 85/577.

5. Legal Concept of the Lease Contract

5.1 German law affords a very expansive concept of a lease contract, where the tenant's position is very close to a property right. In other words, the lease contract gives claim possession when the object is in possession of the tenant.

5.2 Possession is protected against Unlawful Interference by §858 BGB and provides for compensation for damage through §823(I) BGB.

5.3 The Federal Constitutional Court ruled that the tenant's possession right enjoys protection under the property guarantee of A14(I) GG.

5.4 Further rights which are normally associated with property rights include:

5.4.1 §566 BGB stipulates that if the leased land is sold to a third party, then the buyer takes the place of the landlord in the rights and obligations arising from the original lease.

5.4.2 §563 BGB stipulates that spouses or descendants enter into the lease contract in the event of the tenant's death.

5.5 There are also genuine property rights (*dingliche Rechte*), such as the right of residence (*Wohnrecht*), according to §1093 BGB, which are economically comparable to the lease. This right of residence must be included into the contract and has to be registered with the land registry (*Grundbuch*).

5.6 There is also other forms of "lawful possession" of a premise:

5.6.1 §581 Usufructuary Lease (*Pacht*) – right of the tenants to use the fruits of the object.

5.6.2 §598 Gratuitous Loan for Use (*Leihe*) – where the lender does not demand any or very little money for use.

6. Social Regulation Affecting Private Tenancy Contracts

6.1 Subsidies for private investor construction usually resulted in dwellings falling under particular rent restriction regimes. The limitations of these regimes were limited to a certain number of years, after which they joined the private market. These subsidised constructions with rent restrictions have been steadily decreasing, mainly due to tightening public finances.

6.2 The 2001 Reform changed the subsidy approach towards the promotion of housing premises. What subsidies which have remained are now focused on those considered most in need. Moving away from new build construction subsidies, the government encouraged the considerably cheaper alternative of renovating existing housing stock, through renovation subsidies and tax breaks.

6.3 Some *Länder* (Municipalities) ran housing construction programmes solely for the most disadvantaged in society in the seventies and eighties, but are significantly reduced now.

6.4 There are laws to stop the alienation of housing premises, such as the Prohibition of Misappropriation Act (*Verbot der Zweckentfremdung von Wohnraum*), where landlords would be fined if they demolished or leave dwellings derelict.

6.5 Public laws on assigning houses to people in need gives local authorities power to make landlords tolerate tenants who would be homeless. However, this is considered a last resort, as public accommodation does exist for such people.

7. Tenancy Law and the Role of Associations

7.1 They play a multi-faceted role, including:

7.1.1 Assistance in the drafting of rental tables

7.1.2 Providing statistics on local rent levels

7.1.3 Providing legal advice to their members

7.1.4 Issue standards controls

7.2 However, their role in dispute settlement is very limited. Although there is a very low number of disputes between landlords and tenants in Germany, and the parties will continue a contractual relationship following the despite, it is estimated that 300,000 cases in tenancy reach the courts per year. Therefore, tenancy cases are not solved through dispute settlement, but rather through the courts.

7.3 In some cities landlord and tenants associations have created Mediation Centres (*Schlichtungsstellen*). They considerably vary, with some being recognised officially, some able to execute authority under §794(I)(no.1) German Civil Procedure Code (*Zivilprozessordnung* = ZPO), and some have introduced mediation concepts for disputes in tenancy law.

7.4 §15a Implementation Law of the Civil Procedure Code (EGZPO) allows the Länder to make conciliation mandatory before a case can be brought to an ordinary court, where the sum is smaller than €750 and cases concerning personality rights or disputes between neighbours.

7.5 Every court at first instance can work towards an out-of-court settlement under §278(I) ZPO and shall at the beginning of the hearing hold a conciliation hearing under §278(II) ZPO.

8. Tenancy Law and the Courts

8.1 In the first instance the *Amtsgericht* has jurisdiction over tenancy law disputes according to §23 (No.2a) German Judicature Act (GVG). Legal representation is not mandatory before these courts. The parties must submit all relevant facts of the case (*Beibringungsgrundsatz*) but do not need to argue on their legal assessment (*iura novit curia*).

8.2 An appeal before the Second Court of Instance, the *Landgericht*, is possible when matters exceed €600 or when the *Amtsgericht* admits an appeal based on the fundamental importance of the matter according to §511 ZPO.

8.3 Appeals on questions of law can be brought to the Federal Court of Justice if either the *Landgericht* or Federal Court of Justice believes the case regards a fundamental importance to the matter or in order to secure uniform jurisprudence.

8.4 The cost of litigation – including the winning party's legal and court fees – are born by the losing party under §91(I) ZPO

8.5 Legal aid (*Prozesskostenhilfe*) can be provided to those of economic disadvantage should they have a sufficient chance of succeeding, according to §§114 ff ZPO.

8.6 Many tenants have insurance which covers the cost of litigation, and undoubtedly encourages litigation as the costs of losing are reduced.

TENANCY LAWS

9. Conclusion of a Tenancy Agreement

9.1 There must be two reciprocal declarations of intent (*Willenserklärungen*), namely offer and acceptance. Although it is not necessary to be in writing to be valid, §550(1) BGB states that contracts over one year must be in writing.

9.2 There is no public register for lease contracts in Germany. However, a property right of residence according to §1093 BGB has to be registered in the land registry (*Grundbuch*).

9.3 German contract law shows that newspaper advertisements, shop window displays or prospectuses as invitations to treat are not considered as binding offers.

9.4 The principle of private autonomy provides the notion of the freedom to contract, including the freedom to enter a contract (*Abschlußfreiheit*) and the freedom to determine its conditions (*Gestaltungsfreiheit*).

9.5 Exceptions to this freedom have been developed, especially through fundamental rights as set out in the constitution, which have effect throughout the legal system.

9.6 Other exceptions have been legislated for, such as §33 Act Against Unfair Competition (GWB) which prohibits discriminatory practices.

9.7 Public law exceptions include the requirements of the landlord to contract with people of low income in social housing, where for instance they have received building subsidies or planning permission conditional to this agreement.

9.8 Case law has developed other restrictions in showing that the freedom to contract is not absolute, where for example *LG Karlsruhe*[1] shows that housing associations with outstanding status are restricted.

9.9 There is debate as to whether there is a duty to contract, say where a landlord enjoys a monopoly or rejects a tenant without a good reason. The majority of academic opinion and case law infers such a duty from the law of torts in §§826 BGB. The court in *Neuner*[2] argues that it is advisable to codify such a duty.

9.10 Ethnic or religious discrimination is prohibited in private law and would give the right to damages. However, it is unclear whether the remedy would extend to the conclusion of the contract. Furthermore, Directive 2000/43/EC states that the landlord cannot be discriminatory in the conclusion of a contract.

9.11 The Principles of European Contract Law (PECL) are compatible with German law, including the offer and acceptance model in A2:201(2) and the right of freedom of contract in A1:102.

9.12 Furthermore, the PECL states the Principle of Good Faith and Fair Dealing in A1:103, which would impose duties upon the parties in their pre-contract dealings. In particular A4:109 states one party should not take unfair advantage of the other party's dependence, economic distress or other weakness.

9.13 §119, 123 BGB: A landlord may rescind the contract in the event of **error or fraud** if they would not have made the contract under full knowledge of the facts and with reasonable appreciation of the situation. §119(I) BGB extends the right to areas of the business regarded as essential. §123(I) BGB states a person who had been induced into the contract under fraud or unlawful threats may rescind.

9.14 Special remedies are found in §§536 BGB defects in the thing, 536a BGB duty to compensate, and 543 BGB immediate notice. Fraud for instance gives the rescission the same effect as termination of the lease through immediate notice.

9.15 Fraud must be proven to be done "wrongfully" – which has been developed in case law.

9.16 The landlord is permitted to ask legitimate questions compared to questions on personality which do not produce information which

[1] Neuer NJW-RR 2002
[2] Neuner, Diskriminierungsschutz durch Privatrecht, JZ 2002, at 57 and 61.

is objectively necessary for the decision in favour or against the tenant. For example, income would be permitted, while sexual orientation not permitted. Only where the landlord wants to rent to an acceptable certain group of people, such as non-smokers or pet haters, can he ask specific questions relating to these attributes. Directive 2000/43/EC and the constitutional fundamental rights have ensured this non-discrimination effect.

9.17 A4:107 PECL states that a party may rescind a contract when the other person has been induced to conclude it by the other party's fraudulent misrepresentation, defined as if one party knew that the information was incorrect and it intended to deceive the other party.

9.18 It can be argued that the A1:201 PECL principles of good faith and fair dealing would require the landlord to ask appropriate questions and for the tenant to answer honestly. Alternatively, national law should set out the mandatory law to limit the right of rescission, essentially though public law.

9.19 It is common for landlords to use an estate agent to deal with concluding contracts with tenants. The future tenant has to pay estate agent's commission up to a maximum of two monthly payments of rent after conclusion of the contract according to §3(II) of the WoVermittG. Payments can also be made to buy certain objects in the property of the current tenant.

10. Sharing with a Third Person

10.1 §540(I) BGB: the tenant is not entitled, without the permission of the landlord, to transfer the use of the leased premises to a third party, particularly to sublet.

10.2 §543 BGB: the tenant can demand of the landlord to approve a sublease for a part of the premises to a third person provided that the tenant has a legitimate interest in the sublease.

10.3 §543 BGB: if a third person moves in without the landlord's consent, then the landlord can send a special warning (*Abmahnung*) and then give immediate notice.

10.4 Close family members of the tenant, such as a spouse, registered same-sex partner, parents or children, are not regarded as third persons. Their position in the apartment is regarded as an appropriate use of the premises, thus permission is not necessary. Nonetheless, there must be sufficient space for their accommodation.

10.5 It is unclear whether cohabitees are considered as family members, with the lower courts more accepting[3] and the higher courts rejecting this view.[4]

10.6 Thus the landlord has to be asked permission. However, the Federal Court has held that the wish of the tenant to bring his (same sex) partner into the apartment is considered a legitimate interest according to §553(I) BGB.[5] Thus the landlord cannot refuse permission if the tenant wants to bring their (homosexual) partner into the apartment.

11. Succession of Contracts

11.1 §1922 BGB: The Principle of Succession, stating that after the landlord's demise, his heir becomes party to the tenancy contract *ipso iure*. The same holds true in the case of the tenant's death.

11.2 §566 BGB: Rule of "*emptio non tollit locatum*" states a buyer enters a lease contract and has the same rights and obligations as the landlord as the seller used to have.

11.3 §563(I) BGB: The spouse who maintained a joint household with the tenant become party to the contract *ipso iure*. It is essential that the couple maintained a joint household at the time of demise. The surviving registered same sex partner has an analogous right.

11.4 §57a Act on Compulsory Auction (*Zwangsversteigerungsgesetz* = ZVG): In the case of bankruptcy and an auction the new owner has a privileged right to anticipatory notice within the statutory termination time limit.

12. Student Homes

12.1 §553(I) BGB: the tenant who liable for the full rent can demand the permission to sublet rooms from the landlord if he has a legitimate interest in the sublease. The landlord can only reject should there be insufficient space or a serious reason relating to the prospective tenant.

12.2 §540(II) BGB: the tenant in the contract needs to maintain the full rent to the landlord and is responsible for all the damages to the apartment caused by the sub-tenant.

12.3 It is assumed that students have a sufficient economic interest to sublet a spare room given their economic situation.

12.4 There is also an implied contractual agreement from the landlord to the tenant to be able to replace subtenants with another student

[3] LG Hamburg, WuM 1980, at 255; LG Achen WuM 1989, at 372.
[4] BGH, NJW 1985, at 130; OLG Hamm, NJW 1982, at 2876; OLG Hamm, NJW 1992, at 513.
[5] BGH, NJW 1985, at 130-131.

of their choice as the landlord has consented to the rental of a flat sharing community.

13. Subletting

13.1 The landlord has the right to increase the rent in a reasonable manner and can make his permission for the subletting contingent upon the tenant's acceptance of such increase. The increase can only be charged for the intensified use of the premises caused by the sublet.

13.2 §543(II): If the room is sublet without permission, the landlord can send a warning demanding the eviction of the subtenant

13.3 §543(II): if the tenant does not evict the subtenant, then the landlord can give immediate notice

13.4 A termination of the contract is not possible when the sublet has to be accepted on the grounds of §553(II) BGB – a sufficient legitimate interest in the sublease.

13.5 The landlord cannot claim the rent which the tenant charged the subtenant for the sublet.[6]

13.6 The landlord cannot claim for a §280 I BGB breach of duty as there has been no damage to the apartment. The Federal Court also rules that no claim on the grounds of unjustified enrichment can be claimed either.[7] Some argue that there should be a claim against the tenant due to the subletting being a disposition by a person without title, as laid down in §816(I)(1) BGB. However, it is held that a sublease without permission does not constitute a disposition, since the property right of the landlord is neither abolished nor restricted in another way.

14. Duration and Termination of the Contract

14.1 A lease contract can be made for either:

14.1.1 Limited period of time
14.1.2 Unlimited period of time

14.2 German law distinguished between:

14.2.1 Ordinary Notices (*Ordentliche Kündigung*) – where the lease has been entered into for an unlimited period, the termination does not have to be based on a specific reason, and there are certain time periods.
14.2.2 Immediate Notices (*Außerordentliche Kündigung*) – must be based on a specific reason, normally the breach of an important contractual duty.

[6] BGH, NJW 1964, at 1853; BGH, WuM 1969, at 298 and 300; BGHZ 131m at 297.
[7] Ibid

14.2.3 Specific Notice (*Sonderkündigungsrecht*) – given in special cases prescribed by law and subject to a period of notice.

14.3 Both parties can terminate the contract with "***immediate notice** based on an important reason" (außerordentliche Kündigung aus wichtigem Grund*). The severe consequences must have such manifest and grave breaches which will "shatter" the relationship between the landlord and tenant in the sense that it is no longer just and reasonable for one side to continue. Reasons could include:

14.3.1 §569 (II) BGB: Severe disturbance of the sanctity of the home (*Störung des Hausfriedens*). The Courts have accepted that unprovoked severe and repeated insults[8] or criminal acts or threats of criminal acts against the other party can amount to manifest breaches of a contractual relationship.[9]

14.3.2 §543(II)(No.2, 3) BGB: After a special warning or the setting of a time period, he can give notice if the tenant sublets the premises or negligently places the rented premises at risk.

14.3.3 §543(III)(No.3) BGB: Certain cases where the tenant pays his rent too late.

14.4 Both parties can give ***ordinary notice***, however the rules differ between the landlord and tenant:

14.4.1 The landlord can only give notice if he has a *legitimate interest*. The general notice period according to §5732 BGB is 3 months, but gradually increases up to nine months according to how long you have been in the apartment. According to §573(II) BGB this exists if:

14.4.1.1 The tenant is in manifest breach of a contractual duty

14.4.1.2 The landlord needs the premises for himself or his family. This includes family members under the definition set out in §11 LPartG unless certain provisions provide differently. For example the courts are reluctant to accept a termination for a brother-in-law.[10]

14.4.1.3 The lease contract prevents the landlord from making an economically justifiable use of the premises. A simple renovation or modernisation of one apartment that does not require the tenant to leave is insufficient, according to §559 BGB.

14.4.2 The tenant does not need justification for giving notice, and can give notice within the general notice period of three months according to §573c(I) BGB

[8] LG Köln, WuM 1993, at 349.
[9] LG Mannheim, ZMR 1977, at 80.
[10] AG Oldenburg, NJW-RR 1993, at 526.

14.5 There are several exemptions from ordinary notice:

14.5.1 §574 BGB: The tenant can object should the termination give rise to hardship for the tenant or his family that would be unjustified.

14.5.2 §549(II) No.1 BGB: does not apply for houses leased for temporary use.

14.5.3 §549(II) No.2 BGB: does not apply for houses which are part of the landlord's own home and which have been entirely or mainly equipped with furniture by the landlord.

14.5.4 Rented by public entities or private organisations which promote social welfare.

14.5.5 §573a BGB: where the landlord lives in the property.

14.5.6 §573b BGB: in relation to certain parts of the property which is not designed for living purposes.

14.6 Clauses which reduce the tenant protection are invalid, while clauses extending the tenant protection are valid.

14.7 ***Special termination rights*** exist for all actors. For example a tenant has a special termination right in case of rent increases under §561 BGB. Another example is the landlord terminating a contract when a tenant dies and none of his family members enters into the contract under §564 BGB.

14.8 §704 ff ZPO: Rule of enforcement of judgements. When a judgement aimed at the eviction of a tenant has acquired the effect of *res iudicata*, the landlord can enforce it through a bailiff according to §§883, 885 ff ZPO. §788 ZPO states the tenant has to bear the costs of the enforcement, and thus the landlord is not able to recover the legal and court fees.

14.9 §721 ZPO states that to avoid hardship in eviction cases the court may set a time period in which enforcement can be perused, from 2 weeks to a year. Exemptions include short term contracts (§575 BGB) or contracts without notice protection (§721(VII) ZPO).

14.10 §765 ZPO: The competent court may suspend enforcement of termination if there is a life threatening illness. This does not include usual stress or depression, or becoming homeless.

14.11 A1:109 PECL: contracts of indefinite period must have notices on a reasonable length.

14.12 German law only allows for qualified **fixed term** lease contracts (*qualifizierte Zeitmietverträge*) in order to avoid "chain contracts". §575 BGB states that fixed term contracts can only be concluded if the landlord has a reason for such a limitation:

14.12.1 If the landlord wants to use the premise for himself, his family or people living in his household.

14.12.2 The landlord wants to demolish or alter the premises considerably.

14.12.3 The landlord wants to rent it to an employee.

14.13 §575(I)(2) BGB: If these conditions are not met then the contract is deemed extended for an unlimited time.

14.14 §575(I)(1) BGB: The landlord must inform the tenant in writing with the reasons why he wants to limit the contract.

14.15 §575(I)(2) BGB: If the reasons stops, then the tenant can demand a contract unlimited in time.

14.16 §575a BGB: A fixed term contract terminates through lapse of time unless immediate notice is given or the contract is renewed. The tenant cannot extend the contract on ground of hardship

14.17 It is questionable whether the landlord can conclude a contract limited to one year with a renewal clause without adequate reasoning for a limited period.

14.18 §544(2) BGB: When a lease contract has been concluded "**for life**", the right to give ordinary notice is excluded, while both parties retain the right to give immediate notice.

14.19 Where the parties have agreed a **right of residence** under §1093 BGB which is registered in the Land Registry, the property right is independent from the obligatory transaction underlying the right of residence and thus cannot be terminated.

15. Rent

15.1 It is necessary to distinguish the segments of costs involved in a rental contract:

15.1.1 Net-rent (*Nettomiete*) – use of the premises.

15.1.2 Accessory Charges (*Nebenkosten)* – such as charges for insurance, sewage water, caretaker and the consumption for water, gas and electricity.

15.2 §535(I)(3) BGB: The landlord shall bear all charges imposed upon the object of the lease. In practice virtually all contracts contain a clause that the tenant shall bear all but a small proportion of the utility bills.

15.3 §556b(I) BGB: Rent is payable at the beginning and at latest on the third working day of each payment period (*Zeitabschnitt*) as agreed in the contract. Saturdays are regarded as a working day and residential rents are usually paid on a monthly basis.

15.4 §270(I) BGB: The tenant must remit the money to the landlord's bank account at his own risk and expense. The tenant does not bear the risk of delay caused by the bank.

15.5 §562(I) BGB: The landlord, by way of security for his claims arising from the lease, has a right of pledge over the things brought upon the premises by the tenant:

15.5.1 Not extending to things that are not subject to attachment, such as things required for his work.

15.5.2 §562a BGB: The right of pledge is extinguished by the removal of the things from the land, unless the removal takes place with the knowledge of, against the wishes of, the landlord.

15.5.3 To enforce his claims, the landlord has to go to court. Without doing so, he is not entitled to enter the premises and remove items from the tenant.

15.5.4 Pursuant to §562b BGB, the landlord has a very limited right of self-help to prevent the removal of belongings from the premises.

15.6 A7:102 PECL: A party has to effect performance at the time fixed in the contract, or if it is not fixed, within a reasonable time. This is fulfilled by German law.

15.7 Negotiation of the rent is left to the private autonomy of the contracting parties, as shown previously.

15.8 §5 WiStG: Rules of Profiteering:

15.8.1 The landlord commits an administrative offense and can be fined up to €50,000, if in times of a limited offer of housing accommodation he intentionally or with gross negligence demands a rent in excess of 20% of the rent charged for comparable premises.

15.8.2 It has been held that a rent which is set at 50% or more of the rent charged for a comparable premise is assumed to be intentional, and thus is classified as profiteering.

15.8.3 §134 BGB read with §5 WiStG: The contract is partially void, and the tenant can claim the overpayment of rent on grounds of unjustified enrichment.

15.8.4 Particularly important when it comes to periodic rent increases.

15.8.5 For restitution it is necessary to distinguish between if at the conclusion of the contract:

15.8.5.1 The rent was 20% above the average rent level (or reached this level through the progressive increase at a

later point) and later the housing shortage ceased to exist, the tenant can claim his rent overpayment for the whole period.

15.8.5.2 There is sufficient housing to let at the time of conclusion of the contract and the shortage emerges only later, and the rent is over the 20% average level – then can claim restitution only for the periods when the increases fulfilled the prerequisites.

16. Rent Increases

16.1 Whilst the new leases are free of regulation, German law prescribes a complex set of mandatory rules to control rent increases.

16.2 German law distinguishes rent increases between:

16.2.1 Negotiated Increase

16.2.2 Increase by law

16.3 §557(I) BGB: Parties can negotiate a consensual rent increase, where the landlord proposed an increase and the tenant agrees to it.

16.3.1 For such an amendment-contract to exist, the usual contract law requirements of two reciprocal, corresponding declarations of will (*Willenserklärungen*), namely offer and acceptance by the contracting parties is required.

16.3.2 The offeree must not only mentally accept the offer, but must also communicate this to the offeror.

16.3.3 An offer can also implicitly be accepted by acting in a way that an objective addressee can understand this as an acceptance.

16.3.4 §559 BGB: A unilateral demand for an increase in rent based upon modernisation works can be interpreted as an offer.

16.3.5 For an acceptance of an offer there must be an inner will to accept the offer and this intention needs to be communicated.

16.3.6 If the landlord demands the increase unilaterally according to §§559, 560 BGB, payments of the increased rent cannot be seen as acceptance since the tenant had no intention to alter the contract.

16.3.7 The majority of the courts consider regular payments with no reservations as a form of acceptance[11], except where there is no inner will to accept, such as when rent is paid with misgivings.

[11] LG Aachen, WuM 1988, at 280, LG Berlin, WuM 1985 at 311.

16.3.8 Some courts consider payments of rent once or twice as acceptance[12], while others demand a longer period[13].

16.3.9 §§387, 271(I) BGB: If one party did not conclude an 'amendment-contract' and the tenant may claim restitution, a set-off against future rent is possible. The debtor may perform his obligations earlier unless that would be to the detriment of the creditor, according to §277 (II) BGB. The tenant must inform the landlord of his intention to off-set his claim against the rent at least one month before the rent is due.

16.3.10 A2:201(1) PECL: Defines an offer as a proposal to make a contract, and that simple demand would not be an offer.

16.3.11 A5:101(1)-(3) PECL: A contract should be interpreted according to:

16.3.11.1 Common intention of the parties, or

16.3.11.2 The intention of one party if this party did not express its intention accurately and the other side knew the real intention, or

16.3.11.3 An objective method, meaning that the judge shall refer to the meaning that reasonable persons, placed under the same circumstances as the parties, would have given to the contract.

16.3.12 A2:204(1) PECL: The court must look at the circumstances in each case.

16.4 A contract can provide for rent increase clauses through:

16.4.1 §557a BGB: Graduated Rent Increase (*Staffelmiete*): This clause has to indicate the amount annual rent for each year or the amount of rent increase per year. It helps the tenant by showing them exactly the costs of the rent in the future. The landlord cannot further increase the rent according to the average local rents or due to construction measures according to §557a (II)(2) BGB. The indication of a percentage does not fulfil the requirement since the amount of increase is not sufficiently transparent.

16.4.2 §557b BGB: Cost-of-Living Index (*Indexmiete*): Connecting the rent to an official cost-of-living index issued by the Federal Statistics Office. The landlord must inform the tenant of the increase due to a rise in the index in a textual form (*Textform*) according to §§557b(III), 126b BGB. In both cases rent needs to

[12] LG Berlin, WuM 1989, at 308 (two months of rent at once); LG Duisburg WuM 1989, at 192 (tenant paid for many years); AG Leipzig, NZM 2002, at 20 (two months).
[13] AG Bad Hersfeld, WuM 1996, at 708 (five payments); LG Düsseldorf, DWW 1999, at 377 (some months).

remain unchanged for at least a year before the next periodic rent increase.

16.5 §558 BGB: Under certain conditions the landlord can require the tenant to accept a rent increase up to the rent level customary in a certain area (*ortsübliche Vergleichsmiete*)

16.5.1 Provided that the last rent increase took place at least 15 months prior to the date when the demanded increase was to take effect.

16.5.2 §558(III) BGB: The rent increase has a ceiling of 20% in three years.

16.5.3 The average rent customary in a level is not a fixed amount, but is a price range.

16.5.4 It is evaluated by comparing the rents paid over the last four years with the rents paid for other premises similar in size, location and setting.

16.5.5 §§558a, 126b BGB: The demand for an increase has to be in textual form, including the reasons for the rent increase.

16.5.6 §558a (II) BGB: The landlord can rely on:

16.5.6.1 Rental Tables (*Mietenspiegel*)

16.5.6.2 Expert Advisory Opinion

16.5.6.3 Three "sample" rents charged for comparable premises in the same area.

16.5.7 Since the reform of 2001 the municipality can implement either:

16.5.7.1 §558d BGB: Qualified Rent Table (*qualifizierter Mietspiegel*), or,

16.5.7.2 §558e BGB: Simple Rent Table (*einfacher Mietspiegel*).

16.5.8 The rental table is a statistical measure of the rents for premises which differentiates between certain categories and locations.

16.5.9 It is issued by local authorities and approved by the landlord and tenant associations.

16.5.10 A qualified *Mietspiegel* needs to be determined according to scientific standards and updated every two years according to §558d(II) BGB.

16.5.11 §558d(III) BGB: There is a presumption that the rents listed in a qualified *Mietspiegel* constitute the rent level customary in a certain area. This means that the burden of proof to chal-

lenge a rent price based on the qualified *Mietspiegel* is on the tenant, should the demanded rent be within the range of stipulated prices.

16.5.12 The original official Qualified *Mietspiegel* is organised by a private incorporated society (*eingetragener Verein*) formed by different associations and local authorities.

16.5.13 The increase procedure is as follows:

16.5.13.1 The landlord submits a request demanding the increase of rent on grounds of average rent level customary in the area.

16.5.13.2 The tenant has two months to consider the demand.

16.5.13.3 If he agrees to the increased rent, he will pay the rent from the beginning of the third month (§558b(I) BGB).

16.5.13.4 If he does not agree then the landlord can sue the tenant for acceptance after the two months period has passed (§558b(II) BGB). As set out in the next section, the court dispute procedure will then initiate.

16.6 §559 BGB: The landlord can increase the rent per year by a maximum of 11% of the construction costs he invested in modernising the housing accommodation.

16.7 §560 BGB: Where the parties have agreed a utility flat rate (*Betriebskostenpauschale*), the landlord can increase the rent up to the amount that the costs for the utilities have increased.

17. Deposits

17.1 A deposit is not prescribed in German law, although it is common practice.

17.2 §551(III) BGB: The deposit must not exceed three monthly rent payments.

17.3 It serves only as a protection of the landlord's claims against the tenant.

17.4 §551(III) BGB: It must be paid directly into a savings bank account.

17.5 After termination of the contract the landlord has to return the deposit, including interest, unless he has a claim against the tenant. The landlord does not have to return the deposit immediately after the termination of the contract. He can wait up to see whether additional claims may arise. The court will grant up to six months.

18. **Utilities**

18.1 §556 BGB: Parties may agree that the tenant has to bear the costs of utilities as defined in §27(1) II.BV.

18.2 The parties may agree that the tenant shall pay an appropriate lump sum each month to cover the costs of utilities. The landlord must render an account each year of the utilities.

18.3 §535(I)(3) BGB: The landlord shall bear all charges related to the leased thing.

18.4 In order to pass on the charges to the tenants there must be a contractual stipulation, which has become the norm.

18.5 Most contracts make reference to Annex 3 of II. BV, which is a list of all relevant charges and exact enumeration of costs.

18.6 Variance in allocation formulas:

18.6.1 Devices to register the exact consumption of gas and electricity in modern premises.

18.6.2 §§5, 6 HeizkostenVO: Most landlords obliged by law to install read out devices.

18.7 Costs which cannot be recorded by consumption (water supply, garbage):

18.7.1 Size of the apartment in sqm

18.7.2 Per capita

18.7.3 Per accommodation unit (*Wohneinheit*)

18.7.4 §556a(1) BGB: Costs shall be distributed according to the size of the living area, unless the law provides otherwise

18.7.5 §556a(II) BGB: The landlord may however always opt for cost distribution according to consumption

DISPUTE SETTLEMENT

The main course of dispute settlement is through the courts, with an estimated 300,000 cases per year. The legal cost of going to the lowest court is roughly €2000. Membership of a Tenants Association ensures that tenants have legal insurance from them in the event of going to court. On the one hand, there is an incentive for the tenant to try to challenge a rent increase when it is free to do so. On the other hand, it is argued that this protection of the tenant is necessary in order to avoid a market where landlords have greater financial power over the tenant and thus can dictate rent price increases. Legal insurance for landlords is significantly more expensive, and thus less popular.

The tenant and landlord associations play an extensive role in providing information, legal advice, standard contracts, the formation of the *Mietspiegel* and political lobbying, but they have a very limited role in dispute resolution. Wrumnest states that despite that "tenancy law is generally judged to be a suitable field for alternative dispute settlement… few arbitration boards are found."[14] Unlike the Rent Commission in the Netherlands, there is no authoritative institution which rules on tenancy disputes. There have been attempts in some cities by landlord and tenants organisations to set up mediation centres (*Schlichtungsstellen*), some of which have been approved by the Minister of Justice and thus carrying legal power through the German Civil Procedure Code (*Zivilprozessordnung*). There are also practitioners whom offer mediation services, although these are lawyers and thus fairly costly. The federal states have the right to introduce mandatory dispute mediation based on the implementation law of the Civil Procedure Code (EGZPO) for financial matters that amount to less than €750. Furthermore, many cases are settled out of court during the legal process.

The court will not assess the legitimacy of the *Mietspiegel*, but rather will assess whether the rent for the dwelling conforms to the *Mietspiegel*. In order to do this, the court will send out an expert to give an advisory about the dwelling.

Point 8 in the above section shows the legal basis for which the cases go before each stage of the court system. The higher courts are only utilised for cases of large financial sums or where there is a question of law needing to be addressed for the comprehension of jurisprudence. The legal costs are borne by the losing party and financial support is available for those who cannot afford the legal fees.

Landlords have complained about the length of time the legal proceedings takes, where the time between non-payment of rent and the eviction claims being enforced takes at least a year. While an eviction claim can be given after 2 months of non-payment of rent, the practical effect of a dispute could leave the landlord not being able to receive rental income for a year due to the legal system being unable to evict the tenant for such a long time. Should the tenant not put up a defence, then an immediate removal can be made. The problem with the lost income is that the landlords rarely are able to claim for damages, as tenants who are being evicted usually are poor and unable to pay. Reforms are due to be implemented in order to decrease this practical time of eviction.

Kühne-Büning et al stress that there is no institution which controls market rents. The *Mietspiegel*, other rent regulations and tenancy law is part of the civil code where it is up to the individual to utilise these tools in order to ensure there is no illegality.[15] Where there are no public institutions to control the rules, the importance of a clear, definitive and understandable Mietpsiegel is required, which leads us to the next chapter.

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[14] Wolfgang Wurmnest (2010) "Germany" in Christopher Schmid (ed.) *Tenancy Law*, found at http://www.eui.eu/Documents/DepartmentsCentres/Law/ResearchTeaching/ResearchThemes/EuropeanPrivateLaw/TenancyLawProject/TenancyLawGermany.pdf (accessed 28/6/2013).
[15] Lidwina Kühne-Büning, Volker Nordalm and Lieselotte Steveling (2005) *Grundlagen der Wohnungs- und Immobilienwirtschaft* [Fundamentals of Housing and Real Estate Economics] (4th edition). Frankfurt/M: Fritz Knapp Verlag.

CONCLUSION

This chapter sets out the legal framework for the PRS in Germany. It is in such extensive detail so that we can analyse the exact micro-economic effect the law has on tenure choice in Germany, which in turn influences both the demand and supply side. The main aspects of German tenancy law highlighted in this chapter are the regulation of rent price increases and the security of tenancy. The 2001 Tenancy Reform Act has further reinforced the prescriptive nature of German tenancy law, where each section details the specific roles in which the landlord and the tenant must accord to. While the next chapter analyses the *Mietspiegel* in detail for rent as a micro-economic determinant, the grounds for eviction are imperative to the understanding of the level of security and mentality of the dwelling being a home, which further impacts the life-cycle of German households.

CHAPTER 3: THE *MIETSPIEGEL*

INTRODUCTION

The *Mietspiegel* is regarded in the German rental sector as an important rent regulation which restricts the increase of rents from rapidly increasing. The translation of *Mietspiegel* is "Rent Mirror", which aptly describes its functioning, whereby rent must mirror that of other similar dwellings in the same area. The *Mietspiegel* is published by the local government periodically, and reflects the local comparable rent for each district within the city/town. Point 16 in Chapter 2 shows the laws of rent regulation, how the *Mietspiegel* is only part of the rent increase regulation, and introduces the qualified and simple *Mietspiegel* in §558d. This chapter expands on this introduction by giving a more evaluative analysis of their operation, including examples and statistics. Finally, it is argued that the *Mietspiegel* has less of a role in restricting rent increase, but rather reflects the free-market rental prices. It should thus be seen more as a guide as to what rents a landlord can charge, and therefore a guide for the dividend investors will gain from the market.

HISTORY OF PRIVATE RENT REGULATION

The history of rent regulation must be read in conjunction with the history of housing demand and supply in Germany, which had two destructive wars and a split between the East and West for roughly 40 years. Furthermore, rent regulation changed with the overriding political philosophy of the time.

At the turn of 1900 the German economic and political philosophy reflected that of most the Western World: economic liberalism. This is still recognised in the German constitution (BGB) with the principle of private autonomy, including the freedom to enter a contract and freedom to determine its conditions. These principles are still respected today, where the initial contract for an apartment is not subject to rent regulation, which has contributed to increasing customary local reference rents in areas with a high turnover of tenants. Rent regulation encouraged landlords to issue tenancies without any protection of tenants. The liberal economic theory also meant that the government did not provide social housing or provide any subject or object subsidies to encourage growth in the market.

In the aftermath of World War One (WWI) there was a severe housing shortage. This caused the authorities to shape rent regulation for the maximum allocation of dwellings for the demand. In doing so the government had the power to register and distribute dwellings, ensuring tenancy protection and controlling rent. Without any consideration to private investment in the market, there was no development of housing supply. The reactionary nature of this policy following the war to eliminate the housing shortage was subsequently continued by The Third Reich, which installed a nationalist socialist philosophy by prohibiting rent increases from 1936. Other policies for housing included reducing over-populated urban areas and transferring municipal responsibility of housing to the federal level.

Source: SLUB Dresden / Deutsche Fotothek / Richard Peter

Following the Second World War, again there was a severe housing shortage due to the effects of Allied bombing, as shown in this picture above of Dresden. It has been estimated that 25% of the total housing stock was destroyed and only 40% remained undamaged.[16] The German government provided indirect subsidies into the housing market through loans without interest or with low interest contributions, which stimulated the market. In response the tenant was given protection through regulation, such as continuous tenancy, dividend limit and cost determined rent, or was supplied with social housing.

While the East German housing policy remained under the direction of the DDR control economy, the housing market in the West was beginning to mature by the 1960s, which marked a gradual liberalisation of housing policy. Nonetheless, liberalisation of the private rented sector could not be enacted immediately, as the insufficient market would be subject to cartel landlord behaviour and there was still a need to provide social housing for those in need. Thus subsidies to the market continued in order to ensure profitable returns for private investors, while rent control continued. The move away from a control economy following the war to a mature market economy was taking place in other aspects of the German economy, such as public ownership of core industries. This was the case with most other Western countries.

Deregulating principles were enacted to the rent control regime in the 1960s, with the exception of Hamburg, Munich and West Berlin. In response to increasing rent, three principals were enacted in the Housing Employment Protection Act 1971:

- Rental increases must reflect comparable market prices

[16] Jeffry Diefendorf (1993) In the Wake of War: The Reconstruction of German Cities after World War II. Oxford: Oxford University Press, at 126.

- Unilateral security of the tenancy
- Free negotiation of rent in new leases

The 1971 Reform implemented in practice a rent index, although only through the principle of rents being comparable to the market prices. In 1974 the Rent Control Act (*Miethöhegesetz*) was enacted, elaborating on the mechanisms through which rent should be set to the comparable local rent. It was found that the courts were overwhelmed with the task of determining the comparative rent for many cases. Therefore, the Increase Supply of Rental Housing Act 1982 introduced the *Mietspiegel* ("Rent Mirror") to achieve the comparable market rent principal through objective, empirical and representative social science methods. It stated the principle of graduated rent and a cap limit, which were clarified and tightened in the Fourth Tenancy Amendment Act 1993.

The 1970s reforms were in large part due to the response of the German Tenants Association to the increasing rent and the power of the landlords. Tenancy law and rent regulations were thus necessary policies in order to achieve the efficient functioning of the private sector. This is the essence of the German social market economy, which aims to regulate the market where it increases its efficiency, while the government protects the individuals from injustices.[17]

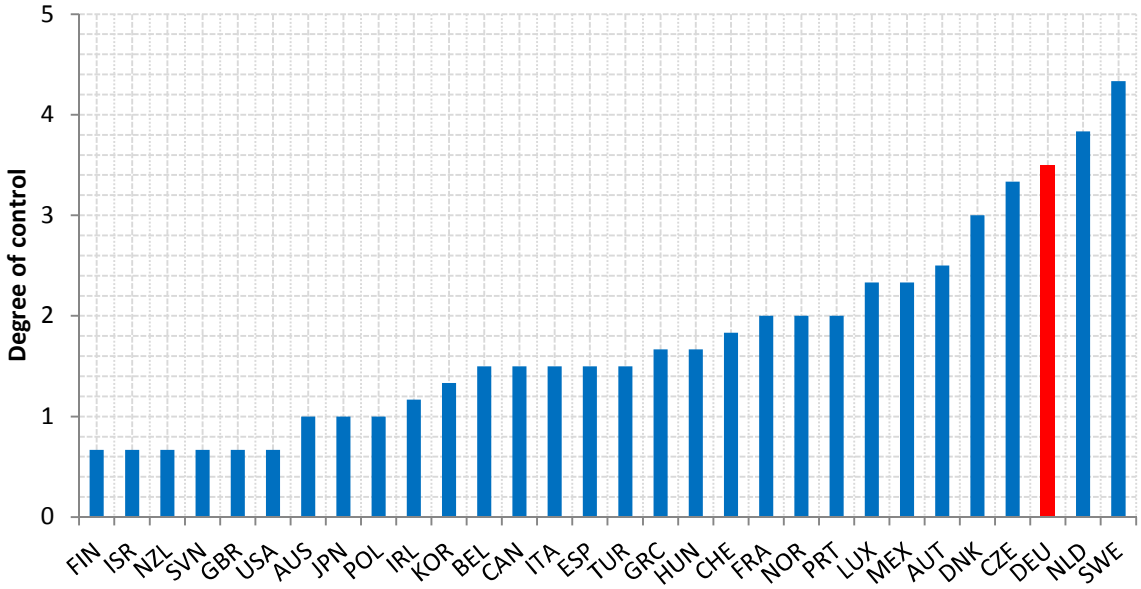
The Tenancy Reform Act 2001 aimed to reform, reorganise and simplify the existing tenancy law in Germany. The principle of "comparative rent" was replaced by "customary local reference rent", showing a rent index to have a clear geographical limitation. Point 16.4 in Chapter 2 of this report sets out the legal basis for the *Mietspiegel*, which is derived from the German Civil Code (BGB) §558c:

"*A Mietspiegel is an overview of the comparable rents, customary in one place, as long as the overlook has jointly been compiled from landlords and tenants in the municipal or their representatives*"

On this basis the OECD rates German rent regulations as the third most regulated country in a selection of comparable OECD countries, as shown in Figure 1.[18] A detailed review of the German rent regulations in this chapter questions the economic basis of this finding, where it is argued that the "controlled rent" is actually reflective of the market rent.

[17] See section "Social Market Economy" in Chapter 4.
[18] OECD (2011) Economic Policy Reforms 2011: Going for Growth. Paris: OECD Publishing.

FIGURE 1: COMPARISON OF RENTAL REGULATIONS BETWEEN SELECTED OECD COUNTRIES, 2009



Note: Rent control in the private rental market, 2009. Scale 0-6: Increasing in degree of control.
Source: Economic Policy Reforms 2011, going for growth. OECD.

COMPOSITION OF THE *MIETSPIEGEL*

The *Mietspiegel*, like most rent regulation instruments, is more complex than its core aim. Three complexities include its application to old and new contract, the difference between simple and qualified methods of calculation, and the principle of subsidiarity creating a non-uniform approach across the nation.

HOW DOES THE *MIETSPIEGEL* PRACTICE?

The *Mietspiegel* is an objective and statistical calculation of the customary local reference rent. It uses both the new rental lease prices for the previous four years and the existing contract lease prices, although the existing rental prices are adjusted for an expected increase over time. There is debate as to whether the *Mietspiegel* should incorporate all leases in a much wider survey, rather than just assuming the existing rents will have increased over time. By factoring in quality characteristics and removing outliers, the *Mietspiegel* shows the medium market price, and shows the upper and lower prices in the market. In other words, it gives a band of prices which the majority of the rental agreements fall within.

By statistically analysing the market rent, the *Mietspiegel* is not a method of political control over the rental market. The only decisions the political parties have when in the municipal office is whether to set up a *Mietspiegel* for their area and secondly whether it should be a simple *Mietspiegel* or a qualified *Mietspiegel*, in accordance with the Federal Tenancy Reform Act 2001. It is usually though the manifesto of the municipality party who wins the election that the form of *Mietspiegel* is implemented, thereby giving the local population a democratic choice. Once the

Mietspiegel is set up, the municipal government must ensure the objective functioning of the data collection, dissemination and presentation, whereby it is common for them to employ a private firm to carry out this function. Thus one cannot use administrative law to bring a case against the municipality for the creation of a *Mietspiegel*.

Translated into practice, the landlord is able to increase the rent if the new rent is within the band of rents applicable in the *Mietspiegel*. There are other rules, such as a limit of increasing the rent more than 20% in three years, which will be expanded further on. Obviously there will be a differentiation in the average market price according to the characteristics of each apartment, such as the floor space or neighbourhood, but as will be described, some of these are factored into the table.

The *Mietspiegel* essentially offers two practical roles:

I. **Tenants** are able to refer to the *Mietspiegel* easily to see whether their rent price is in accordance with the customary local reference rent. Should this not be the case then the landlord will have to use the other methods of rent increase, under a much higher burden of proof, to justify the prices. Alternatively, the ease of reference to the *Mietspiegel* reduces the likelihood that the landlord would attempt to increase rent above the locally comparative rent. **For the tenant, the *Mietspiegel* primarily ensures that the landlords remain easily accountable for rent increases, with any speculative increases unlikely.**

II. **Landlords** are able to increase the rent in accordance with the market they have invested in by easily referring to the *Mietspiegel*. This knowledge that the *Mietspiegel* reflects the customary local reference rent ensures the investor that they will always be getting the natural dividend for the general supply and demand of the market. Should the tenant choose to dispute a rental price which is appropriate according to the *Mietspiegel*, they will have the legal burden of proof to show it is incorrect. **For the landlord, the *Mietspiegel* primarily ensures that they are uninhibited with ensuring an appropriate market income level is set without obstruction of the tenants.**

Besides these two practical roles, the core economic impact of the *Mietspiegel* is the stabiliser effect it has on the cyclicality of the rental prices which could occur due to the housing market. This will be reviewed at the end of this chapter. Nonetheless, it is argued that the practical confidence of the *Mietspiegel* for both the tenant and landlord in acceptance of a non-speculative but financially appropriate dividend is the most important characteristic of the mechanism. It fits both within the social market economy of Germany and the other tenancy law provisions such as secure tenancy.

WHAT RENT IS THE *MIETSPIEGEL* APPLICABLE TO?: DIFFERENCE BETWEEN THE "BESTANDSMIETE" AND THE "NEUVERMIETUNGSMIETE"

The *Mietspiegel* is applied differently between the rent increases in existing rental contracts and for the initial rent price setting of new contracts.

Bestandsmiete: is the rent from the *existing rental contracts*. When the landlord wishes to increase the rent, they will refer to the rent price parameters as set out in the *Mietspiegel*. Furthermore, the other rent increase regulations apply here, including the limit of increasing rent no more than 20% over 3 years, the Index Clause or the Step Clause.

Neuvermietungsmiete: is the *new lease rent*, which adheres to the principle of free negotiation of rent in new leases.

There is some confusion in the press regarding this principle and how much the new rent can be over the *Mietspiegel*. Primarily, §5 WiStG states that there is an upper limit on what the landlord can charge for new contracts: it cannot be higher than an additional 20% on top of the maximum of price of a comparable dwelling as set out in the *Mietspiegel*. Nonetheless, this section is conditional upon the landlord exerting undue influence or negligence over the tenant which has resulted in unjust enrichment. Where the market supply and demand increases the price beyond the 20% it is thus the landlord's economic right of profit from the property to charge this amount without it being classified as unjust enrichment. This is why there have been cases of landlords charging 40% over that as set out in the *Mietspiegel* for a comparative dwelling, and why there are calls from tenants associations and political parties to make this 20% increase a fixed upper limit for a new contract.[19]

The Federal Court clarified the applicability of §5 WiStG, stating that for rents over 20% above the *Mietspiegel* comparative rent the landlord must not be asserting "clearly disproportionate power" over the tenant. It is therefore a matter of the courts to determine whether the new rent is illegal. Furthermore, the court ruled that disproportionate power is evident when the rent is 50% above the customary local reference rent. Both a 50% increase limit and a restriction against disproportionate power are clearly rational in accordance with contract law provisions of protecting the weaker party. Other constitutional rights or statutes state that there cannot be any unfair practices in the negotiation of the contract, such as discrimination on the part of the landlord, and error and fraud on the part of the tenant.

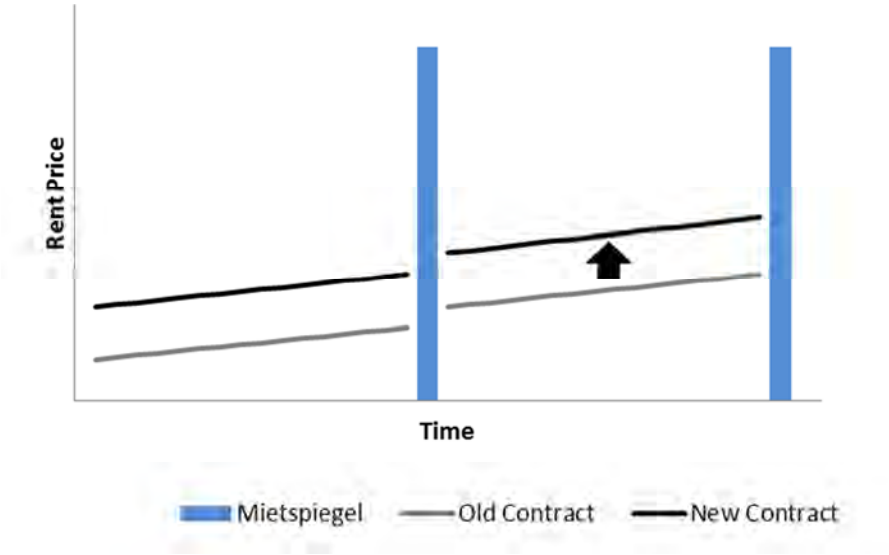
It is extremely unlikely that dwellings would be rented out 50% above the customary local reference rent unless there was abuse of power in the rent setting. In Berlin, regarded as having a high level of growth in rental prices, the increase from the previous rent to the new rent level was only between 7 and 10%. Similarly, with the vast majority of dwellings, a 20% increase on the upper limit would be too high a price for the market. Again, in Berlin the rents rose by 4% in 2009 and 2010, and 3% in 2011 and 2012. Alternatively, where the market is hot, the landlord can justify an increase above 20% in accordance by justifying it with either the market situation or three comparable dwellings. This shows the rent likely under an unregulated open market.

By allowing the *neuvermietungsmiete* to be set higher than the *bestandsmiete*, the regulation thus allows the market forces to influence the *Mietspiegel*, as the new rental prices will subsequently be factored into the following *Mietspiegel* averages and upper limits, which will in turn allow the natural progression of the complete private rented sector market. Figure 2 demonstrates this effect graphically. There-

[19] http://www.zeit.de/wirtschaft/2012-08/mieterbund-obergrenze-vertrag

fore, in areas with a high turnover of households in rented dwellings, the rents will increase at a higher rate. In Berlin, 8% of tenants are moving apartment per year, thus contributing significantly to the increase of the average rent due to the new contract. Political pressures thus arise in areas of gentrification, as the new middle class, urban elite or students migrate into lower quality and lower rent areas and subsequently increase the rent above the affordability of the people living in that area.[20] Under these circumstances, some have called the *Mietspiegel* a "New Contract *Mietspiegel*".[21] The German Tenants Association has called for a rent ceiling for new contracts at 10% increase on the existing customary local reference rent. With elections in September for the Bundestag, there has been increasing discussion about such a move.

FIGURE 2: INFLUENCE OF NEW RENTAL AGREEMENTS ON THE *MIETSPIEGEL*



Source: Author's Own

A gap between existing and new rental prices will cause market inefficiencies. Primarily, the tenant will have the incentive to remain in their apartment should the *bestandsmiete* be below the open market rate, thus locking in the housing market and increasing the market rents en mass. Secondly, it creates an incentive for the landlord not to maintain a good relationship with their tenants, whereby landlord harassment could encourage tenants to leave the dwelling. Thirdly, it might have an impact on the prices of existing stock, where tenants retain their contract and rent price even when the landlord changes. In other words, with the principle of succession, the locking in of tenancy agreements is extensive.

[20] Matthias Bernt and Andrej Holm. (2005) 'Gentrification of a particular type: the case of Prenzlauer Berg' *Gentrification in a Global Perspective*, 106-125.
[21] Christine Ostrowski (2001) Rede der Abgeordneten Christine Ostrowski (PDS) zum Entwurf eines zur Neugliederung, Vereinfachung und Reforms des Mietrechts (Mietrechtsreformgessetz), Deutscher Bundestag, Stenographischer Bericht, 161. Sitzung, Plenarprotokoll 14/161 (29.3.2001), S. 15651-15688, at 15666.

Therefore, the pro-tenant tenancy law as outlined in chapter 2 ensures that the tenant will not be easily evicted under the landlord motive to increase the rent beyond that which is permitted by the rent regulation. The most influential tenancy law is that of unlimited tenancy under §575 BGB. The only ways a contract cannot be unlimited is under fix term contracts and a breach leading to termination, which both have very onerous conditions for the landlord to fulfil or prove. On the other hand, the contract still remains under the principle of succession, be that either the tenant to their next of kin or the landlord to the next owner of the property. With such clear provisions against the landlord being able to evict the tenant for the commercial aim to raise the rent, the landlord is effectively restricted to the rent regulation until the tenant leaves the contract voluntarily.

SIMPLE *MIETSPIEGEL*

The Simple *Mietspiegel* generally is usually found in the smaller cities or towns which are not characterised by increasing rental prices. The Simple *Mietspiegel* is a simple table containing the customary local reference rent, which is revised every two years and made fresh every four years. The data is derived from the *Mietdatenbank*, which is run by local government. Although the *Mietspiegel* is set up by the municipality, it is not open to challenges by way of administrative law, given its simple empirical nature.

The simple *Mietspiegel* has sometimes between referred to as the "Bordeaux-*Mietspiegel*", whereby the tenant and landlord associations in certain towns have come to collective agreements as to the figures in the *Mietspiegel* over a bottle of wine, rather than by a statistical methodology. These agreements take substantial assumptions and lack any systemic or defined method of data collection. As such they would not carry much market or legal credibility.

The *Mietspiegel* reflects the current developments of the housing sector, and is thus a simple mirror. There is no stipulation as to how the updates are made every two years, and this is done usually through the inflation rates, which does not assess the local housing market situation. The data and statistical methods are merely evaluative, without any complex regressions. As such it less accurate than the qualified *Mietspiegel*, meaning that there is room for arguments to the court regarding the appropriate rent for the dwellings. This lack of legal certainty means that the *Mietspiegel* is more advisory, leaving the other means of customary local reference rent such as an expert opinion or three similar dwellings with greater significance. In legal terms, the simple M*ietspiegel* does not make the tenant carry the legal burden of proof when trying to prove that the rent is inappropriate, but gives a legal implication called a presumption.

The Simple *Mietspiegel* therefore does not give the practical security for both the tenant and landlord, particularly in a growing market, which means that the two aims of practical security described previously are not achieved. This is why the 2001 Reform Act introduced the qualified *Mietspiegel*, and why cities with increasing pressures on the private rental sector prices changed from the simple *Mietspiegel*.

The city of Cologne uses a simple *Mietspiegel* in accordance with §558b BGB. The Cologne *Mietspiegel* (KMSP) was created in 1974, is renewed every two years and created freshly every four years. It is drawn up by the property owners association, the tenant association, the property market association and the association of house, flat and land owners. The data is from a large database of about 17,000 leases provided for by these associations, and is supplemented with a survey sent out to tenants and landlords. The city then employs the group Kampmeyer Immobilien to undertake the statistical work impartially. Nonetheless, it does not fulfil the scientific requirements in order to qualify for a qualified *Mietspiegel*. When it is renewed every 2 years, the values are adjusted for the new rents and the estimated market price movements. It is available for a nominal fee, and is often the main basis of argument in the courts over rent disputes.

The KMSP is divided up in particular characteristics, including the building age, location, size and equipment. The equipment is rated according to a list of potential equipment, and this contributes to the range of potential rental prices between the maximum and minimum rent. As shown in Table 1, the building age is classified into age groups, under the assumption that buildings of a certain period are more or less desirable due to the energy efficiency rating. They are adjusted for modernisation work and changes in the construction building codes.

TABLE 1: HISTORY OF THE COLOGNE *MIETSPIEGEL*

Year of Build	Average Price	Lower*	Upper*	Living space	Observations
	--- in Euros ---			sqm.	
Without Year	9.20	6.52	11.88	69.1	14,001
to 1918	10.32	7.99	12.66	76.8	970
1919 - 1948	9.09	7.31	10.86	72.6	771
1949 - 1957	8.53	6.68	10.39	60.1	1,138
1958 - 1968	8.59	6.65	10.52	64.1	2,500
1969 - 1978	8.13	5.91	10.35	68.4	1,808
1979 - 1983	9.05	6.20	11.91	65.9	483
1984 - 1994	8.79	6.74	10.84	66.8	1,026
1995 - 2001	9.34	7.30	11.39	69.4	1,136
2002 - 2007 (ENEV 2002)	9.37	7.39	11.35	83.3	497
2008 - 2009 (ENEV 2007)	10.33	7.77	12.88	87.3	174
2010 - 2011 (ENEV 2009)	11.22	7.96	14.48	86.7	368
New current	10.18	7.40	12.96	77.7	348

*Note: *Upper - upper deviation, *Lower - lower deviation.*
Source: Cologne Mietspiegel, published by the City of Cologne 2012

The size of the apartment is broken down into both the number of bedrooms and the total size of the apartment, as shown in Tables 2 and 3.

TABLE 2: COLOGNE *MIETSPIEGEL* 2012 ACCORDING TO NUMBER OF ROOMS

Number of Rooms	Average Price	Lower*	Upper*	Living space	Observations
	---in Euros---			sqm.	
Without information	8.30	6.00	10.61	80.8	14
1 to 1.5 rooms	10.59	7.67	13.51	35.9	4,514
2 to 2.5 rooms	8.92	6.66	11.17	60.8	9,64
3 to 3.5 rooms	8.45	6.36	10.53	82.9	7,985
4 and more rooms	8.75	6.25	11.25	118.9	2,177

*Note: *Upper - upper deviation, *Lower - lower deviation.*
Source: Cologne Mietspiegel, published by the City of Cologne

TABLE 3: COLOGNE *MIETSPIEGEL* 2012 IN ACCORDANCE TO LIVING SPACE

Sqm. Living space	Average Price	Lower*	Upper*	Observations
	--- in Euros ---			
up to 20 sqm.	14.66	10.41	18.81	160
up to 40 sqm.	10.99	8.05	13.94	2,602
up to 60 sqm.	8.97	6.89	11.04	4,655
up to 80 sqm.	8.36	6.42	10.30	1,138
up to 100 sqm.	8.45	6.31	10.60	2,844
up to 120 sqm.	8.68	6.32	11.05	1,032
up to 140 sqm.	9.82	6.72	12.93	405
up to 160 sqm.	9.55	6.72	12.37	192
up to 180 sqm.	10.45	6.90	14.00	91
up to 200 sqm.	10.02	7.36	12.67	30
up to 250 sqm.	10.04	6.00	14.08	66
up to 300 sqm.	9.92	4.88	14.97	17
over 350 sqm.	10.52	5.60	15.44	16

*Note: *Upper - upper deviation, *Lower - lower deviation.*
Source: Cologne Mietspiegel, published by the City of Cologne

QUALIFIED *MIETSPIEGEL*

With the simple *Mietspiegel* lacking the legal certainty to make it a devise upon which landlords and tenants can precisely rely on for their long term expectations and short term decisions, the 2001 Reform Act introduced a new, more scientifically complex, "qualified" *Mietspiegel*. Scientific principles are recognised as an extensive table method, a regression method, or a combination of both.

According to the BGB, §558d:

"*A qualified Mietspiegel is a Mietspiegel which is gathered from acknowledged scientific principles, and has jointly been compiled from landlords and tenants in the municipal or their representatives.*"

There are two main methodological differences between a simple and a qualified *Mietspiegel*. The first is the adjustment process. Where both a simple and a qualified *Mietspiegel* must be adjusted to the market level every second year and needs to be compiled of new information every four years, the qualified *Mietspiegel* is updated according to the price index of living for private households in Germany, which is calculated by the Federal Statistical Office. Again, it is argued that this method does not consider the particularities of the local housing market. The second difference is that the qualified *Mietspiegel* is more accurately calculated, including the use of hedonic regression analysis or with much greater sample sizes. There is no definitive scientific method, where economists, politicians and even the courts have questioned the adequacy of certain methodologies. Nonetheless, once a city/municipality has agreed on a certain scientific methodology, eligible in the vague rules of the BGB, it carries legal authority in the court of law.

For the scientific methods, the cities which have the qualified *Mietspiegel* employ consultancy firms to undertake the work. For example, the Dresden qualified *Mietspiegel* is carried out by the company called Chempirica, using market research and public input from another company called Chemnitz, in collaboration with the municipal statistics office. The additional financial burden of employing these companies and undertaking greater detailed research means that cities will be hesitant to use a qualified *Mietspiegel* unless there is a political pressure from the tenants.

The reason for undertaking these expenses is the legal certainty a qualified *Mietspiegel* can have in court when it is administered properly. The extensive requirements ensure that the *Mietspiegel* is objective, transparent and accurate. It requires a large burden of proof for a claimant to argue that the rent which is within the given rental price boundary is incorrect, or where a rent which is outside the rental price boundary is correct. The legal certainty reduces the number of rent price challenges to the courts, and gives investors and tenants greater security of expectation regarding the future rents. Another reason why cities might be more inclined to spend a large amount of money creating a qualified *Mietspiegel* is to ensure the efficient and fair operation of their private rental market, making it both economically and socially just, and therefore attractive to live in.

The requirement that the tenants and landlords associations must recognise the *Mietspiegel* gives it further authority. Given the objective and scientific nature of the Qualified *Mietspiegel*, there is little room for political bargaining over any subjective elements to be included. Therefore many tenants and landlords associations state that the involvement within the process is to ensure the statistical accuracy, and then to rubber stamp the final document.

Nonetheless, the Berlin Tenants Association has indicated that they might withdraw their support for the next Berlin *Mietspiegel* on the basis of representing their members concerns at the increasing cost of rent and how not enough is being done to address this issue. This would be a break from the usually consensual approach of the bodies involved in the making, and would raise interesting challenges as to the presumption of legal certainty it is designed to entail.

In Hamburg the qualified *Mietspiegel* is created by the Ministry of Urban Development and Environment with a working group consisting of:

- Hamburg Property Owners Association 1832
- Federal Association of Free Real Estate and State Association of Housing Enterprise
- North German Housing Company Association
- Hamburg Municipalities
- Hamburg Tenants Associations
- IVD Real Estate Consultants
- Managers and Experts Northern Region Housing
- An administrative judge and a judge of the regional court in Hamburg
- Public Legal Advise Consultant

Again, each dwelling has different characteristics which must be considered when finding the customary local reference rent in accordance with the table: type of building, location of the building, floor area, number of rooms and the facilities of the dwelling. The Hamburg *Mietspiegel* highlights:

- the floor space comprises of the sum of the rooms that exclusively belong to the apartment, and thus excludes cellars, store rooms, spare bedrooms outside the apartment, heating rooms and garages.
- Facilities are classified into three categories: 1) apartments without a bath and collective heating system, 2) apartments with a bath or collective heating system, 3) apartments with a bath and collective heating.
- The essential features of a normal apartment include a functional kitchen with sink. Additional features include hot water in the bathrooms and kitchen, water meter for cold water, appropriate flooring, proper surfaces inside and outside the building, elevator in buildings over 6 floors, double glazing, cable/satellite TV, intercom with the door, a balcony/terrace and tiled finished walls.
- It may be justified to increase or lower the rent according to the design, cut and condition of the apartment.

Regression Method in the Munich Qualified *Mietspiegel*

The requirements of using scientific statistical methods to create a qualified *Mietspiegel* can be best illustrated with the example of the Munich *Mietspiegel*. The Munich *Mietspiegel* uses a regression method for analysing the data from a relatively small sample. The justification for this process is that to analyse all the price-forming characteristics of dwellings (size, amenities, condition and location) for many dwellings in a city with the large size and complexity of housing market as Munich would be extremely expensive and costly. The 2013 *Mietspiegel* therefore is being based on 3,000 interviews being conducted.

In this survey both the landlords and the tenants are questioned about the dwelling. The landlord questionnaire includes questions the tenant is unlikely to know, such as the energy classification of the building. The surveys are extensive so that the quality of the 3,000 sample is accurate.

In its most simplistic format, the *Mietspiegel* finds the weighted average using the number of the dwellings, rather than an arithmetic mean. Around this it then applies a two-thirds margin to disregard outliers that can be caused by pure market diversification or other non-controlled variables.

The structure of the regression approach uses the following abbreviations:

QM Net rent (in euros) per square metre per month

EQM Estimated net rent (in euros) from the regression model, per square metre per month. This corresponds to the average customary local reference rent per square metre.

W Dwelling size in square metres

B Building age, i.e. the year in which the residential building was completed.

$X_1, X_2 \ldots$ Other rental price considerations, such as the location, facilities etc., as well as other possible interactions between the considerations (e.g. between the living space and building age, or between X_1 and X_2).

For reasons of flexibility, a semi-parametric model is used in which the QM is the variable to be explained:

$$QM = a + f(W) + g(B) + h(W,B) + a_1X_1 + a_2X_2 + \cdots \varepsilon. \qquad (2.1)$$

Where a is a constant, $f(W)$ and $g(B)$ are flexible features of the living space W and year of construction B which influence the rent, and $h(W,B)$ is the joint effect between the living space and the year of construction on the rent. The parametres $a_1, a_2 \ldots$ describe the special mark-up or mark-down features $X_1, X_2 \ldots$ has on the rent, as they are categorised in the *Mietspiegel* explanation booklet. The remaining $\varepsilon = QM - EQM$ describes the deviation of the observed net rent from the predicted model net rent. Statistical tests found that the interaction between the living area and the year of construction was insignificant, and thus $h(W,B)$ was omitted from the model.

From the sum of $a + f(W) + g(B)$ the basic price table for the mean (average) net rent is formed. Neither constant a alone, nor the basic prices $a + f(W) + g(B)$ can be interpreted as the medium (middle) rent price.

The variance of the error term ε is modelled and estimated in a two staged approach: In the first step, the variance is a function of all the characteristics W, B, X_1, $X_2 \ldots$ shown in model (2.1) in a semi-parametric model and appreciated. This model shows whether the variance of the characteristics is significant or insignificant and gives their margins of variance. In the second step, the model (2.1) is adjusted for the variance. Then they weigh the dwelling cases with the factor $1/E(\epsilon_i^2)$, where $E(\epsilon_i^2)$ is the expected squared deviation of the variance model in step 1. Through this two-stage approach, the homogeneity of variance of the residuals ε is taken into account.

A selection of the regression model (2.1) was carried out on the statistical significance of the relevant characteristics. In addition, the Akaike Information Criterion (AIC) was used to capture the variables in the model.[22] The AIC is a measure of the relative quality of a statistical model, for a given set of data. As such, AIC provides a means for model selection. The AIC takes into account the number of parame-

[22] Hirotugu Akaike (1974) 'A new look at the statistical model identification' *IEEE Transactions on Automatic Control* 19 (6), 716–723.

ters used in the model and avoids too many parameters (over-fitting). By reducing the number of parameters, it increases the stability of the model in terms of predictive power.

CALCULATING THE *MIETSPIEGEL*

The Federal Ministry for Housing states that the increased transparency of the market improves both the market mechanism function and is compatible with a social market economy. Kade states the neo-classical decision logic of the theory of perfect price information as the "economic agent [who] knows all the alternatives available to it, including all possible results of actions, leaving no uncertain elements in the decision-making process."[23] Although such perfect transparency is unattainable, it is a core objective of the *Mietspiegel*.

On an economic basis, a more accurate *Mietspiegel* will result in a greater understanding of the market position of the dwelling, thus enabling the supply and demand to adapt quicker and with less inefficiency. Transparency will increase the competition of PRS suppliers, as the prospective tenants will know according to the *Mietspiegel* when there are better offers or observe cheaper areas to potentially live. Furthermore, transparency in the market reduces risk and uncertainty among stakeholders, leading to more rational corporate governance.

On a social market basis, a more accurate *Mietspiegel* promotes greater transparency for the market participants to have a greater degree of knowledge, and thus become more rational actors leading to less wrong decisions. Without the *Mietspiegel* the tenants would be searching for an understanding of the market in a huge incoherent and opaque mass of data. For example, an accurate update of the *Mietspiegel* in the two year period between the new *Mietspiegel* might find that the market is increasing in price faster than expected, and thus the significantly higher prices in a new *Mietspiegel* would be more expected. As the *Mietspiegel* is used by investors to estimate their income returns and for tenants to coordinate their medium term housing costs, this accuracy will be beneficial.

To achieve this aim, the *Mietspiegel* factors in the sub-market residual factors, focuses specifically on the private sector, includes the key actors on a procedural basis, ensures accurate and timely data collection, and ensures complete transparency of the methodology and final findings.

[23] Gerhard Kade (1962) *Die Grundannahmen der Preistheorie, Eine Kritik an den Ausgangssätzen der mikroökonomischen Modellbildung* [The basic assumptions of price theory, a critique of the output sets of microeconomic modeling]. Berlin: Vahlen.

RESIDUAL FACTORS (*WOHNWERTMERKMALE*)

The rental housing market is in many respects an imperfect market due to the empirical fact of imperfect information. The main reason for this is due to the extreme heterogeneity of the market into "sub-markets", where the rental price reflects the specific user preference in characteristics both objectively and subjectively. The *Mietspiegel* thus incorporates the objective characteristics into the rental price to increase the accuracy of the information. The qualified *Mietspiegel* considers these factors in much greater depth in order to increase statistical accuracy.

Location: Infrastructure and social fabric of the area, such as transport, green spaces and population density. Figure 3 shows the location variance for the city of Dresden, where in the colour scale red is regarded as a good location and white is a bad location.

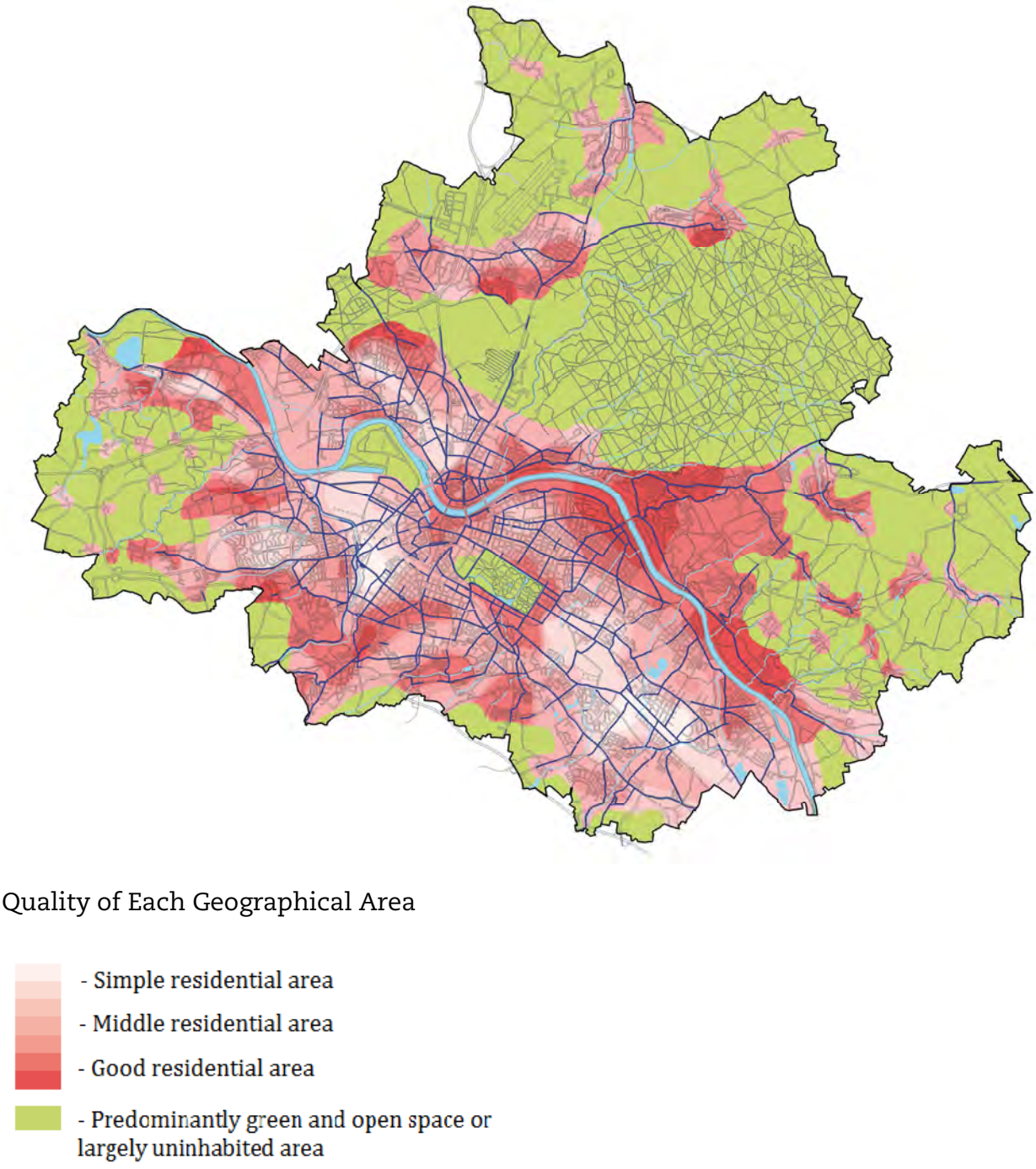
Type of Apartment: Difference between a high rise apartment building and a three story red brick apartment building.

Equipment: According to the amenities provided by the landlord. For example, upscale amenities include bathroom walls tiled, separate bath and shower, separate guest toilet, built in kitchen and high-quality flooring.

Quality: Usual referring to the age of the building, separated into pre-1948, between 1949 and 1990, and post 1990. This refers to the date of readiness for occupancy.

Size of the Dwelling: The belongings of the dwelling contributes to the size, although in different given rates. For example, a dwelling with an unheated conservatory and a patio should be: Total Floor Space + Half of the Unheated Conservatory Size + Quarter of the Patio Size.

FIGURE 3: DRESDEN 2013 *MIETSPIEGEL* DEMARCATING THE QUALITY OF EACH GEOGRAPHICAL AREA



Source: City of Dresden (2013) 'Dresden Mietspeigel' available at http://www.dresden.de/media/pdf/sozialamt/Dresdner_*Mietspiegel_2013_*Broschuere_Web.pdf (accessed 18/02/14).

RENT, OPERATING COSTS AND UTILITY COSTS

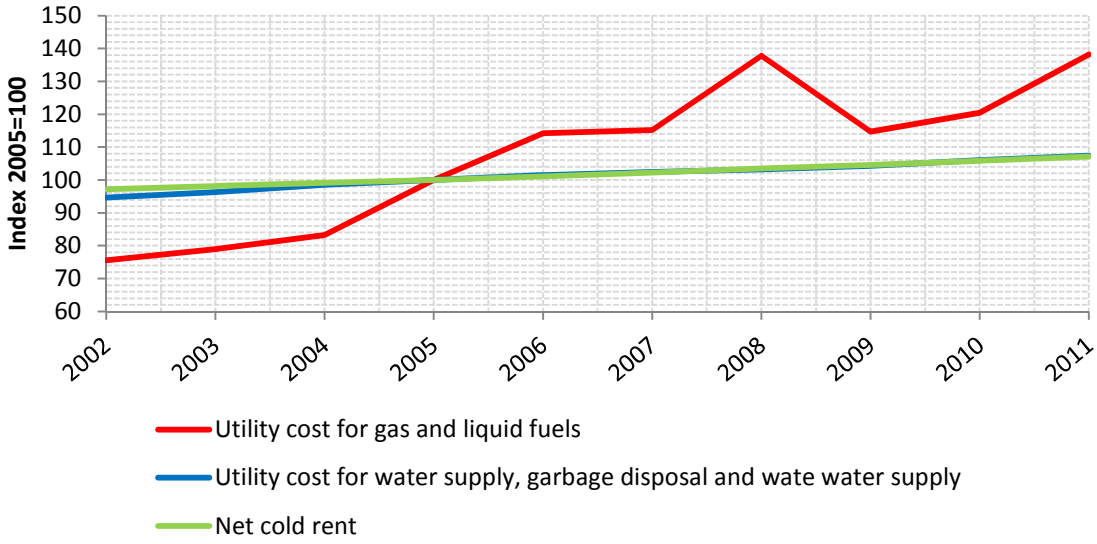
The residual factors give an indication of the operating and utility costs of a dwelling, whereby larger and older dwellings are usually associated with higher energy and service charges. However, the rent regulation only applies for the net-rent on the use of the property (*Nettomiete*), and not the accessory charges (*Nebenkosten*) which consists of operating costs and utility costs. Two difficulties arise out of this. First, it is unclear whether the net rent price as stipulated in the *Mietspiegel* accurately reflects the operating and utility costs through the residual factors. Second, with the utility costs not having been regulated, and fluctuating with the prices setting of the open market for energy, the utilities prices have increased substantially more than the rent price. Most contracts stipulate that energy bills are paid by the tenant, and are not paid monthly to the landlord with the rent. Water on the other hand is usually paid for through the landlord. Where the operating costs are usually paid to the landlord once a month with the rent, it is usually tied to the development of the rent, thus in accordance to the *Mietspiegel*.

It can be seen from Figure 4 that the energy costs for dwellings has increased 83% between 2002 and 2011, while the operating costs and rent price has increased 14% and 10% respectively. Dwellings are thus less affordable with the amount of income being spent on housing drastically increasing. The demand for smaller and more energy efficient dwellings will also have increased.

Three questions thus arise:

- Do the energy efficiency residual factors proportionally reflect the increased demand for energy efficiency dwellings?
- Has net rent been constrained due to increasing energy costs, where household income has squeezed demand?
- Should the energy costs be factored into the *Mietspiegel* so as to control the real rent price?

FIGURE 4: DEVELOPMENT OF RENT AND UTILITY COSTS, 2002-2011



Source: Statistisches Bundesamt, Fachserie 17, Daten und Trends 2012/2013, GdW.

In response to the rising energy prices, the German Tenants Association (*Deutscher Mieterbund e.V*), supported by the Federal Ministry for the Environment , Nature Conservation , Building and Nuclear Safety (*Bundesministeriums für Umwelt, Naturschutz, Bau und Reaktorsicherheit*), produces the ***Bundesweiter Heizspiegel*** (Nationwide Heating Mirror) and in some Municipalities produces a local ***Heizspiegel.*** With this instrument the tenant can see what the average heating costs for their type of dwelling is, and thus can compare the energy efficiency of the building and their energy usage with the average dwelling either nationally or within their municipality. The *Heizspiegel* also provides contact details for local support to households needing information in issues of modernisation and energy savings. In addition, the tenant can request a ***Heizgutachten***, which is a free assessment of the energy bills for the household. Nonetheless, these instruments only permit the households to evaluate the energy efficiency of their dwellings, and thus act individually to reduce sources of energy inefficiency or misdirected energy contracts.

WHICH APARTMENTS ARE INCLUDED INTO THE *MIETSPIEGEL?*

The *Mietspiegel* aims to reflect what the market price is for the private rental sector, so it thus measures the rents which are purely on the market and not subject to any interference. Given the majority of houses in the rented sector are private, it is a more appropriate question to ask what dwellings are not included:

- Homes promoted to the first and second conveying to WoBauG II
- Apartments with rent set under the Housing Promotion Act, i.e. publically subsidised "social" housing
- Subsidised apartments with rents and increases in rent set
- Homes in redevelopments areas
- Unoccupied or occupied by the landlord
- Homes with commercial use
- Temporary rented flats according to §549 BGB paragraph 2 number 1
- Accommodation for people with urgent housing needs, under Public Law or welfare considerations
- Apartments in youth or student residencies
- Fully and partially furnished dwellings which are sublet
- Rented on a personal basis to a friend or family member
- Dwellings with no toilet
- Dwellings in the basement

CREATION OF A RENT INDEX

The creation of a rent index is up to the municipalities, together with representatives of the tenants and landlords.

Actors usually include:

- Local Housing Authority
- Municipal Office for Statistics
- Tenants Associations

- Landlord Associations
- Local Real Estate Associations
- Institutes for Structural Policy and Urban Studies
- Institutions for Empirical Market Analysis
- Advisory committees or individual *Sachverständige* (consultants)
- Data Protection Officers

The actors work together in an advisory manner, rather than a negotiation manner, when operating under the scientifically objective qualified *Mietspiegel*. One of the reasons why the simple *Mietspiegel* was reformed was due to the power the landlord associations had over the process, which led many tenant organisations to remove their participation. The tenants' associations find it necessary to remove their participation and consent to the *Mietspiegel* as in doing so they represent their members in not offering their seal of legitimacy to the process.

However, it is argued that the *Mietspiegel* is a clearly objective process, where the actors involved only have a contribution into the 'scientific' calculations. In other words, the social objectives of the *Mietspiegel* have been formatted when the Federal Government passed the Tenancy Reform Act 2001 and the local government implemented which form of *Mietspiegel* their local population wanted. On this argument, it would be more constructive for the Tenants Associations to influence the local government's housing policy, whereby house prices would decrease should there be an increase in the supply side.

DATA COLLECTION

The core intention for data collection is to find the market rental prices for each area, so that the process of increasing rents can rest upon the findings. Therefore, to ensure legal authority of the *Mietspiegel* the data needs to be collected accurately, timely and with statistical significance. Put simply for legal and normative reasons, the *Mietspiegel* can only be as good as the data on which it is based.

Simple *Mietspiegel*: Data is collected from the Tenants and Landlords Associations, and then made into a simple table. It factors in the residual characters, albeit on a less detailed level than the Qualified *Mietspiegel* which uses complex hedonic regressions. The data is collected from the associations and then processed by the Municipality directly, which is the cheapest mechanism. The same sizes are thus smaller than the qualified format, although the causality is not direct given that simple *Mietspiegel*s usually are found in smaller or lower growth towns and cities. Secondary sources can be used for the simple *Mietspiegel*, although the parties have to agree to its use.

Qualified *Mietspiegel*: This rent mirror needs to be a more reflective analysis of the housing market. Thus, there are more avenues of data collection. The first is where tenants and landlords are directly asked by independent research surveys through writing, telephone or visits. This is regarded as the most authoritative data. The surveys must be done with the sole intention of collecting statistics for the *Mietspiegel*, and no other purposes. The second is again using the data from the Tenants and Landlords Associations. The third is the use of economic data on the consumer price index, which is often used to calculate the expected rise of rents in previously researched dwellings since the last qualified *Mietspiegel* was conducted.

The overall assessment is calculated with statistically sufficient random samples of much higher qualities. Secondary sources are not allowed for a qualified *Mietspiegel*s.

Nonetheless, failures can arise through vacancy of apartments, tenants and landlords unable to be questioned, refusal to participate, incompetent or erroneous surveys and existing rental contracts with other rent agreements, such as index linked increases. The data which is collected is cleaned and the sample sizes are large enough to ensure the findings are statistically significant enough to mitigate the failures.

Sample size must ensure that all dwellings, tenants and landlords are included in the calculation of the *Mietspiegel*, including very expensive dwellings, petty landlords, former social dwellings, elderly tenants, social organised housing groups, inter alia. However, although considered, their share of and influence on the market must be considered proportionately when completing the analysis.

PUBLICATION

Transparency is essential for the efficient operation of the PRS, for three reasons. First, the *Mietspiegel*'s main use is to justify either an increase in rent or the starting rent for a new contract, and thus must be available for reference. Second, it has an additional use of relating the market price of apartments for current or prospective investors or users of the dwellings. It will give a transparent reading upon which short and medium term expectations can be based upon for both actors. Third, complete transparency, including the minutes of meetings, gives the process an enhanced legal authority and an enhanced normative basis of trust or acceptance.

Usually the *Mietspiegel* is published by the municipality in print and for downloading. Nonetheless, some apply charges for access. The *Mietspiegel* is established in more than 300 German cities, where the rental quota in Germany is exceptionally high in comparison to the rest of Europe, with 37m households in private rent in 2007 representing 57% of the total. The German big cities are even higher, with Berlin and Hamburg private rental sector comprising of 85.9% and 79.7% respectively in 2009. The large cities also exhibit higher demand for rental properties, where in theory an open market would have allowed much higher rental market inflation.

RENT INCREASE

According to the *Deutscher Mieterbund*, more than 100,000 rent increases per year are wrong, illegal or not well motivated.[24] This section sets out a more analytical understanding of how rent can be increased compared to the methodological legal understanding in part 16 of the tenancy law chapter. Rent increase and decrease proceedings are carried out under the dispute settlement procedure as described in Chapter 2. In terms of disputes over rent increases, the most common case is when the landlord gives notice about the rent increase, and after 3 months the tenant remains in the dwelling and paying the existing rent. Should the landlord

[24] Deutscher Mieterbund (2011) 'Mieterhöhung' [Rent Increase], http://www.mieterbund.de/mieterhoehung.html (accessed 28/06/2013).

not bring a case against the tenant, after 2 months the rent will remain at the existing level. Therefore, with rent increase law, it is normally the landlord who brings the legal action against the tenant. It is not usually the case that the landlord has a case brought against him for breaking the rent increase law, unless the tenant argues that they were in a weakened position and circumstantially forced into the increase.

LEGALLY EFFECTIVE RENT INCREASES

Notification

The landlord must notify the tenant in writing for the increase, including the reasons why and a comparison with similar properties in accordance with the *Mietspiegel*. Should the rent fall within the price range as stipulated by the *Mietspiegel*, a simple reference to the *Mietspiegel* will suffice. As stated previously, by referring to a qualified *Mietspiegel*, the burden of proof legally falls upon the claimant who is trying to justify rent outside the *Mietspiegel*.

Three Forms of Comparative Local Rent

1. The most common form is the reference to the *Mietspiegel*, where the landlord shows that a dwelling with its characteristics justifies a rent according to the tabular format.

Should the increased rent fall outside of the *Mietspiegel* price for a locally comparative rent, then the burden of proof is on the landlord to prove that the dwelling should have a higher rent. This is achieved through the two final methods:

2. The landlord can employ a housing expert to independently assess the housing market and validate the claim that the rent should be higher. At around €1000, this method of justifying the rent increase is considerably more expensive than reference to the €3 *Mietspiegel*.

3. The landlord can cite three examples of comparable dwellings at the higher rent.

The Federal Court has ruled that the landlord may only increase the rent to the upper limit which has been found in these 3 methods of establishing the customary local reference rent.[25]

Rent Increase Cap

Rent cannot increase more than 20% in a three-year-period (*Kappungsgrenze*). Should the new rental amount be justified comparatively, it is still restricted by this term cap limit. The only exceptions to the term cap limit are when a new contract is signed or modification is carried out to the building. There are significant political debates regarding whether this rent increase cap should be changed to a 15% increase over three-years, 20% increase over four years, or even a 15% increase over four years. A new national reform act was introduced in April 2013, stating

[25] Supreme Court ruling VIII ZR 30/09 / Görlitz AG, decision of 13.08.2007 - 4 C 636/05 / LG Görlitz, decision of 06.01.2009 - 2 S 73/07.

that cities could implement a 15% increase over three-years rule. Although not confirmed, it is likely that it will be introduced by cities with fast growth, such as Berlin and Munich.

Sufficient Time between Rent Increases

The landlord must not ask for a rent increase in the 12 months following the last rent increase. The tenant has 1 month to notify the landlord whether they are willing to accept the increase. Should they not accept the increase, they have a further 2 months of occupancy. This means that a tenant is guaranteed 15 months of occupancy before a rent increase forces them to leave.

Graduated Rent Increase (*Staffelmiete*)

The contract can have a clause which stipulates either the exact amount of rent which will be increased annually or sets out the rent which should be paid for each year. The landlord is then not permitted to increase the rent further according to the usual rent increase rules above. They do have to abide by the 20% increase cap over 3 years rule. With such transparency of the rent increase, there is no rental market volatility risk and there is no confrontation on a rent increase proposal. The household will have a clear indication of the long-term rent, and thus can plan finances on a longer-term basis. These forms of contracts might be appreciated by the tenant where they are moving into a high-growth area with potential for the market rent price to increase drastically. Nonetheless, these contractual clauses are very unpopular, where households have seen low market rent increase over the last 15 years and believe that tying in an increase might be more costly than the market. Furthermore, when the dwelling is in a high-growth area, the landlord will not offer such a contract, in fear of the contractual increase will be lower than the market rent. The most common use of the *Staffelmiete* is in small flats for students, as the mobile younger households do not seek such long-term expectations.

Cost-of-Living Index (*Indexmiete*)

This is another contractual clause which links the rent to an official cost-of-living index issued by the Federal Statistics Office. This will ensure that the landlord has a rental income which will remain stable over the long-run, without having to refer to the customary local reference rent. For the tenant, although they would become subject to macroeconomic inflation volatility, their rent payments would be decoupled from the supply and demand characteristics of the housing market, which again would be attractive in high-growth areas. A further assessment of monetary policy and the housing sector is found in Chapter 5. The landlord must inform the tenant of the increase due to a rise in the index in a textual form (Textform) according to §§557b(III), 126b BGB. This form of rent increase has proven very unpopular with tenants, who seek less uncertainty in their rent price. However, it was extremely unpopular with the landlords as there was not enough inflation. Therefore, it is extremely rare.

RENT AFTER MODERNISATION

German housing policy no longer requires the drive for new dwellings as it did after World War II when there was housing shortages. As will be shown in the next chapter, subsidies, taxes and grants have all been restructured away from incentiv-

ising new build and towards the modernisation of the existing stock. Modernisation of the existing stock is particularly important in Germany due to the high number of vacancies in many regions and also because Germany has obligations to increase the energy efficiency of dwellings to meet new European standards. Modernisation must be differentiated from standard renovation. Standard renovation is the requirement of the landlord to keep the apartment standards in accordance with the contract, while modernisation increases the economic utility of the apartment. Landlords can put into the contract a clause to say that if there has been significant use of the apartment which has caused a wearing down of the standards as set out in the contract, then the tenant must conduct the renovation work themselves. "Beauty clauses" which state that renovation must be done periodically have been deemed invalid for lack of precision.

With such emphasis on requiring the modernisation of the private rental sector, the rules regarding modernisation are the least tenant friendly of all the rental market provisions. The position of the landlord in legal proceedings is strongest when the rent increase is due to modernisation. The tenant will challenge the particularities of the modernisation, including the miscalculation of the exact financial breakdown of the costs or the amount of energy saving brought about by the work. When there is a modernisation of the dwelling, the normal rent increase rules under the *Mietspiegel* are bypassed, and the rent increase falls within §559 BGB:

"*the landlord has carried out construction work, which increases the value of the rental term, improves the general living conditions of permanent or long term savings in energy or water effect (modernization), or has performed other physical measures on the basis of circumstances that he not be held responsible, he may increase the annual rent by 11 per cent of the costs incurred for the cost of housing.*"

Furthermore, §554 BGB stipulates more clearly the conditions:

- A modernisation increase and a normal increase (according to the *Mietspiegel*, expert advice or 3 examples) can occur simultaneously.
- Rent increase due to modernisation can be enforced without tenant approval.
- It must be notified in writing, stating the scope, type, start and end of constructions, and the estimated cost.
- The rent increase must be carefully calculated at 11% of the cost of modernisation.
- Information must be given 3 months in advance.
- New law will state that a tenant cannot demand a rent reduction while the renovation work is taking place

Therefore, the landlord can increase the rent by 11% of the construction costs, meaning that the investment will be paid for by an increased rental income in approximately 10 years. In preparation for this report, a series of interviews were

conducted to investors in the private rental market, and they indicated that the increased returns for modernisation is an extremely important business strategy for higher dividend.

The statutory regulation intentionally removes the requirement to get consent from the tenant. This removes the short term objections that tenants might have to increased rents immediately, given the savings from modernisation materialise over the long run. The legislative intention was that the modernisation of the dwellings took precedence over the concerns of the tenants. However, the modernisation legislation has acted as an investment strategy to increase the rental income from dwellings. Furthermore, investors will use the modernisation increase of rent to make tenants leave the dwelling, as the landlord knows that they cannot adequately afford the new amenities, leaving the landlord able to contract with a new tenant at higher rent. In some areas, such as Prenzlauerberg in Berlin, the municipality is bringing in restrictions to the modernisation rules to limit the growth of rents in the area, which is causing long term tenants to leave. Such amenities include building elevators in buildings which have never had or required one.

The modernisation rules fits into the social market economy structure of German housing policy, whereby the legislation is shaped to incentivise private investment in an area of market inefficiency which requires intervention, albeit this intervention is not through public subsidies. Nonetheless, as will be shown in the next chapter, the landlord also has the opportunity to receive loans and grants from quasi-governmental development banks for modernisation work, usually conditional on energy improvements. These measures collectively explain the supply of high quality dwellings, the significant amount of modernisation work and the decreasing number of vacancies in the PRS. Although the range of subsidies for modernisation is offered to both landlords in the rental market and homeowners, this regulation of passing the investment costs onto the tenant, explains why the rented sector has more investment in energy efficiency.

UNREASONABLE RENTS

Unreasonable rents are set out in §5 of the Economic Offences Act:

"*(1) Any person who intentionally or recklessly rents rooms for living or related ancillary services with unreasonably high fees*"

It stipulates that an elevated position is 20% greater than the local community *Mietspiegel* comparison or where there are insufficient dwellings to compare. Should there be a supply shortage, it must be clearly demonstrated and should consider the whole community rather than an individual district. Therefore, if the market rent has grown more than 20%, then the landlord can argue that the increase is justifiable and there are no intentional, reckless or unreasonable acts on his behalf. Another exception to this article is where it is demonstrated that the rent cannot cover the landlord's operational costs and thus is justified, in which case the rent can be between 20-50% above the *Mietspiegel*.

EXORBITANT RENTS

Exorbitant rents are set out in §291 of the Penal Code, where a landlord exploits the weakness, inexperience, predicament or lack of judgement of the tenant. Intent must be proven. The requested rent must be more than 50% higher than the comparable rent according to the *Mietspiegel*.

§138 BGB furthers this point on unlawful transaction and usury:

"*(1) A legal transaction which is contrary to public policy is void.*

(2) is void in particular a legal transaction by which a person, by exploiting the predicament, inexperience, lack of judgment or considerable weakness of will of another or a third party for the performance advantages grant promise or be contained in a clearly disproportionate to the power stand."

§134 BGB states with regards to Statutory Prohibition:

"*A transaction that violates a statutory prohibition is void, if not the law stipulates otherwise*"

The punishment is up to 3 years in prison and/or hefty fines, with the penalties increasing proportionally according to the amount of hardship inflicted upon the tenant. Other legal consequences include:

- partial annulment of the contract
- rent adjusted to customary local reference rent
- lease can remain valid, to protect against homelessness
- recovery of the overpaid rent, with a limitation of 4 years in back-payment

This law was used in the 1970s before there was an adequate system of rent regulation and rents increased dramatically. However, now this law is rarely evoked as tenants would not accept such a high rent in the first place, given the market is now mature and stable. In reality it would have to be a massive crime from a repeat offender for a 3 year sentence.

RENT REDUCTION

RIGHT TO RENT REDUCTION

When signing a lease under §536 BGB, rent reduction may not be excluded:

"*(1) If the leased property, at the time of transfer to the tenant or during the tenancy, has a deficiency that removes their suitability for the contractual use, such a lack of provides the renter, for the time when the capability is lifted, no obligation for payment of the rent. For the period during which the fitness is reduced, he has to pay only an appropriately reduced rent. An insignificant reduction of suitability is not considered.*"[26]

[26] Translated from German.

The tenant has the right to abatement of rent as long as the suitability of the leased property is restricted or abolished.

However, there are two exceptions:

- The tenant noted the restriction at the conclusion of the contract
- The tenant paid despite knowledge of the defect

Under §536c BGB, the tenant has the duty to "immediately" inform the landlord, meaning "without undue delay", where the defect should be written, confirmed in receipt and with a note to remind the landlord of the contractual obligation to remedy the defect.

WHAT SHORTCOMINGS AUTHORISE THE RENT REDUCTION?

Most of the legal challenges under tenancy law comes through cases of rent reduction due to deficiencies. In particularly, the court needs to determine whether there is a sufficient defect, how much this reduces the utility of the tenant in the dwelling and then how much rent should be reduced in proportion to the loss of utility. Therefore, while the *Mietspiegel* is designed to make rent increase an objective calculation in terms of a comparison with the customary local reference rent, rent reduction for defects are more subjective and thus open for argument. Nonetheless, there is only a small amount of jurisprudence to evaluate, as the courts are reluctant to write long reports for cases involving such small sums. The judge will usually just give the parties the decision in a suggestion.

The jurisprudence stipulates that a deficiency is the difference between the desired state (such as functional heating) and the actual condition (such as failure of heating during the heating season). However, insignificant defects are not counted or can be partially offset from the rent. A judgement of the District Court of Berlin on 15/03/2002[27] lists insignificant defects to include:

- Steps in the hallway were defective
- Paint chipped off the stairway walls
- Front door lock jammed
- Dump not secured with a lock
- House number lighting broken, etc.

The percentage of rent reduced is in accordance with the importance of the defect should the landlord not do anything about them. For example, a functionally incompetent mailbox is set at 1% reduction in the rent, while the total failure of the heating during the heating season entitles 100% reduction of rent. There is no legally binding table for reductions, as this is established through case precedent. The tenant must have proof of the defect and proof that they reported it to the landlord. The tenant can leave the dwelling if the defect is unfit for occupation. The landlord can challenge the rent reduction by arguing that the diminished utility is not large or that the tenant knew that it existed at the start of the tenancy.

27 LG Berlin, 15.03.2002 – Case No.63 S 54/00

Deutsche Mieterbund list the most frequent deficiencies of the apartment as:[28]

- Dampness and mould
- Noise caused by construction or by neighbours
- Dwellings smaller than the contract stipulated
- Malfunctioning technical appliances, such as elevator, boiler and heating
- Damage to the dwelling such as a leaking roof

ECONOMIC IMPACT OF THE *MIETSPIEGEL*

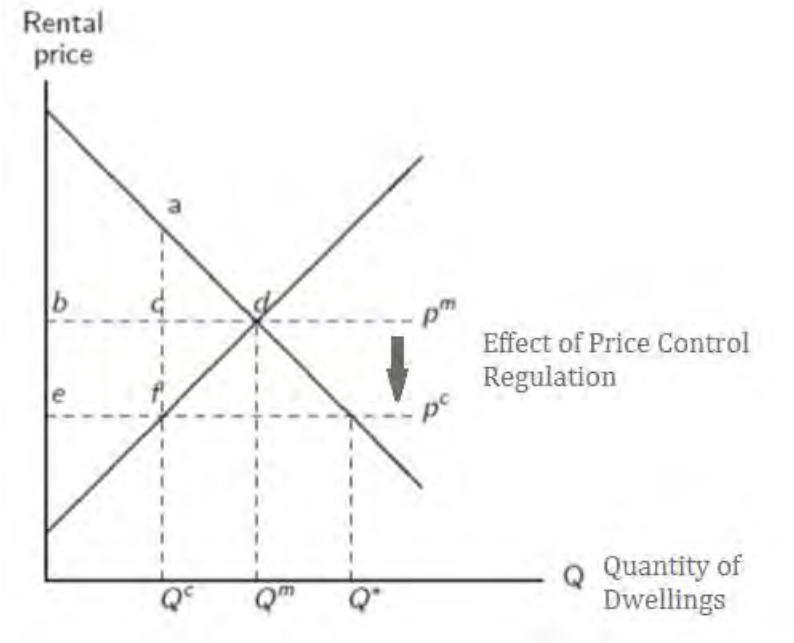
Arnott shows that how economists assess rent control depends on whether they see the market as competitive, monopolistic, with asymmetric information or some other market failure.[29] He argues that simple competitive models are useful abstractions, but the choice should be pragmatic of its empirical application. In a competitive market with no rising supply prices of important inputs, the price elasticity of supply should be large, at least in the long run. However, in reality supply elasticity differs among countries reflecting the different inefficiencies in the supply sides for each country. Turner and Malpezzi offer an interesting analysis on the costs and benefits of rent control.[30] This chapter will express specifically the German case.

Where the rent regulation allows landlords to freely choose a nominal rent when taking on a new tenant, but places restrictions on both raising the rent and evicting the tenant, there is an erosion in the real value of rent if the tenant stays on too long where there is positive inflation.[31] Therefore, the presence of a strict rent control will be a Pareto sub-optimal equilibrium for the investor. This will lead to landlords' discrimination in selecting tenants on the basis of short-term tenancies or tenants changing their preferences (such as moving to work in another city) to stay put. One way the regulation offers to mitigate this effect is offering the possibility of rental contracts being inflation-linked. The other is to effectively allow the *Mietspiegel* to accurately reflect the inflation rate through the market price increases in the rental market. In other words, it does not restrict the market increase of rent, and there is no erosion in the real value of the rent.

The economic effect of rent control can be illustrated using a simple supply and demand graph, where the y-axis on Figure 5 shows the rental price (p) for the x-axis quantity (Q) of a standard unit of rented housing. The effect of rent control (p^c) lowers the price of the standard unit of dwelling below the market price (p^m). The surplus shifts from the landlord to the tenant ($bcef$) and excess demand is created ($Q^* - Q^c$). A deadweight loss is created to the landlord (cdf) and the tenant (acd).

28 Deutscher Mieterbund (2012) 'Right to Rent Reduction' http://www.mieterbund.de/wohnungsmaengel_mietminderung.html (accessed 28/06/2013).
29 Richard Arnott (2003) 'Tenancy Rent Control' Swedish Economic Policy Review 10, 89-121.
30 Bengt Turner and Stephen Malpezzi (2003) 'A review of the empirical evidence on the costs and benefits of rent control' *Swedish Economic Policy Review* 10, 11-56.
31 Kaushik Basu (2000) 'The Economics of Tenancy Rent Control' *Economic Journal* 110(466), 939-62.

FIGURE 5: EFFECT OF RENTED PRICE CONTROL REGULATION



Source: Bengt Turner and Stephen Malpezzi (2003) 'A review of the empirical evidence on the costs and benefits of rent control' Swedish Economic Policy Review 10, 11-56.

The core assumption made here is that p^m will be reduced to p^c due to the rent control. However, the *Mietspiegel* is an instrument which is meant to reflect the customary local reference rent, and thus ensure that the supply and demand in the market meet at *d*. It could be argued that the Dutch regulated rental sector creates the scenario described above, hence the need for the social Housing Associations to supply the large majority of its market and the shrinking position of the private market.[32]

The *Mietspiegel* only slows the cyclical increase of rent prices by setting an applicable bracket of chargeable rents around the market rent. The very high proportion of the private rental dwellings compared to social rented dwellings thus means that market volatility could be larger where the prices of dwellings move in concomitant. There are four arguments to why the *Mietspiegel* will slow down increases in the market.

I. §5 of the Economic Offenses Act provides a ceiling for vastly increasing rents.
II. The calculations include new leases for the previous 4 years, which will inevitably make the reference rents lag.
III. The correction undertaken after 2 years uses inflation rates, which might actually be lower than rent increases on the market.
IV. There is the limit of 20% increase over 3 years.

[32] For a detailed report on the Dutch Private Rented Sector, including the arguments against rent regulation in the Netherlands, see Jonathan Fitzsimons (2013) 'The Dutch Private Rented Sector' *Knowledge Centre for Housing Economics* Working Paper November 2013, http://www.bvc.dk/SiteCollectionDocuments/Analyser/The%20Dutch%20Private%20Rental%20Sector%20Review_3.pdf (accessed 20/12/2013).

The practical effects of these measures are debatable when the market is not moving drastically. They would possibly be constraining where the rent price increase be at over 7% per year on a sustained basis with the economy on low inflation. The qualified *Mietspiegel* uses scientific market data on a more complex basis to ensure that it effectively finds the market price for each form of apartment in each area adjusting for time and market changes. It does not factor in any social or political considerations. Many professionals have argued that the market price for rent in the vast majority of cases would not be as large as to be restricted by the 20% increase over 3 years limitation.

Furthermore, many landlords wanting to increase the rent of the dwellings have the option of finding three comparative apartments with rents similar to the proposed increased rent. In areas of scarcity and thus rising rents, the landlord either consults the *Mietspiegel* increases or finds three comparable rents, which is not hard in places like Berlin, Hamburg and Munich.

The economic impact of the *Mietspiegel* must be further examined within the complete housing market, especially with the market for home-ownership. As we have seen the *Mietspiegel* does not aim to influence the natural price dynamics of the rental prices, apart from mitigating rapid cyclical changes or providing a sense of security for the tenants and landlords. Rather, it gives a clear market price indication for the tenant and investor of what their rent price and rental return will be respectively. This then gives the tenant and investor a basis upon which they can reflect upon whether it would be more or less financially viable to transfer to the home-ownership market, which is more transparent through the use of house prices statistics, fairly stable tax rates and a transparent mortgage market. The efficiency of the macro-economy is thus increased when there is a direct asset substitution between home ownership and the rental market, which are acting as cyclical stabilisers for price fluctuations in either. It is acknowledged that there are other key factors to both the asset substitution and cyclicality dynamics, but the *Mietspiegel*, through its market indications, contributes to the efficient functionality of the system. This respect is shown in the fact that many banks, insurance companies and building societies use the *Mietspiegel* as the basis for calculating the rent returns when lending or insuring landlords.

Extending this line of reasoning, the *Mietspiegel* enhances other short, medium and long term observations of the area in an indirect manner. First, it can offer prospective firms an understanding of the likely wage demands for the establishment of commercial or industrial enterprise in a certain area. Secondly, it can be used by the tax authorities to estimate the income landlords are receiving from their rental income. For instance, certain tax deductions on advertising costs are removed when the property is rented out at less than 75% of the comparative local rent. A third example would be that the *Mietspiegel* offers a greater understanding to the economic, demographic and social structure and development of an area.

This is the heart of the social market economy acting in rent regulation. It is there to prevent market failure through rental bubbles, but does not steer the force of the market in a way which disrupts the long term operation of supply and demand.

CONCLUSION

The *Mietspiegel* is a useful devise for the negotiation of the rental price of a dwelling between the landlord and the tenant. When the proposed rent is in the same range as the local comparative rent, taking into consideration the other objective conditions of the dwelling, then the legal burden of proof lies with the party arguing the rent should be different. This chapter and Chapter 2 sets out the occasions where rent can be legitimately increased and should be decreased. For example, the landlord has the legal right to increase the rent after an energy efficiency modernisation of the dwelling, and the tenant has the right to rent reduction should there be significant shortcomings in the dwelling.

This chapter has shown that the *Mietspiegel* and the rent regulation do not act as a social policy controlling the rent prices for the people. Actually, it calculates mathematically to assess what the current market rent price is, which in turn not only encourages efficient investment into the PRS, but also to ensure the most efficient balance of household tenure with the home-ownership sector. The regulation would impact the rent price in cases of market volatility and unreasonable/exorbitant rents, which in effect is regulating at the point of a market failure. The next chapter will show how the rent regulation and tenancy law is institutionally embedded within the 'social market economy' philosophy of the rented market, and chapter 5 assesses their compatibility with the owner-occupied sector, where for instance we can see that tenancy law gives renting households a sense of "ownership" over their dwelling in this phase of their housing 'life-cycle'.

CHAPTER 4: PRS MARKET DETERMINANTS

INTRODUCTION

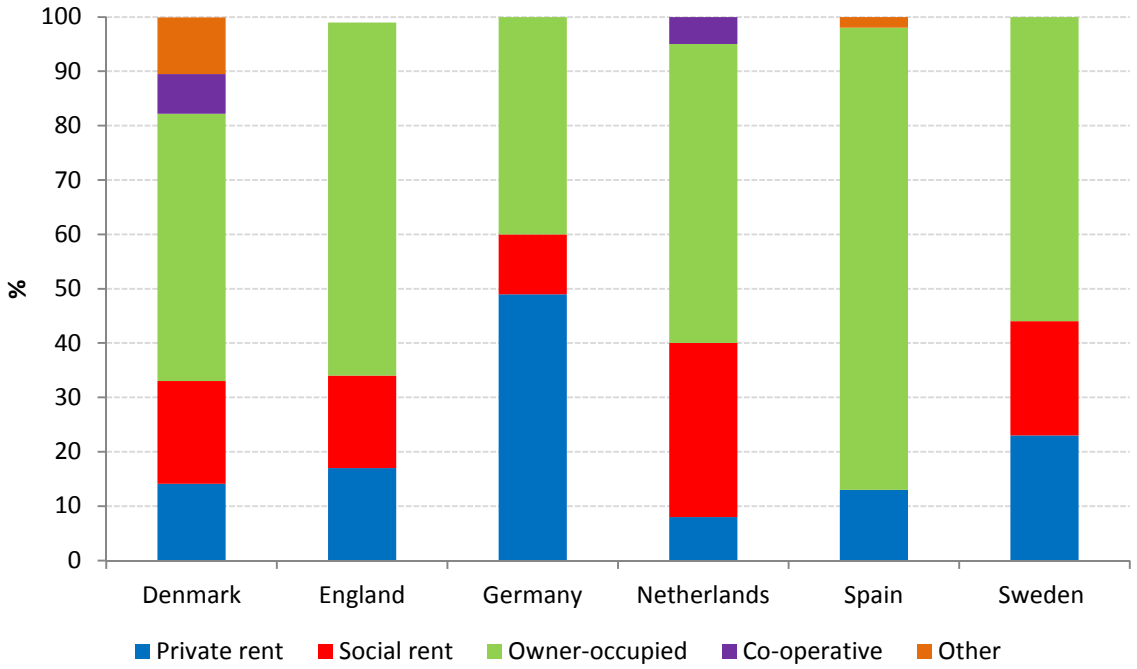
The functioning of the German rental market is highly symbolic of the social market economy philosophy first established in West Germany and now which is enacted for the Federal Republic. This philosophy claims that social welfare is best served by bringing about economic progress through the invisible hand of the market, where government intervention is designed to support the proper and efficient operation of the market.[33] Drost and Knorr-Siedow show that the market-led rent regulation presented in the previous chapter fits into a very much market-led rental housing policy, which has other characteristics such as market investors providing subsidized rental houses to lower income households. This chapter will show these other social market economy facets of the rental market in Germany, and how the rent regulation integrates within this system, finding that the real estate market and household life-cycle theory really are the important determinants of the rental prices. It will initially set out the basic quantitative description of the sector, before moving onto a qualitative analysis.

SIZE AND COMPOSITION OF THE RENTAL MARKET

Germany has a population of 81m, with more than 39m households in 40m dwellings. The rented sector amounts to 60% of this housing stock, which at 24m dwellings is the largest in the EU. In the rented market, slightly over 9m dwellings are rented from professional-commercial landlords and slightly over 14m dwellings are rented from private small 'amateur' landlords. Figure 6 shows the breakdown of the housing stock by tenure type, and shows that the large size of the German private rented sector is comparatively much larger than other European countries. This chapter will assess why this is the case, and whether the rent regulation has a significant contributing factor.

[33] Volker Busch-Geertsema (2004) 'The Changing Role of the State in German Housing and Social Policy' *European Journal of Housing Policy* 4(3), 303-321.

FIGURE 6: OCCUPIED DWELLINGS STOCK BY TENURE (%)



Note: DK: Other includes official housing, not in use and other or unknown. Data from 2011
UK: Data from 2010
GR: Data from 2006
NL: 2010,
ES: Data for private rented sector also includes social rented, no distinction between the two are available. Data from 2008,
SE: Owner-occupied also include co-operative (tenant-owned), data from 2009
Source: The Private rented Sector in the New Century, 2012

The division of landlords in the German private rented sector has been neatly summarized by Oxley et al in their paper 'Promoting Investment in Private Rented Housing Supply: International Policy Comparisons'.[34] In their very clear analysis, they make the important distinction between small providers and professional providers. The distinction enables us to understand the different investment incentives, the different applicability of subsidies and their historical development in shaping the German PRS.

[34] Michael Oxley, Ros Lishman, Tim Brown, Marietta Haffner and Joris Hoekstra (2010) 'Promoting investment in private rented housing supply: International policy comparisons' Report for the UK Department for Communities and Local Government.

Small providers

There are two forms of "small providers" in the German PRS:

- 'amateur' or non-professional landlords
- Professional individual landlords

TABLE 4: TYPES AND CHARACTERISTICS OF INDIVIDUAL, COUPLE AND PARTNERSHIP LANDLORDS WITH MULTI-FAMILY DWELLINGS 2005/06

Type of Landlord	Amateur landlord (up to 15 dwellings)	Professional individual landlord(16 dwellings and more)
Most frequent from	- Individual - Couple - Partnership	- Individual - Couple - Partnership
Characteristics	- Relatively high household income on average - Relatively more often retired - Few dwellings(6-7 on average) - Often personal connection to dwelling or lives close by - Aims for a good relation with the tenant - Prefers security in equity building in real estate to a high return - Partly cannot cope with the necessary information for the management of the dwellings	- Relatively higher household income on average - Relatively more self-employed - More than 45 dwellings on average - Seldom lives in the property
Management	Mostly self, but also outsourced	Mostly self, but also outsourced
Investment motives	- Security in old age - Secure equity building - Tax savings - Sometimes personal reason(family property) - Inheritance building	- Security in old age - Secure equity building - Tax savings - Combination of return and security in equity building - Demand stimuli
Return/vacancies	- 30 % earned a profit - Vacancy share is higher	- 43 % earned a profit - Vacancy share is lower

Source: Michael Oxley, Ros Lishman, Tim Brown, Marietta Haffner and Joris Hoekstra (2010) ' Promoting investment in private rented housing supply: International policy comparisons' Report for the UK Department for Communities and Local Government.

Professional landlords

There are two forms of professional landlords in the German PRS:

- Private housing companies
- Cooperatives

TABLE 5: TYPES AND CHARACTERISTICS OF COOPERATIVE AND COMPANY LANDLORD, 2005/2006

Type of landlord	Cooperative	Private housing company
Most frequent form	Registered cooperative (e.G.)	- Limited company (GmbH) - Company(AG)
Characteristics	- Aim of providing affordable and long-term housing for members - Non-profit status in cooperate tax, if mostly renting-oriented - 97 % of cooperatives are members of umbrella organisation GdW - Average number of dwellings of GdW-members is 1,200 - Majority is post-WWII stock	- Mostly not public stockholders - Sale and purchase of dwellings - Offensive marketing
Management	Member participation, efficient management	Efficient management
Investment motives	- Usage of funds according to articles of cooperative - Cost effective (break-even) - -up-to-date stock for members	- Profit maximisation - Portfolio improvement - Maintaining market share - Expansion - Resale to tenants (privatisation)

Source: Michael Oxley, Ros Lishman, Tim Brown, Marietta Haffner and Joris Hoekstra (2010) ' Promoting investment in private rented housing supply: International policy comparisons' Report for the UK Department for Communities and Local Government.

TABLE 6: PROVIDER STRUCTURES IN THE GERMAN HOSUING MARKET, 2006

	% of stock	% of stock	Number of dwellings(in 1000)
Total	100	100	39,617
Owner-occupied sector	40		**15,960**
One-and Two-family Houses		32	12,812
Multi-family houses		8	3,148
***Small providers**	37		**14,507**
One- and two-family Houses		14	5,421
Multi-family houses		23	9,086
***Professional landlords**	23		**9,150**
Private sector owners		10	4,059
Local HC		5	2,120
Other public HC		1	206
Co-operatives		5	2,079
Owners with management by professional commercial HC		1	4,53
Other providers (churches, other HC etc.)		1	2,33

Note: Housing Companies (HC)
Source: Housing and real Estate Markets in Germany 2006. BBR-Online-Publikation, No. 08/2008

Combining the characteristics in Tables 4 and 5 with the size of their market share in Table 6 provides a more accurate understanding of the supply side of the German PRS. When we consider the small providers contribute 37% of the overall housing stock and the nature of their investment is not essentially driven by the largest return on profits, the interaction between the rent regulation and the German PRS becomes clearer. As the small provider wants to have a decent return on investment equal to the rest of the housing market, but does not want to be inundated with legal challenges resulting from the tenant rejecting rent increases, the *Mietspiegel* offers these landlords an easy and effective means to achieve the investment motives. The motives of the small providers is such that a reliable and secure tenant staying in the dwelling for a long period of time is preferable, and hence the support such landlords would give to the high security of tenure in Germany. The supply section of this Chapter returns to specifically analyse the role of the landlords and investors in detail with other policies such as tax and subsidies.

PUBLICALLY SUBSIDIZED HOUSING

The term 'social housing' rarely is used in Germany, where the terms 'publically subsidised housing' or 'housing promotion' are found in legal texts. While in many other European countries housing can be easily divided into social housing and private housing, this distinction is not so clear in Germany where policy is set out to encourage private investment in providing affordable housing for lower income households. There is a very small section of the housing stock which can be classified as social housing, which is aimed at those who have very limited access to the rental market, such as the homeless or battered women. This forms of housing

makes up only 1% of the national housing stock, as the functioning of the social market economy is such that the private market and the publically subsidised market offers very affordable housing to low income households. Table 7 shows a summary of 'social housing' in Germany, as classified by the European Federation of Public, Cooperative & Social Housing (CECODHAS).

TABLE 7: STATISTICS SHOWING THE CURRENT STATE OF SOCIAL HOUSING IN GERMANY

Topics		Indicators	DATA	EU Average	Years
Social Housing sector	Housing stock	Total dwelling stock(in 1000)	39,268		2009
		Multifamily dwellings stock out of total dwellings stock (in 1000)	20,892		2010
	Social housing stock	Social rental stock as % of total housing stock	4.6%		2008
		social rental stock as % of rental stock	7.8%		2008
		Number of social rental dwellings per 1000 inhabitants	22.6%		2008
	Production of social housing	Social housing as % of new completions	15%		2008
Housing Market Trends	Availability	Number of dwellings per 1000 inhabitants	490		2009
	Affordability	Social rent as % of market rent (average)	77.6%		2010
		Share of housing costs in disposable income (%)	31%	22.9%	2009
		Housing cost overburden rate (as % of population)	23.6%	12.2%	2009
		Total housing cost in Purchasing Power Standard(PPS)	771.5	477.5	2009
		Harmonised index of consumers price in housing (2005=100)	113.5	121.9	2010
		Residential Mortgage debt to GDP ratio index (%)	47.6%	51.9%	2009
	Cost of construction	Construction cost index (2005=100)	111.5	114	2010
	Quality of housing stock	Bath/shower (as % of dwelling stock)	na		
		Hot running water (as % of dwelling stock)	na		
		Central heating (as % of dwelling stock)	92.3%		2006
State involvement	State involvement	General Government expenditure for housing and community amenities (as % of GDP)	na		
Socio Demographic Trends	Population	Crude rate of population change	- 2.5	2.8	2009
		Number of private households (in 1000)	40,188		2009
		Average number of persons per households	2.0	2.4	2009
	Unemployment	Unemployment rate	6.8%	9.6%	2010
	Immigration	Crude rate of net migration with adjustments (in 1000 inhabitants)	1.6	1.7	2010
Housing and Social Exclusion	Population and social conditions	Inequality of income distribution (quintile share ratio)	4.5	4.9	2009
		Population at risk of poverty or exclusion (%)	20%	23.1%	2009
		Population with severe housing deprivation (%)	2.1%	6.0%	2009

Source: Housing Europe Review- The nuts and bolts of European social housing systems, 2012. CECODHAS Housing Europe's Observatory, Brussels (Belgium)

Publically subsidised housing receive bricks-and-mortar loans from the government in return for charging lower rents, while the private market receive no such loans and are only constrained by the normal rent regulations.[35] It does not classify a dwelling according to the ownership or profit-status, as any actor in the rental market can be given the subsidies to provide publically subsidised dwellings.[36] Legally speaking, all the housing cooperatives and municipality housing corporations are private actors which are constrained due to their management principles.

The core aspects of publically subsidised housing are:

- Bricks-and-mortar subsidy
- Available for any actor, including private landlords and home-owners
- Municipality limits the rent charged and eligibility of tenants
- Municipality control is time limited, after which the dwelling is completely private

While the Federal Government explicitly gave up its aim to provide state-subsidised rented housing for a broad stratum of households in the 2002 Federal Housing Act, the *Länder* have a duty to ensure affordable accommodation for those unable to secure adequate housing themselves. This entails a public subsidy to any kind of housing provider in exchange for the use of a dwelling for social purposes, such as enforcing income ceilings and low rents, on a temporary basis. There are different programmes and funding schemes implemented from the different *Länder*, meaning that there are no centralised records. An assessment of the funding is harder to make given the changing nature of the funding given out by each *Land* over time, and that there are no centralised records of these. Nonetheless, the grant or tax relief subsidies cover the gap between the perceived rent and the cost rent. In Berlin, the publically subsidised housing is roughly €2.10 monthly per square metre, with the rental market average roughly at €7.96 monthly per square metre.

The subsidies decrease while the rent increases to market price progressively over the fixed period of public accommodation. The amortization period for which the dwellings subject to public subsidies officially becomes part of the private market is typically 20 years for new build dwellings and 12 years for renovated dwellings. Previously this was 40 years for new builds and 20 years for renovated dwellings. In practice though, the municipally owned companies often continue to operate the units as *de facto* social housing in terms of rent and access.

Germany officially only has private landlords, since the institutional non-profit sector was dissolved in 1989 and the non-profit tax status has largely been abolished in the 1990 Non-profit Housing Act (*Wohngemeinnützigkeitsgesetz*). These non-profit institutions were mainly cooperatives and municipal housing companies, which have now become private companies. For example, the municipal housing companies have shares which are owned by the municipalities, which mean that they act according to the policies and needs of the municipality. However, publi-

[35] Joachim Kirchner (2007) 'The Declining Social Rented Sector in Germany' *European Journal of Housing Policy* 7(1), 85-101.
[36] Marietta Haffner, Joris Hoekstra, Michael Oxley and Harry van der Heijden (2009) 'Substitutability between Social and Market Renting in Four European Countries' *European Journal of Housing Policy* 9(3), 241-258.

cally subsidised housing in Germany can be provided by private landlords, commercial developers and investors with multiple investors. This is distinguished from when tenants receive housing allowances under the social security system and the private landlords act as *de facto* social landlords.

It is important to note that the *Mietspiegel* operates for public housing as well as the private sector. In other words, the only housing which does not operate within the *Mietspiegel* is the Municipal Social Housing, which for example amounts to only 2.3% of the Berlin market (40,000).

There are three reasons why the private sector is increasingly providing publically subsidised dwellings in Germany. First, they are more likely to be granted planning permission or be sold municipal land if they provide part of their development as social housing. Second, they will be liberated from the *Lander* subsidy control after the amortization period, which has been decreased in time. Third, the amount of rent they do not receive from the tenant is made up for by the landlord, while the rent increases are subject to normal private market regulation.

The reduction of social housing can be demonstrated in Table 8, which shows in the Year 2011 the German public sector provider of dwellings has had a net sale of 550,000 dwellings and the private sector has had a net purchase of 618,000 dwellings. Nearly half of the 2011 transactions can be accounted to the exit of Cerberus and Goldman Sachs from the Berlin housing company GSW Immobilien after it went public, which thus explains the large share of transactions involving international investors.

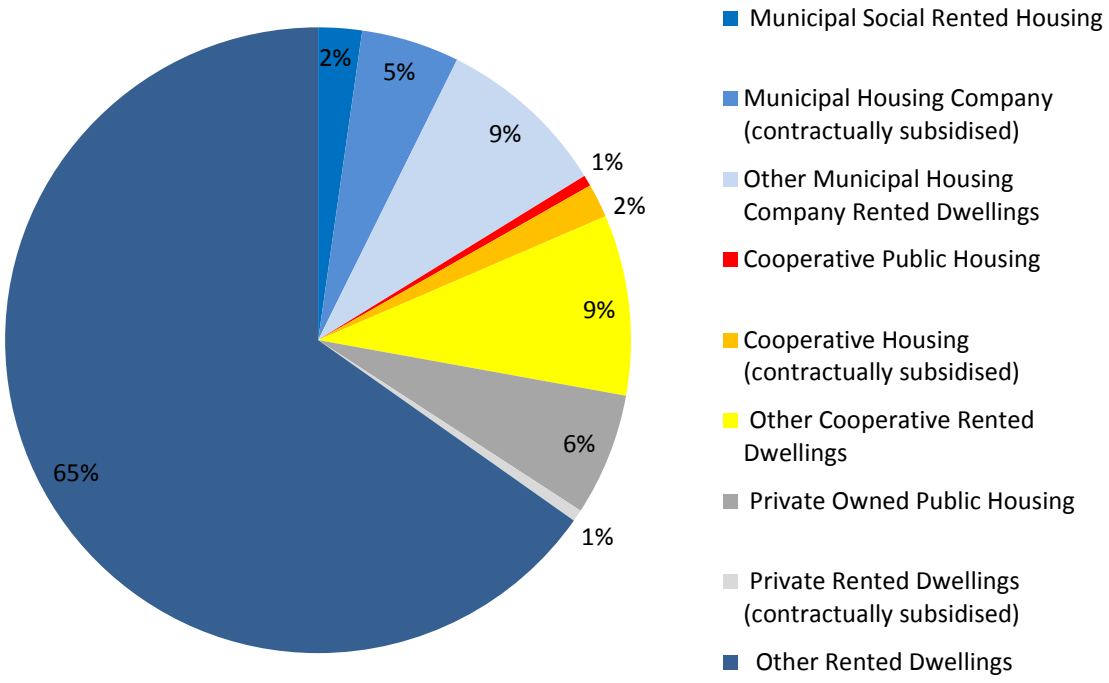
TABLE 8: SALES AND PURCHASES DIFFERENTIATED BY TYPE OF OWNER/INVESTOR, GERMANY 2011

	Sales		**Purchases**		**Balance**
	Flats	***Share***	***Flats***	***Share***	***Flats***
Public Sector	**917,000**	**45%**	**367,000**	**15%**	**-550,000**
Municipality	385,000	19%	158,000	8%	-227,000
Federal/state	532,000	26%	206,000	10%	-323,000
Private Sector	**1,028,000**	**50%**	**1,646,000**	**80%**	**618,000**
German Private sector company	652,000	32%	455,000	22%	-197,000
Companies, Anglo-Saxon, foreign	283,000	14%	953,000	47%	670,000
Companies, Continental Europe, foreign	47,000	2%	208,000	10%	160,000
Private owner without classification	46,000	2%	30,000	1%	-16,000
Other	**105,000**	**5%**	**36,000**	**2%**	**-69,000**
(Cooperation, church, no information, etc.)					
Total	**2,050,000**	**100%**	**2,050,000**	**100%**	

Note: Discrepancies in sum total due to rounding; sales of large housing stock of 800 flats and up are taken into account.
Source: BBSR Housing Transaction Database, BBSR-Analysen kompakt 01/2013 "Transaction of major housing stock".

The Berlin Tenants Organisation (*Berliner Mieterverein*) argues that there should be an increase in the number of social housing in Berlin to mitigate for the increasing rental prices and decreasing social housing sector. In Berlin the public housing stock currently amounts to 265,000 dwellings, which has been decreasing since 1990. In 2012 public companies have bought 10,000 flats under the Berlin government policy to extend the number of public housing to 300,000 dwellings. Nonetheless, these 10,000 dwellings were bought from finance investors, and thus come with rent reflecting the purchase premium. Figure 7 sets out the type of owners, including their commitments to provide the dwelling at below market rent prices.

FIGURE 7: BERLIN RENTED DWELLINGS ACCORDING TO TYPE OF OWNER



Note: The contractual subsidies are in accordance with (BelBindG) and for more information about these Publically Subsidised Housing Conditions see section on the next page.
Source: IBB Wohnungsmarktbericht 2012, Investitionsbank Berlin.

Alternatively many are predicting a growing role of cooperatives (*Genossenschaften*) in building and managing more dwellings in Berlin, although there are no exact numbers on how many will be built. Cooperatives include the future users of the buildings as the project developers and contractors. These members have a design for a block of dwellings or an entire street, usually with particular ecological or social ideals. Kirsten Ring of AA Projects describes in her latest book "Self Made City Berlin" that co-housing (*Baugruppen*), cooperatives and building collectives (*Baugemeinschaften*) has produced exemplary architecture diversity and quality over the

past ten years.[37] She frames the role of cooperatives as providers of housing stock with longer term sustainable financing operations, urban development and living considerations, and a more egalitarian distributive nature.

The book highlights the disruption to the real estate market by the alternative forms of financing such as the *Miethäuser Syndikat*. Cooperative Housing Associations form a collective ownership model, where one becomes a member of a cooperative and then is eventually offered an apartment at fairly low rent which remains constant in the long run. The main difference between the cooperatives is the association fee, which is commonly linked to the quality of the apartment guaranteed. For example, at Pappelallee 43 the association fee was on average €30,000 and the rent is €9 per square metre per month. The construction costs for these buildings are found to be considerable less than the market. Essentially they save the margin that contractors demand for their risk, marketing and profits, with the disadvantages being cost and planning risks, uncertain time horizons and the need for a substantial commitment in planning and organising. It could be argued that contractors with more knowledge in housing are better placed to calculate and take the risks. Thus, with the low real estate prices and empty spaces, places like Berlin does have scope at the current time for such forms of housing, and are expected to reach double digit share of the housing stock.

ECONOMIC THEORY OF PUBLIC SUBSIDISED HOUSING

Housing affordability is determined by the supply and demand functions of the housing market. The efficiency of the market mechanism depends on a perfectly executed framework with transparency, many independent suppliers, many independent demanders and a supply of adequate substitutes. Although in Germany the regulation encourages these characteristics, in practice a perfectly competitive market is unattainable, and thus public incentives and public intervention is required. With demand remaining a fairly stable constant, the government intervention is on the supply side, with action especially needed in growing or shrinking regions.

Supply of housing stock does not match the demand for several reasons, including speculation by investors who are willing to create a scarceness of supply to raise prices, inefficient supply of developed plots for housing estates, spatial policy restrictions, *inter alia*. A functioning housing market exhibits the characteristics of enough housing, dwellings of differentiated standards, a land market with an efficient administrative system, a sufficiently high capacity of the construction sector and a mature financial sector. These points are addressed in the next chapter, where it shows that Germany has a mature social market economy approach to housing policy. Nonetheless, the government is required out of a legal and social responsibility to provide affordable housing to families and households who are unable to access housing due to the imperfections of the market.

[37] Kirsten Ring (2013) *Self Made City Berlin: Self-Initiated Urban Living and Architectural Interventions*. Berlin: AA Projects, Senate Department for Urban Development and the Environment and jovis GmbH.

As Article 11(1) of the International Convention of Economic, Social and Cultural Rights (CESCR) states:

"States parties recognise the right of everyone to an adequate standard of living for himself and his family, including adequate food, clothing and housing, and to the continuous improvement of living conditions."[38]

The main indicator of affordability is the share of housing cost in disposable income. This is commonly set at 30% of the gross household income. EUROSTAT considers a household as 'overburdened' when the total housing costs, including utilities and maintenance costs, is more than 40% of disposable income. Therefore, in respect of these clear legal responsibilities, the governments are required to ensure that there is a framework setting out the required legal and financial requirements of each stakeholder. While the CESCR creates a legally binding commitment to respect the rights within it, it only requires states to take "progressive action", leading to the criticism that the Convention does not necessarily create the required tangible outcomes.[39]

The "quasi-public" framework of the German government is thus an approach which fits into social market economy model, which includes government intervention in areas such as social welfare and wage bargaining.[40] Haffner *et al* show that since 2002 the rent setting for subsidised dwellings has become more market-orientated and is no longer based on cost price only.[41] This change means that the rent control for social rented dwellings is based on negotiations between landlords and local authorities based on market developments. They show that on the balance of evidence, there is a relatively high level of substitutability between the social and private sectors due to the absence of a division between the two sectors. Therefore, the PRS is in competition with the social sector. The rest of this chapter will show the supply and demand interventions and incentives in the housing market to fulfil this responsibility and ensure the efficient functioning of the PRS.

SUPPLY

The economic significance of supply elasticity is undisputable, given the housing market models and policy prescriptions are based on explicit or implicit assumptions about its magnitude.[42] Glaeser et al show that it hinges critically upon the long-term responsiveness of housing supply whether shocks to demand for a loca-

[38] UN Office of the High Commissioner for Human Rights: The right to adequate housing (Art. 11(1)), 13/12/1991. CESR, General Comment 4, No.1.
[39] Scott Leckie and Anne Gallagher (2006) *Economic, Social, and Cultural Rights: A Legal Resource Guide*. Philadelphia: University of Pennsylvania Press.
[40] Torben Iversen, Jonas Pontusson, and David Soskice (eds.) (2000) *Unions, employers, and central banks: Macroeconomic coordination and institutional change in social market economies*. Cambridge University Press.
[41] Haffner *et al* (2009) Ibid [38].
[42] Steven Malpezzi and Duncan Maclennan (2001) 'The long-run price elasticity of supply of new residential construction in the United States and the United Kingdom' *Journal of Housing Economics* 10(3), 278-306.

tion manifest themselves predominantly in construction shifts and city growth or in rising house prices and wages.[43]

The effect thus has profound importance to other parts of the economy, including interregional labour mobility and labour market flexibility. Sanchez and Johansson employ a national time series data to estimate long-run supply elasticity, and find that Germany has a value of 0.428 which amounts to an inelastic supply, compared to 2.014 of the USA.[44]

While Chapter 5 will investigate the supply elasticity of the German housing market generally, this chapter will focus on the characteristics, actors and interventions of the PRS specifically. This will allow an investigation into the functioning of the PRS in the housing market, and whether investment is incentivised according to the special characteristics of the PRS or whether it is considered as part of the whole housing market.

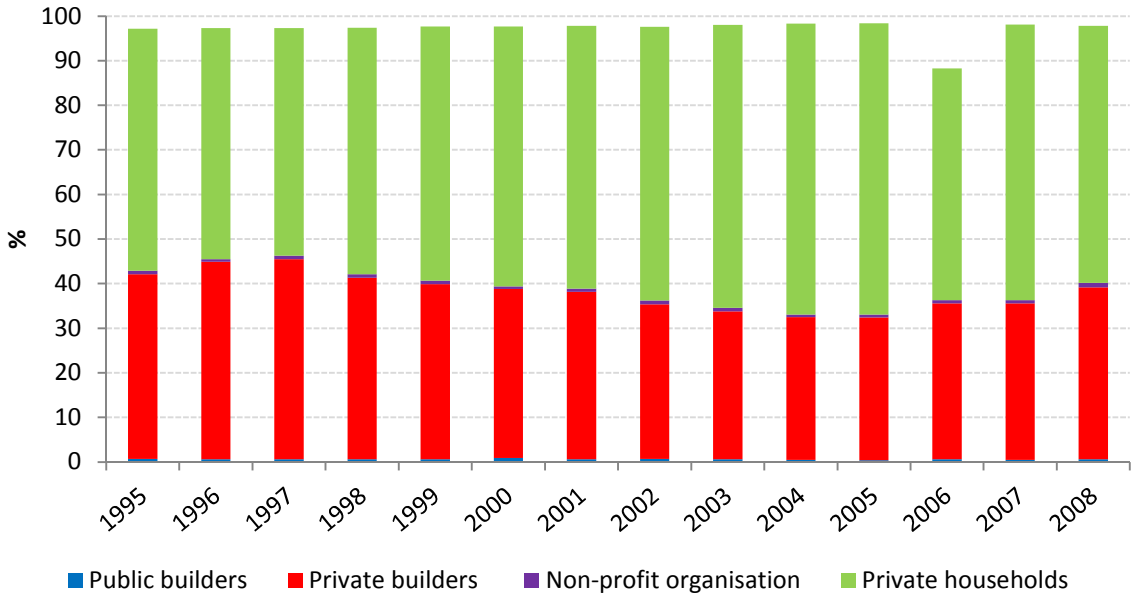
Supply is a particularly important issue in cities which are expected growth areas, with calls for increasing subsidisation to alleviate shortages of dwellings in the likes of Berlin, Hamburg and Munich. This means that there are no national policy discussions about increasing the size of the PRS. On the contrary, the vacancy rate of dwellings was and still is an issue in Germany, where the government has in place some public programmes for redeveloping the stock or incentivising private landlords to modernise the stock.

This section will assess the supply incentives of each actor in the PRS. It shows that supply is usually incentivised by long term investment with stable and safe returns.[45] Nonetheless, these incentives are very important in explaining the popularity and growth of investment in the PRS market, where there is low short term capital gains.

Investment in new build private rented housing has been decreasing since the 1990s, but this does not accurately reflect the total amount of investment in the sector, as investment in the existing stock surpassed the total in new stock since 2000.[46] Figure 8 demonstrates the stability of German supply in terms of providers, where public and non-profit construction is very limited in comparison to the private builders and private households. This helps to explain the overall reduction of non-private dwellings in the German housing market.

[43] Edward Glaeser, Joseph Gyourko and Raven Saks (2006) 'Urban Growth and Housing Supply' *Journal of Economic Geography* 6(1), 71.
[44] Aida Caldera Sanchez and Åsa Johansson (2011) 'The Price Responsiveness of Housing Supply in OECD Countries' *OECD Economics Department Working Papers* 837.
[45] Stefan Kofner (2010) 'Private Vermieter' [Private Renter] *Wohnungswirtschaft und Mietrecht* 3, 123-131.
[46] Bundesinstitute für Bauwesen und Raumordnung (2007) *Wohnungs- und Immobilienmarkte in Deutschland 2006 [Housing and Real Estate in Germany 2006]*. Bonn: BBR.

FIGURE 8: NEW HOUSE BUILDING IN % OF TOTAL NUMBER OF NEW DWELLINGS, GERMANY, 1995-2008



Note: The columns do not add up to 100 because of a category "other" which are not included.
Source: Promoting investment in private rented housing supply. International policy comparisons, Nov. 2010 Department of Communities and Local Government and Statistisches Bundesamt(2009) Fachserie 5, Reihe 1, Jahrgang 1995-2008.

INDIVIDUAL INVESTORS

Most countries with a large private rented sector has a large proportion of that stock owned by individual investors, who usually own only one or two dwellings. In Germany individual investors comprise of approximately 60% of the market and the average size of individual holdings is slightly higher, and can range from six to 45 dwellings. These investors are attracted to the market due to the acceptable rental returns which supplements the pension provision for the individual.

Kofner argues that these individual landlords are more likely to have problems coping with changes such as decreasing demand, increasing number of elderly, increasing share of migrants, high government aims for energy saving, and the limited financial public aid available.[47] A German survey suggested that only 27% of individually owned rental dwellings were not self-managed, but rather use agents to manage their properties.[48]

[47] Kofner (2010) Ibid [47].
[48] BMVBS/BBR (2007) *Investitionsprozesse im Wohnungsbestand – unter besonderer Berücksichtigung privater Vermieter* [Investment processes in the housing stock – with special attention for private person landlords]. Berlin/Bonn: BMVBS/BBR.

INSTITUTIONAL INVESTORS

Institutional investment is defined as investment by the GdW-members, which consists of municipal housing companies (42%), cooperatives (37%), private housing companies (15%), public housing companies (3%), church housing companies (2%) and other housing companies (1%). The composition of the housing market is further elaborated on in chapter 5, which compares the investors with the owner-occupied sector.

Privatisation of Social Housing

Since 1997, there has been a significant sale of social dwellings or former public property (*Volkseigentum*) to financial investors, including private equity firms, German and Foreign Public Ltd firms and institutional investors. These privatisations have significantly slowed down over recent years, due to the political risk of selling social dwellings, low liquidity in the financial markets restricting debt capital and investors suffering in the crisis. Their investment has modest expectations of return in the long run, where their business management increases the profitability due to increased efficiency.

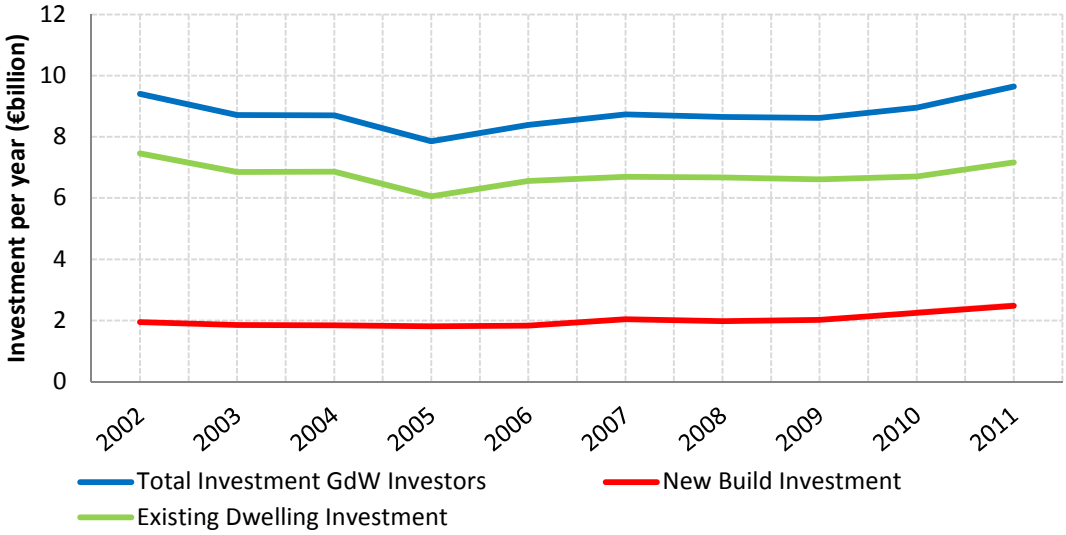
In 2006 Dresden sold its entire stock of 48,000 city-owned apartments to GAGFAH, controlled by the American private equity firm Fortress Investment Group, for $1.2bn (€1.7bn). This wiped out the city of Dresden's public debt in one stroke. The purchase was conditional upon holding onto 32,000 apartments for at least 10 years, a limited ability to raise rents and a restriction against luxury renovation. However, the City of Dresden later brought GAGFAH to court in protest against undermining the social conditions, and they made a settlement out of court. GAGFAH found that the assets failed to deliver the rental income and sales proceeds to justify the high prices. In order to pay off their €3.1bn of debt due, GAGFAH are selling the homes for at least their book value of €1.8bn, with the net profit amounting to €14.8m.

Investment

GdW estimates that their housing companies invested €9.642bn in 2011, which amounts to a nominal increase of 7% from the previous year.[49] Figure 9 shows that investment in the existing stock is nearly 3 times as large as investment in new building. The GdW argues that the decrease in construction since the 1990s is the result of the abolition of the degressive depreciation deduction in combination with the increasing complexity around renovations for energy saving – which is addressed later in this chapter.

[49] GdW (2012) *Wohnungswirtschaftliche Daten und Trends 2012/2013: Zahlen und Analysen aus der Jahresstatistik des GdW* [Dwelling Economic Data and Trends 2012/2013: Figures and Analysis from the Annual Statistics of the GdW]. Berlin: GdW.

FIGURE 9: DEVELOPMENT OF GDW INVESTMENT



Source: GdW (2012) Wohnungswirtschaftliche Daten und Trends 2012/2013: Zahlen und Analysen aus der Jahresstatistik des GdW [Dwelling Economic Data and Trends 2012/2013: Figures and Analysis from the Annual Statistics of the GdW]. Berlin: GdW.

Returns on Capital

Returns in the PRS have been low, but stable, reflecting their status as a safe asset. The returns generally come in from income rather than capital gains, as house prices have not been increasing in the last two decades. The only negative issue for investment in Germany is the vacancy rates, which amounted to approximately 11% in the East and 3% in the West.

The income return on the stock can be increased by institutional investors who can buy stock on large scale, thus reducing acquisition and disposal costs, management costs and market information.

The IPD Annual Property Index shows the returns on investment for different property classes. Apart from in 2008, the return on investment for German residential property has remained consistent due to the steady income returns available to landlords in the PRS.

Policy Debate about Institutional Investors

There are no special measures to promote institutional investors other than the measures which are available to all different types of investors, which will be explained later in this chapter. Similarly there are no debates about increasing institutional investors. However, there is concern about the 'social face' of the non-German institutional investors, who are more focused on larger dividends through profit maximising. Their business model of increasing income return over a period of capital gain growth does not fit in with the historical characteristics of the sector, and thus created resentment among tenants in Germany. Foreign investors see the German rental market as both a lucrative and safe asset.

- **Attractive Asset** – Stagnating price development over the past two decades, attractive financing conditions, more than average income returns, a low rate of ownership and a large portfolio of dwellings available. These conditions have been existing since 2005, around the time when foreign investors were buying former social/public housing stock. Nonetheless, many of these characteristics still exist.

- **Safe Asset –** Many of the pension funds in Europe are near the point of having to pay out the pensions and are on the threshold of adequate capital. Nonetheless, they have significantly invested into state bonds since the crisis, especially the German Bund. The expansionary monetary policy of the ECB is expected to decrease, and in the medium run inflation and interest rates will increase, thus reducing the dividend on bonds. Thus the pension funds are looking to safe assets to reallocate their portfolio away from bonds. With other investment looking risky, such as gold and equities, the pension funds see the stability of the PRS as a perfect investment class. The long run factors for the prosperity of the PRS as an investment class results from both the investment inducing measures by the government and by the demand factors described in this report, which should be added to the expected house price increases shown in chapter 5.

Quantitative easing by the European Central Bank has influenced the housing sector through the portfolio balance channel, where investors have been incentivised to invest in riskier asset classes because the yields on safe assets have been pushed down. The main route of this investment in the housing market has been through the rental sector, where most of the new household formation has been and demand has always been high. Given the increased demand for rental housing, the rent prices have increased and are expected to increase. With other asset yields declining steadily, investors now see value in buying real estate for conversion into rental units. The demand for rental dwellings might have increased due to natural increase in smaller households, but the effect of QE has accelerated this portfolio rebalance. Nonetheless, it is essential to consider that the amount of foreign investors in the German residential market is less than 1% and decreasing.

REAL ESTATE INVESTMENT FUNDS

Apart from direct ownership of private rental dwellings, indirect investment in Germany comes through financial vehicles. A REIT is a security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. Essentially it is a mutual fund for real estate with retail investors obtaining the benefit of a diversified portfolio under professional management. REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.

- **Equity REITs**: Equity REITs invest in and own properties (thus responsible for the equity or value of their real estate assets). Their revenues come principally from their properties' rents.

- **Mortgage REITs**: Mortgage REITs deal in investment and ownership of property mortgages. These REITs loan money for mortgages to owners of real es-

tate, or purchase existing mortgages or mortgage-backed securities. Their revenues are generated primarily by the interest that they earn on the mortgage loans.

REIT involvement in the German property market has been very small, but they were introduced into law in 2007, out of fear of losing out on investment in the market to other nations. The law establishes the following rules in Germany:

- REITs will have to be established as a corporation "REIT-AG" or "REIT-Aktiengesellschaft".
- At least 75% of its assets have to be invested in real-estate.
- At least 75% of the German REIT (G-REIT) gross revenues must be real-estate related.
- At least 90% of the REIT's taxable income has to be distributed to its shareholders through dividends.
- The corporation is income-tax-exempt, but the shareholders will have to pay individual income tax on the dividends.
- Some restrictions apply on establishing residential REIT's

As of May 2013, there are five G-REITs listed with one company registered at the Federal Central Tax Office (*Bundeszentralamt für Steuern*) as pre-REIT, with a total market capitalisation of €1.8bn.

TAX

Taxable net rental income is crucially affected by the deductions that are possible against gross rental income. Tax further explains the interest of investors from abroad, where the low tax rates compared to Denmark incentivised Danish investors.[50] The government has not changed the tax structure over the last several years, thus there is little legal complaints. The applicable taxes will be set out first, and then the deductions will follow.

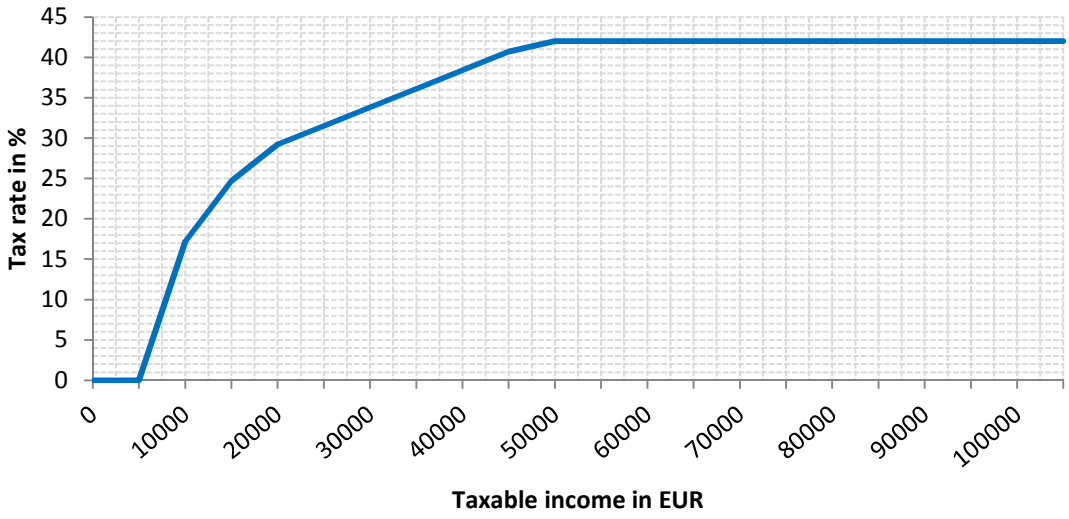
Rental Income Tax

Rental income is treated as private individual income and is treated to the same progressive income tax. The rate of income tax in Germany ranges from 0% to 45%. As a progressive tax, the average tax rate (i.e., the ratio of tax and taxable income) increases monotonically with increasing taxable income, as shown in Figure 10. Moreover, the German taxation system warrants that an increase in taxable income never results in a decrease of the net income after taxation. The latter property is due to the fact that the marginal tax rate (i.e., the tax paid on one euro additional taxable income) is always below 100%.

There are two types of income tax – tax on wages (*Lohnsteuer*) and tax on income (*Einkommensteuer*). The difference is the method of collection; tax on wages is withdrawn at source and paid to the tax office by the employer, while income tax (on income from self-employment, rental income, investments, etc) is paid directly by the individual taxpayer.

[50] Although due to other considerations, foreign investment in the German real estate market remains below 1% of the total market.

FIGURE 10: MARGINAL TAX RATE ON INCOME FOR SINGLES IN GERMANY, 2014



Source: Bundesministerium der Finanzen

Corporation Tax (*Einkommenssteuer*)

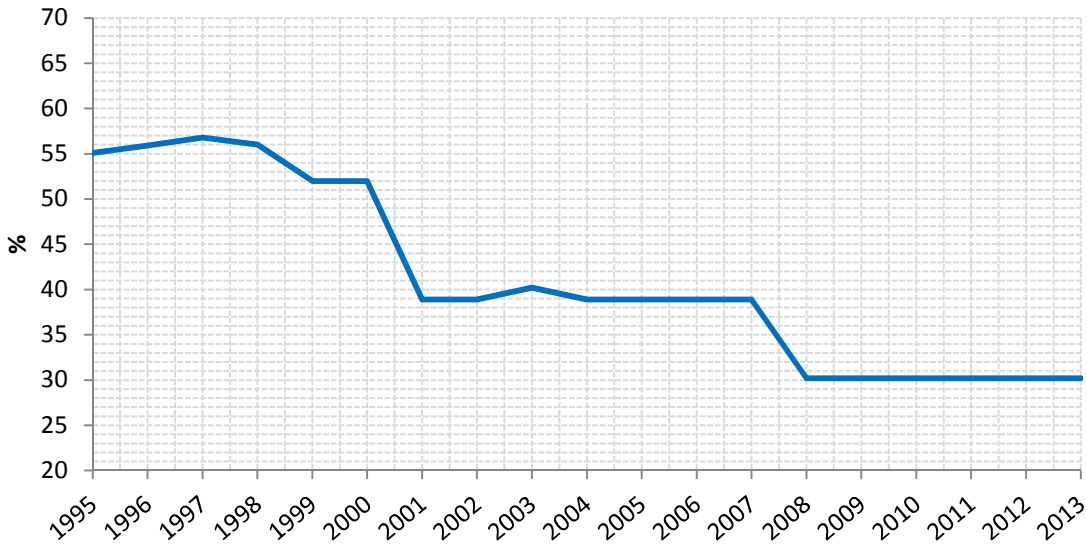
Corporation tax is charged first and foremost on corporate enterprises, in particular public and private limited companies, as well as other corporations such as e.g. cooperatives, associations and foundations. Sole proprietorships and partnerships are not subject to corporation tax: profits earned by these set-ups are attributed to their individual partners and then taxed in the context of their personal income tax bills.

Corporations domiciled or managed in Germany are deemed to have full corporation tax liability. This means that their domestic and foreign earnings are all taxable in Germany.

Some corporate enterprises are exempted from corporation tax, such as charitable foundations and Church institutions. Cooperatives whose rent revenues comprise more than 90% of the revenues have a fiscal non-profit status, and are thus exempt from paying corporation tax.

Corporation tax is a flat tax set at 15% on the revenues the corporation has earned in the calendar year. With the additional solidarity tax (below), the effective total tax is 15.8%. When dividends are paid to an individual person, capital yield tax at a rate of 25% is charged. As Figure 11 shows, the German tax rate on Corporate Income has decreased from 55% in 1995 to 30% since 2008.

FIGURE 11: GERMAN TAX RATE ON CORPORATE INCOME



Note: This graph shows the basic combined central and sub-central (statutory) corporate income tax rate given by the adjusted central government rate plus the sub-central rate. The rates include the regional trade tax (Gewerbesteuer) and the surcharge.
Source: OECD Tax database, table II. 1 Basic (non-targeted) corporate income tax rates http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial

Capital Gains Tax (*Abgeltungsteuer*)

There is a capital gains tax on properties which are sold within 10 years of ownership. This is to prevent speculative housing investments and to encourage long-term holdings of investments in the market. Capital gains tax is 25%. A capital gain from the sale of real estate that is re-invested in the purchase of alternative real estate is exempt from tax, subject to certain conditions. Capital gains tax does not apply to commercial real estate dealers.

In comparison, capital gains tax is charged for financial instruments such as shares and bonds that have been bought since 31 December 2008.

Solidarity Tax (*Solidaritätszuschlag*)

Solidarity tax was introduced during reunification to finance the 5 new East German states, but later has evolved into a tax for publically funded projects in the whole of Germany. It is paid for by all German employees and firms. The Reconstruction of the East (*Aufbau Ost*) started in 1991 and will finish in 2019, transferring nearly €200bn through this tax. Nonetheless, there is fears that the former East German states will not be fiscally sustainable after this period, where new European Union rules on fiscal governance will restrict the ability of state debts and federal bailouts.[51]

[51] Heiko Burret and Lars Feld (2013) 'Fiscal Institutions in Germany' *Swiss Journal of Economics and Statistics* 149(2), 249-290.

The Solidarity tax is a levied income tax (i.e., not the taxable income). In other words, this is where the income tax rate is 25% the effective solidarity surcharge rate is 5.5% x 25% = 1.375% and the effective income tax rate amounts to 25% + 1.375% = 26.375% (not 25% + 5.5%).

Church Tax (*Kirchensteuer*)

When a person declares themselves within a church, they must pay a church tax of between 8-9% of their income tax. For example, a single person earning €50,000 may pay an average income-tax of 20%, thus €10,000. The church tax is then 8% (or 9%) of that €10,000 - €800 (or €900).

Property Tax (*Grundsteuer*)

Real estate tax is levied on real estate in Germany. The tax base is the assessed value (*Einheitswert*) of the property as fixed by the Finance Authority (i.e. assessed value which is usually lower than the purchase price) and rates depend on the location of the property. The basic tax rate is 2.6% to 3.5% for Western federal states, 5% to 10% for the Eastern federal states. The resulting base amount is further multiplied by municipal coefficients to calculate for the final tax due, which ranges from 280% to 810%. The multiplier is 460% for Frankfurt. The tax rates vary because they depend on the decision of the local parliament. Real estate tax is deductible for income tax purposes if the property is used in a trade or business.

Transfer Tax (*Grunderwerbsteuer*)

This is in effect the equivalent of stamp duty in the UK. Since 1 January 2007 this tax is no longer set at federal level and comes under authority of local governments. While most states and cities have so far kept the transfer tax at the previous rate of 3.5% (of the purchase price), Berlin and Hamburg have increased the rate to 4.5%. Transfer tax is generally paid by the buyer. Therefore, for an investor buying a large stock of dwellings, the 1 percentage point difference would prove significant.

Value Added Tax (*Umsatzsteuer or Mehrwertsteuer*)

Letting and leasing of immovable property is exempt from VAT according to § 4 No. 12 *Umsatzsteuergesetz* (Sales Tax Act). The transfer of real estate is not subject to VAT. However, it is possible to 'opt to tax' depending on the purchaser's VAT status. The sale of real estate by way of an asset deal is either "VATable" but tax exempt or "non-VATable" as a transfer of a business as a going concern under German VAT law. Shares have to be analysed on structuring the transaction to see whether they are subject to German VAT at all, as they can be treated as a non-VATable transfer of a business as a going concern, or they can be VATable but (unless the seller opts out) tax exempt. VAT is charged at the standard rate of 16% (19% from 2007) or a reduced rate of 7%.

Deduction I: Degressive Depreciation Deduction (Abolished 2005) – Linear Depreciation Allowance (Since 2005)

Since 1950 the degressive depreciation deduction in income and corporation tax has been ascribed a large part of the successes of the free-financed PRS. In other words, although there was a difference between corporation tax and personal income tax in terms of tax rates, there was no difference between the two taxes in the way of deducting appreciation. This scheme was in place with only a few minor variations until it was abolished in 2005 with a regular system of linear depreciation.[52]

Str oanu very clearly sets out the difference between degressive and linear depreciation.[53] Degressive depreciation, alternatively known as accelerated depreciation, means that the value of the depreciation allowance for tax purposes is generous in the early years of ownership and goes down over time. It recognises that the productivity of the stock has greater capacity at the start of its life and incentivises investment over time. Linear depreciation is based on the theory of depreciation or utilization distributed regularly in time and consists in the uniform calculation and allotment of the input accounting value of the fixed assets throughout the normal useful life expressed in years.

The earlier scheme was much more generous than the new scheme, whereby a large incentive for investment in the private rental sector was removed. It allowed owners to choose between linear and degressive depreciation systems. The degressive depreciation system meant that in 2005 the annual depreciation was 4% for the first ten years, 2.5% until year 18 and 1.25% from year 19 to 50. Table 9 shows the development of the earlier systems, and how this has developed over time, reflecting the need to increase investment in housing during the different periods.

Fiscal depreciation is regarded as a powerful subsidy, as each buyer-landlord of the property could take advantage of the deduction on the basis of the historical purchase price. Thus, house price inflation alone gave the landlords incentives to sell off the dwelling in order to build new dwellings. Braun and Pfeiffer calculated that landlords could have **reduced rents by 20% of the market rent** if they were to pass the benefits to their tenants in full.[54] This would have made renting more attractive than home ownership. A Report for the British Department of Communities and Local Government in 2010 highlighted the role depreciation allowances has played in the German private rented market, and suggested it could be an option to encourage growth in the British private rented market.[55]

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[52] Bundesministerium der Finanzen (2009) *Übersicht die Steurrechtsänderungen seit 1964* [Overview of tax changes since 1964]. Berlin: Referat IA5).
[53] Boni Mihaela Stråoanu (2009) 'Definitions and Groundings Regarding Depreciation According to the Useful Life' found at http://fse.tibiscus.ro/anale/Lucrari2009/111.%20Straoanu.pdf (accessed 22/06/2013).
[54] Rainer Braun and Ulrich Pfeiffer (2004) *Mieter oder Eigentümer – wer wird starker gefördert? Eine analyse der Folgen des Subventionsabbaus zum Jahresbeginn 2004* [Tenants or homeowners: who is more highly subsidized? An analysis of the results of phasing out subsidies at the beginning of 2004]. Berlin: Empirica.
[55] Oxley et al (2010) Ibid [36].

TABLE 9: DEVELOPMENT OF DEGRESSIVE DEPRECIATION DEDUCTION ON NEW-BUILT RENTED DWELLINGS

Before 1989				
Years	***1-8***		***9-14***	***15-50***
Annual depreciation	5%		2.5%	1.25%
Cumulative depreciation	40%		55%	100%
From 1989				
Years	***1-4***	***5-10***	***11-16***	***17-40***
Annual depreciation	7%	5%	2%	1.25%
Cumulative depreciation	28%	58%	70%	100%
From 1996				
Years	***1-8***	***9-14***		***15-50***
Annual depreciation	5%	2.5%		1.25%
Cumulative depreciation	40%	55%		100%
2005				
Years	***1-10***	***11-18***		***19-50***
Annual depreciation	4%	2.5%		1.25%
Cumulative depreciation	40%	60%		100%

Source: Michael Oxley, Ros Lishman, Tim Brown, Marietta Haffner and Joris Hoekstra (2010)'Promoting Investment in Private Rented Housing Supply: International Policy Comparisons' Report for the UK Department for Communities and Local Government.

Depreciation allowances simply reduce the rental income tax due in investments, including the construction of new dwellings for rental, and this increases the profitability of such investment. Incentive schemes linked to depreciation allowances sometimes carry conditions to limit rent, but this is not the case in Germany.

The policy changed in recognition that there was less need for new supply into the German rental market as there was after WWII or the fall of the wall. The policy concern now was the difference between growing and shrinking cities and regions. Some analysts are even predicting the reintroduction of generous depreciation allowances, which are more due to political economy reasons rather than economic allocative efficiency.[56] Currently depreciation allowances for income tax are set at 2% per annum for 50 years for properties built since 1925, and 2.5% for older properties over 40 years.

Deduction II: Acquisition Related Fees

Acquisition fees are expenses that may be occurred after the acquisition of the property in the first three years.

- Expenses exceed 15% of acquisition costs: these are attributable to the acquisition cost and increase the depreciation base (with the depreciation rate remaining unchanged).
- Expenses below 15% of acquisition costs: these can be deducted in the tax year as business expense.

[56] Rainer Zitelmann (2013) ' A Comeback for Tax Breaks?' *Zietelmanns Financial Blog*, found at http://www.zitelmanns-finance-blog.com/a-comeback-for-tax-breaks/ (accessed 20/11/2013).

- When the expenses are for modernising the heating, plumbing, electrical system and windows, the 15% limit is ignored and the costs increase the depreciation base.

Deduction III: Deduction of the Costs of Investment in the Existing Stock in the year of Investment

The costs of modernising or renovating the existing dwelling can be deducted from income for tax purposes. This must be factored into the range of modernisation incentives given to landlords.

Deduction IV: Losses from Rental Income can be Deducted Against Income Tax

Any negative income from housing can be deducted from other income for tax purposes, thus mitigating the risk of investing in areas of a projected reduction in demand. In other words, landlords can benefit not only by paying no income tax on current rental income (because it is negative) but can pay less on their income from work. Until recently this deduction against income tax was also applicable to losses made on stock and savings accounts, showing the continued protection of the rental market from investors losing out to cyclical downturns or unpopular areas.

Further Deductions (*Werbungskosten*)

Other expenses which are tax deductible against income include:

- Expenditures for water, electricity or fuel – these costs are allocated to the tenant
- Property tax
- Depreciation on leased furnishings
- Financing costs (interest on mortgage, debt, discounts and savings agreements), provided they are directly connected to the dwelling
- Costs for legal services in connection with the lease
- Insurance
- Administrative costs

ENERGY EFFICIENCY IMPROVING LOANS

The government has refocused housing policy from the creation of new stock to the energy efficient modernisation of the existing stock, due to the large supply of housing stock and the needs to meet higher energy efficiency targets.[57] Should demand in the German housing market increase, the political debate might return to the energy efficiency enhancement of new dwellings rather than modernisation of old dwellings.

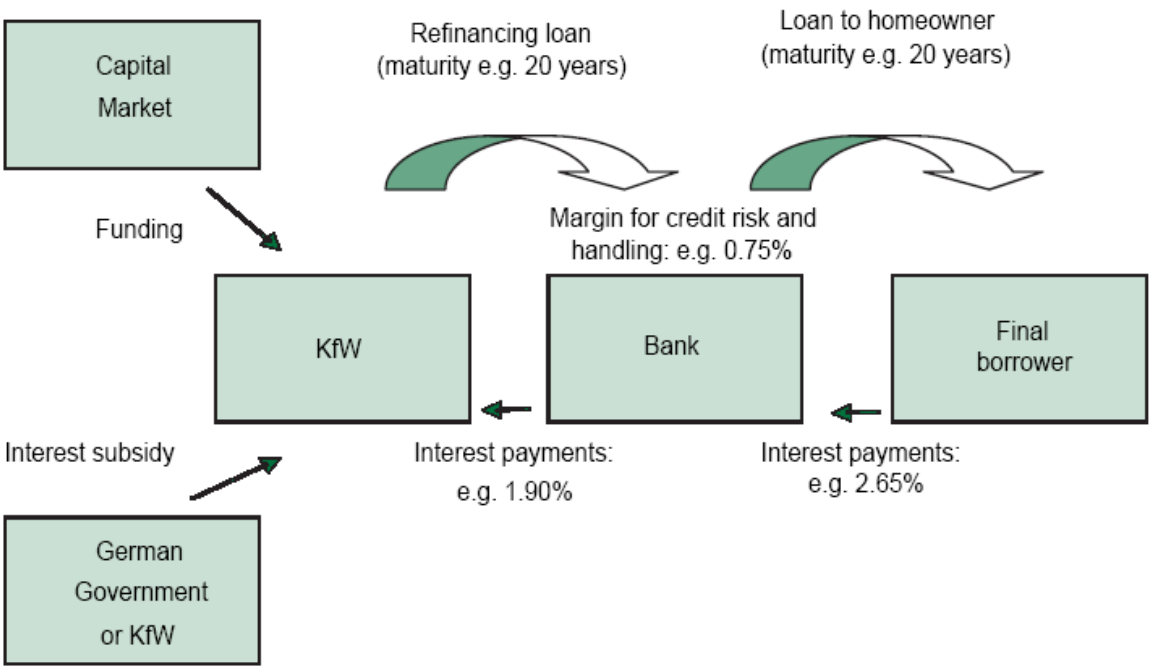
[57] For an in-depth analysis of the growth in German energy efficiency, including policies to promote energy efficiency of the housing stock, see Anne Power and Monika Zulauf (2011) ' Cutting Carbon Costs: Learning from Germany's Energy Saving Program' *What Works Collaborative* found at http://sticerd.lse.ac.uk/dps/case/cp/CCCfull.pdf (accessed 07/08/2013).

KfW Bankengruppe

KfW *Bankengruppe* is a promotional bank of the Federal Republic of Germany, which was founded in 1948. It has a balance sheet of around €400bn, with its shareholders comprising of the Federal Government (80%) and the Federal States (20%), giving it a credit rating of AAA/Aaa/AAA by the three agencies. It is one of the world's biggest financing institutions for energy efficiency and renewable energy, committing €8.1bn and €0.3bn in both of these respective causes in 2008. This subsection introduces the basis service of the KfW applicable to the private rented sector.[58]

The KfW has developed a key institutional role in the German housing framework for meeting the energy requirements for new and existing buildings set out in the German Energy Conservation Ordinance (*Energieeinsparverordnung, EnEV*). They give out low interest loans and grants for energy efficiency construction or rehabilitation in the residential building sector. Figure 12 shows the financial arrangement between the KfW, government, banks and households.

FIGURE 12: KFW LENDING ARRANGEMENT



Source: GDW (2011) 'The Green Investment Bank' UK Environmental Audit Committee (found at http://www.publications.parliament.uk/pa/cm201011/cmselect/cmenvaud/505/50510.htm), Annex A.

[58] For a more expansive report on KfW in English and whether the KfW could be introduced into the UK, see Mark Schröder, Paul Ekins, Anne Power, Monika Zulauf and Robert Lowe (2011) 'The KfW Experience in the Reduction of Energy Use and CO_2 Emmissions from Buildings: Operations, Impacts and Lessons for the UK' *UCL & LSE*, found at http://sticerd.lse.ac.uk/dps/case/cp/KfWFullReport.pdf (accessed 10/10/2013).

There are two types of loans available: construction and rehabilitation.

1. **Energy Efficient Construction**: These loans are used to construct a KfW-Efficient House and are targeted to all investors. It is constricted only to the construction or initial purchase of a KfW House.

2. **Energy Efficient Rehabilitation**: These loans are used for energy saving and $C0_2$ emissions in residential apartments and are targeted to all investors. The measures which contribute to this aim must fulfil the technical requirements of the programme.

The loans have better financing conditions the higher the energy efficiency achievement. As the energy efficiency increases to a lower kWh/a, the repayment bonus increases. In other words, at energy level 140kWh/a, all 100% of the loan has to be repaid, whilst at 40kWh/a only 55% of the loan is repaid.

The KfW also give out Energy-Efficient Rehabilitation Grants, which are aimed at reducing energy consumption and CO_2 emissions in residential buildings. They are available for all measures which contribute to achieving KfW-Efficient Houses and fulfil the technical requirements of the program. The grants increase as a percentage of the overall investment cost in accordance to the energy efficiency attained.

- **Individual Measures**: 5% of the eligible investments costs, no more than €2500 per housing unit.
- **KfW-Efficiency House 100**: 10% of the eligible investment costs, no more than €7500 per housing unit.
- **KfW-Efficiency House 70**: 17.5% of the eligible investment costs, no more than €13,125 per housing unit.
- Furthermore, there are **additional grants** for special support.

Finally, the KfW also gives out grants for the reconstruction of dwellings to meet the needs of elderly people. This is under their lesser funded aim of adapting the housing stock to meet the demographic requirements. These work under fairly the same operation as the energy efficient interest rate subsidies and investment grants, and amounts to around €80bn per year.

***Bundesamt für Wirtschaft und Ausfuhrkontrolle* (BAFA): Federal Office of Economics and Export Control (Energy)**

BAFA is a federal department which provides subsidies for investment in renewable energy, including energy efficient buildings and solar panels. Under the programme "Local consultations to save energy" BAFA gives grants for consultations with home owners by qualified engineers. The reduction of heat consumption in buildings as a result of these local consultations has diminished environmental pollution, mainly CO2-emissions.

BAFA promotes projects of the newly founded Deutsche Energie Agentur GmbH (DEnA) (German Energy Agency) by granting federal subsidies. DEnA task is to obtain lasting improvements in saving energy and a more efficient use of energy in

private households, companies and public administration as well as the utilization of regenerative energy resources.

Summary of Overall Energy Efficiency Modernisation Incentives

For the landlord, there are therefore several incentives to increase the energy efficiency of the dwelling:

1. The landlord can increase the rent by 11% of the construction costs, meaning the construction costs can be passed onto the tenant over 10 years.
2. The landlord can deduct the costs against his income for tax reasons. In other words, income tax would be a percentage of the profit for that year.
3. KfW *Bankengruppe* energy efficient rehabilitation grants and loans at low market interest prices and repayment discounts.
4. Government financed energy efficiency consultation.
5. Increased value of the dwelling.
6. No longer will have to relocate the tenant or reduce the rent while the construction work is taking place.
7. The tenant cannot reject the modernisation work, unless it would cause severely undue economic or physical stress.

FEDERAL AND STATE SUPPLY SIDE SUBSIDIES

The favourable tax conditions for the PRS ensured considerable private investment as a means of tax saving. However, after reunification the Federal Government had to repair the terrible condition of the East German houses. In such areas they extended the tax advantages and gave out supply side subsidies. Many households thus invested into the East German states, which has resulted in a significant proportion of the former GDR dwellings having been renovated. However, the efficiency of these programmes are questionable when there is no demand for housing in these areas and thus the subsidies were used just for tax purposes.

***Soziale Stadt* (Programme on the Social City)**

This programme, which is sponsored by the Federal and Lander governments, is a subsidy for declining neighbourhoods. By 2009 there was 571 area programmes implemented in 355 municipalities. The premise of the programme is the massive social and economic challenges in many cities following the reunification process in the 1990s. The programme provides a comprehensive approach to neighbourhood development, which would stimulate the housing quality, demand and supply.

***Stadtumbau Ost* (Urban Restructuring East)**

This programme was launched by Federal and Lander governments jointly in 2002 to help the declining population and increasing housing vacancies in East Germany and to increase the attractiveness of these cities to boost demand and investment in the housing markets. It developed urban development strategies, such as demolishing vacant dwellings, improvement of inner city neighbourhoods and the preservation of worthy buildings or spaces.

Between 2002 and 2012 there has been a total of €2.7bn invested in this project, of which €1.3bn is from the federal government. For 2013 a further €84m will be proved from the federal government. Since the beginning of the programme, over 400 communities have been regenerated. The programme has been evaluated positively, and the government has committed to continue the programme. Therefore, this Federal and state programme is encouraging investment into the PRS in the Eastern States, as they are mitigating the negative demographic and economic characteristics which would have reduced the market prices for rent.

***Stadtumbau West* (Urban Restructuring West)**

This programme was established in 2004, two years after the Stadtumbau Ost, in recognition of the structural changes which were negatively affecting states in West Germany. While the East German operation was more of an urban development project, this is a preventive urban planning project to prepare for the structural change in the economy, labour market and demographics. The aim is to produce sustainable urban cities and towns.

Between 2004 and 2012 this programme has invested approximately €1.723bn in over 400 communities, of which €574m has come from federal grants. In 2013 federal grants to the project will amount to €83m. This shows that the programme is slightly smaller in size than the Stadtumbau Ost, but not far off.

With the federal-state program, the government wants to support the cities in western Germany, one is to anticipate the necessary adjustment processes. The aim is to produce sustainable urban structures on the basis of urban development concepts. Again, the benefit to the investor in the PRS in these areas is clear.

The program includes the following key points:

- Development and updating of integrated urban development concepts as a basis for making sustainable urban structures in cities,
- Appreciation of the relevant restructured economic and military urban areas, for example by converting brownfields or by strengthening neighbourhoods as residential and business locations,
- Customising the residential areas of the 1950s to the 1970s to current needs, creating sustainable, family-oriented and intergenerational living arrangements, including the avoidance of vacancies.

***Städtebauliche Erneuerung* (Urban Renewal Subsidies)**

This project aims to increase the physical structure of cities and towns, strengthen economic development, and to protect and improve natural resources in the built environment. The funds have been provided by the Municipal Investment Fund (*Kommunalen Investitionsfonds*, KIF) since 1980. Funding for projects can be provided to a variety of public and private partners, where equal opportunity is promoted.

In addition to funding opportunities for individual measures, there are also tax benefits. These include the tax deductibility of construction, maintenance or purchasing costs for buildings in redevelopment and urban development areas.

***Städtebaulicher Denkmalshutz* (Urban Heritage Conservation Programme)**

This programme secures, maintains, upgrades and develops the sustainability of buildings, ensembles and other structures within urban heritage. Furthermore, it has engaged in the conservation and transformation of streets and squares of historical, artistic and urban significance in the former East German Lander since 2009. The development makes the area more attractive for living, work, culture, tourism and leisure, thus increasing the quality of the area which in turn increases the demand for housing.

(Lack of) Social Housing Subsidies

The previous chapter on "Publically Subsidised Housing" has shown that the amount of state subsidies in social housing was so minimal that it was not crowding out private investment. Rather, the Federal Government delegated the responsibility of supplying social housing to the State Governments in 2006. The shift in responsibility was accompanied by a financial compensation from the Federal Government of €518.2m annually until 2013. It has given the state governments the ability to design their housing policies in accordance with their local challenges and political pressures.

The aim of social housing in Germany does not interfere with the PRS supply, as social housing is aimed at the demand from those who do not have access to the PRS. In other words, it is a safety net role of government to ensure there is no homelessness. This is unlike the public Housing Associations in the Netherlands who dominate the rental market both in terms of the market share and the market price setting ability, which has driven out private investment.[59]

CONDITIONAL OBJECT SUBSIDIES

Following the Second World War the government devised conditional object subsidies, which were available to all suppliers to incentivise private and non-profit sectors building dwellings in order to eradicate housing shortages. These bricks-and-mortar subsidies had four core components:

1. **Low interest loans or loans without interest contributions** provided for by the state for those who wanted to build their own homes. This lead to the growth of the home ownership, which became comparatively high in international terms. Nonetheless, for the PRS, landlords could also receive these loans, upon certain rental conditions.

2. **Conditionality of loans** provided to landlords included a restriction on only being able to rent out to low income households, limited dividends, cost determined rents and strong tenancy protection. In other words, they became the providers of what would be regarded social housing, instead termed "publically subsidised housing". The nature of social housing in Germany has been addressed at the start of this chapter, but the financial advantages in the long run are favourable for private investment due to the loan amortization period. Rents start at around €4/m^2 and then rise over time as the subsidies fall.

[59] Fitzsimons (2013) Ibid [34].

3. **Time limited conditionality**: The conditionality of the loans would essentially have limited the involvement in these dwellings to non-profit social organisations. The time period depends on the type of programme and extent of the subsidy, but has generally ranged from 40 years in the 1970s and 1980s to 12-20 years now. However, the German housing policy is shaped on the basis of the social market economy, where social and public amenities can be efficiently provided for by the private sector when the incentives and regulation are properly administered by government. This is the case with these conditional loans, as they are only conditional for a limited time period, after which they are free to be private rented dwellings under the normal rent regulation rules. In other words, the private investor will have compromised the conditionality set low rental returns with the reduced cost of the building of the dwelling and other compensations from the state. The time frames and the means of compensation have developed over the years as the system has been reformed.

4. **Compensation**: The public sector meets the gap between the amount received in rent or mortgage payment and a cost rent

Subsidisation under the 2nd Housing Act 1956 (*Zweites Wohnungsbaugesetz*)

Under this act only bricks-and-mortar subsidies were granted. Under this act there were three subsidy principles:

I. **Cost-rent principle**: Introduced in 1956, this caused over-generous subsidisation and thus resulted in rent distortion between housing built in different years. The commitments were valid until the loan was paid off. The periods of repayment became increasingly shorter, and on average were between 30 and 50 years. The income limit was very wide with 75% of the population able to access the social housing, although this has been decreasing over time.

II. **Higher income & Cost-rent principle**: This second subsidy was introduced in 1965 and largely aimed towards home-owners. It was open for households with income exceeding the limits of the first subsidy by 40%. The commitments were only 10-15 years, as it was aimed at subsidising a larger number of dwellings by means of a lower subsidisation in individual cases.

III. **Agreed Subsidisation**: Introduced in 1989 with the aim to make subsidisation more flexible and cheaper in individual cases, it allowed the *Länder* (states) to define the access restriction, rent levels, rent reviews, commitment periods and subsidy amounts, without reference to the cost-rent principle.

In 1981 the Act for the Reduction of Misdirected Housing Subsidisation was passed, allowing states to charge an income-related compensation payment to households whose incomes rose beyond the income limits after they moved in. In comparison, the access to the Dutch social Housing Association dwellings were not income reviewed after the tenants had moved in, meaning that high income households

were occupying dwellings required by the lower income households. Nonetheless, the Dutch government are introducing measures to increase rent for higher income households in the social dwellings. The 1994 House Building Subsidisation Act incorporated modernisation into the Second Housing Building Act, where previously social dwellings could only be built to receive the subsidies.

Subsidisation under the Housing Subsidy Act 2001 (*Gesetz zur Reform des Wohnungsbaurechtes*)

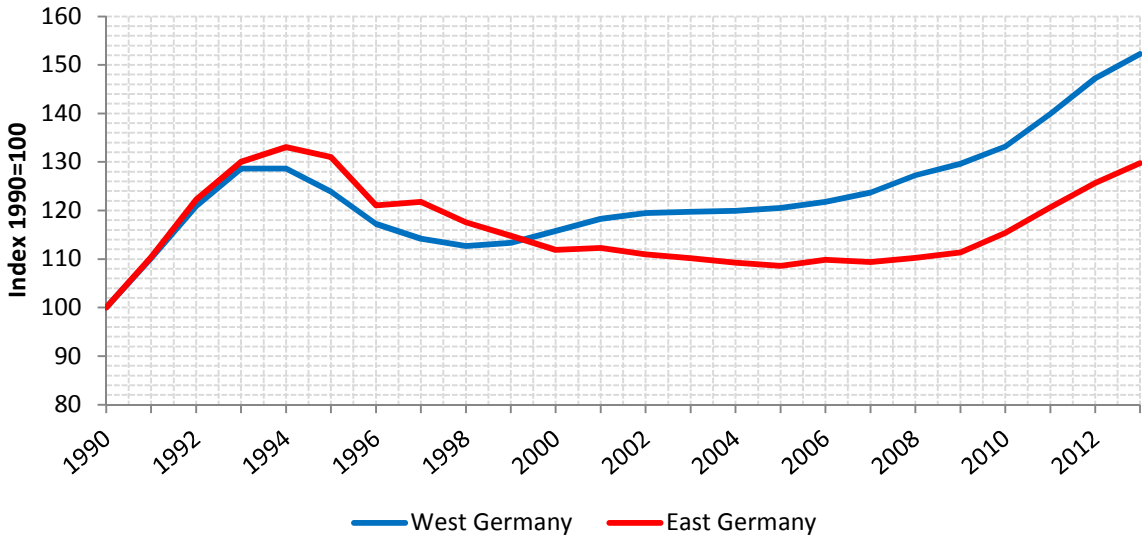
The September 2001 Housing Subsidy Act replaced the Second Housing Building Act of 1956, due to its shortcomings on target group restrictions, limit to bricks-and-mortar subsidies and inefficiency of the subsidies. Essentially the old act aimed to subsidise the housing market in wake of the post-World War II housing shortages and defunct capital markets. It was thus appropriately aimed at large sectors of the population. However, now that the housing and capital markets are adequately mature, the need for such subsidisation has significantly diminished, especially for the large accessibility and the focus on new builds.

The new act concentrates subsidies towards households who cannot find housing in the PRS. The income limits are generally that as the first subsidy method, although the *Länder* are allowed to deviate these. In other words, the new law marks a shift from a socio-spatial policy to individual care. The new law is also wider than the bricks-and-mortar subsidies, including the modernisation, purchasing of the existing property, the acquisition of occupancy commitments from existing stocks and the conclusion of contracts between municipalities and housing companies. The argument of the low income access limit is that the subsidies should only be available for those who do not have access to the private rental market, otherwise public subsidies into the PRS would amount to a crowding out effect and thus disrupt the social market economy.

Principles of Subsidiarity, Shared Contributions and Local Primacy

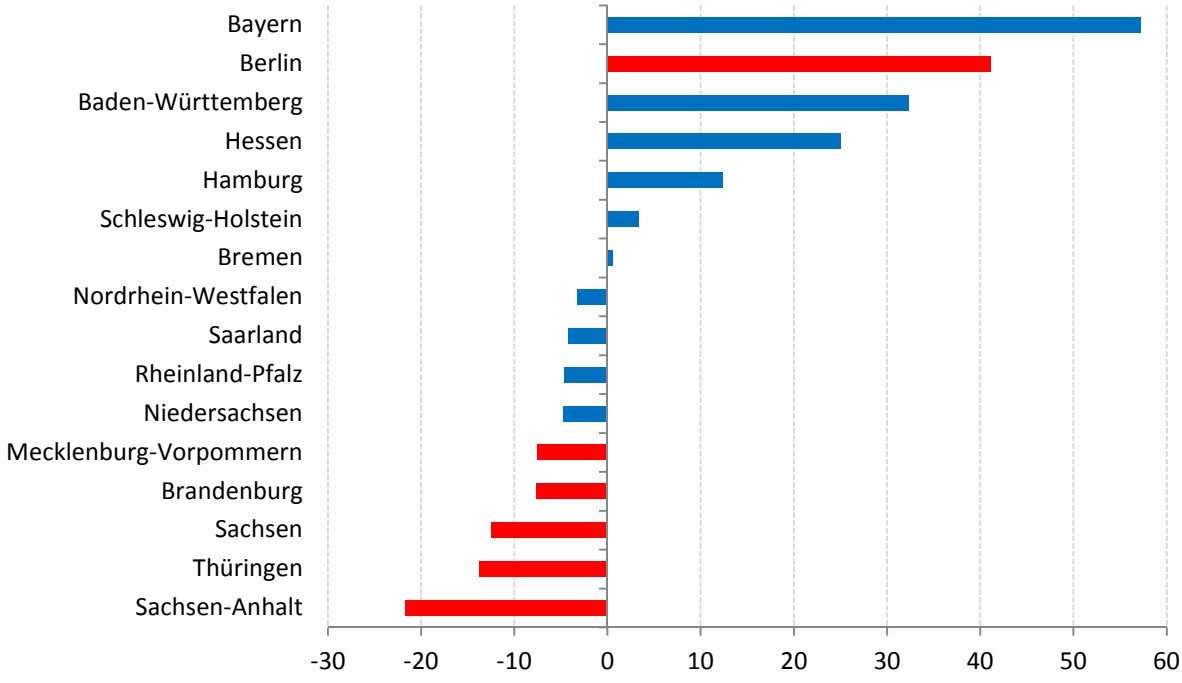
The Federal Government has increasingly transferred greater housing policy powers to the municipalities and states, where there has been a shift from national spatial housing policy to more local specific policies. Devolution of such policy allows the municipalities to solve their own issues, which vary greatly across Germany given the large economic divergence. Figure 13 shows the differences in rental prices between the East and West German states, indexed at 100 for 1990. Furthermore, the absolute rental and house prices are divided in Germany, which is assessed in Chapter 5 in the section 'House Prices: Regional Variety'. When considering that the municipality receives income through property tax based on the value of the dwelling, this means that the municipalities will have different incomes for their budget, and as such local spending must reflect these differences. Figures 14 and 15 shows the long term demographical variety between the different states, and implies that each municipality must direct their long term strategy in accordance with these challenges. For example, we can see that a negative population change in 5 out of the 6 East German states reflects significant long term challenges of diminishing demand, in comparison to Bayern and Berlin with increasing population and thus demand. The shift of powers in public housing to the municipalities thus reflects the variance in effects of demographic changes, which are analysed in further detail in Chapter 5.

FIGURE 13: RESIDENTIAL RENT PRICES: THE EAST-WEST DIVIDE



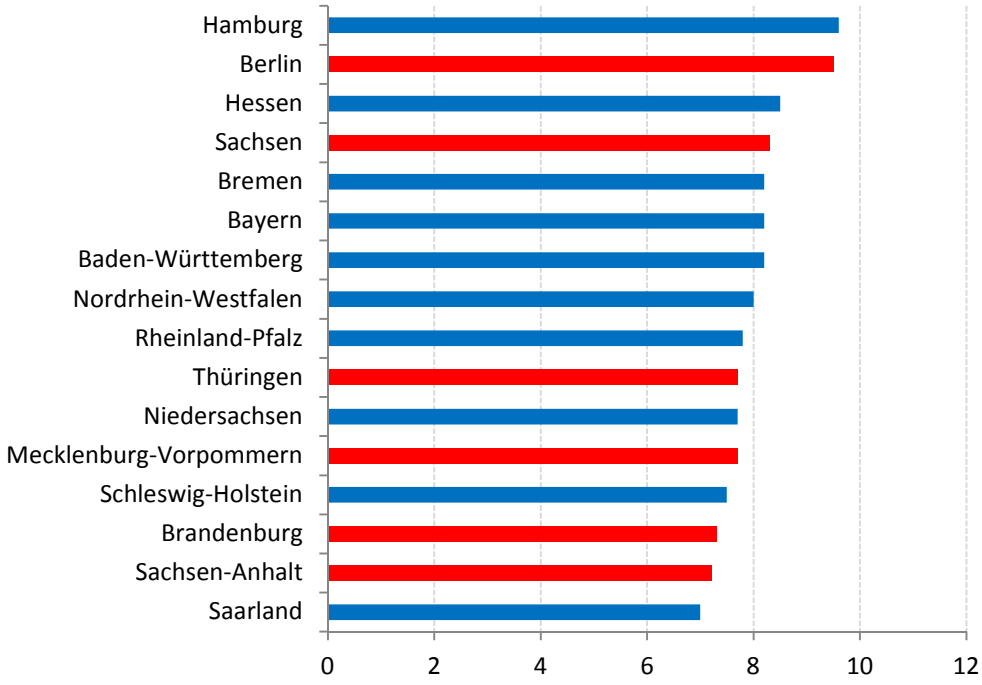
Note: Index is calculated based on the Euro/sqm. for residential rent (new and existing).
Source: Bulwiengesa AG

FIGURE 14: POPULATION CHANGE IN GERMANY IN THOUSANDS, 2011



Note: Red indicates East German states and blue West German states
Source: Eurostat

FIGURE 15: LIVE BIRTHS PER 1000'S INHABITANT IN GERMANY, 2011



Note: Red indicates East German states and blue West German states
Source: Eurostat

Although the housing policies differ between municipalities and states, the Federal funding has followed three core principles:

I. **Principle of Subsidiarity**: Matters should be dealt with at the most local level, where the federal or state governments only intervene when the municipality becomes over-burdened.

II. **Principle of Shared Contributions**: Requires the end users (residents) to pay their share (rents or mortgage payments) in addition to the government contributions.

III. **Principle of Local Primacy**: Requires that no housing will be created as the property of the state or federal government, and is thus legally private. All municipal housing authorities are governed by commercial law (*Wirtschaftsgesetzgebung*) with shares issued to the municipality.

Role of Non-Profit Organisations

The subsidies were not restricted to a specific target group of supplier, such as non-profit organisations, but were granted to all kinds of providers which must uphold the tenancy conditionality of the subsidies. Again this is part of the social market economy, where the private sector was encouraged to invest in the market for affordable homes with the long term incentive of acquiring the reduced cost dwellings for release into the private market. Nonetheless, a large part of the sub-

sidies were allocated to non-profit housing companies, which had non-profit constraints after the expiry of the subsidy-related commitments. They were able to maintain the below market rent prices mainly in part because of the tax advantages they received until these were removed in 1990.

Reduction of Conditional Object Subsidies and The Social Rented Sector

Since the 1970s (in the West), construction of new dwellings became less necessary, with the subsidies moving towards renovation and modernisation of the housing stock. Especially in municipalities with high vacancy rates the emphasis changed to renovating existing property to limit the build-up of potentially discriminatory clusters of homogeneous social housing.[60] This can be widely seen in the 2001 Act. Additionally the PRS became a very functional and mature market which could provide different quality of houses with a wide range of prices. The supply incentives explained above show that landlords were able to rent out dwellings on the private market at lower costs, and were somewhat limited with their rent increases due to the rent regulation. It was found that international investors were attracted in the 2000s to invest in low quality housing in East Germany, as a sign of the functioning of the private market. The shift of government policy was part of the transition from a planned economy towards the social market economy, where government had a much smaller and defined role to help house those unable to access the market. Thus, the subsidies were being significantly reduced.

At the same time as the number of subsidies was being reduced, there was an increasing amount of social housing which was becoming private housing. As described before, once the commitments to social housing rents had finished their time period, the rents could be raised to normal market levels and the properties could be re-rented without further restrictions. With the subsidies being reduced for new social housing and the time periods lapsing, more dwellings were leaving the social sector than were being replaced, leading to the sector decreasing in size to its current small share. The 1987 census stated that there were 3.9m social dwellings, which reduced to 1.8m in 2001. In Berlin in 2006, there were only 9% of dwellings in the west and 24% in the east of the city which are categorised as social or quasi-social housing. This was only mitigated by the share of the former housing being owned by the non-profit sector, which has kept the prices moderately low. This decreasing number of publically subsidised housing has become a greater political debate, particularly in growth cities with increasing rents in the private markets, as more people are now finding rents unaffordable.

SECURITY OF TENURE

It has been shown in Chapter 2 that security of tenure is guaranteed even when ownership of the apartment is traded or inherited, there is no opportunity for the landlord to sell the rented house on the free market to realise the capital gains. Thus the dwelling is locked into the sector, keeping the supply moderately stable. Even when a landlord is going into bankruptcy, the sitting tenants lowers the property asset price in administration.

[60] Christine Drosts and Thomas Knorr-Siedow (2007) "Social Housing in Germany" in Christine Whitehead and Kathleen Scanlon (eds.) *Social Housing In Europe"*. London: LSE.

Nonetheless, investors in the German market do not see strong security of tenancy negatively, but view the long term tenancies as an attractive way keeping down voids and management costs, which in turn ensures the long term secure returns. The PRS in Germany is structured as a balance between affordable and secure rent with sufficient investor dividend. The *Mietspiegel*, as both an instrument to aid negotiation and good will between the tenant and landlord, and as an instrument to state the adequate market rental price, thus provides institutional context for which security of tenancy exists.

On Page 52 the economic impact of rent regulation was assessed, where it was suggested that there would be an incentive for the landlord to harass the tenant in order to affect an end of the tenancy agreement. Plainly, this is not the case in Germany for the most parts, and the next section on demand elaborates further upon the "cultural" aspects of the German PRS.

DEMAND

There is a very large demand for rented housing in Germany from a large range of households. While this section will address the demand specific to the rental market, chapter 5 will assess the general demand for dwellings, including demographics and macroeconomic conditions. It will give the demand in this section a basis in which to compare the household's tenure choice.

Andersen summarises the main motives for tenure choice[61]:

1. The financial return households get from investments in their own dwelling compared to investments in other assets
2. The role of cash-flow, liquidity and borrowing constraints for households during their life cycle
3. Transaction costs and efforts
4. Costs and efforts concerning maintenance and administration of the dwelling
5. Security of tenure, power to change and improve dwelling and freedom of choice
6. Life-cycle, housing values and social status

GOOD QUALITY OF HOUSING

Households' tenure demand is usually driven by their characteristics and socio-economic position.[62] The tenure decision for both the private and social sectors are likely to be from households with lower income, younger, less educated and/or large household size. Thus with these general characteristics of the demand for rented housing, usually the supply is of a low quality, which in turn reduces the supply of good quality housing for higher income households.

[61] Hans Skifter Andersen (2011) 'Motives for Tenure Choice during the Life Cycle: The Importance of Non-Economic Factors and Other Housing Preferences' Housing Theory and Society 28(2), 183-207.
[62] Steven Bourassa (1995) 'A Model of Housing Tenure Choice in Australia' *Journal of Urban Economics* 37(2), 161-175.

Nonetheless, in Germany there is a large supply of good quality rented housing among a large mix of rented housing quality. This is largely driven by the demand of the mixed income, age, education and sized households. There has been no drive in Germany to encourage households with sub-prime creditworthiness into homeownership by either the banking sector or the political parties. As chapter 5 will show, the mortgage market is strictly regulated and thus has a high barrier of entry.

Profiles of households living in the rental sector specific to Germany include:

- Very high percentage of single men and women and sole parents
- Significantly higher for those aged under 40
- Couples without children

The quality of rental housing in Germany is good, particularly in the West. Nonetheless, there are a large number of vacant properties in the former East Germany, where the German strategy of improvement of the housing quality includes demolishing sub-standard buildings. Furthermore, the incentive structures are present in both law and tax to engage in modernisation of the dwelling stock.

Germany does not share the usual demand characteristics of countries which have small social sectors, such as Flanders and Australia, of being a source of accommodation for lower income in an ancillary form of a housing safety net primarily aimed at housing vulnerable households. It is argued that this is because the Germany has an integrated rental market predominantly private landlords, but with strong security of tenure.[63]

SECURITY OF TENURE

It is argued that security of tenure in Germany offers households the security that is sought in home-ownership in other countries. Chapter 2 shows that tenancy law in Germany provides:

- The length of the contract is indefinite in principle, where limited contracts are considerably constricted into narrowly defined exceptions.
- When the landlord can end the contract, they must find the tenant alternative housing to assure the continuity of housing
- Termination of the contract by the landlord is only in limited circumstances.
- The principle of succession means that the tenancy continues when there is a change of ownership or to a sub-tenant upon the removal of the main tenant.
- The municipality can delay a pending eviction to prevent the household from homelessness when there is no publically owned accommodation.
- Notice periods are between 3 and 9 months, depending on the length of time the tenancy has been running for, giving mobility when required.

Landlords and Landlord Associations regularly complain about the unintended phenomenon of "renting nomads" who take advantage of the normally long tenan-

[63] Janneke Toussaint, Gudrun Tegeder, Marja Elsinger and Ilse Helbrecht (2007) 'Security and insecurity of home ownership: Germany and the Netherlands' *European Journal of Housing Policy* 7(2), 173-192.

cy dispute and long periods of notice by moving from one dwelling to another without paying (full) rent.[64] Thus, reforms are taking place to limit these types of renters who are intentionally trying to circumvent the law, but will not affect the basic intent of protecting the tenants.

The security of tenure must also be seen in connection with the operation of the rent regulation, as described in chapter 3. Therefore the German tenants see the private rental market as a tenure choice which will have restricted rent increases over a long secured period of time.

The importance of tenure security in relation to rent regulation is essential in understanding the long term price expectations of households. Case and Shiller argue that "the notion of a bubble is really defined in terms of people's thinking about future price increases".[65] With the rent regulation and security of tenure households could think of the private rented sector both in the long run (without eviction) and low rental expectations (regulated rent). Therefore, in theory bubbles should not occur in German residential rental private market, *ceteris paribus*. This security of tenure contributes significantly to the demand of the private rented market. It is argued that the stability of the large private rental market contributed to the stability of the whole German housing market, whereby the tenure choice was substitutional and thus when home-ownership prices increased then the tenure choice would be for the rental market.

HOUSEHOLD MOBILITY

Housing market research consists of many facets, including the relationship between inelastic supply and demand, the relationship of housing prices and its location, housing markets and welfare/tax and housing booms, bubbles and busts. Another aspect of the housing market is the fact that housing is needed to accommodate the workforce. How the labour market is constructed thus affects the demand of dwellings and the type of tenure, and vice-versa.

Van Ewijk and Van Leuvenstein argues that owning a home makes people more reluctant to move, which creates a geographical mismatch between labour supply and labour demand, in turn increasing unemployment.[66] Owner-occupiers face a higher transaction cost of moving homes, and thus spend longer time in their residence to spread these costs over a longer period. The constriction to home-ownership might be amplified in a time of cyclical downturns where decreasing prices lock-in households due to negative equity.[67] Furthermore, it is harder for the unemployed to enter a region where there is a high percentage of home-owners, increasing this inefficiency. Indirectly, the inefficient labour force supply and demand situation creates inefficient production, which further reduces labour de-

[64] Sarah Harman (2010) "Nomad Tenants Spark German Landlords' Ire" Deutsche Welle News Article, 22 October 2010, found at http://dw.de/p/PjTB
[65] Karl Case and Robert Shiller (2003) 'Is there a bubble in the housing market?' *Brookings Papers on Economic Activity* 1, 299-362.
[66] Casper van Ewijk and Michael van Leuvenstein (eds.) (2010) *Homeownership and the Labour Market in Europe*. Oxford University Press.
[67] Fernando Ferreira, Joseph Gyourko and Joseph Tracy (2008) 'Housing Busts and Household Mobility' *NBER Working Paper* No.14310.

mand. It can also be argued that home-ownership reduces entrepreneurship, where people are less willing to take risks when they have a mortgage to pay off. Although they also find that home-owners are less likely to become unemployed and are more likely to find employment faster when unemployed, on a macro-economic level the labour force is inefficient when mobility is restricted due to the housing market.

In Germany the private rented sector is large, and in theory there should be a higher degree of labour force mobility. However, given the structure of the private rental sector, there are incentives for the tenant to remain in the same location. We have seen that this arises from the mismatch between the initial rent setting freedom and the rent increase regulation. Therefore, in many cases it will not be in the interest of the tenant to move from their dwelling which has benefited from low rent increases over time to a new contract which will be up to 20% higher than the market price. The economic prosperity in a city such as Hamburg and Munich will not only have higher rents due to larger incomes, but will also attract in new labour. This will increase the demand for dwellings, which will increase the rent prices given supply elasticity. The rent regulation will only constrict the rents from increasing more than 20% over 3 years, as the *Mietspiegel* will record the market rent albeit with potential time lags.

It can be argued that the direct effect of home-owners not being willing to move for employment can negatively affect the labour force mobility, but when there is insufficient supply of rental dwellings then the same reluctance to move will occur in the rental market.

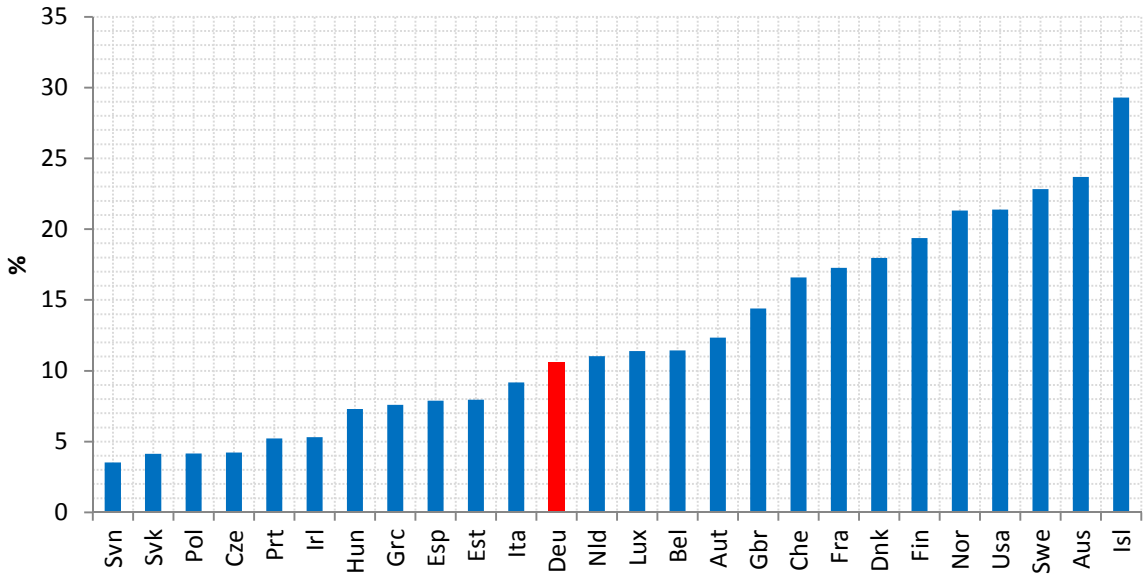
Many studies show that tenants in social housing are less mobile than private tenants, as they are reluctant to give up their below-market rents and higher security.[68] However, with its very small proportion of social housing compared to private dwellings, residential mobility in Germany is not negatively affected by this attachment.

"MODERN PRIVATE RENTED SECTOR"

The PRS demand has also expanded in a sub-market which Rhodes terms the "modern rented sector"[69], which offers affordable and flexible accommodation for households who are in between points of their life cycle of owner-occupation. This can include young professionals and high income renters who are not able or willing to become home-owners, but are not going to be tenants for life. Two examples of this group include a recently divorced high-income person looking for a single-person dwelling for a short period and a young professional couple who have not settled in a long term job and are considering migrating.

[68] Sébastien Menard and Faouzi Sellem (2010) 'How Does Social Housing Affect the Rate of Equilibrium Unemployment?' *Mimeo*, TEPP-GAINS.
[69] David Rhodes (2006) *The Modern Private Rented Sector*. York/Coventry: Joseph Rowntree Foundation/Chartered Institute of Housing.

FIGURE 16: RESIDENTIAL MOBILITY IN OECD AND CANDIDATE FOR ACCESSION COUNTRIES, 2007



Note: Figure shows percentage of households that changed residence within the last 2 years.
The low mobility rate in some Eastern European countries does not seem reasonable and may reflect problem with the underlying data. (Working Paper NO 836: Housing markets and structural policies in OECD countries.)
Source: OECD, Working Paper NO 836: Housing markets and structural policies in OECD countries.

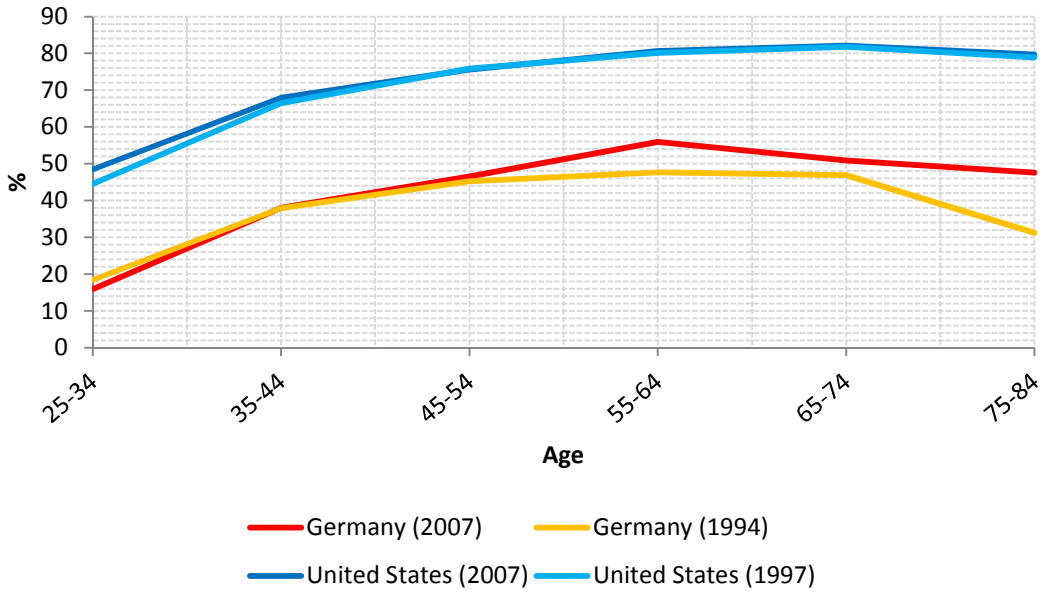
Economic literature suggests that "housing services and residential capital in a perfectly competitive economy are separate goods that are independent and traded on separate markets, so housing demand in theory should be unaffected by the tenure choice."[70] The positive factors which have been found to influence investment in home-ownership include income[71], educational attainment[72] and being married[73]. Therefore, the tenancy choice for young professionals to be in the PRS could be for the economic development of their incomes before home-ownership. Similarly, there could be an increase in the elderly in the PRS due to the reduced income of retirement. The socioeconomic literature shows how changing life cycles can influence the housing needs and preferences.[74] The newly divorced person would thus go into the PRS not on the basis of economic reasons, but for sociological reasons. As such the increasing rate of divorce in Europe will have an important effect on the PRS demand.

However, although this concept of the PRS as a stage in the life cycle is growing, it is more so the norm in Germany. Given the large supply of private rental dwell-

[70] Andersen (2011) Ibid [63] at 184.
[71] Donald Haurin, Patric Hendershott and Susan Wachter (1997) 'Borrowing constraints and the tenure choice of young households' *Journal of Housing Research* 8(2), 137-154.
[72] Joseph Gyourko and Peter Linneman (1997) 'The changing influences of education, income, family structure, and race on homeownership by age over time' *Journal of Housing Research* 8, 1-25.
[73] Haurin et al (1997), Ibid [73].
[74] Han Floor and Ronald van Kempen (1997) 'Analyzing housing preferences with decision plan nets' *Scandinavian Housing and Planning Research* 14, 27-42.

ings, the large mix of quality in the market, the lack of a negative stereotype of renting, the lack of fiscal incentives to become home-owners and the difficulty of getting mortgages until a large capital can be put down with a secure job, renting is regarded as being the normal step in the life-cycle of German housing tenure. Again, the security of tenure and the rent regulation gives households the confidence in living in the same conditions of home-ownership while saving capital for a mortgage. Thus Kofner argues that there is no unreasonable cultural emphasis on home-ownership.[75] Figure 17 shows that the 'life-cycle' role of rented accommodation is evident in both the United States and Germany, but also shows that consistently more households remain in the rented sector across the different ages groups in Germany compared to the United States by a difference of around 30%. Chapter 5 will assess the home-ownership demand side to illustrate this point.

FIGURE 17: HOMEOWNERSHIP RATES BY AGE GROUP



Source: OECD, Working Paper NO 849: Drivers of Homeownership rates in selected OECD countries.

Much of the ideology of home-ownership in the Anglophone countries associates the autonomy of ownership with the ability to normatively associate the dwelling as a "home" with deeper emotional attachments.[76] The legal difference between the tenures is that owner-occupation has a property right over the land and the tenant has a land use agreement. Nonetheless, with German tenancy law ensuring that the tenant is protected in an unlimited contract, the households in the PRS can regard the dwelling as a long-term home. Furthermore, Germany tenancy law treats dwellings in the PRS as "homes" whereby the tenant is afforded considerable freedom to decorate, sublet, introduce homosexual partners as a co-tenant, use

[75] Kofner (2010) Ibid [47] at 123-131.
[76] Shelley Mallet (2004) 'Understanding home: A critical review of the literature' *Sociological Review* 52(1), 62-89; Richard Ronald (2008) *The Ideology of Home Ownership: Homeowner Societies and the Role of Housing*. Basingstoke: Palgrave MacMillan.

and responsibilities of a shared garden, *inter alia*, as extensively outlined in the chapter 2 on German tenancy law. Therefore, households in the German PRS are able to feel their dwelling is a home, partly explaining the large size of the PRS. Further analysis of the life cycle in German housing is found later in the section of chapter 5 titled 'The Life Cycle: From PRS to Home-Ownership'.

SOCIAL SECURITY

All developed nations provide some form of targeted assistance to make dwellings affordable to particular groups of tenants, although they vary in the eligibility and amount. The German welfare system is termed the Bismarckian system, where German Chancellor Bismarck developed the system on the basis of existing mutual aid associations. It has been further classified by Esping-Andersen as a corporatist welfare regime with conservative principles. Social insurance, which covers health, some social care and the income maintenance system (pensions and unemployment benefits), is managed by a system of independent funds.[77]

The system follows three principles. The first is subsidiarity, where the level of state intervention is limited to where there is no other adequate cover by other bodies. The second principle is the welfare state as an enabler of social services rather than a provider, whereby non-governmental organisations are given large influence and importance in the system. The third principle is the welfare system as part of the social market economy, where social welfare is most effectively promoted through economic development, with state intervention and social welfare contributing to this aim.

The government introduced a raft of reforms to the welfare system following the recommendations of the Hartz Commission, where it was argued that the government restructured its policy away from a traditional emphasis on earnings-related towards a means-tested minimal income aimed at the protection from poverty. In other words, it became a minimal protection welfare system found in the Anglo-Saxon countries. Nonetheless, Busch-Geertsema argues that the changes effect Germany less than other countries who are cutting back on welfare system funding because of the principles already applicable in the German social welfare system meant that there is already significant market participation and less reliability on the state.[78] In relation to housing, it can therefore be concluded that the large reform to the welfare system did not impact too much on the rental market, and still plays a small role in tenant demand.

This section evaluates the current welfare system in relation to housing which emerged out of the 2005 reforms. It assesses the housing subsidies through the welfare system in relation to the continuously reducing state subsidies in the supply side of housing. Although not with the direct aim to stimulate investment in the PRS, the housing allowances will indirectly affect the market. Housing allowances in Germany is a legal claim irrespective of the status of the dwelling, with the same rules applying for both social and private market dwellings. There are two main forms of allowances: Housing Allowances and Unemployment Insurance.

[77] Busch-Geertsema (2004) Ibid [35] at 304.
[78] Busch-Geertsema (2004) Ibid [35].

Wohngeld (Housing Allowance)

Wohngeld is an allowance for those people who are not living on social assistance. It is a subsidy for lower income households eligible for help with their housing costs. Since January 2009 heating costs are also included, at €0.5/m^2.

It is conditional upon four factors:

I. The number of family members in the household
II. The total annual family income
III. The amount of rent or mortgage payment that qualifies for support
IV. The six categories of local rent level

Table 10 shows the maximum local rent level per rent class that is subsidised by number of household members, if actual rent paid is higher than the maximum rent.[79]

TABLE 10: MAXIMUM MONTHLY RENT LEVELS SUBSIDIZED WITH HOUSING ALLOWANCES ACCORDING TO NUMBER OF HOUSEHOLD MEMBERS AND CATEGORY OF LOCAL RENT LEVEL IN GERMANY, 2009

Number of Household Members	I	II	III	IV	V	VI
	(low rents)					(high rents)
1	292	308	330	358	385	407
2	352	380	402	435	468	501
3	424	451	479	517	556	594
4	490	523	556	600	649	693
5	561	600	638	688	737	787
Extra amount of eligible rent per extra household member	66	72	77	83	83	99

Source: Marietta Haffner (2011) "Country case study: Germany" in Kath Hulse, Vivienne Milligan and Hazel Easthope (eds.) 'Secure occupancy in rental housing: A comparative analysis'AHURI Final Report No. 170.

[79] Marietta Haffner (2011) "Country Case Study Germany" in Kath Hulse and Vivienne Milligan (eds.) 'Secure Occupancy in Rental Housing: A Comparative Study' *AHURI Project.*

Table 11 shows the maximum amounts of income per month that would allow a household of one-earner to apply for Wohngeld.

TABLE 11: EXAMPLE OF INCOME LIMITS (EURO) FOR DWELLINGS IN MUNICIPALITIES WITH RENT LEVEL CLASS VI (HIGH RENTS) IN GERMANY, 2009

Number of household members	Maximum total income per month according to housing allowance table	Maximum monthly gross income (without child support) for a one-earner household before a lump sum deduction of…			
		6%	*10%*	*20%*	*30%*
1	870	925	966	1,087	1,242
2	1,190	1,265	1,322	1,487	1,700
3	1,450	1,542	1,611	1,812	2,071
4	1,900	2,021	2,111	2,375	2,117
5	2,180	2,319	2,422	2,725	3,114
6	2,440	2,595	2,711	3,050	3,485
7	2,700	2,872	3,000	3,375	3,857
8	2,960	3,148	3,288	3,700	4,228

Source: Secure occupancy in rental housing: A comparative analysis. Country Case Study: Germany, and Bundesministerium für Verkehr, Bau und Stadtentwicklung(2008)

There are many tables available for the different types of earners, based on a formula that includes the three four variables plus three coefficients that vary with household size.

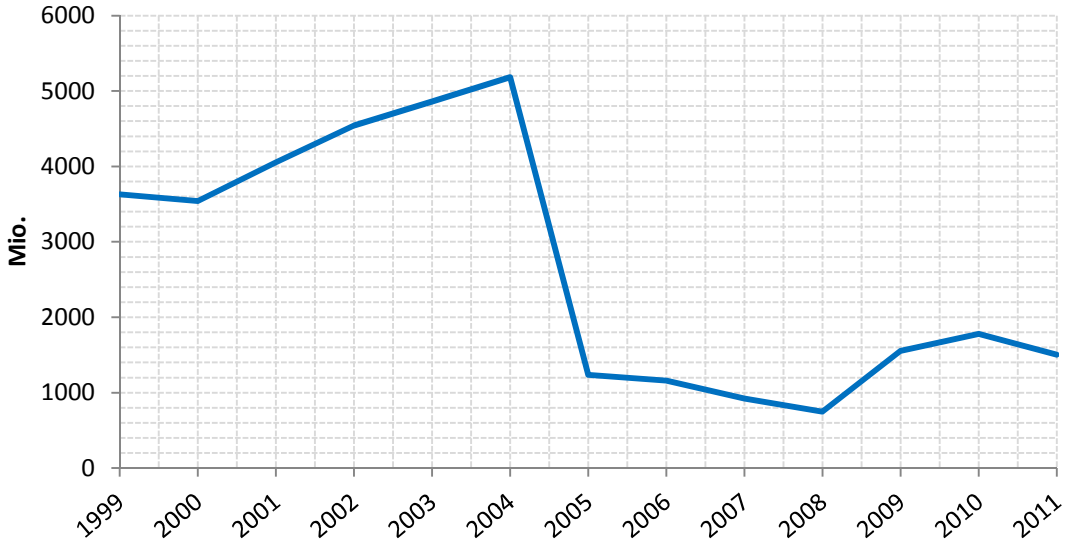
In 2005 the government introduced the Hartz IV reform laws, which introduced a means-tested system to replace the earnings-related system of social security for unemployment assistance after the first year of unemployment.[80] Therefore, everyone with a transfer income and who is in principle available for the labour market will receive a Hartz IV transfer. It was an incentivisation for unemployed people to seek employment. Kofner shows that although the transfer amount for housing was higher than that which they would get under housing allowances, the major result of the reforms was that the number of recipients of housing allowances dropped by over 80%.[81] The reforms have restructured the nature of Wohngeld from a housing subsidy for a wide group of society to a more focused financial contribution to the lowest in society without other transfer of income, with the exception of the short-term jobless.

The long term development of the government expenditure on Wohngeld shows the constant increase until the Hartz IV reforms were implemented. Figure 18 shows the effects of the Hartz IV reforms on the total Wohngeld spending. While the Wohngeld support was increasing from the 1960s to 2005, the social housing supply programmes were being reduced. Thus Wohngeld can be seen as a refocus of government subsidies away from object supply grants towards subject demand

[80] Joachim Kirchner (2006) *Wohnunsversorgung für unterstützungsbedürftige Haushalte. Deutsche Wohnungspolitik im europäischen Vergleich* [Housing provision for households that need support: German housing policy, a European comparison]. Wiesbaden: Deutscher Universitätsverlag.
[81] Stefan Kofner (2007) "Housing Allowances in Germany" in Peter Kemp (ed.) *Housing Allowances in Comparative Perspective*. Bristol: The Policy Press, 159-192.

grants, or in other words a more focused approach of subsidising the market. Nonetheless, at the current situation, with both the supply and demand subsidies having been reduced, we can see that the role of the government in steering the economy is decreasing. Rather we can see the social market economy has matured to a point of sustainability, where the government role in housing is a safety net for those unable to find accommodation in the private or non-profit sector. The reduction of government subsidies in the housing market should be further assessed in the need to reduce government spending in areas which long term growth prospects require capital investment. As such, developing a self-sufficient housing sector with low object and subject grants will reduce the government debt and enable it to make the fiscal rules as set out in the EU Fiscal Compact.

FIGURE 18: DEVELOPMENT OF HOUSING ALLOWANCE IN GERMANY, MIO. EUR, CURRENT PRICES



Source: Statistisches Bundesamt, Wirtschaft und Statistik 2004, 2006 and 2013.

Arbeitslosengeld II (Unemployment Insurance)

Arbeitslosengeld is entitled for those who had contributed for more than 12 month, and was based on previous earnings. It was financed by the central state. Those who could not claim this could only claim social assistance (*Sozialhilfe*), which was strictly means tested and income related in accordance with the household income. Until 2005, those who were entitled to *Sozialhilfe* and *Arbeitslosenhilfe* were entitled to housing benefit. The German Social Code (*Sozialgesetzbuch II*) came into force in 2005, introducing *Arbeitslosenhilfe II* for those who are registered as unemployed, able and willing to work and do not (any more) qualify for *Arbeitslosenhilfe* unemployment benefits. However, the levels of payments and conditionality are very similar to those of social assistance.

Arbeitslosenhilfe II covers the full cost of housing, but is narrowly defined for an "adequate home", subject to size and rent ceilings. This has resulted in a greater demand for smaller dwellings and increased social segregation. The provision is

also applicable to home-owners to pay for their mortgage, with the same size and rent ceilings, and has the additional problems of reducing modernisation and proper maintenance. There are socio-political debates over what is an "adequate" home.

Therefore, it is a minimal and strictly means tested system, which will reduce the fiscal burden on the state, but increases the demand for low-cost housing with a greater risk of rent arrears.[82] The aim of this legislation is to reform the system away from "welfare dependency", by incentivising the unemployed to seek work faster. As such the legislation could have contributed to greater labour force mobility, which could increase the demand for the PRS and furthermore increase rents with a higher rate of new contracts. Henceforth, the effect on the PRS cannot be narrowly defined.

COSTS OF ESTABLISHING A TENANCY

The user-costs involved with establishing a new tenancy are not completely confined to the rent regulations, tenancy laws, subsidies and supply incentives. For a prospective household wishing to access the PRS in Germany, there are ancillary costs which must be included in the household microeconomic decision to relocate.

- **Refundable Deposit**: Normal tenancy contracts stipulate that the tenant must pay a deposit which amounts to the rent for one month in the case of a room or rent for three months in the case of a dwelling. Although less frequent, the payment method can also involve either the deposit being paid in three monthly instalments after the tenancy has started, a bank guarantee or a savings account that is hypothecated to the landlord. The deposit is refundable when the tenant leaves the apartment, although the landlord has the right to hold back the repayment for up to 6 months to ensure that any costs of repair or maintenance resulting from the tenancy can be financed from the deposit. There is no stipulation that the deposit must be held in a special secured account of the landlord like the deposit scheme in the UK.

- **Brokerage Costs:** The law on the regulation of intermediation (*Gesetz zur Regelung der Wohnungsvermittlung*) sets out the rules on the relationship between the tenant and the real estate agent. It regulates the commission a real estate agent can charge. Nonetheless, in areas of high demand such as Berlin, there is a large black market for brokerage costs, whereby prospective tenants will significantly increase the amount they will pay in order to secure the tenancy.

- **Unfurnished:** Dwellings in Germany are typically unfurnished, except for student housing. Where there are furnishings, such as a kitchen, the tenant will usually be paying for it in the rental price. Nonetheless, the cost of furnishing should mitigated due to the tenant already possessing many fur-

[82] Volker Busch-Geertsema (2004) *Die Hartz-Gesetzgebung und ihre Auswirkungen auf die Wohnungslosenhilfe und die Wohnungsnotfallproblematik* [The Hartz-Legislation and its Consequences for People in Urgent Need of Housing and Services for the Homeless]. Bremen: GISS Consult.

nishings in their previous dwelling, unfurnished dwellings creates a large second hand furniture market. The furnishing of apartments gives the tenant more of a feel of "home" belonging and incentives longer tenancy periods.

SOCIAL MARKET ECONOMY

Rent price and tenure regulation internationally fall roughly within two groups, which has separate investment incentive structures:

1. Free market rents and weak security of tenure for tenants offers the landlords opportunity to maximise profit on the land, which in turn would **incentivise a sufficiently high supply** of dwellings in the market to keep prices down. This would be the case in England, which has very low tenancy protection laws and no rent regulation, but the supply for the PRS has been increasing for the past two decades in response of the market conditions.

2. Strong tenant demand is driven by strong tenancy protection and a low risk of dramatic rent increases and this in turn **incentivises investment to meet this demand**. The landlord values the secure income the long term tenancies provides, although it does not always follow that length of tenancy and security of tenancy are proportional, as the English PRS demonstrates.

Therefore, a variety of regulations are compatible with a large PRS, as long as there is a balance between landlords and tenants. The choice between these two categories of regulation which attracts investment therefore depends on the political and economic context of the particular country, where in Germany this is the social market economy.

With regards to the supply and demand subsidy mix, we can see that the trend over the past 25 years has been towards housing allowances and a lesser emphasis on supply subsidies. It reflects the influence of neo-liberal ideas about the role of governments in tackling the problem of affordability of lower income families rather than the lack of affordable houses. The change of policy focus reflects the difficulty of devising a federal supply strategy for a country which has large regional economic conditions as West and East Germany. The approach of giving allowances to low income households essentially makes the landlord a *de facto* social landlord, who is nonetheless investing in the dwelling through private capital. The *Länder* governments, who assumed responsibility for supply subsidies, supports the role of private investment mainly though lower interest rate loans and public guarantees. Czischke describes how the transition from supply-side subsidies to demand-side subsidies across Europe is putting increasing pressures on social housing organisations to become more market orientated business like institutions.[83] While this poses a change in structure for the likes of the social housing organisations in the Netherlands, who once had a clear object subsidy to provide cheap dwellings for low income households, the German rented market has always been embedded within a market setting and thus the transition is much less of a

[83] Darinka Czischke (2009) 'Managing Social Rented Housing in the EU: A Comparative Study' *European Journal of Housing Policy* 9(2), 121-151.

fundamental change. Furthermore, the absence of state subsidies being targeted to social housing associations, where they are available for all types of investors, means that there is no violation of EU competition law rules against state aid, as there has been in the Netherlands.[84]

Varieties of Capitalism: Coordinated Market Economies v Liberal Market Economies

It can be argued that the stable German housing market reflects the coordinated characteristics with which the Varieties of Capitalism literature describes the overall German economy.[85] Under this theory, the German 'coordinated market economy' characteristics of stability, low risk and labour agreements fits with the stability of the property market and negotiation process of the *Mietspiegel* format. In comparison, the UK has a 'liberal market economy' shaped by market competition, which is reflected in the volatile British housing market. Table 12 is a brief summary of the comparison.

TABLE 12: VARIETIES OF CAPITALISM COMPARISON BETWEEN GERMAN AND THE UK

Germany	**UK**
Close links between manufacturing firms and banks, including cross share holding	Market competition
Shareholders looking for long term returns on their investments, 'patient capital'	Manager must maximise shareholder short term profit
Coordination between firms	Simple market competition
Significant trade union involvement at firm level, with low dismissal rates	Weak unions, easy to 'hire and fire'
Coordinated national wage bargaining, which contains inflation and inequality	Decentralised wage bargaining and wage inequality
'Bismarkian' social security, earnings-related benefits are funded by social insurance contributions, aimed at providing income maintenance in the event of unemployment, sickness or retirement	'Beveridgean' social security, means tested, aimed at poverty relief

[84] Claude Taffin (2008) 'Social Housing facing the EU Law' *Housing Finance International* 23(2), 26-31.

[85] Peter Hall and David Soskice (2001) *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press.

When applying these characteristics to the rental market, we can see that the landlords investment incentives fit the CME characteristics: they want a steady flow of rental income, they use low risk/leverage loans (if any), want the tenant to stay in the dwelling for a long time to maintain consistency, use the *Mietspiegel* as a negotiating basis for assessing a fair rent and there is little state interference. The emphasis on investors looking for quick and large dividend through capital gains in LMEs is not considered as important in CMEs.

The literature suggests that an economy is successful when it shows institutional complementarities of these core areas; in other words, the long term investment strategy is complimentary to a coordinated wage bargaining and employing workers in the long term, as wage inflation and extensive job training will be beneficial respectively.[86] The housing market thus acts complementary to the structure of the economy, where low rent and house price rises ensures that there is no pressure on wage increases, and thus the German real wages stay low in order to export cheaply. When housing supply is inelastic, then wage inflation will result in large price increases and capital gains. Therefore, as the inelastic supply in Germany is not combined with large wage inflation, the prices follow long-term price developments, which support the long-term perspective of investment in the CME structure.

CONCLUSION

The German PRS is one of the largest in the world, where supply and demand is very high and produces a range of quality and rental prices of dwellings. We have seen that the rent regulation is formed around a social market economy philosophy, where government shapes the housing market in such a way so as to create large demand for renting, and then gives incentives for the private sector to provide the dwellings. It can be argued that the causality of the supply and demand could be the opposite, although the dynamic has been institutionalised.

On the supply side, the dividend for investors are long-term and stable, but yet negotiated fairly between the landlord and tenants under a coordinated approach symbolic of a coordinated market economy. On the demand side, it is necessary to compare the user cost of renting a dwelling with home-ownership. Furthermore, the complete housing market determines both supply and demand in the PRS, which leads to the next chapter.

[86] Peter Hall and David Soskice (2004) *Varieties of Capitalism and Institutional Complementarities*. Oxford: Oxford University Press.

CHAPTER 5: THE GERMAN HOUSING MARKET

INTRODUCTION

We have found that the social market economy model of the PRS rent regulation largely permits rents to be that of market price. Therefore, the market price is set by the characteristics and dynamics of the housing market. The German property market has been characterised by low growth, low volatility, urbanisation, a large rental sector, prudent mortgage/securities market, an ageing population, regional diversity, economic stability and risk aversion. This chapter will assess each of these characteristics using statistics and economic analysis. It will show how the tenure and investor choice with regards to home-ownership and rental market function simultaneously.

SIZE OF THE MARKET

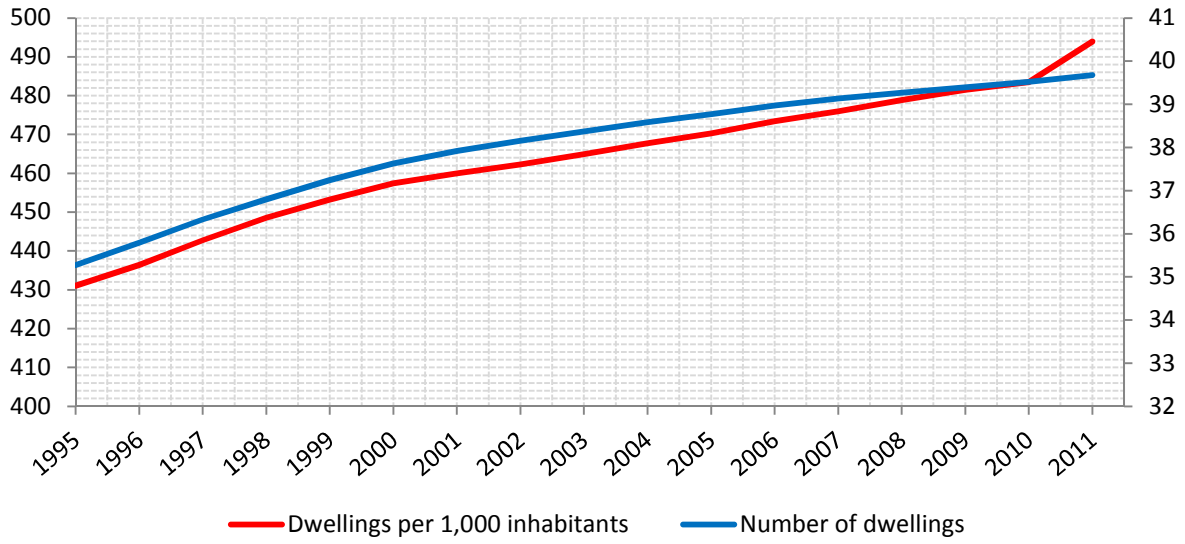
The functioning of housing markets is usually assessed using the stock-flow model, which takes into account the dual role of housing as a capital investment and consumption good and distinguishes between the stock of housing and the flow of investment.[87] As we described in the previous chapter, housing supply elasticity is low and stock equilibrium is achieved only in the long-run. Furthermore, the stock of housing in the long-run is the result of the accumulation of residential investment over time less depreciation of the existing stock. Therefore, this section is going to evaluate the housing market in terms of the current stock size, stock composition, previous construction trends and expected construction trend.

HOUSING STOCK

The structural changes in the German housing market show an increase in housing stock, where there are around 40m dwellings for over 80m people. The housing stock is relatively young, with 75% of all dwellings being built after 1945. This is compared to the UK, France, Spain and Denmark which has less than 65% of dwellings have been constructed after 1945.[88] Figure 19 shows the housing stock steadily increasing since 1995 in terms of the overall number of dwellings and number of dwellings per inhabitants, demonstrating the stability of the German housing market over the past 20 years. In terms of quality, Figure 20 shows that the living space per inhabitant is in general increasing over time, although there is still a difference between dwellings in the East and West of Germany.

[87] Denise DiPasquale and William Wheaton (1994) 'Housing Market Dynamics and the Future of Housing Prices' *Journal of Urban Economics* 35; Elizabeth Steiner (2009) 'Estimating a Stock-Low Model for the Swiss Housing Market' *Mimeo*, Swiss National Bank.
[88] Dan Andrews, Aida Caldera Sánchez and Åsa Johansson (2011) 'Housing Markets and Structural Policies in OECD Countries' *Economics Department Working Paper* No.836, at 12.

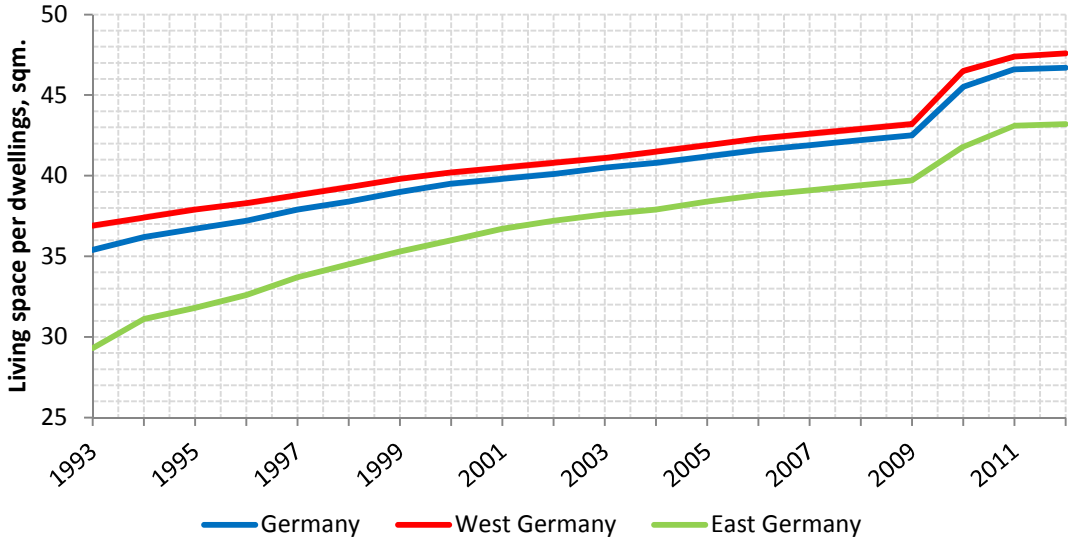
FIGURE 19: HOUSING STOCK INCREASING



Note: Number of dwellings, million (right)
Dwellings per 1,000 inhabitants (left)
Source: DESTATIS

The standards of living between the former West and East German areas are slowly converging.

FIGURE 20: DIFFERENCE IN LIVING SPACE BETWEEN EAST AND WEST



Note: There is a break in the time row from 2010, because there was a huge census of population and also housing stock.
Source: DESTATIS, Fachserie 5 Reihe 3, 2002 and 2014

DISTRIBUTION OF HOME-OWNER SECTOR AND RENTED SECTOR

There are two characteristics about Germany for the distribution of tenure:

I. The rental market accounts for the majority of tenure choice

Only Switzerland and Japan has fewer households in owner-occupied housing in the OECD. Until the financial crisis of 2008, there was a common trend across the OECD of increasing home-ownership rates, partly reflecting demographic changes, socio-economic developments and privatisation of former social housing dwellings.[89]

II. Low proportion of social dwellings

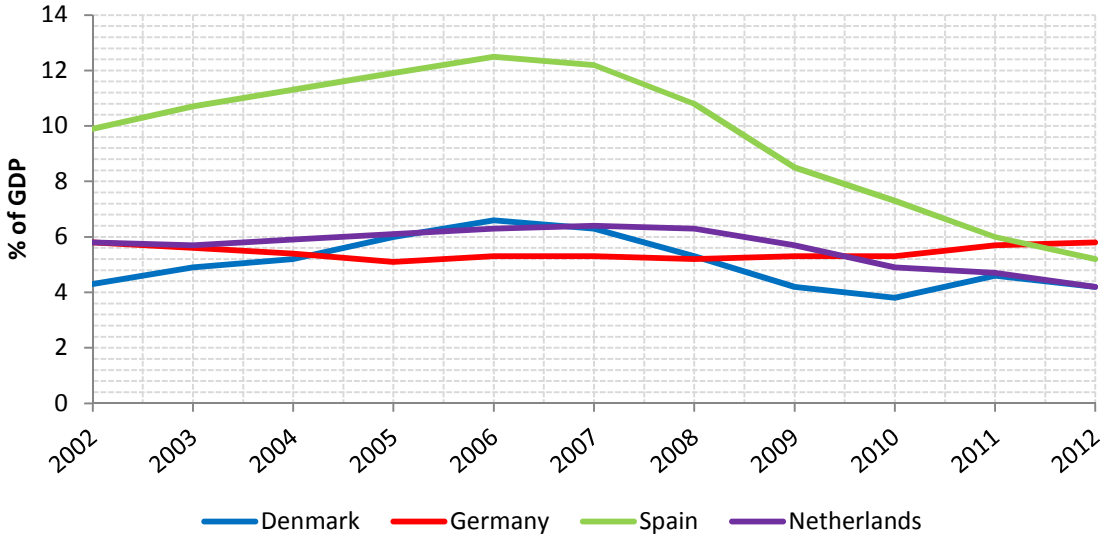
The main difference between owner-occupied housing and rental housing is that the latter is focused on trade in housing services rather than the dwelling itself. Similar to the owner-occupied market, rental stock adjusts gradually to construction, conversions and demolitions according to the expected dividend from the investment. Both the owner-occupied and rental sectors are affected by the same demand variables, such as demographics, income and relative user costs. However, additionally the stock of rental houses depends on costs, real rents and policies affecting rental supply, which are regulated differently in many countries with rent being constrained. Nonetheless, as we have seen from the review of the rent regulation in Germany, the policies aims not to influence the market rent, rather it aims to prevent large rental price volatility. The social housing sector has and is continuously reducing due to the role and size of the private sector in the social market economy. Other imperfections to the stock supply and demand equilibrium in the rental market are being reduced, such as the deductive depreciation allowance, or are afforded to both the rental and owner-occupied markets, such as subsidies and energy efficient loans.

CONSTRUCTION

Nominal investment in construction in 2010 totalled nearly €250bn in Germany, which equated to 10% of Germany's gross domestic product (GDP). €140bn of this total was in residential construction, which thus equates to 6% of German GDP. Figure 21 shows that 6% is roughly the Western European average,[90] where higher readings either reflects overheating (Spain and Ireland pre-2007) or catching-up process (Easter Europe). Figure 22 shows that building construction has decreased among all the different building types.

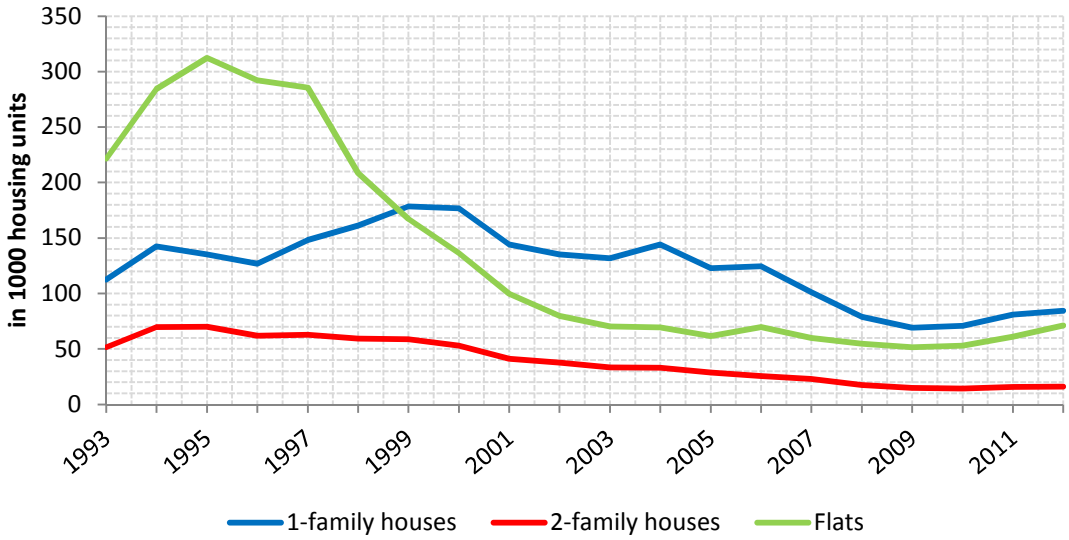
[89] Andrews et al (2011), Ibid [90], at 16.
[90] IMF (2008) *Regional Economic Outlook: Europe, April*. Washington: IMF.

FIGURE 21: RESIDENTIAL CONTRUCTION AS A % OF GDP



Source: Eurostat

FIGURE 22: HOUSING COMPLETIONS IN GERMANY BY BUILDING TYPES



Note: Flats a defined by buildings with 3 or more apartments
Source: DESTATIS, Bauen und Wohnen Baugenehmigungen / Baufertigstellungen, 2012

TOBIN'S Q

"The incentive for new building can be measured by comparing the value for old homes with the cost of building new ones. The new ones won't be duplicates of the old, but will be close functional substitutes. We could expect residential investment to be sensitive to housing q."[91]

Albrecht and Deichmann Haagerup show that in an economy with access to vacant land, house prices must converge towards their replacement cost in the long run.[92] This analysis of why prices and costs should obey an equilibrium process builds upon an economic model used by DiPasquale and Wheaton to show the value of Tobin's q in relation to housing.[93]

$$Tobin's\ q = \frac{Market\ price\ of\ existing\ housing}{Construction\ cost\ plus\ land\ cost\ for\ new\ housing}$$

Tobin's q gives guidance about potential adjustment factors when the housing market is in disequilibrium, as it determines net investment and is an important variable in the transmission process between the valued stock of assets and the flow of new investment.[94] Therefore, if the market value exceeds the replacement cost, i.e. if q is greater than 1, it is worthwhile investing in real capital. This makes Tobin's q an ideal indicator for potential investment activity in the German real estate market. Given the determination to invest in new buildings in the German market depends on when the discounted future rents to be generated are higher than the reproduction costs, this report must analyse what factors will be important in the medium and long term towards both house prices and rent prices, including demographics, supply elasticity, mortgage market regulation, subsidies to both the home-owners and private rental market, investment environment and the especially rent regulation, given the size of this sector. Malpezzi and Wachter highlight the difference between an elastic and inelastic supply in the markets, especially between the short run and long run, and shows that elastic supply like the German market insures Tobin q is not subject to significant housing market bubbles when supply cannot meet demand.[95]

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[91] James Tobin (1978) 'Monetary policies and the economy: The transmission mechanism' *Southern Economic Journal* 44, 421-431, at 425; see the original article, James Tobin (1969) 'A General Equilibrium Approach to Monetary Policy' *Journal of Money, Credit and Banking* 2(1), at 15-29.

[92] Albrecht and Christian Deichmann Haagerup (2008) 'Konjunkturcykler I boligbyggeriet' (Cycles in housing construction), Masters Dissertation, University of Copenhagen, Department of Economics 2008.

[93] Denise DiPasquale and William Wheaton (1996) *Urban Economics and Real Estate Markets*. New Jersey: Prentience-Hall Incorporated.

[94] James Tobin and William Brainard (1977) "Asset markets and the cost of capital" in Richard Nelson and Bela Balassa (eds.) *Economic Progress: Private Values and Public Policy (Essays in Honour of William Fellner)*. Amsterdam: North-Holland, 235-262.

[95] Stephen Malpezzi and Susan Watcher (2005) 'The Role of Speculation in Real Estate Cycles' *Journal of Real Estate Literature* 13(2), 143-164.

Before considering these factors, it is worthwhile considering the current German market conditions. Hayashi argues that the ratio of the existing stock price to the reproduction price does not reflect the actual investment strategy since stock prices show the profit expectations for past investment projects and not for future ones.[96] For this reason, the Deutsche Bank Research report on Tobin's q for German real estate market calculates a marginal q (q_M) by a simple additional ratio of newbuild rent and existing rent.[97] Therefore, the higher the prices of existing houses and the higher the rents for new build houses, the greater the q_M, *ceteris paribus*. In the box below, the methodology is shown, whereby a corresponding graph for Marginal q, new build rent, existing stock rent, new build price and existing stock price is shown over a time series since 1990.

The Deutsche Bank Research report highlights the unambiguous availability of data, and proceed their Tobin q evaluation using statistics from BulweinGesa's RIWIS database on rents and prices, and the German Federal Statistical Office's statistics on building activities. The results show that all indicators showed a very strong increase in prices and rents following the German reunification. The rent ratio remained fairly constant over time. The gap between prices widened, as following the mid-1990s recession new builds remained constant while existing stock have constantly declined. For rents the differences narrowed by the end of the 1990s when new build rents noticeably eased relatively.

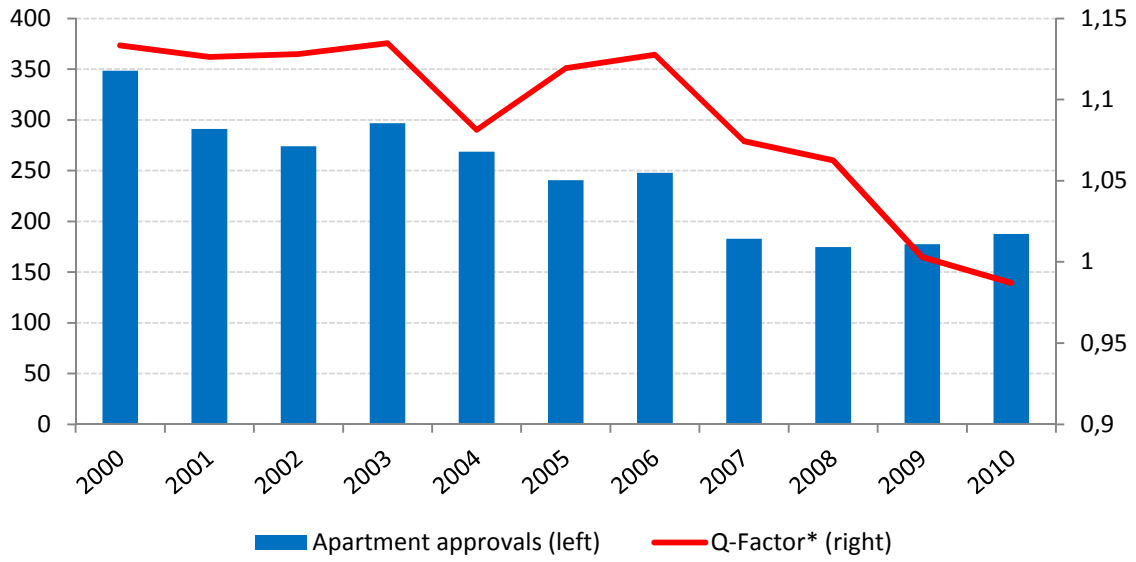
On the whole there has been a steady decline of the Tobin q in Germany. This can be shown in a sustained decline in the number of building permits and completions made since the mid-1990s, shown in Figure 23. The German housing market thus only grew by 1% in the 1990s, with the rate slowing to under 0.5% in the 2000s.

The Deutsche Bank Research report expands their analysis to review the regional characteristics, to show the disparity between Tobin's q in the different German cities. The regional variation in the German real estate market is discussed further in the next section of this chapter. Nonetheless, they show that the inclusion of the surrounding counties can significantly boost the explanatory power of Tobin's q in Germany, where the price dynamics in one city have a spill-over effect beyond the city. Similarly, their analysis shows that university towns show robust uptrend in q_M, even for those situated in the East without regional significance, such as Rostock, Cottbus and Potsdam.

Although housing supply processes over the long term and adjusts slowly, Tobin's q can show the investment decisions into construction for every year, which will thus provide an estimate of the future supply.

[96] Fumio Hayashi (1982) 'Tobin's Marginal q and Average q: A Neoclassical Interpretation' *Econometrica* 50(1), 213-224.
[97] DB Research (2011) 'Residential Construction in Germany: Tobin's q pointing to regional recovery' *Current Issues Report*, August 22, 2011, http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000277260/Residential+construction+in+Germany%3A+Tobin%E2%80%99s+q+pointing+to+regional+recovery.PDF (accessed 12/06/2013).

FIGURE 23: TOBIN'S Q DECREASING FOR GERMANY



Source: DB Research (2011) 'Residential Construction in Germany: Tobin's q pointing to regional recovery' Current Issues Report, August 22, 2011

FIGURE 24: PRICES, TOBIN'S Q AND DEMAND FOR CONSTRUCTION INVESTMENT CHANGING SINCE 2010

2000-2010	**2010-**
Prices of existing houses was reducing against the price of newbuilds and/or rental prices for newbuilds reduced against rent for existing stock	Prices of existing houses are increasing against the price of newbuilds and/or rental prices for newbuilds increasing against rent for existing stock
Decrease marginal q_M	Increasing marginal q_M
Lower demand for construction investment	Increasing demand for construction investment

Source: DB Research (2011) 'Residential Construction in Germany: Tobin's q pointing to regional recovery' Current Issues Report, August 22, 2011

Their paper argues that Tobin's *q* is indicative of building activity in any given region of the German real estate market, but show that heterogeneous, non-transparent, time-lagged and regulated nature of the market means that the findings can be nothing less than an approximation. Nonetheless, they find that Tobin's *q* points to an increase in building activity for many metropolitan regions and university towns, but there is no conclusive nationwide increase.

Schulz and Werwatz assess the cost approach for property valuation used in Tobin's *q* theory of investment according to the German market valuation.[98] The valuation technique is codified in the Regulation on Valuation (*Wertermittlungsverordnung, WertV*) and the accompanying Guidelines on Valuation (*Wertermittlungs-Richtlinien, WertR 91*).[99] They conclude that the valuation methods used make Tobin's *q* formula less accurate.

HOUSE PRICES

There is obviously a clear causality between house prices and rent prices. As nominal house prices have been stable and real house prices have been decreasing over the past 15 years, many investors see the German housing market as undervalued. Whether this is correct depends on an evaluation of all the other supply and demand factors. For example, many of the international investors which bought the former social housing dwellings in many of the East German cities such as Dresden in 2006 have found a no capital gains and a low rental dividend.

The question for the Private Rented Sector is whether the rent regulation has caused the low increases in the rental prices or if this is due to house prices being kept at a low price for other structural reasons. Therefore, while examining the house prices over the last two decades, this aims to assess whether the prices are structural or below long term expectations.

Statistics in German real estate can be found from many sources, for which none alone give an authoritarian analysis of both real estate in general and the PRS specifically. Rather, they provide analysis on different segments of the market using different methods of calculation. Michael Voigtländer has written a very comprehensive understanding of all the data sources in the German real estate sector.[100]

HOUSE PRICE VOLATILITY IS VERY LOW COMPARED TO OTHER OECD COUNTRIES

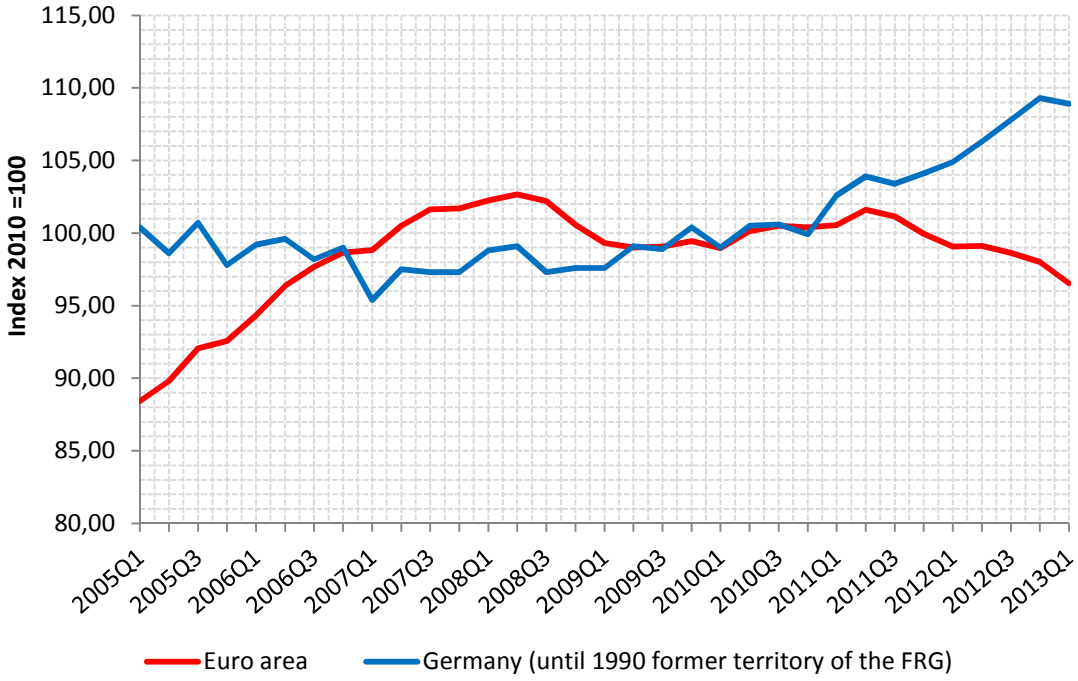
Since the mid-1990s, financial deregulation and the concomitant fall in interest rates have made borrowing easier and less costly, resulting in increased demand for owner-occupied housing, increased real house prices, increased rents and a higher household spending on housing across the majority of the OECD countries.[101] As housing represents a large fraction of the household balance sheet, volatility has a large impact both on household consumption and their collateral to secure loans.

However, the stability of the German property market is somewhat of an exception to the other OECD countries, especially when compared with other European property markets, shown in Figure 25. The prices in the German market stagnated between 1999 and 2008, whereas they rose rapidly in other parts of the EU. On the

[98] Rainer Schulz and Axel Werwatz (2004) 'Real Estate Valuation and Tobin's Q: An Empirical Analysis' 11th European Real Estate Society Conference (2-5 June 2004) Milano, Italy.
[99] Götz-Joachim Gottschalk (1999) *Immobilienwertermittlung*. Munich: C.H Beck, at 49-50.
[100] Michael Voigtländer (2012) "Real Estate Data Sources in Germany" in Tobias Just and Wolfgang Maenning (eds.) *Understanding German Real Estate Markets*. Berlin: Springer.
[101] Andrews et al (2011) Ibid [90] at 9-10.

other hand, German property market has been increasing since 2009, whereas they have been correcting in the rest of the EU. The housing markets of the United Kingdom, Ireland and Spain have experienced a dramatic increase in prices followed by a sharp correction. Although the French and Italian house prices have been less affected by the turbulence, German house prices are unique since they have flat lined over the entire period. The lack of increasing house prices or growing demand for houses in Germany explains why the investment in construction, as shown previously, has remained low over the past decade.

FIGURE 25: GERMAN AND EUROZONE HOUSE PRICES SINCE 2005



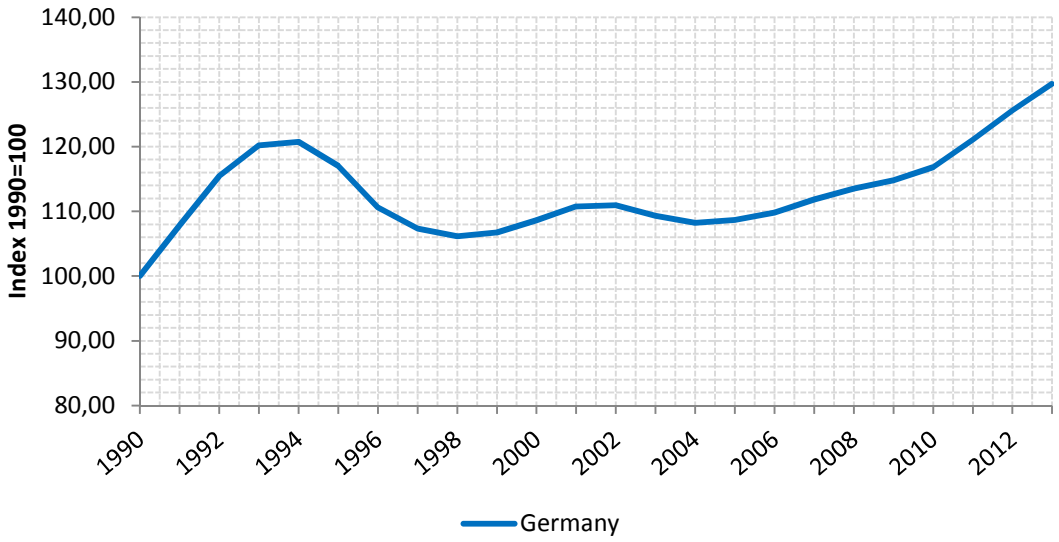
Source: Eurostat

Figure 26 demonstrates the evolution of German house prices since re-unification:

- 1990-1994: House prices increased as Federal subsidies invested into the depleted East German housing stock and where many from the East migrated to the cities of the West. Tax incentives were introduced in the 1990s to encourage West German households to invest in East German properties, which resulted in many investing in property they never actually saw.
- 1994-1998: The property prices decreased from 1994 as the supply of new housing outstripped the demand, especially with the vast number of vacant dwellings in the East.
- 1998-2010: There was stagnation in German house prices. In real terms property prices decreased over these 15 years. Such stagnation resulted in no expectations of capital gains through property investment.
- 2010-now: Property prices have only starting increasing recently, bringing to the property market an expectation of capital gains from property invest-

ment for the first time since 1993. The question of whether there is a property bubble developing in Germany is evaluated later in this chapter.

FIGURE 26: GERMAN HOUSE PRICES SINCE REUNIFICATION



Source: Bulwiengesa AG

The stability of the German housing market can be seen in a long run perspective, whereby between 1970 and 2010 the German market manifested the lowest volatility of nominal and real house prices, measured by the standard deviation of nominal and real house price growth. This cannot be explained through low inflation rates, given the low volatility of the real prices.[102]

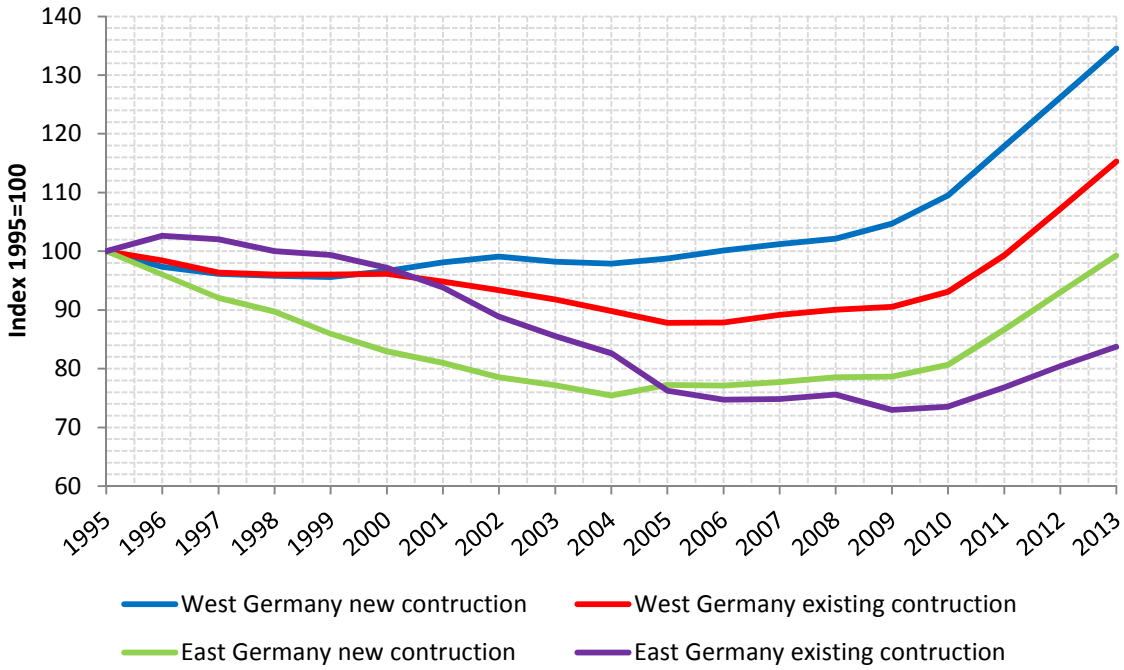
- Housing prices has not been increasing over the last 15 years in nominal terms
- Housing prices have been decreasing over the last 15 years in real values

REGIONAL VARIETY OF HOUSING STOCK, HOUSE PRICES, RENT PRICES, PURCHASING POWER AND ECONOMIC GROWTH

Even twenty years after reunification, there are noticeable differences in the housing stock and households between the West and the East. The west has more single and two-family homes, and has more living space per person. In the east there is a smaller number of persons per household, a lower home-ownership rate and an excess of supply in living space and vacancies. Where the national average shows there has been a small increase over the past 15 years, large cities in the West have experienced significant increases.

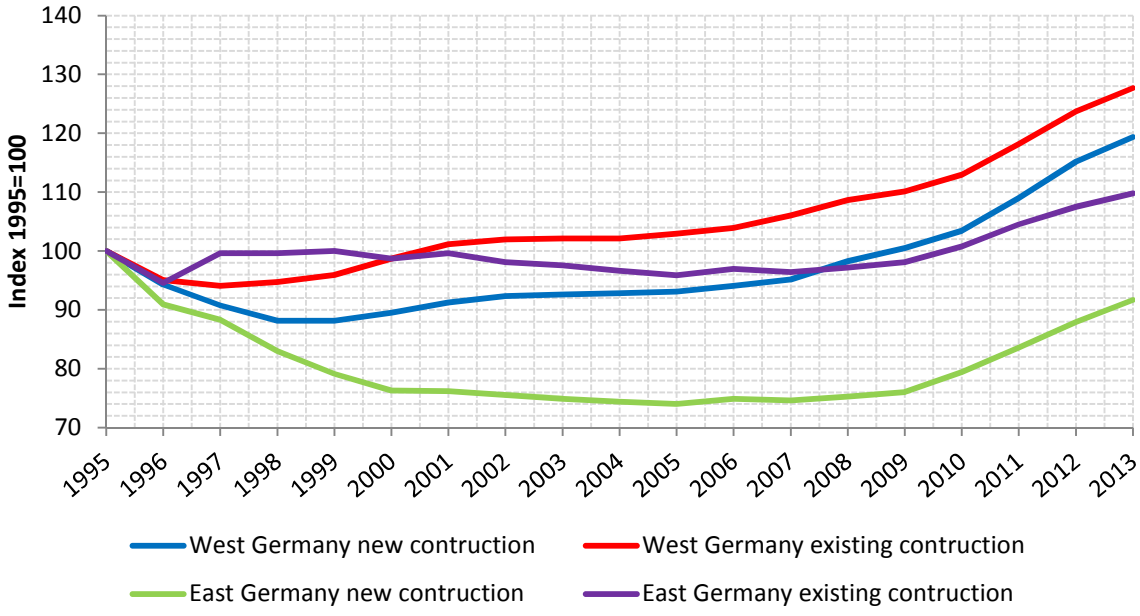
[102] Michael Voigtländer (2012) 'The Stability of the German Housing Market' MPRA Paper, found at http://mpra.ub.uni-muenchen.de/43315/ (accessed 27/5/2013).

FIGURE 27: SALE PRICES OF OWNER-OCCUPIED FLATS



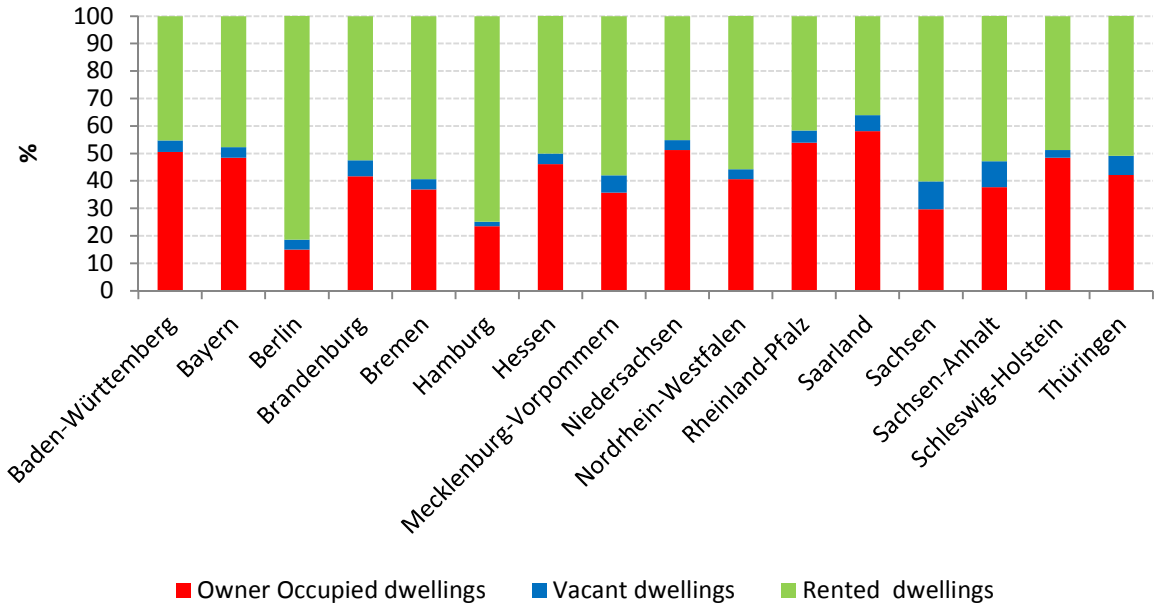
Source: Bulwiengesa AG

FIGURE 28: RESIDENTIAL RENT, RENT LEVEL



Source: Bulwiengesa AG

FIGURE 29: DIFFERENCES BETWEEN THE GERMAN STATES IN THE PROPORTION OF OWNER-OCCUPUED, RENTED AND VACANT DWELLINGS



Source: Statistische Ämter des Bundes und der Länder (2013) 'Zensus 2011'

INTERNET-BASED HEDONIC INDICIES OF RENTS AND PRICES FOR FLATS

Kholodilin and Mense estimate home rents and prices in German regions and cities using the data from the internet ads offering the housing for rent and sale.[103] They assess the home rent and price statistics in Germany as far from perfect and argue that the general public worry about a speculative property bubble in Germany is based on anecdotal evidence rather than statistical data. On the other hand, their methodology of using data from the ads provides such a high level of detail that they can construct quality-adjusted rent and price indices using the hedonic approach.

The three websites they use are Immobilienscount24.de, Immonet.de, and Immowelt.de. Combined these websites have a market share of approximately 74%. The total correlation of ads per region in all market segments and the population is as high as 0.96. They clean the statistics using algorithms, so for example a dwelling will not be found on both sites.[104]

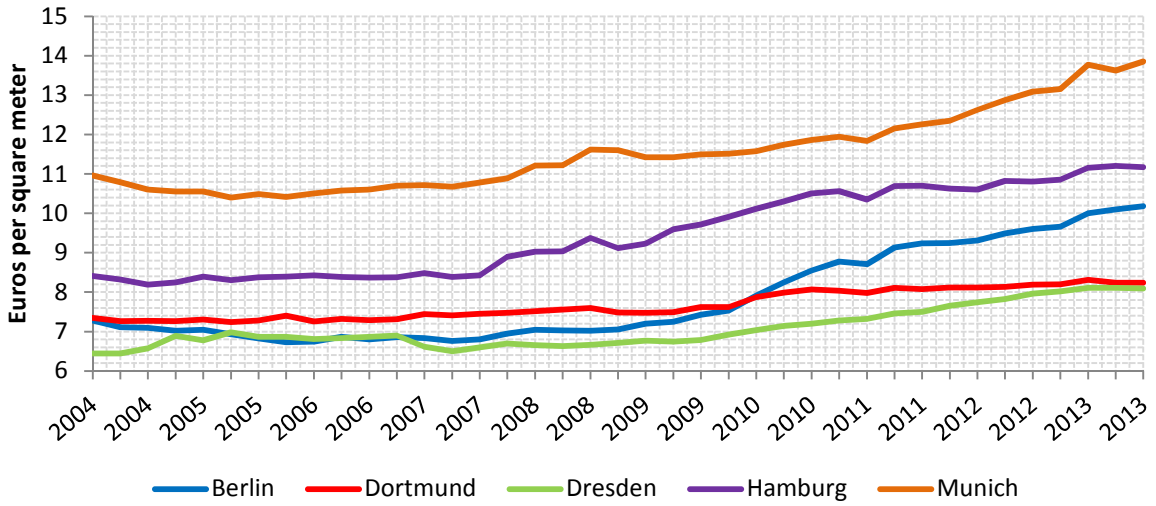
With the clean statistics, Kholodilin and Mense use a hedonic regression approach to allow for the quality adjustment of the rents and prices. The methodology "implies regressing the rent or prices on a set of variables, reflecting the quality and

[103] Konstantin Kholodilin and Andreas Mense (2012) 'Internet-based hedonic indicies of rents and prices for flats: Example of Berlin' DIW Discussion Paper 1191.
[104] Konstantin Kholodilin and Andreas Mense (2011) 'Can internet ads serve as an indicator of homeownership rates?' *DIW Discussion Paper* 1168.

location as well as other characteristics of the flat, which are relevant for the price setting".[105]

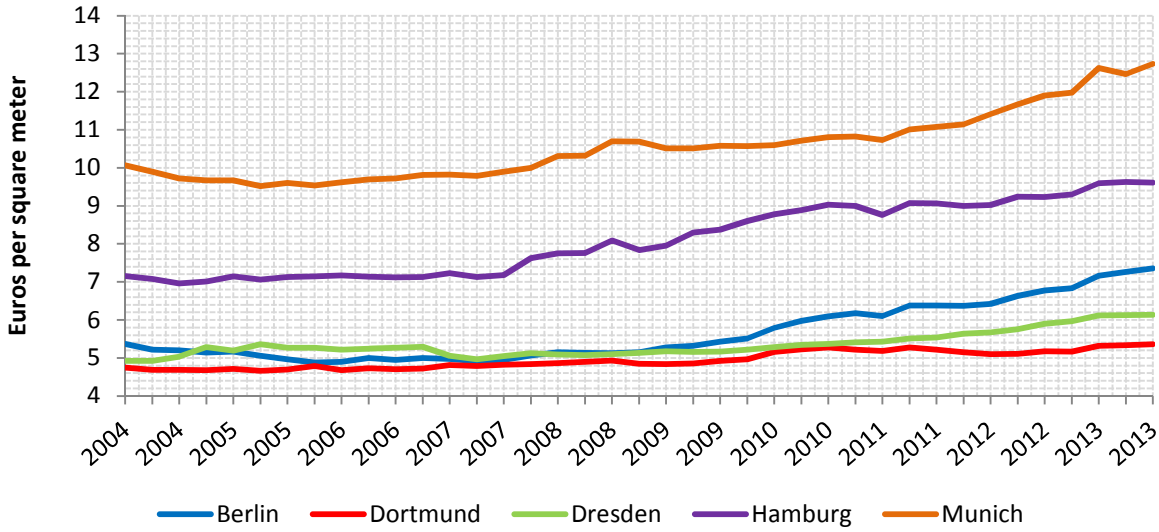
The following graphs show their findings:

FIGURE 30: RENT FOR NEWLY CONSTRUCTED HOUSING



Source: DIW Berlin, Konstantin Kholodilin and Andreas Mense (2012) 'Internet-based hedonic indicies of rents and prices for flats: Example of Berlin' DIW Discussion Paper 1191.

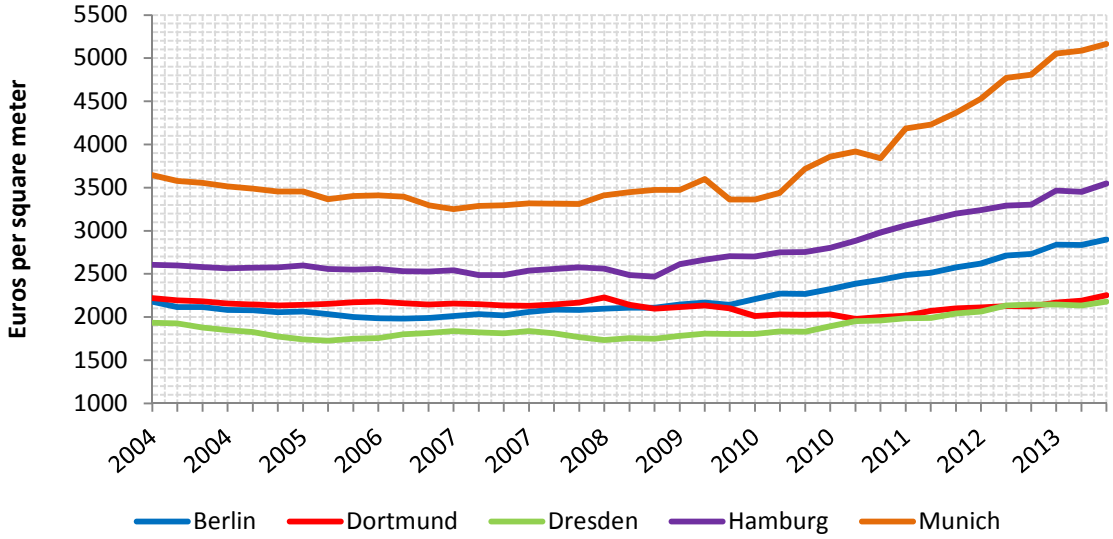
FIGURE 31: RENT FOR EXISTING HOUSING



Source: DIW Berlin, Konstantin Kholodilin and Andreas Mense (2012) 'Internet-based hedonic indicies of rents and prices for flats: Example of Berlin' DIW Discussion Paper 1191.

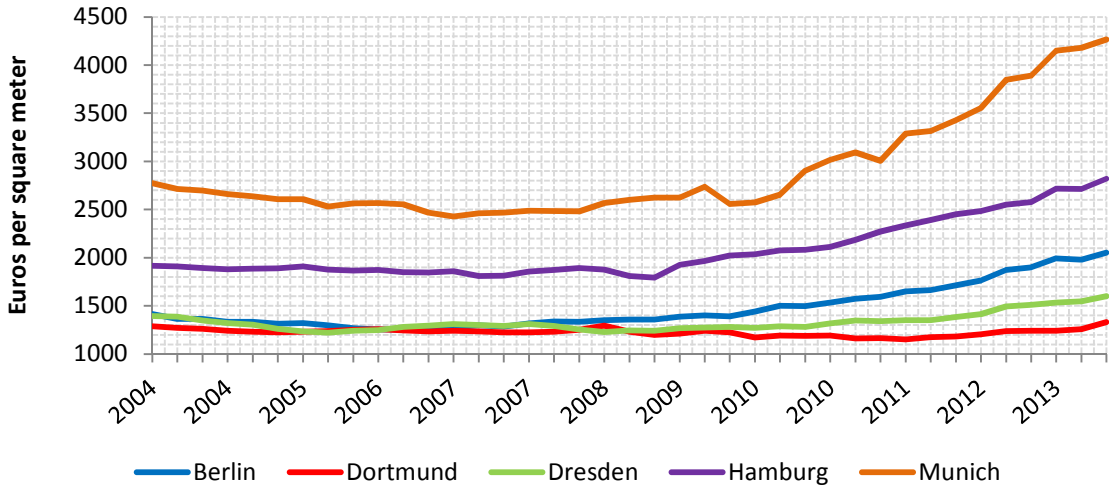
[105] Ibid [105] at 7.

FIGURE 32: PRICE FOR NEWLY CONSTRUCTED HOUSING



Source: DIW Berlin, Konstantin Kholodilin and Andreas Mense (2012) 'Internet-based hedonic indicies of rents and prices for flats: Example of Berlin' DIW Discussion Paper 1191.

FIGURE 33: PRICE FOR EXISTING HOUSING



Source: DIW Berlin, Konstantin Kholodilin and Andreas Mense (2012) 'Internet-based hedonic indicies of rents and prices for flats: Example of Berlin' DIW Discussion Paper 1191.

These graphs support the findings of the other data sources, in that:

- There is a large regional disparity between the different cities in Germany.
- That the prices have started to increase since 2010.
- Previous to 2010, it was found that the rental price was increasing faster than the house prices, while now the house prices are increasing faster than the rental prices.

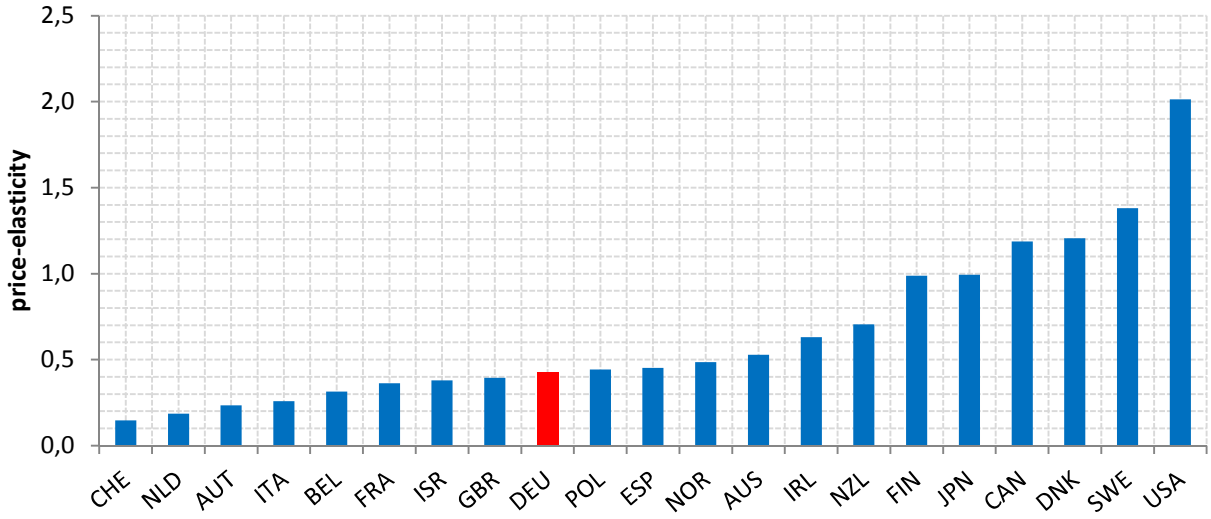
SUPPLY OF HOUSING: STRUCTURAL AND POLICY INFLUENCES

The supply determinants between the PRS and the home-ownership market are fairly similar, given the nature of building dwellings of the two sectors involves the same construction, land purchase, property taxes, energy efficient loans and state subsidies. For energy efficient loans and state subsidies, a reference to Chapter 4 will suffice so as not to repeat the same topic, given that they are accessible to both landlords and owner-occupiers. Nonetheless, with owner-occupied housing, given the household is also the investor, this report includes the tax and finance factors within the demand of housing.

From Figure 34, the OECD estimates that the long-run price elasticity varies considerably across countries. Whereas North America and the Nordic countries are found to have a relatively flexible housing supply, Germany is more rigid.[106]

FIGURE 34: PRICE RESPONSIVENESS OF HOUSING SUPPLY.

ESTIMATES OF THE LONG-RUN PRICE-ELASTICITY OF NEW HOUSING SUPPLY



Note: 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. A greater number indicates a more responsive supply. 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 between early 1980s to early 2000s.
Source: OECD, Working Paper NO 836: Housing markets and structural policies in OECD countries.

Housing supply elasticity can reflect structural conditions, including both policy and non-policy conditions:

- **Population density:** Physical limitations on the amount of land available for development. When viewed with increasing urbanisation, supply can be more rigid in cities with high population density. This can be found in some

[106] Andrews et al (2011) Ibid [90].

German cities in the West, such as Munich. However, in cities in the East there are low populations and considerable amounts of vacant land.

- **Land-use and planning policies:** Although aimed at reducing the negative externalities of new construction, the supply elasticity can be reduced. For example, a slow planning system, rigid land-use plan or provision of infrastructure. The German constitution guarantees a "right to build" on private land unless there is an explicit rule against doing so. Furthermore, the municipalities encourage building on land as their budget is proportional to the number of residents under their jurisdiction.

- **Incentives to develop unused land:** in revitalising unused land for urban regeneration, governments will incentivise reconstruction, for example with tax breaks. In Germany there is a policy of tax based incentives for the redevelopment of vacant buildings in the East.

- **Competition in the construction industry:** The construction industry is typically characterised by a large number of relatively small firms, and competition policy must ensure there is no dominant market position. In practice though, the number of construction firms able to construct large projects is limited. However, with strict EU competition law, the German construction market is considered fairly competitive.

DEMAND FOR HOUSING: THE DETERMINANTS OF HOUSE PRICES

When there is lower supply elasticity, house prices tend to increase more when the demand increases. Positive demand shocks caused by financial or demographic shocks translate into larger increases in real house prices with countries of more rigid housing supply. Demand for housing reflects various medium and long-term conditions of the mortgage market, financial market, demographic trends, urbanisation and housing market policies. These factors will thus affect the demand for the PRS and for the general house prices.

MACROECONOMIC CONDITIONS

Although the housing market is more shaped by microeconomic regulation, such as tax deductions and mortgage conditions, the macroeconomic conditions also help explain the macro-dynamics or trends of the market.

Disposable Income

Housing demand and prices tend to increase with households' disposable income growth.[107] The elasticity of real house prices with respect to disposable income is

[107] ECB (2003) 'Structural Factor in EU Housing Markets' European Central Bank, Frankfurt am Main.

close to unity.[108] The volatility of the macroeconomic conditions influences the households' future expectations regarding income prospects and employment, which influences their investment into the housing market. A reduction in structural unemployment often leads to a greater pool of homeowners, which leads to house price increases.

While the German economy might be the envy of many currently, with the unemployment rate dropping considerably, and an impressive GDP growth, this has not always been the case. Rather, since 1995 accumulative GDP growth and GDP per capita has been greater in the UK, the US, France and OECD Average, when compared to Germany. In some respects then this could explain the lower house prices growth in Germany.

One explanation for the stagnant house prices in Germany could be that net real wages have hardly risen since the beginning of the 1990s, and between 2004 and 2008 they even declined. The weak nominal wage growth is unique during a period of economic growth, and is attributed to the cooperative system of wage bargaining between employers and employees. Labour market reforms have incentivised many into lower paid jobs and an increase in short-term employment contracts.[109] Having low nominal wage growth below other countries is how Germany has gained its increased comparative economic competitiveness, and constructed an export driven economy. Nonetheless, the result has resulted in lower domestic consumption that has acted as a brake on the German economy. The reduced domestic consumption has thus contributed to the stagnated house prices in Germany.

Income can in part explain the variance of house prices in Germany, although not with sufficiently strong correlation to explain the price trend entirely. Deutsche Bank show that house prices only increase if income has risen by at least 2%.[110]

Monetary Policy

Interest rates are negatively correlated with house prices, where the debt servicing burden becomes more costly.[111] This is especially the case with short-term interest rates in countries with predominantly variable rate mortgages, which will be covered in the next section. Under a prudent approach, it is assumed that households expect real house prices to remain constant in real terms, or in other words expect no real capital gains. The unfavourable capital gain expectations contribute to the lack of speculation in the German housing market. Therefore with inflation expectations backward-looking, the expected capital gains are computed as a five-year moving average of the consumer price inflation rate, which is evidently reflective of the macroeconomic conditions. As such rent increases at the rate of inflation.

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[108] Dan Andrews (2010) 'Real House Prices in OECD Countries – The Role of Demand Shocks and Structural and Policy Factors' *OECD Economics Department Working Papers* No. 831. OECD: Paris.
[109] Karl Brenke (2009) 'Real Wages in Germany: Numerous Years of Decline' *German Institute for Economic Research Weekly Report* No.28(5).
[110] Tobias Just (2008) 'The German Housing Market: A Brief Overview' *Deutsche Bank Research*, http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000225635.pdf (accessed 27/05/2013).
[111] IMF (2005) *World Economic Outlook*. IMF: Washington, Chapter 2, "Three Current Policy Issues".

Monetary policy has an effect on the housing market where lower interest rates increase the affordability of mortgages, thus boosting demand and construction. The strong demand in turn increases household wealth, allowing households to increase consumption. Friedman termed this the **wealth channel**, where households benefit from the appreciation of their assets during their life-cycle, showing that households decrease their current savings when house prices increase so that consumption increases.[112] Although influential, economists believe that the **credit channel** is a stronger transmission mechanism between monetary policy and house prices, where the rising house prices increases the opportunities for lending money, which can be used for consumption.[113] With both of these channels increasing consumption, demand for housing increases proportionally, and creates a property bubble. Neither of these two transmission channels has affected the German property market.

The persistently low interest rates and increasingly sophisticated financial innovations gathered significant momentum in the peripheral EU countries due to the backward looking expectations and pro-cyclical financial markets. The ECB's strict mandate for an inflation rate of 2% meant that the interest rate set for the Eurozone, taking into consideration the low growth of the bigger economies, was higher than the Taylor rule would suggest optimal for countries like Ireland and Portugal.[114] Membership of the EMU meant that these countries could not cool down the economy by increasing the interest rates. Furthermore, membership of the Eurozone created the additional incentive to engage in fiscal expansionary policy without punishment through exchange rate or inflation volatility. Persistently low real interest rates with lax fiscal policy led to a huge credit bubble, which was disproportionately lent to the housing and financial sectors, thus creating a boom that contributed to the pro-cyclicality of the fiscal policies. The numerical EU fiscal rules fail to consider the cyclicality and liability effects of huge increases to household credit, mortgage lending, credit to non-financial corporations and investment leveraging. Rather, the revenue of transaction tax, capital gains and VAT rewarded the inflated balance sheets and property prices and the indebtedness of household and non-financial corporations.[115]

For example, in Ireland the low interest rate and capital flow freedom was helped by deregulation in the financial sector, where Dublin became known for processing innovative financial instruments with huge leveraging and complex derivatives and hedging.[116] Capital increasingly came from the lower economic growth core EU countries to the peripheral countries with higher real interest rates. Honohan shows that it should have been very clear to regulators that 20% per annum growth

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[112] Milton Friedman (1957) 'A Theory of the Consumption Function' *National Bureau of Economic Research General Series* 63.
[113] David Miles (1994) *Housing, Financial Markets and the Wider Economy*. Chichester: Wiley.
[114] John Taylor (1993) 'Discretion versus Policy Rules in Practice' *Carnegie-Rochester Conference Series on Public Policy*, 39, 195-214.
[115] Frank Barry and Garret FitzGerald (2009) "Politics and Economic Policymaking in Ireland" Speech at Trinity College Dublin on 9th October, Trinity College Dublin.
[116] Jacques de la Rosiere (2009) *The High-level Group on Financial Supervision in the EU*. Brussels: European Commission.
http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (accessed 02/04/12)

of banks assets was unsustainable.[117] In 2008, following the collapse of Lehmann Brothers, the Irish banks were holding deflated assets on their balance sheets, and financing them through expensive and diminishing interbank and bond markets. Due to mark-to-market accounting, the banks either held fire sales of assets or held the assets waiting for the business cycle to return.[118] For stability the government had to extend a guarantee on existing and future bonds and insurance of the banks. This failed to offset the lack of confidence and huge losses of the banks, so the government nationalised Anglo Irish Bank, recapitalised Allied Irish and Bank of Scotland, and created the National Asset Management Agency (NAMA) to take all development and land loans off the banks' balance sheets.

Following the financial crisis, there is more debate about the role of the European Central Bank's monetary policy in EMU asset price cycles.[119] Taylor argues that if the Federal Reserve had set their rates according to the Taylor rule over the past decade there would have been no housing boom.[120] Former Federal Reserve chairman, Greenspan has responded by stating that the rate which matters for house prices is the rate on long-term, fixed rate mortgages, and not the federal-funds rate. In other words, he states that the long-term rates have been kept low as a consequence of the "savings-glut" of the Asian economies which fuelled the mortgage lending. This argument does not consider the fact that short-term funding of financial products were directly contingent on the monetary policy.

There are two difficulties in giving the ECB this task: detecting housing bubbles with a reasonable degree of certainty in real time is problematic and the use of monetary policy to thwart housing bubbles can be damaging on the whole economy.[121] Moreover, the ECB has to adjust monetary policy for the whole of the Eurozone, where price dynamics have been very different in Germany to the rest of the countries. Therefore, it is likely that the ECB will continue its monetary role in the future to "clean up the mess" by lowering interest rates and providing liquidity rather than adopt a preventative role.

In the European Monetary Union, the use of prudent monetary policy against asset price booms is difficult given the interest rates are applicable for every nation state and thus are out of line with the real interest rate for several economies. Therefore, prudent regulation and supervision of the banking sector is necessary to ensure low housing finance volatility.

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[117] Patrick Honohan (2009) 'Resolving Ireland's banking crisis' *The Economic and Social Review* 40(2), 207-231.
[118] Amir Amel-Zadeh and Geoff Meeks (2011) 'Bank failure, mark-to-market and the financial crisis' *Judge Business School Working Paper,* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1494452 (accessed 02/04/12).
[119] Frederic Mishkin (2008) 'How Should we Respond to Asset Price Bubbles?' speech at the Wharton Financial Institutions Centre and Oliver Wyman Institute's Annual Financial Risk Roundtable, Philadelphia, Pennsylvania, 15 May 2008.
[120] John Taylor (2007) 'Housing and Monetary Policy' *National Bureau of Economic Research Working Paper* No. 13682.
[121] Refet Gurkaynak (2005) 'Econometric Test of Asset Price Bubbles: Taking Stock' *Finance and Economics Discussion Series* No.2005-04, Governors of the Federal Reserve System.

Globalisation, Current Account Imbalances and Housing Markets

International trade imbalances have widened considerably over the past 15 years, caused by capital flows which have a major role in fuelling housing booms. Obstfeld and Rogoff show that there is a strong negative correlation between increases in real house prices and changes in current account balances during the period 2000-2007.[122] As mentioned above, the global macroeconomic imbalances kept interest rates low and abundant capital in the Western Countries, and the European Monetary Union facilitated large capital flows within the Eurozone. Higher demand for houses can reallocate resources from tradable goods sector to construction, potentially weakening the competitive position of a country, and thus increasing the current account deficit.

Germany sat at the opposite end, where real houses declined between 2000 and 2007 and it registered a large 5% current account surplus during the period. Capital was exported from Germany to the higher growth in the EU peripheral countries and the US, meaning that it was not invested into the housing market or into higher domestic consumption. This helped create the competitive exporting economy and avoid the housing boom. Without capital being invested into the domestic market, there was no wealth effect or misallocation of resources. Nonetheless, with the foreign housing market undergoing correction in house prices or weakened by economic recession, it is predicted that investors will see the German housing market as attractive for the coming years. Whether this will cause a housing boom thus depends on the supply and demand conditions.

MORTGAGE MARKET

The mortgage market, embedded within the financial market, has a crucial role in the housing sector, as owner-occupied housing contributes to the largest financial asset of home-owning households, and they require debt financing. There has been a varying degree of financial deregulation across many countries, both in the depth and the timing of reform.[123] Financial deregulation of the mortgage markets has significantly lowered borrowing costs, leading to a large increase in the supply of mortgage loan supply.[124] An increase in mortgage supply would increase the size of the home-ownership sector, decrease the size of the rental market and increase real house prices. Nonetheless, the long-run impact on house prices is unsure once the housing market adjusts to the increased supply shock.

Lending and risk-taking tend to become pro-cyclical as economic agents become more confident and complacent during economic growth,[125] or large institutions take excessive risk under the moral hazard of "too important to fail" governmental

[122] Maurice Obstfeld and Kenneth Rogoff (2009) 'Global Imbalances and the Financial Crisis: products of Common Causes' Federal Bank of San Francisco Asia Economic Policy Conference, Santa Barbara CA, 18-20 October 2009.
[123] Abdul Abiad, Enrica Detragiache and Thierry Tressel (2008) 'A New Database of Financial Reforms' *IMF Working Paper* WP/08/266, IMF: Washington DC.
[124] Luci Ellis (2006) 'Housing and Housing Finance: The View from Australia and Beyond' *Reserve Bank of Australia Research Discussion Paper* No. 2006-12.
[125] Hyman Minsky (1992) 'The Financial Instability Hypothesis' *The Jerome Levy Economics Institute of Bard College Working Paper* No. 74.

guarantee.[126] The financial crisis shows how the relaxing of lending standards can go too far, where in the absence of proper regulation it will lead to an excess in non-performing loans. In the US lending, standards deterioration over the decade of house price growth significantly dropped, where the loans given with zero down-payment increased from 8% in 2001 to 22% in 2007.

In addition, the "financial accelerator" can increase volatility. This is where easier credit increases housing demand, leading to increases house prices and household wealth, which allows households to borrow further.[127] Similarly, when the balance sheets of banks are marked to market, financial institutions are incentivised to an increase their leverage, increase their investments and take more debt when the asset prices increase. Furthermore, these institutions increase their leverage using repurchase agreements.[128]

In light of such volatility mechanisms in the mortgage markets around the world, the German mortgage market has been accredited with maintaining a sufficient level of regulatory governance, which is characterised by smaller growth in the mortgage market, low loan-to-value ratios, long terms loans, fixed interest, 1-2% amortization, mortgage covered bonds and no securities market.[129] It is unclear whether the causality of the small mortgage market is due to low home-ownership, or whether the low home-ownership is due to the small mortgage market. How the financial systems and the housing market institutions interact is well documented, although there is little empirical evidence of their precise effects.[130]

There have been policy reforms in the European Union to facilitate the single market in finance, such as the Second Banking Directive which created a framework whereby financial institutions were to be supervised by the government of their own country and, once licensed, would be free to set up branches in other EU member states. Although the financial market became highly integrated across member states, the mortgage markets in each country were characterised by their own products, rules and institutions. In other words, there was no convergence in the European mortgage market. It has been argued that the housing market is unlikely to be regulated or converged under EU law, where there is no mandate to regulate, there is no clear opinion on housing policy and the member state policies are too divergent.[131] The Liikanen Group advocate that there should be new EU regulation of the real estate market, with maximum LTR and/or loan-to-income ratios in the instruments available for micro- and macro-prudential supervision.[132]

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[126] Mervyn King (2009) Speech by Mervyn King, Former Governor of the Bank of England, to Scottish business organisations, Edinburgh, 20 October 2009.
[127] Kosuke Aoki, James Proudman and Gertjan Vlieghe (2002) 'Houses as Collateral: Has the Link between House Prices and Consumption in the UK Changed?' *Economic Policy Review* 8(1).
[128] Tobias Adrian and Hyun Song Shin (2008) 'Liquidity, Monetary Policy and Financial Cycles' *Current Issues in Economics and Finance* 14(1).
[129] John Muellbauer (1992) 'Anglo-German differences in housing market dynamics: The role of institutions and macroeconomic policy' *European Economic Review* 6(2), 133-49.
[130] Michael Voigtländer (2012) Ibid [104].
[131] John Doling (2012) 'A European Housing Policy?' *International Journal of Housing Policy* 6(3), 335-349.
[132] Liikanen Group (2012) 'High-level Expert Group Report on reforming the structure of the EU banking sector', found at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf (accessed 27/05/2013).

The European Commission proposed on the 31st March 2010 the Directive on Credit Agreements Related to Residential Property (CARP)[133], intended to strengthen the internal market for mortgage credit. The Economic and Monetary Affairs Committee of the European Parliament has put forward proposals on a new principle on financial education, general rules on the conduct of business, minimum qualification requirements, prohibition on tying products to the mortgage credit agreement, pre-contractual information obligations and reflection period, obligations for credit intermediaries to provide information on their status, obligation to provide advice and explanations, credit worthiness assessments, impartial property valuations and the right of early repayment.[134]

The German credit suppliers offer an unlimited diversity of financing schemes as a matter of principle, such as LTV ratios over 100% have been given out in Germany. However, such non-standard products are only made to customers with a top credit rating, who are legitimately expected to be able to afford the refinancing obligations. Furthermore, competition in the German credit industry is so intense that spreads are often the lowest in Europe. Nonetheless, it is characterised as risk averse and stable.

Small Growth in the Mortgage Market

Growth in the German mortgage market has been very small compared to the rest of the Eurozone countries. Voigtländer highlights that there is strong correlation between the housing market and mortgage market in most developed nations, and Germany was decoupled from the growth in the mortgage market that was occurring across the Eurozone.[135] The ECB calculates that the German mortgage market grew on average by 3% between the years 1999 and 2007, which is very small in comparison to the like of Ireland (23.4%), Greece (30.3%) and Spain (19.8%).[136]

Low loan-to-value (LTV) ratio mortgages

An increase in LTV ratios decreases the deposit requirements for mortgage loans, thus increasing the share of households able to move into home-ownership. This affects the structure of housing demand in many countries with higher LTV ratios, where younger and lower income households leave the rental market. The OECD estimates that a 10% increase in LTV raises the aggregate home-ownership rate by 3% from the sample mean.[137]

In 2007, the typical LTV ratio for a new mortgage was around 80% in the majority of the EU Member States, ranging between 63% and 101%. While generally no formal restrictions are in place for this ratio, a threshold can be put in place for capital and provisioning requirements on housing-related loans. Should LTV ratios remain below a certain limit (80% in Spain and Italy, 75% in Greece, Ireland and Portugal, and 70% in Finland, for example), mortgages are treated in the standard way under Basel II, but receive a higher risk weight above that level, requiring banks to

[133] COM(2011) 142 final – COD 2011/0062 Proposal for a Directive of the European Parliament and of the Council on credit agreements relating to residential property
[134] Ibid
[135] Voigtländer Ibid [104] at 6.
[136] European Central Bank (2009) 'Housing Finance in the Euro Area' *Structural Issues Report* March 2009.
[137] Ibid [110] at 38.

hold more (costly) capital against these loans. Likewise, a threshold applies for loans to be eligible as collateral for covered bonds or mortgage bonds (80% in Spain and Portugal, 75% in Ireland, and 60% in Germany, Slovenia and Finland).

German home-owners are used to financing the construction or purchase of real property with capital of their own up to at least 30%. On average 40% of the capital is their own. Small and medium households are unwilling to hold such large amounts of debt and the related financing burdens. There was no demand from "subprime" households in Germany for the financial offers made to the same group in the US.

The low LTV ratio in Germany has contributed to the low potential for transmission of increased house price appreciation to increased consumption, therefore controlling the wealth and capital effects of other countries' property booms.

Long-term loans (10 year)

As house prices have increased and made housing less affordable, lenders have extended the length of the repayment period of mortgages in many countries, with terms of 50 years available in counties such as France and the UK.[138] An ECB Paper analysing housing finance in Europe shows that over half of German housing loans have interest-rate resetting periods above 10 years.[139] 75% of new loans are provided for a fixed-interest period of ten years or more. This is compared to a Eurozone average of only 25%.

Fixed interest rates mortgages

Many countries have seen an increasing share of the mortgage market offering adjustable-rate loans, with adjustable-rate mortgages making up 35% of the market in the US.[140] Adjustable rate mortgages increase the interest rate risk on mortgages. In Germany the mortgages are fixed interest rates, meaning that there is no interest rate cyclical demand for home-ownership and there is a lower interest-rate risk for holders of mortgages. Variable rate mortgages are in principle obtainable in Germany. Members of the small and medium income groups in Germany especially reject the risk of variable-rate loans. This explains partly why the German housing market is less reactive to monetary policy changes over the past two decades, where Demary shows that the UK house price reactions exceed German price reactions to monetary shocks by a factor of five.[141]

At least 1-2% amortization

In many countries there has been a rise in interest-only mortgages, where only interest is paid on a monthly basis and the capital is repaid at the term of the contract. They are most common in countries where there is a tax relief on mortgage

[138] Jens Lunde, Kathleen Scanlon and Christine Whitehead (2008) 'Interest-only and Longer-term Mortgages: Easier Access, More Risk' in *Hypostat 2007*, European Mortgage Federation, November.
[139] ECB (2009) Ibid [138] at 85.
[140] Andrea de Michelis (2009) 'Overcoming the Crisis in the United States' *OECD Economics Working Papers* No.364.
[141] Markus Demary (2010) 'The Interplay between Output, Inflation, Interest Rates and House Prices: International Evidence' *Journal of Property Research* 27(1), 1-18.

interest payments, such as the UK and the Netherlands. Usually, but not always, they were associated with investment products which secured the capital at the end of the term. In other countries, the interest only mortgage payments only last a certain period of the mortgage duration. For example, in Denmark, after a maximum of 10 years the mortgages should be paid off during the remaining duration. In Germany, these mortgages are very uncommon, where most mortgages are normal amortization mortgages, where the capital and interest is paid off monthly at a rate of between 1-2%. Therefore the German housing market has less risk of investment products being under-financed to repay the capital.

Bauspar Market

Whereas the mortgage loans are used mainly for the financing of investing into the private rental market, the *Bausparkassen* is used by most households financing the building or purchasing of their home. Essentially it is a savings account, upon when the savings target is made the *Bausparkassen* is committed to offer a below market rate, fixed interest mortgage.

The history of the Bauspar Market can be traced back to the 1775 establishment of Kettley's Building Society in Birmingham. Through monthly savings contributions, the members of the Society collected a pool of capital from which the customers were able to take out loans to build their homes. The first *Bausparkasse* in Germany was in 1885, and the concept developed strongly after World War II to help people finance building their homes. The concept is based on a social-ethic idea of mutual support for potential home buyers who cannot access mortgage loans.

Today there are 30 million *bauspar* contracts, which fluctuate with the state of the economy. Every second German household has at least one *bauspar* contract. Helbrecht and Tegeder state that 70% of home-owners have a *bauspar* contract.[142] The sum of these is about €763bn, which amounts to 32% GDP. There are currently 22 *bausparkassen* in Germany: 10 public *bausparkassen* operating within regionally defined markets, and 12 private *bausparkassen* conducting business nationally. The public *bausparkassen* are either incorporated under public law or in public ownership. The private *bausparkassen* cover approximately two thirds of the market.

The basic idea is a 'closed pool', with the pooled deposits called the 'allocation fund'. The fund is fuelled by the combined savings of the potential home buyers during the savings phase as well as the redemption payments. The allocation fund is used to pay out the contractually agreed sum to customers when their contracts are allocated. They receive both the credit balance in their account and a low-interest loan up to the amount of the agreed sum.

The capital saved keeps the burden of financing down, and the fixed interest on the loan offers protection against rising interest rates. Further advantages include the possibility to repay the loan early without penalty, fast freedom from debt and a second-rank provision of security.

The most common home-finance mix in Germany is a combination of a *bauspar* loan and a mortgage credit. The general rule for the home finance mix is:

[142] Gudrun Helbrecht and Ilse Tegeder (2005) 'Institutional Study Germany' *OSIS Report: Quantitative Study*, EU Contract No. CIT2-CT-2003-506007. Work Package 2, Deliverable No.9.

- 50% is financed in credit from savings bank or bank loans
- 30% *bauspar* loan, which agreed on a ratio of 60% loan to 40% savings
- 20% already accumulated savings in the *bauspar* pool
- Possibility of other own funds, such as securities or own contributions in kind
- Possibility of external funds, such as a loan from an employer, relatives or state-support

Once ridiculed internationally, the practice of *bauspar* contract has been generally recognised as a factor of stabilisation in the German mortgage market, similar to the low risk success of the *pfandbrief* market.

No Housing Equity Withdrawal

Many countries, particularly in English-speaking countries, have increasingly allowed households to extract equity from their homes through cash-out refinancing. This has been done through either re-mortgaging the home and taking the equity gained, or using the housing equity as larger collateral. This has increased the households' debt, thus increasing the risk of refinancing problems. Withdrawal of housing equity has not been allowed in Germany, thus reducing the amount of household debt and increasing the macroeconomic stability of the German mortgage market as a whole. There is no demand for such equity release; since the German property market has not seen the capital gains on property other countries with a developed equity release market have seen. Since the mortgage lending rates remains constant over time, home buyers cannot take out equity. Property owners can commission a new report to adjust the mortgage lending, but this appraisal is expensive. Without equity withdrawal, the wealth and credit channels of property boom are not encouraged through a transmission of an increase in house prices to an increase in consumption. With a weak public pension and the welfare system under pressure due to demographic changes, the German households keep equity within the house so that they can use it during their pensioner years to subsidise their standard of living.

Residential mortgage backed securities are negligible

In some countries an increased reliance on securitisation has allowed an expansion in mortgages originations. The private mortgage backed securities has allowed the securitisation of non-conforming loans, which are loans which would not qualify for securitisation by the public enterprises. These "subprime" and "Alt-A" loans were loosely regulated, with the risk being difficult to assess. These mortgages were bundled together and sold on as bonds or investment banks sold collateral debt obligations on them. The bundled packages were given AAA ratings by the rating agencies, and thus many pension schemes (*inter alia*) bought them. The investment banks further took out insurance against default, thus leading to large insurance funds insolvency when the mortgages defaulted, with AIG alone losing $53bn.

In Germany such "sub-prime" mortgage market with securities, collateral debt obligations and insurance did not materialise into a significant share of the market. Rather, the mortgages in Germany required stringent income tests and a large cap-

ital down-payment. The large share of the rental market consists of households who are unable to get a mortgage for home-ownership due to the regulation.

Nonetheless, the German banks did invest in the mortgage markets abroad, particularly in the securitisation market. Deutsche Bank still has large liabilities in the US mortgage market. DEPFA Bank Plc. underwrote a group of municipal bonds in the U.S. that subsequently had their ratings downgraded. Under the terms of the underwriting, DEPFA was required to buy back the securities after a downgrade in the ratings. Due to the difficulties in obtaining short-term funding in the markets at that time, DEPFA's liquidity became a major concern, and through a series of bailouts, the German government ended up with 100% ownership of DEPFA's parent company, Hypo Real Estate.

Mortgage covered bonds (*Pfandbrief*) are popular and stable refinancing product

Rather than the development of a securitisation market, the German mortgage market has used covered-bonds to provide long-term funding to mortgage lenders. The *Pfandbrief* is collateralised by long-term assets made up of first ranking mortgages (*Hypothekenpfandbriefe*), ship mortgages (*SchiffsPfandbriefe*), aircraft motgages (*Flugzeugspfandbrief*) or public sector loans (*Öffentlicher Pfandbriefe*), as stipulated in the *Pfandbrief* Act (*Pfandbriefgesetz*). This act also regulates the quality and standard of the covered bonds, with supervision coming from the Federal Financial Services Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, 'BaFin'). Only credit institutions complying with the strict quality demands and have a license are permitted to grant *Pfandbriefe*. Due to the stringent legal provisions, *Pfandbriefe* are deemed particularly safe and given AAA rating. The mortgage lending value is assessed by appraisers who set the property price at the point at which it will not fall even in a severe downswing.[143]

The core difference between a *Pfandbrief* and asset-backed securities is that *Pfandbrief* cover-assets remains on the banks' balance sheets while asset-backed-securities are typically off-balance-sheet transactions. The aggregate amount outstanding under *Pfandbriefe*, including their aggregate interest income, must be covered by 'cover assets' (*Deckungsstock*). The *Deckungsstock* is a pool of specified qualifying assets comprising the respective Mortgage, Ship, Aircraft and Public *Pfandbriefe*, which secures all the outstanding *Pfandbriefe*. Only mortgage or ship loans with a loan-to-value ratio not exceeding 60% qualify for inclusion in the *Deckungsstock*. The *Deckungsstock* will constitute a sufficient cover fund if the aggregate principle amount of and the interest income on the qualifying mortgages at least equals the aggregate face amount (including interest income) of the *Pfandbriefe*. This safety cushion offers *Pfandbrief* holders comfortable protection against depreciation caused by cyclical fluctuation of the market value of the cover assets. All cover assets must be registered in a cover register (*Deckungsregister*) at their nominal amount. The *Pfandbrief* Banks must regularly report their current positions to BaFin, and have an independent fiduciary agent attached.

In the event of the *Pfandbrief* issuer's insolvency, *Pfandbrief* investors have a preferential claim on the cover assets in the cover register because the cover assets are not included in the insolvency proceedings. Nonetheless, there has not been a

[143] Wolfgang Crimmann and Konrad Rüchardt (2009) *Mortgage Lending Value*. Berlin: Verband Deutscher Pfandbriefbanken.

Pfandbrief insolvency since 1901. The IMF argues that the preferential treatment of the *Pfandbrief* financial institution over other lenders to the housing asset has reduced the growth of the securitisation market in Germany.[144] The strong regulation of the *Pfandbrief* reduces the moral hazard of government bailouts in the system, whereby there is a significantly high level of over-collatoralisation and there is the possibility of the government to segregate the cover pool assets into a specialised *Pfandbrief* bank with limited business activity (*Pfandbrief mit besdchränkter Geschäftstätigkeit*).

Pfandbrief issuers have three different *pfandbrief* segments at their disposal: Jumbo *pfandbriefe*, traditional *pfandbriefe* and registered *pfandbriefe*. Traditionally *pfandbriefe* are issued as fixed or floating rate bonds, but may also take the form of zero coupon bonds. The issue usually takes the form of a global certificate.

The Jumbo *Pfandbrief* was brought into the market in 2005 to attract foreign investors. It allows an issuing syndicate with a goal of marketing Jumbo *Pfandbrief* issues and of subsequently ensuring the market making. It must have a minimum issuance volume of €1bn, with the average size being €1.5bn. They are issued as straight bonds, with a fixed interest rate to be paid annually. The minimum maturity is one year, with the bulk of the issues having terms of five to seven or ten years.

The total volume outstanding in the *Pfandbrief* market was €806bn at the end of 2008, making it the third largest segment of the German bond market after public sector bonds and unsecured bank debt. The success of the *Pfandbrief* market has been shown in its resilience in the global credit crisis due to the high level of safety in the regulatory requirements, and the subsequent upsurge in interest by both international investors and financial policy makers.

Prudential Mortgage Market Regulation and Perceptions of Home-ownership

To summarise, against the trend in most other OECD countries, the German mortgage market is characterised by 1) low LTR ratio, long-term and fixed-interest mortgages with 1-2% amortization and no housing equity released, 2) financed through *bauspar* savings contracts and *pfandbrief* covered-bonds, rather than the less regulated and more volatile securitisation market, 3) which led to a small growth in access, risk, debt and volatility in the German mortgage market.

Toussaint *et al* examine the effect of the prudent regulation on the mentality of home-ownership and financial security in Germany.[145]

- There was a concern about insufficient income for the debt refinancing, and thus households only bought a house when they believed that their job and relationship was stable.
    - German people are concerned about a stable income, in part due to the historically high level of unemployment over the last 20 years.

[144] IMF (2011) 'Germany: Technical Note on the Future of German Mortgage-Backed Covered Bond (Pfandbrief) and Securitisation *Markets' IMF Country Report* No.11/369.
[145] Toussaint et al (2007) Ibid [65].

- German households considered renting as the most appropriate tenure while establishing the required capital and financial security before home-ownership.
    - German households will save for a deposit and will only borrow to a maximum of 70-80%.

- German households expect welfare to be cut in the future, whereby the 2005 Welfare Reforms make unemployment for young people a greater financial insecurity.
    - Therefore, income security is more important before receiving a mortgage.
    - German households wish to pay off their housing debt so that the housing capital can act as a safe pension.

- German households see home-ownership as reducing their mobility, and thus young people who are not fully settled in an area will stay in the rental market.

- The negative demographic outlook (see later section in this chapter) gives the expectation of house price decreases, thus the risk of negative equity.

- Interest rate changes are not considered as dangerous given the fixed-interest loans.

ABOLITION OF THE *EIGENHEIMZULAGE* (FIRST TIME BUYERS GRANT)

Until 2005, the highest promotion programme for home-ownership was the *Eigenheimzulage*: a government grant, allocated directly to first time buyers. For an 8 year period the German government would pay home owners 1% of the construction costs of the property and €800 for each child every year. This might help explain the German culture of buying one dwelling as a once-in-a-lifetime transaction. The *Eigenheimzulage* was abolished in 2005 and replaced with the *Bausparkassen* (above). Nonetheless, current and future home owners, depending on their income, can benefit from diverse government bonuses:

- *Wohnungsbauprämie*: government grant for the *bausparen*, at a maximum of €512 per year for 7 years.
- *Arbeitnehmersparzulage*: income limited employees savings allowance for the long-term promotion of saving capital, where part of the income is invested into a building society, investment fund, bank savings plan, amortization of property plan, the business assets of a cooperative enterprise and life insurance. In essence it is a government subsidy to encourage savings, which is often used for housing finance when needed.

HOUSING TAXATION

Typically the tax treatment of home-ownership makes it a less taxed asset for households than other capital investments, including the purchasing of residential property for the PRS. The three main tax advantages in a majority of countries are imputed rents not taxed, mortgage interest relief and exemption from taxes on

capital gains. For example the Dutch tax system allows for a full deduction of mortgage interest payments on taxable income. Such favourable treatment for home-ownership has been justified on positive externalities for society.[146]

However, studies have found that they introduce distortions in market participants' decisions:

- Crowd out more productive investments[147]
- Lead to undesirable effects on tenure choice.[148]
- The increased demand for housing tends to increase the level of the house prices, offsetting part of the tax advantage.[149]
- Encourage excessive leverage (LTV ratio and longer periods of debt)[150]
- Tends to be regressive, favouring higher income households, leading to greater home-ownership inequality[151]

It is therefore argued that the tax treatment for housing should be equal to that of investment and consumption goods. More specifically for this report, it is argued that the marginal tax rate should be equal between renting or owning a dwelling. Nonetheless, this requires a determination whether housing is an investment or a consumption good.

In Germany the main tax advantage is capital gains tax exemption, but it is limited to when property has been owned for more than 10 years. This minimum time condition prevents speculative short-term holdings of property. With capital gains tax at 25% before 10 years, short term investment requires significant price increases, which has not been seen or expected in Germany. This will affect investor types, whereby short term financial investors looking for quick returns will not access the market as favourably as long-term owner-occupiers or buy-to-let landlords.

Other taxes which affect the structure of the housing markets includes property taxes and taxes on transactions (stamp duties, transfer and cadastral taxes and VAT). Property tax (*Grundsteuern*) is set by the municipal governments in Germany, and is based on the size of the property. Real property transfer tax (*Grunderwerbsteuer*) in Germany is set by the *Länder* governments, usually at 3.5%, except for Berlin, Hamburg and NRW which set theirs at 4.5%.

Therefore it can be argued that Germany has a fairly neutral tax treatment between the rental market and the home-ownership market. With a large and mature rental market, a large share of households opt for the rental market where

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[146] Denise DiPasquale and Edward Glaeser (1999) 'Incentives and Social Capital: Are Homeowners Better Citizens?' *Journal of Urban Economics* 45(2).
[147] Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia (2008) 'Tax and Economic Growth' *OECD Economics Department Working Papers* No. 620.
[148] OECD (2009) "Taxation and Growth", Chapter 5, *Economic Policy Reforms 2009: Going for Growth*. OECD Publishing.
[149] Tommy Berger, Peter Englund, Patric Hendershott and Bengt Turner (2000) 'The Capitalization of Interest Subsidies: Evidence from Sweden' *Journal of Money, Credit and Banking* 32(2), 199-217.
[150] Benjamin Harris (2010) 'The Effect of Proposed Tax Reforms on Metropolitan Housing Prices' *Tax Policy Centre Working Paper*, April.
[151] Andrews et al (2011) Ibid [90] at 41.

there is no tax disadvantage. The reduced demand on the home-ownership market thus reduces the volatility in house prices. Hilbers *et al* find a positive correlation between the home-ownership rates in 2004 and property price appreciation between 1990 and 2004 in European countries.[152]

HIGH TRANSACTION COSTS

We have analysed that increasing housing prices will increase the amount of consumption, due to both the wealth effect and credit channel, although these have been found to be weak in Germany. Another feedback loop is that increased consumption will in turn increase house prices, which virtuously loops into booms and busts. In addition to the lower consumption to other comparable OECD countries, it is found that consumers in Germany spend less money on residential property. The average number of transactions in the property market over the past 5 years in the UK was 1.185 million, while this was 0.465 million in Germany.

This can be explained through two straightforward reasons:

1. **Transaction costs are significantly higher in Germany** – Transaction costs, including notary costs, real estate agents and taxes, represents 5% of property costs in the UK, while they represent between 9-13% in Germany.

2. **Low home-ownership rate – diminishes potential for real estate transactions**. The rental dwellings are virtually locked into the rental market due to tenancy law.

The high transaction cost also explains why German households generally tend to buy one property and use it for the rest of their lives.

DEMOGRAPHICS AND URBANISATION

It is argued that home-ownership rates reflect two main factors. The first is a change in a household's preference for home-ownership relative to other tenures, which in turn is influenced by housing policies such as taxation and rent regulation, which this report has extensively reviewed for Germany. The second is demographic, socio-economic and urbanisation developments. For example, with the assumption that home-ownership tenure choice tends to increase with age, it would be could therefore be assumed that an aging population would increase the level of home-ownership overall, *ceteris paribus*.

This section highlights the long term increasing demand for smaller and one-person dwellings, due to the elderly not needing large houses and selling larger dwellings for capital, lower marriage rate, higher rates of divorce, the need for higher energy efficient, the effects of urbanisation and the constrained supply of houses in cities, and the low income of immigrant households.

[152] Paul Hilbers, Alexander Hoffmaister, Angana Banerji and Haiyan Shi (2008) 'House Price Developments in Europe: a Comparison' *IMF Working Paper* WP/08/211.

Demographic change

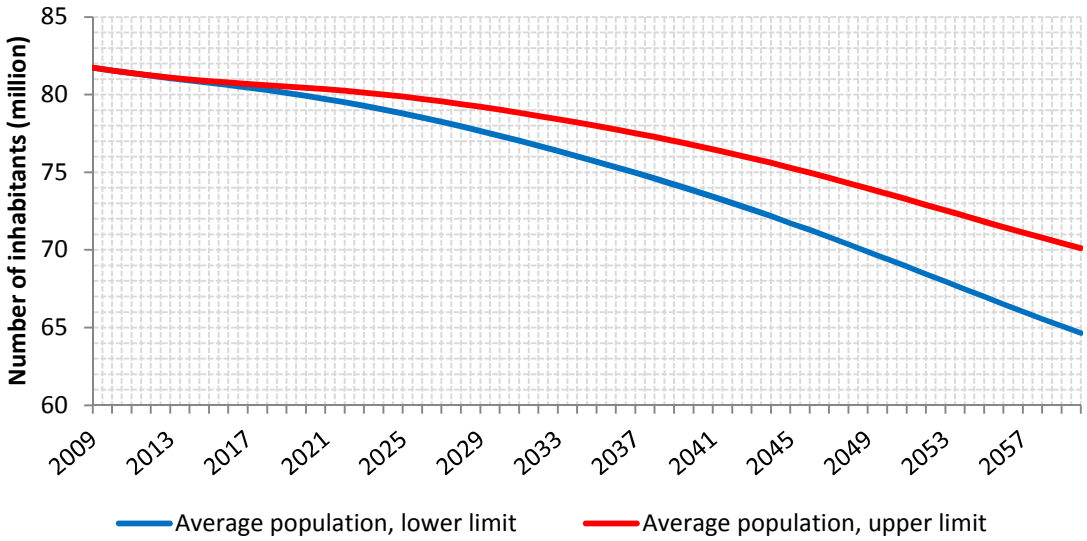
While the long-run equilibrium in the housing market is likely to be influenced by the long-run natural increase of the population, studies have shown that the growth of the population from net immigration has a greater impact on house prices in the medium run.[153] German and Japan, the two countries with the lowest population growth in the OECD, were the only countries in the OECD to experience falls in real estate prices between 2000 and 2006. Due to its ageing population and its decline in population, there is an expectation that house prices will not increase, which is factored into the long-term expectations of investment.[154]

Germany has an aging demographic, with the birth rate being too low to create a workforce sufficient enough to support the current workforce when they retire. The current old-age dependency ratio was 32.7 in 2006 and is expected to rise to 50 by 2035.[155] Figure 35 shows a range of the population decline from the lower to the upper limit. For the public pension scheme, either it will have to reduce the amount paid to the pensioners or will have to raise the contributions from current workers, or both. There might be an increase in home-ownership with an aging population, or with inheritance of the baby-boom generations' dwellings.

Therefore, Germany is reforming its policies in order to create a more sustainable future through two tracks: an increase in immigration and policies to promote higher fertility. Chancellor Merkel famously claimed that multiculturalism had failed in Germany,[156] most publically visible in the recent racist attacks on foreigners by self-proclaimed neo-Nazis.[157] With the enlargement of the EU to 28 member states, and the opening of the borders for migration of workers from the Eastern European states, it is likely that Germany will experience a growth in immigrants to support the labour market. This will lead to inevitably pressures on the housing market, specifically with the demand for low cost dwellings in the rental market. With youth unemployment currently being significantly lower in Germany than most of the other EU member states, it is likely that there will be many educated and skilled youth emigrating to Germany who similarly will initially seek low cost small dwellings in the rental market.[158]

[153] Andrews et al (2011), Ibid [90] at 34.
[154] Anwen Jones, Tim Geilenkeuser, Ilse Helbrecht and Deborah Quilgars (2012) 'Demographic Changes and Retirement Planning: Comparing Households' Views on the Role of Housing Equity in Germany and the UK' *International Journal of Housing Policy* 12(1), 27-45.
[155] Statistisches Bundesamt (2008) *Datenreport 2008* [Data Report 2008]. Bonn: Statistisches Bundesamt.
[156] BBC (2010) 'Merkel says German multicultural society has failed', found at http://www.bbc.co.uk/news/world-europe-11559451 (accessed 28/6/2013).
[157] BBC (2012) 'Germany's new breed of neo-Nazis pose a threat' found at http://www.bbc.co.uk/news/world-europe-17514394 (accessed 28/06/2013).
[158] The Guardian (2013) 'Young Spaniards flock to Germany to escape economic misery back home' found at http://www.guardian.co.uk/world/2013/jul/07/spanish-youth-germany-unemployment-crisis (accessed 28/06/2013).

FIGURE 35: POPULATION DECLINE SPEEDING UP



Source: DESTATIS

Accelerated Growth in Housing Prices in Urban Centres

At the metropolitan level, additional supply determinants include the population, growth, density and infrastructure of a city.[159] Should the city's supply determinants be inelastic to demand, then there will be price increases. With simultaneous backward looking expectations and demand shocks, price bubbles can easily arise.[160] While the increase for German house prices as a whole was 2.7% in 2011, prices in Germany's urban centres recorded above-average growth of between 5 and 9%, as has been shown earlier in the 'House Prices' subsection.

In the 1990s, most large cities in Germany suffered population and migration losses, in particular to the local surrounding areas. Since the late 1990s, the trend in large cities has increased. We have seen in the construction section that Tobin's q is likely to increase in urban areas, where the export-driven German economy growth and high in-migration will draw more into the cities. The increase has coincided with changing lifestyle trends, labour force requirements, household size and an aging population. In the developed and dynamic housing markets with high prices there has been an increase in suburbanisation, which has increased the supply of housing in line with the regional diversity of the German housing market. In the new *Länder* and in regions with negative growth in the old *Länder* (e.g. in the Ruhr area) there has been a standstill in suburbanisation, where there are efforts to focus on the urban centres to improve the demand.

[159] Dennis Capozza and Robert Helsley (1989) 'The Fundamentals of Land Prices and Urban Growth' *Journal of Urban Economics* 26, 295-306.
[160] Edward Glaeser, Joseph Gyourko and Albert Saiz (2008) 'Housing Supply and Housing Bubbles' *Journal of Urban Economics* 64, 198-217.

In comparison to most other European countries, the two largest German cities, Berlin and Hamburg, are not among the 20 most expensive cities. This is due to the special settlement structure in Germany, where there is a wide range of attractive cities which are all competitive at offering working and living conditions. Furthermore to the enormous price differences within Germany, there are also significant differences in purchasing power. The price of a new single-family dwelling in the North of Germany is 5.0 times the annual household income while it is 7 times in the south.

University Towns

In addition to the conurbations, there are also numerous attractive medium-sized towns and cities, with the prime example of those with established universities such as Magdeburg and Göttingen. In Göttingen the student population in 2004 was at 18% of the total population, where the University is ranked 1st in Germany and 43rd in the world. With shorter rental contracts and increasing standard of living requirements, students are driving up the market rents in these cities.

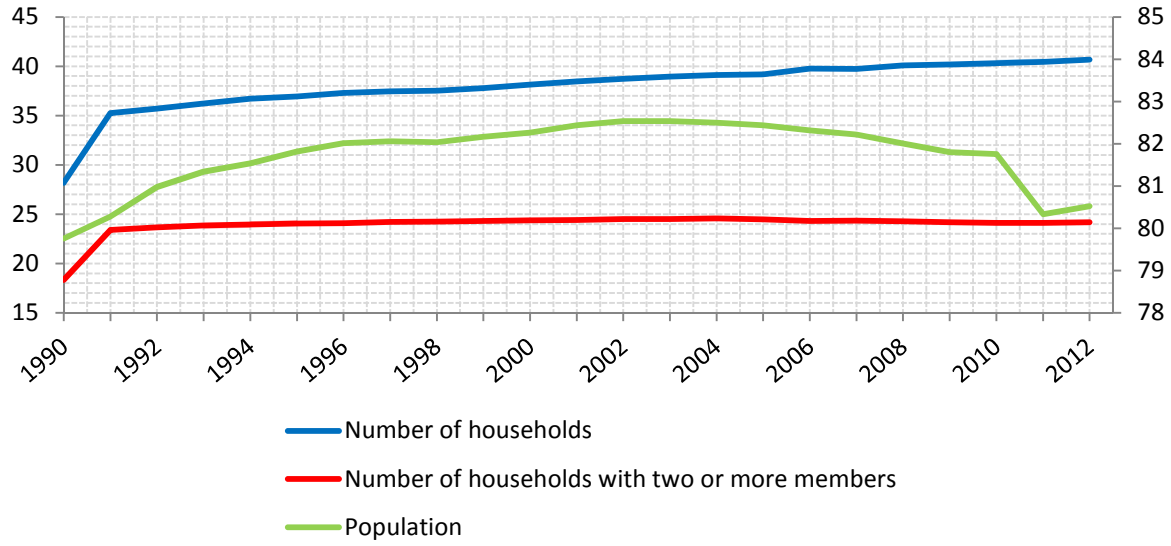
Increasing number of households

In OECD countries, the size of the household has been diminishing in size over time, due to a smaller number of children per family, increasing divorce rates and lone parents and longer life expectancy.[161] Furthermore, the amount of living space per person has been rising for years, reflecting rising income levels and considerable construction activity following World War II and the reunification. This means that the number of households increases faster than the population growth over time, contributing to an increased demand for housing. It is argued that the increasing number of households is balancing out the population decline, and thus the average house prices will remain fairly stable. Deutsche Bank Research argues that the large scale building activity periods has meant that construction has more or less kept up in line with the number of households, thus retaining a supply and demand equilibrium.[162]

[161] Eric Heyer, Sabine Le Bayon, Hervé Péléraux and Xavier Timbeau (2005) 'Límmobilier, pilier de la croissance ou épée de damoclès' *Document de travail de l'OFCE* No.2005-16, October.

[162] Tobias Just (2010) 'German Residential Property: Back in Fashion – With Good Reason?' *Deutsche Bank Research Paper,* http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000261894/German+residential+property%3A+Back+in+fashion+%E2%80%93+with+good+reason%3F.PDF (accessed 27/05/2013).

FIGURE 36: INCREASING NUMBER OF HOUSEHOLDS



Note: Left: Number of households in thousands, Right: Population size in millions.
Source: DESTATIS

GERMAN HOUSING MARKET DURING THE FINANCIAL CRISIS

When assessing the fundamental house prices for the market over the long run, it would be naïve to focus purely on the nominal house prices which tend to be sticky and adjustment takes a considerable time. However, it can be argued that the low risk stable characteristics of the German housing finance market has meant that the natural long-run supply and demand kept the house prices stable, thus avoiding any housing crash as seen in other countries. In comparison, with the increase of financial deregulation and cross-border transactions in the banking sector, the German banks became involved in the housing markets of peripheral Eurozone and the US housing markets, and thus have taken large losses during their housing crises. Within these other countries, there is currently both a lack of investment opportunity due to corrections in house prices and a lack of confidence in the prudential sense of housing market regulation. In Germany there is both: house prices remain on a long-term price equilibrium and the regulation is perceived as adequately prudent. Therefore, investment in the German market is expected in the coming years, especially as pension funds wish to invest for a stable and acceptable dividend.

Stable Housing Market and Housing Financing System

The mortgage market in Germany did not have the subprime loans, atypical contracts, high LTV values and equity release mechanisms which are at the centre of the housing crisis in the US, UK or mainland Europe. Due to the lower risk and leverage regulation of the German mortgage market and the lack of a housing price boom, there has been no negative effect of the global financial crisis on the German housing market. Although unemployment has decreased in Germany, the macro-economy was negatively hit in 2008-09 due to the global crisis. The market for existing owner-occupied dwellings in Germany saw the most significant fall in

price, mainly due to the excess of housing on the supply side. Like Belgium, the German market was immune from the crisis, where there was strong stability and the prices were reflecting predominantly the long term demographic pressures. Commercial real estate was negatively affected in the crisis due to the slow-down of the economy, but the result of this was a shift of investment capital to the housing market.

Although the German government had to intervene in the financial market through capital injections and guarantees on loans, there were no direct measures in the housing market. Equity and investment funds went bankrupt due to the lack of liquidity in the market, with many individual private investors within funds looking to sell the assets off in order to avoid bankruptcy. Indirectly, there were incentives given for energy saving modernisation. The lack of direct intervention illustrates the stability of the market and the sufficient supply of houses. Other European countries provided direct measures such as mortgage guarantees, housing costs assistance, assistance programmes for homeowners, increasing the limit of the mortgage guarantee, fiscal measures, discounts/premiums/loans for newly built dwellings, ensuring the continuation of construction programmes and incentives for social housing construction.

Van der Heijden *et al* states that the stable outcome of the German housing market is due to the structure of the system being "static" rather than "dynamic".[163] In a static system the private individual prefers to buy one or at most two dwellings in their housing career, and prefer to modify their home instead of moving. The dynamic system is where the individual will continuously buy and sell their properties, continuously moving up the property ladder instead of renovating the dwelling. The German static system is less affected by economic recession, where the long term, low risk and stable mortgage can be paid off over the business cycle. Most importantly, the fixed interest mortgages have removed the risk associated with interest rate changes. On the other hand, the dynamic housing system will find people with huge liabilities during economic recession and house prices will be more volatile to the economic business cycle. German house purchasing transactions has remained fairly constant over the last decade, while the UK and Ireland has seen significant drop after the crisis.

Resurgence among Private and Institutional Investors

While there is popularity in investment in the housing markets of the West German conurbations which continue to show strong growth, there is investment interest in the market as a whole following the financial crisis. We have seen from the previous chapter that the rental market offers investors a safe asset for their investment portfolios, given the demand for rental dwellings, the stability of the rental income, the favourable tax advantages of investment and macroeconomic and monetary policy considerations. These macroeconomic and monetary policy considerations are also applicable to the housing market, which is regarded as "concrete gold". Since the crisis there has been a considerable amount of private capital coming from Eastern European and North African investors, which marks a completely new actor in the market.

[163] Harry van der Heijden, Kees Dol and Michael Oxley (2011) 'Western European housing systems and the impact of the international financial crisis' *Journal of Housing and the Built Environment* 26, 295-313.

Summarising the popularity of investment in real estate shows the following influential factors:

1. Positive labour market impetus from lower unemployment and improved creditworthiness, increasing their propensity to invest.
2. Increases in the living space per person and number of small households, pushing up demand.
3. Low household debt, increasing both the propensity to invest and ability to leverage mortgage debt.
4. Mayer and Möber argue that with no nominal increase in house prices over the last 15 years, the German residential property market is priced 20% below its long-term average, including in relation to both disposable income and current rent levels.[164] Nonetheless, if we assume supply and demand is in equilibrium, and the demand increases with supply is inelastic in the short-run, house prices will increase.
5. Compared to other OECD countries undergoing decreasing house price corrections, the prudently regulated German market prices are not expected to decline.
6. With investment expectations being backward looking, the house price increases in the last 2 years (the first since 1999) might induce investment on a psychological basis.
7. Government subsidies and regulation in energy efficient modernisation is increasing the value of the building stock.
8. For institutional investors such as insurance companies, pension schemes, sovereign wealth funds and social security schemes, the German housing market is attractive due to the high volumes of capital and the low price volatility. With yields often exceeding 5%, these are more favourable than government bonds. These investors either have to achieve a yield target stipulated in law or have a contractual/business target to meet, thus German property offers a stable dividend to make it.
9. Private investors remain interested in the property market due to the uncertain financial market environment and inflationary concerns due to the ECB's unorthodox monetary policy.
10. Monetary policy is stimulating investment in the property market through two channels. First, the historically low interest rates mean that financing mortgage debt is much cheaper than the property yields. Secondly, with the medium-run expectation of the interest rates and inflation increasing, the investments in the government bond markets will decrease substantially in value, thus investors are restructuring their investment portfolio away from the bond market onto the stable property market.

The Seeds of Overheating?

With such interest in the German residential market, it is thus legitimate to ask whether there will be a real estate bubble such as that in the US and the peripheral Eurozone countries. From the analysis of the chapter, it is unlikely that such overheating will materialise in Germany, given most of the property market is strongly

[164] Tom Mayer and Jochen Möber (2012) ' Euro area property prices: Germany versus the rest' *DB Research Paper*, http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000290566.pdf (accessed 27/05/2013).

regulated against highly leveraged and speculative investment. For example, the PRS rent regulation is designed in order to allow the private market to function, interfering only when there is an overheating bubble.

Furthermore, this chapter has highlighted that the long-term demand is constrained due to the negative population demographics and the large excess of supply. Investors with long-term positions will undoubtedly factor these demographic considerations negatively.

Economists in Germany do not regard the expected growth of 5% per annum until 2015 as overheating, due to house prices being below the long term average and the expected macroeconomic improvements.[165] In other words, the increase of house prices could be considered an intrinsically rational bubble, where house prices today reflect tomorrow's capital gains and rental income correlated to fundamentals. An IMF Working Paper sets out extensively a model which can be used to consider whether a bubble is rational or irrational.[166] Should the need arise, the German government are capable of using a variety of instruments to ensure micro and macro-prudential stability, including increasing capital buffers for lending institutes and intervention in banks' lending standards.

THE LIFE CYCLE: FROM THE PRS TO HOME-OWNERSHIP

Life-cycle theories have been very successful in understanding the transition of German households' tenure choice between the rental market and home-ownership. At its most basic core, the life cycle theory states that forward-looking agents distribute their income over their life course in a functional capital market, with young people borrowing under the expectation of rising income, middle-aged people saving and building assets with higher income, and elderly consuming their savings as their income is very low.[167] Housing assets have become the biggest asset in most household portfolios through which the spread of consumption is achieved.

There are some other motives which impact the life-cycle consumption of housing which are applicable to German household considerations:

- **Precautionary Motive:** when the financial future is uncertain, borrowing will decrease and saving will increase.

[165] Jochen Möbert (2012) '"Concrete Gold" helps calm nerves' *Deutsche Bank Talking Point*, http://www.dbresearch.de/servlet/reweb2.ReWEB?addmenu=false&document=PROD0000000000285712&rdShowArchivedDocus=true&rwnode=DBR_INTERNET_EN-PROD$IMAPS&rwobj=ReDisplay.Start.class&rwsite=DBR_INTERNET_EN-PROD (accessed 27/05/2013).
[166] Hilbers et al (2008) Ibid [15].
[167] Franco Modigliani and Richard Brumberg (1954) "Utility analysis and the consumption function: an interpretation of cross-sectional data" in Kenneth Kurihara (ed.) *Post-Keynesian Economics*, Chapter 15, 388-436. New Brunswick, NJ: Rutgers University Press.

- **Social Welfare Provision and Public Pension:** When these are generous, households tend to save less, and vice versa.[168]
- **Unemployment without social benefits:** This is where households have insufficient unemployment insurance, and will save a capital buffer in the case of unemployment.
- **Bequest Motive:** This is where households do not consume all their savings and will leave assets for the next of kin to inherit.
- **Profit Motive:** Where households are utility maximisers, they will invest their money in the most profitable way, which could shift their money from savings to bonds when the interest rate is low.

Housing is considered a very illiquid asset, and thus withdrawing equity from the house according to changes to the life cycle is more difficult. The financial markets in the rest of the OECD have added options to withdraw equity, including refinancing the property, additional mortgage debt, a second mortgage and reverse mortgage schemes. These forms of equity release are not applicable in Germany, as we have seen from the tightly regulated and limited range of mortgage products available.

Therefore, from assessing both the rented market and the home-ownership market, the following conclusion can be made of the interconnectivity between the two on the life-cycle of German households.

1. The rented sector provides younger households accommodation where they can save capital in the *bauspar* savings and for the 20% personal capital down payment for home-ownership. Furthermore, households are more willing to stay in the rented sector when there is job, family and partnership instability. The demographics sections showed us that there is an increasing trend in family and partnership formation occurring later in the life cycle, thus an increasing demand in the long-run for rented dwellings. The rental market is very large, offering households a variety of different quality to meet their personal and employment demands. The rent regulation ensures that there will be no sudden increase in the rental price and the rental market remains affordable. The security of tenure and the pro-tenant tenancy law ensures the household as long a tenure as necessary in order to build up their savings. With lower wages, an increase in part-time contracts and less government support due to demographic challenges, the households may have to wait longer for access to home-ownership. On the supply side, there is a significant quantity and quality range due to investors in the PRS market having significant subsidies through the depreciation allowance, acquisition related fees deduction, losses from rental deduction against income tax, other *Werbungskosten* deductions, modernisation rent increases, object 'bricks-and-mortar' subsidies and subject housing allowance subsidies. Furthermore, there is sufficient supply of dwellings in Germany to ensure that prices do not boom.

[168] Arie Kapteyn, Rob Alessie and Annamaria Lusardi (2005) 'Explaining the wealth holdings of different cohorts: productivity growth and social security' *European Economic Review* 49(5), 1361-1391.

2. When a household has a stable income, adequately contributed to unemployment insurance and saved sufficient capital to meet the strict mortgage and *bauspar* requirements, they will then go into the home-ownership sector. In this respect, home-ownership in Germany remains a privilege of higher-income and/or older households and those who have benefited from an intergenerational transfer.[169] This transition into the home-ownership sector has become later in the life-cycle, given the *Eigenheimzulage* first-time buyer subsidy has been removed. Nonetheless, this first-time buyer subsidy helps explain the trend of households buying only one house in their life. Another reason why German home-owners only buy and do not climb the "property ladder" is due to the 25% capital gains tax before ten years of ownership, whereby the number of transactions are more limited than other countries. The homeownership rate among the age cohort of 25-29 year olds is 59% in the UK but only 11% in Germany.[170] German households wish to use this high income phase of their life-cycle to pay off the debt as quickly as possible, where mortgage and *bauspar* conditions permit early repayment without fines. Home-owners commonly cut back on consumption in order to become outright owners. As we have analysed, due to the restrictive regulation of the German mortgage market, there is less volatility in terms of both investment risk and house price volatility. With households acting as backward looking agents, we have seen that German households have much less expectation of their housing assets earning large capital gains than contemporary European neighbours, given house prices have remained static over the past two decades. Without capital gains, households understand that it is only through their income that they can repay the mortgage liability, and thus will not take out large LTV ratio loans.

3. The mortgage debt is paid off as quickly as possible, so that in the case of any future unemployment, the repayment costs will be low enough to finance (through insurance) until a new job is found. The Hartz IV reforms reducing unemployment protection may lower the rate of home-ownership on this basis. Owner-occupied dwellings are regarded as a "pension in stone" in Germany, very much in accordance with the life-cycle theory. With pension being less generous than the income of middle-aged employment, the housing asset can be used to ensure a large capital base upon which they can maintain their level of living standard. As we have seen from the demographics section, a large proportion of the current working population will go into retirement and will need to have their welfare payments financed by the smaller younger generations, who must also contend with the significant level of public debt and lower economic growth. Anticipating a restructuring of the welfare system which will be much less generous, households see their housing assets as a compliment also to their welfare payments. Unlike savings and shares, housing assets are not taken into consideration in the calculation of social benefits. With growth in the varie-

[169] Michael Wagner and Clara Mulder (2000) 'Wohneigentum im Lebenslauf: kohortendynamik, Familiengründung und sozioökonomische Ressourcen' [Homeownership in lifecourse: cohort dynamics, family foundation, and socio-economic resources] *Zietschrift für Soziologie* 29(1), 44-59.
[170] Maria Concetta Chiuri and Tullio Jappelli (2003) 'Financial Market Imperfections and Homeownership' *European Economic Review* 47(5), 857-875.

ty of financial investment instruments, funds and insurance are also joining housing as a compliment for pensions and social benefits in the life-cycle. Furthermore, the life-cycle theory offers an explanation as to the large number of small investors in the German PRS. These investors will purchase a dwelling to rent out during their middle-aged income period or will rent out part of their dwelling in retirement, in order to supplement their retirement income through the rental income. These investors thus suit the social market economy set up of the rental market, where they are not solely profit seeking private investors, but are looking for tenants with long term stable rental contracts. These investors are incentivised by the various tax breaks for landlords and the stability of the market, as discussed in chapter 4. Many investors in the south of German invested into the East German rental markets over the past 15 years, especially when there was such a large amount of federal funds being spent on the reunification projects.

CONCLUSION

This paper has shown that the rent regulation in Germany does not significantly impact upon market rent prices, and has thus led to the investigation as to why rent prices have not meaningfully increased over the past 15 years. The main reason is the institutional interaction with the home-ownership market, and the overall characteristics of housing in Germany. In other words, tenure choice between private renting, social housing and home-ownership is interconnected, and thus a complete review of the housing market is essential in understanding the policies and economics of the PRS.

This chapter has highlighted the restricted access for households entering the home-ownership market, due to prudential mortgage regulation and macroeconomic conditions. In comparison, the Netherlands has significant tax deductions for home-owners, and mortgages are cheaper and easier to access. It could be argued that the difficulty of households to enter the home-ownership sector would cause more demand on private rented housing and thus increase rental prices. However, Germany has a long history of a large rented market supplying to this genre of households. It could therefore be argued that increased regulation of the mortgage market in other countries without such a large private rented market could cause an increase in rental prices until the supply of such dwelling emerges in the long run.

Understanding the restrictive nature of access to the home-ownership market clarifies the role of the PRS for middle income households in their housing 'life cycle'. Whereas in many other countries the mentality of housing is to buy a house as soon as possible and move up the property ladder, Germans take a more risk adverse view in saving the required capital before buying their one and only property. Obviously, the tenancy protection shown in Chapter 2 and the rent price increase regulation shown in Chapter 3 gives the household a sense of home-ownership in the normative sense of a protected 'home' during this phase of their 'life cycle'.

Investment can be substituted between the PRS and the home-ownership market, given rent regulation ensures that market rent prices are set. Therefore, to understand investment in the PRS, house prices must be considered. The developments

and trends have been analysed to show a great deal of stability: long term demand is characterised by a shrinking population, an increase in the number of households and urbanisation; supply might increase where housing becomes an attractive investment. The German housing market consists of 41% home-ownership, 36% renting from a private person, and 20% renting from a housing company. This means that each sector can somewhat act as a price stabiliser against each other in order to prevent a boom in one in the long run. Furthermore, without a particular tax advantage for either the rented sector or the home-ownership sector, investment and demand will be distributed efficiently between the sectors. With the provision that rent cannot be increased over 20% in 3 years, the rented sector offers one stop-gap against market volatility. With publically subsidised housing loans available for the building of affordable housing, there is a capacity to supply dwellings to meet a demand shock for rented housing in the long run.

With the house prices having remained static for the past 15 years, there is no expectation of capital gains in home-ownership, and thus there has been no significant change in households' preference from the rented sector. Similarly, there have been very low increases in rental prices, as has been shown through the decision of GAGFAH Housing Company to sell off their stock in Dresden. The two markets have been correlated through low growth, and it will be interesting to see how they function should property or rent prices start increasing.

CONCLUSION

Compared to other Western Economies, Germany has not experienced a significant decrease in house prices, with many arguing that the German housing market is regulated and organised for greater sustainability. Greater sustainability in the housing market reduces the risk of a banking crisis and a public debt crisis, and thus the institutional arrangements of the German housing market are being observed by policy makers, economists and journalists from other countries. In particular, many see the large private rented sector within Germany as a natural balance against increasing house prices, whereby rent regulation ensures that rent prices remain low and thus offer an alternative tenancy choice should house prices increase. To assess this claim, this working paper has broken down each assumption.

First, why is there are large private rented sector in Germany? On the supply side we have seen that there are many different types of landlords, mainly including private individual landlords wanting to supplement their income, a rich history of Cooperatives providing affordable housing, those who wish to supply affordable housing with public subsidies, Municipality Housing Companies providing for those unable to access the market, and private housing companies. One of the main incentives for individuals supplying dwellings for rent is due to the tax incentives, which include the ability to deduce losses from income tax and a history of very generous degressive and then linear depreciation deduction allowances, inter alia. On the demand side, there is a good quantity and quality of private rented dwellings which makes the sector attractive to not only lower income households, thereby properly offering an alternative to many households not wishing or able to access the homeownership market. The strong legal protection of a tenancy is a fundamental component of the large private rented sector, where for the investor they know that the tenant will stay in the dwelling and provide a stable and reasonable rental income, while for the tenant they know that the rented dwelling can be their home and that they remain protected by the rent price increase regulations.

This proposition that the rent regulation ensures that the rent remains low is the second important question the report studies. Central to the German rent regulation is the *Mietspiegel*, or 'rent mirror' in English. Chapter 3 studies the *Mietspiegel* in depth, including its composition, how it is calculated and the difference between the Qualified and Simple methods. In essence the *Mietspiegel* is a document (optionally) produced regularly by each local government showing what the "local comparable" rent is for each area, factoring in for residual characteristics such as the size, type, location, equipment and quality of the dwelling. In practice it offers the landlord a very easy document to justify a rent increase, where they only have to refer to the local rent. For the tenant it ensures that the rent increase will only be as large as the local market rent. Nonetheless, the local reference rent is mainly calculated using data from new rental contracts, which are unregulated, meaning that the *Mietspiegel* essentially reflects the market rent. The rent regulation also stipulates that rent cannot increase more than 20% in 3 years. This would influence market rent prices, on the basis that the market increases with such volatility. In reality, this clause has not affected many rent increases, and has led to policy changes in major cities for the increase over 3 years to be reduced to 15%.

From this we can conclude that Germany has a large private rented sector which does not have rent regulation impacting on the market rent price. The third question then arises, why has there been no significant rent price increases in Germany? To understand this question, the report distinguishes between *Nettomiete* (net-rent for the use of the premise) and *Nebenkosten* (accessory charges). In particular, it has been shown that within the *Nebenkosten* the prices for gas and electricity have substantially increased, especially since 2005, due to the increased cost of energy in the global market and as a result of energy policy reforms. On the other hand, the stagnation of the rent price increases is due to the overall German housing market. The German property market has been characterised by low growth, low volatility, urbanisation, prudent mortgage/securities market, an ageing population, regional diversity, economic stability, a historical legacy of vacant houses and other macroeconomic and monetary considerations. With greater regulation of the property market, it has been more difficult for households to access the home-ownership market. In the German mortgage market for example, the loan-to-value ratio is approximately 60%, interest-rate resetting periods are generally over 10 years, most are with a fixed interest rate, 1-2% amortization, financed under the prudent *Bauspar* market, without housing equity withdrawal and with securitisation under the prudential *Pfandbrief* market. For a comparison it is worth reading a previous working paper from November 2013 on the Dutch market. While it would be expected for rent prices to increase as more households remain in the rented market and from the effects of urbanisation, the large supply of rented dwellings reduces this impact.

Therefore, this report concludes that to understand the German private rented sector as either a policy or an investment, it must be considered within its complete framework. The 'life-cycle' perspective of German households views the private rented sector as an acceptable and stable tenure choice while they cannot access the home-ownership market. The regulated nature of the mortgage market means that significant capital must be saved by the household while living in a rented dwelling, predominantly through *Bauspar* savings. Not only is the private rented sector large enough to provide a range of different quality dwellings for different households, but also the rent regulation adheres to the principles of the German social market economy, whereby government intervention in the market price for rent will occur when there is a market failure. This means that, in connection with security of tenancy, the household feels relatively safe in the private rented dwelling during this part of their life-cycle. Should there be areas of market rent price increases, the households will exert their political power to call for more publically subsidised housing to increase the supply of houses and reduce the demand, as can be seen currently in Berlin. Once the household has saved a sufficient amount of capital, they will then access the home-ownership market. The perception of home-ownership in Germany does not reflect that of a devise for capital gains like it does in many other countries, but offers the German household a place to live which they can pay off before as soon as possible.

There are several other interesting aspects of the German private rented sector which this paper has highlighted. This first is the drive for energy efficiency, which has embraced the policy of supporting the private sector in achieving this aim. The landlord has several means to increase the energy efficiency of the dwelling, including a grant or loan at below market interest prices and repayment discounts through the *KfW Bankengruppe*, the ability to deduct the costs of modern-

isation against income tax, and finally the ability to increase the rent by 11% of the construction costs without the tenant having a veto against such modernisation. A second interesting aspect is the provision of affordable rented dwellings through publically subsidised housing, whereby the government subsidy to build a dwelling comes with conditionality that the landlord must charge below market rents for a fixed period of time. A third interesting aspect of the German private rented sector is the *Hartz IV* reforms to social security, which has changed the direction of public subsidies away from object grants to a minimal and strictly means tested system. While the reforms arguably fit the mature nature of the German private rented sector and has reduced the overall fiscal spending of the government, issues of fairness and equality has arisen. All of the challenges of this working paper are found in many other countries, particularly in Europe, and the policies thus offer an interesting comparison. However, as this report has shown, policies from one country must not be viewed out of context from the rest of the market as a whole, where it can be argued that every policy of the German government in the rented market adheres to the Social Market Economy principles aimed at private implementation of the social goal.

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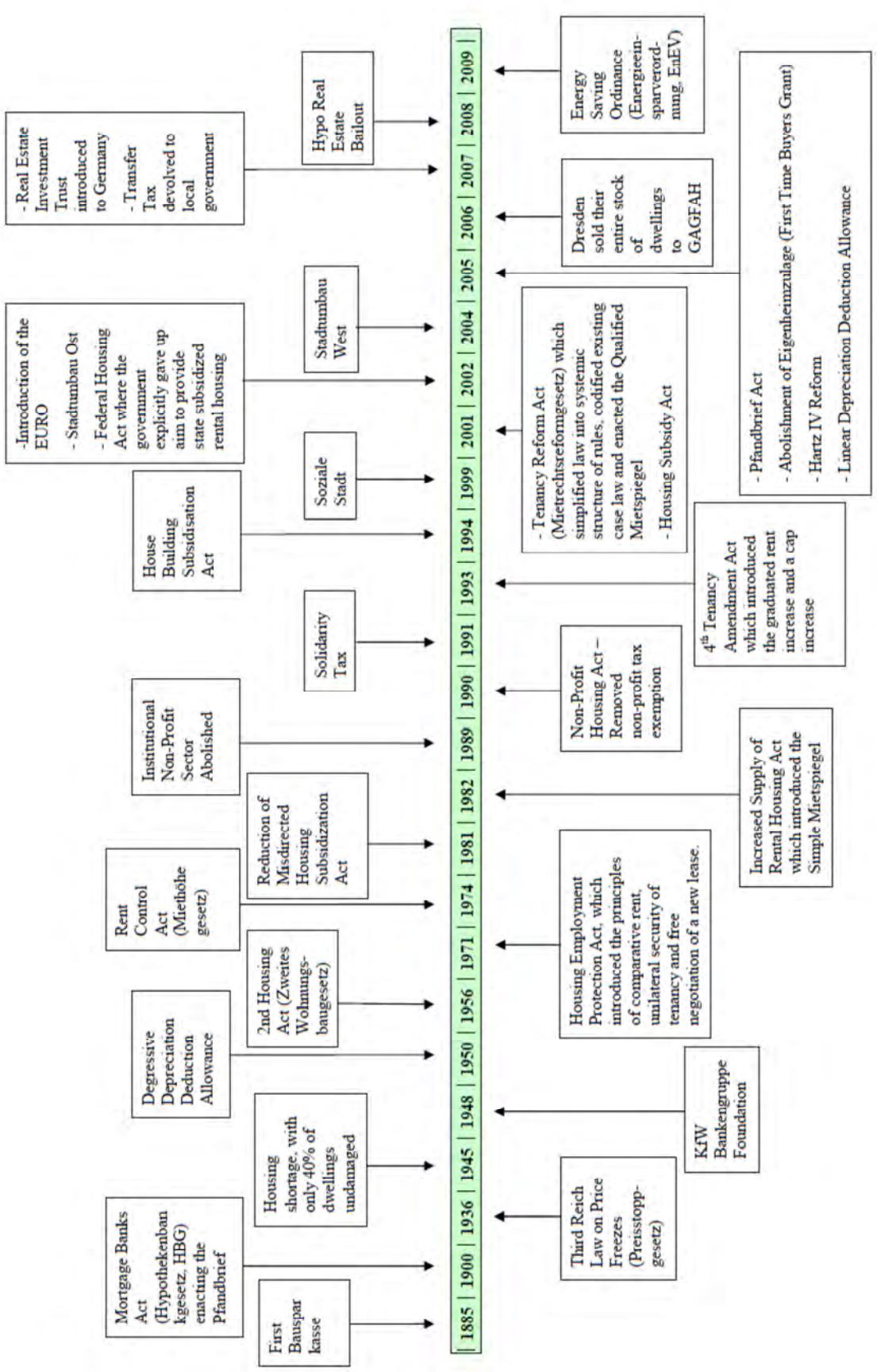
ANNEX 1: HISTORY OF EVENTS



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