

NO QUICK SOLUTIONS IN HOUSING POLICY

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References

This is a translated version of the original German-language chapter "Keine schnellen Lösungen in der Wohnungspolitik", which is the sole authoritative text. Please cite the original German-language chapter if any reference is made to this text.

SUMMARY

In the German conurbation areas, **strongly rising real estate prices and offer rents** can be observed. It is becoming increasingly difficult for apartment seekers to find an apartment that meets their needs within the bounds of their financial possibilities. From an economic policy point of view, this involves possible risks to financial stability on the one hand and the resulting problems for households with lower incomes and for the social structures of cities on the other.

The price pressure triggered by strong migration to conurbation areas was intensified by falling mortgage interest rates. At present, **exaggerations cannot be ruled out** in price developments in large cities, which could lead to corrections, particularly in the event of an abrupt rise in long-term interest rates or changes in expectations. However, the development of supply there is lagging behind demand, and loans and debt are developing moderately. As a result, there are currently **no acute risks** to financial stability from real estate financing.

However, if real estate prices fall, banks are likely to suffer noticeable losses. There will also be a significant increase in interest rate risks. **Macroprudential measures** should therefore be considered, especially as there is reason to fear a delay in the use of instruments. In addition, the data situation on residential and commercial real estate loans should be improved and additional macroprudential instruments should be created in the real estate sector.

There are no quick solutions to **social and urban policy problems**. Regulations on protection against dismissal and on rent increases protect existing tenants from the changed market conditions. The **rent control** offers limited **symptomatic therapy** for people who succeed in obtaining an apartment (“insiders”). It is likely to worsen the situation of “outsiders”, as the supply of regular rental apartments is reduced due to conversions into furnished apartments and the sale to owner-occupiers.

Housing benefits are the most appropriate instrument, as they do not directly intervene in market processes as an instrument of individual support. However, the circle of beneficiaries is small due to the low income threshold. In the case of **social housing**, past mistakes must be avoided by ensuring a social mix and adapting the promotion to the income situation of the tenants in a timely manner.

An expansion of supply is limited by available space. The **property tax** should not be used to mobilise fallow land. In the forthcoming reform, it will be necessary to weigh up arguments for taking the value of real estate into account, for example by means of a land value tax, and the segregation effects that this may entail. This argues in favour of a hybrid solution. Regulations that make building more expensive and lengthy approval processes are proving to be barriers to supply. For example, there is a conflict between the desire for affordable housing and climate policy objectives.

High transaction costs make it difficult for private households to acquire real estate. It would be conceivable to introduce a tax allowance for the **property transfer tax**. However, this would require a reform of the state fiscal equalisation system to the effect that instead of the average tax rate across the states, a notional tax rate of just under 3.5 % would be assumed for fiscal equalisation. Given the tax advantages for owner-occupied and rented real estate, there is no reason for further relief. The **Baukindergeld** is only effective selectively with high deadweight effects. It would be better to **promote private capital formation** on the model of Switzerland, which does not discriminate against real estate compared to other forms of investment.

I. A CHALLENGING REAL ESTATE MARKET

656. For several years now, Germany has seen a sharp rise in prices for residential properties and increased asking rents, particularly in major urban areas. At the same time, it is becoming increasingly difficult for apartment-seekers in these areas to find accommodation that is within their financial means and suits their needs. This ongoing development has been the subject of intense public debate, which incorporates both a macroeconomic dimension and a dimension of social and housing policy.
- On the one hand, the question is whether exaggerations have driven up real estate prices in individual regions to a level that can pose **macroeconomic risks**. Experience from financial crises shows that real estate markets can tend towards critical developments that carry serious consequences for growth and employment and for the financial system.
 - On the other hand, the rapid growth in demand for housing in urban centres creates **problems for social and housing policy**. The sharp increase in asking rents poses a considerable burden, particularly for more socially disadvantaged households that have to spend an above-average proportion of their income on accommodation. With this development comes the risk of social segregation within cities.
657. **Demographic developments** are a main reason for both these problem areas. While population growth has only been moderate overall, a strong increase in the number of people moving to Germany's largest cities has been observed since the mid-2000s. With housing supply only expanding slowly - due in no small part to a shortage of available development sites - it comes as no surprise that the changing market situation is reflected in higher prices and rents. In this context, regulations that restrict rent increases only treat the symptoms of the problem, and cause an excess demand for such rents that are kept artificially low, with the result that many apartment-seekers are inevitably unsuccessful even if they were willing to pay a higher price.
658. The **macroeconomic dimension** of the problem stems from the fact that the price pressure caused by urban migration has been intensified by almost simultaneously **declining interest rates** for property loans. If long-term interest rates were to increase suddenly or expectations regarding future price trends were to change dramatically, an appreciable decline in prices in regions that had experienced particularly sharp price increases up to this point can not be ruled out.

In light of the moderate development in credit and the level of private household indebtedness, there are currently **no acute risks** for financial stability deriving from property financing. However, a significant drop in property prices could result in significant losses by the banks if the value of the loan security was overestimated. Significantly higher risks of interest rate changes are also a factor.

Therefore **macroprudential measures** should by now be considered as the delayed activation of instruments is to be worried.

Furthermore, the **data situation** regarding residential and commercial property loans should be improved promptly to be able to make more reliable decisions on the activation of macroprudential instruments in time. Ultimately, the creation of additional macroprudential instruments would be prudent. This concerns the income-based instruments in the area of residential property, and instruments for the commercial property sector.

659. In terms of **social and housing policy**, the challenge is to find solutions that prevent social hardship on the short term but also ensure that supply can adapt to the higher demand in the medium and long term. From the perspective of urban policy, the priority is to prevent the development of new socially disadvantaged areas. In this context, social housing plays a major role, whereby it is important to ensure a more targeted promotion than in the past. As an instrument of individual support, housing benefit should be strengthened by more regularly adjusting and by raising the income limits.

Symptomatic therapy such as **rent control** (*Mietpreisbremse*) is not constructive. While rent control does benefit a share of people seeking accommodation, on the whole it makes it more difficult for people to find housing, as the supply of rental housing is likely to contract, not least owing to the conversion of apartments into furnished rentals or owner-occupied condominiums. As the expansion of rental housing supply is limited due to the availability of development land in urban areas, and planning procedures are lengthy, quick solutions to the tense situation on the residential property market should not to be expected.

II. DEMOGRAPHIC INFLUENCES ON REAL ESTATE PRICES AND RENTS

660. The **purchase prices of residential property** have surged in Germany since the start of the decade. ↘ [CHART 87 TOP LEFT](#) This is particularly true of the seven largest German cities - Berlin, Düsseldorf, Frankfurt, Hamburg, Cologne, Munich and Stuttgart (“A-cities”) - where prices in 2017 were 81 % higher than in 2010. In all 127 towns and cities, prices had appreciated by 64 %, while the price increase in Germany overall was 46 % in the same period.

Rents for newly let units have also increased significantly, but the increases are nowhere near those seen in property prices. ↘ [CHART 87 CENTRE RIGHT](#) In the period from 2010 to 2017, they increased by 42 % in the seven largest cities, by 38 % in the 127 towns and cities and by 33 % in Germany overall. Owing to extensive protection provisions ↘ [ITEM 699](#) rents in existing rental contracts only rose by 9.8 % during the same period and therefore only increased slightly more than the consumer price index.

661. The **demographic development** offers an important explanation not only for the increasing prices and rents but also for the growing problems in finding accommodation. Overall, there has only been a moderate increase in the population of Germany since the 1990s: in 2017, the population was only 3.5 % higher than it was in 1991. Due to changes in lifestyle, however, there has been a far greater increase in the **number of households**. On account of the growing share of single-person households, this number increased by around 17 % between 1991 and 2017. Further to this, the standard of living has improved significantly, with the average living space per person, for example, rising from 41.2 to 46.5 square meters between 2005 and 2017.
662. Added to this, Germany has also experienced large-scale **population movements**, particularly from the new *Länder* (former East) to the old *Länder* (former West). The population of some parts of the new *Länder* has declined significantly. Saxony-Anhalt - the state hardest hit by this development - has seen its population shrink by 21.9 %. Contrasting with this, considerably more people now live in Bavaria (+12.8 %), Baden-Württemberg (+11.3 %) and Hamburg (+10,4 %) than at the start of the 1990s. [↘ CHART 86 TOP RIGHT](#)

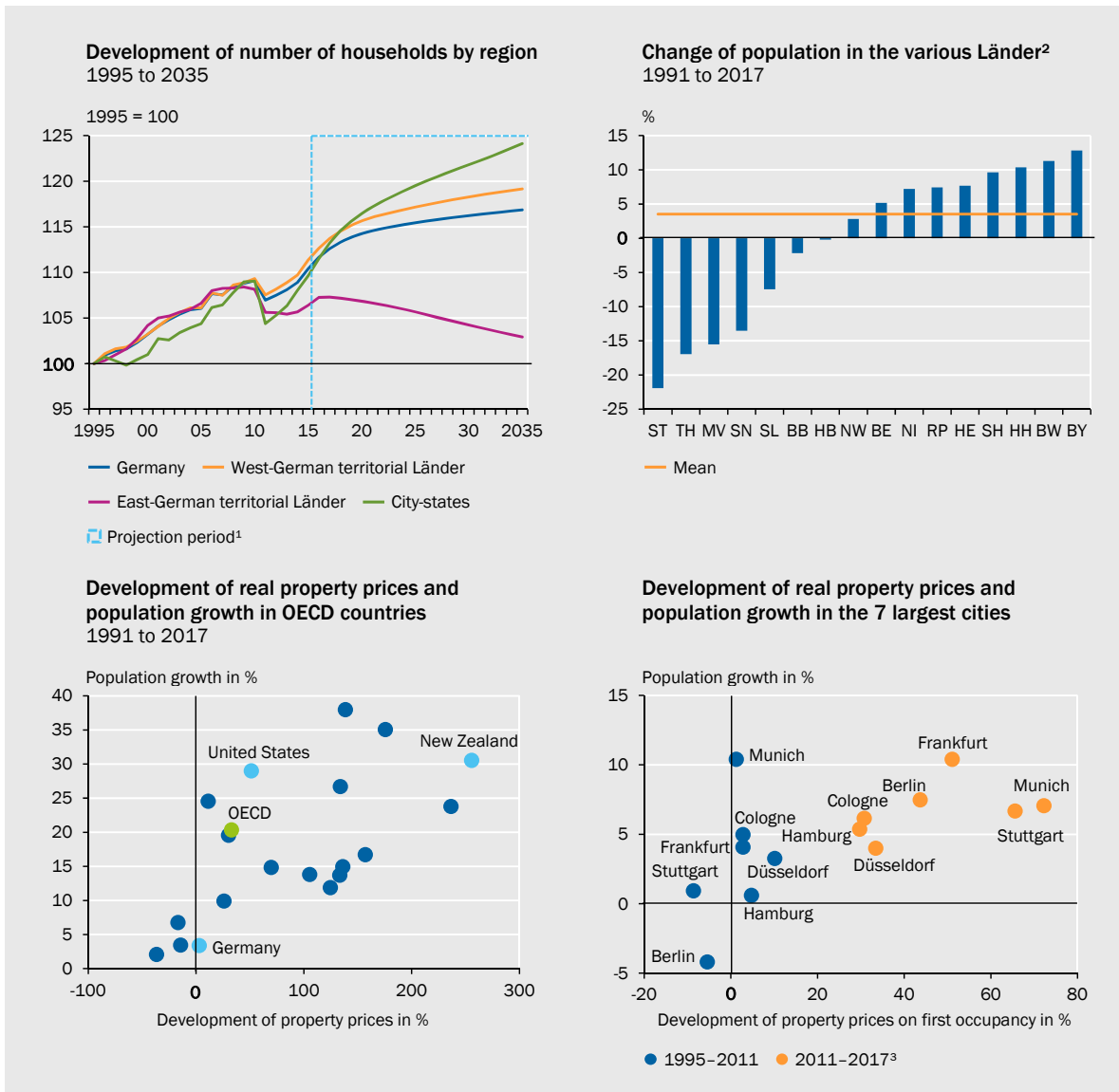
These population movements are reflected in the **number of housing units** in relation to the population. In 2017, far more units were available in the regions affected by outward migration (over 550 units per 1 000 inhabitants) than in the *Länder* with a growing population (fewer than 500 housing units). Accordingly, there are also large regional differences in the **vacancy rate**, which stood at 11.2 % in the eastern German *Länder* in 2014, as opposed to 7.1 % in the western German *Länder*.

663. Since the mid-2000s, this general trend has been associated with particularly pronounced **migration to the seven largest cities**. While the population of these cities remained more or less constant or even fell (in the case of Berlin) in the period after reunification, they have seen a strong population increase since 2005. Topping the list is Munich with a population growth of 16 %, followed by Frankfurt (+15 %) and Berlin (+11 %). The above-average **rise in the price of residential property** observed in the same period and the sharp increase in rents in these cities could therefore largely be attributable to an increase in the demand for housing as a result of demographic developments. [↘ CHART 86 BOTTOM RIGHT](#)
664. These **demographic** trends in Germany are not expected to change to any considerable extent for the foreseeable future. The household projection of the Federal Statistical Office, which is based on the forward projection of current developments, forecasts that the **number of households** will only increase slightly overall (+6 %) from 2015 to 2035. However, with a projected increase of around 13 %, much stronger growth will continue to be seen in the city states (Berlin, Hamburg and Bremen). While there will be a slightly above-average increase of 7 % in the number of households in the west-German territorial *Länder* (*Länder* excluding the city states), the east-German territorial *Länder* will face a 3 % decline in the number of households. [↘ CHART 86 TOP LEFT](#)

665. The influence of demography on residential property prices becomes also clear in an **international comparison**. In the period from 1991 to the present day, real property prices in Germany have lagged significantly behind developments in other countries. In 2017, real prices for residential properties were just 2.9 % above the level in 1991. In contrast, real prices have increased by 25.8 % in the euro area, by 34.1 % in OECD countries and by 51.3 % in the United States. New Zealand tops the list with a real price increase of 255.7 %. ↪ CHART 86 BOTTOM LEFT The price increase tends to be most pronounced in countries that have experienced the biggest increase in population.

↪ CHART 86

Development of households, population and property prices



1 - Results of the household projection (trend variant). 2 - ST-Saxony-Anhalt, TH-Thuringia, MV-Mecklenburg-Western Pomerania, SN-Saxony, SL-Saarland, BB-Brandenburg; HB-Bremen, NW-North Rhine-Westphalia, BE-Berlin; NI-Lower Saxony, RP-Rhineland-Palatinate, HE-Hesse, SH-Schleswig-Holstein, HH-Hamburg, BW-Baden-Wuerttemberg, BY-Bavaria. 3 - Population development for Berlin and Hamburg: 2011-2016.

Sources: AMECO, bulwiengesa, Federal Statistical Office, OECD, World Bank, own calculations

III. AN OVERHEATING PROPERTY MARKET?

666. Developments in the real estate market can produce considerable macroeconomic effects. A broad literature on the **booms and busts** in residential property describes the positive and negative self-reinforcing connection between house prices and credit and the effects this has on macroeconomic activity (Guerrieri and Uhlig, 2016). For the United States, in the period of the Great Recession a strong link can be seen between the collapse in property prices and the **private consumption of heavily indebted and therefore credit-constrained private households** (Mian and Sufi, 2016).

Unfavourable developments in the real estate market are particularly serious for the **banking system**, given that worldwide the share of mortgage loans in banks' total lending portfolios has risen substantially in the past few decades - climbing from 30 % in 1990 to 60 % in 2011 (Jordà et al., 2016).

667. In the past, real estate crises have often been triggered by an **excessive expansion of supply**. The real estate market is particularly vulnerable to this, as there is generally a relatively long time lag between the time the housing supply decision is made and the time the supply gets confronted with the market. The price response to the supply decision therefore takes effect much later than in many other sectors of the economy. For suppliers, the problem is to correctly anticipate the impact of supply on prices, which in turn amplifies price volatility (Glaeser, 2013; Olszewski et al., 2016). The result is a scenario as described in the **pig cycle model**. Due to arrears in interest and amortisation payments, vacant leveraged properties then give rise directly to non-performing bank loans.

Accordingly, this begs the question whether there are indications of price developments in Germany that cannot be explained by fundamental factors, whether excessive supply reactions can be seen at least at the regional level, and to what extent this could produce risks for the financial system.

1. Signs of inflated prices in large cities

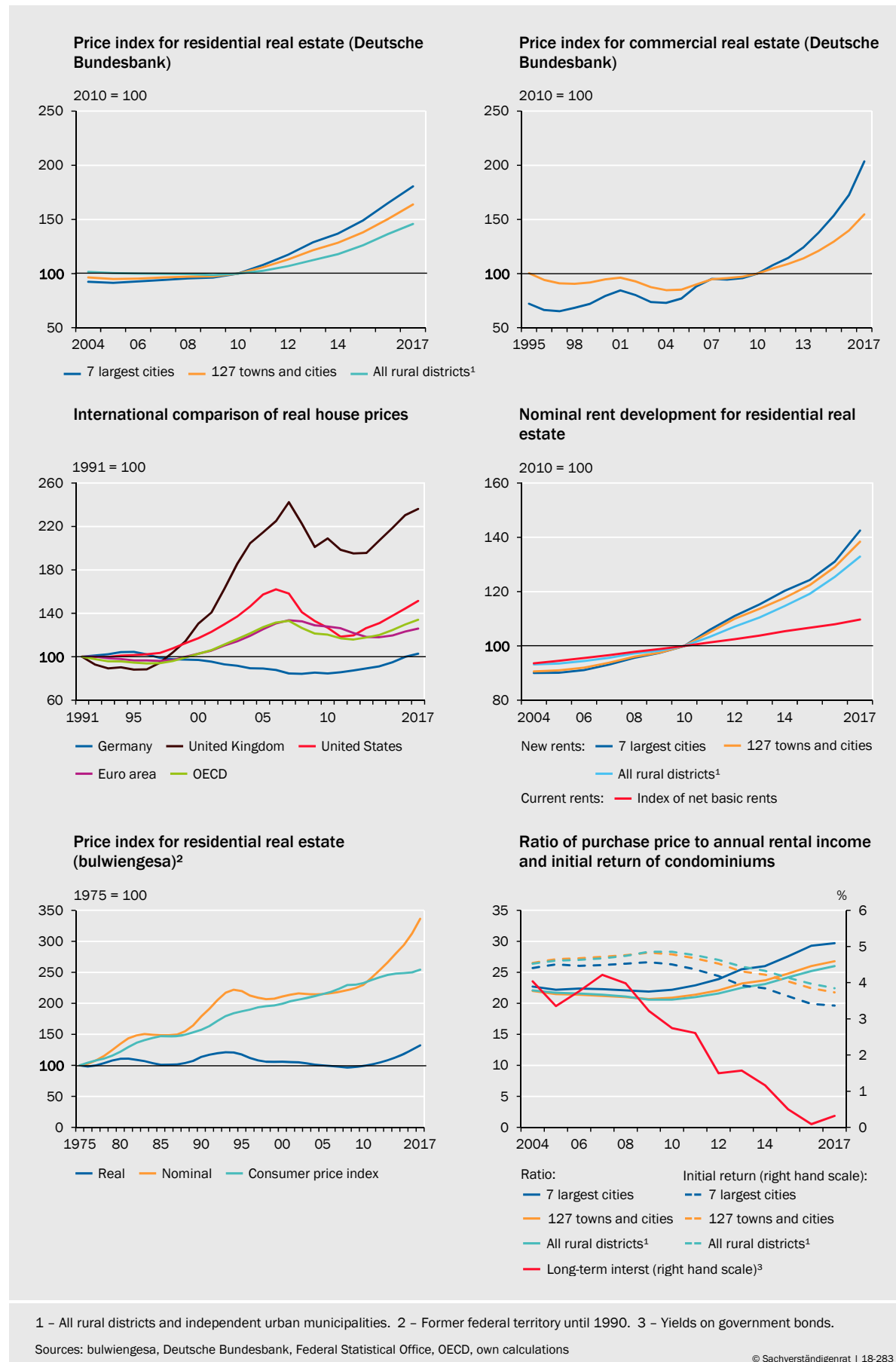
668. The pressure on real estate prices as a result of the sharp regional increase in demand for housing has been amplified by the almost concurrent significant **drop in interest rates on mortgage loans** in Germany. Influenced by the expansionary monetary policy of the European Central Bank (ECB), the interest rates for residential real estate loans, which ranged between around 4 % and 5 % in the 2000s, have fallen to most recently around 2 %.
669. The influence of interest rates on the prices of residential property stems directly from the **continuous interest charges** that a property buyer with a given income has to pay. To provide a rough indication of the effects of interest rates, let us take the example of a private household with own capital of 60 000 Euro and a monthly amount of 1 500 Euro available for interest and amortisation payments. With a constant interest rate of 4 % and annuities calculated on an annu-

al basis, it would be possible to repay a loan of 240 000 Euro in roughly 20 years and purchase a property with a purchase price of 300 000 Euro. With an interest rate of 2 % and all other assumptions being equal, a loan of around 287 500 Euro can be repaid. As a result of the lower interest rates, the feasible purchase price increases by roughly 16 % (from 300 000 Euro to 347 500 Euro).

670. Interest rate development is not only important from a borrower's perspective. In the past, investors **looking for returns** are likely to have invested considerable amounts of capital in real estate. If the rate of return normalises in other areas, such as bonds, they might withdraw their capital from the real estate sector and in doing so put pressure on property prices.
671. For the **assessment of real estate prices**, indicators are often used that consider these prices in relation to **fundamental factors** such as the development of rental income and household income.
- In the period from the first quarter of 2003 to the second quarter of 2018, the ratio of **purchase prices to the income** of private households has increased by 7.6 % (condominiums) in Germany overall.
 - The growing level of interest in the purchase of real estate in **large cities** is reflected in the fact that purchase prices here have increased much more than rents. In the period from 2004 to 2017, the **ratio of purchase prices to annual rent** increased by 30.8 % in the seven major cities, by 21.8 % in the 127 large towns and cities, and by 17.6 % in Germany overall. [↘ CHART 87 BOTTOM RIGHT](#)
 - The ratio of purchase price to annual rent is usually named multiplier. The reciprocal of this ratio is the **initial return of a real estate investment**. In 2004, this consistently stood at around 4.5 %. In 2017, this value had fallen to 3.4 % for the seven largest cities, to 3.7 % for the 127 towns and cities and to 3.8 % for Germany overall. [↘ CHART 87 BOTTOM RIGHT](#) Therefore, the decline in the return on real estate is far less pronounced than the drop in the yields on government bonds: the market yield for public sector bonds dropped from 3.7 % to 0.2 % in the same period.
672. For several years, the **Deutsche Bundesbank** has been estimating the “**fundamental price**” of real estate for Germany as a whole and separately for the group of the seven largest cities using a regional panel data set. The regression model is based on the data of the 401 rural districts and independent urban municipalities for the period from 2004 through to 2017. The underlying control variables comprise the per-capita real estate stock, the income, the population density, the share of the population aged 30-55, the rate of unemployment, the rate of real GDP growth and the mortgage rate. On the basis of these calculations, the Deutsche Bundesbank (2018a) establishes an **overvaluation of up to 30 %** for the seven largest cities in 2017. The degree of overvaluation differs between the observation units: while apartments are overvalued across Germany, this is not true of single-family houses (Kajuth et al., 2016).

↳ CHART 87

Real estate and rental prices



The model illustrates the **influence of low long-term interest rates** on real estate prices (Kajuth et al., 2016). In the basic version, it determines the price deviation for 2014 assuming a constant interest rate since 2009. If the actual interest rates are assumed instead, the deviation identified with the model is reduced by 5 percentage points for the seven largest cities.

673. A general problem for many analyses of the development of real estate prices is that more in-depth data for the German real estate market have only been available since 2004. In this context, it is important to remember, however, that the mid-2000s were characterised by the unfavourable economic climate in Germany at that time. This is seen not least in the fact that real property prices in 2004 were 11 % below the average of the 1990s and were only marginally higher than in the mid-1970s. [↪ CHART 87 BOTTOM LEFT](#)
674. Using OECD data, the German Institute for Economic Research has researched the development of real estate prices in 2018 (Kholodilin and Michelsen, 2018). While the authors do not see a nationwide “real estate bubble”, they do identify **signs of excessive real estate speculation in the A-cities**. UBS (2018) warns of the risk of a real estate bubble in Munich, putting the city on a par with the likes of Hong Kong, Toronto and Vancouver in this respect.
675. The **International Monetary Fund (IMF)** has conducted a panel analysis for the period from 1990 through to 2016, which in addition to economic variables considers the role of policy and institutional and structural factors - such as tax incentives and rent controls - to estimate equilibrium house prices (Geng, 2018). The analysis finds an overvaluation of 6 % for the average of 20 countries. For Germany, all model variants in this analysis suggest **an undervaluation of around 10 %**.
676. While there are no signs of excessive real estate prices in Germany overall, there are indications of overvaluations in the large cities. In addition to residential property, these are also found in commercial real estate. [↪ BOX 19](#) Given the strong migration to these regions, it is not surprising that this is correspondingly reflected in price trends. The fall in interest rates has further amplified the situation. While a change in the demographic trends can be ruled out in the foreseeable future, an interest rate reversal is likely. The **future development of real estate prices in the largest cities** will therefore depend in no small part on the speed at which long-term interest rates rise again. If interest rates were to increase abruptly, an appreciable drop in prices cannot be ruled out.

[↪ BOX 19](#)

Assessment of commercial real estate

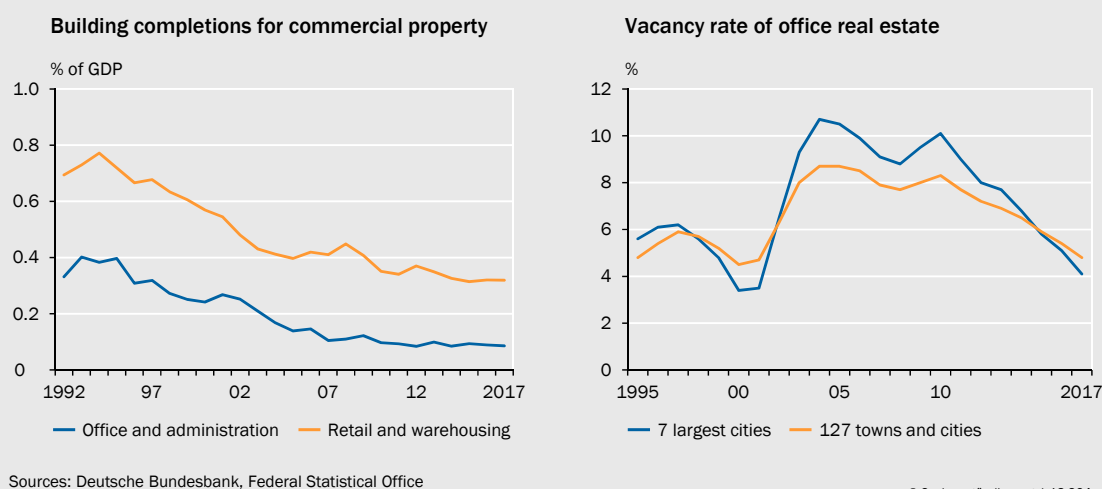
The pricing situation on the commercial property market is tense, a development which can no longer be fully explained by fundamental factors (Erler, 2017). The demand for office and commercial property has increased significantly in recent years (Dorffmeister and Steininger, 2018). The price increases for commercial property has been even more pronounced than for residential real estate. In 2017, the prices in the seven largest cities were 104 % above the level in 2010; in all 127 towns and cities the increase was 55 %. [↪ CHART 87 TOP RIGHT](#) Rents for commercial property have lagged

even more behind purchase price developments than rents for residential property have, with the result that returns on investment have fallen considerably. In the towns and cities overall, the net initial return fell from 6.2 % in 2004 to 4.5 % in 2017, while in the seven largest cities it dropped from 5.4 % to 3.1 % and is therefore less than the rate of return for residential property.

The sharp rise in prices for commercial property is not reflected in an appreciable expansion of supply, however. Accounting for a 2.1 % share in GDP, investment in commercial construction is even slightly below the average for the period from 1991 to 2017 (2.5 %). Building completions for office buildings and for the retail and warehousing sector expressed as a share of GDP are almost at an historic low. ↪ [CHART 88 LEFT](#) It follows that the vacancy rate for office property in the 127 towns and cities and in the seven largest cities is at a low level in a longer-term context. ↪ [CHART 88 RIGHT](#)

↪ [CHART 88](#)

Indicators for the commercial real estate market

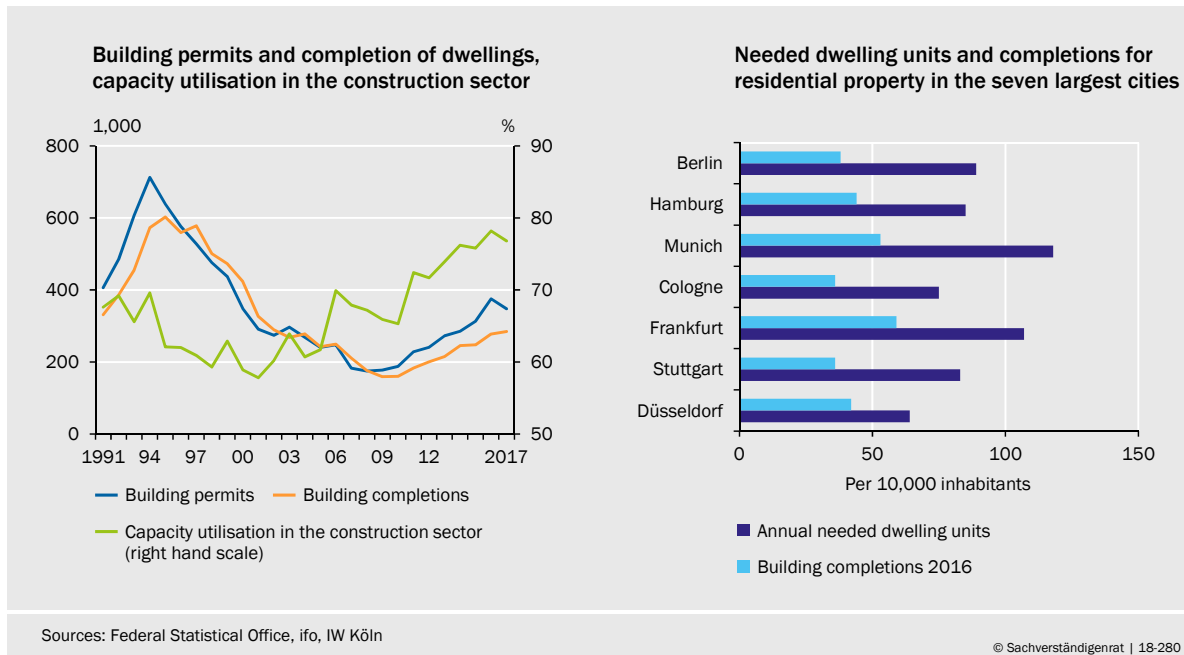


2. No excessive expansion of supply

677. From a macroeconomic perspective, price developments in the real estate sector pose a particular risk if they result in an **excessive expansion of supply** because market participants underestimate future supply (Glaeser and Nathanson, 2015). There are suddenly no buyers or tenants for the new properties, which translates directly to loan defaults. As the financial crisis in Spain and Ireland made clear, a property boom can cause the entire economy to become more and more focussed on this one sector. For example, in 2006 the share of residential construction investment in GDP reached 12.1 % in Spain and even 13.5 % in Ireland. The development in Spain demonstrates that a sudden drop in demand can trigger, in addition to the serious implications for the financial system, a persistently high level of structural unemployment.
678. In Germany, the share of **residential construction investment** in GDP has **risen slightly** in recent years and stood at 6.1 % in 2017. This corresponds exactly to the average for the period 1991 to 2017, which is characterised by a boom phase in the period 1994 to 2000 (7.1 %) and a distinctly weak period in the years 2004 through to 2010 (5.1 %). Therefore, so far there are no indications

↘ CHART 89

Needed dwelling units and construction activity in residential property



that the rising prices have resulted in an excessive increase in supply. In fact, construction activity in the large cities suggests the very opposite.

679. The situation with regard to **building permits, completed buildings and new orders for residential construction** paints a similar picture, with the corresponding figures still clearly below the record highs reached in the first half of the 1990s despite a significant expansion. ↘ CHART 89 LEFT Furthermore, the level of capacity utilisation seen in the construction sector since the year 2000 and the scarcity of land for building development hinder any stronger expansion of building activity.
680. According to calculations of the German Economic Institute (IW Köln), the number of buildings completed in 2016 was well below the estimated 430 000 dwelling units that need to be constructed each year (needed dwelling units) between 2015 and 2020. Construction fell short of the number of needed dwelling units in all **seven of the large cities** in 2016. ↘ CHART 89 RIGHT The regional housing need determined by the German Economic Institute is broken down into demographics-driven need, replacement and backlog-related need, and additional need deriving from increased immigration (Deschermeier et al., 2017). Currently, immigration is the biggest component in the increased housing need.

A current market analysis for Berlin (bulwiengesa, 2018) makes a similar forecast. It anticipates that at least 19 000 new dwelling units would need to be built each year through to 2030 to meet the demand. According to the analysis, the 14 000 new units estimated by the Senate Department for Urban Development and Housing are not enough to provide adequate housing for new people settling in Berlin and for the population already living in the city.

3. Implications for the financial system

681. In recent decades, the **residential property market** has become **increasingly important** for lending by the banks and therefore for the **stability of the financial system** (Jordà et al., 2016). For example, in Germany the share of housing loans to private households in loans to domestic enterprises and resident individuals increased from 23.1 % in 1980 to 36.6 % in the second quarter of 2018. The share of housing loans in total outstanding bank loans to resident individuals and domestic enterprises amounted to 51 %. At the same time, 73 % of the debt of the private household sector was attributable to loans for housing.
682. Soaring property prices are particularly dangerous for the financial system if they are accompanied by a strong increase in lending (Jordà et al., 2015; Brunnermeier and Schnabel, 2016). In Spain and Ireland, for example, the volume of housing loans to private households almost tripled from January 2003 to the peak reached in 2008. Compared to that, **growth in housing loans in Germany** is still **moderate**. While the growth rate in the second quarter of 2018 - at 4.3 % - was well above the 2.6 % average for the period 2011 to 2017, it was below the long-term average since 1982 of 5.5 %.

The level of **debt of private households** and the volume of housing loans in relation to GDP and to disposable income have fallen slightly since the financial crisis. Standing at 54.1 % most recently, the level of indebtedness of private households in relation to economic output was well below the record level of 98.6 % that the debt of US households had reached in the first quarter of 2008. As such, there is **no indication of excessive private household debt** in Germany. Therefore, if the property market did collapse, the effect on private consumption would be clearly less pronounced than then seen in the United States.

683. Credit standards are of central importance for the risks associated with real estate credit. The quarterly Eurosystem Bank Lending Surveys suggest that the German banks surveyed most recently applied **less strict credit standards** for housing loans. With these banks having reported an easing of their standards for residential property loans in three of the four quarters of 2017, this trend continued in the first three quarters of 2018 (ECB, 2018a, 2018b, 2018c). At the same time, **margins** for average-risk and riskier residential property loans have narrowed. However, data on the **level of the credit standards** for residential property loans indicate that the standards are still comparatively tight relative to the standards in place since 2010 (Deutsche Bundesbank, 2018b).

With regard to small and medium-sized banks, the German Financial Stability Committee (*Ausschuss für Finanzstabilität*, AFS) points out that these banks have **not eased** their lending standards in the residential loan sector **to a perceptible degree** (AFS, 2018). On the basis of the low-interest-rate survey (*Niedrigzinsumfrage*, 2017), the AFS finds that a substantial increase in the debt ratio for residential real estate financing cannot be observed among the institutes surveyed for the 2014 to 2016 period. The average loan amounts have increased, however.

These assessments of the lending standards are solely based on survey data, however. **Granular data on the lending standards are not available**, even to the supervisors. Therefore, a reliable assessment of these standards is all but impossible given the current data availability.

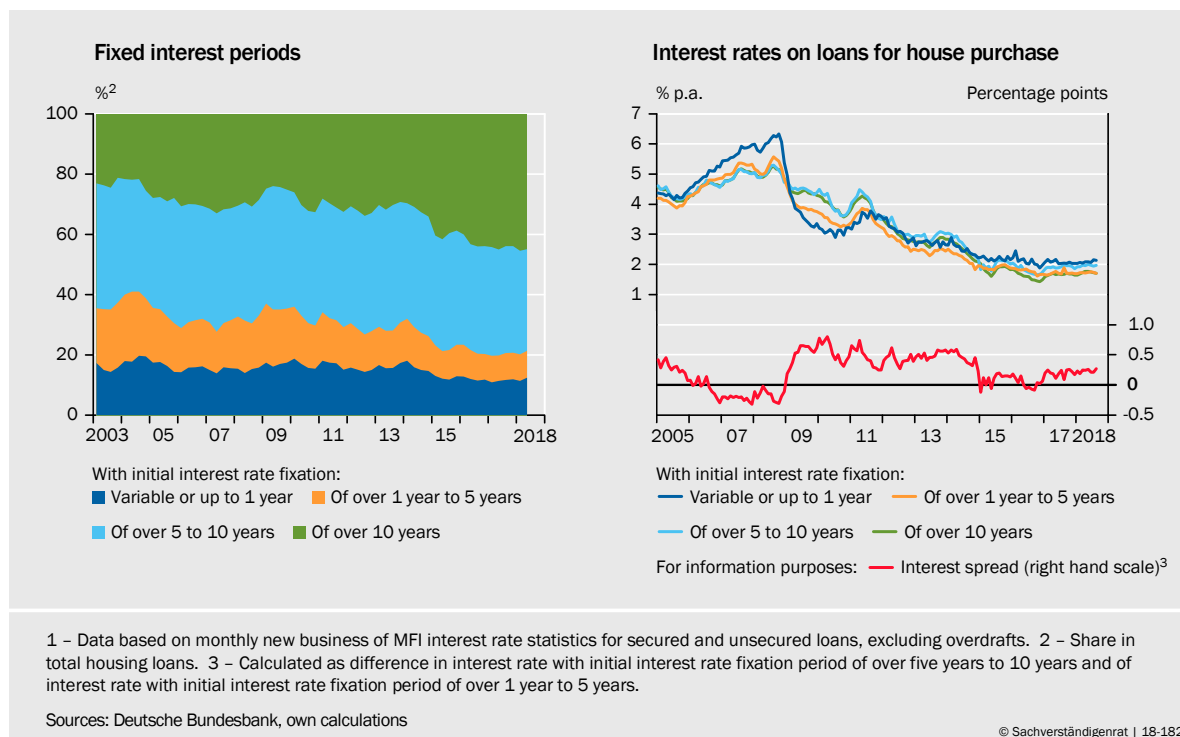
684. Apart from residential property loans, the financing of **commercial real estate** can also carry risks for the stability of the financial system. It should be noted that the financing of commercial real estate plays less of a role than the financing of residential property in this context. In mid-2017, the stock of loans for commercial real estate had an 8 % share in the balance sheet total of German banks, while the stock of loans for residential property had a 16 % share (Deutsche Bundesbank, 2017b).

Despite the significant rise in prices for commercial real estate in Germany, neither the Deutsche Bundesbank (2017b) nor the AFS (2017) see any immediate risks to financial stability. Here, however, it is important to point out that the analyses are largely based on surveys conducted in 2016. Therefore, the **data situation** regarding commercial real estate financing appears to be **particularly fragmentary**.

685. In the current low interest rate environment, the development of interest rates could pose a particular risk. For example, an **abrupt hike in interest rates** could put pressure on property prices and jeopardise the stability of the banking system. In this context, a distinction must be made between loans with a **variable and with a fixed interest rate**. Borrowers with variable interest rates are immediately confronted with the hike in interest rates. The banks only suffer a loss if borrowers are no longer able to meet their payment obligations. In the case of fixed interest loans, which are common practice in Germany for housing loans, the risk of a change in interest rate lies with the banking sector. If interest rates increase, the banking sector faces higher refinancing costs while receiving constant, largely unchanged returns from long-term, low-interest loans. In addition, **collateral depreciation** can also be expected, which could generate larger losses if the borrower defaults (loss given default).
686. By international standards, property loans in Germany have a **long fixed interest period**, which has even been extended in recent years. The credit period for new mortgage loans has increased, going from an average of ten years in 2009 to 14 years in 2017 (vdpResearch, 2017), and the share of loans with an initial interest rate fixation period of over ten years has risen in the past number of years. [↘ CHART 90 LEFT](#) This is associated with a **higher interest rate risk for the banks** (Annual Report 2017, items 475 ff.). Interest rates for housing loans have dropped during the same period. The difference in interest rates (spread) between new business short-term and longer-term loans is persistent at a comparatively low level. [↘ CHART 90 RIGHT](#) At the same time, owing to the significantly lower interest burden, average initial amortisation rates have risen from 1.85 % in 2009 to 3.23 % in 2017 (vdpResearch, 2017) with the result that the amount to be refinanced at the end of the fixed interest period will be significantly lower.
687. As a rule, interest rate risks for banks are taken into consideration in **Pillar 2 of the Basel Framework** for banking supervision (Annual Report 2015,

↳ CHART 90

Fixed interest periods and interest rates for housing loans to private households¹



items 413 ff.). This examines how a parallel shift of the yield curve by 200 basis points up or down affects a bank's capital as a present value loss. If in the overall analysis an institute does not have an adequate capital base, it is possible to impose a capital add-on for interest rate risks in the banking book. In Pillar 1 of the regulation, interest rate risks are not backed by equity.

688. The results of two recent **stress tests** indicate that German financial institutions are sufficiently capitalised to withstand a 30 % decline in residential property prices (Siemsen and Vilsmeier, 2017; Barasinska et al., 2018a). In the two studies, the same stress scenario in which residential property prices drop by 30 % and the unemployment rate increases from under 5 % to 8 % is applied to two different data bases and estimation models.. While the stress tests do reveal a **reduction in the common equity tier 1 capital ratio from 0.6 to 0.9 percentage points**, the studies largely disregard systemic aspects. Therefore the results must be interpreted as a **lower limit** and do not suffice to draw conclusions regarding the impact on financial stability (Barasinska et al., 2018b).

689. In the overall analysis, the available information does **not point to acute risks to financial stability stemming from residential property financing**. That said, it is conceivable that a significant drop in real estate prices could produce unexpectedly high losses if the value of the loan collateral is overestimated. The losses could be of a far greater magnitude than the current stress tests suggest, as a cumulation of different risks and systemic effects in the form of contagion and macroeconomic feedback effects could significantly amplify the impact. Added to this are significantly higher interest rate risks for banks. It is therefore advisable to examine whether **macroprudential instruments** need to be **activated**.

4. Growing need for macroprudential action

690. Supervisors can apply a number of different **macroprudential instruments**. In the context of risks from real estate credit, the main objective is to limit systemic risks in the time dimension, i.e. the **prevention of procyclical effects** in the financial system (Annual Report 2014, item 364). This involves both limiting the build-up of excessive risks during the period of expansion and preventing effects that could exacerbate a crisis during the period of contraction.

The macroprudential instruments introduced under the EU Capital Requirements Directive (CRD IV) and Capital Requirements Regulation (CRR) are designed to strengthen banks' risk-bearing capacity particularly through **additional capital requirements**, some of which vary over the financial cycle (countercyclical capital buffer, capital conservation buffer, Annual Report 2014, items 383 ff.). Further to this, many member states have established the legal framework to be able to implement **minimum requirements** at the loan or borrower level **for the provision of new residential property loans** as targeted macroprudential instruments (Annual Report 2017, items 487 ff.).

691. Only a limited set of tools has been introduced in Germany, however. By specifying **loan-to-value ratios** (LTV ratios), supervisors can demand a minimum share of equity for new loans. In addition, supervisors can also set a time limit for the repayment of a certain percentage of a loan (**amortisation requirement**). Both instruments are essentially suitable to reduce the loss sustained by the creditor should the borrower default. However, they have very little influence on the likelihood of a payment default.

LTV ratios also have a less binding effect than income-based instruments (Annual Report 2017, item 489). This is because in times of increasing real estate prices, the rising prices make higher loan amounts possible while the LTV ratio remains constant (AFS, 2018). As borrowers' income is not likely to increase to the same extent in such an environment, the higher loan amounts could reduce their debt sustainability, and the probability of default increases as a result.

692. As early as 2015, the AFS therefore recommended creating the legal framework for **income-based macroprudential instruments** that explicitly take the debt sustainability of the borrower into account (AFS, 2015). In addition to the possibility of introducing a cap for the **debt-service-to-income ratio** (DSTI ratio), the AFS also recommended a facility for setting an upper limit on the **debt-to-income ratio** (DTI ratio). According to the empirical literature, income-based instruments are considered particularly effective (Gelain et al., 2013; Kuttner and Shim, 2016).

Despite the recommendations, the legal basis for income-based macroprudential instruments has not yet been established in Germany. This is likely to limit the impact of macroprudential policy, as income is a key determinant of debt sustainability, which significantly influences the probability of a loan default. Therefore the legal framework for **income-based macroprudential instruments** should be established (Annual Report 2017, items 487 ff.).

693. Currently **no loan- or borrower-specific macroprudential instruments** are in place to deal specifically with the risks in the **commercial real estate** sector. As the unsatisfactory availability of data is an even bigger barrier to the assessment of systemic risks in this sector than in the residential real estate market, the AFS (2015) issued a recommendation to improve the data situation in this segment as a first step. It announced that it would recommend the creation of the legal basis for macroprudential instruments for commercial real estate as soon as it identified a need for action. However, the AFS (2017) and the Deutsche Bundesbank (2017b) currently do **not see any evidence** of the build-up of **risks** for **financial stability** in the commercial real estate market, and therefore the AFS has so far not put forward the creation of a legal framework for suitable macroprudential instruments. This is surprising, as the risks cannot be reliably assessed without a valid data base and also because the instruments should already be in place when risks materialise. It would therefore be prudent to **establish macroprudential instruments for the commercial real estate sector**.
694. Macroprudential monitoring, the use of appropriate instruments and the evaluation of their impact are significantly hampered by the **unsatisfactory data situation**. Disaggregated data on real estate credit and on the lending standards applied are either not available at all or not in the required quality (AFS, 2018). Consequently, the assessments of the banking supervisors are largely based on survey results, such as the Bank Lending Survey, which are ultimately not reliable given their qualitative and subjective nature. This is a problem from the vantage point of financial stability.

As early as June 2015, the AFS issued a recommendation to the Federal Government to guarantee a legal basis that enables supervisors to collect **data on commercial and residential real estate loans** (AFS, 2015). On account of a recommendation put forward by the European Systemic Risk Board to close real estate data gaps (ESRB, 2016), the Federal Government has refrained from introducing a national legal basis for the collection of data on real estate loans (Bundesregierung, 2017). This is because the availability of granular data in the area of commercial real estate financing will be improved in the future through the collection of data under the **AnaCredit** credit data statistics system. However, this means that the current data situation will remain unsatisfactory for the time being.

AnaCredit will not alter the availability of data on residential property financing where the borrowers are natural persons, as it does not capture loans to natural persons. **Poor data availability** is therefore **a problem** which should be addressed promptly, as it is not possible to reliably identify the need for macroprudential action without such a data base.

695. Considering the moderate development in residential and commercial real estate loans, the slight drop in the level of household debt and the lack of evidence of a general easing of lending standards, there has been no apparent need thus far for measures to curb credit growth. However, even with moderate credit growth, the existing **real estate stock** could present **risks for financial stability** if

the anticipated losses are underestimated due to an overestimation of the loan collateral or if interest rate risks materialise in an environment where interest rates increase at an unexpected speed.

In light of the above, measures should be considered that strengthen banks' ability to sustain losses from their portfolio of real estate loans. Under Article 124 ff. of the CRR, the particularly low **risk weights** for loans secured by immovable property can be **increased** from 35 % (50 % in the case of commercial property) to a maximum of 150 %. Similarly, the minimum loss ratios for loans in default could be adjusted in case banks use internal models to determine the risk weights. However, the Federal Financial Supervisory Authority (BaFin) and Deutsche Bundesbank have concluded that an increase in the risk weights is not yet necessary at present (AFS, 2018).

In view of the general risk situation, the **activation of the countercyclical capital buffer** could be considered as an alternative, even if risks in the property market alone make this hard to justify. Nonetheless, the sharp decline in risk provisioning in the banking sector on account of the consistently positive economic situation (Deutsche Bundesbank, 2017b) and the growing macroeconomic risks may provide grounds for activation. ↘ [ITEMS 303, 207 FF.](#)

696. When it comes to the activation of macroprudential instruments conceived for the financial cycle, the **right timing is essential**, as a procyclical effect could otherwise be produced. Overall, **delayed instrument activation** is the bigger concern. Firstly, it is very difficult to identify risks to financial stability in real time. Secondly, decisions to use the instruments are often delayed (in Germany due to time-consuming consultation and information requirements, for example). Thirdly, considerable implementation lags are also at play, as many measures only apply to new loans or will only take effect in the future.

Additional delays stemming from **inaction bias** are also a cause for concern, as macroprudential measures are extremely unpopular politically. This is particularly true if - as is the case in Germany - the macroprudential committee is dominated by political decision-makers rather than the central bank (Lim et al., 2013; Gadatsch et al., 2018). In the decision-making process, appropriate consideration must be given to the various delays when deploying macroprudential instruments.

IV. THE DIMENSION OF SOCIAL AND HOUSING POLICY

697. The sharp increase in demand for housing in cities has driven up the cost of accommodation considerably and makes it difficult particularly for low-income households to find accommodation that suits their needs and is within their financial means. The high **social relevance** of increasing rents arises from the fact that rent constitutes the biggest expenditure component of private households. In this context, the relative rent burden for households on a low income is

particularly high. In large cities, the **rent burden ratio** – the share of expenditure on rent and running costs in net household income - can exceed the 40 % threshold above which a household is considered overburdened according to the EU definition.

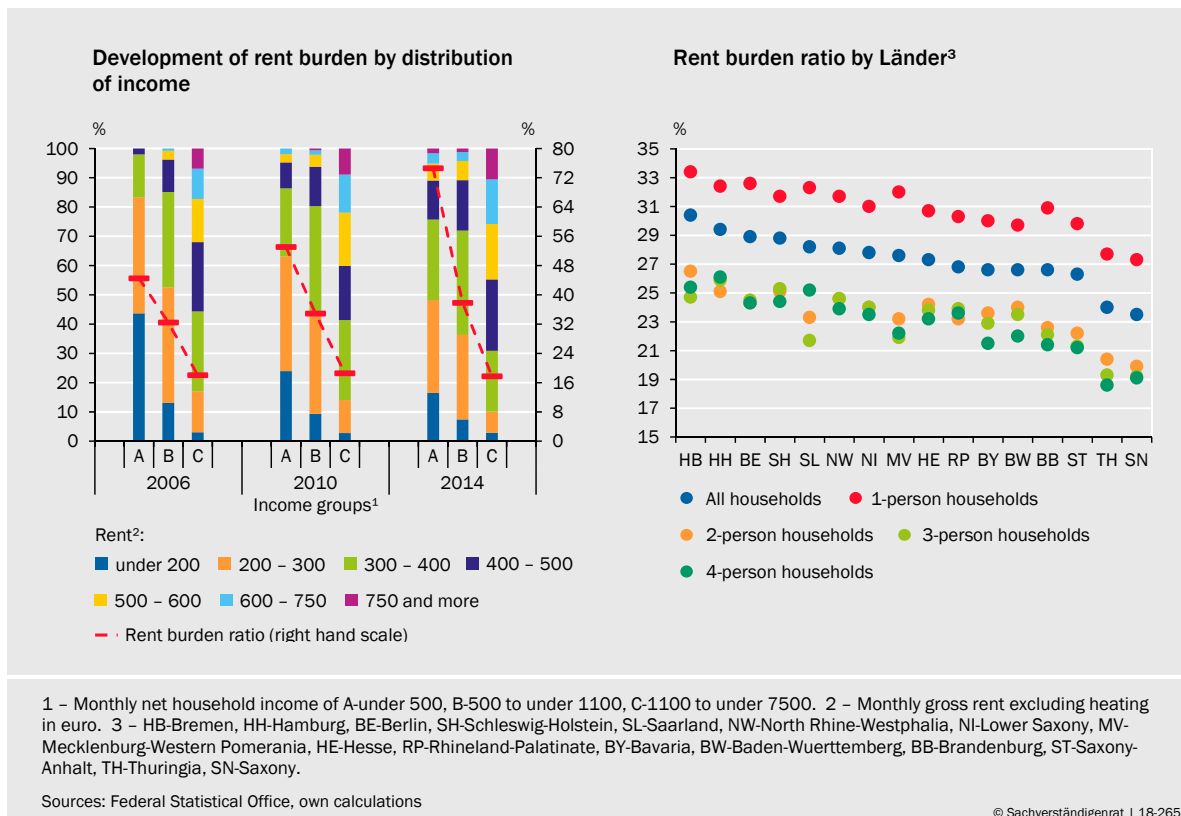
- The average rent burden of households with a net monthly income of between 500 and 1,100 Euro stands at around 40 %. ↘ CHART 91 LEFT The average household in these income brackets is considered overburdened; however, this is not true for every individual household. The rent burden has increased considerably since 2006 for households on a low monthly income (less than 500 Euro). For the most part, however, such income is likely to constitute a transfer payment under the system of basic income support.
- The rent burden varies when disaggregated by individual household type. At roughly 31 %, it is particularly pronounced for single-person households, and significantly lower for multi-person households at 23.5 %. Furthermore, the burden is higher in the city states of Berlin, Bremen and Hamburg than in the territorial, non-city states. ↘ CHART 91, RIGHT The rent burden is relatively low in the eastern German states.

698. The **socio-political challenge** is to find solutions that prevent social hardship but also ensure that supply can be brought into line with the higher demand over the medium and long term. In terms of **urban policy**, the priority is to prevent the development of new socially disadvantaged areas.

A whole range of housing policy instruments are available to address this challenge, as the “**Common Housing Initiative of the Federal Government**,

↘ CHART 91

Rent burden of households



the *Länder* and Municipalities” of September 21, 2018 illustrates. In simplified terms, these instruments can be categorised as follows:

- Measures to protect tenants from rent increases, where a share of the economic rent driven by the housing shortage is passed from landlords to tenants (**rent-increase cap**);
- Measures that enable particularly socially vulnerable tenants to bear the rising cost of housing without claiming the basic income support of Hartz IV (**housing benefit**);
- Measures to increase the supply of housing that is provided below the market price to low- and medium-income earners (“**social housing**”);
- Measures to generally increase the supply of dwelling units, particularly through fiscal measures such as the **property tax**, but also within the framework of **prohibitions on the use of residential property for unauthorized purposes** and the dismantling of **excessive regulations** for new housing developments;
- Measures that enable or improve the ability of renters to become home owners, particularly in the form of the **home buyers' child benefit** or a **reform of the real estate transfer tax**.

1. Protection of tenants from rent increases

699. As the moderate increase in rental costs indicated within the context of the consumer price index demonstrates, **current tenants in a property** have enjoyed relatively comprehensive protection against rent increases for quite some time owing to the provisions of the German Civil Code.

- For example, **rent increases** may not exceed the local comparable rate and rents may not be increased by more than 20 % within a three-year period (§§ 557 to 560 of the German Civil Code). In 365 towns and municipalities, the limit is set at 15 % (capping ordinances).
- **Housing modernisation measures** are an exception to this rule. In this case, landlords may – up to now – apportion 11 % of the costs to the annual rent.
- In addition, tenants are protected against **landlords terminating the rental agreement without a legal reason**. Ultimately a rental agreement can only be terminated in the event of gross misconduct on the part of the tenant or if the landlord requires the accommodation for personal use (§ 573 of the German Civil Code).
- If a **rental apartment is converted to an owner-occupied condominium**, the rental contract cannot be terminated for personal use for a period of three years. In many cities a period of ten years applies. In addition, tenants have an option to buy if their dwelling is put up for sale.
- Protective provisions also apply in the event of **excessive rent payments** such as the prohibition of excessively high rents (§ 5 of the Economic Of-

fences Act (*Wirtschaftsstrafgesetz*), the general prohibition on usury (§ 138 (2) of the German Civil Code) and the ban on rack-renting (§ 291 (1) no. 1 of the German Penal Code).

Rent-increase cap: symptomatic therapy with side effects

700. In the past, landlords were only free to define the rent in a new rental agreement with new tenants. The rent control that came into force on June 1, 2015 closed this gap. It sets **a maximum limit on the rent** charged in new rental agreements that is **linked to the rent index** (§§ 556d to 556g of the German Civil Code). In this context, the *Länder* can define regions as “tight housing markets” for a maximum period of five years. Then, rents in new rental contracts may exceed the rent of a comparable property in the local area by a maximum of 10 %. This rule does not apply to new buildings that came on the market after October 1, 2014 and to the first time an apartment is rented after being fully renovated (§ 556f of the German Civil Code). In addition, the rent control does not apply if the previous rent already exceeded the maximum limit before the mechanism was introduced; in such cases, the rent in the new rental agreement may not exceed the previous rent (§§ 556e, (1) of the German Civil Code).
701. The **rent index** performs an additional function on account of the rent control. In the past, this index served to limit rent increases in existing rental agreements. Accordingly, pursuant to § 558 (2) of the German Civil Code, rents for the rent index are calculated as an average from existing rental agreements, new rental agreements and rental agreements with stepped rents, without any weighting being specified for these variables. Furthermore, the index also captures providers that generally offer rents below the market rate, often even by statutory mandate, such as municipal housing associations, housing corporations or charitable organisations (Sebastian, 2016).

This is why the rent determined by applying the rent index to new rental agreements can be **significantly below the market price**. A study conducted by Held et al. (2014) shows that there can be very pronounced differences in cities with strong demand for housing, and particularly in good residential locations. For example, in 2012 the asking rents in the districts of Mitte, Prenzlauer Berg, Kreuzberg and Friedrichshain in Berlin were in some cases offered more than 50 % higher than the local comparable rent. Therefore, the rent control with the permitted markup of 10 % on the comparable rent can result in a rent that is significantly below the market level.

702. The rent indexes, which are commissioned by the local authorities, vary greatly in terms of **quality** and the **collection of data**. The quality defects of rent indexes became evident in 2015 in Berlin with a decision by the Charlottenburg District Court (Berlin Regional Court, 2016) that found that the qualified rent index for that area was not based on recognised scientific principles. From the German Council of Economic Experts’ point of view, it would therefore be desirable to update the rent index on a more regular basis using prescribed quality standards. This could be accomplished, for example, using digital rental data

from real estate websites (Bauer, 2015; Kauermann and Windmann, 2016; Sebastian and Lerbs, 2016; Voigtländer, 2016; Schlittgen, 2017).

703. The fundamental problem that an increasing demand for housing faces a **limited supply** of accommodation since many years, particularly in major cities, cannot be solved with an instrument like the **rent control**. Rather, such an instrument will tend to drive down the supply of accommodation available to regular renters.
- For example, investors can decide to no longer rent out a dwelling and instead sell it to an **owner-occupier**.
 - While the provisions of the rent control continue to apply if a dwelling is converted into a **furnished unit**, in the case of short-term rentals or accessory dwelling units landlords are entitled to charge a premium on top of the rent for the additional furniture and fittings. As the premium does not need to be explicitly stated in the rental agreement, it is generally difficult for the renter to gain a full understanding of the breakdown of the total rent and whether the law is being breached. The share of furnished accommodation in the total supply of rental housing is already very high in cities with a tight housing market. In the period from January to September 2016, this share stood at 45.1 % in Stuttgart and at 47.5 % in Munich (CBRE and Berlin Hyp, 2017).
 - In some cases it is likely that owners of vacated rental apartments will register the apartment as a **second residence**, opening up the possibility of short-term rental via an online platform. ↘ [ITEMS 739 FF](#).
 - Even though the rent control does not apply for new buildings, it can have a negative impact on **supply decisions** if investors fear restrictive and potentially retroactive regulations for the real estate sector in the future.
704. At the same time, an instrument like the rent control also overrides the effect that higher prices have on reducing demand. Overall, a greater **imbalance on the rental housing market** is produced that ultimately increases the market power of landlords. As other rationing mechanisms in addition to the price come into play on account of the regulation, this inevitably leads to discriminatory behaviour of landlords vis-à-vis those seeking accommodation. With such rationing mechanisms, it can be assumed that tenants with a less favourable social situation will be at a disadvantage.
705. Such protective provisions produce an “**insider/outsider**” situation where renters who manage to get housing at a controlled rent are at an advantage (“insiders”) while accommodation-seekers who do not manage to find a suitable dwelling due to the excess demand are at a disadvantage (“outsiders”). Existing tenants therefore remain in a property even if it has become too big/small for them due to changed family circumstances, as to move would mean changing from the protected “insider” position to the unprotected “outsider” position. With the rent-increase cap in place, unsuccessful accommodation-seekers are forced into the new-build housing sector where they face even higher rents. In addition, such protective provisions are likely to reduce transregional mobility.

706. Econometric evaluations of the rent control indicate that it did indeed **have a dampening effect on price developments for new rentals** at least on the short term. Given its design, the rent control can only be effective in regions where rents in new rental contracts had been trending upwards beforehand by more than 3.9 % per year (Kholodilin et al., 2018). For regions where this was the case, there is evidence of a dampening of the price trend and even one-time price reductions. [↘ BOX 20](#)

[↘ BOX 20](#)

Evaluation of the rent control

Before the introduction of the rent control, its impact was already hotly debated. Held et al. (2014) demonstrated that there were already vast differences in several major cities in Germany between asking rents and local comparable rents. Other authors thereagainst feared that numerous ways to circumvent the rent control mechanism, the lack of consequences for landlords who fail to comply, poor transparency for tenants and ill-established rent indexes would limit the effect of the rent control from the outset (German Renters Association, 2015; Sebastian and Lerbs, 2016).

To identify the causal ex-post effects of the rent control, many studies apply the difference-in-differences approach that compares the developments over time in regulated and unregulated market segments. The method estimates the deviation in the development of rents before and after the introduction of the rent control in the regulated group in relation to the development in an unregulated market and is based on the assumption that the rent trend over time would have been identical in both groups in the absence of the rent control.

Thomschke (2016) and Deschermeier et al. (2016) compare the development of rents for new-builds and refurbished dwellings that do not fall within the scope of the rent control. Thomschke (2016) demonstrates a short-term price-dampening effect of 4.3 % which lagged behind expectations. Similarly, Deschermeier et al. (2016) find that the rent control has only had a minor impact in Berlin and using data through to the end of 2016 estimate a negative effect of 2.7 % on the development of rents. Kholodilin et al. (2016, 2018) compare the rent dynamics for regulated “recent” old buildings with the development of unregulated new-builds. The analysis shows that the rent control in regions with high rent growth in the preceding years resulted in a one-time rent reduction of 2.9 %, while it does not have any effect in regulated regions with previously low rent growth.

Using a difference-in-difference-in-differences approach, Breidenbach et al. (2018) demonstrate that the dampening effect on prices for *regulated rental objects in regulated cities* amounts to around 3 %. The creation of a third difference addresses the endogeneity of the introduction of the rent control more directly than in previous studies. Furthermore, this estimation method takes all German municipalities into account. [↘ CHART 92](#) This makes it possible to take account of potential neighbourhood spillover effects if renters locate to neighbouring unregulated districts due to increased excess demand. The regional graphic illustrates that the rent control primarily applies in urban areas with a high rent level and that *Länder* led by social-democrat governments were the first to introduce them. Like previous evaluations, the results of this study also point to a rather minor dampening effect of the rent control on the development of rents in new rental agreements.

Given that it is limited to the “existing properties” segment, the rent control in Germany is not a blanket price cap for all apartments. Rather, it must be seen as a second generation rent control. In a comparative static model, Kholodilin et al. (2016, 2018) demonstrate that, with a control of this kind, the unregulated new-build segment is the valve for the increased demand that results from capping regulated rents. Therefore, an increase in the rents for new-builds can be expected. The authors

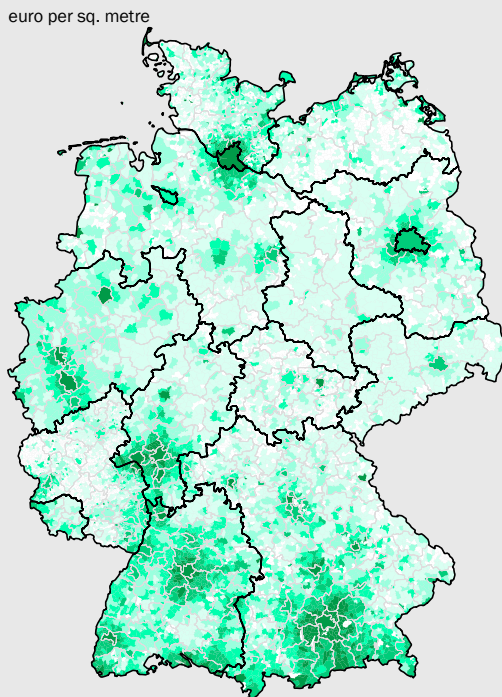
show that in regions with an effective rent control, the regulation has resulted in a short-term rent increase of 2.9 % for unregulated new-build dwellings and in higher prices of land.

It is possible that the rent control has resulted in the increased conversion of rented units into owner-occupied condominiums, which would counteract the positive effect of the mechanism on the supply of housing. While long-term experience with rent controls in the United States points to negative effects of second generation rent controls on the supply of rental housing (Sims, 2011; Diamond et al., 2018), this effect of the rent control in Germany has not yet been sufficiently investigated. With regard to the existing supply of housing, it is argued that smaller-scale renovations to maintain housing quality are not worthwhile for landlords. Kholodilin et al. (2016) find evidence that landlords may have reduced maintenance measures following the introduction of rent control in Germany.

▸ CHART 92

Regional data on rental prices and rent control

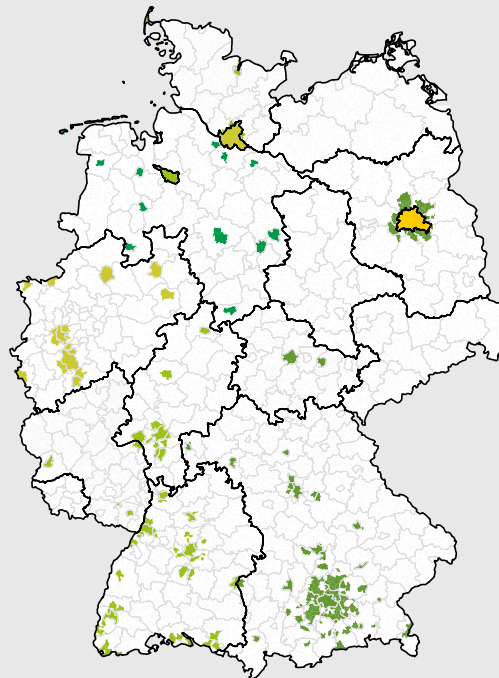
Average rental prices in 2014



euro per sq. metre

up to 5.43
 up to 6.20
 up to 7.23
 up to 8.81
 from 8.82
 No data available

Introduction of rent control (quarter/year)



Quarter 2, 2015
 Quarter 3, 2015
 Quarter 4, 2015
 Quarter 1, 2016
 Quarter 4, 2016
 No rent control

Sources: Federal Agency for Cartography and Geodesy, RWI-GEO-RED, own calculations

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Who is actually affected by the introduction of the rent control still requires clarification. Prior to its introduction it was argued that there would likely be a relative deterioration in the situation of the targeted group – low-income and medium-income households – as landlords would choose tenants in a better financial position in situations of excess demand (Kholodilin and Ulbricht, 2014; Deschermeier et al., 2016). In keeping with this, Thomschke (2016) finds that in Berlin the rent control was only able to have an effect in the upper half of the rent distribution, while the level of rent for inexpensive units was not affected. In a nationwide analysis, Breidenbach et al. (2018) show that the effect of the rent control is stronger with regard to units of a lower quality standard and in the lower price segment than for higher quality, more expensive units.

707. On September 5, 2018, the Federal Government presented a draft bill to amend the regulations on the permitted rental price at the start of a rental agreement and to modify the regulations surrounding the modernisation of the rental object (Tenancy Law Amendment Act (*Mietrechtsanpassungsgesetz*)). Its provisions stipulate that:
- due to new pre-contractual **information duties on the part of the landlord**, when entering into the rental agreement tenants learn whether the landlord is invoking, or can subsequently invoke, a previous rent that is higher than the permitted rental price at the start of the rental period
 - the percentage of the **costs of modernisation** which landlords may pass on to their tenants is reduced from 11 % to 8 % for an initial period of five years in areas in which the adequate supply of rental housing for the population at reasonable conditions is particularly at risk (known as lower cap areas).
708. Overall, a price regulation measure like the rent control constitutes **symptomatic therapy** that will help “insider” renters who benefit from cheap housing on the short term. However, it is likely to further exacerbate the underlying problem of an insufficient increase in the supply of housing. Those who lose out are the “outsiders”, i.e. the accommodation-seekers who have to pay higher rents on the unregulated market for new-build dwellings or who cannot even find appropriate housing. Due to the counterproductive effects of the rent control on the rental housing market over the medium and longer term, the German Council of Economic Experts continues to be in favour of **abolishing the rent-increase cap** (Annual Report 2013, item 862).

2. Housing benefit: expedient support for low-income households

709. The instrument of housing benefit can provide direct relief to low-income households who face a relatively high rent burden. This type of **support for individuals** has the advantage that it does not interfere directly with the pricing mechanism and therefore avoids distortions with regard to supply and demand decisions. Together with the child supplement, housing benefit is an important transfer payment to which every household is legally entitled (§§ 1 ff. of the Housing Benefits Act (*Wohngeldgesetz*)). This helps ensure, in particular, that households with children do not claim basic income support even though one or more members of the household are in regular employment. Households cannot receive support in the form of housing benefit and basic income support simultaneously.
710. The **income thresholds** for housing benefit are typically well below the income limits for social housing. The benefit amount is calculated on the basis of the net income and is intended to prevent households having to spend more than 30 % of their net income on housing. At the highest rent level under the

housing benefit system (level 6), the income limit for a four-person family is 2 166 Euro per month.

711. As protection under the system of basic income support applies for households at the lower margin, the **number of households** that benefit from this transfer payment is already **quite low** from the outset. Before the housing benefit reform of 2016, which brought housing benefit back into line with rent and income developments for the first time since the housing benefit reform of 2009, only 460 000 households were entitled to housing benefit. At the end of 2017, this number stood at 592 000 households, which is equivalent to 1.4 % of all households. In the seven largest cities, the share of entitled households stood at just roughly 1 % in 2004 (Holm et al., 2018). Spending by the Federal Government and the *Länder* on housing benefit in 2017 amounted to 1.1 billion Euro. The next regular adjustment of the housing benefit is scheduled to take place in 2023; outside of this, an increase is expected in 2020.
712. Particularly in times of rapidly rising rents, it is a problem that the housing benefit rules are only readjusted every seven years. With incomes rising, many needy households also no longer qualify for support. A **more dynamic adjustment system** like that for basic income support would be appropriate. Given the sharp rise in rents and the low number of people entitled to housing benefit, there may also be a need to consider raising the income threshold and the benefits. One conceivable approach would be an additional level for cities with particularly high rents.
713. If the benefits under the housing benefit system are expanded significantly, this would, however, amplify the problem of the growing **complexity, inconsistency and lack of transparency in the transfer and contribution system**. Very high effective marginal burdens that can exceed 100 % are already seen at the upper limits for transfer receipts (Peichl et al., 2017). The fact that the number of individuals entitled to claim housing benefit – just like the numbers entitled to the child supplement - is far higher than the number of those actually claiming the benefit is most likely a reflection of the lack of transparency in the current system (Bruckmeier and Wiemers, 2017).
714. Higher housing benefits should therefore only serve as a temporary solution. Over the medium term they would need to be incorporated into an integrated transfer and contribution system together with the child supplement. To this end, Peichl et al. (2017) have developed a model that provides for the integration of basic income support for job-seekers (unemployment benefit II), housing benefit and the child supplement into a **universal transfer benefit** with a constant transfer withdrawal rate of 60 %. This eliminates discontinuities in the transfer system that are problematic for incentive reasons and reduces the transfer withdrawal rates. In contrast to the current legal situation, the proposed reform also makes provisions for the payment of the housing benefit even if the benefit amount is less than 10 Euro. The simulation results for this proposed reform suggest positive effects on employment and income, the latter particularly in the lower income bracket.

3. Social housing: avoiding mistakes of the past

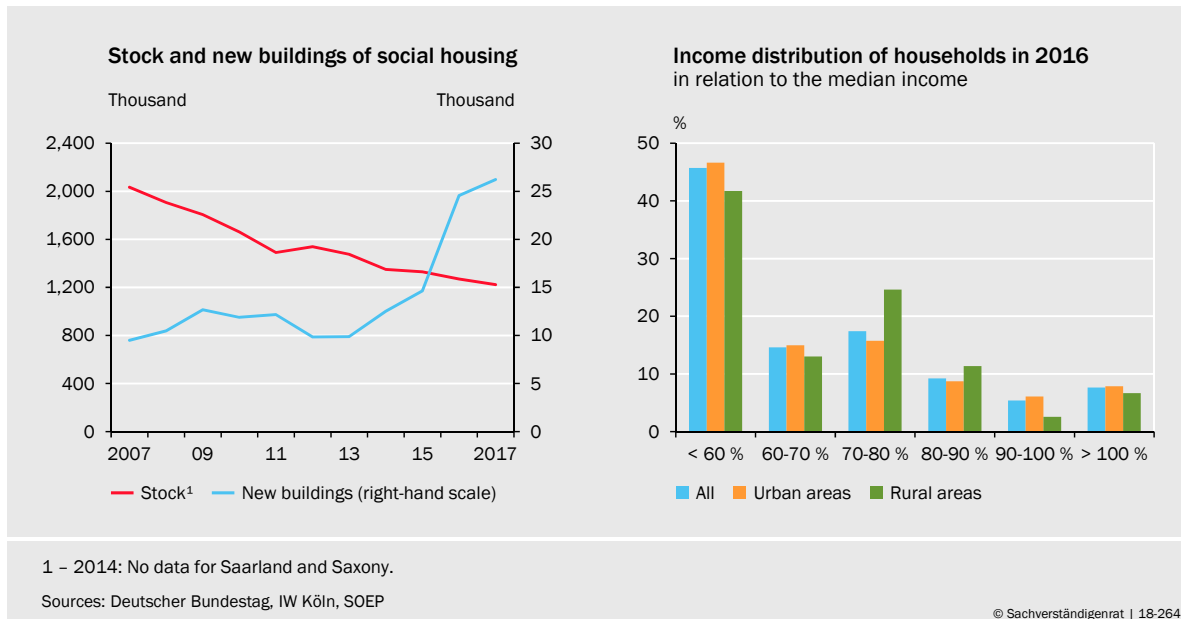
715. Social housing is used to pursue both distribution policy and urban policy objectives. It is an instrument to **promote the supply of property** because housing is offered to low-income and, in some cases, middle-income earners at rents below the market rate. This improves the financial situation of the beneficiary households and helps to prevent people on low and middle incomes from being crowded out of the centres of larger towns and cities as a result of gentrification.
716. The **social housing stock** has been declining for some time. In 1990, for example, there were roughly 3 million tied dwellings, in 2004 there were around 2.2 million and in 2014 there were only 1.4 million (Holm et al., 2018). [↘ CHART 93 LEFT](#) In Berlin and North Rhine-Westphalia the stock has almost fallen to one-third since 1989 (Deutscher Bundestag, 2017). The construction activity of new social housing has been significantly stepped up in recent years. Nonetheless, it is insufficient to offset the annual number of dwellings that fall out of the tie every year (Holm et al., 2018). The amount of funding set aside specifically for social housing has been increased in response to the high levels of immigration of refugees.
717. The level of demand for social housing is difficult to estimate. Various institutions put the **unmet demand** at roughly 1 million dwelling units by 2020 (Deutscher Bundestag, 2017). The greater migration of refugees since 2015 has had a significant impact on this strong demand.

At the federal government's "Housing Summit" in September 2018 the decision was taken to make 5 billion Euro available by 2021 for the construction of an additional 1.5 million social housing units. This federal funding is being made possible by an **amendment to the German constitution** (Article 104d of the Basic Law). This move will allow state-owned land to be sold to developers at reduced rates.

718. Social housing does not have a good reputation. One of the main criticisms of this measure is that it involves large amounts of **mis-subsidies**. A study conducted by Schier and Voigtländer (2016) based on data from the German Socio-Economic Panel (SOEP) shows, for example, that barely 46 % of the households living in social housing have incomes below the at-risk-of-poverty threshold, from which they conclude – judged on the criterion of need – a rate of misallocation of 54 %. The Board of Academic Advisors to the Federal Ministry for Economic Affairs and Energy (2018) believes that any deliberate policy of allocating accommodation based on income poses the added risk that residential blocks will become **socially deprived areas** or that social housing landlords would give preference to tenants on higher incomes over more socially disadvantaged people, which would mean that those earning particularly low incomes would lose out.
719. Despite the great importance of social housing there has been no **comprehensive evaluation** of this economic policy tool. The feasibility of such an evaluation is complicated by the fact that social housing is intended to achieve several

↘ CHART 93

Stock and occupancy of social housing



objectives at once. By expanding the supply of housing it is supposed to create ‘affordable’ homes and besides provide targeted support to tenants who are in need (Schier and Voigtländer, 2016). It should focus on households on low and middle incomes and help ensure a social mix within residential developments.

720. The results of simulations indicate that social housing can increase the density of urban residential space and create the potential for economic growth (Krebs and Scheffel, 2017). This analysis is based on a macroeconomic growth model that describes households according to their number of children, childcare situation, employment status and qualifications; models their employment histories; factors in the intensity of job search and the amount of training dedicated to this purpose; and takes account of saving and consumption decisions, financial markets, and the production of goods together with the associated labour and capital input. Greater public funding of housebuilding improves labour market access for households on low and middle incomes. The interactions between these factors can give rise to indirect effects, for example on employment and remuneration. The model simulates a public funding programme, which makes an additional 5 billion Euro available per year and only funds projects that aim to build socially balanced residential areas, as is the case, for example, in Munich.

The transmission mechanism of improved labour market access for the publicly funded households gives rise to a higher equilibrium value of labour productivity in the model after 34 years. This effect can be explained, for example, by the “skilled cities” hypothesis (Südekum, 2010), which claims that the economic activity of towns and cities can be boosted by the influx of highly skilled workers. Indirect effects arising from interactions between the model sectors manifest themselves in the form of permanently higher employment and remuneration as well as increased tax revenues and lower spending on welfare benefits.

721. The bad experience of social housing in the past is not in principle an argument against this funding instrument. First of all it is worth noting that the German

federalism reform of 2006 transferred responsibility for social housing from the federal government to the *Länder* (federal states). Since then, each *Land* has been free to pursue its own forms of social housing policy. This has the great advantage that **competing institutions** can identify best practice. Efforts should be made here to conduct the corresponding evaluations.

722. The example of the **Bavarian Social Housing Act** from 2007 demonstrates that there are now forms of social housing that should give the ability to largely avoid the mistakes made in previous decades.
- Tenants living in social housing in Bavaria receive a **graduated rent subsidy** according to one of three income brackets and the size of the family.
 - The construction of new social housing benefits from a government subsidy per square metre. Both **public and private housing associations** can act as providers here. They receive rental income that is composed of the rent paid by the tenant and the government's rent subsidy. This generally ensures that the rent received by the provider is more or less in line with market rates.
 - **Misallocation** is avoided because the incomes of those living in new social housing are reviewed every three years. If their incomes exceed the relevant limits, the rent subsidy is either reduced or totally removed. This is especially the case if the family has become smaller. A separate charge for inappropriate occupancy is therefore not necessary.
 - The **risk of creating socially deprived areas** is mitigated by the fact that the top income bracket qualifying for subsidies is set fairly high. The monthly gross income limit for a family with two children is around 5 400 Euro. This ensures that even within social housing developments there is a broad social mix, and a similar approach to subsidised housing has been adopted in Vienna (so-called "**Viennese model**"). The income limit here has been set so high that roughly 75 % of households would qualify for subsidised housing (Ludwig, 2017). Consequently, the free rental market in Vienna is smaller than in German cities of a similar size (Geymüller and Christl, 2014). The general problem, however, is that income limits that have been set fairly high reduce the scope for subsidising socially disadvantaged households.
 - The risk that **preference will be given to higher-earning households** when it comes to social housing is mitigated by the fact that the housebuilding companies must include households from all income groups according to a fixed quota when they are allocating accommodation.
723. Fears that public-sector providers might build and operate less cost-effectively than private-sector ones are allayed by the fact that private housing associations receive full preferential treatment in their construction of housing and the same rent subsidies as public-sector suppliers. If private providers actually manage to achieve cost efficiencies, this would be reflected accordingly in their return on investment. This procedure is therefore fully consistent with the **principles of a market economy**.

724. The social housing legislation in other *Länder* differs significantly in some cases from the Bavarian Social Housing Act. The **specific design of the subsidy** varies in terms of the rules governing the property, recreation facilities and accessibility. The income limit for a family with two children in Baden-Württemberg is just under 5 500 Euro per month and therefore in line with Bavaria's, while the limit in North Rhine-Westphalia is roughly 4 300 Euro and in Hesse it is less than 3 000 Euro. The incomes of social housing tenants in many *Länder* are regularly reviewed.
725. A major prerequisite for social housing is the **availability of reasonably priced building land**. Many towns and cities therefore sell land for affordable homes at reduced rates and stipulate quotas for affordable housing in urban development contracts. The 2017 amendment to Germany's construction planning laws introduced the new category of 'urban areas' in the country's land use regulations, which allows contemporary mixed use and higher building densities in towns and cities, thereby facilitating the creation of residential space.

4. How could the supply of housing generally be increased?

726. The fundamental problem in the real estate market is that supply cannot immediately adjust to the rising level of demand. The **availability of building land** is proving to be a particular bottleneck in large towns and cities. One feasible option might be to increase the supply of building land by offering tax incentives. A decision by Germany's Federal Constitutional Court has recently fuelled a debate about whether property tax should be reformed. Regulations that push up construction costs and delay planning processes can also constrain supply. And, finally, vacation home rentals advertised on online platforms can restrict the supply of regular housing.

Reforming property tax

727. The German government's coalition agreement specifies the intention to introduce a **property tax C**, which municipalities could use to levy a separate tax on undeveloped building land. This is designed to create incentives to make more land available for residential purposes. At present a property tax A is levied on agricultural and forestry land and a property tax B applies to all other types of land. Because property tax B is based on rateable values that take account of the value of the building, undeveloped land is taxed at a relatively lower rate. By levying a separate tax on this type of property, the German government hopes to prevent the **"speculative hoarding" of land**.

However, this solution poses significant problems. For example, no comprehensive data on undeveloped building land is available, and it is not easy to determine the reasons why a particular owner is not building on his or her land. Regulatory hurdles, lengthy approval procedures, funding constraints and fully utilised capacities in the construction industry could all be potential reasons why building land remains undeveloped for extended periods without any speculative

intention being involved. If property tax C is to prevent the speculative hoarding of land effectively, it would need to be set at a higher rate than the expected appreciation in the land's value. The result might then be that undeveloped land would be taxed more heavily than developed land.



A property tax C was actually levied for the aforementioned reasons in 1961 and 1962. It involved an increase in the base rate, which rose progressively in stages over the period during which the owner kept the building land undeveloped. Although it had been the stated aim of this policy to encourage the development or sale of undeveloped land, property tax C failed to achieve this objective. Low-income owners in particular were forced to sell their land (Wissenschaftlicher Dienst des Deutschen Bundestages, 2017). For high-income owners and companies, on the other hand, this tax was not a major consideration, which meant that this fiscal policy measure failed to mobilise a large proportion of the undeveloped building land. Municipalities were given a great deal of discretion in how they evaluated and designated plots of land. In addition, the underlying law granted a number of exemptions and required the plots of land concerned to have already been developed for infrastructure purposes. However, as this did not apply to many of the plots of land affected and a considerable proportion of the undeveloped building land was owned by municipalities, property tax C totally failed to achieve the desired effect. For this reason and because the construction sector was overheating, the property tax C was abolished in 1964.

728. Irrespective of the debate around a potential property tax C, however, property tax has been in need of reform for some time now, and this need has now become an absolute imperative following a recent ruling by Federal Constitutional Court. In April 2018 the Court **declared property tax in its current form to be unconstitutional** (BVerfG, 2018). It justified its ruling on the grounds that the rateable values used to calculate tax liabilities were inappropriate and violated the principle of equality laid down in the Basic Law.

As the German Council of Economic Experts has often highlighted (Annual Report 2016 item 91; Annual Report 2015 item 807), the **outdated method of determining the tax base** is unsustainable. The last time the rateable values were assessed in the Länder of the former territory of the Federal Republic was in 1964, while they were last assessed in the Länder of former East Germany back in 1935. Consequently, the existing rateable values reflect current property values either to only a very limited extent or not at all. This causes potentially unjustified distribution effects both within and between municipalities. The Federal Constitutional Court has therefore ordered the government to enact reforms by 2019 that will include a revaluation of the country's 35 million or so plots of land and must be fully implemented by no later than 2024.



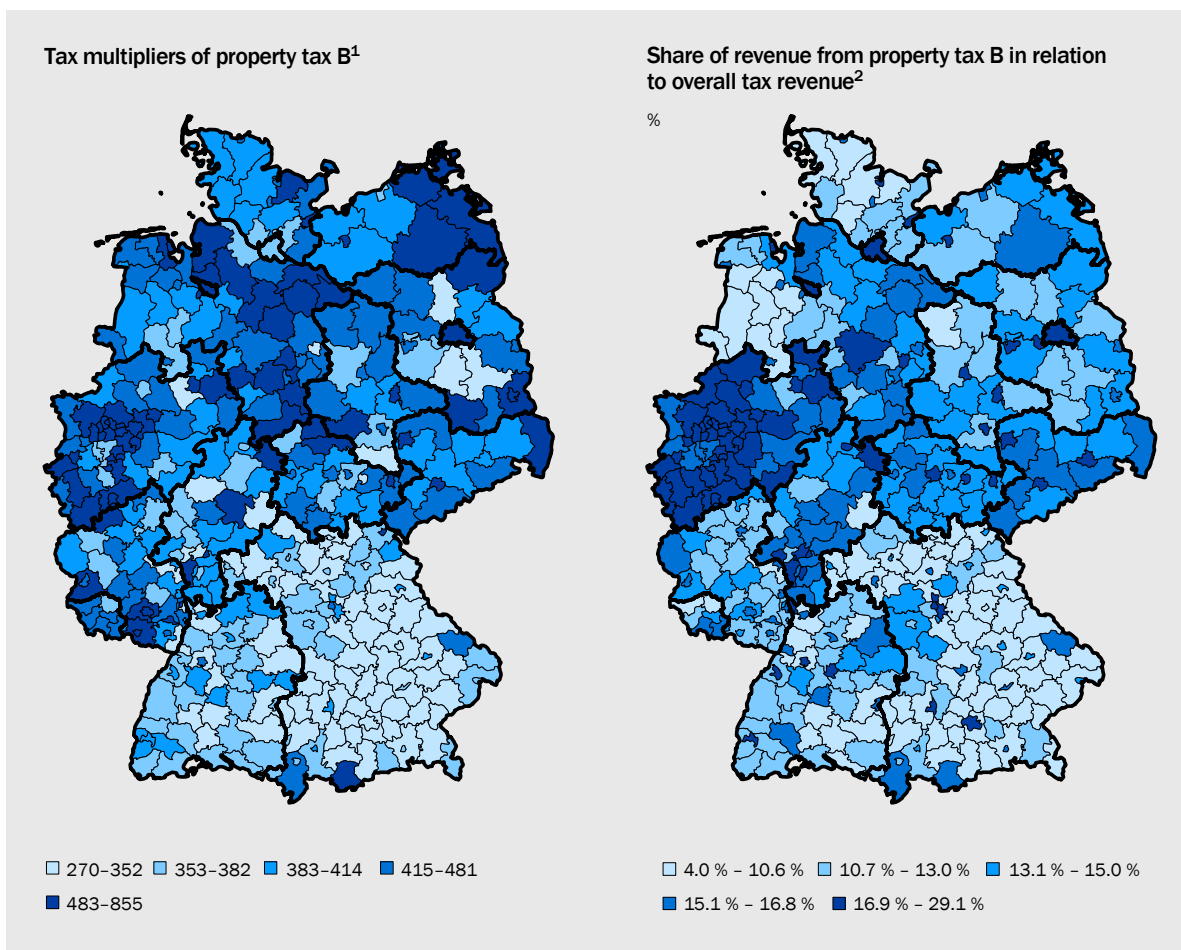
The individual property tax liability is calculated by multiplying the rateable value, the statutory property-tax base rate and the municipality-specific tax multiplier. The purpose of the rateable value in this context is to approximate the value of the land and the building, whereas the property-tax base rate is used to document the type of use and, among other things, differentiates between detached houses, semi-detached houses, and agricultural and forestry businesses. Property tax is one of the few taxes in which the municipalities have **fiscal autonomy**. Municipalities can use municipality-specific tax multipliers to

compete with other municipalities on tax rates and influence the level of tax revenue. A significant proportion of this tax is paid by tenants because landlords can pass the tax on to their tenants in the form of incidental costs (Löffler and Siegloch, 2018). All property tax revenue accrues to the municipalities and constitutes an **important and readily plannable source of revenue for local authorities' budgets**. Considering Germany as a whole, municipal property tax revenue accounts for up to 29 % of local authorities' total tax revenue. ↘ **CHART 94** Property tax B, which is payable on developed and developable land, accounts for roughly 97 % of total property tax revenue. Property tax A, which is levied on agricultural and forestry land, accounts for just a very small proportion of total revenue.

729. There are essentially **three options** currently under consideration in the debate on **reforming property tax**: the cost-value model, the area model and the land-value model. A further potential option would be a model based on a property's market value. Given the considerable amount of administrative work and expense involved here, however, this is unlikely to be a feasible option at present. These models differ with respect to their treatment of the plot of land and the building located on it.

↘ **CHART 94**

Revenue and tax multipliers of property tax B on municipality level in 2016



1 – Weighted average of tax multipliers of municipalities. 2 – Overall tax revenues are composed of municipalities' revenues from property tax A and B, revenue from local business tax net of local business tax levy as well as the municipalities' shares of income and sales tax. Calculation of thresholds based on quintiles; small deviations due to rounding for display purposes.

Sources: Federal office for cartography and geodesy, Federal and state statistical offices, own calculations

730. With a **revenue-neutral reform of the property tax**, any recalculation of rateable values will probably require a substantial adjustment of the statutory base rate or the municipality-specific tax multipliers. However, the specific structure of local authorities' fiscal equalisation systems and federal fiscal equalisation scheme can mean that municipalities are disadvantaged by such adjustments. These repercussions should be considered as part of a reform.

These parameters could be selected in such a way that these reforms would in principle be revenue-neutral for each municipality. Distribution effects, which nonetheless neglect the ability to pass on costs over the longer term (Löffler and Siegloch, 2018), would then only occur within municipalities. Given the hypothetical assumption that municipality-specific tax multipliers and the base rate would initially remain unchanged, however, we would – depending on the reform model used – expect to see **distribution effects varying** between the Länder and between major conurbations and rural areas.

- Under the **cost-value model** the valuation of a plot of land involves multiplying its total area by indicative land values. This data is already collected virtually nationwide by the expert committees. The value of a building is calculated using the estimated cost of production based on the type of building, its age and its floor space. This method could be used to approximate the value of a plot of land and would involve relatively little administrative work and expense. The Länder of Hesse and Lower Saxony jointly submitted a reform proposal to this effect to the Bundesrat back in 2016. Although this proposal was accepted by most Länder, it was rejected by Bavaria and Hamburg. The proposal was not taken any further in the legislative process. One objection here was that it was not possible to ensure that the rateable values had been consistently calculated, because the use of estimates enabled modernisations and refurbishments to be taken into account to only a limited extent (Söder et al., 2016).
- Calculation of the rateable value under the **area model** is based solely on the total area of the land and the floor space of the building and does not explicitly include the location of the land or the value of the building (Arbeitsgruppe der Länder Baden-Württemberg, Bayern und Hessen, 2010). This model only differentiates between plots of land in terms of whether the floor space of their buildings is used for residential or commercial purposes. This model would be especially advantageous for buildings with small amounts of floor space.
- Under the **land-value model** the total area of a plot of land is used as the tax base and factors in an indicative land value (Henger and Schaefer, 2018). The actual development of the land is therefore irrelevant for the purposes of calculating the tax liability. However, the indicative land value reflects the potential uses for the land, which means that a value component is included in the tax base. Compared with the status quo, therefore, this model could in principle create incentives to develop land. This model would, however, pose a greater risk of growing segregation within towns and cities.

731. In order to **evaluate these reform proposals** it is first of all necessary to identify the requirements for a reformed property tax, which will then enable the proposals to be properly assessed. As far as the **incentives for increasing the development** of land are concerned, both the cost-value model and the area model create adverse incentives because any development would incur a higher tax liability than under the land-value model.



Two key principles are used to legitimise the payment of taxes. The **principle of equivalence** requires the government to provide goods and services in return for the taxes that it levies on its citizens. Unlike with the payment of fees or charges, however, this provision of benefits cannot be directly attributed to specific individuals because these benefits are provided in the form of public goods. In the context of property tax and real estate transfer tax it should be noted that because a property is tied to a specific location, only regional or local public goods can be taken into account. The **ability-to-pay principle** requires that the level of taxation be justified and demands that there be consensus on how to measure the ability to pay. Many kinds of tax are based on income in order to satisfy these criteria. The ability-to-pay principle distinguishes between horizontal and vertical tax equity. While the former requires that people on the same levels of income should pay the same amount of tax, the latter postulates that those on higher incomes should be taxed more heavily, but it does not necessarily call for a progressive taxation system.

732. With respect to the **principle of equivalence**, under which the property tax liability should be determined by the benefit derived from publicly funded goods and services, the cost-value model and the area model are preferable. The nature of the land development here is a key indicator of the extent to which local goods and services are used. The location of a property, on the other hand, is less important for the extent to which such public goods and services are utilised. However, the area model neglects the marginal agglomeration costs of the choice of residence or location, whereas the land-value model is able to factor these in.
733. Property tax is a tax on objects. The **ability-to-pay principle** dictates that the amount of tax levied on a property should be based on the ability to pay. It is safe to assume that the value of a building is positively correlated with the owner's or tenant's ability to pay. The area model does not compare very favourably with the land-value model and the cost-value model in this respect because it does not differentiate between good locations and bad locations. This gives rise to a conflict of objectives between the classical principles of taxation and the ambition of creating incentives to build on undeveloped land.
734. In terms of the **administrative expense** involved in calculating the rateable values, the area model and the land-value model would compare more favourably because they ignore the value of the building and thus simplify the process of regularly updating the rateable values. Given the deadline set by the Federal Constitutional Court for reforming property tax, these two reform proposals therefore appear to be more realistic. Because the indicative land values are already available virtually nationwide, this information could be used to approximate the market value. Within the municipalities a solution of this kind would

be more likely to implement a system of taxation based on the ability to pay and to factor in the marginal agglomeration costs.

However, a property tax based on the land-value model would be more likely to intensify the **trend towards segregation** in German towns and cities because desirable residential locations would be reflected in the indicative land values and tenants would therefore also have to pay higher incidental costs there because landlords could pass the property tax on to their tenants (Löffler and Siegloch, 2018). Another factor is that although the indicative land values are available nationwide, their quality is inconsistent.

735. These considerations suggest that the best option would be to find a **hybrid solution** which, on the one hand, takes account of the aforementioned aspects of an efficient property tax while, on the other hand, keeping in view the problem of segregation. A starting point might be the area model which, in addition to differentiating plots of land and buildings according to whether they are used for residential or commercial purposes, could be supplemented with further estimated criteria that reflect the use or location of the property concerned. Ultimately, however, the new property tax base approved at national level cannot exempt the municipalities from their responsibility. The tax multipliers should be adjusted at municipality level to ensure that residents and businesses do not have to pay an excessive amount of property tax.

Reducing regulation

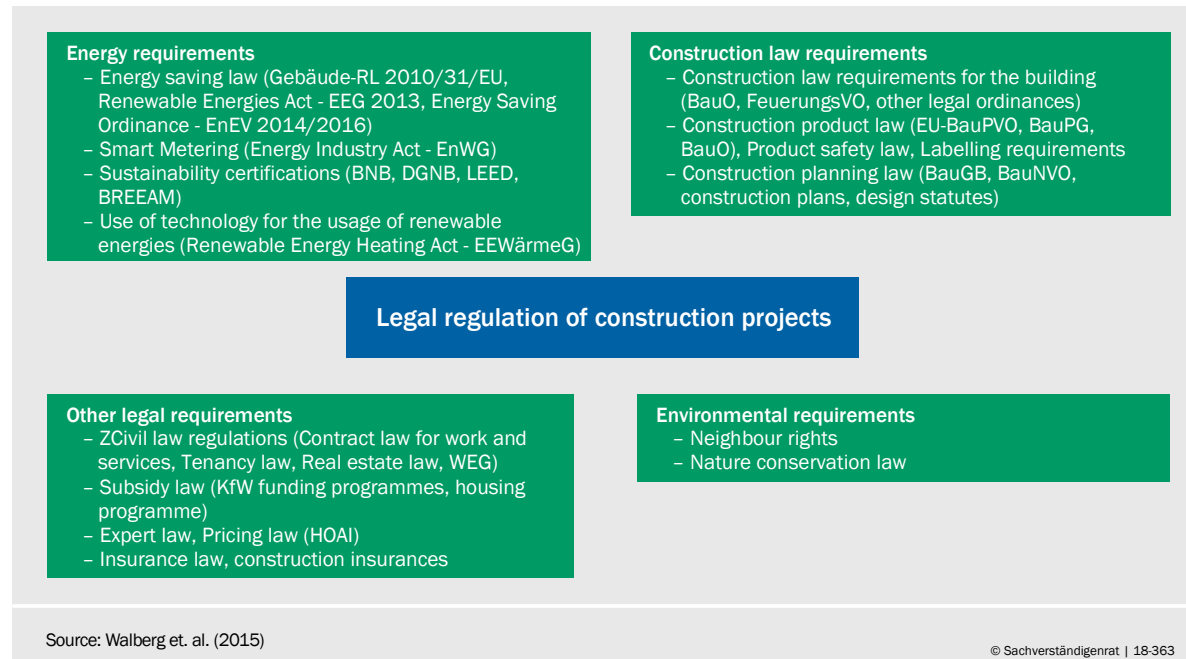
736. The construction of residential property must comply with a **large number of legal regulations** which, in aggregate, have a considerable impact on building costs. ↘ [CHART 95](#) A study conducted by the Institute for Sustainable Constructions (Walberg et al., 2015) reveals that building costs rose by 36 % between 2000 and 2014. 27 percentage points of this increase can be attributed to general price rises, 6 points to more stringent requirements around energy efficiency and renewable energy and a further 3 points to additional requirements relating to fire safety, soundproofing, accessibility, structural stability and others. Allowing also for the Energy Saving Ordinance from 2016 onwards in conjunction with the latest version of the Renewable Energy Heating Act (EEWärmeG), the total increase in construction costs is estimated to be 45 %, which means that regulation adds a further 9 percentage points.

It should be noted here that although energy efficiency measures push up construction costs, they also reduce running costs. It is also important not to ignore the negative externalities created by carbon emissions. There is therefore a clear **conflict of objectives** between providing reasonably priced accommodation and ensuring that new housing is as energy efficient as possible. A **standard carbon price** ↘ [ITEM 25](#) that also applies to homes would constitute a major step towards finding an effective solution to this dilemma.

737. A further problem in the context of improving buildings' energy efficiency is the accuracy of subsidies to target their objective. Grösche et al. (2013) use homeowners' revealed preferences to show that a large proportion of the funding pro-

↳ CHART 95

Overview of the construction law instrument box



vided is subject to deadweight effects and fails to achieve the intended effect of **additional energy savings**. The amount of regulation governing the improvement of buildings' energy efficiency should therefore be reduced.

738. A study on Berlin's real estate market by bulwiengesa (2018) reveals that the completion of construction projects – including all **official procedural and planning stages** – can take more than ten years. This means that construction plans currently being developed and the dwelling units specified therein might not be available on the market for about another ten years. The study also finds that further delays are caused by regulations such as the need to comply with restricted periods for felling trees and relocating animals.

Prohibitions of illegal repurposing of housing

739. The short-term letting of accommodation to tourists via **online vacation rental portals such as AirBnB** has recently exacerbated the shortage of rented accommodation. This form of rental is therefore driving up rents even more. Some agreement has been reached in disputes between AirBnB and the cities of Amsterdam, Barcelona, New Orleans, New York and San Francisco because AirBnB has been prepared to compromise. Very little research has so far been done on the actual impact of online vacation rentals on the supply of residential property. Even in Berlin, which is Germany's leading city in terms of the number of transactions done on AirBnB, the accommodation advertised on this online vacation rental portal accounted for only 0.58 % of the total housing stock as at December 31, 2016 (Busch et al., 2018).
740. In **Berlin** a prohibition of illegal repurposing of housing came into effect in May 2016. This legislation stipulates that dwellings must not be permanently let as vacation homes and must not remain unoccupied without a specific reason (§ 1 (1) Act on the Prohibition of Illegal Repurposing of Housing [ZwVbG]); the

legislation also applies to second homes. Private dwellings are therefore only allowed to be sub-let over the longer term if the rent is in line with the rents usually charged locally. It is questionable, however, whether such a serious encroachment on homeowners' freedom can be justified.

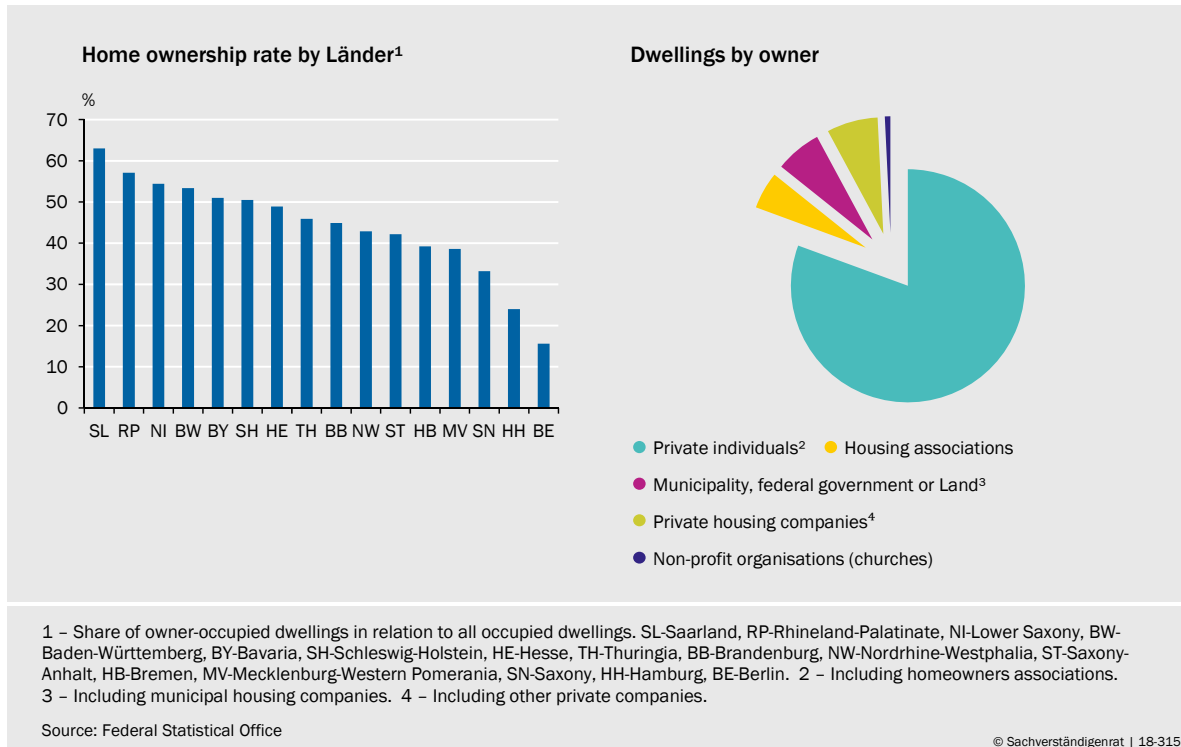
741. In **Bavaria** the prohibition of illegal repurposing of housing originally adopted in 2007 was stepped up in July 2017 in order to place tighter restrictions on sub-letting. The law now states that dwellings cannot be sub-let for more than eight weeks per year and must not remain unoccupied for more than three months. Fines can be imposed for violations. So far in Bavaria only its capital city of **Munich** has implemented this ban. According to the city council's department of social services, roughly 1 000 dwellings are suspected of having violated the prohibition of illegal repurposing of housing. Just to place this in context, approximately 6 700 new homes were built in Munich in 2017.

5. Promoting private households to acquire property

742. Rising property prices are making it harder for many households to buy their own home. Because of the very **low home ownership rate** in Germany compared with other countries, however, there are relatively few households whose personal wealth is being increased by this price rise. Germany's home ownership rate of 45 % is the lowest in Europe except for Switzerland. This rate is even lower in the cities most affected by these price rises: in Berlin it is only 16 % and in Hamburg it is 24 %. The home ownership rate increases as incomes rise, and there is a strong correlation between households' home ownership and their personal wealth (Annual Report 2016 item 839). The sharp rise in property prices therefore means that wealth is becoming increasingly concentrated.
743. The **reasons for the low home ownership rate** in Germany are diverse and partly relate to history (Annual Report 2016 box 28). The substantial funding and support given to the construction of social housing during the postwar years and the comprehensive regulation of rents laid the foundations for Germany's tenant-friendly housing market. Since then, fairly little support has been given to home ownership; the type of assistance made available to homebuyers until 2005 does not appear to have significantly affected the home ownership rate (Voigtländer, 2009). Moreover, the system of encouraging private pension provision in Germany makes it less advantageous to purchase residential property than to acquire assets in the form of financial assets. ↘ [BOX 21, ITEMS 118 FF.](#)
744. The home ownership rate varies considerably among Germany's Länder. ↘ [CHART 96 LEFT](#) Whereas the city states can be found at the lower end of the distribution, owner-occupiers account for 63 % and 57 % of all households in Saarland and Rhineland-Palatinate respectively. Apart from the home ownership rate, little is known about the **ownership of residential property**. The survey of buildings and dwellings carried out ahead of the 2011 census reveals the distribution of residential buildings, roughly 80 % of which are privately owned. ↘ [CHART 96 RIGHT](#)

↘ CHART 96

Structure of residential property in Germany in 2011



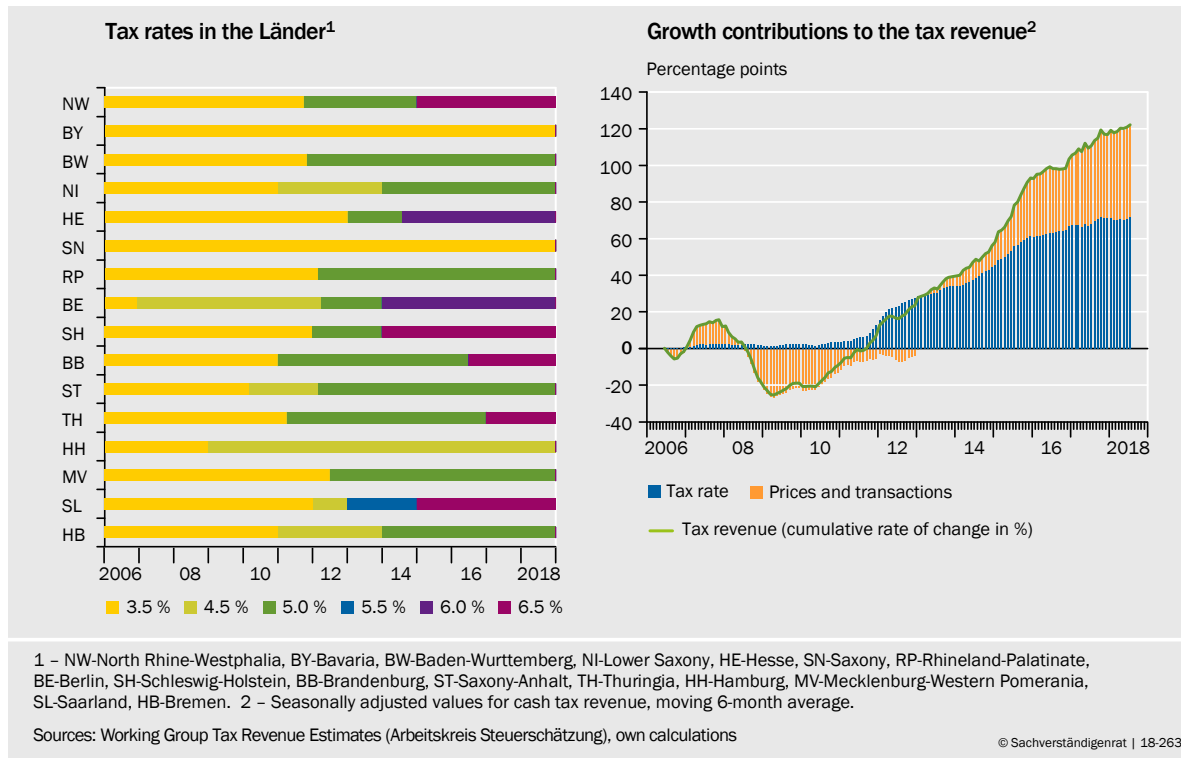
745. From an economic policy perspective, one way of encouraging households to buy their own homes and other property is to lower the **transaction costs** incurred by such purchases. The real estate transfer tax plays a key role here. Another way of achieving this objective is for the state to provide **tax incentives** to invest in property, as is currently happening with the introduction of the **grant scheme to support the acquisition of property** (*Baukindergeld*). It should be remembered, however, that the **existing tax legislation** already offers substantial benefits to those investing in real estate. A further option currently being considered is to reduce the cost of buying property by introducing the “**client-pays-agent**” principle (*Bestellerprinzip*) for the appointment of estate agents, as already happens in the rental market. This would enshrine in law the principle that whoever appoints the estate agent is responsible for paying the agent’s commission.

Reform of real estate transfer tax indicated

746. The **real estate transfer tax** is one of the main contributing factors in the high transaction costs paid in the real estate market. It often accounts for more than half of the total incidental purchase costs (Hentze et al., 2017). It is levied on every land-related transaction in Germany. The resultant tax revenue accrues to the respective Land. Although it generates the highest revenue of all the Länder taxes, it accounts for only 4.6 % of the total tax revenues received by the Länder. Since the reforms of Germany’s federal system were introduced in 2006, the Länder have been free to set the rate of this tax as they see fit. Since then they have increased this tax rate 26 times in total. ↘ CHART 97 LEFT Only the Länder of Bavaria and Saxony have not yet made any changes here. At the same time the resultant tax revenues have grown considerably throughout Germany. In addi-

↘ CHART 97

Real estate transfer tax: Development of tax rates and tax revenue



tion to the tax rate hikes, rising prices and transactions have also contributed significantly to this increase.

747. However, these tax rate increases in Germany have had a dampening effect on the numbers of transactions and on prices (Fritzsche and Vandrei, 2016; Boysen-Hogrefe, 2017; Petkova and Weichenrieder, 2017). Empirical estimates using offer prices for houses based on quarterly data at local-district level also reveal that the practice of **passing on the tax burden** to the vendor is greater in shrinking and rural regions (Christofzik et al., 2018).
748. One likely reason for the rising tax rates is the **limited revenue autonomy** of the Länder. Because the Länder do not have any other fiscal instruments at their disposal, they are increasingly resorting to this highly distorting tax. In the past the GCEE has therefore supported the idea of surcharge and discount rights for certain community taxes, which have a broader tax base (Annual Report 2014 items 634 ff.). If no other fiscal instruments are available to the Länder, capping these tax rates would be problematic because it would restrict the autonomy of the Länder.
749. The **federal fiscal equalisation scheme** creates significant **adverse incentives**. Calculations of a particular Land's fiscal strength are based not on its actual tax rate but on the average tax rate across all Länder. This method assumes that Länder with above-average tax rates are fiscally weaker than is actually the case. This gives rise to higher transfers and lower contributions. This system therefore compensates a Land for revenue shortfalls owing to loss of transactions and lower prices as a result of a tax increase. This compensation can even exceed the revenue shortfall, thereby increasing the incentive for further tax

hikes (Büttner and Krause, 2018). This adverse incentive could be eliminated if the aforementioned calculations were based not on the average tax rates across all Länder but, instead, on a notional tax rate below the initial tax rate of 3.5 %.

750. Several aspects of the real estate transfer tax in its current form must be viewed critically. This is why the misguided incentives to increase this tax further are particularly serious. It should therefore be critically reviewed from the perspective of both the **principle of equivalence and the ability-to-pay principle** (Rappen, 2012; Scherf and Dresselhaus, 2016; Hentze et al., 2017). It is only partially consistent with the ability-to-pay principle because the frequency of transactions bears no correlation with a buyer's ability to pay. For this reason it is only partially consistent with the principle of equivalence as well.
751. In addition, the real estate transfer tax has a **cumulative effect** because it is designed to be a transaction tax without any deduction of input tax. If there are repeated transactions, therefore, the tax is levied not just on the additional appreciation in value but on the total purchase amount in each case. This even applies if losses are incurred on the sale. Real estate transfer tax can also give rise to **double taxation** which punishes construction investment (Rappen, 2012). This comes about when a new building is bought from a developer because the real estate transfer tax has already been paid on the purchase of the land and value added tax has been paid on the construction work.
752. A further frequent criticism is that **share deals** can be used as a legal way of avoiding taxation. In such cases, properties are packaged in a specially created company. If less than 95 % of this company is sold, the deal is not subject to real estate transfer tax, and the remaining shares can subsequently be purchased tax-free after five years. Given the considerable administrative work and expense involved, share deals hold little appeal for households and are mainly used by companies for large-volume transactions. In such cases real estate transfer tax thus has a regressive effect, which means that the average tax liability decreases as volumes increase.

However, this arrangement is not only used for tax management purposes; it also prevents any double taxation if properties are transferred within a company. It therefore **makes sense to treat commercial real estate separately**. In this context, the proposal put forward by the Länder that the holding period be extended to ten years and the exemption limit be reduced to 90 % constitutes a compromise between a justified form of special treatment and a restriction on tax management strategies.

753. Granting a **real estate transfer tax allowance solely for families** who are first-time buyers, as specified in the German government's coalition agreement, should be **viewed critically**, not least because this would make it much more complicated to implement this tax. Any subsidies offered to families would be better if they were targeted, for example through income tax. Moreover, empirical studies show that this tax is not only paid by the buyer. ↘ [ITEM 747](#) Vendors – irrespective of their family status – would therefore be treated differently. Granting personal tax allowances for first-time buyers only might also have undesira-

ble consequences for workers' mobility, which is already low. It might be feasible, however, to introduce a general tax allowance.

754. The **options for reforming** real estate transfer tax could be based on **other countries' experiences**. However, real estate transfer tax is only internationally comparable to a limited extent because the various systems are differently structured and the effective levels of taxation usually differ not regionally but according to property value and type of use. Even if the varying tax rates and exemptions are taken into account, transactions in Germany are taxed comparatively heavily (Bechtoldt et al., 2014). Hentze et al. (2017) show, for example, that if the purchase of a property worth 250 000 Euro in the Netherlands is compared with an identical transaction in North Rhine-Westphalia, the incidental purchase costs in Germany are four times higher. Alternatively, models from other European countries could be used to reform the system of share deals. France, for example, bases this tax on the proportion of real estate assets, which means that real estate transfer tax is paid by companies if the property value of the acquired company exceeds 50 % of the firm's total value.
755. The incidental cost of purchasing real estate could be reduced in the case of the real estate transfer tax either through **adjustments to tax rates or through tax allowances**. In Belgium and the Netherlands, for example, no real estate transfer tax is payable on the purchase of new buildings. The system used in the United Kingdom is based on a system with tax brackets linked to the purchase price; this ensures that buyers on lower incomes and with lower purchase prices pay less tax. Purchasers of large portfolios always have to pay real estate transfer tax. Here they do, however, have the option of an asset deal, which is based on the average purchase price of the property concerned. This price may be lower as a result of the graduated rate. A relatively low tax rate is levied on share deals. It amounts to 1 % for rental income of less than 5 million pound sterling and 2 % for income above this level.

Existing tax incentives for investing in residential property

756. Despite the many calls for tax breaks to be granted for housebuilding, it should not be forgotten that there are already **considerable incentives for private investment in the real estate market**. Against this background, Rumpf and Wiegard (2012) calculate the cost of capital for property investments and compare them with classic investments in terms of the minimum required rate of return.
757. When assessing property investments from the perspective of tax law, a distinction must be made between owner-occupied and tenant-occupied property. The **"consumer-goods solution"** is applied to **owner-occupied** housing for tax purposes. Although the non-cash benefit arising from the notional rent is not taxable, no expenses for debt interest, maintenance investment or depreciation can be claimed for tax purposes. Capital gains are not usually taxable.

In the case of **tenant-occupied property**, on the other hand, the **"investment-goods solution"** is used, and rental income as well as expenses for in-

terest, maintenance and depreciation are tax-deductible. Investors derive particular benefit from the fact that all maintenance expenses can be claimed for tax purposes over the depreciation period. In addition, gains on the disposal of real estate are tax-free if the property has been held for at least ten years (speculative period).

758. A comparison of various types of use and financing reveals that investments in debt-financed and tenant-occupied real estate enjoy special tax privileges. The tax treatment of owner-occupied property – irrespective of how it is financed – is less beneficial. The existing tax legislation on investing in real estate thus **gives preferential treatment to letting rather than owner-occupancy**, which creates incentives to increase the supply of residential property (Rumpf and Wiegand, 2012).
759. The GCEE has in the past discussed an option that would eliminate this distortion. This proposal would be to adopt the **investment-goods solution** for owner-occupied dwellings as well. This would make debt interest tax-deductible. In return, however, a notional rent and any capital gains would be taxable to ensure that no further adverse incentives were created (Annual Report 2013 item 872). This would be difficult to achieve in practice.
760. Debt-financed investments in tenant-occupied property therefore already enjoy tax privileges over other investments (Annual Report 2013 box 28). The benefits of additional **depreciation rules** would appear doubtful in this context. Accelerated depreciation would not eliminate the aforementioned distortion because it too could only be used for the current investment-goods solution. Moreover, accelerated depreciation causes amounts to be shifted between accounting periods, thereby creating incentives to bring property investments forward. Given the significant overutilisation of capacity in the construction industry, this measure would fail to achieve its objective. Furthermore, the special depreciation of 5 % per year over four years envisaged in the German government’s coalition agreement is restricted to the “affordable rental segment”. However, the coalition agreement does not specify exactly what is meant here by ‘affordable’. Given the very low level of long-term interest rates at present, such an arrangement would be unlikely to have a significant impact on the supply of housing.

Baukindergeld: an unsystematic form of funding

761. A government grant scheme to support families buying or building homes (*Baukindergeld*) was approved in June 2018 with the aim of increasing the rate of home ownership among families. This instrument is intended to be used by families with children and by single parents who are looking to buy their first home, and it is available for a period of ten years from the date on which they apply for it. The scheme provides annual funding of 1 200 Euro per child. Children for which this grant is received must be living together with their parents in the purchased property. Those eligible for *Baukindergeld* must have a taxable annual household income of less than 75 000 Euro, and this amount rises by 15 000 Euro for each additional child. Notarised contracts for the purchase of

owner-occupied property are also **eligible for this funding backdated** to January 1, 2018.

762. The backdating of *Baukindergeld* gives rise to a **full-extent deadweight effect**, and future purchases can be expected to cause further such effects. Particularly in towns and cities where there is a considerable mismatch between housing supply and demand it is likely that vendors will be able to **pass this funding on to their asking price**.
763. By restricting the application period for this funding to three years (up to the end of 2020), the German government is looking to limit the expected cost of this scheme. Nonetheless, it is likely to incur a **considerable fiscal cost**. The German government reckons that there are roughly 200 000 eligible families with around 300 000 children (Deutscher Bundestag, 2018a). This amounts to total annual funding of approximately 400 million Euro per funding year. Given the duration of the funding and the growing funding volumes, **total annual spending on this scheme is likely to amount to 4 billion Euro** (Wissenschaftlicher Dienst des Deutschen Bundestages, 2018).
764. The anticipated impact of the *Baukindergeld* reveals significant **parallels with the former Eigenheimzulage** (tax relief for first-time homebuyers), which was available from 1995 to 2005. The German government estimates the average tax revenue shortfall caused by the Eigenheimzulage over the period 2000 to 2005 to be roughly 9.3 billion Euro per year (Deutscher Bundestag, 2018b). The Eigenheimzulage was therefore the single largest subsidy in the German government's budget. In terms of its deadweight effect the Eigenheimzulage can be used as a rough guide to the likely impact of Baukindergeld.

However, the **German government believes** that Baukindergeld will have **less of a deadweight effect** because it is targeted, is being gradually phased in and is structured as a KfW development programme with funding parameters that can be optimised if necessary (Deutscher Bundestag, 2018b). Nonetheless, it is likely that families who would have decided to buy their own homes anyway will benefit from this funding.

765. As far as the **incidence of Baukindergeld on property prices** is concerned, the German government points out the other measures currently being taken to increase the supply of building land, the opportunity to expand capacity in the construction sector over the course of the ten-year funding period, and the persistently adverse trend in building permits (Deutscher Bundestag, 2018b). However, this limited funding period comes at a time when capacity in the construction industry is being overutilised. The government's policies will therefore exacerbate a potentially overheating market. On the whole, therefore, Baukindergeld is a **fairly unsystematic and poorly targeted funding instrument**. Given the high levels of capacity utilisation in the construction sector, the probable price impacts and a potential deadweight effect, a cost/benefit analysis of this scheme seems extremely unfavourable.
766. If the objective here is to find an effective way of encouraging households to become homeowners, this **unsystematic scheme** is inappropriate. Instead, the

government should look for solutions that do not discriminate against purchases of real estate in favour of other forms of investment as part of state-subsidised private pension schemes. [▶ ITEM 120](#) Whereas the so-called “Riester pension” allows the funds saved to be used to buy an owner-occupied property (“Wohn-Riester”), the particularly generous subsidies available under occupational pension schemes do not permit this form of investment.

767. One example of an **allocation-neutral promotion** for private pension provision in this respect can be found in Switzerland. [▶ BOX 21](#) This system allows funds from occupational pension schemes to be used to finance the purchase of owner-occupied property. The **early withdrawal** enables individuals to use the funds saved in their pension pot to buy an owner-occupied property. **Pledges** enable entitlements to future pension payments to be used as collateral.

[▶ BOX 21](#)

Promoting acquisition of residential property in Switzerland

Since 1972, Switzerland’s federal constitution has included the obligation to encourage owner-occupied home ownership (Article 108 (1)). In addition to reducing living expenses and housebuilding costs, increasing the supply of building land is mentioned as an equally important objective (Article 108 (2)). Support is provided especially for families, elderly persons, disabled people and those in need (Article 108 (4)). For this purpose it has been possible since 1990 to use funds from voluntary private retirement pensions. In 1995 this support was extended to include funds from occupational pension schemes.

There are two different ways of using occupational pension schemes to fund the purchase of owner-occupied residential property. The first option is the early withdrawal of retirement benefits, which enables individuals to access the funds saved in their pension schemes. The second option is a pledge, which enables entitlements to future pension payments to be used as collateral. The Swiss system of provision for retirement allows individuals to choose between these options. Furthermore, there is initially no fundamental obligation to repay these funds.

Early withdrawal of pension benefits

The option of withdrawing pension benefits early is only permitted for the owner-occupied residential property of the person insured. This property must be the main residence; second homes are explicitly not allowed. The funding of residential property abroad is also permitted as long as it is the main residence.

The funds withdrawn can be used for various purposes, such as to provide a deposit for a property purchase, to repay an existing mortgage loan, to acquire interests in residential property or to finance a refurbishment or value-enhancing investments. The minimum amount for any early withdrawal of pension benefits is 20 000 Swiss francs and can only be claimed once every five years. The latest date for such an early withdrawal is three years before the policyholder is due to start withdrawing his or her pension benefits.

If there is the risk of a funding shortfall in the pension scheme concerned, the pension provider can forbid the use of occupational retirement benefits for the aforementioned purposes or can restrict their use in terms of timing or amount. When approving an early withdrawal it can also offer additional insurance cover. Policyholders over the age of 50 are subject to additional restrictions on the amount of early withdrawals. The amount of such withdrawals is limited either to the pension en

entitlements that had accrued by the age of 50 or to half of these entitlements at the time the application was submitted. The larger of these two amounts applies.

If the residential property is sold to a third party, the amount withdrawn must be repaid. The amount does not have to be repaid if the property is transferred to legal beneficiaries such as under-age children or spouses. The obligation to repay such amounts only applies until no later than three years before the policyholder is due to start withdrawing his or her pension benefits. The deadline for voluntary repayments is the same.

Pledges

Instead of opting for an early withdrawal of their pension benefits, policyholders can pledge up to the full amount of their occupational pension entitlements. While under this scenario the amount of the policyholders' occupational pension entitlements initially remains unchanged, the aim of pledges is to reduce the deposit required for property purchases by providing collateral. Pledges are governed by the same terms and conditions as early withdrawals of pension benefits.

“Client-pays-agent” principle for property purchases

768. **The high transaction costs involved in property purchases** are often mentioned as an obstacle to home ownership (Annual Report 2016 item 868). Because incidental purchase costs cannot be taken into account for collateral purposes, they also increase the deposit required. The main costs here are the agent's commission and the real estate transfer tax followed by the notary's charges and land registry fees. The share of the individual cost component varies from region to region. In Germany the agent's commission ranges between 4.8 % and 7.1 % of the purchase price and is generally shared equally by buyer and vendor. The notary's charges and land registry fees average 1.5 % to 2 % of the purchase price nationwide.
769. Recent calls in political circles for the **“client-pays-agent” principle** (*Bestellerprinzip*) **to be extended to property purchases** as well is unlikely to alter this situation fundamentally. Assuming that the buyer is willing to pay the purchase price plus incidental costs and that the vendor has a fairly accurate idea of the purchase price less incidental costs, it should be possible for the vendor under the client-pays-agent principle to pass on to the purchase price the additional share of the agent's commission for which he or she is responsible. The standard scales of fees and charges stipulated by the government should be critically reviewed.

6. Promotion of peripheral real estate markets

770. Increasing the supply of housing could not lastly be achieved by designating more building land, reducing regulation of the height of buildings, and speeding up the procedures for approving the release of building land for development (Feld et al., 2018). The planning and approval processes used by the local authorities responsible for this issue are too protracted (*Gemeinschaftsdiagnose*, 2018). Many towns and cities have the potential for **urban recompactio-**

which, if done properly, could make more residential space available (Spars and Heinze, 2013) – or to convert vacant office buildings into housing (Clamor et al., 2011).

However, the amount of residential space potentially still available in towns and cities is limited. Moreover, excessive building at greater density can cause social problems. One alternative solution would be to ease demand by developing the **periphery of cities and major conurbations** more intensively.

771. The targeted development of peripheral real estate markets would focus less on residential property and, instead, aim to **enhance the attractiveness of the location** in order to solve the problem of price. For example, by developing multimodal public transport, which is characterised by the smooth interaction of various modes of transport, it might be possible to improve the appeal of living in suburbs (Deffner et al., 2014) and, consequently, find a more cost-effective way of resolving the shortage of residential space in urban centres than directly subsidising expensive accommodation in inner cities.

Further locational factors that can help to enhance the appeal of towns and cities outside the major conurbations are the ability to attract public institutions and **universities** as well as the **expansion of the broadband network** (Kempermann and Millack, 2017).

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