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German's Housing Policy at the
Crossroads

discussion paper

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Abstract

Compared to other European countries, housing policy in Germany has been favourable towards private rented housing. As a result, the private rented housing sector in Germany is large according to international standards. It appears to be 'healthy' in terms of housing quality and social profile of its occupants. However, during the late eighties housing shortage developed which led to a breakdown of the broad political consensus on housing policy. A number of highly controversial temporary measures have been adopted attempting to tighten up tenure laws, to discourage condominium conversions, and to foster new construction by more generous tax-subsidies.

The paper provides background information on the German housing system and gives a critical assessment of the recent policy shift.

1 Introduction

The private rented housing sector in Germany is large according to international standards. It appears to be ‘healthy’ in terms of housing quality and social profile of its occupants. Beyond political rhetoric, housing policy in Germany has been stable and favourable towards private rented housing. Throughout the seventies and eighties the sector benefited from (i) tenure laws which are ‘liberal’ compared to many other countries in western Europe, (ii) a rather favourable taxation vis-à-vis owner occupation and (iii) a social policy which increasingly relied on general housing allowances while abstaining from direct interference with the market. In response to the recent housing shortage, however, a number of controversial measures have been adopted in the attempt to tighten up tenure laws, to discourage condominium conversions, and to foster new construction by more generous tax-subsidies. This approach, however, is criticized in this paper as being inadequate to solve the present difficulties.

First, the paper provides some background information on the different housing sectors in Germany — putting the private rented sector into its place. We describe the most important features of the legal framework of the sector, including tenure laws, taxation and housing allowances.

Using official statistics and data of a german association of real estate agents it is shown that the recent housing shortage had little impact on the average rent, while rents for new leases soared. Based on this observation we argue that many problems originate from a combination of an increased gap between rents for old leases and rents for new leases and specific features of the institutional framework — rather than from the housing shortage as such. Among those features are: (i) tenure security regulations which prevent moving tenants from competing against sitting tenants except by becoming owner of the dwelling, (ii) the unequal taxation of investment in new construction and of investment in existing housing under renting and owner occupation, (iii) and the focus of the housing allowances system on average rents.

An assessment of recent housing policy reveals that the measures adopted do not address the causes of the crisis. Quite the contrary, the attempt to shelter ‘sitting tenants’ from the market, for example by tightening regulation for rent reviews, will increase and prolong the gap between old leases and new leases and therefore worsen the situation.

Since the housing sector in the former German Democratic Republic has been shaped by very distinct political and economic forces, the paper is restrained to West Germany.

2 Housing in Germany

In principle, the housing sectors can be delineated according to ownership or tenure. In 1987 private persons owned almost 80% of the housing units. For details see table 1.¹ This includes some 7% which are held in a special form of co-ownership allowing for a combination of individual property of dwellings within a jointly owned structure (condominiums). Half of the dwellings are rented out. Housing co-operatives own almost 4% of the stock, which are all rented to members. In 1987 approximately 10% of the stock belonged to non-profit-corporations or housing associations. The owners of these corporations are local authorities (*Gemeinden*) and states (*Länder*) which account altogether for almost 5% of the total stock, as well as churches, trade unions and to a smaller extend industrial companies providing housing for their workers and employees. Together with the co-operatives they formed the

¹There are three principal sources of statistical information on housing in Germany.

1. The ‘Gebäude- und Wohnungszählung’ a total census carried out in 1950, 1968 and 1987.
2. The ‘1%-Wohnungsstichprobe’ a similar assessment based on a sample of 1% of the housing stock carried out in 1972, 1978, 1982, 1987 and 1992.
3. The ‘Einkommen- und Verbrauchsstichprobe’ an assessment of private incomes, assets and spending based on interviews with 50.000 households (1973, 1978, 1983, 1988).

Results from the different sources are not always consistent.

non-profit-housing-sector which was exempted from tax until 1989.

With respect to tenure the most important distinctions are between owner occupation and renting and between social housing and non-social housing. There are contradictory information on the size of the owner occupied sector in Germany. According to the census of 1987 owner occupied housing accounts for 37.85 % of all housing and rented housing for 58.49 %, another 3.65 % is composed of other forms of tenure. For more detailed information see table 2. If vacant dwellings, residential hall, recreational dwelling and dwellings used by foreign army personal are excluded from the basis — as it is usually done — owner occupation accounts for 39.29% and rented housing for 60,71% of all housing.²

In Germany any investor in rental housing (private persons, commercial landlords or housing association) as well as owner occupiers can apply for subsidies under the social housing scheme. Less than one out of eight owner occupied dwellings or 4.33 % of the total stock is subsidized under the social housing scheme. For several reasons the size of the social rented housing sector has been overestimated in the census of 1987. The true figure for 1987 was probably closer to 3.5 mio or 13% of the total stock. More than two thirds of the social housing stock is owned by formerly non-profit housing associations which in addition own some 3.7% of total housing as ‘private’ non-subsidized rented housing.

In the social housing sector rents are regulated at a level which is usually well below market price. Access to social housing is restricted to low and middle income groups. Often the local authorities enjoy the right of nomination. Social housing is converted to private housing after low-interest public loans have been repaid. This will take 25 to 50 years, depending on the exact details of the subsidy arrangement. Since this period varies across the different ages and localities there are no exact information on the number of existing social housing. In the early eighties investors were encouraged to prepay their

²It is often claimed that the size of the owner occupied housing sector is almost 42%. This figure results from estimates based on the ‘Einkommens- und Verbrauchsstichprobe’, which are less reliable than the census.

Tabelle 1: Ownership structure in 1987

owner	housing units in 1 000	% of total
private person or partnership	19 196	72.31
rented ¹	9 552	35.98
owner occupied ¹	9 644	36.33
co-ownership	1 835	6.91
rented ¹	1 048	3.95
owner occupied ¹	787	2.96
cooperative	1 030	3.88
non-profit landlord	2 584	9.73
of these belong to ²		
Federal and state government	547	2.06
local authorities	788	2.97
commercial landlord	494	1.86
others	1 409	5.31
total	26 548	100.00

¹ These include as a fraction vacant housing, housing used by foreign army personal and recreational housing.

² Data refer to 1990

Sources: Bundesbauministerium (1992) Haus und Wohnung im Spiegel der Statistik 1991, Bonn (based on Gebäude- und Wohnungszählung 1987), Gesamtverband der deutschen Wohnungswirtschaft (GdW), own calculation

Tabelle 2: tenure structure (1987)

tenure	dwellings ¹ in 1 000	% of total
rented total	15 372.5	58.49
private rented	11 350.7	43.19
social rented	4 021.8	15.30
owner occupation total	9 948.9	37.85
owner occupation (private)	8 809.7	33.52
owner occupation (social)	1 139.2	4.33
all others total	958.2	3.65
residential hall	152.1	0.58
foreign army personal	113.1	0.43
recreation	225.7	0.86
vacant	467.3	1.78
total	26 279.6	100.00

¹ Dwellings do not include some 0.3 mio housing units lacking a separate entrance or cooking facilities.

Source: Bundesbauministerium (1992) Haus und Wohnung im Spiegel der Statistik 1991, Bonn (based on Gebäude- und Wohnungszählung 1987)

public loans in exchange for a quick release from restrictions on rent and right of nomination. Eventhough the conversion to the private rented sector is no longer fostered, the stock of social housing is ‘melting down’ at a high rate, because a large part of the stock dates from the fifties and early sixties. In 1990, despite an increase in new construction, the social housing stock was estimated to have fallen below 3 mio which is equivalent to 11.4% of the total stock. By mid 1990s half of the stock of 1987 will be turned into private housing.

With respect to owner occupation and private renting the composition of the housing sector was fairly stable during the post war period. This is largely due to of multi-story apartment blocks providing a large proportion of the total number of dwellings. The high rate of owner occupation after world war II was due to the massive destruction of multi-family housing in the inner-cities during the war. The ratio declined with the (re)construction of multi-family housing during the 50’s and 60’s. It was followed by a slow but steady rise of owner occupation during the 70’s and 80’s.

The most spectacular developments have been the rise and fall of the non-profit housing associations and lately the rapid increase of housing held in co-ownership.

While the tradition of housing-cooperatives dates back to the last century non-profit housing corporations were founded not before the twenties. Both benefited from general tax-exemption but were restrained from paying a dividend of more than 4% on equity and to limit their business to non-profit-housing. The social housing system introduced after the second world war was particularly well suited to the needs of the associations.³ Facing less restraints with respect to the mobilization of equity they obtained the lions share of the subsidies and experienced very high growth rates during the fifties and sixties. With the decline of subsidies to social rented housing in the seventies and eighties they were thrown back on the management of the

³The social housing scheme is designed to enable the recipient to construct housing with an equity-ratio of 15% but no additional strain on liquidity after completion of the project. See Hubert (1991a) the details of the subsidy scheme and Ehrmann (1990) on the motivation and constraints of the associations.

Tabelle 3: Development of ownership and tenure

year	1950	1972	1978	1987
	ownership/tenure in % of total			
commercial landlord ¹	4.6	5.5	5.2	7.2
non-profit landlord ²	12.4	18.1	17.5	13.6
owner occupier ³	40.1	35.8	36.4	39.3
private person renting ³	42.9	40.5	41.0	39.9
of these are				
co-ownership	—	2.0	5.2	6.9
rented ³	—	0.8	2.6	3.9
owner occupied ³	—	1.1	2.6	3.0
housing units in 1 000	9 376	21 291	23 771	26 548

¹ including 'others'; ² including cooperatives

³ These include as a fraction vacant housing, housing used by foreign army personal and recreational housing.

Sources: Bundesbauministerium (1992) Haus und Wohnung im Spiegel der Statistik 1991, Bonn (based on Gebäude- und Wohnungszählung and 1%-Wohnungstichprobe), own calculations

existing stock and they were increasingly criticized for inflexible management and inefficient planning. In the mid eighties, when housing markets favoured the demand-side, some of them were troubled by huge and often poorly designed estates of the early seventies. The largest housing company of the western world, the trade union based 'Neue Heimat' collapsed in the midst of a corruption scandal in 1986 leaving behind some 295 000 (of formerly 360 000) dwellings and a debt of 17 billion DM. This gave the legislation a final push which led to the abolishing of the entire non-profit sector by phasing out tax-privileges and business restrictions to the end of 1989. Today the former non-profit associations have the same legal status as other commercial landlords.

In the mid-seventies soaring land-prices and construction cost made the owner-occupier's dream of a bungalow-type house increasingly difficult to fulfill. As a result a market for condominiums held in co-ownership developed. The number of owner occupied condominiums increased from 241 000 units in 1972 to 787 000 unit or 3% of the total stock in 1987. By making investment in rented housing 'divisible' co-ownership became even more popular among investors. Within fifteen years the rented condominiums grew from 176 000 to 1 048 000 which is 3.9% of the stock. In 1976 tax-subsidies for first time owner occupiers were extended to purchases of existing stock. This helped to develop a second hand housing market. It also triggered conversion of rented dwellings to owned condominiums — usually after massive investment in refurbishments and repairs. It has been estimated that 88% of the increase of market share of condominiums between 1978 and 1987 is due to new construction, the other 12% being due to conversion.

Condominium conversion caused considerable concern among tenants whose tenure becomes less secure despite a special clause protecting the sitting tenant for some years against contract termination by the new owner (see below). In the late eighties condominium conversion was blocked in most large cities by administrative measures, which were ruled unconstitutional in 1992.

3 The Institutional Framework

Given the long term nature of housing investment the success of the private rented sector depends on an efficient and stable legal framework for private transactions (most important of which are tenure laws) and/or the availability of subsidies (in particular in comparison to owner occupation). The German system of housing subsidies is rather complex and a complete picture is beyond the scope of this paper.⁴ The two most important subsidies given — not exclusively — to the private rented sector are housing allowances and generous allowances for depreciation. In addition, there are special tax concessions for investment in energy saving and some Länder provide low interest loans or direct financial assistance towards rehabilitation under a variety of schemes. These, however, played a more important role in the 1970s than in the 1980s and will therefore be omitted here.

3.1 History of Tenure–Regulation

In Germany rent controls were introduced as a temporary emergency measure during world war I. They were relaxed and partially dismantled in the twenties and thirties but to be reintroduced during world war II. After world war II the government resorted to the ‘*Wohnungszwangswirtschaft*’ which combined strict rent control of all pre 1948 premises with the assignments of tenants by public authorities. While the allocation of dwellings was left to the market as soon as the worst scarcity was resolved, rent controls and tenure security were maintained until the sixties. Subsequent amendments to the rent laws allowed for gradual increase of controlled rents. In the sixties tenure became deregulated on a regional approach. Rent control as well as tenure security was abolished wherever the estimated housing deficit had fallen below 3%. At the beginning of the seventies the only cities still under rent control were Hamburg, Munich and West–Berlin. While both the former soon became decontrolled, West–Berlin’s rent control will expire in 1994.

⁴See Hills, Hubert, Tomann, Whitehead 1990 or Tomann 1990 for such an overview.

When the removal of war time rent controls was almost completed the coalition of social democrats and liberals passed the Tenure Security Act of 1971 (*Wohnraumkündigungsschutzgesetz*). Ever since then the legal framework for residential leases has been based on three elements:

1. unilateral security of tenure for the tenant,
2. the initial rents of a new lease can be freely negotiated,
3. rent increases for sitting tenants are limited to the level reached by comparable accommodations (*Vergleichsmiete*).

It is important to note that german law regulates contracts universally and is not linked to specific dwellings — in particular it covers new construction.⁵ While the initial rent of a new lease is negotiable, provisions for contract termination and rent reviews cannot be altered to the disadvantage of the tenant.

When the coalition of conservatives and liberal took over the government in 1982 they made no attempt to deregulate tenure in the private rented housing sector. The broad consensus achieved by the early eighties, however, broke down when the housing markets tightened rapidly in the late eighties. The social democrats, now in opposition, argue for strong measures to restrict rent increases in ongoing contracts and to limit rents for new leases. The ruling coalition of conservatives and liberals is split over the issue of additional measures to restrict rent increases — with the liberals, being in charge of the housing ministry, strictly opposing any market interference.

⁵There are three exceptions: (i) These laws do not apply to furnished dwellings. (ii) Contract termination is much easier for dwellings in two family houses provided the landlord occupies the other dwelling. (iii) Some 422 000 units of pre-war rental housing in Berlin are still under rent control. Periodic rent increases used to be allowed for on a percentage basis on historical rents — sometimes with special provisions for amenities and state of repair. In the mid-eighties the central government finally decided to phase out controls until 1 January 1994. Since 1988 rents in ongoing contracts can be raised by 5% annually, rents for new leases could be increased by 10% and without limit since 1 January 1992.

The christian democrats who used to argue strongly for the deregulation of tenure throughout the seventies are now in favour of protective measures.⁶

3.2 Tenure Security

In Germany the duration of a residential lease is infinite. Fixed term leases can only be legally enforced under very restricted circumstances, which strongly resemble those under which even an infinite term contract can be resolved. The period within which notice to quit must be given increases according to the duration of the lease from a minimum of three months up to a year. Immediate contract termination is only possible in cases of severe breach of contract. While the tenants has the right to give notice without any further justification, the landlord can only do so for limited set of reasons. In particular if:

1. The tenant breaches the contract e.g. non payment of rent (minimum arrears of three month payments), negligence, nuisance etc. In severe cases immediate contract termination is possible, though legal procedures will cause some delay before eviction takes place.
2. The landlords or his close relatives need the dwelling for their own use. This desire has to be 'reasonable' and may be denied if eviction would amount to 'undue hardship' for the tenant.

In the case of condominium conversion the sitting tenant is protected by a special freeze period against contract termination from the new owner. This freeze period used to be three or five years, depending on whether or not the local authority had declared a 'housing emergency'. During the late eighties many local authorities prevented condominium conversion through administrative hurdles. When this was proclaimed as unconstitutional through a court ruling in 1992 special legislation

⁶On the discussion see Engels & Stützel & von Weizsäcker 1984, Lühe 1986, Derleder 1987, Eekhoff 1987, Häußermann Siebel 1990, Eekhoff 1990, Boll & Froessler & Selle 1990, Hubert 1990, Ude 1990.

was enacted to extend the freeze period from five to ten years. There are however, doubts as to whether this law will be constitutional.

3. The lease is a hindrance for the economically appropriate utilization of the property. This can be the case if the building is to be completely refurbished or demolished or if a single family house can be sold only at a much lower price when rented. Since courts handle these cases very strictly, only few contracts are being terminated under this clause.

It is not possible to terminate a lease in order to force the tenant to pay a higher rent or because another tenant is prepared to pay a higher rent.

3.3 Regulation of Rents

3.3.1 Initial Rents

In principle the initial rents for new leases are freely negotiable. There is no specific legal limit to the rent when the dwelling is relet. However, if the rent is set more than 20% above other (recently negotiated) rents for comparable dwellings, this might constitute an administrative offense. If it is set at more than 50% higher this will be taken as evidence for usury which constitutes a criminal offense. Hitherto these 'limits' did matter only in exceptional cases, first and foremost because normally tenants refuse to sign contracts charging rents which are higher than those of competing offers. In addition there are a number of legal ambiguities involved. These 'limits' are not derived from tenure law but from criminal law. Hence it is not quite clear, how the legal notion of the '*Vergleichsmiete*' (see below) is to be applied. Second, even a rent up to 50% above the rent other landlords charge, can be justified by the landlords own cost. In court these costs are calculated according to a formal procedure which is derived from social housing. Provided that the building was constructed or bought within the last ten years, cost will often be much higher.

3.3.2 Rent Reviews

The most important notion of German rent law is the ‘*Vergleichsmiete*’ i.e., the rent which a comparable dwelling in the same area command. When the legislation was introduced in the early seventies it remained ambiguous as to whether tenants should be protected against rent increases in general. As a result the notion of the *Vergleichsmiete* was vaguely understood as some sort of average rent in the region. In the next section it is shown that old contracts tend to have a lower rent than the more recent leases. Therefore, the appropriate basis for the determination of the *Vergleichsmiete* remained controversial. In 1982 a reform clarified the issue in the sense that the *Vergleichsmiete* is determined by the rent of contracts which have been agreed upon during the last three years. The intention was to prevent rents in old contracts from lagging too much behind. At the same time, however, an upper bound on rent increases of 30% within three years was introduced in order to prevent hardship.⁷ There are three ways to determine this rent level:

1. through reference to at least three comparable dwellings commanding this rent in the same area, or
2. with the help of a public rent–survey provided by the local authorities (*Mietspiegel*), or
3. through a surveyor’s report.

⁷These legal restrictions apply to what is called the ‘net–cold–rent’. Economically, it is the landlord’s residual income needed to cover cost of management, maintenance, depreciation and capital. Operating cost such as:

- land–tax
- services (cleaning etc.)
- insurances
- maintenance of escalators and similar equipment
but not the physical structure of the building
- water, sewage discharge and other public utilities
- energy and heating

are passed through to the tenant.

If the rent increase is disputed courts will assess the appropriate rent on their own. While the law is neutral as to the way in which the appropriate rent is determined, courts prefer public rent-survey whenever these are available. Nowadays most large cities publish a 'rent-survey'. Ideally it should be based on representative statistical information and be updated at least every two years. While many authorities follow these guidelines others use the power to issue a rent-survey for their own 'rent-policy'. Courts in turn, may disregard rent-surveys that are bargained between politicians and organizations of tenants and landlords — in particular if they were issued in spite of a consensus. But landlords claim with some credibility that unrealistic or outdated rent-surveys are the main obstacle to charge sitting tenants a market rent which moving tenants would be prepared to pay.

There is a special provision allowing the landlord to pass through cost of major improvements — but not maintenance cost. Provided the legal definitions for improvements are met, the annual rent can be raised by 11% of the cost. Such an increase will be disregarded when the maximal limit of 30% in three years is to be assessed. It requires, however, that the tenant approved the measure beforehand. The tenant is entitled to refuse the approval if the measure would raise the standard of the dwelling to an unusually high level and if the new rent would imply particular hardship to him.

For a rent review the landlord needs the consent of the tenant. He cannot increase rent unilaterally except if cost of major improvements are passed through (in which case the tenant's consent is necessary before the investment). The tenant is obliged to give his consent, if the increase is justified which has to be proved by one of the three rules mentioned above. If the tenant refuses to accept the rent review, the landlord has to resort to court. This will usually involve considerable delays and, due to rather heterogenous ruling by lower courts, some risk even in apparently clear cases. It is therefore quite common among private landlords to increase the rent by an amount below the maximum legal limit. The justifications often refer to cost increases or inflation (GEWOS 1987). Even though the procedural requirements stated in the law are ignored in many cases, acceptance by the tenant will make the rent review legal.

At present there is strong political pressure to restrict the scope for raising the rent of an established contract. In fact, a minor, though important step, in this direction has been made when a special law was passed lowering ‘temporarily’ the limit for rent increases within three years from 30% to 20%. This law applies ‘only’ to dwellings built before 1981 with a monthly rent exceeding 8 DM/m². It is however the first time since more than two decades, that a restriction on rent increases was not universal. In confining the ruling to part of the existing stock politicians nourished the naive hope that new investment would not be effected.

3.4 Housing Allowances

Housing allowances were introduced in 1965 in order to assist low income groups while rents were decontrolled. Since then there has been a vigorous discussion whether housing allowances or social housing subsidies are more efficient in achieving social policy goals in the housing market. Due to high cost and poor incidence of social housing, means tested allowances had become the favoured instrument by the mid eighties if measured in terms of political popularity. In reality, however, the increase in spending on housing allowances was modest compared to the increase in tax allowances for owner occupied and private rented housing (Hills, Hubert, Tomann, Whitehead 1990).

The German system of housing allowances is universal covering tenants in social and private rented housing and owner occupiers alike — nevertheless 93% of the recipients are tenants. The basic idea behind the German housing–allowance scheme is that *cost* for *adequate* housing should be in a reasonable relation to household *income*. The basis for the subsidy is taxable income from which certain deductions are made to obtain what is called ‘family income’, which will be of the same order as the disposable income. Allowances are narrowly targeted with respect to income. In 1990 roughly 6% of the population, 10% of the tenants and 1,2% of the home owners, received housing allowances. Among the recipients the average income was only about a third of that of the general population. A third of the recipi-

Tabelle 4: Housing Allowances

year	number of recipients	fraction of tenants	total spending	average spending (tenants)
	1 000	%	mio DM	DM
1980	1 485.7	94.7	1 829.7	85
1981	1 609.0	92.5	2 415.3	105
1982	1 610.9	92.9	2 667.8	106
1983	1 434.2	93.5	2 602.1	110
1984	1 383.1	93.6	2 419.2	117
1985	1 357.3	93.9	2 462.1	118
1986	1 672.9	92.2	3 363.0	143
1987	1 692.3	92.5	3 727.3	144
1988	1 646.8	92.7	3 682.2	147
1989	1 583.2	93.1	3 677.8	150
1990	1 530.9	93.2	3 611.4	155

Source: Bundesregierung (1992): Wohngeld und Mietenbericht 1991, Bonn

ents were receiving social benefit, a sixth were dependent on unemployment benefit and a third on pensions.

In the case of tenants ‘housing cost’ are given by gross-rent, deducting any payments for heating, furniture etc. As for owner occupiers they consist of interest, redemption and a flat-rate for maintenance. The criterion of ‘adequacy’ of consumption is reflected by upper limits for reckonable rents. Expenditures above this ‘limit-rent’ are ignored. The starting point for the determination of the limit-rent is a target for the appropriate space of a dwelling, which is set for each family-size. This reckonable space is multiplied with the average rent paid for such a dwelling to obtain the limit-rent. Regional differences are accounted for by six regional classes. Big cities with high rents will have a limit-rent applied which is 40% above the limit for cheap rural areas. In addition age and amenities are taken into account by a very simple procedure. As a result the limit-rent for a dwelling built after 1978 with bath and central heating will be 60% to 80% higher than for a pre-war dwelling lacking these amenities. However, all these characteristics have no impact on the level of housing allowances if the rent is below the limit-rent.

The allowances are fixed as to ensure that reckonable rent less the allowance divided by ‘family income’ (the rent burden) is somewhere in the range of 15% to 30%. Since the general formula for housing allowances is very complicated the law provides the results in form of extensive tables. However, in the relevant range — when rents are nontrivial and the income is not much below the minimum income for social help — it simplifies to

$$\text{rent burden} = \frac{(r - w) \cdot 100}{y} = a + b \cdot r + c \cdot y \quad (1)$$

with

- r : reckonable rent
- w : housing allowances
- y : ‘family income’ (appr. disposable income)
- a, b, c : parameters depending on the size of the household

The parameters a, b, c depend on family size as follows:

number of persons	1	2	3	4	5	6	7	8
<i>a</i>	6,5669	7,0046	7,6029	6,7286	6,5657	4,8597	3,0890	0,3019
<i>b</i>	0,0509	0,0353	0,0307	0,0243	0,0219	0,0214	0,0207	0,0193
<i>c</i>	0,0035	0,0022	0,0005	0,0001	0,0000	0,0000	0,0001	0,0007

Since *c* is very close to zero (except for singles and doubles) it can be said that the rent burden is almost invariant with respect to income and increases linearly in rent (see figure 1). At the maximum reckonable rent it will be at 25% for households with 4 or more persons, somewhere around 28% for households with 2 or 3 persons and might reach 31% for singles. For those, however, whose rent is above the maximum reckonable rent (roughly 40% of all recipients of housing allowances) the true ‘rent burden’ will be higher. In 1990 the average pre–allowance rent burden among the receiving tenants was 33,7%. An average allowance of 155 DM per month brought this figure down to 23,0%.

There is very little concern in Germany about housing allowances distorting the incentives to achieve higher income and to bargain for rent. Solving 1 for the allowance *w* yields

$$w = r - \tilde{a} \cdot y - \tilde{b} \cdot r \cdot y - \tilde{c} \cdot y^2$$

with $\tilde{a} = a/100\dots$

The implicit marginal tax embodied in the scheme (the rate at which the allowance is withdrawn as income rises) and the marginal subsidy of rent are

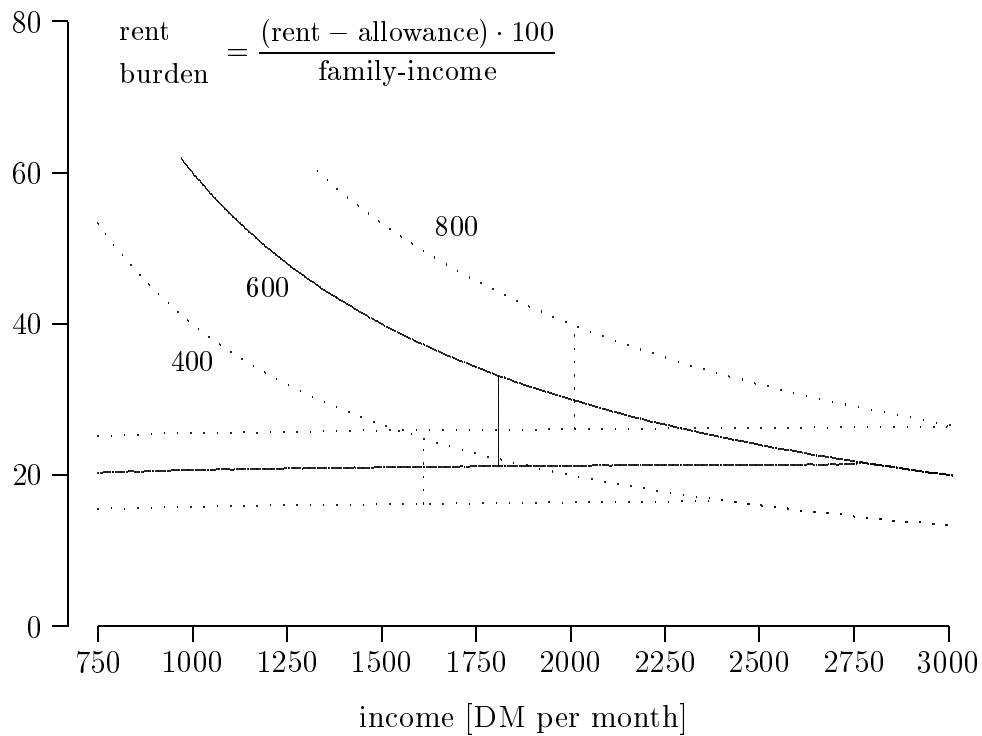
$$\frac{dw}{dy} = -\tilde{a} - \tilde{b} \cdot r - 2\tilde{c} \cdot y$$

$$\frac{dw}{dr} = 1 - \tilde{b} \cdot y$$

The marginal subsidy does not exceed two thirds of an increase of rent and is usually well below that level. The effective marginal tax on income is approximately equal to the rent burden and is usually well below one third.

Housing cost may also be covered by the social benefit system. In this case the social benefit payment will cover all housing cost — provided they are not considered to be unreasonable high. During the last years attempts have

Abbildung 1: Rent Burden as a Function of Income with and without Housing Allowances for different Rent Levels (Family of four)



The hyperbolic curves show the rent burden without housing allowances. The (almost) horizontal curves display the rent burden if housing allowances are taken into account. The vertical lines show the income limit below which a family of four would be entitled to social benefits ensuring a residual income of approximately 1 200 DM a month.

been made to integrate housing allowances better into the social benefit system. There are however conceptual differences. While housing allowances are concerned with the ‘rent burden’, the social benefit system is built upon the notion of a minimum consumption level necessary for a decent living. Most items of the bundle of goods and services defining this level are taken into account using average market prices, hence defining the minimum income. Other items such as housing are taken into account by their true cost — provided that the consumption is not unreasonable. Due to the target of providing a minimum income after rent, it is difficult to avoid a 100% subsidy of rent and a 100% tax on additional income.

There are three major limitations to the German system of housing allowances:

1. It is estimated that only about two thirds of those who are entitled participate in the scheme. It is however not known, whether many of those who forego the benefit would receive substantial or only negligible assistance. By and large the acceptance appears to be good and housing allowances do suffer less from a stigma as social benefits do.
2. Usually it takes five to six years before the scheme is adjusted to inflation. Meanwhile roughly one tenth of the recipients will be driven over the limits of the entitlement and handouts to the others will also decline in real terms (see table 4). In this sense (ex post), housing allowances are less reliable than assistance given through below market rents in the social housing scheme. However, one has to bear in mind, that (ex ante) every entitled household can easily claim allowances whereas access to the social housing sector is difficult.
3. The scheme does not take into account the duration of tenure which is a very important factor determining the rent. As a result housing allowances are not able to cope with the substantial gap between average rents and rents for new leases (see next section). Today, the initial rent for a new lease will often be much higher than the maximum reckonable rent even if the size of the flat is reasonable in relation to the size of the family. As a result low income tenants, who have to move, are

increasingly thrown back on a rapidly declining stock of social housing where rates of turnover are very low.

3.5 Taxation

Housing in General. Property tax, inheritance and gift tax strongly favour investment in housing — be it rented or owner occupied. These taxes are based on an outdated assessment, the *‘Einheitswert’*. The tax base will often be less than a fifth or even a tenth of the market value of the asset. Since any mortgage can be deducted at its nominal value, housing assets are effectively exempted from these taxes. Recently high court ruling declared this taxation as unconstitutional. But it left the government with ample time for reform. There is no tax on capital gains for private persons, provided that the assets have been held for at least two years.

Two special taxes apply to any investment in real estate. A land tax (*Grundsteuer*) is levied annually at approximately 1% of the same low rateable value as the property tax. A flat rate of 2% of the purchase price is levied as a Land Acquisition Tax (*Grunderwerbssteuer*).

Rented Housing. In principle, investment in rented property is treated like any other investment. Any cost — interest, depreciation, management and maintenance — are deducted from revenue before income tax is levied. Losses from investment in housing can be balanced against income derived from other sources.

For buildings, bought more than two years after completion the linear depreciation is 2.5% of the value if it was constructed before 1925 and 2% for those built more recently. These depreciation rates were introduced in the early sixties on the assumption that a pre-1925 building had to be written off within 40 years, and those built thereafter within 50 years. The depreciation, however starts with every transaction from the very beginning. Hence, if a pre-1925 building which 30 years ago was considered to last some 40 years more is sold today, the buyer will again write it off for the next 40 years at

Tabelle 5: Depreciation of new investment in rented housing

before 1989			after 1989		
years after construction	annual rate	accumulated depreciation	years after construction	annual rate	accumulated depreciation
1-8	5%	40%	1-4	7%	28%
			5-10	5%	58%
9-14	2.5%	55%	11-16	2%	70%
15-50	1.25%	100%	17-40	1.25%	100%

an annual rate of 2.5% of the much increased property value. Since the base for the depreciation is the nominal historical price, inflation alone creates a powerful incentive to sell property and reinvest the proceeds in spite of considerable transaction cost. There is very little public awareness of the fact that the ‘normal’ depreciation of rented housing constitutes an important source of subsidies to the housing sector.

There is a particularly favourable tax treatment for new investment in rented housing. For rented housing regulations as to whether expenditures during construction add to assets or are counted as losses, were very generous during the seventies. While regulations regarding reckonable losses during construction were tightened in the early 1980s the allowances for depreciation of newly constructed rented housing were increased from 3.5% to 5% for the first 8 years after construction followed by 2.5% for the following 6 years and 1.25% for the last 36 years. In 1989 tax concessions have been raised even further in order to stimulate the construction of rented dwellings. For buildings completed since then depreciation is 7% for the first 4 years, 5% for the next 6 years, 2% for the following 6 years and 1,25% for the final 24 years.

Unfortunately there are neither official data nor serious estimates of the tax benefits obtained through high depreciation of rented property. But there is no doubt that the favourable tax treatment is a very important motive for investment in private rented housing.

Owner Occupation. Since the 1984 owner occupied housing is treated, in principal, like any other consumption good: there is no tax on imputed rent and no mortgage interest tax relieve.

The main subsidy for owner occupied housing is a ‘depreciation allowance’ on taxable income of 6% on the price of the house and half of the value of the land, subject to a maximum of 19.800 DM per annum. The allowance is reduced to 4% (16.500 DM maximum) after 4 years and ends after 8 years. This subsidy, has been heavily criticized for benefitting primarily rich people with high marginal income tax. It will be substancially reduced for purchases from the existing stock in 1995 when the limits are cut back to 9.000 DM and 6.000 DM respectively. In addition to the depreciation, there is an annual tax–credit of 1.000 DM for each child during the first eight years which is not related to cost (*Baukindergeld*).

For new construction of owner occupied housing. mortgage interest tax relief has been introduced in late 1991 as a temporary measure. It is limited to the first three years after construction and subject to a maximum of 12.000 DM per annum. This special subsidy is only available until the end of 1994.

Beside the temporary mortgage interest tax relief, tax concessions to owner occupiers used to be neutral as to whether the property is bought from the stock or newly built. This is in marked contrast to the tax treatment of rented property which is strongly geared towards new construction. The forthcoming reduction of the ceilings for the depreciation of owner occupied ‘second hand’ housing will not remove that difference completely.

4 Development of Rent

Since housing is a very heterogeneous good it is not surprising that rent, measured in DM per m² and month, varies considerably between different dwellings. In a well performing housing market these differences in price ought to reflect consumer preferences and production cost. However, the rent structure is also shaped by the legal framework.

Unfortunately the census does not give any information on the relation between rent and duration of tenure. Using hedonic methods based on the 1%-Wohnungsstichprobe of 1978 it has been estimated that the average discount for tenure is already 2% after the first year. The discount increases to 17% after 10 years and 24% after 15 years of tenure. Duration of tenure appears to be one of the most important determinants of the rent level (see Behring 1988).

It is, however, difficult to judge how far this discount for duration of tenure is determined by the legal restrictions on rent reviews in Germany. Tenure discounts can be explained without resorting to government intervention and have also been observed in the less regulated housing markets of the USA — though the evidence appears to be inconclusive (Goodman & Kawai 1985, Guasch & Marshall 1987). One strain of argument relies on the well known fact that landlords are afraid of ‘bad’ tenants who do not pay their rent punctually, have trouble with neighbours and do not take care of the house. Provided these characteristics are not (perfectly) observable when the contract is negotiated, landlords will try to avoid the turnover of old tenants who are considered to be ‘good’, since they have to be replaced by unknown new tenants. If this line of reasoning is correct, a discount for tenure might emerge even without any legal restrictions on the increase of rents in ongoing contracts (Hubert 1991a).

The official source of the development of rents is the rent-index published by the ‘Statistisches Bundesamt’. It indicates the development of the *average gross-rent*, with the quality of the house being kept constant. The only source which gives a clue as how the *initial* rent of new leases develop are surveys on *net-rents* published annually since 1971 by the ‘Ring Deutscher Makler (RDM)’, an association of real estate agents. Unfortunately, this information is not based on systematic statistics but a result of an informal inquiry among members. While it is difficult to evaluate the absolute numbers for each year and city, the data should provide a reasonably good picture of the overall trend of the market.

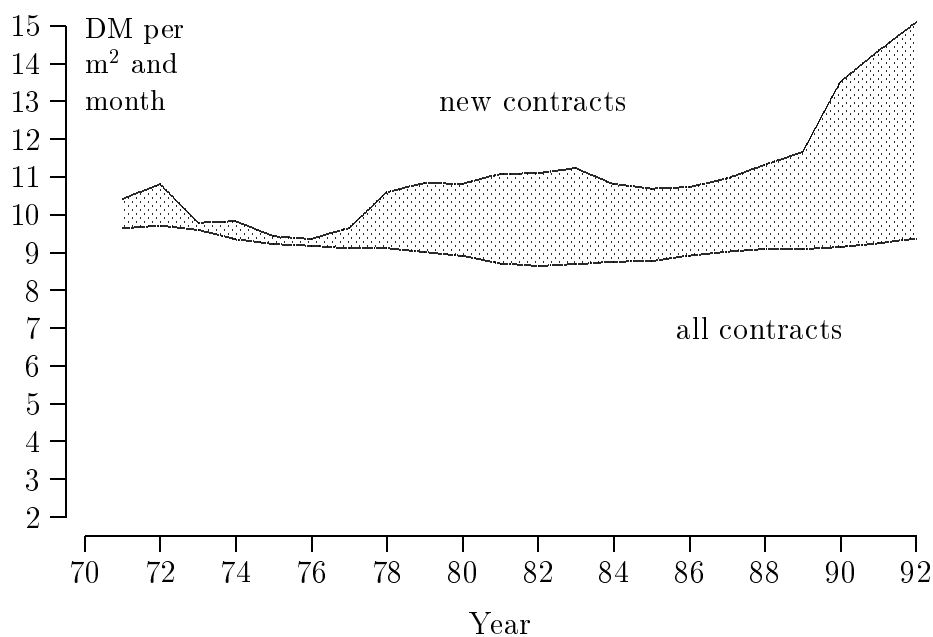
As the entries in table 6 show, the increase of average rent was rather in

Tabelle 6: Increase of rent and cost of living

year	pre-war dwelling		post-war dwelling		cost of living
	average	new	average	new	
	rent	contract	rent	contract	
1970	4,7		4,7		3,6
1971	6,8		5,8		5,1
1972	5,7	8,7	6,4	9,6	5,6
1973	5,3	-0,0	5,7	-3,1	6,9
1974	4,9	3,5	4,1	7,3	6,9
1975	6,7	2,8	4,5	1,6	5,9
1976	5,6	4,3	3,9	3,6	4,4
1977	4,2	9,1	2,9	6,8	3,6
1978	3,5	6,2	2,7	12,8	2,7
1979	3,5	6,9	3,0	6,5	4,2
1980	5,5	8,8	4,2	5,3	5,4
1981	5,0	6,1	3,9	8,8	6,3
1982	5,2	7,3	4,4	5,5	5,3
1983	6,2	4,5	4,0	4,5	3,3
1984	4,5	-1,2	3,2	-1,4	2,4
1985	3,6	1,2	2,2	0,9	2,0
1986	2,7	-0,3	1,6	0,3	-0,1
1987	2,3	2,5	1,4	2,4	0,2
1988	3,1	5,7	2,0	4,6	1,2
1989	3,5	10,7	2,7	5,8	2,8
1990	3,5	17,7	3,4	19,1	2,7
1991	4,5	10,2	4,5	9,7	3,5
1992	6,4	7,3	5,4	9,5	4,0

Source: Own calculation based on RDM and Statistisches Bundesamt, Preise.

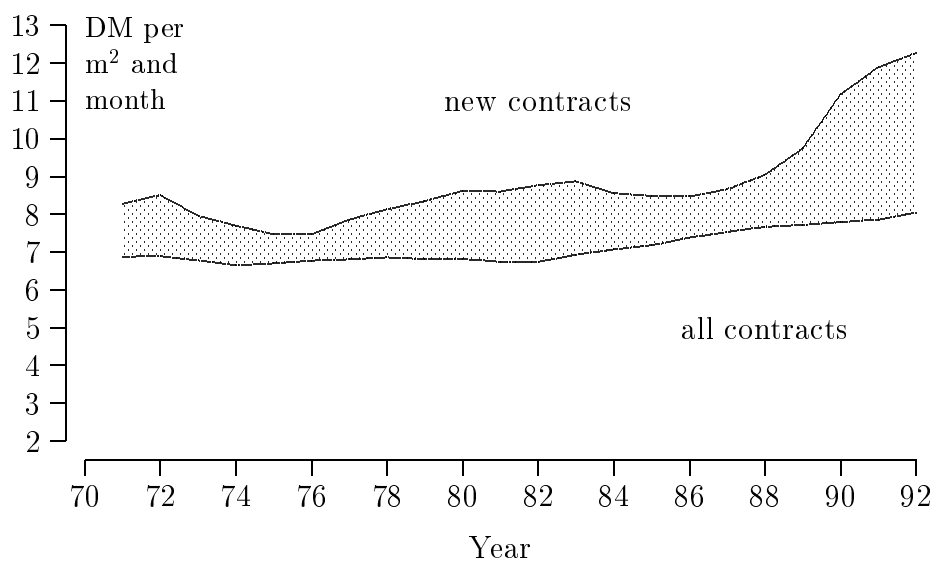
Abbildung 2: Real-rent of post-war housing in prices of 1992



line with the increase in cost of living, while the growth of rents for new contracts was much more volatile. Figures 2 and 3 illustrate this pattern in terms of real rent in prices of 1992. The graphs have been calculated with the help of the figures reported in table 6 and an estimate for the absolute rent level based on the RDM information on initial rents in 1987 and on the Gebäude und Wohnungszählung of 1987 for the average rent.⁸ While the curves will reflect the trends reasonably good, the absolute values for initial rents and average rents, hence the absolute height of the shaded area, can only be considered as a rough guess.

⁸The estimate for the initial rent is obtained by averaging (weighted with the population) the RDM data on net-rents for *medium quality* dwelling in 1987 adding 1.00 DM and 1.50 DM to account for operating cost for pre-war and post-war dwellings respectively. This yields a gross-rent of 7.53 DM per m² and month for pre-war dwellings and 9.53 DM per m² for post-war dwellings. According to the 'Gebäude und Wohnungszählung' in 1987 the average rent for a pre-war dwelling *equipped with central heating, bath and wc* was 6.55 DM per m² and month. The corresponding figure for a post-war dwelling was 7.85 DM. For further details see Hubert (1993b).

Abbildung 3: Real-rent of pre-war housing in prices of 1992



By coincidence, the introduction of tenure security laws in 1971 took place in the mid of a speculative construction boom, fueled by expectations of rising inflation, which burst in late 1972. It took the market more than four years to absorb the excess supply. During the late seventies the market tightened when demand grew faster than supply. From 1983 to 1987 there was again a slack in the housing market. Population declined from 61.66 mio in 1981 to 60.97 mio in 1985, house prices fell and real growth and disposable income recovered slowly from the recession in 1982. Construction rates fell to record low levels, in spite of additional tax benefits for new construction and for owner occupation which were introduced in 1983. At a time when Germans got obsessed with long-term demographic projections predicting their extinction, investment in new housing was not very popular. Demand for housing built up from the mid eighties onwards. Continuous growth in production, employment and real disposable income had already pushed demand when immigration figures jumped with the downfall of the iron curtain in 1989. As a result of growth in demand and low construction rates the housing market rapidly tightened in the late eighties. All these developments nicely show

up in the figures for the real rent of new contracts. The average rent, however, appears to be completely unaffected by the development of the market. It stagnated or even declined until 1983 from which on there was a steady increase.

As such, the insensitivity of average rent to the development of the market can not be taken as evidence for an impact of german tenure laws. Any form of tenure will — in a smaller or greater measure — inhibit the landlords (or the tenants) immediate response to market forces and new opportunities. A contract which puts no restriction at all on the contracting partners behaviour is not worthwhile to be written.⁹ It appears however, that the gap between new and old contracts has widened since the legal restrictions have been introduced. This trend indicates, that the restrictions on rent-reviews protect the sitting tenant too much — probably at the cost of those who have to move.

The turn of the trend of the average rent in 1983 has been taken as evidence that reforms in the same year easing rent reviews were successful. However, the average rent plotted in the figures includes — as a fraction — recent new lettings. It has been estimated that half of the (nominal) increase of average rents in the mid eighties was due to turnover — only the other half was to be attributed to rent reviews within the contract (GEWOS 1987). This implies that the real rent of dwellings with uninterrupted contracts was steadily decreasing. Given a turnover rate of approximately 10% it is clear that the impact of turnover on the average rent is stronger when the gap between new and old rents is larger. Hence, the steady increase of real average rent from 1983 on may also reflect a mechanical feedback of the rent gap.

⁹It should be kept in mind that commercial leases in Berlin — which are not regulated at all — exhibited a very pronounced gap between average and initial rents after the wall came down. In the commercial sector it used to be quite common to agree on a five to ten years lease with a constant rent in real terms. Soaring demand left initial rents for new contracts tripling within a few month without having any effect at all on rents of sitting tenants (Hubert 1990).

5 Unresolved Issues and Policy Options

The analysis of the preceding section suggests that the present hardships and conflicts in the private rented sector are related to the gap between rents for new and old leases, rather than the rent level as such. This gap severely affects the performance of the market:

Inefficient utilization of the existing stock. If a sitting tenant wants to change his housing consumption — which is usually done by moving to another differently sized, located or equipped dwelling — he has to forgo the implicit subsidy of his old contractual rent. This makes an adjustment of consumption extremely costly. If the rent for a new lease is 50% above the contractual rent for the old lease, the total rent payment will *increase* by one eighth if the tenant *decreases* his housing consumption by a quarter — for example by moving to a smaller flat. Opportunity cost of housing consumption obviously do not reflect social opportunity cost. Those who are forced to strike a new contract face the hardship of a tight market. Those who enjoy the low contractual rent are ‘locked in’ with their current housing consumption. It is likely that the inefficient utilization of the available housing stock is pushing market rents for new leases even further up.¹⁰

More landlord tenant conflicts. The gap creates perverse incentives for the landlords. They lose all interest in keeping their old tenants through the provision of good service. As the value of an established tenancy turns into a liability, cases of harassment appear to be getting more common.

Excessive shift towards condominiums. A household who wishes to move faces the choice of renting at a high price or buying a vacant dwelling at a high price. If he does not need immediate access, however, he may buy a rented dwelling at a low price and claim it for himself. Tenure laws protect the sitting tenant against any other competing tenant offering a higher rent. Becoming the owner of the dwelling is one

¹⁰Fallis & Smith 1984 and Hubert 1993a.

way to circumvent this protection. Only the tenant who occupies the dwelling at the time it is turned into a condominium is protected by the special freeze period — recently extended up to ten years — whereas other tenants are not.

The initial depreciation for new construction is 7.5% if it is rented and 6% if it is owner occupied. When the house is purchased from the existing stock the depreciation for renting is 2% while the rate for owning is still 6%. Hence, there is an indirect bias encouraging landlords to invest in new construction and owner occupiers to buy from the existing stock. In particular, new investment is tilted towards the construction of condominiums — initially for renting, later to be sold into owner occupation. This bias will be reduced with the reductions of the limits for depreciation in 1994, but not vanish.

Affordability crisis. The recent development of real rents do not support the claim of a general affordability crisis — except for household whose real income has declined. Nevertheless, the gap between new and old rents undermines housing allowances as a reliable assistance to poor tenants. In its present form housing allowances ignore the duration of tenure when the limit of the reckonable rent is established. Therefore rents in new contracts are often above the limits even if the dwelling is adequate for the household. In these cases housing allowances are insufficient to bring the rent burden down to acceptable levels — which in turn fuels the demand for the extension of rent-restrictions in order to protect the poor.

The government is deeply split over the issue of housing policy. Apparently there are two distinct approaches to meet these challenges.

The first, and certainly more popular approach, is to protect the sitting tenants from the recent development of the market. The most important step in this direction is to limit rent increases during the term. To avoid the negative consequences of the resulting gap between new and old leases additional measures would have to follow: Sitting tenants have to be protected from the indirect competition of moving households either by making it difficult to

convert their dwelling into a condominium or to create obstacles for a buyer to claim it for his own use. While this would help to discourage condominium conversion, it would not be enough to avoid the negative incentives on the part of the landlord. It would be necessary to restrict rents for new contracts, so that the landlord would not gain from an increase in turnover. This would clearly point into the direction of old style rent controls and probably discourage new investment in rented housing — even if it would be exempted. In order to avoid the adverse effect on supply, tax subsidies or assistance on social housing would have to be increased — effectively substituting private money with public money.

Does housing policy follow such an approach? The measures adopted in recent years include:

- the restriction of rent increases in ongoing contracts to 20% in three years provided the dwelling was built before 1981 and the monthly rent exceeds 8 DM/m² (limited until 1998),
- the increase of depreciation allowances for new investment in private rented housing,
- the extension of the special freeze period preventing the buyer of a converted condominium to claim the dwelling for his own use,
- the cut of tax benefits for owner occupiers buying from the stock.

In addition to these measures, subsidies on social housing construction have been substantially increased. Except for the cut of tax benefits for owner occupiers, all measures are consistent with the approach outlined above. This suggests that the overriding concern is to protect the sitting tenants from the recent development of the market. Therefore, it is to be feared that at some point resistance against the reintroduction of general rent controls will wither.

The alternative approach would be to reduce the gap between old leases and new leases and thereby divide the burden of the housing scarcity more evenly. This could be achieved by easing restrictions on rent reviews. However, such

a redistribution from tenants to landlords is highly unpopular among the electorate. An alternative is to raise the land-tax — which would result in a uniform increase of rents. Therefore the gap would close at least in relative terms. Such a measure is certainly not very popular either. But in this case the government could point to high-court ruling which declared the use of the very low ‘Einheitswert’ as a tax base unconstitutional. Moreover the system of housing allowances would have to be modified to take into account the duration of tenure as a determinant of the rent level. This would directly address the specific affordability problem of low income households wishing to move. Finally, the relative taxation of owner occupation and renting should be the same whether it is investment in new construction or investment in the existing stock. This could be achieved most easily by a further reduction of tax allowances for owner occupiers buying from the stock.

These measures would probably mitigate many of the present problems and help to maintain a healthy private rented sector for which Germany is envied by some of the European neighbours.

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