

# Regulation of Rental Increases – an Instrument for Stimulating Affordable Housing?

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## SUMMARY

In Germany, the social structure has changed dramatically and the housing market did as well in recent decades. However, the development is not spatially homogeneous. Particularly major cities report rising population numbers in contrast to many rural areas. Housing, particularly affordable rental housing and small flats, are a scarce resource in some German cities – and the rents are rising rapidly. Therefore, the introduction of a so-called “Mietpreisbremse” is currently being discussed, which is intended to reduce the rental price jumps in cities with pressure on housing markets.

This “Mietpreisbremse” shall come into force in April 2015. Idea is, among others, to cap the rent increase to 10% in cases of tenant change. While this instrument has a lot of advantages, criticism arises on investment barrier, because of reduced yields and reduced incentives for new construction.

Regulating rental prices have the advantage, that they can be introduced quickly and without major costs for public budgets. They also demonstrate the ability to act with respect to major groups of voters who fear a "rental price spiral". However, the private construction can be shifted into condominiums in consequence. Examples show (e.g. England, France) that the trend is accompanied by a decline in quality of living in rented housing to the property. Costs for renovation and modernization cannot be allocated and possibility cannot quickly and completely be refinanced on rents. Owners may invest less accordingly. Socially disadvantaged are particularly affected.

In addition, the rental price regulation prevents the consideration of risks within the rent. An owner is clearly careful to make the choice of his tenants under these conditions; persons with poor social prestige, this will have significant market access problems.

Thus, the instrument of the rent regulation must be used with caution. More important is an increased market transparency associated with an offer extension. Although the offer-oriented housing policy also attracts considerable financial burdens derive (through tax breaks and subsidies), but leads effectively to the desired destination.

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## 1. THE SOCIETAL CHANGE IN GERMANY

Less, older, more diverse – with these three terms, the demographic development of Germany is often summarized. The term “less” describes the effect of the shrinking population due to a declining birth rate. “Older” paraphrases the movement of the demographic pyramid due to increasing life expectancy and declining birth rate at the same time. The term “more diverse” describes the increasing internationalization of the German population. While the overall population is declining, the proportion of the population with an immigrant background continues to rise. In 2011 the percentage was 19.5 percent of the total population, an increase of 1.4 percent over the previous year (Fig. 1) (FEDERAL STATISTICAL OFFICE 2012b: 1).

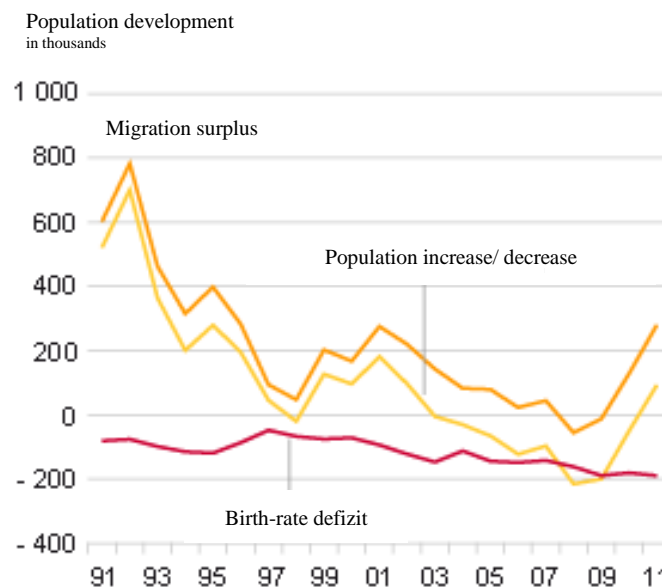


Fig. 1: Population Development in Germany (1991 – 2011) (FEDERAL STATISTICAL OFFICE 2012a: www: modified)

These trends have an impact on all areas of social life. However, demographic change is affecting spatially very heterogeneous. While rural areas have to fight with large population losses many German cities recorded a growing population (JESSEN 2010: 3), due to their specific advantages as a dense network of social and cultural infrastructure as well as the variety of care services (JEKEL ET AL. 2010: 14). This trend is often called re-urbanization or urban renaissance (HERFERT & OSTERHAGE 2012: 86). Literally re-urbanization means the repetition of urbanization (BRAKE & URBANCYK: 2012: 35). This trend is observed since the mid-2000s in Germany. Urban sprawl, also known as the "City Escape", had its heyday in the early 1990s and describes the migration process of the population of the core

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cities in the surrounding area (HERFERT & OSTERHAGE 2012: 86). According to HERFERT & OSTERHAGE (2012: 107) suburbanization was "largely replaced" by the re-urbanization. However, this "new" trend consists less of migration surplus from the suburban areas, rather young families stay in the cities instead of migrate to the suburbs (BRAKE & HERFERT 2012: 409). LIENENKÄMPER (2010: 11) sees the trend of re-urbanization as a chance for urban development, because migration into the cities requires their partial change.

### **1.1 Singularization**

The "traditional household" – consisting of a couple with children in which the father is employed and the mother, staying at home, takes care of the household and the education of children – today, according to SIEBEL (2010: 49) "extincted largely" (see JEKEL ET AL. 2010: 34). Other models of life, such as communities or single households, replace the "classic" family. The proportion of one- and two-person households is continuously rising in the cities. The number of households has increased in Germany in the years 1991 – 2011 by about 15 percent; contrasted by a decline in average household size of 2.27 to 2.02 persons (HAMMES et al 2012: 997). In addition, the proportion of families with children in the population of German cities is relatively low. The majority of the urban population lives alone, 60 percent of all urban households are single person households. One reason for this is the low availability of suitable accommodation (JEKEL ET AL. 2010: 17). The city and its infrastructural conditions and services provide career-oriented men and women a substitute for domestic supply (SIEBEL 2010: 49). By changing the role of women and the declining marriage rate while simultaneously increasing divorce rate increased, the amount of single person households rose (FEDERAL STATISTICAL OFFICE 2013b: 12). The number of married couples has fallen by eight percent in the period 1996 – 2011. In contrast, the number of cohabitation increased in the same period by 52 percent (HAMMES ET AL. 2012: 997). This "separation" of the population also has an impact on other social fields. In 2006, 80 percent of all nursing and care services for elderly people were provided within the family (JEKEL ET AL. 2010: 34). If this familial form of care drops off, it must be fulfilled in a different way, because the life expectancy of men and women continues to rise (FEDERAL STATISTICAL OFFICE 2012c: 1).

### **1.2 Pluralization**

But not only people from other countries are "mobile". Even in Germany, many people are "moving". The pluralization has intensified in recent decades. The "classical" family has been replaced though a variety of life-models, such as unmarried couples with or without children, married couples with children from previous relationships – so-called patchwork families – single parents and single persons. Reasons for pluralization, which has an impact on the housing market, are the expansion of education, the imbalances in the prosperity of the population, the changing gender roles of women and men and the associated increased employment of women and in the acceptance of extramarital partnerships (GANS 2011: 48ff). Frequently, the job location is so far away from home, that daily commuting is impossible. In addition, a small apartment at the site of the work is cheaper than a daily commute. At the secondary residence, the vast majority of 62 percent is in an employment relationship. In addition, three quarters of all secondary residences are single-person households (HAMMES ET AL. 2011: 991). In Germany, about half of all employed persons commutes to their

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workplace and lives in another municipality. The other half of the working population lives and works in the same place (ZENSUSDATENBANK 2013: www). The pluralization of the population contributes to the fact that the demand for small affordable housing continues to rise.

### **1.3 Aging**

As already mentioned, the life expectancy of people is augmenting due to improved medical resources. This leads to an increasing proportion of elderly people in the total population. Life expectancy of newborn girls is currently at 82 years and nine months and of newborn boys at 77 years and nine months. But even people who have already reached the retirement age of 65 years, the statistical life expectancy has increased in the last years. For women it is 85 years and 8 months and for men it is 77 years and 6 months (FEDERAL STATISTICAL OFFICE 2012c: 1). In 2009, the fertility rate was at 1.36 children per woman (Federal Statistical Office 2012a: 41). For a constant population a birth rate of 2.1 children per woman would be necessary (DEMERY & VOIGTLÄNDER 2009: 5). Many case studies have shown that especially the "young olds" are increasingly looking for housing in urban areas, to spend their "retirement" (JEKEL ET AL. 2010: 14). Many elderly people have the desire to stay as long as possible in their own home and in their well-known neighborhood (SIEBEL 2010: 48). In addition, also attract many elderly people from rural areas in the inner-city residential areas as the infrastructure facilities such as public transport, shopping or medical care is better than in rural areas. This means that many retain their independence and are not or only partly dependent on outside help (MARETZKE 2008: 11). However, older people have different demands, such as accessibility to their living space. Many apartments do not correspond to required standards and need a rebuild. However, a structural measure is usually expensive and not every person has sufficient financial resources.

### **1.4 Impoverishment**

The increasing employment in the low-pay sector and the rising unemployment rate led to lower real incomes in the last years. Because of that the amount of "poor" people in the population grows (KEIM 2011: 244f). Every eighth urban dweller refers transfer payments from the state (LIENENKÄMPER 2010: 11). This growing unjust distribution of general prosperity leads to a change of housing conditions (HANESCH 2011: 7). The incomes of many people are not sufficient for the supply of adequate housing. More and more are dependent on financial support from the state. The proportion of this population group is important, especially in cities. A major reason for the high proportion of people with low incomes of the urban population is due to the anonymity offered by the city. The social control of the neighborhood is much less pronounced in urban areas than in rural areas (SIEBEL 1994: 4). Through financial assistance and social housing the needs of low-income populations may be covered, but the proportion of social housing is falling steadily, while the number of those who are dependent increases. The reduction of apartments with occupancy rights, presenting municipalities with new challenges.

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### **1.5 Increasing level of education**

Due to the expansion of education, there is an increased education hike. Many young adults come to the cities for their studies. Universities, located mainly in large cities, reported a growing amount of students. In the period from 2000 to 2011, the number of students has almost doubled at German universities and from 1,798,863 to 2,380,974 (FEDERAL STATISTICAL OFFICE 2013c: www). Students make the housing market its own needs group that has usually a low income and relies on inexpensive housing. Especially in October, when the new semester starts, almost every city with a university determines a housing shortage, which is partly solved in creative ways. Some states and also cities have included the support of students in their programs for housing assistance.

### **1.6 Heterogenization**

The ongoing globalization and international migration lead to more immigrants from different countries. The distribution of migrants is very heterogeneous across Germany (GANS 2011: 117). In the big cities, the proportion of immigrants from other countries is higher than in rural areas. If an immigrant comes to a foreign country, he requires, according to SIEBEL (2010: 49) an "ethnic colony" (see also JEKEL ET AL. 2010: 15). In this ethnic colony he can speak his native language, he gets information about the foreign society and he also finds material and psychological support and protection from isolation (JEKEL ET AL. 2010: 15). Migration is a form of mobility, more precisely the spatial mobility. Reasons for migration are varied. The main reason is mostly the prospect of a better job (GANS 2011: 118). The relative proportion of migrants, government support, obtained for example in the form of housing benefit is significantly higher than the relative proportion of German nationals. Reason for this is the lower general level of education (ZIMMERMANN 2011: www). In response, migrants are a part of the population depending on government support, such as the provision of social housing. While in recent years, the proportion of immigration of ethnic German repatriates declined, the so-called labor migration increases. In the next few years the development is going to lead to an increasing immigration of highly qualified professionals. With regard to highly qualified professionals, the situation of migrants will change in the housing market and the demand for high quality and therefore high-priced living will rise (BMI 2011: 4). Nevertheless, the need for affordable housing will remain.

### **1.7 Segregation and gentrification**

SIEBEL (2010: 50) provides the spatial separation or segregation "of different lifestyles and cultural milieu" as a condition of functioning integration and as a prerequisite for "economic and cultural productivity" of the city. At the same time segregation, the "process of spatial differentiation" and "disproportionate distribution of the population" (GANS 2011: 57) also can be a trap. Socially vulnerable members of society can be displaced from a neighborhood either, known as gentrification process, or left in a neighborhood caused by the outflow of wealthy people. The disadvantaged groups living in the "physical, social and symbolic run-down" (SIEBEL 2010: 51) quarters, see themselves as margins of society.

By a specific development of inner-city neighborhoods, a further segregation could be counteracted (MIKSCH 2010: 54). According to BMVBS (2012: 1) inner cities and town centers functioned as "key factors for urban development" and strengthened citizens' identification with their place of residence. In addition, the internal development has a

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qualitative dimension, "which aims to preserve and to strengthen the urbanity and attractiveness of cities and communities (BMVBS 2012: 17). Confrontational neighborhoods may arise in which immigrants are specifically guided by the control of the housing market. This development should be avoided through intelligent urban development policy.

All these developments present great challenges to the urban housing market. The structural changes in the size and age composition of the urban population will lead to changes in housing demand (BBSR 2010: 6). Students, immigrants, and people depending on financial support from the state, including many retirees, need affordable housing. This compares to an increasing demand for high-quality inner city living by high-income, highly skilled workers (KELLER 1999: 16; SIEBEL 2010: 49). These different demands to the urban housing market are not only subject an ideal but also a spatial separation.

## **2. THE GERMAN HOUSING MARKET**

The housing market in Germany isn't a liberal market. This would require a complete freedom of prices, which occurs only conditionally in Germany. The implementation of state subsidy programs – including social housing – to remove the housing shortage after the Second World War led to interventions in the housing market and has still influence on house prices and ownership (SHLOMO 2011: 26).

### **2.1 Ownership rate and regional disparities**

The German housing market is very heterogeneous. On the one hand, this is reflected in the small-scale supplier and user structure. The largest share of around 41 percent are owners, which use their property themselves, about 36 percent of the apartments are attributable to small private landlords who have invested or inherited their wealth in real estate. Commercial housing companies own the remaining 23 percent. This includes both private and public housing companies and cooperatives (VOIGTLÄNDER 2010: 13f). However, they manage about 39 percent of all rental properties (FRANZEN 2008: 85). The percentage of home ownership in Germany is compared to other European countries very low. (MÜLLER 2006: 85). By 2011, the ownership rate increased by around five percent to 45.8 %. (FEDERAL STATISTICAL OFFICE 2013a: www). Throughout Germany, there are differences, as in cities the ownership rate is much lower than in rural areas. The new federal states reported a lower rate than the former federal territory (MÜLLER 2006: 88).

Another feature of the heterogeneity of the housing market are strong regional differences, because of to the immobility of buildings. Due to demographic change and the related population decline, there is a housing surplus in many regions of Germany. But even growing regions with a pronounced shortage of living space exist. This applies particularly to major German cities and university cities (JESSEN 2010: 3).

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## 2.2 Construction activities and rental price development

The real estate and thus also the housing market is a stock market, as real estate can be used for around 100 years and the capital is tied up for the entire period (DEMARY & VOIGTLÄNDER 2009: 11). New construction activity in Germany is less than one percent per year and is declining. Due to the housing shortage after the Second World War and the provision of funding, there was an increase in construction activity. Until the early 1990s, the share of new buildings went back on inventory and increased due to immigration of ethnic German immigrants from Eastern European countries. Especially in eastern Germany, there was again a further increase in construction activity after the fall of the Berlin Wall and the German reunification due to subsidies from the countries of the former Federal. The currently declining population growth leads to changes in the housing market. New buildings are no longer needed in the future to the same extent as in the past. Rather, there is a qualitative improvement and expansion of the portfolio through renovation to counter the changing demands in the housing market (VOIGTLÄNDER 2009: 12f). Each population group has its own needs and demands on housing (e.g. accessibility). Currently, emphasis is placed on filling gaps in the urban structure rather than, for example, wrap agricultural land. So that urban sprawl is counteracted and the municipalities are compressed (GÜNTHER 2012: 38). The rental price of a residential property is determined by a variety of factors (Fig. 2). In general properties are aligned along market structures (DEMARY & VOIGTLÄNDER 2009: 11). Primarily the residential environment – the location – determines the amount of the price. The apartment properties, such as the size of the apartment, the equipment, the cut and the type and characteristics play in the formation of the monthly rental price a minor, but not an insignificant role. Not only rents for new buildings, but also rental prices for apartments in the portfolio have increased (BEHRENS & KAISER 2013: 15). The prices in the German housing market are nevertheless very stable and have the slightest variation of all OECD countries. One reason for the price stability is the previously mentioned low ownership rate (VOIGTLÄNDER 2009: 18f).

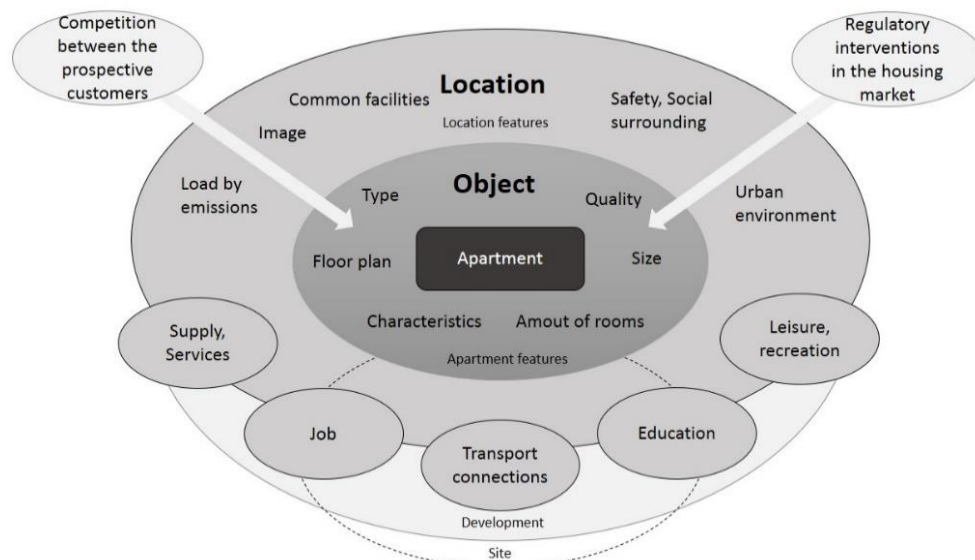


Fig. 2: Factors influencing the rental price (based on: DÖRRBECKER 2006: www)

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### **3. REGULATORY INSTRUMENTS**

At the federal, state, and also at the municipal level, there are formal and informal instruments to regulate the housing market.

#### **3.1 Municipality level**

One of the most important control instruments of urban development in a municipality is urban development planning, which is regulated by the Federal Building Code. There are two forms of urban development planning – the preparatory and the binding land use plan. With these plans, a sustainable urban development, which brings the social, economic and environmental protective requirements in responsible accordance to future generations and a public welfare serving social soil utilization (section 1, paragraph 5, Federal Building Code) should be ensured. In addition, the two plans should help to secure a decent environment to protect natural resources and to develop and promote climate protection and the adaptation to climate change, especially in urban development, as well as to preserve and develop the urban form, the townscape and landscape.

Beside the municipal right of first refusal, which allows the municipality to implement urban development objectives, there is the possibility to conclude contracts with the investors to transfer costs. A list of possible contents of an urban planning contract are included in section 11, Federal Building Code. Usually the investor is obliged to assume planning services and land tenure as well as other measures for the redevelopment of the site. Among other things, it may concern the free transfer of land, the realization of the development and the acquisition of follow-up costs also for non-contributory urban infrastructure and facilities (DRIXLER ET AL. 2014: 28f).

Through the development of housing concepts and the preparation of local housing support programs, municipalities can detect changes in the housing sector. These statistical surveys can help to respond to the negative changes and to provide adequate housing.

#### **3.2 Federal Level & State Level**

With the reform of the federal system in 2006, the federal government has given the responsibility for social housing to the federal states. Even before the federalism reform, the federal states had the opportunity to concretize the requirements of the federal housing promotion act in funding rules to respond to the needs of the regional housing market. But not every federal state has passed an own housing promotion act so far. Only the states of Baden-Württemberg, Bavaria, Hamburg, Lower Saxony, North Rhine-Westphalia and Schleswig-Holstein have replaced the German law on social housing promotion by regional regulations (BMVBS 2013: www).

The federal states are supposed to use the funds (to 2019 518 Mio. € per year) provided by the federal government for the construction and maintenance of affordable and adequate housing. In addition to the investment in social housing, the states have to give detailed information on their support measures. Moreover the government is working on a reform of the housing allowance. Federal and state governments want the housing benefit contributions and the maximum rental prices to be adapted to the development of average rents and real wages (BMUB 2015: www).

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Another instrument, which is currently being discussed by the German Federal Parliament, is the so-called “Mietpreisbremse” (a rental price brake), which is mentioned further on.

#### **4. MIETPREISBREMSE (Rental Price Brake)**

The draft legislation of the federal government "to diminish the increase of rents on tight housing markets and to strengthen the orderer principle in arranging accommodation", the so-called Mietrechtsnovellierungsgesetz (MietNovG) provides amendments in the German Civil Code (BGB) and the German law on housing agencies. German rental housing market is affected of two problems. On one hand, some prosperous cities with tense housing market detect strongly rising rents, sometimes over 30% of local comparison, in re-rentals. Finally, the prices rose in re-letting in Munster by 30% in Hamburg and Munich by 25% and by 19% in Berlin. Even smaller university towns experienced a significant increase, as for example in Regensburg by 33% and by 32% in Freiburg (SPD 2014: 1). On the other hand, tenants must usually pay the estate agents appointed by the landlord. If a prospective customer isn't willing to pay the commission, he can't rent the apartment.

These two factors make it difficult for low-income households to be able to supply them with adequate housing. The changes of clauses in the BGB want to restrict the rents at a re-letting. The so-called “Mietpreisbremse” should not apply nationwide, but in selected areas, specified by the states. They can designate residential areas in their communities as “tight housing markets” by an ordinance (amendment section 556d, paragraph 2, Federal Building Code). The regulation must be accompanied by a statement of reasons, from which the present facts are apparent for the particular case. In addition, the state government must indicate the measures to be taken to improve the existing situation (DEUTSCHER BUNDESTAG 2014: 8).

This legislation should preserve hundreds of thousands of tenants against overpriced rents. "Average income" should be able to provide themselves with adequate living space. Another aim is to strike a fair balance between the interests of the landlord and the tenant (HÖGL 2015: www). HÖGL (2015: www) sees apartments not as "pure commodity" – "they are home to people. It should not just be about profit maximization".

##### **4.1 Statutory Regulations**

A tense housing market exists, according to the amended of section 556d, paragraph 2, item 1 – 4, Federal Building Code of the draft law of the Federal Government (DEUTSCHER BUNDESTAG 2014: 7f) if:

1. rents rise significantly stronger than the national average,
2. the average rent burden of households exceeds the national average significantly,
3. the resident population grows but the required living space is not created by construction activity so far, or
4. low vacancy in large demand.

The definition of the territories shall be initially for five years (amendment section 556d, Federal Building Code). A last-time classification of areas can be carried out in 2020.

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According to the current state of the “Mietpreisbremse” should exist until 2025. However, the “Mietpreisbremse” is not mandatory. The federal states aren’t obliged to designate areas.

The rent, a landlord may require in the future should not be greater than 10% above the local comparative rent (amendment section 556d, paragraph 1, Federal Building Code). For reference, the rent index provided by local authorities should serve. However, there is a continuance (amendment section 556e, Federal Building Code) for already collected rents. Even if the previously paid rent exceeds the usual local rental rate by 10%, a landlord may this amount in a new tenancy. Rent increases closed with the previous tenant during the last year of tenancy will not be considered (DEUTSCHER BUNDESTAG 2014: 8). The landlord is required to give the tenant information about the determination of the rental rate (amendment section 556g, paragraph 3, Federal Building Code). If an overpriced rent have been fixed by the landlord, the tenant has the opportunity to draft a complaint. The landlord has to receive this objection before the rent has to be paid (amendment section 556g, paragraph 2, Federal Building Code).

However, several exceptions apply to this regulation (amendment section 556f, Federal Building Code). Excluded are the apartments which were rented for the first time after 1 October 2014 and apartments, which are re-let after an extensive renovation (DEUTSCHER BUNDESTAG 2014: 8). With these exceptions investments in the housing sector should be maintained and promoted.

#### **4.2 Critical Voices**

Despite the well-recognized fact that an instrument to solve the existing housing problem is necessary, critical voices are raised against “Mietpreisbremse”. The effectiveness of the discussed and by the federal government adopted regulatory measures is questionable. BLANKENAGEL ET AL. (2014: 28f) predict in their report a tightening of supply shortages through the introduction of the “Mietpreisbremse”. An artificially low kept rental price would increase the demand. Especially low-income households would be treated at a disadvantage by landlords in competition with more solvent tenants. In addition, residential areas without tight housing market had to struggle with attractiveness losses since their advantage – cheap rents – would disappear. The danger of the formation of secondary markets is seen. Landlord could charge high transfer fees for furniture made available for the tenants, e. g. for the kitchen, and thus increase the allowable rental income (BLANKENAGEL ET AL. 2014: 28f). The law also allows loopholes for landlords not be affected by the “Mietpreisbremse”. On the internet, a variety of portals (Fig. 3) present possibilities to bypass the “Mietpreisbremse”.

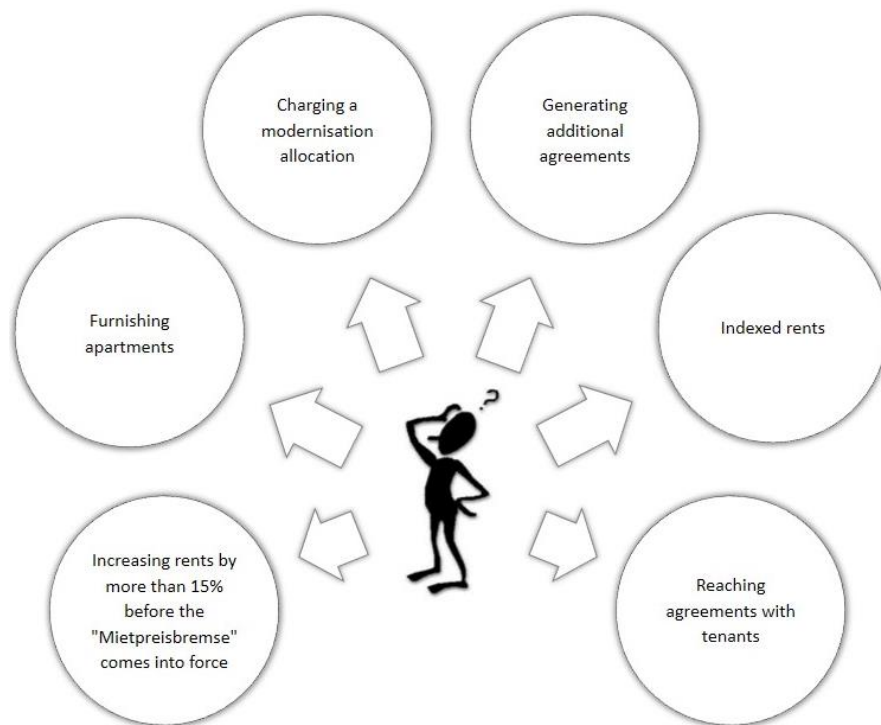


Fig. 3: How to avoid the “Mietpreisbremse”! “Helpful” advices for landlords found in the internet (based on: KNEDEL 2014: www)

## 5. CONCLUSIONS

In some prosperous German cities, the rental market is very tight. Due to the positive population trend, rents are rising sharply. Low-income groups have difficulties to provide themselves with adequate and affordable housing. The municipalities have only limited options to counter the existing housing shortage; necessary building options need time and investments for realization. This requires a short-term assistance.

Therefore, the “Mietpreisbremse” adopted at the federal level and expected to enter into force by April 2015, was established as a regulatory instrument. With their help, areas with tense housing market are to be relieved in short term until the housing shortage can be eliminated by the required construction activities. Whether the hoped-for objective can be achieved with the “Mietpreisbremse”, studies are able to prove in the future.

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