THE LEGAL AND FINANCIAL FRAMEWORK OF AN EFFICIENT PRIVATE RENTAL SECTOR: THE GERMAN EXPERIENCE

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Table of contents

Table of contents

Merits of a substantial PRS

- Mobility → allocation of labour force → economic growth

trade-off between mobility and security of tenure: a large PRS accompanied by low mobility of the workforce?

- less accentuated housing cycle and lower volatility of house prices → stability of the financial sector → macro-economic stability
- Competition between tenures: choice, innovation → small "gap" is better
- Efficiency of subsidization?

Can social housing and homeownership be subsidized more efficiently?

- Efficiency of investment / management (?)

Scale effects

- Less urban sprawl
- Other question: Which structure (mix of tenures) is preferable?

What is an “efficient” PRS?

- An alternative to homeownership
- An alternative to social housing
- in terms of availability, quality and quality differentiation
- Efficiently regulated and subsidized: The sector must be competitive

Is the tenure mix a policy target or the result of anonymous market forces?

Definition of "efficiency": Given level of tenant protection with minimal impairment of market functions and hence minimal need for compensating subsidies.

A substantial number of households has to decide pro renting and against homeownership (Rent or buy-decision).

Table of contents

Determinants of the Rent or buy-decision

Politically suggestible

Mr. Spock's investment calculus

- (Current) relative prices (rents vs. house prices):
  Saved rent payments + Maintenance costs / house price * 100 = Homeownership cap rate (static model)
- Relative transaction costs (moving in / moving out)
- Public subsidies (Buying vs. renting)
- Financial conditions (interest, avail. of credit, LTV credit terms → dynamic) → affordability
- Expectations about future prices (rent development, capital gains, interest rates) → Cash flow modelling
- Individual risk exposure: labour market position, interest rate, divorce, … portfolio mix → individual discount rate

General tenancy risk: influences RRR

- Security of tenure (!)
- Product differentiation and availability in the two sectors (size, quality, neighbourhood, central / decentral location, school districts)

- Income, equity capital (→ past savings): relative to house prices → affordability

- Tastes and preferences (e.g. property ladder, once in a lifetime) → path-dependent?
- Household composition and socio-economic characteristics
- Stage in the familiy life course (marriage, divorce, separation, aging, health issues)

Buying should not be too attractive as compared to renting.
Sector has to be attractive for investors as well!

To square the circle

- PRS must be attractive for investors and tenants (given the alternative of homeownership) as well
- Most potential tenants want a long term perspective
  → dismissal protection and
  → protection against sudden rent increases
- Investors want a reliable, competitive and risk-adequate after tax rate of return on their investment – otherwise they do not invest or transform rental units into condominiums

RRR

- Need for balanced regulation and subsidization of the PRS
- Regulation has to be compensated by *sufficient* incentives for new residential development and modernization of the existing housing stock

also incentives to keep the dwellings in the PRS

Supply side

- Incentives for private investors to engage and stay in the rental sector (new development or investment in existing stock)
- Investment calculus: profitability of housing investment as compared with alternative investments

Determinants of the investment decision

- Expected future rent revenues (location, demand and rent regulation)
- Expected future tax payments
- RRR (Required Rate of Return):
  - Return from alternative investments (e.g. government bonds)
  - Risk assessment (absolute and in comparison with alternative investments)
  - inflation experience
- Restrictions on disposal (tenancy laws)

Political uncertainties

Let us design an adequate regulatory framework together with a compensating subsidy system!

Expectation of rising rents:
- More households decide to become homeowners
- More investors decide to build or buy
- Prices for land and existing houses rise

Table of contents

Legal framework: target system

- General and asymmetric dismissal protection requires some kind of reference rent
- a necessarily (somewhat) artificial market-oriented rent concept characterized by
  - adequate quality and spatial differentiation
  - no rent-capping effect in the long run
  - only limited degree of market split: fluctuation (mobility!), waste of space
  - minimum delay of the adjustment process of the housing market after a shock event (self-regulating system)
    → market clearance
    → limited retardation dependent on degree of excess demand
  - minimal distortion of investment incentives: some is inevitable
  - minimal distortion of the allocation function of rental prices
  - minimal need of discretionary political interference

"market rent" only for new leases, if at all one cannot refer to those rents; they do not represent the whole market and tend to be higher than rents in ongoing contracts

→ limit the side effects of the drug

Freedom of contract environment?

- Why should the parties not agree upon leases with protection against dismissal and rent ceilings if freedom of contract was granted?
- On a tight market, the landlord dictates the terms, e.g. German cities before 1914
- The landlord will require compensation in the form of a higher initial rent.
- Voluntary dismissal protection can not work without a reference rent.

Regulation: outstanding issues

- Construction of the reference rent
  - purely empirical: objective, but hardly feasible
  - purely normative: political football; dysfunctional outcome probable
  - a mixture of empirical and normative elements

Sample range:
- only new leases: not representative
- new and existing leases (if raised): self-referentiality

- Retardation mechanism
  - Related to reference rent itself:
    - time dimension: update rate, reference period
    - mix of newly agreed, increased and unchanged rents

normative shares to limit influence of fluctuation?

No
  - Outside the reference rent: rent caps with relation to reference rent or contractual rent

- Application range
  - only for existing leases
  - or for both, existing and newly signed leases
  - new leases difficult to monitor, exemptions for newly constructed dwellings and comprehensive modernizations may be required → investment incentives
  - Leading and valve function of new leases

→ If we do not cap rents in ongoing tenancies too much, we can refrain from limiting rents for new leases.

Table of contents

Subsidization

Application range also dependent on housing need
Do we need a permanent subsidization?
Justification: acts against pressure to convert into condos

- **Application range**
  - only investment in new residential real estate
  - new investment and modernization
  - new investment, modernization, acquisition and holding of existing dwellings (requiring minimum holding periods)

Long term subsidization with a wide application range

- **Instrumental alternatives**
  - Depreciation allowances: “hidden” subsidy, regressive distributional effect if income tax is not flat
  - Subsidized loans: may have a desired influence on distribution (less interest expense)
  - Investment allowances: to be paid gradually in small portions?

Different instruments are attractive for different groups of investors: Instrumental choice affects the structure of the supply side

Degree of subsidization

- Theory: compensate the present value of the lost rental income - tailored to the project
- We do not / cannot know the market rent!
- Rent controls may be ineffective in low demand regions, hence no losses
- Economic incidence of subsidies, esp. in tight markets → housing land prices
- No efficient solution imaginable: considerable deadweight losses inevitable → keep market distortions by regulation on a low level

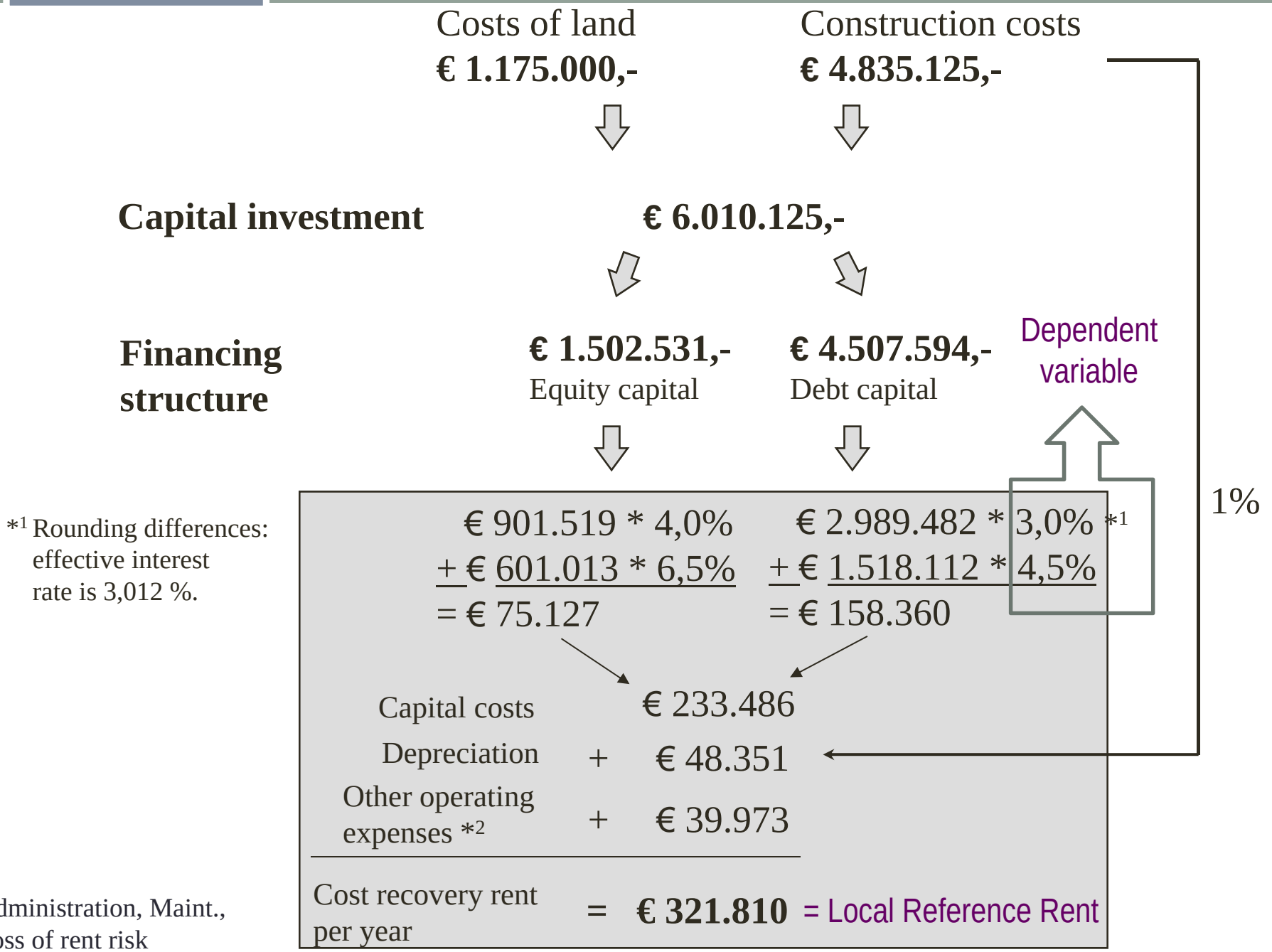
Table of contents

General recommendations

- limit market interference via regulation (rent controls)
- Because the heavier the market distortion, the more expensive it gets to compensate it (progressive dependence) and the higher the deadweight losses
- Social housing may be more efficient: rent controls and subsidies tailored to the project
- Shall we tailor general subsidies for rental housing (without price ceilings and occupancy obligation) to the project, i.e. dynamic cost recovery rent?
- In this way, one could allocate the subsidies according to regional needs.

make interest rate dependent on development of contractual rent (= reference rent); initial interest rate as well as current interest yield

Osten: Gebietskulisse für Investitionszulage



*1 Rounding differences: effective interest rate is 3,012 %.

*2 Administration, Maint., Loss of rent risk