

Tenancy Laws in Berlin – How Rent Control Impedes Residential Construction, Creates Black Markets, and Harms the Poor*

Abstract

Berlin has faced large increases in rent levels over the last decades. To overcome pressure on the market, the Senate of the City of Berlin has repeatedly introduced rent controls. While the German Constitutional Court has found the latest rent-controlling legislation, the Price Ceiling Act of 2020 to be violating German constitutional law and hence invalid and void, there is strong economic evidence for why rent controls do more harm than good and after all even lead to a decrease in housing provided. To provide for affordable housing, the city state needs to pursue other measures that incentivize the construction of new housing: the increase and acceleration of the granting of building permits, release of shallow land and actively engage in municipal construction.

Keywords: Housing, Rent Control, Tenancy Law

Résumé

Au cours des dernières décennies, la ville de Berlin a fait face à de nombreuses augmentations des loyers. Afin de contrecarrer la pression exercée par le marché, le Sénat de la ville a introduit des mesures de contrôle des loyers, et ce, de façon répétée. La Loi sur le plafonnement des prix de 2020, la loi la plus récente en matière de contrôle des loyers, a toutefois été déclarée inconstitutionnelle, et donc nulle et invalide, par la cour constitutionnelle allemande. Il existe d'ailleurs des preuves économiques qui nous font avancer que le contrôle des loyers est plus dommageable qu'utile, puisqu'il mène notamment à une diminution des habitations disponibles. Afin d'offrir des logements abordables, la ville de Berlin doit donc se tourner vers d'autres mesures. Ces mesures devraient promouvoir la construction de nouvelles

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habitations, l'obtention expéditive de davantage de permis de construction, l'utilisation des terres peu profondes. La ville devrait être impliquée activement dans la construction municipale.

Mots-clés : Contrôle des loyers, droit du logement, théorie de l'évaluation des prix, planification urbaine

INTRODUCTION

Law shapes the city. Nowhere this becomes clearer as in the field of tenancy law, which tries to solve the conflict between tenants and homeowners. The home ownership rate in Germany is the second lowest in all OECD countries and was at 46.5% in 2018.¹ As a consequence, rent levels are an important political issue in Germany. This paper focuses on rent control regulation in Berlin. Due to extremely expansive monetary policy within the European Monetary Union and a concomitant decrease of interest rates, Germany's property market has faced a significant inflow of money. With Berlin catching up on economic development and attracting many new citizens, the city has faced a considerable increase in property prices. At the same time, rents have more than doubled for many tenants, who enjoyed very low rental rates after the fall of the Berlin Wall. As a result, some local residents are forced out of their neighborhoods. This has put the city's politicians under pressure.

In 2015, the Senate of Berlin, the legislative body of the city state which also forms one of Germany's 16 federal states, made use of a federal authorization and introduced the so-called "rent brake", a regulation that controls the amount of permissible rent increases. This regulation doesn't forbid rent increases, but increases are ceiled at 10% above the average rent

¹ German Statistical Office, 'Ownership rates by federal states over time' (26 May 2020) <<https://www.destatis.de/DE/Themen/Gesellschaft-Umwelt/Wohnen/Tabellen/eigentuemerquote-nach-bundeslaender.html#fussnote-1-115168>> accessed 11 October 2021.

for a comparable flat in a certain area. In 2020, the Senate tightened its rent control measures and implemented laws according to which rents are retroactively frozen on the level of 2019. While this has brought unexpected windfall gains for many tenants, lessors and housing cooperatives face losses of revenue.

This jeopardizes the construction of new and the modernization of existing dwellings, while increasingly more flats are converted into condominiums to circumvent the rent control regulation. Black markets trading access to flats are thriving. At the same time, fixed rents impede the signaling effect of prices, with the lower rents attracting even more potential tenants to the city. Such rent controls don't incentivize residential construction, but instead harm those that are seeking cheap housing. Even though COVID 19 has caused Berlin's population to decrease for the first time in decades, this has not reversed the trend of rising rents. The ways in which tenancy and property law can instead be used to create cheap housing and make the city a vibrant place to live will be subject of this paper.

PART 1. THE REAL ESTATE MARKET IN BERLIN

Berlin's property market has experienced significant price increases during the last decade. After the fall of the Berlin wall in 1989, the city has experienced a remarkable transition from a divided city and scene of cold-war confrontation to an international metropolis attracting people from all over the world. However, Berlin's housing market has always been a subject of debate. During German partition the city has been divided into a western part, which was (and still is) part of the Federal Republic of Germany, and an eastern part, which formed the capital of the German Democratic Republic (GDR), a socialist one-party dictatorship under the thumb of the Union of Soviet Socialist Republics (USSR). During German partition, the real estate markets in both parts of the city were regulated. In East Berlin, newly built condos were

“peoples’ property” and hence usually owned by the state or housing cooperatives. Private residential property almost played no role in the GDR and was limited to privately used one- and two-family houses. The whole housing market was heavily regulated and condominiums were usually allocated by a public authority when people married and had children. But also in West Berlin, the state regulated the housing market. The municipality invested in social housing for citizens of low income and the German state provided tax incentives for private investments in social housing. German Reunification initially hit Berlin hard. At the turn of the millennium, the city had around 150,000 vacant housings, a negative population forecast and municipal housing associations faced redevelopment backlog and huge debts. As a consequence, the municipality privatized 65,700 condos in 2003.² Not even two decades later, the situation has totally changed. While Berlin’s population moved around 3.4 m in the first decade of the 21st century³, the population has increased since then to almost 3.77 m in mid-2021.

The growing population and increased attractiveness of the city has put pressure on property prices. Besides that, several other factors have caused property prices to rise during the last years. The city’s Gross Domestic Product rose by 77.36% from 2005 to 2020⁴, increasing the productivity of real estate property. Cheap money and a lack of investment

² Hildburg Bruns, ‘Warum Sarrazin und Wowereit Berlins Wohnungen verkauften’ [Why Sarrazin and Wowereit sold Berlin’s Social Housing], (10 April 2019), <<https://www.bz-berlin.de/landespolitik/warum-sarrazin-und-wowereit-berlins-wohnungen-verkauften>> accessed 11 October 2021.

³ See Statista, Population of Berlin from 1960 to 2020, <<https://de.statista.com/statistik/daten/studie/154880/umfrage/entwicklung-der-bevoelkerung-von-berlin-seit-1961/>> accessed 11 October 2021.

⁴ See Statista, Gross Domestic Product of Berlin from 1970 to 2020, <<https://de.statista.com/statistik/daten/studie/5010/umfrage/entwicklung-des-bruttoinlandsprodukts-von-berlin-seit-1970/>> accessed 11 October 2021.

opportunities have further exacerbated pressure on prices. At the same time, global investors have identified housing markets as attractive investment opportunities.⁵ Meanwhile, rents of new leases have also risen significantly during the last decade. While many existing leases benefit from low rents, new leases contain remarkably higher rates. For example, the nominal rent per square meter for new leases of a 30 square meter flat has more than doubled with an increase of almost 123% from 2011 to 2021. For flats of 60 square meter, the price even rose by 128 %.⁶

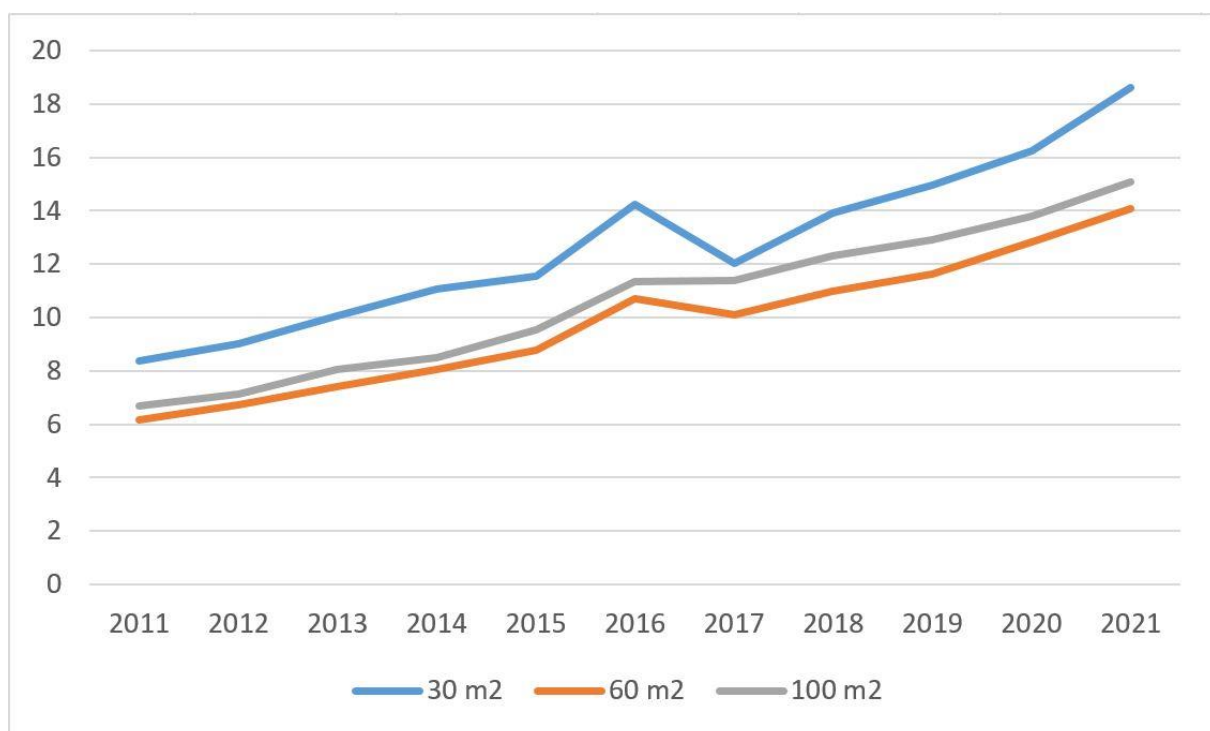


Figure 1. Newly Agreed Net-Rents per Square Meter in Berlin; Prices captured by an Online

⁵ See Arthur Sullivan, 'House Prices: 'Wall of money' hits European Real Estate' (*Deutsche Welle*, 3 June 2021) <<https://www.dw.com/en/house-prices-wall-of-money-hits-european-real-estate/a-57765308>> accessed 11 October 2021.

⁶ Wohnungsboerse, <<https://www.wohnungsboerse.net/mietspiegel-Berlin/2825>> accessed 11 October 2021.

Housing Platform (source: <https://www.wohnungsboerse.net/mietspiegel-Berlin/2825> accessed 11 October 2021).⁷

Existing rent contracts have not increased by the same amount, since the ex-post adjustments of rents is more difficult than agreeing upon higher rents for new leases from the beginning on. One reason is that once a lease is agreed, renegotiating rents with tenants bears transaction costs. While in principle, rent increases are possible,⁸ the tenant has to consent to the rent increase and the lease cannot be terminated if the tenant denies consent. In this case, the landlord has to sue the tenant, which is lengthy and costly. Besides that, there is federal rent regulation in place, which stipulates strict rules as to when a rent increase is allowed.⁹

PART 2. THE “RENT BRAKE” OF 2015

The German Civil Code (BGB) allows the 16 German states to stipulate special rent controls on a regional level if housing markets are deemed to be tight and rents supposedly unreasonably high.¹⁰ The law defines this to be the case, if (1) average local rents increase more than the federal average, (2) the average local rent load for households is significantly above national average, (3) there is an increase in population and new housing is not constructed, or (4) there is little vacancy meeting high demand. In such a situation, the states are entitled to pass a regulation that limits the allowed rent increase to a maximum of 10% of the average rent in a certain area.¹¹ Like many other cities, the Senate of Berlin made use of the possibility to

⁷ The price index is an aggregate of prices offered on an online platform for housing and hence solely captures the rents of new leases.

⁸ See BGB, sec. 557.

⁹ See BGB, sec. 557, para. 3, sec. 558-560.

¹⁰ See BGB, sec. 556d.

¹¹ See BGB, sec. 556d, para. 1.

implement such a “rent brake” and declared the city to be an area where housing markets were tight with effect from 1 June 2015. Consequently, a local rent index is continuously compiled to determine the allowed rent level for new leases. The rent index differentiates between size, neighborhood and age of the dwelling and is frequently updated. New leases are not allowed to exceed the index by 10%. The “rent brake” contains exceptions for housing that was first used and let after October 2014 and for leases subsequent to a modernization.¹²

		Historic Building		New Building					
Ready for Occupancy		until 1918	1919 - 1949	1950 - 1964	1965 - 1972	1973 - 1990 West	1973 - 1990 East	1991 - 2002	2003-2017
Size	Neighborhood								
up to below 40 m ²	simple	7,99 5,56 - 13,11	7,89 6,07 - 8,78	6,50 5,60 - 9,13	6,87 6,06 - 8,93	7,65 7,51 - 8,95	7,22 6,93 - 8,06		
	medium	8,52 6,79 - 12,37	7,74 6,51 - 8,64	6,93 5,71 - 9,15	6,64 5,95 - 8,33	7,82 5,39 - 8,25	7,01 6,52 - 7,31		
	good	11,57 6,61 - 14,39	7,58 6,51 - 9,58	7,55 6,43 - 9,41	9,00 8,24 - 9,86	8,40 7,55 - 10,20	7,21 6,77 - 8,83		
40 m ² -< 60 m ²	simple	6,82 5,32 - 10,05	6,47 5,48 - 8,28	6,07 5,44 - 8,09	5,94 5,11 - 7,09	7,54 6,27 - 8,75	6,08 5,78 - 6,62	8,45 7,79 - 10,31	11,74 9,81 - 15,28
	medium	7,51 5,47 - 10,36	6,81 5,69 - 7,85	6,18 5,45 - 7,72	6,05 5,49 - 7,02	7,82 6,43 - 8,87	6,02 5,46 - 6,77	8,27 7,51 - 9,27	9,96 7,36 - 12,64
	good	8,13 6,06 - 11,09	6,98 6,08 - 9,24	6,59 5,71 - 7,94	7,21 5,35 - 10,11	8,51 7,46 - 9,32	6,08 5,89 - 7,04	9,86 8,23 - 11,24	9,99 7,84 - 12,11
60 m ² -< 90 m ²	simple	6,40 4,88 - 10,11	5,93 5,12 - 7,35	5,64 4,88 - 6,88	5,51 4,94 - 6,15	7,35 6,15 - 9,10	5,33 5,04 - 5,79	7,80 6,30 - 8,68	13,03 8,58 - 14,99
	medium	6,84 4,89 - 10,11	6,31 5,15 - 7,40	6,07 5,34 - 7,16	5,77 5,14 - 6,47	8,09 5,76 - 9,21	5,33 4,65 - 5,82	7,99 6,80 - 9,13	10,20 9,01 - 12,33
	good	7,57 5,68 - 11,04	7,18 5,98 - 9,25	6,61 5,56 - 8,46	6,72 5,26 - 8,40	8,41 6,68 - 9,95	5,63 5,17 - 6,36	9,19 7,53 - 11,14	10,33 8,94 - 12,89
90 m ² and bigger	simple	6,30 4,84 - 9,24	6,20 5,20 - 7,24		5,53 4,94 - 6,12	7,27 5,89 - 8,37	5,29 4,83 - 5,54	8,05 6,71 - 9,42	12,08 8,61 - 13,92
	medium	6,84 4,93 - 9,91	6,08 5,16 - 8,60	6,84 5,68 - 11,54	5,46 5,12 - 6,21	7,72 6,04 - 8,76	5,31 4,66 - 5,62	8,28 7,29 - 9,64	10,19 8,90 - 12,87
	good	7,41 5,54 - 10,60	6,76 5,75 - 9,03	8,32 6,76 - 9,40	8,39 7,62 - 8,99	9,10 7,14 - 12,07	5,38 5,14 - 6,00	9,91 8,26 - 11,83	11,63 9,44 - 13,84

Figure 2. Rent Index 2021 with values as of 1 September 2020 (simplified translation on the basis of the Official Rent Index, available at

¹² See BGB, sec. 566f.

<<https://www.stadtentwicklung.berlin.de/wohnen/mietspiegel/de/download/Mietspiegeltabelle2021.pdf>>, accessed 11 October 2021).

The city of Berlin has prolonged the “rent brake”, that was initially put into place for only five years, on 19 May 2020 until 31 May 2025 notwithstanding many shortcomings of the law.¹³ Most interestingly, the rents in central Berlin increased by almost 10% pursuant to the introduction of the “rent brake”, while rent increases prior to the new legislation only ranged from 1% to 2%.¹⁴ One possible explanation could be that lessors were fearing to have their rents ceiled in the future and therefore, would need to hurry with a rent increase.¹⁵ Besides that, the 10% could function as a benchmark. Commercial landlords might even have been exposed to claims for damages from shareholders if they had waived a corresponding rent increase.

Other shortcoming of the “rent brake” were a lack of enforcement and many loopholes.¹⁶ While exemptions for housing constructed after 1 October 2014 and for renovated housing¹⁷ reasonably create incentives to construct and renovate living space, the latter may induce renovations solely for the purpose of rent increases. Furthermore, the rent brake does not apply to rents that were already above the permitted rent level before the introduction of the brake.¹⁸ Particularly expensive flats would hence not be covered by the brake. Besides that, landlords that charge higher rents have little to fear, as the rent brake was poorly enforced and

¹³ Ordinance on the permissible amount of rent at the start of the rental period pursuant to BGB, sec. 556d, para. 2 (Rent Limitation Ordinance) from May 19, 2020, Law and Ordinance Gazette 2020, p. 343 *et seq.*

¹⁴ Matt Steinglass, ‘Why Germany’s rent cap has failed’ *The Economist* (London, 15 June 2018).

¹⁵ With the Price Ceiling Act (PCA) of 2020 (see below), this should come true.

¹⁶ Matt Steinglass, ‘Why Germany’s rent cap has failed’, *The Economist* (London, 15 June 2018).

¹⁷ See BGB, sec. 566f.

¹⁸ See BGB, sec. 566, para. 1, s. 1.

new tenants were dependent on the landlord disclosing the previous rent level.¹⁹ Besides that, when potential tenants compete with sometimes hundreds of other applicants for housing, people would also accept higher rents.²⁰

Notwithstanding the negative experiences Berlin made with the regulation, the city headed to new shores in 2020, when it passed a price ceiling for rents.

PART 3. THE PRICE CEILING ACT OF 2020

The Senate of Berlin passed the Price Ceiling Act (PCA) on 11 February 2020 that went beyond the provisions of the “Rent Brake” of 2015.²¹ The act applied to housing space with the exemption of publicly funded residential constructions and housing constructed after 2013, sec. 1 PCA. According to sec. 3, rental rates exceeding the level validly agreed upon with effective date of 18 June 2019 were outlawed. Same accounted for graduated and index-linked rents, that are permissible according to federal law.²² To housing that has not been rented on this effective date in 2019 or that has been rented out first-time after the effective date, a complex price ceiling applied according to sec. 4, 6 and 7 of the PCA. The calculation for the permitted rent based on various factors such as the age of the housing, its amenities and its location within the city and hence took up criteria that were already applied in the “Rent Brake”-regulation of 2015.²³

¹⁹ Matt Steinglass, ‘Why Germany’s rent cap has failed’, *The Economist* (London, 15 June 2018).

²⁰ Julia Löhr, ‘Wege aus der Wohnungsmisere ‘ [Ways Out of the Housing Crisis], *Frankfurter Allgemeine Zeitung* (Frankfurt, 16 May 2020) <<https://www.faz.net/-gz7-abqme>> accessed 11 October 2021.

²¹ See Art. 1 of the Law updating the legislation on rent ceilings of February 11 2020, *Law and Ordinance Gazette* 2020, p. 50 *et seq.*

²² See BGB, sec. 557a and 557b.

²³ See *supra* ‘The “Rent Brake” of 2015’.

Central heating and private bathroom (some old buildings used to have jointly used facilities in the staircase) allowed for a higher rent per square meter²⁴. 'Modern equipment' such as an elevator which is accessible both from the flat and the building entrance without any threshold, a fitted kitchen, high-quality sanitary equipment, high-quality floor covering or a low level of energy consumption further allowed to increase the permitted rent by 1 € if at least three of the five criteria were met.²⁵ Equally, if the provided housing is in a building with no more than two flats, the permitted rent level increased by 10%.²⁶ Some modernization costs, such as spending on insulation, energy efficiency, the use of renewable energy, the installation of an elevator or spending to improve accessibility could also partially be apportioned to the tenants.²⁷

With the adoption of the PCA, Berlin significantly toughened its legislation on rent control. While the rent brake of 2015 has put a limit on rent increases, the PCA of 2020 completely abandoned them. Even though the act contained a provision for inflation adjustment, such adjustment was capped at 1.3% p.a. With current inflation expected to be at 4.1%²⁸, lessors would have realized a decrease in real rent.

The problems stipulated by the PCA are manifold. First of all, price ceilings are a heavy intervention in a price mechanism. This raises various economic concerns, that will be discussed below (*4. Economic Considerations*). But already the execution of the price ceiling regulation has raised doubts. The act burdened Berlin's administration with many responsibilities. Public supervisors were supposed to supervise compliance with the price

²⁴ PCA, sec. 6, para. 1.

²⁵ PCA, sec. 6, para. 3.

²⁶ PCA, sec. 6, para. 2.

²⁷ PCA, sec. 7.

²⁸ German Statistical Office, Press release No. 462 from 30 September 2021, <https://www.destatis.de/EN/Press/2021/09/PE21_462_611.html> accessed 11 October 2021.

ceiling regulations. They were entitled to take all measures necessary to execute the provisions of the PCA²⁹. With the rent brake of 2015 already having suffered from a lack of enforcement, the PCA was very optimistic regarding the capabilities of the city state's administration. Besides that, the PCA confined public authorities with large margins of discretion. For example, they were allowed to set rules according to which a residential area would qualify as 'ordinary', 'intermediary' or 'good', what was a high-quality sanitary equipment and which construction would still qualify as a 'built-in kitchen' according to the PCA. Such provisions are prone to cause litigation, misapplication, and arbitrariness.

Besides these practical questions regarding proper enforcement, there were legal doubts on the compliance of the PCA with German constitutional law. Opponents of the act saw a violation of the constitutional protection of private property which also allows owners to enjoy the fruits of their property, for example by collecting rent. However, it was the lack of legislative power that put an end to the PCA. The Federal Constitutional Court of Germany (BVerfG) ruled on 25 March 2021 that German states did not have the legislative power to introduce price ceilings for housing and declared the PCA to be unconstitutional and void.³⁰ In the field of tenancy law, German federal states only have legislative power if the federal level has not made use of its legislative power. However, the constitutional court ruled that with the provisions of the rent brake in sec. 566d BGB, the federal legislative body had exercised its legislative power which prevents any state legislation in this field. Questions regarding the compliance of the PCA's material provisions with constitutional rights was not addressed. Therefore, we don't know anything about the court's general stance on the constitutionality of

²⁹ PCA, sec. 5, para. 3.

³⁰ BVerfG, Order of the Second Senate of 25 March 2021 - 2 BvF 1/20 -, paras. 1-188, ECLI:DE:BVerfG:2021:fs20210325a.2bvfo00120.

a rent cap. However, notwithstanding constitutional concerns about rent caps, there is strong economic evidence against such regulation.

PART 4. ECONOMIC CONSIDERATIONS REGARDING RENT CONTROL

Interfering in a price-setting mechanism usually comes at high economic costs. Within price theory, maximum prices set by the government are a well-studied phenomenon and a textbook classic of microeconomics. Often, such regulation can have fatal consequences for the provision of goods. In this section, we discuss the economic effects caused by interfering with the price mechanism on demand, the citizens' mobility, workarounds and black markets, the landlords' incentives to invest and modernize housing, transaction costs and redistribution.

Excess Demand

A rent cap that is lower than the price determined in a market equilibrium will lead to excess demand in housing.³¹ Excess demand means that there will be more demand for housing than can be met by the supply. There will be potential tenants that can't get a hold on housing, even though they would be willing to pay a rent at least as high as the price ceiling. These persons would be willing to pay a price that suffices the rent demanded by the lessors, but due to the intervention, such mutually beneficial lease now cannot be agreed upon. Economists refer to the economic loss that is caused by such intervention as 'deadweight loss', which is a loss in economic efficiency and makes both lessors and lessees worse off. Due to the price intervention, some transactions will not occur, even though market participants would be willing to contract and such contract would be mutually beneficial.

³¹ David F. Friedman, *Price Theory* (first published 1986, 3rd ed., South-Western Publishing 2019) 399.

The excess demand in housing has two reasons: An increase in demand due to lower rents with a simultaneous decrease in housing being offered. With price ceilings in place, the payments of renting out living space for landlords will decrease. This has been the case in Berlin when lessors faced a sudden and unexpected reduction in rent payments. In some cases, such loss of rent may jeopardize investment plans of lessors, who have financed the housing with bank loans and then have to reschedule their investment plans. Price theory predicts that with lower rents, the amount of housing offered would decrease.³² Flats will be taken from the market, as some lessors are not willing to supply their housing for a lower price. Such apartments may be used for private purposes, left idle or be sold as condominiums. These consequences have been witnessed in Berlin, too. The number of condominiums that were offered on the market and built prior to 2014 and which thus have been subject to the rent cap decreased by 45%. At the same time, the supply of private condominiums for sale that were built prior to 2014 increased by 40%.³³ Hence, we can see that the rent cap that was supposed to protect tenants, was hurting new tenants and those that were planning to relocate within the city.

Besides a reduction in supply, we would expect an increase in demand caused by the price ceiling. The rent cap reduces the price for housing and hence, the demand will rise accordingly.³⁴ In the absence of price control mechanisms, rents would be higher in Berlin and induce some tenants to move to cheaper suburbs and commute to the city center for work.

³² According to the law of supply, the quantity supplied of a certain good will decrease as the price of that good decreases.

³³ Julia Löhr, 'Der Deckel wird zum Mieter-Horror' [The Cap Becomes A Tenant Horror], Frankfurter Allgemeine Zeitung (Frankfurt, 29 July 2020) <<https://www.faz.net/-gqe-aiyto>> accessed 11 October 2021.

³⁴ According to the law of demand, the quantity demanded of a certain good will increase as the price of that good decreases.

However, with price ceilings in place, tenants have no incentive to look for housing elsewhere and want to stay in the city as housing, once rented, remains affordable. As a result, with a maximum price in place, there will be an over demand for cheap housing, attracting more people to the city, which further puts pressure on the market. Instead, in the absence of rent controls, high market prices for central housing in Berlin would properly signal the scarcity of central living space and induce tenants to extend their search for housing to the suburbs. The decrease in supply combined with an increase in demand leads to a large excess demand in housing.

Reduction of Mobility

Rent caps reduce a society's mobility. At first, it is mainly newcomers that suffer from a maximum rent in place as they face a shortage of free apartments, while tenants that already rent a price-controlled apartment initially profit from a cheaper rent. However, the price regulation significantly reduces the mobility of tenants. With a cheap flat in possession, tenants are less likely to relocate within the city, even if they find a new job at the other end of the town and commuting lengthens. "If rent control remains in effect for a long time, where people live becomes determined more and more by where they used to live and less and less by where (size and location of apartment) it is now appropriate for them to live".³⁵ Tenants would accept longer commutes within the city in order to keep their cheap rent-controlled apartment. If rents were at market prices, tenants would find a new apartment closer to their new work, but with rent control in place, tenants will stick to the cheap apartment in possession as they will not find equally affordable housing elsewhere. Therefore, rent controls don't only lead to

³⁵ David F. Friedman, *Price Theory* (first published 1986, 3rd ed., South-Western Publishing 2019) 399.

distributional effects from landlords to tenants, but also cause allocational inefficiencies, which make some people worse off without making anybody else better off.³⁶

Workarounds and Black Markets

Whenever there are market equilibriums that are prohibited by law, we can see workarounds. Such workarounds jeopardize the success of a certain policy and cause costs of circumvention.³⁷ The lawmaker has to consider the likelihood of workarounds and should refrain from stipulating legislation that can too easily be circumvented.

One potential circumvention would be that tenants sublet their downtown apartment and charge a sublease according to market prices. According to the German Civil Code, tenants are not allowed to sublet their apartments without the permission of the lessor.³⁸ However, in practice it is sometimes difficult to control who's living where, especially when people share an apartment and there is a constant change of tenants. In order to minimize own efforts, landlords often allow a main tenant to share her apartment and sublet individual rooms of a flat. If the main tenant pays the monthly rent in due course, the landlord has little incentive to control whether subleases are too high. In such a situation, it will be difficult for the owner to obtain information on the height of the sub rent. As a result, subletting tenants would benefit at the expense of the landlord.

A price ceiling can also be circumvented if lessor and tenant agree upon an illegal surcharge to the legally allowed rent that may be paid in cash.³⁹ With a shortage of housing

³⁶ David F. Friedman, *Price Theory* (first published 1986, 3rd ed., South-Western Publishing 2019) 399.

³⁷ Costs of circumvention are inefficient, because 'they don't make the pie bigger', and hence solely represent an economic loss.

³⁸ See BGB, sec. 540.

³⁹ A tool that largely found application in Berlin for new leases was the specification of so-called "shadow rents", a higher than allowed rent that was meant to apply for the eventuality that the German

under the price ceiling, and a substantial share of tenants having a higher willingness to pay, such practice is likely to occur. Especially since housing is scarce and hence, there is a supplier market, such side payments are what one would expect when “law is in action”. For obvious reasons, it is difficult to estimate how severely Berlin’s rent cap induced illegal side payments. Besides that, in situations where the landlord has means to terminate a lease, for example, because the lease is limited, tenants have little incentive to enforce a lower rent and risk a non-extension.

Another way to work around the price ceiling provisions is to rent out real estate as commercial leases as the price ceiling is not applicable for commercial use. Even though the municipality would need to approve the conversion of housing to commercial use, such approach was common following the enactment of the PCA and with an overstressed administration also difficult to monitor.

A further approach addressed before is to convert leased out housing into condominiums. When selling a condominium, there is no cap on the purchase price. Accordingly, house owners can use this strategy to reap off some of the market value of central housing in Berlin. As we have seen, the market responded to the introduction of the PCA with an increase in condominiums. However, such circumvention comes at a cost: Lessors were ousted out of the housing market, even though they intended to be lessors in first place and

Constitutional Court finds the PCA to violate constitutional law. There is no case law yet as to whether such shadow-rents now find application, since the PSA was found illegal by the Constitutional Court, but about 90% of new leases had provisions for a shadow rent, see Max Baumgart and Felix Mansius, ‘Berliner Mietendeckel gekippt – Was heißt das für Schattenmieten?’ [Berlin’s Rent Cap Void – What Are The Consequences for Shadow Rents?], (Legal Tribune Online, 23 April 2021) <<https://www.lto.de/recht/hintergruende/h/mietendeckel-bverfg-gekippt-rechtslage-ansprueche-schattenmiete-rueckzahlung/>> accessed 11 October 2021. The PCA has thus not only lead to an increase in transaction costs, but also unsettled both lessors and tenants.

hence would have preferred to receive a monthly income rather than a lump sum payment. Especially when an individual has invested in housing for the purpose of old-age provision, a cut in rents means less available income and hence can trigger him to sell off their property. As a result, we have witnessed a decrease in housing in Berlin following the enactment of the PCA, which has further put the market under pressure.

At the same time, some tenants were induced to buy a flat even though they would have preferred to rent one in the first place. As the transfer of real estate in Germany involves large transaction costs of roughly 12% for land transfer tax, brokers, notary and administrative fees for the land registry, the conversion of flats to condominiums comes at a cost and is likely to hamper mobility of former tenants.

Other workaround mechanisms are to rent out furnished flats, which would allow to levy a surcharge. Flats would be equipped with furniture in order to allow for a higher rent. Such circumvention would also come at a cost: Desperate tenants would be inclined to rent a furnished flat, without actual need for furniture. The furniture would simply serve as a workaround mechanism for the rent cap.

Negative Incentive for Maintenance and Construction

A common and widely confirmed side effect of rent control that are in place for a long time is that landlords have no incentive to invest in maintenance. In an unregulated market, the landlord can invest in the house and then reap off the fruits of improvements and repairs by asking for a higher rent. Instead, when the rent is ceiled, the landlord has nothing to gain from investments and hence, will not pursue any. While initially, the tenants will not recognize such side effects, the longer rent control remains in power, the more severe its consequences. Since the PCA has been judged void, the negative consequences of poor maintenance and a lack of

repairs has not been witnessed yet. However, rent control regimes in other countries have had these side effects. For example, New York City and Mumbai introduced rent control regimes.

Both have witnessed poor maintenance and a deterioration of housing quality.⁴⁰

However, rent control doesn't only eliminate incentives for maintenance. Also, it reduces incentives to construct new dwellings. Even though the PSA wasn't applied to housing built after 1 October 2014, price ceilings disincentivize the construction of new dwellings as investors fear future rent caps or other restrictive regulations. In a city, where rents are being ceiled, and public opinion is 'hostile' towards investors, there is little incentive for project sponsors to provide for more housing. This effect could be observed in Berlin, where new dwellings were down by 16.8% from January-September 2020 compared to the same time in 2019.

Increase in Transaction Costs

A further side effect of the PCA is its effect on transaction costs. Besides the inefficiencies caused by circumvention tactics, the act creates uncertainty regarding the 'correct' level of rent. The regulation creates legal uncertainty and would have likely caused litigation as to which improvements and modernizations would justify a rent increase. But while such standards could be provided by the courts in medium-term, enforcement of the provisions stipulated by the PCA would have caused significantly higher enforcement and surveillance costs. In a city that seems overstrained with the provision of common municipal services, further public duties might have overwhelmed it even more.

⁴⁰ For Mumbai, cf. Nergish Sunavala, 'Heritage crumbles as crippling Rent Control Act turns 100' The Times of India (27 June 2018) <<https://timesofindia.indiatimes.com/city/mumbai/heritage-crumbles-as-crippling-rent-control-act-turns-100/articleshow/64755496.cms>> accessed 11 October 2021.

Redistributional Effects

Besides the allocative inefficiencies, rent control regulation also has redistributional effects. It redistributes from landlords to tenants: If tenants must pay a lower rent than what would be the result of a market equilibrium, tenants save on rent and landlords lose. While the regulation created windfall gains for tenants, incomes for landlords suddenly decreased. Such loss doesn't always hit large real estate tycoons with portfolios all over the world, but also many middleclass landlords as well as housing cooperatives. While first mentioned may face a loss of retirement annuity, the latter have less funds to provide for more housing and the modernization of existing dwellings, which further decreases the supply of housing.

Also, the rent ceiling disproportionately benefits current tenants, while new inhabitants of the city face significantly larger burdens when looking for a place to live. While it is plausible from a political economy perspective to make policy for residents, such legislation is exclusionary towards potential future resident. All this considered, price ceilings seem to be a rather antiquated tool to tackle pressure on the housing market and, while causing large inefficiencies, also don't provide for a single additional dwelling being built.

Potential Alternatives

When the German Constitutional Court ruled in April 2021 the PCA to be void, Berlin fell back to the rent brake of 2015 as the sole rent controlling regulation in place. Nevertheless, there are various alternatives to stipulate for the construction of new housing within the city.

First of all, the municipality needs to provide more building plots. Berlin is full of fallow land. Owners have to be identified and given incentives to build on such plots. Publicly owned land can be sold off to investors under the condition that affordable housing shall be provided. Fastening approval procedures and getting rid of red tape when granting building permissions

can also stipulate the construction of new housing. This may also include the easing of official building requirements that make construction more expensive and can impede the space-saving exploitation of building plots.⁴¹ Besides that, public administration is often understaffed and sometimes, authorities rather work against each other than together.⁴²

Construction activity can also be enhanced by using existing tools of the German Building Code (BauGB). Sec. 176 BauGB allows municipalities to oblige the owner of a building plot to pursue construction activities under certain criteria. Even though such obligation is also a severe intervention in private ownership, it leastwise leads to an increase in housing. Furthermore, when granting building permits to investors, the municipality can require the project sponsor to provide a certain share of affordable housing for low-income residents.

Another way to provide for more affordable housing is when the municipality engages in construction activities. Even though public investment activities bring about their own problems, some municipalities have been successful with the public construction of housing. Efficiency losses associated with public undertakings can potentially be overcome with private contractors. However, all these measures require the municipality to take a more active role in building policy and to deal with local action groups and local politicians that may oppose the inflow of new residents.

And in the end, it will not be inevitable that rent levels in downtown Berlin increase. Even though rents have increased sharply during the last decade, the level is still behind other

⁴¹ See Nicolas Katzung, 'Auf was es bei der Regulierung des Wohnungsmarktes ankommt' [What Matters in the Regulation of the Housing Market], Handelsblatt (Düsseldorf, 25 June 2021) with reference to Lars Feld <https://www.handelsblatt.com/inside/real_estate/mietrecht-auf-was-es-bei-der-regulierung-des-wohnungsmarkts-ankommt/27360032.html> accessed 11 October 2021.

⁴² Julia Löhr, 'Wege aus der Wohnungsmisere' [Ways Out of the Housing Crisis], Frankfurter Allgemeine Zeitung (Frankfurt, 16 May 2020) <<https://www.faz.net/-gz7-abqme>> accessed 11 October 2021.

major cities. As Berlin increasingly attracts more inhabitants, the rent level is likely to continue its surge. Such price reactions may not necessarily be bad, as the supply of housing is limited and higher prices impede the influx of ever more people. This makes suburban regions more attractive. For example, rising prices in Berlin can lead to population influx to the State of Brandenburg that surrounds the capital and has been troubled with a decrease of inhabitants, aging population, and concomitant housing vacancies during the last post-socialist decades.

CONCLUSION

Affordable housing is of major concern in metropolitan regions worldwide. While the influx of new residents often was halted during the pandemic, large metropolitan areas remain highly attractive for many. With interests being on a very low level around the globe, property markets worldwide are booming and rent levels are on the rise. While some things can be done to keep housing affordable, price ceilings don't count as an effective tool to tackle rent increases. Rent caps lead to fewer housing being built, sold and maintained, and also harm the tenants in the mid-term. Therefore, rent control is an antiquated measure of urban planning. Instead, municipalities need to provide an attractive framework to stipulate private investments in construction⁴³ and think about engaging in constructing activities themselves if they want to provide for cheap housing.

⁴³ With the citizen initiative to expropriate real estate groups with more than 3,000 condominiums in Berlin, the city is sending contrary signals to potential investors. In the referendum which took place on 27 September 2021, 56.4 % of the participants voted in support of the expropriation. However, the referendum is not binding for the Senate.