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**Article — Manuscript Version (Preprint)**

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Wirtschaftsdienst

*Suggested Citation:* Hiller, Norbert; Schultewolter, Daniel (2014) : Quo vadis German Housing Policy?, Wirtschaftsdienst, Springer, Berlin, Vol. 94, Iss. 1, pp. 34-40, <https://doi.org/10.1007/s10273-014-1622-9>, <http://link.springer.com/article/10.1007/s10273-014-1622-9>

This Version is available at:

<https://hdl.handle.net/10419/101445>

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## Quo vadis German Housing Policy?

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Received: 25 November 2013 / Accepted: 9 January 2014

**Abstract** The massive increase of real estate prices in some regions of Germany is a direct consequence of the ongoing financial and debt crisis. Low interest rates and high inflation expectations increase the demand for real estate. In addition to a potential price bubble risk, social problems arouse more and more public interest. Currently, many tenants are facing significant rent increases. Thus, the shortage of housing dominates current housing policy discussions. The so-called “package for affordable building and living” includes stricter rent controls and other economic policy interventions which aim to ease the situation in the real estate market, but the interventions have the opposite effect.

**Keywords:** Housing Policy; Rent Control; Regulation Policies

**JEL:** R31, R32, R38

### 1 Introduction

The tremendous increase in the price of real estate within a few particular regions in Germany is an immediate result of the past and still present financial market crisis and debt crisis (SVR 2013). This is due to the European Central Bank’s expansive monetary policy, which has, for two reasons, had a lasting impact: On the one hand, with the policy of a persistently low interest rate, inflation expectations are rising and, along with this, the fear of a future devaluation in financial assets. Therefore, many investors have focused on other real assets, including securities and real estate. On the other hand, the present moderate credit

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conditions are encouraging people to retreat into real estate to find value. High demand and slowly reacting supply have led to corresponding price reactions on the real estate market causing prices to rise.

In addition to the possible risk of a price bubble, social problems are arousing public interest as well. Almost one-third of a private household's total income was spent on living costs in 2011 (SVR 2013). Increasing rental costs pose a major challenge particularly to those households with low income. Presently, many renters are being confronted with considerable rent increases. Consequently, in a few large cities there is a difference between rental quotes and the customary comparable rental prices of approximately 23% (BBSR 2013). This has led to social unrest; for example, in September 2013 demonstrations arose in Hamburg und Berlin capturing media attention. Because of these developments issues relating to the housing shortage dominated those coalition discussions between the CDU/CSU and the SPD. As a result, five measures in the "package for affordable building and living" are planned:

1. Increasing the "rent price control,"
2. Reintroducing degressive depreciation,
3. Expanding public housing,
4. Increase the housing subsidy,
5. Passing on real estate agent costs according to the polluter pays principle.

A few of these instruments will be "easy" to obtain but will of course require a corresponding change in the law. Others, on the other hand, are, from a legal standpoint, anything but indisputable and would perhaps have to be financed through considerable tax revenues.

## **2 Is Market Intervention Justified?**

In a functioning market price serves as a signal of scarcity. For example, when the price is high, this is normally reflected in a smaller supply, or, alternatively, a higher demand for the goods being merchandised. In the real estate market rental prices indicate where and when housing is especially, or only slightly scarce. Prices can only fairly correspond to their tax- and information function, when they are subject to no government regulation (Eekhoff 2002). An intervention into the market is only justified if and when the market is determined by indivisibilities (natural monopoly), external effects, asymmetric of information, public goods or

adjustment shortcomings. In these situations the market mechanisms render no welfare enhancing results.

Regulating intervention into the real estate market can only be absolutely justified on the basis of adjustment shortcomings. If supply adjusts in a temporally delayed manner, then expectation can lead to price overreactions. Because of herd mentality and speculative transactions such adjustments ultimately result in a price bubble whose burst causes significant macroeconomic costs. Such negative developments can be identified early by employing representative inquiries of households about possible real estate price expectations (Case and Shiller 2003). Furthermore, how real estate prices develop should coincide with the development of those fundamental pieces of data influencing the prices. Typical price-to-rent- and price-to-income relations are normally complemented through econometric analyses. Demand- (for example, income, demography, and interest rate trend) and supply determinants (for example, inventory change, building costs) provide therefore an accurate explanation of the real estate price. If determining factors play only a secondary role in correct model specifications, then it is safe to assume a negative development in the real estate market. Consistent prices can as well contain a price bubble, in so far as the fundamental data speak for much lower price levels. According to the Council of Experts (SVR 2013) and the Bundesbank (2013), we cannot presently expect any macroeconomic negative developments in the German housing market. Nevertheless, both studies point to fundamentally unfounded price dynamics in specific regions. An de Meulen and Micheli (2013), in their analysis, have come to the conclusion that, only in the segment concerning the sale of existing housing in individual metropolitan regions, unsustainable price developments exist. Such price exaggerations could fundamentally be countered through the establishment of a local maximum price (Fritsch, Wein and Ewers 2005). However, a confirmation of negative developments is urgently needed.

From the perspective of new institutional economics a price boundary in rental contracts could definitely be meaningful. Changing location is always connected with costs for both tenants and landlords, be they material costs, which incur when either moving or renting again, or immaterial costs, like leaving a familiar environment. Frequently, those costs incurred by the tenant exceed those of the landlord. These differences can be corrected through corresponding increases in rent (“Hold-Up-Problem”). Introducing rent control can lead to a higher level of welfare, in so far as long-term predictable rental development can be guaranteed to the market players (Raess and von Ungern-Sternberg 2002). Transaction costs are

lowered and the result is an increase in the number of signed contracts.

Reversing the situation, one could speak just as easily of a “Hold-Up-Problem” if the state were to limit the yield potential of possible investments. When a supplier builds real estate, he calculates rental income into the sum total of his investment. When the state reduces this rental income through legal regulation, it essentially siphons off “votes” at the cost of “budgeting security” and foments uncertainty in the real estate market. This leads to an increase in transaction costs, which is why investors in such circumstances pull themselves out of the market. To summarize, politics should only ‘tentatively’ intervene into the market with institutional measures, while always focusing on creating planning certainty for both the consumers and producers of living space. This corresponds, at its base, to the ordoliberal idea of the “constancy of economic policy” (Eucken 1952).

### **3 Rent Price Control**

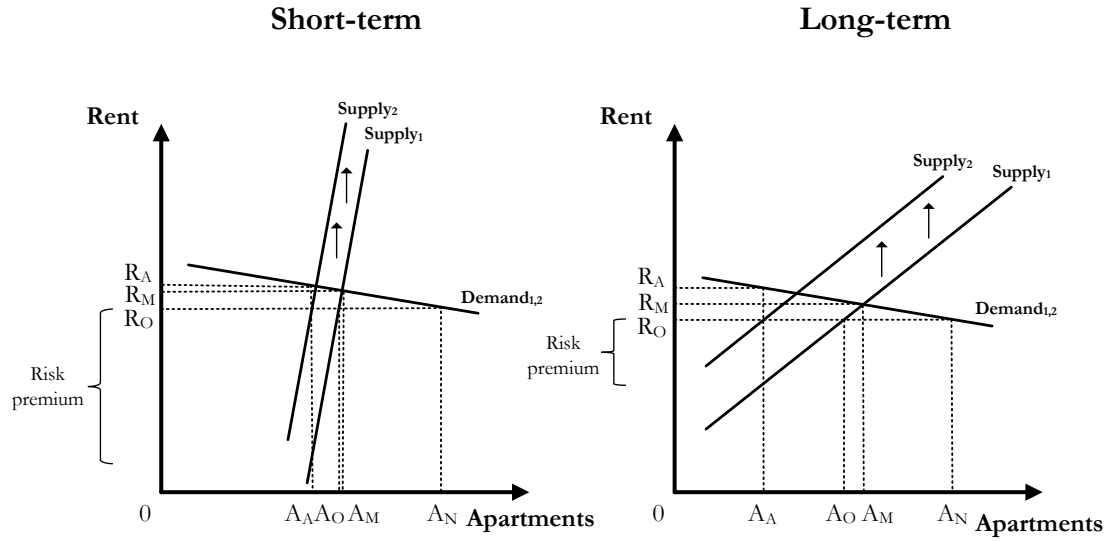
Such considerations are initially secondary in political practice. In times of housing shortage quick, and at first glance beneficial actions are required. What is therefore easier than to diminish rent increase by instating legal regulation? In this manner, renters and, along with them, approximately 50% of the voting population is protected.<sup>2</sup> Pursuant to the coalition negotiations, rents for relets (i.e. property intended to be rented again) should, in regions with strained housing markets, be limited to 10% above the comparable rents customary within the area. In existing rental relationships rent may at the most increase by 15% in four years (3.75% per year). Up until now this has only been the case for a period of three years with a maximum increase in rent of 20% (SPD 2013). Exceptions include rental price increases on the basis of modernization measures. For this reason German housing policy continues its trajectory of increasingly strict rental price regulation.

Rent control frequently revolves around the application of classic rent growth control (Turner and Malpezzi 2003). Maximally achieved rent or, alternatively, yield is thereby subject to a limit, of which we will speak of as a rental price upper limit in what follows. The economic effect of a government-instated rent control can be illustrated with a simple supply and demand diagram (Figure 1). Evident is the difference between a short and long period. In the long period supply reacts stronger to demand, whereby elasticity increases. The distances and displacements

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<sup>2</sup> According to the Destatis (2011), over 50% of all households are tenants.

are intentionally overdrawn, in order to better clarify the impacting mechanisms. Differences regarding price and quantity should therefore not be over-interpreted. The risk premium is, in the left depiction, visually much higher than in the right illustration. In order to be able to represent corresponding effects, the left depiction is to be understood as a “zoomed” view. Correspondingly, the scales of the axes change, and thereby the representation of the risk premium as well. The following argumentation can be applied to not only the short period but also the long one, by which the financial and quantitative differences prevail in the long-term.



**Figure 1.** Short- and long-term effects of rent control

At the initial point, supply and demand meet each other at rent level  $R_M$  and the supplied housing quantity  $A_M$ . By introducing a legal rent control the rent level is lowered from  $R_M$  to  $R_O$ . Consequently, investors have to be satisfied with a lower yield, which in turn curtails the attractiveness of investments in real estate. Price loses its function, which typically conforms to market circumstances, as a signal of scarcity. Other capital investments (like, for example, securities) become enticing as they offer higher interest, which is why efficient suppliers above all pull themselves out of the real estate market. In the long-term this leads to a reduction in the number of available housing from  $A_M$  to  $A_O$ .

The state stopped the price increase, but at the costs of lower housing supply in the immediate term. However, this will not continue, because market players react dynamically to changed circumstances. On the basis of their experiences investors fear further interventions and factor these in as risk premium (Eekhoff 2002).

Consequently, suppliers expect generally higher rent for their housing, whereby the supply curve shifts upwards on the basis of the premium. In the long term suppliers will offer, instead of the quantity  $A_O$ , only the quantity  $A_A$ . To summarize, the quantity of supplied housing will therefore shrink from  $A_M$  over  $A_O$  to  $A_A$  and will be supplied at a price of  $R_O$ .

Determined by the generally lower rent, households are in a better position to demand more living space. The demand quantity is extended to  $A_N$ . Aware of scarcity, market players “hoard” living space: whoever has a large apartment tries to keep this (Hubert 2008). Greater demand stands in stark contrast to an ever-decreasing amount of supply. This affects, above all, socially weaker households with lower income that, on the basis of their personal characteristics, can hardly find adequate housing (Eekhoff 2002). Rent control is thereby, from a socio-political perspective, rarely accurate (Arnott 1999). Transaction costs (for example, searching and information costs) grow ever greater (Turner and Malpezzi 2003) and the frequency of changing location is reduced.<sup>3</sup> Of course, there are those who do profit. Those households that have housing and do not have to move are favored. Scarcer living space is increasingly appropriated through other mechanisms, for example through personal relationship or indirect payments in the form of higher transfer fees for furniture existing within the housing (SVR 2013). Paradoxically, the state will therefore accomplish the opposite of that which it actually wants to counteract: rent control increases housing shortage, especially for socially weak households.

For investors there are sufficient possibilities to increase yield. One could, for example, increase revenue through installment payments for an already present, built-in kitchen or for preexisting parquet floors. The expenditure side can be diminished through a reduction of the building quality or maintenance (McDonald and McMillen 2011). Moreover, investors could transform their rental property into privately owned housing and sell it, in order to ultimately avoid regulatory controls. Through price intervention the present value of rental property will sink, while the sale price of privately owned housing remains unaffected. The investment decision is made to benefit the home ownership market (Voigtländer 2013). In order to counteract this development, the legislator would have to once again intervene institutionally. Regulation induces repeated regulation, which leads to partly undesired market reactions that again demand regulations.

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<sup>3</sup> Following Arnott (1999), the lower mobility also affects the labor market in a negative way.

But, the powers of the market cannot be stopped – price intervention is “cured” by a quantity correction. Other solutions substitute the price mechanism, in order to bring together producer (supplier) and consumer (demander). Ultimately, the willingness to pay is no longer the decisive factor, which, from the political perspective, is momentarily desired. Instead, a “black market,” with mechanisms including personal relationships and compensation payments, will make for a market correction. This leads in the immediate term to disadvantages for all participants.

#### **4 Empirical Problems**

Theoretical considerations have to be tested by empirical analyses and, when possible, confirmed. Turner and Malpezzi (2003) offer an overview of the analyses of public rent controls in various cities and countries. Nevertheless, the empirical results must be observed critically. Numerous reasons complicate the measurement of rent price intervention.

In an “ideal world” one would compare two regions as homogenous as possible. In region A the powers of the free market unfold, whereas in region B a rent control is introduced. The effect of price intervention on supply, mobility, or maintenance can be measured and the theory either supported or refuted. The economic costs of regulatory intervention result then from the differences between the measured amounts.

Nevertheless, it is quite difficult to find homogenous regions. Thus, local demand- and supply determinants appear in varying degrees. Moreover, a regionally specific real estate price cycle can exist and may falsify the results. Those socially weak individuals looking for housing travel from region B into region A, because tenants in region B, on the basis of their lower mobility (the “hoarding” of living space), remain in their housing. This is the case because tenants in region B have already calculated into their transaction costs the difficult task of looking for new housing accommodations. In the long-term both regions are inhabited by socially divergent groups of tenants. Region A will exhibit more new construction, which leads on average to lower maintenance costs. Supply will react only in the long-term to the decline in yield. A longer time period of observation is therefore urgently necessary. Only then will the effects of price intervention accumulate into a measurable value. Aside from economic and monetary policy influences, further regulatory measures



suggested and adopted by policy makers have to be filtered out, in order to isolate the effects of price control.

That a price ceiling has a negative influence on housing supply is beyond question. What is of decisive significance is how high the loss of dependence on the economic, social and institutional circumstances is. Referring to rent price limits, Arnott (1999) draws a simple, but appropriate conclusion: to measure the effects of rent price limit would be like someone wanting to understand a whisper on the other side of a frequently traveled street. On the foundation of a very good data basis the noise could, in the best possible scenario, be reduced to only a tolerable degree.

Hence, price intervention should be carried out very cautiously. Increasing to raise the rent control can only be a temporary, regionally limited solution. The effects are fatal, if rent prices are, in the long term, unable to send the correct scarcity signals to the market. Furthermore, they are not able to keep pace with sales prices. The rental housing market will in the long run become less important.

## **5 Further Results**

### *Re-introduction of Degressive Depreciation*

In order to increase housing supply, tax reliefs for housing construction are being discussed. For this reason, degressive depreciation, abolished initially in 2006, should be introduced again for newly built rental housing. Accordingly, investors would, at the commencement of depreciation, be able to claim as taxable a higher portion of their expenditures than would correspond to the economic depreciation in value. Because there is the possibility of tax-free divestitures of real estate in private wealth, tax benefits could be obtained through well-timed intermediate sales. Particularly after an intermediate sale of acquisition value is amortized, the cumulative taxable write-down frequently amounts to over 100% (Eekhoff 2002). Overall, regulation would create significant incentives for investments in housing construction. Undoubtedly, the financial situation of the public budget would be strained, if the degressive depreciation for rental housing introduced in 2006 were abolished with the goal of gaining financial opportunities and deleveraging the national budget. The grand coalition governing at that time considered the tax subsidy no longer tenable, because the housing provision in Germany was well above the actual need (CDU/CSU 2005).

### *Expansion of Public Housing*

In coalition negotiations it was decided that the financial means for urban development funding should be bulked up to 700 million EUR. A revitalization of public housing is especially popular during housing shortages. Nevertheless, experience shows that using the instrument of a so-called supply-side subsidy offers, from a social-political perspective, little effectiveness and should therefore be rejected (SVR 2013). Eekhoff (2002) introduces numerous problems connected to public housing: for example, an insufficient principle of equal treatment; no systematic testing of need; a tremendous strain on building capacity that is lacking in other places; a high degree of social polarization. Through locally concentrated public housing the danger of segregation exists. In social hot spots unrest can occur on the basis of economies of scale (in the negative sense) (Glaeser and Sacerdote 1999, Pan Ké Shon 2010). For this reason, a frequently observed project is the “just land use” in Munich. It obliges investors to make 30% of newly created residential areas available to people with an especially high need for housing. A social “mixing together” of neighborhoods obviates corresponding segregation tendencies. This initiative nevertheless requires scientific evaluation (SVR 2013).

### *Increasing the Housing Subsidy*

For the reasons mentioned it is necessary to reject a supply-side subsidy. A supply-side subsidy in the form of a housing subsidy is, however, possible as an alternative. Contrary to the instrument of public housing the housing subsidy represents a government transfer payment that households receive up to a specified income level. In this way, those receiving a housing subsidy are able to rent, in spite of lower income, qualitatively high-value housing. Therefore, from a social-political standpoint this instrument is very accurate (Eekhoff 2002). When the heating cost subsidy, which had been abolished in 2011, returned, the housing subsidy was de facto increased. The resulting rise in income leads to an increase in demand, by which rent prices rise in the short term. Nevertheless, housing supply is increased in the long-term through this stimulation of demand, in so far as market forces are able to freely develop and supply is not subject to government regulation.

Compared to the housing subsidy, public housing has a direct effect on housing supply. Which measure is more efficient? On the basis of the poorer social-political

effectiveness and the inefficiencies of public housing, increasing the housing subsidy is the preferred option. This is conditioned on the fact that the channels of influence between supply and demand remain free from regulatory intervention. The housing subsidy should be frequently readjusted to the development of rental prices as well as regionally differentiated (SVR 2013 and Eekhoff 2002).

#### *Passing on Real Estate Agent Costs According to the Causative Principle*

Generally, real estate agents reduce the transaction costs of rental contracts, by incurring the searching and information costs of tenants, resp. landlords, and lower these costs through their expertise. Dependent on the market situation the tenant or the landlord pays the finder's fee. The scarcer the housing supply the earlier the real estate costs are shifted to the tenant. At relatively high housing supply the connection reverses: potential tenants are no longer dependent on the services of a real estate agent, which is why the landlord carries the costs. For this reason, it is not surprising that, in strained rental housing markets with higher demand and lower supply, tenants finance the services of the real estate agents. Those with relatively low income searching for housing suffer to a particularly high degree under these circumstances. Landlords, on the contrary, do not have to expect any losses, because they are able to rent their housing, on the basis of the market situation under the conditions defined by them, without a problem.

With an introduction of the causative principle, landlords, in strained real estate markets, would then have to carry the real estate agent costs. Because homeowners tend to be wealthier, it is precisely those socially weak individuals looking for housing who are relieved and, in turn, the wealthy are burdened. Institutional intervention thereby causes a redistribution of the transaction costs. Nevertheless, landlords are able to offset the increased costs by raising the rent. In so far as this were not possible on the basis of a rent price ceiling, the costs would lead to a decline in the landlord's yield and reduce, in the long term, investments and housing supply. The connections described above will be increased and alternative price mechanisms will be employed.

Overall, competition between real estate agents will increase, which, for efficiency reasons, is thoroughly desired. In the long term, prevailing in the market will be those real estate agents who, through their expertise, are able to significantly lower transaction costs for tenants and landlords. From a macroeconomic perspective this would be quite welcome.

### *The Paradox of Political Stakeholders*

The interests of tenants and landlords are represented in Germany, among others, by two organizations: The “Mieterbund” (Tenant side) and “Haus & Grund” (Landlord, or Owner side). Traditionally, landlords welcome measures that increase investment yields. For this to occur there must be fewer price regulations (free price formation), support measures (subsidies, tax reliefs), as well as lower transaction costs (in order to promote acquisition of ownership). Alternatively, the tenant side represents the other position. It would like to increase “yields” of its members through affordable rent (limited free price formation), support measures (housing subsidy), as well as lower transaction costs (real estate agents costs are carried by those who cause them). Correspondingly, stakeholders on both sides welcome and criticize policy measures.

From a short-term perspective it appears plausible that rent control will be greeted by stakeholders representing tenants and rejected by stakeholders representing landlords, because this measure limits an increase in living costs for tenants and curtails landlords’ profits. On this basis suppliers will increasingly transform their rental housing into privately owned housing and then offer to sell it. Intervention into the rental housing market will consequently lead to higher rates of home ownership. Over time the relationship of submarkets will shift: the importance of the rental housing market will sink, while the significance of the home ownership market will rise. This appears from a long-term perspective paradoxical, in that the tenant side calls for rent control, while the measure itself serves to counteract the tenant interest in a significant and substantial rental housing market.

According to coalition negotiations, tenants (both inhabitants as well as those searching for housing) should be protected from dramatic rent increases. Based on those arguments just introduced, those socially weak individuals searching for housing are most effected by public rent control. According to a member survey of the Tenants’ Association, 1.2% of those questioned stated that it was the search for housing that served as their motivation for joining the association.<sup>4</sup> Consequently, it is not surprising that the effects of rent control on housing supply and the corresponding intensification of the market situation for those searching for housing do not serve as important topics for the Tenants’ Association.

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<sup>4</sup> Multiple answers are possible (Mieterbund 2004).

The German rental housing market has been regarded up until now as quite functional, because excessive interventions in rental price were initiated in a relatively modest manner (Voigtländer 2006). Consequently, the relationship between the private ownership market and the rental housing market was appropriately balanced. In his study on the economic significance of a high rate of home ownership, Voigtländer (2006) comes to the conclusion that citizens obtain a maximum degree of freedom of choice only through a balanced relationship between the private ownership market and the rental housing market. From a macroeconomic perspective there is no reason to institutionally prefer a submarket. In other countries the rate of home ownership, and consequently the significance of the home ownership market, is much higher.

Employing the theory of political economy, Ortalo-Mangé and Prat (2007) were, in a model-theoretical manner, able to prove that governments in these countries are genuinely interested in keeping prices high through artificial scarcity, in order to improve the wealth status of homeowners. Against this background it should be noted that economic policy should support a balance between the home ownership market and the rental housing market.

## **6 Conclusion**

Eekhoff (2002) complains that regulatory price interventions increasingly accentuate over time, a circumstance that can already be observed in the German rental housing market. And, it is remarkable that those who suffer most severely under high rent increases (as is the case for those socially disadvantaged individuals searching for housing) profit least from such interventions, while tenants with high income are perfectly satisfied with rent control ceilings in good situations. The grand coalition's housing policy plans are an example of the slight effectiveness of social-political measures. Instead of making more public housing (supply-side subsidy) available, it is better to prefer the alternative of an increase in the housing subsidy (demand-side subsidy). This would, however, only be the case, if demand stimuli, derived through the housing subsidy, led to an expansion of supply. The re-introduction of degressive depreciation for rental real estate will increase housing supply, while simultaneously lowering tax revenue.

Rent controls are, from an international perspective, a battlefield of ideologies. Those that believe in the power of the "free market" fight against those who do not

believe in it (Arnott 1999). Economics is a social science. It can, contrary to the natural sciences, offer no model-theoretical or empirical accuracy, because it is not based on stringent natural laws. Good economic policy should therefore commit itself to no ideology, but instead it should follow concepts regarding regulatory policy.

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