

Contrasting varieties of private renting: England and Germany

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Introduction

For seven decades, from the First World War until the end of the 1980s, the privately rented housing sector in England declined in both relative and absolute terms. During this period, it changed from being the main housing tenure, accommodating approximately nine out of ten households, to being a residual sector in which less than one in ten households resided. By the 1970s, to many commentators, the PRS seemed to be in almost terminal decline. However, since the end of the 1980s the privately rented sector in England has not only stopped declining, it has actually expanded in size: between, 1988 and 2008, the number of households renting privately increased by 75 per cent.¹ In addition, the reputation of the PRS in England significantly improved over this period. More generally, it has been argued that private renting has been transformed since the late 1970s (Kemp, 2009).

This reversal of fortunes followed the introduction in January 1989 of the provisions of the Housing Act 1988, which deregulated rents, and substantially weakened security of tenure, on all new private lettings. Many commentators have assumed that the revival of private renting was largely caused by that legislation. Furthermore, it is taken for granted by private landlords and policymakers in England that free market rents and limited security of tenure are essential preconditions for a financially viable and vibrant private rental housing market to exist. And yet in Germany – which has a very large privately rented sector – there exists ‘soft’ rent regulation and tenants have very strong security of tenure, conditions that in England would be seen as inimical to investment in the PRS.

The aim of this paper is to address this puzzle. It asks: how is it that free market rents and weak security of tenure are perceived to be vital ingredients for a successful PRS in England, when neither exists in Germany, which has a very large PRS? The next section briefly summarises key characteristics of the political economies and housing systems in these two countries. This is followed by an overview of the PRS in England and then in Germany. Drawing on these overviews, the subsequent section seeks to solve the puzzle of private renting

outlined above. The final section concludes the paper.

Contrasting political economies

The contrast between England and Germany extends beyond private renting and the wider housing market. They also have very different types of welfare state regime and political economy more generally (Table 1). In the highly influential 'varieties of capitalism' literature on comparative political economy, Germany is characterised as a 'coordinated market economy' while England is classified as a 'liberal market economy' (Hall and Soskice, 2001).

In coordinated market economies (CMEs), close links exist between manufacturing firms and banks, with the latter often holding shares in the former. Unlike liberal market economies (LMEs), in CMEs shareholders look for long-term returns on their investments ('patient capital'). There is extensive coordination between firms rather than simply market competition. Moreover, trade unions have significant involvement in the running of firms and workers enjoy a high level of protection against dismissal. Coordinated national wage bargaining helps to contain wage inflation and produces much less earnings inequality than in LMEs. However, strong employment protection for 'insiders' in Germany and other CMEs has helped to stimulate the growth of 'outsiders' in atypical jobs with relatively weak employment protection, low wages and more limited social rights (Rueda, 2008).

In LMEs like England economic coordination takes place through market competition rather than collaboration between firms; and managers are under pressure to maximise shareholder value in the short-term. Wage-setting is relatively decentralised rather than coordinated and there is a high degree of wage inequality. Trade unions are relatively weak and have little or no representation on company boards and have little say in the way firms are managed. Employment protection is also limited and hence it is relatively easy to dismiss workers compared with Germany (Hall and Soskice, 2001; Wood, 2001).

For much the post-war era, the Germany economy was characterised by relatively high rates of growth, low levels of inflation and a high savings rate. Meanwhile, the English economy tended to be the opposite in all three respects: relatively low growth, high inflation and low savings. However, since the 1990s the German economy has endured relatively low rates of economic growth and high levels of unemployment, while the English economy (until the 2007/08 credit crunch) fared better in both respects (Hall, 2007). However, the high growth rate in England from the mid-1990s was fuelled by a credit boom and property bubble, as well as a current account deficit, unlike the German economy with its current account surplus, more restricted credit availability and lack of a housing boom.

The welfare state in England is also significantly different from that in Germany: the former has been described as having a liberal welfare state regime, while the latter is characterised as a conservative welfare state regime (Esping-Andersen, 1990). Conservative welfare regimes like Germany typically have what has been called 'Bismarkian' social security systems, in which generous, earnings-related benefits are funded by social insurance contributions. This contrasts with England, which has a so-called 'Beveridgean' social security system in which both insurance and means-tested benefits are flat-rate and relatively low. Hence, while the German social security system aims to provide *income maintenance* in the even of unemployment, sickness or retirement, the English system is more focused on *poverty relief*. However, while the German social insurance system remains largely intact, increasing use is made of tax-funded, flat rate and means-tested benefits for 'outsiders' and the long-term unemployed (Clasen, 2005).

Finally, Germany and England also have contrasting housing markets (Table 2). Like most CMEs, Germany has a relatively low level of homeownership. Meanwhile, in common with most other LMEs, homeownership is high in England. Mortgage finance is more highly liberalised in England than in Germany, which among other things helps to account for the much greater extent to which mortgage lenders have given loans to sub-prime borrowers in the former than in the latter country (Table 3). In the 1970s and 1980s, variable rate loans dominated the English mortgage market while in Germany fixed rate loans were more common, a difference that reflected the less volatile inflation and nominal interest rates in the latter compared with the former country (Muellbauer, 1994). However, since the 1990s, relatively low inflation and interest rates have helped stimulate the supply of fixed rate mortgage loans in England. Until the 1990s, homeowners in England were able to benefit from mortgage interest tax relief and on average tended to borrow at higher loan to value ratios. The possibility of making capital gains appears to have made owner-occupation both an investment and a consumption good in England whereas in Germany the latter motive predominates. Moreover, as Muellbauer (1994, p242) notes, "Germany is much less prone to speculative fever in its housing markets."

According to Kemeny (2005), Germany has a 'unitary' rental housing market in which there is relatively little difference in the rents and quality of private and social housing. Social rented housing is not confined to the poor and is not stigmatised. In contrast, England is described by Kemeny as having a 'dualist' rental market, in which there is relatively little competition between private and social rented housing, with sharp rent and quality differences between them, and in which social housing is highly stigmatised. Although one could quibble with the accuracy of Kemeny's dichotomy, it does capture some important differences in the rental housing market between these two nations (see also Haffner et al, 2009).

These differences in the housing market, welfare state, labour market and wider political economy between England and Germany provide the contexts within

which their private rental markets are situated. They in part account for the institutional differences that exist between the private rented sectors in these two countries.

Private renting in England

Post-war history

The private rental sector (PRS) in England experienced a sharp decline for much of the post-war period. Although this process is often largely attributed to the existence rent control and security of tenure legislation, the process was in fact much more complex than that (see Kemp, 2004). However, rent control was certainly a very important cause of decline. The type of rent control that existed in England from 1915 until 1965 involved nominal rent freezes, which made rates of return on private rental housing increasingly uncompetitive compared with alternative investments. A more flexible system of 'rent regulation' was introduced by the Rent Act 1965 and gradually replaced the old 'controlled' tenancies. But while the rental yields on regulated tenancies were significantly higher than on controlled tenancies, they were still relatively uncompetitive (Doling and Davies, 1984; Whitehead and Kleinman, 1986).

The low rental yield on private tenancies for much of the post-war period inhibited new investment in the PRS and encouraged landlords to sell their existing properties into the owner-occupied housing market when they could (Merrett, 1982; Hamnett and Randolph, 1988). It also provided landlords with an incentive to find ways to avoid or evade the Rent Acts, principally by letting their properties on contracts that were not covered by the legislation (such as holiday lettings, accommodation with meals, and non-exclusive occupation agreements). These arrangements meant that the properties could be let at market rents and provided only very weak security of tenure to the occupants. However, the exact legal status of individual lettings was unclear, which created uncertainty and increased investment risk for landlords. Moreover, tenants of regulated lettings had the right to refer their tenancy to the local Rent Service in order to get a 'fair rent' established, which was the maximum amount that could legally be charged; again, this created uncertainty for landlords (Kemp, 2004).²

The Rent Acts also made it uneconomic for private landlords to improve or refurbish their properties (Nevitt, 1970). As a result, the condition of dwellings in the sector gradually deteriorated over time. Moreover, most of them had been constructed in the nineteenth century and were built to relatively low standards, with many in sub-standard condition even before rent controls were introduced in 1915. Hence, much of the PRS compared badly with the condition of properties in the owner-occupied and social housing sectors (Kemp, 2004). The fact that there was excess demand for privately rented dwellings, especially from low income tenants, meant that landlords could relatively easily let even properties that were un-modernised or otherwise in very poor condition (Holmans, 1987). The poor condition of many PRS dwellings helped to

undermine the public perception of renting from private landlords.

In the much of the post-war era, the Rent Acts were politically very sensitive. The continuing shortfall of houses relative to households meant that rent controls could not be abolished; and yet many commentators believed that the shortage of private rental housing was due to the rent control. Party political attitudes to rent control, and to private renting more generally, became highly polarised during the post-war years. The Conservative Party argued for rent decontrol, while Labour favoured continued control and, during the 1950s and 1960s, for the 'municipalisation' of the sector (Kemp, 2004). The highly politicised debate on the PRS significantly increased the risk facing potential investors in the sector.

The housing subsidy system has also been highly disadvantageous to private landlords since the Second World War. Successive Labour and Conservative governments provided substantial 'bricks and mortar' subsidies to enable local authorities, and more latterly registered non-profit housing associations, to build and manage rental housing at rents that were mostly well below market levels. In contrast, both of the main political parties have generally been unwilling to provide bricks and mortar subsidies to private landlords.

The tax system in England has also been largely unfavourable to private landlords (Nevitt, 1966), especially in comparative perspective (Harloe, 1985). Unlike in Germany, private landlords in England have not generally been able to depreciate their investments; and nor have they been allowed to offset operating losses against their other sources of income (so-called 'negative gearing'). Meanwhile, owner-occupiers were entitled to mortgage interest tax relief until the 1990s, have been exempt from tax on their imputed rental since 1963, and do not have to pay capital gains tax on their primary residence. Although landlords are eligible for mortgage interest tax relief, they are liable for tax on both rental income and capital gains (Wood and Kemp, 2003).

For consumers, the non-tenure neutral housing finance system helped to make private renting relatively unattractive compared with other housing tenures. Local councils - and also, since 1974, housing associations - have been able to provide housing that was built to higher standards and let at lower rents than that which private landlords could offer to people wishing or needing to rent their home. Meanwhile, until the 1990s, because of the differential treatment of private landlords and home ownership, it was cheaper for people to buy their accommodation than to rent it privately (Milner-Holland Committee, 1965).

Distinctive characteristics

For much of the post-war period, private rental housing in England was characterised by decline and decay. Indeed, some commentators expected it to eventually more or less disappear. There was very little new construction and relatively little investment in the existing stock. Most of the PRS was subject to rent controls and tenants had very strong security of tenure. Private landlords

had a very negative image and renting one's home privately was considered to be unattractive. In general, households much preferred to buy their home or, failing that, rent it from their local council or housing associations. As a result, the PRS was increasingly a residual sector of the housing market, providing accommodation for elderly people who had lived there all their life, low-income households that could not afford to buy or could not gain access to social housing, newly formed households and young people for whom it was, in effect, a 'waiting room' for owner-occupation or social housing (Kemp, 1988).

By the late 1980s, the PRS in England was at the bottom end of the size distribution among the advanced economies. However, over the last two decades, the PRS has been increasing in size and its reputation has improved. There was a sharp surge in investment in the sector by so-called 'buy-to-let' (BTL) landlords from the turn of the century, fuelled in part by the credit boom and the associated house price bubble. BTL investment has become an everyday investment and topic of conversation, while renting privately is now viewed much more positively than it was in the 1970s and 1980s (Kemp, 2009). The need for a viable PRS is a subject of political consensus (Best et al, 1992), in contrast to the sharp differences in the past. However, the PRS continues to focus on a limited number of niche demand groups (Rugg and Rhodes, 2008).

An important feature of the PRS in England is the relatively high level of furnished tenancies (Kemp, 1988), which currently account for about a quarter of the total. A second key feature is the very high level of tenant turnover. In 2007/08, 40 per cent of private tenants had lived in their current address for less than one year and 70 per cent for less than three years. Only 20 per cent had been resident for five or more years. Both of these features are related to the 'easy access' role that private renting plays in England, particularly in relation to new and young households. Although there are long-term tenants, they account for a much smaller share of the market than in Germany. They tend to be low-income households that are unable, or in some cases do not wish, to gain access to social rented housing, which typically provides very strong security of tenure and below market rents.

Private landlords

As in many countries, the main provider of private rental housing is individuals and couples. Moreover, they account for an increasing share of the private rental market. By 2006, three-quarters (74%) of all privately rented tenants in England rented their home from a private individual or couple; only 16 per cent rented from a company and the remaining ten per cent rented from a variety of other types of organisation (CLG, 2008). Despite considerable encouragement from government in recent years, ownership of private rental housing by financial institutions is negligible (Crook and Kemp, 2002). Landlord portfolio sizes are small and have become increasingly so over the last decade (cf. Crook and Kemp, 1996a; CLG, 2008). In 2006, about a third of private tenants rented from landlords that had only one letting and only a quarter from those who had ten or

more lettings. Only about one in twenty private tenants were renting their home from a private landlord that had 100 or more lettings (CLG, 2008). Thus, in contrast to Germany, large-scale private landlords are relatively rare in England.

In general, private landlordism is a largely sideline activity in England. Thus, in 2006 three-fifths of private tenants were renting their home from a landlord for whom letting accommodation was not their main livelihood (CLG, 2008). Most private landlords are amateurs in the sense of having no training or qualifications in property management or related experience to draw upon (Kemp and Crook, 1996b). For example, the most recent national private landlord survey found that 62 per cent of all private landlords in 2008 had neither property nor building industry qualifications or related experience; and only 17 per cent belonged to a professional or trade organisation (CLG, 2008). Moreover, as Crook and Kemp (1996a) have shown, a substantial minority of private landlords are relatively ignorant of landlord-tenant legislation.

In the past, many private landlords in England had inherited their property, which reflected the fact that there had been very little new investment in the sector since 1945. However, with the revival of private renting, and especially with the boom in buy-to-let housing from the turn of the century, the proportion of the PRS owned by landlords who had purchased their property has increased. By 2006, 78 per cent of privately rented addresses had been bought and only 12 per cent inherited, with the remainder acquired in some other way (CLG, 2008). However, among the properties that had been purchased, only three-quarters had originally been acquired in order to let them.

Although many private landlords in England are commercially motivated, a sizeable minority are not (Crook and Kemp, 1996a). However, the proportion of landlords who see their lettings as an investment has increased over the past decade. By 2006, 70 per cent of private tenants were renting from landlords who viewed the property as an investment or their pension. About a third of these investor landlords saw rental income as the most important, another third were more interested in capital gains from rising property values, and the final third viewed these two sources of return as equally important (CLG, 2008).

Tenants and demand-side subsidies

Until about the 1950s, private renting catered for a wide spectrum of households, but this gradually ceased to hold over time as the sector declined in size. By the 1970s, the sector was a minority tenure accommodating particular segments of the housing market (Boviard et al, 1985). At this time, private renting was seen as very much an inferior tenure compared with homeownership or renting from a local authority. An increasing number of households were buying their home or aspired to do so, something that successive governments had encouraged. This was further fuelled by the introduction of the 'right to buy', at substantial discounts from the market value, for council tenants by the Thatcher Government in 1980 (Forrest and Murie, 1988). Unlike Germany, England has become a nation of home owners by the 1980s.

Boviard et al (1985) identified four main roles that PRS was performing on the demand side in England and Wales. First, there was a large rump of elderly people who had always rented privately and who had never moved out of the sector, which Boviard et al termed the 'traditional role'. Second, there was a relatively large, if declining, group of tenants who were living in 'tied accommodation', that is renting their home with their job or business, for example, farm workers and members of the armed forces. Third, the PRS performed an 'easy access' role for a transitional group of mostly new or young households that were renting privately for the time being. And, fourth, the PRS performed a residual role, providing accommodation for low-income tenants who could not afford to buy their home or could not gain access to local authority.

Although these four roles are still important, the number of elderly private tenants and of people renting tied accommodation has fallen, while the easy access and residual roles have become more important (Kemp, 2004). The number of students living in the PRS has trebled over the past two decades as a result of the growth in higher education and they now account for around one in ten of all households renting privately. For a variety of reasons, the number of young, professional people - single or living with their partner - in the PRS has increased as people enter owner-occupation at later ages than was true in the recent past. Increased rates of divorce and relationship breakdown have meant that more people have left homeownership and social housing to move into the PRS, albeit often only for a temporary period. An increasing number of local authorities are making use of private renting to fulfil their obligations under the homeless persons legislation. Meanwhile, the decline in the number of social rented homes has increased the demand for private renting from low income households. The growth in the number of economic immigrants, especially since the expansion of the EU, has also increased the demand for privately rented accommodation (Kemp, 2009). Nevertheless, despite these changes on the demand side, the PRS in England remains largely focused on particular market niches and on providing accommodation for a short period in people's lives (Rugg and Rhodes, 2008).

Low-income private tenants have been eligible for means-tested rent allowances since 1972. The current scheme, known as the local housing allowance (LHA), was introduced for private tenants in 2008 following a four year pilot project. The maximum amount of LHA is a flat-rate amount that varies according to household size and composition; it is set at the median private sector rent for each 'broad rental market area', of which there are about 140 across England. Thus, although the LHA is based on the median rent it is not related to the tenant's actual rent, unlike the previous HB system.

A key aim of the 2008 reform was to give claimants an incentive to 'shop around' when looking for accommodation, something that the previous scheme was thought not to do (Kemp, 2000; DWP, 2002). Under the LHA, if the claimant's

rent is less than the LHA payment, they may keep up to £15 per week of the difference. However, in order to save money, it is currently proposed to abolish these excess payments in 2011 (DWP, 2009). In general, the LHA is based on the 'cold' rent and ignores heating costs and service charges. The LHA is normally paid to the tenant unless they are eight weeks in arrears on their rent or deemed by the local authorities that administer the scheme to be too 'vulnerable' to pay their rent. Landlords and tenants' organisations claim, however, that many private tenants cannot be trusted to pay the rent and hence that the LHA should be paid to the landlord.

The regulatory framework

The current regulatory framework was introduced by the Housing Act 1988, which deregulated new private lettings and made it easier for private landlord to regain possession of their properties (Whitehead and Kleinman, 1989). This Act allowed landlords to set market rents on new lettings and, subject to terms of the lease, to adjust rents in line with the market during the tenancy. Building on changes introduced in 1980 (see Crook, 1986), the new legislation provided that all new private lettings would be 'assured tenancies' unless the landlord issued the new tenant with a notice that the letting would be an 'assured shorthold tenancy'. The principal difference between these two was that assured tenancies were indefinite lettings, while assured shortholds were fixed-term lettings of at least six months, at the end of which the landlord would regain possession unless they wished the tenancy to be renewed.

In 1996, this arrangement was switched around so that henceforth assured shortholds were the default tenancy and landlords had to issue a notice if they wished the letting to be an assured tenancy. The latter reform was, in effect, an official government endorsement of short-term, transitional housing as the primary role of the PRS (Kemp, 2004). Most landlords have opted for assured shortholds rather than assured tenancies. Moreover, because of the very high rates of turnover in the sector, deregulated lettings rapidly dominated the PRS stock. Indeed, by 2008 three-quarters of all lettings were deregulated, of which 85 per cent were assured shortholds (Kemp, 2009). Thus, private renting in England is now very largely deregulated and subject to free market forces. This, of course, is consistent with the characteristics and dominant ethos of a liberal market economy.

Private renting in Germany

The German housing market differs markedly from that in Britain and other European countries in having a low homeownership rate and a very high level of private renting. In 2005, only 39 per cent of all dwellings were owner-occupied and around 47 per cent were let by private landlords (Table 2). Since 1993 there have been three long-term dynamic trends in housing tenure: the level of homeownership grew slowly, the social housing stock rapidly declined, and the private rented sector increased in size.

Post-war history

As in other European countries, the German housing market was severely hit by the Second World War and its political consequences. A considerable part of the living space had been destroyed or damaged and also the market had to cope with a wave of refugees from the Eastern territories (around 13 million people, of which 9 million moved to Western Germany) and requisitions of housing for the purposes of the occupying powers (Führer 1995). When the West German state was founded in 1949 the housing shortfall was around 50 per cent of the 1939 stock (around 11 million dwellings) – and there was already a housing shortage in 1939. Against this background of an extreme shortage of housing, the housing sector remained state controlled until the late 1960s in Western Germany. Rents were controlled, tenants were protected against ‘unfair’ dismissal and the housing stock was rationed by the local housing offices. Also, housing supply was heavily subsidised. In the 1950s housing construction was dominated by state-subsidised social dwellings (Kofner 2003). In total, 61 per cent of the 7 million dwellings completed between 1950 and 1962 were for social housing. Between 1953 and 1967 a very high level of construction - around 10 dwellings per thousand inhabitants - was maintained and, as a consequence, the housing shortage rapidly shrank; by the mid 1960s it had almost disappeared.

Housing policy in the post-war period not only subsidised social housing construction, but also provided incentives for new private housing construction. From 1949 it was possible to deduct ten per cent per year of the total costs of a newly built dwelling for the first two, and another three per cent for the next ten years, from taxable income. In 1950 all non-social dwellings completed later than 20 June 1948 were excluded from rent controls, dismissal protection and the agency monopoly of the local housing offices. After having increased the controlled rents across the board several times, the remaining controlled housing sector was gradually cut back from 1960 (Kofner 2003b).

Distinctive characteristics

What are the characteristics distinguishing the German private rental sector from other European countries? First of all, we should emphasize again the outstanding relative size of the sector: 77 per cent of the rental, and 47 per cent of the total, housing market. It is also important to know that about a third of the dwellings held by private landlords are situated in one or two-family houses. Either the houses are let as a whole or the owner lives together with one tenant party. An important part of the German homes was designed to include a lodger or granny flat from the beginning for tax or personal reasons. This sub-sector accounted for 4.3 million rental units in 2002 (BMVBS 2007) or 26 per cent of all one and two-family houses.

The PRS is dominated by private individual landlords rather than property companies. Private individuals account for 84 per cent of the privately rented housing stock and for 58 per cent of the total rental stock. German private individual landlords as a group are very heterogeneous relating to age, income

and ownership. Predominantly they are self-employed or pensioners. The vast majority of them are amateurs landlords. Their motives for investment are not completely non-economic, but (unlike in England) are characterised by an extremely long-term investment horizon and a very marked preference for security of investment.

Compared with their English counterparts, German private landlords seem to enjoy a better reputation among tenants. The bad press is usually focused on institutional landlords (private or public). Part of the explanation might be the broader range of target groups served by the German private landlords. As a cornerstone of housing provision, the German PRS is by no means a residual sector focussed on the poor and needy unable to finance a home of their own. Since the sector serves different quality and income segments of the housing market, it is not as exposed to prejudice like in Britain or Ireland which either serve the lower end of the market or highly specialised niche markets.

Perhaps the most important underlying reason for the relatively large size of the PRS in Germany is the lower degree of cultural fixation on homeownership in this country. If people are reluctant to buy their home, and social housing is limited to specialist target groups, the PRS is the only option available to many people. The preference order of many German households appears to differ markedly from their English counterparts as far as the rent or buy decision is concerned. For example, the idea of a 'housing ladder' in which households buy as early as possible and regularly trade up to more expensive homes, is unfamiliar to Germans, for whom the motto is more like 'Once in a lifetime', the title of a famous TV series from the 1970s.

Finally, the German housing market is characterised by limited state interference. Entirely different from the Netherlands or Britain, the idea of public interest housing was given up in 1990. Moreover, the market share of social housing is in secular decline. Thus, non-or limited-profit providers only play a minor role in housing. Even an important part of the remaining public housing organisations is profit-oriented. Apart from this, the rental laws are relatively market-oriented. On the other hand, the level of subsidies for the German PRS is currently low. But we need to keep in mind that almost always between 1950 and 2005 degressive depreciation schemes were active. This is important for a country with a progressive income tax and high marginal and top level income tax rates. Rental buildings were always regarded as good tax-saving vehicles by self-employed people like master craftsmen and other higher earners.

All in all, the German housing market of our times is rather well integrated into the framework of a coordinated market economy. There are subsidies and rules for price formation, but they do not interfere deeply into the rule of supply and demand at the housing market.

Private landlords

It is necessary to discuss private individual landlords separately from property

companies which hold their housing stock as a business asset. They differ significantly in terms of average portfolio size, personal liability and tax treatment of the investment. We can further divide private individual landlords roughly into two groups: amateur landlords and professional landlords. For pragmatic reasons, the distinction between the two groups is usually made according to the number of dwellings held. The InWIS-institute (1995) has drawn the line at 15 units and the survey by Analyse & Konzepte (BBR 2001) took 20 units.

Amateur landlords often have personal connections to their buildings. And their investment motives are diverse: economic motives, like tax saving and retirement provision, stand alongside personal and family motives. In some cases, investment is induced by potential tax savings, even though the project as a whole might not be profitable (InWIS 1995). Regrettably, amateur landlords sometimes become victims of fraud. In the 1990s tens of thousands of private investors invested in 'junk property' for tax saving reasons. Under massive pressure from marketing organisations they bought grossly overpriced condominiums to let, which have since fallen in value. Professional private landlords, on the other hand, often have real estate professions and place more emphasis on achieving an adequate rate of return from their investments. They tend to have a supra-regional view and look outside their hometown for investment opportunities (InWIS 1995).

A survey of multi-family buildings constructed before 1991 and owned by private landlords found that the majority (61 per cent) of landlords lived in the city where the rental property was located (BMVBS 2007). It also found that three quarters of owners were amateur landlords owning up to 15 units. Only one in eight private landlords were regarded as 'highly professional' (i.e. owning 30 or more dwellings). Thus, the majority of dwellings let privately are held by amateur landlords, the proportion being higher in smaller towns. One in five private landlords employed a professional company to manage their properties. Only 29 per cent of landlords lived in the same building as their tenants (BMVBS 2007).

The survey also found that a high proportion of private landlords are elderly persons, especially in the West. Indeed, more than 70 per cent were older than 50 years and the mean age was 58. One in three owners was 65 years or older and young landlords were rare. Pensioners were the most important subgroup by professional status (41 per cent of all landlords). One in four landlords was self-employed or a freelancer and only one in five was a salaried employee. Private landlords living exclusively on their income from letting were rare (4 per cent). Hence, private letting of multi-family buildings was primarily a secondary occupation or a means of providing extra income for pensioners (BMVBS 2007).

The survey also revealed that, for the whole of Germany, only 41 per cent of owners were making a profit from the sampled property, the same proportion covered their costs, and 9 per cent made losses. In East Germany, only 20 per

cent of landlords were making a profit and 43 per cent were losing money, on the sampled property. Two-thirds of the loss-making buildings located in the West had no vacancies, compared with just over half in the East. However, cost deficits are exacerbated by vacancies: two thirds of the Eastern buildings with vacancy rates of 20 per cent or higher were in the red. The worse the state of construction, the higher the vacancies tend to be and the lower is the degree to which costs were covered (BMVBS 2007).

The most important method of acquisition of property among private individual landlords in Germany is purchase, which accounted for almost 50 per cent of the total. Most of the remainder (46 per cent) were inherited or received as a gift. Less than four per cent of the sampled properties were leased by the landlord. However, in East Germany, only 16 per cent of the properties were inherited or received as gift, 71 per cent were purchased, and 13 per cent were restituted after 1989 (BMVBS 2007).

The most important motives for building or acquiring residential real estate are old-age provision (3.4 points on a scale ranging from 0 [unimportant] to 5 [very important]) and security of investment / accumulation of capital. Unlike private landlords in England, it is characteristic for the attitude of German private landlords that favorable yield prospects (1.0 points) and resale intentions (0.4 points) play virtually no role as investment motives. Tax reasons, on the other hand, range in the middle of the scale. In Eastern Germany tax considerations were more important. This could be a consequence of the special tax subsidies granted there in the 1990s (BMVBS 2007).

One in five privately rented dwellings in Germany is subject to stock investment per year. Investment in East Germany is less frequent and the amount invested per dwelling is lower than in the West. Landlord investment motives are object-related for the most part. Profit expectations and the use of public subsidies only play a minor role (BMVBS 2007). While the focus of investment in the West German stock is on buildings in the red and with maintenance requirements to improve their market chances, the frequency of investment for the same kind of buildings in Eastern Germany is going down. The major investment hurdles are low rents and lack of equity capital.

The most important part of the financing of the investments carried out by private landlords between 2002 and 2004 was equity capital (63 per cent for Germany as a whole, 50 per cent for Eastern Germany). Next in line are bank credits (19 per cent) and subsidies / subsidized credit (10 per cent). East German property owners finance a much larger part of their investment with subsidies. However, there is a considerable information deficit among private landlords relating to possible public subsidies (BMVBS 2007).

The German income tax law currently does not contain any general tax subsidies for new housing construction. Since 2005, residential buildings can only be written down linearly, at 2 per cent depreciation per year (2.5 per cent for older

buildings). Hence, the scope for reducing tax liability via investment in residential real estate is currently very limited. However, capital gains from the sale of a residential building held privately for more than ten years are tax-free unless the seller is a 'commercial real estate dealer' (i.e. a regular trader).

The use of tax subsidies is widespread among private individual landlords. The offsetting of losses from renting and leasing activities is most common, with two out of three private landlords making use of this possibility. However, only a quarter of landlords deducted maintenance expenditure from their taxable income independent of the purchase. As to be expected, professional private landlords tend to use subsidies and tax advantages more intensely than their amateur colleagues. On the other hand, the investment is a little higher among the small private landlords, maybe in part due to the fact that more of them live in the same building as their tenants and hence have a more direct interest in its condition. In Eastern Germany the stock of inherited property is particularly affected by delayed maintenance, high vacancy rates and losses.

Subsidies for rental housing are currently rather limited compared with the past. Help is focussed on energy modernisation, preservation of buildings and urban redevelopment, but does not include general tax subsidies any more. Since the subsidies for energy-saving improvements, modernisation and the capital gains taxation exemption are also available to homeowners and social housing (except for the tax privilege) there is now an implicit bias against private rental housing in the subsidy system: homeownership and social housing being exclusively subsidised).³

While the housing stock directly held by institutional investors is only modest, there are different vehicles available for indirect investment in German residential real estate. German Real Estate Investment Trusts are not allowed to invest in housing stock built before 2007. Meanwhile, open-ended property funds generally ignore housing as an investment target and the closed-end funds only cover special segments of the market. The most important investment vehicles are German Public Ltd. ('Aktiengesellschaften') and foreign legal structures used by foreign financial investors to structure their investments.

Since 1997 a considerable part of the German public housing stock has been sold to private investors (see Kofner, 2006a, 2008a). This privatisation has mainly involved social housing or former public property (Volkseigentum), but some industrial firms have also sold their company housing to new corporate investors. As a consequence, new investors have entered the market and that tend to behave differently from traditional forms of private landlord, often with serious consequences for the other stakeholders and especially the tenants.

The transactions in this privatisation boom can be roughly divided into four phases. First, between 1997 and 2000 the dominant type of transaction was public authorities selling to German bank subsidiaries or other German public companies. Then, between February 2001 and January 2004, public and former

company housing stock was sold chiefly to German or foreign non-listed companies such as Deutsche Annington. Next, between May 2004 and January 2006, the most common transaction type was the sale of public housing or company housing to private equity groups like Fortress or Blackstone. Finally, in October 2006, private equity investors began to sell their newly acquired housing stock to German and foreign public companies and institutional investors (Kofner 2006b).

Tenants and demand-side subsidies

The German PRS is not focused on particular niche markets, but serves a broad range of market segments in terms of quality and size. It is thus not a residual sector, but instead a cornerstone of housing provision for all parts of the population. This arrangement might contribute to the stability of the German primary credit and real estate markets. Neither the banking sector nor political parties seek to encourage households with problematic ('sub-prime') creditworthiness into homeownership. Hence, German mortgage borrowers are less vulnerable when macro-economic hardship comes. Germany has a low homeownership rate and very low volatility in house prices, which, as the current financial crisis has suggested, might be decisive for the stability and sustainability of the financial sector and the economy as a whole.

Housing allowances in Germany are available irrespective of the status of the dwelling and the same rules apply for social and privately rented dwellings (Kofner, 2007). However, people living on social assistance cannot claim housing allowances (*Wohngeld*), but receive housing benefit as an integrated subsidy according to their basic housing needs. For example, unemployed people with insufficient income get housing benefit as part of *Arbeitslosengeld II* (stage two unemployment benefit).⁴

Three factors determine how much *Wohngeld* a household is entitled to receive: the number of family members in the household, the total annual family income, and the amount of rent or mortgage payment that qualifies for support. Income ceilings and rent ceilings are applicable which depend on household size and local rent level. Recently, a lump sum subsidy for heating costs (50 Cent / m²) was introduced. *Arbeitslosengeld II* is not a complementary social security benefit like *Wohngeld*. It is a last resort, safety net meant to ensure that people's basic living needs are met. Housing costs are fully covered, but only for an 'adequate' home. Adequacy is subject to size and rent ceilings differentiated at the regional level (e.g. high rent ceilings in Munich, low ceilings in Görlitz).

Regulatory framework

According to the German civil code, landlords have no general right to cancel an open-ended rental contract arbitrarily. An ordinary notice of termination of this (most common) type of rental contract is only permitted if the landlord can provide proof of a 'legitimate interest' in the termination (e.g. breach of contractual obligations or need for dwelling for own use). In cases of individual hardship, the judge in an eviction trial has to balance the competing interests of

landlord and tenant. In summary, the disposability of rental property is substantially restrained by the tenant protection provisions.

However, landlords have a legal right to raise the contractual rent up to the level which is regarded as 'normal' in the community. This local reference rent ('ortsübliche Vergleichsmiete') is basically an empirical concept. The landlord should not demand a rent higher than the average by his competitors operating in the same segment of the housing market take. However, the factors contributing to rent price formation ('Wohnwertmerkmale') is restricted to dwelling type and size, equipment, state and location. Furthermore, only rents raised or agreed upon in the last four years are included in the calculation of the local reference rent. The artificial local reference rent will follow the local housing market, but delayed in time. Landlords will not profit from windfall gains in the short run. In the bigger cities, easily accessible rental tables ('Mietspiegel' in German) mapping the local rent price structure are normally available, but may not necessarily be up-to-date or empirically valid.

Regardless of the local rent level, landlords may not raise the rent for more than 20 per cent in three years. This additional rent cap will be a problem for the landlord whenever the contractual rent lags behind the market rent on a large scale, e.g. when social housing loses its special status after the landlord has paid back the public loan or when a landlord (or his testator) has missed out on augmentation opportunities in the past. Also, the landlord will face legal sanction if the contractual rent exceeds the local reference rent for more than 20 per cent. But this rent cap only applies in case of a housing shortage in the relevant segment of the local housing market. In other cases the individual rent may be up to 50 per cent above the reference rent.

We can summarise our results as follows: When letting a dwelling, landlords can demand a rent up to 50 per cent above the local reference rent or 20 per cent in where there is a local housing shortage. In an ongoing rental contract, the local reference rent acts as a strict upper limit on the individual rent level. There is thus no possibility to raise the initial rent until the local reference rent has surpassed the contractual rent. Furthermore the individual rent might be restricted by the rent cap of 20 per cent in three years. Extra rules apply for rent increases after modernisation.

Comparing England and Germany

We have shown that the English and German housing markets represent very different models of private renting (Table 4). The role and operation of the private rental markets, the housing policy and taxation framework, and many aspects of the wider institutional and cultural context within they exist, are significantly different. In this section we attempt to resolve the puzzle outlined in the introduction to the paper.

Any attempt to understand why unregulated rents and weak security of tenure are widely seen as essential preconditions for a commercially viable PRS in England has to take into account not just present conditions, but also the legacy of the past. Housing provision is highly path dependent, both in terms of institutional structures and attitudes to housing. There are at least three aspects of that legacy to be considered. First, for half a century, from 1915 to 1965 a highly inflexible system of rent controls kept rents well below market levels. Although a more flexible regime was introduced in 1965, considerable uncertainties existed about both whether a particular letting was covered by rent regulation and whether regulated tenants would exercise their right to refer the rent to the Rent Officer service established by the 1965 Rent Act. This history has made landlords very wary of forms of rent regulation, even soft or 'second generation' (Arnott, 1995) versions like that in Germany.

Second, rent controlling legislation in England gave private tenants strong security of tenure, making it very difficult for landlords to repossess their property at a time of their choosing. This has made landlords very wary of security of tenure, especially as the resale market for tenanted rental properties has been under-developed in England. Weak security of tenure is particularly important to private landlords because of the opportunities that exist to make capital gains from rising house prices. Over the long-term, house prices have increased in line with average earnings, which since earnings have generally increased at a faster rate than retail prices, means they have risen in real terms. In the short-run, the marked cyclical fluctuations around this secular upward trend in house prices makes the timing of sales into the owner-occupied housing market critical to landlords' ability to make capital gains. Moreover, for much of the period since 1945 there has been a substantial 'value gap' between the price at which vacant and tenanted property can be sold (Hamnett and Randolph, 1988). As a result, landlords have generally needed to obtain vacant possession in order to realise capital gains or to disinvest for other reasons, especially those with a short-term investment horizon. In this context, short, fixed term leases and weak security of tenure make rental housing a much more liquid investment than it would be if long leases and strong security of tenure were in place.

If free market rents and weak security of tenure are believed to be critical for private landlords in England, why is that not the case in Germany? First, as noted above, unlike their counterparts in England, German private landlords generally have very long investment horizons (Table 5). They therefore do not need to have the more liquid investment required by English landlords and therefore have less reason to need short-term tenancies. One reason for the longer time horizon is that the German housing market provides much less opportunity for short-term capital gains, unlike in England. House prices are significantly less volatile in Germany compared with England. Hence, weak security of tenure is not needed in order to time disinvestment at the right time in the housing price cycle to capture capital gains.

Second, because of their long-term investment horizon, German landlords need

to have long-term tenants; short-term tenants would increase their outgoings and the management risk involved in letting property. Although rental yields are low, this is compensated for by negative gearing and (especially before 2005) substantial depreciation allowances on the investment; neither of which have ever existed in the English taxation system for private landlords (see Wood and Kemp, 2003). Moreover, because of the reference rent system, there is relatively little advantage for landlords in replacing their existing tenants with new ones in the short-term in order to re-align rents to market levels.

Private landlords, however, are only part of the story; the tenant perspective also needs to be considered. An important part of the explanation for the differences in rent regulation and security of tenure between England and Germany relates to the size and roles that the PRS performs in each country (Table 4). The broader range of tenants in Germany includes middle-aged and older households that require long-term housing options and hence long leases and strong security of tenure. In contrast, the PRS is a relatively short-term housing option for many of the tenant demand groups in England, such as young adults and households that intend to buy in the relatively new future; in general, such households do not want to be tied down to a long lease but to be free to have the option of moving out.

Since the 1980s there has been a political consensus in England that a viable PRS is required in the housing market to meet short-term housing needs, especially for young or mobile tenants, and for people who are saving up for a deposit in order to buy their home. These perceived 'legitimate' roles for private renting can be met by short-term leases and do not necessarily require strong security of tenure. This policy outlook is fully congruent with the resurgent belief in England and other LMEs in the efficacy of free markets. In contrast, rent regulation and strong security of tenure appear not to be consistent with this neo-liberal ideology. The partial exception to this romance with the primary of free markets is the introduction of licensing for multi-occupied properties and for selective licensing of 'rogue' landlords, introduced by the Housing Act 2004.

Residential mobility is relatively low in Germany, something that is both a cause and an effect of the long leases and strong security of tenure. Further, the widespread availability of good quality rental housing, and the high levels of investment in the existing stock by private landlords, minimises the need for tenants move in order to find better accommodation, unlike the lower end of the rental market in England where poor quality is pervasive and rents do not correlate very highly with dwelling standards (Crook and Hughes, 2001). The higher rate of separation and divorce in England than in Germany also makes short-term leases more attractive than longer ones for those divorcees who intend to rent only for the short-term. While some households do rent privately on a long-term basis in England, they tend to have low incomes, have relatively little market power, and are often seen by landlords as a high management risk, especially if the tenant is a local housing allowance claimant (Kemp, 2004).

Finally, the very large private rental sector in Germany makes tenants an important group politically and one that cannot be ignored by politicians seeking office. This has made it possible to override objections from landlords to rent regulation and strong security of tenure. In contrast, the relatively small number of private tenants in England makes them much less important politically. Moreover, groups of households renting privately in England tend to be less likely to vote than other groups, something that is exacerbated by the very high rate of residential mobility, which makes electoral registration more difficult.

Conclusions

In this paper we have sought to examine why unregulated rents and weak security of tenure are seen as critical to the willingness of private landlords to invest in private rental housing in England, a sector of the housing market that remains relatively small in overall terms, but not in Germany where the PRS is very large. Our attempt to solve this puzzle has pointed to the importance of path dependency, in the sense that the past has created the conditions within which these contrasting perspectives have developed and been sustained.

The regulatory framework in Germany has been relatively stable for many years and, the immediate post-war years aside, has also been very pro-market. The fiscal framework for private landlords was very conducive to investment in the PRS for many decades. And even though the present system is not tilted in favour of landlords, unlike England neither is it unfavourable (Table 6). Nor has homeownership been promoted to the status of a holy grail as has in England and the PRS has provided good quality accommodation for German households to rent. Meanwhile, low inflation and low interest rates have also helped to make rental housing a good, long-term investment for private landlords.

Although German landlords may complain about rent regulation and security of tenure, it is not as onerous as they argue, especially when viewed in international perspective (Lind, 2001; Haffner et al, 2008). Moreover, to the extent that it has moderated the rent levels that landlords can charge, these have largely been compensated for by tax incentives. On the demand side, security of tenure and softly regulated rents have helped to ensure a high level of demand for rental housing from better off households who might otherwise have been prompted to consider homeownership. Meanwhile, the more stable housing market has meant that households do not need to buy their home as there is no 'housing ladder' of upwardly rising real house prices moving out of their reach over time.

In contrast, real house price gains have often been possible in England and have helped to make homeownership a goal for most households. The fact that, during the long years of decline in the English PRS, there was a gap between the value of tenanted and vacant houses meant that landlords needed to sell a

tenant-less property in order to maximise these capital gain. And this is a major reason why landlords are so opposed to strong security of tenure. Meanwhile, the history of inflexible rent controls up to 1965 and the involvement of quasi-state 'rent officers' in setting regulated rents from 1965 onwards, has left a deep scar on the attitudes of private landlords and helped to buttress their belief in deregulated rents.

However, unregulated rents and weak security of tenure are not conducive to long-term renting in the PRS. It is hardly surprising, therefore, that non-poor households in England prefer the security of owning their home, while poor households prefer the security and sub-market rents offered by social housing, to insecurity of tenure and market rents in the PRS. These two conditions – free market rents and insecurity of tenure - are thus not inconsistent with a PRS that is focused largely on short-term tenants and highly mobile households. But they also explain why the PRS in England does not work so well for longer-term, low income tenants who are unable to buy their home and cannot get access to social rented housing. Hence, weak security and unregulated rents only make sense if the PRS is to remain a residual or transitional sector.

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Table 1: Private renting in context

| Regime type | England | Germany |
|----------------------|------------------------|----------------------------|
| Political economy | Liberal market economy | Coordinated market economy |
| Welfare state regime | Liberal | Conservative |
| Rental market | Dualist | Unitary |

Sources: Hall & Soskice (2001); Esping-Andersen (1990, 1999); Kemeny (2006)

Table 2: Housing tenure structure

| Tenure | England | Germany |
|------------------|---------|---------|
| Social rented | 18 | 14 |
| Private rented | 14 | 47 |
| Owner-occupation | 68 | 39 |

Note: England: 2007/08; Germany: 2005

Table 3: The owner-occupied housing market

| | England | Germany |
|---------------------------|-------------------|----------------------|
| Level of homeownership | High | Low |
| Attitude to home purchase | 'Property ladder' | 'Once in a lifetime' |
| Mortgage finance | Liberalised | Regulated |
| Sub-prime borrowing* | Yes | No |
| House prices | Volatile | Stable |

* Pre-2007/08 credit crunch

Table 4: Private renting characteristics

| | England | Germany |
|--------------------|----------------------------|------------------------|
| Size of PRS | Small but increasing | Large and stable |
| Public image | More positive than in past | Positive |
| Rent setting | Free market rents | Regulated market rents |
| Typical tenancies | Fixed-term leases | Indefinite leases |
| Tenancy duration | Short-term | Long-term |
| Security of tenure | Weak | Strong |
| Household types | Niche markets | Caters for all groups |

Table 5: Private individual landlords

| | England | Germany |
|--------------------------------|-------------------|-------------------|
| Market share | 74% | 77% |
| Importance of letting income | Sideline | Sideline |
| Lettings managed by landlord | 40% | 73% |
| Properties purchased | 82% | 50% |
| Properties inherited or gifted | 15% | 46% |
| Purchases financed with a loan | 48% | 29% |
| Ownership horizon | Short/medium term | Long term |
| Most common acquisition motive | Investment | Pension provision |

Table 6: Taxation of private individual landlords

| | England | Germany |
|------------------------------|---------|---------|
| Depreciation allowances | No | Yes |
| Negative gearing | No | Yes |
| Mortgage interest tax relief | Yes | Yes |
| Tax on rental income | Yes | Yes |
| Capital gains tax | Yes | Yes |

¹ As a share of all households, the PRS increased from 9% in 1988 to 14% in 2008.

² Note that landlords could also refer tenancies to the Rent Service if they so wished.

³ Homeownership is subsidised as part of pension plan subsidies.

⁴ For an overview on housing allowances in Germany see Kofner (2007).