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A Rocky Path to Homeownership: Why Germany Eliminated Large-Scale Subsidies for Homeowners

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For most Germans, renting a home is nothing unusual. Germany has developed an affordable, well-functioning rental market and a longstanding reputation as a nation of renters. The rate of homeownership has remained correspondingly low (43 percent in 2013) when compared with the rate in the United States (65 percent in 2013).[1] The story often told is that generous housing subsidies for the rental market and the absence of homeownership subsidies helped produce such an outcome (Voigtländer, 2009). Contrary to this popular belief, however, homeowners in Germany *did* receive sizable tax breaks and subsidies as part of social housing programs from the 1950s until the first decade of the 21st century. For decades, policymakers across the political spectrum have tried to create a nation of homeowners—but have struggled to do so.

After the destruction of World War II (WWII), Germany faced severe housing shortages. To stimulate housing, the German state adopted far-reaching subsidies through the tax code and social housing programs for both renters and homeowners. The subsidies for homeowners even outlived the nation's housing recovery well into the 21st century. The limited success of the subsidies, however, in creating more homeowners or raising the country's homeownership rate to levels seen in other advanced economies made these subsidies politically vulnerable. In the middle of the first decade of the 21st century, the grand coalition of the Christian Democratic Union (CDU) and the Social Democratic Party (SPD) under Chancellor Angela Merkel eliminated most federal subsidies for homeowners.

[1] Data retrieved from the U.S. Census Bureau and Federal Statistics Office Germany. The 2011 census in Germany estimated the homeownership rate to be 46 percent that year.

The key to understanding why the country eliminated its large-scale subsidies for homeowners lies in the power of Germany's federal states (*Länder*). In pursuit of their interests, the Länder both influenced housing legislation at the federal level and implemented federal laws in ways preferable to them at the state level.[2] The Länder undermined the objectives of federal homeownership policies by distributing more social housing funds to the rental sector than to homeowners and by successfully supporting the elimination of tax breaks for homeowners. They did so in part because they wanted to be in control of steering housing policy and distributing funds with sensitivity to the housing needs of their regions and local communities. The influence of the Länder in Germany is all the more remarkable when compared with the situation in the United States, a country also known for its decentralized government, where federal housing policies put federal agencies in charge of the most important homeownership policies.

U.S. policymakers and housing experts may be interested in these findings for a number of reasons. The differences between the German toolkit of home finance policies and that of the United States provide opportunities for comparison that may help us better understand and advance housing policies in the United States. Moreover, contrasting the political economies of housing in the United States and Germany reveals that the degree to which the housing sector plays a key role in the larger economy creates different policy options and opportunities for home finance reform in the two countries. This discussion sheds some light on why the United States is seemingly stuck in a "socialized" homeownership market,[3] a so-called third rail of U.S. politics that is unlikely to be touched by political leaders, whereas German policymakers managed to scale down subsidies for homeowners.

Subsidizing Homeowners Through the German Tax Code, 1949–2006

When roughly one-half of the German housing stock was destroyed or severely damaged as a result of WWII—producing a shortage of 4.5 million homes—the German government under Chancellor Konrad Adenauer (CDU) decided to stimulate both rental and owner-occupied housing. Included in this larger effort to stimulate housing were tax breaks for homeowners dating back to the early years of the Federal Republic, in 1949. Over time, these tax subsidies not only have outlived their original purpose of rebuilding the country but also have become the largest subsidies in the German tax code, amounting to roughly €11.4 billion in 2004.

The nature of tax breaks for homeowners in Germany differed decidedly from those in the United States. Homeowners in the United States have mainly benefited from the mortgage interest deduction, the property tax deduction, the capital gains exclusion, and the foregone tax on imputed rent (a tax on the rental income one generates by living in one's own home). By contrast, U.S.-style tax

[2] Also see Katzenstein (1987) and Scharpf (1988). For an example in a different policy area—that is, old-age care—see Campbell and Morgan (2005).

[3] I adopt this characterization from Mervyn King, the former head of the Bank of England, quoted in McLean (2015). For instance, the U.S. government currently guarantees more than 5 trillion U.S. dollars in mortgage debt and provides sizable tax breaks for homeowners.

subsidies for homeowners were never the most important tax subsidies in Germany—most notably not the mortgage-interest deduction.[4] Instead, homeowners were able to deduct from their income a certain percentage of the construction and financing costs of their homes through the so-called *Eigenheimzulage* (homeownership allowance).[5] The tax break was limited to certain income groups, was co-financed by the Länder and the federal government, was offered as a tax deduction (before 1996) and a direct tax subsidy (after 1996),[6] could be used only once by each taxpayer for a limited time, and for the most part privileged those building new homes over those purchasing older homes. Thus, German policies had a number of key differences when compared with U.S. policies. Technicalities aside, however, both countries—albeit in different ways—subsidized homeowners through tax breaks deviating from the economic principle of tax neutrality.

A distinctive feature of German homeownership tax breaks was their connection to other policy areas, such as family and environmental policy. In 1981, for instance, homeowners with children could deduct a higher amount from their income as part of the tax subsidy. This added a family policy component to the subsidy. In 1996, homeowners building environmentally friendly homes were permitted to deduct higher amounts from their income, which appended an environmental element to the subsidy. Tax breaks for homeowners thereby served multiple policy objectives.

The political story behind these subsidies is intriguing. Largely sustained by strong center-right parties, the German tax subsidies were relatively uncontested until the 1980s—but the political climate changed dramatically in the 1990s. The reunification of the country was especially important in bringing about changes in housing taxes. First, reunification reinforced an existing trend of growing deficits and, with it, fiscal consolidation efforts in the late 1990s and 2000s. Second, it led to some housing market imbalances, with large-scale housing vacancies in eastern Germany and housing shortages in the western parts of the country. Third, given income and wealth differences between the old and new federal states, it elevated the issue of inequality to the political agenda, bringing attention to, among other concerns, the regressive nature of tax breaks for homeowners. This led several Länder, including conservative-led states, to join SPD in launching a series of attacks to eliminate the tax subsidy. The Länder opposed the subsidy because, among other things, they co-financed the subsidy in times of growing deficits and viewed it as an imprecise instrument to manage unbalanced regional housing markets (the vacancies in some regions and shortages in others). In 2006, the grand coalition of CDU and SPD removed the tax break for homeowners, a reform that was supported by the Länder in the country's upper house.

[4] Before 1986, German homeowners could use the mortgage-interest deduction, but they also had to pay a tax on imputed rental income. After 1986, they could no longer use the mortgage-interest deduction, but they were also no longer taxed on imputed rental income. Note also that German homeowners are exempt from paying taxes on the capital gains of home sales if they have owned their home for at least 3 years. Also, from 1950 until 1989, some German homeowners could claim a property tax deduction for 10 years as part of the large-scale social housing programs.

[5] The tax break was renamed and tweaked multiple times: it was called "7b tax break" from 1949 until 1986, "10e tax break" from 1986 until 1996, and Eigenheimzulage from 1996 until 2006. It nevertheless retained its core function of subsidizing homeownership through the tax code until 2006.

[6] Before 1996, high-income households benefited disproportionately from the tax break, because they could reduce their taxable income (and the taxes they owed) more effectively than low-income earners. After 1996, homeowners received a subsidy, rather than a tax break, in an amount independent of their incomes.

How Germany's Social Housing Programs Failed To Promote Homeownership, 1950–2006

The large-scale social housing programs (the *Sozialer Wohnungsbau*) provided significant government subsidies to German homeowners. To most observers, the focus on homeownership as part of social housing programs is counterintuitive, because social housing programs are often associated with public housing projects or the rental sector. Yet, social housing funds (that is, subsidized loans or interest-rate subsidies on loans) in Germany were offered both to homeowners and to the rental sector. The regionalized character of these subsidies is distinctive when compared with the national character of subsidies in the U.S. mortgage market, where federal agencies—Fannie Mae and Freddie Mac, for example—tend to harmonize mortgage rates across regions with different risk levels through federal subsidies and government guarantees (Hurst et al., 2015).

Much like tax breaks for homeowners, social housing subsidies for homeowners date back to the early years of the Federal Republic, when the Adenauer government introduced the First and Second Housing Laws, in 1950 and 1956. The Second Housing Law specified that homeowners should be given priority when it comes to the allocation of these funds, because the Christian Democrats, in particular, tried to create a nation of homeowners in the early postwar years. This effort reflected their strong preference for family life in single-family homes, especially for uprooted families, and an anticollectivist ownership ideology (Diefendorf, 1993; Moeller, 1996).

Despite the federal law's goal of supporting homeowners, most funds were given to the rental sector, because the Länder—responsible for distributing federal housing funds and their own social housing funds—decided to support that sector. With appropriate caveats about some differences between federal states, during only two brief periods from 1950 until 2000 were more social housing funds distributed to homeowners than to renters (from 1976 to 1981 and from 1984 to 1988); in these periods, the share of subsidized owner-occupied housing briefly climbed above 50 percent, peaking at 68.7 percent in 1987.[7] This situation, of course, stands in stark contrast with that in the United States, where the mortgage giants Fannie Mae and Freddie Mac and the Federal Housing Administration supported multifamily rental housing only marginally.

The German Länder favored the rental sector on multiple grounds. Funding single-family homes was often not feasible for states and local communities, especially in metropolitan areas where land is scarce and expensive. In addition, states did not want to encourage urban sprawl and suburbanization, which would have put them on the hook for financing new infrastructure, such as schools and hospitals.[8] It was more efficient administratively to approve funding applications from experienced public or private companies that specialized in building multifamily homes than from thousands of inexperienced homeowners. In sum, many states viewed distributing funds to the rental sector as being more pragmatic and providing affordable housing for more people, and as showing sensitivity to the housing needs of local communities.

[7] Some notable regional variation exists, in that states such as Baden-Württemberg (the so-called land of home builders) and Rhineland-Palatinate offered more subsidies to homeowners than did other states.

[8] Also see Kohl (2016).

The funding of social housing units for renters and for homeowners corresponded closely with developments in the larger housing market. In times of balanced housing markets—a perceived equilibrium between housing demand and supply—federal and state policymakers decreased the number of subsidized units; and, in times of housing shortages, the number of supported units increased. For instance, construction was booming in the early postwar years, with 3.5 million newly built housing units from 1950 until 1956, roughly 70 percent of which received social housing subsidies. Because of strong population and economic growth, construction levels remained high until the mid-1970s (roughly 500,000 to 700,000 units per year), but the share of subsidized units declined steadily to about one-third of the total new units, in part because the housing crisis was over, the private capital market had recovered, and policymakers started celebrating a balanced housing market. Although the federal government had provided the lion's share of social housing funding in the 1950s, the Länder's funding share started to match and exceed federal funds beginning in the 1960s.

The reunification of the country, including the integration of two very different housing markets, upset the equilibrium. While reunification led to an initial increase of housing activity in the country to modernize the eastern German housing market and to stimulate western German housing to cope with newcomers from the eastern parts, it also contributed to an overheated eastern German housing market fueled by short-term tax incentives and other subsidies. The result was large-scale housing vacancy of about 1 million units, followed by federally funded demolitions in eastern Germany. As a result, housing activity in the country leveled off at the turn of the century. In 2003, the social housing programs subsidized a mere 32,000 units (down from 162,000 units in 1994). Still, between 1950 and 2004, the social housing programs subsidized 36 percent of 25.3 million newly built housing units in the country in a government program that most analysts consider a success.

In the new century, the German Länder received even more autonomy in formulating social housing policy. In light of low demographic projections and rebalancing housing markets, the first major reform of 2001 included a notable shift from supporting affordable housing for large segments of the population—the signature theme of the older social housing programs—to supporting those in need of affordable housing.[9] In 2006, as part of Merkel's federalism reform, the Länder received the full authority to distribute social housing funds, effectively sidelining the federal government. This was because for many years the Länder had provided most of the social housing funds and had pushed for more autonomy in social housing policy (Scharpf, 2008). In ceding its authority in this way, the federal government lost its ability to react swiftly to housing shocks caused by demographic and economic developments, including any influx of immigrants or refugees.

[9] Another reason for this reform was that many people lived in subsidized units after no longer fulfilling the income criteria for such units.

Larger Implications

Today, there are relatively few homeownership subsidies left at the federal level in Germany.[10] The few programs that still exist are for the most part administered by the Länder.[11] Despite the country's low rate of homeownership, Germany has developed a relatively balanced and well-functioning housing market, which offers homeownership for some and high-quality and affordable rental housing to others—with a few exceptions in major cities.

How did the German state reduce its footprint in the country's home finance market whereas the United States is struggling to do the same? Comparing the political economies of housing in both countries sheds some light on this issue. Housing is an essential part of the U.S. growth model, based on consumption and credit, with important transmission effects into the larger economy (Leamer, 2007; Mishkin, 2007). The German growth model is much less dependent on housing and instead relies on exports and savings. While rising house prices stimulate credit growth, housing demand, and consumption in the United States, this relationship is less pronounced in Germany, in part because of conservative lending practices and the absence of equity withdrawal (Geiger, Muellbauer, and Rupprecht, 2016). Housing debates in the United States are often centered on a number of sensitive issues that truncate the policy space for comprehensive housing finance reform: the macroeconomic effects of reform on housing demand, mortgage rates, house prices, and consumption. These considerations are all the more important as many Americans use their homes as a form of private social insurance. As noted, home finance policies in Germany have not been tied in closely with the country's economic growth model and have produced fewer homeowners. German policymakers as a result have faced fewer macroeconomic and political constraints, allowing them to tweak and reform housing finance policies in pursuit of a wide array of policy objectives, including family, pension, affordability, or regional priorities. The differing political economies of housing in the United States and Germany thus present different policy options and opportunities for reform in the housing area.

Finally, homeownership is not all we should talk about when it comes to housing. The German experience shows that, although the country's homeownership project struggled, Germany managed to develop a well-functioning, affordable, and high-quality rental market. In contrast to the United States, the German state provided generous subsidies to both forms of tenure (that is, renters and homeowners), often empowering regional governments to decide how to distribute funds. In times of stagnant wages, rising student debt, tight credit conditions, and a slowly resolving financial crisis, many people in the United States are in need of affordable housing. U.S. policymakers could respond to these concerns by shifting some housing subsidies from homeownership toward rental markets, they could expand voucher programs (Desmond, 2016; Green, 2011), and they could distribute federal housing grants with more sensitivity to the rental housing needs of their local communities. These changes might provide affordable housing for larger parts of the population.

[10] For instance, the Kreditanstalt für Wiederaufbau (KfW), a government-owned development bank, extends small subsidized loans to homeowners. Other government programs, such as pension-related contributions (*Wohnriester*) and savings-related contributions (*Bausparen*), do not directly subsidize homeownership.

[11] Some Länder continue to offer programs for homeowners, including small-scale subsidized loans, but these programs differ significantly across the federal states.

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