

#IKEMClimateFinanceWeek

# Germany: Legal barriers to the decarbonisation of dwellings occupied by low-income tenants and financial incentives to overcome these barriers

Regional and local level

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*The thermal performance of dwellings occupied by low-income tenants is often below health and comfort standards. In Germany, this vulnerable group accounts for approximately 15% of the household stock, a percentage that is expected to rise due to the COVID-related economic crisis. While low-income tenants benefit from efficiency improvements to their dwellings, it is their landlords who must pay for the improvements, and the chance of passing the investment through to the tenants is low. Some locations are especially affected; Berlin is one such example. Most dwellings in Berlin (82%) are rented out; as a result, the split incentive in their renovation is a very common problem.*

*This brief presents work that the IKEM team is conducting to identify possible financing and legal solutions to overcome complex barriers to the energy transition. We employ a transdisciplinary approach, as the question touches upon technological, economic, financial, social, policy and legal aspects. The brief articulates a possible solution for energy efficiency in multi-residential buildings in Berlin, given its special circumstances and challenges<sup>1</sup>*

## Why address energy poverty in Germany?

The thermal performance of dwellings occupied by low-income tenants is often below health and comfort standards. This vulnerable group accounts for a significant share of household stock in Germany. In 2019, roughly 15% of households were affected by the risk of monetary poverty and thus could be classified as low-income households. These households rarely own the housing, but rather rent it; overall, 49% dwellings were rented in Germany in 2019. The number of low-income households has decreased over the past several years but is expected to rise again because of the economic crisis related to the COVID-19 pandemic. Some locations, including Berlin, are especially affected. Most dwellings in Berlin (82%) are rented out; as a result, the split incentive in their renovation is a very common problem. Berlin is a service economy, and it was significantly affected by the COVID-19 crisis: its GDP decreased by 1.4% in 2020 as compared to 2019.

Retrofitting dwellings occupied by low-income tenants gives rise to split incentives between the tenants and their landlords, a phenomenon referred to in the literature as the 'landlord-tenant dilemma'. While low-income tenants benefit from thermal efficiency improvements to their dwellings, it is their landlords who must pay for the improvements. For landlords, the value and economic benefits of thermal energy efficiency are of the essence, not energy-saving per se. High energy-performance dwellings have lower vacancy risks and a higher sale price, which influences the rental income of landlords. But due to numerous barriers, some of which are related to legal aspects, landlords have difficulties passing the investment through to tenants.

In light of the economic consequences of the COVID-19 pandemic, renovations have become doubly important for the European economy. As the EU aims to have an almost climate-neutral building stock by 2050, from now on both new and renovated build-

ings must be compatible with the climate goals for 2050. Buildings account for 40% of the EU final energy consumption and 36% of associated CO<sub>2</sub> emissions; given the higher share of rented dwellings in the stock, these, too, must be renovated. The recently adopted European Green Deal has only enhanced these ambitions, as it outlines a plan for the EU to become the first climate-neutral region by 2050. Additionally, investment in building modernisation can stimulate the economy, which is crucial to overcome the economic crisis. The construction sector already generates 9% of the EU's GDP and directly accounts for 19 million jobs. It is expected that additional investment in this sector will create new jobs and increase the EU's GDP, which would ultimately have a positive impact on low-income households.

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## What is energy poverty in Germany?

Poverty is a multi-faceted social phenomenon. There are different approaches to define poverty in general, and energy poverty in particular. Some researchers distinguish between relative and absolute poverty. Those affected by absolute poverty are unable to satisfy their basic needs; in other words, their physical existence is threatened. Poverty, in the sense of this definition, only exists when there is a risk of starvation or freezing. In the European context, such emergencies are, fortunately, rare occurrences.

es. Relative poverty describes a social condition in which people, families or groups have so few resources at their disposal that they are excluded from the way of life that meets the minimum acceptable standard in the state in which they live, as defined by the European Council and the Council of the European Union in 2003. The European Commission recognises the at-risk-of-poverty threshold as 60% of national median equivalised disposable income. The purchasing power standards are used for cross-country comparisons to account for differences in the cost of living across countries.

The definition of poverty is related to the definition of energy poverty but is not identical to it. Inclusive growth was a pillar of the Europe 2020 'strategy for smart, sustainable and inclusive growth', and it remains so in the context of the Green Deal. According to the European Commission's Recommendations of 14 October 2020 on energy poverty, energy poverty is a situation in which a household cannot afford key energy services to ensure a basic standard of living. The recommendations state that adequate warmth, cooling, lighting and energy to power appliances are essential services that underpin a decent standard of living and health, and that access to these energy services is essential for social inclusion. EU Member States establish the definition for energy poverty in a national context. The recommendations further identify energy poverty as a central element of the Green Deal, including its Renovation Wave initiative, and many other pieces of EU legislation and actions, such as the Energy Efficiency Directive, the European Buildings Performance Directive, the Electricity Directive, the Generation EU Recovery Package and the Cohesion Policy.

Germany, the world's laboratory for the energy transition, has long been criticised for not sufficiently addressing the challenge of energy poverty. Even today, it lacks an official definition of the phenomenon. Poor households in Germany are generally those who are only able to reach the socio-cultural subsistence minimum guaranteed under constitutional law. These are eligible for basic income support for job seekers in accordance with Book II of the German Social Code (SGB II) and for social assistance in accordance with Book XII of the German Social Code (SGB XII), or for benefits paid in accordance with the Asylum Seekers Benefits Act. In 2018, there were 5.6 million recipients of benefits under SGB II, representing the largest of these groups.

While a few definitions of energy poverty have been introduced by some German organisations, these definitions are not identical. Thus, the Consumer Office of Rheinland-Pfalz (Verbraucherzentrale Rheinland-Pfalz) defined energy poverty as a situation in which a household can pay energy bills to maintain the usual standard of living in Germany only by expending considerable effort or renouncing other basic needs. For example, the household may incur rental debt or short costs for nutrition, medicines, and education, such as the purchase of textbooks for children. The Consumer Office of North Rhine-Westphalia (Verbraucherzentrale Nordrhein-Westfalen), on the other hand, defines energy poverty as a situation in which a household must spend an above-average proportion of its income on heat and electricity or is no longer able to pay its energy bills at all. The feature common to both definitions is that the proportion of income spent on energy bills is higher for households affected by energy poverty than for the average household.

## What challenges can be addressed with policies?

In recent years, climate change has led to a shift in attitudes towards energy efficiency. However, one of the greatest problems persists, namely how to convince decision-makers such as building owners, property investors and facility managers to improve the energy performance of buildings.

The social and economic theory reflected in policy making is that neither landlords nor tenants have sufficient incentives to invest money in thermal efficiency improvements to dwellings. This can be explained by the fact that, as potential investors in such improvements, landlords and tenants tend to have different interests. The landlord's rationale for investing money in such retrofitting is that energy efficiency may impact the selling price of a dwelling and the rental income streams generated. However, there are also risks related to rental income or vacancy which may be affected by the price changes. These risks are considered to be important factors in the landlord's investment decision. Tenants, in turn, often face informational and financial barriers and uncertainty risks that prevent them from investing money in such improvements. Tenants are usually not motivated to finance the renovation because they do not own the property and are therefore not certain that the investment will be paid back fully in the course of their rental contract. From the landlord's point of view, however, tenants are the end consumers of the benefits of energy renovations, which gives the landlord the right to increase the rent.

In general, tenants cannot evaluate the real thermal quality of a dwelling; this is generally due to limited knowledge and technical understanding as well as to insufficient information on the efforts undertaken by the landlord to improve thermal performance. The tenant's willingness to pay is influenced by uncertainty regarding the length of the rental relationship. If the energy price increases, tenants often prefer to move to a more energy-efficient dwelling because of lower transaction costs. Even if landlords manage to credibly transmit the information about energy savings, this does not mean that tenants are willing to pay the rent that covers total energy cost savings. They can still move and choose between alternative residences. For landlords, this means a higher risk of vacant dwellings and the possible losses related to it. Whereas tenants are protected by law from the unlawful termination of their contracts, landlords have no certainty that tenants will rent dwellings for a long-term period, even if contracts are of an indefinite duration.

## Do current regulations address or aggravate the problem?

Tenancy law is of great importance for the energy modernisation of rental housing stock. In Germany, tenancy law is mainly regulated by the German Civil Code (BGB), which is a federal law. Since 2013, the German government has amended the BGB numerous times to create connection points to the energy transition, as the existing tenancy law provisions did not meet the requirements for rented living space in the context of ener-

gy efficiency and climate protection at that time. As a reaction to this, the law on the energetic modernisation of rented living space and the simplified enforcement of eviction permits (Tenancy Law Amendment Act – MietRÄndG) was enacted in 2013. The MietRÄndG legally defined energy efficiency modernisation for the first time. With this law, the co-responsibility of tenancy law for a successful climate protection policy was recognised by the Germany legislature. The law also aimed to reduce existing obstacles, such as the landlord-tenant dilemma, and to establish new incentives for energy modernisation. The main purpose of the reform was to simplify the implementation of energy efficiency modernisation. This was accomplished by restricting the tenant's right to rent reduction in the event of renovation measures. From this point on, a reduction of suitability would not be considered for the duration of three months insofar as this has been taking place because of a measure which served the purpose of energy efficiency modernisation in accordance with §555b no. 1 BGB, §536 sub-section 1a BGB. In addition, a general toleration of modernisation measures by the tenant was introduced in §555d BGB.

In 2015, the legislature tried to address the causes of rising rents on the secondary real estate market by enacting the Act to Curb the Increase in Rents in Overheated Housing Markets and to Strengthen the Bestellerprinzip in the Facilitation of Residential Tenancy Agreements (Tenancy Law Amendment Act – MietNovG; the Bestellerprinzip requires the party who appoints a letting agent to pay the agent's commission). The BGB now provides a framework for dwelling modernisation.

With the adoption of the Law on the Energetic Modernisation of Rented Housing and the Simplified Enforcement of Eviction Titles (Mietrechtsänderungsgesetz), the landlord who carried out modernisation measures within the meaning of section 555b number 1, 3, 4, 5 or 6 BGB (including energy efficiency modernisation) may increase the annual rent by only 8% of the costs incurred for the flat (§559 subsection 1 BGB). Moreover, the 'capping limit' on rent increases was introduced in subsection 3a of the same legal norm. In the event of increases in the annual rent in accordance with subsection 1, the monthly rent may not increase by more than EUR 3/m<sup>2</sup> of living space within six years, except for increases stipulated in accordance with section 558 BGB (rent increase up to the local comparable rent) or section 560 BGB (changing in operating costs). If the monthly rent before the rent increase is less than EUR 7/m<sup>2</sup> of living space, it may not increase by more than EUR 2/m<sup>2</sup> of living space. Violations of the capping limits can qualify as an administrative or even criminal offence under §5 WiStG (Commercial Criminal Law – Wirtschaftsstrafgesetz).

Berlin introduced the Law on Rent Limitation in Housing in Berlin (MietenWoG Bln) in winter 2020. The main task of this law was to introduce a state limitation on rents in Berlin for five years. Any rent that exceeded the rent effectively agreed on 18 June 2019 (the reference date) was prohibited. This referred, among other things, to modernisation rent increases. The Federal Constitutional Court, however, declared this law incompatible with the Basic Law and therefore void. Nevertheless, this did not solve the lack of incentives for modernisation, as the above-mentioned capping limits for rent increases are still valid.

Therefore, the existing legal framework does not create incentives for any party to the rental contract to support the energy modernisation of dwellings, even when parties have the assets to carry out this modernisation. On the contrary, the legislature has created additional legal barriers preventing the landlord from any form of modernisation, as this has become economically unprofitable for them. For low-income tenants, the outlook is even worse, as an even lower rent-increase cap was established for cheaper dwellings. In order to achieve climate goals, a balance must be struck between the limits imposed by the welfare state principle, on the one hand, and the need for climate change mitigation, on the other.

## Solutions

To address the energy poverty of tenants, it is therefore essential to provide financial incentives for the renovation of rented dwellings to correct the market imperfection aggravated by legal barriers. This is especially the case for economically struggling regions or regions with high legal barriers, as shown in the case of Berlin. In the absence of financial incentives addressing energy poverty at federal level, affected subnational governments at regional or local level must raise additional funds to provide financial incentives for renovations. For this, they could raise additional revenues through levies and taxes, obtain debt or involve third parties in the financing scheme.

As many examples in other countries have shown, a special levy for polluters, e.g. of CO<sub>2</sub> emissions, can help create an additional source of funding for local governments. However, special levies are problematic from a constitutional point of view and, under certain circumstances, may conflict with the constitutional principle of the tax state, according to which the state must essentially cover its financial needs through taxes. There is a danger of undermining the distribution of competences under fiscal constitutional law.

In addition, a special levy assigns a special financial responsibility to certain groups of citizens, which creates burden inequality. According to the case law of the German Federal Constitutional Court, a special factual justification is required for special levies in order to avoid conflict with the constitutional principle of the tax state. Thus, this instrument is complicated, and its application carries legal risks. Moreover, the introduction of special levies is time-consuming, as a (federal) law must pass through all parliamentary stages.

The other option is to raise municipal debt by either taking loans or issuing municipal bonds. However, this option faces legal barriers as well. The Basic Law of Germany generally prohibits balancing the budgets of the Federation and the German regions (Länder) through budget inflows from debt. It is highly controversial whether this rule also applies to municipalities. Nevertheless, at the Länder level, there are also restrictions on indebtedness for municipalities and municipal associations. These are usually laid down in the municipal and district ordinances (municipal constitutions), but sometimes also in the state budget ordinances or even in the state constitutions (e.g. Bremen). These restrictions regularly refer to loans, credit-like payment obligations (i.e. bonds) and cash credits. Loans are generally only per-

missible as a subsidiary means of raising revenue. This is usually the case only if other financing is not possible or economically inappropriate, if borrowing does not lead to a permanent loss of the municipality's financial capacity, and if the competent municipal supervisory authority approves the borrowing in general or in individual cases.

Two options represent a special class of public-private partnerships that could be created for the purposes of raising debt through the issuing of corporate green bonds for renovations.

1. First, the legally independent legal persons are not covered by the constitutional debt brake and thus can issue green bonds for the Federation's purposes, even if they are financed by the Federation or the Federation is ultimately liable for their liabilities. Such legal persons have their own budget and are not attributed to the Federation under budgetary law, even if they belong to the indirect federal administration. The taking out of loans by a legal person under public law is also not covered by the constitutional 'debt brake' if the legal person is financed by the Land, or if the Land is liable for its liabilities. This rule is even more applicable to the legally independent legal persons financed by municipalities. Thus, as it is generally forbidden to create debt obligations for municipalities, they can still establish legally independent legal persons that can issue green bonds for the retrofits of buildings. However, there are certain legal specifications to consider. Any legal person under public law may be treated as an integral part of the federal budget. If it does not perform any material tasks on its own but carries out predominantly or exclusively financial transactions for which the Federation is ultimately liable or for which it assumes

the debt service, it is consolidated with the federal budget for the purpose of Art. 115 of the German Basic Law.

2. The second possible solution to the landlord-tenant dilemma is the promotion of green bond emission through credit institutes of private law. To create financial incentives, one party must take over a guarantee vis-à-vis the credit institute for the case of project renovation insolvency and vis-à-vis investors for the case that the credit institute cannot fulfil its financial obligations. Following the debt break principle, the municipalities are generally not allowed to take over any financial securities. Thus, the legally independent legal entity could take over this role. This scheme allows the municipalities to delegate their obligation to decarbonise the housing stock to legally independent legal entities and to the companies of private law. Even if the project becomes insolvent in the end, the state still fulfils its obligations for climate change mitigation.

Thus, the issuing of green bonds through credit institutes of private law is suitable for any municipality that can stimulate and motivate private institutes to issue green bonds through benefits.

Municipal green bonds and corporate green bonds are frequently used, especially in Nordic countries, which have been pioneers in using green bonds to mobilise capital for sustainability goals. Among the leading issuers of municipal green bonds are Kommuninvest (Sweden), KommuneKredit (Denmark), Kommunalbanken (Norway) and MuniFin (Finland). Below, we provide a case study of one Swedish company, Vasakronan, which issued corporate green bonds for municipal purposes. This could serve as a replication prototype for Berlin.

## Case study: Vasakronan (Sweden)

<b>Background</b>	Vasakronan is Sweden's largest property company, with properties in Stockholm, Uppsala, Gothenburg and Malmö. In 2013, Vasakronan was the world's first corporate green bond issuer, and it remains the largest corporate green bond issuer in Sweden, with SEK 5.2 billion in green bonds outstanding.
<b>Project scope</b>	Green bonds are issued under Vasakronan's EMTN programme. The proceeds from green bonds are used solely for investments encompassed by Vasakronan's Green Bond Framework. These include thermal retrofits of buildings, also in cooperation with municipalities and other stakeholders.
<b>Financing structure</b>	Vasakronan has committed to fulfilling a sustainability mandate with a focus on financial, environmental and social dimensions based on the principles in the UN Global Compact, including taking 'a precautionary approach to environmental challenges', undertaking 'initiatives to promote greater environmental responsibility', and encouraging the 'development and diffusion of environmentally friendly technologies', which provides a framework for the company's green financing programme.
<b>Project implementation</b>	The company has elaborated a sustainability programme with specific environmental, financial and social performance targets set as part of a plan each year, reporting in accordance with the Global Reporting Initiative. As a result of these initiatives, Vasakronan reduced the carbon emissions from its portfolio by 97% between 2006 and 2013 and reduced its energy use by 30% over the same period. In 2017, Vasakronan updated its Green Finance Framework. Vasakronan aims to take further steps towards mobilising debt capital markets for climate change and offering investors further insight into its sustainability strategy.

## Conclusion

Addressing the landlord-tenant dilemma is important for Germany to achieve the climate goals set out in the EU Green Deal. Tenants are a vulnerable social group with limited assets to participate financially in retrofitting their dwellings. The existing tenancy law creates additional legal barriers aggravating the landlord-tenant dilemma. To finance the retrofit of rented dwellings populated by low-income households, regions and municipalities must raise additional financial resources. Best practices that have shown positive results of financing similar projects in other countries face constitutional barriers in Germany and must be transformed to be applicable here. The introduction of a

special levy is a promising solution from a long-term perspective, but it is fraught with legal risks. It is not feasible in the short term because a law regulating this levy would need to pass through the entire parliamentary process. Municipalities are not allowed to take out loans or to take over financial securities, such as bonds. A possible solution is a new form of public-private partnerships. Municipalities could establish legally independent legal entities for the purposes of issuing green bonds and taking over financial guarantees if the bonds for municipal purposes are issued by corporate entities.

<sup>1</sup> For more information and references please see our dedicated projects on assessing financing and legal solutions for energy transition of municipalities and regions, such as Dynamic Light, ESRa, and the PhD dissertation of Jana Karras:

Jana Karras. Forthcoming. Legal barriers of thermal efficiency improvement in dwellings populated by low-income tenants and opportunities to overcome them. Case study of Germany. PhD Dissertation. Greifswald: University of Greifswald.

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## Associated projects:



**ESRa**

Energiewende  
im Sozialen Raum



European Union  
European Regional  
Development Fund

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