Constructing the Crisis:
The Impact of Subsidies on the Berlin Office Market 1989-2002

by

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Submitted to the

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Partial Fulfillment of the Requirements for the Degree of

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ABSTRACT

Following the reunification of Germany and prior to the much debated and twice postponed decision to relocate its capital to Berlin, events were set in motion that resulted in a roller coaster ride for investors in real estate and in particular for those interested in office space. Demand was expected to increase exponentially. Investors, both domestic and foreign, believed the transfer of government would create excessive needs both for the various ministries and political parties but also for national and international businesses thought likely to move to Berlin along with the government.

This paper traces the history of events putting a special focus on the various governmental incentives designed to encourage investment and influencing real estate investment decisions on the part of the several different investment groups. Differentiating between incentives necessary for the private market to operate (planning legislation) and others promising concrete financial rewards (tax laws), the paper describes the causes and effects of the city's resulting real estate crisis, including the political and financial scandal of the Berlin Bank Association. The comparison of real estate cycles in different German cities between 1989 and 2002 demonstrates the fatal consequences of too generous and too long-lasting governmental subsidies for the Berlin real estate market.

The evolution of the Berlin office market is a classic case of market-based decision making being overcome by tax-driven decisions and producing a crisis that in all probability could have been avoided had market conditions alone been allowed to determine the outcomes.

Thesis Advisor: John T. Riordan

Title: Chairman, Center for Real Estate

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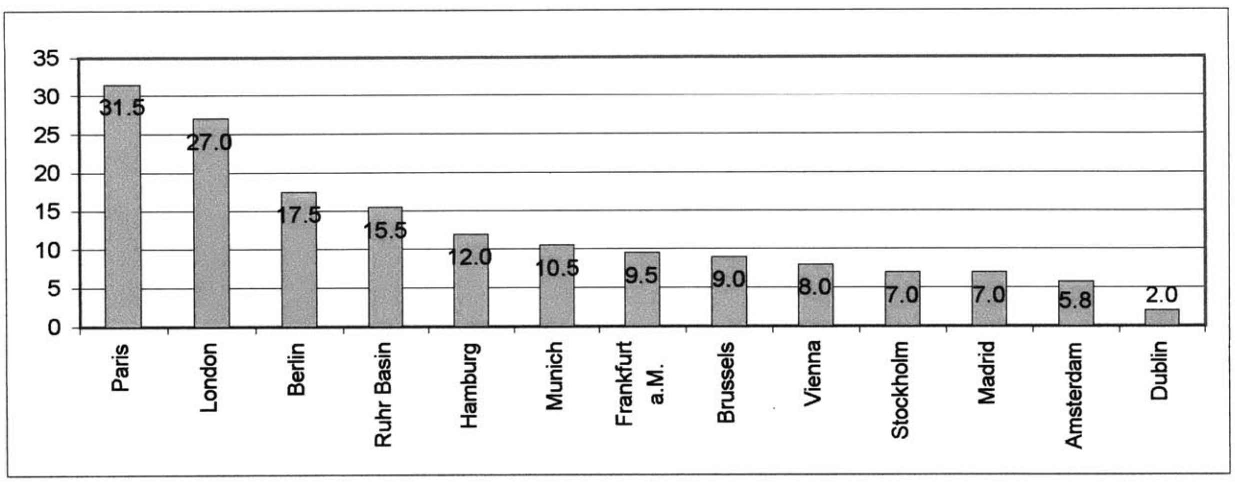
A) Introduction

I. Berlin in 2002

With a total stock of around 17.5 million square meters, Berlin has the largest amount of office space in Germany. In Europe, Berlin ranks third after Paris with 31.5 million m^2 and London with 27 million m^2 (see Fig.1: Office Space in Europe).

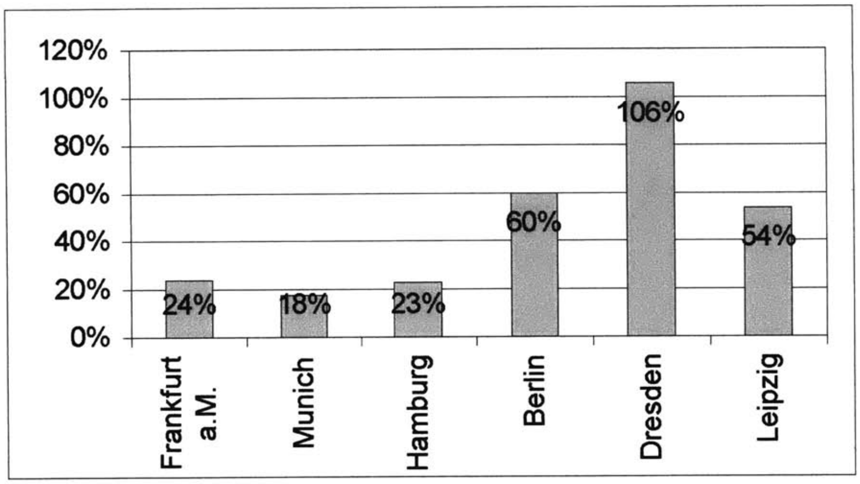
Fig.1: Office Space in Europe
In Million m²



Source: Senatsverwaltung fuer Stadtentwicklung, 2001

Following the German reunification, large amounts of new office space appeared on the market in all large German cities. The largest proportional increase in office space, however, occurred in Berlin as well as in the cities of the former East Germany (see Fig.2: Change in Stock of Office Space 1990-2001). This development can be attributed to the generous subsidy programs issued by the federal government in order to encourage investment activity in the so-called New States (the former DDR) and in Berlin.

Fig.2: Change in Stock of Office Space 1990-2001
In Percent



Source: Bulwien AG 2002, Senatsverwaltung fuer Stadtentwicklung, 2002

II. Outline of the Thesis

This paper analyzes the role of public subsidies as well as the role of general investment incentives in the Berlin office market between 1989 and 2002. The main three questions to be addressed by the research are:

1. What were the incentives and how have they changed over time?
2. Who were the players in the German real estate market and what drove their different investments ?
3. What were the effects of the public subsidies on the Berlin real estate market and how can they be evaluated after the fact?

The body of the thesis is divided into four parts. The first part describes the different incentives to invest in the Berlin office market over time, such as the relocation of the capital, the favorable planning legislation, the rent levels and the benefits from tax legislation. The paper describes the incentives for investors offered by the conditions in the years following reunification as well as those offered in 2002.

The second section describes the types of investors in the German market and in the Berlin market in particular. It analyzes their different legal structures and how this enabled them to take advantage of different incentives. Finally, it describes the effects of changes in legislation on the recent investment behavior of several market players.

The third part examines the financial and political scandal of the Berlin Bank Association (*Bankgesellschaft Berlin*). It analyzes the structure of their investments, their role in the Berlin real estate market, and the outcome of their business plan as well as the financial consequences for the city of Berlin.

The fourth part describes the characteristics of the Berlin crisis, such as vacancies, non occurring demand, consistent building activity and an oversupply of space. These factors are displayed in light of Berlin's economic and financial situation over time. Finally, a comparison of real estate cycles in different German cities between 1989 and 2002 analyzes the effects of public subsidies in Berlin and calls them into question.

B) Factors Stimulating Investment Activity

I. Incentive: Location

1. The German Reunification

1.1 Changes in Geography

> "Last year, New York advertised itself as the "capital of the world". Today, New York will have a competitor: "New Berlin". In the 21st century, Berlin has every chance to become for Europe, what New York has been for the New World." (Der Spiegel, September 1999)

On November 9, 1989 the Berlin Wall burst. This event symbolized the end of the Cold War and reunited a city which had been separated for more than 40 years. The Berlin Wall had divided a city, a country and metaphorically the world (Strom, p.1). Over night, Berlin doubled in size and was, with a total of 3.5 million inhabitants, the nation's largest city. Secondly, and more astoundingly, its geographical location was changed entirely. From its existence as a small capitalist island surrounded by socialist countries, all at once it was a large metropolis, situated in the heart of Germany.

Suddenly, Berlin's location appeared attractive to all kinds of businesses which had never before been interested in the city. Most prominently, Daimler Chrysler, Sanofi, and Sony immediately started planning large office projects on the *Potsdamer Platz*, moving important branches of their businesses to the new center of Berlin[1]. The Berlin Economic Development Corporation reported that in just the three years from 1989 until 1992, 119 new businesses with more than 8,000 employees had settled in Berlin, two thirds of them coming from the service sector (Frankfurter Allgemeine Zeitung, July 1995).

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[1] Daimler Chrysler came with its service section Debis, Sony opened its European headquarters.

1.2 Global City Berlin

It was the national and international belief that Berlin would become the political, financial and cultural center of Germany and had the potential if not the "mission" to reach the status of a "global city" in the center of Europe. Around the world, mostly in Japan, in the US and in Canada numerous Germany Funds emerged. Due to massive international investment, prices on the German stock market rose 35% on average between November 1989 and February 1990 (Wirtschaftswoche, February 1990).

However, the general economic upswing was experienced nowhere as dramatically as in Berlin. Businesses there benefited from the fall of the wall, responding to new consumer demand from the east (Strom, p.118). Serious economic growth was expected not only from a reunited Germany but from the entire eastern bloc. It was therefore claimed that Berlin would quickly become the strategic economic center of East-West relations (*Wirtschafts-Drehscheibe Ost-West*). In 1991, political authorities euphorically stated that "next to Shanghai, Berlin is the most interesting location of the future" (Tageszeitung, February 1991).

2. Relocation of the Capital

2.1 Expectations and Early Investment Activity

On June 20, 1991 the German parliament (*Bundestag*) voted on the question of the German seat of government. By a mere 18-vote margin the decision was made: after a period of over 40 years with a provisional capital in Bonn, the parliament and its ministries would relocate their offices to the city of Berlin. This decision was crucial for the future development of Berlin and further buoyed the already existing ecstatic mood in the reunited city. In its new function as the German capital, Berlin was determined to increase its population and employment. This would result in even greater demand for office space and housing. In the same year, Berlin applied to host the Olympic Games in 2000.

Governmental authorities expected both major events would have significant, long-term and sustaining effects on the city's economy (Lenhard, p.82).

According to early estimates, the organs of the national government alone would occupy some 800,000 m^2 of office space. Of even greater interest to real estate developers, however was the further demand for offices that the government was bound to need. Capital cities are typically gathering points for political parties, interest groups, and trade associations for whom contact with government is essential. According to a government estimate, those activities were expected to create about 100,000 additional office jobs and a corresponding amount of new office space (Stadt Bonn, Daten zur Bundeshauptstadt Bonn).

The decision to relocate the capital also drew private investors to Berlin. Only a few weeks after parliament's decision, the leading association of German manufacturers, the *Bundesverband der Deutschen Industrie* (BDI), publicly announced its plans to move to Berlin, saying "we will follow the government". This declaration was expected to generate a snowball effect, causing lobbyists representing each industrial sector to move their headquarters as well. Indeed, many of Berlin's newcomers decided to invest in Berlin in anticipation of or just after the government's decision, illustrating that the decision to relocate the capital had a serious impact on real estate development (Strom, p.122).

2.2 Postponement and Final Decision

According to the original plan, the parliament was supposed to be up and running in Berlin by 1995. Soon afterward however, government authorities found it more realistic to move in 1998. Finally, in 1993, the parliament in Bonn voted to postpone the relocation until the year 2000. Firms, investors and political authorities called this announcement a true "catastrophe" which was destined to ruin the future of the city (Der Spiegel, October 1993).

For investors as well as creditors, the possibility of Berlin not becoming the capital for seven years was just too risky. Even after the first postponement, numerous developers had run into trouble with their banks, having based their credit agreements on quick and easy leasing assumptions. In the new, more drawn-out timeframe, two elections in parliament would take place and with them the chance that a different chancellor would come into office. In addition, changes in tax legislation were planned for 1995, and it was likely that by 2000, the government would argue differently about issues such as national debt, financial crises and the costs for relocation of the capital.

By 1993 a strong lobby had evolved for keeping the capital in Bonn. The lobby was led by representatives of North Rhineland-Westphalia, where Bonn is located and the representatives of some smaller western states, both fearing an eastward shift of the political center of gravity (Strom, p.160). Pointing to the already enormous expenses associated with the German reunification as well as the increasing national debt, they considered a relocation of the capital an additional and unnecessary national expense. Indeed, the estimates for the costs of the move had increased with each press report from 30 billion DM to 50 billion DM to 200 billion DM (Schweitzer, p.24). As a consequence, public opinion had changed as well: in 1993, only one third of the German population favored the relocation of the capital to Berlin.

In reaction to the new announcement, investors and industrial leaders wrote and signed a public letter to Chancellor Kohl, and 35 large companies took out a full-page ad in major national newspapers demanding more "clarity, certainty, and commitment" in drafting plans for the new capital (Der Spiegel, October 1993). Sony, planning to move its European headquarters to the *Potsdamer Platz*, thought of revising its decision, saying that without the capital functions, Berlin was just a provincial outpost. Some U.S. developers for office buildings at Checkpoint Charlie threatened to sue the federal government for breach of contract if the move was not carried out in the original time-frame (Strom, p.162).

In early 1994, the *Bundestag* publicly announced the final decision to start the relocation in 1999 and conclude it by 2000. This final and irrevocable decision was a great relief to firms, investors and developers who were again willing to take up their investment activity in Berlin. In 1995, a number of foreign governments began to build their embassies, and trade associations started considering sites for their national headquarters (Die Zeit, March 1995). Throughout 1998-1999, federal ministries moved more of their operations to Berlin, and the local press reported on the arrival of central party organizations and national interest groups settling into new quarters around the city (Strom, p.163).

2.3 Actual Impact of the Relocation

All in all, the move of the capital proceeded far more slowly than early investors had envisioned. Further, the arrival of the federal government did not have the transforming effect on the economy or on the real estate market that had once been thought.

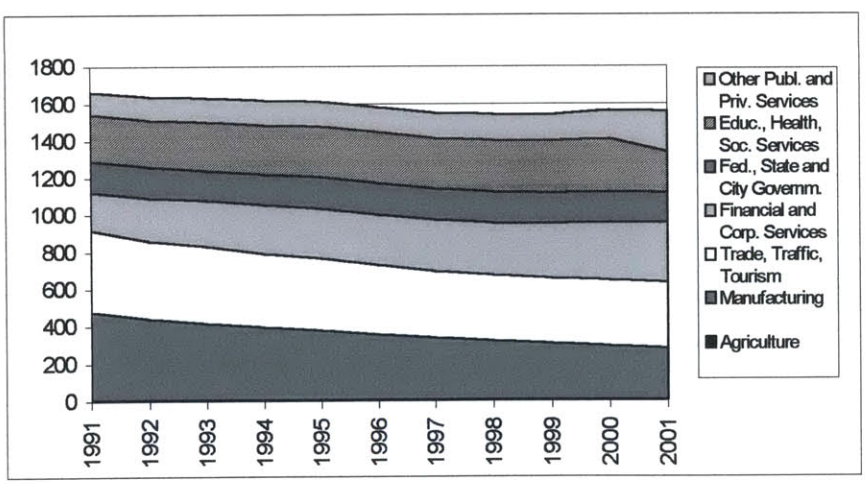
With the contract for the conditions of relocation, Bonn supporters had received a very good deal for their city. Bonn would receive an annual federal aid of 3.4 billion DM over several years and large parts of government would remain in the city. Five of fourteen cabinet-level ministries would remain in Bonn and several governmental agencies would move from Berlin to Bonn resulting in minimal reductions of employment both in government and related private sectors (Strom, p.163).

Out of 11,400 jobs related to the upper and lower houses of the German parliament the *Bundestag* and the *Bundesrat*, about 7,500 jobs were going to be occupied by newcomers. At the same time, 4,350 jobs were transferred from Berlin to Bonn, resulting in only little net gain in employment for the city of Berlin. According to a federal report in 1999, neither the arrival of embassy personnel, (Bonn had 150 foreign embassies with 17,000 registered persons) nor that of around 800 interest groups would yield the critical mass necessary to significantly increase the Berlin service sector (Bericht des Beauftragten der Bundesregierung vom 1.September 1999).

The expectation of around 100,000 new jobs has been seriously revised. Analysts say that in a best case scenario, the increase in non-governmental jobs will be between 20,000 and 30,000. Observing the city's employment situation before and after the relocation of the government, this assumption seems indeed more realistic if not still exaggerated (see Fig.3.1, 3.2: Employment in Berlin by Sector 1991-2001).

Between 1991 and 2002, overall employment in Berlin decreased by 6.3%. While over the same time total service employment increased by 8%, no significant increase in service employment can be observed in relation to the relocation of the capital. Admittedly, between 1999 and 2000, an increase in service employment of 3% could be observed which was relatively large compared to the preceding annual increase of 0.5%. However, in the following year the increase was again at only 0.6%, indicating the definite absence of significant and long-term impacts of the relocation on the development of service sectors in Berlin.

Fig.3.1: Employment in Berlin by Sector 1991-2001



Source: Statistisches Landesamt Berlin 2002

Fig.3.2: Employment in Berlin by Sector 1991-2001
In Thousands

		1991	1998	1999	2000	2001	tot. % change
	Agriculture	10.2	8.1	7.6	7.5	7.3	-28%
	Manufacturing	472.1	315.5	302.0	287.7	274.5	-42%
Services	Trade, Traffic, Tourism	436.2	353.1	349.1	354.6	353.2	-19%
	Financial and Corp. Services	208.6	282.6	294.4	312.0	319.7	53%
	Fed., State and City Governm.	167.4	166.6	162.6	164.0	163.4	-2%
	Educ., Health, Soc. Services	247.1	275.6	281.7	286.2	219.8	-11%
	Other Publ. and Priv. Services	121.1	139.6	141.0	151.8	219.8	81%
	Total	1,662.7	1,541.2	1,538.3	1,563.7	1,557.7	-6%

Source: Statistisches Landesamt Berlin 2002

Today, with an absorption of around 900,000 m^2 of office space, the government occupies only around 15% of the total office space in Berlin (see chapter: Characteristics of the Crisis). Political parties, embassies and foundations will absorb around 400,000 m^2, representing as little as 7% of the total (Buerostandort Berlin, p.20).

In September 1993, the Olympic Committee turned down Berlin's application to host the Olympic games in 2000. This decision disillusioned those who had counted on the positive economic and structural impact of such an event and greatly contributed to the general change in mood in 1993 (Lenhard, p.85).

Clearly, the decision to relocate the capital from Bonn to Berlin has not had the economic impact envisioned by early investors and analysts. Today, it is evident that being the capital city of a nation is not enough to generate sufficient impetus in economic development (Scharenberg, p.86). Before the present employment picture will seriously change, the city needs other, more fundamental structural changes in its economy (Tageszeitung, March 1998).

III. Incentive: Planning Legislation

1. Supply vs. Demand

1.1 Supply Shortage

In the early nineties, Berlin had become Germany's most attractive investment market. National and international firms desired a presence in the future German capital. As a result, brokers and real estate firms were receiving daily requests and offers from London, New York and Tokyo. There was however a huge gap between the increasing demand and the available supply of space.

Traditionally the amount of office space in Berlin had been small relative to the size of the city. West Berlin, with its 2.3 million inhabitants, had had a stock of 4.5 million m^2 or 2 m^2 of office space per person (Wirtschaftswoche, October 1990). In comparison, Frankfurt am Main had the equivalent of 6 m^2 of office space per person at the time. East Berlin in its former function as the capital of the DDR had had relatively more space available with 5 million m^2 for 1.5 million inhabitants. Most of this space however was in very bad condition and major renovation would have been necessary before this space could be used and offered for sale on the market.

Experts estimated that by the year 2000 the size of the city would increase from 3.5 to 5 million inhabitants and that a minimum of 6 m^2/person of office space[2] was needed to fulfill Berlin's function as the future German capital and as a leading European metropolis. To meet this benchmark, 21 million m^2 of new space had to be created in the course of 10 years (Wirtschaftswoche, October 1990). Investors from around the world were ready and eager to fulfill those expectations. However, numerous obstacles prevented immediate building activity.

[2] The ratio found in Frankfurt am Main.

In West Berlin the most interesting spots for development were traditional prime locations such as Kurfürstendamm, Tauenzien Street and Potsdamer Street. Land owners, initially willing to sell their property held it back from sale though in the prospect of increasing land value over time (Wirtschaftswoche, February 1990). In fact, in West Berlin only a few spots were left where large office projects could be realized. Consequently, East Berlin with its large vacant areas was an even more attractive investment location (Wirtschaftswoche, March 1990).

On the other hand, in East Berlin the planning situation was worse due to the unclear ownership status of properties owned by the East German government. Up until 1990 the acquisition of East German land and property was not allowed for "foreigners" such as west German investors. In order to nevertheless acquire property and reserve prime locations in advance, many West Germans paid incredible prices and bought properties through East German nominees (Wirtschaftswoche, February 1990).

The lack of regulations for the disposition of real estate led to a situation where nothing could be done legally. In the "wild East" illegal acquisition methods were commonplace and rents and prices exploded citywide. In this situation it was clear to the government that legislation had to be passed which would enable the disposition of former state properties and encourage investment activity (Wirtschaftswoche, September 1990). This eventually led to the formation of the *Treuhand* and the *Treuhandliegenschaftsgesellschaft*.

1.2 The *Treuhand* and the *Treuhandliegenschaftsgesellschaft*

With the destruction of the Berlin Wall on November 9, 1989, a new era began in Germany where a capitalist country (West Germany) was to merged with a socialist country (East Germany). The tension and problems of transforming both parts into one functioning entity were experienced in its purest and most radical way in the city of Berlin where two different ideological and economic systems met together within the boundaries of a single city. This is why Berlin has often been called the "workshop of reunification" ("*Werkstatt der Einheit*") or the German "microcosm" (Lenhard, p.64) where all of the challenges and problems of reunification became directly obvious and had to be dealt with immediately. One of the main issues that had to be addressed was the question of ownership and restitution.

Under the Soviet regime, the majority of private property, including land and businesses, had been seized by the state and was held as state property. After the dissolution of the DDR and its centralized state economy, land and property had to be redistributed according to the rules of a capitalist system of private ownership.

For this purpose, in March 1990, the *Treuhandandstalt* (THA, or trust administration) was established to transfer state-owned holdings into private ownership for a portfolio of 8,500 businesses employing 4.1 million people. The agency was required to collect bids from prospective buyers with the goal of maximizing job retention and new investment. Due to the poor condition of most East German industry, an additional task of the *Treuhand* organization was to restructure inefficient businesses, often resulting in a serious reduction in the workforce before they could be sold on the market (Strom, p.63).[3]

Although connected to the problems of restructuring businesses, the question of real estate disposition needed a different set of considerations and soon begat the formation of a separate agency. In March 1991 the *Treuhandliegenschaftsgesellschaft* (TLG, or Trust Real Estate Corporation) was created as a subsidiary of the *Treuhandanstalt*. The TLG can be described as a THA-financed brokerage agency which set up a national model for dealing with land and surplus property. Its primary tasks were:

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[3] In 1995 the Treuhand Agency was dissolved and succeeded by the *"Bundesanstalt für vereinigungsbedingte Sonderaufgaben"* (BvS).

1. the restitution of properties to their original owners
2. the sale of properties according to the Law for Encouragement of Investment (*Gesetz zur Förderung von Investitionen*) and
3. the sale of property when questions of original ownership could not be clarified.

At the time of its foundation in 1991, the portfolio of the TLG contained 11 million land parcels and around 1 million real properties (Lenhard, p.67).

1.3 Questions of Ownership and Restitution of Property

One of the crucial issues to be addressed by the *Treuhand* and the TLG was the question of ownership of private property which had been seized through confiscation reaching back to times as early as 1933. At the beginning of the Nazi regime, land and property had in many instances been seized from wealthy Jews by the Nazis. With the invasion of the Soviets land had been seized from "Nazis and War Criminals" between 1945 and 1949. Finally, under the East German government, the remaining majority of all privately held land and property had been confiscated as property to be shared by all people and therefore to be managed and owned by the state. In the Unification Contract between East and West, Germany felt its moral duty to consider the right of original ownership and to redistribute property to its former owners and their heirs. This principle was defined as part of the Unification Contract in a law for the distribution of property, called the *Vermögenszuordnungsgesetz* (VZOG).

In its original version, the *Vermögungszuordnungsgesetz* defined as its guiding principle: "Restitution before Compensation" (*Rückgabe vor Entschädigung*), meaning that original owners that had been deprived of their property after January 30, 1933 had to file a request for restitution and would eventually receive the rights to their property. Until property claims were legally clarified, property could not be made available for disposition or development (Strom, p.122).

1.4 The Investor's Perspective

After German reunification prospective investors had to face two major obstacles hindering them from immediate investment and realization of their projects.

A) The complicated and time consuming legal process associated to the principle of "Restitution before Compensation"

B) The lack of planning rights and planning legislation in the states of the former DDR.

A) Restitution before Compensation

Today, only 60% of all submitted requests for restitution have been ultimately determined and approved by the courts. This fact is an index of the legal complexity of the government's ambition to clarify the questions of true ownership over a period of almost 70 years. The scope of the project was huge: almost three quarters of all property in East Berlin was subject to restitution claims. Further, many properties had multiple claimants. In the city of Berlin there were twice as many claims as properties (Reimann, p.301-413). Even when property claims were identified as belonging to a certain original owner, the legal heirs of this owner oftentimes comprised several families. As a result, it often took years before the new owners agreed on what to do with their property (Strom 2001, p. 123)

B) Lack of Planning Legislation

While in the West German states nearly every square meter of land is covered by a grid of legally binding land-use plans and most parts of the country provide a system of very detailed zoning laws (*Bebauungspläne*), no such system or legislative framework existed in the former DDR. Rather, the legal framework and planning material had traditionally been worked out spontaneously whenever projects came up or had been initiated and approved by the state. With the fall of the Berlin Wall, the eastern planning officials were overwhelmed by innumerable requests for proposals. In the absence of even a rough legal framework, they were not capable of dealing with this new situation and had neither time nor capacity to handle it.

Both of these obstacles lead to serious supply shortages and almost complete stagnation of development activity in the early years after reunification. The German government's primary goal of encouraging investment activity and maximizing economic growth seemed to be in grave danger. In fact, politicians feared, that the shortage of disposable land and the difficult legal conditions would frustrate or scare potential investors and slow down the building boom before it had even started (Wirtschaftswoche, September 1990). In order to support and promote investment activity, it was crucial to invent regulatory tools that offered ease and speed for the realization of projects.

2. Regulations to Encourage Investment Activity

2.1 Changes in the Law of Ownership (Vermögensgesetz, VermG)

In July 1992, the second amendment to the Law of Ownership, the so-called *Zweites Vermögensrechtänderungsgesetz* (2.VermRÄndG) was granted and constituted a large step towards the demands of investors. The crucial element of this legislation was article 6, the so-called "priority of investment" law (*Investitionsvorranggesetz*, InVorG). This principle, in contrast to the old principle of "restitution before compensation", favored investment activity prior to restitution requests.

Under the new rule, dictating "investment before restitution", potential investors were allowed to acquire properties even when former owners had legitimate claims on them. Investors had to submit plans showing how much capital they were planning to invest and how many jobs they would create. This was done by filing an "investment priority request" (*Investitionsvorrangsantrag*). If the former owner could guarantee to deliver an investment of the same scope and in the same timeframe, he could keep the property. If not, he had to accept compensation instead. If an investor was interested in a certain property, an "investment priority request" had to be applied for. In the majority of cases investors' requests were accepted and the original owners were compensated.

2.2 Planning Legislation to Accelerate Building Permits

1. §12 BauGB

In the absence of land-use and construction plans in the states of the former DDR and East Berlin, most early projects could be realized according to §12 of the Building Code (*Baugesetzbuch*, BauGB). This legislation, designed in 1990, allowed the permission of projects on the basis of a Project and Development Plan (*Vorhaben- und Erschliessungsplan*, VEP). §12 BauGB constituted a public-private contract between the investor and the community, where the investor agreed to deliver a planning proposal which was then adjusted to the requirements of the community. The investor also agreed to prepare the land, to assume all or part of the expenses for the development of infrastructure and to complete the entire development within a certain time (§12, Abs.1).

The advantage of this legislation for the community was to save time and expenses for setting up a construction plan and providing for the necessary infrastructure. The advantage for the investor was to obtain a building permit earlier than under normal circumstances and to have serious negotiating power with respect to the legal framework of zoning laws. It has been said that in the early years, the actual planning power was with the investor rather than with the planning officials. The communities, happy to have found a developer, simply "rubber-stamped" their official approval on what had been proposed by the investor.

The acquisition of building permits on the basis of §12, BauGB, however, also had several disadvantages. First of all was the lack of a true exit possibility for the investor. Although investors had the right to exchange positions with other developers (§12, Abs.5), this change had to be accepted by the community and was, in reality, rather complicated. Secondly, by guaranteeing to complete the development in a certain time frame, the investor risked being deprived of all planning rights if he failed to meet the deadline. Under such a scenario, the investor was required to return the land to the community in its original state. He was not to receive an indemnity for any construction work performed up that point in time (§12, Abs. 6).

2. §33, BauGB

In order to further accelerate the permitting process, §33 BauGB (*Zulässigkeit von Vorhaben während der Planaufstellung*) was introduced to the Building Code. According to this regulation, building permits could be obtained even before the actual completion of the zoning (*Bebauungs-Plan*). The prerequisite for the permit was reduced to the completion of the infrastructure and the investor's convincing presentation of a plan that was most likely to fulfill all future requirements. As a consequence, investors were able to receive a permit as soon as 6 weeks after they had applied for it. This greatly increased their flexibility and encouraged immediate development activity.

3. §34, BauGB

In inner city locations, another legal tool was utilized to get easy and quick planning permission. §34 of the Building Code (BauGB) defines projects as permissible as long as they fit into their adjacent environment. Originally, this law had been created for small parcels in inner city locations in order to expedite in-fill construction in already developed areas. However, after reunification, §34 could be used to plan large segments and entire new districts in East Berlin. There are two reasons why it was very attractive for investors to get building permits on the basis of §34.

At first, there as a wide range of interpretation as to what kind of development should be considered "consistent with the surroundings". Secondly, due to its original application to small projects of minor importance, §34 did not require the public participation in the permitting process, as is usually mandated by law. Permission by §34 was a simple and swift administrative act and saved the investors a lot of the usual permitting time.

4. Land-Use Plan of 1994

In 1994, the first step towards a system of planning regulation in the states of the former DDR was the issuance of a land-use plan for Berlin (*Flächennutzungsplan, Senat fuer Stadt und Umwelt* 1994). Critics say that this land-use plan was designed much more liberally than what was usually regarded as the German standard for such plans. For example, important aspects such as the limitation on building heights, massing and design principles had been omitted. These regulations were welcomed by investors because they offered them more freedom than was usually the case. With this legislation, the government once more articulated its intention to encourage investment rather than to scare investors with the burden of too narrowly defined use and design principles.

5. The Power of Execution of the Building Codes

The law for the Execution of the Building Codes (*Gesetz zur Ausführung des Baugesetzbuches*) was introduced on July 14, 1994. It transferred the power to execute construction plans and to give building permits from the level of the Senate of Berlin to the level of the individual city districts. Originally, the permitting process had been two-fold, where construction plans, set up by the community, had to be passed on to the Senate in order to be authorized. The new regulation abolished the superintendence of the Senate and was designed to give more power to the districts and to further accelerate the permitting process.

On November 23, 1995 however, an amendment was added to the new regulation, reserving the power of intervention (*Eingriffsrecht*) for the Senate in all questions concerning the overall guidelines for the development of Berlin and therefore questions of "common interest". While the scope of interpretation of what is common interest as opposed to district interest is wide, districts in many instances have complained that with this amendment the achievements of the 1994 regulation have been entirely reversed.

6. Legislation Used in 2002

In the early days, the most popular way to receive a planning permit was through §34 BauGB since it was an easy administrative act and did not require public participation. Lately, this legislation has been restricted in its application to the original purpose and can no longer be used for the development of large projects lacking a direct urban context.

As a consequence of the continuing shortage of personnel in the planning departments of the former DDR, no implementation of West German planning standards is foreseen in the New States of Germany. Instead, building permits will continue to be granted on the grounds of §12 BauGB, where the investor makes the original proposal and has to negotiate it with the community. Where in the early days communities mostly followed the demands of the investor, their role has changed over time as they demand more negotiating power and will not agree to proposals which do not correspond to the city's overall planning guidelines. The exit problem as well as the liability problem associated with §12 BauGB, can be avoided by modifying the law and combining it with other regulations more favorable to the investor's development strategy and other individual circumstances.

Generally, the planning regulations, designed to support investment under any circumstances in the early years, have become more rigorous over time. Certainly it was easier to obtain building permits in the early years, taking advantage of a general lack of regulations and the authorities' uncertainty in evaluating the new and overwhelming situation. Even today it is easier to receive building permits in the states of the former DDR and in East Berlin than in West Germany. While in West Germany, investors have to wait for 1.5 to 3 years on average, building permits in East Germany and Berlin can be obtained in only 1 to 2 years. In the years following reunification, permits had been distributed as quickly as 6 months to 1 year after the request was made.

III. Incentive: Benefits from Tax Legislation

About 90% of all tax deductions taken in the years following reunification were attributable to real estate tax credits (Wirtschaftswoche, November 1989).

1. Special Depreciation under the Foerdergebietsgesetz (FoerdG)

The *Foerdergebietsgesetz*, passed into law in 1990, is legislation designed to promote and encourage investment and building activity in East Germany as well as in Berlin.

Under German law, buildings can generally be depreciated according to a flat depreciation or a declining depreciation method. The rate for flat depreciation is 4% for office buildings and 2-2.5% for apartment buildings. The more attractive declining method can only be applied if the building has been newly constructed or has been purchased in the year of completion. The rates differ according to the building's use and date of acquisition (see Chapter-Appendix: Methods of Depreciation).[4]

The *Foerdegebietsgesetz* (FoerdG) provided that, buildings which had been constructed in the New States or in Berlin, could, on top of a flat depreciation, take advantage of a Special Depreciation (*Sonderabschreibung*) according to §4 FoerdG. The Foerdergebietsgesetz and §4 in particular, have been modified several times, reflecting changes in the surrounding market conditions.

[4] Along with numerous changes in tax legislation in the late nineties, the declining method has been abandoned for the development of office space. It can only be applied for buildings that were acquired before Jan.1, 1994 (corporate property) and Jan.1, 1995 (private property) respectively. However, for apartment buildings the declining method is still applicable (see Chapter-Appendix: Methods of Depreciation).

1.1 Stage One: 1990-1996

For transactions between 1990 and 1996, the amount of permitted depreciation was 50% of the total building value. The owner had the choice of freely allocating and timing this depreciation during a fixed promotion period (*Begünstigungszeitraum*) of usually 5 years after building completion. He could therefore deduct 50% in a single year or otherwise distribute the savings according to his personal tax situation. The remaining building value had to be depreciated according to a flat depreciation whereby the life of the building was reduced by the length of the promotion period (§7a, Abs.9 EStG).

Example:

A building with a life of 25 years, constructed in January 1991, is to be depreciated according to §4 FoerdG. The building has a total value of 500,000 Euro and a flat depreciation rate of 4%. At the end of the promotion period, the remaining life of the building is 20 years.

Building Value:	500,000 Euro
Depreciation 1991 to 1993:	
3 x 4% = 12% =	60,000 Euro
Special Depreciation:	
50%	250,000 Euro
Depreciation 1994 and 1995	
2 x 4% = 8% =	40,000 Euro
Remaining Value Dec.31, 1996	150,000 Euro

From 1996 on the level depreciation is 5% = 7,500 Euro annually.

Source: Rudolf Haufe Verlag, 2002

1.2 Stage Two: 1997-1998

For transactions after December 31, 1996, the amount of Special Depreciation was reduced to

- 40% for buildings that are used for manufacturing (*verarbeitendes Gewerbe*) for a minimum of 5 years after construction
- 25% for apartment buildings
- 20% for office buildings
- 40% for modernization and subsequent additional construction (§4, 2. FoerdG).

1.3 Stage Three: 1999 - 2002

For transactions after December 31, 1998, the Special Depreciation method could no longer been used.

2. Deduction of Losses

2.1 Stage One: 1949-1999

Under German law, losses from rental activity can be offset against other sources of passive and active income. Paragraph 2, subparagraph 1 (§2, Abs.1) of the income tax legislation (*Einkommenssteuergesetz*, EStG) differentiates among seven sources of income 1) farming and forestry, 2) trade, 3) self-employment, 4) employment, 5) income from capital investments 6) rental income and income from leasing 7) other income. Income and losses from each source can be offset against each other (§2, Abs.3 EStG).

This regulation severely differs from U.S. law, where income or loss from any "rental activity" are considered "passive" as opposed to "active income" from other sources. Section 469, added to the Internal Revenue Code by the Tax Reform Act of 1986, limits the use of losses and credits from passive activities to off-setting income and tax attributable to passive activities. Passive losses in any year which are not used to offset passive income are "suspended" and held indefinitely until passive income appears in the future. These limitations are applicable to individuals, trusts, and personal service corporations. Ordinary income, however, is considered "earned income" or "active income". Neither of them can under normal circumstances be offset by losses from passive income.

The difference in legislation becomes crucial when losses from rental activity accumulate over the years, as it was the case for many Berlin properties. While in the U.S. the losses would not have been able to be offset unless there were earnings in later periods, German law allowed to offset losses against ordinary income and therefore made investment profitable despite the very unprofitable condition of the properties.

2.2 Stage Two: 1999 – 2002

In 1999, the law allowing the offset of passive losses against ordinary income was modified. In its original version, §10d of the income tax code (§10d EStG, *Verlustabzug*) regulating the treatment of private property owners, allowed them to offset losses to their full amount even when they could not be covered by other income streams. Meanwhile, §15a of the tax code, applicable for investors of limited liability, such as shareholders of closed-ended funds (see chapter: Types of Investors and their Role in the Investment Boom) provided that losses could be deducted up to the full amount of investment in the fund (§15a EStG, *Verluste bei beschraenkter Haftung*).

As of January 1999 private property owners can deduct a yearly maximum of 100,000 DM (single) and 200,000 DM (couples) respectively. Losses exceeding this value can be deducted to 50%, the remaining 50% can be deducted in any following year in the future. Under current legislation, the "suspension period" for future deduction of old losses is open-ended. However, experts assume that this regulation might be altered in the future. A similar, but more restrictive, regulation has been passed for investors of tax oriented investment vehicles (*Verlustzuweisungsgesellschaften*), such as closed-ended funds. §2b EStG (*Negative Einkuenfte aus der Beteiligung an Verlustzuweisungsgesellschaften und* *aehnlichen Modellen*) dictates that no losses resulting from investment in tax oriented funds can be offset against other personal income streams.

While in the early years, owners of non-profitable real estate could take advantage of large tax benefits, the 1999 amendments seriously reduced this possibility. The ownership of properties producing losses rather than gains has, from a tax point of view, become very unattractive.

3. Gain on Sale

3.1 Stage One: 1949-2000

According to German law, gains or losses from the sale of property are considered "other income" under §2, Abs.2 EStG (see chapter: Deduction of Losses). They are therefore taxed at the same rate as all other income streams and can be offset against other income streams as well (§2, Abs. 3 EStG). §23 EStG (*Einkünfte aus privaten Veräußerungsgeschäften*) dictates that gain on sale is not a taxable item as long as the sale occurs after the observance of a certain speculation period. Originally, this period was two years for real estate property (Abs.1.1) and half a year for shares and other securities (Abs.1.2).

3.2 Stage Two: 2000-2002

The Tax Reform Act of 2000 made an important change to the previous legislation in extending the speculation period for different kinds of property. The required holding period for shares and securities is now at one year while the speculation period for real estate has been increased to ten years. Currently, the national courts are examining whether a fivefold increase of the required holding period is legitimate under the German Constitution.

Chapter Appendix:
Methods of Depreciation 1990-2002

Building	Use	Flat Depreciation	Declining Depreciation
Corporate property	Business use, Offices	4%	building permit or acquisition before January 1, 1994 4 years x 10% 3 years x 5% 18 years x 2.5%
	Housing	2% or 2.5%	building permit or acquisition before January 1, 1996 4 years x 7% 6 years x 5% 6 years x 2% 24 years x 1.25% building permit or acquisition after December 31, 1995 8 years x 5% 6 years x 2.5% 36 years x 1.25%
Private Property	Business use, Offices	2% or 2.5%	building permit or acquisition before January 1, 1995 8 years x 5% 6 years x 2.5% 36 years x 1.25%
	Housing	2% or 2.5%	building permit or acquisition before January 1, 1996 4 years x 7% 6 years x 5% 6 years x 2% 24 years x 1.25% building permit or acquisition after December 31, 1995 8 years x 5% 6 years x 2.5% 36 years x 1.25%

Source: Steuerlicher Wegweiser für Unternehmensgründer, Industrie- und Handelskammer IHK 2000

IV. Incentive: Skyrocketing Rents

1. Berlin Rents in the German Context

The following Data on Office Rents between 1989 and 2002 was issued by one of the largest broker associations in Germany, the Circle of German Realtors (*Ring Deutscher Markler, RDM*) which has its headquarters in Hamburg. RDM rent statistics are issued every year by a group of real estate professionals and are based on latest sales and leases. The data cover more than 280 cities in Germany and classify office space according to different factors such as location, connection to transportation, infrastructure, public amenities, architectural quality and technical equipment. Accordingly, rents are differentiated between low, medium and high quality office space. Since 1998 the new category "prime rents" has been introduced (Ring Deutscher Makler: Preisspiegel, Ausgaben 1989-2002). The following analysis is a comparison of rent levels in the "high quality space" segment in different German cities. This is done in order to show the rent progression of Berlin relative to the overall German context.

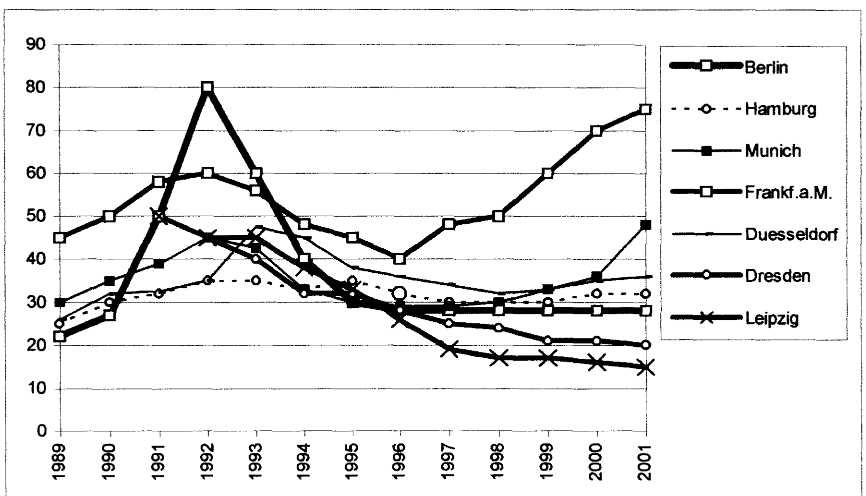
2. The Berlin Boom and the Real Estate Crisis

Traditionally, office rents in Germany have been highest in Frankfurt am Main due to its significance as Germany's financial capital. These were followed by those in Munich, Duesseldorf and Hamburg. Following German reunification begun on November 9, 1989[5] office rents increased in all major German cities. This trend reflects the general belief, that Germany was on its way to become one of the leading economic powers in Europe. During the general building boom, the traditional German ranking for office rents experienced some major changes.

[5] The "official" date of reunification is October 10, 1990. However, the Berlin Wall fell on Nov.9, 1989.

The sharpest rise and fall in office rents, could be observed in the reunited city of Berlin, which was generally regarded as the most attractive investment location. This was due to its future position as the nation's capital and its expected importance as a leading economic center located in the heart of Europe. Rents in Berlin rose from 22DM/m^2 in 1989 to 80DM/ m^2 in1992 representing a 260% increase in a period of only three years. The peak value of 80 DM/ m^2 in 1992 was a historical event: for the first time in decades, Berlin office rents were exceeding rents in Frankfurt am Main. However, by 1993 the results of the nation's building activity triggered by the increase of rents and prices, had reached the market and created an oversupply of stock. After 1993, rents fell at an average of 20% per year. Since 1997, office rents in Berlin have been stable at 28DM/ m^2 meaning that the total decrease between 1992 and 2001 has been 65% (see Fig.4: Office Rents in Selected German Cities).

Fig.4: Office Rents in Selected German Cities 1989-2001
In DM



Source: Ring Deutscher Makler, Immobilienpreisspiegel 1989-2001

Generally, the largest decrease in office rents could be observed in Berlin and in the cities of former East Germany, such as Dresden and Leipzig. Between 1993 and 2001 rents in Dresden decreased by 55%, whereas rents in Leipzig fell by 70% between 1992 and

2001. Today, with an average of 17DM/ m^2 for office space in the cities of the former DDR, rents are about half of west German price levels.

3. Rent Cycles

While rise and fall in rents in the cities of West Germany seem to follow the oscillation of a "normal" rent cycle, the increase and decrease in rents in Berlin and in the cities of East Germany was extreme. This development can partly be explained by the fact that the initial supply shortage and rise in rents could not result in immediate building activity. The unclear ownership status of numerous properties seriously hindered development until 1992 (see chapter: Supply vs. Demand).

Since 1998, a recovery from the rental crisis has occurred in several West German cities, mostly so in Frankfurt a.M. and Munich, both of them showing rent levels above their 1992 peak. Rents in Leipzig and Dresden continue to decline, although at a slower pace than in the mid nineties.

4. Rents Today and Rental Outlook

Today, the original ranking for office rents in Germany has been re-established. Frankfurt a.M. with "high quality" rents of 75DM/ m^2 is leading the market, followed by Munich (48 DM/ m^2), Duesseldorf (36 DM/ m^2) and Hamburg (32 DM/ m^2). Berlin occupies the fifth position with rents of 28DM/ m^2.

While rents for "high quality office space" in Berlin, according to the RDM data, have been unchanged for the last 6 years, a comparative analysis of different quality segments in the Berlin office market shows a downward trend for rents in the low quality and medium quality segment. On the other hand, rents for “prime office space” have gone up by 35% between 1998 and 2002 (see Fig.5: Comparison of Rents in Different Quality Segments).

After years of stagnation, the increase in rents and demand for prime office space in Berlin can be interpreted as a positive sign. As they try to market the city to firms and businesses, some Berlin economic development officials advertise the city’s oversupply of stock and low rent levels as a great “competitive advantage” over other cities in Germany (Krätke/ Borst, p.139). This assumption, however, seems to be exaggerated, based on the fact that in other German cities rents are increasing across the whole price spectrum, indicating their market attractiveness and superior demand relative to Berlin (see Fig.5: Comparison of Rents in Different Quality Segments).

Fig.5: Comparison of Rents in Different Quality Segments 1998-2001

Berlin

	low quality	medium quality	high quality	prime rents	
1998	18	22	28	48	**increase in prime rents**
1999	18	22	28	55	**constant in high quality segment**
2000	16	20	28	60	**decrease in low and medium quality segment**
2001	14	18	28	65	

Frankfurt

	low quality	medium quality	high quality	prime rents	**increase in all categories**
1998	22	31	50	65	
1999	23	37	60	70	
2000	28	40	70	80	
2001	35	40	75	95	

Munich

	low quality	medium quality	high quality	prime rents	**increase in all categories**
1998	14	18	30	55	
1999	14	19	33	55	
2000	15	21	36	60	
2001	21	28	48	65	

Hamburg

	low quality	medium quality	high quality	prime rents	**increase in all categories**
1998	12	17	30	48	
1999	12	17	30	48	
2000	13	18	32	50	
2001	14	19	32	55	

Source: Ring Deutscher Makler, Immobilienpreisspiegel 1998-2001

V. Hypothesis 1: Impact of Legislation on Investment Activity

1. Building Permits

Building permits are the first statistical index of an investor's willingness to build. They can therefore be interpreted as an immediate and direct indicator of market attractiveness.[6] Observing the number of building permits granted between 1989 and 2002, a strong chronological correlation can be found between the issuance of legislation and the generally perceived market attractiveness.

2. Building Permit Drivers

The curve depicting the number of building permits directly responds to the issuance of governmental incentives as well as to general market conditions. The following correlations can be observed:

1. Paragraph 4 *Foerdergebietsgesetz* of 1991: 50% Special Depreciation

1990-1991: Permits increase by 91%

2. a) Investment Priority Act of 1992: Planning rights are made available

b) June 1991: Parliament's decision to locate the capital in **Berlin**

1991-1992: Permits increase by 119%

1992-1993: Permits increase by an additional 11%

3. Since 1993: Rents decrease, **Vacancy** increases

1993-1996: Permits decrease by 10% per year on average

4. Paragraph 4 *Foerdergebietsgesetz* of 1997: Special Depreciation reduced to 25%

1997: Permits increase by 21%[7]

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[6] The usual lag between filing a permit and receiving it is three to six months, provided that the plans are completed for presentation. With the application of §33 BauGB it is also possible to receive permits before the planning documents are completed (see chapter: Incentive: Planning Legislation).

[7] In order to benefit from a 50% depreciation, investors had to make their commitment to an investment before Dec. 31, 1996 (*Investitionsabschluß*). Due to the permitting lag, the numerous additional commitments triggered by the change in legislation do not appear in the statistics until 1997.

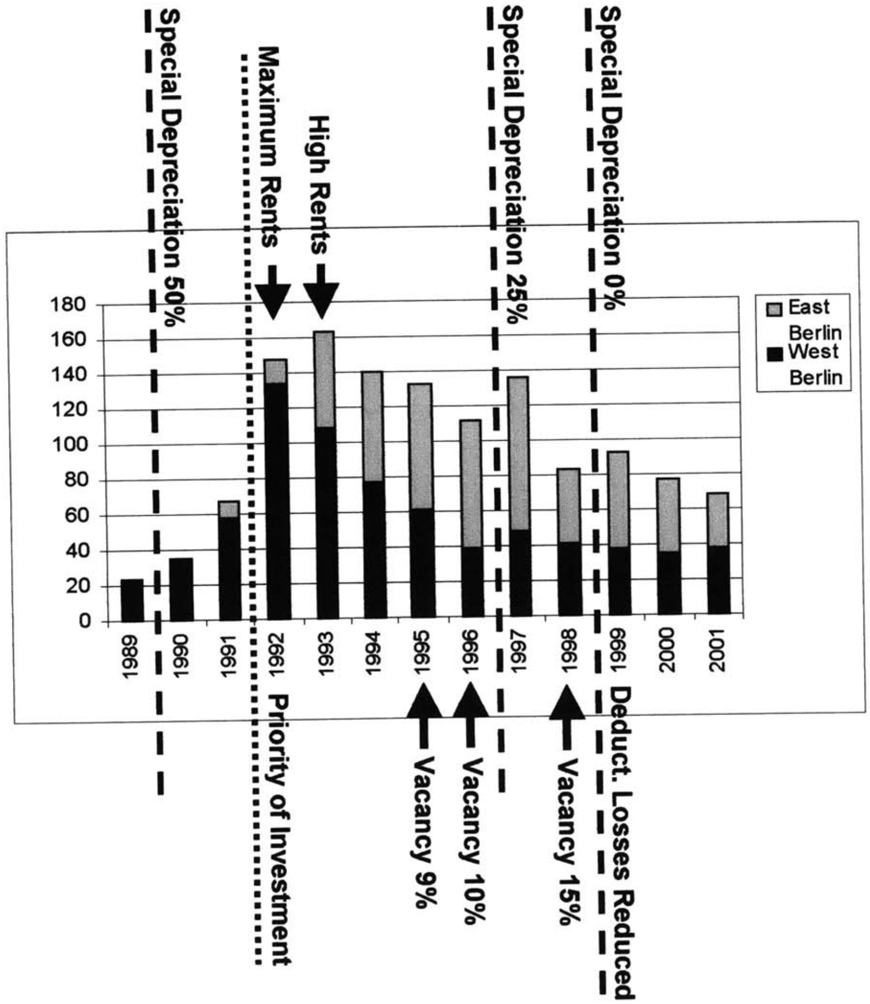
5. Paragraph 4 *Foerdergebietsgesetz* of 1999: Special Depreciation reduced to 0%

1999: Permits increase by 12% (for the same reasons as in 1997)

6. Paragrapph 10d EStG or Paragraph 2b EStG of 1999: Deduction of Losses reduced or eliminated accordingly

Since 1999: Permits decrease by 15% per year on average

Fig.6: Building Permits and Building Permit Drivers
1989-2001



C) Types of Investors and their Role in the Investment Boom

I. Legal Structure and Implications for Investment Activity

On the German real estate market around 10% of the participants are private investors and 90% are institutional investors. The largest groups of institutional investors are Closed-ended Funds, Open-ended Funds, Insurance Companies, Pension Funds, Property Stock Corporations and Leasing Companies. International investors have held market shares ranging from 25% to 1%.

At different times, different investors were attracted to the German real estate market. This is partly due to differences in their legal structures which allowed some of them to take advantage of the tax benefits under the *Foerdergebietsgesetz*, while others based their investment decisions on general market conditions. The following section will give a brief description of the most important investment groups.

1. Closed-ended Funds

Closed-ended funds are set up for investment in specific and limited types and numbers of projects. When a portfolio of projects has been selected, the necessary total investment sum is determined and the fund begins looking for potential investors. Only investors who can meet the minimum investment amount of usually 10-20,000 DM are admitted to the fund (Brauer, p.29). When the necessary number of investors has been found, the fund is "closed". Investors are required to remain committed to their investments for a period of 20-30 years. The only exit possibility for shareholders is to find an investor, who is willing to buy a share of the identical investment value. A secondary market for closed-ended funds is not however well-formed.

Closed-ended funds have the legal structure of a partnership agreement. Therefore, shareholders of closed-ended funds are considered direct owners of the property. The shareholders' yield is considered "rental income and income from leasing" (§2, Abs.1 EStG, see chapter: Incentive: Benefits from Tax Legislation). Due to this definition, shareholders of closed-ended funds can take advantage of all tax benefits associated with the direct ownership of property such as the Special Depreciation under the *Foerdergebietsgesetz*.

2. Open-ended Funds

Open-ended funds are public funds and shares can be acquired by anyone. The amount of total investment in the fund as well as the number of real estate properties are "open" and can vary over time. Investing in open-ended funds is considered a safe long-term investment, promising low volatility and relatively low but steady yields. Due to their legal structure, open-ended funds are subject to the regulation of capital investment corporations (*Gesetz zu Kapitalanlagegesellschaften, KAGG*). They can be set up either as a Limited Liability Companies (GmbH) or as a publicly-held corporation (*Aktiengesellschaften, AG*), whereby the later structure is more common.

Investors in open-ended funds are considered shareholders of the company's assets and therefore are not direct owners of the properties. The shareholder's yield is defined as "income from capital investments" (§2, Abs.1 *EStG*, see Chapter: Incentive: Benefits from Tax Legislation). Due to this definition, shareholders of open-ended funds cannot use tax benefits related to the properties, such as the Special Depreciation under the *Foerdergebeitsgesetz*. However, they have some tax advantages in the disposition of their investment, since the speculation period for securities is only one year as opposed to ten years for the direct ownership of property (see chapter: Incentive: Benefits from Tax Legislation). The secondary market for this investment type is well developed and therefore offers greater flexibility for investors. Also, open-ended funds have the obligation to buy back shares, whenever individual investors want to sell. In order to meet this contingent requirement open-ended funds are required to keep a liquid position of 5% minimum at all times (§35, *KAGG*).

Traditionally, open-end funds have focused on investment in large office and mixed-use properties; lately, due to their higher yields, they have included hotels and leisure properties in their portfolios. Their preferred investment locations are the leading office concentrations in Germany. While cites such as Frankfurt, Duesseldorf, Hamburg, Munich and Berlin have always been favored, no explicit focus on one of theses centers has ever been observed (Jones Lang LaSalle, p.19).

3. Publicly-held Real Estate Corporations

Compared to the U.S., Great Britain and France, the public real estate market has had relatively little importance in Germany. Publicly-held real estate corporations make up only 1.5% of the total European stock market. In the real estate market of Europe, they represent only around 2.6% (Jones Lang LaSalle, p.22). The prime advantages of publicly-held real estate corporations are great liquidity due to an organized secondary market and tax advantages due to the tax-free disposition of shares if the one year holding period is observed.

Until today, the German investment market has been dominated by the "classic" investment vehicles such as closed-ended funds and open-ended funds. However, as a player in the German real estate investment market, publicly-held real estate corporations are gaining increasing popularity. Today, around 70 of them exist in Germany and each year around seven new companies are formed (Jones Lang LaSalle, p.22). The average yield of public real estate corporations is around 9-10% which is clearly higher than the yield of open-ended funds (5-6%).

4. Leasing Companies

Real estate leasing companies are end-investors and are usually formed by bank subsidiaries. These companies hold real estate on a medium or long term horizon and provide a piece of land or property in exchange for a leasing rate. Depending on the individual set-up of the leasing contract, leasing companies either provide only for the financing of the property or offer a full-service package of administration and management of the property during occupancy. Typical business segments of leasing companies range from the acquisition of land, project development, construction planning and realization through the acquisition of already existing properties, financing and disposition of the property on the basis of a leasing contract.

For the lessee, the first advantage of leasing is increased liquidity due to the absence of acquisition expenses. Secondly, leasing implies tax benefits, since leasing rates as well as interest payments are considered corporate expenses and can be fully deducted from taxable income (Brauer, p.32).

5. International Investors

Germany's real estate market has clearly been dominated by national investors. The average international investment activity in Germany since 1989 has only been around 4% (see Fig.7: Real Estate Investment Market Germany).

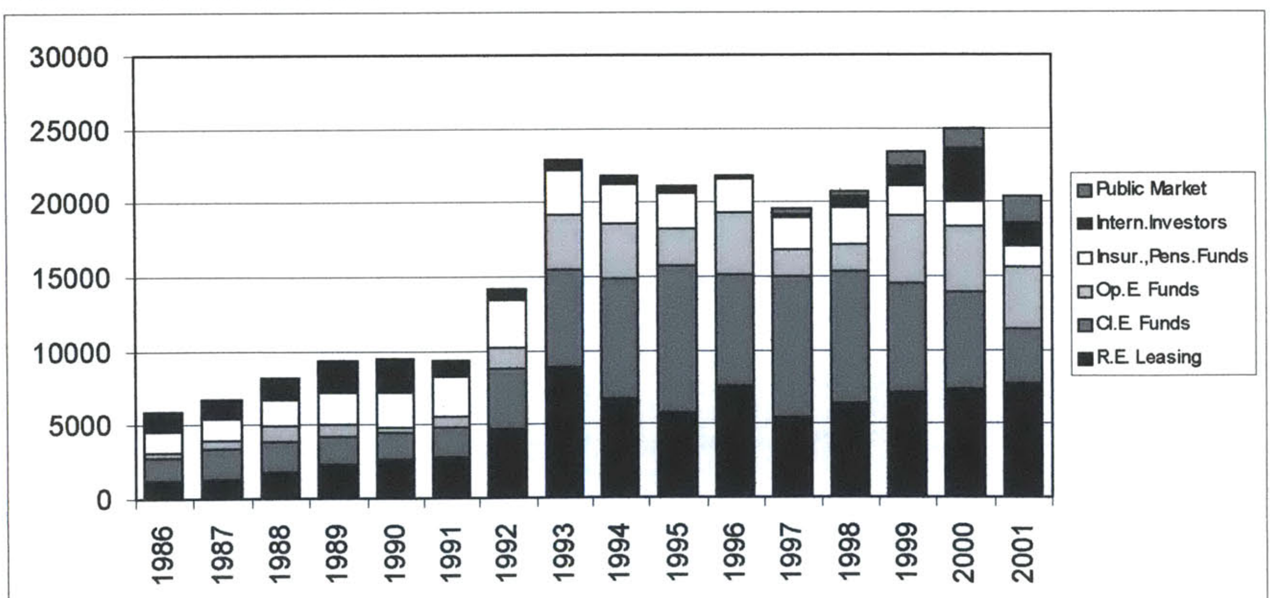
The general reluctance of foreigners to invest in Germany can partially be explained by different investment horizons and market expectations between German and international investors. In the early nineties, 44% of the German office space was owner-occupied, indicating the conservative structure of the market (Strom, p.119). Traditionally, speculative development has been less common in Germany and the real estate market was focused on long-term investments. However, most international investors search for short investment horizons of 2-5 years. Also, international investors usually seek high yields and risk adjusted returns, both of which can rarely be found in Germany. With an average of 5% to 6%, prime office yields in Germany are lower than in most other European countries. Finally, international investors state a general lack of transparency and a lack of exit strategies in the German real estate market (Jones Lang LaSalle, p.24).

II. Different Market Shares at Different Times

1. Investment Market Germany

Total investment volume in Germany sharply increased in the years following the reunification. While in the early years, the market share of the leading investment groups was rather evenly dispersed, this relation dramatically changed in the years following reunification (see Fig.7: Real Estate Investment Market Germany).

Fig.7: Real Estate Investment Market Germany
1986 – 2001 in Million Euro



Source: Bulwien AG 2002

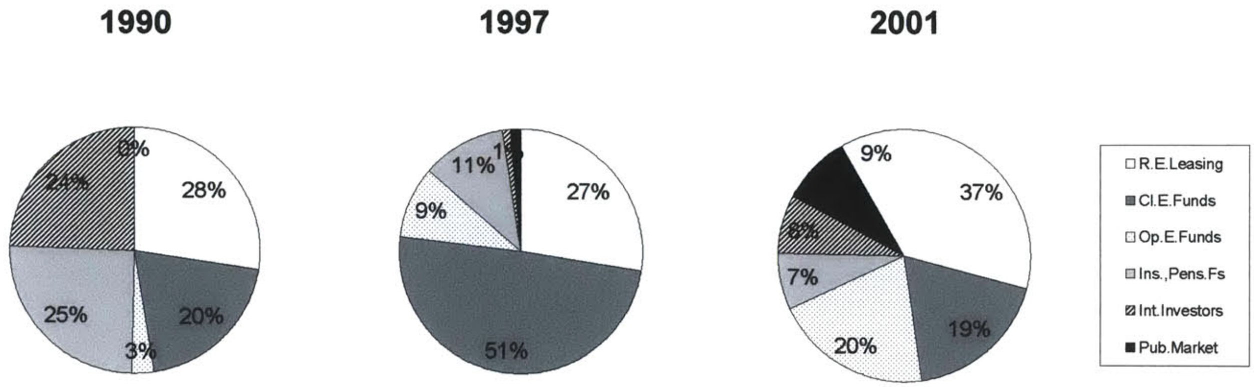
International investors were especially large players on the German market in 1989 and 1990, holding a market share of 22% to 24%. This can be explained by the national and international demand for German investment opportunities after reunification. Since 1991 foreigners have steadily reduced their investment activity, falling to a low of 1% market participation in 1997. Since 1998, foreign investors have again become more active, reaching a preliminary maximum of 14% market share in the year 2000.

Publicly-held real estate corporations did not appear on the German investment market before 1997. However, since then, their market share has steadily increased and reached almost 10% in 2001. This indicates the growing popularity of stock corporations on the German real estate investment market.

Open-ended funds have had a relatively high market participation between 1993 and 1996 with an average of 17% market share. The increased investment activity in the mid-nineties can partly be explained by favorable market prices as a result of vacancies and an oversupply of stock. Along with a general withdrawal of individuals from the speculative stock market, open-ended funds, as a steady and safe investment alternative, have gained increasing popularity. Since 1999, open-ended funds were therefore able to considerably increase their market share.

The most dramatic change in investment behavior can be observed in the group of closed-ended funds which, following reunification, have constantly increased their presence in the German investment market. Closed-ended funds raised their share from 20% in 1990 to 30% in 1993. By 1997, closed-ended funds held a share of 50%. However, in 1998, their investment activity sharply decreased and did so even more severely after 1999. Today, closed-ended funds hold a historic minimum of 19% of total market share (see Fig.8: Market Shares at Different Times).

Fig.8: Market Shares at Different Times
In Percent



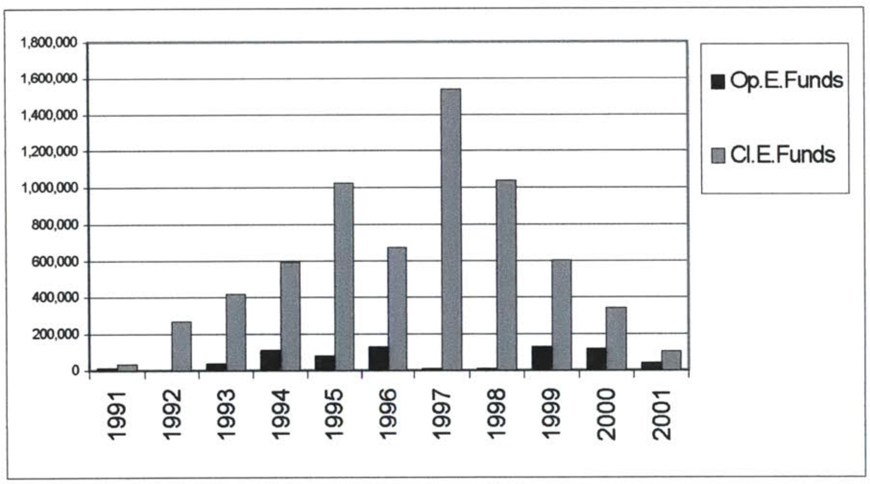
Generally speaking, most investment groups followed the prevailing market conditions over time and based their investment on factors such as rent levels, vacancies and acquisition prices. The only group, besides private investors, with investment strategies largely independent of general market conditions was that of closed-ended funds. Following the implementation of generous tax programs under the *Foerdergebietsgesetz*, numerous closed-ended funds emerged on the German investment market and were for many years among the most popular investment vehicles in Germany.

2. Investment Market Berlin

While no complete data is available to describe the investment of all market participants in Berlin since 1989, it can be assumed that the distribution among the investment groups was largely equivalent to the distribution found for overall Germany. However, all groups who were able to take advantage of the benefits relating to the *Foerdergebietsgesetz*, such as private investors and closed-ended funds, had a much larger percentage share in Berlin and in the New States than in West Germany.

A closer look at the different investment behavior of open-ended funds versus closed-ended funds in Berlin shows investment activity about 10 times higher for closed-ended funds than for open-ended funds (see Fig.9: Investment Activity in Berlin). Today, closed-ended funds in Berlin own about 620 properties, while open-ended funds hold around 55 properties. Considering, that in the data for all of Germany, closed-ended funds appear only about three times larger than open-ended funds, the relationship in Berlin is striking: here the ratio is on the order of 1 to 10.

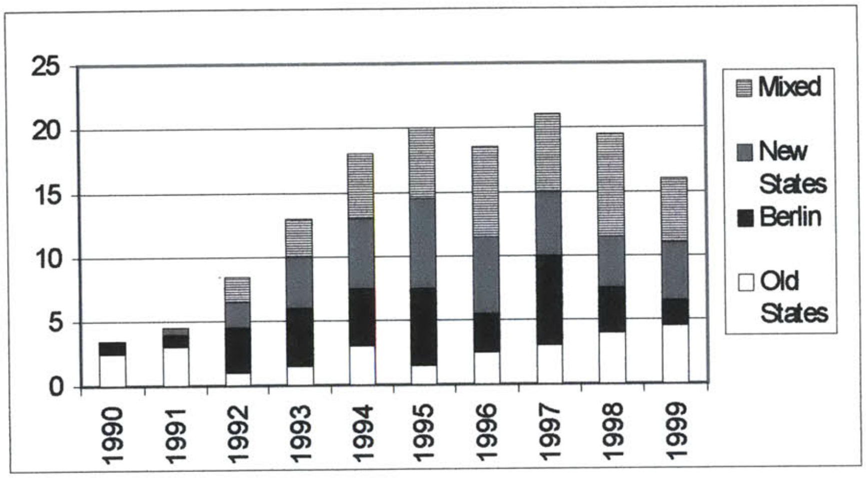
Fig.9: Investment Activity in Berlin:
Open-ended Funds vs. Closed-ended Funds



Source: Open-ended Funds: Annual Reports 2002
Closed-ended Funds: Bulwien AG 2002

In fact, the great majority of closed-ended funds emerging after reunification invested in properties exclusively in Berlin and former East Germany (see Fig.10: Regional Dispersion of Closed-ended Funds). This clearly differentiates them from open-ended funds for which no explicit focus to any German location could be observed at any time (JLLS, p.19). It has been argued, that the great real estate crisis in Germany is largely due to the investment activities of closed-ended funds, which based their investment decisions almost exclusively on tax decisions rather than on market conditions. Huge projects were realized in the middle of nowhere lacking any indicators of market demand from the very first day. The great amount of vacant office and apartment buildings in the states of the former DDR can be viewed as a viable example of misguided, tax-oriented investment activity.

Fig.10: Regional Dispersion of Closed-ended Funds
Investment Volume in Billion DM



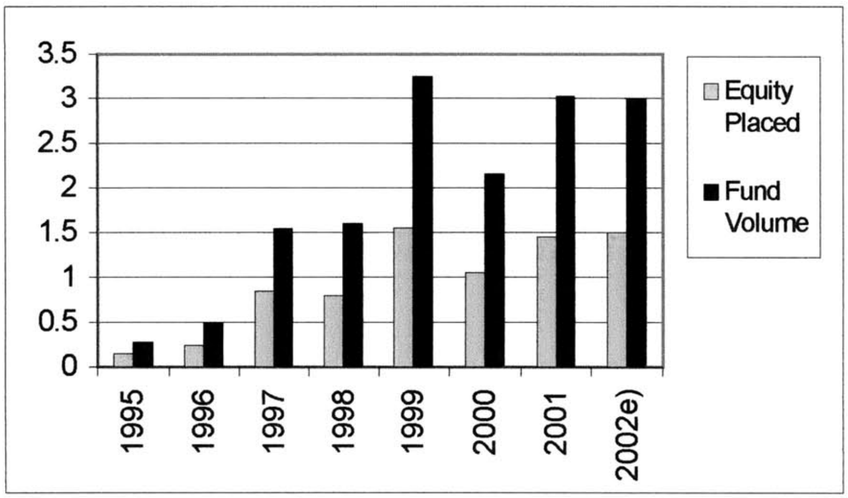
Source: Bulwien and Partner GmbH 2000

3. Recent Investment Behavior of Closed-ended Funds

In the past the prime incentive for investing in closed-ended funds was the possibility for large tax savings. This was primarily attractive for individuals of high income and therefore high tax liability. With the introduction of §2b EStG, eliminating the possibility of deducting losses against other personal income streams (see chapter: Incentive: Benefits from Tax Legislation), the original prime incentive for investment in closed-ended funds has disappeared. As a consequence, many German investors have turned to investing in other countries which often promise higher yields than Germany. Also, by investing abroad, investors can take advantage of the Double Tax Agreement (*Doppelbesteuerungabkommen, DBA*). This regulation provides that the right of taxation belongs to the country where the investment is made. Since most countries define a minimal income bracket which is tax exempt, investors can, provided that their rental income is below the limit, avoid taxation entirely.

The magnitude of the changes in the German tax legislation is reflected by the recent dramatic increase in German investment abroad, for example in the U.S. In 1999, the total investment volume of German closed-ended funds in the U.S. amounted to 3.2 billion DM. Compared to 1.5 billion DM in 1998, the investment volume in U.S. funds has therefore more than doubled within a single year.

Fig.11: Investment Placed in U.S.Funds
1995-2002 in Billion Euro



Source: Loipfinger 2002

Chapter-Appendix:

Real Estate Investment Market Germany

1986 – 2001 in Percent of Total Market Share

	R.E.Leasing	Cl.E.Funds	Op.E.Funds	Ins.,Pens.Fs	Int.Investors	Publ.Market
1986	21%	27%	6%	24%	22%	0%
1987	20%	29%	9%	22%	19%	0%
1988	21%	25%	14%	22%	17%	0%
1989	24%	21%	8%	24%	23%	0%
1990	27%	20%	3%	25%	24%	0%
1991	30%	22%	8%	30%	11%	0%
1992	33%	29%	10%	22%	5%	0%
1993	39%	29%	17%	13%	3%	0%
1994	31%	37%	17%	12%	3%	0%
1995	27%	47%	12%	11%	2%	0%
1996	35%	35%	19%	10%	1%	0%
1997	27%	50%	9%	11%	1%	1%
1998	30%	44%	8%	12%	4%	2%
1999	31%	32%	19%	9%	5%	4%
2000	29%	27%	18%	7%	14%	5%
2001	37%	19%	20%	7%	8%	9%

Source: Bulwien AG 2002

D) Special Investment Vehicles of the Bankgesellschaft Berlin

I. Formation and Mission of the BGB

In January 1994, two private credit institutes (Berliner Bank and Berliner Hypotheken-und Pfandbriefbank) and the Berlin state bank (Landesbank Berlin, LBB) merged to form the Berlin Bank Association (Bankgesellschaft Berlin, BGB). The purpose of the merger was to establish a powerful credit institution in the capital city which would gain a nationwide influence and scope of operations. The Berlin Bank Association was largely held in state ownership with the State of Berlin holding 81% of total shares.

A primary field of action of the BGB was its real estate segment. It was represented by the bank's subsidiaries IBG and IBAG. In the course of only five years, these subsidiaries increased their market share fivefold. In 2001, the bank, with a total investment volume of 10 billion euro was a leading national real estate institution and the largest provider of closed-ended funds in Germany. Further, it was the sixth largest credit institute quoted on the German stock exchange (Der Spiegel, February 2001). The BGB's mission to "go out and dominate the German real estate market" (Der Spiegel, February 2002) had been fulfilled. Mostly though, this success was due to the invention of a very unique investment opportunity. Since 1994, the BGB offered the participation in so-called "Don't-Worry Funds" (*Sorglos Fonds*).

II. Don't-Worry Funds

1. Promises and Guarantees

Between 1994 and 2001 around 70,000 individuals invested in the Berlin Bank Association's 54 closed-ended "Don't Worry Funds" (Der Spiegel, February 2002). During that time, they contributed around 10 billion euro which is around 16% of total investment volume in closed-ended funds in Germany between 1994 and 2001 (see Fig.7: Real Estate Investment Market Germany).

The uniqueness of the don't-worry offer was that the bank assumed every possible risk associated with the investment. This was done by giving out a number of guarantees, slightly varying between the different funds but generally offering the same incredible investment opportunity. The typical guarantees associated with a don't-worry investment were:

1. Guarantee of rental income at pre-determined price (usually the highest existing market rate) over a period of 25 to 30 years. If rental income turned out to be lower than warranted, the BGB would make up for the difference.

2. Guarantee of an increase in rents according to a 3% inflation rate over the same period of time. If inflation was below 3%, the bank would make up for the difference.

3. Guarantee to repurchase the investor's shares at any time and at the original market price. If the shares had lost their market value over time, the bank would make up for the difference in price.

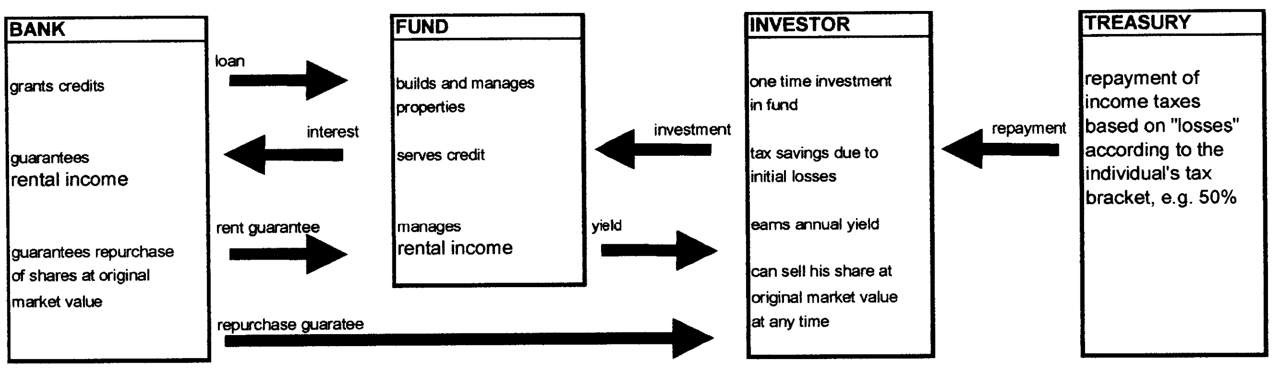
4. Guarantee of predetermined total development costs or acquisition prices for the properties. If the costs were exceeded during construction, the bank was to adjust for the difference (Der Spiegel, February 2002).

5. Guarantee of tax benefits due to the ascertained accumulation of initial losses[8] of up to 100% of the individual's investment (Wirtschaftswoche, April 1995).

[8] to be offset against other income streams (see chapter: Deduction of Losses)

All warrants were based on a declaration of patronage by the management board of the Berlin Bank Association in 1994 (Capital, January 2000). The following graph illustrates the liabilities of the different parties in this deal.

Fig.12: Don't Worry Investments
Closed-ended Funds of the Bankgesellschaft Berlin



Source: Der Spiegel, February 2001

In this context, the most remarkable guarantee appears to be the repurchase of shares at any time at the original market price. Usually, one of the largest risks for investors in closed-ended funds is the lack of exit strategies due to a sparsely developed secondary market (see chapter: Types of Investors and their Role in the Investment Boom). The second risk is a decrease in share value due to unfavorable market conditions. Both risks were eliminated by the promises of the bank.

The other striking part is the rent guarantee for a period of 25 to 30 years. Even if the rent level had been set at a lower, more modest price than it was done by the BGB, rents were certain to decline sooner or later. This is due to the fact that a full rent cycle on the German market has traditionally run between eight and ten years. It therefore seems completely irrational that guarantees were given out for triple the amount of that time.

The "Don't-Worry Funds" eliminated any possible risk for the investor. At the same time, they guaranteed a generous yield. Looking back, the Senator for Finance, Berlin called the *Sorglos-Fonds* an "investment with double-gain guarantee" or a "treasury bill with tax benefits" (Der Spiegel, February 2002).

2. Selection of Properties

Today, analysts know that if it had not been for the tax savings, the majority of the BGB's funds would never have found investors (Manager-Magazin, October 2000). It is indeed questionable if the portfolios themselves were very attractive. The IBAG/IBG properties comprised a wild mix of different building types such as apartments, office buildings, warehouses, automobile shops, restaurants, retirement homes, movie theatres and hotels (Capital, January 2000). Instead of bundling building types and focusing on their efficient and profit-yielding management, the funds seem to have acquired "any object standing around on the lawn" (Der Spiegel, February 2002). Furthermore, the funds acquired properties "for inventory" for a total of 3.5 billion euro, which were supposed to be offered through funds in later times (Der Spiegel, February 2002).

Several funds were set up only in order to make up for financially distressed properties the bank had acquired or received from cases of bankruptcy. Oftentimes, the bank had granted large credits to developers who had got into financial distress. When they failed to adhere to the loan agreement, the bank was stuck with almost completed buildings. The easiest solution was to add these properties to the portfolio of a new fund and to advertise them to private investors as a great investment opportunity (Tagesspiegel, July 2001, Capital, January 2000).

Oftentimes, the BGB included properties in its portfolio which were mere objects of prestige for the government (represented by the governmental authorities in the management board). For example, there were numerous large housing projects, which added more apartments to the already largely overbuilt housing market. These properties were never as economically successful as political authorities had wished (*Tagesspiegel*, July 2001).

So-called "Prominent Funds" (*Prominenten Fonds*) were set up around extremely profitable arrangements, such as special housing projects promoted by the government and therefore offering additional depreciation possibilities. Those and similar projects were included in "Prominent Funds" which were then offered to a small and carefully selected group of investors such as politicians and other VIP's. Along with the funds came guarantees not only of high-end rental incomes and repurchase options but guarantees to provide losses of up to 250% of the shareholder's investment (Der Spiegel, June 2002).

Numerous BGB managers and politicians participated in such dealings and other corrupt business and distributed the earnings among each other. In the meantime, the complete board of directors has been replaced (Tagesspiegel, July 2002). Presently, all former board members are being scrutinized by the media while numerous participants are under pre-trial confinement or have already been sentenced.

3. Other Funds - Similarities and Differences

During the early nineties, the practice of giving out guarantees and warrants was very common in the German real estate investment market. Under the firm conviction of the prospering German market conditions, guarantees were regarded as a simple tool to attract investors. However, most other funds gave out guarantees which were modest compared to those of the BGB. For example, the majority of funds promised rents for no longer than 5 to 10 years. If repurchase options were given they usually guaranteed the current market price instead of the original value as in the case of the BGB. Nonetheless, even these promises were too generous.

In 1997, a study was conducted by the economic journal „The Capital“ and the research institute Bulwien AG in Munich. For one hundred properties of closed-ended funds in East German cities and in Berlin the study compared the guarantees in the funds' investment catalogues with the actual market conditions that had evolved over time. The cities scrutinized were Berlin, Dresden, Leipzig, Magdeburg and Erfurt, the focus was the development of office rents. The result was striking: only three out of one hundred properties earned rents which were higher than those projected in the catalogue. Another handful was slightly below the projection, however the great majority of buildings collected rents far below the initial assumptions and promises (Capital, July 1997).

As a consequence, the great majority of funds, were eventually unable to pay the interest of their loans and went bankrupt. In 2002, it has been estimated by the director of the Association of Closed-ended Funds in Germany that out of 200 companies which issued funds in the early nineties, only about 50 will remain on the German investment market.

While the general set-up and history of failure was similar for the majority of funds in Germany, the crucial distinction between the other funds and the funds of the Berlin Bank Association lies in the fact that the BGB is 81% owned by the State of Berlin. This has two major implications:

1. Due to the patronage of the state, all risks assumed by the bank were ultimately backed by the city of Berlin. Therefore, the Berlin Bank Association could never go bankrupt.

2. The management board consisted of members of private industry as well as government representatives. This lead to agency problems and numerous cases of corruption.

III. Berlin's Financial Patronage

By 2001, the Bankgesellschaft Berlin had accumulated risks of about 20 billion euro (Tagesspiegel, June 2002). Meanwhile, the actual deficit of the bank amounted to 4 billion euro (Wirtschaftswoche, May 2001). Immediate financial help was needed to avoid a complete credit stoppage and the withdrawal of the bank's operating permit. On July 12, 2001, the Senate of Berlin, obliged through the state's patronage status as the bank's largest shareholder decided upon two steps of action to salvage the Bankgesellschaft Berlin. Both steps were approved by the European commission in Brussels on July 25, 2001:

1. An immediate equity subsidy of 2 billion euro to secure the mere existence of the Bankgesellschaft Berlin (Senatsverwaltung fuer Finanzen, December 2001).

2. An ordinance designed to shield the BGB from all risks and long-term liabilities (*Risikoabschirmung*) associated with its real estate subsidiaries. With the ordinance the state guaranteed to pay liabilities of 3.75 billion euro until 2030. However, due to the difficulty of precisely estimating the future risks, the Senate is prepared to assume liabilities of up to 21.6 billion euro (Tagesspiegel, April 2002). For the time being, 300 million euro will be set aside annually in the Berlin budget over the following years (Senatsverwaltung fuer Finanzen, February 2002).

The greatest risks are associated with the guarantees given out by the BGB. Large expenses are expected for the promises of rental income as well as the repurchase of shares over a period of 25 to 30 years. In order to use the tax benefits of the *Foerdergebietsgesetz*, the BGB's funds had primarily been engaged in the New States and in Berlin. Due to the steep decrease in rents in East German cities and in Berlin (see chapter: Incentive: Skyrocketing Rents), rental income for "Don't Worry Funds" had on average been 40% below the initial calculations. Also, by 2002, share values had decreased by an average of 30% (Der Spiegel, February 2002).

According to the ordinance, the Senate guarantees the book value of all land and properties of the BGB, however, all properties must be reappraised under realistic market assumptions. This will result in large value adjustments and additional expenses to be compensated for. In the long run, the Berlin Senate plans to sell the BGB's real estate subsidiaries IBAG and IBG to private investors. It will however take some time before realistic offers can be discussed from both sides. Even in the event of a sale, the Senate will have to assume large guarantees toward the investors, since clearly none of them would otherwise agree to take over the liability (Senatsverwaltung fuer Finanzen, December 2001).

IV. The BGB Crisis in Light of Berlin's Real Estate Crisis

1. Betrayed Investors

Today, the expected tax savings of numerous investors are threatened by the evaluation of the German Treasury Department. This is especially true for investors of closed-ended funds that went bankrupt. If, in connection with a fund's foreclosure, investors have to sell their shares before the expiration of the speculation period (see chapter: Incentive: Benefits from Tax Legislation), taxable gains must be paid, eliminating the prior tax savings from depreciation (Capital, July 1997).

<u>Example:</u>

Through the use of depreciation, investor A) has reduced the book value of his 100,000 euro investment to zero. By definition, taxable gain on sale is the difference between the net selling price and the remaining book value. Selling his share for 50,000 euro the investor will have a gain of 50,000 euro. Assuming a personal tax rate of 50%, he will have to return 25,000 euro to the state, leaving him with a net cash from sale of 25,000 euro. Investor B) has not used depreciation to reduce the book value of his investment, which therefore has remained at 100,000 euro. Selling his share at 50,000 euro he will have a loss of 50,000 euro. He will therefore get 25,000 euro from the Treasury, leaving him with a net gain from sale of 25,000 euro as well. In the end, both investors are in the same financial situation, indicating that if required to pay tax on the gain on sale all prior tax savings from depreciation are nullified.

Since 1999 the Treasury has not only changed numerous regulations making tax-oriented investment much more unattractive, but also seriously tightened its measures of control. Whenever the Treasury finds that investments were dominated by tax speculations, it will recapture all savings from the investor. The main three issues that can generally lead to the deprivation of previous tax savings are:

1. The speculation period was not observed, since the fund sold its properties or the investor sold his shares before the expiration of two years or ten years respectively.[9]

2. The Treasury assumes that the properties of a fund could never have reached the rent levels advertised in their catalogues and used to calculate building values. The Treasury will argue that the primary investment incentive was tax savings and will recapture the entire sum of the investor's savings. The only chance for investors to fight against this accusation is to deliver an expert's report proving the buildings' likeliness to be profitable in the future (Der Spiegel, February 2001).

3. The fund initiator gave out guarantees to repurchase the investor's share at any time. In this case, the Treasury argues that the investment was completely risk free and therefore does not deserve tax benefits. All prior savings will be recaptured as well (Manager-Magazin, April 2002).

[9] Two years for funds issued before June 31, 1995; ten years for funds issued after July 1, 1995.

2. Monetary Crisis versus Structural Crisis

According to the director of the state department of credit supervision, the crisis of the Bankgesellschaft Berlin is the nation's "worst bank crisis in 40 years" (Capital July, 2001). Berlin's finance senator however calls the crisis a catastrophe, which compared to the desperate financial situation of Berlin as a whole "is not the dominant theme" (Der Spiegel, February 2002).

Indeed, the burden of 3.75 billion euro to be paid over the next thirty years, seems to be small compared to the present deficit of almost 50 billion euro in the Berlin budget (see chapter: Berlin's Financial Crisis). If one considers however that over several years, the BGB was the largest German provider of closed-ended funds (representing 16% of all investments in such funds in Germany), the significance of its crisis for the German real estate market should not be underestimated. However, the BGB crisis seems to be a structural crisis more than a financial crisis.

Emerging from a combination of public and private banks, the BGB in its structural arrangement did not differentiate between public and private fields of functions and powers. Being backed by the budget of the Berlin state government, the fund initiators never had to base their decisions on factors of risk and risk adjustment. Under this premise, the natural control mechanisms of market decisions were eliminated. As a consequence, the BGB assumed risks and guarantees of a scale that would have been avoided by a private institution considering the uncertain market conditions. On the other hand, conflicts of interest in the selection of properties prevented market based decision-making. Properties of governmental prestige which were added to the BGB's portfolio brought additional risk for the operation of the funds. Meanwhile, government authorities in the management board failed to practice their public oversight function, encouraging rather than preventing unhealthy investment structures and taking private advantage of them.

E) Characteristics of the Crisis

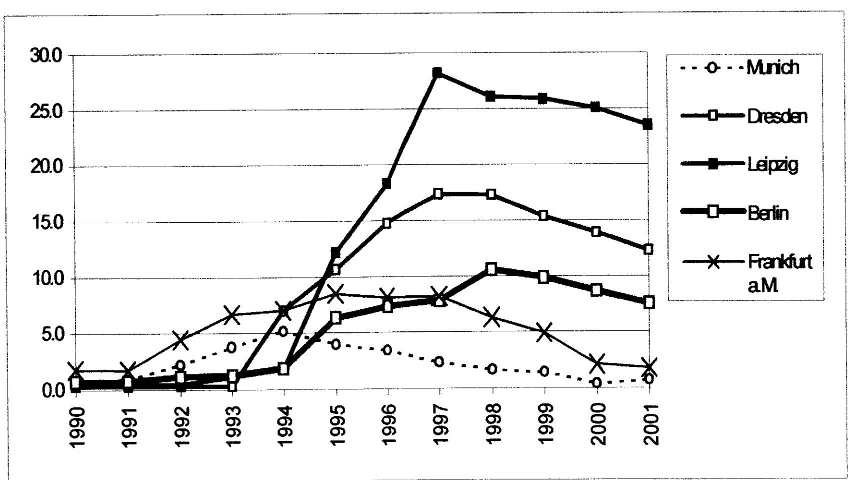
I. Real Estate Data

1. Vacancies

The sharp decline in rents in the Berlin office market from 80 DM/m^2 in 1992 to 60 DM/ m^2 in 1993 (see chapter: Incentive: Skyrocketing Rents) was the first indicator for an oversupply of stock and the upcoming real estate crisis. Just like rents, land prices in prime locations had fallen by 20% and numerous investors took back their projects. Urged by financial problems, other investors had to sell their properties far below their initial market value (Berliner Morgenpost, August 1994).

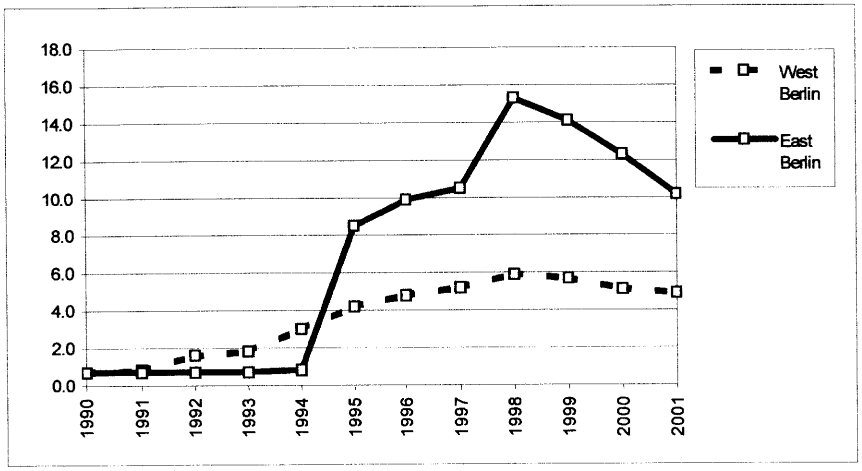
The decrease in rents and prices was caused by the first set of building completions entering the market in 1993. More completions entered the market in 1994 and 1995 causing vacancy rates to suddenly jump from 2% in 1994 to 6.5% in 1995. In 1998, Berlin reached its highest vacancy rates in history with 10.6% (see Fig.13: Vacancies in Selected German Cities).

Fig.13: Vacancies in Selected German Cities
1990-2001



Source: Bulwien AG 2002

Fig.14: Vacancies East Berlin vs. West Berlin
1990-2001



Source: Bulwien AG 2002

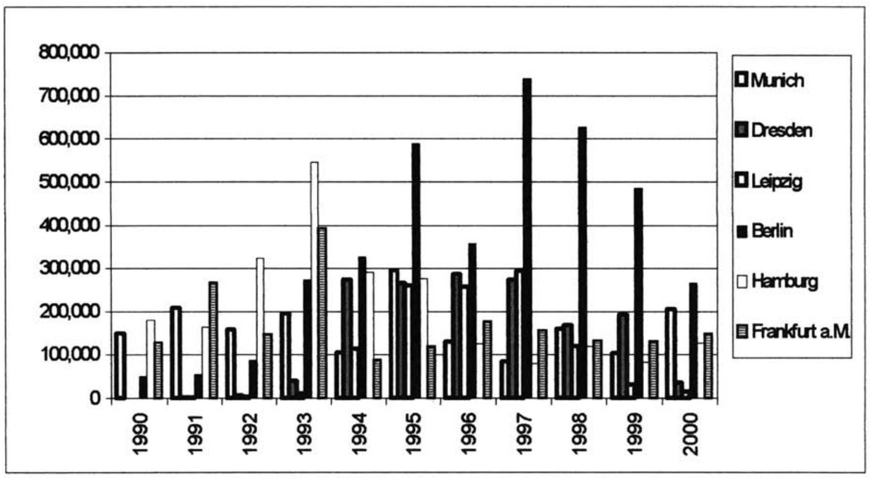
In East Berlin, the situation was generally more dramatic with vacancy jumping from 0.8% in 1994 to 8.5% in 1995 and finally reaching 15.3% in 1998 (see Fig.14: Vacancies East Berlin vs. West Berlin). At that time, investors in prime locations, such as *Friedrich Strasse*, were happy to have occupation rates of 40%. With special incentives, such as rent-free periods, generous tenant improvements or payment of moving expenses, owners tried to attract tenants (Lenhard, p.83).

The Berlin vacancy rates, while low in comparison to other global cities, were dramatic for the city, since in Germany, vacancy rates for office space had traditionally been around 2%. Some people argue that in order to provide for tenant flexibility regarding the choice of space and the ability to move, a higher vacancy rate is a structural advantage. However, no more than a "healthy" vacancy rate of 5% maximum is generally accepted. Today, vacancy rates in Berlin are at 7.5%, while Munich and Frankfurt have rates close to 0% (see Fig.13: Vacancies in Selected German Cities).

2. Building Completions and Office Absorption

Building activity has been far greater in Berlin than in other German cities. In 1997, about 750,000 m^2 of new office space entered the Berlin market, which was five times the amount entering the market in Frankfurt and nine times the amount entering the market in Hamburg (see Fig.15: Office Completions in Selected German Cities). According to an early estimate, by 1998, about 11 million square meters had been completed and added to the Berlin stock of office space. This corresponds to more than 60% of the amount to be completed in 20 years (see chapter: Incentive: Relocation of the Capital), in the course of only six years (Lenhard, p.84).

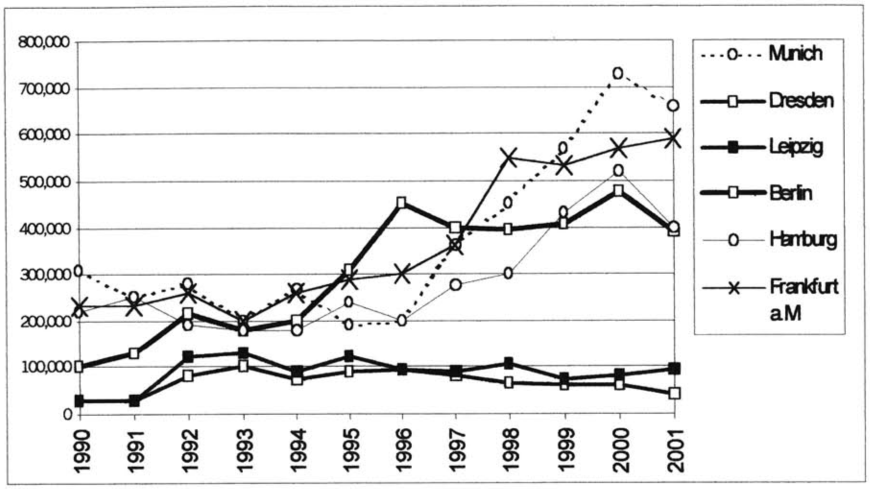
Fig.15: Office Completions in Selected German Cities
1990-2000



Source: Bulwien AG 2002

The large amount of new office space entering the market during a total of eight years was combined with a relatively weak office absorption in Berlin. While absorption significantly increased between 1994 and 1996, since then it has almost remained stagnant. The increase in office absorption in 1994, can partially be explained by the 1994 government's decision to move the capital city from Bonn to Berlin. Since 1997, office absorption in Berlin has clearly been outperformed by absorption in Frankfurt and Munich (see Fig.16: Office Absorption in Selected German Cities).

Fig.16: Office Absorption in Selected German Cities
1990-2001



Source: Bulwien AG 2002

It must, however, be mentioned, that the assumptions for actual increase of stock and subsequent absorption vary greatly according to different statistical sources. For example, the number of building completions of new office space between 1989 and 2002, registered by the Bureau of Statistics Berlin (*Statistisches Landesamt Berlin*), amounts to a total of around 4 million square meters. However, as illustrated in a study by the Berlin Senate, this number does not include the great amount of renovations nor the numerous conversions from apartments to office space and therefore does not represent the actual situation on the market. A detailed investigation by the Senate for Urban Development (*Senat für Stadtentwicklung*) estimated that the actual volume of new space was about 7 million m^2. Due to several factors of diffusion, the Senate today assumes a rough value of 8 million square meters added to the Berlin office market since 1990. Of these 8 million, roughly 6 million m^2 have been absorbed by the market while roughly 2 million m^2 are vacant (Bürostandort Berlin, p.20).

II. Structural Deficits

1. Economic Premises

In 1993, for the first time since reunification, disillusion emerged and skeptical voices were raised by several parties. The economy had not developed at the pace expected during the reunification euphoria. The slight economic upswing caused by the reunification had slowed down and Germany was facing a period of recession wherein Berlin's GNP was far behind that of all other German states (Reissert,Schmitt, p.40). Between 1990 and 1996, Berlin's unemployment rate increased by 69% (Häußermann, p.16) and first statistical studies conducted by the Senate revealed that the optimistic assumptions about economic growth and migration to Berlin had been unrealistic. The interest of leading businesses to settle in Berlin was clearly smaller than originally expected and no significant population growth could be observed. Instead of reaching the expected benchmark of 5 billion inhabitants, Berlin's population has largely remained unchanged since 1990. It has actually even slightly decreased from 3.43 million in 1990 to 3.38 million in 2000 (Statistisches Landesamt Berlin).

Despite such problems, politicians continued to compare Berlin to leading global cities such as London and Paris and promoted its image as the upcoming prime service center and "East-West Interchange". According to state authorities, the crisis was minor and preliminary. All efforts were made to further encourage investment and physical expansion. Today, critics argue that Berlin's only focus was to produce as much office space as possible, assuming that this would automatically lead to economic growth and the aspired importance as a world city.

However, cities with thriving service sectors are usually attractive industry locations as well, as shown by examples such as Frankfurt and Los Angeles (Lenhard, p.86). Until the late eighties, West Berlin had a large number of producing industries in inner city locations, that could afford their existence due to large federal subsidies during the Cold

War. With reunification, those subsidies were eliminated. Due to the dramatic increase in land prices following reunification, most industries could no longer afford to remain in Berlin. Some of them moved to the suburbs, however many of them decided to give up the city entirely. In late 1992, the Berlin government eventually understood the importance of industry for the future prosperity of the region and reserved 21 larger zones for industrial use. However, by that time most relocation decisions had already been executed and only little industry was left in Berlin (Lenhard, p.87).

2. Indecision

Critics say that even now, Berlin never succeeded in defining a true vision of the city (Der Spiegel, April 1993). Instead, Berlin tried to take over the position of Frankfurt as the leading service agglomeration in Germany. The speculation that firms would move their headquarters from Frankfurt to Berlin was completely unrealistic. Even today, numerous geographic advantages make Frankfurt more attractive as a business location than Berlin, last but not least its large international airport offering 290 destinations and 110 airlines. With only 78 destinations and 34 airlines, Berlin offers less than one third of these connections (CB Richard Ellis).

It has been said that the "roles of the cities" in Germany have already been distributed (Scharenberg, p.152). Frankfurt is and will always be the leading office concentration, Munich is known for its large high tech sector and Hamburg is the leading center for media and press. In 1993, Manfred Gentz, top manager at Daimler Chrysler, said in an interview that Berlin had thought for too long that after the fall of the Wall it would be a self-starter although it is not. Instead of trying to copy the functions of other cities, Berlin needed to have a clear vision of its own competitive advantage within the context of Germany and Europe (Der Spiegel, April 1993).

Due to its large stock of educational and cultural institutions (Berlin has five universities and over one hundred theatres), Berlin today is promoting its new image as Germany's "cultural capital" and "center for innovative research and technology". Special subsidies and promotional programs are designed to encourage "innovative technology sectors", such as information technology, medical technology, bio technology, pharmaceutical technology and transportation technology. Even today, it is unclear whether this new strategy will be successful in stimulating economic growth. So far, the image has been a programmatic construction of the Senate rather than reality (Lenhard, p.87).

3. Berlin's Financial Crisis

Before German reunification, Berlin had lived in a financial paradise. For decades, the city, in its isolated location in the middle of the former DDR, had been generously subsidized by the West German government through all kinds of tax benefits for inhabitants, firms and industries. Whenever the city was in financial distress, it could count on the help of a federal government concerned to keep Berlin prosperous and strong. With the end of the Cold War and the reunification of Germany, these subsidies were abandoned, and for the first time in 40 years, the city had to learn how to make and manage a budget without the help in times of financial distress. Critics say, that part of the financial crisis in Berlin today is due to the fact, that the city never learned how to manage a budget, but has instead developed a very elaborate spending mentality (Strom, p. 82).

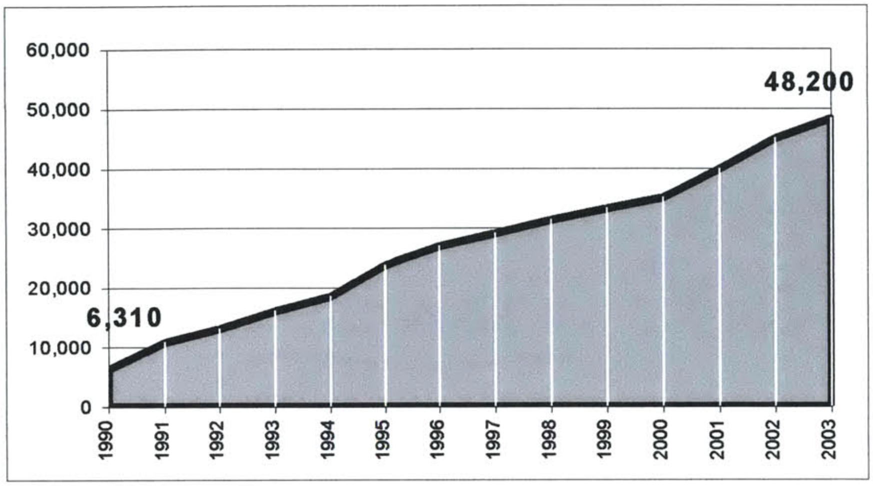
Since 1989, Berlin had incurred huge amounts of "reunification costs". One of the largest expenses was the renewal of infrastructure. Two separate city parts, which had been isolated for more than 40 years had to be reconnected. Moreover, the infrastructure inherited from the East was gravely deteriorated and had to be renewed. Since 1990, Berlin spent about 1.2 billion DM for the construction of roads alone, and 2.4 billion DM for highways, subways and an elaborate system of bridges and tunnels transforming

Berlin into a high tech national traffic node (Senatsverwaltung fuer Stadtentwicklung, Umweltschutz und Technologie).

The second large investment block was public expenses designed to encourage economic growth and attract investment activity. Between 1991 and 1998 the largest public expenses due to direct subsidy programs were in new housing, modernization and urban renewal. Due to generous tax benefits related to real estate investment, the city at the same time was deprived of large internal revenues (Krätke,Borst, p.143). Between 1990 and 1996, the city's revenue from income taxes was reduced by 78% and revenue from taxable gains decreased by 30% between 1993 and 1996 (Deutsches Institut fuer Wirtschaftsforschung).

All in all, since 1989, Berlin has relied on a strategy of "deficit spending" estimating that the deficits would be covered in later prosperous years. However, between 1990 and 2001, Berlin's debt increased from 6,31 billion euro to 38 billion euro which is an increase of more than 500% in the course of eleven years. The prognoses for the city's debt in 2002 and 2003 are 44 billion and 48.2 billion euro respectively (see Fig.17: Berlin Debt 1990-2001). If the prognoses prove correct, Berlin's debt in 2003 will be seven times as high as it was in 1990. Meanwhile the largest annual expenses are interest payments, which were around 0.55 billion euro in 1990 (Scharenberg, p.150), 2 billion euro in 2001 and will be 2.5 billion euro in 2003 (Tagesspiegel, June 2002).

Fig.17: Berlin Debt 1990-2003
In Million Euro



Source: Senatsverwaltung fuer Finanzen 2002
Note: The Data for 2002 and 2003 are Prognoses

Arguing that most of Berlin's expenses over time were related to the German reunification and had therefore been of federal interest, Berlin has demanded financial help from the Federal Government. If necessary, it is intended to enforce this claim before the Federal Constitutional Court (*Bundesverfassungsgericht*). It is however doubtful the Federal government will help, since it has serious problems itself. Earlier this year, the Federal Government barely escaped a stern warning from the European Commission, because the national debt level was about to reach the limit of 3% of GNP. This would have been in violation of the economic stability pact and have threatened an exclusion from the European Union (Der Spiegel, February 2002).

III. Hypothesis 2:
Federal Subsidies were Disproportionate if not Unnecessary

1. Real Estate Cycles

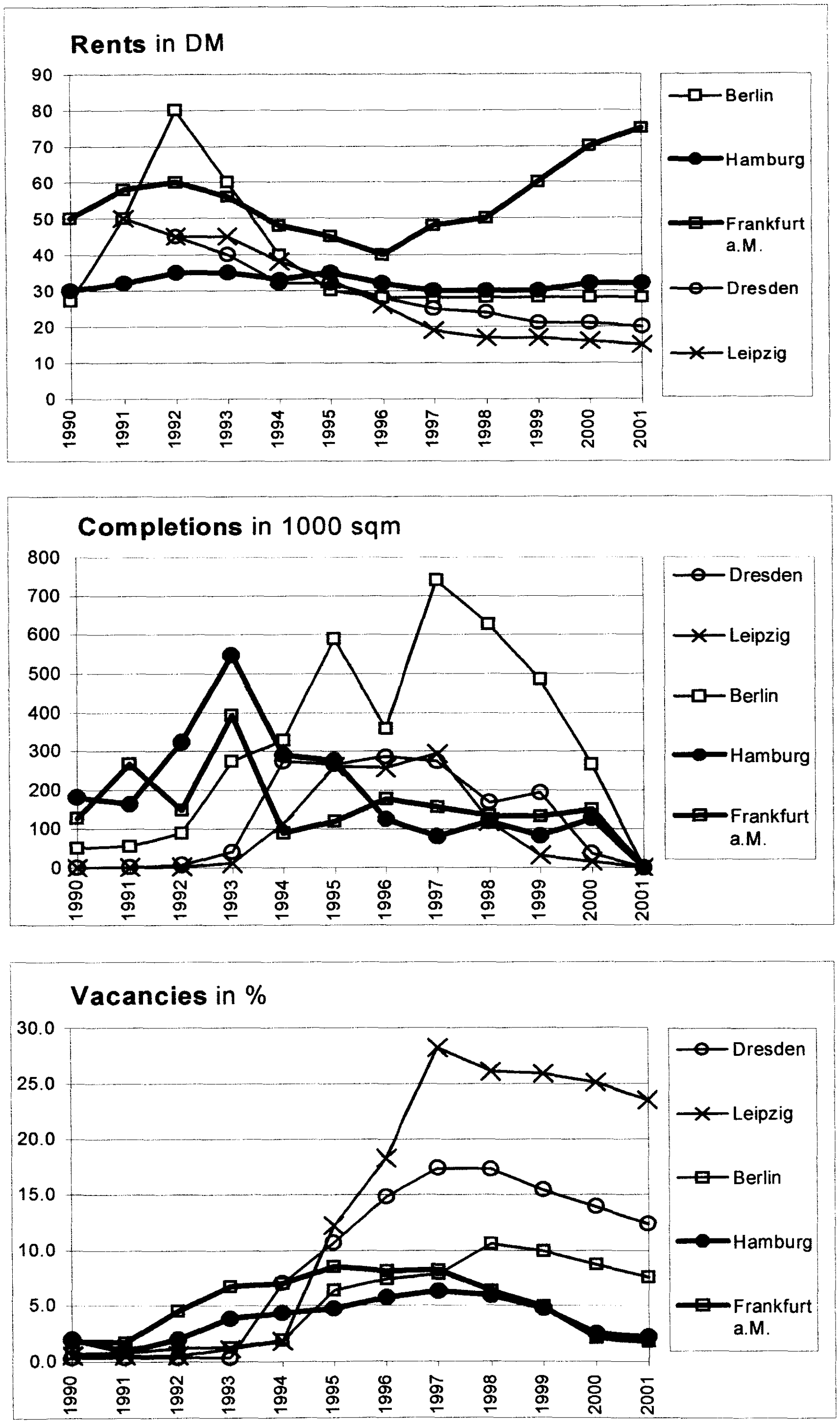
As is generally known, real estate markets move in cycles. According to the Stock-Flow Model, a positive demand shock due to an increase of population or the incremented popularity for a certain location, as in the case of Berlin, will at first cause an increase of rents and prices. Following the initial demand shock, rents and prices will overshoot the long-run equilibrium value (DiPasquale,Wheaton, p.248). The increase in rents and prices makes construction attractive and stimulates building activity. At first, construction will, as well, overshoot the replacement level. From there it will gradually decline to the rate needed to sustain the new steady-state of the stock (DiPasquale,Wheaton, p.248). As new construction occurs, the stock of units begins to rise and prices will gradually decline eventually reaching the new steady state. The decrease in prices makes construction less attractive and building activity will stop.

At different times in different places, real estate cycles reach different magnitudes, depending on economic factors, more or less realistic assumptions about a region's future growth and, last but not least, on governmental regulations encouraging building activity of certain building types in certain regions (Lenhard, p.129).

2. Different Cycles in Different Cities
What Might have Happened without the Subsidies

In this context, it is revealing to compare the real estate cycles of different West German (unsubsidized) and East German (subsidized) cities between 1989 and 2002 (see Fig.18: The Cyclical Behavior of the German Office Market).

Fig.18: The Cyclical Behavior of the German Office Market



Source: Bulwien AG 2002

In West German cities, a one time peak of new construction in 1993 was followed by a decrease in rents in 1994. As a consequence, construction gradually declined. This reaction indicates that West German cities followed a normal cyclical movement. In East German cities and in Berlin however, building activity remained constant over several years. In Berlin, completions reached a first peak in 1995 and a second one in 1997, while building activity was generally extensive until 1999. This was despite a decrease in rents since 1993. Artificially extended through subsidies and tax legislation, construction continued about three times longer than the surrounding market conditions should have permitted.

Today, West German cities have recovered from their crisis, featuring increasing rents and almost no vacancies. While the unsubsidized cities are on their way to the next cycle, the New States and Berlin are stuck with an enormous oversupply, high vacancy rates and stagnant low-level rents. In this context it has to be questioned, why government authorities in Berlin found it necessary and in the "interest of the city" (Lenhard, p.130) to offer additional incentives such as tax benefits, in order to encourage building activity. The example of West German cities has illustrated that in unsubsidized markets, building activity will stop as soon as vacancies rise and rents decline. Based on simple market principles this system is self-regulating. In East Germany and in Berlin however, the natural control mechanisms were eliminated. Supply was increased in the interest of tax benefits rather than true market demand.

Given the great national and international optimism about the future of Berlin and the general investment "run" of the early years, it can be assumed that the existing factors were sufficient to generate the building boom desired by the authorities. A "natural" not subsidized market evolution with self-regulating cycles, might not have led to the scope of oversupply and vacancy rates in present-day Berlin. While some will argue that Berlin needed a "jump-start" and government incentives were a way to effect it, the question remains why tax benefits were granted up until 1999, considering unacceptable vacancy rates began appearing as early as in 1995.

F) Conclusion

On investigating the events in the Berlin office market between 1989 and 2002, I found it necessary to first specify the different investment incentives stimulating the market during that time. These were at first general incentives, such as the expectations of the city's significance in Europe as well as the governments decision to relocate the capital to Berlin. The second category were market incentives, such as high rent levels and increasing land values. The third group were public incentives such as planning legislation and tax legislation.

It has become clear through my research that the strongest impact on investment decisions was related to public incentives. In this context, the most significant legislation was the Investment Priority Act (1992) and the Special Depreciation under the *Foerdergebietsgesetz* (1990-1999).

The direct effect of legislation on investment activity was shown by two factors:
A) the strong correlation between the number of building permits and the issuance of different changes in legislation (see: Hypothesis 1)
B) the non proportionate amount of investments in the New States and in Berlin where the tax advantages of the *Foerdergebietsgesetz* could be applied, as opposed to investments in the Old States, where no subsidy programs were offered (see chapter: Investment Market Berlin).

In a second step, the paper investigated the different investment groups found on the Berlin office market. The analysis of their different legal structures demonstrated that the only groups that could directly benefit from tax legislation were private property owners and investors of closed-ended funds. It was then shown that before reunification the investment market had been equally distributed between the four largest investment groups and that this relation dramatically changed with the issuance of the

Foerdergebietsgesetz in 1990 (see chapter: Different Market Shares at Different Times). During the Berlin building boom, the market leading investment group was closed-ended funds holding a market share of up to 50% over several years.

Having finally realized the negative impact of overly generous and protracted tax incentives, the political authorities in 1999 abruptly changed much tax legislation. Not only was the Special Depreciation abandoned, but also the deduction of losses eliminated and the gain on sale legislation changed (see chapter: Incentive: Benefits from Tax Legislation). These later regulations had been established much earlier than 1990 and had been integral parts of the German income tax legislation over decades. Without claiming to understand or being able to judge the matters of law-making, I nevertheless question whether or not the radical change in all tax-related issues was not a mere political overreaction to the desperate real estate market situation. As a consequence of the rigid alterations, large fractions of investors turned to investments abroad, whereby it is doubtful if this was the politically desired long-term effect.

Considering the effects of the various public incentives, the ordinances related to planning rights can be looked at favorably. The Investment Priority Act as well as the other laws bridging the lack of planning legislation were the impetus of the building boom in the New States. They aimed to accelerate the permitting process and were therefore necessary tools in easing the dramatic supply shortage in the years following reunification. Simply put, barriers were reduced, providing the legal framework which allowed the private market to operate. The tax incentives, on the other hand, exceeded a regulatory function. They directly influenced decision-making through concrete financial rewards. Due to this aspect, they must be questioned seriously.

The third part of the paper described the crisis of the Berlin Bank Association. This appears to be a "microcosm" of the general Berlin real estate crisis. Beforehand the research had considered the effect of public decision-making on the private market. In the case of the BGB however, public authorities were not restricted to delivering a legal framework, but actively participated in management and in making real estate investment decisions. Due to the State's financial back-up, one of the few remaining market factors, risk, had been eliminated. The outcome of this case has been dramatic from a financial and even more so from a structural point of view.

In the final part of the paper, the comparison of real estate cycles in different German cities was used to imagine what could have happened in Berlin without the subsidy programs (see: Hypothesis 2). It appeared, that the unsubsidized West German cities followed a "natural" real estate cycle, while East German and Berlin cycles were artificially extended through subsidies and tax legislation. Observing the quick recovery of West German cities as opposed to the desperate situation in the New States and in Berlin, it was found that the unsubsidized cycles represented a "healthier" development, because they were market-driven and therefore self-regulating. Furthermore, it was assumed that the general "run" on Berlin in the years following reunification would have been sufficient to generate the building boom desired by the political authorities. This lead to the final assumption that the federal subsidies were "disproportionate if not unnecessary".

In light of all this, the story of the Berlin office market after German Reunification appears as a classic case of the misdirected public intention to positively influence private market decision-making. This produced a crisis that in all probability could have been avoided had market conditions alone been allowed to determine the outcome.

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