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Germany's Property Tax System: Not Fit for Purpose

Germany's Constitutional Court recently ruled that the country's property tax system needs an overhaul. Replacing the existing system is going to be complicated – and expensive.

When the Federal Constitutional Court finally spoke, its verdict didn't really surprise anyone. After all, it has been clear for years that Germany's property tax system needs an overhaul. Almost as soon as the verdict was announced, market observers and experts quickly dusted off familiar proposals for a new property tax system. Unfortunately, none of their proposals has yet gained widespread support. This may, in part, be due to the fact that politicians can't seem to agree on how the tax should actually work. Should it be based on the precise value of a property? Or is it enough to base property tax assessments on rough estimates, as long as everyone is treated consistently? And could the opportunity for reform also incentivise the development of new housing?

Let's take a look at the four main alternatives to the current system

Model 1

Despite the court's ruling, legislators are, in principle, free to stick to the existing model – provided they replace the standard values they use as the basis for calculating the property tax with current market values. Revaluing more than 35 million properties would be a truly herculean task and, according to Germany's tax authorities, would take up to ten years. Some of Germany's northern states have suggested that the process could be made easier if they were allowed to use more general figures, as is normally the case for such mass surveys. They would like to use the sales prices of comparable properties, combined with specific criteria such as year of construction, size and construction standard. Nevertheless, the effort would be considerable. A feasibility study arrived at costs of EUR 1.8 billion, plus EUR 220 million per year to update the figures.

Of course, things would be easier once the system is up and running and a suitable database is available. There are already more than 1,000 expert valuation committees around Germany determining standard land values, and many cities already have rent indexes. Data can also be harvested from local tax offices and land registry offices. Nevertheless, it would still be a huge undertaking to network all of these existing databases to allow property tax assessments to produced at the push of a button.

Model 2

A pure land tax would be a far simpler system to administer. A land tax would be based on the actual size of a parcel of land, which is fairly easy to determine. It could tax the value of the land and ignore the value of any buildings on the land. The system wouldn't add much more red tape, because the existing standard land values are a good enough basis for land tax assessments. The only downsides are that the owners of detached houses, particularly in expensive locations, would probably end up with higher tax burdens as a result, as would the owners of undeveloped land. In contrast, apartment building owners would probably face lower tax burdens as their properties occupy relatively little land. A land tax would have the added benefit of encouraging developers to prioritise more compact buildings. This could be a positive political argument in times of ever scarcer housing, even if the property tax alone is not likely to be high enough to steer the real estate market in one direction or another.

Model 3

The most politically advanced alternative is the fiscal cost approach (Kostenwert Modell). In fact, the Bundesrat (the Upper House of the German parliament) presented a bill to this effect at the end of 2016, although it was never implemented. The proposal envisioned a fairly minor change to the current system: Instead of basing tax assessments on the value of a property, they would be based on the standardized manufacturing cost of constructing a similar property. The key factor here is the year the property was built, which would form the basis for calculating how much a building type would cost. In principle, this sounds reasonably fair, because the owners of higher standard properties would pay more property tax.

Critics consider this model counterproductive, however, because new buildings would be taxed at a much higher rate, thus penalising investments in new housing. Modern buildings, for example, are subject to higher energy standards – a factor that would be included in the new tax assessment. Older buildings, on the other hand, not only benefit from lower assessed values, they are also allowed to reduce their assessments by up to 70 percent in the form of age-related depreciation. Compared to a mid-terrace house from 2018, a chic Wilhelminian style villa would be relatively cheap, which is not exactly a positive signal to send out the developers of new housing. In addition, this fiscal cost approach would be fairly complicated and expensive to introduce and administer.

In addition, this model has legal risks of its own: A number of tax law experts have already analysed the proposal and concluded that it would also be likely to be overturned by the constitutional court.

Model 4

The “Southern Model”, named after the states of Bavaria, Baden-Württemberg and Hesse who first proposed it, would be something of a hybrid approach. It would also require no new evaluation of the country’s real estate, because only the areas of land and buildings would be fed into the tax system. Of course, this would not be completely straightforward. While the sizes of plots of land are readily available, it would not be quite so easy to calculate the entire area of each building. With this model, multi-family houses would be potentially worse off than single-family houses. Whether their owners would really end up paying more than today, however, is questionable.