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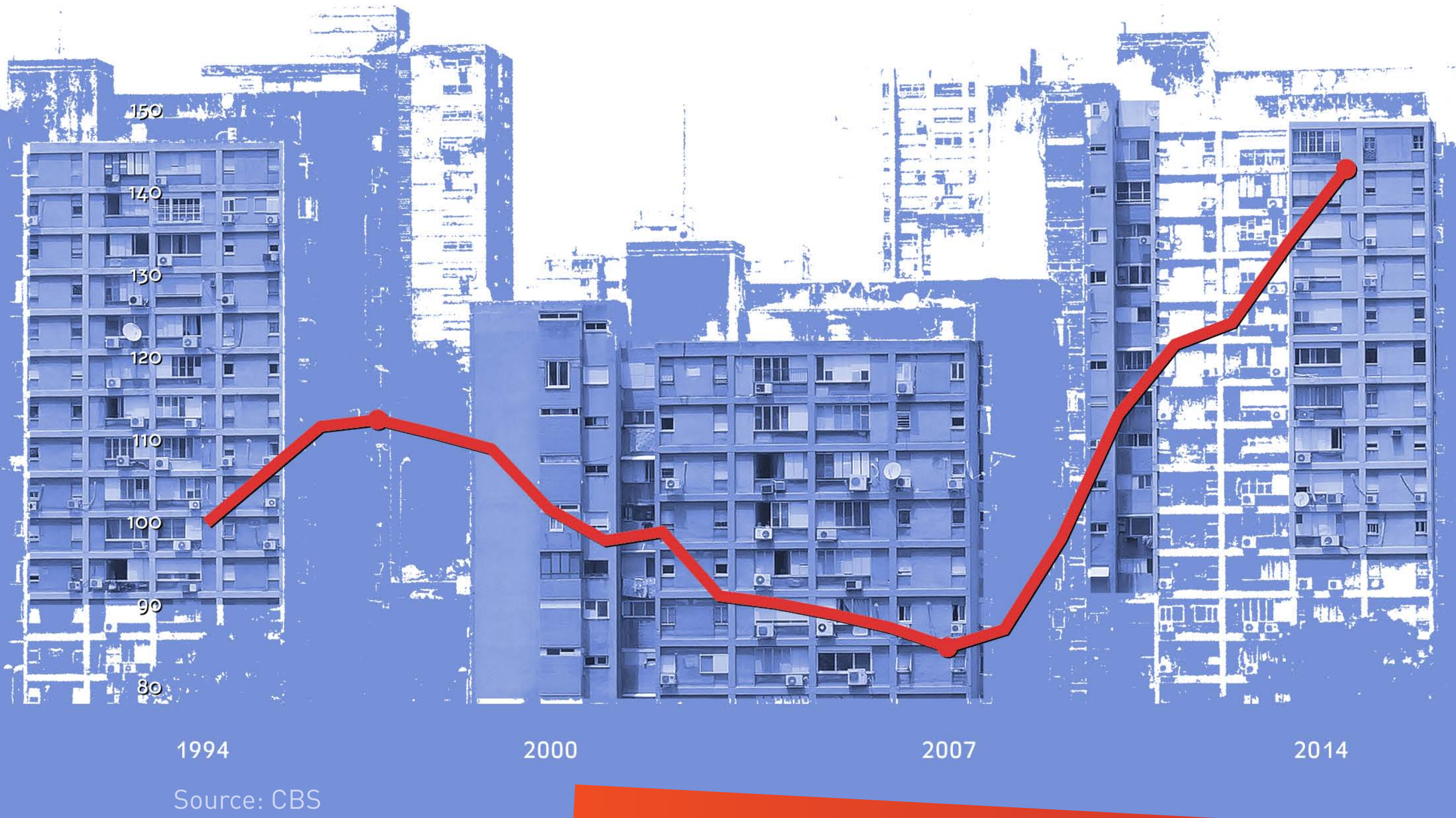

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Executive Summary

Real Estate Tax and Inequality in Israel

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- Summary -

In the last decade, the issue of defining a desirable policy for regulating the Israeli housing market has been at the center of public, political, legal and academic attention. This interest has been driven by the steep rise in housing prices of about 9% a year, amounting to an overall increase of 66% since 2008, as well as the increase, albeit relatively modest, in the cost of renting, particularly in central Israel.

Our research therefore attempts to examine the effects of real estate tax policy on the housing market and inequality in Israel. The first part of the paper will introduce the main factors influencing the housing market, including both regulatory and market factors. In this regard, four main regulatory factors have a significant influence on the housing market: land allocation policy (as most land in Israel is state-owned); management of planning and building procedures; government policy on public spending on housing solutions, and real estate tax policy.

With regards to market factors, we show that the housing market is unique and cannot be fully described based on classic economic market analysis. Unlike in other markets, the supply in the housing market is mainly dependent on the regulatory policy concerning land planning and construction regulation, and is therefore non-elastic. Therefore, higher demand will not lead to increased supply. As for the demand curve, we identify a rise in housing demand due to several main reasons. First, the financial crisis of 2008 made investment in the stock market less attractive; second, low interest rates have made mortgages more attractive; third, the significant reduction in real estate tax rates in 2002 has made real estate a more attractive investment option; and, finally, the population has grown faster than the amount of new houses available. In this regard, it is fair to say that the demand for housing among high–income households home owners is relatively elastic as it is influenced by regulatory incentives, including the tax burden. However, the question of how elastic the demand for housing is among low-income households remains a cause for disagreement. As is

discussed in the paper, this question is relevant to determine the ability of home owners to impose the tax burden on renters.

The second part of the paper provides the theoretical and terminological framework to the analysis offered in the paper.

The basic assumption of the research, common in economic analysis, is that reducing inequality is one of the objectives of the tax system. Tax incentives regarding the housing market are of great importance, due in part to the fact that housing is considered to be a basic commodity, as well as the fact that an inefficient housing market will create additional social costs (for example, it may affect the labor market).

The third part of the paper systematically analyses the main tax systems that apply to real estate in Israel – municipal property tax, betterment tax, purchase and sale tax, income tax on rent, and income tax on businesses engaged in the real estate market. Each of the different taxes is examined in relation to two aspects: first, its progressiveness or regressiveness, and second, its influence on inequality.

The main conclusions are as follows:

- Municipal tax – property tax in Israel is characterised with internal progressiveness, in the sense that the tax rate increases in correlation with the value of real estate. Yet, it also has external regressiveness as the burden it imposes on taxpayers' income is heavier on low-income tax payers.
- Betterment tax– betterment tax in Israel is characterised with external regressiveness, as the huge tax breaks it includes are granted only to home owners, who are usually at the upper percentile of population. In addition, the option to postpone tax liability, in cases such as inheritance, creates an additional regressive outcome.
- Purchase and Sale tax – compared with other taxes, which are imposed on income, purchase tax as well as sales (although its current rate is set to 0% and therefore the following conclusion will be focused only

on purchase tax) are imposed on transactions, regardless of the taxpayers' profit. As such, purchase tax may create a negative incentive for real estate transactions as it has a "lock-in" effect. Purchase tax, however, is progressive, under the assumption that the number of real estate transactions made by investors is higher than the number of transactions made by taxpayers who own a single house, hence the burden is higher on investors.

It should be noted that purchase tax may be perceived differently, as a tax imposed on imputed income from housing, capitalised to the time of the purchase. However, this perception cannot explain the current structure of the purchase tax, nor the fact that the tax is levied on all transactions, including houses that were rented out (rather than held for self-use) and for which income tax has already been paid.

- Income tax on rents – income tax on rent is characterized with internal progressiveness, in the sense that the tax deductions it provides are less available as income increases (especially given there is an exemption on income from rent up to NIS 5,070. Yet, this tax has a negative influence on inequality, as it offers extremely low rates (only 10% tax on the whole income from rent) as well as a certain tax exemption (only for income form rent which is limited to NIS 5,070) provided only to home owners, most of whom tend to have a high economic status.

On this basis, we examined the desirable tax policy with regards to real estate tax, while recognizing that the tax system cannot, by itself, fully solve the problems of the housing market, and the need to promote effective regulatory reform alongside the required changes to the tax system.

The main policy recommendations are as follows:

Municipal tax

- **Property tax should be determined as a percentage of the property's value** instead of the current tax calculation system, in which there are maximal and minimal rates, and the correlation between the property's value and the tax rate is partial at best.
- In addition, **property tax should be structured as a progressive tax**, either by increasing the rates in accordance with the value of the property, or increasing the rates in accordance with the property's size.

Betterment tax and the tax rates on income from rents

- **The betterment tax rate and the tax rate on income from rents should be equal to regular income tax rates, and the income from rent should be additionally subject to VAT and social security payments.** This recommendation is based on the general principle of tax policy, according to which all income should be taxed at the same rates, unless there are justifications to do otherwise. In this regard, the justifications for setting the low tax rates on capital gains are irrelevant with regards to real estate. Furthermore, currently there is no lack of investment in the housing market, which may constitute an incentive for reducing tax rates.

Exemption from betterment tax for owners of a single home

- **There is a need to abolish, or at least to narrow, the current exemption from betterment tax given to owners of one home, as well as the exemption from rent income up to NIS 5,070.** These incentives are regressive, as they grant billions in tax benefits to the wealthiest parts of the population. Rather, the state should grant tax benefits to all, either according to a universal model, or in accordance with a progressive model, based on the taxpayers' income.

- **The ability to postpone tax payments in cases of inheritance should be eliminated.** Not only does the ability to postpone tax liability create a potential for aggressive tax planning, but it has no practical justification. It should be noted that we do not recommend setting an inheritance tax, as tax liability exists with no regard to the death of the homeowner once the home is sold. What we do recommend is that the time of inheritance should be seen as the realization of the asset.

<u>Purchase and sale tax</u>

- **As long as there is no deficit in investments in the housing market, the current purchase tax rates should be maintained.** If such a deficit does occur, reducing the purchase tax in order to incentivize investments may be justified.
- Sale tax can be used if the state wishes to reduce the incentives for house ownership. In such a case, the structure of the tax must change, and should be applied only to homes used for self-housing.

<u>Income from businesses engaged in real estate</u>

- **A clear definition of passive and active income from real estate should be established.** We suggest defining an active income in this regard as profits made out of at least four homes.

<u>Gradual adoption of the recommendations</u>

We recommend that promoting any of our policy recommendations in this paper should be made gradually, in order to examine whether these slow down investments, and the way in which they affect the housing market.

We hope that this research will constitute a useful tool for policy makers in the field of real estate and planning taxation. We further hope that this research, alongside other significant relevant reports published in recent months, will create a solid foundation for academic and public debate concerning real estate taxation, inequality and the housing market.