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Do Local Authorities Face a Negative Incentive to Increase the Population under their Jurisdiction?

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Policy Paper – GGA/2014

March 2014

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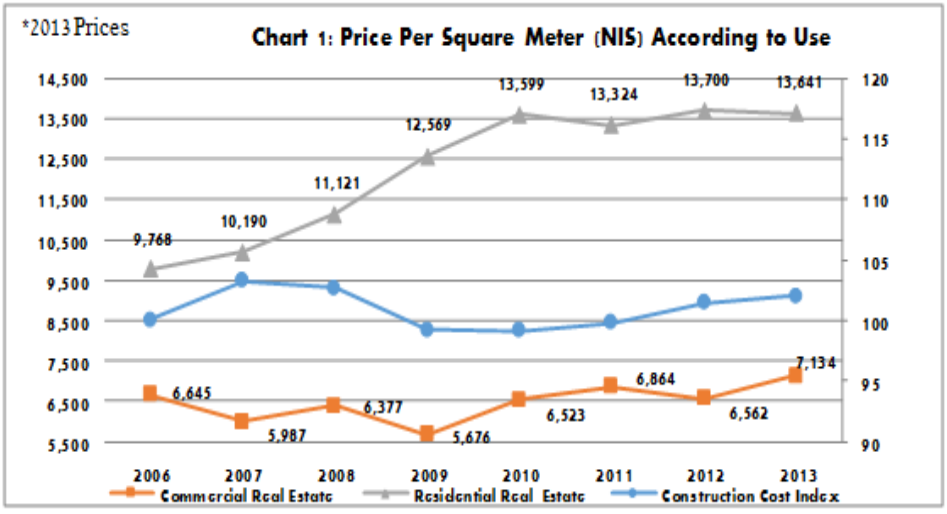
1. Summary and Conclusions

This policy paper was written in order to examine if the local authorities in Israel face a negative incentive to increase the supply of housing in and to add residents to the areas under their jurisdiction and if the existing system of incentives, along with the local authorities' ability to influence the supply of land for different purposes, contributes to the rise in housing prices. In order to examine this, the paper first presents the difference in price levels of real estate zoned for different purposes. It then presents a theoretical and empirical survey of the monocentric city model as it is applied to Israel. This is followed by a survey of the structure of the local authorities in Israel, with an emphasis on the budget structure of the municipalities and their role in the national planning system. Then different methods of municipal taxation are analyzed via a textual analysis of articles and business reports that address existing efforts in this field both in Israel and around the world. After examining these topics, recommendations are formulated for policies whose goal is to provide incentives for local authorities to increase the population in the areas under their jurisdiction and to increase the supply of real estate available for construction, thus helping lower housing prices.

Many studies dealt with the rise in housing prices in Israel in recent years, but the prices of commercial real estate (real estate intended to be used for commercial, industrial, or other business purposes) received little attention. In 2003-2012, the price of a square meter of built area intended for business purposes did not change noticeably or significantly, while the price of a square meter of built area intended for residential use has risen by 40 percent.[1]



(According to the Carmen database – the Israel Tax Authority's database of real-estate transactions, the Israel Tax Authority, and the Israeli Central Bureau of Statistics)

1 The data relates to municipalities in the Jewish sector.

Three main components influence real-estate prices: construction costs; entrepreneurial profit; and land value. The latter is the main one of these three components driving the trend of cyclical fluctuations that characterizes housing prices as well as the most significant component in the price for the consumer. While the residential construction cost index and the consumer price index rose relatively moderately compared to the increase in land prices, the rate of change in the value of land for residential use was significantly higher than the other two, especially in high-demand areas. This data could indicate that land value is the main component behind the increase in housing prices.

In the competitive real-estate market, in which land largely is allocated by price, the prices of land for different uses in a specific urban area should be identical at equilibrium. In actuality, there are significant differences between the prices per square meter of built area depending on whether it is intended for residential use or for commercial use. This price difference is especially large in high-demand areas. Assuming that construction costs are identical for properties irrespective of their use, then the difference in price for land for different uses stems from differences in the limitations on the supply of land intended for residential use and for business purposes. Such differences in value are not able to exist in a market in which land use is determined by the way that maximizes its value.

Housing prices are set at the point where supply and demand intersect. With regard to the demand for additional residential units, policy steps have a limited impact on the price level in the real-estate market since the demand for additional housing units is a derivative of the pace of population growth and so the demand is relatively inflexible. As for the supply of residential units, it is determined by the supply of land available for construction, which is a direct result of the actions of the planning authorities. Therefore, the most efficient way to decrease housing prices is to increase the supply of land available for construction.

As noted above, the main factor in the rise and fluctuations in housing prices in the past decade was land prices. Therefore, in order to lower housing prices, steps must be taken to increase the supply of land available for construction, enabling the stock of housing to increase at a faster rate than the population. In Israel, local authorities actually have a major influence on determining the supply of land within municipal borders that is designated for construction and in zoning this land for different uses. This paper therefore presents the following hypothesis: the local authorities influence land prices.

As part of the stabilization program implemented in the mid-1980s, many expenses were switched from being the direct responsibility of the central government to that of the local authorities and municipalities. The local authorities' sources of revenue are divided into locally generated revenue and government assistance (budget-balancing grants). Today most of the funding for municipal services

comes from the local authorities' locally generated revenue, the lion's share of which comes from municipal rates payments. There are two main categories of municipal rates: residential and non-residential (mainly commercial). In some local authorities, the average price per square meter of municipal rates for commercial real estate is as much as four times that of the average price of municipal rates for residential real estate. According to mayors, local authority heads, and finance directors in local authorities, as well as according to a statistical analysis that was performed for this research, the cost of a household exceeds the municipal rates that it pays by NIS 4,000 to NIS 13,000 annually. Though assessing the value of a square meter of commercial real estate is beyond the scope of this policy paper, in light of the high municipal rates and the low level of services demanded, municipal rates for non-residential real estate clearly is a positive source of revenue for cities and local authorities, particularly in comparison to residential municipal rates. Commercial municipal rates payments therefore constitute an important source of funding for local authorities. This paper asserts that the clear fiscal advantages of commercial municipal rates over residential municipal rates creates a negative incentive for local authorities to increase the population in their jurisdiction and to limit the supply of real estate available for residential construction.

An accepted method around the world for coping with distortions in the municipal incentive system is to institute a tax based on land value. Land value tax has a few latent advantages. First of all, it is a just or equitable tax since a rise in land value stems from the actions of the public and its representatives and therefore it is appropriate for the yield from this to be returned to the general public. Second, it is considered an economically efficient tax since it does not distort the allocation of effort among individuals in the economy. Taxes generally cause economic inefficiency since their imposition distorts market prices and the decision-making process of the individual attempting to maximize value.

Since the supply of land is largely inflexible and the ability to "create" land is limited, imposing a land value tax will not impede economic efficiency of land supply in the real-estate market. In addition, land value taxes reduce the speculative component of the real-estate market since imposing such a tax prevents the process in which landowners who expect another rise in value reduce the supply of land. It thus will reduce fluctuations in real-estate prices and help prevent the formation of speculative bubbles with respect to real-estate prices.

The central recommendations in this policy paper aim to foster gradual change in the existing system of incentives on the municipal level, change that will encourage the local authorities to approve construction on land zoned for residential use. In the long term, changing this system of incentives will contribute to increasing the supply of land available for constructing housing, increasing competition in

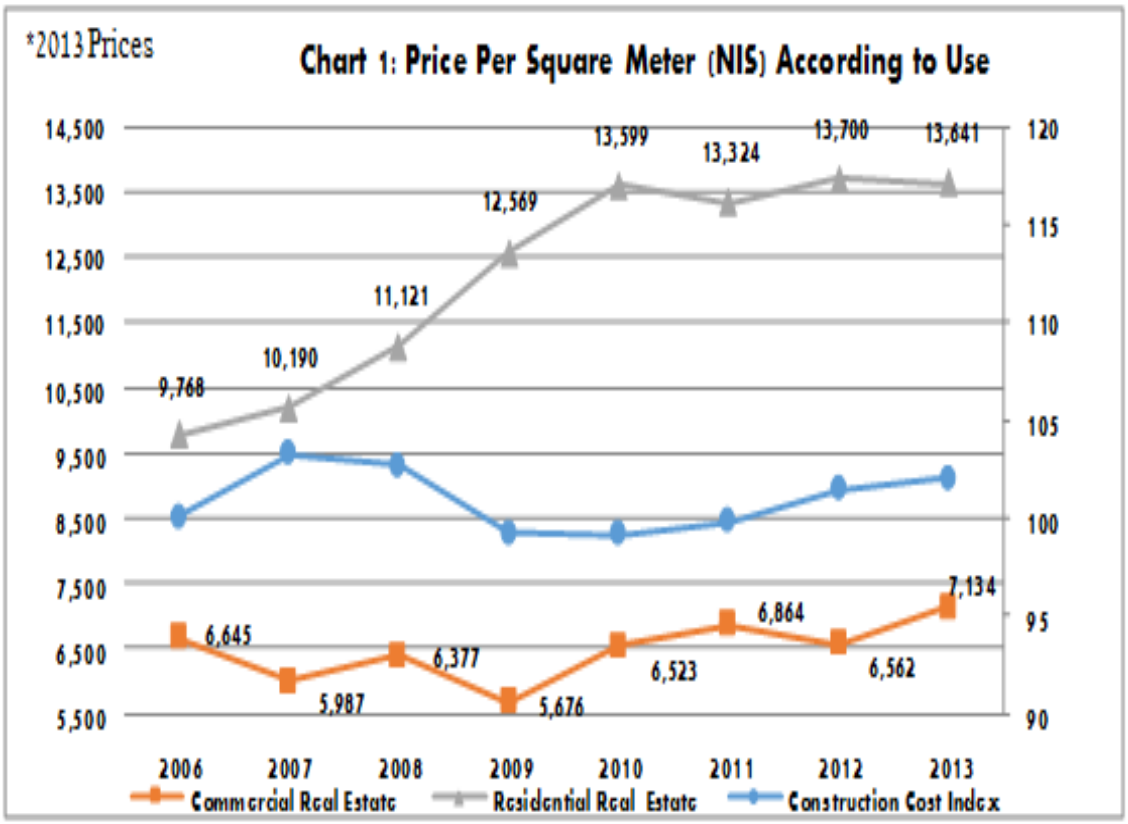
the real-estate market, and lowering housing prices nationwide and particularly in high-demand areas. In order to forge a sustainable, long-term solution, one must compare the marginal benefit of adding a square meter intended for different purposes and the marginal expenses for that same meter. According to economic theory, in such a situation, local authorities would not have a preference for one use over another when approving construction and could ignore economic considerations in the approval and planning process and instead focus on considerations related to residents' welfare.

In light of these principles and with the understanding that locally generated revenue in general and municipal rates in particular constitute a significant component in local authorities' budgets, we propose instituting a land value tax. Since land value is determined to a large extent by the level of services, activities, and infrastructure that the local authorities provide, it would be appropriate for local authorities to be able to tax the real estate under their jurisdiction based on its value. This policy is progressive, could contribute to accelerating the planning and construction of residential real estate, could serve as a source of revenue for municipal activities, and could add more households to local authorities.

2. Background

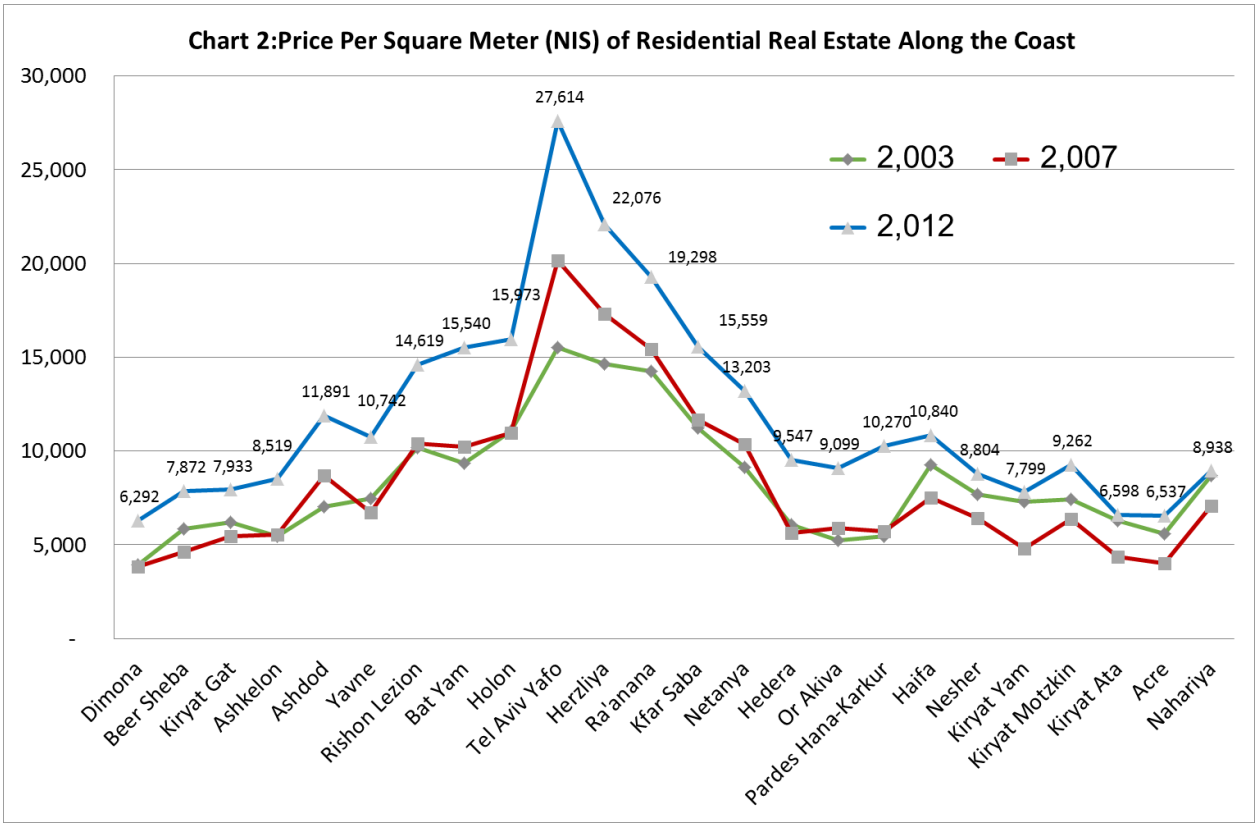
Many studies have addressed the rise in housing prices in Israel in recent years, but the prices of commercial real estate (real estate intended for commercial, industrial, or other business purposes) received little attention. An examination of the price of a square meter[2] in real-estate transactions for commercial purposes in the Carmen database, a database produced by the Israel Tax Authority of all transactions reported during 2000-2013, yielded a surprising result. While the price of a square meter of built area intended for residential use in cities in the Jewish sector rose by 40% during 2006-2013, the price of a square meter of built area intended for commercial use did not change significantly during this period.

2 The price per square meter throughout this paper is calculated as the quotient of the price that was paid for the net built area of the property.



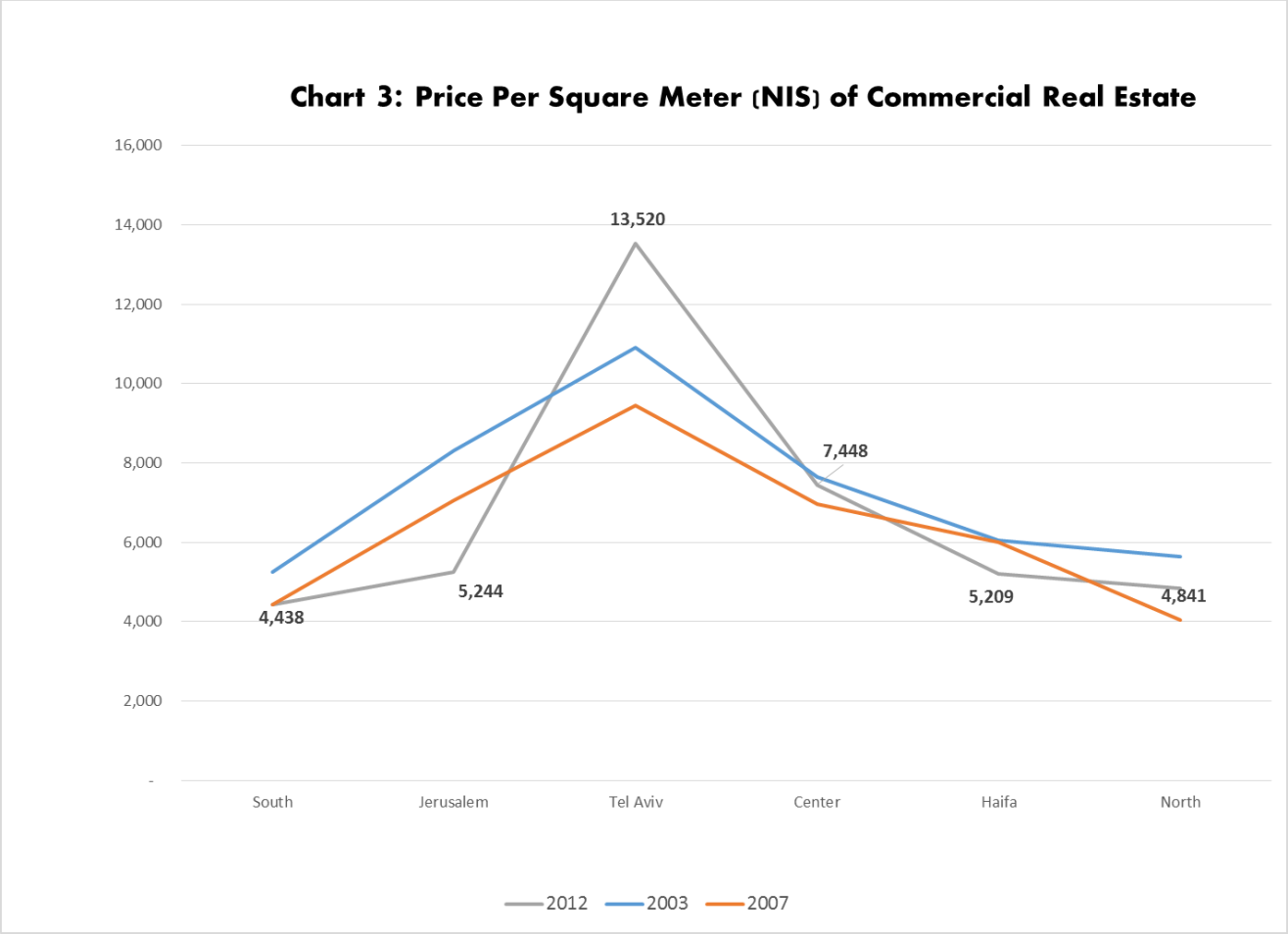
(According to the Carmen database – the Israel Tax Authority's database of real-estate transactions, the Israel Tax Authority, and the Israeli Central Bureau of Statistics).

Most of the rise in housing prices occurred in high-demand areas (the Tel Aviv, central, and Jerusalem regions). For example, in the Tel Aviv region, the real price of housing per square meter rose by 80% between 2003 and 2011, while remaining unchanged in peripheral areas.



(According to the Carmen database) *2013 prices

During that same period, the real price per square meter of commercial real estate rose by 24% in the Tel Aviv region, remained unchanged in the central region, and actually fell in the Jerusalem, northern, and southern regions. Beyond the differences in the price trends for residential and commercial real estate, one also can see that the price per square meter of commercial real estate is, on average, half that of residential real estate.



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Three main components influence real-estate prices: 1. construction costs; 2. land value; and 3. entrepreneurial profit. Of these three components, land value is the main one driving the trend of cyclical fluctuations that characterizes housing prices and it constitutes a significant component in the price for the consumer, particularly in high-demand areas. On average, land value is one third of the average apartment price in Israel, with it being much higher in the center of the country than in Israel's geographical periphery. Another third of the apartment's price is derived from construction costs and the rest is attributed to entrepreneurial profit and taxes. In the past decade, while real construction costs and entrepreneurial profit did not change significantly, the rate of change in land value was significantly and noticeably higher than the other two. This data could indicate that land value is the main component behind the increase in housing prices in Israel (Bank of Israel, 2013b). In addition, assuming that construction costs are similar for commercial and residential real estate, then the difference in price for land for these uses stems from land value.

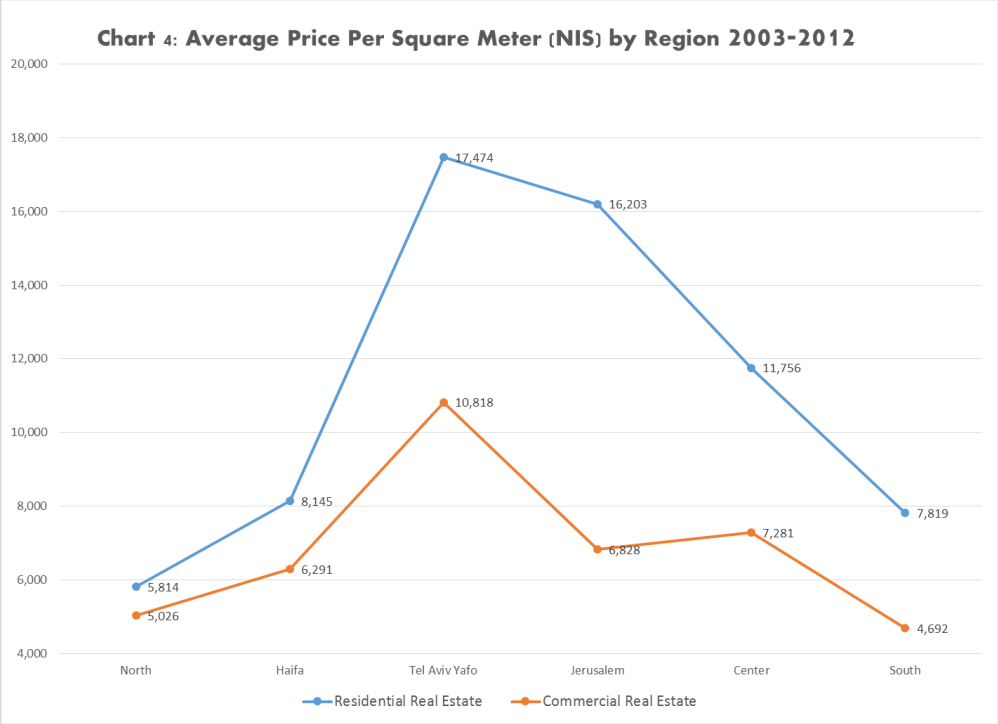
In order to analyze the reasons for the fluctuations in housing prices, one must understand how land value is determined. This paper will use the monocentric city model to do so. This is an economic model (DiPasquale and Wheaton, 1996) that is used to assess land value in urban areas. This model is based on the following assumptions:

1. A metropolitan area has a central business district (CBD) where the individual can obtain a higher income than in the margins of the city.
2. Construction costs per meter for real estate intended for different uses (in this case, the two possible uses are commercial and residential) are equal.
3. Land is allocated to the highest bidder and as a result, the land is put to the use that will yield the greatest returns.
4. There are no limitations on the supply of land for building in the metropolitan area.

If all of the above assumptions are fulfilled, land value will have two characteristics at equilibrium:

1. The price per square meter will be a function of the cost of traveling to the CBD, that is, the further the land is from the CBD, the lower its price per square meter is. Equilibrium is reached when individuals in the economy are indifferent to their different locations in the metropolitan area.
2. The price of land intended for different uses is identical if it is in similar locations.

However, the data in Israel actually shows that there are significant differences between the price per square meter of built real estate intended for residential use and that intended for commercial use. It is especially interesting to see that this price difference grows the closer the land is to high-demand areas. Eckstein, Tolkowsky, and Tzur (2012) showed that the price per square meter for housing in Israel falls the farther it is from the CBD. According to the assumptions of the model and assuming that construction costs are identical for a property whether it is intended to be residential or commercial, the difference in the prices for land for different uses stem from the limited supply of land zoned for housing and the violation of the principle that land is allocated according to the best price. For proof, while housing prices continue to rise, a survey conducted by the government assessor regarding the return on rental property found that in the mid-term, a surplus is expected in the supply of rental property, mainly in high-demand areas, and prices are expected to fall (Israeli Ministry of Justice, Land Appraisal Unit, Unit Director's Bureau, 2013).



(According to the Carmen database)

*2013 prices

Housing prices are set at the point where demand and supply meet. The policy steps related to demand for additional housing units have a limited impact on the price level in the real-estate market since the demand for additional housing units is a derivative of the rate of population growth (40,000 households per year on average during the last decade) and is relatively inflexible. In the terminology of housing units, the supply is set by the stock of land available for construction, something which is completely in the hands of the planning authorities. Therefore the most efficient way to lower housing prices is via supply.

As noted above, the main source of the rise and fluctuations in housing prices in the past decade was the price of land and therefore in order to lower housing prices, action must be taken to increase the supply of land available for building in a way that will encourage competition between landowners and increase the stock of housing at a faster rate than that of population growth. Three main bodies determine the supply of land available for construction: the Israel Land Authority (ILA), which markets the land; the planning institutions of the Israeli Ministry of Interior, which zone the land; and the local authorities, which provide the final permits to build on the land. In reality, the local authorities in Israel have great influence on determining the supply of land intended for construction within municipal territory and for zoning this land for different uses. Neither the ILA nor the Ministry of Interior has a

declared policy that prefers constructing commercial real estate to housing. It therefore is worthwhile to examine whether the local authorities have a negative incentive to approve the construction of housing in the area under their jurisdiction in a way that causes a reduction in the supply of land designated for housing and a rise in housing prices.

2.1 Local Authorities in Israel

This section examines the local authorities' role in the process of making land available for construction, examines the main sources of revenue and expenses in municipal budgets, proposes an economic model that explains why municipalities have a negative incentive to add housing units to the area under their jurisdiction, and finally, surveys different types of municipal taxes and land value taxes used in Israel and around the world.

2.2 Local Authorities' Position in the Planning and Construction Process in Israel

Most land in Israel is owned by the state and therefore the government, through the ILA and the Israeli Ministry of Construction and Housing, is the main entrepreneur that prepares land for construction. Planning the land begins with checking feasibility and submitting plans to the regional committees for approval (Bank of Israel, 2013a).

The regional committee is authorized to submit regional master plans to the national council for approval. The regional master plans set long-term policy for both the entire region and specific areas within it. In addition, the regional committee approves local construction plans in the cities and local authorities under its jurisdiction. The regional committee is composed of 17 representatives of different government departments, including five representatives of local authorities within the committee's jurisdiction.

After receiving the approval of the regional committee and before the land is sold, the ILA prepares plans to develop the land, signs agreements with contractors to develop the land, and issues tenders for the land. After being awarded the land that is planned for construction which the ILA sold, the recipient prepares a detailed plan to develop the land and submits it to the local committee.

The local committee is composed of local representatives of the public. The local committee has the authority to issue building permits in accordance with city construction plans that are approved and to change existing city construction plans (Israeli Ministry of Interior, 2013c). After receiving the permit

from the local committee, construction work can begin at the site (Bank of Israel, 2013a).

According to a Bank of Israel report from 2013, the delay in the provision of apartments and increasing the supply of housing is mainly caused by the local and regional committees, "there are a number of indications that the delay in granting permits in the last year depends mainly on the local committees and not the entrepreneur, and therefore the decline in the number of permits is the source of the fall in the number of construction starts and not the reverse" (Bank of Israel, 2013a, p. 65, our translation). According to the Bank of Israel, the reason for the delay is the larger burden that is put on local authorities and therefore their professional personnel should be increased.

Inflexibility of Supply – Stages of Production of Land Planned for Construction and Evaluation of the Average Time Required (Years)			
Stage	**Initiator**	**Authorizing Institution**	**Average Time Required**
1. Feasibility check and preparing a planning program to submit to the regional committee	Israel Land Authority, Ministry of Construction and Housing		1
2. Approval by the Regional Committee	Israel Land Authority, Ministry of Construction and Housing	Ministry of Interior, Planning Administration	5
3. Preparing a development plan (water, electricity, and roads) and development expenses	Israel Land Authority, Ministry of Construction and Housing	The local authority and various government agencies	1.5
4. Publishing a tender and selecting a recipient	Israel Land Authority, Ministry of Construction and Housing		0.5
5. Granting building permits by the local committee	Contractors	Local Committees	3
6. Obtaining a building permit to commencing construction	Contractors	The local authority	0-0.5
7. Commencing construction to completing construction	Contractors		2

In the Tel Aviv region, for example, the main barriers to implementing approved plans stem from the objections of the local authorities (Eckstein, Tolkowsky, and Tzur, 2012).

Type of Barrier	Percent of Barriers
Local Authorities	32%
Re-planning by the Entrepreneur	22%
Infrastructure	15%
Israel Military Industries	12%
Land	10%
Various	7%

2.3 Revenue, Expenses, and Compensation in the Budget Structure of Local Authorities in Israel

There are three types of local authorities in Israel: A. **Municipality** – a local authority of one settlement that has received the status of a city; B. **Local Council** – a local authority of one settlement that does not have the status of a city; and C. **Regional Council** – a local authority for several settlements, which generally are rural.

Distribution of Local Authorities: Population (2010)	**Total**	**Percent of Population**
Local Authorities	253	100
Municipalities	75	75.6
Local Councils	125	15
Regional Councils	53	9.4

(Based on data from the Israeli Central Bureau of Statistics, 2013)

The budgets of the local authorities in Israel can be divided into two parts: A. **The regular budget**, which is intended to pay for ongoing activities; and B. **The irregular budget**, which is for development and one-time expenses. The local authorities can use intake from the regular budget only for expenses on the regular budget and intake from the irregular budget only for expenses on that budget. For example, the city only can use intake from the capital gains tax, a mandatory payment that the local councils impose on landowners for rezoning land and thus causing its value to rise, in the irregular budget for development expenses such as building schools and kindergartens that will serve residents or infrastructure development. It should be noted that although this tax applies equally to both commercial property and real estate intended to be used for residential purposes, in actuality, all of the exemptions that exist to this law are only for real estate intended for housing (Israeli Ministry of Interior, Planning Administration, 2013). In contrast, municipal rates payments by residents are part of the revenue in the regular budget and so the city only can use them for regular expenses, such as maintaining public spaces, paying salaries, and so on.

2.3.1 Main Expenses in Local Authorities' Budgets

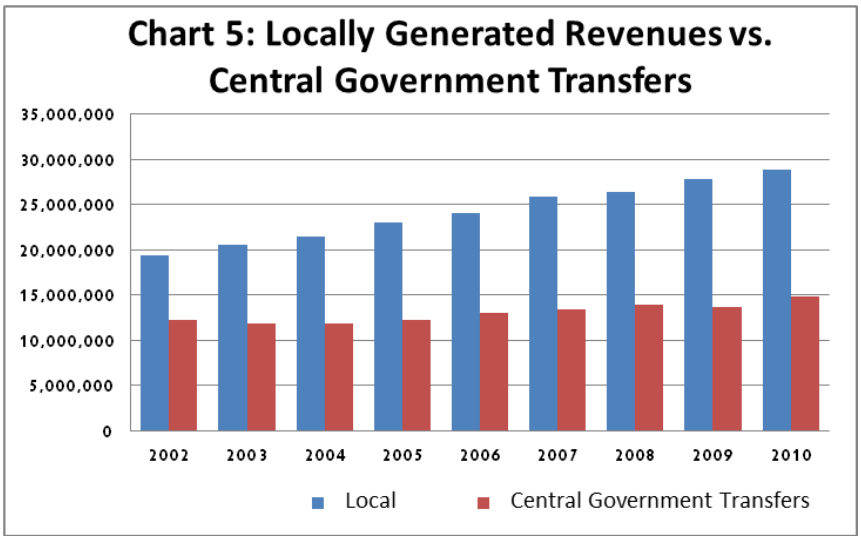
The main expenses in local authorities' budgets are channeled into four tracks: A. Expenses for local services; B. Expenses for national services (mainly education and welfare); C. Expenses to repay loans; and D. Expenses for allocating money for development and funds.

2.3.2 Main Sources of Revenue for Local Authorities

Local authorities have two main sources of revenue: A. Locally generated revenue – money that is collected in municipal taxes or by instituting fees and charges and that is transferred directly from the citizens and the businesses in the area of the local authority's jurisdiction: municipal rates, use of municipal services, intake from bylaws, fees and charges and revenue from use of the authority's properties (rent, intake from selling property that belongs to the authority, and so on); and B. Government assistance – the government ministries participate in funding national services and the Israeli Ministry of Interior provides a general grant to help balance budgets to local authorities whose revenue is lower than their expenses in accordance with specific criteria for each local authority (The Knesset Research and Information Center, 2004).

2.3.3 The Change to Depending on Locally Generated Revenue

In 1985, the process began to switch the financing of some fields to the local authorities and to lower the rate of government participation in funding municipal expenses. Until the 1980s, only 30 percent of local authorities' budgets came from locally generated revenue. In the 1990s, this rose to 66%.



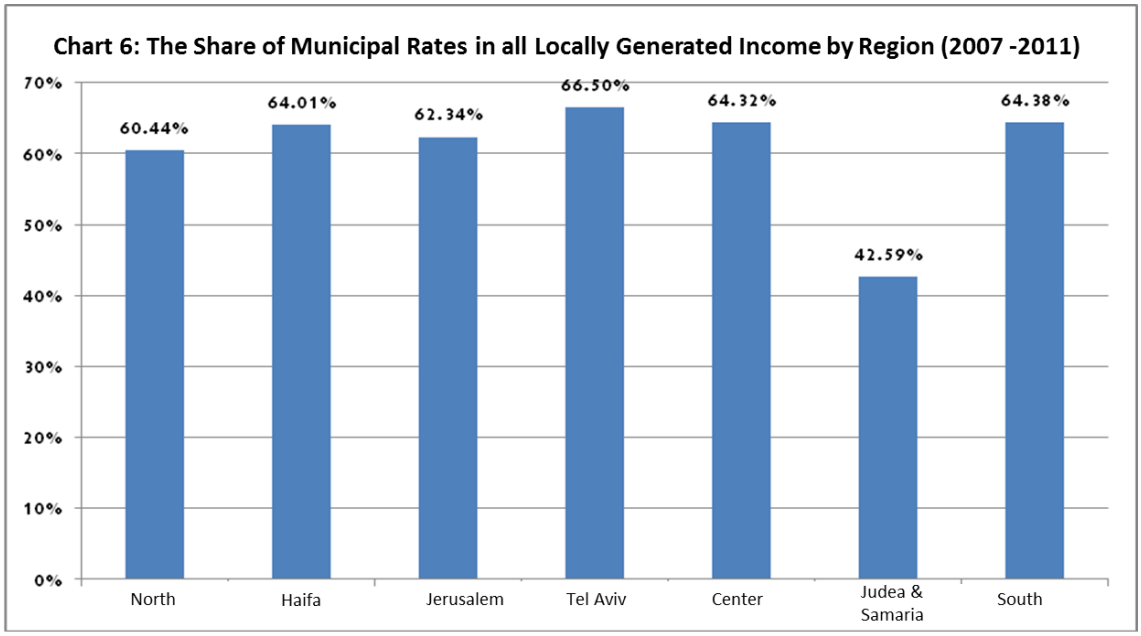
(According to the Israeli Central Bureau of Statistics, 2013)

*2013 prices

The **budget-balancing grant** is part of the government assistance that is intend to balance between each local authority's normative level of expenses, as it is determined by the government, and the local authority's potential revenue, thus guaranteeing that residents receive basic services. Until the middle of the 1990s, the size of this grant was set in negotiations between the Israeli Ministry of Interior and the local authorities. In 1993, within the framework of the Suary Committee's recommendations, criteria were set for the first time for allocating budget-balancing grants. Despite the committee's recommendations, issues of consistency arose, such as providing too much assistance to the smaller local authorities and insufficient attention to the local authority's socioeconomic status. In the wake of that, in 2000, a public committee was appointed, headed by Yaacov Gadish, which determined a formula to allocate the grants that tried to balance between the need to guarantee basic services to residents and to create a system of incentives to encourage local authorities to operate more efficiently. The Gadish formula **limited the maximum amount of the grant per person** as a function of two conditions: first, that the grant not exceed the limit set for the maximum expenditure per person; and second, a minimum independent revenue per person was set. **In practice, despite adopting the Gadish Committee's recommendations, the grants that actually are allocated constitute 80-90%**

of the required grant according to the Gadish formula (Agmon, 2010). In light of this, local authorities prefer not to absorb populations that need expensive services and whose contributions to the authorities' revenue is low (Ben-Bassat and Dahan, 2009). According to Razin and Brander (2004), **this situation is expressed in local authorities' manipulation of housing and construction plans.**

In the wake of these processes and reforms, most of the funds for municipal services come from the local authorities' locally generated revenue, a large part of which consists of municipal rates payments. For example, municipal rates payments in the municipality of Tel Aviv constituted 75% of its locally generated revenue in 2011.



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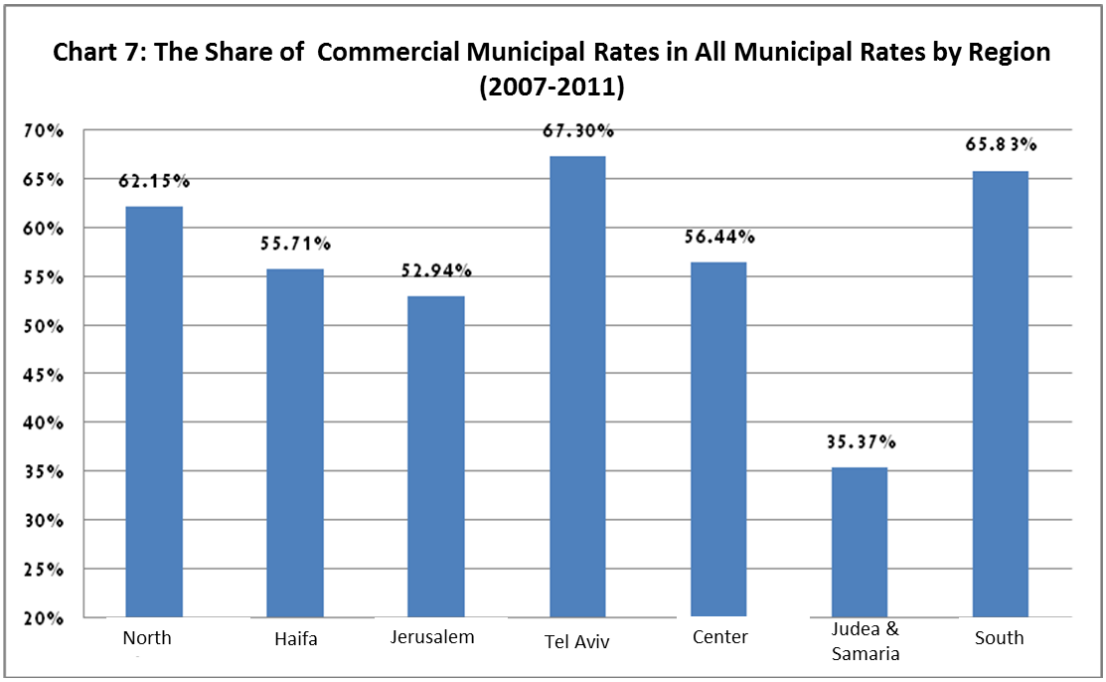

(According to the Israeli Central Bureau of Statistics, 2013)

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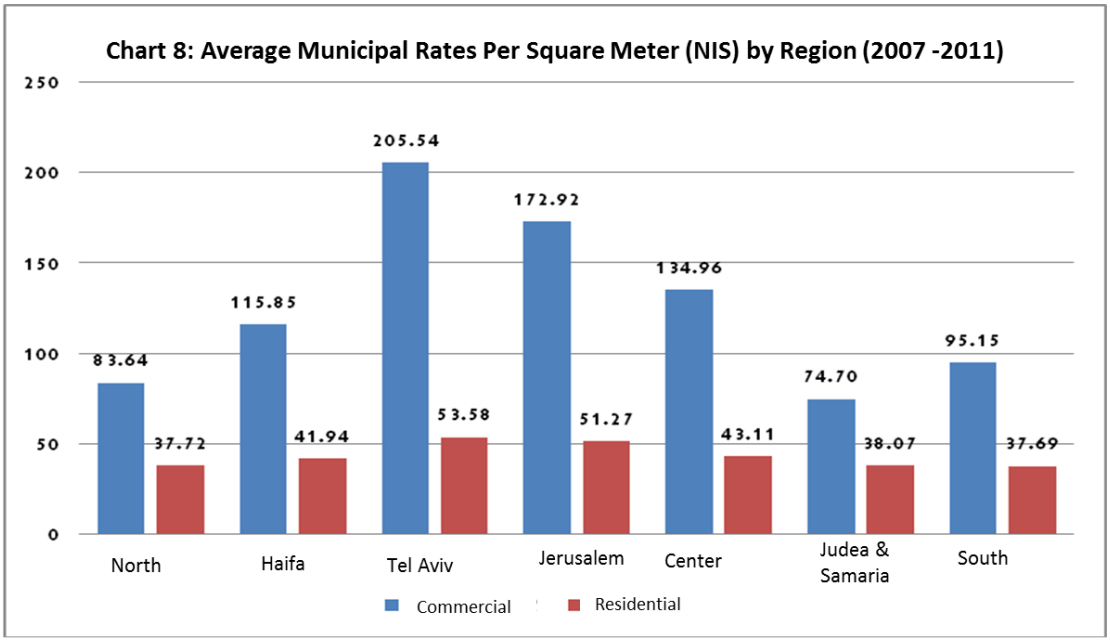
Municipal rates are collected from two main sources: A. Municipal rates on areas zoned as residential and B. Municipal rates on areas that are not zoned as residential (mainly commercial municipal rates). Most municipal rates are collected from areas that are not zoned as residential for several reasons. First of all, the government sets a maximum and minimum level for municipal rates according to different classifications for land and this enables the local authorities to collect municipal rates at higher prices from commercial real estate than from residential real estate (Israeli Ministry of Interior, 2013a). The municipal rates per square meter for businesses is four times that of the municipal rates for residences in municipalities in the Tel Aviv region, while it is three times more in the Jerusalem and central regions. Below is a **table of municipal rates for 2013**:

Category	Minimum Rate	Maximum Rate
Residences	31.62	109.57
Offices	62.08	351.02
Banks	422.16	1264.22
Industrial Uses	22.63	151.28
Hotels	34.94	132.83
Workshops	41.91	204.11

(According to the Israeli Ministry of Interior, 2013a)

In addition, every fifth resident is entitled to an exemption or discount on municipal rates, but the local authorities do not have the legal right to give businesses discounts on municipal rates (Harel, 2004). In practice, the way in which the budget-balancing grant is calculated encourages local authorities to raise municipal rates for businesses (Avital, 2011). Another reason that municipal rates from businesses constitute such a large portion of all municipal rates is that the actual rates for collecting residential municipal rates are relatively low in comparison to those for commercial municipal rates (Feder, 2007).



(According to the Israeli Central Bureau of Statistics, 2013)

*2013 prices

Due to the growing reliance on locally generated revenue as a source of funds and due to the growing portion of this made up of municipal rates in general and those from businesses in particular, circumstances were created in which municipalities interested in increasing their revenue have a clear incentive to approve construction on land zoned for commerce and industry and to give that preference over construction on land zoned for housing, due to the fiscal advantages of commercial municipal rates. The system of fiscal incentives under which local authorities operate combined with their authority in the planning and building committees has created a situation in which between 1990 and 1995, the percent of building starts for commercial areas rose from 12% of all building starts to 25%, creating a surplus of 66% in the supply of commercial real estate relative to the demand for it (Blank, 2004).

2.4 Specific Policy Questions

(1) Do local authorities in Israel face a negative incentive to increase the population in the area under their jurisdiction?
(2) How can the local authorities in Israel be provided with incentives to increase the supply of land zoned for housing?

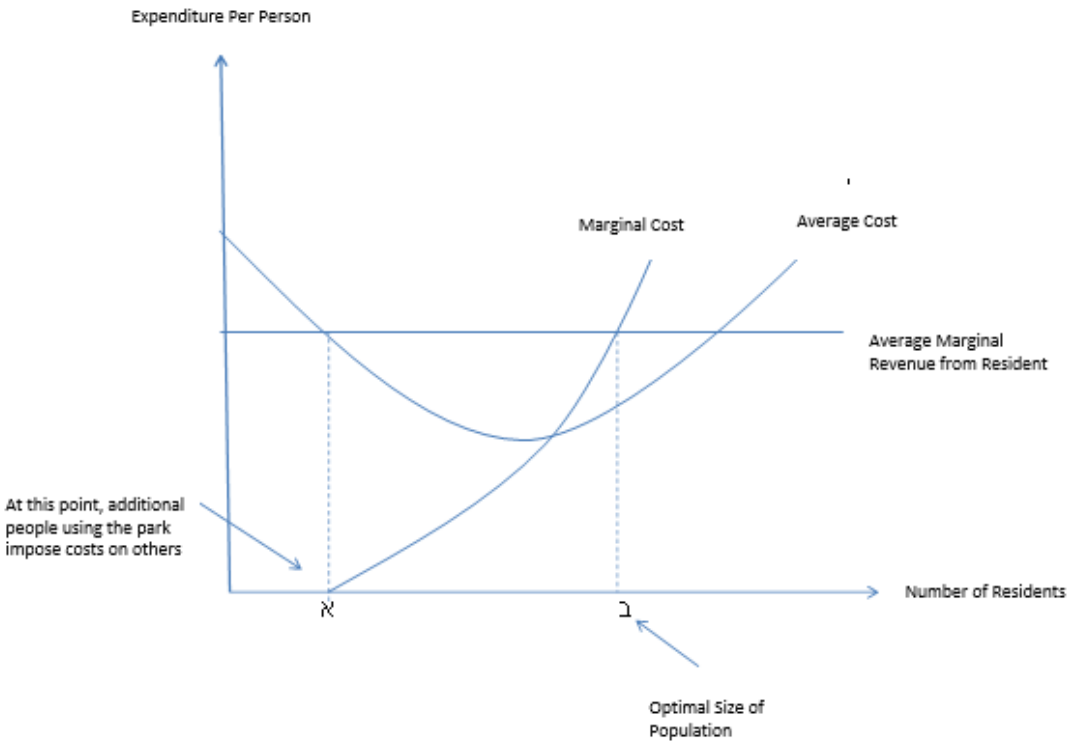
3. Analysis

In order to check if the municipalities really do face a negative incentive to increase the supply of housing and the reasons for this incentive, we decided to conduct a textual analysis of academic articles, government reports, and articles from the media along with a statistical analysis of data from the Israeli Central Bureau of Statistics and the Israel Tax Authority. We put an emphasis on analyzing the expenditure side and the revenue side of municipal budgets and in surveying the literature on the economic model that made it possible to link the local authorities' planning authority to housing prices, commercial real-estate prices, and municipal rates. We also examined local authorities' role in and influence upon the planning and building system. Finally, we presented a model that demonstrates the local authorities' preference for territories zoned for business and commerce and surveyed the various methods for municipal taxation used around the world.

3.1 Municipal Rates – Economic Model

The municipality's role is to create various public goods for the welfare of its residents. In the municipal arena, most public goods are only partially public since their value is influenced by congestion. For example, a streetlight is a "purely" public product since the value of the light it produces is not affected by the size of the population it serves. On the other hand, a park is not affected by the size of the population that uses it only up to a certain point at which the number of people visiting it lowers its value. Assuming that due to congestion and overcrowding, the marginal cost of producing a municipal service rises when the population reaches a certain size and the "price" that the municipality can collect for this service (via municipal rates) is set by the central government, then the optimal size of the population that the municipality will want to accommodate at equilibrium will be

the point where the marginal cost per resident equals the marginal revenue per resident. Beyond this point, the municipality will want to halt the growth of its population. While the central government in Israel sets the "prices" (rates for municipal rates), it is not aware of the different municipalities' expenses to a large extent. If the municipal rate that is set for housing (by the central government) is lower than the marginal cost (for the local authority) of adding a housing unit, then the municipalities have a clear negative incentive to delay or block the construction of housing. In contrast, if the municipal rates for businesses are higher than the marginal cost of adding a business, then municipalities have a positive incentive to facilitate construction for businesses and industry (Fischel, 1985). That is actually the situation today: the normative current expenses per resident in a municipality per year, according to the Israeli Ministry of Interior's calculations, is about NIS 4,000 (Shahor, 2010), while the revenue per person from residential municipal rates are about NIS 1,500 (Israeli Central Bureau of Statistics, 2013). Therefore, **the municipalities lose at least NIS 2,500 for each additional resident.** (Moreover, most of the municipalities, mainly those in high-demand areas, provide residents with services above the normative level and so the current expenses per resident in high-demand areas usually is even greater than that.)



Since residents of the local authorities need municipal services such as health care, education, and welfare more than the businesses that operate in the areas under their jurisdiction, and since the municipal rates for housing are significantly lower than those for businesses, a situation actually is created in which the business sector subsidizes the services provided to residents. This means that if the local authorities want to maintain a balanced budget while adding new areas designated for housing then they must add areas that they can collect commercial municipal rates from in order to fund the addition of the areas zoned for housing.

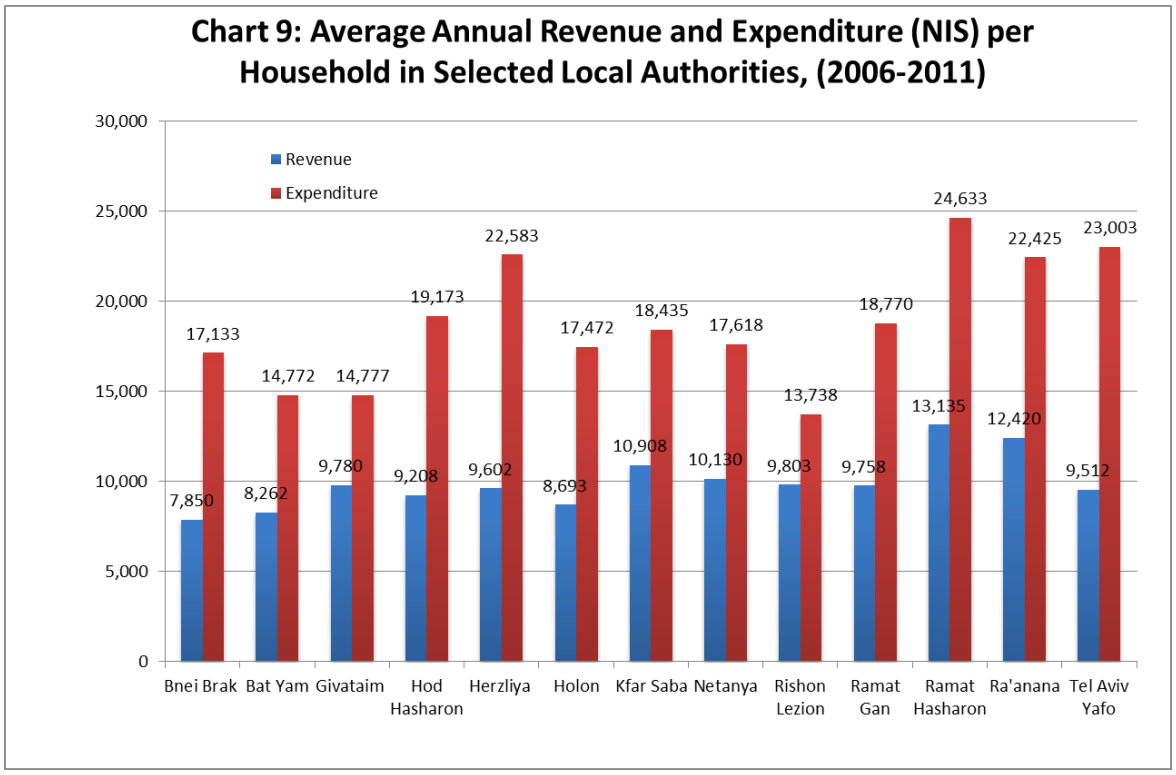
In fact, municipalities that have a shortage of commercial areas, which means that commercial municipal rates constitute a smaller percent of their locally generated revenue, tend to encounter economic difficulties and lack incentives to increase the supply of housing in the areas under their jurisdiction (Schwartz, 2008). The stronger local authorities, in which the potential to actually collect residential municipal rates is higher, also do not have an incentive to increase the supply of housing since doing so would lower the price level and attract a weaker population that would be harder for the local authority to collect residential municipal rates from in the future (Portnov, 2006). The local authorities, particularly the weaker ones, are wary of becoming trapped in a vicious circle in which the lack of commercial areas will result in less revenue from municipal rates and the lower revenue will prevent the local authority from being able to provide its residents with suitable municipal services. That will prompt the "strong" residents to move to other settlements, which means that the revenue from residential municipal rates will fall, causing the level of municipal services to fall in turn and causing additional residents to move away, which will lead to a further reduction in residential municipal rates followed by another drop in the level of municipal services and so on (Agmon, 2010). The fact that the local authorities have so much authority in the municipal planning process not only means that they give priority to areas zoned for commerce and business over those zoned for housing, but also that they have a significant impact on the areas zoned for construction of any sort and as a result on their prices.

3.2 Applying the Economic Model to Selected Local Authorities in the High-Demand Region

In order to estimate the gap between the marginal revenue per household for local authorities and their expenditures on it, we extracted the main revenue and expenditure clauses in the local authorities' budgets that are sensitive to changes in the number of households.

Expenditure clauses: Expenditures on the educational authority; expenditures on the welfare authority; general expenditures; participating in the support of and transferring support and contributions to educational, cultural, health, welfare, and religious institutions and transfers to households and the public sector such as municipal coalitions; expenditures for ongoing activities and acquisitions in order to provide services such as maintaining buildings, transportation, mail, and cleaning; legal expenditures; fees; and so on.

Revenue clauses: Revenues of the local authorities from education; revenues of the local authorities from welfare; and revenues of the local authorities from residential municipal rates (that are collected).



(According to the Israeli Central Bureau of Statistics, 2013)

*2013 prices

The gaps between the local authorities' expenditures per household and its revenues from them per year range from about NIS 4,000 in Rishon Lezion to NIS 13,000 in Tel Aviv on average. Without the addition of commercial real estate to bridge these gaps, every household that is added to a local authority will increase its deficit and thus also increase the negative incentive to construct residential real estate.

3.3 Municipal Taxation around the World

A variety of municipal taxation methods are used around the world in an effort to achieve an equitable and efficient distribution of municipal taxes. The customary ways of collecting local taxes around the world can be divided into three main categories:

(1) **General tax system**: The municipal taxes are included in the general taxes and income tax is divided differentially between local authorities and the national government. In Germany, for example, in addition to the local taxes (property tax, business tax, etc.), 15% of all the income tax that is collected is designated for local authorities and defined as part of the locally generated income of each one.

(2) **Balanced regional system**: Some countries are divided into regions. The regional government collects the municipal tax and divides it in a balanced way between the local authorities in its area of jurisdiction. For example, in France the local government is under the direct supervision of the central government and is divided into three levels: regional, district, and local authorities. Municipal taxes are collected by the districts and transferred to the local authorities (Paz, 2004).

(3) **Comparative allocation of municipal taxes**: The central government redivides the taxes that the local authorities collect between them. For example, in Britain local authorities collect the tax on businesses and transfer it to the central government, which redivides it between the authorities (Harel, 2004).

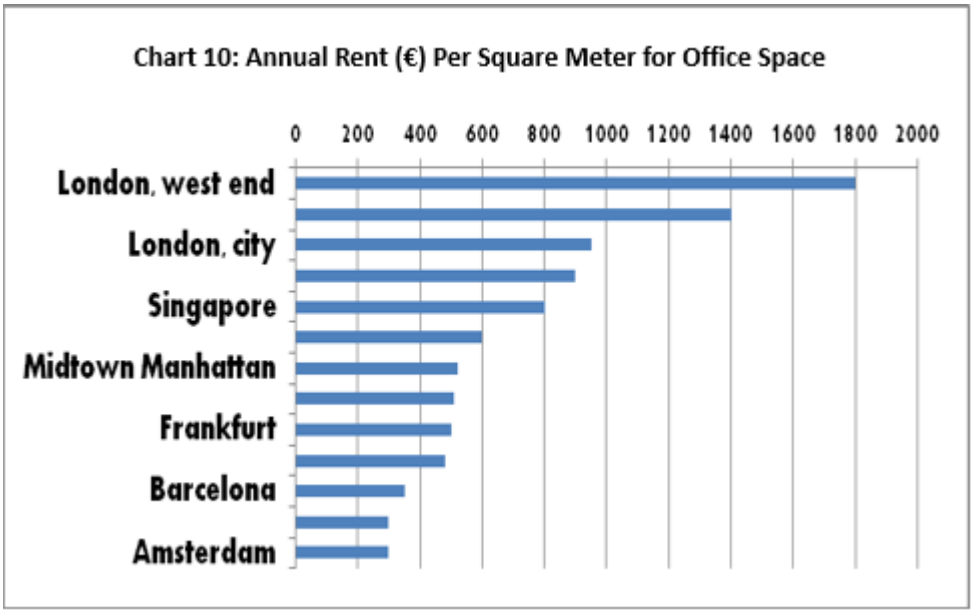
Apart from the differences between different states in the ways they divide municipal taxes, there also are differences in methods of calculating and setting municipal rates on properties within local authorities. The levels of municipal rates in Israel are set in the municipal rates ordinances that the local authority's council decides upon and which differ from authority to authority. The Israeli Ministry of Interior sets minimums and maximums for all the local authorities from which they are not permitted to deviate. The local authority's council sets the actual levels of municipal rates after considering four criteria: type of property; size (in square meters); use; and the area in which it is located. The municipal rates payment is calculated by multiplying the size of the property by the amount that the local authority council sets per square meter (Israeli Ministry of Interior, 2013b).

Unlike the method used in Israel, which is based on multiplying the price per square meter by the size of the property, in most of the world, the level of the tax on property is calculated by multiplying the rate that is set in law by the value of the property. For example, in Australia, when preparing the annual budget, each local authority estimates its needs and its expected revenue for the coming year; the

amount of revenue from municipal rates is divided by the total value of the properties in its jurisdiction that must pay municipal rates and thus the multiplier is found by which each individual property is multiplied to determine the tax on it. The local authorities can institute uniform municipal rates on all the properties, using the same multiplier for all, or it can set the payment based on categories (such as agricultural land, housing, industrial buildings, businesses, etc.). Assessment of the property values generally is based on the market value of the property, that is, by checking sales of similar properties when housing in being considered, or by the value of the annual rent when buildings for businesses are being considered (Tal, 2007).

3.4 Britain as a Test Case

The municipal tax system in Israel provides local authorities with incentives to prefer the construction of commercial real estate over the construction of real estate zoned for housing. In Britain, the municipal tax system does the opposite, providing the local authorities with a negative incentive to develop commercial real estate and commercial zones. The result of this is similar to the rise in housing prices in Israel: commercial areas in Britain are among the most expensive in the world. Thus, for example, real estate zoned for offices in London is three time more expensive than that in Paris, which has the second highest prices in Europe for commercial real estate. However, what demonstrates the level of commercial real-estate prices in Britain most clearly is the difference between commercial real-estate prices in peripheral areas in Britain and those in major cities around the world. Prices for real estate zoned as offices in Glasgow, Edinburgh, and Manchester is higher than the price level in Manhattan and almost twice as high as the price of land zoned for offices in San Francisco, a city in which the local authorities are known for their regulatory strictness and the limitations that they impose on constructing housing, as well as a city with problematic topography in which the economic activity is not only greater than that in the peripheral cities in Britain mentioned above, but also is growing more quickly than in them (Cheshire and Hilber, 2008).



(Kingsturge, 2008)

In Britain, municipal rates are divided into two different types of taxes:

(1) **Council tax** (municipal rates for housing): All residential structures in Britain are classified in one of eight valuation bands; at each valuation band, the amount of the municipal rates is based on the property value and each **local authority** sets the collection rate for each valuation bands. The assessment of residential property is performed by a national assessment agency and the property value is set based on the market value, while taking the residents' socioeconomic status into account so that the property value is lower for weaker populations than for stronger populations.

(2) **Commercial municipal rates**: The tax rate is calculated by multiplying the property value that a national assessment agency sets by the multiplier for businesses that the **central government** sets. The property value is determined by estimating the annual rent during that period.

The local authorities collect both types of tax, but the money that each local authority collects for commercial municipal rates is transferred to the central government, which redivides the funds among local authorities based on their needs. As of 2011, 53% of the revenue of local authorities in Britain is financed by transfers from the central government, which include the revenues collected for municipal rates on businesses. In 2011 and 2012, the total amount of government transfers allocated in Britain was 29.5 billion pounds sterling, of which 19 billion pounds sterling came from commercial municipal rates (Department for Communities and Local Government, 2011b).

The local authorities' dependence on transfers from the central government, which include those for collecting commercial municipal rates, leads to the creation of a negative incentive to promote the

growth of business zones in local authorities in Britain. The local authority must bear the development costs of new business zones and fund the additional services that it must provide to commercial zones in the areas under its jurisdiction yet it also must transfer the tax revenue for this property to the central government, which in turn can allocate it to other local authorities. As one of the heads of a local planning authority said, "[Our main achievement was that] … not a single new major office development has been approved. We managed to keep development down" (Cheshire and Hilber, 2008). The estimated economic cost of rejecting development plans for new business zones is some three billion pounds sterling per year.

Furthermore, local authorities in Britain actually have an incentive to inflate their expenditures in order to guarantee themselves a larger transfer from the central government since the size of the transfer is determined in accordance with the local authority's expenditures (Department for Communities and Local Government, 2011a).

The test case of Britain therefore teaches that economic incentives stemming from the municipal tax systems in a state have a direct influence on the planning authorities in local authorities. A delay in planning commercial territory or a shortage of it significantly increases commercial real-estate prices and harms the city's economic growth.

3.5 Tax on Land Value as a Substitute for Municipal Rates

American economist Henry George first raised the idea of instituting a tax on land value in 1879 in his book, *Progress and Poverty*. According to George, taxing property value has several latent advantages. First of all, taxing property value is economically efficient since it does not cause an excess burden. Imposing taxes is not economically efficient in that it distorts market prices, which leads to the distortion of supply, demand, and the decision-making process of individuals seeking to maximize their benefits. This, for example, is the case with value added tax and income tax, which influence individuals' decisions in the fields of consumption and work. The loss in wellbeing that this distortion causes to the individual is known in economic jargon as "excess burden." On the other hand, the supply of land is generally inflexible and the ability to produce land is limited and therefore imposing a tax on the value of land will not distort the price level and the quantity available in the market and will not harm the economic efficiency of the market for land. In contrast, municipal rates lower the incentive for property owners to invest in and develop new or existing buildings since additional development of a property will lead to an increase in the municipal rates that the property owner must pay and to a

distortion of the price of the property that the individual sees before his eyes. Second, taxing change in land value is just and equitable. Every increase in land value stems from the activities of the public and its representatives in the end. The property owners pay a tax on the yield that stems from the actions of others and not from their own personal efforts; for example, the construction of a new highway or exchange that makes a certain geographic region more accessible certainly increases the value of land in that area. Since this rise in value is the result of the activities of the public and its representatives, and not those of the property owners, it is only just that the yield from this be returned to the public via taxes.

In addition, taxing the value of the land will reduce the speculative aspects of the real-estate market. Assume that an individual owns a certain plot of land and that the individual expects that in the future, the value of that land will rise and thus the return that he will receive from selling the land in the future will be higher than that for selling it now. If all those who own land in the market act or will act in a similar manner, the supply of land will shrink and prices of land will skyrocket with no real justification. This process, in which a rise in real-estate prices stems from a reduced supply of land because it is in the hands of owners who anticipate an additional rise in prices, contributes to fluctuations in land prices and is liable to create speculative bubbles (Dye and England, 2010).

3.6 Land Value Tax around the World

More than 30 countries around the world currently impose a tax on land value in different ways. For example, in the U.S., land value tax first was instituted in 1913 in Pennsylvania because several local authorities in the state assumed that owners of land were hindering development of the land in order to profit from the rise in the value of the land. Indeed, the land value tax became the main source of revenue for 16 local authorities in Pennsylvania. Hawaii is another U.S. state that instituted a tax on land value along with the property tax on real estate. In 1963, the tax was instituted throughout the entire state in order to encourage the development of real estate, particularly for tourism purposes. The fast development of dense real estate caused the level of tourism to drop and political sources found that the reason for this was the tax on land value. The tax on land value ultimately was cancelled in 1977.

In Australia, most of the revenue of the central government and the local government comes from taxing land value. A tax on land value was implemented there in the early eighteenth century. In some regions, the value of the land was taxed, while in others improvements to the land were taxed. New

Zealand also instituted a land value tax in 1840 in some local authorities and as of 1980, 80% of the local authorities in New Zealand had a tax on land value.

3.7 Land Value Tax in Israel

The first attempt in Israel to impose a tax on land value was the property tax, which was first instituted in Israel in 1961 and aimed to encourage construction on lands where the building rights had not been fully realized. One of the main goals of the tax was to encourage construction on available land that already had been planned. Property tax was instituted as an annual tax based on the value of the land. To a large extent, the property tax was imposed on the latent economic potential in the possibilities of utilizing the land (Abramson and Bornstein, 1989).

In 1996, Yoram Gabai, who previously had been responsible for state revenue, was appointed to chair a public commission to examine the continued imposition of property tax. The opposition arguments included that property tax was not a just tax and did not achieve its goals since it was imposed on lands that were not suitable for construction. In addition, various distortions were creating in assessing the value of lands and different values were assigned to lands that were identical in reality. In the end, this commission recommended canceling the property tax and replacing it with a tax that would be imposed when property was sold. The property tax finally was cancelled in 2000 and the resulting loss in revenue to the state is estimated to be NIS 950 million per year. The revenue from the property tax was replaced with revenue from raising the purchase tax and imposing a sales tax, which was cancelled in 2008 (Lipshitz and Munin, 1999).

The Trajtenberg Commission's report called for imposing a tax on delaying housing. The goal of such a tax is to encourage the development and sale of lands and apartments that contractors were hoarding. This tax would be imposed on contractors who did not commence construction and did not sell apartments within a certain period of time. The tax on the sale of every apartment that exceeded this period would be 10% of the apartment's sales price. The tax would be imposed on contractors holding land that had been planned and that was mainly zoned for housing. Bills were submitted for a tax on delaying construction of housing as a result of this recommendation. To this day, the recommendation has not been implemented and no progress has been made on legislation on this issue (Report of the Government Committee for Social and Economic Change, 2011).

An analysis of reports of the 10 largest real-estate companies traded in the Tel Aviv stock exchange in 2010 showed that even though these companies held lands that had been approved in the municipal

master plans and it was possible to construct some 17,000 housing units on them, in 2009 they only carried out projects involving some 2,500 housing units (Pauzner and Levy, 2011).

4. Recommendations

The policy steps proposed in this chapter are intended to facilitate a gradual change in the existing system of incentives in the municipal arena – a change that will encourage the local authorities to approve construction on lands zoned for housing. In the long term, changing this system of incentives will contribute to increasing the supply of land available for constructing housing, increase competition in the market for land, and decrease housing prices nationally in generally and in high-demand areas in particular.

In order to create a sustainable, long-term solution, one must compare the marginal return for adding a square meter zoned for different purposes and the marginal expenses for that same square meter. According to economic theory, in such a situation, local authorities will have no preferences in approving construction of land zoned for different uses and can ignore economic considerations in the process of approving and planning and instead focus on considerations related to the wellbeing of residents.

In light of these principles, and with the understanding that locally generated revenue in general and municipal rates payments in particular constitute a central part of the local authorities' budgets, we propose instituting a tax on land value. Since land values are determined to a large extent by the level of services, activities, and infrastructure that the local authorities provide, it is fitting that the local authorities be able to tax the lands located in their jurisdiction based on their value. This policy is progressive, could contribute to accelerating the planning and building of housing, and serve as a source of funds for municipal activities and the addition of more households to the local authorities.

In addition, as noted above, taxing land value is economically efficient since it does not cause an excess burden. Since the supply of land is largely inflexible and the ability to "create" land is limited, imposing a tax on land value will not distort market prices and will not harm the economic efficiency of the real-estate market. In contrast, municipal rates lower the property owners' incentive to invest in new or existing buildings and their development since additional development of a property will lead to a rise in the municipal rates that the owner must pay and distort the price of the property that the individuals see before their eyes.

In addition, in order to provide incentives and to streamline the approval and construction process for

lands, we propose imposing a differential tax that is determined by the planning stage of the land at the time. The tax would be imposed on all the bodies that hold lands or that delay the development of lands. Thus, for example, the tax rate on agricultural land would be zero. If the land is rezoned for housing, a relatively low tax rate would be imposed on the ILA. After the land is sold to a private entrepreneur, a higher tax rate would be imposed on the local authority until the entrepreneur receives the permits required to build on the land. At the stage in which the contractor holds land that already has received the required permits from the local and national planning institutions, a higher tax rate would be imposed on him than during the earlier stages.

Body to be Taxed	**Level of Tax**	**Stage**
ILA, Ministry of Construction and Housing	Low	Unplanned land
Local Authorities	Medium	Planned land that is awaiting the approval of the local committee
Entrepreneurs/Contractors	High	Land that has been planned and approved for construction

The intake from this tax would be transferred to a closed budget that is designated to fund municipal services. Taxing the value of land would contribute to accelerating planning and construction of housing and prevent speculative bubbles on the part of contractors. In addition, the intake from the tax would contribute to changing the incentives for local authorities to add housing by balancing the budget deficit that is created by approving construction on land zoned for housing. Another aspect of this tax's contribution to increasing the supply of housing is urban renewal projects, such as building plan 38.

This closed budget could help local authorities with a variety of issues, including infrastructure development. The addition of housing units to municipal land requires the construction of "municipal" infrastructure that the local authority must fund but is frequently also used by residents of other local authorities as well. For example, pupils from different local authorities can study at schools of other local authorities and residents from the entire country can enjoy a promenade or park in the jurisdiction of a specific local authority. Since these infrastructures generally serve the general public and are not exclusively for the use of residents of a specific local authority, it is fitting that the funds to develop them be partially born by the central government.

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Appendix: Evidence from the Media

We recently have been witness to remarks by mayors (mainly of cities in high-demand areas) that they wish to shrink the extent of residential construction that various sources are advancing; for example, the mayor of Petah Tikva said, "The municipality of Petah Tikva will be cast into a financial deficit if the building plans for some 12,000 apartments at the Sirkin camp are implemented" (Chudi and Lichtman, 2011, our translation). In the municipality of Tel Aviv, there is opposition to lofts located in buildings that were originally designated for trade and industry and whose owners now want to change their municipal rates classification from industrial to residential (Liberman, 2009). In Rishon Lezion, Mayor Dov Zur declared that he would try to delay construction in the city. He asserted that the city's population is growing too fast (that is, beyond the city's capacity). He also said that due to the high housing prices, many young people prefer to live in neighboring cities instead. In order to prevent the young population from fleeing Rishon Lezion, the municipality is taking steps to develop industrial and high-tech zones, mainly in the Sorek center (Paz-Frankel, 2009). In the article "The Abuse of Municipal Rates: This is How the Municipalities Milk the Businesses," (Tsur, 2013, our translation), the former mayor of Netanya, Miriam Fierburg, claims that "housing in general is a loss for local authorities, even luxury housing, and that is because there is not an appropriate ratio between the taxes that residents pay on residences and the needs and services that the municipality provides to residents and must subsidize. Housing always is a loss for the local authority and what balances the financial situation is the revenue from trade and industry. In our city, 40% of the revenue is from trade and industry, while 60% is from housing and that is a problem since Netanya is not a rich city."

As we noted previously, the potential for local authorities with low socioeconomic profiles to collect municipal rates payments is lower than that for those with populations with higher socioeconomic profiles and therefore local authorities prefer not to absorb weak populations. One example of this is the price tenders for residents, in which state land is sold to the contractor who guarantees the lowest final price of the apartments. The apartments are small and are intended in part for those eligible for housing from the Israeli Ministry of Construction and Housing. The mayor of Ramla recently opposed establishing a project like this in order to prevent the entrance of weak populations to a high-demand area in the city (Pauzner, 2011).

Gazit-Globe Real Estate Institute

The Gazit-Globe Real Estate Institute was established with the aspiration of serving as the main academic platform in Israel for the study and research of the field of real estate. The institute began operating at IDC Herzliya in October 2011 thanks to a generous donation from Gazit-Globe. The institute acts in the spirit of academic excellence, innovation and entrepreneurship that has earned IDC Herzliya renown.

The institute strives to achieve the following goals in the field of real estate in Israel:

- Promote academic research
- Develop academic programs
- Develop executive education programs
- Strengthen ties between academia and practice
- Influence public discourse

In addition to the academic degree programs, the institute performs a wide range of activities, including conducting academic research, creating new indices, offering executive education programs in the field of real estate, and hosting delegations and ongoing activities such as conferences, forums, roundtable discussions and seminars.

Academic Director: Prof. Amnon Lehavi.

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Additional policy paper published by the Institute:

"Are housing prices in Israel higher due to small planning stock?" Zvi Eckstein, Efrat Tolkowsky, Nitzan Tzur.
GGA/2012, December 2012.

"Reforms in the field of housing," Dror Avidor, Zvi Eckstein, Daniel Graff, Efrat Tolkowsky, Tamir Kogut.
GGA/2015, July 2015