FELLOWS PROGRAM | KORET MILKEN INSTITUTE

AUGUST 2004
NO. 2

EXECTUTIVE SUMMERY

ISRAEL'S PROPERTY TAX: A WAY OUT OF THE MORASS

Karen Harel

Koret-Milken Institute Fellow

KORET FOUNDATION | MILKEN INSTITUTE

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Israel's Property Tax: A Way Out of the Morass

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The study recommends:

- **Enact a national municipal tax law with a uniform method of assessing property values.**
- **Adopt methods used abroad to base business property tax on profitability.**
- **Extend discounts for unused property.**
- **Tie state "balancing grants" to a municipality's socio-economic level.**
- **Merge small municipalities into larger ones.**

Introduction

The property tax paid by most American is known in Israel as "arnona." The nature of the tax and its collection are unique, rate calculations are confusing to say the least and the effectiveness of the tax is highly questionable. We seek a method in the aronona madness and recommend concrete proposals to solve its varied problems.

In Israel, there is no single method used to calculate the size of homes or offices or to determine tax level for different neighborhoods. Municipalities use many different methods making tax comparisons impossible. In addition, Israel's national government subsidizes most municipalities with special grants known as "balancing grants," designed to balance their budgets. However, these grants rarely if ever balance a municipality's budget; instead they usually involve taxpayer handouts to wealthier municipalities and they encourage deficits in arnona collection.

We compare systems used in other countries to collect property tax, and demonstrate that the Israeli system needs major surgery, especially since it lacks clarity for the taxpayer, imposes significant burdens on small business, encourages budget deficits, and channels state subsidies to those least in need of assistance.

History

The history of the arnona is one of a love-hate relationship between the national and local governments. No less than ten different committees have been established by the national government or various cabinet ministers to study the arnona and recommend changes. While many of these committee recommendations have been adopted by the government, almost none have actually been implemented. Over the years, the government has decided to grant municipalities more independence in their operations and in managing the arnona tax, but in reality has actually lessened local autonomy and strengthened dependence on the national government. For instance, in 1985, a law designed to stabilize the economy during a period of runaway inflation forbade municipalities from raising their own arnona rates; the legislation transferred this authority to the ministers of finance and interior. This prohibition is still in effect today and therefore local socio-economic levels are not taken into consideration in setting tax rates, and municipalities and municipal leaders unnecessarily continue to be more dependent on the aforementioned ministries and the goodwill of the ministers.[1]

In 1998, the national "Arrangements Law" (an adjunct to the annual budget) included a clause pegging the rate of arnona increases to increases in the consumer price index (CPI); however, the law required municipalities to raise the arnona at less than the full rise in the CPI, in order to encourage efficiency. Since then, however, special permission has been given each year for higher arnona hikes while the demand for efficiency has been deferred.[2] Between 1994 and 2000, the cumulative CPI rose 50 percent while the government ordered municipalities to raise the arnona by a minimum of 70 percent, and allowed for up to 80 percent increases.[3]

In 2000, Natan Sharansky, then the minister of interior, appointed former Finance Ministry budget director Yaacov Gadish to head a committee to study the balancing grants and their effects. Gadish recommended decreasing the size of the balancing grants and that the grants be allocated based on the socio-economic level of a municipality. As far back as 1993, a committee headed by Dr. Itzhak Suary recommended, and the government agreed, to have the Central Bureau of Statistics determine the socio-economic levels of each municipality, with the arnona rates to be set taking these levels into consideration; the intention was to ensure that if, economically, a city has the potential to raise its own funds, it would not receive a balancing grant; if a city is too poor to raise its own operating budget, then the national government would subsidize it. Part of this reform was to authorize localities to set residential arnona rates as they saw fit, though business rates were still to be regulated. But implementation of Suary's recommendations failed to achieve their desired end. The Gadish Committee therefore proposed a different formula for achieving the same ends: Determine the cost of a minimum level of necessary municipal services offset by potential arnona income; if the former is higher than the latter, the government would make up the difference. The committee submitted its recommendations to Sharansky's replacement, Eli Ishai, in 2001; he adopted and then ignored them. In 2003, the new minister of interior, Avraham Poraz, began implementation, and ordered a 2-5 percent reduction in balancing grants every year for the next six years for those municipalities whose budgets can endure such reductions.[4]

In February 2002, Minister Poraz had announced that confusion in arnona rates needed resolution. He authorized 5 municipalities to begin implementing the method used in the United States setting property tax as a percentage of a property's value. To date the change has not been implemented anywhere. Poraz has since announced that he would ease the arnona on business and would allow 15 municipalities to set rates on their own as a means of encouraging independence from his ministry. These reforms have also not yet been implemented. In September 2003, Poraz promulgated a new regulation adding a 30-month 50 percent arnona reduction to the current 6-month arnona exemption for property not in use, in order to ease the plight of businessmen forced to close their businesses during the current extended recession. Under subsequent pressure from municipalities facing a further loss of arnona income, the Ministry of Interior reworded the regulation to make the discount optional rather than required.[5]

In short, after years of studies and committees, Israel still has no national arnona law; instead, Israelis have over 40 laws, regulations and orders dealing with arnona, and every year 266 different arnona ordinances are adopted by local municipalities.[6]

Municipal Budgets and Arnona

Israelis are used to hearing in local news broadcasts that municipalities have exceeded their budgets. In 2001, the average overspending was 5.7 percent; salaries were 5.1 percent over budget. Many senior municipal officials have not paid their arnona, or for water provided their homes by the municipality; municipal employees have flown abroad at taxpayer expense without authorization; and municipalities have funded local organizations without any oversight.[7]

Fifteen of the seventeen largest cities are tens of millions of shekels in debt. Seventy percent of local authorities and municipalities ran deficits in 2002, up from 64 percent in 2001.[8]

Aside from corruption and irresponsible management, one of the main reasons for these deficits is the failure to collect arnona taxes. In 2002, NIS 13.19 billion was due in arnona taxes, while NIS 11.31 billion was collected, nearly a 2 billion shekel shortfall. Including sums due from previous years, municipalities were owed NIS 10.17 billion in unpaid arnona in 2002. This sum was approximately twice the total deficit of all municipal authorities in Israel that year. From 1996-2001, the municipalities succeeded in collecting only some 57 percent of the arnona due them; in 2002, they collected only 53 percent.[9]

In fairness to the municipalities, it should be noted that the national government often shortchanges them in its budgets; the government is required to pay 75 percent of education and welfare expenses but in 2002 paid only about 65 percent, leaving the municipalities with a NIS 1.095 billion shortfall; the municipal operational budget deficit in 2002 was NIS 1.265 billion, 87 percent of which was this imposed overspending.[10]

Minister Poraz tried to economize by proposing to merge smaller municipal authorities into larger ones, as 66 of the 266 municipal and local authorities in Israel (nearly 25 percent) have fewer than 5,000 residents. If Israel had 150 instead of 266 authorities, an estimated 800 million shekels could be saved annually. Political pressure from the municipalities prevented implementation of Poraz's plan.[11]

Problems with the Current Arnona System

1. Lack of correlation between arnona and socio-economic levels: Arnona rates are so random that many poor areas charge higher rates than wealthy areas, while many wealthy areas receive higher balancing grants than poor areas.[12]

Jerusalem, which is rated 5 out of 10 on a rising socio-economic scale, charges NIS 54 per residential square meter, while Savyon, with the highest socio-economic rating of 10, charges NIS 29; Bnei Brak, a low 3 on the socio-economic scale, charges NIS 45 per meter, while Beersheba, rated 5, charges NIS 28.[13]

2. Lack of a single method of computation: It is hard to conceive that there are some 1,300 different methods used to compute arnona in Israel. Some towns include porches when measuring apartments, some only covered porches; some include walls, some not; some include only roofed parking spaces, others also unroofed, and so forth.[14]

Arnona rates for businesses also vary widely. Bat Yam charges a whopping NIS 120 per square meter; Netanya, NIS 110; Jerusalem, 97; Tel Aviv, 88; Haifa, 76; and Carmiel, 34.[15]

3. Exemptions: Long ago many charitable and non-profit organizations received exemptions from arnona. Over the years some of these have become very profitable “businesses” but still enjoy exemptions: basketball teams, lotteries, colleges, even homes for senior citizens. Many of these organizations have branches throughout the country, all exempt from arnona. In the three major cities (Jerusalem, Tel Aviv and Haifa) alone, more than 6,800 institutions are exempt from arnona. Nationwide, the exemptions were worth over two billion shekels in 1998; by 2002, this sum had risen in real terms by 14 percent. In 2001, Tel Aviv reported 900 institutions with arnona exemptions worth NIS 100 million; that year, Tel Aviv found itself with a deficit of NIS 40 million.[16] With fewer exemptions, there would have been no deficit.

Many exempt institutions belong to the government, such as hospitals, airports, and the army. Others are considered infrastructure corporations, such as the Israel Electric Corporation, the Bezek telephone company, and the Mekorot water company, all of which are state monopolies.[17] In relatively poor cities like Jerusalem, with a plethora of government buildings and charities, those residents and businesses that do pay arnona effectively subsidize government institutions. Highway No. 6, a toll road that does not pay arnona, is effectively subsidized by local residents in areas through which it passes.[18]

4. Business is burdened with high taxes: Municipalities are allowed to impose business arnona at different rates for different business sectors as well as different geographical areas. The city of Ashkelon has outdone itself and divided business into 99 different sub-categories with different rates. Nationwide, banks must be charged a minimum of NIS 332 per square meter, which is 690 times the maximum arnona allowed for agricultural land. Sometimes businesses in one building pay at rates 20 times the rates of others in the same building. In Ramat Gan, for example, in one area, a bank pays NIS 1,011 per square meter, a gas station pays NIS 273, offices pay NIS 251, a hotel pays NIS 58 and a parking lot pays NIS 17.[19]

Small businesses in Ramat Gan and Haifa are categorized as crafts, and therefore are sometimes charged higher rates than large industries in the same places. In Ramat Gan, 661 industrial concerns spread over 81,699 square meters pay NIS 101-115 per square meter; 77 "crafts" on only 6,049 square meters pay NIS 160 per square meter.[20]

In 1978 the business sector paid approximately 25 percent of all arnona receipts; today it pays over 80 percent. Businesses often pay 3 to 30 times more than residential premises in the same area.[21] High arnona rates have become one of the most serious burdens facing businesses, especially small ones, and especially during economic slowdowns. According to one study, the arnona imposed on small producers amounts to NIS 5.1 billion, or 40 percent of total municipal arnona income.[22]

Comparisons

Table 1 compares the income from property tax and arnona with the size of national grants to municipalities and municipal budget deficits in selected countries.

Table no. 1
Comparison of Grants, Property Tax, Revenue and Budget Surplus/Deficit in Selected Countries, 2002

	Grants as % of local authorities' revenue	Property tax as % of revenue (excluding grants)	Surplus/deficit as % of local authorities' expenditure
Slovenia	19.79	14.76	24.50
Russian Federation	14.02	7.74	20.06
Croatia (2001)	6.60	7.06	19.02
United States (2001)	40.11	45.69	15.37
Sweden (2001)	17.67	10.02	15.05
France	39.84	55.59	11.81
Romania (2001)	10.91	9.00	10.94
Iceland (2001)	10.05	15.20	10.09
New Zealand	10.61	62.14	9.42
South Africa	18.26	19.68	9.24
United Kingdom	65.40	0.36	4.79
Australia	17.22	46.12	4.75
Austria	20.19	6.23	2.95
Denmark	35.95	5.30	2.82
Latvia	28.56	12.88	1.50
Finland (2001)	22.12	3.14	0.48
Germany	35.06	8.39	-2.37
Israel	**39.34**	**58.41**	**-3.70**

International Monetary Fund, *Government Finance Statistics Yearbook* (Washington, D.C.: International Monetary Fund, 2002), pp. 44, 48, 134,146, 173, 177, 185, 204, 222, 255, 322, 367, 370-1, 399, 402, 426, 458, 462; Interior Ministry, Local Authority Oversight Department, *Local Authority Financial Data Report 2002* (Jerusalem: Interior Ministry, 2002), pp. 26-27.

As can be seen, Israeli cities have higher property tax income than almost any other country, while the "balancing grants" extended by Israel's national government to its cities are also among the world's highest (England's is higher but includes a separate business tax). Yet despite the high arnona rates and large state handouts, Israeli municipalities also have the highest deficits of all of the countries considered.

Recommendations

In most Western democracies, the local and national governments have a relationship based on the central government's encouraging the municipalities to adopt a business-like approach towards their financing. Israel would do well to adopt this attitude, as well as to formulate a single, efficient and socially equitable means of collecting arnona. We make the following specific recommendations for arnona reform:

1. The large number of municipal authorities in Israel imposes a huge financial burden on the country. Sixty percent of the balancing grants are extended to small authorities (under 20,000 residents). The plan for merging small authorities into larger ones, proposed by the ministers of finance and interior in 2004, is a worthy plan that if implemented would save Israeli taxpayers hundreds of millions of shekels every year. Other countries have successfully executed such plans (New Zealand reorganized 204 local authorities into 73[23]) and Israel can do so as well.

2. Implementation of the Gadish Committee formula has only begun and thus no conclusions about its success can yet be drawn. These recommendations need to be implemented in some form in order to eliminate the current negative incentive for municipalities to stay within their budgets and collect arnona in an efficient manner. As long as budget deficits are covered by the national government regardless of their causes, local officials will overspend, travel abroad at city expense, hire too many highly paid friends, and so forth. Balancing grants should be given based on need only.

3. The burdens imposed by arnona on the business sector are oppressive. As in other countries such as Germany and France, Israel should set arnona rates for business based not only on the size of its property or the sector to which it belongs, but also on the the basis of annual turnover, the number of employees or its profitability. Adoption of these methods, or the system used in the United States, where the tax is determined based on a property's annually assessed value, would ease the burden on businesses. Growth and jobs are created when taxes are reduced.

4. Similarly, arnona rates for business should be capped; California, for example, in 1978 capped the tax on business at 1 percent of a property's value.[24]

5. The disproportion between residential and business arnona rates in Israel cries out for change, but the solution is not to raise residential rates. Israelis are already overtaxed. It does need to be understood that the current high arnona rates on business are passed on to residential home owners in the form of higher prices charged to consumers. In France, business rates are tied to residential rates, a more

rational method of allocation. In some Israeli cities the ratio of business to residential rates is as high as 30 to 1.

6. The Israeli tax authority proposal to raise arnona rates on small businesses operating out of residential homes is misguided. It would further punish those small businesses forced by the recession to operate from home, and it would force many of them to close altogether.

7. Minister of Interior Poraz should proceed with his many good ideas for reforming arnona, such as: extending exemptions for unused properties; giving municipalities more independence in setting their own rates; and cutting the umbilical cord that ties them to the national government budget. A good first step would be to determine which municipalities should win their independence. Viable criteria should include: meeting wage expenses and manpower allocation guidelines, meeting collection expectations, not issuing illegal discounts or exemptions, and so forth. Dismissal of municipal leaders who violate the public trust should also be considered.

8. Municipal leaders should be allowed to lower arnona rates, either for businesses facing financial difficulties or to attract new businesses to their cities, without applying for approval by the ministers of finance and interior as currently required, provided that safeguards (such as the Gadish Committee recommendations) ensure no increases in balancing grants.

9. Many arnona exemptions set long ago by the national government but still in effect need to be reconsidered; only families or businesses with real financial hardships should be awarded arnona exemptions.

10. The many different methods used to calculate arnona should be eliminated, and a national uniform method should be adopted. Until this change is adopted, the arnona ordinances of all the local authorities should be made available for the public to view conveniently, perhaps on the website of the Interior Ministry. This would allow Israelis to take arnona rates into consideration when planning on where to live or do business. (Posting the municipalities' budgets, and especially their expenses on salaries, on the website alongside the arnona rates would be a good contribution to sound government.)

11. The state should not fail to transfer to local authorities its portion of the education and welfare budgets (75 percent), and municipalities should efficiently collect the arnona tax.

Implementation of the above reforms would eliminate many economic distortions caused by the current arnona system and ease some of the tax burden on Israeli citizens and businesses. Arnona can be collected by methods that are simple, uniform and equitable. A rational, efficient and clear municipal tax system would create real freedom of choice for Israeli citizens and businesses, and would stimulate competition, investment and economic growth.

Notes

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תוכנית עמיתי קורת – מכון מילקן
בית מילקן, רחוב תל חי 13
ירושלים, 97102

info@kmifellows.org
www.kmifellows.org