

Chapter 9

The Housing Market

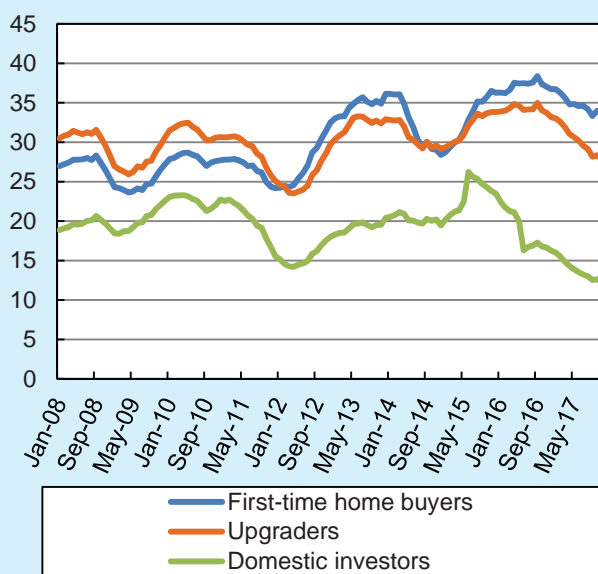
- The number of transactions in the housing market continued to decline in 2017, encompassing all purchaser groups. Prices rose at a more moderate rate than in previous years, due partly to the decline recorded in October-December.
- The Buyer's Price program was expanded in 2017, but first-time home buyers still purchased most of their homes at market prices.
- The continuing decline in the current return on an investment home—as a result of the increase in taxation and the fact that home prices have risen faster than rents—is causing real estate investors to search for alternative investment channels.
- The planning inventory has expanded in recent years, partly because the National Planning and Building Committee for Priority Housing Areas has shortened the bureaucratic processes. The activity of the Committee has eliminated some of the barriers, but efforts to deal with other barriers are being deferred to the licensing and execution stages, and are therefore not significantly shortening the time from the start of planning until the start of building.
- The Buyer's Price program is increasing demand among young couples and includes a large proportion of the supply of new housing. The plan shifts supply from the open market to the subsidized market and reduces prices for young couples. At the same time, it is lengthening the waiting time for a home.
- The urban renewal program has the potential to significantly increase the supply of housing, but the projects are proceeding slowly due to their complexity.
- Since 2013, umbrella agreements have been signed with a large number of local authorities, and they have the potential to increase supply by more than 300,000 housing units. However, a rapid increase in the number of residents in the local authorities is liable to endanger their financial stability if a solution is not found to the problem of their ongoing management.

1. CURRENT DEVELOPMENTS

In 2017, there was a decline in the number of transactions in the housing market and in the rate of increase in home prices. The number of transactions already began to fall in the last quarter of 2016, and encompassed all purchaser groups, although with differing intensities. It was the strongest among investors and those upgrading their homes, and more moderate among first-time home buyers (Figure 9.1). As a result, first-time home buyers as a share of total buyers increased, while investors' share declined. The annual rate of increase in real home prices for December 2017 to January 2018 was only about 0.8 percent, which is low relative to previous years (Table 9.1). This is the tenth year in a row that real home prices have risen, and the cumulative increase since the beginning of 2008 is about 95 percent. However, since September 2017 the index of home prices has declined by 2.5 percent in real terms.

Home prices during the last decade have increased as a result of strong demand factors and the slow response of supply (Table 9.1). With respect to demand, the standard of living (as measured by the growth of per capita GDP) rose; the labor market showed continuous improvement (the rate of unemployment fell to a level not seen since the 1970s and average household income rose); households rapidly accumulated financial wealth due to the increase in prices of financial assets; the group of potential first-time home buyers (the 25–44 age group) expanded at a relatively high rate; mortgage terms became more favorable (the interest rate on all mortgages tracks fell up until mid-2015 and although they subsequently rose—as a result of the capital requirements imposed by the Banking Supervision Department—the level of mortgage interest rates remained lower than prior to the financial crisis); and the profitability of an investment home increased relative to alternative investments (interest rates in Israel and abroad were lowered following the financial crisis and yields on financial investments declined). The drop in mortgage interest rates prevented a major increase in monthly payments even though

Figure 9.1
Yearly Transactions^a by Buyer Group, 2008–17
 (thousands of units)



^a 1.5 to 5-room dwellings only.

Table 9.1
Selected Housing Market Data, 2008–2017

	1997–2007 average (unless otherwise noted)	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Demand Variables											
Population aged 25–44 (rate of change) ^a	2.1	2.0	3.6	1.7	1.3	2.1	1.6	1.5	1.4	1.3	
Average real wage per employee post (rate of change, 2011 prices)	1.2	-0.4	-2.5	0.8	0.4	0.6	1.1	1.3	2.8	2.9	3.0
Average net real household income (rate of change, 2011 prices)	2.3 ^g	2.7	0.8	2.4	-0.2	3.5	4.1	3.1	2.5	2.7	2.3
Unemployment rate among those aged 25–64 (level, percent)	9.4	6.4	8.3	7.2	6.1	5.9	5.4	5.0	4.5	4.1	3.7
Weighted real interest rate on new mortgages ^b (level, percent)	4.3 ^g	3.1	0.9	1.4	2.5	2.2	1.6	1.3	1.0	1.5	1.9
Real per capita GDP (rate of change, 2015 prices)	1.6	1.1	-0.3	3.6	3.3	0.3	2.3	1.5	0.6	1.9	1.4
Financial wealth of the household sector ^c (end of year, rate of change)	11.9 ^g	-14.6	20.9	16.0	0.2	11.6	6.4	6.2	1.2	3.1	
Rate of those planning to buy a home in the next 12 months ^d (percent)					6.6	7.7	7.5	7.3	7.0	7.7	7.4
Supply variables											
Building starts (thousands of units)	36.8	32.9	35.0	40.3	46.6	43.5	47.8	47.2	53.6	54.0	46.3 ^h
Building completions (thousands of units)	41.0	30.5	32.6	33.3	34.1	37.4	42.5	44.7	43.6	46.1	47.4 ^h
Stock of homes under active construction (end of year, thousands of units)	69.9	61.6	63.9	70.8	83.1	88.9	94.1	96.5	106.1	114.2	113.0 ^h
Building permits ^e (thousands of units)	27.8	33.2	33.8	41.7	46.6	44.2	45.4	46.4	53.7	53.9	55.3
Investment in residential construction (rate of change, 2011 prices)	-1.8	9.8	8.0	12.5	9.8	6.7	6.2	6.0	1.5	8.1	1.2
Outcome variables											
Housing transactions ^f (thousand)	90.9	94.1	102.2	104.0	86.5	102.7	114.5	99.6	121.0	111.9	99.0
Home prices (real rate of change, 2011 prices)	-2.3	6.5	15.4	11.1	1.8	6.9	5.4	4.5	9.0	5.0	0.8
Households that do not own a home (percentage of population)	28.2 ^g	29.6	29.3	28.8	27.6	28.0	27.9	27.9	27.5	27.4	
Households that own more than one home (percentage of population)	9.2 ^g	3.4	4.2	4.5	6.4	7.9	8.4	9.1	9.9	9.7	
Percentage of homes purchased for investment (as a share of total purchases)		26.4	28.1	27.9	23.9	22.4	22.7	25.4	23.8	18.8	16.2

^a The break in the series on the population aged 25–44 is due to changes in the Census conducted in 2008.

^b The weighted real interest rate on mortgages is calculated assuming an annual inflation rate of 2 percent.

^c The financial wealth of the household sector includes cash and deposits, shares and other securities, insurance reserves, participatory certificates and financial derivatives. The figure is taken from the National Balance Sheet prepared by the Central Bureau of Statistics.

^d The rate of those planning to purchase a home, taken from the Consumer Confidence Index, Central Bureau of Statistics.

^e Data on building permits relate to the last four quarters.

^f The number of residential housing transactions is based on Property Tax and Betterment Tax data.

^g The average between 2004 and 2007.

^h Temporary data.

SOURCE: Central Bureau of Statistics, Ministry of Construction and Housing, Israel Tax Authority, and Bank of Israel.

home buyers were forced to take out larger mortgages as a result of the increase in home prices.

The supply of housing is naturally inelastic due to the long “production” process. It begins with planning approval on the national and regional levels. Following that the Israel Land Authority markets the land and the local committees issue building permits. Finally, the housing is built over a period of two or more years (see Section 7.1 in the Bank of Israel Annual Report for 2014). Therefore, it is important to prepare a planning inventory of housing units in a timely manner. The rigidity leads to economic boom and bust cycles in the housing market that are longer than the regular business cycle. The previous period of rising real home prices began in 1989 and ended in 1996, and was the result of the massive immigration from the Former Soviet Union. During this period, home prices rose by about 80 percent. The housing crisis that developed at the beginning of the 1990s was solved by accelerating construction for a number of years, and as a result, between 1996 and 2007 real home prices fell continuously as a result of surplus supply. The construction industry reacted to the drop in real home prices by reducing activity. Thus in 1996, there began a gradual decline in the number of housing starts, and in 2001 they fell sharply as a result of the recession and the Intifada. Between 2001 and 2009, there were only about 32,000 housing starts per year, compared with about 56,500 in 1996–7. In order to illustrate the slow response of the industry, it is sufficient to mention that in 2008–9 home prices increased by about 23 percent in real terms, while the number of annual housing starts during those two years fell to an average of 34,000 (Table 9.1). The low elasticity of supply has led to a delayed response to the increase in demand and has contributed to the rise in home prices.

In recent years, the government has invested a great deal of effort in solving the housing crisis. These include: a) general industry-level measures, including the improvement of bureaucratic processes, in order to make it easier to create a sufficient planning inventory of housing; and b) specific measures, some of which are aimed at particular segments of the population (including the Buyer’s Price program and long-term rentals) while others are aimed at specific regions (such as urban renewal and umbrella agreements with the local authorities). Building starts did indeed exceed 50,000 units per year, which is even higher than the growth in the population. Although the planning inventory (on state land only) grew significantly in recent years, there is a mismatch between its geographical distribution and the distribution of households, and therefore, the surplus demand in the Center is likely to continue in coming years unless there is massive urban renewal and construction on privately owned land in the Center. As part of the umbrella agreements signed since 2013, close to 30 contracts, for the construction of about 336,000 housing units, have been signed, most of them in the periphery. The execution of these agreements is likely to significantly increase the number of residents in the relevant local authorities, and this will require a corresponding increase in their income in order to provide municipal services to the new residents. Otherwise, the level of services and/or the financial

situation of the local authorities will be threatened. The rest of the chapter describes the programs in greater detail.

2. HOUSING TRANSACTIONS

As mentioned, in 2017 the downward trend in the number of transactions continued among the various purchaser groups: first-time home buyers, those upgrading their homes and investors (Figure 9.1).

Among first-time home buyers, the number of transactions includes homes purchased as part of the Buyer's Price program and the Target Price program.¹ In 2017², first-time home buyers purchased more than 33,000 homes, of which about 9000 were new and about 5450 were subsidized. In other words, first-time home buyers purchased homes primarily in the non-subsidized market. The Buyer's Price program is expected to increase the proportion of subsidized purchases, but at the same time first-time home buyers will continue to purchase homes at market prices. This is due to the following reasons: (1) They are interested in purchasing a home in a location where the Buyer's Price program does not offer any or in a location where there is only a small probability of winning; (2) The type of dwelling being offered by the Buyer's Price program does not suit their preferences; (3) They are not interested in waiting a long time for their home (many of the projects in the program will be implemented only several years in future); (4) There is a relatively small difference between the price of a home on the open market and the subsidized price, a situation that sometimes arises in the periphery³; and (5) The buyers are concerned that the homes will be built to a lower standard than those on the open market.

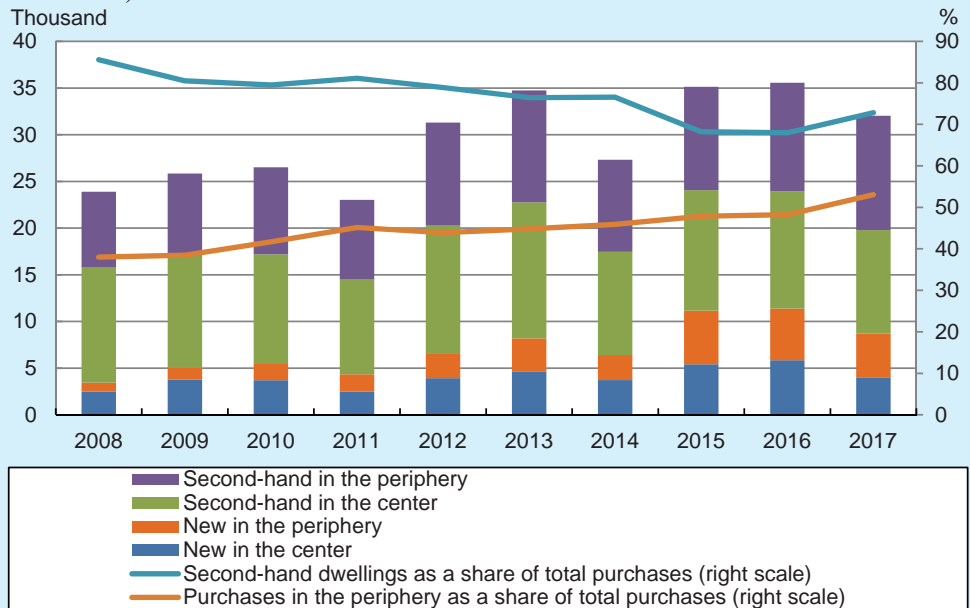
Figure 9.2 shows the purchases carried out by first-time home buyers according to four categories: new homes in the center (the Tel Aviv, Center and Jerusalem districts), new homes in the periphery (the North, Haifa and South districts), second-

¹ In the Buyer's Price program, the transaction is recorded at the time of the actual sale and this is possible only after the project has obtained a building permit and the winners choose a home. Winning a lottery gives one the right to purchase an apartment in the future and this does not occur if the winner does not find a suitable home in the project for which the lottery was held.

² Because the information on transactions arrives with a lag, the data for the last quarter are not complete.

³ According to an analysis carried out by the Knesset Research and Information Center, the discount provided by the Buyer's Price program in centrally located areas is larger than in the periphery. The analysis is based on the estimates of the State Appraiser as of June 2015, and found that the average discount ranges from NIS 175,000 in the south and NIS 190,000 in the North, to about NIS 600,000 in the Tel Aviv area (the project in Herzliya). It may be that the difference is even larger since in the periphery there is sometimes no significant difference between the price in the Buyer's Price program and the price on the non-subsidized market. For example, the prices in the Buyer's Price project in Be'er Sheva are apparently not very different from those on the free market in Be'er Sheva, and as a result there was a high rate of cancellations in this project.

Figure 9.2
Transactions by First-Time Home Buyers, New and Second-Hand Dwellings, by Location^a, 2008–17



^a 1.5 to 5-room dwellings only.

SOURCE: Based on Israel Tax Authority, Carman file.

Since the inception of the Buyer's Price program, the average proportion of second-hand homes among total homes purchased by first-time buyers has declined, and the proportion of homes that they buy in the periphery has grown.

hand homes in the center and second-hand homes in the periphery.⁴ The Figure shows that second-hand homes constitute a significant share of total homes purchased, particularly in areas of high demand in the center, where the supply of land is very limited and almost no new homes are being built. Since the inception of the Buyer's Price program, the average share of second-hand homes within total homes bought by first-time buyers has fallen and the share of homes that they buy in the periphery has increased. It appears that since the social protest in 2011, they are buying more homes in the periphery, both new and second-hand. The rise in prices in the center has forced first-time buyers to look outside the high-demand areas⁵, and this trend has intensified in recent years with the inception of the Buyer's Price program.

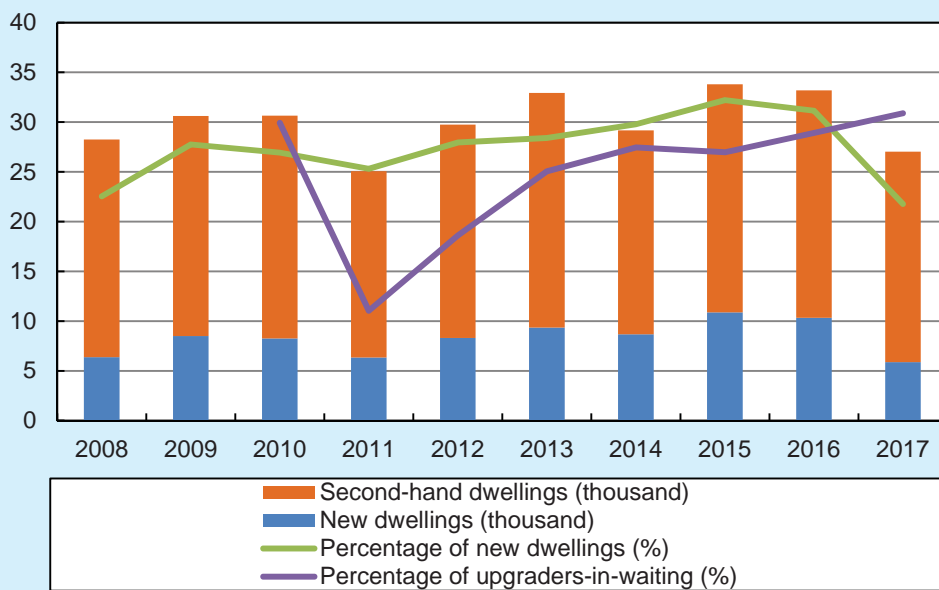
Those upgrading their homes constitute about 38 percent of home buyers (which is similar to the share of first-time buyers). Since the Israel Land Authority

⁴ New homes also include those purchased as part of the Buyer's Price program and the Target Price program. We do not have precise information on the distribution of the subsidized homes between the various locations, but many of them are to be found in the periphery. The analysis does not include the Judea and Samaria district.

⁵ A certain amount of empirical support can be found in N. Tzur-Ilan (2017), "The Effect of Credit Constraints on Housing Choices: The Case of LTV Limit", Bank of Israel Research Department, Discussion Paper 2017.03. The research shows that the limitations placed on mortgages by the Banking Supervision Department between 2010 and 2013 have forced home buyers to move farther away from the center in the search for lower home prices. (It should be mentioned that the study examined only transactions within a 40-kilometer radius from the Tel Aviv area.)

is marketing only a small amount of land for building in the non-subsidized market (relative to what it is marketing as part of the Buyer's Price program), a shortage of projects suited to those upgrading their homes has developed, which is limiting their options to purchase a new home. Figure 9.3 shows that indeed the proportion of new homes bought by those upgrading their homes fell in 2017. Recently it was decided that when Buyer's Price homes are not sold to first-time buyers—primarily in the case of larger and more expensive homes—they will be sold to those upgrading their homes at the discount which is normally provided in those projects.

Figure 9.3
Transactions by Upgraders, New and Second-Hand Dwellings^a, and Upgraders-In-Waiting as a Share of Total Upgraders, 2008–17



^a 1.5 to 5-room dwellings only.

SOURCE: Based on Israel Tax Authority, Carman file.

One of the more interesting phenomena observed in recent years relates to upgraders-in-waiting, that is, individuals who have already purchased an alternative home but have still not sold their previous one, even though they are not planning on keeping it.⁶ Upgraders-in-waiting as a share of all those upgrading their homes has increased. In 2010–15, they constituted an average of about 23 percent of those upgrading their

⁶ This distinction arose because there is a difference between the purchase tax that applies to a single home and that which applies to an investment home. In order to pay the tax that applies to a single home, the previous home has to be sold within 18 months (up until 2016, the period was 24 months) from the moment that the alternative home is purchased, and if it is a home that is still under construction, then from the moment that a Form 4 (occupancy permit) is obtained. If the purchaser does not sell within this time period he will be viewed as an investor and will pay the tax that applies to an investment home.

During the last two years, the proportion of home upgraders-in-waiting has increased.

It is reasonable to assume that they are finding it difficult to sell their apartments at the desired prices since the market has cooled down.

The proportion of investors in the housing market declined sharply in 2017.

homes⁷, and it is reasonable to assume that they deferred the sale of their previous home (and bought their alternative home earlier) because prices were increasing at a high rate and they wanted to sell their previous home at as high a price as possible (and purchase their alternative home at the most convenient price possible). In 2016–7, their average share increased to about 30 percent (Figure 9.3), and it is reasonable to assume that they found it difficult to sell at the price they wanted since the housing market has recently cooled down. Specifically, at least half of those upgrading their homes are moving to a larger home⁸ and are selling their previous home primarily to young couples and investors. However, demand for second-hand homes among young couples has declined as a result of the Buyer's Price program, and investors have been pushed out of the market by regulatory and taxation measures.

The proportion of **investors**⁹ in the housing market declined sharply in 2017 (Table 9.1). During the past decade, they have accounted for about one-quarter of total housing transactions, although there have been fluctuations during the period. Leading up to June 2015, when the tax rate imposed on investors was increased, investors moved up their purchases. Since then, purchases by investors have fallen persistently. This trend intensified to some extent with the Multiple Properties Law (the “third home tax”) due to the high level of uncertainty it has created (the law went into effect at the beginning of 2016; the Supreme Court then rejected it; and for now the legislative process has not been renewed).

The rental housing market in Israel primarily consists of numerous private renters with short-term contracts. In recent years, the government has decided to encourage the creation of a partly subsidized institutional rental market which will offer long-term rental services. The rental market in Israel has in recent decades operated without any government involvement (partly because in the past the Tenant Protection Law limited the rights of landlords) and the level of tenant protection is among the lowest in the OECD countries.¹⁰ The Fair Rental Law, which was approved by the Knesset in July 2017, attempts to rectify the situation by placing minimal demands on the quality of rental homes and specifying the division of responsibility for maintaining them.

From the perspective of investors, buying an investment home is a long-term endeavor that guarantees a fixed monthly income, and many investors even view it as an alternative to pension savings. This is particularly true for the self-employed, since the Compulsory Pension Law was only extended to them in 2017. Although between 2006 and 2015, the share of self-employed among investors dropped from about 43

⁷ We do not possess reliable data on earlier periods.

⁸ About 55 percent of those upgrading their homes in 2001–14 exchanged their previous home for a more expensive one; about one-half exchanged it for an apartment with more rooms; and only 18 percent exchanged it for a smaller home. See H. Allaluf and N. Sussman (2017), “The Effect of Changes in Household Income on the Value of Homes they Own”, *Land*, 17/4. [Hebrew]

⁹ The population of investors includes individuals who own more than one home. The discussion relates to local investors only since foreign investors make up only a negligible proportion of the housing market.

¹⁰ See D. Andrews, A. Caldera Sanchez, and A. Johansson (2011), “Housing Markets and Structural Policies in OECD Countries”, OECD Economics Department Working Paper no. 836, pp. 48-49.

percent¹¹ to about 36 percent due to the increased proportion of employees¹², their proportion among investors is still very high relative to their share of total employment (about 13 percent, which remained unchanged from 2006 to 2015).

Ministry of Finance data show that investors have reduced the period during which they hold on to an investment home. Thus, while the investment homes sold in 2016 were held for more than 20 years on average, from the beginning of 2017 until September of that same year the holding period fell to only about 16 years. This decline may be a response by investors to the uncertainty created by the Multiple Properties Law, as well as the behavior of investors with speculative motives who believe that the rapid increase in prices has exhausted itself, and who now wish to realize their profits.

The profitability of investing in residential homes in Israel is influenced by the taxation on rentals. An investment home yields two types of income: (1) rent, i.e. current income, which is similar to a dividend received on an investment in shares or interest received from an investment in bonds; and (2) capital gains from the sale of the home. The current income from an investment home (rent) is tax exempt if it is less than NIS 5010 per month (as of 2017). If it is higher the home owner can pay a reduced and fixed tax rate of 10 percent. In contrast, the current income from a financial investment is taxed at a rate of 25 percent. With respect to capital gains, the tax is 25 percent of the real capital gain when a financial asset is sold. An investor in an investment home must pay a betterment tax at a similar rate.¹³ However, in contrast to an investor in the capital market, his investment is also subject to a high rate of purchase tax and fees to an attorney and a real estate agent.¹⁴ This additional cost is a burden on the home investor for at least the first eight years, and only after that does the net yield start to stabilize. This illustrates that the profitability of investment in a home is connected to the period for which it is held.

The yield on a residential dwelling is made up of several components: the basic interest rate, the risk premium, a premium for the asset's low liquidity, depreciation, compensation for vacancy periods, compensation for landlord's expenses, etc. The price of homes has risen more than rents in recent years, which has eroded the yield on rental housing (Figure 9.4). However, the yields on financial assets have eroded even further, and mortgage interest rates fell after the global financial crisis. These processes

¹¹ From "Purchasers of Investment Homes – Characteristics and Trends, a Long-Term Analysis", the State Revenue Authority Report for 2008, Chapter 9. [Hebrew]

¹² G. Ben-Naim (2016), "Purchasers of Investment Homes in 2015-16 – Characteristics and Trends", Discussion Paper, Ministry of Finance. [Hebrew]

¹³ Until the end of 2013, investors in housing could receive a full exemption from the betterment tax once every four years if they sold the investment home for less than NIS 4.5 million and held it for at least 18 months. At the beginning of 2014, an amendment went into effect that cancelled the exemption from the betterment tax but provided "linear protection", i.e. the tax would be paid only from 2014 on the assumption that the real capital gain is distributed uniformly over the holding period.

¹⁴ In addition, he pays municipal tax when the home is not rented out.

have strengthened the preferences for investment in housing.¹⁵ It is therefore not surprising that there has been a rapid increase in the number of households that own two or more homes. Central Bureau of Statistics data show that in 2003 they constituted only 3.2 percent of households, and this rate did not change significantly until the financial crisis. However, since 2008, the rate has risen persistently, reaching 9.9 percent in 2015 (Table 9.1).

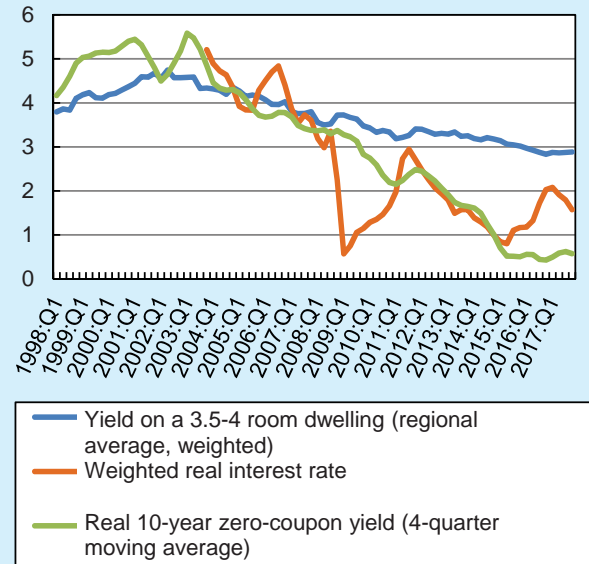
Investors usually purchase second-hand homes (Figure 9.5), perhaps because they are not interested in waiting until the completion of construction but rather

prefer to receive a flow of revenue immediately upon purchase in order to cover the mortgage payments. In 2013, new homes as a share total purchases by investors grew, and in 2015 new homes reached a record level of one-third of investment homes. This trend was affected by the sales campaign of a large customer club (in Petah Tikva, Rehovot, Yavne and Rosh Ha'ayin), which sold thousands of new apartments. In 2016–17, new homes as a share of total purchases by investors declined because since the inception of the Buyer's Price program the Israel Land Authority has been channeling most of the tenders to that program and marketing very little land through the regular channel.

The decline in yields on rental homes and the belief that the potential for capital gains has been exhausted in view of the government's measures to reduce the attractiveness of investment homes have led investors to search for alternatives. Alternative real estate investments primarily include income-yielding residential real estate abroad, income-yielding commercial real estate (offices) in Israel, and mutual funds that

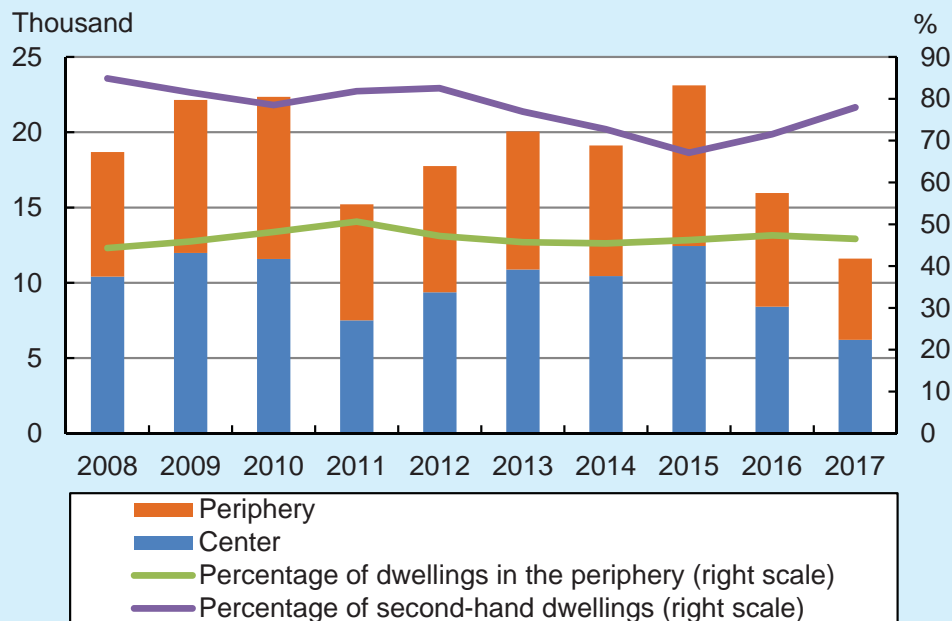
Investors are looking for alternative investments following the drop in current yields from the rental of residential housing and the belief that the potential for capital gains has been exhausted, in view of the government measures to reduce the attractiveness of investment in the housing market.

Figure 9.4
The Yield on Renting Out a Dwelling Compared with the Real 10-Year Zero-Coupon Yield and the Weighted Interest Rate on Mortgages^a, 1998–2017
 (quarterly data, percent)



^a The weighted interest rate is calculated assuming inflation of 2 percent.
 SOURCE: Bank of Israel calculations.

Figure 9.5
Transactions by Investors^a by Location, and Second-Hand Dwellings as a Share of Investors' Purchases, 2008–17



^a 1.5 to 5-room dwellings only.

SOURCE: Based on Israel Tax Authority, Carman file.

specialize in real estate investment. Between 2010 and 2014, net investment by Israeli households in real estate abroad was negligible in value and even negative. However, there was a turnaround in 2015, and between 2015 and 2017 this investment was estimated at more than NIS 1 billion annually, and average gross investment totaled about NIS 17 billion annually.¹⁶ Nonetheless, this level of investment is low relative to investment in residential dwellings in Israel, which averaged about NIS 22 billion gross per year between 2008 and 2016.¹⁷

It is possible to invest in real estate by investing in the asset itself and/or by investing in financial instruments. The latter type of investment has many advantages over the former type: it is diversified over many assets, which reduces the risk; it requires less equity capital; it is liquid; and there is no need to manage the asset. An example of these instruments is mutual funds that specialize in real estate¹⁸, of which there are five in Israel. At the end of November 2017, the value of their risky assets (i.e., less the deposits with the banks) totaled about NIS 630 million.

¹⁶ This is the estimate made by the Bank of Israel's Information and Statistics Department, based on reports from the banks on Israelis' transactions abroad.

¹⁷ We do not have data on the homes sold by investors but it can be assumed that some of them are purchased by other investors. However, the data published by the Ministry of Finance indicates that in recent months the "stock" of homes held by investors has declined.

¹⁸ These funds invest in stocks and bonds of real estate companies, including construction companies, but they focus on income-yielding real estate in Israel.

Similarly, it is also possible to invest in real estate by investing in office buildings. The investment in offices appears at first glance to be more attractive than investing in a dwelling for several reasons: the price per square meter of office space is much lower than the price for residential housing; offices can be purchased in various sizes; the rental contracts are generally for intermediate terms (five years); the restrictions imposed by the Banking Supervision Department on the loan to value ratio (LTV) for residential housing (a 50 percent limit) do not apply to loans for the purchase of commercial real estate; there is a lower rate of purchase tax (6 percent compared with 8 percent on investment homes); and the yield on the rental of office space is higher than that on home rentals (the gross average return, without the increase in value and before tax, is about 8 percent¹⁹ while the yield on residential housing in Tel Aviv stands at about 3 percent). However, the revenue from office rentals is taxable from the first shekel²⁰; the risk is greater; the demand for housing is more stable and is based on growth in the number of households, while the demand for office space is dependent on economic growth and is therefore cyclical, and is also exposed to changes in work habits (for example the trend toward working at home) and changes in retail behavior (for example, rental of shared workspace), all of which reduce demand; and the supply of office space has expanded in recent years which may bring down the levels of rent and/or make it difficult to find renters. (In the latter case owners will have to bear higher costs since holding an office is more expensive than holding a dwelling because of higher municipal tax rates and management fees.)

3. PRICES

As mentioned, home prices have skyrocketed since 2008, and owning a home has become less affordable. In 2017, the average home price was equal to 12.5 years of the average wage and 7.6 years of net household income²¹, while in 2007 it was equal

¹⁹ From “Survey of Yields on Income-Yielding Assets - first half of 2016”, Land Valuation Branch of the Ministry of Justice; based on a sample of income-yielding assets. N. Bergman and D. Baraj (2015) present a similar net yield of 7.5 percent, based on a survey of data on Tel Aviv office buildings contained in the reports of rental real estate companies traded on the Tel Aviv Stock Exchange (calculation based on NOI data).

²⁰ Income from the rental of a commercial property is considered to be passive income and an annual tax return must be submitted to the Israel Tax Authority. The tax rate on passive income is higher than the tax rate on labor income, and the first tax bracket is 31 percent (for investors that have reached the age of 60 the tax rates are lower). In addition, National Insurance Institute payments must be made from rental income. On the other hand, various expenses that are used to create the income can be deducted, including amounts paid as interest and indexation differentials on a mortgage, the cost of repairs and maintenance of the asset, depreciation costs, and legal and accounting fees.

²¹ It is common to present the ratio of the price of the average home to the average wage. However, we also present the ratio of the price of a home to net household income since this makes it possible to account for the significant developments in the Israeli labor market in recent years, particularly the increase in the labor force participation rate and in the employment rate and the increased number of households with more than one breadwinner (for further details, see Chapter 8 in this report). Similarly, net income reflects the changes in direct taxation. Further details on housing affordability appear in Bank of Israel (2014), *Recent Economic Developments*, no. 137, pp. 27–36.

to 8.1 and 5.9 years, respectively (Figure 9.6). The adverse effect on affordability was partially offset by the fall in mortgage interest rates, which prevented a major increase in monthly mortgage payments due to the increase in the size of mortgages. Although the number of transactions began to decline in the fourth quarter of 2016, housing prices continued to rise until August 2017. In September–December 2017, housing prices (according to data that is not final) dropped by 2.1 percent in cumulative terms, and as a result, the annual rate of increase in 2017 moderated to 1.2 percent.²²

The number of housing transactions started to decline in the fourth quarter of 2016, but housing prices continued to increase and only began declining in September–December 2017.

Figure 9.6
Indices of the Affordability of Home Ownership, 2003–17 (Years)



SOURCE: Bank of Israel calculations.

The segmentation of the market into two—the subsidized market and the open market—is liable to increase the price of housing in the open market (second-hand housing and new housing outside the Buyer’s Price program) since the supply is contracting more than demand. However, if a large number of subsidized homes are sold in a particular city, it may moderate the prices of second-hand housing there. Empirical support for this argument can be found in research carried out by the

²² In December 2017, the new housing price index declined (according to data that is not final) by 2.1 percent relative to the previous month. This index gives every transaction equal representation. In December 2017, 19.8 percent of the transactions involved government support (Buyer’s Price). We note that new home sales have a small weight in the stock of housing.

Alrov Real Estate Research Institute²³, which examined the willingness of sellers to compromise on the price of a second-hand apartment. The researchers found that between the third quarter of 2016 and the third quarter of 2017 the gap widened between the initial asking price and the sale price in most of the cities in the sample, although the gap widened the most in Eilat, Modi'in, and Kiryat Ata, cities in which (or near which²⁴) Buyer's Price lotteries took place and a large number of homes were awarded in those lotteries relative to the stock of existing housing.²⁵ However, the findings should be treated with caution since housing in different cities—and even in the same city—varies in quality, and the willingness to compromise on price therefore varies from one home to the next.²⁶ Moreover, the drop in prices in the second-hand housing market may also reflect the tarnishing of a city's image due to its large number of subsidized homes.

The slowdown in the number of new home sales in the open market has reduced the cash flow of developers in residential construction, and the question arises as to whether this will induce them to reduce the sale prices of their stock of housing. The real estate development industry in Israel is characterized by a high level of competition and a highly dispersed structure. There are a few large public companies that carry out large-scale projects with a nation-wide distribution; there is a greater number of medium-size companies, most of them private; and there is an even larger number of small private companies, whose activity is restricted to a limited geographic area. As such, there is no single company with a significant market share.²⁷

Ministry of Finance data indicate that it is actually the large companies that have had to deal with a more tangible slowdown. Thus, in 2015–16 the 100 largest contractors sold about half of all new housing, and in 2017 that share dropped to 44 percent on average. However, it is reasonable to assume that these companies actually have a better chance of weathering the slowdown. First, they accumulated higher profits during the growth years. Second, their financing costs are low relative to other contractors, since public companies have access to the capital market in addition to bank credit, and can issue bonds with low yields (for further discussion of the financing of companies in the construction industry, see Chapter 4). Finally, an examination of their areas of activity shows that the vast majority do not limit themselves to residential construction in Israel, but also operate in a variety of other

The large construction companies are in no hurry to reduce prices even when their inventory of housing is growing, due to the profits they accumulated during the growth years, their relatively low costs of financing and the diversification in their areas of activity.

²³ I. Alter and I. Popliker, "Changes in Sellers' Willingness to Compromise on Prices" (forthcoming). The research was based on data for about 29 thousand transactions in 28 cities from the first quarter of 2015 to the third quarter of 2017, and combined data from the Tax Authority with ads on the Yad2 website.

²⁴ In the case of Kiryat Ata, there were lotteries nearby in Kiryat Motzkin and Kiryat Bialik.

²⁵ There was less willingness to compromise on price when there were fewer homes awarded by lottery relative to the size of the local market, such as in Herzliya, Beit Shemesh, Be'er Sheva, Ramle, Haifa, Rishon Lezion, Ra'anana, Jerusalem, Netanya and Ashkelon.

²⁶ The regression in this research also yielded low explanatory coefficients.

²⁷ According to Ministry of Finance data on the sale of new homes in the third quarter of 2017, the market share of the 10 largest builders stood at only 13 percent; that of the 30 largest builders stood at 27.5 percent; and that of the 100 largest builders stood at 42.4 percent.

domains, including income-yielding residential real estate in Israel and abroad, urban renewal, commercial real estate in Israel and, recently, the Buyer's Price program (primarily in high-demand projects in the center of the country: small local companies win most of the tenders in the periphery). Therefore, it is reasonable to assume that the large companies are not hurrying to lower their prices even while their stock of homes is growing.

Nonetheless, the reduced cash flow of the real estate developers may lead them to sell homes from their inventory at lower prices, but this will mainly depend on the extent to which they expect a turnaround in home prices. We do not have any information on the efforts of contractors in the open market to increase sales and it is possible that they are offering potential purchasers incentives other than price discounts, such as easier payment terms, a loan with convenient terms, an upgrade of the home's specifications, etc. The slowdown in sales is affecting the number of building starts, which declined by about 14 percent in 2017 relative to the previous two years.²⁸ The drop in building starts is apparently an indicator that the contractors are accumulating an inventory of housing units, since most of them start new project stages only after selling a certain proportion of the housing units in the previous stage. It is also reasonable to assume that the negative impact to cash flow makes it difficult for companies to divert sources to new projects. Another explanation for the decline in building starts is that the Israel Land Authority is marketing very little land outside the framework of the Buyer's Price program.

4. GOVERNMENT INTERVENTION IN THE HOUSING MARKET

In recent years, the government has made it a priority to solve the housing crisis and it has indeed adopted policies that are having an impact on both the demand and supply sides, and which have the potential to benefit households unable to buy a home. These policies have an impact on those upgrading their homes as well since they reduce their chances of purchasing a new home. At the same time, these measures also affect investors by pushing them out of the market (which is liable to reduce the stock of rental housing in the future).

The planning inventory

The process of producing a dwelling (from the moment that the committees have approved the plans until the completion of construction) takes about 7 years. Therefore, it is highly important to prepare plans at an early stage and to create a planning inventory, i.e. housing units that can be marketed in the near future. In other

²⁸ This is apparently an underestimate. First, the data for building starts is generally revised upward. Second, the number of building permits, which is a leading indicator of building starts, from January to September 2017 did not decline relative to the same period in the previous year.

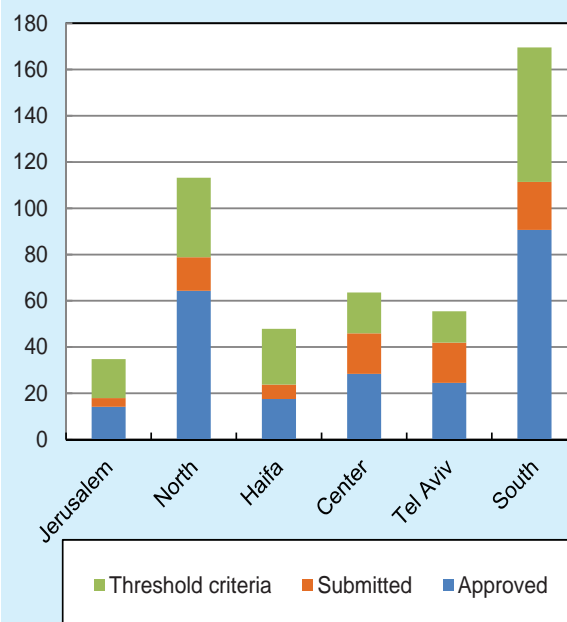
words, the number of housing units that are actually being built is dependent on the planning inventory that was created several years earlier.

The State Comptroller's Report for 2015 on the housing crisis pointed to a shortage in the planning inventory, particularly in high-demand areas in the center of the country. However, the situation has improved to a great extent. In particular, at the end of February 2018, the Israel Land Authority published revised figures on the detailed plans²⁹ that apply to State land and for which there remains a potential to market housing. The plans can be divided into three planning stages: valid plans (i.e. they have been approved), plans that have been submitted, and plans that need to meet certain threshold criteria before being submitted to the planning institutions (Figure 9.7). According to the revised figures, the marketing

In recent years, the planning inventory has grown to a greater extent than in the past, but it is still not distributed by district according to demand.

potential of all of the detailed plans is about 440,000 housing units, of which about 240,000 are valid plans.³⁰ The current situation is a significant improvement relative to 2010, when the planning inventory was only about 280,000 units, of which only about 160,000 were valid. However, the current planning inventory is not distributed among the districts according to demand. Only about 23 percent of the total inventory, and about 21 percent of the valid inventory, are located in the Center and Tel Aviv

Figure 9.7
Planning Inventory of Housing Units by Planning Stage and District, February 2018 (thousand)



SOURCE: Israel Land Authority.

²⁹ Building plans can be issued on the basis of detailed plans. The plans are defined according to the Planning and Construction Law.

³⁰ However, a large proportion of the housing units that have received approval (about half in 2010) are not implementable in the immediate term due to various barriers, including environmental quality problems (such as the pollution of Israel Military Industries land and land that will be freed up by the transfer of IDF bases), marketing failures (in the periphery), legal problems, problems with the land itself (for example, jurisdictional boundaries of the local authorities), infrastructure problems (transportation, sewers, etc.), and incompatibility with the outline plans.

districts, in which about half of the households live.³¹ In the Jerusalem district as well, the planning inventory is out of sync with demand (about 5.5 percent of valid inventory and about 6.4 percent of total inventory as opposed to about 11 percent of households).

The planning inventory has expanded in recent years as a result of the establishment of the National Planning and Building Committee for Priority Housing Areas (VATMAL). The Committee was established in 2014 by the Promotion of Priority Housing Construction Law, which is in effect for 4 years³², with the goal of shortening the planning process.³³ According to the Committee's data as of December 2017, it had received 81 plans that include about 300,000 housing units, of which 33 had been approved, 10 had been deposited for opposition, 3 had been discussed before being deposited for opposition but had still not been deposited, 15 had completed the preliminary discussion before the pre-deposit discussion, 18 had still not been discussed, and 4 had been removed from the Committee's consideration. The plans that were approved include about 94,000 housing units, but their construction has not yet started. The obvious drawback in the Committee's activity is due to the priority given to rapidly increasing the planning inventory, leading to insufficient emphasis on the regional implications (for example, the reduction in open areas) and other needs, such as public and private transportation, infrastructure and public institutions. Since the Committee does not deal with these aspects during the planning stage, they are dealt with only in the licensing and implementation stages, which creates delays.

Urban renewal

The VATMAL deals with large-scale plans, most of which are intended for outlying urban areas. They thus encourage suburbanization, which has negative implications for open and natural areas) and negative externalities (an increase in the use of private vehicles, air pollution and commuting time). In order to exploit built-up and developed areas in the high-demand urban centers, the government is encouraging urban renewal by means of the "vacate-and-build" method and National Outline Plan

³¹ Only about half of the land in the Tel Aviv district is owned by the State, and some of the housing is being built on private land. We do not possess data on the division of land reserves for building between private and State ownership.

³² The government intends to extend the activity of the Committee by at least one year.

³³ The law was approved in August 2014 with the goal of rapidly and efficiently accelerating the process of building plan approvals for residential construction on land that the government has declared as having priority for housing. This is part of a special planning framework that provides clear priority to the development of State land. The Committee was granted most of the powers of the National Council for Planning and Building, as well as the power to prepare plans that take precedence over other national outline plans, apart from National Outline Plan 35. A Priority Housing plan is applied primarily in the case of State land, and includes at least 750 housing units (in Arab localities it can also apply to private land and can include at least 500 housing units). In 2017, Amendment 4 was added to the law, making it possible to approve plans for lands with multiple owners, i.e. private land, and it was recently announced that the first project of this type will be implemented in Petah Tikva.

38.³⁴ In 2014, it was decided to create the Urban Renewal Authority, which would seek to remove the barriers to these projects and make the process more efficient. However, the Government Urban Renewal Authority Law was only approved in 2016, and the Authority received only a small budget relative to the complexity of its task (about NIS 80 million annually for 2017 and 2018).

The urban renewal projects face numerous bureaucratic hurdles, uncertainty, and the need to coordinate between many entities with differing interests, including the local authority, the developer and the home owners. To illustrate, the local authorities condition residential construction on

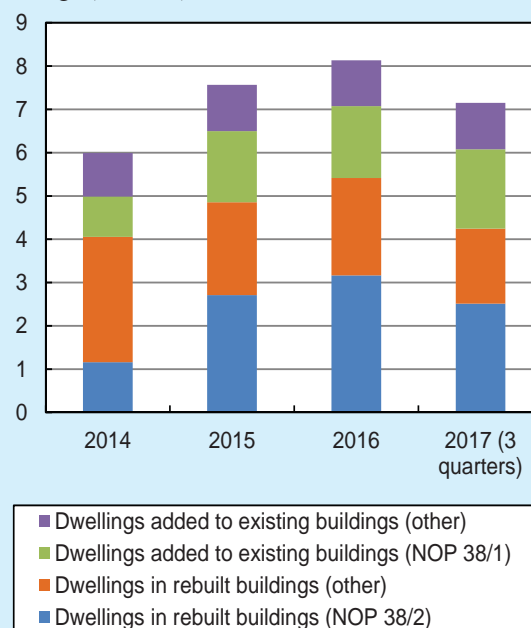
commercial construction (based on considerations of municipal tax revenues), but urban renewal usually involves only residential construction; the projects are economically worthwhile only in areas where the value of land is high, and are not worthwhile in the periphery; and the projects that involve demolition and reconstruction take a long time and require an interim solution for the residents. The government must find solutions to all these problems.

In order to assist developers and improve the profitability of the projects, it was decided to grant urban renewal projects an exemption from permit fees and to allocate additional land that adjoins the project (Decision 1519 of the Israel Land Council). In order to reduce the risk for residents and the costs of the developer, it was decided to implement “build-vacate-and-build”³⁵ in locations where adjacent land can be used. In order to meet the needs of the local authorities, the new Budgetary Arrangements

³⁴ Urban renewal also has several positive externalities: the renewal of the urban space, renewal of infrastructure, and the prevention of deterioration in older parts of the city with disadvantaged populations. However, it also has negative externalities, such as increased congestion on the roads, which sometimes cannot be widened. In addition, it is argued that urban renewal results in long-term residents being moved to hi-rise buildings that impose unaffordable maintenance costs on them.

³⁵ A project of this type gives residents a high degree of certainty that they will receive new homes before their old ones are demolished.

Figure 9.8
Building Starts in Urban Renewal Projects and Dwellings Added to Existing Buildings, 2014–2017:Q3 (thousand)



SOURCE: Central Bureau of Statistics.

Law proposes that they be allowed to expropriate floors for public use (such as daycare centers), rental apartments, hotels, etc. At this point, the small budget of the Urban Renewal Authority does not enable it to participate in projects to strengthen buildings in the periphery.

Figure 9.8, which is based on Central Bureau of Statistics data, illustrates the scope of implementation of the various urban renewal programs (including National Outline Plan 38 and “vacate-and-build”). According to a report written by the Urban Renewal Authority on National Outline Plan 38 (from which only partial figures have been released so far), during the 2005–2016 period, permits were granted for about 29,600 housing units in 1,592 buildings, and about 5,600 housing units in about 328 buildings were populated. The report also states that the scope of implementation is low in the periphery. It is worth mentioning that there is a major potential for the addition of new housing units in urban renewal projects, with the Strategic Plan for the Housing Market estimating this potential at more than 80,000 housing units by 2030.

Target Price and long-term rental

The previous government initiated two subsidized housing programs: Target Price and long-term rental. The former was decided on in 2014, but there were only two participating projects: one in Rosh Ha’ayin (which was recently populated) and one in Modi’in. In 2015 this program was cancelled in favor of the New Format Buyer’s Price program. The long-term rental program was launched with the establishment of the “Rental Home” government company at the beginning of 2015 and the National Planning and Building Committee for Priority Housing Areas Law allocates it about 50,000 housing units. So far, two projects—one in Herzliya and one in Ramat Hasharon (about 550 housing units)—have been populated, and another 14 projects are in various stages of development.³⁶

Buyer’s Price

The New Format Buyer’s Price program began operating in 2015, and it is meant to lower the price of a first home to those who are eligible³⁷ and to enable those with

³⁶ These are figures reported on the “Rental Home” website: two projects are in the formulation stage (in Tel Aviv and Haifa; about 550 housing units); five are in the planning stage to receive a permit (in Jerusalem, Rishon Lezion, Tel Aviv and Or Yehuda; about 1,270 housing units); four projects are in the tender stage (in Ramle, Shoham, Rishon Lezion and Be’er Sheva; about 730 housing units); two projects are in the post-tender stage (in Jerusalem and Holon; about 120 housing units); and in one project, registration has begun for the lottery (in Haifa; about 350 housing units). The count only includes housing units that will be rented out at a subsidized and regulated price.

³⁷ Young couples or singles aged 35 or older (and the handicapped from age 21) who did not possess land rights during the previous six years are eligible to participate in a lottery.

little self-financing to purchase a home.³⁸ This is accomplished primarily by means of subsidizing land (a discount of up to 80 percent), and in some cases providing grants to buyers and development subsidies for contractors. Recently, those upgrading their homes have also been allowed to participate in designated lotteries in projects where the marketing to first-time buyers has failed. The Israel Land Council has extended the program for another two years (2018–19).

As of the beginning of February 2018, more than 119,000 households were granted approval to participate in lotteries, and 42,869 of them won the right to purchase a subsidized home. Another 506 housing units are in the lottery stage. The Ministry of Finance's figures indicate that 8,250 subsidized homes were sold in 2016–17 (some of them as part of the Target Price program).

In order to meet the targets and award as many homes as possible, the lotteries have recently been carried out in the initial planning stages, at the stage in which the land is marketed to the developers and before the receipt of building permits, the development of infrastructure and the expansion of the number of dwellings in the project ("Sheves exemptions"³⁹).⁴⁰ As a result, there is a long period between winning the lottery and beginning the process of choosing an apartment⁴¹ and the actual handovers will occur only after a number of years.

Therefore, a change was made in the program such that it is not permitted to sell an apartment that was acquired as part of the program for 5 years from the receipt of Form 4 (occupancy permit) (a preexisting stipulation) or 7 years from the date of the lottery (a new stipulation), whichever is earlier.⁴² In order to increase the number of subsidized homes, the government decided to make it possible for developers to divert dwellings from the open market to the Buyer's Price program (and to provide a corresponding discount), and in exchange the Israel Land Authority would pay them an amount of no more than NIS 137,000 for each housing unit that is added to the program.⁴³ This initiative may add another approximately 1000 homes to the lotteries.

³⁸ The minimum down payment is only NIS 100,000 (and in the more remote periphery it is only NIS 60,000), and the maximum LTV for the mortgage financing (75 percent of the apartment's value) is determined by its market value (which is determined according to the valuation of an appraiser) as long as its value does not exceed NIS 1.8 million. (The mortgage is, of course, provided subject to the borrower's ability to repay it, which is determined by the lending bank.) These measures are meant to help young couples who cannot afford a home due to the down payment required. The size of the down payment has increased due to the rise in home prices and the 75 percent limit imposed by the Banking Supervision Department on the LTV for a first home.

³⁹ The original Sheves regulation made it possible to increase the number of apartments in a project by a rate of up to 30 percent, but only if the building area was not increased. In 2015, the Sheves regulation was amended to allow the building area to be increased by 20 percent.

⁴⁰ In the large-scale lottery held in December 2017, none of the participating projects had a building permit, and in some of them the tenders issued to the contractors had only recently been completed (including projects in Maale Adumim, Ashkelon, Maalot Tarshiha, Nahariya, Kiryat Bialik, Sderot, and Nahaf).

⁴¹ The contracts can be signed with the winners only after a building permit is received.

⁴² Israel Land Council Decision 1518, which will apply retroactively to all projects in the Buyer's Price program.

⁴³ Israel Land Council Decision 1518.

The lotteries that are part of the Buyer's Price program were recently held during the initial planning stages, and it will therefore be a long time between winning the lottery and occupancy of the apartments.

Several flaws have come to light in the program during its implementation, some of which have been corrected or are in the process of being corrected. Most of the flaws are related to planning⁴⁴ and the tendency of developers to choose a relatively low level of finish compared with the standard in the open market, with the goal of reducing costs. In response, rules were adopted that require the number of rooms to be appropriate to the size of the apartment⁴⁵, and that an elevator be installed in buildings of three stories or more. In addition, an obligatory technical specification was introduced that includes hundreds of clauses specifying the quality of various elements of an apartment, and rules were introduced to compensate buyers in cases where the contractor does not provide the entire specification he is required to (for example, compensation for a kitchen).

About one-quarter of all the winners choose to waive their right for one reason or another. According to Ministry of Housing data for 2016, the most common reasons for the waiver are related to the winner's inability to find an apartment that meets his needs (59 percent of those who gave a reason for their waiver), and difficulty in financing the purchase (38 percent). In general, the proportion of waivers in the periphery is higher than in the high-demand cities, partly because the subsidy is lower there.⁴⁶

At the same time, problems came to light in the tenders issued to the contractors. In 2017, there were tenders issued for 366 projects (some of which were issued more than once) but 136 of them (37 percent) were not awarded, in most cases due to a lack of price quotes and in some cases due to problems in the price quotes or because the contractor won a different project. Most of the projects for which there were no price quotes submitted are located in the periphery, while some are located in the Arab sector, although tenders also failed in high-demand and/or centrally located cities (Figure 9.9). Furthermore, the marketing of a site sometimes fails more than once (as in Ramle, Tiberias, Be'er Sheva, Kiryat Bialik and Beit Shemesh). It is possible that the contractors believe that the maximum prices in these tenders are low relative to the building specifications.⁴⁷ If there are no quotes submitted for the tender, the tender is sometimes rewritten with better terms, including the right to sell some of the apartments on the open market. Nonetheless, three such tenders—in Tiberias, Arad and Ramle—have failed.

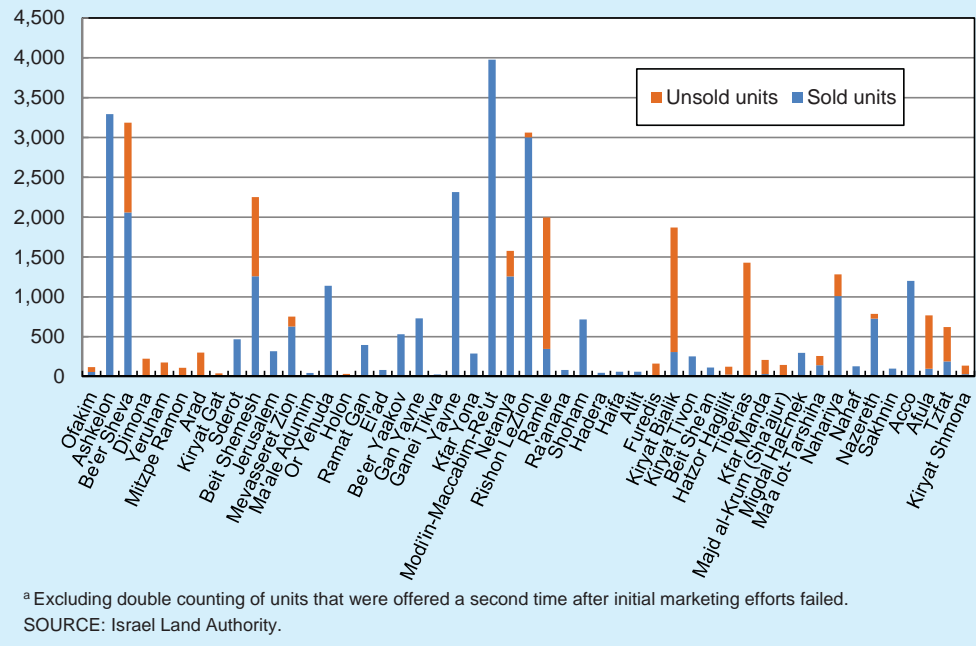
⁴⁴ For example, in a number of projects the number of rooms was small relative to the size of the apartment, since the Buyer's Price regulations specify that a price quote be given according to the size of the apartment rather than the number of rooms. In Yeruham, four-story buildings were planned with no elevator (in this case the local planning committee intervened).

⁴⁵ Every apartment must be at least 75 square meters in size, a 3-room apartment must be at least 90 square meters, a 4-room apartment must be at least 110 square meters and a 5-room apartment must be at least 125 square meters.

⁴⁶ Nonetheless, projects in Glil Yam and Herzliya also reported high rates of waivers due to the quality of the offered apartments and to the fact that they consist of large and relatively expensive apartments, which are not appropriate to the needs of young couples.

⁴⁷ The developers in Buyer's Price compete on price per square meter to the final customer, subject to a maximum price and mandatory building specifications that are determined by the State.

Figure 9.9
Results of "Buyer's Price" Land Tenders^a for Contractors, by Locality, 2017 (units)



In order to understand the possible reasons for the lack of success in marketing some of the land as part of the Buyer's Price program, we focused on cities in which the marketing failed, and assessed the results of the regular tenders (i.e. those not part of the Buyer's Price program) in 2017. The analysis produced mixed results, and it was therefore not possible to conclude that the tenders failed because they are part of the Buyer's Price program. Thus: (1) In some of the cities, the regular tenders were completely successful (Be'er Sheva, Rishon Lezion, Dimona, Kiryat Gat, Ma'alot Tarshiha, Kiryat Shmuna and Nazareth; there were also Arab towns in which the regular tenders were completely successful); (2) In some cities, the regular tenders were partly successful (Hatzor Haglilit and Majd al-Krum); (3) However, in others, and particularly in the periphery, they failed (Yeruham, Kiryat Bialik, Tzfat, and Netanya). In some of the cities in which the marketing of land failed, it was also the case that purchasers showed relatively little interest (in Kfar Manda, the number of interested buyers was less than the number of apartments).

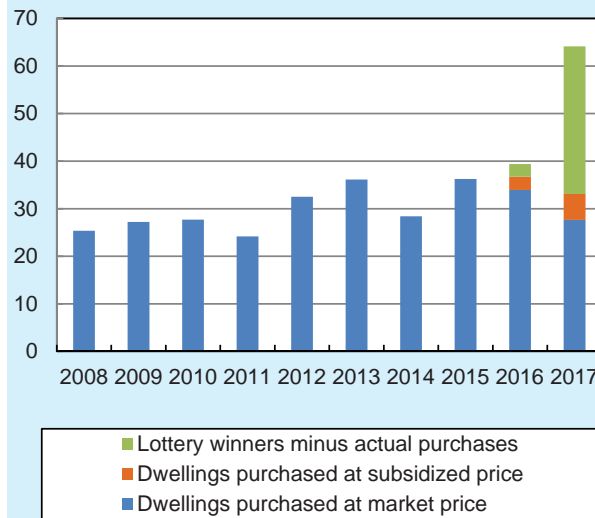
The government has invested significant resources in the Buyer's Price program. The Knesset Research and Information Center estimates that in 2015 the discounts on land led to a loss of revenue of about NIS 350 million, and in 2016 to a loss of NIS 1.3 billion, and that in 2017–18, the loss will be about NIS 2.1 billion each year.⁴⁸ In addition to the incentive to developers, it was decided to also provide an incentive to local authorities within whose jurisdictions projects would be marketed during the

⁴⁸ From A. Milner (2017), "An Analysis of the Discount to Eligible Buyers in the Buyer's Price Program", Knesset Research and Information Center, the Department for Budget Oversight. [Hebrew]

2015–19 period with a total scope of not less than 250 housing units.⁴⁹

The Buyer's Price program also has an impact on the demand for housing. Figure 9.10 shows that many of the first-time buyers (a population that usually meets the criteria to join the program⁵⁰) remained in the open market in 2016–17. However, it is possible that some of them left the open market, deferred their purchase, and participated in the lotteries. In addition, the graph presents an estimate of the potential buyers in the program (the winners of the right to purchase a home minus the actual buyers).

Figure 9.10
Transactions by First-Time Home Buyers and
Winners of "Buyer's Price" Lotteries, 2008–17
 (thousand)



SOURCE: Central Bureau of Statistics.

The Buyer's Price program has an impact on the demand for housing.

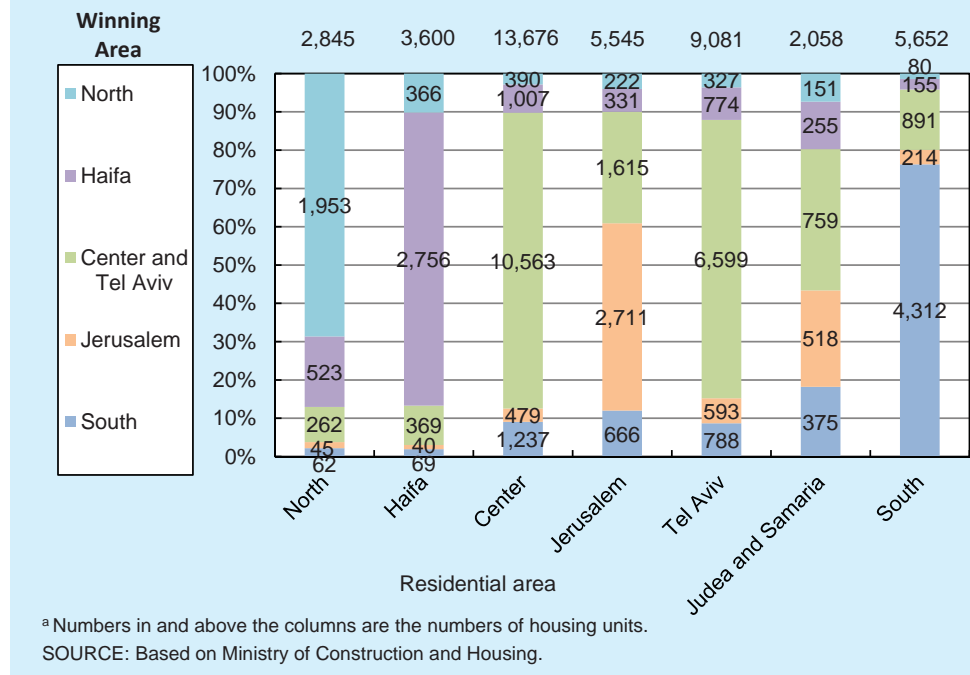
This group includes, among others, households that did not intend to purchase an apartment in the open market, or were pushed out of it by the rise in prices or because they were unable to finance the necessary down payment. Similarly, it is reasonable to assume that the program led eligible households to predate their demand, since it is unclear whether future governments will continue the program and because of the long period between winning the lottery and moving into the apartment. Although most of the winners in the lotteries receive the right to purchase a home in their area of residence, it appears that some of the winners have a tendency to participate in lotteries in distant locations (Figure 9.11), with the intention of renting out the apartment to local residents and selling it in the future at a profit. This approach involves significant risks, since it is not possible at the moment to predict future demand for rental housing in these cities (most of which are in the periphery) and it may not be possible for them to realize their plans.

On the other hand, and to the program's credit, the geographic distribution of the projects matches the distribution of households to a great extent. About half of the housing units that have so far been awarded by lottery are located in the Center and Tel Aviv districts.

⁴⁹ According to Israel Land Council Decision 1518. The incentive will be calculated according to the proportion of the value of the land per housing unit, minus part of the development costs.

⁵⁰ It is possible that some of the first-time buyers do not meet the criteria because they are too young or because they owned a home within the last six years.

Figure 9.11
Distribution of Lottery Winners by Residential Area and Winning Area^a



Umbrella agreements

A second extensive plan operated by the government—umbrella agreements with local authorities—is designed to address the supply side of the housing market by weakening local authorities’ negative incentives to increase their population.

Local authorities provide a range of diverse services to their residents, such as education, welfare, sanitation, municipal transportation, cultural and sport services, environmental protection, maintenance of public spaces and facilities, firefighting services, religious services, veterinary services, business licensing, and others. The operations of local authorities are funded by two-tier budgets: the ordinary part of the budget is used to fund ongoing activities (including salaries), while the extra-ordinary part of the budget is designated for development (construction of infrastructure and public buildings) and one-off expenses. The local authorities’ revenues are generated from the following sources: (1) self-generated revenues: amounts collected from residents and businesses in the form of municipal taxes, levies, and fees; fees for the use of municipal services; proceeds from fees set out in by-laws, and revenues from usage fees of the local government’s property (rentals, proceeds from property sales, etc.); and (2) funds from the national government’s participation in state services (education and welfare), and equalizing grants that the Ministry of the Interior grants

local authorities that meet specific criteria.⁵¹ Each part of the budget (the ordinary and extra-ordinary parts) has exclusive sources. For example, proceeds from land betterment tax⁵² can be used only to feed the extra-ordinary budget, while municipal tax revenues are only fed into the ordinary budget.

Local governments' independent revenues come primarily from municipal taxes collected on areas zoned for residential and non-residential (mainly commercial) uses. Municipal taxes are a tax but from the perspective of residents, municipal taxes represent a fee that residents pay for the diverse services they receive from the local government. Businesses receive a more limited basket of services than do residents. The Ministry of the Interior defines the permitted range (minimum and maximum) of municipal taxes for all types of real estate, and that range applies to all local authorities. In practice, the rates differ from one authority to another, and are defined in the Municipal Tax Order drafted by each local government council.

A local government whose jurisdiction contains extensive office and commercial areas benefits from high municipal business tax revenues. First of all, the municipal tax rate for businesses is higher than the residential tax rate (the minimum municipal business tax rate is twice the minimum municipal residential tax rate, and the maximum municipal business tax rate is more than three times higher than the maximum residential rate). Second, about 20% of all residents (including senior citizens, and individuals with disabilities or low income) are eligible for an exemption from or discount on municipal taxes, something for which there is no parallel regarding municipal business tax.⁵³ Third, the collection rate of municipal business tax is higher than that of municipal residential tax.⁵⁴ As businesses do not require most of a municipality's services, yet pay a relative high rate of tax, they create a cross-subsidy for the services provided to households.⁵⁵ For these reasons, local authorities seek to attract as many businesses as possible into their areas, and are less enthusiastic about developing real estate for residential uses.

The planning system in Israel allows local authorities to put into practice their preferences for real estate development for business uses. First, local authorities are involved in the development of outline plans and zoning. Second, local authorities

Municipal business tax is high, and also subsidizes services provided to households. As a result, the local authorities prefer commercial real estate to residential real estate.

⁵¹ The equalization grant is designed to help local authorities guarantee a basic standard of services to their residents. Eligibility for an equalization grant is based on criteria that were first defined in the 1993 recommendations of the Suary Committee. In 2000, the Gadish Committee redefined the formula for the grant with the aim of balancing the need to ensure basic services to residents with the need to incentivize local authorities to improve their efficiency.

⁵² Land betterment tax is the payment that a property owner is required to pay as a result of planning changes that increase the property value, such as rezoning and increased building rights.

⁵³ K. Harel, "A Mess Called Municipal Tax: Focusing on Municipal Taxation in Israel and Proposals for Change," Milken Institute, 2004.

⁵⁴ H. Feder, "The Effect of Economic, Social, and Political Characteristics on Municipal Tax Collection Rates in Local Authorities," Hebrew University, Federman School of Public Policy and Government, 2007.

⁵⁵ Arguably, a relatively high municipal business tax constitutes compensation for the environmental nuisance that businesses potentially create within residential neighborhoods.

are involved in defining the infrastructure requirements that constitute a condition for the construction of new neighborhoods. Third, as the authority that issues building permits and other approvals to contractors, the local government can affect the pace of residential real estate development in its jurisdiction by controlling the bureaucratic procedures on which such development depends. The economic distortion created by the gap between municipal business and residential tax rates affects housing prices, since tax revenues constitute an important consideration in local authorities' decision to zone areas for business or residential uses.⁵⁶

Furthermore, local governments have a negative incentive to attract residents with a weak socioeconomic background and groups that are extensive consumers of municipal services (such as young families or the elderly), and prefer instead to attract high-income residents. As the local governments control the mix of residential construction, they can divert the housing supply to more expensive and upscale housing (private homes in contrast to hi-rise buildings, or larger rather than smaller apartments) and thereby affect the type of population that lives within their boundaries.

Local authorities with few commercially zoned areas and a large disadvantaged population are hard-pressed to provide adequate services. This, in turn, creates an incentive for more affluent groups to leave, and weakens the situation of these local authorities further. The government equalization grant is designed to bridge the gaps between a local government's potential revenues and its minimal normative per capita expenses, to ensure that all residents receive a basic basket of services. The grants are calculated according to a formula that includes an element of distributive justice. The formula takes into account the size and composition of the population (number of children and number of elderly individuals), its socioeconomic classification, and

⁵⁶ See Z. Eckstein, A. Tolkovsky, A. Eizenberg-Ben Lulu, and Y. Sherman, "Do Local Authorities Have a Negative Incentive to Increase their Populations?" Gazit-Globe Institute for the Study of Real Estate, 2014. The authors argue that given the assumptions underlying the single-center urban model, and the assumption that residential and commercial properties entail identical construction costs, the difference in the price of land for different uses is not justified. If such a difference emerges, it apparently stems from a restriction on the supply of land for residential uses and from a disruption to the highest bidder principle. Between 2003 and 2012, such a difference emerged. No significant change occurred in the per-square-meter price of commercial areas but the per-square-meter price of residential areas (in the Jewish sector) rose by 40%. The Israel Land Authority and the Ministry of the Interior are not responsible for this difference, because they have no preference for residential or commercial use of land. In contrast, local authorities have a negative incentive to approve residential construction. Moreover, local authorities, especially those in a stronger financial position, have no incentive to increase their housing supply because it would possibly dampen prices, attract weaker population groups, and potentially reduce their municipal tax collection rate (S. Fitusi, A. Yakir, and M. Sarel, "Breaking Through the Housing Barriers in Israel. Part 2: The Roles and Preferences of the Local Authorities in Developing Residential Real Estate," Kohelet Policy Forum, 2015).

unique needs (such as unique security needs), while municipal tax is calculated only on the basis of the property's area.^{57,58}

In recent years, the government has introduced several measures designed to reduce the local authorities' negative incentive for residential construction. In 2008, the Ministry of Construction began awarding subsidies to local authorities to finance development work for public-initiated residential construction projects in localities in Preference Area A. In 2013, in order to promote residential construction in more expansive areas, including high-demand areas, the government began signing umbrella agreements with local authorities. Since then, close to 30 umbrella agreements have been signed, with the potential to expand supply by about 336,000 housing units (Table 9.2). In these agreements, the government undertakes to finance the infrastructure and the public buildings required for new neighborhoods, while the local authorities undertake to issue building permits within a defined period and expedite approvals for the building plans and the construction of the infrastructure. Government subsidies make it possible to remove barriers and execute longstanding plans for building residential neighborhoods by providing the means for building critical infrastructure, bridges, intersections, etc. The cost of these agreements includes the cost for land (loss of revenues), development and infrastructure, public buildings, and additional funds and grants. So far, NIS 10 billion of budget for development and public buildings has been used. In 2014, the government added another measure to the two measures described above: It decided to establish a mechanism to incentivize local authorities to issue building permits, even if no umbrella agreement is in place.⁵⁹

In the first stage of their implementation, umbrella agreements benefit local authorities, not only by facilitating the construction of infrastructure for new neighborhoods, but also by facilitating the development and renewal of infrastructure in old neighborhoods, because these agreements permit the local authorities to use the funds that feed their development budgets (the development fees that contractors pay while the land is being marketed, land betterment tax, levies, etc.) for this purpose.⁶⁰

While the umbrella agreements make it possible to develop and renew infrastructure, they may create problems that will become apparent only after occupancy.

⁵⁷ In effect, the grant is lower than the amount calculated according to the Gadish formula, for several reasons including state budget constraints. Between 2010 and 2015, for example, grants awarded were 13% lower than the calculated amount, on average (See T. Agmon, "An Analysis of the Equalization Grants in the Local Authorities in the Years 2014-2015," Knesset Research and Information Center, 2016).

⁵⁸ This document does not discuss the municipal tax or equalization grant formulas. Implementation of the umbrella agreements will apparently require a change in the municipal tax formulas in order to reduce the cross-subsidy between local authorities' revenue sources, and to match the municipal residential tax rate to the cost of services that local authorities provide to the public.

⁵⁹ According to Government Decision No. 1533 (HC/44), such a local government may receive between NIS 7,000 and NIS 12,000 for each housing permit issued in excess of the average number of building permits issued between 2010 and 2012, if the number of housing units that it approved in that year (1) is not lower than 200, and (2) is at least 10 percent higher than the average number of annual permits issued between 2010 and 2012. An annual cap was defined for the grants—no more than 12,000 housing units in all eligible local authorities. Local authorities that signed an umbrella agreement must meet other criteria to become eligible for the grant.

⁶⁰ This situation exists in all land marketing efforts, but the umbrella agreements involve more extensive construction, and therefore, higher revenues.

The umbrella agreements may, however, create problems that become evident only in the second stage of execution, when the new neighborhoods are occupied and the local authorities are obligated to provide services to an increased number of households, but the added revenues from municipal residential taxes and the equalization grant are insufficient to cover the added costs required to provide municipal services at the current standard. To continue to provide such a standard of services, the local authorities must add office and commercial areas in order to maintain the ratio between commercial and residential areas.

As we will see below, the umbrella agreements frequently add a large number of housing units relative to the size of a locality, but many localities are unable to support a corresponding increase in their commercial and office areas, either because their land reserves are limited, or due to their proximity to larger and major localities.⁶¹ These considerations become even more valid when umbrella agreements are signed with several adjacent localities (such as the group that includes Be'er Yaakov, Ramle, Lod, and Rishon Lezion, or the group that includes Ashdod, Ashkelon, and Kiryat Gat). Although most umbrella agreements also include additions to commercial and employment areas, it must be examined whether these areas are sufficient and whether they are justified on the basis of the projected level of future demand for them. It is possible that budget constraints will force some local authorities to consolidate in order to utilize economies of scale.

We examined the chances of success of the umbrella agreements signed between 2013 and 2017. We examined the local authorities' potential to realize the agreements (that is, to increase the number of housing units in accordance with the agreements) through several indicators of the local authorities' financial state. As evident from Table 9.2, the local authorities that signed an umbrella agreement can be divided into three groups, based on potential expansion. The first group includes nine localities in which the agreements will at least double their current population. Although the agreements will be implemented gradually, it is reasonable to assume that these localities will be challenged to absorb such a significant addition to their population without government aid, because their financial position is already fragile: Six are undergoing a rehabilitation or streamlining program and only one is considered financially stable. In several, business tax revenues account for an extremely small share of their total tax revenues.

The second group includes localities that can increase the number of housing units by 50–100 percent. This group includes eight local authorities: two are financially strong, two are stable, three are in a fair financial position, and one is undergoing a streamlining program. In all the localities in this group, municipal business tax revenues as a share of total municipal tax revenues are above the median, and almost all eight are in the top quarter (with municipal business tax revenue accounting for more than 20 percent of total municipal tax revenue). If incoming residents are absorbed gradually, and the

⁶¹ For example, Tirat Hacarmel is adjacent to Haifa; Yavneh to Rehovot; Rosh Ha'ayin to Petah Tikva; and Ofakim and Netivot are proximal to Be'er Sheva.

process is accompanied by an appropriate addition of commercial and employment areas, the umbrella agreements may succeed in the stronger localities in this group. If, however, the umbrella agreements upset the balance between business and residential tax revenues, they may have a debilitating impact on the financial positions of these localities.

The third group includes 11 local authorities, in which umbrella agreements will add less than 50 percent of the number of existing housing units. Five of these are financially strong local authorities, three are stable, and the financial position of three is fair. In all but two local authorities, self-generated revenues account for more than half of their total revenues, and the share of business tax revenues is above the median in all 11 local authorities in this group. It is likely that the local authorities in a good financial position will successfully absorb new residents, provided that they add sufficient commercial and employment areas.

The above analysis indicates that extensive umbrella agreements have been signed with financially weaker local authorities that are already hard-pressed to provide high-quality municipal services. It is reasonable to assume that the realization of these agreements will require an increase in the government's share in financing municipal services (through equalization grants) or an increase in municipal tax revenues. However, it is not certain that the agreements with the financially weaker local authorities will be realized at all, as a demand for housing in them may fail to develop. The government recently approved an amendment to the resolution concerning the umbrella agreements that are to be signed with local authorities in 2016–2018, which provides that a survey of the demand for housing must be conducted before any agreement is formulated, in order to confirm the feasibility of marketing the number of housing units defined in the agreement.⁶² Umbrella agreements have a greater chance of success in financially strong local authorities, but the agreements also have the greatest potential to harm the financial position of these authorities by disrupting the existing balance of business to residential tax revenues.

⁶² Government Decision No. 3260 (HC/167).

Table 9.2
Local authorities with which umbrella agreements have been signed:
Their potential to properly absorb the additional residents based on their financial characteristics

Local Authority	Number of dwellings in the umbrella agreement	Number of dwellings in the umbrella agreement relative to number of existing dwellings	Self-generated revenue as a share of the authority's total revenue (percent)	Municipal tax revenue as a share of total revenue in the ordinary budget (percent)	Municipal residential tax collection rate (revenue as a share of charges) (percent)	Municipal residential tax charges as a share of total municipal tax charges (percent)	Municipal business tax charges as a share of total municipal tax charges (percent) ^a	Socio-economic index cluster in 2013 ^b	Rating of the local authority's financial state in 2015	Per capita surplus/deficit in 2015 (NIS)
Be'er Yaakov	11,653	2.18	37.8	42.8	90	34.1	14.2	7	Streamlining	5.8
Ofakim	14,436	1.89	30.5	22.0	55	62.9	11.9	3	Rehabilitation	-84.9
Netivot	13,103	1.76	25.8	21.1	41.7	57.5	23.9	3	Streamlining	-105.2
Dimona	21,000	1.75	43.5	38.2	43.5	58.8	2.7	4	Streamlining	60.4
Tirat HaCarmel	10,160	1.42	56.6	47.0	22.2	32.4	31.4	4	Intermediate	107.6
Sderot	10,100	1.42	33.5	13.3	59.6	43.6	12.9	4	Rehabilitation	-7.7
Yavneh	15,479	1.22	55.8	55.1	78.2	43.1	8.7	6	Intermediate	17.3
Eilat	18,372	1.00	54.9	52.8	75.5	26.2	23.5	6	Streamlining	-272.0
Acco	15,536	0.98	51.5	31.0	45.5	44.4	18.4	4	Stable	12.7
Ma'alot-Tarshiha	5,545	0.82	41.4	32.4	85.9	56.1	20.0	5	Streamlining	30.0
Lod	17,090	0.77	41.4	41.8	53.6	38.3	31.2	4	Intermediate	308.9
Rosh HaAyin	9,436	0.77	52.8	46.9	77.6	40.4	33.7	7	Strong	78.4
Ashkelon	31,791	0.70	51.7	44.6	75.4	39.2	21.9	5	Strong	15.4
Migdal HaEmek	5,647	0.67	47.4	38.2	88.8	37.3	16.4	4	Stable	1.3
Afula	10,496	0.63	44.8	41.3	72	40.1	29.2	5	Intermediate	4.7
Beit Shemesh	13,007	0.63	44.8	36.8	63.6	54.7	16.2	2	Intermediate	-116.5
Modi'in-Maccabim-Reut	11,804	0.51	39.6	42.6	96.7	65.6	24.6	8	Stable	1.7
Or Yehuda	5,020	0.48	57.5	44.0	88.2	42.8	28.7	5	Stable	-93.0
Kiryat Bialik	7,253	0.47	64.5	43.4	73	56.7	16.9	7	Stable	25.8
Ashdod	30,046	0.46	61.2	48.5	90.6	41.0	29.2	5	Strong	6.1
Nahariya	9,139	0.45	54.0	37.8	68.8	58.5	20.0	6	Intermediate	-28.2
Kiryat Gat	6,442	0.40	44.7	37.9	49.9	39.7	18.5	4	Intermediate	-287.3
Ramle	7,483	0.35	51.4	42.0	68.4	37.6	28.6	4	Intermediate	-160.0
Be'er Sheva	18,140	0.24	57.4	47.2	94.7	42.9	28.9	5	Strong	19.6
Rishon LeZion	17,939	0.23	43.8	42.1	83.2	48.0	29.0	7	Strong	1.8
Herzliya	7,443	0.22	56.4	57.6	85.3	41.0	30.8	8	Strong	190.6
Netanya	12,888	0.18	58.4	45.5	80.6	56.9	20.5	6	Stable	1.5
Haifa	7,000	0.06	54.5	50.2	64.5	40.1	36.5	7	Strong	7.8
Total	363,448									

^a The distribution of the figure on Municipal business tax charges as a share of total municipal tax charges (the percentiles appear in the upper row):

	10%	25%	50%	75%	90%
	3.8%	6.7%	11.5%	20.0%	28.6%

^b The index's values range from 1 to 10, with 1 being the lowest cluster.

SOURCE: Based on Central Bureau of Statistics.

