Regional Science and Urban Economics 66 (2017) 150–174

Contents lists available at ScienceDirect

Regional Science and Urban Economics

journal homepage: www.elsevier.com/locate/regsciurbeco

Removal of renter's illusion: Property tax compliance among renters and owner-occupiers☆

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ARTICLE INFO

JEL codes:
H23
R21

Keywords:
Local property tax
Rental externality
Financial compliance
Moral hazard

ABSTRACT

Several countries provide tax benefits that favor owner-occupiers over renters. The objective of the current study is to examine a potential justification of this policy. We compare the propensity to pay local property tax among owner-occupiers and renters. The Israeli setting provides a unique example for the removal of "renter's illusion". Unlike other countries, municipal property tax charge is registered and paid directly by renters. Consequently, this methodology provides a tractable measure for the degree of financial compliance in renter-occupied units. Micro-level panel data collected from the Jerusalem municipality covering 2012–2014, demonstrate that compared with free-market renters, owner-occupiers without partial exemptions paid 11.95% more of the current local property tax charge, a statistically significant difference. This gap remains robust even after adjustment to the same level of income, age, number of children, location (West vs. East Jerusalem), and the same annual lagged percentage of paid charge. Moreover, the highest gap of 10.63% is found among 20-year-old tenants. Finally, the estimated increase in tax collection associated with tenure mode shift is 0.01–0.77% of the total anticipated collections in 2015. Research findings thus demonstrate the utility of programs designed to motivate renters to become owner-occupiers, particularly among the youngest households without children.

1. Introduction

Previous real estate literature has identified accelerated physical deterioration of renter-occupied dwelling units, compared with owner-occupied ones, and provided several possible explanations. Henderson and Ioannides (1983), for example, defined rental externality as the tendency of renters to over-utilize the housing units due to lack of interest in accruing future asset values.[1] On the other hand, the literature on rent control stressed the disincentive of landlords to maintain the units due to protection against eviction of tenants who occupy rent-controlled units as an alternative explanation (e.g., Arnott, 2003; Seko and Sumita, 2007; Malpezzi, 2008).[2]

The focus of the current study is an alternative measurement of rental externality, namely, the comparison of financial compliance of local property taxes between renters and owner-occupiers.[3] This methodology provides a tractable measure for the degree of renter externality in renter-occupied units, independent of housing quality. Given the extra maintenance costs incurred by the landlord, which the renter should have paid instead, over-utilization of the asset is considered as a negative externality (Henderson and Ioannides, 1983). Consequently, evasion of payments for utilities and property tax, as well as avoidance of reports to the landlord on maintenance problems, are other examples of rental externality.

The Israeli setting provides a unique opportunity to investigate the removal of "renter's illusion" (see, for example, Blom-Hansen, 2005; Oates, 2005; and Brunner et. al., 2015). Unlike US law, where the landlord bears the direct legal obligation to pay the property tax,[4] under Israeli law, the obligation to pay local property taxes falls on the "holder," who becomes the assessee on the municipal tax rolls.[5] Consequently, unlike other countries, the Israeli legislation unintentionally created a unique system, in which the renter, instead of the landlord, bears the full cost of the local property tax charge. Not only

☆ The authors would like to thank the Jerusalem Municipality for provision of project data, and to Yifat Arbel, Danny Ben-Shahar, Dan McMillen (the editor), Edgar Olsen, Stuart Rosenthal, two anonymous referees, and the participants of the 2016 Israel Regional Science Association Meeting for helpful comments.

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[1] Harding et al. (2000) provide other possible explanations for lack of investment in real-estate assets. They distinguish between owners with high and low LTV.
[2] Iwata and Yamaga (2008) provide evidence that compared with free-market renter-occupied units, the quality of rent-controlled units in Japan was found to be significantly lower.
[3] White (1986) stressed the accumulation of local property tax charge as an important factor in motivating the decision of landlords to abandon the real-estate assets in New-York.
[4] Consequently, American renters never see a tax bill and simply assume that they don't pay local property taxes – a phenomenon called "renter's illusion" (see, for example, Banzhaf and Oates, 2013).
[5] See Law for Budgetary Reform, 1993, Section 8(a). The original Hebrew version is available at:http://www.nevo.co.il/law_html/Law01/72981.htm.

http://dx.doi.org/10.1016/j.regsciurbeco.2017.05.008
Received 30 October 2016; Received in revised form 11 May 2017; Accepted 23 May 2017
Available online 06 June 2017
0166-0462/

that the Israeli renters view the exact amount of property tax assessed on their residence, in normal state of events municipal property tax charge is registered and paid directly by the Israeli renters. Only if the renter evades payment, and he or she vacated the unit and cannot be located, according to the common legal practice and the Israeli Land Law from 1969, the registered homeowner becomes the "natural holder", who bears the full obligation to cover the fee.[6] Thus, the collection rate defined as the *PAYMENT–ARNONA_NET* ratio reflects fully the coverage ratio of the local property tax charge for both renters and owner-occupiers.[7]

Consequently, the manifestation of rental externality is different from the classical definition in the literature. From the landlord's point-of-view, a type of assumed moral hazard emerges, namely the probability of either early termination of the lease or accrued charge to the municipality at the end of the lease, without full payment of local property-tax and other charges. [8] In that context, in the United States landlords can potentially offer two types of rental contracts. One that has a sufficiently high monthly rent but with no security deposit, and the other that has a lower rent but with a large up-front security deposit. Tenants who are likely to evade their taxes would self-select into the former contract (high rent without deposit), thereby tax evading tenants would choose higher rent (or smaller security deposits) properties all other things held constant (e.g., Benjamin et al., 1992, 1998).

The economic literature on tax compliance stresses the tendency of individuals to evade tax payments in the absence of audits and fines for tax evasion (e.g., Allingham and Sandmo, 1972; Chung, 1976; Dawes, 1980; Messick and Brewer, 1983; Srinivasan, 1973). Yet, the extent to which audits and fines can actually deter evasion remains an open question (for reviews of the literature see Andreoni et al., 1998; and Kirchler, 2007).[9] In that context, the Israeli rental market provides a strong incentive structure for renters to evade property-tax payments. This is because of lack of interest in the asset on the one hand, and the short duration of the typical free-market rent contract on the other hand - one-year with a bi-lateral option to extend the contract an additional year.[10]

To assess this scenario, we employ a micro-level panel data collected from the Jerusalem municipality, covering 2012-2014. We limit the sample to include only owner-occupied units and renter-occupied units used by individuals for residence. The renter-occupied units are rented either in the free market, or are under rent-control.[11] We exclude units occupied for business purposes.

Results show that compared with free-market renters, owner-occupiers' (rent-controlled) property tax annual charge was significantly higher by 15% (9%). Yet, compared with free-market renters, owner-occupiers (rent-controlled) renters without exemption paid 11.95% (8.50%) more of the current municipal property tax charge in Jerusalem, a statistically significant difference. Our findings may thus suggest that compared with owner-occupiers and tenants in rent-controlled units, financial compliance of renters in free-market units is lower. This may be explained on the basis of longer lease contracts in rent-controlled units.

Our findings further suggest that compared with free-market renters, owner-occupiers have better financial compliance even after adjustments to the same level of income, age, number of children, location (West vs. East Jerusalem), and the same annual lagged percentage of paid charge. These differences in financial compliance are particularly prominent among young households without children. Compared with 20-year-old renters, tax collections from 20-year-old owner-occupiers is significantly higher by 10.63% in West Jerusalem. Compared with renters without children, tax collections from owner-occupiers without children is significantly higher by 7.23% in West Jerusalem.

Oates, 2005 estimates the renter effect, i.e., the increase in local jurisdiction's spending on local services, along with the larger the proportion of renters among their residents in Michigan, by 10%. The author suggests reforming the administration of the property tax so that changes in property tax liabilities on rental dwellings are directly and visibly transformed into changes of monthly rental payments. Interestingly, the Israeli setting permits an observation on the behavior of renters with the removal of renter's illusion, namely, following the application of Oates' suggestion. Under such circumstances, for the entire sample, the increase in projected tax collections associated with a tenure mode shift from renters to owner-occupiers is estimated at 0.01–0.77% of the total anticipated collections in 2015. Research findings thus provide justification to public policy, which favors owner-occupiers over renters, and demonstrate the utility of programs designed to motivate renters to become owner-occupiers, particularly those directed toward younger households without children.[12]

Regarding the higher level of financial compliance of owner-occupiers, Rossi and Weber (1996) and DiPasquale and Glaeser (1999), showed that homeownership commonly tends to be tied to civic participation and community involvement. Arbel et al., (2012) extended these findings to include FSU immigrants to Israel. Unlike previous literature, however, the current study provides evidence with a higher level of reliability for the lowest degree of free-riding among owner-occupiers. This is because unlike previous literature, our data-set is not based on self-reported information obtained via questionnaires filled-in by participants, but rather on municipal-information regarding actual collection of local property taxes from all the residential real-estate assets in Jerusalem.

The outline of the paper is as follows: Section 2 provides background and descriptive statistics on Jerusalem. Sections 3 and 4 describe the general characteristics of financial compliance in Jerusalem, and the incremental tax collection associated with a tenure mode shift from renters to owner-occupiers. Section 5 supplements the control variables. Finally, Section 6 provides a summary and concluding remarks.

2. Jerusalem: background and descriptive statistics

Jerusalem is the capital of Israel, and the country's largest city with a population of almost 830,000 persons in 2013 (http://www.cbs.gov.il/publications15/local_authorities13_1609/pdf/224_3000.pdf

[6] See Land Law, 1969, definitions, Section 2. (the original Hebrew version is available at: http://www.nevo.co.il/law_html/Law01/286_001.htm). Given the short period of lease contracts in the free market, this moral hazard issue might become imminent for landlords in Israel.

[7] Arnona is the Hebrew terminology for local property tax charge. Arnona-net implies that the charge is the balance for payment after discounts.

[8] Note the difference between the legal obligation to cover the local property tax charge, and the breach of the lease contract by the renter. Also note the awareness of landlords to this moral-hazard problem. The common practice among landlords is to require some form of security from the renters, such as, security (post-dated) checks, and bank collaterals. These means, however, do not provide full protection against the risk that renters will not pay the charges.

[9] Kastlunger et al. (2009) study the effect of different audit patterns on future tax compliance via two experiments. Results confirm that early audit experiences lead to increased tax compliance.

[10] Along similar lines, in his review, England (2016) mentioned the failure of previous tax incidence literature to address the vacancy rates, namely the portion of unoccupied units of the existing stock of housing units. Rosen and Smith (1983) found negative and significant partial correlations between vacancy rates and rent increases across 14 US cities. This outcome further stresses the higher bargaining power of renters.

[11] Of the 67,081 units in Jerusalem employed for residence and without any exemption from local property tax, less than 1 percent (only 132 units consisting of 0.20%) are under rent-control. The outcomes of this study show that tenants in units under rent-control exhibit a better financial compliance than renters in the free market (see Tables 2A-2C).

[12] As demonstrated by Kurban et al. (2012), Chicago owner-occupied households without children almost fully subsidize the public education system, namely, households with children, who are the only beneficiaries from this system. If these findings apply to Jerusalem, then the proposed emphasis on households without children may provide an additional advantage to Jerusalem municipality.