Direct Taxation in Israel: Elements, Distortions and Proposals for Change

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This paper reviews the background history of direct taxation in Israel, analyzes Israel's taxation strategy and principles, as they have been established in the past generation, and discusses the salient features of all types of direct taxation in Israel – including international comparisons, the main tax exemptions, economic efficiency and more, describing current conditions, pointing out flaws and recommending change when deemed necessary.

The **first chapter** gives the general background, and the **second chapter** focuses on the history of direct taxation in Israel.

The **third chapter** describes Israel's direct taxation strategy.

The **fourth chapter** outlines individual income tax, and the **fifth** presents corporate tax and other direct taxation.

The **sixth chapter** provides a summary and recommendations.

Summary:

The general goal of taxation is the transfer of resources from the private sector to the public one, in order to provide public services such as infrastructure, healthcare, education, security and welfare. Taxation includes all obligatory payments, from income tax to tolls. As a general rule, the reduction of direct and indirect taxation has a positive effect on economic activity, but the "revenues" from such increase in economic activity are estimated to average only about one-third of the loss of revenue from the reduced tax rates. Hence, a reduction in tax rates generally requires a long-term reduction in government expenditure.

Given the economic budgetary constraint (budget deficit and national debt) under which countries are "required" to maintain financial stability, the total tax burden of the state should be roughly similar to the difference between the weight of public expenditure relative to GDP, and government revenues that are not tax based (such as dividends from state-owned companies). Therefore, the decision on tax rates and the expected revenue from taxation is derived from the decision on budgetary expenditure; the ability to finance part of it through deficit is very limited in scope – especially in the long run.

While North European countries tend to have higher tax burdens in order to finance broad public spending, others, like the US and Korea, tax at lower rates and spend less, so that their citizens pay more out of pocket for services like healthcare and education. Israel spends relatively more on security than the rest of the world and has preferred to minimize the weight of public spending to maintain budgetary stability.

The tax burden in Israel is relatively moderate and close to the OECD average (around 32% of GDP), but higher than several East Asian, non-OECD members with developed economies (such as Singapore). However, while the total tax burden is similar, the structure is different. Direct taxation is low : 18% of GDP compared to an OECD average of 22%. The tax burden of indirect taxes (mainly VAT and fuel and vehicle taxes) is relatively high: 14% of GDP compared to an OECD average of 9%.

Direct taxation in Israel includes income tax for individuals and companies, capital gains and betterment taxes, financial and nonprofit VAT and national social security (*bituach leumi*) payments by employers and employees. Direct taxation is progressive for the most part (i.e., higher for higher incomes), while indirect taxation tends to be regressive. Personal and corporate income taxes in Israel are extremely progressive in their application, while the indirect taxes vary (e.g., cigarette taxation is regressive while car sales are progressive).

In general, the direct taxation system in Israel is functioning well, both theoretically and practically: it has successfully lowered the income tax rate and adjusted to the global economic model, and maintains high progressivity and a moderate level of friction with the public. However, the goal of a simple, fair and relatively equal tax system was not achieved, and the tax policy continues to prefer sectors and areas to no economic or social benefit. In addition, although Israel has succeeded in expanding its tax base by including foreign income and reducing the activities of shell companies, there is still extensive work to be done on the issue of tax evasion and increasing public awareness of the need to pay taxes truthfully.

Recommendations:

- The top marginal tax rate for individual income should be reduced from 50% to 45%, in line with the average of developed countries.
- At the same time, unjustified tax exemptions and preferences should be eliminated - they create a complicated and unfair tax system.

- Consider changing the method of granting tax incentives to promote pension saving. In addition, the tax benefit in the accumulation phase of study funds (*keren hishtalmut*) should be canceled.
- Cancel the tax exemptions granted to the Jewish National Fund and the Caesarea Foundation.
- Abolish the 1985 Eilat Free Trade Zone Law.
- Reduce and limit the tax incentives in the Encouragement of Capital Investment Law: (i) set a rule under which the effective tax rate on any company that benefits from the law shall not drop below 8% in development areas and 12% in the central districts; (ii) set a rule under which the aggregate tax benefit in a given year shall not exceed the company's aggregate cost of employment; (iii) cancel the tax benefit on dividend income and entitlements for accelerated depreciation.
- Cancel the tax allowance for shift work and the gender-based tax benefits for women and reduce several other tax benefits.

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