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How to Improve Taxes and Transfers in Israel

Philip Hemmings

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By Philip Hemmings

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ABSTRACT/RÉSUMÉ

How to improve taxes and transfers in Israel

Ensuring tax and transfer systems bring sufficient revenue to reach macroeconomic fiscal targets, address societal goals in re-distribution and social welfare, recognise the influence taxation has on businesses' competitiveness and adequately address environmental externalities is a tough challenge, arguably more so in Israel than in many other OECD countries. High interest payments and large defence spending make deficit and debt reduction more difficult, socio-economic divides remain wide and as a small-open economy Israel is highly exposed to mobile international capital and competition over international investment. And, as elsewhere, the incorporation of environmental issues into the tax system remains only partial. This review examines ways forward for policy on several fronts: indirect taxation; household income tax and social benefits; taxes on property and wealth; business taxation; and evasion, avoidance and administration issues. This Working Paper relates to the 2013 *OECD Economic Review of Israel* (www.oecd.org/eco/surveys/economic-survey-israel.htm).

JEL classification codes: H23, H24, H25, H26, H53, I38

Keywords: Israel, taxes, transfers, subsidies, environmental taxation, welfare, company tax, pensions, tax evasion, tax avoidance, tax administration

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Comment améliorer le système de prélèvements et de prestations en Israël

Les autorités doivent veiller à ce que le système de prélèvements et de prestations permette de dégager des recettes suffisantes pour réaliser les objectifs budgétaires retenus à l'échelle macroéconomique, d'atteindre les objectifs sociétaux visés en termes de redistribution et de protection sociale, de prendre en compte l'influence exercée par la fiscalité sur la compétitivité des entreprises, et de gérer de manière adéquate les externalités environnementales. L'ampleur de la tâche est redoutable, et elle l'est sans doute encore plus en Israël que dans de nombreux autres pays de l'OCDE. La lourdeur des charges d'intérêts et le volume des dépenses de défense rendent la réduction du déficit et de la dette plus difficile, les fractures socioéconomiques restent larges et, en tant que petite économie ouverte, Israël est fortement exposée aux effets de la mobilité des capitaux internationaux et à la concurrence que se livrent les pays pour attirer les investissements internationaux. En outre, comme ailleurs, l'intégration des questions environnementales dans le système d'imposition reste partielle. Nous examinons dans cette Étude les possibilités d'améliorer le cadre d'action publique sur plusieurs fronts : les impôts indirects, la fiscalité des revenus des ménages et le système de prestations sociales, les impôts sur la propriété immobilière et les autres formes de patrimoine, la fiscalité des entreprises, les problèmes de fraude et d'évasion fiscales, ainsi que les questions d'administration de l'impôt. Ce Document de travail se rapporte à l'*Étude économique de l'OCDE d'Israël 2013* (www.oecd.org/fr/eco/etudes/israel-2013.htm).

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Mots clefs : Israël, les taxes, les transferts, les subventions, la fiscalité environnementale, bien-être, la fiscalité des entreprises, les pensions, la fraude fiscale, l'évasion fiscale l'administration fiscale

Table of contents

How to improve taxes and transfers in Israel ... 5

Notable features of the system ... 5
Key challenges ... 7
Background: the recent history of tax and transfer measures ... 8
Indirect tax ... 8
Household income tax and benefits ... 16
Property and capital gains taxation ... 27
Company taxes and business subsidies ... 28
Evasion, avoidance and administration issues ... 33

Bibliography ... 36

Boxes

1. The 2011 reform of the tax-royalty regime for natural gas and oil resources ... 31
2. The issue of "trapped profits" ... 34
3. Recent alterations to legislation and regulation aiming to reduce tax evasion and aggressive avoidance ... 34
4. Recommendations on taxes and transfers ... 35

Tables

1. Tax and benefit measures since the tent-protests of 2011 ... 9
2. Key features of Israeli indirect tax, 2011 ... 10
3. Personal income tax and social security contributions ... 17
4. Key unemployment and welfare benefits ... 18
5. Key features of the pension system ... 26
6. Targeted programmes providing tax breaks and subsidies ... 30

Figures

1. Tax revenue and social spending indicators ... 7
2. Tax on goods and services ... 10
3. Value added tax ... 11
4. Taxes on gasoline ... 13
5. Gross and net income inequality, 2010 ... 19
6. The incidence of relative poverty based on gross and net income ... 20
7. Top marginal rates of personal income tax and corresponding thresholds[1] ... 21
8. Tax and compulsory payment wedges for a single person at two-thirds average wage, no children. 22
9. The unemployment benefit replacement rate at two-thirds average wage, 2011 ... 23
10. Tax on property ... 28
11. Statutory rates of corporate income tax ... 29

How to improve taxes and transfers in Israel

By

Philip Hemmings[1]

Taxes and transfers are an important tool for reaching economic, social and environmental objectives, including achieving deficit and debt targets, creating a competitive business environment and assisting low-income households. Given the multiple facets of tax and transfer policies, making the most of 'win-win' opportunities and having a good gauge of the trade-offs where these occur are key to good policymaking. In Israel, past and renewed efforts to reduce public indebtedness, while making the tax system more conducive to growth in an environment of high interest payments, large defence-spending commitments and significant socio-economic divides mean the authorities have long been keenly aware of the challenges. This paper evaluates current policies and plans for the future and concludes with a series of recommendations.

Notable features of the system

Israeli policymakers have pushed tax and transfer reforms a long way in some dimensions, most notably away from direct taxation and towards both indirect taxation and parsimonious social welfare payments:

- Until 2011 the authorities had been cutting statutory rates of direct taxation on households and businesses as part of a strategy of containing the 'size' of government and making the tax environment more business friendly. Up to 2007, total tax revenues as a share of GDP had been close to the OECD average, but they have since dropped markedly, reflecting, in part, the effects of reductions in personal-income tax (PIT) and corporate-income tax (CIT) (Figure 1, Panels A and B). However, this created difficulties of squaring goals in public-debt reduction with spending commitments, and the 2011 'tent protests' saw increased political opposition; as a result, the scheduled cuts in the CIT and upper rates of PIT were halted. Since then, rates in both these tax bases have been increased as part of efforts to contain fiscal deficits, but also in response to perceived injustices in the burden of taxation raised by the protests.

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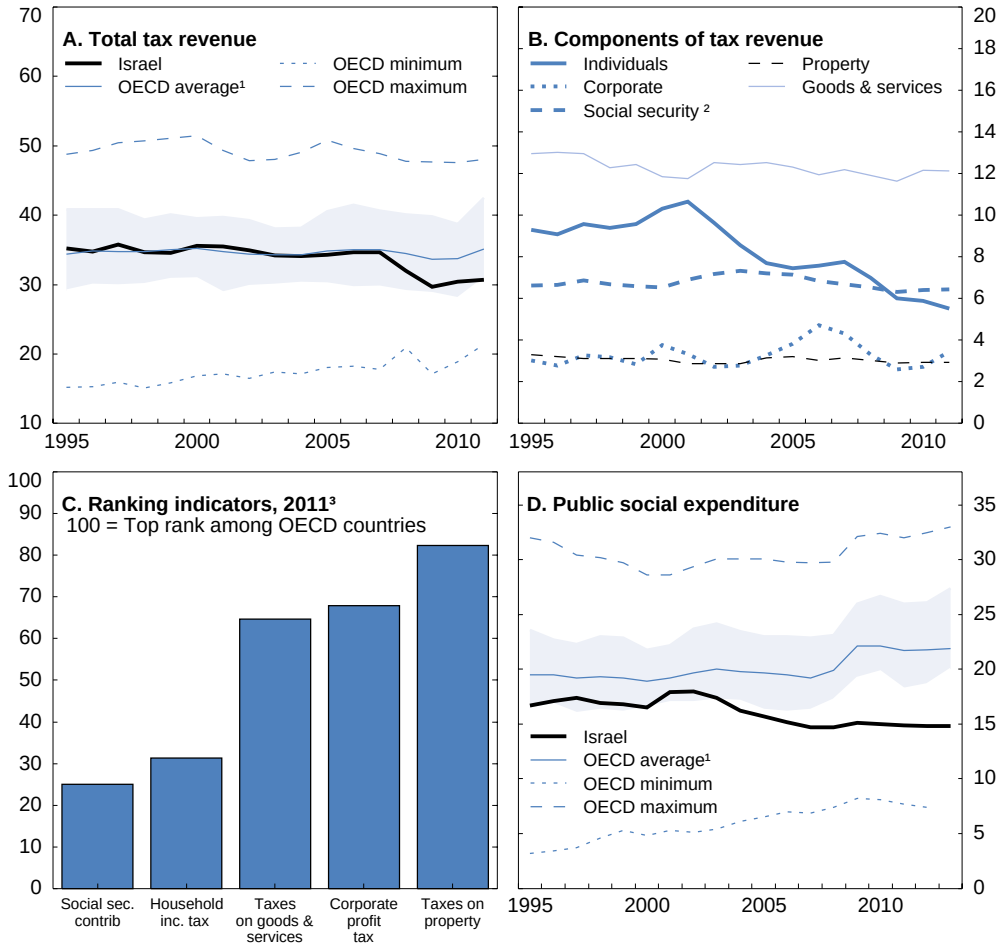
- Indirect and property tax revenues are high as a share of GDP in international comparison (Figure 1, Panel C). Value-added tax (VAT) accounts for the lion's share of indirect tax revenues, and a municipally administered tax on housing and commercial buildings accounts for the vast majority of property tax. Alongside the usual 'sin taxes' on tobacco and alcohol, there are specific customs duties or purchase taxes on many consumer durables and food items. The tent protests prompted cancellations or reductions in many of these. However, some substantial specific indirect taxes remain, including a heavy purchase tax on cars (though this has been given an environmental dimension in recent years), and new taxes on some luxury items have recently been introduced.

- As for civilian public spending as a whole, spending on welfare transfers to households is low in international comparison. This is partly explained by Israel's somewhat faster economic growth and lower unemployment rate than in many other OECD countries, particularly in recent years. But the low level of spending also reflects broader efforts to limit the scale of total public spending in the context of high debt-service costs and defence spending. Arguably, the level of public spending also reflects a 'supply side' policy view by successive governments, in particular a wariness of cash benefits because of their potential to create welfare traps that discourage employment. The low level of social spending can be seen both in the share of social spending in GDP (Figure 1, Panel D) and in comparisons of the tax-benefit positions of different sorts of households. The tent protests nevertheless led to more generous tax breaks for households with children and commitments to provide free childcare and early education services.

- For businesses the landscape is a familiar one. The statutory corporate-tax rate is combined with various allowances (for instance, on R&D outlays and capital depreciation), plus targeted tax breaks and other support aimed at larger businesses and a menu of programmes supporting small- and medium-sized enterprises (SMEs). The centrepiece of support is legislation that includes substantially lower corporate tax rates for internationally competitive businesses. As elsewhere, tax revenues from corporate profits are modest compared with those on labour and on goods and services and fluctuate considerably over the business cycle. However, based on an average of the past seven years, CIT revenues as a share of GDP compare favourably with elsewhere (Figure 1, Panel C), suggesting that the effective rate is perhaps somewhat higher.

Figure 1. **Tax revenue and social spending indicators**

As a percentage of GDP



1. The shaded area is the 25th to 75th percentile range of available OECD countries.
2. And payroll taxes.
3. Or latest available year, except for corporate tax which is based on the average of the previous seven years to reduce the influence of cyclical variation. The rankings are based on the shares of revenue in GDP.

Source: OECD tax revenue database and OECD social expenditure database and OECD Economic Outlook 94 database.

Key challenges

The challenges for tax and transfer policy can be seen as having four inter-related components:

- Identifying the best (or rather least damaging) revenue-raising measures and cutbacks in public spending to achieve targets in deficit and debt reduction. A package of measures as part of the recent 2013-14 budget was the latest initiative to this end.

- Enhancing the role played by the tax and transfer system in achieving a socially acceptable distribution of income and, in particular, in relieving Israel's chronic problems of poverty and weak labour-force attachment in certain communities. High poverty rates and low employment rates, particularly in the rapidly growing Haredi community and the Arab-Israeli sector, remain a

concern, not only from a social perspective but also in terms of long-term growth prospects. Even though Israel already has a reasonably pro-growth tax structure, further improvement on this front, particularly in the context of competition with other countries for international investment, needs to remain a policy priority.

- Improving the environmental features of the tax system. Despite progress in 'greening' some existing tax bases and the introduction of dedicated environmental taxes, as in most countries there is room for further action on this front.

The following sections first summarise the recent history of tax and benefit reforms and then discuss how policy has addressed the above issues and the best way forward under five headings: indirect taxation; household income tax and social benefits; taxes on property and wealth; business taxation; and evasion, avoidance and administration issues.

Background: the recent history of tax and transfer measures

There have been three recent packages of tax and spending measures. The first followed up the recommendations of the Trajtenberg Committee that was set up in 2011 in response to the tent protests and aimed to be fiscally neutral. PIT progressivity was notched up, capital was taxed more heavily, and customs duties were rationalised on consumer durables and food with a view to lowering retail prices (Table 1). Second, by mid-2012 it had become clear that fiscal balances were going seriously off target, prompting revenue-raising measures that included a rise in the standard rate of VAT and further increases in top-end PIT rates. This was followed in the 2013-14 budget by further measures as part of the significant consolidation to bring the deficit back on target. This latest round of changes includes many revenue measures and transfer savings, including additional hikes in the VAT, CIT and PIT rates and cuts in child allowances.

Indirect tax

Indirect taxes have some attractive features. Theory and evidence suggests they are preferable to direct taxes in terms of economic growth (for instance, Arnold, 2008), as they favour saving and investment and have a smaller impact on business costs and profits. Also, for those goods and services where there is inelastic consumer demand (or producer supply), there are opportunities for reliable revenues with comparatively low deadweight losses in economic welfare. Indirect taxes can also 'internalise' externalities, in particular those connected with the environment and public health. Of course there are potential downsides: they can be a vehicle for protectionism, distort household consumption and saving behaviour and can be regressive.

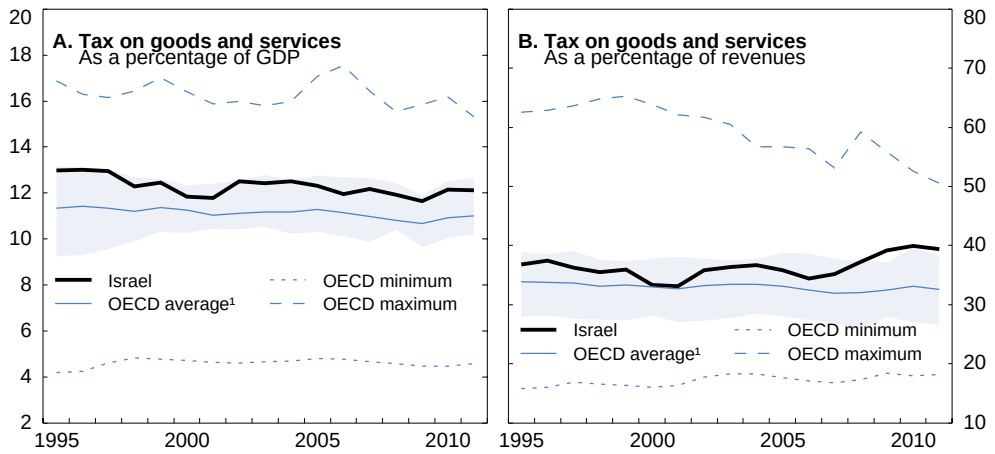
Israel has long made heavy use of indirect taxation. Indeed, at least since the mid-1990s revenues from taxes on goods and services have been among the highest in the OECD area both as a share of GDP and of overall revenues (Figure 2). In revenue terms, VAT is by far the largest single item. Other indirect taxes are by no means insignificant, however, representing about 37% of all indirect tax and nearly 4% of GDP in 2011 (Table 2). They are practically all targeted on specific goods and services in one way or another and comprise various sales taxes, customs duties, excises and fees. Excise on fuels is the largest component, accounting for about 45% of this class of revenues.

Table 1. **Key tax and benefit measures since the tent-protests of 2011**

Response to the tent protests 2011-12	Mid-2012 drive to rein in the fiscal deficit	Spring-summer 2013 revenue measures decided on for 2013-14 budget
Indirect tax		
Reductions and cancellations in customs duties on consumer durables and food items set in train.	VAT rate increased from 16 to 17% (effective September 2012).	VAT rate increase from 17 to 18% (effective June 2013). New purchase taxes on selected luxury items (e.g. planes, yachts).
Cancellation of a scheduled increase in excise on retail vehicle fuels.	Increased purchase tax on beer and cigarettes.	Increased purchase tax on alcohol (July 2013) and cigarettes (May 2013).
	Reduced green-credit discounts in the car-purchase tax.	Increase in the basic rate of car purchase tax for vehicles costing over NIS 300 000.
Household income tax and benefits		
PIT rates: suspension of scheduled cuts, increase in top rate (from 44 to 48%), reduction in some lower rates.	PIT rates: increase in the three upper rates and cancellation of threshold updating for these brackets (effective January 2013).	PIT rates: increases of between 1 and 2 percentage points in rates (effective January 2014). Automatic indexation of brackets cancelled for 2014.
Child tax credit made available to fathers.	Surtax of 2% on income exceeding NIS 800 000 per year.	
Cancelled increase in ceiling on national insurance contributions.		Reduction in child allowances and introduction of an income ceiling on eligibility (NIS 800 000 per year).
Corporate income tax and employer social contributions		
Cancellation of scheduled cuts and increase in rate from 24 to 25%.	A 0.6 percentage point increase in the employers' national insurance contribution brought forward from 2014 to 2013. Further increases are scheduled for 2014 and 2015.	Increase in CIT rate from 25 to 26.5% (effective January 2014). Preferential rates under the Law for the Encouragement of Capital Investment to be increased.
Other		
Increase in tax on interest, dividends, capital gains and 'land betterment' from 20 to 25%.	Extension of an elevated rate of purchase tax rate on second homes to the end of 2013.	Acquisition tax for second homes and investment properties raised from 5 to 6%, exemptions on capital gains on property tax reduced.
Estimated net budgetary impact		
NIS -0.6 billion for 2012.	NIS +9.2 billion for 2013.	NIS +14 billion over 2013 and 2014, of which about NIS 11.8 billion in 2014.

Source: Bank of Israel (2012; 2013) and OECD.

Figure 2. **Tax on goods and services**



1. The shaded area is the 25th to 75th percentile range of available OECD countries.

Source: OECD tax revenue database and OECD Economic Outlook 94 database.

Table 2. **Key features of Israeli indirect tax, 2011**

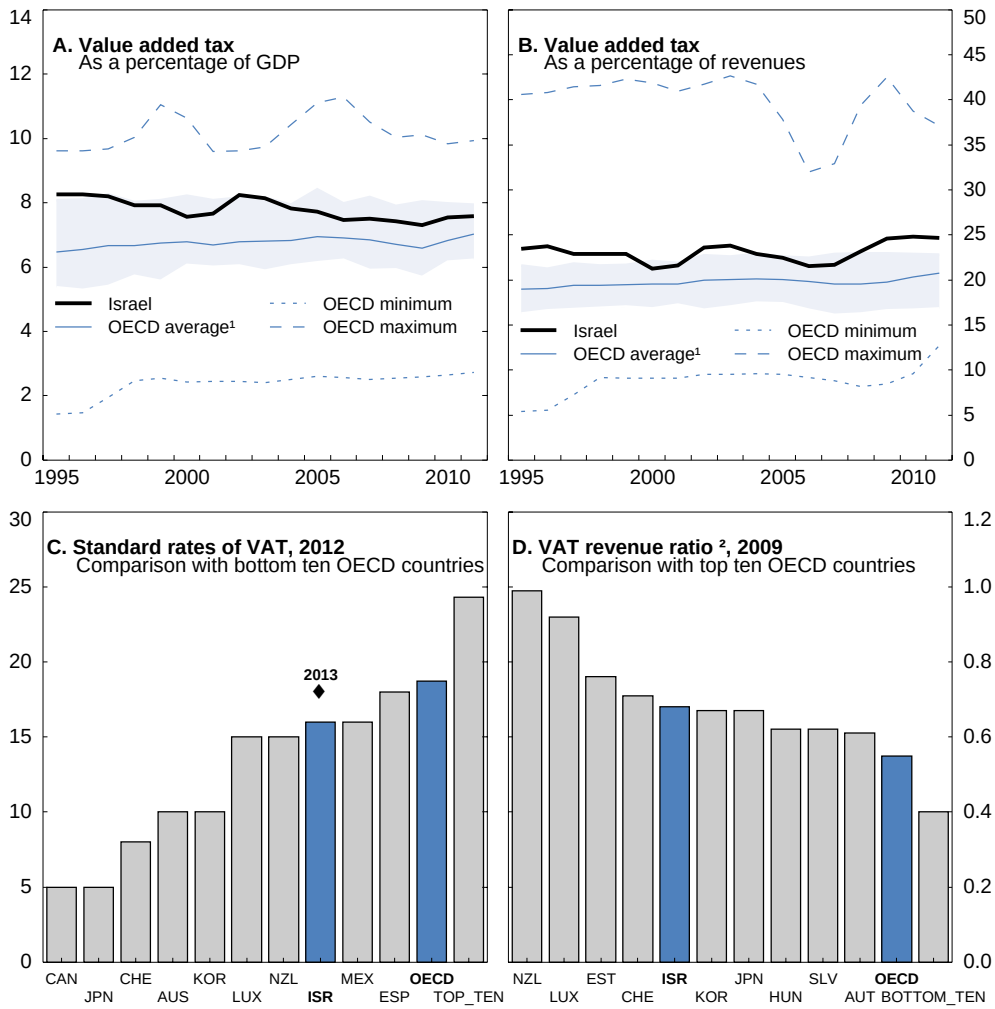
Type of indirect tax	Comment	Share of indirect taxation (1)	Share of total revenues (1)	Share of GDP (1)
Value added tax	Single rate but fruit and vegetables and goods and services bought in the tourist resort of Eilat are exempt	62.6	24.7	7.6
Sales taxes, excise taxes customs and excise duties	Aside from excise on fuels (below), this category includes a substantial car purchase tax, and tax on tobacco, alcohol, various foodstuffs and some consumer durables	30.5	12.0	3.7
of which: Excises on fuels	Chiefly excise on retail motor-vehicle fuels, there is also an excise on wholesale primary fuels	13.5	5.3	1.6
Recurrent taxes	Mainly licence fees, also includes a landfill tax	6.9	2.7	0.8
Total		**100.0**	**39.5**	**12.1**

Source: OECD Revenue Statistics.

A good system of VAT

Israel's VAT system is admirable in that there is a single rate with few exemptions. As a result, revenues (both as a share of GDP and of total revenues) have been consistently above the OECD average, despite the comparatively modest standard rate (Figure 3); thus, the VAT Revenue Ratio is high (this ratio is derived by dividing actual revenues by the revenues implied by applying the standard VAT rate to total household consumption).

Figure 3. **Value added tax**



1. The shaded area is the 25th to 75th percentile range of available OECD countries.
2. The VAT revenue ratio is derived by dividing actual revenues by the revenues implied by applying the standard VAT rate to the total value of household consumption spending.

Source: OECD tax revenue database, OECD Economic Outlook 94 database and OECD (2012), Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administration Issues, OECD Publishing.

Multiple rates of VAT (with 'preferential' rates alongside the standard rate) and more widespread exemptions should be avoided. In contrast to the Israeli case, many OECD countries' VAT systems have become complicated because of such provisions. In principle, preferential rates and exemptions can be used to address equity issues and correct for externalities. However, as pointed out in the OECD's *Consumption Tax Trends* (OECD, 2012a), in general they are not the best tools for the job. As means of addressing income inequality and poverty inefficiency arises because exemptions and preferential rates benefit all households, including the affluent. Similarly, targeting environmental externalities *via* VAT can be a blunt instrument as it may not accurately impact the source of the externality; for instance, reduced rates on energy-saving appliances may boost demand and stimulate use, thus denting the intended curbing of energy consumption. In addition, despite possibly good intentions, creating a subset of items benefitting from preferential rates or exemptions almost inevitably gives rise to anomalies, complications, additional administrative costs and the attention of lobby groups. It is worth noting that while there is only a single

VAT rate in Israel, the retail prices of quite a number of basic food items are regulated, so there is some official attention to affordability issues, although price regulation is not the best solution.

Indeed, the authorities should consider making VAT coverage even wider by removing the remaining exemptions; fruit and vegetables along with services in the tourist centre of Eilat. Although they are hard to justify on economic grounds, they remain fully VAT exempt, despite several proposals to eliminate them, including during the development of the fiscal budget for 2013-14.

Raising the rate of VAT is in many respects a logical choice for increasing revenues. Indeed, it was raised from 16 to 17% in 2012 and to 18% in 2013. As mentioned, VAT is more growth friendly than other taxes, and relatively modest rate increases can yield sizeable additional revenues. For instance, a 1 percentage-point increase is reckoned to add around NIS 4 billion (i.e. around 0.4 percentage point of GDP). Should substantial additional revenues be required to reach the fiscal targets, then further increases in VAT may well be among the best options. However, such a move would no doubt raise concerns about the impact on the cost of living of low-income households. As underscored above, addressing this through exemptions or preferential rates of VAT would be a poor strategy. Instead, consideration could be given to providing offsetting measures in welfare policy.

Welcome reductions in the taxation of specific consumer durables and food items

Israel has historically made heavy use of supplementary forms of indirect taxation (purchase taxes, customs and excise duties). Limited trade with neighbouring economies, tightly controlled points of entry to the country and a low risk of retaliation from trading partners due to the economy's relatively small size have made these attractive tax bases for the treasury and a vehicle for protecting domestic production.

Over time, the number of these supplementary taxes has been reduced, and the rates of tax or duty have been lowered on those that remain. Complaints about the cost of living that were a key issue in the tent protests of 2011 have prompted the government to undertake further rationalisation:

- Customs duties on consumer durables have been completely abolished. Previously, consumer durable items under 21 tariff codes, ranging from microwave ovens to hairdryers, were subject to customs duties typically at a rate of either 10 or 12%.
- Customs duties on food products where there is significant local production are undergoing scheduled cuts that are typically due to be completed in 2015. These were very high on some items and for many will remain significant, even when the reductions are fully implemented. For example, duty on beef products was previously 190% but will only drop to 90%; similarly, the duty on lamb will drop from 50 to 30% and on sausages from 50 to 22%. Clearly, and unfortunately, there is reluctance to remove this dimension of agricultural support entirely.
- Reductions in customs duties on food items that the authorities have classified as having limited local production have already been completed. The rates on these items vary widely such as fish (cut from 5 to 3 shekels per kilo) and dried fruit (reduced from 25 to 8%).
- Customs duties on processed food are also undergoing scheduled reductions.

This is an encouraging development. Taxing imported consumer goods may be perceived as preferable to taxing domestic production, but this point can be overstated as bringing imported goods to customers often involves a sizeable domestic supply chain. Also, such taxes distort consumption patterns, unless the price elasticity of demand for the products is zero. The customs duties on food are one of several elements in Israel's substantial and costly support for domestic agriculture (OECD, 2013a) (see below).

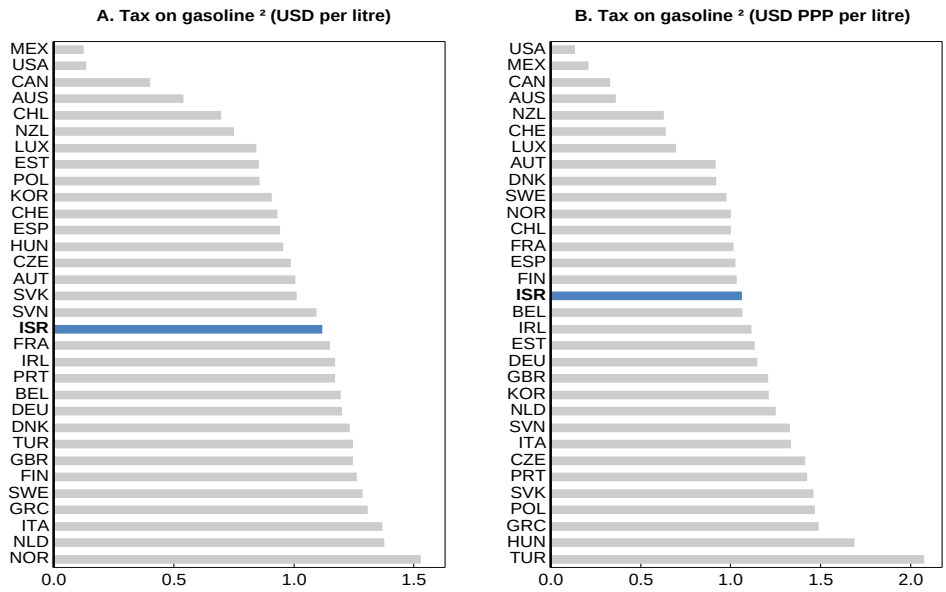
This said the 2013-14 budget introduced new purchase taxes of 15 to 20% on several high-end, luxury consumer goods, specifically airplanes, fur clothing, yachts and jet skis. Also, the car purchase tax has been increased for high-end vehicles. This somewhat arbitrary selection of items for additional taxation represents a largely symbolic gesture at taxing the rich; it is unlikely to raise much revenue or have anything but a marginal impact on the progressivity of the tax system.

Vehicle taxation: there is room for a better balanced system

Israel's vehicle taxation is among the heaviest in the OECD. Excise plus VAT on gasoline and diesel is similar to the levels in many European countries (Figure 4). But, what really distinguishes Israel is the hefty purchase tax imposed on cars, second only to that in Denmark. The high cost of purchasing and running cars for private individuals plus generous tax treatment of company cars has led to a disproportionate number of company cars, though recent reforms have seen some downward adjustment (see below).

Figure 4.**Taxes on gasoline**

2013 Q1[1]



1. Or latest available period.
2. Unleaded premium 95 RON; Taxes comprise both excises and VAT.

Source: OECD Energy database.

Echoing previous OECD advice (for example, in both the 2010 and 2011 *Economic Surveys*), the differentiation of the car purchase tax according to environmental criteria is welcome, but arguably the range of rates should be shifted down. For decades a single, and very high, rate of purchase tax was imposed on private vehicles, and then in 2009 a system was introduced that maintained a high 'basic' purchase tax but with discounts calculated from a "green credit" based on the vehicle's emissions characteristics. The credit is a weighted average using emission levels and shadow-price estimates for a range of pollutants, and this is used to classify vehicles into categories that determine the discounts from the baseline purchase tax. The discounts do not exactly equate with shadow costs, thus departing from pure environmental taxation. Indeed, following substantial behavioural responses in terms of car purchase, the authorities have been lowering the discounts, one official justification being that this helps push consumers

(and importers) towards cleaner cars. However, it is clear that the authorities also have revenues very much in mind. For instance, a round of adjustments was made as part of fiscal consolidation measures in 2012, and another one features in the 2013-14 budget. The bottom line is that the purchase tax, net of discounts, remains high. Generally, effective tax rates range between 30 and 83%, averaging about 60% (hybrid cars are taxed at a 30% flat rate, plug-in hybrids 20% and fully electrical cars 8%). Aside from being a source of revenue there is little merit to such heavy taxation: the distortion in relative prices is substantial, and on environmental grounds it makes more sense to target car use rather than ownership. The authorities have moved somewhat in the opposite direction on this front with the introduction of the higher basic rate of purchase tax on high-end vehicles (applying to vehicles with a pre-tax price of more than NIS 300 000).

One way of increasing the focus of taxation on vehicle use is via the tax on retail gasoline and diesel. Benchmarking Israeli levels of retail gasoline and diesel tax against those elsewhere suggests there is some headroom to raise them further while remaining within the range of international experience (Figure 4). However, as illustrated in the 2011 *Economic Survey* (OECD, 2011*a*), justifying middle-to-high tax burdens on retail gasoline and diesel on purely environmental grounds either requires an assumption of a very high implied price of carbon or taking on board additional externalities (and it may be difficult to argue that fuel-based tax is the best way to internalise some of them). In short, pushing up excise on fuels is certainly a feasible means of raising fiscal revenue, but the environmental case for doing so in Israel (and some other countries) is not strong. Whatever strategy is chosen for fuel excise, pressures to lower it when world oil prices are high should be resisted, as that discourages desirable demand and supply adjustments. In recent years the authorities have occasionally succumbed to such pressures, causing some problems for the treasury.

There is also room to improve the relationship between diesel and gasoline taxation. In Israel the tax per litre of diesel is similar to that on gasoline, which is more than can be said for many OECD countries. This lowers demand for diesel-engine versions of private cars. However, as underscored in OECD calculations (for instance, OECD, 2013b), the effective tax rate in terms of energy use or carbon emissions is nevertheless lower than that that for gasoline. Thus, the authorities should in principle tax diesel more than gasoline.

There is also scope to develop other use-based vehicle taxes. To date most road pricing is in the form of tolls on sections of road that have been built under build-operate-transfer (BOT) contracts with the private sector and is therefore not really designed to manage traffic flows and congestion or contain local pollution. One exception is a reserved-lane system operating on the main highway into Tel Aviv from the south-east where public transport and some other vehicles (for instance, those with at least three passengers) can use the lane for free, while others are charged a fee (which varies according to the current volume of traffic). There is considerable scope to develop user charges further, for example, through more reserved-lane systems, an urban congestion charge or GPS-based road charging. Progress is being made on these fronts. In January 2013 the authorities announced the development of a reserved-lane system on another of the main highways into Tel Aviv. Also, the tax authority is currently conducting a feasibility study for an urban congestion charge. A recent OECD review of Belgian transport infrastructure (OECD, 2013c), which has a similarly high population density to that of Israel, illustrates the challenges and possibilities for policy on this front.

There has been welcome reduction in the generosity of the tax treatment of company cars (typically provided via leasing companies) but further adjustments are needed. For companies, all expenses (leasing costs, maintenance and fuel) are tax deductible with no cap. As regards employees, since 2008 a use-value (or in-kind income) has been added to taxable income, which varies with the car's characteristics (including emissions) and has been substantially increased since its introduction. And, the tax treatment was altered further in 2010 with a switch from seven in-kind income categories to a formula calculating the in-kind income as a percentage of the showroom price. Data suggest there has indeed been a behavioural

response to these reforms. According to the Israeli tax authorities, the share of corporate sales in total car purchases fell from 60% in 2006 to 40% in 2012, and it is likely that the tightened legislation drove at least part of this trend. Nonetheless, the provision of company cars still remains common. A core problem is that the marginal cost to driving a company car for private purposes remains practically zero, as the associated recurrent expenses are often covered by the employer. Thus, the advantageous tax treatment, aside from implying revenue losses, is also not ideal from an environmental perspective (OECD, 2013d). According to the Israeli tax authorities, in the face of higher fuel costs more employers have been voluntarily endeavouring to limit their support by, for instance, charging employees for car use beyond a certain mileage. However, this should not be viewed as a substitute for further improving the tax treatment of company cars. As suggested in the 2011 *Economic Survey*, one solution is to introduce a cap on corporate tax deductibility for fuel expenses, the level of which could be perhaps varied to accommodate occupations where mileages covered for work purposes are high (such as delivery staff).

The fine-tuning of vehicle taxation needs to be accompanied by improvements to alternative transport options. Most notably, as OECD *Surveys* have underscored, public transport has to be sufficiently developed to provide feasible alternatives to car use. Rail transport in Israel is particularly underdeveloped; progress in building intra-urban rail systems has been slow, and the inter-city network remains limited. Without further infrastructure development, ramping up vehicle taxation might fail to elicit a significant reduction in the number of car journeys and associated emissions, and could prompt significant opposition from the public.

Excise duty on wholesale fuel: a potential 'universal' carbon tax

Israel possesses a ready-made instrument for a carbon tax via the excise that is already charged on wholesale primary fuels (heavy oil, natural gas and coal). Practically all domestic GHG emissions originate from these fuels (which apart from natural gas are entirely imported) as they are used to generate all electricity and provide refined hydrocarbon fuels (such as gasoline and diesel for vehicles). Thus, the excise on primary fuels is, in effect, already a carbon tax. However, the excise rates remain well below the levels concomitant with prices of carbon that are typically assumed in policymaking, as illustrated in the 2011 *Economic Survey* (OECD, 2011a, p. 113). Proposals to raise the excise to reflect environmental externalities were made in 2006, although they were never implemented. Ramping up the excise to reflect the shadow price of CO_2 would imply this particular externality is internalised throughout the supply chain. Thus, for instance, in the presence of such a tax it would no longer be valid to include the shadow price of carbon when performing an environmental account of excise on retail vehicle fuels. Similarly, justifying guaranteed feed-in tariffs for renewable energy production on the basis of the shadow price of CO_2 would no longer be appropriate. In any case feed-in tariffs are typically much higher than those suggested by the shadow price of CO_2, and other arguments are used to justify them, such as a need to support demand on the basis that this promotes technological development that might lead to greater economic viability for renewables.

Other issues in environmental taxation

Outside the energy sector, taxation can play an important role alongside regulatory and other measures in ensuring environmental externalities are incorporated into household and business decision-making. Environmental tax reform outside the realm of energy does not tend to involve adjustment to established bases (where revenues can be fiscally important), but rather the introduction of new taxes specifically designed to deal with environmental issues.

A landfill levy has been one of Israel's flagship initiatives of recent years, aiming to reflect the external costs of this form of waste disposal and make other forms of treatment more competitive. The levy varies according to the type of waste; for instance, the highest levy is imposed on the disposal of "sludge"

and the lowest on construction and demolition waste; the low rate on the latter partly reflects a widespread problem of illegal disposal. The proceeds are earmarked to finance waste-related developments. For example, they have been used to help local authorities set up municipal waste-collection points, run education and information systems and build recycling infrastructure. As is almost always the case with earmarked funding, there are no strong grounds for believing that the revenues collected will equate with the optimal amount of spending, and policymakers therefore need to remain aware of the risk of excessive or insufficient funding.

The landfill levies have been increased substantially since the scheme was first introduced in 2007, and legislated increases are continuing for some forms of waste. Concerns about concentration in the waste sector have been voiced and there is the possibility that the price of processing landfill waste may be capped to curtail profit margins for landfill operators. This could perhaps be combined with a hike in the levy so as to further limit margins and preserve a gap between the cost of landfill and more environmentally friendly alternatives.

Environmental levies also apply to water extraction, quarrying and shipping. Similar to the landfill levy, the latter two are linked to dedicated funds (for the restoration of quarries and marine pollution prevention, respectively) (OECD, 2011b). As regards air pollution some progress has also been made in increasing the role of economic instruments; the Clean Air Act (2008) introduced compulsory emission fees and permits for plants with high pollution potential.

Household income tax and benefits

Household income taxes and benefits account for a significant share of fiscal revenues and expenditures, and are an important tool of social policy. The architecture of the Israeli system is similar to that in many other OECD countries. Households face progressive PIT plus social-security contributions on the one hand, and are potentially eligible for a range of transfer programmes on the other hand, including unemployment benefit, general social welfare, child allowances and child support (Tables 3 and 4). In addition, recent years has seen the introduction of an earned income tax credit (EITC) for low-income households. In terms of budgeting, most welfare benefits are administered by the National Insurance Institute (NII), which also receives the social-security contributions directly. Shortfalls in the NII's budget between contributions and spending are made up by central government revenues. Therefore, the contributions are, for all intents and purposes, taxation in another name. Compared with other systems, social contributions are light, and the welfare pay-outs are not hugely generous, reflecting the parsimony in overall civilian public spending.

Israel's light tax-benefit system in terms of spending means it is not strongly redistributive. This can be seen in comparing Gini coefficients for gross income and for income after adjusting for taxes and transfers (net income), where the country has the second-largest degree of overall income inequality in net terms but only the sixth largest in gross terms and is close to the United States on both counts (Figure 5). In terms of relative poverty, the pre-tax rate is similarly close to that of the United States, but the post-tax incidence of relative poverty is substantially higher and indeed is the highest in the OECD area (Figure 6), echoing the low spending on social welfare. The bottom line is that any substantial reduction in Israel's rate of relative poverty is likely to involve more public spending.

Table 3. **Personal income tax and social security contributions**

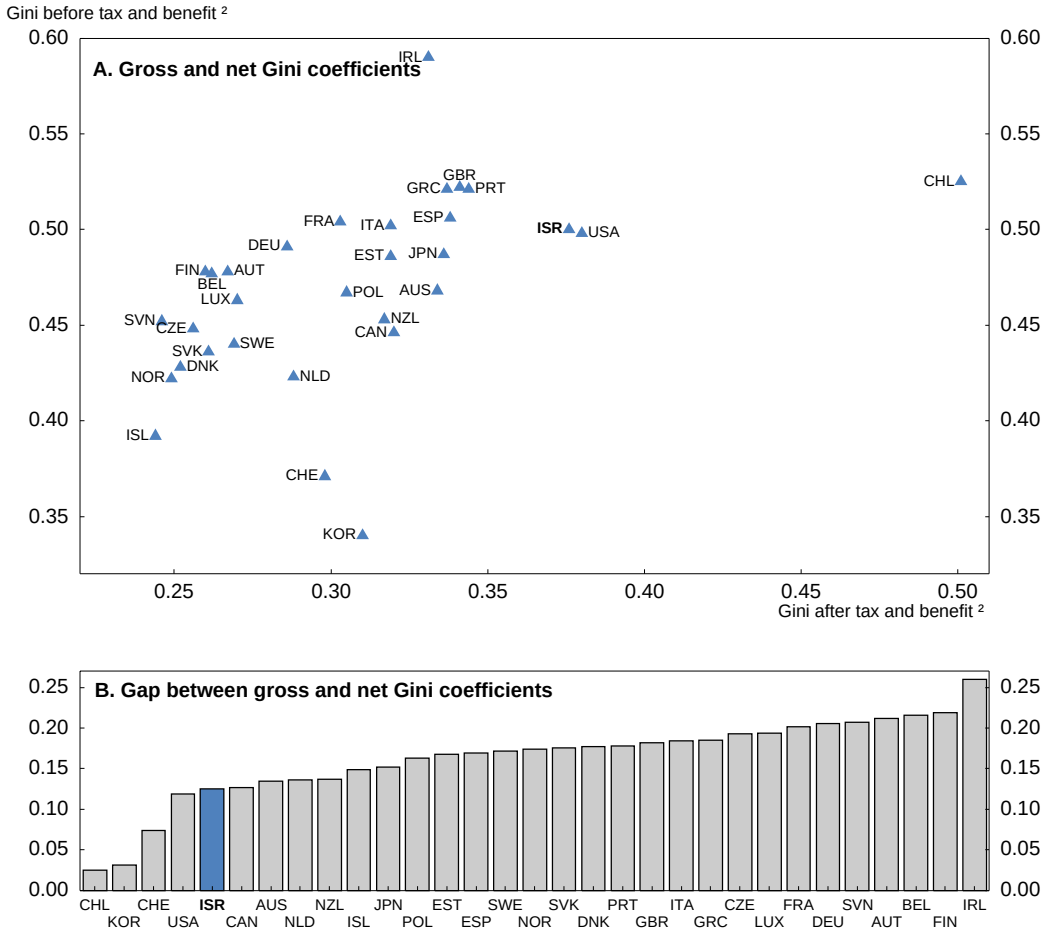
Dimension	Notable features
Scope of the tax base	Levied on an individual basis. Income from employment, some welfare benefits and pensions as well as interest income are included in the base.
Rates and thresholds	As of January 2014, six rates ranging from 11% to 50%, the first threshold is at NIS 62 400 and the last at NIS 501 960. In addition, a 2% "surtax" applies to annual incomes above NIS 800 000. Tax on interest is subject to a ceiling of 25% (i.e. individuals pay their marginal rate of tax on interest income, but only up to a rate of 25%). The ceiling is 15% for interest on non-indexed shekel deposits, and rules differ if the interest is accrued by a "substantial owner" of an asset.
	Thresholds automatically updated to compensate for inflation every year (except for a few years when the threshold update has been cancelled as a one-off fiscal measure).
Wasteable tax credits	Credit points system with a universal component and an additional credit per-child (for fathers the credit applies only for children up to the age of three, unless they are a lone parent). Women also receive an additional tax allowance. The credits mean that large numbers of earners, particularly women with children, do not pay any personal income tax.
Earned-income tax credit (EITC) (non-wasteable)	Applies to households with one or more children and those aged 55 and over. Maximum monthly credit NIS 330 for those with one or two children (NIS 495 for mothers and single fathers) and NIS 480 for those with three of more children (NIS 720 for mothers and single fathers).
National insurance: standard rates	Up to 60% of the average wage: employee contribution 3.5%, employer contribution 3.45%.
	Above 60% of the average wage: employee contribution 12%, employer contribution 6.5% (the latter is due to increase to 7.5% in 2014).
Special conditions	Special contribution rates apply to non-working persons: the unemployed, disabled pensioners and so on.
Other considerations	Compulsory minimum contributions to second-pillar pensions on earnings up to the average wage (Table 5).

Table 4. **Key unemployment and welfare benefits**

Item	Notable features
Unemployment insurance benefit	Pay-out ranges from 45 to 80% of previous earnings (35 to 60% for those aged under 28), accompanied by benefit ceilings. Maximum duration ranges from 50 to 175 days according to age and number of dependents.
	Subject to regular income tax, but a low National Insurance Institute (NII) contribution rate is applied.
	Those taking up “unsuitable work” can receive UI as an in-work benefit.
Income support	Eligibility is means and employment tested. Ownership of a car no longer precludes eligibility, but vehicles are included in the assessment of assets. For instance, monthly support is NIS 2 843 for a couple with two or more children.
	Support increases with household size, but not beyond two children.
	Support can be given when the family has income from other sources (including earnings). There are modest earnings disregards. For earnings above these levels, benefits are withdrawn at rates ranging from 62.5 to 70%.
Paid maternity leave and birth grants	Conditional on NII contributions for 10 of the last 14 months (or 15 out of preceding 22) preceding due date. Those on Income Support would normally be eligible for hospitalisation grants as they pay a health-care contribution.
	A maternity allowance pays 100% of previous earnings for up to 14 weeks.
	In addition, there are one-off birth grants, which decline with the number of children, hospitalisation grants and benefit for precautionary rest taken during pregnancy.
	Leave (and payment) can be switched to the father for up to six weeks.
Universal child allowances	More generous allowances can apply to children born before May 2003, depending on birth order. Monthly allowances were cut in the 2013-14 budget.
	Those on Income Support receive additional allowances equal to 70% of regular child benefit for both the third and fourth children.
	The allowances are paid until the child reaches age 18.
Study grants	Eligible groups notably include lone parents and families on Income Support with at least four children.
	Annual payments of NIS 1 528 per child aged 6 to 12 and NIS 849 per child aged 12 to 14.
Rental support	In general, eligibility is determined by a means test, one notable exception being recent immigrants who are all eligible for rent subsidies (OECD, 2011a, Table 1.5).

Figure 5. **Gross and net income inequality, 2010**[1]

Total population

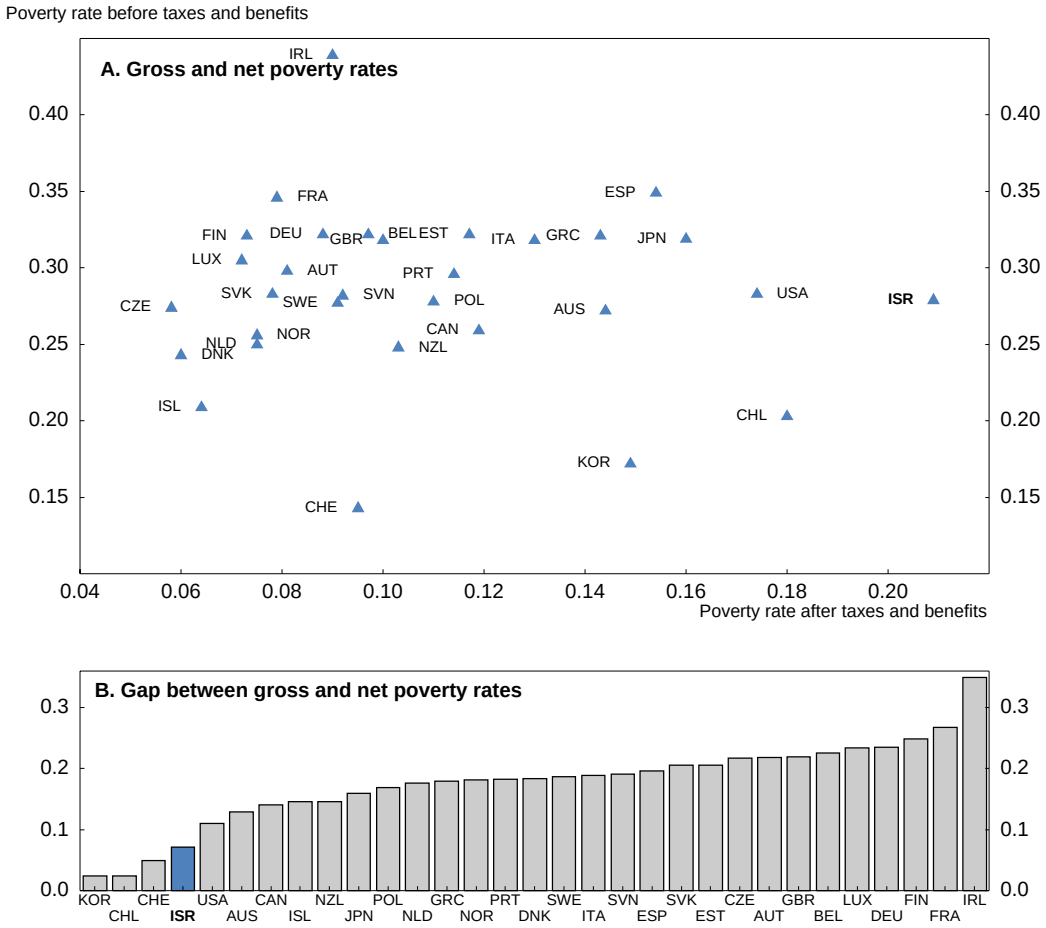


1. Or latest available year.
2. The Gini coefficient takes values between 0 for maximum equity (all households receive the same income) to 1 for maximum inequality (one household receives all income).

Source: OECD Income and Poverty Distribution Databases.

Figure 6. **The incidence of relative poverty based on gross and net income [1]**

2010[2], total population



1. The incidence of relative poverty measures the share of households whose equivalised income is less than 50% of the median income.
2. Or latest available year.

Source: OECD Income and Poverty Distribution Databases.

The government's strategy on personal income tax

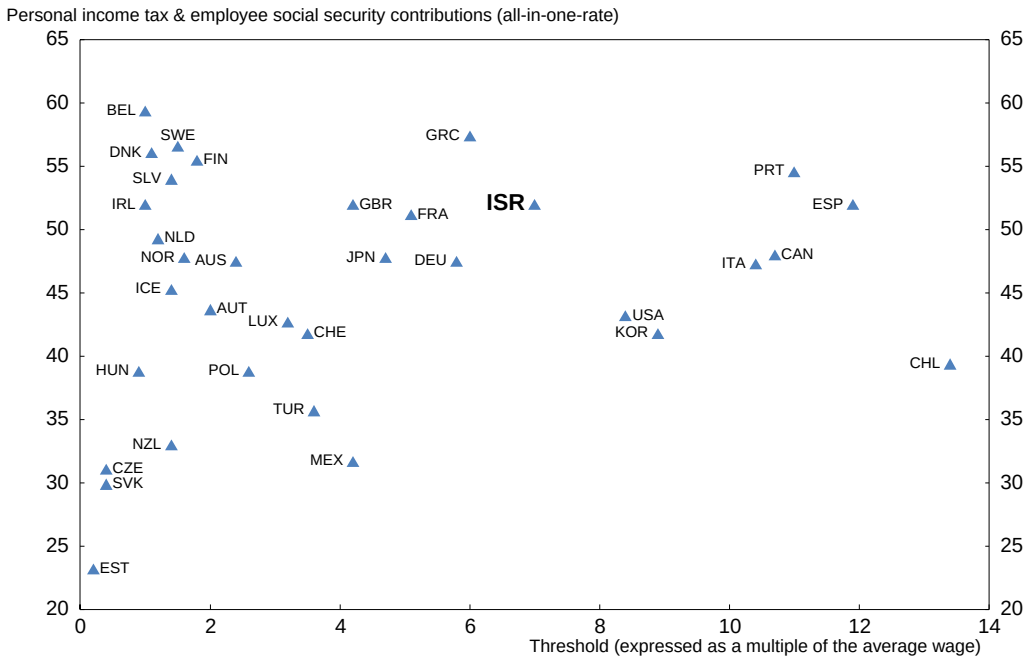
The cancellation of scheduled cuts in PIT rates and the subsequent increases mark a change of direction that Israel's policymakers would probably not have made, were it not for the fiscal difficulties and the political pressures from the tent protests. The planned cuts in PIT, as well as those in CIT, reflected a belief that these generate sizeable positive second-round effects in terms of investment and growth. As OECD *Surveys* have argued, lowering top-end PIT rates probably delivered healthy marginal returns initially in terms of attracting investment and incentivising labour, but these diminished over time with the immediate fiscal consequences of cutting tax rates becoming progressively more prominent.

While the cancellation of the rate cuts was, on balance, a good move from a fiscal point of view, the subsequent increases do pose risks for the country's reputation regarding the business friendliness of the tax environment. There have now been three rounds of PIT rate increases: the Trajtenberg reform saw an

increase in the top rate of tax; the mid-2012 fiscal package brought increases in other high-end rates and a freeze on threshold updating, plus a 2% surtax on very high incomes (Table 1); and finally, all PIT rates are scheduled to rise as part of the 2013-14 budget. Policymakers need to remain mindful that the top statutory rate (including social-security contributions) is now quite high in international comparison at 52% (the ceiling on the employees social security contribution coincides with threshold for the top tax rate of personal income tax and so does not add to the marginal tax rate on earnings in this bracket). This said, the income threshold of the top rate of tax (in relation to the average wage) is good deal greater than in many countries with high top marginal rates, such as Belgium, Sweden, Denmark and Finland (Figure 7). The recent increases in all PIT rates imply Israel's position in international comparison has become slightly less flattering across a wide range of skill levels.

Figure 7. **Top marginal rates of personal income tax and corresponding thresholds[1]**

2012



1. Data comprise the top statutory personal rate plus additional deductions (such as social security contributions) that apply at the threshold where the top statutory PIT rate first applies.

Source: OECD, Tax database and Israeli authorities for Israel.

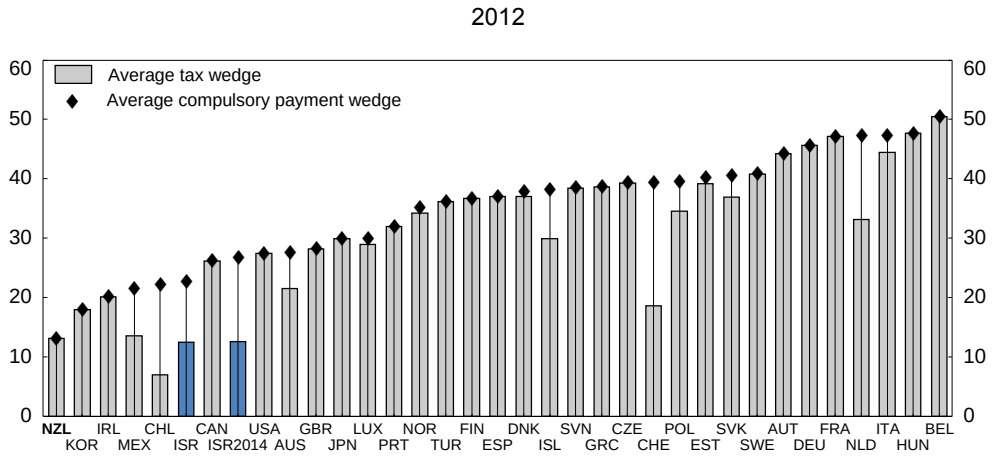
Encouraging employment and combating poverty

Income tax, particularly those aspects applying to people with low earnings capacity, in combination with the generosity, accessibility and qualifying conditions of welfare benefits, govern poorer households' disposable incomes and influence their incentives to engage in the labour market. Ensuring that the system of taxes and transfers is well designed is particularly important for Israel, given the large number of poor households concentrated in the rapidly growing Haredi community and in the Arab-Israeli sector. The issue is regularly assessed, for instance in the National Insurance Institute's *Annual Surveys* and the Bank of Israel's *Annual Reports* and has been discussed in several OECD reports (the latest being a follow-up review on social policy: OECD, 2013e). Of course the tax-benefit system is not the only area requiring attention in order to make progress on reducing poverty. As described by the recent OECD review, the

authorities have, for example, been endeavouring to improve the enforcement of labour legislation by, for instance, increasing the number of labour inspectors.

Over the past few years the tax wedge on labour has shifted away from being among the very lowest in the OECD distribution, although this is not due to the tax-benefit system *per se*. Indeed, personal income tax and total social security contributions on low-wage earners remain very light. Tax credits plus a low bottom rate of tax (for 2013 the rate is 10% for the first NIS 63 360) mean that individuals earning up to the average wage (approximately NIS 110 000) pay little or no income tax. Social security contributions are also modest; the combined employee and employer contribution rate is only 6.95% up to 60% of the average wage and 18.5% on earnings above this amount. Thus, the aggregate tax wedge based on standard taxation and social contributions is among the least burdensome in the OECD. Even with the imminent increases in tax rates, this wedge will still be low. However, mandatory pension contributions to private-sector pension funds ("second pillar" pensions) were introduced in 2008 with contribution rates increasing annually according to a schedule that ends in 2014 (when the total contribution will reach 17.5%). OECD simulations show that as of 2012 the tax wedge for a single person earning two-thirds of the average wage with no children was only 13% of total labour costs, but 23% once the second-pillar pension contribution is included (the "compulsory payment wedge", Figure 8). Moreover, the latter figure is estimated to reach 27% in 2014 due to the further increase in mandated pension contributions. True, the pension-contribution component of the wedge probably elicits milder behavioural responses than the taxation component, to the extent that individuals view it as a redistribution of their own income over time. Also, a tax wedge of this magnitude is still well short of the largest in the OECD area. Nevertheless the negative effects of further increases on the demand for and supply of labour and more generally the business environment should be a consideration in assessing the pros and cons of further recourse to PIT or social contributions as a means of raising revenues.

Figure 8. **Tax and compulsory payment wedges for a single person at two-thirds average wage, no children**



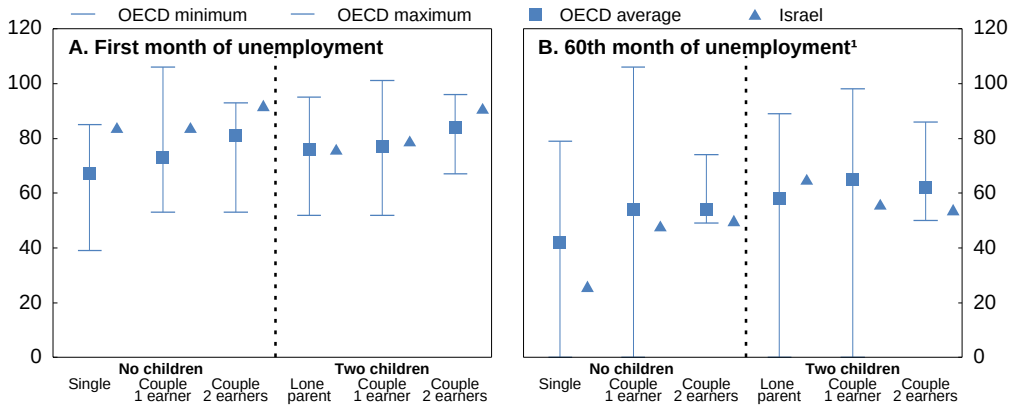
Note: "ISR2014" incorporates the higher mandatory pension contribution that will apply in 2014, while leaving other settings used for the calculation at the 2012 values.

Source: OECD, Taxing wages database.

In other respects the tax-benefit system has some positive qualities in terms of work incentives. Unemployment insurance benefit duration is not excessive, ranging from 1½ to 6 months, depending on the applicant's age and family circumstances. Also, the main welfare benefit – Income Support Benefit – is not only means tested but also requires an employment test (OECD, 2010). As shown in Figure 9, among the various standard household types modelled by the OECD, the replacement rates in the first month of unemployment are typically close to the OECD average, while, at the end of five years some replacement

rates are well below the OECD average, especially for single childless people. Note that these calculations do not incorporate Israel's mandatory pension contributions. Additional calculations for a subset of the household types shown in Figure 9 confirm that including such contributions does push the replacement rate higher (as the contribution is only made when earning) but not to levels that would discourage job-search efforts.

Figure 9. **The unemployment benefit replacement rate at two-thirds average wage, 2011**



1. The micro simulations normally cover only benefits for which there is a general entitlement. For both Italy and Greece, where no broad social-assistance programmes exist, the simulations indicate that benefits are zero for some types of household at the 60th month of unemployment. Hence the minimum OECD replacement rates are zero in some cases. However, in Italy and Greece, and possibly in other countries, local authorities or sub-national governments may provide some form of cash support on a case-by-case discretionary basis.

Source: OECD, tax-benefit models; see www.oecd.org/els/social/workincentives.

The fact that a significant proportion of Israel's poor households are very large affects the policy issues and complicates any assessment of the tax-benefit system. First, the universal child allowances often account for a significant share of income for large households and, consequently, are often at the forefront of debate about welfare benefits. The Haredi community's interest in maintaining generous child allowances has, at least in the past, been intense and often influential. Not only are their families typically large, but the Income Support Benefit is of limited relevance because most Haredi men study full time and are thus ineligible based on the benefit's employment test. Large cuts were made to the child allowances in the early 2000s, but this was followed by some programmed increases. However, the governing coalition has reduced child allowances and moved away from universal provision: they were eliminated for those with incomes of more than NIS 800 000 per year (i.e. around USD 225 000 or seven times the average wage). Abandoning universality is justifiable in terms of spending efficiency in a difficult fiscal situation, but with such a high threshold the savings will likely prove small. The reform to the value of the child allowances is of some concern. The allowance has been cut to NIS 140 per month for each child, previously it was either NIS 175 or NIS 263 (the latter applying to the second, third and fourth child) the higher benefits were granted to children born before 2003. The cut in the allowance in itself implies significant percentage reductions in the incomes of poor families with many children. However, the cut has been made alongside a raft of measures providing positive encouragements to labour force participation and skills development, such as the widening of free childcare, plans to revive private-sector job placement and the increase in the value of the earned-income tax credit (EITC).

The presence of a significant number of large families has also to be borne in mind in considering the extent and significance of poverty and the capacity of the tax-benefit system to bring these households above the standard poverty thresholds. Relative poverty thresholds are commonly calculated as half of "standardised" median income (the poverty rate is then the share of households below the threshold). The

standardisation procedure divides household income by an adjusted figure that gives progressively less weight to each additional family member (conceptually this is intended to reflect economies of scale as households increase in size). OECD relative poverty statistics, for example, use a standardisation weight based on the square root of family size, i.e. the marginal weights for each family member are 1, 0.41, 0.32, 0.27, etc. (Israel's National Insurance Institute uses a different weighting system in which the marginal weights are typically higher). One practical implication is that, for instance, the poverty threshold for a couple with six children is 41% higher than that of one with two children under the OECD's square root approach; keeping large households above the poverty line implies a need for generous welfare provisions.

There is a need to press ahead more vigorously on some fronts, the EITC in particular. The EITC is available to workers with children and/or those aged 55 or over and is a non-wasteable credit: in other words, households can receive a payment from the tax authorities if the credit exceeds the value of tax otherwise owed. In its pilot phase the credit was twinned with a programme introducing government-funded private-sector placement services, which was later cancelled. The EITC has operated nation-wide since 2011 and the credit for mothers and single fathers was increased by 50% in 2012. During the pilot phase (between 2007 and 2010) the scheme is estimated to have boosted recipients' annual income by 7% and to have reduced their incidence of poverty by about 4.5% (Bank of Israel, 2013). Its subsequent extension to the whole country plus the increases in credit amounts will have boosted its impact, but its scale remains small. Further increases in the take-up, and possible also the generosity, of the credit are required to have an appreciable impact on in-work poverty and incentives to enter the labour force (or to increase hours worked among those already employed). Public spending on the credit was only 0.02% of GDP in 2011. This figure will have increased since then due to increased take-up and hikes in the credit but probably not to the level spent on similar schemes for instance in the United States and United Kingdom where the credit costs 0.4 to 0.5% of GDP.

Little progress has been made in reforming the disability benefit system, with disappointing take-up of a new scheme aiming to encourage employment. As in a number of other OECD countries there are concerns that there are fairly significant numbers of disability-benefit recipients who have some capacity to work, but that the system neither encourages nor makes it easy for them to so. Gauged by the total number of recipients, the problem in Israel has not swelled to the levels seen in some countries but nevertheless needs to be tackled. To their credit the authorities have at least been trying to bring about concrete change. Reforms in 2009, *inter alia*, brought a new classification of disability-benefit recipients and the introduction of an earnings top-up payment (the Incentive to Work benefit) as an alternative to regular disability benefit. The Incentive to Work Benefit includes guarantees permitting a return to full-time disability benefit (if, for instance, the individual decides to quit their job) and is, in principle, financially attractive. However, take-up has been extremely low – only 3 490 people entered the scheme in 2011 out of the approximately 215 000 persons on disability pensions. Seemingly, mistrust of the guarantees attached to the scheme and complicated procedures are key reasons for low take-up (OECD, 2013e). Such efforts to engage with those already on disability benefits should not be abandoned. Also, there should be a focus on new claimants, where reforms are often easier to implement and more effective, and on policies encouraging employers' demand for disabled workers. In that vein, new support centres to advise and assist employers with disabled workers are planned.

In addition, tax-benefit policy needs to focus more tightly on the core socio-economic problem: that of poor and often large households with weak labour-force attachment. Since the tent protests of 2011, middle-class concerns have gained in prominence, and there is a risk that these overly divert policy attention and resources away from solving the problems of poverty and wide socio-economic divides. In the Israeli context some measures might, *prima facie*, help both low- and middle-income households but in reality largely benefit the latter (and possibly high-income households too). In particular, reductions in income-tax rates or social-security contributions, as well as expanding wasteable tax credits, are unlikely to relieve poverty or raise work incentives among poor households to any great degree, because a significant

proportion already pay little or no income tax, whether working or not. For example, the decision to allow men to claim child allowance when children are aged up to three years was a good move towards equal treatment (though the treatment remains asymmetric as for mothers the allowance applies to older children too), but also fiscally costly and largely benefiting middle- and upper-income households. Accompanying the extension of the allowance with a reduction in its size would arguably have been a better move.

Of course, adjustments to taxes and benefits are only one element in the range of possible policies to tackle socio-economic problems. For instance, the government is committed to widening access to free daycare for infants and to early childhood education, which should help households combine work and family life. And, with a view to providing longer-term improvement in living standards for poorer communities, policymakers are endeavouring to improve education for Arab-Israeli students and to encourage Haredi schools to pay more attention to core subjects, such as maths and languages.

Pension reform

Israel's pension system combines a modest publicly funded pay-as-you go pension (the first pillar of the system) with favourable tax treatment of pension savings and pay-outs. As mentioned above, since 2008 for (almost all) employees there are minimum compulsory contribution rates to private-sector pension plans (the system's second pillar, see Table 5). Thus, in broad terms, the authorities have avoided significant fiscal commitment. This, combined with favourable demographics, means that public spending on pensions has remained relatively low. And, even though population ageing will increase spending in the future, public pension spending under current policy settings will remain among the lowest in the OECD area.

The first pillar of the pension system ensures reasonably adequate support for retirees when benchmarked against standard poverty thresholds. However, this is not entirely thanks to the state pension. Indeed, as calculations for the 2010 *Economic Survey* show (p. 128), even with the inclusion of seniority payments (Table 5), pension income *per se* probably falls somewhat short of the poverty threshold for many retiree households. However, retirees can be eligible for top-up payments referred to as the Income Supplement (similar to the Income Support benefit discussed above), and calculations suggest these typically ensure retiree incomes are above poverty thresholds (though not by much).

However, the first-pillar pension is not devoid of problems, most notably a singular failure to reach political agreement to bring women's eligibility age for the state pension up to men's. Commendably the retirement age for men has already been increased to 67 years (this was achieved in 2009). However, increases in women's retirement age have stalled, remaining at 62 since 2009, and a series of increases that would bring it to 64 is due to start only in 2017. Among OECD countries it is now extremely rare for women's retirement age to be below that of men and where this is the case for there to be no concrete plans to close that gap.

While the second pillar of the pension system does not involve direct state funding, there are implications for taxes and benefits and related issues. As pointed out above, the introduction of compulsory pension saving involving both employee and employer contributions in 2008 is similar in some respects to a hike in the tax wedge on labour as regards employees' and employers' incentives. Israel's tax treatment of pension saving (or similar forms of saving) comprises partial exemption at the contribution phase, full exemption in the accumulation phase, and imposition of PIT (though with some special breaks) at the pay-out phase (so-called EET tax treatment). Previous OECD assessment (most recently in OECD, 2013e) has suggested the tax treatment should be reviewed. One issue is that introduction of the mandatory pension contributions was not accompanied by a revision to tax treatment, with tax relief continuing to apply to the compulsory component which is in a sense wasteful tax expenditure. Also, the tax benefit on pension income is in the

Table 5. **Key features of the pension system**

First pillar (state pension and related benefits)	
Retirement age	Men's retirement age reached 67 years in 2009. For women the retirement age is currently 62 years; a schedule bringing it to 64 years is due to begin in 2017. There are limits on earnings while in receipt of a public pension up to age 70 for men and age 67 for women (this is being increased to age 70).
Contributions	Total mandatory employee and employer contributions to the NII have several components, including one for pensions. The NII's accounts are fungible in this regard, and the amount of contribution has no bearing on the pension pay-out.
Coverage	Practically universal. Exceptions include immigrants who arrived when over the age of 60 who are covered by a special arrangement.
Pay-out	Pay-outs vary according to household composition and age. For example, as of January 2013 for those under 80 years old the pension for a single person was NIS 1 502 per month and for a couple NIS 2 257 (the pensions are slightly higher for those over 80).
	A seniority increment increases the pension by 2% for each year of full contributions after the first 10 years of contributions (with a ceiling on the total increment of 50% of the pension). Thus, for instance, including the maximum possible increment, the total pension for a single person (aged under 80) is NIS 2 253 and for a couple NIS 3 386.
	The "survivors" pension pay-out is similar that of the regular pension.
Income Supplement	The income-support system guarantees minimum income levels subject to means testing. As of 2013, for example, single persons aged 70 to 80 are guaranteed NIS 2 833 and couples NIS 4 204.
Deductions	A deduction for medical insurance is made on the basic pension (which is lower if the individual is eligible for the Income Supplement).
Second and third pillars (compulsory or voluntary contributions to pension funds or similar)	
Contributions	Mandatory minimum contributions to the new pension funds (introduced in 2008) apply to employees' earnings up to the average gross wage. The contribution rate has been undergoing stepped increases and will reach 17.5% (7.5% from employees and 10% from employers) by 2014. Five percentage points of the employers' contribution also serves as severance insurance.
Tax treatment	Tax treatment not only applies to "regular" pension products but also to saving *via* life-insurance and provident-fund products.
	Employer contributions are not counted in employees' taxable income (with a ceiling).
	Employee contributions are subject to a 35% (wasteable) tax credit (with a ceiling).
	Returns on pension saving are not taxed.
	Pay-outs (annuities) are taxed according to regular income-tax rules except there is: *a*) a tax credit of 35% on the annuity (with a ceiling equal to about 30% of the average wage); and, *b*) an additional tax credit if one's spouse does not work and has no pension.
Other dimensions	Tax incentives generally guide the retirement age (or equivalent) set in long-term saving products. But there are some regulations too. For example, provident-fund savings can be withdrawn only at age 60 or above.
	Defined-contribution pensions include insurance for severance pay, withdrawal of which affects the pension pay-out.
	Pensioners must redeem their pension on a monthly annuitised basis (and not, for example, make capital withdrawals), unless the person already has a monthly income of at least NIS 4 000 (i.e. about 60% of the average wage).
	There are portability provisions for switching between savings products (introduced in 2008).

form of a universal tax credit and is therefore not hugely efficient as a means of combatting pension poverty. A further issue is that the returns to the mandated pension saving for low-income households are dented, since the income from second-pillar pensions can mean reduced income-support payments as

pension income is counted in the means test. Adjustments aiming to further encourage pension saving are being planned alongside proposals to introduce default portfolios in which investment risk declines as the employee ages (the so-called life-cycle approach).

Parenthetically, scrapping the tax credit for medium-term saving in so-called "advanced training funds" (Kranot Hishtalmut) was for a while included in proposed measures for the 2013-14 budget, but unfortunately did not make the final budget. The funds have to be held for three years if the savings are spent on training or education but if held for at least six years they can be spent on a wide range of goods and services, for instance the purchase of cars. As OECD *Surveys* have pointed out there is practically no economic justification for maintaining this particular tax expenditure.

Property and capital gains taxation

Israel is one of several OECD countries that have no taxes on the value of property in the form of wealth tax or on transfers of property through inheritance or gift taxes. Interest income, dividends and capital gains are subject to various flat rates of tax. The basic rate of capital gains tax is the same as that for corporate income tax, but there are variations depending on the purchase date and the nature of the asset. And, as in most other OECD countries, the tax treatment of housing (and real estate in general) differs from that on other assets, which has an important influence on rates of home ownership and property markets and therefore the focus of this section.

Taxation relating to housing

In a welcome move the 2013-14 budget pruned exemptions on capital gains from the sale of property. The in-depth review of the housing sector in the 2011 OECD *Survey* was critical of the scope of these exemptions, and the budget law has narrowed them considerably: exemptions on capital gains from second homes or investment properties have been scrapped entirely (previously there was exemption as long as the owner held onto the property for a minimum number of years); and a limit has been placed on the exemption from capital gains tax for principal residences.

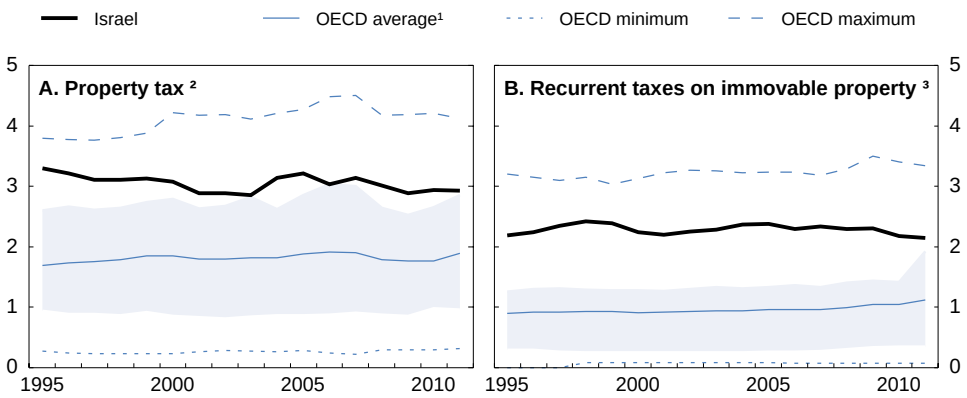
In other respects the tax treatment of owner-occupied housing takes a practical approach. In theory, owner-occupiers should be taxed on imputed rental income but allowed to deduct mortgage interest payments. However, due to the practical difficulties of establishing imputed rents, the treatment is similar to that in some other countries: neither imputed rents nor mortgage interest are taken into account (the assumption being that their values are roughly equivalent, although this is not the case once the mortgage is paid off). More serious is that up to certain limits private taxpayers renting out properties do not have to declare rental income. In addition, the authorities should consider raising the Land Betterment Tax (Hetel Hashbacha), which is imposed when the property sold has benefitted from favourable re-zoning; the tax is currently 20% of the estimated value of the betterment accrued. Such a move would improve the state's share in the windfall profits from re-zoning and reduce the incentives for property developers to try to influence local planning decisions.

Transaction costs on purchasing a house have become somewhat heavier: the tax has been increased when purchasing investment property or second homes, and a supplementary tax has been introduced for high-end property. Given the very wide search for additional revenues in the 2013-14 budget and the continued concerns about the strength of house-price rises, these moves are understandable. Although these particular measures are very unlikely to have dissuaded household mobility to any great extent, the authorities should remain aware of this issue should further hikes in transactions taxes be considered. Also, as a measure to cool the property market, the government has been considering a penalty tax on property developers if the time between receiving the approval for construction and the sale of all properties in the project exceeds three years.

Revenues from recurrent taxes on immovable property (i.e. housing or other buildings) are among the highest in the OECD area (Figure 10, Panel B), representing about 2.25% of GDP and account for the majority of property tax (including that on financial assets) (Figure 10, Panel A). Israeli property tax (the Arnona) is based on the surface area and type of property and is a significant source of municipal revenues. The exploitation of the tax base on immovable property is broadly welcome, given its textbook advantages, in particular the low risk of evasion and less distortionary effects on economic behaviour compared with other tax bases.

Figure 10. **Tax on property**

As a percentage of GDP



1. The shaded area is the 25th to 75th percentile range of available OECD countries.
2. This heading covers recurrent and non-recurrent taxes on the use, ownership or transfer of property. These include taxes on immovable property or net wealth, taxes on the change of ownership of property through inheritance or gift and taxes on financial and capital transactions.
3. This sub-heading covers taxes levied regularly in respect of the use or ownership of immovable property. These taxes are levied on land and buildings.

Source: OECD tax revenue database and OECD Economic Outlook 94 database.

New regulations are in train that, if fully implemented, will double the Arnona on vacant apartments. The move is part of wider efforts to increase the supply of housing; in this instance the intention is to dissuade property owners from leaving apartments vacant for prolonged periods, which is quite common in some localities, especially Jerusalem, where there are substantial numbers of foreign property owners. According to the regulation, municipalities will use water-meter data to determine whether the apartments are 'vacant' and therefore subject to the higher Arnona rate. While this move is perhaps well intentioned, *prima facie* it seems possible that the absent owners may find an easy way around regulation by arranging for someone to occasionally run the water for them or by just leaving the tap on a little. Also, those who are content with leaving apartments unrented are probably not that price sensitive and so the extra levy may not substantially reduce the number of so-called "ghost apartments", although then it would be an efficient revenue-raising base.

Company taxes and business subsidies

Israeli policy on corporate tax and business subsidies appears to be guided by several objectives: *i*) making the profile of taxes and subsidies attractive to investors, especially foreign investors; *ii*) encouraging scientific R&D and other forms of innovation; *iii*) promoting regional development; and, *iv*) providing targeted support for the agricultural sector. Any one element of tax or subsidy often reflects more than one of these goals. Various factors shape how far each is pursued, most notably the strength of revenue pressures and the balance of tax burdens between households and firms. The latter not only

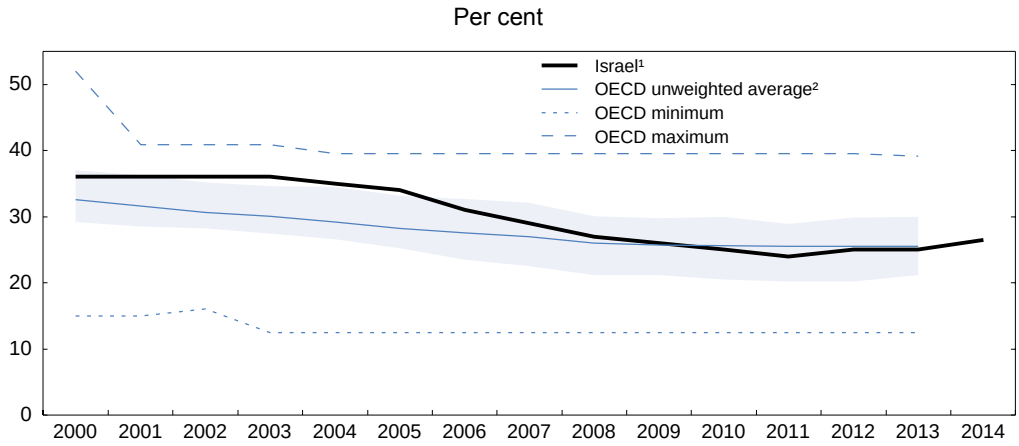
reflecting subjective societal choices but also practical considerations, such as co-ordinating policy on the statutory CIT rate with that on PIT to prevent tax avoidance through incorporation by high earners.

Making the profile of taxes more attractive for business

In small open economies such as Israel's the tension between keeping business tax light in the interests of investment while accommodating revenue needs and tax-fairness considerations is particularly acute because of their intense exposure to capital mobility. As elsewhere, corporate-income taxation involves a range of tax breaks (and subsidies), many of which are, in effect, differentiating between different degrees of capital mobility, thus helping ease policy tensions by targeting special treatment only where it is most required to attract investment. However, the tools for achieving that differentiation are not that precise and can result in a complex system that can be hard to communicate and entail high administrative costs. As an alternative, some OECD countries have focused on imposing a low statutory CIT rate with few base-narrowing rules, tax breaks or subsidies.

Until 2011 Israeli policy was also heading towards a low statutory CIT rate. It had been on a downward track for some years and by 2011 had reached 24%, with further cuts programmed that would have brought it to 18% in 2016. As mentioned, revenue concerns and political opposition arising from the tent protests saw the schedules of cuts abandoned and followed by an increase from 24 to 25% in 2012, with an increase to 26.5% scheduled for January 2014. At that point the rate will probably be once again slightly above the (unweighted) OECD average (Figure 11).

Figure 11. **Statutory rates of corporate income tax**



1. The rate for 2014 (26.5%) is scheduled in measures in the 2013-14 budget.
2. The shaded area is the 25th to 75th percentile range of available OECD countries.

Source: OECD tax database.

The negative impact of these developments on the perceived 'competitiveness' of the tax system has probably not been very large so far. The headline rate has not been increased substantially, and, in any case, the attractiveness of the system also depends on the various factors in calculating the CIT base, as well as tax breaks and subsidy programmes. The Law for the Encouragement of Capital Investments (LECI), the flagship programme on this front, offers CIT rates well below the statutory rate plus other support (Table 6). Previously this legislation explicitly focused on attracting foreign investment; in its current version the eligibility rules assess the firm's export orientation (whether foreign-owned or domestic), a key criterion being that export revenues must account for at least one quarter of turnover.

Table 6. **Targeted programmes providing tax breaks and subsidies**

Law for the Encouragement of Capital Investments (LECI)	
General scheme	• Eligibility, *inter alia*, requires the firm to be "internationally competitive", defined by the industrial sector of the firm or by the geographic diversity of its sales or by having substantial sales to at least one large foreign market. • As of 2014 the CIT rate will be 9% in "priority areas",16% elsewhere. Dividend tax 20%. (There is no time limit to these tax rates.) • Investment grants up to 20% of approved investment available.
Special benefits for large companies	• Eligibility criteria include minimum annual turnover in Israel of NIS 1.5 billion, a combined balance sheet of at least NIS 20 billion, plus either: *a)* productive equipment with a value of at least NIS 400 million in priority areas (NIS 800 million elsewhere); *b)* R&D investment of at least NIS 100 million NIS per year in priority areas (NIS 150 million elsewhere); or *c)* employment in Israel of at least 250 new employees in priority areas or 500 elsewhere. • CIT rate 5% in priority areas, 8% elsewhere.
R&D incentives (managed by the Office of the Chief Scientist)	
R&D fund	• Competitively awarded grants up to 50% of R&D spending with obligation for repayment in instalments if the project is commercially successful. This is the main form of R&D support.
Targets of specialised programmes providing some form of financial support for R&D	• Individual investors and nascent start-ups (Tnufa programme). • Entrepreneurs that are accepted to one of Israel's business incubators. The incubators themselves are privately owned and also partially fund the entrepreneurs. • Academic research particularly in biotechnology and nanotechnology (Magneton and Nofar programmes). • Consortia of firms and academic institutions for joint R&D projects (Magnet programme). • Joint ventures by Israeli and US companies ("BIRD" programme). • Co-operation between Israeli companies and foreign multinational companies. • Centres for R&D in the finance sector. • R&D centres of foreign companies.
Employment grants	
Standard programme	• Available for the establishment or expansion of business premises (involving a least five employees) in certain areas (the priority areas as defined in the LECI, northern and southern areas and selected towns which are dominated by minority populations. • 2½ years of support, declining over time, initially ranging between 10 and 35% of the gross wage bill of the employees concerned, depending on the area of the country and the size of the enterprise (smaller businesses receive more). There is a cap on support per worker of NIS 135 000 over 30 months (i.e. 4 500 per month).
Employment Grant Program for High Salaries (R&D centres)	• Available for the establishment or expansion businesses (involving at least 15 employees) only in northern (Galillee) and southern (Negev) regions of the country. The salary of all new employees must be at least 2.5 times the national average. • Five years of support initially ranging between 35 and 45% of the wage bill. A company that recruits 130 or more employees is entitled to a flat grant of 40% of the wage bill for four years.
Employment Grant Program for large Enterprises ("Anchor")	• Same regional coverage as the "high salary" programme, minimum number of employees 100, average cost of new salaries must be at least 1.5 times the national average. • Four years of support initially ranging between 35 and 45% of salary costs.
Other schemes	
"Angels Law" (2011)	• For the years 2011-15, individuals (foreigners or nationals) investing in "target" companies can deduct the amount invested from their overall taxable income from all sources (up to NIS 5 million per targeted company). • "Target" companies must be R&D-oriented (there are various specific qualification rules in this regard).
"Film Law" (2008)	• Provisions allowing foreign and co-produced filmmakers to withhold tax payments ranging from 9 to 17% of certain production expenses without transferring the amount to the tax authorities.

Aside from taking into account the details of the tax system, investors also value responsible macroeconomic policy. Given that the change in Israeli policy on the statutory rate reflects efforts to bring fiscal balances back on track, the investment community has probably taken a less dim view of it than might otherwise have been the case.

Strong revenue pressures and greater public attention to the distribution of the tax burden between corporations and households have increased the challenges in presenting a business-friendly tax profile. Looking ahead:

- Further hikes in the CIT rate beyond 2014 could be damaging. Even if the direct impact may not be significant, further rises may create the impression that the rate is on an upward trend and prompt fears that economic policy in general is becoming less business-friendly. Rate cuts should certainly not be dismissed entirely from the policy agenda, even though it may be some time before fiscal conditions (and perhaps the political climate too) allow them to resume.

- There may be avenues for improving the efficiency of some CIT features. For example, the LECI's international competitiveness eligibility rule mentioned above could perhaps be raised so as to provide savings and better focus the preferential rates on businesses that are heavily exposed to international competition.

- There may also be opportunities to develop taxation more fully where activities are inherently tied to location, in particular resource extraction. The authorities have already demonstrated a capacity for reform in this area with the new tax-royalty regime for natural gas and oil resources in 2011 (Box 1). Also as from 2011, businesses engaged in natural resource extraction have been precluded from the benefits under the LECI. And, 2013 saw the launch of a committee to re-examine tax-royalty regimes for natural resources outside the sphere of natural gas and oil (dubbed the Sheshinski II Committee, after its chair).

- International comparison suggests there is room to reduce tax compliance costs for business. According to the World Bank's *Doing Business* database Israeli businesses have to deal with a comparatively large number of separate payments; 33 in total. According to the Israeli authorities 27 of these tax payments can be made online. However, the World Bank data suggest taxpayers are nevertheless devoting a considerable number of hours to making these payments (235 hours, on average). In contrast, for example, for Ireland eight payments are reported with an average time to comply of 80 hours (see later sections). Recognising the need for further progress, the authorities aim for only 17 separate payments by end-2015, and ministries have been required to make proposals for cutting red tape in the interface between government and business.

Box 1. **The 2011 reform of the tax-royalty regime for natural gas and oil resources**

The discovery of substantial offshore hydrocarbon resources (mainly in the form of natural gas) prompted positive reform of the tax-royalty regime in 2011 and commitment to establishing a sovereign wealth fund (SWF). The reform left the royalty rate itself unchanged but made numerous adjustments and added new features to taxation (OECD, 2011a). In particular, a special profit levy is now imposed once the ratio of accumulated revenues over costs of a particular gas (and/or oil) field reach a certain level (the levy is often referred to as the Sheshinski tax after the person who headed the committee established to recommend reforms to the regime). The plan is to channel the Sheshinski tax revenues, which will not become substantial for some years hence, into an SWF. Preparations for this are well advanced; as of September 2013 the legislation had completed the parliamentary process. The establishment of the fund reflects a welcome effort to ring-fence the public's share of the hydrocarbon resources and spread the returns across generations through a drawdown mechanism. The fund will also be designed to reduce the risk of so-called "Dutch disease" by skewing the fund's portfolio towards foreign-currency assets (the authorities have already started combating Dutch-disease effects with the Bank of Israel's foreign-currency purchase mechanism).

Encouraging innovation

As elsewhere, R&D activity and innovation in general are encouraged through favourable tax treatment and a host of targeted programmes providing grants and other forms of support. Economic justification for favouring innovative activity lies in externalities arising from gaps between public and private returns to innovation and knowledge spillovers. However, while there is little doubt as to the existence of such phenomena, their scale is uncertain, and the underlying processes generating them are complex. Therefore, developing effective support programmes (either in the form of tax exemptions or grants) requires good systems for monitoring and assessing programme impact and low policymaking inertia when it comes to dropping poorly performing schemes or ramping up those that prove successful.

R&D support programmes in Israel are managed by the Office of the Chief Scientist, which is supervised by the Ministry of Economics and Trade. The main programme comprises a system of competitively awarded grants. Its design is interesting in that, if the supported R&D project generates commercial revenues, then recipients must repay the grant via a deduction comprising a small percentage of annual sales. These repayments are an important source of revenues for the Office and therefore the system is more akin to high-risk loans than a pure 'grant' programme.

A number of additional programmes provide tailored support for small-scale start-ups, academic research (especially when in conjunction with business) and co-operation between domestic and foreign multinationals (Table 6). Also, subsidy schemes endeavour to attract companies to base scientific R&D centres and R&D in the finance sector in Israel. There is support for business parks for start-ups (so-called business incubators) as well. A large number of state-owned incubators were established in the 1990s, the vast majority of which were subsequently privatised (of the 24 currently operating only two remain in state hands). Government continues to play a significant role, as it partially funds the financial (and other) support provided to the entrepreneurs taken on by the incubators.

Given the Israeli economy's impressive scoring on indicators of R&D and high-tech activity (for instance, OECD, 2012b), questions naturally arise regarding policy lessons for other countries on R&D tax breaks and subsidies. At face value the menu of support on offer in Israel does not differ radically from elsewhere, but there may be important differences in detail. Also, there are other forces at work. Training with sophisticated technologies during military service, a large pool of researchers in the Jewish diaspora, and the engineering and science skills brought by the mass immigration from the former Soviet Union in the early 1990s are commonly cited as the key drivers of the economy's success on this front. Digging deeper into this issue requires an in-depth examination of Israel's innovation performance and policy.

Regional development

Israel's tax-subsidy system has fairly strong elements of regional development in that some support is either available, or is more generous, only in certain areas of the country (or specific towns). The preferential CIT rates provided by the LECI, for instance, are lower in certain regions. And, there is a system of employment grants that is available only in some places. As for the other regional incentives (such as those provided for housing), there are some sound socio-economic arguments to justify them; for instance, promoting the development of poor peripheral areas and as a means of combatting the externalities of urban congestion in the centre of the country. However, this is almost certainly not the sole motivation for such regional incentives, given Israel's geopolitical situation.

Support for the agriculture sector

As mentioned in the context of customs duties above, support for the agricultural sector is significant: as of 2012 producer support was estimated at 12% of farm receipts (OECD, 2013a). In addition to the

tariff-based border protection, agriculture is supported through a number of other channels including: implicit subsidies through low rents of state-owned land (almost all land is state-owned), favourable charges for water compared to other users, guaranteed prices and sales volumes for producers, direct income support, capital grants and subsidised insurance schemes. Such heavy support brings higher consumer prices, imposes additional fiscal burdens, curbs structural adjustment toward higher-productivity sectors and implies spillovers on foreign trading partners, especially poor countries with plentiful arable land. As detailed in a recent OECD assessment (OECD, 2013a), reform initiatives have typically headed in the right direction (i.e. lowering support), but implementation is frequently slow. For example, reductions in the guaranteed price paid to dairy farmers for raw milk along the lines recommended by the Kedmi Committee in 2012 have yet to be implemented.

A need for more integrated assessment of targeted business support

Viewed as a whole, Israel's corporate tax and business support is generous, particularly to internationally competitive, high tech operations. The principle of support can only be welcomed, particularly that aiming to overcome informational barriers and asymmetries between private and public returns in innovation. However, it is also important to recognise that, especially when stacked together, tax breaks and other forms of support can be *overly* generous, subsidising much non-incremental activity. The preceding paragraphs suggest this could be the case for Israel. For instance, it seems possible that some firms can simultaneously benefit from the LECI, the R&D fund and employment subsidies and probably enjoy a hefty net subsidy as a result. In light of this, the recent establishment of an inter-ministerial committee to examine the costs and benefits of business subsidies is certainly welcome.

Evasion, avoidance and administration issues

If additional revenues can be raised via enhanced compliance, for instance through more effectively tackling tax evasion and aggressive avoidance, this would create room for manoeuvre in tax strategy and help fiscal balances in general. The increased attention, both domestically and world-wide, to tax evasion and avoidance is providing a political opportunity for renewed policy vigour on this front.

As in other countries the attention of policymakers, the press and the public has homed in on the seemingly low levels of tax paid by some well-known business operations. Particular attention is often drawn to companies' 'tax optimisation' strategies that erode the corporate tax base by shifting profits between tax jurisdictions (base erosion and profit shifting, or BEPS), which has become a focus of OECD analysis (OECD, 2013f). Governments, including Israel's, wish to create attractive environments for business on their own terms, through targeted tax incentives and subsidy programmes such as those described above, not through companies exploiting unintended loopholes. BEPS may not only imply losses in CIT revenue but also put multinational enterprises (MNEs) in an advantageous position over domestic firms and distort investment. Also, the perceived unfairness of BEPS risks damaging trust and compliance elsewhere in the tax system. However, making progress in addressing these issues can be tough, especially when this runs counter to MNEs' vested interests. Recent experience in the taxation of profits (or dividends) when transferred out of the country illustrates that resolving these issues is often a bargaining outcome, rather than one driven only by economic principles (Box 2). This underscores the importance of Israeli policymakers working together with other governments on the BEPS Action Plan to achieve international consensus on actions to deal with weaknesses in the international tax system.

Box 2. **The issue of "trapped profits"**

Big business often has a degree of bargaining power regarding tax treatment, and Israel is no exception. This has been exemplified by the issue of so-called 'trapped profits', which has become prominent. In a previous version of the LECI foreign transfer of dividends or profits was subject to capital taxation. As a result, some large companies held back from such transfers, accumulating large reserves of assets in Israel. A new version of the law, which came into force in 2011, removed this condition, but not retrospectively. The regime for "trapped profits" was offered to companies as a non-obligatory complementary measure following the transition from the former version to the current LECI. Following consultation with business, an amendment to the LECI was passed in November 2012 under which companies that accumulated profits under the former version of the LECI will pay between 40 and 70% of what would have been owed under the previous rules when transferring dividends or profits. This non-obligatory measure stipulates that the amount of saved tax in increasing the plant in Israel by purchasing more machinery and equipment, R&D expenditures or hiring new employees. According to press reports, as of November 2013 the amendment had brought NIS 4.4 billion in revenues.

The authorities' efforts to tackle the 'trapped profits' issue is part of a wider campaign to increase revenues and to tackle evasion and aggressive avoidance. Concrete steps on several fronts have being taken or are underway, including: media campaigns, increased numbers of staff (an additional 400 relative to a total of around 6 000), further development and implementation of e-reporting, computerised systems for fraud detection, and strengthening collaboration with other government bodies (for instance, the police) and with other countries and international organisations. In addition, a host of technical adjustments to legislation and regulation are in train (Box 3). Continued efforts along these lines can only be encouraged.

Box 3. **Recent alterations to legislation and regulation aiming to reduce tax evasion and aggressive avoidance**

Recent measures taken by the Israeli authorities to close legal loopholes have targeted the following:

- Financial trusts: contributions from a foreign trust 'settlor' (i.e. the person who creates the trust, the donor) no longer produce tax-free income for Israeli beneficiaries.
- "Family" companies. Exploitative switching by enterprises in their status for tax purposes between "family run" and regular businesses has been stopped. The amendment also explicitly defines the profits eligible to be distributed to the shareholder free of tax.
- Revaluation gains. Enterprises can no longer avoid two-tiered taxation via revaluation gains. Revaluation gains are surpluses 'generated' by an increase in the value of assets and were previously subject only to dividend tax.
- Real estate taxation. Legal changes include a narrowing of tax exemptions when property is transferred in the form of a gift.
- Vehicle leasing companies. Unintended tax benefits have been removed and a depreciation rule made less generous.

In addition, the campaign to counter evasion includes greater penalties for failing to report items legally requiring disclosure, and, aiming specifically at money laundering, reporting requirements for foreign currency dealers have been ramped up.

Future plans aim to increase the power of the money laundering law, bring in new rules for controlled foreign corporations, improve tax debt collection when activities are "rolled over" into a new company and establish a new expert analyst unit.

The authorities should also contemplate reforms to the institutional and organisational framework of revenue collection:

- There has been a shift internationally towards establishing more autonomous tax authorities, and Israel remains among a handful of countries in which the tax authority (ITA) remains a directorate within the Ministry of Finance (or equivalent) (OECD, 2013g). The arrangement echoes that of the Capital Market Savings and Insurance Division, a supervisory body that is also part of the Ministry of Finance. The establishment of a body that is more independent and genuinely outside of the Ministry should be considered, or, if not, there should be some reflection as to whether the ITA's relation with the rest of the Ministry requires adjustment.

- In Israel, social security revenues are administered separately from the ITA's administration of the tax system. While this approach to revenue collection is also seen elsewhere, a growing number of governments have, over the past two decades, integrated the collection of tax and social security contributions to improve efficiency and effectiveness and to reduce the compliance burden on businesses (OECD, 2013g). Reform along these lines should be considered in Israel as part of efforts to reduce the perceived significant revenue leakage arising from underground economic activities where incomes go unreported (e.g. cash-in-hand payments to casual employees and incomes of self-employed taxpayers) in order to escape both taxation and social security contribution liabilities.

- Increasingly, tax authorities in OECD countries are organising their operations on a "functional" basis, *inter alia* featuring a dedicated division to administer the tax affairs of their largest taxpayers. In addition, many have downsized office networks given reduced needs for 'face-to-face" services arising increasing use of modern electronic services. The potential for further reforms in these areas should also be considered.

Other avenues for improving the effectiveness and efficiency of tax administration should continue to be pursued. These include embedding risk-management approaches for improving compliance across all segments of taxpayers and enhancing the quality of services provided. Policy efforts regarding the latter should focus on further developing and encouraging use of electronic services, especially web information and systems for the electronic filing and payment of taxes, and to encourage their use.

Box 4. **Recommendations on taxes and transfers**

Indirect tax

- Should the regressivity of VAT require a policy response, use existing social welfare mechanisms rather than recourse to multiple VAT rates. Renew efforts to remove the existing exemptions on fruit and vegetables and services in Eilat.
- Press on with the scheduled reductions in customs duties on consumer goods and food items, and maintain a strategic goal for further liberalisation.
- Keep the 'green credits' but cut the basic rate of purchase tax on vehicles. Shift instead to taxing vehicle use, such as by fee-based reserved lane systems and urban congestion charging. Further tighten the tax treatment of company cars. Accompany these moves by expanding alternatives to car use.
- Consider an economy-wide carbon tax by increasing the existing excise tax on primary fuels to levels concomitant with the estimated GHG-emissions externalities.
- Continue to develop environmental levies. Remain aware of the risk of under- or over- funding from earmarking the revenues from such levies for particular areas of spending.

Household income tax and benefits

- Broad strategy on PIT rates: avoid further hikes in PIT rates beyond what is in the pipeline.
- Employment and relative poverty:
  - Avoid further increases in the tax wedge on low-wage labour.
  - Invest more in active social policies. Ensure better take up of the earned income tax credit as part of wider welfare-to-work measures, such as reforms to employment services.
  - Further pare back universal support, and reduce tax credits that largely benefit middle and upper income earners. For instance, lower the income ceiling introduced on access to child allowances.
  - Consider increases in means-tested income support, but ensure these do not create welfare traps.
- Pension issues: bring the age of eligibility for the state pension for women to that for men (67 years). Pursue intended reforms of the tax treatment of pensions.

Property taxation

- Make capital assets deemed to be realised at death for capital gains tax purposes.

Company taxes and transfers

- Refrain from further raising the statutory CIT rate, and consider signalling that reductions will be resumed once budgetary conditions allow it.
- As planned, review the net subsidies granted to firms, taking all tax breaks and support schemes into account. Consider narrowing eligibility for the benefits provided by the Law for the Encouragement of Capital Investment.
- Ensure taxation is adequate in immobile sectors (such as resource extraction).
- Pursue plans to reduce tax compliance costs for business by simplifying the tax code such that the number of payments paid is lower.
- Reform agricultural support to improve the efficiency of the sector and its international competitiveness.

Evasion, avoidance and tax administration

- Press on with campaigns combatting tax evasion and aggressive avoidance. Evaluate the Israel Tax Authority's position within the Ministry of Finance with a view to either moving it outside the Ministry or to strengthening its independence by other means. Consider unifying the collection of tax and social security revenues, and adopting a "functional" approach to tax administration that, *inter alia,* includes a unit dealing with large taxpayers.
- Press on with the further development of electronic services in tax administration.

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