FELLOWS PROGRAM | KORET MILKEN INSTITUTE

JULY 2004
NO. 1

EXECUTIVE SUMMARY

THE VALUE-ADDED TAX (V.A.T.) IN ISRAEL: A PROPOSAL FOR REFORM

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The Value-Added Tax in Israel: A Proposal for Reform

Ayelet Zur

The study recommends:

- **Adopting a deductible-at-source model for VAT collection to ease the burden on small business and save the Treasury NIS 1 billion annually.**

Introduction

The Value-Added Tax (VAT) is the second most important tax in Israel, following income tax. VAT provides the government with about 18 percent of its total income.[1] Unlike income tax, which, being progressive provides a negative incentive to increase earnings, VAT, which is imposed across the board on almost all goods and services, is considered efficient and neutral in its effects on the economy.

Nonetheless, the methods used to collect VAT in Israel are not efficient. Hundreds of thousands of businesses, especially small businesses, are saddled with unnecessary bureaucratic costs and financing problems; these are in effect negative incentives to open and maintain businesses. The irony is that not only do the methods used to collect VAT create an oppressive atmosphere for business, but they cause the Treasury an estimated annual loss of over 1 billion shekels (about $220 million).

The History of VAT

VAT is a relative newcomer to the world's taxes. France pioneered its use in 1954; it was not until 1963, when the European Economic Community (EEC) recommended its use, that VAT became popular. In 1975 it was adopted by the Knesset, effective July 1, 1976, as part of an overall reform of Israeli taxation that was to include a reduction in indirect taxation. Ultimately, and in contradistinction to most of the rest of the world, it was enacted in Israel as an additional indirect tax, rather than a replacement for existing ones.[2]

The VAT Law

VAT was imposed at one rate on what is called the "value added" to all business dealings in Israel (with some exceptions noted in the Law); "value added" is defined by the Law as meaning the difference between the purchases and sales of a business, or the services received and those provided (in financial institutions such as banks it refers to the all wages and profits).[3]

In order to accommodate the different types of businesses operating in the country, VAT is collected by different means. Most regular businesses file bimonthly reports listing the amount due, from which is deducted the amount of VAT they have paid when purchasing goods or services themselves. Generally, VAT is due the fifteenth of the month after goods or services are provided, not when payment is received. As of January 2003, small businesses are exempt from VAT, but "small" is defined today as having an annual turnover of less than approximately $14,000 - one of the lowest exemption thresholds in the world.[4]

The VAT Law empowers the minister of finance to set the rate of the tax, and it was originally imposed at rate of 8 percent. A year later this was raised to 12 percent; by the mid-eighties it was at times as high as 18 percent, a rate again imposed in June 2002, and only in March of 2004 did the rate drop to 17 percent. All told the rate has been changed nine times since its inception, including six rate hikes and three cuts. Finance Minister Benjamin Netanyahu explained the 2004 cut as designed to increase the purchasing power of weaker consumers and encourage consumption and demand. The Treasury estimated the cost of the 1 percent reduction in VAT as NIS 1.65 billion during the remaining ten months of 2004.[5]

This estimate appears to be flawed. The estimate would be correct if the tax cut were not passed on to consumers and therefore there would be no effect on purchases. But a 1 percent reduction in VAT is estimated to cause an average reduction in the price of goods of 0.633 percent,[6] meaning that as the price falls, demand rises, and thus the Treasury's tax loss would be less than 1 percent of the tax base; indeed, in some cases tax income may increase. Netanyahu later announced he would cut VAT by another percent if tax income were higher than estimated.

The Problems with VAT

Regardless of the rate of VAT at any given time, four major problems are created by the method used in Israel (and around the world) to collect VAT. These problems arise: (1) when payments for goods are received after the goods are delivered; (2) when payments for goods delivered are not made; (3) when the Treasury refuses to recognize VAT paid as an expense; and (4) when the VAT Law is abused, mainly by the use of fraudulent invoices. The problems have adverse effects on both businesses and the Treasury.

The system used to collect VAT involves the payment of the tax at every stage of production and sale, each time on the value added; each VAT payment is then recognized in the following stage as an expense, to be deducted from the next VAT payment due. This system is known as one of tax credits. When it works well, it is simple and efficient and a true reflection of added value. But if one of the businesses in the chain of production refuses to pay or cannot pay for any one of several reasons, a domino effect makes the system costly and problematic:

1. Israel imposes VAT on a "commercial" or "accrual" basis rather than on a "cash" basis, with various exceptions including doctors, real estate agents, and businesses

with turnovers of less than about $144,000 and fewer than five employees. (It is unclear how many small businesses can take advantage of this exemption, but about half are not even eligible.) According to the commercial basis, the due date for the tax is the date goods are transferred, not the date payment is made. This system is designed to ensure that by the time a business can actually expense VAT payments, the Treasury has already received them. However, if a business delivers goods on credit or in return for future payment, it must therefore remit its VAT payment to the Treasury before it has itself received payment for the goods; in effect, Israeli businesses must bear the cost of extending credit to the Treasury.[7] The problem becomes graver during a recession, when more payments to a business are delayed or not made, while it must make its VAT payments in advance to the Treasury.

This burden can be especially heavy on a small business that lacks sufficient collateral to secure bank working capital or that can do so only at very high interest rates. Such businesses are also those that must often extend generous credit terms to their customers in order to compete with larger enterprises. The Association of Craft and Industry in Israel therefore asked the Finance Ministry to include small business as one of the sectors operating on a cash basis, as is done in most other countries. On July 14, 2003, the ministry rejected the request, claiming allowing businesses with a turnover of up to NIS 5 million (approximately $1.3 million), estimated to be approximately 80 percent of all businesses in Israel, to operate on a cash basis would entail a loss to the Treasury of "about 650 million shekels" ($150 million) annually, and would encourage the sector to extend even more generous credit to its customers, thus increasing the cost to the Treasury.[8]

Again, the Treasury's numbers seem incorrect. The Treasury will not face a "loss" but only a delay in VAT tax receipts. The appropriate calculation of the true cost to the Treasury is the total income from businesses with turnovers of under NIS 5 million currently operating on a commercial basis during the period of credit (78 days at the time), or NIS 650 million, multiplied by the cost of the delay, i.e., the local interest rate. Even assuming a high 10 percent interest rate the cost would only be NIS 65 million, or some $15 million. Updating the figures to April 2004, the average credit period has increased to 85 days and an additional 23 days of late payments, so the true cost of the change benefiting small business would only be about NIS 90 million ($20 million).[9]

The Knesset has before it five bills proposing to legislate this change, including one proposed by Labor MK Orit Noked (P/1217) that would require businesses to pay VAT no later than 180 days after transfer of goods or services. This provision would cap possible costs to the Treasury but would be a great aid to small businesses, especially during a recession.[10]

2. The second problem with the current system involves cases of bad debts or the cancellation of transactions, when a business applies to the Treasury for a VAT refund of payments made but never collected. The bureaucratic burden is cumbersome, and the business must wait six months before even applying for a refund.

3. The third problem arises when the Treasury does not accept a business' expensing of its VAT payments, as for instance, if an improper invoice were issued to the business for goods it provided. An example of this problem involves the Sela concrete company, which subcontracted work for a state tender, paid the subcontractors and received VAT invoices from them, while some of the work was not done by the subcontractors whose names were on the invoices. The Treasury and, when Sela appealed, the High Court, ruled that even when a business acts in good faith, it may be unable to expense the VAT it paid.

4. Finally, the Treasury itself loses. When a business issues a fraudulent invoice, often for income tax purposes, the invoice also provides "proof" of VAT payments that are in turn expensed though never made. While providing an exact estimate of this loss is difficult, research shows the average amount to be approximately six percent of VAT collected or over $220 million annually, though in 1995-1996 the amount may have been as high as nine percent, or some $440 million.[11] This estimated loss does not include the costs of maintaining a bureaucracy to try to collect these sums.

A Proposal for Reform: Deducting VAT at the Source

As noted, there are currently in the Knesset several proposals for reform that would enable VAT to be collected on a cash rather than commercial basis, and this would be an improvement over the current system, though it would entail other costs. We favor a major but simple alternative:

Since the nineteenth century, deducting tax at the source has been recognized as both less costly and more efficient for ensuring tax collection. But while it is accepted for purposes of income tax, it is not used around the world for VAT collection (except in Israel for financial institutions and non-profits under certain circumstances).[12] We propose adopting it for all VAT.

The system would work as follows: All purchasers (except the final non-business customer, who cannot expense his VAT payments) would no longer add the VAT to the sum paid to the seller of goods, but rather would transfer the VAT directly to the Treasury (deducting it at source) and give the seller proof of tax paid. The seller would give the purchaser a tax invoice, to certify the VAT deducted during the purchase. The tax deducted at source would not be a burden to the purchaser, because he would be allowed to expense it against his own sales; and at the same time, the Treasury would no longer be forced - or even able - to recognize or return the tax expensed unless it had actually been paid. Filing would be done similarly to current income tax filing, and the Treasury's computers would reveal any discrepancies between businesses' filings, thus eliminating the problem of tax evasion.

The proposed system solves all the problems discussed above: (1) The seller would no longer need to bear financing costs as he "lends" the Treasury tax payments made in advance of funds received; (2) Since payment would be made by the

purchaser, there would not be a problem of bad debts; (3) Inappropriate invoices leading the Treasury not to recognize expensing would no longer exist, since the business doing the expensing would actually pay the tax to the Treasury; and (4) The Treasury cannot lose income since nothing can be expensed that had not actually been paid.

(Under the proposed system, the final customer would be treated as today: he would pay VAT to the seller who would pass it on to the Treasury.)

This simple and foolproof system would also permit a reduction in bureaucracy, as the elimination of fraudulent invoices would decrease the need for Treasury agents to oversee collection.

To further limit bureaucracy, we recommend that extremely low-value business transactions with minimal VAT due not be required to deduct the VAT at source.

This proposal would remove many of the burdens facing businesses in Israel, especially the small business sector, while potentially eliminating a one billion shekel annual loss to the Treasury because of fraud and bureaucracy.

Notes

1. Central Bureau of Statistics, *Statistical Abstracts of Israel* 47-53, www.cbs.gov.il.
2. Richard W. Lindholm, Value-*Added Tax and Other Tax Reforms* (Chicago: Nelson-Hall, 1976), pp. 44-48.
   http://europa.eu.int/comm/taxation_customs/publications/info_doc/taxation/tva-2003-5-1_en.pdf (web entry 5 July 2004); Knesset Protocol, Eighth Knesset, Third Session, vol. 11, p. 904 [Hebrew].
3. Knesset Bill 1178, 28 April 1975, p. 235.
4. www.mof.gov.il/customs/osek_frame.htm (30 December 2003).
5. www.mof.gov.il/customs; www.mof.gov.il/research (12 June 2004); *Ha'aretz*, 12 February 2004.
6. Gilad Harush and Clara Kozin, "The Effect of VAT Rate Reduction on the Israeli Economy," *The Israeli Tax Review*, vol. 31, no 122 (Decmeber 2003), pp. 44-45, table 3 [Hebrew].
7. *VAT Law 5736-1975, Book of Laws 5736*, p. 52 [Hebrew]; David Gliksberg, "Taxing Added Value, Tax Accounting and Bad Debts," *Bar-Ilan Law Studies* 10 (1993), pp. 122, 130. [Hebrew]; Dror Zorger, "VAT on a Cash Basis," *The Israeli Tax Review*, vol. 20, no. 78 (April 1992), p. 189 [Hebrew].
8. Dr. Abraham Alter, the lawyer representing the Organization of Craft and Industry in Israel, letter to Minister of Finance Silvan Shalom, 21 October 2001; Shai Dotan, "Due Date for VAT in the Productive Small Business Sector," Ministry of Finance, Customs and VAT Authority, Planning and Economics Department, 16 July 2003 [Hebrew].
9. Dotan, "Due Date"; Dotan, interview with the author, 21 April 2004; Business Data Israel, Inc., *Report on Credit and Payment Behavior -* April 2004 Summary (n.p., 28 April 2004) [Hebrew]. It should be noted that Shai Dotan, to his credit and attesting to his integrity, participated in the author's calculations.
10. P/1119, P/1472, P/1217, P/1802, and P/1934 clauses 1 and 15, submitted by MKs Ayoob Kara, Eliezer Cohen and Yuri Shtern, Orit Noked, Orit Noked and Ruhama Avraham, respectively [Hebrew].
11. Noam Zusman, "VAT Business Evasion: Comparing the VAT Base in National Accounts with Actual VAT Collection," *The Israeli Tax Review*, vol. 30, no. 117, p. 30, table 2 [Hebrew].
12. Arye Lapidoth, *Principles of Income Tax and Capital Gains Tax* (Jerusalem: Tax Museum, 1970), pp. 227-228 [Hebrew]; VAT Law 5736-1976, Rule 6A, Rule Book 3524 (12 May 1976), p. 1590 [Hebrew].

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