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TAX REFORM FOR ISRAEL

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Tax Reform for Israel*

By Shahar Shlush

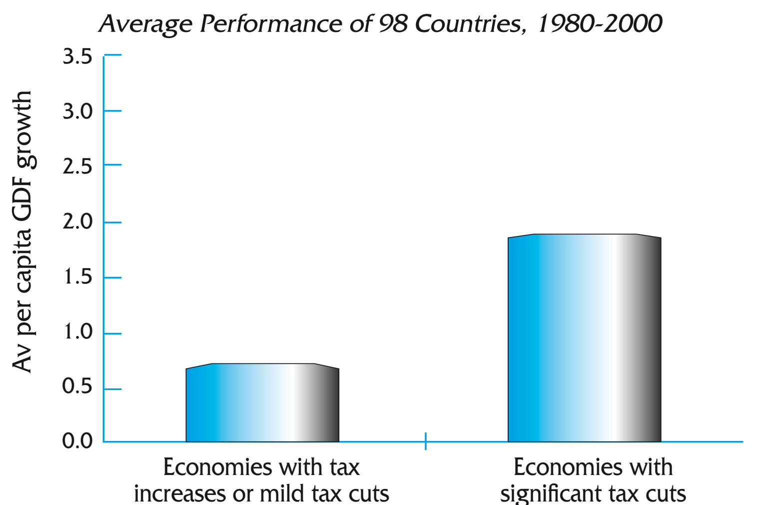
High Israeli tax rates are a disincentive for work and investments, and actually reduce state tax income. Graduated progressive rates penalize the most productive individuals in the economy.

- Since 1994, countries in Eastern and Central Europe have adopted flat rate tax reforms that eliminated graduated tax rates. These countries experienced significant increases in economic growth, foreign investment and income from taxation.
- We recommend that Israel learn from the rapid economic growth achieved in every country that has adopted a flat tax system, and switch to one low tax rate on business and personal incomes, with an exemption for low income populations.

Taxes: Israel and the World

The competition between countries for investment is increasing. A country with an unfriendly tax system – a complicated system with high rates – loses the foreign investment that is necessary for local economic growth. Israel's system should be examined relative to other countries to determine the impact of the tax system on economic growth. The 2007 "Tax Misery" Index, published by *Forbes* magazine, is based on six major tax rates. The country with the lowest "Tax Misery" rating is the UAE. Israel is way behind, at number 32.[1] Also, as can be seen in Graph 1, countries that meaningfully cut taxes grew at an average rate three times that of countries that did not do so.

Graph 1: Income Tax Cuts and Per Capita Economic Growth



Source: Alex Robson, *The Costs of Taxation*, Perspectives on Tax Reform (8), CIS Policy Monograph 68 (St. Leonards, NSW: The Center for Independent Studies, 2005), p. 12, http://www.cis.org.au/Publications/policymonographs/pm68.pdf (May 22, 2007).

* Zev Golan served as editor for this study.

The complexity of the Israeli tax system and its high rates are two obvious drawbacks, which have led to a reduction in the state's income from taxes: High tax rates encourage tax evasion and complex tax planning. In 2003, tax evasion in Israel was estimated at $4.4 billion annually.[2] The costs for tax compliance are also high. It is estimated that the annual costs of complying with the Israeli tax system are over $8 billion.[3]

The Flat Tax

The flat tax was first proposed by professors Alvin Rabushka and Robert Hall. In this system, any income stream is taxed once, and at a low rate. The flat tax is designed to achieve several purposes: First, it encourages growth; Rabushka and Hall estimated that by ending disincentives to work and investment, the GDP would grow by approximately an additional 6% in the course of seven years.[4] Secondly, the system is fair as it imposes equal taxes on people who earn the same amount, regardless of the source of the income. In addition, since only an initial sum is tax exempt, as long a person's income grows, he will be paying a higher amount of his total income; in other words, progressivity is achieved without the damage caused by marginal tax rates that continue to increase. Moreover, the system is also simple; as a result, the costs of compliance can be reduced as much as 94%. There is also a reduction in administrative costs and incentives to evade paying taxes.[5]

International Experience

Since 1994, a tax revolution has occurred in Europe, as it moves towards one flat rate. Some countries introduced intensive market reforms in addition to the flat tax. While these reforms also contributed to their economic growth, the timing of the change in the per-capita GDP growth rate of Estonia, Lithuania and Latvia correlates with the time the flat tax was adopted. Especially relevant is that the countries that adopted the flat tax saw an increase in state income from taxation, a finding sufficient in itself to support the adoption of the system – as the type of tax system and its rates are certainly correlated to the resulting tax income.

The following is a list of the first countries that changed their system to a flat tax:

Estonia: In 1994, Mart Laar, the prime minister of Estonia, exchanged Estonia's three tax rates (16%, 24%, and 33%) for a flat tax of 26%. This rate is expected to drop to 20% in 2009. In 2000, corporations were exempted from taxes on undistributed profits, a move which is a considerable incentive for investment.[6] In the three years preceding the reform (1991-1993) the average annual growth in Estonia was negative, at -11.7%. In the second year after the reform, growth was positive, and reached 4.5%. Foreign direct investments (FDI) in the two years preceding the reform averaged $118 million, but they rose to $202 million in the second year after the reform.[7] The state's income from personal income tax was $138.5 million in 1993, $184 million in 1994

and $313.5 million in 1995. In other words, the state's income from taxes more than doubled in two years. The income from the corporate tax rose from 2001-2005 by 193%.[8] In 2006, real economic growth in Estonia was 11.4%, the second highest in the EU.[9]

Lithuania: Lithuania instituted a flat tax of 33% in 1994 (in 2005 a further reduction to 27% was approved for July 2006 and 24% for January 2008). Corporate tax was reduced gradually from 29% in 1995 to 15% in 2002. Since 1997 undistributed profits have been tax exempt.[10] The state's income from personal income tax rose from $150 million in 1993 to $423 million in 1995. Income from the corporate tax rose from $300 million in 1993 to $561 million in 1995.[11] In the three years preceding the reform (1991-1993), average real economic growth was negative, at -14.4%. In the second year after the reform, real economic growth was 3.3%.[12] FDI rose from an annual average of $33 million in the three years preceding the reform, to $73 million in the second year after the reform.[13]

Latvia: In 1995 Latvia instituted a flat tax of 25%, and the corporate tax was reduced gradually from 25% before the reform to 12.5% in July of 2006.[14] In the three years preceding the reform (1992-1994) the average economic growth in Latvia was negative, at -11.6%. In the second year after the reform, growth reached 3.8%. In 2006, real economic growth in Latvia was the highest in the EU, at 11.9%.[15] In terms of FDI, Latvia's growth has been extraordinary. In the three years preceding the reform, the average FDI was $96 million. In the year of the reform it reached $180 million and in the year after, $382 million.[16]

In Russia and Serbia, the institution of a flat tax saw similar growth.

In Table 1 we can see the spread of the flat tax around the world. The table includes countries that have already instituted a flat tax, countries that have approved a flat tax reform and will be instituting it shortly, and countries that are considering adopting the system.

Small Business

It is universally accepted that the small business sector contributes substantially to economic growth and to employment. This sector should benefit greatly from a flat tax because the simplicity of the system would considerably reduce compliance costs. Studies show that these costs are proportionately a heavier burden for small businesses than for large businesses.[17] In addition, Rabushka and Hall suggested that implementation of a flat tax would lead to a reduction in interest rates of approximately 20%; because small businesses often face more difficulties in borrowing, they would benefit greatly from such a reduction.[18]

Implementation of a Flat Tax in Israel

In 1990, Dr. Jack Menes of the Institute for Advanced Strategic and Political Studies published a detailed study of the Israeli tax system in which

Table 1: The Spread of the Flat Tax

Country	Year of adoption	Tax rate (2007)
Already adopted		
Estonia	1994	22%
Lithuania	1994	27%
Latvia	1995	25%
Russia	2001	13%
Serbia	2003	14%
Ukraine	2004	13%
Slovakia	2004	19%
Georgia	2005	12%
Romania	2005	16%
Kyrgystan	2006	10%
Macedonia	2007	12%
Iceland	2007	35.73%
Mongolia	2007	10%
Montenegro	2007	15%
Adopting soon		
Mauritius	In 2006, a flat tax of 15% was approved for 2009.	
Considering a flat tax		
Kazakhstan	NA	
Kuwait	10%	
Albania	10%	
Czech Rep.	15%	
Slovenia	20%	
China	NA	

Notes: The table includes countries that have adopted a flat tax since the flat tax revolution in Europe began. In addition, there are four countries that are already using such a tax: Hong Kong, considered the freest country in the world according to the 2004 Fraser Index, instituted a voluntary flat tax of 15% in 1947, raised recently to 16%; the British crown colonies of Jersey and Guernsey instituted a 20% flat rate in 1940 and 1960, respectively; Jamaica instituted a flat tax of 33.33% in 1987, which applied to individuals and corporations, and since then the personal income tax in Jamaica has dropped to 25%. Also, in Estonia the rate is expected to drop from 22% to 18% and perhaps as low as 12%; in Lithuania the rate is expected to drop to 24% in 2008; in Macedonia to 10% in 2008; and in Montenegro to 9% in 2010.

Sources: Daniel J. Mitchell, “Flat World, Flat Taxes”, April 27, 2007, http://www.american.com/archive/2007/april-0407/flat-world-flat-taxes (June 1, 2007); Sandra Hadler, Christine Moloi and Sally Wallace, *Flat Rate Taxes: A Policy Note*, ISP Working Paper Number 07-06 (March 2007), pp. 16, 17, http://isp-aysps.gsu.edu/papers/ispwp0706.pdf (May 28, 2007).

he recommended implementing a flat tax. According to Menes' proposal, personal and business income should be taxed at a rate of 25% beginning with the first shekel earned. According to his proposal, the complicated depreciation schedules and regulations would be replaced with immediate write-offs in the year investments are made. The proposed tax rate of 25% included social security. Further simplicity was achieved by combining the reporting of income and VAT by businesses. The system was so simple that a business could report its income on a form the size of a postcard, with only ten lines. Personal income tax would also be computed and reported on one form the size of a postcard – with only five lines.[19]

In 1993, Labor MK Rafi Ellul, then leader of the Knesset's Social Caucus, joined with MKs from Likud and Tsomet in support of a flat tax. In 1996, the Tsomet party headed by Raphael Eitan (Raful) ran on a platform that included a flat tax of 26% on individuals and corporations with a reduced rate of 16% for residents of development towns. In an interview given in the daily *Globes*, Raful indicated that he had discussed his plan with the then-governor of the Bank of Israel, Jacob Frenkl, and received his blessing.[20]

Recommendations

In light of the success of the flat tax in so many countries, its rapid spread worldwide, and clear macro-economic indicators and academic studies supporting the system, the conclusion is easy to reach: Any country would find it worthwhile to exchange a system of multiple high-rates for a system with one low rate. In addition, it is advisable to reduce to a bare minimum any exemptions, credits or deductions. One basic low-income exemption would ensure low-income wage earners are not hurt by the reform, and would achieve progressivity while removing impediments that discourage entrepreneurship and investment and retard increases in labor and economic growth. Israel should adopt such a tax system as soon as possible.

Endnotes:

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2 Herzl Lux, "The Black Market Enrolls more than $20 Billion Dollars a Year," *Haaretz*, September 10, 2003, Walla News, http://news.walla.co.il/?w=//438766, (May 28, 2007).

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7 Sandra Hadler, Christine Moloi and Sally Wallace, *Flat or Flattened? A Review of International Trends in Tax Simplification and Reform* (Washington, D.C.: United States Agency for International, Development 2006), p.21,

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10 Keen, Kim and Varsano, *The 'Flat Tax(es),'* pp. 7, 42; Alvin Rabushka, "A Competitive Flat Tax Spreads to Lithuania," November 2, 2005, http://www.hoover.org/research/russianecon/essays/5084276.html (February 9, 2007).

11 Giedre Balcytyte, head of public relations, Ministry of Finance of the Republic of Lithuania, email to the author, March 28, 2007.

12 Hadler, Moloi and Wallace, *Flat or Flattened?* p. 21.

13 Ibid.

14 Keen, Kim and Varsano, *The Flat Tax(es),* pp. 7-8, 43; Sandra Hadler, Christine Moloi and Sally Wallace, *Flat Rate Taxes: A Policy Note*, ISP Working Paper Number 07-06 (March 2007), p. 12, http://isp-aysps.gsu.edu/papers/ispwp0706.pdf (May 28, 2007).

15 Ministry of Finance of the Republic of Estonia, March 12, 2007, http://www.fin.ee/?lang=en, (April 17, 2007).

16 Hadler, Moloi and Wallace, *Flat or Flattened?* p. 21.

17 Orad, *Compliance Costs*, pp. 49, 50; Arthur P. Hall, Special *Brief, Compliance Costs of Alternative Tax Systems II*, p. 5; Business NZ and KPMG, *Summary Report of the Business New Zealand – KPMG Compliance Cost Survey* (Wellington: Business NZ and KPMG, September 2006), http://www.kpmg.co.nz/pages/101943.html (March 28, 2007).

18 Hall and Rabushka, *The Flat Tax*, chapter 4, p. 144.

19 Jack Menes, *A Comprehensive Tax Reform Plan for Israel*, Institute for Advanced Strategic and Political Studies, IASPS Policy Studies no. 7 (Jerusalem: Institute for Advanced Strategic and Political Studies, October 1990), pp. 36, 39.

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