

**ECONOMICS DEPARTMENT**

**ENHANCING THE EFFICIENCY AND EQUITY OF THE TAX SYSTEM IN ISRAEL**

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By Oliver Röhn

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## Abstract/Résumé

### Enhancing the efficiency and equity of the tax system in Israel

Israel's tax mix is reasonably growth- and employment-friendly. Nonetheless, tax reform is needed to foster an inclusive recovery from the COVID-19 crisis and help tackle Israel's main economic and societal challenges of high poverty, including among those in work, and slow aggregate productivity growth. The earned income tax credit has been an effective tool to reduce poverty and increase employment among the low-skilled and could be further expanded. The business tax system provides large benefits that aim to incentivise companies to become more productive, but the existing design may create distortions. This preferential tax treatment should be reviewed with a view to better targeting the scheme to ensure net benefits to society. There is also scope to simplify the tax system by removing inefficient tax expenditures and better leverage Israel's impressive technological capacity to further lower compliance costs and reduce tax evasion. Finally, excise taxes should be adjusted, including by taxing carbon more heavily, to improve environmental and health outcomes.

This Working Paper relates to the 2020 OECD Economic Survey of Israel

<http://www.oecd.org/economy/israel-economic-snapshot/>

Keywords: Israel, taxes, personal income taxes, business taxes, tax administration, environmental taxation, tax avoidance, transfers, tax evasion, subsidies

JEL Classification: H23, H24, H25, H26, H53, H55, I38

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### Renforcer l'efficace et l'équité du système fiscal en Israël

Le système fiscal israélien est raisonnablement propice à la croissance et à l'emploi. Néanmoins, une réforme des impôts est nécessaire pour favoriser une reprise inclusive après la crise liée au COVID-19, et contribuer à remédier aux principaux problèmes économiques et sociétaux liés à l'ampleur de la pauvreté, y compris parmi les actifs occupés, et à la lenteur de la croissance de la productivité globale en Israël. Le crédit d'impôt sur les revenus d'activité a constitué un outil efficace pour réduire la pauvreté et renforcer l'emploi parmi les personnes faiblement qualifiées, et ce dispositif pourrait être encore étoffé. Le système d'imposition offre aux entreprises des avantages fiscaux importants, qui sont destinés à les inciter à devenir plus productives, mais qui peuvent, en l'état, créer des distorsions. Il conviendrait de réexaminer ce traitement fiscal préférentiel en vue de mieux cibler ces dispositions, de façon qu'elles soient avantageuses pour la société en termes nets. Il est également possible de simplifier le système d'imposition en supprimant les dépenses fiscales inefficaces, et de mieux exploiter les capacités technologiques impressionnantes d'Israël pour réduire encore les coûts induits par le respect de la législation fiscale et faire reculer la fraude fiscale. Enfin, il faudrait ajuster les droits d'accise, notamment en taxant davantage le carbone, pour améliorer les résultats obtenus sur le plan environnemental et sanitaire.

Ce document de travail est lié à l'Étude économique de l'OCDE de 2020 consacrée à Israël

<http://www.oecd.org/fr/economie/israel-en-un-coup-d-oeil/>

Mots clés : Israël, impôts, impôts sur les revenus des particuliers, impôts sur les revenus des sociétés, administration fiscale, fiscalité environnementale, évitement fiscal, transferts, évasion fiscale, subventions

Classification JEL : H23, H24, H25, H26, H53, H55, I38

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# Enhancing the efficiency and equity of the tax system in Israel

By Oliver Röhn<sup>1</sup>

## Main features of and challenges facing the tax system

The economy has experienced an unprecedented economic downturn due to the COVID-19 crisis, with profound negative effects on well-being, jobs, productivity and public finances. As part of the crisis response, the government temporarily enhanced the social safety net, provided transfers to the most vulnerable people, and took several tax measures to help firms shore up liquidity. This included temporary reimbursements of local property taxes and payment deferrals of value-added taxes and social security contributions for small firms. As economic policy shifts from the immediate crisis response, tax reform can play a crucial role in boosting an inclusive recovery while safeguarding fiscal sustainability.

The Israeli tax system has undergone several reforms in the recent past. Most importantly, in the early 2000s the government started to pursue a profound tax and transfer reform with the aim of containing the size of the government and making the tax system more business-friendly. The tax burden was shifted from direct to indirect taxation, and social transfers were cut to strengthen incentives to take up work. This policy shift ended in 2011 following social protests (the so called “tent protests”) and nascent fiscal difficulties. As a result, the government halted further planned cuts in the personal and corporate rates and partly reversed them. The progressivity of the personal income tax was increased, and certain customs duties were lowered with a view to containing retail prices. Yet the fiscal balance went off-target, which prompted the government to hike the value-added tax (VAT) rate (OECD, 2013).

The government that took office in 2015 aimed at keeping the tax burden low while increasing support for families: the VAT rate was reduced from 18 to 17% and the corporate income tax rate from 26.5 to 23%. Relief was provided for families in the form of higher tax allowances, an expansion of the earned income tax credit and higher transfers. Moreover, the progressivity of the personal income tax system was increased, including by raising the surtax on high-income earners from 2 to 3%.

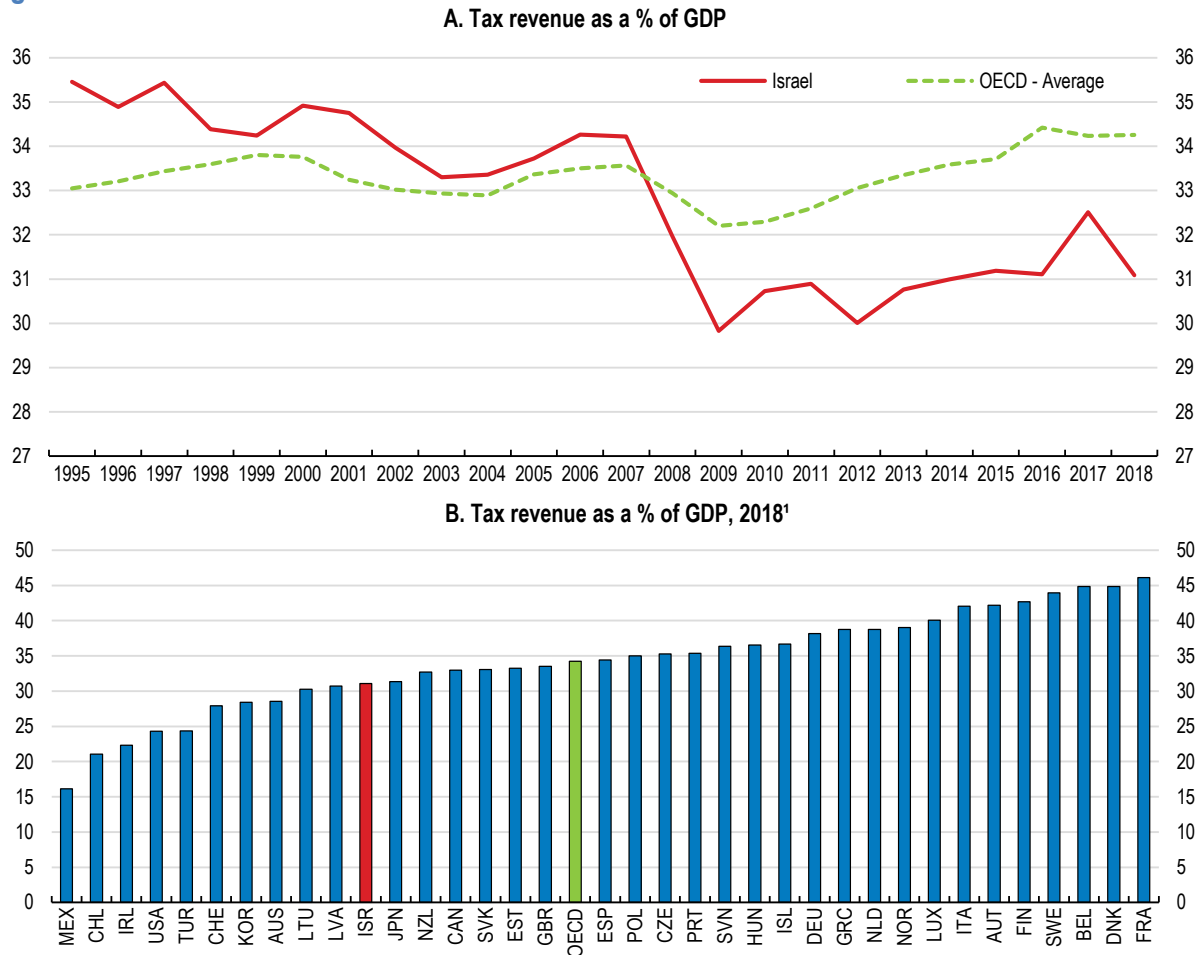
These tax policy changes are reflected in the dynamics of tax revenues. The tax reforms of the early-2000s led to a sharp drop in revenues, which had exceeded the OECD average until then (Figure 1). This was

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mainly due to a marked reduction in personal income tax revenues. Since 2011 tax revenues have stabilised and edged up slightly. Nevertheless, the overall tax burden remains lower than in most OECD countries.

**Figure 1. The tax burden is lower than in most OECD countries**



1. 2017 for Australia and Japan.

Source: OECD, *Tax Revenue Statistics database*.

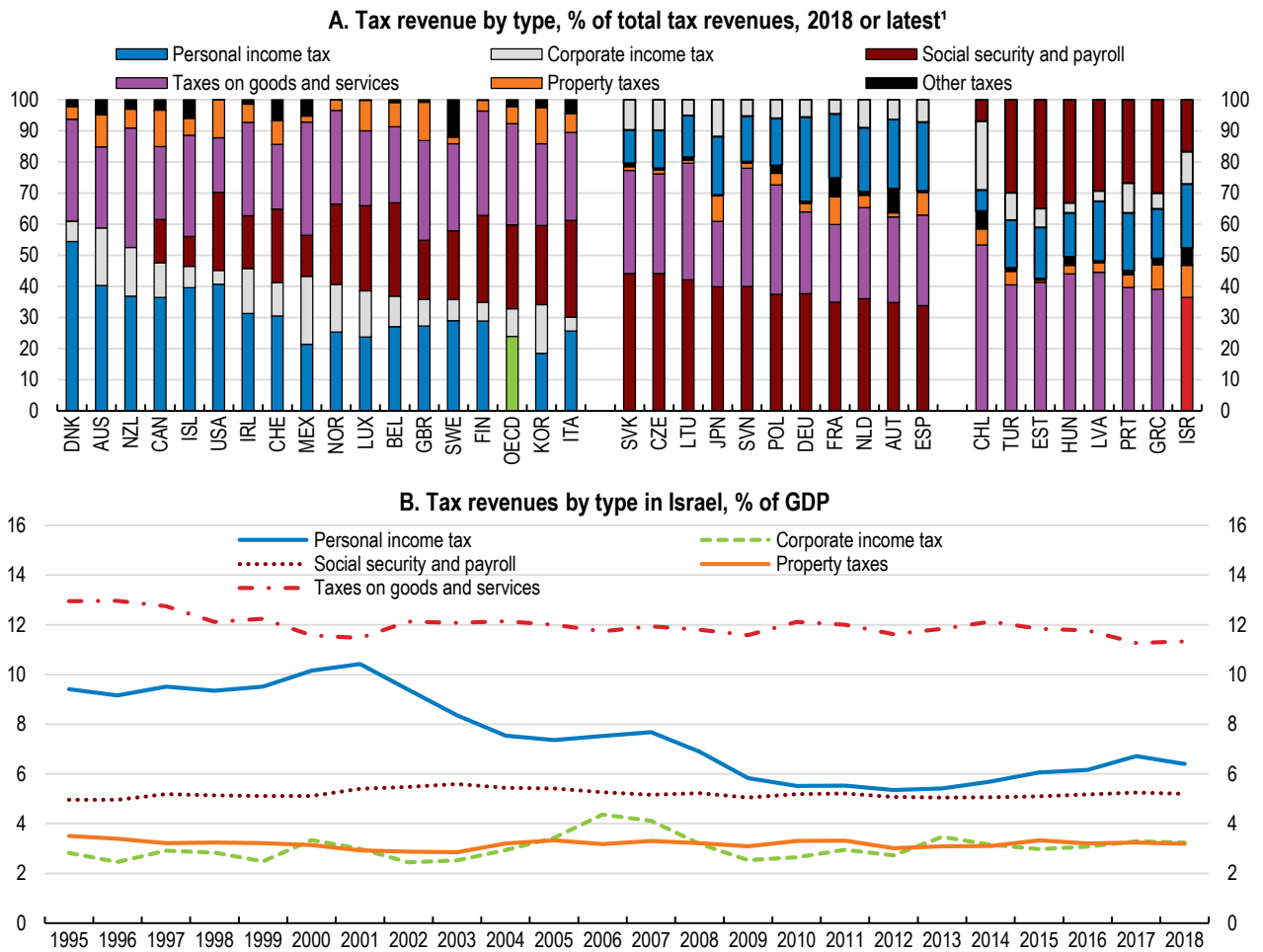
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Israel's tax mix is reasonably growth- and employment-friendly. The tax burden on labour is relatively low in international comparison, and the corporate income tax rate has been lowered in recent years to near the OECD average. Taxes on consumption (mainly through VAT), which are generally less distortive (e.g. Arnold et al. 2011; Akgun et al., 2017), are used more heavily than in other OECD countries (Figure 2). Tax revenues from immovable property are also higher than in most OECD countries. As discussed below, the property tax in Israel suffers from several deficiencies, which create distortions. Since taxing immovable property is in general less distortive, the property tax in Israel should be reformed in order to make it an efficient tax instrument. At the same time, the declining personal income tax share in total tax revenues in the 2000s contributed to the reduction in income redistribution wrought by the tax-transfer system (Strawczynski, 2015; Causa et al., 2018).

Tax reform is needed in a number of areas:

- There is scope to reduce tax expenditures to simplify the tax system and make it more efficient. The Ministry of Finance estimates that annual tax expenditures amount to about NIS 67 billion (4.8% of GDP) and sees scope to increase revenues by NIS 10-20 billion by removing some of them.
- Poverty remains high and is likely to increase due to the COVID-19 crisis as many low-skilled workers have been laid off (Figure 3). Poverty is especially high among the Ultra-Orthodox and Arab-Israeli, who participate less in the labour market, have lower skills, work fewer hours and live in larger households. Transfers to the poor are low in international comparison, reflecting a government policy to incentivise labour market participation. This policy has contributed to raising employment rates among these groups, but they remain low and the income received from work has not been enough to make a substantial dent in poverty. Tackling poverty, while maintaining strong incentives to take-up work, therefore remains a key challenge to improve social cohesion.
- Israel's aggregate productivity growth has been lagging behind leading OECD countries. A marked productivity disparity exists between highly dynamic, trade-exposed, high-tech industries and more domestic-oriented, sheltered sectors (OECD, 2016a). The COVID-19 crisis may further exacerbate this disparity as the high-tech sectors were less affected and better able to cope with the crisis. Reducing this disparity will, first and foremost, require tackling the large educational gaps, insufficient infrastructure investment and lack of competition in several sectors. However, business taxation should be reviewed with a view to reducing distortions between sectors and creating a level playing field so that resources can flow to their most productive uses.
- Pollution is well above recommended levels, and road traffic intensity is the highest in the OECD. Both lead to losses in well-being and productivity. This partly reflects inadequate transport infrastructure (OECD, 2018a), but adjusting excise taxes to better reflect externalities should also play an important role in improving environmental and health outcomes.
- Tax revenues may need to be sustainably raised, together with further efforts to increase spending efficiency, to bring debt back on a declining path while allowing for additional social and infrastructure spending. Extra spending in these areas can boost the recovery and is needed to help narrow Israel's large socio-economic gaps and foster productivity growth (OECD, 2018a). Despite recent increases, civilian expenditure remains low (Figure 4). In addition, the fiscal position started to weaken even prior to the crisis. Despite robust growth and near full employment, the general government budget deficit increased markedly from 0.9% of GDP in 2015 to around 4% of GDP in 2019 as the surge in expenditure coincided with the lowering of tax rates (e.g. VAT and corporate income).

Figure 2. Most tax revenues come from consumption taxes

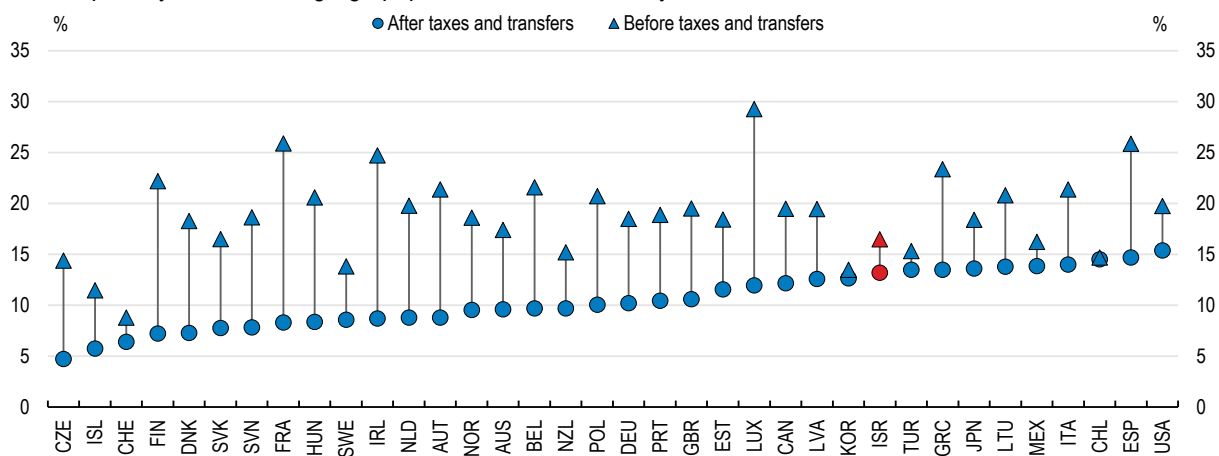


1. Countries are grouped and ranked by those whose income tax revenues (personal and corporate) are the highest share of total tax revenues, followed by those whose social security contributions are the highest share, and then where taxes on goods and services are the highest share. Source: OECD Global Revenue Statistics database.

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Figure 3. Poverty remains high

Relative poverty rates, working-age population, 2017 or latest year available



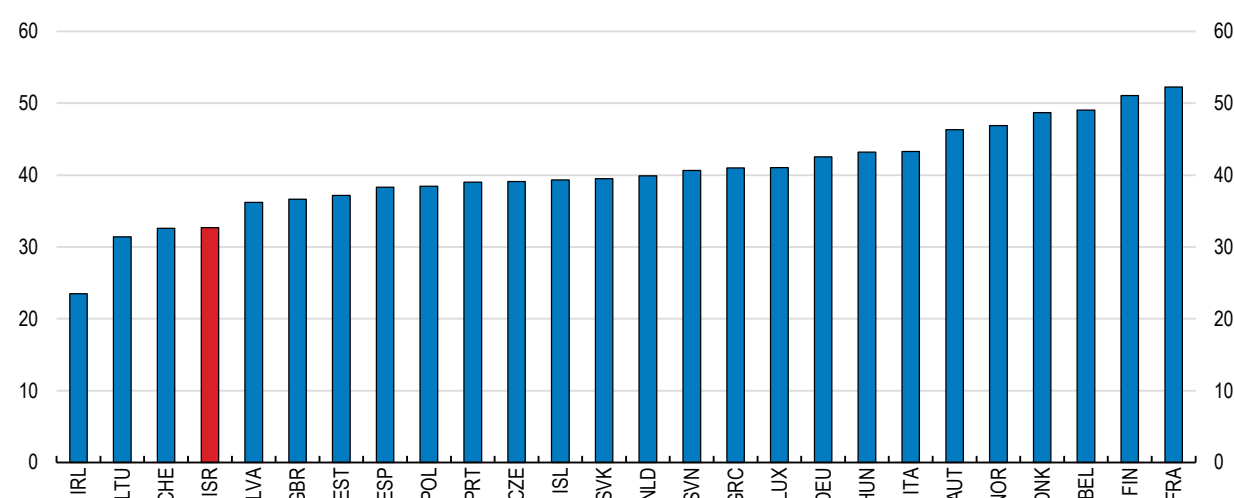
Note: Percentage of persons living with less than 50% of median equivalised disposable income. 2018 data for Australia and Israel. Source: OECD Income Distribution database.

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**Figure 4. Government civilian spending is lower than in most OECD countries**

Primary civilian expenditure, % of GDP, 2018



Source: OECD National Accounts Statistics database.

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## Personal income taxation

Israel's personal income tax (PIT) system is fairly progressive. Individuals are taxed separately. In 2017 some rates and the width of some brackets were changed, effectively decreasing the tax burden for low- and middle-income individuals, while increasing the burden for those on higher incomes. The top marginal rate of 50% is in the upper half of OECD countries', and the income threshold of the top tax rate, at around four times the average earnings, has moved closer over time to the threshold level in other countries with high top marginal rates (Figure 5).

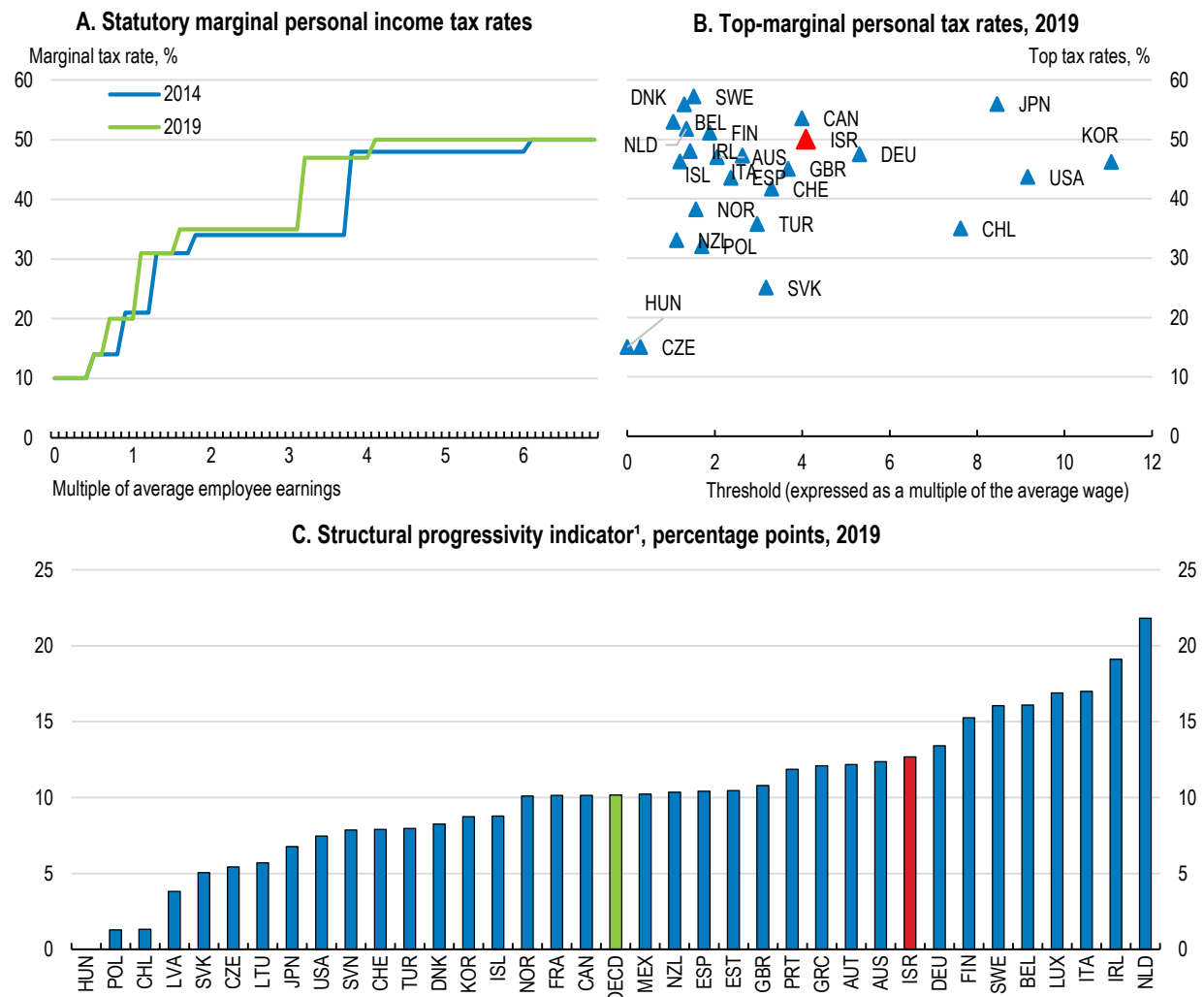
National social security contributions are levied at progressive rates up to a ceiling. The contribution rates paid by employees and employers are applied in two brackets: a reduced marginal rate for income up to 60% of the average wage of 3.5% for employees and 3.55% for employers; and a full marginal rate of 12% for employees and 7.6% for employers for income above 60% of the average wage up to a ceiling of NIS 43 370 per month (about USD 12 070). The full rate for employers was increased in several steps in recent years from 5.9% in 2011 to 7.5% in 2016.

As in other countries, individuals can benefit from a range of tax credits, which reduce the tax burden and can affect the system's overall progressivity. The basic tax credit implies that only individuals with income higher than about 40% of average earnings (slightly below the minimum wage) pay personal income tax. A range of additional (non-refundable) tax credits exists, which lowers the tax burden in particular for families with children, single parents and working women (Table 1). In addition, a (refundable) Earned Income Tax Credit was introduced to support low-income households in 2008 (see below). The distribution of incomes, together with the current personal income tax rate schedule and tax credits, implies that relatively few individuals pay income tax. According to data from the Ministry of Finance, the top two deciles of the income distribution paid 90% of all personal income tax in 2018, while the bottom five income deciles paid only 0.4%.

The costs of all non-refundable tax credits should be monitored closely and the effectiveness of reaching the intended goals regularly assessed. For example, the budgetary costs of the tax credits for residents of development areas have increased substantially over time, from NIS 1.4 billion in 2015 to NIS 2.3 billion in 2019. The purpose of the credits is to increase the attractiveness of poorer regions and encourage migration from richer regions (the centre in particular). However, research by the Bank of Israel finds little

evidence that the tax credits encourage migration to poorer regions (Boi, 2015a). In addition, the credits are prone to abuse. The same research shows that the number of residents who are registered in a region but do not actually live there is higher in areas that benefit from the credits than elsewhere. Furthermore, the income of these “fictitious” residents in areas that benefit from the credit is substantially higher than that of actual residents, suggesting that tax incentives play a role in wrongfully registering in these regions. As discussed in Machlica (2020), a better policy to increase the attractiveness of poorer regions would be to ensure comparable basic services across municipalities, for example by modifying the inter-municipal fiscal framework.

Figure 5. The personal income tax system is progressive



1. The structural progressivity indicator measures the percentage point change of the average income tax rate for a single person with no children if their income increases from 67% to 167% of the average wage. Source: OECD, *Taxing Wages Database*.

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**Table 1. Main personal income tax allowances and credits**

	Comment	Estimated budget cost 2019
<i>Standard tax credits (wasteable)</i>	Each credit point is worth NIS 2 628 in 2020. Each individual income earner is entitled to these credits.	
Basic credit	Every resident taxpayer is entitled to 2.25 credit points	
Additional credit for women	Women are entitled to a further half credit point.	NIS 0.97 billion
Child credit	- Both parents get 2.5 credit points per child aged under 5 - Working mothers with children aged under 18 are entitled to one additional credit point per child	NIS 5.5 billion
Single parent credit	- Single parents (male or female) are entitled to one additional credit point	NIS 0.16 billion
<i>Non-standard tax credits (wasteable)</i>		
Pension contributions	Tax credits of 35% are awarded for contributions to approved pension schemes, up to a ceiling that varies according to the employee's circumstances	NIS 17.7 billion (including tax benefits to contributions from employers)
Residence	Employees living in certain development areas or in conflict zones receive credits as a percentage of their income up to ceiling. Credits range from 7% in the lowest category, to 20% in the highest, with ceilings of NIS 132 000 and 252 840, respectively. About 20% of the population live in these areas.	NIS 2.3 billion
New immigrants	New immigrants are entitled to three additional credit points in their first 18 months in Israel, two additional credit points in the following year and one credit point in the year after that.	NIS 0.03 billion
Soldiers	Discharged soldiers receive 2 credit points for three years after the completion of at least 23 months of service or 1 credit point for a shorter service.	NIS 0.09 billion
Students	Graduates of academic studies receive 1 credit point for 1 year after completing a B.A. degree or the year thereafter (or after the completion of 1 700 study hours that led to a professional certificate) and 0.5 credit point for 1 year after the completion of an M.A. or the year thereafter.	NIS 0.07 billion
<i>Earned Income Tax Credit (non-wasteable)</i>	Applies to workers aged 23 or older who are parents of one or more children aged under 18 and workers aged 55 or older even without children. Maximum monthly credit of NIS 330 for workers aged 55 and older without children, NIS 495 for parents (including single parents) of one or two children and NIS 720 for parents (including single parents) with three or more children. The minimum and maximum earnings thresholds for eligibility vary by family type (e.g. the eligibility window is NIS 2080 to NIS 6350 for parents of up to two children). A temporary measure in 2019 (for earnings in 2018) increased the grant by 30% for eligible workers if the spouse also works and earns a minimum income of NIS 3 650 per month.	0.16% of GDP

Source: OECD (2019), *Taxing Wages 2019*; Ministry of Finance.

### ***Encouraging employment and combating poverty***

Israel's approach to tackling poverty and inequality has focused on providing incentives to take up work. Social transfers are low, as policymakers are concerned that higher transfers slow the progress of job-market integration. The previous government, however, increased benefits for religious students, and eliminated the requirement for both parents to work to receive subsidies for childcare.

The government's strategy is reflected in a small tax burden on labour income. Thanks to low income tax rates, tax credits and reduced social security contributions, the standard labour tax wedge is especially small for low-income earners (Table 2). Individual-level taxation and basic tax credits for each individual earner avoid the disincentives of family-based taxation for second earners. In addition, women benefit from additional basic tax credits and extra credits for each child aged between 5 and 18 years. The preferential tax treatment of women could be justified by the fact that their employment rates are still lower than those for men, especially among the Arab-Israelis. However, the employment gender gap has narrowed substantially and is relatively small in international comparison. In addition, the tax credit mainly benefits women with high income. The government should therefore aim for a more gender-neutral tax treatment in the medium term or target the tax credit better to low-income women.

**Table 2. The average tax wedge is lower than in most OECD countries, 2018**

	Family type						
	Single, no children			Single, two children	Married, two children		
Wage level (% of average wage of each earner)	67	100	167	67	100-0	100-33	100-67
Standard tax wedge							
Israel	15.5	22.4	31.8	2.4	19.9	16.7	16.1
OECD unweighted average	32.1	36.1	40.4	16.0	26.6	28.1	30.8
Including all compulsory payments							
Israel	29.6	33.0	37.8	18	30.7	28.5	28.4
OECD unweighted average	34.8	38.5	42.6	18.9	29.4	30.8	33.4

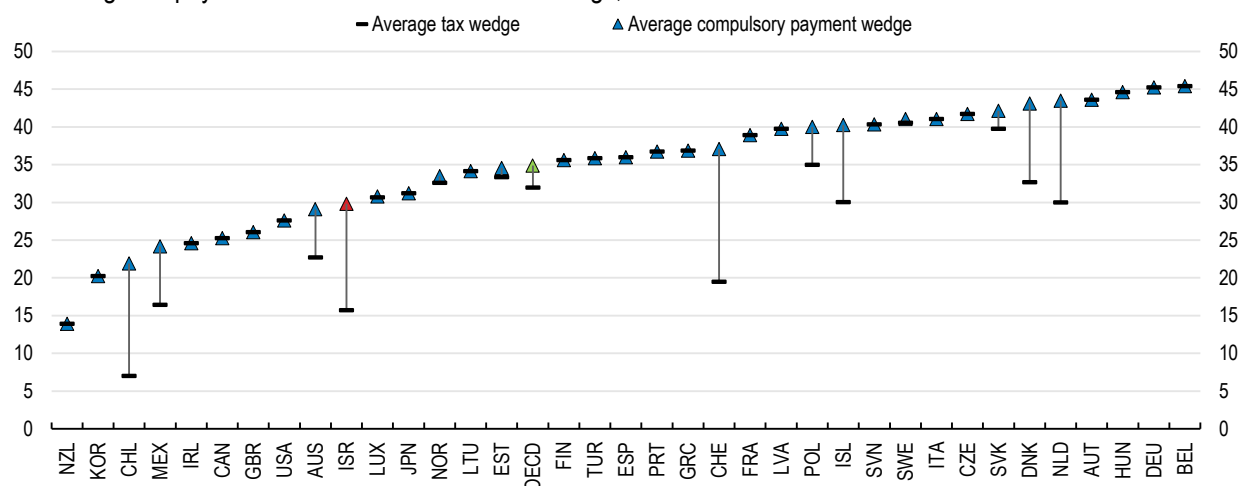
Note: The children in the model are between 6 and 11, and single earners are male. The standard tax wedge is defined as income tax plus employee and employer social security contributions less cash benefits as a % of labour costs. The average compulsory payment wedge is expressed as a % of augmented total labour costs.

Source: OECD, *Taxing Wages database*.

Including mandatory pension contributions to private-sector pension funds (“second pillar” pensions) brings the compulsory payment wedge closer to the OECD average (Table 2 and Figure 6). The minimum rate of contributions is 18.5% of the employee’s salary (up to the average wage). Employees pay about one-third and employers two-thirds of the contribution. The mandatory pension contributions for low-wage workers are high in international comparison (OECD, 2016a). In return, the pension system offers high replacement rates for workers earning less than the average wage. Furthermore, 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. Nevertheless, it may diminish work incentives to some extent, tends to undermine low-income households’ living standards during their working age and may lead to higher informality (Brender, 2011). The government should therefore avoid further increases of the compulsory payment wedge for low-income workers.

**Figure 6. Tax and compulsory payment wedges**

For a single taxpayer with no children at 67% of earnings, 2019



Source: OECD *Taxing Wages database*.

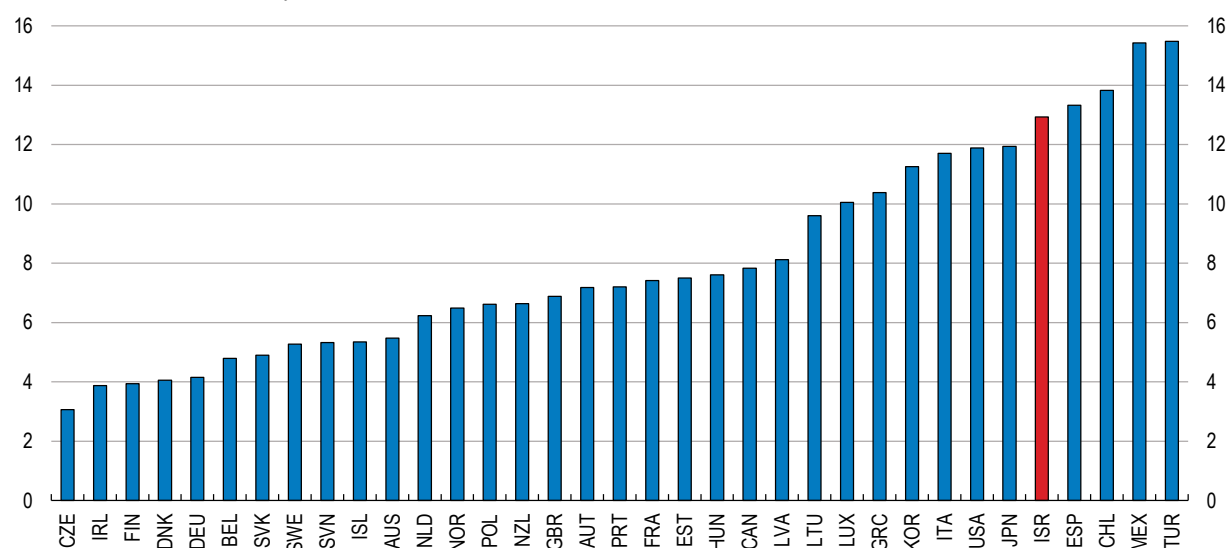
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The Israeli government’s strategy of encouraging employment among previously non-working families has met with substantial success, but the share of working poor has risen and is internationally high (Figure 7). The average real income of poor households has grown faster than the average real income of their wealthier counterparts in the recent past. Many workers with traditionally low labour market attachment

have been able to find jobs, but their families remain poor, since in most cases these jobs are low-paid. This is particularly true for the Haredim and Arab-Israelis for whom the increased number of breadwinners per household in the last decade (including part-time workers) has had only a limited impact on their poverty risks given the typically large size of their families. Therefore, the authorities should focus more on decreasing poverty among those in work.

**Figure 7. The share of working poor is high**

Share of workers in poverty, %, 2017 or latest



Note: Working poor are those with income below the poverty line (50% of median disposable income), living in households with a working-age head and at least one worker. 2018 data for Australia and Israel.

Source: OECD, *Income Distribution database*.

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One way to address this poverty issue is to further expand in-work tax subsidies. Israel's Earned Income Tax Credit (EITC) is an effective redistribution measure with significantly positive employment effects for low-skilled workers (BoI, 2015b; MoF, 2017c; Brender and Strawczynski, 2019). Eligibility for the EITC in Israel is based on individual income, with a relatively high ceiling for family income.<sup>2</sup> This design mitigates negative employment effects on second earners found in similar in-work programmes in the United States and United Kingdom, which are based on family income (Brender and Strawczynski, 2019). The programme is available for workers with monthly wages of 15-55% of the average wage (10-90 % for single parents) and boosts income of eligible persons on average by up to 10-25%, depending on the family situation (Table 1). According to the tax authority about 290 000 employees and self-employed (7.5% of the total workforce) benefited from the EITC in 2017. The take-up rate of the EITC is around 70% (MoF, 2017c), similar to other countries'. The EITC is currently paid four times a year to eligible persons based on their income in the previous year.

Since its inception in 2008, the EITC has been progressively expanded. Most recently, the "Net Family" programme of 2017 included several temporary measures for the 2019 budget: a) an increase of the tax credit for fathers by 50% to the level of mothers of NIS 495 per month; b) the introduction of a 30% bonus in benefits if the spouse has monthly labour income above NIS 3630; and c) an increase in the wage range

<sup>2</sup> The maximum monthly amount that a family can earn and still be eligible for the full individual credit is NIS 13 000 (about 130% of the average salary). If the couple's earned income exceeds this amount, the credit of the eligible individual is offset against the excess income (Brender and Strawczynski, 2019).

in which a worker is entitled to the maximum credit amount. These welcome changes have restored gender balance and strengthened work incentives for second earners. In addition, the expansion is estimated to reduce overall poverty by 0.9 percentage point, with the largest reduction among the Ultra-Orthodox (2.7 percentage points) (BoI, 2018). These temporary measures should be made permanent. In addition, the EITC could be further extended, since its overall budgetary cost including the latest measures is only around 0.16% of GDP (IMF, 2018). Net costs of EITC programmes might be lower than these gross budgetary costs, as EITCs boost labour supply, thereby reducing other welfare payments (Bastian and Jones, 2019). The EITC could be expanded, for instance, by increasing the maximum pay-out amount or the bonus for second earners. However, care would need to be given to the particular design of any EITC expansion to avoid high marginal tax rates in its phase-out range.

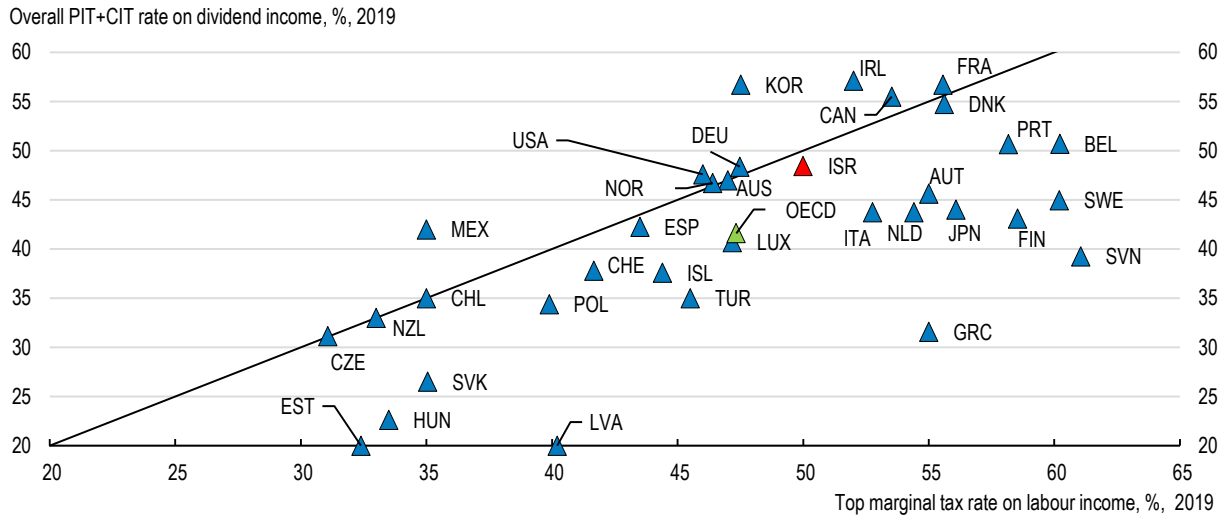
The Net Family programme also increased the (wasteable) tax credit for parents of children under the age of five to 2.5 points. The aim of the extension was to incentivise all working-age adults in a household to continue participating in the labour force while raising young children, and help families smooth consumption over the life-cycle (Brender, Strawczynski, 2015). The extension of the credit led to a reduction in the share of people paying income tax among parents with children below the age of six from 50 to 40%. This change, which costs about NIS 1.8 billion annually, mainly benefited well-off families. According to the Bank of Israel, about 60% of the benefits went to the two highest income quintiles, while only 2% went to the lowest quintile (BoI, 2018). The effect of the extension on labour market outcomes should be further evaluated.

Employment rates of the elderly have increased sharply and are higher than in most OECD countries, but incentives for labour force participation could be further strengthened to reduce high levels of old-age poverty (OECD, 2016a). The effective marginal tax rate for a pensioner choosing to work without postponing pension receipt is excessively high: 74-109% (for a salary between half and three-quarters of the average wage). This is due to the reduction of the first-pillar basic pension benefit, which is means tested for men and women below 70, the loss of rights to the earned income tax credit and the impact of additional income tax and social contributions paid (OECD, 2016a). As argued in previous *Surveys*, the government should reduce this disincentive to work by lessening the reduction of first-pillar basic pension entitlements in the presence of work-related income. For instance, in 2014 an inter-ministerial committee (the Orbach Committee) recommended to reduce the deduction rate of the pension entitlement from 60% for every shekel of income earned above the maximum ceiling to 30%.

### ***There is room to reduce tax distortions in private saving and investment decisions***

Israel generally applies a flat tax rate of 25% on dividends and inflation-adjusted interest income and capital gains. A higher tax rate of 30% applies to substantial shareholders that hold over 10% of a company. An additional surtax of 3% is levied on total income from all sources above NIS 649 560 (USD 188 000) per year. Differences in the taxation of labour and capital income can potentially create incentives for tax evasion by reclassifying labour income as capital income, which is especially easy for manager-owners of closely held corporations. However, in Israel labour and capital taxes are fairly well aligned. The top marginal tax rate on labour income is close to the combined tax on capital income accounting for both corporate and dividend taxation (Figure 8).

**Figure 8. The all-in top marginal tax rate and dividend taxation are aligned**



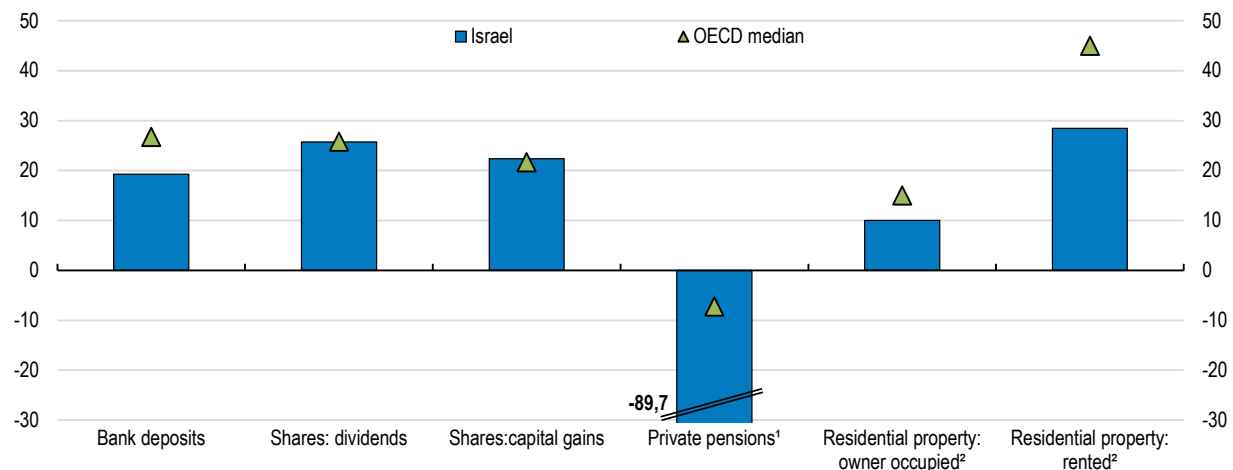
Note: The top marginal tax rate includes personal income tax and employee social security contributions (all-in rate). Non-tax compulsory payments are not included. The overall personal and corporate income tax (CIT + (1-CIT)\*PIT) rate on dividend income reports the overall tax rate on distributed profit, taking into account taxation prior to distribution and at the household level and showing the highest rates.  
Source: OECD Tax database.

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As in other countries, private pensions and owner-occupied residential property are significantly tax favoured (Figure 9). From an efficiency standpoint, such large differences in tax rates across saving vehicles should be avoided, as they distort saving decisions (OECD, 2018b).

**Figure 9. Effective tax rates differ across saving vehicles**

Marginal effective tax rates, average rate taxpayer (100% average wage), 2016



1. Deductible contributions.

2. Purely equity financed.

Note: Details of the methodology to calculate the marginal effective tax rates for each asset type can be found in Annex A of OECD (2018), *Taxation of household savings*. Country-specific inflation rates are used in the calculation.

Source: OECD (2018), *Taxation of household savings*.

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The tax benefits provided to the private pension system are among the highest in the OECD (OECD, 2018b; Achdut and Strawczynski, 2017). Employer contributions are exempt from tax for employees up to a ceiling that was reduced in 2016 from four times to 2.5 times the average wage. Employee contributions benefit from a 35% tax credit, up to the average wage. More than half the total value of the tax deductions on pension contributions goes to the top decile of the income distribution, while around 45% of employees, including the most vulnerable, do not pay income tax and therefore do not benefit (Brender, 2011; OECD, 2016a). Returns on the investment earned prior to payout are fully tax exempt. In addition, 52% of the pension benefits are tax free (with a ceiling). According to current law, this tax exemption is set to rise to 67% of the pension annuity by 2025. The favourable treatment of pension saving is often justified on the grounds that people tend to under-save for retirement. The estimated annual budgetary costs of the combined tax benefits are large, amounting to NIS 27 billion (1.9% of GDP).

The authorities should consider further paring back tax benefits to the private pension system. For example, Achdut and Strawczynski (2017) estimate that lowering the tax-free ceiling for employer contributions from 2.5 times to twice the average wage would generate about NIS 800 million (0.06% of GDP) in additional annual tax revenues. The tax exemption of pension benefits should be reduced or the government should at least scrap the plans to further increase them. In case of a reduction of the tax benefits, the extra revenues could be used to further expand the EITC or the income supplement to old-age pensioners in order to reduce old-age poverty (OECD, 2016a and 2018a).

The government should also reduce the favourable tax treatment of advanced-study funds (Keren Hishtalmut), as argued in previous *Economic Surveys*. Employer (or self-employed) contributions to the funds are not included in taxable personal income and are hence exempt from personal income tax and social security contributions (up to a ceiling). Moreover, capital gains are tax exempt. To benefit from the tax advantages, funds have to be held for three years if the savings are spent on training or education. If held for at least six years they can be spent for any purpose. As part of the government response to the health crisis, withdrawal of funds held for less than six years have also been temporarily tax exempt for people who suffered income losses during the crisis. Around 40% of wage earners invest in these funds and the estimated annual budgetary cost are large, at NIS 8 billion (0.6% of GDP). According to the Ministry of Finance about 75% of the money currently invested in the funds has been held for more than six years. This suggests the funds are generally not used for training purposes. In addition, the tax benefits are very regressive: the share of employees who invest in the funds is much higher among high-income employees (Figure 10). The government should therefore abolish the favourable tax treatment of the advanced training funds entirely or, at a minimum, remove the exemption from capital gains taxes for funds held longer than six years.

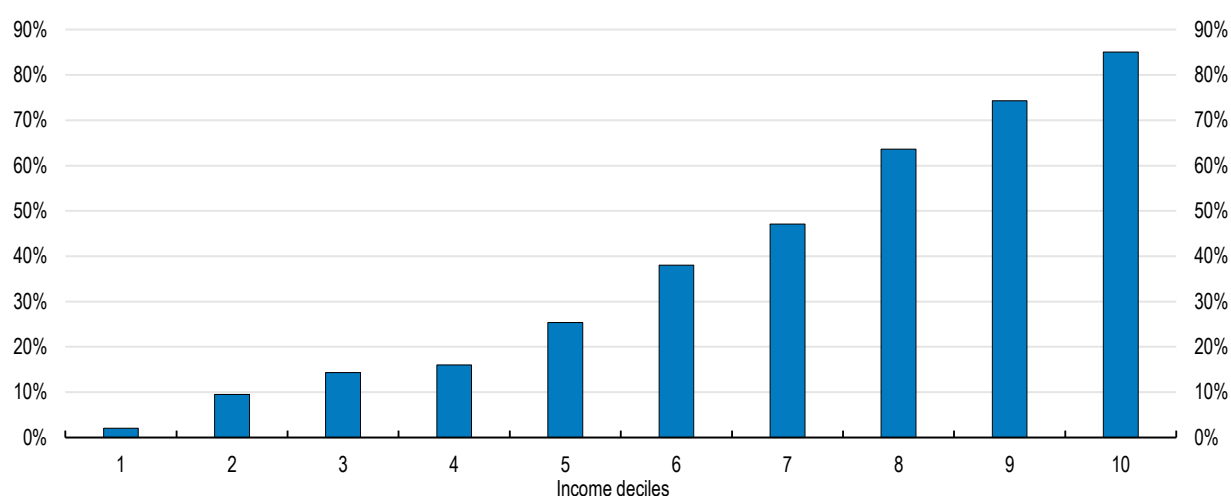
While improving tax efficiency, reducing tax benefits to the private pension plans and advanced-study funds would increase the effective tax burden especially on middle and high-income earners. Any tax reform in this area should therefore take into account possible negative effects on the work and investment incentives for these groups. The reform impact on total savings and benefits towards retirement should also be evaluated.

The tax treatment of owner-occupied housing is more favourable than that applied to rented residential property and financial assets, as in other countries. The purchase (transaction) tax on the first home is subject to tax exemptions and is generally lower than for buyers of a second or subsequent homes, which ranges between 5-10%, depending on the purchase price. Capital gains from the sale of the first home are exempt from tax for sale prices below NIS 4.5 million (USD 1.3 million), while the standard capital gains tax rate of 25% rate applies for higher sale prices. Finally, neither imputed rents nor mortgage interest payments are taken into account in the tax liability of owner-occupied dwellings. In comparison, rental income from residential property is tax exempt up to a ceiling of NIS 5100 per month, and progressive tax rates apply for income exceeding this threshold. Alternatively, a 10% flat tax (without deductions) can be chosen for rental income.



**Figure 10. Tax benefits from advanced training funds mainly accrue to high-income employees**

Share of employees with advanced training funds by income decile, ages 25-61, 2017



Source: Central Bureau of Statistics Israel; and Israel Ministry of Finance.

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Differences in the tax treatment of residential property compared to other assets and between owner-occupied and rented property should be reduced. For instance, the residential property tax could be increased (see below). In addition, tax and reporting exemptions for landlords' rental income below NIS 5100 per month should be removed (Gruber, 2015; OECD, 2016a and 2018a). Stricter reporting requirements can help tackle tax evasion on such income, which seems particularly high (Horesh, 2019; Levi-Weinrib, 2017; MoF, 2017a), but would need to be combined with steps to minimise the administrative burden associated with paying and enforcing taxes. Enhanced tax-authority access to financial institutions' data could help detect evasion. In return, the authorities should lower purchase taxes as transactions taxes can have undesirable side effects such as reducing household mobility. As part of the response to the COVID-19 crisis, the government has recently lowered transactions taxes on second (or multiple) homes and thereby reduced the tax gap between the first home and the second (or multiple) home. This will help reduce incentives to evade taxes by using "straw" buyers, such as relatives who do not own residential property themselves, to benefit from the lower transactions taxes on first homes (Gruber, 2015).

The authorities should also rigorously assess if the tax exemptions on capital income for immigrants contributes to the goal of increasing immigration, and whether less costly measures are available. New immigrants (and returning residents who have lived abroad for at least 10 years) are entitled to a 10-year tax exemption on certain foreign-source income and capital gains. Moreover, during these years they are also exempt from annual reporting on assets and income derived abroad. This reporting exemption should be cancelled.

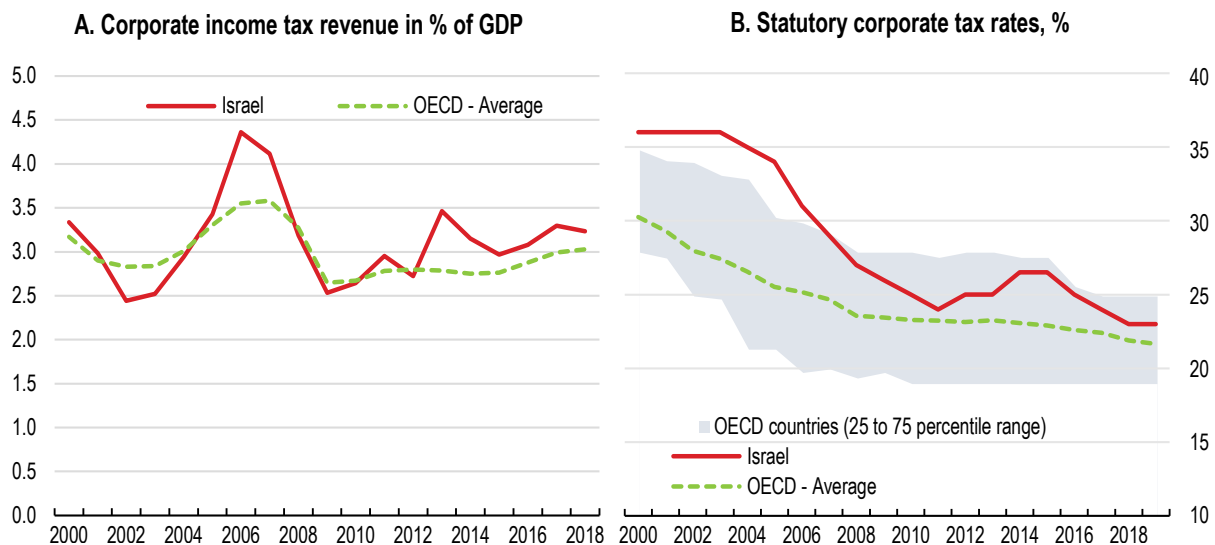
## Business taxation

As a small open economy with a substantial high-tech sector, Israel is particularly exposed to capital mobility. Multinational enterprises (MNEs) have invested heavily in Israel's high-tech sector. The stock of inward FDI is around 45% of GDP. At the end of 2017 around 45% of the total FDI stock was invested in high-tech manufacturing (computer, electronic and optical products) and services (telecommunications, computer programming and R&D) sectors, and the United States was the single largest source of FDI investment, accounting for around 16% of the total FDI stock. Evidence for Israel suggests that domestic firms may benefit from the professional know-how and training that these MNEs provide (Slobodnitsky et

al., 2018). Nevertheless, a marked productivity disparity exists between dynamic, trade-exposed, high-tech industries and more domestic-oriented, sheltered sectors (OECD, 2016a). Hence, while it remains important to keep business taxes attractive to attract foreign investment, it is equally important to reduce barriers and distortions that may hamper technology diffusion and adoption in the economy more broadly.

Israel has recently lowered the statutory corporate income tax (CIT) rate to 23%, close to the (unweighted) OECD average. After a period following the tent protests in 2011 when the corporate tax rate was increased from 24% to 26.5%, the rate has been on a downward trend again since 2015. Revenues from corporate taxation are somewhat higher than the OECD average, both as a share of GDP (3.3%) and as a share of total revenues (10%) (Figure 11).

**Figure 11. Corporate tax revenues and rates**



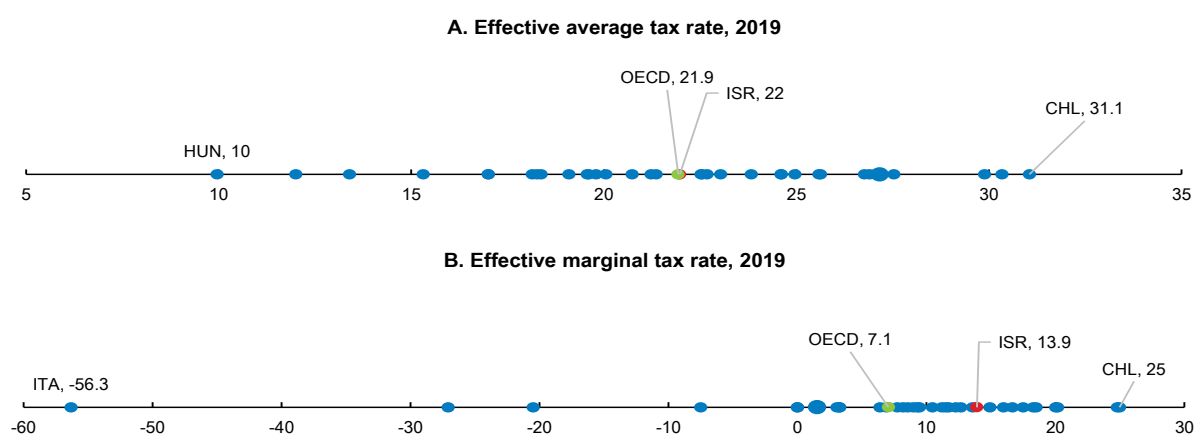
Source: OECD Tax database.

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While statutory tax rates provide important signals to investors about the business environment, differences in the definition of tax bases and various capital allowances can have important implications for investment decisions. Taking into account differences in the generosity of tax depreciation rules and interest-rate deductibility (including allowances for corporate equity) for a range of different assets, the OECD (2019b) has recently computed average and marginal effective tax rates across countries.<sup>3</sup> Average effective tax rates are useful to gauge investment incentives at the extensive margin, that is, location decisions. According to this indicator, Israel is again close to the (unweighted) OECD average. Marginal effective tax rates are more appropriate to analyse investment decisions at the intensive margin, that is, how taxes affect the incentive to expand investment, given a fixed location, and place a higher weight on capital allowances. Israel's marginal effective tax rate is somewhat above the (unweighted) OECD average (Figure 12). This suggests that the capital allowances captured in the analysis are somewhat less generous in Israel than in other OECD countries.

<sup>3</sup> The effective tax rates presented here are “forward-looking” rates, which are synthetic tax-policy indicators calculated using information about specific tax-policy rules. Unlike “backward-looking” rates, they do not incorporate any information about firms’ actual tax payments. For details see Hanappi (2018).

Figure 12. Effective corporate tax rates



Source: OECD Corporate Tax Statistics.

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However, these effective tax rates do not capture tax breaks and subsidies related to particular industries or regions. The Law for the Encouragement of Capital Investments (LECI) is Israel's flagship programme on this front. The LECI aims to foster productivity and provide employment opportunities in peripheral areas. The LECI offers corporate income tax rates well below the statutory rate, plus other support for firms that have demonstrated that they are highly productive including through their export performance (Table 3). In its current version, qualifying firms benefit from reduced tax rates of 8-16% (5-7.5% in development areas) and a reduced withholding tax on dividends. In addition, investment grants are available in development areas of up to 20-30% of the investment expenditure. These grants are more targeted towards SMEs and lower-tech manufacturing firms. For instance, over the period 2015-19, 86% of the projects and 60% of the budget was allocated to SMEs and 60% of the number of grants benefitted low-tech firms, according to the Ministry of Economy's classification.

In 2017 the LECI was amended to further encourage intellectual property-based activity, and a so-called innovation or IP box regime for (special) preferred technology enterprises was introduced. The tax on intellectual property income was cut to 6-12% (7.5% in development areas). These changes are in accordance with the nexus approach under the OECD's BEPS Action 5, which allows taxpayers to benefit from an IP box regime only to the extent that they have themselves incurred qualifying R&D expenditures that gave rise to the IP income. The OECD Inclusive Framework on BEPS classified IP measures as non-harmful. Overall about 2000 companies benefit from the LECI (BoI, 2018), whose fiscal costs are estimated to have amounted to around NIS 5 billion in 2019 (0.4% of GDP or around one-eighth of total corporate income tax revenue).

The LECI's substantial tax benefits for internationally competitive and high-tech firms may have helped to attract FDI and investment in peripheral areas, but it creates distortions in the economy. By increasing profitability, the tax benefits provide incentives to shift production to the tradables sector, driving up demand for factors of production in that sector. This raises the costs for more domestically oriented companies to attract capital and skilled labour (Hercowitz and Lifschitz, 2016; BoI, 2019). This problem is particularly acute in the current environment of skills shortages (notably for engineers). The support for exporting firms could be justified on the grounds that exporting leads to higher productivity (a "learning-by-exporting" hypothesis) or strong externalities from exports. However, the evidence across countries in support of learning-by-exporting or export externalities is rather mixed (e.g. Zimring and Moav, 2016), with evidence also supporting a self-selection of more productive firms into becoming exporters (e.g. Wagner, 2007). Furthermore, sector- and location-specific tax incentives can create tax-planning opportunities and potential for policy capture and may raise the costs of tax administration.

Table 3. Law for the Encouragement of Capital Investments (LECI)

Programme	Key eligibility conditions	Benefits
Preferred enterprise programme	Company needs to be “internationally competitive”, i.e. having exports of at least 25% of total income from sales to a market with at least 15 million residents.	<ul style="list-style-type: none"> <li>● CIT rate: 16% (7.5% in priority areas)</li> <li>● Withholding tax on dividends: 20%</li> <li>● Investment grants (in priority areas)</li> <li>● Accelerated depreciation</li> </ul>
Special preferred enterprise programme	As for preferred enterprises plus annual revenue over NIS 1 billion (or consolidated group revenue over NIS 10 billion), plus either: a) investment in productive equipment of at least NIS 800 million (NIS 400 million in a priority area) over a three-year period; or b) R&D investment of at least NIS 150 million (NIS 100 million in a priority area); or c) employment of at least 500 employees (250 employees in a priority area)	<ul style="list-style-type: none"> <li>● CIT rate: 8% (5% in priority areas)</li> <li>● Withholding tax on dividends: 20%</li> <li>● Withholding tax on dividends to parent companies: 5% (until end 2019)</li> <li>● Investment grants (in priority areas)</li> <li>● Accelerated depreciation</li> </ul>
Preferred technology enterprise	On income from IP developed in Israel according to the Nexus Approach. Company needs to be “internationally competitive” as defined above. In addition <ul style="list-style-type: none"> <li>● average R&amp;D expenses in the three years prior to the current tax year of at least 7% of its total revenues or over NIS 75 million per year.</li> <li>● one of the following conditions: <ul style="list-style-type: none"> <li>○ 20% of company’s employees are R&amp;D staff or the company has at least 200 R&amp;D employees,</li> <li>○ venture capital fund has invested at least NIS 8 million</li> <li>○ average annual revenue growth over the three-year period prior to the tax year of at least 25% or the revenue above NIS 10 million in each year.</li> <li>○ average annual growth in the number of employees over the three-year period prior to the tax year of at least 25% and at least 50 employees each year</li> </ul> </li> </ul> Companies not meeting the above conditions may still be considered as a qualified company if approved by the Israel Innovation Authority	On income from IP <ul style="list-style-type: none"> <li>● CIT rate 12% (7.5% in priority area)</li> <li>● Withholding tax on dividends: 20%</li> <li>● Withholding tax on dividends to a foreign company that holds at least 90% of the firm: 4%</li> </ul>
Special preferred technology enterprise	On income from IP developed in Israel according to the Nexus Approach. As for preferred technology enterprise plus consolidated group revenue over NIS 10 billion	On income from IP <ul style="list-style-type: none"> <li>● CIT rate 6 %</li> <li>● Withholding tax on dividends: 20%</li> <li>● Withholding tax on dividends to a foreign firm that holds at least 90% of the firm: 4%</li> </ul>

In addition, the recent US tax reform could potentially affect the activity of US MNEs in Israel, although the precise effects are still unclear. The United States is an important source of venture capital and FDI in the Israeli high-tech sector, and several important US high-tech firms have large subsidiaries in Israel. The US tax reform included a sharp cut in the federal statutory corporate income tax rate from 35 to 21%. This narrows the tax gap between the two countries, but the tax rate on international high-tech corporations in Israel, effectively in the range of 5–16%, remains lower. Other features of the US tax reform are, however, potentially more important. In particular, the Base Erosion Anti-Abuse Tax (BEAT) could make it more difficult for large US companies to offset payments to foreign companies for expenditure on services, intellectual property and interest against US profits. This may reduce incentives for US firms to conduct R&D in Israel. In addition, the Global Intangible Low-Taxed Income (GILTI) provision is essentially a minimum tax (of 10.5%) on US companies’ profits earned abroad. This implies that any tax differential with respect to the minimum tax could simply lead to a transfer of corporate tax revenue from Israel to the United States.

The government should therefore thoroughly evaluate the tax breaks under the LECI with a view to better targeting the scheme in order to ensure net benefits to society. Such a cost-benefit analysis should evaluate its social benefits and costs comprehensively (IMF et al, 2015). For example, on the benefit side, only the net investment impact should be taken into account, *i.e.* positive effects on investment should be corrected for investment that would have occurred without the incentive or for possible reductions in other investments, which could occur, for instance, if FDI replaces domestic investment. Positive productivity effects on other firms through knowledge or technology spillovers should also be taken into account. On

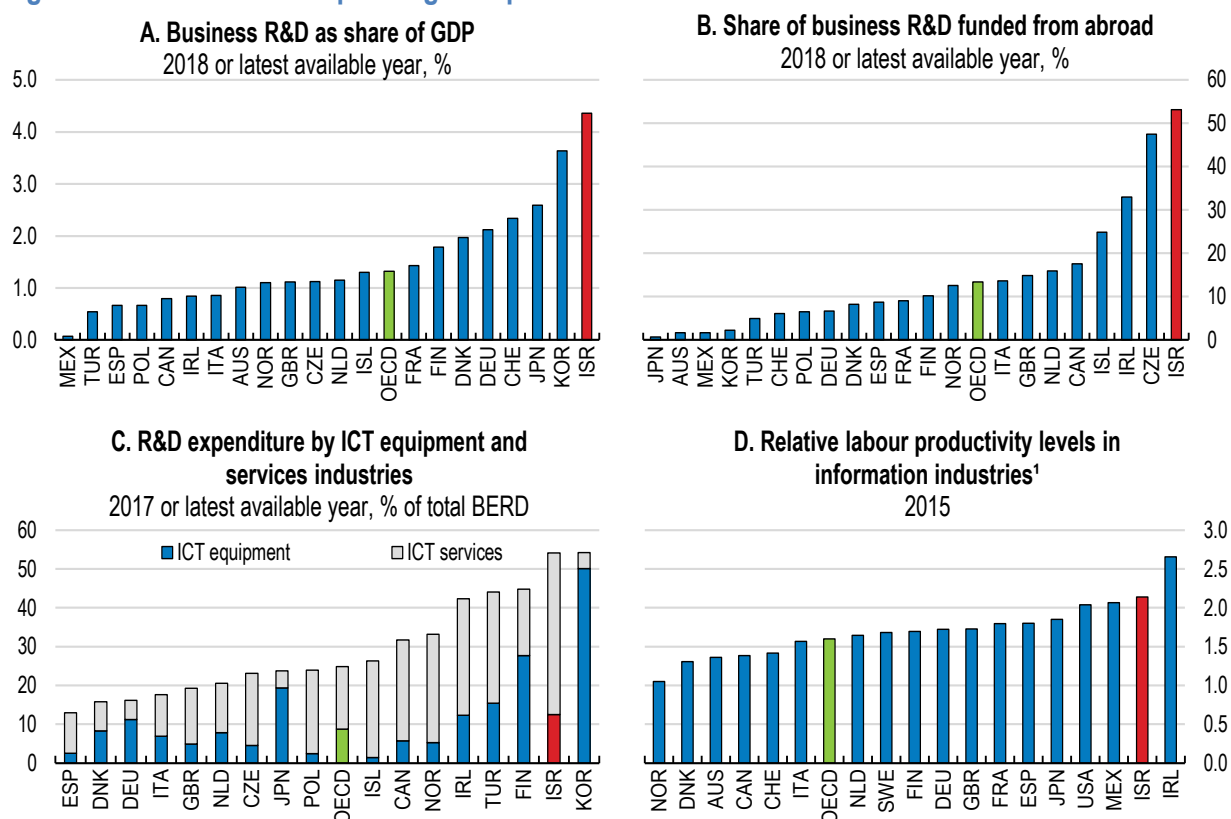
the social cost side, the evaluation should include net tax revenue losses, administrative and compliance burdens, and costs related to distortions in resource allocations as described above.

Reviewing and better targeting the tax incentives could create room to broaden the tax base and increase the resources available for the government. Reducing distortions in the economy could support GDP growth and aggregate productivity.

### Rebalancing support for innovation

Israel's R&D performance is impressive. It has the highest share of business R&D spending as a share of GDP in the OECD (Figure 13, Panel A). The share of R&D by small and young (established less than five years ago) firms in total business R&D is exceptionally high at 9.3% in 2014 (OECD, 2017a), in part related to the fact Israel has one of the largest venture capital markets (relative to its size) in the world (0.4% of GDP in 2016). Funds from abroad are the source of more than half of business R&D (Panel B), with 65% performed by foreign controlled affiliates, the highest share in the OECD. However, R&D expenditure is concentrated in information industries, with ICT manufacturing and service sectors accounting for more than half of total business R&D, compared to about a fourth in the average OECD country (Panel C). Among the top 20 R&D investors with headquarters in Israel, 10 operate in software and computer services or technology hardware and equipment (EU, 2018). This strong concentration of R&D investment in ICT sectors may explain the particularly large gap in the productivity levels between the ICT sectors and the rest of the economy in international comparison (Panel D).

Figure 13. Business R&D spending is impressive but concentrated in ICT sectors

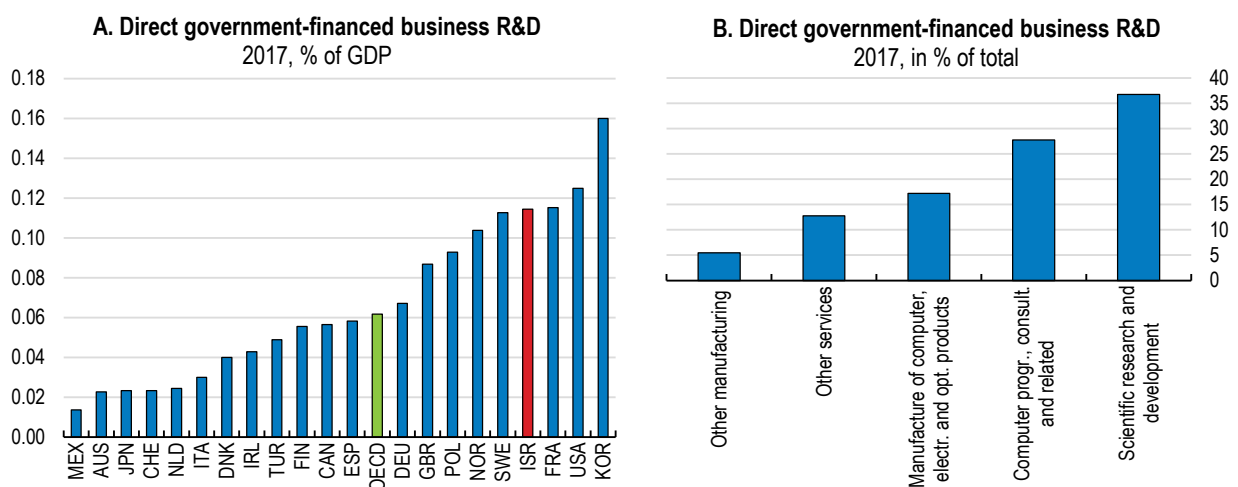


1. Value added per person employed relative to aggregate labour productivity of other industries in the non-agriculture business sector. Source: OECD, R&D Expenditure database; OECD (2017), Science, Technology and Industry Scoreboard 2017.

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The authorities actively promote R&D and innovation through favourable tax treatment of expenses (e.g. accelerated depreciation (scientific investment deduction) for capital R&D expenditure) and income from intellectual property (under the LECI as described above) as well as direct support measures (e.g. R&D grants and procurement). The Israel Innovation Authority (IIA, formerly the Office of the Chief Scientist until 2016) manages R&D incentives. While data on the value of income- and expenditure-based R&D tax incentives are lacking, direct government support is high, amounting to around 0.1% of GDP (Figure 14, Panel A). Among the grant schemes, the R&D Fund is the main incentive programme. It offers conditional financial support of up to 50% of R&D expenditures and is open to businesses in all sectors. Companies with commercially successful projects are obliged to repay the grant in instalments via royalties. In addition, a host of targeted financial-support programmes exist, for example, for start-ups, academic research, business incubators, R&D centres and international R&D cooperation.

**Figure 14. Direct government R&D support is substantial but concentrated in a few sectors**



Source: OECD, *R&D Expenditure database*.

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The government's efforts to support innovation are commendable, but it could consider a stronger targeting of support to firms and sectors that are lagging behind the productivity frontier. Evidence suggests that public R&D funding can reduce the costs of adopting new technologies and ideas and hence speed up technology diffusion (Berlingieri et al., 2018). Despite the wide scope of the grant system, direct government R&D support mainly benefits a few sectors. Three sectors - manufacturing of computer, electronic and optical products; computer programming and consultancy; and scientific R&D – account for 80% of total direct government-funded business R&D (Figure 14, Panel B). To promote technology adoption by lagging sectors, the authorities have more recently established several grant programmes for firms in traditional manufacturing industries (such as plastic, metal, textiles and food). In particular, the “*Increasing Productivity in Industry*” and the “*Implementing Advanced Manufacturing Technologies*” programmes, established in 2017 and 2018, respectively, support productivity-enhancing investment and adoption of advanced manufacturing/industry 4.0 production technologies. These programmes should be assessed and, if found effective, could be further enhanced. Similar grants for domestically oriented services sectors could be made available.

The authorities could also consider replacing the current system of preferential tax rates for IP-based income with a broader system of tax incentives for R&D expenditure, beyond the existing accelerated depreciation provision (scientific investment deduction). Benefits of IP boxes and similar income-based provisions are likely to accrue mainly to large MNEs, as they hold most intellectual property (Appelt et al.,

2016). Young, innovative firms are often credit constrained and need the funds to conduct their research as early as possible, but IP-related incomes may materialise only years after the initial investment. IP boxes by their very nature also give an ex post reward only to successful innovators that already hold monopoly rights on their inventions and receive income from it. Furthermore, income-based provisions may push firms to focus on innovations that lead to outcomes that are likely to be protected by IP rights and, therefore, distort firms' choice regarding the form of R&D on which to focus (Akcigit et al., 2013). Finally, research shows that IP boxes' tax advantages do not stimulate local innovative activities (Alstadsæter et al., 2018), although the nexus provision of Israel's programme -- which requires that in order to benefit from preferential tax rates on IP income R&D expenditures have to have taken place in Israel (see above) -- has the potential to attenuate this effect.

Expenditure-based R&D tax incentives such as tax credits could avoid some of the drawbacks of income-based incentives and complement direct R&D funding. Tax incentives have become a widely used policy tool to promote business R&D in OECD countries (OECD, 2019c). The literature generally finds that R&D tax incentives lead to additional R&D investment (e.g. Appelt et al., 2016; Westmore, 2013). Expenditure-based measures have an advantage over income-based measures in that they more directly support the financing of R&D and thus help overcome difficulties in finding external funds, especially for small and young firms, which is the main rationale for providing public support in the first place. While direct grants have the advantage of being easier to target to projects with high social returns, tax incentives avoid "picking winners" and should require fewer administrative resources to operate.

To avoid overly favouring incumbents (Bravo-Biosca et al., 2016) it is important that tax benefits include carry-forward provisions or cash refunds (e.g. reductions in social security and payroll taxes), so that small and young firms and basic research projects can benefit (Appelt et al., 2016). Cash refunds may be particularly suited to mitigate financial market imperfections that hamper investment by young and small firms. For example, Australia, Canada, France and the United States offer refundable R&D tax incentives that particularly target smaller R&D performers, allowing them to make use of earned tax credits even in the case of insufficient tax liabilities. In order to contain the overall fiscal costs the authorities could use upper ceilings and thresholds to eligible R&D expenditure or tax benefits or apply differential rates for SMEs and large firms. Expenditure-based tax incentives could also go beyond R&D and target innovation activity more broadly, and include, for example, training, ICT investment or IP acquisitions as eligible expenditures. For example, the French innovation tax credit includes patent fees as eligible expenditure for SMEs, which may help small firms adopt new technologies. Effective *ex post* evaluation should be an integral part of every innovation policy, and R&D and innovation tax incentives should be no exception.

### ***Protecting the corporate tax base in a globalised and digitalised world***

In an increasingly globalised economy protecting the tax base from erosion is a major challenge. Israel has 58 tax treaties in force. It was among the first 11 countries to ratify the OECD's multilateral instrument, developed as part of the Base Erosion and Profit Shifting (BEPS) package, in September 2018 and included 53 of its treaties therein. The multilateral instrument covers treaty-related minimum standards and enables the parties to implement other tax treaty measures developed in the BEPS project. Peer reviews on the BEPS minimum standards for Israel have been positive but have concluded that further progress is needed in the implementation of country-by-country reporting (Action 13), which requires all MNEs to provide data on the global allocation of income, profit, taxes paid and economic activity among tax jurisdictions in which they operate. Israel has not yet introduced a country-by-country reporting obligation into its domestic law due to the internal political situation. The newly elected Knesset will discuss the relevant bill. Israel should implement these reporting measures and start exchanging country-by-country data as soon as possible.



In Israel, as in many countries, the growing digitalisation of the economy is challenging the effectiveness of the existing income tax system to deal with new business models. Since digital activity often requires only a minimal physical presence in countries where value is created, traditional rules, which rely on a physical presence to determine taxing rights, fail to capture the income from this value creation. To address this issue, the authorities introduced a “Significant Economic Presence” test in 2016, which establishes criteria based on digital/online presence, under which a foreign company deriving income from online sales to domestic customers may become subject to taxation in Israel, subject to relevant tax treaty provisions. Israel is actively participating in the development of a long-term, consensus-based solution within the OECD/G20 Inclusive Framework on BEPS, based on two pillars, which is key to avoiding a fragmentation of the international tax architecture and to putting an end to tax avoidance. Significant progress has been made in the development of the two pillar approach, with the aim to reach political agreement by the end of 2020. Without a global long-term solution, a proliferation of unilateral, fragmented rules, would have negative impacts on international trade and investment.

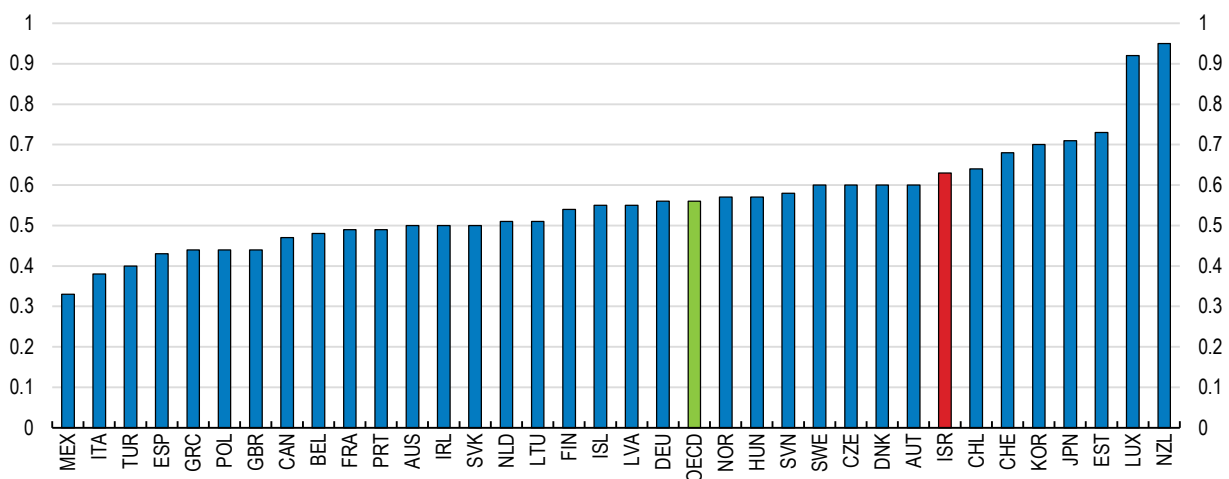
### Taxes on goods and services

Israel relies heavily on indirect taxation of goods and services, raising revenues of more than 11% of GDP in 2018 therefrom. At least since the mid-1990s revenues from taxes on goods and services have been consistently above the OECD average both as a share of GDP and of overall revenues. In revenue terms the value-added tax (VAT) is by far the largest single item (65% of revenue in this category). Excise taxes (13% of revenue in this category) and recurrent taxes on the use of goods are also important sources of revenue.

#### ***The VAT has few exemptions, but the base could be further broadened***

The VAT system is efficient and characterised by a single rate, which at 17% is low in international comparison, with relatively few exemptions. Hence, the VAT revenue ratio (the difference between the VAT revenue collected and what would theoretically be raised if VAT was applied at the standard rate to the entire potential tax base in a “pure” VAT regime) is relatively high by international standards (Figure 15).

**Figure 15. The VAT revenue ratio is higher than in most OECD countries**



Source: OECD (2019), *Consumption Tax Trends 2018: VAT/GST and Excise Rates, Trends and Policy Issues*, OECD Publishing, Paris.

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However, once the economy has fully recovered from the COVID-19 crisis, the VAT base could be further broadened by removing inefficient tax exemptions (Table 4). Preferential rates and exemptions are frequently used to address equity issues and correct for externalities. However, this is often inefficient, because exemptions and preferential rates benefit all households, including the affluent (OECD, 2018c). Furthermore, differential VAT rates provide opportunities for tax evasion by re-classifying goods to benefit from lower rates. Finally, raising VAT revenues through base broadening instead of rate increases tends to be more growth-friendly (Acosta-Ormaechea and Morozumi, 2019).

**Table 4. VAT exemptions, 2019**

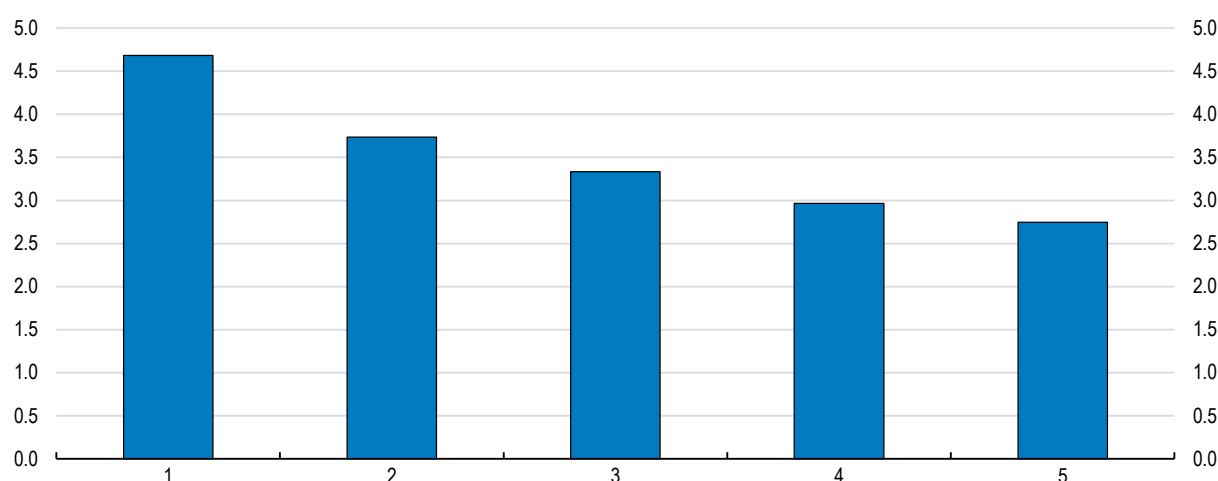
	Cost in million NIS	Cost in % GDP
Fruit and vegetables	3 490	0.26
Eilat Law	880	0.07
Tourism services	860	0.06
Online purchases	500	0.04
<b>Total</b>	<b>5 730</b>	<b>0.43</b>

Source: Ministry of Finance.

OECD *Surveys* have long argued that tax exemptions on fruit and vegetables, on certain tourist services (e.g. accommodation) and on goods and services in the tourist centre of Eilat are inefficient and should be gradually phased out. Poorer households in Israel indeed spend a slightly larger share of overall consumption on fruit and vegetables than more affluent households (Figure 16). Thus abolishing the exemption would have regressive effects. However, the extra revenues could be spent on existing and more targeted transfer schemes to more than offset such an effect. For example, simulations in Gotlibovski and Yaacobi (2018) show that abolishing the exemptions on fruit and vegetables and using the extra tax revenues to increase child allowances or the EITC would lead to an overall decline in inequality. Removing still high tariffs on certain fruits and vegetables along with other tariffs on agricultural products would help offset resulting price increases (OECD, 2019e).

**Figure 16. Poorer households spend slightly more on fruit and vegetables than the more affluent**

Household expenditure on fruit and vegetables by income quintile, % of total expenditure, 2017



Source: Israel Central Bureau of Statistics, *Household Expenditure Survey*.

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The tourism sector has been one of the hardest hit sectors during the crisis. Hence abolishing the VAT exemption on tourist services (including in Eilat) in the current circumstances would be counterproductive. Nevertheless, abolishing VAT exemptions on tourism services should remain on the government's medium-term agenda as they create an uneven playing field between companies in different sectors, diverting resources from their most efficient use. In addition, they also tend to have an adverse effect on administrative and compliance costs, as they complicate the tax system. Finally, VAT exemptions on tourism services are generally regressive, as poor households travel little. Israel is one of few cases in the OECD, where the VAT exemptions for tourism services only apply to foreigners (with the exception of the exemptions in Eilat). This differentiation may increase the compliance costs for firms, even as distributional effects would be less of a concern.

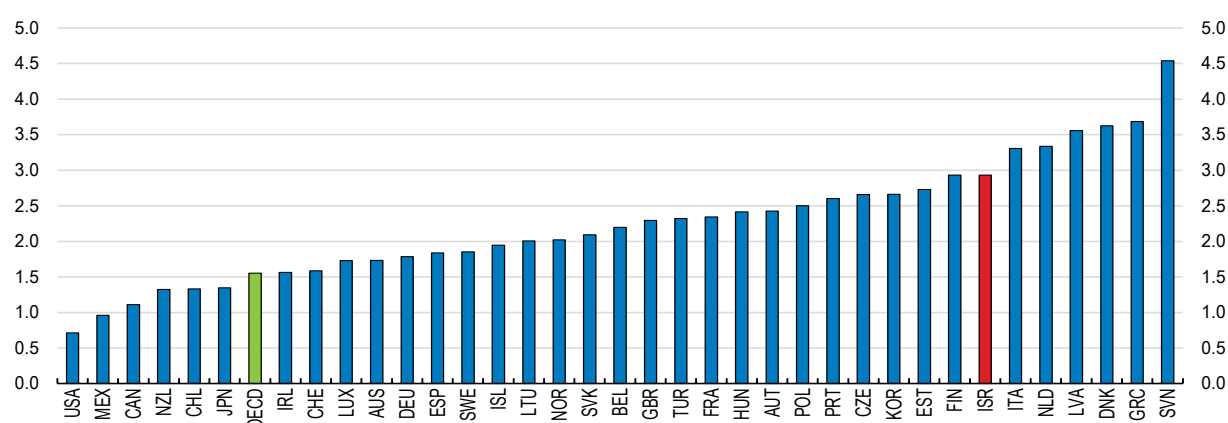
To avoid overly disruptive effects, VAT tax exemptions could be phased out over time. For instance, the government could announce its intention to abolish VAT exemptions 1-2 years ahead of the scheduled date.

The authorities should also remove the exemption threshold for imports of low-value goods, accompanied by improvements in the efficiency of processing and collecting the VAT on such imports. Personal imports below a value of USD 75 are currently exempt from VAT. Many countries operate such exemption thresholds, as the administrative costs of bringing these low-value items into the customs and tax net tend to outweigh the extra revenue. However, these exemptions have become increasingly controversial in the context of the growing digital economy (OECD, 2018c). Other countries have seen rapid growth in low-value imports of physical goods from online sales on which VAT is not collected. This results in potentially unfair competitive pressures on domestic retailers, who are required to charge VAT on their sales to domestic consumers, and in decreased VAT revenues. The estimated cost of this exemption in terms of foregone tax revenue is currently relatively low in Israel (Table 4), but the Ministry of Finance estimates that the value will more than double in the next five years as online commerce expands. Several OECD countries (Australia, New Zealand, Switzerland) as well as the EU (VAT e-commerce package) have implemented or are planning to implement simplified VAT registration and collection procedures for foreign online vendors to lower the cost of collection of VAT on low-value goods in return for scrapping the VAT exemptions (OECD, 2019f).

There may be room to increase the VAT rate to generate additional revenue if necessary. The Bank of Israel estimates that an increase of the VAT rate by 1 percentage point to 18% could raise additional revenues of NIS 5.5 billion (0.4% of GDP). The extra revenue could be used to lower public debt, finance productive spending and/or reduce other more distortionary taxes.

### ***Excise taxes should be adjusted to improve environmental and health outcomes***

Environmentally related tax revenues are high compared to other OECD countries (Figure 17). Revenues originate mainly from taxation of motor vehicles in the form of excise on gasoline and diesel as well as a vehicle purchase tax. Indeed, in 2009 Israel introduced a sophisticated vehicle tax rebate system. The system combines a high purchase tax rate of 83% of the import value for the most polluting cars with rebates, which are set according to the pollution and CO<sub>2</sub>-emissions performance of the vehicle. It also includes reduced tax rates on hybrid cars, plug-in hybrids and battery engine vehicles, which the government started to gradually remove in 2020. The 2009 reform was successful to the extent that it led to significant reduction of market shares of heavily polluting cars (OECD, 2016b; MoF, 2018).

**Figure 17. Revenues from environmental taxes are fairly high in Israel**Environmentally related taxes, % GDP, 2018 or latest year available<sup>1</sup>

1. 2014 for Canada, Israel and Korea; 2016 for Australia and the United States; 2017 for France.

Source: OECD, *Going Green database*.

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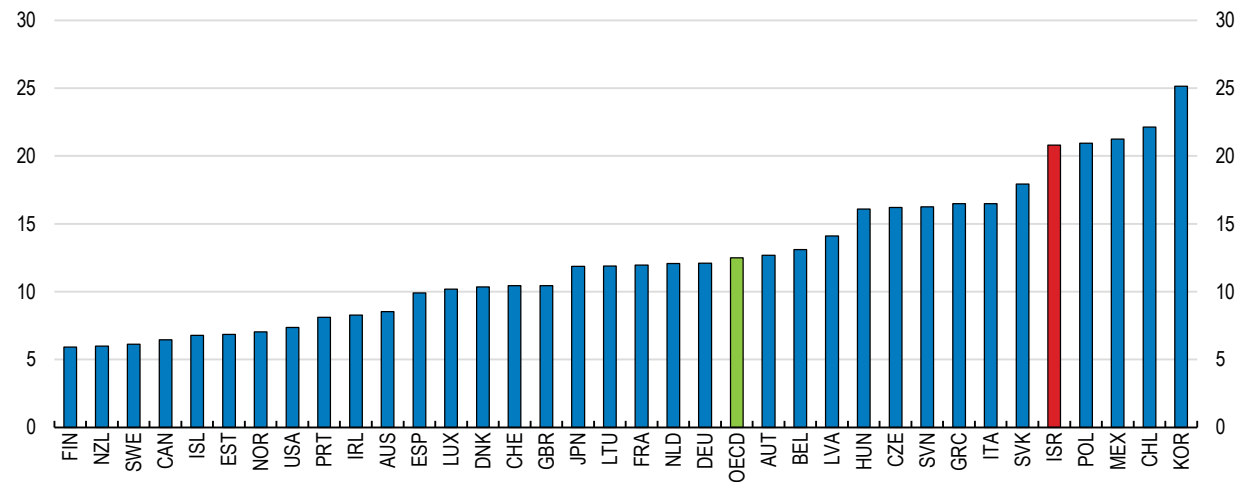
Vehicle use should be taxed more heavily to better reflect the external costs of car use, including congestion, air pollution, accidents, noise and infrastructure use. Small-particle pollution is high (Figure 18), and traffic congestion in the big metropolitan areas, especially Tel Aviv, is severe and likely to worsen without policy action. Road traffic intensity is much higher than in other OECD countries. The costs of congestion alone are estimated at around 2% of GDP (Trajtenberg et al., 2018), above levels in other high-income economies. Congestion charges are a cost-effective way of reducing congestion (van Dender, 2019). For instance, in Stockholm traffic volumes fell by around 20% immediately after a congestion charge was introduced. The authorities are considering two approaches to congestion charges: charges for entering three concentric rings or cordons in Tel Aviv and a kilometre charge, which would be higher during congested hours. The OECD (2019g) conducted a preliminary analysis of the two proposed schemes and found that the cordon scheme could result in an unequal and inefficient treatment of trips within zones compared to trips crossing zones. In contrast, the kilometre charge is proportional to the distance driven so that no trip is left unpriced, and drivers who mainly travel within zones are not disproportionately favoured by the policy. Regardless of the chosen scheme, a GPS-based monitoring technology can increase its efficiency and leave enough flexibility to adjust the design as the system is implemented.

Congestion charges should be complemented by allowing municipalities to set higher parking prices. On-street parking prices in Israeli cities are very low or zero for many car users (OECD, 2019g). Setting efficient parking tariffs is necessary to prevent cruising for parking. The associated external costs in terms of CO<sub>2</sub> emissions, pollution and congestion in busy downtown areas can be substantial (Brandt, 2012; Shoup, 2011).

The revenues from any eventual congestion charges could be used for investment in better public transport. Revenues could also be used to reduce car ownership taxes, which may also help with acceptability by the public, but could weaken the contribution of these taxes to achieving environmental and mobility policy objectives. Equally important are information campaigns that focus on the rationale and benefits of the proposed scheme. Israel's major ongoing investments in metro and light-rail systems will transform mobility in the longer term and provide alternatives to car use. In the near term the congestion charges should be accompanied by improvements in the quality of bus services – the current main public transport service in Israel – and measures to facilitate the uptake of carpooling.

### Figure 18. Air pollution is high in Israel

Mean exposure of the population to PM<sub>2.5</sub>, in micrograms per cubic metre, 2017



Source: OECD, *Going Green database*.

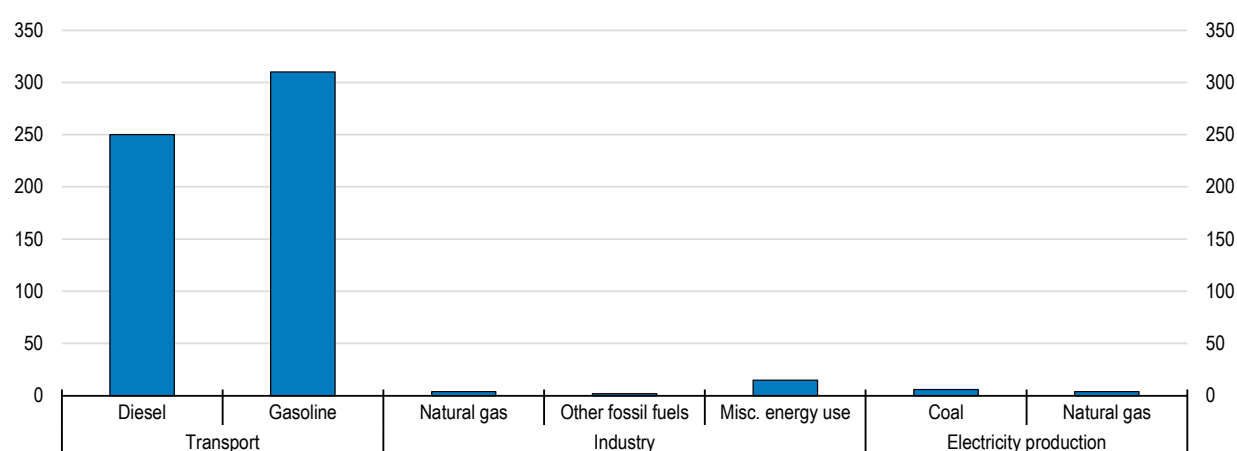
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Tax rates on gasoline and diesel are relatively high by international standards. Nonetheless, they cover only a fraction of the costs of vehicle use in urban areas (OECD, 2018h), and therefore additional road-use charges in metropolitan areas are warranted. Road-use charges would also prepare Israel for the planned phase out of petrol- and diesel-fired cars from 2030. Tax rates are slightly lower on diesel than on gasoline, although combusting diesel emits higher levels of carbon dioxide per litre than gasoline and often also more of other harmful air pollutants such as fine particulate matter (PM). In 2018 Israel started a welcome programme to gradually phase out diesel tax rebates in the transport sector including for trucks, buses and taxis by 2026 (OECD, 2019c). These rebates cost about NIS 2.5 billion (0.2% of GDP) per year.

Most importantly, taxes on non-transport carbon-based fuels should be increased to better reflect their environmental externalities. Coal and natural gas are taxed very lightly (OECD, 2018h; Figure 19). Israel already generates a substantial part of its electricity from natural gas, and this share will increase markedly in the future thanks to several large offshore discoveries of natural gas over the past decade. The government plans to end electricity generation from coal by 2026. A planned tax hike on coal for 2019 was postponed to 2021, though. Replacing imported coal and oil by gas in power generation will cut CO<sub>2</sub> emissions and reduce air pollution. Gradually raising the existing excise tax on primary fuels (heavy oil, natural gas and coal) or introducing a carbon tax to better reflect externalities would lower CO<sub>2</sub> emissions in a cost-minimising way, make renewable energy generation more competitive and help to further reduce air pollution.

**Figure 19. Israel's effective carbon tax rates on non-transport carbon-based fuels are very low**

Effective carbon tax rates, EUR per tonne of CO<sub>2</sub>



Note: Tax rate applicable on 1 July 2018. CO<sub>2</sub> emissions are the result of OECD calculations based on energy use data for 2016.  
Source: OECD (2019), *Taxing Energy Use 2019: Using Taxes for Climate Action*, OECD Publishing, Paris.

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A more effective pricing of CO<sub>2</sub> emissions would help Israel to reach its greenhouse gas emissions-reduction targets cost-effectively. Israel taxed around 98% of all CO<sub>2</sub> emissions in 2015, a high share by international standards (OECD, 2018d). However, only 27% of emissions were priced at EUR 60 per tonne, a midpoint estimate of carbon's costs in 2020 (and a low-end estimate for 2030). The High-Level Commission on Carbon Prices (2017) found that carbon prices should amount to USD 40 - 80 per tonne of CO<sub>2</sub> by 2020 and USD 50 - 100 by 2030 to induce the technological change in the electricity sector and the electrification of industry, household heating and transport necessary to reach the goals of the Paris Agreement. A carbon tax or ramping up the excise tax on primary fuels to reflect the shadow price of CO<sub>2</sub> would internalise this particular externality throughout the supply chain. Part of the extra revenues from carbon taxation could be used to avoid real income losses, in particular of low-income households, which could also increase support for such a tax. British Columbia in Canada successfully implemented a carbon tax, redistributing the revenues from the tax to households via lump-sum transfers and cuts in other taxes.

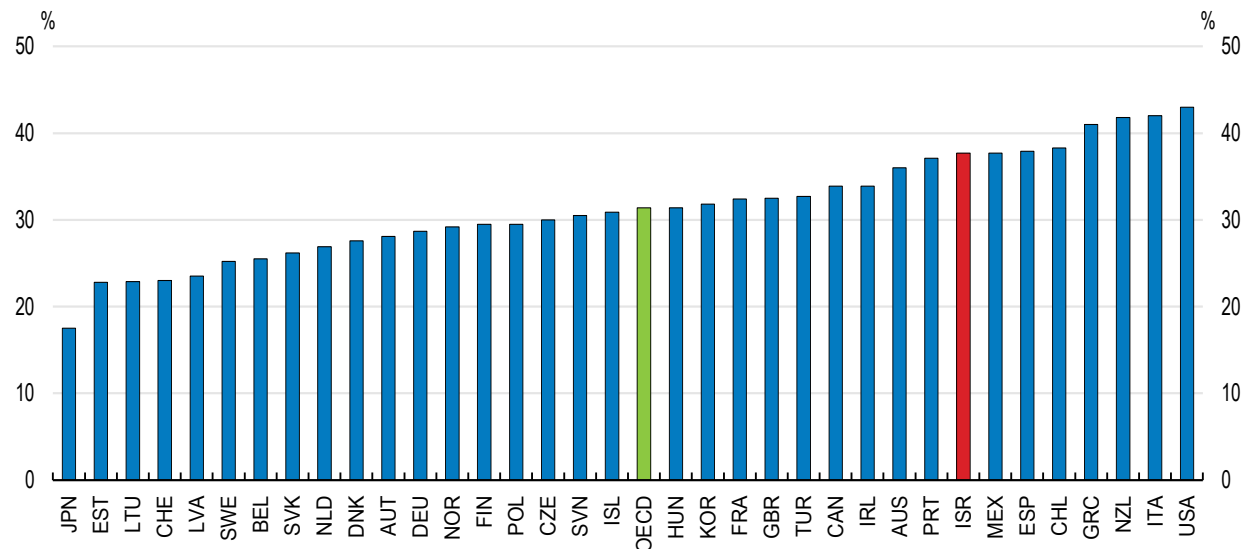
There is no immediate need to adjust alcohol and tobacco excise taxes. Alcohol consumption is low in Israel compared to other OECD economies and its taxation close to OECD averages (OECD, 2018c). Levels of tobacco consumption have fallen as in other OECD countries and are close to the OECD average. Taxes on cigarettes are fairly high and account for about 83% of the price of a standard pack of 20 cigarettes, compared to 73% on average in OECD countries. The government's decision in 2019 to hike the tax on rolling tobacco and equalise the tax treatment with cigarettes is welcome. The government also plans to tax electronic cigarettes.

The Ministry of Health has recently called for a tax on sugary foods and beverages, as Israelis seem to consume a large amount of such foods in their diets. Obesity rates are still comparably low among adults but have been rising and are higher than the population average for lower socio-economic groups. Overweight (including obesity) among the young (5-9 year-olds) is high (Figure 20). A sugar tax or a tax on sweetened beverages is an increasingly common tool to fight obesity and other diet-related diseases. Such taxes have been introduced in a number of OECD countries, including Finland, France, Hungary, Mexico, Norway, Belgium and the United Kingdom (OECD, 2018e). Increasing prices of sugary and high-caloric food items through appropriate tax levies could promote healthier diets, as the consumption of these products seems to have a high price elasticity (Sassi, 2016; Sassi et al., 2013). Studies for Mexico show

that taxation of sweetened beverages was correlated with a decrease in consumption when a healthier untaxed alternative was provided (Marron et al., 2015; Sassi et al., 2013; Sassi, 2016). Lower socio-economic groups would likely experience greater-than-average health improvements (Sassi et al., 2014). Such a tax should be complemented by additional measures to promote healthier lifestyles including stricter food labelling requirements and mass-media campaigns.

### Figure 20. Overweight among the young is high

Overweight (including obesity) among 5-9 year-olds, 2016



Source: OECD (2019), *Health at a Glance 2019: OECD Indicators*, OECD Publishing, Paris.

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### Property taxation

Israel's property taxes account for roughly 10% of total tax revenue and 3.3% of GDP - a high share compared to other OECD countries. Revenues from recurrent taxes on immovable property (i.e. housing or other buildings) are among the highest in the OECD area, representing about 2% of GDP and accounting for the majority of property tax revenues. The Israeli property tax (Arnona) is a municipal tax, accounting for roughly 40% of local governments' revenues. The Arnona is levied on the user of the property, and Israel is among only a small group of OECD countries that still use an entirely area-based assessment, while the majority now take property value into consideration.

The Arnona system suffers from several major deficiencies and should be reformed, as discussed in detail in Machlica (2020) and in a recent OECD in-depth evaluation (OECD, 2020). The current system gives local authorities discretion over the precise methodology to calculate the tax base. This has led to a very non-transparent system in which it is impossible to compare the property tax burden across municipalities. The central government should therefore introduce a transparent and uniform system to establish the tax base. In particular, it should be based on (regularly updated) property market values. Moving towards a value-based system would probably not be overly costly. Data to establish non-residential property values already exist from other taxes with which businesses have to comply, and recently developed techniques for property assessment have greatly reduced the costs involved in determining the market value of residential property. However, a change towards a value-based system would potentially involve large changes in individual taxpayer liabilities and should thus be phased in gradually over time.

It would also be advisable to reduce the current differences between residential and non-residential tax rates. The property tax charged for non-residential land can be up to 11 times higher than that on residential properties. This is inefficient, as business property taxes tend to have stronger distortionary effects, for instance by affecting location decisions. Moreover, the difference incentivises municipalities to assign land for commercial use at the expense of residential housing, contributing to housing shortages and large revenue differences across municipalities. Cutting the non-residential property tax rates and raising the residential rates would contribute to reducing this gap. The central government should also establish bands with minimum and maximum rates for both the residential and non-residential Arnona and give local authorities the autonomy to choose rates within these bands. To offset possible regressive effects of higher residential property tax rates, the central government should standardise most residential Arnona discounts and exemptions for low-income households (see Machlica, 2020).

A fundamental reform of the Arnona also needs to take into account interactions with the rest of the tax system, especially with other taxes related to property, such as the land betterment tax (a levy on property-value increases due to changes in zoning and land-use regulations), the taxation of (imputed and actual) rents and property transaction taxes. While a somewhat higher tax burden on residential immovable property seems appropriate, a gradual and coordinated approach is needed to avoid sharp hikes in property-related tax liabilities.

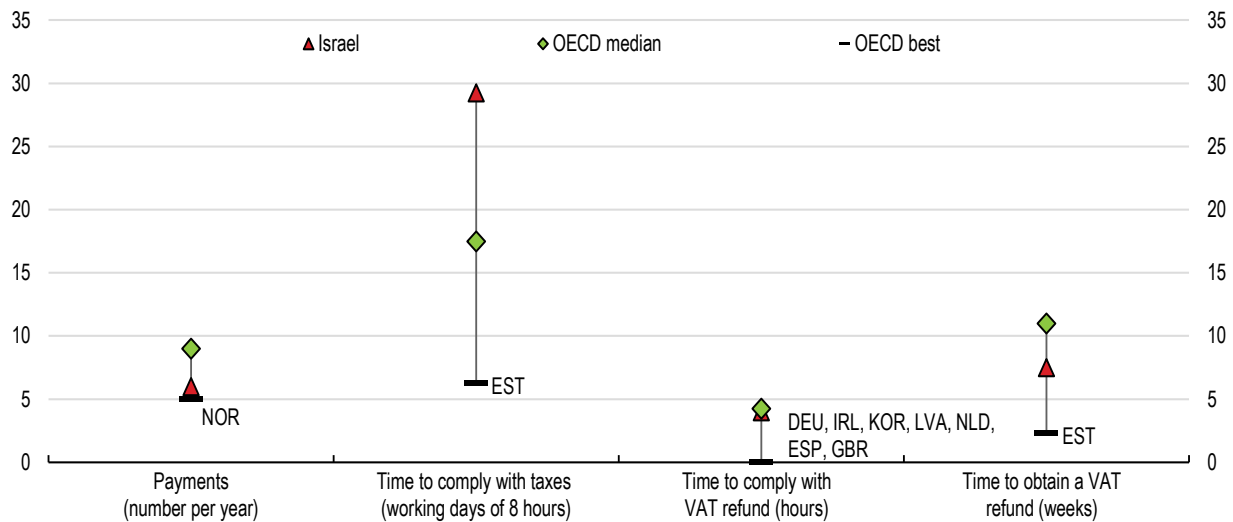
## Strengthening tax administration

Efficient and effective tax administrations help reduce the compliance costs of businesses and individuals and lower tax evasion. Evidence from OECD countries highlights that well-resourced tax administrations increase tax capacity and therefore revenue (Akgun, Bartolini and Cournède, 2017). The Israeli Tax Authority is reasonably well resourced. Its budget, around 0.2% of GDP, is close to the OECD average, and the number of staff relative to the adult population or active personal income taxpayers somewhat above that in the average OECD country (OECD, 2017b).

Israel has made significant recent progress in reducing the tax compliance costs for businesses. The Israeli Tax Authority is moving forward in taking advantage of digitalisation and in developing electronic systems designed to support client services and facilitate procedures, and tax simulators and online payments have been developed for several taxes. Most notably, Israel recently introduced an electronic system for filing and paying value added tax and social security contributions. Nevertheless, the time needed to comply with taxes remains greater than in other OECD countries (Figure 21). In addition, on-time filing rates of corporate income tax and personal income tax returns are somewhat lower than in the average OECD country, suggesting further room to simplify tax filing (OECD, 2017b). The Israel Tax Authority's strategic plan contains a number of digital projects that are likely to improve service levels and strengthen enforcement capabilities in the coming years. Some of these projects are expected to be implemented in the short term such as the full digitisation of annual tax reports.

In addition, enhancing tax certainty, stability, and transparency can reduce compliance costs for taxpayers and have a positive impact on growth. Changes in tax rates have been frequent in Israel and at times pro-cyclical, reducing the capacity of the tax system to offset fluctuations in economic activity. For instance, the VAT rate has been changed 9 times since 2002.

Figure 21. The time needed for businesses to comply with taxes is still relatively long



Source: World Bank, Doing Business 2020.

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Greater use of third-party data can help move from post-assessment verification to pre-assessment and possible pre-filing of tax returns, which reduces compliance costs and non-compliance. An increasing number of OECD tax administrations are moving towards pre-filing of tax returns (OECD, 2017b). The data needed for pre-filing is simplest in the case of employees with only one source of income and where the employer has provided the relevant income information to the tax authority. Conducting regular taxpayer satisfaction surveys, as is done in most other OECD countries, can also help assess performance and identify areas where progress is needed. As previous *Economic Surveys* have argued, the government could also consider integrating the collection of tax and social security contributions to improve efficiency and effectiveness and to reduce the compliance burden on businesses (OECD, 2013).

Tackling tax evasion and strengthening compliance remain important. Estimates of the shadow economy in Israel vary widely, as in other countries. According to recent estimates by Medina and Schneider (2018), the size of the shadow economy in Israel is 13-19% of GDP, depending on the methodology used for its estimation, which is slightly larger than in other high-income OECD economies. The Ministry of Finance estimates that reducing the shadow economy by 1% of GDP could boost revenues by about NIS 3.5 billion (0.25% of GDP). The authorities have taken recent steps to shrink the shadow economy. For example, in January 2019 the Law for Reducing the Use of Cash came into effect. The law limits the use of cash in transactions between private individuals and businesses and among businesses to NIS 11 000 and to NIS 50 000 for transactions among private individuals.

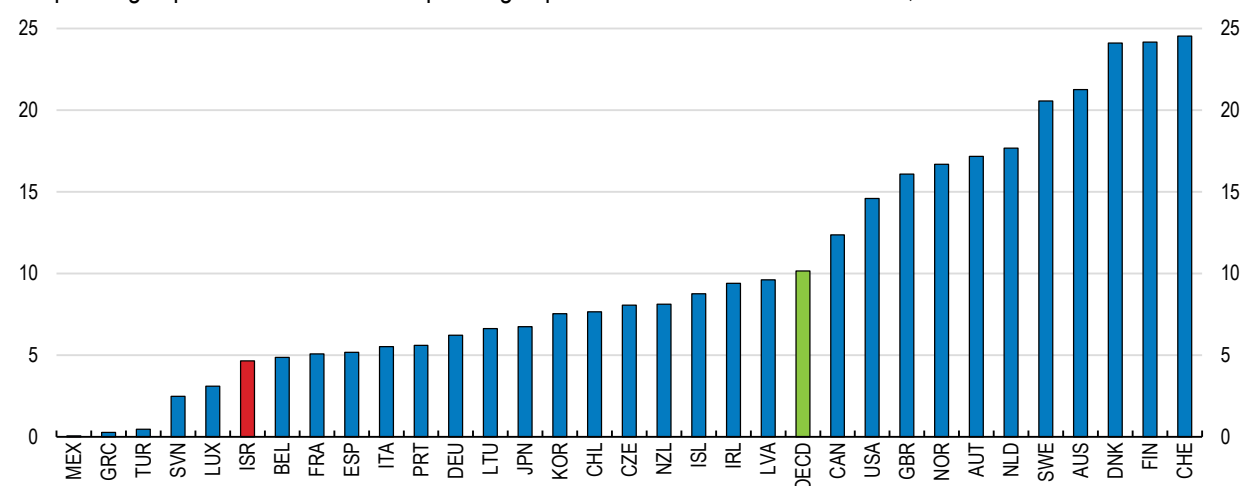
In order to gain a better understanding of tax evasion, the Ministry of Finance publishes VAT gap analyses. This should be complemented by analyses of the corporate income tax compliance gap. An increasing number of OECD countries estimate tax gaps (the difference between the theoretical revenues the government should have collected assuming perfect compliance and the revenues actually collected), most commonly for VAT but also for corporate and personal income tax (OECD, 2017b). Tax gaps can provide valuable insights to inform policy and compliance strategies and help revenue authorities to better understand the scale of non-compliance and emerging risks. Bottom-up corporate income tax and VAT approaches, in particular, provide information about characteristics of non-compliant firms, such as size, sector and region, that can help improve the Israeli Tax Authority's predictive, risk-based analytical tools for audit selection.



Improving analytical tools using modern data analysis to detect tax evasion may require further investment in ICT, which is relatively low in Israel (Figure 22), and expanding data collection. Many tax administrations in OECD countries are moving in this direction. For example, Poland created a centralised data warehouse, introduced improved modelling tools to better detect irregularities and facilitated information exchange with banks when there is a suspicion of tax fraud (OECD, 2018f).

**Figure 22. There is room to increase the tax authority's IT spending**

IT operating expenditure in % of total operating expenditure of the tax administration, 2017



Note: For Japan: the total operating expenditure includes capital expenditure. OECD average is an unweighted average of the countries with available data shown in the graph.

Source: OECD (2019), *Tax Administration 2019: Comparative Information on OECD and other Advanced and Emerging Economies*, OECD Publishing, Paris.

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There is scope to improve tax transparency. In particular, the government should scrap the 10-year exemption for immigrants and returning residents on annual reporting of assets and income from abroad, as well as the reporting exemption on monthly rental income below NIS 5100. As discussed above, tax evasion seems particularly prevalent in the real estate market.

The government should also continue to support international efforts to improve tax transparency and reduce tax evasion. In January 2019 Israel passed regulations necessary to participate in the Automatic Exchange of Information (AEOI) under the OECD's Common Reporting Standard (CRS), which will facilitate transfers of information to and from Israel. In July 2019 Israel started exchanging financial information with 53 countries for the tax year 2017 and 70 countries for the tax year 2018

Table 5. Recommendations for tax policy reform

FINDINGS	RECOMMENDATIONS (key recommendations in bold)
<b>Enhancing efficiency and simplifying the tax system</b>	
There is scope to reduce inefficient tax expenditures, which complicate the tax system and introduce distortions. Reducing these tax benefits can help finance extra spending needs.	<b>In the medium-term streamline VAT exemptions.</b> Offset any regressive effects with an increase in existing welfare programmes. Phase out the threshold for VAT exemptions on online sales.
Private pensions, medium-term saving plans and owner-occupied residential property are significantly tax favoured, which distorts saving decisions and opens up tax-planning opportunities.	Reduce differences in the tax treatment of personal savings across sources. Pare back tax benefits to the private pension system. <b>Consider reducing tax breaks on savings in the “advanced training funds” taking into account effects on income distribution and work incentives.</b> Abolish the tax exemption on rental income below NIS 5100 per month in exchange for lower purchase taxes for residential property.
The municipal property tax system is opaque. Non-residential property tax rates are substantially higher than residential rates, which provides incentives for municipalities to assign land for commercial use at the expense of residential housing, contributing to housing shortages and large revenue differences across municipalities.	<b>Reduce the difference between non-residential and residential property tax rates. Replace the area-based property tax with a transparent and uniform system based on property market values.</b>
<b>Improving social cohesion and maintaining strong work incentives</b>	
The share of working poor is high.	<b>Make the temporary changes to the earned income tax credit permanent. Evaluate and consider expanding the programme further.</b>
The effective marginal tax rate for a pensioner choosing to work without postponing pension receipt is excessively high.	Reduce the disincentive to continuing to work beyond the pension eligibility age by lowering the reduction of first-pillar basic pension entitlements in the presence of work-related income.
<b>Boosting productivity by reducing distortions and levelling the playing field</b>	
The business tax system provides large benefits to internationally competitive and high-tech firms. This may have attracted FDI but also creates distortions and tax planning opportunities, and raises the costs of tax administration.	<b>Review the preferential tax treatment under the Law for the Encouragement of Capital Investment with a view to better target the scheme.</b>
R&D expenditure is concentrated in information industries. Benefits of IP boxes and similar income-based provisions are likely to accrue mainly to large MNEs, as they hold most intellectual property.	Consider replacing the current system of preferential tax rates for IP-based income with a broader system of tax credits for R&D expenditure with cash refunds or carry-forward provisions.
<b>Improving environmental and health outcomes</b>	
Pollution is well above recommended levels and road traffic intensity is the highest in the OECD. Congestion causes the loss of both work and leisure hours, and increases in air pollution and road accidents. Israel plans to end the sale of petrol- and diesel-fired cars in 2030.	<b>Introduce congestion charges, accompanied by significant improvements in the quality of public transport services and higher parking fees.</b>
Effective carbon tax rates on non-transport carbon-based fuels are very low. Higher rates would lower CO2 emissions in a cost-minimising way, make renewable energy generation more competitive and further reduce air pollution.	<b>Either introduce an economy-wide carbon tax or increase the existing excise tax on primary fuels to levels that reflect estimated emissions externalities. Offset real income losses, in particular of low-income households, through transfers.</b>
<b>Strengthening tax administration</b>	
Greater use of third-party data can help move from post-assessment verification to pre-assessment and possible pre-filling of tax returns, which reduces compliance costs and non-compliance.	Enhance access and use of third-party data to move towards pre-filling of tax returns.
Estimates of the size of the shadow economy put Israel somewhat above those of other high-income OECD. Improving analytical tools using modern data analysis to detect tax evasion may require further investment in IT by the tax authorities, which is relatively low.	Abolish the temporary reporting exemption for immigrants and returning residents on assets and income from abroad and the reporting exemption for landlords' rental income below NIS 5100 per month. Increase tax authority investment in IT to improve analytical tools and modern data analysis to detect tax evasion.

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