The Israeli Tax System

This publication contains two articles dealing with main issues in the Israeli tax system:
1. “VAT Revenue Forecasting in Israel”
2. "Are Income and Consumption Taxes Ever Really Equivalent? Evidence from a Real-Effort Experiment"

The articles written as part of the Falk Institute’s “Policy Teams” project, which investigates policy issues in Israel.

Three additional articles that were written for the project in English appear in Issue 07.04 B:
1. "A Forecasting Model for Government Tax Revenues in Israel and an Evaluation of the Forecast Uncertainty"
2. "Shifting of VAT and Purchase Tax Rates onto Consumer Prices"

We wish to thank all participants in the project:

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Introduction

The articles written for the "Israeli Tax System" research project advance our understanding of two tax-related policy issues that have been central in recent times and, in our opinion, will remain so in the years to come.

The first issue is that of forecasting tax revenues. This is a key topic in the design of a budget policy that corresponds to government targets and for achieving macroeconomic stability -- the budget deficit and the national debt being main targets of the national economic stabilization policy. The second issue dealt in the articles is the attitude toward the substitutability of indirect and direct taxation and its implications for welfare, consumption and savings, prices, etc.

The two articles on revenue forecasting were written by Adi Brender and Guy Navon (“A Forecasting Model for Government Tax Revenues in Israel and an Evaluation of the Forecast Uncertainty”, published in D.P. No. 07.04A) and Tatiana Slobodnitsky and Lev Drucker (“VAT Revenue Forecasting in Israel”).

The expenditure side of the budget is fixed by the law. Therefore, overshooting it is legally impossible. Undershooting takes place due to underperformance and statutory rigidity in transferring funds among items. On the other hand, deviations on the tax-revenue side occur very frequently due to methodological flaws in the outlook or significant changes in economic indicators (consumption, imports, product, etc.). Past experience shows that unsuccessful tax forecasts were an important component in triggering financial crises. For example, in 1996–1997 and again in 2002–2003, state tax revenues fell far short of the original outlooks. The first case brought on the provident-fund crisis (via bonds); the second case was occasioned by the second intifada and resulted in massive budget cuts.

Better forecasting and a better understanding of the relationship between economic indicators and tax revenues (especially at times of economic turnaround) might have eased the crises by facilitating an earlier and faster adjustment of the expenditure side.

The question of the substitutability of indirect and direct taxation has been much discussed in recent years. Many researchers find consumption taxes much more advantageous than income taxes in terms of the labor market. Other scholars prefer income taxes to consumption taxes due to income-distribution or price considerations. Still other researchers conclude that indirect taxation and income tax as equivalent because in equilibrium, their effects are almost identical.
The “Israeli Tax System” project examines this issue in two dimensions. First, Tomer Blumkin, Bradley J. Ruffle and Yosef Ganun’s article – Are Income and Consumption Taxes Ever Really Equivalent? Evidence from a Real-Effort Experiment – examines this issue by means of an experiment and finds substantive differences between the two taxation methods. The second article that probes this question, by Natalie Mironychev, Dmitri Romanov, Merav Oren-Yiftach, and Noam Zussman – “Shifting of VAT and purchase tax rates onto consumer prices” (published in D.P. No. 07.04 A), examines the pass-through of changes in VAT and sales taxes to prices of goods and services. This article analyzes the extent of pass-through over time, and difference in pass-through between the tax hikes and tax cuts, as well as the effect on various groups of products.

David Gliksberg’s study analyzes important aspects of Supreme Court decisions in tax law, among them “certainty”, from a normative and empirical perspectives (the article was published in D.P. No. 07.04 A). The first part of the article presents a picture that is interesting and fascinating in terms of its findings. First, from a normative standpoint, the revolution in interpreting the tax law, presently under way in the Supreme Court, ultimately increases economic uncertainty. Second, in empirical terms, the main finding of the study at this stage (1997–2006) is that the Supreme Court’s decisions have been showing a conspicuous “pro-Tax Authority” approach, as reflected in the Authority’s 70 percent “win rate” in court cases. This interesting empirical finding surely lends itself to various explanations and may have many meanings and implications.

These studies reach interesting and important conclusions for the shapers of economic policy. By addressing central issues in the tax system, the “Israeli Tax System” project has enhanced our ability to improve the government’s macroeconomic performance from the tax perspective.

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