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Reforms to the Israeli income tax

 Beny Tzarfati¹

Abstract

Income tax is a major component of state revenues, earmarked to finance the services provided by the government. Income taxes have a significant impact, among other things, on economic growth and income distribution. According to economic theory, personal income tax—perceived as progressive tax—is the main policy tool of the governments of developed countries and is aimed at reducing inequality in income distribution. The Israeli income tax has been through major reforms in the last decade and a half. These reforms include a reduction in income tax exemptions, steadily decreasing tax rates, simplification of tax calculation rules, re-allocation of resources from the public and revenue sharing by reducing the income tax burden on the middle classes, a transfer from territorially based taxation of income earned or accrued in Israel to personally based taxation of income of Israeli residents, regardless of the place of earning the income. The result of changing the tax system and the transition to taxation on a personal basis means, in practice, an expansion of the tax base in Israel. This paper aims to describe the income tax prior to the reforms and the major reforms that had taken place up to 2017.

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Introduction

The aim of this paper is to introduce the major reforms that have been made in the Israeli income tax since 2003, and the directions of the reforms. Most of the reforms were in the 2000s and were intended to fulfill the following objectives: to expand the tax base, to reduce income tax exemptions, to steadily decrease tax rates, to simplify tax calculation rules, to re-allocate resources from the public and share revenue by reducing the income tax burden on the middle classes.

The first section of the article describes the income tax prior to the reforms. The second part is devoted to the reforms introduced, mainly the major reform of 2003, and the third chapter is devoted to the income tax today and its challenges for the future.

The methodology of the paper is to present the reforms on a time scale, without analysing the direction of the reforms, and to group the reforms according to their major objectives, and through that to analyse the direction of changes and their socio-economic influence. This method of presentation enables the reader to better understand the Israeli income tax and the reforms that have taken place. The article ends with conclusions and predictions about future reforms.

1. The income tax up to 2003

Until 2003, there were two separate tax divisions: the Income Tax and Land Taxation Department and the Customs and Value Added Tax (VAT) Division. Following the government's decision of September 2003 to consolidate the management of the collection of taxes under one head administrator and to authorise them by law to activate the relevant tax laws, the two tax divisions were consolidated, and the Israel Tax Authority was established. The Authority is responsible for the collection of direct and indirect taxes in Israel and operates by virtue of laws, regulations and directives. The Authority is also involved in the planning of taxation policy and in initiating various tax reforms. The income tax up to 2003 was based on three pillars: a) territorial base, b) high income tax, particularly for the middle classes, c) relatively narrow tax base.

The first pillar (up to 31.12.2002)—income tax in Israel was territorially based, so only income generated in Israel was taxable, with a few exceptions. Income derived by Israeli residents overseas was not taxed in Israel. The second pillar was high income tax, particularly for the middle classes. As a result, high tax rates on income had serious negative effects, as they reduced the desire to work, harmed

growth, increased the incentive to avoid paying taxes, reduced the amount of disposable income that remained after paying the tax and harmed the well-being of the taxpayer and their family. The third pillar involved a relatively narrow tax base, with a scope of extensive exemptions harming state revenues.

1.1. The first pillar: territorial method

The Income Tax Ordinance adopted the principle of the territorial connection between the source of income and the state of Israel as a basis for tax liability (Income Tax Ordinance [new version] 5721–1961). According to this principle, tax was not imposed on income derived in Israel, whether by a resident of Israel or by a foreign resident. As a result, certain income of Israelis abroad was not taxed in Israel, the most salient examples of which was passive income from dividends paid by foreign resident companies to Israeli residents abroad, and there was no tax charge for personal income generated abroad (Ministry of Finance Tax Reform Committee, 2002).

Residents of Israel whose investments were abroad (rent, interest, royalties, dividends) were not liable for tax on their income as long as their first receipt was not in Israel. The tax discrimination between income from investments in Israel and income from investments abroad created an artificial preference for the latter (Ministry of Finance Report of the Public Committee for Income Tax Reform, 2000).

1.2. The second pillar: high income tax, particularly on the middle classes

Tax brackets are determined by the Knesset and the Income Tax Ordinance. When determining the bracket, the socio-economic situation and the impact of change on the state budget are taken into account. The levels of the tax brackets (and other amounts set by the Income Tax Ordinance) are updated at the beginning of each year according to changes in the Consumer Price Index (CPI) over the past year.

High income earners who earn over 18,841 new Israeli shekels (NIS) a month are subject to a direct marginal tax of 50%, which is not higher than the rate in many OECD countries. On the other hand, the marginal tax rates applying in Israel to the middle classes are very high compared to those in other countries. At a monthly income level above 3,950 NIS, the marginal income tax rate reaches 30%, and it rises to about 45% at an income level above 10,401 NIS (Table 1).

Table 1. Israeli tax rates before the reform of 2002—tax brackets applicable to income from personal exertion

Annual income level (NIS)	Monthly income level (NIS)	Rate (%)
0–23,640	0–1,970	10
23,641–47,400	1,971–3,950	20
47,401–124,800	3,950–10,400	30
124,801–226,080	10,401–18,840	45
Above 226,081	Above 18,841	50

Source: based on data from Ministry of Finance Committee of Experts on Income Tax Reform for Individuals Sheshinski Committee (1988).

There is a striking gap between taxation on labour income and the tax exemptions on most of the profits from interest and income from the capital market, in which the top decile holds a significant share. The high tax burden on income from labour is a result, among other things, of tax exemptions for most financial income. The high rate of income tax on labour income is liable to impair the full extent of the workers' skills and makes it difficult for the Israeli economy to enter the global competition. A high income tax rate at high income levels creates an incentive to invest in tax planning aimed at reducing tax payments in productive activities.

For these reasons, raising the marginal tax rate on labour income above 50% could cause economic damage without significantly increasing tax revenues. At the same time, it is clear that there is no possibility of charging low wage earners with a high tax rate. These considerations, along with the wide scope of the exemptions, imposed a high tax burden on labour income and created a distorted tax structure, which already burdens middle wage earners.

Increases in wages are accompanied by relatively rapid rises in marginal tax rates. Reducing the tax burden on the middle classes is a change that will contribute to greater fairness in the tax system, stimulate and reward work, help economic growth, have broad implications for the tax system as well as the economic reality in the State of Israel and the quality of life of the country's citizens.

1.3. Third pillar: relatively narrow tax base

The scope of extensive exemptions that reduce the state's income indirectly contributes to increases in tax rates on personal income. Most of the capital is concentrated in the hands of high-income earners, and they are the ones who benefit mainly from the large volume of exemptions on capital income and non-taxation of income from abroad, which increases the gap in the effective tax burden borne by the middle-income brackets. The damage is especially severe in areas

where human capital mobility is high, e.g. high-tech. Human capital is the most important resource of the state of Israel, and it would be a mistake if Israel's ability to preserve its human capital is impaired as a result of the poor structure of the tax system.

Tax rates on low income earners in Israel are relatively low by international standards due to the extensive system of credits and deductions that result in more than 40% of individual Israeli taxpayers not exceeding the income tax threshold. The high tax burden on income from work created an incentive for tax sectors to obtain tax breaks. The relative ease of granting tax benefits led to the expansion of the list of tax benefits. This situation required a work plan that would lead to accepted taxation principles, such as the desire for uniformity and neutrality in the income tax, in order to prevent distortions in the allocation of resources, prevent tax planning where fiscal harm is severe and simplify the operation of the tax system to the greatest extent possible. If targeted deductions, credits and exclusions are avoided, substantial revenues can be raised with low tax rates (Henchman, 2012).

2. Reforms to the income tax between 2003 and 2017

Any tax reform needs to balance a number of competing objectives and trade-offs. The impact of growth oriented tax reforms on revenues, the distribution of income, tax avoidance and evasion, as well as tax compliance and enforcement costs all have to be taken into account. Fiscal federalism considerations, the transitional costs of changing tax systems and complex timing issues also have to be considered (OECD, 2010).

The basic considerations for income tax reform in Israel were social justice, economic efficiency, adjustments to global tax systems, simplification and accessibility of income tax laws, administrative costs and implementation mandates, and a balanced budgetary reform. Since 2003, many reforms have been made to the income tax. The direction of the major reforms was to reduce marginal tax rates especially at medium and high income levels, reduce tax evasion and change the income tax base. Under the reform of 2003, it was decided to move from a territorial basis of taxation—income tax that taxes domestic income but not foreign income—to personally based taxation of the income of Israeli residents, regardless of the place of producing the income. The main aspects of the tax reform include reducing the tax burden on employment income, taxation of foreign income, taxation of the capital market, tax relief for foreign residents and new residents, encouragement of business and technology entrepreneurs, as well as the real estate tax reform (Table 2).

Table 2. Expert committees that led to income tax reforms in Israel

Year	Reform
1975	Ben-Sachar Committee: Expanded tax base: all employee income (except for a limited number of exceptions) taxable. Steadily decreasing tax rates. Tax calculation rules simplified.
February 1988	Ministry of Finance Committee of Experts on Income Tax Reform for Individuals Sheshinski Committee (1988): The spacing of the tax brackets to reduce the tax rate calculated by them. The addition of a credit point, which means reducing the tax burden and raising the tax threshold. Payment of a child allowance on a universal basis (i.e. cancellation of the tax imposed on them). Imposition of tax on real capital gains in the capital market. Imposition of a tax on the employer's contribution to a study fund. Cancellation of certain tax benefits, such as tax exemption for gifts and meals.
May 2000	Ministry of Finance Report of the Public Committee for Income Tax Reform, Ben Bassat Committee (2000): removal of certain exemptions, changes in marginal tax rates and imposition of new taxes. Taxation of income from the capital market, taxation of financial income, capital gains and real estate gains, tax benefits for retirement savings, betterment tax on residential apartments, personal allowances for achieving national and social goals: child allowances, credit for working mothers, tax benefits for the disabled, tax benefits for residents of development areas.
June 2002	Ministry of Finance Tax Reform Committee, Rabinovich Committee (2002): reducing the tax burden on employment income, taxation of foreign income, taxation of the capital market, tax relief for foreign residents and new residents encouraging business and technology entrepreneurs, Real Estate Tax Reform
Jan 2003	Income tax reform
December 2004	Report of the Committee for the Examination of Tax Decisions by the Israel Tax Authority (Ministry of Finance, State Revenue Division, 2004)
June 2005	Report of the Ministry of Finance Report of the Committee on the Multi-Year Tax Plan, Mazza and Kaputa (2005).
2007	Reduced marginal tax rates especially at medium and high incomes
2008	Tax break package for new immigrants and returning residents
January 2014	Separate calculation rules have changed, the family unit may request a separate calculation of earned income, even if the husband's income is dependent on one source of income of the other spouse

Source: the author's own analysis based on the publication of the Ministry of Finance cited in the table and Ministry of Finance, State Revenue Division (2001).

2.1. Reforms to reduce tax rates on income

The major change was in January 1, 2003 when it was decided that most tax reduction would affect middle income brackets. As of January 1, 2008, the marginal

tax rate inclusive of social security on a monthly income of \$7,150 amounted to 49%. Up to January 1, 2008, there was a gradual reduction in tax rates. Most economists agree that tax systems should have broad bases and low rates (Henchman, 2012). With this solution in mind, Israel adopted an approach similar to those in many EU member states, which reduced the income tax burden of the most vulnerable members of society (Čok et al., 2012).

2.2. Reforms to the taxation of foreign income

The major changes included: the transition to worldwide taxation, determination of residence, source rules, foreign companies and foreign corporations owned by Israeli residents taxed in Israel, off-setting of foreign losses, foreign tax credits, transfer pricing, tax on Israeli individuals changing their residency.

The reform of the territorial method was to change the tax base from the territorial method to the personal method. The taxation of income earned in Israel by non-residents and the taxation of income earned abroad by Israeli residents requires explanation. The switch to the personal tax base system means that income tax is payable, for each tax year, on the income of an Israeli resident derived or earned in Israel or abroad and on the income of foreign residents derived or earned in Israel from these sources (Income Tax Ordinance [new version], 5721–1961). Foreign residents will be taxed on income earned in Israel.

The main advantages of the personal method: it prevents horizontal discrimination between taxpayers who generate income from sources in Israel and those who generate income from foreign sources, and adjusts to the multi-national activity deriving from the globalisation of the world's economy. In Israel, it facilitates Israel's integration into the global system to prevent double taxation, assuming that taxpayers pay the tax. The disadvantage of the system is that the broadening of the tax base could make it difficult for Israeli residents living abroad to compete with residents of countries that do not tax on a personal basis. Source Rules determine the location of income accrual (income location). The purpose of determining the location of income is to establish in what cases a resident of Israel shall be entitled to a foreign tax credit and in what cases a foreign resident will be charged tax in Israel.

Foreign losses are treated as though they were accrued from a single country and set off against foreign income. Losses from passive activity are distinguished from business and vocation losses. Capital losses from the sale of assets abroad shall be set off first against foreign capital gains. Foreign tax credits shall be granted to Israeli residents only and shall offset Israeli tax levied on the same income, while separating income from different sources. No credits will be given for income

exempt from tax in Israel. Foreign tax credits on income from a certain source will not exceed the amount of tax chargeable in Israel for that source of income. Access to foreign tax can be carried up to 5 years forward.

2.3. Reforms to the capital market

As of January 1, 2003, tax shall be levied on the sale of tradable securities by individuals and companies to whom the Law of Adjustments does not apply. Foreign investors will remain exempt from capital gains tax on the sale of shares traded on the Israeli stock exchange. Tax rates on the sale of securities traded on the Israeli stock exchange shall be 15% upon the sale provided that no financing expenses have been deducted.

Capital gain from the sale of foreign securities traded on foreign exchanges that have been purchased since the beginning of 2007 onwards shall be charged at a tax rate of 15%. The sale of foreign traded securities until the end of 2006 shall be charged at a tax rate of 35%.

Tax is charged at a rate of 15% on interest received by an individual in the following cases: interest on linked bonds issued, interest paid on foreign traded securities (35% for interest paid before that), bank deposits outside Israel—made in institutions operating according to their domestic law. Furthermore, tax is charged at 10% on interest received by an individual if the asset is not linked. All other interest shall be charged at the marginal tax rate and no interest expenses shall be deducted from interest income. Dividends received by individuals are subject to no change in the present law and have a 25% tax rate (35% tax rate previously). Dividends from foreign traded securities—25% tax rates.

2.4. Reforms for foreign residents and new immigrants

There is tax relief for foreign residents, as well as tax exemption for foreign residents in venture capital funds and investments by foreign investors through venture capital funds in accordance with prior approval. There is also exemption from capital gains tax on the sale of shares in a qualifying research and development company and the sale of tradable securities. Tax relief for new immigrants (“Olim”) applies to an individual who was not a resident of Israel and has become one.

There is reduction in tax on pensions received by new immigrants to Israel, on account of employment or work in a foreign country. The tax rate shall not exceed the tax that would have been paid on that same pension if the immigrant

had remained a resident of a given country. The relief is not limited to any maximum periods, and is also granted to those who came to Israel before the amendment to the tax law.

There is a 5 year tax exemption rule on passive income—interest, dividends, allowances, royalties and rental income—accrued from assets outside of Israel that were owned before becoming a resident. This relief is extended by transitory provisions. Returning residents are entitled to relief on passive income, provided the bearing assets were purchased abroad after they ceased to be residents of Israel. This relief is extended by transitory provisions. Income from a business owned by a new immigrant during the 5 years before he became resident of Israel is exempt from tax for 4 years after the change of residence, and this relief applies whether or not the new resident continues to participate actively in the business (Israel Tax Authority, 2021).

Relief for the capital gains of new immigrants: there is exemption from capital gains tax for assets sold within 10 years of becoming a resident. This applies to assets outside of Israel owned before becoming a resident. Relief for the capital gains of a returning resident: there is exemption from capital gains tax for assets sold within 10 years of becoming a resident. This applies to assets acquired abroad after ceasing to be an Israeli resident. Assets sold after 10 years of becoming a resident shall be entitled to partial relief, calculated according to relative periods (Israel Tax Authority, 2021).

2.5. Reforms to encourage business and technology entrepreneurs

Capital gains tax on the sale of capital assets other than tradable securities shall be reduced to 25% for both individuals and corporations. The reduced tax rate shall apply to all sales occurring after January 1, 2003, on a proportional part of the profit, calculated linearly. Options or shares given to employees shall be considered as income only upon their sale. The issuing company may choose either of the following methods of taxation when issuing the securities: Method A—Revenue Income—the employee is deemed to have received employment income from which the employer may deduct expenses. Method B—Capital Income—the employee is taxed as having received capital gains (25% tax) from which the employer may not deduct expenses (PwC Israel, 2022).

The chargeable income and losses of the company shall be charged in the hands of the shareholders, according to their share of the rights to profits. The exemption for foreign residents in Venture Capital Funds shall be expanded by lowering the criteria. Foreign investors will remain exempt from capital gains tax on the sale of shares traded on the Israeli stock exchange.

2.6. Other changes

In 2008 a tax break package for new immigrants and returning residents (amendment 168 to the Income Tax Ordinance – see: Income Tax Ordinance [new version] 5721–1961) was introduced. The main benefits for new immigrants and returning residents who became citizens are as follows: 10-year exemption from paying tax on foreign-source income, 10-year exemption from declaring foreign source income which is exempted, 10-year exclusion from the definition of an Israeli company resident for a company established abroad and owned by an Oleh or a Senior Returning Resident, an option to be considered as a foreign resident for taxation purposes for one year after arrival, 3.5 years of entitlement to tax credits with options for extension.

The following entities are entitled to the tax benefits: Oleh and Individuals who have returned to Israel after living continuously outside of Israel, returning to Israel not sooner than 10 years after having ceased to be a resident of Israel (Senior Returning Resident). Those people are also entitled to income tax benefits on passive income—10-year exemption on dividends, interest, rent, royalties and pensions generated by assets held overseas. Additionally, 10-year exemption on capital gains from the alienation of assets located abroad. This is extended to assets located abroad acquired after becoming an Israeli resident; 10-year exemption on business income generated by assets held overseas; 10-year exemption on salaries and income from activities of an independent nature, generated abroad. It applies to businesses and occupations acquired or started before or after becoming an Israeli resident. A company established abroad and owned by an Oleh or a Senior Returning Resident, will not be considered as an Israeli company for taxation purposes for a period of 10 years, and thus will be exempt from taxes in Israel during this period on foreign source income.

Tax credits: All Israeli residents are entitled to 2 credit points, as well as 0.25 additional points for a working man and 0.75 points for a working woman, which are not taxed. A working Olim is entitled to additional points on top of that, for a period of three and a half years following their Aliyah. This benefit may be extended whilst carrying out compulsory army service and whilst studying at university or college. For the first 18 months there are 3 additional credit points, for the following 12 months 2 additional credit points, and for the following 12 months 1 additional credit point. Additional reductions are available for parents of young children, working mothers, discharged soldiers and many other categories. The credits along with marginal tax rates contribute to a more equitable distribution of income (Barbetta et al., 2018).

3. The income tax in Israel 2021

The idea behind establishing tax levels is that any increase in the tax rate that a person must pay as their income rises is controlled, so that there is a situation in which the person earning a higher gross salary will also earn a higher net salary. Tax bands in Israel are narrow, and wage and recorded income tax are charged to everyone (Table 3).

Table 3. Israeli tax rates—tax brackets applicable on income from personal exertion for the year 2021

Monthly income level (NIS)	Tax rate (%)
0–6,290	10
6,290–9,030	14
9,030–14,490	20
14,490–20,140	31
20,140–41,910	35
Above 41,411	47

Source: the author's own analysis based on data from the Ministry of Finance, Help table for calculation Income tax from salary and wages (2021).

The tax structure is a very important aspect of in the quality of taxation. It deals with the design of tax policy to achieve desired policy objectives, while at the same time promoting economic growth, minimising distortions and reducing the cost of tax collection (Lee & Gordon, 2005). With tax burdens differentiated by earning levels and family situations, they serve as a central role in redistribution policies (Cordes & Juffras, 2012). In Israel about 54% of employed individuals do not pay income tax at all (Ministry of Finance, State Revenue Division, 2014). This is due to both the lower tax rates for low income earners and credit points to which every citizen is entitled. Between 2000 and 2021 there was an increase in the extent of Israel's progressive income tax, which contributes to reducing inequalities to a relatively large extent. There is no exact formula and definition of the extent to which income tax should be progressive (Szarowská, 2014).

A higher income tax rate on an employee's salary could prevent workers from utilising all their skills and hamper the integration of Israel into the international economy. High tax rates at high income levels create an incentive to invest in tax planning aimed at reducing income tax payments rather than productive activity. According to these considerations, raising marginal tax rates on labour income in excess of 50% can cause economic damage without significantly increasing the collection of income tax. At the same time, we cannot charge high income tax

rates on low incomes. These considerations, together with the wide scope of the exemptions, required a high tax burden on labour income, and the income tax structure created distorted middle income wage levels.

A credit point is an amount that can be deducted from the tax, provided that the credit given to the taxpayer is not an amount exceeding the tax payable by the taxpayer. The value of a credit point for tax in 2017 is 215 NIS per month. The significance of eligibility: income tax from the employee's pay shall be reduced by an amount equal to the product of the number of credits worth credit points. The offset value is annual and includes the month in which the employee did not work. Therefore, an employee who is in mid-year will be entitled to a higher monthly credit than the employee who has worked during the whole year (total annual credit will be the same for both). The amount of credit as an income tax offset applies to an employee in a job. Any employee who is a resident of Israel is entitled to 2.25 credits from the Israel tax authority. In addition, there are various criteria that entitle extra points. The taxpayer who best meets the criteria will gain the greater number of credits. The amount of credit as an income tax offset applies to an employee in a job.

The significance of entitlement is that any income tax on employee pay shall be reduced by an amount equal to the sum of the number of credits worth credit points. Credits reduce the maximum tax value to zero, so they are useful only to the employee. For example, the annual value of 2 credits in 2017 is 5,160 NIS (2,580 NIS is the annual value of one credit point). For workers who are entitled to 2 credits and where the total income tax due is lower than 5160 NIS, they take only the share of credits worth the amount of income tax they must pay (they are not required to pay income tax at all).

The following are the main credit points: credit for the resident of Israel—two credit points shall be taken into account in calculating the tax of an individual who has been a resident of Israel in the tax year, credit for Oleh, credit for commuting to the workplace—in calculating the tax of an individual resident of Israel, 1/4 credit point shall be taken into account as a travel credit, credit for women—in calculating the tax of a woman, 1/2 credit point shall be taken into account, credit for a spouse—in calculating the tax of a beneficiary of an individual resident of Israel, who proved to the Assessing Officer's satisfaction that he supported his spouse during the tax year, one credit point shall be taken into account, credit for a working spouse—if the chargeable income of an individual resident of Israel, who is a registered spouse, includes the income of his spouse; if it is proved to the Assessing Officer's satisfaction that the spouse's income was obtained by personal exertion from any business or vocation or from employment, including income from personal exertion, then in calculating the chargeable income, 1/4 credit point shall be taken into account; 1.5 credit points if they are not entitled to a pension point and 1.75 credit points if they are entitled to an aforesaid pension point; credit for

a spouse—in calculating the tax of an individual resident of Israel whose spouse helps them in obtaining their income from any business or vocation during at least 24 hours in each week during nine months of the tax year, then 1.5 credit points shall be taken into account if they are not entitled to a pension point and 1.75 credit points if they are entitled to an aforementioned pension point, and in respect of a beneficiary individual.

Credit points for those made redundant, pension and credit points for children, a divorced man who has remarried, a juvenile, an individual who completed studies for a bachelor's or master's degree, professional studies, a person who returned to work, a spouse who was married during part of the year, for the expense of maintaining a relative in an institution, for incapacitated persons, insurance premiums and benefit funds (Income Tax Ordinance [new version], 5721–1961).

The income tax threshold is the threshold above which tax is only beginning to be charged on income. This threshold depends on the individual tax credits to which taxpayers are entitled. For example, a man who is entitled to 2.25 credit points began to pay income tax starting at an income of 4,905 NIS a month in 2015. In 2015 there were 52.3% persons under the tax threshold (Table 4).

Table 4. Annual and monthly value of credit point in 2011–2021

Annual value (NIS)	Monthly value (NIS)	Year
2,616	218	2021
2,628	219	2020
2,616	218	2019
2,592	216	2018
2,580	215	2017
2,592	216	2016
2,616	218	2015
2,616	218	2014
2,616	218	2013
2,580	215	2012
2,508	209	2011

Source: the author's own analysis based on data from the Ministry of Finance, various years.

Tax benefits differ from state to state. For example, the United States Congress provides citizens with incentives to save for their own retirement. The two pillars of the private retirement system are the tax-exemption of the pension plan income and income smoothing. The smoothing benefit is a consequence of tax progressivity. By contributing before-tax income during working years, when infra-marginal tax rates are high, and withdrawing funds at retirement when they tend to be low, lifetime tax liability is reduced.

Conclusions

Israel's income tax has been through major reforms in the last decade and a half. The major directions of the reforms have been: transfer from a territorial basis for taxation of income derived or accrued in Israel only to a personal basis for taxation of the income of residents of Israel, regardless of the place of producing income; expansion of the tax base; reduction of income tax exemptions; steadily decreasing tax rates; simplification of tax calculation rules; re-allocation of resources from the public; and revenue sharing by reducing the income tax burden on the middle classes.

Although the state of Israel has succeeded in adapting the income tax in Israel to that accepted around the world, in 2017 the system still had many challenges and issues for debate, such as:

- 1) Tax evasion—in 2012 income tax accounted for approximately 42% of total state tax revenue and it is estimated that the size of the black economy in Israel, according to the World Bank's publication reached 23% of GDP. The Income Tax Ordinance is not exempted from income tax derived from an illegal source. The Tax Authority should act in a comprehensive, efficient and effective manner in order to increase tax collection in this area. The Israel tax authority only criticises a small fraction of taxpayers and this does not have an effective deterrent effect on this behavior and can even create an incentive for those individuals to avoid taxes.
- 2) Israel's competitiveness—as personal income taxes contribute significantly to the overall tax burden on labour, it is also a relevant factor in international competitiveness (Szarowska, 2013) and the functioning of labour markets or fiscal federalism.
- 3) A consistent income tax policy, long-term strategic planning and adjustment of income tax changes to government policy from a broad fiscal perspective and the simplicity of the income tax, reducing inequality, boosting economic growth and redistribution of wealth are also challenges and issues for debate. The State of Israel preferred that the tax unit, with tax revenues on personal labour, be calculated according to the individual rather than the family. This is the reason for the progressive nature of the tax system, which in their opinion should be applied to the entire family income. The income tax system must ensure transparency of tax laws, increase the compatibility between tax laws and tax collectors, and increase reporting to citizens. These properties are correlated to the real involvement of taxpayers in the decision-making process. Tax laws that are not clear enough can be abused to hide the real price of imposing taxes on the one hand, and circumventing laws on the other. Thus, for example, the transparency of the income tax in

the case of the minimisation of arbitrariness in the tax system. The simplicity of income tax laws is necessary not only to increase consumer access but also to reduce the costs of tax collection. Tax collection involves costs such as the salaries of income tax officials, time required to fill forms and payment to consultants. Most of these challenges are not unique to Israel.

The author's opinion is that the income tax should be examined in order to minimise the damage it causes to the economic system. However, some damage is necessary to finance government expenditure. In any case, the distortions in this necessary system should be minimised as much as possible. Any reduction in income tax requires the imposition of tax on another factor in the economy, causing damage to growth and tax revenues. Future reforms should be in directions that will allow for successful income tax policy in terms of collection, norms and tax evasion. Future income tax rates should be correlated with the economic and technological reality. It is forbidden to impose a tax that has no proper basis for implementation, such as the taxation of child allowances in the 1980s. Income tax rates should be similar to other countries. Tax policy managers should strive to avoid complicated taxation. An overly complex income tax results in taxes having negative consequences and sometimes it is not clear whether they are legal. In the author's view, simpler income tax laws are preferable to complex income tax laws that try to find solutions to all alternatives and possibilities. Sometimes the judges' inability to reach decisions on tax issues leads the system to reach an arrangement with the taxpayer, which increases the likelihood of tax evasion. The taxpayer assumes that in most cases they will not be caught, and if they are caught, they can always reach an arrangement and pay less tax. The Israel tax authority must take into account the impacts on the socio-economic system and act reasonably and transparently, so that citizens understand that the tax burden is fair.

It is possible that the highest exemption is thus granted to individuals with the lowest income and vice versa (Čok et al., 2012). A reduction of the tax bracket from 7 to 5 and a reduction of the tax rate for the first bracket as well as removal of some tax exemptions and deductions would make the Israeli income tax more equal, transparent and simple.

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