Death by Taxes

It is no secret that Israel is facing its most acute economic crisis since the days of 400-percent inflation nearly a generation ago. The country's economy, which must expand more than 2 percent annually just to keep pace with population growth, has shrunk in each of the last two years, and a further decline is predicted for 2003. With unemployment over 10 percent, government welfare payments have swelled, while receipts from taxes have plummeted. As a consequence, Israel faces a budget deficit that, at its current rate, will equal 6 percent of the gross domestic product (GDP) in 2003—*twice* the level generally considered dangerous by international credit rating agencies. For Israel, a beleaguered country facing severe military challenges and increasing diplomatic isolation, the resumption of economic growth is an urgent, existential need.

Most economists and public figures have pinned the blame on the collapse of the world high-tech market, as well as the downturn in tourism and foreign investment since the outbreak of war with the Palestinian Authority in September 2000. Although these factors account for part of the economic malaise, they are far from explaining how these setbacks have succeeded in bringing Israel to the brink of financial ruin; and they are even less helpful in pointing towards a solution. To get to the heart of the matter, one has to look at a more systemic, long-term problem: The reckless spending and taxation policies of successive Israeli governments, which have relentlessly choked off economic initiative.

Last year, government spending in Israel constituted 55 percent of the country's economic activity. This puts Israel three percentage points ahead of Sweden for the dubious distinction of having the largest public sector in the industrial world. And tempting as it is to blame excessive spending on the threats Israel faces, defense expenditures account for only one-fifth of its annual budget of $56 billion. The real problem lies with social benefits, transfer payments, and the bloated government payroll, which together comprise more than half the budget. In other words, even if it were possible to lower Israel's defense spending to the level of a typical European country (3 percent of GDP, instead of 10 percent), the Jewish state would still rank with Sweden, Denmark, and France as a world leader in budgetary profligacy.

Though Israelis have been slow to acknowledge this long-festering problem, the current crisis has led to a growing awareness of it, especially since the appointment of Finance Minister Benjamin Netanyahu, who has made deep budget cuts the centerpiece of his ministry's emergency recovery plan. "*The* problem," he explained at a March press conference unveiling the plan, is that "the public sector… which does not create money and only consumes it… constitutes 55 percent of economic activity, while the productive sector constitutes only 45 percent." In keeping with this assessment, the vast majority of the proposals in the 174-page plan slash spending in a wide variety of areas, including taxpayer-financed pension programs for Histadrut union workers, salaries for senior officials in government-run monopolies, and allocations for the Religious Affairs Ministry.

High taxes, on the other hand, have received relatively little attention in the public debate, and tax reduction plays only a peripheral role in the emergency plan. In July 2002, the national unity government of Ariel Sharon passed a modest income tax cut, to be phased in by 2008, as part of a package that included new taxes of between 10 percent and 25 percent on savings, dividends, and capital gains. The first phase of that reform—which introduced the full weight of taxation on the capital markets, and only a symbolic reduction on income taxes—went into effect in January of this year. While the Finance Ministry has now declared its intention to pick up the pace, moving the target date for final implementation to 2005, this step is still a far cry from the deep reductions needed to get a catatonic private sector moving again.

Indeed, it might well be that the greatest problem facing Israel's economy is not the size of its government, but the tax burden needed to fund it. It is here that Israelis at every level—workers, employers, and investors—face a grueling string of disincentives. Consequently, a systematic effort to reduce taxes is essential if Israel is to find a path to stable growth.

Just how high are the taxes Israelis face? In the two areas that wreak the greatest havoc in the life and work of the individual—taxes on labor and purchase taxes on goods and services—Israeli rates are among the highest in the world.

Consider, first, the bite government takes out of salaries. From every paycheck, employers deduct income tax, national insurance tax, and health tax, whose combined effect places a married Israeli man with two children and an annual salary of $13,200 (5,300 shekels a month) into the 38-percent tax bracket; a similarly situated woman would reach that bracket at a salary of $14,980 due to a higher tax credit given to women, while above that level, men and women alike pay the same high rates. At $28,300 (which is 11,400 shekels a month), an annual salary that is typical for Israel's middle class, a worker reaches a marginal rate of 55 percent. Not even the best-compensated investment banker in Manhattan—who must pay substantial state and city taxes on top of his federal tax bill—is in as high a bracket. But this is still not the maximum rate Israelis face: At a salary of $50,300, an Israeli reaches the top bracket, at which 60 percent of his marginal income goes directly to the government.

These figures, however, tell only part of the story, as Israelis are confronted with a battery of additional taxes that sharply diminish the purchasing power of whatever is left of their earnings. Most burdensome among them is an 18-percent value-added tax (VAT) levied on virtually all goods and services, including staples like bread and milk. This means, for example, that a middle-class worker earning less than $30,000, who is already in the 55-percent tax bracket, loses another one-sixth of his net salary the moment he needs to buy something with it.

Yet VAT is only part of the problem, as many items considered essential in the industrialized world face punitive taxes and customs duties in Israel. Suppose that the middle-class worker from our example above decides to take a second, part-time job in order to earn enough to buy a car. Were he living in the United States, he could purchase a modest vehicle such as a Honda Civic for about $13,500, including taxes; and if he were taxed at American rates, he would need an additional salary of $20,000—no small feat, but feasible over a period of a year or two. In Israel, however, due to customs duties of 110 percent and VAT of 18 percent, the same car costs $25,400. To retain that much income after taxes, the Israeli would have to earn an additional $56,400—nearly three times more than his American counterpart would need.

But the tax burden faced by the Israeli car owner does not end once he has finished paying for his new vehicle. Since the sticker price is nearly twice what it is in the United States, car insurance in Israel is also far more expensive, costing about $1,600 annually for the Honda Civic. Gasoline is taxed even more aggressively; today, the price for a gallon of unleaded gas in America is around $1.80, while in Israel, due to a purchase tax of 190 percent (plus the omnipresent VAT), the same gallon costs $3.90. Thus, if the Honda owner were to drive 10,000 miles a year, gas alone would cost about $1,000 more than an American driver would pay. To add insult to injury, the Israeli even has to pay an annual tax of $25 on his car radio to help cover the costs of the deficit-ridden government broadcasting network.

Nonetheless, it has often been claimed that Israeli tax rates are "reasonable," as they are allegedly no higher than those in most European countries. Writing in September 2002, prominent *Ha'aretz* commentator Aryeh

Kaspi averred that the Israeli public "is awash in misleading information suggesting that taxation in Israel is higher than the average in the West." Shlomo Swirski, director of the Adva Center for Information on Equality and Social Justice, has likewise argued that, "The tax burden on individuals in Israel is not among the highest in the world. A comparison with figures published by the OECD [Organization for Economic Cooperation and Development] shows that Israel sits neatly in the middle."

This claim, however, falls apart as soon as one compares labor taxes in Israel and in the OECD nations—a group whose two dozen members include most of the European states. Consider, for example, the textbook case of a married man with two children, whose gross salary is equal to the per capita GDP in his country (that is, roughly average for that country). According to a study by Adi Brender of the Bank of Israel's Research Division, such a worker in Israel paid a marginal tax rate of 40 percent in 2002—a full 26 percentage points more than was paid by his counterpart in Germany, 14 points more than in France, 10 points more than in Norway, and 7 points more than in Sweden. Similarly, an Israeli whose income is twice the national average is taxed at 55 percent, a rate exceeded only by two Western countries, Denmark and Belgium.

But even this analysis downplays the degree to which the Israeli tax burden is high. For starters, taxation in the leading welfare states of Europe includes substantial set-asides for pensions, whereas Israeli workers have to fund their own pensions. Taxes in many European countries also fund crucial services for which Israelis must pay extra: In Sweden, for example, education is free of charge, whereas Israeli parents have to pay for school supplies, books, field trips, and "supplemental" classes for their elementary, middle, and high school-age children. Swedish university studies are likewise covered by the government, whereas college-bound Israelis have to foot the bill for tuition, room, and board.

Given all this, it is hard to escape the conclusion that Israelis are among the most highly taxed people in the Western world. And when it comes to the middle class—upon whom any hope of sustained economic growth ultimately depends—Israel may well have the most onerous taxes anywhere.

The devastation caused by Israel's tax burden plays itself out in a long string of disincentives that quash economic activity at every turn. High taxes on labor undermine the individual's incentive to work harder, while discouraging employers—who typically must give the government one dollar for every dollar they add to the net income of an employee—from promoting workers or hiring new ones. These same taxes also stifle capital development, since they leave Israelis with little disposable income to save or invest. And, by raising the expenses of companies both for labor and for the procurement of goods and services, high taxes are a formidable obstacle to Israel's competitiveness internationally.

All this is bad enough, but it may not be the worst of it. High taxes dramatically increase the incentive to cheat, as anyone who has ridden in Israeli taxis quickly discovers. The reason the meter is typically "broken" is that cab drivers prefer not to run it, as it produces an official record that will be used for calculating income tax and VAT payments. In the same way, Israeli teachers often supplement their income by teaching private lessons after school hours, for which parents pay with personal checks on which the payee line is left blank. Virtually the entire industry of home additions and repairs likewise operates on a cash basis, which entails the creation of "unofficial" receipts given to the customer, but not to tax authorities. The prevalence of illegal economic activity, driven in large part by exorbitant tax rates, turns hundreds of thousands of otherwise law-abiding citizens—most of whom unhesitatingly leave their families to serve their country in army reserve duty—into tax cheats, accustomed to duplicity in their economic transactions.

But perhaps the worst result is that Jews from Western countries are deterred from moving to Israel, while many Israelis—including some of the country's most skilled workers and entrepreneurs—are driven to emigrate. Statistics in this area are notoriously difficult to obtain, but anyone familiar with California's Silicon Valley or Boston's Route 128 high-tech belt knows what an extraordinary price Israel has already paid, and continues to pay, in economically motivated Jewish emigration. But there is nothing surprising here. As Alan Reynolds of the Hudson Institute points out, "Although good tax policy alone does not ensure a good economy, world history offers no examples of economies that prospered with punitive tax rates.... Just as so-called 'tax havens' attract investment and skilled immigrants, countries with punitive tax systems face chronic capital flight and brain drain."

Instead of encouraging Jews to come to Israel and take part in the ongoing effort to build a Jewish state, the current tax regime creates every possible incentive for Israelis to leave. As such, it is nothing less than a threat to the success of the Zionist enterprise.

Israel must make deep cuts in the national budget, and the government, led by Finance Minister Netanyahu, deserves praise for facing this necessity head on. But that is not enough. Israel's leaders must come to grips with the fact that high taxes also bear a large share of the blame for the current crisis. A comprehensive effort to introduce broad-based reductions in taxes must be viewed not only as one element within the government's efforts to get the economy back on track, but as perhaps the most crucial vehicle for fueling desperately needed growth.

Judged from this perspective, the income tax reform introduced by the government in 2002 and accelerated in the new emergency plan is hardly sufficient. At the end of the proposed reform in 2005, a worker earning $13,200 will *still* be saddled with a marginal tax rate of 36 percent, while a 47-percent rate will be levied as soon as a person's salary reaches $47,200.

Israelis will likewise see no reduction in the 18-percent across-the-board VAT, or in the bewildering array of other taxes that raise their cost of living substantially. Rather than offering a strategic change, the current plan would leave what is probably the economy's worst problem largely intact.

A far deeper series of tax cuts is needed, but the possibility of even considering such a step has thus far been precluded by the widespread concern that Israel cannot afford them when it is grappling with high deficits, negative growth, and unemployment. In this light, it is instructive to consider three recent cases in which Western nations facing similar problems responded with substantial tax cuts, and achieved stunning results.

Shortly after Margaret Thatcher became prime minister in 1979, the British economy entered a deep recession, in which growth was negative for two straight years. Inflation reached 16 percent, unemployment climbed above 10 percent, and the government deficit consistently approached 3 percent of GDP. One leading cause for the stagnation was a minimum, "basic" tax rate of 40 percent (including national insurance taxes), coupled with a series of increasingly onerous tax brackets that culminated in a top rate of 83 percent. Within the next decade, Thatcher's government reduced the basic rate to 33 percent, and cut the top tax rate in half, to 40 percent. In the ensuing years, Britain's economy surged: Growth reached 4 percent annually, inflation shrank to 5 percent, and by the end of the 1980s, the government even succeeded in running a budget surplus.

When Ronald Reagan became president in 1981, the United States was suffering from what was popularly known as "stagflation," a devastating combination of 13-percent inflation and 7-percent unemployment. Tax rates were high and climbing at almost all levels of income, and the top rate was 70 percent. In response, Reagan and the Congress slashed tax rates by a quarter across the board during the next three years, and ultimately cut the top rate in half, to 35 percent. In the ensuing six years, tax revenues, which skeptics claimed would drop precipitously, rose by $375 billion. During these same years, an estimated 20 million new jobs were created, and the standard of living of Americans at every income level rose. These tax cuts set the stage for 20 years of virtually uninterrupted growth, in which the U.S. economy expanded by more than a third, increasing the net worth of Americans by $15 trillion.

The same lessons come through even more clearly in the case of New Zealand. In the 1950s, this small nation was one of the five wealthiest in the world, but by the early 1980s its standard of living had fallen to nearly the bottom of the OECD. Economic growth was negligible, unemployment rose from almost nothing to 5 percent, and the budget deficit reached an astounding 9 percent of GDP. The government, under Prime Minister David Lange, began a series of sweeping reforms in 1984, which included not only deep spending cuts and a massive privatization effort, but also radical reductions in income taxes—including a halving of the top rate from 66 percent to 33 percent. Within a number of years, economic growth accelerated to a steady 5 percent, and in less than a decade the government ran a budget surplus of 4 percent of GDP. By the mid-1990s, New Zealand was ranked by the OECD as one of the ten most competitive economies in the world, and was likewise among world leaders in its standard of living.

Though success can never be guaranteed, there is good reason to believe that Israel's economy can resume a pattern of growth if its government, too, recognizes the importance of cutting taxes broadly. Of course, as with any radical measure, it can always be argued that the timing is not right, and that Israel should first take smaller steps to end its current crisis. But this approach is mistaken: Tax cuts are in fact one of the best means for setting the country on the path to growth. The decision to wait would also reflect an error in political judgment, as there is no better atmosphere than one of crisis to spur policy-makers and the public alike to consider steps that might otherwise be rejected out of hand.

Severe recession and unemployment have inflicted much suffering on the Israeli public. But the current crisis, which has put economic policy at the top of a crowded public agenda, presents Israel with an opportunity to make strategic changes in the way the country does business. Such changes hold out the prospect of a Jewish state that would offer a decent living to its citizens and would be attractive to Jews everywhere. Such changes are at once an economic necessity and a foremost Zionist imperative.

Daniel Polisar, for the Editors
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