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**THE IMPACT OF THE EXPECTED TAX RATE CHANGES
ON THE MIDDLE CLASS**

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The Impact of the Expected Tax Rate Changes on the Middle Class

Ayal Kimhi and Kyrill Shraberman*

Abstract

In light of the current budget situation, the Israeli government decided to raise the VAT by 1 percent as of September 2012, and to impose higher income tax rates and National Insurance payments on higher-earning Israelis starting in 2013. In doing so, the government has gone even further than the Trajtenberg Committee, whose tax recommendations it only partly adopted in late 2011. Although the recent decisions affect all strata of the population, Israel's middle class will feel their impact the least. Nevertheless, it is reasonable to expect additional tax increases and/or budget cuts that will reverse this conclusion.

The Committee for Economic and Social Change, popularly known as the Trajtenberg Committee, was established in August 2011 in response to the social protest movement to recommend to the government steps to ease the economic burden on Israeli households. Within seven weeks of the committee's founding a document was submitted which, in

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its words, outlined a comprehensive and deep change in Israeli socioeconomic policy. The committee recommendations reflect an attempt to maintain fiscal responsibility which opposes any increase in the government deficit; the recommendations thus include measures designed to increase not only state spending, but state revenues as well.

Within the taxation sphere the committee recommended reducing indirect taxes (sales tax, customs and excise duties) and raising direct taxes progressively. In particular, it was recommended that scheduled income tax rate reductions be repealed, that the tax rate for those with especially high incomes be raised, and that employer National Insurance contributions for relatively high wages be raised as well. The committee also recommended raising the corporate tax and the capital gains tax, and according fathers two tax credits per child under the age of three – as a means of easing the burden on working families. Overall these measures were meant to increase state revenue by some NIS 3.3 billion, and to reduce income inequality.

The Law for Change in the Tax Burden, passed by the Knesset in December 2011, adopted the majority of the Trajtenberg Committee's tax recommendations, with a few modifications. The surtax on high incomes was not included in the law, while the tax rate for the third tax bracket (monthly income of NIS 8,880 to NIS 14,430) was reduced by 2 percent. Employer National Insurance contributions were not increased.

The left-hand side of Table 1 presents the income tax rates prior to the Trajtenberg Committee (the "Before change" column), the committee's recommendations, and the actual provisions of the law (the "After change" column). Compared with the Trajtenberg recommendations, the government forfeited potential annual revenues in excess of NIS two billion. Additionally, simulations run in accordance with the Taub Center tax model have shown that full adoption of the Trajtenberg Committee recommendations (the blue bars in Figure 1) would have led to a more equitable distribution of earned income than that which emerged subsequent to the late 2011 legislation. This was primarily due to the 2 percent surtax that would have been imposed on high incomes. In

particular, one can see that the surtax would mainly have hurt Israeli households in the highest decile, with a lesser degree of impact on households in the decile just under it. By contrast, the income share enjoyed by households in deciles 1-7 would have grown. One should note that while the changes presented in the graph relate to the shares of total earned income of the various deciles, the decisive majority of workers would likely have paid higher taxes in absolute terms.

Table 1. **Income tax rates in various policy alternatives**

Suggested tax and actual tax policy in 2012				New decision in 2013	
Tax bracket (NIS per month)	Tax rate			Tax bracket (NIS per month)	Tax rate
	Before change	Trajtenberg	After change		
0-5,200	10%	10%	10%	0-5,200	10%
5,201-8,880	14%	14%	14%	5,201-8,880	14%
8,881-14,430	23%	23%	21%	8,881-14,000	21%
14,431-21,780	30%	30%	30%	14,001-20,000	31%
21,781-41,830	33%	33%	33%	20,000-41,830	34%
Over 41,830	44%	48%	48%	Over 41,830	48%
Over 83,000	---	50%	---	Over 67,000	50%

Source: Ayal Kimhi and Kyrill Shraberman, Taub Center.

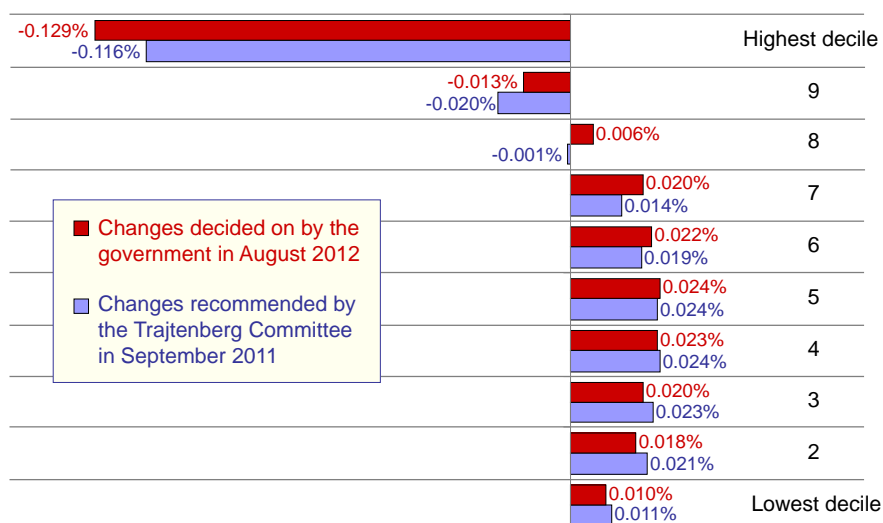
Data: *The Report of the Committee for Economic and Social Change*, 26 September 2011. The Law for Change in the Tax Burden (Amendments to the Legislation), December 5, 2011. Knesset announcement from August 5, 2012 (Knesset website).

The government took several measures to address the budget shortfall that emerged during the first half of 2012 (a crisis whose causes lie beyond the scope of this paper) and the expectation that it will persist in the coming years. Firstly, the government deficit target for 2013 was doubled from 1.5 percent to 3 percent of GDP – equivalent to a total of NIS 14 billion. Additionally, a state spending cutback in a similar amount was announced, and a plan formulated to increase state revenue by over NIS 14 billion, through, among other things, changes in income tax rates.

Within the plan framework that was approved by the Knesset in early August 2012 which will come into effect on January 1, 2013, tax brackets 3-4 were narrowed (meaning that a certain number of workers will be pushed into a higher bracket), the income tax rate for brackets 4-5 (monthly income of NIS 14,000 to 41,830) was raised by 1 percent, and an additional 2 percent surtax was imposed on annual incomes exceeding NIS 800,000 (monthly income of NIS 67,000; right-hand side, Table 1). This is the type of surtax that the Trajtenberg Committee recommended – but the government went even further than the committee, which recommended imposing the tax only on annual incomes above NIS 1,000,000 (monthly income of NIS 83,000). Another Trajtenberg Committee recommendation which the government originally rejected but now chose to adopt was that of increasing employer National Insurance contributions for high salaries (the share of the salary that exceeds 60 percent of the average wage).

Overall, the recent tax rate and National Insurance contribution changes are expected to yield annual revenues of nearly NIS 3 billion. As can be seen in Figure 1 (the red bars), these changes are even more progressive than those proposed by the Trajtenberg Committee recommendations. More specifically, compared with the Trajtenberg Committee recommendations the changes affected the highest decile the most, and are somewhat more favorable to deciles 6-9 – deciles associated with the upper middle class. The outcome is a certain reduction – one might call it a miniscule reduction – in income inequality.

Figure 1
Expected changes in distribution of earned income
 the change from the 2012 situation in each decile's income share*

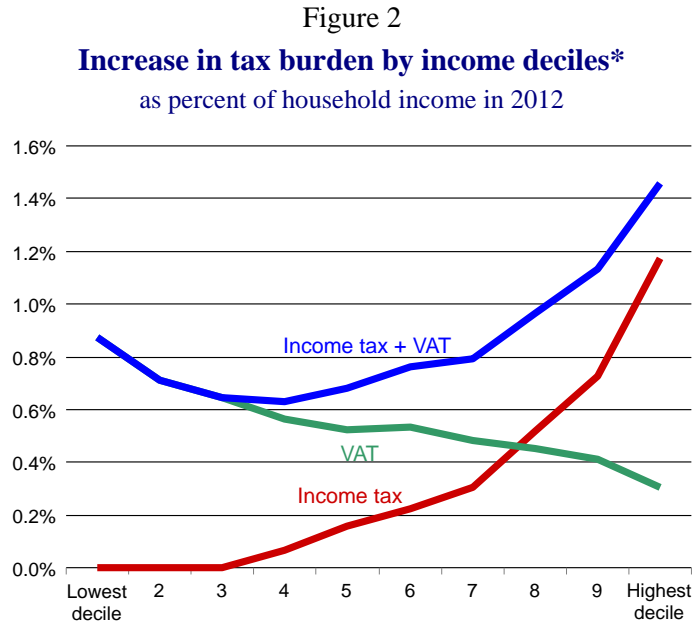


* Zero change (vertical axis) means that the decile's income share did not change.

Source: Ayal Kimhi and Kyrill Shraberman, Taub Center.

Thus, one year after the Trajtenberg Committee recommendations were submitted, the Israeli government has adopted an income tax policy that will increase its revenues and decrease earned-income inequality. However, the new tax policy encompasses an additional element – raising the value added tax (VAT) by 1 percent as of September 2012. The VAT, as an indirect tax, is regressive and mainly hurts the weaker social strata.

Figure 2 shows the increased tax burden to be borne by Israeli households by per capita income decile. One can see that the income tax burden increases along with income, while the VAT burden actually decreases as income rises.



* By household per capita income decile.

Source: Ayal Kimhi and Kyrill Shraberman, Taub Center.

Adding up the two tax burden additions – the VAT and income tax increases – one finds that most of the burden falls upon the three highest deciles, due particularly to the surtax. The impact on deciles 3-5, i.e., the lower middle class, is the smallest.

It should be remembered that the new policy relies on billions of shekels in revenue from sources that at this point exist solely on paper, such as tax payments on “trapped profits,” intensified tax collection and a war on shadow economy activity. If these revenues are not received in full, additional state budget cuts will have to be enacted – cuts that are also likely to hurt the lower socioeconomic strata and the middle class. Thus, although Israel’s tax policy for 2013 includes some elements of good news for the relative position of the middle class, there is an ultimate lack of clarity over which population segments will be more negatively affected by the government’s economic policy as a whole.

