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Israeli Corporate Tax Policy: A Pro-Growth System at Risk

By Alex Brill

Globally, corporate tax rates have been declining for over two decades (except in the United States), and one consequence has been an increase in investment, a boost in workers' wages, and little or no loss of tax revenue. But a troubling tax policy trend is emerging in Israel, where once-aggressive efforts toward a competitive corporate tax are being reversed. Proposals to raise the headline Israeli corporate tax rate for a second year and, in particular, to raise taxes on highly mobile, export-oriented production represent the wrong approach and will harm economic prosperity. The consequences of this reversal in a small and open economy like Israel's are potentially dire and could extend to investors in the Israeli economy from the United States and other foreign countries.

Recent corporate tax policy changes and proposals in Israel raise concerns about the country's continued economic growth. In 2012, Israel canceled a scheduled phase-down of its top corporate income tax rate and instead raised the rate 1 percentage point to 25 percent. Yair Lapid, the finance minister in Israel's coalition government, is seeking to increase a number of tax rates, including the overall corporate rate and a preferential rate for export-oriented businesses, as part of a deficit-reduction package.[1]

Although reducing the deficit will require Israel to make difficult tax and spending choices, increasing the tax rate on business income, particularly mobile business activities such as export-oriented production, is the wrong approach. Such tax increases will cause diminished economic prosperity and potentially reduce revenue by discouraging foreign direct investment (FDI) into Israel and encouraging Israeli firms to expand their businesses abroad rather than at home.

In this paper, I explore the detrimental effects of a corporate tax rate increase on FDI in Israel and discuss implications for other open economies. To set the stage for this analysis, I begin by highlighting the recent controversy over Israel's growing deficit and reviewing Israel's current economic situation, deteriorating fiscal outlook, inward FDI flows, and current corporate tax system. Next, I offer a brief review of the academic literature on the effect of corporate tax rates on domestic investment generally. I then discuss the shortsightedness of a plan to reduce Israel's budget deficit by restricting business investment, a key to Israel's economic success and future growth. Last, I highlight the impact that the proposed tax increases in Israel could have on the United States.

Israel's Economic and Fiscal Situation

In 2012, Israel ran a budget deficit of $10.43 billion (or 4.2 percent of gross domestic product [GDP]), which was more than twice the targeted amount.[2] This situation raised serious concerns among many in Israel about the country's fiscal future, leading to the appointment of the austerity-minded Yair Lapid as finance minister.[3] Lapid, who has proposed the tax increases I noted in the previous section as well as significant spending cuts, has drawn criticism for his hard line on spending and revenues and the lack of progressivity in his proposals.[4] His plan to increase the deficit target to 4.65 percent in 2013 before reducing it to 3 percent in 2014 has also been controversial.[5]

Israel's Economy. Despite the country's recent fiscal troubles, Israel's economic performance in the last few years has been admirable. Although growth during the global financial crisis in 2009 slowed to 1.1 percent, Israel avoided a recession and returned to strong growth of 5.0 percent and 4.6 percent in 2010 and 2011, respectively. Economic growth in 2012 was somewhat lower, at 3.1 percent. Israeli labor markets are also performing well. The unemployment rate dropped from 8.7 percent in the first quarter of 2010 to 6.6 percent in the first quarter of 2013, while the labor market participation rate increased from 61.9 percent to 63.9 percent.[6]

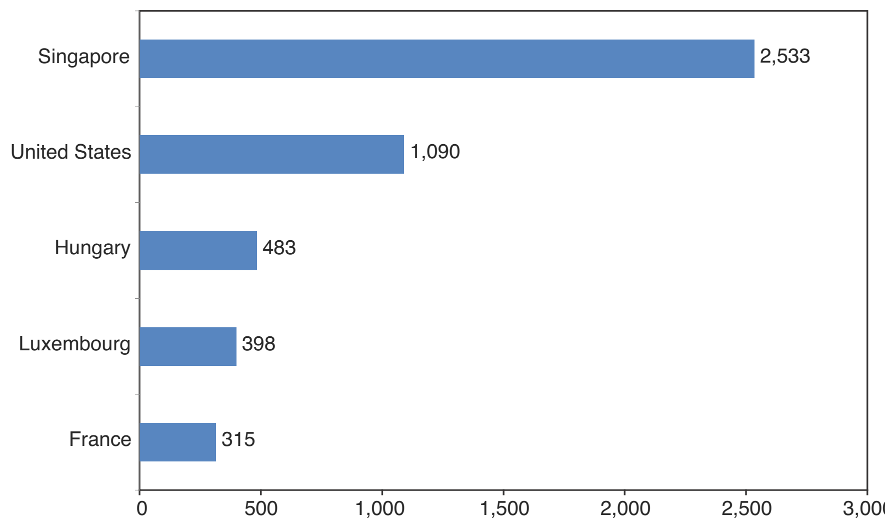
The Israeli economy produced approximately $240 billion in goods and services in 2012.[7] Exports in 2011 were $91 billion, 37 percent of total output. (By comparison, exports comprise approximately 14 percent of GDP for the United States.) Israel's exports have been increasing, but at a pace slower than overall growth—in the five years prior to 2009, exports were more than 40 percent of GDP.[8]

Israel's Fiscal Outlook. The fact that Israel is running substantial budget deficits while its economy is doing fairly well demonstrates that the problem is structural rather than cyclical. Therefore, Israel cannot rely on economic growth alone to correct the deficit but must make changes to spending, taxes, or both. Unfortunately, several of the current proposals to reduce the deficit would inhibit FDI, which, as the remainder of this paper shows, is a shortsighted solution.

FDI in Israel. In response to the Great Recession, Israel's FDI inflows dropped drastically between 2008 and 2009—from $10.9 billion to only $4.4 billion. Recovering slightly to $5.5 billion in 2010, FDI inflows finally rebounded in 2011, reaching $11.1 billion, 4.5 percent of GDP.[9] Figure 1 shows Israel's top five partner countries by FDI inflows in 2011.

FIGURE 1

TOP FIVE SOURCES OF ISRAELI FDI INFLOWS, 2011 (US$ MILLIONS)



Source: OECD, "FDI Flows by Partner Country: Israel," 2011, http://stats.oecd.org/Index.aspx?DatasetCode=FDI_FLOW_PARTNER.

The total stock of FDI into Israel has increased steadily for the last several years, from $49.7 billion in 2008 to $66.6 billion, or roughly 31 percent of Israeli GDP, in 2011.[10] Of this, the United States contributed over $15 billion in 2011, by far the largest source of FDI in Israel.[11]

> Israel cannot rely on economic growth alone to correct the deficit but must make changes to spending, taxes, or both.

Israel is particularly well known for being a research and development (R&D) hub for multinational high-tech companies, beginning with Intel in 1974 and followed by Motorola, GE, Siemens, HP, IBM, Cisco, Microsoft, Google, and Apple, among others. More than 250 multinational corporations, two-thirds of which are US companies, conduct R&D in Israel today, contributing to FDI inflows.[12]

Corporate Taxation in Israel. Israel's top corporate tax rate declined steadily from 36 percent in 2003 to 24 percent by 2010. The scheduled rate phase-down that Israel canceled in 2012 would have reduced it even further, to 18 percent by 2016. The 1 percentage point rate hike that Israel implemented instead therefore reversed nearly a decade of Israeli corporate tax policy aimed at keeping the Israeli corporate tax rate competitive with European countries that have also dramatically reduced their corporate tax rates.

An important component of Israel's corporate tax system is the Law for the Encouragement of Capital Investment. Enacted in 1959, this law seeks to increase capital investment in Israel both from foreign and domestic sources. According to an English translation of the original law:

> The objective of this Law is to attract capital to Israel and to encourage economic initiative and investments of foreign and local capital, in order to —
>
> (1) develop the productive capacity of the national economy, to utilize its resources and economic potential efficiently, and to utilize fully the productive capacity of existing enterprises;
>
> (2) improve the State's balance of payments, to reduce imports and to increase exports;
>
> (3) absorb immigration, to distribute the population over the area of the State according to plan and to create new sources of employment.[13]

The law targets capital associated with export production, likely to be the most mobile form of capital. As such, it is explicitly intended to encourage growth in the business sector and improve the global competitiveness of Israeli industries.[14] Substantially revised in 2010, with revisions taking effect at the beginning of 2011, the law now offers a 7 or 12.5 percent corporate income tax rate on all domestic income earned by a qualifying Israeli corporation.[15] Business activity located in the central part of Israel can face the 12.5 percent rate, and activity in the northern and southern regions enjoys the lower rate. To be eligible for one of these reduced rates, a company must be registered in Israel and export more than 25 percent of its production (or be primarily involved in biotechnology or nanotechnology).[16]

The Law for the Encouragement of Capital Investment represents a long tradition in Israel of pro-growth policies. Before the 2010 revisions, companies had to apply for "approved enterprise" status and received only investment incentives specifically granted to them by the Israeli government.[17] The new iteration of the law does not require a company to apply for the benefit; it is simply made available to those who engage in qualified activities. These rates for qualified corporations are scheduled to be reduced to 6 and 12 percent in 2015. However, as I will discuss, the current government is seeking to raise these preferential rates.

Corporate Tax Rates and Foreign Direct Investment

Globally, average corporate tax rates among developed nations have steadily declined over the past two decades. In 2012, the OECD average corporate rate was 25.4 percent, down from a high of 48.0 percent in 1982.[18] Ireland, which is in many instances Israel's direct competitor for FDI because of its skilled workforce, location, and attractive fiscal policy, reduced its rate from 40 percent in the mid–1990s to 12.5 percent by 2003. The United States stands out from other developed nations in that its top corporate statutory rate is a full 10 percentage points higher than most and is now the highest corporate statutory rate among developed nations.

These trends signify an increasing awareness of businesses' ability to move activities globally in response to differences in tax policies across jurisdictions. For example, Ireland's corporate rate cut triggered a massive influx of FDI and a surge in the Irish economy.

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Academic studies have confirmed a statistically significant relationship between a country's corporate tax rate and FDI and shown that the relationship has strengthened over time. Altshuler, Grubert, and Newlon found that the elasticity of US investments abroad with respect to after-tax rates of return increased from 1.5 in 1984 to 3.0 in 1992.[19]

De Mooij and Ederveen reviewed empirical research on FDI and taxation across a range of countries and found that, on average, a 1 percentage point reduction in the corporate tax rate resulted in a 3.3 percent increase in FDI.[20] In a study of corporate tax rates in Central and Eastern Europe between 1995 and 2003, Bellak and Leibrecht found that a 1 percentage point drop in the corporate rate caused a 4.3 percent increase in FDI.[21]

It is important to note that rate reductions largely have not resulted in lower tax revenues, as might be expected. According to OECD researchers, base broadening is partially responsible for keeping revenues constant,[22] but research I conducted with my colleague Kevin Hassett confirms that lowering high corporate tax rates in a country tends to result in additional revenues by encouraging companies to report more profits in that country.[23]

Corporate tax rates are particularly important for the competitiveness of small countries with open economies. Haufler and Wooton find that, all else being equal, a company will choose a larger national market when locating abroad.[24] As the next section makes clear, size and openness of the economy are particularly relevant to Israel.

Table 1

Exports as Percentage of GDP: OECD Countries, 2011

1. Luxembourg	176%	18. Norway	42%
2. Ireland	107%	19. Finland	41%
3. Hungary	92%	20. Chile	38%
4. Estonia	92%	21. Israel	37%
5. Slovak Republic	89%	22. Portugal	36%
6. Belgium	84%	23. United Kingdom	32%
7. Netherlands	83%	24. Mexico	32%
8. Czech Republic	73%	25. Canada	31%
9. Slovenia	72%	26. Spain	30%
10. Iceland	59%	27. New Zealand	30%
11. Austria	57%	28. Italy	29%
12. Korea, Rep.	56%	29. France	27%
13. Denmark	53%	30. Greece	25%
14. Switzerland	51%	31. Turkey	24%
15. Germany	50%	32. Australia	21%
16. Sweden	50%	33. Japan	15%
17. Poland	42%	34. United States	14%

OECD average: 26%

Source: World Bank, "Exports of Goods and Services (% of GDP)," http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS.

Israel's Corporate Rate Reversal: Consequences for Israel

To put Israel's size in context for a US audience, Israel has the population of Virginia, an economy the size of Wisconsin or Tennessee, and land mass comparable to New Jersey.[25] In short, Israel is a small country. On top of this, Israel's economy is very open. Its exports, $65 billion worth of goods in 2012, rank it 54th in the world.[26] As a share of GDP, exports comprise more than a third of Israel's economy, making it 21st by this measure among OECD countries and 11 percentage points higher than the OECD average. (See table 1.)

Unlike many of its global competitors, Israel faces an unusually high risk of terrorism. As business scholars have noted, "Terrorism generates price mark-ups equivalent to a hidden tariff or tax."[27] Businesses face costs from potential acts of violence and the burden of complying with government regulations intended to thwart terrorism. Although Israel offers businesses terrorism risk insurance for property damage and a separate program related to bodily harm,[28] a number of econometric studies have estimated that the risk of terrorism depresses economic output.[29]

Instead of pursuing a lower corporate tax rate that reflects the additional burden imposed by terrorism risk, Israel has begun to raise its corporate tax rate, driven by the goal of deficit reduction. Israel was the only OECD country to raise its statutory rate in 2012. In contrast, Canada, Finland, and the United Kingdom all cut their corporate rates. Empirical evidence from cross-country analysis suggests that the 1 point rate increase may do little or nothing to close Israel's fiscal gap but much to discourage both investment and repatriation of foreign-earned income back to Israel.

Now, Israel is considering raising its corporate rate again and eliminating or curtailing the reduced tax rates for Israeli exporters under the Law for the Encouragement of Capital Investment. Removing these export incentives would only amplify the harm of a rate hike, as these highly mobile companies would lose the incentive to operate domestically. The reduced rates are explicitly intended to encourage growth in the business sector and improve the global competitiveness of Israeli industries by targeting the most mobile capital: FDI or capital used to serve foreign markets.

Arguably, this tax policy may appear unfair to non-qualifying Israeli businesses solely servicing resident Israeli customers. But the broader impact of a policy that successfully attracts or maintains this capital will materialize nationally in the form of higher wages and employment. In fact, the evidence that high corporate tax rates can impede workers' wages is mounting, particularly for small, open economies like Israel.

In a review of the theoretical and empirical literature, my AEI colleagues Matthew Jensen and Aparna Mathur describe the evolving evidence that the corporate income tax has a significant impact on wages:

> The main factor that reduces the incidence [of the corporate income tax] on capital in an open economy setting is the relative mobility of capital compared with labor. If corporate taxation reduces the return on capital in the domestic economy, capital is free to move abroad. As capital flees, the marginal product of the remaining domestic capital increases to the worldwide level, which is unchanged.[30]

The theoretical models that Jensen and Mathur review find that (assuming perfect capital mobility and international product substitutability) labor (wages) bears three-fourths of the burden of corporate income taxes, if not more. Other empirical studies find that a $1 increase in corporate taxes reduces wages by more than $1, meaning that not only would a corporate tax rate increase harm workers, but individual income tax receipts would likely decline by more than corporate tax receipts would increase.[31] In other words, an increase in Israel's corporate tax rate harms not only Israeli corporations and inward FDI but also Israeli workers.

Israel's Corporate Rate Reversal: Consequences for the United States

An increase in corporate tax rates in Israel is not just an isolated change without consequence to the rest of the world. In particular, the United States is vulnerable in three separate ways. First, the United States is itself embroiled in a debate over corporate tax reform, with proposals to reduce the US statutory rate from 35 percent to 28 or 25 percent.[32] A core motivation for reducing the US statutory rate is a desire to compete with the lower rates in other OECD countries. If Israel's corporate tax policy reversal signals an emerging trend among other countries, that trend could affect the target for the US corporate rate. Conversely, if Israel's proposed rate increase is enacted and FDI shifts away from Israel, that may bolster US policymakers' resolve to bring down the high corporate tax rate.

Second, Israel is an important destination for US investment. The FDI flow of $1 billion from the United States to Israel in 2011 may seem modest relative to the overall size of the US economy, but the accumulated value of US investment in place in Israel is many times larger. As I noted above, the stock of US FDI in Israel was over $15 billion in 2011. However, US FDI stock in Israel has been declining in recent years—an issue that a higher corporate tax rate will certainly not help assuage.

Furthermore, FDI is but one category of investment. For example, US venture capital funds invest heavily in Israeli high-tech companies, and US mutual funds and institutional investors own significant shares of publicly traded Israeli companies. The market cap of the 10 largest Israeli companies that trade on the NASDAQ exchange exceeds $50 billion.

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Conclusion

Countries interested in attracting FDI and preventing domestic firms from going abroad face an intense degree of international tax competition induced by global capital's increased mobility and sensitivity to tax policies. Given this reality, Israel must maintain a competitive business tax regime to keep and attract global capital. The reduced tax rate for export-oriented production that the Law for the Encouragement of Capital Investment provides is an important component of this competitiveness.

An appropriate resolution to the real or perceived inequity caused by distinct corporate tax rates in Israel would be to lower the overall corporate rate to match the rate made available to qualified firms under the Law for the Encouragement of Capital Investment. If Israel were to pursue that strategy, it would effectively match the corporate tax rate now in place in Ireland (12.5 percent) and would likely experience an investment boom.

If Israel removes the incentive currently in place, it would be reversing course on its long-standing, aggressive strategy geared toward promoting investment and exports. Such a move would undo Israel's decades of work to establish itself as a hub of FDI and threaten the substantial growth that has resulted from these policies. Israel must address its fiscal imbalance, but not at the expense of economic growth. Such a change would have adverse effects for US investors in Israel, including shareholders in publicly traded Israeli companies, US venture capital in Israel, and US FDI into Israel.

About the Author

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Notes

This paper expands on an article by the author published on Real Clear Markets on April 26, 2013, available at www.aei.org/article/economics/fiscal-policy/taxes/how-the-corporate-tax-negatively-impacts-israeli-investment.

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