Palestine Economic Policy Research Institute (MAS)

# Scenarios for the Reform of Income Tax Brackets and Rates: Impact and Required Policies

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**Scenarios for the Reform of Income Tax Brackets and Rates: Impact and Required Policies**

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# Foreword

Since its establishment, the Palestine Economic Policy Research Institute (MAS) has focused much of its attention on fiscal policy, particularly taxation, as this is one of the government's policy tools for enhancing its revenues. It is also one of the most important tools through which countries can further social justice, by improving the living conditions of the most marginalized groups. This study aims to master the finer details of Income Tax Law No.8 (2011), specifically the number and extent of tax brackets for individuals and companies, and efforts made to amend these. This contributes to formulating the best-fit income tax policy through which government can secure the financing needed for the fulfillment of social and economic goals announced by the Ministry of Finance in 2011.

The study's analysis is based on the use of computerized models of the general equilibrium (a dynamic iterative simulation model) and its application to a number of scenarios for income tax applied on individuals and companies. It compares the current law (the base scenario) with proposals for amendment suggested by the Ministry (scenario 1), and two alternative scenarios proposed by the study (scenarios 2 and 3). Results indicate that scenario 3 achieves the highest positive effects on all macroeconomic factors. It proposes imposing four tax brackets on individuals ranging from 5-20%, and three tax brackets on companies ranging from 15-25%, as most appropriate for realizing stated financing goals by satisfactorily increasing government revenues, while increasing consumption and savings by low-income groups, in addition to addressing unemployment by increasing employment.

The study presents numerous recommendations that enhance government tax revenues, while also contributing to social justice. The most important is to adopt the third scenario: expand the tax base by enforcing tax collection from the self-employed and from tax evaders; combating tax evasion through key amendments to the law that criminalize tax evasion; in addition to sourcing all requirements for relevant departments (legal, HR, logistics) to monitor this issue. This must take into consideration economic, social and other incentives provided to taxpayers in order to encourage them to comply with voluntary taxation.

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Raja Khalidi
Director General

## Executive Summary

Tax policy is one of the most important tools through which states can achieve a form of social justice, and improve the living conditions of the most marginalized groups through reduced poverty and inequality. Tax policies can contribute to achieving social justice in more than one way:

1. Increasing budget allocations for public spending, especially in the social sectors: education, health, and social protection.
2. Redistribution of wealth between high- and low-income groups, as well as through the introduction of a progressive income tax.
3. Supporting accountable governance and representation by giving taxpayers an opportunity to comment on how taxes are spent.
4. Changing the harmful practices of individuals and companies through the 're-pricing' of goods.
5. Stimulating economic activity to support national development plans and adopting industrial policies that help create job opportunities and provide goods and services.

This study aims to identify the constituents of Income Tax Law No. 8 of 2011, covering the number and extent of income tax brackets for individuals, companies, and cases of exemptions, in order to determine whether this Law succeeded in fulfilling the financing, social and economic goals announced by the Ministry of Finance in 2011. This study acquires additional significance in the Palestinian context, given the limited evaluative macroeconomic power that the Palestinian government can exercise in monetary and trade policy, compounded by its inability to control borders and the absence of a Palestinian currency. Thus, the study proposes a number of scenarios for taxing the income of individuals and companies in order to study its various effects on GDP, as well as the private consumption habits of individuals with incomes that lie within proposed income tax brackets. It also examines effects on total private consumption, total savings, government revenues, local employment, and value-added taxes across various economic sectors including agriculture, manufacturing, construction, transportation and storage, and services.

The study relied on analyzing and calculating the impact of various scenarios using the "Mitigation, Adaptation and New Technologies Applied General Equilibrium (MANAGE)" model. This is a dynamic, iterative simulation model used by a country to reflect the relationship between all sectors in the local economy and the external economy. It is a derivative of the Computerized General Equilibrium (CGE) model. The CGE model is typically used to simulate different scenarios for the application of economic policies, and their effects on primary, macroeconomic indicators. Therefore, this model makes it possible to put forward different income tax scenarios for different individuals and economic activities. In order to assess the effects of different income tax scenarios, the model used the Social Accounts Matrix (SAM) issued by PCBS. This is based on the Household Expenditure and Consumption Survey of 2017, which is considered a determinant of the accuracy of the results of the study, given changes that occurred in the data within this matrix during the past four years.

### 1. Reform Scenarios

This study addresses the issue of reforming the income tax law, albeit differently from what was done previously. The study proposes using a multi-sector simulation model, by adopting only four scenarios for tax segments and ratios, while comparing the results of these scenarios with the existing base scenario (Income Tax Law No. 8 of 2011). The scenarios depended on changing the tax brackets and rates only, taking into consideration that social and economic exemptions - and permissible deductions - did not change from the base scenario.

The effect on taxable income is fixed, given that tax brackets will be applied to increased income after deducting required exemptions and deductions. In its presentation of the third and fourth scenarios, the study relies on the results of consultations and interviews undertaken by the research team. This included focus groups, specialized workshops, and feedback from employees in the private sector, from the Association of Auditors, and several private sector organizations.

Regarding the third scenario proposed by the study, it was designed to examine the impact of an imposition of a progressive tax on companies similar to that applied to individuals. However, no accurate statistics and figures are available in the social matrix, and at the Ministry of Economy, on the classification of companies according to annual profits. Therefore, the study suggests imposing the tax on companies according to the sector in which they operate, as the research team is convinced, firstly, that the distribution of proposed sectors is commensurate with the size of current profits for these sectors, and secondly, that this distribution is consistent with the distribution of corporate tax in neighboring countries.

## 2. Results & Recommendations

The results of data analysis show that if one is to adopt the scenario of amending the law as proposed by the Ministry of Finance, GDP increases by a very low rate of 0.61% compared to the base scenario. It can also be noted that consumption increases by a small percentage across all groups: by 0.67% for incomes less than NIS 90,000 (the first tier), while the consumption rate for the second tier increases by 1.45%, followed by increases of 0.48% and 0.86% respectively for the third and fourth tiers. On the other hand, it is surprising to note that the volume of government revenues decreases by 0.35%, which is the opposite of what the Ministry of Finance wants to achieve, while savings increase by 1.93% and employment by 0.09%. Regarding sector-specific production volumes, results indicate an increase in production in the agricultural and industrial sectors by 0.24% and 0.34% respectively, while the real estate sector's production increases by 0.97%, the highest margin of growth experienced by any sector. Moreover, there is a slight increase in the transportation and other services sectors, by 0.18% and 0.68% respectively. This weakness in the economy's response to the proposed amendment is due to the fact that it leads only to the transfer of a part of individuals from the third segment to the second; and part of the second to the first. However, it does not reflect any fundamental changes in the structure of the income tax system. Government revenue from income tax also falls, while the rise in other revenue streams is not sufficient to offset losses caused by weak consumption.

The analysis shows that there are varying results between the study's first scenario, which was suggested by the research team when compared to the base scenario. GDP rises by only 0.75%, and consumption for the lower income groups increases by 1.17%, 1.57%, and 1.52% respectively, while it rises for the highest income group by 0.66%. Total savings increase by 1.68%, government revenues increase by 0.8%, and employment by 0.66%, compared to the base scenario. In terms of production, the agricultural sector's production capacity increases by 0.5%, while industrial production and construction increase by 0.87% and 0.94% respectively. Production volumes in the transportation and other services sectors also increase by 0.25% and 0.75% respectively. However, the response of economic variables to this scenario is still modest, since the increase in the percentage of individuals who become members of the upper-income bracket does not exceed 3%.

As for the scenario proposed by the Ministry of Finance for this study, the analysis showcases different results when compared to the base scenario; the GDP increases by 0.78% annually, and the total private consumption by 1.19%, while the volume of government revenues increases by merely 0.09%. As for consumption, it will increase by 1.19% for the first income group (those with income of NIS 90.000 or less), 1.6% for the second group (90,001-150,000), for the third group (150,001-270,00) it will increase by 1.53%, and the same percentage 0.68% for the fourth (270,001-350,000), and fifth (those earning more than NIS 350,000) groups. Additionally, the total saving will increase by 1.71%, and employment will increase by 0.69% when compared to the base scenario. This increase in employment could be explained by the fact that the income effect of individuals is higher than the effect of substitution when their real income decreases, which was explained in the theoretical framework of this study. As for production, the scenario expects a growth in the added value of the agricultural sector by 0.5%, and the industrial and construction sectors by 0.91% and 0.98%, respectively. As for the added value of the transportation sector and other service sectors, it will grow by 0.27% and 0.77%, respectively

As for the second scenario suggested by the research team, which includes different rates of corporate income tax, results indicate an increase in GDP by 1.84% and employment by 1.95%, which are considered high rates of increase compared to the three scenarios outlined above. It should be noted that in this scenario, the increase in the volume of consumption among the lowest income group (those with income less than NIS 90,000) is more than the increase for the remaining groups, which helps to address disparities between social groups. It also concludes that the volume of government revenues increases by 3.37%, due to the high tax rate on high-income individuals, in addition to the high rate of employment and tax on financial companies, banks, and telecoms, all of which reap high profits. The level of consumption for the lowest tier increases by 1.84% compared to the base scenario, while the consumption of each of the second and third tiers increases by 2.81% and 1.9%, respectively. The consumption of the two highest tiers increases by 0.46% and 0.11% respectively.

The results of the second scenario suggested by the research team are not considered inconsistent with the theory, especially given that the increase in taxes on high-income individuals did result in a corresponding increase in their consumption, but at a lower rate than the increase among other low-income groups. The marginal propensity to consume is low among high-income groups but higher among low-income groups. This can be explained by the fact that people with high incomes also receive part of this income from investment returns. Moreover, the profits and incomes of company owners increase, and consequently their consumption and saving capacity increases as well. The production of companies in the agricultural sector increases by 1.97%, in the industrial sector by 3.72%, in the construction sector by 1.00%, in the transportation and storage sector by 2.51%, and in the other services sector by 1.51%. In addition, it can be noted from the results that the rate of increase in consumption decreases with the increase in income. This is consistent with consumer theory, as most of the income reaped by those with high incomes is channeled into savings. In addition, the presence of a significant increase in the consumption of low-income groups works to reduce income disparities within society, albeit in a much slighter way. This is one of the objectives of public fiscal policy: to promote a redistribution of income. As for the increase in government revenues, it can be explained theoretically as well. The higher GDP is reflected in higher employment and income, and thus higher taxable income for all categories within the model.

Based on the results of data analysis, the study recommends:

1. Adopting the third scenario (which is the second scenario suggested by the research team), with the tax brackets and percentages contained therein, while retaining all components of Income Tax Law No. 8 of 2011, as follows:

   a. Adopting the following tax brackets:

| Taxable Income | Individual Tax Rate |
|---|---|
| NIS 1-90,000 | 5% |
| NIS 90,001-150,000 | 10% |
| NIS 150,001-270,000 | 15% |
| NIS 270,001-350,000 | 20% |
| Over the above | 25% |

   b. Corporate income tax is levied as follows:
      - 15% on companies operating in the agricultural, manufacturing, warehousing, hotels, and restaurants sectors
      - 20% on the real estate and commercial sectors
      - 25% on telecoms, banks, and financial institutions.

2. Expanding the tax base by following up on tax collection from the self-employed and tax evaders.
3. Combating tax evasion by making fundamental amendments to the law and criminalizing tax evasion, in addition to providing all the requirements of the logistical, personnel, and legal tax departments to follow up on this issue.
4. Considering a set of economic, social, and other incentives offered to taxpayers to encourage them to commit to voluntary taxation and to submit an annual income statement voluntarily.
5. Assessing the structure, effectiveness, and performance of current tax units in order to implement an integrated reform of the income tax system, and not only the income tax law.