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Policy Brief

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

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1. Introduction

Direct taxes are an essential tool in revenue policies and are of great importance in financing public government expenditures to achieve economic and social goals, given their impact on consumers, producers, savings, and investment on the one hand, and on producers' profits and activities on the other. This, in turn, is reflected in their increased tendency to undertake expansionist investments, increasing production and creating new job opportunities. Taxes are also the second direct instrument of fiscal policy after government expenditure. These two tools work in tandem to lubricate the wheels of an economy, helping to realize economic and social goals.

2. Income Tax in Palestine

After Israel occupied the West Bank and Gaza Strip in 1967, the military government issued military orders No. 28 and No. 35, which stipulated that the income tax law would remain as it was. In 1973, tax brackets and rates were amended, reflected in a higher rate of taxation. Taxes on the lowest income brackets rose from 5% to 15%, while taxes on the highest bracket remained at 55%. The corporate income tax rate in Gaza was raised from 25% to 37.5%, as in the West Bank. The contribution of income taxes to the general revenues of the Civil Administration increased, reaching their highest level in 1989, at 38% of total tax revenues. The contribution of income taxes to tax revenues during the occupation years of 1967-1994 ranged from 12% to 38%, with an average of 22%. In the Gaza Strip, the percentage ranged from 20% in 1972 to 40% in 1980, with an average of 28%.

The Paris Protocol on Economic Relations, signed on April 29, 1994, constituted a basic determinant of Palestinian financial policy regarding indirect taxes from customs and value-added taxes. However, it gave the Palestinian National Authority (PNA) full powers over direct taxes, especially income tax. Article No. 5 of the Paris Protocol stipulates that:

1. Israel and the PNA will independently determine and regulate their tax policies in matters of direct taxation, including income taxes on individuals and corporations, property taxes, as well as municipal taxes and fees.
2. Each tax administration will have the right to collect taxes generated from economic activities within its area.
3. Each tax administration may impose additional taxes on individuals and companies residing within its territory.
4. Israel should transfer to the PNA an amount equal to:
   a. 75% of income taxes collected from Palestinians from the West Bank and Gaza Strip, working in Israel.
   b. All income taxes collected from Palestinians from the West Bank and Gaza Strip, working in the settlements.
   c. The two sides will agree on a set of measures to address issues related to double taxation.

After the emergence of some problems related to the application of income tax Law, No. 17 of 2004 and its various amendments in 2007, 2008, and 2009, a new law, Income Tax Law No. 8 of 2011 was issued in the form of a decree. The justification for issuing this new law stressed the need to modernize and develop laws regulating the work of the PNA and the requirements for the advancement of the national economy. In this context, the new law aims to increase revenues and enhance self-reliance capabilities.

Decree-Law No. 8 of 2011 contained substantial amendments to Law No. 17 of 2004 across most of its articles, focusing specifically on exemptions, tax brackets, and rates. Brackets were defined as follows:

1. Taxes shall be collected on the income of any natural person according to the following percentages and categories of annual declared income:
   a. Income ranging from NIS 1-40,000: a rate of 5%.
   b. Income ranging from NIS 40,001-80,000: a rate of 10%.
   c. Income of more than NIS 80,000: a rate of 15%.
2. Tax is levied on the taxable income of any legal person at the rate of (15%).
3. A tax rate of 5% shall be collected on insurance companies that provide life insurance, from the total sum of life insurance premiums due to the company.

3. Justifications for Reforming the Law

There is a need to reconsider the tax brackets and rates mentioned in Decree-Law No. 8 of 2011, based on the following considerations:

3.1 Financial Justifications

When the government adopted Decree-Law No. 8 of 2011, it explicitly announced that the aim was to raise the contribution of income taxes to local revenues, from 6% (as it was at that time) to 30% in the coming years. This means raising the volume of income tax revenues from $150 million annually to $600 million annually, to contribute to covering the budget deficit, in addition to amendments to address difficulties in implementing the law.2.2 Legal and regulatory external factors

3.2 Justifications concerning the distribution of the tax burden

Actual figures for income tax revenues show that corporate tax proceeds increased from NIS 219 million in 2011 to NIS 386 million in 2012, the year in which the new law came into force. However, these revenues fluctuated. In 2020, they amounted to about NIS 340 million, an increase of 55% compared to 2011 and a 12% decrease compared to 2012. This also applies to other components of income tax, except clearance transfers for income taxes from Israel, which rose from NIS 29 million in 2011 to NIS 206 million in 2019, settling at NIS 76 million in 2020. This is due to fluctuations in the number of Palestinian workers in Israel and the settlements. According to the Paris Protocol, Israel transfers 75% of the income tax withheld from workers in Israel and 100% of the tax withheld from workers in settlements to the PNA, by means of a monthly clearance transfer. On the other hand, discrimination is evident in the composition of income tax proceeds and their distribution by component, between companies, professions, vehicles, and employee deductions. Statistics released by the Ministry of Finance indicate that corporate income tax amounted to 44% of total revenues in 2011, increasing in 2012 to 57%, and then decreasing to 46% of total tax revenues in 2020. Taxes on individuals (professions, vehicles, employee deductions) decreased from 49% in 2011 to 40% in 2012, rising to 43% in 2020. This illustrates the unfair distribution of the tax burden between individuals on the one hand, and companies on the other.

3.3 Economic Justifications

Interviews with the Palestine Investment Promotion Agency (PIPA) and the Income Tax Authority confirmed the impression that the Investment Promotion Law Law No. 1 of 1998 resulted in noticeably low-income taxes on companies granted exemptions under the Law. This law does not perform the required developmental role in compensating for forfeited income taxes resulting from exemptions. This is evident in the statement made by the former Palestinian Prime Minister

during the Fourth National Dialogue Conference for both the public and private sectors, held in Ramallah in 2014. He stated that 600 Palestinian companies do not pay taxes (exempted) due to the Investment Promotion Law despite high profits and that tax evasion reaches levels of 86%. At the same conference, the Palestinian Minister of Finance confirmed that due to the spread of tax evasion, especially throughout the informal sector and those who are self-employed. tax revenues decreased from 25% of GDP to 20%.

On the other hand, PIPA believes that the Investment Promotion Law generates economic development that exceeds losses in taxes as a result of exemptions granted to investors, especially in light of low tax rates and income tax brackets that are in force in Palestine, which do not exceed 15% in all cases.

4.Reform scenarios

The study examines four scenarios for tax segmentation, and rates on individuals and companies, calculating the financial, economic, and social results of each scenario. The study recommends the adoption of the third scenario (the second scenario in the study, proposed by the research team) for taxing individuals:

Rate	Income Bracket
5%	NIS 1 – 100,000
10%	NIS 100,001 – 200,000
15%	NIS 200,001 – 500,000
20%	NIS 500,001+

As for taxing companies, given the difficulty of applying a sector-based tax system as the income of companies in the same sector is not homogeneous, the paper recommends:

- 15% tax levied on companies operating in the agriculture, industrial, transportation restaurant, and hotel sectors
- 20% tax levied on companies operating in real estate, construction, health, and education sectors.
- 25% tax levied on telecoms, banks, and financial institutions

5. Recommendations and policies to reform the income tax law

After reviewing the effects of the four scenarios (for income tax brackets and rates levied on both individuals and companies) at the macroeconomic level, the study shows that the recommended third scenario (the imposition of 4 tax brackets on individuals ranging from 5%-20% and 3 tax brackets on companies ranging from 15%-25%) achieves the best results at the macroeconomic level. When compared to the base scenario and current reality, it can be discerned that this scenario is the most appropriate, capable of realizing public financing goals by satisfactorily increasing government revenues, while also increasing consumption and savings for low-income groups. In addition, it increases employment and partly addresses high unemployment rates, through an increase in GDP.

The fourth scenario, emanating from the workshop conducted by the research team with the Ministry of Finance, came in second place in terms of results, which is represented in the following tax brackets and rates:

Rate	Income Bracket
5%	NIS 1 – 100,000
10%	NIS 100,001 – 200,000
15%	NIS 200,001 – 300,000
20%	NIS 300,001+

As for taxing companies, tax is levied as follows:

- 15% tax levied on a group of companies
- 20% tax levied on telecom companies, banks, financial institutions, and franchise companies

On the other hand, there is no doubt that all legal materials, especially economic laws, have a general philosophy and objectives, initially developed for the purposes of drafting legal materials that serve policy orientations adopted for this field. Since the reform of income tax laws aims to boost the ability of income taxes to achieve approved financing and social and economic goals, such reform cannot be achieved solely by reforming legislative articles related to tax brackets and rates. Rather, as mentioned above, it requires addressing several other topics that are no less important than amending brackets and rates, which constitute the income tax system in Palestine. The study recommends the following tax broad policies:

a. Reconsider the revenue system and strategy in Palestine, to serve economic and social objectives: Since the Public Treasury is the 'pockets of its citizens', it is not acceptable for the consumer to bear 90% of the tax burden in the form of indirect taxes, while thousands of high-income earners bear only a very low percentage of the tax burden, where income tax amounts to around 2% of GDP.

b. Expand the taxpayers' base: Official statistics indicate that the proportion of income tax revenues in the 2020 budget amounted to 20% of GDP, which means that a large part of economic activity remains outside the tax system. There is consensus in the relevant literature that expanding the tax base without placing additional burdens on current taxpayers is one of the most important measures for reforming the income tax system. This includes legal measures to combat tax evasion across its various forms, as well as measures to include the informal and unorganized sectors through their regulation, obligating them to register for tax payments. This is especially relevant to the self-employed, e-commerce activities, and other unorganized sectors.

c. The tax base can be expanded in two directions:
   1. Expanding the taxable income base, whether via registered or unregistered taxpayers, with the aim of increasing tax proceeds and achieving social justice. Attention must be paid to the risk of the attrition of committed taxpayers, by imposing new brackets and searching for incomes that have not been taxed to date.
   2. Expanding the base of the tax-paying community, by adding new taxpayers to the income tax system and including their income in taxable income as a first step.

d. Improving tax efficiency and fighting tax evasion (tax performance)
   Official and unofficial statistics indicate the existence of tax evasion ranging from 30%-40% of tax revenues owed to the general budget. Therefore, the law must include legislative texts that criminalize tax evasion, as is the case in developed countries, enabling and assisting tax departments to combat tax evasion in all its forms and various types. Work must proceed to provide an effective, executive body for tax follow-up and prosecution, in addition to providing human, technical, logistical, and protective resources for income tax departments and their employees, to combat tax evasion as a crime. The Palestinian judiciary should be enabled to pursue and follow up on tax evasion cases, as this is one of the basics of success in eliminating tax evasion.

e. Motivating taxpayers to comply with tax incentives.

The tax revenue system suffers from the low commitment of taxpayers to tax laws and the inability of tax departments to reach all taxpayers. Tax theories confirm that one of the most important ingredients for the success of tax administrations is the voluntary commitment of the taxpayer to tax laws. In this context, various types of incentives constitute the magic wand that increases the commitment of taxpayers to tax laws.

f. Expand and promote progressive tax brackets (legislative issues).

The PNA can adopt an income tax policy that serves its financing, social and economic objectives, without any restrictions. In the continued absence of the Legislative Council, the adoption of the revised law and its new articles requires consensus between all components of Palestinian society and the tax community in defining desired goals. Work can then proceed to activate and expand progression in formulating and defining income tax brackets and rates. This is reflected in the study’s adoption of the third scenario, which maximizes positive results on all components of GDP and various economic sectors.