# Tax Cut!

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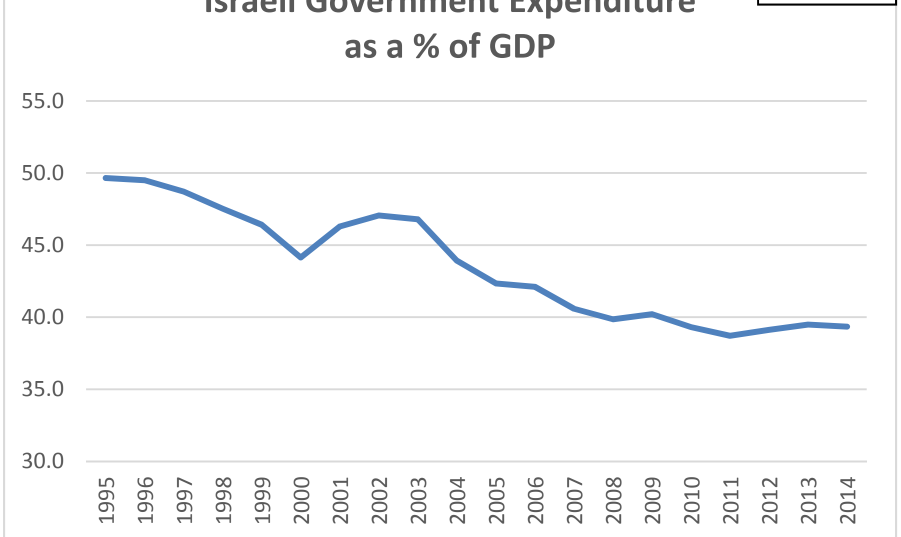
In early September, Prime Minister Benjamin Netanyahu and Finance Minister Moshe Kahlon announced a reduction in the Israeli corporate tax rate from 26.5% to 25% and the V.A.T. (Value Added Tax) rate from 18% to 17%. While America does not have a V.A.T., Israel's corporate tax rate will be ten percentage points below our 35% rate. Pro-growth economic policies like this tax cut allowed the Israeli government to simultaneously decrease taxes, reduce the debt burden, and boost spending on defense over the past two decades.

In order to understand this latest decision, we need to put Israel's fiscal policies into historical perspective. Total government expenditure rose from $84 billion in 2008 to $112 billion in 2014 while defense spending increased to $17 billion from $14 billion, an annual average gain of 4.9% and 3.3% respectively. During this period of global financial crisis and recession, the government's share of the economy increased markedly in most countries. In Israel, by contrast, government spending as a percentage of Gross Domestic Product (GDP) was flat in recent years and shrank substantially over the past two decades (see Chart 1).

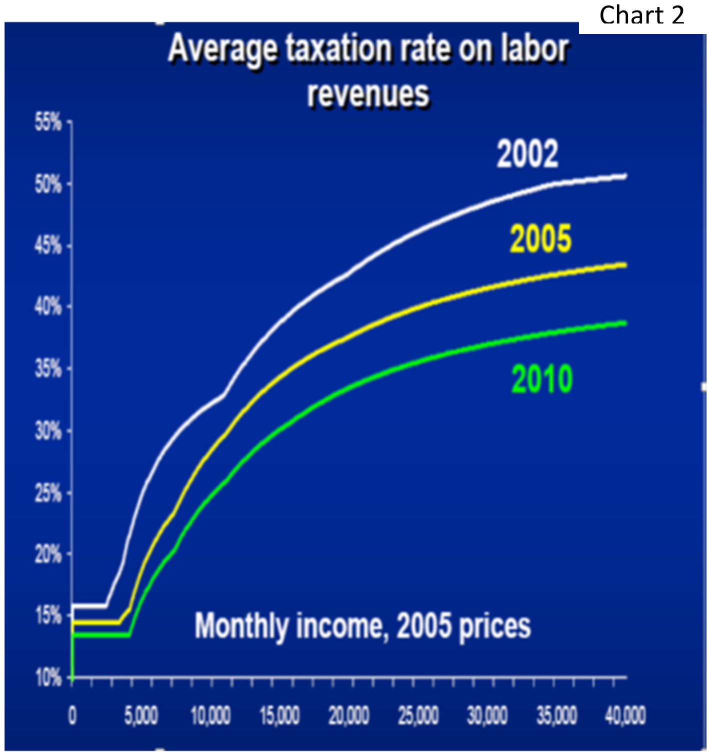
Chart 1



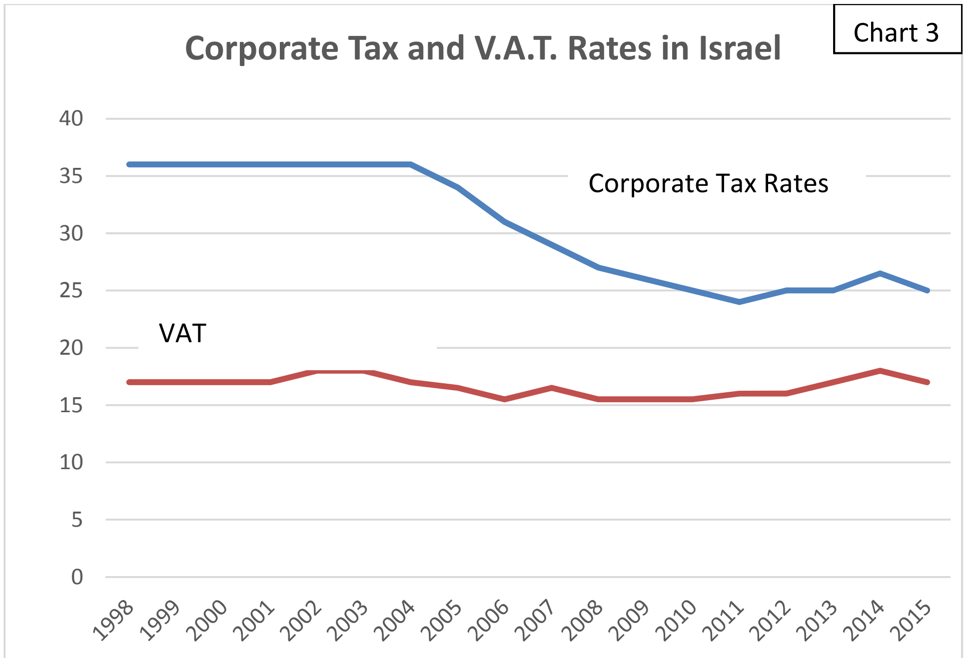

Source: Israel Central Bureau of Statistics

As can be seen in Chart 2, Israel reduced personal income tax rates in three successive waves since 2002. Following the social protests in 2011, Israel backtracked on these tax cuts somewhat when the government imposed new income taxes on top earning households. Chart 3 highlights the downward trend for corporate tax rates and the relative stability of V.A.T. rates. Chart 4 demonstrates that despite tax cuts the Israeli government steadily reduced its debt burden.

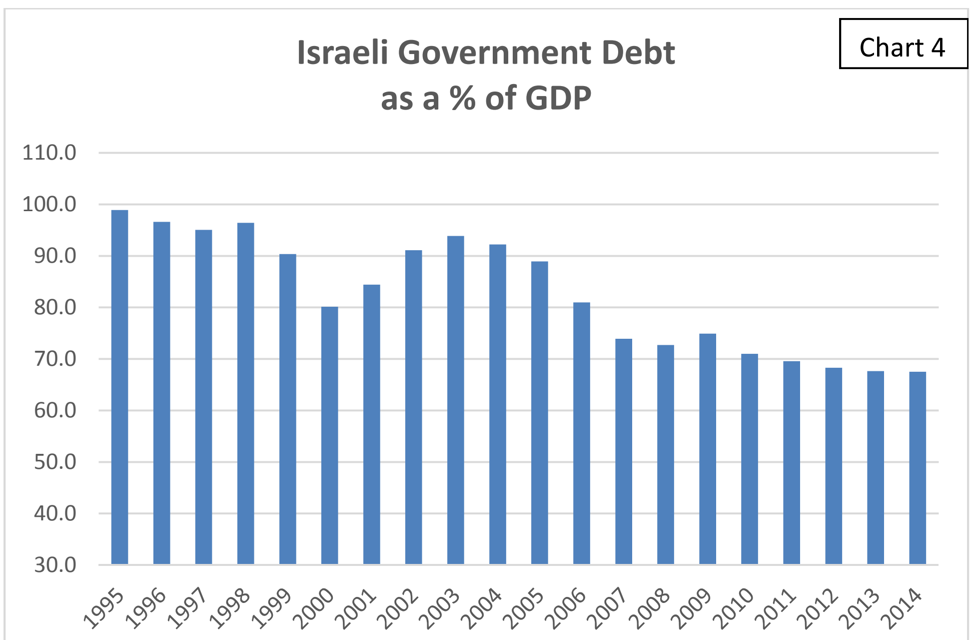
Chart 2




Source: Ministry of Finance: Israel Tax Authority




Source: Bloomberg, LP




Source: Israel Central Bureau of Statistics

Karnit Flug – Governor of the Bank of Israel – criticized the government's plan to reduce taxes, arguing that the extra funds should be devoted toward further debt reduction and infrastructure investment. While her concerns about debt are debatable given the positive long-term trend, her comments about infrastructure are quite valid. Israelis no longer have the highest tax burden in the world, but Israel's infrastructure is inadequate for a modern developed country.

In recent years, Israel inaugurated several major infrastructure projects. Jerusalem now has a light-rail network and construction started on a similar system for Tel-Aviv this past summer. Another train link is currently being built between Jerusalem and Tel-Aviv. The Israeli military is closing major bases in the heart of Tel-Aviv and relocating them to the Negev. The closed bases will be redeveloped, while the infrastructure near Be'er Sheva is being upgraded. Several major intercity road projects are also underway. All of this infrastructure activity will boost economic growth in the coming years, but a great deal more is needed.

Tax policy in Israel helped foster economic growth over the past two decades while simultaneously allowing the government to reduce debt and invest in defense. Reacting to the slower economy in 2015 the Prime Minister and the Finance Minister believe lower taxes will provide needed stimulus. This move is only the latest in a long-term trend toward a healthier tax burden for the Israeli public and business sector.

Israel still has room to lower taxes without threatening its debt targets, but the Israeli economy also needs substantial infrastructure investment. Current projects must be funded while others also get necessary attention. Only continued economic growth will allow fulfillment of all of these objectives. Recent Israeli government policies move in the right direction, but Israel – as a small export oriented nation - also needs the global economy to do its part.