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The tax system composition: The relation between direct and indirect taxation

Abstract:

- In determining the desired ratio of direct to indirect taxes, considerations of efficiency and justice must be balanced.
- Indirect taxation in Israel is very high relative to OECD countries, both as a percentage of GDP and in relation to overall taxation.
- As opposed to the OECD where the relation between kinds of taxes in the past three decades has been stable, with no increase in the part of indirect taxes, in Israel there is a distinct trend of expansion of indirect taxes and reduction of direct taxes.
- The continuation of this trend may be detrimental to the effectiveness of the Israeli tax system as an instrument for the reallocation of resources, and increase inequality in Israel.

Introduction

The taxation systems in most countries are based on two primary kinds of taxes: “direct taxes,” which are “directly” imposed on income or property, and “indirect taxes”, imposed on expenditure for purchasing services or goods.[1]

However both the composition of each of these groups and the exact characteristics of the taxes included in them (tax computation techniques, its percentage, amount of exemptions from it, and so on), vary from country to country, and so does the relation between the two kinds of taxes.

On this issue there are large differences between OECD countries: from the USA and Japan, where the part of indirect taxes is very low – less than 20% of all taxation - to Mexico, Turkey and Iceland, where indirect taxes comprise some 50% of the state’s income from taxes.

Policy considerations: efficiency vs. social justice

When determining the desired relation between taxes according to income and taxes according to expenditure, efficiency and justice considerations must be balanced.

Some researchers believe that indirect taxes are economically advantageous, because they are more neutral than direct taxes; they entail less of a distortion-causing “surplus load”, which changes behavior and reduces output and economic growth.

A possible explanation is connected to the influence of taxes on savings. Direct taxes are usually more heavily imposed on savings than indirect taxes, which affect savings only in the consumption stage.

[1] For international comparisons between direct and indirect taxes it is customary to define as direct taxes all the taxes included in the income statistics of the OECD under headings no. 1,000 (taxes on incomes and profits), 2,000 (social insurance taxes), no. 3,000 (employer taxes), and no. 4,000 (property taxes). Taxes included under heading no. 5,000 (taxes from services and goods) are considered to be indirect.

Increasing the part of indirect taxes may provide an incentive for savings, increase investment and contribute to economic growth.

Another explanation is related to the influence of taxes on labor. Because of the progressiveness of direct taxation, the percentage of marginal direct tax (for each additional work hour) is higher than the worker's average tax percentage. Therefore, a reduction in the part of direct taxes, even if not changing the total amount of taxes paid by the average worker, should reduce the total percentage of marginal tax (direct plus indirect), and as a result increase the incentive to work, improving the economic efficiency of the tax system.

Indirect taxes also have administrative advantages. They are easier to supervise and entail relatively low administrative and compliancy costs on the part of the taxation authority and the citizens.

However, the same characteristics that are advantageous from the aspect of efficiency, become a disadvantage from the aspect of social justice. Since indirect taxes are imposed on expenditures and do not reflect the ability to pay, they are a heavier load on weaker segments of the population creating a feeling of injustice. Even if indirect taxes are formally relative, on the essential level of income division they are regressive. The similarity between the percentages of marginal and average tax retains the incentive to work, but at the same time reduces the ability of indirect taxes to reallocate resources and reduce inequality.

A similar situation occurs in savings. In OECD countries, the upper decile has even a larger share of savings and capital than of the income from labor, and therefore progressive taxation on capital increases vertical equality and reduces inequality. An increase in the part of indirect taxes is advantageous to those with higher incomes, who have most of the savings.

Therefore, when policy makers try to determine the suitable proportion between direct and indirect taxes, they should take into account the trade-off between efficiency and justice. Increasing one kind of tax on the account of the other may increase efficiency and reduce justice, or vice versa.[2]

Competitiveness

In an era of globalization, another consideration comes to the fore: competitiveness. Some claim that indirect taxes (especially VAT) are not as detrimental to the country's competitiveness in the international arena as direct taxes. This argument is strongest when comparing VAT to corporate tax. While corporate taxes increase the cost of capital for the user and therefore the marginal cost of production, making competition in foreign markets more difficult, VAT has no negative impact on the ability of local companies to export, because there are VAT returns for exports.

Tax composition development in the OECD countries

Following international tax competition, researchers have voiced the concern that mobility of capital and labor would gradually lead to a change in the composition of taxation, with a reduction of income tax and corporate tax and increase in the part of indirect taxes, thereby diminishing the progressiveness of tax systems and their effectiveness as an instrument for reallocation of resources. The theoretical concern was supported by the belief of policy makers and public opinion that in many of the countries there is indeed a clear trend of the reduction of direct taxes, some even speaking of a "Race to the Bottom".

However, an examination of the development of direct and indirect taxes in OECD countries shows that a general trend of an increase in indirect taxes does not exist. In the past fifty years, the relative part of indirect taxes in all OECD taxation not only did not increase but actually decreased by some 8% (from 39% to 31%),[3] and in some countries (Italy, Canada) there was even a steeper decline of close to 20%. Most of the decline was between the years 1955 and 1975, while in the past 30 years there was general stability, including the past decade.

The stability in the part of indirect taxes is a result of two opposite trends which cancelled each other out: on the one hand, an increase in VAT (from 0% to 18%), and on the other hand, a reduction in sales taxes and customs.

Similar stability can be found in direct taxes. While there was a decline in the relative part of personal income tax from 30% to 25%, it was offset by an increase in the part of social insurance from 22% to 26%.

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[2] A reservation is in order here: there are significant differences in the characteristics and economic implications of various taxes included in the same general group of direct or indirect taxes. For example, personal income taxes are usually progressive, but corporate taxes, social insurance taxes and capital taxes are sometimes relative or even regressive. Actually, a direct tax can be made to be very similar, economically, to an indirect tax. For example, an income tax at a uniform rate, which provides exemption from savings, is almost equivalent to uniform VAT with a wide base, at least in a closed economy. Therefore, we should be careful with generalizations concerning advantages and disadvantages of various mixes of direct and indirect taxes.

[3] This datum concerns a normal average of OECD countries. See details below.

To sum up, as opposed to the general opinion that indirect taxes in the OECD countries are rising, such a trend **does not exist**. The part of indirect taxes as a percentage of GDP remains stable (10%-11%), and so does the relative part of indirect taxes from all income from taxes – about 31% (according to a normal average).

The Situation in Israel

Table 1: Tax burden in Israel related to OECD countries (weighted average as percentage of GDP)

	Israel	OECD	Difference
Direct taxes	19.6%	23%	-3.4
Indirect taxes	17.4%	10.3%	+7.1
Total	37%	33.6%	+3.4

Table 1 shows that the difference between the tax burden in Israel and the tax burden in the OECD countries, calculated according to a weighted average of GDP, is 3.5 percent of GDP. The difference reflects a negative gap of some 3.5 GDP percent in direct taxes, and a positive one of 7 GDP percent in indirect taxes. The main reason for the high indirect tax burden in Israel is the wide VAT base and the high sales tax on cars.

Table 2: the composition of taxes in Israel relative to the OECD (weighted average according to GDP)

	Israel	GDP	Difference
Indirect taxes	37%	21% (normal average – 31%	+16 (relative to normal average - +6 percent)
Income tax and corporate tax	36%	40%	-4
National insurance	15%	27%	-12
Property taxes	10%	8%	+2
Other	2%	3%	-1

Table 2 demonstrates two significant differences between the Israeli tax system and the OECD average: the part of indirect taxes in Israel is high relative to the OECD, and the national insurance in Israel is low relative to the OECD.

Indirect taxes are the major source of the government's tax income in Israel, some 37% of all collection in 2007, as opposed to only 21% in the OECD weighted average.[4]

The VAT percentage in Israel in the past few years (16%) is more or less average on an international comparison (OECD VAT percentages vary from 5% in Japan to 25% in Denmark, Sweden and Hungary).

Trends

In the past 30 years there was no increase of indirect taxes in Israel, which remained stable at 17% of GDP. Similar stability occurred in the OECD.

However, as opposed to OECD, the same period witnessed a reduction in direct taxes of 5% of GDP (from 25% of GDP in 1980 to 20% in 2007).

Therefore, when examining the composition of taxes in Israel we find an increase of indirect taxes relative to direct taxes, a trend which does not exist in the OECD. In 1980 the difference in the part of VAT, sales tax and customs between Israel and the OECD weighted average was some 11%, which grew to 16% in 2007.

The reduction of direct taxes in Israel is expected to continue. According to existing legislation, corporate tax is supposed to drop to 18% by 2016, and the maximum marginal income tax to 39%. These reductions will decrease direct taxes by nearly one percentage point. At the same time, indirect taxes are expected to increase in order to finance the reductions. These two trends together will accelerate the change of the Israeli tax system to a situation in which indirect taxes have more weight and direct, progressive taxes have less.

In addition, there are further possible changes inside the direct taxes group (for example expansion of tax benefits under various support laws), which will further reduce the progressiveness of direct taxes in Israel.

The combined result will probably be the continuing enfeeblement of the Israeli tax system as an instrument for resource reallocation, and the increased growth of inequality in Israel, even beyond its present high level.

[4] It is important to recognize that this large difference is in comparison to a weighted average according to GDP in the OECD. The weighted average significantly lowers the part of indirect taxes in the OECD, owing to the size of the USA (where there is no VAT) and Japan (where it is very low). These two countries constitute about a half of the weighted average. The OECD itself does not calculate a weighted average, but rather gives all its members equal weight, and according to its statistics indirect taxes constitute 31% of all taxes. Such a calculation reduces the difference between Israel and the OECD to only 6%.