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THE SHADOW ECONOMY IN ISRAEL

Noam Gruber

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The Shadow Economy in Israel

Noam Gruber*

Abstract

The size of the shadow economy in Israel is estimated at about 20 percent of GDP, double that of more advanced countries. It is estimated that halving the size of the shadow economy would increase state revenues by 3-4 percent of GDP, about NIS 30-40 billion. With this additional income, the government would be able to increase public spending, reduce the tax burden and lower the national debt. The primary factors encouraging the shadow economy include a high marginal tax rate, cumbersome bureaucracy, insufficient enforcement, and flawed reporting norms. In order to reduce the size of the phenomenon, it is necessary to focus on three main areas: (1) improving the enforcement process: it is recommended that goals be set for the Israel Tax Authority both in terms of enforcement and in terms of improved service and more streamlined reporting, and that norms of transparency be applied with regard to meeting these goals; (2) changing the collection method: to make it more difficult for citizens to evade taxes, it is recommended that tax filing be made mandatory, that the system move to taxation on the basis of households (rather than individuals) and that it recognize expenses, and that information technology is leveraged to facilitate automated reporting and regulation; and (3) reducing the tax burden: it is recommended that tax rates be lowered for small businesses that use electronic means of reporting income in order to reduce incentives to conceal income.

* Dr. Noam Gruber, senior researcher, Taub Center for Social Policy Studies in Israel. The author is grateful to Dan Ben-David, Ayal Kimhi and Kyrill Shraberman of the Taub Center for Social Policy Studies in Israel for their useful comments.

Introduction

The shadow economy arises from the concealment of income from legal economic activity. It is concentrated mainly in the self-employed and small business sectors. For example, plumbers, farmers, shop owners, or salaried employees who do not report income to the tax authorities are all part of the shadow economy. The definition of the shadow economy does not include income from illegal activity, such as drug dealing, extortion or prostitution, although these cases also concern unreported income. Individuals and companies that evade taxes through legal loopholes, for example by means of wallet companies¹, are not included in the definition of the shadow economy either, as long as their income reporting is honest. Since employees in large companies usually do not have much opportunity to avoid paying income taxes, and since the risks of tax evasion are generally greater than the benefits for large companies, tax evasion is likely most common among the self-employed, small businesses and those they employ (OECD, 2013c).

Income that is required to be reported to the tax authorities, but does not get reported avoids being taxed according to the law and thus the state is deprived of revenues estimated at tens of billions of shekels. In addition to the harm caused to the state from the loss of revenues from taxes, those involved in the shadow economy may be harmed personally because they do not enjoy the protection of the law.²

¹ A wallet company is formed for the benefit of its owner's tax-planning, and it does not conduct any independent economic activity. The company provides the same service that its owner would provide if he were a hired employee, and its main purpose is to reduce its owner's tax burden.

² For example, workers who collude in the concealment of their income may find themselves earning less than the minimum wage, without receiving any social benefits stipulated by law, such as deductions for pension and severance pay. Businesses in the shadow economy will find it hard to defend themselves against crime, such as extortion, fraud or theft, because turning to the authorities may expose their concealment of income.

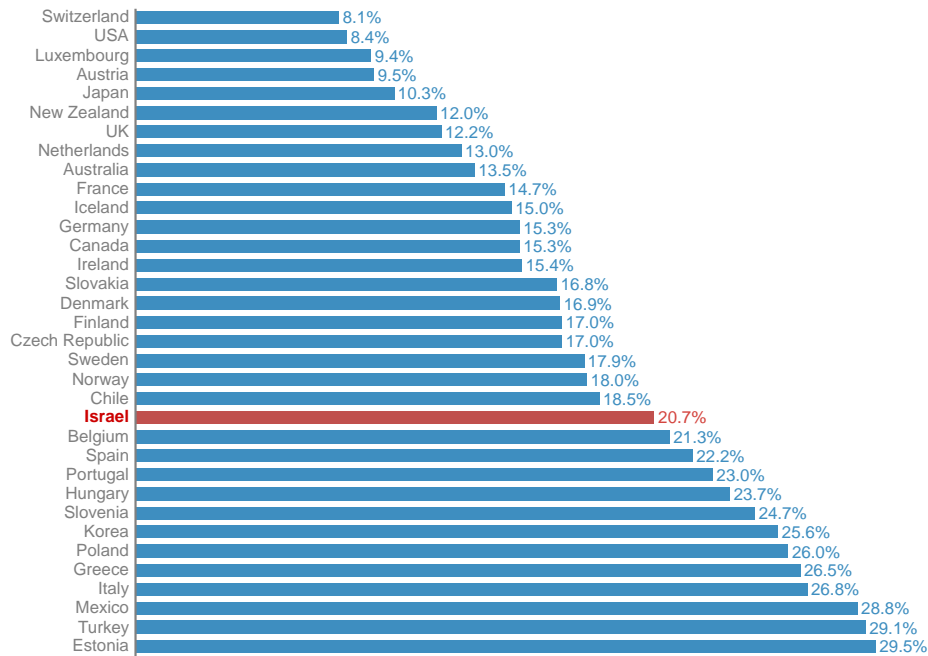
Enforcement efforts by the Tax Authority provide a partial glimpse into the size of the shadow economy,³ but this phenomenon's very nature makes it difficult to estimate its exact proportions. There are a range of estimation methods, from anonymous income surveys, to the use of indirect economic indicators such as electricity consumption or the cash stock circulating in the economy, through to economic models based on theoretical assumptions.⁴

According to Buehn and Schneider (2011) and Elgin and Oztunali (2012), the size of the shadow economy in Israel is slightly more than one-fifth of GDP, which is currently about NIS 200 billion. For comparison, the size of the shadow economy is estimated to be 16-17 percent of GDP on average for the OECD countries; and in the United States, Japan, and the most advanced European countries, it is estimated at about 10 percent of GDP.

³ See the Tax Authority's website:
<http://taxes.gov.il/EnforcementAndDeterrence/Pages/EnforcementHodaot.aspx>.

⁴ For a survey of the methods in the relevant economics literature, see Elgin and Oztunali (2012) and Schneider and Buehn (2013).

Figure 1
Shadow economy in Israel and the OECD
 as percent of GDP, 2007



Source: Noam Gruber, Taub Center for Social Policy Studies in Israel

Data: Buehn and Schneider, 2012

The potential to increase state revenues by reducing the size of the shadow economy in Israel is clear. Reducing the scope of concealed income by 10 percentage points, that is, almost by half, (at an assumed average tax rate of 30-40 percent⁵), would increase state revenues by 3-4 percent of GDP, or NIS 30-40 billion. This amount is equivalent to the

⁵ The rate of the state's revenues from taxes in Israel is about 30 percent of GDP. Since the motivation for concealing income is to avoid paying taxes, despite the risk involved, it may be assumed that the unreported income likely would have been taxed at a high rate.

budget of the Ministry of Education. Along with increasing the state's revenues from taxes, reducing the size of the shadow economy would allow for a more equitable and just taxation system, by both taxing income that is currently concealed and reducing tax rates for all taxpayers. Furthermore, on the assumption that many of those who conceal income also receive social assistance on the basis of self-reported false income data, reducing the size of this phenomenon would free resources for the benefit of those who truly need them.

What, then, are the reasons underlying the shadow economy phenomenon, and what are options for addressing it?

1. Main Reasons for the Shadow Economy

The reasons for the shadow economy can be classified into several main categories:⁶

The Tax Burden

Clearly the tax burden is a primary motivation for tax evasion. The marginal tax rate is an important consideration in the decision to conceal income, and the higher the rate, the greater the motivation to do so. In Israel, as in many other countries, a business owner may pay taxes as a self-employed individual ("authorized dealer") or as a limited liability company. As a company, the owner pays tax on profits at a uniform rate of 48.55 percent (57.8 percent inclusive of value-added tax (VAT)).⁷

⁶ For an academic discussion of the reasons for the shadow economy, see Schneider and Buehn (2012); for a survey of the literature presenting examples from the OECD countries, see OECD (2010).

⁷ For every 1 shekel of income inclusive of VAT, the state currently collects 18 agorot (i.e., NIS 0.18) in VAT. Of the 82 agorot remaining, 26.5 percent in corporate tax, or an additional 22 agorot, is collected, leaving 60 agorot. When these profits are drawn, 30 percent, or another 18 agorot, will be collected as the dividend tax of an interest-holder. At the end of the process, 42 agorot remain, which puts the overall tax rate at 58 percent.

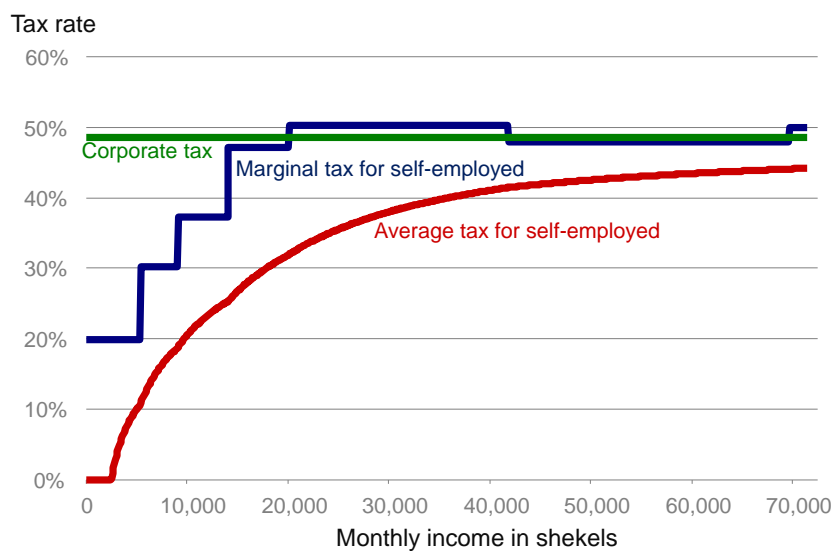
Starting at monthly taxable income of NIS 14,000, the marginal tax rate (income tax and National Insurance Institute contributions) of an authorized dealer is similar, at about 47 percent, as shown in Figure 2.

For example, the tax on a transaction between a consumer and a self-employed service-provider in Israel will generally be the VAT⁸ (currently 18 percent) as well as the marginal tax rate applied to the service-provider, which together can reach almost 60 percent for monthly income above NIS 14,000.⁹ At such a tax rate, there is growing temptation not to report the transaction. Aside from taxation, it is necessary to add the benefits of transfer payments received by low-income earners, mainly unemployment benefits, income supplements and negative income tax. The higher these payments, the greater the temptation is to conceal income in order to receive them. As such, increasing the tax rate contributes to enlarging the shadow economy in addition to harming economic activity. In light of this, raising tax rates too high may even diminish the state's total revenues from taxes.

⁸ Since an authorized dealer or limited liability company is entitled to reimbursement for the VAT they paid, VAT is actually collected only on the added value or operational profit of the transaction.

⁹ For example, a self-employed worker whose monthly income is between NIS 14,000-20,000: for every 1 shekel, the state collects 18 agorot VAT. Of the remaining 82 agorot, 47 percent (income tax and national insurance for self-employed), or an additional 39 agorot, is collected. Of the original 1 shekel, about 43 agorot remain, so the overall tax rate for self-employed is 57 percent.

Figure 2
Tax rates for self-employed and companies in Israel*



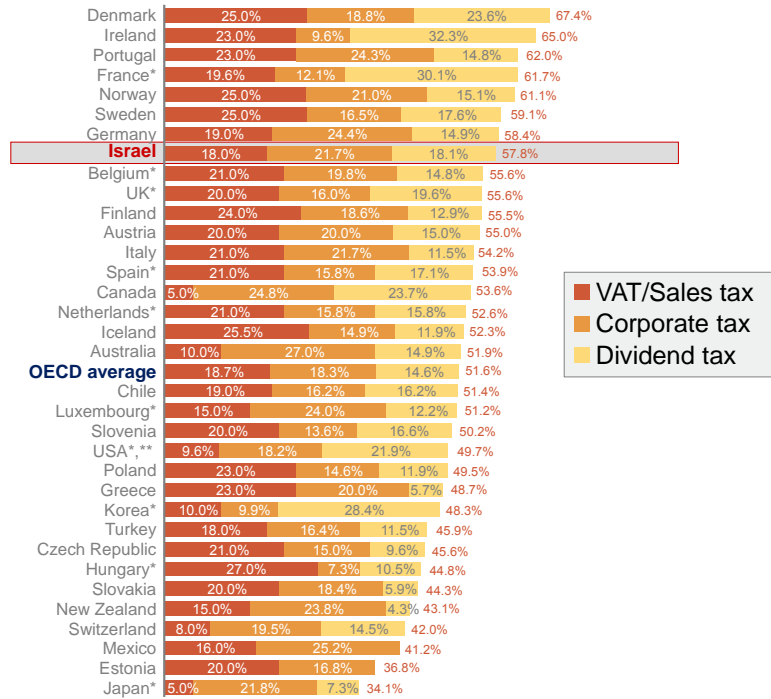
* The calculations assume 2.25 credit points of about NIS 218 per point. For the self-employed, the rate includes income tax and National Insurance Institute contributions, without negative income tax. For Israeli corporations, the rate includes income tax and dividend tax for controlling owners. For details of tax rates see Appendix Table 1.

Source: Noam Gruber, Taub Center for Social Policy Studies in Israel

Data: Tax Authority

An international comparison of the tax burden as calculated, inclusive of VAT, shows that the tax rate for small businesses in Israel is relatively high (Figure 3).

Figure 3
Effective tax rate for small businesses
 in Israel (2014) and OECD countries (2013), as percent of income



* Calculation include preferential tax for small businesses

** Average of all the states

Source: Noam Gruber, Taub Center for Social Policy Studies in Israel

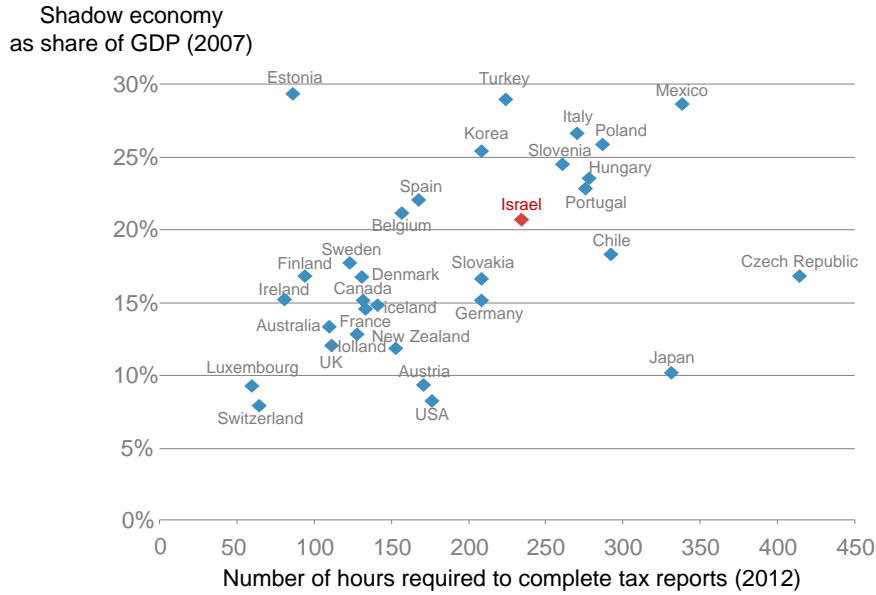
Data: OECD

The complexity and transparency of the taxation system also have a substantial influence on the extent of concealment. More complicated and costly reporting and greater uncertainty regarding the tax to be assessed is likely to result in a greater reluctance to report. The bureaucratic burden facing lawful businesses (and the scope of institutional corruption, if such exists) can be considered another type of tax that drives businesses to

operate in the shadows. If on the other hand, state institutions were to assist with business activity, it would provide an incentive for those concealing income to join the formal economy. The connection between tax rates, the complexity of the collection and payment system, and the estimated size of the shadow economy is supported empirically by a large number of economic studies. More recent studies on this subject include Gorodnichenko et al. (2009), Peter (2009), and Schneider and Buehn (2012).

According to the World Bank, in 2012, a company in Israel had to spend an average of 235 working hours (about 20 hours a month) to complete the required tax filing process, as opposed to an average of 163 hours in the European Union, 175 hours in the United States, and less than 100 hours in some other countries (Luxembourg, Switzerland, Hong Kong, Ireland, Estonia, Norway, and Finland). Such a bureaucratic burden is even more onerous to small businesses, which are already prone to conceal income, due to its high cost relative to the businesses' revenue and particularly their profit. Furthermore, the relative size of a small business often does not warrant using the services of a professional to interface with the tax authorities and sometimes does not even economically justify the use of accounting services. The OECD data clearly show the correlation between the time required to file corporate tax reports and the size of the shadow economy (Figure 4).

Figure 4
Relation between time needed to file corporate tax reports and size of shadow economy



Source: Noam Gruber, Taub Center for Social Policy Studies in Israel
 Data: World Bank, Buehn and Schneider (2011)

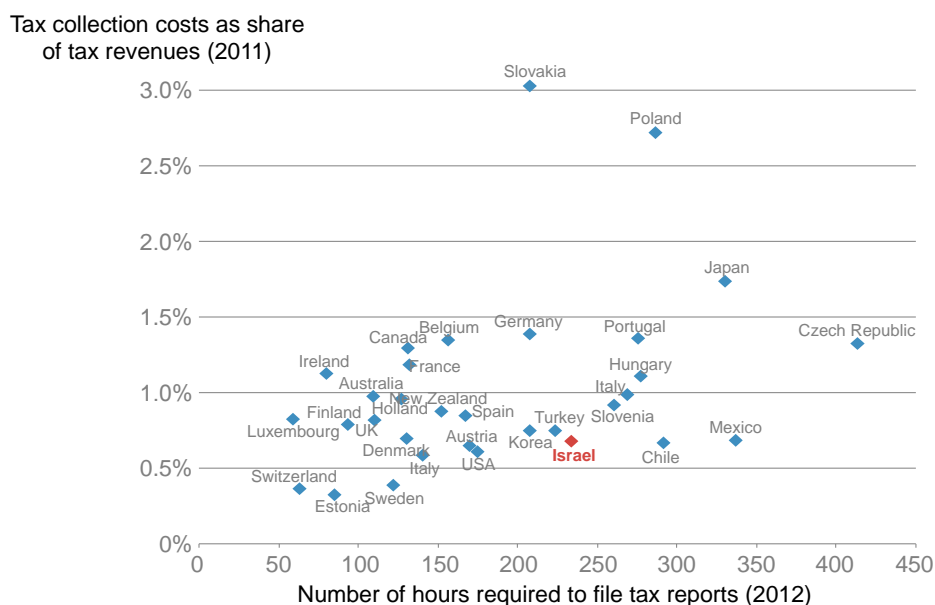
There is a clear trend in the developed world wherein tax authorities treat small businesses and their tax advisers as they would clients, and are investing resources in streamlining and automating the reporting interface with the aim of simplifying the process.¹⁰ Accordingly, the tax agencies establish goals for improving satisfaction with the collection process, and assess whether they have met these goals through periodic questionnaires

¹⁰ This policy is called Engagement and Involvement. See for example, the OECD survey in this field (OECD, 2013c), the HMRC report in Britain (HMRC, 2013a), and tools for involvement in the United States: <http://www.irs.gov/uac/Get-Involved>

and even individual interviews, which allow small businesses to provide suggestions for improvement. Meanwhile, it is evident that countries such as the Netherlands and Denmark are progressing towards full automation of the taxation process for small businesses, whereby electronic tax payments are calculated and processed by computer, without any active involvement by the business itself. In Israel, too, progress can and should be made in these directions.

Relieving the complexity of the reporting process may reduce not only the size of the shadow economy, but also the cost of tax collection to the state. As Figure 5 shows, there is a correlation between the cost of tax collection and the time required to report income.

Figure 5
**Relation between time needed to file tax reports
and tax collection costs**



Source: Noam Gruber, Taub Center for Social Policy Studies in Israel

Data: World Bank, OECD

Enforcement and Punishment

Efficiency of regulation and severity of punishment may deter people from concealing income and thereby reduce the size of the shadow economy. The greater the probability of being caught by the tax authorities and paying a steep fine, the less attractive concealment becomes. The harder it is to discover the concealed income – for example, in a transaction between a supplier and a client where the sides agree, explicitly or implicitly, to withhold tax and split the profit among themselves in the form of a “cash discount” – and the more infrequent and the less thorough the monitoring by tax agencies, the less effective is the deterrence. In such cases, reporting becomes dependent on the goodwill and moral integrity of the parties to the transaction. The deterrent effect that is achieved by active enforcement and effective punishment is supported by studies such as Andreoni et al. (1998), Slemrod (2007), and Blackwell (2007).

The Israel Tax Authority publicly reports on only a small portion of its monitoring and enforcement operations. Unlike its counterparts in other countries, such as the American Internal Revenue Service (IRS) and Her Majesty’s Revenue and Customs in Britain (HMRC), it does not publish regular and comparable statistics about the annual scope of this activity, even though such reporting was explicitly recommended in 2000 as part of the conclusions of the Ben Bassat Committee.

As shown in Table 1, in the fiscal year 2013, the IRS conducted 5,314 criminal investigations, filed 3,865 indictments, and won 3,311 convictions. Of the convicted tax offenders, 80.1 percent were sent to prison. In 2012, \$5.3 billion, or 44 percent of the IRS budget of \$12.1 billion was invested in enforcement. Of that sum, \$645.6 million (5.3 percent) was allocated to investigations, and about \$4.5 billion (37.25 percent) was invested in inspections. The \$5.3 billion that was invested in enforcement yielded the collection of a total \$31.1 billion from unpaid taxes or reporting errors (IRS, 2013).

In the United Kingdom (Great Britain and Northern Ireland), in the fiscal year 2011-2012, more than one-quarter of the HMRC budget (£1.0

billion out of £3.8 billion) was invested in enforcement and compliance activities. Total revenues from taxes came to £474 billion, of which £16.7 billion was collected by means of enforcement activity. This activity included, among other things, the filing of 545 indictments and the obtaining of 413 convictions, which yielded more than £1 billion, as well as the prevention of mistakes and fraud in negative income tax to the extent of £1.5 billion. Enforcement activity in the UK continues to grow, and from January through November 2013, there were 690 convictions in cases brought by HMRC against assessed taxpayers for the concealment of income which corresponded to a total of 355 years' imprisonment. HMRC has announced its goal of more than 1,000 indictments in 2014 (HMRC, 2013b; 2013c).

Table 1. **Performance of tax collection agencies in the USA and UK**

Performance measures	Internal Revenue Service (IRS), USA*	Her Majesty's Revenue and Customs (HMRC), UK**	Israel Tax Authority
Share of budget spent on enforcement	44% (\$5.3 billion)	26% (£1 billion)	Data not published
Indictments	3,865	545	Data not published
Convictions	3,311	413	Data not published
Revenue from enforcement activity	\$31.1 billion	£16.7 billion	Data not published

* Data for fiscal year 2013

** Data for fiscal year 2011-2012 (the UK includes Britain and Northern Ireland)

Source: Noam Gruber, Taub Center for Social Policy Studies in Israel

Data: IRS, HMRC (2013b, 2013c)

Given the lack of reporting in Israel, it is not possible to properly compare the activity of the Israel Tax Authority in the fields of enforcement and collection with that of their counterparts in other countries. Since 2009, the Tax Authority has ceased publishing annual reports on its activity (although reports in the past also did not include data on the scope of enforcement activity and its results). The yearly report published by the Tax Authority's own Unit for Implementation of the Freedom of Information Law includes only partial data on the Authority's activity and budget, from which it may be concluded that the Tax Authority spent NIS 1.67 billion in 2012. The expenditures on operations and information-gathering amounted to NIS 6.5 million, and spending by the Unit for Fighting Crime came to NIS 8.3 million. According to this data, the Tax Authority allocated less than 1 percent of its budget to enforcement, although this finding is dependent upon the definition of various expenditures.

In an interview conducted upon his retirement, former Tax Authority director (2007-2011) Yehuda Nasardishi revealed that the sampling rate of tax returns dropped dramatically over the last decade, from 8.8 percent in 2004 to 2.4 percent in 2011 (Bassok, 2011). The Tax Authority website lists four convictions for tax offenses in 2011, five in 2012, and four in 2013, with some of these cases being appeals. However, a search of online judicial decision databases shows a far larger number of tax offense files.¹¹ With regard to the Israel Tax Authority, then, the preliminary picture that emerges is one of lack of transparency and an absence of clear goals in the area of enforcement.

Not only are very few resources allocated to the identification of unpaid taxes, but the punishment does not serve as effective deterrence either. Although the Tax Authority has the power to impose stiff punishment, the use of such sanctions is rare. In the years 2006-2010, according to Or's study (2013), on average 27 percent of private

¹¹ See, for example, <http://www.takdin.co.il/searchg/%D7%94%D7%A2%D7%9C%D7%9E%D7%AA%C2%A0%D7%9E%D7%A1.html> (in Hebrew).

companies had not filed an income report to the Tax Authority as of three months following the deadline set by law, but punitive action was taken against only 8 percent of these companies. A relatively low administrative fine was imposed on 3.1 percent of them, and an investigation that could lead to a criminal proceeding was launched against 4.5 percent. About 20 percent of the companies that did not file on time did not file at all throughout the five-year period of the research, so there was no possibility of making an assessment and collecting tax from them. Proceedings were undertaken against only 12.5 percent of these companies.¹² Or's findings on geographical distribution show an especially low tax filing rate in two sectors: Arab localities and Jewish settlements beyond the Green Line.

Faced with such light enforcement, even the self-employed and businesses that choose to file a tax report may nonetheless try to conceal income. Those caught concealing income for the first time can usually avoid criminal proceeding by paying a fine, generally 20-40 percent of the concealed income, in addition to the tax due. The overburdening of the judicial system has also led to the creation of an administrative punitive procedure as an alternative to criminal proceedings, with the latter being undertaken only as a last resort in the most serious cases.¹³

As noted, the marginal tax rate in Israel for a company or the self-employed with a monthly income that reaches NIS 14,000 is almost 60 percent. This means that a business owner who has not yet been caught concealing income, can assume that, if caught, he will be given the option of paying 30 percent of the amount concealed or a similar fine assessed by administrative procedure. The business owner will thus prefer to conceal income as long as he estimates that there is less than a two-thirds probability of being caught.

¹² Before the Knesset's Finance Committee on February 3, 2014, Tax Authority representatives argued that a considerable share of the companies that failed to report were in the process of dissolution at the time. Or disputes this claim.

¹³ Or (2013) shows that relatively little use is made of the administrative procedure.

Under these conditions – when very few of those who choose to report are audited, and of those who are audited and caught, many can choose an administrative rather than criminal proceeding – the evasion of tax payment is especially appealing.

Reporting Norms

The more the concealment of income from the tax authorities is considered commonplace and legitimate by the public, the greater the chances that an individual will choose not to report income. Public perception of the justice and equality of the taxation system also impacts the magnitude of concealment of taxable income – with the feeling “If the rich hardly pay any taxes, why should I pay?”¹⁴ – as does the perception of the returns to tax, in terms of the quality of public services for the individual and the fair distribution of these services among the entire population. It appears then, that fairness, transparency and consistency in the collection of taxes and a public emphasis on good governance may in and of themselves contribute to an increase in the state’s revenues. The role and importance of reporting norms have been investigated in studies such as Feld and Frey (2007) and Torgler and Scheider (2009).

With regard to the taxation of companies in Israel, it is hard to argue that small businesses, whose ability to conceal income is relatively great, are accorded equal treatment in taxation. As Ben Naim and Gedalia (2013) show, the share of companies that are awarded preferential taxation status through the Encouragement of Capital Investments Law increases the larger the company. When companies are divided into percentiles by revenue size, the share of companies awarded preferential status in the 1st to 75th percentile is very low (only a few percentage points), while preferential status jumps to about 20 percent in the upper quartile.

In 2014, companies that have been awarded the status of “preferred business” through the Encouragement of Capital Investments Law,

¹⁴ This attitude is well reflected in Alon’s (2013) opinion piece.

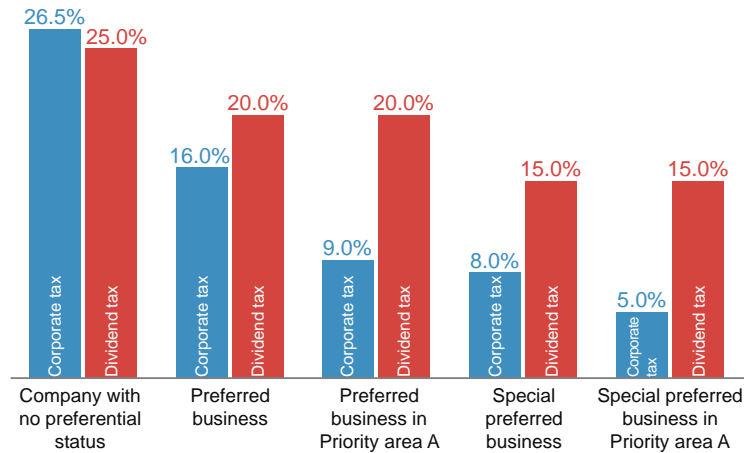
according to the criterion of exporting at least one-quarter of their production, had a 10.5 percentage point reduction in corporate tax and a 5 percentage point reduction in dividend tax (tax assessed on profits distributed among company shareholders) compared to a regular company.¹⁵ Companies of this status located in national priority areas¹⁶ pay corporate tax at a rate of only 9 percent (up from 7 percent in 2013), about one-third that of a regular company. Large companies that are awarded the status of “special preferred business” receive additional significant benefits, as shown in Figure 6, which presents the taxation rates according to the Encouragement of Capital Investments Law. The international comparison conducted by Ben Naim and Gedalia (2013) shows that, unlike in Israel, tax benefits elsewhere around the world are not conditional on the share of exports, but rather on meeting investment and employment goals.¹⁷ Additional concerns are highlighted by the remarks made by the State Comptroller in his last annual report (2013): “[...] the cost of the Law has been rapidly growing in recent years, but there has been no thorough examination of its benefit to the economy.”

¹⁵ These gaps have narrowed from 2013, when the difference in corporate tax was 12.5 percentage points and the difference in dividend tax was 10 percentage points.

¹⁶ Government-defined development zones, mostly in the northern and southern regions of Israel.

¹⁷ Furthermore, it bears mention that Israel is a signatory to the World Trade Organization charter, which prohibits the encouragement of exports. The Encouragement of Capital Investments Law in its present form contravenes the charter.

Figure 6
**Comparison of tax rates in the
 Encouragement of Capital Investments Law**
 dividend and corporate tax rates, by company status, 2014



Source: Noam Gruber, Taub Center for Social Policy Studies in Israel
 Data: Ministry of Finance, Ministry of Economy

Approved enterprises are also entitled to investment participation and accelerated depreciation grants, and the larger ones among them may obtain, through direct negotiation, special grants for billions of shekels. According to the State Revenue Division's report, the cost of the income tax benefit stemming from the Encouragement of Capital Investments Law rose from NIS 2.3 billion in 2003 to about NIS 7.2 billion in 2011, even though during those years the regular corporate tax rate dropped from 36 percent to 24 percent (Ben Naim and Gedalia, 2013). For the sake of comparison, in 2011, a total of NIS 26.7 billion in corporate taxes was collected; the cost of the tax benefit by means of the Encouragement of Capital Investments Law constituted 27 percent of that revenue. It could be argued that the State Revenue Division's calculation overestimates the Law's cost, as it assumes zero flexibility in corporate

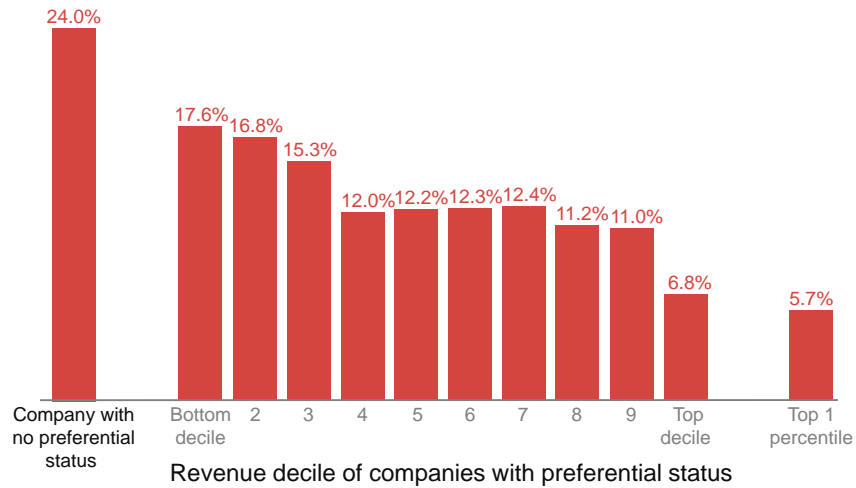
profits, (i.e., that companies' activity and profits remain the same even at different tax rates), whereas it is reasonable to assume that profits would decrease if companies were required to pay the full tax. However, it could also be argued to the contrary that the calculation is in fact an underestimation, since it does not include the cost of the dividend tax and accelerated depreciation benefits and special grants, or the issue of trapped profits,¹⁸ which saved some corporate giants billions of shekels in tax payments in recent years.

Tax exemptions given by the law are extremely biased in favor of larger companies. For example, the one-tenth of companies that had the highest income among the approved enterprises (the top decile) received 92 percent of the benefits, and the four largest companies,¹⁹ which constitute only 0.5 percent of the 829 approved enterprises, received almost 60 percent of the benefits. As shown in Figure 7, not only are the benefits to the corporate giants larger, but there is also an inverse relation between the effective corporate tax rate and company size: among companies with preferential status, the top decile by corporate revenue paid an effective tax rate of 6.8 percent, less than half the rate paid by the bottom decile (17.6 percent).

¹⁸ In the framework of the Encouragement of Capital Investments Law, companies enjoyed an exemption from tax on profits reinvested in Israel. Profits that were neither distributed nor reinvested, (i.e., trapped profits), enjoyed this exemption until such time as they were distributed or reinvested, as the state was interested in encouraging reinvestment in Israel. A 2012 amendment to the Law required companies that had received an exemption from tax on trapped profits to begin to pay tax on these profits. The amendment allowed significant tax benefits on trapped profits, with the aim of encouraging companies to distribute the trapped profits and pay tax on them.

¹⁹ Teva, Intel, ICL, and Checkpoint.

Figure 7
Effective corporate tax rate for companies with preferential status*
 by company income decile, 2011



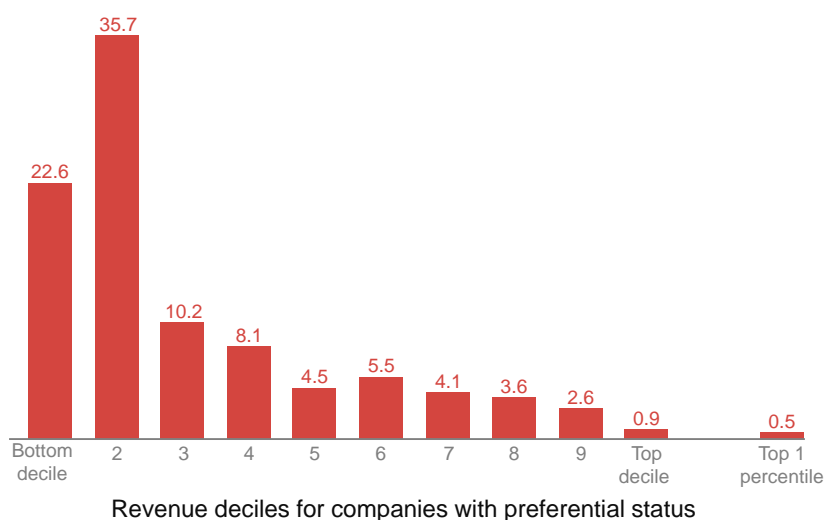
* According to Encouragement of Capital Investments Law

Source: Noam Gruber, Taub Center for Social Policy Studies in Israel

Data: Ben Naim and Gedalia (2013)

A comparison of the taxes collected from companies that enjoy preferential status (corporate tax and wage taxes) and the cost to the state of the benefits, shows that the large companies are able to exploit their bargaining power vis-à-vis the state and to pay less taxes relative to benefits (Figure 8) to such an extent that, in effect, the tax revenues from the top revenue decile of preferential status companies are lower than the cost of the benefits received by them.

Figure 8
Ratio between tax revenues and benefits
 for companies with preferential status*, by company revenue decile, 2011



* According to Encouragement of Capital Investments Law

Source: Noam Gruber, Taub Center for Social Policy Studies in Israel

Data: Ben Naim and Gedalia (2013)

Besides the Encouragement of Capital Investments Law, grants and benefits to the extent of NIS 1.5 billion are awarded by the Chief Scientist, which are not relevant to small businesses because they generally are not technology-intensive and do not have the resources to fulfill all the grant requirements. In total, then, each year the State of Israel awards at least NIS 9 billion to big businesses.²⁰ For the sake of comparison, total revenues from corporate income tax came to NIS 26

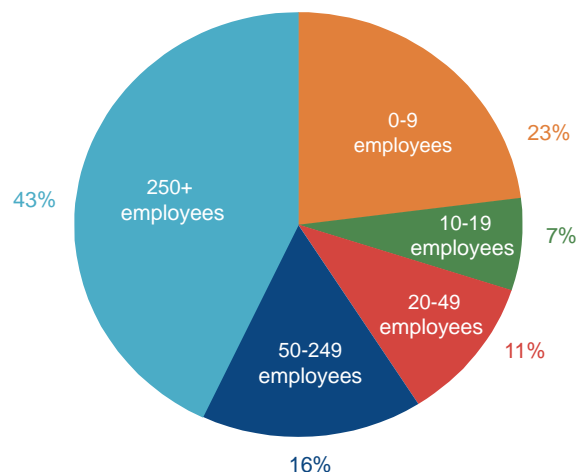
²⁰ The Encouragement of Capital Investment Law awards NIS 7.2 billion in corporate tax reductions, plus dividend tax reductions, investment grants and directly negotiated grants. On top of that, the Chief Scientist awarded NIS 1.5 billion worth of grants. NIS 9 billion is a rough total estimate.

billion in 2012, while those from self-employed income tax came to about NIS 11 billion. There is no doubt that the effective tax rates for large companies are much lower than those set by law, and that reducing the magnitude of grants and benefits to such companies could go a long way toward financing a significant easing of tax rates for small businesses and the self-employed.

It can be asserted, then, that taxation policy in Israel is more severe when it comes to small businesses than to larger ones. Since the discrimination against small businesses clearly provides a justification for the norm of concealing income, and since eliminating it would allow for decreasing the tax burden – which in turn would reduce the incentive to conceal income – it is necessary to examine whether this discrimination is justified from economic considerations of profit and loss to the state. In other words, are small businesses being treated properly by the state, especially considering the fact that they do not have much power to stand up to or bargain with the authorities? As Figure 9 shows, businesses employing up to four workers (defined as “very small businesses”) and those employing 5-19 workers (“small businesses”) together employ about 30 percent of the wage workers in the commercial sector. According to The Small and Medium Businesses Agency in Israel, 99.3 percent of all the businesses in Israel are small and medium-sized businesses that employ up to 100 workers. Fifty-five percent of all employees work in such businesses, which represent about 45 percent of GDP (The Small and Medium Businesses Agency in Israel (2013)²¹).

²¹ It should be noted that data from The Small and Medium Businesses Agency in Israel does not match that of the OECD, according to which in 2009, 15 percent of workers were employed in businesses with 0-9 workers; about 10 percent in businesses with 10-19 workers; about 23 percent in businesses with 20-49 workers; about 15 percent in businesses with 50-249 workers; and about 37 percent in businesses with more than 250 workers (OECD, 2013c).

Figure 9
Distribution of employees in the business sector
by number of company employees, 2008



Source: Noam Gruber, Taub Center for Social Policy Studies in Israel
Data: Ben Naim and Gedalia (2013)

The tax environment for small businesses has a known impact on key economic variables in the entire economy: 1) cost of living – businesses pass on their costs to customers; 2) dynamics of the economy – low taxation encourages the establishment of new businesses and expansion of existing ones; 3) economic stability – small businesses, which are among the largest employers in the economy overall, are the most vulnerable to variations in the business cycle. There is no economic logic behind the discrimination against small businesses when eliminating such discrimination and reducing the tax burden on them would limit the size of the shadow economy and lead to an improvement in reporting norms in the long run, which in turn might contribute to a rise in total state revenues. In 11 of the OECD countries, small businesses enjoy

preferential taxation.²² Such preference should be considered in Israel as well, especially in the context of a transition to an electronic transaction reporting system, as will be detailed.

2. Mandatory Tax Filing

The call for implementing mandatory tax filing in Israel has been raised several times in the past: in the Ben Shachar Committee (1975), in the Sheshinsky Committee (1988), in the report of the State Revenue Division (1997), and in the report of the Ben Bassat Committee (2000).²³ According to the proposal, each year every resident in Israel, whether salaried or self-employed, would be required to declare income from all sources. This move is mainly aimed at reducing the concealment of income in Israel and at reducing the size of the shadow economy. An additional aim is to make it possible to conduct more in-depth income audits, and to thereby ensure that government assistance reaches only those who are truly in need.

However, assuming that mandatory filing will reduce the size of the shadow economy is not a foregone conclusion. After all, those who withhold tax clearly know that they are breaking the law. Furthermore, as discussed previously, the potential for tax evasion is higher among the self-employed and small businesses, which are already required to report income. Why, then, should there be an expectation of improved collection if the reporting obligation is extended to the entire population? As discussed in the report of the Ben Bassat Committee (Chapter 11), mandatory filing would allow the transition to a different taxation model, more like the one employed in the United States. In such a model, the tax paid by a household is determined on the basis of the combined income

²² For details, see Tzadik (2012).

²³ The Ben Bassat Committee recommended applying a general reporting obligation in stages, starting with assessed taxpayers with a high income as well as “high-risk” taxpayers — certain professionals and households whose expenditures and property do not align with their income (Ben Bassat, 2000).

of the two partners, including entitlements to deductions for specific expenses on the basis of tax receipts. Since this approach focuses on household income, it is easier to verify the income data against the consumption and property data as a control for the truthfulness of the reporting. Thus, when one household reports low income but has considerable property, while another household reports that it is renting an apartment from the first household, the first household would be required to explain the discrepancy between its low income, high expenditures, and expensive property. Furthermore, a system of deductions that requires proof of expenditure incentivizes households to demand and keep receipts and to report expenditures, so concealment becomes more difficult. Entitlement to deductions for expenditures such as housing, household upkeep and repair, automobile maintenance, and education and childcare services is expected to greatly diminish the concealment of income in these areas, and to make transactions without a receipt generally less acceptable. Additionally, the taxation procedure in general will become simpler and include income from a variety of sources that are taxed uniformly according to the tax bracket of each household – instead of the current assessment of different tax rates on selected sources of income, which favors some sources over others. Simplifying the taxation system by eliminating the different tax rates may even lower the costs of enforcement.

The recurring proposals to implement mandatory filing have been met by stiff opposition, led by the Tax Authority. One State Revenue Division report asserts: “This step involves not insignificant costs to the tax authorities and the assessed taxpayers, will increase friction between the citizen and the authorities, especially among populations that are not relevant to the tax authorities, and is liable to encounter widespread noncompliance” (State Revenue Division Report, 1997, Chapter 18; from Zussman and Romanov, 1998).

The Tax Authority’s opposition to mandatory filing, joined with fears of its considerable costs, widespread public indignation and an explosive confrontation between the state and certain populations, has made mandatory filing politically unfeasible in the past. Nonetheless, it is a step

that is still being considered. The chapter on the taxation system in the report of the Trajtenberg Committee for Socioeconomic Change refrained from recommending the institution of mandatory filing, emphasizing instead increased enforcement by existing means. On the other hand, the Arbeli Committee for Fighting Black Capital, which was established as a continuation of the work of the Trajtenberg Committee, strongly recommends its implementation. This is a highly important recommendation, considering that the Arbeli Committee is an internal committee of the Tax Authority, which has led the opposition to mandatory filing (Arlosoroff, 2013).

It is, therefore, a good time to examine to what extent, if any, mandatory filing would reduce the size of the shadow economy in Israel. Likewise, the expected costs should be clarified and weighed against the anticipated benefits.

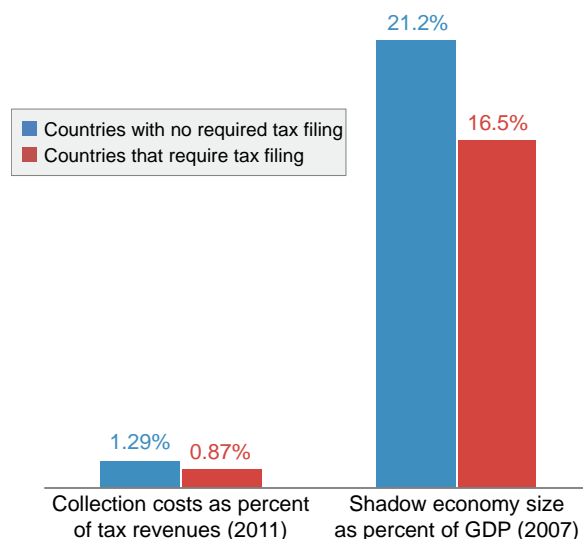
For the sake of comparison, OECD countries are classified into two categories: countries such as Israel that have not implemented mandatory filing for salaried employees, and countries where there is such an obligation.²⁴

The OECD countries that have mandatory filing are: Australia, Austria, Belgium, Canada, Chile, Denmark, Estonia, France, Germany, Great Britain, Iceland, Ireland, Italy, Netherlands, New Zealand, Norway (no data on collection costs), Portugal, Spain, Sweden, Switzerland, and the United States.

The OECD countries that do not have mandatory filing are: the Czech Republic, Finland, Greece (no data on collection costs), Hungary, Israel, Japan, Luxembourg, Mexico, Poland, Slovakia, Slovenia, South Korea, and Turkey.

²⁴ For the purpose of classifying the countries, data were used from several information sources: 1. Effective rates of tax payment channels in the OECD, oecd.org/site/ctpfta/Table-7-4.xlsx; 2. Worldwide-tax.com; 3. Europa.eu; 4. Kpmg.com.

Figure 10
**The shadow economy as a share of GDP and
collection costs as a share of tax revenues**
according to whether or not tax filing is mandatory,
average for OECD countries



Source: Noam Gruber, Taub Center for Social Policy Studies in Israel

Data: World Bank, Buehn and Schneider (2012)

Of the 10 OECD countries in which the size of the shadow economy is extremely small, only Japan and Luxembourg do not have mandatory filing. It is hard to compare Luxembourg, a tiny and rich country that is in effect a city-state, with other countries. In Japan, although the shadow economy is small even in the absence of mandatory filing, collection costs are the highest of all the OECD countries that did not belong to the former Communist Bloc. It would seem that the small size of the shadow economy in Japan is achieved by, among other things, exceptionally intensive enforcement.

On average, in the OECD countries that do not have mandatory filing, collection costs amount to 1.29 percent of revenues, that is, on average to collect 1 shekel in taxes, 1.29 agorot must be invested. Slovakia and Poland stand out for their high collection costs. The average estimated size of the shadow economy in countries without mandatory filing is 21.2 percent, slightly higher than the estimate for Israel, and ranges from about 10 percent in Luxembourg and Japan to almost 30 percent in Turkey and Mexico.

In terms of economic development, the countries that do not have mandatory tax reporting are very diverse. The per capita GDP in Turkey and Mexico, about \$17,000²⁵ in 2012, is among the lowest in the OECD, while the per capita GDP in Finland, about \$38,000, is higher than the OECD average, and the per capita GDP in Luxembourg, about \$91,000, is among the highest in the world.

For the sake of comparison, the 21 of 34 (61 percent) OECD countries that have mandatory filing are characterized by a higher than average level of economic development, as well as by a smaller shadow economy (16.5 percent of GDP on average, about 5 percentage points less than in countries that do not have mandatory filing) and lower collection costs (0.87 percent of revenues on average – lower by 0.4 percentage points, or about one-third, than in countries that do not have mandatory filing). The tax authorities in countries with mandatory filing must handle and process many more yearly reports, and therefore the fact that their collection costs are lower is slightly surprising. This may indicate a lack of efficiency on the part of the collection agencies in some of the countries that do not have mandatory reporting.²⁶

In this context, it is important to note that the costs of collection by means of mandatory filing, as presented here, are the costs to state

²⁵ American dollars weighted by purchasing power.

²⁶ In this regard, Blass (2013) argues that the significantly higher number of Tax Authority workers in Israel relative to the entire population as compared to the United States attests to inefficiency. It should be noted that collection costs' share of tax revenues in Israel, 0.68 percent, is in fact relatively low, especially compared to countries that do not have mandatory filing.

institutions only, and do not include the costs to taxpayers in terms of time, effort invested, and payment for tax counseling services. Those costs constitute another reason why it is necessary to simplify and streamline the income tax laws in Israel, and to eliminate the exemptions and reductions currently given, which contribute to distorting the entire collection procedure and making it more expensive.²⁷ However, the data clearly do not support the Tax Authority's claim that the implementation of mandatory filing necessarily entails high costs. It is reasonable, though, to expect that the change in the reporting system will entail exceptional expenditures in the initial period, both for training personnel and outreach and for a "trial period" of strict enforcement, which is necessary for generating sufficient response and habit changes from the public. Nonetheless, as emerges from the data presented in Figure 10, the claim that a transition to mandatory filing would increase collection costs in the long term has no grounding. If mandatory filing would facilitate a reduction in the size of the shadow economy in Israel, then it would seem quite logical to impose such a reporting obligation.

The intelligent use of modern technology can certainly lower the costs of the transition, both to the authorities and to citizens. According to OECD data, one of the prominent developments of the last decade in the tax field has been the creation of computerized systems, which leverage vast information accumulated from a variety of sources on the known incomes of a household for the purpose of creating pre-completed tax reports (OECD, 2013b). The household receives a yearly report, usually electronic, on its income and taxes, and it must correct the report and add any unlisted income, as well as submit receipts against expenditures for tax deductions. The entire reporting procedure is made accessible and can be performed online, simply and quickly. The more information that authorities can collect ahead of time to create pre-completed tax reports, the more blurred becomes the distinction between general reporting and taxing at the source, and accordingly, the lower the reporting burden on

²⁷ In this context, it is not surprising to discover that the Tax Counselors' Bureau in Israel supports the implementation of mandatory filing (Ozeri, 2012).

households. This is especially so for salaried employees, since their entire income is automatically reported to the authorities. In combination with data on property and expenditures, the concentration of information makes it possible for the tax authorities to conduct automatic searches for suspect households, the veracity of whose reports should be inspected. There is no doubt that the State of Israel's technological capabilities allow the automation of the tax system so that oversight will increase, whether by means of a broader reporting obligation and enhanced deterrence or by means of computerized searches for tax evaders, without significantly increasing the costs of the process either to the authorities or to the taxpayers.

A proposal currently under discussion in the Knesset, would make tax evasion a criminal offense under the Prohibition on Money Laundering Law. This initiative may provide the Tax Authority with a variety of tools against tax evaders, such as the power to prevent individuals from exiting Israel and the impoundment of vehicles. More importantly, it would allow the Tax Authority (Ministry of Finance) and the Money Laundering and Terror Financing Prohibition Authority (Ministry of Justice) to pool their information, thus providing a more robust infrastructure for identifying tax offenders. The concentration of information on household income and expenditures is vital, then, to an efficient monitoring system and reducing tax evasion.

3. Electronic Money, Reduced Use of Cash and Automatic Transaction Reporting

In May 2013, Visa Europe issued a report promoting the company's electronic payment system as a means of reducing the use of cash, with the aim of decreasing the size of the shadow economy in Europe (Visa Europe et al., 2013). Following this initiative, such a step was also discussed in Israel (Kaneh, 2013).

Cash transactions leave no trace, and are therefore most difficult to discover and tax. The relative extent of the use of cash is considered a

leading indicator for shadow economy activity. In countries characterized by a large shadow economy, the amount of cash in circulation relative to the total amount of cash and liquid deposits is higher, and vice versa – the lower the rate of income concealment, and the better the infrastructure for electronic payments, the less cash is used.

Cash, therefore, fulfills a dual role: on the one hand, it facilitates the creation of a shadow economy in that it allows transactions to be concealed from the authorities; while on the other hand, it serves as an indicator for the existence of the phenomenon. The more convenient and accepted electronic payments become, the more efficiently the authorities are able to monitor large movements of cash, thus limiting unreported transactions. It is clear, however, that as long as non-reporting remains the norm and cash transactions remain common and profitable as a simple way of concealing income, electronic payments will not replace the use of cash sufficiently enough to impact the shadow economy. It seems that the power of prohibiting large cash transactions in order to deter those who, from the outset, intend to break the law and conceal income is extremely limited. Any radical measure to significantly reduce the supply of cash would harm all who use it, for legal purposes or otherwise, and might cause economic damage and spark a public outcry. Ultimately, the outcome may be the use of cash in the form of foreign currencies as a substitute for the local currency. In Sweden, the country closest to the ideal of a “cashless society,” the transition to electronic methods of payment was entirely voluntary, with no coercion.

The concern is that the regulator, the Israeli government, will be too hasty to use the stick – punitive actions against the possession of cash, which could cause more harm than good – instead of focusing on the carrot – improving the electronic money infrastructure in Israel and rewarding individuals and businesses that choose to use it. The Antitrust Authority and the Bank of Israel have taken action recently against the credit card clearance monopoly and the arbitrary commissions, totaling about NIS 3 billion a year, charged to businesses for the use of credit instead of debit (Izasco and Koren, 2013). However, much more can be done to encourage electronic payment. Given that the relative cost of

reporting income is higher for small businesses, the electronic reporting of their transactions to the tax authorities should be made more accessible through the computerized taxation of their income and deductions. This would greatly relieve them of the bureaucratic burden of reporting, in terms of both time and accounting expenses. Such systems, which were designed in consultation between the tax authorities and the taxpayers, are already being implemented in the Netherlands and Denmark. An OECD (2013b) report describes the Danish project as follows:

“The central idea is the automatic flow of information on transactions between the business, its bank, the accounting system, and the collection agency. Thus, small business owners will no longer have to understand (and concern themselves with) complex tax regulations. Instead, they will be able to focus on their expertise, while the collection agency will have better certainty regarding the quality of their reports.”

As previously stated, the high tax rate on small businesses as compared with that on large companies creates an ostensible justification for the concealment of taxable income, and there is no reason to believe that the differential taxes are economically efficient. Furthermore, it can be reasonably expected that automatic taxation of small businesses will also save substantial costs for the Tax Authority, and provides justification for considering a significant tax discount on the income of small businesses who use automatically reported transactions. With regard to the implementation of mandatory filing, electronic receipts from such a system could entitle households to receive automatic tax deductions computed by pre-completed tax reports. This benefit could incentivize both small businesses and households to prefer electronic payments over cash transactions, thus reducing the extent of such transactions and making progress towards changing the norm.

4. Summary and Conclusions

The moral objective of shrinking the shadow economy is to distribute the tax burden more fairly, and the utilitarian objective is to simultaneously increase public spending, lower taxes, and reduce the national debt. The conditions for achieving these objectives are simple: eradicate the factors that incentivize taxpayers to conceal taxable income, enhance deterrence against the concealment of income, and change the social norms that regard the phenomenon with understanding and forgiveness.

Contending with the factors that incentivize taxpayers to conceal income demands a lowering of the tax rates for small businesses on the one hand, and a streamlining of the reporting process and a view of the taxpayer as a client on the other hand. When someone earning NIS 14,000 a month faces a marginal tax rate of almost 60 percent (including VAT), and is also forced to spend 20 hours a month dealing with the bureaucracy that surrounds the reporting, the temptation to conceal income is considerable. The tax authorities in the advanced countries establish clear goals for improving service quality and taxpayer satisfaction, and publish their performance on a yearly basis. These authorities conduct an ongoing dialogue with the tax-paying public, in particular with the owners of small businesses. This communication allows for organizational and technological improvements that streamline the reporting and collection process and contribute to the user experience.

Alongside easing the bureaucratic burden for truthful reporters, enhanced deterrence demands efficient and firm enforcement against evaders, far beyond what currently exists. It is necessary to root out the impression, which is largely justified today, that the chances of getting caught for tax evasion are low and that, even if concealment is discovered, the treatment of the offense will be forgiving. The high cost of the criminal procedure in terms of time and money has led to a decline in its use and the rise of several administrative alternatives, which themselves are hardly utilized (Or, 2013). It seems, however, that the short-run savings to the state in the costs of enforcement and punitive measures have led to a long-run loss, due to the debasement of reporting

norms. Serious crime demands scrupulous enforcement, and the performance of the advanced countries' tax authorities attests to the fact that there is no substitute for the deterrence that such enforcement produces. To that end, transparency regarding the scope of the Tax Authority's activity is required, as are clear punitive goals, immediate fines for any unauthorized delay in filing tax reports, as well as yearly monetary goals regarding the discovery of withheld taxes – as is customary in counterpart systems such as the American IRS or British HMRC. It is likewise necessary to reduce the bottlenecks in the judicial system by strengthening the taxation and economic departments in the State Attorney's Office, and by establishing a court for tax affairs with expert judges. There is great potential for leveraging information technology both to provide relief to taxpayers and to aid enforcement efforts. Such technology would allow merging and cross-referencing data from a variety of sources, so that a large number of files can be swiftly audited for suspicious patterns. These data can also be used to create pre-completed tax reports, which would greatly streamline the reporting process for households and facilitate the transition to mandatory filing with minimal burden. An electronic payment system that interfaces with the Tax Authority's computers would allow both the automatic taxation of businesses (saving costs for both the Tax Authority and the businesses), as well as automatic deductions to households for recognized expenses. The advantages of using electronic payments will induce both businesses and households to substitute them more and more for the use of cash.

In addition to easing the tax process and intensifying enforcement, changing public norms requires a public perception of tax collection as fair and expenditures as efficient. In Israel, it is commonly believed that taxes are invested in an inefficient and inequitable manner, so that powerful groups in and out of the public sector benefit more. The question regarding the efficiency of expenditures is beyond the scope of this work, but an important step in this area would be for all public entities to set measurable goals for improvement in efficiency and service to the public.

With regard to the fairness of tax collection, the public has a (justified) perception of inequality in the tax system, whereby the strong use their power to obtain tax relief, whether through tax planning or through the Encouragement of Capital Investments Law, the Office of the Chief Scientist, or direct bargaining with the government. To change the situation, it is necessary to promote transparency in the tax system, simplify the system and make it more accessible to taxpayers, fight aggressive tax planning, and implement a more reasonable distribution of the tax burden between small and large businesses. Small businesses have no real lobby nor do they have bargaining power, but they are very important to employment, competition and the growth of the economy. The Encouragement of Capital Investments Law needs to be amended to encourage investment and employment in both small and large businesses, as is customary in many countries. The preferential taxation of small businesses could be limited to income reported through the electronic payment system as described in this chapter, thus encouraging businesses to participate.

The size of the shadow economy in Israel reflects problematic norms among the tax-paying public, but also significant failures of the taxation system and regulation. Improving the functioning of the Tax Authority, leveraging information technology, easing the tax burden of small businesses, and transitioning to mandatory filing are necessary and possible steps that can dramatically diminish the phenomenon of tax evasion in Israel and increase available public resources.

Appendix

Appendix Table 1. **Tax rates for self-employed in Israel*, 2014**

Tax brackets (NIS)	Marginal income tax (%)	National Insurance (%)	Total marginal tax (%)	Actual tax (NIS)	Average tax rate (%)
5,280	10	9.8	19.8	556	10.5
9,010	14	16.2	30.2	1,684	18.7
14,000	21	16.2	37.2	3,541	25.3
20,000	31	16.2	47.2	6,375	31.9
41,830	34	16.2	50.2	17,340	41.5
67,630	48	0.0	48.0	29,724	44.0
More than 67,630	50	0.0	50.0	–	–

* 2.25 deduction points at a value of NIS 218 per point. Note the lack of correspondence between the income tax rates and the National Insurance rates (a reduced rate up to NIS 5,297 and collection ceiling at NIS 42,435).

Source: Noam Gruber, Taub Center for Social Policy Studies in Israel

Data: Israel Tax Authority

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