Tax Benefits for Retirement Savings in Israel

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This is a short summary, for the full paper (in Hebrew) see https://www.idc.ac.il/he/research/aiep/pages/policy-papers.aspx.

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Tax Benefits for Retirement Savings in Israel

The government of Israel provides tax benefits for long-term savings by an array of tax exemptions and tax rate reductions at each stage of retirement saving: the deposit of funds, the accumulation of the deposited funds and their withdrawal. In the past, tax benefits were also provided for provident funds with a maturity of 15 years, but these were cancelled in 2008. The remaining tax benefits are given for study funds with maturities of five years[1] and for retirement savings. Recently, the government of Israel began to reduce the tax benefits for retirement savings and has lowered the maximal wage for which benefits are given – from four times the average wage to two and a half times the average wage.[2] This change was intended to reduce the budget cost of the tax benefits and to provide a more progressive tax benefit model. It should be noted that the tax benefits for retirement savings are in addition to a large number of exemptions for savings and other types of activity, which totaled about NIS 47 billion in 2014. In the area of long-term savings, the net tax benefits total about NIS 13 billion annually.[3] In terms of GDP, these amounts are not excessive relative to other countries (OECD, 2010). There are tax benefits for retirement savings in many OECD countries and they fulfill a particularly important function in countries where there is greater reliance on saving in privately funded pension funds than on the public system. The provision of tax benefits to encourage savings was common in countries that enacted reforms to privatize the pension system.

In recent years, there have been increasing calls to examine the efficiency of such benefits, in view of the fact that they must be financed by higher tax rates on other channels. This is a particularly important issue because the benefits are provided to more well-off segments of the population, who are in general aware of the need to save for retirement and less prone to undersave for the long term.[4] It is generally argued that the main reason for granting tax benefits for retirement savings is the shortsightedness of individuals, who don't save sufficiently for their retirement. At the same time, and since rich individuals possess a great deal of wealth when they die, it is common to hear the opposite claim, i.e. that government intervention distorts the maximization process of individuals or alternatively it replaces

[1] The efficiency of these benefits has been questioned in recent public discourse, but this issue is beyond the scope of the present paper.

[2] As part of the government's recent proposed budgets (for example, 2013-14), a more drastic proposal was prepared by the Ministry of Finance, according to which the maximal income would be NIS 15,000 (about one and a half times the average wage).

[3] To this should be added the estimated tax benefits for severance pay.

[4] Appendix A of the full paper (in Hebrew) presents a model to analyze this issue and shows which deciles save.

savings that would have taken place in any case, without the intervention of the government.

In this policy paper, we analyze the current benefits from an economic perspective. To this end, we focus on three aspects of the issue: (1) an international comparison of tax benefits in various countries, with emphasis on those given for retirement savings; (2) a simulation of various alternatives for reducing the benefits for retirement savings and estimation of their financial implications; and (3) a simulation of the improvement in social welfare resulting from the cancelation of the tax benefits for retirement savings and their replacement by alternative policy measures to reduce poverty. The analysis shows that in comparison to other countries, the level of benefits in Israel is high, particularly at wage levels above the average. Estimation of the savings achieved from reducing the benefits under various scenarios shows that lowering the ceiling to twice the average wage will generate about NIS 800 million in additional annual tax revenues, an amount that the government will need to allocate to other purposes. In order to illustrate, we analyze various ways in which the additional tax revenues can be used to reduce the incidence and depth of poverty. It was found that increasing the income supplement to the old age pension reduces poverty far more than increasing either the old age pension and survivors' benefits or the negative income tax. We would emphasize that in principle the government can use the additional income to reduce the debt, cut taxes or increase expenditure. From a public policy perspective, it would be desirable that the released funds be used for goals with social priority. In view of the high levels of poverty in Israel relative to the OECD countries, we believe that examining the use of the funds to finance various poverty-reducing alternatives will be beneficial to policy makers when the time comes to examine the advantages and disadvantages of these alternatives.

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