EVALUATION OF THE INCOME TAX LAW OF 2011 AND ITS AMENDMENTS

FROM A SOCIOECONOMIC JUSTICE PERSPECTIVE

Evaluation of the Income Tax Law of 2011 and its Amendments from a Socioeconomic Justice Perspective

“Tax Justice, Budget Monitoring and Citizens’ Participation in oPt” Project

First Edition December 2015

Supported by OXFAM NOVIB

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FOREWORD

MIFTAH's strategic objective has always been to contribute to "To influence policy and legislation to ensure their safeguarding of civil and social rights for all sectors and their adherence to principles of good governance". In line with this, MIFTAH has conducted a study entitled: "Evaluation of the Income Tax Law of 2011 and its Amendments from a Socioeconomic Justice Perspective," as part of its project, "Tax Justice, Budget Monitoring and Citizens' Participation in oPT". The project was implemented in partnership with AMAN, Teacher Creative Center (TCC) and The Applied Research Institute - Jerusalem (ARIJ) with support from OXFAM-Novib.

Income tax is considered one of the most significant direct taxes. However, its application system has always been under review and modification and has yet to stabilize. Hence, this effort aims first and foremost at analyzing and evaluating the income tax policy and system in Palestine from the perspective of socioeconomic justice and according to international criteria for transparency regarding best practices in the administration of this system.

In order to produce a comprehensive evaluation, MIFTAH and its team have offered a comprehensive overview of income tax in Palestine, from the perspective of its vision, policy, legal texts and practical measures. The study also showcases the issues in dispute regarding the law and its application, in addition to ways of addressing and overcoming them.

Hence, the results, conclusions and recommendations in the study offer a comprehensive overview of income tax in Palestine and constitute a solid foundation for official and nongovernment bodies and for active and influential individuals in the field of economy and economic growth in Palestine. It offers them a focal point until this system can be developed in a way that will be more compatible with the conditions of the Palestinian economy, the requirements for its resuscitation and the requirements of socioeconomic justice.

We would like to thank everyone who contributed to the completion of this work. We would also like to thank our project partners and OXFAM-Novib.

Lily Feidy, Ph.D.
Chief Executive Officer
MIFTAH

1

THEORETICAL FRAMEWORK

Tax revenue is one of the most important sources for funding public expenditure, which is usually appropriated to channels that work to drive the economy and achieve the social welfare of the nation. Naturally, there should be a reasonable threshold for the tax burden imposed on individuals and organizations. Tax capacity (i.e. size/ structure of GDP and public expenditure; economic and social conditions of taxpayers; and the government's collection capacity) should be considered carefully when squeezing a limit for tax. If the actual tax burden– the ratio of the actual tax receipts to GDP– is in excess of an economy's relative/absolute tax capacity, concerns might arise regarding sustainable dynamisms of the local private consumption and foreign investment.

That is why most contemporary economic theories and applications assign the taxation system (including regulations, policies and procedures) great importance. It is the government that assumes the role of creating a conductive business enabling environment, thus bringing about a reasonable level of sustainable development based on justice and equality in wealth and income distribution.

Tax revenues are either direct (income and property taxes) or indirect taxes (VAT, sales tax, purchase tax and customs duties). The contribution of each type to the public finance varies by country and often depends on the tax system and the GDP structure.

The income tax in Palestine accounts for a scant 10 percent of tax revenues, while the remaining revenue comes from different types of indirect tax. This immense imbalance in the tax structure– with presumable inequalities in the system– requires thoughtful examination. Because indirect tax (especially VAT) is levied on basic and luxury goods and services consumed by the rich and the poor alike, it flies in the face of the principle of economic and social equity. On the other hand, direct taxes come for the most part from individuals incomes (deducted automatically by employers), while corporate income tax share is very low either because a large number of big companies are tax exempted (under the Investment Promotion Law) for many years, or because of limited progressive tax rates on high income earners. In equity terms, these facts put the Palestinian tax system in general and the effective Income Tax Law in particular in jeopardy.

Since the Palestinian income tax system– and its related policies set forth by the regulatory/executive framework– has undergone frequent amendments and is yet to settle down, it is imperative to conduct a sensible evaluative analysis. Determining the extent to which this system is effective and equitable will hopefully contribute to improving such a system, making it function in line the Palestinian context and enabling it to stimulate economic development within a framework of socioeconomic equity.

1.1 Objectives of the study

The main goal is analyzing and evaluating the Palestinian income tax system from a socioeconomic justice perspective and within international standards of transparency and best practices in the management of the tax system.

Narrower objectives, however, first need to be achieved:

- Examining developments the legal framework of the income tax had undergone in previous years;
- Assessing community engagement in building tax legislation, specifically the 2011 Income Tax Law and its amendments;
- Identifying controversial issues in this law and its amendments, including the problems/infringements and their impact on different categories of the community, especially marginalized groups (women, the poor, the camps, rural and endangered areas, etc);
- Identifying the tax burden and its impact on society and the economy, as well as the losers/winners;
- Making policy recommendations regarding the amendments needed to create an all-important socioeconomic justice.

1.2 Rationale

The findings are expected to elucidate the Palestinian income tax system, as well as its goals, policies and operational procedures. Part of the effort is the identification of the controversial issues in the law and its applications and ways to address such issues. The study recommendations are expected to inspire lawmakers to consider social and economic equity when they enact income tax laws and the executive bodies when they enforce the laws. Decision-makers will find the results beneficial when considering the interventions needed to achieve the ultimate goal. The tax policy, embedded in the overall fiscal policy, plays an important role not only in funding the government expenditure (usually allocated to public health & education services, business stimulation and social subsidies), but also in redistributing wealth and income among different segments of the society based on justice and equality. Tax justice, in turn, directly contributes to ameliorating economic and social equality.

1.3 Methodology

The methods/tools detailed below were used to reach the overall goal and the objectives of the study:

- A review of the income tax legislation, particularly the 2011 Income Tax Law and its amendments;
- A literature review: studies, reports and theories;
- Obtaining data from official sources for related statistics and analyses (such as the Ministry of Finance, the Palestinian Central Bureau of Statistics, the Ministry of Social Affairs, the Ministry of Labor and trade unions);
- Conducting specialized interviews and / focus groups with interested parties, as well as with representatives of official agencies, private sector and labor union;
- Holding a consultation meeting that brought together experts, government officials and representatives of the private sector and NGOs to discuss the methodology and the expected results;
- Hosting a public workshop with stakeholders to present the conclusions and recommendations of the study.

2

CONCEPTUAL FRAMEWORK

Tax policies have an outsized role in funding government expenditure and achieving socioeconomic development. An effective taxation would stimulate private investment and redistribute income in line with the principle of justice. One of the requirements of taxation effectiveness is keeping the actual tax burden (total tax revenue as percentage of GDP) within tax capacity (the upper limit of the tax revenue that takes into account the size/structure of GDP and public expenditure and its productivity; economic and social conditions of taxpayers; and the government's collection capacity). A proper tax burden is bound to generally ignite economic development and establish an enabling business environment, particularly creating jobs.

In addition to the burden size, how such a burden is distributed across taxpayers is to be taken into consideration. A certain tax burden might fit well for an economy; yet it may not be distributed in an equitable way, and as such damages might accrue to vulnerable groups in the community, which broadens the already existing social gap, making wealth highly concentrated in relatively few hands, as it is in Palestine. It is also of great importance to look into tax exemptions and holidays, which may be inconsistent with the economy's investment needs. Some breaks are lavishly given to non-labor intensive businesses or those that do not utilize hi-tech.

A prudent tax policy can achieve its goals if it considers a set of elements (Kharabsheh, 1996):

1. Adopting a progressive tax regime in order to:
   - avoid wealth concentration in the possession of few already wealthy individuals or entities, and redistribute wealth based on equality;
   - Progressivity should be based on the ease of earning money; Encouraging the establishment of joint stock public companies as well as small and medium-sized firms.
2. Defining fair tax brackets and rates based on the taxable income of the taxpayer together with tax burden and capacity;
3. Creating an enabling, stable investment climate to stimulate domestic and foreign investment, especially in productive sectors, such as agriculture and industry;

4. Developing national savings to meet investment needs;
5. Stimulating commodity and service export.

The effectiveness of tax management is not only weighed against the size of revenue it generates, but also against the extent to which the management commits itself to a well-thought plan that relates tax revenue to the macroeconomic indicators. In the first place, however, one should consider the implications for such revenue on a nation's social justice and welfare. We already know about some poorly-performing tax departments that can collect large amounts of public revenue from vulnerable segments that can be easily taxed (such as workers and employees in the public and private sectors) via 'source deduction'.

In this case, the tax burden may be proportionate to the economy's tax capacity, but definitely it wouldn't be equitably distributed across taxpayers. In other words, the bulk of this burden is borne by one category, which might not be the most fortunate. Part of the taxpayers may carry a tax burden that is smaller than their fair share, of course at the expense of another segment, and thus social justice– a fundamental goal of tax systems– is compromised.

2.1 Terminology

Tax capacity is defined as the upper limit of the tax revenue that takes into account the size/structure of GDP and public expenditure and its productivity; economic and social conditions of taxpayers; and the government's collection capacity.

Tax capacity is thus the optimal tax burden which strikes a balance between the government's need for tax revenue to cover its expenses and enhance its collection, on the one hand, and the ability of the taxpayers to pay taxes, on the other. Dalton (1991) spoke of two types of tax capacity: absolute taxable capacity (within an economy) and relative taxable capacity (within more than one economy).

The absolute taxable capacity refers to the maximum tax paying capacity of the economy. The tax is levied without producing unfavorable effects on the economy or individual/group taxpayers. Thus, when a tax system behaves in an adverse way, this means that tax revenues are beyond the absolute taxable capacity of the economy. Therefore, the first obstacle to determining the taxable capacity of a country is defining the negative effects and whether the tax capacity should be linked to government spending. It is a common sense that benefits from public expenditure should compensate for the loss arising from paying taxes.

The relative taxable capacity is a reference to the proportion in two or more nations in contribution towards public expenditure through taxation. Drawing conclusions between such contributions by different nations reveal discrepancies: whether either has exceeded the tax capacity relative to the other or remained within such capacity.

Tax burden is the total tax revenue relative to one indicator of income within a nation, such as GDP or GNP.

Tax equity is an ideal that involves a set of means that eventually make an individual/entity pay tax relatively willingly. Naturally, people pay taxes voluntarily only when they are certain that they contribute to the nation preservation according to their income and ability to pay and in a fair share. People, in this case, should be quite sure that their share is proportional to the shares of other taxpayers within the economy. Together with other procedures, tax equity is a prerequisite to achieving socioeconomic justice.

Tax equity is germane to the individual/entity tax capacity, thus producing two types of equity: vertical equity and horizontal equity.

Horizontal equity is the idea that people with a similar ability to pay taxes (same income and family size) should pay the same amounts of taxes.

Vertical equity refers to the idea that people with different incomes should pay different amounts of taxes, so that those with a greater ability to pay taxes should pay more.

Taxpayer: Under the law, the taxpayer is any individual, group or organization that pays taxes, deducts taxes for the benefit of the Tax Department or transfers taxes to the Tax Department.

Natural person is any individual or a partner general or limited partnerships or any person specified by the law.

Legal person is a non-human entity that is treated as a person for limited legal purposes, including public companies, limited liability companies, limited partnerships, foreign companies, whether resident or nonresident.

Taxable income is the gross income minus deductions of respectively retained losses, exceptions and donations as set forth by the law.

3

TAX SYSTEM IN PALESTINE

3.1 Legislative and regulatory framework

Income tax was imposed for the first time in Palestine during the British Mandate. The Income Tax Act No. 23 of 1941 entered into force as of September 1, 1941. Later, it was repealed and replaced with Income Tax Act No. 13 of 1947 which entered into effect on April 1, 1947. After the unification of the two Jordan banks under the Jordanian regime, the state enacted the law No. 50 of 1951, which unified tax legislation in the two banks. Later, the low was abolished and replaced with Law No. 12 of 1954, which exempted Jordanians outside the country from income tax and reduced the rates and brackets of progressive tax[1]. However, the great development came with Law No. 25 of 1964, which repealed the previous law, expanded the tax base and imposed higher rates on higher incomes, and provided for the formation of a court for income tax appeals, with the main task of hearing task disputes. The law also adopted the regional standard for imposing income tax. However, the law failed to explicitly define income, and instead it only described the taxable income. The law did not stipulate income regularity for tax liability, and rather made any income-generating transaction– such as money arising from the sale of brand names or copyrights– subject to taxation[2].

In the Gaza Strip, Income Tax Act No. 17 of 1947 remained in force. This law had some differences from the Jordanian law effective in the West Bank. For example, while the Jordanian law considered the incomes of the husband and wife as one taxable income, the British law in Gaza would consider the two incomes independently[3].

Following its occupation of the West Bank and Gaza Strip in 1967, Israel changed the tax system in the newly seized territories through a set of military orders, particularly Ordinance No. 2 (June 7, 1967), which stipulated that all taxes shall be paid to the chief commander of the Israeli military. Shortly after that, Military Order No. 28 gave

1 Rifai Al-hazaimeh: Income tax exemptions in Jordan, p. 22.
2 Saleh Khasawneh: Tax structure in Jordan, p. 27.
3 Jihad Zamari, the Institute of Law– Birzeit University: An interview with the Director General of Income Tax Department titled “A review of the Income Tax Law of 2004 and its amendments,” March 17, 2009.

the official appointed by the chief commander the responsibility of tax collection (under the Income Tax Act) and with full powers to appoint officials– in the Palestinian territories– with powers he deems appropriate. To further pressure Palestinian taxpayers, the Israeli amendments to the two laws in effect in the West Bank and Gaza (the Jordanian and the British Mandate, respectively) targeted tax brackets and rates, as well as year of estimation and method of collection. The military orders gave the 'military committees' full supervision powers over tax committees and tax courts of appeal. Under Military Order No. 406, the powers of income tax court of appeal were revoked and instead ordained to the objections committee based on a conjecture of Military Order No. 172. The objections committee was formed by the chief commander of the military and it comprised three members. Revoking the powers of the income tax court of appeal created a single-degree rather than two-degree litigation (appeal and cassation), thus assaulting the principle of justice.

The changes were basically meant to add funds to the state coffers and narrow the gap existing between the tax system applied in Israel and its counterpart in the occupied Palestinian territories. Needless to say, such changes were also intended to further the occupier's de facto policies, which generally aim to suffocate the Palestinian productive sectors. The arbitrary tax policy during nearly three decades was instrumental to undermining the existing and potential investments and putting spanner in the economic activity, thus keeping the Palestinian economy fragile and dependent on that of Israel. Under the new amendments, income tax was imposed on companies and factories, with a corporate income tax of 38.5 percent. Further, most allowable tax deductions[4] were eliminated, which overstrained existing factories and made other potential investors refrain from setting up new factories[5].

Adding insult to injury, Israel imposed VAT and production tax. The latter was levied on products manufactured locally for domestic consumption or for industry uses, with rates ranging from10 percent

4 Such as retirement, death, holidays and recreation and sick allowances, as well as the amounts paid to the insurance funds and other bad debts.

5 Abdul Fattah Abu Shokor et al., Manufacturing in the West Bank, An-Najah National University, Documentation and Manuscripts Center, Nablus, October 1991, p. 37.

on apparel to a massive 27 percent on cosmetics. VAT was imposed in 1976 first at 8 percent and then gradually up to 18 percent in 1991[6].

Since its inception in 1994, the Palestinian National Authority has borne the brunt of inherent economic and social distortions, a fact that required intervention in the form of a range of laws and policies, notably those related to taxation. The PA has thus enacted new laws and amended some existing ones to regulate business, particularly the Income Tax Law.

3.2 Types of taxes

Taxes are vital for healthy economies, whether developed or developing, and a major source of treasury revenues. Taxes are also used as a tool for fiscal policy, the social and psychological implications of which affect a wide gamut of population sectors. An effective tax system should account for equity, appropriateness and applicability, so that revenues will be large enough to meet expenditure needs, on the one hand, and stimulate business and investment, on the other.

With the contagious globalization creeping into most of global economies and with many nations now racing to join the GATT Agreement, Palestine has to respond and develop a national tax system that compares well to the other systems in the comparable neighboring countries. Because of the binding bilateral economic agreements with Israel, the PA has retained only a narrow margin for developing a tax policy that takes into consideration the Palestinian economic and social context independent of Israel.

Indeed, the PA does not have the power to enact or amend VAT and purchase tax laws or even determine customs duties for goods imported via Israel. It, however, has the full power to amend the income tax system and manage it. The Paris Protocol–signed on April 29, 1994– expressly states that the Palestinian Authority has

6 Ibid

the right to define and regulate its direct taxation policies, including income tax for individuals and firms as well as property tax. It also stipulated that the PA has the right to levy direct taxes arising from economic activities within its jurisdiction[7].

Below is a summary of tax types in Palestine:

First: Direct taxes
Income tax
Income tax is imposed and collected from all taxpayers working in the territory of a sovereign state. It is levied on business profits, salaries and other earnings generated by individuals and companies across all sectors in an economy. The amended Palestinian Income Tax Law No. 8 of 2011 defined two types of income tax:

A. Personal income tax
This is imposed on a Palestinian resident (natural person) who continuously resided in Palestine for a period not less than 120 days during the year in which the income is received. The tax is levied on the income derived from any business, job, profession or any taxable income in accordance with the law in force.

B. Corporate income tax
Corporate income tax is imposed and collected from private shareholding and public companies after deducting all costs and expenses that were spent entirely and exclusively for the production of gross income. Still, some expenses and costs are subject to taxation, such as certain proportion of doubtful debts, end of the service remunerations and mixed expenses (which are used for purposes other than the main business, such as capital losses). Investment businesses with an exemption certificate are tax-exempt under the Palestinian Investment Promotion Law No. 11 and its amendments.

7 See: Articles 3-11of the Paris Protocol.
Several paragraphs in the Protocol referred to the powers granted to the PA and Israel regarding the imposition, modification and collection of taxes from the Palestinians working in Israel and the settlements.

Property tax

The property tax legal frame in Palestine is inherent from the Jordanian property tax law No. 11 of 1954, which was designed to collect the property tax from within the municipal boundaries only. The tax is collected annually as 17 percent of the annual rent value of buildings and real estate after deducting 20 percent as consumption. Around 90 percent of the total amount of collected property tax is appropriated to the local government units, leaving 10 percent to the treasury.

Second: Indirect taxe

Indirect taxes are levied on consumption, production and import activities as well as on assets of real estate.

A. Local production value-added tax

VAT is levied and collected on all goods and services consumed by the population. Under the Paris Protocol, the Palestinian VAT rate shall not be 2 percent lower than or higher than the Israeli VAT rate. In 2012, this rate in Palestine was 17 percent before it was lowered to 14.5 percent following a reduction in Israel. However, it was raised to 17 percent following Israel's raise to 18 percent. Later Israel lowered the rate to 17 percent, but in Palestine, a similar reduction is yet to be made.

VAT is collected from companies and individuals registered in the value-added tax departments after deducting production inputs and sales tax. The total VAT cost is ultimately borne by the final consumer.

B. Purchase Tax

Purchase tax is imposed on certain goods such as alcohol, cigarettes, chemicals and automobiles.

C. Clearance tax (consolidated bill)

This is a value-added tax levied on imports from/via Israel. The Israeli side collects these revenues and then transfers them to the Palestinian Ministry of Finance at the end of each month through the clearance mechanism.

D. Fuel tax

Fuel tax is imposed on all kinds of fuels used in the Palestinian territories. There is no law in Palestine regulating this tax, and thus it is considered a purchase tax exactly like the tax levied on cigarettes and tobacco. The legal framework for this tax is the Jordanian Customs and Excise Law No. 1 of 1962.

E. Customs duties and excise

These are regulated by the Jordanian Customs and Excise Law No. 1 of 1962 and the Israeli military orders. This type of tax is levied on the private sector's commodity and service imports. Under the Paris Protocol, it is collected by the Israeli customs department on behalf of the Palestinian treasury.

F. Production tax

Except for agricultural products, production tax in Palestine is regulated by the Jordanian Law No. 16 of 1963 which defines tax rates on local products.

The present study focuses on the income tax system: legislation and management.

4

INCOME TAX

The incomes of both the natural and legal persons are taxed under this type of direct taxes. Apart from funding the state treasury, many nations use income taxes to realize economic and development goals, particularly through tax holidays granted to investors to stimulate economic activity in certain areas or in specific economic sectors. Income tax is also an effective policy tool aiming at achieving social equity within the society. Technically speaking, the ethos behind income tax is progressivity, in that taxpayers of higher incomes pay more than those of lower incomes. The revenues are then used to build public facilities and provide free services to the poor and low-income households. This way, the nation's wealth is indirectly distributed within the community with the ultimate goal of maintaining the economic and social stability.

4.1 Income tax regulatory framework in Palestine

Upon its inception in 1994, the Palestinian Authority had to run two legal/administrative income tax systems: the Mandate Palestine Income Tax Act No. 13 of 1947 in Gaza and the Jordan Income Tax Law No. 25 of 1964 in the West Bank. The PA then had to struggle with two different laws (with clear differences in texts and management procedures) that could not live up to the new facts on the ground. From the very beginning, the PA tried more than once to enact a single income tax law, but it was only ten years later (in 2004) that the PA succeeded in enacting the Income Tax Law No. 17 of 2004, a national unified tax law for the West Bank and the Gaza Strip.

The new law was in lieu of:

A. The Jordanian Income Tax Law No. 25 of 1964, effective in the West Bank.
B. Income Tax Act No. 13 of 1947 (Mandatory Palestine) effective in the Gaza Strip.
C. Israeli military orders issued since June 1967.

The new law has been applied to all companies, agencies and individuals in both the West Bank and Gaza. We can say without reservation that the approval of the Palestinian Income Tax Act and putting it into force in 2004 came too late and somehow created a loose awareness and commitment among a large number of companies and individuals (that form the tax base) due to the fact that both the Jordanian Law and the Mandatory Palestine Law were not suitable for the present time. Rather than establishing compliance as a national duty and treasury source of funding, they indeed inspired tax evasion and avoidance.

Upon the operation of the law, a range of problems/gaps emerged: negative impact on the private sector and foreign investment; objections by individual/business taxpayers; and poor compliance in conjunction with the Palestinian divide in 2007. Substantial amendments were thus made under the Presidential Decree No. 2 of 2008.

The Decree amended 14 Articles of the original law, particularly tax brackets and rates/types of exemptions. The tax rates of 8 percent, 12 percent and 16 percent were lowered to 5 percent, 10 percent and 15 percent, respectively. Under the 2004 law, the individual residents and their family members were tax-exempt for the purposes of house purchase, medical treatment, university fees and contributions to pension funds. The 2008 law made these exemptions a lump sum of USD 7,200 without taking into account the taxpayer conditions. The 2008 law also provided for 10 percent of annual income as allowable tax deduction for the taxpayer’s transport and contribution to the employee pension funds.

The amendments received support from wide segments of companies and agencies subject to the law.

Two goals have informed such amendments. First, the Decree sought to reduce the income tax rate on individuals and grant many exemptions in order to stimulate savings and investment. Second, the amendments were meant to reduce the corporate/investor income tax rate as compensation for the increased instability and uncertainty, which helps stimulate domestic and foreign investment.

Though they were supported by a wide range of businesses, the new amendments did not achieve their goals.

The tax regulatory policy continued to be reluctant and uncertain, which in early 2011 produced a new amendment: Law No. 8 of 2011. In our analysis, we will focus on 2011 Law and its later amendments. The analysis will specifically consider the Law from a socioeconomic justice perspective, particularly its ability to address the imbalances/ gaps in the previous laws.

4.2 Income Tax Law 2011 and its amendments
(see Table 1)

First: The 2011 Law
On September 26, 2011, the Palestinian President issued the Decree No. 8 of 2011 on income tax. The Decree by law was published in the Official Gazette on October 24, 2011 and entered into force as of that date in lieu of the 2004 law and its 2008 amendments. The new law was applied to incomes received in 2011.

The most important amendments in the 2011 Decree:

- **The tax collection currency**: The tax shall be levied and collected in shekels instead of US dollars.
- **Tax brackets and rates:**
  First: The brackets and rates shall be calculated in shekels instead of US dollars.
  Second: The tax rate on life insurance premiums was reduced from 10 percent to 5 percent.
  Third: The amendments gave the Council of Ministers, upon a recommendation from the Minister of Finance, the right to totally or partially change rates and/or brackets of income tax in accordance with the public interest.
- **Exemptions:** The tax exemption value became NIS 30,000 instead of USD 7,200 (equivalent to 24,000 shekels) for the individual resident. The amendment added an exemption of NIS 6,000 per year for paying the person's tuition fees, his/her spouse or his/her children's tuition fees at a university.
- **Tax-exempt income**: The Law repealed the exemptions specified in the previous law, namely the farmers' incomes and the rental value of buildings the person holding the title rents out. The

Law also lowered the exemption on capital gains arising from the sale of an asset or securities to 25 percent of those gains after they had been fully tax-exempt. The amendment also taxed the end of service gratuity for those receiving remunerations of more than one month for each year, which was fully exempted in the previous law. The last amendment targets employees under formal contracts only, while informal employees are not subject to this regulation. Unlike the previous law– which granted exemption to charities and civil society organizations only– the new law gave exemptions to all non-profit organizations.

Second: The 2012 Amendment

Based on the powers granted by the 2011 Law, the Council of Ministers proposed in early 2012 increasing the number of tax brackets to five instead of three (thus adding two new brackets, namely 22.5 percent and 30 percent on high-income earners).

The proposed amendments triggered a wave of discontent among businesses and individuals before the amendments were published to the public. The argument was that the law overburdens taxpayers who already suffer declines in their business activity. This stirred debate, forcing the government to enter into an open dialogue with representatives of the private and civil sectors. After a lengthy debate, they reached a compromise which abolished the two proposed brackets, replacing them with a fourth bracket with a rate of 20 percent of income. The 2012 amendment thus set rates at 5 percent, 10 percent, 15 percent and 20 percent.

Third: The 2014 Amendment

In March 2014, the PA president issued a Decree with some limited amendments to the original law (Presidential Decree No. 4 of 2014). The amendment re-granted the 100 percent exemption for capital gains profits arising from assets and securities (which were reduced to 25 percent in the previous amendment). The amendment also imposed a tax of 10 percent on the profits of micro-finance, and a similar rate on dividends, whether cash payments or shares of stock.

Fourth: The 2015 Amendment

The most recent amendment (No. 5 of 2015) was released in late March 2015. The amendment raised income tax exemption from NIS 30,000 to NIS 36,000. The tax brackets have been lowered; the 20 percent rate has been lowered to 15 percent for individuals and companies, leaving the 20 percent rate for monopolies only.

Table 1: Amendments made to the Income Tax Law since 2011

	Date of issuance	Tax brackets	Tax rates	Exemptions	Other important amendments
Law No. 8 of 2011 (the original law)	24/10/2011	In NIS 1-40,000 40,001-80,000 80,000+ + Companies	5% 10% 15%	• NIS 30,000 • University education expenses: NIS 6000 per year • House purchase: NIS 30,000 paid once • 25% (down from 100%) exemption for profits arising from trading with stocks and bonds • Tax-exempt for nonprofit organizations • Repealed exemptions for farmers' incomes • Repealed exemption for rental value • Repealed exemption for end-of-service gratuity paid under regulations in force with a maximum of one month for each year of service (this was not specified before)	• Repealed 2004 law which was later amended in 2008 • For the first time, the shekel is used in tax calculation instead of the USD • Gave the Council of Ministers the right to modify tax brackets and rates • Lowered tax on life insurance premiums from 10% to 5% of the premiums value
Council of Ministers Executive Order No. 1/116/13 of 2012	1/1/2012	1-40,000 40,001-80,000 80,001-125,000 125,000 + + Companies	5% 10% 15% 20%		
Decree No. 4 of 2014	11/3/2014	No changes	No changes	• 100% exemption from capital gains generated by trading in securities • Imposed a tax of 10% on the profits of microfinance • Imposed a tax of 10% on dividends, whether cash payments or shares of stock	Abolished the 5% tax on deposits
Decree No. 5 of 2015	31/3/2015	1-75,000 75,001-150,000 150,000 + + companies Telecomm operators and monopolies	5% 10% 15% 20%	• Raised income tax exemption from NIS 30,000 to NIS 36,000 • Exempted end-of-service gratuity paid under regulations in force to employees of universities with a maximum of two months for each year of service	

4.3 Reflection on the Palestinian Income Tax Law from a socioeconomic justice perspective

Income tax laws often instigate debate among various stakeholders with different/conflicting views and considerations. On the one hand, the government seeks to increase its revenues, thus increasing expenditure to improve the services provided to the population. On the other hand, the private sector and major taxpayers seek to reduce taxes on their profits, and take advantage of the tax holidays provided by investment promotion laws. Small taxpayers, vulnerable groups and low-income earners look for a law that eases their tax burden through exemption, brings social justice and contributes to redistributing income within the community. It is the role of the legislature and civil society organizations to create asatisfactory compromise between the interests of these different groups.

The Income Tax Law in Palestine is meant to achieve the same goals set forth in all other systems around the world. Yet, the Palestinian context is peculiar in terms of deteriorating economic and social scene. The status quo challenges undermine development and adversely impact economic social indicators, and alarming poverty and unemployment rates made a massive proportion of the population vulnerable to shocks. The private businesses are at stake given the further constrains imposed by the occupier, eroding competitiveness and restraining the potential to take off. According to the Palestinian Central Bureau of Statistics, the unemployment rate in Palestine reached 27 percent in 2014 (40 percent in Gaza and 20 percent in the West Bank), while poverty is at an alarming rate of 25.8 percent (38.8 percent in Gaza and 17.8 percent in the West Bank).

Such an uncertain context makes the job of lawmakers and decision-makers more demanding– having to enact laws that consider the complexities of such a peculiar context as well as the requirements of development and needs of vulnerable segments.

In this section, we analyze the Palestinian Income Tax Law of 2011 and its amendments. The analysis is based on exploring the law potential to achieve economic and social justice and establish equality. The results are supported by a survey of the views of various stakeholders: legislators, executive and technical agencies, taxpayers and civil society organizations.

Below, we provide some remarks on the provisions of the law:

- The law and the frequent amendments since 2011 raised many questions constitutionally and procedurally. It appears that the peculiarity of the context in which the law was enacted stirred up controversy and raised the ire of many human rights organizations and legal community. Naturally, laws are enacted exclusively by the Legislative Council. However, the peculiar context (state of emergency) in the Palestinian Territory since 2007 allowed the executive authority (represented by the government and the President) to enact urgently needed laws.

  A legitimate question that needs a carefully reasoned answer is whether such a law (and its later amendments) was really needed. Different legists believe that the law is not constitutional because it does not reflect an urgent need for the Palestinian economy (the only case when the executive authority can enact laws). In addition, such a law contravenes the Basic Law as it grants powers to the Council of Ministers to amend tax exemptions and brackets.

The report by the Legislative Council Panel on Financial and Affairs on the Income Tax Law No. 8 of 2011 included many legal, technical and equity observations (see Annex 3).

"We reject the law on two accounts. First, the parliamentary blocs cannot accept presidential decrees that do not express urgent needs, or even making amendments to some laws. Second, we do not accept to grant the executive branch legislative powers. The justification of the 'necessity knows no laws' by the government (regarding the needs of the public interest and the desired flexibility to address issues arising from changes) is by no means acceptable."

Qais Abu Laila, PLC Member

- Observers[8] made several reservations: the law gave powers to the Council of Ministers to modify exemptions (Article 12, Paragraph 2) and tax brackets/rates (Article 16, Paragraph 5), thus breaching the Basic Law Article 88 and the Budget Law Article 7 (that no tax shall be levied or exemption given without a law). In its justification of the amendments, the Ministry of Finance reasoned that the powers of the Council of Ministers were granted in 2008, and that nobody at that time questioned these powers. However, when we referred to the legal text, we found that the powers granted to the Council of Ministers were limited to amending the exemptions but not brackets or rates.

  The law was also severely criticized for granting unlimited powers to the Director General of Tax Department. In their defense, the Ministry of Finance officials said this provision is meant to reduce tax evasion, reasoning that there are many countries that grant such powers to Tax Departments, especially in cases of peremptory tax where litigation might take several years. Here, we need to recall that tax evasion in Palestine was estimated at 37 percent during the past few years[9].

- Technically speaking, income tax laws seek to fulfill three main objectives: financial (increasing treasury revenues); economic (stimulating the economy and promoting investment); and social (achieving social equity in the distribution of income and access to public services). The three objectives represent the spirit of the related laws.

  Given the context in which the law was enacted, a meticulous and objective critical consideration might conclude that the tax law could not equally realize the three envisioned objectives. Its focus on increasing revenue (the first objective) was definitely at the expense of the other two objectives (the economic and the social). As evidenced by the budget speeches and national plans, the Palestinian government seeks to rely on its national resources, rather than on foreign aid, in financing the public expenditure.

8 An interview with Qais Abu Laila, PLC member, September 21, 2015.
9 Qubaja, Ahmed. Master Thesis: "Tax evasion and tax ethics." Hamburg University, Germany, 2010.

Our strategy is to increase the national sources of funding so as to safeguard our political will, further our political independence fand empower the PA to meet the urgent needs of the population.

Salam Fayyad, a former prime minister

The philosophy behind the law, based on the assumtion that the budget will rely on taxpayers to account for its expenditure, should be reconsidered. We have to bear the occupation burden, which is now borne by the donors.

Bassam Salhi, PLC member

Obviously, the government seeks to increase tax revenues by expanding the tax base and making subject to taxation additional incomes that were previously exempted (particularly, life insurance, farmers' income and capital gains arising from trading in securities)[10].

Taxing agricultural income, for example, overlooks the fact that this sector is intentionally targeted by the occupation, and it impacts a wide range of social groups and low-income earners in terms of both production and consumption. Data show that agricultural holdings in Palestine are small in size (33.6 percent of holders own holdings with less than 3 donums). Agricultural holdings constitute the main source of income of the holders (42 percent of holders are farmers), and around 6.7 percent of agricultural holdings are owned by women[11].

The Council of Ministers reported in its meeting held on April 7, 2015 that– within the government's policy of supporting agriculture and resilience of farmers– it would complete the procedures for exempting farmers from income tax before the end of April.

Thus, any tax imposed on agricultural will increase prices, which weakens the ability of the Palestinian families to afford such products

10 An interview with Mr. Salah Odeh, General Manager of Ramallah and Al Bireh Chamber of Commerce, September 20, 2015.

11 Survey of agricultural holdings in Palestine 2010-2011, PCBS.

for reasonable prices as businesses can always shift the tax burden to consumers.

The government's wish to increase the public treasury revenues from taxes often collides with many determinants prescribed in the law, particularly the focus on a limited proportion of traditional taxpayers (major taxpayers) and fixed-term employees, as well as subjecting new incomes to tax and refraining from expanding the tax base through the inclusion of the self-employed (such as lawyers, doctors, engineers, etc).

Under the current Palestinian tax system, the tax base is relatively narrow and the tax department does not have the tools to assess real incomes for many segments of the population. One study[12] estimated the tax on the individual self-employed taxpayer at NIS 270 per year on average, which means that the average annual income of a self-employed taxpayer (doctors, engineers, etc) is only NIS 41,000 (or NIS 3,417 per month), which is completely unrealistic and deceptive.

The data in the Table below show changes in income tax revenue during 2011-2014. The figures provide a picture of the extent to which the government could/couldn't achieve the goal of the amendment, namely increasing the contribution of income tax to total revenue.

Table 2: Income tax revenues as % to total domestic revenues and total revenues, 2011-2014 (NIS millions)

Year	2011	2012	2013	2014
Income tax revenue	474	662	714	685
Total revenue	7,737	8,423	9,181	10,445
As % to total revenue	6%	8%	8%	7%
Domestic revenue	1,727	1,852	2,157	2,149
As % to domestic revenue	27%	36%	33%	32%

Source: Ministry of Finance

As the Table reveals, the amendments to the Income Tax Law has done little to increase the contribution of income tax in the total and domestic revenues. Despite the significant increase in 2012 income tax revenue, its contribution has remained relatively low, reaching

12 Qubaja, Ahmed. Fiscal sustainability of the PA: Experience and future prospects. MAS, Ramallah, Palestine.

only 8 percent at best.
In other comparable economies in the region, the income tax contribution to total tax revenue reached 17 percent in Jordan and 28 percent in Egypt, not to speak of the 70 percent reported in developed economies.

To shed light on the second (economic) and third (social) objectives, we will consider economic and social data to demonstrate how poorly-performing the Income Tax Law and its amendments were in improving the economic and social conditions of the population. According to PCBS data[13], poverty rates among Palestinian households did not improve, remaining at high levels since 2001, with the percentage of households below the poverty line reaching 28 percent in 2001. The 2011 Law virtually failed to improve the economic situation of the Palestinian families, where poverty levels remained at the same rates reported before 2011.

PCBS data[14] also show that unemployment has continued to be the most challenging socioeconomic problem in the past few years. The Income Tax Law and its amendments have not substantially contributed to increasing jobs or reducing unemployment rate in the Palestinian Territory. The new regulations have not helped raise the income of individuals. According to the PCBS[15], the per capita GDP has not substantially improved in recent years. In 1999, it was USD 1,724, and 15 years later (during which the Income Tax Law and its amendments entered into force), it remained virtually unchanged at USD 1,735.

Nor has the level of public services seen any concrete improvement though the Law and its amendments sought in the first place to increase the treasury revenues, and eventually spending on public services. Development projects, including infrastructure and building schools and hospitals, have been almost entirely funded through foreign aid as developmental expenditure has not increased in recent years and remained at a scant 1 percent of total public spending. We are quite aware that the external factors (primarily those germane to the Israeli occupation and its constraints, as well as the relatively meager effectiveness of foreign aid) are the major

13 PCBS: Household expenditure and consumption survey, different years.
14 PSBS: Labor force survey, different years.
15 PCBS: National Accounts, different years.

impediments to economic growth and development. However, the performance of government agencies and the legal system regulating economic activities remain an important factor influencing economic performance and social indicators. According to relevant data, the performance of public agencies, businesses and civil society organizations and legal framework governing economic activity has not contributed to improving the economic performance or achieving the envisioned goals of sustainable economic and social development.

- Much debate has centered on the most appropriate number of tax brackets in the Palestinian context. Undoubtedly, increasing the number of brackets would improve economic and social equity and distribution of income; yet, the more the brackets, the highest the costs and the more the human resources needed for collection.

In economics, the process of determining tax brackets is guided by two theories. The first proposes 7-10 brackets, while the second recommends only 3 on the account that a small number of brackets would reduce costs and tax evasion.

Proponents of the first theory believe that the more the brackets, the higher the opportunities for achieving social equity and the better the distribution of income. This method, however, compounds the tax assessment burden and triggers more evasion. Proponents also argue that a small number of brackets would compromise social justice in that it levies the same amount on individuals earning NIS 150,000 per year (the highest bracket, with 15 percent) and companies that might reap millions in profits a year[16].

In the 2012 amendments, the Palestinian legislator (i.e. the government) tried to increase the number of brackets to five, but later it had to reduce the figure to four after the proposal came under severe criticism from the private sector.

16 Later in the study, we will examine (in figures) the distribution of the tax burden and social equity under the current tax brackets.

- The deductions the Law made reveals partiality to the wealthiest segments (companies and major taxpayers). It gave lavish expenses deductions reaching 11 percent of the profits of companies, including 2 percent for training, 2 percent for R & D, 2 percent for compliance with specifications, 2 percent for market search, 2 percent for the head office spending on branches and 1 percent for hospitality). Other itemized deductions for companies include losses resulting from replacing machinery, and debt and risk allocations, and others. These amounts might reach millions of dollars annually, compared to a lump of NIS 36,000 for individuals.

- Two important amendments were made to the provisions regulating taxation of pension salaries. The 2004 Law gave full exemption to these salaries. The first amendment to the 2011 Law granted exemption for end-of-service gratuity paid under regulations in force with a maximum of one month for each year of service. The 2015 amendment extended exemptions to end-of-service gratuity paid under regulations in force to employees of universities with a maximum of two months for each year of service. The amendment, thus, kept the end-of-service gratuity (with a maximum of one month for each year of service) subject to taxation (save for employees of universities).

At first, we need to express deep concerns regarding the tax provisions relating to the pension system, with explicit breach of the Palestinian labor law, which grants those who are wrongfully discharged a gratuity equivalent to a value of a salary of two months for each year of service. As such, 50 percent of the compensation will be subject to tax. According to the labor union, this is prejudice to the right of the unprivileged workers who represent a large segment of the population. Indeed, many private and civil society organizations grant generous end of service benefits, giving retirees more than a month for each year of service. Thus, the Law is expected to trigger controversy when employees are discharged or retire.

- As the 2011 Law (and its later amendments) entered into force, it set the annual exemption maximum at a lump sum of NIS 30,000 before the amendment raised it to NIS 36,000, without taking into account the number of dependencies in a family. The 2004 Law was more equitable (taking the social conditions of the taxpayers into consideration), granting an exemption of USD 500 for each member in the family, including parents, spouse and first and second class dependent children.

- The 2011 amendment was also a departure from the principle of supporting students seeking higher education, especially children of poor households. While in the 2004 Law, all dependencies seeking higher education would be entitled to exemptions, the 2011 Law limited the number of tax-exempt students to only two. The 2004 Law also set the exemption amount at USD 2,500 per family member no matter the number of family members. The 2011 Law lowered the amount to NIS 6,000 for a maximum of two students each year. The 2011 Law does not take into account the increasing willingness of poor families to send their children to universities, and now many families have to fund education for more than two children as the size of the Palestinian family is relatively large (5.3 members), according to the PCBS[17]. To say the least, the negative impact on poor families could have been reduced if laws/policies provided for adequate allocations to fund needy university students' grants/loans.

In parallel, the Law abolished the medical treatment exemption granted by the previous law provided that the supporting documents should be presented and that the exemption should not exceed the annual income of the taxpayer. Although more than 85 percent of the households that receive assistance from the Social Affairs Department receive free health services– under the government health insurance system (in addition to health services provided to the refugees by UNRWA)– healthcare is still of low quality, and therefore patients rely on out-of-pocke spending for medication in private facilities at home or abroad. Under such conditions, tax exemption for treatment expenses should have been considered.

17 http://www.pcbs.gov.ps/Portals/_Rainbow/Documents/e.htm

- The 2011 Law granted companies and employers exemptions on rental value of the houses and rents paid for business purposes. In contrast, it did not give individuals exemptions for expenses arising from renting houses (compare the right to adequate housing as enshrined in the Universal Declaration of Human Rights). For comparison purposes, the reader might need to know that the 2004 Law granted individuals an exemption of up to USD 2,000 per year per family.

  The 2011 Law provided for 40 percent of municipal tax paid as expenses. By doing so, it did not differentiate between a person who lives in his/her own house/apartment and the landlord who owns dozens of apartments.

- While the Law raised the value of the one-time exemption for purchasing a house from USD 5,000 to NIS 30,000, it lowered the value of the exemption from the amount of actual interest paid on housing loans to NIS 4000 for a period not to exceed 10 years (i.e. a total of NIS 40,000). The exemption in the previous law was USD 2,000 without a time limit. For illustration, under the previous law, a person receiving a loan to buy an apartment with a 20-year repayment plan was entitled to an annual exemption of USD 2,000. In the current law, the value of the exemption during the repayment period will not exceed NIS 40,000. In addition to cutting the value of the exemption, small taxpayers (who own one credit-financed apartment) and wealthy taxpayers (with multi-storey buildings financed by bank loans) are put on equal footing.

- The 2004 Law granted full exemptions for profits arising from trading in securities. The proportion of exemption was lowered to 25 percent in the 2011 Law. Later, however, the 2014 amendment re-granted such profits full exemption. Of course this stimulates trading in securities, but it compromises the spirit of social justice when it makes no distinction between those who trade in securities in order to improve their economic conditions (usually low and middle-income earners) and major investors with a large volume of profits generated from trade in securities.

4.4 Applications of the Income Tax Law

An effective law should yield voluntary compliance from the target individuals, groups and organizations. However, how the law is enforced by the executive branch and the way management behaves also remain essential to determining compliance and achieving the envisioned goals.

When the 2011 Law and its later amendments were approved, they triggered discontent from a wide range of stakeholders. Both the provisions of the law and the approach to enforcing it were severely criticized. Below we list some highlights on the problematic issues in the Law and its enforcement mechanisms:

- The Law taxed pension salaries (with more than one month for each year). Apart from the fact that this procedure explicitly breaches the Palestinian labor law– which grants those with severance a gratuity equivalent to a value of a salary of two months for each year of service (i.e. only one month is taxed)– important questions are being raised about the methods of calculating the pension tax. Will the tax dues be taken as a single payment or in installments? How will the taxation departments act when an employee borrows from his/her savings and quits before paying back? Will the end of service gratuity benefit from exemptions granted by the law (such as the annual exemption and other income deductions)?[18] As yet, answers to these questions do not exist and the Tax Department has not yet faced similar problems, and it seems that the decision to tax pensions is currently frozen.

  Social equity is compromised when a tax system targets pensions. Retirees worked hard and saved hard all their lives to have their gratuity, which is unfortunately being equated with a reward or a gift a person receives without effort. Also, the Law imposes the same rate on high and low pension salaries.

- The provision taxing farmers' income has instigated discontent from farmers and their representative societies, as well as from

18 An interview with Shafiq Awashreh, certified auditor, September 17, 2015.

consumer protection associations. Apart from its role in building national resilience and steadfastness, agriculture provides food security for consumers. At the technical level, opponents anticipate great difficulties in calculating the income of farmers, the majority of whom do not organize their business in administrative and accounting records that show income and expenses. Indeed, the majority of agricultural holdings and projects are informal".

- Farmers always raise questions regarding the practical methods that should be in place to regulate VAT rebates, with documented delays from the government. Though they in principle reject imposing income tax on their production, the farmers finally acquiesced and even proposed a mechanism in which their tax rebates are swapped with their income tax, but this offer was disregarded by the Taxation Department, which ultimately hinders the enforcement of the law. On the other hand, the legislation stipulated that the annual income of less than NIS 100,000 is not subject to taxation. The incomes higher than that are taxed the same rate no matter how large the income is, thus disregarding disparity between large-scale and small-scale farmers and the socioeconomic conditions of the latter segment.

The government's policy is by no means an enabler of the development of the agricultural sector. While the Israeli farmer in the settlements receives subsidies of up to 37 percent, the Palestinian farmers are subject to taxation, which undermines their competitiveness, thus pushing them to refrain from investment in the sector and encouraging them to evade taxes through denying the Tax Department access to bills for purchases from the Israeli market[19].

"The farmers in different governorates gathered outside the Tax Departments to protest taxing agriculture. The government's pledge in April to repeal the tax has yet to be fulfilled. We are planning to intensify our movement and mount a central protest outside the Cabinet building. We expect several surprises from the farmers during the protest."
Abbas Milhem, the Palestinian Farmers Union

- One of the main impediments to enforcing the law and making it fulfill economic and social equity is the poor coordination between

19 An interview with Abbas Milhem, Executive Manager, The Palestinian Farmers Union, September 17, 2015.

the income tax departments, on the one hand, and regulatory bodies and representatives of taxpayers, on the other. Examples of such bodies/representatives include Palestine Capital Market Authority, Palestine Monetary Authority, Palestinian Engineers Association, Palestinian Contractors Union, Palestinian Bar Association and Palestinian Medical Association. Given the weak coordination with these bodies, the tax departments will find it very difficult to spot the economic activities, and thus the incomes of individuals working within these institutions.

The law assigned the function of handling many issues to ad hoc regulations and instructions. Not all of these instructions have been released yet; and it is expected that they will trigger much indignation once they are made public, particularly as the source is the executive authority (the Cabinet) not the Legislative Council, which means the taxpayers will continue to suffer for a long time. For some, the regulations would be as imprudent as the law that stipulated them.

"The law has many shortcomings. It does not address some issues relating to incomes, including the gains on share sale (public offering); taxes paid abroad on income generated abroad (and subject to taxation abroad). The Law also made the shekel the calculation currency, which means that at the end of the fiscal year, the financial statements for companies that manage accounts in a currency other than the shekel will be denominated by the shekel, which produces significant financial positive/negative differences. The Law says nothing about its approach to dealing with such differences. Prior to the 2011 Law, these items would be included within shareholders equity, and thus exempted from tax."

Sameer Huleileh, the private sector

Officials in the Ministry of Finance report that– owing to poor financial resources, lack of logistics and limited human resources and weak compliance by different taxpayers and their sectors – the taxation departments face significant difficulties in implementing the law. The Ministry officials believe that poor awareness of the role of income taxes in achieving equity makes the enforcement of the low much more difficult. According to MoF officials, compliance is weak, with a high proportion of taxpayers avoiding registering their businesses at the Tax Departments[20]. Such a state would encourage tax evasion; force the Tax Department to bring many cases before the court; and make the Department staff overworked, having to comply with the letter of the Law and to deal with a large number of tax dodgers.

Since income tax is collected on an annual basis, the Law retroactive application to incomes received in 2011 did not cause any problem. Returns (declarations) of a large number of taxpayers have been under consideration by the Tax Department for several years, which makes it easier to work out the tax amounts under the new Law[21].

"Naturally, an income tax law is a social legislation that seeks to redistribute income and achieve greater social equity. That is why it should be part of an integrated and harmonized legal, economic and social system. However, the exemptions granted to large projects under the Investment Promotion Law impair the Income Tax Law and undermine the envisioned social equity"

Fida Abu Hamid, the Ministry of Finance

- When it enacted the 2011 law and its amendments, the government envisioned that the new law would be enforced in both the West Bank and Gaza Strip. Within the action-reaction context between the PA in Ramallah and Hamas government in Gaza, the President issued in 2007 midyear (and following Hamas seizure of the Strip) a decree exempting all taxpayers in the Gaza Strip from income tax. The Law, thus, remains effective in the West Bank only.

4.5 Community participation in enacting the Income Tax Law and its amendments

As economic and financial laws, particularly the Income Tax Law, have manifold bearings with direct impact on a wide gamut of segments in the society, these laws should be part of the human centric principles. Part of the effort is building a broad engagement

20 An interview with Hamza Zalloom, Director General of the Tax Department, the Ministry of Finance, September 20, 2015.
21 An interview with Ms. Fida Abu Hamid, Director General of the Palestinian Institute for Tax- Ministry of Finance, Former legal adviser in the ministry, September 20, 2015.

from those who will be potentially affected by or interested in the legislation. This also involves keeping the public informed of the results of dialogues/discussions about the potential laws through various media and channels. There are many different public participation mechanisms, including large-scale consultations and meetings with representatives of the public sector and civil society organizations. Although reaching an absolute agreement seems impossible given the different interests of parties, broad community participation would be a win-win approach where all parties benefit from the outcome, albeit to varying degrees.

In Palestine, poor community engagement is reported in building legislation. The influence of community organizations and the public sector on the decision-making process is minimal. Executive agencies in Palestine often develop economic policies, national plans, the general budget and a number of economic and financial laws without bothering to make a room for public engagement. They unfortunately do the same when developing tax regulations. Parties affected by the law have made a set of observations on the government behavior regarding the enactment of the Income Tax Law and its later amendments.

"When the government drafted the FY 2014 budget, it did not consult the Legislative Council. In the FY 2015 budget, the government claimed that the budget was approved only after consulting with the Legislative Council, which is not true. The government pursues an exclusion policy when developing economic and financial policies and regulations. There is an intentional policy of excluding the Legislative Council, and, as it may appear, the government has determined to pass legislations without being subject to legislature control."

Qais Abu Laila, PLC Member

It seems that the absence of the Legislative Council (or intentional disestablishing) since 2007 has weakened community participation and reduced the role of civil society organizations. The Palestinian Legislative Council, no matter how effective or influential, remains an important platform to accommodate divergent views. In technical terms, it is the body with the inherent right to enact laws and control the executive branch.

In a letter to the Palestinian President, the Legislative Council Panel on Financial and Affairs demanded a repeal of the Income Tax Law of 2011. The demand received a negative answer. The draft bill, proposed by the government and seen by the Panel for pre-legislative scrutiny, was amended and published in the National Gazette, overlooking all legal and technical observations by the Panel (see Annex 3). This is decision-making disarray to the exclusion of the legislature and its role in regulating the economic activities.

"The Income Tax Law and its amendments were immoderate in bestowing to the private sector. The government would even show off its identification of the private sector priorities, certainly at the expense of less fortunate/ less influential segments."

Qais Abu Leila, PLC member

The private sector, in turn, criticized the process of drafting, approving and amending the Income Tax Law. The argument is that given the challenges the private sector has to deal with– particularly those imposed by the Israeli constraints– it was essential to develop a tax incentive policy that stimulates investment and enhances resilience and competitiveness of businesses. Representatives of the private sector[22] say they did not engage in the process of drafting the Income Tax Law, nor were they consulted regarding the later amendments. Some believe that the community participation in the current law is insignificant compared to the situation before 2007, when the affected/interested parties and their representatives from the private sector would be involved in the process through consultations and discussions hosted by competent legislative institutions, mainly the Legislative Council[23].

22 An interview with Salah Odeh, Director General of Ramallah and Al Bireh Chamber of Commerce, September 20, 2015.

23 An interview with Khalil Rizq, Head of Federation of Palestinian Chambers of Commerce, October 12, 2015.

> "There is absolutely no point holding a community dialogue on the Income Tax Law after the law takes effect. The private sector and its representatives were not engaged in the process of enacting the law and its later amendments. Therefore, the law provoked the ire of the private sector and other sectors in the community. In short, the law has failed to achieve the concord and balance needed in such cases."
>
> Salah Odeh, the private sector

The less fortunate segments also have something to say about the process of building tax laws. Though they are the most affected by tax laws and other regulations, these segments have historically had a minor role in drawing tax policies. The best that the government could do was inviting representatives of the working class to attend the national dialogue sessions held following the 2012 amendments. The type and scale of engagement were inappropriate, where representatives of small businesses and farmers' associations were completely disregarded. The meeting did not produce important changes to the Law or further tax exemptions to vulnerable groups. Local civil society institutions, research centers and universities held several meetings to discuss the Income Tax Law and its amendments. Economic and financial experts gave presentations, exchanged working papers, made observations and provided policy recommendations to the government so that it can make the necessary amendments. However, the efforts have never been able to get off the shelves as the government skipped over them when it made the amendments.

5

ANALYZING THE TAX BURDEN

Tax burden is the total amounts of taxes paid by a taxpayer (companies, individuals and organizations). There are several ways to measure the tax burden. One recognized method is working out the total tax revenue relative to one indicator of income within a nation, such as GDP or GNP (in constant prices). Tax burden is influenced by several factors, including:

- The legal framework potential to expand the tax base and increase tax revenue;
- The efficiency of the Tax Department and national governance;
- GDP[24].

It is expected that the lower the GDP, the higher the tax burden. Typically, effective tax departments and tax legislation reduce tax evasion and broaden coverage, which in turn increases revenue from tax and compounds the tax burden.

It is also important to know the extent to which taxpayers can tolerate the burden of taxes; i.e., the taxable capacity (the upper limit of the tax revenue that takes into account the size/structure of GDP and public expenditure and its productivity; economic and social conditions of taxpayers; and the government's collection capacity). Tax capacity is thus the optimal tax burden which strikes a balance between the government's need for tax revenue to cover its expenses and enhance its collection, on the one hand, and the ability of the taxpayers to pay taxes, on the other.

The tax burden in the Palestinian territories has seen many changes resulting from broader changes in tax revenue and GDP. While the tax burden reached 21.8 percent in 2000, it dropped to 16 percent due to a decline in tax revenue following the Israeli and international blockade placed on the Palestinian economy and the government that Hamas formed after its win of the legislative elections. The tax burden then jumped to a historical high of 27 percent in 2007-2008 before settling down at 21 percent in 2010; i.e., before the adoption of the new law (see Figure 1).

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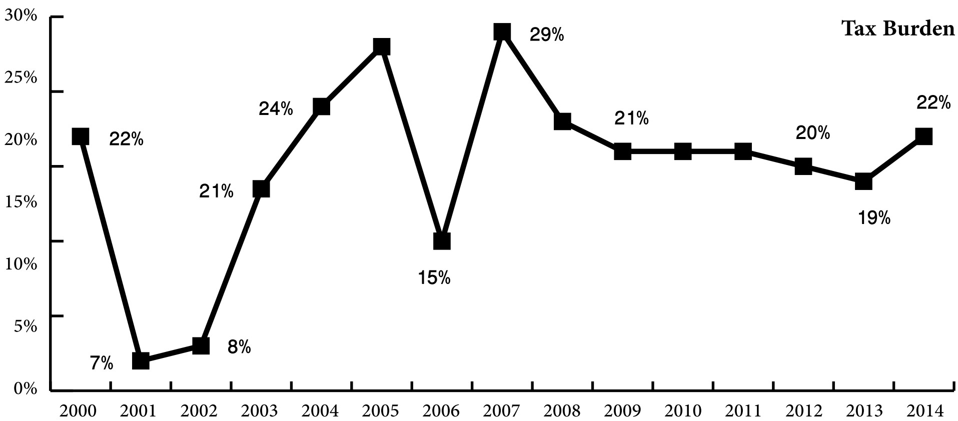
24 Abdul Karim, Naser; and Mohammed, Ruslan (2012). The PA tax policy and its potential to motivate private investment. Palestinian Affairs Magazine, the Research Center, PLO.

Figure 1: Tax burden in the Palestinian economy (2000-2014)



Source: The authors worked out the rates based on data obtained from the Palestinian Central Bureau of Statistics and the Palestinian Ministry of Finance.

5.1 Tax burden in figures after the amendments made to the 2011 Law

According to GDP and tax revenue data, the tax burden fell to 19 percent in 2011, the year the 2011 Law was issued. At face value, the burden declined in 2011, while indeed it saw some increase, but by a rate less than the significant GDP growth in that year (15 percent).

In 2012, and in conjunction with the amendments (modifying tax brackets) which triggered heated debate, the tax burden fell to 20 percent; the same figure was also reported in 2013. A year later, however, the rate saw a marked increase resulting from a surge in government revenues (see Table 3).

Table 3: Tax burden in Palestine 2003-2014

Item	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Net revenues	747	1,050	1,370	722	1,616	1,780	1,549	1,845	2,176	2,240	2,320	2,791
Nominal GDP	968	4,329	4,832	4,910	5,506	6,674	7,268	8,913	10,465	11,279	12,476	12,766
Tax burden	19%	24%	28%	15%	29%	27%	21%	21%	21%	20%	19%	22%

Source: The authors worked out the rates based on data obtained from the Palestinian Central Bureau of Statistics and the Palestinian Ministry of Finance.

For clearer picture of the Palestinian tax burden, we present figures from other comparable countries. As Table 4 clearly shows, the tax burden in Palestine is relatively higher than in the majority of the countries in the region. There are several explanations for such high rates in Palestine[25]:

- Higher rates of tax evasion in other countries compared with Palestine (around 40 percent in Egypt and 73 percent in Algeria).
- Differences in the tax systems (for example, most of these countries, if not all, impose sales tax instead of the value-added tax).
- The decline in the Palestinian GDP since 2000: The growth achieved in some years helped only in offsetting losses and the slowdown that plagued the economy since 2000. In contrast, the economies of most comparable countries have seen growth rates during that period.
- Collection and tax revenues in Palestine are highly dependent on the consolidated bill whose revenues constitute about 65 percent of the Palestinian Authority revenues. Since the tax in this bill is levied on purchases of goods from Israel, high compliance rates are reported as declining to disclose such bills by taxpayers is considered disloyalty. When these bills are withheld, their revenue will accrue to the Israeli treasury. Such withholders are usually held legally liable and might receive a fine or a penalty.

Table 4: Tax burden in selected Arab countries in selected years, as % to GDP

Country	2000	2006	2007	Average tax burden
Palestine	22%	15%	27%	21%
Jordan	16%	17%	17%	16%
Syria	13%	18%	19%	19%
Egypt	16%	20%	21%	19%
Tunisia	18%	21%	22%	20%
Morocco	20%	21%	22%	21%

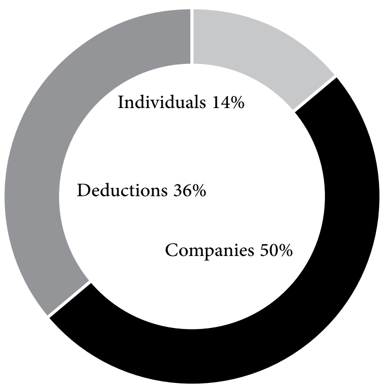
Source: International Monetary Fund, International Financial Statistics

25 Abdel Karim, Nasr; and Mohammed, Ruslan (2012), ibid.

- Currently, tax burden in Palestine is very high (22 percent) compared with that in developing countries (15 percent). According to (Maeremans 2015)[26], a high tax burden is a major cause for the decline of social welfare and economic development.

- There are three sources for the Palestinian income: companies, individuals and deductions from salaries. The ammounts collected from companies account for around 50 percent of total income tax revenue. Deductions from salaries of public, private and civil sectors staff represent 36 percent. These amounts are deducted directly by employers and then transferred to the tax department. The collections from individuals (self-employed, workers in Israel, car importers) are only 14 percent of total revenue. The latter contribution is very small considering the constituent segments, particularly the self-employed. According to the Palestinian Central Bureau of Statistics, around 208 thousand people in Palestine are self-employed (see Figure 2).

Figure 2: Average % contribution of taxpayers to income tax revenue 2011-2014



Source: The authors worked out the shares based on data obtained from the Income Tax Department and the Ministry of Finance.

- A significant change in the contributions of the three categories has been reported of late, a change resulting from the income

26 Maeremans, Dominique (2015).Western European economies saddled with taxburden 40% higher than the global average. http://www.uhy.com/western-european-economies-saddled-with-tax-burden-40-higher-than-the-global-average/

tax law and its amendments. Table 5 reveals that the contribution of companies rose significantly after 2012 simultaneously with a drop in the shares of individuals and salary deductions. This has perhaps resulted from the 2012 amendments, which raised the number of tax brackets to four and raised the top marginal income tax rate to 20 percent instead of 15 percent.

- There is a reason behind such changes: perhaps increasing the number of brackets redistributed the tax burden in such a way that raised the rates on high income earners, and thus reduced them on individuals and small taxpayers.

Table 5: Value and average % contribution of taxpayers to income tax revenue 2011-2014 (NIS millions)

	Companies		Individuals		Deductions from salaries		Total
2011	232,0	45%	67,2	13%	211,7	41%	510,9
2012	386,7	58%	73,4	11%	212,1	32%	672,2
2013	411,2	55%	78,8	10%	261,4	35%	751,5
2014	314,2	42%	144,2	19%	286,1	38%	744,5

5.2 Tax burden from a socioeconomic justice perspective

There is a legitimate question regarding the extent to which the 2011 Law and its amendments have contributed to redistributing the tax burden in furtherance of economic and social equity. The following is a set of observations about the law and its amendments, with the focus being particularly placed on the redistribution of income to increase opportunities for the less wealthy members of the society.

- The indirect taxes comprise 90 percent of the Palestinian tax revenues, while the share of direct taxes (which are supposed to consider the personal circumstances of the taxpayers) is barely 10 percent or sometimes lower. The most important type of indirect taxes is VAT, which is sometimes described as a blind tax since it is levied on all types of consumer commodities, and as such all consumers (the rich, middle income earners and the poor) are subject to it. The poor and low-income earners are particularly affected by VAT since a major volume of their spending goes to basic goods. The tax system in Palestine levies VAT with a constant marginal rate on both basic and luxury products, thus affecting all segments of the population. For the sake of better economic and social justice, it is necessary to revisit the tax policy, raising marginal personal income tax rates on high earners and investment activities that yield large and quick gains, while reducing rates for low-income earners and basic goods/services[27].

- The frequent amendments to the income tax law made several large cuts of income tax levied on corporate profits. Back in the late 1990s, the PA would have to operate the tax system effective at that time, with extremely high rates on companies and high income earners (38.5 percent and 48 percent, respectively). In 1999, the rates were reduced to 20 percent for individuals and companies. With the first Palestinian income tax law No. 17 of 2004, the rates were cut to 16 percent for both companies and high income earners, and then down to 15 percent in the Amendment No. 2 in 2008. However, the 2011 Law raised it again to 20 percent before the amendment of the law brought the rate down to 15 percent for high income earners and ordinary companies, while retaining the 20 percent for telecom operators and monopolies.

  Obviously, the Palestinian legislators (the Legislative Council, the government and the President) have, each time they enacted new laws or amended the already existing ones, lowered income tax for companies and high-income earners, sometimes up to 100 percent. The premise behind such an approach is stimulating investment in Palestine and promoting business competitiveness. In contrast, the cuts for the poor and low-income earners (typically under the first and second brackets) were very small. Perhaps the 2008 amendment was the most equitable, lowering the rates from 8 percent, 12 percent and 16 percent to 5 percent,

27 An interview with Mohammed Naji, Rapporteur of Budget and Financial Affairs Committee, September, 21, 2015.

10 percent and 15 percent, respectively. Indeed, the contribution of the poor and low-income earners is humble (reaching only 20 percent under the most favorable circumstances) in an already modest contributor to tax revenue, i.e. income tax. Indeed, the significant reductions granted by the tax laws to the high-income earners have not substantially increased the income tax rate's share in public revenues, with the contribution remaining insignificant at 8 percent at best.

- The Law granted NIS 36,000 as an annual tax exemption to all natural persons, high, middle and low-income earners alike. On the other hand, as we explained earlier, the net incomes of natural persons higher that NIS 150,000 are taxed 15 percent rate, no matter the size of the incomes in excess of NIS 150,000. By the same token, all companies (apart from telecom operators and monopolies), no matter the sector– agriculture, manufacturing, services or trade– are taxed the same rate on their profits.

- The law did not establish a preferential tax structure based on geographical location. Perhaps it would have been more convenient if the law had considered preferential treatment to people and projects working in vulnerable areas and those threatened by the settlements and the segregations wall.

The figures in Table 6 below support the observations we are enumerating. The figures suggest that the tax justice has gotten worse, as the very rich are not taxed their fair share, and it seems that the desired goals of economic/social equity and redistribution of income have been compromised.

Table 6: Income tax calculation mechanism under the 2011 amendments; and tax burden relative to income

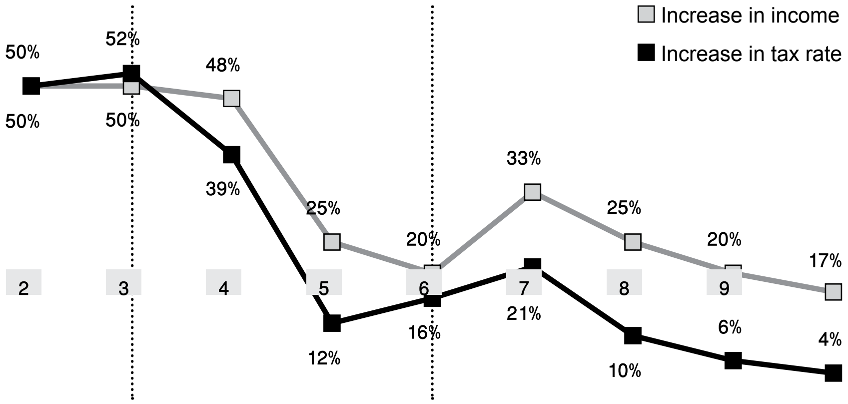
	1	2	3	4	5	6	7	8	9	10
Annual income (in NIS)	**60,000**	**90,000**	**135,000**	**200,000**	**250,000**	**300,000**	**400,000**	**500,000**	**600,000**	**700,000**
Exemptions	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000
Taxable income	24,000	54,000	99,000	164,000	214,000	264,000	364,000	464,000	564,000	664,000
5% bracket	1,200	2,700	3,750	3,750	3,750	3,750	3,750	3,750	3,750	3,750
Remaining income	-	-	24,000	89,000	139,000	189,000	289,000	389,000	489,000	589,000
10% bracket	-	-	2,400	8,900	13,900	15,000	15,000	15,000	15,000	15,000
Remaining income	-	-	-	-	-	39,000	139,000	239,000	339,000	439,000
15% bracket	-	-	-	-	-	5,850	20,850	35,850	50,850	65,850
Total tax payable	1,200	2,700	6,150	12,650	17,650	24,600	39,600	54,600	69,600	84,600
Net income after tax	58,800	87,300	128,850	187,350	232,350	275,400	360,400	445,400	530,400	615,400
Tax as % to annual income	2%	3%	5%	6%	7%	8%	10%	11%	12%	12%
% increase in income	**-**	**50%**	**50%**	**48%**	**25%**	**20%**	**33%**	**25%**	**20%**	**17%**
% increase in tax	**-**	**50%**	**52%**	**39%**	**12%**	**16%**	**21%**	**10%**	**6%**	**4%**

It is important to consider the notes below for better understanding of the figures in the Table:

- The Table fleshes out 10 classes of income within three brackets. Bracket 1 applies to classes 1 and 2; bracket 2 targets classes 3, 4 and 5; while the last one encompasses classes 6, 7, 8, 9 and 10.
- The figures apply to natural persons only, as the rate for companies is 15 percent and for telecom operators and monopolies 20 percent.

As the Table reveals, the system is not progressive, strictly speaking. While it is fair regarding the cutoff point between the class 1 and class 2 within the first bracket, the 25 percent increase in class 5 income renders only 12 percent increase in tax rate. As such, the tax burden is regressive rather than progressive. The regressive regime is better explained when we consider the figures under the third bracket. The 20 percent increase in class 9 income produces only 6 percent increase in tax rate. Probably worse, the 17 percent increase in class 10 income yields only 4 percent increase in tax rate. Figure 3 below shows the relationship between the increase in income and the increase in the tax rate across the board.

Figure 3: Increase in income vs. Increase in tax rate



6

THE PALESTINIAN INCOME TAX LAW AND INTERNATIONAL STANDARDS OF ACCOUNTABILITY AND TRANSPARENCY

International organizations and national civil society organizations seek to create a standard global system where governments and official agencies pledge to comply with the principles of integrity, accountability and transparency in building and implementing financial and tax legislations, among other things. One important initiative seeking to create such an environment is the Code of Good Practices on Fiscal Transparency produced by the Interim Committee of the Board of Governors of the International Monetary Fund in its fiftieth meeting in Washington, 1998. The Code is the only document which identifies a set of principles of transparency and best practices in building finances of the government. The Code was updated in 2001 and later in 2007.

Commitment to the principles of integrity, transparency and accountability is not an end in itself; rather it is only a method to reduce corruption. Lack of transparency and management opacities are cited as corruption. On the other hand, lack of accountability is a call for arbitrary application of the laws. The authorities responsible for enforcing laws and implementing public policies are thus required to disclose information, comply with the law and guard against any possible misuse of powers.

In this section, we provide a review of the Palestinian Income Tax Law in terms of its theoretical and practical compliance with integrity, transparency and accountability.

- Under a transparent tax regime, legislation should be clear and direct without a room for different interpretations. The power the legislation grants to tax department staff must not allow these people to personally interpret the law regarding the assessment and collection of tax. One shortcoming of the Palestinian Tax Law is that it gave the Council of Ministers the powers to modify tax exemptions, brackets and rates, thus breaching the basic rule (that no tax shall be levied or exemption given without a law) which was adopted by the IMF Code of Good Practices on Fiscal Transparency. Also, the tax law gave unlimited powers to the Director General of the Tax Department in terms of assessing and collecting taxes, which will definitely create disputes between taxpayers and tax department. Naturally, granting broad powers to tax department increases the likelihood for administrative and financial corruption, as power tends to corrupt and absolute power corrupts absolutely.

- The law assigned the function of handling many issues to ad hoc regulations and instructions. It is expected that they will trigger much indignation from segments that are already discontented with the Law, particularly as the source is the executive authority (the Cabinet) not the Legislative Council, which means the taxpayers will continue to suffer for a long time.

> "The wording of the law is ambiguous and the majority, or even all, of the articles need interpretation. This requires implementation instructions by the officials or the minister. To be clear enough, the instructions might reach 200 pages or even more…There are many similar examples."
>
> The Palestinian Accountants and Auditors Association, a position paper

- Within the principle of transparency, there should be an environment that allows the taxpayers/other affected segments easy access to the laws, regulations and procedures relating to the process of estimating and levying taxes. This could be done through different channels of communication usually used by the tax departments. Transparency also entails clear law provisions free from ambiguity and vagueness of wording.

- One can only consider the large number of tax cases brought before courts to understand how different and contradictory the interpretations of the Law are. The General Directorate of Income Tax (GDIT) has been criticized for not disclosing information to the public regarding the tax regime and the rights and duties of taxpayers. The GDIT does not issue leaflets or prospectuses, nor does it have a website that provides guidelines for filing taxes. Tax auditors have reported extremely complicated tax returns (declarations) used to file income taxes, which made the Palestinian Accountants and Auditors Association hold training courses for auditors to explain those returns. The sections in the returns that need to be filled by the taxpayers are another episode of suffering[28].

The Ministry of Finance website does not provide detailed information on income tax or its brackets and rates or even the classification of taxpayers (individuals, companies, self-employed, etc). The person in need of such information will have to communicate directly with the tax department.

Since Palestinian taxpayers know very little about the tax law and its enforcement procedures, they always seek consulting services from tax experts for filing taxes.

- Transparency is not only restricted to the behavior of the tax authorities; taxpayers should also behave in a responsible, transparent manner. The taxpayers should provide accurate information about their revenue to the concerned authority. According to the GDIT, taxpayers usually underestimate their revenues. This forces the GDIT to reconsider files and provide new estimates, which in turn creates tax disputes.

- Broader community participation helps ensure more effective, more transparent drafting and enforcement of the law. In the Palestinian context, the legislators do not give enough time for taxpayers to discuss the major amendments to tax legislation. More often than not, engagement of community occurs after enacting and approving amendments. For good governance, community participation increases confidence in the tax departments, encourages taxpayers to cooperate and file accurate tax returns, and reduces incidences of tax evasion.

- Solid internal controls and external oversight are needed to ensure transparency and accountability. The absence of the Legislative Council– inherently with legislative and oversight authorities– has encouraged the executive authorities to assault

28 An interview with Belal Fares, CEO, the Palestinian Accountants and Auditors Association, October 12, 2015.

the principles of integrity and transparency. Usually, external control guards against any possible misuse of power. When there is no such control, the executive bodies might abuse the powers transferred to them.

- Other audit bodies, such as the Financial and Administrative Control Bureau (in charge with ensuring proper application of the procedures and rules in government agencies) lack effective tools to hold executive bodies accountable. Under normal conditions, the Bureau's annual financial and administrative report is presented to PLC for the purposes of approval or otherwise rejection.

  With respect to internal audit, the IMF Code of Good Practices on Fiscal Transparency stipulated that tax administration should be organized in such a way as to minimize opportunities for collusion between taxpayers and tax officials. One of the factors helping to achieve this, the Code recommends, is increasing reliance on taxpayers' self-assessment. Also, tax department is advised to use selective audit. In addition, administrative functions should be distributed across the tax department so as to ensure a self-checking element, whereby the work of employers engaged in one function serves as a control on the work performed by employers in other functions. According to the Code, it is also important to strengthen the central administration's role in designing processes and programs and controlling offices and sub-divisions.

- The Income Tax Law maintains in Article 44 the confidentiality of taxpayers' information. However, the broad powers given to the tax staff (judicial police) or any tax employee with a written commission to enter any facility and retain taxpayers' documents may harm the principle of confidentiality enshrined in the Law. The Law also allowed the tax staff and commissioned employees to use the information obtained from the judicial police in tax courts when necessary, which allows for the abuse of rights or construing necessity based on discretion, thus harming the principle of information confidentiality.

- Another discrepancy in the Law is the peremptory tax and the right of the taxpayer to litigation and appeal. Article 21 gave the assessor the right to reject the tax return and to withhold reasons/justifications and disclose them only in a hearing session held for this purpose. The law also gave wide powers to the assessor to accept or reject the tax return, whether the information provided is true or not true. The Article relieved the assessor form proving the invalidity of information provided by the taxpayer. The Law gave the taxpayer the right to file an appeal against the decision of an assessor before the competent court. According to legal experts, filing a challenge before the court should be the last bid, as in Palestine there are no judges specialized in considering tax disputes. Still, there are two tax appeal courts in Palestine, one in the West Bank and the other in Gaza. Indeed, judicial records in this regard do not indicate potential gains from litigation before these courts. Therefore, the majority of taxpayers would prefer to reach a settlement with the tax departments and eventually acquiesce to the decisions of the taxation staff. In other words, the right to litigate and appeal does exist, yet it is of no tangible use for auditors[29].

29 An interview with Khalil Rizq, Head of Federation of Palestinian Chambers of Commerce, October 12, 2015.

7

CONCLUDING NOTES

Tax legislation in Palestine is one of the main methods and tools for economic policy, which in turn seeks to achieve a set of financial, economic and social goals. An effective tax system would definitely increase revenues, stimulate private investment and redistribute income in line with the principle of justice. The Palestinian tax regulation framework saw significant developments that helped shape it. For a 10 year-period starting from 1994, the PA would have to operate the laws of the countries the controlled the Palestinian territory in the 20th century. Year 2004 saw the issuance of the first Palestinian income tax law, which was amended later in 2008 by a presidential decree. In 2011, a new income tax law was enacted in lieu of other previous laws. The law was later subject to four amendments that touched the main content of the law.

This study sought to analyze the Palestinian Income Tax Act and its amendments from an economic and social equity perspective. Part of the analysis focused on the Law's compliance with integrity, transparency and accountability.

We conclude this study with a set of remarks, namely:

- The Income Tax Law and the frequent amendments since 2011 raised many questions, constitutionally and procedurally. Naturally, laws are enacted exclusively by the Legislative Council. Different legists believe that the law is not constitutional because it does not reflect an urgent need for the Palestinian economy. Such a law further contravenes the Basic Law as it grants powers to the executive authorities to amend tax rates, exemptions and brackets.
- The Income Tax Law could not equally realize the three envisioned objectives (financial economic and social). Its focus on increasing revenue (the first objective) was definitely at the expense of the other two objectives (the economic and the social). The amendments to the Income Tax Law have done little to increase the contribution of income tax in the total and domestic revenues as the income tax revenue has remained relatively low, reaching only 8 percent at best. The government's approach to increase the public treasury revenues behaves in such a way that it always

focuses on a limited proportion of traditional taxpayers (major taxpayers) and fixed-term employees, rather than expanding the tax base through better inclusion of the self-employed.

- Increasing the number of brackets would improve economic and social equity and distribution of income; yet, the more the brackets, the highest the costs and the more the human resources needed for collection. The current number of brackets in the Palestinian tax system is unlikely to achieve the social goals.
- The deductions the Law made reveals partiality to the wealthiest segments (companies and major taxpayers). It gave lavish expenses deductions reaching 11 percent of the profits of companies
- The Income Tax Law made income generated from agriculture and pension salaries subject to taxation, which would encroach on the earnings of these low-income earners and create collection problems.
- When it set the annual exemption, the Law did not take into account the number of dependencies in a family or the economic conditions of the taxpayers, as it lowered the university education exemption and ignored medication and dependency expenses. The previous laws were more socially equitable.
- There are some observations on the problematic issues in the Law and its enforcement mechanisms, namely the lack of tools for assessing pensions and agricultural income. Owing to poor coordination between the tax department and audit bodies, poor financial resources, lack of logistics, limited human resources and weak compliance by different taxpayers and their sectors, the taxation departments face significant difficulties in implementing the law.
- Poor community engagement is reported in the legislation policy-making. The type and scale of engagement was inappropriate. A wide segment was completely disregarded: the private sector, small businesses, farmers' associations, labor unions, women representatives, remote rural areas and projects operating in vulnerable areas and those threatened by the settlements and the segregations wall.
- The tax burden in Palestine is high compared with neighboring countries. The distribution of this burden and sources of funding do not contribute to the achievement of social justice across

different social groups. The results showed that large segments of the high-income earners do not pay their fair share. The Law does not take into consideration the size of profits in the economic sectors, nor does it establish a preferential tax structure based on geographical location. Many questions about the mechanism of dealing with taxpayers in the Gaza Strip have been raised in light of the presidential exemption decree that still applies to all residents of the Strip.

- As indirect taxes continue to account for the largest share of tax revenue, prospects for social equality are unlikely since the indirect taxes do not treat taxpayers according to their socioeconomic conditions.
- The Income Tax Law does not meet the requirements of transparency, integrity and accountability as different articles are ambiguous and thus subject to contradictory interpretations.
- The Income Tax law gave unlimited powers to the Tax Department staff, which will definitely increase the incidences of administrative/financial corruption and abuse of rights.
- The Income Tax Law assigned the function of handling many issues to ad hoc regulations and instructions– which is a call for executive authorities to use their discretion to interpret the provisions of the Law.
- The absence of the Palestinian Legislative Council and the poor performance of audit bodies weaken internal and external oversight of the performance of the executive branch.
- Public’s right of access to information seems threatened due to poor performance of the executive bodies and their failure in disclosing information in an easy, succinct way.
- Poor community participation reduces the prospects of transparency and accountability in drafting enforcing tax legislation.
- The Income Tax Law ostensibly maintains the confidentiality of taxpayers’ information. However, the broad powers given to the tax staff may encroach on the principle of confidentiality.
- Though the Law gives the taxpayers the right to litigation and appeal, judicial records in this regard do not indicate potential gains from litigation before courts, which forces litigating taxpayers to acquiesce to settlements with the tax departments.

8

RECOMMENDATIONS FOR THE REFORM OF THE INCOME TAX LAW

- Providing remedies to the constitutional and procedural encroachments brought by the entire process that produced the Income Tax Law through reestablishing the PLC as the only competent authority with legislation powers, as well as avoiding making further amendments without approval from the PLC.
- Proceeding with disclosing the remaining regulations and instructions of the Law, taking into account the principles of clarity, simplicity and transparency.
- It is important to increase the number of tax brackets to 5 (instead of 3) to ensure better social justice, and imposing higher rates on the fourth and fifth brackets. It is also important to improve the performance of the tax department so as to expand the tax base and extend the coverage to additional incomes (or those with weak coverage) such as the self-employed professions, capital transactions and trade in real estate.
- It would be imperative to reconsider the tax burden in such a manner that contributes to achieving social equity. This requires reconsidering the current tax base to include/further spot non-traditional, non-value added activities that achieve big profits. In parallel, it is necessary to increase the exemptions for lower-income earners, individuals/businesses engaged in productive activities, and vulnerable rural areas. An exemption of NIS 40,000 would be adequate in the first stage. Additional exemptions are also expected to be given to high added-value activities and those that create new jobs. It is also important to grant exemptions to areas affected by the settlements expansion and the segregations wall. Later amendments should encourage private businesses and monopolies to increase their social responsibility allocations, which would later be deducted from the taxable income. Oversight methods should be in place to guarantee that the companies make actual appropriations for social responsibility purposes.
- The economic and social goals of the Law should be taken with due consideration. It is important to consider the socioeconomic conditions of the taxpayers, particularly when considering allowable deductions for dependency, university education and healthcare, allowing also for preferential treatment for productive activities and vulnerable areas.
- Granting full income tax exemptions to agricultural income and pensions.

- Enhancing coordination between tax departments and representatives of taxpayers (particularly trade unions) through a computerized tax system; and exchanging information and coordination with other government departments.
- Supporting the tax department with the financial resources and logistics needed to build the capacity of the staff, as well as offering training courses for the tax department staff.
- Of urgent need is expanding community engagement through discussions with concerned groups. Community participation would enhance cooperation and accountability, help the government realize the goals of the tax system and strengthen external oversight on the performance of the executive bodies.
- For the sake of better economic and social equality, it is necessary to revisit the tax policy, raising marginal personal income tax rates on high earners and investment activities that yield large and quick gains, while reducing rates for low-income earners and basic goods/services.
- Tax laws and procedures should be clear and transparent, which allows for better external oversight (by the public, civil society organizations, etc). Building an effective audit system would maintain the rights of both the taxpayer and the tax department.
- It is necessary to improve tax department's outreach through annual and periodic reports on the total tax revenues and channels of spending. The taxpayer's access to information should be made easier through leaflets and other means of communication. It would also be doable to hold training meetings for taxpayers.
- Operating strict standards to combat various forms of corruption in the tax departments; ensuring transparency; and defining clear and decisive instructions for estimating income in a way that regulates assessments by tax staff.
- Facilitating taxation procedures; executing unfinished files; and increasing tax incentives for early bird taxpayers and those wishing to provide tax returns.

ANNEXES

Annex 1: List of interviews conducted for the purpose of the study

Body/sector	#	Agency	Name	Position	Date
Executive Branch	1	Tax Department, Ministry of Finance	Hamza Zalloom	Director General	September 20, 2015
	2	Legal Affairs Department, Ministry of Finance	Fida Abu Hamid	Legal Adviser	September 17, 2015
Audit/legislative branches	3	The Palestinain legislative council (PLC)	Qais Abu Laila	Member, Legislative Council Panel on Financial Affair	September 20, 2015
	4	The Palestinain legislative council (PLC)	Mohammed Naji	Rapporteur, Budget and Financial Affairs Committee	September 15, 2015
Private sector	5	Ramallah and Al Bireh Chamber of Commerce	Salah Odeh	Director General	September 15, 2015
	6	Federation of Palestinian Chambers of Commerce	Khalil Rizq	Head	October 12, 2015
Auditors	7	Auditing company	Shafiq Awashreh	Certified auditor	September 17, 2015
	8	The Palestinian Accountants and Auditors Association	Belal Fares	CEO	October 12, 2015
Civil society	9	The Palestinian Farmers Union	Abbas Milhem	Executive Manager	September 17, 2015

Annex 2: Questions in the field interviews

Body/sector	Questions
Executive Branch (Ministry of Finance)	• What are the goals of the new Income Tax Law? How could it handle gaps found in previous laws? • Has the new law helped increase tax revenue or reduce tax evasion? • Have you taken into consideration the economic and social goals when you enacted and implemented the law? Are there some tools in place to achieve these goals? • What do you think are the observations about the law regarding its constitutionality and compatibility with the Basic Law? • What are the plans you have taken to engage the community in developing/implementing the law?
Legislative Council	• What are your main reservations about the law? • What is your role in enacting the law and in its later amendments? • On what economic/legal basis do you evaluate the law? • Do you have some concrete lobbying tools to change/amend the law? • Do you think that the law will achieve the economic and social goals, apart from the financial goals?
Private sector	• How do you evaluate the scope of your participation in enacting the law and later its amendments? • Do you think that the law can realize the envisioned economic and social goals? • To what extent has the law, in general, and its tax rates and brackets, in particular, influenced you investment decisions? • How do you evaluate the deductions/holidays the law has given investment projects? • How do you see the wording of the law? Do you have any major observations about the law? • Do you think the law will help achieve the envisioned economic and social equity?
Auditing companies	• What are your technical and legal observations about the law? • How do you see the practical aspects of the law? Have you faced some specific problems? • Has the law made taxing/filing return procedures easier? Has it enhanced integrity, transparency and accountability? • How do you see the provisions related to litigating tax disputes? • How do you see the powers the law granted to tax department staff regarding the settlement of tax debts and the staff's right to inspection? • How do you evaluate the performance of the tax department staff commissioned with collecting taxes?
Civil society	• Do you think the community was adequately engaged in drafting the law and its amendments? • To what extent has the law contributed to achieving economic and social justice? Has it distributed the tax burden across taxpayers and income classes in an equitable way? • The law expanded the tax base to include new economic activities and incomes which were exempted in earlier legislations. What do you feel about that?