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Executive Summary

Capital Productivity Gaps in Israel: Evaluating the Law for the Encouragement of Capital Investments

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About the Milken Institute Fellows Program

The Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental challenges. Our goal is to accelerate Israel's transition from a Start-up Nation to a Global Nation with solutions that others can replicate.

Directed by the Milken Institute Israel Center, the Milken Institute Fellows Program awards annual fellowships to outstanding Israeli university graduate students. Through the Milken Institute Fellows program, we train some of Israel's best and brightest young professionals in creating pragmatic financing and economic policy solutions, and they deploy them as resources to government ministries, nonprofits and other key organizations. Our applied research and Financial Innovations Labs® are a launching pad for transformative change, using innovative financing mechanisms, programs and policies to bridge social, regional, economic and productivity gaps within Israel and between Israel and the world.

In addition, Fellows craft their own policy studies during their internship aimed at identifying barriers to job creation and capital formation in Israel. The Fellows' research, carried out under the guidance of an experienced academic and professional staff, support policy makers who shape economic reality in Israel. The program offers the ultimate training opportunity, combining real-life work experience with applied research.

Throughout the year, Fellows receive intensive training in economic and financial analysis, public policy processes, and research methods. They acquire tools for communication and presentation, policy analysis, leadership and project management. The fellows participate in a weekly research workshop where they meet senior economic and government professionals, business leaders, and top academic and financial practitioners from Israel and abroad. They also participate in an accredited MBA course. The course, which focuses on financial and economic innovations, is taught at the Hebrew University School of Business Administration by Prof. Glenn Yago (Senior Director/Senior Fellow at the Milken Institute).

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve in key positions in government ministries while others work at private-sector companies or go on to advanced graduates studies at leading universities in Israel, the United States and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, accelerating economic growth, and improving the quality of life for Israel's citizens.

The Milken Institute Fellows Program is a non-partisan, non- political organization. It is funded by the Milken Institute and other leading philanthropic organizations and individuals in the United States and Israel.

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The Law for the Encouragement of Capital Investments (LECI) in Israel was enacted in 1959 as a means to foster economic growth and development by attracting foreign direct investment (FDI). Over the years, the conditions affecting FDI and the way multinational firms operate have changed, and while LECI has been amended numerous times since its inception, with tax subsidies and grants to targeted companies rising steadily, the changing global landscape suggests further research is necessary to ensure the best possible outcomes for Israel's economy.

In the past, a multinational firm would establish all parts of its production, marketing, and distribution chains in one country, which was usually chosen based on its proximity to the destination market and/or the local labor and manufacturing costs. Consequently, this host country would enjoy the fiscal and economic benefits generated by the firm's activities. However, in recent decades, with the rapid globalization of manufacturing and supply chains, FDIs have become more dispersed as multinational firms attempt to capture relative advantages throughout the global marketplace.

LECI's original objective was to provide incentives for FDI to encourage multinational firms to:

- Open subsidiaries or new branches in the host country;
- Merge with or acquire existing firms;
- Operate a single joint venture with a partner from a different country.

In general, countries compete to attract multinational firms because of the compelling positive externalities that FDIs can offer the host country. Among these side benefits are:

- Spillover of knowledge to local suppliers, customers and competing firms, as well as the arrival of a skilled labor force;
- Improvement of human capital through training and maintenance of labor market standards;
- Regional development; including improvement of manufacturing standards, promotion of labor market laws etc.

- Strengthening of international relationships in trade and research and development (R&D).

In the case of Israel, the goals of LECI–to develop the country's productive capabilities, sharpen the business sector's competitive edge in international markets, and create infrastructure for new and sustainable jobs–are inseparable from the magnitude of FDI. Hence, Israel's capital investment incentives must be part of the race to attract multinational firms. Currently, however, the effects of LECI on productivity are in question. Israel's current productivity stands at 76% of the average labor productivity among OECD countries.

While FDI in Israel is relatively high, as we show, most of those investments are concentrated in R&D, an area where Israel exhibits a strong competitive advantage. In this field, each employee contributes substantial value; however, comprising only 8% to 9.5% of the total labor force, their effect on the overall market is small.

A weak point in LECI's current FDI policy is that R&D centers operate on a cost-plus basis–a fixed additional rate is added to production costs and accounts for the R&D center's profit. As a result, Israel fails to reap the benefits of the later-stage manufacturing that results from the intellectual property (IP) developed at the R&D centers. Furthermore, the country misses out on any tax revenue from the distribution of these products developed from the IP.

For this and other reasons, LECI has been the target of much criticism in recent years. Specifically, LECI has been said to:

- Distort the allocation of resources by artificially preferring import goods;
- Fail to account for intellectual property capital flight, which would require some performance criteria for retaining activities in Israel;
- Fail to create high-productivity jobs in the country's periphery.

In addition, corporate tax reductions since 2011 have amplified tax benefits to multinational corporations, exaggerating the gap between the statutory tax rate and the tax subsidies provided through LECI. The current study employs data from the tax authority, including both business data on firms and individual data on their employees to assess tax incidence and impact.

The main findings of this study show that the benefits given to firms as part of the law are unevenly distributed. Since 2010, only four big firms have received as much as 70% of the tax benefits (3.9 billion out of 5.6 billion shekels).

The size of the tax benefit is calculated as follows:

$$Tax\ Benefit = (Statutory\ Tax\ Rate - Effective\ Tax\ Rate) \cdot Taxable\ Income$$

From this calculation, it is easy to see the direct correlation between the company's profits and the size of its benefit. However, the data show that another important cause for this correlation is the fact that the firms with the highest profits are also the ones paying the lowest effective tax rate. This is especially true for the top percentile of firms (by tax benefit size) that pay an average effective tax rate of 5% while the rest pay an average effective tax rate of 10%.

Size and geographical effects of tax benefit distribution to firms are also illuminated in this study. According to the data, firms that are located 50 to 100 km from Tel Aviv are larger than the ones in the center–they employ more people. In town, however, there is a large income gap between firms benefiting from LECI and others that do not. The average income per employee in a firm that qualifies under the law is almost twice as high as a firm not benefiting from LECI in the Tel Aviv area. In the periphery, this gap is much smaller. These findings suggest that LECI does not succeed in its legislative intent of attracting high-paying jobs to the periphery, where firm size and the low cost of labor and land are the predominant criteria influencing investment decisions.
Further, findings show that the gap between the average benefit per employee and the average monthly income is much higher among the top percentile of firms (by benefit size) than among the rest. This suggests that among these top-percentile firms, tax benefits are meant to compete against other tax regimes, rather than offset relative production costs. Firms enjoying the majority of tax benefits are capital-intensive, which increases the weight of tax credits in their location decisions. These two findings
indicate that the absolute majority of tax benefits go to firms that are very likely to take their activity out of Israel in the absence of such a tax regime, which is why these incentives should not be perceived as a cost for the country, but rather as a tool necessary to ensure the positive effects of attracting these firms to Israel.

Looking ahead, further research into the behavior of these firms should focus on their export patterns, the type and volume of employment, their location inside Israel and the alternatives they have abroad. Such data will help inform a more realistic and current assessment of LECI, as the law does not appear to be influencing multinational firms' decisions in ways that are consistent with the law's original intent

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