

Chapter 5

The Public Sector¹

In the past two years a policy of fiscal restraint has been implemented, as expressed in a sharp reduction of the public-sector deficit, which fell from 4.1 percent of GNP in 1996 to 2.6 percent in 1998. The objective was to reduce the balance-of-payments deficit, minimize the damage to the economy from world crises, and create conditions for returning the economy to a path of sustainable economic growth. The slowdown in economic activity which was considerably affected by the policy, was expressed in 1998 by the moderate rate of growth in tax receipts (2.3 percent) and sharp increases in payment of unemployment benefits and income maintenance (17.5 percent). The recession served to increase the overall public-sector deficit by about 1 percent of GNP, but the fiscal restraint, expressed in a reduction in both per capita civilian public-sector consumption and the share in GNP of capital transfers and subsidies, together with the increase in the profits of Bank of Israel (0.5 percent of GNP), slowed the increase in the public deficit, which this year grew by only by 0.3 percent of GNP.

Regarding tax rates and the composition of the allocation of resources, no significant steps appear to have been taken in 1998 to create conditions for a return to sustainable growth, as statutory tax rates did not fall after increasing in 1997, and the share of public-sector investment in GNP rose by only 0.2 percentage points, following a fall of 0.5 percent of GNP in 1997. As a result of the recession and the fiscal deficit, the public-sector deficit grew from 89.3 percent of GNP in 1997 to 89.6 percent of GNP in 1998, a reversal of the declining trend that has characterized the public-sector deficit since 1985.

The government succeeded in meeting the overall deficit target in 1998, but its domestic deficit exceeded the planned level by 1.1 percent. Besides meeting the requirements of the Budget Deficit Reduction Law, as a means of long-term policy the government's fiscal strategy includes the gradual reduction of public expenditure and the government debt/ GNP ratio without increasing the tax burden. All these factors were intended to help create the conditions for returning to a sustainable growth path.

¹ The public sector comprises the central government, the National Insurance Institute, local authorities, the National Institutions (the Jewish Agency for Israel and the World Zionist Organization) and public non-profit organizations (Health Funds, universities, etc.) and the Bank of Israel.

1. MAIN DEVELOPMENTS

The fiscal restraint that commenced in 1997 and continued during 1998 manifested itself in a lower public-sector deficit, which fell from 4.1 percent of GNP in 1996 to 2.6 percent of GNP in 1998.

The fiscal policy that prevailed in 1998 was a continuation of the policy in effect during 1997. The fiscal restraint that began in 1997 and expressed itself in higher taxes and lower public-sector investment and expenditure, was expressed in the contraction of the public-sector deficit from 4.1 percent of GNP in 1996 to 2.6 percent of GNP in 1998; this came within a strategic fiscal framework of narrowing the public-sector deficit through reducing the balance-of-payments deficit and minimizing Israel's vulnerability to world crises. The public-sector deficit grew by only 0.3 percent of GNP this year, against the background of the economic slowdown that increased expenditure on unemployment benefits and income support payments (17.5 percent) and brought in its wake a reduction in the growth of tax receipts (2.3 percent). The contribution of the economic slowdown to the increase in the deficit was offset in part by fiscal restraint, resulting in a reduction in per capita civilian expenditure and a fall in the share of capital transfers and subsidies in GNP. The increase in the profits of Bank of Israel (0.5 percent of GNP), stemming mainly from the rapid depreciation at the end of 1998, also moderated the effects of the recession.

In the past two years tax rates have increased and public-sector infrastructure investment has declined—a change which has served to slow economic growth.

From an examination of tax rates and public-sector investment it emerges that in the past two years no measures were adopted to stimulate sustainable growth; public-sector investment grew by a mere 0.2 percent of GNP after falling by 0.5 percent of GNP in 1997. Statutory tax rates were unchanged after increasing in 1997 (raising tax receipts by 0.8 percent of GNP). The fall in the share of tax receipts in GNP in 1998 (by 0.5 percent of GNP) resulted mainly from the slowdown in activity in the real estate market and a decline in the purchase of highly-taxed consumer durables, and not from legislative changes. In spite of the high rates of return on infrastructure investment in Israel, due to the backlog of this kind of investment in the past, the public sector reduced investment in infrastructure during the past two years, a change that served to slow economic growth. It is noteworthy that the rates of return on infrastructure investment even increased during the slowdown as some of the factors of production had no alternative use.

Per capita civilian public consumption declined by 0.9 percent in 1998, after falling by 0.4 percent in 1997.

Civilian public consumption grew this year by 1.5 percent—a fall of 0.9 percent in per capita public consumption, after declining by 0.4 percent last year. The share of defense consumption in GNP grew by 0.2 percent this year and reached 9.3 percent. The change was due to an increase of 8.1 percent in defense imports, which are characterized by considerable volatility, as well as to an increase of 7.5 percent in domestic purchases. Current transfers and subsidies grew (in real terms) by 5.3 percent. In part, the increase derives from the slowdown, as net of unemployment payments and income support payments it rose by a more moderate 4.3 percent. The additional transfer payments not attributable to the business cycle are made up of the rapid increase in national insurance payments (6.5 percent excluding unemployment and income support payments), expressing a real increase in allowances, and a 4.9 percent rise in other transfer payments, while subsidies fell by 5.1 percent.

The public-sector debt/GNP² ratio grew by 0.3 percentage points to stand at 89.6 percent of GNP—a reversal of the declining trend that has characterized it since the Economic Stabilization Program (ESP) of 1985. While privatization receipts (1.1 percent of GNP) contributed to a reduction of this ratio, the depreciation of the NIS served to increase it (by 0.6 percent of GNP).

In 1998 the government met the total deficit target—2.4 percent of GNP—but the domestic deficit deviated by 1.1 percent of GNP from its planned level. The attainment of the deficit target, despite the deviation from the planned domestic deficit, was made possible by the inclusion of the Bank of Israel's 'Real Realized Profit,' amounting to 1.4 percent of GNP, in the government's income from abroad. This profit arises from the method of calculation, whereby income of the Bank from interest on its foreign-exchange reserves is recorded as income, while the interest expenditure on its liabilities to the public is not recorded as an expense. The switch from a domestic deficit objective to an overall deficit one in 1997 allowed the government (in keeping with the accounting method currently in use) to attribute income to itself that in practice is offset (by expenses that are not recorded), thereby enabling the government to meet the overall deficit target of the past two years. As noted, the domestic deficit excluding the Bank of Israel's 'Real Realized Profit' deviated from the planned level, as actual government incomes fell short of the forecast. Income was overestimated mainly because the actual growth rate (2 percent) was less than predicted in the budget (3.1 percent), and the forecast rise in tax receipts was not realized.

Apart from adopting a deficit reduction target, the government set itself other long-term objectives, including gradually reducing the public expenditure/GNP ratio and the government debt/GNP ratio without intensifying the tax burden. The government did, in fact, refrain from raising taxes and, due to the slow growth rate, the government expenditure/GNP ratio remained unchanged (Table 5.A.5). Thus, from a long-term perspective, the performance of the government this year was not in contradiction to its long-term objectives.

The government met the overall deficit target—2.4 percent of GNP—in 1997, but the domestic deficit deviated by 1.1 percent of GNP from the planned level.

2. FISCAL POLICY

The public-sector deficit and the public debt

Macroeconomic developments in 1998 were characterized by the intensification of the economic slowdown that had begun in the third quarter of 1996, and a world crisis that harmed Israel's exports and threatened its financial stability. The worsening recession in 1998 was expressed in an 0.4 percent fall in per capita GNP, after it rose by only 0.1 percent in 1997, and by an increase in the unemployment rate, from 7.7 percent in 1997 to 8.6 percent in 1998.

² The public-sector debt includes the gross government debt (as published by the Monetary Department of the Bank of Israel) and the local authorities debt *less* obligations of the public to the government (government loans via the banks) *less* the assets of the Bank of Israel.

The policy of fiscal restraint implemented during a recession was intended to prevent a financial crisis.

Assessing the effect of fiscal policy on GNP in 1998 is not straightforward. An expansionary policy during a recession can sometimes serve to increase domestic demand, and therefore this year such a policy could have accelerated economic activity in the short-term; however, significant fiscal expansion could signal neglect of the government's long-term fiscal targets, undermine investors' confidence in the economy, and harm its ability to withstand shocks emanating from international markets. In view of the fiscal deficits of 1995 and 1996, it was very important to tighten fiscal discipline, as was in fact done over the past two years, in order to prevent a financial crisis developing in the foreign exchange market. This was made more acute by developments in October, that illustrated the vulnerability of Israel's financial markets to shocks on overseas markets. Although, it is difficult to quantify the contribution of the fiscal discipline of the past two years in preventing a financial crisis, it is our opinion that fiscal expansion in a period of crisis in world markets is likely to increase the probability of a crisis, thus resulting in a substantial drop in GNP.

The fiscal policy of the last two years was tight as regards its effect on aggregate demand. The aim was to reduce the balance-of-payments deficit and the probability of a financial crisis, bringing about conditions conducive to a return to sustainable growth.

In assessing fiscal policy in 1998 via the public-sector deficit it is necessary to strip out a number of components that make up the deficit but do not add to an understanding of fiscal policy. These include the growth in the Bank of Israel's profits (0.5 percent of GNP), which are connected with monetary developments, and the increase in interest payments on the public debt (0.1 percent of GNP), which reflect previous liabilities. Adjusting for these items, the public-sector deficit increased by 0.7 percent of GNP. The rise in the initial deficit (not including interest payments and the Bank of Israel's profit) should be assessed against the backdrop of the recession. The annual average growth rate of per capita income in the last twenty years reached 1.7 percent, even though in 1998 it fell by 0.4 percent of GNP.

The cyclically-adjusted deficit fell by 0.3 percent of GNP in 1998, after falling by some 2.6 per-cent in 1997—a change that demonstrates the power of the tight fiscal policy of the last two years.

The slower growth rate than the long-term average reduced tax receipts by about 0.9 percent of GNP, increased unemployment payments by 0.1 percent of GNP, and contributed 1 percent of GNP to the rise in the deficit. Thus, the deficit adjusted for the business cycle declined in 1998 by approximately 0.3 percent of GNP, after a fall of 2.6 percent in 1997 (similarly calculated), indicating the intensity of the fiscal restraint of the past two years.

The public debt/GNP ratio, which has fallen steadily since the ESP, increased in 1998 from 89.3 percent to 89.6 percent. Israel's debt/GNP ratio is considerably above the 60 percent target set by the European Community in the Maastricht agreement, and in 1998 is even further away from it.

The public debt/GNP ratio, which has been falling since the ESP, rose from 89.3 percent in 1997 to 89.6 percent in 1998.

The total public-sector deficit (2.6 percent of GNP) and the depreciation of the NIS³ (approximately 0.6 percent of GNP) caused an increase in the debt. Privatization receipts,

³ The depreciation of the NIS (by 17.5 percent relative to the dollar) increased the public debt/GNP ratio by some 0.6 percent. The relatively small change is due to the fact that the external debt accounts for 6 percent of the public debt, and GNP as calculated here in terms of end-year prices, also grew in line with the exchange rate.

Table 5.1
The Public Sector: Receipts and Expenditure, 1994–98

	(percent of GNP)				
	1994	1995 ^a	1996	1997	1998
Total receipts	53.3	53.6	52.0	52.5	52.7
<i>of which</i> From property	1.1	1.6	1.0	0.6	0.8
Total taxes	40.0	40.7	39.8	41.3	40.8
Indirect, on domestic production	14.2	14.3	14.7	15.1	15.0
Indirect, on civilian imports	5.6	5.6	5.3	4.8	4.5
Direct taxes, fees, and levies	15.4	15.0	13.9	15.1	15.0
National Insurance income	4.8	5.8	5.8	6.2	6.2
Total expenditure	54.4	56.3	56.1	54.9	55.3
<i>of which</i> Domestic civilian consumption	17.7	20.2	20.4	20.1	20.0
Domestic defense consumption	7.9	7.7	7.6	7.4	7.4
Defense imports	1.9	1.4	1.7	1.7	1.9
Direct subsidies	2.2	1.7	1.5	1.4	1.3
Transfer payments on current account	11.3	11.8	12.4	12.8	13.1
Transfer payments on capital account	1.9	2.1	2.0	1.4	1.3
Public-sector investment	3.7	3.7	3.8	3.3	3.5
Interest payments	7.1	7.2	6.4	6.5	6.6
Total deficit	-1.1	-2.7	-4.1	-2.3	2.6
Total surplus excluding interest and receipts from property	4.6	2.4	0.8	2.8	2.1

^a Including receipts and expenditure due to the Health Law.

by contrast, contributed 1.1 percent of GNP to its reduction, as did GNP growth (which offset 1.7 percentage points of GNP of the debt/GNP ratio). The substantial income from privatization receipts in the past two years (3 percent of GNP) made the reduction of the debt/GNP ratio possible in 1997 and moderated its increase in 1998. Privatization and its receipts is a temporary phenomenon, however, so that the continued reduction of the debt/GNP ratio depends on the renewal of growth and a reduction in the public deficit. Privatization receipts, which amounted to only 0.8 percent of GNP (accumulated) in 1994–96, rose significantly in the past two years, to 1.9 percent of GNP in 1997 and 1.1 percent of GNP in 1998. Most privatization receipts in the past two years were from the sale of Bank Hapoalim (NIS 1.6 billion), Israel Chemicals (NIS 498 million), United Mizrahi Bank (NIS 419 million), shares in the Israel Telecommunications Corp. Ltd. (NIS 327 million), Bank Leumi (NIS 270 million) and Discount Bank (NIS 181 million). The main motivation for privatizing is, as is known, the contribution of private management to greater efficiency and improved competitiveness and not raising capital in order to reduce of the public debt, and therefore it is important to ensure that the privatized companies operate in a competitive environment.

Developments in public-sector expenditure

The share of civilian public consumption in GNP fell by 0.1 percent of GNP in 1998, after declining by 0.3 percent of GNP in 1997.

The share of civilian public consumption in GNP fell by 0.1 percent of GNP in 1998, after declining by 0.3 percent of GNP in 1997. Civilian public expenditure rose by 1.5 percent in 1998, alongside a 0.5 percent fall in its relative price (in comparison with the GDP deflator). The volume growth stemmed in the main from an increase of 2.5 percent in purchases, while labor input increased by a moderate 0.9 percent (without the strikes in the public sector the growth would have been greater). According to labor force survey data, the number of hours worked in the public services rose more rapidly—by 3.8 percent. The analysis in this chapter is based on National Accounts figures, which are regarded as being more reliable.⁴ If, however, the labor force survey data reflect developments in the public sector, the rapid growth of public-services employment (5.7 percent) embodies an increase in future wage payments in the public sector, indicating the relaxation of the fiscal discipline attained in 1997.

The fiscal restraint of the past two years was accompanied by a significant drop in public-sector investment—from 3.8 percent of GNP in 1996 to 3.3 percent of GNP in 1997, and 3.5 percent of GNP in 1998.

The fiscal restraint of the past two years was accompanied by a significant drop in public-sector investment—from 3.8 percent of GNP in 1996 to 3.3 percent of GNP in 1997, and 3.5 percent of GNP in 1998. While the fall in investment contributed to a reduction in the deficit, it caused an investment backlog, that could harm economic growth (and increase the need for investment in coming years). Despite the fall in investment, there was a substantial increase in roads investment (21 percent), due mainly to a rise in this kind of investment by local authorities (31 percent). The acceleration was brought about by the extensive activity of the local authorities this year, though in view of the financial position of many of them, it is doubtful whether this level of investment will persist.

Transfer payments rose by 0.2 percent of GNP in 1998—a change that reflects a 6.5 percent increase in current transfers and a steep 7.4 percent drop in capital transfers.

Transfer payments rose by 0.2 percent of GNP in 1998, a change that reflects a 6.5 percent increase in current transfers and a steep 7.4 percent drop in capital transfers. National Insurance payments, which constitute the lion's share of current transfers, grew this year by 8.3 percent, pension payments of civil service workers rose by 1.3 percent, and other pension payments increased by a steep 8.4 percent. The latter include grants to demobilized soldiers, which increased by 65.5 percent, grants to victims of Nazi persecution (8 percent), the immigrant assistance package and Ministry of Defense allowances (which grew at a similar rate of 3.1 percent). The fall in transfer payments to firms reflects, among other things, a sharp decline of 21.6 percent for expenditure under the Encouragement of Capital Investments Law due to the deterioration in conditions for investors and the recession. The share of in GNP of direct subsidies given by the public sector fell by 0.1 percent of GNP, in line with its long-term declining trend.

⁴ The National Accounts data are based on a considerably larger sample than those of the Labor Force Survey and hence are regarded as being more reliable. The rapid growth found in the survey may be due to the rise in public-sector employment via outsourcing services to sub-contractors and personnel companies, or because the private-sector demand for educational services, health services, etc. increased.

The increase in National Insurance payments (8.3 percent) is largely due to the rapid rise in unemployment benefits (15.4 percent) and income support (19.8 percent), explained mainly by the greater number of persons eligible for allowances (11 percent and 12.6 percent, respectively) because of the recession. There was also a rapid increase in welfare payments, general disability, old-age, and survivors' allowances (13, 11.4, and 7.5 percent respectively), partially explained by the greater number of those receiving allowances (10.8, 6.6, and 3.5 percent respectively). The increase in expenditure over and above the rise in the number of pensioners stems mainly from the 2.2 percent increase in the average wage, and the greater proportion of persons eligible for increased welfare payments.

Public-sector revenue

Public-sector tax receipts (including property taxes) fell in 1998 by 0.5 percent of GNP, although statutory tax rates remained unchanged. Most of the decline is attributable to indirect taxes (whose share in GNP fell by 0.4 percent), because the rate at which private consumption expenditure rose (5.1 percent) was more moderate than that of product prices (7.1 percent), as well as to the slump in the real-estate market and the fall in the share of tax-intensive consumer durables—causing the nominal increase in indirect taxes (6.9 percent) to fall below that in private consumption (8.6 percent). The slump in the real-estate sector was reflected by a mere 0.7 percent increase in property taxes⁵ and a moderate rise in VAT receipts (7.2 percent). These grew less than private consumption, as VAT is also imposed on the purchase of new apartments (an element that is not included in private consumption), which decelerated. The rate at which demand for durable goods rose (2.7 percent) was more moderate in 1998 than that of private consumption, including the expenditure on tax-intensive imported personal vehicles (1.9 percent); this was expressed in the moderate nominal rate of increase in purchase-tax receipts (2.0 percent).

The proportion of direct taxes in GNP fell by 0.1 percent, because the rate at which company tax receipts rose (4.7 percent, in nominal terms) was far below that of the return on gross capital (15.5 percent, in nominal terms). Thus, the ratio of company tax receipts to the rate of return on capital fell in 1998, after increasing sharply in 1997.

The budget deficit

In the last two years the government has met its overall deficit target under the Budget Deficit Reduction Law. Meeting the overall deficit target (despite the deviation of the domestic deficit from its planned level) was made possible, amongst other things, by including the 'Real Realized Profit' of the Bank of Israel in government revenue. These profits arise from the accounting method, whereby interest income of the Bank of Israel from its foreign exchange reserves is recorded as income, while the interest cost

Public-sector tax receipts fell by 0.5 percent of GNP in 1998, due to the slump in the real-estate market, and a fall in the share of tax-intensive consumer durables. Statutory tax rates remained unchanged.

Meeting the total deficit target (despite the deviation of the domestic deficit from its planned level) was made possible *inter alia* by including the Bank of Israel's real realized profits in government revenue.

⁵ Including improvement and land betterment tax, which are not included in indirect taxes.

Table 5.2
The Government Deficit: Planned and Actual, 1996–98

	1996 ^a	1997	1998
Overall deficit			
Planned	3.6	2.8	2.4
Actual	4.1	2.8	2.4
Actual <i>less</i> Bank of Israel profits	4.6	3.5	3.5
Domestic deficit			
Planned	2.5	2.3	2.2
Actual	4.7	3.1	3.3
Surplus receipts ^a		-1.1	-1.2
Surplus expenditure ^a		-0.5	0.1 ^b

^a After adjusting forecast price increases in the budget (11.2 percent in 1997 and 9.2 percent in 1998) to the actual average rise in the CPI (9 percent in 1997 and 5.5 percent in 1998). No forecast of price increases was published in 1996, so that the deviation of receipts and expenditure in that year could not be calculated.

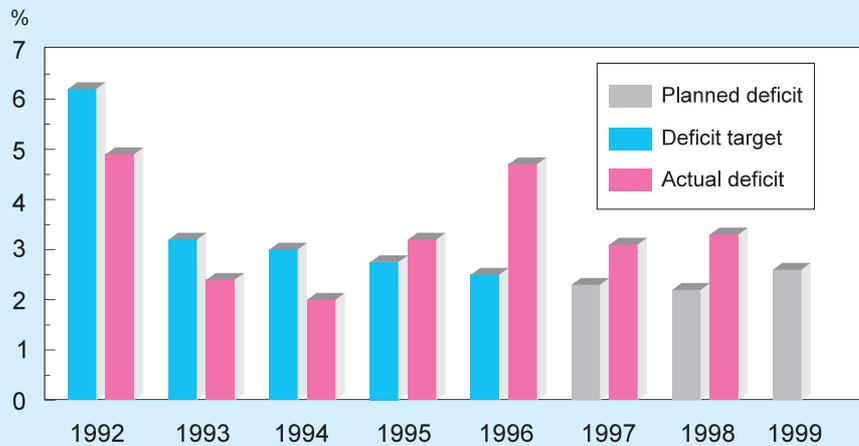
^b An increase in the reserve made against price increases from 3 to 5 percent at the beginning of the year made it possible to adjust the price-increase assumed in the budget to the slowing of the inflation rate, thereby helping to meet the expenditure target.

on its liabilities is not recorded as an expense. The ‘Real Realized Profit’ of the Bank of Israel (1.4 percent of GNP in 1998 and 1 percent of GNP in 1997), which do not reflect the Bank’s actual income surplus, reduced the government’s external deficit and enabled it to meet the overall deficit target. The overall deficit dropped from 2.8 percent of GNP in 1997 to 2.4 percent of GNP in 1998. The domestic deficit, which better reflects the development of the budget deficit, actually increased this year (by 0.2 percent of GNP), to approximately 3.3 percent of GNP, and thus deviated by 1.1 percent of GNP from the planned level. The deviation from the planned domestic deficit stems in the main from the revenue side, which fell short of the forecast because the actual rate of growth (2 percent) was less than the predicted in the National Budget (3.1 percent), and also because the expected extent of revenues was not attained.

In retrospect, the switch from the domestic to the overall deficit (in 1997) made it possible to increase the domestic deficit at a time of economic slowdown, when developments in Israel and globally resulted in greater ‘Real Realized Profit’ of the Bank of Israel. If the growth rate of the past two years had been in line with that of the past twenty years (4.1 percent), tax receipts would have been greater than they were by about 0.5 percent of GNP in 1997, and by an additional 0.7 percent of GNP in 1998 (assuming that their elasticity relative to GNP is unitary). Therefore, the deviation from the domestic deficit target in 1998 (1.1 percent of GNP) is due chiefly to the recession (beyond the annual average) and to the consequent loss of tax receipts (about 1.2 percent of GNP). The adjustment of the domestic deficit to the business cycle was almost coincidental, however, and not sufficiently transparent, and occurred without the creation of a mechanism to ensure a speedier reduction of the deficit at a time of economic prosperity.

The deviation from the domestic deficit target in 1998 (1.1 percent of GNP) is due to the recession and the consequent loss of tax receipts (about 1.2 percent of GNP); it indicates that the adjustment of the domestic deficit to the business cycle was coincidental and not transparent.

Figure 5.1
Domestic Budget Deficit/GNP Ratio,^a 1992-99



^a Until 1996 the target was defined as the domestic deficit, and since 1997 as the overall deficit.
SOURCE: Based on Central Bureau of Statistics data.

3. FISCAL POLICY AND ECONOMIC ACTIVITY, A LONG-TERM PERSPECTIVE, 1994-98

In recent years fiscal policy has been influenced to a great extent by the Budget Deficit Reduction Law. This law regards the contraction of the fiscal and public deficit as a central long-term government objective. The law was passed in response to the spiraling inflation of the early 1980s, when enormous public-sector deficits, increased the debt burden and depressed growth rates. The Budget Deficit Reduction Law does not take into account fluctuations in the business cycle, which, as is known, characterize economic activity and are expressed in a rapid increase in government revenues during an upswing and their deceleration in a downswing. In the 1990s, Israel experienced a sharp change in the business cycle, beginning with a boom that had its origin in the influx of immigrants, the peace process, and expansionary economic policy, resulting in unsustainably high growth rates. This was followed by a slowdown when immigration tapered off and, allied with the uncertain political-security climate, this was exacerbated by the global economic crisis that commenced in East Asia as well as by the tightening of economic policy.

The Budget Deficit Reduction Law requires the government to curtail its expenditure (and increase in its tax receipts) more in a recession than would be necessary given long-term considerations, but does not prevent the rapid growth of expenditure (and reduction of the tax burden) during a boom. Therefore, as the business cycle gains momentum, it is necessary to adjust the deficit target to prevailing conditions. But adapting the deficit to the swings of the business cycle can undermine the credibility of

The Budget Deficit Reduction Law requires the government to contract its expenditure in times of recession more than would be needed by long-term considerations, but does not prevent a rapid increase in expenditure during periods of prosperity.

In recent years, fiscal policy was expansionary during an upswing and contractionary during recession, thereby exacerbating the business cycle.

fiscal policy. Furthermore, it is difficult to define the deficit unequivocally while stripping out the effects of the business cycle.

The GDP growth rate, as an annual average, leaped by 6.8 percent in 1994–95, and plummeted to 2.3 percent in 1997–98. The sharp fluctuations in GNP caused a similar fluctuation in expenditure by the government and the public sector, and the pro-cyclical fiscal policy and the composition of public expenditure appear to have exacerbated the business cycle. Tax receipts, which grew rapidly in 1994 and 1995, served the fiscal expansion (Table 5.2): public-sector wages rose significantly, public expenditure and transfer payments accelerated, and statutory tax rates were reduced. The expansionary policy created a substantial deficit in the government and public-sector budget which first emerged in 1995 and more intensively with the slowing of the rate growth in 1996. In response to the marked increase in the public-sector deficit, and the concurrent deficit in the balance of payments, the government replaced the expansionary policy that had characterized the years of prosperity with a contractionary one, doing so during a period of slowdown. In addition, there was no significant change in the composition of public expenditure in favor of items that could have accelerated economic activity during the recession, such as infrastructure investment.

The fiscal consolidation implemented in 1997 only partly corrected the rapid rise in public expenditure evident during the upswing, so that in 1994–98, there was an increase in all the components of public expenditure: labor input in the public sector grew at an annual average of 3.3 percent, while the civilian labor force grew by only 2.2 percent; the cost of labor input increased at an average annual rate of 3.6 percent, a much faster rate than the increase in salaries in the business sector (0.8 percent); per capita transfer payments rose by 4.5 percent, compared with a far more moderate increase in per capita GNP (2.0 percent). These developments are not consistent with the government's long-term objectives (which include, in addition to lowering the deficit, the reduction

Table 5.3
Selected Indicators of Fiscal Policy, 1994–98

	(percent, annual average rates of change)			
	Accelerated growth 1994–95	Transition period 1996	Economic slowdown 1997–98	Entire period 1994–98
Rate of GNP growth	6.8	4.7	2.3	4.6
Rise in public-sector unit labor cost	9.0	1.5	-0.6	3.6
Rise in civilian labor input	4.8	3.7	1.6	3.3
Rise in civilian consumption	5.8	4.4	1.8	3.9
Rise in transfer payments (excl. unemployment benefits)	9.3	8.6	5.0	7.4
Rise in tax receipts (excl. national insurance)	6.8	1.4	3.8	4.5
Effect of change in law on tax receipts ^a (cumulative change as percent of GNP) ^b	-1.6	-0.1	0.6	-1.1

^a The rise in tax receipts refers to public-sector revenues, including health service payments.

^b The estimate of the effect of the change in the law is based on the estimates of the State Revenue Administration.

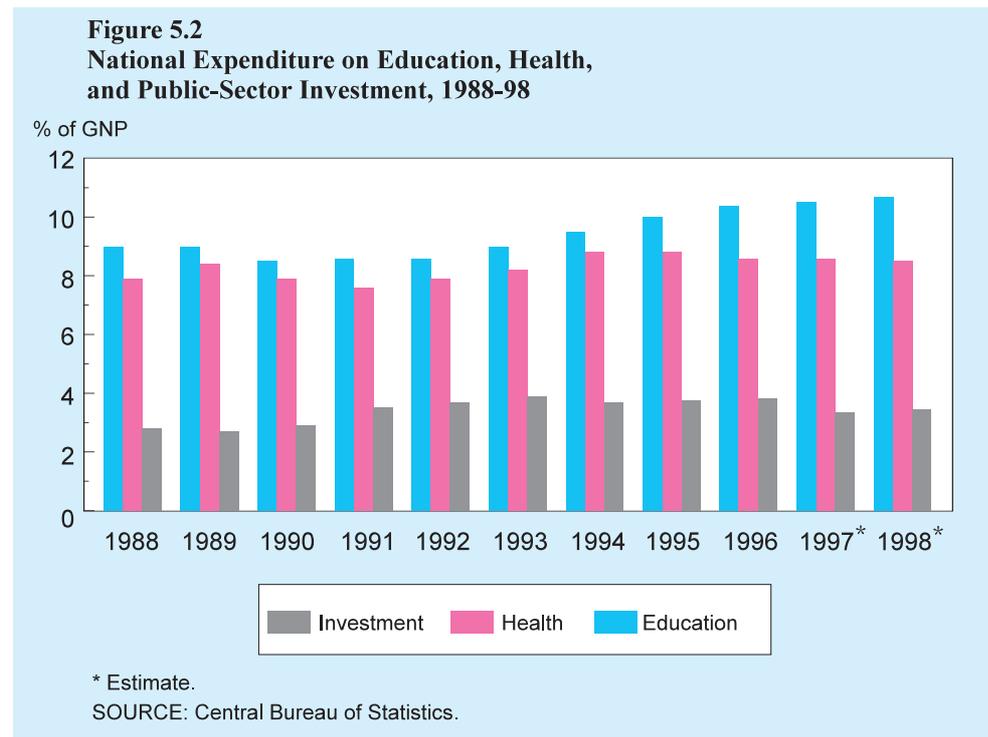
of the debt/GNP ratio, the contraction of the share of government expenditure in GNP, and no increase in taxes). As a lesson for the future, they indicate the need to add expenditure limits to the Budget Deficit Reduction Law, making it effective in periods of prosperity without neutralizing the effect of the ‘automatic stabilizers’ during a slump.

4. RESOURCE ALLOCATION POLICY AND ECONOMIC INEQUALITY IN THE 1990S

National expenditure on education in Israel is the highest in the western world (as a percentage of GNP). In 1996 it was 10.4 percent of GNP, substantially higher than the average in western countries (6.2 percent of GNP in 1994). In recent years investment in human capital has risen impressively: the share in GNP of national expenditure on education was 2.1 percent greater in 1998 than in 1992.⁶ Although public expenditure on education (which finances some 80 percent of national expenditure on education) is recorded as part of public expenditure, it should be regarded as investment in human capital, contributing to economic growth. From 1991 to 1996 there was an impressive rise in physical investment by the public sector, reaching an annual average of 3.7

The fiscal policy of the last few years serves as a lesson for the future regarding the need to add spending limits to the Budget Deficit Reduction Law, which will be effective during a boom and will not neutralize the effect of the ‘automatic stabilizers’ in a recession.

National expenditure on education grew from 8.7 percent of GNP in 1992 to 10.4 percent in 1996.



⁶ According to Central Bureau of Statistics estimates, expenditure on education grew from 8.7 percent of GNP in 1992 to 10.4 percent of GNP in 1996. As the CBS does not have data for 1997 and 1998, the estimate for these years is based on the rise in the number of employees and their salaries.

percent of GNP compared with an average of only 2.4 percent in the 1980s. In recent years, concurrent with the deceleration of the growth rate and the reduction of the public-sector deficit, public-sector investment in education fell to 3.4 percent of GNP (on average).

Health expenditure in Israel was 8.4 percent of GNP in 1997, similar to the average in the west.

Besides educational services (8.3 percent of GNP), public consumption includes health services (6.2 percent) and other government services—expenditure for ensuring public order, social welfare, etc. Health expenditure in Israel reached 8.4 percent of GNP in 1998, similar to the average in western countries (the relatively young age-composition of the population in Israel helps to keep national health expenditure down and increases national expenditure on education). As a result of the introduction of the State Health Insurance Law,⁷ which was intended to ensure equality in health treatment, the public sector finances 74 percent of national health expenditure. (44 percent before the law was passed). Although national health expenditure has not risen since the law came into effect in 1995, this situation cannot be expected to continue; experience shows that the demand for health services grows faster than incomes: expenditure on health in Israel has risen (on average) from 5.3 percent of GNP in 1970 to 8.4 percent of GNP in 1997, similar to the rate (on average) in developed countries.

In response to the rise in economic inequality, the progressive effect of direct taxes and transfer payments served to reduce this inequality.

Economic inequality: In the last decade inequality in gross income distribution (before taxes and transfer payments) has increased significantly. In families headed by a wage earner (or non-working individual) the Gini⁸ index rose from 0.3700 in 1998 to 0.3946 in 1997, a change that attests to greater inequality in income distribution. This rise is largely attributable to the increased return on education and the exposure of the economy to imports that are labor-intensive and to foreign workers. In response, direct taxes and transfer payments served to reduce inequality, as is indicated by the relatively moderate increase in net income inequality: the Gini index rose from 0.3221 in 1988 to 0.3332 in 1997. The increasingly progressive effect (almost certainly associated with the rise in the excess tax burden)⁹ is reflected by both the increase in the share of current transfer payments in GNP, from 13 percent in 1988 to 14.3 percent in 1998, as well as by the greater share in GNP of direct taxes, which rose from an average of 19.1 percent in 1988–94 to 20.7 percent in 1994–98 (the increase in taxes was affected by the health tax, which intensified this progressiveness).

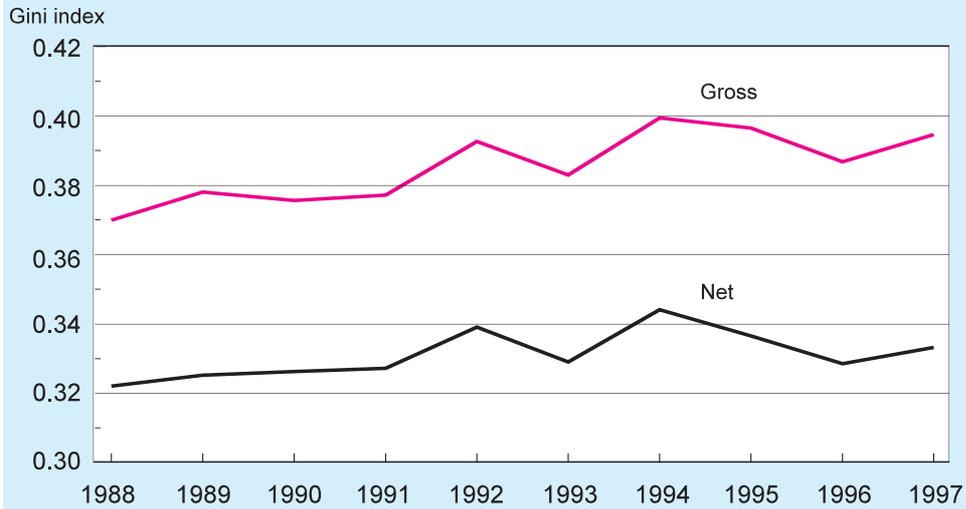
In recent years there has been a sharp fall in the subsidization of basic goods: the share of subsidies in GNP fell from 3.4 percent in 1989 to 1.3 percent in 1998, increasing the inequality in purchasing power (but enhancing economic efficiency). Both the

⁷ See Box 5.1 in last year's edition of this publication.

⁸ The Gini index is an accepted measure of the inequality of income distribution. An index of zero would indicate absolute equality of incomes while an index of one would indicate that all incomes are concentrated in the hands of a single individual (or family). According to international comparisons of the Gini index, income inequality in Israel is amongst the highest in the western world. See report the National Insurance Institute, 1995/6 (in Hebrew).

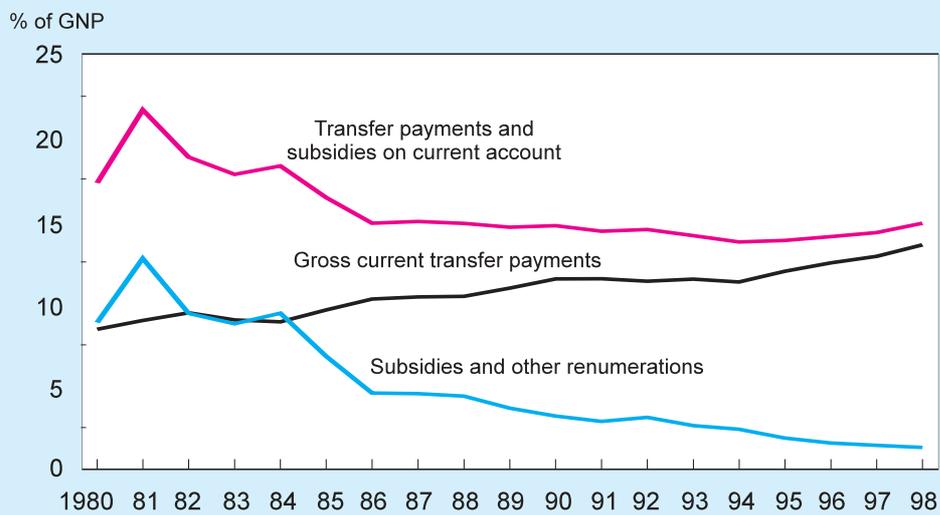
⁹ The excess tax burden is the cost associated with the distorting effect of taxes and subsidies on resource allocation.

Figure 5.3
Index of Inequality Among Families Where Wage Earner is Employed
or Not Working, 1988-97



SOURCE: Based on Central Bureau of Statistics data.

Figure 5.4
Transfer Payments and Subsidies, 1980-98



SOURCE: Based on Central Bureau of Statistics data.

reduction in expenditure on the subsidization of basic goods and the cessation of credit subsidies (which reached 3.4 percent of GNP in 1982–84) demonstrate a slackening in public-sector intervention in the activities of the private sector. The most important development in the public sector's allocation of resources is the reduction in defense expenditure (Box 5.1), which contributed to a lowering in the of debt/GNP ratio, and hence to a decline in debt-servicing payments.

Box 5.1: Defense Expenditure

The main development characterizing the public sector since the 1985 ESP is the drop in defense expenditure. The fall in its share in GNP—from one fifth at the beginning of the 1980s to one tenth in the second half of the 1990s—was due mainly to economic growth (in 1998 GNP was 107 percent greater than in 1980), developments such as the peace treaty with Egypt that brought the arms race between Israel and its neighbors to a close, the end of the cold war, and the drop in fuel prices. According to the SIPRI¹ Institute, Egypt reduced its military expenditure by 73 percent between 1980 and 1994, while the expenditure of Syria and Israel fell by 18 percent in the same period.

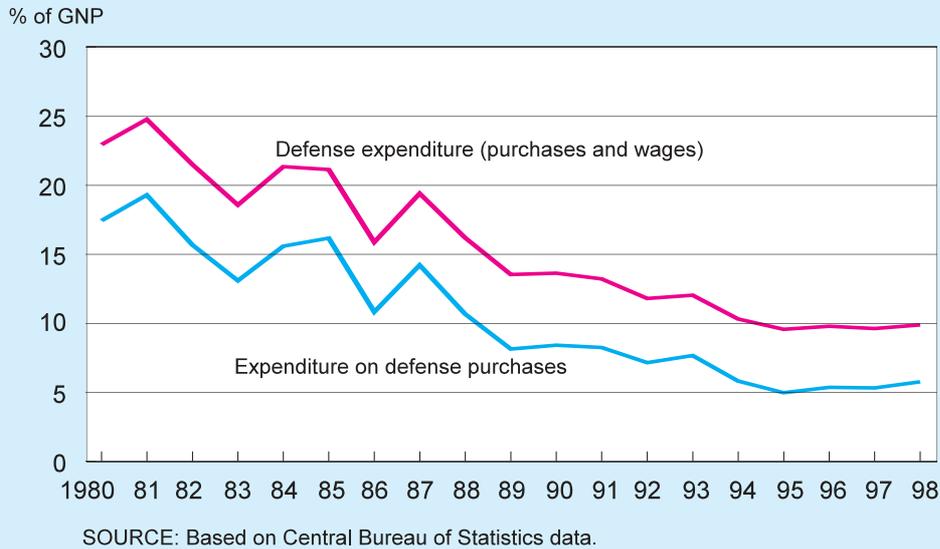
The fall in Israel's defense expenditure stemmed largely from a dramatic decline in the share of defense procurements in GNP—from 17.5 percent in 1980 to 5.5 percent in the last three years. The share in GNP of the defense establishment's wage payments fell moderately, from 5.6 percent to 4.4 percent, even though throughout the entire period (1980 to 1998) labor inputs increased by only 5 percent, and the rate at which the cost of defense labor inputs rose was similar to that of civilian labor inputs. The continued fall in the proportion of defense procurements in GNP made it possible to reduce the share of public-sector expenditure in GNP, from 80 percent in 1981 to 54.4 percent in 1994. From that year onwards the decline in defense procurements stopped (as a percentage of GNP) and the declining trend of public expenditure was reversed.

The defense burden, including the opportunity cost of the standing army—a burden that is not taken into account in the defense expenditure—had reached, according to a rough estimate,² 2.6 percent of GNP by 1997. Over the years the quota of soldiers in the standing army has risen both quantitatively and qualitatively at a pace similar to that of the labor force, so that the cost to the economy from their service (as a percentage of GNP) does not appear to have fallen significantly (the quantitative growth in manpower and the real fall in procurements almost certainly increased manpower intensity in the Israel Defense Forces). As the fall in the defense establishment's procurement item reaches an optimum, a continuation of the fall of the defense burden would seem to depend to an increasing extent on the contraction of manpower in the defense establishment.

¹ Stockholm International Peace Research Institute.

² The estimate is for 1997. As the standing army's manpower quota is secret, we assumed that 75 percent of Jewish adult males and 50 percent of Jewish females in the appropriate age groups serve the full period of military service. The opportunity cost of mobilized soldiers is calculated from the average wage of males and females (according to the survey of incomes).

Figure 5.5
Defense Expenditure, 1980-98



5. MAIN TRENDS IN NATIONAL INSURANCE PAYMENTS IN 1985–98

The share in GNP of National Insurance payments rose from 6.2 percent in 1985 to 8.0 percent in 1998, alongside the fall in expenditure on subsidies for basic goods from 4.8 percent of GNP in 1985 to 1.2 percent of GNP in 1998. The progressive effect of National Insurance allowances increased during this period due to the supplementary pension allowances to non-working individuals, the unemployed, and those without means of support, all of which grew rapidly. For example, the combined share in GNP of income support and welfare payments rose from 0.21 percent to 0.93 percent, the share of disability allowances rose from 0.81 percent to 1.04 percent, and the proportion of unemployment payments increased from 0.16 percent to 0.76 percent. Old-age and survivors' pensions and child allowances, which are paid irrespective of means (and are the principal National Insurance outlays), rose more moderately—from 4.59 percent of GNP in 1985 to 4.83 percent of GNP in 1998. Most of the increase in these payments was due to the expansion of eligibility among the disadvantaged population which in the past was not entitled to such allowances, e.g., housewives, new immigrants, child allowances in the Arab and ultra-orthodox sectors (as these allowances were no longer contingent on service in the IDF), and these changes made National Insurance allowances more progressive. The rapid growth in National Insurance payments and their increased progressiveness slowed the rise in the inequality of income distribution: the decline in the inequality index due to transfer payments grew from 20.2 percent in 1985 to 21.8 percent in 1997.

In 1985–98 the progressive effect of National Insurance payments increased.

Table 5.4
Development of the Principal National Insurance Categories, 1985–98

Type of benefit	Share of benefit in GNP	Annual rates of change		
		Rise in no. of eligible persons	Rise in relevant population	Real rise in value of benefit ^a
Retirement	3.18 ^b	4.2	Aged 65+ (3.4)	3.1 (0.9)
Beneficiaries		1.2		2.4 (0.2)
Children	1.69	3.3	Aged 0–19 (1.8)	1.9 (–0.3)
Unemployment	0.78	13.6	Unemployed (4.9)	4.8 (2.6)
General disability	1.04	5	General population (2.7)	1.0 (–1.2)
Permanent disability	0.59	4.4	Employed (3.4)	3.9 (1.7)
Days unable to work	0.18	7.2	Employed (3.4)	5.1 (2.9)
Maternity grant	0.26	1.8		5.5 (1.3)
Maternity pay	0.22	3.1		7.2 (3.0)

^a The table relates to the rate of increase in the value of the average benefit. The real wage rose by 2.2 percent in that period, while the average increase in the real wage of women was 4.2 percent. Figures in parentheses show the rise beyond the increase in the relevant real wage.

^b Joint share of retirement and beneficiaries benefit.

The rise in the number of persons eligible for benefits outstripped that of the relevant population, and most benefits grew faster than the average wage.

As Table 5.4 shows, the number of persons eligible for allowances rose more quickly than the relevant population group and that the average value of most allowances grew at a faster rate than the average wage. The rapid increase in the number of unemployed persons entitled to benefits was particularly pronounced, as was the increase in the number of those receiving disability payments and allowances for inability to work. Unemployment and disability payments grew at annual average rates of 19.1 percent and 6.1 percent respectively. The rise in unemployment benefits was due to the increase in the proportion of unemployed persons, from 20.5 percent to 57.9 percent. In addition, the rise in the average unemployment benefit exceeded that in the real wage. The rise in disability allowances is attributable to the higher proportion of recipients in the population, which rose from 2.9 percent in 1985 to 3.5 percent in 1998.

The average old-age pension rose in 1985–98 by an annual average rate of 3.1 percent. The increase stemmed from a 2.2 percent increase in the real wage (leading to a 2.4 percent increase in the basic old-age allowance linked to wages and from seniority increases. Seniority increases are awarded to persons receiving National Insurance pensions for more than 10 years, and this item grew at the maximum rate of 50 percent of the basic pension. The average increase in seniority of insured persons explains the increase in the old-age allowance beyond the average wage. The average child allowance rose by a real annual average rate of 1.9 percent, slightly below that of the average wage. During the period reviewed the proportion of families with four or more children receiving benefits continued to decline, while the proportion of families with one child receiving allowances increased—from 14.7 percent in 1985 to 34.4 percent in 1998. Since the child allowance paid to families with a large number of children is greater than that paid to families with a small number of children, in effect the child allowance grew by more than 1.9 percent.

Maternity payments are divided into a maternity grant (54 percent) and a maternity allowance (46 percent). Most of the maternity grant is transferred to the hospitals, and the increase in this item reflects a rise in the cost of hospitalization. Maternity benefits are awarded to working women. In 1985 the maternity grant was awarded for 42.1 percent of births, while in 1998 this was 50.3 percent. The rise reflects the increase in women participating in the labor force (from 37.5 percent to 45.8 percent). In 1998 the maternity allowance was 73.0 percent of the average wage compared only 40.4 percent in 1986. The rapid increase reflects the fact that since November 1994 maternity allowances have been paid according to the total average wage of those giving birth in comparison with 75 percent until then, and the fact that women's wages grew faster than the average wage. In 1997 women's wages were 76 percent of the average, while in 1985 they were only 60 percent.

Box 5.2 : Economic Inequality and the Education System

A public education system that is open to all strata of the population contributes to social mobility and the maximization of the economy's growth potential. It does not operate in a vacuum, however, and its ability to realize the potential latent in each student depends to a great extent on their socioeconomic background. A study of 80 townships in Israel whose population was greater than 10,000 indicated that the proportion of successes in matriculation examinations increased in line with the average wage and education level (of individuals aged 35 years and over) in the township. It was also found that the percentage of matriculation successes improved as the average family size in the township diminished. Another way of examining the effect of average socioeconomic background in the township on the extent of matriculation successes is to examine the percentage of students (in the 20-29 age group) attending institutions of higher education; a close correlation was found with the socioeconomic variables in this respect, too.

The relation between socioeconomic variables and children's scholastic success is attributable to a number of factors. The main one is income—a high income affords the student better conditions (lower occupancy per room, private lessons, etc.), or in other words, private investment in education rises in line with income.¹ Another factor is that educated parents give their children informal education, which improves their chances of success. The regression analysis shows that the elasticity of the proportion of children receiving a matriculation certificate in a township and the average income there is approximately unitary, i.e., a 1 percent increase in average income² will increase the percentage of

¹ The connection could be due to the liquidity constraint, or from a complementary relationship between private consumption and private investment in education.

² The reference is to that proportion of average income in the township that is not explained by the average education level there.

eligible matriculation pupils by 1 percent (e.g., from 50 percent to 50.44 percent). The conclusion that may be drawn from the correlation between parents' income and a child's scholastic success is that reducing economic inequality (e.g., through transfer payments and progressive taxation) can lower educational inequality amongst students, even though there might be more efficient methods of improving children's achievements in townships where incomes are low.³

The significant relationship between parents' income and children's success demonstrates the limited nature of social mobility and the difficulty encountered by the education system in enabling children from low-income townships to realize their potential. In view of this finding, the question arises whether allocating greater educational resources to schools with pupils from a lower socioeconomic background would increase their chances of success. Professor Victor Lavi⁴ found that an increase of that kind does improve the achievement of pupils in primary schools. In a study of 635 primary schools, he found that an increase in outlay per pupil, a longer school day, and an increase in the proportion of qualified teachers helped to improve reading and arithmetical skills. The study also demonstrated that the lower the socioeconomic level of the school, the greater the improvement in pupils' achievement (for a given outlay).

³ The assumption is that the differences in the distribution of innate abilities among the populations of the various townships is negligible, and that there is no other variable that explains the correlation between parents' income and children's success.

⁴ V. Lavi, 'Endogenous School Resources and Cognitive Achievement in Primary Schools in Israel,' Hebrew University, Falk Research Institute, Discussion Paper No. 95.03.1 (Hebrew).

6. ISSUES RELATING TO THE TAX SYSTEM IN ISRAEL

Israel's tax system imposes a very high marginal tax rate on medium and high wage incomes, and a relatively low tax on the return on capital.

Israel's tax system imposes a very high marginal tax rate on medium and high wage incomes, and a relatively low rate on the return on capital. The latter is divided between shareholders and lenders. While the return to shareholders is taxed at 52 percent (36 percent company tax and 25 percent tax on dividends, i.e., the profit after company tax), the return to lenders is largely exempt from tax, since the interest that the firm pays to lenders is a recognized deductible expense for tax purposes, and the income of lenders is almost entirely tax-exempt (see Box 7.2). Since a large part of a firm's capital is obtained as loans from banks and through bonds, the effective tax rate on the return on capital is less than 52 percent. Other factors that contribute to the reduction of the effective tax rate on shareholders' capital are the Encouragement of Capital Investments Law, which sets a reduced tax rate of 25 percent to approved enterprises, as well as the capital gains tax for quoted companies, which allows shareholders to defer some tax payments by means of dividends.

The low tax rate on the return on capital in Israel is due mainly to the low tax imposed on interest incomes and to the exemption from capital gains tax in the securities market.

In principle, a tax on capital encourages individuals to bring consumption forward (on the assumption that the substitution effect is stronger), and leads to lower rates of saving and investment, harming the capital accumulation that promotes growth. The taxation of capital, by contrast, adds to the equality of income distribution. Inequality in the distribution

of income from capital outweighs by far the inequality in the distribution of wage income, hence the taxation of capital is an essential element in a progressive tax system that seeks to impose a tax burden commensurate with each individual's economic ability. As is known, taxing capital represents a choice between economic efficiency and greater equality in the distribution of income. A comparison with the taxation of capital in western countries showed that in most cases the tax on capital is higher than in Israel. The higher taxation in the west is due, as stated, to the existence of a capital gains tax in the securities market, as well as to a higher tax rate on income from interest. Thus, for example, in the US, England, and Germany the tax on interest incomes is commensurate with the tax-payer's tax bracket, while in Japan it is set in accordance with the level of income from interest.

As opposed to the low rate of taxation on capital, Israel's tax system imposes a heavy burden on medium and high wage incomes. This burden harms the incentive to work and to acquire human capital. The marginal tax rate on labor income—which includes income tax and the National Insurance payments of the employee and the employer—reaches 59.4 percent and starts from a monthly income level of NIS 9,331; at an income level of between NIS 16,911 and NIS 23,284 it rises to 64.4 percent. From this level onwards the marginal tax rate falls to only 50 percent (due to the ceiling on National Insurance payments). For progressive tax considerations, as well as for reasons of efficiency, it is not necessarily preferable to reduce the marginal tax rate at the higher income tax brackets. It is our opinion that even at these levels the marginal tax rate should rise in line with income, and this should be a goal for future reform. In reducing tax, the focus should be on the brackets where the marginal tax rates are between 59 and 65 percent, since these are so high that they impair the incentive to work,¹⁰ and even create discrimination between investment in human and physical capital (as a higher marginal tax rate is imposed on human capital).

In the framework of the tax reforms discussed in 1998, the intention was to reduce the tax benefits for social welfare and population dispersion. These benefits contain a regressive element, since only individuals whose income above the tax threshold can receive them, as well as a progressive element, since the benefits are given mostly to weaker groups. Benefits are sometimes given by means of credit points, which reduce the average tax, but have almost no effect on the marginal tax. Consequently, reducing credit points while at the same time lowering the tax rate on wage income will increase the incentive to work. On the other hand, credit points sometimes serve to improve the tax system. For example, awarding credit points to working mothers is a form of compensation for expenses not recognized for tax purposes that are incurred by women going out to work—such as payments to maids, nursemaids, or day-care centers. Another form of tax benefit is to award a tax-exemption on National Insurance benefits and Ministry of Defense allowances. The tax reform was intended to reduce the marginal tax rate on labor, but including child allowances in the tax base would push wage-earners into a higher tax bracket, which contradicts the objective. The child allowances are important for enhancing horizontal equality between families of differing sizes, and including in the tax base would increase inequality in per capita income.

¹⁰ The Ben Shachar Committee, which examined the direct tax burden in 1975, recommended a marginal tax rate that increases with salary, reaching a maximum rate of 60 percent.

The high marginal tax rate on medium and high labor income impairs the incentive to work and to acquire human capital.

Tax benefits sometimes enable the tax system to be improved, so that it is necessary to examine each benefit specifically and avoid a sweeping cancellation of them all.

