Chapter 5
The General Government

The general government deficit,[1] public expenditure, the tax burden, and the public debt remained in 1999 at similar levels to those of 1997 and 1998. The central government deficit, measured according to the budget definition, exceeded the target, but was lower than in 1998. In view of the slow rate of GDP growth in 1998 and 1999, and the fact that 1999 was an election year, these developments indicate that fiscal discipline was to some extent becoming more firmly based, after the adjustment of the deficit path in 1997. The general government deficit adjusted for the output gap (the difference between actual and potential output) declined for the third successive year, and there are signs of tighter fiscal discipline not just in the central government, but also in the local authorities and the health funds. Nonetheless, in light of the increase in expenditure during past economic booms—both in Israel and in the OECD countries—the real test of whether there has been a change in policy, and the key to realizing the potential reduction of the deficit/GDP ratio—i.e., the actual reduction of the deficit—lies in preventing a rise in general government expenditure as income increases after the recession. This is especially acute in view of the potential to increase central government expenditure since the central government deficit target for the next few years was raised as a result of the forecast, which turned out to be erroneous, of a large deviation from the 1999 target.

Despite tighter fiscal discipline since 1997, the general government deficit remained very high compared with levels in the developed countries, and public expenditure and the public debt in Israel are among the highest of those countries. Moreover, since 1994, after most of the direct budgetary expenditure arising from absorbing the influx of immigrants at the beginning of the 1990s had been incurred, progress towards reducing the share in GDP of the general government deficit, public expenditure, and the public debt was slow in relation to the OECD

[1] The general government 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.). Its activity is measured in accordance with the definitions in the National Accounts, which differ from those used in the central government budget (see below).

countries, even after allowing for the effects of the business cycle. Hence, fiscal policy made no significant contribution to bringing the economy to a sustainable growth path. Furthermore, the changes in the composition of the budget in the last few years, and in particular the fall in general government investment—including a sharp decline in road investment in 1999—did not support sustainable growth either. The central government announced that it intended to reform direct taxation in 2001. A comparison with the OECD countries shows that the tax burden in Israel is not exceptional. Taxation on individuals' income in Israel has certain features which set it apart from the norm in industrialized countries, mainly the steep reduction in the marginal tax rate at high income levels, and the extensive tax exemptions on income from financial assets.

1. MAIN DEVELOPMENTS

The deficit of the general government, excluding the volatile item of the Bank of Israel's surplus income, has remained at 4% of GDP for the third year.

The (net) general government debt/GDP ratio did not change.

General government investment, especially in roads, fell steeply.

In 1999 the main fiscal aggregates remained at levels similar to those of 1997 and 1998 (Table 5.1). The general government deficit (excluding the volatile item of the Bank of Israel's surplus income[2]) stayed at about 4 percent of GDP for the third consecutive year,[3] with no change in the share in GDP of public expenditure or general government income, including the tax burden. The net general government debt/GDP ratio hardly changed either, and general government investment, particularly in roads, plunged. Thus, 1999 was another year in which no progress was made towards reducing the general government deficit, the public debt, or public expenditure in terms of GDP, or towards alleviating the tax burden and increasing infrastructure investment. These variables remained at their 1994 levels—after the main direct government expenditure arising from the absorption of the mass immigration at the beginning of the 1990s had been incurred—and to which they returned as a result of the fiscal consolidation of 1997.[4] As has been shown in empirical studies, it is vital to make progress in these areas in order to set the economy on a sustainable growth path based on increasing the supply of business-sector product, and in reducing vulnerability to financial crises.

The central government deficit, as defined in the budget, was 2.2% of GDP in 1999, slightly above the target but just below the 1998 deficit.

The deficit of the central government, the largest entity in the general government, amounted to 2.2 percent of GDP in 1999, according to the measurement method used in the national budget. This deficit was about one-fifth of one percent of GDP above the target set in the Budget Deficit Reduction Law which was in effect when the 1999 budget was presented, but was slightly below the actual 1998 deficit (in 1999 the law

[2] See discussion below.

[3] The series of general government data (including data for previous years) published by the Central Bureau of Statistics (CBS) changed in 1999 because of the switch to the Standard National Accounts (SNA) 93 system of accounting. The main changes relate to the income of the Israel Lands Administration and the Bank of Israel. Another change is that the data are now given in terms of GDP instead of GNP as in the past.

[4] For an account of the period 1994–98 as a fiscal cycle, see Chapter 5 of the Bank of Israel *Annual Report, 1998*.

Table 5.1
The Main Components of Income and Expenditure of the General Government, 1994–99

(percent of GDP)

	1994	1995[a]	1996	1997	1998	1999
Total receipts	51.5	51.4	49.7	49.9	50.7	49.7
of which: From property	1.4	1.9	1.6	1.1	1.7	0.8
Total taxes	39.3	39.8	38.5	39.7	39.5	39.5
Indirect taxes on domestic production	13.9	13.9	14.2	14.5	14.3	14.3
Indirect taxes on civilian imports	5.6	5.6	5.1	4.6	4.5	4.7
Direct taxes, fees, and levies	15.1	14.6	13.5	14.7	14.6	14.4
National Insurance income	4.7	5.7	5.7	5.9	6.0	6.1
Total expenditure	55.0	56.2	55.2	54.0	54.3	54.4
of which: Domestic civilian consumption	17.9	20.1	20.3	20.0	19.8	19.8
Domestic defense consumption	7.9	7.7	7.5	7.3	7.1	7.2
Defense imports	2.0	1.5	1.8	1.8	1.9	2.1
Direct subsidies	1.9	1.4	1.1	1.0	0.9	0.8
Transfer payments on the current account	11.5	12.0	12.0	12.6	12.9	13.0
Transfer payments on the capital account	3.0	2.8	2.6	2.0	1.6	1.7
General government investments	3.6	3.6	3.7	3.1	3.5	3.1
Interest payments	6.9	7.0	6.1	6.1	6.3	6.5
Total general government deficit	3.5	4.8	5.5	4.1	3.6	4.8
Total general government deficit excluding the Bank of Israel	3.8	5.2	5.8	3.9	4.0	4.0
Total surplus excluding interest and receipts from property	2.0	0.3	–1.0	0.9	1.0	0.9
Net public debt[b]	92.5	89.9	89.7	88.3	88.3	87.8
Gross public debt excluding the Bank of Israel[c]	118.1	111.8	109.5	107.1	111.2	106.0

[a] From 1995, including receipts and expenditure due to the National Health Law.
[b] Divided by GDP at end-of-year prices.
[c] After deducting local authorities' debts to the government.
SOURCE: Based on Central Bureau of Statistics data.

was amended for the fourth time since 1992). This was the first time the deficit deviated from the target, after two years in which the central government had complied with the original provisions of the law. Despite the downward path of the deficit (budgeted and actual), after deducting the accounting item of the Bank of Israel's 'real realized profits,'[5] which includes most of the Bank's income but only a small share of its expenses, the deficit declined by only 0.2 percent of GDP in the last two years, and in 1999 was about one percent of GDP higher than in 1994 (Table 5.2). The domestic deficit, which in 1999 deviated by about 0.4 percent of GDP from the budget estimate, was only 0.1 percent of GDP lower than in 1997. The deficit deviated from its 1999 target as a result of the lower level of income, mainly non-tax income, than forecast in the budget, alongside some under-expenditure. The end-year deficit turned out to be significantly

Adjusted for the accounting item 'Bank of Israel's profits,' in the last two years the deficit has declined by only 0.2% of GDP, and was 1% of GDP higher in 1999 than in 1994.

[5] A discussion of the Bank of Israel's real realized profits appears in section 5 below.

The central government's tax revenues in the last four months of 1999 were up by NIS 3 billion over the forecast prepared in September.

If the expenditure framework is maintained in accordance with the budget approved by the Knesset, and if the expansionary trend of economic activity is not reversed, the central government will be able to reduce its deficit in the year 2000.

lower than that estimated during the year, an estimate which had led to the deficit path being raised for the years 2000 to 2003. The smaller deficit was due to the significant expansion of the central government's tax revenues in the last four months of the year, to a level almost NIS 3 billion (7.5 percent) higher than the estimate prepared in September, and which already incorporated an increase of NIS 750 million. The main cause of the sharp increase in tax revenues at the end of the year was the acceleration in economic activity in that period, together with temporary factors which increased receipts from real-estate taxes. It seems, therefore, that if the central government adheres to the expenditure framework in accordance with the budget approved by the Knesset (Israel's parliament), and there is no reversal of the GDP growth trend, the deficit can be reduced in 2000, too.

Table 5.2
Development of Government Deficit, Defined in Different Ways, 1994–2000

(percent of GDP)

	1994	1995	1996	1997	1998	1999	2000[c]
Maximum government domestic deficit[a]	3.0	2.8	2.5	2.3	2.2	2.6	2.8
Actual government domestic deficit	1.9	3.2	4.5	3.1	2.9	3.0	...
Maximum total government deficit[b]	3.5	3.8	3.6	2.8	2.4	2.0	2.5
Maximum total government deficit excluding profits of the Bank of Israel	3.8	3.9	3.7	3.0	2.8	3.1	3.6
Actual total government deficit	2.3	4.1	3.8	2.7	2.4	2.2	...
Actual total government deficit excluding profit of the Bank of Israel	2.3	4.5	4.3	3.4	3.4	3.2	...

[a] Until 1996 – the deficit ceiling specified by law; from 1997—the planned deficit, excluding credit. The difference between the planned and the actual deficit includes 0.15 percent of GDP reflecting foreign-exchange tax receipts which are recorded as domestic when the budget is being prepared, but as receipts abroad in the data of performance.
[b] Until 1996, the planned deficit; from 1997, the deficit ceiling specified by law.
[c] As in the budget.
SOURCE: Based on the National Budget Summary and Central Bureau of Statistics data.

The central government resisted the temptation to diverge from its declared strategy of gradually reducing the deficit in order to try to expand demand in the short run.

In spite of the lack of improvement in the fiscal aggregates, an analysis of their development, in view of persistent (annual average) GDP growth at a significantly lower rate than that of potential output—and taking into consideration the fact that 1999 was an election year—indicates that, as in 1998, fiscal discipline was maintained in 1999, not only by the central government but also by the other components of the general government. An estimate of the public deficit that incorporates the effect of the deviation from potential output (see below) points to a 0.8 percent of GDP reduction of the deficit in 1999 and a cumulative 1.5 percent in the last two years. This calculation of the direct effect of general government activity on economic activity in 1999 indicates a limited negative fiscal impulse, as was the case in 1998, after the general government was active in slowing economic expansion in 1997. Thus, the central government did not succumb to the temptation to deviate from its declared strategy of gradually reducing the budget deficit in order to try to increase demand in the short run. Notwithstanding, calculations of this kind are sensitive to the estimate of potential output and to assump-

tions regarding the extent to which tax revenues and public expenditure respond to GDP growth. Progress towards Israel's fiscal targets, even adjusting for the effect of the business cycle, is slow in comparison with the fiscal consolidation implemented by many of the developed countries in recent years, but the reduction of the deficit in 1997 narrowed the gap that had emerged between Israel and the developed countries in 1994–96.

As a share of GDP, general government expenditure remained unchanged in 1999.

General government expenditure as a share of GDP remained constant this year (rising from 54.3 percent of GDP in 1998 to 54.4 percent in 1999), even though the growth rate of public expenditure accelerated, outstripping those of GDP and the population. Domestic expenditure declined by 0.5 percent of GDP, but this was mostly in investment—in some of whose components there is a grave backlog (see Chapter 2)—and in interest payments, which reflect mainly the results of past policy. Concurrently, defense imports continued to rise, and were up by 0.2 percent of GDP in 1999. There was a notable slowing of the rise in transfer payments to individuals this year, their share in GDP remaining steady after several years in which they had grown particularly rapidly. With the exception of the Bank of Israel's profit, changes in the income items were negligible, and the tax burden remained unchanged. No significant statutory changes were introduced regarding the tax system in 1999 although a local property tax hike was approved that went beyond adjusting it to inflation, as was done in the last few years.

The general government deficit, which includes the Bank of Israel's surplus income as recorded in the National Accounts, rose from 3.6 percent of GDP in 1998 to 4.8 percent in 1999, similar to its level in the early 1990s. The wide fluctuations in the Bank of Israel's surplus income in recent years, which affect the general government deficit, reflect the volatility of the year-end inflation rate, which was 1.3 percent in 1999 vis-à-vis 8.6 percent in 1998. As the Bank of Israel's main expenditure item since 1997 has been interest payments on banks' deposits, which are in nominal terms, unexpected swings in inflation lead to sharp shifts in the *ex post* real interest rate on these deposits (a sort of 'inflation tax'). Consequently, this item has been excluded from the analysis of the development of fiscal policy in the short run.

2. THE GENERAL GOVERNMENT DEFICIT AND THE PUBLIC DEBT

No progress was made in 1999 in reducing either the general government deficit or the public debt/GDP ratio, but part of the stagnation in these areas can be ascribed to slow GDP growth.

As stated, no progress was made in 1999 towards reducing the general government deficit and the public debt/GDP ratio, but some of the stagnation in these areas can be ascribed to the slow rate of GDP growth. This is particularly the case because the expansion of aggregate demand was directed towards imports, especially of investment goods and inventory inputs (mainly diamonds), which are tax-exempt. Since the size of the general government deficit is endogenous to the development of GDP, it is customary to examine also the development of the 'structural' general government deficit, calculated on the basis of the assumption that output is at its potential level.

According to estimates made in the Bank of Israel's Research Department, the deviation of the rise in business-sector product from its potential was 3 percent in 1999

and a cumulative 5 percent in 1998–99.[6] When these estimates are adjusted for the output gap (i.e., the extent of the deviation of actual from potential GDP growth) they indicate a 2 percent gap in 1999 and a cumulative 3.5 percent gap in the last two years. As the elasticity of tax receipts to GDP in the last decade is approximately unity,[7] adjusting tax receipts in accordance with the output gap in 1997–99 increases them by 3.6 percent (1.4 percent of GDP) over their 1997 level.

The analysis of the effect of the output gap on expenditure can be divided into three major components: a. unemployment benefits and income assurance payments; b. central government subsidies for investment and construction; c. other expenditure. It can be assumed that, had there been no deviation from potential output, unemployment would not have risen in 1998 and 1999, and the unemployment rate in 1999 would have been 7.5 percent,[8] 1.4 percentage points (i.e., 16 percent) lower than it actually was. Reducing unemployment benefit and income assurance payments by 16 percent would have lowered the general government deficit by 0.2 percent of GDP. As for subsidies for investment and housing, which amounted to 1.7 percent of GDP in 1999 (and 2.6 percent in 1996), because of the frequent policy shifts of the last decade it is difficult to estimate their elasticity to economic activity, but it appears to be fairly large, hence their deviation due to the output gap more or less offsets the effect of unemployment benefits.

Since other central government expenditure is not automatically coordinated with the level of economic activity it can be assumed that its level is not affected by the output gap. Under this assumption, the general government deficit adjusted for the business cycle contracted by 0.8 percent of GDP in 1999, and by 1.5 percent of GDP since 1998. The empirical data contradict the assumption that general government expenditure is not elastic to GDP, however. For example, studies by Gavin and Perotti as well as by Melitz found a positive relation between changes in GDP and a rise in public expenditure in the OECD countries and Latin America.[9] Hercowitz and Strawczynski[10] found that between 1975 and 1997 public expenditure rose in the OECD countries (i.e., in each one separately) by more than the average for the entire period in those years when GDP growth outstripped the average, so that the ratio of public expenditure to GDP did not alter. On the other hand, in years when GDP growth was

[6] Based on the method in Y. Muallam and Y. Menashe (2000), *Measuring the Output Gap and Its Effect on the Import Surplus*, Bank of Israel, Research Department, internal memorandum (Hebrew).

[7] Estimates made for most OECD countries yielded similar results (OECD, Economic Outlook 66, December 1999).

[8] The calculation is the deviation of actual from potential output in the same year. Hence, if GDP growth in these two years had been in step with its potential, the unemployment rate would have remained as it was in 1997, rather than at its lower 'natural' rate.

[9] M. Gavin and R. Perotti (1997), "Fiscal Policy in Latin America," *NBER Macroeconomic Annual*, 12, 11–61; J. Melitz (1997), *Some Cross-Country Evidence About Debt, Deficits and the Behavior of Monetary and Fiscal Authorities*, CEPR discussion paper 1653 (May).

[10] Z. Hercowitz and M. Strawczynski (1998), *On the Cyclical Bias in Government Spending*, Bank of Israel discussion paper 98.06.

below the average, public expenditure did not rise by less accordingly, so that as a share of GDP it increased. Against this backdrop, Israel's progress in the last two years—the period of economic slowdown—in reducing the general government's structural deficit can be seen as an achievement. Nonetheless, benefiting from the achievement, so that it is expressed in a reduction of the actual deficit, will depend on not allowing the rise in expenditure to accelerate once the output gap is closed.

In view of the experience of the developed countries, Israel's progress in the last two years—a time of economic slowdown—in reducing the general government's structural deficit can be seen as an achievement. However, utilizing it will depend on not increasing expenditure at a time of rapid economic growth.

According to the above calculation, fiscal policy served to widen the output gap by some 0.8 percent (excluding the effect of the Bank of Israel's surplus expenditure). However, it is more difficult to assess the overall effect on economic activity of changes in the structural deficit. This calculation of the fiscal impulse fits the Keynesian approach of emphasizing the short-term influence of policy, on the basis of which the fiscal impulse affects GDP in accordance with the size of the multiplier. In the long run, on the other hand, reducing the general government deficit serves to increase GDP through its positive effect on the supply side.[11] In addition, a smaller general government deficit (and hence a smaller debt) reduces the economy's vulnerability to financial crises. Consequently, a fiscal consolidation implemented when there is a danger of a financial crisis (as was the case in Israel in 1997) could prevent the crisis from seriously impairing economic activity; even if the adjustment involves some slowing of activity in the short run, this will still be higher than the level to which activity would have sunk had it not been for the adjustment.

The general government deficit adjusted for the business cycle contracted by 0.8% of GDP in 1999, and by 1.5% of GDP in the last two years.

In the two last decades, due *inter alia* to the process of integration of the global economy and the development of the capital markets, doubts have been voiced in the economics literature as to whether the process of reducing the general government deficit necessarily involves an economic slowdown in the short run (see Box 5.1). Empirical data from many countries indicate that large fiscal consolidations that are appropriately constituted can bring about the expansion of economic activity even in the short run. According to the analysis in Box 5.1, however, the composition of Israel's fiscal consolidation of 1997 served to slow economic activity.

The composition of the fiscal adjustment made in Israel in 1997 appears to have slowed economic growth.

An international comparison shows that Israel's general government deficit is particularly large (Table 5.3). Among all the developed countries, as defined by the IMF, only Japan—which adopted an especially expansionary fiscal policy at the end of the 1990s (and failed in its attempt to trigger the revival of growth thereby)—had a larger deficit than Israel in 1998.[12] Furthermore, in Israel the average size of the general

An international comparison shows that Israel's general government deficit is particularly high.

[11] Z. Hercowitz, Y. Lavi and R. Melnick (1999), "The Impact of Macroeconomic Factors on Productivity in Israel," *Bank of Israel Economic Review* 72, 103–124; M. Strawczynski and Y. Lavi, *The Effect of Policy Variables and Immigration on the Supply and Composition of Business-Sector Product, Factors of Production, and Productivity: Israel 1960–95*, Bank of Israel, Research Department, discussion paper 98.07 (Hebrew).

[12] In Israel the data on the general government deficit do not include the CPI indexation component in interest payments on the public debt (including imputed unindexed debt), while in the other countries nominal interest is incorporated in full. According to Central Bureau of Statistics estimates, actual indexation differential payments on the public debt amounted to an annual 3–4 percent of GDP in 1998 and 1999.

Box 5.1
The Effect of Fiscal Consolidation on Economic Activity in the Short Run

Until the early 1990s there was general agreement among economists that the process of reducing the general government deficit involved a slowdown in economic activity in the short run. However, some studies undertaken since then have shown that in many instances the reduction of the budget deficit was accompanied by the expansion of economic activity and a fall in unemployment even in the short run.[1] Fiscal consolidation led to the acceleration of activity in those cases where a smaller deficit (excluding interest and adjusted for the business cycle) was maintained for at least two or three years after the consolidation. The main characteristics of these kinds of consolidation were: a. Most of the adjustment was by reducing expenditure, rather than raising taxes; b. Most of the reduction of expenditure was in general government wage payments (including employment) and transfer payments; c. The cut in general government investment accounted for a relatively small share of the reduction of expenditure (less than a quarter, on average); d. the tax increases affected indirect taxes rather than those on wages. The findings concerning the effect of the size of the fiscal adjustment (beyond the minimum required to define it as such) on its chances of persisting and success in preventing the slowing of economic activity are not unequivocal. No correlation was found between the state of the economy before the consolidation and its success, apart from the size of the public debt and the rate at which it grew; theses were greater in countries in which the reduction in the deficit was maintained.

Explanations of the existence of 'expansionary budget cuts' focus on three main factors, which may be connected with one another: a. Cutting the deficit reduces country risk and the risk of inflation, and thereby operates to reduce the interest rate—especially the risk premium—and stimulate investment;[2] this was found to be particularly significant in countries with a large debt. b. Reducing the deficit, especially by expenditure cuts perceived as permanent, eases the future debt burden expected by individuals, thereby increasing permanent disposable income. Assuming that the distorting effect of taxes grows together with the tax burden, the rise in individuals' permanent income may exceed the reduction in the deficit, especially in countries with a large debt. c. Cuts in general government wage expenditure, especially those attained in agreement with the unions or in competitive labor markets, facilitate a reduction in unit labor costs, an important component of the growth that occurred after the deficit reduction. In this context, refraining from taxing labor is important, as it increases unit labor costs.[3]

The characteristics of the fiscal adjustment implemented in Israel in 1997 are the opposite of those found to support the persistence of fiscal adjustments and subsequent expansion of economic activity (although naturally this is not enough to cast aspersions on the need for the adjustment or to blame it for all or most of

The Composition of Fiscal Consolidation, 1996 and 1997

(percent of GDP)

	1996	1997	Contribution to change in the deficit
1. The deficit, excluding interest, property, and unilateral transfers	–4.3	–2.4	100.0
Cyclically-adjusted deficit	–4.2	–1.6	–
2. Total tax revenue	39.4	40.4	52.6
of which: direct taxes including social security (gross)	19.2	20.6	73.7
3. Import taxes	5.1	4.6	–26.3
4. Total general government expenditure, excluding interest	49.1	47.9	63.2
Domestic civilian consumption	20.3	20.0	15.8
Domestic defense consumption	7.5	7.3	10.5
General government investment	3.7	3.1	31.6
5. Transfer payments to households	11.3	11.8	–27.4
Transfer payments to companies	0.7	0.7	0.0
6. The share of wages in public civilian consumption	67.4	67.4	–
The share of wages in public defense consumption	58.5	58.1	–
7. Public-service employees as a percentage of total civilian employment	28.8	29.2	–

SOURCE: Based on Central Bureau of Statistics data.

the slowdown in and after 1997). First, about half the adjustment was based on an increase in taxes (box table). Furthermore, the aggravation of the tax burden concentrated on direct taxes—whose rise accounted for about three-quarters of the adjustment—and especially on taxes on labor. Consequently, as predicted in the literature, unit labor cost rose in that and the subsequent years. Second, the adjustment of public expenditure was solely in the capital account, and half of it derived from a cut in general government investment. There was no change in current expenditure, as the decline in public consumption was offset by the increase in current transfer payments. The share of general government employment in total employment rose by 0.4 percent, and the share of wages in public consumption did not fall. Thus, as predicted in the literature, the debt/GDP ratio was hardly any lower in 1999 than in the year of the adjustment, and the rate of GDP growth, which was 1.5 percent above the weighted average of the developed countries which were Israel's trading partners in 1996, was 0.2 percent below that average in 1998 and 1999.

[1] The acceleration of economic activity is measured against average GDP growth in the developed or G7 countries in order to adjust for the effect of the business cycle, see e.g., F. Giavazzi and M. Pagano (1990), "Can Severe Fiscal Adjustments be Expansionary? Tales of Two Small European Countries," *NBER Macroeconomic Annual*; A. Alesina and R. Perotti (1995), "Fiscal Expansions and Adjustments in OECD Countries," *Economic Policy* 21, 205–248; IMF (1996), *World Economic Outlook*; A. Alesina, R. Perotti and J. Tavares (1999), "The Political Economy of Fiscal Adjustments," *Brookings Papers on Economic Activity* 1, 197–266.

[2] F. Fasselli, A. Giovannini and T. Lane (1998), *Fiscal Discipline and the Cost of Public Debt Servicing: Some Estimates for OECD Countries*, IMF working paper WP/98/55.

[3] See A. Alesina and R. Perotti (1997), "The Welfare State and Competitiveness," *American Economic Review*, 87 (5), 921–939.

Table 5.3
The Current and Cyclically-Adjusted Deficit, and General Government Debt Burden in Israel and the OECD Countries, 1993–99

	General government deficit (–)[a] (% of GDP)			Reduction of expenditure as share of change	Cyclically-adjusted general government deficit (–)[b] (% of potential output)			Total general government debt (gross)[a] (% of GDP) 1993–98			Real increase in per capita public consumption 1993–98
	1993	1998	Change	(percent)	1993	1998	Change	1993	1999	Change	(percent)
Israel[c]	–4.1	–4.2	–0.2	..	–2.9	–2.3	0.6	111.8	106.0	–5.8	1.6
Greece	–13.8	–2.4	11.4	36.3	–13.1	–2.5	10.6	108.7	103.8	–4.9	1.4
Sweden	–11.8	1.9	13.7	82.5	–6.4	4.1	10.5	77.2	68.3	–8.9	–0.4
Italy	–9.4	–2.7	6.7	116.4	–8.2	–1.5	6.7	123.1	117.1	–5.4	–0.4
Britain	–8.0	0.3	8.3	64.6	–4.8	–0.3	4.5	58.9	54.0	–4.9	0.5
Canada	–7.6	0.9	8.5	87.1	–4.6	1.6	6.2	99.2	86.9	–12.3	–1.6
Belgium	–7.3	–0.9	6.4	83.9	–5.4	–0.3	5.1	129.8	114.1	–15.7	1.1
Finland	–7.1	1.5	8.6	122.4	–1.8	1.5	3.3	58.1	44.9	–13.2	1.5
Spain	–6.7	–1.7	5.0	134.9	–5.0	–1.3	3.7	68.4	70.4	2.0	1.4
Portugal	–6.1	–2.3	3.8	46.2	–5.4	–2.4	3.0	65.9	56.6	–9.3	2.3
France	–5.9	–2.7	3.2	48.5	–3.4	–1.3	2.1	59.4	65.2	5.8	0.7
Australia	–4.4	0.2	4.6	62.3	–2.9	0.3	3.2	42.2	31.3	–10.9	1.7
Austria	–4.2	–2.1	2.1	178.9	–3.7	–1.8	1.9	69.4	63.3	–6.1	–0.1
USA	–3.6	1.3	4.9	66.7	–2.2	1.3	3.5	68.3	59.3	–9.0	–0.1
The Netherlands	–3.2	–0.9	2.3	228.6	–2.4	–1.4	1.0	75.5	62.9	–12.6	0.9
Germany	–3.1	–2.0	1.1	53.3	–3.0	–0.7	2.3	59.1	62.6	3.5	0.8
Denmark	–2.8	1.0	3.8	134.2	–1.1	–0.1	1.0	73.9	55.4	–18.5	2.0
Ireland	–2.3	2.4	4.7	165.3	–0.2	0.8	1.0	80.8	43.9	–36.9	3.3
Japan	–1.6	–5.3	–3.7	..	–1.5	–3.8	–2.3	76.0	105.4	29.4	1.7
Norway	–1.4	3.9	5.3	86.8	0.1	2.1	2.0	41.1	34.3	–6.8	1.6
New Zealand	–0.1	2.4	2.5	120.0	–0.5	1.9	2.4	..	..	..	0.5
Average OECD	–5.5	–0.4	5.2	101.0	–3.8	–0.2	3.6	75.5	68.4	–7.1	0.9
Average of 15 EU countries	–6.6	–0.8	5.8	106.9	–4.6	–0.5	4.1	79.2	70.2	–8.9	1.1
Average of countries with 1993 deficit larger than Israel's	–7.7	–0.8	6.9	88.7	–5.4	–0.3	5.1	80.0	73.0	–7.0	0.7

[a] SOURCE: *Statistical Window on OECD Member Countries Government Sector*, OECD Internet Site.
[b] SOURCE: *World Economic Outlook*, IMF, October 1999.
[c] For 1993 – the average of 1993 and 1994.
For 1998 – the average of 1998 and 1999.

government deficit in 1998 and 1999 was similar to that in 1993 and 1994 (the two years in which most of the direct budgetary expenditure on the absorption of immigrants came to an end), whereas in the developed countries the deficit contracted by 3.3 percent of GDP in 1993–98, and by about 5 percent in the OECD countries. A comparison of the development of the structural deficit also shows a similar trend. In Israel the structural deficit has declined by about 0.5 percent of GDP in the last five years, while in the developed countries it has fallen by some 3.6 percent of GDP. In addition, one of the reasons why there is not a greater difference between Israel and the developed countries regarding the reduction of the structural deficit is that this was small in some of the latter or there was even a budget surplus at the outset, so that they did not act to reduce the deficit in this period. Countries whose deficit was greater than Israel's in 1993 reduced the structural deficit by an average of 5.1 percent of GDP in the period reviewed, and the overall deficit by 6.9 percent. The reduction of the deficit in the OECD countries, after it had risen for several years, expresses the change in fiscal policy which the developed countries, especially the members of the EU, agreed to and implemented in the wake of the Maastricht Treaty, as well as the depreciations which the markets imposed on several countries in 1992. The difference between the development of the deficit in those countries and in Israel cannot be explained by varying growth rates, as at that time Israel's per capita GDP rose at an annual rate of 2.1 percent, 0.6 percent more than the average in 1972–99, while in the OECD countries it grew by an average of 2.7 percent, also 0.6 percent above the average of the last three decades. Nevertheless, the fiscal adjustment implemented in 1997 narrowed the gap between Israel and the OECD countries as regards the size of the structural deficit.

The average size of the general government deficit in Israel in 1998 and 1999 was similar to that in 1993 and 1994, while in the OECD countries it declined by 5 percent of GDP in that period.

The difference between the development of the deficit in the OECD countries and Israel in recent years cannot be explained by varying growth rates.

The gross public debt declined by about 5 percent of GDP in 1999, after rising at a similar rate in 1998, and stood at 106 percent of GDP. These fluctuations derive primarily from exchange-rate shifts, as in the calculation of the gross debt foreign-currency liabilities assume greater weight.[13] The public debt/GDP ratio is much larger in Israel than in the developed countries (Table 5.3), and it has declined at a slower rate in recent years than in these countries. Israel's debt is also far above the target set by the EU countries at Maastricht (60 percent of GDP).

As a share of GDP, Israel's public debt is far larger than that in the developed countries, and has declined at a slower rate in the last few years.

3. THE EXPENDITURE AND INCOME OF THE GENERAL GOVERNMENT

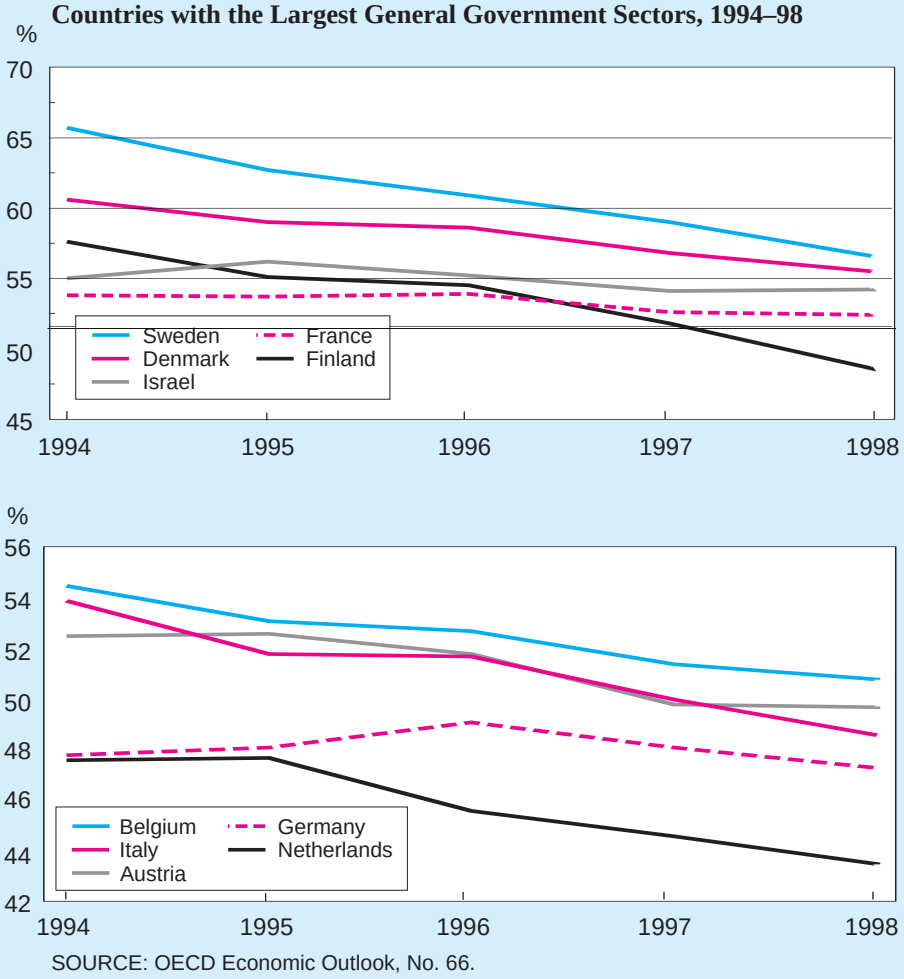
Public expenditure in Israel is among the highest in the world, and there was no real change in its extent in 1999, when it accounted for 54 percent of GDP. In terms of potential output, it declined by about one percent of GDP. There were no major changes in the composition of public expenditure in 1999, though the gradual trend evident in the last two years of reducing capital expenditure persisted—due this year to the contraction of general government investment from 3.5 percent of GDP to 3.1 percent—as did the increase in current expenditure.

[13] In calculating the net debt, liabilities are offset by the foreign-exchange reserves. Hence the exchange rate has far less effect on the net debt.

General government expenditure in Israel is higher than in all the developed countries except Sweden, where it is greater, and France and Denmark, where it is similar.

An international comparison shows that as a share of GDP public expenditure in Israel is higher than in all the developed countries, with the exception of Sweden, where it is greater, and France and Denmark, where it is about the same. In the last few years (especially since the adoption of binding deficit targets by the EU countries) there has been growing awareness in the developed countries that a large general government hinders economic growth, causing many countries to reduce its size. In Israel, too, as stated, the reduction of the size of the general government has been one of the government's policy objectives in recent years. The progress made in this respect by Israel and the nine developed countries in which public expenditure is the highest can be seen in Figure 5.1. In all these countries except France, and to a lesser extent Germany, considerable progress has been made in reducing the general government, while none whatsoever was made in Israel.[14]

Figure 5.1
The Share of General Government Expenses in Israel and in the OECD Countries with the Largest General Government Sectors, 1994–98



SOURCE: OECD Economic Outlook, No. 66.

[14] Similar results are obtained when the development of expenditure without interest is examined.

One of the major components of general government expenditure which could facilitate Israel's return to a sustainable growth path is investment, especially in the infrastructure. The reduction of general government investment played an important role in the fiscal adjustment of 1997, its share of GDP declining from 3.7 percent in 1996 to 3.1 percent in 1997. In 1998 this item grew, largely in the local authorities, but this was short-lived, and in 1999 investment dropped again, so that its share of GDP was again 3.1 percent—its lowest level since 1990. While on an international level Israel's public investment is not low (the average in the OECD countries was 2.7 percent of GDP in 1997), bearing in mind the extent of Israel's cumulative backlog in the last two decades in comparison with the developed countries, it is not sufficient to close the gap. Thus, investment in roads fell by 14 percent in 1999, and in railways by 38 percent, even though their levels were significantly below those of most European countries (see section on transport in Chapter 2). Nonetheless, some growth in infrastructure investment is expected in the year 2000 through another channel of public investment—the Cross Israel Highway, whose construction is being financed under the BOT system.[15] Investment undertaken in this framework is recorded as private investment, but in effect the project is a public one, covered by extensive public guarantees of its attendant risks, including the extent of demand as well as interest rates in Israel and abroad.

General government investment declined in 1999, to only 3.1% of GDP, the lowest level since 1990.

Investment in roads fell by 14% in 1999, and in railways by 38%, even though their levels were significantly below those in most west European countries.

Public consumption growth in volume terms accelerated to 3.9 percent in 1999, outstripping the rates of population and GDP growth, and similar to that of potential output. From a longer-term perspective, domestic civilian consumption, which grew markedly in 1994 and 1995 (even adjusting for the effect of the National Health Insurance Law), established itself at the new, higher level. Since 1994 the growth rate of per capita public consumption in Israel has exceeded that of the developed countries. The share of civilian consumption in GDP has risen by 3.7 percent of GDP in the last decade (1.5 percentage points of this reflecting the effect of the National Health Insurance Law), despite the rapid growth rate of GDP in that time. This development indicates that the general government did not utilize potential economies of scale created during the period of economic expansion in order to reduce its relative size. This is also apparent in the employment statistics: during the decade the share in total employment of general government civilian employment[16] rose from 29.4 percent in 1990 to 30.2 percent in 1999.[17] Until 1994 the general government's share of employment contracted due to the rapid rise in the labor force. Since 1995, however, the share of the general government has risen in step with the growth of the labor force and the working-age population. In this way the general government has contributed

Public consumption growth accelerated to 3.9%, outstripping the growth rates of population and GDP.

In the 1990s the general government failed to utilize potential economies of scale created in the process of expansion to reduce its relative size.

[15] See note 12 in Chapter 1.

[16] In addition to the civil services, general government employment also includes private-sector employees who work in the general government, e.g., in education, health, and welfare. Nonetheless, payment for a large part of private-sector activity in these spheres is by means of the general government.

[17] In the OECD countries, only Denmark and Sweden had similar rates of general government employment.

Table 5.4
Trends in Social Security, Benefits by Main Categories, 1994–99

(percent)

	Old-age and surviving relatives' pension	General disability	Work accidents	Maternity	Children	Unemployment	Income support	Other	Total
Share of total payments in 1998	36.5	12.1	6.7	5.7	19.5	8.8	6.4	4.3	100.0
Real increase[a]									
1994	5.2	9.7	12.5	9.3	5.3	–12.5	3.2	13.2	5.3
1995	9.2	17.4	14.3	22.0	4.8	15.3	13.9	17.1	11.0
1996	4.0	10.6	12.0	10.3	4.0	15.5	7.6	1.9	6.5
1997	4.7	9.5	–0.9	8.3	5.1	30.7	10.5	12.1	7.5
1998	7.8	12.4	6.4	9.3	2.1	15.8	20.2	13.8	8.8
1999	2.3	8.4	–4.3	1.5	5.7	2.1	12.9	10.5	4.2
Contribution to growth from 1994-98	29.1	16.4	6.3	7.7	10.2	16.0	9.0	5.3	100.0
Contribution to slowdown in rate of increase in 1999	43.9	10.8	15.9	9.8	–15.4	26.4	10.4	3.1	100.0

[a] Deflated by the CPI.
SOURCE: Based on Central Bureau of Statistics data.

directly to the reduction of unemployment in the last few years. However, counter-cyclical behavior of this kind can impair the process of adjusting the structure of employment during a recession, especially if the increase in the share of general government employment is permanent, and all the more so since Israel's general government is large in comparison with other countries.

Table 5.5
Distribution of Tax Revenue During 1999

(real rate of change from equivalent period in 1998)

	Jan–Mar.	Apr–June	July–Sept.	Oct–Dec.	Jan.-Dec.
Total taxes	–0.8	3.7	3.6	9.8	4.1
Income tax (net)[a]	–5.3	5.2	–1.0	10.2	2.1
Income tax (gross)	–3.4	5.1	4.3	11.6	4.3
Real estate taxes (net)	4.6	–8.8	57.2	15.1	14.5
VAT (net)[a]	4.5	1.7	3.6	9.4	4.8
Domestic VAT (gross)	3.7	6.1	5.8	6.5	5.5
VAT on imports (gross)	3.3	2.3	18.4	14.0	9.4
Other import taxes	11.4	–4.7	20.3	14.9	10.3
Domestic taxes[b]	–1.3	1.4	0.9	1.7	0.7
Compulsory payments	4.5	13.8	44.2	–3.2	12.8

[a] After deducting refunds.
[b] Comprising domestic purchase tax, fuel tax, tobacco excise duty, and stamp tax.
SOURCE: State Revenue Administration.

The ratio of general government income (including that from property) to GDP in 1999 was similar to that in 1998, and there was no significant change in the tax burden relative to the two preceding years. The foremost development of 1999 in this area was in the path of tax revenues over the year: these were lower (in real terms) in the first quarter than in the equivalent period in 1998, in the second and third quarters they were 2.8 percent above their 1998 levels, and in the fourth quarter they rose by 9.7 percent (Table 5.5). The acceleration is particularly marked if gross income-tax receipts and gross domestic VAT receipts are examined separately. The paths of import and real-estate taxes are similar, though less stable, apparently reflecting shifts in the exchange rate of the NIS and specific developments in real-estate taxes respectively. At the beginning of the year 2000 the statutory tax rate on labor was increased by raising the wage ceiling on which social security payments are made from four to five times the average wage.

4. THE CENTRAL GOVERNMENT AND THE BUDGET

The overall budget deficit of the central government amounted to 2.2 percent of GDP in 1999, a fifth of one percent of GDP above its target as defined in the Budget Deficit Reduction Law, and 0.2 percent of GDP lower than in 1998. The deviation of the deficit from the target was due entirely to the domestic deficit, while the external surplus

The overall deficit of the central government was 2.2% of GDP in 1999, 0.2% of GDP above its statutory target, and 0.2% of GDP lower than in 1998.

was in accordance with the budget.[18] The deviation of the domestic deficit stems from the NIS 2.9 billion gap between the budgetary projection and actual non-tax revenues, as well as from the NIS 1.6 billion shortfall in tax receipts. While the latter is explained primarily by the failure to attain the ambitious objective of enhanced tax-collection of NIS 1.8 billion, some 40 percent of this deviation derives from the rate of growth, which was lower than that used for the budget projections (2.5 percent). The GDP deflator rose in line with the budget forecast in 1999, but prices of private consumption, which affect VAT receipts from domestic economic activity, were about 1.5 percent below the budget forecast. Expenditure was some NIS 3.3 billion below the budget allocation, *inter alia* because of a lower than predicted increase in the CPI—the basis for the adjustment of wages, which constitute the main component of general government consumption, as well as of some National Insurance benefit calculations. Adjusting for the effect of this deviation, expenditure was 0.6 percent below the budgetary allocation.

Most of the decline in the central government deficit in the last two years stemmed from the sharp rise in the Bank of Israel's 'profits' as recorded in the budget.

The central government's ability to attain its deficit targets is crucial for Israel's assessment by foreign investors, which affects the price of net borrowing. In the last two years progress has been made in reducing the central government deficit in line with the path set in the law as it was amended in 1997 (for the third time since 1992). The deficit fell from 2.7 percent of GDP in 1997 to 2.2 percent in 1999, in the context of an economic slowdown (Table 5.2), and this achievement contributes to the government's credibility, stressing its commitment to the long-term path of fiscal consolidation. However, most of the improvement stemmed from the sharp rise in the 'Bank of Israel's profits,' as recorded in the budget (see above); adjusting for this item, the budget deficit amounted to 3.2 percent of GDP in 1999, better by only 0.2 percent of GDP than in 1997, and the domestic deficit/GDP ratio was virtually unchanged. Notwithstanding, the overall deficit adjusted for the effect of the business cycle and Bank of Israel's profits declined by 1.4 percent of GDP in this period. Hence, altering the definition of the deficit target in 1997 from the domestic to the overall deficit[19] in effect made the full cyclical adjustment of the budget deficit possible while formally attaining the deficit reduction target. Note that Israel's fiscal consolidation was small in comparison with the reductions of deficits (actual and structural) in the developed countries in recent years.

Adhering to the expenditure ceiling approved in the budget for the year 2000 while using the 'inflation reserve' only in accordance with the actual development of prices will enable the deficit to be reduced in 2000.

The deficit developed differently during the year than in the past, so that at the time the budget for the year 2000 was prepared the assessment was that the overall budget deficit for 1999 would amount to 3 percent of GDP. On the basis of that assessment, the government decided to amend the Budget Deficit Reduction Law, maintaining the declining path of the deficit but adapting its level to the projected outcome. In retrospect, the deficit was significantly less than that estimated, so that the deficit target for the

[18] After adjusting for the reporting of foreign-currency tax receipts as income from abroad in the implementation estimates.

[19] This change led to the inclusion of the Bank of Israel's profits in the calculation of the deficit for the purposes of the law.

year 2000 is higher than the actual deficit in 1999. Nonetheless, since the main reason for the decline in the deficit at the end of 1999 was a faster rise than expected in revenues, adhering to the ceiling on expenditure as approved in the budget for 2000 while using the 'inflation reserve' in accordance with the actual development of prices will enable the actual deficit to be reduced below its 1999 level in 2000.

5. THE BANK OF ISRAEL'S ACTIVITY AS REFLECTED IN THE FISCAL ACCOUNTS

In measuring the Bank of Israel's excess profits there is a large gap between 'profits' as calculated in accordance with the various definitions, and even the directions and magnitudes of the shifts in 'profits' are not always similar.

The Bank of Israel's surplus of income over expenses is measured in the fiscal accounts in three different ways, each one serving a different purpose: a. Nominal measurement, which includes 'Unrealized profits,' i.e., mainly exchange-rate and revaluation differentials; this is found in the Bank of Israel's profit and loss account, which is used to determine the surplus income that is transferred to the government. b. 'Real realized profits' as calculated in the National Accounts; this takes into account the inflationary erosion of the Bank's local-currency assets and liabilities. c. Partial calculation of 'Real realized profits;' this calculation is included in the National Budget, and since 1997 has also been used to calculate the deficit in accordance with the Budget Deficit Reduction Law; it does not include the Bank of Israel's income from and expenditure on its monetary activities. There is a large gap between the 'profits' as calculated under the various definitions, and even the directions of change and size of the 'profits' are not necessarily similar (Table 5.6).

The changes that have occurred in recent years in the capital markets and the macroeconomic environment—together with the expansion of the Bank of Israel's balance sheet and marked change in its composition due *inter alia* to these changes—have increased the variance between the different methods of measurement. The method of calculating the Bank of Israel's profits in the national budget, which was determined at the beginning of the decade, includes most of the Bank's realized income, but only a small part of its realized expenditure. As a result, the budget systematically gives a distorted picture of the joint surplus realized income of the Bank of Israel and the central government vis-à-vis the public. As measured in the budget, the central government deficit declined by 0.1 percent of GDP in 1994–99, due *inter alia* to a rise of about one percent of GDP in the Bank of Israel's profits. However, during this period the Bank of Israel's surplus real realized income, as measured in the National Accounts (which also reflects the Bank's realized expenditure), fell by 1.1 percent of GDP. Hence, if this calculation had been used in the budget, the overall deficit in 1999 would have been 2 percent of GDP higher than in 1994.

Another problem arising from the different ways of calculation and their uses is the gap between the income recorded in the budget and the 'profits' transferred by the Bank of Israel to the central government (calculated on a nominal basis), which include capital gains and losses. This creates a significant gap between the deficit presented by

Table 5.6
The Bank of Israel's Surplus Income, According to Various Definitions, 1991–99

(percent of GDP)

	Definitions			
	National accounts[a]	In the budget[b]	Bank of Israel balance sheet[c]	Actually transferred to the government[d]
1991	1.3	0.3	1.5	1.5
1992	1.0	0.2	1.1	1.1
1993	0.6	0.0	0.7	0.7
1994	0.3	0.0	0.8	0.8
1995	0.4	0.3	0.9	0.9
1996	0.3	0.5	–0.1	0.0
1997	–0.2	0.7	–0.3	0.0
1998	0.4	1.0	2.8	2.4
1999	–0.8	0.9	–2.2	0.0

[a] The realized income including actual income and expenses in local and foreign currency, excluding revaluation differentials and exchange-rate differentials. The calculation includes an adjustment of the Bank's local-currency assets and liabilities to the CPI.
[b] 'Bank of Israel realized profits,' including actual income and expenses in local and foreign currency, excluding revaluation differentials, exchange-rate differentials, the Bank's income and expenses arising from its monetary activity, and income received from the government.
[c] All the Bank's income and expenses, including those arising from revaluation and exchange-rate differentials.
[d] Profit as calculated on the Bank of Israel balance sheet is transferred to the government in every year when there is such profit, after deducting losses accumulated in previous years. When the Bank has losses, the government does not transfer money to the Bank to cover them.
SOURCE: Based on the National Budget Summary and Central Bureau of Statistics.

the central government and its financing requirements.[20] Moreover, since the 'profits' the Bank of Israel transfers to the central government are not identical with (and often not even similar to) the Bank's 'realized profits,' the central government can finance its deficit through its account with the Bank of Israel—which is tantamount to 'printing money'—without the Bank of Israel accumulating surplus income in its activity vis-à-vis the public.[21] This is what the central government did in 1999, for example (in 1998 the Bank of Israel's profits from exchange-rate differentials amounted to NIS 13.1 billion, and its excess expenditure in the other items was NIS 2.1 billion). The distribution of 'unrealized profits' is particularly problematic because the central government does not cover the Bank's surplus expenditure in years when such surpluses occur. Given the current macroeconomic environment, in which there may be significant local-currency appreciation or depreciation from one year to another, this system allows for the distribution of 'profits' which may be wiped out shortly after they are created, as occurred in 1999. The problematic nature of the various definitions is illustrated in Table 5.7.

[20] 'Excess profit' is offset by section 3 of the budget—as negative financing from the Bank of Israel—and is not included in the calculation of the deficit.

[21] The Bank of Israel's ability to transfer 'unrealized profits' to the central government stems from its capacity—in contrast to a commercial firm—to issue money. Nonetheless, for a given monetary target, if the central government uses these 'profits' to finance its deficit, the Bank will have to absorb the excess amount printed by attracting deposits from the public, so that in effect, at the end of the process, the Bank finances the distribution of the 'unrealized profits' through loans, just like a commercial firm.

Table 5.7
Examples of the Bank of Israel's Surplus Income, According to Various Definitions[a]

	Example				
	A	B	C	D –Year 1	D –Year 2
Interest (percent per year)					
Bank of Israel	5.0	3.0	5.0	5.0	5.0
Abroad	5.0	3.0	5.0	5.0	5.0
Rate of inflation (percent per year)					
Israel	2.0	2.0	2.0	2.0	2.0
Abroad	2.0	2.0	2.0	2.0	2.0
Foreign reserves ($ billion)	24.4	24.4	12.2	24.4	24.4
Exchange rate (NIS/$)	4.10	4.10	4.10	4.51[b]	4.10
Bank of Israel surplus income (NIS billion)					
On balance sheet (i.e., surplus transferred to government)	0.0	0.0	0.0	10.0	–10.0[c]
Budget	5.0	3.0	2.5	5.0	5.0
National accounts	2.0	2.0	1.0	2.0	2.0

[a] Assuming that all the variables are constant during the year, except for Example D. All the Bank of Israel's liabilities bear local-currency interest as shown in the table.
[b] Assuming that the depreciation occurred in the last days of the first year, and the appreciation in the first days of the following year.
[c] The government does not cover the loss; it is offset against the Bank's profits in the future.

The problems created by using the various definitions can be resolved by adopting a uniform way of measuring 'the Bank of Israel's profits' in the budget and determining the actual transfer of the Bank's 'profits' to the central government. This definition could be based on an estimate of the Bank's total realized income and expenditure—i.e., without exchange-rate and revaluation differentials—adjusted for such items as the interest on the Bank's loans to the central government. This system does not negate continuing to calculate the Bank's profits on an accepted accounting basis; the balance of profits that are not distributed in accordance with the new rules will remain in a fund at the Bank, as is done by many European central banks.[22] With regard to the national accounts, the decline in Israel's inflation rate emphasizes the need to unify the treatment of realized nominal income in both local and foreign currency. Such uniformity can be attained through the nominal measurement of income in both local and foreign currency, or by measuring each foreign currency while adjusting for the CPI (or the GDP deflator). If this is not done, the systematic bias will persist, serving to increase measured income over expenditure.

[22] Technically, it is possible to record unrealized revaluation differentials directly in the balance sheet, without including them in the profit and loss statement.

6. THE HEALTH FUNDS AND THE LOCAL AUTHORITIES

Among the factors that prevented the rapid reduction of the general government deficit in Israel until 1997 were the local authorities and the health funds.

In the last two years there appears to have been a marked improvement in the fiscal discipline of the local authorities and the health funds.

The criteria set by the central government for granting reductions in municipal taxes explain a large proportion of the differences between the various local authorities as regards actual as opposed to potential tax collection.

Among the factors preventing the rapid reduction of the general government deficit in Israel until 1997 were developments connected with the budgets of the local authorities and the health funds, entities whose activities are not included directly in the central government's budget but which receive large budgetary allocations. Not only have the deficits of these entities enlarged the overall deficit and debt of the general government, they have also led to instability in the budgetary implementation because the central government has had to intervene from time to time in order to prevent the cessation of their activities due to liquidity crises. These deficits are created despite (or perhaps because of) the central government's formal control over the activities of the local authorities and the health funds (principally since the introduction of the National Health Insurance Law). Nevertheless, it seems that since 1997 there has been a significant improvement in the fiscal discipline displayed by these entities, and if it persists it will serve to enhance control over the central government's budget.

Israel's local authorities are supposed to operate under close central government supervision. Largely by means of the Ministries of Finance and the Interior, the central government controls many of their activities, and even has the right to depose elected mayors whose actions are fiscally (or otherwise) irresponsible. In addition, the central government determines the annual rate at which property taxes—the main source of municipalities' budgetary income—may be updated.[23] In addition, the central government decides the criteria for granting reductions in municipal rates, and these reductions explain much of the differences between local authorities regarding the extent of tax actually collected relative to the statutory potential. However, although the local authorities are obliged to balance their budgets, they have run up large deficits, despite receiving repeated emergency financial transfers—representing considerable budgetary expenditure—from the central government in order to avert crises. From 1988 to 1996 the debt of the local authorities swelled by one percent of GDP, and annual transfers to them from the central government grew by another one percent.

Since 1997 there has been a change in the fiscal discipline of the local authorities, following the implementation of a more effective policy on the part of the central government regarding the supervision of their budgets, and in particular making the transfer of payments in the framework of the rehabilitation program for 1997–99 contingent on their meeting defined budgetary targets. This condition represented a substantial departure from previous recovery programs, which focused on assurances of better behavior rather than on performance.[24] In 1997 the real debt of the local authorities grew by only 2.4 percent, meaning that there was no change in the per

[23] In the past, municipalities had some leeway to change the effective tax rate by reclassifying assets, but this has apparently been restricted following a court ruling handed down in January 2000 that requires the government to determine a uniform system of classification for assets throughout Israel.

[24] Rehabilitation programs for the local authorities were implemented in 1989, 1992, 1994–95, and 1996.

capita debt, and in 1998 their total debt (as reported by them to the Ministry of the Interior) fell by 1.2 percent. Note in this context that 1998 was a year of municipal elections, which in the past have been characterized by a substantial increase in the local authorities' deficit and debt. Data for the first nine months of 1999 indicate that the debt is continuing to decline. The restriction of the central government's willingness to continue financing the local authorities' deficits, and the imposition of marked improvements in their financial reporting, appear to have led to a change in residents' attitudes to the creation of deficits and accumulation of debts by the local authorities (Box 5.2), and this has found expression in the implementation of policy.

Restricting the central government's willingness to continue financing the local authorities' deficits, as well as requiring a marked improvement in their financial reporting, appears to have also changed residents' attitudes to the creation of deficits and accrual of debts by mayors.

Box 5.2
The Effect of Local Authorities' Fiscal Position on their Election Results

There are two approaches in the economic literature to residents' preferences regarding local authorities. The first relates to residents as consumers of public goods that are supplied by the local authorities. These consumers will prefer a continuous, uninterrupted service, and will hence oppose the creation of budgetary deficits in the present for fear that this will harm the quality of services or increase taxes in the future. According to this approach, the value of homes will decline in areas where there is a deficit, so that persons leaving the area will also have to 'pay' for the deficit by means of the fall in the value of their property. According to the other approach, since municipal deficits are usually shared by citizens living elsewhere in the country (via the government) residents will favor the creation of deficits. Consequently, if residents vote in accordance with their fiscal preferences, under the first approach mayors who create deficits will be replaced at the elections, while under the second approach they will be re-elected. It has also been claimed, however, that residents do not have the information required in order to assess the municipality's fiscal situation, and that the local elections are decided on the basis of national issues, so that the fiscal topic has no effect on residents' electoral choices.

A study of local election results in Israel in 1989, 1993, and 1998[1] found no connection between the fiscal situation of local authorities (including municipalities) and their election results in 1989 and 1993. In the 1998 elections, however, there was a strong correlation between a local authority's fiscal performance and the chances of the person at its head to be re-elected: in local authorities which had accumulated debts, a large current-account deficit, high level of debt, exacted municipal taxes below the statutory rate,[2] and paid excess wages during the incumbent's period of office, his or her chances of being re-elected were significantly lower than those of others. It was also found that mayors who managed during their term in office to enlarge the percentage of pupils graduating from high school and devoted a larger part of their budget to development (at a given level of debt and debt-accrual) increased their chances

of re-election. These results obtained also when the level of income in the area, its socio-economic ranking, and the popularity of the mayor in the previous elections were taken into account. On the other hand, increasing the deficit in an election year or success in obtaining additional money from the government during the mayor's term of office did not help his or her chances of re-election. The model correctly predicted the election results in over 78 percent of the local authorities in which elections were held in 1998, and had a similar success rate in areas where the mayor was re-elected or replaced.

The significant rise in the effect of fiscal variables on the election results can be explained by several factors which may be connected with one another: a. the cessation of the link between local election lists and the national political parties, a process that began with the introduction of the law for the direct election of mayors in 1978 and accelerated with the introduction of the law for the direct election of the prime minister; b. the gradual improvement of the quality of financial reporting by the local authorities, bringing their financial situation to the knowledge of both the electorate (by means of local communications media, which also developed during the period), and the government ministries with which they worked; c. a stricter government stance since 1997 as to readiness to cover the local authorities' deficits, and the adoption of more objective criteria regarding grants to them, as recommended by the Swary Commission Report; d. the rise in the population's income level, leading them to focus on the quality of services and making it less ready to put up with interruptions to services during struggles for government financing to cover deficits accumulated by the local authority.

[1] A. Brender (1999), *The Effect of Fiscal Performance on Local Government Election Results in Israel: 1989–1998*, Bank of Israel, Research Department, Discussion Paper 99.04.

[2] Taxation below the level explained by the government's criteria.

The financial situation of the health funds followed a path similar to that taken by the local authorities. After the introduction of the National Health Insurance Law, which included the settlement of the debts of the General Health Fund (i.e., of the Histadrut), the funds were required to balance their budgets. The law, which set the funds' income via the 'health tax' as well as the services they were required to provide (through a 'basket' of health services) meant that the funds could compete with each other only by becoming more efficient or by creating deficits. In the event, the funds had an annual deficit of NIS 1.5 billion in 1997, and its rise accelerated during the year.[25] In order to halt this rise, the government and the health funds agreed on a recovery program which, like the local authorities' recovery programs, guaranteed a 'safety net' of NIS 430 million, contingent on the implementation of a plan to reduce the funds' deficits. In

[25] The deficit amounted to NIS 560 million in the first half of 1997, and to NIS 930 million in the second half.

1998, the funds' deficits did indeed decline—to about NIS 410 million (including the safety-net figure)—and in 1999, when a similar program was instituted, the funds came close to balanced budgets (based on initial estimates).

7. TAXATION OF INDIVIDUALS' INCOME IN ISRAEL: AN INTERNATIONAL PERSPECTIVE

One of the economic targets set by the government was the reform of direct taxation in 2001, and the Minister of Finance appointed a committee of experts to recommend reforms. In the framework of the discussion of the reform, the tax systems of the industrialized countries should be reviewed to identify the factors they have in common, and learn from their experience. Although Israel does not have to adopt the tax system of any particular country, the choice of measures that differ from those accepted in industrialized countries requires at the least an explanation of which characteristics unique to Israel justify the difference.

The overall tax burden in Israel is slightly greater than the average in the OECD countries, and slightly less than that in the EU countries.

The overall tax burden is slightly heavier in Israel than the average in the OECD countries, and slightly less than the average in the EU (Table 5.8). The fact that the tax burden in Israel is on a par with that in developed countries, despite the high level of general government expenditure, is 'facilitated' by two factors: grants, mainly those of the US government, and Israel's larger deficit (Table 5.3). Consequently, on the basis of an international comparison, it would appear that as long as the central government does not intend to introduce a comprehensive reform of the general government that will include the marked reduction of expenditure, it will not be possible to reduce total income. Notwithstanding, this does not detract from the importance of easing the tax burden as a factor which could serve to increase GDP and productivity,[26] especially in view of the trend in some industrialized countries towards alleviating the burden of direct taxes in the next few years.

The composition of the general government's income from taxes shows that the tax burden on individuals' income (including social security payments), 16.9 percent of GDP, is lower in Israel than in the OECD countries, where the average is 20.2 percent, and especially than in the EU countries (23.9 percent). The share of tax on individuals' income in total tax revenues in Israel is higher only than it is in Iceland, Korea, Mexico, and Turkey. The relatively low direct tax burden in Israel reflects two components of the tax system: relatively low payments by employers to the National Insurance Institute, and the relatively extensive exemption of individuals from taxation of income from financial assets. However, even when tax receipts from capital (with reasonable assumptions about their extent) are deducted, the tax burden on labor in Israel is not high by international standards. The comparison points up the fact that the marginal

[25] The deficit amounted to NIS 560 million in the first half of 1997, and to NIS 930 million

Table 5.8A
International Comparison of the Tax Burden and its Composition, Israel and the OECD, 1996

	Total tax revenue	Corporate tax	Income tax	Social security	Consumption tax	Other, incl. property taxes	Income tax and social security as percent of total revenue
	Percent of GDP						
Israel[a]	**40.1**	**3.1**	**10.9**	**6.0**	**16.0**	**4.1**	**42.1**
USA	28.5	2.7	10.7	7.0	4.9	3.1	62.3
Japan	28.4	4.7	5.7	10.4	4.4	3.3	56.5
Germany	38.1	1.4	9.4	15.5	10.6	1.2	65.4
France	45.7	1.7	6.4	20.8	12.4	4.3	59.6
Italy	43.2	4.0	10.8	14.8	10.6	2.3	60.2
Britain	36.0	3.8	9.3	6.2	12.7	3.9	43.2
Canada	36.8	3.3	13.9	6.0	8.7	4.2	55.1
Australia	31.1	4.7	12.8	2.1	8.7	2.8	47.9
Austria	44.0	2.1	9.2	18.1	12.5	1.1	63.5
Belgium	46.0	3.1	14.3	14.9	11.6	1.2	64.7
Czech Republic	40.5	4.2	5.3	17.0	13.5	0.6	54.9
Denmark	52.2	2.4	27.8	1.9	17.1	1.8	58.2
Finland	48.2	3.2	16.9	12.4	14.5	1.2	60.8
Greece	40.6	2.6	5.0	12.8	17.4	1.4	45.4
Hungary	40.3	1.9	7.1	13.7	16.8	0.8	51.6
Iceland	32.3	0.9	10.4	2.8	15.1	2.7	41.4
Ireland	33.7	3.2	10.5	4.9	13.3	1.6	46.0
Korea	23.2	2.7	4.2	2.2	10.2	3.9	27.6
Luxembourg	44.7	7.2	9.8	11.9	12.4	3.4	48.5
Mexico	16.3	2.3	1.8	2.7	4.8	0.6	36.9
The Netherlands	43.3	4.1	7.6	17.1	12.3	2.1	57.2
New Zealand	35.8	3.5	15.6	0.3	12.3	2.0	47.2
Norway	41.1	4.3	10.7	9.6	15.5	0.9	49.5
Poland	42.1	3.1	9.3	13.4	15.0	1.3	53.9
Portugal	34.9	3.3	6.6	9.0	14.0	1.1	45.9
Spain	33.7	2.0	7.7	12.1	9.6	2.0	59.3
Sweden	52.0	2.9	18.4	16.8	11.8	2.0	67.8
Switzerland	34.7	1.9	11.1	13.0	6.1	2.4	69.9
Turkey	25.4	1.5	5.2	4.0	9.7	5.0	36.2
Average OECD	37.7	3.1	10.1	10.1	11.7	2.2	54.3
Average 15 EU countries	42.4	3.1	11.3	12.6	12.9	2.0	57.0

[a] The data are for 1998.
SOURCE: OECD-Tax Database

Table 5.8B
International Comparison of the Tax Burden and its Composition, Israel and the OECD, 1998

(percent)

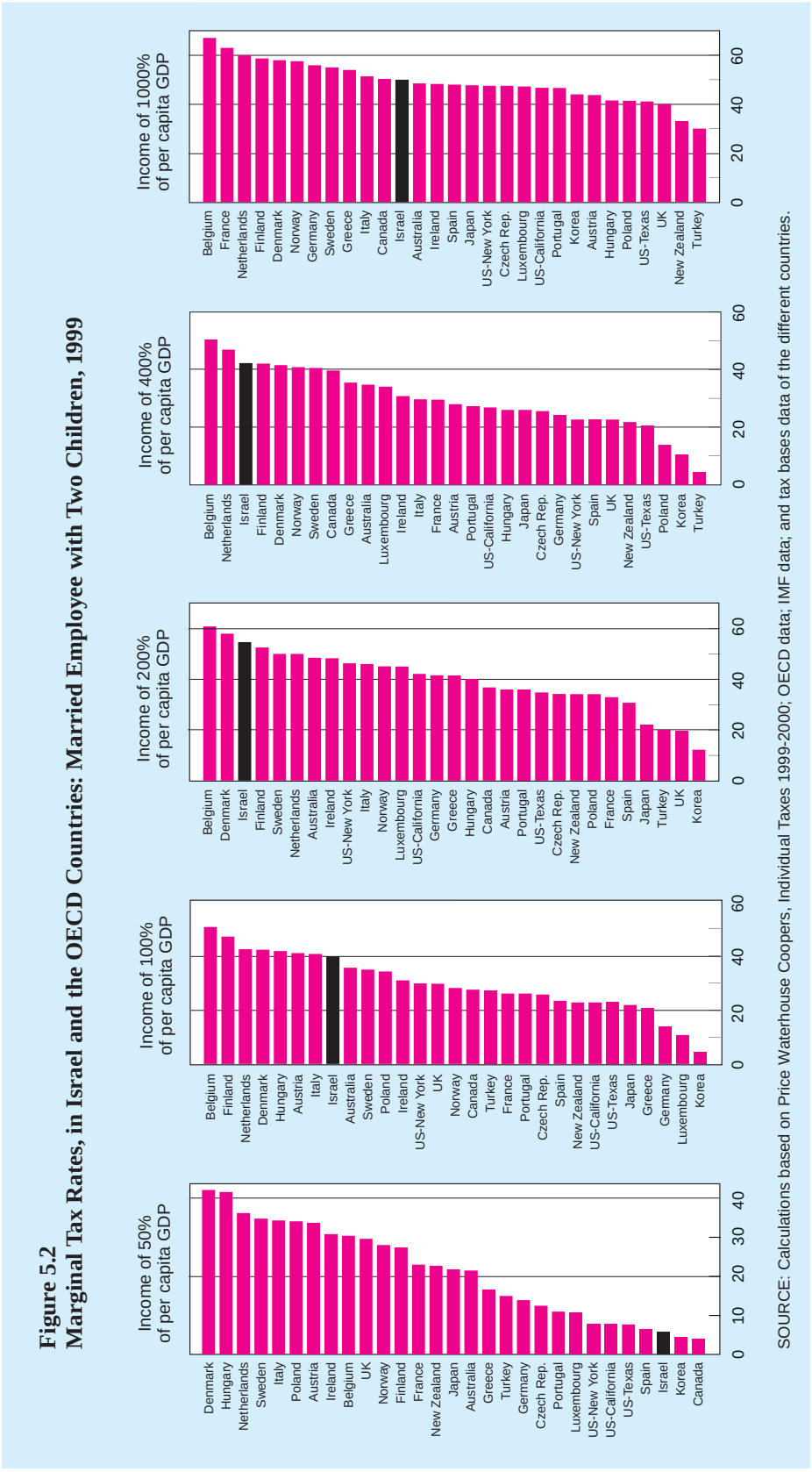
	Corporate tax incl. local taxes and levies	Marginal tax of an average production worker	Marginal tax and social security on higher incomes[a]
Israel	**36.0**	**39.7**	**50.0**
USA	35.0–42.8	29.9	48.1
Japan	50.9	21.6	65.0
Germany	56.0	55.2	55.9
France	36.7–41.7	35.4	61.6
Italy	41.3	40.7	50.8
Britain	31.0	33.0	40.0
Canada	35.6–44.6	45.0	54.1
Australia	36.0	35.5	48.5
Austria	34.0	42.5	50.0
Belgium	40.2	55.9	66.1
Czech Republic	..	30.0	47.5
Denmark	34.0	52.1	62.4
Finland	28.0	50.7	62.0
Greece	35.0–40.0	20.1	54.0
Hungary	..	41.6	43.5
Iceland	30.0	39.2	49.6
Ireland	32.0	54.7	50.2
Korea	..	8.1	45.9
Luxembourg	37.5	43.1	46.6
Mexico	..	17.6	35.0
The Netherlands	35.0	55.1	60.0
New Zealand	33.0	33.0	33.0
Norway	28.0	45.3	49.5
Poland	..	20.0	40.0
Portugal	37.4	26.0	46.6
Spain	35.0	26.8	56.0
Sweden	28.0	35.7	59.6
Switzerland	16.9–31.1	31.1	51.4
Turkey	30.0	30.5	61.3
Average OECD	35.7	36.4	51.5
Average 15 EU countries	36.4	41.8	54.8

[a] The marginal tax rate for an individual with a high income who resides in the region with the highest marginal tax rate in the country.
SOURCE: OECD-Tax Database

tax rate on high incomes in Israel is not very high, even though many other countries also have a wage ceiling for social security payments. Thus, the comparison does not indicate the need to direct the reform particularly at reducing the highest tax bracket, especially in view of the findings in the literature that the elasticity of incomes to taxation among high income earners is significant in the short term, but almost zero for a term of over one year.[27]

[27] D. Golsbee (1997), *What Happens When You Tax the Rich: Evidence from Executive Compensation*, NBER working paper 63333.

Figure 5.2
Marginal Tax Rates, in Israel and the OECD Countries: Married Employee with Two Children, 1999



SOURCE: Calculations based on Price Waterhouse Coopers, Individual Taxes 1999-2000; OECD data; IMF data; and tax bases data of the different countries.

In order to examine the distribution of the tax burden between the various income levels, and its possible effects on the labor supply, we undertook an international comparison of the tax submissions of representative individuals (sole earners) at various income levels (50, 100, 200, 400, and 1,000 percent of per capita GDP) and various family status (single, married, and married with two children). We focused on labor income, and assumed that each individual utilizes the accepted standard deductions in his country. The taxes include local taxes[28] and employees' social security payments.

The marginal tax rate in Israel at income levels between that of per capita GDP (which is similar to the average wage in Israel) and four times per capita GDP is significantly higher than the average in both the OECD and the EU countries.

The main findings are that in Israel the marginal tax rate at income levels between per capita GDP (which is similar to the average wage in Israel) and four times that level is significantly higher than the average in both the OECD and the EU countries, and this holds even when tax rates are examined for each country individually. At income levels twice that of per capita GDP the marginal tax rate is higher than Israel's in only two countries, Belgium and Denmark, and at income levels four times that of per capita GDP, only in Belgium and Holland (Figure 5.2). On the other hand, at wage levels that are ten times that of per capita GDP the marginal tax rate in Israel is similar to the average in the OECD countries, lower than the average in the EU, and lower than that in eleven countries. Similar results are obtained when the marginal tax rates on significant changes in income level are examined (e.g., due to education or obtaining a new job).[29] A feature that is unique to Israel is the sharp drop in the marginal tax rate upon moving to the highest income level.

The income of an Israeli who is eligible for income assurance, is married, and has two children, one of them of pre-school age will decline if he enters the labor market at a wage equal to the median for a full-time position.

While at the lowest income level, one half of per capita GDP, the marginal tax rate is lower in Israel than in the other countries, a comparison of tax rates at this income level does not reflect the full cost to the individual of the decision to work, which for many individuals means losing the right to various benefits and reductions. As a result, the effective tax rate at these income levels is 100 percent. For example, there will be a decline in the income of an Israeli who is eligible for income assurance and is married with two children, one of which is of pre-school age, if he enters the labor market at a wage equal to the median wage at a full-time position. The latter is a distant dream for most new labor-force entrants or for unemployed persons who are about to end their period of eligibility for unemployment benefit. Note, however, that child allowances, which may constitute a significant part of the income of low-income families, are not income-dependent, and are not taxed in Israel, as is the case in most OECD countries.

One of the main differences between the personal income tax system in Israel and the OECD countries is the treatment of income from financial capital. In Israel the interest received by individuals on most bank deposits, unindexed bonds, and savings schemes is tax-exempt. The situation is similar in Hungary, Poland, and applies to most deposits in Finland. In the other countries nominal income from interest is taxed

[28] For each country we chose either a business center or the average.

[29] The marginal tax refers to small changes around the individual's wage level, e.g., working overtime. When shifting from one income level to another, the individual may lose various tax benefits that depend on his or her level of income, and move to a different tax bracket, on the one hand, or exceed the social security ceiling, on the other.

Table 5.9A
Features of Taxation on Individuals' Income in OECD Countries[a]

	Taxation on personal income from interest on deposits[b,c]		Taxation on personal dividend income[b,c]		Taxation of individuals' capital gains from financial assets[b,d]	
	Method of taxation	Percent deducted at source	Method of taxation	Percent deducted at source	Method of taxation	Tax rate
USA	Personal income	–	Personal income	–	Special tax	20.0
Canada	Personal income	–	Personal income	–	Personal income	–
Australia	Personal income	–	Personal income	–	Personal income	–
Denmark	Personal income	–	Final deduction at source	25.0	Special tax	25.0
Luxembourg	Personal income	–	Personal income	25.0	Exempt from tax	–
The Netherlands	Personal income	–	Personal income	25.0	Exempt from tax	–
Norway	Personal income	–	Personal income	28.0	Personal income	–
Sweden	Personal income	–	Personal income	–	Special tax	30.0
Germany	Personal income	31.7	Personal income	48.5	Personal income	–
Britain	Personal income	20.0	Personal income	–	Personal income	–
New Zealand	Personal income	21.5	Personal income	–	Exempt from tax	–
Turkey	Personal income	12.0	Personal income	10 or 20	Personal income	–
Spain	Personal income	25.0	Personal income	28.6	Personal income	–
France	Deduction with refund	25.0	Personal income	33.3	Special tax	26.0
Austria	Deduction with refund	25.0	Deduction at source with refund	25.0	Personal income	–
Belgium	Deduction with refund	10.0	Deduction at source with refund	15.0	Exempt from tax	–
Switzerland	Deduction with refund	35.0	Personal income	35.0	Exempt from tax	–
Ireland	Final deduction at source	10–26	Personal income	–	Special tax	20.0
Japan	Final deduction at source	20.0	Several possibilities	–	Special tax	26.0
Italy	Final deduction at source	27.0	Several possibilities	–	Special tax	12.5
Czech Republic	Final deduction at source	15.0	Final deduction at source	25.0	Exempt from tax	–
Iceland	Final deduction at source	10.0	Final deduction at source	10.0	Special tax	10.0
Korea	Final deduction at source	24.2	–	–	Exempt from tax	–
Mexico	Final deduction at source	17.0	Personal income	–	Exempt from tax	–
Portugal	Final deduction at source	20.0	Deduction at source with refund	25.0	Special tax	10.0
Hungary	Exempt from tax	–	Final deduction at source	20–35	Special tax	20.0
Poland	Exempt from tax	–	Final deduction at source	20.0	Personal income	–
Finland	Exempt from tax	–	Personal income	28.0	Special tax	28.0
Greece	Final deduction at source	15.0	–	–	Exempt from tax	–

[a] For a full description see: A. Brender, *The System of Direct Taxation in Israel in an International Perspective*, internal memo of the Research Department of the Bank of Israel, January 2000.
[b] Personal income: Taxation as a share of total personal income. Deduction at source with refund: deduction at source, with an option of a refund for those paying marginal tax at a rate lower than that of the deduction at source.
[c] Germany–Income higher than DM6,100 (13 percent of *per capita* GDP) for an individual, or DM12,200 for a couple from interest and dividends.
[d] Sweden–uniform tax of 30 percent. Britain–reduction of 5 percent for every year of holding asset, up to 10 years; after 10 years, reduction of 60 percent.
Spain–at the end of two years of holding an asset, the net profit is reduced by 25 percent per year. Germany, Austria, and Turkey–on assets held for less than one year. USA–above 18 months; 28 percent on 12–18 months and personal income on holdings of less than a year. Portugal–option of including profit in total income. Luxembourg and the Czech Republic–on assets held for more than six monthso
SOURCE: European Tax Handbook (1998), OECD: Tax Database, OECD (1991): Taxpayers' Rights and Obligations.

Table 5.9B
Features of Taxation on Individuals' Income in OECD Countries[a]

	Tax exemptions on public pensions[b,c] Type of exemption	Tax benefits on private pensions[b,d] Type of exemption/benefit	Taxation on one-off withdrawal	Requirement to report to income tax authority
USA	Employers' contribution and profits	Contribution and profits	Yes	General
Canada	Contribution and profits	Contribution and profits	Yes	General
Australia	Contribution and profits	Preferred tax	Yes	General
Denmark	Contribution and profits	Only contributions exempt	Yes	General
Luxembourg	Contribution and profits	–	–	–
The Netherlands	Contribution and profits	Contribution and profits	Yes	General
Norway	Employers' contribution and profits	Contribution and profits	Yes	General
Sweden	Contribution and profits	Only contributions exempt	–	General
Germany	Contribution and profits	Contribution and profits	No	General
Britain	Employers' contribution and profits	Contribution and profits	No	Samples-one-third of taxpayers
New Zealand	Contribution and profits	Preferred tax	No	General
Turkey	Contributions, profits and withdrawals	Tax preferences	No	Exemption for some employees
Spain	Contribution and profits	Contribution and profits	Yes	General
France	Contribution and profits	Contribution and profits	No	General
Austria	Contribution and profits	Tax preferences	Yes	Mainly self-employed
Belgium	Contribution and profits	Contribution and profits	Yes	General
Switzerland	Contribution and profits	Employers' contribution and profits	Yes	General
Ireland	Contribution and profits	Contribution and profits	Yes	Self-employed and some employees
Japan	Contributions, profits and withdrawals	Contribution and profits	Yes	Exemption for employees in one job
Italy	Contribution and profits	Contribution and profits	Yes	General
Czech Republic	Contributions, profits and withdrawals	Only profits exempt	Yes	–
Iceland	Contribution and profits	Contribution and profits	Yes	–
Korea	Withdrawal	Preferred tax	No	–
Mexico	Employers' contribution and profits	–	–	–
Portugal	Contribution and profits	Contribution and profits	Yes	General
Hungary	Withdrawal	Tax preferences	No	–
Poland	Contribution and profits	–	–	–
Finland	Contribution and profits	Contribution and profits	Yes	General
Greece	Contribution and profits	–	General	

[a] For a full description see: A. Brender, *The System of Direct Taxation in Israel in an International Perspective*, internal memo of the Research Department of the Bank of Israel, January 2000.

[b] Contribution and profits–exemption on employees' and employers' contributions to pension plans and on profits, with a tax on withdrawals. Contributions, profit, and withdrawals–exemption on contributions, profits, and withdrawals. Employers' contributions and profits–exemption on employers' contributions and profits; tax at reduced rate or exemption on withdrawals. Withdrawal–taxation of contributions, exemption on withdrawals. Preferred tax –exemption–no exemption on contributions and profits; preferential tax or exemption on withdrawals. Tax preferences–on contributions and withdrawals.

[c] Germany–taxation on allowance, only on the share deriving from interest. Also, a deduction of 40 percent from the allowance (up to DM6000 per year). France–private pensions taxed on a declining scale based on age. Austria–tax credit of SCH5500 per year; tax on only 25 percent of the amount saved above the legal requirement. Belgium–reduced rate of income tax. Britain–tax benefit, reducing gradually on incomes above £15,600 per year. Greece–maximum contribution for deduction, 15 percent or 200,000 drachmas per year, (whichever is lower). Ireland–increased reduction of income tax for pensioners. Australia and New Zealand–public pension financed by general taxation.

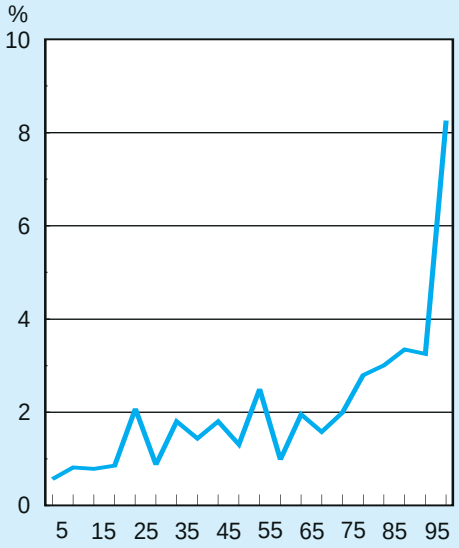
[d] Britain–maximum contribution (between 17.5 percent and 40 percent of income, depending on income). In certain cases, preferential tax on allowance. Canada–maximum of 18 percent of previous year's wage. Switzerland–the basis of tax on withdrawal is adjusted to allow a return on capital.

SOURCE: European Tax Handbook (1998), OECD: Tax DataBase, OECD (1991): Taxpayers' Rights and Obligations.

at a standard rate throughout the saving period (excluding pensions savings).[30] In half the countries income is taxed in accordance with the individual's marginal tax bracket, and in another five tax is deducted at source while enabling individuals who are in a low tax bracket to receive a rebate upon submitting their annual tax returns. In eight countries income is taxed at source at a rate of between 10 and 27 percent.[31] Financial (nominal) capital gains—generally net—are also taxed in most countries; in some of these countries an exemption or reduction is granted for holding long-term assets (usually for over a year). The tax rate is usually low in relation to the individual's marginal tax bracket, in order to offset the effect of revaluation due to inflation. Offsetting losses is usually permitted only against capital gains or capital income.

One of the main differences between individual taxation in Israel and the OECD countries is the extensive tax-exemption on income from financial capital in Israel.

Figure 5.3
The Ratio of Income from Capital to Income from Labor in Israel, by Twentieths



SOURCE: Based on Household Expenditure Survey, 1997.

The tax exemption on a large part of an individual's capital income in Israel also affects the relative tax burdens in Israel and the OECD countries regarding medium and high incomes. There are no precise data for Israel regarding the distribution of capital income between individuals at different wage levels, but indicative figures can be obtained from the survey of incomes undertaken by the Central Bureau of Statistics. According to this survey, the ratio of income from capital (excluding pensions, provident funds, and imputed income from housing and a car) to income from labor in the top five percentiles of the distribution of income is 8.5 percent, compared with 3 percent at the level of twice per capita GDP (Figure 5.3), which is similar to the distribution in the OECD countries. Consequently, if capital income in Israel is taxed in a manner similar to that in the developed countries this will greatly increase the burden on individuals with high incomes relative to the rest of the population.

[30] In Turkey the tax is on real interest, and in Mexico only the first ten percentage points of interest paid are taxed.

[31] The tax on real interest is far higher. Thus, for example, if there is a final tax of 20 percent on a 5 percent interest rate with a 2 percent inflation rate, this constitutes a tax of 33 percent on real interest.