Chapter 5
The Public Sector

The domestic budget deficit rose from 3.2 percent of GDP in 1995 to 4.7 percent in 1996. This was reflected by a NIS 6.8 billion departure from the deficit target, which in 1996 was 2.5 percent of GDP. The increase in the deficit aggravated the main problem confronting Israel's economy—the large current-account deficit. The total public debt rose from 89.3 percent of GDP in 1995 to 89.7 percent of GDP in 1996, reversing the declining trend that had characterized the debt/GDP ratio in the last ten years. Together with the loss of credibility of the Budget Deficit Reduction Law, this acted to increase inflationary pressures and raise interest rates.

The total public-sector deficit rose from 3.1 percent of GDP in 1995 to 4.2 percent in 1996, largely due to exceptional wage agreements signed in 1993–94 which raised public expenditure on a permanent basis; this was financed by large tax receipts in 1993–94, but an overestimate of these receipts for 1996 precluded any serious attempt to overcome the problem of the structural deficit. Only a fraction of the considerable shortfall between estimated and actual tax receipts is explained by the fact that the GDP growth rate was below expectations.

1. MAIN DEVELOPMENTS

The total public-sector deficit rose to 4.2 percent of GDP in 1996, compared with 3.1 percent in 1995. This is particularly worrying in view of the high level of the deficit in 1995 and the objectives set for Israel's economy in 1996. The increase in the public-sector deficit, due entirely to the rise in the budget deficit, aggravated the main problem confronting the economy—the decline in the national saving rate and the consequent large balance-of-payments deficit.

In 1996 the domestic budget deficit rose to 4.7 percent of GDP.

In 1996 the government deviated substantially from the target set in the Budget Deficit Reduction Law. The domestic deficit (cash basis) rose to 4.7 percent of GDP, compared with a target of 2.5 percent of GDP. The NIS 6.8 billion deviation from the target is due mainly to the shortfall in tax receipts and the failure to adjust expenditure to actual receipts. Although it was evident at the beginning of the year that tax revenues had been overestimated, both the outgoing and the incoming governments refrained

from making significant cuts in the 1996 budget. This aggravated the balance-of-payments problem, giving rise to an undesirable monetary and fiscal policy mix and damaging the credibility of the Budget Deficit Reduction Law.

Most of the increase in the deficit in 1996 was due to a decline in tax receipts and a rise in transfer payments.

The increase in the total public-sector deficit and the slowdown in GDP growth increased the public debt/GDP ratio by 0.4 percentage points. This constitutes a reversal of the declining trend in this ratio evident in the last ten years. The large public-sector deficit, the fact that the credibility of the Budget Deficit Reduction Law was undermined, and the higher debt/GDP ratio all contributed to creating inflationary pressures and raising real interest rates.

The total public-sector deficit increased as a result of a fall in revenues of 1.6 percent of GNP, which was offset to a small extent by a reduction in expenditure of 0.3 percent of GNP. The share of tax receipts in GNP fell by 0.7 percentage points, more than half the decline being the result of legislative changes—the reduction of income tax paid by individuals and firms, lower national insurance contributions on non-wage income, and a higher excise tax on fuel. Additional factors contributing to the lower share of tax receipts in GNP were the excess revenues of 1995—which led to increased tax rebates to firms and self-employed persons—and the lower share in GNP of expenditure on the purchase of highly-taxed durable goods.

In addition to the decline in tax receipts in 1996, income from property fell by 0.4 percent of GNP, due to the decline in the profits of the Bank of Israel.

Although as a proportion of GNP the public sector's domestic demand remained unchanged in 1996, and so did not help to create excess aggregate demand, fiscal policy did serve to do so by sharply reducing the share of net tax receipts in GNP.

There was a 3.1 percent volume rise in the domestic demand of the public sector, alongside an increase in its relative price resulting from continued real wage hikes in that sector.

The increase in the budget deficit caused a decline in the national saving rate.

Direct tax receipts remained unchanged in real terms in 1996, while transfer payments increased sharply—by 9.6 percent. As a result, the share of net taxes in GNP declined by 1.6 percentage points, contributing to the increase in private consumption and investment. This change was reflected by the decline in the national saving rate and rise in the current-account deficit.

2. FISCAL POLICY

Despite the current-account deficit, fiscal discipline was not imposed in 1996.

There was some falling-off in 1996 in the contribution of fiscal policy to attaining the real and nominal economic objectives the government had set itself. The main problem for fiscal policy was the current-account deficit, which reflects the gap between gross investment and the national saving rate, and which grew substantially in 1995 due to the decline in the latter. Fiscal discipline was not imposed in 1996, even though this would have helped to increase public saving and reduce the current-account deficit.

Table 5.1
The Public Sector: Receipts and Expenditure, 1993–96

(percent of GNP)

	1993	1994	1995[a]	1996
Total receipts	53.8	53.0	53.1	51.7
of which From property	1.1	1.1	1.6	1.2
Total taxes	39.0	39.9	40.4	39.7
Indirect, on domestic production	14.3	14.1	14.0	14.4
Indirect, on civilian imports	5.8	5.6	5.6	5.3
Direct taxes, fees, and levies	14.1	15.4	15.0	14.2
National Insurance income	4.7	4.8	5.8	5.8
Total expenditure	56.1	54.1	56.3	56.0
of which Domestic civilian consumption	16.4	17.2	19.9	20.2
Domestic defense consumption	8.1	8.2	8.0	7.7
Defense imports	3.1	1.9	1.4	1.8
Public-sector investment	3.9	3.7	3.7	3.5
Transfer payments	14.4	13.3	13.9	14.4
Interest payments	7.6	7.1	7.2	6.6
Direct subsidies	2.4	2.2	1.7	1.4
Total deficit	-2.3	-1.2	-3.1	-4.2

[a] Including receipts and expenditure due to the Health Law.

Fiscal restraint, as envisaged in the Budget Deficit Reduction Law, would have decreased the current-account deficit by reducing the government's economic involvement and attaining the inflation target. Far-reaching fiscal discipline was required in 1996 in order to achieve the deficit target, due to the decline of tax receipts as a share of GDP, but as there was no such restraint, the government failed to attain the target.

The expansion of government expenditure in recent years, and the exceptional wage agreements of 1994, have caused the budget to rise continuously, creating a structural deficit problem, and the overestimate of tax receipts in 1996 precluded any attempt to cope with this. In light of the decline in tax receipts, the failure to tackle the high level of expenditure made it difficult to attain the economic targets for 1996.

The large public-sector deficit of 1996 was largely the outcome of the expansionary fiscal policy of 1994 and 1995. In those years rapid economic growth and the fall in unemployment made it possible to reduce statutory tax rates without reducing the share of tax receipts in GNP.[1] The steep increase in tax receipts appears to have made

[1] Under a system of progressive taxation, a rise in per capita GNP increases the share of tax receipts in GNP.

it easy for the government to respond to demands to increase public expenditure in general, and public-sector wages in particular. As a result, public civilian consumption rose from 16.4 percent of GNP in 1993 to 18.4 percent of GNP in 1995 (deflated by the effect of the Health Law), despite the rapid expansion of GNP. In 1996 the pace of economic growth slowed but the decline in statutory tax rates persisted, so that the share of tax receipts in GNP fell by one percentage point. The share of public consumption in GNP, which had risen on a permanent basis in 1994 and 1995, remained unchanged in 1996, so that the total public-sector deficit grew to 4.2 percent of GNP.

Public-sector revenues as a share of GNP fell steeply in 1996, by 0.7 percentage points. Legislative changes which affected revenues this year included the reduction of income tax on individuals in September 1995, the reduction of corporation tax by one percentage point, the lowering of national insurance contributions on non-wage income, and higher taxes on fuel and cigarettes. The lower share of tax revenues due to these changes is estimated at 0.43 percent of GNP.

Income tax receipts fell by 0.8 percent of GNP in 1996. Apart from the decline in statutory tax rates, which reduced revenues by 0.5 percent of GNP, the fall is explained by the overtaxation of 1995, which led to a rise of 0.32 percent of GNP in tax rebates to firms and individuals as well as a decline in the share of return on capital. Income tax on non-labor income is higher than that on labor income, so that the decline in the share of the return on capital—from 12.8 percent of GNP in 1995 to 12 percent in 1996—reduced income tax receipts by 0.15 percent of GNP. The share of national insurance receipts from wages declined by 0.1 percentage points in 1996, even though the greater share of returns to labor extended the national insurance revenue base.

The share of indirect tax receipts in GNP rose by 0.1 percentage point in 1996. Higher taxes on fuel and the increased share in GNP of consumption increased the share of indirect taxes on domestic production by 0.4 percentage points. On the other hand, the moderate rise in prices of imported consumer goods and the smaller share of expenditure on purchases of highly taxed consumer durables led to a reduction of 0.3 percentage points in the share in GNP of indirect taxes on imports.

In addition to the reduction in tax revenues, public-sector income from property also declined in 1996, due to the fall in the profits of the Bank of Israel. Contractionary monetary policy and the subsequent cost of sterilization *inter alia* cut the central bank's profits by 0.4 percent of GNP. Income deriving from capital transfers of the public fell by 0.3 percentage points in 1996, mainly due to the decline in the public sector's revenues from its own corporations and institutions as well as to the drop in receipts from the land improvement and land purchase taxes.

The share of transfer payments rose by 0.5 percent of GNP in 1996, while that of direct subsidies fell by 0.3 percentage points. The real 9.6 percent increase in transfer payments resulted from the rapid rise in pension payments to public-service employees and in capital transfers. National insurance benefits, which form the lion's share of

transfer payments, rose by a real 7.4 percent due to the implementation of a special program to eradicate poverty and the continuing reduction of the link between child allowances and military service.

Debt-servicing payments by the public sector declined by 0.7 percent of GDP. The reduction of the total public debt from 100.1 percent of GDP in 1993 to 89.6 percent in 1995 contributed to this decline—from 7.1 percent of GDP in 1994 to 6.5 percent in 1996.[2]

The expansionary effect of direct demand did not become more acute in 1996, as its share in GNP remained unchanged. The combination of the smaller share in GNP of public-sector investment with the persistent increase in the share of public consumption will have an adverse effect on future economic growth, however.

The overall effect of fiscal policy on demand was expansionary.

Fiscal policy affects aggregate demand via both direct public-sector demand and its effect on the disposable income of firms and individuals. The decline in the share of net direct taxes in GNP *less* the fall in domestic interest payments and in direct remuneration increased disposable income by 0.8 percent of GNP. Since the capital market is not perfect—interest rates are not identical for borrowers and lenders—the increase in disposable income served to increase investment and private consumption so that the total effect of fiscal policy on demand in 1996 was expansionary.

Although it was clear at the beginning of the year that actual revenues would be lower than predicted, the government did not cut the budget.

The domestic budget deficit rose from 3.2 percent of GDP in 1995 to 4.7 percent in 1996, while the target for 1996 was 2.5 percent. As a result of the shortfall in actual tax revenues the government deviated significantly from the target set in the Budget Deficit Reduction Law. The forecast was based on an overestimate in 1995 of the revenue base. It was evident at the beginning of 1996 that there was a shortfall of NIS 2 billion in the revenue base vis-à-vis that used for preparing the 1996 forecast, and revenues in 1996 were therefore expected to be below the original estimate. Nevertheless, the government refrained from cutting the budget, and actual expenditure at the beginning of the year even exceeded the estimate by NIS 660 million.The forecasting error (the actual growth rate of GDP was 4.4 percent, not 5 percent) can explain only part of the large gap between predicted and actual tax receipts.

The Budget Deficit Reduction Law was introduced in order to tighten fiscal discipline, generate public expectations of declining government economic involvement, free resources for the expansion of the business sector, and reduce inflationary pressure. For the first three years after the law went into effect (1992–94) the government met the annual deficit target, and the actual deficit was even below it. Since 1995, however, the government has failed to attain the deficit target, even though there was a more pressing need to do so due to the balance-of-payments problem.

[2] The marked fall in interest payments in 1996 is not in line with the moderate decline of the public debt/GDP ratio in 1995; this is because interest payments are calculated on a cash, not an accrual, basis.

Table 5.2
The Budget Deficit and the Law, 1992–96

(percent of GDP)

	1992	1993	1994	1995	1996
Maximum domestic deficit according to law	6.2	3.2	3.0	2.75	2.5
Actual deficit	4.9	2.4	2.0	3.2	4.7
Public-sector domestic deficit	6.4	4.1	2.4	4.3	5.3
Deviation from maximum	-1.3	-0.8	-1.0	0.4	2.2
NIS million					
Receipts	-5,321	3,630	5,419	-2,002	-6,140
Expenditure	-7,100	2,119	3,223	-746	660

The deviation from the deficit target in the two years when fiscal restraint was required may have generated public uncertainty as regards the government's ability to reduce the deficit in the future, causing real long-term interest rates to rise in 1996, further increasing uncertainty, and aggravating inflationary pressure.

In order to comply with the provisions of the Budget Deficit Reductio Law, the government decided to reduce the domestic deficit by 2.4 percent of GDP in 1997.

The Budget Deficit Reduction Law does not directly restrict the extent of public expenditure. In view of the surplus tax revenues of 1994 the government submitted a supplementary budget, principally in order to pay exceptional wage increases in the wake of agreements signed at the end of 1993 and in 1994, albeit without departing from the provisions of the law. The wage hikes increased permanent public expenditure, creating a discrepancy between the continued easing of the tax burden and adherence to the Budget Deficit Reduction Law. In order to comply with the law, the government decided to reduce the domestic deficit by 2.4 percent of GDP in 1997. Estimates show that most of the planned reduction derives from increasing the tax burden, and there is virtually no decline in public expenditure, since according to the 1997 budget, the share of income in GDP is expected to rise by 2.1 percent of GDP and that of expenditure to fall by 0.3 percent of GDP.

Approaches to reducing the deficit

The public debt rose to 89.7 percent of GDP in 1996.

The high public-sector deficit, in concert with the slower rate of economic growth, caused the public debt to grow from 89.3 percent of GDP in 1995 to 89.7 percent of GDP in 1996. The rise in the public debt/GDP ratio is particularly noteworthy in the context of its steady decline in the last few years, beginning in 1985, when it was 183 percent, and persisting (with the exception of 1989) until 1995. Despite the impressive decline, Israel's debt/GDP ratio is far higher than the EU's Maastricht criterion of 60 percent. As

some of the effects deriving from immigrant absorption come to an end, and in view of the expected slowdown in economic growth, the continued decline of the public debt/GDP ratio depends on the reduction of the public-sector deficit. This will reduce the demand for capital, thereby helping to bring down real interest, increase the national saving rate, and raise per capita GDP in the future.

Against the backdrop of the slowing of the growth rate in 1996, due in part to supply-side problems (see Chapter 2), fiscal policy should support aggregate supply by aiming to ease the tax burden and increase public investment. Reducing the deficit by raising taxes and curtailing public investment will impair aggregate supply and economic growth. Reducing the deficit by cutting public expenditure is also generally considered to slow growth in the short term, because it suppresses domestic demand. According to two recent studies published by the IMF,[3] however, a significant and permanent reduction in current public expenditure increases investment and does not impair growth, even boosting it. This is because a permanent reduction in current public expenditure signals a permanent reduction in the tax burden, increasing investment and consumption demand. If this rise exceeds the fall in public demand, GDP will grow but there will be no immediate improvement in the balance of payments; the situation will improve only after the new investments have borne fruit. If investment and consumption demand rises by less than the decline in public consumption, the balance of payments can be expected to improve and inflationary pressure to abate, though these changes involve a slowdown in growth in the short term. The short-term effect of a reduction in the deficit may be taken to depend on its composition, extent, and permanence.

A study of the long-term connection between the public-sector budget and the per capita growth rate in Israel[4] showed that the latter is affected positively by the share in GNP of public investment, and negatively by the direct tax rate. The indirect tax rate was found to be neutral as regards its effect on economic growth.

Financing the deficit

The financing of the deficit by the public sector (i.e., the government and the Bank of Israel) is shown in Table 5.3. Net borrowing from abroad (defined as borrowing from abroad *less* the increase in the official foreign-exchange reserves) was $ 1.8 billion in 1996. This increased the official reserves and hence did not constitute net borrowing

[3] John McDermott and Robert F. Westcott, *An Empirical Analysis of Fiscal Adjustment*, IMF 1996; Alberto Alesina and Roberto Perotti, *Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects*, IMF 1996.

[4] M. Dahan and M. Strawczynski, "The Public Sector Budget and Economic Growth in Israel," *Journal of Economic Development*, 21 (1), June 1996.

Table 5.3
Financing the Deficit, 1993–96

(percent of GDP)

	1993	1994	1995	1996
Financing of public deficit(+)/surplus(–)	2.3	1.2	3.1	4.2
External net borrowing	–2.6	3.3	–3.2	–1.5
Change in monetary base	1.0	0.9	–0.3	1.2
Domestic net borrowing	1.7	0.0	6.7	5.0
Via government	2.4	0.5	3.3	2.6
of which Sale of assets	1.7	0.3	0.4	0.1
Via Bank of Israel	–0.7	–0.5	3.4	2.4
Residual	2.2	–3.0	–0.2	–0.5

from abroad. Net borrowing from abroad was negative in 1996, mainly because the Bank of Israel bought foreign currency from the private sector. This was done primarily in order to keep the exchange rate against the currency basket within the band, and increased the central bank's foreign-exchange reserves by $ 0.9 billion. Negative net borrowing from abroad reduced the public-sector foreign debt (see Chapter 6).

Foreign-exchange conversions by the public sector enlarged the monetary base. Its moderate rise in 1996, despite the extensive conversions, is explained by the fact that the central bank absorbed (borrowed) local currency from the public, thereby enlarging the public-sector's internal debt.

Most of the deficit financing of the public sector in 1995–96 was by net domestic borrowing from the public.

Most of the financing of the deficit in 1995–96 was through domestic borrowing by the government and the Bank of Israel. This increased the internal debt, caused real interest to rise, and crowded out private investment.

The allocation of resources

The long-term trend is of declining defense expenditure.

Certain long-term trends in the allocation of resources by the public sector have begun to resemble those characteristic of the developed countries (Table 5.A.4). Israel's security and debt burdens are far heavier than those of other developed countries, but the long-term trend is towards reducing defense expenditure and the share of the debt, which cuts debt-servicing costs and brings Israel more into line with the developed countries in this respect. The share of total defense consumption has fallen from 22.9 percent of GNP in 1980 to 9.5 percent in 1996, and expenditure on servicing the debt has declined from 12.1 percent of GNP in 1980 to 6.6 percent in 1996.

Another important trend is the reduction of direct involvement in private-sector activities, reflecting a decline in the share of subsidies to products and producers. At

the same time, the share of total welfare expenditure has risen steadily; this applies particularly to transfer payments to individuals, so that it is impossible to define the overall effect of increased welfare expenditure on the distribution of income and on efficiency.

The share of public-sector expenditure in 1996 was 56.8 percent of GNP—5 percentage points above the average in developed countries. A comparison of the allocation of resources shows that the share of civilian consumption is slightly higher in Israel than in developed countries, while that of subsidies and transfer payments is lower—15.8 percent of GNP in Israel compared with 21 percent in the west.

Box 5.1: Public-Sector Expenditure in Israel

The permanent share of public-sector expenditure in GNP in Israel is similar to that of other developed countries,[5] using the tax/GNP ratio as an indicator, as this smooths short-term fluctuations in the share of public-sector expenditure adjusted by debt-servicing payments. The average tax/GNP ratio in the OECD countries was 39.3 percent of GNP in 1992, while the average in those OECD countries whose GNP and population size resembled those of Israel was 38.9 percent. In Israel this ratio stood at 39.7 percent in 1996, but as the government is planning to increase its revenues by 2.1 percent of GNP the tax/GNP ratio will rise. Not only is the tax burden in Israel higher than the average in the west; the share of current public expenditure is higher, too, constituting 50.6 percent of GNP in Israel vis-à-vis an average of 46.8 percent in the west.

The fact that the public sector in Israel is larger than in other western countries does not necessarily mean that its size is not optimal. The security threat to Israel is significantly greater than that to those countries, and whereas Israel's defense expenditure was 9.5 percent of GNP in 1996, the average in the west was only 2.5 percent. Hence, Israel's civilian public sector is smaller than that customary in the west. The heavy defense burden borne by Israel is financed in part by intergovernmental transfers, which account for 3.3 percent of GNP, in part by taxes, and in part by forgoing some items of public civilian consumption.

One of the long-term trends evident in Israel is the decline in the defense expenditure/GNP ratio. If it persists it will be possible to ease the tax burden and improve public services. The optimal size of the public sector is, however, an important issue that warrants public debate.

[5] Many economists claim that in most western economies the public sector is too large. This contention is true if the average voter's preferences differ from those of the country as a whole, or if voters take only the short-term view.

Public-sector demand

Public-sector civilian consumption surged in 1996, as its relative price continued to rise.

Public-sector civilian consumption rose by a real 4.8 percent in 1996 as a result of a real 7.6 increase in purchases, which increased the pressure on the goods market, and a 4.0 percent growth in public-sector employment. The share of public-sector employees in the civilian labor force has risen steadily since 1994, intensifying public-sector pressure on the labor market. The price of labor input in the public sector rose by 3 percent in 1996, even after significant wage hikes in the preceding two years.

Domestic defense consumption rose by 0.5 percent in 1996, the result of a 2.7 percent increase in domestic purchases and 1.4 percent reduction in labor input—which has been declining since 1991. Direct defense imports, which tend to fluctuate widely, rose by 28.8 percent in 1996, so that total defense consumption increased by 7.4 percent.

3. TAXES, TRANSFER PAYMENTS, AND SUBSIDIES

The tax/GNP ratio fell as a result of the decline in direct tax receipts

The tax/GNP ratio fell from 40.4 to 39.7 percent in 1996 due to the decline in direct tax receipts, while the share of indirect taxes in GNP grew by 0.1 percentage points. The reduction of statutory tax rates on individuals and firms, the rise in tax rebates, and the decline in the return on capital contributed to the fall in direct tax revenues. The higher share of private consumption and the increased excise tax on fuel raised the share of indirect taxes on domestic production, but this was offset by the decline in the share of expenditure on imported consumer goods in general, and on consumer durables in particular, which reduced indirect tax receipts on imports. Since 1995 the ratio of indirect to direct taxes in Israel has been rising, and is now higher than in any OECD country.

The effect of net taxes on income distribution in 1996 is not clear. The higher ratio of indirect to direct taxes, and the lower progressiveness of income tax served to increase inequality, while the rise in transfer payments acted to reduce it.

Direct taxes

The lower tax/GNP ratio is due mainly to lower tax rates and higher tax rebates to firms and the self-employed.

The share of direct taxes in GNP fell from 20.8 to 20 percent in 1996. Income tax receipts declined by a real 2.2 percent so that their share of GNP fell by 0.8 percentage points. National insurance receipts rose by 4.6 percent, and their share of GNP remained unchanged.

Wage income-tax receipts grew by 1.2 percent in 1996; the 4.4 percent increase in employee posts and 1.4 percent rise in real wages expanded the tax base, but the

lowering of individual income tax rates in September 1995 reduced tax receipts. Assuming that without the legislative changes tax receipts would have risen at the same rate as the tax base, the lowering of the individual tax rates caused income-tax receipts to shrink by 0.45 percent of GNP.

The share in GNP of corporation-tax receipts and deductions at source fell by 0.5 percentage points in 1996 due to the marked rise in corporation-tax rebates, the fall in the share of return on capital in GNP, from 12.7 percent in 1995 to 12 percent in 1996, and the reduction of corporation tax—from 37 to 36 percent.

The decline in the share of the return on capital caused corporation tax receipts to drop and wage income-tax receipts to rise.

The smaller share of the return on capital reduced corporation-tax revenues and increased those on wages. Income-tax rates (corporation tax and deductions at source) are higher on capital than on labor, so that the lower share of the former in GNP reduced the proportion of income-tax receipts in GNP by 0.15 percentage points.

Taxes can be divided into two main categories: those that impair the incentive to save and those that lower the incentive to work. The taxes on wage income and on consumption have similar effects—since both of them reduce the purchasing power of an hour's work they serve as a disincentive to work. The extent of this effect depends on the marginal tax rate. In 1995 the average (weighted) tax rate on wage income was 48 percent. This estimate does not include the effect of indirect taxes, which account for 20 percent of GNP in Israel, compared with an average of 13.5 percent in the OECD countries. The high level of indirect taxes raises the average marginal tax on wage income and serves as a disincentive to work. Taxes which

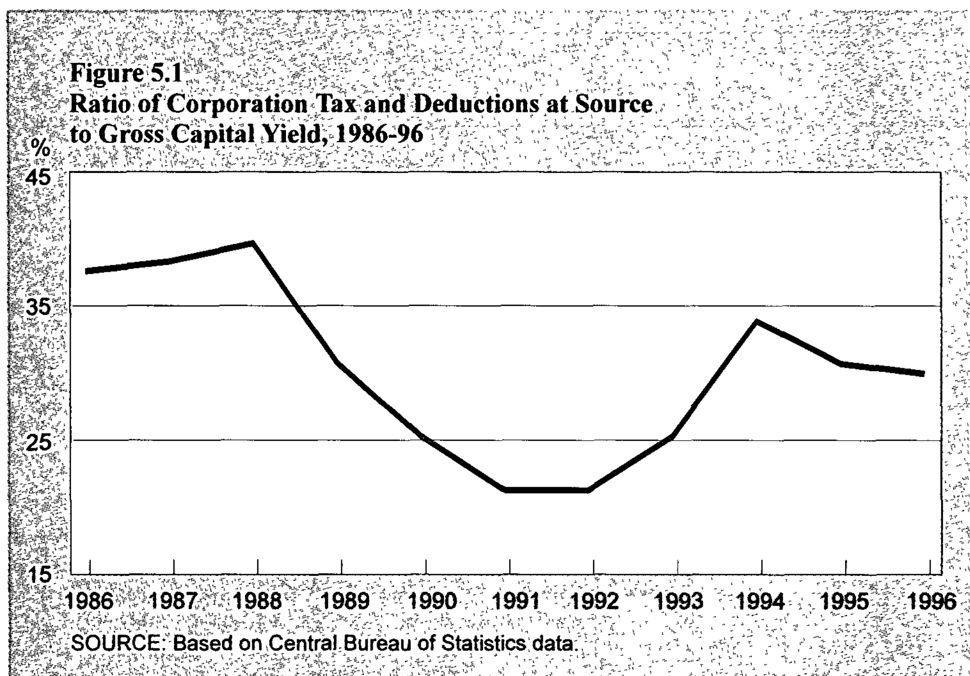

Figure 5.1
Ratio of Corporation Tax and Deductions at Source to Gross Capital Yield, 1986-96

SOURCE: Based on Central Bureau of Statistics data.

constitute a disincentive to save include those on savings and those on non-wage earnings such as corporation taxes, taxes on dividends, land improvement tax, and capital gains tax. Most savings channels in Israel are tax-exempt (in some western countries short-term savings are taxed), and some are even subsidized. Capital gains on the stock market are not taxed, the statutory tax rate on corporations does not exceed that customary in OECD countries, and some firms benefit from incentives under the Encouragement of Capital Investments Law. The damage caused by the tax system in Israel to the incentive to save and invest is relatively moderate, but the harm to the incentive to work is far higher than it is in the west, and this situation should be addressed.

Transfer payments

Transfer payments to the public rose by a real 9.6 percent in 1996.

Transfer payments to the public rose by a real 9.6 percent in 1996, mainly as a result of the increase in pensions and capital transfers. National insurance benefits, which constitute 60 percent of all transfer payments, rose more moderately—by 7.4 percent.

The growth in national insurance benefits resulted mainly from the rise in the eligible population, and to a lesser extent from the real increase in their value. The 1995 amendment to the Reduction of Poverty Law increased the benefits paid to disabled persons and single-parent families, as well as old-age pensions. The process of gradually reducing the extent to which child allowances were contingent on military service continued in 1996, contributing to their increase.

Indirect taxes

Indirect tax revenues from domestic production rose by a real 6.4 percent.

Revenues from indirect taxes on domestic production rose by a real 6.4 percent in 1996, and their share of GNP increased from 14.0 to 14.4 percent. This was the result of both the higher share of consumption in GNP and the rise in taxes on fuel and cigarettes. The main components of indirect taxes on domestic production are VAT, which accounted for 61 percent in 1996, municipal taxes, which constituted 17 percent, and the excise on fuel, which was 10 percent.

The 4.6 percent increase in expenditure on private domestic consumption, and the 3.5 percent rise in expenditure on public-sector consumption, expanded the VAT base, and as a result these revenues from domestic production grew by 3.9 percent.

The 27.5 percent increase in the excise tax on fuel expanded these revenues by 19.9 percent, so that their share in GNP rose by 0.2 percentage points. This tax makes the use of private vehicles more costly, with its attendant social costs (air pollution and congestion). The excise on fuel is still lower in Israel than in western Europe.

Despite the 12 percent volume increase in imports of consumer goods, tax revenues on civilian imports declined by a real 0.5 percent. This was because the price of imported consumer goods rose by only 1.9 percent while the implicit index of GDP prices went up by 11.8 percent.

Since 1991, when the process of reducing tariffs on imports from countries with which Israel does not have a free trade agreement began, the share of tariffs in indirect import taxes has fallen from 13.8 percent to 3.2 percent. Continued tariff reduction will limit the damage incurred as a result of the diversion of trade, and will reduce the distortions in consumption and production.

4. INCOME DISTRIBUTION

The inequality of income distribution declined in 1995.

The data on income distribution are drawn from the annual survey of incomes undertaken by the CBS, and published a year later. According to the Gini index customarily used for measuring inequality of income distribution, this declined throughout the Israeli population in 1995. The improvement in the distribution of both wage and disposable income resulted from the decline in the unemployment rate. Inequality of wage income rose among wage-earners, due to increased demand for human capital. Inequality of disposable income did not grow, however, indicating that the progressive effect of direct taxes and transfer payments intensified in 1995.

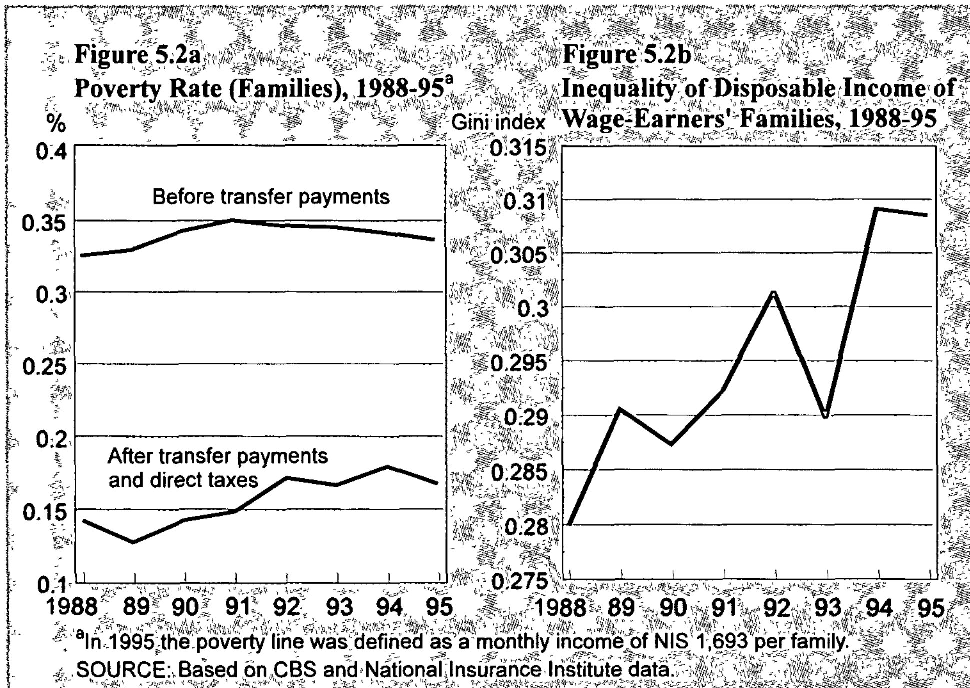

Figure 5.2a
Poverty Rate (Families), 1988-95[a]

Figure 5.2b
Inequality of Disposable Income of Wage-Earners' Families, 1988-95

[a] In 1995 the poverty line was defined as a monthly income of NIS 1,693 per family.
SOURCE: Based on CBS and National Insurance Institute data.