Chapter 6
The General Government, Its Services and Their Financing

- The general government deficit fell from 3.4 percent of GDP in 2010 to 3.1 percent this year.
- The public sector debt/GDP ratio contracted from 76.1 percent in 2010 to 74.2 percent this year. This is in contrast with the situation in most of the OECD countries, where this ratio continued to rise, reaching an average of 81.9 percent. The decline in this ratio in 2011 was more moderate than the downward trend evident in 2003-2007.
- In 2011 tax receipts rose at a faster rate than GDP growth, but were below the forecast, mainly due to a decline in asset prices.
- The government adopted the recommendations of the Committee for Economic and Social Change regarding taxation: reducing indirect taxes, cancelling the continuation of the direct taxation reduction plan and increasing direct taxes.
- The government increased public expenditure and reduced taxes for 2012 relative to the original budget. The spending increase was in the spheres of education and defense and also covered wage agreements with high-school teachers and physicians and the increase in the minimum wage.
- The cyclically-adjusted deficit rose by 3.3 percent of GDP in 2011, returning to its level in the early 2000s. Conforming to the deficit and public expenditure ceilings and significantly reducing the debt/GDP ratio comprise a significant challenge for the years ahead, requiring important government decisions regarding national priorities.
- This year, as in the past, the original defense budget was set at a level several billions of shekels below actual defense expenditure. The defense budget for 2012 has already been increased considerably from its original level.
- The performance of Israel's health system is good by international standards, but in order to maintain its quality it is necessary to invest in hospitals and in training for medical professionals.
- New collective agreements were reached this year with high-school teachers and physicians. The agreed upon wage hikes were combined with important structural reforms in both sectors.
- The term to maturity of the government debt is lower than the OECD average, while the burden of debt-service payments in Israel is greater than in most advanced economies. This situation underlines the relative vulnerability of the government debt to market and budget risks.

1. FISCAL POLICY

The current fiscal figures for Israel were good this year. The adoption of the Trajtenberg Committee's recommendations signaled the start of a shift in national priorities.

In 2011 Israel's current fiscal data were better than those of most advanced economies. The general government deficit fell slightly, as did the debt/GDP ratio. However, the deficit remained high in relation to the economy's position in the business cycle. The social protest, and the adoption of the recommendations put forward by the Committee for Economic and Social Change, appointed by the government in its wake, signaled the possible start of a process for reassessing and changing national priorities. The signals include the cessation of the income and corporate tax reduction path for the next few years. The continuation of this trend is vital for bolstering Israel's fiscal resilience.

The overall deficit, the government debt, and the public debt declined in 2011, and tax revenues rose faster than public spending.

The general government's overall deficit was lower in 2011 than in 2010. The central government's budget deficit was also lower than in 2010, deviating only slightly from the deficit ceiling. The public sector debt was down by 1.9 percentage points from 2010. Public expenditure rose by 6.3 percent in nominal terms, below the expenditure ceiling, and tax receipts rose by 7.1 percent in nominal terms, although they were slightly lower than forecast.

Israel's cyclically-adjusted deficit is high relative to its GDP growth rate in recent years, and has returned to its level at the beginning of the century.

Israel's fiscal policy in 2011 was mildly expansionary. The cyclically-adjusted deficit was higher than in 2010 and stood at 3.3 percent of GDP[1] (Table 6.1). Israel's overall deficit[2] was similar to the average of the OECD countries this year, and the cyclically-adjusted deficit consistent with international definitions also rose, exceeding the OECD average (Figure 6.1). This was in contrast to the contractionary policy required in order to reduce the deficit to a level that would be in line with the ongoing reduction of the debt/GDP ratio, the position of the economy in the business cycle, and Israel's output gap in 2011 – a level similar to that in 2005–2007. Since 2007, the year in which there was the sharpest reduction in the direct tax on labor in the last ten years, there has been a rise in the cyclically-adjusted deficit. The fact that this deficit was higher in 2011 than in 2003, when the process of reducing the share of public expenditure in GDP began, indicates that the program of consolidation of the last few years has in fact led primarily to reduced government spending rather than to the contraction of the deficit. Public expenditure was indeed reduced several years before taxes were cut, but in the end, after the tax cuts, the deficit rose to a high level once more. This means that the consolidation that was required in 2003 – a reduction in public expenditure or a rise in taxes – is still needed now, in order to reduce the deficit and enable the debt/GDP ratio to continue to decrease.

In 2003-2007 public expenditure contracted rapidly, reducing the deficit and hence the debt.

In 2003–2007 Israel adopted a contractionary fiscal policy, expressed in the reduction of public expenditure relative to GDP and increased tax receipts. The share of public spending in GDP in 2011 was 7.8 percentage points lower than in 2003, most of it (6.3 percentage points) occurring between 2003 and 2007 and encompassing both

[1] If the expectations of more moderate growth and higher tax receipts that prevailed at the time the budget was approved in 2010 had been fulfilled, the cyclically-adjusted deficit would have been 2.7 percent of GDP.

[2] In line with accepted international definitions (Table 6.3).

Table 6.1
The Cyclically Adjusted Deficit of the General Government, 2003–11[a]

(percent of potential output)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Overall cyclically adjusted deficit	3.3	2.2	1.3	1.3	1.1	2.8	4.1	3.1	3.3
Domestic cyclically adjusted deficit	3.4	2.4	0.9	1.1	1.2	2.8	4.3	3.6	3.7
Overall cyclically adjusted deficit by international definitions[b]	4.4	3.1	2.3	2.4	1.9	3.9	5.1	4.0	4.1
Average cyclically adjusted deficit of the advanced economies[c]	2.1	1.7	1.3	0.7	0.7	2.5	4.5	4.6	2.8

[a] Interest payments were calculated assuming that the rate of inflation during the year was 2 percent, and not according to the actual inflation rate.
[b] The overall deficit was brought into line with the accepted international definitions by adding indexation differentials to the CPI-indexed and unindexed local-currrency debt, assuming inflation of 2 percent.
[c] Arithmetic mean of OECD countries.
SOURCE: Based on OECD Economic Outlook 90, November 2011, and Central Bureau of Statistics data.

civilian and defense spending (Table 6.2). This decline made the rapid reduction of the deficit possible, and this, together with rapid GDP growth, led to the contraction of the public sector debt/GDP ratio (21.1 percentage points) and the fall in interest payments.[3] Tax revenues rose consistently in this period in the wake of economic growth,[4] despite the reduction of statutory tax rates which began in 2003.

In 2008-2011 government income fell sharply, in the wake of the global crisis and tax cuts, causing the deficit to rise.

Since 2008, Israel's fiscal policy has been expansionary. In that year the decision was made to reverse the contractionary trend of the share of public expenditure in GDP and to accelerate its growth rate – a change expressed in the adoption of a new expenditure rule in 2010. At the same time the growth of public sector revenues began to slow. These fell from 36 to 31 percent of GDP between 2007 and 2009 in the wake of the reduction of tax rates and the impact of the global financial crisis, but rose again in 2010 and 2011, though only to 32.6 percent of GDP. Tax receipts fell by 3.6 percent of GDP between 2007 and 2011, while public sector spending contracted by only 1.6 percent of GDP. This situation caused the rate at which the debt was reduced to slow in 2009-2011 relative to previous years, and returned both the deficit and the cyclically-adjusted deficit to their levels at the beginning of the 2000s. The fiscal expansion developed as follows: government revenues contracted more sharply than expenditure, so that the deficit was 3 percent in 2010 and 2011, even though those were years of rapid annual GDP growth (4.8 percent in real terms and 6.5 percent in nominal terms). The tax burden in Israel, which was less than the OECD average

3 See Figure 6.5 in the section on The Public Debt below.
4 Total public revenues declined following the $ 1.1 billion reduction in the US annual aid grant since 2004.

before the financial crisis, has fallen steeply since 2008, even relative to the advanced economies, which were severely affected by that crisis.[5]

The fiscal expansion evident since 2008 stemmed from concerns regarding the global crisis as well as from the failure to reduce the budget during periods of growth.

The main reasons for the fiscal expansion since 2008 have been inertia in budgetary planning and apprehensions regarding the global crisis and its effects. The two-year budget for 2009 and 2010 was prepared during 2009, in the shadow of the global crisis, and hence under the assumption that the government should bolster economic activity and allow the automatic stabilizers to operate, rather than reducing expenditure. In actual fact, 2010 was not a crisis year for Israel but one of strong GDP growth. However, the policy had been determined in advance. Despite the robust growth, the 2011-2012 budget did not include consolidation measures for 2011, but the target for 2012 was contractionary – a deficit target of 2 percent of GDP. The budget did not incorporate measures for implementing this contraction but relied on the persistence of rapid growth, which was expected to lead to the reduction of the deficit in the wake of the continued rise in tax receipts. Since GDP growth in 2012 is now expected to be lower than the original forecast, the deficit target in the 2012 budget remains contractionary but there is no mechanism to attain it. Consequently, it is expected that the deficit will continue to be higher than the target, unless tax rates are raised or

Table 6.2
Changes in Public Revenue and Expenditure, by Category, 2003, 2007 and 2011
(% of GDP)

		2003-2007	2007-2011	2003-2011
Revenue	Taxes	1.3	-3.6	-2.3
	Grants[a]	-1.1	-0.5	-1.6
	Property tax	-0.3	-0.3	-0.6
	National Insurance	-0.4	0.1	-0.4
	Other	-0.2	0.0	-0.2
	Total	-0.8	-4.3	-5.1
Expenditure	Civilian	-1.5	0.3	-1.2
	Defense[a]	-1.3	-1.0	-2.3
	Interest	-1.3	-1.0	-2.3
	Transfer payments	-1.4	0.2	-1.3
	Investments	-0.8	0.2	-0.6
	Subsidies	0.0	-0.1	-0.1
	Total	-6.3	-1.5	-7.8
Total deficit		-5.6	2.9	-2.7

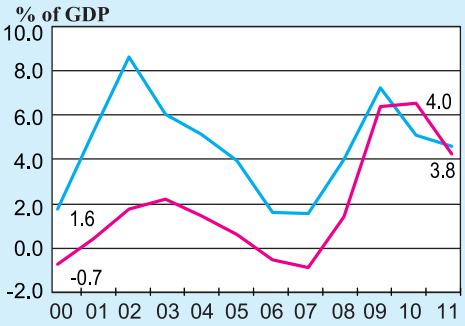
[a] About one third of the reduction in defense expenditure in 2003–11 was due to the decline in value of the defense grant from the US relative to GDP.

SOURCE: Based on Central Bureau of Statistics data.

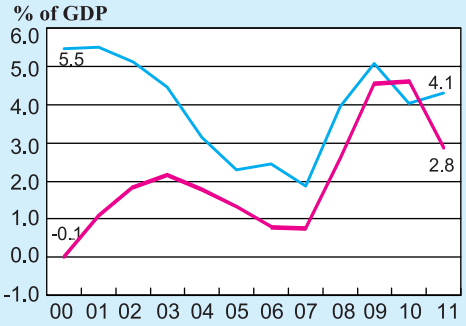
[5] The only OECD countries in which the reduction of the tax burden between 2008 and 2011 was more pronounced than in Israel were Iceland (4.4 percent of GDP) and Spain (5.5 percent of GDP).

Figure 6.1

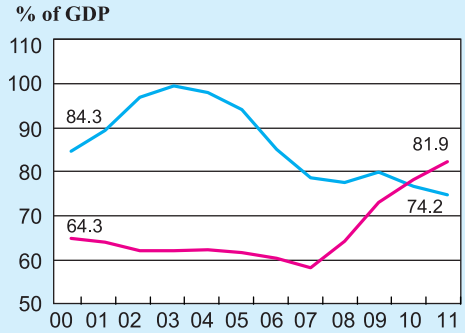
The General Government Deficit in Israel[a] and the OECD,[b] 2000-11



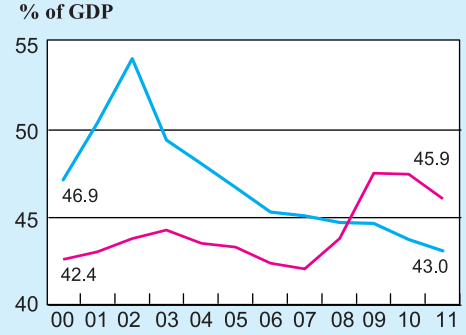
The Cyclically Adjusted Deficit in Israel[a] and the OECD,[b] 2000-11



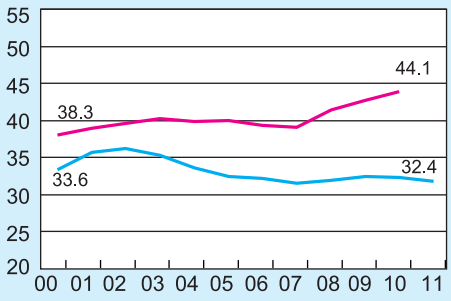
Gross Public Sector Debt in Israel[a] and the OECD,[b] 2000-11



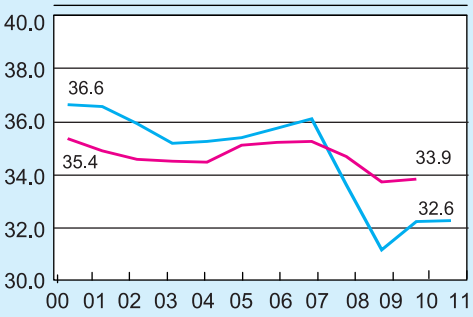
Government Expenditure in Israel[a] and the OECD,[b] 2000-11



Government and Civilian Expenditure in Israel and the OECD,[b,c] 2000-11



The Tax Burden in Israel and the OECD,[b,c] 2000-11



[a] The figures for Israel are the general government deficit excluding the Bank of Israel. The data on the deficit and expenditure are adjusted to the internationally accepted definitions.
[b] OECD figures are the average for all OECD members whose data is found in the OECD system.
[c] OECD data available only up to 2010.
SOURCE: Based on Central Bureau of Statistics data and OECD Revenue Statistics 2011.

spending is cut (under present circumstances tax revenues will not increase because of the slow growth rate).[6].

The deficit is expected to exceed its ceiling in 2012 as a result of slower than forecast growth and changes in the tax rates.

The 2012 budget was prepared on the basis of a nominal GDP growth rate of 6.2 percent. According to the Bank of Israel's most recent forecast, nominal GDP is expected to rise by only 4.5 percent in 2012, and this will reduce tax receipts relative to their projected level. Furthermore, changes in tax rates approved by the Knesset at the end of 2011 will decrease revenues by more than NIS 1 billion a year relative to the government's original proposal.[7] Given these changes, and provided the expenditure ceiling is not exceeded, it is expected that the budget deficit in 2012 will be about 3.2 percent of GDP – more than one percentage point above the ceiling set by law.

Many expenditure measures have been added since the budget was approved, and significant spending cuts will be required in order to avoid exceeding the expenditure ceiling in 2012.

On the expenditure side, additional funding is required in order to implement the decisions made by the government since the budget was approved – including an increase in the minimum wage, the wage agreements with the high-school teachers and physicians, the supplement to the defense budget and the government's approval of the recommendations of the Committee for Economic and Social Change on education. The sum needed is larger than the amounts approved in previous years, and its absorption by means of budgetary transfers will be challenging. The expenditure recommendations of the committee were balanced for this year, but the main budgetary source it proposed for financing them, namely, defense spending cuts of NIS 3 billion, did not materialize, and the net defense budget in fact grew by NIS 3.6 billion.[8] The other sources intended by the government for financing these expenditures – a 4 percent across-the-board cut in ministries' budgets and the allocation of budgetary reserves in 2012 – are not sufficient to cover the cost. Significant reductions will be required in other expenditure in order to make the implementation of all the plans approved possible without exceeding the expenditure ceiling for 2012, and without increasing the deficit in 2012 even beyond the level currently expected.[9]

In a necessary and important step, the government brought cuts in direct taxes to a halt.

At the end of 2011, in the wake of the recommendations of the Committee for Economic and Social Change, the Knesset approved several changes in the tax system, among them a freeze of the direct tax reduction path. These changes in taxation will slightly reduce tax receipts in 2012 relative to the budget forecast,[10] but the freeze of the reduction path precludes a significant fall in revenues. According to the tax reduction path, corporate tax was expected to drop to 18 percent by 2016, and the highest income-tax rate on individuals to 39 percent. This freeze by the government,

6 For further explanation, see "The Expected Performance of the Government Budget for 2012 vis-à-vis the Budget Targets." Bank of Israel, December 2011 (Hebrew).

7 For additional information, see the section below on Tax Revenues.

8 This increase in the defense budget is not exceptional. Similar increments were allocated in recent years (see the section on Budgetary Items below)..

9 See Recent Economic Developments 132, Bank of Israel, Research Department.

10 For further explanation, see the section on Tax Revenues below.

following the difficulty in meeting its other fiscal targets, because of the effect on revenues of the downward path, is a necessary and important decision. Freezing the path of tax cuts will increase tax revenues in the next few years, help to observe fiscal rules, and increase the probability that the public debt will continue to be reduced. It also enhances the credibility of fiscal policy by putting an end to the uncertainty caused by the very existence of an unsustainable path of tax cuts, which it was obvious would have to be rescinded at some point.

Fiscal policy faces significant challenges in the next few years, and national priorities will have to be reassessed.

The cessation of the tax cuts stabilizes the debt/GDP ratio and public sector revenues, assuming public sector expenditure increases in accordance with the expenditure rule (Figure 6.2). However, this policy is consistent with adhering to the deficit ceiling only if there is real average GDP growth of 6 percent in the next few years. This is not likely even without the negative effects of the ongoing European debt crisis. If growth rates are lower, the government will have to choose between a slower rise in spending and an increase in revenues through higher tax rates. The challenge is intensified by the fact that the level of expenditure derived from the government's decisions on implementing the recommendations of the Committee for Economic and Social Change and specific programs in the spheres of defense, education,[11] welfare, and infrastructure is already higher than the expenditure ceiling stipulated by law for 2013 and subsequently. This challenge lowers the chance that the increase in spending will decelerate to below the ceiling in order to help reduce the deficit. However, if the government chooses to adhere to the deficit and expenditure ceilings to which it is committed, it will have to restore the tax burden to its level in 2006 and 2007,

Figure 6.2a
Debt/GDP ratio under Various Scenarios, 2010-20

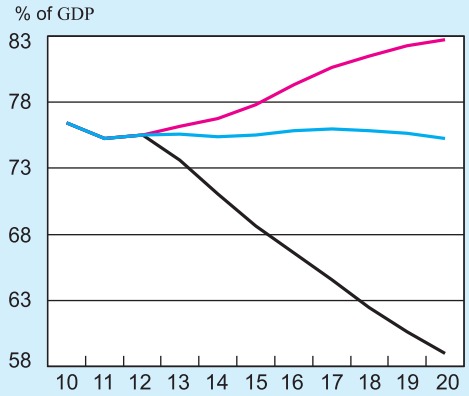
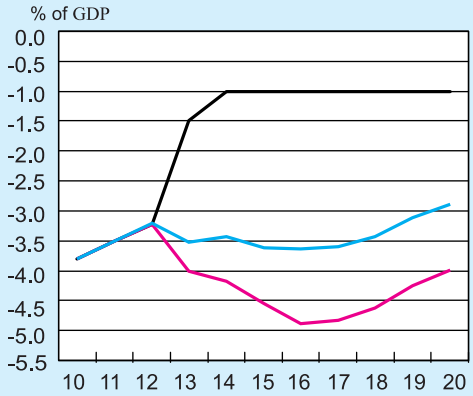
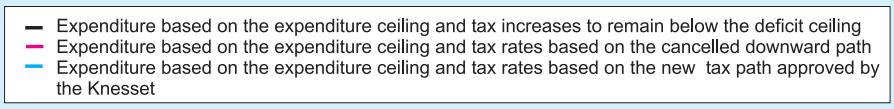


Figure 6.2b
Ratio of Tax Revenues to GDP under Various Scenarios, 2010-20





SOURCE: Bank of Israel.

[11] Including the plan to implement the 'New Horizon' program in junior high schools, the 'Strength for Change' program in high schools, and the budgetary increment for higher education.

similar to that prevailing in the advanced economies. This choice will require the reassessment of priorities in choosing the appropriate taxation mix for a higher tax burden.

Although the debt/GDP ratio continued to contract this year, debt-service payments are still high.

The public debt/GDP ratio declined this year as a result of rapid GDP growth, continuing the downward path of the debt since 2003. This path is one of the main indications that Israel's economic situation is very different from that of the advanced economies: the public sector debt was down by more than one percentage point from 2010, while the average public sector debt of the OECD countries has continued to rise rapidly ever since the 2008 financial crisis, and in 2011 it grew by another 4 percent (Figure 6.1). The contraction of the debt/GDP ratio reduces Israel's debt service costs, but these payments are still high and, together with defense expenditure, continue to restrict the expansion of public services in Israel. These payments, which amounted to 3.6 percent of GDP in 2011, constitute an annual payment of NIS 4,100 per capita in Israel because of past debts. One of the reasons for the heavy burden of interest payments in Israel is the country's geopolitical risk, expressed in the interest rate demanded by investors. Nevertheless, it is possible and desirable to ease the burden by continuing the downward path of debt-reduction.

The development of the debt crisis in Europe underlines the importance of continuing to reduce the public debt and reordering priorities.

The importance of decisions about national priorities and establishing the credibility of fiscal policy is apparent from the development of the debt crisis in Europe. In the wake of the crisis, which began in Greece and spread to other countries in Europe, the sensitivity of the financial markets to risk increased, leading to several sudden, sharp shifts in bond yields of advanced economies, which embody the risk levels assessed by the markets. In some cases the shifts were not in response to major economic or political events but rather to the accumulation of negative data, or to a rise in the risk assessment regarding a neighboring or linked country. Countries which reached a turning point of this kind had to make major fiscal adjustments and introduce extensive austerity measures. Israel, being a small open economy, with neither a low public debt nor a low deficit (Figure 6.1), is exposed to the risk of contagion by the crisis, particularly because of the country's regional risk: The lack of stability in the region in the wake of the 'Arab Spring', and threats of escalation, terrorism or war, could weaken Israel's relative position and cause investment in it to decline. It is therefore important to continue with the path of public debt reduction and to make credible fiscal decisions as soon as possible, thereby signaling that Israel is economically stable and avoiding, as far as possible, contagion by the debt crisis.

2. THE OVERALL DEFICIT, PUBLIC EXPENDITURE AND REVENUE

The general government deficit and the deficit of local authorities contracted this year.

The overall deficit of the general government was slightly lower in 2011 than in 2010, and stood at 3.1 percent of GDP (Table 6.3). This deficit is high in view of the rate of GDP growth in the last few years. The overall deficit is that of the government plus the small deficits of the national institutions and the local authorities, less the budget surplus of the National Insurance Institution and the surpluses of the public sector

nonprofit institutions (6.A.9). The level of the local authorities' deficit was down by 0.2 percent of GDP from 2010, and was similar to its level in 2004-2009.

Tax revenues, which constitute the principal component of public revenue, were up in 2011 over 2010, expanding more rapidly than the increase in nominal GDP, so that their share of GDP rose slightly. As a result of this increase, the decline in transfers from abroad to the national institutions and nonprofit institutions, and the contraction of transfer payments by the public, public sector revenue remained unchanged.

Table 6.3
The Main Components of Revenue and Expenditure of the General Government,[a] 2003–11

(percent of GDP)

	2000–03 average	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total public revenue	45.0	44.0	43.1	42.8	43.7	43.3	40.7	37.7	38.9	38.9
Income from property excluding Bank of Israel	1.5	1.4	1.2	1.2	1.1	1.1	1.0	0.9	0.7	0.7
Total taxes	36.1	35.2	35.3	35.4	35.7	36.1	33.7	31.3	32.3	32.6
Indirect taxes on domestic production	12.5	13.1	12.9	12.9	12.4	12.4	12.3	12.2	12.6	12.5
Indirect taxes on civilian imports	3.9	3.7	4.1	4.1	3.9	4.5	4.2	3.9	4.1	4.2
Direct taxes, fees and levies	13.9	12.5	12.4	12.6	13.8	13.7	11.6	9.8	10.0	10.3
National Insurance surplus	5.7	6.0	5.8	5.8	5.6	5.5	5.6	5.4	5.6	5.6
Grants	3.5	3.4	2.7	2.4	3.0	2.3	2.1	1.8	1.9	1.8
Other[b]	4.0	4.0	4.0	3.8	3.9	3.8	3.9	3.8	3.9	3.8
Total public expenditure	49.1	49.8	47.1	45.1	44.6	43.5	42.6	42.7	42.3	42.0
Current expenditure	45.3	46.1	43.6	41.8	41.3	40.0	38.8	38.9	38.6	38.5
Domestic civilian consumption	18.7	18.8	18.4	17.9	17.5	17.4	17.5	17.4	17.5	17.6
Domestic defense consumption	6.4	6.6	6.1	5.8	5.8	5.6	5.6	5.4	5.2	5.1
Defense imports	1.8	1.8	1.5	1.7	1.7	1.5	1.2	1.0	1.0	1.0
Direct subsidies	0.8	0.9	0.7	0.7	1.1	0.8	0.8	0.8	0.7	0.7
Transfer payments on current account	12.1	12.1	11.1	10.7	10.5	10.1	10.1	10.6	10.6	10.5
Interest payments	5.5	5.9	5.6	5.0	4.7	4.6	3.6	3.7	3.6	3.6
Transfer payments on capital account[c]	1.4	1.2	1.6	1.6	1.7	1.8	2.0	2.1	1.9	1.6
Investments of general government	2.4	2.5	2.0	1.7	1.6	1.7	1.8	1.7	1.9	1.9
Total deficit of the general government	4.1	5.8	4.0	2.4	1.0	0.2	2.0	5.0	3.4	3.1
Current deficit of general government	3.2	5.0	3.5	2.1	0.8	-0.1	1.4	4.1	3.0	2.8
Deficit using international definition	4.8	5.4	4.6	3.5	1.4	1.4	3.6	6.5	4.5	4.0
Net public debt[d]	80.3	87.6	87.6	83.8	74.8	69.2	69.1	70.8	69.2	67.3
Gross public debt excluding Bank of Israel	92.3	99.3	97.7	93.7	84.7	78.1	77.1	79.5	76.1	74.2

[a] This table no longer includes the Bank of Israel balance sheets, because the Central Bureau of Statistics has adopted the internationally accepted norms which exclude the central banks.

[b] Including transfer payments from the public on the current and capital accounts, imputed pensions, depreciation, capital transfers from abroad, and transfers from abroad to National Institutions and nonprofit organizations.

[c] Including mortgage subsidies and transfers on the capital account to nonprofit organizations and businesses.

[d] Excluding municipalities' debts to the government.

SOURCE: Based on Central Bureau of Statistics data.

Public-sector expenditure accelerated in nominal terms this year, and civilian expenditure increased more rapidly than defense expenditure.

This year, in line with the expenditure rule adopted in 2010, the accelerated expansion of public expenditure continued (Table 6.4). The nominal acceleration of public expenditure and consumption in 2009–2011 checked the downward trend of the share of public expenditure in GDP which began in 2003. Nominal spending by the general government rose by 6.3 percent in 2011, more than in 2010, and its share in GDP declined (0.3 percent of GDP). The share of civilian spending – wages and purchases – in GDP rose, and the share of defense expenditure fell, because its 4.9 percent increase was lower than that of GDP. This situation is consistent with the policy of expanding civilian expenditure more rapidly than defense expenditure.[12] Transfer payments on the capital account are the only expenditure item which contracted in nominal terms, and this is explained by the 55 percent reduction in government transfers to the old pension funds (NIS 2.1 billion) in 2011, in contrast with 2010. The growth rate of transfer payments remained unchanged in 2011. Expenditure on transfer payments accelerated in 2009, mainly because of the activity of the automatic

Table 6.4
Rates of Nominal Increase of Public Expenditure in Israel, 2005–11

	2005	2006	2007	2008	2009	2010	2011
Total public expenditure	1.5	6.6	3.2	3.3	6.1	5.1	6.3
of which: Interest payments	-5.3	0.8	3.7	-16.7	7.5	2.2	7.1
Total primary expenditure	2.4	7.3	3.2	5.7	5.9	5.4	6.2
of which: Current primary expenditure	2.8	7.2	2.4	4.9	5.9	5.6	6.6
Current primary civilian expenditure	2.6	7.0	2.9	5.8	7.5	6.0	7.0
Public consumption	3.5	6.1	3.2	4.6	3.6	5.9	6.8
Public consumption excluding defense imports	2.6	5.7	4.4	5.7	4.8	5.9	6.9
Civilian consumption	3.3	5.2	4.9	6.2	5.6	6.5	7.4
Per capita civilian consumption	1.5	3.3	3.1	4.3	3.7	4.6	5.5
Wage expenditure	1.8	4.8	3.5	5.4	3.8	7.3	7.4
Purchases	5.0	5.8	7.1	7.0	8.7	5.9	7.6
Domestic defense consumption	0.8	7.3	3.4	4.0	2.1	3.6	4.9
Wage expenditure	2.5	5.0	2.4	-0.7	3.2	5.5	3.6
Transfer payments on domestic current account	1.7	5.9	2.4	5.2	10.7	6.0	5.9
Per capita transfer payments on domestic current account	-0.1	4.1	0.6	3.4	8.7	4.1	4.0
Investments of the general government	-7.5	1.5	11.0	9.8	1.1	15.1	11.3
of which: Land transport infrastructure	-39.6	44.3	16.7	16.7	0.2	5.1	0.4
Transfer payments on the capital account	4.5	16.4	12.1	17.7	11.6	-6.2	-6.8
Change in CPI (annual average)	1.3	2.1	0.5	4.6	3.3	2.7	3.5
Change in GDP deflator	1.1	1.7	0.0	0.8	4.9	0.1	1.4
Change in public consumption price index	1.5	3.0	0.0	2.7	1.6	3.2	2.9
Change in nominal GDP	6.0	7.8	5.9	5.4	5.9	6.1	6.9

SOURCE: Based on Central Bureau of Statistics data.

[12] Report of the Committee for the Assessment of the Defense Budget, May 2007.

stabilizers in response to the global crisis and the increase in unemployment. Expenditure on unemployment benefits rose in 2009, declined in the two subsequent years, and returned to the 2008 level in 2011. The real growth rate of most expenditure items rose in 2011, when adjusted by both the implicit price index of the GDP deflator and the CPI (Consumer Price Index).

Public-sector expenditure did not exceed its ceiling in 2011.

In 2010 the Knesset approved a rule determining that the real rate of increase of the expenditure ceiling would be determined each year as the product of the average GDP growth rate of the previous ten years multiplied by the ratio of the debt target – 60 percent – to the debt/GDP ratio.[13] Any rise in expenditure is subject to the deficit ceiling, so that it is possible to increase expenditure up to either the expenditure ceiling or the deficit ceiling, whichever is lower. The approved budget must adhere to this rule, but the rule does not restrict budgetary implementation. The actual expenditure of the central government adjusted by the CPI rose by 1.9 percent from 2010 to 2011. This growth rate is below the expenditure ceiling, which was 2.66 percent in 2011. The expenditure ceiling for 2012 is also 2.66 percent, and the ceiling expected for 2013 is 2.93 percent.[14]

3. TAX REVENUES

The rate at which tax revenues rose was faster than that of nominal GDP but tax receipts were lower than predicted in the budget.

The increase in tax revenues which began in 2010 persisted in 2011. Although its rate slowed, it was slightly above the rise in nominal GDP. As in recent years (with the exception of 2009), the tax model of the Bank of Israel's Research Department shows that the macroeconomic data provide a good explanation of the level of tax revenues. The principal variables which explain the slower rate at which tax receipts rose are the decline in the capital market and stagnation in the real wage. The government's tax receipts (excluding the local authorities and the National Insurance Institute) amounted to NIS 212.1 billion in 2011 – a 9 percent rise over 2010 (Table 6.7), but NIS 2.9 billion less than the budget forecast (NIS 1 billion of this difference is due to the cancellation of the hike in the excise tax on fuel). Adjusted for legislative changes and one-off income, the government's tax receipts in 2011 were 5.2 percent higher in real terms than in 2010. Most of the rise in tax revenues was due to direct taxes.

Legislative changes increased tax receipts in 2011, and the excise tax on fuel was adjusted several times during the year.

Legislative changes in 2011 led to a net increase of NIS 940 million in tax receipts, constituting 0.11 percent of GDP. This is a result of the NIS 1,400 million rise in indirect taxes and the NIS 460 million contraction in direct taxes. The main shifts in indirect taxes were the higher tax on cigarettes,[15] an increase in the excise tax on diesel and heating oil, coal, and bio-diesel, and the imposition of VAT on land for

[13] The Deficit Reduction and Restriction of Budgetary Expenditure (amendment no. 11) Law, 5770-2010.

[14] Real average growth in 2002-2011 was 3.62 percent, and the debt/GDP ratio in 2011 was 74.2 percent (2.93 = 3.62*60/74.2).

[15] Implemented in June 2010, but expressed in the comparison between the whole of 2011 and the whole of 2010.

buyers groups formed for purchasing land. The NIS 0.20 per liter hike in the excise tax on gasoline was revoked as part of the economic easing program introduced in February 2011. This excise tax was further reduced in August, on a temporary basis, by NIS 0.27 per liter for just one month, in the wake of the rise in global fuel prices.[16] The main shifts in direct taxes were the continued reduction of corporate tax to 24 percent, the further decline in the direct tax rate on labor, an increase in the ceiling of the lowest (10 percent) tax bracket, and a rise in the value of company car use.[17]

Most of the rise in tax receipts was due to direct taxes and import duties.

Direct tax receipts rose in real terms by 6.7 percent, outstripping the real GDP growth rate. This stems from the expansion of all the items other than net capital market deductions, which contracted by 13 percent following the ongoing falls in the capital market this year. The rise in land taxes (7.6 percent in real terms) continued, albeit at a slightly slower rate, as a result of the slower growth in real-estate activity. Indirect taxes expanded by 2.9 percent in real terms in 2011, more slowly than in 2010. Net VAT receipts rose by 3.7 percent, due to the continued rapid rise of VAT on imports, compared with the slow rise in domestic VAT. The latter comprised a rise in receipts in the first half of the year over the equivalent period in 2010 and a drop in receipts in the second half of the year over the first half and over the equivalent period in 2010. The slowdown was due to the fact that most VAT on domestic production comes from three areas: construction, commerce, and real-estate and business services. In commerce there was a real 6 percent decline in VAT receipts, and in construction and real-estate the real decline was about 0.5 percent. Import taxes excluding VAT rose at a similar rate to VAT on imports, and receipts from other domestic taxes, most prominent of which is the excise tax on fuel, were up by 0.3 percent.[18] The moderation of the rate at which indirect tax receipts rose is characteristic of this stage of the business cycle, and reflects an increase in the efficiency of VAT collection due to the process of closing the output gap. The smaller the output gap, the higher is the ratio between VAT receipts and the tax base.[19] When the economy approaches its potential GDP this index stops rising.

Domestic income excluding taxes, national insurance, and interest amounted to NIS 2.3 billion in 2011, compared with NIS 4.3 in the budget forecast, a gap of 0.2 percent of GDP. This revenue item comprises royalties, dividends, and other income. The reasons for their decline this year and the disparity from the forecasts are not clear. A more detailed presentation of the budget forecast for this item would enable an analysis of its dependence on the business cycle, contributing to an understanding of its volatility.

[16] Beyond these changes, the excise tax on fuels is updated by law three times a year (January, May, September) at a rate commensurate with the rise in the CPI since the previous update. Thus, the excise tax on gasoline in January 2012 was lower by 12.6 agorot per liter than its level in January 2011.

[17] According to Ministry of Finance data, 2011-2012 Budget.

[18] The excise tax on fuel rose by 3.5 percent (in real terms, adjusted by legislative changes).

[19] The index of the efficiency of VAT collection is calculated as the ratio between VAT collection for each percentage of tax relative to the tax base. The elasticity of this index to the output gap in Israel is -0.97 (see Recent Economic Developments 132, Bank of Israel, Research Department).

The tax burden: A historical view and international comparison

The burden of indirect taxes is greater in Israel than in the OECD countries, and the income from them is about half of total tax revenue.

In 1989–2007 the tax burden in Israel was relatively stable (Figure 6.3), and averaged 36 percent of GDP. This burden was slightly higher than the OECD average and followed a similar path.[20] The average ratio between direct tax receipts and total tax receipts in OECD countries was stable in 1985–2009 at about 63 percent, compared with a ratio in Israel that varied around 50 percent during that period. Throughout that period the indirect tax burden in Israel was greater than the OECD average, while since 1990 the direct tax burden has been less than the OECD average.[21] This difference has been accentuated following the reductions of the statutory tax rates in Israel since 2007, because most of the reductions were in direct taxes: the direct tax burden contracted by 3.5 percent of GDP, while the indirect tax burden fell by only 0.1 percent of GDP, so that the ratio of indirect to direct tax receipts rose (Figure 6.3).

Indirect taxes impair growth less than direct taxes but tend to increase inequality.

Income tax and corporation tax, which are the principal direct taxes and are perceived as progressive, are among the main policy instruments of the governments of the advanced economies for reducing income inequality. Consequently, a tax mix in which the share of these taxes is low could decrease the contribution of the tax system to the reduction of inequality. However, the large share of indirect taxes in the tax burden in Israel embodies several potential advantages: one of these is the stimulation of growth, as according to several studies, taxes on consumption, such as VAT, purchase tax, and excise tax, impair growth to a lesser extent than direct taxes, such as income tax, corporation tax, and capital gains tax,[22] as taxes on consumption constitute less of a disincentive to work, save, and invest. On the other hand, income tax and corporation tax could have an adverse effect on the incentive to work and produce, and hence on economic growth, as well. In the last few years, as part of the policy of stimulating growth, the government has reduced income tax and generally left the level of indirect taxes unchanged. Moreover, the labor force participation rate in Israel is significantly lower than that in most of the advanced economies, inter alia because large groups within the population choose not to participate in it; the only way of having these groups bear part of the burden of public expenditure is through indirect taxes.

In the wake of the Trajtenberg Committee's recommendations, the government reduced indirect taxes and increased direct taxes.

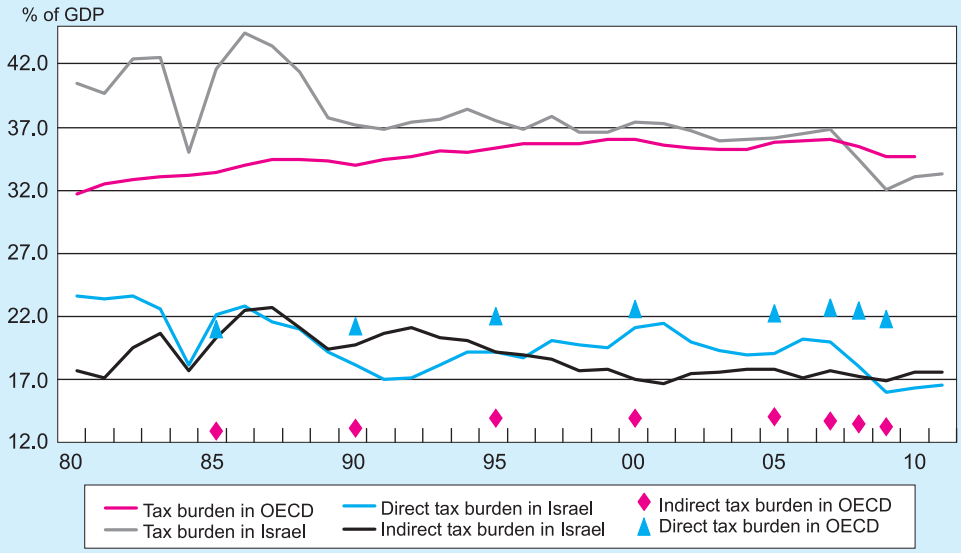
The social protest that erupted in the summer, and the conclusions of the Committee for Economic and Social Change that was appointed in its wake, led to changes in the tax system in 2011. The committee recommended that a series of tax changes be introduced, aimed primarily at supporting the middle class and employed persons, and financed by cancelling the downward path of direct tax reductions and increasing

[20] The arithmetic mean of the overall tax burden – on both direct and indirect taxes – in the OECD countries (excluding other taxes, which amount to about one percent of the tax burden) as a percentage of GDP in 1985, 1990, 1995, 2000, 2005, 2007-2009 (OECD Revenue Statistics 2011). For a discussion of the way the mean is calculated, whether arithmetically or weighted, see A. Brender, "Tax Rates on Labor Income in Israel from an International Perspective, 2008-2009," Bank of Israel, March 2009 (Hebrew).

[21] The indirect tax burden in Israel has been higher than that in any of the OECD countries except Denmark since 2000, and Iceland in 2000-2007.

[22] Tax Policy Reform and Economic Growth, OECD Publishing, OECD (2010).

Figure 6.3
The Total Direct and Indirect Tax Burden, Israel and the OECD, 1980-2011



SOURCE: Based on Central Bureau of Statistics data and OECD Revenue Statistics 2011.

taxes on capital gains, on corporations, and on high earners (Table 6.5). In the wake of the committee's decision that the changes in taxation and expenditure should each be balanced in budgetary terms, the recommendations of the committee on taxation were balanced in the 2012 budget. Most of the committee's recommendations in this sphere were adopted by the government and the Knesset,[23] and the Knesset added a 2 percent reduction in income tax on the third tax bracket, at an annual cost of about NIS 800 million.[24] The changes in taxation that have been approved set the direct tax burden on individuals at its present rate and reduce the indirect tax burden. This effectively trades current and future direct tax reduction for immediate indirect tax reductions. Total receipts from direct taxes, including capital gains tax and corporation tax, increased by NIS 2.7 billion (0.3 percent of GDP), and those from indirect taxes declined by NIS 3.25 billion (0.4 percent of GDP). Thus, the Change in the Tax Burden Law, which was passed by the Knesset, is not balanced in budgetary terms, and is expected to increase the deficit by NIS 0.55 billion in 2012 (assuming that customs duties will be lowered as expected).

[23] A surtax on annual income of NIS 1 million or more was not approved. Expected income from it was about NIS 400 million a year.

[24] Change in the Tax Burden Law, 5771-2011.

Table 6.5
The Effect of the Change in Tax Burden Law on Tax Revenue in 2012

	NIS billion
A. Taxation on individuals' labor income	
1. Suspension of the reform reducing taxes on individuals	1.8
2. Reduction of marginal tax on the NIS 8,860 to NIS 14,070 tax bracket	-0.8
3. Increase in tax on the top income bracket from 44 percent to 48 percent	0.8
4. Granting two tax credit points to a father for every child up to 3 years old	-1
5. Cancelling the rise in the wage ceiling liable to National Insurance contributions and returning it to five times the average wage	-0.8
B. Corporate tax	
1. Increasing corporate tax from 24 percent to 25 percent	0.7
2. Cancelling the reduction in corporate tax from 24 percent to 23 percent	0.7
C. Capital gains taxation	
1. Increasing the real tax rate on interest, devidends, capital gains and land betterment tax from 20 percent to 25 percent	1.3
D. Customs and purchase taxes	
1. Cancelling the increase in excise on fuels	-2.5
2. Cancelling customs on goods not produced domestically and reduction of purchase taxes in competitive industries	-0.75
Total change in tax revenue	-0.55

SOURCE: Based on the Trajtenberg Report.

4. THE NATIONAL BUDGET

The budget deficit declined this year but slightly exceeded its ceiling.

The central government's overall budget deficit (excluding credit extended) was lower in 2011 than in 2010, but was slightly above the budget forecast and the ceiling defined by law (Table 6.6).[25] This was mainly because all the income items were lower than anticipated at the time the budget was planned, while the rate of budgetary performance was 98.6 percent (Table 6.7). The planned deficit for 2011, 2.9 percent of GDP, was based on a forecast of nominal GDP of NIS 864 billion and tax revenues of NIS 215 billion. Nominal GDP expanded beyond the budget forecast,[26] but tax revenues were less than forecast. The performance rate of the government's current expenditure was slightly below its 2010 level, as was the case with the performance rate of the civilian and defense ministries. In order to continue reducing the debt/GDP ratio it will be necessary to make a fiscal effort and maintain a declining deficit path in the next few years.

Despite the two-year budget, the changes in public expenditure for 2012 were greater than the customary change from one budget year to another.

In 2011, Israel began implementing its first full two-year budget, as the 2009–2010 budget was approved only in mid-2009. The implementation of the two-year budget was intended to enable ministries and the government as a whole to plan expenditure in the

[25] The average disparity between the deficit and the deficit ceiling in 2000-2011 was 0.6 percent of GDP in absolute terms, and in most of these years the deficit was below the ceiling.

[26] Nominal GDP in 2011 was NIS 869 billion.

Table 6.6
Central Government Deficit, Revenue and Expenditure,[a] 2003–11

(percent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Overall government deficit ceiling excluding credit granted	3.0	4.0	3.4	3.0	2.9	1.6	6.0	5.5	3.0
Total actual government deficit excluding credit granted	5.1	3.6	1.8	0.9	0.1	2.0	5.1	3.7	3.3
Actual government domestic deficit	4.6	2.6	0.7	-0.2	1.4-	0.5	3.7	2.5	2.2
Total net revenue[b]	31.5	31.7	32.4	32.5	32.5	30.1	26.8	27.5	27.5
Taxes and imposts	26.9	26.9	27.1	27.3	28.0	25.6	23.3	24.1	24.4
Interest, profits, royalties, revenue from land sales	1.0	1.0	1.3	1.2	0.9	1.0	0.7	0.6	0.5
Loan from the National Insurance Institute (NII)	1.7	1.9	2.1	2.1	2.1	2.1	1.6	1.4	1.6
US government grants	2.0	1.9	1.9	1.9	1.5	1.3	1.1	1.3	1.0
Total net expenditure[b]	36.8	35.2	34.3	33.3	32.5	32.2	31.9	31.2	30.8
of which: Interest, repayment of principal to to NII and credit subsidy	7.2	6.7	6.6	6.4	5.9	5.5	5.4	5.2	5.1
Defense expenditure[c]	8.4	8.1	8.0	8.0	8.0	7.9	7.4	7.5	6.9
Total net primary civilian expenditure	21.3	20.4	19.7	18.9	18.6	18.7	19.1	18.5	18.7

[a] Revenue and expenditure in 2006 do not include the NIS 2.8 billion transferred to a compensation fund and paid to the public as compensation for the (Second) Lebanon War.

[b] After deducting government repayment of credit from the public.

[c] Defense expenditure in this table is larger than defense consumption shown in Table 6.3, because the Central Bureau of Statistics records pensions and other payments by the defense establishment as transfer payments.

SOURCE: Based on the State Budget—Major Provisions of the Budget, Central Bureau of Statistics data, and State of Israel Financial Statements as of December 31, 2011.

long run. However, the departures from the two-year budget forecast which occurred in 2011, as well as those emerging in 2012, underline one of the main disadvantages of the system: the ability to reliably predict economic (and other) variables is limited, and declines as the forecast horizon lengthens.[27] Hence a system which is based on predicting many variables over two years will require considerable amendments and adjustments along the way, whether they are introduced in the second year of a given budget or have a greater effect on the planning of the subsequent one. Moreover, since the expenditure ceiling is determined in advance, an increase in spending in one item will require unplanned reductions in others, so that the stability and planning horizon that a two-year budget is intended to provide are not attained. This is what will happen in 2012: in the course of 2011 and at the beginning of 2012 changes were made in public expenditure which surpassed the customary change from one budget year to another, without the usual procedure of approving a budget.

The path of defense expenditure as a share of GDP has been declining since 2003. Since the introduction of the Brodet Committee Framework in 2007 it has declined

[27] Adi Brender and Guy Navon (2008), "A Model for Forecasting the Government's Tax Revenues and Analyzing the Uncertainty of the Forecast," Economic Quarterly 4 (Hebrew).

Table 6.7
Components of the Deviation from the Government's Original Budget for 2011

(at current prices)

	Actual performance in 2010	2011		
		Original budget	Performance	Deviation
	(NIS billion net, excl. credit)			
Deficit (–)	-30.2	-25.2	-28.7	-3.5
of which: Domestic deficit	-26.2	-21.9	-24.4	-2.5
Deficit abroad	-3.9	-3.2	-4.3	-1.1
Revenue	223.4	244.9	238.7	-6.2
of which: Domestic revenue	211.2	234.7	229.1	-5.6
Taxes[a]	194.5	215.0	212.1	-2.9
Loan from the National Insurance Institute	11.8	14.6	14.0	-0.6
Other revenue[b]	4.8	6.7	4.0	-2.7
Grants from US government	10.4	8.7	8.6	-0.1
Expenditure[a]	253.5	270.1	267.4	-2.7
of which: Domestic expenditure	237.4	256.6	253.5	-3.1
Expenditure abroad	16.1	13.5	13.9	0.4
Defense	60.9	57.3	59.9	2.6
Interest, repayment of principal to National Insurance Institute, and credit subsidy	42.5	45.3	44.6	-0.7
Civilian Ministries and transfer payments	150.1	168.6	162.9	-5.7

[a] Including VAT on defense imports.

[b] Revenue from interest, royalties, dividends and other revnue.

SOURCE: Based on the Accountant General's Data on the Performance of the 2011 Budget.

from 7.3 percent to 6.4 percent of GDP (Table 6.2). This is because the Ministry of Defense's actual expenditure is still close to the framework, thereby enabling the expenditure of the civilian ministries to rise more rapidly than the expenditure ceiling. However, defense expenditure this year was NIS 2.6 billion higher than in the original budget.[28] The increment was financed by diverting budgets that had not been used by the civilian ministries to the defense budget, with the approval of the Ministry of Finance and the Knesset. In 2007, in the wake of the Second Lebanon War and the ongoing divergence of defense expenditure from its original budget,[29] a

[28] This was over and above the defense expenditure of NIS 6.1 billion allocated in the reserve item, which was used for defense expenditure as planned.

[29] Recent Economic Developments 129, Bank of Israel, Research Department.

The Ministry of Defense's original budgets for 2008-2011 were lower than those delineated by the Brodet Committee, as well as billions of NIS below actual expenditure by the Ministry of Defense in those years.

committee was set up to examine the defense budget – the Brodet Committee.[30] The committee delineated a long-term framework for the real defense budget for 2008–2017, aimed at setting the Ministry of Defense's expenditure at a level that would enable the expansion of the per capita civil services provided by the government while preserving the defense of the State. Despite the framework delineated, the original budgets of the Ministry of Defense for 2008–2011 were lower than the amounts it required. In the course of each year supplementary budgets in the amounts of NIS 2–4 billion were transferred to the Ministry of Defense, bringing the Ministry's budgetary performance to the level of the framework, or slightly above it (Table 6.8).[31] This development serves to emphasize the difficulty of long- and medium-term budgetary planning and restraint, as despite the existence of a long-term budget framework delineated by a public committee with government consent and support, budgetary performance has continued to be problematic and the published defense budget does not accurately represent the expectations of the government and the IDF regarding actual expenditure.[32]

The Ministry of Defense's original budget for 2012 was lower than expected defense expenditure, and a defense supplement was again allocated, despite the Trajtenberg Committee's recommendations regarding cuts.

The government's decision of January 8, 2012, regarding the addition of NIS 4.1 billion to the Defense Budget for 2012[33] – despite the recommendations for cuts by the Trajtenberg Committee and going beyond the Brodet Committee Framework – makes it clear that cutting the budget of the defense establishment to below the level delineated by the Brodet Committee is not a politically sound way of financing other activities, inter alia in view of the geopolitical situation. It is important to amend this practice and plan the original budget of the Ministry of Defense in such a way as to enable it to accurately and transparently represent – within the constraints of confidentiality – the government's demands of the IDF in the budgetary year,[34] excluding an exceptional defense event; this is in opposition to the existing practice of approving a budget that is below the Brodet Committee Framework and allocating supplements during the year.

The nature of the activity of the Ministry of Defense, which includes long-term planning and contracts, requires budgetary stability and minimal budgetary shocks, but

[30] The report of the Committee for the Assessment of the Defense Budget, May 2007.

[31] The estimates of the budget in line with the Brodet Committee Framework are above the estimates published in December, as the data for 2011 have since been updated in accordance with the actual rise in the various price indices, and the data for 2012 have been updated in accordance with the average increases in prices in the long term (for further explanations, see the Bank of Israel's publication, "A Comparison of the Ministry of Defense's Budget in 2008-2012 with the Brodet Committee Framework," December 2011).

[32] An example of the problematic behavior is the transfer of NIS 1.6 billion to the Ministry of Defense only in the last week of 2011, even though this had been agreed upon by the Ministries of Defense and Finance at the beginning of the year. One of the reasons for the transfers over the course of the year is the lack of agreement between the Ministries of Defense and Finance as to the method of indexing the Brodet Committee Framework to current prices.

[33] The supplement is contingent on the demand for transparency and payment according to milestones.

[34] The government's decision of January 8, 2012 does this for 2012, but this was a post factum change. The original budget apparently did not represent the government's expectations of the Ministry of Defense.

Table 6.8
The Brodet Defense Budget Framework and the Defense Budget[a]
(NIS million, at current prices)

	Brodet framework, gross	Original gross budget[b]	Actual defense expenditure, gross,[b,c,d]
2008	50,528	48,735	48,957
2009	49,400	48,590	52,207
2010	54,556	53,240	54,857
2011	56,607	54,233	57,433
2012	58,423	55,771	59,938

[a] The gross defense budget includes the local currency budget from domestic sources, expenditure conditional on revenue and all aid from the US. This figure is different from the defense budget shown in Table 6.7, which includes the budget reserve, and does not include the conditional expenditure and some of the US aid.
[b] For the purpose of this examination, NIS 2.5 billion were subtracted from the 2008 budget and actual defense expenditure, reflecting compensation for military expenses of the Second Lebanon War, and were excluded from the Brodet framework.
[c] Net of transfer from general reserve intended for defense, under the assumption that the full amount transferred was spent. If the amount spent was higher than the transfer, it means that the actual expenditure reported in this table is higher than actual expenditure.
[d] 2011–12 data are the original budget plus transfers. The original defense budget for 2012 is NIS 55,771 million, and the expected additions in 2012 total NIS 4,167 million.
SOURCE: Based on the report of the Brodet Committee for the Assessment of the Defense Budget, May 2007, and the Accountant General.

also external monitoring of the approval and implementation of plans. To this end an independent and objective entity is required which will be charged with understanding the costs and benefits of defense expenditure, the effect of changes in this expenditure, and the substitutability between them and civilian expenditure. In the spirit of the recommendations of the Brodet Committee, one of the tasks of this entity, which will include experts in the fields of defense, economics, and logistical analysis, is to ensure that the operation of the defense establishment in emergency situations is budgeted in advance, in order to avoid a repetition of what happened in the Second Lebanon War, when reserve battalions found themselves short of equipment as they went into battle. It is doubtful whether the measures regarding transparency and monitoring approved by the government will in fact enable supervision of this kind.

5. THE GOVERNMENT'S SERVICES AND OBJECTIVES

Since 2003 government policy has stressed the reduction of its intervention in economic life by reducing taxes and public expenditure.

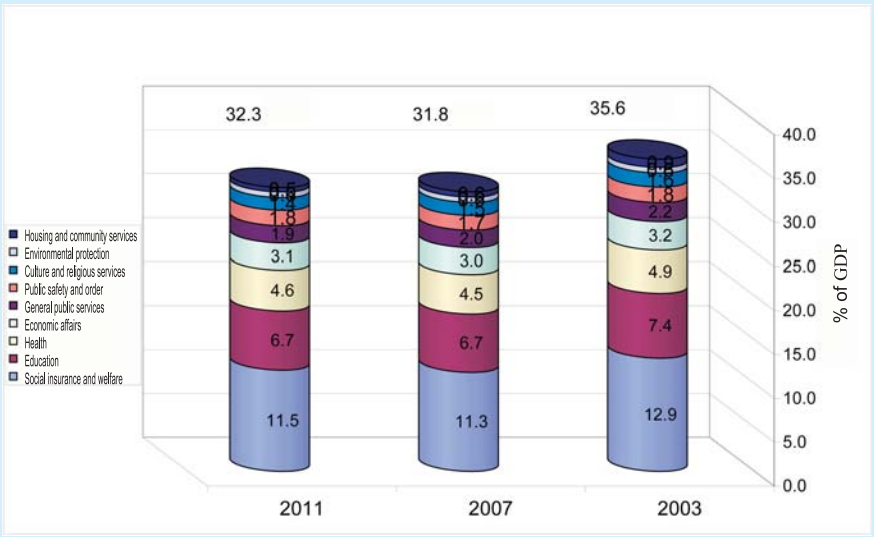
The government's main tasks are to maximize citizens' welfare and provide adequate public goods and services. The latter include national defense, personal safety (policing, law and order), transport infrastructure, public health, public education, a social security network, and a system of legislation and regulation. The government chooses the mix of services and the way they are delivered according to its preferences, which are dictated by its electorate. The policy of Israel's government since 2003 has stressed the reduction of intervention in the economic life of its citizens,

including reducing taxes (decreasing public sector revenue) and lowering public sector expenditure. In light of this policy civilian expenditure excluding interest has contracted as a percentage of GDP by 9.0 percent between 2003 and 2011, while the tax burden has eased by 7.5 percent. The significance of this policy is that although real per capita GDP rose by 22.5 percent between 2003 and 2011, real per capita civilian expenditure excluding interest rose by only 6.7 percent. On the other hand, the easing of the tax burden increased the disposable income of Israel's citizens who are employed at income levels above the tax threshold[35] (Table 6.A.13). This policy has been expressed in reductions in benefits and transfer payments as well as in the decline in various taxes since 2003, measures which are intended inter alia to improve the relative situation of the working population and encourage individuals to enter the work force. These measures have in fact increased the labor force participation rate and the employment rate. In 2010, a program of earned income-tax credits was introduced in order to support workers earning a low wage and encourage them to remain in the labor market; furthermore, at the recommendation of the Committee for Economic and Social Change, an additional tax credit was given to fathers for each child under 3 years of age. These changes support the working population only (the last relates only to persons whose wage is above the tax threshold, see Box 6.1).

The reduction of the debt/GDP ratio in the last ten years has cut interest payments and freed up extensive resources for other expenditure and tax cuts.

Government expenditure can be divided into three components: interest payments, other civilian expenditure, and defense spending. Interest payments on the public

Figure 6.4
Composition of Primary Civilian Expenditure in 2003, 2007 and 2011



SOURCE: Based on Central Bureau of Statistics data.

[35] About 40 percent of employed persons, whose wage is below the tax threshold, do not benefit directly from the reduction of tax rates.

sector debt have fallen in recent years, for both direct and indirect reasons. The direct reason is the fact that the public sector debt/GDP ratio, which rose to 99 percent at the beginning of the century, has fallen to 74.2 percent in recent years; the indirect cause is the continuing downward path of the public sector debt/GDP ratio, which has reduced the markets' assessments of the risk of government debt,[36] so that the interest rate on the debt has declined.[37] The latter declined from 5.9 to 4.9 percent, and interest payments fell from 5.5 percent of GDP at the beginning of the 2000s to 3.6 percent of GDP in the last few years. Thus, in the last ten years the sources available for other expenditure or tax reductions rose by 1.9 percent of GDP.

Defense expenditure[38] relative to GDP and public expenditure has contracted since the beginning of this century, leaving it at 6.4 percent of GDP. This level is higher than in most other countries, especially the advanced economies. It also limits civilian expenditure to a greater extent than is the case in most of the advanced economies, but the ongoing erosion of the defense expenditure/GDP ratio, in line with the Brodet Committee Framework (which restricted the real rise in defense expenditure to an annual rate of 1.3 percent), together with the contraction of interest payments, has increased the sources available for civilian expenditure.

The ratio of civilian expenditure to GDP contracted in 2003-2007 and has risen slightly in recent years.

As a percentage of GDP, civilian expenditure excluding interest contracted by 3.2 percent between 2003 and 2011. Between 2003-07 all the civilian expenditure items excluding interest declined, and the large expenditure items (social security, education, and health) fell by between 8 and 12 percent. Between 2007 and 2011 the share of most of the items in GDP rose, but remained lower than it had been at the beginning of the 2000s (Figure 6.4). While the government expenditure as a percentage of GDP contracted in those years, the relative size of most of its components remained unchanged.

a. Health

Public expenditure on health in Israel is lower than that in most of the OECD countries, but according to various basic health indices Israel's situation is better than that of most of those countries.

The public sector finances most of national expenditure on health in Israel, and is the principal provider of health services. Public sector expenditure on health in Israel is one of the lowest among the OECD countries. Nevertheless, the level of health services delivered to the population does not appear to be inferior to that in the advanced economies, inter alia because of the difference in age composition. The fact that Israel's population is younger[39] and the country is open to technological advances may mean that Israel can provide health services at a lower cost and with fewer inputs. There are difficult measurement problems with assessing the quality of the health services and their effect on public health. It is possible to see a continuous

[36] Yield gaps vis-à-vis countries which are similar to Israel, such as Australia, New Zealand, and Switzerland, contracted in the same period. However, the yield gaps between Israel and the US and Germany did not contract consistently.

[37] See section on 'The Public Sector Debt' below.

[38] Including US defense aid.

[39] The proportion of the population aged 65 and above and the rate at which this age group is growing in Israel are among the lowest in the OECD.

improvement in two basic indices of health: infant mortality in Israel has declined consistently over many years, and life expectancy has risen (Table 6.A.22). The improvements are similar to the average improvement in the OECD countries in those years, and have kept the infant mortality in Israel lower than in most of the advanced economies, and life expectancy in Israel is higher. The improvements in these indices are widespread, but their intensity within different segments of the population is not uniform: between 1999 and 2010 infant mortality declined by 2 per 1,000 births in both the Jewish and the Arab populations, but was higher in the latter by 3 per 1,000 births than in the former. Regarding the rise in life expectancy at birth, that of Jewish men and Jewish and Arab women rose by 3.5 years between 1996 and 2009, while that of Arab men rose by only 1.6 percent, i.e., 1.2 years.

The number of physicians in Israel is high relative to its population size, but the number of persons graduating from medical schools relative to the general population is far smaller than in the OECD countries.

The number of physicians per 1,000 persons in Israel is higher than the OECD average, but has been declining since the 1990s, in contrast with its average rise in the OECD (Table 6.A.22). This trend has not impaired public health to date, but if it persists health outcomes may be affected, especially as the population ages. Consequently, the fact that the share of physicians graduating from medical school in Israel's population is less than half the OECD average, and that this rate has been declining over time, gives cause for concern. Half of the physicians receiving licenses to practice medicine in 2005-2010 were graduates of medical schools in Israel.[40] This rate is higher than it was in the past, but Israel still depends on the immigration of physicians from abroad and the return of Israeli physicians who have studied abroad to staff the health system.

The grades of elementary school pupils have been rising in recent years, and class sizes are gradually being reduced.

The low level of spending on health relative to other countries is expressed inter alia in the declining number of hospital beds relative to the population as well as in the rise in their occupancy rate. The number of beds in hospital departments per 1,000 persons fell from 2.1 in 2005 to 1.9 in 2010, and the average occupancy of those beds rose from 96 to 99 percent (Table 6.A.22). This occupancy rate varies over the course of the year, exceeding 100 percent in the winter months. Many departments, among them the larger ones, such as internal medicine and obstetrics and gynecology, have had occupancy rates of over 100 percent throughout most of the last eight years. There are other departments, however, whose occupancy rates did not approach 100 percent in that period. Hospital bed occupancy in Israel is the highest in the OECD countries. These figures demonstrate that whereas hospitals in Israel make efficient use of their resources, their scope of action is limited, and in many cases negative. It is clearly necessary to increase the number of hospital beds and examine their distribution among the various departments.

The number of hospital beds in Israel is low in relation to its population size, and average occupancy is nearly 100 percent

b. Education

As a percentage of GDP, national expenditure on education in Israel is one of the highest among the OECD countries,[41] but average expenditure per pupil is below the

[40] This rate is expected to rise slightly in the future following the inauguration of a medical faculty in Safed.

[41] Education at a Glance, OECD, 2011.

OECD average because Israel's population is younger than that of most of the OECD countries. Most of this expenditure is invested in the national, national-religious, and ultra-Orthodox education systems, which constitute the principal education systems in Israel. An examination of indices of the quality of education gives rise to different conclusions regarding different levels of education. The grades of pupils in the national and national-religious education systems in the PISA examinations for 12-year-olds show that there has been a steady improvement since the examinations began in 2007 (Table 6.A.23), encompassing all the subjects tested. Class sizes have also been declining gradually in the last few years. The education level of elementary school teachers has risen significantly in recent years, and this may be behind the improvement in pupils' examination grades. Now almost one-sixth of teachers have a second or higher degree. Notwithstanding, in the last few years the wages of elementary-school teachers have not risen relative to the average wage in Israel.

Another improvement in the education system in recent years has been the marked decline in average class size in high schools, and this has contracted at a faster rate than that in elementary schools,[42] after a long period of stagnation. The proportion of teachers with a second or higher degree has risen by more than ten percentage points since 2004, and now more than one third of high-school teachers have a second degree at least (Table 6.A.23). On the other hand, the proportion of pupils qualifying for the bagrut high school graduation degree varies around an average of 47 percent and shows no indication of rising, while the average wage of high-school teachers has been declining in recent years, although it is still on a par with the average wage.

Class sizes in high schools have been falling in the last few years, and the proportion of pupils eligible for school-leaving certificates has not changed.

c. Wage agreements

A collective wage agreement was reached with high-school teachers in 2011 which included the "Oz Le'tmura" (Courage to Change) reform. According to this agreement, the wage of teachers in these schools will rise by 42 percent, in addition to the 7.25 percent increase from the public sector collective wage agreement, and in return the teachers will work for 40 hours a week instead of 24. The additional hours will be divided into six hours of small group teaching hours and ten hours of attendance during which the teachers will grade examination papers, prepare lessons, and meet with parents and other teachers. The reform also includes promotion and remuneration for teachers on the basis of excellence. It will be introduced in schools in four annual stages, starting in the 2011–2012 school year. The cost of the reform is estimated at about NIS 0.5 billion in 2011, NIS 1.3 billion in 2012, and NIS 3.3 billion when it reaches full implementation in 2014.

In 2011 an agreement was reached with high school teachers which increased their wage in return for additional hours of work.

This year there was a physicians strike, which lasted for five months. At its conclusion a new collective agreement for nine years was signed, at a total annual cost of NIS 2.6 billion, most of it concentrated in 2011-2014 (for details, see Chapter

A wage agreement was signed with the physicians and with medical interns, after they had gone on strike.

[42] According to OECD figures, the variance in class size in Israel is among the largest in the OECD countries, and is similar to that in Turkey and Mexico. In the highest decile of class size there are 40 pupils in a class, while in the lowest there are only 15.

5, The Labor Market). After the strike ended some interns refused to accept the agreement which the Israel Medical Association (IMA) had signed, claiming that it did not represent them. They began to demonstrate, continuing with strikes and threats of mass resignations. This protest continued for four months, at the end of which an agreement was signed which included a grant of NIS 60,000 for every intern who completes his or her internship (from the funds allocated for the agreement signed with the IMA), and a review of the agreement with the physicians at the beginning of 2015.

Wage agreements constitute an important tool of government administration, enabling public services to be improved in return for wage hikes

To date it has not been possible for groups represented by an employee association to withdraw from an agreement after it has been signed. The success, albeit partial, of a withdrawal of this kind undermines the framework of labor relations and wage agreements in Israel. It is no longer clear whether, as a result of this, labor associations will have to prove that they represent the absolute majority of employees before it is possible to sign an agreement with them. There is also a possibility that a change in the accepted norm will make it more difficult to conduct negotiations in order to reach labor agreements, thus making strikes more frequent.

The wage agreements with the physicians and teachers in the public sector are doubly important. The agreements have to be renewed every few years in order to bring employment conditions and wages into line with unanticipated changes and structural shifts in the industries concerned. Wage agreements may also serve as an instrument for attaining important national objectives. Thus, for example, the agreement with the physicians includes grants to encourage physicians to work in areas of medicine which are not considered attractive, or those in which there are few opportunities for private practice, or to provide an incentive for physicians to work in peripheral regions. The "Oz Le'tmura" program incorporates an increase in the number of hours worked by teachers. The introduction of structural changes in return for wage hikes involves certain risks, as it does not always work and can even hamper and prolong the negotiation process. However, it is an important administrative instrument for the government, enabling it to improve the service to the population in return for an increase in wages.

6. THE PUBLIC SECTOR DEBT

a. The debt/GDP ratio and the cost of debt financing

The contraction of the debt/GDP ratio was supported by high nominal growth rates relative to (net) government borrowing.

The (gross) public sector debt/GDP ratio declined by 1.9 percentage points in 2011, in contrast to developments in the OECD countries, where it rose by an average of 4.2 percentage points. Its decline was sustained by high nominal growth rates relative to the government's net borrowing. The low level of borrowing relative to GDP expresses changes in the way the deficit is financed: repayment of credit extended to the public by the government in the past, large privatization proceeds, and the financing surplus from previous years all served to reduce the government's borrowing requirements.

Consequently, net borrowing was 1.4 percent of GDP, significantly below the GDP growth rate, contributing a 4.9 percent reduction of the debt/GDP ratio (Table 6.9). A large budget deficit at a time when the economy is near the summit of the business cycle, alongside the drawing down of the government's deposits in the Bank of Israel for the second year in succession, as well as high privatization proceeds, all indicate that the reduction of the debt/GDP ratio was based on favorable macroeconomic conditions and a financing surplus from previous years. This is in contrast to the reduction of this ratio by the contraction of the cyclically adjusted deficit – a trend that characterized fiscal policy in the years before the global crisis.

In 2008, in the context of the global crisis and the increase in the deficit, the rapid rate of decline in the debt/GDP ratio was checked.

The development of the debt/GDP ratio in 2011 displays a continuation of its moderate decline in 2008–2010. Between 2003 and 2007 the public sector debt contracted by 21 percent of GDP – a rapid decline that was sustained by the gradual reduction of the budget deficit alongside high GDP growth rates. The decline in the debt/GDP ratio in that period contributed to the easing of the burden of interest payments in the government budget. In 2008, in the context of the global crisis, the rapid rate of decline of the debt/GDP ratio was checked, mainly because of the expansion of the deficit (Figure 6.5). In spite of Israel's rapid growth rate in recent years, the government deficit/GDP ratio remained high – similar to the average of the OECD countries, which were the principal victims of the crisis. Whereas Israel's debt/GDP ratio contracted relative to those of the advanced economies, an international comparison of its composition emphasizes the rise in the cyclically adjusted deficit

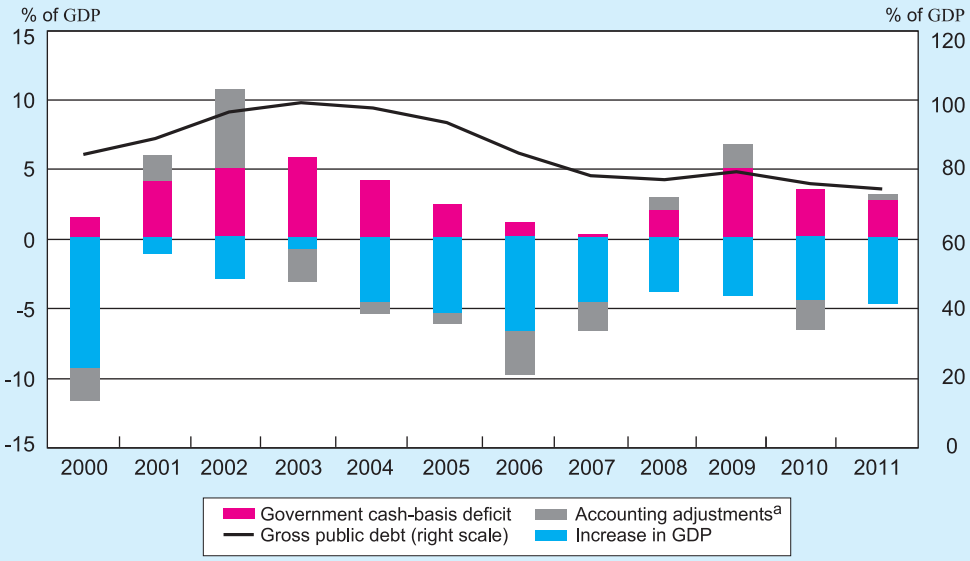
Table 6.9
Components of the Increase in the Gross Public Debt, 2009–11

(% of GDP)

	2009	2010	2011
Debt at end of previous year	77.0	79.3	76.1
Nominal increase in GDP	-4.3	-4.6	-4.9
Net borrowing	5.5	1.4	1.4
of which: Government deficit, cash basis	5.1	3.7	3.3
Net repayment of credit by the public[a]	-0.7	-0.7	-0.6
Privatization proceeds	-0.3	-0.5	-0.8
Total change in government bank deposits[b]	1.4	-1.1	-0.4
Revaluation of shekel-denominated indexed debt[c]	1.5	1.0	0.7
Revaluation of foreign currency debt	0.0	-0.6	0.8
Adjustement to cost of issue of debt	-0.5	-0.2	-0.2
Residuals[d]	0.2	-0.1	0.3
Debt at end of period	79.3	76.1	74.2

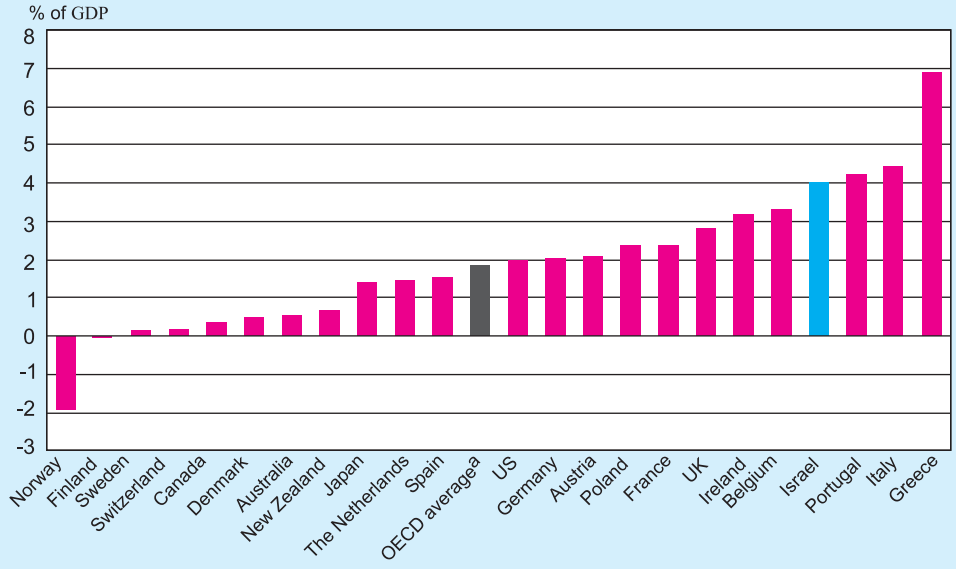
[a] Including granting of credit and collecting principal.
[b] Excess capital raised.
[c] Rise in CPI during the year.
[d] Rounding.
Source: Bank of Israel.

Figure 6.5
Components of the Increase in the Gross Public Debt/GDP Ratio, 2000-11



a Adjustments include the revaluation of the debt with various indexations, privatization proceeds, and the change in government deposits in the Bank of Israel.
SOURCE: Based on Ministry of Finance and Central Bureau of Statistics data.

Figure 6.6
Net Interest Payments on Government Debt as Percent of GDP in Israel and OECD Countries in 2011



[a] Simple average.
SOURCE: Based on Ministry of Finance data and Bloomberg's data system.

(Figure 6.1). If this deficit is not reduced it will be difficult to attain the debt/GDP target (60 percent), and the rate at which the burden of interest payments in the budget is eased will slow.

The cost of financing the government debt, which is measured by the burden of interest payments relative to the level of the debt, is high by international standards.

The cost of financing the government debt, measured by the burden of interest payments as a share of the debt level, is high by international standards, and reflects the risk and extent of the debt (Figure 6.6). The risk inherent in the government debt, embodied in the burden of interest payments, is expressed inter alia by the interest rate spread between Israel and the advanced economies: there is a negative correlation of 0.8 between the ratio of interest payments to GDP in Israel vis-à-vis that in the advanced economies, on the one hand, and the change in the interest rate spread between Israel and those countries, on the other (Figures 6.6 and 6.7).

b. The composition of the debt

In the second half of the year nominal yields on long-term government bonds fell. This trend has characterized many other advanced economies, but was sharper in most of them than in Israel.

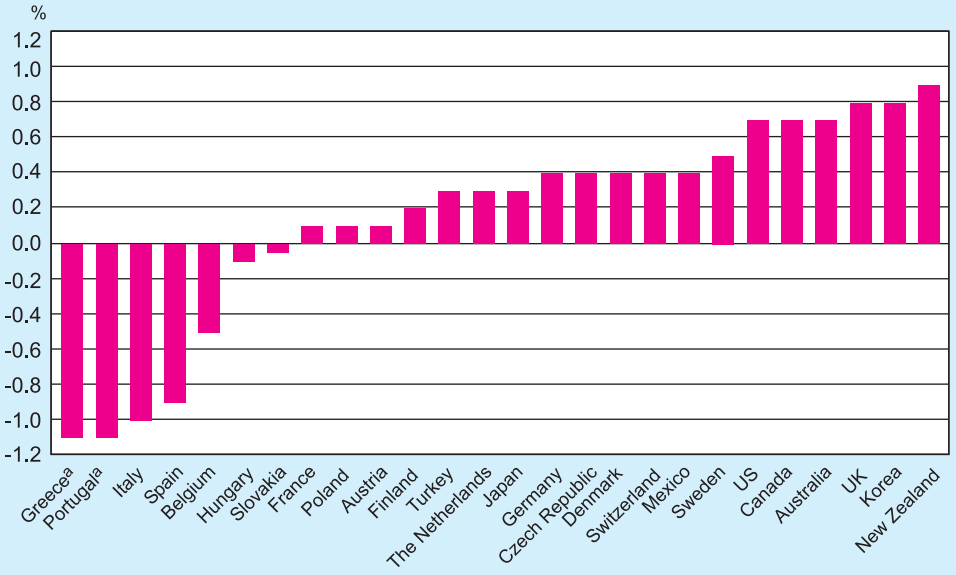
The composition of the debt in 2011 reflects the widening of the interest rate spread between Israel and the advanced economies. In the context of the rise in the Bank of Israel's key interest rate and the increased interest rate spread vis-à-vis the advanced economies, the extent of capital inflow into Israel grew, augmenting the demand for government debt assets. The increase in government bond holdings by nonresidents is evident primarily in the unindexed, fixed-rate channel, as this is the most liquid and tradable government debt asset. At the same time, the extent of issues in this channel was stepped up and its share of domestic borrowing rose. Particularly prominent was the extensive use of short-term government bonds. By contrast, the share of the unindexed, variable-rate element in government borrowing contracted, after rising in 2010. The contraction of its share in 2011 attests to the declining attractiveness of variable-interest borrowing as a result of expectations of an interest-rate hike alongside the expected decline in tax receipts.

In view of the increase in uncertainty in the financial markets and the expansion of demand by nonresidents, in the second half of the year nominal yields on long-term government bonds declined. This trend characterized many of the advanced economies, but was steeper in most of them than in Israel, so that the interest rate spread between it and them widened (Figure 6.7).

The downward trend that has characterized foreign exchange denominated borrowing in recent years intensified in 2011. The extent of government issues abroad was 60 percent less than in 2010, and their share in government borrowing declined to a record low level of 6.5 percent. Furthermore, only one third of the amount issued in 2011 was on the open market; the remaining borrowing was carried out by the Israel Bonds organization – whose issues are characterized by low sensitivity to shocks in the international markets and low financing cost.

Borrowing policy in recent years, including the extensive use of short-term government bonds, has enabled the government to utilize the low cost at the lower end of the yield curve, thereby cutting borrowing costs and interest payments. On the other hand, the exposure of government debt to sharp shifts in market conditions

Figure 6.7
The Change in the Yield Differential between 10-Year Israel Government Bonds and 10-Year Bonds of Advanced Economies, 2011 Average Compared with 2010 Average



[a] The yield differential between Israel government bonds and those of Greece and Portugal declined by 8.6 percent and 4.4 percent, respectively.
SOURCE: Based on Ministry of Finance data and Bloomberg's data system.

increased. The extensive demand in 2011 reduced yields on government bonds, contributing to the decline in the cost of borrowing in the short term; however, the cost of the government debt is measured in the long term, and is hence dependent on future interest payments and the cost of rolling over the debt, as well as on its exposure to sharp changes in interest rates. The increased share of nonresidents in the outstanding government debt also contributes to the rise in the risk of refinancing short-term bonds because the massive divestment of their holdings, including from the long-term channels, could have an adverse effect on the government's borrowing terms. Since the cost of borrowing has fallen substantially in recent years, in long-term channels as well, for reasons of risk reduction in terms of interest payments in the long term the possibility of utilizing this development and issuing long term, fixed rate bonds should be considered.

A shortening of the debt's term to maturity enabled the government to reduce its interest payments. In contrast, the government debt's exposure to sharp changes in market conditions increased.

c. The term to maturity of the outstanding debt

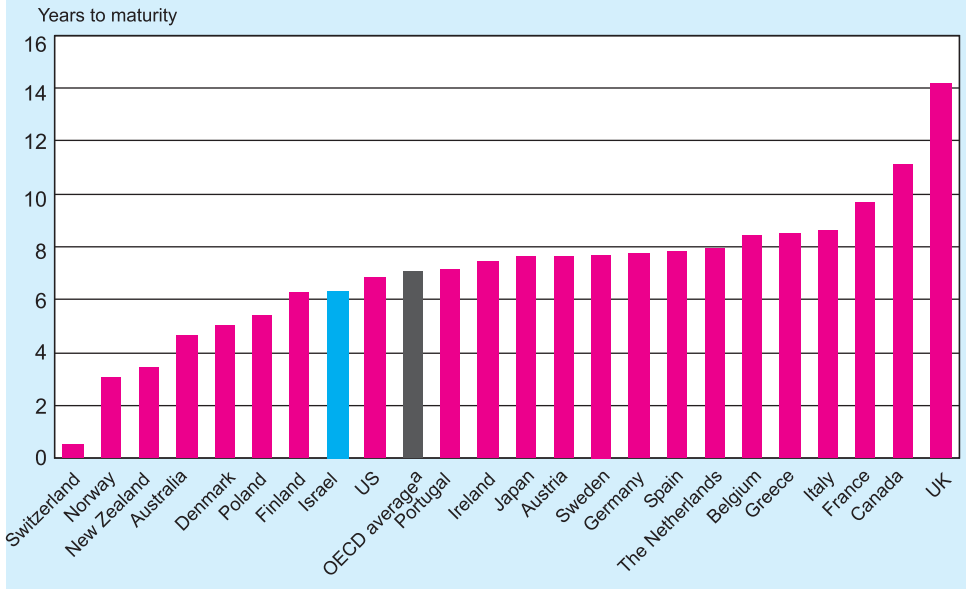
The downward trend of the average term to maturity of the government debt continued, falling to 6.3 years. The contraction of the term of the debt stemmed from the large extent of short- and medium-term debt issues. In 2011, as in 2010, there was extensive resort to short-term government bonds, their average term being six months: in the second half of the year these constituted about 35 percent of total issues in the

unindexed, fixed-interest channel. In the last few years the share of bonds issued for terms of up to five years has also risen, reaching 50 percent of total fixed rate bonds (excluding short-term government bonds). Accordingly, the average term to maturity of total borrowing declined, reaching 6.3 years, compared with an average of 9.9, 7.6, 7.5, and 6.5 years from 2007 to 2010 respectively.

The average term to maturity of the outstanding government debt is low by international standards. The heavier the burden of interest payments as a share of GDP, the greater the sensitivity of the government debt to market and budgetary risks, and the more important it is to increase the term to maturity of the outstanding government debt in times of prosperity. An international comparison shows that most of the OECD countries in which the term to maturity of the debt is lower than Israel's are characterized by particularly low interest payments as a share of GDP, so that they are less exposed to refinancing risks. In Israel, on the other hand, the burden of interest payments is greater than it is in most of the advanced economies, except for the European countries at the heart of the debt crisis, while the average term to maturity of the government debt is lower than the OECD average (Figures 6.6 and 6.8). The relative vulnerability of the government debt in Israel to refinancing risks appears to be expressed in the risk premium demanded.

The global crisis which began in 2007, and its exacerbation in some European countries in recent years, illustrates the importance of the term to maturity of the debt

Figure 6.8
Average Term to Maturity of Government Debt in Israel and OECD Countries in 2011



[a] Simple average.
SOURCE: Based on Ministry of Finance data and Bloomberg's data system.

as an index of the elasticity of debt management, and the government's budgetary elasticity. A longer borrowing horizon reduces the fear of extensive refinancing in the event of a temporary market crisis, enabling the more favorable distribution of borrowing and terms to maturity. Governments as well as financial and nonfinancial institutions whose liabilities were based on short-term debts or were obliged to roll debt over at unfavorable market conditions, even though their economic situation was not affected, encountered financing difficulties. The latter aggravated their liquidity constraint because of the rise in the risk premium, in the context of the greater vulnerability of the borrowing entity and increased concerns regarding its insolvency. Global practice in the last few years indicates that in times of prosperity the cost of refinancing risk exceeds the liquidity premium demanded for longer-term debt issues. For these reasons it is desirable to increase the term to maturity of the debt, even if short-term issues – because of their greater liquidity and tradability – make it possible to borrow at a lower immediate cost.

At a time when interest rates are low it is advisable to increase the share of long-term issues in borrowing, despite the lower costs of short-term issues.

In summary, the public sector debt/GDP ratio declined in 2011, supported by Israel's positive macroeconomic conditions, as well as borrowing costs which remained low this year in view of the extensive demand for government bonds. However, alongside the reduction in these borrowing costs, the government's debt risk rose in relative terms, and the yield gaps vis-à-vis those markets considered to be safe widened. In a less favorable macroeconomic environment, extensive issues, stemming from the rolling over of the short-term debt, could have repercussions on the stability of the debt, and hence borrowing costs. Thus, in order to smooth the size of future maturities it is advisable to increase the share of long-term issues in borrowing when interest rates are low, despite the lower cost of short-term issues.

Box 6.1

Tax Benefits for Working Families with Children

Until now, child tax credits were granted in Israel only to women. In the wake of the recommendations of the Trajtenberg Committee, the tax benefit system has been changed, and for the first time tax credits are allocated to men for children under 3 years of age. The new benefit, which is expected to directly affect about 280,000 families, focuses on fathers who are working full time or near to full time, increasing their monthly income by up to NIS 430 for each child. However, the benefit does not affect the one third of working families who constitute the weaker segment of the target population – those whose income does not attain the tax threshold – and provides only partial assistance to another fifth of families. Extending the benefit to men who do not utilize it in full and work at least half-time, by means of the income grant (formerly termed the earned income tax credit, EITC) will reduce the number

of impoverished working families by 6 percent. An international comparison shows that the tax credits granted to fathers will close the gap between Israel and the advanced economies as regards tax benefits to parents of small children. If tax credits are awarded to fathers of children aged between 4 and 18 to the same extent as the average in the advanced economies, in a revenue-neutral way, the number of impoverished working families could be reduced by another 7 percent.

In response to the social protest which erupted in the summer of 2011, the government and the Knesset decided, on the basis of the recommendations of the Committee for Economic and Social Change (the Trajtenberg Committee), to expand the assistance extended to working families with children, placing special emphasis on families with small children. These families incur high childcare expenses, and most of them are earning a low income on a temporary basis. One of the main components of this policy is the allocation of two income tax credits to fathers for each child aged 3 or less,[1] and adding 50 percent to the income grant[2] for mothers whose income is low. Thus, in addition to the existing tax credits for mothers, a family with one child under 3 in which both parents are working can now enjoy a monthly tax benefit of NIS 860, which is about 45 percent of the cost of child-care in a supervised day-care framework. In contrast to child benefits, this measure focuses on working families, most of whom are expected to bear a greater tax burden in the future, once their income increases and their children grow older. The extent of the new tax benefit for eligible fathers is similar to the average in the OECD.[3]

Granting tax credits to fathers of small children is an important step in boosting the role of the direct tax system in reducing inequality. To date such tax credits have been granted only to women, most of whom did not manage to utilize them to the full, because of their low income.[4] Thus, for example, a mother can utilize the tax credits for her children in full[5] only if she earns above NIS 7,050 a month and if she has one child, above NIS 8,540 if she has two children, and above NIS 9,200 if she has three children.[6] The average wage of mothers of children aged between 0 and 4 is NIS 6,600, so that only 13 percent of working mothers with children of these ages – most of them with one or two children – can utilize the benefit in full. Another 24 percent can utilize this benefit partially (as shown in Table 1), some of them in small amounts of less than NIS 100 a month. Because the average wage of men is higher, according to estimates made in 2012 about 49 percent of working fathers with children aged between 0 and

1 Each credit reduces income tax by NIS 215 in 2012.
2 Formerly 'earned income-tax credit.'
3 A. Brender, "Tax Rates on Labor Income in Israel in an International Perspective: 2008-2009," Bank of Israel, Research Department, March 2009 (Hebrew).
4 A. Brender, "Tax Benefits for Women in Israel: an International Perspective and an Examination of Take-Up Rates," Taxation and Gender: The Attitude of the Tax System to Women, Adva Center, November 2005 (Hebrew).
5 After utilizing the 2.75 individual credits allocated to all women.
6 Assuming that she does not have children under the age of 5.

4[7] – about 200,000 fathers – will utilize the new benefit in full, receiving an average supplement to their monthly income of NIS 380.[8] About 77 percent of these fathers are from the five highest deciles of per capita income. Some 20 percent of those eligible for the benefit, about 85,000 fathers, will utilize it only partially, receiving an average supplement of NIS 230 to their monthly income. The new benefit focuses on helping fathers who work full time: 86 percent of fathers of children in the age group which makes them eligible for benefits work full time (at least 35 hours a week) and are expected to utilize the benefit, half of them in full. In contrast, only 36 percent of fathers who do not work full time will utilize it, about 55 percent of them in full; moreover, 33 percent of the fathers who utilize the benefit are from families in which both parents work full time. Thus, 89 percent of the total amount of the benefit will be provided to families in which the total number of hours worked by the parents is at least equal to the extent of a full-time position, and this means that the benefit will in fact focus on parents of small children who work to a significant extent. However, 90 percent of the total benefit will be provided to families in the seven highest deciles of per capita income, and because of this the benefit is not expected to have a substantial effect on the incidence of poverty in Israel or to reduce inequality to a great extent.

The expansion of tax credits, despite its important contribution, does not help the weakest segment of earners—those whose income does not attain the tax threshold—and many fathers who work full time can utilize the benefit only partially; this prevents the significant improvement in the situation of the population in accordance with the principles delineated by the committee. In order to deal with the weaker segments of the policy's target population too, and increase the effectiveness of the tax benefit that has been established by law, it is possible to extend the value of the two tax credits for each child under 3 by means of an income supplement system,[9] while adjusting the

Table 1: Estimate of Partial and Full Utilization of Tax Credit Points for Children by Employees with Children up to 4 Years Old[a]

Number of children up to 4 years old	Share of working fathers who utilize tax credits for children		Share of working mothers who utilize tax credits for children	
	In full	In part	In full	In part
1	55	16	15	24
2	37	27	7	23
3	16	35	3	16
Total	49	20	13	24

a From the calculation of expected entitlement in 2012, after the additional tax credit given to women for every child under 5 years old.

SOURCE: Bank of Israel.

7 Two tax credits are allocated to fathers for each child under 3, but in effect the benefit is also given in the child's fourth year.

8 The average is below the value of two tax credits because in the child's first and third years only one tax credit is granted.

9 So that all those eligible for the tax benefit can enjoy the supplement, the additional restrictions on this supplement which prevent it from being granted (because of high family income, ownership of property, and age) could be annulled.

offset rates of the supplement to the tax threshold derived from the tax credits. Thus, this supplement would also extend the value of the tax credits to fathers who utilize it only partially. Mothers of children under 3 would also benefit from the supplement, but after deducting 50 percent of the income grant (EITC) they have already received in the wake of the Trajtenberg Committee's recommendations. About 170,000 fathers and 230,000 mothers with low income would receive the supplement, the increment that each one obtains being expected to average about NIS 420 a month. Some 65,000 employed persons would not benefit from the supplement because their low income does not exceed the lowest rung of eligibility for the grant (NIS 2,000 a month), while some 80,000 employed persons whose monthly income is between NIS 2,000 and NIS 3,500 would benefit partially from the supplement.[10] This step is expected to reduce the number of impoverished working families[11] by 6 percent. The budgetary cost is expected to be NIS 1.3 billion a year,[12] and can be financed, for example, by raising the first tax bracket from 10 to 11 percent, and the second from 14 to 15 percent. This should be done with a long-term view towards the broader distribution of the burden – easing the situation of young families in return for a heavier burden when their children are older and their income increases.

As stated above, the extent of the new tax benefit for fathers of children up to 3 is similar to that accepted in the OECD countries.[13] In those countries the average tax rate for married fathers of two children who earn a wage equivalent to per capita GDP is 7 percentage points below the average of men who earn a similar wage but do not have children. However, working fathers of older children in Israel are not eligible for any benefit. If a policy is adopted which is similar to that in the advanced economies, granting up to two tax credits (worth NIS 430 in 2012) to fathers for children aged between 4 and 18, this will increase the income of some 380,000 working fathers, and 50 percent of them will utilize the benefit in full. Supplementing this benefit by means of the income grant (EITC) will help about half a million working parents at low income levels, and the average supplement per wage-earner entitled to the grant is expected to amount to NIS 260 a month. The cost of granting tax credits to fathers, together with attaining equality by means of the income supplement system, is expected to be NIS 2.6 billion a year.[14] In order to finance this measure it is possible to raise the first tax bracket by two percentage points and the second by one percentage point. Summing up the effects of this step (as described in Table 2) shows that the

[10] The calculation of the income grant is based on income level as an estimate of the extent of employment. Hence, the failure to allocate the grant, or allocating it only partially, to those whose monthly income is below the threshold determined by the program, is in line with the aspiration to focus support on families which work to a significant extent.

[11] Defined as families with children in which the total number of weekly hours worked by the parents is more than 35 (i.e., the parents' total extent of work is at least equal to the extent of one full-time position).

[12] This estimate is based on a sample consisting of national income from wage-earners, who constitute over 90 percent of total persons employed.

[13] See note 3 above.

[14] Assuming the take-up rate of the income grant is 80 percent.

net marginal supplement to the income of families with children will be positive at every income level, but will decline as income rises. Note that in Israel, where about ninety percent of working adults have children by the time they are in their forties, and because the proposed change is balanced in the budget, a step of the kind examined here will not alter the permanent income of most employed persons, but will ease their liquidity constraint at a time when their needs increase, in return for assuming a heavier burden at a later stage, when their situation improves. A step of this kind, alongside the implementation of the proposed amendment for parents of small children, will reduce the Gini Inequality Index by 0.44 percentage points, decrease the incidence of poverty in Israel by one percentage point, and moderate the number of impoverished working families by 13 percent.[15] However, because of its high budgetary cost, it is advisable to examine whether this measure is really better for the economy than other policy measures.

Table 2: Breakdown of the Cross-Effects of Broadening the Tax Benefit to Fathers of Children Aged 4–18 Years, by Wage-Income Quintiles and Family

(NIS per month's work, at 2011 prices)

	Working fathers with children aged 4–18 years			Working fathers without children
Wage income quintilea	Average increment from income grant and tax creditb	Average increment from change in income tax bracketsc	Average increment from policy proposal	Average increment from change in income tax brackets
1	343	-20	323	-23
2	336	-67	268	-78
3	338	-122	216	-121
4	348	-138	210	-139
5	361	-176	185	-176

[a] According to gross income of each employee, provided it is more than NIS 3,500 a month (so that the results in the lowest decile should not be negatively biased by individuals who are not entitled to the income grant in full, and are therefore less affected by the program).

[b] Assuming the current tax rates, before the proposed change.

[c] The increase in the first tax bracket from 10 percent to 12 percent, and the second from 14 percent to 15 percent. Assuming the current system of tax credit points.

SOURCE: Bank of Israel.

[15] Most of the effect on these indices stems from granting tax credits to fathers of children aged between 4 and 18 – if this measure is introduced.