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for Social Policy Studies in Israel

The Share of Public Expenditure in GDP in View of the Need to Increase Defense Spending*

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Professor Zvi Sussman, 1930–2006

Professor Zvi Sussman prepared this study at the Taub Center in the summer of 2006 and finished its main draft before he fell ill. Despite his illness, he continued to work on the draft and completed the final version in the hospital in the last days of his life. The article reflects his indefatigable spirit and deep concern about the strength of Israel's economy and society and culminates his series of contributions to the economy and economic research in Israel.

May his memory be blessed.

The basic guidelines of the new government, presented in May 2006, stipulated a budget policy that would halt the cutbacks in social expenditure in the 2007 budget. The cutbacks to be stopped followed those made in 2000–2006, which triggered a considerable decline in per capita expenditure on education, health care, and, especially, social transfer payments.[1] The funding for the extra social expenditure was to come from two sources[2]:

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[1] Achdut et al., 2006.

[2] Basic Guidelines, 2006.

a. raising the ceiling to the increase in total government expenditure, starting with the 2007 budget, from 1 percent to 1.7 percent (matching the expected rate of population increase);
b. considering a long-term cutback in the defense budget starting in 2007 and earmarking the savings, if any, for social aims.

However, the planned changes in the 2007 budget, following these principles had no effect on the focal point of the policy: reducing the share of general government in the economy. The intention was to hold the increase in public expenditure to a rate slower than expected growth in business sector and household private consumption, estimated at more than 4 percent per year. Concurrently to this decrease, the share of government expenditure, the tax cuts that had been approved as part of the tax reform that began in 2003 were supposed to continue. The reform was intended to reduce tax revenue in 2010 by NIS 13 billion relative to the level that would have prevailed had its implementation been suspended in 2007.[3]

1. The State Budget in View of the Recent War in Lebanon

The need to increase the defense budget immediately in order to cover war-related expenses and war damage to northern Israel led to the formulation of a new budget proposal for 2007 (in addition to the immediate transfer of NIS 1.7 billion from civilian budget lines to defense in the 2006 budget). According to the 2007 budget, some of the war damage will be paid for by a one-time increase in the expenditure ceiling so that the special expenditure may be made outside the basic budget framework.

[3] State Revenues Administration, 2006.

The principles of the post-Lebanon War budget for 2007 may be summarized as follows:

1. The basic budget will continue to grow in coming years at the annual rate of 1.7 percent in real terms.
2. The government will continue in 2007 and subsequent years to cut taxes in accordance with the approved reform.
3. The limit on the rate of increase in general government expenditure will be raised on a one-time basis by 2.1 percentage points in the 2007 budget,[4] bringing the adjusted maximum increase in 2007 to 3.8 percent (the original 1.7 percent increase plus 1.6 percent in war expenses and 0.5 percent for the disengagement). In 2008, the original 1.7 percent expenditure ceiling is to be raised by another percentage point, making it 2.7 percent; this will allow the expenditure of an extra NIS 2.2 billion to cover war-related and rehabilitation expenses.
4. The total special expenses (for the war and the disengagement) will be financed by raising the 2007 deficit – on the basis of a 3.8 percent GDP growth forecast – to a maximum of 2.9 percent of GDP instead of 2 percent as had been originally planned.
5. Beyond the special funding for war expenses by non-recurrent increases in the budget and deficit ceilings, the basic budget for 2007 was to grow by NIS 3.9 billion (1.7 percent). Of this sum, NIS 1.7 billion was allocated to the defense budget as a supplement beyond the funding of the special war expenses. The remaining NIS 2.2 billion was earmarked for an increase in civilian expenditure (mainly for

[4] This is a 1.6 percent increase to cover the special expenses brought on by the war in Lebanon of NIS 3.5 billion – NIS 2.7 billion for the defense budget and NIS 800 million to rehabilitate the North – and 0.5 percent to cover NIS 1.1 billion in expenses for the disengagement from the Gaza Strip and northern Samaria.

health care, education, personal social services, and social transfer payments). This amounts to a 1.3 percent increase in civilian budget expenditure, 0.4 percentage point less than the expected rate of population growth in 2007. Changes in the structure of social expenditure included reductions in expenditure items that stem from coalition agreements and non-adjustment of benefits, a measure that would save NIS 1.1 billion.

Improvements that the public had been promised in the social service lines were not carried out in the 2007 budget and, evidently, will not be made in the coming years' budgets either. The failure stems from two factors. First, there was an expectation of financing an increase in civilian expenditure, in general, and in social expenditure, in particular, that would be faster than the increase in the budget ceiling (1.7 percent per year) by gradually reducing the "regular" defense budget. This will not happen in 2007; per capita social expenditure will continue to decline and will probably continue to do so in the years to come. Second, even in the longer term, when it becomes possible to hold per capita government social expenditure to a constant level within the limit of the 1.7 percent spending increase, this leaves no resources for improvements in the publicly funded social service, education, and health care systems. Therefore, the services will continue to lag behind the rise in the average personal standard of living.

Below an alternative government budget policy for future years is presented. It does not replace the plan that would finance the special expenditures by means of a one-time increase in the budget deficit. Instead, it offers the possibility of increasing public social expenditure by raising the basic budget expenditure ceiling from 1.7 percent to 3.0 percent in each of the years 2007–2010. To prevent the increase in social spending from endangering financial stability, the proposal halts the ongoing tax cuts that had been planned for the coming years.

Thus, raising the basic budget ceiling to 3 percent will have no significant effect on the size of the budget deficit or the time necessary to attain the deficit and public debt targets at accepted European Union levels relative to the Ministry of Finance's planned trajectory and subject to the 1.7 percent limit. The alternative will not cause the budget deficit to overrun the 3 percent of GDP limit in any year, since the increase in expenditure will be covered by the increase in tax revenues that will become possible by holding the tax rates at their 2006 level – a level obtained following a number of tax cuts.

It is important to emphasize that the main consideration in this alternative is to increase social expenditure as much as possible without jeopardizing fiscal stability or diverging from norms of accepted macro-economic policy. The intent is to implement a policy that will allow the state to increase social expenditure according to its priorities as long as the supplement is covered by taxes and not by a budget deficit that would undermine financial stability. The trajectory proposed by the Finance Ministry is quite different: its combination of downscaling general government expenditure while continuing to reduce per capita social spending and implement tax cuts has become an aim unto itself and exceeds what is necessary to maintain domestic financial stability.

The alternative trajectory (see Appendix) will make it possible to increase government expenditure by NIS 3.5 billion in 2007 and another NIS 7.3 billion in 2008. If the path is followed until 2010, budget outlays will be NIS 15 billion higher that year under the proposed alternative than according to the trajectory proposed by the Ministry of Finance. If the proposed alternative is adopted, business sector growth will be slightly less vigorous than the maximum rate that would be attained if the strategy of reducing the government's share in the economy were applied. The advantage of this alternative, however, is that it will allow a higher level of public spending

on education and health care services even if a limited increase in the defense budget becomes necessary in subsequent years. It will allow Israel to expand its social service system in order to decrease significantly the poverty rates and disparities that have been widening in recent years. Indeed, the resumption of business sector growth in the past two years proves a point that studies on previous periods of growth have established: **growth is not a substitute for a high level of social expenditure**, since precisely during the recent two years of rapid growth, poverty intensified and the disparities widened significantly.

2. Financial Stabilization while Cutting Social Expenditure and Lowering Taxation of the Affluent

The strategy of reducing the share of general government in the economy was conceived in the early 1980s, when public expenditure attained heights that were unprecedented in Israel and that deviated from levels that characterize developed countries. As Table 1 shows, in 1966 the share of public expenditure was 34 percent of GDP, slightly below the 36 percent average in ten small Western European countries. State revenues covered all public expenditure and the state budget was in balance.

The rapid increase in government expenditure began after the Six-Day War, partly due to steep growth in defense outlays but also due to a rise in social transfer payments to households and subsidies to businesses (Table 2). Despite tax hikes, revenues did not suffice to pay for the increase in expenditure. Thus, the state went over from a balanced budget to deficits in the range of 10-15 percent, covered largely by loans from the public and from abroad. The rapid increase in the public debt raised the burden of interest payments to a high of more than 11 percent of

GDP. Overall, the share of public expenditure rose between 1966 and 1980 by 42 percent of GDP and peaked at 76 percent of GDP. The upturn was divided among defense (which contributed 16 percent of GDP to the increase), transfer payments and subsidies (19 percent), and interest payments (10 percent).

Table 1. Government Expenditure, Revenues, and Deficit, 1966–2005 (Percent of GDP)

Year	Government expenditure				Revenues	Deficit
	Defense	Transfers and subsidies	Interest	Total		
1966	6.8	9.4	1.3	33.8	33.4	0.4
1980	23.2	28.3	10.1	75.9	61.1	–14.8
2005	8.0	13.5	5.6	49.1	46.4	2.7
Change in period (%)						
1966–1980	16.4	18.9	8.8	42.0	27.7	15.2
1980–2005	–13.4	–7.4	–5.0	–24.9	–15.6	–9.3

Source: Bank of Israel (2005), *Appendix to Annual Report,* Tables A2(1), (2), columns "Transfer Payments," "Direct Subsidies," and "Credit Benefits." The changes between 1980 and 2005 and the proportions in 2005 are according to the new classification of government expenditure. The difference is 0.9 percent of GDP in total revenues, 1.9 percent of GDP in expenditure, and 2.8 percent in the deficit.

The central feature of the 1985 Economic Stabilization Policy was an unprecedented budget cut that aimed to restore budget equilibrium and lower the public debt. The deficits that had accumulated over the previous fifteen years brought the public debt to dangerous levels. At about the time of the Six-Day War, however, the public debt (net) stood at 60 percent of GDP, a rate

considered sound under the rules that the European Union countries had established.

Table 2. Budget Deficit and Public Debt, 1966–2005

Year	Budget deficit (–) / surplus (+)	Public debt
1965	1.8	60.1
1970	–12.2	78.4
1975	–21.0	125.1
1980	–14.8	152.3
1985	1.0	161.0
1990	–4.8	119.2
1995	–4.2	87.6
2000	–2.0	82.9
2005	–2.7	86.4

Source: Table 1.
* To permit comparison with the 1960s and the 1970s, the debt is expressed in net terms. The gross debt, the accepted parameter in international comparisons, was 101.9 percent of GDP in 2005.

The debt rose to 95 percent of GDP by the eve of the Yom Kippur War and peaked at 161 percent in 1985, when the Stabilization Plan went into effect. Although the Stabilization Plan had additional components, its fiscal equilibrium provisions were considered crucial in restraining the surging inflation. The budget deficit was slashed mainly by reducing expenditure but initially there was also large scale assistance from the United States Government. The two measures totally eliminated the deficit in 1985 and 1986. Even after the special assistance was discontinued, the government managed to hold the deficit to less than 5 percent and cut it to 2 percent in 2000. The deficit decline was reflected in a decrease in the gross public debt to 91 percent in 2000. The economic crisis in 2001 caused the deficit to spike again to 6.7 percent in 2003; the gross

debt that year surged to 107 percent of GDP. To cope with the worsening fiscal equilibrium, budget cuts were made in the second half of 2002 and still deeper ones in 2003. They focused on child allowances and income-maintenance benefits but also affected in-kind social services (foremost education and health care). The combination of budget cuts and the resumption of economic growth restored *de facto* budget equilibrium; in 2005, the deficit receded to 2.7 percent and the gross debt to 102 percent of GDP.

In Israel's economic history, periods of external shocks (wars, adverse developments in international markets) that impair economic activity and instability are recurrent phenomena. The fiscal stabilization measures that came in response were based mainly on cutting expenditure but were sometimes accompanied by tax hikes. Financial stabilization was usually attended by declarations about the importance of reducing the government's share in the economy as a long-term goal. Ultimately, however, after the non-recurrent spending cuts under the 1985 Stabilization Plan, the share of general government in the economy remained more-or-less constant on both the expenditure side and the revenue side.

Importantly, the most recent round of fiscal stabilization differed from preceding ones in that it was accompanied by sizable **tax cuts.** The cutback in expenditure was deeper than the extent needed to restore financial stability; it was also meant to pay for the tax cuts. According to the Ministry of Finance programs, in 2003-2010 cutbacks in income tax and corporate tax were supposed to result in a cumulative tax loss of NIS 127 billion![5] Factoring in the reduction in Value Added Tax and National Insurance contributions, and the introduction of tax withholding on capital gains, the net revenue loss occasioned by

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[5] State Revenues Administration, 2006.

the planned changes in tax rates in 2003–2010 was estimated at NIS 67 billion.

The state budget is an immensely powerful tool for the narrowing of disparities and poverty. This is because the tax system is progressive – i.e., it takes relatively more from those who can afford it – while social expenditure, for education, health care, and benefits, focuses more on the lower income deciles. In 2001, before the spending and tax cuts began, the budget narrowed economic income disparities at the rate of 49 percent. An average household in the lowest income decile (the bracket of the poorer half of all the poor) **gained,** in net terms, the equivalent of NIS 5,000 per month in education services, health care, and benefits, whereas a household in the upper decile **paid,** also in net terms (after subtraction of the value of services) around NIS 8,800. In the 2002–2005 period, due to the combined outcome of the cutbacks in social spending and taxes, the value of the budget subsidy for a lowest-decile household declined by NIS 480 while the burden on an upper-decile household fell by NIS 1,160.[6] Concurrently, the contribution of the budget to the narrowing of economic gaps decreased by 7 percent. Examination of the 2006 budget shows that these trends were intended to continue that year and definitely worsened in the second half of 2006 because the increase in defense outlays entailed cutbacks in other areas of expenditure. Some of this was inevitable due to concerns about fiscal instability that would bring on a financial crisis. However, part of the adverse effect of the budget on economic disparities and poverty stemmed from the effect of the tax cuts on the disparities and the need to counterbalance the cuts by decreasing expenditures that were supposed to reach the lower income deciles.

[6] Achdut et al., 2006.

3. Criticism of the Finance Ministry's Strategy for Downsizing the Public Sector

Four basic assumptions underlie the Finance Ministry strategy for downsizing the share of government in the economy – the strategy under which the tax cuts since 2003 have been made:

a. The public sector is a "burden" to the public, in general, and the business sector, in particular. Former Finance Minister Benjamin Netanyahu expressed this philosophy in his parable about the skinny man (the business sector) who carries a fat man (the public sector) on his back. A bulky public sector, especially a big welfare system, causes many forms of economic harm with little benefit, if any, to the public.
b. Limiting the increase in public expenditure is an important way of spurring growth.[7] By cutting expenditure and lowering taxes, one can raise the growth rate. On the one hand, spending cuts free up inputs for the business sector which will use them more efficiently and facilitate faster growth. On the other hand, lowering tax rates increases labor input, primarily among those with high-level and human capital skills, by creating an incentive. Similarly, cutting corporate tax encourages investment by making it more profitable.[8]
c. Faster growth is the most effective way to narrow disparities and fight poverty. It creates more jobs and brings into the labor cycle more potential breadwinners whose families are below the poverty line due to low income. Cutting benefits for households that have working-age breadwinners who elect to remain unemployed and receive social transfer payments, will force them to go to work and, thereby,

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[7] Ministry of Finance, 2006.
[8] Ministry of Finance, 2003.

increase the labor force participation rate of less-skilled workers.

d. Child allowances allow large families to lead idle lives, encourage parents to have lots of children, and bring families into poverty. Cutting these allowances will help to increase labor supply. Any saving achieved on account of welfare payments will allow a greater budget cut and, therefore, a greater tax cut as well, thereby encouraging even more growth without prejudicing financial stability.

The assumptions behind this strategy were adopted without thorough examination, even though they immediately affected the welfare of large parts of the public. They became the main plank in government policy for future years without being based on thorough research and, worse still, in total disregard of facts relating to the Israeli economy that do not support them. Thus, the policy applied not only lacks a basis in research but also overlooks studies that do not reinforce its assumptions.

a. The public sector is not a "burden"; it generates important public goods.

The main criticism of the small government strategy focuses on its view of the public sector as a "burden" on the business sector, disregarding highly important "outputs" that government generates.

One of the most important "outputs" of the public sector is its contribution to the narrowing of social inequality and poverty. Israel's levels of income disparity and poverty, in terms of household economic income, give this country a dishonorable place among developed countries, especially with regards to child poverty.[9] The state budget, by taxing the upper income

[9] National Insurance Institute, 2005, 2006.

deciles more heavily than the lower ones, and by focusing allowances and benefits, as well as education and health care services on the lower income deciles, is an immensely powerful tool for the narrowing of inequality and poverty. The social spending cuts in recent years have lessened the beneficial influence of the budget on inequality and poverty, creating a trend that should be reversed to the extent possible.[10] An aggressive policy to reduce poverty and inequality is not only something that the public demands[11]; it would also contribute to a higher growth rate in the longer term.[12]

The budget pays for crucial education and health care services that the public would not consume adequately if it had to pay for them solely from personal income. There are several reasons for this. First, members of weak population groups cannot afford these services privately. Second, household expenditure on education and health care has favorable effects on the public at large; the individual household does not take this into account in its resource allocation. Third, some of the public's expenditure on education and health care has positive long-term effects.[13] Individuals do not properly value the future importance of their current expenditure on education and health care. Thus, in the 1995–2005 decade, real per capita public expenditure on education stagnated and average per capita public expenditure on health care edged upward by only 1 percent. Concurrently, per capita private expenditure excluding private consumption of education and health care services increased by 15 percent in real terms.[14] This trend has been

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[10] Achdut et al., 2006.
[11] Taub Center, 2003.
[12] Iradian, 2005.
[13] In regard to education: Barro, 2001; in regard to health care: Kessler, Stang, 2006.
[14] CBS, 2006.

worsening in recent years: in 2002–2005, public funding of education and health care services declined by 5 percent in real terms.[15]

b. Israel's public sector in its current size does not significantly harm growth.

Many findings indicate that public sector doesn't significantly harm business sector growth so long as it does not exceed the accepted levels that characterize many developed countries. This is stated above all in regard to public funding of education and health care services, which amount to an investment in the human capital of the potential labor force. The positive contribution is not revealed in studies on the short-term effects of government spending but is striking in the long-term analyses.[16] The same should be said about expenditure on the social welfare system. It is important to bear in mind in this context that when government expenditure narrows disparities and poverty, it creates a more stable society that offers a more favorable investment climate. Also, the negative effects of taxes on business sector growth are not acute, especially in respect of personal income tax and VAT.

Indeed, as Table 3 shows, different countries determine their public expenditure and tax rates at different levels in accordance with their social priorities. Israel's tax rates and level of public expenditure do not exceed those of developed Western European countries of similar size. In this context, the findings of two important studies are worth mentioning. One study, recently published,[17] shows that the large income tax cut in the United States in 1986 had only a negligible long-term effect on

[15] Achdut et al., 2006.
[16] Romero-Avila, D., 2006.
[17] Li, Sarte, 2004.

growth – a loss of 0.12-0.34 percent per year – but widened inequality significantly. (The Gini index for inequality rose between 20 and 24 percent.) This outcome, in the opinion of the authors of the study, casts doubt on the ability of tax cuts to affect meaningfully the prospects of American economic growth in the long run. The second recent study shows that a level of social transfer payments that Israel's Finance Ministry described as very harmful does not negatively affect economic growth in an average developed country: "Raising social transfers [. . .] has no negative effect on GDP of an average OECD country." [18]

The Bank of Israel's researchers concur: "Israel's tax burden is not high by the standards of [a selection of developed countries]. As the process [of cutting the tax burden] moves ahead, Israel will have a lower level [of taxation] than most developed countries, especially since most developed countries have stopped their tax-cutting processes and several European countries intend to raise their rates."[19]

Another study[20] also shows that while there is some negative effect of the level of taxation on the growth rate, the positive long-term effect of a higher level of government expenditure on growth is even greater. Finally, a new study of the components of a quality pro-growth macro-economic policy found that the anti-growth variable is not necessarily the size of the public sector but the budget deficit/GDP ratio (along with the inflation rate and administrative intervention in the foreign currency market).[21]

A correct macro-economic policy and the maintenance of financial stability are important cards that the government can play if it wishes to influence the growth rate favorably. Such a

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[18] Lindert, P. H., 2004.
[19] Bank of Israel, *Annual Report 2005,* March 2006, pp. 202–203 (Hebrew).
[20] Romero-Avila, D., 2006.
[21] Sirimaneetham, V., Temple, J., 2006.

policy, however, should not be based on reducing the public sector and cutting taxes below their current levels.

The choice of downsizing government as a central strategic goal of economic policy is evidently a broader reflection of the inability or unwillingness of Israel's political echelon to integrate professional assessments into its decision making. In any event, many social researchers feel that the policy is inadequately grounded in research. "The frequent changes in social policy in recent years," Prof. John Gal notes, "are typified less by reliance on empirical findings and conclusions, derived at systematically and based on studies, than on ideological, political, and budget related motives."[22]

Table 3. Are Israel's Levels of Taxes and Public Expenditure Too High?

a. Tax Burden, Ten Small European Countries and Israel, 2005* (Percent of GDP)

Country	Percent of GDP
Ireland	30.2
Greece	35.7
Portugal	37.1
Israel	38.3
Netherlands	39.3
Austria	42.9
Finland	44.3
Norway	44.9
Belgium	45.6
Denmark	49.6
Sweden	50.7

[22] Gal, J., 2004.

b. Public Sector Expenditure,* Ten Small European Countries and Israel, 2005** (Percent of GDP)

Ireland	35.8
Norway	36.1
Portugal	47.6
Greece	47.7
Belgium	49.1
Austria	49.5
Israel	50.8
Finland	50.9
Denmark	54.0
Sweden	57.2

* Central govern*ment, municipal authorities, and National Insurance
** Europe – 2004, Israel – 2005

c. Growth does not narrow disparities and reduce poverty.

A society's level of welfare is determined not only by per capita product but also by the distribution of the product among households and the size of the disparities between poor and rich households. A country's level of social welfare is also determined by the share of the population that lives under what the country accepts as the poverty line. Therefore, without ignoring the importance of growth, a policy of narrowing gaps and fighting poverty even if it reduces somewhat the average growth rate of the business sector should not be ruled out *ab initio*. It goes without saying that the existence of large low-income population groups directly impairs the welfare of members of these groups. It is important to emphasize, though, that the welfare of the better-off is also impaired by the existence of overly large disparities and poverty. What is more, the affluent are willing to support a policy that aims to narrow

disparities and poverty levels that seem too great to them.[23] Finally, many studies show that there is an economic price to large disparities and high poverty levels mainly because of their negative impact on investment, productivity and growth,[24] but also because they result in increased public expenditure on health care, law and order, and crime fighting. However, the claim that growth in itself will narrow disparities and reduce poverty – and that, therefore, it is a preferred substitute for a large social service system – is utterly unfounded in research.[25]

In this context, data on the effect of the 6 percent per capita GDP growth in the past two years (2003–2005) are instructive.[26] Only the strong population groups benefited from the renewed growth; the weak ones not only failed to gain but actually lost real income and consumption in **absolute** terms. The most comprehensive measure of change in income distribution – the Gini Index – points to a 5 percent increase in net household income disparity per standard person in 2003–2005, placing Israel among the "leading" Western countries in the size of income disparities. During this time, net per capita income in the lowest income decile, to which 200,000 people belong, **declined** by 1 percent while that in the highest decile (to which the same number of households belongs) rose by an unusually high 15 percent! Changes in per capita consumption followed the same trend, **decreasing** during these years by 3.5 percent in the lowest decile while rising by 6.5 percent in the uppermost decile.

The widening of disparities and the decrease in per capita income and consumption in the lowest income decile originate in two factors: a decline in the real wages of unskilled and poorly skilled workers, in the midst of the growth process, and a

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[23] Taub Center, 2005.
[24] Shai et al., 2000.
[25] Sussman, 2005; Brander, Strawczynski, 2005.
[26] CBS, 2006.

budget policy that cut benefits and concurrently reduced taxes for the well-off. Evidence of the fact that the weaker workers did not benefit from the growth can be seen in the 2.5 percent decline in the real wage of poorly skilled male workers in 2003–2005 and a 7.1 percent increase in the wages of workers in academic occupations during the same period.

d. It is not the social welfare system that created the most frequent kind of poverty, that among working households.

The cutting of social benefits stems from the belief that Israel's high poverty rates are the result of an excessively generous and oversized welfare system. Thus, the poverty problem in Israel has been portrayed as one of potential breadwinners who would rather live off benefits than go out to work. If so, they may emerge from poverty only by being forced to enter the labor market. This view totally disregards the findings of many studies that point to a completely different reality:

1. By the standards of developed countries, Israel's welfare system is anything but oversized and its levels of benefits for households with working-age adults, in terms of percent of GDP, are in no way excessive.[27] Furthermore, while Israel has been downsizing its welfare system in recent years, there has been a rise in the extent of income redistribution in many developed countries. A study on redistribution changes in thirteen such countries found that the extent of redistribution increased in eleven of them.[28]
2. Comparison of the effect of welfare system size on poverty and disparities in developed countries shows clearly that a

[27] National Insurance, 2005.
[28] Kenworthy, 2004. National Insurance, 2004, 2006; Kenworthy, 2004.

larger welfare system **reduces** poverty and economic disparities.[29]

3. Most poverty in Israel occurs in low wage working households. In 2004/05, about half of all poor individuals, measured both by household economic income and by net household income after taxes and transfers, had a working head of household. For every 100 poor households, as defined by economic income in which the adults did not work, there were 133 working poor households. For every hundred poor persons in households with no working head of household, there were 163 poor individuals in working households. Furthermore, in 2002-2004/05, the number of poor persons (in terms of economic income) among the working population increased by 153,000 while the number of poor in all other types of households – of elderly and non-working persons – decreased by 20,000.[30] To address the problem of working poor households, in which most poor children are also concentrated, is of the utmost importance. The highest priority should be given to increasing the social budgets in order to finance the introduction of a negative income tax, a method of subsidizing low wage workers, parents, and children that has been implemented successfully in several Western countries.

In contrast to common rhetoric, there was an increase among many developed countries in the use of transfer payments and taxes to narrow inequality in the economic income of working-age households (as measured by the Gini index) in the 1980s and 1990s (ten of eleven countries examined by Kenworthy and Pontusson, 2005). They did so in response to the increase in economic income inequality and, as a rule, the higher the

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[29] National Insurance, 2004, 2006; Kenworthy, 2004.
[30] National Insurance, 2006.

increase in economic inequality in a country, the higher the rate of redistribution by the government.

4. An Alternative Trajectory: Increase Government Expenditure by 3 Percent per Year instead of 1.7 Percent as in the Finance Ministry Policy

The recent war in Lebanon found the country in a state of macro-economic recovery and financial stability that had been attained by reducing budget expenditure for social goals, foremost education, health care, and social transfer allowances. The cutbacks, however, were steeper than those required to restore financial stability; they also were enough to finance, during the same period, far-reaching income tax cuts that benefited mainly the higher income deciles. As a result of this policy, the Israeli economy had attained record levels of income disparity and poverty before war broke out. Even raising the target rate of the annual increase in public expenditure from 1 percent to 1.7 percent was not enough to insure the appropriate increase in social service expenditure. The need to increase defense spending in the aftermath of the war will result in an even larger gap in future years between the delivery of publicly funded social services and the expected trajectory of private consumption.

The following assumptions underlie the alternative trajectory:

a. The population will increase by 1.7 percent per year, much as it has in recent years.
b. The labor force will grow by 2 percent per year.
c. The business sector will grow at an average long-term rate of 4.3 percent per year due to a 1.5 percent rise in total productivity, a 2 percent increase in labor supply, and

investment at a level that is sufficient to maintain a constant capital/output ratio.

d. A 3 percent increase in public sector expenditure, if the public sector product rises by 3.2 percent. Total Gross Domestic Product will increase at the rate of 4.1 percent per year. The fiscal policy will lower the budget deficit progressively each year so that it will be less than 1 percent of GDP in 2010, aided by domestic revenues and foreign aid at the 2005 level of NIS 15 billion per year.

e. The policy of gradually lowering the public debt/GDP ratio will continue until the ratio declines to 91 percent in 2010, with a goal of 70 percent in 2015. The decrease will be attained in two ways: holding the debt more or less constant in absolute terms (in the absence of a budget deficit) and through economic growth.

The alternative path will make it possible to increase publicly funded social service expenditure at a rate exceeding that of population increase. The continuation of tax cuts will be suspended but the convergence toward a balanced budget will continue and the public debt will continue to decline, although these fiscal targets will be attained more slowly than they would under the Finance Ministry's trajectory (see below). A year-to-year breakdown of the trajectory up to 2010 appears in the Appendix that follows.

Table 4. Public Expenditure, Deficit, and Public Debt: Alternative Trajectory

	2006	2007	2010
Added expenditure (NIS billions) relative to Finance Ministry path	–	3.5	15.4
Deficit as percent of GDP	2.3	3.0	0.7
Debt as percent of GDP	100.2	98.9	91.2

Appendix

Alternative Trajectory – Suspension of Tax Reform and Raising of Expenditure Ceiling Relative to Finance Ministry Policy, 2007–2010

	2005	2006	2007			2008		
		Finance Ministry trajectory	Finance Ministry trajectory	Alternative trajectory	Increase	Finance Ministry trajectory	Alternative trajectory	Increase
Budget expenditure								
NIS billions	271.9	274.6	279.3	282.8	3.5	284.0	291.3	7.3
% of GDP	49.1	47.6	46.5	47.1	0.6	45.4	46.6	1.2
War funding			4.6	4.6	0.0	2.2	2.2	0.0
Domestic revenue								
NIS billions	238.4	242.5	249.5	252.4	2.9	256.1	262.7	6.6
% of GDP	43.0	42.0	41.6	42.0	0.4	41.0	42.0	1.0
Total revenue								
NIS billions	257.0	261.4	268.5	271.4	2.9	275.3	281.9	6.6
Deficit								
NIS billions	14.9	13.2	15.4	16.0	0.6	10.9	11.6	2.7
% of GDP	2.7	2.3	2.6	2.7	0.1	1.7	1.9	0.2
Public debt								
NIS billions	564.6	577.8	593.2	593.8	0.6	604.1	605.4	1.3
% of GDP	101.9	100.2	98.8	98.9	0.1	96.7	96.9	0.2
GDP NIS billions	554.0	576.7		600.4			625.0	

Business sector product and public sector (annual avg. % increase)	**Business sector**	**Public sector**
Finance Ministry trajectory	4.7	1.8
Alternative trajectory	4.3	3.2

	2009			2010		
	Finance Ministry trajec-tory	**Ater-native trajec-tory**	**Increase**	**Finance Ministry trajec-tory**	**Ater-native trajec-tory**	**Increase**
Budget expenditure						
NIS billions	288.8	300.1	11.3	293.7	309.1	15.4
% of GDP	44.4	46.1	1.7	43.4	45.6	2.2
Domestic revenue						
NIS billions	264.0	273.5	9.5	272.2	284.7	12.5
% of GDP	40.6	42.0	1.2	40.2	42.0	1.8
Total revenue						
NIS billions	283.3	292.8	9.5	291.7	304.2	12.5
Deficit						
NIS billions	5.5	7.3	9.5	2.0	4.9	2.9
% of GDP	0.8	1.1	0.3	0.3	0.7	0.4
Public debt						
NIS billions	609.6	612.7	3.1	611.6	617.6	6.0
% of GDP	93.7	94.2	0.5	90.3	91.2	0.9
GDP	650.6			677.3		

Differences between the trajectories:

Alternative trajectory: 3.0 percent annual increase in budget expenditure; 4.1 percent annual increase in GDP and domestic revenue.

Finance Ministry trajectory: 1.7 percent annual increase in budget expenditure; 4.1 percent annual increase in GDP, 4.1 percent annual increase in domestic revenue, less NIS 2.9 billion in 2007, NIS 6.6 billion in 2008, NIS 9.5 billion in 2009, and NIS 12.5 billion in 2010, all relative to 2006.

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