
Government Expenditure for Social Services

1. State of the Economy in 2001

The Israeli economy experienced severe setbacks in 2001, and according to realistic forecasts this situation will continue, if not worsen, in 2002. The first stage of the slowdown appeared in 1996, when GDP (Gross Domestic Product) growth rates began to decline after having been particularly high for several years. Real growth rates fell from an annual average of about 6 percent in 1990–1995 to 2.6 percent in 1999. An exception in this trend was the year 2000, when growth rose to 6.4 percent, driven by the high-tech sector. Despite this impressive growth, unemployment rates did not fall substantially and remained at around 8.6 percent. In the last quarter of 2000, the economy fell into a deep recession. In 2001, the GDP declined in real terms by half a percent.

Three factors can be identified that put the economy back into a recession in 2001: (1) the outbreak of the Al-Aqsa Intifada in October 2000; (2) the onset of a recession in Western countries, the beginning of a global high-tech crisis, and the decline in prices of shares, particularly those of high-tech companies; (3) the endogenous cyclical forces that had been dominant from 1996 to 1999 augmented by tight fiscal and monetary policies.

A major factor that worsened the situation in 2002 was related to the adverse economic and financial consequences of the terrorist attacks in the United States – the destruction of the World Trade Center and the strike on the Pentagon – on September 11, 2001, and the subsequent war in Afghanistan.

These factors have had strongly negative impacts on several areas of the Israeli economy, including the following:

- Exports continue to decrease (on top of a 12 percent decline in 2001);
- Tourism continues to decrease;
- As foreign investments fall, so does total investment, especially in high-tech. This trend began in 2000 and gathered strength in 2001;
- The influx of financial and real capital from abroad is diminishing;
- The balance of payments – in both the current and the capital account – is worsening;
- The construction industry is not expected to recover soon.

As these economic events occur and economic activity slows to even lower levels than 2001, unemployment rates can be expected to rise and foreign reserves decrease, possibly impairing the price stability achieved in recent years with the concomitant high cost of slowed growth.

Setting government expenditure on the basis of potential GDP rather than actual GDP seems to be the correct thing to do when the government is trying to use its expenditure as an automatic stabilizer and a countercyclical policy tool. In hard times, however, when the budget deficit is larger than planned, economic policymakers worry about potential harm to price stability and the country rating as determined by international financial institutions, an increase in the share of government expenditure in GDP, and impaired performance of markets. These concerns may prompt the government to reduce its spending without sufficient planning and forethought and with a focus on easily cut expenditure items. There are examples of this in Israeli budgetary history, including cutbacks in infrastructure, transfer payments, education and health. In other words, there is a reasonable likelihood that government social expenditure will decrease in view of the economic situation and the expected

deficits in the state budget. This concern is reinforced by the fact that a large component in the state budget – defense – is expected to grow in 2002.

Thus, the global economic situation, the state of the domestic economy, and the security situation may combine to force a rollback in the social services. Cuts in the state budget – including social service budgets – are sometimes unavoidable. This is the case when the damage caused to the economy by an increase in the budget deficit exceeds the damage caused by a reduction in social spending. Such an evaluation is linked, of course, to value judgments, but it is also a question of the size of the deficit, and the general economic circumstances and expectations. If the size of the deficit and its trend threatens economic stability, budget cuts may become unavoidable. It is, however, important that the government exercise extreme caution when facing difficult dilemmas of this sort. The budget deficit problem should be regarded as a temporary development caused by an economic slowdown that will be followed by an upturn. As soon as the economic outlook will show significant indications of this expected recovery, the basic structure of government expenditure should return to its pre-cutback track.

2. Government Social Expenditure

Government expenditure for social services includes the provision of in-kind services as well as transfer payments, most of which are made by the National Insurance Institute. In-kind social services provided by the government work in two ways: the government itself provides some of the services, such as education and health care. In other cases, the government funds, either fully or in part (by means of subsidies), services provided by nonprofit organizations and private businesses. The latter method is applied to varying extents in education (especially higher education but also secondary and vocational education),

health – in which much activity is carried out by nonprofit organizations (e.g., health funds and nongovernmental hospitals) – personal social services, and housing.

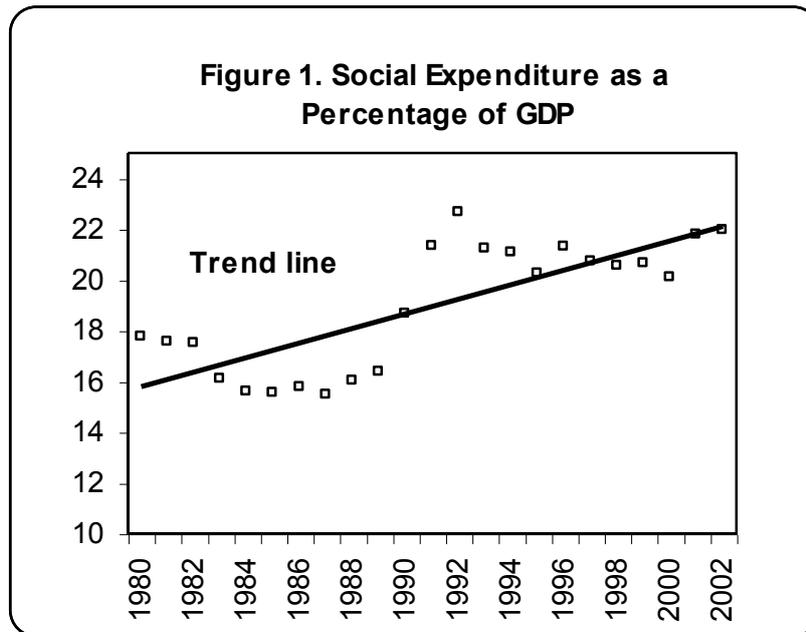
In 2002, the total government budget for social services will come to NIS 107.5 billion (in current prices). About 40 percent of this will be spent on income maintenance, by means of National Insurance benefits, and the rest will go for in-kind services.

Table 1. Total Government Social Expenditure and Its Components, 2002 Budget
(NIS millions, current prices)

| | |
|---------------------------------|---------|
| Total social expenditure | 107,561 |
| Income maintenance | 43,712 |
| In-kind social services – total | 63,849 |
| <i>Thereof:</i> Education | 31,385 |
| Health care | 15,443 |
| Personal social services | 5,040 |
| Employment | 683 |
| Immigrant integration | 1,762 |
| Housing | 9,535 |

Government social expenditure is determined by three main factors:

- 1) the prevailing ideology regarding the desired level of government involvement. This factor has a major effect on total government spending relative to GDP;
- 2) the state of the economy. This factor determines the level of economic activity, which in turn determines the level of total resources on which the government may draw for various public needs;
- 3) the set of government priorities and needs as perceived by policymakers. These affect the allocation of state resources among various uses.



Government spending as a percentage of GDP has fallen considerably in the past two decades. Budget deficits decreased concurrently, thereby reducing the national debt and the ongoing burden of debt payback and interest payments by the state. In keeping with the socioeconomic philosophy that prevailed in the West in those years, total government spending declined from 74 percent of the GDP in 1980 to a planned 55 percent in 2002. Government spending excluding debt payback fell from 56 percent of GDP in 1980 to 39 percent in 2002 (see Table 2). Nevertheless, perhaps in part due to a substantial reduction in government expenditure for items other than social services (defense and others), it became possible to increase government social expenditure from 17.8 percent of GDP in 1980 to a planned 22.1 percent in 2002.

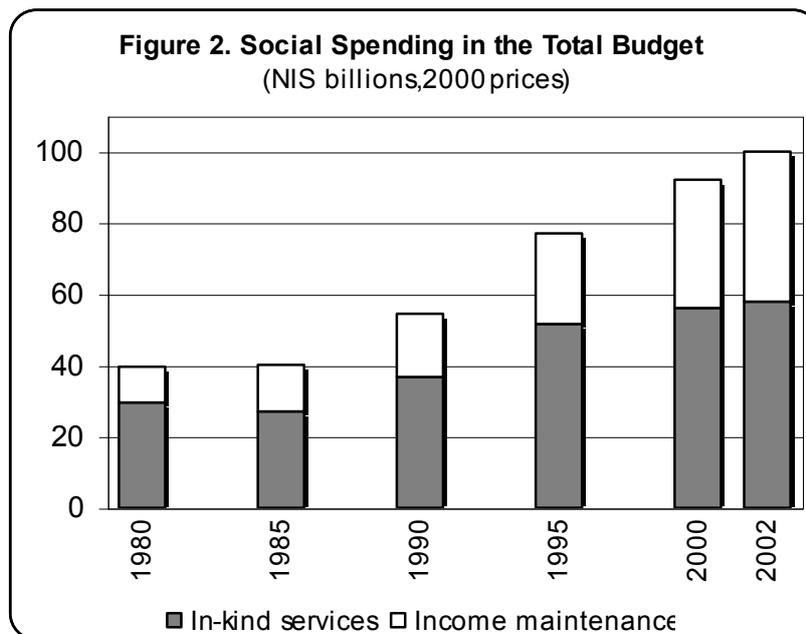
Table 2. Government Expenditure, by Main Components
(Percent of GDP)

| | Total | Total, excluding debt payback | Social services | Defense | Other |
|------|--------------|--|----------------------------|----------------|--------------|
| 1980 | 74.3 | 56.1 | 17.8 | 22.2 | 16.2 |
| 1985 | 85.5 | 48.4 | 15.5 | 19.4 | 13.4 |
| 1990 | 61.5 | 41.2 | 18.6 | 12.9 | 9.7 |
| 1995 | 55.2 | 38.7 | 20.3 | 9.5 | 8.9 |
| 1999 | 53.5 | 37.5 | 20.7 | 8.9 | 8.0 |
| 2001 | 58.3 | 40.0 | 22.2 | 9.0 | 8.6 |
| 2002 | 55.3 | 38.9 | 22.1 | 8.4 | 8.4 |

The state budget, excluding repayment of national debt, represents consumption, investment, and transfer payments by the government sector. As stated above, this aggregate of components of government expenditure decreased in relative terms in the past two decades. This process picked up speed after 1985, when the stabilization policy that ultimately put an end to inflation in Israel was instituted. The reduction in government demand engendered a substantial decrease in budget deficits and domestic national debt, and this also substantially reduced the debt-payback component of the budget. Nevertheless, Israel still has a larger national debt and burden of government interest payments, in relative terms, than most developed countries, although several European Union member states (e.g., Belgium and Greece) resemble Israel in this respect.

In this context, it is important to understand that Israel can afford a larger budget deficit and national debt than most developed countries, because the social burden of these variables is determined relative to GDP. Since the Israeli economy has a higher natural growth rate than that of other developed countries (due to higher rates of natural increase), in the long term the burden of the national debt is expected to

shrink more quickly than in other developed countries. This gives Israel more leeway in determining the size and makeup of the budget, even when state revenues are unstable. In times of budget stress (as is projected for 2002), it is sometimes convenient for the government to reduce expected budget deficits by reducing social spending. Since such a policy may have undesirable social and economic repercussions in both the short and the long terms, the government should do its best to refrain from cutting back on social expenditure when trying to deal with transitory budgetary difficulties caused by temporary exogenous and endogenous forces.



In 2002, the government intends to spend NIS 100 billion (in 2000 prices) for various social services (Table 3) – NIS 40 billion for transfer payments and NIS 60 billion for in-kind services, as noted above. In the past twelve years (1989–2001), there has been a substantial increase in government expenditures for social services, as manifested in the state budgets: during this period, total social expenditure rose from NIS 47 billion (in 2000 prices) to NIS 99 billion, i.e., double the amount. However, the rates of change in total expenditure and in the relative size of its components were uneven during that time.

Table 3. Government Social Expenditure, by Main Components
(NIS millions, in 2000 prices, and percent)

| | Total | Income mainte- nance | In-kind services | Total | Income Mainte- nance | In-kind services |
|---|-----------------------------------|-------------------------------------|-----------------------------|--------------------------------|-------------------------------------|-----------------------------|
| | <i>NIS millions (2000 prices)</i> | | | <i>Percentage Distribution</i> | | |
| Total budget (current and development) | | | | | | |
| 1989 | 46,992 | 17,562 | 29,360 | 100 | 42.4 | 57.6 |
| 1992 | 73,382 | 19,797 | 53,585 | 100 | 28.9 | 71.1 |
| 1996 | 83,951 | 27,155 | 56,796 | 100 | 33.3 | 66.7 |
| 2000 | 92,037 | 35,979 | 56,069 | 100 | 39.1 | 60.9 |
| 2001 | 99,483 | 40,492 | 58,991 | 100 | 39.6 | 60.4 |
| 2002 | 100,055 | 42,182 | 57,873 | 100 | 40.6 | 59.4 |
| Annual average rate of change (%) | | | | | | |
| 1989–1996 | 8.7 | 6.4 | 9.9 | | | |
| 1996–2002 | 3.0 | 7.6 | 0.3 | | | |
| Current budget | | | | | | |
| 1989 | 45,203 | 17,562 | 27,641 | 100 | 44.5 | 55.5 |
| 1992 | 55,376 | 19,797 | 35,579 | 100 | 40.4 | 59.6 |
| 1996 | 72,057 | 27,155 | 44,903 | 100 | 39.0 | 61.0 |
| 2000 | 83,449 | 35,979 | 47,471 | 100 | 43.1 | 56.9 |
| 2001 | 88,466 | 40,492 | 47,974 | 100 | 44.5 | 55.5 |
| 2002 | 90,276 | 42,182 | 48,094 | 100 | 45.0 | 55.0 |
| Annual average rate of change (%) | | | | | | |
| 1989–1996 | 6.9 | 6.4 | 7.2 | | | |
| 1996–2002 | 3.8 | 7.6 | 1.2 | | | |

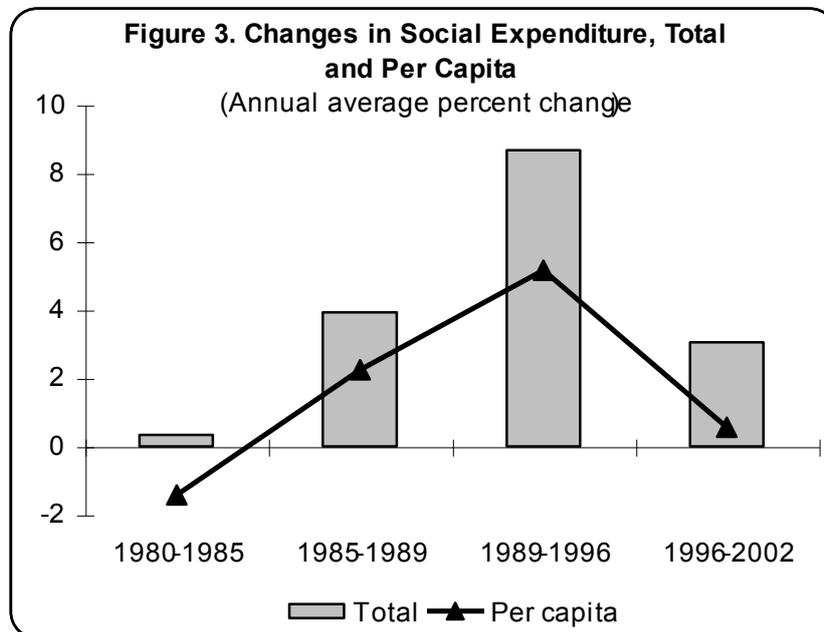
Table 4. Government Per Capita Social Expenditure by Main Components (NIS, 2000 prices)

| | Total | Income maintenance | In-kind services |
|---|--------------|---------------------------|-------------------------|
| Total budget (current and development) | | | |
| 1989 | 10,385 | 3,887 | 6,498 |
| 1992 | 14,323 | 3,864 | 10,459 |
| 1996 | 14,767 | 4,776 | 9,990 |
| 2000 | 14,634 | 5,721 | 8,914 |
| 2001 | 15,462 | 6,294 | 9,196 |
| 2002 | 15,187 | 6,403 | 8,784 |
| Annual average rate of change | | | |
| 1989–1996 | 5.2 | 3.0 | 6.3 |
| 1996–2002 | 0.5 | 5.0 | –2.1 |

The first half of the period was marked by mass immigration from the former Soviet Union, the onset of the Oslo peace process, high rates of economic growth, foreign investment, and a strong sense of optimism both in the business sector and in the government sector. These factors combined to give policymakers the feeling that government social expenditure – both for income maintenance and for in-kind services – could and should be increased.

The result was an increase in total government social expenditure in 1989–1996 at an annual average rate of 8.7 percent. Expenditure for in-kind services increased more rapidly, by 9.9 percent on annual average, while income maintenance grew by 6.4 percent per year, also fairly high. The expansion of in-kind services during this period stemmed, of course, from needs occasioned by mass immigration from the former Soviet Union; in particular, housing and immigrant integration expenditure rose considerably. However, there was also a very significant increase in spending on education and health care, beyond that necessitated by the volume of

immigration. These increases reflected the need to compensate for many years of budget erosion in these fields in the 1980s. They also reflected heightened public awareness of the importance of these services, especially education, for economic growth, equal opportunity, and social justice.



In the same period, 1989–1996, the incomemaintenance components of social expenditure grew at an annual average rate of 6.4 percent, as stated. These components were influenced by natural demographic changes, including a birth rate of 2.5 percent per year and a gradual aging of the population. The

contributing factors included mass immigration from the former Soviet Union, economic growth, and, most importantly, a rise in real wages (which raised the level of wage-indexed benefits) and the reinstatement of first and secondchild allowances for the entire population.

These trends have changed in the past six years. An economic slump has set in, and with the exception of 2000 – a year of rather vigorous growth – growth rates have declined steadily and unemployment rates have increased. The period has also been characterized by fiscal and monetary restraint and adverse political and economic events. The effect on government social policy has been that although total social expenditure has continued to grow by 3 percent per year, on average, the rate of increase of expenditure for in-kind services has fallen to 0.3 percent, while expenditure for income maintenance has grown by an average of 7.6 percent per year. This trend has altered the mix of social spending. In 1996, one-third of this expenditure was used for transfer payments and two-thirds for in-kind services, whereas in 2002, nearly 40 percent will be used for cash benefits and only 60 percent for in-kind social services. There is no doubt that the stagnation in government expenditure for in-kind services originates mainly in the general budgetary restraint that has been applied during this period. As often occurs in times of restraint, the investment component has suffered more than the current component of expenditure.

Unlike in-kind social services, transfer payments grew rapidly due to demographic forces that affected them automatically, increases in real wages (which continued even as the economy slowed), and an increase in unemployment, which led to a considerable upturn in safety-net outlays – unemployment compensation and benefits under the Income Maintenance Law.

The recomposition of government social expenditure in the past six years gives evidence of an undesirable situation for society and the economy. Another quantitative expression of this change can be seen in a computation of social spending and its two main components on per-capita average. As Table 4 shows, total social spending per capita climbed from NIS 14,767 (in 2000 prices) in 1996 to NIS 15,187 in 2002, an annual average change of 0.5 percent. When we break this variable down into its two main parts, however, we find that per-capita income-maintenance expenditure rose in this period from NIS 4,776 to NIS 6,403 (average growth of 5.0 percent per annum) while per-capita expenditure for in-kind services decreased from NIS 9,990 to NIS 8,784 (an average decline of 2 percent per year).

The direction of change in the makeup of government social expenditure is a symptom of the economic languor that Israel has been experiencing in the past six years, the nature of the fiscal policy, and a level of economic activity that falls significantly below its potential. Furthermore, the change in the mix of social spending has economic ramifications that are worth addressing.

Income-maintenance expenditure has a major impact on economic demand, especially due to its contribution to private consumption by recipients of the benefits, most of whom belong to low-income groups. This instrument has no direct effect on the supply side, production capacity, productivity, and economic growth. In contrast, many in-kind social services provided by government – in education, housing, employment, and even health care – contribute not only to the demand side but also to the supply side by boosting productivity, enhancing the ability to adopt new technologies, and, as a result, promoting economic growth.

The income-maintenance component is of paramount social importance because it gives society an economic safety net and

functions as one of the two main mechanisms for income redistribution and reduction of economic inequality. When the burden of transfer payments increases in times of economic downturn and budget stress, one always encounters government policymakers and economists who propose reducing this budget item for the sake of the economy. The government should avoid solutions of this sort, especially during a recession, since they may cause severe damage to issues of social justice and equality in a society as complex as Israel's. The economic ramifications of such a step may actually create more dire budget problems than the ones it proposes to solve.

3. Income Maintenance

Israel's income maintenance mechanism functions by means of transfer payments made by the National Insurance Institute. The incomemaintenance system fulfills an important social function. It provides a safety net and ensures a minimum standard of living. It contributes to social justice by reducing economic disparities and, by means of child allowances, rectifies certain distortions in the tax base. The system is based on universal rules, most of which are formalized in law. Thus, the level of expenditure for the various programs is determined by the parameters stipulated in the laws, and the size of the eligible population is derived from those same laws. The sizes of these population groups are determined by dynamic forces, cyclical forces, and exogenous, political, and other events. Therefore, unless it amends the rules or definitions, the government has little control over this component of expenditure. The parameters can be changed from time to time, but governments rarely invoke this option.

Government expenditure for income maintenance rose rapidly in recent decades, at a rate exceeding the growth rate of the economy. Therefore, the share of transfer payments as a

percentage of GDP has been rising steadily. In all, the government is expected to spend NIS 44 billion (in current prices) on these payments in 2002 – 9 percent of GDP. For comparison's sake, incomemaintenance expenditure accounted for 3.1 percent of GDP in 1970, 5.5 percent in 1980, and 6.7 percent in 1990. These figures attest to a steady increase in the share of this form of social expenditure.

Tables 5 and 6 show the increase in incomemaintenance expenditure over the past dozen years. Throughout that time, this expenditure component grew more rapidly than the economy as a whole, the population, and total government expenditure. The result is that the burden of income maintenance increased as a percentage of GDP, its share in total public expenditure rose steadily, and, in per-capita average terms, it climbed from NIS 3,887 in 1989 (in 2000 prices) to NIS 6,403 in 2002. The annual average growth rate has accelerated in the past six years due to rapid growth in all components of income maintenance except child allowances.

Old-age pensions are the largest component of income maintenance. Although they declined from 44 percent of total incomemaintenance expenditure in 1989 to 36 percent in 2002 due to the expansion of other benefits (unemployment compensation, Income Maintenance Law, and disability) in recent years, the long-term trend shows a steady rise in their share of GDP, which is projected at 3.3 percent in 2002. Under the present law, the two main factors that determine the extent of old-age pension payments are the number of seniors eligible for these benefits and the average wage, to which the pensions are indexed.

Table 5. Income-Maintenance Expenditure, by Main Components
(NIS millions, in 2000 prices, and percent)

| | Total | Thereof: | | | | |
|-------------------------------------|--------|-----------------------|----------|--------------------|--------------|------------------------|
| | | Old age and survivors | Children | General Disability | Unemployment | Income Maintenance Law |
| NIS millions, in 2000 prices | | | | | | |
| 1989 | 17,562 | 7,567 | 4,046 | 2,041 | 1,310 | 534 |
| 1992 | 19,797 | 8,528 | 4,058 | 2,095 | 1,797 | 1,018 |
| 1996 | 27,155 | 10,775 | 6,041 | 3,266 | 1,885 | 1,604 |
| 2000 | 35,979 | 13,483 | 6,942 | 4,961 | 2,959 | 2,875 |
| 2001 | 40,492 | 15,092 | 7,497 | 5,734 | 3,352 | 3,474 |
| 2002 | 42,182 | 15,298 | 7,570 | 6,222 | 3,640 | 3,757 |
| Annual average rate of change (%) | | | | | | |
| 1989–1996 | 6.4 | 5.0 | 5.9 | 6.9 | 5.3 | 17.0 |
| 1996–2002 | 7.6 | 6.0 | 3.8 | 11.3 | 11.6 | 15.2 |
| Distribution by percentage | | | | | | |
| 1989 | 100 | 44 | 23 | 12 | 8 | 3 |
| 1992 | 100 | 43 | 21 | 11 | 9 | 5 |
| 1996 | 100 | 40 | 22 | 12 | 7 | 6 |
| 2000 | 100 | 38 | 19 | 14 | 8 | 8 |
| 2001 | 100 | 37 | 19 | 14 | 8 | 9 |
| 2002 | 100 | 36 | 18 | 15 | 9 | 9 |

The Israeli population is aging and the percentage of elderly has risen in recent decades. Today, seniors (aged 65+) make up about 10 percent of the population. This population group is expected to grow in coming years by 2.6 percent annually, apace with the population at large. In other words, barring a major exogenous change, the elderly will maintain their share in the population at least for the next decade. Thus in the coming years, demographic changes per se will not contribute to an increase in the financial burden of old-age pensions. If this burden grows in the future, it will be due to other factors, such

as substantial increases in the average wage and macroeconomic factors that impair economic growth. In comparison with Western countries, Israel is in a relatively good demographic position. In Scandinavia, France, Italy, and some other parts of Western Europe, for example, people aged 65 and over account for up to 20 percent of the population, following a continuous trend of declining rates of natural increase, which in some cases has neared zero. The result, in terms of state pension insurance, is that these countries have a much larger burden of old-age pensions and transfer payments than Israel's and devote a larger share of public expenditure to it.

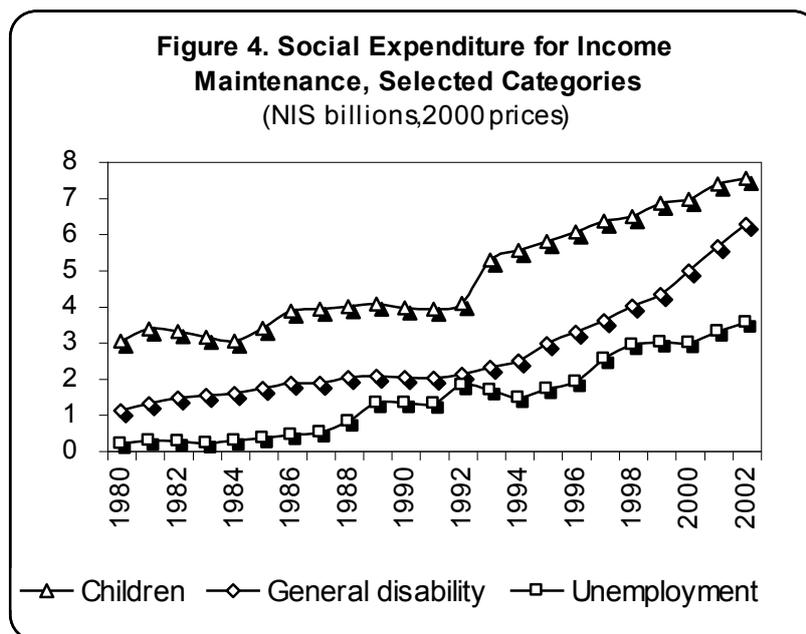
Table 6. Per-Capita Expenditure for Income Maintenance, by Main Components (NIS, 2000 prices)

| | Total | Thereof: | | | | |
|-----------------------------------|-------|-----------------------|----------|--------------------|--------------|------------------------|
| | | Old age and survivors | Children | General disability | Unemployment | Income Maintenance Law |
| 1989 | 3,887 | 1,695 | 896 | 452 | 290 | 118 |
| 1992 | 3,864 | 1,665 | 792 | 409 | 351 | 199 |
| 1996 | 4,776 | 1,895 | 1,063 | 575 | 332 | 282 |
| 2000 | 5,721 | 2,144 | 1,104 | 789 | 470 | 457 |
| 2001 | 6,294 | 2,346 | 1,165 | 891 | 521 | 540 |
| 2002 | 6,403 | 2,322 | 1,149 | 944 | 552 | 570 |
| Annual average rate of change (%) | | | | | | |
| 1989–1996 | 3.0 | 1.6 | 2.5 | 3.5 | 1.9 | 13.2 |
| 1996–2002 | 5.0 | 3.4 | 1.2 | 8.6 | 8.9 | 12.4 |

Old-age pensions reflect the function of the National Insurance Institute as a pension insurance provider that assures senior citizens a minimum level of income. National Insurance has additional important functions. Child allowances are the second-largest expenditure component among social transfer payments. In the past, child allowances were increased as a

substitute for deductions for children in the income-tax base, which hardly takes family size into account.

Expenditure for child allowances is affected by demographics and by policy, as manifested in financial criteria and eligibility. The long-term trend is determined by demographic forces; policy changes generally cause nonrecurrent volatility in the volume of allowances but do not necessarily affect the trend.



The parameters of child allowances were changed over the past two decades, and most recently in 2000; thus, this tool was used to achieve goals different from the original one. In the 1980s, the government eliminated child allowances for the first and second children as part of its anti-inflation fiscal policy. In 1993, the benefits for the first two children were restored. In 2000, the Knesset enacted the Large Families Law, which increases child allowances sharply for the fourth child and even more for the fifth and subsequent children. By so legislating, Knesset turned child allowances into a social mechanism for the subsidization of large families, i.e., a policy tool to encourage higher birth rates.

In the past six years, child-allowance payments increased by an average of 4 percent per year. The average was strongly affected by a 8 percent rise in 2001 as a result of the introduction of the Large Families Law. Similarly, after 1993, when the decision to reinstate benefits for first and second children was made, the level of benefits increased sharply. As in many other developed and developing countries, birth rates in Israel are declining, causing the share of allowance-eligible children (ages 0–18) to decline as well. In recent years the growth rate of this population group fell to 1.6 percent per year, which is less than the overall growth rate of the population (2.6 percent). Consequently, unless the parameters of child allowances are changed by legislation, the relative burden that they pose can be expected to decrease in the coming years.

The benefits that reflect most strongly the state's social safety net are unemployment compensation, benefits under the Income Maintenance Law, and disability pensions. The amount paid out in unemployment compensation is an indication of the existence of acute unemployment, in part due to cyclical volatility in economic activity and exogenous economic and political factors. In contrast, benefits under the Income Maintenance Law are a sign of chronic unemployment, people leaving the labor force,

and the existence of unproductive sectors of society. In 2002, the National Insurance Institute is expected to spend NIS 7.3 billion for these two types of benefits, making them the third-largest component in the aggregate of transfer payments.

The past twelve years may be divided into three periods with respect to these two categories of benefits. The years 1989–1992 were a time of economic slowdown and relatively high unemployment rates of 9.0–11.2 percent. During this period, expenditure for unemployment compensation and the Income Maintenance Law was fairly stable. In 1992, these two variables rose to 9.1 and 5 percent of transfer payments, respectively. Indeed, unemployment reached a record high that year: 11.2 percent.

The 1993–1996 period was one of heady economic growth. During this time, the recorded unemployment rate fell to 6.3 percent (1995). Consequently, unemployment compensation declined in absolute terms compared with the spike in 1992, and its share in transfer payments fell from 9.1 percent in 1992 to 6.3–6.9 percent. However, despite the economic boom, benefits under the Income Maintenance Law continued to rise, reaching levels of close to 5–6 percent of National Insurance payments. By inference, the decline in recorded unemployment during that time of economic growth was partially offset by an increase in chronic unemployment.

The past few years, 1996–2001, witnessed another economic decline that worsened with time. Official unemployment rates rose from 6.5 percent in 1996 to 9 percent in 2001. Unemployment compensation outlays are projected at NIS 3.6 billion (in 2000 prices) in 2002, some 8.6 percent of total transfer payments. The annual average increase in total unemployment compensation in 1996–2002 is 11.6 percent. Concurrently, benefits under the Income Maintenance Law increased substantially. The annual average rate of growth for this period is 15.2 percent. In absolute terms, expenditure for

these benefits rose from NIS 1.6 billion (in 2000 prices) in 1996 to NIS 3.8 billion in 2002. These facts reinforce the claim that the unemployment rates computed and reported by the Central Bureau of Statistics present an incomplete picture that downplays the severity of the problem. There is no doubt that the large rise in benefits paid out under the Income Maintenance Law reflects a substantial increase in the number of people who are chronically unemployed or have given up and dropped out (according to the official statistics) of the labor force.

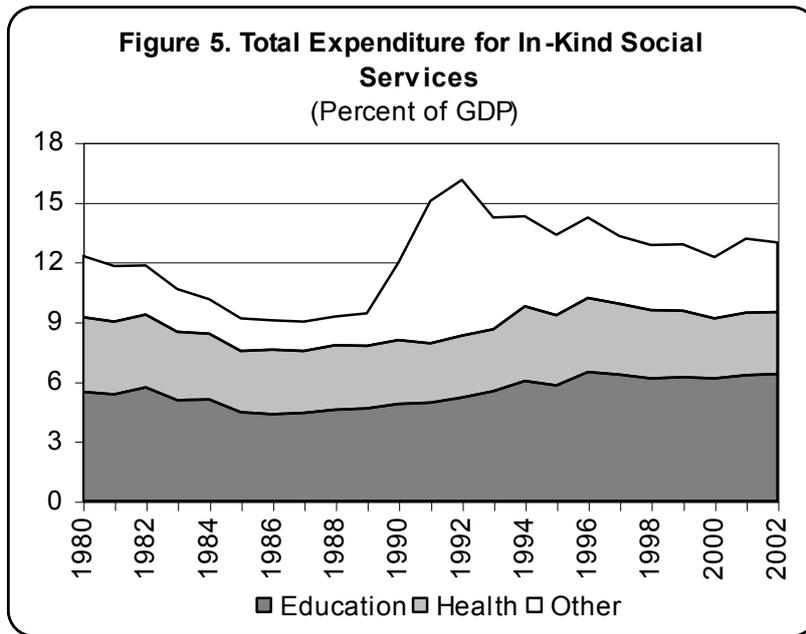
Outlays for disability pensions also increased noticeably in 1996–2001. In 2002, these benefits are projected at NIS 6.2 billion (in 2000 prices), reflecting an annual average increase of 11.3 percent since 1996. This rise may also be related to the deepening recession, which encourages people to drop out of the labor force.

4. In-Kind Social Services

The largest aggregate of expenditure in the state budget is in-kind social services, at a projected NIS 64.0 billion (in current prices) in 2002, about 13 percent of GDP. This aggregate includes government expenditure for education, health, personal social services, employment, immigrant integration, and housing. Until 1991, total expenditure for these services was the second largest item in the state budget, after defense. In 1991, social expenditure climbed sharply, mainly because of the housing needs of immigrants from the USSR. Even after immigration slowed, expenditure for in-kind services continued to oscillate around 13 percent of GDP, while the share of defense spending dropped steadily, falling to 9 percent of GDP in 2001.

Some of the in-kind social services provided by government are also delivered by it (education and health); others are funded fully or in part by government but delivered by nonprofit

organizations and private businesses (education, health, personal social services, and employment). The government is involved in delivering, funding, or subsidizing these services because some of them include public goods, as defined in economic terms; some of them fulfill the function of a safety net; and some of them are important auxiliary factors in the redistribution of income and property and the creation of equal opportunity.



Long-term observations of government expenditure for in-kind services point to mixed trends: the share of such services climbed steadily in the 1970s and peaked at 12.3 percent of GDP in 1980. For comparison's sake, defense spending that year was 22 percent of GDP, and the main components of expenditure for in-kind social services – education, health, and housing – were 5.5, 3.7, and 2.2 percent of GDP, respectively. In the 1980s, as

efforts were made to reduce budget deficits and fight inflation, government expenditure for direct services eroded, as did its main components. The total fell to 9.4 percent of GDP, and spending on education, health, and housing each decreased in absolute terms (in constant prices) as their share of the GDP declined to 4.6, 3.1, and 0.7 percent, respectively.

Table 7. Total Expenditure for In-Kind Social Services, by Main Components (NIS millions, 2000 prices)

| | Total | Education | Health | Personal Services | Employment | Immigrant integration | Housing |
|-----------------------------------|--------|-----------|--------|-------------------|------------|-----------------------|---------|
| 1989 | 29,360 | 14,768 | 9,902 | 2,043 | 334 | 642 | 1,670 |
| 1992 | 53,585 | 18,871 | 11,299 | 2,499 | 347 | 3,040 | 17,529 |
| 1996 | 56,796 | 26,100 | 15,063 | 3,175 | 439 | 1,773 | 10,246 |
| 2000 | 56,059 | 28,116 | 13,861 | 4,191 | 549 | 1,943 | 7,399 |
| 2001 | 58,991 | 28,225 | 13,926 | 4,462 | 600 | 2,052 | 9,726 |
| 2002 | 57,873 | 28,242 | 13,886 | 4,530 | 614 | 1,584 | 9,019 |
| Annual average rate of change (%) | | | | | | | |
| 1989–1996 | 9.9 | 8.5 | 6.2 | 6.5 | 4.0 | 15.6 | 29.6 |
| 1996–2002 | 0.3 | 1.3 | -1.3 | 6.1 | 5.7 | -1.9 | -2.1 |

The trend changed in the early 1990s. Since then, total expenditure for social services has risen in absolute terms almost every year. The year 1992 stands out in this period, as expenditure reached a peak of 16.1 percent of GDP. This was due to immigrant integration needs, especially in housing. That year, expenditure for housing peaked at NIS 17.5 billion (in 2000 prices), 6.2 percent of GDP. The trend in education, the largest component in the aggregate of social expenditure, also reversed direction in the 1990s, particularly in 1993, when the Israeli government declared a change in priorities. Between 1992 and 1996, education spending rose from NIS 18.9 billion (in 2000 prices) to NIS 26.1 billion, an increase from 5.2 to 6.5 percent of GDP.

Table 8. Total Expenditure for In-Kind Social Services
(Percent of GDP)

| | Total | Education | Health | Personal Services | Employ- ment | Immigrant integration | Housing |
|------|-------|-----------|--------|----------------------|-----------------|--------------------------|---------|
| 1980 | 12.2 | 5.5 | 3.8 | 0.6 | 0.1 | 0.1 | 2.2 |
| 1989 | 9.4 | 4.7 | 3.1 | 0.6 | 0.1 | 0.2 | 0.7 |
| 1992 | 16.1 | 5.2 | 3.1 | 0.7 | 0.1 | 0.8 | 6.2 |
| 1996 | 14.2 | 6.5 | 3.7 | 0.8 | 0.1 | 0.4 | 2.7 |
| 2000 | 12.2 | 6.1 | 3.0 | 0.9 | 0.1 | 0.4 | 1.6 |
| 2001 | 13.4 | 6.5 | 3.2 | 1.0 | 0.1 | 0.5 | 2.1 |
| 2002 | 13.3 | 6.5 | 3.2 | 1.0 | 0.1 | 0.4 | 2.0 |

Expenditures on health services are the only major component of government social expenditure that continued to decline throughout most of the 1990s. In the first half of the decade, spending increased by 6.2 percent on annual average, but this rate, although significant, fell short of the rate of increase in total social expenditure (8.7 percent) and in total spending on in-kind social services (9.9 percent). Subsequently, in 1996–2001, public spending on health declined by 1.6 percent on annual average, and the level of expenditure projected in the 2002 budget is similar to that in 2001. Thus, in 2002, health expenditure will total 3.2 percent of GDP, similar to the 1989 level and much lower than that in 1980 (4.5 percent). The erosion reflected by this change is especially great when one recalls that technological improvements and other factors have been raising the costs of health services at a rather vigorous pace.

These and other figures definitely show that policymakers regard education as a public good, in which government has an important role to play, but do not think of health the same way. The government is reducing its involvement in the health system and is allowing the private sector and market forces to play a growing role, with all the social implications that this has.

a. Government Expenditure on Education

There is a broad consensus regarding the importance of government involvement in education. Education may be the most unifying factor between Right and Left, between those who generally oppose government activism and those who favor it, and between those who believe in the efficacy of the market mechanism and those who advocate restrictions on it. Education is perceived as a factor that improves efficiency in the long term, promotes economic growth, and is a necessary condition for the development and application of technological improvements. It also fulfills the social functions of promoting equal opportunity and social mobility. Additionally, education plays an important role in qualitative social improvement, raising social consciousness, raising the level of general knowledge, and improving the performance of democracy as a basic mechanism of social order. Therefore, there is a feeling that it is worth allocating additional resources for education and that an increase in public expenditure delivers a positive net gain.

The Israeli government is expected to spend NIS 31.4 billion (in current prices) for education in 2002, 6.5 percent of GDP. Outlays by local authorities add another percentage point of GDP, bringing total public expenditure for education to 7.4 percent. Private expenditure for education brings total national education expenditure to approximately 9 percent of GDP. According to international comparisons by the World Bank and the OECD, Israel is one of the three or four leading countries in the world in its allocation of resources for education, with respect to both public expenditure and national expenditure. It should be kept in mind, however, that this finding is strongly

**Table 9. Government Expenditure for Education,
Current Budget, by Main Components**
(NIS millions, 2000 prices)

לוח 9 הוצאות הממשלה

**Table 10. Total Current Expenditure for Education,
Per-Pupil Average, by Main Components**
(NIS, 2000 prices)

| | Total | Pre- schools | Primary | Post- primary | Higher education |
|------|--------------|-------------------------|----------------|--------------------------|-----------------------------|
| 1989 | 10,582 | 2,462 | 6,186 | 13,192 | 37,271 |
| 1992 | 12,141 | 2,798 | 7,191 | 13,655 | 37,269 |
| 1996 | 15,539 | 4,339 | 9,628 | 18,504 | 38,215 |
| 2000 | 14,624 | 4,112 | 9,657 | 17,042 | 34,747 |
| 2001 | 14,402 | 4,083 | 9,934 | 16,505 | 30,562 |

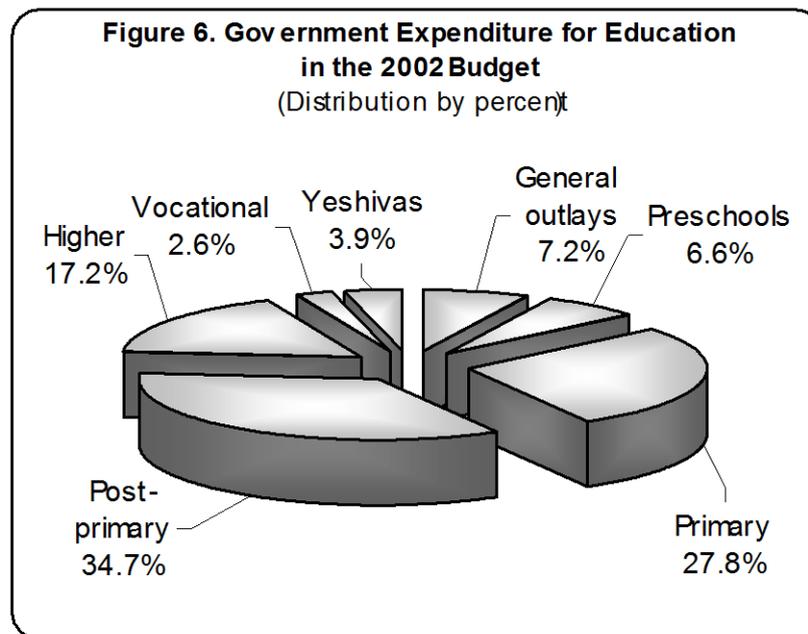
affected by the relatively young age structure of the Israeli population compared with most industrialized countries. Indeed, if the calculations are adjusted to take the size of the student population into account, per-pupil expenditure in Israel resembles the average in OECD member countries.

The 1990s were a time of recovery for the education system, after budget erosion in the 1980s. Government education expenditure shot up in the mid-1990s (1993–1996) from NIS 17–NIS 19 billion (in 2000 prices) at the beginning of the decade to NIS 27–NIS 28 billion at the end. As stated, the turning point was the government's decision in 1993 to realign national priorities. The decision boosted average per-pupil expenditure from NIS 12,141 (in 2000 prices) in 1992 to NIS 15,539 in 1996. In the past few years, government expenditure for education has stabilized: the annual average rate of growth has been only 1.6 percent, meaning that average per-pupil expenditure has been declining.

b. Components of Education Expenditure

Post-primary education is the largest component of government education expenditure. Current expenditure in 2002, about NIS 10.5 billion, accounts for 35 percent of total current

expenditure for education. Like most other components of education spending, this item eroded in the 1980s. The reprioritization in the mid-1990s reversed the trend and increased spending for post-primary education from NIS 6 billion (in 2000 prices) in 1992 to NIS 9–NIS 9.5 billion in 1996–2001. In the past five years the absolute level of expenditure has been relatively stable, despite an increase in post-primary enrollment. Consequently, average per-pupil expenditure at the post-primary level has declined from NIS 18,504 (in 2000 prices) in 1996 to NIS 16,505 in 2001.



The second-largest component is primary education, on which the government plans to spend NIS 7.6 billion (in 2000 prices) in 2002. Primary education, too, experienced impressive budget growth in the mid-1990s: an average of 8.2 percent per year from 1989 to 1996. In the past five years, however, the fiscal restraint policy has led to budget cuts that have reduced

the rate of increase to 2.3 percent on annual average. Nevertheless, because the rate of increase in primary enrollment has declined, average per-pupil expenditure has remained more or less stable at NIS 9,500–NIS 10,000 (in 2000 prices).

Higher education is the third-largest component of government education expenditure. The government allocates about NIS 5 billion to institutions of higher education, covering 73 percent of their current expenditure. In the 1980s the system suffered from a decrease in government resources even though higher-education enrollment increased swiftly. This erosion was partially reversed in the mid-1990s, and since 1996 government expenditure has been stable, with some ups and downs, at approximately NIS 4.5 billion (in 2000 prices). Despite the correction, average government expenditure per higher-education student is still only 62 percent of the 1980 level.

Higher education fulfills a range of economic and social functions in the twenty-first century world. It contributes to the technological changes that have enabled economic growth in recent years, especially in high technology. However, market forces have also brought about substantial increases in the wages of people with higher education, resulting in large income disparities between degree holders and the rest of society. The value question is this: should the state subsidize students in institutions of higher education even though ultimately the market will reward them handsomely for their investment in academic studies? The answer is yes, since, as stated, higher education produces positive external effects from which all of society can potentially benefit. Of course, mechanisms should be set up to enable all of society to benefit from higher education, either directly or indirectly. In this regard, it is important to ensure that capable students from low income backgrounds have maximum access to institutions of higher education. The higher education budget may have to be augmented or redistributed with a focus on increasing access to these institutions. This

would enhance equal opportunity, promote social mobility, improve intergenerational distribution of income, and comply with the principles of social justice.

The smallest component of government education expenditure is early-childhood education. About NIS 1.7 billion (in 2000 prices) was allocated for this purpose in 2001. In the past two decades, policymakers have apparently recognized the importance and the increasing needs of early childhood. Of all components of educational spending, only this one was not affected by the overall erosion in government expenditure that occurred in the 1980s; what is more, it greatly benefited from the “budget generosity” of the mid-1990s. As a result, average expenditure per preschooler has almost doubled, from NIS 2,026 (in 2000 prices) in 1980 to NIS 4,083 in 2001.

c. Government Expenditure for Health

The government plans to spend NIS 15.5 billion (in current prices), 3.2 percent of GDP, on health services in 2002. The large and growing disparity between national expenditure and government expenditure, one of the main issues in this field, is the product of the health policy in the past two decades, as reflected by the budget data. It has been the Israeli government’s consistent policy to reduce government involvement in the health system, especially with respect to funding.

In the early 1980s, government allocations totaled 3.5–3.8 percent of GDP. Over the years, as national health expenditure as a percentage of GDP increased substantially (in Israel and around the world), the share of government spending decreased. The mid-1990s (1994–1997) were an exception. During this period, after years of erosion, government health expenditure rose again to 3.5–3.7 percent of GDP. To some extent, this was part of the reprioritization policy, but it was chiefly due to the health funds’ severe financial crisis, which required government intervention.

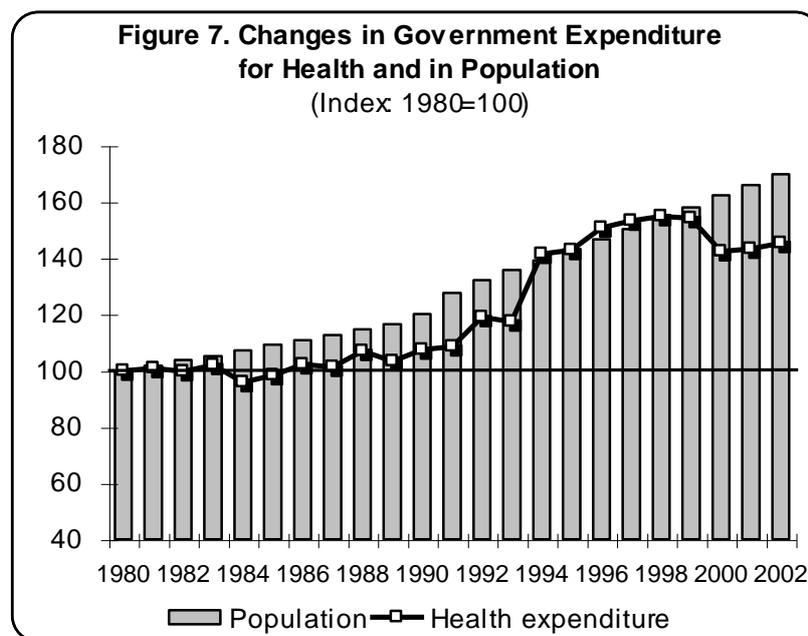


Table 11. Current Health Expenditure, Per-Capita Average, by Main Components (NIS, 2000 prices)

| | 1989 | 1992 | 1996 | 2000 | 2001 | 2002 |
|--|-------|-------|-------|-------|-------|-------|
| Participation in health insurance | | | | | | |
| Total | 2,167 | 2,200 | 2,511 | 2,143 | 2,108 | 2,080 |
| Parallel tax | 1,390 | 1,291 | 1,282 | 0 | 0 | 0 |
| Suppl. Insurance | 159 | 205 | 340 | 1,332 | 1,339 | 1,279 |
| Other transfers | 61 | 27 | 192 | 82 | 88 | 127 |
| Direct expenditure | | | | | | |
| General hospitalization | 29 | 34 | 34 | 25 | 20 | 20 |
| Psychiatric treatment | 131 | 142 | 185 | 165 | 158 | 146 |
| Long-term care | 108 | 106 | 130 | 151 | 154 | 152 |
| Public health | 90 | 90 | 115 | 161 | 125 | 129 |
| Other* | 199 | 303 | 233 | 227 | 224 | 226 |

*Including health expenditure not included in the Health Ministry budget.

The downtrend in government involvement in health services is manifested in changes in per-capita government expenditure. In 1980, the government budget on health amounted to NIS 2,443 (in 2000 prices). This sum then declined steadily and reached a low point of NIS 2,079 per capita in 1991. In the mid-1990s, as stated, the trend stopped temporarily, and in 1996 government expenditure per capita came to NIS 2,511. It has dropped steadily since then and is projected at NIS 2,080 (in 2000 prices) in 2002.

For several years, health care services in Israel have been undergoing a number of concurrent changes. Even as the government was attempting to reduce its involvement in the funding of health care, the State Health Insurance Law was enacted, with a far-reaching impact that is still hard to predict fully. The uncertainty that Israel has encountered in regard to the future organization and financing of health care may be found in almost all Western countries due to the special characteristics of health services. These services have features of public goods and are strongly related to elements of safety net, social justice, ethics, and morality. On the supply side, rapid technological changes and the market forces involved have resulted in delivery costs that are increasing rapidly over time. On the demand side, demographic and social changes are contributing to an increase in the population's medical needs. Consequently, the share of national health expenditure in GDP is rising rapidly. Despite considerable awareness of the need for government involvement due to the special nature of these services, the Israeli government has apparently chosen to reduce its involvement in order to limit the burden this places on the budget. Therefore, it is allowing a rising measure of privatization in the health-care sector, with all the resultant social implications.

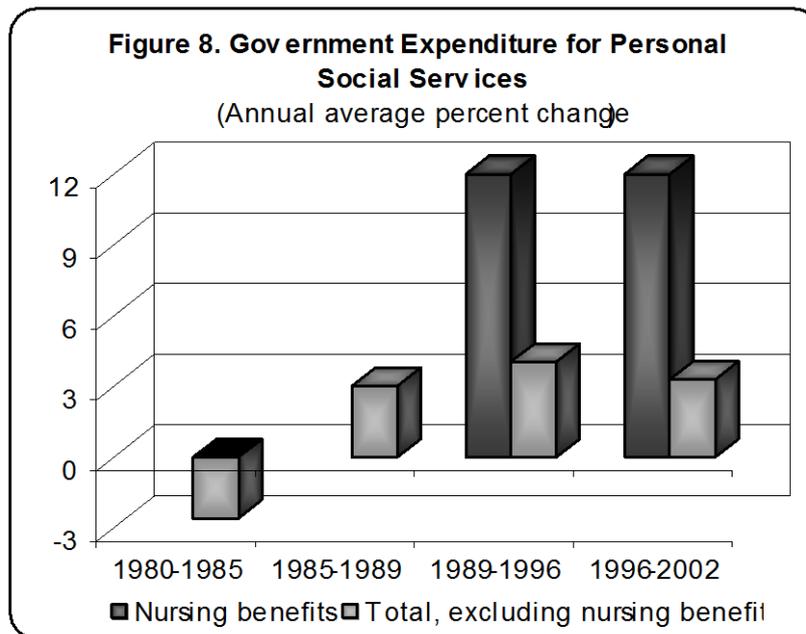
d. Government Expenditure for Personal Social Services

Since the government is the main source of funding for personal social services, fluctuations in government expenditure have a decisive influence on the supply patterns of these services. The budgets for personal services in the 1990s are very different from those of the 1980s. The payment of nursing benefits to eligibles under the Long-Term Care Insurance Law (as of 1988) has had a crucial impact on expenditure trends. When this law went into effect, government expenditure for personal services began to climb rapidly and has continued to do so in recent years. This development has focused primarily on nursing benefits provided by the National Insurance Institute; outlays for services provided in-kind by the government have increased more slowly.

Table 12. Personal Social Services: Total and Per-Capita Expenditure (*Constant prices, 2000*)

| | 1989 | 1992 | 1996 | 2000 | 2001 | 2002 |
|---------------------------------------|-------|-------|-------|-------|-------|-------|
| General expenditure (NIS millions) | 2,043 | 2,499 | 3,175 | 4,191 | 4,462 | 4,530 |
| Expenditure per capita (NIS) | 452 | 488 | 558 | 666 | 693 | 688 |

Government expenditure for personal social services is expected to come to 1 percent of GDP in 2002. This figure has been rising steadily. Until the enactment of the Long-Term Care Insurance Law, about 0.5 percent of GDP was spent on these services annually. Since the law took effect, the sums have increased rapidly, as noted, by an average of 6.5 percent per annum.



The relatively rapid increase in the nursing-care component of expenditure has made the personal social services budget the third-largest component of current social expenditure for in-kind services, after education and health care. This expenditure item is expected to continue to grow with considerable vigor, since it is closely aligned with population increase. Like the incomemaintenance component of social spending, which grew automatically due to demographic changes, the Long-Term Care Insurance Law introduces a similar factor into the costs of its implementation.

The personal services provided directly by the various units of the Ministry of Labor and Social Affairs, or funded by municipal welfare bureaus, also benefited during this period from a substantial injection of additional resources.

Table 13. Government Expenditure for Personal Social Services, 1990–2002: Current Expenditure, Excluding Nursing Benefits
(NIS millions, 2000 prices)

| | Total, excluding nursing | Special population groups | Thereof: | | Children and teenagers | Elderly | Municipal welfare services |
|--------------------|--------------------------------|---------------------------------|----------|----------|------------------------------|---------|----------------------------------|
| | | | Disabled | Retarded | | | |
| 1990 | 1,620 | 541 | 136 | 326 | 400 | 174 | 281 |
| 1993 | 1,818 | 627 | 169 | 362 | 444 | 208 | 316 |
| 1996 | 2,150 | 767 | 224 | 433 | 468 | 242 | 402 |
| 1998 | 2,315 | 856 | 253 | 477 | 528 | 256 | 407 |
| 2001 | 2,662 | 1,074 | 304 | 570 | 572 | 254 | 455 |
| 2002 | 2,597 | 1,083 | 292 | 593 | 540 | 246 | 435 |
| Rate of change (%) | | | | | | | |
| 1990–2001 | 64 | 98 | 123 | 75 | 43 | 46 | 62 |

Between 1990 and 2001, government expenditure for personal social services (excluding nursing care) rose from NIS 1.6 billion (in 2000 prices) to NIS 2.7 billion – an impressive increase of 64 percent. The figure in the 2002 draft budget, NIS 2.6 billion, indicates that this lengthy process – which was partly intended to compensate for the standstill in budgets for personal social services throughout the 1980s – has come to a halt.

The two areas that experienced particularly notable budget increases in the past decade are services for the physically disabled and for the mentally impaired. These two items accounted for a sizable proportion of the personal services budgets in the past, too, and their rapid expansion has boosted their share of total resources. At the beginning of the 1990s, total institutional and community services for aid and treatment of the mentally impaired and the physically disabled together came to 28 percent of total expenditure for personal social

services (excluding nursing); by the end of the decade, this figure was up to 33 percent. In 1990–2002, these budgets increased from NIS 450 million (in 2000 prices) to nearly NIS 900 million.

Budgets for the care of children and teenagers in distress also grew during this period by 43 percent in real terms. After considerable budget erosion – a process that was typical of most of the 1980s – these budgets remained at their reduced level in the first half of the 1990s. Only since 1997 has a major effort been made to augment the resources devoted to these services, which are intended to resolve the personal and social hardships of children and youngsters. The total budget for this service, most of which is used to support away-from-home settings (residential facilities, foster homes, etc.), climbed from NIS 450 million (in 2000 prices) in the first half of the 1990s to NIS 570 million in 2001. The 2002 budget for this service, NIS 540 million, marks the end of the steady growth trend and even points to a slight cutback.

Expenditure for institutional and community care of the elderly rose in 1990–2001 at a rate (46 percent) similar to that of the budgets for care of the population groups at the other end of the age spectrum – children and teenagers – but in a reverse process. Services for the elderly (excluding nursing) grew rapidly and continuously beginning in the mid-1980s, but the trend ended in the second half of the 1990s. Since then, the level has been relatively constant at NIS 250 million. Notably, the increase in this item was facilitated, at least in part, by the injection – by law – of additional resources taken from funds collected by National Insurance under the Long-Term Care Insurance Law and earmarked for the expansion of institutional and community settings for seniors' care.