

Government Expenditure for Social Services

In the past two years, as economic growth resumed and the general economic situation improved, poverty increased and economic gaps widened. Thus, the dilemmas of socio-economic policy remain unresolved: is a pro-growth macroeconomic policy enough to enhance the well being of weak population groups? And if the general improvement does not trickle down enough, or does so at an unsatisfactory pace, how should the government intervene? Should Israel revert to its traditional policy of spending more on social services and transfer payments, or should it take a different approach, more focused and less universal, including significant changes in expenditure targets?

Ideological outlooks influence attitudes toward these questions. Even people who share similar worldviews, however, may disagree due to practical difficulties that originate, among other things, in limitations in identifying and measuring costs and benefits and, primarily in comparing the cost-benefit ratios of different public social outlays. The review that follows strives to establish a factual basis for discussion of a desirable government socio-economic policy. Apart from describing developments and noting main long-term trends, the analysis also makes a partial assessment of the efficacy of the expenditures.

1. The State Budget as a Major Tool in the Implementation of Government Policy

The state budget is a major instrument in the implementation of government policy. The budget that the government presents the Knesset for approval reflects policies and priorities; the final outlay data released at the end of the year give an indication of how the policies were actually carried out. When the plan and the execution do not tally, the discrepancies may indicate that these policies have not been implemented and/or that there has been a deviation from the stated priorities.

**Table 1. Social Expenditure in the Current Budget, 2004
According to Draft Budget, Adjusted Budget, and
Final Expenditure (NIS billions and percent)**

Type of expenditure	Draft budget	Adjusted budget	Final Expenditure	Deviation from:	
				Draft budget %	Adjusted budget %
Total	93.5	92.7	91.3	-2.3	-1.5
Income maintenance	40.5	38.6	38.6	-4.6	0.0
In-kind services	53.0	54.1	52.7	-0.6	-2.6
Thereof:					
Education	29.5	30.1	29.2	-1.0	-3.0
Health care	15.8	16.0	16.0	+1.2	0.0
Personal social services	5.2	5.2	5.3	+0.6	+0.4
Other services	2.5	2.8	2.3	-8.9	-18.3

In 2004, government expenditure for social services again fell short of the programmed level. According to the budget proposal social expenditure in the current budget amounted to NIS 93.5 billion and after mid-year reductions, the final budget figure was NIS 92.7 billion. In practice, social expenditure in the current budget came to NIS 91.3 billion. Thus, the actual expenditure was 2.3 percent under the original plan and 1.5

percent under the adjusted budget (Table 1). These deviations between actual and planned budget outlays, however, were smaller in 2004 than in 2003 (Table 2).

Table 2. Deviations of Final Social Expenditure Implementation, from Proposed Budget and Adjusted Budget, 2004 vs. 2003
(Current Budget, Percent)

Type of expenditure	2004		2003	
	Deviation from Proposed budget	Deviation from Adjusted budget	Deviation from Proposed budget	Deviation from Adjusted budget
Total	-2.3	-1.5	-6.0	-3.2
Income maintenance	-4.6	0.0	-6.1	-2.2
In-kind services	-0.6	-2.6	-5.9	-4.0
Thereof:				
Education	-1.0	-3.0	-5.4	-2.3
Health care	+1.2	0.0	-5.6	-3.8
Personal social services	+0.6	+0.4	-5.5	-3.7
Other services	-8.9	-18.3	-16.0	-25.0

Despite the improvement, it bears emphasis that program and implementation deviations remained significant in 2004. Furthermore, in certain expenditure items the deviations in implementation were even larger relative to the adjusted budget than to the original budget proposal. In other words, during the year urgent needs that warranted budget increases arose but outlays failed to keep up, causing the gaps to widen. Some budget increases are accompanied by more intensive involvement by the Ministry of Finance in execution. This results in less flexibility in budget use and, ultimately, in underutilization of the budgets.

The deviations from original plan were larger in income-maintenance expenditure than in outlays for in-kind services, whereas deviations from the adjusted budget were actually greater in expenditure for in-kind services and, especially, education and items related to immigrant integration (included in the "other services" category).

2. Economic Developments

Economic developments in 2004 moved in opposing directions: the overall economic situation continued to improve while the weak population groups continued to lose ground. This dualism has not yet found sufficient expression in government expenditure policies, be it in the 2005 budget or in the 2006 draft budget.

The expansion of economic activity that began in the middle of 2003 continued in 2004 after two years of negative growth. Gross Domestic Product (GDP) grew by 4.3 percent and business sector product grew by 6.1 percent, as against 1.3 percent and 1.7 percent, respectively, in 2003 (Table 3). On the uses side, exports contributed to growth due to the general expansion of global trade, including trade in high-tech products, and private consumption did the same due to higher disposable income, relative easing of security tension, and an increase in consumer confidence.

The favorable trend persisted in the first half of 2005 as well, with GDP growth projected at 5.1 percent and growth in business sector product at 6.4 percent. The growth estimate for 2006 is somewhat more modest.

The turnaround in the business cycle eventually brought about an improvement in the employment situation. At first, the decline in unemployment lagged behind the expansion of economic activity. Thus, in 2004 the unemployment rate remained at 10.4 percent as against 10.7 percent in 2003. By the last quarter of 2004, however, the unemployment rate had

already fallen to 10 percent and should reach 9 percent in 2005. No less important, the decrease in unemployment coincided with a rise in the labor force participation rate from 54.5 percent in 2003 to 54.9 percent in 2004 and 55.3 percent in the second quarter of 2005.

Employment opportunities also increased due to the replacement of foreign workers by Israelis. The number of Israelis employed increased by 2 percent in 2003, 3 percent in 2004, and (estimated) 4 percent in 2005. Concurrently, the share of non-Israelis among total employed in the business sector fell from 12.3 percent in 2003 to 10.8 percent in 2005 (as against 15 percent in 2000). Nevertheless, in the first half of 2005, the number of non-Israelis employed has risen again.

Wages also increased in 2004; after two years of a cumulative decline of more than 9 percent, real average wages rose by 2.7 percent. The rise in employment, higher average wages, and tax cuts brought about an increase in disposable income from wages of 5.2 percent. At the same time, though, there was a decrease in transfer payments, with the result that disposable income from wages and transfer payments grew by only 3.1 percent.

The positive economic developments were reflected in a rise in the average standard of living. Per-capita private consumption increased by 3.2 percent in 2004 and another 2.3 percent in the first half of 2005, after a 2 percent cumulative decrease in 2002 and 2003. Thus, the average standard of living was about 4 percent higher in 2005 than at the beginning of the decade.

However, due to the unbalanced nature of the economic growth that focused on industries that are skilled labor intensive and due to the government's tax and transfer-payment policies, poverty continued to rise and economic disparities widened steadily despite the overall improvement. For example, in 2004 the unemployment rate among the well educated (16+ years) was 5.3 percent while 16.1 percent of the poorly educated (up to

8 years) were unemployed. Household gross income rose by 2.5 percent in the uppermost decile and decreased by 2.6 percent in the lowest income decile (both rates in 2004 relative to 2003). The gap in consumer spending between households in the uppermost quintile and those in the lowest quintile widened from a factor of 2.4 in 2003 to 2.6 in 2004.

The income distribution data reinforce the estimates about the widening of economic disparities. In 2004, while the Gini index of inequality in distribution of economic income decreased by about half a percent, the index of inequality in distribution of *disposable* income rose by 3.1 percent (3.4 percent not including the population of eastern Jerusalem). Furthermore, the Gini index climbed much more quickly in 2004 than in previous years; the increase this year alone accounted for more than half of the cumulative increase in the past five years. This is largely the result of the steadily decreasing effectiveness of taxes and transfer payments on the easing of inequality in income distribution. Thus, taxes and transfers reduced inequality by 34.5 percent in 2002, by 30 percent in 2003, and by only 27.4 percent in 2004.

The widening of economic gaps is also reflected in the data on the incidence of poverty. In 2004, 20.3 percent of households were under the poverty line in terms of disposable income, as against 19.3 percent in 2003 and 18.1 percent in 2002. What is more, the poor households became poorer: the "poverty gap" (the distance of the average income of poor households from the poverty line) was 33.3 percent in 2004 as against 30.5 percent in 2003 and 29.7 percent in 2002.

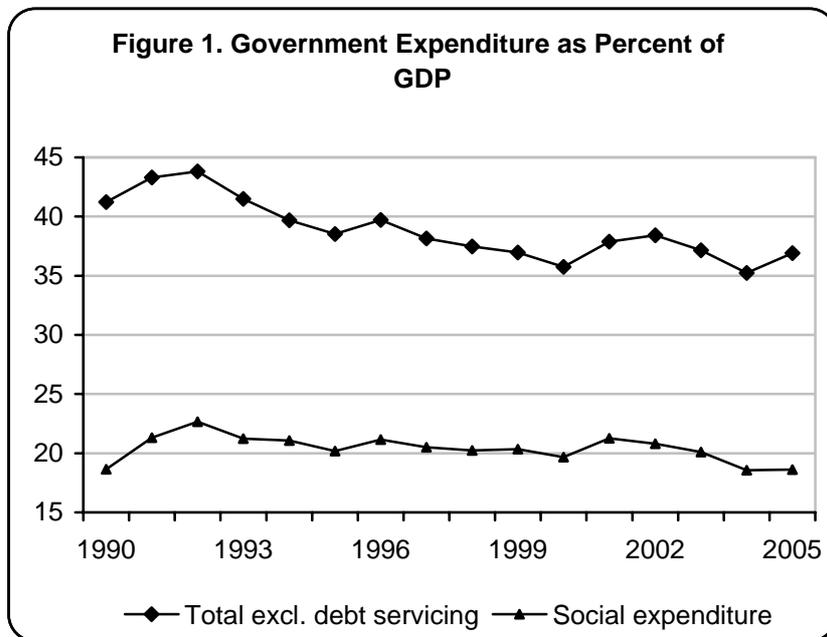
Table 3. Economic Developments – Positive and Negative Indicators (percent)

	2003	2004	2005
Economic growth			
* GDP	1.3	4.3	5.1
* Business sector product	1.7	6.1	6.4
Employment			
* Labor force participation	54.5	54.9	55.3
* Unemployment rate	10.7	10.4	9.0
* Increase in number of Israeli employed	2.0	3.0	4.0
Increase in income and standard of living			
* Real wage per employee post	-3.0	2.7	1.2
* Per-capita private consumption	-1.0	3.2	1.6
Widening of economic gaps and increase in poverty			
* Unemployment rate among:			
High education	5.9	5.3	
Low education	16.6	16.1	
* Change in household gross income:			
Highest decile		2.5	
Lowest decile		-2.6	
* Gini index for disposable income	0.3685	0.3799	
* Incidence of poverty among households	19.3	20.3	
* Poverty gap	30.5	33.3	

Thus, the resumption of economic growth, the improvement in employment, and the increase in income have not yet eased the plight of Israel's weak strata. In fact, the situation of these groups has actually worsened. An economic policy that aims to boost employment and income by means of pro-growth measures alone seems to be insufficient. To improve the welfare of the weak population groups, more direct and focused policy measures are needed.

3. The Government's Expenditure Policy

In 2002 and 2003, the government reduced its spending with the purpose of freeing up resources for the use of the business sector and renewing economic growth. Much of the cutback took place in budget items related to social services, especially current transfer payments. The Ministry of Finance held that government assistance for households creates disincentives to labor force participation and that decreasing support would encourage employment. In the wake of these cutbacks, the share of net government expenditure (excluding debt servicing) fell from 38.4 percent of GDP (2002) to 35 percent (2004) and the relative share of social expenditure fell from 20.8 percent to 18.6 percent in the respective years (Figure 1).



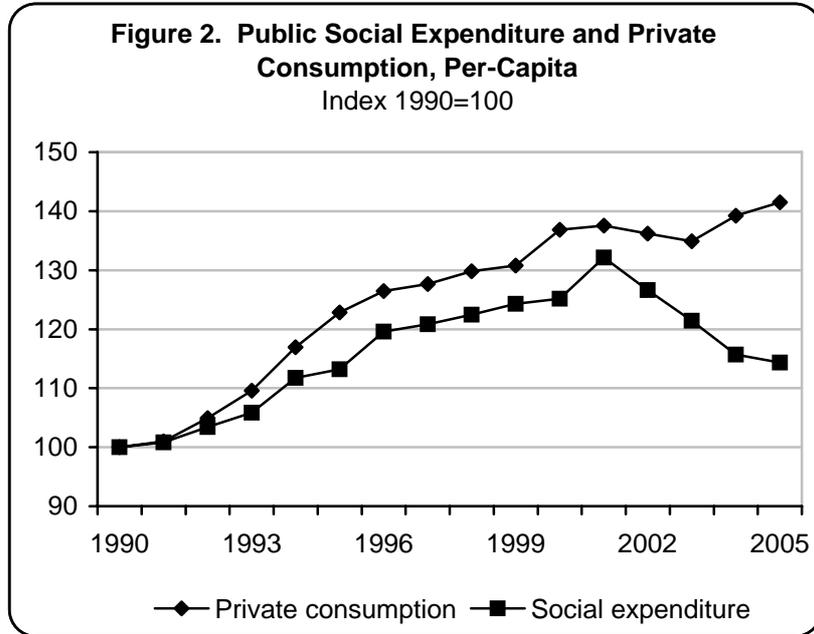
Once economic growth resumed, the government set the consolidation of growth as a principal goal in the coming years and continued to apply a policy of budgetary restraint. In 2005, and in the approved budget proposal for 2006, total expenditure is dictated by two constraints: a real annual increase in spending of one percent and a deficit target of 3 percent of GDP. With higher growth rates, keeping within these constraints is expected to have the effect of reducing the share of government spending in GDP and, thereby, continuing to free resources for the use of the business sector. Furthermore, keeping to these limits will also make it possible to lower the tax burden gradually.

Concurrently, the 2005 budget and the approved 2006 budget proposal speak explicitly of an additional target: strengthening the social fabric of society. Accordingly, in 2005, benefits were increased for elderly citizens who depend solely on income maintenance, the national health insurance budget was raised, and a hot lunch program for children attending a long school day was budgeted. In 2006, the government intends to earmark funds for strengthening the periphery and the Arab sector, curbing violence, and the building of more classrooms. These increases were relatively modest and so despite the declared policy and the budget supplement, the share of social expenditure in GDP remained 18.6 percent in 2005,¹ as in 2004. The contradiction between the declared policy and the data is even more noticeable in view of the expected proportional increase in total net government expenditure excluding debt servicing in GDP.

Without a real change in the composition of the budget, it is doubtful whether a policy that limits the increase in government expenditure to a rate lower than the rate of increase in population can strengthen the social fabric. Transfer payments account for much of the income of the weaker population groups and government's in-kind services figure prominently in their consumption. If the budget constraints are honored and social

¹ Based on the 2005 government budget as adjusted to August 2005.

expenditure is not increased at the expense of other expenditure items, per-capita social spending will decline and inequality and disparities will widen.



A comparison of per-capita private consumption with per-capita government social expenditure serves to illustrate the widening gaps. In the 1990s, per-capita private consumption increased by 31 percent and average per-capita government social spending grew by 24 percent. Since then, in 2000–2004, per-capita private consumption increased by another 6 percent while the government's average per-capita social expenditure declined by 11 percent. These opposing trends created an intolerable gap: whereas per-capita private consumption was about 40 percent higher in 2004 than in 1990, average per-capita government social expenditure increased by only 10 percent during that time.

4. Government Expenditure by Main Areas of Activity

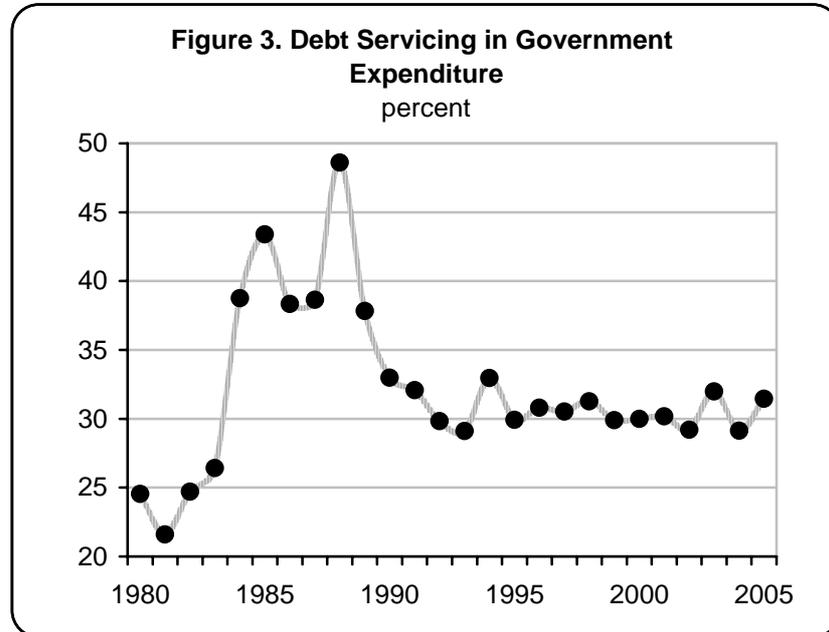
In 2004, 29 percent of government expenditure was earmarked for debt servicing and the rest was divided among social services (52.6 percent), defense (24.6 percent), and economy and administration (22.8 percent). In 2005, the share of *disposable* government expenditure (i.e. expenditure net of debt servicing) decreased, and within this, the proportion of social expenditure declined and that of economy and administration increased.

Table 4. Distribution of Government Expenditure by Main Areas of Activity (Percent)

	1985	1992	2001	2003	2004	2005
Total	100.0	100.0	100.0	100.0	100.0	100.0
Debt servicing	43.4	29.8	30.2	32.0	29.1	31.5
Disposable expenditure	100.0	100.0	100.0	100.0	100.0	100.0
Social services	32.1	51.7	56.1	54.1	52.6	50.4
Defense	40.2	26.1	23.6	24.3	24.6	24.9
Economy and administration	27.7	22.2	20.3	21.6	22.8	24.7

From a long-term perspective, the share of social services in disposable government expenditure has been rising steadily since the middle of the 1980s. In 1992, for the first time, it accounted for more than half of disposable government expenditure and reached a peak of 56 percent in 2001. The trend turned around in 2002; by 2005 social spending reverted to about half of disposable government expenditure. The proportional increase in social expenditure occurred mainly at the expense of defense spending whereas the decline in recent

years has been accompanied by a relative increase in spending for economy and administration.



Debt Servicing

Obviously, the less a government has to spend on its debt – principle and interest – the more it can allocate for other activities. The government debt, in turn, is a function of the budget deficit and how it is financed. Israel's vigorous policies on limiting the budget deficit, applied since the middle of the 1980s, caused the ratio of debt to GDP to drop sharply – from 200–300 percent in the early 1980s to 90 percent in 2000. Consequently, the proportion of debt servicing in total government expenditure also fell, from 43 percent in 1985 to 30 percent in 2000. The trend turned around in 2001 and the debt to GDP ratio rose to 107 percent by 2003. In 2004, the budget

deficit contracted, allowing the debt to GDP ratio to fall back to 105 percent.

The effect of changes in the size of the government debt on debt-service expenditure is not limited to the year in which the change takes place; it spreads over time. Therefore, the increase in debt at the beginning of the decade induced a downward trend in the disposable share of government expenditure: from 71 percent in 2004 to 68.5 percent in 2005 and, according to the budget proposal, 65 percent in 2006.

Defense

Defense expenditure peaked in the mid-1970s. In the 1980s and the early 1990s, its share in disposable government expenditure declined significantly: from about 40 percent in 1980 to 24 percent in 1994. Since then, it has been more-or-less constant at around one-fourth. In recent years, however, the level of defense aid from the United States has risen (due to the reassignment of some American economic aid to defense), creating the possibility of freeing more *local* currency resources from defense to other activities. Thus, the proportion of defense expenditure in local currency has contracted more than the data on total defense spending indicate.

Economy and Administration

Economy and administration expenditure includes a wide variety of activities – from economic incentives to encourage capital investment, research and development, exports, agricultural and other subsidies to maintenance of public order and law enforcement, environmental protection, advancement of Israel's foreign relations, and more.

The share of economy and administration in disposable government expenditure fell from more than 30 percent in the early 1980s to about one-fourth at the end of that decade. There was a further decline in the 1990s but in recent years there has

been a rise. In 2001 and 2002, about one-fifth of total disposable expenditure was allocated and in 2005 the figure was back to around one-fourth. Since the share of defense expenditure was stable, the relative increase in economy and administration expenditure came at the expense of social spending.

Since there appears to be a substitutability effect between economy and administration expenditure and social expenditure, the recent upward trend in the former group deserves further investigation. First, the increase was divided more-or-less equally between the current budget and the development budget. Second, in the current budget, the main contribution to the increase was made by expenditure items related to public security as well as pension and severance payments to retired civil servants. Third, most of the increase in the development budget concentrated on investments in development of roads and railroads.

Social Expenditure

Social expenditure finances services that the government provides to the public in-kind, services provided to the public by other public and private institutions with full or partial government funding, and various social transfer payments via the National Insurance Institute. In-kind government social services include education, health care, personal social services, public housing, and assistance for recent immigrants. The main transfer payment programs are child allowances, old-age and survivors' pensions, benefits for persons with disabilities, unemployment compensation, and income maintenance.

In 2004, social expenditure came to NIS 97.7 billion, most of which – 93 percent – was from the current budget. In 2002–2004, real social expenditure decreased by 11 percent in cumulative real terms: 3.4 percent in 2002, 2.4 percent in 2003, and 5.1 percent in 2004. This steep relative decline came after a

continuous rise since the middle of the 1980s (5.5 percent on annual average in 1984–2001). In 2005, real social expenditure seems to have grown by 2.5 percent, largely due to an increase in housing investment. If this upturn actually occurred, expenditure will have recovered to the level of about five years ago. However, in recent years there have been significant discrepancies between the budget plan and final outlays (see Section 1 above). A similar discrepancy in 2005 would continue the downtrend in government expenditure this year, as well.²

5. Social Expenditure: In-Kind Services and Transfer Payments

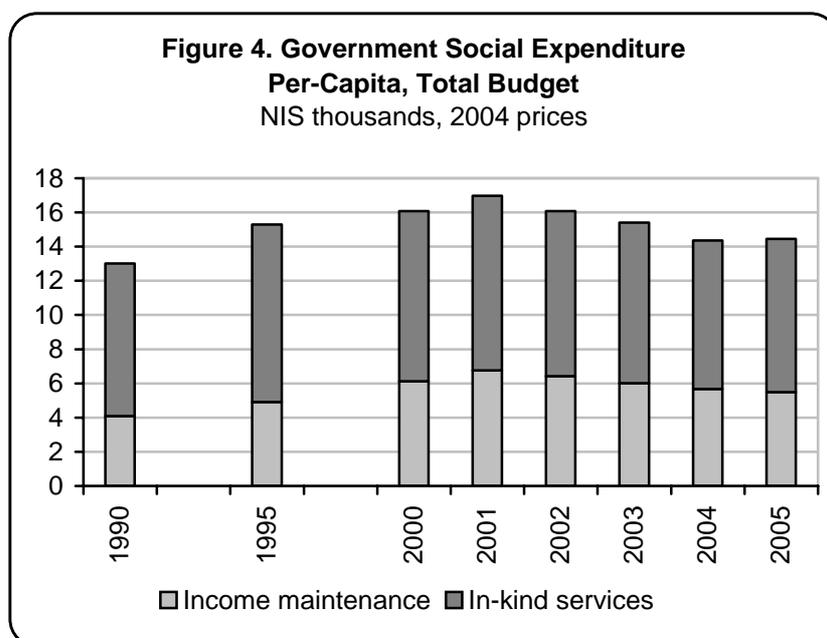
Social expenditure is divided between in-kind services and transfer payments. While the latter fall under the purview of government ministries and are fully included in the state budget, most transfer payments are made by the National Insurance Institute and the state budget is charged only for the difference between total outlays and National Insurance receipts from contributions (premiums charged to the public). To obtain a full picture of the social expenditure, the discussion that follows (and the data in the Appendix) addresses itself to total transfer payments from government to the public, including the National Insurance Institute.

Thus defined, social expenditure in 2005 was NIS 100 billion – NIS 62 billion for in-kind services and NIS 38 billion in transfer payments. This marks an increase of NIS 2.5 billion from the previous year but a 9 percent decline relative to 2001. In real per-capita terms, expenditure fell by 14.8 percent – from NIS 16,970 in 2001 to NIS 14,461 in 2005.

² It is important to note that the gap between planned and actual final outlays in the development budget of the Ministry of Construction and Housing tends to be especially large and explains most of the increase.

Table 5. Government Social Expenditure
(NIS billions, 2004 prices)

	Total	In-kind services	Transfer payments
2001	109.3	65.8	43.5
2003	103.0	62.8	40.2
2004	97.7	59.1	38.6
2005	100.1	62.1	38.1
Per-capita expenditure (NIS)			
2001	16,970	10,218	6,751
2003	15,397	9,394	6,003
2004	14,351	8,684	5,667
2005	14,461	8,964	5,497



Over the years, there has been a general downward trend in the share of expenditure for services and, in contrast, an increase in the share of transfer payments (Table 6). A striking deviation from the overall trend occurred in the early 1990s due to the need to provide public housing for hundreds of thousands of new immigrants from the former Soviet Union. During the rest of that decade, the proportion of in-kind expenditure decreased by 11 percentage points and that of transfer payments increased proportionately. In recent years, in-kind expenditure has accounted for about 60 percent of total government social spending and transfer payments for about 40 percent.

The changes in the composition of social expenditure reflect major differences in the development of each component in the 1980s and 1990s (Table 7)³. Expenditure for in-kind services was more-or-less stable during the 1980s, rose steeply in the first half of the 1990s (mainly due to immigrant integration needs), and remained stable in the second half of the 1990s. In contrast, real expenditure for transfer payments has increased continuously for two decades. Thus, while real in-kind expenditure doubled between the beginning of the 1980s and the start of the twenty-first century, transfer payment outlays more than quadrupled. In 2002–2004, contrary to widely held assumptions, the cutbacks in social spending reduced both components in equal measure.

³ Real changes were calculated in expenditure for in-kind services by deflating the nominal data by the Public Consumption Price Index; for transfer payments the Consumer Price Index was used.

Table 6. Social Expenditure by Main Components (Percent)

	Total	In-kind services	Transfer payments
1980	100.0	69.3	30.7
1989	100.0	57.6	42.4
1992	100.0	71.1	28.9
2001	100.0	59.6	40.4
2002	100.0	59.0	41.0
2003	100.0	60.1	39.9
2004	100.0	60.5	39.5
2005	100.0	62.2	37.8

Table 7. Main Components of Social Expenditure
(Index: 1980=100)

	In-kind services	Transfer payments
1980	100	100
1989	99	175
1996	190	271
2001	197	405
2004	177	359
2005	186	354

6. In-Kind Social Services

a. Trends in Total In-Kind Expenditure

Total expenditure for in-kind social services was NIS 62 billion in 2005 as against NIS 59 billion in 2004 and NIS 66 billion at the beginning of the decade. The largest item in this aggregate is education, on which approximately NIS 31 billion was spent.

Table 8. Expenditure for In-Kind Social Services
(NIS billions, 2004 prices)

	Total	Education	Health care	Personal social services	Other
2001	65.8	32.6	16.2	5.0	11.9
2003	62.8	31.7	15.7	5.4	10.1
2004	59.1	29.7	16.1	5.3	8.0
2005	62.1	30.5	16.4	5.3	9.8
Per-capita expenditure (NIS)					
2001	10,218	5,071	2,515	783	1,849
2003	9,394	4,731	2,350	804	1,509
2004	8,684	4,361	2,368	777	1,179
2005	8,964	4,408	2,373	768	1,414

The changes in the composition of expenditure for in-kind services (Table 9) were strongly affected by the mass immigration of the early 1990s. The increase in expenditure for immigrant integration, especially in government investment in housing, found expression in a proportional increase in expenditure on the “other services” aggregate, which includes, the budgets of the Ministry of Construction and Housing and the Ministry of Immigrant Absorption. The influence of this component has been decreasing in recent years. Excluding the impact of mass immigration, the share of education expenditure has been remarkably stable (at about half of the expenditure on

services in the 1980s and the early 1990s), that of health care expenditure has been falling, from about one-third of expenditure on services in the 1980s to roughly one-fourth in the early 2000, and that of the personal social services has been rising somewhat, especially since the mid-1990s.

Table 9. Components of In-Kind Social Service Expenditure (Percent)

	Total	Education	Health care	Personal social services	Other
1985	100.0	48.5	33.7	5.2	12.6
1989	100.0	49.4	33.1	6.8	10.7
1992	100.0	32.3	19.1	4.2	44.4
1995	100.0	43.5	26.3	5.8	24.4
2001	100.0	50.0	24.8	7.7	17.5
2002	100.0	49.8	25.4	8.7	16.1
2003	100.0	50.4	25.0	8.6	15.9
2004	100.0	50.2	27.3	8.9	13.6
2005	100.0	49.3	26.5	8.6	15.7

b. The Share of Government in National Education and Health Care Expenditure⁴

National education expenditure is composed of spending for all public and private education institutions from preschool to higher education; household outlays for private tutoring, textbooks, etc.; and investment expenditure for the building and equipping of new educational institutions. National health care expenditure includes spending for all health care services provided at clinics and hospitals, the services of private physicians and dentists, medicines and medical equipment, government health care administration, health care research, and

⁴ The data in this section are based on definitions and estimates of the Central Bureau of Statistics; they may differ from data in other sections of this survey that are based on Taub Center calculations.

investment in the construction and equipping of health care facilities. The funding of national expenditure for education and health care is divided between the government sector, including local government, and the household sector.⁵

According to estimates by the Central Bureau of Statistics, the proportion of gross national income spent on education has climbed from 8.5 percent in the late 1980s and early 1990s to approximately 10 percent since 1996. During this time, the share of government in funding has fluctuated: from 76 percent in the late 1980s to 80 percent in the mid-1990s and back to 78 percent in 2001–2003.

The share of GDP spent on health care was 7.9 percent in the mid-1990s, 8.6 percent in 2002, and 8.3 percent in 2004. During this time, the proportion of total national health care expenditure financed by government has declined – from 75 percent in 1996 to 67 percent in 2000, and remains unchanged from then until 2004.

The increase in total national expenditure for education and health care on the one hand, and the proportional decline in government funding for these services on the other hand, has led to a significant increase in household outlays for education and health. This development – the “privatization” of education and health care funding – increases the danger of widening inequities in the use of these services. Indeed, at least in respect to health care, surveys by the Taub Center indicate that a rather large share of the population refrain from using some essential medical services due to its cost to the user. At the same time, some of the added private expenditure for education was a result of the expansion of the higher education system (the establishment of colleges, etc.) and reflected an increase in accessibility to higher education.

⁵ In recent years, about 3 percent of national education and health care expenditure has been covered by donations or from unknown sources.

c. Education

Expenditure on education is the largest item in government spending for in-kind social services. In 2004, the government spent NIS 29.7 billion on education, about NIS 2 billion less than in 2003, which represented a real decrease of 6.2 percent. The projected expenditure in 2005 is NIS 30.5 billion, reflecting – if it comes to pass – a 2.8 percent real increase relative to 2004.

The decline in government education expenditure in 2004 marks the continuation of a trend that began in 2002 and has brought about a 9 percent cumulative real decrease. Until then, government education expenditure had risen steadily from the mid-1980s. From 1987 to 2001, real government education expenditure increased at an average annual pace of 5.3 percent. Growth was especially vigorous from 1989 to 1996, at 8.2 percent per year, as pupils who had come in the mass immigration of the early 1990s were being admitted to the education system. Since 1997, the growth rate has been slowing and the average annual rate has been only 2.4 percent.

The following discussion focuses on two main aspects: changes in priorities and developments in the quality of education.

The government's priorities in education may be observed by examining the distribution of current expenditure (Table 10). The distribution has been largely unchanged for the past decade and a half. The only perceptible change was an increase in the share of spending for preschools, reflecting the extension of compulsory education to the 3–4 age cohort. Another change, a proportional decrease in spending for *yeshivot* (institutes of religious learning), is most certainly due to the elimination of redundancies that occurred when their budgeting was transferred from the Ministry for Religious Affairs to the Ministry of Education. The long and relatively stable period in distribution raises the possibility that the trend in expenditure has been

affected mainly by natural (demographic) developments and that policies and priorities have had only limited influence.

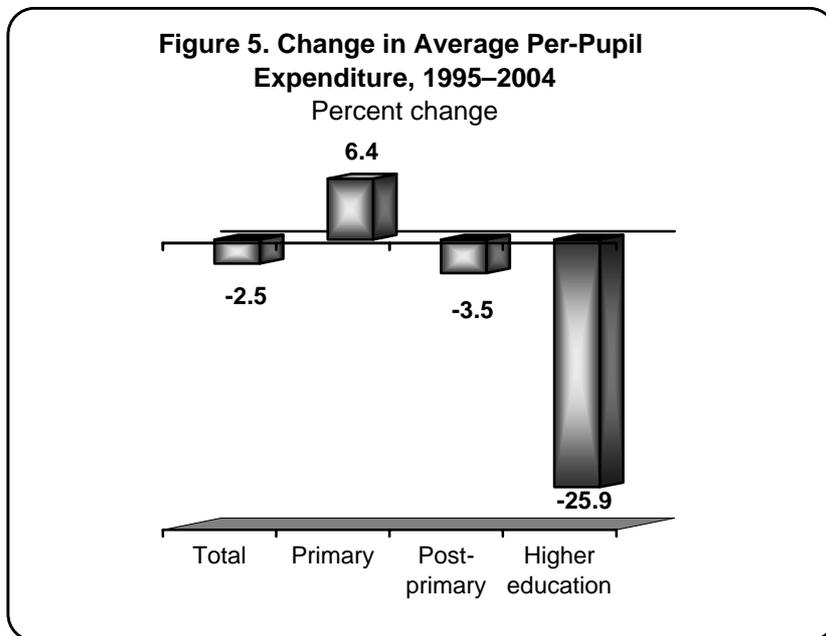
Table 10. Distribution of Current Education Expenditure by Main Components (Percent)

	1990	1995	2000	2004	2005
Total	100.0	100.0	100.0	100.0	100.0
General expenditure	7.8	7.1	7.0	6.8	7.5
Preschool	4.9	4.6	6.1	7.7	7.4
Primary	26.7	28.5	26.4	28.7	28.3
Post-primary	34.5	34.6	35.5	35.9	33.8
Higher education	17.2	17.4	18.3	16.6	18.6
Vocational training	3.1	3.0	2.6	2.2	2.4
<i>Yeshivot</i>	5.8	4.8	4.1	2.1	1.9

Another aspect of priorities pertains to the distribution between the current budget and the development budget. The development budget includes expenditure for the construction, renovation, and equipping of schools, i.e., expenditure related to adjustment of the physical infrastructure of the education system for the future. In recent years, only 2–3 percent of total government education expenditure has been devoted to investment outlays. In absolute terms, in constant 2004 prices, development expenditure has been NIS 1.1 billion on annual average in 1998–2001, NIS 815 million on annual average in 2002–2003, and NIS 497 million in 2004. The declining level of investment, low to begin with, raises the fears that the future is being neglected. Considering the natural increase of the pupil population, a dangerous gap between needs and available infrastructure may develop and have a negative impact on the quality of education. It is true that investment is expected to double in 2005 and that the 2006 budget proposal speaks explicitly of the need to build classrooms, especially in the Arab

sector. Again, however, the experience in recent years points to considerable discrepancies between planning and implementation.

Current per-pupil average expenditure, in constant prices, may be considered a rough overall indicator of quality of education. Data on the change in average per-pupil expenditure in the past decade in general, and by levels of education in particular, are shown in Figure 5. Since the average expenditure increase may reflect a greater increase in the actual prices of inputs than that reflected in the general price index, partial data are also used to examine the change in average classroom hours per pupil and are also shown.



Average per-pupil expenditure decreased in the system at large, mainly due to a sharp decline in average per-student expenditure in higher education. In the past decade, higher-education enrollment increased by some 60 percent, mostly in

colleges and other new educational settings that cost less per student than the older, well-established universities. Thus, the decrease in average per-student expenditure in higher education may reflect a change in the mix of students and not necessarily a decline in the quality of education. At the primary level, the average per-pupil expenditure increased by 6.4 percent and average hours per pupil rose even higher, by 7.2 percent – which could indicate an improvement in quality and efficiency. Finally, at the post-primary level, although average per-student expenditure decreased, average per-student hours rose by 5.2 percent. Here again, efficiencies may have helped to prevent a decline in the quality of education. The downward trend in average per-student expenditure is projected to have continued in 2005.

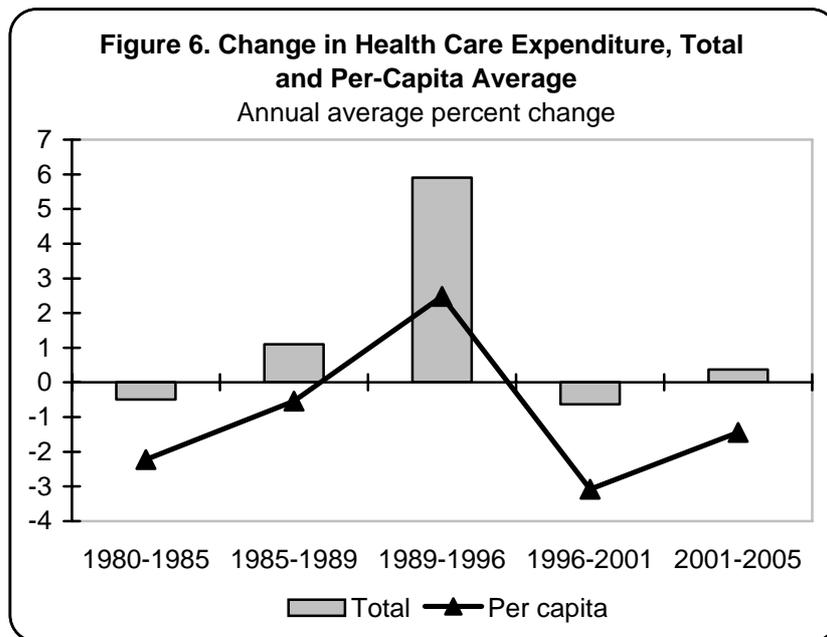
d. Health Care

Government expenditure for health care came to NIS 16.1 billion in 2004, up 2.6 percent in real terms from 2003. Expected expenditure in 2005 is NIS 16.4 billion, marking another real increase of 1.8 percent.

From a long-term perspective, government health expenditure can be divided into three periods since 1980. The first ten years, 1980–1989, were noted for stability. The next seven years, 1990–1996, witnessed rapid growth as expenditure attained a plateau that was more than 50 percent higher. Since then, for nearly a decade, expenditure has remained at the new level, with minor fluctuations (with the exception of a 6.2 percent decrease in 2000 versus 1999).

If expenditure remains constant for years, average per-capita expenditure must decrease. Furthermore, the prices of health care services have tended to rise more quickly than those in the general price index. For example, in 1997–2004 (the third period listed above), the cumulative increase in the price of a day of inpatient care was more than 8 percent higher than the

general Consumer Price Index. The combined effect of these factors – stability in expenditure, population increase, and the rise in relative prices of health care services – allows an estimate that government funding for health care services to the public has been eroded by at least 25 percent since 1997.⁶



Government expenditure for health care includes investments in buildings and equipment. From 1993 to 1997 the investments stood at some NIS 655 million (in 2004 prices) and decreased to NIS 357 million a year in 1998–2002 and to only NIS 180 million in 2003–2004. In recent years, investments are 1–2 percent of total government health expenditure. If the level of investment is too low, the physical infrastructure of the health

⁶ During the review period, the price index of health care services (included in the Consumer Price Index) rose by roughly 16 percent more than the total CPI.

care system erodes, as noted in regard to the education system, and is likely to result in poor quality services in the future.

Current expenditure is divided between government participation in health insurance – effectively, government funding for health care services delivered by non-governmental institutions – and expenditure for health care services provided directly by the government. Over the years, the share of the former has declined and that of the latter has risen (Table 11). Some of the decrease in transfers to other institutions is the result of the elimination of the “parallel tax” (paid by employers) in 1997.

Table 11. Distribution of Current Expenditure on Health Care, by Main Components (Percent)

	1990	1995	2000	2004	2005
Total	100.0	100.0	100.0	100.0	100.0
Participation in medical insurance	71.2	70.0	66.0	67.2	67.8
In-kind expenditure	28.8	30.0	34.0	32.8	32.2
 Total	 100.0	 100.0	 100.0	 100.0	 100.0
General hospitals	10.0	11.9	3.4	3.5	2.8
Psychiatric care	21.9	23.2	22.6	25.2	26.7
Long-term care	17.1	17.2	20.8	24.5	22.6
Public health	14.0	17.2	22.1	18.6	16.4
Misc.*	37.0	30.5	31.1	28.1	31.5

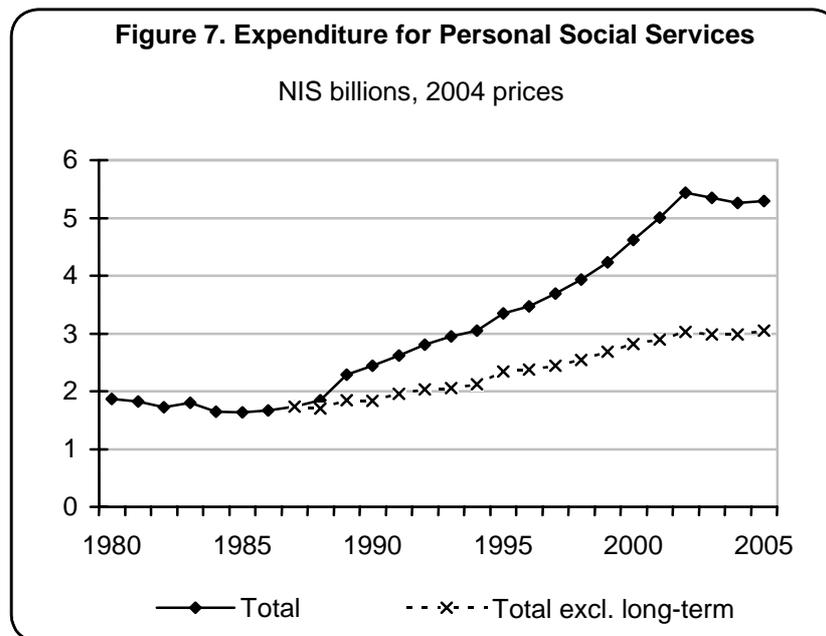
* Including health care expenditures outside the Ministry of Health budget, mainly National Insurance Institute outlays for maternity hospitalization, treatment of workplace accidents, etc.

Within the broad category of in-kind expenditure, spending for general hospital services has declined markedly and two major expenditure items – psychiatric care and long-term care – have increased moderately. The changes in the distribution of

expenditure indicate that the focus is on special health care services.

e. Personal Social Services

The Ministry of Social Affairs and local authority welfare departments administer personal social services. In 2004, government expenditure for these services came to NIS 5.3 billion, 1.5 percent less in real terms than in 2003, after a similar real decrease in 2003 versus 2002. In 2005, no real change in expenditure for these services is expected. In the 1980s, until the Long-Term Care Law was enacted in 1988, expenditure was around NIS 1.7 billion per year (in 2004 prices) with no significant annual fluctuations. There has been a steady increase since then and the annual level of expenditure has roughly tripled.



Government expenditure for personal social services is divided into two main components: long-term nursing care benefits (which represents around 43 percent of today's total) and other services, including social services for children and youth, geriatric care, care of special population groups (inactive youth, persons with disabilities, and the mentally retarded), and social and community services for individuals and families.

7. Transfer Payments – the National Insurance System

For more than two decades, until 2001, transfer payments to the public, via the National Insurance Institute, increased continuously. An abrupt turnaround took place in 2002, as cutbacks in benefits, revision of the eligibility rules, and tougher enforcement brought the level of expenditure down. Expenditure in 2005 was NIS 38 billion, down 12.4 percent in real cumulative terms from its peak in 2001.

The rates of decrease from the peak year to 2005 varied among the different programs (Table 13). There were especially large cumulative decreases in child allowances (45 percent), unemployment compensation (48 percent), and income-maintenance (26 percent). In contrast, general disability benefit outlays increased. The cumulative data show that the decrease was primarily in child allowances (67 percent of the total decrease in transfer payments) and unemployment compensation and income-maintenance benefit (50 percent).

Table 12. Expenditure for Transfer Payments

(NIS billions, 2004 prices)

	Total	Old-age and survivors	Children	General disability	Unemployment and income maintenance	Other
2001	43.5	16.1	8.0	6.3	7.4	5.7
2003	40.2	15.5	6.1	7.0	5.6	5.9
2004	38.6	15.8	4.8	7.1	5.0	5.9
2005	38.1	15.9	4.4	7.3	4.7	5.7

Per-capita expenditure (NIS)

2001	6,751	2,501	1,247	971	1,153	880
2003	6,003	2,315	906	1,052	844	886
2004	5,667	2,317	704	1,044	741	861
2005	5,497	2,301	636	1,055	679	825

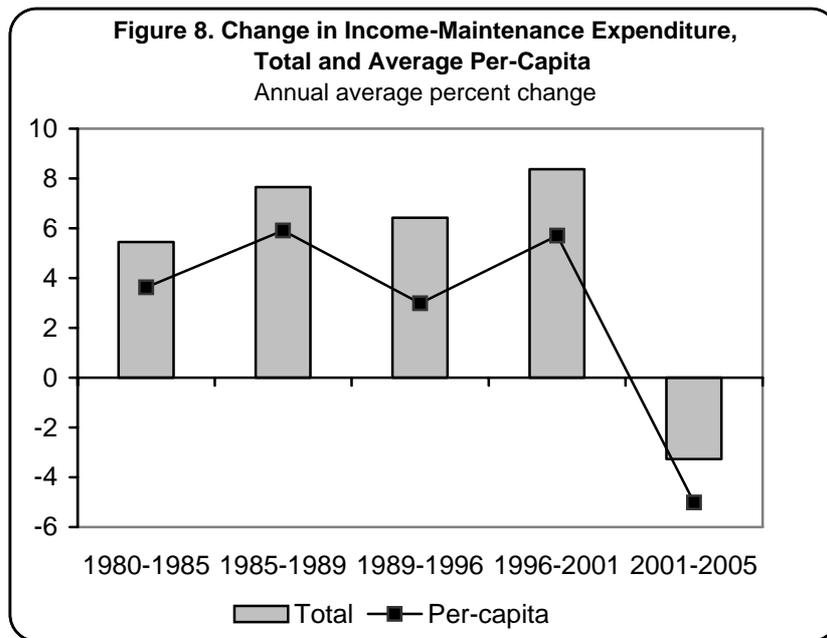


Table 13. Distribution of Decrease in Transfer Payments – 2005 vs. 2001 (Percent)

	Relative share	Cumulative change
Total	100.0	-12.4
Old-age and survivors	3.1	-1.0
Children	66.9	-45.1
General disability	-19.4	+16.8
Unemployment and income maintenance	50.2	-36.6
Thereof:		
Unemployment	32.8	-47.7
Income maintenance	17.5	-25.5
Other	0.9	-0.8

The primary motivation in making these cutbacks in transfer allowances (as noted in Section 3) was to reduce government outlays and cut the budget deficit, as well as the belief that personal and household subsidies by government create disincentives to labor force participation and economic activity. Since the amount of the benefits and the eligibility rules are set by law, the government had to allocate ever-increasing budgets for transfer payments each year, if only for demographic reasons (population increase, including immigration, and changes in population composition). Liberal interpretation and generous application of the eligibility rules, on the one hand, and an increase in the public's awareness of its rights, on the other hand, contributed to this development. Thus, the real growth rate of social transfer payments rose from 6 percent on annual average in the 1980s to 8 percent in the 1990s until 2001. Gradually, transfer payments became a heavy burden on the budget. Their share in government expenditure, in current prices, rose from 7 percent in 1980 to 11 percent in 1990 and 16 percent in 2001. Against this background, it was increasingly believed that only by changing the policy on transfer payments

could government expenditure be trimmed and the budget deficit lowered to the acceptable levels that characterize stable economies. Concurrently, as economic growth stopped and the unemployment rate grew, it was claimed that the transfer payments were making it less worthwhile for people, especially those of low income, to work. In particular, they pointed to the steep increase in the number of income-maintenance recipients of working age: from about 9,900 households in 1982, when the Income Maintenance Law went into effect, to 32,000 in 1990 and 155,000 in 2003.

Although the rationales in favor of arresting the rapid increase in transfer payments are substantial, one cannot ignore the socioeconomic price of the cutbacks that were made. Transfer payments together with the tax system are meant to impact on the inequality in the distribution of national income. As noted previously, the effect of taxes and transfer payments on the Gini index of income distribution inequality has been diminishing in recent years. Indeed, the contribution of taxes and transfers to reducing the index dropped from 32.5 percent in 2001 to only 27.4 percent in 2004. Their contribution to reducing the incidence of poverty has also fallen: in 2001, the number of poor households as measured by the criterion of disposable income was 47.5 percent lower than the number of poor households according to economic income; in 2004, the figure was only 40 percent.

Furthermore, transfer payments function as a social safety net, i.e., they should assure the weak population groups – the elderly, persons with disabilities, and the unemployed, for example – a minimum level of income that corresponds, at an appropriate ratio, to the national standard of living. Thus, the effect of reducing transfer payments should be tested not only in absolute terms but also in relative terms, taking into consideration developments in the benefit recipients' environment.

For this purpose, a calculation was made of the relationship between the various transfer payments, on per-recipient average, and the average standard of living, as reflected in per-capita private consumption, at three points in time (Table 14). At the first point, 1989, the impact of mass immigration from the former Soviet countries had not yet made an impact. (For reasons of data availability, the first point of reference for child allowances is 1990, and for unemployment compensation is 1991.) The second point in time is 2001, preceding the government decision that changed the long-term trend in transfer payments; the third is 2004, the latest year for which full budget implementation data exist. The changes in these ratios are shown in index terms, with 1989 as the base year.

Table 14. Average Benefits Relative to Average Standard of Living (Percent)

	1989	2001	2004
Old-age and survivors	100	92	83
Children	*100	76	43
General disability	100	106	104
Unemployment compensation	**100	111	111
Income maintenance	100	94	71
* 1990			
** 1991			

In all benefits except for unemployment compensation, the ratio calculated was lower in 2004 than in 2001. Furthermore, in regard to old-age and survivors' pensions, child allowances, and income maintenance, the calculated ratio was lower in 2004 than in the base year. The decrease was especially marked in child allowances and income-maintenance benefits. Although these rough calculations are not without drawbacks, they lead inevitably to the conclusion that the cutbacks conflict with the relativity concept described above.

The largest item among the transfer payments is **old-age and survivors' pensions** (Table 15). The level of expenditure on this account is largely a function of the size of the elderly population and the proportion of elderly who receive the benefit. In the 1990s, the upward trend in expenditure was influenced by an influx of seniors during the period of mass immigration, many of whom were entitled to income supplements to their basic pensions. The decrease in expenditure since 2002 reflects the 4 percent across-the-board reduction in the size of the benefit, raising of the age of eligibility, greater use of income tests, and the indexing of the benefit to the Consumer Price Index instead of the national average wage. Against this, the number of benefit recipients increased.

In most years, **child allowances** ranked second among income maintenance programs. In the 1990s, expenditure for this item increased due to three main changes: reinstating the child allowances for first and second children in the household, eliminating the criteria that reduced allowance levels for non-army "veteran" families, and the Large Families Law. The decisions that the Government has made since 2002 include a 15 percent decrease in the allowances and gradual equalization over seven years of the allowances for all children regardless of their birth order in the family (and effective immediately for children born after June 2003). For these reasons, real expenditure in recent years has fallen to a lower level than that prevalent in the middle of the 1990s. What is more, expenditure is expected to continue declining as further phases in the plan to equalize allowances for all children are implemented.

**Table 15. Distribution of and Change in Transfer Payments
– Main Components (Percent)**

	1990	1995	2001	2004	2005	Annual avg. % change	
						1999– 2001	2002– 2005
Total	100.0	100.0	100.0	100.0	100.0	7.8	–3.4
Old-age and survivors	44.6	40.5	37.0	40.9	41.5	6.0	–0.9
Children	22.2	22.8	18.5	12.4	11.5	6.0	–13.2
General disability	11.3	11.6	14.4	18.4	19.0	10.2	2.3
Unemployment and income maintenance	10.6	12.6	17.1	13.1	13.2	12.5	–13.4
Thereof:							
Unemployment	7.3	6.7	8.6	5.5	5.5	9.4	–18.1
Income maintenance	3.3	5.9	8.5	7.6	7.7	17.4	–9.4
Other	11.3	12.5	13.0	15.2	14.7	9.2	–0.3

Expenditure for **disability benefits** increased rapidly throughout the review period, especially since the mid-1990s. This is the only area that the benefit cutting policy, introduced in 2002, didn't touch. In fact, special benefits have been added: one for the severely disabled, a supplement for disabled persons with severe deficiencies in earning power, a supplement for disabled children, and so on.

Expenditure for **unemployment compensation and income-maintenance benefits** was the fastest growing component of social transfer payments in the 1990s. The steep increase reflects the economic deterioration and the spread of unemployment during the relevant years, plus a rise in the public's awareness of its entitlements in these respects. Unemployment compensation expenditure climbed in the 1990s even though the rules were toughened in several ways. Since 1995, for example, young unemployed persons (up to age 35) must accept any job offered them, and since 1999 the maximum unemployment

compensation has been capped. The decisions that have been made since 2002, in contrast, caused expenditure to drop sharply. The new policy extended the qualifying period for unemployment compensation, limited the maximum term of eligibility for the young unemployed, and reduced compensation for the repeatedly unemployed and participants in vocational training programs. As for income maintenance, the benefit was cut by 4 percent and the maximum benefit was reduced by 10–23 percent, depending on the household composition. Furthermore, eligibility for the increased benefit rate for new beneficiaries at certain ages was removed, the parameters of the income test were revised, exemptions from an employment test in certain cases were cancelled, and various discounts (on municipal property tax, public transit fares, etc.) for new beneficiaries were reduced or eliminated.

The sources of funding for transfer payments include National Insurance contributions from the public, participation from the state budget, and interest from the National Insurance Institute's financial reserves. Since 1987, as part of a government policy to reduce labor costs, National Insurance contributions from employers and the self-employed were reduced and the Ministry of Finance began to indemnify the National Insurance Institute against the difference. In order to analyze the long-term changes in the composition of funding sources (Table 16), the indemnification sums are included in state budget financing along with government participation in the funding of contributory benefits and government financing of non-contributory benefits. In most years, receipts from National Insurance contributions and budget participation actually exceeded the transfer payments and the surplus – after coverage of operating expenses – augmented the interest earning reserves available to the National Insurance Institute, which are kept with the Accountant General of the Ministry of Finance.

Up until the past two years, state budget financing exceeded National Insurance contributions from the public by several percentage points. The cutbacks in benefits and the one percent increase in National Insurance contributions from employers and the self-employed, coupled with the reduction of the rate of indemnification from the Ministry of Finance starting in July 2002, brought the proportions of the two sources into balance in 2003 with a somewhat higher rate of public contributions in 2004.

Table 16. Funding Sources for NII Transfer Payments
(Percent)

	Total benefit payments*	National Insurance contributions from the public	State budget financing**
1990	100	44	50
1995	100	33	67
2000	100	46	49
2001	100	43	51
2002	100	44	51
2003	100	49	49
2004	100	52	50

* Net of compensation from third parties.

** Not including interest on account of balances deposited with the Accountant General of the Ministry of Finance.

8. Summary

Although the overall state of the economy continued to improve in 2004 and the first half of 2005, the plight of society's weak groups continued to worsen. The economic policy strove to broaden the cycle of employment and raise income by means of growth promoting measures only. To improve the welfare of weak population groups, more direct and focused policy measures are needed.

The 2005 budget and the approved 2006 budget proposal speak of strengthening the country's social fabric as an explicit target. Even so, the ratio of government social expenditure to GDP was unchanged in 2005 relative to 2004, after an uninterrupted decline in 2001–2003. Furthermore, the share of social spending in disposable government expenditure continued to decrease. One cannot strengthen the social fabric by holding the increase in total government expenditure to a lower rate than that of population increase unless one increases social expenditure at the expense of other expenditure items. Nor does it suffice to revise the priorities in the budget plan. Care must be taken that implementation does not deviate significantly from the plan. The deviations in 2004 were smaller than in 2003 but remained significant.

In 1992, for the first time, social expenditure accounted for more than half of disposable government expenditure. Its share in the total peaked in 2001 and has been falling since then. By 2005, the proportion of social spending reverted to about half of disposable government expenditure. At the same time, the share of expenditure for economic and administrative purposes has been rising.

The internal distribution of social expenditure – between in-kind services and transfer payments – has been constant in recent years. Contrary to a commonly held misconception, cutbacks in government social expenditure in 2002–2004 reduced both components by more-or-less the same rate.

Over the years, national expenditure for education and health care has been rising but the share of government in financing it has been decreasing. Thus, household outlays for education and health care have been rising significantly. This “privatization” of education and health care services threatens to widen inequity in the use of these services.

For the past decade and a half, the distribution of current government education expenditure between school levels has not changed significantly. This relative stability, sustained over a lengthy period of time, suggests that the trend in expenditure was affected mainly by demographic developments and only in a minor way by policies and priorities.

In primary schooling, average per-pupil expenditure increased and average hours per pupil rose even faster, possibly attesting to an improvement in quality and efficiency. At the post-primary level, although average per-pupil expenditure declined, the average number of hours per pupil increased, again possibly indicating that greater efficiency helped to prevent a decline in the quality of education.

Government expenditure for health care has been stable in real terms for the past decade. This stability, coupled with population increase and a rise in the relative prices of health care services, leads to a conclusion that government funding of health care services has been eroded by at least 25 percent since 1997.

The changes in the distribution of direct outlays for health care services indicate that the focus has moved to special health care services. Spending related to general hospital care has decreased while expenditure for psychiatric and long-term care has risen moderately.

Investments in the development of physical infrastructure for the education and health care systems have been low and have been declining in recent years. The low and decreasing level of investment arouses concern over a lack of sufficient planning for

the future. As the population grows, a dangerous gap is liable to open between needs and the available infrastructures, to the detriment of the quality of both education and health care.

In 2002, the trend in expenditure for transfer payments to the public via the National Insurance Institute turned around sharply due to decisions to drastically cut the benefits, revise the eligibility rules, and toughen enforcement in the execution of payments. Consequently, a cumulative real decrease in expenditure of 12.4 percent occurred within four years, relative to the peak in 2001. The decrease focused on child allowances, unemployment compensation, and income-maintenance benefits.

The cutbacks in transfer payments were motivated largely by the desire to lessen the heavy burden on the state budget and to minimize the possible adverse effects of transfer payments on the beneficiaries' labor force participation and economic activity. Even though these rationales deserve to be taken seriously, the socio-economic price of the cutbacks cannot be overlooked. The effect of transfer payments (and taxes) on reducing inequality in income distribution and the incidence of poverty has diminished severely. Furthermore, the cutbacks that have been made mark a departure from an underlying concept of Israel's socio-economic policy, i.e., that transfer payments are supposed to create a safety net and assure society's weaker groups a minimum income at an appropriate ratio to the general standard of living.

Until two years ago, the share of state budget financing in the funding of transfer payments was several percentage points greater than that of National Insurance contributions from the public. The cutbacks in benefits and the raising of rates of contribution from employers and the self-employed brought the two sources into balance in 2003, and in 2004 the contributions from the public once again represented a greater share of the overall sources of funding.