Proposal for an Alternative Economic Policy*

For the past three years – since 1996 – Israel has been mired in an economic downturn that has progressively worsened. The slump, more intensive and prolonged than any the country has known in its fifty-year history, is a major factor in most of the negative socioeconomic phenomena that the country has experienced during these three years.

The main characteristic of the economic policy adopted in recent years is severe fiscal and monetary restraint. The restraint policy, meant to lower inflation, has been pursued too long and too vehemently. The monetary policy has actually strengthened the sheqel against the dollar artificially, thereby slowing export growth and increasing the volume of imports. For most of this time and in most respects, the Bank of Israel has applied monetary policy and the Finance Ministry has invoked fiscal policy without coordinating their actions and without consensus.

These policies have had one favorable effect – they helped lower the annual inflation rate from 11 percent in 1992-1996 to 5 percent in 1998-1999. Nearly all the other effects have been negative, and one may relate to them as the steep price that Israeli society has paid: economic growth has stopped, per-capita Gross Domestic Product has not increased since 1997, the

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unemployment rate peaked at 9 percent in 1999, domestic demand – private consumption, public consumption, and investments – has decreased steeply, and the growth rate of exports has declined significantly.

The alternative economic policy proposed here is designed to extricate the economy from its lethargy, reignite growth, and boost employment on the basis of vigorous growth of exports, by revising the underlying strategy of the country's fiscal and monetary policies. This section of the book also discusses needed reforms in taxation, the capital market, major economic infrastructure projects, and defense spending, which carries a major macroeconomic impact. The resumption of growth should be accompanied by a reduction in income-distribution inequality and the attainment of additional social goals.

The plan is based on the view that the current policies, if allowed to continue, will not lead to the desired turning point in the next few years. According to historical experience, the Israeli economy was lifted out of downturns by a combination of policy measures and exogenous shocks (the Six-Day War, mass immigration in the 1990s, etc.). As 1999 drew to a close, economic activity began to recover to some extent, but not energetically enough to induce the economy to utilize all of its production and growth potential.

The downturn has claimed a price in lost product and a decline in per-capita GDP, as reflected in a decrease in living standards, vitiation of Israel's strength (including defense strength, because of the contraction of its edge over the Arab countries), idling of production factors, and growth in unemployment. Apart from the considerable economic price that is paid, social and personal prices are paid as well, mainly in the form of unemployed households, greater inequality in income distribution, and more poverty.

1. Economic Trends – Situation Assessment

Rapid growth was the hallmark of the first half of the 1990s. Gross Domestic Product (GDP) increased swiftly – amidst the integration of mass immigration – at a rate that outpaced population growth. Thus, per-capita GDP also increased. Concurrently, the economy became more open, exports (especially in high-tech industries) and imports increased, and important economic reforms were carried out.

Table 1. GDP and GDP of the Business Sector, 1990-1999
(Quantity percent change)

	*1990-95	1996	1997	1998	1999
GDP	5.8	4.6	2.9	2.2	2.0
Per-capita GDP	2.3	2.0	0.4	0.2-	0.3-
Business-sector GDP	7.0	5.3	2.9	2.2	1.6
Per-capita business-sector GDP	3.4	2.7	0.4	0.2-	0.7-

* Annual average percent change.

The main engine of growth in the early 1990s was mass immigration and its integration. The major features of the growth process provide a natural point of departure for the requisite emphases in a long-term growth policy for the years to come: (a) rapid technological development, particularly in computers and communications; (b) integration into the world economy – “globalization” – both in expansion of foreign trade and in greater integration into and use of international capital markets; (c) important economic liberalization reforms, including an easing of the tax burden accompanied by improvement in income distribution, greater latitude and flexibility in the capital market, far-reaching liberalization of the foreign-currency market and more vigorous action by the authorities to maintain competitiveness; and (d) enhancing and making better use of human capital by fully integrating immigrants into the labor market, among other actions.

The 1996-1999 Economic Slump and Its Causes

The process described above reversed direction abruptly in 1996; the growth trend stopped and was replaced by a protracted economic slump. The slump worsened in 1999: GDP expanded by only 2 percent and that of the business sector by even less, 1.6 percent. Per-capita GDP and per-capita GDP of the business sector contracted by 0.3 percent and 0.7 percent, respectively. The unemployment rate climbed to 9 percent and the deficit on balance-of-payments current account ballooned to $2 billion. The inflation rate between September 1998 and September 1999 slowed to 5.3 percent.

The main problem of the Israeli economy in 1999 was a paucity of demand. Private consumption increased by 2.7 percent and public consumption, excluding defense imports, by 3 percent. Investments worsened: investments in fixed assets grew by 2.9 percent, but most of this increase was devoted to imports of machinery and equipment; construction and housing investments continued to contract.

After three years of economic slowdown and underutilization of domestic production capacity, one may estimate product in 1999 at 7 percent under the economy’s production potential. The unutilized production capacity is reflected, above all, in the growth of unemployment, which also, in all likelihood, reflects unused capital stock in buildings, which has led to a protracted decline in investments in this field. The surplus production capacity did help moderate price increases in the course of the year.

The economic downturn was caused by a combination of externalities and economic policies. The externalities are the downturn in immigration, a decline in the security situation, and the moratorium in peacemaking. These three factors totally transformed the atmosphere in the business sector, depressed domestic demand, and, in particular, caused investments to decline. In the past two years, there has been an additional externality: the crisis in international financial markets that began in Asia and spread to other locations. This crisis raised the level of uncertainty in the capital and currency markets and resulted in severe volatility in exchange rates and prices of assets. Although (as stated) some of the slowdown was inevitable, appropriate policies could have limited its extent. Notably, the very fact of the halting of growth and, especially, the expectations of continued slump set in motion a mechanism that depresses investments, since firms adjust the level of actual capital to that desired, which corresponds to the expected growth rate. If the expected level is lower, investments will decline in order to attain the desired level of capital – a development that, in itself, lowers GDP.

The expansionary fiscal policy in effect until 1996 gave way, starting in 1997, to a policy of restraint that operated in tandem with a severely tight monetary policy. The combination of fiscal restraint, which was necessary to return the economy to a more balanced long-term trajectory – and the toughening of monetary restraint turned the slowdown, which had been predicted, into a severe slump. Although it is difficult to quantify and isolate, with precision, the separate effects of the externalities and the policy factors, one can definitely question the logic of toughening the policy restraint in view of externalities that were restraining economic activity to begin with.

The decline in 1999 was affected by the ongoing combination of a further increase in monetary restraint, meant to attain the inflation target, and a fiscal policy based on the Budget Deficit Reduction Law. Monetary restraint was tightened in late 1998 in response to a steep currency depreciation that jeopardized the inflation targets. By raising the key lending rate by 4 percentage points, the Bank of Israel halted the depreciation and actually caused the sheqel to appreciate relative to its October 1998 level. The severe increase in interest and its result, the currency appreciation, halted an upturn in domestic prices. In fact, the price level in August 1999 was similar to that of December 1998, meaning that price stability had been attained.

These developments were reflected in a severe increase in real interest rates – from 5.5 percent on average in 1998 to 6.8 percent in the first half of 1999 – that helped extend and exacerbate the downturn in activity during the first half of the year. In the fiscal domain, the government deficit widened, mainly because the economic slump depressed tax collections, while the spending limits were not overrun. In the composition of expenditure, nonproductive spending continued to increase and infrastructure investments continued to decline.

Economic activity in 1999 was affected by early elections for the Knesset and the premiership. The relatively lengthy election campaign aggravated economic uncertainty and, evidently, suspended some economic activity and prolonged the slump.

Global economic events – foremost the leveling off of world trade – were detrimental to Israeli exports and created opportunities that made imports more profitable. Thus, imports climbed steeply, especially to replenish stocks and replace imported capital goods, and the balance of payments worsened. The current-account deficit climbed by $1.6 billion and came to $1.9 billion.

Developments during the year were uneven. In the first half, the slump continued and worsened to some degree; in the second half – for which final data were not available at the present writing – some recovery in activity was observed. The salient indicators of the recovery, as stated, are increases in investments in machinery and equipment investment and in stocks. These changes sent initial signals of a gradual emergence from the slump. However, the recovery is still hesitant and the declared economic policy for 2000 – continued monetary and fiscal restraint – is counteracting the pro-recovery forces.

Resolute action by the Bank of Israel to attain the inflation target in 2000 (3-4 percent) may also impede the recovery trend.

2. Goals of the Proposed Policy

The proposed economic plan sets detailed economic and social targets for 2000-2003 and indicates the economic policy needed to attain them. This policy creates an initial impetus to energize economic activity and is based on principles other than those that have informed policy in recent years. The principles pertain to fiscal policy, monetary policy, exchange-rate policy, and the cooperation that must be assured to attain economic goals in Israel. The fiscal policy is based on actions that operate in a countercyclical way that mitigates the need for current decisions, without breaching fiscal discipline. The monetary policy aims to keep inflation at its current level (5-6 percent), in the belief that this level will not thwart the resumption of growth. The monetary policy should not act deliberately to reduce the inflation rate further but should exploit disinflationary events. This policy should facilitate a gradual reduction in interest rates and loosen the monetary restraint that is impeding the resumption of economic growth. The plan offers a strategy that will help ease exchange-rate volatility and the magnitudes of destabilizing capital flows without risking financial stability. Finally, the plan is predicated on the intention of attaining a broad-based national consensus among the government, the Bank of Israel, organized labor, organized management, and the public at large – a consensus that should include both the policy targets and the means used to attain them.

The plan should have the following main results:

a. **Swift resumption of growth:** GDP will grow by 3.7 percent in 2000 – allowing per-capita GDP to expand by 1 percent – and GDP of the business sector will grow by 4.1 percent. In 2001, GDP of the business sector will grow by 4.6 percent, approaching its potential growth rate, and will exceed this rate in 2002 and 2003, thus closing the gap that has opened between the actual and the potential levels of product.

b. **Reversal of the unemployment trend:** The unemployment-rate trend will reverse its direction by the end of 2000 and will decline steadily in subsequent years to 5.7 percent in 2003 – a lower level than that observed in the 1990s and an approximation of full employment under Israeli economic conditions.
c. **Inflation:** The inflation rate will be approximately 6 percent, with the possibility of a further decrease if the opportunity comes about.
d. **Real currency depreciation relative to the real exchange rate trend in recent years:** This will help accelerate exports, restrain imports, and allow growth to resume. Since exports will be the most rapidly expanding use in terms of growth rate, they may be seen as the locomotive of economic growth.
e. **Small current-account deficit:** The deficit will decrease to $500 million in 2001 and will maintain lower levels afterwards.
f. **Decrease in the share of government expenditure in GDP:** This indicator will decline by 4.6 percentage points and the fiscal deficit will decline steadily.
g. **Public debt:** The share of the public debt in GDP will decrease steadily, by 4.5 percent of GDP in cumulative terms, to 86 percent in 2003.

3. Comparison of Current Policy with That Proposed

Below we compare the focal points of the current policy with those of the proposed plan.

Current Policy

The economic policy of the past few years – which, as stated, has had a pro-cyclical effect that exacerbated the slump[1] – has four major characteristics:

* **Budget Deficit Reduction Law**. The fiscal policy forced the government deficit to continue declining in accordance with a trajectory and definitions that hardly changed over time. The law did much to restore fiscal discipline and served the Finance Ministry as an important tool in tightening fiscal control; in view of the narrow governing coalitions that Israel has typically had, this should not be belittled. However, the law as applied had negative macroeconomic effects. It exacerbated the economic cycle, i.e., it aggravated fluctuations in economic activity instead of stabilizing them. In times of economic downturn and falling tax collections, the law forces the government to reduce its spending, thereby worsening the slump. In contrast, at times of economic upturn and rising tax revenue, the law allows the government to increase spending without breaching its limits, thereby enhancing the upturn. Furthermore, since it is easier to increase spending than to reduce it, when the upturn petered out the government complied with the Deficit Reduction Law

[1] A policy is pro-cyclical when it affects economic activity in a direction that corresponds to external shocks or domestic processes. For example, the decrease in immigration depressed demand in various ways. Concurrently, the government reduced its budget and the Bank of Israel raised the key lending rate. This policy is pro-cyclical because it exacerbated the depressive effect on demand of the immigration slowdown.

by raising tax rates instead of cutting expenditure – thus obviating the possibility of reducing its share in the economy.

* **Tight monetary policy as part of an inflation-target regime.** To keep the inflation rate on a downward path, monetary policy was implemented by means of severe and protracted increases in the key lending rate. This policy succeed in respect to disinflation but came at the price of a steeper economic downturn. Since it was necessary to lower the inflation rate each year and because the inflation targets were set irrespective of the state of the economy in other respects, the Bank of Israel had to maintain a long-term state of restraint that, as stated, was reflected in high nominal and real interest rates. The high interest caused major changes in asset and credit portfolios: increases in the share of sheqel-linked assets, in foreign-currency credit – much of it from abroad – and in foreign reserves. These realignments do not reflect a stable equilibrium, since a decrease in interest in the future would have the opposite effect. Therefore, restoring monetary equilibrium will be no simple matter; it may require a financial shock.
* **Gradual movement toward a mobile exchange-rate regime.** In the past few years, the diagonal-band regime of the exchange rate was eased by widening the limits of the band significantly and by ending central-bank intervention in the foreign-currency market as long as the exchange rate does not cling to the limits of the band. The growing liberalization of capital flows – a welcome development that should be pursued further – has exposed the economy to large potential turbulence from abroad. In view of monetary developments, this regime has created a situation in which it takes high interest rates to maintain financial stability. Notably, even if the inflation targets are met, the Bank of Israel will find it difficult to bring down interest rates lest this precipitate a financial shock. This situation is perpetuating the monetary restraint and impeding the resumption of growth.

* **Lack of coordination and consensus in economic policy.** The policy applied in recent years has been typified by lack of coordination among economic players in respect to the implementation of fiscal and monetary policies because of disagreements between the Bank of Israel and the Finance Ministry. The lack of coordination aggravated uncertainty and lessened the credibility of the policies at issue. Notably, Israel's most impressive economic achievements since the 1980s – the 1985 Stabilization Program and immigrant integration in the early 1990s – were attained by means of consensus and cooperation. On both occasions, inflation declined and growth accelerated.

The Proposed Policy Alternative

The proposed growth-resumption policy rests on four main provisions:

* **Government Budget Expenditure Ceiling Law.** The new law would replace the Deficit Reduction Law and set budget expenditure, as a share of GDP, on a declining path. Such a policy would reduce the share of government activity in the economy. Tax rates would be set so that total tax collection, in a state of full employment, would sustain a low deficit that would reduce the public debt as a share of GDP. This, in turn, would move Israel toward the European Union (Maastricht) standard, i.e., a share of public debt not to exceed 60 percent of GDP. Reducing the share of government debt in GDP, although a worthy goal in itself, may also help Israel join the Euro bloc, as discussed below. On the one hand, the new statute would have an automatic countercyclical effect[2] and a

[2] "Autostabilizers" are policy tools that have countercyclical effects in the absence of explicit government decisions. For example, if the government sets a given level of expenditure and for some reason the economy slows, it will lose tax revenues and its deficit will expand for some time. The increase in the deficit automatically counteracts the slowdown.

stabilizing influence on activity; on the other hand, it would give the Finance Ministry a powerful tool with which to maintain fiscal discipline.

* **Monetary policy that aims to stabilize the inflation rate.** The inflation rate attained in recent years is not an impediment to the resumption of growth. Therefore, the monetary policy should focus on maintaining the current inflation rate (a single-digit level), correcting severe deviations occasioned by inflationary pressures, and deflecting serious risks to financial stability. Actions in all these respects should be moderate; to avoid risking the resumption of growth, no active attempt should be made to continue lowering the inflation rate. This entails an asymmetric fiscal policy: when inflationary pressure occurs, the Bank of Israel should apply restraint to stem an inflationary eruption; when disinflationary pressure is evident monetary policy should follow the trend in order to exploit it. This policy would create a disinflationary trend without any drastic attempt by the central bank to dictate its pace.
* **Efforts to join a currency bloc.** A small open economy such as Israel's cannot maintain a mobile exchange-rate regime without being exposed to severe shocks or having to apply continual monetary restraint. The correct strategy is to join one of the currency blocs currently taking shape, euro or dollar. This would help bring down inflation quickly and would give the economic leadership the credibility it needs to prevent or significantly reduce destabilizing capital flows. Domestic interest rates would move toward accepted world levels. Joining a currency bloc would help open up the economy and enhance its growth. The act would also have political significance. Therefore, it is assumed here that political negotiations will take place as the economic plan is carried out. Until a lender-of-last-resort arrangement is concluded in the course of these negotiations, a fixed exchange-rate regime should be adopted. Until Israel joins a

currency bloc, the exchange-rate policy should aim to prevent exceptional volatility while keeping the exchange rate on a trajectory that will allow real depreciation to occur. The central bank should be prepared to intervene in the foreign-currency market if and when exceptional pressures build up, e.g., after the key lending rate is lowered.

- **National consensus.** The policy should be based on the broadest possible consensus among the government, the Bank of Israel, organized labor, organized management, and the public at large. The consensus should embrace both the policy targets and the means used to attain them.

4. Practical Measures

Policy measures should be applied at three main levels: fiscal policy, monetary policy, and an aggregate of complementary steps.

Table 2. The Proposed Economic Policy Compared with the Continuation of Current Trends

	1999	2000	2001	2002	2003
Public sector (percent of GDP)					
Proposed plan	56.0	55.3	53.9	52.6	51.4
2000 budget and current trends	56.0	55.7	55.1	54.4	53.7
Taxes and revenues (percent of GDP)					
Proposed plan	46.9	46.5	46.3	46.3	46.3
2000 budget and current trends	46.9	47.4	47.7	48.0	48.4
Government deficit (percent of GDP)					
Proposed plan	2.6	2.9	2.1	1.2	0.3
2000 budget and current trends	2.6	2.5	1.9	1.2	0.2
Real key lending rate (percent)					
Proposed plan	6.0	5.0	4.7	4.5	4.2
2000 budget and current trends	6.7	6.2	6.0	5.7	5.5

Fiscal Policy

1. **Sizable increase in infrastructure investments.** To sustain balanced economic growth based on rising productivity, economic infrastructure and other production factors must develop in tandem. Although government investments in infrastructure, foremost in roads, have increased in recent years, the other production factors (capital and labor) have grown more rapidly, resulting in unbalanced growth and impeding productivity. Furthermore, the cumulative lag in infrastructure development since 1973 has not yet been eliminated. Infrastructure bottlenecks – transport, sewage, and water systems, to name only three – are still hindering productivity and growth. It is important to include R&D in the economic infrastructure, since expanding R&D investment is an important component in the development of growth and productivity. However, care should be taken to give the government a partial return on these investments.
2. **Reduction of current government expenditure,** in real terms, relative to the current national budget, which reflects the continuation of past trends. To attain this decrease, expenditure must be recomposed by reducing wage outlays (the public-service payroll) and increasing government procurements. Since these changes have a pro-growth effect, they will boost tax revenues; this alone will help pare the deficit. Transfer payments to the public should be kept at their current share of GDP, but they should be reallocated to attain social targets more efficiently.
3. **Easing of the tax burden.** Tax rates should be lowered so that the tax cut will reduce revenue more than the recomposition of budget expenditure will increase it. The result will be a favorable fiscal impetus in the first year. Afterwards, the tax rates should be stabilized at a level lower than the prevailing one. The share of the public debt in GDP

should continue to decline and the total deficit will verge on zero in 2003.

Monetary Policy

1. **Real interest rates should be lowered gradually** to 4-5 percent. This rate reflects the trend and not the rate at any given point in time, which may vary in response to changes in short-term conditions.
2. The downward interest trajectory will lead to a higher rate of **exchange-rate depreciation,** allowing a real depreciation to occur.
3. Practical measures should be taken to **join a currency bloc.** These steps will lend credence to the monetary policy and reduce the risk of an exchange-rate spike when the key lending rate is lowered.

Tax-System and Capital-Market Reforms

Vigorous implementation of the reforms described in Section 6 below.

National Infrastructure Reforms

Reforms in the field of national infrastructures will enhance productivity and, thereby, create an impetus for sustainable economic growth. The reforms include the privatization of certain activities of public infrastructure companies in order to enhance competition. At the same time, extensive construction and expansion of infrastructures would help the economy climb out of its slump by stimulating domestic demand.

Additional Measures and Constraints

1. Maintenance of economic stability is a basic component in the resumption of GDP and productivity growth. The attributes of stability are: (a) low inflation and movement toward the inflation rates in other industrialized countries;

(b) passing and implementing the Government Budget Expenditure Ceiling Law, so that total government spending relative to GDP shall decline by 4.5 percent; and (c) keeping the fiscal deficit small and virtually eliminating it by 2003, thus assuring the continued decline of public debt as a share of GDP.

2. Reducing the growth rate of government employment. To maintain stability while lowering the tax burden and investing more in infrastructure, it is necessary to pare current government expenditure.
3. Reprioritization of items in the government budget in favor of growth-inducing measures – reducing unproductive outlays and providing more funding for productive ones, amidst an overall decrease in the share of government expenditure in GDP. The government should increase its procurements, i.e., obtain more services from the business sector, thereby enhancing productivity and attaining targets in these crucial fields.
4. Improving the performance of the business sector. The government has an important role to play in this respect. The effect – an indirect one – should be attained by enhancement of competitiveness in various industries through privatization, liberalization, and a policy of exposure to overseas markets, including capital markets; improvement of allocation of human capital by vocational retraining and a policy of enhancing human capital and adjusting it to the economy's needs; and increased funding for R&D and expansion of basic research.

5. Expected Results and Achievements of the Plan

The main results of the plan, as shown in Table 3 (see Appendix Tables 1-5 for full details), are:

1. Rapid recovery of economic activity. The recovery may be faster if a favorable turning point in the peace process improves the business environment by enhancing the growth of exports and investments. GDP of the business sector will increase at a rate approximating its potential in 2001 and at a faster pace in 2002 and 2003, thus eliminating the cumulative lag between actual and potential product.
2. Decreasing unemployment-the unemployment rate will reverse direction in 2000. In subsequent years, the rate will decline steadily to 5.7 percent in 2003, lower than the 1990s rates and approximating full employment under Israel's economic conditions. If the current trend is allowed to continue, the unemployment rate will stay at approximately its present level in 2000 and 2001 and will decrease afterwards by only one percentage point.
3. The proposed economic plan will probably result in a somewhat higher inflation rate than that expected from the continuation of current trends. The proposed 2000 budget, which expresses the continuation of these trends, places inflation in the 4-5 percent range; the proposed economic plan estimates it at 6 percent. This forecast does not take account of significant externalities that may create an opportunity for further disinflation.
4. The currency will depreciate in real terms relative to the trend in recent years. This will help boost exports and restrain imports. In 2000 and subsequent years, exports will grow more vigorously than other uses and, therefore, may be regarded as the economy's growth locomotive.
5. Improved profitability in tradable goods, occasioned by the real currency depreciation, will cause the balance-of-payments deficit to contract.
6. The national saving rate will stabilize as the private saving rate falls and the public saving rate rises.
7. As the economic plan is carried out, the share of the public debt in GDP will decline steadily and move

toward the Maastricht standard. In 2003, the public debt will be 86 percent of GDP.

6. Tax-System and Capital-Market Reforms

Tax and capital-market reforms are a major component of the proposed socioeconomic plan. The high tax rates in effect today depress yields on all types of assets, especially human capital, a key variable in improving productivity. It is important to boost productivity because of its crucial value in promoting sustainable growth at a rate that will lift the economy out of its slump. Other components of the reform are meant to help reduce social inequality.

Examination of the tax system should focus on three main aspects and one secondary aspect. The main aspects are total taxation, implications for inequality in distribution of disposable income, and implications for economic inefficiency. The secondary aspect is the cost of collection.

The size of the budget, the level of taxation, the implicit deficit, and ways of financing the deficit are the main macroeconomic variables that lie within the government's control in making economic policy. The following principles will make it possible to reduce the tax burden-an important step in enhancing economic productivity and growth.

Israel has one of the world's highest rates of inequality in income distribution. As measured by the Gini index, only Ireland, Switzerland, and the United States among OECD countries have higher levels of inequality than Israel's. The situation is similar with respect to other indicators, such as the income of the uppermost decile relative to the lowest decile and the income of the uppermost quintile relative to the lowest quintile. The tax system and transfer payments reduce this inequality perceptibly. The aim should be to improve equality both within the limited framework of income tax and National Insurance and within the total economy.

Income Tax and National Insurance

The ceiling on National Insurance contributions should be abolished in order to eliminate the anomaly of a decrease in the marginal tax rate at the transition from medium to high income.

An additional marginal tax bracket of 60 percent should be introduced for taxpayers in the five highest centiles. If this is done, the highest marginal tax rate in Israel will resemble that in several European countries. However, since wage gaps have also been increasing in recent years, there is good reason to consider establishing an additional, higher tax bracket for incomes in the uppermost thousandth.

These proposals are not meant to increase the general tax burden. On the contrary: they will make it possible to ease the tax burden for most taxpayers except for those in the upper half of the uppermost decile. The plan stabilizes transfer payments to the public, as a share of GDP, and makes these payments more effective in reducing inequality in income distribution.

Broadening the Tax Base

Over the years, Israeli governments have reduced taxes for specific groups to give them an incentive or economic compensation. This method is inefficient and detrimental to economic well-being; it penalizes those excluded and encourages tax avoidance. In all, “tax benefits” add up to some NIS 20 billion per year. Of this total, it seems possible to eliminate NIS 4 billion – NIS 5 billion not only without harming the economy but also improving general well-being.

Systemic Reform

The overall effect of the changes proposed – broadening the tax base and adding tax brackets for the five uppermost centiles and the uppermost thousandth – will be a reduction in inequality in the distribution of disposable income and the economic distortions that the current tax rules have created. The reform may be implemented in a way that increases tax collection and lowers the tax burden. Hence, a majority of taxpayers will pay less both in income tax and in other taxes.

The proposed strategy is to spread out the tax brackets so that all taxpayers, except for those in the upper half of the uppermost decile, will pay at a lower marginal rate than they do today or, at the most, at the same rate. Additionally, priority should be given to reducing and eliminating regressive taxes, thereby making the entire system more progressive. As a second priority, one could deal with the most distortive taxes. As the reform is implemented, however, the efficiency of collection must be kept in mind.

In view of the budget ceiling constraint, the ability to broaden the tax base will be the factor of the greatest impact on latitude in lowering income-tax rates and eliminating regressive taxes.

Universal Filing of Tax Returns and Simplification of the Tax Formula

The issue of having all residents file tax returns has been surfacing in and retreating from the public debate for years. This measure would make it possible to introduce income tests in various fields and improve the taxation of non-labor income. However, it has the drawbacks of the government expenditure that the system would entail and the cost to the economy and to individuals of the need to file.

In its current structure, the tax formula is so complicated that the average taxpayer cannot fill out an annual return and must consult a tax advisor. The current plan proposes that thought be given to simplifying the tax formula – a matter of value in itself – and introducing universal filing gradually.

The Inflationary Adjustments Law

Two statutes – the Inflationary Adjustments Law and its predecessor, the Taxation under Inflationary Conditions Law – were passed in response to protracted inflation. The time has come to repeal them and to revert to taxation of nominal income. Nominal computation is not only the world standard; it is easier for both taxpayers and tax collectors to use. It also contains an element of built-in flexibility. Finally, repealing the Inflationary Adjustments Law would be a step toward the elimination of various indexation practices.

Capital Market and Banking Sector

Reform in the capital market and banking sector is a crucial component of the growth resumption plan. In the course of this reform, it is proposed to carry out the package of changes recommended in the Brodet Commission report, focusing on taxation of savings and financial assets; regulation of pension, provident, and advanced-training funds; and enhancement of competition in the financial and banking sector.

Taxation of Savings and Financial Assets

The tax reform should include the following: savings for non-retirement purposes should be taxed just as any other source of income. Tax benefits should be reserved for retirement saving only. Yields on all types of assets should be taxed at a final, uniform, and limited rate. The capital gains of controlling principals in public corporations should be taxed.

Pension, Provident, and Advanced-Training Funds

Earmarked bonds for new pension funds should be discontinued, thereby completing the gradual downscaling of the pension funds' yield subsidy from the State budget. Contributions to pension funds on wages up to a stipulated level should be made compulsory. Concurrently, the pension component in National Insurance benefits should be increased. The possibility of keeping liquid funds in new provident and advanced-training funds should be eliminated. Interrelations in the management of provident funds by banks should be regulated, especially in view of conflicts of interests.

The Financial and Banking Sector

Restrictions on investments by institutional investors should be lifted except to assure financial stability. Barriers that have prevented the emergence of a secondary mortgage market should be removed. Competition among banks and other capital-market players should be stimulated by exposing the Israeli economy, including its capital market, to globalization with international capital markets, including a lowering of the entrance barriers that foreign banks face. The reform should also complete the regulation of control of holding companies that include a bank by principals who also control nonbanking companies.

7. Implications for the Defense Budget

Total Defense Consumption

Defense expenditure consumes 10 percent of GDP and 7 percent of total resources. It should be the long-term goal to reduce the defense burden or to tilt it gradually toward conventional rates in other countries. However, within the time frame of the current discussion (up to 2003), an increase in defense consumption may be needed for three main reasons: (a) Israel's order of forces was built mostly in the 1970s and 1980s and needs to be overhauled and adjusted for strategic threats that are developing in the region; (b) the volatile progress in regional peacemaking may be accompanied by instability and current-security problems; (c) in the aftermath of peacemaking arrangements, special redeployments and rearmament may become necessary.

The proposed economic plan foresees a cumulative increase of 20 percent in GDP in 1999-2003. The target of easing the defense burden in the long term, combined with a practical attitude that recognizes security needs, makes it possible to hold the cumulative increase in defense consumption to 12-15 percent.

Composition of Defense Expenditure

Re-optimization may be pursued at two levels: between expenditure out of foreign-currency assistance sources and expenditure in domestic currency, and between rearmament and current outlays. In the first respect, the level of direct defense imports is dictated by the restraints of American defense assistance, whereas other defense outlays are derived from the local-currency budget restraints. This leads to a less-than-optimal composition of expenditure; there is reason to believe that more "defense" could be purchased at a given level of spending were the use of American assistance funds not constrained. The goal should be to increase the share of American assistance that can be used without restrictions; to accomplish this, Israel should – if necessary – accept, perhaps at its own initiative, a formula stipulating the reduction of defense assistance over a period of years.

To overhaul the order of forces within a reasonable period of time without elevating defense consumption unreasonably, economies in current spending must be made. To accomplish this, a new conception should be adopted of the line that separates "make" (needs met at home) from "buy" (procurement of goods and services from outside suppliers).

The Domestic Military-Industrial Base

The domestic military-industrial base develops and manufactures armaments of its own design and specific military equipment that have multiplier effects on the enhancement of the army's strength. The government policy with respect to the defense industries should combine defense considerations with sound economic criteria. In accordance with this approach, a distinction should be made within the military-industrial base between defense activities that are too important to forego even if they are too small to be profitable and activities on a scale that makes them sustainable under conventional economic business criteria.

To assure the future of the military-industrial base, Israel should develop a privatization policy for its state-owned defense industries and implement it over the next few years. Such a policy should be based on gradual privatization (after the enterprises and activities are incorporated in subsidiaries), including a combination of selling shares to strategic investors along with issues to the public and to workers. The prior consent of labor should be achieved by providing a “safety net” for workers who fail to find jobs in the new structure.