

Government Expenditure on Social Services

The expansion of economic activity, which has continued uninterrupted since the middle of 2003, has improved Israel's macroeconomic picture significantly and has recently begun to be detected by socioeconomic indicators as well. It is precisely for this reason that the distress of specific population groups who have not benefited from the trickle down effect of this economic growth stands out all the more. The experience of recent years shows that pro-growth macroeconomic measures take a long time to benefit society's weaker groups and that even then the achievements are incomplete and inadequate. Therefore, to cope effectively with socioeconomic problems, the government should also employ a range of direct and focused measures.

Policymaking and the selection of methods of promoting the welfare of weaker population groups have been flawed for various reasons including difficulties in identifying and measuring costs and benefits and, particularly, in comparing cost-benefit ratios among different kinds of public social expenditure. The purpose of this review is to enhance the discussion of the government's socioeconomic policies by improving its factual base. It describes developments over time and evaluates the main trends in government social expenditure.¹ It also tries to assess, to the extent possible, the efficiency of resource allocation.

¹ The survey is based on final expenditure data for government outlays in 2006 and previous years and on an estimate of final expenditure in 2007. Developments indicated by the 2008 proposed State budget are also noted. The 2007 estimates of budget utilization are based on actual expenditure in

1. The State Budget – Deviations between Proposals and Performance

The 2006 State budget was not passed into law until June of that year. Until then, the government operated on the basis of monthly allocations that were equal to one-twelfth of the previous year's budget. No sooner had the budget been approved than the Second Lebanon War broke out and added to the budget uncertainty. Consequently, there were large deviations between the proposed budget and the actual expenditure of various budget items. According to reports of the Ministry of Finance Accountant General, total government expenditure in 2006 was 6 percent under the final approved budget. Since items related to the servicing of government debt (principal and interest) were completely utilized, all the non-utilization was in budget items in the current budget and the development budget. The non-utilization rate in these items came to 9 percent. Underutilization is also expected in 2007, as only 67 percent of the budget, including adjustments, was utilized in the first three quarters of the year. Deviations from the proposed budget, including underutilization of budgeted sums, raise doubts about whether the policy and the priorities that the government and the Knesset established are being fully realized.

Government expenditure on social services has also fallen short of the approved budget. According to data analyzed by the Taub Center (Table 1), social expenditure in the approved current budget for 2006 was supposed to be NIS 97.2 billion and changes during the year were to bring the total to NIS 99.0 billion. Actual budget

the first nine months of the year and estimates for use for the balance of the budget for the rest of the year, including updates, the transfer of surpluses from previous years, and the allocation of most of the general reserve to various budget items. Previous years' experience shows that the utilization estimate and the final utilization data may differ significantly.

expenditure, however, was NIS 97.0 billion, NIS 2 billion under the program. The deviation centered on the delivery of in-kind services and was especially marked in education spending.

**Table 1. Social Expenditure, Current Budget, 2006
Final Expenditure vs. Proposed Expenditure
(NIS billions, percent)**

	Proposed budget	Adjusted budget	Final expenditure	<i>Deviation from*</i>	
				Proposed budget	Adjusted budget
Total	97.2	99.0	97.0	-0.3	-2.0
Income maintenance	40.9	41.1	41.0	0.1	-0.2
In-kind services	56.3	57.9	56.0	-0.5	-3.3
<i>thereof:</i>					
• Education	31.1	31.7	30.5	-2.1	-3.8
• Health care	17.0	17.3	17.3	2.1	0.2
• Personal social services	5.6	5.9	5.7	2.2	-3.1
• Other services	2.6	3.1	2.5	-3.8	-18.7

* Rates of deviation were calculated before rounding.

Deviations from the proposed budget also occurred in previous years (Table 2). The rate of underutilization in total social expenditure in 2006 resembled that reported in 2005. In current expenditure for education, however, the rate of deviation increased for the fourth consecutive year, bringing the cumulative underutilization since 2003 to approximately NIS 4 billion. Health care budgets, in contrast, were not underutilized in 2006.

**Table 2. Social Expenditure, Current Budget, 2003-2006
Final Expenditure vs. Proposed Expenditure (Percent)**

	<i>Deviation of utilization from</i>							
	<i>Proposed budget</i>				<i>Adjusted budget</i>			
	2003	2004	2005	2006	2003	2004	2005	2006
Total	-6.0	-2.3	-1.0	-0.3	-3.2	-1.5	-2.2	-2.0
Income								
maintenance	-6.1	-4.6	-0.2	0.1	-2.2	0.0	-0.1	-0.2
In-kind services	-5.9	-0.6	-1.4	-0.5	-4.0	-2.6	-3.6	-3.3
<i>thereof:</i>								
• Education	-5.4	-1.0	-1.5	-2.1	-2.3	-3.0	-3.5	-3.8
• Health care	-5.6	1.2	-0.4	2.1	-3.8	0.0	-1.2	0.2
• Personal social services	-5.5	0.6	0.2	2.2	-3.7	0.4	-1.9	-3.1
• Other services	-16.0	-8.9	-9.2	-3.8	-25.0	-18.3	-22.7	-18.7

2. Economic Achievements Fail to Narrow Disparities and Reduce Poverty

The economic growth that began in the middle of 2003 continued in 2006 despite the Second Lebanon War and accelerated in the second half of 2007. In 2006, gross domestic product increased by 5.1 percent and the business sector product increased by 6.4 percent; in the first half of 2007, the annualized rates of increase were 6.6 percent and 7.9 percent, respectively (Table 3).

**Table 3. Economic Developments
Positive and Negative Indicators (Percent)**

	2003	2004	2005	2006	2007
<i>Economic growth</i>					
▶ GDP	1.5	4.8	5.2	5.1	6.6 ¹
▶ Business sector product	2.2	6.8	6.7	6.4	7.9 ¹
<i>Improvement in employment</i>					
▶ Labor force participation rate	54.5	55.0	55.2	55.6	56.6 ²
▶ Unemployment rate	10.7	10.4	9.0	8.4	7.6 ²
▶ Increase in number of Israeli employed	2.0	3.0	3.9	3.2	4.2 ³
<i>Increase in income and standard of living</i>					
▶ Increase in real wage per employee	-3.0	2.5	1.8	1.6	3.6 ³
▶ Increase in per capita private consumption	-1.0	3.7	2.2	2.7	5.7 ¹
<i>Economic disparities and poverty rates</i>					
▶ Unemployment rate among:					
High-level education	5.9	5.3	4.1	4.0	
Low-level education	16.6	16.1	15.1	16.0	
▶ Gini index of disposable income distribution	.3685	.3799	.3878	.3923	
▶ Incidence of poverty among households	19.3	20.3	20.6	20.0	
▶ Poverty gap	30.5	33.3	33.1	33.8	

1. Annualized, based on data for first half of year.

2. Second quarter, seasonally adjusted.

3. First quarter compared to same quarter of the preceding year.

As economic activity expanded, so did the economically active population. The labor force participation rate rose from 54.5 percent in 2003 to 56.6 percent in the middle of 2007, the unemployment rate fell from 10.7 percent to 7.6 percent, and the number of Israeli employed increased by roughly a quarter million. Some 10 percent of the newly employed Israelis replaced foreign workers. This seems to have exhausted the potential of this source for increasing the employment of Israelis; in the past two years, the number of non-Israelis employed in the economy has also been growing steadily.

However, without making light of the important and positive developments in the labor market, two matters require further discussion. First, the improvement in the employment situation has affected most population groups but not equally; second, the average duration of unemployment has increased.

In regard to the first matter, differences in employment are especially evident when the population is analyzed by level of education. Among those with higher education (16+ years), the unemployment rate fell from 6 percent in 2003 to 4 percent in 2006; among those of low education (up to 8 years), it remained high and almost unchanged between 2003 and 2006, at around 16 percent. The trend continued in early 2007: most new members of the labor force and most of those newly employed during the first quarter of the year had a post-secondary education, whereas some of those of low education quit the labor force and the employment cycle. Regarding the second issue, the average duration of unemployment increased despite more than three years of economic growth and falling unemployment rates. The share of unemployed persons who sought work for more than one year rose from 18 percent in 2003 to 26 percent in 2006. The combination of these two phenomena indicates that most of the remaining unemployment is structural in nature and cannot be narrowed significantly by macroeconomic means alone.

The growth in employment was matched by increases in income and its corollary, the standard of living. In 2005 and 2006, real wages per employee rose little – by 1.8 percent and 1.6 percent, respectively – but in the first quarter of 2007 they increased by 3.6 percent over the preceding year. Here again, there were significant disparities: industries that typically employ large proportions of well educated workers led the upward trend in real wages, whereas wages in industries with small proportions of well educated workers hardly changed. This provides further indirect evidence of the structural nature of unemployment in Israel.

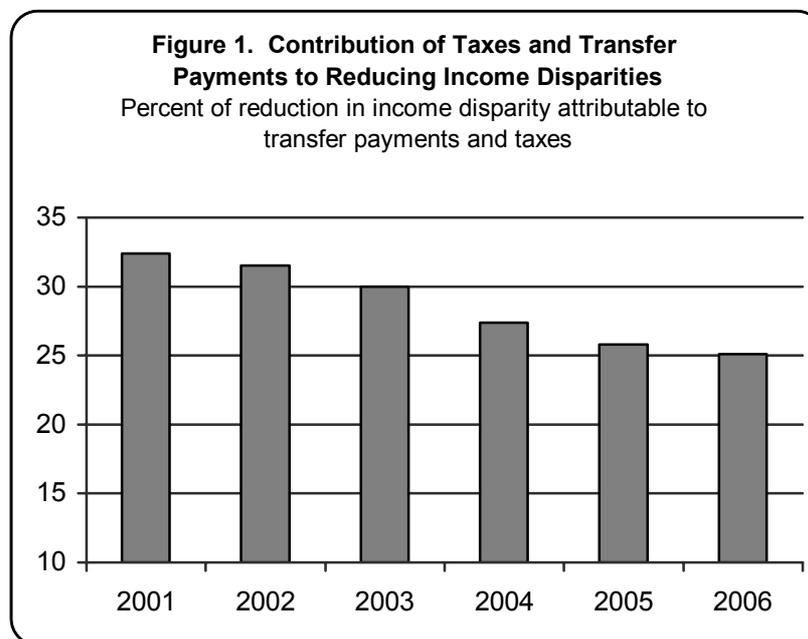
The average standard of living, as measured by per capita private consumption, rose by 2.2 percent in 2005, 2.7 percent in 2006, and 5.7 percent (annualized) in the first half of 2007. Measured in terms of per capita adult equivalent disposable income, the standard of living improved in 2006 in all income deciles although differentially – by 3-5 percent in the lowest nine deciles and by 7 percent in the highest decile.

These positive developments, however, have not yet narrowed society's economic disparities, which remain wide even after more than three years of relatively vigorous growth. In fact, all accepted aggregate indicators – the Gini index of disposable income distribution, the incidence of poverty among households, and the average per household poverty gap – show only small changes, some of which are statistically insignificant or, in the best case, show no change.

Indicators of economic disparities and poverty are affected not only by the trend in economic income but also by the government's taxation and transfer payment policies. Several changes with contrasting effects were made at the beginning of 2006. On the tax side, the marginal income tax rates were lowered, mainly at middle and high income levels and the tax brackets were adjusted to reflect price increases; but the value of the credit point was left unchanged and therefore eroded in real terms. In National Insurance and health

tax contributions, changes were made for the purported purpose of lowering the burden on those of low and medium income without affecting total contributions (a “revenue-neutral” approach). With regard to transfer payments, National Insurance benefits were raised by 2.7 percent, commensurate with price increases, for the first time since 2002. (The old-age benefits were adjusted by only 1.8 percent because they had been raised at the beginning of 2005.) Furthermore, the temporary cut in child allowances was repealed but the lowering of benefits under the policy of equalizing the benefit level for each child continued. In the middle of the year, the part of the across-the-board cutback in old-age benefits that had not yet been implemented was canceled. As a result of all of these measures, the contribution of taxes and transfer payments to the narrowing of income inequality continued to decline – from 32.5 percent in 2001 to 25.8 percent in 2005 and only 25.1 percent in 2006. At the same time, the Gini index of inequality in disposable income distribution rose by around 1.2 percent relative to 2005. Thus, the expansion of economic activity and its concurrent positive effects were insufficient to narrow income gaps and reduce poverty. In fact, although the overall number of poor households declined by 1.5 percent in 2006, the number of such households that were headed by working people increased by 4.7 percent. In other words, the proportion of economically active households among poor households increased.

This is further confirmation that relying on economic growth to improve the welfare of weaker population groups is insufficient. The inescapable conclusion is that direct and more focused policy measures are needed. This statement is doubly validated by evidence of the structural nature of unemployment and additional characteristics of the incidence of poverty.



3. The Government's Expenditure Policy: Cost Cutting by Relative Reduction of Social Expenditure

In recent years, total government expenditure has been limited to a fixed maximum rate of real annual increase. At first, as the economic policy for 2004 was being debated, it was decided to limit the increase in total government expenditure to 1 percent per year in each of the years 2005-2010. Later, as part of the May 2006 coalition agreements, it was stipulated that government expenditure excluding one-time outlays would be allowed to grow by 1.7 percent per year. For this reason, the 2007 budget and the government's 2008 budget proposal included increases in expenditure that were the full permissible rate each year, plus non-recurrent outlays related to the Second Lebanon War and the disengagement from the Gaza Strip. The non-recurrent outlays

added 2.1 percent and 1.5 percent to the total expenditure in the respective years.

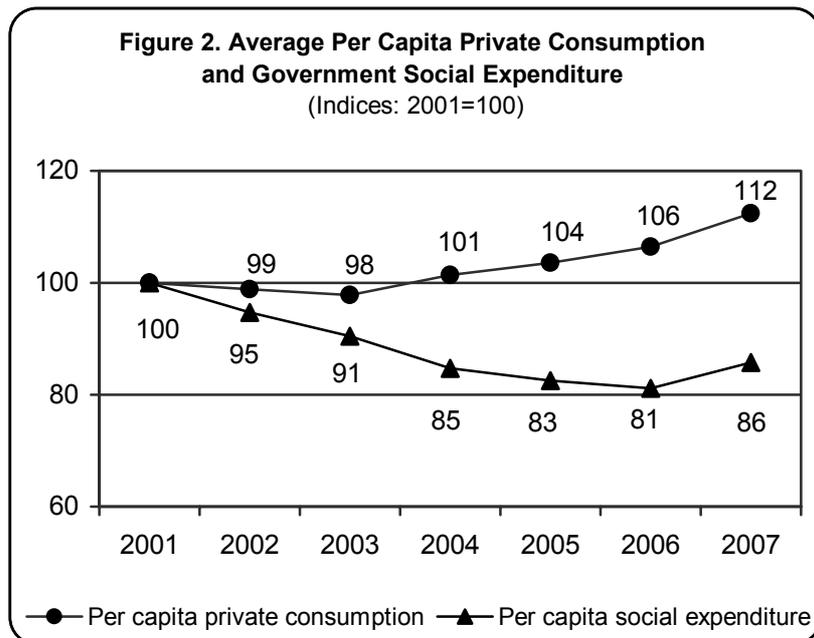
The rationale behind capping the real increase in government expenditure was to assist growth by freeing resources for the business sector to use. Indeed, the government expenditure/GDP ratio has been falling over the years. Expenditure net of debt servicing declined from 36.2 percent of GDP in 2001 to 31.7 percent in 2006 (Table 4). This decrease, however, was achieved largely by a relative cutback in social expenditure, which declined in GDP terms from 20.3 percent in 2001 to 16.1 percent in 2006. In fact, during the entire review period, social expenditure contributed more than 90 percent to the decline in the ratio of government expenditure (net of debt servicing) to GDP.

Table 4. Government Expenditure as Percent of GDP

	Total expenditure	Expenditure excluding debt servicing	Social expenditure
2001	51.8	36.2	20.3
2002	51.7	36.6	19.8
2003	52.0	35.4	19.2
2004	47.3	33.5	17.6
2005	47.2	32.3	16.7
2006	46.7	31.7	16.1
2007	47.8	33.7	16.7

The government's choice of social expenditure as the vehicle for the relative decrease in its expenditure in relation to the GDP contradicts its declarations regarding the aim of "strengthening society" that appear in official economic policy and budget documents. Government social services are an important component of the weaker population groups' consumption, and transfer payments constitute a major part of their income.

Furthermore, when the share of government social expenditure falls and that of other uses rises, social inequality and economic disparities widen steadily. This can be seen by comparing the trend in per capita private expenditure with the trend in per capita average government social expenditure. The comparison (Figure 2) shows that in 2002-2006 per capita private consumption increased by 6.4 percent whereas per capita average government social expenditure declined by 18.8 percent. In 2007, despite a seeming increase in government social expenditure, the gap remained unchanged. Thus, according to the estimates, average per capita government social spending and per capita private consumption are expected to increase at similar rates.

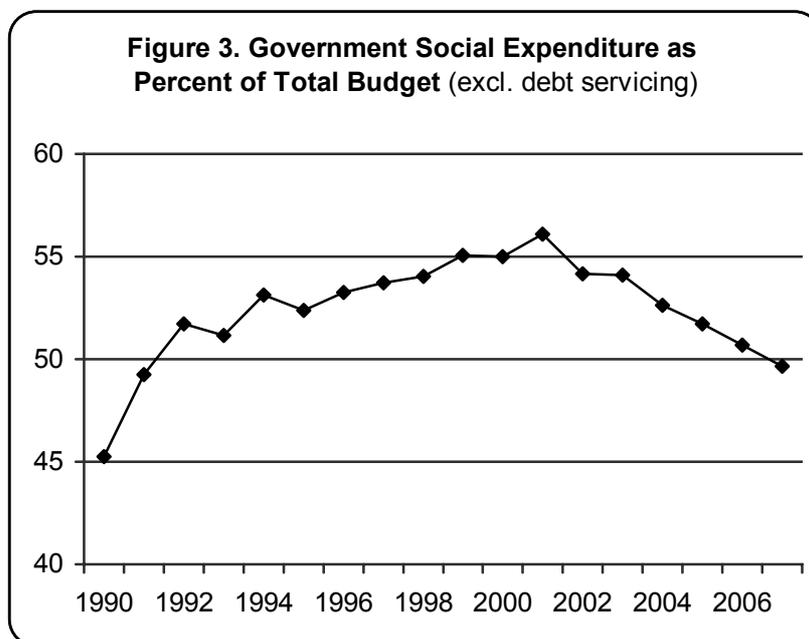


4. Main Government Expenditure Items: Guns and Butter or Economic Stability?

In 2006, 32 percent of government expenditure was directed to debt servicing and the remainder was divided among social expenditure (50 percent), defense (25.7 percent), and economy and administration (23.6 percent) (Table 5). The share of disposable government expenditure (total expenditure after debt servicing) was smaller than in 2005 and, within this aggregate, that of social expenditure fell for the fifth consecutive year. Defense outlays, in turn, began to increase again and accounted for more than one-fourth of total disposable government expenditure in 2005 and 2006, as had been the case at the peak of the wave of terror in 2002, and exceeded outlays in most years in the 1990s. Economy and administration expenditure covers a wide variety of activities – from incentives for investment, research and development and exports to the maintenance of public order, environmental quality, and more – and has been claiming a steadily rising share of disposable government expenditure since the beginning of the current decade.

Table 5. Distribution of Government Expenditure by Main Areas (Percent)

	Total	Debt servicing	Disposable expenditure	Social services	Defense	Economy and Administration
1985	100.0	43.4	100.0	32.1	40.2	27.7
1992	100.0	29.8	100.0	51.7	26.1	22.2
2001	100.0	30.2	100.0	56.1	23.6	20.3
2002	100.0	29.2	100.0	54.2	25.4	20.4
2003	100.0	32.0	100.0	54.1	24.3	21.6
2004	100.0	29.1	100.0	52.6	24.6	22.8
2005	100.0	31.6	100.0	51.7	25.3	23.0
2006	100.0	32.1	100.0	50.7	25.7	23.6
2007	100.0	29.5	100.0	49.7	25.1	25.2



According to the 2007 budget expenditure estimates, the share of social expenditure will continue to decline and will slip below half of disposable government expenditure for the first time since 1991. The proposed budget for 2008 changes this trend, restoring social spending to 51 percent of disposable government expenditure at the expense of defense and economy and administration expenditure. However, it is premature to estimate the development of actual expenditure. After all, in the past four years all approved budgets included an increase in the share of social spending but final expenditure data showed the opposite outcome.

From a long-term perspective (back to the middle of the 1980s), the ratio of social expenditure to disposable government expenditure has been rising steadily. It was in 1992 that more than half of disposable government expenditure first went for social services. After peaking at 56 percent in 2001, the trend turned around and the share declined steadily to 51 percent in 2006.

Interestingly, the proportional increase in social expenditure came mainly at the expense of defense spending, whereas the decline in recent years is largely due to the proportional increase in economy and administration.

The relation between defense and social spending or, generally, civilian uses, again became a central issue on the public agenda due to the Second Lebanon War. Specifically, it has been argued in recent years that domestic defense expenditure has been cut too severely (nearly all defense imports are covered by American grants-in-aid, which have been rising) and that economic and social goals have been given too much priority. Analysis of the overall balance of domestic public expenditure and income since the beginning of the 1990s (Table 6) shows that domestic defense consumption declined and domestic civilian uses increased, but only in the first half of the 1990s, due to the necessities of the absorption of the mass immigration of those years. From 1995 to 2006, domestic defense expenditure declined by only 1 percent of GDP. Since GDP increased during these years, absolute defense consumption also grew in real terms. Furthermore, in the past decade, concurrent with the 1 percent decrease in the share of defense spending in GDP, the share of government domestic civilian uses in GDP also fell (by 1.7 percent).

During the entire period, the most marked change is the contraction of the domestic deficit – from 7.2 percent of GDP in 1990 to 2.6 percent in 2006. The change reflects the high priority that was given to the maintenance of economic stability and the influence of an ideological approach that favored smaller government involvement in the economy, which all governments have shared since the inflation crisis of the mid-1980s. The decrease in the domestic deficit since 1990 – by 4.6 percent of GDP – occurred because interest payments to the public were cut by 2.8 percent of GDP (due to the decline in the deficit and the government debt/GDP ratio), direct subsidies were decreased by

Table 6. Components of Public Sector Domestic Expenditure and Revenues, 1990-2006*a. Percent of GDP*

	1990	1995	2000	2005	2006
Domestic defense consumption	9.5	7.2	6.3	6.0	6.2
Domestic civilian uses	18.4	22.4	21.0	21.0	20.7
Total domestic demand	27.9	29.6	27.3	27.0	26.9
Taxes	35.7	36.9	37.1	35.7	36.2
Transfer payments to public, net	10.1	10.6	10.9	10.7	10.3
Taxes less transfer payments to public	25.6	26.3	26.2	25.0	25.9
Direct subsidies	2.7	1.3	0.8	0.7	1.0
Interest payments	6.3	4.8	4.1	3.9	3.5
Revenue from property and other	4.1	4.1	2.5	3.4	2.9
Domestic deficit	7.2	5.3	3.5	3.2	2.6

b. Rate of change (percentage points)

	1990-2006	1990-1995	1995-2000	2000-2005	2005-2006
Domestic defense consumption	-3.3	-2.3	-0.9	-0.3	0.2
Domestic civilian uses	2.3	4.0	-1.4	0.0	-0.3
Total domestic demand	-1.0	1.7	-2.3	-0.3	-0.1
Taxes	0.5	1.2	0.2	-1.4	0.5
Transfer payments to public, net	0.2	0.5	0.3	-0.2	-0.4
Taxes less transfer payments to public	0.3	0.7	-0.1	-1.2	0.9
Direct subsidies	-1.7	-1.4	-0.5	-0.1	0.3
Interest payments	-2.8	-1.5	-0.7	-0.2	-0.4
Revenue from property and other	-1.2	0.0	-1.6	0.9	-0.5
Domestic deficit	-4.6	-1.9	-1.8	-0.3	-0.6

1.7 percent of GDP, and government domestic demand was cut by 1 percent of GDP. From the other direction, property revenues and other domestic revenues fell by 1.2 percent of GDP. The tax burden inched upward – by only 0.5 percent of GDP – but some of the increase was offset by a slight upturn – 0.2 percent of GDP – in transfer payments to the public.

In 2006, the domestic deficit continued its downward trend, mainly due to an increase in the tax burden and a cutback in transfer payments to the public. At the same time, domestic defense expenditure increased and domestic civilian uses contracted, leaving the share of domestic demand in GDP virtually unchanged.

5. Social Expenditure – Total, In-Kind Services, and Transfer Payments

Social expenditure pays for services delivered directly by government, services provided to the public by other public and private institutions with full or partial government funding, and transfer payments, largely provided by the National Insurance Institute. The list of government funded services includes education, health care, personal social services, public housing, and assistance for recent immigrants. The main transfer payments are child allowances, old-age and survivors' benefits, allowances for persons with disabilities, unemployment compensation, and income maintenance.

In 2006, NIS 101.8 billion was spent on social services, mostly – 95 percent – via the current budget. In 2002-2005, social outlays decreased by 11 percent in real cumulative terms: 3.4 percent in 2002, 2.7 percent in 2003, 4.7 percent in 2004, and 0.8 percent in 2005. These relatively steep decreases followed a steady increase from 1984 to 2001 (5.5 percent in average annual terms).

The downward trend was halted in 2006 (with an increase of 0.2 percent) whereas the estimated expenditure for 2007 points to a

real increase of 7.5 percent in social expenditure. In the past two years, then, a turnaround has occurred. However, even after the upturn (if it comes to pass), the level of social spending in 2007 will have been 4.3 percent lower than the 2001 peak. Furthermore, the 2008 budget calls for a lower level of expenditure (by 3.8 percent), meaning that the 2007 level may turn out to be an exception.

Social expenditure, as stated, is divided between in-kind services and transfer payments. Government offices are responsible for the delivery of services and the expenditure for them is fully incorporated into the state budget. Most transfer payments are made by the National Insurance Institute; the state budget covers the difference between total outlays and receipts from the public's insurance contributions. The discussion that follows (and the data in the Appendix) relates to total government social expenditure, including National Insurance transfer payments. This is a good way of presenting the full picture of government social spending.

In 2006, NIS 60.8 billion was spent on in-kind services, 60 percent of total social expenditure, and NIS 41.0 billion went for transfer payments. Over the years, the share of expenditure for services has been declining and that of transfer payments has been rising (Table 7). A notable departure from the overall trend occurred in the early 1990s following mass immigration from the former Soviet Union and the need to provide hundreds of thousands of immigrants with public housing. During the rest of the 1990s, the share of expenditure on in-kind services declined by 11 percentage points and that of transfer payments increased in parallel. In recent years, the ratio of services to transfer payments in total government social expenditure has stood at roughly 60:40.

Table 7. 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	60.4	39.6
2006	100.0	59.7	40.3
2007	100.0	62.2	37.8

The changes in the composition of social spending reflect major differences in the development of each of the two components in the 1980s and the 1990s (Table 8).² In-kind service outlays held more-or-less steady throughout the 1980s, increased steeply in the first half of the 1990s (mainly due to immigrant integration needs), and leveled off again in the second half of the 1990s. In contrast, a real increase in transfer payments continued uninterrupted in both decades. For this reason, by the turn of the twenty-first century, in-kind service expenditure had doubled relative to the beginning of the 1980s whereas transfer payments had quadrupled. In 2002-2005, contrary to conventional belief, the cutbacks in social expenditure reduced both components at the same rate. In 2006, in-kind service expenditure continued to fall and transfer payment outlays increased, both in real terms.

² Real changes in expenditure on in-kind services were calculated by adjusting them for changes in the Public Consumption Price Index, whereas transfer payments were deflated by the Consumer Price Index.

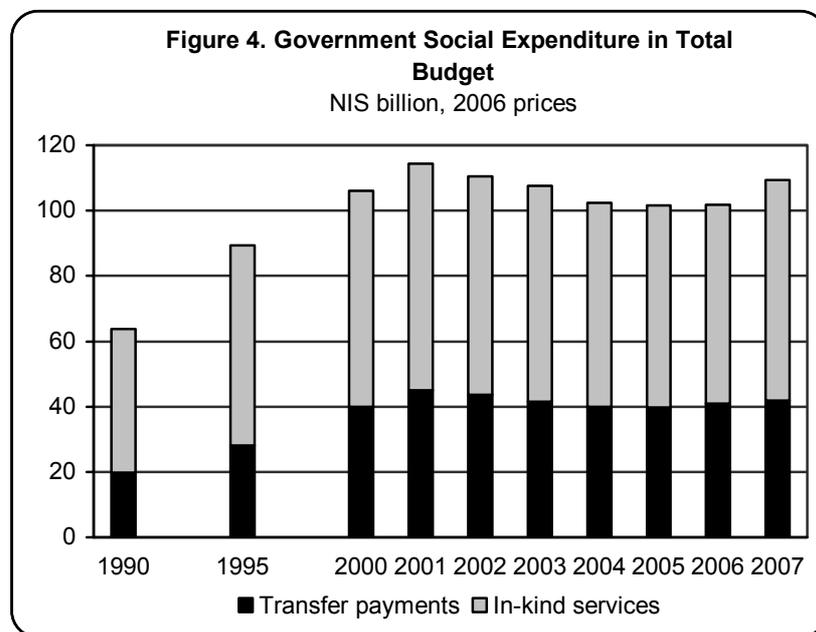


Table 8. Development of Main Components of Social Expenditure (Constant prices, Index: 1980 = 100)

	In-kind services	Transfer payments
1980	100	100
1989	99	175
1996	190	271
2001	196	405
2005	175	357
2006	172	369
2007	191	377

According to the 2007 expenditure estimates, both components are expected to have increased – in-kind service expenditure by 11 percent and transfers by 2.3 percent. In fact, most of the increase in overall social expenditure in 2007 – some 87 percent – was designated for in-kind services. The planned decrease in social spending in 2008 also pertains entirely to the in-kind services, whereas transfer payments are expected to grow by 3.5 percent. The annual fluctuations in in-kind service expenditure – if the 2008 expenditure conforms to the proposed budget – reinforce the assessment that 2007 will have been an exception in the trend of government social expenditure.

6. In-kind Social Services

In 2006, NIS 60.8 billion was spent on in-kind social services, for a 12.2 percent real cumulative reduction since 2001. Within the aggregate, education was the largest item at NIS 31 billion, 51 percent of the total expenditure.

a. Composition of Government Expenditure on In-Kind Social Services

The composition of in-kind social service expenditure has changed over the years (Table 9) mainly due to the effects of mass immigration in the 1990s. The increase in immigrant integration expenditure, especially in government investment in housing, was mirrored in a proportionate increase in the catch-all category “other services,” which includes the budgets of the Ministries of Construction and Housing and of Immigrant Absorption. The impact of this factor has been declining steadily in recent years.

Excluding the effect of mass immigration, several trends stand out: stability in the share of education spending (about half of total expenditure in the 1980s and the first half of the current decade); relative decrease in health care expenditure share (about one-third

of service expenditure in the 1980s and roughly one-fourth at the beginning of this decade, with an upward trend in recent years); and, a long-term slow rise in the share of expenditure on personal social services, especially since the mid-1990s.

In 2007, according to the expenditure estimates, there was a notable increase in the relative share of expenditure on “other services”, reflecting exceptional rises in spending on housing (55 percent) and employment (34 percent). The budget supplements that were allocated to these two items, if fully utilized in 2007, explain most of the deviation in government social expenditure in general and in-kind service expenditure in particular.

Table 9. Composition of In-Kind Social Service Expenditure
(Percent, current prices)

	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	50.6	28.2	9.1	12.1
2006	100.0	51.0	28.9	9.4	10.7
2007	100.0	49.6	27.2	9.3	13.9

b. Government's Share in National Education and Health Care Expenditure³

National education expenditure includes the outlays of all public and private institutions of education from pre-primary to higher education; households' expenditure on private tutoring, textbooks, etc.; and expenditure for the construction and equipping of new educational institutions. National health care expenditure includes outlays for all health care services provided at clinics and hospitals, services of private physicians and dentists, outlays for medicines and medical instruments, government research and administration in the field of health, and investments in physical facilities and equipment. Funding of national expenditure for education and health care is divided between the public sector, including municipal authorities, and households.⁴

In the estimation of the Central Bureau of Statistics, the share of national education expenditure in gross national income rose from 9.1 percent in 1995 to 9.7 percent in 2001 and 2002 and then decreased to 8.4 percent in 2006. At the same time, the share of government funding in national education expenditure declined from 80 percent in the mid-1990s to 77 percent in 2002 and 75 percent in 2004-2005.

The proportion of national health care expenditure in GDP rose from 7.9 percent in the mid-1990s to 8.4 percent in 2001 but decreased steadily to 7.8 percent in 2005-2006. During those years,

³ The data in this section are based on estimates by the Central Bureau of Statistics and may differ from data in other parts of the survey, which are based on Taub Center analyses.

⁴ Donations covered about 1 percent of national education expenditure, mostly for universities. About 3 percent of national health care expenditure was not funded by government or households; in the main, this reflects the deficits of the sick funds (HMOs) which, in the past, were largely covered by government.

the government reduced its share in the funding of national health care expenditure as it did in education but even more so: from 74 percent in 1996-1998 to only 64 percent in 2006.

The proportional decrease of government funding of national education and health care expenditure has forced households to pay much more for these services. This development – the “privatization” of education and health care funding – threatens to increase inequality in the use of these services. Indeed, at least with respect to health care, findings of the Taub Center’s Public Survey, supported by findings from a Brookdale Institute survey and others, indicate that a large share of the public refrained from using some essential medical service in the year preceding the survey due to its direct cost to the consumer. With respect to education, some of the increase in private funding for education stems from the expansion of the higher education system (the establishment of colleges, etc.) and reflects the increase in the number of Israelis acquiring higher education.

c. Government Education Expenditure

Education is the largest single item in government expenditure on in-kind social services. In 2006, government education spending totaled NIS 31 billion, similar to spending in the two preceding years. Over the past three years, expenditure declined gradually to a level 6.5 percent lower in real terms than in 2001-2003. The expenditure estimates for 2007 point to a real increase of 8 percent; the 2008 budget proposal includes a real cutback of 4.5 percent. Even if the budget program is fully implemented, annual average education expenditure will remain roughly 4 percent lower than at the beginning of the decade, despite the natural increase in needs.

From the mid-1980s until 2001, government education expenditure increased steadily at a rather brisk average rate of 5.3 percent annually. The growth was especially swift from 1989 to 1996 – 8.2 percent per year – as new students who had arrived in

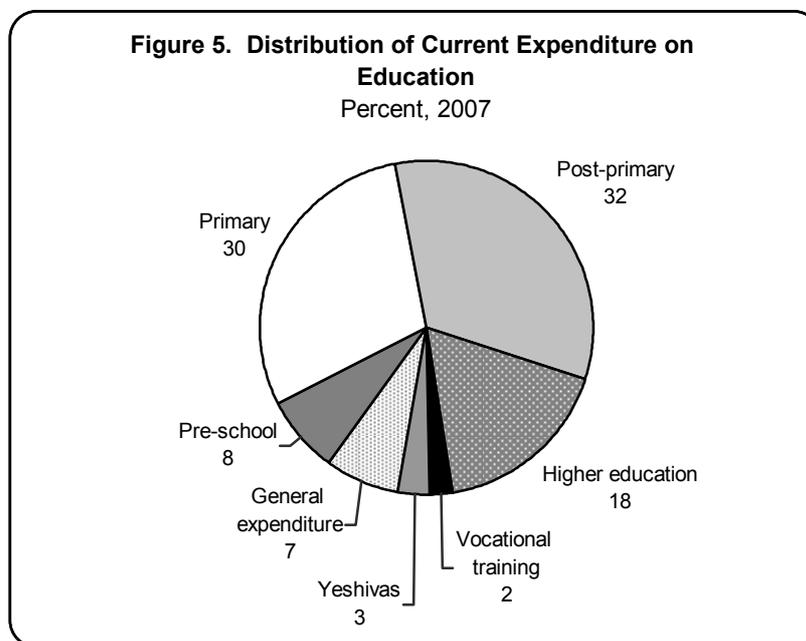
the mass immigration of the early 1990s entered schools. In the years 1997-2001, the rate of annual increase slowed to 2.3 percent. Two main issues in this field call for special attention: changes in priorities and the trend in education quality.

The distribution of current expenditure among levels of education is generally considered a suitable proxy for government priorities in education spending (Table 10 and Figure 5). Thus, over a decade and a half, including the 2007 estimates, the distribution of expenditure did not change in any major way. The most notable difference was an increase in the proportion of expenditure for preschools, reflecting the extension of the Compulsory Education Law to the 3-4 age cohort. Another change, the proportional decrease in outlays for *yeshivas* (non-State religious high schools), evidently stems from the elimination of budgeting redundancies when some of the budget was transferred from the Ministry of Religious Affairs to the Ministry of Education.

This relative stability over such a long time makes one suspect that the path of expenditure is being influenced mainly by demographic trends and that policies and priorities have had only a minor effect.

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

	1990	1995	2000	2005	2006	2007
Total	100.0	100.0	100.0	100.0	100.0	100.0
General						
expenditure	7.8	7.1	7.0	7.1	6.6	7.1
Preschool	4.9	4.6	6.1	7.4	7.7	7.5
Primary	26.7	28.5	26.4	29.3	30.2	29.6
Post-primary	34.5	34.6	35.5	34.3	33.8	32.9
Higher education	17.2	17.4	18.3	18.0	17.7	17.5
Vocational training	3.1	3.0	2.6	1.9	1.7	2.4
<i>Yeshivas</i>	5.8	4.8	4.1	2.0	2.3	3.0



Another aspect of priorities is related to the distribution between the current budget and the development budget. The development budget is used for the construction, renovation, and equipping of schools, i.e., adjusting the system's physical infrastructure to future needs. In the past two years, only 2 percent of total government education spending has been allocated to the development budget. In absolute terms (constant 2006 prices), average annual development spending was NIS 1.3 billion in 1998-2001, NIS 905 million in 2002-2003, and NIS 581 million in 2004-2006. The low and falling level of investment raises concerns that future needs are being neglected. Given the natural increase of the student population, a dangerous gap may open up between needs and available infrastructure, to the detriment of education quality. Although an increase is foreseen in 2007 (by about NIS 0.5 billion over 2006), it is evidently related to the renovation of schools that

were damaged in the Second Lebanon War and has nothing to do with a real response to the growing gap. Furthermore, the 2008 budget reverts to the 2004-2006 level of investment.

Average current per student outlays, in constant prices, may be considered a rough proxy of overall education quality. Table 11 presents data on the change in average per student expenditure since 1995, overall and by levels of education, along with partial data about changes in average per student classroom hours. The ratio of the changes gives some indication of increased efficiency in the system.

During the entire period under review (1995-2006), average per student expenditure throughout the system declined by roughly 7 percent. The decrease was especially steep in higher education but was also notable at the post-primary level. In primary education, in contrast, there was an increase. The overall period, however, is composed of two rather distinct sub-periods. In the second half of the 1990s, average per student expenditure increased system wide as well as at the primary and post-primary levels and declined slightly in higher education. In the first half of the current decade, average per student expenditure continued to rise modestly at the primary level but declined significantly at the post-primary and higher levels and in the system at large. In 2006, the trends of the previous half-decade continued. Thus, the quality of education seems to have declined, especially in recent years.

However, several complementary remarks are in order. First, the steep decrease in average per student expenditure in higher education does not necessarily attest to a parallel decline in education quality; it may reflect a change in the mix of students. In the past decade, higher education enrollment has grown by 60 percent, from 160,000 to 260,000, and most of the increase was in colleges and other new settings of study that have lower average per student cost than the long established universities. Second, at the primary level, both average per student expenditure and

average per student classroom hours increased. This may indicate that quality improved but efficiency did not. Finally, at the post-primary level both average per student expenditure and classroom hours decreased, but the decline in hours was smaller. Thus, efficiencies may have helped to inhibit a decline in education quality.

Table 11. Average Per Student Expenditure and Classroom Hours (Period percent change)

	1995/2000	2000/2005	2005/2006	1995/2006
<i>Avg. per student expenditure</i>				
Total	6.5	-11.2	-1.5	-6.8
Primary	5.3	1.3	0.7	7.4
Post-primary	4.1	-12.4	-1.9	-10.3
Higher education	-3.7	-19.2	-3.1	-24.6
<i>Avg. per student classroom hours</i>				
Primary	10.2	-1.1	-3.8	4.8
Post-primary	3.1	-4.0	-1.6	-2.6

Source: Ministry of Education, Economics and Budget Administration (Economics and Statistics Division) and Central Bureau of Statistics (CBS): "Main Data about the Education System," from Enrollment Outlook for the 2006/07 School Year.

d. Government Health Care Expenditure

In 2006, the government spent NIS 17.6 billion on health care, 1 percent more than in 2005 in real terms. Another real increase of 4.5 percent is foreseen in 2007 whereas the 2008 budget program cuts spending by 8 percent. Since 1980, the trend in government health expenditure can be divided into several sub-periods. Spending was typically stable in the first ten years, 1980-1989. In the next seven years (1990-1996), expenditure rose swiftly to a new plateau roughly 15 percent higher than the earlier one. From

then until 2003, expenditure remained at the new level with minor fluctuations (except for a 6.2 percent decrease in 2000 relative to 1999). In the last four years, especially if the budget increase in 2007 is utilized as planned, a new trend may have developed: a cumulative real increase of as much as 12 percent.

If expenditure remains at a constant real level for years, or even if it grows slightly, average per capita expenditure declines. Furthermore, price increases in health care services tend to outpace the general price index.⁵ Taken together, the stable level of spending, the effect of population increase, and the rise in the relative prices of health care services allow an estimate that the delivery of government funded health care services to the public has eroded by 25-30 percent since 1997.

Government health care expenditure includes investments in physical facilities and equipment. The level of investment has fallen steeply from the relatively high plateau that persisted in the early 1990s; in the past three years, it was only 1 percent of total government health care expenditure – NIS 200 million on annual average (in 2006 prices). In 2007, according to the expenditure estimates, an increase in investment is foreseen. Either way, inadequate investment in health care, as in education, erodes the system's physical infrastructure and may later result in service of poor quality.

Current expenditure is divided between participation in health insurance – practically speaking, paying for health care services delivered by non-governmental organizations – and direct outlays for the delivery of health care services. Over the years, the share of health insurance participation has been falling and that of direct expenditure has been rising (Table 12), mainly due to the

⁵ In 2000-2006, the index of health care services prices (a component of the Consumer Price Index) rose by roughly 9 percent more than the general CPI.

elimination of the employer-paid “parallel tax” in 1997. In 2007, pursuant to the government resolution to transfer insurance responsibility for mental health to the sick funds (public HMOs), the original budget was adjusted to reflect an increase in transfers to NGOs and a decline in in-kind expenditure. For the time being, however, the expenditure estimates give no evidence of such a change.

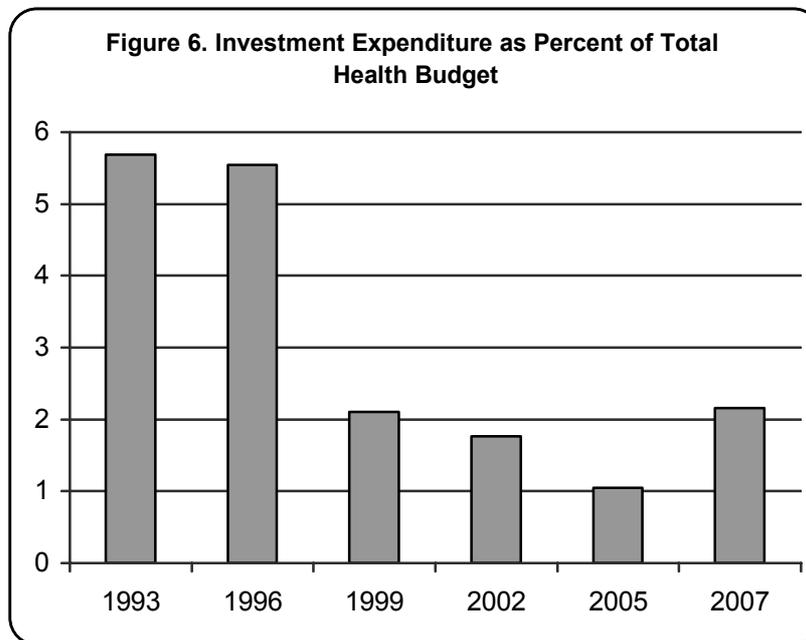


Table 12. Distribution of Current Government Health Care Expenditure – Main Components (Percent)

	1990	1995	2000	2005	2006	2007
Total	100.0	100.0	100.0	100.0	100.0	100.0
Participation in health insurance	71.2	70.0	66.0	67.3	67.4	67.3
In-kind expenditure	28.8	30.0	34.0	32.7	32.6	32.7
In-kind expenditure						
Total	100.0	100.0	100.0	100.0	100.0	100.0
General inpatient care	10.0	11.9	3.4	3.1	3.1	2.2
Psychiatric care	21.9	23.2	22.6	27.3	25.7	25.5
Long-term care	17.1	17.2	20.8	21.8	22.6	22.6
Public health	14.0	17.2	22.1	18.6	18.8	15.8
Other services*	37.0	30.5	31.1	29.2	15.8	33.9

* Includes health care expenditure outside the Ministry of Health budget, mainly National Insurance outlays for inpatient maternity care, treatment of workplace casualties, etc.

Within the aggregate of in-kind expenditure, changes have occurred that are generally indicative of a focus on special health care services. Thus, expenditure on general inpatient care has fallen and the two main expenditure items – psychiatric and long-term care – have increased slightly (Table 12). In the future, when insurance responsibility for mental health is transferred to the sick funds, expenditure for psychiatric care will decrease (according to the 2008 budget, it will fall to 10.2 percent of in-kind outlays) and the composition of in-kind outlays is expected to change considerably.

e. Personal Social Services

The personal welfare services are administered by the Ministry of Social Affairs and Social Services and municipal welfare bureaus. In 2006, the government spent NIS 5.7 billion on these services, up 2.3 percent in real terms over 2005, following a cumulative real decrease of 3 percent in 2003-2004 and an increase of about 0.5 percent in 2005.

In the 1980s, until the Long-Term Care Insurance Law was passed in 1988, expenditure was around NIS 1.85 billion per year (in 2006 prices) with minor year-to-year fluctuations. Since then, the annual expenditure has been increasing steadily and has roughly tripled.

Government expenditure for personal social services is divided into two main classes: long-term care benefits, the share of which has risen in recent years and accounted for 45 percent of total outlays in 2006; and all other services, including social services for children and youth, care of the elderly, special population groups (marginalized youth, persons with mental and physical disabilities), and personal and family welfare services in centralized locations and in the community.

7. Transfer Payments – the Social Insurance System

For more than two decades until 2001, transfer payments to the public via the National Insurance Institute rose steadily, at real annual average rates of 6 percent in the 1980s and 8 percent in the 1990s and up to 2001. In 2002, an abrupt turnaround occurred as the level of benefits was cut, and eligibility rules were modified and applied more strictly. Thus, the outlay for transfer payments in 2006, NIS 41 billion, was roughly 9 percent lower in real terms than the 2001 peak.

In 2006, transfer payment expenditure increased by 3.1 percent relative to 2005. In fact, 2005 was a watershed year of sorts (Table 13). Until then, both total transfer payments and outlays for the main benefit categories (with the exception of general disability) declined, whereas in 2006 the picture turned around and only outlays for unemployment compensation and income maintenance continued to decrease. Child allowances, the largest factor in the decline until 2005, led the increase in 2006. If the expenditure estimates prove accurate, the rise in overall transfer payments and main benefits programs will have continued in 2007.

Outlays for different benefits declined at different rates between the peak year and 2006 (Table 13). Thus, there were especially large cumulative decreases in unemployment compensation (49 percent), child allowances (40 percent), and income maintenance (32 percent). In contrast, expenditure on general disability benefits increased (by 25 percent). Spending on old-age and survivors' benefits decreased by 3.8 percent in 2002 and increased cumulatively by 7.1 percent since 2004.

Table 13. Changes in Transfer Payments – 2006 vs. 2001
(Cumulative percent change)

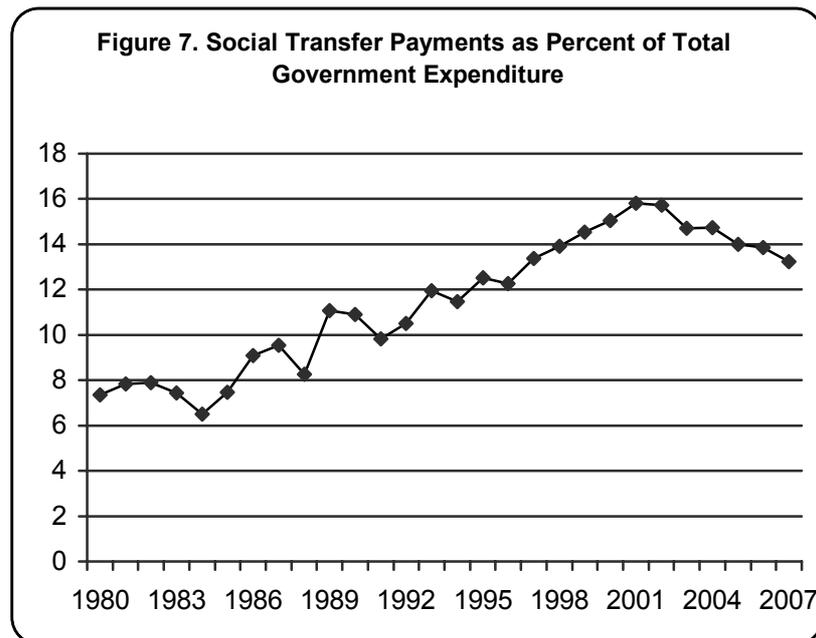
	2006 vs. 2001	2005 vs. 2001	2006 vs. 2005
Total	-8.9	-11.7	3.1
Old-age and survivors	3.0	-0.3	3.4
Child allowances	-40.1	-44.9	8.6
General disability	25.2	18.4	5.8
Unemployment and income maintenance	-40.4	-36.8	-5.7
<i>Thereof:</i>			
Unemployment	-49.2	-47.1	-3.9
Income maintenance	-31.5	-26.4	-7.0
Other	4.8	2.9	1.9

a. Policy Changes and Their Significance

The reasoning behind the turnabout in the government's policy on transfer payments was serious. With the level of the benefits and the eligibility rules set in law, the government had to enlarge its transfer payment budgets each year, if only for demographic reasons (population increase, including that resulting from immigration, and changes in the population's composition). Eligibility rules were being interpreted liberally and applied generously; the public was also becoming increasingly aware of its entitlements. Gradually, transfer payments became a heavy burden on the budget, increasing from 7 percent of government expenditure in 1980 to 11 percent in 1990 and 16 percent in 2001, (all in current prices.) Under these circumstances, it was felt that to lower government expenditure and the budget deficit to levels that characterize stable economies, the transfer payment policy must be changed. At the same time, as economic growth ground to a halt and employment rates among Israelis declined, it was argued that transfer payments were creating a disincentive to work – especially among those of low income – and, in turn, to economic activity. The proponents of this view pointed in particular to the steep increase in the number of income maintenance beneficiaries of working age – about 9,900 households in 1982, when the Income Maintenance Law went into effect, to 32,000 in 1990 and 155,000 in 2003. Benefit cutbacks were thus meant to stimulate participation in the labor force.

However, the cutbacks that were adopted claimed a socioeconomic price that cannot be ignored. Transfer payments, together with the tax system, are meant to impact on inequality in the distribution of national income. As noted previously, the effect of taxes and transfer payments on lowering the Gini index of income distribution inequality has been diminishing in recent years – from 32.5 percent in 2002 to only 25.8 percent in July 2005 to June 2006. Similarly, the two systems have been less and less

effective in reducing the incidence of poverty: the number of poor households as measured by disposable income was 47.5 percent lower than that of poor families measured by economic income in 2001, as against only 39 percent lower in July 2005 to June 2006.



Moreover, transfer payments serve as a social safety net that is supposed to assure economically and socially weak population groups – the elderly, the disabled, the unemployed, etc. – a minimum income at a reasonable ratio to the society's general standard of living. The effect of the cutbacks in transfer payments, then, should be tested not only in absolute terms but also in relative terms, i.e., relative to developments in the benefit recipients' social environment.

To perform this test, the ratios of the various transfer payments to the average standard of living at several points in time were

calculated. The transfer payments were measured on per recipient average and the proxy for standard of living was per capita private consumption. At the first point in time, 1989, the effects of the mass immigration from the former Soviet Union were not yet felt. (Due to differences in the availability of data, the first point of reference in 1990 in regard to child allowances and 1991 for unemployment compensation.) The second point was 2001, preceding the government's decisions that reversed the long-term trend in transfer payments. The third point is 2005, when the policy change had the greatest downward effect on the level of transfer payments. Data for 2006 (the last year for which full expenditure data exist) are also shown. The changes that occurred in these ratios are presented in index terms, with the earliest year as the base year (Table 14).

Table 14. Average Benefits vs. Average Standard of Living
(Percent)

	1989	2001	2005	2006
Old-age and survivors	100	92	83	84
Child allowances	100*	76	39	40
General disability	100	106	102	101
Unemployment	100**	111	101	100
Income maintenance	100	94	67	66

* 1990.

** 1991.

In all transfer categories, the calculated ratios were lower in 2005 than in 2001. In regard to old-age and survivors' benefits, child allowances, and income maintenance, the ratios were lower in 2005 even than the base year. (The ratios for disability benefits and unemployment compensation were similar at both points in time.) The steepest decrease occurred in child allowances and income

maintenance. In 2006, the changes were minor: a slight rise in old-age and survivors' benefits and child allowances and an additional small decline for other beneficiaries. Even though these rough calculations have their drawbacks, they lead to the unavoidable conclusion that the cutbacks clash with the concept of proportionality.

b. Main Transfer Payment Programs

The largest component in the aggregate of transfer payments is old-age and survivors' benefits (Table 15). The level of expenditure on this item depends mainly on the size of the population of the elderly and the proportion of elderly entitled to supplementary income maintenance. In the 1990s, expenditure was pushed up by the arrival of large numbers of seniors in the mass immigration, many of whom needed income maintenance. As part of the policy that was introduced in 2002, a general reduction in benefits was agreed upon, the age of eligibility was raised, means tests were toughened, and benefits were indexed to the Consumer Price Index instead of the national average wage. As a result, total outlays in 2002 and 2003 were roughly 4 percent lower than their 2001 level even though there were more beneficiaries. Outlays increased by 1.9 percent in 2004, 1.7 percent in 2005, and 3.4 percent in 2006. Contributory factors to the increase in 2005 were an increase in the income supplement benefit, a partial repeal of the across-the-board cutback (from 4 percent to 1.5 percent), and an inflation adjustment. At the beginning of 2006, benefits were updated by another 1.8 percent and the across-the-board reduction was totally repealed in mid-year.

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

	1990	1995	2001	2005	2006	<i>Annual average percent change</i>	
						1991- 2001	2002- 2006
Total	100.0	100.0	100.0	100.0	100.0	7.8	-1.9
Old-age and survivors	44.6	40.5	37.0	41.8	41.9	6.0	0.6
Child allowances	22.2	22.8	18.5	11.5	12.1	6.0	-9.8
General disability	11.3	11.6	14.4	19.3	19.8	10.2	4.6
Unemployment and income maintenance	10.6	12.6	17.1	12.2	11.2	12.5	-9.8
<i>Thereof:</i>							
Unemployment Income maintenance	7.3	6.7	8.6	5.1	4.8	9.4	-12.7
Other	3.3	5.9	8.5	7.1	6.4	17.4	-7.3
Other	11.3	12.5	13.0	15.2	15.0	9.2	0.9

In most years, child allowance payments were the second largest program within the total transfer payment expenditure. In the 1990s, spending for this purpose increased due to three major changes: repeal of the freeze of benefits for first and second children; extension of eligibility to households whose members had not served in the army; and, passage of the Large Families Law. Government policies since 2002 included, among other things, a 15 percent reduction in allowance size and phased equalization over seven years of allowances for all children irrespective of their birth order in the family (and, for those born after June 2003, immediately). Thus, by 2005 the outlay in real terms fell by 45 percent. At the beginning of 2006, the ad hoc provision concerning the fixed-sum cutback expired and the allowances were adjusted to inflation. However, the cutback under the policy of standardizing all children's allowance benefits remained in effect. As a result of

these changes, payments in 2006 were 8.6 percent higher in real terms than in 2005.

Expenditure on disability benefits increased rapidly throughout the review period, especially since the mid-1990s. In fact, this is the only area of benefits that was untouched in the 2002 cutback policy. What is more, several benefits were added to this rubric, amongst them: a special benefit for the severely disabled, an extra benefit for persons with disabilities who are rated at severe loss of earning capability, a supplemental benefit for disabled children. Another contributing factor to the increase in expenditure since 2005 is the deferring of the retirement age, which allows persons with disabilities to receive disability benefits for a longer period of time until they are eligible for old age benefits. In 2006, outlays were 5.8 percent higher than in 2005 in real terms.

Expenditure on unemployment compensation and income maintenance was the fastest growing component of transfer payments in the 1990s. The steep escalation reflected the economic downturn and the rising unemployment rates during those years, coupled with a rise in the public's awareness of its entitlements in these respects. Unemployment compensation outlays grew in the 1990s even though some provisions of the program were toughened. The policies adopted since 2002, however, caused expenditure to drop sharply. The new policy lengthened the qualifying period for unemployment compensation, limited the maximum term of eligibility for the young unemployed, and reduced benefits for the repeat unemployed and participants in vocational training programs.

The income maintenance benefit was reduced by 4 percent and the maximum entitlements were cut by 10-23 percent depending on household composition. Furthermore, eligibility for the highest rate benefit was eliminated for first time recipients of certain ages, the parameters of the means test were revised, exemptions from the employment test were revoked in certain cases, and miscellaneous

discounts (on municipal property tax, public transport fares, etc.) were reduced or eliminated for new beneficiaries. Altogether, the changes cut outlays by 32 percent in cumulative terms by 2004 and by another 12 percent in 2004-2006. The downturn in the past two years also reflects an improvement in the state of employment: the number of income maintenance and unemployment compensation recipients has declined and the unemployed have been spending less time in the unemployment compensation system.

c. Funding of Transfer Payments

The sources of funding for transfer payments include the collection of insurance contributions from the public, participation from the State budget, and interest income on the National Insurance Institute's financial reserves. Since 1987, as part of the government policy to lower labor costs, the insurance contributions of employers and the self-employed have been reduced and the Ministry of Finance has been compensating the National Insurance Institute for the difference. To examine the changes in the composition of funding sources over time, the following calculations include this compensation as part of the state budget financing, along with government participation in the financing of contributory benefits and government funding of other benefits. The sum total of insurance contributions and state budget participation has exceeded transfer outlays in most years (Table 16), leaving a surplus that – after covering operating expenses – bolstered the interest earning financial reserves that the National Insurance Institute maintains with the Accountant General of the Ministry of Finance.

Until 2002, state budget participation outweighed contributions from the public by several percentage points. The combination of the benefit cutbacks, a 1 percent increase in National Insurance contributions from employers and the self-employed, and a reduction in the rate of compensation by the Ministry of Finance

starting in July 2002 brought the contributions of the two sources into equilibrium in 2003 and caused collection from the public to outweigh state budget sources in the past three years.

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

	Total benefit outlays*	Contributions from public	State budget participation**
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
2005	100	54	51
2006	100	53	52

* Net of third-party compensation.

** Not including crediting of interest on account of National Insurance reserves deposited with the Accountant General of the Ministry of Finance.

8. Conclusion

The macroeconomic achievements since resumption of economic growth in the middle of 2003 have prevented further widening in Israel's economic disparities and poverty levels but have not narrowed the gaps. Therefore, promoting the welfare of society's weaker population groups requires more than a pro-growth macroeconomic policy; more direct and focused measures are needed – especially given the evidence of the structural nature of Israel's unemployment and additional characteristics of its incidence of poverty.

Expenditure on social services in either form – in-kind or in-cash (transfer payments) – is a key weapon in the government’s arsenal of direct measures for tackling the economic distress of various population groups. Even though the government’s budget policies in recent years have spoken of the target of “strengthening society,” social expenditure continued to decline in 2006 relative to GDP (for the fifth consecutive year) and relative to the government’s overall disposable expenditure. In fact, most of the fiscal restraint in recent years, meant to further growth by freeing resources for the business sector’s use, came at the expense of social outlays.

In absolute terms, however, 2006 may have marked a turnaround. Government social expenditure increased steadily over more than two decades and peaked in 2001. The trend changed direction in 2002, resulting in a cumulative real erosion of 11 percent over the next four years. In 2006, the downturn was halted (in fact, a small real increase occurred) and the 2007 expenditure estimates indicate a 7.5 percent real increase.

Recent years’ experience, however, shows that the budgets are not fully utilized as the government and the Knesset intend. The 2006 budget was also underutilized, at a rate similar to that in 2005. The main deviation was in expenditure on in-kind services and especially in current education spending, in which the rates of underutilization have been rising steadily from year to year.

The 2007 expenditure estimate, as stated, indicates a significant increase in government social expenditure in real terms. However, the utilization data for the first three quarters of the year suggest that 2007 will be another year of underutilization. If, nevertheless, the increase in expenditure really comes to pass, it is expected to focus largely on the delivery of in-kind services, especially in housing and employment. These characteristics give reason to presume that 2007 will be an exception. After all, the 2008 proposed budget includes lower levels of expenditure for in-kind

services generally and, in particular, in the items in which increases were noted.

In years when social spending and its share in overall disposable government expenditure increased, the increases came mainly at the relative expense of defense spending. The decrease in the social budgets of the past few years, in contrast, was accompanied by an increase in the share of economy and administration spending. If too much defense expenditure was reassigned to social services, as has been claimed, it did not happen in recent years.

As social expenditure was being reduced in 2002-2005, its distribution among in-kind services and transfer payments remained more-or-less steady. Therefore, the cutbacks lowered both components at roughly the same rate, contrary to the widely held belief that transfer payments bore the brunt of the cutbacks. In 2006, outlays for the delivery of in-kind services continued to fall whereas transfer payments increased in real terms.

The ratio of national education and health care expenditure to GDP has been falling since 2002. At the same time, the public sector share in this expenditure has been reduced and the household share in funding has been increasing. This "privatization" of education and health care financing may exacerbate inequality in the use of these services.

Over the past decade and a half – including 2007 if the expenditure estimates prove accurate – no major changes took place in the distribution of current education expenditure among the various levels of education. This relative stability over such a long time leads to the conclusion that expenditure is being influenced mainly by demographic trends and that policy and priorities have had only a minor effect. In the past five years, average per student expenditure increased modestly in primary schooling but fell noticeably at the post-primary and higher levels. The upturn in average per student expenditure at the primary level was accompanied by a decline in average per student classroom

hours, suggesting that it may reflect inefficiency rather than an improvement in quality. At the post-primary level, in contrast, both average per student expenditure and average per student classroom hours decreased but the decline in hours was smaller, suggesting that improved efficiency helped to prevent a significant decline in education quality. Finally, the decrease in average per student expenditure at the higher education level largely reflects a change in the composition of the student body as opposed to a decrease in education quality.

Government health expenditure was unchanged in real terms for quite a long time and has been increasing slowly since 2004, especially if the increase seemingly observed in 2007 proves to have actually occurred. Given the increases in population and relative prices of health services, the delivery of government funded health care services to the public seems to have eroded by 25-30 percent since 1997, notwithstanding the upturn in recent years.

Investments in the physical infrastructure of the education and health care systems have been low and trending down in recent years. A falling level of investment, especially if it is low to begin with, raises concern about the formation of a dangerous gap between needs and available infrastructure in future years.

In 2002, the trend in social transfer payments to the public via the National Insurance Institute changed abruptly causing real transfers to contract by 12 percent over four years relative to the peak level in 2001. The decline focused on child allowances, unemployment compensation, and income maintenance. The cutbacks widened the gap between average benefit levels and the general standard of living and frayed the safety net that transfer payments represent for economically weak population groups.

The picture was reversed in 2006. Only unemployment compensation and income maintenance payments continued to decline; child allowances, which made the greatest contribution to

the downturn until 2005, led the upturn in 2006. According to the proposed budget, overall transfer payment outlays and main benefit categories are expected to have continued rising in 2007.

For many years, the share of state budget participation in the funding of transfer payments exceeded that of National Insurance contributions from the public. However, the benefit cutbacks and an increase in the rate of contributions from employers and the self-employed brought these two sources of funding into equilibrium in 2003 and caused collection from the public to outweigh government financing in the past three years.