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Adva Center Critique of "Operation Economic 'Defensive Shield'"

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Executive Summary

The economic measures to be implemented under a new program entitled "Economic 'Defensive Shield'" place most of the burden of financing the expenses and economic implications of the recent war on Israel's middle and weaker social strata.

The most severely affected are Israelis who derive much of their income from **National Insurance benefits**. If the proposed measures are approved, these Israelis, whose income falls in the six lowest income brackets, will become "three-time losers": two months ago the government decided not to adjust the benefits to the national average wage in 2002, and now it proposes to cut the benefits by 4 percent and refrain from adjusting them in 2003 as well.

Several groups of recipients will face especially grave consequences: ultra-Orthodox and Arab children, against whom Operation "Economic 'Defensive Shield'" discriminates on the basis of their parents' beliefs or nationality; the unemployed, whose terms of eligibility for unemployment compensation have been toughened after having been stiffened repeatedly in recent years; and recipients of income maintenance benefits.

The wealthy, in contrast, emerge unscathed. It turns out that the most-discussed measure, the taxation of capital gains has been deleted from Operation "Economic 'Defensive Shield.'" In the two days before the press conference, the Finance Ministry went out of its way to leak reports about its intention to tax capital gains, including seemingly precise details about the level and incidence of the tax. However, the program itself merely mentions the establishment of a committee charged with making recommendations. The Finance Minister promised only to "try" to implement the committee's recommendations, once he receives them, "some time during the Knesset summer session."

The Finance Ministry also targets all wage earners by **freezing their wages** for a year and a half by means of legislation. While the wealthy emerge from Operation "Economic 'Defensive Shield'" without having to pay very much, ordinary working people are supposed to forego the right to negotiate for a decent wage.

A very important clause in Operation "Economic 'Defensive Shield'" is the Finance Ministry's proposal to **shackle the Knesset** by requiring the support of a majority of members of the house for any bill that entails budget expenditure. This is the Finance Ministry's third attempt within a year to restrict bills proposed by individual legislators, as opposed to bills proposed by the Cabinet. The Ministry reminds us that most countries limit such legislation but fails to mention that, unlike the Knesset, the legislatures in most of these countries have a real possibility of influencing budget policy.

A. National Insurance Benefits

Restoring the Increased Child Allowance for Israel Defense Forces Veterans

This measure involves outright discrimination against some Israeli children on the basis of their parents' beliefs or nationality.

Higher child benefits for army veterans were invented after the Six-Day War, when economic disparities widened severely and touched off widespread social protest. The government at that time chose to compensate low wage earners-Jewish ones, that is, and especially Mizrahi Jews, who typically had large families at the time-by increasing their child allowances instead of their wages. To withhold this assistance from Arabs, the government awarded the increased allowances only to children whose parents had served in the army. This restriction, however, affected another group noted for large families, the Haredi Jews. To ease their plight, eligibility for the larger benefit was extended not only to children who had one army-veteran parent but also to children who had a sibling veteran and children whose grandparents had served-even if the veteran were no longer alive. Even so, some Jewish households remained outside the orbit of eligibles: recent immigrants, yeshiva students, and persons exempt from army service for reasons of poor health or social problems. To solve the problem, special methods were devised for them, too. Immigrants received an enlarged allowance from the Jewish Agency, yeshiva students an expanded stipend from the Ministry of Religious Affairs, and welfare households larger subsidies from the state treasury.¹

The proposal to restore the enlarged child allowance is inimical to both haredi Jews and to Arabs, a large majority of whom do not serve in the army. The difference is that a constellation of special subsidies from the Ministry of Religious Affairs has been developed for Haredi Jews.

This proposal impairs the universalistic basis of child allowances by creating a breach that will set a precedent for future erosion. As for its practical effects, it will deal large families a substantive and very painful blow by reducing their income significantly in one stroke. According to a calculation by the newspaper *Ha'aretz*, a household with five children that is found ineligible for the enlarged allowance will lose NIS 1,100 per month.²

Four Percent Across-the-Board Cutback in National Insurance Benefits

The main adverse effects of Operation "Economic 'Defensive Shield'" will be absorbed by Israelis who derive much of their income from National Insurance benefits. If the measures are approved, these Israelis will suffer three losses within two months: (1) their benefits will not be adjusted in 2002 (pursuant to a government resolution in February 2002), (2) their benefits will be slashed by 4 percent across the board, and (3) the current proposal would abolish the adjustment in 2003 as well. Notably, National Insurance benefits are low to begin with; they suffice for a poverty-line income only. The main casualties of the cutback will be persons in the six lowest income deciles:

Monthly Household Income from National Insurance Benefits, 2000

Income deciles by household income before taxes, 2000 (NIS)

1	2	3	4	5	6	7	8	9	10
1,182	1,612	1,451	1,546	1,407	1,236	977	939	737	613

Source: Central Bureau of Statistics, *Household Expenditure Survey 2000*, Table 3.1.

Child allowances are excluded from the across-the-board cutback. However, as stated above, allowances for the Arab sector, **and in practice, it alone**, will be slashed severely. Additional exceptions are general disability and survivors' benefits, compensation for army reserve duty, and old-age pensions for recipients of income-maintenance benefits.

Unemployment Compensation

In Operation "Economic 'Defensive Shield,'" the period of time during which a person must work before s/he may apply for unemployment compensation will be doubled, from 180 days to 360. The plan also reduces unemployment compensation for persons who are taking vocational training. Finally, the program targets young Arabs specifically by raising the age of eligibility for unemployment compensation to 21 for men and 20 for women (At those ages, most Jewish men and women are in the military service).

This set of proposals follows a decade of cutbacks and strictures in respect to unemployment compensation: the unemployed have to accept any job offered them irrespective of their education level or vocational training, even if the place of work is up to 60 kilometers from their homes, and even if the wage offered is lower than the unemployment compensation to which they are entitled. The rate of unemployment compensation falls incrementally so that, after the first five months, it may not exceed two-thirds of the national average daily wage. Claims are limited to one per year. The number of eligibility days for unemployed persons up to age 35 who have no dependents has been slashed from 138 to 100.

B. Taxation

Taxation of Capital Gains

The wealthy emerge from Operation "Economic 'Defensive Shield'" unscathed.

The stricture that attracted the most attention before the Finance Minister's press conference, the taxation of capital gains, is totally omitted from the package of measures that the Finance Ministry is about to present to the government for its approval. At first, the Finance Ministry went out of its way to leak reports about its intention to tax capital gains, including seemingly precise details about the level and incidence of the tax. However, the economic program itself includes only a mention of the establishment of a committee to draw up recommendations.

One Percentage Point Increase in VAT

Whereas the Minister of Finance refrained from including taxation of capital gains in "Operation Economic 'Defensive Shield'" and even soothed the rich by describing the measure as a complex one that would require preparation, he did not hesitate to take the easy step of raising the rate of Value Added Tax—a measure more harmful, in relative terms, to low-income Israelis. All Israelis, irrespective of income, will have to pay uniformly higher prices for everything they consume. To illustrate the differences in the extent of harm caused, below we show the differential impact of an NIS 100 increase in total VAT on households' monthly income, by deciles.

Percentage of Average Household Monthly Income that an NIS 100 Increase in Value Added Taxes Represents, 2000 By income deciles per standard person

1	2	3	4	5	6	7	8	9	10
3.9%	2.6%	1.9%	1.5%	1.2%	1.1%	0.9%	0.7%	0.5%	0.0%

Source: Adva Center, based on Central Bureau of Statistics, *Household Expenditure Survey 2000*, Table D.

Tax Increase on Cigarettes

Since a large proportion of low-income persons smoke, this decision will have the greatest effect on them. In 2000, persons in the lowest income quintile spent NIS 104.0 per month for cigarettes and those in the uppermost quintile spent NIS 63.8.

Monthly Expenditure for Cigarettes, by Net Income Quintiles Per Standard Person, 2000

1	2	3	4	5
104.0	94.4	96.5	70.6	63.8

Source: Central Bureau of Statistics, *Household Expenditure Survey 2000*, Table 1.

Elimination of the Income Ceiling for Health Tax and National Insurance Contributions

Today, National Insurance contributions and health tax are paid only up to an income ceiling of five times the national average wage (about NIS 35,000 per month). Wage earners who earn NIS 100,000 per month pay both taxes on NIS 35,000 only and not on the remaining NIS 65,000. Now the Finance Ministry proposes to abolish the ceiling and impose both taxes on the entire wage.

In principle, this might be viewed as a positive measure; after all, high-income earners should contribute more than others to the funding of current needs. However, there is

a fly in the ointment: the Finance Ministry proposes it as an alternative to an increase in income tax and/or the imposition of a war duty, for the sole purpose of avoiding any step that might be defined as a "tax increase." By so doing, the Finance Ministry is about to infringe on the definition of National Insurance as an institute that provides a social-security net and collects monies for the provision of specific types of insurance coverage. Practically speaking, the Finance Ministry will transform the National Insurance Institute into a department of the Income Tax Division. There is reason for concern that high-income earners will develop a negative attitude toward the National Insurance Institute and, thus, diminish its legitimacy.

C. Wages

Wage Freeze

This measure is way out of line. One may doubt the Finance Ministry's seriousness in proposing it and the government's ability to implement it. A wage freeze is harmful not only to the free market vision that Finance Ministry officials so love to promote but also to labor's right to fight for a better wage. As a consequence of the latter problem, it also undermines the *raison d'etre* of the trade unions.

The Finance Ministry justifies its action by arguing that "the real national average wage has been rising vigorously in recent years." That is true, of course, mainly due to wage escalation in the upper reaches of the economy. Thus, if the government means business about freezing wages by means of legislation, and if it has the ability to carry out its intent, it should focus solely on high-wage earners.

Five Percent Cutback in Wages of Ministers, Members of Knesset, Other Elected Officials, and Senior General-Government Officials

This is a commendable action. However, it can be improved by the additional step of revising the adjustment and indexation mechanisms that have placed senior officials on an automatic path of ever-increasing wage levels.

D. Government Ministries

Four Percent Across-the-Board Cutback in Government Ministries' Budgets

Since the ministries that have the largest budgets (apart from defense) are those that provide social services, they will be the main casualties of this cutback. The budgets of these ministries, foremost Education and Health, have been eroding for years. Health funds and schools rely increasingly on co-payments from their customers—the ill in respect to health and pupils' parents in respect to education. The cutbacks currently proposed, on the heels of a cut announced in February 2002, will merely exacerbate the trend of shifting the funding burden to the public. The main casualties of the trend are low-income Israelis, who will receive inferior service because they cannot obtain the services curtailed by paying for private alternatives out of their own pockets.

In addition, the Finance Ministry has also decided to go over to a nominal budget base and do away with automatic indexation. Therefore, the 2003 budget will be smaller than the 2002 budget by the inflation rate.

E. Employment

Financial Incentives for Employers of New Workers

This proposal attracted considerable resistance when it was proposed in December 2001, opponents arguing that the incentives would give employers a way to increase profits at the expense of the state. However, a study by the National Insurance Institute in 1995³ that compared employers' incentives with employers' subsidies (see separate section below) showed that the former are less expensive and more efficient than the latter. Between 1986 and 1995, the state spent NIS 49 billion on employers' subsidies (in 1996 prices)-"without knowing a thing about its effect on employment growth" (ibid.: 264). In contrast, in 1991-1995 employers were given incentives for the hiring of an additional 237,000 workers, at a total cost of NIS 2.5 billion (in 1996 prices), thereby providing a large majority of the additional workers with long-term employment situations.

Cutback in the Finance Ministry's Subsidizing Employers' Social Security Taxes

Even though there is no evidence that Finance Ministry's subsidizing of employers' Social Security payments have actually stimulated employment, they remain in effect to this day. The 2002 state budget allocates NIS 3.45 billion for this purpose. Therefore, the proposed cutback is a laudable idea; one may only regret that the method has not been discontinued altogether.

F. Housing Assistance

Cutting Mortgages Once Again

Operation "Economic 'Defensive Shield'" proposes a 4 percent decrease in government mortgages for eligible households that lack permanent housing. This adds up to about NIS 3,000 for some 60 percent of persons entitled to assistance from the Ministry of Construction and Housing.

The measure seems relatively harmless in itself. It is worth bearing in mind, however, that it marks the continuation of a downtrend in the value of government mortgages and reflects the Finance Ministry's wish to abolish the universal nature of the government mortgage program. The share of government mortgages in total homebuying credit slipped from 38 percent in 1994 to 25 percent in 2000. Now it is expected to decrease further.

Lowering Rent Subsidies

Operation "Economic 'Defensive Shield'" proposes to cut the rent subsidy for eligibles in half, from a maximum of NIS 1,170 per month to NIS 600. It also proposes that the subsidy be reduced by 5 percent per year after a household receives it for three years.

Finally, starting on June 1, 2002, single-parent families that need this assistance (new women applicants) will have to pass not only an income test but also an employment test (i.e., they will have to prove that they had applied to the Labor Exchange but did not find work).

G. Shackling the Knesset

In Operation "Economic 'Defensive Shield,'" the Finance Ministry wishes to tie the Knesset's hands by amending the Basic Law: State Economy, so that bills that have budget implications (bills proposed by individual Members of Knesset, as opposed to bills proposed by the Cabinet) will require an absolute majority (61 votes) of members of the house. Since such a majority is extremely rare, the proposal will have the practical effect of limiting the Knesset's ability to influence budget policy.

The Finance Ministry (and the media) loves to portray the Israeli legislature as a "loose cannon" that "does not understand" its role in the interplay of democratic forces. The Finance Ministry shows by citing various sources that various "advanced countries" limit the parliament's ability to pass "private members' bills" and, in some cases, withhold recognition from such legislation. The Finance Ministry's account tells only part of the story, since it overlooks the fact that the status of the parliament generally, and in budget affairs specifically, is stronger in most Western countries than in Israel. In Israel, the Budget Division of the Finance Ministry calls almost all the shots in budget affairs large and small; the Knesset is mainly a rubber stamp that has neither the organizational nor the research ability to examine the draft budget and propose alternatives or significant changes.

Parliaments in other countries have much more influence on the budget. The **United States Congress** is a crucial player in budget affairs and has its own research agency that provides it with forecasts and assessments that are independent of the president's budget division. In the **Netherlands**, the parliament's ability to amend the draft budget is unlimited. Although, practically speaking, the changes that are accepted are marginal, the parliament prepares more seriously for the budget debate than the Knesset does, for reasons including the practice of debating individual ministries' budgets in one of fourteen dedicated committees. In Israel, the Finance Committee debates all ministries' budgets even though it cannot probe any of them in depth. In **Sweden**, the government submits the macroeconomic targets of the budget to the parliament before it presents the detailed budget proposal; thus, the parliament can influence macroeconomic policy and the size of the budget. In Israel, as we know, the Knesset does not debate the macroeconomic targets at all and is asked to approve a sealed budget that can be pried open only by means of political negotiations termed by opponents "extortion." In **Germany**, legislators have real ability to propose amendments to the draft budget and have, in fact, introduced meaningful changes. The German constitution authorizes the legislature to modify the budget bill even without the consent of the Cabinet as long as the changes increase revenues or lower expenses. Changes that have the opposite effect-reducing revenues or increasing outlays-require the Cabinet's approval. Additionally, the legislature divides the task of studying and debating the budget between two committees: a budget committee that debates the expenditure side (i.e., the state budget) and a finance committee that debates the revenue side (taxation). The Swedish parliament does much the same.

¹ Zeev Rosenhek, *The Origins and Evolution of a Dual Welfare State: The Arab Population in the Israeli Welfare State*, Ph.D. dissertation, the Hebrew University of Jerusalem, 1995 (Heb.).

² Ruthi Sinai and Jalal Bana, *Ha'aretz*, April 26, 2002.

³ Jacques Bendelac, "The Business Sector Encouragement Law: Five Years of Payment of Employers' Incentives," in National Insurance Institute, *Annual Survey 1995/96* (Heb.).