Is Government Expenditure Comparatively Low in Israel, and Should it be Increased?

By: Nisan Avraham and Michael Sarel

This paper addresses the claim that Israel's government expenditure is comparatively low and should be increased. We point out the measurement biases in calculating government spending in Israel that are the result of institutional and demographic differences, which obscure Israel's higher expenditure, and demonstrate that even without controlling for these biases, Israel is average in its spending. Furthermore, an in-depth analysis of the correlation between government spending and economic growth indicates the heavy long-term cost of increasing expenditure.

The **first chapter** reviews Israel's government spending in comparison to other developed states.

The **second chapter** details the measurement biases in calculating government expenditure in Israel stemming from institutional and demographic differences between Israel and other countries.

The **third chapter** examines the correlation between government expenditure and economic growth.

Summary:

As globalization expands and economic ties between states strengthen, there is an increased need to obtain accurate information about international comparisons in order to make informed policy decisions. However, when institutional and demographic differences between countries are not taken into account, comparisons will be distorted and suffer from biases. Disregarding these differences when calculating Israel's government expenditure relative to other developed states often results in significantly lower measures for Israel. However, even without controlling for these significant differences, government expenditure in Israel is not low, but similar to other developed

countries – slightly above or below average, according to which states it is compared to.

This paper addresses two types of differences:

1. **Institutional differences**
   (a) Government intervention in the market through regulation as opposed to taxation and redistribution creates a bias in measuring state expenditure, when regulation costs are not included. Our research focuses on two kinds of regulation: the first aimed at achieving a specific social goal – such as the "mandatory pension law"; the other meant to protect an interest group such as the agricultural sector or the taxi industry. We found that the regulation of pensions and agriculture replaces government spending far more significantly in Israel than in other developed countries.
   (b) In Israel, most transfer payments are exempt from income tax and are usually subject to only minimal health insurance deductions. In contrast, most developed states tax transfer payments at the same as or at a lower rate than income from employment. This means that in other countries, a large portion of transfer payments return to the state treasury through the direct taxation system, artificially increasing the measured tax burden and reported government spending in comparison to Israel.
   (c) Israel's special circumstances entail high security costs, far beyond the norm in other developed countries. Some of this spending comes directly from Israelis' pockets and is not measured as government expenditure.

2. **Demographic differences**
   Israel differs greatly from other states demographically. States with higher percentages of the elderly (especially European countries) typically spend more on social security and health, thus increasing government expenditure in comparison to Israel, where the elderly population is smaller (and the percentage of children higher). Our research reveals that the proportion of elderly can influence government spending to a greater extent than the proportion of children, so that states with a lower proportion of the elderly and a higher proportion of children are expected to exhibit lower government expenditure.

Finally, we review how an increase in government spending or in government civil expenditure is projected to impact the average growth rate of per capita GDP in developed countries. This paper examines the correlation of these in different time periods over the past three decades. In all of them, we found a significant negative correlation between an increase in government expenditure and the growth rate. This correlation amplified over time and was more significant in the past decade.

The obvious conclusion is that before considering proposals to further increase government spending, we must consider not only the heavy short term costs (higher taxes) but the long term costs as well (the negative effect on the rate of growth).

For the full Hebrew Paper