Chapter 5

The Public Sector

The contractionary fiscal policy applied in 1997—a turnaround from the fiscal expansion of 1994–96—was necessitated by the large overrun of the government deficit target and the sizable balance-of-payments deficit in 1996. The total public-sector deficit declined by 1.7 percent of GNP, mainly because of an increase in the share of taxes and a decrease in the share of public investment in GNP—a combination that does not encourage economic growth in the medium and long terms. The government, the main player in the public sector, met the total deficit target this year and overran the planned domestic deficit by 0.6 percent of GNP—an improvement relative to the large deviation from this target in 1996.

Fiscal policy has been pro-cyclical in recent years. Rapid economic growth and sharp increases in tax revenues in 1994 and 1995 prompted the government to adopt an expansionary policy that aggravated excess demand and created unsustainable fiscal deficits. This year, in view of the downturn in economic activity, the government carried out a fiscal adjustment to fund the current public expenditure that had increased during the years of rapid GNP expansion. An increase in tax rates contributed to the decline in domestic demand and the deceleration of GNP growth. Privatization receipts this year, at NIS 8.5 billion, helped lower the debt/GNP ratio from 91.3 percent of GNP in 1996 to 90.1 percent in 1997.

1. MAIN DEVELOPMENTS

A contractionary fiscal policy was applied in 1997 to contend with the public-sector[1] deficit and the balance-of-payments deficit—a turnaround relative to the expansionary policy of 1994–96. The total deficit in the public sector decreased this year to 2.5 percent of GNP as against 4.2 percent of GNP in 1996, chiefly because of a 1.6

A contractionary fiscal policy was applied in 1997—a turnaround from the fiscal expansion of 1994–96.

[1] In the discussion of the fiscal policy, the public sector is defined as central government, the National Insurance Institute, municipal government, the National Institutions (the Jewish Agency for Israel and the World Zionist Organisation), and public nonprofit organizations (public health-service providers, universities, etc.). In contrast, the Budget Deficit Reduction Law concerns itself with the budget deficit of the central government, the main player in the public sector.

percentage point increase in the share of taxes in GNP and a decrease of 0.9 percentage points in the proportion of expenditure on capital account in GNP. The share of current expenditure in GNP increased by 0.3 percentage points.

About half the increase in the fraction of taxes in GNP (0.8 percent of GNP) stems from legislative changes—erosion of tax brackets, an increase in employers' national insurance remittances, and increases in municipal taxes, fuel tariff, and taxes on tobacco and automobile air conditioners. Corporate-tax revenues increased by 31.5 percent in real terms because of a decline in tax refunds to companies. In view of the correspondence between corporate tax and return on capital in previous years, and in view of the return on capital in 1997, corporate-tax revenues are an estimated 0.75 percent of GNP higher than the level warranted by the return on capital in 1997 (see the section on direct taxes, below).

The total public-sector deficit declined this year to 2.5 percent of GNP as against 4.2 percent of GNP in 1996.

The decrease in capital expenditure reflects a 0.4 percentage-point decline in the share of public-sector investment and a similar decrease in that of transfer payments to firms. The decrease in investment is composed of a 20 percent downturn in municipal investment and an 8.6 percent decline in investment in roads. Some of the decrease in transfers to firms reflects a fall in capital investment encouragement grants. In contrast to the decline in expenditure on capital account, the share of current expenditure in GNP rose this year. The share of civilian public consumption increased by 0.2 percentage

Table 5.1
The Public Sector: Receipts and Expenditure, 1993–97

(percent of GNP)

	1993	1994	1995[a]	1996[a]	1997[a]
Total receipts	54.4	53.3	53.6	51.8	52.9
of which From property and interest	1.8	1.4	2.4	1.7	1.6
Total taxes	39.4	40.1	40.7	39.8	41.4
Indirect, on domestic production	14.5	14.2	14.2	14.4	14.8
Indirect, on civilian imports	5.9	5.7	5.6	5.3	4.9
Direct taxes, fees, and levies	14.3	15.5	15.1	14.2	15.5
National Insurance income	4.8	4.8	5.8	5.9	6.2
Total expenditure	56.4	54.4	56.8	56.0	55.5
of which Domestic civilian consumption	16.3	17.2	20.0	20.1	20.3
Domestic defense consumption	8.2	8.2	8.2	8.0	7.9
Defense imports	3.2	1.9	1.4	1.7	1.8
Direct subsidies	2.4	2.2	1.7	1.5	1.4
Transfer payments on current account	11.6	11.4	12.0	12.4	12.9
Transfer payments on capital account	2.7	1.9	2.0	1.8	1.4
Public-sector investment	3.9	3.7	3.7	3.5	3.1
Interest payments	7.6	7.2	7.3	6.5	6.4
Total deficit	–2.1	–1.1	–3.1	–4.2	–2.5

[a] Including receipts and expenditure due to the Health Law.

points of GNP, and that of transfer payments (on current account) by 0.5 percentage points. A 0.2 percentage-point decrease in the share of support payments in GNP partly offset these developments.

In view of the general slowing in the growth rate of domestic demand, fiscal policy dampened demand growth from 5.2 percent in 1996 to 1.1 percent in 1997.

In view of the general downturn in the growth rate of domestic demand, fiscal policy lowered the increase in demand from 5.2 percent in 1996 to 1.1 percent in 1997. The fiscal restraint slowed the expansion of domestic demand of the public sector from 3.0 percent to 0.3 percent and reduced private consumption demand by raising the fraction of net taxation in GNP, thereby reducing private current disposable income. The composition of the deficit reduction—a contraction of public investment and a higher tax burden—seems to have impaired the economy's medium- and long-term growth trajectory by reducing private investment demand and firms' future earnings. Insofar as individuals have internalized the decrease in their future income, the decline has reduced their consumption in the present. The contractionary effect of the fiscal policy on domestic demand, coupled with additional factors (see Chapter 2), slowed GNP growth and narrowed the balance-of-payments deficit.

Fiscal policy has been pro-cyclical in the past few years—expansionary in times of vigorous growth and contractionary during slumps.

Fiscal policy has been pro-cyclical in recent years. From 1994 until the first quarter of 1996, the economy was typified by rapid growth and falling unemployment rates in view of mass immigration and the peace process. An expansionary fiscal policy was applied during this time, public-sector employees were given large wage increases, and statutory tax rates were reduced. Rapid economic growth caused government tax revenues to swell and made the fiscal expansion affordable with no overrun of the 1994 deficit target and only a small overrun in 1995. A slowdown in growth and a decrease in tax revenues that began in the second quarter of 1996 created a substantial overrun of the deficit target even though the share of public expenditure in GNP did not increase. This year, the contractionary fiscal policy adopted in response to the large deficit-target overrun helped reduce the public-sector deficit and aggravated the slowdown. The deficit, occasioned by the increase in public expenditure in 1994 and 1995, was narrowed in 1997 by the higher share of taxes in GNP. Thus the government seems to have increased public expenditure and the tax burden on a permanent basis.

The slowdown in growth caused a loss of tax revenue of 0.9 percent of GNP.

To analyze the effect of fiscal policy on the long-term deficit, the trend of the 'structural deficit' should be examined. The structural deficit is the actual deficit less nonrecurrent revenues and expenditures and the effect of 'automatic stabilizers,' which—reflected in a decrease in tax revenues and an upturn in transfer payments during downturns and the opposite behavior in times of rapid growth—do not affect the deficit in the long term. The GNP growth rate in 1997 was 2 percent below the long-term rate (an annual average of 4.1 percent in the last 20 years). The slowdown in growth caused a loss of tax revenue of 0.9 percent of GNP, and the increase in unemployment raised the share of transfer payments in GNP by 0.15 percentage points. This automatic stabilizer effect, however, was offset by exceptional corporate-tax revenues (0.75 percent of GNP) and the decrease in public-sector investment (0.4 percent of GNP). The decline in investment, which is detrimental to the accrual of public capital stock, does not reduce the structural deficit because it will have to be replaced by an increase in the future. In view of the decline in investments, the increase in corporate-tax revenues, and the effects of the automatic stabilizers, the decrease in the structural deficit of the public sector may be estimated as similar to the decrease in the actual deficit.

Privatization receipts climbed to a record NIS 8.5 billion in 1997—most of which (NIS 7.1 billion) derived from sale of equity, foremost the controlling equity in Bank Hapoalim. The privatization revenues made it possible to draw down the public debt, net public debt decreasing from 91.3 percent of GNP in 1996 to 90.1 percent of GNP in 1997. The composition of the public debt has changed significantly in the past two years: the fraction of external debt in the total decreased from 18.6 percent to 6.3 percent, because of an increase in the foreign reserves held in the Bank of Israel.

In 1995 and 1996, the Gini index of income-distribution inequality declined, reversing the upward path that has characterized the economy since the mass immigration began. The decrease in inequality is attributable to the decline in the unemployment rate, which in 1996 settled at the level that had prevailed in 1988, before the influx of immigrants.

2. FISCAL POLICY

Fiscal restraint was applied to attain the government's budget-deficit target and narrow the balance-of-payments deficit.

The dominant macro-economic developments in 1997 were a slowdown in economic activity and a decline in per-capita GNP. The downturn, which began in 1996, drove the average unemployment rate up to 7.7 percent. Fiscal restraint was applied to attain the government's budget-deficit target and narrow the balance-of-payments deficit. This fiscal restraint was one of the factors—along with the depletion of the expansionary effects of the influx of immigrants, the tight monetary policy, and continued security uncertainties (see Chapter 2)—that slowed the growth of domestic demand from 5.2 percent to 1.1 percent. The slowdown in the growth of domestic demand helped narrow the balance-of-payments deficit and attain the inflation target, but it also contributed to the deceleration of GNP growth and the rise in unemployment. The adjustment of fiscal policy reduced the public sector's structural deficit and enabled the government to meet the budget-deficit target, but the composition of the chosen adjustment—a higher tax burden and a smaller share of investments in GNP, rather than a lower share of current public consumption in GNP—did not serve the cause of long-term economic growth.

In 1994 and 1995 a structural deficit was created in the public-sector budget, requiring a substantive turnaround in fiscal policy.

Fiscal policy in 1997 had to contend with the deficit created in 1994 and 1995, when expansionary fiscal policies were adopted in the context of rapid growth and falling unemployment. Exceptional wage increases for public-sector employees elevated real labor costs by 9.6 percent in 1994 and 5.9 percent in 1995. Statutory tax rates were reduced: personal income-tax brackets were broadened, the corporate-tax rate was reduced by 1 percentage point each year, customs tariffs and purchase taxes were slashed, and the general import levy was abolished. Although the tax decreases and the real wage increase created a large structural deficit in the government budget, the deficit target was not overrun significantly in those years because rapid growth and the progressivity of the tax system caused tax revenues to rise perceptibly. The growth rate slowed in 1996, but the tax revenue forecast assumed that GNP and tax revenues would continue to expand rapidly. Because of the overestimate of expected tax revenues,

Table 5.2
Main Indicators of Fiscal Policy, 1993–97

(annual rates of change)

	1993	1994	1995	1996	1997
Rate of GNP growth	3.5	6.8	7.1	4.4	1.9
Income from growth other than 4.1%[a]	–0.2	1.1	1.2	0.2	–0.9
Effect of legislation on tax revenues[b]	–0.5	–0.7	–0.9	–0.1	0.6
Rise in public sector unit labor cost	3.0	9.6	5.9	1.1	–0.6
Rise in civilian consumption[c]	1.9	7.2	4.0	4.6	3.0

[a] Percent of GNP. Income from growth other than 4.1 percent (an approximation for the average growth rate in the last twenty years) is calculated assuming that the elasticity of total tax receipts is unitary.

[b] Percent of GNP. Estimates of the effect of the legislation are based on data from the State Revenue Administration.

[c] Excluding the effect of the Health Law on the rise in cilivilian public consumption in 1995.

coupled with the elections and the change of government, the government did not deal with the deficit problem. Thus, in 1996 the deficit overran the target set in the Budget Deficit Reduction Law by 2.2 percent of GDP and required a substantial turnaround in fiscal policy.

The public-sector deficit decreased because of an increase in the share of taxes in GNP and a decrease in the proportion of expenditure on capital account.

The large deviation from the deficit target and the ballooning balance-of-payments deficit pointed to the need for a fundamental change in fiscal policy. Fiscal policy did in fact tackle the structural-deficit problem in 1997 and furthered attainment of the deficit target. The total deficit of the public sector decreased by 1.7 percent of GNP, as the share of public-sector investment in GNP fell by 0.4 percentage points and that of taxes rose by 1.6 percentage points. Approximately half of the latter increase originated in legislative changes; the rest reflects exceptional corporate-tax revenues. The fraction of capital transfers in GNP declined by 0.4 percentage points, reflecting a real 11.2 percent decrease in grants under the Encouragement of Capital Investments Law. The share of civilian public consumption in GNP increased by 0.2 percentage points, and that of transfer payments (on current account) by 0.5 percentage points. The latter increase was affected by an upturn in outlays for unemployment compensation and income maintenance (0.15 percent of GNP). Public-sector revenues from property and interest slipped by 0.1 percent of GNP because of a decline in profits of the Bank of Israel.

The fiscal restraint of 1997 was moderated to a great extent by the budget's built-in automatic stabilizers which—by reducing the deficit in times of growth and expanding it in a slump—make it more difficult to cut the budget in times of economic slowdown. Our calculations show that had the growth rate in 1997 resembled the average over the past 20 years (4.1 percent a year), and the unemployment rate resembled that of the previous year, the combined share of civilian public consumption and current transfer payments in GNP would have been unchanged and the total deficit of the public sector would have decreased by 2.7 percent of GNP. This finding provides an indication of the strength of the fiscal restraint applied this year.

Fiscal restraint slowed GNP growth in the short term, and the composition of the deficit reduction is detrimental to growth in the long term.

Fiscal restraint served to slow GNP growth in the short term, and the composition of the deficit reduction does not encourage growth in the long term. Cutting an unsustainable structural deficit, either by raising taxes or by reducing public expenditure, usually depresses domestic demand and growth in the short term. This year, the restraint of demand and the deceleration of activity were aggravated by exceptional corporate-tax revenues and the decrease in public-sector investment—which made a negligible contribution to reducing the structural deficit. The threat to growth in the long term stems from the composition of the cutback. Public expenditure comprises two main components: transfer payments and the public-sector payroll. Substantial cutbacks in these expenditures are fraught with difficulties, such as strikes and the disruption of public services, adversely affecting the social fabric. By refraining from cutting public expenditure and by raising the tax burden, the government signaled to investors that public expenditure is inelastic and that the permanent tax burden has increased. The higher tax burden appears to be deterring resident and nonresident investors, and is therefore leading to a decrease in the economy's future capital stock and a slowdown in its growth rate, which will also harm real wages in the long run. The short-term and long-term effects are not unrelated: a fiscal adjustment conducive to long-term growth whets demand for investment and private consumption, and an increase in private-sector demand may moderate the contractionary effect of the decline in public-sector demand. Since, however, the main feature of the fiscal adjustment in 1997 was an increase in the share of tax revenues in GNP, it did not serve to boost private-sector demand.

The stagnation of public-sector domestic demand and the increase in the tax burden had a restraining effect on domestic demand.

Fiscal policy acted to restrain domestic demand. The volume rise in net domestic public-sector demand was down to a mere 0.3 percent—reflecting a 12.1 percent downturn in investment and a moderate 2.4 percent increase in domestic public consumption. Private consumption fell because the higher net tax burden reduced current disposable income, and the reduction of the deficit, coupled with an increase in the share of GNP devoted to public consumption, signaled a permanent increase in the tax burden—adversely affecting future disposable income. According to a study by Yaakov Lavi,[2] the 1.2 percentage-point increase in the share of net direct taxation in GNP in 1997 reduced private consumption by an estimated 0.5 percent of GNP.

Fiscal policy helped reduce the balance-of-payments deficit.

Fiscal policy helped reduce the balance-of-payments deficit, which reflects the difference between aggregate demand and supply. The stagnation of public-sector demand and the dampening effect of fiscal policy on demand for private consumption and investment depressed aggregate demand. In contrast, the erosion of income-tax brackets and the increases in employers' national insurance contributions and the fuel tariff made inputs more costly and harmed aggregate supply in the long term. A rise in gross wages in line with the tax increase will be possible only when the wage agreements are reopened, and the slowing of the growth rate of capital stock accumulation consistent with the rise in gross wages is a lengthy process. Thus, the contraction of the deficit

[2] Yaakov Lavi, "Does Change in Current Income Help Explain the Change in Consumption in Israel?" *Bank of Israel Economic Review* 71, 1998 (in press). Lavi found that between 40 and 50 percent of the change in private consumption is explained by changes in disposable income.

reduced both aggregate demand and aggregate supply. Since most of the damage to aggregate supply is in the long term, fiscal policy had a short-term contractionary effect on the balance-of-payments deficit.

By reducing investment demand and increasing the supply of savings, fiscal policy helped to bring down real long-term interest rates.

The balance-of-payments deficit reflects the difference between investment and saving. The increase in the tax burden, the downturn in grants under the Encouragement of Capital Investments Law, and the contraction of public investment apparently dampened investment demand. Since public infrastructure complements private investment, the decline in investment in roads (9 percent), railroads (28 percent), and sea-ports (15 percent) evidently caused demand for private investment to contract (see Chapter 2). The increase in public saving (expressed in the contraction of the public-sector current deficit), only partly offset in the short term by a downturn in private saving, resulted in an increase in the national saving rate.[3] However, the latter declined in 1997 as individuals drew down their savings to avoid cutting consumption in the wake of the general downturn, which was perceived as temporary in part. By reducing demand for capital (investment) and increasing the supply of capital (saving), fiscal policy helped bring down real long-term interest rates.

When a deficit is reduced by cutting public consumption—most of which is of nontradables—pressure for a real currency depreciation builds up.[4] The composition of the deficit reduction in 1997, however, served to moderate the forces for real depreciation, because higher taxes reduce private consumption of both tradables and nontradables.

Since fiscal policy has been pro-cyclical in the past few years—expansionary in times of vigorous growth and contractionary during slumps—it has exacerbated the business cycle. The economic surge and the large excess demand in 1994 and 1995 led to fiscal expansion. Rising public expenditure and falling tax rates aggravated excess demand, increased the balance-of-payments deficit, and strengthened inflationary pressures. As the effects of the mass immigration petered out over the past two years, domestic demand contracted and the growth rate slumped. The slowdown in growth depressed tax revenues, exposed the problem of the public sector's structural deficit, and pointed to the need for a turnabout in fiscal policy. The fiscal restraint applied in 1997 aggravated the economic slowdown by further dampening domestic demand.

The pro-cyclical fiscal policies applied in 1994–97 exacerbated the business cycle and permanently increased the tax burden.

The pro-cyclical fiscal policies of recent years increased the tax burden on a permanent basis because public consumption and transfer payments increased during the years of fiscal expansion but were not cut back when restraint was applied. The permanent increase in public expenditure arrested the downtrend in the tax burden that had been a hallmark of the Israeli economy in 1986–91. It is inefficient to reduce statutory tax rates during boom years and to raise them during downturns, as this is detrimental to social welfare. According to theory, statutory tax rates should be set on the basis of long-term considerations, since any temporary change aggravates the tax burden and impairs efficiency. It is especially harmful to slash statutory tax rates during

[3] Assuming that aggregate supply was not impaired in 1997, as this would reduce national saving.

[4] Real depreciation reflects a decline in the relative price of nontradables.

economic upturns and raise them during slumps, because this change exacerbates economic uncertainty and the business cycle.

The ratio of public debt to GNP decreased from 91.3 percent in 1996 to 90.1 percent in 1997 due to privatization receipts.

The ratio of public debt to GNP decreased in 1997 from 91.3 percent to 90.1 percent due to privatization receipts of NIS 8.5 billion. Privatization reduces both the assets and the liabilities of the government and has no effect on net public debt, but since the value of government enterprises does not appear on the balance sheet of public-sector assets and liabilities, the public debt figures convey the misleading impression that the sale of government enterprises reduces the debt/GNP ratio. Net of privatization receipts, the ratio of net public debt to GNP increased in 1997, the total public-sector deficit (2.5 percent of GNP) outpacing GNP growth (1.9 percent). Although the debt/GNP ratio has been declining steadily since the 1985 Economic Stabilization Program, it still far exceeds the 60 percent target set by the European Community at Maastricht. To continue lowering the debt/GNP ratio, it will be necessary to reduce the total public-sector deficit and revive growth, since privatization and its revenues are transitory.

The composition of the public-sector debt changed significantly in 1997, with the share of the external debt plummeting from 14.1 percent in 1996 to only 6.3 percent. Long-term capital inflows prompted by an upturn in nonresident investment, and short-term inflows occasioned by interest-rate differentials, drove the exchange rate to the bottom of the crawling band. The inflows obliged the Bank of Israel to buy foreign currency from the private sector to keep the exchange rate against the currency basket within the band, and these purchases boosted the Bank of Israel's foreign reserves by $ 8.6 billion. Because the Bank of Israel is part of the public sector, the increase in foreign reserves reduced the net external debt of the public sector but increased the internal debt.

The Budget Deficit Reduction Law

The Budget Deficit Reduction Law limits the deficit of the central government (the main player in the public sector). The law was passed at a time when mass immigrant absorption forced the government to create budget deficits for several years; the deficits

Table 5.3
Financing the Deficit, 1993–97

(percent of GNP)

	1993	1994	1995	1996	1997
Financing of public deficit(+)/surplus(–)	2.1	1.1	3.1	4.2	2.5
External net borrowing	–2.5	3.5	–3.1	–1.6	–8.9
Change in monetary base	1.0	0.9	–0.3	1.3	1.1
Domestic net borrowing	1.7	0.0	8.7	5.4	9.5
Via government	2.4	0.5	3.4	2.6	2.3
of which Sale of assets	1.8	0.3	0.4	0.1	1.9
Via Bank of Israel	–0.7	–0.5	5.4	2.8	7.2
Residual	1.8	–3.2	–2.2	–0.9	0.7

were to fall gradually as the influx of immigrants ebbed. The law was meant to signal to the public that the increase in government deficits at the onset of the mass immigration did not portend a return to the budget indiscipline of the early 1980s that had sent the economy into a tailspin. In practice, the mass immigration led to rapid growth and unexpectedly high government revenues in 1993 and 1994. The government used the temporary surfeit of tax revenues to pay for a protracted increase in expenditure, thereby eluding the purpose of the Deficit Reduction Law while formally attaining the deficit target. Since the deficit target was seriously overshot in 1996, it was vastly important to meet the target in 1997. In contrast to the ease with which the target was met in 1992–94, considerable fiscal contraction was necessary in 1997. Thus, by attaining the total deficit target the government enhanced the credibility of the Budget Deficit Reduction Law in public opinion, i.e., the public's expectations that fiscal discipline will be maintained in the future.

In 1993–95, the government used the temporary surfeit of tax revenues to pay for a protracted increase in expenditure, thereby eluding the purpose of the Deficit Reduction Law.

The total government deficit in 1997 (2.4 percent of GDP) was 0.4 percent of GDP below the total deficit target (2.8 percent of GDP), but the domestic deficit, at 2.9 percent of GDP, overran the original planned deficit by 0.6 percent of GDP. The total deficit target was attained because overseas revenue exceeded the forecast by NIS 3.1 billion, chiefly because the government credited to itself NIS 2.4 billion in interest income from foreign reserves kept with the Bank of Israel. Since there are local-currency liabilities against these reserves, the Bank of Israel has interest expenses on local-currency liabilities against the interest income on the foreign reserves, and these expenses are not charged to the total government deficit. Imputation of Bank of Israel revenues without imputation of the expenditure does not point to a contraction of the government deficit and is contrary to the spirit of the Budget Deficit Reduction Law.

The total deficit of the government in 1997 was 0.4 percent of GDP below the total deficit target.

Table 5.4
The Budget Deficit and the Law, 1992–97

(percent of GDP)

	1992	1993	1994	1995	1996	1997
Maximum domestic deficit under law	6.2	3.2	3.0	2.75	2.5	2.3
Actual deficit	4.9	2.4	2.0	3.2	4.7	2.9
Deviation from maximum	–1.3	–0.8	–1.0	0.4	2.2	0.6
Receipts	–3.3	1.9	2.4	–0.7	–2.0	–1.8
Expenditure	–4.4	1.1	1.4	–0.3	0.2	–1.2
Public-sector domestic deficit	5.3	3.9	2.1	4.1	4.1	2.4

	1997	1998	1999	2000	2001
Total deficit reduction under law[a]	2.8	2.4	2.0	1.75	1.5
Actual deficit	2.4				

[a] Until 1996 the Budget Deficit Reduction Law referred to the domestic deficit, and since 1997 it refers to the total deficit.

The domestic deficit of the government exceeded the planned domestic deficit by 0.6 percent of GDP.

The domestic deficit of the government (excluding net allocation of credit) was 2.9 percent of GDP—0.6 percent of GDP higher than the planned domestic deficit. Underperformance was recorded in both domestic revenue and domestic expenditure. Part of it was caused by an unexpectedly low rate of price increases—9.0 percent on average as against the 11.1 percent rate on which the state budget was predicated. After correcting for the price assumption, actual domestic revenues were 1.1 percent of GDP lower than the revenue forecast, and actual domestic expenditure was 0.5 percent of GDP below the planned level.

Economic growth in 1997 was 2.0 percentage points slower than the rate on which the revenue forecast was based. Assuming that the elasticity of government tax receipts relative to GNP is 1.2, the slowdown caused the loss of 0.75 percent of GNP in tax revenues. Because the decrease in tax receipts occasioned by the economic slump was offset by exceptional revenue of 0.75 percent of GNP due to corporate tax, the deficit target was attained this year despite the slowdown in activity.

The 1998 revenue forecast in the national budget may again prove to be an overestimate (as occurred in 1995–97). The collection base used in preparing the forecast is NIS 700 million larger than actual collections in 1997 and includes exceptional corporate-tax revenues. The forecast assumes a growth rate of 3.1 percent, as against 1.8 percent growth in the second half of 1997. Finally, it is doubtful whether improved collection efforts will increase tax revenue by NIS 1.09 billion, as the budget assumes.

It is important to prevent excessive volatility in government expenditure and statutory tax rates in response to volatility in GNP.

Volatility in economic activity is known to create similar volatility in tax revenues. Accordingly, it is sometimes necessary to make budget adjustments in order to meet the deficit target. It is important to relate to the trajectory of government expenditure—not only the deficit target—to prevent excessive volatility in government expenditure and statutory tax rates (which should be informed foremost by long-term considerations) in response to tax-revenue volatility occasioned by short-term volatility in GNP.

Resource-allocation policy

The decline in defense and debt-service expenditure is narrowing the difference in public-sector resource allocation between Israel and the developed countries.

Several long-term trends are causing resource allocation in the Israeli public sector to converge with the trend customary in the developed countries. Israel has significantly heavier defense and debt burdens than those in other developed countries, but the long-term downtrend in defense and debt-service expenditure is narrowing the difference. The share of total defense spending in GNP fell from 22.9 percent in 1980 to 9.7 percent in 1997, and debt-servicing expenditure declined concurrently from 12.1 percent of GNP to 6.4 percent.

Another important trend is the decline in direct intervention in private-sector activity, reflected in a decrease in the share of GNP spent on commodity and producer subsidies. Because the share of welfare-state expenditure—especially in personal transfers—has been rising steadily, the total effect on inequality in consumption and on efficiency cannot be determined.

Israel's national expenditure on education is high by international standards, and its national expenditure on health resembles the conventional Western level.

Israel spends 9.8 percent of GNP on education, which is high by international standards, and 8.7 percent of GNP on health, which is similar to the level in the West.

Box 5.1: The State Health Insurance Law

Public intervention in the health sector flows from the inability of the free market to assure an efficient health system, along with social sensitivity that insists on adequate medical care for every citizen. Until the State Health Insurance Law went into effect in 1995, the system suffered from a market failure known as 'negative selection,' in which some public health-care providers rejected candidates who contributed little in revenue and required much care. This enabled small providers to provide high-quality service but left the General Health Fund, with its high concentration of members who were elderly, chronically ill, and of low income, on the verge of collapse. The State Health Insurance Law was meant to eliminate negative selection and assure an equal package of health services for all. Thus, rejection of applicants was prohibited and the previous funding method—direct remittance of membership fees to providers—was replaced with a modified capitation arrangement in which the government pays each provider commensurate with the number and age of its members. This has mitigated the providers' motivation to reject low-income adults as members.

The providers' rising deficits raise questions about the efficiency of the health insurance law and its effect on public expenditure. The health funds' expenditure per standard person[1] increased by 12.7 percent in 1995 (the first year of implementation) and by 14.6 percent in 1996. Deflated by the price index of health services, weighted per-capita expenditure rose in 1995 and 1996 by 2.4 percent on annual average, as against an average increase of 0.8 percent in 1972–94. Since the health law went into effect, the service providers' per-capita outlays have been converging: the General Health Fund's expenditure per standard person increased by 3.5 percent on annual average and that of the other providers decreased by 2.2 percent. About 80 percent of new members in 1995 and 1996 joined the small providers, among which per-capita spending is relatively high, and the growth in the market share of these providers contributed to the increase in expenditure per standard person.

The providers' deficits stem partly from erosion in the list of insured services. The adjustment mechanism for the list reflects the rise in health-care prices (including wage increases), but does not give full expression to population growth, aging, and technological improvements. In the past two years, the list was adjusted by 2.2 percent in real terms each year, while the standard population increased by 2.95 percent in 1996 and by 2.85 percent in 1997. In these two years, the list of services eroded by 1.36 percent per standard adult. The per-capita deficit of the small health-care providers exceeds that of the General Health Fund by a factor of more than three, but presumably the continued convergence toward equality in per-capita expenditure will eventually bring the former down. Since the health law is still quite new, it is too early to quantify its long-term effect on public expenditure.

[1] Current expenditure, not including development and interest costs. The data are based on the health funds' financial statements. Standardization takes the effect of age into account.

The relative youth of Israel's population has an upward effect on education expenditure and a downward effect on health outlays. In 1976–97, per-pupil expenditure at the primary and secondary levels rose by 2.9 percent on annual average and national per-capita health spending rose by 4 percent. When population aging during that period is taken into account, the annual average increase in expenditure was 3.7 percent.

Public-sector demand

Domestic demand of the public sector rose by only 0.3 percent.

Civilian public consumption increased by 3.0 percent, a more moderate rate than in 1994–96. The increase is composed of real upturns of 3.2 percent in procurements and 2.7 percent in civilian labor input in the public sector—a moderate increase relative to the 4.7 percent annual average growth of employment in the three previous years. The price of labor input in the public sector decreased by 0.64 percent in real terms. In the past four years, those covered by the 1994–97 labor accords, public-sector labor input rose by 3.9 percent on annual average.

Domestic defense consumption increased by 0.7 percent, as domestic procurements edged upward by 1.2 percent and labor input was unchanged. Labor input in the defense sector has been declining for the past seven years. Defense imports increased by 2.1 percent, bringing the expansion of total defense consumption to 1.3 percent. Because the growth in domestic defense and civilian consumption demand was offset by a sharp 12.1 percent decrease in investment, total domestic demand of the public sector rose by only 0.3 percent.

3. TAXES, TRANSFER PAYMENTS, AND INCOME DISTRIBUTION

The tax burden as a share of GNP rose because of legislative changes and exceptional corporate-tax revenues.

The tax burden climbed from 39.8 percent of GNP in 1996 to 41.4 percent in 1997 as legislative changes and exceptional corporate-tax revenues boosted tax receipts by 0.8 percent of GNP each. Collection of direct taxes grew by a substantial 1.6 percent of GNP. Factors in this increase were the exceptional corporate-tax revenues, tax-bracket erosion (0.4 percent of GNP), and an increase in national insurance contributions (0.15 percent of GNP). Domestic indirect taxes increased by 0.4 percent of GNP, mostly (0.25 percent of GNP) in response to legislative changes including rate increases in fuel excise, taxes on tobacco and automobile air conditioners, and municipal property tax. The share of indirect taxes on civilian imports decreased by 0.4 percent of GNP because of a decline in the share in GNP of imports of tax-intensive motor vehicles.

Direct taxes

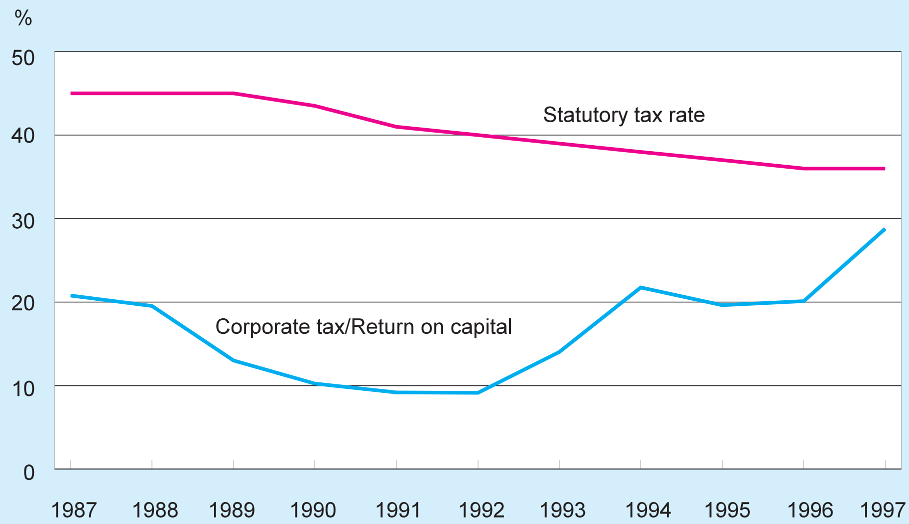
Wage income-tax receipts rose due to an increase in real wages and erosion of the tax brackets.

Wage income-tax receipts rose by 10.2 percent. Because income tax is progressive, the 2.2 percent increase in real wages resulted in a 4.0 percent rise in receipts (the average marginal income-tax rate is 34 percent). The real wage increase and the 1.9 percent growth in the wage-earning population boosted receipts by 6.0 percent. The rest of the increase occurred because the tax brackets were not adjusted. Until 1996, tax brackets and tax-credit points were adjusted three times a year—in January, February, and August—whereas in 1997, the legislature left tax brackets and credit points unadjusted. This legislative change eroded the tax brackets and credit points by 5.2 percent, causing wage income-tax receipts to rise by 4 percent. The legislature has decided that the tax brackets will be adjusted only once a year starting in 1998, and that the January 1998 adjustment will not compensate for the increase in the Consumer Price Index between June and November 1996. Thus, the income-tax brackets have been permanently eroded.

Corporate-tax receipts jumped by 31.5 percent. Corporate tax is noted for a time lag between the creation of taxable income and remittance of the tax. During the year, companies make advance payments on account of corporate tax on the basis of profit estimates; at the end of the year they file annual returns through which their tax liability is reckoned on the basis of actual profit, and they pay the balance of tax due, or collect refunds owed, with a lag of one or two years. The increase in corporate-tax receipts in 1997 was due to a startling 43 percent decline in tax refunds, because the advance payments collected in 1995 and 1996 approximated actual tax liabilities. Labor disruptions at the income-tax bureaus may also have caused a delay in refunds. Figure 5.1 shows the correspondence of corporate tax to the return on gross capital. On the basis of the tax/return ratio in 1994–96 and the decline in return on capital in 1997, it is estimated that corporate-tax revenues in 1997 were higher by 0.75 percent of GNP than the level warranted by the return on capital. Accordingly, they may be expected to decrease in 1998, reflecting the lower return on capital in 1996 and 1997.

Corporate-tax receipts in 1997 were higher than the level warranted by the return on capital.

Figure 5.1
Ratio of Corporate Tax and Deductions at Source to Gross Return on Capital and Statutory Tax Rate, 1987-97



SOURCE: Based on Central Bureau of Statistics data.

National insurance receipts expanded because of a rise in national insurance contributions and the increase in real wages.

Health tax revenues rose by 4.5 percent, in line with the increases in real wages and employment. National insurance receipts from wages expanded by 10.3 percent in real terms because of increases in wage receipts, legislative changes, and collection of arrears on account of previous years. National insurance contributions are remitted in two tax brackets: a reduced rate for income up to half the national average wage, and a regular bracket for income from that level up to approximately four times the average wage. The share of national insurance contributions at the reduced rate climbed from 9.5 percent in 1996 to 10.7 percent in 1997, causing national insurance revenues from wages to decline by 4 percent—0.15 percent of GNP.

Transfer payments

The increase in national insurance benefits was affected by the upturn in unemployment: unemployment compensation and income maintenance payments climbed by 20 percent.

Transfer payments on current account grew by a real 5.9 percent. National insurance allowances, which account for 62 percent of transfer payments, expanded by 8.1 percent. The increase in national insurance allowances was strongly affected by the rise in unemployment: unemployment compensation and income maintenance payments climbed by 20 percent. The other national insurance benefits—old age and survivors' pensions, child allowances, disability, workers' compensation, and maternity benefits—grew by 5.4 percent on average. Child-allowance payments rose at a similar rate, as the gradual process of ending their contingence on prior military service continued.

Benefits for civil servants and the Defense Ministry remained unchanged in 1997, after an average real increase of 14 percent in 1994–96. The reason for the standstill was the moderate real decline in public-sector wages. The 20.4 percent decrease in capital transfers stems partly from an 11.2 percent fall in grants extended under the Encouragement of Capital Investments Law.

Indirect taxes

Domestic indirect tax receipts expanded because of real increases in the rates of municipal property tax, the fuel tariff, and taxes on cigarettes and automobile air conditioners.

Domestic indirect tax receipts rose by 4.7 percent in real terms, and their share in GNP climbed from 14.4 percent to 14.8 percent. The increase was occasioned by a rise in the share of consumption in GNP and from legislative changes; real increases in the rates of municipal property tax, gasoline excise, and taxes on cigarettes and automobile air conditioners boosted collection by 0.25 percent of GNP. The main domestic indirect taxes are Value Added Tax (VAT, 59 percent), municipal taxes (17.5 percent), and the fuel tariff (10 percent).

VAT receipts on domestic production increased by 4.3 percent. The VAT base, applied to private and public consumption, expanded as a result of the 3.3 percent volume growth in private consumption—including a 1.1 percent rise in the relative price of private consumption—and a 1.8 increase in public consumption, including a 1.2 percent upturn in its relative price.

Receipts due to the fuel tariff rose by 9.4 percent, in the wake of a 10 percent increase in this tariff in December 1996. The fuel tariff makes private automobiles more costly to use and prompts consumers to internalize the social cost of this use (in terms of air pollution and congestion). The fuel tariff is still lower in Israel than in European countries, especially in view of the extent of congestion and pollution in Israel, both of which exceed European levels.

Municipal tax receipts increased by 7.4 percent in real terms, as these tax rates rose by 2.2 percent in real terms and an increase in housing completions caused the tax base to expand by 2.7 percent. Receipts on account of land-betterment tax and real-estate purchase tax fell by 21 percent in real terms as the number of transactions in residential housing declined by 20 percent.

VAT receipts on civilian imports declined by 9.6 percent in real terms. Contributing to the decrease were a 4.2 percent volumr downturn in imports of capital goods and a 5.2 percent decline in their real price, along with a 2.8 percent quantity increase in imports of consumption goods and a 4.4 percent decrease in their real price. Purchase-tax receipts were down by 5.4 percent in real terms. Purchase tax applies mainly to durables, most of which are imported, and about half of the revenues in this category originate in taxation of private motor vehicles. The decline in purchase-tax receipts is due to a real 16.0 percent decrease in expenditure on imported private vehicles, an 11 percent upturn in expenditure for other imported durables, and an increase in the tax on cigarettes.

The decline in purchase-tax receipts is the result of a decrease in expenditure on private motor vehicles.

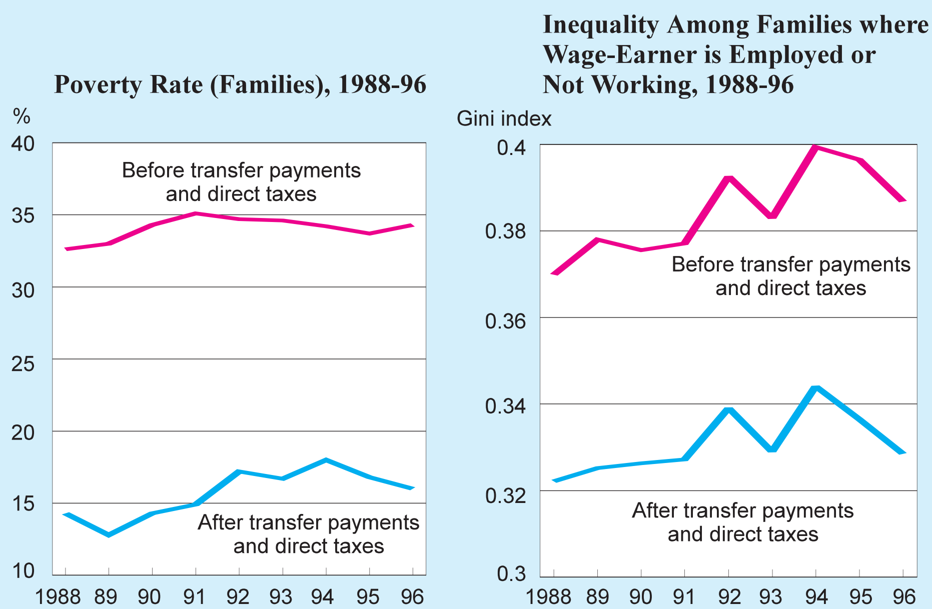
In 1991, Israel embarked on a phased reduction of customs tariffs on imports from countries with which it has no free trade agreements. Since then, the share of customs in indirect taxes on imports has fallen from 13.8 percent to only 4 percent.

4. INCOME DISTRIBUTION

The data on inequality in income distribution are based on the annual income surveys of the Central Bureau of Statistics. According to the Gini index, conventionally used to measure inequality in income distribution, inequality in the distribution of both gross and net income decreased in 1995 and 1996 among families headed by wage-earners and non-working individuals. This marks the reversal of the rise in inequality that had lasted from 1988 to 1994, prompted mainly by the upturn in unemployment rates that began with the influx of immigrants. As the immigrants entered employment and the unemployment rate declined in 1996 to a level similar to that of 1989, economic inequality decreased in 1995 and 1996. Inequality is still above the pre-immigration level, however, because of the structural change that the economy has undergone, with the wages of skilled workers rising in line with the increased demand for such workers (especially in high-tech industries), on the one hand, and those of unskilled workers declining because of exposure to imports of foreign labor and products intensive in low-cost labor, on the other. The increase in inequality in net-income distribution in 1988–96 was more moderate than that in gross-income inequality, attesting to the greater progressivity of direct taxes and transfer payments.

Income-distribution inequality decreased in 1995 and 1996, marking the reversal of the increase in inequality that has typified the economy since the beginning of the mass immigration.

Figure 5.2



SOURCE: Based on CBS and National Insurance Institute data.