Chapter 5
The Public Sector

The share of public expenditure in GNP fell slightly in 1993, its components moving in different directions—a reduction in payments to contractors for apartments and rapid completion incentives, and a vast increase in public investment. While civilian consumption rose by 3 percent due to population growth and additional hours of education, domestic defense consumption fell. The revenue/GNP ratio remained virtually unchanged because tax rates stayed the same, unilateral transfers from abroad declined, and income from apartment sales rose. The domestic public sector deficit was 3.5 percent of GNP, after reaching 5.7 percent in 1992. There was a substantial decline in the external surplus, so that the total deficit went down only slightly. This decline reflects the government's deficit-reduction program in accordance with the Budget Deficit Reduction Law, and was intensified by under-expenditure and tax receipts that exceeded expectations.

1. MAIN DEVELOPMENTS

The public expenditure/GNP ratio was 56.6 percent in 1993, compared with 57.2 percent in 1992, with differences between the changes in its components. The main feature was the reduction of payments arising from government involvement in construction. At the same time public investment rose, especially in roads (by about 62 percent). Public civilian consumption rose by some 3 percent because of an increase in the population and the addition of hours of schooling due to the wage agreement with the teachers. Domestic defense consumption declined by 3 percent, while defense imports rose steeply, so that total defense consumption increased by a real 9 percent. There was a slight decline in the share in GNP of general government income, which reached 54.7 percent, reflecting the absence of change in the tax/GNP ratio, a decline in unilateral transfers and interest income from abroad, and an increase in income from the sale of government-owned apartments. The slight decline in income and larger reduction in expenditure served to lower both the domestic and the total public deficit. The latter was 1.9 percent of GNP, compared with 2.4 percent in 1992, while the former was 3.5 percent of GNP, after reaching 5.7 percent in 1992. The reduction of the deficit reflects mainly the government's program under the Budget Deficit Reduction Law, and this was intensified in 1993 because of under-expenditure and tax revenues which were greater than planned.

Table 5.1
General Government: Receipts, Expenditure, and Deficit, 1980–93[a]

(percent of GNP)

													NIS million[b]
	1980–84	1985–93	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1993
Receipts													
Internal	50.2	48.1	43.6	48.8	52.6	50.7	49.8	45.3	45.8	45.2	46.7	47.5	86,244
External	12.1	11.2	17.4	22.3	16.1	10.9	9.0	8.8	9.2	9.4	8.1	7.2	13,142
Total	62.3	59.3	61.0	71.1	68.7	61.6	58.9	54.2	55.0	54.6	54.8	54.7	99,386
Expenditure													
Internal	63.5	52.8	62.2	56.0	52.8	51.9	53.8	52.9	52.4	52.2	52.4	51.0	92,607
External	11.3	8.1	12.6	14.5	11.4	9.5	7.8	6.6	6.4	6.4	4.9	5.7	10,292
Total	74.8	60.9	74.8	70.5	64.2	61.5	61.6	59.6	58.7	58.6	57.2	56.6	102,900
Surplus (+)/Deficit (–)													
Internal	–13.4	–4.8	–18.7	–7.1	–0.2	–1.2	–4.0	–7.6	–6.5	–7.0	–5.7	–3.5	–6,363
External	0.8	3.1	4.8	7.8	4.7	1.3	1.2	2.2	2.8	3.0	3.2	1.6	2,850
Total	–12.6	–1.7	–13.9	0.6	4.5	0.1	–2.7	–5.4	–3.7	–4.0	–2.4	–1.9	–3,514

[a] Internal public debt—excludes the government's commitment under the bank shares Arrangement (see Chapter 7).
External public debt—the annual estimate of the public debt, internal and external, is calculated as the arithmetic mean of quarterly debt/GNP ratios.
[b] At current prices.
SOURCE: Based on Central Bureau of Statistics data.

The downward trend of the public expenditure/GNP ratio, which has prevailed since 1985, persisted in 1993, and this ratio is no longer very different from that of most industrial countries. This development—a reduction of public expenditure amounting to 18 percent of GNP compared to its level in 1984—is outstanding both historically and internationally. The reduction comprises mainly a cutback in defense spending of 10 percent of GNP and a decline in financing costs of 6 percent of GNP. This trend would have intensified in 1993 had it not been for the appreciable rise in defense imports, which tend to fluctuate widely because of the irregular delivery pattern.

The share in GNP of current transfer payments grew in 1993 as a result of the resumption of allowances for the first and second child to some 370,000 families. At the same time, the total amount of absorption grants paid to immigrants fell, since the period of eligibility of most of them had ended. Thus, despite the slowdown in immigration, the share of current-account transfer payments in total expenditure continued to rise, almost equaling that of defense expenditure.

After years in which public-sector investment in the roads infrastructure was static, there was a policy shift in 1993. The surge in this investment will contribute to firms' production processes as well as to sustainable growth. In the long term these investments pay for themselves, and expanding them (within reason) does not increase the tax burden.

In January value-added tax was reduced from 18 to 17 percent and corporation tax from 40 to 39 percent, while the maximum marginal tax rate on wage income rose (see below). Thus, the tax burden—measured by the tax revenue/GNP ratio—rose slightly in 1993, after increasing in 1992, too. Since 1986 the trend has been to ease the tax burden—from 46.8 percent of GNP in 1986 to 38.3 percent in 1991—and this continued even in the first two years of immigrant absorption (1990 and 1991). The downward trend was checked in 1992 and 1993, and even reversed, with the figure rising to 39.7 percent of GNP in 1993.

The decline in the public expenditure/GNP ratio—along with the increased infrastructure investment and unchanged tax burden which add up to a reduction of the domestic and total public deficits—indicate that the policy adopted in 1993 was more contractionary than in 1992. Although the unemployment rate declined, it remained high, so that a permanent reduction of the tax rate should have been implemented. In recent years the government's involvement in construction has caused sharp fluctuations in economic activity. These tax policy measures should have been implemented in 1993 in order to stimulate the supply side, since they could have served to moderate the negative effect on economic activity of the contraction of construction. In addition, the trade liberalization policy made this a good time to reduce the tax burden, enhancing the competitiveness of Israeli firms and helping to attract foreign investors. (The average tax burden is lower abroad than in Israel.) The process of expansion, which erodes the debt/GNP ratio, makes it possible to lower taxes while maintaining or even reducing the present debt/GNP ratio. Furthermore, public expenditure is currently biased upward by about 2.5 percent of GNP in comparison with the long-term trend, because of the temp-

Table 5.2

General Government Receipts and Expenditure, Current and Capital Accounts, 1986–93

(percent of GNP)

	1986	1987	1988	1989	1990	1991	1992	1993	NIS million[a] 1993
Receipts									
Current receipts									
From property	2.6	1.8	2.0	2.5	3.2	3.1	3.0	2.7	4,957
of which Interest from abroad	1.0	0.8	0.9	1.1	1.2	1.3	1.0	0.6	1,073
Current-account transfers from the public	1.0	1.0	1.1	1.1	1.0	1.0	1.0	1.0	1,821
Indirect taxes									
On domestic production	14.7	14.4	14.1	13.7	14.3	14.9	15.5	14.7	26,714
On civilian imports	8.2	8.5	7.7	5.5	5.6	5.9	6.3	5.9	10,782
Direct taxes, fees, and levies	17.6	16.6	16.7	14.5	13.7	12.6	13.2	14.3	26,058
National Insurance income	6.3	5.8	5.6	5.4	5.3	5.0	4.7	4.8	8,676
Intergovernmental transfers	13.3	8.6	7.0	6.4	6.4	6.7	5.8	5.3	9,678
Unilateral transfers to national institutions[b]	1.3	1.1	0.9	1.0	1.2	1.1	1.0	1.0	1,821
Total current receipts	**65.1**	**57.8**	**55.1**	**50.2**	**50.8**	**50.2**	**50.5**	**49.8**	**90,507**
Capital receipts									
Capital-account transfers from the public	1.4	1.7	1.7	2.0	2.2	2.5	2.4	3.1	5,701
Public-sector depreciation	1.7	1.7	1.8	1.7	1.6	1.6	1.5	1.4	2,608
Capital transfers from abroad	0.5	0.3	0.3	0.3	0.4	0.4	0.3	0.3	570
Total capital receipts	**3.6**	**3.8**	**3.8**	**4.0**	**4.3**	**4.4**	**4.3**	**4.9**	**8,879**
Total receipts	**68.7**	**61.6**	**58.9**	**54.2**	**55.0**	**54.6**	**54.8**	**54.7**	**99,386**

Expenditure									
Current expenditure									
Domestic consumption[c]	27.1	26.9	27.5	27.1	27.1	25.9	25.6	25.1	45,561
Defense imports[d]	6.3	5.0	3.8	3.2	3.3	3.7	2.2	2.9	5,293
Domestic interest	7.9	7.1	6.6	6.8	6.8	6.3	5.9	5.7	10,277
Interest abroad	4.6	4.0	3.6	3.1	2.7	2.3	2.2	2.2	3,968
Subsidies	4.6	4.5	4.5	3.7	3.2	2.9	3.1	2.6	4,702
Current transfers (gross)	9.5	9.6	9.9	10.1	10.8	10.7	10.6	10.8	19,539
Total current expenditure	**60.1**	**57.1**	**56.0**	**53.9**	**53.9**	**51.8**	**49.6**	**49.2**	**89,340**
Capital expenditure									
Investment	2.1	2.5	2.7	2.6	2.8	3.4	3.7	4.3	7,885
Capital transfers	1.2	1.4	1.4	1.2	1.6	3.3	3.8	2.7	4,883
Repayment of compulsory loans	0.7	0.5	1.4	1.8	0.5	0.1	0.1	0.4	792
Total capital expenditure	**4.1**	**4.4**	**5.6**	**5.6**	**4.8**	**6.8**	**7.6**	**7.5**	**13,560**
Total expenditure	**64.2**	**61.5**	**61.6**	**59.6**	**58.7**	**58.6**	**57.2**	**56.6**	**102,900**
Surplus (+)/deficit (–)									
Current account (net savings)	5.0	0.7	–0.9	–3.8	–3.2	–1.6	0.9	0.6	1,167
Gross savings	6.7	2.4	0.8	–2.1	–1.5	–0.1	2.4	2.1	3,775
Current + capital accounts	4.5	0.1	–2.7	–5.4	–3.7	–4.0	–2.4	–1.9	–3,514

[a] At current prices.
[b] The Jewish Agency and public nonprofit institutions.
[c] Including civilian consumption abroad.
[d] Including advance payments, excluding taxes.

orary expenditure arising from immigrant absorption and the high level of unemployment.[1]

Any significant reduction of the tax rate in 1993 would have led to a greater deficit than was actually the case, as well as requiring the amendment of the Budget Deficit Reduction Law[2] only one year after its introduction, thereby damaging credibility. Nonetheless, two years after the law was passed, an amendment was adopted during the debate on the 1994 budget to the effect that the reduction of the budget deficit in the next few years would be slower than originally intended. The 1993 deficit was lower than the target set in the Maastricht agreement, and the implementation of the Budget Deficit Reduction Law will ensure that this situation is maintained in the coming years, too. Due to economic growth and budgetary discipline, the latter being given legislative force in the last two budgets, Israel's public debt is approaching the target set at Maastricht (a gross debt/GDP ratio of 60 percent) at a far faster pace than those of the other parties to the agreement. Nonetheless, the debt/GDP ratio is still high.[3] The reduction of the debt helped to slow inflation, and played a pivotal role in capital market reform, reflected by the decline in interest rates. Alongside the decline in the public debt, the reduction of interest payments increases the flexibility with which the budget can be allocated to different purposes. Privatization, which expanded substantially in 1993, also helped to reduce the public debt.

2. FISCAL POLICY

Fiscal policy should be examined in its macroeconomic context. First, despite the slower growth of GNP, the unemployment rate fell in 1993, after having risen steadily since 1988. In addition to the expansion of economic activity, this was the result of the replacement of workers from the administered areas by Israelis due to the closure, the continued subsidization of incremental labor, and public relief works. Although the unemployment rate fell, it was still relatively high. Consequently, unemployment is still one of Israel's main economic problems and, provided it is not structural, causes irrecoverable loss of output. There is a personal and social price to be paid for unemployment, because persons who are not in the pool of employment are pushed to the lowest deciles, even though income support, unemployment benefit, and other mechanisms compensate to some extent for loss of income.

[1] Government transfers to institutions in difficulties, such as the General Sick Fund, *kibbutzim*, *moshavim*, and the defense industries, rose substantially in 1993; this has negative implications regarding future budgetary discipline.

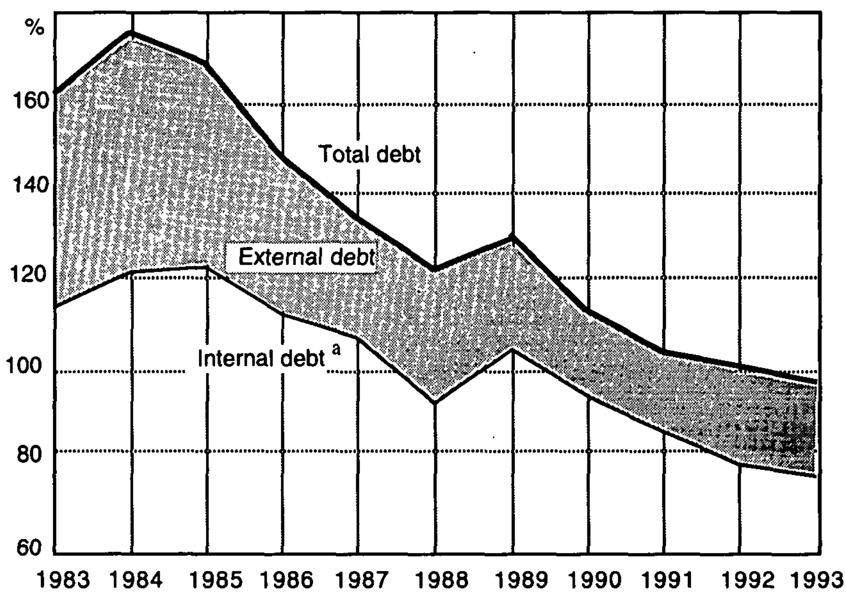
[2] Nonetheless, some reduction of the tax rate would have been possible without amending the law if the possibility of under-expenditure had been taken into account from the outset.

[3] When defined in accordance with the Maastricht ruling, Israel's national debt in 1993 was 99 percent of GNP, even though ten years ago it was twice as large.

Second, the contraction of construction in 1993 was expected to temporarily slow the expansion of output from its high 1990–92 rate—which should resume in the next few years.

Finally, the debt/GNP ratio has fallen appreciably since the 1985 economic stabilization program (ESP), and this process has even persisted in the last few years, when an influx of immigrants was absorbed. In comparison with other western countries, however, Israel's debt/GNP ratio is high. Although this reduction has helped to slow inflation since 1991, the latter is still higher than that of Israel's trading partners, and this has implications for economic stability.

Figure 5.1
Debt/GNP Ratio, 1983–93



[a] Including net government debt (excluding local authorities) and Bank of Israel debt to the public.

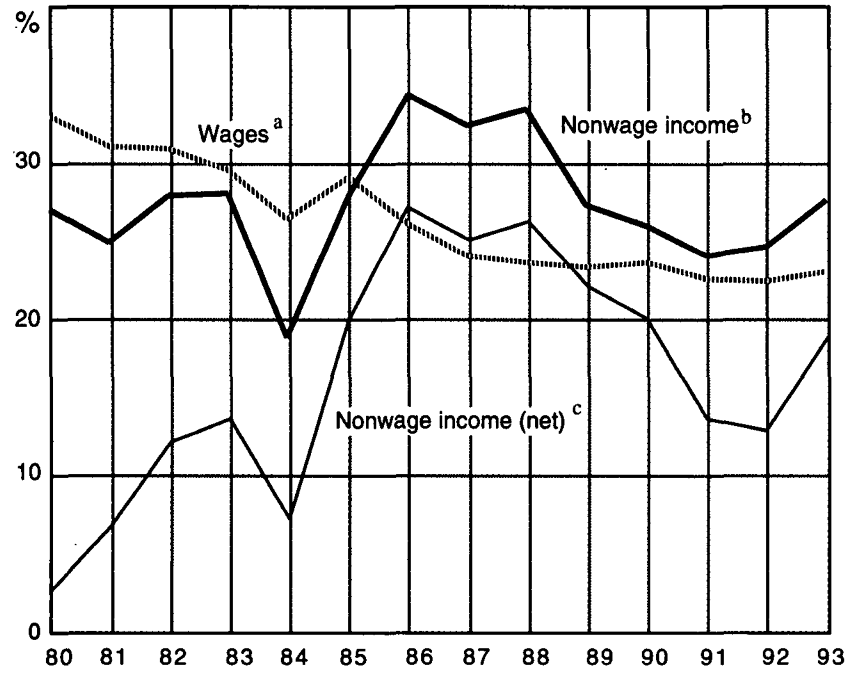
The government's objectives in 1993 were to create the appropriate conditions for sustainable economic growth—thus expanding permanent employment—while increasing short-term employment. It accordingly reversed the trend in infrastructure investment, expanding it massively. The traffic congestion resulting from years of under-investment in the infrastructure created bottlenecks which hampered the movement of factors of production and merchandise, adversely affecting profitability (see detailed account in Chapter 2).

Two policy measures served to expand employment immediately. The subsidy amounting to a third of the wage of incremental employment continued. There was a 35 percent increase in the number of employees thus subsidized, which reached 53,000.

For certain employers the wage subsidy represents government participation in training employees, thus making it worthwhile to employ some of them permanently. Relief work projects were also increased in 1993, providing employment for about 3,000 persons.

The tax burden, measured by the tax revenue/GNP ratio, remained at the 1992 level, so that its effect on economic activity remained unchanged. An alternative index, the tax rate on nonwage income—which reflects the effect on the business sector, rose steeply in 1993 (Figure 5.2).

Figure 5.2
Average Direct Tax Rates on Wage and Nonwage Income, 1980–93



[a] Excluding corporate managers' salaries.

[b] Gross business-sector income at factor cost, excluding salaries (except corporate managers).

[c] Less credit subsidies and capital transfers to firms.

SOURCE: Based on Central Bureau of Statistics data.

The conclusion of government involvement in construction was reflected by a steep fall in payments for apartments under the purchase guarantees, while income from sales of apartments purchased earlier rose. The sharp cut in purchase guarantees caused demand for apartments to drop, contributing to reduced employment in construction and ancillary industries.

Table 5.3
General Government Expenditure by Type of Intervention, 1980–93

(percent)

	1980–84	1986–93	1985	1986	1987	1988	1989	1990	1991	1992	1993
Public goods											
Defense	27.9	22.6	29.3	27.0	26.0	23.5	22.5	22.4	21.6	19.0	19.3
Administrative services[a]	6.4	7.1	6.3	6.8	7.4	7.2	7.4	7.4	7.0	7.0	7.0
Investment	3.3	5.1	2.7	3.3	4.1	4.4	4.4	4.7	5.8	6.5	7.7
Total	**37.6**	**34.9**	**38.3**	**37.0**	**37.5**	**35.1**	**34.2**	**34.4**	**34.4**	**32.6**	**33.9**
Social services											
Merit goods	18.0	21.3	17.7	18.6	18.9	20.6	21.2	22.3	22.2	23.0	23.7
Education[a]	*10.0*	*11.7*	*10.0*	*10.7*	*10.5*	*11.6*	*11.8*	*12.2*	*12.0*	*12.3*	*12.6*
Health[a]	*4.8*	*5.6*	*4.7*	*4.8*	*4.9*	*5.2*	*5.3*	*5.9*	*5.9*	*6.3*	*6.6*
Welfare[a]	*3.2*	*4.0*	*3.0*	*3.1*	*3.5*	*3.8*	*4.1*	*4.2*	*4.4*	*4.4*	*4.4*
Current transfers	10.7	16.9	12.4	14.6	15.2	15.8	16.8	18.1	18.0	18.2	18.5
Total	**28.7**	**38.2**	**30.1**	**33.2**	**34.1**	**36.3**	**38.0**	**40.4**	**40.2**	**41.2**	**42.2**
Direct intervention (business sector)											
Subsidies	5.9	3.3	5.0	3.2	3.1	3.6	3.0	2.9	3.2	4.0	3.6
Credit subsidy	6.0	1.3	2.9	2.3	2.3	1.7	1.2	1.0	0.8	0.6	0.5
Capital grants	3.4	3.5	1.8	1.9	2.3	2.3	2.0	2.7	5.6	6.6	4.7
Foreign trade subsidies	1.8	1.5	1.9	1.6	1.9	2.0	2.1	1.6	1.0	0.9	0.5
Total	**17.0**	**9.6**	**11.6**	**9.0**	**9.6**	**9.6**	**8.2**	**8.2**	**10.5**	**12.1**	**9.3**
Financing outlays											
Repayment of compulsory loan	1.0	1.1	0.5	1.2	0.7	2.3	3.0	0.8	0.1	0.1	0.8
Interest on public debt											
Internal	10.3	11.1	11.1	12.3	11.5	10.8	11.4	11.6	10.8	10.2	10.0
External	5.4	5.7	8.4	7.2	6.5	5.8	5.2	4.6	4.0	3.8	3.9
Total	**16.7**	**17.3**	**20.1**	**20.7**	**18.8**	**18.9**	**19.6**	**17.0**	**14.9**	**14.1**	**14.6**
Grand total			**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Percent of GNP	74.8	59.7	70.5	64.2	61.5	61.6	59.6	58.7	58.6	57.2	56.6

[a] Estimated from the general government consumption figures; for 1988–93 provisional estimate based on change in number of employee posts.
SOURCE: Based on Central Bureau of Statistics data.

The effect of fiscal policy was to reduce the domestic deficit, i.e., it wa contractionary. (This conclusion is not borne out when an alternative index, such as th change in the total public deficit, is examined.) The deficit was reduced by more in 199 than required by law. The domestic deficit excluding net credit was 2.5 percent of GDP while it could have been 3.2 percent. This is the second successive year since the Budge Deficit Reduction Law was introduced that the actual deficit has fallen short of th permitted level.

The question arises as to whether a permanent tax reduction could have been made thus further increasing employment. According to assessments of potential outpu growth (see Chapter 2), the annual average growth rate of business-sector product ha been 6 percent since 1990, and is expected to remain at this level in the next few years Under these conditions, even an annual total public deficit of 3 percent of GNP, enablin the substantial reduction of taxes and expansion of employment, will further reduce th public debt by some 15 percent of GNP in five years. This calculation does not take int account financing through expansion of the money supply, which is estimated at abou 0.5 percent of GNP annually, the positive effect on economic growth of reducing ta rates, or receipts from privatization. The total public deficit also reflects temporar income and expenditure arising from immigrant absorption and the curren unemployment level. Table 5.4 shows receipts and expenditure flows which are partly o entirely of a temporary nature.[4]

Table 5.4
Temporary Expenditure (Net), 1989–93

(NIS million, current prices)

	1989	1990	1991	1992	1993
Housing[a]	60	217	697	3,065	380
Unemployment[b]	191	306	418	1,187	1,640
Absorption grant, etc.	349	1,129	1,902	1,683	1,470
Export subsidy[c]	1,050	977	827	804	453
Compulsory loan redemption	1,511	488	99	112	792
Total, net	3,161	3,117	3,943	6,851	4,735
Percent of GNP	3.8	3.1	3.0	4.4	2.6

[a] Expenditure on housing includes net purchases of apartments, rapid completion incentives, an participation in rent.

[b] Including unemployment benefit, income support (above the 1988 level), wage subsidization, an relief work.

[c] This was not originally regarded as temporary, but once the exchange-rate insurance premium fo exporters is abolished this expenditure will cease.

As the table shows, current public expenditure is biased upwards by 2.6 percent o GNP. If we adopt a more conservative approach, however, and assume that only half o

[4] The table does not encompass all temporary money flows, in particular tax receipts, which ar dependent on economic activity and the unemployment rate.

t is temporary, the rest becoming permanent (because existing expenditure will persist or ›e replaced), the long-term expenditure, given the information currently available, will ›e lower by about 1.3 percent of GNP.

Trade is in the process of being liberalized. The reduction of taxes, which plays an mportant part in a closed economy through profitability and disposable income, affects ompetitiveness. It can make Israeli firms more competitive and attract foreign investors, hus compensating to some extent for the short-term loss of jobs which goes hand in ıand with liberalization.

According to forecasts made in 1992, there should have been a temporary deviation in he growth rate of GNP in 1993. One of the government's traditional functions is to mooth fluctuations in economic activity, and the acceleration of public investment in 993 served to weaken the contractionary effect of construction. This also explains why 993 would have been a good time to ease the tax burden.

However, the reduction of taxes required amending the Budget Deficit Reduction Law ust one year after its introduction. Some reduction was possible within the framework ›f the existing law in view of the fact that there are bureaucratic limitations which give ise to a shortfall in budgetary spending. However, despite its advantages, the law xacts a price. Its advantages derive from the budgetary discipline it imposes on the governnment, preventing the expansion embodied in the budget deficit due to the cost of imnigrant absorption from becoming permanent. This gives economic policy the credibility hat is essential for stability and growth. The law also reduces uncertainty as regards ›udget policy, thus helping economic agents to plan ahead. The price of this framework s that it makes it more difficult for the government to respond should economic levelopments be other than predicted. In this case, adherence to the law requires esponding on the income side, giving rise to uncertainty with regard to the tax rate.

In effect, the law is concerned with the government's domestic deficit, and this creates everal problems (see Bank of Israel *Annual Report,* 1992, Chapter 5). As Table 5.5 hows, a gap has developed between the general government domestic deficit and the otal public-sector deficit, which is the variable relevant to the cumulative public debt. 'ogether with high unemployment, this debt was one of the main reasons for the amendnent of the Budget Deficit Reduction Law in the 1994 budget.

'able 5.5

ieneral Government Domestic Deficit[a], 1987–94

(percent of GNP)

	1987–1990	1991	1992	1993	1994	1995–1997
ıccording to previous law			6.2	3.2	2.2	0.0
ıccording to new law					3.0	declining
)perating estimate	3.5	6.7	4.9	2.5		
iovernment domestic deficit	4.8	7.0	5.7	3.5		
'otal public-sector deficit	2.9	4.0	2.4	1.9		

[a] According to old definition.

Table 5.6
Direct Demand of General Government, 1989–93

	NIS million			Annual change, percent							
				Price			Quantity				
	1991	1992	1993	1991	1992	1993	1989	1990	1991	1992	1993
Consumption (net)											
Civilian	*22,348*	*26,580*	*31,000*	21.4	12.7	12.9	4.2	0.8	4.5	5.6	3.3
Defense	*17,275*	*18,301*	*22,011*	20.3	13.6	10.3	–16.5	4.7	3.7	–6.7	9.1
Total	39,623	44,881	53,011	20.9	13.1	11.8	–5.8	2.5	4.1	0.2	5.6
Domestic consumption (net)											
Civilian	*22,040*	*26,161*	*30,442*	21.5	12.7	12.9	4.2	0.7	4.6	5.3	3.0
Defense	*11,838*	*13,627*	*14,580*	21.9	13.1	10.1	–1.9	0.8	–4.1	1.8	–2.8
Total	33,878	39,788	45,023	21.6	12.8	12.0	1.8	0.8	1.4	4.1	1.0
Investment	4,520	5,840	7,885	14.4	10.1	8.4	1.6	14.7	40.2	17.4	24.6
Direct demand	**44,143**	**50,721**	**60,896**	20.3	12.6	11.2	–5.3	3.4	7.1	2.0	8.0
Direct domestic demand	**38,398**	**45,628**	**52,908**	20.8	12.4	11.2	1.8	1.9	5.0	5.7	4.3
Government-guaranteed construction[a]	6,918	6,907	2,621	15.5	9.8	8.5	7.9	208.6	290.5	–9.0	–65.0

[a] Private housing construction with government guarantee to purchase unsold apartments.

SOURCE: Based on Central Bureau of Statistics data.

Adherence to the Budget Deficit Reduction Law has caused a further reduction of the public debt/GDP ratio, and if this continues, despite the amendment, the decline will presumably accelerate. Strict budgetary discipline has had an effect on inflationary expectations, thus apparently helping to slow inflation. The reduction of the debt/GDP ratio contributed to increasing the part of the budget subject to current decisions by policy-makers by reducing the share in it of debt servicing. There are two reasons for this. First, the smaller debt/GDP ratio arising from increased privatization of government corporations naturally reduces interest paid at fixed rates. Second, it also reflects reduced government intervention in the capital market, creating downward pressure on the interest on the internal debt.

3. DEFENSE CONSUMPTION

Total defense consumption rose by about 9 percent; defense labor input declined by one percent as the length of reserve duty was reduced, domestic purchases fell by a real 4 percent, and defense imports rose by some 43 percent.

Table 5.7
Indicators of Defense Consumption, 1980–93

	Percent of: GNP *plus* unilateral transfers[b] (1)	Defense consumption[a] as percent of GNP: Total (2)	Domestic (3)	Domestic *plus* foreign funding[c] (4)	Compensation of employees: defense[a] as percent of total (5)
1980	19.9	23.2	14.0	17.4	10.5
1981	21.4	24.6	14.1	17.3	10.3
1982	19.1	21.6	15.0	19.3	10.8
1983	16.4	18.9	14.2	18.0	9.9
1984	18.4	21.7	14.3	19.0	10.2
1985	17.3	21.6	12.7	17.7	9.5
1986	13.0	15.9	11.0	15.1	8.8
1987	16.5	19.4	11.0	14.6	8.6
1988	14.1	16.6	10.7	13.8	9.2
1989	12.0	13.6	10.3	12.9	9.1
1990	11.8	13.5	9.9	12.2	9.1
1991	11.4	13.1	9.0	11.2	8.9
1992	10.1	11.7	8.7	10.7	8.2
1993	10.6	12.1	8.0	10.0	7.6

[a] Excludes conscripts.
[b] Unilateral transfers converted to NIS at the official exchange rate.
[c] Budgeted foreign-currency outlay and principal and interest on US government loans.
SOURCE: Based on data of the Central Bureau of Statistics and the Ministry of Finance.

Table 5.8
Taxes, Subsidies, and Transfers, 1980–93

(percent of GNP)

	1980–84	1985–93	1986	1987	1988	1989	1990	1991	1992	1993	NIS million[a] 1993
Taxes and transfers											
Taxes	41.7	41.8	46.8	45.3	44.1	39.1	38.9	38.3	39.7	39.7	72,230
less Net transfer payments[b]	8.5	9.5	8.9	8.5	9.7	9.9	9.4	10.4	10.8	9.5	17,199
less Direct and credit subsidies	10.2	4.0	4.6	4.5	4.5	3.7	3.2	2.9	3.1	2.6	4,702
Total	**22.9**	**28.3**	**33.3**	**32.4**	**29.9**	**25.5**	**26.2**	**25.1**	**25.8**	**27.7**	**50,329**
Direct taxes											
Direct taxes	23.3	20.6	23.9	22.4	22.3	19.9	19.0	17.6	18.0	19.1	34,734
less Transfer payments	8.5	9.5	8.9	8.5	9.7	9.9	9.4	10.4	10.8	9.5	17,199
Total	**14.8**	**11.1**	**15.0**	**14.0**	**12.6**	**10.0**	**9.6**	**7.2**	**7.2**	**9.6**	**17,535**
Indirect taxes, domestic											
Taxes	11.0	14.4	14.7	14.4	14.1	13.7	14.3	14.9	15.5	14.7	26,714
less Direct and credit subsidies	7.0	3.0	3.5	3.3	3.3	2.4	2.3	2.3	2.6	2.3	4,210
Total	**4.0**	**11.4**	**11.2**	**11.1**	**10.8**	**11.3**	**12.0**	**12.6**	**12.9**	**12.4**	**22,504**
Net foreign trade taxes	**4.5**	**5.8**	**7.1**	**7.3**	**6.4**	**4.3**	**4.7**	**5.3**	**5.8**	**5.7**	**10,290**
Net import duties	7.2	7.0	8.5	8.7	7.8	5.5	5.6	5.9	6.3	5.9	10,780
Export subsidies[c]	2.6	1.1	1.3	1.3	1.4	1.3	1.0	0.6	0.5	0.3	490

[a] At current prices.
[b] Including compulsory loans, excluding imputed civilian and defense pensions.
[c] Direct export subsidies and export credit subsidies.
SOURCE: Based on Central Bureau of Statistics data.

Domestic defense consumption was not affected significantly by Israel's incursion nto southern Lebanon in July. An event which will affect defense consumption, albeit vith a lag, was the signing of the Declaration of Principles with the PLO in September. Γhe temporary costs incurred as a result of its implementation with regard to the edeployment of the IDF will cause a nonrecurring increase in defense consumption.

The indicators in Table 5.7 reflect the defense burden.[5] Most of them show that the ɔurden has been reduced, continuing the long-term trend. Despite the dramatic decline in he share of defense consumption in GNP—from 23 percent of GNP in 1980 to 12 percent n 1993—Israel is still far above the OECD average (about 2.5 percent).

ŀ. TAXES, SUBSIDIES, AND TRANSFERS

n comparison with 1989—the year the influx of immigrants began—the average tax ɔurden did not decline in 1993, even rising slightly, as reflected by the tax/GNP ratio. Γhe share of total taxes in GNP was 39 percent in 1989, and 40 percent in 1993 (Table ͻ.8). The share of direct taxes in total tax receipts rose steeply in 1993, and so that of ndirect taxes fell, in contrast with the trend of the last few years. Nonetheless, the share ɔf indirect taxes in GNP in Israel is still one of the highest in the west because of the ɔroad base of VAT. All these changes reflect inconsistent policies over time; in March 1990 VAT was raised from 15 to 16 percent, nine months later it was put up again, to 18 ɔercent, and in January 1993 it was reduced to 17 percent. Frequent changes within a elatively short period create uncertainty in the business sector.

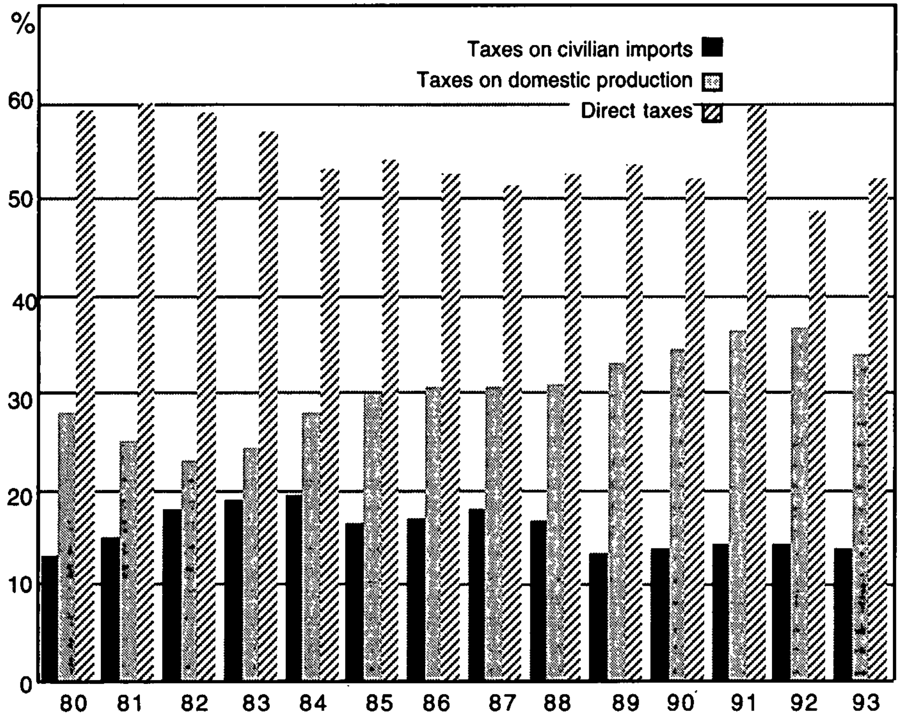
Ɔirect taxes

Γhe continued expansion of economic activity brought about a real 11 percent increase in lirect tax receipts. In 1993 the trend of the previous years was reversed, and the share of lirect taxes in total tax receipts rose, reducing that of indirect taxes. Wage income-tax eceipts grew by a real 11 percent, i.e., by far more than the increase in GNP and in total vage payments.

Nonwage income-tax receipts rose by a real 15 percent. This exceeded the real ncrease in both business-sector product and wage income-tax receipts, so that the share ɔf wage income-tax receipts declined. Because profits may be offset against losses from ɔrevious years, and the tax system determines advance payments on the basis of the ɔreceding year's returns, tax receipts increase with economic expansion. In 1993 an ıdditional percentage point was docked from the corporation tax rate, bringing it down to ʒ9 percent, as part of the plan to reduce this tax to 36 percent by 1996.

[5] These indicators exclude conscripts and other factors which affect the burden.

Figure 5.3
The Composition of Taxes, by Type of Tax, 1980–93



Transfer payments

Total transfers to the public remained at more or less the same level in real term (deflated by the CPI). The slight decline is the net result of uneven developments in th components of this item; current transfer payments increased by a real 5 percent, becaus of the expansion of child allowances, and the increase would have been greater still ha it not been for the decline in absorption grant payments to immigrants. Transfe payments on capital account fell by a steep 15 percent, however, after soaring by 11 percent in 1992–92. Since the mass immigration began, the stock of government-owne housing has grown due to the implementation of the purchase guarantees, budget financed construction, and the import of mobile homes and caravans. Governmen intervention in construction, which in previous years involved budgetary expenditure,

[6] The purchase of an apartment (an asset) by the government alters the stock of assets and liabilitie but does not affect the budget deficit as long as this does not involve an implicit subsidy. The curren recording method biases expenditure, income, and the deficit. The bias in the deficit disappears whe viewed over the long term, because all that remains then is the difference between income an expenditure, i.e., a subsidy, which should be included in the deficit.

hrank appreciably in 1993, and at the same time sales of apartments to the public icreased, as did income from rent. As a result, net capital transfer payments to the ublic were negative in 1993, and this unusual development may persist in 1994, too.

'able 5.9
stimated Value of Allowances, 1990–93

(percent)

	Annual real change[a]				Until mid–year (NIS)
	1990	1991	1992	1993	1993
eflated by CPI					
For two children	–50.6	–77.3	–100.0		204.0
For four children[b]	4.9	–5.1	2.5	–0.5	792.0
Individual old age pension[c]	–1.1	–8.4	0.1	1.7	803.0
eflated by average wage					
For two children	–50.2	–76.3	–100.0		
For four children[b]	5.8	–2.2	1.4	–1.0	
Individual old age pension[c]	–0.3	–5.6	–1.0	1.2	

[a] Monthly deduction.
[b] Including IDF veterans' allowance.
[c] Old age pension *plus* income supplement; this is equivalent in value to dependent's allowance *plus* icome supplement, and to the total disability allowance.

OURCE: Based on National Insurance Institute data.

Government transfers to institutions in financial difficulties, such as the General Sick 'und, the *kibbutzim* and *moshavim*, the defense industries, etc., increased sharply in 993, even though their level was relatively high in 1992. These transfers, which mounted to some NIS 100 million in 1989, reached NIS 1 billion in 1993. Beyond nvolving extensive budgetary expenditure, these policy measures postpone the ppropriate solution of the problem and convey a negative message regarding budgetary iscipline.