

CHAPTER V

THE PUBLIC SECTOR¹

The public sector's overall deficit was reduced to a very low level in 1985, and its external account even showed an excess of income over expenditure thanks to an increase in U.S. government grants. The domestic deficit shrank appreciably owing to a much larger tax collection, the cutting of subsidies, erosion of public sector wages, and contraction of the sector's direct domestic demand. On the other hand, transfers to households increased this year. This fiscal restraint was due partly to endogenous developments and the government's policy toward the end of 1984 and in the first half of 1985, and partly to the economic stabilization program introduced in July. The slashing of the public deficit permitted a real reduction of the public debt, but in relation to GNP it nevertheless went up.

Direct domestic demand was down 2.5 percent this year, as defense spending and investment were cut back. The domestic defense bill was 3 percent smaller than in 1984. This decrease, most of which occurred in the second half

¹ The public sector comprises the central government, National Institutions, and local authorities. The analysis of civilian consumption also covers nonprofit institutions (the public sector and the nonprofit institutions combined are referred to as "public services").

This chapter deals primarily with the sector's real activity and its influence on the economy. Its direct demand consists of public consumption (civilian consumption and defense spending in Israel and abroad) and investment initiated by the sector.

The public sector absorption indirectly influences individuals' and the business sector's demand via the changes in disposable income or relative prices: taxes (and other public sector income) increase the absorption, while subsidies, transfer payments, and interest outlay reduce it. "Net taxes" are defined as taxes less direct subsidies and transfer payments (i.e. the absorption excluding property and entrepreneurial income, interest payments, and the credit subsidy).

The public deficit is defined as the difference between the public sector's direct demand and absorption. It is financed by foreign loans, borrowing from the public, and expansion of the money base (money creation).

Data presented as a percent of GNP are in current prices, while rates of change are in real terms. Public consumption and investment were deflated by the respective implicit price indexes derived from the national accounts; taxes, subsidies, and transfers were deflated by the consumer price index.

Several changes were introduced this year in integrating the Bank of Israel's accounts. Its interest payments on redeposits of Patam (resident accounts denominated in foreign currency) were included in public sector interest payments, interest payments related to the money base were deducted from the change in the money base (money creation), other Bank income and expenditure items were included in property and entrepreneurial income, and the Bank's borrowing from the public was included in public sector borrowing.

of the year, can be attributed to both the withdrawal from Lebanon and the pressure exerted on the defense establishment to reduce the domestic defense burden. On the other hand, direct defense imports, which to some extent are an alternative to domestic defense procurements and are financed with American aid, expanded by 24 percent. On balance, noncivilian consumption rose 6.5 percent, but its weight in GNP did not change.

From 1980 to the beginning of 1985 the defense establishment incurred large outlays in connection with two extraordinary events: the withdrawal from Sinai and redeployment in the Negev, and from 1982 the war in Lebanon. Completion of the main stages of the Negev withdrawal and termination of the war in Lebanon may permit (provided there is no change in the security situation) a reduction of defense spending in the coming years without hurting current requirements.

Public civilian consumption per capita has receded steadily since 1980, and in 1985 it was back to its real level in 1973. One reason for the downturn is the declining weight of the age group that consumes educational services (youths) and the group that is a heavy user of health services (the elderly). In line with the trend of the past few years, the number of workers in the public services (the public sector and nonprofit institutions) edged up 1.7 percent on average, with the result that their weight in total employment held steady. The second half of the year, however, saw a decrease in public services employment, mainly in segments directly controlled by the government. According to incomplete information, this apparently involved a high price—the awarding of enlarged pensions (which are part of the transfer payments item), high severance pay, and so forth.

Public sector wages (changes in which are presented here as an estimated price change) eroded in the second half of 1985, and this was the main reason for the sagging weight of public civilian consumption in GNP. The erosion was not long-lasting, and since the end of 1985 wages have been moving up. Because of the steep adjustment of income tax brackets in the second half of the year, net wage expenditure (gross wages less direct taxes) declined more slowly than the gross expenditure.

Tax collections (and transfer payments from the public) shrank in 1984 because of the law for taxation under inflationary conditions, the bank share crisis, and the escalation of inflation, which severely eroded the tax receipts. In 1985 tax collections rose strongly to stand at 49 percent of GNP (in 1975–85 they averaged 48 percent of GNP). Most of the increment derived from non-wage income, which had yielded a smaller revenue the year before. Examination of the average tax rates on wage and nonwage income shows that in 1984 there was an inordinate drop in the rate of direct taxes on income, but in 1985 they reverted to their pre-1984 level.

The 8 percent growth of tax revenue in 1985 can be attributed to several factors. First, the slowing of inflation resulted in a smaller erosion of real collections (stemming from the time-lag between the creation of the tax liability and its collection). At the same time, however, it enlarged the tax brackets in real terms, with a consequent contractionary effect on collections. Calcula-

Table V-1
PUBLIC SECTOR DEMAND, ABSORPTION, AND DEFICIT, 1975-85
 (percent of GNP, current prices)

	1975- 1985	1980	1981	1982	1983	1984	1985
Direct domestic demand	30	29	29	31	30	30	27
Domestic absorption	17	17	16	20	23	13	19
Direct demand for foreign currency	13	12	14	11	9	13	15
Receipts from abroad	12	11	10	9	9	13	22
Public sector deficit							
Total	13	14	17	12	7	17	1
Domestic	12	12	13	11	7	16	8
of which Excl. interest & credit subsidies	6	5	11	7	4	12	2
Foreign	1	2	4	2	-0	0	-7
Financing of total deficit							
Net borrowing from abroad	5	5	8	4	5	9	-2
Net money creation	2	2	2	2	1	3	6
Net domestic borrowing	} 6 ^a	6 ^a	8	7	-1	3	-2
Errors and omissions			-1	-0	2	2	-0
Public debt ^b							
Domestic	111	112	114	123	118	123	143
Foreign	43	37	38	40	40	51	60
Employed in public services as percent of total civilian employed persons	29	29	30	30	29	29	30

^a Includes net domestic borrowing, for which there were no estimates before 1981.

^b Arithmetic mean of quarterly debt/GNP ratios.

DEFINITIONS

Direct domestic demand: Domestic public consumption (civilian and defense) and public sector investment.

Domestic absorption: Tax revenue and income from property and entrepreneurship less subsidies (including credit subsidy), net transfers, and interest paid.

Direct demand for foreign currency: Direct defense imports (net of import duties), government imports n.e.s., interest payments to rest of world, and Bank of Israel expenditures abroad on minting and printing money.

Receipts from abroad: Unilateral transfers to the public sector plus interest receipts on foreign reserves less transfers to the Civil Administration of Judea-Samaria and Gaza District.

Public sector deficit: The difference between demand and absorption (receipts). Public sector dissaving is equal to the total deficit less public sector investment.

Domestic deficit: Direct domestic demand, subsidies, transfer payments, interest payments, and credit subsidies (imputed and other) less taxes, income from property, and transfer receipts.

Net borrowing from abroad (short, medium, or long term): the decline in foreign reserves less repayment of principal and less defense advances.

Net money creation: Increase in narrow money base (currency in circulation and deposits of commercial banks with the Bank of Israel), less Bank of Israel expenses on the money base (interest paid on deposits of commercial banks, etc.).

Errors and omissions: Total deficit less the other components of deficit finance.

Domestic public debt: Total private sector claims on the public sector (excluding the government's commitment under the Bank Share Arrangement).

Foreign public debt: Total claims of foreigners on the public sector less foreign reserves.

SOURCE: Central Bureau of Statistics, Accountant-General, and Bank of Israel.

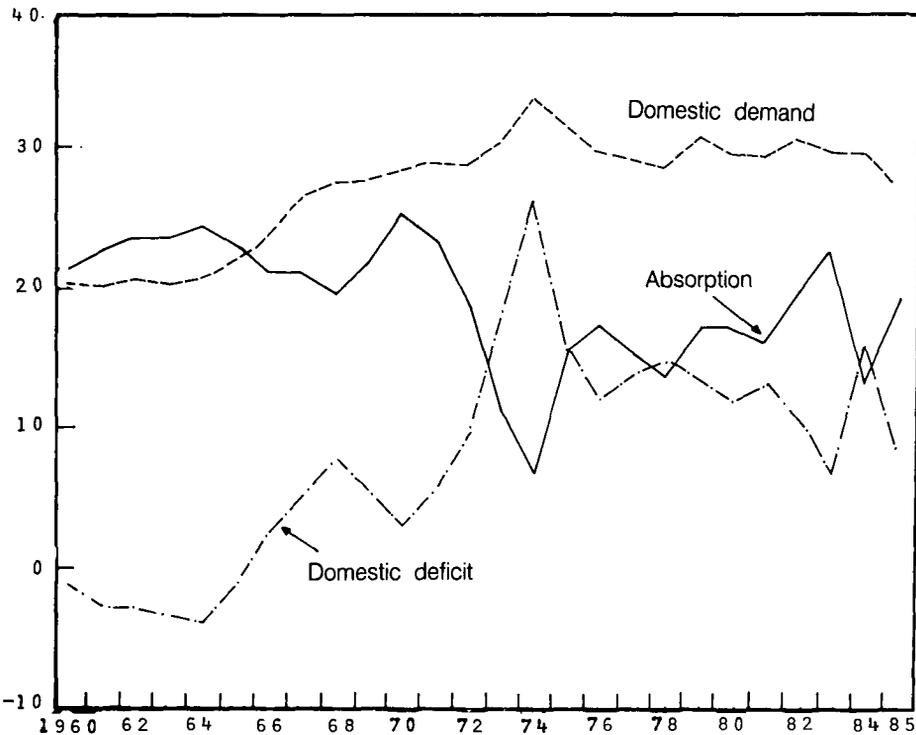
tions show that on balance the deceleration of inflation had a positive effect, accounting for a quarter of the incremental tax revenue in 1985.

The desire to reduce its deficit motivated the government to boost tax revenue, and one way of doing this was to impose nonrecurrent levies. But since it also increased its compensation payments to low-income groups because of the real wage erosion, net income from this source accounted for only a fifth of the additional tax revenue in 1985. If the wage erosion in the second half of the year is also viewed as a temporary phenomenon, the one-time and temporary factors depressed tax revenue in the year reviewed.

Direct production subsidies were equivalent to 6-7 percent of GNP in the past few years. They were trimmed under the package deals implemented in the first half of 1985, and again under the economic stabilization program. On an annual average, they declined to 5 percent of GNP, but since most of the cuts were made in the second half of 1985, they will find full expression only next year.

Domestic interest payments were equal to 7 percent of GNP in real terms, compared with 4 percent in 1984 and a similar average during the past decade.

Figure V-1
PUBLIC SECTOR DEMAND, ABSORPTION, AND DOMESTIC DEFICIT, 1960-85
 (percent of GNP, current prices)



The 1985 increase was due to two factors: (a) the final month's indexation increment lost by bond owners upon redemption was smaller this year because of the slowing of inflation, and (b) the foreign currency-linked debt appreciated in real terms because of the weakening of the sheqel in relation to European currencies. These increases were partly offset by the termination in February 1985 of interest payments on Patam deposits for less than one year.

U.S. government assistance to Israel was stepped up in 1985: in addition to a \$750 million special emergency grant, the military aid, which in the past had been given in the form of both grants and loans, was this year given entirely as a grant. Discounting that part of American aid that went to service past U.S. government loans, the amount of freely usable funds (for direct defense imports and other uses) was about \$1 billion larger in 1985 than in the two preceding years. The increased aid made it possible to virtually erase the overall public sector deficit, augment the country's foreign reserves, and reduce the external debt.

The weakening of domestic demand and the growth of the public sector's income—domestic and foreign—led to the narrowing of the public deficit. On an annual average, the domestic deficit was equal to 8 percent of GNP (compared with 12 percent in 1975–85). Various indicators show that the deficit shrank appreciably already in the first half of 1985 because of the cutting of subsidies and the recovery of tax collections, and under the economic stabilization program it was reduced to 6 percent of GNP, compared with 10 percent in the first half of the year and 16 percent in 1984. This trend carried over through the first four months of 1986.

In recent years the public deficit was funded for the most part by borrowing from the public and abroad and to a lesser extent by money creation (printing money). The curbing of inflation and the high interest rates set on short-term sheqel deposits resulted in a rapid increase in net money creation (the change in the narrow money base less the Bank of Israel's related expenditures), bringing it up to 6 percent of GNP. This high level was presumably a one-time phenomenon, caused by the heavy demand for real money balances during the sharp transition from high inflation to price stability. (In 1960–85 money creation averaged only 2 percent of GNP.)

The trimming of the overall deficit and the sizable money creation permitted a real contraction of the public debt—domestic and external alike—but in relation to GNP it nevertheless continued to rise (see Table V-1). As regards the external debt, this is explained by the depreciation of the sheqel (annual average): this brought up the weight of the debt in sheqel terms, despite its decrease in foreign currency terms. As to the domestic debt, the bulk of it is linked to the consumer price index; since the index outpaced the rise in GNP prices in 1985 (because of the lifting of subsidies and so forth), the debt as a proportion of GNP went up. Another factor was related to the method of estimation: the domestic debt was calculated on the assumption that it was redeemed in each of the years concerned. In the case of government bonds, the owner loses the final month's indexation increment upon redemption; the aggravation of inflation increases this loss, thereby reducing the debt, while the

slowing of inflation has the opposite effect. The government's commitment in connection with the bank shares covered by the arrangement worked out after the October 1983 crisis is not included in the domestic debt. In October 1985, \$670 million worth of "arrangement" shares held by senior citizens were redeemed. Part of this sum was reinvested in financial assets created for this express purpose (about 40 percent) and in other financial assets, thereby enlarging the recorded domestic debt. For all these reasons, the public debt as a proportion of GNP rose strongly in 1985 even though it contracted in real terms.

Table V-2

PRINCIPAL COMPONENTS OF PUBLIC SECTOR DEMAND AND ABSORPTION, 1975-85
(percent of GNP, current prices)

	1975- 1985	1980	1981	1982	1983	1984	1985
Direct domestic demand	29.8	29.7	29.8	30.9	29.8	29.8	27.2
Domestic public consumption							
Civilian	11.2	11.8	11.7	11.6	11.4	11.9	10.9
Defense	14.7	14.3	14.5	15.6	14.8	15.1	13.7
Public sector investment	3.7	3.4	3.2	3.4	3.5	2.7	2.5
Domestic absorption	17.2	17.5	16.3	20.0	22.8	13.3	19.2
Tax revenue	47.5	46.5	45.4	49.4	49.8	41.8	49.3
less Subsidies	5.8	3.0	7.9	6.1	6.0	6.7	5.1
less Transfer payments	16.6	16.9	16.5	17.3	16.4	16.1	17.1
less Credit subsidies	5.5	7.2	5.5	4.2	3.5	3.5	2.1
less Real interest payments	4.2	4.3	2.5	3.5	2.3	3.5	7.6
Income from property	1.8	2.4	3.2	1.6	1.3	1.4	1.0
Direct demand for foreign currency	13.0	12.4	14.1	10.8	9.1	13.4	15.3
of which: Direct defense imports	10.4	10.0	11.6	7.6	5.3	8.5	9.9
Net interest payments to abroad	2.3	1.6	1.9	2.3	2.8	4.0	5.6

DEFINITIONS

Domestic civilian public consumption: Civilian public consumption less government imports n.e.s.

Domestic defense consumption: Defence consumption less direct defense imports and less estimated domestic sales by defense establishment.

Public sector investment: Does not include public housing.

Tax revenue: Direct and indirect taxes (excl. import duties on direct defense imports) plus transfer receipts from households.

Subsidies: Does not include subsidy element of credit.

Credit subsidy: Subsidy element of credit to enterprises (includes subsidy derived from inflationary capital gains) and direct credit subsidy.

Real interest payments: Real interest paid to domestic factors by central government, local authorities, National Institutions, and the Bank of Israel less adjustment for repayment of principal.

Income from property: Domestic operating profit of the Bank of Israel plus other income from property and entrepreneurship (rent, dividends, interest) plus imputation for subsidy element of credit to enterprises.

Direct defense imports: Includes import duties.

Net interest payments to abroad: Nominal interest on the foreign public debt less interest received on foreign reserves.

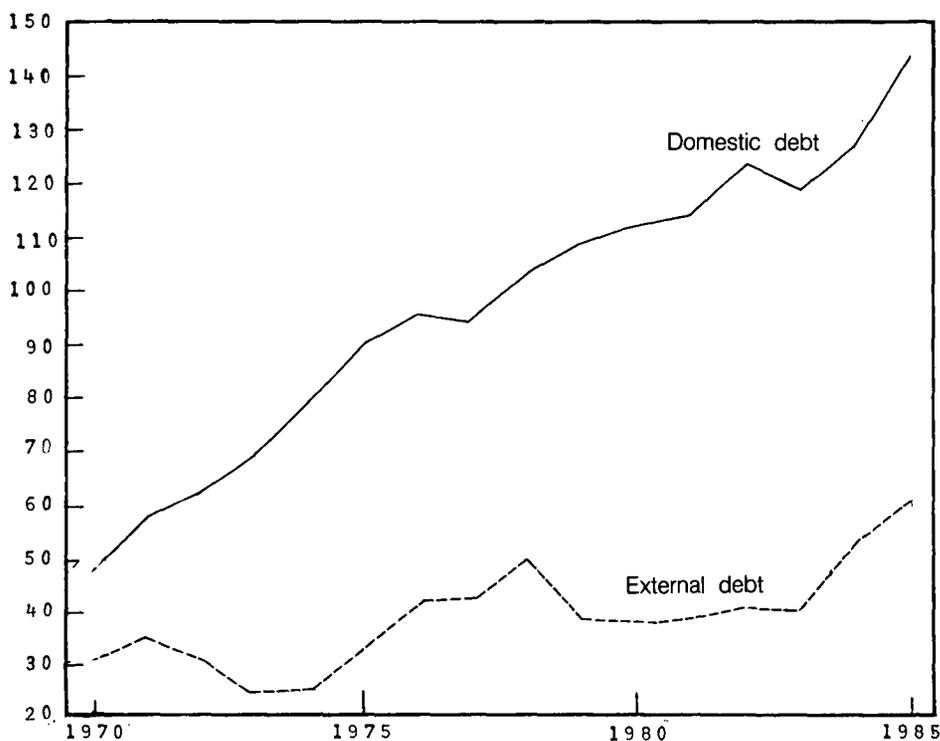
SOURCE: Central Bureau of Statistics and Bank of Israel.

Fiscal Policy

The basic problem facing the public sector during the past two decades was a chronic large deficit. This arose because of a much bigger defense bill after the Six-Day War, while public civilian consumption hardly changed and public investments were cut back only marginally (as a percent of GNP). Net tax revenue (taxes less direct subsidies and transfer payments) increased, but not enough to prevent a deficit. The deficits generated a public debt—internal and external—which in 1985 was double GNP (not counting the government's commitment in connection with bank shares). Real interest outlay on the overall debt reached 12 percent of GNP in 1985, and averaged 7 percent during the past decade. These expenditures increased the deficit, which in turn increased the debt, giving rise to a vicious circle. Because of the persistent deficit, mounting public debt, and high inflation, in recent years the public several times lost its confidence in the government's ability to meet its liabilities, with the consequence that it sometimes encountered difficulties in rolling over the debt.

The swelling public deficit was accompanied by rapidly accelerating inflation until 1984. There is an interaction between these two variables. Here we shall

Figure V-2
PUBLIC DOMESTIC AND EXTERNAL DEBT, 1970-85
(percent of GNP, current prices)



discuss only the main effects of inflation on the government deficit. First of all, inflation enlarged the subsidy component of public sector credit to businesses and households by more than was envisaged, until it averaged 5.5 percent of GNP in the 1970s. But beginning in 1980 the government took steps to reduce it, and by the end of 1985 it was down to 2 percent of GNP. Secondly, inflation eroded the government's tax receipts, which are collected after some time-lag. On the other hand, it had a contractionary effect on the government's expenditures, eroding part of the public sector's transfer payments, as well as the final month's indexation increment lost by owners of government bonds upon redemption, etc. No estimate has been made of the overall effect of inflation on the public sector deficit, but it seems that on balance it contributed to its growth.

The deficit was only partly covered by money creation, borrowing from the public, and long-term U.S. government loans. As a result, the balance of payments deficit widened, making it necessary to take additional foreign loans, with a consequent strain on the country's foreign exchange reserves.

To sum up, the growth of noncivilian consumption without a corresponding growth of income resulted in chronic large public deficits, which increased from year to year because of the interest payments. Since the government was unable to fully finance its expenditures from domestic sources, the balance of payments deficit on current account also grew. The public deficit further fueled inflation, both directly and indirectly (through the policy of depreciating the currency in order to narrow the balance of payments deficit, but which was not accompanied by measures to dampen domestic demand); the escalating inflation in turn contributed to the growth of both the public and balance of payments deficits. In these conditions a new malady plagued the economy—stagnation and a shift in the composition of GNP toward unproductive financial services.

From time to time attempts were made to cope with the fundamental problems facing the economy, especially inflation. It was obviously having a harmful effect as it did not finance the public deficit, and it seemed that it could be eliminated separately without solving the other problems. But these attempts did not succeed. Moreover, in recent years there were frequent shifts in government policy priorities, from fighting inflation to mending the balance of payments, and vice versa. The policy measures focused on taxes, subsidies, the nominal exchange rate, and only to a minor degree on the public sector's direct demand. The outcome was a short-lived partial success, but no basic solution of the crucial problems—the public and balance of payments deficits, inflation, and stagnation.

Toward the end of 1983 there were several developments which created relatively favorable conditions for the economic plan initiated in mid-1985. The civilian import surplus began to turn down, the U.S. government made its \$1.5 billion special emergency aid (over a two-year period) conditional on implementation of a comprehensive economic plan, a general awareness of the increasingly pernicious effects of inflation developed, and a broad-based national unity government was formed.

Table V-3
CENTRAL GOVERNMENT BUDGET, 1980/81-1986/87
 (percent of GNP, at current prices)

	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86		1986/87
						Approved budget	Actual (estimate)	Budget proposal
Total expenditure								
Consumption and investment	37.0	35.7	35.2	34.7	34.0	34.9	32.2	32.2
Other current outlays	24.5	28.5	29.9	30.3	33.1	34.9	32.9	32.9
Total	61.5	64.2	65.1	65.0	67.1	69.9	65.1	65.1
Domestic expenditure								
Consumption and investment	25.5	26.3	28.5	24.7	22.5	23.4	23.1	23.4
Other current outlays	21.6	25.7	24.8	24.8	25.7	26.9	24.9	26.6
Total	47.1	52.0	53.3	49.4	48.2	50.3	47.9	50.1
Revenue and grants								
Total	51.5	50.7	51.8	54.6	53.0	66.2	69.2	62.5
Domestic	40.4	40.6	47.5	45.4	37.2	45.3	48.3	45.3
Deficit								
Domestic	6.7	11.4	5.8	4.1	11.0	5.0	-0.3	4.8
Foreign	3.3	2.1	7.4	6.3	3.1	-1.4	-3.8	-2.2
Total	10.0	13.5	13.3	10.4	14.1	3.6	-4.1	2.6
Deficit finance								
Net borrowing from abroad	3.4	4.5	6.9	4.6	1.7	-1.7	-2.1	-1.6
Net borrowing from the public	5.0	6.1	0.8	-2.2	4.1	1.1	2.0	3.7
Adjustments	0.0	0.0	0.0	-2.3	4.7	0.0	0.0	0.0
Net borrowing from central bank	1.6	2.8	5.5	10.3	3.6	4.1	-4.0	0.5
Total	10.0	13.5	13.3	10.4	14.1	3.6	-4.1	2.6
Injection	1.7	5.3	5.0	6.3	6.9	3.9	-2.3	1.4

SOURCE: Based on Ministry of Finance data.

The year reviewed opened under the influence of the package deal policy introduced in November 1984. It produced some positive results, but on the whole it was only partially successful. Subsidies were slashed and the relative price of imports increased, but in the absence of a comprehensive policy combining demand restraint with measures to ease cost pressures and end the self-perpetuation of inflation, the government could not neutralize the basic factors pushing up prices and deteriorating the balance of payments. While the package deals prepared the ground for implementing an overall economic plan and proved that inflation could be quickly contained, it became clear that a lasting price stability could not be achieved through a partial policy of this sort. In order to capitalize on the improved conditions and to preserve the achievements of the package deals, there was need for additional policy measures. The economic stabilization program was launched at the beginning of July 1985 with the aim of simultaneously mastering inflation and further bolstering the balance of payments. It tackled the basic problems on a broad front, combining measures to dampen demand, ease cost pressures, and break the self-perpetuating inflationary process. After an initial large devaluation and the steep hiking of subsidized and other commodity prices, the exchange rate was stabilized in relation to the dollar and commodity and service prices frozen. Domestic demand was depressed both directly, by dampening consumption (notably noncivilian) and public investment, and indirectly by increasing net taxes in order to squeeze disposable income and by setting high interest rates. The tight monetary policy aimed to halt the dwindling of foreign reserves, while suspension of the cost-of-living allowance arrangement and the temporary erosion of wages were designed to keep down production costs and preserve the real devaluation. The stabilization plan succeeded in dramatically lowering inflation, narrowing the balance of payments deficit on current account, expanding foreign reserves, and whittling down the net external debt.

The overall public deficit—a feature of the local scene for the past two decades—was not only eliminated but even turned into a surplus in the second half of 1985. Some of the fiscal policy achievements were of a transitory nature: (a) public sector wages fell appreciably in the third quarter of 1985, but since the end of the year they have been on the rise; (b) some of the taxes imposed upon the launching of the new plan were one-time levies, which have a smaller effect on private consumption than permanent taxes have.

The drop in the weight of the public sector's direct demand in GNP by 3 percentage points in 1985 is attributable to the temporary wage erosion (1.5 points) and a real decrease in the sector's purchases and investment. To safeguard this achievement without inhibiting future economic growth, the government must reduce the sector's real consumption and step up public investment, which was severely cut back in recent years. The dampening of consumption must encompass both the civilian and noncivilian components. With the termination of the extraordinary defense outlays and the increased American aid, which permits the expansion of defense imports, it would seem that domestic noncivilian consumption can be reduced without harming current defense requirements.