Chapter 5
The Public Sector

In 1994 the total public-sector deficit fell from 2.8 percent of GNP to 1 percent, its components following different trends. The combination of the expansion of domestic demand with a steep rise in its average price, due to the large wage increases in the public services, were largely responsible for the acceleration of economic activity and prices. The reduction in the deficit was mainly due to factors whose influence on domestic economic activity was negligible in 1994, namely, an exceptional increase in corporation tax receipts arising from activity in previous years, a decline in capital transfers following the cessation of government involvement in construction, and a reduction in defense imports. In addition, the share of interest payments in GNP fell, because of the 7 percentage point decline in the debt/GDP ratio.

An analysis of the composition of taxes shows that the tax burden remained unchanged in 1994. A slight decline in statutory tax rates did not reduce revenues as direct tax receipts rose steeply due to the surge in economic activity and the progressive nature of income tax. A breakdown of the components of the public sector until 1993 shows that the government's deficit continued to decline, due to budgetary restraint under the Budget Deficit Reduction Law, while that of the local authorities increased sharply in 1993.

1. MAIN DEVELOPMENTS[1]

The total public-sector deficit declined from 2.8 percent of GNP to 1 percent (Table 5.1), its components following different paths. Domestic public demand rose by 4.6 percent, and its average price by 15.6 percent (Table 5.7), as a result of wage increases in the public services. The deficit declined mainly because of factors whose effect on domestic economic activity in 1994 was negligible, namely, an exceptional increase in corporation tax receipts arising from the economic activity of previous years, a decline in capital transfers as government involvement in construction declined, and a reduction in defense imports. In addition, the share of interest payments in GNP declined, in the wake of the steep drop in the internal debt/GDP ratio.

[1] Several changes have been made in the presentation of the data this year. The profit of the Bank of Israel, which was formerly based on nominal profit, is now calculated on the basis of real profit, so that the deficits published in previous years have been recalculated (Table 5.1). The financing of the deficit is presented (Table 5.1). The deficit is also given in terms of the shares of the different components of the public sector, but data are available only until 1993 (Table 5.4)

Table 5.1
General Government: Receipts, Expenditure, and Deficit, 1980–94[a]

(percent of GNP)

	1980–84	1985–94	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	NIS million[b] 1994
Receipts													
Internal	50.1	47.7	49.7	52.0	50.8	48.8	45.1	45.3	44.8	46.2	46.6	47.5	103,797
External	12.1	10.6	22.3	16.0	10.9	8.8	8.8	9.2	9.4	8.1	7.2	5.6	12,147
Total	62.2	58.3	71.9	68.0	61.6	57.7	53.9	54.5	54.3	54.3	53.8	53.1	115,944
Expenditure													
Internal	63.7	52.3	55.9	52.6	52.1	52.5	52.9	52.4	52.2	52.4	51.0	49.4	107,973
External	11.3	7.8	14.5	11.4	9.5	7.6	6.6	6.4	6.4	4.8	5.7	4.6	10,128
Total	75.0	60.1	70.4	64.0	61.6	60.1	59.5	58.7	58.6	57.2	56.6	54.0	118,101
Surplus (+)/Deficit (–)													
Internal	–13.6	–4.6	–6.2	–0.7	–1.3	–3.6	–7.8	–7.1	–7.3	–6.2	–4.4	–1.9	–4,176
External	0.8	2.9	7.8	4.6	1.3	1.2	2.2	2.8	3.0	3.2	1.6	0.9	2,019
Total	–12.8	–1.8	1.5	4.0	0.0	–2.5	–5.6	–4.2	–4.3	–2.9	–2.8	–1.0	–2,157
Financing of surplus (+)/Deficit (–)													
External net borrowing			–5.9	–3.1	–4.2	5.1	–5.3	–2.6	–0.3	1.7	–0.5	1.7	3,757
Change in monetary base			6.9	1.7	2.3	–1.4	0.7	0.5	0.6	0.5	1.0	0.9	1,903
Internal net borrowing			2.4	–1.9	0.7	–1.2	8.7	2.7	4.6	2.9	3.0	0.8	1,756
Via government			–1.9	–3.9	0.2	3.8	7.7	1.5	3.2	1.8	2.4	0.5	1,158
of which Sale of assets			0.0	0.0	0.0	0.0	0.2	0.3	0.4	0.8	1.8	0.3	696
Via Bank of Israel			4.3	2.0	0.5	–5.1	1.0	1.2	1.4	1.1	0.6	0.3	598
Residual[c]			–4.9	–0.7	1.2	0.0	1.5	3.6	–1.2	–2.3	–0.8	–2.4	(5,259)
Total			–1.5	–4.0	–0.0	2.5	5.6	4.2	4.3	2.9	2.8	1.0	2,157
Public debt/GDP ratio[d]													
Internal			126	110	106	92	100	93	90	81	78	72	164,882
External			46	34	27	27	24	19	18	21	21	20	45,217
Total			172	144	133	119	124	112	108	102	99	92	210,099

[a] Internal public debt—excludes local authorities and public nonprofit institutions, as well as the government's commitment under the bank shares Arrangement;
External public debt—all the government's foreign liabilities *less* the foreign reserves (change in foreign reserves *less* repayment of principal).
[b] Current prices.
[c] The financing of the public deficit is not fully explained by these items because the deficit is calculated according to the statistical (CBS) criteria rather than on a cash basis, and because it does not include non-government entities (primarily the local authorities).
[d] End-year prices.
SOURCE: Based on Central Bureau of Statistics data.

In order to examine the effects of fiscal policy, a distinction must be made between the short and the long term—and this applies especially to 1994. In the short term, it has become clear *ex post* that the macroeconomic environment has changed. In the last few years, the unemployment rate, which was over 11 percent in 1992, constituted the main problem. On the eve of the 1994 budget debate it stood at 10 percent, higher than it had been before the influx of immigrants began. In 1994, however, it fell to 7.8 percent, alongside price acceleration which already during the first half of the year was jeopardizing the 8 percent inflation target. The combination of an increase in the domestic demand of the public sector with a steep rise in wages in that sector, which contributed significantly to the expansion of private consumption, helps to explain the acceleration of economic activity and rise in prices in 1994. Thus, fiscal policy had an expansionary effect in the short term.

Several processes with long-term economic implications evident in the public sector in recent years persisted in 1994. The most prominent of them was the sharp fall in the public debt/GDP ratio, due to the accelerated rise in GDP and the decline in the public sector deficit. This process was fueled by the continued reduction of the share of public expenditure—particularly defense items and interest payments on the internal debt—in GNP. In contrast to the trend of the last few years, however, the composition of expenditure changed, reflecting a rise in the share of public consumption in GNP due to the wage increases, which are also expected to have an effect in 1995. This will make it difficult to continue cutting public expenditure in the years ahead—a necessary condition for reducing the tax burden and thus making sustainable growth possible.

A positive development in recent years is the substantial increase in public-sector investment (Table 5.2), particularly in the roads infrastructure, after this had fallen to 3 percent of GNP in the 1980s. In 1994 the level was maintained at the relatively high level of 1993—over 4 percent of GNP.

Although the steady decline in public-sector expenditure justifies a permanent reduction of the tax/GNP ratio, an analysis which takes into account the exceptional factors affecting tax revenues shows that this trend has been checked in recent years. Although statutory tax rates declined slightly the tax burden has not changed, mainly because of the steep rise in direct tax receipts. A more significant reduction of tax rates in the last three years would still have allowed adherence to the Budget Deficit Reduction Law, as the domestic budget deficit was about 1 percent of GDP lower (on average) than the annual limit set by the law.[2] The government submitted a supplementary budget in 1994, for the first time since 1990, which made it possible to earmark additional income of NIS 5.6 billion for items not included in the original budget—primarily public services wage increases, support for public institutions and corporations in difficulties, and the implementation of the autonomy agreement with the Palestinians.

[2] The question whether a significant reduction of tax rates in 1994 would have been appropriate given the short-term macroeconomic environment is discussed below.

Table 5.2
General Government Receipts and Expenditure, Current and Capital Accounts, 1987–94

(percent of GNP)

	1987	1988	1989	1990	1991	1992	1993	1994	NIS million[a] 1994
Receipts									
Current receipts									
From property	1.8	2.2	2.3	2.7	2.8	2.5	1.9	1.7	3,683
of which Interest from abroad	0.8	0.8	1.1	1.2	1.3	1.0	0.6	0.3	629
Current-account transfers from the public	1.0	1.1	1.1	1.0	1.0	1.0	1.0	1.1	2,324
Indirect taxes									
On domestic production	14.4	13.8	13.7	14.3	14.9	15.5	14.7	14.6	31,812
On civilian imports	8.5	7.5	5.5	5.6	5.9	6.3	5.9	5.5	12,049
Direct taxes, fees, and levies	16.6	16.3	14.5	13.7	12.6	13.2	14.3	15.7	34,209
National Insurance income	5.8	5.5	5.4	5.3	5.0	4.7	4.8	4.8	10,564
Intergovernmental transfers	8.6	6.8	6.4	6.4	6.7	5.8	5.3	4.1	9,060
Unilateral transfers to national institutions[b]	1.1	0.9	1.0	1.2	1.1	1.0	1.0	0.9	1,898
Total current receipts	**57.8**	**54.0**	**49.9**	**50.2**	**49.9**	**50.0**	**49.0**	**48.3**	**105,599**
Capital receipts									
Capital-account transfers from the public	1.7	1.7	2.0	2.2	2.5	2.4	3.1	3.1	6,867
Public-sector depreciation	1.7	1.7	1.7	1.6	1.6	1.5	1.4	1.3	2,918
Capital transfers from abroad	0.3	0.3	0.3	0.4	0.4	0.3	0.3	0.3	560
Total capital receipts	**3.8**	**3.7**	**4.0**	**4.3**	**4.4**	**4.3**	**4.9**	**4.7**	**10,345**
Total receipts	**61.6**	**57.7**	**53.9**	**54.5**	**54.3**	**54.3**	**53.8**	**53.1**	**115,944**

Expenditure									
Current expenditure									
Domestic consumption[c]	26.9	26.9	27.1	27.1	25.9	25.6	25.1	25.3	55,334
Defense imports[d]	5.0	3.7	3.2	3.3	3.7	2.2	2.9	2.1	4,534
Domestic interest	7.1	6.5	6.8	6.8	6.3	5.9	5.7	5.1	11,184
Interest abroad	4.0	3.5	3.1	2.7	2.3	2.2	2.2	2.2	4,702
Subsidies	4.5	4.4	3.7	3.2	2.9	3.1	2.6	2.3	5,116
Current transfers (gross)	9.6	9.7	10.1	10.8	10.7	10.6	10.8	10.6	23,222
Total current expenditure	**57.1**	**54.7**	**53.9**	**53.9**	**51.8**	**49.6**	**49.2**	**47.6**	**104,092**
Capital expenditure									
Investment	2.5	2.7	2.6	2.8	3.4	3.7	4.3	4.2	9,259
Capital transfers	1.4	1.4	1.2	1.6	3.3	3.8	2.7	2.0	4,323
Repayment of compulsory loans	0.6	1.4	1.8	0.5	0.1	0.1	0.4	0.2	427
Total capital expenditure	**4.5**	**5.5**	**5.6**	**4.8**	**6.8**	**7.6**	**7.5**	**6.4**	**14,009**
Total expenditure	**61.6**	**60.1**	**59.5**	**58.7**	**58.6**	**57.2**	**56.6**	**54.0**	**118,101**
Surplus (+)/Deficit (–)									
Current account (net savings)	0.7	–0.7	–4.0	–3.7	–1.9	0.4	–0.2	0.7	1,507
Gross savings	2.5	1.0	–2.3	–2.1	–0.4	1.9	1.2	2.0	4,425
Current + capital accounts	0.0	–2.5	–5.6	–4.2	–4.3	–2.9	–2.8	–1.0	–2,157

[a] At current prices.
[b] The Jewish Agency and public nonprofit institutions.
[c] Including non-classified items.
[d] Including advance payments, excluding taxes.

An analysis of the total deficit in 1988–93 in terms of the entities comprising the public sector (Table 5.5) shows that while the government deficit has been declining in the last few years as a result of the budgetary discipline imposed under the Budget Deficit Reduction Law, the deficit of the local authorities soared in 1993. As a result, their deficit drew closer to that of the government, and this may undermine the credibility of public-sector policy in general.

Per capita civilian consumption was higher in 1994 than before the influx of immigrants began. Most of the rise was due to the increase in labor input, 5.7 percent in 1994 compared with 2.4 percent in 1993. Labor input in defense consumption declined slightly, however, continuing the trend of the last few years. The rise in public-sector consumption prices in 1994 was due to wage agreements originally intended to ameliorate the status of groups of employees whose relative wage had been eroded—principally in education. However, these increases rapidly spilled over to other public services as well as to the defense sector, undermining the inflation target.

Direct tax receipts soared in 1994, while the share of receipts from indirect taxes on domestic production and import tariffs declined slightly (Table 5.9). The increase is explained by the steep rise in corporation tax receipts—since the way the tax is calculated takes profits from previous years into account—and by income tax, because of the marked rise in labor input, the progressive nature of the tax, and the increase in public services wages. As a result of these developments, direct taxes once again became the largest component of tax revenues—thereby intensifying the progressive nature of the tax system but raising the effective tax rate on saving.

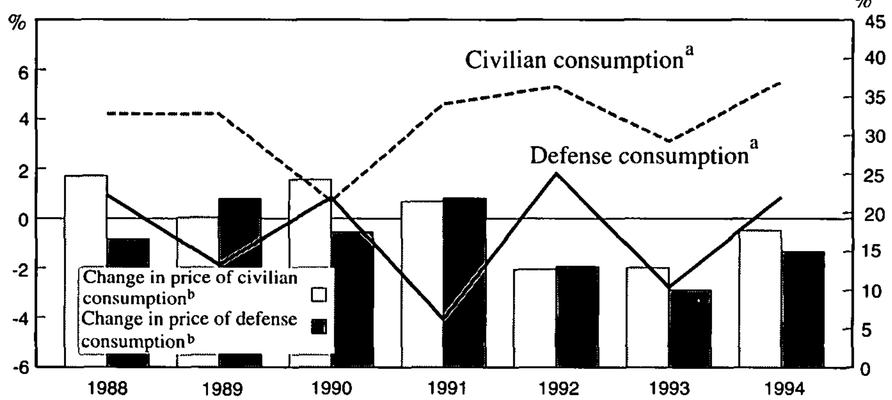
The share of transfer payments declined as a result of the fall in capital transfers—compulsory loans and transfer payments—particularly to housing. Assistance to firms also declined in 1994 due to the cancellation of the exchange-rate insurance premium for exporters and the reduction of settlement grants.

2. FISCAL POLICY

The main thrust of macroeconomic policy in recent years has been to reduce the unemployment rate, which rose from about 9 percent prior to the influx of immigrants to 11 percent in 1992. Just before the 1994 budget debate unemployment was 10 percent. Employment expanded considerably in 1994, however, outstripping the increase in the labor force and bringing the unemployment rate down to 7.8 percent. At the same time, price increases accelerated, and in the first half of 1994 this jeopardized the attainment of the 8 percent annual inflation target. The question arises whether fiscal policy had a stabilizing effect in the short run, moderating the macroeconomic trends that developed during the year, or helped to accelerate both economic activity and price increases.

The increase in public-sector domestic demand did not itself exert pressure on resources, but the combination of the slight acceleration in demand with the large public-services wage increases was largely responsible for the expansion of economic activity

Figure 5.1
Change in Price and Quantity of Domestic Public Consumption (Civilian and Defense), 1988-94



[a]Left-hand scale.
[b]Right-hand scale.
SOURCE: Central Bureau of Statistics.

and rise in prices.[3] Total domestic demand rose by 4.6 percent, after an increase of 4.3 percent in 1993.[4] The price of domestic consumption rose by 17 percent (Table 5.7), due to public-services wage agreements which caused increases of 23 and 22 percent in the prices of civilian and defense labor input respectively. These wage increases were granted to certain sectors, e.g., education, as compensation for the erosion of their relative wage, but rapidly trickled down to other public services groups and to the defense sector. The increases granted to other groups hindered attainment of the annual inflation target, and were largely responsible for the rise in private consumption (see Chapter 2).

Most of the quantitative increase in public-sector domestic demand resulted from the 5.5 percent rise in civilian consumption, after this had grown by 3.1 percent in 1993 and by an annual average of 5 percent in 1991 and 1992, both of them years of rapid economic growth. Most of the expansion was in civilian labor input, which rose by 5.7 percent, far beyond the 2.6 percent annual average of 1989–93.

The rapid expansion of expenditure is partly explained by the exceptional increase in tax revenues, due to economic activity in former years (corporation tax) and the extraordinary increase in property tax receipts in the wake of the steep rise in real estate prices (Table 5.3).

[3] Several indicators show that the increase in prices was also translated into acceleration of the inflation rate (see Chapter 3).

[4] Domestic demand data do not include the effect of government-initiated residential construction, which is reflected in the short term. When construction is included, domestic demand rose by 2.8 percent, compared with a decline of 5 percent in 1993 (Table 5.7).

Table 5.3
Exceptional Tax Receipts, 1989–94

(percent of GNP)

	1989	1990	1991	1992	1993	1994
Taxes						
Excluding property tax	39.1	38.9	38.4	39.7	39.7	40.6
Including property tax[a]	39.8	39.7	39.0	40.4	40.7	41.7
Exceptional tax receipts[b]	0.8	0.2	–0.8	–0.8	0.1	1.0
Property tax	0.1	0.2	0.1	0.0	0.1	0.2
Corporation tax	0.7	0.0	–0.9	–0.8	0.0	0.8
Total excl. exceptional tax receipts						
Excluding property tax	38.3	38.7	39.2	40.5	39.6	39.6
Including property tax	39.0	39.5	39.8	41.2	40.6	40.7

[a] Includes purchase and land improvement taxes; recorded under 'Capital receipts' (Table 5.2)
[b] Exceptional property tax receipts are calculated as the difference between the housing index and the CPI; exceptional corporation tax receipts are calculated as the difference between effective average tax rates in 1989–94 and actual receipts, with the return to capital as the tax base.

As the table shows, when adjustment is made for exceptional receipts there was no change in the tax burden in 1994. This income enabled government expenditure to rise without infringing the Budget Deficit Reduction Law, but in order to implement the additional expenditure, the government submitted a supplementary budget, expanding the original budget framework (see box). Consequently, in order to ascertain whether the increase in expenditure will undermine the government's credibility, it is necessary to examine whether permanent expenditure rose—requiring a future increase in tax rates—and if expenditure is biased in favor of production, thereby stimulating economic growth.

A breakdown of public-sector expenditure shows that the decline in it is permanent, and is fully explained by the factors that increased it in 1993 and which reduced it as expected in 1994. Of the total decline of 2.6 percent of GNP in 1994, direct defense imports fell by 0.8 percent of GNP, and capital transfers by 1 percent of GNP because of the reduction of government involvement in housing and the contraction of compulsory loans.[5] Interest payments on the internal debt also declined, by some 0.6 percent of GNP, due to the steep decline in the debt/GDP ratio; beyond this, however, the composition of the rest of expenditure changed trend—with a slight rise in the share of domestic consumption, after this had remained stable in 1987–90 and declined in 1991–93. This change calls the continued fall in the share of public expenditure in GNP into question, especially in view of the fact that wage increases will also have an effect in 1995.[6]

[5] See Table 5.4 (Temporary Expenditure) in last year's *Annual Report*. Although direct defense imports tend to fluctuate widely, part of this year's decline now appears to be permanent.

[6] To complete the picture regarding permanent expenditure, note that there are several additional temporary factors that will act to reduce public expenditure in the next few years, e.g., immigrant absorption costs, while others—e.g., the pension funds crisis, the kibbutz debt arrangement, and assistance for public corporations and institutions in financial difficulties—threaten to increase it.

Table 5.4
General Government Expenditure, by Type of Intervention, 1980–94

(percent of GNP)

	1980	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Public goods											
Defense	23.1	20.7	17.3	16.0	14.1	13.4	13.1	12.6	10.9	10.9	9.8
Administrative services[a]	4.7	4.4	4.3	4.6	4.3	4.4	4.3	4.1	4.0	3.9	4.0
Investment	2.6	1.9	2.1	2.5	2.7	2.6	2.8	3.4	3.7	4.3	4.2
Total	**30.4**	**27.0**	**23.7**	**23.1**	**21.1**	**20.4**	**20.2**	**20.2**	**18.6**	**19.2**	**18.0**
Social services											
Merit goods	13.8	12.5	11.9	11.6	12.4	12.6	13.1	13.0	13.1	13.4	13.8
Education[a]	*7.3*	*7.0*	*6.9*	*6.5*	*7.0*	*7.0*	*7.1*	*7.0*	*7.1*	*7.2*	*7.5*
Health[a]	*3.9*	*3.3*	*3.1*	*3.0*	*3.1*	*3.2*	*3.5*	*3.4*	*3.6*	*3.7*	*3.8*
Welfare[a]	*2.5*	*2.1*	*2.0*	*2.1*	*2.3*	*2.4*	*2.4*	*2.6*	*2.5*	*2.5*	*2.5*
Current transfers	7.8	8.7	9.4	9.3	9.5	10.0	10.6	10.5	10.4	10.5	10.5
Total	**21.6**	**21.2**	**21.3**	**21.0**	**21.8**	**22.6**	**23.7**	**23.5**	**23.6**	**23.9**	**24.3**
Direct intervention (business sector)											
Subsidies	2.7	3.5	2.0	1.9	2.2	1.8	1.7	1.8	2.3	2.1	2.0
Credit subsidy	7.0	2.0	1.5	1.4	1.0	0.7	0.6	0.4	0.3	0.3	0.2
Capital grants	3.3	1.3	1.2	1.4	1.4	1.2	1.6	3.3	3.8	2.7	2.0
Foreign trade subsidies	0.2	1.3	1.1	1.2	1.2	1.2	1.0	0.6	0.5	0.3	0.2
Total	**13.3**	**8.1**	**5.8**	**5.9**	**5.8**	**4.9**	**4.8**	**6.1**	**6.9**	**5.3**	**4.3**
Financing outlays											
Repayment of compulsory loans	1.2	0.4	0.7	0.5	1.4	1.8	0.5	0.1	0.1	0.4	0.2
Interest on public debt											
Internal	7.8	7.8	7.9	7.1	6.5	6.8	6.8	6.3	5.9	5.7	5.1
External	3.2	5.9	4.6	4.0	3.5	3.1	2.7	2.3	2.2	2.2	2.2
Total	**12.1**	**14.2**	**13.3**	**11.5**	**11.4**	**11.7**	**10.0**	**8.7**	**8.1**	**8.3**	**7.5**
Grand total	**77.4**	**70.4**	**64.0**	**61.6**	**60.1**	**59.5**	**58.7**	**58.6**	**57.2**	**56.6**	**54.0**
GNP *(NIS million)*	107	27,217	42,912	55,003	68,570	83,382	102,271	132,084	156,822	181,723	218,537

[a] Estimated from the general government consumption figures; for 1988–94 provisional estimate based on change in number of employee posts. The 1994 figure is based on national budget estimates regarding the wage agreement reached with the teachers in May 1993.

SOURCE: Based on Central Bureau of Statistics data.

Budgetary policy tools: the supplementary budget and the transfer of surpluses

The most important tool of fiscal policy is the budget. In the last few years the budget framework has been limited by the 1992 Budget Deficit Reduction Law, which set a path for the reduction of the budget deficit each year (Table 5.6). The budget framework comprises the original budget, which is based on a forecast of receipts—taking projected legislative changes into account—and expenditure prepared before the fiscal year, the transfer from former years of surpluses in expenditure items that were not fully utilized, and—in 1994 for the first time since 1990—a supplementary budget, which was approved toward the end of the fiscal year.

Expenditure is determined so that the domestic deficit falls within the bounds set by law—3 percent of GDP in 1994. Nonetheless, surpluses from the preceding year's budget are transferred each year, making expenditure more flexible (in 1994 there were surpluses of NIS 5 billion from previous years). While the utilization of the entire surplus could cause deviation from the legal limit, the actual deficit has been lower than the permitted ceiling in the three years since the law was passed.

In 1994 actual income exceeded the forecast by an appreciable NIS 5.6 billion, i.e., 2.5 percent of GDP. The government decided to use the surplus to increase the budget framework by means of a supplementary budget. The surplus was used primarily for public services wage increases, for supporting public institutions and corporations in difficulties, and for implementing the Palestinian autonomy agreement. In effect, the deficit was about 1 percent of GDP lower than the permitted level, so that expenditure rose by only 1.5 percent of GDP beyond the originally planned level.

If the change in income continues to be influenced by exceptional factors, the permanent part of the increase in expenditure could make it difficult for the government to adhere to the limit set by law. The relevant aspect here is the overall action taken by the public sector, specifically, what part of additional expenditure is permanent, exerting pressure to raise tax rates in the future, and what part is intended for expenditure that encourages future production.

The short-term effect of tax policy in 1994 was mixed. On the one hand, the automatic stabilizers (income tax) acted to reduce demand, while on the other, legislative changes reduced tax rates only slightly. The large increase in corporation tax receipts, arising from the activity of previous years, had a relatively small effect, because it had already been taken into account by firms.

Long-term trends in the public sector

The downward trend in the public-sector deficit persisted in 1994 for the third year in succession. A low deficit is an important element in the process of reducing the debt/GDP ratio that plays a crucial role in maintaining long-term economic stability, signaling

Table 5.5

General Government: Composition of Receipts, Expenditure, and Deficit, 1988–93

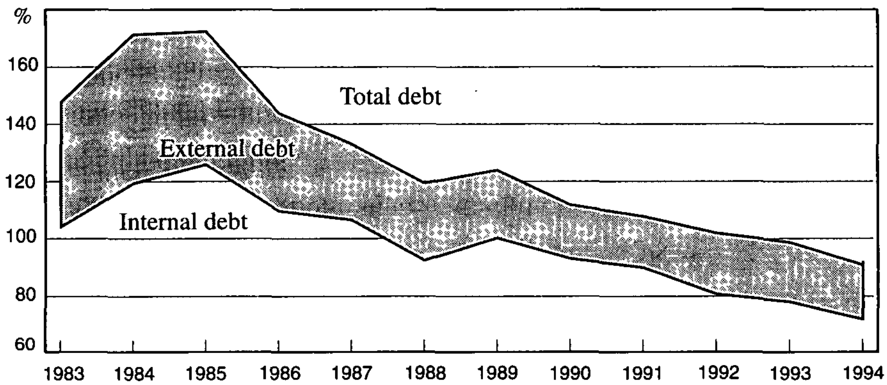
(percent of GNP)

	1988	1989	1990	1991	1992	1993
Receipts from the public						
Government	46.3	42.5	42.9	43.3	43.5	43.1
National Insurance Institute	5.5	5.4	5.4	5.0	4.8	4.8
National institutions	1.0	1.0	1.4	1.2	1.0	1.1
Local authorities	3.6	3.6	3.6	3.6	3.8	3.7
Public nonprofit associations	1.2	1.4	1.2	1.1	1.2	1.2
Total	**57.7**	**53.9**	**54.5**	**54.3**	**54.3**	**53.8**
Expenditure on the public						
Government	40.2	39.1	37.9	38.5	36.9	35.2
National Insurance Institute	7.0	7.4	7.4	6.9	7.2	7.6
National institutions	0.9	0.9	1.3	1.2	1.0	0.9
Local authorities	6.5	6.5	6.3	6.6	6.8	7.6
Public nonprofit associations	5.4	5.6	5.8	5.4	5.4	5.5
Total	**60.1**	**59.5**	**58.7**	**58.6**	**57.2**	**56.6**
Unilateral transfers to rest of public sector						
Government	9.4	9.6	9.4	8.9	10.6	10.6
National Insurance Institute	–3.0	–3.2	–2.8	–2.4	–3.6	–3.6
National institutions	0.1	0.1	0.0	0.0	0.0	0.0
Local authorities	–1.6	–1.6	–1.7	–1.8	–2.1	–2.1
Public nonprofit associations	–4.9	–4.9	–4.9	–4.7	–4.9	–5.0
Total	**–0.0**	**–0.0**	**0.0**	**–0.0**	**–0.0**	**–0.0**
Total deficit						
Government	–3.3	–6.2	–4.4	–4.1	–4.0	–2.7
National Insurance Institute	1.5	1.2	0.8	0.5	1.2	0.8
National institutions	–0.1	–0.0	0.0	0.0	0.1	0.2
Local authorities	–1.4	–1.2	–0.9	–1.2	–0.9	–1.8
Public nonprofit associations	0.8	0.7	0.3	0.4	0.7	0.7
Total	**–2.5**	**–5.6**	**–4.2**	**–4.3**	**–2.9**	**–2.8**
Current account deficit						
Government	–1.8	–4.7	–3.7	–1.9	–0.9	–0.9
National Insurance Institute	1.5	1.2	0.8	0.5	1.2	0.8
National institutions	–0.1	–0.1	–0.1	–0.1	–0.1	–0.0
Local authorities	–0.6	–0.7	–0.6	–0.6	–0.3	–0.6
Public nonprofit associations	0.5	0.4	0.0	0.2	0.5	0.5
Total	**–0.6**	**–3.9**	**–3.6**	**–1.9**	**0.5**	**–0.2**
Capital account deficit						
Government	–1.5	–1.5	–0.7	–2.2	–3.1	–1.8
National Insurance Institute	0.0	0.0	0.0	0.0	0.0	0.0
National institutions	0.1	0.1	0.2	0.1	0.1	0.2
Local authorities	–0.7	–0.4	–0.3	–0.5	–0.6	–1.2
Public nonprofit associations	0.3	0.3	0.3	0.2	0.2	0.2
Total	**–1.8**	**–1.6**	**–0.5**	**–2.4**	**–3.3**	**–2.6**

SOURCE: Central Bureau of Statistics

credibility in the implementation of domestic policy, and improving Israel's international economic standing. In 1994, the debt/GDP ratio declined by a steep 7 percentage points, reaching 92 percent and bringing it to almost half its level a decade earlier (Table 5.1, Figure 5.2). Despite its impressive decline, the debt is still large by international standards, and far above the EU target (a gross debt/GDP ratio of 60 percent).

Figure 5.2
Debt/GDP Ratio, 1983-94[a]



[a] See Table 5.1.

In a long-term perspective, the reduction of the deficit is explained mainly by the moderate real rise in defense expenditure, so that its share in GDP fell. This has fallen by 20 percentage points in the last twenty years, while public expenditure has contracted by 30 percent of GNP. The other factor contributing to the smaller deficit was the decline in the share in GNP of interest payments.

A positive development in 1994 was that the share in GNP of public-sector investment remained constant. After a long period of underinvestment in this sphere, this ratio rose markedly in 1993, especially investment in roads. A greater increase in the level of investment in 1994 would have required greater associated costs, because of the logistic difficulties associated with extensive work on the infrastructure. It is preferable to maintain a high level of investment over several years, than to concentrate expenditure within a few isolated years.

An unwelcome development was the halt of the decline in the share in GNP of taxes. This reduction is critical for economic growth and business-sector competitiveness. The persistent decline in public expenditure makes the permanent reduction of the tax burden possible.[7] This process began in 1987–88, but has been checked in the last few years. A

[7] Alongside the decline in the share in GNP of public expenditure, the share of unilateral transfers from

permanent reduction of the tax rate would have been consistent with adherence to the Budget Deficit Reduction Law in the last three years, because since its introduction in 1992, the government's domestic deficit (excluding net credit) has been lower than the limit prescribed by the law, as the following table shows.

Table 5.6
Public Sector Domestic Deficit, 1992–97

(percent of GDP)

	1992	1993	1994	1995	1996–97
According to law	6.2	3.2	3.0	2.75	declining
Operating estimate	4.9	2.4	2.0		
Public-sector domestic deficit[a]	6.2	4.4	1.9		
Total public-sector deficit[a]	2.9	2.8	1.0		

[a] Percent of GNP

Three years after the implementation of the law it is possible to pinpoint some of its advantages and disadvantages. Among the former can be counted the tight budgetary discipline it imposes, giving rise to credibility regarding positive long-term trends. Its disadvantages include inflexibility in fiscal policy, due to the excessive concern attached to remaining within the limit prescribed by the law. This caution—indicated by a deficit below that required by law—may have blocked a more drastic reduction of taxes, thus going against the government's declared long-term policy aims. Furthermore, not all public-sector entities are subject to the deficit constraint, contrary to the spirit of the law.

In the context of the failure to reduce taxes, a conflict developed in 1994 between long-term objectives and the possibility of attaining them given the short-term macroeconomic environment. In 1992 and 1993 the tax/GNP ratio could have been reduced without accelerating inflation. In 1994, however, the new environment required considerable caution in weighing the extent and composition of tax reductions, to prevent additional upward pressure on prices. Hence, policy makers refrained from significantly reducing taxes for highly-taxed middle-income groups, in contrast to the government's declared policy.

The share of unilateral transfers from abroad declined from 6.3 to 5 percent of GNP, continuing the trend of the last few years. As in earlier years, the decline in 1994 was influenced by the fact that US aid in dollars remained unchanged, by real appreciation of the NIS, and by the decline in defense imports, which constitute the accounting basis for part of the unilateral transfers.

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abroad has fallen. Bank of Israel calculations show that even if the latter is taken into account, the share of taxes in GNP can be reduced without infringing the long-term budget constraint, while reducing the debt/GDP ratio.

Table 5.7
Direct Demand of General Government, 1990–94

	NIS million			Annual change, percent							
				Price			Quantity				
	1992	1993	1994	1992	1993	1994	1990	1991	1992	1993	1994
Consumption (net)											
Civilian	*26,580*	*31,000*	*38,446*	12.7	12.9	17.6	0.8	4.5	5.6	3.3	5.4
Defense	*18,301*	*22,011*	*22,504*	13.6	10.3	12.9	4.7	3.7	–6.7	9.1	–9.5
Total	44,881	53,011	60,950	13.1	11.8	16.0	2.5	4.1	0.2	5.6	–0.8
Domestic consumption (net)											
Civilian	*26,161*	*30,455*	*37,831*	12.7	12.9	17.7	0.7	4.6	5.3	3.1	5.5
Defense	*13,627*	*14,580*	*16,910*	13.1	10.1	15.0	0.8	–4.1	1.8	–2.8	0.9
Total	39,788	45,036	54,740	12.8	12.0	16.9	0.8	1.4	4.1	1.1	4.0
Investment	5,840	7,885	9,259	10.1	8.4	8.7	14.7	40.2	17.4	24.6	8.0
Direct demand	50,721	60,896	70,209	12.6	11.2	14.8	3.4	7.1	2.0	8.0	0.4
Direct domestic demand	45,628	52,921	63,999	12.4	11.2	15.6	1.9	5.0	5.7	4.3	4.6
Government-initiated residential construction[a]	6,907	2,707	2,152	9.8	8.8	12.2	208.6	290.5	–9.0	–64.0	–29.1
Domestic demand, including construction[b]	52,535	55,628	66,151	12.1	11.7	15.6	5.3	18.8	3.4	–5.2	2.8

[a] Private housing construction with government guarantee to purchase unsold apartments.
[b] In the short run government-initiated construction has a direct effect on demand, while in the long run it also affects supply.
SOURCE: Based on Central Bureau of Statistics data.

3. PUBLIC-SECTOR DEMAND

The moderate 0.5 percent rise in total public-sector demand was the result of uneven shifts in its composition (Table 5.7). Domestic demand, which comprises most civilian consumption, two-thirds of defense consumption, and investment, rose by 4.6 percent, while defense imports, which tend to fluctuate widely, declined by 29 percent.

Table 5.8
Indicators of Defense Consumption, 1980–94

	Percent of: GNP *plus* unilateral transfers[b] (1)	Defense consumption[a] as percent of GNP: Total (2)	Domestic (3)	Domestic *plus* debt servicing[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	16.2	10.4	13.4	9.2
1989	12.0	13.6	10.2	12.9	9.1
1990	11.8	13.5	9.9	12.2	9.1
1991	11.3	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	7.7
1994	9.1	10.3	7.7	9.5	7.7

[a] Excludes conscripts.
[b] Unilateral transfers converted to NIS at the official exchange rate.
[c] Includes 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.

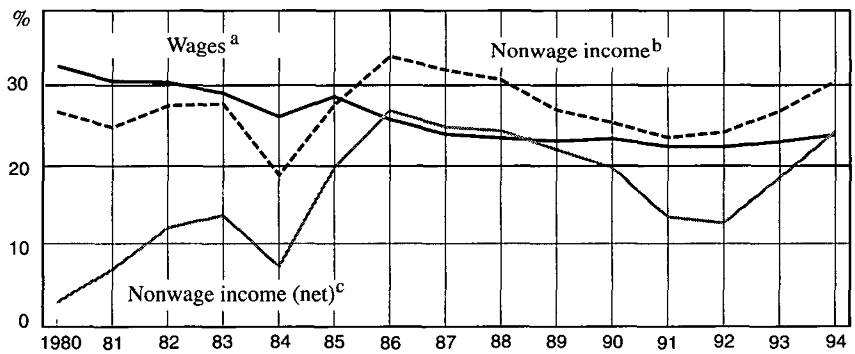
The rise in domestic demand was led by domestic civilian consumption, which rose by 5.5 percent, and by investment, which increased by 8 percent. Both civilian labor input and domestic civilian purchases rose by over 5 percent, without taking into account the effect of the sharp rise in relative labor costs, which for the first time since 1989 caused the share in GNP of domestic consumption to rise (Table 5.2).

The quantitative decline in government-initiated construction persisted in 1994, continuing the trend that began in 1992 and intensified in 1993. This policy is consistent with the government's intention of extricating itself from the housing market, allowing market forces to determine the allocation of resources.

4. TAXES, SUBSIDIES, AND TRANSFERS

The tax/GNP ratio rose in 1994 for the third successive year, after declining in 1987–91 (Table 5.9). Part of the increase is due to exceptional factors, primarily the expansion of receipts from corporation and property taxes (see Table 5.3). The tax/GNP ratio rose despite the reduction in statutory tax rates in 1994—especially the implementation of the first stage of the reduction of income tax on individuals, and the reduction of corporation tax by one percentage point, as well as of import tariffs and purchase tax. Most of the increase in tax revenues is explained by the steep increase in receipts from direct taxes, while there was a slight decline in the share in GNP of indirect taxes and taxes on foreign trade. The share in GNP of transfers and subsidies declined, largely due to the reduction of capital transfers and of subsidies to domestic production.

Figure 5.3
Average Direct Tax Rates on Wage and Nonwage Income, 1980-94



[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: Central Bureau of Statistics.

Direct taxes

The share in GNP of direct taxes rose by 1.4 percentage points, following the rise in the direct/indirect tax ratio first evident in 1993. Excluding exceptional factors, which caused corporation tax receipts to soar in 1994, wage income-tax and national insurance receipts rose sharply. Since wages form the basis of these taxes, the receipts were affected to a great extent by the increase in the relative wage in the public services, in both

Table 5.9
Taxes, Subsidies, and Transfers, 1980–94

(percent of GNP)

	1980–84	1985–94	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	NIS mill.[a] 1994
Taxes and transfers													
Taxes	41.7	41.6	44.4	46.7	45.3	43.0	39.1	38.9	38.4	39.7	39.7	40.6	88,634
less Net transfer payments[b]	8.5	9.4	8.3	8.9	8.6	9.5	9.9	9.4	10.4	10.8	9.5	8.5	18,483
less Direct and credit subsidies	10.2	3.8	6.9	4.6	4.5	4.4	3.7	3.2	2.9	3.1	2.6	2.3	5,116
Total	22.9	28.4	29.3	33.3	32.2	29.1	25.5	26.2	25.1	25.8	27.7	29.8	65,035
Direct taxes													
Direct taxes	23.3	20.6	23.5	23.9	22.4	21.8	19.9	19.0	17.6	18.0	19.1	20.5	44,773
less Transfer payments	8.5	9.4	8.3	8.9	8.6	9.5	9.9	9.4	10.4	10.8	9.5	8.5	18,483
Total	14.8	11.2	15.2	14.9	13.8	12.3	10.0	9.6	7.2	7.2	9.6	12.0	26,290
Indirect taxes, domestic													
Taxes	11.0	14.4	13.5	14.7	14.4	13.8	13.7	14.3	14.9	15.5	14.7	14.6	31,812
less Direct and credit subsidies	7.0	2.9	5.3	3.5	3.3	3.2	2.4	2.3	2.3	2.6	2.3	2.1	4,677
Total	4.0	11.5	8.3	11.2	11.1	10.6	11.2	12.0	12.6	12.9	12.4	12.4	27,135
Net foreign trade taxes													
Net import duties	7.2	6.7	7.7	8.5	8.7	7.6	5.5	5.6	5.9	6.3	5.9	5.5	11,973
less Export subsidies[c]	2.6	1.0	1.9	1.3	1.3	1.3	1.3	1.0	0.6	0.5	0.3	0.2	363
Total	4.5	5.8	5.8	7.1	7.3	6.3	4.3	4.7	5.3	5.8	5.7	5.3	11,610
Total taxes incl. property tax[d]	42.6	42.3	44.9	47.4	46.1	43.7	39.7	39.7	39.0	40.4	40.7	41.7	91,228

[a] At current prices.
[b] Including compulsory loans, excluding imputed civilian and defense pensions.
[c] Direct export subsidies and export credit subsidies.
[d] Includes purchase and land improvement taxes; recorded under 'Capital receipts' (Table 5.2).
SOURCE: Based on Central Bureau of Statistics data.

the civilian and the defense sectors. Another factor behind the increase in the share of national insurance receipts was the rapid rise in civilian labor input. This could also have increased income-tax receipts, but did not because many of the civilian labor force entrants earned a wage below the tax threshold (e.g., the minimum wage). It would appear, therefore, that the considerable increase in wage income-tax receipts—far exceeding the growth in GNP—is explained mainly by the progressive nature of taxation on the established labor force.

Two factors are largely responsible for the steep rise in corporation tax receipts, despite the reduction of the tax from 39 to 38 percent and the decline in the real rate of return on capital. First, the tax is on the rate of profit, which is determined on the basis of previous years and applied to turnover in the current year. Thus, tax receipts in 1994 were affected by the rise in profit in earlier years, including real profit from stock-market activities received at the end of 1993. Second, as a result of the continued expansion of economic activity, several firms which made losses have now become profitable.

Transfer payments

As in 1993, total transfers to the public declined slightly in real terms, and their composition changed. Current transfer payments rose by some 7 percent, while capital transfers plummeted by 26 percent.

National insurance allowances rose by 5 percent, with a further increase in child allowances, following the replacement of a means test by a general allowance for each child as of March 1993. This brought 370,000 families with 1–3 children back into the pool of recipients. The Reduction of Poverty and Income Differentials Law, 5754–1994, introduced at the end of July, had some effect, increasing the incomes of weaker segments of the population. Unemployment benefits declined sharply, because of the impressive reduction of unemployment.

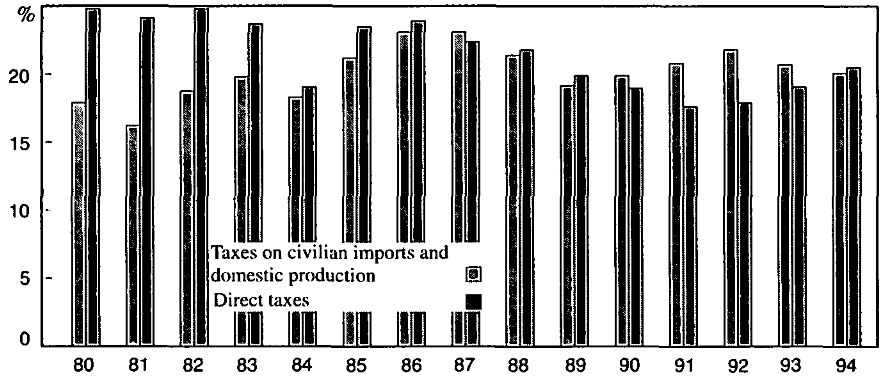
Two main factors account for the decline in capital transfers. The first was housing—one of the principal items in 1992—which declined sharply in 1993, and fell by half in 1994. This reflects the reduction of government intervention in construction, effected mainly through its commitment to purchase apartments and the import of caravans and mobile homes. The second was the repayment of compulsory loans, which fell to NIS 400 million in 1994, from double that amount in 1993.

Indirect taxes

Indirect taxes on domestic production declined by 0.1 percent of GNP in 1994 (Table 5.9), due mainly to a moderate increase in local authority taxes and fuel tax, while the rise in VAT receipts (which account for some 60 percent of receipts from indirect taxes on domestic consumption) outstripped that in GNP.

As a result of these changes, the share in GNP of direct taxes exceeded that of indirect taxes for the first time since 1990 (Figure 5.4). Since the indirect/direct tax ratio is higher

Figure 5.4
The Composition of Taxes, by Type of Tax, 1980-94



SOURCE: Central Bureau of Statistics.

in Israel than in the other OECD countries,[8] this change brings the country closer to the level customary in the west, and makes the tax system more progressive (largely because of the extremely progressive nature of Israel's income tax system).[9] However, this change increases the effective tax rate on saving, because saving (investment) is taxed again when the product resulting from the saving (investment) is produced. Taxation on consumption, on the other hand, makes no distinction between present and future consumption, and hence is not a disincentive to saving. The legislative changes introduced in 1994 are not unequivocal as regards the indirect/direct tax ratio, as while income tax rates for individuals were reduced, so were purchase, excise, and import taxes.

[8] One of the principal reasons for this is that VAT in Israel has a wide basis (fruit and vegetables, tourist services, and transactions in Eilat are the only exceptions), while elsewhere various categories enjoy a lower tax rate, mainly for income distribution reasons.

[9] In effect, the change in progressiveness depends on the legislative changes that were introduced in 1994 and on developments in the distribution of income (for which data are not available). As mentioned earlier, the changes in income-tax legislation in 1994 did little to increase progressiveness.