

Chapter 5

The Public Sector

1. MAIN DEVELOPMENTS

In 1992 the total public deficit amounted to 2.4 percent of GNP, and the domestic deficit to 5.7 percent of GNP—the lowest rates since 1989 (Table 5.1). Under the provisions of the 1991 budget law, introduced as part of the three-year budget, the domestic deficit of the government (the principal constituent of the public sector) should have been 0.5 percent of GNP lower in 1992 than in 1991, falling to 6.2 percent of GNP; in fact it went down by more. Gross public savings (Table 5.2),¹ which may be a better indicator of economic activity than the deficit, turned positive in 1992, amounting to 2.3 percent of GNP.

Public-sector expenditure declined by 2 percentage points of GNP, mainly because of the reduction in defense imports, while income relative to GNP remained the same, though its composition changed—tax revenue rose and unilateral transfers from abroad fell as defense imports decreased. The increase in tax revenue contributed significantly to the decline in the domestic deficit.

The composition of the domestic budget deficit, as well as its reduction, indicate that policy was more contractionary than desirable in the short run although, in view of the public debt, this is a desirable long-term trend. Together with the reduction of the public debt from 113.6 to 91.2 percent of GNP over the last three years, this policy helped to reduce inflation but, in the context of the continuing high unemployment rate and slowdown in immigrant arrivals, what is needed is a substantial increase in infrastructure investment—which yields a high return to the economy as a whole—and a permanent reduction in tax rates, i.e., a change in the composition of expenditure and the deficit. Such steps will serve to expand employment in the short run and create the conditions for sustainable growth. An alternative policy of pushing up demand by increasing public-sector consumption, which is characterized by downward rigidity, might have expanded employment in the short run but is not consistent with increased growth in the long run as it harms exports and has an adverse effect on interest and investment.

Public civilian consumption rose by a real 5.2 percent, which is more than the increase in the population, and less than the rise in GNP. Defense consumption fell by a real 8 per-

¹ In this *Annual Report*, Table 5.2, General Government Receipts and Expenditure, is presented in terms of the current and capital accounts, and figures on nominal interest payments replace real interest payments data.

Table 5.1
General Government: Receipts, Expenditure, and Deficit, 1980–92^a

	(percent of GNP)											NIS million ^b	
	1980–84	1985–92	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1992
Receipts													
Domestic	50.1	47.6	52.0	43.5	48.6	52.3	49.5	48.6	45.2	45.7	44.7	46.0	72,807
Foreign	12.1	11.6	11.4	17.3	22.2	16.0	10.8	8.8	8.8	9.2	9.3	8.0	12,676
Total	62.2	59.2	63.4	60.8	70.8	68.3	60.3	57.5	54.0	54.9	54.0	54.1	85,483
Expenditure													
Domestic	63.5	53.0	60.8	62.1	55.9	52.9	52.5	53.1	53.5	52.6	52.0	51.7	81,802
Foreign	11.3	8.4	9.0	12.6	14.5	11.4	9.5	7.7	6.6	6.3	6.3	4.7	7,446
Total	74.7	61.4	69.8	74.7	70.3	64.3	62.0	60.8	60.1	58.9	58.3	56.4	89,247
Deficit (-)/Surplus (+)													
Domestic	-13.4	-5.4	-8.8	-18.6	-7.2	-0.6	-3.1	-4.5	-8.3	-6.9	-7.3	-5.7	-8,995
Foreign	0.8	3.3	2.4	4.8	7.7	4.6	1.4	1.2	2.2	2.9	3.1	3.3	5,230
Total	-12.6	-2.2	-6.4	-13.9	0.5	4.0	-1.7	-3.3	-6.1	-4.0	-4.3	-2.4	-3,764
Public debt													
Domestic	114.4	94.9	111.3	115.6	122.7	114.2	105.5	91.8	88.9	86.6	77.0	72.5	114,700
Foreign	39.3	29.0	38.8	48.7	53.0	40.3	31.2	25.8	24.7	20.9	17.0	18.7	29,498
Total	153.8	123.9	150.1	164.4	175.7	154.5	136.7	117.6	113.6	107.5	94.0	91.2	144,198

^a Domestic public debt—excludes the government's commitment under the bank shares Arrangement (see Chapter 7).

Foreign public debt—the annual estimate of the public debt, domestic and foreign, is calculated as the arithmetic mean of quarterly debt/GNP ratios.

^b At current prices.

SOURCE: Based on Central Bureau of Statistics data.

cent, however, since there was an appreciable real drop (24.6 percent) in defense imports. Because defense imports fluctuate widely, no conclusions regarding a turnabout in defense consumption should be drawn from this, and in essence general government consumption has remained the same.

The share in GNP of public-sector investment in the roads and water infrastructure has not changed despite the severe shortfall of the last few years. While economic activity increased in the last three years, investment in the roads infrastructure did not keep up, and this may harm prospects for future growth.

Current transfer payments went up by a real 4 percent in 1992. Absorption grants to new immigrants fell by a real 28 percent as the number of arrivals declined, while national insurance payments soared due both to the steep increase in unemployment benefits and income-support payments, and to the numbers of immigrants becoming eligible for them.

The tax revenue/GNP ratio rose from 38.1 percent in 1991 to 39.6 percent in 1992 (Table 5.4). This was due more to the continued increase in economic activity than to the change in tax rates. Three factors account for the larger real rise in tax revenue than in GNP. First, the labor input of established employees rose substantially. Second, corporation tax receipts rose more than business-sector product, after two years in which these receipts had risen more moderately than economic activity. Since profits may be offset against the previous year's losses, and the advance payments companies are required to make each year are based on the business results of the preceding year, receipts from corporation taxes lagged behind the acceleration in economic activity of the preceding year. In 1992, however, the lag was less dramatic, and tax receipts were influenced more by the economic expansion. Third, imports of transport equipment and highly-taxed consumer durables rose steeply.

Transfer payments on capital account to firms went up by a real 31 percent in 1992, after rising by some 36 percent in 1990 and 130 percent in 1991; as a percentage of GNP there was an increase of 2.6 percentage points over 1989. In the past, investment grants under the Encouragement of Capital Investments Law constituted the principal component of transfer payments on capital account, while in recent years it has been outlays arising from government involvement in housing. Predictably, the decline in the number of immigrants created an excess supply of apartments in outlying parts of the country, and the government was obliged to honor its purchase guarantees by buying these apartments at the price set when the guarantees were signed, which was higher than the current market price. The government can expect income in the future from the sale or rent of these apartments.

2. FISCAL POLICY

Despite the considerable increase in GNP since the influx of immigrants—in comparison with other western countries and Israel in the 1980s—the high rate of unemployment

Table 5.2
General Government Receipts and Expenditure, Current and Capital Accounts, 1985-92

	(percent of GNP)								
	NIS million ^a								
	1985	1986	1987	1988	1989	1990	1991	1992	1992
Receipts									
Current receipts									
From property	1.8	2.6	1.8	1.9	2.5	3.2	3.1	2.9	4,580
<i>of which</i> Interest from abroad	1.2	1.0	0.8	0.8	1.1	1.2	1.3	1.0	1,533
Current-account transfers from the public	1.0	1.0	1.0	1.1	1.1	1.0	1.0	1.0	1,588
Indirect taxes									
On domestic production	13.5	14.6	13.1	13.8	13.7	14.3	14.8	15.4	24,281
On civilian imports	7.4	8.2	8.6	7.5	5.5	5.6	5.8	6.4	10,057
Direct taxes, fees, and levies	16.9	17.5	16.6	16.3	14.5	13.6	12.5	13.2	20,804
National Insurance income	6.5	6.3	5.8	5.5	5.4	5.3	5.0	4.7	7,403
Intergovernmental transfers	18.8	13.2	8.6	6.8	6.4	6.4	6.6	5.7	9,079
Unilateral transfers to national institutions ^b	1.6	1.3	1.1	0.9	1.0	1.2	1.1	1.0	1,561
Total current receipts	67.4	64.7	56.5	53.8	50.1	50.7	49.8	50.2	79,353
Capital receipts									
Capital-account transfers from the public	1.1	1.4	1.7	1.7	2.0	2.2	2.4	2.1	3,327
Public-sector depreciation	1.8	1.7	1.7	1.6	1.6	1.6	1.4	1.5	2,300
Capital transfers from abroad	0.6	0.5	0.3	0.3	0.3	0.4	0.4	0.3	503
Total capital receipts	3.4	3.6	3.8	3.6	3.9	4.2	4.2	3.9	6,130
Total receipts	70.8	68.3	60.3	57.5	54.0	54.9	54.0	54.1	85,483

Expenditure**Current expenditure**

Domestic consumption ^c	29.4	27.4	27.5	27.5	27.7	27.4	26.0	25.6	40,479
Defense imports ^d	8.0	6.3	5.0	3.7	3.2	3.3	3.7	2.2	3,483
Domestic interest	7.8	7.9	7.1	6.5	6.8	6.8	6.2	5.7	9,033
Interest abroad	5.9	4.6	3.9	3.5	3.1	2.7	2.3	2.1	3,372
Subsidies	6.8	4.5	4.5	4.4	3.7	3.2	2.9	3.2	5,047
Current transfers (gross)	8.9	9.5	9.6	9.7	10.1	10.7	10.7	10.5	16,606
Total current expenditure	66.8	60.2	57.7	55.3	54.5	54.1	51.7	49.3	78,020

Capital expenditure

Investment	1.9	2.1	2.5	2.7	2.6	2.7	3.3	3.3	5,151
Capital transfers	1.3	1.2	1.4	1.4	1.2	1.6	3.1	3.8	5,964
Repayment of compulsory loans	0.4	0.7	0.5	1.4	1.8	0.5	0.1	0.1	112
Total capital expenditure	3.6	4.1	4.4	5.5	5.6	4.8	6.5	7.1	11,227

Total expenditure	70.3	64.3	62.0	60.8	60.1	58.9	58.3	56.4	89,247
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Surplus (+)/deficit (-)

Current account (net savings)	0.7	4.5	-1.1	-1.5	-4.4	-3.4	-1.9	0.8	1,333
Gross savings	2.4	6.3	0.6	0.2	-2.8	-1.8	-0.5	2.3	3,633
Current + capital accounts ^e	0.5	4.0	-1.7	-3.3	-6.1	-4.0	-4.3	-2.4	-3,764

^a At current prices.

^b The Jewish Agency and public nonprofit institutions.

^c Including civilian consumption abroad.

^d Including advance payments, excluding taxes.

^e Since 1992, nominal interest payments as calculated by the Central Bureau of Statistics have replaced real interest figures.

which has prevailed for the last three years is the main problem facing the government, and is exacerbated by its considerable regional variability. Much of this unemployment is apparently structural, and in the short run either unemployed persons should be retrained in line with producers' requirements or the economy should adapt to provide them with employment (see Chapter 4). However, some unemployment is due to lack of demand, and it is necessary to examine the introduction of policy measures which are designed to increase economic activity but will not harm long-term development.

The decline in the proportion of public-sector expenditure—including investment—and the rise in the share of taxes in GNP, reflected by the reduction of the public debt in 1992, indicates that the public sector had a contractionary effect. These changes are not due to cyclical factors; unemployment actually increased, and this had an expansionary effect on expenditure and the deficit. Transfer payments on capital account rose, principally because of the crisis in construction and greater subsidization of mortgages. Because of the policy of extending purchase guarantees to contractors, the effect of the subsidy on construction activity (at the time the purchase guarantee was given) preceded its payment (when the guarantee was called in). Thus, while the expansionary effect of the policy was felt in 1991, the budgetary expense was incurred in 1992. The policy's expansionary effect on construction was felt in 1992, too, though to a far lesser extent. If the greater outlay on purchase guarantees (some NIS 2 billion) is deducted from the deficit, the contractionary effect of the deficit-reduction is even greater. This conclusion is consistent with the declaration of intent reflected in the provisions of the 1991 budget law, under which the 1992 deficit should be smaller than that of 1991 (6.2 and 6.7 percent of GNP respectively).

On the face of it, a less contractionary—or even expansionary—fiscal policy might have had an adverse effect on private investment, generating expectations of rising interest rates; but the latter are also influenced by the debt/GNP ratio, among other things. A change in this ratio is affected by both the deficit and the expansion of economic activity. A change in the debt in absolute terms disregards the demand for bonds, which rises with income, so that the debt/GNP ratio, which reflects both demand and supply elements, is a better index of the effect of the public sector on interest. If the composition of the deficit were to shift towards an increase in investment and a decline in the share of taxes, together with the reduction of the public debt, this would not harm private investment significantly and would help to expand economic activity further.

Dividing the public-sector account into its current-account and capital-account components makes it possible to analyse the government's policy more closely, focusing on the implications of budgetary policy for reducing the public debt in the long run. Capital-account expenditure (income) is classified as either public investment, support for business-sector investment, or nonrecurring expenditure. All other budgetary items are ascribed to the current account. This distinction enables us to separate permanent from non-recurring flows and to ascertain the expected public debt path.

As Table 5.2 shows, for the first time in six years the general government current account showed a surplus, 0.8 percent of GNP in 1992 (against a deficit of 1.9 percent in

Table 5.3
General Government Expenditure by Type of Intervention, 1980–92

	(percent)									
	1980–84	1985–92	1985	1986	1987	1988	1989	1990	1991	1992
Public goods										
Defense	27.8	23.7	29.2	26.8	25.7	23.2	22.2	22.2	21.5	19.0
Administrative services ^a	6.5	7.2	6.4	6.9	7.7	7.4	7.6	7.4	7.0	7.0
Investment	3.3	4.4	2.7	3.3	4.1	4.4	4.3	4.6	5.7	5.8
Total	37.6	35.3	38.3	37.0	35.0	37.5	34.2	34.3	34.2	31.8
Social services										
Merit goods	18.1	21.0	17.9	19.0	19.6	21.1	21.8	22.7	22.7	23.5
Education ^a	10.0	11.6	10.1	10.9	10.9	11.8	12.1	12.4	12.2	12.6
Health ^a	4.9	5.5	4.7	4.9	5.1	5.3	5.5	6.1	6.0	6.4
Welfare ^a	3.2	3.9	3.1	3.2	3.6	3.9	4.2	4.2	4.5	4.5
Current transfers	10.7	16.1	12.3	14.5	15.0	15.7	16.6	18.0	18.1	18.4
Total	28.8	37.1	30.2	33.4	34.6	36.7	38.4	40.7	40.8	41.9
Direct intervention (business sector)										
Subsidies	5.9	3.5	4.9	3.2	3.1	3.6	2.9	2.9	3.2	4.1
Credit subsidy	6.0	1.6	2.9	2.3	2.3	1.7	1.1	0.9	0.7	0.6
Capital grants	3.3	3.1	1.8	1.9	2.2	2.3	2.0	2.7	5.4	6.7
Foreign trade subsidies	1.7	1.6	1.9	1.6	1.9	2.0	2.0	1.6	1.0	0.9
Total	16.9	9.8	11.5	9.0	9.5	9.5	8.1	8.1	10.3	12.3
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
Interest on public debt										
Domestic	10.3	11.1	11.1	12.2	11.4	10.7	11.3	11.6	10.7	10.1
Foreign	5.4	5.6	8.4	7.2	6.3	5.8	5.1	4.5	3.9	3.8
Total	16.7	17.8	20.0	20.6	18.5	18.7	19.4	16.9	14.7	14.0
Grand total			100.0							
Percent of GNP	74.8	61.4	70.4	64.3	62.1	60.8	60.1	58.9	58.3	56.4

^a Estimated from the general government consumption figures; for 1988–92 provisional estimate based on change in number of employee posts.

SOURCE: Based on Central Bureau of Statistics data.

1991). The current-account surplus, and the expansion of economic activity in 1992, as in the two preceding years, reduced the debt/GNP ratio considerably. This would seem to indicate that the tax burden was needlessly heavy in the first few years of immigrant-absorption.

Budgetary policy is subject to several restrictions, however. First, unduly rapid expansion of government demand could come at the expense of demand from households and firms. Second, past experience shows that increasing demand by expanding public-sector consumption, which is downwardly rigid, can improve the situation in the short run but causes damage in the long run. Third, a temporary reduction in tax rates (as announced with regard to the reduction of labor costs in 1991) has less effect than a permanent one because households and firms plan on a long-term basis and will not alter their behavior significantly as a result of short-term incentives. Hence, short-term fiscal policy must increase public-sector investment, provided this is profitable and does not harm stability. Another measure, which does not involve the disadvantages listed here, is to step up the activity of the automatic stabilizers in the tax system.

The influx of immigrants, which began at the end of 1989, obliged the government to incur a budget deficit lasting for several years but declining gradually. In order to signal that budgetary activity during this period would be very different from the one which caused such harm to the economy in the early 1980s, the government chose to limit itself and define the declining path of the budget over a three-year period under the 1991 budget law.

There are advantages and disadvantages to this legislation. It imposes budgetary discipline on the government, ensuring that the increase in the budget deficit due to immigrant-absorption expenditure does not become permanent, as this would harm long-term price-stability and growth. It also reduces uncertainty regarding budget policy, thereby making it easier for economic agents to plan ahead. However, restricting its freedom could hamper the government should economic developments turn out to be different from those expected.

The situation in 1992—the first year in which the law was put to the test—bore this out. Fewer immigrants than predicted arrived, while the unemployment rate continued to rise. Implementing an expansionary budget policy in 1992 would have required amending the law; this would have been interpreted as signalling the abandonment of budgetary discipline, with the resultant damage to credibility. During the course of the year it transpired that the actual budget deficit was lower than planned, so that a less contractionary policy—i.e., a greater increase in investment and reduction of taxes—could have been adopted without violating the law or harming credibility.

Two problems could arise from the fact the legislation concentrates on the government's domestic deficit. First, the budget does not accurately reflect the government's effect on economic activity because it is based on cash flow. Second, the law does not apply to the deficit of such public-sector institutions as local authorities, the National Insurance Institute, public nonprofit institutions, the JNF, etc. Nonetheless, it is

Table 5.4
Taxes, Subsidies, and Transfers, 1980-92

	(percent of GNP)										
	NIS million ^a										
	1980-84	1985-92	1985	1986	1987	1988	1989	1990	1991	1992	1992
Taxes and transfers											
Taxes	41.6	41.7	44.2	46.6	44.1	43.1	39.0	38.8	38.1	39.6	62,545
<i>less</i> Net transfer payments ^b	8.5	9.5	8.2	8.9	8.4	9.5	9.9	9.4	10.3	11.1	17,588
<i>less</i> Direct and credit subsidies	10.2	4.2	6.8	4.5	4.5	4.4	3.7	3.2	2.9	3.2	5,047
Total	23.0	28.0	29.1	33.2	31.1	29.2	25.4	26.2	24.9	25.2	39,910
Direct taxes											
Direct taxes	23.3	20.7	23.4	23.8	22.4	21.8	19.9	18.9	17.5	17.8	28,207
<i>less</i> Transfer payments	8.5	9.5	8.2	8.9	8.4	9.5	9.9	9.4	10.3	11.1	17,588
Total	14.8	11.2	15.1	14.9	13.9	12.3	9.9	9.5	7.2	6.7	10,619
Indirect taxes, domestic											
Taxes	11.0	14.1	13.5	14.6	13.1	13.8	13.7	14.3	14.8	15.4	24,281
<i>less</i> Direct and credit subsidies	7.0	3.1	5.2	3.5	3.3	3.2	2.4	2.2	2.3	2.7	4,219
Total	4.1	11.0	8.2	11.2	9.8	10.6	11.2	12.0	12.5	12.7	20,062
Net foreign trade taxes	4.6	5.8	5.8	7.1	7.4	6.3	4.3	4.6	5.2	5.8	9,229
Net import duties	7.2	7.0	7.7	8.4	8.7	7.6	5.5	5.6	5.8	6.4	10,087
Export subsidies ^c	2.6	1.2	1.9	1.3	1.3	1.3	1.3	1.0	0.6	0.5	858

^a At current prices.

^b Including compulsory loans, less imputed civilian and defense pensions.

^c Direct export subsidies and export credit subsidies.

SOURCE: Based on Central Bureau of Statistics data.

difficult to find an alternative index. The legislation did take into account the relation of the government's domestic deficit to that of the entire public sector in 1987-90, thereby considering the relevant deficit. In actual fact, however, there is a wide gap between the two definitions, as Table 5.5 shows.

Table 5.5
Domestic Deficit, 1987-95

	(percent of GNP)					
	1987-90	1991	1992	1993	1994	1995
Domestic deficit under law ^a	3.5	6.7	6.2	3.2	2.2	0.0
Actual public deficit	3.8	4.3	2.4			

^a According to the previous definition.

The decline in the debt/GNP ratio in 1992 (Table 5.1) was largely the result of an increase in taxes and the under-utilization of the government budget. Although the debt/GNP ratio is still high by western standards, its decline in the last three years has engendered stability and reduced interest payments. In a period of immigration, however, when there is nonrecurring expenditure, the public debt could be increased, to be offset in the future when more immigrants enter the labor market. At the least, fiscal policy could be implemented without increasing the debt/GNP ratio in the short run.

Fiscal policy measures should take into account the desired long-term debt path. The provisions of the 1991 budget law requires a sharp reduction of the deficit/GNP ratio in 1992, declining to zero over the subsequent two years.

3. DEFENSE

Defense consumption went down by some 8 percent. Defense labor input fell by a real 3 percent, as the number of days of reserve duty declined. Domestic purchases rose by about 2 percent, and imports declined by some 25 percent in real terms.

The indicators of defense expenditure in Table 5.6 show the reduced defense burden, continuing the long-term trend. The relative decline does not indicate a quantitative reduction in the fighting force or weaponry. For a thorough analysis of the implications of defense expenditure, the 'demand' side must be taken into consideration. Defense outlays are the result of the threat to Israel's security, and changes in the level of the threat require shifts in expenditure. The figures in the table refer to the 'supply' side only, i.e., the extent to which the country's defense needs can be met through the resources available, and their cost.

The demand side must include such factors as the extent to which hostile countries are arming themselves, strategic alliances, etc., but it is difficult to construct an index that reflects the level of the security threat. Thus it is not clear if the shift in defense expenditure constituted an adequate response to the change in the level of the security threat.

Table 5.8
Indicators of Defense Expenditure, 1980-92

	Percent of: GNP plus unilateral transfers ^b (1)	Defense consumption ^a as percent of GNP			Compensation of employees: defense ^a as percent of total (5)
		Total (2)	Domestic (3)	Domestic plus foreign funding ^c (4)	
1980	19.9	23.1	14.0	17.5	10.5
1981	21.4	24.5	14.0	17.7	10.3
1982	19.1	21.6	15.0	19.2	10.8
1983	16.4	18.8	14.1	17.9	9.9
1984	18.4	21.7	14.3	19.0	10.2
1985	17.3	21.5	12.7	17.8	9.5
1986	13.0	15.8	11.0	15.1	8.8
1987	16.5	19.4	11.0	14.6	8.7
1988	14.1	16.2	10.4	13.6	9.3
1989	12.0	13.6	10.2	12.9	9.2
1990	11.8	13.5	9.9	12.2	9.2
1991	11.2	13.0	8.9	11.1	9.0
1992	10.0	11.5	8.5	10.5	8.3

^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.

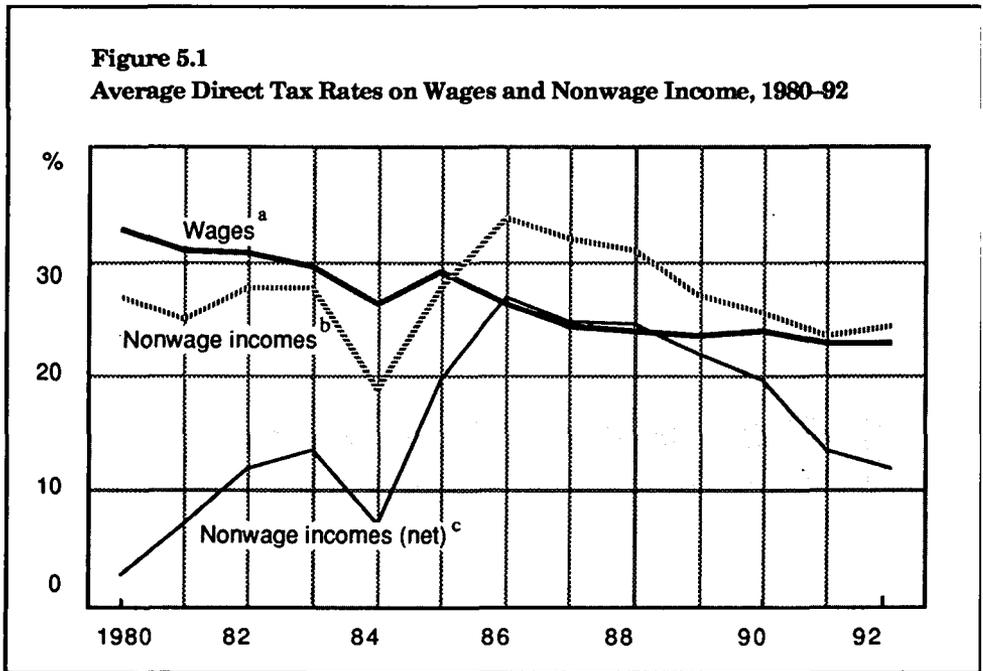
Basic US aid to Israel (excluding special aid connected with the 1985 economic stabilization program and during the Gulf crisis) has been about \$ 3 billion for a number of years (\$ 1.2 billion in civilian and \$ 1.8 billion in military aid). It has thus been eroded by a real 4-5 percent a year as a result of inflation in the US; the ratio of aid to GNP (and per capita) has fallen even more.

4. TAXES, TRANSFER PAYMENTS, AND SUBSIDIES

The share of taxes in GNP rose from 38.1 to 39.6 percent in 1992, representing a slight increase in the share of direct taxes and a greater rise in indirect taxes, in line with the long-term trend of the growing share of indirect taxes in GNP. The rise in the tax/GNP ratio indicates an increase over and above that attributable to the expansion of economic activity. Changes in legislation had little real effect on tax receipts, and the large increase in taxes resulted from the greater number of hours worked by established employees, and from the delayed response of direct taxes to the economic growth of the last three years. In addition, due to higher imports of motor vehicles and consumer durables, import taxes represented a higher share of GNP, while the higher rates of excise duty on

fuel, purchase tax, and local authority taxes also contributed to the increased share of indirect taxes.

Total taxes *less* subsidies and capital transfer payments (excluding housing),² which reflect the tax burden on the business sector, rose (Figure 5.3), despite pronouncements about the need to improve conditions for this sector. Although profitability is affected by the statutory tax rates, the increase in tax revenue was expected (see the National Budget for 1992—1994). It seems, therefore, that legislative steps could have been taken in order to reduce taxation, continuing the trend—which started in the mid-1980s—of reducing direct taxes.



^a Excluding company managers' salaries.

^b Gross business-sector income at factor cost, excluding salaries (except company managers).

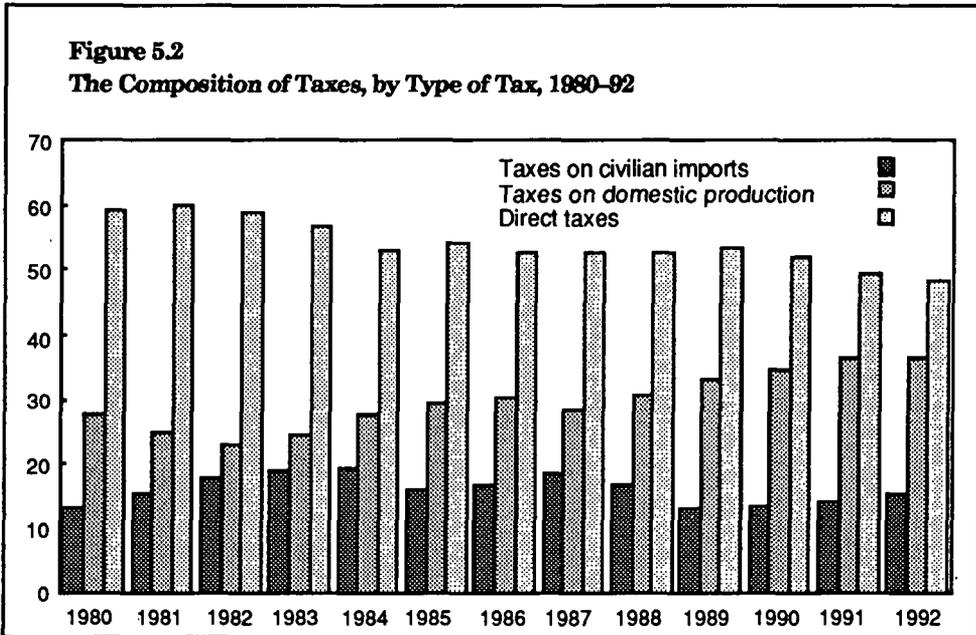
^c Less credit subsidies and capital transfers to firms.

SOURCE: Based on Central Bureau of Statistics data.

² Current transfer payments (retirement pensions and child allowances) have no direct effect on the manufacturing sector's tax burden. Transfer payments for the support of building contractors (purchase guarantees) are not relevant here, as most represent acquisition of assets.

Transfer payments

Transfer payments to the public rose in real terms (more than the increase in the CPI) by about 10 percent. In 1992, as in 1991, capital transfers to firms rose significantly, by about 31 percent, while current transfers grew more moderately, by some 4 percent.

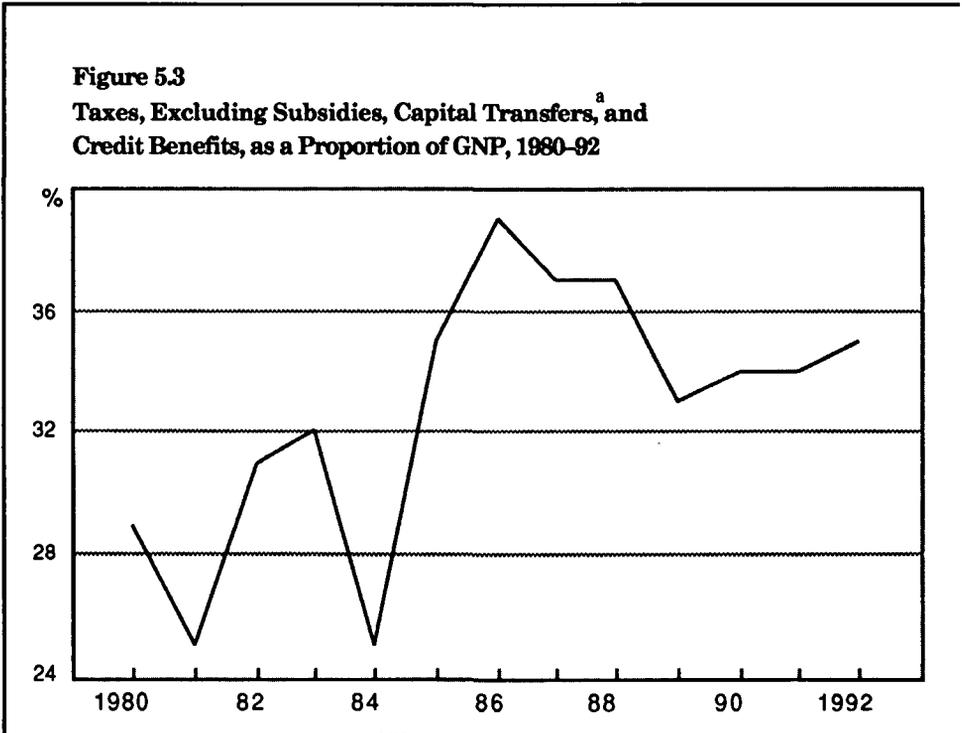


The persistently high unemployment rate resulted in a rise in the number of claims for unemployment benefits (from about 62,000 to some 86,000), and hence in a real 36 percent increase in unemployment benefits paid. The continuing high unemployment rate also led to a significant increase in income support payments. The slowdown in immigration in 1992 reduced absorption grant payments, while immigrants of longer standing joined the ranks of those entitled to benefits from the National Insurance Institute.

The cumulative increase in capital transfer payments to firms over the last three years amounted to some 410 percent. This gives a budgetary measure to the massive government intervention in construction, as expressed by such policies as purchase guarantees to building contractors, direct construction, import of mobile homes, etc. Purchasing an apartment from a contractor or importing a mobile home is classified in the national accounts as a capital transfer payment. This is a transaction which alters the government's assets/liabilities (and if a subsidy is imputed in it, this results in a net increase in liabilities). From a budgetary point of view, purchasing an apartment or imported mobile home and renting it to a household is equivalent to purchasing a bond, which guarantees future interest payments. Thus, this transfer payment only increases

the public debt to the extent of the imputed subsidy. There is nevertheless a difference between apartments and bonds as regards the cost of managing and maintaining stock.

In order to speed up the sale of government-held apartments, because of the fear of losses arising from long-term government ownership, prices were reduced below their market value, thus creating an additional subsidy. Government purchases of apartments in 1992 imply expected future income, whether from selling or renting them, and as the slowdown in immigration will lead to a reduction in capital transfer payments, some budgetary relief can be expected over the coming years.



^a Excluding housing.

The increase in the government's intervention in construction was paralleled by its greater investment in nondwelling industries. This was in the form of subsidies for R&D, capital grants, and investment guarantees. The purpose of the Encouragement of Capital Investments Law is to encourage population dispersal and promote employment by forging a link between the return (and/or risk) to the economy and the return (and/or risk) to the investor. The considerable increase in transfer payments highlights the question of the cost of achieving these objectives. Part of the growth of investment in the principal industries would have been achieved even without investment grants, so that company owners are in effect granted an income by law. Furthermore, some of the investment grants make investments which are unprofitable for the economy as a whole.

profitable for companies, but are financed by taxing profitable companies. The incentive to increase unprofitable investments thus serves as a disincentive to profitable firms.