

## CHAPTER V

# THE PUBLIC SECTOR<sup>1</sup>

### 1. MAIN ACTIVITIES

The government has pursued a restrictive fiscal policy since late 1984; the measures included in the the July 1985 stabilization program, in particular, were designed both to cut public spending and to increase revenue. In the last two years domestic public expenditure has declined by 5 percent of GNP as compared with its average share in 1980–84, while domestic revenue increased by 4 percent of GNP. As a result of the fiscal policy of the last two years public sector revenue exceeded expenditure from the second half of 1985 to the first quarter of 1987; instead of the large deficits that characterized the last two decades, the public sector ran a surplus which in 1986 amounted to 6 percent of GNP. One percent of this was domestic surplus and 5 percent was a surplus of the public sector external account.

A fiscal policy designed to achieve a rapid reduction of public expenditure cannot affect all its components with equal intensity. Interest payments on the public debt,

<sup>1</sup> The Central Bureau of Statistics has adopted the New System of National Accounts recommended by the United Nations Statistical Office. In the present chapter the national accounts are presented in their new form from 1980 onwards. According to the new definitions the public sector comprises the central government, the National Insurance Institute, the local authorities, National Institutions, and those private nonprofit institutions whose expenditures are mainly financed by the public sector institutions listed earlier (the universities, the sick funds, etc.).

This chapter deals primarily with the public sector's real activity and, to some extent, with its influence on the economy. For a fuller description of the public sector's influence on the economy, the reader is referred to other chapters of the Annual Report.

The expenditures of the public sector are defined as its direct demand outlays, interest payments, subsidies and transfer payments. The direct demand of the public sector is defined as public consumption (civilian and defense expenditure in Israel and abroad) and investment at public-sector initiative.

Public sector revenue consists of taxes and compulsory payments, income from property and other income, and unilateral transfers to the public sector. The public deficit or surplus is defined as the difference between revenue and expenditure. The public deficit is financed by borrowing abroad and domestically and by increasing the money base ('money printing').

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. Other expenditures and revenues were deflated by the consumer price index.

for example, are commitments that cannot be reduced in the short run. Similarly, it is in the short run impossible to reduce the subsidy element of cheap loans granted in the past by the government to the public. The burden of cutting public spending therefore falls on expenditures of direct demand—civilian public consumption, defense, public investment and part of the transfer payments. In the last two years these amounted to some two thirds of total public expenditure. Domestic defense expenditure has declined continuously in the last three years, by a cumulative 10.5 percent, of which 8 percent were the 1986 cut alone. The share of domestic defense expenditure in GNP, which between 1975 and 1984 amounted to 14–15 percent of GNP, decreased in 1986 to 12 percent. This cumulative contraction of defense spending resulted from fiscal restraint, and was assisted by the termination of non-recurrent defense expenditures caused by one-time events (the redeployment of the Israel Defence Forces in the Negev following the return of the Sinai peninsula to Egypt, and the Lebanon war). It is, however, at present still unclear whether the reduction of defense expenditure will be permanent or represents a running down of stocks that will be rebuilt again in the future.

Israel's defense expenditure, which stems from the continued threat to its security and survival by Arab countries, is large by any standard and represents a heavy economic burden. The contraction of the last three years has significantly eased this burden, even though defense spending still remains at a high level. Moreover, the statistics on direct defense spending do not reflect other defense-related costs—the loss of output of conscripts, the building of bomb shelters, and others. A rough estimate indicates that these indirect defense costs alone (which have not changed in recent years) are a bigger share of GNP than the total defense expenditure of the European countries.<sup>2</sup> The government has for several years pursued a policy of cutting civilian public consumption. This policy has been made easier by a slight decline in the proportion of the young and the elderly in the population—age groups which consume more public services than others. Total public civilian consumption declined in 1986 by 2 percent; the cumulative decrease since 1980 has been 10 percent per capita.

In the last two years direct subsidies to domestic production were cut by 60 percent, reducing their share in GNP from an average of 4 percent in 1975–84 to 2 percent in 1986.

Fiscal policy in the last two years has succeeded only partially in reducing transfer payment to households. Child allowances for families with up to three children have been cut (the allowance for the first child has been eliminated and those for the

<sup>2</sup> Prof. Eitan Berglas has estimated the cost of the GNP lost as a result of obligatory military service at 5 percent of GDP. See Berglas, E. (1986) Defense and the Economy, in Ben Porath (ed.), *The Israeli Economy*, Harvard University Press.

second and third child have been made partially taxable). The pensions of retired public sector employees have been eroded relative to wages. Attempts to cut other (mostly statutory) benefits have not been successful (for example, the proposal to reduce the old-age pensions of the National Insurance Institute). On the contrary: the indexation of the old-age pensions has led to an increase of these transfer payments as inflation slowed down. Overall, there has been a real rise in transfer payments in the last two years, and their share in GNP has remained constant at the level of the 1980–84 average—12.5 percent.

As stated above, interest payments on the domestic debt are not a feasible short-run objective of restrictive fiscal policy. Under inflation, the incomplete indexation of the domestic debt eroded interest payments; with the slowdown of inflation this erosion has lessened, with the result that interest payments have risen from 3.5 percent of GNP in 1980–84 to 6.5 percent in the last two years. The real interest rate on the domestic debt, which in 1980–84 was 3 percent, rose to 5 percent in the last two years. Real interest payments on the domestic debt now amount to a sizable share of total public expenditure. Their future reduction depends on a long-term policy of abstaining from running a public-sector deficit so as to permit a gradual redemption of the large domestic debt, and on GNP growth which will reduce the relative weight of the domestic debt.

The second component of the elimination of the public deficit in the last two years was, as stated above, the increase in revenue. Revenue from taxes and transfer payments by the public increased by 12 percent in 1986, raising it from 47 percent of GNP in 1975–84 to 52 percent. The high rate of taxation in 1986 came partly from one-time levies imposed in July 1985, some of which remained in force in 1986, particularly in the first half of the year. Another cause of the rise in tax revenue was the amendments to the income tax laws referring to non-wage income (the ‘Steinberg Committee Law’) which, together with other factors, resulted in a rapid increase (of 22 percent) in tax revenue from the business sector. However, half of the increase in tax revenue in 1985–86 was not the direct result of fiscal policy, but came from an extraordinarily high rise in private consumption, and especially from the steep rise in the acquisition of durable consumer goods which are taxed heavily. If private consumption had increased at the same rate as GNP, domestic revenue would have been smaller by 2 percent of GNP than it has actually been. As against the rise in tax revenue from the business sector, revenue from taxes on wages declined: employers’ contributions to the National Insurance Institute were lowered, and income tax rates on individuals were reduced as the tax brackets were adjusted upwards.

In the foreign-currency expenditures of the public sector, a 40 percent decrease in direct defense imports was recorded in 1986. The national accounts record defense imports (like all imports) according to the date of their release from the ports. This estimation method results in large year-to-year fluctuations. If the advances paid to

the U.S. suppliers of defense goods are added to the imports already supplied, there has been no change in total foreign-currency defense expenditure in 1986. These expenditures primarily depend on U.S. military grants-in-aid. At the end of 1984 the U.S. government changed the manner in which it provided Israel with military assistance, extending it wholly as outright grants (economic assistance had already earlier been given as a grant). In addition, in 1985 and 1986 the U.S. provided an emergency grant of \$750 million a year. These grants contributed significantly to the liquidation of the public sector deficit, and underpinned the credibility of the July 1985 stabilization program as a whole.

In 1986 the public sector's interest payments to the rest of the world amounted to some \$1.5 billion. Most of these were payments to the U.S. on account of military aid loans received in the past, and the remainder were payments to the government of the Federal Republic of Germany, individuals and banks.

The surplus in the public sector accounts in the last two years made it possible, for the first time in many years, to retire some of the principal of the public debt, foreign and domestic. The decline in domestic public borrowing requirements (together with other monetary factors) resulted in a fall of the real interest rate on new bond issues made for the purpose of recycling the domestic debt as old bonds fell due for redemption.

In 1986 the domestic and foreign public debt decreased in real terms. The appreciation of the sheqel eroded the component of the domestic debt linked to foreign currency, and the foreign debt was reduced as some of the old loans were repaid. These debt retirements and the differences between the rates of increase of the various indexes to which the domestic debt is linked, between the value of the dollar (in which most of the foreign debt is stated) and the implicit GNP prices, resulted in a sharp decline in the share of the public debt (foreign and domestic) in GNP in 1986 relative to 1985. This causes sharp year-to-year fluctuations in the debt/GNP ratio, which should therefore be taken as no more than a rough indicator of the debt repayment burden in any single year.

## 2. FISCAL POLICY

In July 1985 the government adopted a comprehensive economic program with the objective of simultaneously attacking three problems: inflation, the balance of payments deficit and the public deficit. In the public sector accounts the program resulted in a reduction of public spending and a rise in revenue, so that the public deficit was eliminated.

The measures introduced by the program had different effects on various budget items, so that the composition of expenditure and revenue changed. The proportion

of direct demand outlays and subsidies in public expenditure declined while the share of interest payments and transfer payments rose as these increased in real terms. On the revenue side, direct taxes on the business sector increased while taxes on wages decreased and at the same time, income from abroad rose.

These changes in the level and composition of public expenditure had varying effects on the economy: (a) The cuts in domestic procurement, especially for defense, reduced the business sector's volume of activity because during the period under review firms that had been producing for the public sector (particularly those supplying defense goods) did not convert fully to production for exports or alternative domestic uses. (b) The decrease in the labor input in the public sector in 1986 did not lead to a proportionate rise in the supply of labor to the business sector. The reason was that this decline in the labor input was partly due to a reduction of man-hours per employee and to the early retirement of employees who were mostly in the middle and older age groups. The terms offered for early retirement were favorable, providing the retirees with a living standard that enabled them not to continue working. At the same time, the reduction in military reserve duty requirements made it possible to use the existing workforce more efficiently; as the recruitment of new public sector employees slows down, the supply of labor to the business sector will therefore increase gradually in the future. (c) In 1986 there was a decline in 'other' domestic expenditures (subsidies, transfer payments and interest payments) which contributed to reducing private disposable income. However, the various effects of these expenditures on aggregate demand are not clear.

Effective direct taxation of non-wage income rose in 1986. After deducting transfer payments on capital and credit subsidies (which have declined in recent years) from direct taxes, the net taxation of the business sector is seen to have risen steeply from its very low level in the early 1980's. High rates of taxation have an adverse effect on the efficiency of production and restrain the growth of the business sector product.

By contrast, the effective rates of direct taxes on wages have fallen in the last two years. As inflation slowed down the tax brackets were raised steeply, and employers' contributions to the National Insurance Institute on account of their workers were reduced by a third. Both of these increase the supply of labor as well as the demand for it.

Business sector activity picked up in the second half of 1986. This recovery may be due to the adjustment of the business sector to the cutback of public sector demand—a process eased by the gradual decline of effective tax rates in the course of 1986 (for further factors of the upswing in economic activity, see Chapters I and II).

The reduction of the public sector's domestic deficit since the second half of 1985 and the slowdown of inflation have created a favorable background for the conduct of monetary policy. The public sector's external drain has contracted, strengthening

**Table V-1**  
**PUBLIC EXPENDITURE AND REVENUE, THE DEFICIT**  
**AND ITS FINANCING, 1980-86**  
(Percent of GNP, current prices)

	1980- 1984	1985- 1986	1980	1981	1982	1983	1984	1985	1986
Total public expenditure	72.9	70.0	76.0	74.6	72.6	68.0	73.5	72.9	67.0
Thereof: Domestic	61.3	56.4	62.7	62.9	62.1	58.8	59.9	58.0	54.8
Foreign	11.7	13.6	13.3	11.7	10.5	9.1	13.6	14.8	12.3
Total revenue	60.6	73.0	61.5	60.8	62.1	62.0	56.7	73.1	72.9
Thereof: Domestic	50.3	54.2	50.6	50.5	52.7	52.8	44.6	52.4	56.0
Foreign	10.4	18.8	10.9	10.3	9.4	9.2	12.1	20.7	16.9
Public deficit (-) or surplus (+)									
Total	-12.3	3.0	-14.4	-13.8	-10.5	-6.0	-16.8	0.2	5.8
Domestic	-11.0	-2.2	-12.0	-12.3	-9.4	-6.1	-15.3	-5.6	1.2
Foreign	-1.3	5.2	-2.4	-1.4	-1.1	0.1	-1.5	5.8	4.6
Financing of total deficit or surplus									
Net borrowing from abroad	6.7	-1.9	5.0	6.6	6.0	5.3	10.7	-1.5	-2.3
Net money creation	1.8	3.3	1.9	1.7	1.6	0.7	2.9	6.0	0.6
Net domestic borrowing	4.6	-1.2	5.8	7.7	8.0	-1.2	2.7	-2.2	-0.3
Residual	-0.8	-3.1	1.7	-2.2	-5.2	1.2	0.5	-2.5	-3.8
Public debt									
Domestic	119.3	131.3	112.5	114.6	122.8	120.0	126.4	136.9	125.7
Foreign	41.5	47.9	35.9	38.3	39.1	42.9	51.1	53.5	42.4

#### DEFINITIONS

*Domestic expenditure:* Domestic public consumption (civilian and defense), public sector investment, subsidies, transfer payments and domestic interest payments.

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

*Domestic revenue:* Revenue from taxes and compulsory payments, income from property and other income (imputed depreciation and imputed commitments for pension payments).

*Receipts from abroad:* Unilateral transfers to the public sector plus interest receipts on foreign reserves, less transfers to the Civil Administration of the administered areas.

*Public sector deficit:* The difference between expenditure and receipts. Total public sector deficit less public investment equals gross saving of the public sector.

*Net borrowing from abroad:* Short, medium or long term changes in the foreign reserves, less repayment of principal and less advances on defense imports.

*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, changes in the discount-window loan, etc.).

*Domestic borrowing:* Domestic public sector borrowing as estimated by the Department of Management Accounting in the Accountant-General's Office and the Bank of Israel.

*Residual:* The difference between the total public sector deficit and receipts from loans from abroad, net money creation, and domestic borrowing; includes deficits of public sector nonprofit institutions and 'errors and omissions'.

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

*Foreign public debt:* Total claims of foreigners on the public sector less foreign reserves. The annual estimate of the public debt, domestic and foreign, is calculated as the arithmetic mean of quarterly debt/GNP ratios.

SOURCE: Central Bureau of Statistics and the Department of Management Accounting in the Accountant-General's Office, and Bank of Israel.

**Table V-2**  
**PRINCIPAL COMPONENTS OF PUBLIC SECTOR**  
**EXPENDITURE AND REVENUE, 1980-86**  
(Percent of GNP, current prices)

	1980- 1984	1985- 1986	1980	1981	1982	1983	1984	1985	1986
<b>Total public expenditure</b>	72.9	70.0	76.0	74.6	72.6	68.0	73.5	72.9	67.0
Domestic expenditure	61.3	56.4	62.7	62.9	62.1	58.8	59.9	58.0	54.8
Direct domestic demand	35.2	31.7	35.0	34.9	36.0	35.1	35.0	32.4	31.1
Thereof: Civilian	17.2	16.3	17.4	17.4	17.2	16.9	17.4	16.2	16.5
Defense, net	14.7	12.5	14.2	14.4	15.4	14.6	14.7	13.4	11.6
Public sector investment	3.3	2.9	3.4	3.1	3.4	3.6	2.9	2.8	2.9
Direct subsidies	5.7	4.0	2.9	7.6	5.9	5.8	6.3	4.9	3.0
Transfer payments	12.4	12.5	13.5	12.4	12.7	12.0	11.3	11.9	13.1
Credit subsidies	4.6	1.8	7.0	5.3	4.0	3.4	3.3	2.2	1.5
Real interest payments	3.3	6.4	4.3	2.6	3.5	2.5	3.9	6.7	6.0
<b>Direct demand for foreign currency</b>	11.7	13.6	13.3	11.7	10.5	9.1	13.6	14.8	12.3
Thereof: Direct defense imports	8.3	7.3	9.7	11.2	7.3	5.1	8.0	9.4	5.2
Advance payments on defense imports	0.2	1.4	1.4	-1.9	0.1	0.4	1.0	0.2	2.6
Net interest payments to abroad	2.0	4.5	1.1	1.2	1.3	2.4	4.0	5.1	4.0
<b>Domestic revenue</b>	50.3	54.2	50.6	50.5	52.7	52.8	44.6	52.4	56.0
Taxes and transfer payments									
by households	45.2	50.4	45.2	44.3	48.0	48.5	40.0	48.5	52.3
Income from property	2.3	1.1	2.6	3.5	1.9	1.6	1.8	1.3	0.9
Income n.e.s.	2.8	2.7	2.8	2.8	2.8	2.7	2.8	2.6	2.7

#### DEFINITIONS

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

*Domestic defense consumption:* Total defense consumption less direct defense imports and less estimated domestic sales by the defense establishment, deflated by the CPI; annual average.

*Public sector investment:* Does not include public housing.

*Direct subsidies:* Subsidies to domestic production, imports and exports.

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

*Real interest payments:* Nominal interest paid to domestic factors by the public sector and the Bank of Israel, less adjustment for repayment of principal.

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

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

*Income from property:* Domestic operating profit of the Bank of Israel, plus other income from property and entrepreneurship (rent, dividends, interest), property income of private nonprofit institutions classified as part of the public sector, less receipts of real interest on government loans to the public which are included under credit subsidy.

*Income n.e.s.:* Imputation as receipts of the obligations for pension payments to retired public sector employees who are entitled to a budgetary pension, and imputation for depreciation of capital stock in the public sector.

SOURCE: Central Bureau of Statistics and Bank of Israel.

the public's confidence in the government's commitment to honor its domestic debt obligations and thereby easing the recycling of the public debt while the real interest rate on new bond issues falls. In 1984–86 monetary policy relied mainly on very high interest rates, especially on nondirected local-currency credit, although preferred economic activities continued to benefit from lower rates of interest. The high interest rates had a restraining effect on demand, but also aggravated the difficulties encountered by some economic sectors which depend heavily on nondirected credit (for example, moshavim, kibbutzim, the Histadrut health insurance fund, universities and construction firms). After some delay, the government decided to relieve the financial difficulties of some of these sectors and institutions and to assist them in several ways: with direct grants, by forgiving interest, extending the term or consolidating loans, and by substituting high-cost debts with cheaper loans from the public sector.

The favorable development of the public sector accounts in 1985–86 resulted largely from the increase in foreign currency receipts. However, the U.S. emergency grant for 1985–86 will not be renewed in 1987. The government will therefore have to continue balancing domestic expenditure and revenue in order to avoid a recurrence of the budget deficits of previous years. The reduction of direct tax rates (on unearned income and on wages) in 1987, and the lowering of import duties required by the agreement with the European Community make it necessary to adjust expenditure to the expected lower level of revenue. Defense expenditure has contracted in recent years; in the short run its renewed expansion should be avoided so as to allow the process of the economy's adaptation to the present spending level to persist. Subsidies have been reduced significantly, leaving little room for further cuts in this rubric. Interest payments have increased in recent years, and their future reduction depends on the extent to which the domestic debt will be retired. Public sector investment has fallen to a low level and it is now desirable to increase it, especially as regards infrastructure investment. Taken together, these narrow the options of reducing public spending to civilian public consumption and transfer payments to households (while maintaining a reasonable level of income).

The prevailing high level of taxation requires careful choice between different forms of taxes with a view to preferring those which have the least damaging effect on the economy. Israel's tax system is characterized by a complex and unwieldy income tax law and widely disparate rates of indirect taxes on imports and domestic production. Simplification of the system of direct taxes on the business sector and greater uniformity of indirect taxes will reduce the damage these taxes cause, and will ease the revival of economic growth.

**Table V-3**  
**INDICATORS OF CHANGE IN CIVILIAN PUBLIC SERVICES, 1980-86**  
 (Percent, current prices)

	1980	1981	1982	1983	1984	1985	1986
Civilian public consumption:							
As per cent of GNP <sup>a</sup>	17.8	17.7	17.5	17.3	17.7	16.7	16.8
As percent of private consumption <sup>b</sup>	32.9	31.9	30.3	29.1	31.3	28.3	26.5
Per capita <sup>c</sup>	100.0	99.4	97.8	97.1	96.4	95.1	91.8
Employees in civilian public services, as percent of civilian labor force <sup>d</sup>	29.7	30.2	30.2	29.7	29.7	30.0	29.7
Wage bill in the civilian public sector as percent of total wage bill	24.8	24.3	23.0	23.1	24.0	22.3	21.5
Index of the share of age groups 0-24 and 65+ in total population <sup>e</sup>	100.0	99.7	99.3	99.2	98.8	98.7	98.6

<sup>a</sup> Includes government imports n.e.s.

<sup>b</sup> Excluding consumption of private nonprofit institutions.

<sup>c</sup> Index (1980=100), constant prices.

<sup>d</sup> Data from labor force surveys since 1985—new series. The data for earlier years have been chained to the change in the series in 1985.

<sup>e</sup> Index; 1980=100.

SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

### 3. THE DEFENSE BURDEN

The volume of defense consumption was reduced sharply in 1986—more than in any year during the 1980s. All components of defense expenditure were reduced simultaneously: direct defense imports were 38 percent less than in 1985,<sup>3</sup> following two years in which they had expanded; and domestic defense procurement, which has been declining for three years, was reduced even more steeply in 1986—by 9 percent compared with 2 percent in each of the two preceding years. The labor input in the defense sector also decreased in the year under review—by 6 percent, following a 3 percent decline in 1985. The decline in the domestic components of defense spending was due to the tight fiscal policy and to the reduced share of non-recurrent expenditures—mainly related to the IDF's withdrawal from Lebanon.

The defense burden is a multi-dimensional concept; there is in fact no single quantitative measure to express the economic burden of defense. It is therefore customary to analyze several indicators, each of which highlights a different aspect of the

<sup>3</sup> Defense imports are recorded by date of supply, and therefore fluctuate considerably from year to year. These fluctuations do not necessarily indicate any change of trend.

defense burden, and all of which together provide an indication of its overall trend. All the quantitative indicators assembled in Table V-6 show that in 1986 the defense burden has eased and stabilized at its lowest level since 1973. Moreover, if the defense burden in 1986 is evaluated by the first three indicators listed in the table, it was at the lowest level since 1967.

**Table V-4**  
**INDICATORS OF ISRAEL'S DEFENSE OUTLAYS, 1964-86**  
(Percent, at current prices)

	As percent of gross national income from all sources <sup>a</sup>	Defense consumption as percent of GNP			Defense wage bill as percent of total wage bill
		Total, net of defense grants <sup>b</sup>	Domestic <sup>c</sup>	Domestic, plus foreign-currency outlays and debt service <sup>d</sup>	
	(1)	(2)	(3)	(4)	(5)
1964-66	9	10	6	6	5
1967	16	17	10	10	8
1968-69	17	19	12	12	8
1970	23	26	14	14	9
1971-72	19	20	13	14	8
1973-75	27	31	17	19	11
1976-79	21	21	14	19	10
1980-81	21	21	14	18	10
1982-84	19	19	15	19	10
1982	20	21	16	20	10
1983	18	18	15	19	10
1984	20	18	15	20	10
1985-86	16	12	13	17	9
1985	19	14	13	19	9
1986	14	10	12	16	9

<sup>a</sup> GNP plus unilateral transfers from abroad at the effective exchange rate; GNP data until 1979 are according to the old System of National Accounts definitions.

<sup>b</sup> Grants include the grant-equivalent of U.S. government defense loans. This is the difference between the loan proceeds and the present value of the repayments at the going market interest rate, here assumed to be 10 percent for 1964-77 and 12 percent for 1978. Since 1979 the grant-equivalent has been negligible (For details of the calculation, see Oded Liviatan, 'Israel's External Debt,' *Bank of Israel Economic Review*, No. 48-49 (May 1980), pp. 144 & ff.).

<sup>c</sup> Total domestic defense outlays less local sales of the defense establishment; does not include wages of soldiers in obligatory military service.

<sup>d</sup> Principal and interest on U.S. government defense loans.

SOURCE: Columns 1-3 and 5—Central Bureau of Statistics and Bank of Israel calculations; column 4—Budget Division of the Ministry of Finance and Bank of Israel calculations.

The first indicator measures defense consumption as a percentage of the economy's total resources (GNP plus unilateral transfers from abroad), and shows that the defense burden has eased considerably in 1986. The third indicator measures the

claim of direct defense demand on the GNP, and also points in the same direction, although less strongly than the first measure. The second indicator deducts the various grants received from abroad from total defense expenditure, and measures what part of the country's defense outlays is borne directly by Israeli residents. This measure also shows that the defense burden has become much lighter in 1986. The fourth indicator estimates the defense burden after deducting U.S. government grants, and the defense imports tied to them, from total defense expenditure. This measure sums domestic defense consumption, defense procurement abroad paid with foreign currency other than U.S. grant funds, and the servicing of foreign debts incurred to finance defense expenditure, including U.S. government defense loans granted in the past. Since this measure is made up of several components which do not necessarily vary interdependently, it shows no clear change of trend in recent years. The steepest decline in this indicator since 1973 was recorded in 1986, but part of the decrease seems to be temporary.

The fifth indicator examines the burden imposed by defense outlays on the labor market. The fall of the defense sector's wage bill relative to that of the economy as a whole indicates that the upward pressure on the wage level stemming from the defense sector has weakened in 1986. It is noteworthy that since 1973 this ratio has been stable, at 10–11 percent, and declined to 9 percent only in 1986.

#### 4. THE GOVERNMENT BUDGET<sup>4</sup>

For an examination of how the government actually implemented its policy, budget data are preferable to data on the public sector as a whole (see Table V-7 and, for greater detail, Table 5-A2), for two reasons: first, because the public sector includes entities not completely under the control of the central government, which are therefore able to conduct a budgetary policy not entirely consistent with the government's programs; second, the budget data represent the planned path of expenditure and revenue for the fiscal year, while the data for the public sector are compiled for the calendar year.

The data on the implementation of the budget show that in fiscal 1986—the year in which the stabilization program was carried out—there was a sharp reversal of trend as regards the government deficit. The domestic deficit was reduced to some half a

<sup>4</sup> The budget data are for the central government alone; other parts of this chapter refer to the public sector as a whole, which in addition to the central government, includes the local authorities, the National Institutions and the public-service private nonprofit institutions.

**Table V-5**  
**TAXES, SUBSIDIES AND TRANSFER PAYMENTS, 1980-86**  
 (Percent of GNP, current prices)

	1980-1985-		1980	1981	1982	1983	1984	1985	1986
	1984	1986							
<b>Net taxes (1-2-4)</b>	22.5	32.1	21.8	18.9	25.4	27.3	19.1	29.5	34.6
1. Total taxes and transfer payments by the public to the public sector	45.2	50.4	45.2	44.3	48.0	48.5	40.0	48.5	52.3
2. Total direct subsidies and transfer payments to the public	18.1	16.5	16.4	20.1	18.6	17.8	17.6	16.8	16.2
3. Net taxes, excluding credit subsidies	27.1	33.9	28.8	24.2	29.4	30.7	22.4	31.7	36.1
4. Imputed credit subsidies	4.6	1.8	7.0	5.3	4.0	3.4	3.3	2.2	1.5
<b>Net direct taxes (5-7)</b>	14.1	15.3	13.5	14.5	15.9	15.9	10.5	15.3	15.4
5. Direct taxes, compulsory loans and transfer payments by the public to the public sector	26.4	27.8	27.0	26.9	28.6	27.9	21.8	27.2	28.5
6. Thereof: Income tax	16.4	17.3	17.5	17.1	17.2	16.8	13.5	16.8	17.9
7. Transfer payments to the public	12.4	12.5	13.5	12.4	12.7	12.0	11.3	11.9	13.1
<b>Net taxes on domestic production (8-9-10)</b>	4.2	9.8	6.0	1.5	3.9	5.7	4.1	8.2	11.4
8. Indirect taxes on domestic production	11.2	14.2	12.3	10.8	10.9	11.6	10.6	13.6	14.9
9. Direct subsidies	4.4	2.7	2.7	6.3	4.4	3.9	4.7	3.5	2.0
10. Credit subsidies to business firms	2.6	1.7	3.7	3.0	2.6	2.1	1.9	1.9	1.5
<b>Net taxes on foreign trade</b>	4.7	7.0	3.5	3.5	5.8	6.0	4.6	6.1	7.8

SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

percent of GNP, instead of the deficit in the external account there was a surplus, and for the first time in many years their total, i.e. the overall government deficit, turned into a surplus of 2.5 percent of GNP.

The slowdown of inflation facilitated better management, control and implementation of the budget. Nevertheless, a supplementary budget increasing current expenditure by some 5 percent was submitted in the course of the year. A large part of this additional expenditure was due to higher government payments to the National Insurance Institute for benefits, and to make up for the cut in employers' contributions which was to lower labor costs to employers. On the other hand, there was an increase in current revenue that had not been foreseen when the original budget was submitted. As a result, no pressure was generated on other sources of financing the budget. The combined budget—the sum of the original budget and the supplementary

budget—shows an increase in the deficit. The Accountant-General's data, by contrast, show a surplus; it is therefore possible that the data on the implementation of the budget presented in Table V-7 for fiscal 1986/7 are upward biased on the revenue side and downward biased on the expenditure side.

Despite the supplementary budget, the deviation of the budget, as a percentage of GNP, from its actual implementation was small by comparison with previous years. This is true even for a detailed comparison of the various budget items. The large discrepancies between original budget and implementation in previous years were in part due to high inflation rates. The data for 1986 show that actual policy did not deviate materially from the outlines planned when the budget was submitted.

The government budget for 1987/88 foresees a total government deficit of more than 3 percent of GNP. This is a substantial increase, when contrasted with the surpluses achieved in the last two years, and is due primarily to the discontinuation of the U.S. emergency grant. The 1987/88 budget projects the continued reduction of domestic expenditure and the continued decline of tax revenue. Two thirds of the deficit are to be financed by public borrowing, and the remaining third—by loans from the Bank of Israel. As in the last two years, there is to be a further reduction of the foreign debt.

**Table V-6**  
**CENTRAL GOVERNMENT BUDGET, 1980/81-1987/88**  
(Percent of GNP, at current prices)

	1980/ 1981	1981/ 1982	1982/ 1983	1983/ 1984	1984/ 1985	1985/ 1986	1986/ 1987 <sup>a</sup>	1987/ 1988 <sup>b</sup>
<b>Total expenditure</b>	61.3	64.3	65.1	63.7	65.7	62.9	60.4	55.5
Thereof: Domestic expenditure	47.3	52.4	53.8	49.6	47.9	45.6	46.5	44.4
Expenditure abroad	14.0	11.8	11.3	14.1	17.8	17.3	13.9	11.1
<b>Total revenue</b>	51.5	50.1	50.2	51.9	48.7	62.7	60.1	52.1
Thereof: Domestic revenue	40.7	40.3	46.0	43.4	35.3	42.2	43.9	41.4
Foreign currency receipts	10.8	9.8	4.2	8.4	13.4	20.4	16.1	10.7
<b>Total deficit (-) or surplus</b>	-9.8	-14.1	-14.9	-11.8	-17.0	-0.3	-0.4	-3.4
Thereof: Domestic deficit	-6.6	-12.1	-7.8	-6.2	-12.6	-3.4	-2.6	-3.0
Foreign deficit	-3.2	-2.0	-7.1	-5.6	-4.4	3.1	2.2	-0.4
<b>Deficit finance, total</b>	9.8	14.1	14.9	11.8	17.0	0.3	0.4	3.4
Net borrowing from the public	7.2	9.3	3.0	0.2	7.5	3.9	1.8	2.3
Net borrowing from abroad	3.3	3.5	6.7	5.5	1.6	-1.0	-1.4	-1.2
Net borrowing from central bank	-0.8	1.4	5.3	6.2	7.9	-2.7	0.0	2.3

<sup>a</sup> Provisional data.

<sup>b</sup> At 1986/87 prices.

SOURCE: Based on Ministry of Finance data.