

## CHAPTER XX

# THE FINANCIAL ACTIVITIES OF THE GOVERNMENT

### 1. THE "BALANCE OF PAYMENTS" BETWEEN THE GOVERNMENT AND OTHER ECONOMIC SECTORS

This chapter analyzes the financial activities of the Government with respect to the monetary flows to and from other sectors, i.e. the public, the banking system and the rest of the world.

Government finances can be discussed from different aspects, each determining its appropriate framework. For the purpose of the present analysis, a "balance of payments" between the Government and the other economic sectors will be drawn up. This balance will include total government payments and receipts, deriving from current output, unrequited receipts and payments, the sale or purchase of assets created in the past and from transactions in financial assets<sup>1</sup>.

The activities included in this balance of payments may be timed either according to the date on which the service was rendered or the goods delivered, or according to the date on which payment for such goods or service was actually made. These two stages do not necessarily coincide. The second timing alternative, known as the "cash basis" is preferable, as the balance of payments deals with money flows.

For the purpose of analyzing the flow of money between the Government and other sectors, some adjustments have been made in the data furnished by the financial reports of the Accountant-General with the help of the cash books of this government office. The financial reports purport to show how the budget has actually been implemented. They are therefore constructed to correspond to the structure of the budget estimates, covering all sections and operations included therein. The reports of the Accountant-General are designed to compare the performance of operations during the period reviewed with those planned in the budget estimates. Therefore the recording of each transaction is timed according to the date of the actual implementation of the service or transfer of the goods concerned (the "adjusted cash" basis and not according to the date, when payment for the goods or service was in fact made. However, the adjustments made for the purpose of the present analysis, on the basis of

<sup>1</sup> Purchases of financial assets refer to grants of short-term and long-term loans as well as to debt redemption. Sales of financial assets refer to the receipt of long-term and short-term loans (both local and foreign) as well as to collections on account of loans granted in previous years.

the cash books, have not entailed any significant divergence between the figures shown and the corresponding data included in the Accountant-General's reports.

The balance of payments shown in table XX-1 lists on the payments side all disbursements on account of the Government's activities made during the period under review. These include payments by the Government in its capacity as a supplier of services, investor of capital, payer of transfer payments and purchaser of financial assets. Taxes, other obligatory payments, counterpart funds of unrequited receipts from abroad and sales of financial assets appear on the receipts side.

At this stage, the data shown mainly cover the activities of the Treasury. The activities of other ministries, in so far as they carried out separate financial transactions with the public, have not been included. Moreover, only if the coverage were extended to include the activities of the Local Authorities and public institutions, would it have been possible to analyze the financial relations between the whole public sector and the other sectors of the economy.

These data refer to the first nine months of the fiscal year 1956/57. As comparable data for earlier periods are not available, no comparison could be made between the developments of the period under review and the preceding years.

According to table XX-1, Treasury payments amounted to about IL.770 million during the period under review. Of these payments, nearly IL.600 million—approximately 80 per cent—mainly related to transfer payments and to transactions in goods and services. The remaining 20 per cent, represented financial operations—mostly debt redemption and the granting of loans within the framework of the Development Budget.

The breakdown of the resources available to the Government according to their various uses, shows that 66 per cent of Government payments went to consumption (including defence) and current transfer payments, about 29 per cent to various investment activities, and the remaining 5 per cent (i.e. about IL.41 million) were applied to debt redemption and the granting of short-term advances. Direct investments in capital assets within the framework of the Development Budget and investments in stocks, represented less than half of all investment operations. The remaining investment operations covered the granting of loans, i.e. the acquisition of financial assets. It must be stressed that it is difficult to make a clear distinction between direct Government investment and loans, because certain loans granted within the framework of the Development Budget have been given either to companies in which the Government is an influential shareholder, or to other bodies belonging to the public sector. Debt redemption included payments of IL.27 million on account of long-term loans and IL.14 million on account of short-term loans and advances. The latter figure represents the difference between the sums repaid to local suppliers on account of current debts incurred during the preceding year on the one hand, and, the short-term liabilities which the Treasury incurred with these suppliers

**TABLE XX-1**  
*The Balance of Payments of the Government, April-December 1956*  
*(in IL. millions and in per cent)*

	<i>IL.</i> <i>millions</i>	<i>Per</i> <i>cent</i>		<i>IL.</i> <i>millions</i>	<i>Per</i> <i>cent</i>
<i>Transfers and Transactions in Goods and Services</i> <i>(on current and capital account)</i>					
<b>RECEIPTS</b>			<b>PAYMENTS</b>		
1. Revenue from Taxes and Other Obligatory Payments <sup>a</sup>	414.8	53.8	3. Current Payments for Goods and Services	450.7	58.4
2. Unrequited Receipts from Abroad <sup>b</sup>	111.7	14.5	4. Transfer Payments and Subsidies	58.9	7.6
	<u>526.5</u>	<u>68.3</u>	5. Payments on Capital Account for Goods and Services	85.9	11.2
				<u>595.5</u>	<u>77.2</u>
<i>Transactions in Financial Assets</i>					
<i>With the Rest of the World</i>			<i>With the Rest of the World</i>		
6. Long-Term Loans	89.3	11.6	11. Redemption of Long-Term Debts	20.6	2.7
7. Short-Term Loans (Net)	30.4	3.9	<i>With the Public</i>		
<i>With the Public</i>			12. Development Budget Loans	135.0	17.5
8. Long-Term Loans <sup>c</sup>	26.2	3.4	13. Payments of Long-Term Debts	6.2	0.8
9. Collections on account of Loans	14.8	1.9	14. Payments of Short-Term Debts and Advances (Net)	14.2	1.8
<i>With the Banking System</i>					
10. Short-Term Loans (Net) <sup>d</sup>	84.3	10.9			
	<u>245.0</u>	<u>31.7</u>		<u>176.0</u>	<u>22.8</u>
15. <i>Total Receipts</i>	771.5	100.0	16. <i>Total Payments</i>	771.5	100.0

<sup>a</sup> Includes taxes on income, expenditure and on licences, fees, collections on account of interest, as well as Treasury income from national insurance, war risk insurance, the Development Authority, equalisation funds and institutions (on account of exchange rate differentials).

<sup>b</sup> IL.33.9 million from the U.S. Government's Grant-in-Aid were given in the form of long-term loans repayable in Israel currency and are therefore included under "Long-Term Loans from Abroad".

<sup>c</sup> This amount may also include Government securities remaining with the banks as final purchasers.

<sup>d</sup> Includes the cash deficit with the banking system, and also reflects changes in Government deposits with the banking institutions and the Bank of Israel. By virtue of a law passed in March, 1957, IL.65 million of this amount were converted into a long-term loan from the Bank of Israel.

SOURCE: The Accountant-General, Ministry of Finance.

during the period under review, on the other hand. It also includes advances paid to the public.

The following breakdown shows the financing of Government payments during the first nine months of the fiscal year 1956/57: revenue from taxes covered slightly more than 50 per cent, receipts from the counterpart funds of the Grant-in-Aid and Reparations represented about 15 per cent, short and long-term loans amounted to slightly over 30 per cent. The distinction between financial resources of foreign and local origin shows that 70 per cent of Government activities were financed by internal resources. The Treasury received IL.245 million in the form of loans; about half of this amount came from abroad, while the other half was provided by the public and by local banks. The same ratio existed between long and short-term loans.

Hereunder, an attempt will be made to analyze, on the basis of the data contained in table XX-1, the influence of the financial activities of the Government on the market of goods and services and the influence of the Government, in its capacity as purchaser and supplier of services, on aggregate demand as well as the relation between the latter and the national product. On the one hand, the Government appears as a buyer of services rendered by those working for it, or as a purchaser of goods sold by producers and other suppliers. The total sum of these purchases represents the Government's effective demand, which constitutes a considerable proportion of the entire effective demand of the economy. On the other hand, the Government supplies the public with various services—not necessarily against payment—ranging from education to defence; it collects, however, taxes and other obligatory payments from the public. Thus, resources which otherwise would have been available to other sectors of the economy are transferred to the Government; the monetary demand of these sectors is thereby directly reduced<sup>2</sup>. As long as total current transfers from the public to the Government are equal to the total amount spent by the Government on purchases, the resources released through the reduction in the demand of the public are sufficient to meet Government demand. However, when such expenditures exceed these revenues, the Government has to resort to other sources of finance. This difference represents an excess of local demand over domestic output.

The following calculation, based on table XX-1, shows that during the period under review the Government required supplementary financial means in order to pay for purchases effected during April–December 1956. Accordingly, Government expenditure exceeded current revenue by IL.181 million during that period:

<sup>2</sup> Expenditure on transfers and subsidies must be deducted from "Government Revenue from Taxes and Other Obligatory Payments" in order to obtain the correct value of the resources transferred to the government.

Government Payments for Purchases on Capital Account and on Current Account (3+5)	IL. 536.6 million
less: Current Transfers from the Public to the Govern- ment (1-4)	IL. 355.9 million
	IL. 180.7 million

It must be stressed that the above result is incomplete, because the present analysis considers all loans granted by the Government, including loans within the framework of the Development Budget, as funds supplied for the financing of the demand of other sectors of the economy. In fact, under the circumstances prevailing in Israel, the dividing line between the Government's direct investments and loans or grants destined for development purposes is likely to vacillate from year to year. Some of the loans given to public institutions during the current period may at a later stage be converted into grants, while the distinction between Government and non-Government companies is often temporary and liable to change. There can, therefore, be no doubt that some of the above loans actually represent Government demand for goods and services and, only if the amount of such demand were known, would it be possible to include it with Government purchases on capital account, i.e. with Government demand.

In a closed economy which does not trade with other countries, local effective demand must *ex post* equal local output, every sale being simultaneously also a purchase. Under these circumstances, Government expenditure can exceed revenue from current transfers only if non-governmental sectors save, thereby releasing additional resources designed to meet excess expenditure. However, in the case of an economy trading with foreign countries, aggregate effective demand can be greater than the national product. This situation can, however, only prevail over a longer period if there is an inflow of capital, i.e. when there is a deficit in the current account of the balance of payments with the rest of the world.

This, in fact, corresponds to the situation in Israel, where the current deficit in the balance of payments with the rest of the world finances the effective surplus demand of all domestic economic sectors. As long as surplus demand is not higher than the anticipated volume of capital imports, the tendency of the local economy to create an excess of demand over supply does not result in a rising price level. In the event of a decline of capital imports, however, the volume of Government activities or the expenditure of non-governmental sectors will have to be curtailed in order to prevent a sharp upward trend of the price level.

So far, this analysis has been devoted to the relations between economic sectors and their respective influence on the price level as reflected by the intersectoral flow of goods and services. These interrelations can also be expressed

by the monetary flows between the different economic sectors, in analyzing the influence of Government activities and their financing upon the money supply available to the public. This influence is of material importance, as the relation between the money supply available to the public (i.e. cash and demand deposits) and the value of transactions effected during the same period influences the average price level of the economy.

The money supply is affected by the Government in two opposite ways. On the one hand, it withdraws funds from non-governmental sectors by means of taxes, loans and other collections. On the other hand, the Government remunerates the public for work done, pays interest for the use of capital and the market price for assets purchased and furthermore grants loans and repays debts. In so far as the total sum of money received by the Government from the public is equal to the amount of money paid, its activities have no effect on the quantity of money held by the public. If, however, payments to the public exceed receipts, Government operations leave a greater quantity of money in the hands of the public. The difference between the total sum of Government payments to the public and its receipts therefrom means that Government receipts from the local banking system or from foreign banks exceed payments made to these sectors. That is to say, that the surplus of Government payments over revenue from the public is financed by net income in local currency obtained by the conversion of foreign currency and by local currency loans from the domestic banking system<sup>3</sup>.

No breakdown of the Government's domestic and foreign purchases has so far been available. At this stage it is therefore not possible to determine accurately the relationship between the flow of payments and receipts from and to the Government. It is only possible to compare the extent of Government indebtedness to each of the three other sectors: the public, the domestic banking system and the rest of the world. This comparison may serve as an indicator of the Government's influence upon the quantity of money held by the public, not only by virtue of the credits received by the Government from the domestic banking system, but also as a result of its financial relations with foreign countries.

Table XX-1 shows that the increase in the governments net indebtedness with foreign countries and with the banking system amounted to IL.99 million and IL.84 million respectively. The sum of all loans which the Government granted to the public and those received from it shows, that the public's net indebtedness with the Government increased by approximately IL.114

<sup>3</sup> Were it not for the "Rest of the World" sector, the surplus of payments to the public over receipts therefrom would be equal to Government borrowing from the domestic banking system, and, identical with the net increase in the money supply resulting from the increase in credit granted to the Government. When, however, the economy is trading with the rest of the world, and payments to abroad exceed external receipts, the increase in the money supply held by the public, resulting from Government activities, is partly offset by the excess of the public's payments to the rest of the world over its receipts from abroad.

million. This amount is the balance of all transactions in financial assets effected between the Government and the public, including loans granted from the Development budget, the redemption of Government debts, as well as payments of advances to the public, on the one hand and, loans obtained from the public, including collections on account of the public's debts to the Government, on the other hand. As regards short-term borrowing and advances, it should be noted that the Government reduced its liabilities (mainly outstanding debts to suppliers) during the period under review, while advances granted to the public amounted to a net total of IL.14 million.

## 2. FISCAL REVENUE

Table XX-2 shows the fiscal revenue of the Government for the months April-December 1956, as compared with the corresponding months of 1955 and the fiscal year 1955/56. This comparison indicates a 35 per cent increase, in absolute figures, for the period under review as compared with the corresponding period of the preceding year—each separate item of revenue showing an absolute increase. There was, however, no significant change in the relative shares of the various items of revenue. The slight variations in the proportion of individual revenue items as compared with total revenue were due to the introduction of the "Defence Tax", superimposed on the existing fiscal framework, which otherwise remained substantially unchanged.

The "Defence Tax" was imposed both on income and on expenditure and represented 10 per cent (including contributions to the Defence Fund) of total tax revenue during the period under review. Eighty-three per cent of total "Defence Tax" receipts came from direct levies on income and from voluntary contributions, which resulted in a proportionate increase in the weight of taxes on income and a corresponding decline in that of taxes on expenditure. In spite of this, total revenue from taxes on expenditure was still somewhat higher than that from taxes on income. This does not apply to customs duties; in spite of the fact that tariffs were raised, the relative weight of customs duties remained unchanged as the Defence Tax was not imposed thereon.

Normally, revenue from taxes on income tends to increase during the last quarter of the financial year when collections are accelerated, while taxes on expenditure are distributed more evenly over the whole year. It may, therefore, be assumed that the weight of income taxes will have increased by the end of the fiscal year 1956/57; the relative weights of the various tax items for the first three quarters reviewed are not comparable to those of the corresponding periods of 1955, but are closer to the relative weights of the whole preceding fiscal year.

A law amending the Income Tax Ordinance as from 1957/58 was approved by the Knesset and came into force on the 1st of April, 1957. This amendment is designed to correct certain deficiencies of the former system. The main revision

**TABLE XX-2**  
**Fiscal Revenue, April-March 1955/1956 and April-December 1955 and 1956**  
*(in IL. millions and in per cent)*

	April 1955 to March 1956 (A)		April-December 1955 (B)		April-December 1956 (C)		Increase of (C) over (B) (D)	
	IL. millions	per cent	IL. millions	per cent	IL. millions	per cent	IL. millions	per cent
<i>Total Fiscal Revenue</i>	466.6	100.0	299.3	100.0	405.4	100.0	106.1	35.4
Taxes on Income	176.3	37.8	108.0	36.1	151.4	37.3	43.4	40.2
Income Tax	171.8	36.8	105.5	35.2	148.4	36.6	42.9	40.7
Property Tax, Land Appreciation Tax and Inheritance Tax	4.5	1.0	2.5	0.8	3.0	0.7	0.5	20.0
Taxes on Expenditure <sup>a</sup>	190.2	40.8	132.4	44.3	164.1	40.5	31.7	23.9
Customs Duties	65.0	13.9	42.3	14.1	57.0	14.1	14.7	34.8
Fuel Duty	33.3	7.1	24.5	8.2	26.0	6.4	1.5	6.1
Excise Duties	47.2	10.1	34.0	11.4	41.7	10.3	7.7	22.6
Purchase Tax	35.1	7.5	24.8	8.3	29.0	7.2	4.2	16.0
Other Taxes on Expenditure	9.6	2.1	6.8	2.3	10.4	2.6	3.6	52.9
Licence and Service Fees	15.5	3.3	10.0	3.3	13.2	3.3	3.2	32.0
<i>Total Taxes<sup>b</sup></i>	382.0	81.9	250.4	83.7	328.7	81.1	78.3	31.3
Collections on Account of Interest and Other Income	30.7	6.6	18.4	6.1	24.6	6.1	6.2	33.7
Other Obligatory Payments	53.9	11.6	30.5	10.2	52.1	12.9	21.6	70.8
Revenue from Subsidies <sup>c</sup>	17.4	3.7	6.5	2.2	17.6	4.3	11.1	170.8
Revenue from the Development Authority, War-Risk Insur- ance, and National Insurance	36.5	7.8	24.0	8.0	34.5	8.5	10.5	43.8

<sup>a</sup> Does not include surpluses from government enterprises.

<sup>b</sup> Includes collections of "Defence Tax" and contributions to the "Defence Fund", which were imposed both on income and on expenditure.

<sup>c</sup> Income from Exchange Equalization Funds and from Institutions, on account of exchange rate differentials.

is the substitution of the exemptions and allowances system for the former system of tax credits. The tax rates have also been revised. The system of personal exemptions and allowances, which is applied in most countries with a highly developed fiscal structure, affords a simplification of the tax structure and thus facilitates payment and collection. It also moderates the steep progression of tax rates, which hitherto reached a marginal rate of 70 per cent on incomes of IL.5,400 per annum.

The new rates reduce the tax burden of persons with large families and of those earning IL.6,000 per annum or more; they weigh more heavily on single persons and childless families whose income is below this figure. The former system, which consisted of an agglomeration of features derived both from the allowance and tax credit system, in effect afforded excessive concessions to small families. There was also some apprehension that it might have acted as a deterrent to increased productivity and higher earnings.

Other amendments to the Income Tax Ordinance were designed to achieve greater tax equality between wage earners and independent earners. Changes were also introduced in the rates of the "Defence Tax"—now being collected together with income tax; these rates now range from 4 to 11.5 per cent of taxable income.