

## Chapter 5

# The Public Sector

*In 1995, for the first time since the Budget Deficit Reduction Law was passed in 1992, the government's domestic deficit rose above its target. The total public-sector deficit rose from 2.3 percent to 3.4 percent of GNP, reflecting mainly a reduced share of tax revenues. Expansionary fiscal policy was the main cause of the lower share of savings in total income, and hence of the increase in the current-account balance of payments deficit which occurred in the same year that Israel's terms of trade deteriorated. In the context of the deviation from the deficit target—which detracted from the success achieved regarding growth, inflation, and unemployment—a more determined approach is needed to return fiscal policy to the path of deficit reduction. The tax burden fell in 1995, but this may be only temporary, as there are no clear indications that the long-term process of reducing the share of public expenditure in GNP will persist. A breakdown of the various components of the public sector deficit up to 1994 shows that the deficit of the local authorities remained at its high level of the previous year.*

### 1. MAIN DEVELOPMENTS<sup>1</sup>

For the first time since the Budget Deficit Reduction Law was introduced in 1992, the government's domestic deficit was higher than the maximum 2.75 percent of GNP, and reached 3.45 percent. The total public-sector deficit rose from 2.3 percent of GNP to 3.4 percent, reflecting mainly a fall in the share of income (including health service payments, Table 5.1). Although the volume rise in domestic demand was lower than its average during the years of mass immigration from the CIS, the combination of this increase—particularly civilian labor input—steep wage hikes, and a lower net tax rate was the main reason for the reduced share of national savings in total income. The fall in savings and the higher share of investment led to a deterioration in the current-account balance of payments—a decline of 1.2 percent of total available income.

Although budget cuts decided on during the year helped prevent actual expenditure from exceeding the planned levels, the deficit surpassed the legal maximum because

<sup>1</sup> The following changes have been introduced this year: nominal interest on government bonds has been replaced by real interest, and the debt of the local authorities has been included in the net public-sector debt. The \$0.9 billion of aid from the US has been included in the analysis, although for technical reasons this was not received until the beginning of 1996.

<b>Table 5.1</b> <b>The Public Sector: Receipts, Expenditure, and Deficit, 1981-95<sup>a</sup></b>							
	(percent of GNP)						
	1981-85	1986-90	1991-95	1992	1993	1994	1995
							NIS million <sup>b</sup>
							1995
<b>Receipts</b>							
Internal	49.5	48.7	46.4	45.9	46.2	47.0	47.7
External	14.1	10.8	6.9	7.9	7.0	5.4	4.9
Total	63.7	59.5	53.3	53.8	53.2	52.5	52.6
Total receipts <i>plus</i> health service payments <sup>b,c</sup>				55.4	54.8	54.1	52.6
<b>Expenditure</b>							
Internal	62.4	53.5	52.1	53.3	51.4	50.3	52.1
External	11.5	8.0	4.9	4.6	5.4	4.5	3.9
Total	74.0	61.4	56.9	57.9	56.8	54.8	56.0
<i>of which</i> Effect of Health Law							1.5
<b>Surplus(+)/deficit(-)</b>							3,900
Internal	-12.9	-4.8	-5.7	-7.4	-5.2	-3.3	-4.4
External	2.6	2.8	2.1	3.3	1.6	1.0	1.0
Total	-10.3	-2.0	-3.6	-4.1	-3.5	-2.3	-3.4
<b>Financing of surplus(+)/deficit(-)</b>							
External net borrowing				1.8	-2.7	4.5	-3.8
Change in monetary base				0.5	1.0	0.9	-0.3
Domestic net borrowing				-1.8	1.7	0.0	6.7
Via government				1.8	2.4	0.5	3.3
<i>of which</i> Sale of assets				0.8	1.7	0.3	0.4
Via Bank of Israel				-3.6	-0.7	-0.5	3.4
Residual <sup>d</sup>				3.5	3.5	-3.2	0.8
Total				4.1	3.5	2.3	3.4
<b>Net public debt/GDP ratio<sup>d,e</sup></b>							
Internal				83	81	75	75
External				21	21	20	17
Total				104	102	95	92

198,524  
45,009  
243,532

<sup>a</sup> The public sector includes the central government, the Bank of Israel, the National Insurance Institute, National Institutions, local authorities, and public nonprofit associations.

<sup>b</sup> In all tables, health service payments refer to the public's payments to the four health funds.

<sup>c</sup> The financing of the public deficit is not fully explained by the items listed because the deficit is calculated according to the statistical (CBS) criteria rather than on a cash basis, and does not include non-government entities (primarily the local authorities).

<sup>d</sup> Internal public debt including local authorities—total end-of-year net liabilities of the government, the Bank of Israel, and local authorities; excluding 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).

<sup>e</sup>At end-of-year prices.

SOURCE: Based on Central Bureau of Statistics data.

**Table 5.2****The Public Sector: Receipts and Expenditure, Current and Capital Accounts, 1992-95**

(percent of GNP)

	1992	1993	1994	1995	NIS million <sup>a</sup> 1995
<b>RECEIPTS</b>					
<b>Current receipts</b>					
From property	2.4	1.7	1.4	2.1	5,350
<i>of which</i> Interest from abroad	1.0	0.6	0.3	0.7	1,890
Current-account transfers from the public	1.5	1.4	1.6	1.7	4,345
Indirect taxes					
On domestic production	15.1	14.3	14.0	14.3	36,738
On civilian imports	6.2	5.8	5.7	5.6	14,474
Direct taxes, fees, and levies	13.1	14.2	15.5	15.0	38,534
National Insurance income	4.7	4.7	4.8	5.8	14,958
Intergovernmental transfers	5.7	5.3	4.1	3.2	8,174
Unilateral transfers to National Institutions <sup>b</sup>	0.9	0.9	0.8	0.8	2,029
<b>Total current receipts</b>	<b>49.6</b>	<b>48.4</b>	<b>47.8</b>	<b>48.5</b>	<b>124,602</b>
<b>Capital receipts</b>					
Capital-account transfers to the public	2.4	3.1	3.1	2.6	6,698
Public-sector depreciation	1.5	1.4	1.3	1.3	3,413
Capital transfers from abroad	0.3	0.3	0.2	0.2	577
<b>Total capital receipts</b>	<b>4.2</b>	<b>4.8</b>	<b>4.7</b>	<b>4.2</b>	<b>10,688</b>
<b>Total receipts</b>	<b>53.8</b>	<b>53.2</b>	<b>52.5</b>	<b>52.6</b>	<b>135,290</b>
<b>Total receipts including health service payments</b>	<b>55.4</b>	<b>54.8</b>	<b>54.1</b>	<b>52.6</b>	<b>135,290</b>

<b>EXPENDITURE</b>					
<b>Current expenditure</b>					
Domestic consumption <sup>c</sup>	26.0	25.1	25.7	27.7	71,185
<i>of which Effects of Health Law</i>				1.5	3,900
Defense imports <sup>d</sup>	2.2	2.9	2.1	1.5	3,862
Domestic interest	5.7	5.6	5.2	5.4	13,838
Interest abroad	2.1	2.1	2.1	2.0	5,114
Subsidies	3.1	2.6	2.4	1.9	5,014
Current transfers (gross)	11.3	11.5	11.4	12.0	30,967
<b>Total current expenditure</b>	<b>50.5</b>	<b>49.8</b>	<b>48.7</b>	<b>50.5</b>	<b>129,980</b>
<b>Capital expenditure</b>					
Investment	3.6	3.9	3.9	3.7	9,424
Capital transfers	3.7	2.7	2.0	1.8	4,545
Repayment of compulsory loans	0.1	0.4	0.2	0.1	155
<b>Total capital expenditure</b>	<b>7.4</b>	<b>7.0</b>	<b>6.0</b>	<b>5.5</b>	<b>14,124</b>
<b>Total expenditure</b>	<b>57.9</b>	<b>56.8</b>	<b>54.8</b>	<b>56.0</b>	<b>144,104</b>
Surplus (+)/Deficit (-)	-0.9	-1.3	-0.9	-2.1	(5,378)
Current account (net savings)	0.6	0.1	0.4	-0.8	(1,965)
Gross savings	-4.1	-3.5	-2.3	-3.4	(8,814)
Current + capital accounts	<b>55.4</b>	<b>54.8</b>	<b>54.1</b>	<b>52.6</b>	<b>135,290</b>
<sup>a</sup> At current prices.					
<sup>b</sup> The Jewish Agency and public nonprofit institutions.					
<sup>c</sup> Including non-classified items.					
<sup>d</sup> Including advance payments, excluding taxes.					

revenues received fell below the budgeted amount. The supplementary budget presented in 1994, based on the exceptional revenues of that year, appears to have had an expansionary effect on the deficit in 1995. The fact that the deficit exceeded the target just when the economy was faced with a deterioration in the terms of trade detracted from the achievements in the fields of growth, inflation, and unemployment. Taking into account the possibility that the deterioration in the terms of trade may not be corrected, the deviation from the deficit target requires fiscal policy to reflect greater determination to return the economy to the desired path, in particular that of a declining deficit.

The tax burden fell in 1995 (see Table 5.3), partly because some receipts were delayed until 1996 due to difficulties in the initial implementation of the National Health Law. At present it does not seem likely that the decline in the tax burden will be permanent, as the 0.5 percentage point increase in the share of public consumption in GNP (excluding the effect of the Health Law, Table 5.2)<sup>2</sup> raises doubts about the ability of the public sector to maintain the downward trend in the share of public expenditure in GNP. This share rose—for the first time since 1984—in 1995.

Public-sector domestic demand rose by 2.4 percent in 1995, with its (imputed) price soaring by 15.2 percent, due mainly to public-sector wage increases. Unlike in 1994, when the rise in public-sector wages presaged the acceleration of private consumption, in 1995 other factors seem to have compensated for this effect. The lower net tax rates had only a partial effect on consumption, possibly because they were perceived as temporary. The volume increase in demand reflects a rise of 3.9 percent in labor input, slightly higher than the average rate (3.7 percent) during the years of the influx of immigrants (1990–94), following a steeper rise in 1994.

The net public debt/GNP ratio fell by 3 percentage points in 1995, with its components developing at different rates. After many years in which the internal debt/GNP ratio declined, it stabilized in 1995, whereas the external debt fell. This reflects the change in the financing of the deficit (Table 5.1)—financing via domestic bonds rose, and net overseas loans fell.

Table 5.5 shows that in the allocation of public resources, the share of defense expenditure in GNP fell again, due to the decline in the proportion of defense imports. Nevertheless, it is doubtful whether this downward trend can continue, since the defense burden index, which summarizes the share of own sources devoted to defense, rose slightly. This stemmed mainly from wage increases in the defense industry in 1994–95, raising the cost of labor input in defense by 23 percent, compared with a rise of 16.5 percent in the civilian sector. Public resources set aside for health and education also rose significantly in 1994–95, by 0.7 percent of GNP (adjusted for the effect of the Health

<sup>2</sup> Due to the Health Law, there was a switch of 1.5 percent of GNP between private and public consumption (excluding the increase in demand resulting from the expected addition of some 300,000 new insured persons). Hence, throughout this chapter and for purposes of macroeconomic analysis we refer to the share of public expenditure and to volume changes adjusted for this effect. To enable comparison of the tax burden, the public's payments to the health funds (health service payments) in previous years have been added.

**Table 5.3****Exceptional Tax Receipts, 1992-95<sup>a</sup>**

	(percent of GNP)			
	1992	1993	1994	1995
Exceptional tax receipts <sup>b</sup>	-0.8	0.1	1.0	0.5
Share of tax plus health service payment, excluding exceptional receipts	42.1	41.4	41.7	41.3
Receipts due to growth of over 4 percent				
NIS million	1,806	-449	2,280	3,246
Percent of GNP	1.1	-0.2	1.0	1.2

<sup>a</sup> The calculation of exceptional receipts from corporation tax is based on the difference between receipts in 1995 and the amount which would have been received if a long-term average tax rate had been applied, the base of the tax being net capital yield. Property tax is included in the share of tax (Table 5.10). Receipts from a growth rate of over 4 percent (the approximate average growth rate over the last twenty years) are calculated as GNP growth *minus* 4 percent, assuming a unitary elasticity of total tax receipts.

<sup>b</sup> Mainly from corporation tax.

Law). Most of the increase relates to improved conditions for those employed in these sectors.

The share of public-sector investments in GNP fell slightly in 1995, as the rate of increase of investment in roads slowed after rising rapidly in recent years. The fact that a high level of investment was maintained narrowed the gap caused by underinvestment in this area in the past. Current transfer payments rose by about half a percentage point of GNP, continuing their long-term trend. By contrast, direct intervention by the government in the business sector has fallen in recent years, in particular transfer payments on the capital account. Government-initiated construction rose significantly in 1995, due to the policy of making building land more readily available.

Per capita public consumption followed the upward trend which has prevailed since 1991, despite the reduced share in the population of those up to 24 or over 65 years old (both inclusive) which serves as a partial indicator of the incremental needs of the civilian population. This may be due partly to the lag created during the influx of immigration and the steady rise in demand for public services with increased national income. The share of public-services employees in total civilian employment was unchanged.

The lower tax burden in 1995 was the result of a reduction (of 1 percentage point of GNP) in direct taxes, which stemmed from a decline in exceptional corporation tax receipts from their level in 1994, and a fall in National Insurance receipts following a change in legislation. The share in GNP of indirect taxes on domestic production rose slightly, while that of taxes on civilian imports was stable. This may indicate a resumption of the upward trend in the share of indirect taxes in total taxes following two years in which the trend was reversed (Figure 5.4). This seems to suggest a regressive effect on income distribution, as the usual assumption is that direct taxes are

**Table 5.4****The Budget Deficit and the Law, 1992-96**

	(percent of GNP)					
	1992	1993	1994	1995	1996	From 1997
Maximum domestic deficit according to law	6.2	3.2	3.0	2.75	2.5	declining
Actual deficit	4.9	2.4	2.0	3.45 <sup>a</sup>		
Public-sector domestic deficit	7.4	5.2	3.3	4.4		
Total public-sector deficit	4.1	3.5	2.3	3.4		
Deviation from maximum	-1.3	-0.8	-1.0	0.7		
Receipts	-4.7	2.4	2.6	-1.6		
Expenditure	-6.0	1.6	1.6	-0.9		

<sup>a</sup> Estimate, cash basis. This is apparently an underestimate, due to the technical postponement of some expenditure and tax rebates to the 1996 fiscal year.

more progressive than indirect taxes, but since the new legislation made taxes more progressive, it cannot be determined in which direction the tax changes affected income distribution. The rise in current transfer payments to households, which incorporated all categories of National Insurance recipients, had a progressive influence in 1995. All these developments occurred in the context of data published regarding income inequality in 1994, which indicate that it rose significantly.

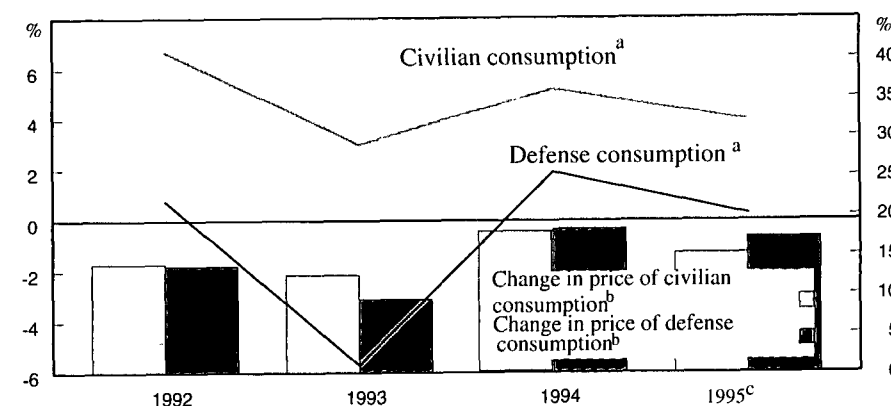
## 2. FISCAL POLICY

Per capita economic growth, which started in 1994, continued and unemployment fell to 6.3 percent of the civilian labor force, its lowest level for years. The Consumer Price Index (CPI) rose more slowly, and inflation was at the lower end of its 8-11 percent target range for 1995. These positive developments were to some extent offset by the rise in the balance-of-payments deficit from 3 percent of total income in 1994 to 4.2 percent in 1995 (from 3.4 percent of GNP to 4.8 percent), with a significant deterioration in the terms of trade. The rise in the deficit resulted from a 1.1 percentage point decline in public-sector savings, and a 0.6 percentage point increase in the share of investment, partly offset by an increase of 0.4 percentage points in private savings. For the first time since the Budget Deficit Reduction Law was passed in 1992, the domestic budget deficit exceeded the target set by the law.

An analysis of the short-term effect of fiscal policy shows that the rise in public-sector domestic demand was below the 4 percent annual average during the period of large-scale immigration, but the combination of the rise in demand (mainly civilian labor input), wage increases in the public services, and the reduction in the net tax rate contributed to the decline of the share of savings in national income. These effects were



**Figure 5.1**  
**Change in Price and Quantity of Domestic Public Consumption**  
**(Civilian and Defense), 1992-95**



<sup>a</sup> Left-hand scale.

<sup>b</sup> Right-hand scale.

<sup>c</sup> The change in quantity in 1995 has been adjusted for the effect of the Health Law

SOURCE: Central Bureau of Statistics

partly offset by an increase in private saving, the extent of this possibly being explained by the degree of permanence of the tax reduction. If the reduction were viewed as permanent, i.e., as part of the long-term decline of the share of public-sector expenditure in GDP, most of it would have been reflected in a fall in the national saving rate. Thus it seems that the lower tax was perceived as temporary,<sup>3</sup> since individuals used only part of it for consumption, the rest serving to increase private savings. The effect of wage increases appears to have been stronger in 1994, when employees in the public services obtained a rise in their permanent income based on long-term wage agreements.

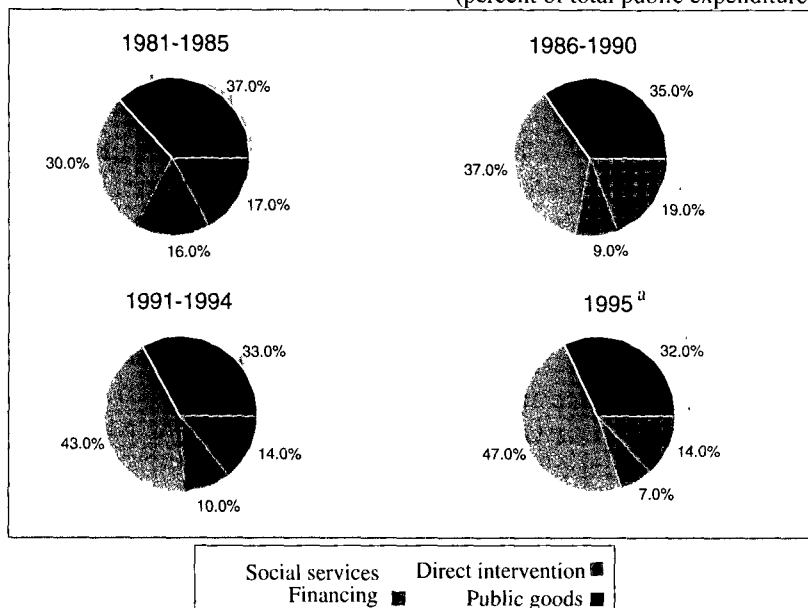
The deterioration in the basic account balance of payments (the current account balance of payments *less* long- and medium-term net capital imports), the significance of which is increased financing requirements in the short run, makes caution in formulating future policy essential, despite the fact that in 1995, too, accelerated growth led to a smaller net public debt/GDP ratio. The question of what is the optimum fiscal policy in the light of the exogenous deterioration of the terms of payment is crucial; if no corrective measures are taken, this development may overshadow economic performance for years to come. The situation which prevailed in 1995, with fiscal policy exacerbating the negative

<sup>3</sup> Evidence of the temporary nature of the reduction in the tax burden was provided at the beginning of 1996, when excise duty on petrol was raised for the first time in several years, with the express purpose of increasing receipts.

**Figure 5.2**

**Public Sector Expenditure, by Type of Intervention, 1981-95**

(percent of total public expenditure)



<sup>a</sup> Adjusted for the effect of the Health Law.

SOURCE: Based on Central Bureau of Statistics data.

exogenous effects on the balance of payments, cannot continue for long. Moreover, an opportunity was missed in 1995, since at a time of rapid growth and an impressive fall in unemployment, and even allowing for some rise in expenditure, its share in GNP could have been reduced, at a modest cost in terms of employment allocation, as the economy approached full employment.

The question is whether the decline in public saving is long-term, possibly having an adverse effect on the balance of payments for several years, or whether it is a passing phenomenon, especially in the context of the government's commitment to reduce the deficit. In order to answer this question, the components of the deficit, i.e., expenditure and income, must be analyzed separately.

As Table 5.2 shows, on the expenditure side the rise in the share of expenditure of the public sector resulted mainly from the increased proportion of domestic consumption in GNP. This was due to a volume increase of 2.7 percent in domestic consumption, and particularly to a rise of 15.9 percent in its implicit price (Table 5.7), far in excess of the

## **THE NATIONAL HEALTH LAW**

This law came into effect in 1995, substituting compulsory insurance for the voluntary insurance which had covered about 95 percent of Israeli residents, under conditions which varied from one health fund to another. The law grants a uniform basket of health services, according to the standard set by the General Health Fund. Some of the law's salient features are outlined below.

### **Adverse selection**

This world-wide problem in health care impairs the proper performance of health insurance. The insurance principal requires that resources are transferred from healthy to sick individuals. As a result of asymmetry in information on the state of health of the insured, only those with a high probability of becoming sick may join the system at given insurance prices. Thus in a competitive system, losses will be incurred, high insurance premiums will be charged, and/or there will be discrimination in favor of those with a low risk of sickness. The health law tackles the problem of adverse selection—which was recognized under the previous system, e.g., with a high concentration of the elderly being members of the General Health Fund—by instituting compulsory insurance and allowing free movement from one fund to another.

### **Government intervention**

The new law increased the extent of government intervention in the health system, and made the health funds more dependent on the government. The Ministry of Health was given wide powers, including supervision of the funds' expenditure, the distribution of money among them, and control of the quality of service. This raises a number of issues: first, regarding expenditure—the supervising body, in possession of incomplete information, may impair the efficient allocation of resources and cost control. Second, regarding the distribution of money, the formula used to determine allocations is of crucial importance (it is currently based mainly on the age of the insured). An incorrect formula may lead to losses in a fund and/or create discrimination among insured. Finally, it is difficult to define clearly parameters of a basic basket of health services, and this may harm the quality of service.

### **Progressiveness**

The method used to collect membership dues in the General Health Fund—which covered 64 percent of the population prior to the law's enactment—was regressive. The average rate fell as income grew. The law made contributions more progressive (see the section on direct taxes).

**Table 5.5****Public Sector Expenditure, by Type of Intervention, 1981-95**

(percent of GNP)

	1981-85	1986-90	1991-95	1992	1993	1994	1995
<b>Public goods</b>							
Defense	20.6	14.8	10.9	11.1	10.9	10.1	9.6
Administrative services <sup>a</sup>	4.7	4.4	4.1	4.1	3.9	4.0	4.3
Investment	2.3	2.5	3.7	3.6	3.9	3.9	3.7
Total	<b>27.7</b>	<b>21.7</b>	<b>18.7</b>	<b>18.7</b>	<b>18.7</b>	<b>18.0</b>	<b>17.5</b>
<b>Social services</b>							
Merit goods	13.2	12.3	13.8	13.2	13.4	13.8	15.6 (14.1) <sup>b</sup>
Education <sup>a</sup>	7.4	6.9	7.2	7.1	7.2	7.3	7.5
Health <sup>a</sup>	3.5	3.2	4.1	3.6	3.8	4.0	5.7 (4.2) <sup>b</sup>
Welfare <sup>a</sup>	2.3	2.3	2.5	2.5	2.5	2.5	2.5
Current transfers	8.8	10.5	11.3	11.1	11.2	11.2	11.7
Total	<b>22.0</b>	<b>22.8</b>	<b>25.1</b>	<b>24.3</b>	<b>24.7</b>	<b>25.0</b>	<b>27.4 (25.9)<sup>b</sup></b>
<b>Direct intervention</b> (business sector)							
Subsidies	4.5	1.9	2.0	2.3	2.1	2.0	1.7
Credit subsidy	3.5	1.0	0.3	0.3	0.3	0.2	0.1
Capital grants	2.1	1.4	2.7	3.7	2.7	2.0	1.8
Foreign trade subsidies	1.5	1.1	0.3	0.5	0.3	0.2	0.1
Total	<b>11.7</b>	<b>5.4</b>	<b>5.3</b>	<b>6.8</b>	<b>5.3</b>	<b>4.3</b>	<b>3.7</b>
<b>Financing outlays</b>							
Repayment of compulsory loans	0.6	1.0	0.2	0.1	0.4	0.2	0.1
Interest on public debt							
Internal	7.7	7.0	5.6	5.7	5.6	5.2	5.4
External	4.6	3.6	2.1	2.1	2.1	2.1	2.0
Total	<b>12.9</b>	<b>11.6</b>	<b>7.9</b>	<b>8.0</b>	<b>8.1</b>	<b>7.5</b>	<b>7.4</b>

<sup>a</sup> Estimated from the public-sector consumption figures and nonprofit associations (civilian services); the figures for 1988-95 are estimates, based on the appropriate Labour Force Surveys.

<sup>b</sup> Excluding the effect of the Health Law (see note 2 in text).

SOURCE: Based on Central Bureau of Statistics data.

9.3 percent increase in the implicit price of GDP. As these items continue to push the level of public-sector expenditure upwards, this threatens the long-term process of reducing the share of public-sector expenditure in GNP—an important source for increased national saving. In the short run, moreover, if GDP expands more slowly, the continuous increase in expenditure will lead to a further decline in the share of public-sector saving, since expenditure is relatively inelastic, whereas income depends on the expansion of economic activity.<sup>4</sup> Table 5.3 shows that in 1995 a share of income equivalent to 1.2 percent of GDP is explained by accelerated economic growth, assuming a long-term growth rate of 4 percent. Thus, the government must act with the utmost caution on the expenditure side to prevent any further deterioration in the saving rate.

On the income side, Table 5.3 shows that in 1994 exceptional corporation tax receipts amounted to about 1 percent of GNP, reflecting the economic activity of previous years, since tax calculations are based on the collection of advances based on profits in previous years. These receipts served to increase the basis of expenditure and the deficit in 1995 (see Table 5.4). To assess whether this effect is likely to persist, we try to analyze whether there were exceptional tax receipts in 1995, too, which do not reflect the yield on capital.

As the table shows, corporation tax receipts exceeded the amount which would have been expected from the yield on capital by 0.5 percent, even though they declined significantly in 1995. Thus here, too, it is vital that the implementation of the 1996 budget be observed with great care.<sup>5</sup>

Two issues require attention in connection with the tax burden: first, the addition of health service payments to past tax payments; second, an adjustment for exceptional tax receipts arising from the economic activity of previous years (corporation tax). Table 5.3 shows that the tax burden declined by 0.4 percent of GDP in 1995, the result mainly of changes in legislation regarding national insurance receipts. Some of the reduction, however, merely reflects the fact that some receipts were delayed to 1996 due to difficulties in collecting the health tax in the first year after the law was passed. Thus, the decline in the tax burden does not appear to be significant, indicating that the long-term process of reducing it is at a standstill. The economy requires this process to continue, since a high tax rate causes distortions, *inter alia* lowering its ability to compete in world markets.

In the first three years after the introduction of the Budget Deficit Reduction Law the government met the target, and was actually below it by an average of 1 percent of GDP; in 1995, however, the domestic deficit reached 3.45 percent of GDP, exceeding the 2.75 percent target. Table 5.4 compares planned and actual budget deficits. Deviations from

<sup>4</sup> When GNP expands more slowly, a rise in expenditure is reflected by its greater share in GDP while the tax/GNP ratio remains unchanged.

<sup>5</sup> Note that exceptional tax receipts will increase the future deficit only to the extent that they were not taken into account in the budget. Other factors may offset this effect, such as a recovery in capital yield, so that clearly these would have to be taken into consideration when examining budget developments.

**Table 5.6****The Public Sector: Composition of Receipts, Expenditure, and Deficit, 1990-94**

(percent of GNP)

	1990	1991	1992	1993	1994
<b>Receipts from the public</b>					
Government	43.1	43.5	43.5	42.9	42.4
National Insurance Institute	5.3	5.0	4.7	4.8	4.8
National Institutions	1.4	1.2	0.9	0.9	0.7
Local authorities	3.6	3.6	3.5	3.5	3.4
Public nonprofit associations	1.2	1.1	1.2	1.2	1.2
<b>Total</b>	<b>54.6</b>	<b>54.5</b>	<b>53.8</b>	<b>53.2</b>	<b>52.5</b>
<b>Expenditure on the public</b>					
Government	38.2	38.7	36.9	34.8	32.8
National Insurance Institute	7.3	6.9	7.1	7.5	7.4
National Institutions	1.3	1.2	1.0	0.9	0.8
Local authorities	6.3	6.6	6.7	7.2	7.4
Public nonprofit associations	6.3	6.0	6.2	6.3	6.3
<b>Total</b>	<b>59.4</b>	<b>59.3</b>	<b>57.9</b>	<b>56.8</b>	<b>54.8</b>
<b>Unilateral transfers to rest of public sector</b>					
Government	9.3	8.9	10.4	10.5	11.9
National Insurance Institute	-2.8	-2.4	-3.5	-3.5	-3.9
National Institutions	0.0	0.0	0.0	0.0	0.0
Local authorities	-1.7	-1.8	-2.0	-2.0	-2.4
Public nonprofit associations	-4.8	-4.7	-4.9	-5.0	-5.5
<b>Total</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Total deficit</b>					
Government	-4.4	-4.0	-3.8	-2.5	-2.3
National Insurance Institute	0.8	0.5	1.2	0.8	1.3
National Institutions	0.1	0.0	0.0	0.1	-0.2
Local authorities	-0.9	-1.2	-1.2	-1.8	-1.6
Public nonprofit associations	-0.3	-0.2	-0.2	-0.1	0.5
<b>Total</b>	<b>-4.8</b>	<b>-4.8</b>	<b>-4.1</b>	<b>-3.5</b>	<b>-2.3</b>
<b>Current account deficit</b>					
Government	-3.7	-1.8	-0.8	-0.7	-1.5
National Insurance Institute	0.8	0.5	1.2	0.8	1.3
National Institutions	-0.1	-0.1	-0.2	-0.1	-0.2
Local authorities	-0.5	-0.6	-0.6	-0.9	-0.7
Public nonprofit associations	-0.5	-0.5	-0.4	-0.3	0.3
<b>Total</b>	<b>-4.1</b>	<b>-2.5</b>	<b>-0.8</b>	<b>-1.3</b>	<b>-0.9</b>
<b>Capital account deficit</b>					
Government	-0.7	-2.2	-3.0	-1.7	-0.9
National Insurance Institute	0.0	0.0	0.0	0.0	0.0
National Institutions	0.2	0.1	0.1	0.2	0.1
Local authorities	-0.3	-0.5	-0.5	-0.8	-0.8
Public nonprofit associations	0.3	0.2	0.2	0.2	0.2
<b>Total</b>	<b>-0.6</b>	<b>-2.3</b>	<b>-3.2</b>	<b>-2.2</b>	<b>-1.4</b>

SOURCE: Central Bureau of Statistics.

the planned deficit in 1995 resulted mainly from the overestimation of income—particularly of corporation tax—in the original budget. The failure to take into account the transfer of tax revenues to the Palestinian Authority and changes in legislation also played a part. The submission of a supplementary budget in 1994, based on exceptional tax receipts in that year, appears to have been partly responsible for the failure to meet the target in 1995, because it added certain ongoing expenditure to the budgetary basis, although some of the receipts on which the budget was based were only temporary. The budget cuts decided upon during 1995—only some of which were effective—helped to curtail expenditure, thereby preventing the deficit from deviating even more widely from the target. Nonetheless, the fact that the government failed to meet the deficit target emphasizes the importance of correcting deviations from the budget, while updating the budgetary framework in light of information received during the year.

The net public debt/GDP ratio continued to fall in 1995, from 95 percent to 92 percent. Despite the increased deficit, which threatened this trend, the significant growth rate of 1995 enabled the decline in the ratio to persist. This was achieved by means of the external public debt, while the internal debt remained stable in terms of GDP, after falling for many years. These developments reflect trends in the financing of the deficit, including a reduction in net borrowing from abroad and a rise in domestic borrowing.

In 1995 the government determined the principles of the pension funds arrangement, guaranteeing terms of retirement, but discriminating between veterans and newly insured persons. This was done in the context of the considerable actuarial deficits in the funds which had resulted from the difference between their liabilities according to the conditions of retirement and contributions paid by insured persons. The principles adopted clearly express the government's obligation to cover the pension funds' deficits, and thus incorporate increased liabilities in the future, i.e., a permanent tax increase (the implications of the new arrangement for the capital market are discussed in Chapter 7).

### 3. PUBLIC-SECTOR DEMAND

Public-sector demand rose by a real 1.1 percent in 1995 (Table 5.7). Domestic demand increased by 2.4 percent *pari passu* with population growth and the rise in the standard of living. Exceptional wage hikes, which had started in 1994, continued, raising the price of civilian labor input by 16.5 percent. Thus, the share of wages in civilian and defense public consumption rose, increasing pressure on resources. The volume rise in domestic demand resulted mainly from the increase in civilian labor input, which was slightly higher than the annual average increase in the years of mass immigration, although less than the steep rise in 1994; this occurred despite the government's decision to cut back on the record number of public-service employees. The share of domestic defense consumption in GDP was unchanged, while defense imports fell in real terms.

The impetus in construction came from the sharp rise in the number of apartments built at government initiative, under the new policy of making land available for building.

**Table 5.7****Direct Demand of the Public Sector, 1992-95<sup>a</sup>**

(annual change, percent)

	NIS mill. <sup>a</sup>	Price				Quantity			
		1992	1993	1994	1995 <sup>b</sup>	1992	1993	1994	1995 <sup>b</sup>
Consumption (net)									
Civilian	50,426	13.7	12.4	17.6	15.0 (15.2)	6.8	3.2	5.1	12.9 (4.0)
Defense	25,772	13.9	9.6	15.5	14.0	-6.4	7.1	-8.7	-3.1
Total	76,198	13.8	11.2	16.9	14.8 (14.9)	1.0	4.8	-0.7	6.7 (1.2)
Domestic consumption (net)									
Civilian	49,760	13.8	12.4	17.7	15.1 (15.3)	6.7	3.0	5.2	13.1 (4.0)
Defense	21,097	13.5	9.3	18.2	17.1	0.8	-5.7	1.9	0.1
Total	70,857	13.7	11.4	17.9	15.7 (15.9)	4.5	-0.1	4.1	8.9 (2.7)
Nonresidential investment <sup>c</sup>	9,424	10.1	8.4	9.4	10.2	14.5	16.6	8.8	0.3
Direct demand	85,622	13.3	10.8	15.8	14.4 (14.3)	2.4	6.2	0.5	5.8 (1.1)
of which Domestic demand	80,281	13.1	10.8	16.6	15.3 (15.2)	5.7	2.1	4.8	7.6 (2.4)
Government-initiated residential construction <sup>d</sup>	3,493	9.9	10.2	12.6	4.8	-8.7	-60.6	-32.9	46.6
Domestic demand, including construction <sup>d,e</sup>	83,774	12.8	11.4	16.7	14.6 (14.8)	3.5	-6.5	2.6	9.0 (4.0)

<sup>a</sup> Current prices.<sup>b</sup> Since the Health Law was introduced, the government—not the insured person—pays the health funds. The figures in the column show volume changes; those in brackets ignore the effect of the Health Law.<sup>c</sup> Estimated from price increases for nonresidential construction.<sup>d</sup> Private housing construction with government guarantee to purchase unsold apartments.<sup>e</sup> 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.



**Table 5.8****The Development of Public Services, 1980-95**

	(percent, at current prices)							
	1980	1985	1990	1991	1992	1993	1994	1995
Public civilian consumption as share of GDP <sup>a</sup>	18.2	16.6	17.0	16.8	17.1	17.1	17.6	19.6 (18.1) <sup>b</sup>
Public civilian consumption as share of private consumption <sup>c</sup>	33.5	27.5	27.0	27.3	27.7	27.1	27.6	31.3 (28.9) <sup>b</sup>
<i>Per capita</i> public civilian consumption <sup>d</sup>	131.8	130.4	97.1	96.0	99.0	99.7	102.4	112.6 (103.8) <sup>b</sup>
Share of the population under 24 and over 65 years old	59.1	58.2	58.1	57.5	57.3	57.2	57.2	56.7
<i>Per capita</i> public civilian consumption in the above population	129.5	130.1	97.1	97.1	100.5	101.3	104.0	115.3 (106.4) <sup>b</sup>
Public civilian services employees as share of total civilian employees	29.6	29.9	29.5	29.6	29.3	28.6	28.0	28.1
Total public service wages as share of total wages.	26.0		22.4	23.3	23.0	23.2	24.5	24.7
<sup>a</sup> Including items not mentioned elsewhere. <sup>b</sup> Excluding the effect of the Health Law (see note 3 in text). <sup>c</sup> Excluding nonprofit organizations. <sup>d</sup> At fixed (1990) prices.								
SOURCE: Based on Central Bureau of Statistics data.								

## Defense consumption

There was a small rise (0.2 percentage points) in the index of the defense burden in 1995, bringing it to 9.3 percent of available resources (Table 5.9). This is the first year of publication of this index which is calculated using the method recommended by the Committee for Estimating the Cost of Defense. The index measures the share in total resources of own resources devoted to defense, taking into account the full alternative cost, in particular that of compulsory military service and reserve duty. Direct expenditure—for instance on building shelters or using emergency stocks—which previously had not been classified in the national accounts in the defense consumption category, is also included. Own resources devoted to defense do not include most defense imports, since these are financed by external sources (principally the US), and hence do not constitute a domestic burden. Total resources include GNP as defined in the national accounts, the additional product of conscripts and soldiers on reserve duty, and civilian unilateral transfers from abroad.

**Table 5.9**

**Indicators of Defense Consumption, 1980-95**

	(percent)							
	1980	1985	1990	1991	1992	1993	1994	1995
Defense burden <sup>a</sup>						9.1	9.1	9.3
Defense consumption								
Share in gross income <sup>b,c</sup>	19.7	17.0	12.0	11.5	10.3	10.6	9.4	9.0
Total net share in GNP <sup>b</sup>	22.9	21.1	13.8	13.3	11.9	12.1	10.6	10.0
Domestic share in GNP <sup>b</sup>	13.9	12.5	10.4	9.5	9.1	8.1	8.2	8.2
Defense wages								
Share in total wages	10.5	9.5	9.6	9.4	8.8	8.2	8.3	8.4
Share in net domestic defense consumption	39.5	39.6	50.3	51.9	50.8	53.7	55.4	57.7
<sup>a</sup> Percent of total available resources. Calculated by the method recommended by the Committee for Estimating the Cost of Defense (see section 3b).								
<sup>b</sup> Excluding conscripts.								
<sup>c</sup> Gross income from all sources, equals GNP <i>plus</i> unilateral transfers, converted to NIS at the official exchange rate.								
SOURCE: Based on Central Bureau of Statistics data								

Real total defense consumption declined in 1995 due to the 11 percent fall in defense imports (which have a high variance), and its share in GNP contracted by 0.6 percentage points (Table 5.9). In quantitative terms, domestic defense consumption was unchanged, as was its share of GNP, despite the rapid growth of the latter. This was due to the steep rise in wage costs, of about 18 percent, expenses imputed to pensions, and the increase in the cost of reserve duty. These three factors together raised the price of labor input by 23 percent. Although quantitative labor input was virtually unchanged, wage increases once again raised the share of wages in the defense industry's total domestic

consumption, continuing the long-term trend in which this share expanded from 39.5 percent in 1980 to 57.7 percent in 1995. These developments indicate that the permanent part of defense expenditure has risen, and this will make it more difficult to reduce the defense burden in the future. Domestic defense purchases, which increased by a real 1 percent in 1995, included expenses arising from the implementation of the agreement with the Palestinians.

#### 4. TAXES, SUBSIDIES, AND TRANSFER PAYMENTS

For the first time since 1992 the share of taxes in GNP (including property tax and health service payments) fell, by 0.9 percentage points (Table 5.10). The share of direct taxes went down by 1 percentage point of GNP, because of the decline in revenues from corporation tax and national insurance resulting from legislative changes. The share in GNP of indirect taxes on domestic production rose slightly, while that of taxes on civilian imports remained stable.

This may indicate a return to the trend from which the economy had deviated in 1993–94, in which the share of indirect taxes expands at the expense of direct taxes (Figure 5.4). Although the lower share of direct taxes may seem to increase income inequality, no clear conclusion can be drawn as to the nature of this effect, since some of the reduction stems from progressive legislative changes.

Purchase tax was reduced further in 1995, and another step in the liberalization program was implemented: customs duties on imports from third countries were cut, and those on imports from the US were abolished, preventing the share in GNP of indirect taxes on imports from rising.

Net transfer payments increased by 0.6 percent of GNP, due mainly to changes in legislation and the rise in real wages. On the other hand, subsidies on domestic production fell by 0.4 percent of GNP.

##### **Direct taxes**

Revenues from direct taxes (*plus* health service payments) rose by only 1 percent in real terms, despite the impressive growth of GNP; their share in GNP fell by 1 percentage point (Table 5.10). This was due mainly to the contraction in revenues from corporation tax compared with the exceptional receipts in 1994, and to the decline in national insurance receipts (excluding the health tax).

Following the trend of recent years, and in line with the economic boom, the revenues from income tax on wages grew by a real 5.7 percent. This effect was strengthened by the progressiveness of income tax, due to the significant increase in wage payments (mainly in the public services). As a result of this rise, and the fall in nonwage income-tax receipts, the share of wage income-tax receipts in total income tax increased, reflecting wage-earners' higher share of income and of the tax burden. Legislation served to lower the tax burden somewhat, mainly on the middle strata: in January 1995

**Table 5.10**  
**Taxes, Subsidies, and Transfers, 1981-95**

	Percent of GNP							NIS million <sup>a</sup>
	1981-85	1986-90	1991-95	1992	1993	1994	1995	1995
Net taxes	23.5	28.9	26.9	24.9	26.7	28.9	29.5	75,847
<i>plus</i> Health service payments	..	..	..	26.5	28.2	30.5	29.5	75,847
Total taxes	41.9	42.9	39.4	39.1	39.1	40.0	40.7	104,704
<i>plus</i> Health service payments	..	..	..	40.6	40.6	41.5	40.7	104,704
Net transfer payments <sup>b</sup>	8.7	9.5	9.9	11.0	9.8	8.7	9.3	23,843
Direct and credit subsidies	9.6	4.5	2.6	3.1	2.6	2.4	1.9	5,014
Net direct taxes	14.2	12.2	9.2	6.7	9.1	11.6	11.5	29,649
<i>plus</i> Health service payments	..	..	..	8.3	10.7	13.1	11.5	29,649
Direct taxes	23.0	21.7	19.0	17.7	18.9	20.3	20.8	53,492
<i>plus</i> Health service payments	..	..	..	19.3	20.4	21.8	20.8	53,492
Net transfer payments <sup>b</sup>	8.7	9.5	9.9	11.0	9.8	8.7	9.3	23,843
Net domestic taxes	4.5	10.7	12.3	12.5	12.0	11.9	12.5	32,077
Indirect domestic taxes	11.3	14.0	14.5	15.1	14.3	14.0	14.3	36,738
Direct and credit subsidies	6.8	3.3	2.2	2.6	2.3	2.2	1.8	4,661
Net foreign trade taxes	5.0	5.9	5.5	5.7	5.6	5.4	5.5	14,121
Net import duties	7.5	7.3	5.8	6.2	5.8	5.6	5.6	14,433
Export subsidies <sup>c</sup>	2.5	1.3	0.3	0.5	0.3	0.2	0.1	312
Total taxes incl. property tax <sup>d</sup>	42.8	43.5	40.3	39.7	40.0	41.2	41.8	107,423
Total taxes incl. property tax <sup>d</sup> and health service payments	..	..	..	41.3	41.5	42.7	41.8	107,423

<sup>a</sup> At current prices.

<sup>b</sup> Including compulsory loans, excluding imputed civilian and defense pensions.

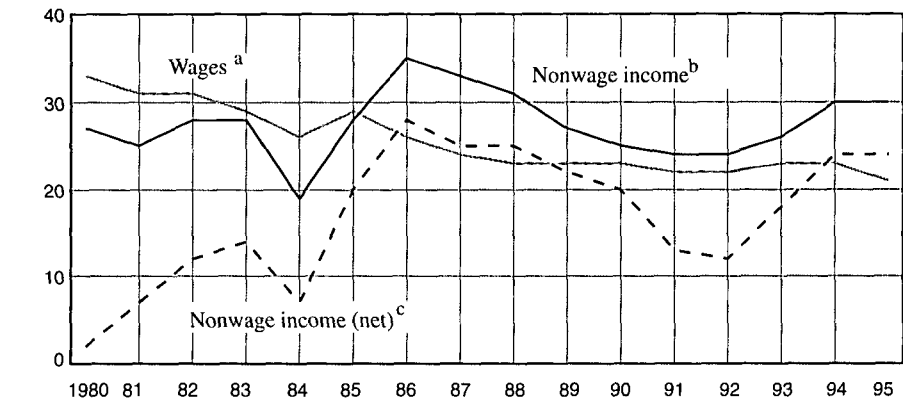
<sup>c</sup> Direct export subsidies and export credit subsidies.

<sup>d</sup> Includes purchase and land improvement taxes; recorded under 'capital receipts' (Table 5.2).

SOURCE: Based on Central Bureau of Statistics data.

**Figure 5.3**

**Average Direct Tax Rates on Wage and Nonwage Income, 1980-95**



<sup>a</sup> Excluding corporate managers' salaries.

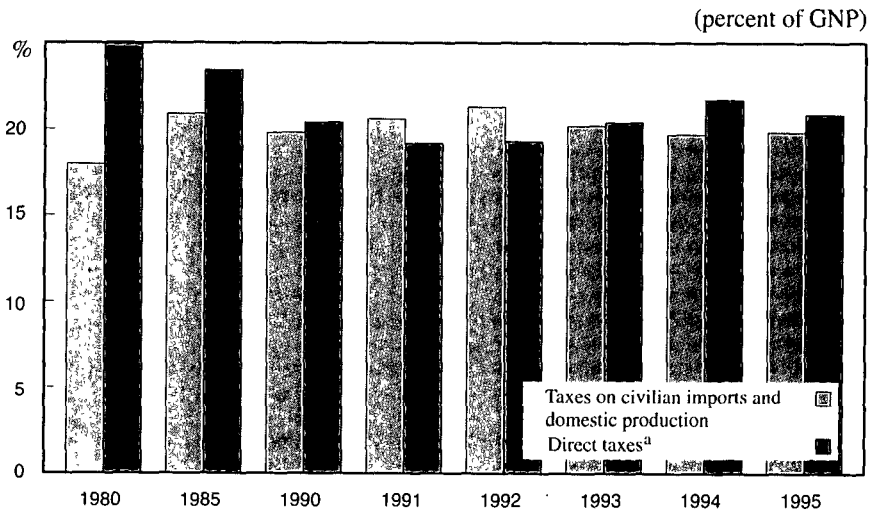
<sup>b</sup> Gross business-sector income at factor cost, excluding salaries (except corporate managers).

<sup>c</sup> Less credit subsidies and capital transfers to firms.

SOURCE: Based on Central Bureau of Statistics data.

**Figure 5.4**

**The Composition of Taxes, by Type of Tax, 1980-95**



<sup>a</sup> Includes health service payments from 1990.

SOURCE: Central Bureau of Statistics.

the 30 percent tax bracket was extended upwards, at the expense of the 35 percent bracket—which was abolished—and the 45 percent bracket, and in September the 30 and 45 percent brackets were extended, but to a smaller degree.

Despite the continued rapid growth of business-sector product, real revenue from corporation tax dipped sharply. The fall matched that in the yield on capital, and is explained by the increase in tax rebates—tax calculations take into consideration previous years' profits. Additional factors acting to reduce corporation tax in 1995 were the stock market slump of 1994 (partially offset by profits in 1995), the fact that accelerated depreciation was recognized in 1995, too, and the 1 percentage point reduction in the rate of the tax to 37 percent (of undistributed profits).

The National Health Insurance Law lays the responsibility for collecting the health tax on the National Insurance Institute. The rate of tax is differentially set as follows: on incomes up to half of the average wage, it is 3.1 percent on chargeable income; on higher incomes, up to a maximum of four times the average, the rate is 4.8 percent.

National insurance receipts from wage incomes fell in real terms by 13.4 percent in 1995, despite the rise in total wage payments. This was due to legislation. First, employers' contribution to health insurance was reduced by 1.95 percent,<sup>6</sup> lowering the cost of employment, and a reduced rate of 1.78 percent was set for those employing workers at wages up to half of the average wage, whereas the normal rate of 3 percent applied up to the highest income of four times the average wage. Secondly, the employee's share of national insurance contributions for reserve duty was reduced by 0.45 percentage points. Thirdly, a reduced rate of 2.6 percent was set on incomes up to half the average wage, and the maximum income bearing the new standard rate (4.9 percent instead of 5.35 percent) was raised.

These legislative changes in both national insurance contributions and health tax raised the marginal tax rate on incomes of between three and four times the average wage. This had a negative effect on economic growth, reducing labor supply and entrepreneurship (assuming that the labor supply is not inelastic). Moreover, a situation has arisen in which at wage levels above four times the average, the marginal tax rate falls from 54.7 percent to 50 percent; this warrants further examination.

### **Transfer payments**

Total transfer payments increased by 7.4 percent in real terms, after remaining stable in 1993–94. In line with the trend of recent years, payments to the public on the current account rose, while those on the capital account fell. The former, which comprise about 85 percent of all transfer payments, increased by a real 10.8 percent. This rise, which is steep also in comparison with previous years, encompassed all components. Alongside the higher fiscal burden, the increase creates greater income equality.

<sup>6</sup> The reduction is clearly significant when the public and private sectors are compared, but was not reflected in national insurance receipts, as the government makes up the balance of the payment. Note that despite the reduction, real unit labor cost rose (Chapter 4).

The 10.6 percent increase in national insurance benefits—which constitute the lion's share of transfer payments—resulted from both legislative changes and the 2 percent rise in the average real wage. Whereas the rise in benefits in 1994 reflected mainly an increase in the number of recipients of various national insurance pensions, in 1995 it stemmed essentially from higher benefits. The full effect of the Poverty Reduction Law which was passed in August 1994 was felt in 1995, with increased pensions to the elderly, to surviving relatives, and to low-income families with children.

### **Indirect taxes and subsidies**

Increased economic activity, together with the rise in the standard of living, led to a real 7.9 percent expansion of receipts of indirect taxes on domestic production and 5.4 percent on civilian imports. The level of these taxes thus rose slightly, to 19.9 percent of GNP, after falling by 0.5 percent of GNP in 1994 (Table 5.10). Legislative changes prevented these taxes from rising faster. In line with the trend to lower purchase taxes, that on spare parts for vehicles was reduced in 1995, and the distortions intrinsic in a system with differential rates of purchase tax on different items (in contrast to VAT which is uniform) were diminished. Likewise, as part of the liberalization program, there were further reductions in import levies.

Receipts from VAT—which accounts for 61 percent of total indirect taxes—rose by 10.4 percent. Property tax, receipts of which soared in 1994, rose more moderately in 1995 due to lower property and land purchase tax rates, a slower increase in the number of transactions, and the slower rise—relative to 1994—of apartment prices over and beyond that of the CPI.

Fuel tax receipts increased by 7.7 percent, despite the reduction of excise on diesel and heating oil in the second half of 1994, which provided some incentive to domestic production.