CHAPTER V

THE PUBLIC SECTOR[1]

1. MAIN DEVELOPMENTS AND GOVERNMENT POLICY

Net tax revenue fell this year by an unprecedented 40 percent, the net outcome of a 14 percent drop in tax revenue and a 9 percent rise in subsidies. Domestic demand did not decline much and the public sector's domestic demand surplus expanded by 121 percent, reaching its highest level since the Yom Kippur War, 15 percent of GNP (compared with 9 percent in the last two years). A similar change was recorded in the total demand surplus, which rose to 11 percent of GNP, compared with 12 percent and 6 percent in 1982 and 1983 respectively.[2]

In spite of these developments, the civilian import surplus did not rise since private consumption and investment both fell. The decline in private consumption (or rise in savings), mostly the result of developments in previous years, is part of the explanation of the decline in absorption, since it reduced indirect tax receipts; but a good deal of the decline in the revenue—and the accompanying rise in disposable income—is attributable to the acceleration of inflation. The public, consequently, does not appear to have viewed this as a permanent change, so that permanent income was not affected and consumption did not rise. Instead the public generally preferred to use its incremental saving for the purchase of foreign currency, thereby drawing down the country's foreign reserves and increasing the net foreign debt. The public also invested in (net) domestic financial assets which represent government liabilities, thereby increasing the domestic public debt. This trend, which began last year, reflects the shift from domestic borrowing to the sale of foreign currency to the public and money creation as

[1] The public sector comprises central government, the local authorities, and the national institutions. The analysis of civilian consumption in this chapter also covers private nonprofit institutions. This chapter deals with the sector's real activities; for monetary developments see Chapter VIII.

Unless otherwise stated, the rates of change cited are in real terms. Public consumption and investment are deflated by the respective implicit price indexes derived from the national accounts. Taxes, subsidies, and transfers are deflated by the CPI.

[2] Direct demand is defined as public consumption, public sector nondwelling investment (which includes the investments of public sector enterprises but not of public sector corporations). Direct defense imports and imports of government services n.e.s. are excluded from domestic demand. The domestic demand surplus is defined as the difference between domestic demand and absorption, and total demand surplus is the domestic surplus *plus* overseas spending (consumption and interest) *less* unilateral transfers.

Table V-1

INDICATORS OF PUBLIC SECTOR ACTIVITY, 1960–84

(Percent of GNP, at current prices)

	1960–1965	1966–1967	1968–1972	1973–1974	1975–1977	1978–1984	1980	1981	1982	1983	1984
Domestic demand[a]	21	25	28	32	30	30	29	29	31	30	30
Absorption	22	20	21	19	19	22	24	18	24	28	20
Domestic demand surplus	−1	5	7	13	11	8	5	11	6	3	12
Net interest on domestic public debt	1	2	2	3	3	4	4	2	3	5	5
Domestic demand surplus incl. interest	0	7	9	16	14	12	8	14	9	9	15
Domestic demand surplus incl. credit subsidy	0	7	9	16	14	16	16	18	14	10	17
Total demand surplus[b]	3	11	17	20	20	13	10	20	12	6	11
Civilian public consumption	10	12	10	11	11	12	12	12	12	12	12
Civilian public services[c]	17	19	17	17	18	20	20	20	20	20	20
Defense consumption[d]	10	14	22	32	29	23	24	26	23	20	24
Domestic	6	9	13	16	15	14	14	14	15	15	16
Imports	4	5	9	15	13	9	10	12	8	5	9
Public sector nondwelling investment	5	5	5	6	4	4	3	3	3	4	3
Public residential construction	4	2	3	5	3	2	3	3	2	1	1
Public services employment as percent of total civilian employed persons	22	24	23	25	27	29	29	30	30	29	29

[a] Excluding residential construction.

[b] Domestic demand *plus* direct defense imports and imports of government services n.e.s. *less* net receipts (including interest) from abroad.

[c] Consumption of public sector and private nonprofit institutions.

[d] Net of defense establishment sales of goods originally imported.

SOURCE: Based on data of the Central Bureau of Statistics.

means of financing the deficit. As in the last few years, the per capita domestic public debt[3] rose slowly (1 percent). The magnitude of the domestic debt (130 percent of GNP) and the decline in the public's willingness to invest in government financial assets make it essential to reduce the deficit if the foreign debt is not to escalate; this year's decline in tax revenue was thus not precisely helpful.

This year, too, the rise in the government's demand surplus was accompanied by higher inflation. The two are connected, since inflation increases the deficit through its effect on tax revenue—the acceleration of inflation was directly responsible for a 3 percent drop in the revenue (another 3 percent is ascribable to the indirect effect of the law for taxation under inflationary conditions). The deficit in turn intensifies inflation—whether by increasing the public's portfolio or by causing the balance of payments to deteriorate; attempts to deal with the balance of payments by devaluation and subsidy cuts (as at the end of 1983 and the beginning of 1984) intensified inflation, which was in turn reinforced by the increase in monetary aggregates; the latter is largely automatic since most financial assets are indexed and since the asset base expanded (this year mainly owing to the increase in the budget deficit).

Fiscal Policy

Government direct domestic demand, which rose by 4 percent in 1982 and 2 percent in 1983, hardly changed this year, declining by 2 percent. The entire decline was concentrated in public sector investment, which dropped by 16 percent. The recent year's cuts in the public civilian budget chiefly affected investment, which is a flexible component of public-sector spending; in the last six years, the public sector's gross investment fell by an annual average of over 1 percent. This is liable to hold back infrastructure development and hence future economic growth (see Chapter II). Consumption (defense and civilian) showed virtually no change this year (see Table V–2). Hourly labor costs in the public sector rose by 8 percent and the relative prices of other components rose moderately, so that the ratio of domestic demand to GNP remained stable. On the other hand, defense imports went up by 38 percent and total demand, including defense imports, rose by 4 percent.

As mentioned, the public sector's absorption declined considerably this year, owing both to an endogenous decline in the revenue and to tax measures introduced last year. The decline in absorption was thus mostly the result of the government's failure to take action in response to the decline in revenue, and partly of the increase in subsidies. Net interest payments by the public sector to the rest of the world grew markedly this year, coming to 4 percent of product (3 percent in 1983).

[3] Does not include the government's guarantee of bank shares.

Table V-2

DIRECT PUBLIC SECTOR DEMAND, 1980–84

	Billions of current IS				Percent annual change							
					Quantity					Price		
	1981	1982	1983	1984	1980	1981	1982	1983	1984	1982	1983	1984
Consumption[a]												
Total												
Civilian	29	65	164	819	–1.2	0.9	0.7	0.6	–0.1	119.5	152.2	399.6
Defense	62	123	279	1,591	14.7	9.9	–12.3	–9.1	10.9	125.5	148.8	413.4
Total	**91**	**188**	**443**	**2,410**	9.1	6.9	–8.1	–5.7	6.8	123.4	149.8	408.8
Domestic[b]												
Civilian	28	62	157	780	–1.2	2.7	0.9	0.6	0.0	118.0	153.4	397.6
Defense	35	85	206	1,022	4.8	1.0	5.3	0.9	0.5	127.5	140.9	392.7
Total	**63**	**147**	**363**	**1,802**	4.7	1.8	3.3	0.8	0.2	124.0	145.7	395.0
Public nondwelling investment	8	18	49	187	–18.8	–7.9	7.1	13.1	–15.8	123.6	136.0	355.8
Direct public sector demand[a]												
Total	**99**	**206**	**492**	**2,597**	5.7	5.6	–6.7	–4.1	4.2	123.6	148.6	406.3
Domestic[b]	**71**	**165**	**412**	**1,989**	1.0	0.6	4.1	2.0	–1.9	123.7	144.8	393.3
Public residential construction	6	11	20	72	48.6	–4.7	–21.7	–19.3	–23.5	118.6	126.1	371.5

[a] It is arbitrarily assumed that 60 percent of sales are of goods originally imported; the remaining 40 percent sales of domestic goods are thus deducted from local defense consumption (see also note c to Table V-1).

[b] Excluding direct defense imports and imported government services n.e.s.

SOURCE: Based on data of the Central Bureau of Statistics.

Altogether, government activity this year increased the import surplus, in part because of the rise in direct demand and in interest payments abroad (from 3 to 4 percent of GNP) and partly because disposable income rose (by 5.5 percent).[4] However, unilateral transfers to the government rose from 10 percent of GNP in 1983 to 17 percent in 1984.

To summarize, although this year's government activities raised the import surplus, their effect on the current balance of payments is not clear, since part of the increase in demand is covered by the increase in grants from the United States. The government's immediate effect on inflation was through devaluation and indirect tax and subsidy policy (see Chapter III), particularly at the end of 1983 and the beginning of 1984: the subsidy cuts and the large devaluation of October 1983 pushed up the monthly inflation rate from 8.5 percent (in the first ten months of 1983) to 15 percent (from October 1983 to December 1984). At the end of 1984, as part of the first package deal, the government undertook not to raise the prices of essentials, fuel, and government fees and licenses, and it froze the exchange rate used to calculate import taxes. Consequently, the rate of price increase dropped steeply (although the underlying inflationary pressures persisted). The price freeze on essentials imposed a heavy burden on the budget: in terms of increased subsidies and import tax forgone during the three months it was in effect, the price of the package deal was estimated at between $200 and $300 million.[5]

The dampening of the price rise had other results not directly related to the package deal; on the one hand, tax revenue rose by $200–$250 million; on the other, the government's real redemption payments on indexed bonds were about $110 million greater than they would have been if the price rise had not been held back.[6] Total government losses were thus in the range of $150–$200 million (excluding the loss of inflation tax on non-interest-bearing unindexed local-currency assets). It should be borne in mind that what is here at issue is not the loss to the economy but the effect of the package deal on the budget deficit; it is this effect which changed the government's approach to the second package deal.

A look at a longer period shows that, in contrast to 1960–65—when the domestic budget was balanced—the ratio of domestic demand to product rose by 9 percentage points between 1978 and 1984; this was due primarily to the rise in domestic defense consumption. Domestic absorption/GNP declined by 2 points and domestic interest payments/GNP rose by 3 points (the foreign demand surplus/GNP fell by 2 points). Since then the expansion of the deficit has been inflationary; as the efforts to combat inflation by different types of absorption

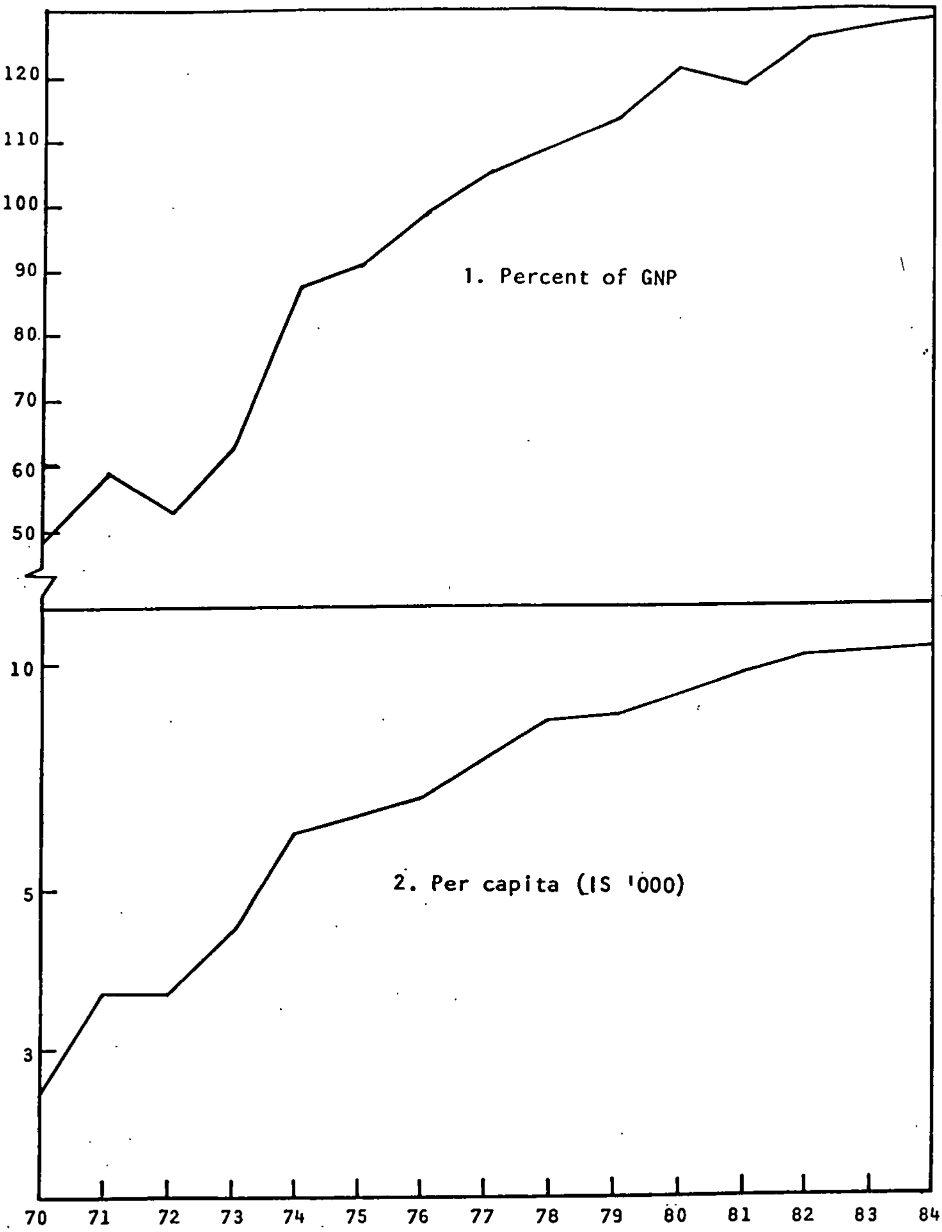
[4] Private consumption fell by 6.3 percent, so that private saving increased (see Chapter II).

[5] Bank of Israel and the Ministry of Finance.

[6] Indexed bonds are redeemed at the end of the month in which they mature, according to the last known index, which is for the preceding month. The consequent loss to bondholders increases with inflation.

Figure V-1

THE DOMESTIC PUBLIC DEBT, 1970-84[a]



[a] Panel 1, at current prices; panel 2 at 1976 prices (semilog scale).

Table V-3

INDICATORS OF ISRAEL'S DEFENSE OUTLAYS, 1964–84[a]

(At current prices)

	Defense consumption as percent of GNP					Compensation of employees, defense ÷ total, percent
	Total	Excluding defense grants[b]	Excluding all grants[b]	Local	Local, plus foreign currency outlays[c] and debt servicing[d]	
1964–66	10	10	9	6	..	5
1967	18	17	17	10	..	8
1968–69	19	19	19	12	..	8
1970	26	26	26	14	..	9
1971–72	22	20	19	13	..	8
1973–75	32	25	23	17	..	11
1976–78	26	20	16	13	18	10
1979–81	24	19	14	13	17	10
1982–84	22	19	13	15	19	11
1980	24	19	14	14	17	10
1981	26	23	19	14	17	10
1982	23	21	18	15	19	11
1983	20	19	12	15	19	10
1984	24	20	10	16	20	11

[a] Net of defense establishment sales of goods originally imported.

[b] 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.]

[c] Foreign currency expenditures other than from defense loans and grants.

[d] Principal and interest on U.S. government defense loans.

SOURCE: Based on data of the Central Bureau of Statistics, except for foreign currency outlays and debt servicing, which are based on budgetary data of the Ministry of Finance.

and slower devaluation have failed, it seems that there is no alternative but severe budget cuts. Because of the large size of the defense establishment, any cuts must affect defense spending; civilian spending must also be cut. One way of doing this is to shift some of the functions at present carried out by the government to the private sector; another way is to charge for public services. The deterioration of the balance of payments (especially since 1981) has stemmed chiefly from the increase in private consumption, following a considerable rise in disposable income; reduced spending should therefore be accompanied by increased absorption, whether by reducing subsidies or by means of a comprehensive tax reform designed to raise the revenue.

2. Taxes, Transfers and Subsidies

The tax burden[7] fell by around 25 percent this year, to a new low of 20 percent of GNP. This was the net outcome of the unprecedented 14 percent decline in tax revenue, the 9 percent rise in subsidies, and the 4 percent decline in transfers. Credit subsidies rose by 2 percent, so that the tax burden (definition b) went down.

The decline in the revenue followed a rapid rise in the ratio of taxes to GNP—from 45 percent in 1981 to 50 percent in 1983. In 1984, it dropped to 43 percent, about the level prevailing in the early 1970s. This is a surprisingly large drop, and it affected direct taxes (down by 17 percent), import duties (15 percent), taxes on domestic production (6 percent) and other levies (31 percent). Deseasonalized data show that the decline began in the second half of 1983 and continued until the beginning of 1984. The revenue began to recover at the end of 1984, as the result of some slowdown in inflation and, apparently, economic recovery.

Several factors were responsible for the severe reduction in tax revenue: (a) the decline in imports (especially durable goods, which are heavily taxed); (b) the jump in the inflation rate, which further eroded the tax revenue; (c) bank losses in 1983, owing to which most banks did not pay tax advances in 1984 and even received rebates on account of 1983; (d) the law for taxation under inflationary conditions, under which capital losses on the stock exchange are tax deductible; (e) the end of the "Peace for Galilee" loan in 1983 and the abolition of the tax on the sale of securities in 1984; (f) the decline in the real wage bill;[8] (g) the domestic production tax base narrowed; (h) the "Elscint Law" which gives tax concessions to persons investing in securities issued for the purpose of financing scientific research, came into force;[9] (i) the freezing of the exchange rate used to calculate import taxes under the first package deal. These factors account for a decline of $2.3 billion in the revenue, partly offset by the rise in direct and indirect tax rates and the expansion of nonwage income, so that the net decline comes to $1.9 billion.

[7] The tax burden is defined in two ways: (a) taxes *less* subsidies *less* transfers to the public (excluding interest on the public debt); definition (b) is also net of the loan subsidy.

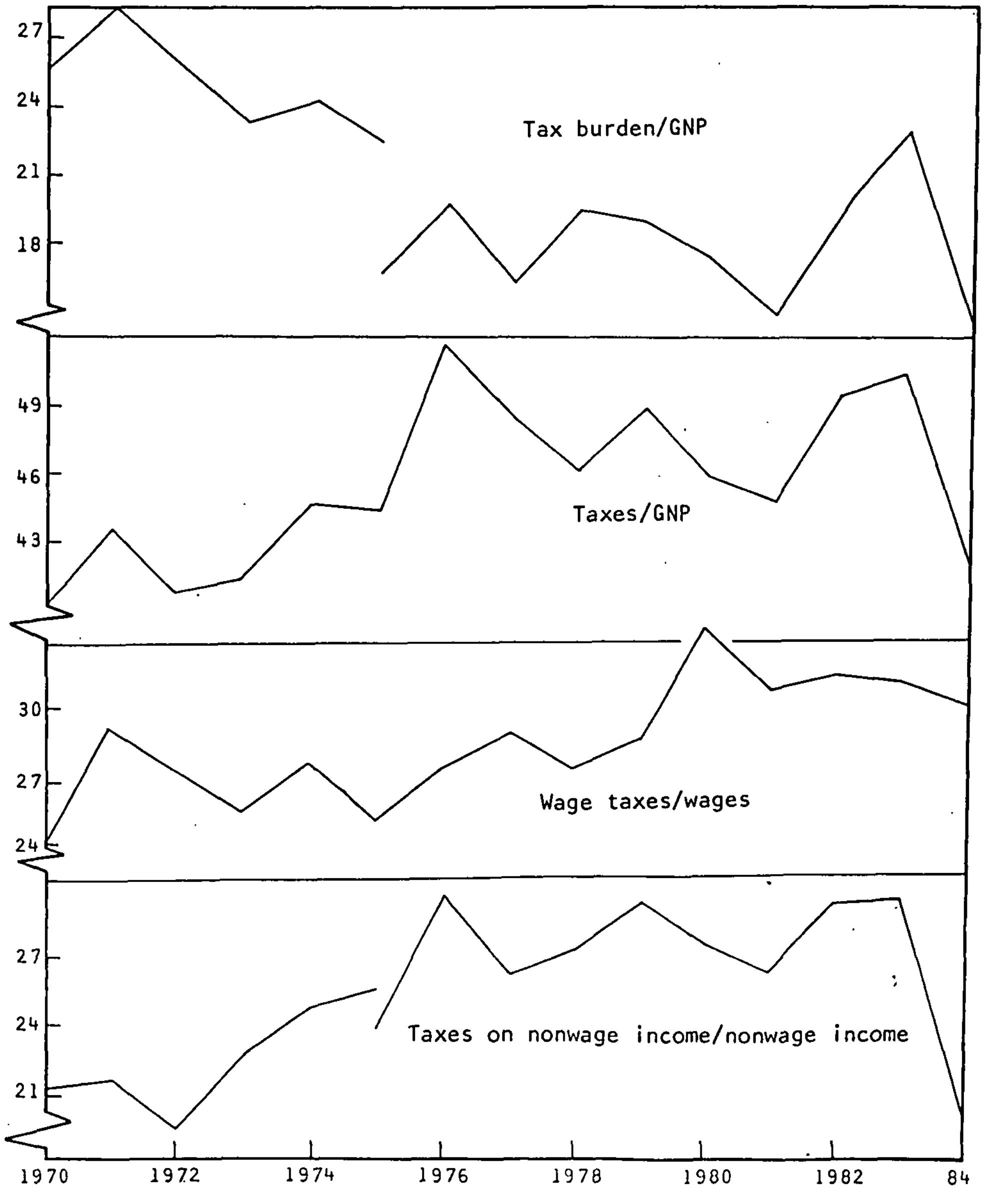
[8] According to estimates of the National Insurance Institute, real wages per employee post fell by 1 percent, while the number of posts remained the same. However, this calculation is based on a deflation procedure which lags the price indexes by two weeks. When this is corrected for, a decline of 3 percent is obtained.

[9] Under this law, such investment is tax deductible, a provision that lowers the revenue. However, since, the issuing company is not eligible for direct research grants, the effect on the tax burden is smaller.

Figure V-2

SELECTED TAX RATES, 1970–84[a]

(Percent)



[a] Tax burden—taxes net of subsidies and transfer payments (from 1975, includes credit subsidy).
Taxes—includes compulsory loans and transfers from the public.
Wage taxes—direct taxes, compulsory loans, and employers tax.

Since mid-1982, import tax rates have been rising faster than tax rates on local products. For example, the rate on imported consumer goods reached 25 percent in 1983, while the rate on locally produced consumer goods stood at 9 percent. Together with the rise in export subsidies, this indicates a return to the period before the 1977 reform of the exchange-rate regime, when taxes and subsidies served as exchange-rate substitutes. Presumably, such a policy was preferred to formal devaluation in order to do away with capital gains on exchange-rate linked assets and thereby to weaken the wealth effect on demand. In the short run this policy succeeded, contributing to this year's drop in imports. But its drawbacks should not be overlooked: discriminatory tax rates distort the allocation of resources and encourage a black market.

The decline in imports was accompanied by a decline in import tax revenue and the pressure to find alternative sources of finance intensified. In February, child allowances ceased to be entirely tax exempt, and a 66 percent tax bracket was introduced.[10] Other devices for raising the revenue—such as a levy on property—were not implemented this year.

The economy has been plagued by inflation for over ten years, and the tax system has suffered accordingly. Inflation makes it difficult to determine taxable income in the business sector and erodes tax revenue, because of the lag between accrual of the tax liability and payment of the tax. The tax authorities' efforts to deal with the problem have not been satisfactory. On the one hand, the 1982 law for taxation under inflationary conditions was not effective; on the other, there is still significant erosion of tax revenue, in spite of measures to reduce the collection lag: deduction at source was extended, tax advances from firms have been pegged to current turnover; VAT is now collected monthly and (in 1985) municipal rates were indexed to the CPI. With a monthly rate of inflation of 15 percent, the collection lag translates into a loss of 10 percent of nominal revenue, or over $1 billion.[11] The jump from a monthly inflation rate of 9 percent in 1983 to 13 percent in 1984 generated an additional loss of some $400 million (at 1983 prices).[12] The lag also affects the distribution of the tax burden: while firms and the self-employed can postpone tax payments (including deductions from employees' wages and VAT) inflation, by eroding tax brackets, increases the burden on employees.

At the end of 1984, price control was imposed under the first package deal. Between November and January, the monthly inflation rate went down from

[10] In addition, the self-employed have (since April) been required to pay their sick-fund contributions to the National Insurance Institute, which then transfers them to the sick funds, so that the tax burden is not affected. However, this procedural change has made it possible to reduce subsidies to the sick funds.

[11] This calculation assumes constant real activity and applies only to tax revenue. Since there is also a lag in government outlays, the net loss would be smaller.

[12] The loss from the collection lag amounted to $480 million, but part of it was offset by the erosion of tax brackets, which increased effective income tax rates on earned income.

25 to 5 percent, and the erosion of the revenue was to some extent checked, although effective import taxes declined under this package deal.[13]

The last three years' increase in tax rates is a labor disincentive and lowers the country's competitiveness, even though in 1984 it was not accompanied by a rise in the revenue. High tax rates combined with exemptions and subsidies distort the allocation of resources and encourage tax evasion. A comprehensive reform is indicated—lower tax rates, subsidies and exemptions, and less discrimination between effective tax rates on imports and domestic products, on the one hand, and between wages and nonwage income on the other. The solution to the balance-of-payments problem and the budget deficit must not be sought solely through the tax system. Other measures (principally the contraction of direct demand to induce real depreciation of the currency) must be resorted to.

[13] A gain of $180 million due to the slowdown of inflation and a loss of $30 million due to the freeze on import taxes, with a net gain of 7 percent of the revenue during the period. This calculation assumes constant real activity and applies to November through January. It does not take account of income tax concessions to employees since February 1985.