CHAPTER V

THE PUBLIC SECTOR[1]

1. MAIN DEVELOPMENTS

The public sector's domestic demand rose by 4 percent this year, compared with 2.5 percent in 1982 and no change in 1981. Direct demand, however, which fell by 6 percent in 1982, declined by a further 3.5 percent in 1983, owing to the contraction of defense imports and the completion of redeployment in the Negev.[2]

Total tax revenue rose by 5 percent, faster than domestic demand but more slowly than in 1982. The slowdown occurred chiefly in the second half of the year, and reflected the end of the Peace-for-Galilee compulsory loan, implementation of the law for taxation under inflationary conditions, and the last quarter's economic slack. The increase (5 percent) was concentrated mainly in indirect taxes (up by 11 percent on domestic products and 10 percent on imports); direct taxes rose by only 1 percent.

The domestic demand surplus came to 8 percent of GNP in 1983 (17 and 11 percent in 1981 and 1982 respectively). Although the demand surplus declined, public sector demand pressure intensified; this is because the increase in tax revenue, which offsets the rise in public consumption, reduces private saving as well as private consumption.

The rise in public sector direct domestic demand reflects a 7 percent increase in local defense outlays (on top of the 7 percent 1982 increase). Civilian consumption, however, continued at the level of the last three or four years, and it again dropped per capita, by 1 percent (2 percent in 1982).

Public nondwelling investment, which declined by 18 and 8 percent in 1980 and 1981 respectively, has risen rapidly in the last two years, by 9 percent in 1982 and 13 percent in 1983. Public sector residential construction dropped by 19 percent (it declined in 1981 and 1982 as well).

[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), and public residential construction. Direct defense imports and imports of government services n.e.s. are excluded from domestic demand.

Table V–1

INDICATORS OF PUBLIC SECTOR ACTIVITY, 1960–83

(Percent of GNP,[a] at current prices)

	1960–1965	1966–1967	1968–1972	1973–1974	1975–1977	1978–1983	1978	1979	1980	1981	1982	1983
Total demand surplus	3	9	15	17	15	12	14	5	10	21	14	6
Demand	29	34	41	53	48	41	43	40	42	44	41	38
Revenue	26	24	25	36	33	30	29	35	32	23	27	33
Local demand surplus[b]	2	6	8	15	12	11	10	8	9	17	11	8
Demand[b]	25	27	31	37	33	32	30	32	32	32	33	33
Absorption	23	21	23	21	21	21	20	24	23	15	21	24
Total local demand surplus[c]	—	—	—	—	18	15	14	15	16	21	15	11
Civilian public consumption	10	12	10	11	11	12	12	13	12	12	12	12
Civilian public services[d]												
Consumption	17	19	17	17	18	20	19	21	20	20	19	20
Employed persons[a]	22	24	23	25	27	29	29	29	29	30	30	29
Defense consumption[e]	10	14	22	32	29	24	26	21	24	26	24	21
Local	6	9	13	16	15	15	13	14	14	15	16	16
Imports	4	5	9	15	13	9	12	7	10	11	8	5
Public sector nondwelling investment	5	5	5	6	4	4	4	4	3	3	3	4
Public residential construction	4	2	3	5	3	2	1	2	3	3	2	1
Civilian/defense consumption, percent[a]	115	98	51	34	40	52	47	61	51	47	51	57

[a] Except for employed persons (percent of total employed persons) and the civilian/defense consumption ratio.
[b] Excludes direct defense imports and imports of government services n.e.s.
[c] Includes loan subsidy (the subsidy element of government loans to the business sector).
[d] Public sector *plus* private nonprofit institutions.
[e] Net of defense establishment sales of goods originally imported.

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

Subsidies to domestic production declined by 6.5 percent, the result of rising subsidy rates and expenditures until October 1983 and sharp cuts in the fourth quarter, when the policy of allowing the prices of controlled commodities to rise by no more than 5 percent monthly was abandoned (it was introduced in September 1982).

There was no change in transfers: transfers to households rose moderately (2.5 percent), while transfers to private nonprofit institutions went down.

The government budget for the fiscal year 1983/84 rose to 85 percent of GNP this year, in the course of which two supplementary budgets had to be introduced, chiefly because prices increased faster than forecast.

Economic Policy

Public expenditure has grown steadily since the Six-Day War (1967), primarily because of the rise in defense outlays; in the last few years the part of the latter financed by the economy has amounted to about one fifth of product. This compares with 10 percent in the years before the Six-Day War (see Table V–2) and with 2 to 6 percent in the West. Civilian consumption (12 percent of product) fluctuated, but much less than defense outlays, and in the last few years it has, on the whole, been held in check.

Taxes failed to keep up with the rapid rise in public consumption and transfers (the latter rose in the early and middle 1970s). As a result, the demand surplus rose and deficit financing was resorted to. The demand surplus can be financed by private saving, by increased imports, or by erosion of financial assets (inflation tax). The average propensity to save has declined in recent years, which reduces the potential supply of savings (as a percentage of product) available for financing the demand surplus. Inflationary taxation failed to divert any significant volume of resources from the public to the government (see Chapter VIII), and in some years the net inflation tax was negative since the public sector had a negative indexation balance.

The persistence of the demand surplus has caused the balance of payments to deteriorate and increased the rate of inflation, and it has helped to escalate the domestic and foreign debt. The solution of the fundamental problem facing the public sector and the economy entails the elimination of the demand surplus by reducing demand, direct and indirect.

In spite of the reduction in defense imports, defense expenditures continue to be high; the rise in civilian consumption has been kept within reasonable bounds for several years. However, there have been frequent changes of policy—mainly fiscal policy. In 1981, the stress was on combating inflation and considerable use was made of subsidies on essential commodities and (direct and indirect) tax cuts. When the war in the Lebanon began, the emphasis shifted to financing the war and reducing the budget deficit; direct and indirect taxes were raised and the tax burden reached heights not seen for many years.

Table V-2

INDICATORS OF ISRAEL'S DEFENSE OUTLAYS, 1964–83[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	24	17	..	11
1976–78	26	21	17	14	19	10
1979–83	23	20	15	15	19	10
1979	21	16	10	14	17	10
1980	24	19	15	14	18	10
1981	26	23	19	15	18	10
1982	24	21	18	16	20	11
1983	21	20	14	16	20	10

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

In the autumn of 1982 there was yet another switch; the new policy sought to combat inflation by stabilizing the rate of devaluation and the rise in prices of controlled commodities at 5 percent per month, and it was pursued for a year with marked lack of success. The prices of uncontrolled commodities rose by more than the 5 percent target rate, so that the rate and volume of subsidies swelled. Moreover, the relative price of tradables declined and the balance-of-payments situation deteriorated.

Expectations of a new switch in policy gathered momentum as the months went by without any of the hoped-for price developments, and the public stepped up its purchases of imported goods and foreign exchange. The 7.5 percent devaluation of August 1983 made no impression, and the public continued to make massive purchases of foreign-exchange linked assets (imports, Patam deposits, and currency), which were made possible by, *inter alia*, the bank-share support which enabled the public to sell its bank shares at high prices. The inability of the banks and the price-supporting institutions to cope with the massive sales signalled the end of the 5-percent policy introduced a year earlier. In October 1983, the currency was devalued by 23 percent (in addition to the daily float) and subsidies were cut, so that controlled prices were raised by 50 percent. Moreover, the government's order of priorities changed, the balance of payments coming to the fore.

In the last few years, policy has concentrated on containing inflation and, since the autumn of 1983, on rapid balance-of-payments improvement. The means employed (lowering taxes and raising subsidies in the first case and damping down domestic activity in the second) are, however, short-run solutions which are no substitute for a substantial cut in the public sector's demand, particularly its defense demand.

2. THE DEMAND SURPLUS AND THE DOMESTIC DEBT[3]

The domestic demand surplus excluding the subsidy element of public sector loans (loan subsidy) has fluctuated strongly in the last few years, mainly because of the fluctuations of tax-subsidy policy. In 1981, when taxes were cut and subsidies increased, it reached the extraordinary level of 17 percent of GNP, and in 1982 it dropped back to 11 percent when taxes were raised. In 1983, the domestic demand surplus again declined, but at 8 percent of GNP it remains high.

As regards the financing of the domestic demand surplus, the share of foreign-currency sales to the public has in the last two years risen at the expense of domestic borrowing; and there has been a small increase in the printing of money. Thus foreign-currency sales financed two thirds of the demand surplus in 1983, compared with 40 percent in 1982 and about 25 percent in 1979–81. Net domestic borrowing financed only 13 percent in 1983, compared with 50 percent in 1982 and 65 percent in 1979–81. The share of the surplus financed by printing money rose from 10 percent in 1979–81 to 20 percent in 1983.

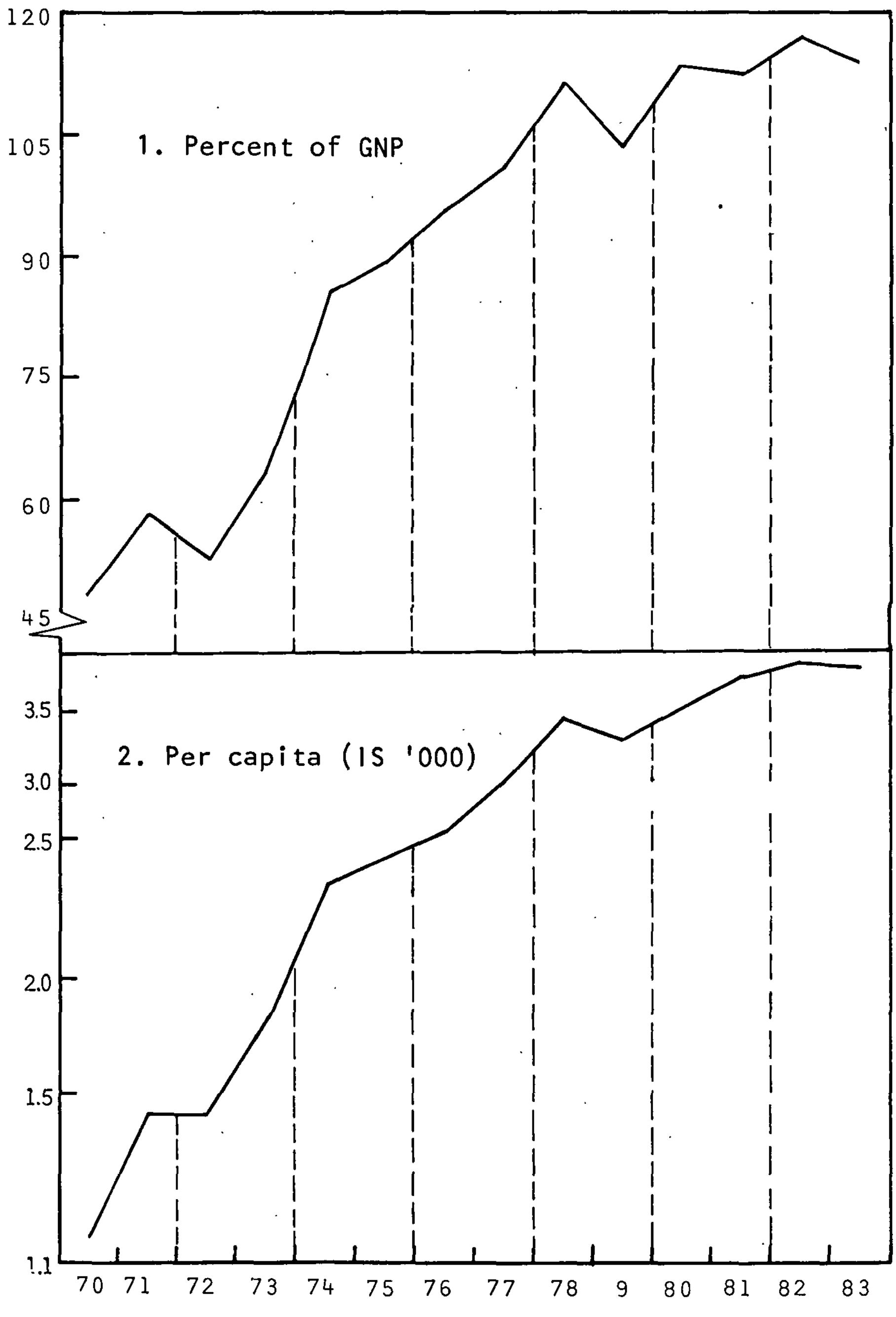
The persistent demand surplus has over the years generated a large foreign and domestic debt.[4] The net domestic debt (i.e. the public sector's obligations to the public *less* the public's obligations to the public sector) came to $27–28 billion in 1983 or to 115 percent of GNP.

[3] The demand surplus is defined as the difference between demand and absorption. As defined, it does not reflect the fact that the expansionary effect of consumption expenditure outweighs the contractionary effect of taxation (because the marginal propensity to consume of individuals is less than unity). For this reason, the intertemporal comparison of demand surpluses gives only a rough indication of the trend, and undue importance should not be ascribed to absolute differences from one year to the next.

[4] This chapter concentrates on the domestic debt. For the foreign debt, see Chapter VII. The estimate of the domestic debt is based on estimates of the public's wealth; it does not include the government's obligations under the bank-share arrangement of October 1983 (see Chapter VIII).

Figure V–1

THE DOMESTIC PUBLIC DEBT, 1970–83[a]



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

The public sector has had a demand surplus since 1967 and the domestic debt has grown rapidly. How rapidly is illustrated by the fact that in the early 1970s it stood at about 50 percent of GNP, compared with the 115–120 percent of the last three years; and the real per capita debt tripled in 1970–83, coming to $7,000 in 1983.

3. DIRECT DEMAND[5]

The public sector's direct demand, which declined by 6 percent in 1982, again declined in 1983, by 3.5 percent. Like last year, this is due chiefly to the concentration of direct defense imports—domestic demand rose by 4 percent (2.5 percent in 1982, see Table V–3). The increase in domestic demand reflects increased domestic defense expenditure and restocking, whereas civilian public consumption has for several years grown quite slowly, and in per capita terms declined to the 1976 level in 1983. Public sector investment rose in 1983, after several years of decline.

Defense Expenditure

Defense outlays came to IS300 billion in 1983 (about $5 billion), having dropped appreciably in both 1982 (10 percent) and 1983 (7 percent): direct defense imports dropped by over 30 percent in both years, while domestic outlays rose by 7 percent because of the Lebanese war.

To obtain a full picture of defense outlays it is necessary to look back. In the early 1960s, total defense expenditure stood at about 10 percent of GNP (in the 1950s it was 8 percent, or 5 percent excluding the Suez Campaign). The 1967 Six-Day War was a turning point—the longer lines of supply, the construction of defensive lines, the penetration of terrorists, and the war of attrition led to an almost unbroken rise in defense outlays. They came to a peak at the time of the Yom Kippur War (1973) and in the following two years; in 1965–75, defense outlays rose by a factor of 7, to reach one third of GNP. In 1975–76, there was a drop in military expenditure and since then the ratio has been in the 20–25 percent range. In the last two or three years, the ratio has dropped from one quarter to one fifth, and this is of course of great importance in releasing resources for productive purposes. Nevertheless, the absolute amounts involved are enormous—defense outlays are now double what they were in the 1950s and 1960s. To take another comparison, Israel's defense outlays are from 4 to 10 times those of other western countries.

Most of the defense outlay is financed by the economy of Israel; much of the rest is United States aid. Since the Yom Kippur War, American aid, consisting of grants and loans, has been of significant proportions. The loans have covered from 20 to 30 percent of defense outlays in the last few years.

[5] Direct demand comprises public consumption and public sector investment.

Table V–3

DIRECT PUBLIC SECTOR DEMAND, 1978–83

	Current IS million		Percent change over preceding year							
			Quantity						Price	
	1982	1983	1978	1979	1980	1981	1982	1883	1982	1983
Consumption[a]										
Total										
Civilian	64,161	163,569	5.4	2.1	-1.2	0.9	0.4	0.8	118.3	153.0
Defense	126,392	287,717	9.8	-13.7	14.7	9.2	-9.6	-6.9	124.9	144.5
Total	**190,553**	**451,286**	8.4	-8.7	9.1	6.4	-6.4	-4.2	122.6	147.3
Local[b]										
Civilian	61,181	156,299	2.5	5.9	-1.1	2.4	0.4	0.9	118.3	153.2
Defense	85,883	217,664	-2.3	2.2	4.8	1.8	7.0	7.4	127.0	136.0
Total	**147,064**	**373,963**	-0.3	3.8	2.2	2.1	4.0	4.6	123.4	143.1
Public sector investment										
Nondwelling investment	18,681	48,801	3.0	9.0	-18.4	-7.7	9.1	12.8	124.7	131.5
Residential construction	10,897	20,056	-24.3	26.6	48.6	-4.7	-21.7	-18.7	118.6	126.5
Total	**29,578**	**68,857**	-5.5	13.4	0.2	-6.4	-4.9	1.0	122.5	130.6
Direct public sector demand[a]										
Total	**220,131**	**520,143**	6.3	-5.7	7.6	4.5	-6.2	-3.5	122.6	145.0
Local[b]	**176,642**	**442,820**	-1.3	5.7	1.6	0.4	2.4	4.0	123.2	141.1

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

4. TAXES, TRANSFERS, AND SUBSIDIES

In 1983 taxes rose, subsidies on domestic production declined, and transfers rose moderately; the net result was that the tax burden rose slightly over the high 1982 level—from 24 to 26 percent of GNP.

In the second half of 1983, income tax revenue fell off because the "Peace for Galilee" Loan came to an end (it was imposed for the period July 1982–April 1983) and because the law for taxation under inflationary conditions came into effect. On the other hand, as the sheqel was increasingly overvalued in the course of the year, import taxes were raised as a substitute for devaluation—the foreign travel tax was reimposed (it was levied for three months in 1982 and again from April 1983), a levy on foreign-currency purchases was introduced in April, a deposit requirement was imposed on some imports in June, and purchase tax was raised. Subsidies on domestic production grew fairly steadily until the last quarter of 1983, when they were cut substantially. The steep devaluation of the second half of the year also reduced the government's outlays on export promotion.

Available data suggest that the tax burden fell slightly in the second half of the year. At the time, the government proposed to tax part of the child allowance, to introduce a surtax, and to increase the foreign travel tax, with a view to increasing absorption, but these measures were deferred to 1984.

As a result of the country's highly redistributive tax system, only half of the tax revenue is available for financing the government's expenditure on goods and services (in the last two years tax revenue came to over half of GNP, while transfers came to 22–23 percent). Such a system may have some advantages (a more equalitarian income distribution via transfers and guaranteed minimum nutrition via the subsidization of essentials). There are, however, also social costs—the disincentive effect of high tax rates, the diversion of resources to tax havens which are inefficient for the economy as a whole, the inducement to evade taxes. There is no quantitative estimate of the resulting loss of product, but it is presumably large; on the margin, the ill effects are even more serious. Furthermore, it emerges from a study of the effects of taxation[6] that the present income distribution can be maintained (perhaps even improved) by simultaneously reducing taxes, transfers, and subsidies.

[6] Joseph Gabbay, "The Social Implications of Fiscal Policy." (Jerusalem: Center for Social Policy Studies, 1983.)

Figure V–2

SELECTED TAX RATE INDEXES, 1970–83

(1970 = 100)