CHAPTER V

THE PUBLIC SECTOR[1]

1. MAIN DEVELOPMENTS

In 1987 public sector income and expenditure was balanced, after having recorded, for the first time in many years, a surplus of some 3 percent of GNP in 1986. The transition from surplus to balance was mainly due to the termination of the U.S. emergency grant while the changes in the various income and expenditure items were slight. The fact that this year the public sector did not slide into deficit prevented a significant deterioration in its domestic and foreign liabilities position. Since the adoption of the stabilization program, the public sector current accounts (excluding nondwelling investment) posted a positive saving—a position not attained since the early 1970s. In 1985 public saving amounted to half a percent of GNP, in 1986—6 percent, and in 1987—3 percent. Public sector investment, other than in public services, increased particularly rapidly in 1987, although still remaining below the level of the mid-1970s.

In 1987 the direct domestic activity of the public sector contracted relative to that of the private sector in three main markets: its purchases in the domestic goods market declined, as a proportion of GNP; in the labor market, the share of its employment decreased, and in the capital market it played a smaller role both in total borrowing and credit granted to the public. In view of the earlier large scale of these public sector activities, it may reasonably be assumed that their reductionis a beneficial contribution both to the allocation of resources and production factors, and to a more efficient functioning of these markets themselves. This year the government also initiated cuts in tax rates; due to the expansion of economic activity, tax revenue did not decline, public sector income even rose, and the domestic deficit stabilized at a low level. These developments in the public sector's income, expenditure and deficit prevented a strengthening of the public's expectations of devaluation, thereby contributing to stability in the foreign currency market, and establishing favorable conditions for the tax and capital market reforms that were begun in 1987. It is nevertheless to be

[1] The public sector comprises the central government, the National Insurance Institute, the local authorities, the National Institutions, and the nonprofit institutions financed mainly by the former, such as the sick funds, universities, etc.

emphasized that despite this year's decline in the public sector's domestic activity relative to the private sector, the share of government in GNP still remains very high.

The year under review saw changes in income taxes: tax rates were lowered, the tax threshold on personal income was raised, corporate tax rates and the employers' tax in the commerce and services sector were cut. In addition, a further round of tariff cuts was implemented, in accordance with the trade agreements with the European Community and the U.S. The classification of goods subject to purchase tax was revised. Relative to the previous year's tax base, these changes in the tax system should havereduced tax revenue by some 3 percent of GNP (in terms of the 1986 tax base), but the growth in economic activity and improved tax collection—due, among other things, to the lower inflation rate—broadened the tax base, and resulted in a 5 percent increase in tax revenue, in the same terms. However, the combined effect of these two factors—increased economic activity and better tax collection—which amounted to 2 percent of GNP in 1986 terms, did not show up in 1987 GNP terms because of this year's rapid GNP growth. Tax revenue and transfer payments therefore remained at last year's level—48 percent of GNP. This is much higher than the net tax burden that had prevailed in Israel for many years, and also much above the usual levels in other countries.

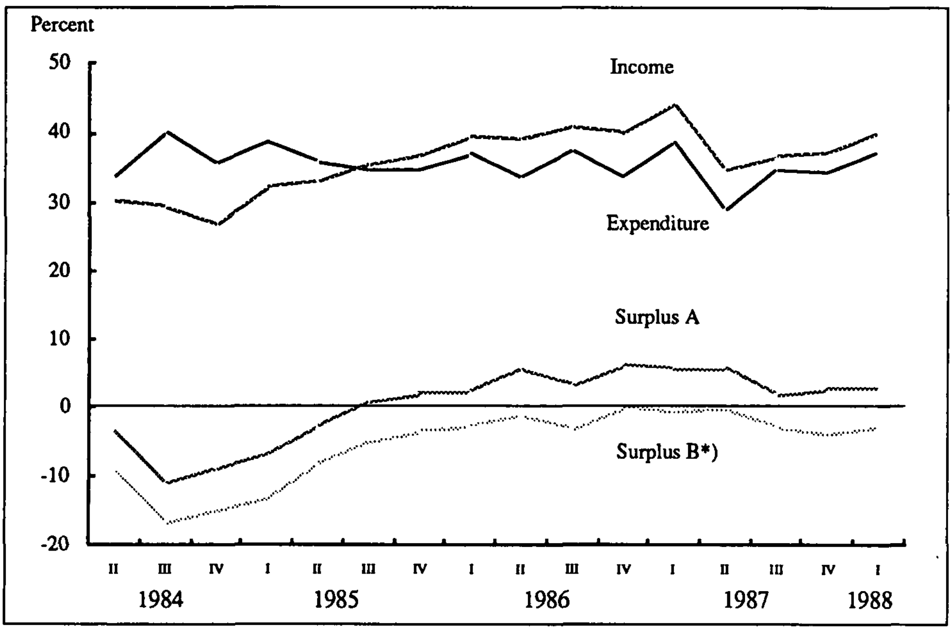
The public sector's direct domestic demand rose in 1987 by a moderate 3.6 percent, following a continuous decline the three preceding years. The slight increase in 1987 is composed of a slow rise in civilian and defense consumption and a steep increase in investment in the economic sectors. Civilian purchases went up while the civilian labor input remained unchanged, whereas in the defense sector domestic procurement rose, and the labor input, which began to be reduced in 1985, continued to contract. Government investment expanded rapidly in 1987, with changes in composition—a steep rise in infrastructure investments and a decrease in machinery and equipment.

The public's tax burden (defined as the share of total tax revenue in GNP, less transfer payments and subsidies), which had risen to a peak in 1986, eased to some extent in 1987. Its slight reduction was the sum of changes in tax laws, which cut tax rates; the broadening of the tax base; and some decline, as a share of GNP, in the transfer payments and subsidies which the government pays to the public. It should be noted that the main beneficiaries of this year's reform in direct taxes were the upper income groups, as explained below. In view of the negligible change in transfer payments and subsidies, the easing of the tax burden this year may be regarded as having benefited mainly the upper income groups. In the previous year, in contrast, the average tax rates on the lower income groups decreased more than those on the higher income groups—mainly as a result of the lower inflation rate.)

Real interest payments to the public on the domestic debt remained at a high 6 percent of GNP. In the last three years, real interest payments amounted on average to 6.3 percent of GNP, as against only 3.3 percent in 1980–84. Two factors combined to raise the level of interest payments in the last three years: a) the rapid growth of the internal debt in the period prior to 1985 broadened the base of interest payments with which the more recent period started; and b) the sharp cut in the inflation rate reduced the real erosion of interest payments (among other things, due to their indexation to the last-known CPI). A future reduction of interest payments under conditions of lower inflation therefore depends on decreasing the ratio of domestic debt to GNP, by running a surplus of income over expenditure.

The elimination of deficits reduced the public sector's domestic borrowing requirements, and its capital market operations were mainly limited to recycling the existing domestic debt. However, despite the balance in its accounts, the public sector continued to borrow (see Table V–1, item 4c), increasing the domestic debt[2] and generating pressure on the local capital market.

Figure V–1
GOVERNMENT EXPENDITURE, INCOME AND CASH DEFICIT, JUNE 1984–APRIL 1988
(Percent of GNP, quarterly moving average)



*) Includes imputed real interest according to Bank of Israel data.

[2] The data on the balance of the domestic debt (Table V–1, item 5a) show a decline of 11 percent in GNP terms, but domestic borrowing through bond issues actually increased the internal debt by 1.9 percent (see Table V–1, item 4c). The difference between the two series is mainly due to the revaluation of the indexed and dollar-linked debt items. This revaluation is not included in the borrowing flow shown by item 4c.

Table V–1
PUBLIC EXPENDITURE AND REVENUE, THE DEFICIT AND ITS FINANCING, 1980–87
(Percent of GNP, current prices)

	1980-1984	1985-1987	1981	1982	1983	1984	1985	1986	1987
1. Total public expenditure	72.5	66.2	74.4	71.5	67.2	73.7	71.1	65.2	62.3
a. Domestic	60.3	54.1	62.0	60.4	57.7	59.4	56.3	53.4	52.6
b Foreign	12.1	12.1	12.4	11.1	9.5	14.3	14.8	11.8	9.7
2. Total revenue	58.5	66.4	59.0	59.3	59.3	54.7	68.9	68.0	62.2
a. Domestic	48.3	50.8	48.9	50.3	50.4	42.8	49.0	52.0	51.4
b. Foreign	10.2	15.6	10.2	9.1	9.0	12.0	19.9	16.1	10.8
3. Public deficit (–) or surplus (+)									
a. Total	–13.9	0.2	15.4	–12.1	–7.8	–19.0	–2.2	2.8	–0.1
b. Domestic	–12.0	–3.3	–13.2	–10.2	–7.3	–16.6	–7.3	–1.4	–1.2
c. Foreign	–1.9	3.5	–2.2	–2.0	–0.5	–2.4	5.2	4.2	1.1
4. Financing of total deficit or surplus									
a. Net borrowing from abroad	6.6	–0.6	6.5	5.8	5.1	10.4	–1.4	–1.8	1.6
b. Net money creation	1.7	2.3	1.6	1.6	0.7	2.6	5.7	0.7	0.6
c. Net domestic borrowing	4.5	0.2	7.6	7.7	–1.2	2.9	–1.8	0.6	1.9
e. Residual	1.2	–2.1	–0.3	–3.0	3.2	3.1	–0.3	–2.2	–3.9
5. Public debt									
a Domestic	123.4	129.6	122.0	125.4	120.1	127.5	138.2	130.2	120.6
b. Foreign	40.5	41.3	37.7	37.8	41.5	50.0	51.1	38.9	33.8

DEFINITIONS:

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

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

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

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

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

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

Net money creation: Increase in narrow money base (currency in circulation and deposits of commercial banks with the Bank of Israel) less Bank of Israel expenses on the money base (interest paid on deposits of commercial banks, changes in the discount-window loan, etc.).

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

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

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

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

Table V-2
PRINCIPAL COMPONENTS OF PUBLIC SECTOR EXPENDITURE AND REVENUE, 1980–87
(Percent of GNP, current prices)

	1980-1984	1985-1987	1981	1982	1983	1984	1985	1986	1987
Total public expenditure	72.5	66.2	74.4	71.5	67.2	73.7	71.1	65.2	62.3
Domestic expenditure	60.3	54.1	62.0	60.4	57.7	59.4	56.3	53.4	52.6
Direct domestic demand	35.6	31.2	35.5	35.9	35.3	35.6	32.2	30.6	30.9
Thereof: Civilian	18.0	16.5	18.2	17.7	17.6	18.3	16.7	16.4	16.4
Defense, net	14.3	11.7	14.2	14.9	14.2	14.4	12.8	11.2	11.0
Public sector investment	3.2	3.1	3.1	3.3	3.5	2.9	2.7	3.0	3.5
Direct subsidies	5.7	3.7	7.6	5.8	5.8	6.3	4.8	3.1	3.2
Transfer payments	11.2	11.0	11.2	11.4	10.9	10.3	10.5	11.4	11.0
Credit subsidies	4.5	1.6	5.2	3.9	3.3	3.2	2.1	1.5	1.3
Real interest payments	3.3	6.6	2.5	3.4	2.5	3.8	6.8	6.8	6.2
Direct demand for foreign currency	12.1	12.1	12.4	11.1	9.5	14.3	14.8	11.8	9.7
Thereof: Direct defense imports	8.1	7.6	11.0	7.1	4.9	7.8	9.0	5.2	8.8
Advance payments on defense imports	0.2	0.2	–1.8	0.1	0.4	1.0	0.2	2.5	–2.2
Net interest payments to abroad	2.7	4.3	2.1	2.2	3.0	5.0	5.5	4.0	3.4
Domestic revenue	48.3	50.8	48.9	50.3	50.4	42.8	49.0	52.0	51.4
Taxes and transfer payments by households	43.2	47.0	42.6	45.5	46.1	38.2	45.1	48.4	47.6
Income from property	2.3	1.1	3.5	1.9	1.6	1.8	1.3	0.9	1.1
Income n.e.s.	2.8	2.6	2.8	2.8	2.7	2.8	2.6	2.6	2.7

DEFINITIONS

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

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

Public sector investment: Does not include public housing.

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

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

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

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

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

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

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

SOURCE: Central Bureau of Statistics and Bank of Israel.

Provided that the 1988 budget will be implemented as submitted to the Knesset, the weight of the public sector in the economy is likely to diminish further. Public consumption will increase, but its share in GNP will fall; the tax burden will be further lightened, with taxes declining as a proportion of GNP, while transfer payments will show a relatively large increase (due to sizeable redemptions of compulsory loans); the government's domestic borrowing requirements will grow with a larger deficit, and at the same time the government's foreign debt is expected to decrease. The income, expenditure, and deficit data of the Accountant-General (presented in Table V–1) provide an indicator for the expected 1988 deficit. The Accountant-General's data are on a cash basis, and are therefore not identical with the budget figures, but they have the advantage of showing developments during the year. These data show that the income surplus of the Accountant-General fell off in the second half of 1987 and remained at a low level also in the first quarter of 1988. A similar picture is obtained when real interest payments, as imputed by the Bank of Israel, are included in expenditure (the lower curve in Fig. V–1), which means that the deficit was higher in the second half of 1987 as well as in the first quarter of 1988.

2. FISCAL POLICY

The data on public sector income and expenditure are ex-post figures; therefore, they reflect both changes initiated in fiscal policy itself and changes caused as that policy was implemented. Thus, for example, the adoption of an expansionary policy, through tax cuts, causes tax revenue to decrease, but the implementation of the policy causes aggregate demand to increase, which in turn raises tax revenue, thus offsetting its initial contraction. When fiscal policy is restrictive, the offsetting is in the opposite direction. The ex-post data on public income and expenditure therefore do not properly reveal the nature of fiscal policy as actually implemented. For the purpose of tracing fiscal policy, it is necessary to distinguish between the influence of legislation introduced by the government on income and spending, and the actual effects resulting from that policy.

At the beginning of the fiscal year direct tax rates were reduced, a further round of tariff cut was carried out, and the goods subject to purchase tax were reclassified. The calculated outcome of these policy changes should have led to a fall in revenue of some 3 percent (see Section 4 below). Domestic demand is pushed up by cuts in tax rates, and makes for higher economic activity. Cuts in tax rates also have a favorable effect on the supply of product: the reduction of taxes on wage income augments the supply of labor, and lower corporate taxes raise the profitability of investment, thus increasing the supply of goods.

Domestic public consumption rose in 1987 by less than 2 percent—below the growth rate of both actual and potential GNP (i.e., the GNP estimated on the assumption of capacity use of the production factors[3]). It is therefore seen that the increase in public consumption has not crowded out private sector investment, but on the contrary: the faster growth, relative to public consumption, of actual and potential GNP left more resources at the disposal of the private sector. The rise in public consumption therefore did not fully offset the expansion of private sector demand that resulted from the cuts in tax rates.[4] It follows that the overall effect of fiscal policy in 1987 led to demand expansion.

This conclusion is supported by the data of the 1987 budget as enacted: first, the budget provided for an overall deficit of 3 percent of GNP, which may indicate that the government intended fiscal policy to be expansionary in 1987; and secondly, when the original budget is compared with its actual implementation, it turns out that the income actually received was considerably greater than planned in the budget. A substantial part of the initial upward push to demand given by fiscal policy is therefore not disclosed by the ex-post figures.

3. THE DEFENSE BURDEN

In 1987 the volume of defense consumption increased more than in any year during the 1980s, due to an exceptional near-doubling of defense imports. These imports fluctuate widely from year to year, according to the timing of supplies of defense matériel; their unusually large increase this year therefore does not necessarily represent the beginning of any new trend. In domestic defense consumption the various components changed in 1987 in opposite directions, resulting in an unchanged total volume. Domestic defense procurement increased this year by some 5 percent, after three years of continuous decrease; this year's rise was apparently connected with the steep fall of domestic purchases in 1986. The labor input in the defense sector (excluding conscript soldiers) continued to contract, in line with the general policy of cutting the labor input in the public sector as a whole.

The defense burden is a multi-dimensional concept; there is in fact no single quantitative measure to express the economic burden of defense. It is therefore customary to analyze several indicators, each of which highlights a different aspect of the defense burden, and all of which together provide an indication of its overall trend.

In the previous year all the quantitative indicators (see Table V–3) pointed to an easing of the defense burden, but for 1987 the first two of these indicators are in the

[3] Assuming that the labor force grows at the same rate as the working-age population, and potential capital stock and productivity growth is their actual growth, the 1987 growth of potential business sector product is estimated at 4.9 percent.

[4] Private consumption is inversely related not only to taxes, but also to public consumption.

opposite direction, due to the exceptional surge in defense imports and the anticipated end of the U.S. emergency aid of the last two years—granted as support for the stabilization program. These two indicators are particularly subject to wide fluctuations, so that it is best to examine them from the perspective of several years. When presented by sub-periods (see Table V–3), all the indicators point to an easing of the defense burden in the more recent period (1985–87) as compared to the earlier period of 1980–84.

The first indicator of Table V–3 measures defense consumption as a percentage of the economy's total resources (GNP plus unilateral transfers from abroad) and represents that portion of resources allocated to defense that was not obtained by increasing the foreign debt. By this measure, the defense burden has become heavier because of the sharp, but anticipated, reduction of U.S. grants-in-aid. The second indicator deducts the various grants from total defense consumption, and measures what part of the country's defense outlays is borne directly by Israeli residents. This indicator, too, shows a heavier defense burden in 1987.

The third indicator measures the claim of direct defense demand on GNP, and points to an easing of the burden since the beginning of the 1980s. The fourth indicator estimates the defense burden after deducting U.S. government grants, and the defense imports tied to them, from total defense expenditure. This measure sums domestic defense consumption, defense procurement abroad paid with foreign currency other than U.S. grant funds, and the servicing of foreign debts incurred to finance defense expenditure, including U.S. government defense loans granted in the past. In 1987 this indicator recorded its lowest level since 1973.

The fifth indicator examines the burden imposed by defense outlays on the labor market. The fall of the defense sector's wage bill relative to that of the economy as a whole indicates that the upward pressure on the wage level stemming from the defense sector has weakened somewhat in the last two years, as compared with the period since 1973.

4. TAXES, TRANSFER PAYMENTS AND SUBSIDIES

In 1987 tax revenue and gross transfer payments by the public, at constant prices, rose much more slowly than in 1986—by 4 percent. Although less than the growth rate of GNP, it is much below last year's exceptional 12 percent increase. The increment of tax revenue, at current prices, came to some NIS 5.1 billion, and the share of taxes in GNP declined by less than one percentage point, to about 48 percent (see Table V–4).

Despite the slight decline in the level of taxation in 1987, it still remains high compared with all the years since 1960, excepting only 1986, which was a peak in this respect. Total transfer payments to the public and direct subsidies to local production decreased this year very slightly, to 14.2 percent of GNP, of which 11 percent were

Table V–3
INDICATORS OF ISRAEL'S DEFENSE OUTLAYS, 1980–87
(Percent, at current prices)

	As percent of gross national income from all sources[a] (1)	Defense consumption as percent of GNP			
		Total, net of defense grants[b] (2)	Domestic[c] (3)	Domestic, plus foreign-currency outlays and debt service[d] (4)	Defense wage bill as percent of total wage bill (5)
1980–84	19.9	19.2	14.3	18.2	10.5
1983	17.3	17.8	14.2	18.0	10.1
1984	20.0	17.8	14.4	19.0	10.5
1985–87	16.6	12.6	11.7	15.9	9.3
1985	18.2	13.3	12.8	17.7	9.8
1986	14.0	9.7	11.2	15.4	9.2
1987	17.6	14.7	11.0	14.7	9.1

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

[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 &ff.).

[c] Total domestic defense outlays less local sales of the defense establishment; does not include wages of soldiers in obligatory military service.

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

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

transfer payments to the public. Net taxes as a percentage of GNP therefore also declined, by half a percentage point. However, it should be noted that in 1987 the level of net taxation was substantially higher than the average for 1980–84, due to the combined effect of a considerable rise in total gross taxes on the one hand, and on the other—the gradual decrease, in recent years, of total direct subsidies and transfer payments to the public.

The tax system, in all its diverse components, has for many years called for a comprehensive reform, both from the viewpoint of the efficiency of the system itself, which has over the years become increasingly complicated, and because of the distortions caused by the system in resource allocation and income distribution. Direct taxation was characterized by a high tax rate and a ramified and arbitrary system of exemptions and benefits which generated considerable discrimination between the tax rates on income from capital and wages, and within these two categories of income. Indirect taxes on domestic production and imports, too, are a system of differential rates, resulting in different levels of protection against competitive imports; in part, these taxes are also combined with administrative protection. Such a structure of the tax system has adverse implications for the efficiency of resource allocation, productivity, and the incentive to work and invest, thus hampering economic growth and indirectly, also impeding the reduction of the tax burden as a proportion of GNP. In addition, this system has confounded economic considerations in the conditions of uncertainty created by frequent, and sometimes retroactive, changes in tax policy. Such changes occurred mainly during the period of rapid inflation, when they were made in order to prevent the erosion of tax revenue. The substantial slowing of inflation and the significant cut in public spending which resulted from the 1985 stabilization program have therefore created favorable conditions for the tax reforms begun in 1987, but these are for the time being still partial.

At the end of 1986 the government announced its intention to carry out a comprehensive reform of the direct tax system, which was to be made up of significant cuts in the rates of personal and corporate taxes, together with a matching elimination, in an amount of half the proposed tax cuts, of tax exemptions and benefits. Since the government's proposal to abolish the exemptions was not accepted, the 1987 tax reform remained limited to tax cuts lower than originally planned, while the other constituent parts of the reform—the elimination of tax benefits, the simplification of the system, and further tax cuts—were handed over to the Expert Committee for Personal Income Tax Reform (the 'Sheshinski Committee').[5] The committee's terms of reference restricted it to a revenue-neutral reform, with tax cuts to be offset by broadening the tax base so as to leave total tax revenue unchanged. The committee's recommendations, submitted in February 1988, have not yet been implemented, and include: a) individual income from capital of all kinds and sources (interest, dividends and real capital gains) is to be made taxable, as far as possible at a uniform rate; b) the actual elimination of various tax exemptions; and c) the addition of one tax bracket and the raising of the tax threshold.

In 1987 the tax system therefore functioned under the first stage of the reform in direct taxes, which consisted mainly of cuts in income tax on individuals and corporations, as well as other tax reductions. The revisions in the tax laws are estimated to have reduced tax revenue by 6 percent, in 1986 terms. The changes in private consumption, imports and wages, contributed some 7 percent to revenue, and the slowing of inflation accounted for another 2 percent (leaving an unexplained residual of one percent).

The cuts in income tax rates and the lowering of labor costs by reducing employers'

[5] So named after its chairman, Prof. Eytan Sheshinski of the Hebrew University, Jerusalem. The committee was appointed on June 18, 1987.

Figure V-2
DIRECT TAX RATES ON WAGES AND NON-WAGE INCOME, 1980–87

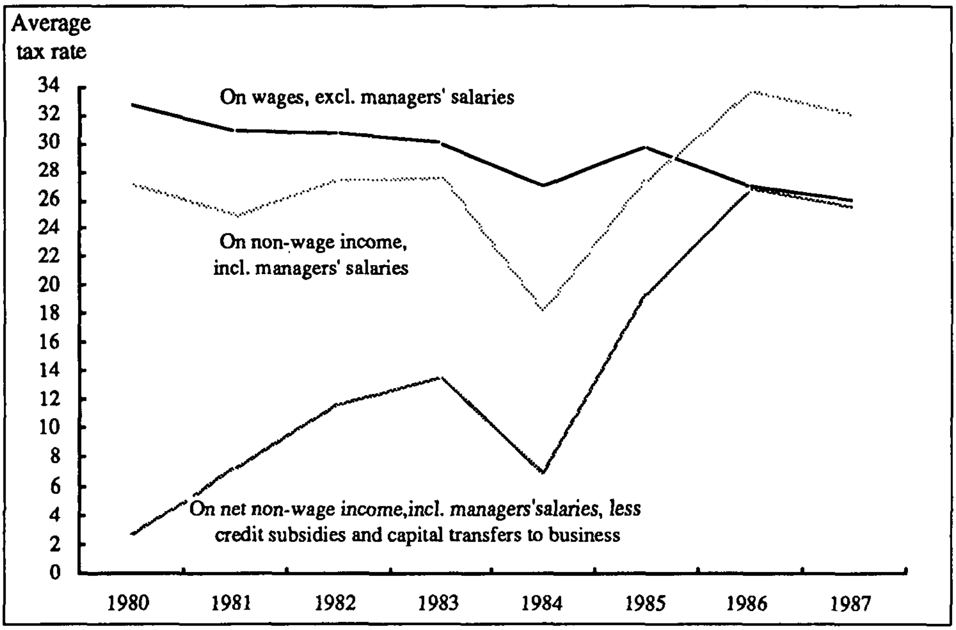
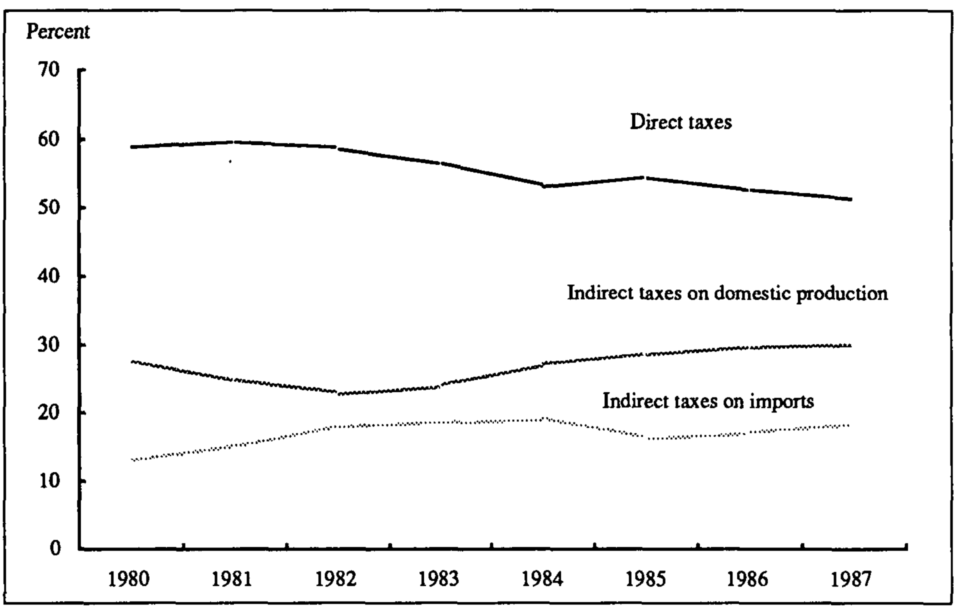


Figure V-3
TAX REVENUE, BY PERCENTAGE OF MAIN TAX CATEGORIES IN TOTAL, 1980–87



national insurance contributions caused a further fall in the average level of taxation of wages[6]—a decline that, except for 1985, has been continuous since 1981. It is to be noted that in 1987 the decline of direct taxes on wages was less steep than in 1985–86, mainly due to the 'silent reform' in personal income taxes in the second half of 1985 which resulted from a rapid rise in the real tax brackets and credit points as inflation slowed, and the continued monthly updating of the tax brackets.

A turning point occurred in the taxation of non-wage income: the average tax rate on such income declined by 6 percent, to 32 percent, following its steep rise in 1985–86, mainly as a result of the slowing of inflation and a stricter implementation of the tax laws in these years. Despite this year's fall in the average taxation rate, its level was still higher than in the years up to 1986, in most of which net taxes were very low. Moreover, in the last two years the average tax rate on non-wage income was higher than on wage earnings—contrary to earlier years.

While revenue from direct taxes increased in 1987 by one percent, the rise in expenditure taxes on domestic products and imports continued, albeit more slowly than in 1986. As a result, the percentage of direct taxes in total tax revenue declined in 1987 to 51 percent—its lowest level since 1980 (see Fig. V–3).

Tariffs on imports were reduced in 1987, as a further round in the liberalization of imports, but their cut was partly offset by a matching increase of purchase tax rates, which were re-classified into fewer product groups, thus narrowing the variation between tax rates on imports. However, more recourse was had to non-tariff restrictions on imports, which means higher protection for domestic enterprises and a diversion of trade to 'expensive countries'.

The continuous inflation that had prevailed in the economy pushed the tax system into raising tax rates, adding new taxes, and perfecting the mechanisms of indexation and adjustment, so as to reduce the erosion of tax revenue by inflation. Real tax revenue rose after the curbing of inflation, and in 1985–87 the cumulative effect of this factor was much greater than that of the changes in fiscal legislation. The latter might have been greater, had the government not been apprehensive of running a deficit. A reform of the tax system is therefore needed in order to assure sustained growth against the background of the rise in effective taxation rates as inflation has come down.

If the reduction of tax rates will indeed lead to an expansion of economic activity, it will at the same time reduce the tax burden as GNP grows, and under some conditions (which are not certain to exist in Israel) may even result in larger tax revenue. Since the endogenous factors generally make themselves felt with a lag, the effects of the 1987 changes in taxes are not yet clear: on the one hand, this year's developments in GNP

[6] It should be emphasized that taxes on wages in this calculation include employers' tax and employers' national insurance contributions on behalf of their workers; they do not include income tax on company managers. Non-wage income includes the latter.

are the fruit of past events and other factors operating in 1987, and on the other—the reform of direct taxes has not yet shown its full effect in 1987, and is expected to express itself in future years.

Table V–4
TAXES, SUBSIDIES AND TRANSFER PAYMENTS, 1980–87
(Percent of GNP, current prices)

	1980-1984	1985-1987	1981	1982	1983	1984	1985	1986	1987
Net taxes (1–2–4)	21.8	30.7	18.5	24.5	26.2	18.3	27.7	32.4	32.1
1. Total taxes and transfer payments by the public to the public sector	43.2	47.0	42.6	45.5	46.1	38.2	45.1	48.4	47.6
2. Total direct subsidies and transfer payments to the public	16.9	14.7	18.8	17.2	16.6	16.7	15.3	14.5	14.2
3. Net taxes, excluding credit subsidies	26.3	32.3	23.7	28.4	29.5	21.5	29.8	33.9	33.4
4. Imputed credit subsidies	4.5	1.6	5.2	3.9	3.3	3.2	2.1	1.5	1.3
Net direct taxes (5–7)	13.7	13.9	14.3	15.4	15.2	10.0	14.2	14.1	13.3
5. Direct taxes, compulsory loans and transfer payments by the public to the public sector	24.9	24.9	25.4	26.8	26.1	20.3	24.7	25.6	24.3
6. *of which:* Income tax	16.0	16.5	16.8	16.6	16.3	13.2	16.1	16.9	16.5
7. Transfer payments to the public	11.2	11.0	11.2	11.4	10.9	10.3	10.5	11.4	11.0
Net taxes on domestic production (8–9–10)	4.0	10.0	1.3	3.6	5.4	3.8	7.7	10.9	11.3
8. Indirect taxes on domestic production	11.0	14.0	10.6	10.5	11.2	10.4	13.0	14.5	14.5
9. Direct subsidies	4.4	2.5	6.3	4.4	3.9	4.7	3.5	2.1	2.0
10. Credit subsidies to business firms	2.6	1.5	2.9	2.5	2.0	1.8	1.8	1.5	1.3
Net taxes on foreign trade	4.6	6.9	3.4	5.7	5.8	4.5	5.8	7.3	7.5

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