Economic Downturn, Growth, and the State Budget

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The downturn that has affected the economy since the second half of 1996 continued in 1998. According to provisional data, it became more acute during the course of the year. The effects of the decrease in immigration from the former Soviet Union, the restraint, and high real interest rates were compounded by the slowdown in world trade, prompted by the crises in southern Asia, Russia, and South America. The protracted slump warrants the application of a counter-cyclical policy by means of a more expansionary state budget and a less contractionary monetary policy, which would help the business sector break out of the slump and attain a growth rate commensurate with the increase in the labor force and productivity in the years to come. In view of the instability in the world financial system and the rising susceptibility of the Israeli economy to exogenous shocks, however, expansionary measures in general, and budgetary policy in particular, should be applied in moderation, subject to multi-annual targets for public expenditure, derived from the optimum long-term growth potential of the economy.

1. The Slump Continued and Intensified in 1998-99

Initial estimates for 1999 indicate that the downturn that began in the second half of 1996 has continued and, in many areas of economic activity, actually worsened:

Slowdown in growth: The growth rate of business-sector Gross Domestic Product, which reflects economic activity, fell to 1.8 percent in 1998 is expected to stay at that level in 1999.

Decrease in per-capita GDP: In per-capita GDP, which reflects the potential standard of living for the longer term, there was a significant decrease in 1998 and will stabilize at that level, according to preliminary estimates.

Increase in unemployment: The unemployment rate, which bottomed out in the first half of 1996, has been rising steadily since then, and reached the level of 9 percent in 1999.

Decrease in investments: The decline in investments in fixed assets, about three percent in 1997, gathered momentum in 1998-99, mainly because of a decline in residential building.

Slowdown in exports: In 1997, the 7 percent increase in exports far surpassed the growth in domestic demand, and effectively prevented a steeper decrease in economic activity. In the course of 1998, export growth was halted; the annual average growth rate for the year was 6 percent.

These negative developments were accompanied by a substantial slowdown in the inflation rate, to the point that there was a negative change in the index in three of the last four months of 1997. The trend continued in 1998, and intensified in 1999.

a. Decline in Production Capacity

An analysis of the factors that led to the sharp downturn in economic activity must distinguish between long-term factors, which caused a decline in *production capacity*, and more transient factors, which caused *non-utilization* of existing production capacity. The long-term growth potential of the economy is determined by the population growth rate, which largely dictates the growth of the potential labor force, and by the increase in total productivity.[1] Indeed, during the rapid economic growth of 1990-95, the contribution of the large immigration from the former Soviet Union was conspicuous. The immigrants generated a large domestic demand for housing and for everything needed to establish households in the new country. Immigration expanded the labor supply. Along with the increase in foreign workers and the rehiring of some long-time unemployed, the Israeli and foreign labor force grew by an almost unprecedented 6.6 percent per year in 1990–1995.

Figure 1. Population and Labor Force

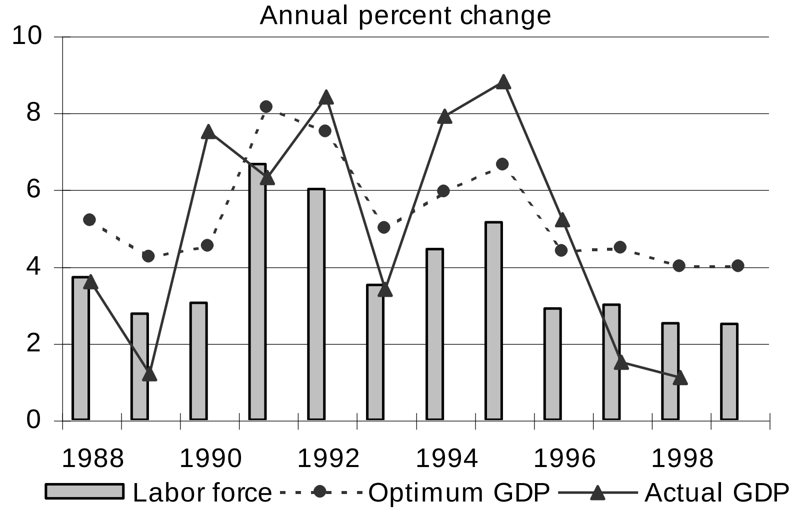
Annual percent change

[1] The optimum production capacity of the economy is estimated here on the basis of growth in the labor force, and on the assumption of an increase in total productivity of about one percent per year (as against the approximately two percent decrease in productivity in both 1997 and 1998). It is also assumed that the capital stock is adjusted to the growth in product, so that the capital-to-product ratio remains constant.

The second factor that made rapid growth possible was large investments in the economy. The moving force behind this was the immigration, which generated the demand and concurrently provided the labor needed to step up production. The optimistic climate that prevailed after the conclusion of the Oslo Accord generated a favorable environment for large-scale investments in housing as well as in other industries. The international financing made available to Israel, chiefly the U.S. government guarantees that facilitated raising capital in the U.S., provided the resources to pay for the large-scale investments.

Figure 2. Optimum* and Actual GDP of the Business Sector

Annual percent change



*For the method of computing the optimum product, see note 1.

The soft underbelly of the renewed growth in the first half of the 1990s was the slow growth of productivity; the rapid expansion of the labor force and of productive capital camouflaged poor performance in productivity. Here it is interesting to compare the current period with a corresponding period two or three decades ago. In contrast to the rapid economic growth then, accompanied by rapid increase in productivity, the 1990s growth process was totally different: growth based on expansion of production factors, with almost no increase in total productivity and no growth whatsoever in product per worker. The slower growth of the labor force – a result of the downturn in immigration and imposition of restrictions on entry of foreign workers – entails a long-term growth potential that is significantly lower than the high rates of 1990–1995, as long as there is no substantial change in the growth of total productivity. On the basis of the correspondence between growth in production factors and GDP, considering the sluggish growth of the labor force, and assuming that total productivity will rise at a rate of one percent per year, it is possible to estimate the growth capacity of the business sector in the past few years, as well as the optimum growth rate in the years to come, at about four percent annually.[2]

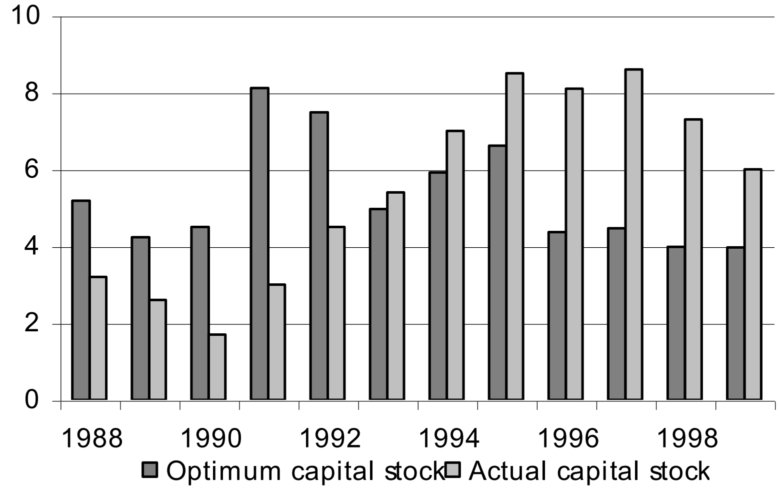
[2] If the measures to enhance efficiency and achieve more rapid productivity growth bear fruit, it will be possible to increase the estimate of growth capacity commensurably.

b. The negative effect of lower production capacity on short-term economic activity

The slower trajectory of long-term growth capacity has implications for the use of existing production capacity in the short-term. If a swift increase in capital stock was needed during the period of mass immigration, because of the rapid growth of the population and labor force, the slowdown in immigration made it necessary to reduce the growth rate of capital stock.

Figure 3. Optimum* and Actual Capital Stock

Annual percent change



*The rate of change in optimum capital stock is derived from the actual growth of the labor force and an assumption of an ongoing growth in total productivity of one percent per year (See also note 1).

Capital stock is adjusted by means of changes in the level of investment: the advent of the new growth trajectory requires a nonrecurrent contraction of the level of investments (residential building and other). Because domestic investments are one of the most important factors in determining aggregate demand, it was to be expected that the retuning of the economy would have a detrimental effect on the utilization of existing production capacity and the economy would slip into an unavoidable short-term slump.

At the present time, we are unable to estimate the individual effects of the adjustment process described above and of the other factors that generated the slump of the past two years. We can, however, point to several factors that made things worse than they would have been had adjustment to a lower growth trajectory been the only factor at work.

- The economy’s point of departure, before the effects of the slowdown in immigration began to be felt, was one of hyperactivity, caused by the huge accumulated increase in investments required to integrate the immigrants, which were carried out with a certain time-lag. Hence it could be expected that, in the short-term, the fluctuations in economic activity – up and down – would be more severe than entailed by the slowdown in growth capacity and by changes in the rate of increase in capital stock in the long term.
- As a result of the expansionary, pro-cyclical budgetary policy, in the aftermath of public-sector wage agreements that caused a significant increase in domestic public expenditure, in an economy that was already overheated, the budget deficit overran the target and the balance-of-payments deficit ballooned. The measures of budgetary and monetary restraint taken to correct these overruns and continue to reduce inflation aggravated the effect of the downturn in immigration. High interest rates encouraged large capital imports that caused appreciation of the sheqel exchange rate

and made exports less profitable. The sizable depreciation of the currency in September and October was largely an over-correction for the accumulated appreciation.

- The uncertainty that prevailed in the wake of the suspension of the peace process, coupled with a series of terrorist attacks, caused a perceptible decline in incoming tourism.
- A series of financial crises, first in eastern Asia and afterwards in Russia and elsewhere, created a climate of slowdown and caused world trade to contract. These crises are liable to harm many developed economies, including Israel.
- Rapid economic restructuring of the economy, with a boom for high-tech industries but declining competitiveness and unused production capacity in traditional industries, has had a moderating effect on the growth rate, at least during the transition period.

2. Fiscal Policy in 1998

The Government's fiscal policy for 1998, as reflected in the State Budget approved by the Knesset, was essentially a continuation of the fiscal restraint applied since the middle of 1996:

> *To attain its targets, the Government will act to gradually reduce the size of the total deficit . . . as a percentage of GDP, in accordance with the Deficit Reduction Law: The planned deficit will decline to 2.8 percent of GDP in 1997 and to 2.4 percent in 1998. To meet the deficit target, . . . a cut of [NIS] 2.3 billion is needed in the budget base. In 1998, no new tax legislation is planned (National Budget, October 1997).*

The coupling of adherence to a contractionary macro economic policy, and the refusal to adopt a more expansionary fiscal policy that would stimulate aggregate demand is not coincidental. It stems from the economic model adopted by the Ministry of Finance and the Bank of Israel. This model is based on the following principles:

a. Fiscal policy should work to create conditions for long-term expansion of production capacity by reducing the share of public expenditure and cutting the deficit. Fiscal (and monetary) policy should not aim at increasing economic activity when the economy is in a slump and existing production capacity is not being utilized. Any expansion of activity that might be attained by a budget deficit larger than that originally set and by a reduction in the interest rate will have only a temporary effect and will postpone the attainment of sustainable growth.
b. Government-initiated structural changes will play a major role in boosting the economy onto a path of sustainable growth. These include downscaling government involvement in the economy (restraining the growth of public-sector employment, reducing or even shutting down agencies whose activity can be handed over to the business sector), more rapid privatization, elimination of rigidities in the economy (especially in the labor market), and enhancement of competition. These structural changes should accelerate economic growth and thereby lower the unemployment rate.
c. A continuation of the downward trend in the inflation rate, in order to attain price stability by 2001, is stipulated as a major target. This is

primarily a target of the monetary policy, but fiscal policy, too, should be applied to attain it. This is because high taxation and a large budget deficit – inevitable if expenditures are not reduced – will generate protracted inflationary pressures. Attainment of price stability will promote maximum economic growth, strengthening Israel's standing in the world market and attracting foreign investments.[3]

The discussion in this chapter does not focus directly on an examination of these longer-term goals of Government and Bank of Israel policy or on whether the policy steps enumerated here can indeed achieve those goals. Instead, it concentrates chiefly on whether the fact that the economy is experiencing a slowdown justifies exclusive adherence to long-term policy while ignoring short-term problems that beset the economy. Or does the state of the economy in fact dictate a change in fiscal policy to provide it with maximum assistance to get back on track?

It is important to emphasize, at the start of any assessment of the 1998 fiscal policy, that there is a broad consensus that the slowdown was exacerbated by budgetary and monetary restraint that led to a rise in real interest rates.[4] In fact, the influence of the "automatic stabilizers" (which should have increased the

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[3] "The only way to get out of this situation [of economic downturn] is by cutting government expenditure and reducing the deficit. . . . Only the business sector can return the economy to a path of growth" (Finance Minister Yaakov Neeman, *Ha'aretz,* May 22, 1998 and June 7, 1998). "Low inflation and price stability are the key to placing the economy back on the growth track. . . . Unemployment should not be fought by increasing the budget deficit or by lowering interest rates rapidly" (Remarks by the governor of the Bank of Israel, Jacob Frenkel, when presenting the 1997 report; see also *Yedioth Ahronoth,* May 22, 1998, and *Globes,* June 10, 1998).

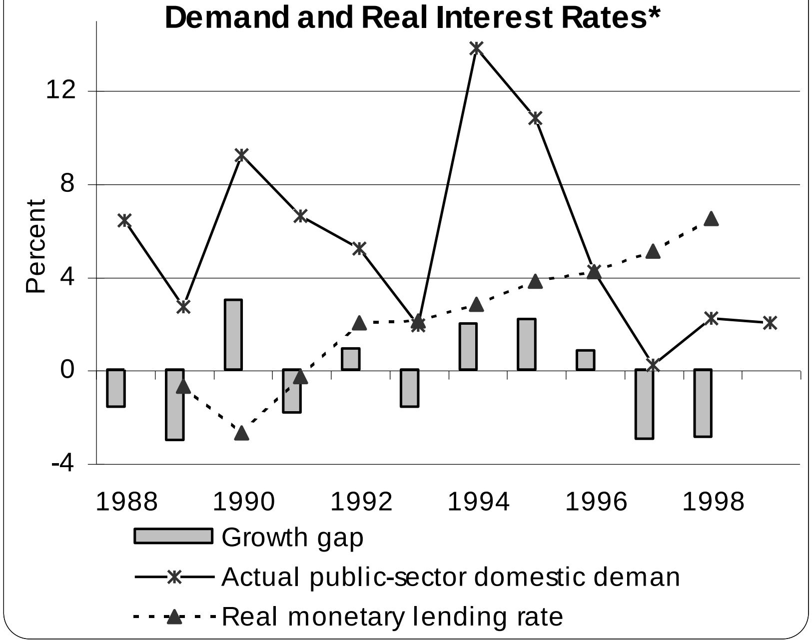
[4] Bank of Israel Annual Report, 1997.

budget deficit during a downturn) was neutralized by a decrease in expenditure as well as by an increase in taxes. If it is agreed that fiscal policy can have an effect on economic activity, at least in the short-term, why was it categorically ruled out as an option for stimulating the economy to climb out of the slump? This question arises with greater intensity because, in contrast to the pro-cyclical fiscal policy adopted by Israel in 1997-1998, in developed countries the budget usually has a stabilizing-counter-cyclical-effect on economic activity. When

there is a slowdown or recession, tax revenues decrease; this along with a certain rigidity in government spending, acts as an "automatic stabilizer" of economic activity.[5]

[5] Riccardo Fiorito (1997), "Stylized Facts of Government Finance," G-7 IMF Working Paper WP/97/142, October.

Figure 4. The Growth Gap: Actual Public Demand and Real Interest Rates*



*The growth gap is the difference between the actual and optimum growth rates of business-sector product.

The non-application of a counter-cyclical fiscal policy seems even more enigmatic when we consider that the budgetary restraint was implemented simultaneously with a policy of monetary restraint that maintained high real interest rates and encouraged large-scale capital imports, which pushed the exchange rate toward the bottom of the diagonal band.

A detailed analysis of the monetary policy of the last two years is beyond the scope of this chapter. We should emphasize, however, that monetary restraint that does not take account of the state of real activity is an aberrant phenomenon among the central banks of developed countries.[6] Evidently both the Bank of Israel and the Finance Ministry applied restraining measures to attain long-term goals of growth, productivity, and price stability, irrespective of the state of economy and without the degree of coordination appropriate when policy tools that have direct effects on real activity are being used.

The fiscal (and monetary) policy applied must be assessed within the context of a cost-benefit analysis that weighs the long-term benefit against the short-term cost. Such an assessment must relate separately to two questions:

1. What is the sacrifice ratio between the slowdown in growth and upturn in unemployment (both caused by short-term contractionary measures), on the one hand, and the contribution of disinflation and a reduction in the scope of government economy (the objectives of the contractionary measures), on the other, to stimulate economic growth in the longer term. In order to achieve maximum transparency of the anticipated negative and positive effects of the policy measures adopted, the public should be apprised of policy-makers' assessments of these expected effects.
2. Assessments of the impact of policy on real activity should be supplemented by more subjective assessments of costs and benefits that are not amenable to simple measurement. For example, various damages – from the impingement on the human capital of unemployed persons to the long-term psychological damage incurred by them – must be estimated. At the same time, the capacity of the economy to withstand world economic turmoil and

[6] Ben S. Bernanke and Frederic S. Mishkin (1997), "Inflation Targeting: A New Framework for Monetary Policy?" *Journal of Economic Perspectives* 11(2), pp. 97–116.

the speculative attacks – a result of a contractionary fiscal policy – is a benefit that is difficult to quantify. However, the difficulty of supplementing estimates of quantifiable effects with subjective assessments of other damages cannot justify the failure to provide the general public with a detailed cost-benefit analysis of the policy of restraint.

3. State Budget Framework for 1999

As of the present writing (late 1999), the Israeli economy is remote, not only from its growth capacity of the first half of the 1990s, but even from utilization of its reduced growth capacity, and is immersed in a deep slump. Total public expenditure should be derived from the sluggish state of the economy and should contribute to stimulating demand and activity in the short term.

Just as with inflation, privatization, and various economic reforms, it is important to set a multi-annual target for the level of public expenditure in Israel. When this target is set, appropriate consideration should be given to the importance – indeed the essential nature – of various categories of expenditure, such as defense, education, health, law and order, infrastructure investment, and transfer payments to disadvantaged sectors. The equilibrium between the growth of these services and the growth in private consumption of goods and services – an equilibrium that was seriously perturbed after the introduction of the economic stabilization policy in the mid-1980s – should be restored.

Civilian Public Services and Private Consumption, 1986–1997

Type of consumption	**Real per-capita growth rate**	
	Cumulative growth	**Annual Average**

		growth
Households	41.7	3.2
Nonprofit organizations	4.2	0.4
Civilian public consumption	19.5	1.6

By the same token, one must not ignore the possibility that growth of the public sector will deter business-sector growth: the scope of the damage will be proportional to the size of the public sector. Of course, long-term economic growth will depend not only on the size of the sector but also on the composition of its expenditure. Finally, one must consider the ability of the public sector to finance these expenditures by means of taxation: here too, the negative impact on productivity and growth will be proportional to the weight of the tax burden.

In the shorter term, one should take into consideration the rigidity of many expenditure items that cannot be increased immediately and without planning – such as investments in infrastructure, which require complex educational activities, land acquisitions, equipment procurement, and so on. It would be even more difficult to cut back expenditures after they were increased in order to encourage economic activity, if and when the economy requires greater budgetary restraint.[7] In these conditions, and on the basis of experience in many developed countries, the best course of action is to adopt a fiscal policy that sets a stable annual growth rate of expenditure, in real terms, for several years in advance, in accordance with the growth capacity of the economy; the counter-cyclical aspect of the policy would

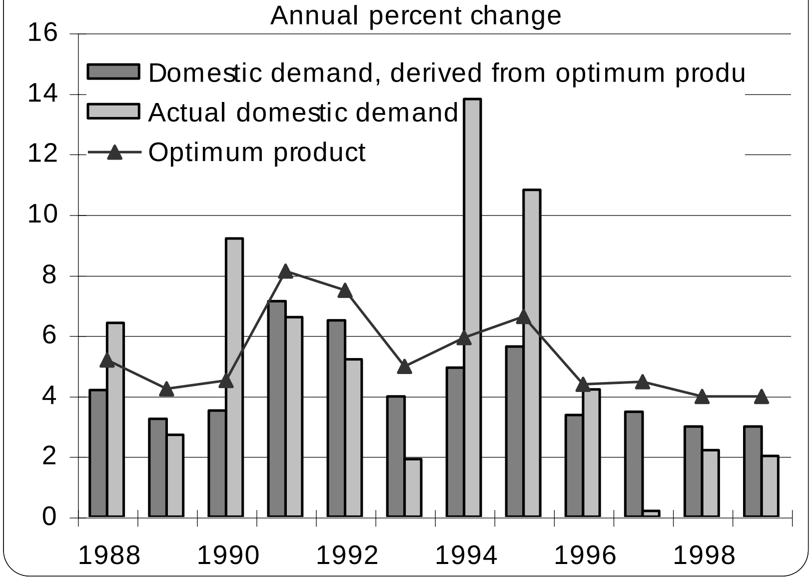
[7] Martin Eichenbaum (1997), "Some Thoughts on Practical Stabilization Policy," *American Economic Review* 87(2), pp. 236–239.

imply that, as long as the downturn lasts, any increase in revenue would be smaller than the increase in expenditure, producing a temporary increase in the public-sector deficit.

*Domestic demand of the public sector is derived from the optimum product and is equal to one percent less than the increase in the optimum product

Figure 5. Domestic Demand of the Public Sector and Optimum Product*

Annual percent change



Assuming a future optimum growth rate of four percent a year, a reasonable growth rate for government spending in the years to come can be derived, as a first stage in the elaboration of a long-term policy for determining the appropriate size of the public sector.

The reasonable long-term growth rate should be subject to the following constraints:

- Public expenditure should grow at a slightly lower rate than the optimum for business-sector product. As a result, there will be a slight decrease in the share of public expenditure, relative to business-sector product, during these years.

- For many years, a portion of public-sector expenditure has been financed by domestic and foreign borrowing. Consequently, a large foreign debt has built up. The increase in tax revenues, at the existing tax rates, should make it possible to finance public expenditure and also to gradually reduce public debt as a share of GDP. Initially this can be attained by a lower deficit; later, as the economy places itself on the optimum growth trajectory, or perhaps above it, this can be done by means of a budget surplus.

Public-consumption growth of three percent a year should make it possible to satisfy these constraints during the transition period. After the economy returns to a higher optimum growth rate, it would also make it possible to lower tax rates gradually. The transition period should be utilized for drafting detailed multi-annual plans that set the appropriate size of the public sector and allocate expenditure among defense, social services, transfer payments, and infrastructure investment.

Assuming that we set a multi-year ceiling for budget expenditure that permits a slight increase in real spending above the level of the past two years, what budget items should be increased in the short term in order to stimulate economic activity as quickly as possible? An expenditure item is better suited for promoting economic activity during a slump in proportion as (1) it can be increased more rapidly; (2) it stimulates greater domestic demand; (3) it can be pared back again when this becomes appropriate; and (4) the increase corresponds to long-term priorities. One point worthy of emphasis is that an increase in transfer payments to the disadvantaged increases demand for business-sector product only, without augmenting public-service production and labor force.

Ways of Financing a Three Percent Rate of Expenditure Increases

How should the government finance a three-percent growth rate of public expenditure as long as the economy is sluggish and the business sector is growing by only one to two percent a year? If this policy is adopted, a slight increase in the budget deficit, entailing larger raising of capital by the government, will be inevitable.[8] If the increase in expenditure is perceived as permanent, it is liable to generate expectations of higher interest rates subsequent to a rapid growth of domestic debt, higher expectations of inflation, and a deterioration in the balance of payments – the "twin" deficit phenomenon.[9] Hence it is important that the government make it clear that the three-percent budgetary growth rate will be maintained even after the economy comes out of its slump. If this rate is indeed maintained, the increase in the deficit will be temporary; when growth resumes, tax revenues will climb along with the increase in economic activity and make it possible to cover the deficit – and perhaps even generate a surplus. It is important that the controlled expansionary fiscal policy be accompanied by a less-contractionary monetary policy that will make it easier to finance the budget deficit and make its own contribution to stimulating business-sector demand in general and for investments in particular. A moderate expansionary policy of this type will not undermine domestic and external economic stability and will strengthen the economy during a period when

[8] It is true that, in an economy growing by at least four percent a year, some of the budget deficit can be covered by printing money. In view of Israel's long history of inflation, however, this option should probably be forgone for now.

[9] The "twin" deficit phenomenon is the effect that increasing the budget deficit (which usually reflects a decline in public-sector savings) has on increasing the balance-of-payments deficit, and vice versa.

there is a slowdown in many world economies and especially in world trade.

During the past two years, the important role of government in enhancing the future production capacity of the economy has to some extent been confounded with its responsibility for enabling the economy to utilize the existing production capacity. Policies are needed that will increase production capacity in the longer term; so are policies that encourage the use of existing production capacity. But one should not expect that the same policies can promote both goals concurrently. The opposite is frequently the case: measures such as enhancing competition, greater exposure of domestic manufactures to imports, privatization – accompanied by streamlining – of public-owned companies, and the like will increase productivity in the long term but may be detrimental to economic activity and increase unemployment in the short term. One certainly should not expect such a policy, and the significant disinflation – welcome developments in themselves – to lift the economy out of the slump in which it has been mired since the middle of 1996. Hence it is important that the creation of conditions that permit more vigorous growth be accompanied by a more expansionary macroeconomic policy in the more distant future, one that will mitigate the detrimental effects of efficiency measures and ensure public support for the requisite structural changes.