

CHAPTER X

GOVERNMENT AND NONGOVERNMENT PUBLIC SECTOR

I. CONSOLIDATED ACCOUNT

Some 80 percent of the total financial transactions of the public sector—which comprises the government, local authorities, and National Institutions¹—is accounted for by the government, whose dominant influence is even greater than indicated by its budgetary operations.

For the second year running, a financial report for the period April to December had not yet been prepared by the Accountant General when the Hebrew edition of this chapter went to press. This report served as the basis for calculating the government's budget and extrabudgetary operations during the calendar year; in its absence full data are not available on the government's budget performance and its financial transactions, and therefore its operations cannot be quantified with any reasonable degree of reliability. Nevertheless, we can broadly assess the sector's influence on aggregate demand and the level of economic activity in 1974 as compared with the previous year.²

As is evident from the estimated domestic demand surplus and liquidity injection

¹ The local authorities include religious councils and the municipal expenditure of cooperative agricultural settlements. The National Institutions comprise the Jewish Agency, World Zionist Organization, Jewish National Fund, and Keren Hayesod.

² Estimates of the government's operations based on past growth rates and budgets, which may serve as a fairly good approximation in years when developments are more or less normal, are not suitable for periods like the past two years or so, which witnessed hyperinflation and a drastic change in the scope of the government's operations—a problem further complicated by the fact that part of its financial operations are extrabudgetary. The partial data on government operations presented in this and other chapters of the Report are based on information made available by various sources other than the Accountant General. But since the data received from these sources (such as the Central Bureau of Statistics, the State Revenue Administration, the Budgets Department of the Ministry of Finance, the State Loans Administration of the Bank of Israel, and others) are fairly specific, the accounts of the government and the rest of the public sector cannot be presented in as comprehensive and detailed a manner as in previous years.

of the sector, its operations had an expansionary influence on domestic activity, even though the sweeping revenue and expenditure measures introduced by the government at the end of 1973 and during 1974, some of which will make their impact felt only in 1975, worked in the other direction.

The domestic demand surplus consists of the sector's local expenditures on current and capital account, less its inland revenue. But when examining this indicator, as well as that of the liquidity injection, it must be remembered that we are dealing with pounds with a disparate effect on aggregate demand but which are assigned an equal weight in the calculations. This is inevitable, since it is difficult to estimate the contractionary or expansionary influence of each item of government expenditure and revenue, although obviously the contractionary effect of taxes, for example, is greater than that of credit from the public. Similar problems exist in estimating the effect of different expenditure items, such as payrolls, direct investment, transfers, and credit provided.

The estimate of the public sector's demand surplus is based on that of the National Institutions and local authorities in calendar years, plus the government's demand surplus in fiscal 1973/74 and the budget proposal for 1974/75. The National Institutions' demand surplus is structural in nature, since their resources are mobilized abroad and spent locally. Although the demand surplus doubled between 1972 and 1974, the increase in 1974 was mild compared with the high level reached the year before. The contribution of the National Institutions to the sector's overall demand surplus did not exceed 14 percent in 1974, while its share in the domestic demand surplus came to 26 percent.

The sector's domestic demand surplus shot up 62 percent to hit IL 6.5 billion at current prices. After adjusting for the 36 percent jump in the prices of domestic uses, the real increase was 19 percent. Less net compulsory loan receipts, the demand surplus was IL 4.1 billion, up 50 percent at current prices.

Another indicator of the aggregate influence of the sector's operations on the economy is its estimated liquidity injection, which is calculated as the sector's total domestic operations on current and capital account, plus its net credit flow. The amount of money pumped into the economy in 1974 reached IL 3.5 billion,³ as against IL 900 million in 1973 and a IL 400 million absorption in 1972. The government and the National Institutions were responsible for about 90 percent of the sum in the year reviewed. The enormous sale of government bonds in the final quarter of 1974 moderated the liquidity inflow. It is important to note that the huge public sector liquidity injection in 1974 was accompanied by a sizable private sector

³ This definition of the liquidity injection includes government interest payments to the Bank of Israel and net bank credit received by the local authorities.

absorption via the balance of payments.

An additional indicator of the public sector's influence on demand, both domestic and abroad, is its overall demand surplus, consisting of the domestic demand surplus and the government's overseas outlays on current and capital account; in 1974 this is estimated at IL 14.5 billion—53 percent up on 1973.

This hefty demand surplus was financed by way of a net domestic credit absorption, unilateral transfers, and net foreign borrowings. Net capital imports totalled IL 6,285 million (\$ 1,405 million), compared with IL 8,528 million (\$ 2,030 million) in 1973. Despite the downturn, the volume was still more than double that in prewar years. The share of unilateral transfers remained at its high 1973 level of about two-thirds; this compares with 40 percent in 1972 and only 25 percent in 1971. The proportion of capital imports financed by the government increased notably. Its share is closely connected with the total volume of imports, and is liable to change appreciably with any change in the political or military circumstances.

The sector's total foreign currency transactions were roughly in balance this year in IL terms.

The share of noncivilian public consumption, and hence of total public consumption, in GNP and total domestic uses was much higher in 1974 than before the Yom Kippur War. This is of cardinal importance in analyzing the government's influence on the economy in the year reviewed, despite the slight drop in the weight of public consumption in GNP and uses from the inordinately high 1973 average level: the exceptionally strong upswing in the final wartime quarter sharply pulled up the average for 1973, and for analytic purposes this quarter should be considered together with 1974.

Public sector consumption was up 33.2 percent at current prices, and 1.4 percent at constant prices, after a 46.4 percent real increase in 1973, most of which was concentrated in the immediate postwar period.

Real domestic public consumption (i.e. consumption less direct defense imports), which directly and immediately affects domestic demands, went up by a much faster 12.5 percent, following a sharp 19 percent rise in 1973, most of it also in the last quarter of the year. This high level is explained by the 18.2 percent growth of domestic defense outlays, payrolls, and purchases, while real per capita civilian public consumption held steady. The bulk of the extra domestic noncivilian demand was for construction and manufactures (metal goods, electronic products, and transport equipment).

At the end of 1973 and in January 1974 the government took action to blunt the expansionary effects of its operations by hiking taxes, imposing compulsory and voluntary War Loans, and slashing subsidies on essential goods and services, in

Table X-1
INDICATORS OF PUBLIC SECTOR OPERATIONS, 1970-74
 (IL million. at current prices)

	Percent annual increase											
			1972		1973		1974					
	1970	1971	Jan.- Sept.	Entire year	Jan.- Sept.	Entire year	1974	1971	1972	Jan.- Sept. ^a	Entire year	1974
1. Public sector consumption	6.728	7,940	6.795	9,242	7.974	16,396	21,845	18.0	16.4	17.4	77.4	33.2
Civilian	1.973	2,483	2.228	3,046	3.062	4,145	5,772	25.8	22.7	37.4	36.1	39.3
Noncivilian	4.755	5,457	4.567	6,196	4.912	12,251	16,073	14.8	13.5	7.6	97.7	31.2
2. Revenue from taxes	6.222	8,595	7.787	10,792	10.277	14,502	21,557	38.1	25.6	32.0	34.4	48.6
Direct taxes	3.057	4,010	3.471	4,790	4.675	6,307	8,786	31.2	19.5	34.7	31.7	39.3
Indirect taxes												
On imports	1.188	2,160	2,151	3,036	2.923	4,644	7,575	81.8	40.6	35.9	53.0	63.1
On domestic production ^b	1.977	2,425	2,165	2,966	2.679	3,551	5,196	22.7	22.3	23.7	19.7	46.3
3. Compulsory loan receipts	538	1,040	889	1,185	1,005	1,426	2,660	93.3	13.9	13.0	20.3	86.5
4. Demand surplus	3,539	3,672		4,102		9,500 ^c	14,500 ^c	3.8	11.7		131.6	52.6
5. Liquidity injected into the economy	975	1,112		-400		925	3,548					
5. Outstanding govt. loans on March 31 ^d												
Domestic	13,989	17,970		24,947		30,144	39,149	28.5	38.8		20.8	29.9

Linked ^a	5,384	7,227	10,289	13,208	19,725	34.2	42.4	28.4	49.3
Unlinked	1,915	1,913	1,906	2,084	1,726	9.3	-17.2
Foreign	6,690	8,830	12,752	14,852	17,698	32.0	44.4	16.5	19.2

Percentages

Weight of public sector consumption in total domestic uses	28.5	27.5	25.9	26.6	22.6	31.5	29.9
Weight of public sector consumption in GNP	36.0	34.0	31.2	31.0	28.7	43.2	41.2
Weight of noncivilian public sector consumption in GNP	25.3	23.4	21.0	20.8	17.7	32.3	30.3
Weight of public sector tax revenue in GNP	33.1	36.9	35.7	36.2	37.0	38.2	40.6
Weight of public sector revenue from taxes and compulsory loans in GNP	36.0	41.3	39.8	40.1	40.6	42.0	46.7

^a Compared with January-September 1972.

^b Including licenses, fees, and property tax.

^c Estimate.

^d Excluding loans from the National Insurance Institute, Development Authority, and the War Risks (Arnona) Fund.

^e Excluding revaluation increments.

order *inter alia* to bring local prices in line with those prevailing in the world markets; as a result, total subsidies for keeping down the prices of both imports and domestic products hardly rose in 1974. Part of the ensuing price rise was compensated for by the government and employers through a 6 percent cost-of-living allowance increment in February and by increasing benefit and other transfer payments.⁴

The government also moved to preserve the competitiveness of Israel's exports and even to enhance it. Export incentives were upped in August and November 1973 and in July 1974, considerably boosting the effective rate of exchange in 1974. With the official devaluation of the IL in November 1974, the incentives were kept at a maximum of IL 1.3 per dollar. This item was budgeted at IL 1.9 billion in 1974—a formidable 84 percent rise over the previous year.

The public sector influenced investment demand in several ways. Its direct capital spending, including that of its trading enterprises, was down 6 percent at constant prices, due to the tabling of a smaller development budget, the elimination of the frozen development budget reserve, and various other cuts during the year. Investment in economic services, government enterprises, afforestation, land preparation, and road construction made up 54 percent of the total capital outlays at current prices. These items fell off more than the sector total—by 13 percent at constant prices. Other public sector investments are in social and municipal services; these went up 3.8 percent at constant prices.

The government also took steps to restrain other investment activity in the economy, freezing the construction of public buildings as well as large flats and single-family homes. At the same time, it supplied much more credit for residential construction, and publically sponsored home building was stepped up 50 percent (6 percent in real terms).

The overall effect of the income policy measures adopted at the end of 1973 and in 1974 was a 48.6 percent growth of tax revenue and an 86.5 percent jump in compulsory loan collections. The government implemented its tax policy mainly via indirect taxes, since the direct tax machinery has lost much of its flexibility; as a result, the share of direct taxes in total tax revenue declined 3 percent.

At the end of 1973 and in the course of 1974 the government increasingly resorted to compulsory loans as a means of absorbing funds. The contractionary effect of this instrument is smaller than that of direct taxes, although because of the worsening of the terms of new bond issues, the tax element in the War Loans

⁴ The slashing of subsidies in January made the commodities concerned about IL 1 billion dearer at annual rates. The effect of the November devaluation is estimated at some IL 2.5 billion.

exceeds that of the Defense Loan, which was discontinued. The sizable growth of tax collections pulled up the share of this item in GNP to a record 40.6 percent, and together with compulsory loans, to 46.7 percent.

The restraining impact of taxes and loans was partly offset by an appreciable rise in the sector's transfer payments. The combined effect of the taxes, loans, and transfer payments was to depress gross disposable private income from domestic sources (less net compulsory loans) by 3.9 percent in real per capita terms. Thus it trailed behind the growth of GNP, whereas in the two preceding years it had outpaced the product growth rate. The use of value-linked compulsory loans to finance its operations inhibits the government's ability to carry out policy measures involving a rise in the consumer price index, for any rise appreciably increases the public debt and the current debt servicing burden.

A description of developments in 1974 as a whole in comparison with the average for the previous year obscures the drastic changes that occurred in the course of the year. The data available are not sufficiently precise for a detailed analysis of these changes, but they can be broadly assessed with the help of liquidity injection indicators.

Despite the government's action to siphon off money at the end of 1973 and the beginning of 1974, the first quarter of 1974 ended with a IL 230 million injection, in contrast to the usual seasonal absorption. This occurred despite the soaring volume of bond sales and compulsory loan collections this year: the contractionary effect of such revenue is outweighed by the expansionary impact of the sector's direct expenditure.

In the last quarter of 1973 and the first quarter of 1974 the Bank of Israel followed a policy of monetary expansion in order to minimize the difficulties anticipated because of the extensive mobilization, changing pattern of demand, and release of reservists. The pumping of liquidity into the economy by the Bank of Israel and the government in the first quarter facilitated the rapid recovery of the economy and reabsorption of discharged reservists.

The original government budget for 1974/75 did not contemplate any additional income policy measures beyond those adopted before the start of the new fiscal year, apart from the discontinuation of the Defense Loan and a slight rise in income tax rates.

In the course of 1974, and especially in the second half of the year, it transpired that the tighter measures adopted by the government were insufficient. The IL 2.7 billion of liquidity pumped into the economy by the public sector in the second and third quarters was much higher than in the same quarters of the previous year and also well above the level in the first quarter of 1974—a result of the failure to completely realize the sector's income estimates and a faster-than-expected growth of

expenditure. At the same time the cost-of-living index shot up and Israel's balance of payments position eroded more than envisaged. In view of these developments, the government took action in July to mop up liquidity, cutting down outlays and upping taxes. But when it became evident that these too were inadequate to arrest the deterioration in the balance of payments, it introduced on November 9 a number of additional steps, notably the devaluation of the IL by 43 percent. As a result, the liquidity injection in the final quarter was, at about IL 700 million, down 40 percent from its third-quarter level.

2. THE GOVERNMENT BUDGET FOR 1974/75

The government's budget proposal for 1974/75 was presented to the Knesset in the middle of March 1974 and approved on June 27. The delay in tabling the budget and its approval was not due solely to technical difficulties, but was also connected with the prevailing uncertainty as to the new defense budget, world economic developments (notably the advance of prices and the energy crisis), the release of reservists, and likely changes in demands. Because of the uncertainties, the budget proposal was not only presented to the Knesset rather late, but a frozen reserve was created in the development budget, to be implemented should economic activity fail to bounce back at the hoped-for pace.

The tabling of the budget was preceded by a number of fiscal measures embodied in supplementary budgets for 1973/74 and by the jacking up at the end of 1973 and the beginning of 1974 of the prices of such commodities and services as fuel, electricity, travel, basic products, and fodder. The domestic demand surplus projected in the original 1974/75 budget proposal totalled IL 3.2 billion at current prices, well below the IL 4.9 billion budgeted in 1973/74 and the IL 4 billion actual demand surplus that year.

The expenditure estimates provided for a 6 percent nominal increase in government outlays on current and capital account (including reserves), as compared with the approved 1973/74 budget (10.7 percent compared with the final outrun in 1973/74).

The planned increase in government spending other than on defense (which was down sharply from its peak level of 1973/74) amounted to 33 percent at current prices, leaving real per capita civilian consumption and nominal subsidies for stabilizing prices at roughly the previous year's level. The development budget provided for a 56 percent larger volume of credit to finance home construction and a moderate 10 percent rise in direct investment, other investment credit, and investment grants. Debt repayment and interest were budgeted about 26 percent higher this year, bringing up their weight in total expenditure to 17 percent.

Table X-2
THE GOVERNMENT BUDGET, 1972/73 TO 1974/75
(IL million, at current prices)

	1972/73	1973/74		1974/75		
	Final outrun	Adjusted budget	Final outrun	Original budget	Total budget	Adjusted budget ^a
A. Demand surplus						
1. Expenditure	14,594	28,585	27,343	30,279	34,572	34,459
Consumption						
Civilian	1,908	2,746	2,778	3,598	3,598	4,021
Noncivilian	6,120	16,840	15,400	14,700	16,361	16,328
Transfers to households and nonprofit institutions	795	1,303	1,381	1,553	1,619	2,182
Interest paid	1,775	2,062	2,237	2,783	3,465	3,465
Transfers to rest of public sector	1,116	1,425	1,409	1,921	2,429	2,950
Price supports and export subsidies	1,662	2,695	2,597	2,719	3,302	3,361
Investments, grants, and par- ticipation in investments	1,042	1,403	1,432	1,716	1,716	2,048
Reserves and miscellaneous	176	111	109	1,289	2,082	104
2. Revenue	11,633	15,896	15,922	21,306	24,280	24,280
Taxes ^b	9,428	13,901	13,115	18,734	21,464	21,464
Other domestic revenue	2,205	1,995	2,807	2,572	2,816	2,816
3. Total demand surplus (1-2)	2,961	12,689	11,421	8,973	10,292	10,179
B. Net absorption of credit						
4. Net loans granted to the public	1,656	1,624	1,739	2,009	2,493	2,600
5. Net credit received	2,787	5,427	5,552	4,887	4,544	4,544
Gross compulsory loan receipts	1,239	1,849	1,713	1,666	2,861	2,861
Other credit, gross	2,701	5,059	5,483	4,950	3,670	3,670
Less: Repayments	1,153	1,481	1,644	1,729	1,987	1,987
6. Net credit absorbed (5-4)	1,131	3,803	3,813	2,878	2,051	1,944
C. Government deficit						
7. Balance to be financed (3-6)	1,830	8,886	7,608	6,095	8,241	8,235
8. Financing	1,830	8,886	7,608	6,095	8,241	8,235
Unilateral transfers and net credit from abroad	2,333	8,925	7,440	6,165	7,875	7,875
From Bank of Israel, net	-32	-39	-41	-70	-70	-70
Budget surplus ^c	-471		209		6	
Exchange rate differentials ^d					430	430
D. Liquidity injection						
9. Domestic demand surplus	291	4,941	4,005	3,245	2,750	2,645
Total demand surplus (3)	2,961	12,689	11,421	8,973	10,292	10,179
Less: Purchases and expenditure abroad	2,670	7,748	7,416	5,728	7,542	7,534
10. Net credit absorption (6)	1,131	3,803	3,813	2,878	2,051	1,944
11. Total liquidity injected into the economy (9-10)	-840	1,138	192	367	699	701

^a Includes a supplementary budget, budget cuts, and estimated allocation of reserves.

^b Excludes National Insurance Institute collections; its deposits with the Ministry of Finance are included in "other domestic revenue".

^c A surplus is denoted by (-).

^d Bank of Israel profits in excess of the original budget estimate.

SOURCE: Ministry of Finance.

Apart from a value-added tax, no additional taxes were contemplated, on the assumption that the action taken at the end of 1973 and beginning of 1974 was adequate, and also in order not to hamstring the recovery of the economy.

The effect of these measures, together with the expansion of business, was expected to yield the Treasury's coffers 34 percent more revenue from taxes and other internal sources. The War Loan imposed in October 1973 was extended upon the discontinuation of the Defense Loan and the reduction of the Savings Loan collected from employers by 2.5 percentage points, which was accompanied by the upward revision of income tax rates. At the same time various concessions were granted with respect to income tax deductions.

As part of the tax policy (but outside the government budget framework), the ceiling wage and salary subject to national insurance contributions was raised from IL 1,500 to IL 2,500 a month, and local authority fees and property taxes were also hiked.

With the expenditure estimates trailing behind the planned growth of revenue, the demand surplus was projected at about IL 9 billion, as against an actual IL 12.7 billion surplus in 1973/74 and IL 3.1 billion originally budgeted that year. Despite the appreciable decline, the absolute size of the demand surplus was still of such dimensions as to necessitate a much heavier funding than before the Yom Kippur War.

The budget provided for a IL 2.9 billion net absorption of domestic credit (both compulsory and voluntary)—about IL 900 million less than in 1973/74. This was expected to finance approximately one-third of the demand surplus, with the IL 6.1 billion balance to be covered by unilateral transfers and net credit from overseas. No loans from the Bank of Israel were projected. It soon became obvious that the expenditure estimates were on the low side, insufficient allowance having been made for world economic developments and the intensification of inflationary pressures in the economy.

As already mentioned, the government also employed several extrabudgetary instruments: the ceiling wage and salary for national insurance contributions was raised, as were local authority fees and property tax; price control on staple commodities was extended to the end of 1974; and obligatory import deposits at the rate of 20 percent without interest were reintroduced for one year.

Even before the end of the first quarter of the fiscal year, i.e. by the middle of 1974, it became clear that the original budget proposal and the other policy measures adopted could not solve the most pressing problems facing the economy: a marked deterioration in the balance of payments, the continued spiralling of prices, and an expected growth of expenditure. Budget commitments far exceeded the budgetary reserves, with most of the growth being in payrolls, social services, export

promotion, emergency civilian outlays, and housing. On the other hand, it seemed unlikely that the revenue estimates for the voluntary War Loan and other budgeted bond issues would be realized.

Jitters over a possible hiking of government taxes or a devaluation of the IL triggered a rush of sales of staple foodstuffs and durable goods in June 1974. At the beginning of July the government decided on a number of restraining measures: it pared the ordinary budgets of government ministries by IL 300 million, reducing appropriations for the purchase of goods and services and transfer payments to public institutions by 15 percent, and cut the development budget by IL 200 million; it erased the IL 400 million frozen development budget reserve; shelved a number of projects; obligated the absorption within the framework of the existing budget of anticipated price increases to the tune of IL 450 million; and decided not to compensate government departments and supported institutions for the dearer cost of commodities and services.

These cuts in the ordinary, defense, and development budgets were intended to cover the increased expenditure. It was also decided not to approve any overspending of the existing budget. Public corporations, local authorities, and public institutions were required to adhere to these decisions.

On the revenue side, the principal changes were the upping of the War Loan rates by 5.25 percentage points for individuals and 3 points for companies, and the levying of a special War Loan at the rate of 3 percent of the appreciation of real estate values (added to the land betterment tax paid upon the transfer of ownership of such property). The increase in the compulsory War Loan included a 2.25 percent arms procurement loan.

The general levy on imports was raised 10 percentage points, with those products that had been previously exempt continuing to enjoy exemption. It was also decided to hold the lid on the prices of 14 essential commodities.

A one-time defense procurement tax was imposed on assets subject to property tax, to be paid in three annual installments, at the rate of 0.8-1.7 percent per annum. The excise on tobacco was raised 15 percent.

In addition to these budgetary measures, it was decided to ban the construction of public buildings, apartments of over 110 sq. meters gross, and single-family homes, and to jack up the interest rate on development loans by 1-3 points in high-priority branches in Development Zones A and B respectively. The government undertook to adopt special measures to boost direct tax collections by IL 1.5 billion, mainly from the self-employed and companies.

In October 1974 a supplementary budget was submitted to the Knesset, incorporating the anticipated growth of government expenditure and revenue as a result of the economic developments and the policy measures adopted since July.

This proposal called for the slashing of the demand surplus by IL 1.5 billion despite a IL 1.4 billion increase in expenditure over and above the amount financed by budgetary cuts. The absorption of domestic credit was expected to remain at its original level despite the forecast contraction of the voluntary War Loan and other voluntary bond issues. Without these steps, the demand surplus would probably be IL 2.5 billion larger.

All the various policy measures introduced until the tabling of a supplementary budget in October did not suffice to blunt the inflation or forestall a widening of the balance of payments deficit on current account and a marked dwindling of foreign exchange reserves. Even before the new budget was approved, the government had introduced a series of wide-ranging measures, including changes in the official and effective rates of exchange, paring of government budgets, hiking of taxes, and the raising of subsidized commodity prices.

The official rate of exchange of the IL in relation to the U.S. dollar was upped from IL 4.2 to IL 6. At the same time the levy on imports was reduced by 20 percentage points, and the maximum incentive per export dollar was fixed at 130 agorot. Specific customs duties and purchase tax rates were raised by the rate of the devaluation. Taxes on a whole list of luxury goods were increased by 10-20 percentage points and the foreign travel tax was also revised upward. The import of 30 selected luxury goods was banned for a period of six months. The capital gains tax and at-source income tax deductions were increased, and a financial services tax levied. A surtax was slapped on stocks at a rate equal to the change in the external value of the IL and the import levy.

The prices of basic commodities, cigarettes, fuel, electricity, water, public transport, telecommunication and postal tariffs, and various fees were upped steeply as a result of the devaluation of the IL, the advance in foreign prices, and the trimming of subsidies. These increases made it possible to keep subsidies at the volume planned for 1974/75. Without them, a much heavier subsidization would have been necessary to keep prices down. The general levy on imports was also applied to fuel and some food items which previously had been exempted, such as wheat, rice, and soybean oil. The government decided to pare its budget by no less than IL 500 million, by refraining from the launching of new projects and wherever possible by halting projects already in the pipeline.

Low-income and large families were compensated for the higher prices through the social welfare machinery and the National Insurance Institute. The government decided to continue the freeze on construction and bank credit, and the criteria for obtaining development loans in the developed coastal region were stiffened. At the same time rules were laid down for saving foreign currency. Among the various policy measures adopted in November was a decision to set up a committee for the

reform of the wage, income, and tax structure. The committee submitted its recommendations in 1975.

The supplementary budget submitted in October 1974 was withdrawn and a new proposal, incorporating all the changes originating in the November policy, was presented to the Knesset in January 1975. Under the adjusted proposal, which included the estimated allocation of reserves and budget cuts, the overall demand surplus was projected at IL 10.2 billion,⁵ about IL 1.2 billion more than originally budgeted, while the domestic demand surplus was to be IL 600 million lower.

The projected absorption of net credit, which consists of loans provided to the public, collections of such loans, proceeds of compulsory and voluntary loans, and loan repayments, was IL 1.9 billion—IL 1 billion less than the amount originally set. The government deficit, which was revised from IL 6.1 billion to IL 8.2 billion, was expected to be financed chiefly by unilateral transfers and net foreign credit.

The dent in the domestic demand surplus, in both the original proposal and even more in the adjusted budget, had a contractionary influence, especially given the marked acceleration of inflation in fiscal 1974/75. But this effect was largely offset by a significantly smaller net credit absorption.

At the end of February it was decided to impose a payroll tax and to up purchase tax rates. Cigarettes became more expensive, with one-third of the increase going to manufacturers and distributors, and two-thirds to the Treasury as excise. These taxes will make their impact felt mainly in the next fiscal year.

3. GOVERNMENT TAX AND COMPULSORY LOAN RECEIPTS

(a) *Main developments*

In 1974 the government had to contend with the pressing need to mobilize funds for financing a huge budget, in the face of a previously unheard of rate of inflation, and to prevent the drawing down of foreign exchange reserves. The tax system therefore had to cope with fiscal and rate-of-exchange problems and to fill an anti-inflationary role.

Total government tax revenue, including national insurance contributions and the current surplus of government enterprises, less certain taxes defined in the national accounts as transfer payments (such as the land betterment tax, inheritance tax, and

⁵ Bank of Israel gains from exchange rate differentials were not included in domestic revenue.

driving license fees) soared 49.3 percent. Excluding the levy on defense imports, the increase was higher—52.3 percent. Including compulsory loans but excluding the defense import levy, the figure came to IL 22.3 billion—up 55.7 percent (as against 28.6 percent in 1973 and 32.2 percent in the first nine months of 1973).

The growth of revenue inclusive of compulsory loan receipts outstripped the gain in tax receipts alone. This never happened before, and it points to the greater use made of compulsory loans for siphoning off funds from the public (in 1973 such loans had contracted). The increase in revenue eclipsed that in GNP (39.8 percent), imports for the domestic market (35.6 percent), and national income (36.6 percent)—a development reflecting the hiking of tax and loan rates.

The share of direct taxes continued downward, in line with the trend evident since 1970, and stood at 41.8 percent of total tax revenue. The principal reason for this trend was the erosion of the tax base in recent years as a result of successive hikes of the tax-exempt cost-of-living allowance and the growing practice of paying increases in wages and other incomes in the form of allowances that are either tax-exempt or subject to lower rates. As a result of this, and also because of the need to boost revenues, marginal tax rates have become very high, with the average tax rates trailing behind; hence the government has leaned more heavily on indirect taxes, especially those on imports.

To correct this distortion, an income tax and compulsory loan reform was drawn up and applied gradually between 1972/73 and 1974/75. It was designed to reduce the marginal loan and tax rates, thereby improving labor productivity and tax morality. But the reform was cut short and its practical effect nullified with the imposition of a stiff War Loan from the end of 1973 onward.

The decline in the share of direct taxes in government revenue does not necessarily mean that the tax system has become less progressive. This requires a more precise analysis of the direct tax burden (which at present is imposed on only part of the income) and of indirect taxes at the various income levels according to specific consumption baskets. The effect of the tax system on the distribution of income in the economy constitutes only part of the government's total influence on the distribution of income and wealth by income strata.

The proportion of property taxes in total tax receipts has remained stable in the past few years despite the imposition of a high defense procurement tax in July 1974, since its effect was only partly reflected in the data for 1974 and the share of property taxes in total tax revenue is low. The weight of indirect import taxes rose from 33 percent in 1973 to 36 percent. The upping of these taxes largely took the place of a modification of exchange rate policy until the devaluation of the IL in November 1974. The weight of indirect taxes on domestic production, which yield greatly disparate sums, remained virtually unchanged in the year reviewed.

(b) Direct taxes and compulsory loans

Total income tax and compulsory loan receipts (excluding the War Loan on the appreciation of real estate values) came to IL 9,148 million in 1974, a gain of 53 percent. This surpassed the growth of net national income (36.6 percent) and net private income from economic activity (35.5 percent), and was achieved even though much of the incremental national income was tax-exempt. The increase in income tax receipts alone (i.e. excluding compulsory loans) was 42.5 percent. These growth rates were the resultant of a number of contrasting influences specific to 1974, as well as of those operating for a number of years.

The factors pulling up income tax receipts by more than can be attributed to the expansion of taxable national income and the progressive income tax structure were as follows:

1. In April 1974 the third stage of the income tax and compulsory loan reform was introduced; this included the discontinuation of the 7 percent Defense Loan and the raising of personal income tax rates while reducing the total burden. On the other hand, the tax threshold (the maximum income not liable to tax) was increased, and the annual taxable income subject to the maximum rate was raised from IL 42,000 to IL 70,000. These changes were expected to boost income tax revenue but to trim aggregate income tax and compulsory loan receipts by IL 500 million at annual rates (Defense Loan collections amounted to IL 886 million in 1973 alone.)

The corporate tax structure was also altered. Along with the discontinuation of the 7 percent Defense Loan, company profits tax and company income tax were raised from 38 to 42 percent and from 25 to 30 percent respectively, and income tax on industrial concerns was increased from 10 to 15 percent. These changes were calculated to keep tax and compulsory loan collections at their previous level—i.e. an increase in income tax at the expense of compulsory loans.

The decision to gradually abolish the tax exemption on car maintenance, professional literature, and various other nontaxable benefits with a view to enlarging the tax base did not augment revenue in 1974.

As part of the effort to boost direct tax revenue, it was decided to charge interest on balances due on final assessments for earlier years, the Income Tax Ordinance was amended to treat the listing on the Tel Aviv Stock Exchange of the shares of closely held private companies (a change which carries with it substantial income tax benefits on dividends) as the realization of profits and hence subject to the capital gains tax,⁶ the capital gains tax reduction allowed for every year in which a

⁶ This is collected and reported together with income tax, although it more closely resembles the land betterment tax, which is treated here as a transfer from the public to the government and not as a tax.

Table
GOVERNMENT TAX
(IL)

	1971	1972		1973		1974
		Jan.- Sept.	Entire year	Jan.- Sept.	Entire year	
Direct taxes	4,010	3,471	4,790	4,675	6,307	8,786
Income tax	2,768	2,402	3,311	3,372	4,556	6,492
National insurance	1,242	1,069	1,479	1,303	1,751	2,294
Taxes on property	311	253	373	336	441	732
Property tax	257	187	284	265	347	623
Land registry fees ^b	54	66	89	71	94	109
Indirect taxes						
Imports	2,160	2,151	3,036	2,923	4,644	7,575
Customs and levy on civilian imports	1,556	1,409	1,987	1,955	2,627	4,528
Purchase tax	376	358	534	582	754	1,385
Foreign travel tax	70	66	80	77	88	117
Surtax on stocks	28	12	15	6	5	185
Subtotal	2,030	1,845	2,616	2,620	3,474	6,215
Levy on defense imports	130	306	420	303	1,170	1,360
Domestic production	1,766	1,603	2,175	2,020	2,679	3,914
Purchase tax	519	464	645	609	778	1,325
Fuel tax ^c	355	360	488	428	594	689
Tobacco excise	162	150	199	180	262	307
Cement excise	57	45	60	51	75	166
Excise on beverages	32	28	35	18	22	27
Defense stamp tax	143	121	160	154	201	262
Other fees (incl. current surplus of govt. enterprises)	264	223	297	295	385	630
Revenue stamp tax	157	149	204	199	253	352
Vehicle license fees	77	63	87	71	92	101
Financial services tax	—	—	—	15	27	55
Total indirect taxes on expenditure						
Incl. the defense import levy	3,926	3,754	5,211	4,943	7,323	11,489
Excl. the defense import levy	3,796	3,448	4,791	4,640	6,153	10,129
Total tax revenue						
Incl. the defense import levy	8,247	7,478	10,374	9,954	14,071	20,007
Excl. the defense import levy	8,117	7,172	9,954	9,651	12,001	10,647

^a Compared with January-September 1972.

^b Including the tax paid in lieu of the land registry fee. The tax figure for 1971 is an estimate: since 1972 separate data have been provided by the Ministry of Finance.

X-3

REVENUE, 1971-74

million)

Percent increase				Percentage distribution					
1973				1972			1973		
1972	Jan.- Sept.	Entire year	1974	1971	Jan.- Sept.	Entire year	Jan.- Sept. ^a	Entire year	1974
19.5	34.7	31.7	39.3	48.6	46.4	46.2	46.9	44.9	41.8
19.6	40.4	37.6	42.5						
19.1	21.9	18.4	31.0						
19.9	32.8	18.2	66.0	3.8	3.4	3.6	3.4	3.1	3.5
10.5	41.7	22.2	79.5						
64.8	7.6	5.6	16.0						
40.6	35.9	53.0	63.1	26.2	28.8	29.2	29.4	33.0	36.1
27.7	38.8	32.2	72.4						
42.0	62.6	41.2	83.7						
14.3	16.7	10.0	33.0						
-46.4	-50.0	-66.7	—						
28.9	42.0	32.8	78.9						
223.1	-1.0	178.6	16.2						
23.2	26.0	23.2	46.1	21.4	21.4	21.0	20.3	19.0	18.6
24.3	31.3	20.6	70.3						
37.5	18.9	19.7	18.0						
22.8	20.0	31.7	17.2						
5.3	13.3	25.0	121.3						
9.4	-35.7	-37.1	22.7						
11.6	27.3	25.6	30.3						
12.5	32.3	29.5	63.6						
29.9	33.6	24.0	39.1						
13.0	12.7	5.7	9.8						
—	—	—	103.7						
32.7	31.7	40.5	56.9						
26.2	34.6	28.4	64.6						
22.6	34.6	29.6	52.3						
25.8	33.1	35.6	49.3	100.0	100.0	100.0	100.0	100.0	100.0

^c Excluding the imputed import levy on fuel.

SOURCE: Income and property tax—Ministry of Finance; national insurance collections—National Insurance Institute; indirect taxes—Central Bureau of Statistics.

nondepreciable asset was held by the seller was cut from 5 to 3.5 percent, and the requirement to make at-source deductions was extended to additional branches (metalworking, electrical and electronic products, transport, and clothing).

2. In November the amount of tax withheld at source on dividend payments was raised from 30 to 35 percent, and the capital gains tax was upped from 40 to 50 percent (the aforementioned reduction allowed on the latter was cut again, from 3.5 to 3 percent for each year the asset was held). Penalties for tax evasion, not keeping books, etc. were stiffened.

The factors dampening the growth of income tax receipts were as follows:

1. The payment of three cost-of-living allowance increments during the year (in January, February, and July), combined with the effect of the increment paid in July 1973. These accounted for about half the increase in compensation of employees (wages and salaries plus fringe benefits) in the year reviewed.

2. The continued impact of the second phase of the income tax and loan reform introduced in 1973, which included the paring of income tax rates, an increase in personal deductions, the raising of the tax threshold, and discontinuation of Savings Loan collections from employees.

3. The erosion of the tax base, which has been going on for a number of years and is due, as already mentioned, to the fact that employees are paid partly in the form of benefits that are either nontaxable or subject to lower rates (wage incentive payments, approved overtime pay, and various concessions granted under the Law for the Encouragement of Capital Investments and the Law for the Encouragement of Industry).

Analysis of income tax collections according to assessee shows that the share of employees went up 38.4 percent (and by a similar rate if company directors listed as salaried employees and members of cooperatives are included); this compares with a rise of 36.4 percent in employee compensation and 37.4 percent in wage and salary payments according to National Insurance Institute reports (which exclude fringe benefits). This rate was achieved despite the dampening effect of the cost-of-living increments discussed above.

Income tax revenue from self-employed went up only 18 percent, compared with 24.8 percent in the first nine months of 1973 and 19 percent for the year as a whole. This increase fell far short of what should have been achieved, given the 34.1 percent gain in net private nonwage income from economic activity and that of 24.9 percent in such income less imputed residential rents. Even if the total amount withheld at source from payments to suppliers of goods and services and contractors is added to the receipts,⁷ the increment still came to only 23.5 percent. The rise was

⁷ Even though these deductions include collections from companies.

sluggish despite the declared intention of the Treasury to intensify such collections, and even though part of the receipts was on account of previous years, when economic activity, incomes, and profits had expanded notably. To attribute this to an impairment of self-employed income because of the war and mobilization is not an adequate explanation, especially as there had been a laggard increase in collections in previous years as well. Another possible reason is the growing tendency among high-earning self-employed to incorporate their offices. The number of companies has swelled in recent years, while the number of self-employed has inched up by only 1 percent per annum. It is nonetheless a reasonable inference that the slack growth of receipts from the self-employed was chiefly due to collection difficulties.

Company income tax payments soared 63.5 percent, following a formidable 53.9 advance in 1973. This is explained by bulging business profits in 1972 and 1973, which resulted in the payment of large balances on account of the final assessments for these years, as well as the relatively slight damage sustained by companies because of the war. National insurance contributions rose 31 percent to IL 2,294 million (excluding employer contributions to a health insurance scheme, which are transferred to the Sick Funds). Total wages and salaries (exclusive of fringe benefits), the basis for calculating national insurance contributions, rose by a faster 37.4 percent. The difference stems from the fact that such contributions are calculated not on total earnings but only up to a certain ceiling. This was increased in April 1974 from IL 1,500 to IL 2,500 a month, with the rates being trimmed slightly.

The policy measures introduced this year with respect to income tax collections were implemented chiefly through government loans. In April 1974 the Defense Loan was discontinued and it was decided to extend the collection of the War Loan until the end of 1974/75. The loan rates were not revised, remaining at 7 percent on taxable personal income of up to IL 40,000, 9 percent on the next IL 20,000, 12 percent on an additional IL 20,000 and 17 percent on any sum above IL 80,000. A compulsory 9 percent loan was imposed on companies. Employers Saving Loan rates were cut in April from 5 to 2.5 percent of the gross payroll, after they had been reduced from 6 to 5 percent in April 1973. This change will deprive the Treasury of an estimated IL 350 million in 1974/75.

Besides the income policy measures embodied in the original budget proposal, several other changes were introduced during the year. First, War Loan collections from both individuals and companies were raised by 3 percentage points (at annual rates). In addition, the government imposed a special compulsory loan to finance the procurement of armaments, at an annual rate of 2.25 percent on individuals and the same rate on employers' wage and salary payments (in place of the freezing of half the cost-of-living allowance increment payable from July and a 5 percent payroll tax which had been proposed by the government but rejected by both the Histadrut

Table
GOVERNMENT REVENUE FROM INCOME
(IL)

	1972		1973		1974	
	1971	Jan.- Sept.	Entire year	Jan.- Sept.		Entire year
Income tax^b						
Self-employed	521	423	599	528	713	841
Companies	663	598	828	924	1,274	2,083
Wage and salary earners	1,220	1,045	1,424	1,479	1,976	2,735
Directors of companies listed as salaried employees and members of cooperatives	95	87	116	91	122	170
Deductions at source	276	252	348	350	471	663
Thereof: From suppliers of goods and services	87	80	112	113	154	230
Total	2,775	2,405	3,315	3,372	4,556	6,492
Compulsory Defense and War Loans^c						
Self-employed	46	52	81	78	117	232
Companies	89	85	125	161	259	745
Wage and salary earners	291	265	355	335	486	1,014
Directors of companies listed as salaried employees and members of cooperatives	22	20	27	16	24	50
War Loan on the appreciation of real estate values						4
Total	448	422	588	590	886	2,045
Compulsory Savings Loan						
Employers	399	373	503	415	540	615
Employees	173	86	86	—	—	—
Directors of companies listed as salaried employees and members of cooperatives	13	4	4	—	—	—
Total	585	463	593	415	540	615
Total income tax and compulsory loans	3,808	3,290	4,496	4,377	5,982	9,152
Thereof: Compulsory loans	1,033	885	1,181	1,005	1,426	2,660

^a Compared with January-September 1972.

^b Net collections (i.e. after tax rebates). Includes Absorption Loan collections totalling IL 7 million in 1971 and IL 4 million in Jan.-Sept. and Jan.-Dec. 1972. In 1972 collection of this loan was discontinued.

TAX AND COMPULSORY LOANS, 1971-74

million)

1972	Percent annual increase			Percentage distribution					
	1973		1974	1971	1972		1973		1974
	Jan.-Sept.	Entire year			Jan.-Sept.	Entire year	Jan.-Sept. ^a	Entire year	
15.0	24.8	19.0	18.0	18.8	17.6	18.1	15.6	15.6	13.0
24.9	54.5	53.9	63.5	23.9	24.9	25.0	27.4	28.0	32.1
16.7	41.5	38.8	38.4	44.0	43.4	42.9	43.9	43.4	42.1
22.1	4.6	5.2	39.3	3.4	3.6	3.5	2.7	2.7	2.6
26.1	38.9	35.3	40.8	9.9	10.5	10.5	10.4	10.3	10.2
28.7	41.3	37.5	49.4	3.1	3.3	3.4	3.4	3.4	3.5
19.5	40.2	37.4	42.5	100.0	100.0	100.0	100.0	100.0	100.0
76.1	50.0	44.4	98.3	10.3	12.3	13.8	13.2	13.2	11.3
40.4	89.4	107.2	187.6	19.9	20.2	21.2	27.3	29.2	36.4
22.0	26.4	36.9	108.6	64.9	62.8	60.4	56.8	54.9	49.6
22.7	-20.0	-11.1	108.3	4.9	4.7	4.6	2.7	2.7	2.5
31.2	39.8	50.7	130.8	100.0	100.0	100.0	100.0	100.0	100.0
26.1	11.3	7.4	13.9	68.2	80.5	84.8	100.0	100.0	100.0
-50.3	—	—	—	29.6	18.6	14.5	—	—	—
-69.3	—	—	—	2.2	0.9	0.7	—	—	—
1.4	-10.4	-8.9	13.9	100.0	100.0	100.0	100.0	100.0	100.0
18.1	33.0	33.1	53.0	100.0	100.0	100.0	100.0	100.0	100.0
14.3	13.6	20.7	86.5	27.1	26.9	26.3	23.0	23.8	29.1

^a The Compulsory War Loan has been collected since October 1973. In April 1974 collection of the Compulsory Defense Loan was discontinued.

SOURCE: Ministry of Finance.

(Labor Federation) and the Manufacturers' Association. This was added to the War Loan collected from individuals, bringing up the rate to 12.25 percent p.a. on taxable income of up to IL 40,000, and that on additional income as set out in the previous paragraph being scaled up by 5.25 percent. Collections from employers were added to the Saving Loan, pushing up the total rate to 4.75 percent p.a. These changes were calculated to add IL 1.1 billion to the exchequer at annual rates and IL 830 million in fiscal 1974/75.

In July the War Loan was also applied to the appreciation of real estate values, at a 3 percent rate; this was expected to yield IL 60 million a year and IL 45 million by the end of fiscal 1974/75. The loan actually went into force in August, and only IL 4 million was collected by the end of December, owing to the paucity of property transactions during this period. The steep increase in compulsory loan rates at the end of 1973 and in 1974 caused collections to soar 86.5 percent to IL 2,660 million.

(c) *Indirect taxes*

Indirect tax revenue came to IL 11,489 million—56.9 percent up on the previous year. Excluding the levy on defense imports, which actually constitutes an internal transaction in the government's accounts, the gain was 64.6 percent.

Import tax receipts reached IL 7,575 million; excluding the defense import levy, this was an increase of 78.9 percent. As far as fiscal policy goes, this striking growth had only limited significance, mainly at the beginning of the year; its principal implications lay in exchange rate policy, its impact mounting steadily until the November 1974 devaluation.

In October 1973 the general levy on imports was upped from 20 to 25 percent and the purchase tax by an additional 5 percent; these increases were also imposed on imports coming within the scope of the Law for the Encouragement of Capital Investments. In addition, the purchase tax on selected luxury goods was increased by more than 5 percent. The effect of these steps, calculated to yield about IL 750 million at annual rates, was reflected in the data for 1974.

In July 1974 the import levy was put up from 25 to 35 percent—a change expected to boost tax receipts by IL 1 billion at annual rates (including the incremental purchase tax involved). In November the IL was devalued to IL 6 per U.S. dollar; at the same time the import levy was reduced from 35 to 15 percent. Other tax changes were also introduced: specific customs duties were raised by the rate of the devaluation, the general levy was extended to a number of commodities which previously had been nontaxable, the customs duty on some luxury goods was jacked up by an additional 10 points, and 10 points were added to the purchase tax

on a whole list of luxury goods (including imports), the general import levy was applied to all types of fuel at a 15 percent rate, the foreign travel tax was boosted by 15 points, with the categories of persons exempt from the tax being curtailed appreciably, a surtax and exchange rates adjustments were charged on importers' stocks, and a 17.5 percent levy was imposed on Ports Authority revenue from various fees paid in foreign currency.

These measures did not greatly affect tax revenue in 1974, both because they were introduced close to the end of the year and because of the banning of the import of certain highly taxed luxury goods for a six-month period (in the case of some items, notably private cars, the ban was deferred for awhile because many orders had been placed before the devaluation). These changes deprived the Treasury of an estimated IL 1 billion (at annual rates) in receipts from customs duty and the import levy and a further IL 140 million in purchase tax on imports; on the other hand, the surtax on stocks was expected to yield IL 500 million and the travel tax an additional IL 65 million at annual rates.

The year reviewed saw another round of tariff cuts under the import liberalization program; at the same time, however, the tariff was raised on certain other goods. The reduced customs duty on trucks, designed to encourage the acquisition of trucks for emergency periods, remained in force in early 1974.

Indirect taxes on domestic production went up 46.1 percent (23.2 percent in 1973), outstripping the 39.8 percent gain in GNP. There were several reasons for the disparate growth rates. In October 1973 the purchase tax was hiked 5 percent; the effect of this change, slated to add IL 150 million to the exchequer at annual rates, was felt mainly in 1974. The boosting of the purchase tax in November on 16 luxury articles was calculated to net IL 160 million a year, but it came too close to the end of 1974 to affect revenue to any noticeable degree this year.

The striking increase in receipts from the cement excise in 1974 stemmed chiefly from the hiking of the excise in November 1973 from IL 40 to IL 100 a ton. Fuel taxes (excluding the 15 percent levy, which in Table X-3 is included in the import levy data) were raised significantly in November 1974, but this will be felt mostly in 1975. The increase in this item is explained entirely by the jump in fuel prices, which depressed consumption.

The financial services tax on banks and insurance companies, levied in April 1973 at the rate of 3.5 percent of their total payroll and profits and 3.5 percent on commissions paid to insurance agents, was increased in November 1974 to 5 percent.

The taxes on property brought in 66 percent more revenue this year, with most of the advance being accounted for by the property tax proper and the defense procurement tax, collections of which spurted 79.5 percent. The latter tax,

introduced in July 1974, is a one-time levy payable in three annual installments and falling on all assets liable to property tax, except equipment and inventories. The annual rates are 1 percent on vehicles, 1.25 percent on hotels, 0.8 percent on homes worth more than IL 400,000, 0.8 percent on buildings rented under the Tenant Protection Law, and 1.7 percent on other immovable property. This tax is scheduled to yield IL 250 million a year, but it did not of course bring in this sum in 1974.

Collection of land registry fees was transferred in October from the Ministry of Justice to the Income and Property Tax Department of the Ministry of Finance and unified with the tax collected in lieu of the land betterment tax. The latter had been levied at the same rates as the land registry fees, in cases where there was no possibility of registering the transfer of the property or because the parties to the transaction were unwilling to do so.

4. THE NATIONAL INSTITUTIONS

The operations of the National Institutions—the Jewish Agency, World Zionist Organization, Jewish National Fund, and Keren Hayesod—have expanded greatly since the inauguration of the special emergency fund-raising campaigns in 1967; these have enabled the Jewish Agency to extend its activities and to help finance various social services. The extent of its participation in these activities has changed from year to year, depending on the inflow of funds from overseas.

The greater part of the Institutions' operations results, by definition, in a demand surplus,⁸ since their domestic income is very small. In addition, they provide credit to the rest of the economy, primarily through the development budgets of the Jewish Agency and the World Zionist Organization. The Institutions seldom resort to domestic borrowing. In each of the past four years, however, the National Institutions had a net credit outflow to the rest of the world. One reason for this was the deliberate effort to gradually reduce their foreign currency liabilities.

The Institutions' demand surplus totalled IL 2,056 million, compared with IL 1,854 million in 1973. Before 1967 it came to IL 250-300 million a year at current prices.

The National Institutions provided IL 383 million in net credit in 1974, as against IL 300 million the year before. Before 1967 they were net borrowers from the rest of the economy.

All told, they required IL 2,439 million for financing domestic operations, compared with IL 2,154 million in 1973. The bulk of this sum was obtained in the

⁸ The demand surplus of the public sector as a whole and that of the National Institutions are discussed in section 1 of this chapter.

Table X-5
NATIONAL INSTITUTION OPERATIONS, 1972-74

(IL million, at current prices)

	1972	1973	1974	Percent annual increase	
				1973	1974
1. Demand surplus					
Domestic consumption and current expenditure abroad	254	357	516	40.6	44.5
Transfers and subsidies	745	956	1,219	28.3	27.5
Interest paid	104	140	131	34.6	-6.4
Investments, grants, and participation in investments ^a	477	602	455	26.2	-24.4
Less: Domestic revenue	55	65	59	18.2	-9.2
Net transfers from rest of public sector	421	136	206	-67.7	51.5
Demand surplus	1,104	1,854	2,056	67.9	10.9
2. Net domestic credit granted					
Net loans granted to the public	166	205	309	23.5	50.7
Net credit received	34	-95	-74	-379.4	22.1
Net domestic credit granted	132	300	383	127.3	27.7
3. Balance to be financed (1+2)					
Financing	1,236	2,154	2,439	74.3	13.2
Unilateral transfers and net credit from abroad	1,048	2,772	1,701	164.5	-38.6
Net credit from the banking system	188	-618	738	-428.7	219.4
4. Liquidity injection					
Domestic demand surplus	932	1,630	1,692	74.9	3.8
Total demand surplus (1)	1,104	1,854	2,056	67.9	10.9
Less: Purchases and expenditure abroad	172	224	364	30.2	62.5
Net domestic credit granted (2)	132	300	383	127.3	27.7
Total liquidity injected into the economy	1,064	1,930	2,075	81.4	7.5

^a Including participations and credit for financing housing construction.

form of unilateral transfers from overseas, and the balance by drawing on their massive bank deposits built up at the end of 1973 in the wake of the Yom Kippur War. The deposit withdrawals accounted for much of the sizable net increase in bank credit.

Foreign unilateral transfer receipts from the fund-raising campaigns reached \$ 392 million according to the Institutions' reports, as contrasted with \$ 686

million in 1973 and \$ 334 million in 1972. Although the curve turned steeply downward in 1974, it was still above the 1972 level.

The volume of unilateral transfers in 1974 assumes particular significance in view of the strong upsurge in 1973 and the economic slump in those countries providing the lion's share of these receipts, one of Israel's major sources of foreign currency income.

The decline in capital expenditure—investments, grants, and participation in investments—occurred almost entirely in participations and credit for financing housing.

In 1973 the Jewish Agency's receipts exceeded the budget estimates for 1973/74 as well as the projected outlays for the year. Fully 80 percent of the total was received in the postwar quarter of 1973. The Agency's budget, drawn up at the beginning of the fiscal year, outlines the tasks which it undertakes to fulfill. By the end of 1974 its proceeds from fund-raising campaigns were running far behind the IL 702 million target set for fiscal 1974/75, with less than half the sum being mobilized, for reasons enumerated above.

The Jewish National Fund enjoyed a substantially higher income this year from donations and bequests, especially the former. This enabled it to step up its land amelioration and afforestation program.

5. THE LOCAL AUTHORITIES⁹

Local authority spending was 11.6 percent up on 1973 at constant prices. Consumption rose less, payrolls advancing 6.3 percent and purchases on current account by 3.5 percent; the growth of capital outlays came to 11.6 percent.

The heavier spending was financed mostly through government transfers and borrowed funds. Tax revenue expanded 26.6 percent, less than the growth of expenditure. This further depressed the share of the authorities' autonomous sources—a trend evident for the past few years. A large portion of the municipal taxes is hardly connected with the level of business activity, while another part is connected in only a circumscribed area (such as the taxation of building), the volume of collections hinging on fluctuations in such activity.

The much heavier government participation¹⁰ this year is explained by the growth

⁹ Municipalities, local, regional, and religious councils, and regional authorities. Also included are the municipal expenditures of kibbutzim and cooperative agricultural settlements

¹⁰ On the government's participation in the local authorities' budgets see Bank of Israel, *Annual Report 1973*, p.221.

of government tax revenue, a fixed percentage of which is transferred to the authorities in the form of "shared income" and Ministry of Interior grant-in-aid. Total transfers under this head went up from IL 457 million in 1973 to IL 666 million, or by 46 percent. The general grant-in-aid, which is not set at a certain percentage of any specific taxes, came to IL 322 million in 1974, as against IL 258 million the year before (up 25 percent). The rest of the increment represented participations of various ministries, which soared 111 percent—from IL 392 million in 1973 to IL 825 million. This enormous increase can be ascribed to a deliberate policy of drawing up a balanced budget for the authorities, with a larger government participation, especially in the financing of such State services as compulsory elementary education, secondary schooling, hospitalization, etc.

The sharpening of inflation in 1974 severely strained the local authorities. A rise in prices does not affect revenue and expenditure symmetrically: expenditures are immediately affected through payroll outlays, purchases, repayment of linked loans, and transfer payments; the effect on revenue is reflected partly by the hiking of taxes and fees (most of which are not connected with the level of economic activity) and by an increase in government transfers, with the adjustment of revenue lagging behind the change in expenditure.

Since the authorities have run a demand surplus for many years, their outstanding indebtedness has grown appreciably. In mid-1973 the upswing became much more pronounced with the jump in the consumer price index, as the bulk of their debt is value-linked. This of course swelled their loan repayment burden. A partial indicator of this may be found in the volume of loan repayments to the intermediaries making up the capital market,¹¹ which constitute only part of the credit market and from which the authorities obtain most of their long- and medium-term borrowed funds. The volume of principal, interest, and linkage differential payments soared from IL 300.2 million in 1973 to IL 591.7 million in the year reviewed. To meet these expenditures, on top of their other incremental ordinary and development budget outlays, the authorities had to borrow much more heavily, the sum obtained through the capital market rising from IL 459 million in 1973 to IL 784 million. In order to finance the bulk of their development budget, ordinary budget deficit, and interim finance requirements, the authorities generally turn to the credit market.

The greater part of the development budget is financed by way of loans, some of them on soft terms and without linkage, with the balance consisting of linked bank and financial institution loans. The share of the development budget covered by borrowed funds has increased during the past two years (the most up-to-date reliable

¹¹ For a definition and discussion of the system of intermediaries see note ¹ in Chapter XVIII.

Table X-6
DEMAND SURPLUS OF THE LOCAL AUTHORITIES AND ITS
FINANCING, 1972-74
(IL million)

	1972	1973	1974	Percent annual increase	
				1973	1974
A. Demand surplus					
1. Expenditure	1,839	2,677	3,894	45.6	45.5
Consumption	986	1,330	1,882	34.9	41.5
Transfers	240	406	667	69.2	64.3
Interest paid	111	141	159	27.0	12.8
Purchases on capital account	502	800	1,186	59.4	48.3
2. Revenue	1,501	2,071	3,105	38.0	49.9
Taxes	446	470	595	5.4	26.6
Other domestic revenue	336	431	543	28.3	26.0
Net transfers from the government	719	1,170	1,967	62.7	68.1
3. Demand surplus (1-2)	338	606	789	79.3	30.2
B. Financing of demand surplus					
4. Credit (net)	338	606	789	79.3	30.2
Banking system ^a	208	269	376	29.3	39.8
Other domestic credit ^a	130	337	413	159.2	22.6

^a Including consolidation loans.

SOURCE: Taxes and consumption—Central Bureau of Statistics; other data—Bank of Israel estimates.

figure available is for fiscal 1973/74, which shows that 87 percent of the development budget was funded through loans, as contrasted with 70 percent in 1972/73 and 72 percent in 1971/72).

The reason for financing most of the development budget through borrowed funds is that the assets thus created are not wholly consumed during the same year, and hence the expenditure ought to be apportioned over a number of years. The financing of such spending with loans repayable through the ordinary budget over a period of several years is therefore justified, but on condition that the development budget is so constrained as to permit the repayment of the loans in this manner.

In reality, the authorities are subject to only such constraints as they impose on themselves. They are not required to submit for the Interior Ministry's approval a comprehensive annual development program, an analysis of whose financing would make it possible to estimate the ordinary budget loan repayment burden in the years ahead and to assess the authorities' ability to shoulder such a burden. True, they have

to submit for approval each planned project and the method of financing it. As a rule, a project is not launched in the same year in which it is presented for approval, and implementation generally stretches over a number of years. Hence, examination of the approvals issued in a particular year does not make it possible to estimate the extra budget burden in the coming years. Lately some of the authorities have been submitting annual development budgets but without full specifics as to financing, which of course is not known in the blueprint stage. If to this is added the fact that the authorities tend to publish their financial reports quite belatedly, the possibility of controlling them through the machinery employed in recent years and of preventing them from getting financially entangled is obviously quite slim.

Another factor impelling the authorities to turn to the private money market is their sizable ordinary budget deficits. For years they have been in the red, with a substantial chunk of their deficits (but not all) being covered by consolidation loans (half of them unlinked) provided by the government through commercial banks. These loans jumped from IL 71 million in 1970/71 to an estimated IL 215 million in 1974/75. This type of financing, besides piling up an ordinary budget deficit from year to year, creates a problem of interim financing, since disbursement of the loans lags behind the expenditures. The balance of the deficit is financed by borrowing in the private credit market on stiffer terms.

The authorities also take on a heavy load of short-term loans for interim financing purposes during the year. Besides government transfers, their income consists of taxes, fees, levies, and transfers obtained through their own collection machinery. In recent years the share of government transfers has been on the ascendant and that of receipts from autonomous sources on the decline. The distribution of the different categories of receipts over the year varies greatly. The bulk of the autonomous revenue, notably taxes, flows in during the early part of the fiscal year as a result of the discounts given to those paying the annual property rates in a lump sum in April. The payment arrangements in force in various places of employment, which also entitle the rate-payer to a discount, have the same effect. By contrast, government transfers do not reach the authorities in a steady flow during the budget year, and in some items they may lag by up to one month (the Ministry of Welfare's participation in welfare allotments) and in others still longer (the Ministry of Education's participation is conditional upon the submission of an expenditure report and is disbursed long after the actual outlay).

In general, special transfers (consolidation loans, special grants from various ministries, etc.) are subject to longer delays than ordinary grants given according to fixed criteria. The volume of government transfers is affected by liquidity policy considerations, as happened in the second half of 1974/75.

The rise in the proportion of government transfers in the authorities' expenditure