CHAPTER V

GOVERNMENT AND NONGOVERNMENT PUBLIC SECTOR[1]

1. MAIN DEVELOPMENTS

Economic Policy

The year reviewed saw a steep rise in subsidies,[2] the cutting of indirect taxes on domestic production and imports, elimination of the lag in adjusting income tax brackets, and a rapid increase in transfer payments compared with recent years.[3]

Public domestic consumption rose a little faster in 1981 than in the three preceding years, and its weight in the product (at current prices) did not decline. Both the sector's dwelling and nondwelling investment were cut back in 1981. The government's budget outlays in 1981/82 were up 150 percent (in nominal terms) from the previous fiscal year.

The domestic demand surplus[4] swelled following a 21 percent smaller absorption and a 2 percent growth of domestic demands. In the first half of 1981 the surplus was largely financed through the mobilization of capital from the public, which resulted in a smaller flow to the private sector. In the second half of the year the government greatly stepped up its spending, and the ensuing injection[5] financed a larger share of the demand surplus.

[1] The public sector comprises the central government, local authorities, and National Institutions. The central government dominates the sector from the aspect of economic policy determination and its weight in total expenditures and income. This chapter focuses on the real (nonfinancial) activities of the sector; a more detailed description of monetary developments appears in Chapter VIII.

[2] The reference is to the direct subsidization of domestic production, imports, and exports. Subsidies in the form of cheap credit will be mentioned explicitly in the discussion below.

[3] The rates of change cited here are in real terms unless otherwise indicated. Public consumption and investment have been deflated by the relevant price indexes customarily used in the national accounts. Taxes, subsidies, and transfer payments have been deflated by the consumer price index.

[4] This surplus is defined as the difference between the sector's total real demands (consumption and investment) and its absorption. The absorption consists of direct and indirect taxes on domestic production and imports, less transfer payments and subsidies on domestic production, imports, and exports.

[5] In this chapter the term "injection" is used in its narrowest sense—the injection of money—unless otherwise indicated.

The government's policy in 1981 was aimed at cooling inflation through direct action on the price front (subsidies and taxes) and by dampening inflationary expectations.[6] However, the measures adopted were confined to a relatively narrow segment—controlled prices and part of the products liable to purchase tax. Some of the sector's activities were not conducive to realizing the paramount objective of slowing inflation, and sometimes they even had an opposite effect. The sector's direct demands rose fractionally this year, and the weight of public consumption in GNP did not decline. In the all-important area of costs, namely wages and salaries, sizable raises were granted during the year to public servants. The growth of the government's demand surplus generated by these measures resulted in a sizable injection, and in the long run this is liable to aggravate inflation or expand imports.

In the course of 1981 signs appeared that the price policy was achieving some success: the rise of the consumer price index slowed down, cost-of-living adjustments declined, and the implicit price deflator for the business sector product at factor cost remained at the previous year's level. The hiking of wages and salaries, reduction of direct taxes, and the heavier subsidization swelled private disposable income relative to the growth of GNP (15 vs. 5 percent); this is likely to stimulate demand for goods and to push up their prices.

In 1980 the economy operated under the shadow of the second oil price shock (1979-80)—which threatened to further erode the balance of payments—as well as the continued escalation of inflation. This prompted the government to adopt a restrictive policy, based mainly on the slashing of subsidies and restraining of budget spending, especially for civilian purposes. The experience of developed western economies shows that stringent fiscal and monetary policies have a moderating effect on inflation, but only if they are implemented for a fairly long period, and if the country is willing to pay a high social price in the form of increased unemployment.

The tougher policy followed in Israel in 1980 bore fruit as far as the balance of payments deficit is concerned, retarding the expansion of consumption and domestic investment. But inflation was not reduced, unemployment mounted, immigration to the country fell off, and emigration rose.

For various reasons the government did not persist in this policy (which, as stated, was an essential condition for blunting inflation). Toward the end of 1980 the policy was revised somewhat, at a time when a number of items were being more heavily subsidized and the restriction of budget spending was relaxed a bit.

At the beginning of 1981 the government's policy changed direction, notably with respect to subsidies and taxes. This year policy focused, as

[6] See, for example, the budget proposal for 1981, February 1981, p. 31 (in Hebrew).

Table V-1
INDICATORS OF PUBLIC SECTOR OPERATIONS, 1960-81
(Weight in GNP, rounded percentages at current prices)

	Average									Percent annual real increase			
	1960-65	1966-67	1968-72	1973-74	1975-77	1978	1979	1980	1981	1978	1979	1980	1981
1. Direct domestic demand	25	27	30	37	35	30	33	32	32	-0.4	4.4	2.2	1.9
2. Absorption	22	21	24	22	20	21	25	24	17	11.3	24.4	-1.0	-20.7
3. Absorption, incl. effect of inflation on private wealth					16	17	17	18	12	13.1	8.7	3.7	-24.0
4. Domestic demand surplus	3	6	6	16	14	10	8	8	15	-9.2	-13.0	5.7	98.2
5. Domestic demand surplus, incl. effect of inflation on private wealth					19	14	15	14	20	-5.8	17.4	-2.9	51.8
6. Civilian consumption	11	13	11	12	12	12	13	13	12	5.4	2.3	0.0	1.3
7. Civilian services	17	19	17	18	18	19	20	19	19				
8. Weight of civilian services in total employment	21		24	25	28	27	29	29	30				
9. Noncivilian consumption	10	14	22	32	30	27	22	25	27	15.4	-13.7	11.7	11.0
10. Thereof: Domestic noncivilian consumption	6	9	13	17	16	14	14	14	15	0.1	1.7	3.1	4.1
11. Direct defense imports	4	5	9	15	14	13	8	10	12	40.0	-31.3	26.4	20.7
12. Investment	5	5	5	6	5	5	5	4	4	-0.8	10.5	-16.5	-4.5
13. Construction	4	2	3	5	3	1	2	3	3	-24.3	26.6	48.5	-1.5
14. Total civilian consumption/total noncivilian consumption	115	98	51	35	41	45	59	51	47				
15. Public sector injection/narrow monetary base [a]				25	85	79	32	141	114				

NOTE: Lines 1 to 14 — see Tables V-3 and V-A1.

[a] Public sector injection in relation to the monetary base at the end of the previous year. For 1978-81 the monthly injection was deflated by the consumer price index, bringing it to the level at the end of the previous period.

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

already pointed out, on a relatively narrow front. Since the supported products and services make up about 20 percent of the basket used for constructing the consumer price index, to slow the index to any noticeable degree required the heavy subsidization of these items. This in fact is what was done, and the rise of the consumer price index slackened. However, in the course of the year it became clear that continuation of this policy would greatly strain the budget, distort resource allocation, and create expectations of a cancellation of subsidies. The growth of subsidies was therefore slowed down in the second half of 1981, and in some cases the subsidy was even reduced.

If the subsidy rates had remained at their 1980 level, the outlay on this item would have been IS10.5 billion lower in the year reviewed than it actually was. If we add to this the trimming of indirect taxes (purchase and fuel taxes and the tobacco excise), we find that it amounted, on an annual average, to about 10 percent of private consumption—an approximation of the possible reduction of the consumer price index due to the upping of subsidies and pruning of indirect taxes. (This estimate does not take into account the ripple effects of the cost-of-living adjustments on the one hand and the increased liquidity injection on the other.)

The anti-inflationary policy was not complemented by appropriate action in other areas; in fact, the opposite was true. Public domestic consumption rose 3.5 percent in 1981, compared with 2 percent the year before, and its weight in the product did not drop. Such a decline might have prepared the ground for a sustained cooling of inflation.

A major factor on the costs side is the wage and salary item; during 1981 earnings per public sector employee shot up 136 percent, compared with a 117 percent rise in the consumer price index. To be sure, under the cost-of-living arrangement the effective adjustments exceed the official rates in a period of weakening inflation, but since the adjustments in 1981 covered only 80 percent of the increase in the index, this alone could not have brought up real wages and salaries. What is more, the lowering of income tax rates in April 1981 (see below) created a favorable climate for keeping down gross wages and salaries without affecting real earnings, and hence for easing pressure for raises. In awarding pay increases to its employees, and thus influencing wages and salaries in the business sector as well, the government prevented the use of this important tool to retard inflation.

During 1981 there were indications that the price policy was succeeding to some extent: the consumer price index went up at a lower rate than in 1980, and the cost-of-living adjustments, which reached 21.6 and 19.3 percent respectively in January and April 1981, fell to 16.2 and 11.5 percent respectively in July and October. But a policy limited to subsidies and indirect taxes cannot be pursued for any length of time, and at the end of the year and beginning of 1982 the price indexes began to accelerate, and the cost-of-living adjustments paid in January and April rose to 17.8 and 16.6 percent respectively.

Main Activities of the Public Sector

Noncivilian consumption expanded this year by 11 percent (11.7 percent in 1980), with the fastest growth recorded in direct defense imports, a development explained primarily by the military redeployment in the Negev. Defense employment sagged 3.6 percent in 1981 according to a Central Bureau of Statistics estimate. On the other hand, domestic purchases rose at a relatively strong 8.4 percent rate, which was partly related to the Negev redeployment.

Defense expenditures account for about a quarter of GNP. Even if U.S. government aid is excluded, the weight of such outlays financed by the domestic economy is very high in comparison with other western countries. The defense burden, to which has been added a large energy bill since 1973, hampers the resumption of economic growth which prevailed until 1973, and has been one of the factors responsible for the inflationary spiral.

In public civilian services (the public sector and nonprofit institutions) there was a slight per capita increase in 1981, after a 2 percent decline the year before. Here there is a long-term rising trend in the weight of employment: at the beginning of the 1960s one-fifth of all employed in the economy were in public civilian services; in the first half of the 1970s the proportion rose to a fourth, and in recent years it reached 29-30 percent. The expansion of public civilian services and the high level of defense spending are not consistent with the principal economic targets: the renewal of growth, reduction of the balance of payments deficit, and the mastering of inflation.

The direct subsidization of domestic production and imports swelled sixfold in 1981 in nominal terms—from IS3 billion in 1980 to IS17.5 billion. The weight of these subsidies in the product reached 7.4 percent, which was more than double last year's figure and also higher than in earlier years. The jump in this item took place mainly in the first half of the year, while in the second half subsidies were raised on only a limited number of products and in some cases were even reduced. Since the government's subsidy payments are made several months after the rates are officially raised, most of the disbursements in 1981 were concentrated in the second half of the year and early 1982, as reflected by an increase in the government's cash outflow in the second half of 1981.

In taxation too the government's policy underwent considerable changes during the year reviewed: between February and August 1981 the purchase tax was cut on a wide range of products. In addition, the effective tax rates on fuel and tobacco were lowered, and the property tax was largely abolished. Total revenue forgone as a result of these indirect tax changes is estimated at IS4-5 billion, equal to about 2 percent of GNP.[7]

Income tax brackets were adjusted appreciably in April 1981 (especially the lowest bracket, in which a large percentage of the population falls). This more or less restored the brackets to their original level when the direct tax reform went into force in 1975.[8] According to Treasury estimates, the updating of brackets reduced revenue by some IS2 billion (in fiscal 1981/82, at current prices). The brackets are now adjusted quarterly, and are fully linked to the consumer price index.

The Demand Surplus and Its Financing

The smaller public sector absorption and a real increase in the sector's spending resulted in 1981 in a much larger domestic demand surplus compared with 1980. (It should be borne in mind that 1980 was a slump year, with tax revenues lower than normal; hence the demand surplus was greater than it would have been in a full-employment situation.) The weight of the demand surplus in GNP rose in 1981 by seven points to reach 15 percent.

Subsidies in the form of cheap credit declined this year in real terms, owing to the continued reduction of such finance and the slowing of inflation. The domestic demand surplus inclusive of the effect of inflation on private wealth grew more mildly than the demand surplus excluding this effect, and its weight in GNP went up from 14 to 20 percent.

The domestic demand surplus was financed through long- and medium-term capital mobilization, the liquidity injection engendered by Bank of Israel credit, and the conversion of currency from foreign sources. In 1981 the government relied more heavily than before on the capital market for financing the surplus, while the share of the liquidity injection was smaller than in 1980. (There are relatively large discrepancies in this year's financing estimates, which for the most part seem to be due less to economic factors than to the use of different sources for estimating the various components, as well as to the provisional nature of some of the data.) Our estimates indicate that the excess financing from foreign sources was lower in 1981 in real terms than in previous years.

The government's heavy intervention in the capital market is reflected in its large share of total capital raised and the determination of saving terms, rates

[7] Subsidizing a product liable to VAT reduces its market value and hence revenue from VAT. The sharply higher 1981 subsidy budget also affected indirect tax revenue, to the tune of IS1-1.5 billion.

[8] The brackets are adjusted according to the consumer price index. Because of the large real increase in wages and salaries since 1975, the average tax on such earnings, even after the updating of the brackets, is higher than its level when the tax reform was introduced.

Table V-2

FINANCING OF THE PUBLIC SECTOR DEMAND SURPLUS, 1978-81

(IS million, at current prices)

	1978	1979	1980	1981
A. **Domestic demand surplus**				
1. Domestic demand surplus [a]	2,187	3,394	8,290	35,622
2. Long-term capital mobilization (adjusted) [b]	1,435	3,427	4,730	15,607
3. Public sector injection (adjusted) [c]	1,107	811	2,590	10,240
4. Domestic finance differential (2+3-1) [d]	**355**	**844**	**-970**	**-9,775**
B. ***Foreign demand surplus***				
5. Foreign demand surplus [e]	800	-451	420	10,416
6. Long-term financing from abroad	1,508	2,861	6,932	12,862
7. Foreign finance differential (6-5) [f]	**708**	**3,312**	**6,512**	**2,446**

[a] *Domestic demand surplus of the public sector as defined in this chapter* (see Table V-A1).

[b] Long-term capital mobilization by the public sector, less credit extended to the private sector after adjustment for net interest receipts (included in both the domestic demand surplus and in capital mobilization) and for redemption of compulsory loans (line 4 in Table V-A3).

[c] Public sector injection, less early redemption of Israel Bonds and injection generated by exports of government enterprises (line 9 in Table V-A3).

[d] Includes short-term finance and errors and omissions.

[e] The difference betweeen the public sector's purchases and grants received, income of the Jewish Agency, and the Bank of Israel's net income before revaluation (line 17 in Table V-A3).

[f] The foreign finance differential results in changes in the public sector's foreign currency balances, the outstanding government credit balance with the Bank of Israel, and the financing of the public sector's domestic demand surplus. The differential arises *inter alia* from conceptual differences between the national accounts accrual basis estimates and the budget cash flow estimates, as well as from errors and omissions.

SOURCE: Bank of Israel (Table V-A3).

of interest, and criteria for the extension of credit. Its almost complete dominance of the money market enables the government to raise funds from the public and to allocate them for financing both its own and the private sector's activities. In 1981 the amount of capital mobilized rose more than 40 percent in real terms, totaling IS18.3 billion as against some IS6 billion the year before.[9] Of this sum, IS8.8 billion was lent to the private sector (a real decline of 15 percent from 1980); the balance, used to finance the public sector's domestic demand surplus, was 3.5 times larger (in real terms) than the amount diverted for this purpose in 1980.

[9] See Tables VIII-8, VIII-11, and VIII-B19.

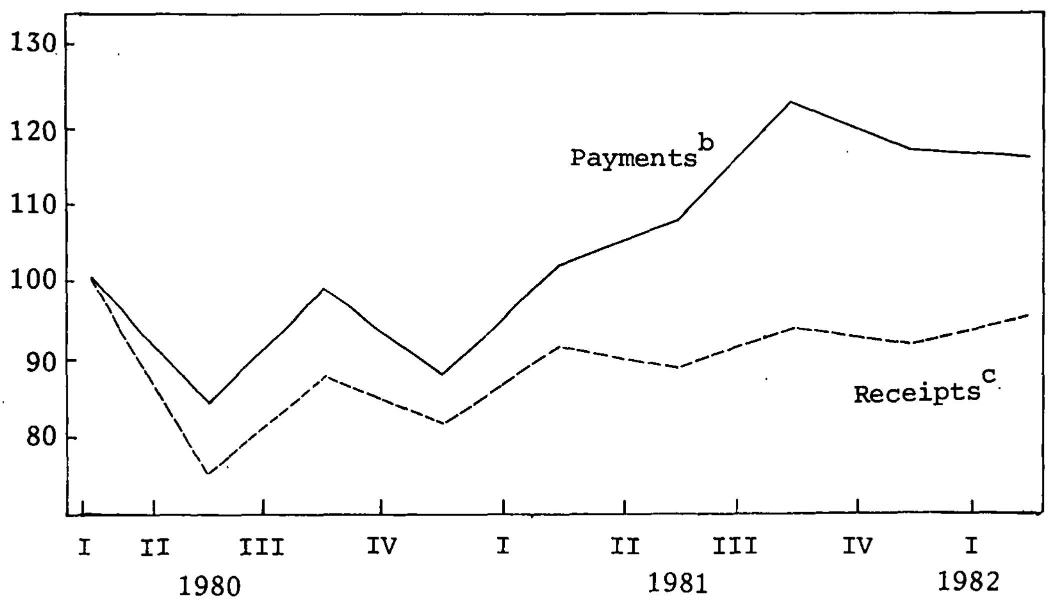
The increased capital mobilization was achieved thanks partly to the government's continued improvement of the terms of the various saving channels. A more liquid, higher-yield scheme with a shorter maturity than the older schemes was introduced, and the array of schemes was broadened to include dollar-linked savings for a period of three to six years, as well as a savings-for-housing plan. In addition to the rapid real expansion of saving scheme deposits, there was a further growth of social insurance funds, the leading component in capital mobilization. On the other hand, sales of tradable government bonds fell off, and this source showed a negative IS2.7 billion net figure this year.

There was also some modification of the terms governing part of the commercial banks' deposits with the Treasury, which can now be withdrawn after five years instead of the 17-20 year period previously in force. This saving channel expanded appreciably in real terms, owing *inter alia* to the Bank of Israel's tight credit policy (under which it set ceilings on the growth of bank credit).

Figure V-1

INDEX OF REAL[a] GOVERNMENT PAYMENTS AND RECEIPTS, 1980-82

(1980 I = 100)



[a] Deflated by the consumer price index.

[b] Expenditure on consumption, investment, and construction; transfer payments; credit subsidy disbursements; and credit granted to the private sector.

[c] Tax revenue, compulsory payments, and property and entrepreneurial income.

SOURCE: Ministry of Finance.

The public sector injection was 50 percent larger than in 1981, but its weight in the financing of the demand surplus declined. Examination of the injection in the course of the year shows a steep rise in the second and third quarters and some leveling off toward the end of the year.

The tight monetary policy, coupled with the growth of imports and the public's financial asset holdings, absorbed much of the money put into the economy by the government in 1981, and in the short run may have reduced the upward pressure on prices that would have been generated by an excessive monetary expansion. It would seem, however, that in the long run the siphoning out of liquidity through savings schemes, bonds, and the like cannot in itself neutralize the inflationary effects of the demand surplus and the resulting injections.

The 1981/82 Budget

The original government budget for fiscal 1981/82 totaled IS220 billion, compared with the 1980/81 final budget of IS105 billion. In the course of the year the budget was increased by IS4 billion (due to the upward revision of the income projection by this amount), and toward the end of the fiscal year a IS42 billion supplementary budget was submitted. In the end, the 1981/82 budget reached IS265.5 billion, representing a nominal increase of 153 percent over 1980/81.

The budget estimates were based on the assumption that inflation would come to 98 percent for the fiscal year and 115 percent on an annual average. This was close to the actual rate shown by the principal price indexes,[10] but the relative prices of the public sector's expenditures rose faster than envisaged. This necessitated the tabling of a supplementary budget and resulted in a greater than planned deficit. The most striking deviation was in the subsidization of basic commodities and services: originally this was budgeted at IS6 billion, but the final allocation come to IS16 billion.[11]

Examination of the government's cash outflow reveals a generally rising trend during the year, with a deviant increase in the third quarter and a downturn (partly seasonal) in the last quarter. The third-quarter upsurge stemmed from the disbursements on account of subsidies, which were made some time after the new subsidy rates went into effect. The government's cash receipts developed more regularly than disbursements, and this was reflected in the fluctuating level of the injection.

[10] The indexes of consumer prices, industrial output prices, and construction input prices rose by 110, 114, and 122 percent respectively on an annual average for the fiscal year, and by 104, 106, and 108 percent respectively during the year.

[11] These data do not include the allocation to the general reserve; the addition of this item would probably bring the figure up to IS20 billion.

Table

DIRECT DEMANDS OF THE

(IS million, at

	1977	1978	1979	1980	1981
A. Public consumption					
1. Civilian consumption					
Wages and salaries	1,241	1,983	4,170	9,043	21,415
Purchases	514	828	1,486	3,541	8,162
Total	**1,755**	**2,811**	**5,656**	**12,584**	**29,577**
Thereof: Government imports n.e.s	120	202	333	758	1,449
2. Noncivilian consumption					
Wages and salaries	727	1,131	2,351	5,112	11,717
Domestic purchases	1,292	2,030	3,779	9,254	23,590
Purchases abroad	1,326	3,050	3,401	10,212	27,807
Total	**3,345**	**6,211**	**9,531**	**24,578**	**63,114**
Total public consumption	**5,100**	**9,022**	**15,187**	**37,162**	**92,691**
3. Public domestic consumption					
Domestic civilian consumption	1,635	2,609	5,323	11,826	28,128
Government	1,012	1,570	3,261	7,184	17,411
Local authorities	565	923	1,844	4,119	9,415
National Institutions	68	116	218	522	1,302
Domestic noncivilian consumption	2,019	3,161	6,130	14,360	35,307
Total public domestic consumption	**3,654**	**5,770**	**11,453**	**26,186**	**63,435**
B. Public sector investment					
1. Nondwelling investment	630	1,057	2,093	3,843	8,384
Investment less direct import component	552	878	1,686	3,223	6,873
2. Housing construction initiated by public sector	216	269	742	2,853	6.542
C. Total direct demands	**5,946**	**10,348**	**18,022**	**43,858**	**107,617**
Thereof: Domestic demands	4,422	6,917	13,881	32,268	76,850

[a] Rates of change in price and quantity in 1978-80 were calculated at 1975 prices, and for 1981 at 1980 prices.

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

V-3

PUBLIC SECTOR, 1977-81

current prices)

Percent annual increase [a]							
Price				Quantity			
1978	1979	1980	1981	1978	1979	1980	1981
52.7	104.6	115.6	134.3	4.6	2.8	0.6	1.2
50.7	77.2	141.4	126.4	6.9	1.3	-1.3	1.8
52.0	**96.7**	**122.5**	**132.0**	**5.4**	**2.3**	**0.0**	**1.3**
36.0	108.1	127.6	142.0	23.7	-21.6	0.0	-20.7
49.9	97.0	117.9	137.8	3.8	5.5	-0.2	-3.6
60.0	86.9	133.2	136.1	-1.8	-0.4	5.0	8.4
64.3	62.3	138.1	125.6	40.0	-31.3	26.4	20.7
60.9	**77.8**	**130.9**	**131.4**	**15.4**	**-13.7**	**11.7**	**11.0**
57.8	**84.4**	**127.4**	**131.6**	**12.1**	**-8.7**	**7.6**	**7.7**
53.3	95.4	122.2	131.5	4.1	4.4	0.0	2.7
54.5	97.3	119.6	132.8	1.4	5.3	0.3	4.1
51.2	92.5	125.4	129.5	8.0	3.8	-0.8	-0.4
57.8	87.9	134.5	131.6	8.1	0.0	0.3	7.6
56.4	90.7	127.2	136.1	0.1	1.7	3.1	4.1
55.1	**93.1**	**124.8**	**134.0**	**1.8**	**2.8**	**1.7**	**3.5**
69.1	79.2	119.9	128.4	-0.8	10.5	-16.5	-4.5
63.6	81.0	122.8	132.0	-2.8	6.1	-14.2	-8.1
64.5	117.9	158.9	133.1	-24.3	26.6	48.5	-1.6
59.8	**84.3**	**128.7**	**130.6**	**8.9**	**-5.5**	**6.4**	**6.4**
57.1	92.2	127.5	133.2	-0.4	4.4	2.2	2.1

Public consumption rose 7.7 percent at constant prices in 1981, following a similar increase the year before. As in 1980, this resulted from a very heavy defense spending abroad (up 21 percent), which was rendered necessary by the military redeployment in the Negev in the wake of the peace agreement with Egypt. Analysis of the public sector's consumption in the short run will focus on the domestic component, because of both the sharp irregular fluctuations in overseas defense procurements and the assumption that they are financed by foreign grants and loans, which do not have an immediate effect on domestic activity. Less direct defense imports, public consumption grew 3.5 percent this year, after increasing by 1.7 percent in 1980 and 2.8 percent in 1979.

The contribution of public consumption to aggregate domestic demand is not fully revealed by the quantitative rates of increase, for the demand indirectly created by the public sector through its high wage payments must also be taken into account. In 1981 the sector's consumption prices averaged 134 percent more than in the previous year; this was much higher than the rise in the GNP price deflator (126.4 percent) or in private consumption prices (118.5 percent), and it reflects a large nominal increase in direct and indirect wage outlay and in defense establishment purchases.

The gap between public consumption prices and the consumer price index is explained by the impact of subsidies and indirect taxes on domestic prices. An analysis of the demands indirectly generated by the government's subsidy and indirect tax policy will be presented below.

The large nominal growth of public consumption brought up the weight of domestic consumption in GNP from 26 percent in 1980 to 27 percent in the year reviewed—a development inconsistent with a policy of demand restraint.

(a) Civilian Consumption

Civilian consumption was characterized in 1981 by a small real increase of 1.2 percent in the labor input and of 1.8 percent in purchases.[12] However, real wages per civilian service worker rose by a steep 7.9 percent (deflated by the consumer price index). The weight of public civilian consumption in GNP was similar to the figure in the previous two years—12.3 percent in 1980 and 12.4 percent in 1981 (see Table V-4). This is a high level compared with the early 1970s, and it should be viewed against the accelerated expansion of GNP in 1981.

[12] Compared with a 4.6 percent increase in GNP.

A complete analysis of civilian consumption should include nonprofit institutions because of the high degree of substitution between their services and those provided by the public sector, and the fact that the institutions largely operate in accordance with official policy and most of their funding comes from the public sector (notably the government). Such an overall analysis shows a very similar picture to that described in the previous paragraph, namely a moderate 2,1 percent expansion of consumption in constant price terms, and virtual stability in the weight of such services in GNP (18.7 percent in 1980 and 18.8 percent in 1981).

A breakdown of the consumption of civilian services by function shows the same basic pattern as in previous years:[13] a steady rise in the weight of education and a decline in economic services, mainly administrative (see Table V-5).

The mounting weight of civilian services in GNP is also reflected in the rising share of public services in total employment. Despite the policy of freezing government personnel, the number of public and community service workers increased 3.6 percent this year. The restriction of manpower recruitment in the government was outweighed for the second year running by increases in other segments of the public sector, with the result that the sector's share in total employment continued to move up. Public services

Table V-4

INDICATORS OF THE GROWTH OF PUBLIC CIVILIAN SERVICES, 1970-81

(Ratios in percent, at current prices)

	1970	1972	1974	1976	1978	1979	1980	1981
Public civilian consumption/GNP [a]	10.3	10.0	10.5	11.3	12.0	13.1	12.4	12.4
Public civilian consumption/private consumption [b]	18.8	19.5	18.9	19.4	21.2	22.4	22.4	21.9
Public civilian consumption per capita [c]	20.4	21.4	22.6	23.1	24.2	24.1	23.6	23.7
Public civilian services/GNP [d]	16.9	16.1	17.1	17.6	18.7	20.2	18.9	18.9
Public civilian services/private consumption [b]	30.6	31.3	30.5	30.3	33.1	34.7	34.3	33.2
Public civilian services per capita [c]	31.3	33.0	34.9	36.0	37.2	37.4	36.6	36.7

[a] Distribution expenditures in connection with Israel Bonds are excluded from public consumption.

[b] Private consumption excludes nonprofit institution services.

[c] At constant (1975) prices, in IS.

[d] Public civilian services include the public sector and nonprofit institutions.

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

[13] See the Bank of Israel Annual Report for 1980, p. 88, and for 1979, p. 185.

Table V-5

CONSUMPTION OF PUBLIC CIVILIAN SERVICES BY FUNCTION, 1969-81[a]

(Percentages, at constant prices)

	Average annual increase					Distribution						
	1969-72	1972-74	1974-76	1976-78	1978-81	1969	1972	1974	1976	1978	1980	1981
Education	9.5	5.8	4.9	6.0	5.1	34.5	37.0	37.4	37.8	39.2	40.8	41.2
Health	10.6	6.0	6.3	-0.3	6.5	18.2	20.2	20.5	21.3	19.7	20.0	21.2
Other welfare and social services	4.8	6.4	6.4	8.4	-3.2	19.4	18.4	18.8	19.6	21.2	20.4	19.2
Total social welfare services	**8.5**	**5.9**	**5.6**	**5.0**	**3.4**	**72.1**	**75.6**	**76.7**	**78.7**	**80.1**	**81.2**	**81.6**
Economic and other services	2.0	2.8	-0.3	0.0	-2.3	27.9	24.4	23.3	21.3	19.9	18.8	18.4
Total public civilian and nonprofit institution consumption	**6.8**	**5.2**	**4.3**	**3.9**	**2.2**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

[a] The estimates of total public consumption and consumption of nonprofit institution services are based on Central Bureau of Statistics data. The rates of increase in the components of public civilian services were calculated for 1969-78 on the basis of public civilian expenditure by function, and for 1979-81 on the basis of the increase in the number of employee posts in the relevant sectors.

SOURCE: Central Bureau of Statistics data from National Insurance Institute sources.

accounted for 30 percent of all employed in the economy in 1981, as against 29 percent in 1980 and an average of 25 percent in the first half of the 1970s (see Table V-1).[14]

(b) **Noncivilian Consumption**

Noncivilian consumption was 11 percent up on 1980, the result of a 20.7 percent larger defense import bill and a more modest 4.1 percent increase in domestic spending. Defense imports are subject to sharp year-to-year fluctuations, due to the timing of procurement deliveries, and so they should be examined on a multiyear basis. In addition, they have no immediate effect on the level of economic activity or domestic prices. For these reasons an analysis of noncivilian consumption in the current year is based on the domestic component.

Payrolls and domestic purchases developed in opposite directions this year: local purchases by the defense establishment expanded strongly (8.4 percent), while the labor input fell 3.6 percent. In addition, the price of both components rose precipitately. Wages per worker in the defense sector increased 9.5 percent (deflated by the consumer price index), while the prices of domestically procured items also went up sharply (see Table V-3), owing partly to the pay hikes awarded in the defense industries.

For the first time since 1978, the weight of domestic noncivilian consumption in GNP moved up, from 14.1 percent in 1980 to 14.8 percent (see Table V-5). While the share of defense spending in GNP can generally be taken as a yardstick of the economy's current defense burden, this year's increase, when viewed from a multiyear perspective, did not indicate any significant aggravation of the current burden. Another measure of the burden is the weight in GNP of the sum of domestic defense expenditure, outlays in freely usable foreign currency, and the servicing of the defense-related debt to the U.S. This indicator (presented in Table V-6, col. 5) shows a stable trend since its decline from the peak level reached in the immediate post-Yom

[14] This discussion is based on labor force survey data of the Central Bureau of Statistics, and includes employment in the nonprofit institutions, which are largely funded through the government budget. On the other hand, the estimates of the wage component in civilian consumption (Table V-3) are based on a direct measurement of government personnel and on National Insurance Institute data on employment in the local authorities and the National Institutions. These data are adjusted for changes in the number of hours worked per employee (as indicated by labor force surveys), and are weighted by permanent and temporary employees (measured according to their actual wages). In 1981 there was very little discrepancy in the number of public sector employees as indicated by these two sources; the relatively large increase in the number of public and community service workers was mostly accounted for by the nonprofit institutions.

Table V-6
INDICATORS OF DEFENSE EXPENDITURES, 1964-81
(Percentages, at current prices)

	Weight in GNP					
	Total non-civilian consumption (1)	Total non-civilian consumption, excl. military grants [a] (2)	Total non-civilian consumption, excl. total grants (3)	Domestic noncivilian consumption (4)	Domestic defense expenditures, foreign currency expenditures, and loan repayment [b] (5)	Weight of defense in total wages (6)
1964-66	10	10	9	6		5
1967	18	18	17	10		8
1968-69	19	19	19	12		8
1970	25	25	25	14	22	9
1971-72	23	20	19	14	19	9
1973-75	33	24	22	17	22	11
1976-78	27	21	15	15	20	10
1979-81	25	19	13	14	19	10
1978	27	22	16	14	18	9
1979	22	17	9	14	20	10
1980	25	17	13	14	19	10
1981	27	22	18	15	19	9

NOTE: Columns 1-4 and 6 are based on definitions of the National Accounts Department of the Central Bureau of Statistics; the estimates in column 5 are based on government budget data adjusted to calendar years.

[a] Grants include the grant equivalent of U.S. government defense loans. The subsidized loans can be broken down into two elements—the loan proper and the grant equivalent, the latter being the difference between the loan proceeds and the present value of the repayments calculated at the going commercial interest rate. This alternative interest is assumed to be 10 percent for 1964-77, 11.5 percent for 1978, 12 percent for 1979, 13 percent for 1980, and 13.5 percent for 1981 (see also Oded Liviatan, "Israel's External Debt", Bank of Israel *Economic Review*, No. 48-49, 1980).

[b] Loan repayments include principal and interest on account of U.S. government defense loans.

SOURCE: Columns 1-4 and 6—Central Bureau of Statistics and Bank of Israel calculations; column 5—Ministry of Finance and Bank of Israel calculations.

Kippur war period and the subsequent sizable buildup of the country's defense capacity (1973-75).

In contrast to the stable current defense burden, total defense expenditures display marked year-to-year variations (see Table V-6, columns 1-3). The ratio of total noncivilian consumption to GNP, as well as the ratio of such consumption excluding U.S. grants (and the grant equivalent of U.S. loans) to GNP, dipped abruptly in 1979, but since then these indicators have swung up again to regain their level of 1976-78. However, the trend in the last two years was worrisome, for an upsurge in direct defense imports was accompanied by a proportionately smaller increase in U.S. military aid grants. Furthermore, there was a marked decline during these two years in economic aid loans (supporting assistance) and an increase in military aid loans. Because of the greatly disparate grant element in military and nonmilitary loans, these changes sharply depressed the grant equivalent of the loans, and this is why in 1979-81 the ratio of total noncivilian consumption (excluding total grants and the grant equivalent of loans) to GNP showed a bigger increase than did the other indicators. These striking changes may have been partly due to the lag between the receipt of the grants and the delivery of the goods purchased. In any case, it will be several years before the financing of defense imports through loans will find full expression in the current defense burden.

(c) Dwelling and Nondwelling Investment

Public sector investment declined 4.5 percent in 1981, after being cut back 16.5 percent the year before. This reflected the government's policy of restraint in the past two years, which proved relatively successful in curbing this most flexible component of public sector expenditure. The biggest decreases were in public services, where investment was reduced 6.7 percent in 1981 and 22.7 percent in 1980, while investment in government enterprises (communications, sea- and airports, the railway, and gas pipelines) and in land amelioration was trimmed more moderately (2 percent in 1981 and 9.4 percent in 1980).

The contraction of public sector investment was also influenced by the long-term downtrend in capital spending on structures relative to equipment. The capital stock of this sector, particularly public services, consists largely of structures, and so the decline of investment here was sharper than for the economy as a whole (see also Chapter II).

Residential construction initiated by the public sector edged down 1.6 percent this year, after expanding strongly in the two preceding years (26.6 percent in 1979 and 48.5 percent in 1980). This year's downturn is explained by the 15 percent reduction of starts in 1980.

It should be noted that public construction has changed in character in the last few years, with a steady shift from direct implementation of construction projects by the public sector to full or partial Ministry of Housing financing of building implemented by others, or a commitment to contractors to purchase unsold dwelling units at prefixed prices. Since 1979 public sector building starts have more or less stabilized, and today they seem to be less sensitive than in the past to changes in government macroeconomic policy (see also Chapter VI).

3. TAXES, TRANSFER PAYMENTS, AND SUBSIDIES

The tax and subsidy system served as one of the government's principal policy tools in 1981. Subsidies on domestic production, imports, and exports swelled by roughly 180 percent in real terms; indirect tax rates, on the other hand, were pruned, resulting in a 3.5 percent drop in indirect tax revenue from domestic production. The hefty expansion of imports, however, compensated for the reduced imposts, so that total import tax receipts rose 24 percent in real terms. The deceleration of inflation and a better adjustment of transfer payments for rising prices contributed to a real increase in such payments.

The tax burden (total taxes less subsidies and transfer payments) was 5–6 percentage points lighter than in 1980, depending on how the burden is defined (see Table V-7).

A low tax burden possesses several advantages, notably social, if brought about by means of relatively high tax rates coupled with transfer payments and subsidies. On the other hand, it may also have negative repercussions, such as tax evasion and work disincentive. The income redistributive effect of inflation via the tax system may have been inequitable, favoring capital at the expense of labor. Israel's tax system is not neutral as far as inflation is concerned: the acceleration of inflation resulted in higher effective direct tax rates for some taxpayers, lower rates for others, and a real erosion of transfer payments. At the same time it increased the subsidy component of directed credit. In retrospect, we see that inflation has not led to an "automatic" absorption of liquidity through the tax system. This points up the need to make the system of taxation and transfer payments less dependent on inflation.

(a) Direct Taxes

Total direct tax revenue rose 9 percent in 1981, compared with a 15 percent growth in national income. Most of the increase in direct tax receipts was accounted for by national insurance contributions (up 14.6 percent), while income tax collections lagged behind this year (7.5 percent).

Examination of the tax structure reveals different rates for wage and nonwage income, to the detriment of the former. This differential taxation

Figure V-2
TAX REVENUE, 1977-82
(IS million, three-month moving average of seasonally adjusted data, at 1976 prices)

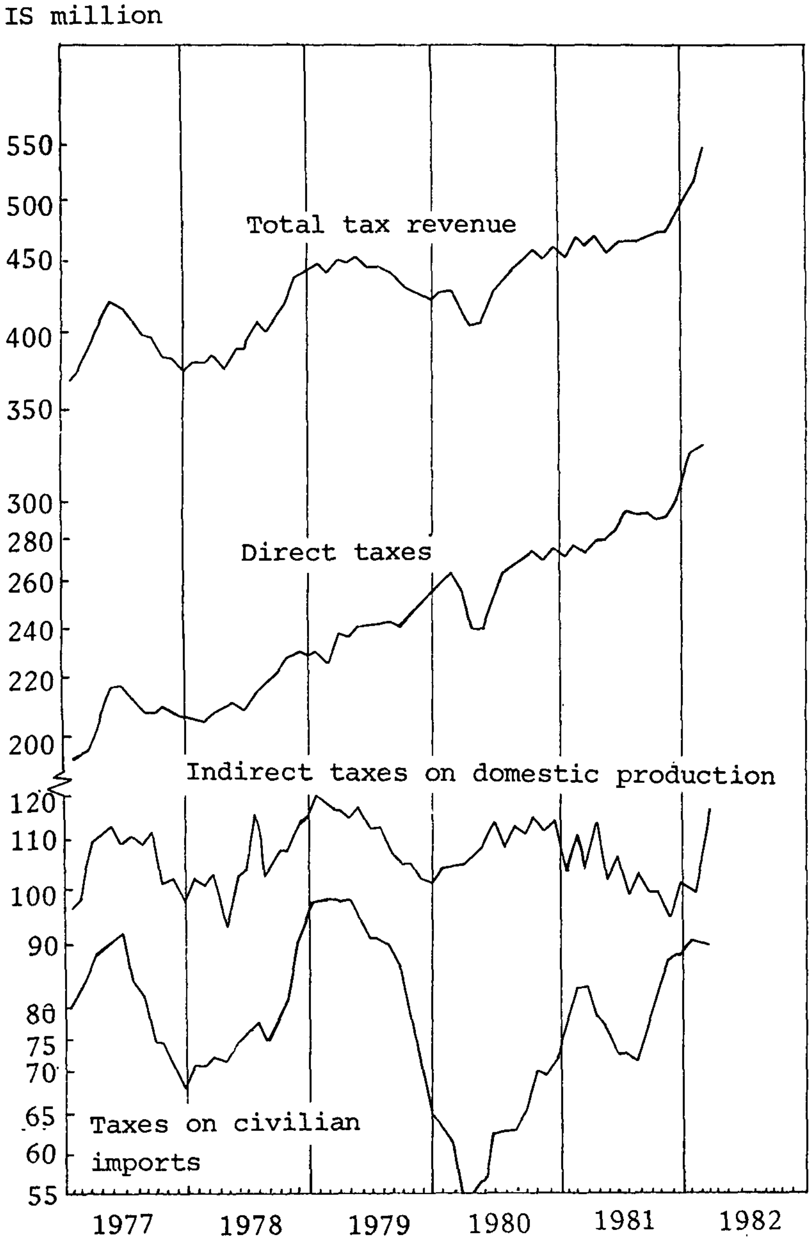


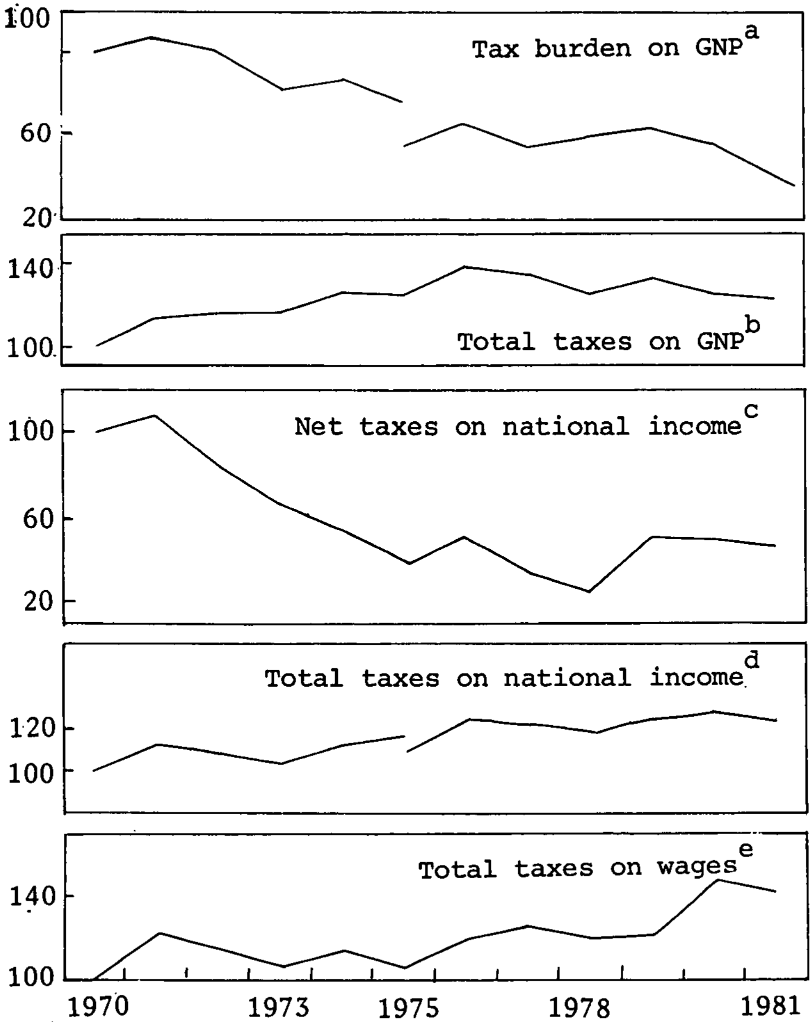
Table V-7
TAXES, SUBSIDIES, AND TRANSFER PAYMENTS, 1970-81
(Percentages, at current prices)

	Weight in GNP									Percent annual real increase [a]				
	1970-74	1975-77	1978-81	1976	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
A. Tax burden [b]														
Excl. credit subsidy	19	20	21	23	20	21	24	23	17	-7	13	23	-2	-22
Incl. credit subsidy	..	13	12	15	12	14	14	14	9	-15	25	5	0	-25
Total taxes	38	46	46	49	48	45	47	46	45	5	1	11	-2	7
Total direct subsidies and net transfer payments	19	27	25	26	28	24	23	22	28	15	-7	1	-1	38
Imputed credit subsidy to business	..	7	9	8	8	7	10	10	7	8	-5	58	-6	-17
B. Net direct taxes and transfer payments [c]	5	4	5	5	4	3	5	7	6	-22	-19	96	22	-3
Direct taxes	17	22	25	24	24	23	24	26	26	6	5	12	8	9
Thereof: Income tax	12	16	18	17	16	16	17	19	18	1	4	15	9	7
Net transfer payments [d]	12	19	20	19	20	20	19	19	20	14	10	-1	4	13
C. Net indirect taxes on domestic production	8	4	3	4	5	5	3	4	1	15	25	-41	72	-84
Indirect taxes	10	13	13	14	14	14	14	13	12	6	6	7	-1	-4
Direct subsidies on domestic production [e]	2	3	4	3	3	3	4	3	7	3	12	10	-15	148
Credit subsidy on domestic production	..	6	6	7	7	6	8	6	4	3	-8	43	-19	-20
D. Taxes on foreign trade	5	5	4	6	4	6	6	3	3	-27	69	-5	-54	16

[a] Deflated by the consumer price index.
[b] Civilian taxes (excluding taxes on direct defense imports), less subsidies and transfers. Taxes do not include compulsory loan repayments.
[c] Income tax, compulsory loans, national insurance contributions, and inventory surtax, less transfer payments to the public, nonprofit institutions, and businesses, interest, and transfer payments from the public.
[d] Excludes compulsory loan redemptions.
[e] Excludes the credit subsidy.

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

Figure V-3
TAX INDICATORS, 1970-81
(Average 1970=100)



a The weight in GNP of direct taxes and indirect taxes on domestic production and imports, less transfer payments and subsidies. Since 1975 the subsidy component of cheap credit is included in subsidies.

b The weight in GNP of direct taxes and indirect taxes on domestic production and imports.

c The weight in national income of direct taxes less transfer payments. Since 1975 national income includes the credit subsidy.

d The weight of direct taxes in national income.

e The weight in wages of direct taxes on wages and the employers tax.

favors investment in capital over the use of labor, and is liable to distort the economy's priorities.[15]

Income Tax[16]

Income tax collections on wages grew more slowly than in the two preceding years—6 percent as against 24 and 16 percent in 1979 and 1980 respectively. Collections on nonwage income expanded at roughly the same rate as economic activity in 1981.

Total income tax revenue trailed behind the growth of national income in the year reviewed (133 vs. 155 percent). But this was due not so much to economic factors as a strike which disrupted the income tax collection machinery at the end of 1981. Part of the taxes which fell due in 1981 was actually collected in the following year. (Collections in the first quarter of 1981 were 2 percent higher, in real terms, than in the same quarter of the previous year, while in the first quarter of 1982 they were 28 percent above their level in the corresponding quarter of 1981.)

From the introduction of the income tax reform in 1975 to the end of 1979, the income tax brackets were only partly updated. When the reform came into force, the brackets were adjusted once every six months to the extent of 70 percent of the rise in the consumer price index (in line with the formula for calculating the increase in the cost-of-living allowance). Mounting inflation, however, continued to erode the brackets, leading to both higher tax receipts and demands for pay increases. The system of adjusting the tax brackets was gradually improved: in October 1979 they were fully linked to the rise in the consumer price index, and since July 1980 they have been adjusted every three months.

In 1981 it was decided to revise the tax brackets in order to remedy their accumulated erosion since the 1975 reform. The lowest bracket (25 percent) was virtually restored to its level when the tax reform went into effect. The

[15] This does not refer to the overall distribution of income between labor and capital. For such a comparison transfer payments and subsidies have to be added to both factors of production.

[16] Income tax revenue is defined here as total gross collections, less tax loans, refunds, canceled receipts, and outstanding balances under payment arrangements (i.e. credit granted to assessees for income tax payments). The Income Tax Commission includes the last-mentioned item in total tax collections, whereas the Bank of Israel treats it as credit and does not include it in the revenue data. This item is calculated on the basis of the commercial banks' reports, which differ from those of the Income Tax Commission.

In 1981 the definition of wage and nonwage income was revised, and this somewhat impairs the significance of the rates of increase in revenue from these two categories in the year reviewed.

Table V-8

GROSS WAGES, TAXES, AND NET WAGES PER EMPLOYEE POST,[a] 1977-81

(Percentages)

	Weight in gross wages						Percent annual real increase [b]				
	1977-81	1977	1978	1979	1980	1981	1978-81	1978	1979	1980	1981
A. Average actual wage							4	1	9	-3	10
Income tax [c]	17	14	14	18	19	17	9	5	39	-1	-5
Net taxes [d]	15	10	11	17	18	15	16	14	63	4	-7
Net wages	85	90	89	83	82	85	3	0	2	-5	14
B. Average real wage [e]							0	0	0	0	0
Income tax	14	12	12	15	16	13	1	0	18	10	-19
Net taxes	11	8	8	12	14	10	7	8	41	19	-28
Net wages	89	92	92	88	86	90	-1	-1	-4	-3	5
C. Double the actual average wage							4	1	9	-3	10
Income tax	29	25	26	31	32	30	8	6	30	-1	2
Net taxes	330	25	26	32	33	31	11	8	32	3	3
Net wages	70	75	74	68	67	69	2	-1	1	-6	13
D. Double the real average wage [e]							0	0	0	0	0
Income tax	25	23	24	27	28	24	1	3	12	6	-15
Net taxes	26	23	24	27	29	25	3	5	14	8	-14
Net wages	74	77	76	73	71	75	-1	-1	-4	-3	6

[a] Employee post as defined by the National Insurance Institute.

[b] Deflated monthly by the consumer price index.

[c] Assuming that only the head of the family works and that there are no other deductions or credits.

[d] Net taxes: Income tax and national insurance contributions, less the child allowance. National insurance: Employees' contributions only; it is assumed that all wage income is subject to national insurance (up to the income ceiling stipulated for this purpose). Child allowance: Assuming that the employee has two children.

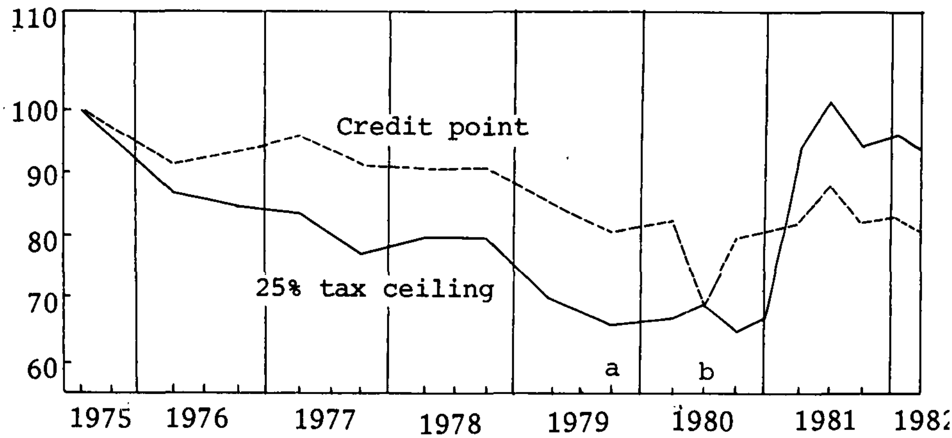
[e] Real wages at their July 1975 level, inflated monthly by the consumer price index.

SOURCE: Central Bureau of Statistics and Bank of Israel.

higher brackets were adjusted to a lesser degree, but earners of large incomes have also enjoyed the reliefs granted to the lower income groups.[17]

Total tax collections on wage income in 1981 rose 6 percent,[18] compared with a 12 percent growth in wages. The easing of the tax burden is illustrated in Table V-8. Assuming constant real wages, the updating of the brackets would have resulted in a 19 percent lower tax payment in the case of an employee whose income was close to the national average, and a 15 percent reduction for those earning double the average income. However, because of the rapid increase in real wages, the calculated reduction in the case of the average wage came to only 5 percent, while for those earning double the average income there was a 2 percent increase.[19]

Figure V-4
INDEX (REAL) OF TAX CEILING (25%) AND CREDIT POINT, JULY 1975 TO APRIL 1982
(July 1975=100; deflated by the consumer price index)



[a] Introduction of the full adjustment of tax brackets to the consumer price index, according to the cost-of-living allowance formula.
[b] Introduction of trimonthly adjustment of tax brackets.

[17] The updating was based on the consumer price index, as real wages per employee post had risen by 30 percent since the introduction of the tax reform. Even after the full adjustment of the tax brackets, the average tax rate moved up.

[18] This estimate is downward-biased owing to the aforementioned strike at the end of the year.

[19] An additional indicator is the 7 percent rise in 1981 in the gross wages and 11 percent rise in net wages (after deduction of income tax and national insurance contributions) of permanent employees in the civil service and government business-type enterprises. The aggregate data show that national insurance contributions outpaced income tax collections this year.

In 1981 income tax reliefs were granted for shift work in industry (and also to discharged soldiers). Experience has shown that such concessions open the way to tax evasion and create tension between different groups of workers, etc. Since the tax reform of 1975, which abolished differential and special rates, the economy has taken the long, hard road of adjusting wages to the tax laws. The reintroduction of special rates in 1981 resulted in a larger disposable income for a relatively small number of wage-earners, and pressure began to be exerted for extending these reduced rates to additional groups. At the time of writing these lines the reduced rates for shift work was extended for part of the 1982/83 fiscal year.

Tax revenue from nonwage income was up 8.6 percent in real terms in 1981, with most of the increment being in receipts from companies and in at-source deduction (these include payments by companies, self-employed, and employees).

The problem of taxing nonwage income in a period of inflation remained unsolved.[20] In 1980/81 and 1981/82 a global reduction in income tax payments was allowed to the entire business sector, without any connection with the specific activity of the individual firm. Arrangements of this kind, as well as the inventory tax relief introduced earlier, do not solve the basic problem of taxation under inflationary conditions; they merely reduce the Treasury's income tax revenue. Last year a bill dealing with the taxing of company profits in an inflationary period, which was drafted by the committee appointed to study and advise on this problem, was tabled in the Knesset. However, it was not adopted, and a second proposal, which to some extent developed out of the first, was tabled in 1982 and at the time of writing this chapter was under discussion.

The rapid, prolonged inflation has exposed some defects in the tax collection and income redistribution machinery, which militate against economic efficiency. Thus, a comparison of company income tax receipts with government payments to the business sector (under the Law for the Encouragement of Capital Investments and in the form of directed credit and other concessions) reveals that the net amount left for financing other government activities is small and perhaps even negative. Moreover, the distribution of taxpayers is not identical with that of the recipients of concessions. The government alters the interfirm and intersectoral distribution of income (and, consequently, that between individuals). It is worth considering whether the economy would not be better served were companies made to pay less income tax on the one hand and given smaller concessions on the other.

[20] See earlier Annual Reports of the Bank of Israel.

National Insurance

Receipts of the National Insurance Institute rose 14.6 percent in 1981. All the increment came from wage-earners, while collections from self-employed, (which account for a small percentage of the total) declined in real terms.

The rapid growth of employees' contributions was due to a 12 percent real increase in total payroll outlay and to the upping of the income ceiling for national insurance. In April 1980 the ceiling was raised to three times the average wage in the economy, but since the ceiling is adjusted only twice a year, the effective ceiling in 1980 was twice the average wage, and in the year reviewed 2.4 times the average.

(b) **Direct Transfer Payments**

Total transfer payments to individuals were up 9 percent in 1981, following a 2-3 percent rise in the previous two years.

The relatively rapid growth of transfer payments to households, particularly those by the National Insurance Institute, can be mainly attributed to an improved system of adjusting the allowances and other benefits for the increase in the consumer price index and to the slowing of inflation in 1981. Thus, for example, the child allowance, which had eroded steadily since 1977, rose in 1981 in real terms after being updated four times during the year instead of only twice previously. The larger volume of National Insurance Institute transfer payments is also explained by the increase in the number of beneficiaries and by the growing coverage of the welfare laws passed earlier.

The upsurge in national insurance receipts in 1981 (due to the rise in wages and the effective income ceiling) led to a 19 percent increase in payments to nonprofit institutions on account of employers' matching contributions. Other transfer payments to nonprofit institutions remained unchanged in real terms in comparison with 1980.

Transfers to business on capital account were 15 percent up on 1980. This item includes compensation to inhabitants of Yamit and other settlements who were relocated following the signing of the peace agreement with Egypt. While such payments rose rapidly in the year reviewed, the bulk of the compensation will be paid in 1982.

Interest payments on domestic loans include interest paid by the government to the Bank of Israel; this item rose steeply in 1981 but is of only marginal economic importance.[21] If interest payments on domestic loans are deducted from total transfer payments, the balance shows a modest real 2 percent increase.

[21] These payments, together with other net earnings of the Bank of Israel, are included in its net income transferred to the Treasury.

Table V-9

ESTIMATED EROSION OF VARIOUS ALLOWANCES, 1977-81

(Average monthly allowance at 1976 prices, in IS)

	July 1975 to March 1976[a]	1977	1978	1979	1980	1981	Percent real increase: 1981 as against July 1975–March 1976	Percent real increase: Annual 1978	1979	1980	1981
				Deflated by the consumer price index[b]							
Allowance for family with 2 children	24.4	23.8	22.8	20.1	18.4	21.1	-14	-4	-12	-8	15
Allowance for family with 4 children[c]	76.2	75.9	72.0	66.9	58.4	66.0	-13	-5	-7	-13	13
Income maintenance for single persons[d]	72.6	69.5	69.2	71.3	80.0	89.8	24	0	3	12	12
				Deflated by the index of average wages per employee post[b]							
Allowance for family with 2 children	24.0	21.5	20.3	16.4	15.5	16.1	-33	-6	-19	-5	4
Allowance for family with 4 children[c]	75.1	68.9	64.1	54.5	49.2	50.5	-33	-7	-15	-10	2
Income maintenance for single persons[d]	71.6	63.1	61.7	58.3	67.2	68.7	-4	-2	-6	15	2

[a] The income tax reform was instituted during a period when inflation was running at 40 percent, and so the value of the allowances as fixed in July 1975 fell monthly until updated in April 1976. The average monthly allowance during this period serves as an approximation of the amount which the indexation system was supposed to preserve.

[b] Deflated monthly.

[c] Includes the allowance for veterans.

[d] The rate of change of disability allowances is identical to the change in income maintenance.

SOURCE: Bank of Israel calculations.

Table V-10
INDIRECT TAXES AND SUBSIDIES ON DOMESTIC PRODUCTION, 1976-81
(IS million)

							Percent annual real increase[a]				
	1976	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
A. Total indirect taxes on domestic production	1,352	1,927	3,083	5,875	13,448	28,112	5.9	6.2	6.9	-0.9	-3.6
Taxes on economic activity	965	1,432	2,312	4,478	10,202	20,790	10.2	7.2	8.7	-1.4	-6.0
Value added tax	154	496	1,110	2,257	5,334	11,978	139.3	47.3	15.1	2.3	3.6
Purchase tax	313	304	366	562	985	2,090	-27.8	-20.0	-14.0	-24.1	-2.1
Fuel tax	157	168	190	448	930	1,722	-20.5	-24.9	32.2	-10.1	-14.6
Employers tax	117	202	331	726	1,900	3,042	28.1	8.8	23.3	13.2	-26.1
Other taxes on economic activity[b]	224	262	325	485	1,053	1,959	-12.9	-17.7	-16.2	-6.0	-14.2
Property tax	155	159	201	352	864	2,033	-23.9	-15.9	-1.8	6.1	8.6
Local authority rates	115	169	264	447	915	1,879	9.2	3.7	-5.0	-11.4	-5.3
Other taxes[c]	117	168	306	598	1,467	3,410	6.7	21.2	9.5	6.3	7.1
B. Subsidies on domestic production	820	1,084	1,585	3,359	6,884	23,339	-1.8	-2.9	18.9	-11.3	56.4
Direct subsidies	330	458	770	1,511	2,971	15,967	3.1	11.6	10.1	-14.9	147.9
Imputed credit subsidy	490	626	815	1,848	3,913	7,372	-5.1	-13.5	27.2	-8.3	-13.1
C. Net taxes on domestic production											
Excl. imputed credit subsidy	1,022	1,469	2,313	4,364	10,477	12,145	6.8	4.6	5.8	3.9	-46.5
Incl. imputed credit subsidy	532	843	1,498	2,516	6,564	4,773	17.7	18.0	-5.8	12.9	-66.5

[a] Deflated by the consumer price index, annual average.
[b] Tobacco and cement excise, revenue stamp tax, various fees and licenses, defense stamp tax.
[c] Post and ports surpluses and taxes on earmaked income.
SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

(c) **Indirect Taxes on Domestic Production**

Indirect taxes on domestic production yielded 3.6 percent less income in 1981, as the reduction of tax rates outweighed the expansion of economic activity. Excluding local authority rates and government property tax (which are not directly related to current economic activity), the decrease was even sharper (6 percent). The share of indirect taxes on domestic production in GNP fell in 1981 to 12 percent, compared with 14 percent in 1976-79 and 13 percent in 1980 (see Tables V-10 and V-7).

Value Added Tax

Introduced in the second half of 1976, VAT quickly became one of the principal indirect taxes on domestic production. In 1981 it accounted for almost 40 percent of total revenue from this source.

Collections of VAT on domestic production are estimated to have gone up 3.6 percent in real terms in 1981. This was proportionately less than the expansion of domestic activity liable to this tax, a fact attributable to the increase in subsidies and the lowering of the purchase and fuel taxes and the tobacco excise. Were it not for the subsidies, the market prices of commodities would have been higher and hence would have yielded more VAT revenue. If the subsidies, purchase and fuel taxes, and tobacco excise had remained at their 1980 level, VAT collections would have gone up 5-6 percent in real terms, instead of 3.6 percent.

A comparison of potential with actual collections of VAT in 1981 shows that, as in previous years, there was a close correspondence between the two—evidence of consistent reporting to the tax authorities and the Central Bureau of Statistics.

Purchase Tax

Between February and August 1981 there were several rounds of purchase tax cuts. These affected most of the goods liable to the tax and were steepest in the case of durables (there are eight purchase tax rate groups).

Since the reductions were made at various times during the year, their full effect will become evident only in 1982; in 1981 revenue from this source declined only 2 percent in real terms.

Property Tax

The property tax was abolished on all categories of immovable assets except nonagricultural land. The net result of this measure and collections of arrears was a 20 percent real contraction of such revenue.

(d) **Direct Subsidies on Domestic Production and the Credit Subsidy**

The direct subsidization of domestic production was, as stated, one of the government's major policy tools in 1981. Such support was stepped up in real terms to 2.5 times its volume in 1980, and totaled IS16 billion at current prices. Its weight in GNP reached 6.7 percent—a very high level compared with earlier years.

In 1981 numerous commodities were added to the list of subsidized items, and subsidy rates were increasingly hiked. The main supported items were margarine, edible oils, milk and milk products, poultry, eggs, public transport, animal and poultry feed, wheat, water, fuel, and electricity. Full details on the subsidy rates during the year for the various items are not available, but partial Treasury estimates reveal that in many cases the subsidy was increased repeatedly. For example, the subsidy on milk and its products, which in January 1981 stood at 16 percent of their market price, went up to 65 percent in mid-1981 and to 95 percent in January 1982. To take another example, the fuel subsidy rate was 8 percent in April 1981, rose to 28 percent in October 1981, but fell to 13 percent in January 1982.

Toward the end of 1981 and in early 1982 the prices of subsidized items were adjusted more frequently in order to check the bulging of the subsidy budget and to reduce the subsidy on some of the items.

Of the total IS16 billion subsidy bill in the calendar year 1981, 44 percent was on fuel and electricity. The world market prices of crude oil dropped this year, which helped to slow the advance of fuel prices in Israel. The relative prices of the various types of fuel changed in 1981, with distillate and residual fuel oil becoming comparatively more expensive than gasoline.

Public transport was the second biggest item on the subsidy list, with 13 percent of the total, followed closely by milk and milk products, with 10 percent.

Over the years the public sector has provided the private sector with credit at a below-market interest rate. With the rapid growth of such finance and the lagged adjustment of its interest rates (compared with the steep rise in the free market rates), the subsidy component of such credit grew to sizable dimensions. This component is not fully and explicitly reflected in the national accounts, where it is presently classified partly as a subsidy and partly as a transfer payment. In this chapter no distinction is made between the two elements.

The weight in GNP of the total credit subsidy (i.e. both elements mentioned) reached a record high of 10.5 percent in 1979. In the next two years, however, the total credit subsidy to business shrank 22 percent in real terms, and that to households fell even more. This change of trend is attributable to the following factors:

1. The total credit subsidy swelled rapidly and reached an excessively high level; this prompted the government to take corrective action.

2. Since this subsidy depends partly on the rate of inflation, it is not fully controllable by the lender nor foreseeable with certainty by the borrower. Therefore its effect on production and consumption is smaller than that of a subsidy whose size is known with certainty.

3. No clear-cut relationship has been found to exist between the size of the total credit subsidy and such important variables as the firms' value added.

4. The large volume of cheap directed credit depressed the share of free market credit, thereby narrowing the scope within which monetary policy could operate effectively.

In 1979 it was decided to start indexing credit granted by the public sector. The transition to medium- and long-term credit allocation on linked terms, which has been going on since then, and the curbing of directed credit in 1981 have reduced the total credit subsidy, especially in the case of households and industry and less so in export credit.

While enjoying the credit subsidy, the private sector has also had to pay an inflation tax as a result of the erosion of unlinked financial assets (the narrow monetary base). With the persistence of high inflation, however, individuals learned to reduce this "tax" by diminishing their resort to financial assets yielding no real return. The net "inflation tax", i.e. the depreciation of financial assets less the total credit subsidy, was actually negative in 1976–81; in other words, the private sector has so far gained from inflation. Since 1979, however, inflationary profits, as already noted, have been on the decline.

(e) Taxes and Subsidies on Foreign Trade

The growth of private income in 1981, the lowering of import taxes, and a sharp contraction of private consumption last year induced a much larger import in 1981 of private consumption goods subject to a high tax. Real tax revenue from civilian imports thus shot up 24.2 percent in real terms, with the rise being faster in customs duties and purchase tax (29 percent) and less so in the broader based VAT on imports (16 percent).

Table V-11

INFLUENCE OF INFLATION ON PRIVATE WEALTH, 1976-81

(IS million, at current prices)

	1976	1977	1978	1979	1980	1981	Percent annual real increase [a] 1977	1978	1979	1980	1981
1. Total outstanding cheap credit to business (annual average)	3,218	4,275	6,624	10,513	20,585	37,986	-1.3	2.9	-10.9	-15.2	-14.9
2. Monetary base narrowly defined (annual average)	865	1,314	1,703	2,150	3,627	6,844	12.9	-13.9	-29.2	-26.5	-13.0
3. Nonindexed loans to households (end-year balances)	810	1,010	1,330	1,900	2,690	3,842	-12.5	-11.1	-32.4	-39.2	-29.1
4. Subsidy component of credit to businesses [b]	759	1,103	1,577	4,444	9,687	17,430	8.0	-5.1	58.1	-5.6	-17.0
5. Inflationary erosion of monetary base [c]	253	400	597	1,570	2,984	1,872	17.5	-0.9	47.5	-17.7	-71.1
6. Subsidy component of credit to households	217	277	405	1,163	1,992	2,317	-5.1	-2.9	61.1	-25.9	-46.3
7. Increase in private wealth (4-5+6)	**723**	**980**	**1,385**	**4,037**	**8,695**	**17,875**	**0.7**	**-6.2**	**63.5**	**-6.8**	**-5.2**

[a] Deflated by the consumer price index.

[b] See also Table VIII-3, which presents the estimated subsidy component of Israeli currency credit only. The data in this table also include the subsidy component of foreign currency credit.

[c] The average monthly monetary base narrowly defined multiplied by the rise in prices during the year, less the average interest paid on the narrow monetary base on account of liquid assets deposited with the Bank of Israel. A negative rate of change signifies a tax reduction.

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

Table V-12

TAXES AND SUBSIDIES ON IMPORTS AND EXPORTS, 1976-81

(IS million, at current prices)

							Percent annual increase				
	1976	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
1. Taxes on civilian imports	1,049	1,416	1,848	3,841	6,351	17,096	35.0	30.5	107.8	65.3	169.2
Value added tax	100	280	676	1,433	2,704	6,822	180.4	141.0	112.1	88.7	152.3
Customs [a]	495	592	527	1,014	1,584	4,370	19.7	-11.0	92.3	56.2	175.9
Purchase and other taxes [b]	454	544	645	1,394	2,063	5,904	19.8	18.6	116.1	48.0	186.2
2. Import subsidies	30	58	97	169	95	1,694	93.3	67.2	74.2	-43.8	1,683.2
3. Net taxes on civilian imports (1-2)	1,019	1,358	1,751	3,672	6,256	15,402	33.3	28.9	109.7	70.4	146.2
4. Taxes on defense imports	235	223	327	322	971	2,647	-5.1	46.6	-1.5	201.5	172.6

[a] In 1976 and 1977 includes the import levy.

[b] Other taxes include adjustments to balance of payments definitions. In 1976 and 1977 they also include the levy on service imports, foreign travel tax, and the fuel levy.

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

Table V-A1

DOMESTIC DEMAND SURPLUS, 1977-81

(IS million, at current prices)

	1977	1978	1979	1980	1981	Percent annual real increase [a] 1977	1978	1979	1980	1981
A. Domestic demand surplus										
1. Demand surplus, as customarily defined (6-12)	1,600	2,187	3,394	8,290	35,622	7.0	-9.2	-13.0	5.7	98.2
2. Demand surplus, incl. effect of inflation on private wealth (6-16)	2,165	3,072	6,430	14,423	47,452	9.0	-5.8	17.4	-2.9	51.8
B. Direct public domestic demand										
3. Public domestic consumption[b]	3,654	5,770	11,453	26,186	63,435	-2.0	1.8	2.8	1.7	3.5
4. Public domestic investment	552	878	1,686	3,223	6,873	-5.1	-2.8	6.1	-14.2	-8.1
5. Residential construction initiated by the public sector	216	269	742	2,853	6,542	-47.3	-24.3	26.6	48.5	-1.5
6. Total direct domestic demands	**4,422**	**6,917**	**13,881**	**32,268**	**76,850**	**-8.7**	**-0.4**	**4.4**	**2.2**	**1.9**
C. Absorption										
7. Taxes[c]	6,654	10,159	20,120	45,724	106,619	4.6	1.4	11.1	-1.6	7.6
8. Property and entrepreneurial income of the public sector	457	523	1,176	3,275	7,686	32.3	-24.0	26.1	20.6	8.1

9. Subsidies[d]	1,117	898	1,761	3,202	19,672	17.7	-46.6	10.0	-21.3	183.4
10. Transfer payments, less compulsory loan redemption	2,757	4,554	8,047	19,257	49,908	13.9	9.7	-0.9	3.6	17.9
11. Government subsidization of credit (actual disbursements)[e]	415	500	1,001	2,562	6,045	-14.1	-20.0	12.3	10.8	8.8
12. Total absorption, as customarily defined[f] (7+8-9-10-11)	**2,822**	**4,730**	**10,487**	**23,978**	**41,228**	**-16.9**	**11.3**	**24.4**	**-1.0**	**-20.7**
13. Subsidy component of credit to business sector	1,103	1,577	4,444	9,687	17,430	8.0	-5.1	58.1	-5.6	-17.0
14. Subsidy component of credit to households[g]	277	405	1,163	1,992	2,317	-5.2	-2.9	61.1	-25.9	-46.3
15. Inflationary erosion of monetary base[h]	400	597	1,570	2,984	1,872	17.5	-0.9	47.5	-17.7	-71.1
16. Absorption, incl. effect of inflation on private wealth (11+12-13-14+15)	**2,257**	**3,845**	**7,451**	**17,845**	**29,398**	**-4.6**	**13.1**	**8.7**	**3.7**	**-24.0**

[a] Deflated by the consumer price index, except for direct public domestic demand components, which were deflated by the relevant indexes.
[b] Civilian and noncivilian.
[c] Direct and indirect (on domestic production and foreign trade, excluding compulsory loans).
[d] On domestic production, exports, and imports (excluding imputed credit subsidy).
[e] This sum is included in line 12.
[f] Taxes less the credit subsidy (i.e. less actual disbursements of subsidized credit, plus public sector property and entrepreneurial income).
[g] The difference between a real interest rate of 4 percent and the average nominal interest rate paid by households, multiplied by the average nonindexed credit balance.
[h] The decrease in the narrowly defined monetary base (annual average) as a result of inflation.
SOURCE: Central Bureau of Statistics and Bank of Israel.

Table V-A2

DIRECT TAXES, COMPULSORY LOANS, AND TRANSFER PAYMENTS, 1976-81

(IS million)

	1976	1977	1978	1979	1980	1981	Percent annual real increase[a] 1977	1978	1979	1980	1981
1. Income tax	1,684	2,289	3,602	7,372	18,519	43,141	1.0	4.5	14.8	8.7	7.5
Wages	624	956	1,412	3,119	8,341	19,174	13.8	-1.9	23.9	15.8	6.0
Nonwage income	1,060	1,333	2,190	4,253	10,176	23,967	-6.6	9.1	8.9	3.6	8.6
Companies	558	594	957	1,857	3,585	8,489	-20.9	7.0	8.8	-16.4	9.2
Self-employed	205	298	511	971	2,209	4,946	8.0	13.8	6.7	-1.6	3.3
Company directors and members of cooperatives	81	161	236	580	1,650	4,055	47.7	-2.7	37.8	23.1	13.4
Deductions at source	216	280	486	844	2,734	6,477	-3.7	15.3	-2.6	40.2	9.3
2. National insurance contributions	615	961	1,575	2,997	7,342	18,241	16.1	8.8	6.7	6.0	14.6
Wages[b]	568	888	1,456	2,783	6,851	17,218	16.2	8.9	7.2	6.6	15.9
Nonwage income	47	73	119	214	491	1,023	15.3	8.2	0.9	-0.7	-3.9
3. Inventory surtax	28	61	51	36	64	29	61.6	-44.0	-60.9	-23.0	-79.1
4. Total direct taxes (1+2+3)	**2,327**	**3,311**	**5,228**	**10,404**	**25,925**	**61,411**	**5.7**	**4.9**	**11.6**	**7.9**	**9.3**
5. Compulsory loans	157	193	297	634	183	0	-8.7	2.2	19.7	-87.5	...
Thereof: Employers saving loan	114	181	289	628	181	0	18.0	6.0	21.9	-87.5	...
6. Total taxes and compulsory loans (4+5)	**2,484**	**3,504**	**5,525**	**11,038**	**26,108**	**61,411**	**4.8**	**4.7**	**12.1**	**2.4**	**8.5**
7. Transfer payments to households	967	1,336	2,018	3,513	8,652	21,465	4.9	-1.9	-2.4	6.6	14.4
Through National Insurance Institute	634	868	1,332	2,342	5,845	14,959	1.7	1.9	-1.4	8.0	18.0
Provident fund, pension, and other transfers	333	498	686	1,171	2,807	6,506	11.1	-8.5	-4.3	3.8	6.9
8. Net transfer payments to nonprofit institutions	461	719	1,270	2,490	5,678	13,014	15.9	17.3	10.0	-1.3	5.7

Net current transfers	394	655	1,186	2,339	5,346	12,134	23.5	20.3	10.6	-1.1	4.7
Thereof: Employers' matching contributions	96	159	286	574	1,565	4,036	23.0	19.4	12.6	18.0	19.0
Transfers on capital account[c]	67	64	84	151	332	880	-29.0	-12.8	0.8	-4.8	22.3
9. Capital transfers to business[c]	74	103	164	436	1,202	3,000	3.4	5.7	49.1	19.3	15.1
10. Interest payments on domestic loans	512	809	1,440	2,201	4,936	12,300	17.4	18.2	-14.3	-2.9	14.9
11. Redemption of compulsory loans	144	222	351	505	1,253	1,390	14.5	5.0	-19.3	7.4	-48.8
12. Total transfer payments to the public (8 to 11)	**2,158**	**3,218**	**5,243**	**9,145**	**21,721**	**51,169**	**10.8**	**8.2**	**2.2**	**2.8**	**8.7**
13. Transfer payments from the public	216	240	338	593	1,211	2,421	-17.5	-6.5	-1.6	-11.6	-7.8
On current account	105	136	158	226	446	1,021	-3.8	-22.9	-19.8	-14.6	5.6
On capital account[c]	111	104	180	367	765	1,400	-30.4	14.9	14.4	-9.8	-15.6
14. Total net transfer payments (12-13)	**1,942**	**2,979**	**4,905**	**8,552**	**20,510**	**48,748**	**14.0**	**9.3**	**-2.2**	**3.8**	**9.6**
15. Net transfer payments, less compulsory loan redemption (14-11)	1,798	2,757	4,554	8,047	19,257	47,358	13.9	9.7	-0.9	3.6	13.4
16. Net transfer payments, less interest (14-10)	1,430	2,170	3,465	6,351	15,574	36,448	12.7	6.0	2.8	6.1	8.0
17. Direct taxes and compulsory loans, less transfer payments (6-14)	542	525	620	2,486	5,598	12,663	-28.1	-21.5	124.9	-2.5	-4.3
18. Direct taxes and compulsory loans, less transfer payments to households and business (17+8)	1,003	1,244	1,890	4,976	11,276	25,677	-7.9	0.9	47.7	-1.9	-5.0
19. Direct taxes, less transfer payments minus compulsory loan redemption (4-15)	529	554	674	2,357	6,668	14,053	-22.2	-19.1	96.1	22.4	-2.8
20. Direct taxes, less transfer payments to households and business and compulsory loan redemption (19+8)	990	1,273	1,944	4,847	12,346	27,067	-4.5	1.4	39.8	10.2	-1.1

[a] Deflated by the consumer price index.
[b] Includes contributions on account of managers' salaries.
[c] Provisional estimate for 1981.
SOURCE: Central Bureau of Statistics, Ministry of Finance, and Bank of Israel.

Table V-A3

FINANCING OF THE PUBLIC SECTOR DEMAND SURPLUS, 1978-81

(IS million, at current prices)

			1978	1979	1980	1981
A.	1.	Net long-term capital mobilization by the public sector [a]	-68	526	1,059	9,527
	2.	Net compulsory loan redemption [b]	-235	-757	886	1,620
	3.	Net interest payments [b]	1,268	2,144	4,557	7,700
	4.	Long-term capital mobilization, adjusted (1-2+3)	1,435	3,427	4,730	15,607
	5.	Sale of tradable bonds [c]	-456	117	1,217	-2,663
B.	6.	Public sector injection [a]	1,447	1,480	4,916	17,235
	7.	Early redemption of Israel Bonds [d]	240	469	812	2,695
	8.	Injection by government enterprises	100	200	1,514	4,300
	9.	Public sector injection, adjusted (6-7-8)	1,107	811	2,590	10,240
	10.	Basic injection (5+6) [e]	991	1,597	6,136	14,572
	11.	Injection generated by domestic demand surplus (1+6-7) [e]	1,139	1,537	5,163	24,067
C.	12.	Public sector purchases abroad [f]	3,431	4,141	11,590	30,767
	13.	Taxes on defense imports [g]	327	322	971	2,647
	14.	Net public sector purchases abroad (12-13)	3,104	3,819	10,619	28,120
	15.	Income from abroad [h]	2,304	4,270	10,199	17,704
	16.	Thereof: Intergovernmental transfers	1,777	3,545	8,332	15,737
	17.	Foreign demand surplus (14-15)	800	-451	420	10,416

[a] See also Table VIII-8. Interest receipts and payments are included in the public sector domestic demand surplus and in net capital mobilization (line 1). To avoid double-counting they should be added to net capital mobilization.

[b] See Table V-A2.

[c] A component of line 1.

[d] See Table VIII-A11.

[e] The terms "basic injection" and "injection generated by the demand surplus" appear frequently in Chapter VIII.

[f] See Table V-3.

[g] See Table V-12.

[h] U.S. government grants, Jewish Agency transfers for financing its operations in Israel, and net foreign currency income of the Bank of Israel (less revaluation).

SOURCE: Bank of Israel.