

## CHAPTER IX

### PRICES

#### 1. MAIN DEVELOPMENTS

The rapid trend in price increases continued in 1976: from the beginning of the year until the end, the Consumer Price Index rose by 38 percent, while the Wholesale Price Index of industrial output rose by 39 percent. Because prices climbed relatively slowly in 1975, the annual averages were lower, the Consumer Price Index rose by 31 percent on the average, while use and product prices increased at an annual average of 25–28 percent.

TABLE IX-1  
RISE IN PRICES OF RESOURCES AND USES, 1961–1976  
(percent)

	Average							
	1961	1966–	1968–	1971	1973	1974	1975	1976
	1965	1967	1970	1975				
Gross National Product	8.1	5.3	4.2	23.4	20.8	35.3	35.9	25.4
Imports <sup>a</sup>	9.3	2.2	7.6	27.8	20.4	42.9	44.5	32.8
Private consumption	7.4	4.4	3.6	24.5	19.6	38.5	40.0	28.6
Public consumption, excl. direct defense imports	9.8	5.9	4.8	25.1	22.4	36.3	38.4	29.5
Gross domestic investment, excl. ships and aircraft	8.9	0.9	7.6	25.6	24.8	40.8	34.3	24.2
Total domestic uses <sup>a</sup>	8.0	4.5	4.4	24.9	21.7	38.6	38.0	27.5
Exports	10.0	4.9	7.1	24.9	18.2	36.0	41.6	30.0
Total uses <sup>a</sup>	8.3	4.5	5.0	24.9	20.9	38.1	38.8	28.2

<sup>a</sup> Excluding ships, aircraft and direct defense imports.

SOURCE: Central Bureau of Statistics.

Inflation in 1976, as in the two previous years, derived mainly from government policy measures to improve the balance of payments and reduce private sector demand. The Israel pound was devalued by 24 percent during 1976; in the middle of the year an 8 percent Value Added Tax was imposed, and in March and November subsidies on essential items were lifted. Although those measures did decrease demands and improve the balance of payments, they accelerated price increases at the same time. These could have been slowed through the creation of wider unemployment or through direct measures taken to reduce demands, especially by cutting the budget instead of raising taxes.

The relative prices of exports improved at a rate of 6-7 percent. (Export prices increased by 30 percent, and the business product price by 24.5 percent.)

The prices of controlled items increased by 37 percent during 1976, and their contribution to the Consumer Price Index rise was 7.5 percent. Continuing an upward trend, relative prices of free services in the Consumer Price Index increased by 45 percent in 1976, as against a rise of 38 percent in the Consumer Price Index.

The index of housing construction input prices rose at an annual average of 26.5 percent in 1976, and throughout the year by 30 percent. (Because it is an input index, the Central Bureau of Statistics decided not to include Value Added Tax payments in it.)

In contrast, apartment prices increased during 1976 by 8-10 percent. The downward trend in the relative prices of flats and in profitability in the construction branch has thus continued for the third straight year.

## 2. PRICE DEVELOPMENTS IN 1976

As mentioned above in 1976 the Consumer Price Index rose (from December to December) by 38 percent. Other indexes also rose rapidly: the Wholesale Price Index of industrial output for domestic purposes rose by 39 percent, and the index of housing construction input prices, by 30 percent. (The relatively slow increase in this last index is due to the fact the the Value Added Tax was not included in it.) The rapid price increases during 1976 will cause a significant average price increase in the following year: if prices in 1977 stabilize at the December 1976 level, the average price level of 1977 will exceed the level of 1976 by 17 percent.

TABLE IX-2  
RISE IN VARIOUS PRICE INDEXES, 1974-1976  
(percent)

	Average						
	1964-1966		1967-1969		1970-1972		
	1966	1969	1972	1973	1974	1975	1976
Consumer Price Index	6.9	2.1	10.3	20.0	39.7	39.3	31.3
Excl. fruit and vegetables	7.1	1.9	10.5	19.3	40.6	38.5	31.5
Excl. fruit, vegetables and housing	5.8	1.9	9.5	16.5	39.9	40.5	33.4
Wholesale Price Index of industrial output	3.2	1.9	9.2	19.1	51.5	40.8	30.9
Index of agricultural input prices	6.2	4.6	10.9	17.9	55.1	46.5	33.8
Index of housing construction input prices	8.2	2.3	12.4	28.5	47.2	30.6	26.5
Index of road construction input prices	—	2.8	11.4	20.0	49.8	49.1	26.0

SOURCE: Central Bureau of Statistics.

Price increases during the year were not homogeneous: in the first quarter of 1976, they were relatively slow, and in the last three quarters — rapid and homogeneous. At the end of the first quarter, prices of vital items, water and public transportation were raised, and this caused an average increase of 25 percent in the prices of these items; fuel and electricity increased by 11 percent. In the second quarter various fees were raised, as were national insurance rates and employers' matching contributions, and a Cost-of-Living allowance of 10 percent was paid. The third quarter of each year normally shows a seasonal slowdown in price increases, but in July 1976 a Value Added Tax of 8 percent was imposed, and that gave push towards a general price rise, which caused a 5 percent jump in the Consumer Price Index. In the last quarter of 1976 a Cost-of-Living allowance of 12 percent was paid, and prices of vital items and public transportation were increased by 20 percent; fuel increased by 11 percent.

The slow increase in prices in 1975 caused the average price rise in 1976 to be lower than price increases throughout 1976, and lower than the average rise in 1975. Private consumption prices increased in 1976 at an average of 29 percent, whereas between the last quarter of 1975 and the last quarter of 1976 these prices climbed by 34 percent. Investment prices rose in this period by 33 percent as against an average rise of 23 percent in 1976.

As to the relative prices of the various uses, relative prices of exports were outstanding: they increased by 30 percent in 1976, as compared with an increase of 24.5 percent in the business product prices. The relative prices of exports improved by 15 percent between 1973 and 1976, which encouraged the expansion of exports and employment in the branches producing for export. It should be remembered that in the 1966–67 recession, relative prices of exports fell, which intensified the effect of the recession, whereas in 1976 the increase in relative prices of exports moderated the decline in other demands. At the same time, the increase in relative prices was not homogeneous in all branches; in industry, for example, the change in relative prices was smaller (see Table IV-1).

The relative prices of investments dropped this year; investment prices increased by 24 percent, while prices of all domestic uses increased by 28 percent. This decline in relative prices to a certain extent reflects the decline in the relative price of housing, and partially the fact that the Value Added Tax was not imposed on investments in the economic branches of the business sector.

### 3. CAUSES OF THE INFLATION

Prices began to climb rapidly in the years 1971–1973, at a rate of 12–20 percent per year. Price increases in these years derived from demand pressures in the economy, which partially led to rapid real growth in uses and product (10–12 percent per year), and partially to price increases.

TABLE IX-3  
QUARTERLY RISE IN VARIOUS PRICE INDEXES, 1975-1976  
(percent)

	1975				1976			
	Jan.- March	April- June	July- Sept.	Oct.- Dec.	Jan.- March	April- June	July- Sept.	Oct.- Dec.
<b>Consumer Price Index</b>	13.1	4.7	1.4	10.3	4.6	10.1	1.6	9.5
Excl. fruit and vegetables	12.2	4.1	2.7	9.1	4.6	10.7	8.6	8.3
Excl. fruit, vegetables and housing	12.8	4.8	2.5	9.2	4.8	11.0	9.8	9.1
<b>Wholesale Price Index of industrial output</b>	13.2	2.9	1.5	8.2	5.1	9.1	11.9	7.9
Index of agricultural input prices	16.6	2.9	3.7	4.4	5.2	19.7	6.2	5.2
Index of housing construction inputs	8.9	3.4	6.8	3.5	3.3	11.9	8.3	3.2
Index of road construction input prices	14.4	3.8	5.7	8.4	4.2	7.5	5.3	5.0

SOURCE: Central Bureau of Statistics

Since the Yom Kippur War, the rate of price increases has accelerated, while the causes for these increases have varied. Between 1974 and 1976, prices increased at an annual rate of 30 to 40 percent; demand pressures, which had characterized price increases until 1973, disappeared (in spite of continuous growth in production potential, product and uses did not grow significantly in the years 1974-1976) and prices became subject to cost pressures.

Cost pressures were mainly the result of government policy measures. Government policy was meant to improve the balance of payments by improving the relative prices of exports and directing domestic resources from domestic uses to exports and import substitution. In order to achieve those goals, the Israeli pound was devalued from November 1974 in a series of "creeping devaluations", which accumulated to about 100 percent through the end of 1976. In order to reduce domestic demands, indirect taxes were raised, new taxes imposed, and prices of subsidized items increased.

Alternative measures which might have slowed the inflation rate — increase of unemployment or a significant cutback in public expenditure, and direct action to reduce private income — were not taken.

The effect of price increases abroad on domestic prices in 1975 and 1976 was marginal, whereas in the preceding period this effect was significant because of the higher price of fuel.

TABLE IX-4

**CONTRIBUTION OF PRIMARY FACTORS TO THE PRICE INCREASE OF USES,  
1976  
(percent)**

	Total compared to 1975	Labor	Capital	Imports	Net taxes	Housing
Private consumption	28.5	11 (31)	2.5 (16)	10 (31)	2.5 (8)	2.5 (14)
Public consumption (excl. direct defense imports)	29.5	20 (71)	2 (6)	6.5 (19)	1 (4)	—
Investments (excl. ships and aircraft)	24.0	11 (30)	-1 (25)	12.5 (41)	2 (5)	—
Exports	30.0	10 (29)	7.5 (38)	13 (46)	-0 (-2)	—

NOTE: The numbers in parentheses represent the weight of each export factor in each use.

SOURCE: Bank of Israel.

According to the weight of the various factors of uses (labor, capital, imports, and taxes), one can estimate the direct effect that the price rise of each factor had on the total price rises. Temporary estimates of these effects in 1976 are presented in Table IX-4.

#### A. IMPORTS

The direct effect of the increase of import prices on the price rise of uses in 1976 ranged between 20 percent in public consumption and 50 percent in investments. The increase of import prices has further effects: the rise in the Consumer Price Index causes an increase in the Cost-of-Living allowance, which adds further upward pressure to prices. This factor increased the effect of imports to 40 percent in public consumption and 57 percent in investments.

The effect of devaluations on prices of uses is in fact greater than the weight of imports in production. The import price rise entails increases in the prices of import substitutes, even if the import component in these items is small. Similarly, because the return in Israeli pounds of export products also marketed in Israel was higher, their price in the domestic market also rose. The price of goods tradeable in the domestic market tends to rise at the same rate as the devaluations even if the import component in them is small, due to the process of price equalization.

#### B. TAXES

The importance of taxation as a cost factor creating pressure for price increases, grew in 1976 due to the imposition of the 8 percent Value Added Tax in July 1976. This step caused a general price rise of 4-8 percent. The difference in the rates of increase derived from the variation in the incidence of the V.A.T. in various uses. For example, in private consumption: fruit and vegetables are exempt from V.A.T.; the subsidy on vital items was increased at the same time as the tax went into effect; on wages paid by nonprofit institutions, the tax is only 3 percent; banking institutions and social insurance funds pay 6 percent, and investments in economic branches and exports are exempt from V.A.T. On the other hand, there was a rapid increase in subsidies to domestic production. In 1976, the prices of vital products rose, contributing to price increases, though apparently this should be seen as an adjustment of the prices of these products to rising costs.

#### C. WAGES

The average salary per employee's post rose in 1976 by 32.5 percent, and in the business sector, by 36 percent. The wage rise contributed to between 1/3 and 1/2 of the price increases in private consumption, investments and exports. (The weight of labor in the production of these uses is 30 percent, see Table IX-4.) It seems that the wage rise in 1976 did not derive from an intensified demand for workers, but from existing agreements and trade union pressure. These agreements and pressures were made possible in part by the nonappearance of overt unemployment (see Chapter XII).

To summarize, inflation in 1976 can be identified as "cost inflation" (or "functional inflation"). The main factors pushing costs up were the devaluation, and the rise in the rates of indirect taxes (Value Added Tax), arrangements which prevent a significant decline in real wages, and workers' pressure to increase wages.

Another criterion confirming that the upward pressure on prices was due to costs is the division of incomes between labor and capital. In periods of slow price increases or in periods of inflationary demand, income is divided according to the contribution of production means to the production process, and changes in the division of income will be small. When cost pressures develop, no unemployment is created, and arrangements which follow wage increases remain in force. This development finds expression in the falling weight of capital return in the business sector.

TABLE IX-5

WEIGHT OF LABOR COSTS IN THE BUSINESS SECTOR, BY USES, 1964-1976  
(percent)

	1964- 1965	1966- 1967	1968- 1970	1971- 1973	1974- 1976	1973	1974	1975	1976
(1) Private consumption	54	56	52	51	58	51	53	58	64
(2) Investments	63	76	62	52	55	51	47	55	64
(3) Public consumption	53	61	59	63	75	76	77	74	73
(4) Exports	57	61	49	46	53	46	50	52	53
(5) Total business sector	56	61	54	51	58	52	54	58	61
(6) Total business sector <sup>a</sup>	56	58	52	51	—	50	49	52	—

<sup>a</sup> The source of these data — Central Bureau of Statistics.

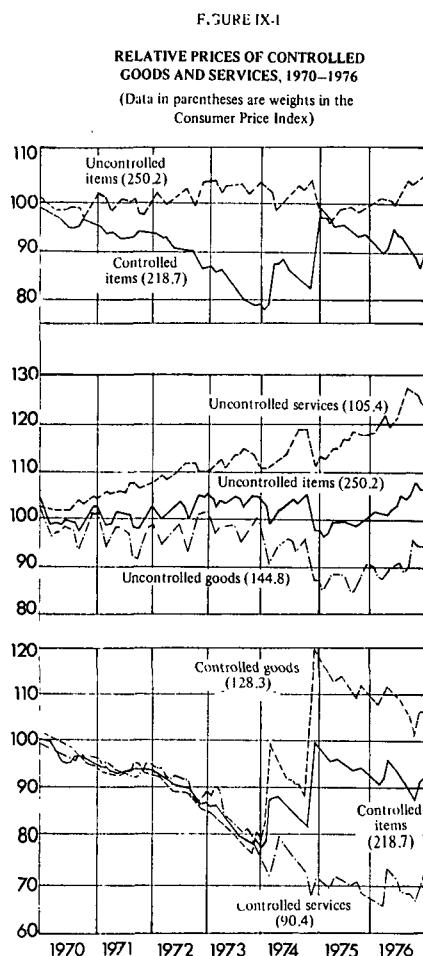
NOTE: The calculations are based on the division of uses into primary factors (labor, capital, imports and taxes). The results are based partly on temporary data.

SOURCE: Bank of Israel, Central Bureau of Statistics.

The weight of capital return in the business sector has declined significantly. This development has continued intensively for three years, and therefore the only explanation can be that it is the result of cost pressures. Moreover, the increase in the weight of labor in domestic uses is outstanding (according to government policy they were not meant to grow). On the other hand, in exports (the use which should be encouraged by government policy) the increase in the weight of labor is the slowest. In the 1966-67 recession the relative prices of exports worsened, and exports did not grow; this was shown by an increase in the weight of the return on labor in the total income deriving from exports.

## 4. VARIOUS PRICE INDEXES

### A. CONTROLLED AND FREE ITEMS IN THE CONSUMER PRICE INDEX



Prices of controlled items were increased three times in 1976. In the middle of March and the beginning of November, subsidies on basic products were cut, and prices of fuel, electricity, water and public transportation were increased. As a result, the prices of these items increased, in March by 16 percent, and in November by 12 percent. In July, due to the implementation of the Value Added Tax, the controlled item price index rose by 4 percent. (The index did not rise at the same rate as the tax, since subsidies were raised at the same time.)

In sum, controlled item prices increased by 37 percent in 1976, and their contribution to the general increase during the year was 7.5 percent.

The increase in controlled item prices, especially of essential items, has taken place twice a year in the recent past, with full coverage in the media. This caused a much higher price increase than the weight of essential products in total consumption and in the production processes of other products. The increase of controlled item prices gives sanction and serves as a criterion for price increases in various fields which are not related to the controlled items.

In a period when the cost prices in Israeli currency increase rapidly, and the size of the subsidy budget is fixed, there is no choice but to increase controlled item prices, but in order to prevent some of the negative effects of their increase a new method of adjustment should be considered, such as a "creeping" price rise, so that price increases of controlled items would be smaller and more frequent.

<sup>1</sup> For selected items and their respective weights, see Bank of Israel Report 1974, p.233.

Relative prices of free services continued their long-term upward trend in 1976. The annual average prices of free services increased by 40 percent, and contributed an increase of 5 percent to the total Consumer Price Index rise (which was 31 percent). During the year (from December to December) the prices of free services increased by 45 percent.

The price increases of free services cannot be explained through government intervention in determining prices or cost pressure, since the import component in them is small. In addition, the demand for these services was not high in 1976 (a real increase of 5 percent). The most reasonable explanation seems to be that suppliers of these services adjusted their revenues and incomes to the general price increase — a sort of "continuous Cost-of-Living allowance". Comparison of the free services price index to the controlled goods and services index shows that when the controlled goods prices increase, there is a rapid increase in the price of free services<sup>2</sup>.

#### B. WHOLESALE PRICE INDEX OF INDUSTRIAL OUTPUT FOR DOMESTIC DESTINATIONS

The annual average rise in 1976 in the wholesale price index of industrial output for domestic destinations was 31 percent; throughout 1976 it rose by 39 percent. Price increases occurred throughout the whole year, but were faster in the third quarter of 1976, with the implementation of the Value Added Tax. Sector price increases were mostly similar to the general average, except for leather and leather products, where prices increased by 76 percent because of price increases of raw materials abroad, and transportation equipment which increased in price by only 29 percent.

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2 In months when the prices of controlled goods increased, the rate of price increases of free services was considerably higher than in other months. Following are data on the average monthly price increase of free services in different months:

Years	Months when subsidies were canceled	Months when no subsidies were canceled
	(percent)	
1973	2.3	2.0
1974	6.4	2.8
1975	5.2	1.9
1976	4.6	2.2

The adjustment of free service prices is not immediate, and therefore adding a month or two to those months in which subsidies were lifted, would have made the differences even sharper.

TABLE IX-6

CHANGES IN CONTROLLED AND UNCONTROLLED COMMODITY PRICES, 1973-1976  
(percent)

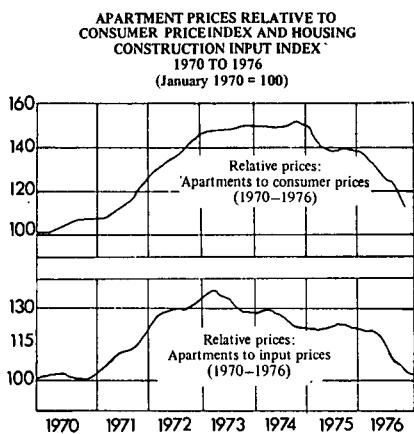
Weight in index	December levels				1975				1976			
	1973	1974	1975	1976	Jan.- March	April June	July- Sept.	Oct.- Dec.	Jan.- March	April June	July- Sept.	Oct.- Dec.
(per 1,000)												
Controlled items	218.7	13.0	102.6	12.4	37.0	18.5	2.5	0.8	7.8	2.3	14.8	4.4
Uncontrolled items	250.2	25.5	48.2	27.2	44.0	7.7	6.8	2.1	11.5	5.1	11.4	11.7
Services	105.4	27.5	59.6	29.1	45.4	10.7	6.4	4.9	9.1	6.8	10.8	14.4
Goods	144.8	23.9	39.6	25.5	42.7	5.2	7.2	-0.3	13.7	3.6	11.9	9.2
Fruit and vegetables	75.4	24.2	31.5	48.6	39.9	25.2	12.3	-13.7	27.8	5.6	3.3	-4.4
Other items	455.7	32.5	49.3	23.4	34.9	12.0	3.5	3.8	8.6	5.3	8.6	8.8
Total	1,000	26.4	56.2	23.5	38.0	13.1	4.7	1.4	10.4	4.3	10.1	7.6
												9.5

SOURCE: Central Bureau of Statistics and Bank of Israel.

### C. INDEX OF CONSTRUCTION INPUT PRICES AND INDEX OF HOUSING PRICES

The index of housing construction input prices rose at an annual average of 26.5 percent in 1976, and during the year by 30 percent. This increase was lower than price increases in other areas, but this is mostly a "technical" difference, since the Value Added Tax was not included as a component in the price increase of construction inputs (according to the definition of the Central Bureau of Statistics)<sup>3</sup>. Among the main components, there was a 33.5 percent rise in wage costs (December compared to December) and a 27 percent rise in other inputs.

FIGURE IX-2



Prices of apartments increased from October 1975 until October 1976 by 8 percent, whereas the general price index in this period increased by 36 percent, and the index of construction inputs by 29 percent. The steep decline in the relative prices of flats which began in 1974 also continued. The drop in relative prices of flats as against the construction input prices represents a drop in the profitability of housing construction to the level of 1969-1970<sup>4</sup>.

It should be noted that the apartment price index which is one of the main components of the Consumer Price Index, estimates the change in prices of apartment consumption, and the consumption prices may differ from the prices of flat purchases<sup>5</sup>. According to an apartment survey, a wide gap was created in 1976 between the increase of

flat prices (8 percent between October 1975 and October 1976), and flat consumption prices (22 percent according to the sector's definition of the periods).

<sup>3</sup> See the Central Bureau of Statistics, Monthly Price Statistics, July 1976, p.129. We think that the Value Added Tax on that part of ongoing construction which has not yet been sold to customers should be included in the input index.

<sup>4</sup> Since the Value Added Tax is not included in the input index, but is included in the index of apartment prices, the decline in profitability is higher than shown in Figure IX-4 (if the surveys included flats sold after the implementation of the tax).

<sup>5</sup> For a detailed explanation, see the Central Bureau of Statistics, the Consumer Price Index, publication No. 29, 1967-68, pp. 56-65.

#### D. PRICE INDEXES OF POPULATION GROUPS<sup>6</sup>

The Cost-of-Living Index, published by the Central Bureau of Statistics, is an average index for all urban families in the economy. Since the price increase is not homogeneous, and the expenditure structure is different among the various population groups, it is possible that the price increases for certain population groups deviate from the general price increases.

Total consumption prices of the lower population groups increased in 1974–1975 at a faster rate than the average (classification according to expenditure groups). In 1976 the trend reversed: the consumption baskets of "rich" families increased at a faster rate than the average and those of "poor" families, at a lower rate. These changes caused the cumulative price increase from 1969 to 1976 to be very similar in all population groups, except the lowest, where the price increase was slightly higher than the average. However, one cannot conclude an absolute worsening in the living conditions of the lowest groups, since the support for these families rose together with the price increases.

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<sup>6</sup> This check is based on the division of urban families into seven expenditure groups. The consumption basket was broken up to 35 items. See Appendix to this Report.