

CHAPTER XI

GOVERNMENT AND NONGOVERNMENT PUBLIC SECTOR¹

1. MAIN DEVELOPMENTS

Public domestic consumption and nondwelling investment stabilized in 1978 and even began to climb, following a decline which began in 1976 but tapered off somewhat last year. Along with a slow increase in direct tax collections, which for the second year in a row lagged behind the growth of private income, this year saw a significant growth in government subsidies and interest payments, while the long-term uptrend in transfer payments was checked. In contrast to these rather moderate developments, a weighty expansionary factor was at work in the past two years: the huge amount of subsidized government credit granted to the private sector. Together with the acceleration of inflation, this led to a much heavier subsidization of capital² in 1978, augmenting demand pressure on the part of the public.

Domestic expenditures of the defense establishment stabilized this year after they had declined steadily since 1975, while public sector civilian services rose 5 percent, continuing the upward trend of the past few years. The expansion of public consumption found expression in a further rapid growth in the number of public servants and their weight in total employed in the economy — a development which intensified demand pressure in the labor market. Direct nondwelling investment of the public sector was up 6 percent this year, reversing the downtrend begun in 1976; this resembled the turnaround in private sector investments.

¹ The public sector comprises the government, local authorities, and National Institutions. This chapter deals with the real activities of the sector, while monetary developments are discussed in Chapters XVI–XIX below. The sources of data in this chapter are estimates of the Central Bureau of Statistics, unless otherwise stated.

² In the current method of national accounting, the subsidy element in such credit is not treated as an increase in government demand; the conceptual definition of this subsidy is presently being reexamined. For the purpose of estimating the real impact of the public sector on aggregate demand in the economy, the subsidy element in outstanding business sector credit will be treated in this chapter as an increase in indirect demand, along with the conventional national accounting treatment.

The Central Bureau of Statistics estimates of this subsidy reflect the current support given to borrowers to lighten the interest payment burden, and estimate the resulting incremental income.

TABLE XI-1
INDICATORS OF PUBLIC SECTOR OPERATIONS, 1968-1978
 (percent, at current prices)

	1968- 1969	1970- 1972	1973	1974	1975	1976	1977	1978
A. Weight in GNP of direct demands of the public sector^a								
Civilian public consumption	9.7	9.6	9.8	9.7	9.6	10.0	10.9	10.7
Domestic noncivilian public consumption	8.6	9.5	11.4	12.8	12.6	11.3	10.6	10.1
Defense import burden ^b	2.4	4.2	5.6	4.1	5.9	6.0	5.4	5.8
Total noncivilian consumption	11.0	13.7	17.0	16.9	18.5	17.3	16.0	15.9
Total public consumption	20.7	23.3	26.8	26.6	28.1	27.3	26.9	26.6
Nondwelling investment	4.9	3.9	3.3	3.6	3.9	3.2	3.0	2.9
Total direct demands	25.6	27.2	30.1	30.2	32.0	30.5	29.9	29.5
Public housing construction	1.2	2.7	3.6	4.2	3.9	2.0	1.1	0.8
B. Weight in GNP of civilian public consumption and nonprofit institution consumption	15.7	15.6	15.9	15.6	15.4	16.0	17.4	17.2
C. Weight of public services in total employed in economy^c	22.7	24.2	24.7	26.1	27.1	27.5	27.8	28.9
D. Weight in GNP^d of public sector revenue and transfer payments								
Public sector revenue less subsidies ^{e,f}			33.6	38.6	29.4	36.5	34.1	33.5

Net transfer payments ^g	13.2	16.4	18.2	20.5	21.0	20.8
Liquidity absorption ^{f,h}	20.4	22.2	11.2	16.0	13.1	12.7
Subsidy element in credit to business sector			8.6	9.1	9.7	11.0
E. Ratio between balance of subsidized credit of business sector and the money base at end of previous year			3.0	4.5	4.8	5.8

- ^a These weights were estimated for the various direct demands in items A and B by dividing the GNP components of each direct demand by GNP at factor cost. The product components of the various demands provide an estimate of their value added. In calculating the product components, the direct and indirect import components were deducted from the various direct demands, as were taxes on the import components and on domestic production. These calculations were made with the help of the input-output table for 1968/69, with revisions made for the changes which occurred in relative prices and in taxation rates.
- ^b The defense import burden is defined here as the weight in GNP of the export added value required to finance the imputed interest on that part of the external debt arising from defense imports. This estimate is based on the assumption that the annual increment to the defense debt was the direct and indirect defense imports, less grants and the grant equivalent of US government loans. It was also assumed here that the commercial interest to borrowers in the international markets was 10 percent in the period under discussion (see also Table XI-7).
- ^c Public services are defined according to labor force surveys of the Central Bureau of Statistics; this does not coincide with the definition of the public sector in the national accounts. The labor force surveys include those employed in the nonprofit institutions, as well as those privately employed in education and health, but do not include some government, local authority, and National Institution employed, who are classified according to the sector in which they work and are included in the national accounts definition. The definition of public service employees according to labor force surveys is thus a broader one.
- ^d The product at market prices.
- ^e Revenue from taxes, compulsory loans, and property and entrepreneurial income, less subsidies on domestic production, imports exports and taxes on defense imports.
- ^f Beginning in 1975, a new series in which the subsidy element in credit to the business sector is deducted.
- ^g The structure of this item – in Table XI-II.
- ^h Revenue of the public sector, less subsidies and net transfer payments.

In 1978 direct defense imports grew by 40 percent, after declining by 37 percent last year; this can be attributed to fluctuations in delivery dates of imported equipment. The sizable direct and indirect defense import delivery in recent years, financed only partly by way of grants, increased the external debt of the State and indirectly limited the supply of resources for domestic uses: the growth of the debt increases the current repayment burden, and thus widens the deficit on current account. In order to reduce the deficit it is necessary to expand exports, or to cut imports, thus reducing the resources allocated to domestic uses.

Direct tax revenue grew by only 2 percent³ this year, compared to 8 percent in private income. Net transfer payments rose at a similar rate, about 2.5 percent (as against 9 percent last year). The growth stemmed entirely from the rise in interest payments (24 percent); excluding the latter, net transfer payments actually declined by 4 percent (as against a rise of 9 percent last year). This decline reflects a serious erosion in the value of the various allowances due to the lag in adjusting them to the mounting inflation.

In the last two years the hefty subsidization of capital exerted a strong expansionary effect. The subsidy in 1978 is estimated at about IL 25 billion.⁴ This represents an increase of 18 percent, and it came on top of a 13 percent rise last year. There were two major reasons for this: the balance of subsidized credit in the business sector grew at a rapid pace,⁵ and the acceleration of inflation resulted in a larger subsidy because of the growing gap between the nominal interest paid on outstanding credit and the rise in the price level (this factor in itself can accelerate the inflationary process).⁶ Together with the harm to efficiency which results from the subsidization of credit, the taxation of nominal profits during an inflationary period has a distorting effect, and it is necessary to take measures to mitigate it. The subsidies on basic commodities were raised 24 percent in 1978 in order to keep down their prices throughout most of the year.

³ The rates of change in taxes, transfer payments, and subsidies are calculated in terms of constant private consumption prices.

⁴ This estimate does not include the subsidy component of credit to households.

⁵ According to provisional estimates of the Central Bureau of Statistics, in 1975-78 the average balance of subsidized credit owed by the business sector was as follows (in IL million).

1975	1976	1977	1978
12,961	38,929	56,594	102,339

⁶ The destabilizing effect of this factor grew in proportion to the ratio of the unlinked credit balance to the amount of money in the hands of the public (see Table XI-1).

The combined result of the above-mentioned developments in taxes and property entrepreneurial income on the one hand and in transfer payments for subsidizing capital and other economic activity on the other was a significant reduction, for the second year in a row, in the amount of purchasing power siphoned off from the public:⁷ 13 percent in 1978, after a decline of 18 percent in 1977 and a sharp rise in 1976 (34 percent).

Public residential construction continued to sag this year, though the downtrend slowed from 48 percent in 1977 to 25 percent, which is similar to 1976. This reflects the lagged impact of the sharp contraction in the number of housing starts in previous years. It should be emphasized that in the housing construction market there are substitution effects in the long run between private and public construction. The government's departure from the construction market in recent years indirectly resulted in a shortage of homes, and this was one of the factors in the cyclical resurgence of the housing market beginning in the second half of 1977. It would seem, therefore, that no great weight should be ascribed to the changes in the volume of public housing construction during the past two years in estimating the government's influence on aggregate demand in the economy.

We shall again attempt to estimate the cumulative effect of fiscal activity on aggregate demand using the domestic demand surplus as a measure. This surplus is defined as the difference between the direct domestic demand of the public sector and the absorption of purchasing power from the public through taxes and in the form of property and entrepreneurial income less subsidies and transfers from the public sector to the general public. Even though this indicator has many limitations,⁸ we shall examine the developments which occurred in recent years in the domestic demand surplus according to various definitions (Table XI-2). The effects of the demand surplus should be analyzed in light of the level of economic activity, which accelerated in 1978, so that the impact of a demand surplus which amounted to a high proportion of the product (10 to 20 percent, according to various definitions) was more severe this year. Among the estimates of the demand surplus plus the credit subsidy, the effective exchange rate shows a further growth of 8.5 percent in 1978, following an 11.5 percent increase last year. This indicator of the official exchange rate, which includes the effect of the net absorption through taxes on foreign trade, points to stability in 1978 (after a sharp 28 percent rise last year) and reflects a significant increase in net taxes on foreign trade, due to the exchange rate reform in the

⁷ This estimate includes the subsidy element in credit to the business sector, but excludes net taxes on external trade (taxes on imports, less import and export subsidies).

⁸ These limitations were discussed at length in the Bank of Israel Report 1977, pp. 251-58.

TABLE XI-2

DOMESTIC DEMAND SURPLUS, 1975-1978^a
(IL million, at current prices)

	1975	1976	1977	1978	Percent annual increase, at constant prices		
					1976	1977	1978
A. Direct demands							
1. Domestic public consumption	20,330	25,579	37,451	58,252	-3.6	-0.4	1.0
2. Domestic investments of the public sector	4,012	4,128	5,673	9,332	-18.2	-3.8	1.0
3. Total direct domestic demands (1 + 2)	24,342	29,707	43,124	67,584	-6.0	-0.9	1.0
4. Housing construction initiated by the public sector	3,631	3,153	2,147	2,634	-24.8	-47.7	-25.0
B. Liquidity absorption							
5. Revenue from taxes and compulsory loans, less subsidies ^b	27,187	41,660	56,734	94,398	19.0	0.1	7.6
6. Property and entrepreneurial income of the public sector	1,463	2,556	4,573	5,481	35.6	31.5	-22.5
7. Government subsidization of credit (actual payments)	100	735	1,789	3,100			
8. Net transfer payments	13,727	19,840	29,456	46,697	12.2	9.1	2.5
9. Absorption (5+6-7-8)	14,823	23,641	30,662	50,082	23.8	-6.6	7.7
10. 9 (above) plus impact of changes in the public sector wage level ^c	14,823	23,641	30,062	50,082	23.7	-15.5	9.6
11. Subsidy element in business sector credit ^d	6,476	8,805	13,549	24,738	5.6	13.1	18.1

12. Taxes less subsidies, incl. subsidization of foreign trade credit ^e	1,431	3,436	2,032	6,519	86.4	-56.6	107.5
Absorption including credit subsidization							
13. At official exchange rate (10+7-11)	8,447	15,571	18,302	28,444	43.0	-27.1	2.4
14. At effective exchange rate (13-12)	7,016	12,135	16,270	21,925	34.1	-18.8	-13.6
C. Domestic demand surplus							
15. Domestic demand surplus (national accounts definition) ^f (3+4-10)	13,150	9,219	15,209	20,136	-44.7	18.3	-18.7
Domestic demand surplus including subsidization of credit ^g							
16. At effective exchange rate (3-14)	17,326	17,572	26,854	45,659	-22.2	11.6	8.4
17. Weight in GNP (percent)	23.0	18.2	19.2	20.4			
18. At official exchange rate (3-13)	15,895	14,136	24,822	39,140	-32.0	28.5	0.1
19. Weight in GNP (percent)	21.1	14.6	17.7	17.5			

^a In estimating the changes in constant prices, the direct demand components at constant prices were taken from Central Bureau of Statistics data, and the various absorption components were deflated by the consumer price index.

^b Direct taxes and compulsory loans and indirect taxes, less subsidies on domestic production, imports and exports.

^c The national accounts assume a stable productivity level in public services. Accordingly, an increase in the real wage level is treated here as an increase in the indirect demand of the public sector, reflecting its influence on the public's purchasing power.

^d Provisional estimates of the Central Bureau of Statistics.

^e Taxes on civilian imports, less subsidies on imports and exports, including the subsidy element in export credit. An approximate estimate of this component is that of the Bank of Israel (see Table XI-14 below).

^f This estimate includes public housing construction.

^g The weight in GNP of the demand surplus, which includes housing construction initiated by the public sector, plus the credit subsidy, is as follows (in percent):

	1975	1976	1977	1978
A. At effective exchange rate	27.8	21.4	20.7	21.6
B. At official exchange rate	25.9	17.9	19.3	18.6

TABLE XI-3
FINANCING OF THE PUBLIC SECTOR DEMAND SURPLUS, 1977-1978
(IL million)

	1978	1977
Domestic demand surplus	20,140	15,210
Net purchases abroad	28,920	11,390
Total surplus to be financed	49,060	26,600
Government credit from abroad ^a	18,710	9,090
Jewish Agency financing from abroad ^b	3,700	2,470
U.S. government grants	20,770	10,670
Total financing from abroad	43,180	22,230
Net medium- and long-term domestic government financial transactions	-8,160	-1,840
Finance items included in demand surplus ^c	10,380	5,400
Credit from the Bank of Israel ^d	1,240	8,285
Total domestic financing	3,460	11,845
Remainder for short-term financing ^e (incl. long-term financing of local authorities and the Jewish Agency)	2,420	-7,475
Total financing	49,060	26,600

^a Includes credit on account of direct defense imports.

^b Jewish Agency liquidity injection.

^c Part of the above government financial transactions constitutes indirect demand and is also defined as part of the public sector demand surplus (e.g. payments of interest). The net effect of these transactions is deducted here in order to prevent double recording.

^d Excluding Bank of Israel profits (see Table XVII-7A).

^e This is residually calculated from the data in this table; the data were obtained from various sources, and should be accepted with caution.

SOURCE: Estimates of the Bank of Israel Research Department.

latter part of 1977.⁹ It is doubtful whether this estimate of the incremental absorption reflects the main changes in the government's influence on aggregate demand which were due to the reform.

⁹ Under the reform export incentives were abolished and the structure of import taxes altered. The heavier subsidization of export credit in 1978 offset only part of the incremental net taxes on foreign trade consequent on the reform.

TABLE XI-4

DIRECT DEMANDS, 1975-1978
(IL million, at current prices)

	1975	1976	1977	1978	Percent annual increase, at constant price		
					1976	1977	1978
A. Public consumption							
Civilian public consumption							
1. Wages	5,479	7,490	12,248	19,573	4.3	1.9	4.1
2. Purchases	2,562	3,629	5,188	8,313	7.6	6.2	5.6
3. Total	8,041	11,119	17,436	27,886	5.5	2.6	4.6
4. Thereof: Government imports n.e.s.	646	1,000	1,195	2,619	12.9	-18.2	23.7
Public noncivilian consumption							
5. Wages	3,845	4,645	7,405	11,540	-4.2	1.4	3.3
6. Domestic purchases	9,090	10,815	13,805	21,445	-10.2	-6.6	-2.5
7. Purchases abroad	12,959	14,357	14,262	30,500	-18.9	-36.1	40.0
8. Thereof: Taxes and levy on defense imports	(1,753)	(2,497)	(2,432)	(3,383)			
9. Total	25,894	29,817	34,472	63,485	-13.7	-19.1	14.5
10. Total public consumption (3+9)	33,935	40,936	51,908	91,371	-9.1	-13.0	11.3
Domestic public consumption							
11. Domestic noncivilian consumption (5+6)	12,935	15,460	21,210	32,985	-8.4	-4.1	-0.6
12. Domestic civilian consumption (3-4)	7,395	10,119	16,241	25,267	4.8	5.3	3.2
Thereof:							
Government	4,417	5,976	9,982	15,107	5.3	6.6	0.8
Local authorities	2,650	3,705	5,825	9,065	4.4	3.4	7.0
National Institutions	328	438	674	1,095	1.5	2.1	6.8
13. Total domestic public consumption (11+12)	20,330	25,579	37,451	58,252	-3.6	-0.4	1.0
B. Public sector nondwelling investment	4,640	4,701	6,236	11,136	-20.3	-6.7	6.0
14. Investments less direct import component	4,012	4,128	5,673	9,332	-18.2	-3.8	1.0
C. Total direct demands of the public sector (10+B)	38,575	45,637	57,581	102,507	-10.5	-12.3	10.7
Thereof: Direct domestic demands (13+14)	24,342	29,707	43,124	67,584	-6.0	-0.9	1.0
D. Housing construction initiated by public sector	3,631	3,153	2,147	2,634	-24.8	-47.7	-25.0

TABLE XI-5

INDICATORS OF GROWTH OF THE CIVILIAN PUBLIC SERVICES, 1970-1978
(ratios are in percent)

	1970	1972	1974	1975	1976	1977	1978
Civilian public consumption/GNP ^a	10.3	10.0	10.5	10.7	11.2	12.6	12.2
Civilian public consumption/ private consumption ^b	18.8	19.5	18.9	19.1	19.4	22.2	20.8
Civilian public consumption per capita ^c (IL)	632	673	704	744	749	715	805
Civilian public services/GNP ^d	16.6	16.1	16.7	16.8	17.5	19.4	19.2
Civilian public services/ private consumption ^b	30.1	31.5	29.9	30.0	30.3	34.3	32.7
Civilian public services per capi- ta ^c (IL)	1,014	1,102	1,148	1,198	1,216	1,236	1,270

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

^b Excluding nonprofit institution consumption.

^c At constant (1970) prices.

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

As in 1977, the overseas sector covered most of the funding of the demand surplus and the net domestic financial transactions of the public sector. In contrast to last year, the weight of Bank of Israel credit plunged this year, while the share of short-term resources from the various economic sectors and the banking system rose. The change in the domestic financing pattern of the demand surplus was partly reflected in an expansion of the various categories of credit to the private sector, so that the significance of the decline in Bank of Israel credit¹⁰ is quite limited.

2. PUBLIC CONSUMPTION

Domestic public consumption rose in 1978 by one percent, in constant prices, after declining for three years. The upswing was the net result of a 3.2 percent growth in

¹⁰ See the more detailed discussion in Chapter XVI.

TABLE XI-6

CIVILIAN PUBLIC SERVICES CONSUMPTION (INCL. NONPROFIT INSTITUTIONS), 1969–1978^a
(percent, at 1975 prices)

	Average annual increase				Distribution				
	1969–1972	1972–1974	1974–1976	1976–1978	1969	1972	1974	1976	1978
Education	9.5	5.8	4.9	4.2	34.5	37.0	37.4	37.8	38.0
Health	10.6	6.0	6.3	1.1	18.2	20.2	20.5	21.3	20.2
Other welfare and social services	4.8	6.4	6.4	7.2	19.4	18.4	18.8	19.6	20.8
Total welfare services	8.5	5.9	5.6	4.1	72.1	75.6	76.7	78.7	79.0
Economic and other services	2.0	2.8	-0.3	3.1	27.9	24.4	23.3	21.3	21.0
Total civilian public and nonprofit institution consumption	6.8	5.2	4.3	3.9	100.0	100.0	100.0	100.0	100.0

^a The estimates of total public consumption and nonprofit institution consumption are based on Central Bureau of Statistics data. The growth rates in the components of civilian public services were calculated for 1969–1976 on the basis of civilian public expenditure by destinations, and for 1976–1978 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.

civilian consumption and a 0.6 percent drop in defense spending. The growth of civilian consumption reflects a rather stable long-term trend, whereas the stabilization of noncivilian consumption this year followed reductions in 1975–77 of 3.8, 8.4, and 4.1 percent, respectively. The purchases component of domestic noncivilian consumption continued to decline this year (though at a slow 2.5 percent pace), while the upward trend in payrolls, which began in 1977, gained strength. In civilian consumption, the wage item rose faster than domestic purchases (4 percent¹¹ as against 1 percent).

Total public consumption rose by a significant 11.3 percent in quantitative terms, after a drop of 13 percent in 1977. These sharp changes were due to fluctuations in defense imports. It should be remembered that the apportioning of defense imports over any two years is largely a matter of happenstance, and stems from the lack of continuity in the delivery dates of military purchases. It appears that the expansion of civilian public consumption was only slightly affected by the defense burden, which has shot up since the Yom Kippur War, and by the changes in the growth rate of the economy; the ratio of civilian public consumption to GNP, which rose from 10.3 percent in 1970 to 12.2 percent in 1978, is evidence of this fact.

The development of civilian consumption is analyzed in this chapter within the broad framework of total civilian services; to civilian public consumption is added the consumption of services supplied by nonprofit institutions, since these too are managed according to national policy considerations, and are funded principally from the resources of the public sector.¹²

About one third of the resources of nonprofit institutions are net transfers from the public sector.¹³ In recent years government pressure on these institutions to increase the funding from their own sources has led to the hiking of tuition fees at institutions of higher education and a jump in medical insurance premiums of the Sick Funds. This has lowered the weight of the public sector in the total resources of nonprofit institutions, from a peak of 40.5 percent in 1974 to 33.1 percent in 1978, with a corresponding rise in the level of self-funding, from 36.8 percent to 45.2 percent.

Total consumption of civilian services (at constant prices) rose by 4.2 percent in 1978, continuing the upward per capita trend which began at the end of the last decade. This

¹¹ These data are based on National Insurance Institute estimates of the number of employed. Labor force surveys of the Central Bureau of Statistics point to a larger growth in the number of public sector employees, and do not coincide with these data.

¹² See Chapter XI, "Nonprofit Institutions", in the Bank of Israel Report 1977. In the present Report, as stated, the institutions are not surveyed in a separate chapter but are integrated into this chapter.

¹³ According to estimates of the Bank of Israel Research Department.

TABLE XI-7

**DEFENSE IMPORTS, U.S. GOVT. GRANTS, UNILATERAL INSTITUTIONAL TRANSFERS TO ISRAEL, AND
THE GRANT EQUIVALENT OF LOANS FROM THE U.S. GOVERNMENT AND
WORLD JEWRY, 1964-1978**
(\$ million)

	1964-1966	1967-1969	1970-1972	1973-1975	1976-1978	1964-1978
Direct defense imports	324	867	1,650	4,354	4,306	11,501
Indirect defense imports	98	254	453	995	1,047	2,847
Total defense imports (1+2)	422	1,121	2,103	5,349	5,353	14,348
U.S. govt. defense-related grants	-	-	-	1,600	2,036	3,636
Grant component of U.S. govt. defense loans ^a	-	30	310	389	340	1,069
Total grants and grant component of U.S. govt. defense loans (4+5)	-	30	310	1,989	2,376	4,705
U.S. govt. grants for civilian needs	86	14	50	436	1,555	2,141
Grant component of U.S. govt. civilian loans ^a	-	-	-	-	375	375
Total grants and grant component of U.S. govt. civilian loans (7+8)	86	14	50	436	1,930	2,516
Total grants and grant component of U.S. govt. loans (9+6)	86	44	360	2,425	4,306	7,221
Unilateral institutional transfers to Israel (cash)	283	657	824	1,653	1,433	4,850
Grant component of Development Loan (Israel Bonds)	60	105	140	180	150	635
Total unilateral transfers and grant component of Development Loan (12+11)	343	762	964	1,833	1,583	5,485
Grants and grant component of loans from U.S. govt. and World Jewry (10+13)	429	806	1,324	4,258	5,889	12,706

^a The grant component is the "grant equivalent", presented in Oded Liviatan's article in *Bank of Israel Economic Survey*, 48-49. The commercial interest rate, for the purpose of these calculation, is 10 percent.

trend is most evident in welfare services, which rose at an average annual rate of 6.3 percent over the past decade. Particularly conspicuous is the steady growth of educational services, which stems in large measure from the rise in the school attendance rate. Consumption of health services has also increased quite rapidly since 1969, due partly to the rise in the average age of Israelis. It should be noted that in recent years the expansion of health services consumption has slowed a little.

The increased consumption of civilian services is also reflected in the rapid growth of public sector manpower: the share of public servants in total employed ¹⁴ climbed from 23 percent in 1969 to 29 percent in 1978. In 1974–77, the public sector absorbed a very high percentage of the additional workers in the economy (see also Chapter XII). This development is particularly worrisome in light of the fact that as early as 1974 the civilian public sector accounted for a very large share of the total workers in the economy compared to other countries at a similar economic level. An excessive number of workers is found mainly in educational and administrative services.¹⁵ The number employed in public services expanded by 8.5 percent¹⁶ in 1978, with striking jumps in the administrative services of local authorities and in education and research institutions.

3. THE DEFENSE BURDEN

Israel's defense burden comprises three components: (a) the product component of domestic defense expenditures; (b) the growth of Israel's external debt as a result of defense imports; (c) the loss of alternate income, which stems from the employment of part of the work force in the defense sector, since its wages (which are included in domestic noncivilian consumption) do not reflect the true output of such labor nor its alternative wage in other sectors.

Examination of the domestic expenditure component of GNP shows an increase in its weight since the Yom Kippur War as compared to the preceding period; but after peaking at 13 percent in 1974, the trend slowed progressively to stand at about 10 percent in 1978 (Table XI-1).

Defense expenditures in foreign currency have soared since the Six Day War, and accelerated further after the Yom Kippur War. These expenditures have increased Israel's external debt, and even though they have no direct impact on aggregate demand for

¹⁴ Excluding those employed in the military sector, whose share in the work force apparently rose as well during the period under consideration.

¹⁵ See Gur Ofer, "Industrial Structure of Israel: An International Comparison", in *Issues in the Economy of Israel*, 1976 (Hebrew).

¹⁶ According to Central Bureau of Statistics data based on National Insurance Institute sources, there was a slow rise this year of about 4.5 percent.

domestic resources, they indirectly affect such demand in the long run because of the need to finance the growing deficit in the balance of payments, which creates pressure on domestic resources.

A comparison of the defense import bill with U.S. government grants and unilateral transfers (Table XI-7) shows that since the Yom Kippur War U.S. military grants (including the grant equivalent of loans) have funded only about 41 percent of Israel's defense imports, while the remainder, about \$ 6.3 billion, has had to be financed from other sources. Adding the non-military grants from the U.S. government to the figure eases the severity of the situation somewhat, but still leaves about \$ 4 billion to be funded from other sources.

An estimate of the defense burden (defined here as the interest payments on the external debt piled up in consequence of defense needs)¹⁷ is based on various assumptions associated with the purposes of the grants.

The following table presents the defense burden resulting from the increase of the external debt, based on alternative assumptions.

**IMPUTED INTEREST ON EXTERNAL DEBT DUE TO DEFENSE
EXPENDITURES SINCE 1964
(\$ million)**

	Assumption A ^a	Assumption B ^b	Assumption C ^c
1969	151	141	86
1972	331	316	211
1975	667	608	413
1978	964	713	439

^a Assumption A – Israel's only defense-related receipts are U.S. government military grants (and the grant component of defense loans).

^b Assumption B – All U.S. government grants (including the grant component of loans) serve to cover defence expenditures.

^c Assumption C – In addition to U.S. government grants, 50 percent of institutional unilateral transfers to Israel (including the grant component of the Development Loan) are used to cover defense expenditures.

¹⁷ Assuming that principal payments can be rolled over, and that the commercial interest rate on loans in the international markets was 10 percent during the period under consideration.

It will be seen that even according to assumption C, which is a minimum assumption, in 1978 Israel had to allocate for this purpose about \$ 440 million of export added value (\$ 690 million of exports). According to assumption A, Israel's defense burden continued to expand in 1975-78 while according to the second assumption, nominal interest payments rose during this period, but to an insignificant extent in real terms, allowing for the rise in dollar prices.

4. DIRECT INVESTMENTS AND RESIDENTIAL CONSTRUCTION

There was a change of trend in direct public sector investments this year: after a cumulative decline of 22 percent over the past two years, nondwelling investment edged up 1 percent in quantitative terms in 1978. This contributed to the renewal of economic growth, but the gain was slower than that in other sectors. There was a huge increase this year in imports of equipment for public services, so that total nondwelling investment rose by 6 percent all told. The incremental investments were concentrated this year in public services only, while investments in infrastructure (in public sector enterprises) shrank.

Public housing construction continued to sag noticeably in 1978, as a result of the small number of starts in 1976-77. The number of starts grew by 24 percent in 1978, and this will help to increase investments in the years to come. It should be emphasized that the level of starts is still far below that of the peak years 1974-75.

5. TAXES AND TRANSFER PAYMENTS

Public sector income from direct and indirect taxes on domestic production climbed by 58 percent in 1978, similar to the rise in GNP (60 percent). Under the exchange-rate reform the import levy was abolished, customs duties and purchase taxes were reduced, and direct export incentives were almost totally eliminated, so that taxes on imports went up by a comparatively modest 33 percent. Together with the other direct and indirect taxes, the proportion of taxes in GNP and in resource use declined; however, this indicator is of limited significance, since the decline reflects a change in the exchange rate policy.

Transfer payments swelled in 1978 at a similar rate to taxes, 58 percent; but "direct" subsidies¹⁸ on domestic production rose by 84 percent, due to the price freeze agreement between the government and the Histadrut (General Federation of Labor).

¹⁸ The term "direct" subsidies refers to subsidies as conventionally defined, i.e. it does not include the subsidy element in cheap credit.

TABLE XI-8

**WEIGHT OF TAXES AND COMPULSORY LOANS AND
WEIGHT OF NET TAX BURDEN IN GNP AND DOMESTIC USES, 1970-1978**
(rounded percentages)

	1970	1971	1972	1973	1974	1975	1976	1977	1978
A. Weight of direct and indirect taxes on domestic production									
In GNP	30	32	30	30	32	34	40	38	38
In domestic uses	26	28	27	25	26	28	33	33	32
B. Weight of direct and indirect tax burden on domestic production									
In GNP	20	21	18	15	14	13	16	14	13
In domestic uses	17	18	16	13	11	11	13	12	11
In GNP ^a						(7)	(10)	(8)	(7)
In domestic uses ^a						(6)	(8)	(7)	(6)
C. Weight of total taxes									
In GNP	36	41	39	40	44	43	50	49	46
In domestic uses	32	36	34	33	35	35	42	42	39
D. Weight of total tax burden									
In GNP	36	41	39	40	44	43	50	49	46
In domestic uses	32	36	34	33	35	35	42	42	39
In GNP ^a						(9)	(13)	(10)	(10)
In domestic uses ^a						(8)	(11)	(9)	(9)

NOTE: Total taxes are defined as taxes and compulsory government loans (excl. the levy and VAT on defense imports) and local authority taxes as defined in this chapter. The direct and indirect tax burden on domestic production refers to direct and indirect taxes on domestic production, less transfer payments and indirect subsidies on domestic production.

In calculating the indicators in this table, we treated compulsory loans as a tax. An alternative calculation, deducting the compulsory loans, reveals a similar growth pattern.

^a Including an imputation for the subsidy elements in cheap credit.

This year, for the first time, the Central Bureau of Statistics published estimates of the subsidy component in the cheap credit extended to businesses. This subsidy, mainly because of its dimensions in recent years, has great importance in the allocation of productive factors in the economy, the level of activity, and the distribution of capital and income. According to Central Bureau of Statistics estimates, the total subsidy element in such credit granted to businesses reached nearly IL 25 billion in 1978, of which about IL 13.5 billion was for domestic production¹⁹ (compared to IL 8.5 billion according to the previous definition, which did not include the subsidization of credit). With the abolition of direct export subsidies under the foreign currency reform, cheap export credit was greatly expanded, and the subsidy component doubled compared to 1977, reaching IL 11.5 billion.

The share of taxes, less transfers and subsidies, which is an indicator of the tax burden²⁰ of the public, decreased slightly in 1978. In 1975-78 it was lighter than in 1970-72, which is explained by the more rapid rise in the weight of transfers and subsidies than that of taxes. Assuming that the share of the subsidy element in directed credit has increased over the past few years because of the acceleration of inflation, the decrease in the tax burden was even more pronounced.

There may be certain advantages to a small tax burden obtained by means of high rates of taxation and transfer payments. On the other hand, the higher the tax rates, the greater the propensity to evade payment. The impact of credit subsidization on the distribution of income has not yet been studied, but there are some who believe that the rapid growth in this subsidy in recent years as a result of inflation has resulted in a more inequitable distribution of income and capital in the economy. According to this assumption, the present level of the tax burden could probably have been attained at lower rates of taxation and transfer payments, with a more progressive distribution of income and capital, were the element of credit subsidization reduced.

A. DIRECT TAXES

The system of direct taxation, based chiefly on income tax and national insurance contributions, constitutes the government's main tool for financing public sector activities and achieving a more equitable income distribution. A number of important problems have cropped up in recent years, and the steps taken to solve them should be considered.

¹⁹ The distribution of the subsidy between domestic production and exports was computed by the Bank of Israel.

²⁰ Due to the modification of exchange rate policy, which involved a reduction in import taxes and direct export incentives, the implications of using the sum total of taxes and subsidies should be treated with caution. Table XI-8 presents all the indicators. The reference in the text is to taxes and subsidies excluding those on foreign trade.

1. Collecting a "true tax" from every segment of the population. This problem, which is found among a large percentage of the self-employed and some companies, has turned, by virtue of its size, from an economic into a severe socio-economic problem. The 1975 direct tax reform hiked average rates of taxation, abolished various exemptions and concessions, and made it mandatory to keep books, use cash registers, etc. As a result, income tax collections on nonwage incomes grew faster than collections on wage income. But this still did not resolve the severe problem of income concealment. Even though direct tax revenue from nonwage incomes went up this year at the same rate as such incomes, it is not possible to point to a more efficient tax collection. (The implications of changes in the tax regulations were not examined.)

2. The income tax system in Israel, as in other countries, is based on a nominal-value record keeping. Rapid inflation and the failure to fully modify the tax laws to this situation have caused inequities in income tax collection. In practice tax arrangements are made with strong, organized groups of assesses (such as most of industry and part of agriculture), but these arrangements do not solve the problem of proper reporting of profits during an inflationary period. Rather, they permit the assesseees who benefit from such arrangements to avoid income tax payment on their full nominal income. It should be emphasized that arrangements which are not based on real incomes, taking inflation into account, are likely to generate inequities in tax collection within a short time. Furthermore, in a society one of whose avowed principles is equality before the law, these selective arrangements discriminate against sectors which do not enjoy similar concessions.

The Ben-Shahar Commission laid the groundwork for adjusting taxes on earned income for inflation. The tax brackets were only partially adjusted in 1976 and 1977, fully adjusted in 1978, and partially adjusted in April, 1979. Failure to adjust the tax rate boundaries in a prolonged period of high inflation will impair the progressiveness of the tax system and push up the average tax rates to too high a level.

3. An additional question concerns the progressivity of the system of direct taxes on income derived from labor. Tax payments are progressive, ranging from 25 to a maximum of 60 percent of income. In contrast, national insurance contributions are set at 20 percent of the wage up to a certain ceiling, so that they are supposed to reflect the insurance aspect of these payments. The employers' payroll tax is proportional, amounting to about 4 percent of wages.

Combining these taxes greatly impairs the progressivity of the brackets and tax rates. An examination conducted on the basis of the data of the family expenditure survey for 1975/76 (see the Bank of Israel Annual Report 1977, pp. 268-70) found that transfer payments had a greater effect on income distribution than did direct taxation.

TABLE XI-9
 WEIGHT OF DIRECT TAXES, 1970-1978
 (rounded percentages)

	1970	1971	1972	1973	1974	1975	1976	1977	1978
A. 1) Wage income	25	30	28	26	29	26	29	31	30
2) Nonwage income	21	21	19	22	24	26	32	28	28
3) Nonwage income, incl. credit subsidy	—	—	—	—	—	22	26	22	22
B. 4) Income from labor	23	27	26	24	26	23	26	28	26
5) Nonlabor income	23	21	18	24	28	34	50	42	42
6) Nonlabor income incl. credit subsidy	—	—	—	—	—	24	31	25	24

Definitions:

Taxes: Direct taxes on wages are defined as income tax, national insurance, and employers' payroll tax (the last item is defined in the national accounts as an indirect tax, and to all appearances does not seem to be imposed on income from labor; actually there is no difference between this tax and national insurance contributions paid by the employer). In 1970-75 compulsory loans are also included. Direct taxes on labor are defined as taxes on wages plus the imputed direct tax on self-employed, income tax of company directors listed as salaried employees, and national insurance contributions of the self-employed. Direct taxes on nonwage income consist of income tax on companies, self-employed, company directors and members of cooperatives, and deductions at source (less direct tax imputed on income from self-employed labor).

Income: Wages — total wages as defined by the Central Bureau of Statistics in the national accounts. Income from labor — wages plus wages imputed to self-employed (at the average wage for wage-earners), according to National Insurance Institute estimates for the period. Nonwage income — the gross domestic product of the business sector at factor cost, excl. wages of business sector employees, incl. imputed wages of company directors listed as salaried employees and members of cooperatives (non-labor income is exclusive of imputed wage of self-employed).

SOURCE: Income Tax Administration, Central Bureau of Statistics, and Bank of Israel calculations.

4. Table XI-9 presents data on the weight of direct taxation based on two different distinctions: the first (A) which is less significant but more widespread, is between taxation of wage income and that from nonwage sources (these include the return to the labor of self-employed, members of cooperatives, and salaried managers, as well as entrepreneurial income and that on capital). The more meaningful distinction (B) is that between income derived from labor (which includes any income which can be attributed to work, whether of employees, self-employed, salaried managers, or members of cooperatives) and income which is not derived from work (including that earned on capital and entrepreneurial income). According to the second distinction, the share of taxes on income derived other than from work rose significantly during the last four years. This can be attributed in part to a more efficient collection, and in part to the effect of inflationary taxation with the acceleration of the price rise; but when the subsidy element in cheap credit is added to income from nonwork sources (line 6), the tax share falls back to the previous level. Moreover, if we look at the tax burden, i.e., if we deduct the credit subsidy element from the total direct taxes paid, we get a negative figure, since the subsidy element exceeded the total direct taxes collected on non labor income.²¹ It is important to emphasize that these two inequities – inflationary taxes and subsidization by means of cheap credit – do not offset each other, since in practice (and not from the macroeconomic aspect) not everyone who pays taxes on inflationary profits receives a compensatory subsidy, and vice versa. Even more important is the fact that these two inequities, by virtue of their cumulative effect, intensify the preference for capital investments.²²

B. INCOME TAX²³

Total income tax revenue climbed by 58 percent in 1978, reaching about IL 36 billion. The growth, however, lagged behind that of GNP (60 percent) and national income (62 percent).

Collection of income tax from wage earners grew by 45 percent in 1978, while total wages jumped, according to national accounts estimates, by about 60 percent. The lagging of income tax revenue behind wages stemmed from a number of factors:

²¹ There is also a direct subsidization of labor in the form of temporary wage supports given to some academically trained new immigrants, but the absolute sum involved is insignificant.

²² See also the chapter on investments.

²³ Income tax revenue is defined here as gross collections, less tax loans, refunds, cancelled receipts, and outstanding obligations under the payments arrangements. The last item is calculated on the basis of bank reports, which differ somewhat from the reports of the Income Tax Authority.

TABLE XI-10

INCOME TAX AND NATIONAL INSURANCE CONTRIBUTIONS, 1974-1978
(IL million)

	1974	1975	1976	1977	1978	Percent annual increase				Percent annual real ^a increase			
						1975	1976	1977	1978	1975	1976	1977	1978
On income from wages	5,295	7,617	11,918	18,432	28,387	43.9	56.5	54.7	54.0	2.5	21.5	13.8	- .4
Income tax on wage earners ^b	2,659	3,820	6,242	9,554	13,826	43.7	63.4	53.1	44.7	2.4	26.9	12.6	-6.4
National insurance	2,636	3,797	5,676	8,856	14,561	44.0	49.5	56.0	64.4	2.6	16.1	14.7	6.4
On nonwage income	3,626	5,931	11,069	14,182	23,487	63.6	86.6	28.1	65.6	16.5	44.9	-5.8	7.1
Income tax ^b													
On companies	1,883	3,150	5,581	6,007	9,781	67.3	77.2	7.6	62.8	19.2	37.6	-20.9	5.3
On self-employed	738	933	2,048	2,944	5,065	26.4	119.5	43.8	72.0	-10.0	70.4	5.7	11.3
On company directors and members of cooperatives	170	292	810	1,700	2,600	71.8	177.4	109.9	52.9	22.4	115.4	54.3	-1.1
Deductions at source	665	1,276	2,159	2,800	4,851	91.9	69.2	29.7	73.3	36.7	31.4	-4.6	12.1
National insurance	170	280	471	727	1,190	64.7	68.2	54.4	63.7	17.3	30.6	13.5	5.9

^a Deflated by the private consumption price index.

^b Net of change in outstanding loans to tax debtors.

SOURCE: Income tax – Bank of Israel calculations according to data from Income Tax and Property Tax authorities, the Accountant General, the bank reports on loans to tax debtors; national insurance – the National Insurance Institute.

1. Large wage differentials were paid during 1977, mainly in the public sector. As a result, income tax collections were relatively high that year, followed by a compensatory relatively slow growth in 1978.

2. In October, 1977, an (additional) quarter of a credit point was given to workers to cover travel expenses. This found full expression in 1978, depressing income tax collections from wage-earners by 3–4 percent.

3. The lag in transferring employee income tax credits to the tax authorities (by local authorities and private employers) may have grown in 1978.

Income tax collections from the self-employed soared 72 percent in 1978. During the year a number of regulations dealing with income tax collections from companies owned by a small number of shareholders were amended, reducing the incentive which the 1975 tax reform gave for withdrawing profits in the form of managerial salaries. If to the “self-employed” we add company managers and members of cooperatives, the collection growth rate drops to 65 percent. The rapid rise in income tax withheld at source (73 percent) stemmed from the growth of economic activity and the extension of the obligation to deduct taxes at source.

It is interesting to compare the growth in income tax collections on nonwage income with the growth of income according to national accounts data. This shows that the share of such revenue declined from 30 percent in 1976 to 25 percent in 1977, and then rebounded slightly (to 26 percent) in 1978. The real rise in nonwage income in 1978 is explained by the emergence of the economy from the stagnation which had bogged it down during the past few years. The growth in income tax revenue in 1978 more or less matched the growth of nonwage income; thus, according to this indicator there was not a more efficient collection this year.

The rapid inflation which has gone on now for a number of years, creates several problems with respect to income tax, some of which were considered above. A large portion of nominal incomes – both from wages and from nonwage sources – does not constitute “real” income; but the income tax law and regulations do not recognize that part of income which derives from inflation. In a period of rapid inflation great importance attaches to the prompt and full adjustment of income tax rates to the pace of price rises, since otherwise the tax rates will reach an intolerable level for most of the public.

The 1975 income tax reform included a number of important steps for indexing the tax rate boundaries of the various brackets and the assigning of credit points for income earned from work. In 1976 and 1977 there was only a partial (70 percent) adjustment of the tax brackets, so that they eroded between 1975 and 1978 by 15 to 20 percent, increasing the average and marginal tax rates. In 1978 the tax brackets were fully

TABLE XI-11
 DIRECT TAXES, COMPULSORY LOANS, AND TRANSFER PAYMENTS, 1974-1978
 (IL million)

	1974	1975	1976	1977	1978	Percent annual increase				Percent annual real increase ^a			
						1975	1976	1977	1978	1975	1976	1977	1978
1. Total direct taxes	9,106	14,228	23,272	33,192	52,376	56.2	63.4	42.6	57.8	11.3	27.0	4.9	2.0
Income tax	6,115	9,471	16,840	23,005	36,123	54.9	77.8	36.6	57.0	10.3	38.0	0.4	1.6
National insurance ^b	2,806	4,077	6,147	9,583	15,751	45.3	50.8	55.9	64.4	3.5	17.1	14.6	6.3
Inventory surtax	185	680	285	604	502								
2. Compulsory loans	2,660	2,615	1,572	1,933	2,980	-1.7	-39.9	23.0	54.2	-30.0	-53.3	-9.6	-0.3
Employers savings loan	615	888	1,144	1,807	2,889	44.4	28.8	58.0	59.9	2.5	0.0	16.1	3.4
Other compulsory loans ^c	2,045	1,727	428	126	91	-15.6	-75.2	-70.6	-27.8				
3. Total direct taxes and compulsory loans (1+2)	11,766	16,843	24,844	35,125	55,356	43.1	47.5	41.4	57.6	2.0	14.5	4.0	1.9
4. Transfer payments to households	4,442	6,714	9,671	13,701	20,816	51.1	44.0	41.7	51.9	7.7	11.8	4.2	-1.7
Through the National Insurance Institute	2,393	4,101	6,337	8,725	13,377	71.4	54.5	37.7	53.3	22.1	20.0	1.2	-0.8
Provident funds and pensions	904	1,149	1,608	2,425	3,764	27.1	39.9	50.8	55.2	-9.5	8.7	10.9	0.4
Other transfers	1,145	1,464	1,726	2,551	3,675	27.9	17.9	47.8	44.1	-8.9	-8.5	8.7	-6.8
5. Net transfer payments to nonprofit institutions	2,270	3,599	4,603	7,040	10,633	58.5	27.9	52.9	51.0	12.9	-0.7	12.5	-2.3
Net current transfers ^d	1,987	3,259	4,142	6,459	10,144	64.0	27.1	55.9	57.1	16.8	-1.3	14.7	1.6
Thereof: Employers' matching contributions	449	677	961	1,590	2,730	50.8	41.9	65.5	71.7	7.4	10.2	21.7	11.1

Transfers on capital account	283	340	461	581	489	20.1	35.6	26.0	-15.8	-14.4	5.3	-7.3	-45.6
6. Capital transfer to businesses	414	716	1,111	1,526	2,295	72.9	55.2	37.4	50.4	23.2	20.5	1.0	-2.7
7. Interest payments in IL ^e	2,286	3,410	5,183	7,681	14,269	49.2	52.0	48.2	85.8	6.2	18.0	9.0	20.2
8. Redemption of nonnegotiable compulsory loans	185	732	1,352	2,037	2,450	295.7	84.7	50.7	20.3	181.8	43.4	10.8	-22.2
9. Total transfer payments to the public (4 to 8)	9,597	15,171	21,920	31,985	50,463	58.1	44.5	45.9	57.8	12.6	12.2	7.3	2.1
10. Transfer payments from the public	916	1,444	2,080	2,529	2,766	57.6	44.0	21.6	48.9	12.3	11.8	-10.6	-3.7
On current account	372	514	1,053	1,309	1,929	38.2	104.9	24.3	47.4	-1.6	59.1	-8.6	-4.7
On capital account	544	930	1,027	1,220	1,837	71.0	10.4	18.8	50.6	21.8	-14.3	-12.7	-2.6
11. Total net transfer payments (9-10)	8,681	13,727	19,840	29,456	46,697	58.1	44.5	48.5	58.5	12.6	12.2	9.2	2.5
12. Net transfer payments less interest (11-7)	6,395	10,317	14,657	21,775	32,428	61.3	42.1	48.6	48.9	14.9	10.3	9.2	-3.7
13. Direct taxes and compulsory loans, less net transfer payments (3-11)	3,085	3,116	5,004	5,669	8,659	1.0	60.6	13.3	52.7	-28.1	24.7	-16.7	-1.2
14. Direct taxes and compulsory loans, less transfer payments to households and businesses (13+5)	5,355	6,715	9,607	12,709	19,292	25.4	43.1	32.3	51.8	-10.7	11.1	-2.7	-1.8

^a Deflated by private consumption price index.

^b Including employers' matching contributions.

^c Defense loan and cost-of-living loans.

^d Current transfer payments to nonprofit institutions, less transfer payments from them.

^e The payments include interest to the Bank of Israel. Below is an estimate of the payments excl. this item:

Year	1974	1975	1976	1977	1978
IL million	1,959	2,872	4,447	6,259	11,977
Percent annual real increase		4.4	21.0	2.8	23.8

SOURCE: Income Tax and Property Tax Administration, Central Bureau of Statistics, and Bank of Israel estimate.

adjusted to the rise in the consumer price index. In other segments of the economy *ad hoc* adjustments were made, such as the concessions to industry with respect to inventories.²⁴ In other sectors no adjustments were made, and the assesseees have "adjusted" their incomes by means of large-scale income concealment, or by raising prices.

It is therefore desirable to promptly amend the income tax regulations, so that taxes will not be collected on what are not real profits. Such an amendment must be applicable to all assesseees in the economy, and it should deal with profits deriving directly from inflation.

Total national insurance contributions rose by 64 percent in 1978 to reach IL 16 billion. Collections on account of wage income (i.e. employee and employer contributions) also increased by 64 percent, as the result of a 60 percent rise in wages and an approximately 3 percent annual average increase in contribution rates.

National insurance contributions by nonemployees grew in 1978 at a slightly slower pace than income tax collections from the self-employed (64 percent as against 72 percent), despite the rise of about 4 percent in the contribution rate and a moderate rise in the income brackets subject to lower rates.²⁵ This might have been due to the income ceiling on national insurance contributions, whereas income tax collections are not subject to any ceiling and are progressive.

National insurance rates underwent a number of modifications in 1978: the rate for the Unemployment Insurance Fund was lowered, the rates were raised for the general disability branch and employers' matching contributions, and the secondary education impost took effect (for wage-earners only). The total rate of national insurance contributions on wage income reached 20.8–24.1 percent at the end of 1978.²⁶

The national insurance rates for self-employed ranged at the end of 1978 from 9.3 percent on low incomes to 16.1 percent on high incomes. The rates for wage and nonwage income differ because payments on account of unemployment insurance, employers matching contributions, and corporate dissolution or bankruptcy are not collected from the self-employed, while work injury insurance is collected from them at a uniform rate

²⁴ In fiscal 1978/79 a tax exemption at the rate of 25 percent of the rise in the CPI was given on the growth of inventories; in the 1979/80 fiscal year the exemption will be raised to 50 percent.

²⁵ Reduced rates are imposed on low incomes of the self-employed. In the case of wages a uniform rate is in effect for all income levels.

²⁶ The range is the result of differential insurance rates in the work casualty insurance branch.

TABLE XI-12

**ESTIMATED EROSION OF VARIOUS ALLOWANCES, (AVERAGE MONTHLY
ALLOWANCE, 1975 PRICES), 1976-1978
(IL)**

	July 1975 to March 1976 ^a (1)	1976 (2)	1977 (3)	1978 (4)	Percent annual increase			(4)/(1)
					1976	1977	1978	
Deflated by consumer price index								
Allowance for family with 4 children	582.1	561.1	578.2	548.1	-3.62	3.06	-5.21	-5.85
Income maintenance for single persons	553.2	532.1	528.9	527.3	-3.81	-0.61	-0.31	-4.69
Old-age pensions to single persons	327.9	301.4	312.6	317.5	-8.07	3.69	1.58	-3.17
Deflated by the index of average wage per employee post								
Allowance for family with 4 children	572.5	558.6	524.6	488.0	-2.43	-6.09	-6.96	-14.75
Income maintenance for single persons	544.1	529.8	480.1	470.4	-2.64	-9.39	-2.00	-13.54
Old-age pensions to single persons	322.5	299.9	282.4	282.7	-7.00	-5.83	0.08	-12.38

^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 is used as an approximation of the amount which the indexation system was supposed to preserve.

^b Including allowance for veterans.

^c The rate of change of disability allowances is identical to the change in income maintenance.

that is below the average for employees; in addition, the imposition of the secondary education levy on the self-employed was postponed²⁷ to the 1979/80 fiscal year.

C. DIRECT TRANSFER PAYMENTS

The deceleration in the growth of transfer payments to households,²⁸ which began in 1977, turned into a 1.7 percent drop this year. This was the net result of the non-revision of the base level²⁹ of the various allowances and the erosion in their value due to the escalation of inflation on the one hand, and the growth in the number of persons receiving allowances due to demographic changes on the other.

The period 1970–75 witnessed an increase in welfare legislation, especially in the children's allowance and old-age pensions. This legislation increased both the base level of the allowances and the eligible population, thus contributing, along with the normal demographic growth, to an annual average rise of about 20 percent in National Insurance Institute payments.

Since 1975, when the income tax reform was implemented, the policy of enlarging the allowances has been altered to one of preserving their existing level. Toward this end the allowance linkage arrangements were modified, and special legislation was passed which provided for the payment of one-time compensation to the lower socio-economic strata. However, the impact of the acceleration of inflation outweighed the effect of these arrangements, so that the real value of the allowances – including the children's allowance (which is linked to the price level), disability benefits, old-age pensions, and social welfare allotments (which are linked to the average wage in the economy) – was eroded.

The purchasing power of the children's allowance shrank by about 5 percent in 1978 – a rate comparable to the cumulative erosion in 1975–77 – in consequence of the higher price increases this year. The allowances which are linked to the average wage in the economy have eroded by a cumulative total of 13 percent, although only a small part of this occurred in 1978 (see Table XI-12).

Among the principal demographic changes which affected the total number of persons eligible for old-age pensions was a rapid increase in the 65+ age group, which grew 3 percent faster than the national average, bringing up its share in the population, from 7.2 percent in 1970 to 8.9 percent in 1978. The increased rate of female participation in the labor force resulted in a larger number of women eligible for the maternity allowance.

²⁷ By about six months.

²⁸ The share of the National Insurance Institute in such payments is nearly two-thirds, and that of the government about 25 percent.

²⁹ The base level is set at a certain percentage of the average wage in the economy, plus support payments determined according to the number of credit points, etc.

Other transfer payments to households, consisting chiefly of welfare payments by the local authorities and participation in graded tuition fees, were down 7 percent in real terms continuing the trend evident in the past few years. Transfer payments by the local authorities also declined this year to a significant extent (20 percent) in consequence of the substantial reduction in the number of families receiving financial aid; some of these families (such as the disabled) were transferred to the jurisdiction of the National Insurance Institute. The participation of the government and the Jewish Agency in graded school fees rose this year by 25 percent. The law providing for free secondary education³⁰ took effect in September, 1978, with the result that students in grades 10–12 were exempted from payment of tuition. It should be emphasized that this law has a regressive effect on the distribution of incomes, since children of low-income families had previously been exempt, in part or in full, from paying tuition, so that the additional sum which the government is now disbursing to the local authorities is essentially in place of the fees previously paid by families who are better off economically.

Interest outlay by the public sector rose by 24 percent, due to the large redemption of noncompulsory loans paying accrued interest upon maturity. However, the public's behavior was not influenced this year by the full extent of this expenditure, since its assets portfolio³¹ was appreciating even during the period when no actual interest payments were made.

D. INDIRECT TAXES ON DOMESTIC PRODUCTION

Total revenue from indirect taxes on domestic production was up 59 percent in 1978, similar to the growth of GNP and private consumption. If property taxes and local authority rates (which are not connected with the current level of economic activity) are deducted, the level climbed by an even more rapid 62 percent, reflecting a moderate rise in the rates of indirect taxes on current activity.

The weight of the value added tax continued to rise in 1978 (to about one-third of total indirect taxes), while that of the purchase tax declined. The rise in the share of VAT is significant, since this tax falls equally on the returns to capital and labor (in those uses

³⁰ At the same time the National Insurance Institute imposes a secondary education levy, but utilization of the right is not contingent on payment of the levy.

³¹ This portfolio reflected the price rise of bonds traded on the Stock Exchange.

TABLE

INDIRECT TAXES AND SUBSIDIES
(IL

	1974	1975	1976	1977	1978
A. 1. Total indirect taxes on domestic production	5,243	8,721	13,528	18,674	29,659
2. VAT ^b	55	123	1,537	4,326	10,241
3. Purchase tax	1,352	1,998	3,132	3,034	3,691
4. Fuel tax ^c	676	1,581	1,565	1,673	1,819
5. Employers' tax	—	560	1,173	2,017	3,171
6. Excise	473	685	876	989	1,132
7. Other indirect taxes ^d	1,343	1,875	2,761	3,534	5,209
8. Taxes on economic activity (2+7)	3,899	5,822	11,044	15,573	25,263
9. Property tax	749	1,149	1,334	1,336	1,746
10. Local authority taxes	595	750	1,150	1,765	2,650
B. Subsidies on domestic production	1,108	2,037	3,200	4,580	8,441
11. Imputed credit subsidy		4,247	5,053	8,066	13,540
12. Subsidies on domestic production, including imputed credit subsidy	1,108	6,284	8,933	12,646	21,981
C. Net taxes on domestic production	4,135	6,684	10,288	14,184	21,218
D. Net taxes on domestic production, including subsidies on capital					
13. Capital subsidies		2,437	4,575	6,118	7,678
14. Rate of taxes on GNP ^e (percent)	11.0	13.1	16.2	15.4	15.3
15. Rate of taxes, less subsidies, on GNP (percent)	7.8	9.7	11.9	11.3	10.5
16. Tax rate less supports, incl. credit subsidy (percent)		3.3	5.0	4.6	3.6

^a Deflated by the private consumption price index.

^b Including service tax on financial institutions, which was collected until the imposition of VAT.

^c Excluding the import levy on fuel which was imposed in November 1974 and cancelled in October 1977. The import levy is included in import taxes.

ON DOMESTIC PRODUCTION, 1974–1978
 million)

Percent annual nominal increase				Percent annual real increase ^a			
1975	1976	1977	1978	1975	1976	1977	1978
66.3	55.1	38.0	58.8	18.5	20.4	1.5	2.7
75.0	61.9	41.0	62.2	24.6	25.7	3.7	4.9
83.8	62.0	38.8	84.3	30.9	25.8	2.0	19.2
	33.1	42.7	67.9		3.3	4.9	8.6
	42.5	41.2	73.8		10.6	3.9	12.4
61.6	53.9	37.9	49.6	15.1	19.5	1.4	-3.2
	87.7	33.7	25.5		45.7	-1.7	-18.8

^d Stamp tax, defense stamp, vehicle licenses, Ministry of Justice and various service fees, Broadcasting Authority fees, the current surplus of communications enterprises and the ports and miscellaneous.

^e The share of taxes in GNP, less indirect taxes.

SOURCE: Central Bureau of Statistics.

to which VAT applies), so that this tax does not cause inequities in relative prices and factor allocation. On the other hand, VAT may indirectly have a regressive effect on income distribution: assuming that the proportion of total income spent on consumption is greater among low-income earners than in the higher brackets, a rise in the weight of VAT increases the share of taxes in the total income of the low groups. We should not conclude from this that the low income groups are discriminated against since, besides VAT, there are subsidies on domestic production, transfer payments, progressive income taxes, and differential price increases among the various population groups.

The share of property and local authority taxes shows a long-term and almost continuous downward trend: whereas during the period 1965–70 they accounted for 31–32 percent of total indirect taxes on domestic production, in 1976–78 their share declined to 17–18 percent.

E. SUBSIDIES ON DOMESTIC PRODUCTION AND EXPORTS

The changes in this item can be analyzed both according to the conventional definition, viz. subsidies for goods and services (including basic commodities), and according to this definition plus the subsidy granted in the form of low interest on credit to businesses: Because of the swelling of such credit in recent years, together with the acceleration of inflation, this component has a growing impact on aggregate demand.

Subsidized credit is given by the government, Bank of Israel, and banking institutions at nominal interest rates far lower than the rate of price rise. The value of the current subsidy component of such credit is estimated as the differential between the average nominal interest on the outstanding credit balance and a real interest rate of 4 percent, multiplied by the balance of this type of credit in the hands of the public.³²

The Central Bureau of Statistics estimated the balance of subsidized credit to businesses and the subsidy element in 1975–78 as follows:

³² This estimates both the value of the current subsidy given to borrowers to ease their interest payment burden and the growth of their income resulting therefrom. It should be emphasized that in estimating the influence of subsidized credit on investment decisions, one must take into account the value of the grant component of the credit extended during the year surveyed.

SUBSIDY COMPONENT OF CHEAP CREDIT
(IL million, at current prices)

	Current prices				Percent real annual increase		
	1975	1976	1977	1978	1976	1977	1978
(1) Total cheap credit	23,961	38,292	56,594	102,339	24.1	8.7	17.0
(2) Subsidy component	6,476	8,805	13,549	24,738	5.6	13.1	18.1
(3) Thereof: For domestic production	4,247	5,653	8,066	13,540	3.3	4.9	8.6
(4) Thereof: For exports ^a	2,229	3,152	5,483	11,198	9.8	27.9	32.1

^a The export component of medium- and long-term credit was calculated by estimating total credit by main economic sectors and the export share of the product originating in each sector; most short-term credit is granted for exports.

SOURCE: Rows (1) and (2) – Central Bureau of Statistics; rows (3) and (4) – Bank of Israel estimates.

Subsidies on domestic production increased this year by 12.5 percent, after a slow 4 percent rise in 1977. The 8.6 percent growth in the subsidy component was due to the much larger volume of cheap credit granted this year and the appreciable sharpening of inflation, which eclipsed the increase in the nominal interest on the balance of such credit.

Direct subsidies on domestic production, which consist mainly of supports on basic commodities and subsidized mortgage loans to young couples, rose this year by 19 percent, after a standstill in 1977. The major cause of this was the agreement between the government and the Histadrut, under which the prices of basic commodities were frozen from April until September; in the course of the year they rose by only about 15 percent,³³ as opposed to the general price rise of 48 percent. Expenditures on basic commodities grew to nearly IL 5 billion, similar to payments on account of the children's allowance.

Reducing the rise in basic commodity prices has a moderating effect on the consumer price index, though its strength is not sufficiently clear. An estimate of its impact from

³³ Public transportation prices increased by 25 percent.

the expenditure side indicates that a 25 percent increase in the prices of basic commodities should push up the index by 3.7 percent over the course of the year; this includes the direct effect of the price rise of basic commodities, an indirect effect on the cost of products for which basic commodities serve as inputs, and the effect of the cost-of-living adjustment. There are two other factors whose strength is not known: the restraining influence of the decline in incomes due to the rising price of goods; and in contrast to this, the upward thrust which the rise in basic commodity prices has on the prices of other commodities, together with the intensification of the inflationary effect generated thereby.

It appears that subsidies on basic commodities are a less efficient tool for income distribution than other available means: the lion's share of the subsidy goes to families who are not economically disadvantaged, since the amount of the subsidy hardly declines with a rise in family income (for a given family size),³⁴ and the progressivity of the subsidy results from the fact that its relative size decreases as the family income grows.

In contrast to the children's allowance, the subsidies do not favor large families over smaller ones.³⁵ A further drawback of the subsidies is a wasteful resource allocation because of the sharp changes in relative prices which they entail. As against these limitations, it should be noted that they do not create a disincentive to work, unlike the various form of support awarded on the basis of a means test.

Export supports fell by 35 percent this year, after hefty increases in the two preceding years. This was caused by the abolition in October, 1977 of the policy of subsidizing the exchange rate for exporters. At the same time there was a significant 34 percent growth in cheap export credit, while the subsidy component in such finance rose to a similar extent, so that the impact of the abolition of direct subsidies was partly cancelled out.

F. INDIRECT TAXES ON IMPORTS

Until the foreign currency reform, these taxes determined the effective exchange rate for imports, in addition to their "classic" role as a fiscal measure and protecting domestic production. The export incentives were also intended to raise the effective exchange rate above the official rate.

With the implementation of the reform, the role of import taxes and export incentives in setting the effective exchange rates was curtailed: the 15 percent import levy and the foreign travel tax were abolished, and the tariffs and purchase tax on imports were re-

³⁴ According to expenditure equations for groups of basic commodities from 1975/76 Family Expenditure Survey data (except for frozen chicken).

³⁵ At a given level of income for a standard adult.

TABLE XI-14
 TAXES AND SUBSIDIES ON IMPORTS AND EXPORTS, 1974-1978
 (IL million)

	1974	1975	1976	1977	1978	Percent annual increase			
						1975	1976	1977	1978
Indirect taxes on civilian imports	6,041	6,912	10,342	14,227	18,645	14.4	49.6	37.6	31.1
VAT	—	—	1,001	2,962	7,177				
Other taxes ^a	6,041	6,912	9,341	11,265	11,468				
Import subsidies	426	950	301	702	603				
Net taxes on civilian imports	5,615	5,962	10,041	13,525	18,042	6.2	68.4	34.7	33.4
Taxes on defense imports	1,447	1,753	2,497	2,432	3,383				
Export incentives	1,950	2,302	3,453	6,010	325	18.1	50.0	74.1	-94.5
Imputed subsidy on export credit	—	2,229	3,152	5,483	11,198				
Export subsidies including imputations	1,950	4,531	6,605	11,493	11,523		45.8	74.6	3.

^a Including customs, purchase tax, import levy, and foreign travel tax (see also note c in Table XI-13).

SOURCE: Central Bureau of Statistics.

duced. Net taxes on imports grew by only 33 percent in 1978, while imports jumped by 85 percent (at the official exchange rate). Direct export subsidies, which reached about IL 5 billion in 1977, plummeted to almost zero in 1978.

The reform provided for a uniform exchange rate for imports, exports, and capital transfers, thus going a considerable way to making production and resource allocation more efficient. At the same time import duties and purchase taxes (part of which are specific to imports, despite the fact that theoretically they are supposed to apply to domestic production as well) remained in effect. These import taxes impair the efficiency of the economy by altering the relative prices of domestic production and imports, so that they bend the official exchange rate downward (indirectly they represent a tax on exports).

A significant reduction in import taxes would lower the prices of import goods and import substitutes and would free productive factors which are presently employed in the inefficient production of import substitutes, thus making possible an increase in the product, while toning down inflation and mitigating the harm to exports.