

CHAPTER X

GOVERNMENT AND NONGOVERNMENT PUBLIC SECTOR¹

1. MAIN DEVELOPMENTS

The public sector's activities in 1979 were characterized by a relatively rapid expansion of direct domestic demands² (after a decline in previous years), a heavier subsidization of credit to the private sector, and the awarding of significant pay rises to public sector employees. These expansionary factors were partly offset by a much larger real liquidity absorption this year.

While on balance the government's activities reduced the demand surplus (as customarily defined) in comparison with 1978, they did not help to curb inflation. The existence of a relatively large demand surplus in 1979 and in previous years was one of the factors exacerbating inflation, as it resulted in the pumping of considerable money into the economy. The growth of the government's direct demands and the much heavier capital subsidization did not help to create favorable conditions for slowing inflation. The pay increases awarded to public servants this year led to claims for increases in other segments of the economy. The raising of the effective direct tax rates dampened the public's demands, but at the same time it directly pushed up prices and indirectly generated upward pressure through wage demands.

To cool inflation the government must trim its demand surplus by reducing direct demands, refraining from raising tax rates, and creating a proper institutional wage framework for the public sector that will prevent sharp increases or decreases in real wages and salaries.

Among the outstanding developments during the year were a real 5 percent growth of employment in the defense establishment, a hefty 21 percent expansion of residential construction initiated by the public sector (after several years of

¹ The public sector comprises the central government, local authorities, and National Institutions. This chapter deals with the sector's real activities; monetary developments are discussed in Chapters XV-XIX below.

² The public sector's direct domestic demands are defined as the sum total of public consumption and public investment, less civilian and noncivilian purchases abroad and direct imports for public investment.

Table X-1

INDICATORS OF PUBLIC SECTOR OPERATIONS, 1960-79
(Weight in GNP^a, rounded percentages, at current prices)

	1960-65	1966-67	1968-72	1973-74	1975-76	1977	1978	1979
A. 1. Domestic demands ^b	25	27	30	36	36	33	32	34
2. Liquidity absorption (at the official exchange rate) ^c	22	21	24	22	22	21	20	26
3. Demand surplus (at the official exchange rate) ^d	3	5	5	15	14	11	11	8
4. Imputed credit subsidy ^e					7	9	8	14
5. Decrease in the narrow money base ^f					-3	-4	-4	-6
B. 6. Civilian consumption	11	13	11	11	11	13	12	13
7. Civilian services ^g	17	19	17	18	18	20	19	21
8. Public sector employees as a percent of total employment ^h	21	..	24	25	28	28	29	29
9. Defense consumption	10	14	22	32	33	25	28	23
10. Thereof: Domestic defense consumption	6	9	13	17	17	15	14	15
11. Direct imports	4	5	9	15	16	10	14	8
12. Investment and construction	9	6	7	10	10	6	6	7
C. 13. Public sector injection in relation to the money base				25	80	95	83	73

^a Except for B8 and C13.

^b Domestic public consumption, total investment, and construction initiated by the public sector.

^c Revenue from direct and indirect taxes, compulsory loans, and property and entrepreneurial income, less transfer payments, subsidies on domestic production, exports, and imports, and actual payments on account of the credit subsidy.

^d Domestic demands, less liquidity absorption at the official exchange rate.

^e The difference between the alternative interest rate and the actual rate paid, multiplied by the balance of nonindexed credit to business.

^f The difference between the alternative interest rate and the actual rate paid on the money base narrowly defined (for holding liquid assets in the Bank

of Israel), multiplied by the narrow money base.

^g The figure for 1960-65 pertains only to 1964 and 1965.

^h 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 national accounts. The labor force surveys include employees of nonprofit institutions, as well as private sector employees in education and health, but exclude certain government, local authority, and National Institution employees, who are classified according to the sector in which they work. The labor force survey definition of public service employees is the broader of the two. The figure for 1960-65 relates only to 1964 and 1965.

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

stagnation), and a 14.5 percent increase in defense construction as a result of the military redeployment in the Negev.

Public sector demands apparently continued to rise in the course of the year: estimates for wages and salaries (in the civilian and noncivilian segments) and construction (both defense and residential) point to a growth in both the first and second halves of the year, as compared with the corresponding periods in 1978. Estimated civilian and defense purchases were smaller in the second half of 1979 than in the first half, but the data on purchases are less reliable than those on payroll outlays and construction.³ Tax collections declined by 3 percent between the first and second halves, while the net amount of capital mobilized by the government dropped even in nominal terms. The larger expenditure and the decrease in tax revenue resulted in a IL17 billion public sector liquidity injection in the second half of 1979, after a net absorption of about IL1 billion in the first half.

An examination of domestic demands over the years reveals a long-run rising trend in civilian consumption and civilian services (including those supplied by nonprofit institutions). This is particularly noticeable in the proportion of civilian public servants in total employment in the economy, which moved up steadily from 21 percent in 1964 and 1965 to 29 percent in 1979. The scope of public sector civilian services and particularly the number of persons employed therein do not accord with the declared aim of diverting the economy's resources to mastering the balance of payments problem and inflation.

Domestic defense spending also rose rapidly during this period. After averaging 6 percent of GNP in 1960-65, the level reached 13 percent in 1968-72 and 14-15 percent in 1978-79. This heavy expenditure, a product of Israel's special needs and sources of funds, severely strains the country's limited resources and hampers the implementation of economic policy. In 1976-79 U.S. military and nonmilitary aid grants financed Israel's direct defense imports and about 10 percent of domestic defense expenditures, but the remaining 90 percent of such spending was financed from local sources.

Net income from taxes and property and entrepreneurial income soared 33 percent in real terms this year. The growth of tax collections resulted from a larger import (especially of durable goods), a real increase in wages and salaries, and the acceleration of inflation, which moved income earners into higher tax brackets and eroded the value of some transfer payments.

³ The assessment that public sector demands grew in the second half of 1979 is strengthened by the sector's current expenditure estimates, which were 9 percent higher in real terms in the second half than in the first half (see Table XVI-4). It should be stressed that the estimates of public sector demands appearing in this chapter relate to the real activities of the sector, and not necessarily to its payments flows.

Table X-2

FINANCING OF THE PUBLIC SECTOR DEMAND SURPLUS, 1977-78
(IL million)

	1977	1978	1979
Domestic demand surplus	16,070	25,850	35,190
Net purchases abroad	11,740	29,230	30,990
Total surplus to be financed	27,810	55,080	66,180
Government credit from abroad ^a	9,090	18,710	25,120
Jewish Agency financing from abroad ^b	2,470	3,800	6,100
U.S. government grants	10,670	20,770	21,430
Total financing from abroad	22,230	43,280	52,650
Net medium- and long-term domestic govt. financial transactions	-1,530	-8,580	-4,530
Financial items included in demand surplus ^c	3,680	12,810	19,600
Credit from the Bank of Israel ^d	8,285	1,240	-2,640
Total domestic financing	10,435	5,470	12,430
Remainder for short-term financing ^e (incl. long-term financing of local authorities and the Jewish Agency)	-4,855	6,330	1,100
Total financing	27,810	55,080	66,180

^a Includes credit on account of direct defense imports.

^b Jewish Agency liquidity injection.

^c Part of the government's financial transactions constitute an indirect demand and are 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-counting.

^d Excludes Bank of Israel profits (see Table XVII-A7).

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

Source: Estimates of the Bank of Israel Research Department.

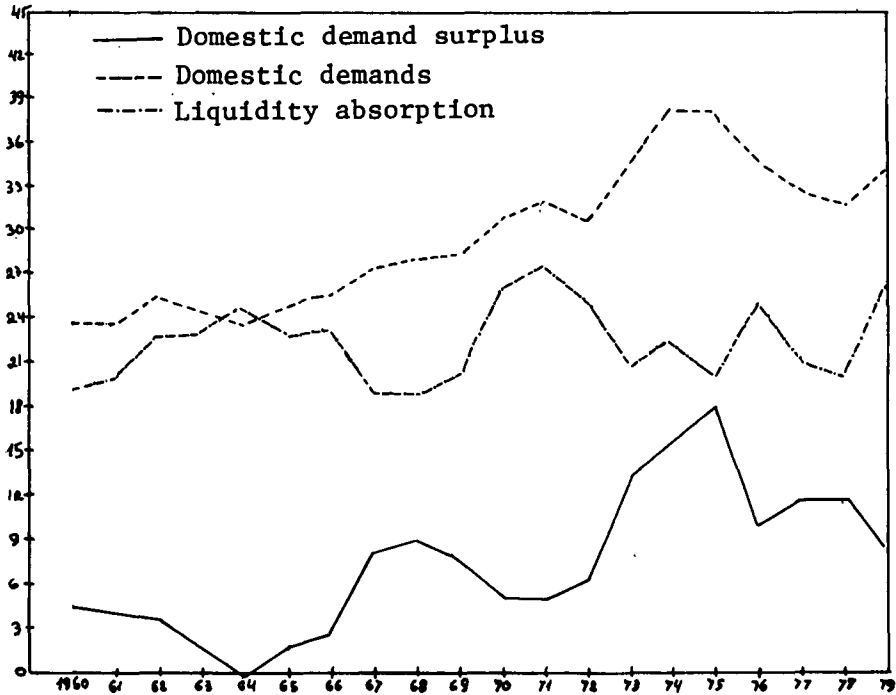
The inflation-related increase in net tax rates can be looked upon as a sort of automatic stabilizer which moderates incomes and demands, but it must be emphasized that the rise in tax rates leads to demands for pay increases and the upping of prices.

Until 1979 the government granted nonindexed loans to the private sector at preferential rates of interest. The aggravation of inflation in recent years caused the gap between these special rates and the market rate to widen steadily. In 1979 subsidies to the business sector⁴ in the form of interest differentials on nonindexed loans amounted to about IL60 billion according to Central Bureau of Statistics estimates. This did not reflect any particular activity on the government's part in

⁴ The quantitative estimates of nonindexed loans and their subsidy component relate only to the business sector (i.e. excluding households).

Figure X-1

DEMANDS, LIQUIDITY ABSORPTION, AND DEMAND SURPLUS
RELATIVE TO GNP, 1960-79



1979, but was a function of outstanding loans granted in the past and the high rate of inflation. This, however, does not derogate from the economic significance of the credit subsidies, especially as the government could have taxed the indexation increments, in whole or in part, as in the case of loans from employers to employees.

In 1979 the government decided to fully index business sector credits and to index a significant portion of the housing loans granted to those eligible for such assistance. Since these decisions were implemented only toward the end of 1979, their impact will be felt in the coming years.

If credit subsidies are treated like other, more typical, forms of government assistance and deducted from tax revenue, the public sector liquidity absorption in

recent years was much smaller—even if the inflationary taxation of cash balances in the hands of the public (and in banks) is added to the tax figures; moreover, the rate of absorption in relation to GNP will be seen to have declined in 1979 as compared with 1978.

The increase in credit subsidies, which, as stated, is also a function of the rate of inflation, offsets to some extent the increase in effective tax rates. Furthermore, such subsidies are not allocated in an equitable manner: not every population group whose effective net tax rate has gone up receives this support, and vice versa.

The demand surplus is defined as the difference between the public sector's direct domestic demands and its liquidity absorption. The demand surplus so defined reached a record level during the period of the Yom Kippur War (October 1973) and its aftermath, and has been on the decline ever since. Nevertheless its weight remained high in 1979 as compared with the period before the Yom Kippur War and especially before the Six Day War. Whereas in 1960-65 the surplus was equal to 3 percent of GNP, in the interwar years 1968-72 it doubled to 6 percent, and in 1979 reached 8 percent.⁵

If the credit subsidy to the business sector is included in the demand surplus, the difference in its magnitude in recent years in comparison with the pre-Yom Kippur War period will be even more conspicuous.⁶ These demand surpluses have been one of the main factors stoking inflation in recent years.

The amount of financing required for the domestic demand surplus and for government purchases abroad was only moderately higher in nominal terms in 1979 (excluding the financial items in the demand surplus, the increase was even smaller). There was also a decline in government transfers for financing domestic medium- and long-term operations (see Chapter XVII). As in 1978, most of the required financing was obtained in the form of foreign transfer receipts; the outstanding changes here were the increased weight of foreign government credits, a drop in grants, and a continued decrease in Bank of Israel credit.

2. PUBLIC CONSUMPTION

Total public consumption declined 8.8 percent in real terms in 1979, reflecting a sharp drop of 35 percent in defense purchases abroad and of 7 percent in foreign

⁵ These demand surplus figures do not reflect the impact on economic activity of each of the various components of the surplus. Thus the long-term comparative figures must be regarded as merely indicative of the general trend, and no undue importance should be attached to absolute interyear differences.

⁶ A more comprehensive estimate of the demand surplus would include not only credit subsidies to business but also those to households (mainly in the form of housing loans). On the other hand, private sector losses from holding cash balances in an inflationary period should be deducted. A provisional estimate of the hidden subsidy in housing loans in 1979 shows that it was about equal to the losses incurred on cash holdings.

Figure X-2
WEIGHT OF PUBLIC CIVILIAN AND NONCIVILIAN CONSUMPTION IN GNP,
1960-79
 (Percentages, at current prices)

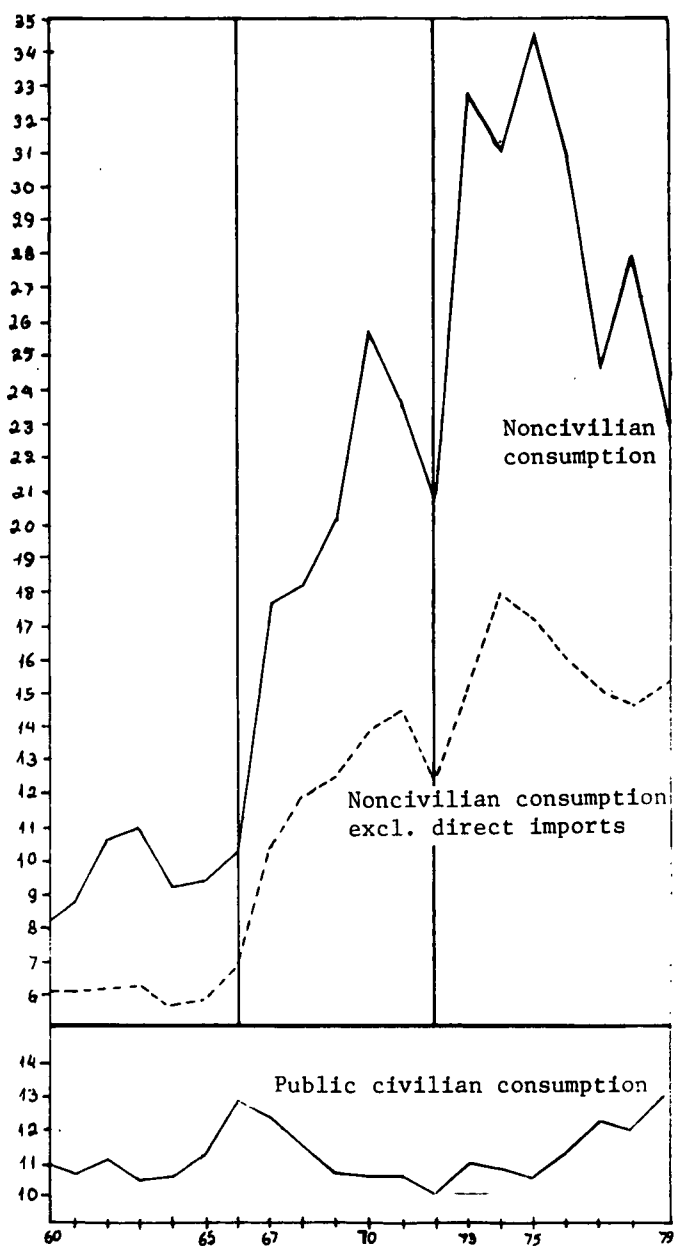


Table X-3

DIRECT DEMANDS, 1976-79
(IL million, at current prices)

	1976	1977	1978	1979	Percent annual increase, at constant prices		
					1977	1978	1979
A. Public consumption							
1. Civilian public consumption							
a. Wages and salaries	7,490	12,410	19,589	40,062	1.8	4.6	3.2
b. Purchases	3,629	5,138	8,194	15,047	5.0	6.0	3.4
c. Total	11,119	17,548	27,782	55,109	2.9	5.1	3.3
d. Thereof: Government imports n.e.s.	1,000	1,195	2,019	3,327	-18.2	23.7	-20.8
2. Public noncivilian consumption							
e. Wages and salaries	4,645	7,405	11,408	22,991	1.4	3.3	4.9
f. Domestic purchases	10,815	13,805	21,106	40,960	-6.6	-4.4	2.9
g. Purchases abroad	14,357	13,262	30,500	31,838	-36.7	40.0	-35.4
h. Total	29,817	34,472	63,014	95,789	-19.1	13.7	-14.2
i. Total public consumption	40,936	52,020	90,797	150,898	-13.0	10.9	-8.8
3. Domestic public consumption							
j. Domestic civilian consumption	10,119	16,353	25,163	51,782	4.9	3.7	5.4
Thereof:							
Government	5,931	10,024	15,111	31,970	4.8	1.3	6.5
Local authorities	3,705	5,645	8,893	17,675	4.4	7.0	4.3
National Institutions	438	684	1,159	2,137	10.2	9.0	0.5
k. Domestic noncivilian consumption	15,460	51,210	32,514	63,951	-4.1	-1.8	3.6
l. Total domestic public consumption	25,579	37,563	57,677	115,733	-0.5	0.5	4.4
B. Public sector nondwelling investment	4,941	6,303	11,188	20,633	-9.0	-2.6	7.4
m. Investments less direct import component	4,272	5,515	9,175	16,888	-5.1	-5.5	2.4
C. Housing construction initiated by public sector	3,153	2,147	2,621	7,108	-47.7	-25.8	21.4
D. Total direct demands of the public sector	49,030	60,470	104,606	178,639	-15.1	7.7	-6.2
Thereof: Direct domestic demands	33,004	45,225	69,473	139,729	-6.2	-1.9	4.9

Note: Since 1977 car allowances paid to public sector employees have been included in wages and salaries; previously they were included in purchases.

Source: Central Bureau of Statistics.

civilian purchases. In contrast, there was a 4.4 percent increase in public domestic consumption, continuing the trend that began in 1978; the growth encompassed all purchase items and labor inputs.⁷ In addition, the government indirectly con-

⁷ The quarterly data on civilian and noncivilian purchases are less reliable than yearly data, thus limiting our estimate of changes in public consumption in the course of the year.

tributed to the higher demand through the awarding of substantial pay hikes to public sector employees.⁸

The 10 percent real pay increase per public sector employee in 1979 indirectly augmented demands by IL5.7 billion, of which IL4.1 billion was in the civilian and the remaining IL1.6 billion in the defense segment. These sums constituted 5 percent of total public domestic consumption in 1979. The expansion of domestic demands in an economy whose spending since the Yom Kippur War has been on a very high level has undoubtedly had an expansionary effect, which does not square with the need to restrain inflation and improve the balance of payments, which has deteriorated as a result of mounting oil prices.

(a) Civilian Consumption

Public civilian consumption in 1979 was up 3.3 percent in constant prices, while in domestic consumption alone growth was even greater—5.4 percent—continuing the long-run trend. Increases on this scale, combined with the cumulative real rise in public sector wages and salaries,⁹ brought up the weight of civilian public consumption in GNP over the decade—from 10 percent in 1970 (in current prices) to 13 percent in 1979.

As with civilian consumption in general, the weight of civilian public services consumption in GNP has moved up steadily¹⁰ (see Table X-4). This reflects the continued expansion of social services (education, health, welfare, etc.), together with a freeze, or even a decline, in administrative and economic services¹¹ over the past five years. Thus social services accounted for 81 percent of total spending on services in 1979, compared with 72 percent in 1969. Since 1970 per capita consumption of public services has grown by 2.6 percent per annum, and the ratio of civilian services consumption to private consumption has risen from 30 to 34 percent (in current prices). This is explained by the large-scale welfare policy introduced at the end of the previous decade. It also reflects the rapid relative aging of the Israeli population, which necessitates more spending on health, and a rise in school attendance, which increases educational outlays.

⁸ Wage agreements in the public sector are generally biennial; the agreements for 1978 and 1979 were signed at the start of 1979, and provided for large retroactive payments on account of the previous year. Wage and salary payments unaccompanied by a rise in labor inputs are treated as a price change by the Central Bureau of Statistics, and are not reflected in the real data. This approach assumes a zero rate of increase in public sector productivity, or, alternatively, a rise in the cost of labor in the public sector, which does represent an improvement in the quality of the workforce.

⁹ Payroll outlay constitutes about 75 percent of total expenditure.

¹⁰ In this chapter it is customary to analyze civilian consumption in the context of civilian public services consumption, which includes the consumption of nonprofit institution services; this is because of the high degree of substitution between the "products" of these two sectors and the fact that nonprofit institutions largely operate in accordance with government policy and most of their financing comes from the public sector.

¹¹ These services include management, engineering research, market surveys, consulting, issuance of directives, and inspection in departments dealing with economic and labor matters.

Table X-4

INDICATORS OF THE GROWTH OF CIVILIAN PUBLIC SERVICES, 1970-79
(Ratios in percent)

	1970	1972	1974	1976	1978	1979
Civilian public consumption/GNP ^a	10.3	10.0	10.5	11.2	12.2	13.1
Civilian public consumption/private consumption ^b	18.8	19.5	18.9	19.4	21.0	22.0
Civilian consumption per capita ^c (IL)	650	686	725	762	789	815
Civilian public services/GNP ^d	17.1	16.7	17.6	18.2	19.4	20.9
Civilian public services/private consumption ^b	31.0	32.7	31.5	31.5	33.2	35.1
Civilian public services per capita ^c (IL)	1,045	1,143	1,210	1,264	1,294	1,325

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

^b Excludes nonprofit institution consumption.

^c At constant (1970) prices.

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

The 3.4 percent growth in public sector employment¹² also resulted in a larger civilian consumption. The proportion of public sector workers in total employment, which rose sharply during the past decade (see Table X-1), continued upward in 1979, though at a more moderate pace, and reached 29.2 percent—a very high figure in comparison with other countries at a similar income level.¹³ There were steep rises in local government administrative personnel (5.5 percent) and in the health services (5.3 percent). In contrast, the number of administrative workers in the central government and the Jewish Agency declined 1.7 percent.

The relatively moderate increase in personnel, particularly in the central government and the Jewish Agency, was reflected by a decline in requests for workers submitted to labor exchanges (of which the government is a major client) and in the development of a climate of retrenchment in both the private labor market and economy in general.¹⁴

(b) Noncivilian Consumption

Total noncivilian consumption shrank 14 percent in 1979; domestic spending was 3.6 percent higher this year, but foreign purchases were down 35 percent. Such purchases are subject to sharp year-to-year fluctuations, which are influenced by

¹² National Insurance Institute data show a higher growth rate in public service employment (about 4.5 percent). An opposite situation prevailed in 1978, when the increase was 8.5 percent according to labor force surveys and 4.2 percent according to National Insurance sources. The real growth rates in payroll expenditure is calculated using the latter data, with an adjustment made for the change in the number of hours worked per employee as measured in labor force surveys.

¹³ This subject is discussed in the Bank of Israel Annual Report for 1978, Chapter XI; see also Chapter XII in the Reports for 1977 and 1978.

¹⁴ See Chapter XI below.

Table X-5

**CIVILIAN PUBLIC SERVICES CONSUMPTION (INCL. NONPROFIT
INSTITUTIONS), 1969-79^a**
(Percentages, at 1975 prices)

	Average annual increase				Distribution					
	1969-72	1972-74	1974-76	1976-79	1969	1972	1974	1976	1978	1979
Education	9.5	5.8	4.9	3.2	34.5	37.0	37.4	37.8	38.4	37.4
Health	10.6	6.0	6.3	4.6	18.2	20.2	20.5	21.3	21.6	21.5
Other welfare and social services	4.8	6.4	6.4	8.2	19.4	18.4	18.8	19.6	20.0	22.4
Total welfare services	8.5	5.9	5.6	4.6	72.1	75.6	76.7	78.7	80.0	81.3
Economic and other services	2.0	2.8	-0.3	-0.9	27.9	24.4	23.3	21.3	20.0	18.7
Total civilian public and nonprofit institutions consumption	6.8	5.2	4.3	3.5	100.0	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 rates of increase in the components of civilian public services were calculated for 1969-77 on the basis of civilian public expenditure by destination, and for 1977-79 on the basis of the increase in the number of employee posts in the relevant sector.

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

the delivery dates of military equipment. Nevertheless, a downturn from the high 1973-75 level can be discerned.

The development of domestic defense consumption stands out glaringly in the light of this reversal of the general trend. After declining steadily in 1975-78, the figure rose 3.6 percent in the year reviewed. (In this context it should be recalled that the effect of the military redeployment in the Negev was only partly reflected in the data for 1979, since it got underway toward the end of the year.)

The influence of domestic defense expenditures is different from that of the foreign purchases component. The former has a direct, immediate impact on the level of economic activity, while that of the latter is indirect and is spread over a much longer period. For the first time since 1974, the weight of domestic defense expenditures in GNP, which serves as an indicator of the relative magnitude of domestic expenditures, rose in 1979, from 14 percent the year before to 15 percent. This was reflected by a 4.9 percent increase in defense sector employment—a trend that began in 1977 and became more pronounced in the past two years.

A study of Figure X-2 reveals that following the steep jump in domestic expenditures after the Yom Kippur War, the trend declined for several years. In 1979, however, it reversed itself: the ratio of such expenditures to GNP was very high

compared with the pre-Six Day War period, and even in the period between this war and the Yom Kippur War. In addition to these measurable expenditures, there has been a sharp rise since the Six Day War in the unmeasurable items, such as the lengthening of the period of compulsory service,¹⁵ introduction of security arrangements at various institutions, establishment of the Civil Guard, fencing and illumination of sensitive sites, and so forth. The high level and weight of domestic defense spending in the State budget has unquestionably contributed to the worsening of inflation since 1973, and impeded the implementation of an efficient anti-inflation policy in the past few years.

The direct defense import component has only a slight short-term effect on domestic activity, since it is fully financed by U.S. government aid-grants and loans. However, the piling up of such loan debts imposes on the economy a heavy medium- and long-term principal and interest payment burden, which reduces the resources available for domestic uses.

The impact of this burden can be estimated by examining the accrued interest on the debt. This is calculated according to two assumptions concerning the size of the debt. In the first we subtract from defense direct defense imports U.S. government grants, which are formally defined as military aid-grants. Under the second approach we subtract total grants, defense and civilian alike.

Accrued Interest on the Direct Defense Import-Related Foreign Debt^a
(\$ million)

	1969	1972	1975	1978	1979
Assumption A	120	250	490	690	750
Assumption B	110	240	430	430	420

^a For purposes of our calculation we assume a 10 percent interest rate for 1964-77, 11.5 percent for 1978, and 14 percent for 1979.

Despite the difference between the two estimates, there was clearly a rapid growth during the decade in the foreign debt service burden related to defense imports. In 1979 its weight in GNP was somewhere between 2.5 and 5 percent, depending on which assumption is used in the calculation. The addition of these figures to domestic defense expenditures throws into sharp focus the magnitude of the defense burden in comparison with the period before the Six Day and Yom Kippur Wars.

¹⁵ Conscripts' pay, which appears in the noncivilian consumption data, does not reflect the alternative return they could earn in the civilian sector; the lengthening of military service probably increases the downward bias in the defense consumption estimates.

3. INVESTMENTS AND RESIDENTIAL CONSTRUCTION

After sagging three consecutive years, nondwelling investment by the public sector turned up 7.4 percent in 1979; less the direct import component, the increase was 2.4 percent.

Most of the incremental investment was in equipment, both Israeli-made (up 35 percent) and imports (96 percent), for the sector's enterprises and infrastructure projects. In contrast, in public services the figure edged up only 1.5 percent, while in construction it dipped 3 percent. The heavier investment in public sector enterprises and infrastructure was due to catch-up demand from earlier years.

After being cut back in 1975-78, public residential construction expanded 21.4 percent, reflecting an upswing in the number of units started this year and in particular in 1978. This is explained by the short supply of homes in previous years and the resulting precipitous jump in prices. Housing construction initiated by the public sector accelerated strongly in 1979.

Because of the special nature of the construction industry, investments display an irregular pattern over a three-year building period. The bulk of the expenditure (about 60 percent) is made in the second year of construction; hence the 1978 resurgence in building starts led to a much heavier investment in the year reviewed. The deferral of a large number of building starts to the end of 1979 (due to planning delays) assured the sustained growth of investment in 1980.

In the past public sector residential construction did not help to smooth fluctuations in the supply and price of dwellings. The economic efficiency of public sector construction (which is actually executed by private constructors) and of its allocation of homes to eligible groups is open to grave doubt. It is therefore recommended that government intervention in the housing market be reexamined with a view to ensuring that it be confined to providing financing for eligible groups, and that it should not be involved in actual construction, in particular in urban centers, where there is no shortage of contractors.¹⁶

4. TAXES, TRANSFER PAYMENTS, AND SUBSIDIES

The year reviewed saw an increase in direct tax rates and a decline in transfer payments to the public and direct subsidies on domestic production. The tax burden (taxes minus transfer payments and subsidies) was thus heavier than in the previous year. However, this was mainly due not to changes in the formal rates of taxes and transfer payments but to general economic developments. The effective direct tax rates went up because of the growth of real income and the partial adjustment of the tax laws to the rate of inflation. The erosion of transfer payments

¹⁶ See also the discussion in the chapter on investments and construction.

Table X-6

**WEIGHT OF TAXES AND COMPULSORY LOANS AND WEIGHT OF NET TAX
BURDEN IN GNP AND DOMESTIC USES, 1970-79**
(Rounded percentages)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
A. Weight of direct and indirect taxes on domestic production										
In GNP	30	32	30	30	32	34	40	38	38	40
In domestic uses	26	28	27	25	26	28	33	33	32	32
B. Weight of direct and indirect tax burden on domestic production										
In GNP	20	21	18	15	14	13	16	14	13	18
In domestic uses	17	18	16	13	11	11	14	12	11	14
In GNP ^a						10	11	10	9	11
In domestic uses ^a						8	9	9	7	9
C. Weight of total taxes										
In GNP	36	41	39	40	44	43	50	49	46	49
In domestic uses	32	36	34	33	35	35	42	42	39	40
D. Weight of total tax burden										
In GNP	24	25	23	20	21	18	23	19	21	26
In domestic uses	21	22	19	15	16	15	19	17	17	21
In GNP ^a						13	14	11	13	12
In domestic uses ^a						10	12	9	10	10

Note: Total taxes are defined as government taxes and compulsory 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 is defined as direct and indirect taxes on domestic production, less transfer payments and indirect subsidies on domestic production. In calculating the indicators in this table compulsory loans have been treated as a tax. An alternative calculation, in which compulsory loans are excluded, shows a similar development over the years.

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

Source: Bureau of Statistics and Bank of Israel calculations.

continued in 1979, mainly because of their belated adjustment for the rise in prices.

Indirect taxes on domestic production did not increase during the year—neither the formal nor the effective rates went up. Subsidies on domestic products were slashed at the end of 1979, but this of course had little effect on the annual average level.

The sharply higher import of durable goods, which are heavily taxed, led to a rapid rise in import tax revenue, especially in the early part of the year. There were not significant changes in direct export incentives or in import subsidies.

The aggravation of inflation increased the subsidy component of nonindexed

loans granted by the public sector.¹⁷ Inclusion of the subsidy in the calculations moderates, and even reduces, the tax burden as compared with 1978.

It is customary to view the increase in the effective size of the tax burden during an inflationary period as a sort of automatic stabilizer, for the higher tax collections reduce disposable income and dampen demands. However, the growth of the tax burden can also have detrimental repercussions. In a full employment situation, coupled with the system of institutional arrangements that exists in Israel, the increased tax burden spurs wage demands and price hikes in various areas, leading to an inflationary spiral of the kind that has prevailed in recent years.

The interrelation between the tax structure and inflation has other undesirable implications. The dependence of the tax rates on inflation may get out of control: the effective rates may rise steeply, leading to a more widespread tax evasion and a greater disincentive to seek additional earnings, with its negative effect on production. In an inflationary period an inflexible tax structure is liable to cause undesirable changes in income distribution, hurt recipients of transfer payments, and harm certain sectors (especially commerce and services), which have to pay taxes on inflationary profits. At the same time, other sectors enjoy special arrangements that reduce the inflationary tax burden, such as income tax relief on inventories, while holders of nonindexed loans enjoy an ever-growing subsidy as inflation worsens.

In the light of these factors, and considering that if inflation should slow down the existing arrangements would work to reduce the tax burden and increase disposable income, it would seem that an attempt should be made to lessen the vulnerability of the tax and transfer payments structure to inflation. The tax reform introduced in 1975 laid the groundwork for adjusting the rates on income derived from labor for the rise in prices. But the escalation of inflation in the past few years has shown that the pace and scope of the adjustments are inadequate. There will apparently be several additional modifications in 1980: tax brackets will be updated four times a year and the taxing of nonwage income may also be changed.

(a) Direct Taxes

Total direct taxes (income tax and national insurance contributions) and compulsory loans were up 12 percent in real terms in 1979. Income tax revenue, especially from wage income, accounted for the bulk of the increase, with the result that direct tax rates¹⁸ rose on both wage and nonwage income. The average rate of

¹⁷ It has not yet been decided how to treat the subsidy component of nonindexed business sector loans in the national accounts. For our purposes the full amount of the subsidy has been included in the calculations.

¹⁸ It should be stressed that in the table on direct taxes this item includes not only income tax and national insurance contributions, but also the employers' payroll tax and the surtax on inventories.

direct taxes on wage income inched up from 29 percent in 1978 to 30 percent. The average rate on nonwage income rose from 31 to 37 percent, but if the credit subsidy is included in such income, the average rate declined. If the credit subsidy to business is subtracted from direct taxes, the change in the direct tax burden on nonwage income was negligible. It should be noted that earners of nonwage income are not a homogeneous group, and that income in the form of the credit subsidy is not equally distributed. Among certain groups inflation has pushed up both the effective rates of direct taxation and income from nonindexed loans, while among other groups it has increased only the tax rates.

WEIGHT OF DIRECT TAXES IN INCOME, 1970-79
(Rounded percentages)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Wage income	24	29	27	25	28	25	28	29	29	30
Nonwage income	22	22	20	23	26	29	38	32	31	37
Nonwage income, incl. credit subsidy	—	—	—	—	—	25	30	26	26	25

Definitions:

Taxes: Direct taxes on wages are defined as income tax, national insurance, and employers' payroll tax.

In 1970-75 compulsory loans are also included. Direct taxes on nonwage income consist of income tax on companies, self-employed, company directors, and members of cooperatives, deductions at source, and inventory surcharge.

Income: Wages—total wages as defined by the Central Bureau of Statistics in the national accounts.

Nonwage income—the gross domestic product of the business sector at factor cost, excluding wages of business sector employees and including imputed wages of company directors listed as salaried employees and members of cooperatives.

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

(b) Income Tax¹⁹

Total income tax revenue shot up 105 percent in 1979 (15 percent in real terms), outpacing the advance of GNP (86 percent) and national income (85 percent).

Collections from employees rose 120 percent, whereas wages and salaries increased at a slower 92 percent rate. The differences in growth rates can be attributed to three principal factors:

1. Tax brackets were only partially adjusted in April 1979, compensating for 70 percent of the rise in the consumer price index (but tax credit points were fully adjusted, as in the past).

¹⁹ Income tax revenue is defined here as total gross collections, 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 from the reports of the Income Tax Authority.

2. Tax brackets were updated only twice in 1979, while wages and salaries were, as usual, adjusted more often. Income tax on employees' earnings is withheld at source at the time they are paid, and this, together with the acceleration of inflation during 1979, caused income tax collections to rise faster than wages and salaries.

The increase in the average rate of income tax (after subtracting the children's allowance) for an employee earning an "average wage" is shown below.²⁰ In order to distinguish between the tax increase resulting from higher real wages and salaries and that caused by the erosion of the tax brackets, estimates are also presented on the assumption that real wages and salaries remained constant at the average level of July 1975.

	Average rate of tax (%)			
	1976	1977	1978	1979
Average wage				
Constant real wage (at July 1975 level)	4.5	4.2	4.5	7.7
Actual wage	5.6	6.5	7.4	12.6
Double the average wage				
Constant real wage	18.9	19.4	20.2	23.6
Actual wage	19.0	21.7	23.1	28.6

Failure to fully adjust the tax brackets pushed up income tax rates by 3 percentage points in 1979, while the growth of real wages and salaries, as estimated according to National Insurance Institute sources, added another 2 points.

3. In 1979 public sector wage agreements were signed with effect retroactive to 1978. Under these pacts significant differentials were paid in the year reviewed, pulling up tax collections (the real increase in wages and salaries in this sector, including retroactive increments, was 10 percent).

Income tax revenue from the self-employed rose 5 percent in real terms this year. However, the classification of assesseees as self-employed is not always clear-cut, since many self-employed withdraw profits in the form of salaries, insofar as the tax regulations render it advantageous to do so. It is therefore useful to examine a homogeneous group of self-employed, company directors, and members of cooperatives (although some members of cooperatives really come under the category of wage-earners). Total income tax revenue from this group rose 14.5 per-

²⁰ The wage-earner is assumed to be married, the father of two children, his wife does not work outside the home, and he earns the average wage as measured by the National Insurance Institute. Starting with the 1979 tax year, women are granted tax credit points for each child (previously only the first child and every second child thereafter entitled the mother to a credit point). This change moderated the rise in tax rates for women in 1979.

Table X-7

INCOME TAX AND NATIONAL INSURANCE CONTRIBUTIONS, 1976-79
(IL million)

	1976	1977	1978	1979	Percent annual real increase ^a		
					1977	1978	1979
On wage income	11,918	18,437	28,681	59,018	14.9	2.9	16.2
Income tax from employees ^b	6,242	9,559	14,119	31,191	13.8	-2.4	24.9
National insurance	5,676	8,878	14,562	27,827	16.2	8.7	8.0
On nonwage income	11,069	14,059	23,090	44,695	-5.6	8.1	7.8
Income tax							
On companies	5,581	5,940	9,571	18,583	-20.9	5.4	8.9
On self-employed	2,048	2,979	5,107	9,714	8.1	13.5	5.1
On company directors and members of cooperatives	810	1,610	2,360	5,800	47.7	-3.5	25.2
Deductions at source	2,159	2,799	4,862	8,459	-3.7	14.8	-3.1
National insurance	471	731	1,190	2,139	15.3	8.0	0.5

^a Deflated by the consumer price index.

^b For 1978-79 the rates of change were calculated from monthly deflated figures.

Source: Income tax—Bank of Israel calculations based on data from the Income Tax and Property Tax Authority, the Accountant General, and bank reports on loans to tax debtors; national insurance—the National Insurance Institute.

cent in 1979, as against 7.5 percent the year before.

The authorities apparently made a greater effort in 1979 to collect a "true tax" from the self-employed. For lack of reliable data on this group, it is impossible to quantify the success of this attempt. But it should be noted that the average rate of direct taxes for the broader category of nonwage income earners declined in 1979.

The self-neutralizing effect of the income tax structure for the self-employed in a period of rapid inflation should again be stressed. The self-employed benefit from institutional arrangements which enable them to defer tax payments during the year and even beyond. On the other hand, their income is also subject to taxes on inflationary profits, which are not profits in the real sense of the word but are treated as such for tax purposes.

Income tax collections from companies increased 9 percent in 1979 in real terms, even though some tax rates were reduced in the 1979/80 fiscal year: industrial firms now pay 20 percent instead of 35 percent, and enterprises approved under the Law for the Encouragement of Capital Investments pay 30 percent instead of 40 percent. In addition, industrial concerns were granted income tax relief on inventories in 1979.

Taxes withheld at source fell 3 percent in real terms this year. The obligation to deduct tax at source was extended in 1979, but the full impact of this change was not felt in the calendar year.

National insurance contributions rose 90 percent, representing a real increase of 7 percent. Collections on account of wage income (employer and employee contributions) were up 8 percent in real terms, while contributions by the self-employed remained unchanged (in real terms). The more rapid increase for employees was due partly to the hiking of wages and partly to a rise in contribution rates (the secondary education impost).

National insurance rates contain a regressive element: a fixed rate is levied on wage income up to a certain ceiling; for income in excess of this ceiling the rates decline to zero. The combining of national insurance contributions with other direct taxes—income tax and employers' payroll tax—significantly reduces the progressiveness of the income tax brackets and rate structure.²¹

The zero real growth of national insurance contributions by the self-employed in 1979 is ascribable to the fact that the collections are largely based on past income tax assessments. Together with the escalation of inflation, this has caused a marked erosion in the effective rates paid by the self-employed. The National Insurance Institute's rates policy and collection system for the self-employed should be reexamined, and modifications made as required by changing economic conditions.

It is interesting to note that this method of collection—proportional contribution rates with an income ceiling—permits an effective reduction in the national insurance rates.

(c) Direct Transfer Payments

Total net transfer payments fell 8 percent in 1979, after rising about 10 percent in each of the three preceding years. The change resulted from a sizable drop in interest payments, after they had previously gone up at a rapid rate.

The early 1970s witnessed a wide-ranging program of social legislation, with the result that transfer payments through the National Insurance Institute grew to major proportions. In 1976-79 there was a significant slowdown in such legislation, and this curbed the accelerated increase in payments. In 1979, for the third consecutive year, there was only a slight change (and for the first time even a decline). A number of contrasting developments combined to produce the 1979 downturn. On the one hand, demographic changes caused the population eligible for allowances to increase faster than the general population: the number of persons entitled to the children's allowance and old-age and survivors' pensions rose 2.8 and 3.9 percent respectively, while the country's population expanded by 2.5 percent. On the other hand, the acceleration of inflation and the fact that pensions were only partially adjusted for this slowed the real growth of the benefits. These factors

²¹ See the Bank of Israel Annual Report for 1978, p. 216.

Table X-8

**ESTIMATED EROSION OF VARIOUS ALLOWANCES, (AVERAGE MONTHLY
ALLOWANCE, 1975 PRICES), 1976-79
(IL)**

	July 1975 to March 1976 ^a					Percent real increase				
						Annual				
	1976 ^a (1)	1976 (2)	1977 (3)	1978 (4)	1979 (5)	1976 (6)	1977 (7)	1978 (8)	1979 (9)	(5/1)
Deflated by the consumer price index										
Allowance for family with 2 children	186	177	181	174	154	-5.0	2.2	-4.0	-11.8	-17.4
Allowance for family with 4 children ^b	558	561	578	548	510	-3.6	3.1	-5.2	-7.0	-12.4
Income maintenance for single persons ^c	553	532	529	527	546	-3.8	-0.6	-0.3	3.7	-1.3
Deflated by the index of average wages per employee post										
Allowance for family with 2 children	183	176	164	155	144	-3.8	-6.9	-5.6	-7.1	-21.4
Allowance for family with 4 children ^b	572	559	525	488	477	-2.4	-6.1	-7.0	-2.3	-16.7
Income maintenance for single persons ^c	545	530	480	470	510	-2.6	-9.4	-2.0	8.5	-6.3

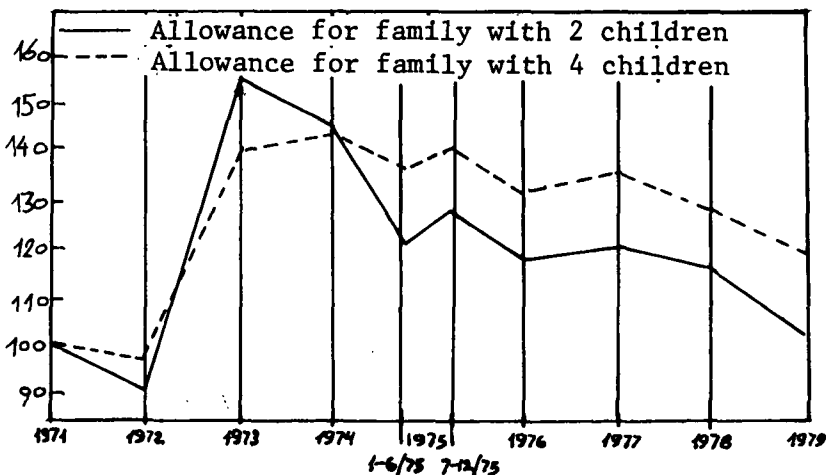
^a The income tax reform was instituted during a period when inflation was running at 40 percent, and so the value of the allowances as fixed in July 1975 fell monthly until updated in April 1976. The average monthly allowance during this period is used as an approximation of the amount which the indexation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

Figure X-3

**CHILDREN'S ALLOWANCE 1971-79
(1971 = 100)**



largely offset each other, thus precluding any substantive change in national insurance payments.

In order to compensate for the impairment of the real value of the allowances, the indexation arrangements were improved for certain categories of beneficiaries (the elderly, widows, recipients of social welfare allotments, and the disabled). These allowances are now updated more frequently and more generously;²² this increased the purchasing power of the benefits by about 3.5 percent in 1979. These modifications were not applied to the children's allowance or to old-age pensions. Consequently, the latter suffered a real decline of about 3.5 percent, while the children's allowance lost 12 percent of its value for families with two children and 7 percent for families with four children. The erosion of the children's allowance has been going on for a number of years, but it is still higher than the level in 1971 (see Figure X-3).

The law providing for free secondary education took full effect in 1979, following its partial implementation the year before. This law has a regressive element, in that low-income families had previously been exempt from tuition fees, while families who are better off financially now receive this benefit too. The additional expenditures are to be funded through the secondary education levy, which is collected by the National Insurance Institute; thus the law does not affect disposable income but only its distribution.

(d) Indirect Taxes on Domestic Production

Total revenue from indirect taxes on domestic production grew 6.5 percent in real terms in 1979. Excluding government property tax and local authority rates (which are not directly related to current economic activity), the real increase was 8.5 percent, reflecting a moderate rise in the average indirect tax rates.

As regards the composition of these taxes, the trend of the past few years continued in 1979: the weight of the value added tax rose, while that of other taxes—in particular the government property tax and local authority rates—declined. The swelling of VAT revenues (a real rise of 15 percent in 1979) was due predominantly to the expansion of uses subject to this tax and, to a lesser extent, to a more efficient collection.

(e) Subsidies on Domestic Production and Exports

There are two basic components of such subsidies. The more customarily defined component is the direct subsidization of goods and services (including basic commodities); this rose 4 percent over the 1978 figure. Subsidies on a

²² Under the new arrangements which went into force in June 1979, the allowances are updated whenever the consumer price index rises 10 percent above the latest base index used for adjusting the allowances. As a result of this modification, the payments were revised in six of the last seven months of the year.

Table X-9

INDIRECT TAXES AND SUBSIDIES ON DOMESTIC PRODUCTION, 1976-79
(IL million)

	1976	1977	1978	1979	Percent annual real increase ^a			
					1976	1977	1978	1979
A. Total indirect taxes on domestic production	13,527	18,789	30,169	57,155	18.1	3.2	6.6	6.3
VAT ^b	1,537	4,391	10,325	21,263				
Other taxes on economic activity ^c	8,143	9,346	12,122	22,066				
Property tax	1,550	1,681	2,013	3,464				
Other taxes ^d	2,297	3,371	5,709	10,362				
B. Subsidies on domestic production	3,300	4,580	8,072	14,936	23.4	3.1	17.0	3.8
Imputed credit subsidy	4,830	6,313	8,905	26,745	41.6	30.7	-6.3	68.4
C. Net taxes on domestic production	10,227	14,209	22,097	42,219				
D. Net taxes on domestic production, including imputed credit subsidy	5,397	7,896	13,192	15,474				

^a Deflated by the consumer price index.

^b Included service tax on financial institutions, which was collected until the imposition of VAT and was subsequently merged with the latter.

^c Employers' tax, purchase tax, fuel tax, excise, and various fees.

Source: Central Bureau of Statistics.

number of basic commodities were abolished toward the end of 1979, but the full effects of this measure will only be felt in 1980.

The other component is the current subsidy element in nonindexed credit to business, which augments the income and wealth of private individuals. In 1979 this component swelled 85 percent in real terms. Cheap credit is granted by the government (either directly or in accordance with its directives), the Bank of Israel, or other banking institutions at a nominal interest rate far below the rate of price advance. According to Central Bureau of Statistics estimates, the current subsidy element of such finance reached some IL60 billion in 1979 (as compared with only IL15 billion for the other component).²³

The private sector's nonindexed debt to the government includes not only loans to business but also those to households. The Central Bureau of Statistics has not estimated the subsidy component of this credit, but a Bank of Israel estimate puts it at IL19.5 billion in 1979. On the other hand, the private sector owns nonindexed assets, which depreciate as a result of inflation. The net effect of these two factors was not great in 1979, and so the net amount imputed to personal income came to IL55 billion, as compared with IL15 billion in 1978 (a real increase of 105 percent).

The main reason for the growth of the credit subsidy was the acceleration of inflation from 48 percent in 1978 to 111 percent during the year reviewed.²⁴ Two additional, less potent, factors worked in opposite directions in 1979: one was the imposition of a 12 percentage point interest surcharge on foreign currency loans, which sharply drove up the subsidy component of such loans; the other factor was the indexation of development loans to the business sector. The latter measure will undoubtedly have a strong impact in the future, both on the total volume of loans and on their subsidy component. In 1979, however, the weight of such indexed loans was only marginal since most were granted at a nominal interest rate of 30 percent.

Subsidies on local production, as customarily defined, were 4 percent up on 1978. The changes this year in the average price of basic commodities did not differ significantly from the general average. To be sure, in 1979 steps were taken to raise the prices of basic commodities and reduce their subsidization, but they were concentrated in the second half of the year, notably in November when the subsidies were eliminated on milk and dairy products, edible oils, and certain other items.

²³ The credit subsidy is calculated as the difference between the nominal rate of interest paid on the various types of loans and the alternative interest rate. In most cases the alternative real rate was taken to be 4 percent; for foreign currency loans it was the going market rate plus a 12 percentage point surcharge.

²⁴ In the Bank of Israel Annual Report for 1978 the inflationary effect was calculated by comparing the rise in the annual average price levels instead of December levels. As a result of this and other changes, the Central Bureau of Statistics' estimates of the subsidy component were revised for 1975 onward.

The full effect of these measures will, of course, be apparent only in 1980. In the short run, however, the subsidy cuts did speed up price increases, as basic commodity prices went up much faster than consumer prices in general. The abolition of subsidies was probably the first concrete move in carrying out the government's long-declared policy of eliminating distortions arising from the subsidy programs.

SUBSIDY COMPONENT OF CHEAP CREDIT, 1975-79

(IL million, at current prices)

	1975	1976	1977	1978	1979	Percent annual real increase ^a			
						1976	1977	1978	1979
Total cheap credit	27,015	35,816	48,778	75,107	127,931				
Subsidy component	4,280	8,512	12,359	18,187	59,976	51.5	7.9	-2.3	85.0
For domestic production	2,597	4,830	6,313	8,905	26,745	41.7	-2.9	-6.3	68.4
For exports ^b	1,683	3,682	6,046	9,282	33,231	66.6	22.0	1.9	100.8
Narrow money base (end of year)	7,224	10,550	15,897	20,358	23,188				
Decline in value of money due to inflation ^c	1,862	3,434	5,701	8,276	24,485	40.4	23.3	-3.6	66.0

^a Deflated by the consumer price index.

^b See note b to Table X-10.

^c Real interest of 4 percent, less the average interest paid on the narrowly defined money base on account of liquid assets deposited with the Bank of Israel, multiplied by the money base.

(f) Indirect Taxes on Imports

Indirect taxes on civilian imports netted 105 percent more in nominal terms in 1979. This was the outcome of a 45 percent average rise in exchange rates, a 27 percent growth of total imports (in foreign currency terms), and a significant increase in the share of durable goods, which are highly taxed. Toward the end of 1979 the import of durable goods slackened, thereby slowing the growth of import tax revenue.

Table X-10
TAXES AND SUBSIDIES ON IMPORTS AND EXPORTS, 1975-79
 (IL million)

	1975	1976	1977	1978	1979	Percent annual increase			
						1976	1977	1978	1979
Net taxes on civilian imports	5,962	10,041	13,284	17,744	36,599	68.4	32.3	33.6	106.3
VAT	—	1,001	3,034	7,429	15,504				
Other taxes ^a	6,912	9,341	11,150	11,610	23,986				
Import subsidies	950	301	900	1,295	2,891				
Taxes on defense imports	1,753	2,497	2,432	3,383	4,413				
Export incentives	2,302	3,453	6,010	305	540	50.0	74.1	-94.9	77.0
Imputed subsidy on export credit ^b	1,683	3,682	6,046	9,282	33,231				
Export incentives, including credit subsidy	3,985	7,135	12,056	9,587	33,771	79.0	69.0	-20.5	252.3

^a Customs, purchase tax, import levy, and foreign travel tax.

^b The imputed subsidy on export credit consists of two components. One is the Central Bureau of Statistics estimate of export incentives granted in the form of directed credit, as follows (in IL million)

1975	1976	1977	1978	1979
521	894	1,798	3,286	14,481

The second component is the Bank of Israel estimate of the imputed subsidy in medium- and long-term credit, based on the export share of the industrial product.

Source: Central Bureau of Statistics and Bank of Israel estimates.

Table X-A1
DOMESTIC DEMAND SURPLUS, 1975-79
 (IL million, at current prices)

	1975	1976	1977	1978	1979	Percent annual real increase ^a			
						1976	1977	1978	1979
A. Direct demands									
1. Public domestic consumption	20,330	25,579	37,563	57,677	115,733	-3.6	-0.5	0.5	4.4
2. Investments and construction initiated by the public sector	8,378	8,094	8,450	13,809	27,741	-19.7	-24.7	-9.2	10.6
3. Total direct domestic demands (1+2)	28,708	33,673	46,013	71,486	143,474	-8.3	-6.7	-1.5	5.6
B. Liquidity absorption									
4. Direct taxes on domestic production, property and entrepreneurial income	27,027	40,927	58,423	90,355	175,221	15.3	6.1	2.7	8.8
5. Taxes of foreign trade	6,912	10,342	14,184	19,039	39,490	14.0	1.9	-10.9	16.3
6. Transfer payments and domestic product subsidies	15,467	22,661	33,751	56,403	93,278	11.6	10.8	10.8	-7.2
7. Foreign trade subsidies	3,252	3,754	6,910	1,600	3,431				
8. Government subsidization of credit (actual payments)	100	735	2,000	5,400	8,290				
9. Subsidy element in business sector credit	4,280	8,512	12,359	18,187	59,976	51.5	7.9	-2.3	85.0
10. Absorption, at the official exchange rate (4+5—6—7—8)	15,120	24,119	29,946	45,639	108,286	21.5	-7.7	1.2	33.1
11. (10) plus effect of changes in the public sector wage level ^b	15,120	24,119	29,946	45,639	108,286	20.4	-15.9	1.1	28.6
12. Absorption, at the effective exchange rate (11+7—5)	11,460	17,531	22,672	28,200	72,227	15.0	-15.1	-20.3	37.8

C. Demand surplus									
13. At the official exchange rate (3—11)	13,588	9,554	16,067	25,847	35,188	-40.2	13.9	-5.8	-35.2
14. At the effective exchange rate (3—12)	17,248	16,142	23,341	43,286	71,247	-23.8	1.7	14.2	-13.3
D. Demand surplus incl. credit subsidy									
15. At the official exchange rate	15,906	13,897	20,725	30,358	62,389	-33.5	10.8	-2.7	15.3
16. At the effective exchange rate ^c	17,883	16,803	21,953	38,515	65,217	-28.4	-2.9	16.5	-5.0

^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 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.

^c These data include the export credit subsidy (see also Table X-10).

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

Table X-A2
DIRECT TAXES, COMPULSORY LOANS, AND TRANSFER PAYMENTS, 1975-79
 (IL million)

	1975	1976	1977	1978	1979	Percent annual real increase ^a			
						1976	1977	1978	1979
1. Total direct taxes	14,228	23,272	33,127	52,290	104,038	22.8	5.8	4.8	11.6
Income tax	9,471	16,840	22,887	36,019	73,747	35.4	1.0	4.5	14.8
National insurance	4,077	6,147	9,609	15,752	29,966	14.8	16.1	8.9	6.7
Inventory surtax	680	235	631	519	325				
2. Compulsory loans	2,615	1,572	1,934	2,976	6,340	-39.9	-8.6	2.2	19.5
Thereof: Employers savings loan	888	1,144	1,807	2,889	6,280				
3. Total direct taxes and compulsory loans	16,843	24,844	35,061	55,266	110,378	12.3	4.8	4.7	12.0
4. Transfer payments to households	6,714	9,671	13,656	20,178	35,105	9.7	4.9	-1.9	-2.4
Through the National Insurance Institute	4,101	6,337	8,678	13,323	23,265	17.7	1.7	1.9	-2.1
Provident fund, pension, and other transfers	2,613	3,334	4,978	6,855	11,840	-2.8	10.9	-8.6	-3.1
5. Net transfer payments to nonprofit institutions	3,599	4,409	7,137	12,701	23,020	-6.7	20.3	18.2	1.7
Net current transfers	3,259	3,948	6,556	11,864	21,310	-7.7	23.4	20.2	0.7
Thereof: Employers' matching contributions	677	961	1,590	2,855	5,575	8.1	22.9	19.2	9.5
Transfers on capital account	340	461	581	837	1,710	3.3	-6.4	-4.3	14.6
6. Capital transfers to businesses	419	734	1,051	1,650	2,651	33.4	6.4	4.2	-9.9
7. Interest payments in IL	3,410	5,183	7,681	14,055	19,600	15.8	10.1	21.5	-21.8
8. Redemption of compulsory loans	732	1,444	2,227	3,513	5,051	50.2	14.6	4.7	-19.4
9. Total transfer payments to the public (4 to 8)	14,874	21,441	31,752	52,097	85,427	9.8	10.0	8.9	-8.0
10. Transfer payments from the public	1,444	2,080	2,581	3,414	5,660	9.7	-7.8	-12.2	-6.4
On current account	514	1,053	1,361	1,577	2,515	56.0	-4.0	-23.1	-10.6
On capital account	930	1,027	1,220	1,837	3,145	-15.9	-11.7	0.0	-4.0
11. Total net transfer payments (9—10)	13,430	19,361	29,171	48,683	78,767	9.8	11.9	10.8	-8.1

12. Net transfer payments, less compulsory loan redemptions (11—8)	12,698	17,917	26,945	45,170	74,716	7.5	11.7	11.3	-7.2
13. Net transfer payments, less interest (11—7)	10,020	14,178	21,490	34,628	60,168	7.8	12.6	7.0	-2.5
14. Direct taxes and compulsory loans less net transfer payments (3—11)	3,413	5,483	5,890	6,583	30,610	22.4	-20.2	-25.8	160.8
15. Direct taxes and compulsory loans, less transfer payments to households and business (14+5)	7,012	9,892	13,027	19,284	53,630	7.4	-2.2	-1.7	56.0

^a Deflated by the consumer price index; direct taxes in 1978 and 1979 were deflated monthly using this index.

Table X-A3

**DEFENSE IMPORTS, U.S. GOVT. GRANTS, UNILATERAL INSTITUTIONAL TRANSFERS TO ISRAEL,
AND GRANT EQUIVALENT OF LOANS FROM THE U.S. GOVERNMENT AND WORLD JEWRY, 1964-79**

(\$ million)

	1964-66	1967-69	1970-72	1973-75	1976-78	1979	964-79
1. Direct defense imports	324	867	1,650	4,354	4,050	1,158	12,403
2. Indirect defense imports	98	254	453	995	1,042	342	3,184
3. Total defense imports (1+2)	422	1,121	2,103	5,349	5,092	1,500	15,587
4. U.S. govt. defense-related grants	—	—	—	1,600	2,013	470	4,087
5. Grant component of U.S. govt. defense loans ^a	—	30	310	389	340	150	1,219
6. Total grants and grant component of U.S. govt. defense loans (4+5)	—	30	310	1,989	2,353	620	5,302
7. U.S. govt. grants for civilian needs	86	14	50	436	1,533	433	2,552
8. Grant component of U.S. govt. civilian loans ^a	—	—	—	—	375	170	545
9. Total grants and grant component of U.S. govt. civilian loans (7+8)	86	14	50	436	1,908	603	3,097
10. Total grants and grant component of U.S. govt. loans (6+9)	86	44	360	2,425	4,261	1,223	8,399
11. Unilateral institutional transfers to Israel (cash)	283	657	824	1,653	1,433	456	5,306
12. Grant component of Development Loan (Israel Bonds)	60	105	140	180	150	60	695
13. Total unilateral transfers and grant component of Development Loan (11+12)	343	762	964	1,833	1,583	516	6,001
14. Grants and grant component of loans from U.S. govt. and World Jewry (10+13)	429	806	1,324	4,258	5,844	1,739	14,400

^a The grant component is the "grant equivalent", presented in Oded Liviatan's article in the Bank of Israel *Economic Survey*, No. 48-49.