

CHAPTER V

GOVERNMENT AND NONGOVERNMENT PUBLIC SECTOR¹

1. MAIN DEVELOPMENTS

Total public consumption rose 7.5 percent in 1980, owing primarily to a heavier defense spending because of the military redeployment in the Negev. Domestic defense outlays were up 4 percent and defense imports by 26 percent.

Civilian consumption edged down 0.5 percent, after a 3–5 percent annual increase in recent years. Nondwelling investment and residential starts initiated by the public sector declined in 1980 (although its investment in residential construction expanded by a formidable 50 percent). The sector's direct domestic demands (investment and consumption) rose 3 percent in 1980, compared with 4 percent the year before.

Taxes (direct and indirect) held steady in real terms, with a drop in import taxes being offset by an increase in direct taxes. Direct subsidies on domestic production were trimmed by an average of 15 percent in 1980, and there was no change to speak of in transfer payments to the public. The total absorption from the public was 2 percent higher in 1980.²

The demand surplus (the difference between the public sector's direct domestic demands and its absorption) was also up 2 percent in the year reviewed, and its weight in GNP remained unchanged.

To ease the balance of payments strain and retard inflation government policy has aimed, since the final part of 1979, to curb domestic uses in general and public sector demands in particular. Toward this end the government has cut back public civilian spending, slashed subsidies, and created expectations of a slowdown in economic activity. At the same time the Bank of Israel has continued its stringent monetary policy.

As a result, the economic slowdown which began in mid-1979, prior to the implementation of the government's policy of restraint, became more pro-

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 Chapter VIII.

² In addition to taxes, subsidies, and transfer payments, the sector's absorption includes property and entrepreneurial income and actual disbursements on account of subsidized credit.

nounced at the beginning of 1980. However, the balance of payments improved significantly and the acceleration of inflation was checked (although it remained very high). Several major budget items were reined back: civilian consumption was reduced, for the first time in recent years, and the public sector's real payroll expenditure was down 7 percent on an annual average (after a relatively rapid rise in 1979). The sector's non dwelling investment fell, and the weight of loans to households and business, which are linked either to the consumer price index or to the exchange rate, grew. On the other hand, domestic defense outlays were 4 percent up on 1979, and residential construction initiated by the public sector expanded strongly.

Public sector spending continued to be restrained in the second half of 1980, but less so than in the first six months. The supplementary budget submitted to the Knesset provided for some expansion of government spending, and in the last quarter of 1980 the government began to increase subsidies (a policy that was broadened in the first half of 1981).

These developments were accompanied by a much larger public sector injection, since the drop in revenue due to the economic slowdown exceeded the drop in expenditures.

Noncivilian consumption rose 12 percent in real terms in 1980. Most of the increment was in direct defense imports (up 26 percent), a large proportion of which was for the construction of airports in the Negev by American contractors. The domestic component of noncivilian consumption rose by a more moderate 4 percent; here too the military redeployment in the Negev was the dominant factor.

A long-term analysis shows that the Six Day War (1967) marked a turning point in Israel's defense spending. Since then such expenditures have shot up both absolutely and as a percent of GNP. The increases were most striking in periods of hostilities—the war of attrition (1970), and even more the Yom Kippur War and its aftermath (1973/74)—after which the level tapered off. In 1979–80 one-quarter of Israel's GNP was diverted to defense, more than in the period before the Yom Kippur War (21–22 percent between 1968 and 1972).

Israel receives grants and loans from the U.S. to help finance its defense budget. Even excluding such aid, the defense share of GNP that is financed by the domestic economy is extremely large and has no equal in other western countries.

The mounting of oil prices since 1973 (which has increased the economic and military power of the Arab states) has placed a heavy burden on the Israeli economy. Whereas before the energy crisis oil expenditures amounted to 1–2 percent of GNP, in 1980 the figure reached 10–11 percent. This has rendered the defense burden more onerous than in the past.

It is difficult for the Israeli economy to renew its growth, reduce its dependence on American aid, and at the same time maintain the current trend in military spending. It would seem that before determining the size of the defense

Table
INDICATORS OF PUBLIC
(Weight in GNP, rounded)

		Average		
		1960-65	1966-67	1968-72
A.	1. Direct domestic demand	25	27	30
	2. Absorption	22	21	24
	3. Absorption, incl. effect of inflation on private wealth ^a			
	4. Domestic demand surplus	3	5	5
	5. Domestic demand surplus, incl. effect of inflation on private wealth			
B.	6. Civilian consumption	11	13	11
	7. Civilian services	17	19	17
	8. Weight of civilian services in total employment	21	..	24
	9. Noncivilian consumption	10	14	22
	10. Thereof: Domestic noncivilian consumption	6	9	13
	11. Thereof: Direct defense imports	4	5	9
	12. Investment and construction	9	6	7
	13. Total civilian consumption/total noncivilian consumption	115	98	51
	14. Public sector injection/narrow monetary base ^b			

NOTE: Lines 1 to 5—see Table V-A2; lines 6, 9, 10, 11, 12—see Table V-3.

^a Line 2 plus subsidies to business and households in the form of cheap directed credit, less the inflationary erosion of the monetary base.

budget, taking into consideration the strength of the Arab countries on the one hand and the economic constraints and the peace agreement with Egypt on the other, national (as well as economic and social) priorities must be established and a public debate held on the desirable allocation of Israel's resources between defense needs and domestic uses.

Public civilian services declined 3 percent per capita in 1980, following a slow but steady growth in recent years. A long-term examination reveals a significant increase in the weight of social services—education, health, etc. Adding transfer payments, which are of a similar nature, we find an accelerating long-run uptrend in this item. The 1980 downturn in public civilian services (in relation to GNP) brought them to their 1978 level. A substantive reduction of this item requires

V-1

SECTOR OPERATIONS, 1960-80

percentages, at current prices)

1973-74	1975-77	1978	1979	1980	Percent annual real increase		
					1978	1979	1980
36	35	31	32	33	-0.3	4.0	3.1
22	21	20	25	25	1.3	28.8	1.3
	17	16	16	19	12.3	4.3	21.3
15	13	10	8	8	9.7	-20.2	1.7
	16	14	16	13	-4.3	22.0	-18.2
11	12	12	13	12	5.4	2.3	-0.6
18	18	19	20	19			
25	28	27	29	29			
32	30	27	23	25	15.4	-12.9	12.0
17	16	14	15	15	0.1	3.1	3.9
15	14	13	8	10	40.0	-31.3	26.1
10	8	6	6	7	-6.3	7.8	5.3
35	40	45	58	49			
25	85	79	32	141			

^b Public sector injection in relation to the monetary base at the end of the previous year. For 1978-80 the monthly injection was deflated by the consumer price index, bringing it to the level at the end of the previous period.

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

that such services be harnessed for a number of years along with a faster GNP gain. The expansion of such services and a heavier defense spending (particularly in a period of laggard economic growth) do not accord with the declared aim of diverting resources to reduce the balance of payments deficit and tone down inflation.

Domestic production subsidies were sharply pruned beginning in November 1979, and on an annual average were 15 percent lower in 1980 than in the previous year. (There was a change of policy at the end of 1980, and subsidies were restored on a number of products—a trend that was stepped up in the first half of 1981.) The subsidization of domestic production in the form of cheap directed credit declined 36 percent as a result of the “erosion” of

Table V-2
FINANCING OF THE PUBLIC SECTOR DEMAND SURPLUS, 1978-80
 (IS million, at current prices)

	1978	1979	1980
A. 1. Domestic demand surplus ^a	2,299	3,271	7,685
2. Domestic demand surplus to be financed (8+9-10)	2,053	2,767	6,590
3. Domestic finance differential (1-2) ^b	246	504	1,095
B. Financing of the domestic demand surplus			
4. Net long-term capital mobilization by the public sector ^c	-68	526	1,059
5. Thereof: Sale of tradable bonds ^d	-456	117	1,220
6. Injection	1,447	1,480	4,916
7. Basic injection (5+6) ^e	991	1,597	6,136
8. Liquidity injection generated by demand surplus (4+6) ^e	1,379	2,006	5,975
9. Interest adjustments ^f	1,068	1,232	2,993
10. Other adjustments ^g	394	471	2,378
C. 11. Public sector purchases abroad	3,451	4,184	11,736
12. Financing from abroad (14+15+16)	3,118	4,969	12,965
13. Foreign finance differential (11-12) ^h	333	-785	-1,229
D. Financing from abroad			
14. Government credit from abroad ⁱ	662	1,220	4,461
15. Jewish Agency financing from abroad ^j	379	615	1,144
16. U.S. government grants	2,077	3,134	7,360

^a Domestic demand surplus of the public sector as defined in this chapter (see Table V-A2).

^b The differential stems from the conceptual difference between the national accounts accrual basis estimates and the budget cash flow estimates (short-term financing), as well as from errors and omissions.

^c Proceeds from the sale of tradable and nontradable bonds and deposits with the Treasury of the earmarked proceeds of security issues and other deposits, less net credit granted (see Table VIII-9).

^d See Table VIII-8.

^e The terms "basic injection" and "liquidity injection generated by the demand surplus" appear frequently in Chapter VIII below (see Tables VIII-8 and VIII-9).

^f Interest payments and receipts are included in the public sector domestic surplus (line 1) and in net capital mobilization (line 4). To prevent double-counting they should be added to net public sector capital mobilization.

^g Adjustment for the early redemption of Israel Bonds, collection and redemption of compulsory loans, and other adjustments.

^h The foreign finance differential results in changes in the public sector's foreign currency balances, the outstanding government credit balance with the Bank of Israel, and the financing of the public sector's domestic demand surplus. (For these reasons one cannot add lines 3 and 13). Part of the public sector's injection originates in the conversion of its foreign currency receipts, but not all of the foreign financing surplus is used to cover the domestic demand surplus. The differential arises from conceptual differences between the national accounts accrual basis estimates and the budget cash flow estimates, as well as from errors and omissions.

ⁱ Includes credit for direct defense imports; repayments include interest payments.

^j Jewish Agency injection.

SOURCE: Bank of Israel.

the stock of outstanding loans and the renewal of loans on indexed terms. Export subsidies through directed credit grew 31 percent in 1980 (see note ^c to Table V-13).

Direct tax revenue (the bulk of which derives from wage income) rose 7.5 percent. On the other hand, import taxes declined and indirect taxes on domestic production remained unchanged. Total tax revenue (direct and indirect) from the civilian sector did not change in the year reviewed.

The public sector's demand surplus³ stabilized in 1980, both in absolute real terms and in relation to its weight in GNP. Taking into consideration the indirect effect of the public sector on private demands through the granting of nonindexed loans, as well as the erosion of the monetary base, it turns out that in 1980 the demand surplus (including the impact of inflation on individual wealth) declined compared with the previous year. It should be emphasized that the economic slowdown (which, as stated, was partly due to deliberate government policy) depressed indirect taxes on imports and thereby increased the measured demand surplus. If this factor is discounted, the public sector's demand surplus actually declined in 1980.

Even though the demand surplus has contracted since the Yom Kippur War, its weight in GNP is still greater than in the prewar period. This surplus has been one of the principal factors stoking and prolonging inflation. To significantly leash inflation it must be reduced, preferably by dampening direct demands rather than increasing taxes, since the latter is likely to push up costs.

As in 1979, the demand surplus was to some extent financed by net capital imports, one of the components of the public sector's domestic injection.⁴ This injection (i.e. the printing of money), which also resulted from the changes in Bank of Israel credit and the shrinkage of indirect tax revenue (in the wake of the economic slowdown), was 3.3 times larger than in 1979. It did not proceed at a uniform pace during the past two years. In the first half of 1979 there was an absorption (mainly because of capital market operations); from the second half of the year until the first quarter of 1980 (the end of fiscal 1980/81) the injection accelerated; in the second and third quarters of 1980 it tailed off because of the slackening of government disbursements and a larger net capital mobilization from the public. Toward the end of 1980 the uptrend reasserted itself. During the year as a whole the injection financed half the domestic de-

³ This surplus is defined as the difference between the public sector's direct domestic demands and its absorption from the public. It does not reflect the influence of the various components of the surplus. Consequently, a comparison of the demand surplus in different years reveals only its trend, and no great significance should be attached to interyear changes.

⁴ Some of these funds are used to augment the sector's foreign currency balances and to reduce outstanding Bank of Israel credit, while another part is pumped into the economy (see the notes to Table V-2).

mand surplus, compared with a quarter in 1979.⁵ The net amount of capital raised by the public sector was up 6–7 percent in 1980, with tradable bonds setting the pace.

In 1979–80 the capital inflow, as mentioned, exceeded the public sector's purchases abroad. In the last three years the proportion of U.S. government grants in total foreign financing fell, whereas the share of foreign government credit rose.

The 1980/81 Budget

The original government budget for fiscal 1980/81 totaled IS65.3 billion, which assumed a real decrease in total expenditures (government consumption, transfer payments, debt repayment, etc.).⁶ Shortly before the budget was tabled, it became clear that it did not accord with all the economic policy targets set by the Treasury. Even before the ink was dry on the budget proposal, a whole string of cuts and partial freezes was initiated.

(a) Following a court ruling an additional IS500 million was needed to pay wage increases awarded to teachers. The government decided to preserve the budget framework and to finance this extra outlay by reducing the budgets of all ministries.

(b) In June the government decided to make two further budget cuts in most of the ministries, including Defense.

(c) The Accountant General restricted purchases, the ordering of work, and the signing of agreements until the end of April 1980. Subsequently he also restricted the ministries' disbursements and liabilities. (These restrictions proved to be effective.)

The price projections on which the original budget was based were below the actual rate of inflation, and so the Treasury presented a IS25 billion supplementary budget in October (inflation turned out to be even faster than envisaged in this budget).

In February 1981 another supplementary budget, amounting to IS7 billion, had to be submitted in order to meet the increase in subsidies and exchange rate and price rises. The final budget for fiscal 1980/81 thus came to IS97.1 billion.

These developments point up the difficulty of drafting a government budget during an inflationary period. To improve the countercyclical functioning of

⁵ Adjusting the injection for various factors (line 10 in Table V-2) brings up its share in the financing of the demand surplus from a quarter to a third. But even so, its contribution to covering the domestic demand surplus was still larger in 1980 than in the previous year.

⁶ See the Ministry of Finance, "Budget Proposal for 1981", pp. 27–30 (Hebrew).

the budget, nominal targets have to be established. One way of doing this is to alter the method of presenting the budget. The real budget estimates must be clearly determined, and when prices are updated these adjustments and the real changes should be presented separately. Some real absorption in the ministries' activities must be allowed for in case prices go up faster than forecast. The real estimates must be regarded as the upper bound of the ministries' activities should the actual price rise be lower than predicted. In addition, it is important to place quarterly limitations on government spending within the budget framework.

2. PUBLIC CONSUMPTION AND INVESTMENT

Public consumption rose 7.5 percent in 1980, following a similar percentage decline the year before. Most of the increase was accounted for by Defense Ministry purchases abroad (up 26 percent). This item displays sharp year-to-year fluctuations, due partly to the delivery dates of military equipment, and so the short-term data are of limited significance. For this reason, and also in order to determine the effect of public consumption on domestic activity, the analysis usually focuses on the domestic component of public consumption.

Public domestic consumption edged up 2 percent this year, continuing the rising trend evident since 1978. The increase resulted primarily from the military redeployment in the Negev;⁷ the other component items either held steady or declined. Real wages in the public sector fell 7 percent this year, which constituted an indirect absorption of demands.⁸ If this factor is taken into account, public domestic consumption sagged 2 percent in real terms in 1980 (wages deflated by the consumer price index and purchases by the relevant price indexes). On balance, the growth of public domestic consumption was restrained in 1980, and its weight in GNP inched down half a percentage point.

Domestic consumption was increasingly bridled following the submission of the 1980/81 budget. In the first quarter of 1980 local spending was 4 percent up on the previous quarter (a typical development at the end of the fiscal year); in the second quarter it shrank 4 percent, and in the next two quarters it continued downward at a slower rate.

⁷ Including local purchases for the airfields being built by U.S. contractors in the Negev.

⁸ Wage payments unaccompanied by an increase in the physical labor input are treated by the Central Bureau of Statistics as a change in prices, and do not find expression in the real data. This approach assumes a zero rate of increase in public sector productivity, or, alternatively, a rise in the price of labor unaccompanied by an improvement in the quality of the workforce.

Table

DIRECT DEMANDS OF THE

(IS million, at

	1977	1978	1979
A. Public consumption			
1. Civilian consumption			
a. Wages and salaries	1,241	1,983	4,157
b. Purchases	514	828	1,486
c. Total	1,755	2,811	5,643
d. Thereof: Government imports n.e.s.	120	202	333
2. Noncivilian consumption			
e. Wages and salaries	727	1,131	2,353
f. Domestic purchases	1,292	2,030	3,863
g. Purchases abroad	1,326	3,050	3,448
h. Total	3,345	6,211	9,664
i. Total public consumption	5,100	9,022	15,307
3. Public domestic consumption			
j. Domestic civilian consumption	1,635	2,609	5,310
Government	1,002	1,570	3,248
Local authorities	565	923	1,844
National Institutions	68	116	218
k. Domestic noncivilian consumption	2,019	3,161	6,216
l. Total public domestic consumption	3,654	5,770	11,526
B. Public sector nondwelling investment	630	1,088	2,044
m. Investment less direct import component	552	889	1,641
C. Housing construction initiated by public sector	215	262	719
D. Total direct demands	5,945	10,372	18,070
Thereof: Domestic demands	4,421	6,921	13,886

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

V-3

PUBLIC SECTOR, 1977-80

current prices)

1980	Percent annual increase					
	Price			Quantity		
	1978	1979	1980	1978	1979	1980
8,875	52.7	103.9	114.8	4.6	2.8	-0.6
3,559	50.7	77.2	140.9	6.9	1.3	-0.6
12,434	52.0	96.2	121.7	5.4	2.3	-0.6
758	36.0	108.1	127.6	23.7	-20.8	0.0
5,126	49.9	97.4	117.8	3.8	5.4	0.0
9,684	60.0	86.7	136.1	-1.8	1.9	6.2
10,349	64.3	64.6	138.0	40.0	-31.3	26.1
25,159	60.9	78.6	134.2	15.4	-12.9	12.0
37,593	57.8	84.6	128.2	12.1	-8.1	7.6
11,676	53.3	95.1	121.4	4.1	4.3	-0.7
7,033	54.5	96.8	118.3	1.4	5.1	-0.8
4,119	51.2	92.5	125.4	8.0	3.8	-0.9
524	57.8	87.9	134.5	8.1	0.0	2.5
14,810	56.4	90.7	129.3	0.1	3.1	3.9
26,486	55.1	92.8	125.5	1.8	3.6	1.9
3,894	70.5	82.8	109.4	1.3	2.8	14.5
3,265	63.5	84.8	118.4	-1.5	-0.1	-12.2
2,784	64.2	118.7	158.8	-25.8	25.5	49.6
44,271	59.9	85.1	128.3	9.1	-5.9	7.3
32,535	57.0	92.6	127.6	-0.3	4.0	3.1

(a) Civilian Consumption

Domestic civilian consumption drifted down 0.5 percent in 1980, the first time in the past 25 years that a decline was recorded. It encompassed all wage and purchase items. It should nevertheless be noted that this reversal of trend merely pushed down the weight of civilian consumption in GNP to its 1978 level, which was still about 20 percent higher than its average level in 1970–74.⁹ Other uses (private consumption and investment) also slumped this year, and so the ratio between public and private consumption changed only fractionally.

During the past decade civilian consumption grew quite rapidly, influenced only slightly by such factors as wars and the business cycle. Consumption of civilian services also moved steadily upward,¹⁰ in relation to both GNP and private consumption. Nearly all the increase was in social services, while economic services (primarily general administration) hardly changed.¹¹

The steepest rise was posted in education, whose weight in total civilian services reached 43 percent in 1980 (compared with 34 percent in 1969). This reflected both a higher secondary and postsecondary school attendance rate and an increase in the manpower input per pupil in the educational system in general and in secondary schools in particular. Thus, for example, the number of pupils per teacher¹² in the entire system fell about 10 percent between 1969/70 and 1979/80 (nearly all the change occurred in the secondary schools, where the figure dipped about 30 percent; there was scarcely any change in the primary schools). Because of the weight of education in total civilian consumption, it is difficult to reduce civilian services consumption to a significant degree without making cuts in this sphere.

The growth in civilian services consumption is also reflected in the proportion of public and community service workers in total employment—29 percent in 1980, roughly the same as in the previous year. This item too has displayed a long-term rising trend, the level moving up from 21 percent in 1960–65 to 24 percent in 1968–72.

The total number of public and community service workers crept up 1.7 percent in 1980. It is noteworthy that government administrative personnel declined in 1979 and 1980 (by 1.7 percent and 2.9 percent respectively); however, there were increases in other segments of the public sector, especially in local government administrative personnel (5.5 percent in 1979 and 6.8 percent in 1980) and in educational and research services (5.3 percent in 1980, which

⁹ See Table V-4.

¹⁰ In this chapter it is customary to analyze civilian consumption in the context of civilian public services, which include services provided by nonprofit institutions; 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 official policy and most of their funding comes from the public sector.

¹¹ See Table V-5.

¹² The reference is to a full-time teaching post.

Table V-4

INDICATORS OF THE GROWTH OF CIVILIAN PUBLIC SERVICES, 1970-80

(Ratios in percent, at current prices)

	1970	1972	1974	1976	1978	1979	1980
Public civilian consumption/GNP ^a	10.3	10.0	10.5	11.2	12.2	13.0	12.2
Public civilian consumption/private consumption ^b	18.8	19.5	18.9	19.3	21.0	22.5	22.3
Public civilian consumption per capita ^c	20.4	21.4	22.6	23.7	24.6	24.6	23.9
Public civilian services/GNP ^d	16.9	16.1	17.1	17.9	19.0	20.0	18.7
Public civilian services/private consumption ^b	30.6	31.3	30.5	30.6	32.5	34.7	34.2
Public civilian services per capita ^c	31.3	33.0	34.9	36.5	37.7	37.7	36.7

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

^b Private consumption does not include nonprofit institution services.

^c At constant (1975) prices, in IS.

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

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

was close to the long-term trend). It seems that the way has not yet been found to implement an overall restrictive policy throughout the public sector.¹³

(b) Noncivilian Consumption

Total noncivilian consumption was 12 percent up on 1979 in real terms. This was due to a 26 percent expansion of direct defense imports, which was largely related to the construction of airfields in the Negev by American contractors.

There was less restraint in defense expenditures than in public civilian consumption. The domestic component of noncivilian spending rose 4 percent in

¹³ This discussion is based on labor force survey data of the Central Bureau of Statistics. According to the National Insurance Institute, public sector employment drifted down 0.1 percent and the growth of local authority personnel was much milder. This was the third year that there have been sizable discrepancies in the number of public sector employees reported by these two sources. The real percentage increase in the wage component of public consumption is based on National Insurance Institute data and on the change in the number of hours worked per employee, as measured in the labor force surveys (see also the Bank of Israel Annual Report for 1979, p. 186).

Table V-5

CONSUMPTION OF CIVILIAN PUBLIC SERVICES BY FUNCTION, 1969-80^a

(Percentages, at 1975 prices)

	Average annual increase					Distribution					
	1969-72	1972-74	1974-76	1976-78	1978-80	1969	1972	1974	1976	1978	1980
Education	9.5	5.8	4.9	6.0	4.7	34.5	37.0	37.4	37.8	39.2	42.7
Health	10.6	6.0	6.3	-0.3	1.5	18.2	20.2	20.5	21.3	19.7	20.0
Other welfare and social services	4.8	6.4	6.4	8.4	-8.6	19.4	18.4	18.8	19.6	21.2	17.8
Total welfare services	8.5	5.9	5.6	5.0	1.2	72.1	75.6	76.7	78.7	80.1	80.5
Economic and other services	2.0	2.8	-0.3	0.0	0.2	27.9	24.4	23.3	21.3	19.9	19.5
Total public civilian and nonprofit institution consumption	6.8	5.2	4.3	3.9	1.0	100.0	100.0	100.0	100.0	100.0	100.0

^a The estimates of total public consumption and consumption of nonprofit institution services are based on Central Bureau of Statistics data. The rates of increase in the components of public civilian services were calculated for 1969-78 on the basis of public civilian expenditure by function, and for 1978-80 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.

1980, in line with the trend begun in 1978. Here too most of the increment was connected with the military redeployment in the Negev, while other purchase and construction items hardly went up and the number of persons on the defense establishment payroll held steady.

An overall economic appraisal of the defense bill necessitates a multiyear analysis which takes into account the economic constraints facing the country (such as the energy crisis), as well as defense imports and military grants and loans.

There are two aspects to the defense burden: one is the timing of the expenditures themselves, and the other is the repayment schedule of the related financing. Outlays in a given year may be financed by loans which fall due at a later date, and so it is possible to defer repayment, thereby spreading the financing burden more evenly over the years.

A conventional yardstick of the defense burden (but not its financing) is the weight of total noncivilian consumption (domestic and imports) in GNP. This indicates the extent to which the economy can cover the defense bill from its own resources. A glance at column 1 in Table V-6 shows that the Six Day War (1967) marked a turning point in Israel's defense expenditures: they swelled both absolutely and relative to GNP, so that in 1971-72 the weight of total noncivilian consumption was more than double the figure for 1964-66. It should be noted that even in the period before the Six Day War defense took a bigger slice of GNP than in other countries.

After the Yom Kippur War (1973/74) defense spending spurted to an all-time high. Subsequently it abated, both absolutely and relatively. This lasted until 1978; in the past two years the level eclipsed that between the Six Day and Yom Kippur Wars. This measure does not reflect the diminished ability of the economy to shoulder the defense burden because of the terms of trade deterioration caused by the energy crises of 1973-74 and 1979-80. The country's oil bill jumped from 1-2 percent of GNP at the beginning of the decade to 10-11 percent in 1980.

An indicator of the impact of the defense burden on domestic activity is the weight of domestic noncivilian consumption in GNP. The picture here resembles that for total noncivilian consumption, except that the downswing since the Yom Kippur War has been more moderate: in the past two years such expenditures accounted for about 15 percent of GNP, as opposed to 13 percent in 1968-72. Another important aspect of the defense burden is the amount of manpower tied down in the defense establishment. An indicator of this is the weight of defense in the economy's total wage bill; in recent years this has moved up (see column 3 in Table V-6).¹⁴ The increase in domestic defense

¹⁴ This indicator does not measure the weight of the defense establishment in total employment, since the wages of military personnel—the regular army, reservists called up for their spell of duty, and conscripts—differ from the average wage in the economy.

Table V-6
INDICATORS OF DEFENSE EXPENDITURES, 1964-80
(Percentages, at current prices)

	Weight in GNP and unilateral transfers					Domestic defense ex- penditures, foreign currency ex- penditures, ^b and loan repayment ^c (6)
	Weight in GNP		Weight of defense in total wages (3)	Total noncivilian consumption		
	Total noncivilian consump- tion (1)	Domestic noncivilian consump- tion (2)		Incl. grants ^a (4)	Excl. grants ^a (5)	
1964-66	10	6	5	9	9	
1967	18	10	8	16	15	
1968-69	19	12	8	17	17	
1970	25	14	9	23	19	19
1971-72	22	14	9	19	17	16
1973-75	33	17	11	29	21	19
1976-78	27	15	10	24	18	18
1979-80	24	15	10	21	16	18
1978	27	14	9	24	18	16
1979	23	15	10	20	15	18
1980	25	15	10	23	17	17

NOTE: Columns 1 to 5 are based on the definition of the CBS National Accounts Department.

^a Includes the grant equivalent of U.S. government defense loans; unilateral transfers are deducted from U.S. government grants and the grant equivalent of U.S. government loans.

^b Expenditures in freely usable foreign currency; i.e. other than foreign defense-related grants and other military assistance.

^c The estimates in column 6 are based on government budget data, adjusted to calendar years.

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

outlays makes it hard to tame inflation and divert more resources to the export sector.

Israel finances part of its defense spending with the help of American military assistance, given in the form of direct grants and loans, most of them subsidized.¹⁵ Since the Yom Kippur War such aid has increased significantly. On the other hand, there has also been a steep rise in the servicing of the defense-related debt.

¹⁵ Most U.S. government loans carry interest below the going market rate. The grant equivalent of this credit can be estimated by comparing the present value of the stream of repayments with that for loans granted on regular commercial terms (see also Oded Liviatan, "Israel's External Debt", Bank of Israel *Economic Review*, No. 48-49).

The defense financing burden can be measured in two ways. One is total non-civilian consumption less U.S. military grants; the second is the sum of domestic defense expenditures, outlays in freely usable foreign currency, and the servicing of the defense-related debt.¹⁶ These two yardsticks show that fluctuations in the defense financing burden are smaller than those in noncivilian consumption itself. The actual financing burden in recent years has therefore probably not differed much from that before the Yom Kippur War. It must nevertheless be stressed that the absolute level of defense spending is very high, compared with both other countries and before the Six Day War.

(c) Dwelling and Nondwelling Investment

Budget cuts slashed public sector nondwelling investment by 14 percent in 1980, with public services being most affected (22 percent), and to a lesser degree public sector enterprises (4 percent).

Capital expenditure on domestically produced goods was down 12 percent, the net result of a decline in buildings and an increase in equipment.

Residential starts initiated by the public sector fell off in 1980. This is explained by the drawn-out negotiations between the Housing Ministry and construction companies, in which the Ministry attempted to lower construction prices.¹⁷ On the other hand, investment in housing construction shot up 50 percent; this stands out glaringly against the general slackening of the sector's demands, and is largely explained by the volume of starts in previous years.¹⁸

¹⁶ The assumption underlying this measurement is that defense loans are specific loans which would not have been given for other purposes. Their burden is estimated according to the actual repayment schedule; the imports financed by these loans are not directly included in the calculation. This is one logical way of distributing the defense import burden over a number of years. But the choice of this method is somewhat arbitrary, as a good case can be made for methods based on other assumptions—e.g. that repayments of principal (and perhaps even interest) are rolled over, or that repayments of supplementary loans, which are not officially defined as defense loans, should be added to defense loan repayments. The conclusions reached using this measure alone should therefore be treated with some caution.

¹⁷ The opposite situation prevailed last year, when the Housing Ministry, in an attempt to encourage construction, promised the companies it would buy up unsold homes at fairly high prices (see also Figure III-5).

¹⁸ 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 (some 60 percent) is made in the second year, and only 20 percent each in the first and, third year.

3. TAXES, TRANSFER PAYMENTS, AND SUBSIDIES

The system of taxes, subsidies, and transfer payments has undergone many major changes in recent years, most notably the income tax reform (1975/76), the introduction of VAT as the principal indirect tax on domestic production (1976), and the revision of foreign trade taxation following the foreign currency liberalization (1977).

Transfer payments have also changed considerably, with the increase in the number of eligible groups and the raising of the rates in 1973–75 bringing up the weight of payments to households and nonprofit institutions¹⁹ from 10 percent of GNP in 1971–72 to 14 percent in 1977. In 1978, however, the trend was reversed, and the weight of such payments has since been on the decline.

A new form of subsidy has appeared in recent years—the imputed subsidy component of credit for domestic and export production. The credit granted directly and indirectly by the public sector to the private sector, mostly for financing productive investment and the purchase of housing, generally carried interest at a below-market rate. The interest was not fully adjusted to the nominal increase in interest rates in recent years (to allow for the acceleration of inflation), and consequently the subsidy element in such credit rose steadily until 1979.²⁰

According to Central Bureau of Statistics estimates, the credit subsidy to business in 1979–80²¹ amounted to about half of total subsidies and transfer payments. There is no CBS estimate of the subsidy given in the form of cheap housing loans to households, but it has reached sizable dimensions: a Bank of Israel estimate puts it at roughly IS2 billion for 1980 (compared with IS8.7 billion for regular transfer payments to households).

Despite the numerous changes in taxes, subsidies, and transfer payments, the tax burden²² exclusive of the credit subsidy did not vary much during the past decade, although in the last two years it was above-average. The credit subsidy to business alters the picture drastically, sharply reducing the tax burden in

¹⁹ Current transfer payments (gross) to households and nonprofit institutions, with the child allowance revised for 1971 and 1972, and excluding transfers of employers' matching contributions. (The collection and transfer of the matching contributions began in 1973; to render the data comparable with earlier years, the contributions must be deducted from the other transfers.)

²⁰ It has not yet been decided how to incorporate this subsidy item in the national accounts. Among other problems, the relative share of this item and that of transfer payments in the total subsidy component of credit have not yet been determined. In this chapter they are treated as subsidies (see also Chapter II, note 4 and section 8).

²¹ In 1980 the subsidy contracted in real terms owing to the erosion of the stock of cheap loans and the granting of new loans at higher interest and linkage rates.

²² The tax burden is defined as taxes less subsidies and transfer payments (excluding taxes on direct defense imports and compulsory loans).

recent years in comparison with the start of the decade.²³ In 1980 the burden (including the credit subsidy) again turned up, reaching 15 percent of GNP as against 12 percent in the previous year.

Net direct tax revenue also rose in 1980, since income tax and national insurance contributions on wage income went up faster than the growth of such income, and the increase in transfer payments was relatively moderate (those to nonprofit institutions fell, while payments to households rose 5 percent, after declining in the previous two years).

In 1980 import taxes yielded less real revenue than in the previous year, owing to a change in the import mix and a decline in volume. Export subsidies in the form of cheap directed credit were up 31 percent.

In recent years inflation has confronted the system of taxes, subsidies, and transfer payments with formidable challenges, the most prominent one being the change in net liquidity absorption from the public. In the case of some components inflation has resulted in a larger absorption: until 1980 the adjustment of income tax brackets lagged behind the rate of inflation (they were updated only twice a year and for only 70 percent of the rise in prices). The result was an increase in income tax collections on income from labor (including the self-employed). There was also a larger revenue from some companies because of the taxing of inflationary profits. Most transfer payments to households were eroded by inflation, and this too pumped out more money from the economy.

On the other hand, the income ceiling for national insurance contributions was eroded since it was adjusted only twice a year. In addition, some business firms enjoyed inventory income tax relief, but the growth of the credit subsidy had the greatest impact of all. On balance, in recent years inflation eased the tax burden.

The influence of inflation on the tax system must also be gauged from the aspect of income distribution: the credit subsidy does not lead to a more equal distribution of income and wealth. Some groups in the business sector pay less taxes because of inflation and subsidized loans, while others pay tax on illusory (i.e. nominal but not real) profits. In a period of rapid and protracted inflation it is necessary to mitigate the effects of inflation on the tax system as well as on subsidies and transfer payments, so that the tax burden, which also serves social and economic goals, remains at a desirable level.

A number of steps in this direction were taken in 1980. The indexation of transfer payments and income tax rates was adjusted, efforts were made to check the growth of directed credit, and a bill was drafted for adjusting company income tax rates in inflationary periods.

²³ Estimates of the credit subsidy to business are available from 1975 onward. The subsidy existed before then, but the total amount was small compared with the post-1975 period.

Table
TAXES, SUBSIDIES, AND

(Percentages, at

	Weight		
	1970-74	1975-77	1978-80
A. Tax burden^b			
Excl. credit subsidy	22	19	23
Incl. credit subsidy	..	12	14
Total taxes	41	45	46
Total direct subsidies and net transfer payments	19	26	23
Subsidy component of credit	..	7	9
B. Net direct taxes and transfer payments^c	8	5	4
Direct taxes	17	22	24
Thereof: Income tax	12	16	17
Transfer payments to the public and non-profit institutions ^d	10	14	14
C. Net indirect taxes on domestic production	8	2	3
Indirect taxes	10	13	14
Direct subsidies on domestic production ^e	2	3	3
Credit subsidy on domestic production	..	7	7
D. Taxes on foreign trade			
Net taxes on civilian imports	9	9	8
Taxes on defense imports	2	2	1
Direct export subsidies ^f	3	4	0
Export credit subsidy	3

^a Deflated by the consumer price index.

^b Civilian taxes (excluding taxes on direct defense imports), less subsidies and transfers. Taxes do not include compulsory loans, and subsidies do not include compulsory loan repayments.

^c Income tax, compulsory loans, national insurance contributions, and inventory surtax, less transfer payments to the public, nonprofit institutions, and businesses, interest, and transfer payments from the public.

TRANSFER PAYMENTS, 1970-80

current prices)

in GNP					Percent annual real increase ^a			
1976	1977	1978	1979	1980	1977	1978	1979	1980
23	20	20	24	24	-7	11	24	2
14	12	13	12	15	-14	23	0	23
49	47	45	47	47	4	2	11	0
26	27	24	23	22	13	-5	0	-2
8	8	7	12	9	7	-6	69	-20
5	4	3	5	7	-15	-31	111	26
24	24	23	24	26	6	5	12	8
17	16	16	17	18	1	4	15	8
15	15	15	14	13	12	5	-1	-4
2	2	4	1	5	-10	128	-65	304
14	13	13	14	14	3	7	9	2
3	3	3	4	3	3	12	10	-15
8	8	6	9	6	7	-23	57	-36
10	10	8	9	7	1	-12	14	-20
3	2	1	1	1	-27	-35	-36	27
4	4	0	0	0	29	16	47	-9
..	..	1	3	4	123	31

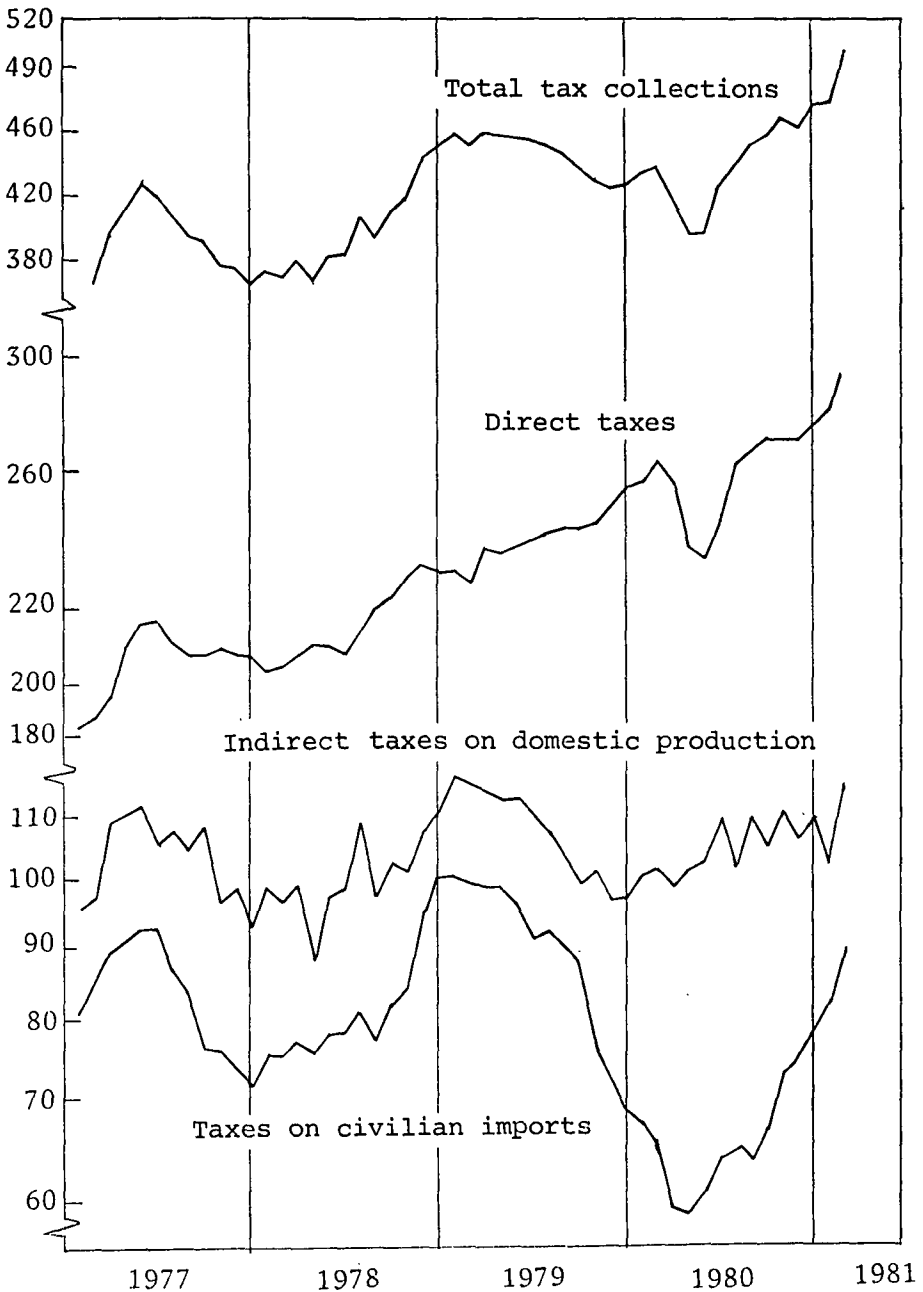
^a Gross current payments.^e Excludes the credit subsidy.^f Excludes the credit subsidy; estimates of the credit subsidy exist from 1975 for domestic production and from 1978 for exports.

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

Figure V-1

TAX REVENUE, 1977-81

(IS million, three-month moving average of seasonally adjusted data, at 1976 prices)



Semilogarithmic scale.

(a) Direct Taxes

Total direct taxes (income tax, national insurance contributions, and inventory surtax) rose 8 percent in real terms in 1980,²⁴ outpacing the growth of GNP and national income. Direct tax revenue has moved up in recent years, only slightly influenced by swings in the business cycle. This trend continued

Table V-8
DIRECT TAXES, 1970-80
(Percentages, at current prices)

	1970-75	1976	1977	1978	1979	1980
Weight of total direct taxes						
In wage income	26	27	28	27	28	33
In gross nonwage income, excl. credit subsidy	24	38	35	33	38	37
In gross nonwage income, incl. credit subsidy	23	30	28	28	28	31
Weight of income tax						
In wage income	9	14	14	13	14	18
In gross nonwage income, excl. credit subsidy	18	33	29	28	33	32
In gross nonwage income, incl. credit subsidy	18	26	23	23	24	26

Definitions:

Taxes: Direct taxes on wages are defined as income tax, national insurance contributions, 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; inventory surcharges; and national insurance contributions of self-employed and company directors.

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 and members of cooperatives.

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

²⁴ The real rates of change presented in the text and the tables are based on an annual deflation of the nominal data. A number of tax items can be deflated monthly. In some cases this would result in significant differences; for example, whereas collections of VAT on domestic production fell by 1.5 percent when calculated according to an annual deflation, a monthly deflation would show a 5 percent decrease.

in 1980, with a greater-than-average fluctuation in the second quarter.²⁵ In the final quarter receipts were 11 percent higher in real terms than in the same period in 1979.

As in 1979, income tax collections—particularly on wages, which jumped 16 percent in real terms—expanded faster than national insurance contributions. Average direct taxes on wage income increased in each of the past two years.²⁶ Two factors were responsible for this: a rise in the effective income tax rates because of the erosion of tax brackets, and a more efficient collection. The average national insurance contribution rate also went up in 1980, after declining in the previous year.

The rate of direct taxes on nonwage income rose significantly in 1979, and plateaued at this level in the year reviewed. If we subtract from direct taxes transfer payments to business on capital account and the subsidy component of cheap credit, the change in the tax rate on nonwage income was negligible. It should be noted that nonwage-income-earners are not a homogenous group—some benefit from inflation through reduced tax payments and receipt of the credit subsidy, while others are much more heavily taxed because of the aggravation of inflation.

The differential taxation of the factors of production favors investment in capital over the use of labor, and so it is liable to disrupt the economy's priorities. The differential taxation of nonwage income has a similar detrimental effect.

*Income Tax*²⁷

Total income tax revenue expanded nominally by 150 percent in 1980, surpassing the growth of GNP (133 percent) and national income (130 percent). As in the previous year, collections on wage income grew faster than those on nonwage income (real increases of 17 and 2 percent respectively). The precipitate rise in 1980 in income tax receipts from employees despite the drop in real wages is surprising. Considering that income tax collections are statistically recorded one to two months later than wages, adjusting for this time lag would result in a still larger gap.

²⁵ This deviation was caused by a decline in income tax collections on wage income in April and May.

²⁶ It should be noted that in Table V-8 direct taxes comprise, in addition to income tax and national insurance, the employers payroll tax, which does not differ essentially from national insurance contributions.

²⁷ Income tax revenue is defined here as total gross collections, less tax loans, refunds, canceled receipts, and outstanding obligations under the payments arrangements (the granting of credit to assesseees for income tax payments). The Income Tax Authority includes the last item in total tax revenue, but the Bank of Israel treats it as credit and does not include it in the revenue data. This item is calculated on the basis of the commercial banks' reports, which differ from those of the Income Tax Authority.

Income tax brackets for labor income were updated four times in 1980 (compared with two adjustments the year before), and at a higher rate. This helped to retard the erosion in the effective tax rate. The effect of the decline in real wages combined with the more frequent and higher rate of adjusting tax brackets is presented in Table V-9; it shows that there was no real increase in the tax paid by the individual employee in 1980.

The State Revenue Administration attributes the discrepancy between the average income tax paid by the individual and the increase in total income tax collections on wages to a more efficient collection—the shortening of the period for transmitting at-source deductions, the stiffening of the interest and penalties paid by employers for failure to transmit such deductions on time (the interest and penalties are included in the estimated taxes collected on wages), and various measures to enforce these transfers (investigatory orders and legal action against private employers, local authorities, and nonprofit institutions). No data are available for assessing the success of these measures. If the Administration's explanation is correct, then the effective rate of tax on nonwage-income-earners actually increased.²⁸

Income tax revenue from nonwage income rose 2 percent in 1980. The breakdown between self-employed and companies (presented in Table V-A1) does not fully reflect the change, since the at-source deductions item relates primarily to these two groups (such deductions increased 40 percent in 1980). Nevertheless, it is clear that real income tax receipts from companies dropped significantly this year. This can be ascribed partly to the inventory tax concessions enjoyed by industrial companies and partly to other tax shelters.

The income tax reform introduced in 1975 laid the groundwork for adjusting tax rates on labor income to inflation. No such adjustment was made in the case of profits. The accounting system presently used by companies does not make allowance for the influence of inflation, which results in the payment of tax even on illusory profits. To help compensate for this, industry has been granted tax relief on inventories, and the suggestion has been made (and will probably be accepted) that the self-employed and companies be allowed a reduction in income tax payments for 1980/81. These concessions do not really solve the problem of taxing profits in an inflationary period, since they create inter-company differentials and reduce the Treasury's income tax receipts. The committee appointed to study this problem has submitted its recommendations, and the requisite legislation is being prepared.

²⁸ It may be that in addition to these factors there was a change in income distribution within the wage-earner group, which could cause an increase in income tax collections on wages.

Table V-9
GROSS WAGES, TAXES, AND NET WAGES PER EMPLOYEE POST,^a 1976-80
 (Percentages)

	Weight in gross wages						Percent annual real increase ^b				
	1976-80	1976	1977	1978	1979	1980	1976	1977	1978	1979	1980
A. Average actual wage											
Income tax ^c	16	13	14	15	19	19	79	21	6	39	1
Net taxes ^d	13	8	10	12	17	18	163	37	14	62	3
Net wages	87	92	90	88	83	82	6	8	0	3	-5
B. Average real wage^e											
Income tax	14	13	14	13	15	16	28	-2	0	18	11
Net taxes	10	8	8	9	12	14	75	-3	8	40	19
Net wages	90	92	92	91	88	86	-7	0	-1	-4	-3
C. Double the actual average wage											
Income tax	28	23	26	27	32	32	67	22	7	30	-1
Net taxes	28	22	25	26	32	34	82	24	9	32	3
Net wages	72	78	75	74	68	66	1	6	0	1	-6
D. Double the real average wage^e											
Income tax	25	23	24	24	27	29	28	-2	0	18	11
Net taxes	25	22	23	24	27	29	75	-3	8	40	19
Net wages	75	78	77	76	73	71	-7	0	-1	-4	-3

^a Employee post as defined by the National Insurance Institute.

^b Deflated monthly by the consumer price index.

^c Assuming that the employee's wife does not work and that there are no other deductions or credits.

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

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

SOURCE: Central Bureau of Statistics and Bank of Israel.

National Insurance

National insurance contributions rose 6 percent in real terms in 1980. All the increment was accounted for by employees,²⁹ while collections from nonwage-earners held steady.

The income ceiling for national insurance was raised in April 1980 from two times the average wage in the economy to three times the average wage. Since this ceiling is adjusted only twice a year, the average effective ceiling between April and December 1980 was only 2.3 times the average wage.

(b) Direct Transfer Payments

After dipping 2.9 percent in 1979, transfer payments rose 2.7 percent in the year reviewed to regain their high 1978 level, which was the product of an average annual 11 percent increase between 1975 and 1978.

Transfer payments to households were up 5 percent, due entirely to a sizable 8 percent rise in National Insurance Institute payments after three years of stability. Apart from the child allowance, the growth encompassed all benefit groups (old-age and survivors, general disability, work injury, maternity, and unemployment). This year the disability allowances and the guaranteed minimum income were updated with every 5 percent increase in the consumer price index, instead of 10 percent previously. This resulted in nine adjustments during the year, which increased the purchasing power of the benefits by 12 percent. The child allowance, on the other hand, was updated only twice during the year, and at rates which led to an erosion of 9 and 13 percent in its purchasing power (for families with two and four children respectively).

Unemployment benefit payments also swelled in 1980—from IS8 million the year before to IS90 million. The main reason was a jump in the number of jobless, as reflected by the larger number of days for which benefits were paid—1.6 million in 1980 as opposed to 270,000 in 1979. Another factor was the real 16 percent increase in the average daily benefit paid.

After moving up three years at an accelerated rate (an average of 14 percent), payments to nonprofit institutions inched down 1.5 percent in 1980. National Insurance Institute payments to the Sick Funds (employers' matching contributions) came to IS1.6 billion this year (28 percent of total expenditure in this item).

As part of the effort to increase the Sick Funds' own-income, the employers' matching contributions were raised from 3.95 percent of wages in 1979 to 4.95 percent. This item largely constitutes a substitute for direct transfers to the Funds, which shrank 7 percent in real terms this year. Transfers to business on

²⁹ National insurance contributions amount to about three-quarters of income tax collections on wages (including the imputed wages of company directors listed as salaried employees).

Table V-10
ESTIMATED EROSION OF VARIOUS ALLOWANCES, 1976-80
 (Average monthly allowance at 1975 prices, in IS)

	July 1975 to March 1976 ^a	1977	1978	1979	1980	Percent real increase				1980 as against July 1975
						Annual				
						1977	1978	1979	1980	
Deflated by the consumer price index										
Allowance for family with 2 children	18.6	18.1	17.4	15.4	14.0	-1.1	-3.9	-11.5	-9.1	-24.7
Allowance for family with 4 children ^b	55.8	57.8	54.8	51.0	44.5	3.6	-5.2	-6.9	-12.7	-20.3
Income maintenance for single persons ^c	55.3	52.9	52.7	54.3	60.9	-4.3	-0.4	3.1	12.2	10.1
Deflated by the index of average wages per employee post										
Allowance for family with 2 children	18.3	16.4	15.5	12.3	11.9	-10.4	-5.5	-20.6	-3.3	-35.0
Allowance for family with 4 children ^b	57.2	52.5	48.8	41.0	37.8	-8.2	-7.0	-16.0	-7.8	-33.9
Income maintenance for single persons ^c	54.5	48.0	47.0	43.9	51.5	-11.9	-2.1	-6.6	17.3	-5.5

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

^b Including the allowance for veterans.

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

SOURCE: Bank of Israel calculations.

capital account were 19.3 percent up on 1979, the result of a 10 percent increase in grants given under the Law for the Encouragement of Capital Investments and the payment of IS360 million to inhabitants of Yamit, who are being relocated following the signing of the peace agreement with Egypt.

(c) Indirect Taxes on Domestic Production

Indirect taxes on domestic production rose 2 percent in real terms in 1980. Excluding government property tax and local authority rates (which are not directly related to current economic activity), there was a 2 percent drop. The changes in this item³⁰ reflect the flagging of economic activity in 1979 and early 1980. In the second half of the year revenue from this source picked up with the recovery of domestic activity.

Employers Tax

The employers tax is included in indirect taxes by the Central Bureau of Statistics. In 1980 it was abolished for industry, agriculture, hotels, residential buildings, and family-owned companies.³¹ Elsewhere it was hiked from 4 to 7 percent.³² The increase in commerce and services outweighed the exemptions, and consequently this item yielded 13 percent more real income this year. There is no essential difference between the employers tax and income tax on labor or national insurance contributions. Taxing labor more heavily in comparison with capital has undesirable repercussions.

Value Added Tax

In the past two years the share of VAT in total indirect taxes on domestic production reached 40 percent. In 1980 revenue from this source fell 1.5 percent³³ following the slowdown in economic activity, and especially the decline in private consumption, the main component of this tax base.

VAT is levied mostly on private consumption, government and nonprofit institution purchases, and home acquisitions. A comparison of potential with actual collections shows a close correspondence between the two.

³⁰ See Figure V-1. Indirect taxes on domestic production in this diagram do not include local authority rates, postal and port surpluses, and taxes on earmarked income.

³¹ The reference is to persons employed in family companies whose stock they own. Partial (and smaller) exemptions were given in the past—to approved industrial enterprises in development areas and export enterprises in industry, tourism, and the hotel trade.

³² The tax remained at 4 percent for international shipping companies and airlines.

³³ A decline of 5 percent on a monthly deflation basis.

Table V-11
INDIRECT TAXES AND SUBSIDIES ON DOMESTIC PRODUCTION, 1976-80
 (IS million)

	1976	1977	1978	1979	1980	Percent annual real increase ^a			
						1977	1978	1979	1980
A. Total indirect taxes on domestic production	1,353	1,878	3,016	5,852	13,781	3.1	6.6	8.8	1.9
Taxes on economic activity	968	1,373	2,244	4,445	10,093	5.4	8.5	11.1	-1.7
Value added tax	154	439	1,033	2,223	5,066	111.8	56.2	20.7	-1.4
Purchase tax	313	303	366	562	947	-28.1	-19.8	-13.9	-27.1
Fuel tax	157	167	188	448	956	-21.0	-25.2	33.6	-7.7
Employers tax	117	202	331	726	2,130	28.3	8.8	23.0	-27.0
Other taxes on economic activity ^b	227	262	326	486	994	-14.3	-17.4	-16.4	-11.5
Property tax	155	168	201	346	863	-19.5	-20.6	-3.5	7.9
Local authority rates	155	169	264	479	1,260	9.2	3.7	1.8	13.8
Other taxes ^c	155	168	307	582	1,565	8.5	21.3	6.3	16.4
B. Subsidies on domestic production	1,137	1,617	2,120	5,293	8,563	5.7	-12.9	40.0	-30.0
Direct subsidies	330	458	770	1,511	2,971	3.1	11.6	10.1	-14.9
Imputed credit subsidy ^d	807	1,159	1,350	3,782	5,592	6.7	-22.7	57.1	-36.0
C. Net taxes on domestic production									
Excl. imputed credit subsidy	1,023	1,420	2,246	4,341	10,810	3.1	5.0	8.4	7.8
Incl. imputed credit subsidy	216	261	896	559	5,218	-10.2	128.0	-65.0	303.9

^a Deflated by the consumer price index, annual average.

^b Tobacco and cement excise, revenue stamp tax, various fees and licenses, defense stamp tax.

^c Post and ports surpluses and taxes on earmarked income.

^d In 1976 and 1977 includes respectively IS89 million and IS180 million imputed export credit subsidy.

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

Fuel Tax

The steep jump in the world market prices of oil were largely passed on to domestic consumers this year. At the same time the effective tax rates were lowered: this source yielded roughly IS1 billion in 1980, down 8 percent in real terms. The Fuel Equalization Fund, which was in equilibrium in most of the preceding years, wound up the year reviewed with a deficit (this constitutes a subsidy to the public).

Taking taxes and subsidies together, revenue from this source has been on the decline in recent years.³⁴

(d) Subsidies on Domestic Production and Exports

Total subsidies on domestic production rose nominally from IS5.3 billion in 1979 to IS8.6 billion, but in real terms they fell by a steep 30 percent after soaring 40 percent in 1979. The downturn occurred in the two basic components: the direct subsidization of domestically produced goods and services as customarily defined was reduced by 15 percent, while the subsidy component of credit for domestic production declined 36 percent.

At the end of 1979 basic commodities were desubsidized with the exception of public transportation and bread. The full effect of this measure was felt in 1980, when domestic production subsidies dipped 14.9 percent, although at the end of the year and the start of 1981 they turned up again. The annual average rise in basic commodity prices outraced the consumer price index (131 percent): milk shot up 252 percent, oils and margarine—223 percent, public transportation—212 percent, bread—182 percent, and eggs—179 percent.

The deficit in the Fuel Equalization Fund stood at about IS500 million this year, compared with IS100 million in 1979. Although the retail prices of refined petroleum products far eclipsed the rise in the consumer price index, they lagged behind the cost of imported crude, which soared 320 percent. This was accompanied by a larger consumption of the subsidized products (distillate and residual fuel oil) and a smaller consumption of heavily taxed gasoline, a development which increased the total subsidy on refined petroleum products. The deficit in the Fuel Equalization Fund grew substantially in the early part of 1981.

The other component item is, as stated, the imputed subsidy component of cheap credit, which is given to business either directly by the government or in accordance with its directives through financial institutions and the Bank of Israel, at a nominal interest well below the going free market rate. The subsidy³⁵ totaled IS9.1 billion in 1980 (IS3.5 billion for exports and IS5.6 billion for

³⁴ Including value added tax. These calculations are for total fuel marketed. There is a relatively high tax on gasoline, while other refined petroleum products are subsidized.

³⁵ The imputed credit subsidy during the year is in principle equal to the present value of the difference in the subsidy component between the beginning and the end of the year.

Table V-12
INFLUENCE OF INFLATION ON PRIVATE WEALTH, 1976-80
 (IS million, at current prices)

	1976	1977	1978	1979	1980	Percent annual real increase ^a			
						1977	1978	1979	1980
1. Total outstanding cheap credit to businesses (annual average)	3,218	4,275	6,624	10,513	20,585				
2. Subsidy component of such credit	807	1,159	1,644	4,949	9,121	6.7	-5.8	68.8	-20.2
3. Thereof: For domestic production	718	979	1,351	3,782	5,592	1.3	-8.4	57.0	-36.0
4. Thereof: For exports	89	180	293	1,167	3,529	50.3	8.0	123.3	30.9
5. Monetary base narrowly defined (annual average)	865	1,314	1,703	2,150	3,650				
6. Inflationary erosion of monetary base ^b	253	400	597	1,570	2,984	17.5	-0.9	47.5	-17.7
7. Nonindexed loans to households (end-of-year balances)	810	1,010	1,330	2,110	2,512				
8. Subsidy component of such credit	217	277	405	1,163	1,992	-5.2	-2.9	61.1	-25.9
9. Increase in private wealth (2+8-6)	771	1,036	1,452	4,542	8,129	-0.2	-6.9	75.4	-22.5

^a Deflated by the consumer price index.

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

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

domestic production); this represented a real decline of 36 percent, all of which was accounted for by domestic production credit, as most of the new loans were linked.

Besides business, unlinked loans are granted to households. At the end of 1980 these totaled IS3.2 billion, and the imputed subsidy came to IS2 billion. With the linkage of housing loans, the balance tumbled 20 percent in real terms by the end of the year, accompanied by a 25 percent drop in the imputed subsidy.

The private sector owns unlinked financial assets (the narrowly defined monetary base), whose value is eroded by inflation. The rapid acceleration of inflation in the past two years depressed demand for these assets, and their average balance fell 26 percent, following a 30 percent contraction in 1979. In the latter year the escalation of inflation was faster than the decline in the narrow monetary base and in loans granted to households. By contrast, in 1980 the increase in the inflation rate did not match the percentage decrease in these assets, and consequently the monetary base eroded 18 percent.

The net effect on private wealth of the credit subsidy to business and households, after discounting the erosion of the monetary base, was a decline of 23 percent, following a 75 percent appreciation in 1979. It seems that the impact of this factor (in real terms) peaked in 1979, and that further real steep declines may be anticipated in the coming years.

(e) Import Taxes

The downturn in imports in 1980 (and the slackening of growth in the second half of 1979) was severest in private consumption goods, which are heavily taxed. This sharply pulled down real tax revenue from civilian imports, especially customs duties and purchase tax. In the second half of 1980 the trend began to turn steeply upward (see Figure V-1).

The weight of customs duties fell relative to purchase tax.³⁶ This is attributable primarily to the various international agreements which provide for the mutual lowering of customs barriers.

Besides their fiscal function, import taxes serve to protect domestic production. There is considerable differentiation in customs tariffs, which results in the oversheltering of certain industries. What is more, while the purchase tax is ostensibly imposed at equal rates on imports and local manufactures, the value of the goods subject to purchase tax is calculated differently in the two cases, with the consequence that the effective rate on domestic goods is lower than that on imports.

³⁶ From 1978 to 1980. Until 1977 the import levy was included in the customs estimate.

Table V-13

TAXES AND SUBSIDIES ON IMPORTS AND EXPORTS, 1976-80
(IS million, at current prices)

	1976	1977	1978	1979	1980	Percent annual increase			
						1977	1978	1979	1980
1. Taxes on civilian imports	1,034	1,418	1,904	3,851	6,860	37.1	34.3	102.3	78.1
Value added tax	100	303	743	1,457	2,941	203.0	145.2	96.1	101.9
Customs ^a	495	591	525	1,010	1,619	19.4	-11.2	92.4	60.3
Purchase and other taxes ^b	439	524	636	1,384	2,300	19.4	21.4	117.6	66.2
2. Import subsidies	30	58	97	169	66	93.3	67.2	74.2	-60.9
3. Net taxes on civilian imports (1-2)	1,004	1,360	1,807	3,682	6,794	35.5	32.9	103.8	84.5
4. Taxes on defense imports	250	244	338	383	1,123	-2.4	38.5	13.3	193.2
5. Total export subsidies	345	601	324	1,248	3,699	74.2	-46.1	285.2	196.4
Direct subsidies	345	601	31	81	170	74.2	-94.8	161.3	109.9
Imputed credit subsidy ^c	—	—	293	1,167	3,529	—	—	298.3	202.4
6. Net taxes on civilian foreign trade (3-5)	659	759	1,483	2,434	3,095	15.2	95.4	64.1	27.2

^a In 1976 and 1977 includes the import levy.

^b Other taxes (in IS million):

	1976	1977
Levy on service imports	45	37
Foreign travel tax	28	34
Fuel levy	81	85

^c Central Bureau of Statistics estimates. These differ from the estimates in Chapter VII — see the note to Table VII-17.

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

APPENDIX TABLES

Table V-A1
DIRECT TAXES, COMPULSORY LOANS, AND TRANSFER PAYMENTS, 1976-80
 (IS million)

	1976	1977	1978	1979	1980	Percent annual real increase ^a			
						1977	1978	1979	1980
1. Income tax	1,684	2,289	3,602	7,382	18,482	1.0	4.5	14.9	8.4
Wages	624	956	1,412	3,119	8,415	13.8	-1.9	23.9	16.8
Nonwage income	1,060	1,333	2,190	4,263	10,067	-6.6	9.1	9.2	2.2
Companies	558	594	957	1,866	3,556	-20.9	7.0	9.4	-22.1
Self-employed	205	298	511	971	2,207	8.0	13.9	6.6	-1.6
Company directors and members of cooperatives	81	161	236	580	1,570	47.7	-2.7	37.8	17.2
Deductions at source	216	280	486	846	2,734	-3.7	15.3	-2.4	39.9
2. National insurance contributions	615	961	1,575	2,997	7,342	16.1	8.9	6.7	6.1
Wages ^b	568	888	1,456	2,783	6,851	16.2	8.7	8.0	6.6
Nonwage income	47	73	119	214	491	15.3	8.0	0.5	-0.7
3. Inventory surtax	28	61	52	36	65	58.8	-43.4	-61.3	-21.8
4. Total direct taxes (1+2+3)	2,327	3,311	5,229	10,419	25,889	5.7	4.9	11.7	7.6
5. Compulsory loans	157	193	297	634	183	-8.7	2.2	19.7	-85.7
Thereof: Employers saving loan	114	181	289	628	181	18.0	6.0	21.9	-85.7
6. Total taxes and compulsory loans (4+5)	2,484	3,504	5,526	11,049	26,072	4.8	4.7	12.1	2.2
7. Transfer payments to households	967	1,366	2,018	3,594	8,736	5.0	-1.9	-0.1	5.2
Through National Insurance Institute	634	868	1,332	2,342	5,845	1.7	1.9	-1.4	8.0
Provident fund, pension, and other transfers	333	498	686	1,252	2,891	11.1	-8.5	2.4	-0.1

8. Net transfer payments to nonprofit institutions	462	720	1,270	2,490	5,663	15.8	17.1	10.0	-1.5
Net current transfers	395	656	1,186	2,339	5,331	23.4	20.1	10.6	-1.3
Thereof: Employers' matching contributions	96	159	286	574	1,565	23.0	19.4	12.6	18.0
Transfers on capital account	67	64	84	151	332	-29.0	-12.8	0.8	-4.8
9. Capital transfers to business	74	103	164	436	1,202	3.4	5.7	49.1	19.3
10. Domestic interest payments	518	768	1,498	2,162	4,773	10.2	29.5	-19.1	-4.4
11. Redemption of compulsory loans	144	222	351	505	1,250	14.5	5.0	-19.3	7.2
12. Total transfer payments to the public (8 to 11)	2,165	3,179	5,301	9,187	21,624	9.1	10.7	-2.8	1.9
13. Transfer payments from the public	216	240	338	593	1,237	-17.5	-6.5	-1.6	-9.7
On current account	105	136	158	226	472	-3.8	-22.9	-19.8	-9.6
On capital account	111	104	180	367	765	-30.4	14.9	14.4	-9.8
14. Total net transfer payments (12-13)	1,949	2,939	4,963	8,594	20,387	12.0	12.2	-2.9	2.7
15. Net transfer payments, less compulsory loan redemption (14-11)	1,805	2,747	4,612	8,089	19,137	11.8	12.7	-1.6	2.4
16. Net transfer payments, excl. interest (14-10)	1,431	2,171	3,465	6,432	15,614	12.7	6.0	4.1	5.1
17. Direct taxes and compulsory loans, less transfer payments (6-14)	535	565	563	2,455	5,685	-21.5	-33.8	144.6	0.2
18. Direct taxes and compulsory loans, less transfer payments to households and business (17+8)	997	1,285	1,833	4,945	11,348	-4.2	-5.3	51.3	-0.7
19. Direct taxes and compulsory loans, less transfers (4-14)	378	372	266	1,825	5,502	-26.9	-52.5	284.8	30.5
20. Direct taxes, less transfer payments to households and business (19+8)	840	1,092	1,536	4,315	11,165	-3.4	-6.6	57.6	12.0

^a Deflated by the consumer price index.

^b Including contributions on account of managers' salaries.

SOURCE: Central Bureau of Statistics, Ministry of Finance, and Bank of Israel.

Table V-A2
DOMESTIC DEMAND SURPLUS, 1976-80
 (IS million, at current prices)

	1976	1977	1978	1979	1980	Percent annual real increase ^a			
						1977	1978	1979	1980
1. Demand surplus, as customarily defined (6-12)	847	1,391	2,299	3,271	7,685	22.0	9.7	-20.2	1.7
2. Demand surplus, incl. effect of inflation on private wealth (6-16)	1,544	2,227	3,211	6,984	13,203	7.2	-4.3	22.0	-18.2
B. Direct public domestic demand									
3. Public domestic consumption ^b	2,492	3,654	5,770	11,526	26,486	-1.0	1.8	3.6	1.9
4. Public domestic investment	427	552	889	1,641	3,265	-5.1	-1.5	-0.1	-12.2
5. Residential construction initiated by the public sector	315	215	262	719	2,784	-47.7	-25.8	25.5	49.6
6. Total direct domestic demands (3+4+5)	3,234	4,421	6,921	13,886	32,535	-6.6	-0.3	4.0	3.1
C. Absorption									
7. Taxes ^c	4,714	6,607	10,149	20,118	46,530	4.1	2.0	11.2	0.1
8. Property and entrepreneurial income of the public sector	257	547	523	1,176	3,275	32.1	-24.0	26.1	20.6

9. Subsidies ^d	705	1,117	898	1,761	3,207	17.6	-46.7	10.1	-21.3
10. Transfer payments, less compulsory loan redemption	1,805	2,717	4,612	8,089	19,137	11.8	12.7	-1.6	2.4
11. Government subsidization of credit (actual disbursements) ^e	74	200	540	829	2,611	100.8	79.3	-13.9	36.3
12. Total absorption, as customarily defined (7+8-9-10-11)	2,387	3,030	4,622	10,615	24,850	-5.7	1.3	28.8	1.3
13. Subsidy component of credit to business sector	807	1,159	1,644	4,949	9,121	6.7	-6.0	68.9	-20.2
14. Subsidy component of credit to households ^f	217	277	405	1,163	1,992	-4.9	-3.2	61.2	-25.7
15. Inflationary erosion of monetary base ^g	253	400	597	1,570	2,984	17.1	-0.9	47.8	-17.8
16. Absorption, incl. effect of inflation on private wealth (12+11-13-14+15)	1,690	2,194	3,710	6,902	19,332	-3.5	12.3	4.3	21.3

^a Deflated by the consumer price index, except for direct public domestic demand components, which were deflated by the relevant indexes.

^b Civilian and noncivilian.

^c Direct and indirect (on domestic production and foreign trade, less compulsory loans).

^d For domestic production, exports, and imports (excl. imputed credit subsidy).

^e This sum is included in line 13.

^f The difference between a real interest rate of 4 percent and the average nominal interest rate paid by households, multiplied by the average nonindexed credit balance.

^g The decrease in the narrowly defined monetary base (annual average) as a result of inflation.

SOURCE: Central Bureau of Statistics and Bank of Israel.