

## CHAPTER X

### GOVERNMENT AND NONGOVERNMENT PUBLIC SECTOR

#### 1. MAIN DEVELOPMENTS<sup>1</sup>

The activities of the public sector caused a moderation of the pressure on domestic demands in 1976. At the same time, the restraining economic policy did not make itself felt in all segments of the sector's activity. The moderating influence stemmed from the decrease in domestic defense consumption and investments, and from a considerable growth of revenues. These were only partly offset by a parallel increase in transfer payments. In contrast, the undesirable growth of civilian public consumption continued this year, and the number of employed in these services increased.

The moderation of domestic demands led to a considerable reduction in the domestic demand surplus and to the decrease of its weight in the product, from 15 percent in 1975 to 9 percent in 1976. These developments took place against a backdrop of widening fiscal activity and quick growth in domestic demand surplus in 1973 and in 1974, followed by a certain stabilization in 1975.

The activities in the public sector in the field of credit were not uniform in 1976. The effect of the large absorption that had characterized all financial activity in previous years (especially in 1975) disappeared, although there was real reduction in credit for investments.<sup>2</sup> The mobilization of domestic credit for budget financing (mainly the sale of bonds) did not increase this year in real terms, though there was a considerable in-

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<sup>1</sup> The public sector includes the government, the local authorities, and the national institutions. The influence of the government, in the framework of its budgetary and other actions, is decisive on domestic economic activity in general, and the public sector in particular. The source of data for the assessment of domestic demand surplus is the estimates of the Central Bureau of Statistics in items where current estimates are prepared, as follows: public consumption, investments (by public sector initiative, by the authorities of the sector and the business operations of the government), current assistance to domestic production, imports, and exports, as well as indirect taxes. The other components necessary for the calculation of domestic demand surplus were estimated by the Bank of Israel. These items are: in expenditures – transfer payments to household and nonprofit institutions, transfer payments in the capital account to nonprofit institutions and businesses, and interest payments in Israel; in income – transfer revenues in the current account and capital accounts, income from property, and interest revenues in Israel. Direct taxes were estimated on the basis of data from the Department of Income and Property Tax after deducting the rise in the unpaid balance of loans to tax debtors. The source of data on liquidity injection by the public sector and credit activities are estimates of the Bank of Israel.

<sup>2</sup> Credit from the sector's budget and directed emissions; this does not include credit for financing of food inventories.

crease in repayment of the sector's domestic debt. Other public sector credit activities<sup>3</sup> injected IL 1.6 billion this year, while in 1975 they absorbed IL 2.6 billion. Despite the reduction in domestic demand surplus, a greater decline in the net absorption of credit led to growth in the liquidity injection of the public sector. The extent of the injection was IL 7.8 billion in 1976 – an amount that should be measured against about 90 percent of the money base at the beginning of the year. This injection was absorbed by monetary policy activities and the deficit in the balance of payments, simultaneously with an increase in interest rates and relatively restrained monetary expansion.

TABLE X-1  
INDICATORS OF PUBLIC SECTOR OPERATIONS, 1972-1976  
(percent, at current prices)

	1972	1973	1974	1975	1976
Weight in product of:					
1. Direct domestic demands <sup>a</sup>	30.2	33.6	36.8	36.4	33.8
2. Indirect domestic demands <sup>b</sup>	18.6	21.5	24.0	27.2	30.5
3. Total domestic demands (1+2)	48.8	55.1	60.8	63.6	64.3
4. Fiscal income <sup>c</sup>	43.7	43.7	43.7	48.3	55.6
5. Net absorption (4-2)	25.1	22.2	23.3	21.1	25.1
6. Domestic demand surplus (1-5)	5.1	11.4	13.5	15.3	8.7
7. Domestic public consumption	22.1	25.0	27.3	27.1	26.9
8. Civilian domestic public consumption	9.6	10.0	9.7	10.0	10.7
9. Domestic investments <sup>d</sup>	8.2	8.6	9.6	9.3	6.9
Other indicators:					
10. Liquidity injections relative to money base at end of previous year	-3.0	15.1	50.4	69.1	91.3
11. Weight of public consumption in total uses	20.0	25.4	23.8	25.8	24.5

a Domestic public consumption, public investments, and housing construction initiated by the public sector.

b Subsidies, transfer payments, grants, and payment of non-negotiable compulsory loans.

c Taxes, compulsory loans, transfers from the public, income from public sector assets.

d Public investments in economic sectors and housing construction initiated by the public sector.

• 3 Mainly suppliers' credit and short-term credit outside the framework of the budget.

TABLE X-2

**DOMESTIC DEMAND SURPLUS, NET DOMESTIC CREDIT ACTIVITY,  
AND PUBLIC SECTOR INJECTION, 1973-1976**  
(IL million, at current prices)

	1973	1974	1975	1976
1. Domestic demand surplus	4,291	7,327	11,557	8,266
2. Net credit granted in the sector's budgets	-2,840	-3,712	-3,417	-2,025
3. Additional net credit granted <sup>a</sup>	621	113	-2,644	1,585
4. Total net credit granted (2+3)	-3,461	-3,825	-6,061	-440
5. Injection (1+4)	830	3,502	5,496	7,826

<sup>a</sup> Including nonbudgetary activities, credit to suppliers, and short-term credit.

Subsidies, transfer payments and grants<sup>4</sup> — from which the indirect influence of the public sector on domestic demands stems — continued to grow rapidly in 1976, about 11.7 percent in terms of purchasing power. This growth reflects the freezing of the real level of price stabilizing subsidies, a decrease in transfers to nonprofit institutions, and a great increase in the other items: private transfer payments, export incentives, and domestic interest payments. The continued growth of subsidies on the one hand, and the continued stagnation of the product on the other, brought about an increase in the involvement of the public sector in the economy this year; the weight of its direct and indirect demands increased both in the product and in the domestic uses.

Restraint of the direct domestic demand of the public sector began in 1975 and was aggravated this year; real growth of direct domestic demand in 1974 was 14.5 percent, and in 1975, 1.5 percent, while in 1976 there was a decrease of 8.4 percent in this demand. (Domestic defense consumption decreased by 7.4 percent<sup>5</sup> this year, and investments initiated by the public sector in the economic sectors and in housing construction were reduced by 20.9 percent.) Thus, the weight of direct domestic demand in the product declined from 36.4 percent in 1975 to 33.8 percent this year. This is a positive process which also suits the purposes of economic policy. In contrast, domestic civilian public consumption continued to grow this year at a rate of 3.7 percent, mainly reflecting a growth of 4.0 percent in the number of employed. This development stood out during a two-year standstill in the domestic product, and this indicates a continued

<sup>4</sup> Including payment of nontradeable compulsory loans.

<sup>5</sup> The decrease in defense consumption was contrary to planning at the beginning of the year, when a real growth of about 2.0 percent was foreseen.

undesirable upward trend in the share of public services in manpower and in the product as a whole.

The growth that occurred in public sector transfers in 1976 was smaller than the growth of domestic revenues<sup>6</sup>, which grew by 18.8 percent in real terms. The growth of the absorption stemmed entirely from the growth of taxes, while compulsory loans and other domestic revenues dropped by 29.2 percent. The decrease in other domestic revenues stems partly from the fact that most of the financial assets of the government are unlinked. (Inflation causes quick growth in governmental expenditures for interest, while its revenues from interest grow at a slower rate.) The weight of net absorption in the product<sup>7</sup> rose from 21.1 percent in 1975 to 25.1 percent in 1976, which is a reflection of the restraint policy of the public sector. It should be remarked that restraint through absorption entailing a considerable increase in taxes (mainly indirect) and a reduction of price stabilizing subsidies, is less effective for the restraint of domestic demand than the reduction of the direct demands of the sector. An increase of indirect taxes creates cost pressure on prices, and then price increases raise the costs of the public sector itself through the mechanism of wage-linkage, Cost-of-Living allowance, transfer payments, and the payment of debts. Direct taxes and compulsory loans increased in real terms by about 14.9 percent in 1976, and net indirect taxes rose by about 23.8 percent.

A comprehensive expression of the effect of fiscal activities of the public sector on the economy can be found in the domestic demand surplus, which is a combination of direct and indirect demands of the sector after deduction of its domestic income from taxes, property and transfers.<sup>8</sup> In 1976, the real demand surplus declined considerably (41.7 percent), and its weight in the Gross National Product fell to 8.7 percent. Contrastingly, in the previous three years there was an extensive increase in real demand surplus, and its weight in the GNP reached 15.3 percent in 1975.

In 1976, the public sector absorbed net credit amounting to only about IL 0.5 billion<sup>9</sup>, as against an absorption of IL 6.0 billion in 1975, which, from the point of view of monetary influence, canceled out about half the domestic demand surplus of that year. The small absorption of credit in 1976 reflects on the one hand, a reduction of absorption by means of budgetary activities, and on the other hand, an injection in other credit

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<sup>6</sup> Taxes, compulsory loans, revenues from property, and transfers from the public.

<sup>7</sup> Domestic revenues after deduction of transfer payments, subsidies, grants and payment of nontradeable compulsory loans.

<sup>8</sup> This indicator has a basic limitation: it does not distinguish between the influences of the various components of expenditure and those of income of the public sector.

<sup>9</sup> For activities included in the net absorption of credit, see footnote 57.

allocation activities outside the budgetary framework.<sup>10</sup> (In 1975 other credit activities led to absorption.)

The loans given by the public sector within the framework of its budget in 1976 decreased in real terms by 14.0 percent,<sup>11</sup> and there was also a decrease in directed and free emissions, which also serve for the financing of investments according to public priorities, but are not reflected in the accounts of the sector. These declines are compatible with the restraint policy adopted by the government in direct demand. The slow-down in loan grants does not give a full picture of government influence on the allocation of credit in the economy. This is because there is widespread allocation of exchange rate and linkage insurance, which makes possible additional mobilization of subsidized loans without their being considered as a current activity of the public sector. There is indeed evidence that in 1976 the government expanded these activities.

The public sector received domestic credit amounting to IL 8.8 billion, within the framework of its budget in 1976, as against IL 7.1 billion in 1975. This represents a standstill in real terms in the absorption of purchasing power. The slow growth in credit revenue was not sufficient to absorb the considerable real growth (about 52.0 percent) in the repayment of domestic debts, as well as the credit that was granted in other credit activities. The slow growth in the receipt of credit, despite the considerable increase in repayments, can partly be explained by the worsening of the conditions of linked bonds in 1975, due to public fear of changes in the capital market that might adversely affect existing bonds, and partly by the relatively low growth of disposable income.

## 2. DIRECT DEMANDS

### A. PUBLIC CONSUMPTION

Total public consumption decreased in 1976 in fixed prices by 7.8 percent, and its weight in the product and in domestic uses decreased as well. This decrease occurred against a backdrop of considerable real growth in the last three years that brought the weight of public consumption in 1975 to a record level of 25.8 percent of the uses.<sup>12</sup> Indeed, the weight of public consumption in the product and the uses is still considerably high compared to the years preceding the Yom Kippur War.

Domestic public consumption declined by 3.4 percent in 1976. The entire decline resulted from the defense component; the civilian component grew by 3.7 percent. The decrease of domestic consumption contributed to the reduction of aggregate demand by reducing domestic purchases, while the number of employed rose by 1.3 percent. This

<sup>10</sup> Other credit activities are carried out in the framework of current assets and liabilities in the balance sheets of the public sector, including suppliers' credit, advances, and nonbudgetary short-range financial activities.

<sup>11</sup> Not including credit for the financing of food inventories.

<sup>12</sup> The weight of public consumption in the uses is calculated at current prices.

TABLE

## DOMESTIC DEMAND SURPLUS OF

	At current prices				
	1972	1973	1974	1975	1976
	(IL million)				
<b>A. Expenditure</b>					
1. Direct demands					
Domestic public consumption	6,498	9,407	14,797	20,446	25,612
Domestic investment of the public sector	1,241	1,589	2,430	3,390	3,644
Domestic housing construction from public sector initiative	1,168	1,629	2,754	3,620	2,934
Total (1)	8,907	12,625	19,981	27,456	32,190
2. Indirect demands					
Transfers to households and nonprofit institutions	2,675	3,934	6,638	10,218	14,156
Domestic interest payments	1,170	1,507	2,311	3,510	5,285
Subsidies & transfers to business	1,630	2,656	3,898	6,005	8,237
Nontradeable compulsory loan payments <sup>a</sup>	—	3	185	732	1,352
Total (2)	5,475	8,100	13,032	20,465	29,030
Total (A)	14,382	20,725	33,013	47,921	61,220
<b>B. Income</b>					
Taxes <sup>b</sup>	10,366	13,193	20,390	29,774	47,046
Nontradeable compulsory loans	1,185	1,426	2,660	2,615	1,573
Other domestic income	1,330	1,815	2,636	3,975	4,335
Total (B)	12,881	16,434	25,686	36,364	52,954
<b>C. Net absorption (B) less (A 2)</b>	7,406	8,334	12,654	15,899	23,924
<b>D. Domestic demand surplus<sup>c</sup> (A-B)</b>	1,501	4,291	7,327	11,557	8,266

<sup>a</sup> Including linkage to the fund.

<sup>b</sup> Not including defense import levy.

<sup>c</sup> Domestic demand surplus is shown in terms of effective exchange rate (1 below) as well as in

	1972	1973	1974	1975	1976
1.	3,133	6,219	12,992	15,217	14,854
2.	1,737	4,382	10,060	10,320	7,045

In (1) total import taxes are not included in income, and export incentives and import subsidies

In (2) taxes on imports related to exchange rate policy are not included (see section on indirect

**THE PUBLIC SECTOR, 1972-1976**

## Annual increase of (-) decrease

At current prices				At fixed prices			
1973	1974	1975	1976	1973	1974	1975	1976
(percent)				(percent)			
44.8	57.3	38.2	25.3	17.4	14.9	0.3	-3.4
28.0	52.9	39.5	7.5	5.1	9.3	1.1	-16.3
39.5	69.1	31.4	-19.0	10.8	17.0	8.7	-28.5
41.7	58.3	37.4	17.2	14.9	14.5	1.5	-8.4
47.1	68.7	53.9	38.5	20.9	23.4	11.8	7.4
28.8	53.4	51.9	50.6	6.6	13.3	10.0	20.1
62.9	46.8	54.1	37.2	35.3	6.9	12.6	10.1
-	-	295.7	84.7	-	-	181.6	43.7
47.9	60.9	57.0	41.9	22.2	17.7	14.5	11.7
44.1	59.3	45.2	27.8	17.7	15.8	6.8	4.1
27.3	54.6	46.0	58.0	6.5	11.6	4.4	22.8
20.3	86.5	-1.7	-39.8	0.7	34.7	-29.8	-53.1
36.5	45.2	50.8	9.1	9.1	6.2	10.5	-13.7
27.6	56.3	41.6	45.6	6.2	13.0	1.5	13.3
12.5	51.8	25.6	50.5	-5.6	8.6	-11.9	15.4
185.9	70.3	57.7	-28.5	141.4	28.8	28.9	-41.7

terms of demand surplus discounted by the element of exchange rate policy (2 below):

1973	1974	1975	1976	1973	1974	1975	1976
98.5	108.9	17.1	-2.4	60.0	31.0	7.0	-22.3
152.3	129.6	2.6	-31.7	..	44.1	1.3	-47.0

are not included in expenditures.

taxes in text), and export incentives and import subsidies are not included in expenditures.

increase reflects a considerable growth in the number of employed in the civilian segment of the public sector, at an average rate of 4.0 percent, and a fall in employment in the defense segment. This fall was not the result of a decision concerning a lower level of defense, but rather from difficulties in manpower recruitment. It is therefore reasonable to assume that this development is temporary, since demand for manpower in the public sector in 1976 was in fact higher than that reflected by the number of actual employed.

The growth in the number of workers employed in the civilian segment clearly contradicts declared government policy concerning the freezing and reduction of the number of employed in the services, and this is bound to affect the extent of public consumption over the long range. It will also continue to make difficult a structural change in the composition of domestic employment, which is essential for improving the balance of payments.

A restraining wage policy was in force in the public sector throughout most of 1976. The cost of work<sup>13</sup> rose by 27.3 percent, and the decline in the relative wages of employees in this sector as compared to other economic sectors, continued<sup>14</sup>. The cost of labor facing the public sector and the nonprofit institutions in 1976 was lower than its "actual" price, since most wage agreements in the public sector for 1967/77 will be paid retroactively in 1977/78.

Civilian consumption grew considerably in 1976, by 5.1 percent. The consumption of national institutions declined for the second year in a row, due to the reduction in the number of immigrants, while the consumption of local authorities<sup>15</sup> and of the government increased (about 3.8 and 6.5 percent respectively),<sup>16</sup> although the reduction of immigration should have been felt here as well. No classification of public consumption according to destination is available for calendar years, while the estimate for budgetary years (see table below) shows a considerable growth in the share of defense, which was the main destination of public consumption, between the years 1972/73 and 1975/76. As to the other targets, there was an increase of expenditures for social and community services, the largest item in public consumption apart from defense and a parallel decrease in economic services.

The high weight of social services in public consumption (and its increase in recent years) does not reflect the full expenditure of the public sector in this field. Transfer payments should be added to this (there was a considerable growth in these this year), as well as the participation of the public sector (and financing from abroad) in the consumption of nonprofit institutions, which is weighted against about 30 percent of civilian public consumption.

<sup>13</sup> Including Value Added Tax payable on wages in the public sector.

<sup>14</sup> See Chapter XII.

<sup>15</sup> The number of employed in the local authorities increased by 2.8 percent.

<sup>16</sup> Domestic civilian consumption of the government rose by 4.4 percent; the balance of the increase stems from the increase in government "unspecific" imports.

Current transfer payments received by nonprofit institutions from the public sector declined by about 7.2 percent in fixed prices this year, while the number of employed increased by about one percent.<sup>17</sup> A partial explanation of the capability of nonprofit institutions to continue to maintain a level of consumption and employment somewhat higher than that of 1975, despite the decrease of transfers from the public sector, can be found in the increase of transfers from abroad to these institutions. These grew by about 46 percent in terms of Israeli currency. Another explanation is that nonprofit institutions received linkage insurance and guarantees in 1976 that enabled them to borrow money. In previous years, this instrument served mainly for the financing of investments in productive sectors, and not for the financing of consumption activities.

### PUBLIC CONSUMPTION BY DESTINATION

(percent, at current prices)

	1972/73 '73		1974/75	
Defense	67.9		76.5	
Other	32.1		23.5	
Social and community services		61.8		66.7
Administration and public order		27.2		27.1
Economic services		11.0		6.2
Total	100.0	100.0	100.0	100.0

Consumption of civilian services and products in the domestic economy is being done either directly by households, or by means of the public machinery (government, local authorities, and national institutions, and to a certain extent nonprofit institutions as well). Since 1973, private consumption, excluding nonprofit institutions, has been restrained, while civilian public consumption and the consumption of nonprofit organizations continued to grow. The difference in growth rates brought about a significant change in the ratios of consumption in recent years, following a period of similar growth in civilian public and private consumption before 1972, when the ratio between them remained constant. The growth of civilian public consumption was in each case double the growth rate of the population, i.e. there is a permanent and clear inclination to grant more public services per capita.

<sup>17</sup> No direct measurement of the change in the number of employed in nonprofit institutions is available. The Central Bureau of Statistics publishes data on public services, which includes both the public sector and nonprofit institutions. The growth that took place in the number of employed in these services was 2.9 percent. If we deduct the growth in the number of employed in the public sector (4.0 percent) we obtain an increase of one percent in nonprofit institutions.

TABLE

## PUBLIC CONSUMPTION BY

	1972	1973	1974	1975	1976
(IL million, at current prices)					
A. Civilian public consumption					
Payroll <sup>a</sup>	2,107	2,893	3,928	5,479	7,383
Purchases	939	1,252	1,782	2,676	3,762
Total (A)	3,046	4,145	5,710	8,155	11,145
B. Thereof: Government imports n.e.s.	231	399	453	644	993
C. Noncivilian public consumption:					
Payroll <sup>a</sup>	1,138	2,128	2,740	3,845	4,645
Domestic purchases	2,545	3,533	6,800	9,090	10,815
Foreign purchases	2,119	5,448	5,437	11,271	12,393
Defense import levy <sup>b</sup>	394	1,142	1,386	1,688	2,432
Total (C)	6,196	12,251	16,363	25,894	30,285
D. Total public consumption (A+C)	9,242	16,396	22,073	34,049	41,430
Government	8,120	14,880	19,929	31,071	37,420
Local authorities	986	1,330	1,885	2,650	3,607
National institutions	136	186	259	328	408
E. Total domestic public consumption <sup>c</sup>	6,498	9,407	14,797	20,446	25,612
Domestic civilian consumption	2,815	3,746	5,257	7,511	10,152
Thereof: Government	1,693	2,230	3,113	4,533	6,142
Domestic noncivilian consumption	3,683	5,661	9,540	12,935	15,460

<sup>a</sup> Including Value Added Tax on payroll paid by the public sector.

<sup>b</sup> Defense import levy and Value Added Tax.

## COMPONENT, 1972-1976

Annual increase of (-) decrease							
At current prices				At fixed prices			
1973	1974	1975	1976	1973	1974	1975	1976
(percent)				(percent)			
37.3	35.8	39.5	34.8	3.9	4.8	6.3	4.0
33.3	42.3	50.2	40.6	12.8	2.5	7.2	7.1
36.1	37.8	42.8	36.7	6.9	4.0	6.6	5.1
72.7	13.5	42.2	54.2	62.4	-3.1	-9.2	18.0
87.0	28.8	40.3	20.8	56.7	2.0	-2.5	-2.1
38.8	92.5	33.7	19.0	16.2	31.7	-4.4	-9.8
157.1	-0.2	107.3	10.0	132.9	-17.2	34.0	-16.5
189.8	21.4	21.8	44.1	0.0	0.0	0.0	0.0
97.7	33.6	58.2	17.0	66.2	1.5	11.8	11.9
77.4	34.6	54.3	21.7	46.4	2.1	10.5	-7.8
83.3	33.9	55.9	20.4	..	1.9	11.2	-8.8
34.9	41.7	40.6	36.1	..	4.8	5.7	3.8
36.8	39.2	26.6	24.4	..	3.7	-7.1	-6.7
44.8	57.3	38.2	25.3	17.4	14.9	0.3	-3.4
33.1	40.3	42.9	35.2	2.1	5.0	8.7	3.7
31.7	39.6	45.6	35.5	..	5.2	12.0	4.4
53.7	68.5	35.6	19.5	28.6	20.7	-3.8	-7.4

c Total public consumption, less defense procurements abroad, defense import levy, less government imports, n.e.s.

Despite the considerable increase in defense expenditures as a result of the three wars that have taken place in the last decade (the Six Day War, the War of Attrition and the Yom Kippur War) public consumption has continued to grow at a rapid pace, and there has been no offsetting cut in civilian public activity alongside the growth of defense activity.

#### B. PUBLIC SECTOR INVESTMENT<sup>18</sup>

Investments of the public sector dropped considerably in 1976, by 22.3 percent, following a slowdown that had already been noted in 1975. This decrease reflects a reduction of 28.5 percent in housing construction, and a decline of 16.2 percent in other investments.

The sharp decline of investments in housing construction is the consequence of the sector's activity in the years 1974 and 1975. In these years public construction had continued to grow and to create surplus flats, despite the fact that the ebb in the housing market had already begun to be felt in 1974.

The weight of domestic investments in the product decreased from 9.3 percent in 1975 to 6.9 percent in 1976. This decrease contributed about a quarter of the decline in domestic demand surplus at fixed prices. The reduction of investments as a means of reducing public sector pressures is desirable in segments where there is surplus production capacity. The decrease of investments in other segments does not cause difficulties in the short term, but a considerable reduction in the development of the economic infrastructure (communications, roads, drainage), which is mainly the responsibility of the public sector, may make the renewal of economic growth more difficult in the future.

In addition to investments made directly by the public sector, it also has an indirect effect on the level of investments of other sectors through capital transfers and the allocation of credit for investment. The source of capital transfers is in the development budget of the sector, while allocation of credit is carried out through the development budget as well as indirectly, through direction of credit and allocation of linkage and exchange rate insurance. The direction of credit allocated through financial institutions, and linkage and exchange rate insurance granted by the government are not included in the accounts of the public sector.

Capital transfers of the public sector to nonprofit institutions declined by 10.7 percent in 1975, and in 1976 they were frozen at their real level. As a result, real investments of nonprofit institutions dropped by 4.0 percent in 1975, and by 9.0 percent this year. Capital transfers to business, on the other hand, continued to grow rapidly

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<sup>18</sup> Including direct investments of the authorities of the public sector (in services, roads, drainage, land reclamation and afforestation), investments in business operations of the government (communications, railways, airports), investments in ports and publicly initiated housing construction. Not including investments of public sector companies and investments in government warehouses.

this year: by about 24.0 percent in real terms, following a real growth of 28.7 percent in 1975. These transfers made possible a quick growth in the investments of the public sector companies; these investments increased by 51.0 percent in the last two years.

Credit for investments through development budgets and the direction of credit through emissions decreased by about 8.0 percent in real terms (see discussion of credit in Section 5 below).

### 3. INDIRECT DEMANDS OF THE PUBLIC SECTOR

Subsidies, transfer payments, and grants of the public sector are an indirect component of domestic public demand, and they are an important indicator for the examination of trends in economic policy.<sup>19</sup> The level of this component in 1976 was 2.6 times larger than civilian public consumption. The rate of its growth in recent years has been quick, reaching 11.7 percent in real terms in 1976. Its weight in the product has also increased continuously: from 18.6 percent in 1972 to 30.5 percent in 1976. The growth of these demands this year offset part of the considerable growth in tax revenues.

The real growth in 1976 did not encompass all the components of indirect demand: transfer payments to nonprofit institutions in the current and capital accounts and direct subsidies on products decreased in real terms, while the other components of transfers increased at a rapid pace (see Table X-5).

#### A. TRANSFER PAYMENTS TO INDIVIDUALS AND NONPROFIT INSTITUTIONS

Transfer payments to households increased in real terms by 15.9 percent<sup>20</sup> following high rates of real growth in the previous three years. This considerable and prolonged growth stems partly from the exchange of the method of income tax deduction for the method of child allowance. This made itself felt fully in 1976 and contributed about a quarter of the growth.

The rest of the growth reflects the social policy of securing income by means of universal subsidies. The portion of direct taxes on individuals and nonprofit institutions<sup>21</sup> that was returned to them through net transfer payments decreased as compared to the previous two years: in 1976, about 100 percent of direct taxes were returned by means of net transfer payments, as against a refund of about 129 percent in 1975. Nevertheless, the rate of repayment is still considerably high as compared

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<sup>19</sup> Principal payments and principal linkage of nontradeable compulsory loans were also included in this analysis this year. Collection of nontradeable compulsory loans was considered as a fiscal absorption act.

<sup>20</sup> Discounted by the consumption price index.

<sup>21</sup> Including the worker's share of National Insurance, the direct tax on the self-employed, directors and members of cooperatives, about half the deductions at source, and direct taxes on nonprofit institutions.

TABLE

## PUBLIC SECTOR TRANSFERS, SUBSIDIES, AND GRANTS, AND

	1973	1974	1975	1976
(IL million, at current prices)				
<b>A. Transfer payments to households &amp; the National Insurance Institute</b>				
Pensions	1,125	1,782	2,961	4,825
Other transfers	245	611	1,140	1,512
Provident & pension fund	393	904	1,149	1,680
Other transfers	545	964	1,192	1,552
Total (A)	2,308	4,261	6,442	9,569
<b>B. Transfer payments to nonprofit institutions<sup>b</sup></b>				
On the capital account	271	283	340	399
On the current account	1,355	2,094	3,436	4,188
Total (B)	1,626	1,377	3,776	4,587
<b>C. Capital account transfer payments to business</b>	240	414	716	1,100
<b>D. Subsidies to goods &amp; services</b>				
Domestic production	875	1,108	2,037	3,440
Import products	506	426	950	290
Exports	1,035	1,950	2,302	3,407
Total (D)	2,416	3,484	5,289	7,137
<b>E. Domestic interest payments</b>	1,507	2,311	3,510	5,285
<b>F. Total transfers and subsidies to the public (A to E)</b>	8,097	12,847	19,733	27,678
<b>G. Redemption of nontradeable compulsory loan</b>	3	185	732	1,352

<sup>a</sup> The real rates of growth were calculated according to the differential index of growth rates.

## REDEMPTION OF NONTRADEABLE COMPULSORY LOANS, 1973-1976

Nominal growth rate, at current prices			Real growth rate, at fixed prices <sup>a</sup>		
1974	1975	1976	1974	1975	1976
(percent)			(percent)		
58.4	66.2	63.0	14.0	17.5	27.2
149.4	86.6	32.6	79.3	32.0	3.6
130.0	27.1	46.2	65.3	-10.2	14.1
76.9	23.7	30.2	27.5	-12.6	1.5
84.6	51.2	48.5	32.8	6.9	15.9
4.4	20.1	17.4	-25.6	-10.7	.9
54.5	64.1	21.9	15.8	24.7	-7.2
46.2	58.9	21.5	9.0	20.7	6.5
72.5	72.9	53.6	22.8	28.7	24.0
26.6	83.8	68.9	-7.9	35.1	34.8
-15.8	123.0	-69.5	-39.6	58.0	-76.3
88.4	18.1	48.0	39.2	-13.2	18.1
44.2	51.8	34.0	5.4	10.9	8.4
53.4	51.9	50.6	13.3	11.8	20.1
58.7	53.6	40.3	16.1	12.0	10.5
..	295.7	84.7	..	181.6	43.7

<sup>b</sup> Including transfers to nonprofit institutions for employers' matching contributions.

to 1972 (about 88 percent) and it partially cancels out the burden of direct taxation while changing the distribution of income.

Transfer payments to nonprofit institutions are intended to finance part of their current activity and part of their investments. These transfers decreased in 1976 by about 6.5 percent. Net budgetary transfers decreased at a higher rate, about 18.0 percent, because the revenue of the government from nonprofit institutions increased considerably, mainly due to the rise of hospitalization fees in government hospitals. Transfers in the capital account to nonprofit institutions were frozen in real terms, after decreasing considerably in the previous two years. This decrease is an expression of the maturity of infrastructure investments in the social services, and it reflects the desire to direct part of the burden of budgetary restraint to areas in which the influence of restraint is not immediately noticeable.

From data on transfer payments it can be seen that the policy of budgetary restraint in the field of transfers was carried out mainly vis-à-vis the nonprofit institutions. However, there is evidence that the government enabled medical institutions to borrow extensively by providing guarantees and insurance. In previous years, the government had used these instruments for financing service activities. The shifting of this kind of financial resource is an apparent curtailment of indirect demands stemming from the public sector, and it enables the public sector in the wide sense (including nonprofit institutions) to maintain a real level of activity in public financing that is higher than the one reflected in the government budget.

#### B. TRANSFERS IN THE CAPITAL ACCOUNT FOR BUSINESS

Transfers in the capital account for business are connected with domestic investments. Also included in this category is the covering of losses. In 1976 investments of the private sector and of public sector companies in the economic sectors decreased by 14 percent in real terms,<sup>22</sup> while transfer payments in the capital account increased in real terms by 24.0 percent. The explanation for this is related to the increase in the weight of investments of public sector companies, mainly those for the development of energy sources. These investments are financed mainly through this item.

#### C. INTEREST PAYMENTS

Interest payments of the public sector<sup>23</sup> increased in 1976 at a rate of 60.6 percent in current prices. Domestic interest payments<sup>24</sup> constitute about two-thirds of total interest payments, and they have increased in nominal terms by 50.6 percent.

<sup>22</sup> Not including investments in housing.

<sup>23</sup> Not including interest payments to the National Insurance Institution and the Property Tax Fund.

<sup>24</sup> Payments of domestic interest, as defined here, include some linkage and exchange rate insurance. The balance of the insurance mainly on the nongovernmental debt fund, appears as credit activities and is not included in the account of indirect demand and disposable income.

There are several main causes for the increase in domestic interest payments. (a) Payments interest to owners of Pazak and Tamam deposits have been financed this year entirely by the government, and they increased by IL 656 million. This increase caused about one third of the increase in domestic interest payments.<sup>25</sup> (b) In 1976 large quantities of choice bonds, that had accumulated interest and linkage differentials on interest for 5 years, came due. (c) The rest of the growth of interest payments stems from the increase of the total debt of the public sector and from a considerable growth in insurance payments on interest and exchange rate differentials.

It should be emphasized that the considerable growth of interest payments stems from the financing policy of the public sector in the past, and they are not subject to change over the short range.

#### D. SUBSIDIES TO DOMESTIC PRODUCTION AND IMPORTS<sup>26</sup>

The amount of subsidies was frozen in 1976 following a real growth of about 41 percent in 1975. Their share in the product remained constant, about 3.9 percent as against about 2.2 percent in 1972. The freezing of subsidies at their real level reflects a decrease of about 11.6 percent in direct subsidies to products and services, in terms of purchasing power of individuals, and an increase of about 31.0 percent in indirect subsidies to domestic production.

The decrease in direct subsidies is due to the fact that twice in the course of the year, in March and in November, the prices of subsidized products and services were raised, by an average of 25 and 20 percent respectively.<sup>27</sup> A considerable real increase in subsidies to transport, at a rate of about 48 percent prevented an even greater decrease in direct subsidies to products and services. The weight of the subsidy to transport reaches 23 percent of total direct subsidies today. Since there was almost no quantitative

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<sup>25</sup> In 1975, the Bank of Israel financed part of the interest payments on Pazak and Tamam deposits. These amounts were not registered as transfer payments of the public sector and were not included in the calculation of disposable income arising from them. This year the government paid the full amount and it is included in its entirety in the calculation of transfer payments of the public sector. This accounting change increased disposable income measured this year (in relation to 1975) by about 0.75 percent.

<sup>26</sup> Subsidies to domestic production include: (a) Direct subsidies, intended to maintain the price of basic products and services appearing in the subsidy budget. (b) Additional indirect subsidies given to domestic production. Among these are the normal budget of the Ministry of Housing, the budget for the reduction of the price of credit in the Ministry of Trade and Industry, and various additional expenses of ministries in the budget intended as support for domestic production. Import subsidies include direct subsidies to agricultural products and raw materials granted in the subsidy budget. Direct subsidies are defined below as the total subsidies to products and services of domestic production and of imports from the subsidy budget (subsidies to domestic production, item (a) together with import subsidies).

<sup>27</sup> The estimate of absorption from the public through the increase of prices in March 1976 was IL 1.1 billion in terms of a full year, through the rise of the prices of basic commodities, and IL 0.7 billion through the rise of the price of oil.

growth in subsidized products and services (a growth of 0.3 percent), the entire decrease resulted in a reduction of the subsidy per unit.

The amount of subsidies to domestic production increased this year by 34.8 percent, while subsidies to imports decreased by 76.3 percent. There are several main sources for the increase of subsidies to domestic production.

(a) Domestic production costs increased at a rate higher than the average increase of subsidized product prices.<sup>28</sup>

(b) There was a transfer from subsidizing production factors (reduction of the prices of imported agricultural raw materials, which were previously recorded as import subsidies) to subsidizing finished products.<sup>29</sup>

By this transfer a certain saving in the amount of subsidies was attained, since the subsidy is now aimed at the preferred product instead of the raw material which is more widely used.

Subsidies to imported products dopped by 76.3 percent in 1976, while the quantitative decline was only of 7.8 percent. The 30 percent decrease in the prices of these products abroad was more or less offset by the change in the exchange rate and by the rise in domestic prices. The difference between the decrease of subsidies and the decrease of quantities can be related to the shifting of the subsidy from imported to domestic products, as already mentiond.

(c) There was a considerable increase in the total net current expenditure of the Ministry of Housing (this is defined as a subsidy to domestic production), and a considerable increase in the item for credit price reduction in the budget of the Ministry of Trade and Industry.<sup>30</sup>

(d) At the beginning of 1976, subsidized products still enjoyed particularly high subsidy rates due to the freezing of their prices during 1975 and until March 1976. In March 1976, prior to the rise of prices, the consumer in fact paid between two-thirds and one-half of the money received by the producer.

(e) The imposition of the Value Added Tax in July 1976 was accompanied by a rise in the budgetary subsidies to basic commodities, in order to prevent an increase of prices. The rise was by about IL 130 million during the rest of the budgetary year.

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<sup>28</sup> In 1975, for example, the average wages of an employee increased by about 32.9 percent. The wholesale price index of industrial output increased by 31 percent, while the prices of controlled products rose by only 26.5 percent. The price increase of controlled products in November 1976 was lower than planned due to the opposition of the Histadrut.

<sup>29</sup> For example, subsidies to wheat, soybeans and fodder were transferred to products such as bread, oil and milk.

<sup>30</sup> In the 1976/77 budget year an increase of about IL 250 million in the Ministry of Housing, and an increase of about IL 121 million in the Ministry of Trade and Industry. These two amounts contributed about half the growth of subsidies to domestic production, based on 1975.

**TABLE X-6**  
**TAXES AND COMPULSORY LOAN, 1974-1976<sup>a</sup>**

	1974	1975	Annual nominal growth			Annual real growth	
			1976	1975	1976	1975	1976
Direct taxes <sup>c</sup>	9,106	14,140	23,181	55.3	63.9	10.9	27.4
Property taxes	749	1,149	1,525	53.4	32.7	9.6	3.2
Indirect taxes on domestic production	4,494	7,573	12,055	68.5	59.2	20.4	23.8
Indirect taxes on civilian imports	6,041	6,912	10,285	14.4	48.8	-18.3	15.7
Total taxes	20,390	29,774	47,046	46.0	58.0	4.3	22.9
Compulsory loans	2,660	2,615	1,573	-1.7	-39.8	-29.8	-53.2
Total taxes and compulsory loans	23,050	32,389	48,619	40.5	50.1	0.4	16.7
Import taxes discounted by the estimated exchange rate policy component <sup>d</sup>	2,932	4,897	7,809	67.0	59.5	19.3	24.0
Total taxes discounted by the estimated exchange rate policy component <sup>d</sup>	17,281	27,759	44,570	60.6	60.6	14.7	24.9
Total taxes and compulsory loans discounted by estimated exchange rate policy component <sup>d</sup>	19,941	30,374	46,143	52.3	51.9	8.8	18.1

<sup>a</sup> For definitions of the different taxes, see below in the detailed tables.

<sup>b</sup> Discounted by the private consumption price index.

<sup>c</sup> Direct taxes – including surtax on inventories and exchange rate differentials, while until the 1975 report was included in indirect taxes on civilian imports.

<sup>d</sup> The exchange rate policy component is that part of indirect import taxes which is not a fiscal tax, and whose function is to complement the exchange rate policy expressed in the establishment of the official rate. See the discussion below on indirect taxes for the method of estimating this component.

SOURCE: Central Bureau of Statistics, the National Insurance Institute, and the Income and Property Tax Commission.

Estimated subsidies to domestic production, as given above (and similarly estimated subsidies to imports), do not include all the subsidies allocated through the intervention of the government, since an additional large subsidy is given by means of the Compensation Fund for Oil. This fund collects hundreds of millions of pounds from certain kinds of oil, and this is used to reduce the prices of other oil products, as a subsidy to the production of goods and services.<sup>31</sup>

The Water Balancing Fund functions in a similar way. Subsidies to domestic production through these funds are measured by the deficit in the funds (if there is one). Evidently, the extent of intervention of the government is much higher than that reflected in such a measurement.<sup>32</sup>

#### E. ENCOURAGEMENT OF EXPORTS

Subsidies to exports increased in 1976 by 48.0 percent as compared to an increase of 18.1 percent last year. There are two causes for this; (a) Exports entitled to incentives increased in 1976 in dollar terms, by about 24.0 percent; in 1975 there was an increase of only 10.0 percent. (b) The cost to the government of the export dollar entitled to subsidies rose at an average rate of about 19.0 percent, against an increase of about 7.4 percent last year.

The increase in the cost of the export dollar to the government is due to a number of factors: (a) In 1976 the use of subsidies for export encouragement was widened, while in 1975 a greater part of the encouragement of exports was done directly by changing the official exchange rate.<sup>33</sup> (b) Beginning in March 1976, the automatic rebate of indirect taxes to industry, agriculture and diamonds was linked to the rate of the creeping devaluations.<sup>34</sup> This linkage caused an average growth of about 27 percent in the incentive to industrial and agricultural exports. The incentive to diamond exports increased at a much higher rate, 118 percent. This increase stemmed mainly from a considerable rise at the end of 1975, apart from its linking to the change in the exchange rate in the course of 1976. The average growth of the automatic tax rebate to which agricultural, industrial and diamond exports are entitled, amounted to about 30.0 percent in 1976. (c) A con-

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<sup>31</sup> The Oil Fund provided subsidies of about IL 800 million in 1975/76, and about IL 900 million in 1976/77.

<sup>32</sup> The deficit of the Water Balancing Fund, which is included in the estimate of subsidies amounted to about IL 110 million in 1976/77, while no subsidy was estimated through the Oil Fund.

<sup>33</sup> The average exchange rate rose by 41.0 percent in 1975, including the effect of the November 1974 devaluation, while in 1976 the exchange rate rose by 25.6 percent.

<sup>34</sup> As a result, the subsidy in the high added value group in industry rose from IL 1.85 per export dollar at the beginning of the year, to IL 2.63 per dollar at its end – an increase of about 42.0 percent.

siderable increase took place in the export incentives to tourism, to the export of know-how, and in various sectorial subsidies that are not automatic.

It seems that export incentives, for the current year are higher than those actually paid out, and they will make themselves felt in 1977.

#### 4. REVENUES OF THE PUBLIC SECTOR FROM TAXES AND COMPULSORY LOANS<sup>35</sup>

The revenues of the public sector from taxes and compulsory loans rose by 17 percent in real terms<sup>36</sup> in 1976, as against an increase of less than one percent in 1975. The burden of taxes and compulsory loans<sup>37</sup> increased even more, because the growth of transfer payments, although quick in itself, did not reach the rate of growth of taxes and compulsory loans this year.

It seems that this development was the most striking expression of the restraint policy of the government, which was introduced in order to reduce the purchasing power of the private sector.

The restraint of aggregate demand by means of absorbing purchasing power through taxes brought with it a rise of prices; this, in turn, made necessary the refunding of part of the revenue collected from taxes through government expenditure on wages, purchases, and transfer payments. From this point of view the efficiency of absorption through taxes, particularly indirect taxes, is smaller than the restraint of demand through a reduction of expenditure. Indirect taxes, whose effect on prices is more immediate, increased in real terms by 31 percent this year.<sup>38</sup> This increase stems entirely from the

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<sup>35</sup> Revenues of the public sector from taxes and compulsory loans include the taxes and compulsory loans collected by the government, and the taxes collected by local authorities. National institutions have no revenue of this kind. The definition of taxes in this paragraph is adapted to the definitions used in national accounting, and it is different from that used in government publications in general. The National Insurance revenues are included here in direct taxes. Also included here are the fees of the Broadcast Authority and the current surplus of the business operations of the government, mainly the Post Office and the ports. (Deficits of business operations are included in the subsidies.) On the other hand, some of the compulsory payments, such as Land Betterment Tax, death duty, fines, license fees and certain service fees (such as drivers' licensing fees and passport fees) are defined as transfers from the public to the government and not as taxes. For a discussion of transfer payments, see above in this chapter.

<sup>36</sup> Discounted by the private consumption price index.

<sup>37</sup> The total of taxes and compulsory loans, less transfer payments to the public (except for interest payments), and after deducting the proceeds from nontradeable compulsory loans and the distribution of certificates of tradeable loans. This estimate of the tax burden ignores the difference that exists between the effect of the various components of income and transfer payments on real disposable income, and it therefore constitutes only a rough indicator of the size of the tax burden, so that its main role is to indicate the trends of development of this burden.

<sup>38</sup> Indirect taxes on domestic production (including property taxes) and indirect taxes on imports (less the exchange rate component) after deduction of subsidies to domestic production and imported products.

the imposition of new taxes – Value Added Tax and a Defense Levy on service imports, and the effects of the increase in tax rates in 1975. As a result of this, the average rate of indirect tax on resources at the disposal of the economy<sup>39</sup> increased from 9 percent in 1974 to 11 percent in 1975, and 15 percent in 1976.

Direct taxes and compulsory loans rose by 15 percent in real terms, and among them the increase of income tax stands out in particular. The effect of these taxes on prices is not immediate and direct. They may trigger wage demands from the employees, and responding to them will increase production costs, which will in turn affect the increase of prices. It can therefore be assumed that the influence of direct taxes on prices in 1976 was limited, although it is possible that they contribute to the awakening of wage demands at the end of 1976 and in 1977.

TABLE X-7

TAX AND COMPULSORY LOANS, BY TYPE, 1974-1976

	Distribution of taxes and compulsory loans			Same, discounted by the exchange rate policy component		
	1974	1975	1976	1974	1975	1976
Direct taxes	39.5	43.7	47.7	45.7	46.6	50.2
Property taxes	3.3	3.5	3.1	3.8	3.8	3.3
Indirect taxes on domestic production	19.5	23.4	24.8	22.5	24.9	26.1
Indirect taxes on civilian imports	26.2	21.3	21.2	14.7	16.1	16.9
Total taxes	88.5	91.9	96.8	86.7	91.4	96.5
Compulsory loans	11.5	8.1	3.1	13.3	8.6	3.5
<b>Total taxes and compulsory loans</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Thereof : Direct taxes and compulsory loans	51.0	51.8	50.9	59.0	55.2	53.7

<sup>39</sup> The average rate of indirect taxes, according to their definition in footnote 38, on the Gross National Product with the addition of import surplus, excluding direct defense imports.

The weight of taxes and compulsory loans in the total resources at the disposal of the economy expresses the extent of government involvement in the allocation of resources through taxes and compulsory loans. Table X-8 describes the development of this involvement in recent years; considerable growth is noticeable in this indicator in 1976, expressing the great increase in collections. The weight of taxes and compulsory loans after deduction of transfer payments, in the total resources at the disposal of the economy, is an indicator of the tax burden in 1975, as a result of the considerable growth in transfer payments to the public and the reduction of the taxation component that was a substitute for devaluation this year,<sup>40</sup> in 1976 it showed a considerable increase in the tax burden, stemming from the fast growth of tax collection, against the background of a slower growth of transfer payments and a real standstill in the product.

Despite the considerable growth in the weight of taxes and compulsory loans in the resources at the disposal of the economy, the level of the burden did not rise in 1976 above that prevailing in 1971, owing to a parallel expansion of transfer payments to the public.<sup>41</sup> This expansion reflects, among other things, the quick development of a system of securing income in Israel during these years.

#### A. DIRECT TAXES AND COMPULSORY LOANS<sup>42</sup>

Direct taxes increased in 1976 in real terms<sup>43</sup> at a considerable rate: 27 percent, as against 11 percent in 1975. The main growth stems from the striking increase in income tax collections in 1976 compared to the previous year: 78 percent, and 53 percent in 1975. The increase in income tax collection resulted from three main causes:

(a) About 23 percentage points of the increase in the total collections in 1976, and about 18 percentage points in 1975, is the result of the cancellation of Defense and War Loans in the framework of the reform in direct taxation, beginning in April 1975.<sup>44</sup>

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<sup>40</sup> The burden of taxes and compulsory loans decreased in 1975, but after deduction of the exchange rate component, it increased somewhat; on this component, see Note 4 to Table X-6.

<sup>41</sup> Except for the increase of the tax burden, stemming from the exchange of a great part of the compulsory loans for taxes. The weight of compulsory loans in the total of taxes and loans was 11 percent in 1971, and 3 percent in 1976. Since the tax component in compulsory loans is smaller than 1, it follows that the exchange of loans for taxes constitutes in itself an increase of the tax burden.

<sup>42</sup> Direct taxes include collection of income tax (together with company tax and capital gains tax), collections of the National Insurance, and surtax on inventories. Compulsory loans include Defense and War Loans, employers' loans and the cost-of-living allowance loan (imposed on the cost-of-living allowance paid to employees between January and June 1975). The surtax on inventories, included in the report of 1975 in indirect taxes on imports, was classified this year in the national accounting system as a direct tax, and that is how it is treated here.

<sup>43</sup> Discounted by the private consumption price index.

<sup>44</sup> The reform was activated in July 1975, effective retroactively from April 1975.

TABLE X-8

**WEIGHT OF TAXES AND COMPLUSORY LOANS IN GNP  
AND DOMESTIC RESOURCES, 1971-1976**

	1971	1972	1973	1974	1975	1976
<b>Weight of taxes and compulsory loans</b>						
In GNP	40.8	39.2	38.9	42.5	43.0	51.0
In domestic resources	35.5	34.8	32.4	34.1	35.0	42.2
<b>Weight of taxes and compulsory loans, discounted by estimate of exchange rate policy component</b>						
In GNP	37.0	35.1	34.5	36.7	40.3	48.4
In domestic resources	32.2	31.2	28.8	29.5	32.8	40.1
<b>Tax and compulsory loan burden</b>						
In GNP	28.2	27.2	23.4	24.4	22.3	28.1
In domestic resources	24.5	24.2	19.5	19.5	18.1	23.3
<b>Tax and compulsory loan burden discounted by estimate exchange rate policy component</b>						
In GNP	28.3	26.4	23.2	23.1	23.9	29.4
In domestic resources	24.6	23.5	19.3	18.5	19.5	24.4

**DEFINITION** : Taxes and compulsory loans – government taxes (excluding levy and VAT on defense imports) and taxes of the local authorities, as defined in this chapter. Estimate of exchange rate policy component – see below, in discussion of indirect import taxes.

Tax and compulsory loan burden – taxes and compulsory loans, less net transfer payments and less redemption of compulsory loans and distribution of tradeable loan certificates.

GNP – at effective exchange rate.

Domestic resources – GNP, plus import surplus (imports CIF and exports FOB) at effective exchange rate; including imports from the administered areas direct defense imports and interest payments of the public sector are not included here.

**NOTES** : In calculating the indicators in this table, compulsory loans were treated as taxes. An alternative calculation, deducting the compulsory loans, gives a similar picture over the years.

All indicators are calculated according to the GNP and total domestic resources. Conceptually, the most suitable base for the Israeli economy is total domestic resources, but we have also included the calculation based on the GNP, since that is the calculation used in other countries.

(b) An additional cause of the increase is the result of the development of payment arrangements: these increased by about IL 300 million in 1974, and by IL 1 billion in 1975, while in 1976 there was only a small increase in the arrangements. Payment arrangements are made by means of bank loans to assessees, according to tax authorities; against the amounts of the loans to assessees, parallel amounts are recorded in the books of the bank to the credit of a special deposit account of the Treasury. The meaning of the arrangements is the transfer of the task of collecting these debts from assessment officials to banks.<sup>45</sup> Since the average period of these loans is one year, the extraordinary expansion of arrangements in 1975 contributed about 12 percent to the increase of collections in 1976. As long as there is no decrease in the balance of the payment arrangements, this effect continues, its real meaning being a reduction in assessees' debts to income tax authorities.

TABLE X-9  
DIRECT TAXES AND COMPULSORY LOANS, 1974-1976

	1974	1975	1976	Annual change	
				1975	1976
	(percent)				
A. Total direct taxes	9,106	14,140	23,181	55.3	63.9
Income tax	6,115	9,383	16,742	53.4	78.4
National Insurance <sup>a</sup>	2,806	4,077	6,147	45.3	50.8
Inventory surtax <sup>b</sup>	185	680	292	..	..
B. Total compulsory loans	2,660	2,615	1,573	-1.7	-39.8
Defense and War Loans <sup>c</sup>	2,045	1,651	341	-19.3	..
Employers' savings loan	615	888	1,144	44.4	28.8
COL allowance loans	—	76	88	—	15.8

<sup>a</sup> Including employers' matching contribution, which began in April 1973. Total collections in 1973 equaled IL 219 million, in 1974 IL 449 million, in 1975 IL 677 million, and in 1976 IL 1,043 million.

<sup>b</sup> The inventory surtax is levied on product and goods inventories and balances in foreign currencies held by the banks following large devaluations, in order to absorb the large profits of importers resulting from the devaluations. In the past this was classified as an indirect import tax. This year the classification has changed in the National Accounts, and the data have been corrected retroactively.

<sup>c</sup> Including the War Loan on land betterment.

SOURCE: Income Tax Commission, National Insurance Institute, Accountant General.

<sup>45</sup> On the loan terms and their development see the 26th Annual Report of the State Comptroller, pages 100-101 (Hebrew).

(c) Beyond the influence of the factors detailed above, the reform in direct taxation acted as well by reducing the marginal tax rates simultaneously with a considerable expansion of the tax base, imposing interest and linkage on arrears in tax payments, and compelling all assesseees in the economy to submit income declarations and all the self-employed and the companies to keep accounts. A comprehensive declaration of income was not yet introduced in 1976, but the keeping of accounts was very much expanded in the self-employed sector. (Companies already kept accounts before the reform.) It is still difficult to assess the effect of the reform on the flexibility of income tax over a long range, but from the collection data of 1976 it is fair to assume that the average tax on total income<sup>46</sup> increased as a result of the reform.

Summing up, it can be said that most of the increase in income tax collections in 1976 stems from the introduction of the reform, and in particular the effect of the exchange of loans for taxes, the imposition of interest and linkage on arrears in tax payments, and the compulsory keeping of books. It is worth mentioning that collection was not full in the reported year due to organizational difficulties and lack of manpower in the income tax establishment that became very severe. Despite these difficulties, collection from the self-employed was broadened; its effect on total collections is small due to the low weight of collections from the self-employed in total income tax collections.

Collection in income tax from employees increased in 1976 by 64 percent as against 43 percent in 1975, while the weight of these collections in the total collection of income tax continued to fall. After deducting the growth stemming from the exchange of loans for taxes and the effect of payment arrangements, collections increased by 41 percent in 1976 as against only about 19 percent in 1975. Payment arrangements to employees are in fact almost entirely payment arrangements for employers, who encountered difficulties in transferring the deductions from their employees' wages, and taxes from employees were deducted in their entirety in the year in which the income was earned. It follows from this that for the purpose of examining the tax burden on employees, the influence of payment arrangements should be deducted. The low rate of growth in 1975 is explained by the "warming-up" period of the reform and by the transitional arrangements that accompanied its introduction. (The most outstanding among them was the arrangement for maintaining net wages in the 1975/76 tax year.) The increase in 1976 (which is deducted, as mentioned, from the effect of the exchange of loans for taxes and payment arrangements) corresponds with a comprehensive tax flexibility of about 1.1.<sup>47</sup>

In tax collections from the self-employed, an increase of 127 percent took place in 1976, as against 23 percent in 1975. The influence of payment arrangements on collec-

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<sup>46</sup> Including income that was previously nontaxable, such as the cost-of-living allowance, car and telephone allowance, etc.

<sup>47</sup> The increase in total wage payments in the economy in 1976 was 36 percent.

tions from the self-employed is outstanding, the implication being that assesseees apparently considered the expansion of payment arrangements as usual bank loans, and their payment in 1976 did not come in place of usual tax collections in this year. After deducting the effect of the exchange of compulsory loans for taxes and the influence of payment arrangements, collections from the self-employed increased by 55 percent in 1976, as against 34 percent in 1975.<sup>48</sup> This increase proves that there was a broadening of collections from this sector, and there is direct evidence to this effect.<sup>49</sup> Average declarations for the tax year 1975/76 were about 80 percent larger than average declarations for 1974/75, and the number of those who keep accounts among the self-employed increased from about 15 thousand before the introduction of the reform to about 120 thousand at the beginning of 1977, representing about two-thirds of the total number of self-employed who are required to keep accounts. The great increase in declarations apparently stems from the more favorable marginal tax rates, the enforcement of book-keeping, and the imposition of interest and linkage on arrears in tax payments. At the same time, in a sample check<sup>50</sup> it was found that average assessment, after examining the declaration, was about 100 percent higher than that quoted by the assessee. This fact points to the extent of collections that could be reached by additional collection efforts directed at this sector.

In collections of income tax from companies, the low rate of increase in 1976 stands out (after deduction of the effects of the exchange of loans for tax and the expansion of payment arrangements), following several years of high and stable growth in tax collections from companies. This slowdown is explained by the decrease of profitability in the years for which the tax was collected, and tax concessions stemming from the rules for calculating accelerated depreciation in companies to which the Law for the Encouragement of Capital Investments applies. In addition, a considerable part of the great increase in collections from directors of companies and members of cooperatives was offset by the slowdown in the collections from companies. The reform in direct taxation equalized tax rates on income of individuals and on undistributed profit, making the withdrawal of directors' salaries more profitable in comparison to the previous situation<sup>51</sup>. The effect of the expansion of payment arrangement to companies acted as well, at least partially, in slowing down current collections this year, since

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<sup>48</sup> In real terms, discounted by the private consumption price index, there was an increase of about 20 percent in 1976 as against a real decrease of about 4 percent in 1975.

<sup>49</sup> Data supplied by the State Income Administration.

<sup>50</sup> A small sample of about 1,200 dossiers, which is not necessarily representative; the examination is aimed at branches in which there was fear of greater than average concealment of income.

<sup>51</sup> Before the reform, it was worthwhile for directors to receive lower salaries and to draw part of the profit as loans from the company and as refund of expenses, and similar nontaxable items.

companies pay taxes according to account books, and the increase of commitments for the payment of tax in 1975 (in these arrangements) was not added to the usual collections.

The collection of compulsory loans dropped considerably in 1976, as a result of the cancellation of Defense and War Loans on income received starting in the 1975/76 tax year. At the same time, the weight of employers' savings loans in total compulsory loans is on the rise. The tax component in this loan is becoming smaller with the relatively greater deterioration in recent years of bonds tradeable on the Stock Exchange, and in taxation on profits of companies from interest and linkage differentials in these bonds.<sup>52</sup>

#### b. Indirect Taxes

Indirect taxes on domestic production increased in 1976 by 59 percent, as against 69 percent in 1975. Part of this growth stems from the imposition of the Value Added Tax in July 1976. Excluding VAT, indirect taxes increased in 1976 by 42 percent. The GNP (in production factor prices), which is the base for these taxes, grew by only 28 percent in 1976. The growth of indirect taxes beyond the growth of the tax base is explained by the increase in the rates of government and city taxes and service fees, and by the effect of imposing the employers' tax and the increase of the rates of the purchase tax twice during 1975. The effect of these steps was partially offset by the cancellation of the stamp tax on receipts, and a certain reduction in the rates of purchase tax, which became effective together with the imposition of VAT.

Taxes on property increased in 1976 by 33 percent. An especially moderate increase took place in land registration fees (19 percent) in 1976, due to a slackening in the housing construction branch.

Indirect taxes on civilian imports increased by 49 percent in 1976, as against 14 percent in 1975. About 20 percentage points of the increase in collections in 1976 stems from the imposition of VAT and the expansion of the incidence of levies to service imports. The increase in purchase tax collections stands out in particular (50 percent), stemming from the increase of imports of durables, in addition to the influence of the rise in rates in 1975. In contrast, there was a moderate increase in collections of customs duties and security levies in civilian imports, influenced by the development of total imports with the great expansion of the incidence of the levy on imports which took place in the last two years.<sup>53</sup>

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<sup>52</sup> Revenue from linkage differentials and interest on bonds held by firms is to be set against interest payments of the firm, which are recognized as expenditures for tax purposes, and are therefore in fact taxed. Revenue from linkage differentials on employers' savings loans is not set against interest payments and is therefore tax free.

<sup>53</sup> In dollar terms, total imports declined except for ships, aircraft and diamonds. The increased import of consumption assets, durable goods and in particular transport equipment did not apparently offset the effect of the general decline of imports, despite the high customs on these products.

TABLE X-10

**COLLECTION OF INCOME TAX AND DEFENSE AND WAR LOANS  
ON INCOME, 1974-1976**

	1974	1975	1976	Annual change		Distribution of collection		
				1975	1976	1974	1975	1976
	(IL million)			(percent)		(percent)		
<b>A. Wage earners</b>								
Income tax	2,659	3,794	6,225	42.7	64.1	43.5	40.4	37.2
Income tax and defense & war loans	3,673	4,356	6,225	18.6	42.9			
Gross income tax <sup>a</sup> & defense & war loans	3,705	4,406	6,229	18.9	41.4			
<b>B. Company managers and cooperative members</b>								
Income tax	170	292	810	71.8	177.4	2.8	3.1	4.8
Income tax & defense & war loans	220	320	810	45.5	153.1			
<b>C. Companies</b>								
Income tax	1,883	3,110	5,485	65.2	76.4	30.8	33.2	32.8
Income tax & defense & war loans	2,628	3,934	5,672	49.7	44.2			
Gross income tax <sup>a</sup> & defense & war loans	2,822	4,544	5,697	61.0	25.4			
<b>D. Self-employed</b>								
Income tax	738	910	2,062	23.3	126.6	12.0	9.7	12.3
Income tax & defense & war loans	970	1,126	2,211	16.1	96.4			
Gross income tax <sup>a</sup> & defense & war loans	1,067	1,434	2,224	34.4	55.1			
<b>E. Deductions at source</b>								
Income tax	665	1,277	2,160	92.0	69.1	10.9	13.6	12.9
<b>F. Total</b>								
Income tax	6,115	9,383	16,742	53.4	78.4	100.0	100.0	100.0
Income tax & defense & war loans	8,156	11,013	17,078	35.0	55.1			
Gross income tax <sup>a</sup> & defense & war loans	8,479	11,981	17,120	41.3	42.9			

<sup>a</sup> Gross income tax – before deduction of estimate of the growth of payment arrangements. The growth in payment arrangements is a growth in the non-cleared balance of loans to tax debtors through the banks. The division of the payment arrangements among the assesseees is an estimation, and therefore the discounted data for 1975 should be examined with suitable caution, since in that year the sums involved in the payment arrangements increased substantially.

SOURCE: Income and Property Tax Commission. Estimate of the growth in payment arrangements – the Accountant General.

Collections of the Value Added Tax imposed in July 1976 totaled IL 2.8 billion by the end of 1976. The tax fell *a posteriori*, on consumption and on investments in housing construction; other investments<sup>54</sup> and exports are exempt. The great advantage of this tax is in that it does not distort the allocation of resources, except for a deliberate discrimination against consumption as opposed to investments and exports. This advantage has not yet been entirely felt, since the introduction of VAT was not accompanied by an extensive cancellation of other indirect taxes that are imposed at differential rates only on some products, thereby causing distortions in the allocation of resources.

Indirect taxes have a double role in the execution of government policy : as a fiscal instrument, with the purpose of transferring resources from the public to the government for financing its expenses, and as an instrument for controlling the effective exchange rate, the purpose of which is to influence, together with the official exchange rate and the export incentive policy, the balance of payments. These two components change according to the aims of the economic policy, and other measures that are taken not necessarily to the same extent or in the same direction. It follows that the examination of import taxes without separating the components makes the understanding of the development of taxes and the changes in them difficult.<sup>55</sup> This difficulty stands out in the analysis of tax development in recent years. In the early seventies, until the devaluation at the end of 1974, taxes on imports served increasingly as an instrument for the execution of the balance of payments policy (despite the devaluation in the official exchange rate in 1971). Since the introduction of the creeping devaluation in 1975, the role of the balance of payments policy in import taxes declined considerably, and total taxes collected from imports have grown much more moderately than other taxes – since the government introduced an aggressive policy of absorption by means of other taxes in these years, as mentioned above.

As already mentioned, the component of exchange rate policy in import taxes is not an economic tax, but a substitute for devaluation (despite the fact that its influence on the economy is not identical with the influence of a devaluation, even if it is accompanied by suitable export incentives),<sup>56</sup> and its inclusion in the tax total distorts the analysis of parameters such as the tax burden, the governmental domestic demand surplus and ongoing injection, especially in the years in which this component undergoes a sharp change, such as between 1974 and 1975, and after.

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<sup>54</sup> Including investments in inventory.

<sup>55</sup> On the need for separating these components and its repercussions see: Amotz Monag, *Government Financing in Israel*, Magnes Press, 1967, page 215. (Hebrew).

<sup>56</sup> The difference stems from the fact that the tax and the incentive do not fall on all components of the balance of payments, and there is therefore a difference in the effect on the allocation of resources between the government and the public due to transfers of foreign currency of the private sector that are being carried out at the official exchange rate.

On the assumption that the fiscal policy of the government is expressed in the taxation on GNP, the fiscal tax rate on imports is estimated as being equal to the indirect tax on the product, and all taxation on imports beyond this is considered as a substitute for devaluation. Average tax rates obtained by this system of estimation are given in the following table:

**AVERAGE TAX RATES ON IMPORTS, THE FISCAL COMPONENT,  
AND THE DEVALUATION REPLACEMENT, 1969-1976**

	1971	1972	1973	1974	1975	1976
1. Average tax rate on imports	22.8	22.9	21.5	24.3	18.9	22.0
2. Tax rate which is replacement for devaluation	10.0	10.6	10.1	12.5	5.5	5.3
3. "Pure" fiscal tax rate	11.6	11.1	10.3	10.5	12.7	15.9

**NOTES :**

1. The "pure" fiscal tax rate is, according to the assumption, equal to the average indirect tax rate on the Gross National Product.

2. The average overall tax rate on imports is not the total of the average tax rates of the components. Rather, it is expressed in the following formula :

$$T_1 = M \cdot R (1+t_2) t_1$$

$T_1$  = "Pure" fiscal tax collection on imports

$M$  = Imports in dollar terms

$R$  = Official exchange rate

$t_2$  = Rate of tax which is replacement for devaluation

$t_1$  = "Pure" fiscal tax rate

3. The imports in these calculations are imports excluding ships, aircraft and direct defense imports. For details and an explanation, see Appendix.

### 5. CREDIT ACTIVITIES

In 1976, the public sector absorbed net credit totaling only IL 0.5 billion, following three years of considerable absorption<sup>57</sup> that reached about IL 6.0 billion in 1975. The absorption of credit stems both from budgetary credit activities and from other nonbudgetary activities that find their expression in the financial balance sheets of the

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<sup>57</sup> Net credit absorption summarizes the following activities: the granting of loans, less collection of loans that were given in previous years. The receipt of voluntary credit, less payment of credit received in previous years (including payment of tradeable compulsory loans).

TABLE X-11

## INDIRECT TAXES, 1974-1976

	1974	1975	1976	Annual change	
				1975	1976
	(IL million)			(percent)	
A. Property taxes <sup>a</sup>	749	1,149	1,525	53.4	32.7
B. Taxes on domestic production	4,494	7,573	12,055	68.5	59.2
Purchase tax	1,326	1,977	3,104	49.1	57.0
Value Added Tax <sup>b</sup>	55	123	1,477	..	..
Gasoline tax <sup>c</sup>	676	1,581	1,572	133.9	-0.6
Employers' tax	-	560	1,173	-	109.5
Other government taxes <sup>d</sup>	1,842	2,582	3,449	40.2	33.6
Taxes of local authorities	595	750	1,280	26.1	70.7
C. Indirect import taxes	7,488	8,665	12,862	15.7	48.4
Levy and VAT on defense imports	1,447	1,753	2,577	21.1	47.0
Indirect taxes on civilian imports	6,041	6,912	10,285	14.4	48.8
Thereof : VAT	-	-	951	-	-

- a) Including property tax, acquisition financing tax, and land registration fees.
- b) Including VAT on businesses, on nonprofit institutions and the public sector, and on financial institutions. This also includes service tax collections on financial institutions, which was absorbed into VAT with its implementation.
- c) Excluding the petroleum levy, which is included in indirect import taxes.
- d) Including the excise tax on cement, on tobacco and beverages, stamp tax, defense stamp, automobile registration fees, the surplus of government businesses, and various other fees.
- e) Including customs and defense levy, purchase tax, foreign travel tax, service import levy. In the past the surtax on inventories and exchange rate differentials was included in import taxes. This year this tax is included in direct taxes, and the data have been corrected retroactively for previous years.

SOURCE : Central Bureau of Statistics.

credit activities injected about IL 1.6 billion. In 1975, budgetary activities absorbed IL 3.4 billion, and other credit activities absorbed about IL 2.6 million as well. It seems that part of the absorption of the other credit activities in 1975 was an expression of the transfer of payments (and monetary injection) for activities carried out in 1975 for the

<sup>58</sup> These activities were obtained as the difference between ongoing injection from the budgets of the sector and the cash injection measured at the Bank of Israel. Apart from this there are credit activities that are influenced by the public sector but do not find expression in its budgetary accounts and balance sheets. These are mainly credit direction and exchange rate and linkage insurance.

coming years.<sup>59</sup>

The loans given by the public sector in the framework of its budget to other sectors declined in real terms by 14.0 percent in 1976.<sup>60</sup> In contrast, in 1975, there was still a real growth in loans for investments. Directed and free emissions, which also serve for the financing of investments according to a public order of priorities, but do not pass through the State Budget, decreased in real terms at a rate of about 5.7 percent. Total budgetary and emissive loans for the financing of investments (excluding credit for food) decreased by about 8.0 percent. This decrease is in accordance with the restraint policy the government introduced in its direct demand.

Investments in economic sectors decreased in 1976 by 14.0 percent; in view of the fact that loans decreased at a lower rate, the rate of investment financing (budgetary and emissive) increased by about 10.0 percent. An even greater increase in the rate of financing was found in the data of the institutional structure of the capital market. The additional growth that was found in the rate of financing apparently stems from additional monetary sources that were at the disposal of the institutional structure of the capital market (except those mentioned above). There is evidence that in 1976 the government expanded its use of the granting of exchange rate insurance, which is one of the sources for the allocation of credit and is not considered a current activity of the public sector.

In 1976, the public sector, in the framework of its budget, mobilized domestic credit amounting to IL 8.8 billion as against IL 7.1 billion in 1975, which represents a real freeze from the point of view of purchasing power. Government bonds and emissions deposited in the State Budget constituted about three-quarters of credit revenue. The rest of the credit was received from loans and deposits of banks and other bodies that are enlisted by the sector for financing its budget.

The slow growth in credit revenues was not sufficient to absorb either the considerable real growth of about 52.0 percent in domestic debt payments, or the credit that was given in the framework of other activities. The slow growth in the receipt of credit, despite the considerable increase in payments, is partially explained by the worsening of conditions of linked bonds in 1975, and by fear of changes in the capital market that would adversely affect existing bonds, as well as by the relatively low growth in disposable income. Part of the explanation of the considerable growth in payments can be found in the fact that

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<sup>59</sup> An increase of about IL 1.3 billion in suppliers' credit in 1975/76 obtained as a result of the fact that the payments of the public sector did not increase at the same rate as its real activity.

<sup>60</sup> Not including loans for housing, since public construction for dwelling was considered in its entirety as a direct investment of the public sector. Also excluded are directed credit activities, which were included in 1976 in the framework of "earmarked income" in the State Budget. The real decrease of 14.0 percent does not include credit for the financing of food inventories in stores, the greater part of which is being spent on purchases abroad. The inclusion of this credit in the calculation would have brought about a real increase of the credit given from the budget of the sector (see Table X-12).

TABLE

## DOMESTIC CREDIT ACTIVITIES IN THE

	At current prices			
	1973	1974	1975	1976
	(IL million)			
A. Voluntary receipt of domestic credit	5,170	6,672	7,062	8,777
B. Domestic loan repayment				
1. Voluntary loans	1,638	2,257	2,720	5,334
2. Tradeable compulsory loans	135	191	234	293
Total (B)	1,773	2,448	2,954	5,627
C. Net receipt of credit (A-B)				
1. Voluntary loans	3,532	4,415	4,342	3,443
2. Tradeable compulsory loans	-135	-191	-234	-293
Total (C)	3,397	4,224	4,108	3,150
D. Loan granting to the public	890	998	1,213	1,706
E. Domestic collections	333	486	522	581
F. Net loan granting (D-E)	557	512	691	1,125
Total net receipt of credit (C-F)	2,840	3,712	3,417	2,025

<sup>a</sup> Not including housing credit activities and other net domestic credit activities.

<sup>b</sup> Real growth rates were calculated using product and investment price indexes.

Development and Defense Loans, which were issued in large quantities in 1971<sup>61</sup>, came due for payment at the end of five years of high price increases that accumulated as linkage on principal and interest. Ten-year loans, on which interest and linkage become payable at the end of five years, also came up for interim payment. The rest of the growth is connected with a considerable increase in the total internal debt, which is mostly linked.

<sup>61</sup> In 1971 financing received by the government through bonds (governmental and deposited) and through banks doubled.

PUBLIC SECTOR BUDGETS<sup>a</sup>, 1973-1976

Annual increase of (-) decrease					
At current prices			At fixed prices <sup>b</sup>		
1974	1975	1976	1974	1975	1976
(percent)					
29.1	5.8	24.3	-3.9	-23.3	-0.9
37.8	20.5	96.1	1.9	-11.4	56.5
41.5	22.5	25.2	4.6	-9.9	—
38.1	20.7	90.5	2.1	-11.3	52.0
25.0	-1.7	-20.7	-6.6	-29.2	-36.8
-41.5	-22.5	-25.2	-4.6	9.9	—
24.3	-2.7	-23.3	-7.0	-30.1	-38.9
12.1	21.5	40.6	-20.4	-9.6	13.4 <sup>c</sup>
45.9	7.4	11.3	3.5	-20.1	-10.3
-8.1	35.0	62.8	-34.7	0.5	31.2
-30.7	-7.9	-40.7	-2.1	-33.8	-51.6

<sup>c</sup> Less loan granting for financing food inventories, there was a decline in the real rate, of about 14.0 percent.

Collections of the loan fund granted by the sector in past years (mostly unlinked) increased at a moderate rate of 11.3 percent in current prices, despite the fact that total financial assets of the government and of national institutions increased in 1975/76 by 43.0 percent.