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DISCUSSION PAPER

COMPENSATION FOR INFLATION UNDER ISRAEL'S
EMERGENCY ECONOMIC POLICY

by

JACK HABIB and ROBERT LERMAN

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Compensation for Inflation under Israel's Emergency Economic Policy

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Abstract

This paper offers an overview of the Israeli government's compensation measures taken in connection with its Emergency Economic Policy (EEP). The goals of compensation policy under the EEP were to shield the needy from the effects of the unusually rapid inflation while reducing overall consumption. In contrast, the normal goal of compensation policy is to preserve the income shares of workers and transfer recipients in times of rising prices. To adjust to the change in goals, the government departed from its normal measures by advancing the date of compensation to welfare payments, child allowances, and old-age, survivors, and disability pensions. But the government decided against special advances to wages and delayed the decision over how much compensation to pay in July 1975 under existing formulas. The paper examines the implications of the timing and amount of compensation.

The government's special measures provided full and immediate compensation to those entirely dependent on welfare payments and pensions, but most working poor families received far less than full compensation. This policy created inequities among the poor. Even if the working poor receive compensation to wages under the normal formulas and the normal time lags between price increases and cost-of-living supplements, they still will lose purchasing power worth about two months in salary. Thus, the advances in COL supplements in themselves have constituted an important financial advantage. A further implication of these policies was to raise substantially the financial attractiveness of welfare relative to working, at least in the short-run. Partial advances to wages and/or higher advances to child allowances could have partly relieved the inquieties and adverse work incentives. However, these difficulties were partly consequences of the government's goals, which imply a narrowing of income differentials, and of the sudden nature of EEP-induced price increases.

This paper suggests two kinds of policy changes which could improve incomes policy in Israel. First, to improve significantly the equity and efficiency of compensation policy, the government should institute structural reforms in the system of taxes and transfers. The Tax Reform Committee headed by

Haim Ben-Shachar has recommended a new system which includes the substitution of tax credits for personal exemptions. Under this system, the government could provide compensation effectively to low income families of all sizes by raising tax credits. In this way, workers could receive compensation without having to resort to welfare. Whether tax credits provide sufficient income support to workers in the future depends on the government's decision on how to adjust tax credits over time. If credits keep pace with average wages, welfare's income maintenance responsibilities will be limited to a small number of families with special or emergency needs. If credits fall relative to average wages, then welfare will have to provide income support to many working poor families. A second recommendation is that the government take steps to avoid sudden price increases. One interesting finding in the paper is that under normal compensation policies, sudden price increases do not cause any higher losses in real income than do smooth price increases of the same total size. From this standpoint, the suddenness of price increases does not justify changing compensation procedures. Nevertheless, sudden price increases do place a strain on incomes policies and stimulate public pressure for advances to COL supplements. The government could help to smooth out the pattern of price increases by making more frequent alterations in exchange rates and by changing the food subsidy program so as to fix the subsidy level rather than the retail price.

Finally, the paper notes that government policy toward noncash benefits appeared haphazard. At a time in which the government attempted to compensate fully the cash incomes of low income groups, a number of noncash benefits and social services targeted on low income groups declined in real terms for no apparent reason.

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Introduction and Conclusions

On November 9, 1974 the Israeli government announced a new economic policy in response to the rapid deterioration in Israel's balance of payments and its level of foreign reserves and to the rapid increase in the costs of the government food subsidy programs that resulted from rises in world food prices. The primary measures taken were a 40 per cent devaluation of the Israeli lira and raising prices of subsidized food commodities and other goods and services subject to government control. To insure the success of the emergency economic policy (hereafter EEP), the government had to impose a reduction in consumption of 3 to 5 per cent in 1975. One of the government's declared goals was to distribute the burden of reduced consumption in a progressive manner. The lowest income groups (hereafter referred to as the poor) were to suffer no losses at all; above these levels, the decline in living standards was to become larger the higher the family's income.

The primary method used to reduce consumption was to allow prices to rise faster than incomes. The government exerted its substantial influence on the real income losses borne by different population groups by varying the timing and the amount of cost-of living supplements to wages and government income transfers. It is important to recognize that the existing compensation mechanisms provide only partial control over the net incidence of inflation. The extent of government control over real wages is controversial. Economists have argued that government-imposed wage scales are at least partially subverted by market forces. Moreover, there are differences in debts, savings, home-ownership, and foreign exchange holdings within and between income and demographic groups. With the exception of government bonds linked to the price index, existing compensation policies have little influence on gains or losses from inflation to these income sources. Although the factors other than wages and income supplements are quantitatively significant, the government apparently did little to take these factors into account in deciding upon or defending its compensation policies.

This paper offers an overview of the Israeli government's compensation measures taken in the immediate post-EEP period. After describing the normal procedures used to adjust for inflation, we examine whether special compensation

measures were necessary to attain the goals of the EEP. Next, we assess the impact of compensation measures on families in different age, income, and family size categories. A third section considers the pros and cons of other policies to provide compensation to the poor without subverting other goals in the EEP. The concluding sections address broader questions of incomes policy, such as: was the policy of narrowing gaps between welfare recipients and workers, or of increasing the size of population eligible for welfare, the inevitable consequence of the government's goals and current circumstances? Could this problem and the problem of inadequate compensation to the working poor be mitigated in the future through the use of existing tools or new ones established by structural changes in the current tax-transfer system? What strains do sudden price changes place on the system of compensation? How can such strains be avoided in the future?

The main points of the paper are:

(1) The goals of imposing reductions in aggregate consumption while providing full and immediate compensation to the poor imply a narrowing of income differentials. Instead of focusing on this basic fact, much of the public debate has centered on its implications, such as the increased incomes available to welfare recipients relative to those available to workers. Although partial advances to wage earners and higher advances to child allowances might have moderated these implications, they are largely the inevitable consequence of government goals. If real incomes are not allowed to rise in the near future, we must either abandon the goal of full compensation to the poor or find better ways to implement a further narrowing of income differentials.

(2) Normal compensation measures in normal periods of inflation impose significant real income losses because of the time lags between increases in prices and the payment of cost-of-living allowances. We estimate that a 12 per cent annual price increase results in a net real loss equivalent to over one month's salary. The real losses to wage earners and transfer recipients increase with the <u>magnitude</u>, but not with the <u>suddenness</u> of inflation. This result provides a rationale for linking the frequency of compensation to the rate of inflation.

(3) One consequence of the government's policies was that some low income groups, primarily welfare recipients and the aged, received the full 24 per cent compensation, while compensation to the working poor was much less adequate, ranging from 2 per cent for poor families with two children to 15 per cent for

poor families with six children. These inequities are an important limitation of the government's compensation policy. In fact, those low income families granted full and immediate compensation received more favorable treatment than they would have under a normal inflation and normal compensation. The advances in compensation themselves represent an important financial advantage, which the favored groups will retain even if others are paid full cost-of-living supplements at a later date.

(4) To improve substantially the equity and efficiency of compensation measures requires structural changes in the system of taxes and transfers. The Tax Reform Committee headed by Haim Ben-Shachar has recommended a new system which includes the substitution of tax credits for personal exemptions. Under this system, the government could provide compensation effectively to low income families of all sizes by raising tax credits. In this way, workers could receive compensation without having to resort to welfare. Whether tax credits provide sufficient income support to workers in the future depends on the government's decision on how to adjust tax credits over time. If credits keep pace with average wages, welfare's income maintenance responsibilities will be limited to a small number of families with special or emergency needs. If credits fall relative to average wages, then welfare will have to provide income support to many working poor families.

(5) Sudden jumps in prices impose a strain on incomes policies. Among the measures that could help smooth out the pattern of price increases are more gradual adjustments of exchange rates and of the prices of subsidized commodities. One specific recommendation is to change the food subsidy programs so as to fix the subsidy level rather than the retail price.

Why were departures from regular indexing procedures necessary?

To understand the need for special measures as part of the EEP, one must examine the normal compensation policies. Normal policies serve three related goals: to preserve the income shares of wage earners; to maintain real wages; and to insure that transfers do not decline as a share of average wages.[1]

[1] There has been criticism of the goal of maintaining real wages under all circumstances. The critics point out that the goal of preserving income shares of wage earners does not always justify compensating workers for inflation. For example, increased import prices represent an added burden on the entire economy. To avoid increasing the balance of payments deficits, an increase is required in the share of national output that goes into foreign hands. Thus, maintaining the shares of income received within the country would involve less than full compensation for inflation. A number of proposals have been offered to compensate for inflation on the basis of a price index purged of the influence of increased import prices and (cont. next page)

A number of arrangements have developed to implement these goals. They include:

1) A cost-of-living (COL) escalator clause in national wage agreements. These increases are tax exempt. Thus, the lowest income from earnings subject to tax is adjusted upward automatically.
2) Increases in transfers linked to increases in average wages. This has now become the accepted practice for some programs, such as employee's child allowances and is embedded in law for others, such as old-age, survivors, and disability pensions.[2]
3) Increases in private pensions linked to increases in wages.
4) Compensation to some forms of savings, such as government bonds linked to the COL.

The process of compensation may be characterized in terms of three dimensions:

Measure of COL Increases

The COL measure has been calculated as the price increases in a basket of goods and services representing the consumption pattern of the average urban family in 1969. Only one COL measure has been used for the entire population.[3]

Extent of Compensation

The extent of compensation received by an individual family depends on its income sources and the amount of compensation paid to each source. In normal times, compensation paid to low and moderate wages,[4] child allowances, welfare payments, and public and private pensions equals the full increase in the COL. This implies full compensation for those whose income comes from these sources alone. But for some groups, such as high wage workers, the self-employed, and those with interest, dividends, and other non-employment income, the government generally does not insure full compensation for inflation.

Timing of Compensation

The value of compensation depends on the lag between price increases and increases in income. The length of the time lag is determined by the frequency of compensation and the formula for computing average price increases. The

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1 (cont.)
indirect taxes. See Report of the Committee to Investigate the Cost of Living Allowance, Tel Aviv, 1966, Mimeograph (Hebrew) for a more extended discussion of these issues.

[2]Transfers are increased in July and January by the same percentage rate as the cost-of-living adjustment to wages. In April, transfer payments are adjusted so that their value as a proportion of the average wage per employee post does not decline. The average wage figure is derived from employee withholding tax records.

[3]The price index used to compute COL allowances accords a lower weight to housing than does the general price index computed by the Central Bureau of Statistics.

[4] (following page)

current formula uses a 12 month moving average. Until 1973, compensation was paid on an annual basis; but with the acceleration of inflation in the last two years, compensation to wages has been paid once every six months and to transfers sometimes more frequently.

Unusual circumstances in the current period forced the government to depart from its normal compensation policies.[5] While the normal compensation mechanisms were designed in large part to maintain real incomes during inflation, the present objective is to restrain overall consumption by allowing inflation to reduce real incomes. Second, the current inflation is unusually rapid and sudden. That is, the average annual inflation rate is expected to be particularly high and concentrated in the first few months of the post-EEP period. A third factor is that recent price increases were expected to exert a larger percentage effect on the poor than on middle and upper income groups. This expectation followed from the larger increases in world food prices, which were suddenly translated into higher domestic food prices by the government's decision to cut food subsidies.[6]

To implement the reduction in consumption the government had to choose how to divide the burden. It was decided that the decline in consumption should be borne exclusively by the non-poor, allowing the poor to maintain their pre-devaluation living standard and causing a rise in the poor's share of total income. This decision, in itself, required adjusting normal compensation mechanisms. But the government's mandate was an inadequate guide for such adjustments. This required the EEP Committee to provide its own answers to such questions as: Which groups were to be considered "needy" for purposes of providing full compensation? Should compensation measures also play a role in distributing the burden progressively among the non-poor?

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[4] Current policies place a ceiling on the cost-of-living allowance to wages. Thus, high wage earners to not receive full compensation. The Committee referred to in footnote 1 recommended against such a ceiling on grounds that it is inconsistent with the goal of preserving the share of wages in total income.

[5] The government decisions were made in many stages. For our purposes, it is necessary to mention two. One set of decisions concerned economic restraint and full compensation to the poor. To put these goals into effect, the government appointed a special committee (The Committee to Examine Compensation for Inflation under the EEP, hereafter the EEP Committee) to decide on the specific adjustments in various programs. The EEP Committee was headed by Amiran Sivan,, Director-General of the National Insurance Institute, and included representatives from the Histadrut, the Treasury, and the Central Bureau of Statistics. The EEP Committee was not allowed to recommend changes in wages or in tax policy. Our analysis focuses on overall government policy, not simply the decisions of this special committee.

6 (following page)

To account for expected differences in the effect of inflation on different population groups, the EEP Committee undertook to calculate price changes separately for selected income and demographic groups. The Committee estimated that the devaluation-induced price increases would be 24 per cent for low-income persons in all demographic groups; 20 per cent for middle income groups, and 18 per cent for high income groups.[7]

In recognition of the unusually rapid and sudden nature of the inflation expected in the post-EEP period, the government decided to forego the normal delays between price increases and compensation payments and to pay the poor immediately. This change in timing represents a considerable financial benefit to the poor over other groups. To what extent were these advances justified by the magnitude and the sudden nature of the inflation? What was the size of the real income gain attributable to paying compensation immediately instead of at the normal times?

Normally, compensation is paid twice a year and is based on a 12 month moving average of the price level. Price increases in a given month are translated into nearly equal income increases after a lag.[8] The lags range from one to one and a half years, depending on which month's price increases one is considering. If we consider a one per cent monthly rate of inflation from January through December 1975, we find that the cost-of-living adjustments do not reach close to the full 12 per cent until January 1977. The cumulative loss in real income that results from this lage in compensation totals slightly more than

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[6] But even with these cuts, planned expenditures on imported and domestic food subsidies have jumped from IL 569 million in 1974 to IL 1167 million in 1975. See Proposed Budget, Fiscal Year 1975, Volume 18, page 1.

[7] For further details, see Nira Shamai, "Compensation to Low Income Groups in Light of the November 1974 Devaluation", National Insurance Institute, Bureau of Research and Planning, Jerusalem, 1975 (Hebrew).

[8] It is interesting to note that under formulas in current use, COL supplements for specific price increases may never reach the level necessary for full compensation. Consider the price increase which raised the price level from 100 in October 1974 to 124 in December 1974. To isolate the compensation attributable to this increase, assume that no additional price increases occur. According to current formulas, the final COL wage increase related to these price increases will occur in January 1976. But it will bring wages up to only 1.223 times October 1974 wages, not the 1.24 necessary for full compensation.

one month's salary, or approximately 4 per cent per month over the 24 month period. As the magnitude of the annual inflation rises, so does the cumulative loss in real income. Thus, high rates of inflation pressure the government to alter normal compensatory mechanisms. Such adjustments may take the form of increased payments in January and July or payments at more frequent intervals.[9] In the current period, the unusually high annual rate of inflation in 1974, exacerbated by the EEP, justified advancing the date of the compensation to the poor. The price level rose by 52 per cent between December 1973 and December 1974, as compared to 26 per cent in 1973, 12 per cent in 1972, and 11 per cent in 1971.

Another possible justification for immediate compensation is that the EEP-induced inflation occurred with unusual suddenness. The estimated increases were expected to take place within the first few months. Obviously, sizable short term increases create serious problems for many families, problems that might not arise if the 24 per cent increase were spread over a longer period. Does the sudden pattern in itself imply a greater real loss than a smooth pattern of inflation of the same magnitude, given current compensatory mechanisms? Assume the price increases equalled 14 per cent in November and 10 per cent in December 1974.[10] Consider the real loss from this pattern of inflation as compared with the loss that would have occurred if the same 24 per cent had been spread evenly over the months November 1974 through June 1975. Table 1 presents the respective losses from different inflation patterns and Figure 1 illustrates the path of monthly losses. Note that the cumulative loss is actually greater under the smooth than under the sudden pattern if no allowance is made for interest costs within each period. Comparing the present value of the losses from November 1974 through July 1976, using an 8 per cent discount rate, we find that the sudden inflation costs slightly more than the smooth

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[9] For example, the government provided advances to transfer recipients in February 1974 in combination with measures to reduce food subsidy payments.

[10] Actual price increases among average urban workers were 12 per cent in November and 7 per cent in December. Since inflation was higher among the poor, these figures understate the two month increase in prices borne by the poor. On the other hand, not all of the November-December increases were necessarily the result of the EEP.

TABLE 1

Real Losses from Inflation by Pattern and Rate

	Pattern of Inflation	Months	Size of Total Inflation	Months of Full Compensation	Cumulative Loss in Real Income as Per Cent of Initial Monthly Wage: Sum of Monthly Losses	Cumulative Loss in Real Income as Per Cent of Initial Monthly Wage: Discounted Sum as of Beginning of Period[c]
1.	Smooth[a]	January 1974 through December 1974	12%	January 1976 24 months from beginning of period	113	103
2.	Smooth[a]	November 1974 Through June 1975	24%	July 1976 20 months from beginning of period	220	205
3.	Sudden	November 1974[b] through June 1975	24%	July 1976 20 months from beginning of period	229	211

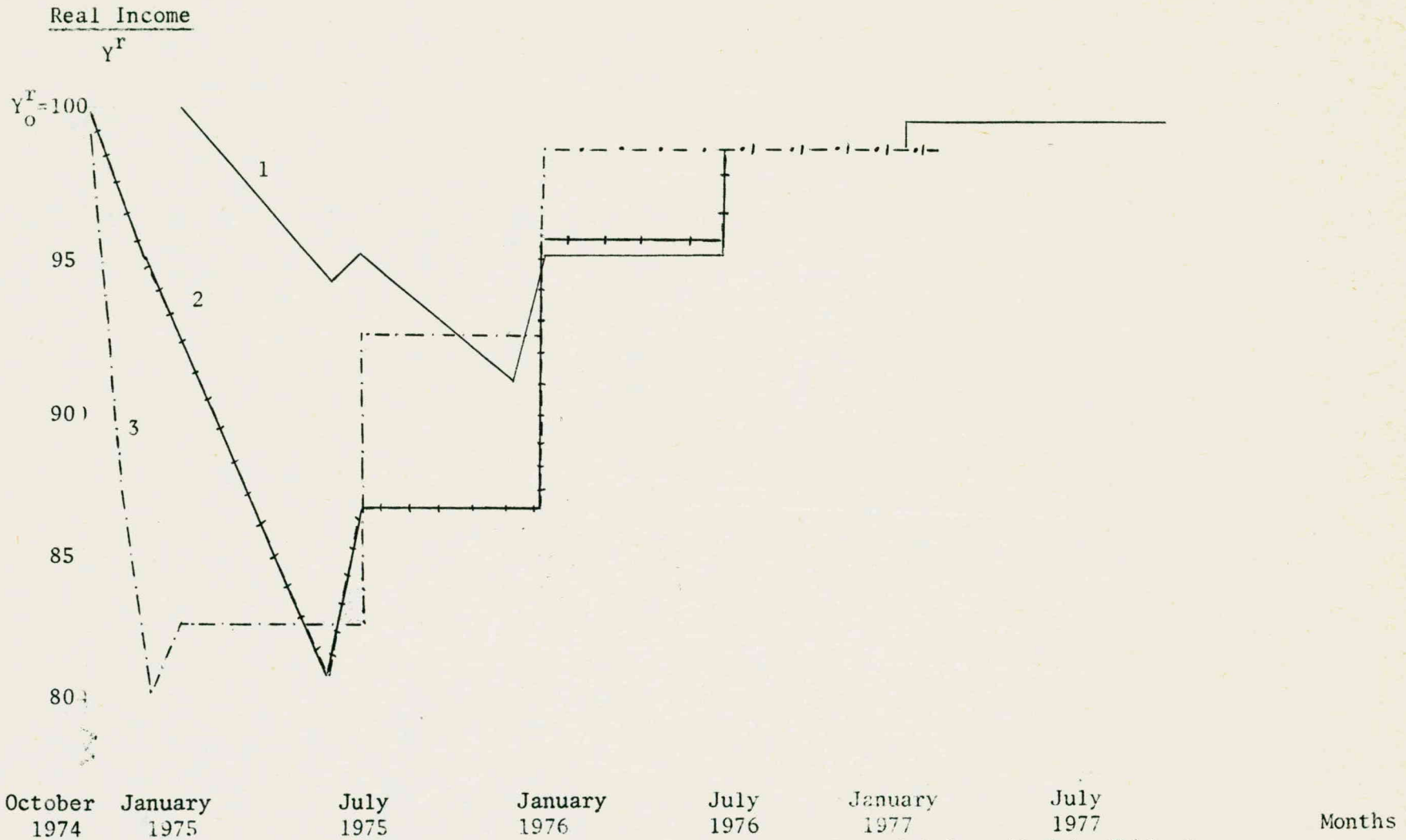
(a) Smooth denotes constant monthly percentage increase.

(b) The price increases in case 3 are approximately 14% in November, 10% in December and zero from January through June.

(c) The discount rate applied is an 8% annual rate.

Figure 1

Monthly Trend in Real Income by Pattern of Inflation
Using Normal Compensation Formulas



Note: Inflation Patterns 1,2, and 3 correspond to patterns 1,2, and 3 described in Table 1.

pattern; both cost slightly more than two months' salary.[11] The high cost from the smooth pattern is due partly to the use of a moving average of prices to calculate the compensation. Although the losses would be delayed more under a smooth inflation rate, the period required to complete compensation would be six months longer and the increase in wages in January and July 1975 would be smaller.

The issue of whether delays in paying cost-of-living supplements imply less than full compensation has been controversial.[12] The Committee examining compensation mechanisms concluded that workers do generally receive full compensation, after a one period lag.[13] The Committee reached this conclusion by comparing price increases with wage increases occurring in the same period. Using a table similar to Table 2, the Committee pointed out that prices rise faster than wages in period of accelerating price increases (years 3-4), but wages rise faster in periods of decelerating prices increases (years 5-6). Unfortunately, the Committee's perspective does not highlight the large losses that can occur because of initial lags. More important, the Committee does not relate the compensation payments to the specific price increases for which compensation is due. It does not

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[11] The total cost would be higher if the losses from subsequent months were included. Since current formulas yield a maximum COL increase of 22.3 per cent, or 1.7 per cent less than 24 per cent, the total losses in the example include an infinite flow of monthly losses. Excluding the losses after 20 months does not affect the comparison of the alternate compensations provided under the two patterns of inflation.

[12] See Nadav Halevi, "Economic Policy Discussion and Research in Israel", American Economic Review, Supplement to September 1969 Edition: Surveys of National Economic Policy Issues and Policy Research, pp. 106-107; and Report of the Committee to Investigate the Cost of Living Allowances.

[13] At the time the Committee analysed compensation mechanisms, COL allowances were paid once a year. Under this system, the length of time before workers receive full compensation varies from 12 to 23 months depending on which month's price increases one is examining. Under the present system, in which compensation is paid twice a year, the lag declines to from 12 to 17 months.

TABLE 2

Illustration of the Lags in Compensation for Inflation

Years	Price Index (a)	Percentage Changes in Prices	Wage Index (b)	Percentage Change in Wages	Gap Between Price and Wage Increases
0	100	-	-	-	
1	104	4	100	-	
2	108.2	4	104	4	0
3	113.6	5	108.2	4	0
4	120.4	6	113.6	5	-1
5	126.4	5	120.4	6	+1
6	131.5	4	126.4	5	+1
7	136.7	4	131.5	4	0
8	?	?	136.7	4	?

(a) The price index in any year is a simple 12 month average of price level, where the price level in year 0 equals 100.

(b) The wage index in a given year is equal to the wage level in the base year (year 1) plus increases in wages directly associated with COL allowances. Other increases in wages are ignored.

mention that compensation for each year's price increases comes with a delay, a delay which results in real losses. Consider year 8 in Table 2. The wage increases of 4 per cent paid in year 8 compensate for the 4 per cent price increases in year 7. Increases in wages made at the beginning of year 8 are independent of price increases in year 8. This means that price increases of any size occurring in year 8 reduce real incomes of wage earners during year 8. Thus, whether price increases accelerate or decelerate, the lags in compensation result in real income losses in every period.

These findings have implications for the government's compensation policies. Under the government's normal compensatory mechanisms, the delays in compensation may impose heavy real losses on wage earners and on transfer recipients. The extent of the real losses from inflation in a given period depends on the magnitude of the inflation, but not on the suddenness of inflation within the period.[14] The government shielded some groups from the unusually high price increases generated by the EEP by providing them full and immediate compensation. Interestingly, the compensated groups will face lower real losses than they would from a more normal inflation and the regular delays in compensation. Although the unusually high inflation rate expected is a sound justification for adjusting regular mechanisms, the government's measures go beyond compensating for the special effects of the EEP. The advances provided will produce substantial discrepancies between the immediately compensated groups and other groups. These differences will be highly significant even if full compensation is paid at the normal times to the groups receiving little or no advance compensation.

The high real losses that currently result during periods of rapid inflation provide a rationale for linking the frequency of compensation to the rate of inflation. A proposal for making such linkages with respect to wages and tax credits has been included among the recommendations made by the Tax Reform Committee. The Committee suggested that compensation be paid after three months whenever prices increase by more than 10 per cent in the preceding three months.

What were the compensation measures chosen under the emergency economic policy?

The special compensation measures represented a one-time change in the ongoing system of indexing for inflation. The normal system calls for cost-of-

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[14] Timing also matters to a small extent. The losses from a given month's price increases are higher the more the increases occur in months near July and January.

living increases in January and July. Since the January 1975 increases were intended to compensate primarily for pre-devaluation price increases, policy-makers believed they had only limited freedom to interfere with these increases. The discretionary policy dealt largely with adjustments to the normal July 1975 and January 1976 increases. The government decided to pay some groups an advance on their July 1975 increases and to postpone the decision about whether to allow the normal wage increases due in July 1975 to go into effect. Although these measures constitute the primary departure from the normal system, the January 1975 cost-of-living payments are also relevant to an analysis of the EEP. Whatever period the January increases were meant to cover, these additions to money income took effect in the post-devaluation period and the government could and did influence them.

A brief description of the compensation payments appears in Table 3. Note that the compensation directly attributed to the devaluation is called "November compensation" and the compensation primarily attributed to pre-devaluation price increases is called "January compensation". The government provided November compensation by making immediate and full cost-of-living adjustments to welfare payments; to old-age, survivors, and disability pensions; and to child allowances. In addition, welfare recipients and recipients of supplementary benefits were granted 16 per cent increases in January to reflect pre-devaluation price increases. The January increases in child allowances and basic pensions were considerably less than 16 per cent. The committee did not provide a clear rationale for these lower increases. However, government sources cited the advances in February and July as the justification for the less than full COL payments in January. In the case of wages, the government decided against any November compensation and left open the possibility of limiting July 1975 increases to less than what would be mandated by the usual cost-of-living formulas. Further, the government reduced January compensation for high wage earners by placing a maximum of IL200 on the cash component of the wage increase. Workers due to receive more than IL200 were granted additional increases up to IL100 in bonds.[15]

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[15] As of March 1975 the exact terms of the bonds were not determined.

TABLE 3

A Summary of COL Compensation in the Immediate Post-Devaluation Period

Income Source	Percentage Compensation: November or Special Compensation	Percentage Compensation: January or Regular Compensation
COL Supplement to Wages	Zero	About 16% up to a maximum cash per month payment of IL200 and maximum cash plus bonds compensation up to IL300 per month
Basic Pension to Old-Age, Survivors, and Disabled Persons	20%	6%
Supplementary Pension	30%	30%
Basic plus Supplementary Pension	24%	16%
Large Family Child Allowances to third and more children	IL 50 per child, the increases range from 46% for 8 children to 73% for families with 3 children	0%
Employee's Child Allowances for first two children	30%	6%
Welfare Payments	24%	16%

How did the government's compensation policies affect various subgroups?

The goal of the government was to provide full and immediate compensation to the poor and to distribute the burden fairly among the non-poor. How well did the government succeed? Although a thorough analysis of the adequacy of compensation must await the government decisions relating to July 1975 and January 1976 cost-of-living increases, a preliminary assessment is worthwhile. As previously noted, advancing the date of compensation in itself has a significant effect on the real losses resulting from inflation. What follows is an examination of how government decisions affected the incomes of poor and nonpoor groups.[16] The focus is on government decisions affecting the cash component of income. There is little discussion of efforts to maintain the real value of government services and of the effects of market forces on money wages or fringe benefits.[17] In considering the relative adequacy of compensation to incomes, one should recall that estimated price increases ranged from 24 per cent for the poor to 20 per cent for middle income groups and 18 per cent for high income groups.

The government's compensation policy for transfer programs allowed poor families entirely dependent on welfare, child allowance, and pension income to receive full compensation for the EEP-related price increases. This group includes most welfare recipients and recipients of disability pensions and supplementary pensions to old-age persons. However, low wage workers heading families received advances in compensation only for child allowances. The increased child allowances were far from sufficient to compensate the working poor fully. Table 4 illustrates how the pattern of compensation to the working poor varies primarily with family size. A couple with two children whose head is below official retirement age (hereafter a non-aged couple) and whose gross earnings equalled the poverty line before the EEP gained an advance

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[16] The definition of poverty used in this study parallels the measure used by the National Insurance Institute. It is based on an estimate of 40 per cent of the median family income per standard adult, where per standard adult refers to a needs measure taking account of economies of scale in consumption. The poverty lines for families of four and six in October 1974 were IL 1000 and IL 1300 per month. This standard compares to the cash incomes of IL 711 and IL 1036 guaranteed to families of four and six on welfare. The latter measures are referred to below as welfare guarantees.

[17] The government reached agreement with the Histadrut and employers to freeze existing wage contracts. In addition, the slowdown in economic activity moderates the upward pressure on wages from market forces and workers' organizations in key sectors.

TABLE 4

Compensation to Families by Type and by Income Relative to Poverty in October 1974

Family Type and Relative Poverty Position	October 1974		November 1974		January 1975	
	Net Income[a] (with welfare)	Gross Earnings	Net Income[a] (with welfare)	Percent Compensation to Net Income[b] (with welfare)	Net Income (with welfare)	Percent Compensation to Net Income[c] (with welfare)
Non-Aged Couple						
Poverty Line[f]	619	750	619 (767)	0 (24)	699 (866)	13 (40)
1.4 Times Poverty Line	877	1200	877	0	1043d	19
1.8 Times Poverty Line	1122	1650	1122	0	1330d	19
Non-Aged Couple +2 Children						
Below Poverty Line	913	1000	933 (1073)	2 (18)	1040 (1213)[e]	13 (33)
Poverty Line	974	1100	995 (1073)	2 (10)	1136 (1213)	17 (25)
1.4 Times Poverty Line	1366	1800	1384	1	1646d	20
1.8 Times Poverty Line	1746	2900	1756	1	2029	16
Non-Aged Couple +4 Children						
Poverty Line	1271	1100	1396 (1498)	10 (18)	1537 (1684)	21 (32)
1.4 Times Poverty Line	1777	2000	1892	6	2156	21
1.8 Times Poverty Line	2277	3500	2386	5	2659	17
Non-Aged Couple +6 Children						
Below Poverty Line	1415 (1422)	1000	1645 (1829)	16 (29)	1742 (2015)	22 (42)
Poverty Line	1552	1150	1782 (1829)	15 (18)	1923 (2015)	24 (30)
1.4 Times Poverty Line	2161	2100	2377	10	2641	22
1.8(1.72) Times Poverty Line	2666	3500	2876	8	3148	18
Aged Couple[g]						
Poverty Line[f]	620	-	759	22	858	38
1.4 Times Poverty Line	870	-	1009	16	1148	32
1.8 Times Poverty Line	1120	-	1191	6	1333	19

TABLE 4 (Cont.)

a. Net Income equals gross earnings plus child allowances less income and national insurance taxes, compulsory loans, payments to the Histadrut for dues and for Kupat Holim, and private pension contributions. The figures in the parentheses are net incomes as defined above plus welfare payments available to the unit. Where numbers do not appear in parentheses, the family is not eligible for cash welfare payments. Special grants from Welfare and Education Ministries to the family are ignored. We assume that the wage increases paid in bonds to the high wage workers are part of the net income.

b. Percent compensation in November equals the difference between November and October net income, divided by October net income.

c. Percent compensation in January equals the difference between January and October net income, divided by October net income.

d. These figures slightly underestimate January net incomes and percentage increases.

e. These figures slightly overestimate January net incomes and percentage increases.

f. The poverty lines used in this table are approximations of the poverty lines of October 1974 as defined in footnote 16 .

g. It is assuned that the aged couple receives income from public pensions (basic and supplementary) and private pensions. For example, we assume that the aged couple whose October net income equals IL 870 received IL 290 from a private pension and was entitled to IL 580 in basic and supplementary pension payments. The private pension payments (of 40, 290, and 785) are linked to COL supplements to wages and are assumed to increase in 16 per cent in January 1975.

of only 2 per cent; in comparison, couples with four and six children whose initial gross earnings position was also at the poverty line received advances of 8 and 11 per cent.

The analysis of compensation policy toward the working poor is complicated by the large increase in welfare eligibility among low wage workers. For example, a worker supporting a wife and two children on earnings of IL 1000 per month found that his net income from earnings and child allowances rose by only 2 per cent as a result of the November compensation. However, because of the increased welfare standards, the worker became eligible for a welfare supplement of IL 140 in November, which could have provided him with a total compensation of 18 per cent. In fact, when welfare payments are taken into account for all family sizes, the advantage in compensation to large families relative to small ones declines substantially. Certainly, including welfare supplements makes the government's compensation policy appear adequate for some of the working poor.[18] Nevertheless, it is generally misleading to include such payments. Because of lack of information and the stigma associated with welfare, many workers heading families newly eligible for welfare payments have not and probably will not apply for benefits. And some applicants may not receive supplements noted here because of eligibility rules unrelated to income. Reports from the Welfare Ministry show that the number of families added to the welfare rolls in December did not exceed normal enrollments.[19] Thus, the conclusion remains that most working poor families received far less than full compensation. A further implication is that many non poor families found that their real income fell below October 1974 poverty lines. For example, a couple with four children with an income just above the poverty line received only 10 per cent in special compensation. Thus, they saw their real income fall to about 87 per cent of the October 1974 real poverty lines.[20]

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[18] Some moderate to large low income families did not qualify for increased welfare grants. For example, a couple with earnings at the poverty line and with four or six children would receive no benefits from the increases in welfare.

[19] The Jerusalem Post, January 23, 1975 ("Price Rises Didn't Send Families to Public Aid"); Al Ha-Mishmar, January 22, 1975 ("Welfare Payments Were Raised--Number of Recipients Did Not Increase").

[20] One implication of a relative measure of poverty, defined above as 40 per cent of the median wage, is that a decline in the real median wage leads to a decline in the real poverty line. Nevertheless, it is unusual to think of people needing <u>less</u> to escape poverty simply because of a decline in the median wage.

An interesting parallel to the increased welfare eligibility is the increased eligibility for the supplementary pension. Consider an aged couple that had IL 600 in private pension income and IL 355 in basic pension income in October 1974. Because their private pension exceeded IL 592, they were ineligible for the supplementary pension.[21] As a result of the November and January increases in private pensions,[22] in basic and supplementary pensions, and related increases in the eligibility level for supplementary pensions, this couple gained an IL 94 increase in its basic pension and became eligible for a supplementary pension payment of IL 133. In contrast to the welfare case, aged couples are likely to apply and to receive the added benefits.[23] These increases raised the couple's potential gross income in January to IL 1260, a 32 per cent increase over the couple's October income.

The pattern of compensation to the nonpoor resembled the pattern of compensation to the poor. Nonpoor aged persons received the most favorable treatment, followed by large families. An aged couple whose October 1974 income was 1.5 times the poverty line gained 15 per cent in November compensation. In comparison, families with two, four, and six children in the same relative poverty position received only 1, 6, and 11 per cent increases. Particularly striking is the fact that benefits to the nonpoor aged far exceeded compensation to poor small and moderate size families. This occurred in spite of the higher inflation rate borne by poor families.

Thus, the extent of compensation was directly related to the share of income the individual or family received from welfare or National Insurance benefits. Low income families, for whom transfers were and remained a small share of total income, received little compensation. In contrast, moderate income groups with substantial transfer income gained sizable advances.

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[21] A couple's eligibility for supplementary pension payments depends on its income from other sources. The maximum private pension income at which a couple would qualify for any supplemental payments was IL 592 in October 1974.

[22] It is assumed that private pensions rose by about 16 per cent.

[23] Dr. G. Lotan and Dr. A Nizan report that in 1969 only a small proportion of aged pensioners eligible for supplementary benefits did not receive the supplements. See Supplementary Benefits to Old Age and Survivors Pensioners, National Insurance Institute, Jerusalem, February 1970, p. 30.

What problems arose from paying inadequate compensation to the working poor?

The promise of full and immediate compensation to the poor went unfilled to working poor families who did not become welfare recipients. As noted above, large families in this category gained special November advances worth about 10-15 per cent of their incomes, while compensation to small families was 6 per cent or less. These advances were only one-half and one-fourth of the increases necessary for full compensation. In contrast, the government provided families on welfare with the full 24 per cent increase. Taken in combination, these decisions had the effects of raising substantially the income level at which families retain eligibility for welfare and of narrowing the gaps between the net income available from work and welfare and the net incomes of families relying only on earnings. Much has already been written on these issues.[24] Nevertheless, they are important enough to merit further discussion here.

Although there has been much controversy over the actual number of families newly eligible for welfare cash supplements,[25] it is clear that maximum earnings levels at which families qualify for welfare have risen substantially as a result of both November and January compensation. The maximums rose from IL 905 and IL 1010 to approximately IL 1350 and IL 1450 for couples with two and four children. Thus, current income eligibility levels are reaching well up into the income distribution. A couple with four children whose head earns 75 to 80 per cent of the median wage would now qualify for welfare.[26] For those with heads at lower paying jobs, the gain from becoming a welfare recipient has risen considerably. Note in Table 4 that a father supporting a wife and two children who earned IL 1000 per month in October 1974 and was ineligible for welfare now qualifies for a supplement of IL 173. In the case of a couple with six children

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[24] See the report prepared by Marjorie Honig, et.al., published in Hebrew by the National Insurance Institute's Bureau of Research and Planning as Research Paper No. 8. Its translated title is "The Israeli Transfer System on the Eve of the November 1974 Devaluation and After." Much discussion of this issue has also appeared in the Israeli press.

[25] Honig, et.al., estimated the increase in welfare eligibles at 48,000 families. This figure has been disputed by the Welfare Ministry. See Haaretz, January 26, 1975, p. 3.

[26] Data on the January 1975 average monthly wage per employee post is not yet available. We use IL 1900, an approximation made by Reuben Steiner at the National Insurance Institute; this amount is IL 350 above the average wage reported in September 1974.

whose gross earnings also equals IL 1000, the gain from going on welfare rose from IL 7 in October to IL 307 in January. Do these increased income eligibility levels constitute a problem?

Looked at simply as an income supplement program, welfare is simply another tool by which the government attempts to lessen income inequality and to help those families for whom wages and other private sources are inadequate to meet the families' needs. In this sense, welfare is no different from child allowances and supplementary pensions. Actually, welfare's effectiveness in channeling large shares of its benefits toward the lowest income families made the program a good candidate for helping to meet the government's compensation goals of full compensation to the poor while containing the increases going to the nonpoor. Note in Table 4 that the inclusion of welfare allows families with earnings at the poverty line to receive full compensation while families at higher earnings levels receive far less than full compensation. Why, then, has the prospect of a large rise in the number of welfare families aroused such concern?

Those concerned have several good justifications. Because the welfare system was not designed to deal with large numbers of families in a pure income maintenance role, the system is ill-equipped to handle a substantial increase in new cases. Administerting the payments usually involves wide discretion at the caseworker level and the application of a complex set of rules. These features and the absence of a modern system of checking income and other eligibility criteria open the program to abuse through fraud and arbitrary distinctions between equally eligible families. A second difficulty is that the public attaches considerable stigma to those able families who resort to welfare. As a result, instead of providing a standard amount of help to all families of equal size and income, welfare will help only those undeterred by this stigma. Many poor will receive no benefits simply because their image of the program deters them from applying. Others may be unaware of their eligibility and therefore will not apply. Another important difficulty is that the welfare program imposes severe penalties on the increased earnings of recipients and may thereby produce reductions in work effort. Over wide ranges of income, recipients lose nearly a lira in welfare benefits for every additional lira they earn from work. This feature does help channel benefits to the needy most efficiently, but using these rules in a program that includes many families with workers could

easily cause reductions in work effort by the primary or secondary earners or increases in unreported income. The Welfare Ministry is trying to guard against these possibilities by a series of ad hoc measures whereby increases in welfare benefits would be denied to those who reduce work hours. But this policy is at best only a stopgap measure. The Welfare Ministry will have a difficult time distinguishing between work reductions caused by the worker and those caused by the employer or in distinguishing between those who do not want to work and who cannot find suitable work. In addition, declining work effort among wives and children will be especially difficult to monitor. Yet, it is among these secondary earners that work reductions are most likely to occur.[27]

The problem of increased eligibility levels for special welfare grants resembles the problem involving cash welfare payments. The maximum income at which a family continues to qualify for special grants was in October 1974, well above the income eligibility level for cash welfare payments. With the November and January increases, the new income eligibility level allows many new families to qualify for special welfare grants for such purposes as housing, clothing and medical care. These eligibility levels, which reach well into the middle class, are unrealistically high for a system designed to provide benefits to the lowest income families.[28] However, since actual grants are limited by the fixed overall budget, most of the newly eligible families will not receive help even if they apply. Moreover, the families which in October received various types of special grants face reductions in benefits because of budget cuts.[29] The budget limit may be necessary in light of the funds that can be made available for social welfare purposes. Although this limit reduces work incentive problems that could have arisen by providing additional income-related benefits to moderate income families, other significant problems remain. It is likely that a small percentage of the eligible families will

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[27] See Reuben Gronau, "The Allocation of Time of the Israeli Married Woman", Falk Institute Discussion Paper 747, Jerusalem, November 1974.

[28] For example, the maximum gross earnings at which a couple with two children retains eligibility for rental payments from the Welfare Ministry rose from IL 1550 to IL 2300 per month. The new eligibility standard is 1.21 times the average wage.

[29] See remarks by Aharon Langerman, a high official at the Ministry of Welfare, as quoted in Maariv, January 29, 1975, p. 15.

receive moderate benefits while all other eligibles receive nothing. And there is no assurance that the eligible families which actually receive grants will be the neediest. Further, the image of a system which provides special grants to families at moderate income levels and combined benefits to the poor that appear generous may arouse a backlash among the public against the entire welfare system, to the detriment of needy recipients.

Moreover, the government's entire policy toward noncash benefits appears haphazard. At a time in which the government attempted to compensate fully the cash incomes of low income groups, a number of noncash benefits and social services targeted on low income groups declined in real terms for no apparent reason. For example, education subsidies, considered an important vehicle for raising occupational opportunities of low income youths, were not adjusted adequately to provide equivalent help in the post-EEP period.[30] And municipal governments often made indiscriminate cuts in those social services which require local financial participation.

Returning to the issue of cash differentials between workers and welfare recipients, one may assess the work-welfare gap in two ways. One is to compare the income of workers not on welfare with that of nonworking welfare recipients. This measure represents the income gain from working at various wage levels relative to quitting work and going on welfare. A second way is to measure the income gap between workers entitled to partial welfare grants and workers above welfare eligibility levels. It appears as columns 3 and 6 in Table 5. This gap reflects the income differentials between workers under the more realistic assumption that family heads do not stop working. Note in Table 5 how the recent compensation policies narrowed both gaps significantly. Narrowing cash income differentials to the degree illustrated in Table 5 is likely to intensify the demand for increased fringe benefits such as untaxed car allowances and vacation bonuses and may also reduce incentives to work by second earners in low income families. Complaints have also been heard that such greatly narrowed differentials are unfair because they provide an insufficient reward for working harder or improving one's skills.

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[30] Al Ha-Mishmar, January 22, 1975 ("Treasury Will Cancel Grants for Textbooks and School Uniforms").

TABLE 5

Recent Changes in the Relation Between Income from Work and Income from Welfare, by Family Type and Relative Earnings

Family Types and Relative Earnings Position	October 1974			January 1975		
	Gross Earnings	Net Income without Welfare (with Welfare)	Welfare Guarantee + Disregarded Income[a] / Net Income without Welfare	Gross Earnings	Net Income without Welfare (with Welfare)	Welfare Guarantee + Disregarded Income[a] / Net Income without Welfare
	(1)	(2)	(3)	(4)	(5)	(6)
Non Aged Couple						
Welfare Alone[b]	0	0,(464)	-	0	0,(649)	-
Earnings equal:						
40% of average wage	650	546,(619)	1.13	750	634,(866)	1.37
100% " " "	1650	1122	0.55	1900	1330	0.65
150% " " "	2500	1446	0.43	2800	1716	0.50
200% " " "	3300	1676	0.37	3600	1946	0.45
Non Aged Couple + 2 Children						
Welfare Alone[b]	0	0,(711)	-	0	0,(996)	-
Earnings equal:						
40% of average wage	650	659,(866)	1.31	750	786,(1213)	1.54
100% " " "	1650	1286	0.67	1900	1527	0.79
150% " " "	2500	1620	0.53	2800	1905	0.64
200% " " "	3300	1857	0.47	3600	2139	0.57
Non Aged Couple + 4 Children						
Welfare Alone[b]	0	0,(1036)	-	0	0,(1467)	-
Earnings equal:						
40% of average wage	650	866,(1191)	1.38	750	1093,(1684)	1.54
100% " " "	1650	1594	0.75	1900	1937	0.87
150% " " "	2500	1970	0.60	2800	2355	0.72
200% " " "	3300	2223	0.54	3600	2605	0.65

a. The welfare guarantee plus disregarded income is the total net income of welfare recipients with small or moderate amounts of income.

b. This figure represents the welfare guarantee, or the net income assured to a family by the Welfare Ministry.

Would alternative compensation policies have proved superior?

The government's compensation policy suffered from three important limitations:

1. The increase in benefits paid to the working poor was insufficient to compensate them fully for the EEP-induced price increases.
2. The differential in the compensation paid to welfare recipients and to the working poor increased the number of families eligible for welfare, potentially straining a system not designed to handle large numbers of families.
3. The compensation policy narrowed the income gap between workers and welfare recipients.

This section examines whether two additional measures--raising wages or larger increases in child allowances--could have relieved these problems without introducing other difficulties.

Raising wages or large increases in child allowances had clear advantages. Either would have provided more adequate compensation to the working poor and would have prevented a large increase in the number of families eligible for welfare. However, neither could have prevented a narrowing of the gap between work and welfare without conflicting with the goal of economic restraint.

While restraining aggregate demand is of overriding importance to the EEP's success, it is not easily translated into targets for compensation policy. The link between compensation to child allowances and aggregate demand is direct, since increased child allowances raise government expenditures without any offsetting demand reductions.[31] The direct link between higher compensation and higher consumption also extends to the case of raising wages of government employees. However, the effects of raising wages in the private sector are less clear. Wage increases no doubt could induce a variety of effects, including lowering profits, lowering investment, raising prices, and raising the subsidies from government to industry. The combined impact of these effects on aggregate demand is uncertain. In this section we will treat equal increases in wages and in transfers as if

[31] The actual extent to which higher child allowances becomes translated into higher consumption demand depends on the marginal savings rates of the groups receiving the added income. However, one would not expect the division of child allowances among families of different size and income to alter the result that 90 per cent or more of the allowances are consumed.

their net effects on demand were equivalent. On this assumption, the demand constraint is the limit on the increase in total incomes allowed in the framing of the EEP compensation policy. Apparently, in spite of the government's concern to limit aggregate demand, it had no clear notion as to what increases in income could be allowed or were implied by the goal of full compensation to the poor.

Whatever the precise limits on aggregate demand that were appropriate, the goal of limiting demand meant that compensation measures had to channel a large proportion of benefits to the poor. This does not necessarily mean that the best measure would confine all income gains to the poor. One reason is that compensation measures had a role to play in assuring a progressive distribution of the burden of inflation on the nonpoor. Because the recent price increases had a smaller effect on higher income families, there was particular justification for progressive increases in incomes of the nonpoor. A second reason is the possible distortion of economic incentives. A gradual reduction in the adequacy of compensation as one moves up the income ladder is necessary to avoid decreasing incentives to work and to seek higher wages.

In the context of this mix of goals, finding a satisfactory set of policies was difficult. Raising wages was the most direct way to help the working poor. But the government rejected various alternatives for providing special advances to compensate wages, both the general increases proposed by the Histadrut and the selective increases proposed by the National Insurance. An equal percentage increase in wages involving full compensation to the poor would have preserved the gains from work over welfare. But such an increase would have clearly conflicted with the goal of restraining demand. It would have been possible to raise wages selectively, by, for example, providing successively smaller percentage increases to successively higher wage workers or by taxing the cost-of-living increases or both. Selective wage increases could have completed the job of compensating the working poor with a smaller total impact on demand. However, some narrowing of the gap between work and welfare would have remained, albeit on a smaller scale. This illustrates the conflict between maintaining the advantages of work over welfare and limiting aggregate consumption.

The more selective the wage increase, the lower the level of aggregate consumption but the greater the reduction in the gains from work over welfare. Selective wage increases had additional disadvantages. Further narrowing of the cash wage differentials could create dissension among workers, which, in turn, could create additional pressures to use fringe benefits to restore the differentials. Another unintended consequence might be an increase in unemployment among low wage workers as their cost began to exceed their value to employers.

A substantial increase in COL supplements paid through child allowances is an alternative way to raise compensation to the working poor. To limit the impact on aggregate demand of these increases and to confine them primarily to low and middle income groups, the government could have accompanied the increases in child allowances with a cut in the personal exemptions under the income tax.[32] Although the actual increases in child allowances were a substantial 30 to 50 per cent, these amounts constituted far less than full compensation because child allowances were a small or moderate proportion of total incomes, even for the working poor. To compensate the working poor through child allowances by the full 24 per cent increase in prices would have required much larger percentage increases. A couple with four children and a net income equal to the poverty line received IL 307 in child allowances, or 24 per cent of its net income. Full compensation to such a family would have required a 126 per cent increase in child allowances. (The required increases exceed 100 per cent because child allowances for the first two children are taxable.) The comparable increases for couples with two and six children at the poverty line were 348 and 70 per cent. Were such increases economically desirable or politically acceptable? How do they compare with the alternative of increasing wages?

In considering larger child allowance increases, one must distinguish between the employee's child allowance for the first two children and the large family allowances paid to all families with three and more children. Since the employee's allowances would have gone to most families in Israel,

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[32] The EEP Committee recommended reducing personal exemptions. A bill has been pending before the Knesset to make possible automatic adjustments in the relative level of child allowances and personal exemptions.

the costs of full compensation to small families would have been substantial and no doubt would have conflicted with the government's overriding goal of economic restraint. In addition, the required increases of 564 and 348 per cent for families with one and two children would change the nature of the current program, necessitating basic adjustments. Low income self-employed workers would have to be covered if the program were to avoid the serious problem of paying widely differing amounts to equally poor families.

Large family child allowances are more efficient at improving the adequacy of compensation to the working poor than are employee allowances. Although large family allowances go to all families with three or more children, rich and poor alike, large families happen to be concentrated in the low income range. For example, in 1969, 26 per cent of large families were poor on the basis of pre-transfer income as compared to 6 per cent of small families.[33] And, 50 per cent of large family allowances went to the families in the lowest two income deciles, as compared to 15 per cent of employee allowances.[34] But this efficiency advantage is partially offset by the potential inequity of the government providing overly high benefits to large families relative to small ones. Such wide differentials may create undesirably large economic incentives for low income families to bear children, although there is little evidence that these incentives actually would influence behavior.[35]

Turning to an overall comparison of the wage and child allowance alternatives, one must again consider efficiency and incentive effects. Child allowances appear to have the advantage in channeling compensation to the poor. As noted above, poverty in Israel is heavily concentrated in large families, and most large families have low incomes. Since the use of child allowances allows one to vary the compensation by family size while the use of wages does not, a higher share of child allowances

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[33] Jack Habib, "Poverty in Israel Before and After Receipt of Public Transfers," National Insurance Institute, Bureau of Research and Planning, Discussion Paper 4, July 1974, p. 81.

[34] Jack Habib, "Redistribution Through National Insurance in Israel by Income and Demographic Groups," forthcoming in Social Security.

[35] See Marjorie Honig, "The Effect of Child Allowances on Fertility," National Insurance Institute, Bureau of Research and Planning, Discussion Paper No. 3, 1974.

may be channeled to low income families. Further, an increase in child allowances may be more progressive than an increase in wages of equal cost even among families of a given size. Compare an increase in wages of the same absolute magnitude for all workers with a child allowance increase with the same effect on a low income family of a given size. Greater leakage of payments to the nonpoor would result from compensating wages because the many nonpoor families with secondary earners would gain more through wages than through child allowances.[36] On the other hand, compensating wages is preferable on grounds of helping low wage people without children and of encouraging added work effort. Theoretically, increased child allowances raise the non-work component of income and allow family members to work less for the same total income. However, their actual effect on work behavior is uncertain.[37] Independent of actual induced reductions in work hours, the substantial rise in the transfer component of income resulting from higher increases in child allowances may arouse public opposition.

In conclusion, both selective wage increases and higher increases in child allowances could have improved compensation to the working poor and lowered the number of welfare eligibles. Although these measures have disadvantages, they would have been desirable assuming they could have been put into effect without overly large increases in demand. However, neither measure would have overcome entirely the important criticism that the government's compensation policy narrowed the gap between the incomes available from work and those available from welfare. This problem is, in fact, the inevitable implication of the government's goals of restraining the economy and providing immediate and full compensation to the poor.

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[36] Abraham Doron and Rafael Roter report that as of 1971 only 24% of low wage workers were the sole breadwinner in the family. About 50% of low wage workers were unmarried childless workers. See "Supplementary Benefits to Low Wages Paid Through Employers," The Hebrew University and the National Insurance Institute, Jerusalem, December 1974, p. 43.

[37] An important point to recognize is that child allowances do not reduce the gain from increased work. Unlike welfare payments and supplementary and basic pensions, whose payments decline over some ranges of added earnings, large family child allowances are independent of earnings. The fact that child allowances do not penalize added work diminishes the likelihood of declines in work effort.

Since the poor, including welfare recipients, would maintain their living standards while middle income people would have to bear much of the burden of economic restraint, some narrowing of the gap between welfare and work would have to occur.

What lessons follow from recent events for incomes policies in the future?

The previous section pointed out that deep problems in the Israeli economy required making difficult choices and that no compensation policy would have been without its limitations. To what extent are these conflicts inevitable and to what extent are structural changes possible that would allow incomes policy to operate more smoothly in the future?

Basic to any discussion of incomes policy is the question of income distribution. As noted above, the narrowing of income differentials did not result from a lack of cleverness on the part of the committee deciding on compensation but was the inevitable consequence of the government's goal to impose economic restraint without lowering living standards of the poor. To some, such narrowing has the undesirable consequences of reducing the rewards for working relative to welfare and, in some cases, of creating inadequate cash wage differentials between workers of different levels of skill and responsibility. For others, more income equality is a desirable step towards reducing the social gap, whether it is achieved through incomes policy or some other means. Difficult questions regarding the income distributional effects of incomes policy remain for the future. Suppose further declines in living standards are necessary; should the government again attempt to shield the poor from any decline in living standards? If so, there will be a further narrowing of income gaps with a probable worsening of the problem of the growing size of the population eligible for welfare. Under the more likely circumstances of constant or rising real incomes, there remains the question of whether to allow income differentials to return to their pre-EEP levels or to maintain post-EEP differentials. Although basic conflicts over income distributional questions are inevitable, the problems arising under compensation policy might be relieved by various structural reforms.

One direction for the reform which would reduce the strain on incomes policy is to take measures that would lessen the sudden nature of price increase experienced in recent years. Sudden price increases create the need for abrupt adjustments by consumers, business firms, and the government. In the case of compensation policy, ad hoc adjustments in the cost-of-living formulas were viewed as necessary because of the sudden nature of the price increases. The probable result of such ad hoc measures is to under-compensate supplements to wages and thereby penalize the working poor relative to other low income groups who rely primarily on transfer payments. This is because transfers are easier for the government to change than are wages, given the difficulty of obtaining the agreement of employers and the Histadrut.[38] Thus, the problem of wide fluctuations in the population eligible for welfare would be exacerbated by ad hoc adjustments. Such fluctuations needlessly give rise to discontent among workers, add to the difficulties of sensibly designing and administering the welfare system, and produce long-term difficulties as low and moderate wage workers gain eligibility for various special grants.

Although there are various structural changes that could make price increases more gradual, two are of major significance. One is the move to a policy of more frequent or continuous devaluations.[39] Its probable effect would be to cause small changes in prices more frequently but large changes less frequently. A second is a change in the method of subsidizing food prices. Currently, the government sets the retail price of bread, sugar, and other food items and pays suppliers a subsidy equal to the difference between the supplier's costs and the government-determined price. As a result, a change in world food prices changes the level of the government subsidy but not the retail price of food. In the world of recent years, where food prices have risen steadily at a high rate, the government's food subsidy expenditures have also risen until the point was reached where fiscal considerations forced large sudden increases in the price of many food items. If, instead, the government fixed its subsidy per item

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[38] Even if full compensation is paid to wages under the normal mechanisms, the lags between price and wages increases will have imposed considerable losses on workers.

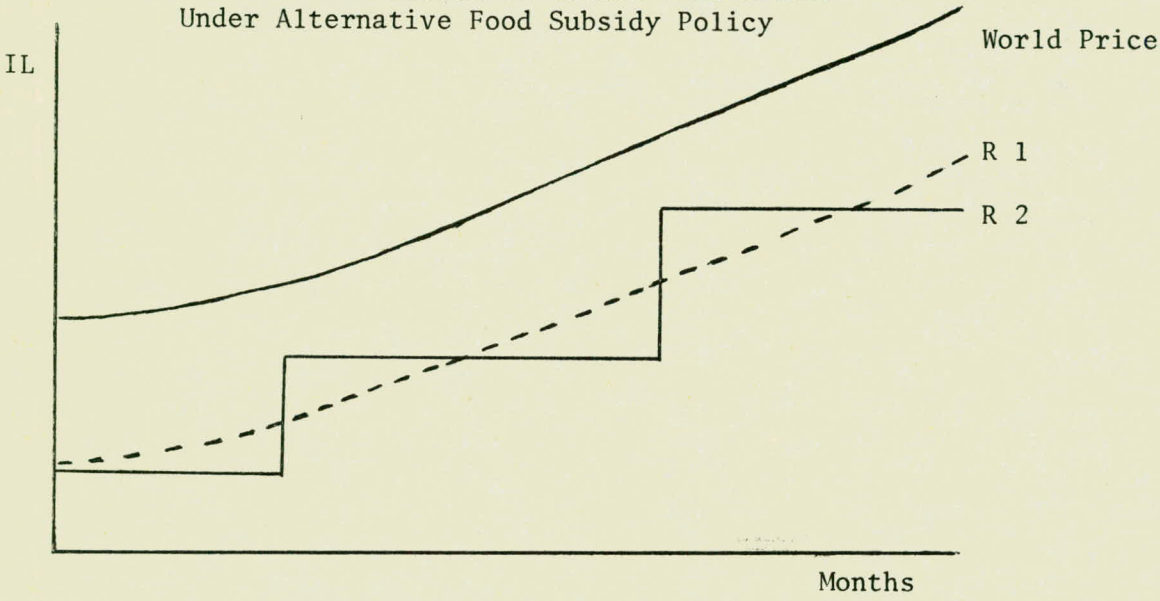
[39] See Don Patinkin, "The Economic Development of Israel", Falk Institute, Jerusalem, 1970, Part 4.

and allowed the retail price of food to vary with market forces, the food price changes would have been considerably more gradual than those recently experienced.

Figure 2 illustrates patterns of retail food prices under the two subsidy systems assuming a steady upward trend in world food prices. The dotted line (R 1) represents the retail price pattern that would result from fixing the subsidy per unit; the solid line (R 2) represents the retail price path using the current fixed price approach. Clearly, consumers face more sudden increases under the current policy than under a fixed subsidy policy.[40] While this illustration assumes that total expenditure on subsidies are held constant, the same conclusion would follow if subsidies were allowed to increase. For example, fixing the percentage of the world price that is subsidized would be another way to achieve gradual price increases while allowing subsidy expenditures to vary with world prices.

[40] A policy of fixing the subsidy rather than the price does not always result in more gradual price changes. Where prices fluctuate around a constant long-run price, fixing the price has the advantage of eliminating price changes without adding to the government's planned outlays.

FIGURE 2: Illustrative Trends of Retail Food Prices Under Alternative Food Subsidy Policy



R 1: Retail Price Trend Under Fixed Subsidy Policy

R 2: Retail Price Trend Under Fixed Price Policy

A fixed subsidy policy offers the additional advantages of improved public understanding and of reduced political pressures for expanded food subsidies. In spite of the government's decision to raise food prices substantially, total food subsidies have continued to rise rapidly. Note in Table 6 how the sudden and large food price increases in April 1973, February 1974, and October 1974 did not prevent an upward drift in subsidies per unit. For all but one item, the percentage rise in subsidies between 1972 and December 1974 far exceeded the 80 per cent increase in the overall price index. The fiscal 1975 budget included IL 1.167 billion for imported food and agricultural subsidies; this figure is more than twice the IL 569 million pounds planned for Fiscal 1974. If the government had decided to restore food subsidies to their earlier levels, the sudden food price increases would have been larger and probably would have generated a great public outcry. Although the facts show an expanded government role, what is most obvious to the public is that the government raised food prices. In contrast, under a fixed subsidy policy, price increases would be more gradual and therefore less noticeable. Further, citizens would have less of a tendency to blame the government for the increases in food prices since it would be more apparent that the world food market and not the Israeli government determines the price of food.

Another direction for reform is to make major changes in the tax-transfer system. Recently, the Tax Reform Committee recommended changing the income tax in a way that could improve the functioning of the income transfer system, including its ability to adjust to changes in wages, prices, and income policy goals. A major element of the proposal is to replace the current system of personal exemptions and child allowances with a unified tax credit, accompanied by a substantial reduction in the range of marginal tax rates.[41] If the Tax Reform committee's proposals are enacted, tax credits will provide for the first time direct cash support outside the welfare system to those working poor who do not have children and will raise substantially the nonwelfare cash aid to low income families with one or two children.

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[41] Elsewhere Habib has shown that substituting credits for exemptions and reducing the range of marginal tax rates have the dual advantages of increasing progressivity and improving work incentives. For an extended discussion of various reforms of the tax and transfer system, see his "Alternative Tax-Transfer Structures" in Issues in the Economy of Israel, eds. Nadav Halevi and Yaacob Kop, Jerusalem; Falk Institute, forthcoming.

TABLE 6

Trend in Prices and Government Subsidies for Selected Items

Period:	1972		Apr. 73-Jan. 74	Apr. 73	Jan. 74	Feb. 74-Oct. 74	Feb. 74	Oct. 74	Dec. 1974		1972-Dec. 74
Item:	retail price	subsidy	retail price	subsidy	subsidy	retail price	subsidy	subsidy	retail price	subsidy	Subsidy percent increase
	(IL)	(IL)	(IL)	(IL)	(IL)	(IL)	(IL)	(IL)	(IL)	(IL)	%
Sugar 1 Kg.	0.84	0.34	1.14	0.39	1.00	2.00	0.30	7.50	6.00	3.00	772.0
Oil 1 liter	0.71	0.34	0.71	0.39	0.93	1.05	0.70	1.94	2.60	2.02	494.0
Eggs 1 unit	0.14	0.02	0.15	0.06	0.12	0.26	0.04	0.20	0.38	0.08	300.0
Milk 1 liter	0.64	0.12	0.64	0.26	0.56	1.00	0.24	0.82	1.60	0.22	83.0
Bread 1 Kg.	0.38	0.13	0.38	0.28	0.65	0.55	0.75	1.20	1.00	0.84	546.0

Sources: Proposal for Budget, Fiscal Year 1974, Treasury, Volume 16, March 1974, p.26; I.H. Arkin, "Changes in the Subsidy Budget, 1974" Economic Quarterly, May 1974, p.57; and "Recommendation for New Retail Prices and Subsidy Reductions" prepared by the Treasury, October 1974.

The move to a credit system would improve the effectiveness of compensation policy. Consider a simplified version in which there is only one marginal tax rate. If prices and wages rise by the same percentage rate, an equal increase in the credit would compensate for inflation in a way that prevents one group from gaining at the expense of another. Each taxpayer and credit recipient would maintain his share of income; the impact of inflation would be distributionally neutral. If wages rise faster than prices, then the government must raise the credit by the percentage increase in wages in order to maintain the income share of low income families. In both cases, government revenues as a percentage of income would remain constant.

The credit system is also a desirable mechanism for paying compensation in periods like the current one, in which the government is attempting to reduce overall consumption while maintaining the real incomes of the poor. The government could raise the credit by the percentage increase in prices and could raise tax rates by enough to increase total revenues. In this way, the percentage compensation would decline gradually with income. Currently, the progressive structure of marginal tax rates and high revenues needs make marginal tax rates too high to be increased further. Thus, selective compensation involving a large increase in child allowance and tax rates is difficult to achieve. Another advantage of the credit system is that compensation could be equitably distributed among families of different sizes and thus would remedy the current difficulty of paying too much to large families relative to small ones.

Turning to the issue of the relation between welfare payment levels and wages, one finds additional advantages accruing from the credit system. The increased cash support from credits will reduce the earnings level at which families qualify for welfare and will decrease the number of families eligible for welfare. That is, the credit system can supplant much of the income maintenance role of the welfare system. This approach would allow the government to provide cash support for most low income people currently eligible for small or moderate welfare grants through a system that is far simpler and more efficient to administer and that is free of the stigma aspects of the welfare system. In periods when

welfare levels rise faster than average wages and credits, it is still true that more families will become eligible for welfare. However, diminishing the role of welfare relative to tax credits will reduce the size of these increases and will avoid the problem of large numbers of low wage workers qualifying for welfare.

Another direction of reform is to streamline the welfare system. By lowering the penalty to earnings, by making payments in a less discretionary manner, and by counting income over longer periods, the government would make welfare a better system for helping low wage workers. However, the program would become less sensitive to special and emergency needs, such as those arising from psychological instability or sudden financial crises. The critical question in overhauling welfare is: should welfare provide income support to large numbers of families or should it be limited to dealing with families who have special or emergency needs? The appropriate role for welfare will be determined in combination with the government's decision on how to adjust tax credits over time. If credits keep pace with average wages, then welfare's income maintenance responsibilities will be limited to a small number of families with special or emergency needs. Under this approach, the case is strong for a welfare system that involves considerable discretion and penalties to earnings high enough to keep income eligibility levels low. If credits fall relative to average wages, then welfare will have to provide income support to many working poor families. In this case, the need for reforms to improve work incentives and to simplify and to standardize payment procedures will become urgent. Thus, the future role of the welfare system could depend largely on current decisions concerning how to compensate tax credits for wage and price changes.

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