THE NATIONAL INSURANCE INSTITUTE
ISRAEL

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by
*Raphael Roter* *Nira Shamai*

Jerusalem, September 1976

DISCUSSION PAPER 13

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Various studies published in recent years in Israel have identified large families (four or more children) as a group having one of the highest incidences of poverty.

Jewish families with four or more children comprise only 8% of the total number of families, but constitute 35% of the total number of children.[1] Of these, approximately 40% are characterized by what we will call economic disadvantage insofar as their income is less than one half the median income.[2] Of the total number of children living under conditions of economic disadvantage, 75% are from families with at least four children while 50% are from families with at least six children.[3]

Moreover, approximately 40% of the children from large families live in substandard conditions with respect to housing density (i.e., three or more persons per room), in comparison with only 5% of those from small families. Viewing these findings from a different perspective, we can say that 82% of all children living in substandard conditions of housing density are children from large families.[4]

One of the interesting findings of research in this area is that the great majority of economically disadvantaged large families are intact, typical families, in other words, having two parents and at least one breadwinner. In fact, more than 90% of poor children have two parent families, more than 96% belong to families the heads of which are of working age, and for 80% the head of the family is employed.[5] What we have then is a group of families who may not have any serious social problems, but for whom the combination of low income and many children results in an extremely low per capita income.

## 1. The System of Transfer Payments for Families with Children, Prior to the Reform

### *1.1. Alternative forms of assistance to large families*

Israel has for many years been concerned with the question of assistance to large families.

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* The authors are, respectively, Deputy Director General of the National Insurance Institute, and Deputy Director, Bureau of Research and Planning, National Insurance Institute. The authors wish to express their appreciation to the staff of the Bureau of Research and Planning for the time and effort devoted by them to preparation of this article. Special thanks are due to Chana Keren-Ya'ar, Miriam Souery and Yosef Tamir.

(1) Nira Shamai and Chana Keren-Ya'ar, *Families with Children in Israel 1969 70*, Survey No. 7, Bureau of Research and Planning, The National Insurance Institute, 1972, pp. 10–12. Updated data presented in this paper have been regularly processed by the National Insurance Institute from the labor force survey of the Central Bureau of Statistics.

(2) Raphael Roter and Nira Shamai, "Patterns of Poverty in Israel – Preliminary Findings," *Social Security*, No. 1, published by the National Insurance Institute, pp. 17–28 (in Hebrew), 1971.

(3) Jack Habib, *The Role of Child Allowances in a Tax-Transfer Structure*, Maurice Falk Institute for Economic Research in Israel, Jerusalem, Oct. 1972.

(4) *Op. cit.*, N. Shamai and C. Keren Ya'ar, Table 10 D.

(5) *Op. cit.*, J. Habib.

The attempt to improve their condition has taken a number of forms simultaneously within the various areas of economic and social policy. Steps are being taken to ease the burden of childrearing via a system of universal services provided free of charge (e.g. public transportation, compulsory education) or via indirect universal subsidies on commodities (e.g. basic foodstuffs), or direct means-tested subsidies (e.g. graduated high school tuition).

However, we will not be concerned here with the above mentioned subsidies but will limit the discussion to direct income supplementation measures which place consumption decisions in the hands of the family.

Until now Israeli society has operated in five areas of income maintenance:

(a) Personal income tax exemptions for children.
(b) Universal National Insurance child allowances.
(c) Public assistance.
(d) Low-wage subsidies.
(e) Minimum wage.

In each of these areas, Israel has attempted to maintain and supplement the income of low income, large families. In practice, however, there has existed a wide disparity between the objectives of supplementing the income of these families and the actual effects of the various measures. Lack of policy coordination has often resulted in program overlaps and possibly in offsetting effects.

**(a) Personal Income Tax Exemptions for Children**

Under the income tax system, certain flat-rate income tax exemptions were given which varied only by family size. These exemptions were intended to ensure horizontal equity in the distribution of the tax burden[6] since they took into consideration family size as well as family income. Low-income families below the tax threshold did not benefit from this exemption, of course, whereas high income families liable to high tax rates benefited from a maximum supplement of IL 90 per month for each child. In other words, this exemption was vertically regressive[7] and did not solve the income maintenance problem of large families, which generally have average or low incomes. The exemptions could not be used to supplement the incomes of families below the tax threshold[8].

**(b) Child Allowances**

Concomitant with the personal income tax exemptions was a uniform benefit paid for children. This income supplement was paid to the family for each child regardless of level of earned income. This may be regarded as a form of tax credit

(6) We refer to the equitable distribution of the tax burden among families having the same income but which are dissimilar in size, composition, and needs.

(7) Families of the same size, composition and needs benefited progressively from this exemption with rising income.

(8) About one quarter of heads of large families were in fact exempt from paying income tax for this reason.

paid in accordance with number of children, in other words to be applied to the family's income tax liability. Under this system, each family benefited from an equal supplement for each child which may in fact have been larger than its tax obligation. In other words, the system of child allowances partially or wholly reimbursed the income tax paid by some families and represented a net increment to the lowest income families who were below the tax threshold.

**(c) Public Assistance**

The system of public assistance has continued to operate alongside the system of personal tax examptions and child allowances. A family whose income was below a given level was eligible for an income supplement. The problems inherent in this system have been described by the Committee for Income Maintenance in the Prime Minister's Commission for Children and Youth in Distress:[9]

> "The use of the present public assistance program, as a means for supplementing the income of low-income families has several disadvantages. The most serious of these is the social stigma attached to the use of welfare services, and the low probability that this population will extricate itself from a socially undesirable situation. Public assistance has also often been associated with a lack of work incentive. Moreover, part of the needy population is deterred from using the available assistance due to stigma. Indeed, those families which are most sensitive to economic fluctations (with a breadwinner but who must supplement their income from work) may benefit least."

**(d) Low Wage Subsidies**

The system of low wage subsidies was instituted in the 1960's and has since undergone various modifications.[10] Historically, it developed as a method to compensate low wage earners for price incereases. Employers provided a flat-rate grant for each day or month, of work, to workers earning below a given ceiling. For the most part families with a single wage-earner were eligible, and no preference was given to large families; in other words, large families did not especially benefit from the system. Other limitations were inherent in this system. More than one third of the eligible did not make use of their rights and every seventh or eighth recipient was ineligible.[11] It was suspected that, in effect, a good portion of the grants became subsidies to employers of low-wage workers, and only a part actually reached the worker's net wage. Reductions in the amount of the grant for those whose wages were above the wage ceiling were in effect, a form of

(9) Although the complete report was published in Hebrew an English summary may be found in: *Prime Minister's Commission for Children and Youth in Distress*, (Summary of Recommendations), The Szold National Institute, July, 1973.

(10) See Abraham Doron, "Supplementary Cash Grants: A Case Study in Selective Income Maintenance Services, *Journal of Social Policy, 1(3)*, 1972, pp. 213–225.

(11) Abraham Doron and Raphael Roter, *Supplementary Benefits to Low Wages Paid Through Employers*, Draft of Final Report, The Hebrew University of Jerusalem and the National Insurance Institute, Jerusalem, December, 1974.

heavy taxation on small wage increments. Employers complained of planned abscence and disruptions in production in an effort of workers to keep their wages below the ceiling. Moreover, it was claimed that a large number of workers who could potentially earn adequate wages become recipients of quasi-public assistance, thus damaging the self-image of the worker and his place in society.

**(e) Minimum Wage**

Another attempt to improve the condition of low wage earners was the minimum wage. Setting a minimum wage appears to have improved the relative earnings of a significant number of low wage earners, including those with large families. It is obvious, however, that this system in itself can never solve the problems of income maintenance for large families. Consider, for example, the impossible task of setting a minimum wage at a level which would assure a reasonable living for a family of 10 children.

Because of the drawbacks in public assistance, low wage subsidies and the minimum wage, Israel has in recent years preferred to establish its programs of assistance to families with children, and especially large families, primarily on the basis of universal flat-rate grants and tax exemptions for children. In particular, these two forms of assistance were broadened in late 1972 in response to the following principles adopted by the Prime Minister's Commission:

"Child allowances should be at a level that will remove from public assistance recipient families of any size with a breadwinner whose income is not below the net minimum wage. The child allowance should prevent the income of the family from dropping below the minimum income guarantee. This objective will be achieved if the total amount of child allowances received by a family equals the difference between the net minimum wage and the minimum income guarantee adjusted for family size."[12]

A second stage in this development which was intended to supplement earlier moves began in 1975 with the complete integration of tax benefits and benefits awarded through the system of transfer payments. This new policy will be referred to hereafter as the 1975 reform.

*1.2. Universal Benefits for Children Before the 1975 Reform*

The mixed system which operated in 1975 before the reform was comprised of the following sub-systems:

a. Employee child allowances, paid to employees for the first and second child via the employers, were considered part of the wage and thus taxable at regular rates. The tax was deduced by the employer.

b. Nontaxable large family allowances were paid directly by the National Insurance Institute to all families with three or more children.

c. Non-taxable army veteran allowances were paid directly by the National Insurance Institute to families of veterans for the third and subsequent children.

d. Tax exemptions for children within the income tax system.

(12) *Op. cit.*, report of the Prime Minister's Commission Committee on Income Maintenance, Recommendation No. 2.

Diagrams 1 and 2 show the effect of this system of benefits at various income levels, for an employee's family with two, four or six children, and for a self-employed family with the same number of children. Income level is shown as multiple of the average wage for an employee (in IL/month), which was approximately IL 2,000 just prior to the reform.

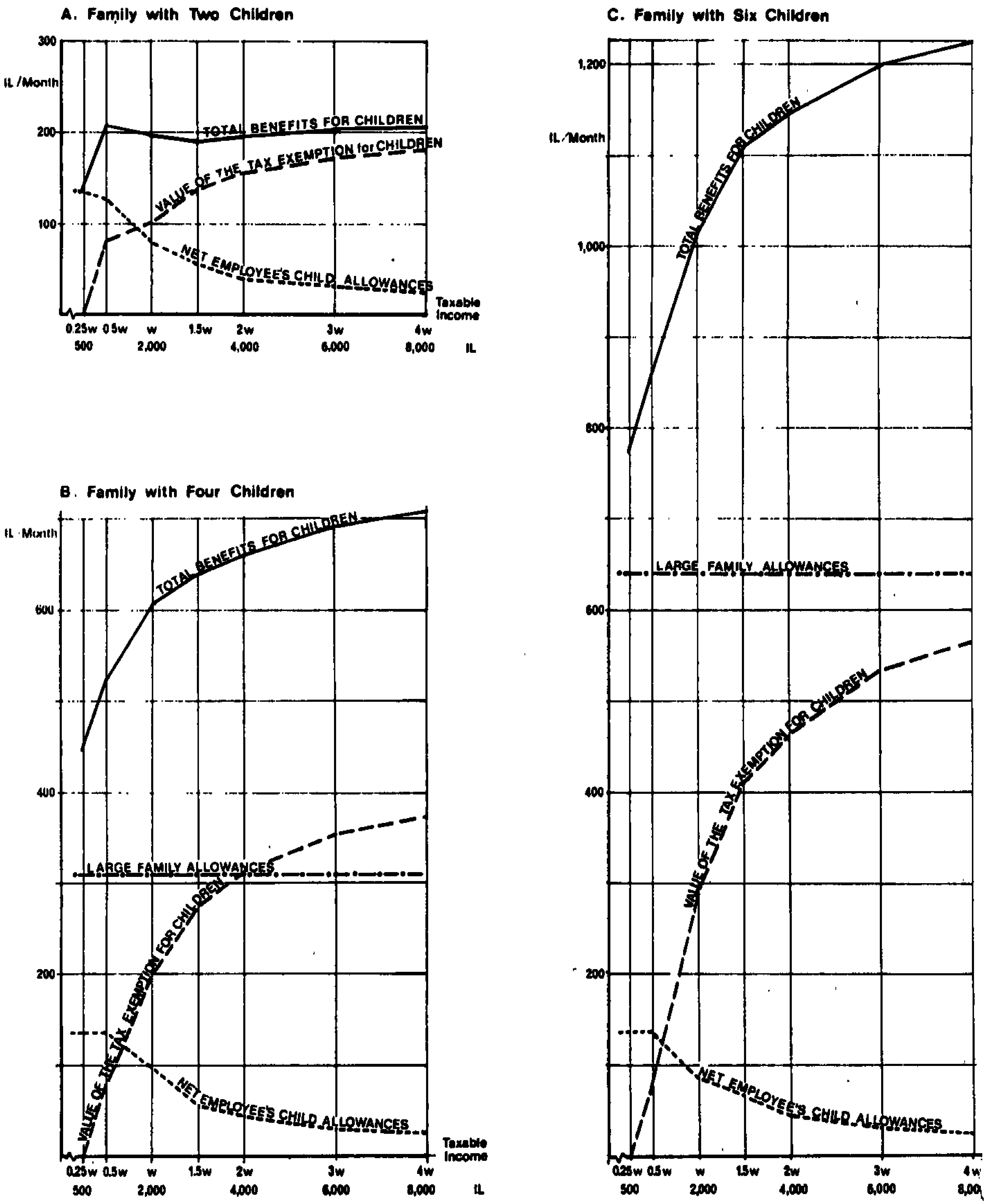
The diagrams show the patterns created by each of these systems of child benefits according to family income level, as well as the combined effect of the various systems. The net level of employee child allowance for the first two children does not change as long as the family does not have to pay tax i.e., its income is below the tax threshold. This level is sharply reduced as increasing tax rates are applied to higher income levels. The large family allowances are of a flat-rate for all income levels whereas the system of exemptions has a regressive pattern. In other words, the value of the exemption is higher the higher the family income. Note that the regressive pattern of the tax exemptions dominates the combined system of benefits. For families with two children, however, the combined effect of the taxable employee child allowances and the tax exemption is balanced. In other words, families at all income levels receive more or less the same amount. On the other hand, for larger families which also receive the flat-rate allowances for the third and subsequent child, the combined system is clearly influenced by the regressive nature of the tax exemption; therefore, families whose income is below the tax threshold and thus do not benefit from tax exemptions, receive less in child benefits as compared to high and middle income families.

For example, just before the reform, an employee with four children whose income was equal to the average wage received IL 605 monthly in child benefits (an average of IL 151 per child). At the same time, a family with the same number of children but whose income was four times the average wage, received a total of IL 704 monthly (an average of IL 176 per child). A similar pattern was obtained for families of other sizes.

In summary, the combined effect of the various unco-ordinated programs did not fully serve the social policy of aiding low-income, large families.[13]

(13) This phenomenon in income maintenance in Israel was often pointed out by Dr. Israel Katz, former director of the National Insurance Institute, and by Mrs. H. Domait, former director of the child insurance branch in the Institute.

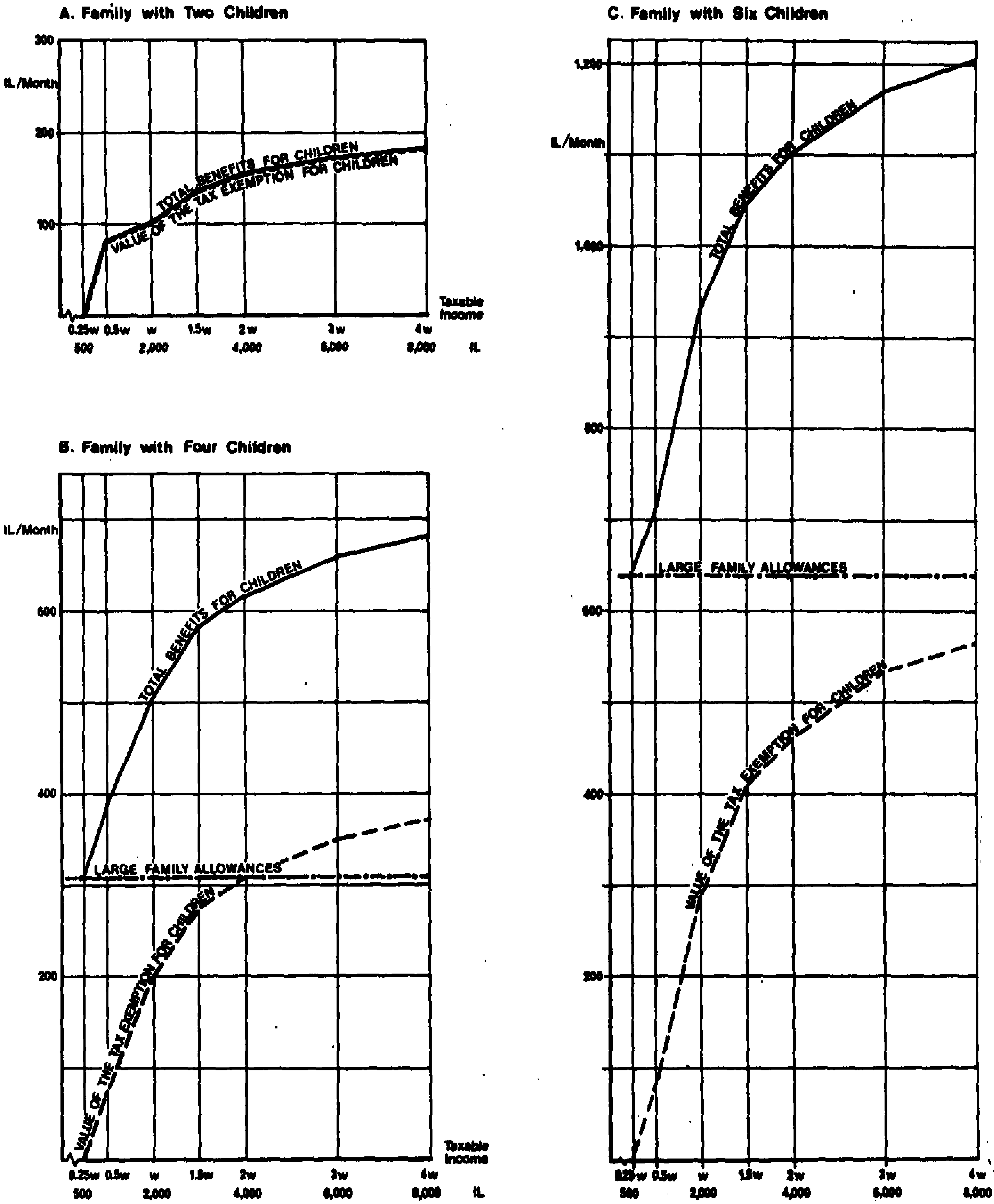
**FIGURE 1 - Total Benefits for Children in the Tax - Transfer System Before the Reform.**
**(Employee with non-working wife)**




w = Average monthly wage (= IL 2,000 in April - June 1975), defined as the aggregate monthly wage bill divided by the number of employee posts during the month

**FIGURE 2 - Total Benefits for Children in the Tax - Transfer System Before the Reform**

**(Self-employed with non-working wife)**




See note at figure 1.

## 2. The Reform of July 1975

### *2.1. Recommendations of the Committee*

On December 15, 1974, in accordance with a government decision, the Minister of Finance appointed a commission of experts under the chairmanship of Professor Chaim Ben-Shahar.[14] The role of the Commission was to submit a detailed proposal for a revised tax system, in accordance with the following objectives as set forth in the letter of appointment:

a. The equitable distribution of income.

b. Prevention of distortions and their negative effects on work productivity and on tax compliance. The proposal must result in a boradening of the tax base, in a simplification of the tax structure, and in increased efficiency of tax collection. The Commission may on its own judgment recommend necessary changes in the system of income maintenance.[15]

The Commission on Tax Reform was asked to evaluate, if only partially, issues in income maintenance because of the links between the income tax and social insurance systems, both of which utilize credits, exemptions and allowances. While both income tax and social insurance use similar criteria of family and personal status (e.g., age, number of children, working wife, etc.) to calculate level of benefits, the objective of the former is to ease the tax burden whereas the objective of the latter is to compensate for lost income or to supplement low income.

The Commission's proposals submitted to the Minister of Finance at the end of March, 1975, included extensive reforms not only in the tax base and in tax rates but also in the system of exemptions, credits and allowances.

One of the Commission's main proposals was the creation of a joint, uniform system to encompass tax exemptions for children and National Insurance child allowances. The purpose was to achieve a degree of coordination and rationalization between taxation and income maintenance functions, a simplification of the system without reducing overall efficiency, and a first step toward a negative income tax system.

The Commission's report states as follows:

"Today, in addition to the standard personal exemption and the exemption for a non-working spouse, there exists a most complicated system taking account of the number of children. The system of universal benefits for children is a mixture of tax exemptions, taxable allowances on the first and second child of employees (paid by the National Insurance Institute via the employer), and tax-exempt allowances for the third and subsequent children paid directly to the family . . . Child allowances have served as an im-

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(14) Professor Chaim Ben-Shahar is a professor of economics and the president of Tel-Aviv University. The other members of the committee included Professors Michael Bruno and Yoram Ben-Porath, of the Economics Department of the Hebrew University, Jerusalem; Shalom Ronel, accountant; and Boaz Nahir, attorney.

(15) From the letter of appointment of the Commission, 15.12.1974, included in "Proposals for Changes in Direct Tax; Report of Commission for Tax Reform" (in Hebrew), Jerusalem, March, 1975.

portant means of supporting relatively poor families and as a principal way of compensating for inflation.

Recommendation 1 · 5:
The 'credit point' will serve as the basis for personal credits and child allowances. The initial value of the credit point, at the date of the reform (July 1975), will be IL 100 per month (IL 1,200 annually), and the credit point is to be linked to the Consumer Price Index.

Recommendation 1 6:
A 'credit' is defined as an amount fixed by law to be set off against the tax obligations. An 'Allowance' is an amount set by law which is paid in full even when there is no tax obligation to set off against. A married taxpayer with a nonworking spouse is to receive 3 credit points, and a single person or separately assessed wife, 2 credit points.

Recommendation 1 7:
The taxpayer receives 1 credit point for the first child, 1 credit point for the second child and 2 credit points for the third and each subsequent child. Child allowances will be paid to all sectors of the population: employees, self-employed, welfare recipients, and so forth. This system is to replace the existing system of income-tax exemptions and the allowances paid by the National Insurance Institute."[16]

In addition to creating a uniform system the Commission proposed to equalize the treatment of employees and self-employed with respect to the first two children.

The proposal also distinguished between credit points received for the first two children and credit points for the third and subsequent children. Although in the Commission's opinion it would have been desirable to provide a uniform allowance for all children it was feared that it was not possible to make such a recommendation at that time, largely due to budget constraints.

The commision's proposals for the complete integration of child benefits carried through the intent of the previously mentioned Committee on Income Maintenance of the Prime Minister's Commission. This committee recommended a negative income tax or the conversion of the system of tax exemptions to allowances, as desirable measures of income maintenance for families with children. These recommendations were postponed, however, until such a time as major reform would be introduced into the income tax system.[17]

## 2.2. *Implementation of the Commission's Rexommendations*

Following the submission of the Commission's report to the Minister of Finance and to the government, inter-agency committees began to discuss means of implementing the recommendations and of preparing necessary statutory changes in Income Tax Law and in National Insurance Law. The Commission's recommendations were put into effect in the statutory changes of July 1, 1975. The greatest change in the system of child benefits

(16) Ibid. ch.1 Credits and Allowances.

(17) *Op. cit.*, Report of the Prime Minister's Commission, Committee on Income Maintenance, Recommendation No. 11.

was, of course, an integration between income tax exemptions for children and the various child allowances (taxable and tax exempt) into a uniform system of child allowances.

The new child allowance is tax exempt and has a dual function. It supplements the income of families with income below the tax threshold and is thus a kind of "negative income tax". It also constitutes a tax-credit for families with income above the tax threshold, taking into consideration ability to pay in accordance with the number of dependent children.

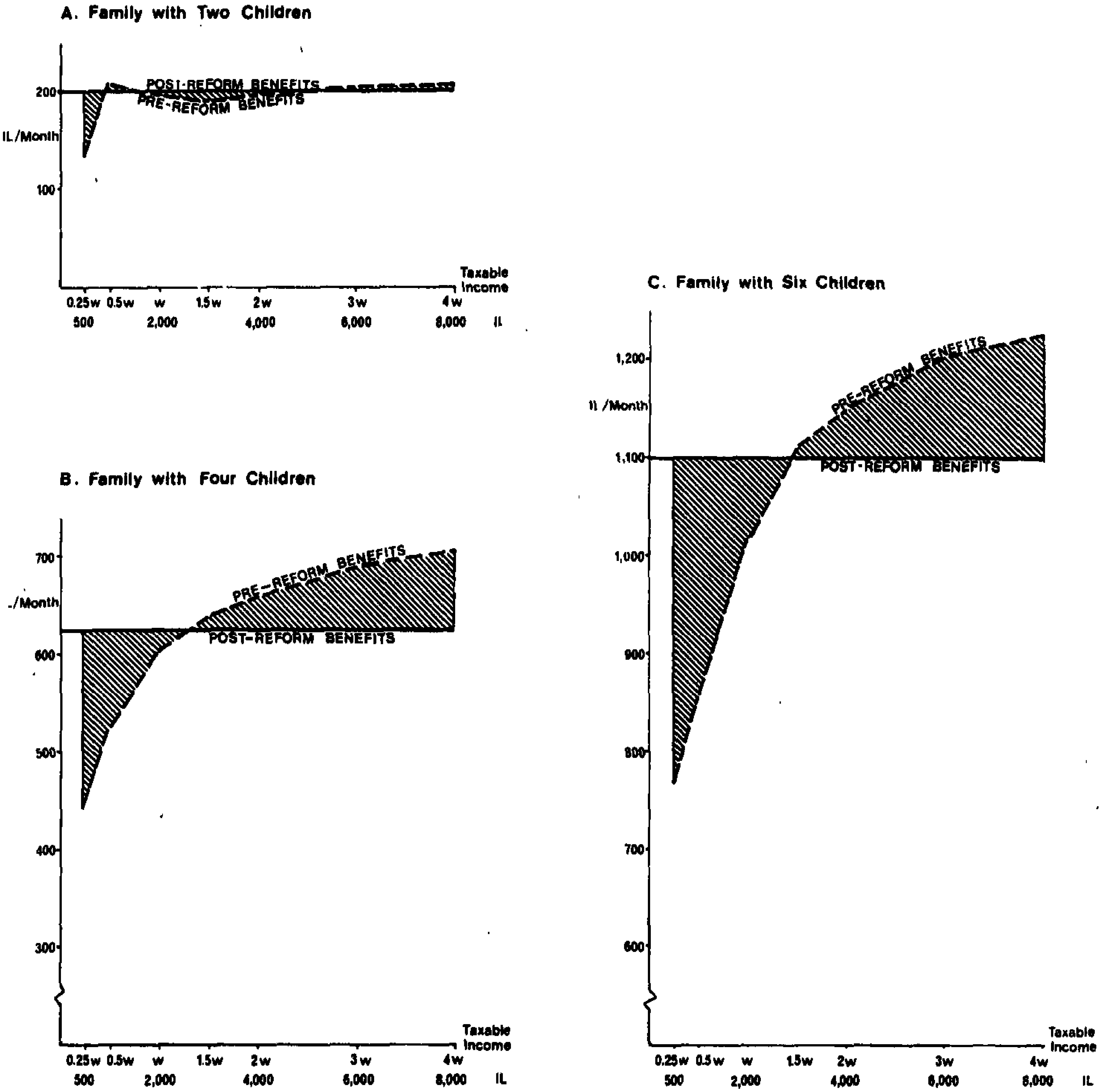
The allowance is calculated according to the value of the income tax credit point and is linked to the Consumer Price Index. The first two children each receive one allowance point IL 100 per month beginning July 1975 and each additional child receives 1.25 points (IL 125 per month). The Veteran's Allowance (according to the Veteran's Law) was set at 0.75 of a point for the third child, one point each for the fourth and fifth child, and 1.25 points each for the sixth, and subsequent children. The Veteran's allowance is used to increase the allowance for the third and subsequent children, to the approximate level recommended by the Commission. These implementations were in line with the accepted policy towards large families, prior to the reform.

Diagrams 3 and 4 compare total benefits for children before and after the reform. As in diagrams 1 and 2, the following family types are compared: employee and self-employed, according to number of children.

From the diagrams we see that the system after the reform is more progressive with respect to the manner in which it considers the number of children.

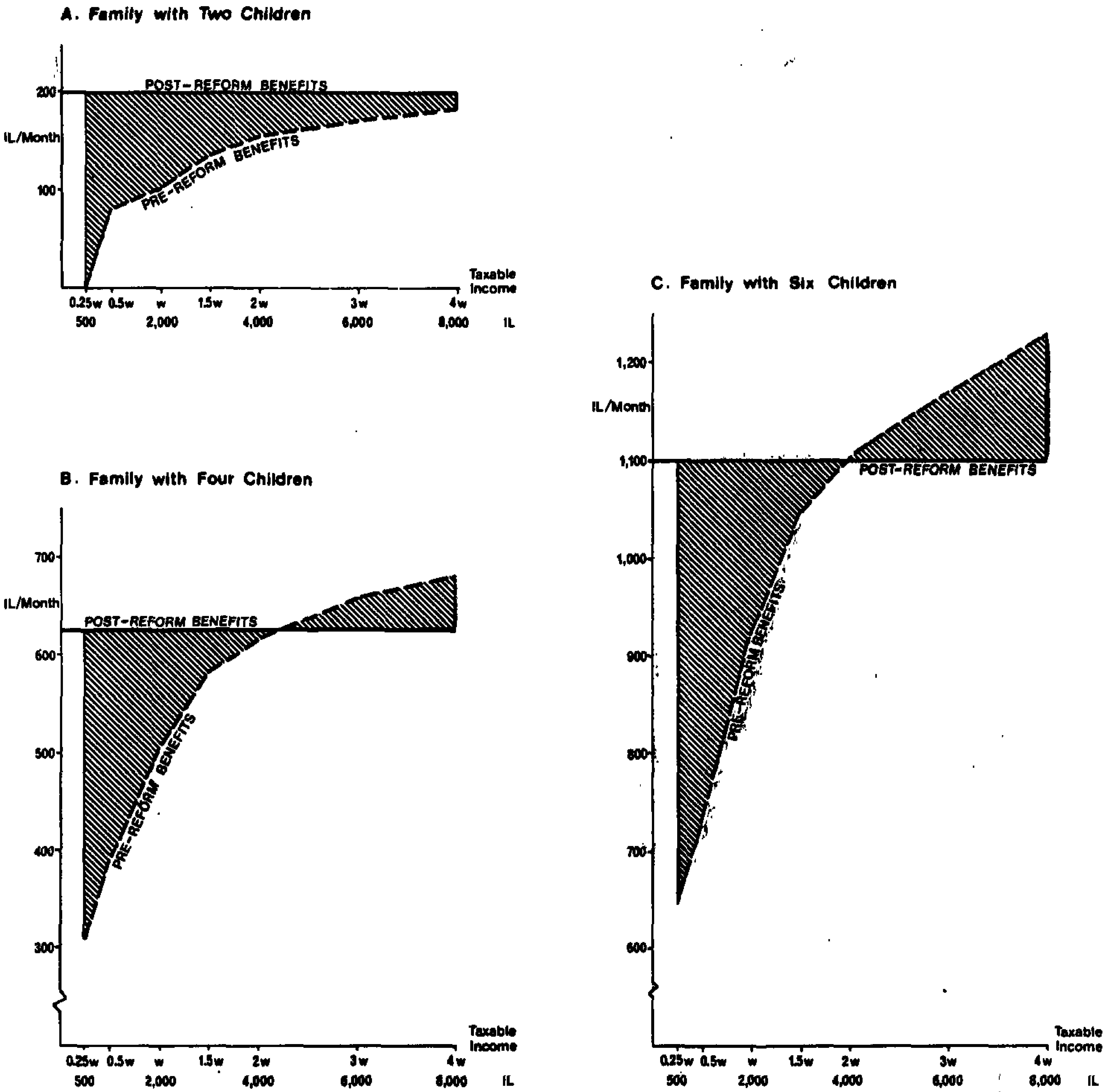
Families whose income is below the average wage receive a sizable supplement compared to the period before the reform. The net income of families whose income is above the average is somewhat less compared to before the reform. In effect, equalizing child allowances for families of different income levels corrected the previous situation in which high-income families enjoyed greater financial support from the government on behalf of their children than did low-income families.

**FIGURE 3 – Benefits for Children Before and After the Reform.**
**(Employee with non-working wife)**




.ee note at figure 1.

**FIGURE 4 - Benefits for Children Before and After the Reform**
**(Self-employed with non-working wife)**

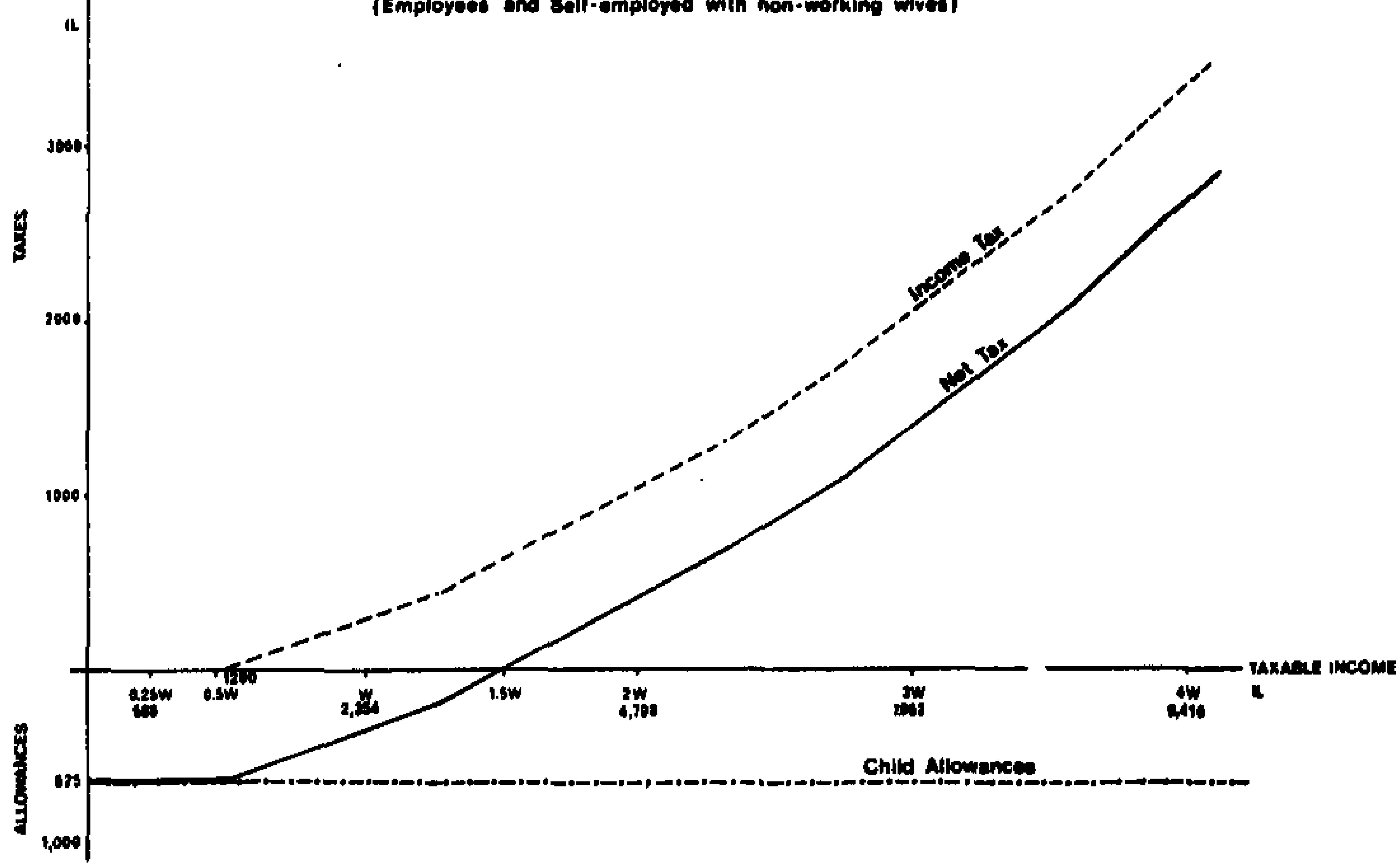



See note at figure 1.

### 3. The Tax Transfer System as a Negative Income Tax

Until the July 1975 reform the complexity of the mixed system made it difficult to explain that essentially, the child allowance was conceptually similar but not formally recognized as a tax credit, or as a negative tax, which should be subtracted from income tax in order to obtain the "net-tax".[18] The Ben-Shahar Commission specifically proposed that the child allowance be considered a tax credit in a limited negative income tax system for families with children.[19] In keeping with Green's[20] presentation of the transfer by taxation idea. Diagram 5 examines the nature of the negative income tax system which came into effect after the reform. The X-axis represents the level of taxable income and the Y-axis indicates the amount by which government intervention reduces this income via income tax and also increases it via child allowances. The positive tax appears above the X-axis while the allowances which may be considered a negative tax, appears below the X-axis. The dotted line above the X-axis describes the positive tax function for a couple without children, where the wife does not work. It begins at a threshold of IL 1200 a month,[21] with a slope of 0.25 (indicating a 25% marginal tax rate) until IL 3,000 an increased slope of 0.35 (35% marginal tax rate) until IL 5,500, and 0.45 until IL 6,500, and so on.

FIGURE 5 - Income Tax, Child Allowances and the Net Tax for a family with four children After the Reform
(Employees and Self-employed with non-working wives)




w = Average monthly wage (= IL 2,354 in October - December 1975). See note at figure 1.

(18) R. Roter, "The Reform in Child Allowance in Israel" (in Hebrew), *Social Security 4–5,* July, 1973, pp. 81 - 82.

(19) *Op. cit., Report of the Commission on Tax Reform,* Chapter 1, "Credits and Allowances."

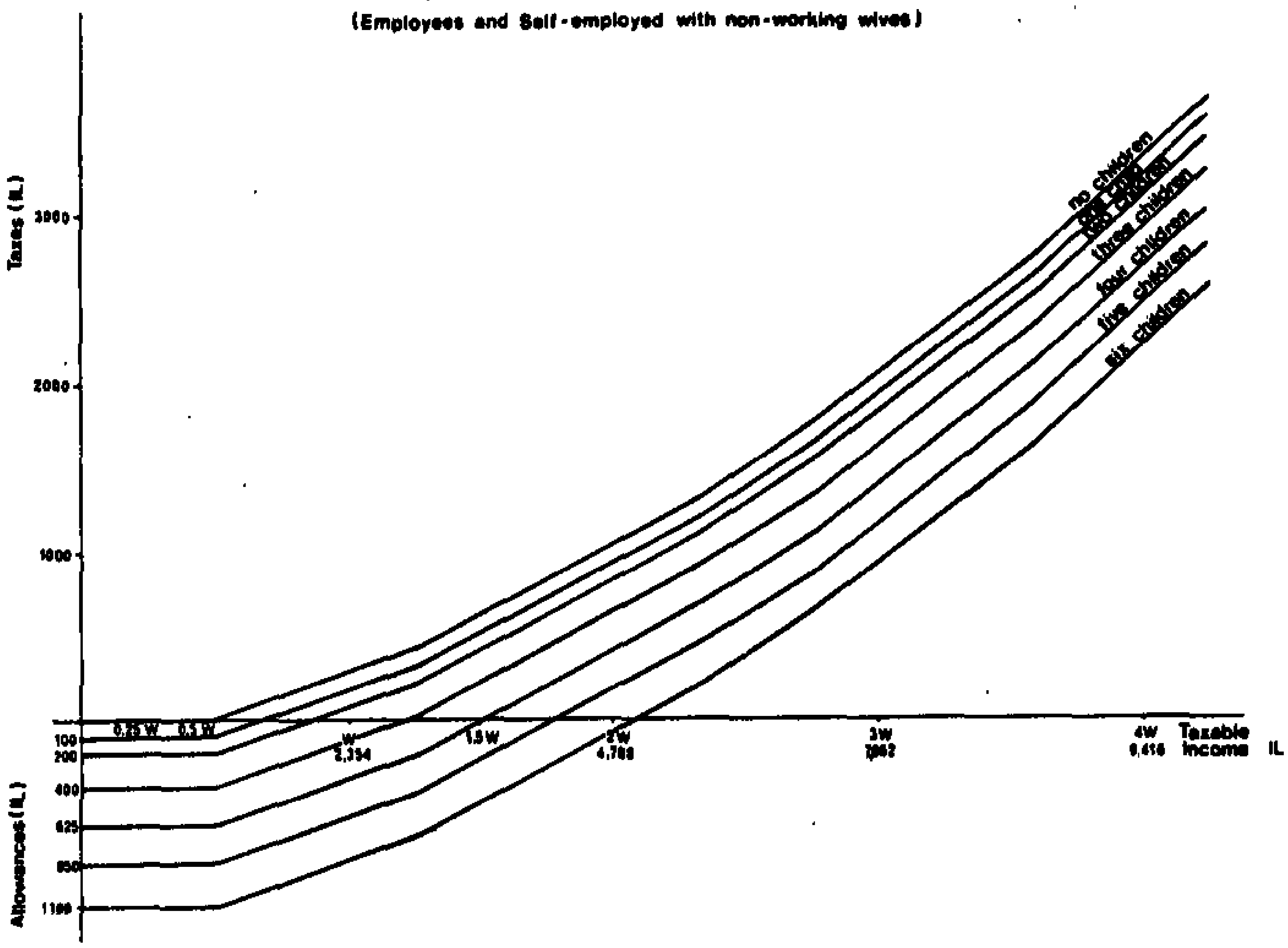
(20) Cristopher Green, *Negative Taxes and the Poverty Problem.* The Brookings Institution, Ch. VI, Washington D.C., 1967.

(21) This is the income at which the tax (25% of IL 1,200) is equal to the value of three credit points (two for the individual and one for a non-working spouse), i.e., IL 300 per month.

A family with four children under the age of 18 is eligible for a child allowance of IL 625.[22] *This allowance, which is not dependent on income level and is non-taxable, is represented by* the dotted line below the X-axis. The net "tax" to be paid by a family with four children can be calculated by subtracting the amount of the allowance from the tax. This is obtained in the diagram by raising the allowance curve, for each level of taxable income, by the amount of the tax shown on the tax curve for that level of taxable income. This is shown in the diagram *by a solid line. Looking at its net tax curve we find that up to an income of IL 1, 200* a family receives a negative tax (i.e., the positive allowance) at a constant amount of IL 625 per month. This negative tax is subsequently reduced at a rate of IL 0.25 per each additional pound (IL) of income and disappears at an income of IL 3,500. At this income level the income tax is equal to the allowance (IL 625). Above this income, the family changes status from that of a *recipient* of net negative taxes to a *payer* of net positive taxes. This is, in effect, the tax threshold for a family with four children compared to IL 1,200, which is the threshold for a family without children (since it receives no allowances).

Diagram 6 shows the net tax of families according to number of children and income level. It is worth noting that the greater the number of children the lower the tax or the higher the negative tax. The increment for each child remains the same at each income level -- moreover, the income ceiling for the maximum negative tax (maximum allowance) and the tax threshold *increases with the number of children.*

**FIGURE 6 - The Net Tax in the Child Allowances - Tax System for Various Family Sizes After the Reform**
(Employees and Self-employed with non-working wives)




See note at figure 5.

(22) See Appendix Tables 3 and 4.

4. **The Effect of the Reform on Other Income Maintenance Programs**

The introduction of a universal system of child allowances created a situation in which previously non-eligible recipients of public assistance and various social insurance benefits were now receiving the universal child allowances. Prior to the reform they had received supplements for children which varied in amount according to the number of children and the type of program. After the reform it became important to examine whether the new universal system of child allowances assured a minimum subsistence level for each child, or whether the allowances would still have to be supplemented by the various programs.

In mid-1975, the minimum income necessary for an adult to remain at the poverty line was IL 380.[23] An income equivalence scale indicates that three or more children in a family at the poverty line each require an income supplement equal to about one-half that required by an adult, i.e., IL 190 monthly per child. If we compare the new child allowances to the minimum equivalent sum previously allocated to a child under the public assistance program (IL 160--180) or under Old Age Survivor's and Disability Insurance (OASDI) (IL 210 220), we find that the new child allowances for the third and subsequent children (IL 200 250) per month are in themselves adequate to ensure a subsistence level for these children.

On the other hand, the new child allowances which provide only IL 100 each for the first two children were not adequate. Even though, they covered previously ineligible families (i.e., self employed public assistance recipients, the disabled, widowed, aged, etc.) the IL 100 allocated for these children covered only one-half of the minimal needs for a child at the poverty line. Therefore, in order to adapt the social insurance and public assistance programs to the new situation, it was necessary to cancel all special supplements provided for the third and subsequent children but to retain some child supplements for the first two children. This was accomplished as follows:

**Social security** The universal supplement for the first two children in the OASDI program was fixed at 5% of the average wage (compared to a previous 6% – 7.5% ). In this way, through the combined universal child allowances and the OASDI supplement, each child was assured a subsistence level of at least IL 200. It was thus possible to achieve an important social objective by doing away with the income-tested supplementary benefits for children which existed prior to the reform. In other words, upon the new system the mere existence of dependent

(23) The poverty line is defined as approximately 40% of the median income for a standard adult. The line changes according to family size, using an equivalence scale for family size.

| Family size | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|
| Number of standard adults in family | 1.25 | 2.00 | 2.65 | 3.20 | 3.75 | 4.25 |
| Weight of additional person | 1.25 | 0.75 | 0.65 | 0.55 | 0.55 | 0.50 |
| Poverty line June 1975 in IL/month | 475 | 760 | 1,004 | 1,213 | 1,421 | 1,611 |

children will not constitute a reason for income-tested supplementary benefits which in the past had been provided for 15,000 children who were either orphans or children of the disabled and the aged. Thus under the reform these children were withdrawn from the system of income-tested social benefits.

**Public Assistance** Under public assistance all forms of support are, of course, income tested, so that the additional supplement for the first two children still required under the new system must also be subject to a means test. It is important to note, however, that the role of public assistance was significantly reduced under the new system since it is now restricted to only the first two children, and the amount of the supplement is lower.
What remains of its function is to assure a minimum income for families which are incapable of reaching the minimum income (from work, assets, or universal social insurance) necessary for a family of 2, 3 or 4 persons. There has therefore been a real reduction in the income ceiling below which families with children are eligible for support.

**5. Low Wage Earners and the "Poverty Trap"**

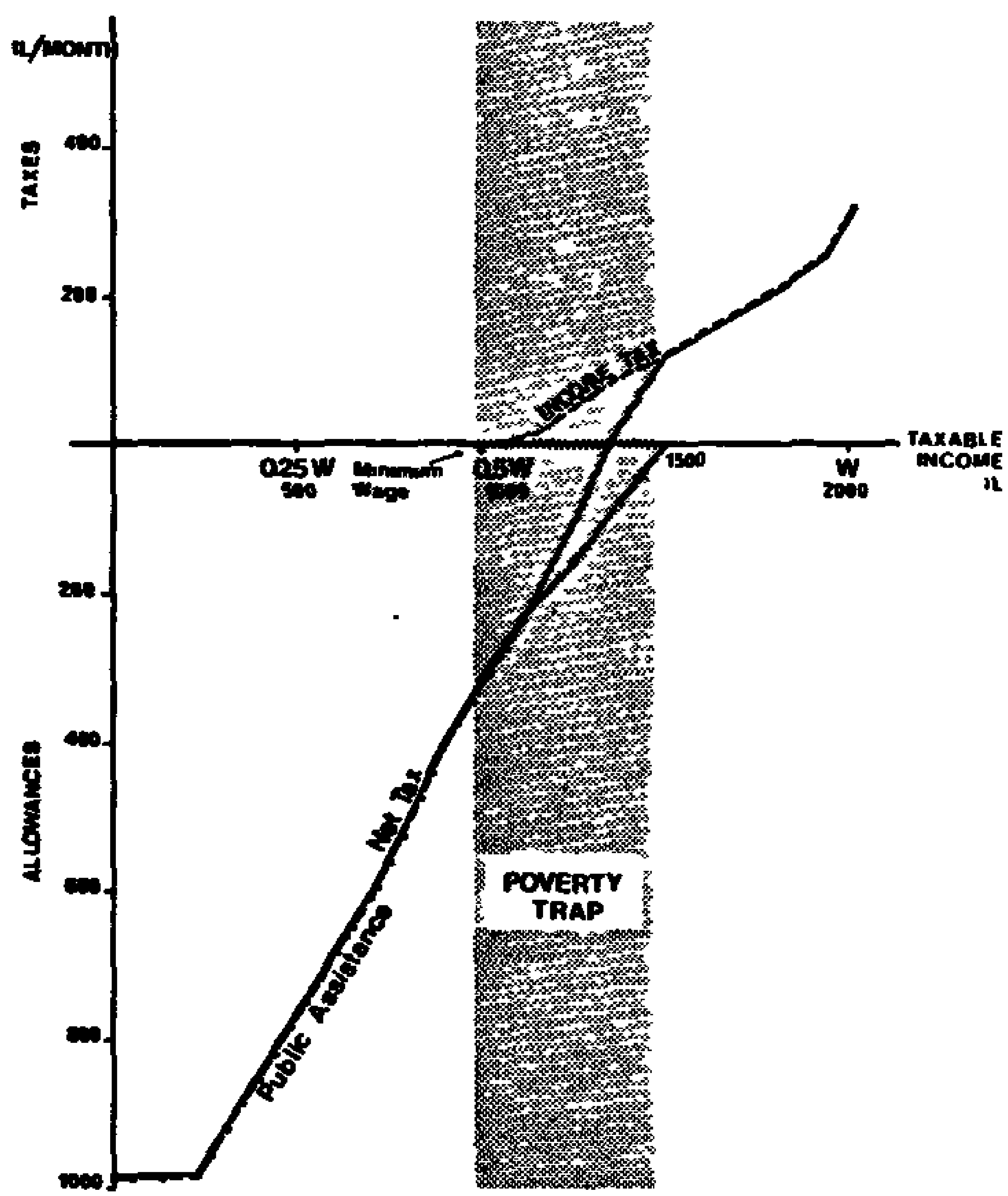
The reform was accompanied by a significant increase in the tax threshold, a real decrease in the income ceiling below which the individual is eligible for support and, from January 1976, an increase in the minimum wage. The result was a significant reduction in the "poverty trap" which had been created in previous years.
This "trap" appeared clearly in 1974 when measures taken to compensate the low-income population for a large devaluation and resulting rapid inflation served to raise the minimum income guarantee and the public assistance ceiling relative to the minimum wage and the tax threshold.[24] The income ceiling for public assistance in fact was raised above the tax threshold which was equal to or lower than the minimum wage for various family types. A situation was thus created in which a large number of low wage earners were defined as living below a minimal standard living and thus eligible for support, yet at the same time were considered economically liable to income tax.

Diagram 7 describes this situation for am employee with two children,and Diagram 8 compares it with the post-reform situation. Prior to the reform his tax threshold accured at a wage of IL 984 and for each additional pound (IL) he was taxed at a rate of 15% . This marginal rate increased to more than 40% at a wage above IL 1,150. At a wage level equal to the tax threshold he was eligible for an income supplement of about IL 300. This supplement decreased with increasing wages, reaching zero only at a wage of IL 1,500. About 10% of employee's families (6% – 7% of wage earners) were actually cuaght within this IL 500 range between the tax threshold (IL 984) and the income eligibility ceiling. For increases in earnings within this range families were liable to a high rate of income tax and had to forego income supplements at even higher rates. They were thus caught in a "trap" in which even large increases or reductions in wages did not change the level of their disposable income. In effect, the tax rate on their wages approached 100% , as seen in Diagram 9.

(24) Honig, M. et al., "The Structure of the Transfer System in Israel Before and After the Devaluation of November, 1974," Discussion Paper No. 8, (in Hebrew), The National Insurance Institute, Jerusalem, 1975.

FIGURE 7 - Net Tax in the Public Assistance - Tax System Before the Reform

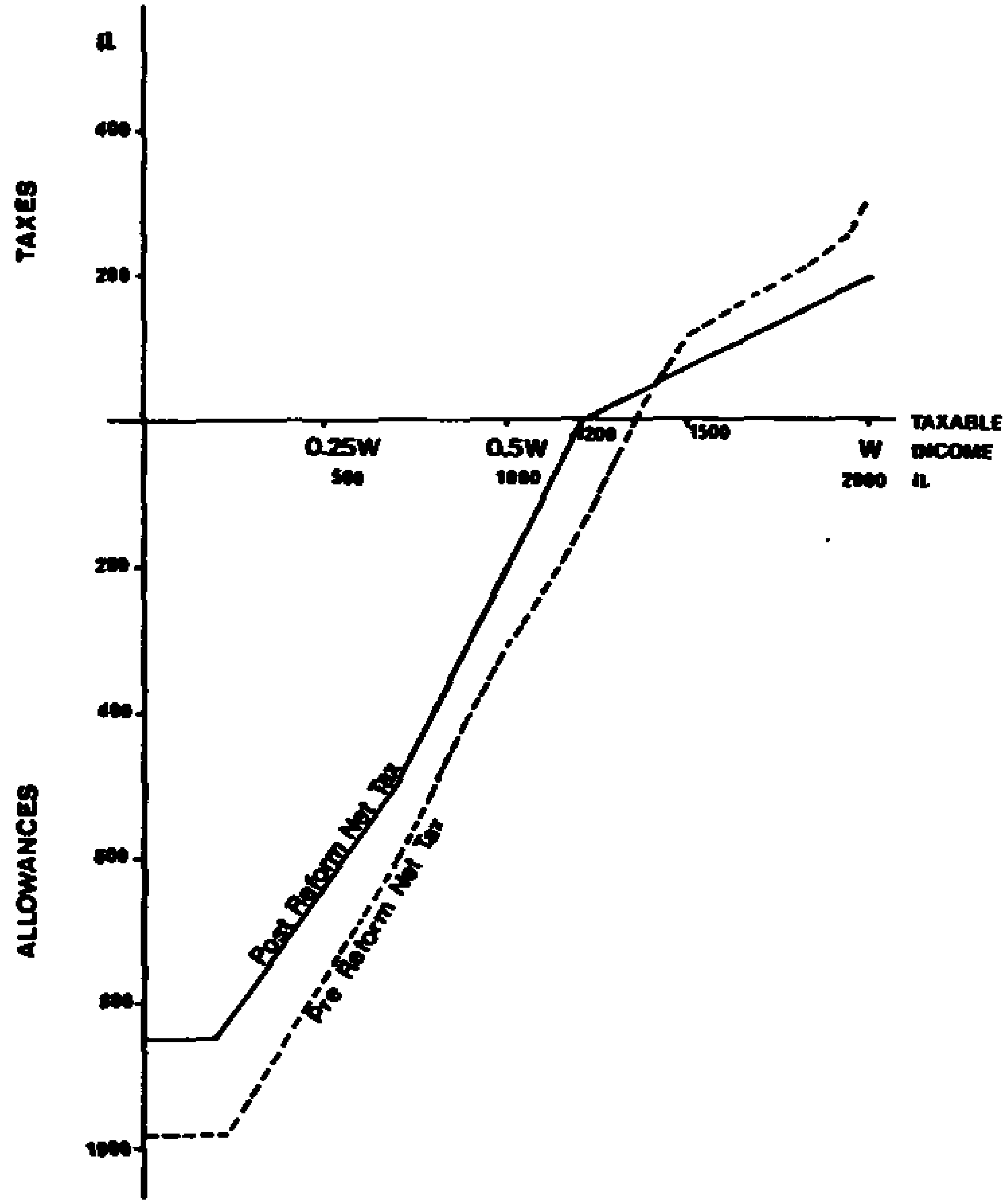
(Employee with non-working wife and two children)




See note at figure 1.

FIGURE 8 - Net Taxes in the Public Assistance-Tax System Before and After the Reform

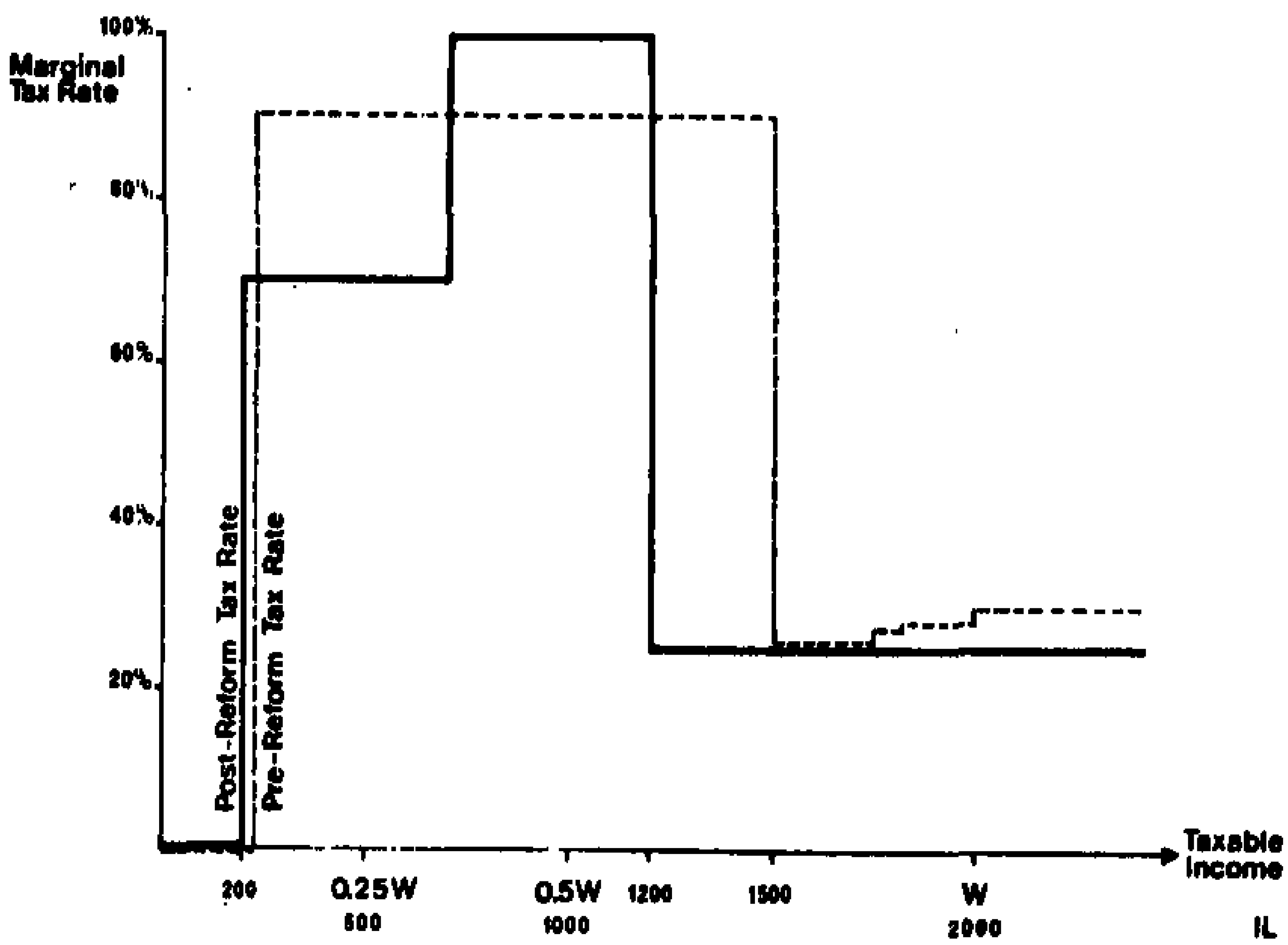
(Employee with non-working wife and two children)




See note at figure 1

FIGURE 9 - Marginal Net Taxes in the Public Assistance-Tax System Before and After the Reform

(Employee with non-working wife and two children)




See note at figure 1.

The reform served to reduce these rates considerably. Increasing the universal child allowance and the tax threshold fixed the eligibility boundaries at a level which was not lower than the tax threshold. The overlap between the tax system and the transfer system was eradicated. There is currently no public assistance at a wage level of IL 1,200 (compared to a previous IL 1,492), while income tax is paid only on income above IL 1,200 (compared to a previous IL 984). The minimum wage was also increased to IL 1,010 as of January 1976, leaving a relatively small gap between the minimum wage and the eligibility ceiling. As a result, there was a considerable decrease in the wage range above the minimum wage within which workers were subject to exceedingly high tax rates, as shown in Diagram 8. Also reduced in size from 10% to a current 4% was the group of families with a wage earner still eligible and in need of public assistance supplement. We assume that most of the remaining eligible families have a single breadwinner who is unable to work at a full-time position on a full-year basis. The number of families with a breadwinner able to work at or above the minimum wage full time on a full-year basis, but still eligible for support, is negligible.

**6. The Effect of the Reform on Income Distribution and the Incidence of Poverty**

Too short a period has passed since the reform for us to be able to evaluate its effect on income distribution and on the incidence of poverty among families with children. Several indicators, however, show the direction of these effects.

Firstly, in Diagrams 3 and 4 we note that the new system favors low income families relative to, those with high incomes, thus introducing a progressive pattern into the system. It must be remembered, however, that at the same time there were additional changes in the tax base and in the marginal tax rates so that it is difficult to determine, whether and to what degree the reform reduced the vertical and horizontal inequalities in income distribution.[25]

In any case, it seems that the reform significantly reduced the incidence of poverty for families of the working poor. An estimate[26] indicates that before tax and transfers 11% of urban employees with children had incomes below the poverty line.[27] Child allowances before the reform reduced this group to 6% 7%. It was further reduced to only 5% after the reform. The principle effects were naturally on large families. In fact, 36% of large families headed by a wage earner would have been poor were it not for child allowances. Among this group the incidence of poverty was reduced to about 17% before the reform and to only 10% after the reform.

Furthermore, it can be assumed that there has been a sizable reduction in the incidence of poverty among the poor self-employed, since this group now receives increased allowances for the first two children.

This cursory evidence gives some support to the hypothesis that the reform served to reduce the incidence of poverty among the employed and self-employed working poor, and that it decreased their dependence on public asisstance.[28]

7. **Benefits for Children as a Proportion of the Gross National Product (G.N.P.)**

The sum of child benefits before the reform, in other words, the net value of employee allowances for the first two children (after applying income tax), the tax exempt allowances for third and subsequent children and the value of tax exemptions for children, was approximately 2.1% of the GNP. After the reform the increased child allowances amount to 2.8% of the GNP.

Slightly more than half of this increase may be explained by the fact that the new program included the previously ineligible first two children of the self-employed. The rest is explained by the child supplements which were transferred from the OASDI program and from public assistance and added to child allowances. There was in effect only a small real increase in child benefits. We can therefore say that basically the scope of this system was not significantly broadened except for the self-employed and that the change was primarily in a restructuring of the various income maintenance programs.

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(25) A study on this question is currently being undertaken by the Bureau of Research and Planning, the National Insurance Institute.

(26) The estimate was calculated on the basis of data from the Survey of Employee's Income, 1974 (The Central Bureau of Statistics), extrapolating to 1975 by simulating various alternatives.

(27) See footnote (23).

(28) Perhaps more important, the proportion of the eligible population taking advantage of their rights should increase with the change from a selective, stigma-associated system to a more universal program.

## 8. Summary

Since 1959 Israel has developed an income maintenance program based largely on a universal system of child allowances, in particular to large families. This system has served to remove from poverty the largest economically disadvantaged section of Israeli society.

The preceding discussion has described in some detail the major reforms which have been implemented in this system in recent years. In particular, the discussion has concentrated on the 1975 reform in the transfer system which was co-ordinated with a major reform in the tax structure. The most fundamental change at this time was the change over from a mixed system of child allowances and tax exemptions for children to a uniform system of child allowances in which the value of previous tax exemptions was incorporated into the child allowances. The effect of the new system has been to increase the amount of public child support to low-income families who had not previously benefited from the tax exemption system.

The paper discusses the impact of the 1975 reform on the "poverty trap" affecting low-wage earners, on the incidence of poverty among families with children, and on the greater efficiency and rationality introduced by the integration of the tax and transfer systems. Although additional research is required to estimate the full impact of the reform on income distribution, preliminary evidence suggests that the desired goal of greater equality of income has been achieved.

## APPENDIX

Table 1 – Total Benefits for Children in the Tax · Transfer System Before the Reform
(Employee with non-working wife)

June 1975

IL Per Month

| Pre-Reform Gross Income[1] | Value of the Tax Exemption for Children | Net Employee's Child Allowances for first two Children | Large Family Allowance[2] | Total Benefits for Children |
|---|---|---|---|---|
| | | Two children | | |
| 0.25 w | – | 134 | | 134 |
| 0.50 w | 80 | 132 | | 212 |
| w | 102 | 96 | | 198 |
| 1.50 w | 137 | 52 | | 189 |
| 2.00 w | 152 | 43 | | 195 |
| 3.00 w | 171 | 31 | | 202 |
| 4.00 w | 181 | 24 | | 205 |
| | | Four children | | |
| 0.25 w | – | 134 | 307 | 441 |
| 0.50 w | 83 | 134 | 307 | 524 |
| w | 199 | 99 | 307 | 605 |
| 1.50 w | 277 | 56 | 307 | 640 |
| 2.00 w | 310 | 45 | 307 | 662 |
| 3.00 w | 351 | 31 | 307 | 689 |
| 4.00 w | 373 | 24 | 307 | 704 |
| | | Six children | | |
| 0.25 w | – | 134 | 638 | 772 |
| 0.50 w | 83 | 134 | 638 | 855 |
| w | 288 | 88 | 638 | 1014 |
| 1.50 w | 410 | 63 | 638 | 1111 |
| 2.00 w | 464 | 46 | 638 | 1148 |
| 3.00 w | 532 | 31 | 638 | 1201 |
| 4.00 w | 565 | 24 | 638 | 1227 |

(1) w = Average monthly wage ( = IL 2000 in April – June 1975), defined as the aggregate monthly wage bill divided by the number of employee posts during the month.
(2) Including Army Veteran Allowance

Table 2 - Total Benefits for Children in the Tax – Transfer System Before the Reform
(Self-employed with non-working wife)

June 1975

IL Per Month

| Pre-Reform Gross Income[1] | Value of the Tax Exemption for Children | Large Family Allowance[2] | Total Benefits for Children |
|---|---|---|---|
| | Two Children | | |
| 0.25 w | – | | – |
| 0.50 w | 80 | | 80 |
| w | 102 | | 102 |
| 1.50 w | 137 | | 137 |
| 2.00 w | 152 | | 152 |
| 3.00 w | 171 | | 171 |
| 4.00 w | 181 | | 181 |
| | Four Children | | |
| 0.25 w | – | 307 | 307 |
| 0.50 w | 83 | 307 | 390 |
| w | 199 | 307 | 506 |
| 1.50 w | 277 | 307 | 584 |
| 2.00 w | 310 | 307 | 617 |
| 3.00 w | 351 | 307 | 658 |
| 4.00 w | 373 | 307 | 680 |
| | Six Children | | |
| 0.25 w | – | 638 | 638 |
| 0.50 w | 83 | 638 | 721 |
| w | 288 | 638 | 926 |
| 1.50 w | 410 | 638 | 1048 |
| 2.00 w | 464 | 638 | 1102 |
| 3.00 w | 532 | 638 | 1170 |
| 4.00 w | 565 | 638 | 1203 |

(1) See note 1 table 1

(2) See note 2 table 1

Table 3 Comparison of Benefits for Children Before and After the Reform.
(Employee with non-working wife)

June July 1975

IL Per Month

| Pre-Reform Gross Income[1] | Total Pre-reform Benefits | Post-reform Benefits | Net Change in Benefits |
|---|---|---|---|
| | | Two Children | |
| 0.25 w | 134 | 200 | 66 |
| 0.50 w | 212 | 200 | (-) 12 |
| w | 198 | 200 | 2 |
| 1.50 w | 189 | 200 | 11 |
| 2.00 w | 195 | 200 | 5 |
| 3.00 w | 202 | 200 | (–) 2 |
| 4.00 w | 205 | 200 | (–) 5 |
| | | Four Children | |
| 0.25 w | 441 | 625 | 184 |
| 0.50 w | 524 | 625 | 101 |
| w | 605 | 625 | 20 |
| 1.50 w | 640 | 625 | (–) 15 |
| 2.00 w | 662 | 625 | (–) 37 |
| 3.00 w | 689 | 625 | (–) 64 |
| 4.00 w | 704 | 625 | (–) 79 |
| | | Six Children | |
| 0.25 w | 772 | 1100 | 328 |
| 0.50 w | 855 | 1100 | 245 |
| w | 1014 | 1100 | 86 |
| 1.50 w | 1111 | 1100 | (–) 11 |
| 2.00 w | 1148 | 1100 | (–) 48 |
| 3.00 w | 1201 | 1100 | (–) 101 |
| 4.00 w | 1227 | 1100 | (–) 127 |

(1) See note 1 table 1

Table 4 – Comparison of Benefits for Children Before and After the Reform
(Self-employed with non-working wife)

June July 1975

IL Per Month

| Pre-Reform Gross Income[1] | Total Pre-reform Benefits | Post-reform Benefits | Net Change in Benefits |
|---|---|---|---|
| | Two Children | | |
| 0.25 w | — | 200 | 200 |
| 0.50 w | 80 | 200 | 120 |
| w | 102 | 200 | 98 |
| 1.50 w | 137 | 200 | 63 |
| 2.00 w | 152 | 200 | 48 |
| 3.00 w | 171 | 200 | 29 |
| 4.00 w | 181 | 200 | 19 |
| | Four Children | | |
| 0.25 w | 307 | 625 | 318 |
| 0.50 w | 390 | 625 | 235 |
| w | 506 | 625 | 119 |
| 1.50 w | 584 | 625 | 41 |
| 2.00 w | 617 | 625 | 8 |
| 3.00 w | 658 | 625 | ( ) 33 |
| 4.00 w | 680 | 625 | (-) 55 |
| | Six Children | | |
| 0.25 w | 638 | 1100 | 462 |
| 0.50 w | 721 | 1100 | 379 |
| w | 926 | 1100 | 174 |
| 1.50 w | 1048 | 1100 | 52 |
| 2.00 w | 1102 | 1100 | (--) 2 |
| 3.00 w | 1170 | 1100 | (--) 70 |
| 4.00 w | 1203 | 1100 | ( )103 |

(1) See note 1 table 1.

Table 5 – The Net Tax in the Child Allowances – Tax System for Various Family Sizes After the Reform
(Employees and Self-employed with non-working wives)

| Post-reform Gross Income[1] | Number of Children | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | [illegible] |
| 0.25 w | (–) 100 | (–) 200 | (–) 400 | (–) 625 | (–) 850 | (–)1100 | (–)1350 | (–)1600 |
| 0.50 w | (–) 100 | (–) 200 | (–) 400 | (–) 625 | (–) 850 | (–)1100 | (–)1350 | (–)1600 |
| w | 189 | 89 | (–) 111 | (–) 336 | (–) 561 | (–) 811 | (–)1061 | (–)1311 |
| 1.50 w | 536 | 436 | 236 | 11 | (–) 214 | (–) 464 | (–) 714 | (–) 964 |
| 2.00 w | 948 | 848 | 648 | 423 | 198 | (–) 52 | (–) 302 | (–) 552 |
| 3.00 w | 1956 | 1856 | 1656 | 1431 | 1206 | 956 | 706 | 456 |
| 4.00 w | 3325 | 3125 | 2925 | 2700 | 2475 | 2225 | 1975 | 1725 |

(1) w = Average monthly wage (w = IL 2354 in October – December 1975), see note 1 table 1.