

Chapter 3

The Budget and the General Government¹

The general-government deficit exceeded 5 percent of GDP in 2003 for the second year in a row and the gross general-government debt climbed to 107 percent of GDP. The central government-budget deficit ballooned to 5.6 percent of GDP, the highest level since the 1985 Economic Stabilization Program and 2.6 percent of GDP over the target. The deficit level dropped markedly during the year—from 7 percent of GDP in the first half of the year to less than 4 percent in the second half—due to the application of the Economic Recovery Plan. Since the deficit-cutting provisions of the plan were based largely on reducing expenditure, general-government expenditure declined in 2003 after years of rapid growth and a deceleration in 2002. Thus, the deficit increase in 2003, unlike those in 2001 and 2002, traced to a decline in government revenues—tax revenues in particular—and not to rising expenditure. The credibility of fiscal policy was enhanced in 2003 by the results of the war in Iraq, which eased Israel's expected long-term defense burden, and the receipt of US loan guarantees, which lowered the risk of a financial crisis in the short term.

The deficit resumed its upward march shortly after the mid-2002 'Economic Defensive Shield' program because the budget was again based on overoptimistic assumptions. Thus, in view of the impending war in Iraq, the depreciation of the NIS, and the upturn in interest rates on the government debt in the middle of 2002, another economic plan was needed. The 2003 Economic Recovery Plan restored confidence in fiscal policy because its immediate deficit-cutting measures were largely permanent and because it included additional steps to further reduce government outlays several years ahead. Furthermore, structural matters such as pension arrangements, the

¹ The general government is comprised of the central government, the National Insurance Institute, local authorities, nonprofit associations (health funds, universities, religious seminaries, etc.) that derive most of their income from general government, and the National Institutions (the Jewish Agency for Israel and the World Zionist Organization). Its activity is measured in accordance with National Accounts definitions, which differ from those used in the central government budget.

retirement age, and the structure of National Insurance benefits were addressed. The resulting credibility was further enhanced by the successful enshrinement of most of the main measures in agreements with the Histadrut (albeit after a lengthy struggle). However, the methods used to approve the plan—as well as some additional measures that were authorized along with the 2004 budget—touched off vehement public controversy due to the use (and the threat of use) of legislation to amend existing agreements and the hasty discussion of several structural provisions of the plan.

In addition to the contribution of the economic plan to financial stability, the composition of the plan—especially the decisive share of expenditure-cuts in reducing the deficit and the attempt to leave infrastructure investment unscathed—is conducive to sustainable economic growth, as soon as global economic developments and domestic security make this possible. To apply the plan in full, however, the Government will have to make a long-term commitment to its implementation, a condition that was not fulfilled in the past. Moreover, at the time the plan was approved, the deficit was expected to surpass the Government's targets for several years ahead and the general-government debt was expected to continue rising even under the assumption that the plan would be fully applied. For these reasons, and since Israel still has very high levels of general-government expenditure and deficit by international standards, another large adjustment had to be made in the 2004 budget, alongside a significant raising of the deficit target. An additional sizable adjustment will probably be needed in the 2005 budget as well. The economy has been paying a heavy price for these recurrent adjustments in the coin of institutional instability, disruption in planning the activities of budgeted entities, and labor disputes. The harm was compounded in 2003 by overaggressive attempts to slash expenditure in several fields—e.g., in the general grants for municipal authorities—that had to be reversed and required additional adjustments immediately after the budget was approved. The budget measures applied in the past two years, taken as a whole, have also changed the composition of expenditure in a way that is less conducive to reducing inequality. Although the acceptable extent of inequality is a matter of sociopolitical preference, it is important for the Government to promptly invoke policy measures that will spare individuals who are incapable of working from too much harm, especially in regard to education and health. Such measures should aim to sustain the social mobility and earning potential of such people and their children, a necessary condition for the economy to realize its growth potential.

Israel's tax rates have undergone far-reaching changes in the past two years (including early 2004)—increases in 2002 and 2003 and cuts in 2004. These adjustments increased the indirect-tax burden, mainly due to the raising of the fuel and cigarettes excises. The direct-tax burden hardly changed but

was significantly recomposed: general tax rates on wages were lowered and exemptions were revoked—especially in regard to regional benefits—and households' income from financial assets was taxed. The full application of the income-tax reform, planned for 2006, will eliminate most of the gap between Israel and the developed countries in tax rates on earned income in the three highest deciles. Concurrently, the imposition of taxation on households' capital income narrowed one of the most conspicuous gaps in tax-system structure between Israel and developed countries.

1. THE CENTRAL GOVERNMENT BUDGET AND THE DEFICIT TARGET

The government deficit in 2003 was 5.6 percent of GDP,² the highest rate since the 1985 Economic Stabilization Program (Figure 3.1). The full-year figure, however, masks an abrupt turnaround in the deficit trajectory in mid-year due to the implementation of the Government's economic plan: from more than 7 percent of GDP in the first half of the year to less than 4 percent in the second half. Furthermore, unlike the 'Economic Defensive Shield' program that was applied in the middle of 2002, the 2003 plan placed strong emphasis on measures that reduced—or are expected to reduce—the deficit permanently. By so doing, the plan helped to enhance the credibility of fiscal policy in the long term. (see Section 6 in this chapter). This credibility was consolidated by additional measures adopted as the 2004 budget was being approved and the successful enshrinement of most sensitive components of the plan, and of the 2004 budget, in agreements with the Histadrut (albeit after a lengthy struggle). Moreover, the composition of measures in the plan is conducive to the restoration of sustainable growth as soon as the security situation and global economic developments make this possible. The management of fiscal policy this year was abetted by the receipt of US Government guarantees that facilitated convenient long-term financing of the large deficits that had been amassed, thereby lowering the risk of a short-term financial crisis and obviating the need for an immediate tax hike or steeper cutbacks in public expenditure than those actually made. The results of the war in Iraq also improved fiscal credibility by easing the expected long-term defense burden.

In 2003, as in 2002, fiscal policy had to cope with the implications of an excessively optimistic government budget, reflected in a severe revenue shortfall relative to the budget program and the need to increase the defense budget significantly. These underlying events and the looming war in Iraq made the financial markets jittery at the beginning of the year, the NIS depreciating and interest rates on government debt escalating nearly to mid-2002 levels. To cope with this situation, fiscal policy had to

The government-budget deficit ballooned to 5.6 percent of GDP, the highest level since the 1985 Economic Stabilization Program.

Due to the Government's Economic Recovery Plan, the deficit trajectory fell from more than 7.0 percent of GDP in the first half of 2003 to less than 4.0 percent in the second half.

The results of the war in Iraq enhanced fiscal credibility by lowering Israel's expected long-term defense burden.

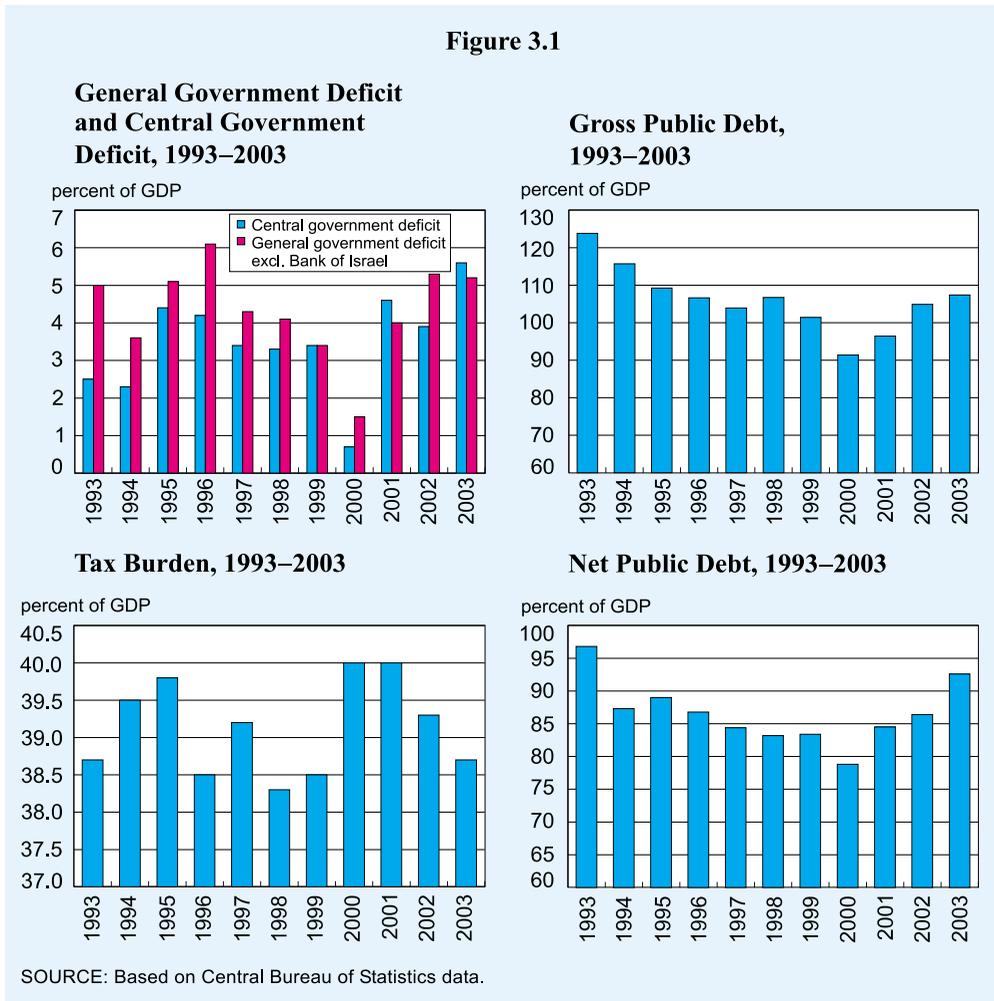
In 2003, as in 2002, fiscal policy had to cope with the implications of an excessively optimistic government budget.

² Due to accounting changes introduced this year, when the Israel Railways became a corporation, a NIS 400 million government loan to the Israel Railways was not recorded as a budget expenditure. Furthermore, a NIS 650 million payment to the US government as a scoring fee on account of the loan guarantees was not recorded as an expenditure. Had these sums been recorded, the deficit would have climbed to 5.8 percent of GDP.

Since the implementation of the Economic Defensive Shield program in 2002 was followed by a rapid return to a high deficit, vigorous measures were needed to influence the composition and deficit of the budget in the short term and to change the deficit path in the medium and long terms.

ease the financial shocks, avert a financial crisis that might have difficult and long-lasting implications for economic activity, and create conditions that would support sustainable growth as soon as improvements in the security situation and the global economic environment permit this. Since the implementation of the Economic Defensive Shield program in 2002 was followed by a return to a high short-term deficit, vigorous measures were needed to influence the composition and deficit of the budget in the short term and change the deficit path in the medium and long terms. The main reasons for the necessity were the high general-government debt/GDP ratio and the lack of progress over the past decade in reducing the budget deficit, the debt, the share of general-government expenditure in GDP, and the tax burden (Figure 3.1)—four targets that Israeli governments had expressed the wish to attain for a decade and that most developed countries had attained. Against this background, the Government in mid-year adopted an economic plan that lowered the deficit at once and included measures to stabilize the budget in the long term and structural changes supportive of sustainable

Figure 3.1



growth. Even after the plan went into effect, however, the expected deficits several years ahead were poised to remain higher than those in developed countries and higher than Israel's deficit level in the past. Only additional measures, included in the 2004 budget, placed the deficit on a path that would lead to lower levels. Due to the planned tax cuts, however, only a gentle decrease in the general-government debt/GDP ratio will be possible in the next few years. To attain a more substantial decline, the government will have to take further measures to keep the increase in expenditure within the target rate of only 1 percent in each of the years 2005–2010.

To lower the general-government debt significantly, the government will have to take further measures to keep the increase in expenditure within the target rate of only 1 percent in each of the years 2005–2010.

Table 3.1
Central Government Deficit,^a Receipts and Expenditure, 1997–2003

	(percent of GDP)						
	1997	1998	1999	2000	2001	2002	2003
Government domestic deficit ceiling ^b	2.3	2.2	2.6	2.8	0.5	4.1	2.3
Actual government domestic deficit	3.0	2.8	2.8	0.5	3.6	3.5	5.4
Overall government deficit ceiling (including profits of the Bank of Israel)	2.8	2.4	2.0	2.5
Actual overall government deficit (including profits of the Bank of Israel)	2.7	2.3	2.4	0.1
Overall government deficit ceiling ^c	3.0	2.8	3.1	3.6	1.8	3.9 ^d	3.0
Actual overall government deficit	3.3	3.2	3.3	0.7	4.6 ^e	3.8 ^e	5.6
Total receipts ^f	37.9	37.5	36.5	37.1	35.3	36.4	34.3
Taxes and imposts	30.7	29.7	29.8	31.3	31.1	30.3	29.3
Interest, profits, royalties, revenue and land sales	1.7	2.2	1.9	1.7	1.3	1.4	1.0
Realized Bank of Israel profits	0.7	1.0	0.9	0.0	0.0	0.0	0.0
Loan from NII	1.6	1.4	1.4	1.5	0.9	1.6	1.9
US government grants	3.2	3.2	2.6	2.5	2.1	3.1	2.2
Total expenditure, net ^f	40.6	39.8	38.9	37.7	39.8	40.2	39.9
of which Interest, repayment of principal to NII, and credit subsidy	7.4	7.3	6.9	7.0	7.0	6.8	7.7
Defense expenditure, net	9.4	9.3	8.8	8.6	9.0	9.8	9.4
Total primary expenditure excl. defense	23.8	23.1	23.2	22.2	23.7	23.6	22.8

^a According to various definitions.

^b The difference between the planned and the actual deficit includes 0.15 percent of GDP receipts which are recorded as domestic receipts when the budget is being prepared, but as foreign receipts in expenditure data.

^c From 2001, the deficit ceiling specified by law.

^d The target set in the middle of 2002. The target set when the budget was approved by the Knesset (parliament) was 3.0 percent of GDP.

^e The designated economic aid had not been received by the end of 2001, and hence was not recorded as receipts in that year. If it had been received on time, the actual total government deficit would have fallen to 4.0 percent of GDP. The aid was recorded in 2002 and reduced the deficit by 0.6 percent of GDP. On the other hand, \$ 431 million of aid expected in 2002 did not arrive, although the amended forecast in the middle of the year of receipts for the year included this amount. If it had arrived the deficit would have been 0.4 percent of GDP lower. Based on the aid figure of \$ 600 million originally scheduled for 2002, the deficit for the year would have been 4.2 percent of GDP.

^f Excluding expenditure contingent on receipts, and receipts used to finance contingent expenditure.

SOURCE: Based on the National Budget Summary and Central Bureau of Statistics data.

The total government deficit in 2003 was a very high 5.6 percent of GDP—1.8 percent higher than the 2002 level and 2.6 percent above the 2003 target.

The share in GDP of civilian expenditure excluding interest and payback of principal to the National Insurance Institute declined from 23.6 percent in 2002 to 22.8 percent in 2003.

The total government deficit in 2003, as stated, was a very high 5.6 percent of GDP—1.8 percent higher than the 2002 level and 2.6 percent of GDP above the 2003 target (Table 3.1). This level, the highest since the 1985 Stabilization Program, attests to the severity of the fiscal problem that policymakers faced this year. The increase in the deficit was occasioned mainly by the decline in tax revenues (1 percent of GDP) and an increase in interest expenditure (0.9 percent of GDP), some of which was technical and caused by the method used to calculate interest expenditure in the budget.³ There was also a significant decline in US Government grants, but this was mainly due to changes in the timing of the transfer of defense aid and exchange-rate change; it was offset by a parallel decrease in defense imports. The share in GDP of civilian expenditure excluding interest and payback of principal to the National Insurance Institute declined from 23.6 percent in 2002 to 22.8 percent in 2003, for a real decrease of 0.8 percent (in CPI terms)—the first decline in this expenditure parameter since the 1985 Stabilization Program.

Box 3.1

Fiscal Analysis according to Budget Data: Accounting Issues

The fiscal targets of Israeli governments, including the deficit target and the (new) expenditure target, are set in accordance with budget definitions. Therefore, the public debate over fiscal policy often focuses on fiscal aggregates that are measured in view of these definitions. For this reason this chapter includes a broad analysis of fiscal developments using the budget definitions. However, it is important to keep the weaknesses of using these definitions in mind. Use of the budget definitions to measure government activities fails to accurately reflect the macroeconomic effect of these activities, for several reasons. First, revenues from activities such as sale of land, which constitute a sale of assets and are not economic revenue, are recorded in the budget but not in the National Accounts. Second, the budget does not include all interest payments on loans backed by US Government guarantees and does not reflect the full and very intensive involvement of central government in the activities of other entities that are aggregated under the general-government heading.¹ Furthermore, it is possible to transfer expenditure and revenue items to different components of general government and also, at least in the short term, to shift deficits among them, especially since the budget deficit is computed on a cash basis. This matter became conspicuous in 2003 when the Government slashed its participation

¹ For example, central-government transfers to public nonprofit institutions increased this year; this increased the budget deficit but did not affect the general-government deficit. For data on the components of the general government, see Table 1.A.3.9.

³ When interest expenditure in the government budget is calculated, the rate of change of the Consumer Price Index is subtracted from the nominal interest rate paid on nonindexed bonds issued before 2001. Accordingly, the inflation decline in 2003 relative to 2002 reduced the amount subtracted, resulting in a 0.4 percent of GDP increase in reported interest expenditure.

in municipal budgets (see below) and became even more important due to the change in fiscal targeting from deficit targets to expenditure targets. For these reasons, it is an accepted practice in developed countries to focus the macroeconomic analysis on the general government and not on the central government only. The activities of the general government are conventionally estimated in accordance with accepted international National Accounts rules, which require measurement on an accrual basis and not in accordance with budget definitions that vary from country to country.² Accrual-based measurement was especially important this year because the deferral of tax refunds from late 2002 to early January 2003 lowered government tax revenues by NIS 1 billion.

Apart from the ‘ordinary’ limitations that come into play when the budget definitions are used, two additional accounting issues of importance in analyzing budget developments this year and in future years came up in 2003:

1. Since the Israel Railways was reconstituted as a government-owned corporation, government investments in the railways are now recorded as investments in the corporation’s share equity or as loans to the corporation. In 2003, NIS 400 million in loans to the Israel Railways was recorded as credit and, therefore, was not included in government budget expenditure. In 2004 and in subsequent years, government investments in share equity of the railways corporation will similarly be excluded from government expenditure, in contrast to the accepted international rules for the recording of the National Accounts. Since the Government is expected to transfer large sums to the railways corporation in order to finance the corporation’s investments—NIS 1.9 billion in 2004 and more than NIS 2 billion per year in subsequent years—this practice skews the deficit data downward and creates a discrepancy between the deficit data and the behavior of the government debt.

2. Although the state budget is reported on a cash basis, the budgetary cost of the issuance of US-guaranteed bonds is not recorded. At the time the bonds are issued, a certain percent of the receipts is forwarded to the US Government as a scoring fee. The cost of scoring for a \$ 3 billion issue is NIS 700 million–NIS 1 billion, but hardly any of this sum is included in the government expenditures that the budget reports as having been made in the year of the issue. In other words, the government debt increased by the full sum of the issue at the time of the issue but the sum added to the government’s account is only that of the issue less the scoring fee. Since the discrepancy between the size of the government debt and the receipts of the issue is not included in government expenditure at the time it is created, the deficit data and the level of the debt no longer correspond.

² Additionally, in Israel the definitions of the central-government budget deficit have changed several times over the past decade.

In 2004 and subsequent years, government investments in share equity of the Israel Railways will be excluded from government expenditure, in contrast to the accepted international rules for the recording of the National Accounts.

Tax revenues were NIS 15 billion lower than the budget outlook, even though real GDP growth slightly surpassed the outlook.

The deficit decline in the second half of 2003 reflected strong expenditure restraint—2.7 percent of GDP—and an increase of 0.6 percent of GDP in tax revenues.

The deviation from the deficit target in this year's budget is explained entirely—with room to spare—by the severe NIS 15 billion shortfall of revenues relative to the budget outlook (Table 3.2) even though real GDP growth slightly surpassed the growth outlook. Almost half of the deviation had been expected by the end of 2002, when the 2003 budget was approved.⁴ The lower inflation relative to the outlook⁵ reduced revenues by NIS 4 billion and the unexpectedly acute decrease in real wages dampened revenues by another NIS 2 billion. The two last-mentioned items, however, had a negligible effect on the deficit because they also contributed to a similar decline in government expenditure relative to the budget outlook—directly, by reducing wage costs, and indirectly, by allowing procurements to be made at lower prices. The deferral of tax refunds from the end of 2002 to the beginning of 2003 lowered 2003 tax revenues by another NIS 1 billion.⁶ Surpluses of the National Insurance Institute, which are recorded in the budget as investments by the NII in Government bonds,⁷ were NIS 3.4 billion under the outlook. Revenues on this line have been overbudgeted in six of the past seven years, but the deviation in 2003 was the largest thus far. Total domestic expenditure was NIS 5 billion under the original budget. The entire decrease was in civilian expenditure; the defense budget was fully spent. However, net of the gap between the actual increase in prices and the inflation assumption used in preparing the budget, domestic expenditure was only NIS 1 billion under the sum budgeted. The Government's external deficit was NIS 2.5 billion lower than budgeted; this had been expected at the beginning of the year due to the overbudgeting of external-expenditure items for technical reasons related to budget management. Expenditures and revenues in the external budget also fell short of the budget outlook because the NIS appreciated considerably against the dollar instead of depreciating, as the budget outlook had projected.⁸

Government tax revenues in 2003 fell short not only of the budget outlook but of 2002 revenues as well. Revenues (not including Value Added Tax on defense imports) ended the year at NIS 143.8 billion, down NIS 4 billion (3.3 percent) in real terms. Net of the effect of legislative changes, which had an upward effect on tax revenues this year, the real decline was 4.2 percent.⁹ Examination of the real trajectory of collections

⁴ See Section 3 of the corresponding chapter in *Annual Report 2002*.

⁵ The average Consumer Price Index rose by 0.6 percent in 2003 as against an outlook of 3.3 percent in the budget.

⁶ Legislative changes that were not known when the budget was prepared and that went into effect in 2003 created an additional small decline in revenues.

⁷ The way in which activities of the National Insurance Institute are recorded in the government budget is explained in Box 2.3 in the corresponding chapter of *Annual Report 2002*.

⁸ The dollar value of US civilian aid was only slightly under the budget outlook. An unbudgeted grant of \$ 431 million—the balance of civilian aid that was deferred from the end of 2002—was received at the beginning of the year but the \$ 480 million grant for 2003 had not been received by year's end.

⁹ The legislative changes include changes that did not go into effect until 2003 and the impact of previous years' changes on revenues in 2003. For a detailed discussion of legislative changes in taxation during the past two years, see Box 3.3.

Table 3.2
Components of Deviation from Original 2003 Budget

(NIS billion, net, excl. credit)

	Original budget	Performance	Difference between budget and performance ^a
Deficit (-)	-15.2	-27.7	-12.5
<i>Of which</i> Domestic	-11.6	-26.6	-15.0
External	-3.6	-1.1	2.5
Revenue	192.7	170.4	-22.3
<i>Of which</i> Domestic	177.3	157.6	-19.7
Taxes ^a	159.6	145.3	-14.3
Loan from NII	12.6	9.2	-3.4
Grants from US government	13.5	10.7	-2.8
Other ^b	7.0	5.1	-1.9
Expenditure	207.9	198.0	-9.9
<i>Of which</i> Domestic	188.9	184.2	-4.7
<i>Of which</i> Abroad	19.0	13.8	-5.2
Defense ^c	46.8	46.9	0.1
Interest, repayment to National Insurance and credit subsidy	39.5	38.2	-1.3
Civilian ministries and transfer payments ^c	121.4	112.9	-8.5

^a Including V.A.T. on defense imports.

^b Income from interest, land sales, royalties, dividends, and other income.

^c NIS 3 billion which was included in the inflation reserve in the budget book is shown here in the budget column as part of the defense budget.

SOURCE: Based on data of the Accountant General regarding the performance of the 2003 budget.

in 2003 using the Research Department tax model¹⁰ shows that most of the decline originated in real variables (Table 2.3).¹¹ (1) Tax revenues fell by 3.0 percent due to the decline in consumer-goods imports. The import decline was quantitative; average import prices (in NIS) were unchanged relative to 2002. (2) The decline in new-dwelling sales in the first half of 2002, caused mainly by the expiration of nonrecurrent promotions meant to stimulate demand, lowered tax collection by 1.9 percent. (3) The real wage decrease dampened tax revenues by 0.9 percent. In the opposite direction, the increase in GDP boosted revenues by 1 percent and the financial variables included in the model did so by 0.5 percent. Share prices on the Tel Aviv Stock Exchange were especially important among the financial variables; they strengthened revenues by 1.1 percent.

¹⁰ For a full description of the model, see Adi Brender, "Estimates of the Tax Revenue Function in Israel," Bank of Israel Research Department, Discussion Paper 2001.02, January 2001 (Hebrew). As the paper explains, the contribution of each explanatory variable reflects not only the behavior of a specific tax base but also the correlation between the variables and other tax bases.

¹¹ The model includes consumer-goods imports and wages as deviations from the estimated long-term relationship between these variables and GDP.

Table 3.3
The Impact of Macroeconomic Variables on the Government's Tax Receipts in 2003^a

	(percent of total revenue)
	Contribution to change in receipts
Total change in tax receipts	-4.2
Real variables	-4.8
GDP ^b	1.0
Real wage per employee post ^c	-0.9
Imports of consumer goods ^d	-3.0
Sales of new apartments ^e	-1.9
Financial variables	0.6
Prices of shares on TASE ^f	1.1
Share of sales by Israeli control holders abroad ^g	-0.2
Outstanding foreign-currency credit by the banking system ^h	-0.4

^a The impact of the variables as estimated by the tax model of the Bank of Israel's Research Department. The government's tax receipts, at constant prices, were calculated while adjusting for the effect of the change in the law and without V.A.T. on defense imports.

^b The level of GDP, at current prices, deflated by the CPI, with a one-quarter lag; with the addition of the effect of the change in product, with a two-quarter lag.

^c The extent of deviation of the real wage per employee post from its long-term association with GDP.

^d The extent of deviation of total imports of consumer durables, in local currency at constant prices, from its long-term association with GDP.

^e The number of new apartments sold two quarters previously.

^f The real change, in basis points, in the General Share-Price Index in Tel-Aviv.

^g Sales of shares by Israeli control holders abroad, including sales made in the framework of company mergers, with a three-quarter lag.

^h Total bank credit in or indexed to foreign currency, with a two-quarter lag, calculated in local currency at constant prices.

SOURCE: Based on Bank of Israel data.

The economic plan and the changes in economic activity caused significant differences in budget performance between the first half of the year and the second (Table 3.4). In the first half, the domestic deficit was 7.0 percent of GDP (NIS 35 billion in annual terms); in the second half it contracted to 3.8 percent of GDP (NIS 19 billion in annual terms). The decline was composed of an appreciable restraint of expenditure—a decline of 2.7 percent of GDP—and an increase of 0.6 percent of GDP in tax revenues, mainly due to the economic recovery. Even in the second half of the year, however, tax revenues fell far short of the budget outlook. The analysis in Section 2 below shows that the measures taken in accordance with the plan, if they continue to be applied, will help the deficit to continue declining in the years to come. The composition of measures is also supportive of sustainable economic growth, as reflected in the experience of other countries that applied fiscal stabilization plans during the past two decades.

The composition of the measures in the Economic Recovery Plan is supportive of sustainable growth.

Table 3.4
The Government's Domestic Deficit,^a First and Second Halves of 2003

	(percent of GDP in annual terms) ^b		
	First half	Second half	Annual
Deficit	-7.0	-3.8	-5.4
Total domestic expenditure (net)	38.5	35.8	37.1
Total domestic revenues	31.5	32.1	31.8
Tax and bond receipts ^c	28.7	29.3	29.0
Investment by NII ^d	1.9	1.9	1.9
Other	0.9	0.9	0.9

^a Excluding credit.

^b The division into halves of the year takes the seasonal distribution of revenues and expenditure into account.

^c The effect of the postponement of tax rebates from the end of 2002 on the distribution of annual revenues was smoothed by distributing it evenly over the two halves of the year.

^d The implementation of the National Insurance Institute's investment in government bonds (recorded as revenue in the budget) reflects technical considerations, so that this item was divided up for the halves of the year on the basis of the activity of the National Insurance Institute vis-à-vis the public and not of the investment dates.

SOURCE: Based on data from the Accountant General.

Table 3.5
Government Expenditure Priorities, 1997–2003

	(percent)						
	1997	1998	1999	2000	2001	2002	2003
Total government expenditure ^a	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Education ^b	15.1	14.6	15.2	14.8	14.9	13.8	14.9
Health ^c	15.1	15.8	15.4	15.1	15.0	14.6	15.0
Defense	23.2	23.3	22.3	23.1	22.6	25.5	24.5
National Insurance benefits and disability pensions ^d	17.6	18.3	18.7	19.2	19.7	19.3	19.5
Infrastructure investments ^e	2.1	2.2	2.1	2.2	2.2	2.6	2.6
Other	26.9	25.8	26.3	25.6	25.6	24.1	23.4

^a Excluding interest *plus* net National Insurance expenditure. This includes government hospitals, which have been removed from the budget since 1998, but excludes credit extended. National Insurance expenditure is included net of government payments to the National Insurance Institute, which are included in government expenditure.

^b The budget of the Ministry of Education and budgetary allocations to the universities and colleges.

^c The budget of the Ministry of Health, government hospitals, and transfers of Health Tax from the National Insurance Institute to the Health Funds.

^d Excludes payment for reserve duty which is included in defense expenditure.

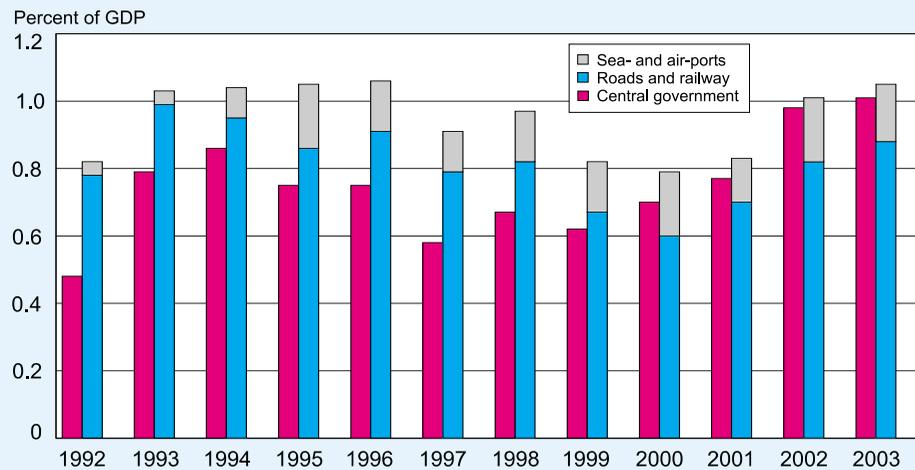
^e The government's nonresidential investment, excluding subsidies to government enterprises, and government participation in road investment of local authorities.

SOURCE: Based on National Budget Summary, Ministry budgets, and Central Bureau of Statistics data.

The numerous economic plans that have been submitted in recent years—whether corresponding to annual budgets or in the middle of fiscal years—include frequent adjustments of government expenditure. They created opportunities to recompose government expenditures in ways that would reflect the priorities of the Government

and the Knesset. However, the examination of expenditure in Table 3.5 shows that the composition has hardly changed in recent years. The only exceptions are moderate increases in the shares of defense expenditure and transfer payments in total expenditure, as against a gentle proportional decline in ‘other expenditure’ due to the cutbacks in housing grants and municipal grants. The share of government investment (excluding investment in housing and public services) in total expenditure was stable in 2003 after a sizable increase in 2002. However, this item accounts for a small fraction of total expenditure.

Figure 3.2
Central and General Government^a Investment in the Transport Infrastructure, 1992–2003



^a General government expenditure on the transport infrastructure includes investment in roads, railways, trains, seaports and airports. General government expenditure data are from the National Accounts, and central government expenditure data are taken from the National Budget (these two sources use different calculation methods). The data do not include the investment of the *Derekh Eretz Company*, which is a private company, in the Cross Israel Highway.

SOURCE: Based on National Budget Summary and Central Bureau of Statistics data.

General-government investment in transport infrastructure continued to rise, a salient development amidst the upturn in the government deficit and the restraint of government expenditure.

General-government investment in transport infrastructure continued to rise, a salient development amidst the upturn in the government deficit and the restraint of government expenditure, especially in the second half of the year (Figure 3.2). Although nonbudgeted entities accounted for most of the increase in this investment item, budget investment in this respect also surpassed the 2002 level. Total public investment in transport infrastructure increased by 6 percent in 2003 (deflated by the Consumer Price Index), after a large increase in 2002, and came to 1.1 percent of GDP, the highest proportion in recent decades and a level similar to that of the mid-1990s.¹² This is a notable achievement, especially in view of the tendency—documented in economic literature abroad and evidenced in Israel in the past—to reduce investment at times of budget

¹² There are discrepancies between the investment data reported by the Central Bureau of Statistics and those reported in the state budget; in part, they reflect differences in measuring methods and the organizations covered. Both methods point to similar trends in transport infrastructure expenditure.

difficulties. However, since the level of total investment in infrastructure—transport infrastructure in particular—is still insufficient to close the gaps in quality and quantity that took decades to amass,¹³ it is important to continue expanding such investment in coming years. The long-term investment plan of the Israel Railways is especially important in this context. The plan, approved in 2003, includes a massive increase in rail-infrastructure investment during the next five years with prior approval of financing from the budget. However, the increase in investment should be transparent, i.e., expenditure in this respect and the debt accumulated on its account should be reflected appropriately in the budget, and expenditure for this purpose should be coordinated with the other budget targets.

Notwithstanding the wish to make rapid progress in infrastructure investment in order to close cumulative gaps of past years, the magnitude and external effects of infrastructure projects necessitate using caution and not rushing ahead without adequate examination. Such examination should insist stringently on correct project planning that includes analysis of the costs and benefits to the country at large, business forecasting that will indicate the extent of subsidization needed for the investment and for its operation, and complementary planning that will maximize the use of the infrastructures being built and reduce their adverse external effects. This kind of examination may slow the initiation of projects but may also prevent delays in their completion. Therefore, any acceleration of infrastructure investment should be based on more effective planning and examination and not on the avoidance of these measures by administrative means.

Stringent examination of infrastructure projects may slow the initiation of the projects but may also prevent delays in their completion.

2. THE ECONOMIC RECOVERY PLAN

It was already clear by early 2003 that the budget was not consistent with its targets, especially the deficit target of 3.0 percent of GDP. Government revenues were far under the budget outlook while expenditures were running at full-performance level. The defense system demanded a large budget increase that the Government honored in the sum of NIS 2 billion. Against this background, the estimates—including those presented by the Ministry of Finance to the Government—were that the deficit would be at least 6.5 percent of GDP, even if budget expenditure were restrained stringently during the year. Furthermore, analysis of the deficit trajectory pointed to another increase in future years that would cause the general-government debt/GDP ratio to escalate rapidly.¹⁴ The acceleration of currency depreciation at that time and the increase in interest rates on the government debt led to rising concern about the development of a financial crisis that might have a protracted effect on economic activity. Therefore, the Government decided to stanch the deficit uptrend by applying an emergency economic plan.

It was already clear by early 2003 that the budget performance was not consistent with its targets, especially the deficit target of 3.0 percent of GDP. The acceleration of currency depreciation at that time and the increase in interest on the government debt led to rising concern about the development of a financial crisis. Therefore, the Government decided to stanch the deficit uptrend.

¹³ For detailed discussion, see 'Transport and Communications' in Chapter 1.

¹⁴ For a comprehensive analysis of the deficit trajectory that had been expected before the economic plan, see Kobi Braude and Adi Brender, "Influence of the Economic Plan on the Government Budget in 2003–2008," Bank of Israel, July 2003 (Hebrew).

The Economic Recovery Plan was composed of immediate measures and longer-term ones that were expected to exert a cumulative effect in future years.

The 2003 economic plan was materially different from previous plans due to its long horizon, and this may have enhanced its credibility.

Nearly all of the deficit adjustment was made by reducing expenditure, in a salient difference between the 2003 plan and the Economic Defensive Shield program that was implemented in 2002.

The plan was composed of immediate measures and longer-term ones that were expected to exert most of their cumulative effect in future years. The impact of the immediate measures on the deficit was also spread over several years, because the plan was to be implemented gradually and because it was invoked in mid-year. The main immediate measures are listed in Table 1 in Box 3.2. In addition to the provisions of the plan, it was decided to impose a temporary wage cut throughout the general government in order to reduce the deficit in each of the years 2003 and 2004 by NIS 500 million (taking into account the revenue loss due to less tax collection on wages), to move up the tax cuts included in the income-tax reform, and to reinstate the income ceiling for National Insurance contributions more quickly than had been intended. (The two last-mentioned measures increased the deficit in the short term). It was also decided to freeze various budget lines, to revise the method of adjusting National Insurance benefits, and to gradually erode some expenditure items in order to continue restraining general-government expenditure in future years. The 2003 economic plan was materially different from previous plans due to its long horizon, and this may have enhanced its credibility.

The list of measures in Table 3.2.1 shows that nearly all of the deficit adjustment was made by reducing expenditure, in a salient difference between the 2003 plan and the Economic Defensive Shield program. By 2006, when the measures will have exhausted themselves, the deficit will have been reduced by NIS 12.2 billion—NIS 2.5 percent of GDP—relative to the budget trajectory preceding the plan. Of the total, NIS 11.9 billion will reflect cutbacks in expenditure—almost all in current expenditure—and tax revenues are to increase by only NIS 1.5 billion.¹⁵ Additionally, the pension reform is expected to gradually increase government expenditure to NIS 1.2 billion in 2006. However, since it had been widely presumed before the pension reform that the government would back pension funds' liabilities to members even though this undertaking was not enshrined in any formal arrangement, one may reason that the reform did not increase the government's long-term deficit but merely made this part of the increase transparent.¹⁶

In addition to the immediate measures, longer-term steps adopted by the government are expected to lower the deficit by 1.5 percent of GDP by 2005 and another 2.0 percent of GDP in 2006–2008. This long-term effect—if it comes to pass—will bring the total impact of the plan, when fully applied, to 6 percent of GDP, almost entirely by cutting government expenditure relative to the original path. The plan also included several structural measures related to infrastructure and general-government management that had been deferred. The application of these measures may help to improve efficiency in the general government and the economy at large and, by so doing, may enhance the Government's ability to continue reducing the share of its outlays in GDP.

¹⁵ Moving up the income-tax reform may reduce tax revenues in 2006 by NIS 4 billion relative to the original path of the reform, but this is only a temporary reduction, since from 2008 on the tax cut will be in accordance with the original path. Therefore, this effect may be overlooked.

¹⁶ It is also possible that the terms of fund members were worsened more severely than the public had estimated before the reform, due to which the estimate of the Government's future liabilities actually decreased.

The composition of the economic plan is compatible with the needs of the Israeli economy, which has one of the world's highest general-government expenditure/GDP ratios and a relatively high tax burden. The emphasis on lowering current government expenditure in GDP, including a large immediate cutback and measures to support continued reductions in future years, enhanced the credibility of the plan. Tackling long-term issues such as the pension reform, the retirement age (not only in regard to pension funds), and the structure of National Insurance benefits made fiscal policy more credible in the long term. However, since much of the deficit cut is to be achieved by long-term measures, perseverance in applying the plan in future years will be crucial. Otherwise, the achievements of the plan may go to waste. As in the past, the policy commitment to restrain budget expenditure will be put to the test when economic activity expands, revenues resume growing, and the sense of crisis passes. Furthermore, since the deficit level was expected to remain high for the next few years irrespective of the economic plan, additional major fiscal adjustments were needed shortly after the reform was applied (as explained in Section 5 of this chapter). This threw the economy into yet other period of labor unrest and uncertainty with regard to the fiscal framework and various institutional arrangements.

Tackling long-term issues such as the pension reform, the national retirement age, and the structure of social security benefits enhanced the long-term credibility of fiscal policy.

Unless the plan is applied with perseverance in future years, its achievements may go to waste.

Box 3.2

How the Plan is Affecting the Economic Recovery

When the Economic Recovery Plan went into effect—coupled with other important developments such as the global economic recovery, the removal of the Iraqi threat against Israel, the approval of the US guarantees, and a decline in Palestinian terror attacks—Israel's protracted economic downtrend slowed and GDP growth began to rally, even though the plan had a direct downward effect on demand. Thus, a question arises about the immediate effect of the plan on economic activity. The economic literature in recent years has discussed many examples of countries that underwent significant fiscal consolidation, and experienced immediate accelerations of growth.¹ Israel's adjustment in 2003, in terms of its magnitude and composition, resembles those described in the literature as having contributed to an upturn in economic activity (assuming that the public expects the Government to persevere in applying the plan²). Therefore, the plan may in fact have contributed to the improvement in growth. The similarity is focused on the following points.

¹ The best known examples are Ireland and Denmark in the 1980s, which underwent rapid GDP growth after fiscal contraction. See F. Giavazzi and M. Pagano (1990), "Can Severe Fiscal Adjustments Be Expansionary? Tales of Two Small European Countries," in O. J. Blanchard and S. Fischer (eds.), *NBER Macroeconomics Annual 1990*, MIT Press. Many similar episodes were documented in the 1990s.

² One of the characteristics shared by the growth-inducing plans was several years of steady deficit-cutting efforts.

1. The deficit cut attained in the episodes discussed in the literature, in cycle-adjusted terms, was at least 1.5 percent of potential GDP. In Israel, the cycle-adjusted general-government deficit contracted by 1.8 percent of GDP in 2003 and by more in annual terms, since the plan was implemented in mid-year.³

2. Most of the adjustment in the countries at issue (75 percent) was made by reducing expenditure. Table 3.2.1 shows that nearly all of the adjustment in Israel was accomplished in this fashion.

Principal Components of the Government's 2003 Fiscal Package, and their Contribution to Reducing the 2006 Deficit^a

(NIS billion, net, at 2003 prices)

	Cumulative 2003–2006
Reduction of National Insurance benefits ^b	4.1
Across-the-board cuts ^c	2.8
Cuts on other specific budget items	1.0
Cancellation of housing assistance grants	1.3
Reduction of balancing grant to local authorities (incl. across-the-board cut)	0.7
Reduction of public-services employment	0.9
Water & transport infrastructure (incl. local authorities and across-the-board cut)	0.4
Reduction of defense budget	0.6
Total expenditure cut	11.9
Regional tax concession	1.0
Tax-exemption for immigrants and returning residents	0.1
Lottery tax (gross)	0.3
8 percent tax on foreign workers	0.2
New taxes	1.5
Pension fund reform ^d	–1.2
Total effect on deficit	12.2

^a Excluding the early implementation of the tax reform and the annulment of the ceiling on the collection of National Insurance payments, as these steps had been planned. Benefits, except for child allowances, will increase by 4 percent in 2007, at a cost of about NIS 1 billion. The early implementation of the tax reform increases the expected deficit in 2006 by about NIS 4 billion, but this will be offset in 2007 and 2008.

^b This item includes the postponement of a rise in some National Insurance benefits, amounting to NIS 1.7 billion.

^c Excluding defense, infrastructure, transport, water, and local authorities.

^d The cost of the pension reforms is the difference between the proposed payment to the designated fund and the expected cash payment, and the expected saving of interest payments due to the cancellation of issuance of earmarked bonds.

SOURCE: Based on Bank of Israel data.

³ To create the cyclical adjustment, the effect of changes in economic activity on the deficit is subtracted. The computation is discussed and explained in detail in Section 3 below.

3. The measures included in the comparison countries' adjustments were permanent. So were most of the measures that Israel applied in 2003, unlike those under the Economic Defensive Shield plan. Moreover, further measures and mechanisms to support continued cutbacks in general-government expenditure were adopted.

As in the countries that invoked growth-inducing plans, unit labor cost decreased in Israel in 2003—after several years of increases—and exports accelerated vigorously enough to narrow the import surplus. However, unlike the other countries, Israel did not experience a clear increase in investment.

Even though the major budget adjustment was largely a necessity occasioned by the rapid increase in deficit and debt, the methods used to implement the plan and some of its constituent measures engendered severe public controversy. This was mainly because the plan used legislation to amend agreements that the Government had concluded in the past. Even if the government did not actually resort to legislation in most cases or replaced legislation with new agreements that it concluded with representatives of labor, the very use of legislation, or its threat, may undermine the credibility of the government's agreements and reduce the government's ability to make reliable commitments in future agreements. Thus, the gains of a successful fiscal adjustment based on these measures may be offset by their cost. On the other hand, there may have been no choice but to use this method, because the previous arrangements gave the labor organizations so much power that fiscal adjustments of the magnitude and the urgency required could not have been made without breaching them. The severe dilemma that the government faced was largely a reflection of the price of these previous arrangements. The eventual success in modifying the arrangements by consent in most contested issues did much to solidify the credibility of the changes made. Only in the future, however, will it be possible to determine whether the cost of using the threat of legislation will not outweigh the utility of the changes attained. This is stated especially in view of the rapid recourse to this instrument when the complementary measures to the 2004 budget were approved, even though some of the measures clashed even with the agreements that had been obtained several months earlier as part of the economic plan.

Another problem stemming from the hasty approval of the plan and the magnitude of the measures required was the difficulty in conducting a systematic public debate over important structural reforms and the long-term implications of the plan. The reforms are needed in order to consolidate the market's confidence in the fiscal stabilization, especially after the rapid deficit increase that followed the previous stabilization plan shortly after its implementation. Decisions had to be made within a few weeks in matters such as pension-fund reform, far-reaching changes in tax rates, the structure and adjustment mechanism of National Insurance benefits, and the merger of municipalities

The method used to implement the plan and some of its constituent measures engendered severe public controversy, mainly because the plan used legislation to amend agreements that the Government had concluded in the past.

The eventual success in modifying the arrangements by consent did much to solidify the credibility of the changes made.

Only in the future will it be possible to determine whether the cost of using the threat of legislation did not outweigh the utility of the changes attained.

Due to the hasty approval of the plan and the magnitude of the measures required, it was difficult to conduct a systematic public debate over the extremely important structural reforms and the long-term implications of the plan.

Israel's new target retirement age for men, sixty-seven starting in 2009, is the world's highest and resembles only that in Denmark and the US, which will go into effect in 2027.

Most developed countries no longer differentiate between women and men in retirement age; in this respect, Israel will remain exceptional even after the higher age goes into effect.

(seventy authorities in fourteen days, according to the original plan). Under such conditions, obviously many important considerations could not find expression and opportunities for errors in application were created. This is mainly the price that Israel is paying for not having dealt with these structural matters before the crisis erupted.

One of the most important components of the economic plan approved by the Knesset in early 2004, pursuant to the agreement with the Histadrut, is the raising of the national retirement age. This measure will affect the ages of eligibility for social security, old-age benefits, budgetary pension, and pension benefits paid by old and new pension funds alike. The change will also affect additional citizen entitlements at and on the verge of retirement age. In comparison with other countries that have debated or raised their retirement ages recently, Israel's new target retirement age for men, sixty-seven starting in 2009, is the world's highest and resembles only that in Denmark and the US, which will go into effect in 2027. The target retirement age for women—sixty-four starting in 2017—resembles the OECD average (Table 3.6). However, most developed countries no longer differentiate between women and men in retirement age; in this respect, Israel will remain exceptional even after the higher age goes into effect.¹⁷

One may find justification for the choice of a relatively late retirement age in Israel, relative to developed countries, in Israel's relatively long life expectancy and relatively late entry into the labor market, due to military service. Furthermore, most developed countries realize that their current retirement ages are too low. However, another characteristic of the adjustment of the retirement age in Israel is the rapid pace of the adjustment (Table 3.7). In Israel, the retirement age of men and women will be raised

Table 3.6
Legal Retirement Age in the OECD Countries, 2000

	Men	Women
Czech Republic	62	61
Hungary	60	57
Poland	65	60
Austria	65	60
Belgium	65	65
Denmark	67	67
Finland	65	65
France	60	60
Germany	63	63
Greece	65	60
Ireland	65	65
Italy	65	60
Luxembourg	65	65
Netherlands	65	65
Portugal	65	65
Spain	65	65
Sweden	65	65
UK	65	60
US	65	65
Japan	65	65
New Zealand	65	65
Canada	65	65
Australia	65	61
OECD average ^a	64	63

^a Arithmetic mean of all the countries in the table.
SOURCE: IMF.

¹⁷ Among the OECD countries, only Greece, Italy, and Poland maintain lower retirement ages for women than for men and have no active plans to equalize them.

Table 3.7
Changes in Retirement Age, Israel and OECD Countries

	Change in retirement age		Target age		Rate of annual rise	Comments
	Men	Women	Men	Women		
	(rise in years)				(average months in year)	
Israel	2	4	67	64	Men 5, Women 4 ^a	
US	2	2	67	67	1	Announced 3 years in advance
Belgium	0	5	65	65	5	
Denmark	2	2	67	67	Not gradual; announced 6 years in advance	
Australia	0	4	65	65	3	
Switzerland	0	1	65	64	4	
UK	0	5	65	65	6	Begins in 2010
Hungary	2	7	62	62	1 Every other year	
Czech Republic	2	4–5	62	57–62	Men 2, Women 4	Retirement age for women depends on number of children; 3.5 years for women with 4 or more children
Slovakia	0	3	60	60	2.4	
Estonia	1	5.5	63	63	Men 12, Women 6	Announced 3 years in advance
Lithuania	2.5	5	62.5	60	6	
Korea	5	5	65	65	3	Begins in 2013
Latvia	2	4.5	62	62	6	

^a For women: 5 months a year until age 62, then a 3-year interval, followed by a similar rate of increase.
 SOURCE: Based on data from OECD, IMF, and elsewhere.

by two years over a five-year period (from the middle of 2004 to the middle of 2009) and that of women by another two years in 2012–2017.¹⁸ Furthermore, the hikes began to go into effect almost as soon as the ink on the legislation dried. The rapidity of the change is injurious to many older workers who cannot adjust their savings and employment arrangements on such short notice in order to retire in the manner that they had planned. Most other countries that raised their retirement ages did so more gently or allowed a significant transition period until the beginning of the increase. It is true that several Eastern European countries instituted a faster adjustment than Israel's, but they did so at lower retirement ages. The discrepancy stands out in particular because these countries, including those in Eastern Europe, have more severe and urgent population aging problems than Israel has. Furthermore, Israel has already adopted arrangements that capped the growth rate of pension liabilities.¹⁹

Most other countries that raised their retirement ages did so more gently than Israel did or allowed a significant transition period until the beginning of the increase.

¹⁸ Unless a different decision is made pursuant to the recommendations of a public commission that will be established to look into the matter.

¹⁹ The—more generous—'old' pension funds are blocked to new members. Newly hired workers in general government are no longer entitled to budgetary pension and are insured with new pension funds that have to maintain actuarial balance.

3. MAIN DEVELOPMENTS IN THE ACTIVITY OF GENERAL GOVERNMENT

The general-government deficit exceeded 5 percent of GDP for the second consecutive year.

The general-government deficit exceeded 5 percent of GDP for the second consecutive year (Table 3.8).²⁰ The deficit during this period was the highest since 1996, 4 percent of GDP over the low deficit level in 2000, and much higher than in the years preceding

Table 3.8
The Main Components of General Government Receipts and Expenditure, 1994–2003

	(percent of GDP)						
	Average						
	1994–1997 ^a	1998	1999	2000	2001	2002	2003
Total receipts	49.8	49.3	47.9	48.9	49.7	50.7	47.9
<i>Of which</i> Excl. Bank of Israel	49.6	48.9	48.6	49.6	49.8	49.9	48.8
<i>Of which</i> From property	1.6	2.2	1.1	1.0	1.5	2.4	0.6
Total taxes	39.3	38.3	38.5	40.0	40.0	39.3	38.7
Indirect taxes on domestic production	14.6	14.2	14.3	13.5	13.6	14.3	14.4
Indirect taxes on civilian imports	5.2	4.3	4.4	4.6	4.2	4.2	4.2
Direct taxes, fees, and levies	14.2	14.1	14.0	16.0	15.9	14.4	13.5
National Insurance income	5.3	5.8	5.7	5.9	6.3	6.4	6.5
Grants	4.1	4.0	4.0	3.7	3.7	4.1	3.7
Other ^b	4.8	4.9	4.4	4.2	4.5	4.9	4.8
Total expenditure	54.3	53.0	52.1	51.1	53.8	55.2	54.0
<i>Of which</i> Current expenditure	48.2	48.1	47.6	47.0	49.6	50.9	50.1
Domestic civilian consumption	19.3	19.3	19.3	19.0	20.3	21.0	20.7
Domestic defense consumption	7.4	6.8	6.6	6.7	6.7	7.4	7.3
Defense imports	1.7	1.8	2.0	1.7	1.9	2.4	1.9
Direct subsidies	1.3	0.8	0.8	0.8	0.8	0.7	0.7
Transfer payments on current account	12.0	12.8	12.7	12.8	14.0	14.0	13.6
Interest payments	6.5	6.4	6.0	6.0	5.9	5.4	5.9
Transfer payments on capital account	2.5	1.6	1.7	1.5	1.5	1.6 ^c	1.2
General government investments	3.5	3.3	2.7	2.6	2.7	2.7	2.7
Total general government deficit	4.6	3.7	4.2	2.1	4.1	1.5	6.1
Total general government deficit excl. Bank of Israel	4.8	4.1	3.4	1.5	4.0	5.3	5.2
Total surplus excl. interest and receipts from property	0.3	0.5	0.7	2.8	0.3	-1.5	-0.9
Net public debt^d	86.9	83.2	83.4	78.8	84.5	86.4	92.6
Gross public debt excl. Bank of Israel^e	108.8	106.7	101.4	91.4	96.4	104.9	107.4

^a From 1995, including receipts and expenditure due to the National Health Law.

^b Including transfer payments from the public on the current and capital accounts.

^c Including capital transfers of NIS 1,523 million to China, in compensation for the cancellation of the Falcon deal.

^d Divided by GDP at end-of-year prices.

^e After deducting local authorities' debts to the central government.

SOURCE: Based on Central Bureau of Statistics data.

²⁰ When the volatile item of 'Bank of Israel profit'—an item that mainly reflects unforeseen changes in the inflation rate, the exchange rate, and global interest rates—is included in the calculation, the deficit increased in 2003 by 1.6 percent of GDP and came to 6.1 percent. However, the Bank of Israel does not actually transfer to the government the 'profits' that the CBS calculates (see corresponding section in *Bank of Israel Annual Report 2001*). For this reason, and since in most developed countries, including those of the EU, it is conventional to record as government revenue only profit that the central bank actually transfers, the deficit discussed in the rest of the analysis does not include the Bank of Israel.

1996. However, in contrast to the past two years, during which the deficit increased because of an upturn in the share of general-government expenditure in GDP, the 2003 deficit leveled off because the shares of government revenues and expenditure in GDP declined in similar degrees. Furthermore, the deficit excluding interest and property income decreased in 2003 after rising strongly in 2001–2002. The high level of deficit caused the public debt/GDP ratio to grow again this year, bringing the gross general-government debt back to the mid-1990s level and raising the net debt ratio to the highest level in a decade.

Table 3.9
Components of Increase in Public Expenditure/GDP Ratio, 2000–2003

	Percent of GDP	Proportion of total increase
Total increase in public expenditure	2.9	100.0
Domestic civilian consumption	1.7	58.8
Defense consumption	0.7	24.9
Direct subsidies	-0.1	-4.3
Current transfer payments	0.8	28.3
Interest payments	-0.1	-3.4
Investments and transfer payments on capital account	-0.2	-6.0

SOURCE: Based on Central Bureau of Statistics data.

Examination of the factors behind the increase in the general-government deficit over the past three years shows that 2.9 percent of the 3.7 percent of GDP increase in the deficit traced to an upturn in the share of general-government expenditure in GDP. By implication, the deficit increase was occasioned not by the absence of the unusually strong revenues that the government had received due to the economic spike in 2000, but rather by the continued rapid increase in expenditure—despite the recession—until the middle of 2002. The composition of the growth of expenditure in GDP during this time (Table 3.9) shows that despite the security deterioration, the deficits (which caused the general-government debt to balloon), the high interest rate during much of the period, and the infrastructure investments, more than half of the increase traced to an increase in civilian general-government expenditure in GDP as against 30 percent due to a proportional increase in current transfer payments. Only one-fourth of the upturn in the share of general-government expenditure in GDP during this time was traceable to an increase in defense spending. Interest payments, investments, and capital-investment subsidies played an even smaller role. The decrease in general-government expenditure in GDP in 2003 reflected, in the main, a decline in capital subsidies—including a steep decrease in housing subsidies—and in defense imports, coupled with less civilian consumption.

The large deficit in 2003 caused the general-government debt/GDP ratio to rise perceptibly. Gross debt increased more gently than the deficit due to the moderating effect of the appreciation of the NIS against the dollar, in which most external debt is denominated (Table 3.10). Another factor that helped to restrain the debt/GDP ratio was the decrease in the Consumer Price Index (to which most of the debt is indexed²¹)

²¹ The composition and development of the debt are analyzed in the Monetary Department section of this Report.

In contrast to the previous two years, during which the deficit increased because of an upturn in the share of general-government expenditure in GDP, the 2003 deficit leveled off because the shares of government revenues and expenditure in GDP declined in similar degrees.

Of the 3.7 percent of GDP increase in the deficit, 2.9 percent was due to an upturn in the share of general-government expenditure in GDP.

Only one-fourth of the upturn in the share of general-government expenditure in GDP in 2000-2003 was traceable to an increase in defense spending.

relative to the GDP deflator. The ratio of net debt to GDP—a parameter that includes the Bank of Israel—climbed more swiftly in 2003, mainly because it is not sensitive to exchange-rate changes.²² The ratio today resembles that of 1993, meaning that it has not declined over a decade (Figure 3.1), and is steadily rising at the present time.

Israel's relatively high and rising government debt has raised the risk that investors attribute to the Israeli economy.

The high level of debt explains the vast importance of the mid-2003 economic plan, which reversed the trajectory of the deficit, and the measures in the 2004 budget that will help to keep the deficit—and the debt/GDP ratio—on a downward path for several years to come.

Because it is high by global standards (Table 3.11) and efforts to reduce it have long failed, its rising trajectory in the past three years—which is expected to continue in 2004—has elevated the risk that investors attribute to the Israeli economy. In particular, it constrains the government's ability to soften the impact of external and security shocks without risking financial crisis. Hence the vast importance of the mid-2003 economic plan, which reversed the trajectory of the deficit, and the measures in the 2004 budget that will help to keep the deficit—and the debt/GDP ratio—on a downward path for the next few years. (See Section 6 below.) The raising of the retirement age also reduces future government liabilities on account of National Insurance pensions, budgetary pensions, and the pension-fund settlement. Additional components of the pension-fund settlement reduce uncertainty about the government's actuarial liability in this regard. It is true that the expected age composition in the next few decades will be less burdensome to the budget in Israel than in developed countries,²³ and in this sense it would seem possible to maintain a higher debt/GDP ratio without risking a downslide. In recent years, however, it has become clear that Israel's security risks—and their economic effects—actually entail greater caution, i.e., a lower debt/GDP ratio than the global standard. In this context, the large deficit and the high debt/GDP ratio underlay difficulties that the government has encountered in mobilizing sources for the construction of the separation fence, notwithstanding its decisions to go ahead with this project swiftly.

Table 3.10
Components of Increase in Gross Public Debt from 2002 to 2003

	(percent of GDP)
Debt at end of 2002	104.9
Increase in GDP	-1.3
Budget deficit, cash basis ^a	5.4
Revaluation of foreign-currency debt	-1.4
Revaluation of local-currency debt ^b	-0.9
Revaluation of indexed debt, GDP deflator	0.1
Increase in debt beyond the deficit	0.7
Total	107.4

^a Including credit extended, principal paid, and the scoring on bonds issued under US government guarantee.

^b The difference between the decline in the CPI during the year and the decline in the GDP deflator.

SOURCE: Bank of Israel.

²² The net external debt (external debt less foreign reserves) is less than 3 percent of GDP, whereas the gross external debt is 27 percent of GDP.

²³ For discussion of the effect of Israel's demographic outlook through 2020 on government expenditure, see Kobi Braude (2003), "The Influence of Demography on Long-Term Public Expenditure," *Economic Quarterly*, 50, December (Hebrew).

Table 3.11
The Overall Deficit, the Primary Deficit, and the General Government Debt Burden in Israel and OECD Countries, 1992–2003

	General government deficit (-) (% of GDP)		Reduction in the share of expenditure in GDP 1994–2003 (percent)		Primary general government deficit (-) (% of GDP)		Total general government debt (% of GDP)		Real increase in per capita public consumption 1994–2003 (percent)		
	1992–94	2002–03 ^a	Change	1994–2003	1994	2003	Change	1995		2003	Change
Israel ^b	-4.8	-5.3	-0.4	0.2	3.3	0.6	-2.7	109.2	107.4	-1.8	1.5
Greece	-11.6	-1.6	10.1	-4.0	4.6	3.6	-1.0	108.7	102.9	-2.3	1.3
Sweden	-9.9	0.7	10.6	-11.9	-9.7	0.5	10.2	82.1	62.5	-22.1	0.5
Italy	-10.1	-2.6	7.5	-6.0	1.7	2.2	0.5	132.4	117.1	-13.6	0.7
Britain	-7.0	-2.2	4.8	-2.2	-4.1	-1.3	2.8	60.5	53.5	-9.8	1.3
Canada	-8.2	0.9	9.1	-9.6	-1.7	3.2	4.9	100.8	75.6	-18.7	0.4
Belgium	-6.8	0.4	6.9	-3.6	4.2	5.5	1.3	133.9	102.4	-28.5	1.7
Finland	-6.1	3.4	9.5	-11.9	-6.8	2.4	9.2	65.8	52.6	-18.4	1.6
Spain	-5.7	0.1	5.8	-8.0	-1.9	1.9	3.8	73.8	63.3	-7.4	2.8
Portugal	-6.9	-2.8	4.1	0.7	-1.1	0.2	1.3	64.3	59.8	-4.5	2.8
France	-5.2	-3.6	1.7	-0.5	-2.4	-1.2	1.2	62.9	69.5	3.8	1.4
Australia	-5.7	1.0	6.6	-3.2	-0.6	2.6	3.2	43.1	18.4	-21.4	2.2
Austria	-3.7	-0.9	2.9	-5.8	-1.5	1.4	2.9	69.2	66.8	-5.9	0.6
US	-4.8	-4.2	0.7	-0.6	-0.1	-3.2	-3.1	74.2	63.4	-13.8	1.1
The Netherlands	-3.5	-2.0	1.5	-5.0	0.9	0.2	1.1	77.2	54.1	-25.5	1.7
Germany	-2.7	-3.8	-1.1	0.4	0.4	-1.4	-1.8	57.1	65.3	5.3	1.1
Denmark	-2.5	1.4	3.9	-5.0	0.9	2.2	1.3	79.5	50.7	-30.7	1.7
Ireland	-2.6	-0.6	2.0	-9.1	2.5	0.8	-3.3	82.9	32.5	-48.5	5.1
Japan	-1.8	-7.3	-5.5	3.1	-2.5	-5.7	-3.2	86.6	154.6	62.3	2.6
Norway	-1.0	10.4	11.4	-5.7	2.5	14.3	11.8	34.4	23.7	-9.0	1.8
New Zealand	-0.7	2.7	3.4	-3.2	3.9	2.2	-1.7	56.9	38.4	...	2.0
OECD average ^c	-5.3	-0.5	4.8	-4.6	-0.5	1.4	2.0	77.3	66.4	-11.0	1.7
EU average ^c	-6.0	-1.0	5.0	-6.1	-0.9	1.1	2.0	82.2	68.1	-14.9	1.7
Average of countries with 1993 deficit larger than Israel's ^{c, d}	-7.2	-0.6	6.6	-5.5	-1.6	1.8	3.4	83.1	70.4	12.4	1.4

^a Average.

^b Deficit data for Israel do not include the Bank of Israel or indexation differentials on the public debt.

^c Arithmetic mean of all countries in the group.

^d Average of countries whose deficit in 1993 was larger than Israel's.

SOURCE: Based on *OECD Economic Outlook*, 74, December 2003, and CBS data.

Table 3.12
Principal Fiscal Aggregates by Common International Definitions; Israel,^a
OECD, and EU Countries, 1999–2003

	(percent of GDP)				
	1999	2000	2001	2002	2003
General government deficit (–)					
Israel	–4.2	–1.5	–4.8	–9.2	–4.4
OECD average ^b	0.0	1.2	0.6	–0.2	–0.9
EU average ^b	–0.2	0.8	0.0	–0.7	–1.4
General government expenditure					
Israel	53.0	51.1	54.8	59.7	53.0
OECD average ^b	45.9	44.9	45.1	45.4	45.9
EU average ^b	48.4	47.5	47.7	47.6	48.5

^a The data for Israel were brought into line with the accepted international definition: indexation differentials (accrual basis) on the NIS debt (indexed to the CPI and unindexed) were added to the general government's deficit and expenditure as defined in the National Accounts, and indexation differentials on the public's debt to the government were deducted from the deficit.

^b Arithmetic mean of member countries.

SOURCE: Based on *OECD Economic Outlook*, 74, November 2003 and Central Bureau of Statistics data.

In the past decade, Israel's general-government deficit increased by 0.4 percent of GDP while the OECD countries lowered theirs by 4.8 percent of GDP on average.

The OECD countries reduced their share of general-government expenditure in GDP by 4.6 percent during the past decade, whereas in Israel this parameter increased.

To appreciate how exceptionally large Israel's deficit is, one may compare Israel with the OECD countries in this regard. According to accepted international definitions, Israel's general-government deficit in 2003 was 4.4 percent of GDP (Table 3.12) as against an average of only 0.9 percent in the OECD countries.²⁴ Israel is exceptional by long-term comparison, too: in the past decade its general-government deficit increased by 0.4 percent of GDP while the OECD countries lowered theirs by 4.8 percent of GDP on average (Table 3.11). Only part of the discrepancy is traceable to differences in Israel's point in the business cycle: over the past decade, the cycle-adjusted deficit decreased by only 0.7 percent of GDP in Israel as against 3.3 percent in the OECD countries at large and 5.0 percent in OECD countries that had larger deficits than Israel's at the beginning of the period (Table 3.13).²⁵ The comparison also indicates the reason for the difference: the OECD countries reduced their share of general-government expenditure in GDP by 4.6 percent during this time, whereas in Israel this parameter increased. Thus, whereas at the beginning of the decade Israel's share of general-government expenditure in GDP resembled that of the European Union countries (even though Israel's defense and immigrant-absorption expenditures were larger then than they are now), today Israel has a much higher share than these countries

²⁴ To translate the Israeli definition of the general-government deficit into international terms, one should add indexation differentials on the NIS debt of general government, which were –0.7 percent of GDP in 2003. At 2.0 percent inflation—the middle of the range that is defined as price stability—the increase comes to about 1 percent of GDP.

²⁵ The 1992–1994 years were chosen as the base period because they correspond to the beginning of the Maastricht-based fiscal adjustment in Europe and the end of massive immigrant-absorption expenditure in Israel. Israel's cycle-adjusted deficit was skewed upward in the beginning of the period because it continued to spend massively for immigrant absorption until 1994.

Table 3.13
The Cyclically Adjusted Deficit in Israel and OECD Countries,
1992–1994 vis-à-vis 2002–2003 Averages

	(percent of potential output)		
	General government's cyclically-adjusted deficit (-)		
	Average 1992–1994	Average 2002–2003	Change
Israel ^a	-2.8	-2.1	0.7
OECD average ^b	-4.2	-0.8	3.3
EU average ^b	-4.2	-0.6	3.6
Average of countries with large deficit ^c	-5.2	-0.2	5.0

^a General government excluding Bank of Israel.

^b Arithmetic mean of all OECD countries.

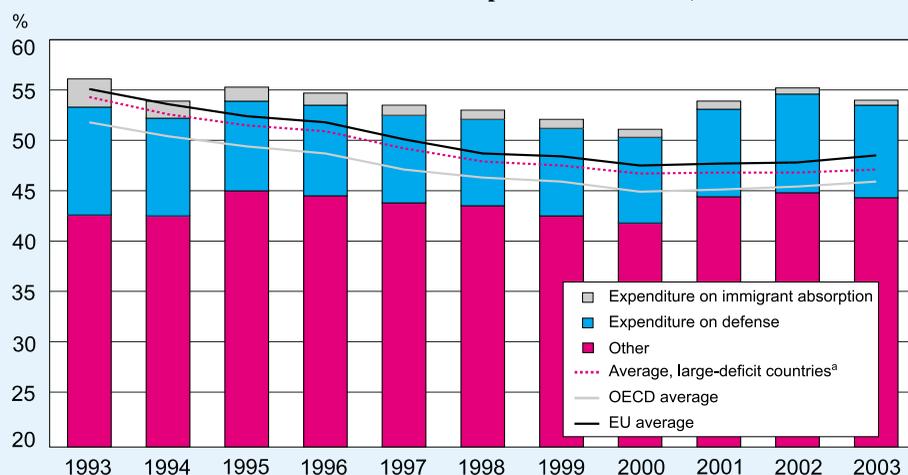
^c Arithmetic average of countries whose deficit in 1993 was greater than Israel's.

SOURCE: Based on data from *OECD Economic Outlook*, 74, December 2003.

(Figure 3.3). It is true that over the past two years several countries have adopted a policy of increasing their general-government deficits, but these seem to be large countries (the G-5); the smaller countries are adhering to the path of fiscal consolidation due to market discipline and the success of this policy in previous years (Figure 3.4).²⁶

The tax burden—the share of tax payments in GDP—declined in 2003 after decreasing in 2002 (Figure 3.1). The tax burden contracted by 1.3 percent of GDP

Figure 3.3
The Share of General Government Expenditure in GDP, 1993–2003



^a Average of countries whose deficit in 1993 was larger than Israel's.

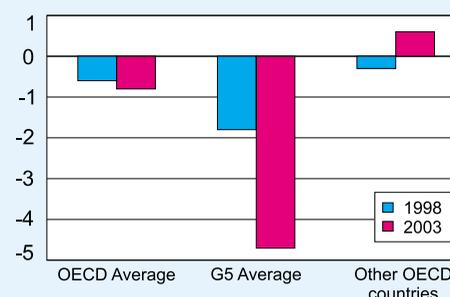
SOURCE: Based on OECD and Central Bureau of Statistics data.

²⁶ For details, see D. Kalush (Aug. 14, 2003), *Survey of Fiscal Developments in OECD Countries* (Hebrew), www.bankisrael.gov.il

The tax burden contracted by 1.3 percent of GDP during the past two years and returned to the mid-1990s level.

during the past two years and returned to the mid-1990s level. Both years' decreases focused on direct taxes and were occasioned mainly by falling real wages and corporate earnings. The indirect-tax burden, in contrast, climbed in 2002–2003, mostly due to legislative changes (Box 2.3). Net legislative changes contributed NIS 1.7 billion to the increase in the tax burden in 2003 after having contributed NIS 3.2 billion in 2002 (including the effect of eliminating the social security contribution ceiling, which was reinstated in the middle of 2003).

Figure 3.4
Deficit (–)/Surplus (+) of General Government; OECD Average,^a G5 Average,^b and Other OECD Countries, 1998 and 2003



^a Arithmetic mean of countries in Table 3.11

^b G5 countries: US, Japan, Germany, France and UK.

SOURCE: Based on OECD data.

Box 3.3

Tax-Related Legislative Changes in 2002–2004

Israel's tax system has been modified in many ways in recent years in order to boost government revenues and cut the deficits, which swelled from 2001 on, and to lower the tax rate on earned income, which was very high by international standards (especially in parts of the country where reduced tax rates were not in effect), particularly in the three uppermost income deciles.¹ The legislative changes raised the tax burden by NIS 1.7 billion (0.3 percent of GDP) between 2001 and 2004 (Table 1 Box 3.3).² This net increase, however, conceals much larger changes that cancel each other out in revenue terms, including tax rates that were raised and then lowered again. Overall, tax increases during this period augmented revenues by nearly NIS 12 billion and tax decreases lowered them by NIS 10 billion. Among other measures, income ceilings for National Insurance contributions were abolished and reinstated, the rate of VAT was raised and lowered, a 'soak the rich' tax was applied and cancelled in 2002, and real-estate taxes were lowered temporarily.

¹ For a comparison of tax rates on wages, see A. Brender, "Tax Rates on Earned Income: Israel from an International Perspective," Bank of Israel Research Department, July 2002, bankisrael.gov.il (Hebrew).

² The rate of Value Added Tax, including VAT on nonprofit and financial institutions, was lowered at the beginning of March 2004. Calculated over a full year, this measure would lower the cumulative increase in tax revenues by NIS 400 million, including NIS 300 million in indirect taxes.

Analysis of the overall effect of legislative changes that were applied in the past three years and not repealed shows a clear differentiation between direct and indirect taxes: the indirect-tax burden increased considerably during this time and the direct-tax burden declined slightly. Furthermore, property taxes were cut by about NIS 0.5 billion³—a change that widens the gap in the composition of tax revenues between Israel and the norm in developed countries, since the share of indirect taxes in revenue is higher in Israel.⁴ However, since the increases in indirect taxes focused on narrowing distortions in fuel and cigarette taxes—and on lowering purchase and customs taxes—they helped to make the composition of taxes more efficient.

Under existing legislation and government policy, there will be a cumulative tax decrease of NIS 7 billion during the next four years.

The Effect of the Legislative Changes on Revenues, 2002–04

	(NIS million, year-on-year change)			
	2002	2003	2004	Cumulative effect
Total	2,620	1,670	-2,615	1,675
Direct taxes on capital and labor	1,110	240	-1,777	-427
Annulment of exemptions ^a	250	2,770	1,210	4,230
Increase in tax rates ^b	860	1,220	-37	2,043
Reduction of tax rates ^c	0	-3,750	-2,950	-6,700
Indirect taxes^d	1,810	1,820	-1,078	2,552
Property tax^e	-300	-390	240	-450

^a Reduction of tax credits to inhabitants of development areas, tax on use of employer's cellular phone, cancellation of tax credit on treatment of incapable parent, tax on financial capital gains as part of the income tax reforms, tax on lottery and prize winnings, cancellation of benefits to the temporarily disabled, and increase in the pensionable age granting 35 percent eligibility.

^b Increase in V.A.T. for non-profit organizations and financial institutions, and its reduction in March 2004, cancellation of tax credits for foreign workers and imposition of 8 percent tax on their employment (except for home-care workers), and 1 percent increase in National Insurance payments paid by employers and the self-employed.

^c Reduction of tax on personal exertion in the framework of the income tax reform, and change in tax brackets at the beginning of 2004 in order to ease the tax burden.

^d Increase in V.A.T. to 18 percent and its return to 17 percent in March 2004, increase in excise tax on diesel and heating oil from 11 to 66 agorot a liter (by stages), increase in purchase tax on cigarettes, increase in excise tax on oil, reduction of tax benefits for new immigrants and returning residents, reduction of purchase and customs taxes in February 2004, and reduction of stamp tax.

^e Reduction of real-estate taxes at the end of 2002 and nonadjustment of rate of change of property tax to CPI in 2003 and 2004.

SOURCE: Based on data from the State Revenue Administration.

³ The definition of a change in tax rates as legislative as opposed to 'ordinary' is largely a matter of judgment. For example, we define the downward adjustment of income-tax brackets and personal tax credits at the beginning of 2004 as an 'ordinary' change because it was made in accordance with existing law. In contrast, raising municipal property tax at a lower rate than CPI increase in 2003, and the non-lowering of this tax in 2004 commensurate with the decline in the CPI, are counted among the legislative changes because they were contrary to the practice for many years. The reckoning does not reflect authorizations given to some municipal authorities to raise property-tax rates by more than the standard rate approved by the Knesset.

⁴ Israel's direct-tax burden (including social security contributions) was lower than that in the OECD countries by about 2 percent of GDP in 2001, whereas the indirect-tax burden was about 3 percent of GDP higher.

The tax reform will lower the total tax burden—particularly that related to wages—enough that it will approximate the norm in developed countries even at medium and high income levels.

The slight change in the direct-tax burden, in turn, masks a much greater change in the composition of the tax burden during these years, as tax rates on earned income were cut by NIS 6.7 billion in cumulative terms while other taxes on wages were raised by NIS 2.0 billion. Additionally, NIS 4.2 billion in income-tax exemptions were eliminated, including most tax reductions for residents of various parts of the country. Furthermore, the introduction of taxation of personal income from financial assets, included in the income-tax reform, brings Israel one step closer to the global norm.⁵

Apart from changes already applied, several laws were passed in 2003 that, if implemented, will lower the tax burden considerably. The continued income-tax reform is expected to reduce the net burden by NIS 4 billion by 2006, and the reduction in the stamp tax will gradually lower the burden by another NIS 700 million by 2007. A gradual 1.5 percentage-point decrease in social security contributions by employers and the self-employed is expected to take effect in 2005–2007, lowering net tax payments by another NIS 2 billion. Thus, existing legislation and government policy add up to a cumulative tax decrease of NIS 7 billion over the next four years. This will lower the total tax burden—particularly that related to wages—enough that it will approximate the norm in developed countries even at medium and high income levels.

⁵ For an international comparison of taxation of financial assets, see A. Brender, “Israel’s Direct-Taxation System from an International Perspective,” Bank of Israel Research Department, February 2000 (Hebrew), bankisrael.gov.il.

The absence of change in the general-government deficit/GDP ratio traced largely to the effects of the recession. Since the size of the general-government deficit is directly affected by the behavior of GDP, mainly by means of tax revenues, it is also common to examine the general-government deficit in ‘cycle-adjusted’ terms, i.e., on the assumption that the economy is operating at its potential GDP level.²⁷ In Israel, it is also necessary to adjust the calculation for inflation because interest payments are recorded in the National Accounts and the budget in a unique way; subtraction of price increases from the nominal interest rate makes the calculated interest rate volatile when the inflation rate changes.²⁸

²⁷ The calculation of potential GDP in this analysis is based on the average increase in per-capita GDP since 1973—1.5 percent per annum. Accordingly, in 2003 there was a 2 percent discrepancy between the actual GDP growth rate and that of potential GDP and a cumulative discrepancy of 8.5 percent between actual GDP and the potential level. This assumes that GDP was equal to potential GDP in 1996. The cycle-adjusted GDP is calculated on the assumption that tax revenues increase commensurate with GDP and that total expenditure and non-tax revenues are not sensitive to changes in GDP. For a detailed discussion of the method of calculation, see Section 2 in Chapter 5 of *Annual Report 1999*.

²⁸ To calculate the interest expenditure of general government, the Central Bureau of Statistics subtracts the actual rate of price increases from the interest rate paid on the nonindexed NIS debt. When prices decrease, the rate of decrease is not added to the interest rate. Our calculation of the cycle-adjusted deficit presumes a ‘normative’ inflation rate of 2.0 percent.

Table 3.14
The Cyclically Adjusted Deficit of the General Government, 1999–2003

	(percent of potential output)				
	1999	2000	2001	2002	2003
Overall deficit ^a	-2.6	-1.9	-2.7	-3.0	-1.2
Domestic deficit ^a	-2.8	-2.4	-3.0	-3.2	-1.5

^a Since the item ‘Surplus income of Bank of Israel,’ as calculated in the National Accounts, is extremely volatile, it is not included in the estimate of the cyclically-adjusted deficit.

SOURCE: Based on Central Bureau of Statistics data.

Thus calculated, the cycle-adjusted deficit of general government fell by 1.8 percent of potential GDP to below the 2000 level (Table 3.14). Thus, the increase of the deficit during this time may be explained as a widening of the gap between actual and potential GDP. The comparison also shows that net of the effects of the recession, the deficit declined during this time, albeit at lower rates than the Government’s targets, and that the entire decrease took place in 2003. The cycle-adjusted domestic deficit of general government also contracted by 1.7 percent of GDP this year. According to this calculation, which approximates the direct effect of general-government activity on demand in 2003, the decline contributed to a perceptible contraction in aggregate demand.²⁹ However, it is possible that due to the size of the deficit in 2003—especially at the beginning of the year—and concerns about the development of a financial crisis, the reimposition of the fiscal control by the economic plan helped to restore consumers’ and investors’ confidence in the economy and to reignite economic growth (for discussion of this possibility, see Box 3.2).

In addition to the question of how to interpret the effect of the decrease in the cycle-adjusted deficit in 2003, it is important to emphasize that these deficit computations are highly sensitive to the potential GDP estimate and to assumptions about the intensity of the response of tax receipts and general-government expenditure to an upturn in GDP. The computation presumes, for example, that general-government expenditure will not change when the gap between actual and potential GDP is closed. In the Israeli case, however, there is a positive correlation between real growth of business-sector GDP and an increase in general-government expenditure: each percent of increase in business-sector GDP leads to a 0.5 percent upturn in general-government expenditure (deflated by business GDP prices). This correlation reflects increases in general-government wages during times of economic growth, the indexation of many social security benefits to the national average wage (a practice that was largely abandoned in 2004), and the tendency of the political echelon to increase expenditure when tax revenues rise. Potential GDP estimates around the world are also ‘notorious’ for sizable

The cycle-adjusted deficit of the general government decreased by 1.8 percent of potential GDP and fell under the 2000 level.

The ‘GDP gap,’ measured on the basis of trends from the past, may be an overestimate of the economy’s ability to increase its output at the end of the recession.

²⁹ Lavi and Strawczynski, for example, show that cutting the deficit by reducing general-government consumption dampens short-term aggregate demand even after accounting for its expansionary effect on private expenditure. See Y. Lavi and M. Strawczynski (2003), “Does Fiscal Expansion Increase Aggregate Demand and Activity in Israel? An Empirical Examination for 1960–2000,” *Economic Quarterly*, 50, December (Hebrew).

changes over time.³⁰ In Israel, the persistence and depth of the current recession increase the possibility that some production potential that was not utilized in the past three years has been lost permanently. If so, the ‘GDP gap,’ as measured on the basis of trends from the past, may overestimate the economy’s ability to increase its output at the end of the recession. If this is so, then the estimated cycle-adjusted deficit is skewed downward.

The trend in general-government expenditure changed conspicuously in 2003 relative to the past two decades: expenditure contracted by 2.1 percent in real terms (deflated by business-sector GDP prices) and by 3.3 percent net of interest expenditure.

4. THE COMPOSITION OF GENERAL-GOVERNMENT EXPENDITURE

The share of general-government expenditure in GDP declined to 54 percent in 2003, similar to the level a decade ago but higher than this level if temporary outlays for immigrant absorption, which were especially high in the 1990s, are subtracted (Figure 3.3).³¹ However, the trend in general-government expenditure changed conspicuously in 2003 relative to the past two decades: expenditure contracted by 2.1 percent in real terms (deflated by business-sector GDP prices) and by 3.3 percent net of interest

The decline in general-government expenditure was evident in almost all components except investments in transport infrastructure.

Table 3.15

Growth Rates of Public Expenditure in Israel, 1994–2003

(percent, deflated by implicit price index of business-sector product)

	Average 1994–99 ^a	2000–01	2002	2003
Total public expenditure	4.4	6.0	2.3	-2.1
<i>of which</i> Interest payments ^b	2.4	3.2	-7.9	8.5
Total primary public expenditure	4.7	6.3	3.6	-3.3
<i>of which</i> Current primary expenditure	6.2	6.9	3.5	-2.5
Current primary expenditure excl. defense	7.5	7.6	1.5	-1.7
Public consumption	5.9	6.0	6.0	-2.6
Public consumption excl. defense imports	7.0	6.2	4.6	-1.0
Civilian consumption	8.7	6.9	3.1	-1.0
Per capita civilian consumption	6.0	4.3	1.0	-2.7
Wage expenditure	7.0	7.0	0.9	-4.1
Purchases	15.3	7.0	7.6	3.9
Domestic defense consumption	2.7	4.9	8.9	-1.0
Wage expenditure	4.2	4.9	3.6	-4.0
Transfer payments on current account	7.6	9.3	0.0	-2.8
Per capita transfer payments on current account	4.9	6.6	-2.0	-4.5
General government investment	0.5	3.6	-0.4	-0.6
<i>of which</i> Transport infrastructure	0.6	8.0	23.2	4.2
Transfer payments on capital account	-9.8	-3.9	11.3	-27.6

^a From 1995, including expenditure due to National Health Law.

^b The decline in interest payments in 2002 and their rise in 2003 reflect mainly the effect of changes in the rate of inflation on the CBS method of calculating the interest rate.

SOURCE: Based on Central Bureau of Statistics data.

³⁰ See International Monetary Fund, *World Economic Outlook*, October 1999, Chapter III.

³¹ The subtraction of defense expenditure, which has increased in the past two years, further widens the discrepancy between the current level of expenditure and early 1990s level, since the share of defense expenditure in GDP was lower in 2003 than then.

expenditure (Table 3.15). Although the growth rate of expenditure slowed somewhat in 2002, the pace of expenditure increase that year still exceeded a rate consistent with the decline in its share in GDP. The decrease in 2003 reflects a much lower rate of growth than that of potential GDP, even if only the lower range of the potential GDP estimates is considered. The decline in general-government expenditure was evident in almost all components except investments in transport infrastructure.

Conspicuous among the components of general-government expenditure was a 4 percent decrease in wage outlays, occasioned by a significant nominal decrease in per-hour wage in the civilian sector (Table 1.A.3.7) and in defense labor input (Table 1.A.3.6). The decrease in nominal wage per hour worked in general government, the first that Israel has experienced in decades, shows that the wage-setting mechanism in this sector is responsive to economic conditions—by means of negotiations with the Histadrut and individual trade unions—and that the government was determined to correct the perceptible increase in wage outlays in the years up to 2001. In sum for the past two years, real wages in general government declined at a rate similar to that of wages in the private sector after having increased by much less in the previous three years (see Table 2.8 in this Report). The nominal wage decrease and the nominal decline in other expenditure items are vastly significant in the message they send the capital market about the government’s ability to stanch fiscal crises without resorting to inflationary surprises. This message may help to lower the risk that investors in Israel attribute to nonindexed assets—in addition to the contribution of the lowered deficit itself.

Another field of marked change in the trend of general-government expenditure is current transfer payments (foremost social security benefits). Real per-capita current transfers expanded by more than 5.5 percent on annual average in 1994–2001, raising their share in GDP by 2.8 percentage points (Table 1.A.3.5). In the past two years, the trend turned around, payments decreasing in real terms by about 3 percent per capita on average. Most of the decline reflects cutbacks in social security benefits and especially in child allowances, unemployment compensation (for which government expenditure fell by more than 30 percent), and income maintenance. However, the share of total social security benefits in GDP declined by only 0.4 percent of GDP in 2003 and remained higher than in 2000 and all preceding years (Table 1.A.3.14). The combined share in GDP of unemployment-compensation and income-maintenance payments—the benefits that were cut most severely—retreated to the 1997 level but still surpassed all earlier years, including the high-unemployment period of the early 1990s. Because the numbers of unemployed have swelled considerably in recent years, the erosion of the benefit terms was especially acute. Although the goal behind the erosion policy was to induce the unemployed and income-maintenance recipients to go back to work, the policy lacked the complementary facet of a resource allocation that would suffice for active assistance to jobseekers and subsidies for their entry into the labor market.³²

³² For discussion, see A. Brender, O. Peled-Levi, and N. Kasir (2002), “Government Policy and the Labor-Force Participation Rates of the Prime Age Population—Israel and the OECD Countries in the 1990s,” Bank of Israel, *Economic Review*, 74, November (Hebrew).

The decrease in nominal wage per hour worked in general government shows that the wage-setting mechanism in this sector is responsive, via the Histadrut, to economic conditions.

The nominal wage decrease is vastly significant in the message it sends the capital market about the Government’s ability to stanch fiscal crises without resorting to inflationary surprises.

The trend in transfer payments turned around in the past two years, real per-capita transfer payments decreasing by 3 percent.

Although the goal behind the policy of eroding benefits was to induce the unemployed and income-maintenance recipients to go back to work, the policy lacked the complementary facet of a resource allocation that would suffice for active assistance to jobseekers and subsidization of their entry into the labor market.

An important change in social security benefits in 2003 was the indexation of most of them to the Consumer Price Index instead of the national average wage. The change has not yet affected benefit payments, which remain frozen due to previous decisions, but it is expected to slow future growth rates significantly. It is also expected to weaken the contribution of social security benefits to income-distribution equality because the national average wage tends to increase by more than the Consumer Price Index over time; thus, the indexation of benefits to the CPI instead of to the average wage will erode recipients' relative income. However, the change in the indexation mechanism has neutralized a powerful procyclical mechanism in general-government expenditure that had caused expenditure to increase automatically in times of economic upturn. The indexation had also had the peculiar effect, in respect to able-bodied population groups, of preventing an increase in the utility of accepting jobs in economic good times, when opportunities were better.

One of the reasons for slashing social security benefits, especially for people of working age, is the wish to increase the employment rate; the benefits were found to encourage people to leave the labor market,³³ while the key to breaking out of poverty is the opposite: an increase in the number of employed persons in the household.³⁴ However, this policy has another effect: the changes lower the standard of living of those incapable of working unless accompanied by the creation of mechanisms to distinguish between those who are unwilling to work and those who cannot. Because it is no easy matter to make a distinction on this basis, and Israel has no system capable of effecting it, the cut in allowances also hurts those incapable of working. The perceptible decrease in the population of foreign workers will help some benefit recipients to find employment. This, however, is not an adequate substitute for the development of a comprehensive system that would, on the one hand, make it clear to non-participating groups that society can no longer finance their disinclination and, on the other hand, help these groups to enter the labor market in consideration of their particular needs.³⁵

The cutback in social security benefits in the past two years—especially with its focus on child allowances, unemployment compensation, and income maintenance—combines with the elimination of housing grants and the severe reduction in the general grants for municipalities³⁶ to create a package of measures that greatly reduces the contribution of government expenditure to narrowing income inequality. The next phases of the income-tax reform, as approved by the Knesset, are expected to have a similar

The measures taken in the past two years greatly reduced the contribution of government expenditure to the narrowing of inequality, at least in the short term.

³³ A. Brender, O. Peled-Levi, and N. Kasir, above; D. Gottlieb (2002), "From Welfare to Work: Income Support at Working Age in Israel" *Economic Quarterly*, March, pp. 121–158 (Hebrew); N. Sussman and D. Romanov (2001), "Income-Maintenance Benefits and Their Effect on Labor Supply and Tax Evasion," *Economic Quarterly*, 48, pp. 607–647 (Hebrew).

³⁴ K. Flug and N. Kasir (Kaliner) (2001), "Remarks on Poverty, Labor, and What Lies Between Them," *Economic Quarterly*, 4, 48, December, pp. 516–542 (Hebrew).

³⁵ For example, by promoting employment in Arab villages, which will help Arab women to enter the labor market.

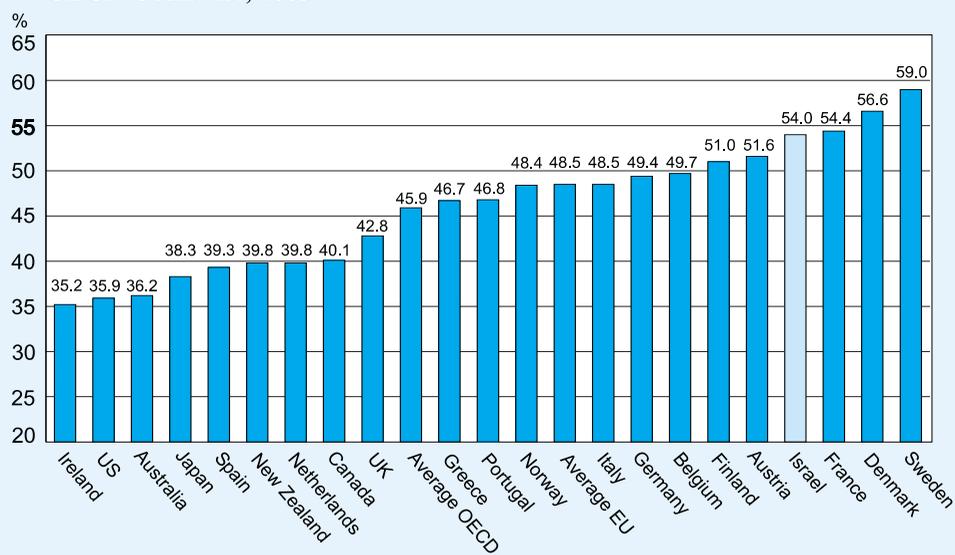
³⁶ Some 55 percent of the general-grant is earmarked for authorities in the four lowest socio-economic clusters, where 28 percent of the population lives.

effect in the next few years. This amounts to a significant change in the direction of policy after a decade in which the system of taxes and transfer payments acted with rising intensity to offset the increase in economic inequality. The accepted extent of inequality is mainly a social and political issue and the policy change may reflect a change in attitudes in the direction of less equality. However, inequality also has economic implications that need to be tackled. In particular, the increase in inequality must not be accompanied by raising barriers to economic mobility. If the income level of weak population groups is lowered *and* their ability to invest in human capital—and *a fortiori* of their children—is diminished, the economy will be less able to fulfill its growth potential in the future. Therefore, the cutback in transfer payments should be coupled with the development of differential budgeting mechanisms to assure the quality of education and health services for the less advantaged.

Israel's share of general-government expenditure in GDP, although lower in 2003 than in 2002, remains very high by the standard of developed countries; only Sweden and Denmark have higher levels and France is roughly Israel's equal³⁷ (Figure 3.5).

The increase in inequality must not be accompanied by higher barriers to economic mobility.

Figure 3.5
Share of General Government Expenditure in GDP; Israel and OECD Countries, 2003



SOURCE: Based on OECD and Central Bureau of Statistics data.

From a longer-term perspective, the share of general-government expenditure in the developed countries declined substantially during the past decade (Table 3.11) because these countries became increasingly aware that a large general-government sector impedes economic growth by entailing a high tax and deficit burden that aggravates the general-government debt. Figure 3.3 shows the extent of progress that Israel and

³⁷ Israel lost its 'lead' among developed countries after changes in the National Accounts definitions in Sweden and Denmark increased these countries' reported general-government expenditure.

A decade ago Israel's share of general-government expenditure in GDP resembled the EU level and surpassed the OECD average by a small fraction; today, Israel's level is significantly higher than the rates in these countries.

Israel's faster rate of increase in general-government expenditure traces not to an uptrend in real per-capita expenditure but to increases in the relative prices of general-government services and in transfer payments.

The policy response to the deficit upturn was different in 2003 than in the past, both in its intensity and in its emphasis on long-term measures that will sustain a downtrend in future years as well.

It is very important to attain the fiscal targets without revising the accounting definitions frequently and 'transferring' deficits to other general-government entities.

the developed countries have made in this direction over the past decade. At the beginning of the period, Israel's share of general-government expenditure in GDP resembled the EU level and surpassed the OECD average by a small fraction; today, Israel's level is significantly higher than the rates in these countries, even though Israel spent a larger proportion of its GDP on defense and immigrant-absorption than it does now.³⁸ Although the downtrend in the other countries' share of general-government expenditure in GDP has stopped recently due to the economic downturn, it has done so at the low level established in the 1990s. Furthermore, the rate in these countries, unlike Israel, has not increased significantly in recent years. Comparison of the real growth rate of general-government consumption during this time shows that Israel's faster rate of increase in general-government expenditure traces not to an uptrend in real per-capita expenditure (which could indicate an improvement in service quality) but to increases in the relative prices of general-government services³⁹ and in transfer payments. Table 3.12 shows that there is a gap of 7 percent of GDP between Israel's total general-government expenditure, following accepted international definitions, and that in the OECD countries. Although most of the gap traces to Israel's higher level of defense expenditure, this explanation of Israel's steep general-government expenditure—however justified it may be—does not diminish the damage caused by the size of general government to the country's economic competitiveness, since the defense budgets are spent on a product—security—that competing economies obtain at much lower cost.

The decrease in general-government expenditure in 2003 reflects the response of policymakers to the rapid increase in the deficit—occasioned by the security situation and the inability of policy to attain its targets in recent years—that threatened to bring on a financial crisis. Policy responded differently this time than in the past, both in intensity and in its emphasis on long-term measures that will sustain a downtrend in future years as well. However, despite the success of policy in changing the path of the deficit and of general-government expenditure in the immediate term, it should be borne in mind that the deficit today, the deficits predicted for the next two years, and the share of general-government expenditure in GDP all remain within the same narrow range in which they have been fluctuating during the past decade. This range seems to be delimited by a 'ceiling' dictated by the markets—especially in view of the increasing openness of the economy to international flows of goods, factors of production, and financial capital—and a 'floor' dictated by policymakers' unwillingness to reduce expenses. Therefore, the test of the policy will lie in its ability to continue holding expenditure to a low rate of increase—in keeping with targets—even after economic growth resumes and tax revenues rise. It is also very important to attain the fiscal targets without revising the accounting definitions frequently and transferring deficits to other general-government entities because they will eventually come to roost at the government's doorstep (see Section 7 below).

³⁸ Similar results are obtained when the primary expenditure trend is examined.

³⁹ During that period, general-government consumption prices (relative to GDP prices) rose by 2.5 percent on annual average in Israel as against 1 percent in the OECD countries.

5. THE 2004 BUDGET

Despite the powerful deficit-cutting effects of the mid-2003 economic plan, the expected deficit in the 2004 government budget remained very high—5.5 percent of GDP—and the deficit trajectory was expected to decline slowly over the next few years. Not until 2008 did the projection envisage a deficit smaller than 3.0 percent of GDP, the upper limit of the 2004 target range as set forth in the Budget Deficit Reduction Law (before the 2004 Arrangements Law amended this statute). At such rates of deficit, the ratio of general-government debt to GDP would continue to rise, and if the return to economic growth were to be delayed, the deficit might surge again. Thus, the Government resolved in its 2004 budget deliberations to lower the deficit to 4.0 percent of GDP by means of a new set of measures. The new deficit cut was needed to consolidate the calm that had been attained in the markets in the aftermath of the economic plan and the renewed trust in fiscal policy, especially in view of fresh memories of the rapid deterioration that swept the markets in late 2002 and early 2003. The resumption of decline in government bond yields in the last quarter of the year—after a slowing of the downtrend during the third quarter—may partly reflect the markets’ positive response to this policy.⁴⁰

The additional deficit cut in the 2004 budget was needed to consolidate the calm that had been attained in the markets in the aftermath of the economic plan and the renewed trust in fiscal policy, especially in view of fresh memories of the rapid change that swept the markets in late 2002 and early 2003.

Table 3.16
The Effect of the 2004 Budget Measures on the Deficit

	(NIS billion)
	2004
Total contribution to deficit reduction (+)	5.8
Spending reductions	3.9
<i>Of which</i> Across-the-board cuts	4.7
Reduction of child allowances ^a	0.6
Other	0.5
<i>Less</i> increase in expenditure ^b	-2.0
Additional revenue	1.9
<i>Of which</i> One-off transfer from automobile insurance	1.6
Additional tax receipts ^c	0.2
Other	0.1

^a The reduction of child allowances increases the National Insurance Institute’s surplus transferred to the government, and is hence recorded as a rise in revenue in the budget.

^b The increase in expenditure is in accordance with those decisions of the government in February 2004 which did not constitute a cancellation of cuts on specific measures approved in the 2004 budget.

^c The reduction of V.A.T. in March 2004 is not included in the calculation, as under the original provisional directive it should have been reduced at the end of 2003.

SOURCE: Based on Bank of Israel data.

⁴⁰ The yield on nine-year *Shahar* bonds, for example, fell from 11.3 percent in the first quarter to 8.6 percent in the second quarter, 8.3 percent in the third quarter, and 7.3 percent in the fourth quarter. Yields on *Galil* CPI-indexed bonds followed a similar trajectory.

Like the economic plan approved in the middle of 2003, most of the deficit cut in the 2004 budget was made on the expenditure side (relative to the pre-cutback plan).

The 2004 budget as approved by the Knesset included measures that lowered the deficit by NIS 8 billion, but changes introduced by the Government in early 2004 cut the decrease to NIS 6.0 billion.⁴¹ Like the economic plan approved in the middle of the year, most of the deficit cut was made on the expenditure side (relative to the pre-cutback plan) and one-third reflects an increase in revenues (Table 3.16). Most of the revenue increase originates in a nonrecurrent transfer to the Government of surpluses from the compulsory motor-vehicle insurance arrangement,⁴² a measure that does not contribute to any permanent decrease but makes no permanent increase in the tax burden. Most of the expenditure cutback was achieved by reducing all government ministries' expenditure budgets by an across-the-board uniform rate, reflecting the political system's difficulties in prioritizing budget cuts.⁴³

The deficit target for 2004 is 4.0 percent of GDP⁴⁴ (NIS 20.6 billion), NIS 7.1 billion smaller than the actual 2003 deficit but NIS 5 billion higher than the upper limit of the previous target for the year. According to the budget book, the deficit cut will be based on a hefty NIS 12 billion increase in government revenues (Table 3.17), 7 percent in real terms,⁴⁵ and a 2.4 percent increase in expenditure. The budget is predicated on an NIS 6.5 billion increase in tax revenues, 4.4 percent in real terms, and an NIS 2 billion upturn in surpluses of the National Insurance Institute. Since other revenues are also expected to increase vigorously, the deficit estimate may prove overoptimistic at the 2.5 percent growth outlook that underlies the budget. Furthermore, the lack of a significant general reserve in the budget as approved by the Knesset, coupled with the allocation of the entire special reserve to meet the deficit target at the beginning of the year, will make it difficult to respond to further needs that may materialize during the year (e.g., accelerated construction of the separation fence or a change in its path) or to deviations from the revenue outlook, especially in view of the large tax cuts made at the beginning of the year.

On the expenditure side, the restraint applied in 2003 is to continue. Although total budgeted expenditure grew by 2.4 percent relative to actual 2003 expenditure, most of the increase is in higher interest outlays. Expenditure net of interest is poised to expand by a modest 0.6 percent but will probably decline by 0.5 percent in view of the expected underspending of external expenditure. This extent of continuity—two consecutive years of falling government expenditure (excluding interest)—is unprecedented in recent decades, and meeting the 2004 target will provide important evidence of the government's determination to push ahead with the fiscal consolidation process in order to facilitate a long-term reduction of the deficit.

⁴¹ These changes did not raise the expenditure ceiling from the formal standpoint, since parallel reductions were made in budget reserve lines.

⁴² Coupled with the transfer of responsibility for future claims on account of the insurance arrangement to the Government.

⁴³ The across-the-board cutback, while not reflecting system-level priorities, still allows each ministry to implement the cuts according to internal priorities.

⁴⁴ 4.5 percent including transfers to Israel Railways.

⁴⁵ This assumes that the average price index for 2004 will resemble that in 2003, an assumption that is consistent with a 2 percent price increase during the year.

The lack of a significant general reserve in the budget as approved by the Knesset, coupled with the allocation of the entire special reserve to meet the deficit target at the beginning of the year, will make it difficult to respond to further needs that may materialize during 2004.

Table 3.17
The Government's Net Income and Expenditure in 2003 and in the 2004 Budget
 (NIS billion)

	Performance 2003	Budget 2004	Real Change ^a
Income excl. credit	170.4	182.3	7.0
Taxes	145.3	151.8	4.4
National Insurance	9.2	11.2	21.3
Grants	10.8	12.0	11.0
Automobile insurance surplus transferred	0	1.6	...
Other	5.1	5.7	11.8
Expenditure excl. credit ^b	198.0	202.8	2.4
Less interest and principal to NII	159.8	160.7	0.6
Defense ^c	46.9	49.3	5.1
Civilian	112.9	111.4	-1.3

^a Assuming there is no change from 2003 to 2004 in the average CPI.

^b When transfers to the Israel Railways are included, the change is 3.3 percent.

^c Including NIS 3 billion from the budget general reserve and an additional NIS 1.8 billion approved by the government in February 2004.

SOURCE: Based on data from the Accountant General, the Ministry of Finance.

6. LONG-TERM ANALYSIS OF THE GOVERNMENT BUDGET

Due to the long-term failure to attain the deficit-reduction targets,⁴⁶ the government changed the target for 2005 and subsequent years from the deficit to the rate of change in real expenditure. Thus, budget expenditure is targeted to increase by no more than 1 percent per year (in real terms—deflated by the Consumer Price Index) in each of the years 2005–2010, provided that the government deficit be no higher than 3 percent of GDP. This change carries the significant disadvantage of permitting relatively easy circumvention of the policy goals by means of accounting changes.⁴⁷ For example, if government participation in the National Insurance Institute budget is reduced and transfers from the NII to the government are also cut back, it will be possible to meet the target without any material change in government policy. To make the law more credible, it may be advisable to define the target on a general-government basis, as

The general-government debt/GDP ratio is not expected to decline significantly if the deficit levels in the next few years verge on the 3 percent of GDP ceiling that the new law sets forth.

⁴⁶ The evolution of the Budget Deficit Reduction Law is discussed in the corresponding chapter of *Annual Report 2001*.

⁴⁷ For reasons including technical questions that still surround the implementation of the targets. For example, will the expenditure growth rate be examined in view of actual expenditure in the previous year or the budget? If actual expenditure is chosen, until what date will expenditure be measured? Some expenditure on account of each year is neither performed nor recorded until the first few months of the following year. Will compliance with the target be tested at the planning phase (as the Government behaved in regard to deficit targets) or at the performance phase? If the targets are based on actual expenditure, budgeted entities may spend money faster to avert the risk of losing unspent money for good. How will the measurement treat previous years' unused funds—as current expenditure or as expenditure belonging to previous years? If the latter option is chosen, the significance of the expenditure ceiling will be severely compromised.

most developed countries do with their deficit targets. This aside, defining the targets in expenditure terms allows the government to support various goals—such as capital and industrial R&D investment—by awarding tax benefits, so that the deficit may increase (within the limit of 3 percent of GDP) without breaching the target to which the government is committed. Therefore, to make the new law a meaningful peg for fiscal policy, it should be accompanied, at the very least, by a medium-term target for the general-government debt/GDP ratio. Such a target would make it possible to examine, in any given period, the extent of efficacy of government policy in lowering the debt/GDP ratio. It would also provide a counterweight to tax-cut pressures, which are less inhibited under the new method. In this context, it is important to note that the general-government debt/GDP ratio is high today (see Section 3 above) and is not expected to decline significantly if the deficit levels in the next few years verge on the 3 percent of GDP ceiling that the new law sets forth.

Determining the growth rate of expenditure in future years makes it possible to prepare the state budget framework on the basis of long-term plans that will allow for more efficient use of resources.

Alongside its drawbacks, the government's new target has a salient advantage in respect to planning. By setting the growth rate of expenditure for future years, the government also effectively sets the total expenditure level irrespective of volatility in economic activity and tax revenues, provided that the deficit is under the legal limit. This kind of planning allows policymakers to prepare the state budget framework on the basis of long-term plans that will allow for more efficient use of resources in defense, education, health, infrastructure, and so on. This will do much to improve the performance of government relative to the erratic budgeting of various activities in recent years. These advantages, however, may find expression only if the deficit level is sufficiently low that changes in economic activity and government revenues do not lead to a breach of the deficit ceiling that would entail repeated adjustments of expenditure. An example of a framework within which such a policy might work is the one adopted by the European Union. The EU's Stability and Growth Pact decrees that the budget shall be balanced or in surplus throughout the business cycle and that deviations from the ceiling of 3.0 percent of GDP be avoided at times of economic slump.⁴⁸

To determine whether the government's targets for the next few years correspond to its decisions about specific policy measures, we analyzed the expected trajectory of the government budget in view of the government's decisions thus far and the trajectory of various fiscal variables in the past.⁴⁹ The main assumptions underlying the analysis—including the macroeconomic scenario for the next few years—are explained in Box 3.4. The analysis in the box makes it possible to estimate the size of the supplemental budget adjustment required to meet the government's targets and to choose the parameter that should limit the government budget in future years—an expenditure ceiling or a deficit ceiling.

⁴⁸ Thus far, the deficit ceiling has been effective in most EU countries. However, the two largest countries in the Union—France and Germany—have deviated from the ceiling recently and are not expected to lower their deficits to less than 3 percent of GDP in the next two years.

⁴⁹ For a detailed description of the frame of analysis, see Kobi Broida and Adi Brender (2003), "The Influence of the Economic Plan on the Government Budget in 2003–2008," Bank of Israel, July (Hebrew).

Box 3.4**Main Assumptions in the Multiannual Budget Outlook¹**

* GDP will increase by 2.4 percent in 2004 (similar to the budget assumption), by 3.3 percent in 2005, and by 4.0 percent per year in 2006–2010. This growth rate will be predicated on a faster rate of employment increase than of the labor force—causing the unemployment rate to recede to its natural level by 2010—and on annual growth of 1.34 percent in GDP per person employed, resembling the average during the past thirty years.² The acceleration of growth will be abetted by the lowering of the tax burden as part of the income-tax reform, the other legislative changes, and the increase in infrastructure investment. These assumptions are based on coefficients that studies in Israel have shown to exist.³

* Real wages will increase at the rate of output per person employed.

* The real yield on government bond issues in 2004 will be 4.25 percent (6.25 percent on nonindexed bonds) and will decline gradually to 4 percent from 2006 on, resembling the average during the past decade.

* The government will follow through on its decisions to freeze personnel and nominal budgets in general government. The rate of increase of public-consumption prices (apart from education and health) will resemble that of GDP prices. This is an optimistic assumption, since public-consumption prices in Israel (and in developed economies at large) have outpaced GDP prices in recent decades.⁴ If this consideration is taken into account, government expenditure will increase even more, with a partial offset due to the increase in tax revenues.

* The implementation of private Knesset Members' legislation that has been deferred thus far will continue to be deferred.

* Annual US civilian aid will decline by \$ 120 million per year and defense aid will increase by \$ 60 million per year, in accordance with the long-term agreement.

* Tax revenues net of legislative changes will increase at an elasticity of 1.1 to GDP growth, in keeping with the elasticity that has been calculated

¹ Based on resolutions and measures already taken.

² The population and labor-force growth rates are based on Central Bureau of Statistics outlooks for 2000–2020. For details, see Kobi Broida (2003), "The Long-Term Influence of Demography on General-Government Expenditure in Israel," *Economic Quarterly*, 50, December (Hebrew).

³ See M. Strawczynski and Y. Lavi (2001), "The Effect of Policy Variables and Immigration on Business-Sector Product and Its Components—Factor Inputs and Productivity—in Israel, 1960–1995," Bank of Israel, *Economic Review*, 73, pp. 109–141 (Hebrew).

⁴ During the past thirty years—and the past twenty years—the increase in public-consumption prices has surpassed the increase in GDP prices by 1.5 percent per year on average.

over the past decade.⁵ This assumption may be overly conservative for the initial period after the exit from recession.

* The 2004 defense budget will remain at the level approved in February 2004. In subsequent years, it will grow by 0.6 percent per year in real terms due to the increased defense aid that Israel is to receive under the agreement that reduced the civilian aid. Various reductions that the government resolved to implement will be subtracted from this rate.

* The tax reform will be carried out as prescribed in legislation, the stamp tax will be lowered gradually as the government resolved, and social security contributions from employers and the self-employed will be lowered gradually in 2005–2007 by 1.5 percent in cumulative terms.

* The NIS–dollar exchange rate will be NIS 4.5 at the end of 2004 and NIS 4.7 a year later. The Consumer Price Index will rise by 2 percent per year.

* Education and health expenditure will increase commensurate with changes in the size and composition of the population groups that use these services. The quantitative growth of the services—expressed in per-service-recipient terms⁶—will keep pace with the increase in GDP per person employed, productivity will not change, and the increase in wage per person employed in education and health will resemble that of the national average wage.⁷

* Interest payments on government bond issues in 2001 and in subsequent years will be recorded in the state budget on the basis of the new recording method that was introduced in 2001, i.e., including indexation differentials as an expenditure.

* Government transfers to the Israel Railways will be based on the long-term plan that the Knesset approved. These transfers will not be recorded in the government budget—in accordance with a decision by the Ministry of Finance—but will affect the government debt. Scoring fees to the US government for bond issues under the guarantees program will be recorded in the budget as being spread out for twenty years starting in 2004.

⁵ See A. Brender (2001), “Estimates of Israel’s Tax-Revenue Function,” *Bank of Israel Discussion Paper 2001.02*, January (Hebrew).

⁶ For example, per pupil in primary education. This assumption is also meant to express the increase in the number of service recipients due to legislative changes, e.g., expansion of the Free Education Law to prekindergarten age groups.

⁷ This assumption is consistent with the rate of increase in per-pupil expenditure in primary and secondary education in 1976–1997.

According to this analysis, the growth rate of expenditure in 2005, in accordance with resolutions of the incumbent government, will be consistent with the 1 percent

Table 3.18
Expected Path of Principal Budget Aggregates, According to Specific Government Decisions, 2002–2010
 (percent of GDP)

	Estimate		Forecast						
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenue	39.4	36.8	37.4	36.9	36.6	36.3	36.7	36.8	36.9
Expenditure	43.2	42.4	41.7	40.9	40.0	39.7	39.1	38.9	38.3
Net, excl. interest & principal payments to NII ^a	33.4	32.2	31.2	30.6	29.7	29.4	29.1	28.8	28.5
Deficit excl. credit	-3.8	-5.6	-4.3	-4.0	-3.4	-3.4	-2.4	-2.0	-1.3
Incl. transfers to Israel Railways	...	-5.7	-4.7	-4.5	-3.8	-3.8	-2.8	-2.4	-1.7
Gross public debt	105.3	107.4	110.9	112.0	110.7	109.0	106.6	104.0	100.8
<i>Of which</i> Government debt	102.0	104.6	108.3	109.4	108.3	106.6	104.3	101.8	98.7
Real change in expenditure (percent)	1.1	-1.5	1.0	1.3	1.7	3.3	2.5	3.2	2.4

^a National Insurance Institute.

SOURCE: Based on Bank of Israel data.

ceiling that the government has set (Table 3.18). However, the deficit is expected to overrun the government's ceiling of 3.0 percent of GDP by 1 percent of GDP (Figure 3.6) due to the size of the deficit in 2004, the absence in 2004 of the nonrecurrent revenue from the motor-vehicle insurance arrangement, and an expected decrease in government revenues in 2005 as the income-tax reform moves on to its next phase. This means that a large fiscal adjustment will be required in 2005 to hold the deficit under the ceiling, and for this reason real expenditure will have to decrease by more than 1 percent instead of rising by 1 percent. Otherwise, the government would have to increase its revenues by deferring the next phase of the income-tax reform or by raising other taxes. After 2005, the annual increase in expenditure will outpace the 1 percent target unless additional measures are taken. Therefore, additional significant budget adjustments will be needed to lower the growth rate of expenditure for these years. In the absence of additional measures, the deficit will not fall under 3 percent of GDP until 2008 and the general-government debt/GDP ratio will not slip under 100 percent of GDP even in 2010.

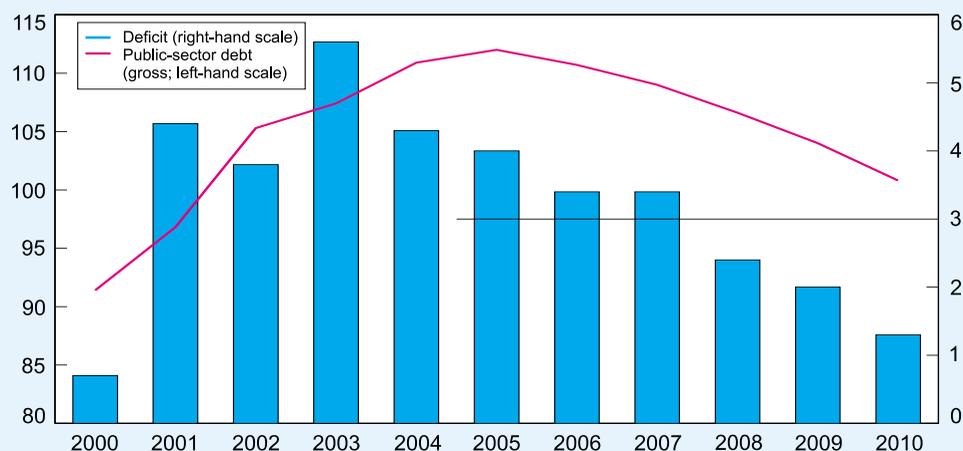
Thus, to meet its targets over the next five years, the government will have to cut its expenditure by NIS 20 billion—14 percent of total expenditure excluding interest, payback of principal to the National Insurance Institute, and pension liabilities—relative to the expected trajectory of expenditure as set forth in resolutions taken thus far. If the cutback is applied, real per-capita expenditure (in CPI terms) in 2010 will be 10 percent under the 2003 level. The quantitative decrease will be even greater, since it is expected that real wages in health and education will advance in 2006–2010 at approximately the rate of increase in the national average wage. Accordingly, the government will still have to make a massive fiscal effort, in resolutions and legislation, to attain the fiscal targets up to 2010. Since it will be difficult to base a long-term declining expenditure path on reductions in the relative prices of general-government services

A large fiscal adjustment will be needed in 2005 to hold the deficit under the ceiling; thus, real expenditure will have to decrease by more than 1 percent instead of rising by 1 percent.

To meet its targets, the Government will have to cut its expenditure by NIS 20 billion over the next five years.

The Government will still have to make a massive fiscal effort, in resolutions and legislation, to flesh out the resolution concerning fiscal targets up to 2010.

Figure 3.6
Path of Government Deficit (+) and Public-Sector Debt,^a 2000-2010
(percent of GDP)



^a Expected deficit and debt, according to specific measures and decisions made by government to date.

SOURCE: Bank of Israel.

and, especially, of wages, the government should develop plans to downscale general-government services including expenditure and employment in the defense sector. In view of the magnitude of the adjustments that will be needed to maintain the credibility of the government's commitment to these resolutions, the planning and the preparatory measures for these adjustments should be made in the near future within the framework of a long-term budget.

7. THE EFFECT OF GOVERNMENT BUDGET CHANGES ON LOCAL AUTHORITIES AND HEALTH FUNDS

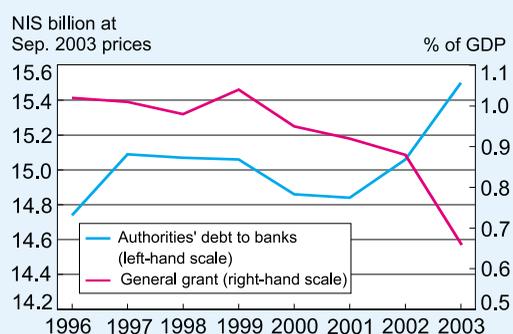
a. Local authorities

In the mid-1990s, municipal government ceased to be a sector that inflated the general-government debt each year and became one that accounted for little of the deficit increase, even though some authorities' management remained problematic.

Until the middle of the 1990s, the general-government deficit was much larger than the central-government deficit, largely due to massive deficits at the municipal level. Since then, however, the local authorities have changed their budget behavior considerably and have arrested the uptrend in their debts to banks, even though the share of central-government transfers in their activities—general grants in particular—has not increased (Figure 3.7). The improvement traces mainly to efficient enforcement of financial reporting requirements, a stricter budget constraint presented by the government to municipal decision-makers, and an improvement in voters' ability to monitor the financial management of their local authorities.⁵⁰ These processes, coupled

⁵⁰ For a survey of these developments, see A. Brender (2003), "The Effect of Budget Performance on Municipal Election Results in Israel, 1989–1997," Bank of Israel, *Economic Review*, 75, pp. 113–136 (Hebrew).

Figure 3.7
Total Debt to Banks of Local Authorities,^a and General Grant, 1996–2003



^a Debt figures, from end-September 2003.
 SOURCE: Ministry of the Interior and Bank of Israel.

with recovery plans that many authorities put into action, transformed municipal government from a sector that inflated the central-government debt each year to one that accounted for little of the deficit increase, even though some authorities' management remained problematic.

The trend of improvement in municipal budget management, however, slowed in 2002 and turned around perceptibly in 2003, to the considerable detriment of services in many localities and, in some places, causing protracted liquidity and solvency problems. The main underlying cause of the downside, as

Table 3.19 shows, was the steep and sudden cutback in central-government participation in municipal budgets. Total general grants for municipal authorities (Sections 18 and

The main underlying cause of the downside in municipal finances in 2003 was the steep and sudden cutback in central-government participation in municipal budgets.

Table 3.19
Grants from the Ministry of the Interior to Local Authorities,^a 2002–2004

(NIS '000 at Dec. 2003 prices)

Budget item	Performance 2002	Budget ^b 2003	Performance 2003	Budget 2004
(1801) Balancing grants	4,002	3,937	3,364	2,185
(1803) Earmarked grants	269	267	242	219
(18) Total general grants	<u>4,271</u>	<u>4,204</u>	<u>3,583</u>	<u>2,404</u>
(5705) Development budgets	388	368	327	309
(5706) Development budgets to minorities local authorities	132	145	116	91
(57) Total development (current year)	520	513	442	400
(57) Authorization to commit to expenditure in future years	586	476	0	0

^a The data in this table differ from those in the Report in Hebrew due to the revision of data by the Ministry of Finance.

^b Original budget.

SOURCE: Based on data from the Ministry of Finance.

57 of the Interior Ministry budget) were reduced in 2003 by NIS 1.1 billion (about 25 percent) and longer-term spending authorization for municipal authorities was abolished. An additional cutback in 2004 brought the total reduction in 2002–2004 to NIS 2 billion (40 percent). Furthermore, a deviation from the long-standing practice of adjusting municipal property tax rates for changes in the Consumer Price Index reduced tax

receipts by NIS 0.4 billion in 2003, and only half of this sum was offset in 2004. These cutbacks are expected to deal a severe blow to services to the public and to worsen the financial situation of the authorities affected. Authorities in low socioeconomic clusters—for which the grants are a main source of revenue—will suffer more than the others, and the worst-off of all will be those in the four lowest clusters, which (with the exception of Jerusalem) have a combined population of 2,000,000—Arab municipalities, Jewish localities inhabited mainly by the ultraorthodox (Upper Betar, Upper Modi'in, and Benei Beraq), and most development towns.

The authorities that were harmed by the cutback in government grants were not necessarily those that benefited from the wage decrease and the municipal property-tax hike.

The Economic Recovery Plan played a relatively minor role in the total damage inflicted on local authorities in the past year and a half. The plan did reduce central-government participation in municipal expenses by NIS 600 million, not including the elimination of the spending authorization and the cutback in transfers from the ministries of Education and Social Affairs (the rules of municipal funding by central government are explained in Box 3.5). Since general-government wage costs were lowered and an increase in municipal property tax rates was approved at this time, the total increase in municipal deficits occasioned by the plan reflects only a small portion of the overall recent decrease in the sources available to municipalities.⁵¹ The authorities that were harmed by the cutback in government grants, however, are not necessarily those that benefit from the wage decrease and the tax hike. About half of municipal real-estate tax receipts and 40 percent of wage payments are in authorities that do not receive balancing grants and, for this reason, were not affected by the cutback in the grants. In contrast, authorities that receive balancing grants suffered a much greater cutback than the saving occasioned by the wage cut and the added revenue generated by the tax increase.

Box 3.5

Criteria for the Allocation of Central-Government Grants to Local Authorities

In 2002, central government contributed NIS 12.6 billion to funding of municipal activities,¹ 39 percent of total municipal revenues. Most of the central government's participation in municipal revenues takes place by means of the ministries of Education and Social Affairs (NIS 8.6 billion); the rest comes from a general grant for municipal activity, balancing grants to reduce accumulated deficits, and prizes for outstanding authorities. Subsidies for municipalities favor localities in peripheral areas, Jewish

¹ Source: *Budget Proposal for Fiscal Year 2004, Booklet E—Ministry of the Interior*.

⁵¹ However, the cutback in government grants is permanent whereas the wage cut is for two years only. Thus, unless municipal budgets are adjusted during the next two years, they will probably come under additional pressure in 2005.

localities,² and those that rank low on the socioeconomic scale. Also preferred in the allocation of grants are authorities that have National Priority Area status and those in Judea-Samaria and the Gaza District. Grants from the Ministry of Education, 40 percent of total municipal grants, are apportioned among authorities in accordance with criteria of population dispersion, location on the map of National Priority Areas, and class size in schools. The Ministry of Education also gives special incentives to localities that participate in programs for the disadvantaged. Grants from the Ministry of Social Affairs, 18 percent of total municipal grants, are apportioned on the basis of the authorities' score on a welfare index based on a formula that takes account of the number of local welfare cases, socioeconomic situation, location on the map of National Priority Areas, and the metropolitan area to which the authority belongs. In this formula, one-fourth of the grant depends on the number of open welfare files in the authority and the intensity with which the clients are treated. The remainder is apportioned on the basis of socioeconomic status (S), which is calculated in accordance with residents' income, unemployment rate, and percent of children and elderly. The three largest cities and authorities in Class A National Priority Areas receive a 10 percent supplemental grant; authorities in Class B National Priority Areas receive 5 percent. This grant, like other grants to the municipalities, is apportioned according to the ratio of the municipality's welfare index *divided by* the total welfare index of the local authorities and *multiplied by* the total grant. Interior Ministry grants (GP), 34 percent of total municipal grants, are comprised of general balancing grants, loans for the development of sewage and water infrastructure, loans to reduce cumulative deficits, and grants for outstanding authorities that meet their deficit targets. The total balancing grant, NIS 3.7 billion in 2002, is divided among authorities in accordance with the Swary formula,³ which weights the rate of change in socioeconomic situation (A), the rate of change in population size (B), the rate of change in area that is liable to residential property tax (C), the rate of change in payback of loans as a percent of total expenditure (D), and the rate of takeup of the grant in previous years. The formula is:

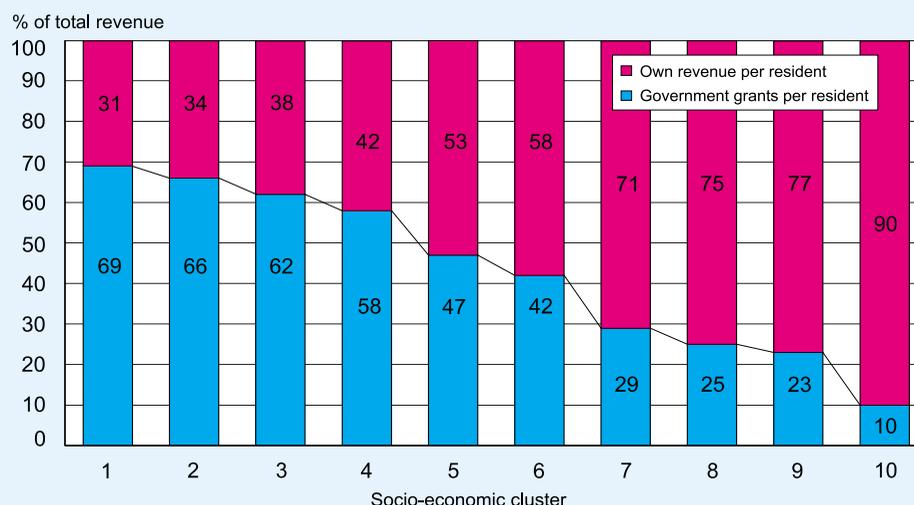
$$GP = X * (1 + A + B + C + D).$$

² See E. Razin (1998), *Fiscal Disparities among Local Authorities in Israel, 1972–1995*, The Floersheimer Institute for Policy Studies; and M. Justman and A. Spivak (2001), "Socioeconomic Dynamics of Municipal Authorities," *Economic Quarterly*, 48 (4) (Hebrew).

³ From 2004, the allocation will vary according to the Gadish Committee criteria. Small authorities will no longer receive preference and various types of populations will be taken into account.

The basic grant (X) is determined in accordance with the size of the balancing grant that was budgeted for the previous year plus the reserve for price increases. The Swary Committee set the basic grant in the base year on the basis of a calculated normative expenditure for the authority at issue in 1992. In addition to the general grant (GP), authorities in Class A and Class B National Priority Areas receive supplemental grants of 2.25 percent and 1.15 percent, respectively. Authorities on the confrontation line receive a 2.5 percent supplement and those in Judea-Samaria and the Gaza District get 2.75 percent.

Own Revenue and Government Grants as Share of Total Revenues of Local Authorities,^a by Socio-Economic Cluster, 2002 (percent)



^a Excluding industrial local authorities and regional councils.

SOURCE: Based on audited accounts of local authorities for 2002.

The financial condition of Israel's municipal authorities varies widely. In terms of the relationship between budget lines and authorities' characteristics, the higher a local authority stood on the scale of social clusters in 1997–2001, the higher its level of per-resident spending, the greater its per-resident revenue, the higher its rate of collection of municipal property tax, and the lower the participation of central government in its expenditure. Furthermore, scale economies in municipal management were found; they decline in logarithmic progression, so that large authorities manage to stay solvent while small ones run up protracted debts. Another finding in the comparison is that the government makes an above-average contribution to welfare in peripheral localities (apart from Arab and Druze ones), because most weak authorities are in peripheral areas. Examination of the distribution of revenues in Israel's 210 municipalities and local councils⁴ (Figure 3.5)

shows that the lower their ranking in terms of socioeconomic cluster, the more dependent they are on central-government grants. Moreover, the 151 municipal authorities that ranked in the six lowest clusters and were home to 56 percent of the population, derived most of their revenue per inhabitant from government grants. Since these resources are allocated progressively, the steep cutback in municipal grants in the past two years has been especially adverse to weak population groups that have been harmed by the economic program to begin with. This process is also expected to increase municipal debt at the expense of central-government debt and to widen the social gap.

⁴ Omitted from the processing were the two industrial councils (Migdal Tefen and Ramat Hovav) and the regional councils, because they are different in nature.

In view of such an acute cutback in balancing grants—tens of percent—and the across-the-board reductions in transfers from the ministries of Education and Social Affairs, one might expect even authorities that practice reasonable budget management to teeter and municipal services in many authorities to collapse. Since the worst of the blow is absorbed by municipal authorities that have economically weak populations—those that are most reliant on balancing grants—one may also expect the socioeconomic gap between weak and affluent authorities to widen, in a reversal of the trend that has been dominant since the mid-1990s. Therefore, the Government’s resolution in late January 2004 to ease the blow to the municipal authorities and to set aside a significant sum for recovery plans in some authorities seems to have been inevitable, even though it was adopted after the price—harm to the delivery of services—had already been paid. Now that the decision to budget municipal recovery plans has been made, there is reason to hope that the plans will be used to streamline municipal activities in ways that will invoke scale economies, e.g., encouraging the merger of small authorities or the integration of such authorities’ municipal services. However, the return to the previous situation, in which local authorities conduct their affairs in accordance with their ability to extract sources from central government, is a marked retreat from the tougher budget constraint that has been achieved in recent years.

b. Health funds

The health funds, the main players in Israel’s health-care system, spent NIS 24 billion in 2002 and had an aggregate deficit of NIS 447 million (1.9 percent of expenditure). The funds operate under the State Health Insurance Law, implemented in 1995, which concerns itself with the financing of the funds’ operations and stipulates ways to eliminate their current and cumulative deficits. The funds’ aggregate deficits have decreased since the law went into effect and have ceased to be a system-level problem in the past two years. During this time, the problem has focused on one fund, Clalit Health Services.

Most of the blow caused by the cutback in grants was absorbed by municipalities that have economically weak populations.

A return to the previous situation, in which local authorities go about their affairs in accordance with their ability to extract sources from central government, is a marked retreat from the stricter budget constraint that has been achieved in recent years.

In the past two years, the problem of health-fund deficits has ceased to be a system-level problem and has focused on one fund, Clalit Health Services.

The discrepancies among health funds in financial strength widened during this two-year period. Two funds, Maccabi and Meuhedet, brought their budgets into balance and an external auditor—who took action to lower its deficit—was appointed for a third fund, Leumit. The deficit of Clalit Health Services, however, did not decrease significantly, even though the health-fund financing mechanism under the law takes account of demographic changes and differences in the composition of persons insured among the funds. This problem, originating mainly in the fact that Clalit has higher levels of expenditure than the other funds—especially for inpatient care—points to insufficient indemnification for insuring the elderly through the capitation formula that is used to apportion government participation and health tax receipts, and/or to inefficiency in Clalit's management.

The Economic Recovery Plan inflicted no meaningful harm on the financial situation of the health funds.

In 2003, as part of the Economic Recovery Plan, the government lowered its support for the health funds with emphasis on a NIS 110 million annual cutback in its subsidy for Clalit's recovery plan. The government also froze payments for the expansion of the list of insured health-care services, reducing the funds' real income by another NIS 200 million. Concurrently, however, the Economic Recovery Plan also helped to lower the funds' expenses by bringing down the per-day rate of inpatient care—the largest component in health-fund expenditure—and by reducing labor costs, which account for 43 percent of the funds' expenditure. Thus, the plan inflicted no meaningful harm on their financial situation. The main effect of the plan was a slight decrease in the deficit of the small funds and a small increase in that of Clalit Health Services—developments that are expected to continue in 2004.