Chapter 6

The General Government, Its Services and Financing

- The general government deficit was 2.4 percent of Gross Domestic Product in 2015, half a percentage point below the previous year's level. The budget deficit declined by 0.6 percentage points to 2.1 percent—below the ceiling established in the budget (2.9 percent).
- The public debt to GDP ratio was 64.8 percent of GDP at year's end—2 percentage points below the previous year and low compared to the OECD average.
- Total noninterest public expenditure by the general government increased by 4 percent in 2015 compared with 2014. Civilian noninterest expenditure was 30.7 percent of GDP—below the 2014 level and very low by international standards.
- The real increase in civilian public consumption in 2015 was less than the real increase in domestic defense consumption, similar to 2014. Real per-capita expenditure on transfer payments grew rapidly due to an increase in social service outlays, demographic changes, and the decline in the Consumer Price Index.
- The government operated without a budget until November but its ministries managed to spend 99 percent of the new budget—a performance rate only 0.5 percentage points lower than the average in years when the budget was approved on time. The performance rates of the social affairs ministries were 2 percentage points lower than they were in normal years.
- General government revenues continued to increase, continuing the trend that followed the fiscal stabilization program in 2013, to 36.7 percent of GDP. Tax revenues were 30.9 percent of GDP.
- Direct taxes on real estate and Value Added Tax on new homes, which accounted for 5 percent of total tax collection in 2014, contributed 30 percent of the total increase in revenue in 2015 and were about half a percent of GDP above their level in the middle of the previous decade.
- About one-fourth of the total increase in tax revenue in 2015 originated in payroll taxes, with a similar proportion coming from income tax on corporate earnings and the self-employed.
- The government decided to support economic activity by lowering the rates of VAT and corporate tax, a reduction made possible by the strong revenue from the housing market.
- In the 2015–2016 budget, the government decided on a permanent increase in public expenditure beyond the level derived from the current expenditure rule. Since the increase in expenditure was not matched by a permanent increase in revenues, the government also raised the deficit ceilings for coming years.
- The government and the Knesset decided to apply a mechanism for monitoring and control of future budget spending commitments and structural reductions in revenues ("the Numerator"). The mechanism is expected to improve budget management and compliance with budget targets.

1. MAIN DEVELOPMENTS AND FISCAL POLICY

The government spent most of 2015 operating without an approved budget. Therefore, fiscal policy in the reviewed year was based chiefly on measures and rules set forth in the previous budget, for 2013 and 2014, and on the fiscal stabilization program that budget included. **The general government deficit** continued to decline, ending 2015 at 2.4 percent of GDP—half a percentage point below its 2014 level (Table 6.1) and very close to the OECD average (Figure 6.1). Since the domestic output gap widened relative to 2014, the cyclically adjusted deficit declined more steeply—by about 1 percentage point—to 2.1 percent of GDP.[1] The difference between Israel's cyclically adjusted deficit, adjusted to the international definitions, and that of the OECD countries narrowed. The budget deficit declined to 2.1 percent of GDP, lower than both the ceiling established in the new budget (2.9 percent) and the one previously in effect (2.5 percent). To fund expenditure without requiring a commensurate increase in tax rates, the government raised the deficit ceiling for 2016 and set future deficit contraction on a more moderate path.

The general government deficit continued to decline, ending 2015 at 2.4 percent of GDP. Net of the slow growth, the cyclically adjusted deficit declined markedly but remains higher than the average among the OECD countries.

Total general government **public expenditure** (not including interest payments) increased by 4 percent in nominal terms compared with 2014. An examination of the expenditure components shows that the real increase in **civilian** consumption per capita was 0.9 percent in 2015—below the real increase in domestic **defense** consumption, which increased by 3.5 percent, matching its growth rate in 2014, when all expenditure related to Operation Protective Edge in Gaza was funded. Public expenditure per capita on **current transfers** (mainly benefit payments) increased by 4.1 percent in real terms[2], a marked acceleration compared with previous years, due to demographic changes, government-initiated increases in benefits, and the decline in the Consumer Price Index, which amplified the benefits' purchasing power.

The government decided to increase expenditures without raising tax rates accordingly, and therefore decided to also increase the deficit ceilings and to slow its decline in the future.

The real increase in domestic defense consumption was more rapid than the real increase in civilian consumption for the second straight year. Real public expenditure on transfer payments increased rapidly.

Even though total public expenditure grew, its proportion of GDP—39 percent—was slightly lower than in 2014 (by 0.2 percentage points)—marking the continuation of a downward trend that has seen only brief pauses since 2003. The decline in 2015 reflects a downturn in noninterest civilian expenditure relative to GDP and a steady ratio of defense expenditure to GDP. The new budget includes increases in government expenditure in excess of the rate derived from the expenditure rule. The increase in expenditure is permanent and is the equivalent of 1.2 percent of GDP. (Some of the increase was realized in 2013 and 2014 but became permanent in 2015.) The frequent introduction of changes in total expenditure reflects the difficulty in making further cuts in public (particularly civilian) expenditure relative to GDP. The growth of GDP increases individuals' income, leading to greater consumption of government services

Public expenditure as a share of GDP continued to decline. In the new budget, the government decided to increase its expenditure base beyond the level derived from the expenditure rule.

[1] Starting in 2015, the cyclically adjusted deficit is calculated relative to potential GDP as derived from the growth rate of the main working age population (25– 64) and not from the growth rate of the population at large. Since the growth rate of the working age population has slowed in recent years, so has the potential GDP growth rate.

[2] The real rate of increase in the public consumption aggregates was calculated by deducting the change in the Public Consumption Price Index. The real growth rate of transfer payments was computed by deducting the change the Consumer Price Index.

Table 6.1
The main components of the general government's revenue and expenditure, 2002–15

(percent of GDP)

	Average 2002–2006	Average 2007–2011	2012	2013	2014	2015
Total public revenue	**41.0**	**37.1**	**35.1**	**35.9**	**36.4**	**36.7**
Income from property	1.5	0.9	0.7	0.7	0.6	0.7
Total taxes	33.1	30.8	29.1	30.1	30.7	30.9
Indirect taxes on domestic production	11.5	11.4	11.2	11.7	11.9	11.9
Indirect taxes on civilian imports	3.7	3.9	3.5	3.4	3.7	3.4
Direct taxes, fees and levies	12.1	10.4	9.4	10.0	10.0	10.3
National Insurance Institute revenue	5.4	5.2	5.0	5.1	5.1	5.2
Grants	2.7	1.8	1.5	1.4	1.3	1.4
Other[a]	3.7	3.6	3.7	3.7	3.7	3.7
Total public expenditure	**44.5**	**39.8**	**39.2**	**39.5**	**39.2**	**39.0**
Current expenditure	40.5	35.9	35.3	35.5	35.4	35.4
Domestic civilian consumption	17.0	16.2	16.6	16.9	16.9	16.7
Domestic defense consumption	5.7	5.0	4.5	4.5	4.5	4.5
Defense imports	1.7	1.1	1.1	1.0	1.1	1.0
Direct subsidies	0.6	0.6	0.7	0.7	0.8	0.7
Transfer payments on current account	10.6	9.7	9.7	9.7	9.7	9.7
Interest payments	4.9	3.4	2.8	2.7	2.6	2.8
Transfer payments on capital account[b]	1.6	1.9	1.7	1.9	1.7	1.6
Investments of the general government	2.5	2.1	2.2	2.2	2.1	2.1
Primary civilian expenditure	**32.2**	**30.4**	**30.8**	**31.3**	**31.1**	**30.7**
Total deficit of the general government	**3.5**	**2.7**	**4.2**	**3.6**	**2.8**	**2.4**
Deficit using international definition[c]	4.3	4.0	5.1	4.5	3.0	2.1
Current deficit of the general government	2.7	2.1	3.4	2.8	2.3	2.2
Total cyclically adjusted deficit[d]	1.6	2.5	5.0	4.4	3.2	2.1
Total cyclically adjusted deficit using international definition[e]	2.6	3.4	6.0	5.4	4.0	2.7
Net public debt[f,g]	78.1	64.7	62.6	62.2	62.6	60.9
Gross public debt[f]	88.4	71.6	67.8	67.2	66.7	64.8

[a] Includes transfer payments from the public on the current and capital accounts, imputed pensions, depreciation, capital transfers from abroad, and transfers from abroad to National Institutions and nonprofit organizations.

[b] Includes mortgage subsidies and transfers on the capital account to nonprofit organizations and businesses.

[c] The deficit in this item was brought in line with the accepted international definition by adding indexation differentials on indexed and unindexed shekel debt. Indexation differentials need to be added in respect of unindexed debt because the Central Bureau of Statistics imputes a reduction of these differentials when reporting interest payments.

[d] Starting this year, the definition of the cyclically adjusted deficit shown here is different than in the past. We now calculate the effect of the cycle relative to the potential GDP derived from the growth rate of the primary working age population (aged 25–64) instead of the rate derived from the growth of the entire population. The slowdown in the growth of the working-age population in recent years slowed the growth of potential GDP.

[e] The deficit in this item was brought in line with the accepted international definition by adding indexation differentials on the indexed and unindexed shekel debt, assuming inflation of 2 percent.

[f] Excluding municipalities' debts to the government.

[g] Net public debt equals the gross public debt minus active loans minus government deposits with the Bank of Israel.

SOURCE: Based on Central Bureau of Statistics data.

and to expectations of a social safety net that befits their income. The meaning of the increase in GDP—more economic activity, more business transactions—forces government to spend on infrastructure and on making its systems more available (e.g., faster resolution of more conflicts in the judicial system, quick response in the issuance of larger numbers of business licenses and construction permits, etc.). By international comparison, Israel's public expenditure to GDP ratio was similar to the OECD average in 2007. After the global crisis, however, expenditure increased in the OECD countries and declined in Israel, leaving expenditure in Israel about 6 percentage points of GDP below the international average. Since defense expenditure as a share of public expenditure in Israel (around 6 percent of GDP) surpasses the OECD average (1.3 percent)[3], and interest expenditure (2.5 percent according to the international definition) still exceeds the average in these countries (1.6 percent), noninterest civilian public expenditure as a share of GDP in Israel is far below the OECD average. Most of the gap (80 percent) originates in very low social transfer payments (principally National Insurance benefits) in Israel relative to the OECD norm (a difference of 9.3 percentage points of GDP[4]). In-kind transfers to households in Israel (chiefly services such as healthcare and education) are 1.8 percentage points of GDP lower than the OECD average, explaining another 15 percent of the civilian expenditure gap.

Public expenditure in Israel is lower than the OECD average. Since defense expenditures and interest payments in Israel are high, the gap in civilian expenditure increased even more, and is reflected mainly in the very low volume of transfer payments in Israel.

Even though they operated without an approved budget in most of 2015, government ministries' total budget performance was only slightly lower than in years when there was an approved budget for the entire year. At the beginning of the year, the lack of a budget resulted in the deferral of expenditure. Thus, spending totalling about 0.25 percent of GDP was postponed from the first third of 2015 to the rest of the year or was not carried out at all (relative to the distribution of expenditure in ordinary years).

The government operated for most of the year without an approved budget, but the budget performance rate of government ministries was only slightly lower than in normal years.

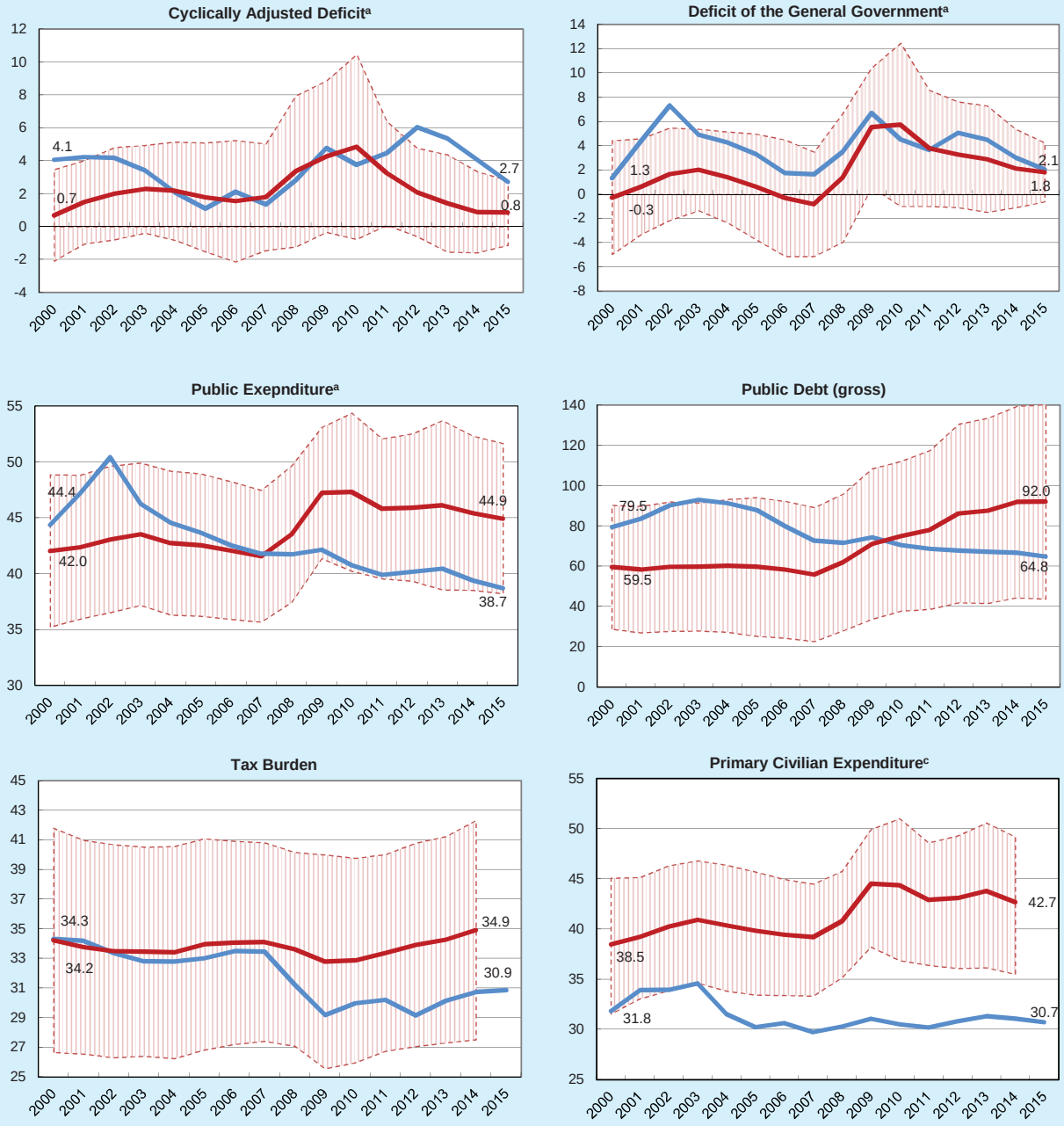
Tax **revenues** increased in 2015 for several reasons: the surging real-estate market (abetted by investors' response to the increase in the real estate purchase tax and the return of buyers to the market after the zero-VAT program for new homes was withdrawn); growth in employment and wages; increased private consumption; and larger corporate earnings (for reasons including declines in prices of imported commodities, which had an upward effect on national income). Non-tax revenues also grew (chiefly in National Insurance Institute surpluses). Due to strong tax revenue in mid-year, abetted by lively activity in the real estate market, the government lowered VAT and corporate tax rates. Thus, in effect, the government used high tax revenue in a specific market (real estate) to support growth in the economy at large. The stimulus was not limited in time. Therefore, it may raise the deficit to a level exceeding the lawful ceiling if the economy fails to grow rapidly or if the real estate market boom ends. The Ministry of Finance, however, said that the continuation of the stimulus measure will depend on the fiscal situation. Tax revenues were 30.9 percent of GDP in

The growth in the real estate market contributed greatly to state revenue from taxes, as did the increase in employment and in wages and the increase in corporate profits. The government used the high revenues to lower taxes, thereby supporting economic growth.

[3] Some of Israel's large defense outlays are funded by means of grants from the US.

[4] The composition of the noninterest civilian expenditure gap was calculated on the basis of OECD data for 2013 (the latest data that are nearly complete).

Figure 6.1
Israel's Fiscal Aggregates Compared With the OECD Average[b], 2000–15 (percent of GDP)



[a] Deficit and expenditure data for Israel were adjusted to the accepted international definition.
[b] Data for OECD countries are arithmetic averages of all countries for which there are data in the OECD's system.
[c] There are still no data for OECD countries for 2015. For a number of countries with missing data, we assumed that the volume of defense expenditures in 2014 remained the same as in 2013.
SOURCE: Based on OECD data, Central Bureau of Statistics, and OECD Revenue Statistics 2015.

2015[5]— 0.2 percentage points more than in 2014, in continuation of an upward trend in revenues that began in 2013. Israel's tax revenues in the middle of the previous decade approximated the OECD average. Today, however, largely due to repeated reductions in income tax rates in the previous decade, they are 4 percentage points of GDP below the OECD average.

Public debt continued to decline, mainly thanks to price changes in the economy, and totaled 64.8 percent of GDP. The government extended the time to maturity on tradable debt, thereby lowering the risk of refinancing the debt.

The **public debt to GDP ratio** fell to 64.8 percent compared with 66.7 percent in 2014. Most of the acceleration in the decline of this ratio (relative to 2014) originates in the rapid growth of output prices in the reviewed year (a circumstance that increases the denominator in the debt to GDP ratio), whereas the Consumer Price Index fell (making the indexed debt—the numerator—smaller). Although Israel's debt is below the OECD average, the interest rate paid on it remains above the OECD average. By lengthening the duration of newly issued tradable debt in 2015 relative to previous years, the government reduced the rollover risk that attends to the debt.

Transition budget

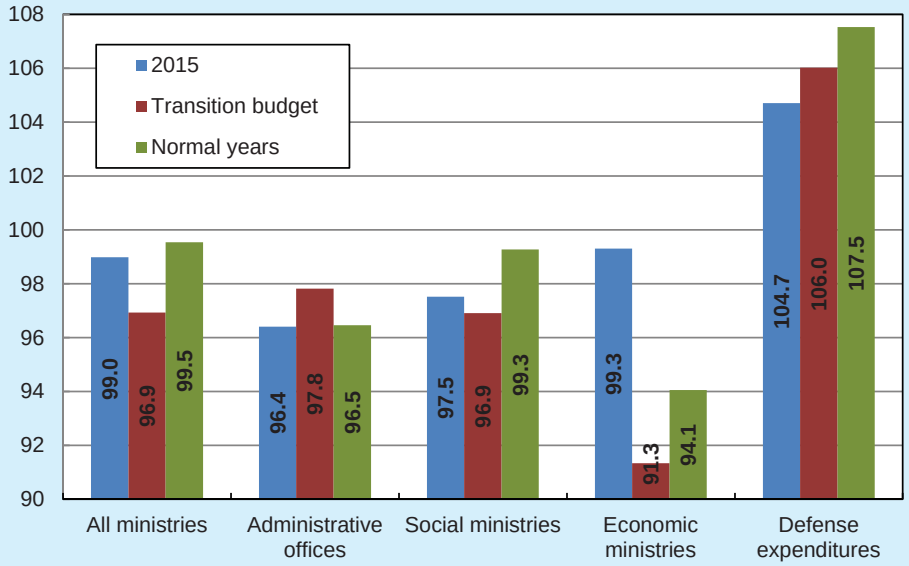
For the fourth time in ten years, the government operated for most of the year without an approved budget. In 2015, the lack of a budget had only a slight negative impact on the performance rate of the total budget of the ministries.

In late 2014, the Knesset dissolved without approving the coming year's budget and a new budget was not passed until November 2015. Thus the government, as prescribed by law, operated for most of the year under a transition budget that allowed it to spend, up to a certain month, only the pro-rated share of total expenditure in the previous year.[6] It was the fourth time in the past ten years that the government operated without a budget for half a year or longer. An examination of budget performance rates in 2015 relative to years when an approved budget existed all year long (Figure 6.2) shows that performance in 2015—99 percent of the budget for government ministries—was only slightly lower than in ordinary years (99.5 percent on average), the difference being the equivalent of NIS 1.5 billion (0.14 percent of GDP) in underspending. The performance rate in 2015 exceeded the average in all years when a transition budget was used for long periods (2006, 2009, 2013, 2015—96.9 percent), indicating that the mechanism that manages government spending in the absence of a budget has become more professional and that the exceptions committees that approve new or self-renewing expenditures have become more flexible. In 2015, the social affairs ministries underperformed relative to ordinary years (a gap of NIS 2.4 billion) and defense spending was underperformed as well (by NIS 1.9 billion). Spending by

[5] The rate would have been 0.1 percentage points higher had the government not brought forward, from 2016 to 2015, a NIS 1.5 billion transfer to a fund that compensates citizens for damage occasioned by enemy action or war operations—an (accounting) fund that operates under the Property Tax and Compensation Fund Law, 5721–1961. The transfer to this fund is not recorded as a budget expenditure; instead, it reduces the sum that is recorded as tax revenue.

[6] That is, by the end of January the government was allowed to spend one-twelfth of the previous year's total authorized expenditure, two-twelfths by the end of February, and so on.

Figure 6.2
Budget Performance Rate in 2015 and in Years with a Transition Budget, Compared with Performance Rates in "Normal" Years in the Past Decade[a]
(percent)



[a] The years in which there was a transition budget: 2006, 2009, 2013 and 2015.
SOURCE: Based on Ministry of Finance data.

ministries that deal in economic affairs, in contrast, exceeded spending in ordinary years (by NIS 1.2 billion).[7]

An examination of the distribution of expenditure during the year shows that in 2015, total ministry spending was lower than in ordinary years at the beginning of the year. By April, the cumulative gap came to about 0.5 percent of total annual expenditure, i.e., NIS 1.5 billion in underspending during that period.[8] Adding together the two effects described above—(a) smaller annual performance of the budget and (b) a smaller rate

[7] For expenditure purposes, the ministries are sorted as follows: **social affairs** (48 percent of the budget for ministries in 2015)—Health, Education, Municipal Authorities, Higher Education, Religious Affairs, Labor and Social Services, Housing, Immigrant Absorption, and transfers to National Insurance; **economic affairs** (9 percent of the budget for ministries)—support payments, Agriculture, Energy and Infrastructure, the fuel economy, the water economy, Economy, Tourism, Communications, Transportation, public works, and the Center for Mapping; **administrative affairs** (17 percent of the budget for ministries)—the President, the Knesset, the Prime Minister's Office, Finance, Interior, Public Security, Justice, Foreign Affairs, State Comptroller, Science, Culture and Sports, Environment, and pensions and compensation; **defense expenditure** (24 percent of the budget) includes the general reserve, earmarked for the Israel Security Service (GSS, Shabak) and the Mossad; "**miscellaneous**" (2 percent of the budget) is included only in the aggregate expenditures of the ministries.

[8] Apportioned by expenditure classification, there is evidence that about NIS 1 billion of spending by social affairs ministries by the end of April was deferred to ensuing months and that NIS 3.5 billion in defense spending up to the end of March was also diverted to later in the year.

of expenditure at the beginning of the year—total spending by ministries in January–April 2015 was NIS 2.8 billion (0.25 percent of GDP) lower than in ordinary years.[9]

The high rates of budget performance in 2015 despite the protracted lack of a budget give evidence of flexibility available to the Ministry of Finance (Division of the Accountant General) within the expenditure framework set forth in the law. The spending ceiling is determined on the basis of total budget expenditure in the previous year (indexed to the CPI[10]), including expenditure on principal and interest. In 2015, payments of principal were NIS 28 billion lower than in 2014, leaving a larger balance for distribution to the government ministries.[11] Since payments of principal vary from year to year and even within a year, thought should be given to excluding them from the expenditure ceiling by law. Thus their volatility would not distort potential allocation to the ministries by making it either too large (when payments of principal decrease) or too small (when repayments increases).

The decline in debt payments raised the permitted expenditure ceiling for government ministries in the absence of a budget. In order to prevent distortion, a separation of volatile debt payments from the expenditure ceiling should be considered.

A natural tension exists in making rules of budget comportment in the absence of a budget. While there is a wish to allow the government and its institutions to operate smoothly in order to spare the economy from harm, there is also concern about the harm that may be caused by too much flexibility—tying the Knesset's hands in setting fiscal limits and priorities in the next budget. In balancing out these extremes, the United States is an outlier among OECD countries in that government services are shut down if there is no approved budget (even provisional). Almost all other OECD countries have rules in place that allow the government to continue operating on the basis of a provisional budget if the legislature fails to approve a new budget on time.[12] The frequent use of transition budgets in Israel (on four of the seven occasions in the past ten years when the Knesset had to approve a new budget) and the lengthy term of its use (almost eleven months in 2015) are indicative of a considerable degree of flexibility that lowers the political price of its use. This flexibility originates in two factors: the decrease in debt repayment in recent years—which, as stated, raises the possible expenditure ceiling for government ministries—and the amassing of

[9] As of the present writing, in the absence of more detailed data about the purposes of the expenditures that were deferred to later in the year, it is hard to estimate how the deferral of expenditures affected economic activity in the first quarter, if at all. For example, if the deferral of defense spending was manifested in the postponement of procurements from abroad or if it caused the defense system to amass debts that were repaid later, its impact on the economy was small. It is worth noting that the correlation between total quarterly spending by government ministries and quarterly public consumption in the National Accounts was 85 percent between 2002 and 2015. The correlation between the quarterly rates of change of these aggregates was 49 percent.

[10] The law does not explain whether, when a provisional ceiling is set, errors in predicting the CPI in the previous budget should be offset, as is usually done when a new budget is approved, or disregarded. The Accountant General's interpretation was that such an adjustment, which in any case would have to be made with the approval of the new budget, should be made. The adjustment lowered the provisional ceiling for 2015 by NIS 8 billion.

[11] Ministry of Finance, Division of the Accountant General (2015), "Summary of State Budget Management by the Division of the Accountant General in the Absence of a Budget Approved by the Knesset, January 1– November 19, 2015" (Hebrew).

[12] OECD (2004), "The Legal Framework for Budget Systems—An International Comparison," *OECD Journal on Budgeting*, 4:3.

experience and changes in the mechanism of the exceptions committees, allowing government ministries to enter into new contracts and review applications for support more easily.[13] In choosing whether to change the existing balance, it should also be remembered that the use of a transition budget means that decisions on spending priorities are in great part handed from elected officials (Members of the Knesset) to appointed ones, leaving the public's representatives with no influence over these important decisions for some time.

Fiscal rules and a mechanism for monitoring and control of future budgets

The new government amended the two fiscal rules that determine the budget framework. For 2015, the government expenditure base was raised by an additional 2 percentage points beyond the permanent rate of increase set in the expenditure rule (or by another 4.4 percentage points if one includes the government decision to refrain from correcting expenditure pursuant to the overestimate of inflation in the previous budget—see elaboration in Section 3 below). The government also authorized a nonrecurrent 0.25 percentage point supplemental increase in expenditure in 2016. The spending hikes reflect the government's difficulty in accommodating social and defense demands within the total expenditure ceiling that it had set forth—which would have meant a protracted decrease in government expenditure relative to GDP—particularly given Israel's very low level of noninterest civilian public expenditure by international standards (Figure 6.1). Unlike the measure taken in early 2014, which was balanced in that it reduced both taxes and spending, the spending increase now was not accompanied by a corresponding (present or future) tax hike, and made it necessary to raise the deficit ceiling set forth in the law.[14] The government's decision was to raise the ceiling for 2015 and 2016 to 2.9 percent of GDP (instead of 2.5 percent and 2 percent, respectively) and to slow the downward path of the deficit so that it would decline to 1.5 percent in 2021 instead of 2019.[15] Increasing the deficit does support economic activity in the short term (against the backdrop of the negative output gap) but, importantly, the future deficit path should make it possible to continue lowering the public debt.

In the past few years, governments in Israel have made spending commitments that overshot the expenditure and deficit ceilings. When it came time to honor those undertakings, they repeatedly had to renege, slash other spending items,

[13] In 2015, exceptions committees approved new contracts or advance payments leading to NIS 12.4 billion in expenditures in 2015 and NIS 42.7 billion in spending commitments in future years. They also approved the hiring of workers for 1,188 posts. Committees for which there are data approved about 73 percent of the 3,155 applications that were presented to them.

[14] As explained in Chapter 6 of the Bank of Israel *Annual Report* for 2014, it is worth considering replacing the deficit rule with a "balancing rule" that would require balancing for measures that surpass the expenditure rule. Namely, the rule would make it necessary to accompany a tax cut by a spending cut and an increase in spending beyond the total expenditure ceiling with a tax hike to pay for it.

[15] This deferral is relative to the path that was approved in the budget framework for 2013–2014. In the trajectory preceding that, approved in the budget framework for 2009–2010, the deficit ceiling for 2013 was set at 1.5 percent and was supposed to fall to 1 percent of GDP in 2014 and thereafter.

or allow expenditures and deficits to surpass the maximums set forth in the fiscal rules—impairing not only the credibility of the rules but also the credibility of the government's budgeted commitments. To cope with such problems, in 2015 the government and the Knesset created a new mechanism for monitoring and control of future government expenditure ("the Numerator").[16] It includes monitoring of planned expenditures and foreseen revenues and reconciling them with expenditure and deficit ceilings for three years following the current budget year. The attendant forecasts and estimates are to be updated at least once per year (ahead of approval of the budget). The mechanism requires the government to reconcile its planned budget expenditures with the spending limit in ensuing years and to refrain from making decisions or advancing legislative proposals that would cause the permissible expenditure ceiling to be breached[17] unless a measure that balances out the overrun is taken concurrently. The government must also refrain from proposing in the budget, or in any other statute, tax cuts that would cause the deficit ceiling to be exceeded in the ensuing three years (or that would increase an existing overrun) unless it takes balancing measures. The limits that the Knesset imposed on the government will go into effect gradually; thus, when the budgets for 2017 and 2018 are approved, they will not require full reconciliation of expenditure with the lawful ceiling to three years ahead.[18] The mechanism established in the law improves budget management. If it is complied with, it will enhance the credibility of the fiscal rules and the government's budget commitments.

The new mechanism for monitoring and control of future government expenditure ("the Numerator") will track the adjustment of planned expenses and forecast revenues to the budgeting rules, thereby preventing unbalanced exceptions to the rules and improving budgetary management.

2. GOVERNMENT REVENUES

General government revenues were 36.7 percent of GDP in 2015—up 0.3 percentage points from 2014, continuing the upward trend in revenues that followed the 2013 fiscal stabilization program. Tax revenues increased at a similar pace in 2015 and came to 30.9 percent of GDP.[19] This fraction is still 2.5 percentage points below the high level of revenues that occurred in the years preceding the Global Financial Crisis

General government revenues increased this year, continuing the trend that followed the fiscal stabilization program of 2013, and totaled 36.7 percent of GDP.

[16] Amendment 49 to the Foundations of the Budget Law, passed by the Knesset as part of the Economic Efficiency (Legislative Amendments to Attain Budget Targets for Fiscal Years 2015 and 2016) Law, 5766–2015 (p. 253).

[17] The permissible expenditure ceiling is lower than the lawful expenditure ceiling: 99 percent of the lawful ceiling in the year after the budget is approved and 98 percent of the lawful ceiling in Years 2 and 3. These limits on planned expenditure in years following the coming budget year give the government 1–2 percent latitude to make decisions each year that would bring future planned expenditure to the full expenditure ceiling.

[18] For the 2017 budget, the mechanism will allow expenditure in the three ensuing years to stand at 100.5 percent, 100.5 percent, and 100 percent of the lawful ceiling, and at 100.5 percent, 100 percent, and 99 percent of the ceiling in the three years after the 2018 budget.

[19] Not including an exceptional transfer of NIS 1.5 billion (0.1 percent of GDP) from real estate purchase tax revenues to the Compensation Fund. This transfer was moved up from 2016 and is not recorded under tax revenues in the budget.

Table 6.2
Forecast and actual[a] tax revenue by type of tax, 2014–15

(Current prices)

	Revenue in 2014	Forecast for 2015 from August 2014[b]	Increase in revenue from 2014 to 2015	Contribution to total increase in revenue	Contribution to deviation from the forecast
	NIS billion		Percent		
Total tax revenue	255.7	261.2	6%	100%	100%
Revenue from direct taxes	126.2	127.8	10%	77%	103%
of which: Income tax on employees and executives	50.7	52.3	7%	22%	19%
Income tax on companies and self-employed	45.5	46.1	9%	26%	34%
Capital gains tax	4.0		1%	0%	
Real estate taxes	7.8	7.2	36%	18%	32%
Employers' payroll taxes	13.1	13.7	3%	2%	-2%
Revenue from indirect taxes	123.5	127.0	2%	18%	-6%
of which: VAT (net)	85.7	87.5	3%	19%	11%
of which: VAT on imports (gross)	45.1		-6%	-17%	
Domestic VAT (gross)	74.1		9%	43%	
of which: VAT on new homes[c]	5.9		28%	10%	
VAT refunds	-33.5		4%	-8%	
Import purchase tax	17.5	17.8	-6%	-6%	-13%
Customs	2.8	2.9	3%	1%	0%
Domestic taxes excluding VAT	17.5		5%		
of which: Fuel excise	16.4	17.4	5%	5%	-2%
Imposts	6.0	6.4	12%	4%	3%

[a] The data are according to the Israel Tax Authority definitions (including revenue transferred from the Compensation Fund).

[b] The forecast included in the proposed 2015 budget, which was approved in first reading by the Knesset on November 10, 2014, but not advanced thereafter. The forecast was compiled in August 2014. The forecast does not include the effect of tax changes proposed in the proposed budget.

[c] Estimate. For details on the calculation, see Note 22 in the body of the chapter.

SOURCE: Based on data from the State Revenue Administration and the Israel Tax Authority.

(2006–2007). The decline was influenced mainly by reductions in income tax rates in the previous decade and by strong capital gains revenues before the crisis.

Tax collection accelerated in 2015 even though the (real) GDP growth rate was stable. The increase was abetted by the strong labor market, lively activity in the housing market, an increase in private consumption, and weakening of the restraining effect of tax hikes that had gone into effect in 2013—an effect that generally crests in the first two years after changes are implemented and recedes thereafter.[20]

The acceleration of tax revenues was influenced by the fact that the composition of economic activity was tax-intensive and contributed to high revenue from the real estate market, the labor market, and corporate profits.

[20] According to an estimate derived from Brender and Politzer (2014), the slackening of the restraining effect of previous years' tax changes contributed NIS 1.5 billion to tax revenue in 2015. For details on the dynamic effect of changes in taxation, see Brender and Politzer, (2014), "The Effect of Legislated Tax Changes on Tax Revenues in Israel," Bank of Israel Discussion Paper 2014.08.

Both average wages and the number of employees increased by 2.3 percent in 2015 compared with 2014, leading to an increase in total wage payments that contributed to an 8 percent increase in income tax revenue from employees and executives[21]—one-fourth of the total increase in collection relative to 2014 (Table 6.2). In the housing market, there was buoyant activity in the reviewed year, following moderation in the middle of 2014 as homebuyers waited for the "zero VAT" program on new homes to go into effect. Given the boom in this market, the government raised the purchase tax on homes bought by investors—a countercyclical measure specific to the housing market and investors active in it. By the time it went into effect, however (at the end of June 2015), investors had set in motion a spike in homebuying in an attempt to avoid having to pay the higher tax rate. Against the background of the vigorous activity in this market, direct real estate tax revenues increased by 36 percent in 2015 compared with 2014, and estimated revenues from VAT on new homes climbed by 30 percent.[22] The increase in revenue from these taxes (which brought in 5.4 percent of total tax revenue in 2014) was equal to 30 percent of the total growth in tax revenue in the reviewed year. Revenues from these components amounted to NIS 18.2 billion in 2015—1.6 percent of GDP, half a percentage point of GDP greater than the average revenue from these two taxes in the second half of the previous decade, when the housing market boom began[23] (Figure 6.3). The proportion of these two taxes in total tax revenue increased from 4 percent in the middle of the previous decade to 7.6 percent in 2015. The large number of new home sales in the past two years will also lift VAT revenues in 2016 because payments for these homes will spill into that year.[24] In addition to these factors, corporate earnings increased in 2015, boosting revenue from

Revenue from direct real estate taxes and from VAT on the sale of new homes contributed about 30 percent of the total increase in tax revenue in 2015, five times these taxes' share of revenue in the previous year.

Taxes from the real estate industry in 2015 were half a percentage point of GDP (about NIS 6 billion) greater than in the second half of the previous decade, when the housing market boom began.

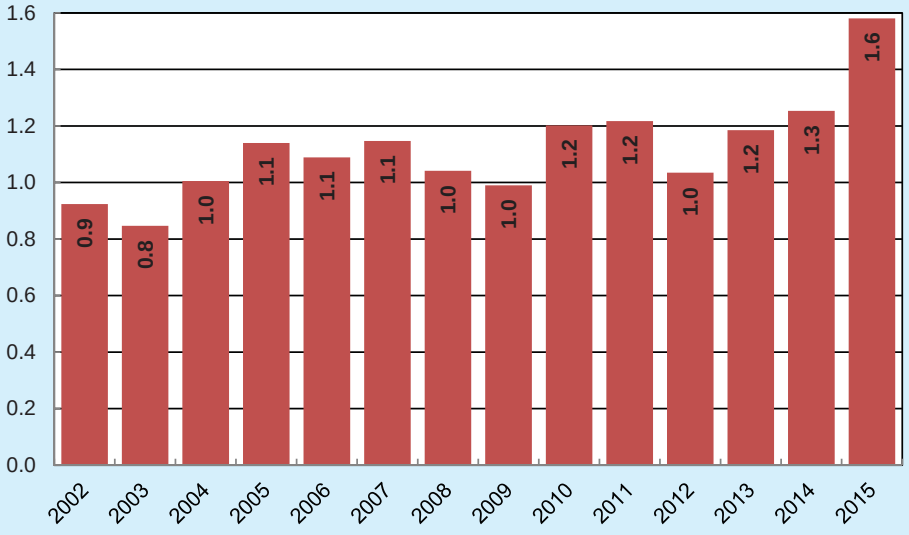
[21] Even as wages rose, tax brackets declined slightly due to the negative CPI, augmenting the (nominal) increase in revenues even more.

[22] Collection of VAT on new homes is an estimate based on the value of transactions executed each year and reported to the authorities (sources of data: State Revenue Administration and the Carmen database of real estate transactions). Since actual payments for the purchase of a home are sometimes spread over a lengthy time, VAT revenues on account of the purchase are not received in full in the year of the purchase. To estimate payments actually made each year, we used Central Bureau of Statistics data on the length of time for which new homes sold each year were on the market (average for 2012–2015) and assumed that the payments for a home are spread across the years in a linear manner from point of sale to completion of construction—three years after the new home enters the market. In other words, the payments for a home sold in its first year on the market are spread over three years and the full payment for a home sold in its third year on the market is received that year.

[23] It is worth noting that the real estate boom evidently helped to boost state revenues in additional ways that we cannot estimate directly at the present time. They include collection of income tax on the wages of those employed in the construction industry, corporate tax on the earnings of firms in the industry, VAT on construction inputs and services relating to new homes that were not sold, and taxes on industries that are indirectly affected by the housing market. In addition, the surging real estate market augmented municipal revenues as well as state revenues from land sales.

[24] It is estimated that transactions executed in 2014 and 2015 will contribute some NIS 4 billion to revenues in 2016 and NIS 2 billion in 2017.

Figure 6.3
Estimated VAT Revenue on New Homes and Direct Real Estate Tax Revenue, 2002–15 (percent of GDP)



SOURCE: Based on Ministry of Finance (Chief Economist), CARMEN real estate data register, and Centreal Bureau of Statistics.

income tax on corporate and self-employed earnings by 9 percent[25]—one-fourth of the total year-on-year increase in tax revenue. The increase in earnings was probably supported by in the increase in output prices and, foremost, by a decline in import prices (foremost those of energy). Net of VAT revenue on new homes, total (net) VAT revenue increased in 2015 by a moderate rate of 1.6 percent compared with 2014, explaining 8 percent of the increase in tax revenues. *Domestic* VAT revenue (gross, excluding new homes) increased by 8 percent—abetted by the increase in private consumption—but this rise was offset by an increase in VAT refunds and a 6 percent decline in VAT revenue from *imports* (gross). The latter decline was influenced by falling prices of imported commodities and the bringing forward of vehicle imports to the end of 2014 in order to avoid the tax hikes that went into effect in January 2015. The VAT rate was lowered from 18 percent to 17 percent toward the end of the year. This measure had no material effect on revenue in 2015. Most of its impact will be felt in 2016.[26]

[25] Corporate tax revenue was almost unchanged from 2014. This, however, was because exceptional income from several large transactions in 2014 led to especially strong revenue in 2014. Income tax revenue from the self-employed was 31 percent higher in 2015 than in 2014. Another factor that may have reduced corporate tax revenue in late 2015 was the expectation of a reduction in the rate of corporate tax in 2016. Large firms may have found it easier to shift activity and recording of earnings to the coming year in order to benefit from the reduced tax rate.

[26] The Ministry of Finance's assessment is that the reduction lowered VAT revenues in 2015 by NIS 0.8 billion (static estimate).

Tax revenue in 2015 surpassed the forecasts in the (unapproved) draft budget—compiled in August 2014—by NIS 10.5 billion. The difference traces mainly to mistaken forecasts of the increases in private consumption, employment, wages, and activity in the real estate market, and to underforecasting of the increase in output prices. In the budget discussions for 2015–2016, the new government was presented with an updated forecast. Even so, due to strong revenue in July–August (also influenced by lively activity in the real estate market ahead of the increase in purchase tax on investors), by September actual revenue exceeded the monthly distribution in the updated forecast by an aggregate NIS 4 billion. In view of the surplus, the government made tax cuts—lowering the rate of VAT by one percentage point (to 17 percent) from October onward and cutting the corporate tax rate from 26.5 percent to 25 percent starting in 2016. The cost of these reductions is estimated at NIS 5.7 billion per year.[27] (For their effect on the deficit, see Section 4 below.)

Following the surplus revenue in July–August, the tax revenue forecast submitted to the Knesset within the framework of the new budget exceeded the previous projections, and at year's end actual tax revenues resembled those in that forecast. In contrast, non-tax revenues surpassed the forecast in the budget by NIS 3.3 billion (Table 6.5) at NIS 31.4 billion, 17 percent higher than in 2014. This was the main reason for the surplus of revenue relative to the forecast set forth in the new budget. The increase in these revenues was mainly due to an increase in National Insurance surpluses (which are recorded as revenue in the government budget) consequent to below-forecast benefit payouts and an increase in collection of National Insurance contributions due to higher employment and wages.

3. GOVERNMENT EXPENDITURE

While the real increase in civilian consumption per capita slowed, domestic defense consumption continued to grow vigorously. The decline in the Consumer Price Index and demographic changes contributed to a marked real increase in per capita transfer payments.

The public expenditure of general government, net of interest payments, increased by 4 percent in nominal terms in 2015 compared with 2014 (Table 6.3). While the real increase[28] in *civilian* consumption per capita slowed from 2 percent in the previous five years to 0.9 percent in the reviewed year, domestic *defense* consumption grew at a vigorous 3.5 percent pace—as it had in 2014, when all expenses related to Operation Protective Edge were paid for.[29] Defense consumption grew more rapidly in the past two years than in previous years. Transfer payments (chiefly benefits) are another component of public expenditure, and per capita expenditure on current transfer

[27] This is a static estimate. Since tax cuts are supportive of economic activity, the resulting loss of revenue is smaller, particularly in the first two years of their effect. See Brender and Politzer (2014).

[28] The real increase was calculated by deducting the change by the Public Consumption Price Index, which went up by 1 percent in 2015.

[29] The quality of many government-provided public services depends on per capita expenditure, whereas the level of security that the state provides hinges on total, not per-capita, defense expenditure. Therefore, the comparison is made between *per capita* civilian expenditure and total defense expenditure. It is worth noting that the growth rate of *total* civilian expenditure was also lower in 2014 and 2015 than that of defense spending.

Table 6.3
Rates of nominal increase of public expenditure in Israel, 2000–15

	Average 2000–2009	2010	2011	2012	2013	2014	2015
Total public expenditure	**4.0**	**4.7**	**4.4**	**8.3**	**6.3**	**2.7**	**4.7**
of which: Interest payments	1.4	1.3	-6.9	7.2	2.1	-2.1	14.9
Total primary expenditure	**4.3**	**5.0**	**5.5**	**8.4**	**6.7**	**3.1**	**4.0**
of which: Current primary expenditure	4.3	5.9	5.8	7.8	6.3	3.7	4.4
Current primary civilian expenditure	4.6	6.3	6.3	8.4	6.8	3.4	4.6
Public consumption	4.2	6.4	5.8	7.7	6.6	3.8	4.2
Public consumption excluding defense imports	4.5	6.2	5.9	7.1	7.0	3.4	4.5
Civilian consumption	4.7	7.1	7.2	8.4	7.3	3.5	4.1
(Per-capita civilian consumption)	2.6	5.2	5.3	6.4	5.3	1.6	2.1
Wage expenditure	3.7	8.9	7.2	8.4	6.7	4.2	4.8
Purchases	6.0	5.8	7.8	8.3	9.2	2.7	3.0
Domestic defense consumption	4.1	3.4	3.2	2.6	4.7	3.9	4.7
Wage expenditure	3.0	3.3	3.4	3.9	4.3	2.2	3.0
Transfer payments on the domestic current account	4.6	5.6	5.2	7.3	4.8	3.5	5.5
(Per-capita transfer payments on the domestic current account)	2.6	3.7	3.3	5.3	2.9	1.5	3.4
Investments of the general government	1.9	3.8	9.8	13.3	8.0	0.1	3.1
of which: Land transport infrastructure	15.2	2.6	-0.3	17.1	60.6	-9.1	-21.7
Transfer payments on the capital account	7.9	-8.0	-4.6	14.2	12.6	-3.7	-3.7
Change in the CPI (annual average)	2.0	2.7	3.5	1.7	1.5	0.5	-0.6
Change in the GDP deflator	1.6	-0.1	1.0	3.9	2.0	0.7	3.0
Change in the public consumption price index	2.1	3.8	3.3	3.8	2.5	0.4	1.2
Change in nominal GDP	5.4	7.1	6.9	6.9	5.5	3.6	5.2

SOURCE: Based on Central Bureau of Statistics data.

payments increased by 4.1 percent in real terms[30] in 2015—much faster than in the previous five years (1.4 percent). The acceleration was abetted by demographic changes and a real increase in the purchasing power of transfer payments due to the decline in the Consumer Price Index. (National Insurance benefits are not adjusted when the index falls.)

[30] Since transfer payments are largely used by households, their real rate of increase was calculated by deducting the change in the Consumer Price Index, the annual average of which was 0.6 percent lower in 2015 than in 2014.

Since the increase in nominal GDP in 2015 outpaced the increase in expenditure, noninterest civilian expenditure as a share GDP declined from 31.1 percent in 2014 to 30.7 percent in the reviewed year—very low by international standards. (See elaboration in Section 1 above.) Government ministries spent NIS 326 billion, NIS 3.3 billion less than the sum planned for this purpose in the budget for the year, approved in November (Table 6.5). Defense expenditures exceeded the original budget whereas those of civilian ministries fell short of it. Government domestic expenditure was NIS 3.6 billion below what was planned.

As part of the new budget, the government increased expenditures beyond the level derived from the expenditure rule, for the most part permanently. The expenditure rule dictates a low increase in total expenditure, which makes it difficult for the government to respond to social and defense requirements and needs.

Within the framework of its budget for 2015–2016, the government raised its spending level beyond the increase set forth in the expenditure rule. The measures that will allow the spending ceiling to be overrun, as stated, reflect the government's difficulty in responding to social and defense needs and demands within the spending limit that it had adopted. Had the exceptions to this rule not been made, public expenditure as a share of GDP would have contracted, despite the very low civilian expenditure by international standards. The expenditure rule had effectively held the annual increase in spending to 2.66 percent. The measures taken will allow a faster rate of growth.

First, the government explicitly resolved to increase spending in 2015 by an additional 2 percent "due to the accumulation of past liabilities and coalition agreements."[31] This is a permanent increase that went into effect at that point. Second, the government decided not to correct the budget aggregates after inflation slipped below the forecast on which the 2013–2014 budget was based—a decision that in retrospect was the equivalent of an additional real (and permanent) 2.4 percent increase in spending.[32] The two measures together boosted expenditure by NIS 14 billion in 2015 terms (1.2 percent of GDP) beyond the level derived only from the expenditure rule.[33] The spending increase occasioned by these measures exceeds the NIS 3.75 billion (permanent) spending cut that the government had resolved to make in late 2013.[34] Third, the government decided to increase expenditure by another 0.25 percent (NIS 0.8 billion) in 2016, on a nonrecurrent basis. In addition to these measures, the budget that was approved for 2015–2016 was constructed on the basis of relatively high inflation forecasts in both budget years—forecasts that, in effect,

[31] Ministry of Finance (2015), *State Budget, Proposal for Fiscal Years 2015–2016, Main Provisions of the Budget and Multiannual Budget Program* (Hebrew).

[32] The CPI forecasts in the 2013–2014 budget were 1.7 percent and 2.3 percent in the respective years (*Main Provisions of the Budget* for 2015, p. 190)—4 percent in cumulative terms. In actuality, the CPI went up by 1.6 percent in those years.

[33] The government also adjusted the expenditure ceiling to accommodate a bookkeeping change that it had made, revising the recording of two National Insurance expenditures—admission grants for hospitals and medical expenses for casualties of workplace accidents—so that they would be recorded as part of government spending from 2016 onward. This change has no effect on the deficit or the extent of public expenditure as recorded in the Central Bureau of Statistics National Accounts.

[34] Concurrent with the spending cut, the previous government retracted a planned increase in income tax rates.

allow additional expenditure to take place during those two years.[35] The gap between the budget forecasts and actual inflation in 2015 and the prevailing inflation forecasts for 2016 have the effect of an additional NIS 6.5 billion (real) increase in expenditure (0.6 percent of GDP). Unless the gap is corrected in the next budget (for 2017), the spending increase will become permanent. Given the difficulty in predicting the inflation rate and the need for retroactive corrections, it is recommended that the government switch to nominal-based budgeting that would index expenditure not to the actual change in the CPI but to a permanent price increase of 2 percent per year (the midpoint of the price stability target range).[36]

Wage expenditure

The total wage expenditure of the government sector[37] increased (in nominal terms) by 3.7 percent in 2015 relative to 2014 and came to NIS 73.5 billion—the result of 1.9 percent average wage growth in this sector and a 1.8 percent increase in the number of employees (an additional 10,000 employees).[38] The government and the Histadrut agreed in late 2015 on principles for a new public sector wage accord. The agreement, intended to cover the 2013–2017 period, will include a 7.5 percent increase in the basic wage, implemented incrementally in 2016–2018. It was also agreed that public sector employees would receive a NIS 1,000 grant in each of the years 2016 and 2017. The principles of the accord portend a real increase in the wages of persistent employees (those who continue to work) in the government sector at an annual pace of 2.5 percent in 2015–2019—identical to the average pace in the preceding five years.[39,40] The government and the Histadrut agreed that at least half of the wage increase (7.5 percent) in every public entity would be given as a uniform shekel raise for all employees of that entity and the rest would be awarded relative to each

According to the principles of the public sector wage agreement, the real increase in wages of persistent employees in the sector is expected to remain the same as the pace of increase in the past few years.

[35] The forecast in the budget set inflation at -0.2 percent in 2015 and 1.5 percent in 2016. Actual inflation in 2015 was -0.6 percent and the prevailing outlooks at the beginning of 2016 speak of -0.1 percent inflation in the latter year.

[36] For discussion of this proposal, see the Bank of Israel *Annual Report* for 2013, Chapter 1 (pp. 35–36).

[37] Central Bureau of Statistics data. The government sector is composed of the central government (including the National Insurance Institute and the National Institutions), municipal government, and public nonprofit organizations.

[38] Based on the average monthly workforce in the government sector for 2015. Other public service institutions and firms—mainly private nonprofits—added approximately 22,000 employees in 2015.

[39] This growth rate does not include wage creep occasioned by upward movement in public sector employees' seniority and grade—a process that raised persistent employees' real wages by an annual real rate of 2.1 percent in 2010–2014. To perform the calculation, we assumed that the nominal average wage in this sector rises by 1.9 percent each year due to particular agreements beyond the wage accord that covers all workers in the public sector or for other reasons. This rate of wage growth (1.9 percent beyond wage creep) was attained in 2014, when there was no wage accord in effect for the public sector at large. It is worth noting that this rate of increase relates to persistent employees only. To calculate the average wage of all public sector employees, the rate of retirement of persistent (high wage) employees relative to the pace of entry of new (low wage) workers should also be factored in.

[40] To calculate the real increase, we assumed that inflation would gradually return to the middle of the price stability target: -0.1 in 2016, 1.5 percent in 2017, and 2 percent per year from 2018 onward.

worker's wage. The agreement concluded in this matter, like the two uniform grants included in the accord, will help to narrow disparities among workers within every public sector body.

Benefits and long-term savings for children

The savings scheme for children will help families that already set aside a certain percent of their income for their children's savings, will in the future help parents who support their children as they begin their adult lives, and could encourage planning for the future and the accumulation of assets.

The government and the Knesset earmarked some of the expenditure increase in the new budget for supplemental spending on social services, including child allowances and income maintenance benefits for the elderly. The previous government, in 2013, reduced the child allowance and set it at a flat rate of NIS 140 per month per child, irrespective of the positioning of the child in the family. The new government restored differentiality in the child allowance, paying a smaller benefit for a family's first child than for others.[41] It also deferred a NIS 50 increase in the monthly benefit for each child to 2017, earmarking the increase (retroactive to mid-2015) for savings for each child up to age eighteen. The decision flowed from the government's need to defer some of the spending related to the implementation of its coalition agreements to the 2017 budget in order to avoid an immediate additional increase in the deficit. The cost of the enlargement of the benefit is around NIS 1 billion and that of the outlay for savings is NIS 1.64 billion per year. The twin supplements will bolster expenditure on child benefits by 54 percent relative to 2014 (when NIS 4.9 billion was spent on these benefits). Even after the spending increase, government support for families with children in Israel will remain low by international standards.[42]

The savings scheme for children does not efficiently help families with low incomes who do not save, since compared to an increase in current benefits, the scheme may push off investments in children's schooling and welfare that would have been possible with an increase in current benefits.

The savings scheme will directly help families that already set aside a certain percent of their income for their children's savings: It will give them government funding for medium-term savings, at low management fees and with an additional monetary grant at the time of withdrawal.[43] These families will also be able to deposit additional funds in the account, up to the total child allowance (or a lower sum as determined by the Minister of Finance); in the absence of additional benefits, however, the incentive to do this is small (as the earnings are not tax-exempt). In contrast to households that already save, and in comparison with the alternative of redirecting the cost of the program to an increase in the current child benefit, the state-sponsored savings scheme is not the most efficient way to help families that have liquidity constraints and need additional income to cover their childraising expenses *in the present*. Data from the Central Bureau of Statistics Household Income and Expenditure Survey for 2014 indicate that households with children in the three lowest income deciles belong to this population of families and, on average, do not save. Therefore, by and large,

[41] The benefit will rise by NIS 10 per month for each family's first and fifth children and by NIS 48 per month for second, third, and fourth children.

[42] See Adi Brender and Michel Strawczynski (2015), "Government Support for Young Families in Israel," *Israel Economic Review* 12:2, pp. 1–49.

[43] The law awards an additional NIS 500 upon withdrawal of the account at age eighteen and raises the sum to NIS 1,000 if the funds in the account are left there until age twenty-one. The increases were given in order to compensate for payments of tax on earnings in the account. Withdrawal of the funds at age eighteen effectively provides a full refund of the tax payments if the annual accrued (real) return is 1.8 percent; withdrawal at age twenty-one does the same even at a 2.5 percent annual (real) return.

they will not benefit from the government's savings arrangement today.[44] By means of the savings, the government is effectively forcing households to transfer some of the benefit funds to a closed account. By so doing, it may thwart investments in children's schooling and welfare at an early age—investments that might be made if the current benefit were increased. Early investments of these kinds are usually more useful than investments at a later age.[45] The governmental savings arrangement will directly support children only in the future, when they become young adults and can draw on the savings as an asset. The scheme will then provide all young people with initial capital that will help them take independent steps and will lessen the implications of asset inequality among young households. Among other things, the existence of such an asset will enhance financial resilience and, in turn, help to cope with risks (e.g., the kind associated with opening a new business or coping with the loss of a job); it will also help in making investments that will pay off in the future (e.g., in further education).

Farther ahead, the government's savings plan may be indirectly supportive of young adults' parents, who are often asked to help their children to acquire schooling or set up their families. (However, insofar as parental support accrues to young families that have children, an increase in current benefits would also be helpful by reducing the support that grandparents are asked to provide.) Data from the 2014 Household Expenditure Survey suggest that young households receive appreciable sums in aid. Households headed by people aged 18–29 obtain, on average, NIS 469 per month in support from other households.[46] Young ultra-Orthodox households, which for the most part begin family life at earlier ages, receive more (NIS 731). The support decreases steadily as heads of household age. Beyond parental support, the deferral of part of the child benefit may also lessen the disincentive to work among parents of children. This, however, is a temporary advantage (because the money will be available to the household in the future) that focuses mainly on households that have liquidity constraints.

[44] We calculated the savings of households that participated in the survey as the difference between income and spending. It is possible, however, that some households' spending includes items that are effectively a type of saving. This may occur among ultra-Orthodox households that donate to free-loan institutions (known by the Hebrew acronym GMACH) that may provide them with contributions and interest-free loans in the future. The expenditure survey data indicate that ultra-Orthodox households with children that belong to the three lowest deciles contribute NIS 262 per month to "enterprises and institutions" compared with NIS 30 per month among other households with children in the same deciles.

[45] Temple and Reynolds (2007), for example, present evidence from the United States that an investment in preschool education is more effective in cost-benefit terms than an investment in education at a later age, improving scholastic achievements years afterward and mitigating criminal involvement. See J.A. Temple and A.J. Reynolds (2007), "Benefits and Costs of Investments in Preschool Education: Evidence from the Child-Parent Centers and Related Programs," *Economics of Education Review*, 26, pp. 144–126.

[46] Not including parental support of children who continued to live with them.

Programs that encourage savings exist in other countries as well. Most of them, however, are not universal and target low-income households that do not save.[47] Advocates of these plans claim that they are useful for such families as well because they encourage planning for the future, promote the accumulation of assets, are helpful in financial education, and provide an accessible tool for savings growth. Given the low level of support for families with children in Israel and in comparison with the alternative of increasing the current benefit, it is not clear whether these advantages surmount the risk that the savings would defer to age eighteen investments in children's welfare and education that might take place if the current benefit is increased.

***

Total expenditure on child benefits was 0.45 percent of GDP in 2014—40 percent lower than in 2012 before the previous government reduced the child allowance (Figure 6.4). The new government's measures will allow this benefit's share of expenditure to rebound. Even after this happens, however, expenditure on child benefits will remain below its level at the beginning of the previous decade, contributing to the fact that the support that Israel offers young parents is low by international standards.

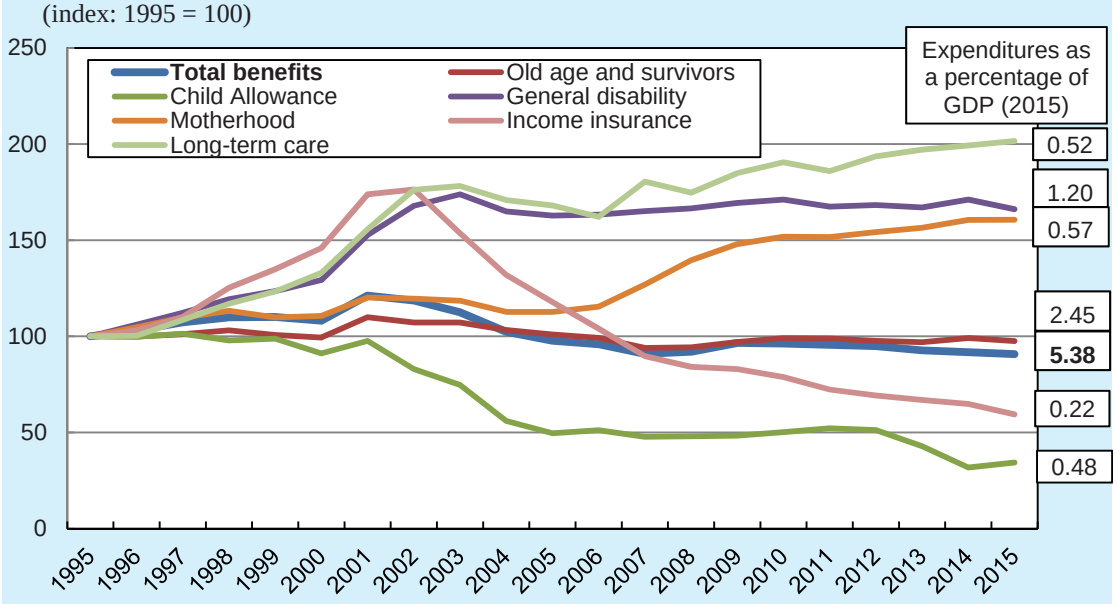
Total expenditure on National Insurance benefits was 5.5 percent of GDP in 2015. As a share of GDP, expenditure on child allowance and income insurance payments declined over the past decade, while expenditure on payments related to childbirth and long-term care increased.

Total expenditure on National Insurance benefits was 5.5 percent of GDP in 2015—basically unchanged from two years previously. In the past decade (2006–2015), income maintenance expenditure as a share of GDP plummeted (by 43 percent) and settled at about 0.25 percent of GDP at the end of that interval. The decrease was affected both by the toughening of eligibility terms for the benefit in the early 2000s and by the booming labor market and the increase in the employment rate (factors that themselves were influenced by the cutback in benefits). Concurrently, maternity expenditure (including payments to new mothers and for births) increased by 39 percent, to 0.6 percent of GDP in 2015. The increase was influenced by increases in the number of women of childbearing age who participate in the labor force (and therefore qualify for maternity benefits) and in the payment of hospitalization grants to hospitals—a benefit that is meant to finance neonatal care but also serves de facto as a subvention for general hospitals.[48]

[47] The UK awards a tax exemption on capital gains and interest earned on Junior Individual Savings Accounts, which allow withdrawals for any purpose but only at age eighteen. The exemption is universal, i.e., irrespective of household income, but is limited to £ 4,000 per year. In 2011, the government discontinued a program in which it itself deposited funds in savings plans such as these (the Child Trust Fund). In other countries, such programs are not universal; they focus on encouraging saving among low-income persons, irrespective of their having children. In these plans, the government or a philanthropic entity deposits funds in a savings account for every deposit made by the account holder (matching) or after a predetermined saving target is attained. These schemes often entail financial stewarding or education for the household. They exist in Australia (Saver Plus / Matched Saving Scheme) and, partially, in Canada (learn$ave) and the United States (IDAs).

[48] In the 2015–2016 budget, the government approved the recording of hospitalization grants as an expenditure of government ministries and not as a National Insurance outlay.

Figure 6.4
Expenditures on Selected National Insurance Benefits, 1995–2015
(index: 1995 = 100)



SOURCE: Central Bureau of Statistics.

Expenditure on old-age and survivors' benefits has remained largely steady in the past decade—2.5 percent of GDP—but is expected to increase in the future as the Israeli population ages. Population aging is also expected to necessitate more spending on long-term care benefits and related items[49], a form of expenditure that has been rising steadily in the past decade and amounted to around 0.5 percent of GDP in 2015. The government decided to increase its transfers to the National Insurance Institute each year, starting in 2016, for its participation in old-age and long-term care benefits, commensurate with the rate of increase in the relevant population. This important measure will help to reflect and internalize, in the budget, the implications of population aging for the payment of National Insurance benefits.

Expenditure on lowering the cost of living

The government decided not to set differential Value Added Tax rates and, instead, to lower public transport fares and basic water consumption prices[50] by increasing the subsidies for these uses, and anchoring the increase in a law.[51] The Ministry of Finance

[49] Additional payments related to long-term care are made for the development of community services, an increase in the number of inpatient admissions, and dependency tests.

[50] Water consumption in the lowest bracket is limited to 3.5 m³ per person per month but no less than 7 m³ per dwelling.

[51] The statute relating to public transport fares is the Public Transport Fares Law, 5766–2016. Legislation that would make the subsidization of water rates permanent has not yet passed.

The government's decision not to set differential Value Added Tax rates is welcome, since such a measure would have increased opportunities for tax evasion. Subsidizing water and public transit prices is more helpful to low-income households than were previous proposals.

estimates the cost of these measures at around NIS 1 billion per year. The avoidance of differential VAT is welcome because multiple VAT rates create opportunities for tax evasion and may lead to additional exemptions in the future, the cost of which would not be weighed against other expenditure items. Securing the lowering of prices in legislation gives the measures enhanced stability, the very goal that the supporters of differential VAT wished to achieve. Relative to proposals to introduce a reduced VAT rate on food, under the step approved low-income households will benefit from a larger share of the costs. This share, however, remains smaller than that achieved by a measure that would introduce an additional increase in benefits[52] (e.g., earned income tax credits for low-wage workers[53]).

The reduction of water prices encourages increased water consumption—a measure that does not contribute to the well-being of the economy.

Subsidizing water encourages greater consumption of water[54]—an increase that has no substantial positive externality—and therefore may hurt total welfare. Admittedly, it is not clear how much the rate cut will affect inelastic demand for this good. However, since subsidization has to be paid for from tax revenues[55] or by withholding additional budgets from public goods and other public services that are provided mainly by government (such as education and healthcare), this inefficient measure may be detrimental to welfare. In addition, the subsidy is harmful to the closed-budget water economy, in which rates are supposed to reflect the cost of producing and delivering water to consumers.

Reducing public transit fares also encourages the public to use more of this service.[56] However, since the use of public transit creates positive externalities even for those who do not use it (e.g., by reducing road congestion and air pollution), the use of taxpayer money to encourage and subsidize it enhances the welfare of the entire economy. Aside from lowering the fares, measures that enhance the availability and quality of public transit will also encourage the use of public transit and make it a better alternative to private vehicles—helping to lower citizens' cost of living even if fares are not cut. From the mid-1990s to the early 2000s, bus system availability relative to

[52] Some 26 percent of the cost of a benefit relating to bus and rail fares would reach households in the two lowest income distribution deciles, as opposed to 17 percent in the case of a reduction in VAT on food. Around 36 percent of any increase in child benefits would reach these households. For elaboration, see the Bank of Israel *Annual Report* for 2014, Chapter 6.

[53] In early 2016, the government expanded citizens' eligibility for the Earned Income Tax Credit to single-parent households and persons with disabilities. Even afterwards, however, the level of the credit and public expenditure on active labor market policies remain low by international standards.

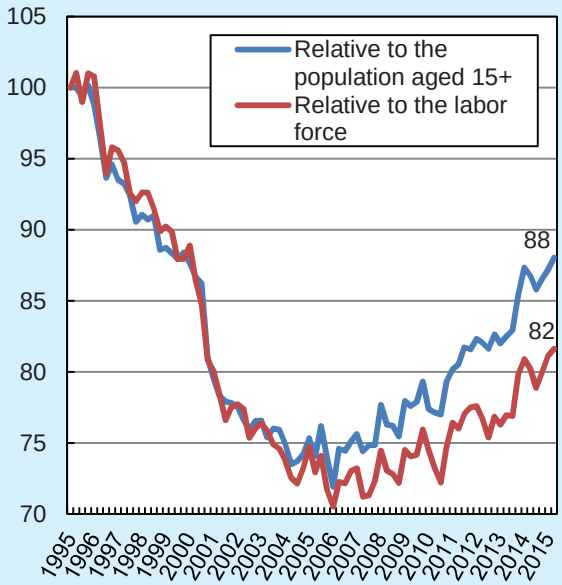
[54] Since the price is subsidized only in the basic consumption bracket, its impact is limited. The 2014 *Household Expenditure Survey*, however, shows that some 40 percent of households (936,000) consume water at lower cost than the ceiling of the basic quantity to which they are entitled. These households can, on average, increase their consumption by 60 percent (around 5 m^3 per month) until they reach the maximum consumption in the lowest bracket.

[55] From a macroeconomic perspective, this is equivalent to moving money from one pocket to the other. However, since there is a deadweight loss in taxation, "balanced" transfers such as these, which deliver no added utility, may be harmful to the economy at large.

[56] For example, Sharaby and Shiftan (2012) found that lowering transit fares as part of a comprehensive fare reform in the Haifa area in 2008 boosted public transit ridership considerably as people switched from private vehicles or taxis to buses. See N. Sharaby and Y. Shiftan (2012), "The Impact of Fare Integration on Travel Behavior and Transit Ridership," *Transport Policy*, 21, pp. 63–70.

potential demand deteriorated (as measured by an index that weights the number of buses operating on regular lines, the number of seats they offer, and the extent of trips that they make. The index does not take into account the growing use of interurban rail and the Jerusalem light rail[57]). In the past decade, in contrast, the availability index has been rising due to larger government investment in and support of the public transit industry and opening it to competition. Figure 6.5 shows that the marked increase in the labor force in the past decade has made it more challenging for the system to respond to potential demand and continue to improve availability—something that in itself supports employment growth (particularly among low income individuals). In further raising public transit subsidies, cost-benefit considerations should influence the choice between measures that would make fares even lower and those that would improve the availability and quality of bus and rail service.

Figure 6.5
Index of Bus Service Availability, 1995–2015 (1995 = 100)



SOURCE: Based on Central Bureau of Statistics data.

Defense expenditure

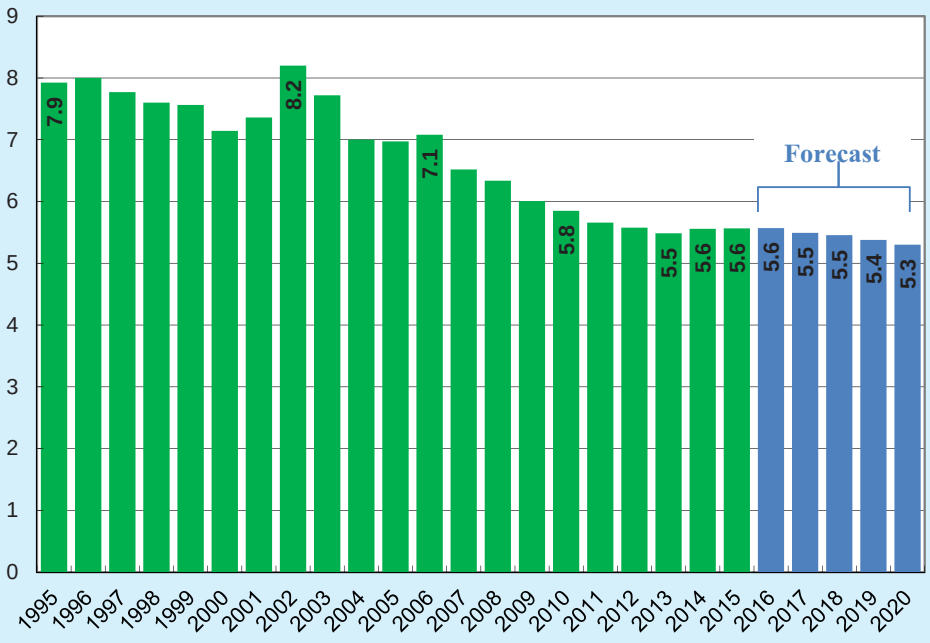
In November 2015, the ministries of Finance and Defense agreed on the defense budget for the next five years. The accord, the details of which are not yet fully known, includes an increase in the budget, full transparency of the budget vis-à-vis the Ministry of Finance, and solutions for several disputed matters, including revision of the IDF career service model and reducing the number of career service people to 40,000 by 2017. The agreement sets the annual budget of the Ministry of Defense in 2017–2020 at NIS 59 billion, awards a NIS 375 million budget supplement each year, and gives the Defense Ministry an estimated NIS 1–2 billion in annual compensation for price increases. It was also agreed that several matters would be budgeted separately and not included in the Defense Ministry budget. They include the IDF's move to the Negev,

[57] The index was introduced in the Bank of Israel *Annual Report* for 2009 (Chapter 2, p. 104) as the "Weighted Index of the Level of Bus Services." The index mainly examines elements of service availability and congestion on bus lines and does not weight factors such as timeliness, adjustment of lines to the population's travel characteristics, age and cleanliness of buses, and so on.

The agreement between the Ministry of Finance and the Ministry of Defense will continue the downward trend of defense expenditure as a share of GDP for the next five years.

defense of natural gas rigs, a basic allowance for conscript soldiers, phased reductions of the length of compulsory service in 2018 and 2022, and revision of the army's career service model. The accord, once implemented, will enhance certainty about the defense budget in the next few years and hopefully put an end to the interminable debates that surround it. The agreement will continue the steady downward trend in defense spending as a share of GDP in recent decades (Figure 6.6).

Figure 6.6
Past Defense Expenditure and Future Expenditure Based on the Outline Compiled by the Ministries of Defense and Finance, 1995–2020
(percent of GDP)



4. THE DEFICIT

The general government deficit declined by about half a percentage point of GDP to 2.4 percent of GDP. The cyclically-adjusted deficit declined by a greater percentage, mainly due to the adjustment to the low inflation and interest rates in the economy.

The general government deficit was 2.4 percent of GDP in 2015, compared with 2.8 percent in 2014. The cyclically adjusted deficit declined more steeply (by about 1 percentage point), to 2.1 percent of GDP[58], mainly due to the adjustment of income and expenditure to Israel's low interest and inflation rates and the widening of the domestic output gap relative to the previous year. It is worth noting that the cyclical adjustment of the deficit in this calculation is determined on the basis of the output gap for the entire economy and does not take separate account of the cyclicality of specific markets such as housing. Since the (cyclical) boom in the housing market

[58] Starting this year, the cyclically adjusted deficit is calculated relative to the potential GDP derived from the primary working-age population (25–64) and not the population at large. The primary working-age population has grown more slowly in recent years, slowing the potential growth rate of the economy.

made a major contribution to revenues in 2015, the decrease in the cyclically adjusted deficit would have been smaller had this effect been taken into consideration.[59] The cyclical adjustment also ignores the fact that the composition of growth (based on private consumption and not on exports and investments) is tax-intensive and induces an increase in tax revenue despite sluggish growth. The general government deficit has been falling for three years since it peaked at 3.9 percent of GDP in 2012; the downward trajectory is based on the fiscal stabilization program that was introduced as part of the 2013–2014 budget.

The central government deficit in 2015 was NIS 24.5 billion, 2.1 percent of GDP (Figure 6.4). The actual deficit was smaller than the lawful deficit ceiling for the year—both as set forth in the new budget (2.9 percent) and as determined in the previous one (2.5 percent). The deficit was lower than the ceiling established in the budget that was approved in November mainly due to higher than expected nontax revenues and underperformance of the budget. (This underperformance in 2015, as explained above, was only slightly higher than in years when there was an approved

Table 6.4
Central government deficit, revenue and expenditures, 2006–15

(percent of GDP)

	Average 2006–2010	2011	2012	2013	2014	2015
Total government deficit ceiling excluding credit granted	3.8	3.0	2.0	4.3	2.9	2.9
Total actual government deficit excluding credit granted	2.2	3.1	3.9	3.1	2.7	2.1
Actual government domestic deficit	1.0	2.0	2.9	2.2	1.8	1.2
Total net revenues[a]	**28.2**	**25.5**	**24.6**	**25.5**	**25.9**	**26.2**
Taxes and imposts	24.2	22.6	21.9	22.9	23.4	23.4
Interest, profits, royalties, revenue from land sales	0.8	0.4	0.4	0.5	0.3	0.4
Loan from the National Insurance Institute (NII)	1.8	1.5	1.4	1.3	1.3	1.4
US government grants	1.4	0.9	0.9	0.8	0.8	0.9
Total net expenditure[a]	**30.2**	**28.5**	**28.5**	**28.6**	**28.6**	**28.3**
of which: Interest, repayment of principal to NII and credit subsidy	5.3	4.8	4.7	4.5	4.5	4.3
Net defense expenditure[b]	7.3	6.4	6.2	6.1	6.3	6.1
Total net primary civilian expenditure	17.6	17.4	17.7	18.0	17.8	17.9

[a] Excluding credit granted by the government and excluding credit repaid to the government.

[b] Defense expenditure in this table is larger than defense consumption shown in Table 6.1 because the Central Bureau of Statistics records pensions and other payments by the defense establishment as transfer payments, while recording an imputation of compulsory service.

SOURCE: Based on the State Budget—Major Provisions of the Budget, Central Bureau of Statistics data, and State of Israel Financial Statements as of December 31, 2015.

[59] Something similar happened in the years preceding the Global Financial Crisis (up to 2007), when a capital market boom in most OECD countries contributed cyclically to a sizable increase in revenues. It is worth noting that while the cyclically adjusted deficit does not deflate the effect of cyclicality in the real estate market, it does take account of cyclicality in the capital market.

budget from beginning to end.) The government's domestic deficit was NIS 4 billion lower than its 2014 level (or NIS 5.5 billion net of the aforementioned supplemental transfer to the Compensation Fund).

The government raised the deficit ceiling for 2016 from 2 percent of GDP to 2.9 percent. The change was made in order to allow spending in excess of the increase set forth in the expenditure rule, at a permanent level of 1.2 percent of GDP, as well as a nonrecurrent supplemental increase of NIS 800 million to be spent in 2016. (See details in Section 3.) The permanent increase in expenditure was unbalanced, i.e., not accompanied by measures for an equivalent *permanent* increase in revenues, in the present or in the future.[60] The changes in taxation that the government resolved

Table 6.5
Components of the deviation from the government's original budget for 2015

(current prices)

		2015		
	Actual performance in 2014	Original budget (Nov. 2015)	Performance	Deviation
	(NIS billion, net, excluding credit)			
Deficit (-)	-29.9	-31.4	-24.5	6.9
of which: Domestic deficit	-23.3	-25.6	-19.7	5.9
Deficit abroad	-6.6	-5.9	-4.8	1.0
Revenue	282.9	297.6	301.2	3.6
of which: Domestic revenue	272.0	286.7	289.0	2.2
Taxes[a]	256.1	269.3	269.8	0.5
Loan from National Insurance Institute	14.5	14.6	16.4	1.8
Other revenue[b]	3.7	4.7	5.1	0.4
Grants from US government	8.6	9.0	9.9	0.9
Expenditure[a]	312.8	329.0	325.7	-3.3
of which: Domestic expenditure	298.8	312.3	308.7	-3.6
Expenditure abroad	14.1	16.7	17.0	0.3
Defense[c]	68.7	67.1	70.3	3.2
Interest, repayment of principal to National Insurance Institute, and credit subsidy	49.4	49.6	49.2	-0.4
Civilian ministries and transfer payments excluding miscellaneous	192.7	207.1	201.6	-5.5
Miscellaneous expenditures	2.6	5.7	4.7	-1.0

[a] Including VAT on defense imports.

[b] Revenue from interest, royalties, dividends and other sources.

[c] Including estimated transfers to defense from the economic reserve.

SOURCE: Based on the Accountant General's data on the performance of the 2015 budget.

[60] Several revenue-building measures in 2016 are nonrecurrent or reflect bringing forward approximately NIS 1.2 billion in expected revenues from ensuing years—an increase in royalties from the Airports Authority, the taking of dividends from state-owned enterprises, and a change in the fund for environmental cleanup operations (Ministry of Finance estimate, August 2015).

to implement actually amount to a structural cut in revenues, mainly because the reductions in VAT and corporate tax will reduce revenue by an estimated NIS 5.7 billion per year. These measures prompted an increase in the planned 2016 deficit and the deferral of the downward deficit trajectory to subsequent years.[61]

Enlarging the deficit has its advantages and disadvantages; the task of weighing them against each other belongs to policymakers and depends on their preferences and the extent of risk that they are willing to foist on the economy. Allowing the deficit to grow is advantageous when growth is slow and the domestic output gap is negative. A measured increase in the deficit is especially supportive of growth when the economy slows and when monetary policy tools are limited.[62] In such a situation, an appropriate fiscal policy may also help to attain the price stability target, first, because increasing the deficit in a way that stimulates domestic demand supports price increases, and second, if a temporary increase in the deficit induces a future increase in taxes on consumption, the expectations of such a tax hike will make current consumption less expensive than future consumption, encouraging greater consumption, much as an interest rate cut would.[63,64]

Temporarily enlarging the government deficit supports economic growth, particularly during slow periods and when monetary policy is limited in terms of the tools available to it. However, a structural increase of the deficit contains risks that may be realized in a future crisis.

It is true that the Israeli economy is not in a recession, its unemployment rate is at an historical low, and its growth rate in 2015 resembled that of the previous two years. In view of the continued lethargic growth, however, an increase in budget expenditure has countercyclical properties that are supportive of activity, as does the tax cut that the government decided upon in September. This cut was facilitated by, among other factors, the surging housing market, which gave tax revenues an upward push. (For elaboration, see Section 3 above.) Therefore, even if the VAT and corporate tax cuts are pro-cyclical in nature from the standpoint of revenue (i.e., they were made against the background of strong revenue), they serve as a countercyclical measure for the Israeli economy. Thus, the taxation policy allows the government to apply a stimulant fiscal policy to the economy at large and a restraining measure (for specific players)

The high tax revenues, due in part to the boom in the housing market, made it possible for the government to lower tax rates and to support economic activity. Since some of the revenue is cyclical or one-off, the reduction may increase the deficit in the future.

[61] To avoid a further increase in the reported deficit, the government chose to finance several construction projects with revenue from land sales, in contravention of international government accounting standards. These accounting measures reduced the deficit shown in the 2016 budget by NIS 3.5 billion (0.3 percent of GDP) but should be recorded in the performance data. For details, see Bank of Israel (2016), "Fiscal Survey: The Fiscal Situation for 2016 and Trends Expected over the Remainder of the Decade," *Recent Economic Events*, 140, April–September 2015.

[62] The fiscal multiplier—the ratio by which fiscal expansion affects GDP—is greater at times of slowdown and recession and also, evidently, when monetary policy is limited in what it can do. For an up-to-date overview of studies in this field, see IMF (2013), "Reassessing the Role and Modalities of Fiscal Policy in Advanced Economies," IMF Policy Paper.

[63] For details about a (theoretical) proposal to combine several types of taxes in order to emulate a monetary interest rate cut, see I. Correia, E. Farhi, J.P. Nicolini, and P. Teles (2013), "Unconventional Fiscal Policy at the Zero Bound," *American Economic Review*, 103(4), 1172–1211.

[64] If the deficit is increased by means of a (surprise) lowering of consumption taxes, as was done with this year's VAT cut in Israel, such an increase also has an immediate and nonrecurrent downward effect on domestic prices. Afterwards, the expectations of a rebound of the VAT rate in the future, if the cut is temporary, push toward an increase in demand and in prices.

in the housing market by raising the rate of real estate purchase tax that applies to investors.[65]

Deficit-increasing steps also come with disadvantages and risks. While it is true that when the government unveiled its tax cut, the Minister of Finance stated that it would be repealed if tax revenues were to decline, the economic and political challenge is to act countercyclically and revoke the tax cut precisely as the economy recovers and tax revenues *increase* (and not only due to revenues from a specific market—the housing market—or nonrecurrent developments)**.** In the absence of a binding blueprint for a future increase in tax revenues and given that the increase in expenditure has been pledged to long-term social goals, it is difficult to regard the policy's countercyclical support of economic activity as temporary. Therefore, support by cutting taxes means a future increase in the structural deficit beyond the trajectory set forth in the law. The risk of such a measure is that an additional crisis will propel the deficit to an excessively high level and impair fiscal credibility. The protracted decline in Israel's public debt mitigates this risk but the experience of developed countries in the most recent global recession shows that an acute crisis (in financial or asset markets) may trigger a steep decline in revenues that quickly causes the public debt to balloon when GDP is impaired. Therefore, debt levels that are considered "safe" have been lowered in recent years.[66]

5. THE PUBLIC DEBT AND ITS FINANCING

The public debt amounted to 64.8 percent of GDP at the end of the year—2 percentage points lower than in 2014 (Table 6.6). This marked decline was abetted largely by a rise in the denominator of the ratio—nominal product—due to the rapid increase in output prices. This coincided with a decline in inflation that, by lowering the indexed debt—which accounts for around half of the public debt—reduces the numerator of the debt to GDP ratio. The repayment of government-issued credit (chiefly in the form of subsidized housing loans) increased in 2015, channeling 0.5 percent of GDP in revenue to the capital account. Privatization revenues—largely from land sales—amounted to 0.3 percent of GDP. These two revenue sums helped to finance the government deficit and, in turn, allowed the government to refrain from further debt offerings. An international comparison shows that Israel's debt is below the OECD average (92 percent of GDP) and its protracted downward trend is the opposite of the upward movement that the developed countries have experienced since the global crisistoward the end of the last decade (Figure 6.1).

[65] While it is true that the measure had a stimulating effect on activity from the time expectations of an increase in purchase tax took shape until the time it actually happened, the effect was temporary. It is worth noting that the tax hike was not the direct precipitant of most of the increase in tax revenue from the housing market, but it did indirectly stimulate activity in the industry before it went into effect.

[66] IMF (2013).

Table 6.6
Components of the increase in the gross public debt, 2010-15

(percent of GDP)

	2010	2011	2012	2013	2014	2014
Debt at the end of the previous year	74.3	70.5	68.7	67.8	67.2	66.7
Nominal growth of GDP	-4.9	-4.6	-4.4	-3.5	-2.3	-3.3
Net capital inflow	1.3	1.3	3.7	3.3	1.7	1.7
of which: Government's cash deficit	3.4	3.1	3.9	3.1	2.7	2.1
Net repayment of credit by the public[a]	-0.7	-0.6	-0.4	-0.4	-0.4	-0.5
Privatization proceeds	-0.5	-0.8	-0.1	-0.1	-0.2	-0.3
Funding beyond the financing deficit[b]	-1.0	-0.4	0.3	0.7	-0.5	0.4
Revaluation of the shekel-denominated indexed debt[c]	0.9	0.7	0.5	0.5	-0.1	-0.3
Revaluation of foreign currency-denominated debt	-0.6	0.7	-0.2	-0.6	0.9	0.0
Adjustment to issuance costs	-0.2	-0.2	-0.3	-0.3	-0.3	-0.2
Remainder[d]	-0.3	0.3	-0.1	-0.1	-0.4	0.1
Debt at year end	70.5	68.7	67.8	67.2	66.7	64.8

[a] Including the provision of credit and principal collection.

[b] Funding surplus.

[c] Effect of the increase in the Consumer Price Index during the year on indexed debt.

[d] As a result of roundings.

SOURCE: Bank of Israel.

Interest payments on the public debt, relative to GDP, declined markedly in the past decade, and are close to the OECD average.

Government interest payments were 2.8 percent of GDP in 2015, larger than in 2014. Annual interest payments are 1.7 percentage points of GDP lower today than on average in the previous decade (2000–2009). Adjusted to the international definitions, interest payments in 2015 were 2.5 percent of GDP, still above the OECD average but no longer seriously aberrant among organization members (Figure 6.7).

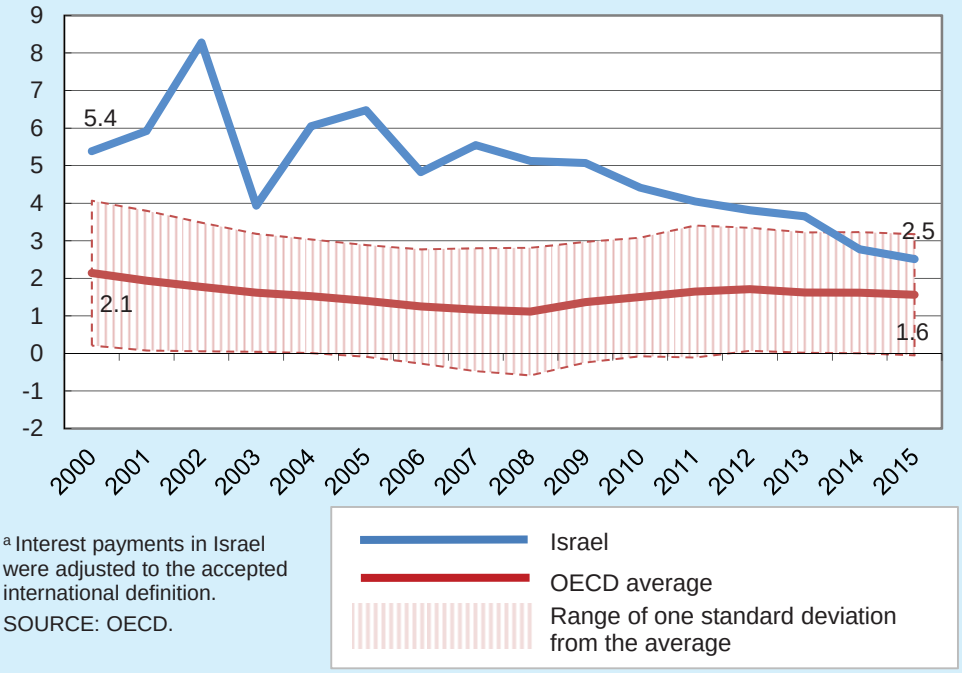
The time to maturity of tradable bonds issued by the government this year—9 years—was longer than in 2014 and lowered the risk inherent in refinancing of the debt.

The cost of tradable debt offerings[67] in 2015 resembled that in 2014 where indexed debt was concerned (average gross yield: 0.6 percent) but declined in respect of nonindexed debt (from 1.8 percent to 1.3 percent). The maturation of tradable bonds issued became much longer—from 7.8 years in 2014 to nine in the reviewed year—mitigating the implicit rollover risk. Some 30 percent of total proceeds were generated in offerings of designated bonds to pension funds—a large share that was basically unchanged from 2014. In the secondary market, the ten-year sovereign yield was 2.1 percent at the end of 2015—0.3 percentage points lower than in 2014 but 0.6

[67] Not including issues that are part of swap auctions.

percentage points higher than the low point that occurred in April 2015. At year's end, the yield spread between these bonds and the average among similar bonds of other developed countries was 0.9 percentage points (Figure 6.8)—0.3 percentage points less than a year earlier and 1.6 percentage points less than the wide spread observed in September 2012—a decline abetted by the fiscal stabilization program that was carried out in the interim.[68]

Figure 6.7
Burden of Interest Payments on the Public Debt in Israel[a] and in the OECD, 2000–2015 (percent of GDP)

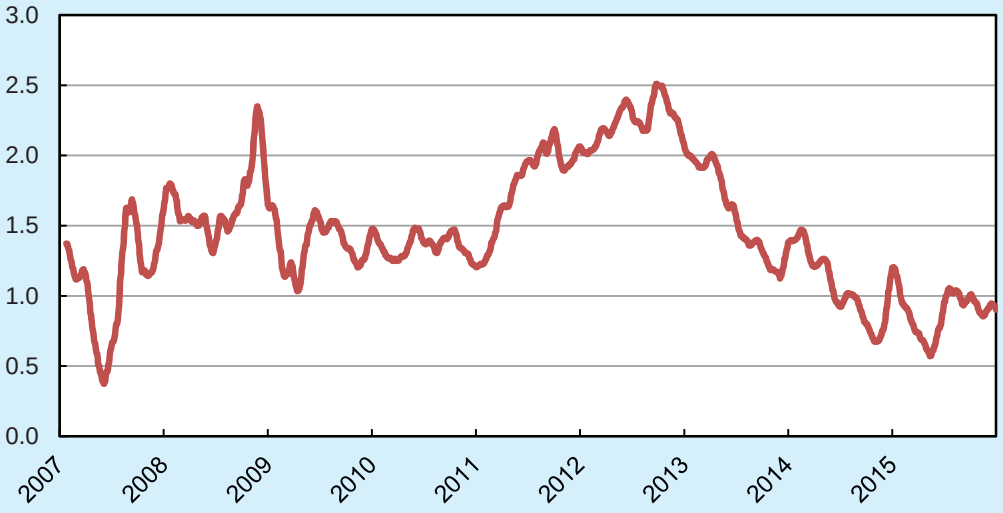


[a] Interest payments in Israel were adjusted to the accepted international definition.

SOURCE: OECD.

[68] For more on the effect of fiscal policy on sovereign yields, see A. Brender and S. Ribon (2015), "The Effect of Fiscal and Monetary Policies and the Global Economy on Real Yields of Israel Government Bonds," Bank of Israel Discussion Paper 2015.02.

Figure 6.8
Yield Spreads on 10-Year Government Bonds Between Israel and the Other Advanced Economies[a], 2007–15 (percentage points)



[a] Monthly moving average of daily yield spreds between Israel and selected countries: Japan, Belgium, Canada, Austria, France, Netherlands, German, Denmark, US, Switzerland, Finland, UK, New Zealand, Norway, Australia, and South Korea.

SOURCE:Bloomberg, and Bank of Israel calculations.