Chapter 3

The Budget and the General Government[1]

In 2004, the government deficit amounted to 3.9 percent of GDP which is somewhat less than the target determined during budget approval and represents a substantial reduction from its level of 5.6 percent of GDP in 2003. The deficit of the general government, which is measured according to the National Accounting rules[2], declined to 5.1 percent of GDP in comparison to 5.6 percent of GDP in 2003. The decline in the deficit and rapid economic growth made it possible to also reduce the ratio of public debt to GDP, which had increased substantially during the previous three years. The reduction in the deficit was achieved through the continuing real decline in government spending, which was even lower than the amount budgeted, the more rapid than expected growth in GDP and the steep rise in the import of consumption goods. These factors enabled the government to meet the deficit target despite the implementation of significant tax reductions, some of which were approved in earlier periods while others were planned for the end of 2004 and implemented early or added during the course of the year. However, the decline in the deficit this year is primarily the result of the high level of the deficit during the first half of 2003. In comparison to the second half of 2003, the period following the implementation of the Economic Recovery Plan, the ratio of the deficit to GDP remained stable, despite rapid economic growth, reflecting moderate

[1] The general government is composed of the central government, the National Insurance Institute, the local authorities, non-profit organizations (the Sick Funds, universities, yeshivas, etc. whose primary source of income is the general government) and the National Institutions (the Jewish Agency, Keren Hakayemet and the World Zionist Organization). Its activity is measured according to the National Accounts definitions which differ from those of the government budget (see Text Box 3.1).

[2] Although the calculation in Israel does not include exchange-rate valuation adjustments of the public debt.

declines in both expenditure and revenues. During the past two years, total employment in the general government also declined, with the number of hours worked falling by 2.8 percent. This was the first time since the 1985 Stabilization Program that such a reduction continued for two consecutive years. The timing of expenditure in 2004 differed from past years and was characterized by particularly low levels from June to November and an exceptionally high level in December.

The restraint in spending made it possible to reduce tax rates in a credible manner, which is likely to contribute to sustainable economic growth. Specifically, the reduction in income tax rates on wages during the past two years brought them down to the common levels in developed countries. However, the reduction in tax rates limited the decline in the ratios of the public debt and the deficit to GDP, despite the acceleration in economic growth. In view of the high level of debt in Israel, which exceeds the common levels world wide, it is important that fiscal policy converge to a path which will enable a substantial reduction in the debt to GDP ratio in coming years and thereby contribute to reducing the risk attributed to the Israeli economy. The fiscal targets for the years 2005-2010, if met, will in fact enable such a reduction although this is conditional on the government exploiting the planned moderate increase in its spending to reduce the deficit and the debt and not only to reduce tax rates.

The trend of general government expenditure this year represents a continuation of the cycle which began at the end of 2000 when the proportion of public expenditure in GDP reached its lowest level since the mid-1990s. During the first two years of the cycle, the real rate of growth in public spending accelerated even beyond the rapid rates of growth which characterized the 1990s and the share of public expenditure in GDP rose by 4 percent. The increase in public expenditure during this period encompassed transfer payments, defense expenditure and civilian consumption. Following a slowdown in mid-2002, an absolute decline in public spending was recorded in 2003 and 2004 which returned its proportion of GDP to a level similar to that in 2000. Among the components of public expenditure, the proportion of GDP of transfer payments and civilian consumption (net of the one-off addition for vacation pay) returned to its level in 2000 while the proportion of defense consumption declined (though it remained higher than at the beginning of the period). Therefore, the rise of the deficit during this period is primarily explained by the decline in revenues which was due, in the beginning of the period, to the major slowdown in economic activity and later to the reduction of tax rates.

1. MAIN DEVELOPMENTS

The general government deficit declined in 2004 to 5.1 percent of GDP in comparison to 5.6 percent of GDP in 2003 (Table 3.1).[3] The government budget deficit declined sharply this year to 3.9 percent of GDP which was within the target set by the government and was 1.7 percent of GDP less than in 2003 (Figure 3.1).[4] The deficit target was finally achieved following three consecutive years in which the government either exceeded its target or was forced to change it during the course of the year. However, despite the significant reduction in 2004, the level of the deficit remained close to the average for the past decade and was higher than what is considered acceptable in developed countries. The decrease in the deficit this year was a result of the reduction of almost two percentage points in the proportion of public expenditure in GDP which was a result of the moderate real increase in expenditure (net of interest expenses), following a decrease last year, and a decline in per capita expenditure. The reduction in the deficit, the acceleration in economic growth and the revaluation of various components of the government debt led to a decline of 1.6 percentage points in the ratio of (gross) public debt to GDP and 2.6 percent in the net public debt. Nonetheless, the public debt remained high relative to other countries and relative to the low historic levels reached in the late 1990s and in 2000. Furthermore, the current size of the deficit does not enable a rapid and ongoing reduction in the public debt to GDP ratio and in order to achieve this, the government will have to continue curbing its expenses in coming years.

The deficit target was finally achieved following three consecutive years in which the government either exceeded its target or was forced to change it during the year.

Despite the reduction in the deficit by 1.7 percent of GDP in 2004, its level was higher than that considered acceptable in developed countries.

The current size of the deficit prevents a rapid and ongoing reduction in the public debt to GDP ratio.

The challenge before the government this year was to reinforce the fiscal credibility that was restored by the Economic Recovery Plan and the approval of the 2004 budget. In addition to meeting the deficit target, the government endeavored to convince the public of its commitment to reducing public spending and the tax burden in coming years in order to boost economic activity while at the same reducing the public debt to GDP ratio. Factors in the government's favor included the improved security situation, accelerated economic growth, stability in the international financial markets and the assurance provided by the US guarantees which reduced the risk of a financing crisis. During the last two years a number of issues have been dealt with, such as the retirement age and the method for updating National Insurance benefits, which will

The government endeavored to convince the public of its commitment to reducing public spending and the tax burden in coming years in order to boost economic activity while at the same reducing the public-debt/GDP ratio.

[3] If Bank of Israel profits (which reflect unforeseen changes in inflation, the exchange rate and global interest rates and tend to be quite volatile) are included in the calculation, then we find that the deficit declined by 1.4 percent of GDP to a level of 5.1 percent of GDP. However, since the Bank of Israel does not actually transfer its "profits" (which are calculated by the Central Bureau of Statistics as explained in the Comptroller's Office Report in the 2001 Bank of Israel Annual Report) to the government and since in most developed countries, including those in the EU, it is the convention to recognize as government revenue only those profits which are actually transferred, we will focus on the definition of the deficit which does not include the Bank of Israel.

[4] The gap between the general government deficit and the central government deficit is larger than it was in previous years. This primarily reflects the higher estimates of the government's defense expenditures and interest payments in the National Accounts relative to the data on budget implementation and the lower estimate of transfers from abroad, which is a result of the difference in the methods of recording.

contribute to long run fiscal stability; however, in order to reinforce the credibility of fiscal policy the government will have to devise programs that will enable it to deal with the country's most urgent problems, including the disengagement plan, the war against terror and the construction of the separation fence, the reform of the education system and the reduction of poverty and unemployment, within the budget framework the government has adopted.

Table 3.1
The Main Components of General Government Receipts and Expenditure, 1994–2004

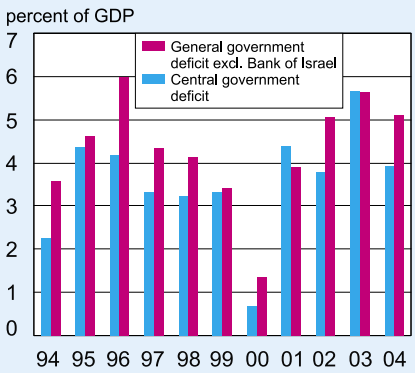
(percent of GDP)

	Average 1994–1997[a]	1998	1999	2000	2001	2002	2003	2004
Total receipts	49.6	48.9	47.6	48.4	49.1	50.1	46.7	46.4
Excl. Bank of Israel	49.4	48.5	48.4	49.1	49.1	49.3	47.6	46.5
From property	1.6	2.2	1.1	1.0	1.5	2.4	0.6	1.2
Total taxes	39.3	38.2	38.5	39.8	39.7	39.0	38.1	37.9
Indirect taxes on domestic production	14.6	14.1	14.2	13.4	13.5	14.2	14.3	13.9
Indirect taxes on civilian imports	5.2	4.3	4.4	4.6	4.2	4.2	3.9	4.5
Direct taxes, fees, and levies	14.2	14.1	14.0	15.9	15.8	14.3	13.4	13.3
National Insurance income	5.3	5.7	5.7	5.9	6.2	6.4	6.4	6.2
Grants	4.1	4.0	4.0	3.6	3.6	4.1	3.6	2.9
Other[b]	4.6	4.6	4.1	4.0	4.2	4.6	4.5	4.4
Total expenditure	54.1	52.6	51.8	50.4	53.0	54.3	53.2	51.6
Current expenditure	48.0	47.8	47.4	46.5	48.9	49.9	49.3	47.4
Domestic civilian consumption	19.6	20.0	19.9	19.6	20.7	21.1	20.8	20.2
Domestic defense consumption	7.4	6.8	6.6	6.6	6.7	7.3	7.1	7.1
Defense imports	1.7	1.8	2.0	1.7	1.9	2.4	1.9	1.6
Direct subsidies	1.4	0.9	0.9	0.8	0.9	0.8	0.8	0.8
Transfer payments on current account	11.3	11.9	11.8	11.8	13.0	13.0	12.5	11.6
Interest payments	6.5	6.3	6.0	5.9	5.8	5.4	6.1	6.1
Transfer payments on capital account	2.6	1.7	1.8	1.5	1.5	1.7[c]	1.2	1.7
General government investments	3.4	3.2	2.6	2.5	2.6	2.7	2.7	2.5
Total general government deficit	4.4	3.7	4.2	2.0	3.9	4.2	6.5	5.1
Total general government deficit excl. Bank of Israel	4.6	4.1	3.4	1.3	3.9	5.0	5.6	5.1
Total surplus excl. interest and receipts from property	0.5	0.5	0.7	2.9	0.4	–1.3	–1.0	–0.3
Net public debt[d,e]	86.5	83.1	80.5	75.7	81.8	84.9	91.0	88.4
Gross public debt excl. Bank of Israel[e]	109.1	106.4	100.8	90.8	95.9	104.7	106.5	104.9

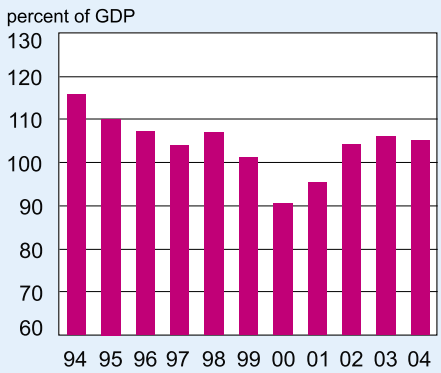
[a] From 1995, including receipts and expenditure due to the National Health Law.
[b] Including transfer payments from the public on the current and capital accounts.
[c] Including capital transfers of NIS 1,523 million to China, in compensation for the cancellation of the Falcon deal.
[d] Divided by GDP at end-of-year prices.
[e] After deducting local authorities' debts to the central government.
SOURCE: Based on Central Bureau of Statistics data.

Figure 3.1

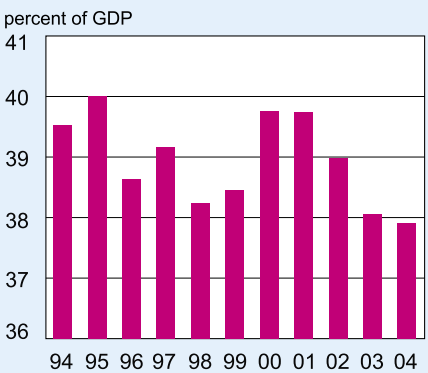
General Government Deficit and Central Government Deficit, 1994–2004



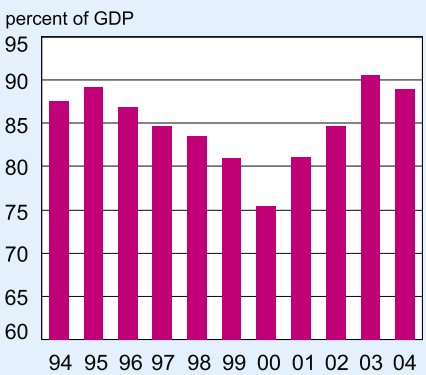
Gross Public Debt, 1994–2004



Tax Burden, 1994–2004



Net Public Debt, 1994–2004



SOURCE: Based on Central Bureau of Statistics data.

Box 3.1
Fiscal Analysis using Budget and National Accounting Data—Accounting Issues

The governments' fiscal targets, including those for the deficit and expenditure, are determined on the basis of the budget definitions and therefore the public debate over fiscal policy usually focuses on economic aggregates that are measured according to those definitions. Consequently, part of this chapter provides an analysis of fiscal developments according to the budget definitions. However, it should be kept in mind that these definitions have certain weaknesses. The measurement of government activity according to the budget definitions does not accurately reflect its

macroeconomic effects. For example, the budget, as opposed to the National Accounts, includes additional revenue from sources such as the sale of land, which reflects the sale of assets rather than economic revenue. In addition, the budget does not include all interest payments on loans which are within the framework of the US guarantees or the interest payments on zero-coupon bonds.[1] For these reasons, the government deficit (including the National Insurance Institute but not including the local authorities, non-profit organizations and the National Institutions), according to the National Accounting definitions, is higher over time than the government deficit according to the budget definition. In addition, the budget does not fully reflect the government's involvement in the activity of other entities included within the general government.[2] Furthermore, expenditure and revenue items can be moved between the various components of the general government, at least in the short run. In this way deficits can also be moved between them, especially since the calculation of the budget deficit is on a cash basis. Thus, for example, as a result of the method of settling of accounts between the government and the National Insurance Institute, a reduction in National Insurance benefits is recorded in the budget as an addition to revenues (a loan from the National Insurance Institute) rather than a reduction in expenditure as it is recorded in the National Accounts. For these reasons, macroeconomic analysis and fiscal policy targets in developed countries relate to the general government. The activity of the general government is usually estimated according to the accepted international standards for National Accounting which call for measurement on an accrual basis rather than budget definitions which differ from country to country.[3] The National Accounts are also based, to whatever extent possible, on economic data and not just the flow of funds[4]

[1] This method of recording allows the government to reduce the deficit and the expenses reported during a specific period by issuing zero-coupon bonds rather than bonds which pay interest at regular intervals. Since the interest payments are recorded in the budget only at redemption, the delay can be for a number of years.

[2] In 2003, for example, government transfers to public non-profit organizations increased which enlarged the budget deficit but had no effect on the general government deficit. In 2004, the joint deficit of the local authorities and public non-profit organizations was 0.1 percent of GDP as opposed to a surplus of 0.2 percent of GDP in 2003. Data on the components of the general government are presented in Table A.3.9.

[3] In addition, the definitions of the government budget deficit in Israel have changed several times in the last decade.

[4] For example, the wages of employees of the local authorities are recorded in the National Accounts in the appropriate months, whether the wages are actually paid or not. In contrast, the government budget does not record the expense for Equalization Grants, which are used to pay these wages, until the transfer is actually carried out.

and thus better reflect the influence of the government on real economic activity.

The National Accounting definitions of the government deficit also differ from international standards due to the adjustment of interest expenses to inflation. The norm in most countries is to record interest expenses according to their full nominal value while in Israel their real value is recorded. This is the case for both the National Accounts and the budget (for indexed bonds and unindexed shekel-denominated bonds issued prior to 2001). As a result, the data on the deficit and public expenditure in Israel is not directly comparable to that of other countries and complicated modifications are required in order to convert the data into the internationally accepted form. In the past, this approach was acceptable in view of the high rate of inflation in Israel. However, following five years of inflation which has been lower than in most other countries and the adoption of the price stability target, the justification for this approach has become much weaker.

Table 3.2
Components of the Increase in the Share of Public Expenditure in GDP, 2000 to 2004

	2000-2004	2000-2002	2002-2004
		(percent of GDP)	
Total increase in public expenditure[a]	1.1	3.9	-2.8
Local civilian consumption[a]	0.6	1.5	-0.9
Defense consumption	0.4	1.4	-1
Direct support	-0.1	-0.1	0
Transfer payments	-0.2	1.1	-1.3
Interest payments	0.2	-0.6	0.7
Investment and transfer payments in the capital account	0.2	0.5	-0.3
Total increase in public revenue	-2.6	0.2	-2.8
Tax revenue	-1.8	-0.8	-1
Grants	-0.8	0.4	-1.2

[a] In 2004, includes the payment of Vacation Pay and the Jubilee Grant for 2005 in the amount of about one half of one percent of GDP to general government workers in early 2004.
SOURCE: Central Bureau of Statistics and processed data of the Bank of Israel.

The share of public expenditure in GDP fell again in 2004 and was close to its level in 2000.

An examination of the data on fiscal aggregates for the past few years reveals a high degree of volatility in public spending together with a decline in revenues (Table 3.2). From 2000 to 2002, the proportion of public expenditure in GDP grew by 3.9 percentage points. This increase reflected the continuation and even acceleration of the rapid rates of growth in public expenditure (discounted by business sector output prices) since the mid-90s (Table 3.3) combined with a fall in GDP. This increase was halted in mid-2002 and the proportion of public expenditure in GDP fell again in 2004 to the level it was at in 2000[5] (which was its lowest level since the mid-70s). This volatility was seen not just in total public expenditure but in its components as well––the increase in transfer payments followed by a decrease of more than one percent of GDP; civilian expenditure which grew by 1.5 percent and then fell by 0.9 percent of GDP, despite the early payment of vacation pay and the Jubilee Grant totaling 2.5 billion shekels (about one percent of GDP) in December 2004[6] instead of January 2005; and defense expenditure which grew by 1.4 percent of GDP and then fell by one percent of GDP. The fall in revenues primarily reflected the changes in tax revenues whose proportion in GDP fell at the beginning of the period due to the slowdown in economic activity, especially the sharp fall in real wages, imports and activity in the real estate market. Once GDP, the import of consumption goods and real wages began to rise in mid-2003 and continued to do so with added momentum in 2004, the growth in tax revenues was slowed by the reduction in tax rates (including deductions for National Insurance). The grants from the US government offset the fall in the proportion of revenues in GDP until 2002 and helped finance the increase in defense imports; however, during the past two years this assistance has declined due to the continuing reduction in civilian assistance and the fall in the dollar exchange rate.

The share of tax revenues in GDP fell between 2000 and 2002 due to the slowdown in economic activity. Once activity started recovering in mid-2003 and more strongly in 2004, the growth in tax revenues slowed due to the reduction in tax rates.

The decline in the deficit and the acceleration of growth led to a moderate decline in the ratio of the (gross) public debt to GDP from 106.5 percent at the end of 2003 to 104.9 percent at the end of 2004, following a large increase in previous years. An additional factor in the decline of the ratio was the partial financing of the deficit through the redemption of credit extended in the past by the government to the public, which greatly exceeded the amount of new loans (primarily mortgages) provided this year, and also to a lesser extent through the receipts from the sale of government corporations (Table 3.4). The net redemption of loans provided by the government is expected to continue in coming years as a result of the reduction in government credit for mortgages. Changes in relative prices had only a small influence on the ratio of public debt to GDP this year. Thus, the shekel-dollar exchange rate at the end of 2004 had appreciated relative to its rate at the end of 2003 and the rise in output prices of 0.6 percent somewhat eroded the ratio of unindexed shekel-denominated debt to GDP.

[5] Corrected for the double payment of vacation pay and the Jubilee Grant.

[6] The total payment for vacation pay and the Jubilee Grant is about 2.5 billion shekels for the general government while the total expenditure in the central government budget for these items is a little over one billion shekels. The difference reflects the payments to employees of institutions within the general government who are paid directly from the budgets of those institutions.

Table 3.3
Rate of Growth in Public Expenditure in Israel, 1994 to 2004
(discounted by the business output price index)

	Rate of Growth				
	1994-1999[a]	2000-2001	2002	2003	2004
	(annual average)				
Total public expenditure	4.4	5.6	2.2	-2.1	2.2
Of this: Interest payments[b]	2.4	2.9	-7.6	13.1	5.8
Total public expenditure without interest payments	4.6	5.9	3.4	-3.8	1.7
Of this: Current expenditure without interest payments	6.1	6.4	3.0	-3.0	0.8
Current expenditure without interest payments and defense expenditure	7.4	7.1	0.7	-1.8	0.4
Public consumption	6.3	5.4	5.2	-3.3	2.0
Public consumption without defense imports	7.4	5.6	3.8	-1.8	3.0
Civilian expenditure	9.3	6.1	2.0	-1.2	2.1
Per capita civilian expenditure	6.6	3.5	-0.1	-3	0.4
Expenditure on wages	5.0	6.5	0.3	-4.8	5.7
Purchases	22.4	5.6	3.6	2.9	-4
Local defense consumption	2.7	4.6	9.3	-3.4	5.4
Expenditure on wages	4.2	4.6	4.0	-4.3	6.9
Transfer payments in the current account	6.3	9.3	-0.4	-3.4	-2.2
Per capita transfer payments in the current account	3.6	6.6	-2.4	-5.1	-3.8
Investment by the general government	-0.2	4	4.3	-1.7	-3.4
Of this: Transportation infrastructure	1.9	4.5	21.5	1.4	1.1
Transfer payments in the capital account	-9.3	-4.2	12.2	-28.1	43.5

[a] Starting from 1995 - includes expenditure due to the National Health Insurance Law.
[b] The decrease in interest payments in 2002 and the increase in 2003 primarily reflect the influence of changes in inflation on the interest rate calculated by the Central Bureau of Statistics.
SOURCE: Central Bureau of Statistics and processed data of the Bank of Israel.

In contrast, the CPI, to which most components of the debt are indexed,[7] rose during the year by 1.2 percent, which was higher than the increase in output prices, thereby contributing to an increase in the debt to GDP ratio. The net debt, which is calculated relative to GDP at the end of the year, fell to 88.4 percent of GDP although its absolute level was still close to what it was in 1995. Thus, the progress made up until 2000 was erased during subsequent years (Figure 3.1) and as a result the ratio has not declined for a whole decade.

In view of the high level of debt relative to international standards (Figure 3.5) and the lack of progress in reducing it over time, the reduction of the debt to GDP ratio

[7] The composition of the debt and its changes are analyzed in the Survey of the Monetary Department in this Report.

Table 3.4
Components of the Increase in the Gross Public Debt from 2003 to 2004 (percent of GDP)

Debt at the end of 2003	106.5
Growth in GDP	-4.4
Government deficit on cash basis	3.9
Net redemption of credit by the public and privatization[a]	-0.7
Valuation of foreign-currency-denominated debt	-0.6
Valuation of indexed debt denominated in shekels[b]	0.5
Valuation of unindexed debt in GDP prices	-0.1
Adjustment for issue prices and risk commissions	-0.2
Total	104.9

[a] Including granting of credit, collection of principle and payment of the risk premium on issues guaranteed by the US government.
[b] The gap between the increase in the CPI during the year and the increase in GDP prices.
SOURCE: Calculations of the Research Department and calculations of the Bank of Israel.

It appears that the decline in the risk premium and the rates of interest on the government debt in 2004 reflect the impact of fiscal measures and the credibility of the fiscal targets among investors.

In order to preserve the credibility which has been achieved the government will have to meet its targets; otherwise, the risk premium and interest rate on the government debt are liable to rise again.

should be accelerated in order to reduce the risk attributed by investors—both foreign and Israeli—to the Israeli economy. The fiscal targets which have been set by the government for the coming years make such a reduction possible and it appears that the decline in the risk premium and the rates of interest on the government debt during the last two years reflect, among other things, the impact of fiscal measures and the credibility of the fiscal targets among investors.[8] Nonetheless, in order to preserve the credibility which has been achieved, following the real risk of a financial crisis that existed as recently as 2002-2003, the government will have to meet the targets it has set; if it does not do so, the risk premium and interest rate on the government debt are liable to increase again, especially following the removal of the "safety net" provided by the US guarantees. As to the optimal rate of reduction in the pubic debt ratio, Israel has some characteristics which allow for a relatively slow reduction: 1) a debt structure which is based on loans with long maturities, thereby reducing the risk of sudden financing crises; and 2) the relatively small burden on the budget in coming decades, due to the expected age distribution, in comparison to other developed countries,[9] which has further been reduced recently by the changes in the age of retirement, in

[8] For a discussion of the influence of the government deficit and deficit targets on the rates of interest paid on the government debt, see H. Ber, A. Brender and S. Ribon (2004), "Are Fiscal and Monetary Policies Reflected in Real Yields? Evidence from a Period of Disinflation and Declining Deficit Targets," Israel Economic Review, Vol. 2 No. 2, December.

[9] For a discussion of the influence of expected demographic changes on government expenditure up to 2020, see Kobi Braude (2003), "The Demographic Influence on Public Expenditure in the Long Run," Economic Quarterly, 50, December.

Table 3.5
The General Government's Total Deficit, Deficit without Interest and Debt Burden in Israel and the OECD Countries - 1992 to 2004

	Deficit of the general government (-)			Deficit of the general government (-) not including interest			Total general government debt (gross)			The real rate of growth in per capita public consumption 1994 to 2004[b]
Country	Average 1992-1994	Average 2003-2004	Change	1994	2004	Change	1995	2004	Change	
	(percent of GDP)			(percent of GDP)				(percent of GDP)		(percent)
Israel[a]	**-4.8**	**-5.4**	**-0.5**	**2**	**-0.3**	**-2.2**	**109.7**	**104.9**	**-4.8**	**0**
Japan	-11.6	-5.0	6.6	4.2	-0.1	-4.3	108.7	112.1	3.4	1.4
Sweden	-9.4	0.3	9.7	-8.5	0.2	8.6	82.2	61.2	-21.0	0.5
Italy	-10.1	-2.7	7.4	1.7	1.8	0.1	133.5	120.0	-13.5	0.7
Britain	-7.1	-3.3	3.7	-4.1	-1.6	2.5	52.7	43.4	-9.3	1.3
Canada	-8.2	0.9	9.1	-1.5	2.4	4.0	100.8	70.6	-30.2	0.4
Belgium	-6.9	0.1	7.0	4.1	4.6	0.5	138.8	100.4	-38.4	1.7
Finland	-6.2	2.2	8.3	-4.6	2.2	6.8	65.7	51.8	-13.9	1.6
Spain	-5.7	-0.3	5.4	-1.9	1.2	3.0	70.3	58.4	-12.0	2.9
Portugal	-6.8	-2.9	4.0	-1.1	0	1.1	72.5	70.6	-1.9	2.8
France	-5.2	-3.9	1.3	-2.4	-1.2	1.2	63.9	74.0	10.0	1.4
Australia	-5.7	0.7	6.4	-0.6	2.2	2.8	44.6	20.6	-24.0	2.3
Austria	-3.4	-1.4	2.1	-1.7	1.0	2.6	69.7	69.5	-0.2	0.6
US	-4.8	-4.5	0.3	-0.2	-2.6	-2.4	74.2	63.5	-10.7	1.1
Holland	-3.5	-3.1	0.4	1.0	-0.6	-1.6	90.8	66.1	-24.7	1.7
Germany	-2.7	-3.9	-1.2	0.4	-1.2	-1.6	57.1	67.0	9.8	1.1
Denmark	-2.5	1.0	3.5	0.9	1.9	1.0	78.4	48.4	-30.0	1.7
Ireland	-2.5	0.2	2.7	2.6	0.3	-2.2	81.9	29.3	-52.6	6.4
Japan	-1.8	-7.1	-5.3	-2.5	-5.0	-2.5	87.1	163.5	76.5	2.6
Norway	-1.0	8.2	9.2	-1.9	4.7	6.7	34.4	34.9	0.5	1.8
New Zealand	-0.7	3.0	3.7	3.9	2.6	-1.3	56.9	34.6	-22.3	2.1
OECD average[c]	-5.3	-1.1	4.2	-0.6	0.6	1.3	78.2	68.0	-10.2	1.8
EU average[c]	-6.0	-1.6	4.4	-0.7	0.6	1.3	83.3	69.4	-13.9	1.8
Average of countries with a large deficit[c,d]	-7.5	-1.3	6.3	-1.3	1.1	2.4	84.9	71.2	-13.7	1.5

[a] Israel's data applies to the general government deficit without the Bank of Israel. The deficit figures do not include indexation differences on the public debt.
[b] Because changes were made in the National Accounts definitions in 1995 by the Central Bureau of Statistics, this figure corresponds to the period 1995-2004 for Israel.
[c] Arithmetic average of all countries included in the group.
[d] Average of countries whose deficit was larger than that of Israel in 1993.
SOURCE: OECD Economic Outlook 76, January 2005, Central Bureau of Statistics and processed data of the Bank of Israel.

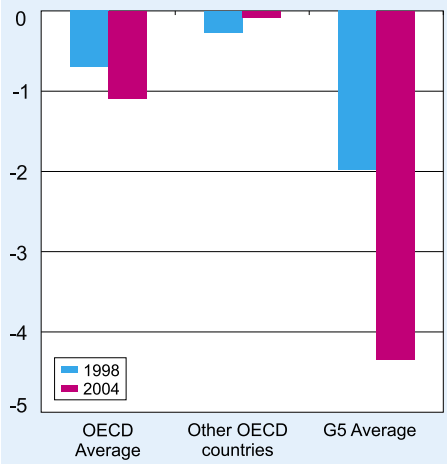
The present size of the debt restricts the ability of the government to smooth the effects of external and defense shocks without undermining financial stability.

National Insurance benefits and in the pension system. Nonetheless, the present size of the debt still restricts the ability of the government to "smooth over" the influences of external and defense shocks without undermining financial stability. In addition, the experience of recent years shows that Israel's security risks—and their economic effects—require erring on the side of safety or, in other words, rapidly reducing the currently high level of debt and debt to GDP ratio to levels characteristic of other countries.

According to the common international definitions, the deficit of the general government in Israel reached 5.9 percent of GDP in 2004 (Table 3.6), while the average deficit for OECD countries was only 1.1 percent of GDP.

The comparison of the deficit in Israel to those in OECD countries[10] illustrates that, despite the reduction this year, the level of the deficit remains high. While according to the common international definitions, the deficit of the general government was 5.9 percent of GDP this year (Table 3.6), the average deficit for OECD countries was only 1.1 percent of GDP.[11] A comparison over time also illustrates the difference between Israel, whose general government deficit increased somewhat during the past decade, and the OECD countries who reduced their deficits during the same period by an average of 4.2 percent of GDP (Table 3.5). Only part of this gap can be explained by Israel's current position in the business cycle relative to the OECD countries. Thus, Israel's cyclically adjusted deficit fell by only one percent of GDP during the past decade while in OECD countries it was reduced by 2.8 percent of GDP. In OECD countries with deficits higher than that of Israel at the beginning of the period, the reduction was 4.5 percent (Table 3.7).[12] These

Figure 3.2
Deficit (–)/Surplus (+) of General Government; OECD Average,[a] G5 Average,[b] and Other OECD Countries, 1998 and 2004



[a] Arithmetic mean of countries in Table 3.5
[b] G5 countries: US, Japan, Germany, France and UK.

SOURCE: Based on OECD data.

[10] The comparison relates to the 20 veteran members of the OECD whose per capita GDP was higher than $10,000 per year and for which there were data available for the last twenty years. The comparison to the EU relates to the 14 countries who were members prior to 2003, except for Luxembourg.

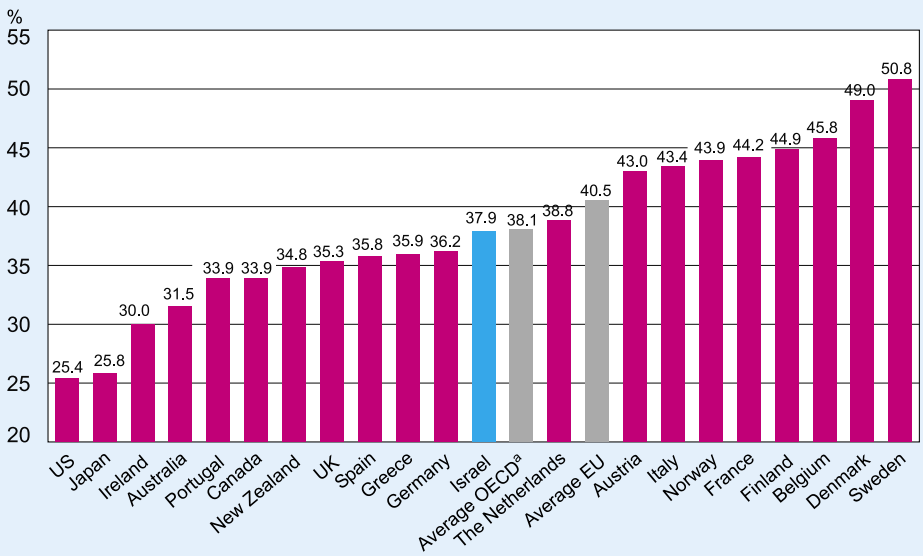
[11] In the transition from the Israeli definition of the general government deficit to the international definition, one must add the indexation differences on the shekel-denominated debt of the general government which totaled 0.8 percent of GDP in 2004. With inflation of 2.0 percent—which is the mid-point of the range defined as price stability—the addition is about 1.3 percent of GDP.

[12] The choice of the years 1992-1994 as the base period reflects the beginning of fiscal adjustment in Europe following the signing of the Mastericht agreement and the end of the large expenses involved in the absorption of immigration in Israel. The cyclically adjusted deficit in Israel is biased upwards at the beginning of the period due to the large expenditure for the absorption of immigration which only ended in 1994.

differences in the size of the deficit do not enable Israel to reduce the gap in the public debt to GDP ratio between it and other developed counties. Although in the last two years, a number of countries have increased their deficits, these have primarily been larger countries (the G5). The majority of smaller counties have continued on the path of fiscal consolidation and have maintained balanced budgets, apparently as a result of market discipline and the success of this policy in recent years (Figure 3.2).

The differences in the size of the deficit will not allow Israel to reduce the gap between its public-debt/GDP ratio and those in other developed countries.

Figure 3.3
The Tax Burden, Israel and the OECD Countries, 2004



[a] Arithmetic mean of the OECD countries shown in this figure.

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

The tax burden, which is defined as the proportion of taxes in GDP, fell somewhat during 2004 following a decline of 1.6 percent of GDP during the previous two years (Figure 3.1). Though the current proportion of tax revenues in GDP is the lowest in the past decade, it was at similar levels several times during that period. In order for the government to successfully reduce the tax burden it will have to make a more determined effort to reduce its expenditure than in the past. A low tax burden will support sustainable growth in the economy if the government can convince the public that it will persevere in its efforts.[13] The stabilization of the tax burden reflected on the one hand the increase in economic activity, particularly the importation of highly taxed goods, as seen in the significant increase in import taxes (Table 3.1), and on

The stabilization of the tax burden in 2004 reflected on the one hand the increase in economic activity and imports, and on the other hand the influence of the reductions in tax rates and National Insurance premiums.

[13] For a discussion of this issue and findings regarding the influence of the tax burden on GDP in Israel, see Y. Lavi and M. Strawczynski (2001), "The Influence of Policy Variables and Immigration on the Increase in Business Sector Output and its Components—Factors of Production and Productivity—in Israel, 1960-1995," Bank of Israel Survey 73.

Table 3.6
Main Fiscal Aggregates according to Accepted International Definitions
Israel[a] and the OECD Countries, 1999 to 2004

	1999	2000	2001	2002	2003	2004
The general government deficit (-)						
Israel[b]	-4.2	-1.5	-4.7	-8.9	-4.8	-5.9
OECD average[c,d]	0.1	1.5	0.3	-0.7	-1.1	-1.1
EU average[c]	-0.1	1.1	-0.2	-1	-1.5	-1.7
General government expenditures						
Israel[b]	52.7	51.1	54	58.9	52.2	52.4
OECD average[c,d]	45.8	44.5	45.2	45.5	46	45.6
EU average[c]	48.4	47.1	47.7	48.1	48.7	48.6

[a] The figures for Israel have been modified to fit the accepted international definitions: Indexation differences (on an accumulation basis) on the shekel debt (CPI-indexed and unindexed) were added to the general government's deficit and expenditures according to National Accounts definitions. Indexation differences on the public's debt to the government were not included in the calculation of the deficit.
[b] The increase in the deficit in 2004 and the small decrease in expenditure reflect the influence of the rate of inflation that year which increased the indexation differences on the public debt.
[c] Arithmetic average of all the countries included in the group.
[d] Presented in Table 3.5 - Average of the OECD countries.
SOURCE: OECD Economic Outlook 76, January 2005, Central Bureau of Statistics and processed data of the Bank of Israel.

Table 3.7
The Cyclically Adjusted Deficit in Israel and the OECD Countries, Average for 1992-1994 compared to the average for 2003-2004

	The cyclically-adjusted deficit of the general government (-)		
Country	Average 1992-1994	Average 2003-2004	Change
	(percent of potential GDP)		
Israel - general government without the Bank of Israel	-2.9	-1.9	1.0
OECD average[a]	-4.0	-1.2	2.8
EU average[a]	-4.2	-1.0	3.2
Average for countries with a large deficit[a,b]	-5.4	-1.0	4.5

[a] Arithmetic average of all countries included in the group.
[b] Average of countries whose deficit in 1993 was larger than that of Israel.
SOURCE: OECD Economic Outlook 76, January 2005, Central Bureau of Statistics and processed data of the Bank of Israel.

the other hand the influence of the reduction in government tax rates and National Insurance premiums.[14] In comparison to other developed countries, Israel's tax burden is not high (Figure 3.3) but rather somewhere in the mid-range of the distribution. The tax burdens of the Anglo-Saxon countries and Japan are lower than that of Israel while those of the Northern European countries, France and Italy are higher. In contrast to earlier periods, payroll taxes in Israel are currently no higher than in other countries at most salary levels as a result of the recent reductions in tax rates.

In contrast to the past, payroll taxes in Israel following the latest reductions are no higher than in the advanced countries.

Box 3.2
An International Comparison of Income Tax Rates on Wages in Israel[1]

One of the goals of the income tax reform in Israel, which was implemented over the past two years, and of the additional reduction in taxes in 2004 was to reduce the tax burden on wage earners in Israel relative to the countries that Israel competes with. The rationale for this policy was that too high a tax burden is liable to reduce the supply of labor as well as the attractiveness of the Israeli economy in the view of companies that choose where to locate their activities. Previous comparisons which examined the tax rates on wages in Israel found them to be higher than those in the developed countries, particularly in the upper quarter of the income distribution. A comparison done in 2002, prior to the implementation of the reform, found that marginal tax rates in Israel were much higher than corresponding rates in the developed countries at all wage levels beyond per capita GDP. At a wage level of twice per capita GDP, it was found that only three countries had higher marginal tax rates than Israel while at a level of four times per capita GDP, there were only two. As a result, the average tax burden for married men, for example, whose wages were twice per capita GDP, was about 2.5 percentage points higher than the average

[1] For a detailed discussion of this research, see Adi Brender, "Tax Rates on Labor Income in Israel Following the Tax Reform: an International Comparison," Bank of Israel, Research Department, March 17, 2005, www.bankisrael.gov.il.

[14] Some of the self-employed apparently managed to avoid paying the additional National Insurance premium which resulted from the cancellation of the ceiling in mid-2003 by recording their activities as corporations which are exempt from National Insurance payments. See D. Romanov, "The Corporation as a Tax Shelter: Evidence from Recent Israeli Tax Changes," Bank of Israel Research Department, Discussion Paper 2004, 17. Nonetheless, the vast majority of high-income individuals paid the additional National Insurance premium. This led to a significant increase in the revenues of the National Insurance Institute.

for the developed countries and at higher levels of income the difference reached more than 10 percent.[2]

In order to determine how the tax reform and the additional tax reductions influenced Israel's relative position, we compared the marginal and average tax rates for individuals at various levels of income and various family statuses between Israel and 26 developed countries.[3] For each of the 8 levels of income examined (in terms of each country's per capita GDP), a tax calculation was done for each type of representative individual (single, married and married with two children)[4] which took into account the tax brackets and tax benefits in each country. The calculation was done for the most recent year for which a full set of data existed, i.e. 2003 or 2004. The calculation also included national insurance premiums paid by workers and income taxes imposed by regional and municipal governments in those countries where this was relevant.

The comparison shows that following the tax reform and tax reductions in 2004, tax rates in Israel in 2005 are no higher than in other developed counties (Table 3.2.1). The average tax rate, which represents the overall tax burden on the worker, is lower in Israel at most levels of income. The tax burden is lower than the EU countries at all levels of income and higher than the average for the countries in the comparison only at the highest levels of income, which represent only a few percent of all taxpayers.[5] An examination of Israel's ranking among these countries shows that average tax rates for single wage earners in Israel are lower than in most of the developed countries while tax rates for married men and fathers are near the midpoint of the range for the developed countries. This is also the case when marginal tax rates are compared.

The most prominent difference between Israel and the developed countries is the relative neutrality of the taxpayer's family status in Israel's tax system.[6] In most of the countries in the comparison, there are reduced tax rates or credits for parents and to a lesser extent also for workers whose

[2] The difference was smaller for residents of certain regions who were eligible for additional tax exemptions during that period.

[3] The ranking in Table 3.2.1 includes 28 observations since three different calculations were made in the US—for residents of Texas, California and New York City.

[4] The assumption in both cases was that the spouse does not work.

[5] Most of this gap will be eliminated with the implementation of the final stage of the reform in 2006.

[6] In Israel, credit points are granted for children only to working women while in most other countries credit/deduction points are granted to the spouse for whom they have a higher value.

Income Tax Rates in Israel and the Developed Countries[a]

Income (percent of per capita GDP)	Israel 2005	OECD average[b]	EU average[c]	Gap between Israel and the OECD countries	Gap between Israel and the EU countries	Ranking of Israel relative to benchmark group
Average Tax Rate				(percent of total revenues)		
Single						
50	4.5	17.8	17.8	-13.3	-13.3	28
75	10.1	21.9	23.1	-11.7	-13.0	27
100	15.9	24.9	27.0	-8.9	-11.0	27
133	21.6	28.0	30.5	-6.4	-8.9	24
166	25.8	30.4	33.3	-4.7	-7.6	21
200	29.4	32.5	35.6	-3.1	-6.2	20
400	38.8	38.2	42.1	0.7	-3.3	13
1000	45.1	42.9	46.8	2.2	-1.7	12
Married+2						
50	4.5	8.3	9.6	-3.8	-5.1	17
75	10.1	14.7	15.5	-4.5	-5.3	18
100	15.9	18.8	20.0	-2.8	-4.0	16
133	21.6	22.8	24.6	-1.2	-3.0	13
166	25.8	25.7	28.0	0.1	-2.2	11
200	29.4	28.0	30.7	1.3	-1.4	11
400	38.8	35.3	38.7	3.5	0.1	10
1000	45.1	41.6	45.3	3.5	-0.2	9
Marginal Tax Rate				(percent of total revenues)		
Single						
50	4.5	26.9	29.2	-22.4	-24.7	28
75	33.3	31.5	35.5	1.8	-2.2	11
100	33.3	36.6	40.5	-3.3	-7.1	18
133	42.3	39.6	44.4	2.7	-2.1	15
166	42.3	41.5	45.6	0.8	-3.3	14
200	47.3	43.0	46.6	4.3	0.7	9
400	49.3	44.6	49.4	4.7	-0.1	9
1000	49.0	46.6	50.0	2.4	-1.0	10
Married+2						
50	4.5	21.8	21.7	-17.3	-17.2	24
75	33.3	29.5	31.5	3.8	1.9	13
100	33.3	33.4	36.4	-0.1	-3.0	12
133	42.3	35.9	39.7	6.5	2.6	11
166	42.3	38.4	42.4	4.0	-0.1	11
200	47.3	40.0	44.0	7.4	3.3	8
400	49.3	43.3	47.9	6.0	1.4	9
1000	49.0	46.6	50.0	2.4	-1.0	10

[a] Simple average of the group of 28 developed countries in 2003 and 2004 (for each country the calculation was based on the most up-to-date data available). The tax rates include taxes imposed on income by all levels of government, including municipal taxes on income. In the US, the tax rates were calculated for Texas, California and New York City.
[b] Average for the OECD countries which are listed in Table 3.5
[c] Simple average of the 15 EU countries.
SOURCE: Bank of Israel.

spouse either does not work or has a low income. Thus, for example, in the countries included in the comparison, the average tax rate for a single taxpayer, whose wage is equal to per capita GDP, is 6 percentage points higher than the rate for a married man with two children. In contrast, both individuals are taxed at the same rate in Israel. Although credit points are granted to women for their children, only one quarter of families with children enjoy this tax benefit since only 55 percent of mothers in Israel work and only 50 percent of them reach the tax threshold (taking into consideration the personal tax credits). In addition, even among those families that enjoy this tax benefit, only about two thirds—primarily families with one or two children—are at a level of income which enables them to enjoy the full tax benefit. Thus, Israel does not use the tax system to reduce horizontal inequality, that is, to reduce the per capita income differentials between households with similar labor income. The gap between Israel and other countries is particularly evident at low levels of income. Thus, while in Israel the average tax burden of singles is the lowest in the ranking of countries, the tax burden of married fathers is close to the median.

The advantage of the Israeli approach lies in the simplicity of the tax system and in the incentive for singles with lower than average earning potential to enter the labor market early. Together with the significant benefits given to mothers for their children through credit points, which is also not common in other countries, and to the disabled, these characteristics create a system of incentives to enter the labor market. At the same time, the system of taxes and transfer payments in Israel is less directed at reducing differentials between households of different types than in other countries, particularly since child allowances in Israel are not very high by international standards. This finding on its own does not require a policy adjustment since the degree of involvement in reducing inequality between different groups in the population is a socio-political decision which reflects the preferences of each country and furthermore because the tax rates at low levels of income are not very high even for married fathers. Nonetheless, increasing tax credits according to size of family, at least at low levels of income, while reducing them for singles could contribute significantly to reducing poverty in households with working parents without reducing tax revenues. This approach is in fact common in other countries. In view of the ambitious targets for reducing public expenditure in coming years and the desire to reduce poverty, it is important that policy makers be aware of this possibility.

Legislative changes made in the past two years, if fully implemented, are expected to significantly reduce tax rates. In addition to the reduction in taxes in the amount of some two billion shekels in 2005, the income tax reform is expected to reduce (net) revenues by an additional 1.5 billion shekels in 2006. Furthermore, the gradual reduction in the corporate income tax rate to 30 percent in 2007 is expected, upon completion, to reduce tax revenues by an additional two billion shekels annually. The gradual reduction of the stamp tax, upon completion in 2007, is expected to lead to a loss of tax revenue in the amount of some 700 million shekels annually. The gradual reduction in National Insurance premiums paid by employers and the self-employed, which will be implemented during 2005-7, is expected to reduce net tax payments by another two billion shekels. Thus, existing legislation is expected to lead to a cumulative reduction in taxes of some six billion shekels over the next three years. At the same time, the increased taxation of diesel gasoline is expected to increase tax revenues by one billion shekels. These changes in tax rates are expected to offset the increase in the tax burden due to the growth in GDP and therefore will maintain the tax burden at its present level during the next few years.[15]

Legislative changes in the past two years, if implemented, are expected to further reduce tax rates significantly in the next few years.

The reduction in the ratio of the general government deficit to GDP this year paralleled the recovery in economic activity. Since the size of the general government's deficit is directly affected by changes in GDP, primarily through the effect on tax revenues, the cyclically adjusted deficit of the general government, which is calculated on the assumption that output is at full capacity,[16] is also included in the analysis. In Israel, the calculation has also to be adjusted for inflation as a result of the unique method of recording interest payments in the National Accounts and in the budget, whereby the discounting of nominal interest payments by inflation leads to fluctuations in calculated interest payments when the rate of inflation changes.[17]

The cyclically adjusted deficit of the general government stabilized in 2004, reflecting the opposing effects of cutbacks in expenditure, which led to a decline in their share in GDP, and the reduced tax rates, which curbed revenues.

[15] According to the Research Department's tax model, the rate of growth in government revenues from taxes in the long run is 1.1 percent for each percentage point of growth in GDP. Therefore, if statutory tax rates remain unchanged, the tax burden is expected to grow with GDP. However, it was also found that during the 1990s, the government adjusted tax rates when GDP rose, such that the tax burden remained unchanged.

[16] The calculation of potential output in this case is based on the average growth of per capita GDP since 1973 which was 1.5 percent annually. According to this calculation, output grew in 2004 by one percent more than potential output and the cumulative deviation of output from its potential level declined to 7.5 percent under the assumption that output was at its full potential in 1996. The "cyclically adjusted" deficit is calculated under the assumption that tax revenues increase proportionally with output and that total expenditure and non-tax revenues are not sensitive to changes in output. For a detailed discussion on the method of calculation, see Section 2 in Chapter 5 of the 1999 Bank of Israel Annual Report. For a discussion of alternative methods of calculation, see the text box in Chapter 1 of this report.

[17] In the calculation of the general government's interest expenses by the Central Bureau of Statistics, the actual rate of inflation is used to discount the interest paid on the unindexed shekel-denominated debt. However, in the case of a decline in prices, the rate of decrease in prices is not added to the interest payments. In the calculation of the "cyclically adjusted" deficit, we assume a "normative" rate of inflation of 2.0 percent.

According to this calculation, the general government's cyclically adjusted deficit increased by 0.2 percent of potential output this year. The level of the cyclically adjusted deficit during the past two years was similar to that in 2000 (Table 3.8) and therefore the growth in the deficit during this period can be explained by the widening of the gap between output and potential output. The stability of the cyclically adjusted deficit this year reflects the opposing effects of cutbacks in expenditure which led to a decline in their proportion in GDP and the reduced tax rates that curbed revenues. The general government's "cyclically adjusted" local deficit declined by 0.4 percent of GDP, which was a continuation of the decline of 1.1 percent recorded in 2003. According to this last calculation, which approximately reflects the direct influence of general government activity on aggregate demand this year, the government's activity contributed to reducing demand.[18]

The possibility cannot be ruled out that the return to fiscal control during the past two years actually contributed to the economic recovery, through its contribution to consumer and investor confidence and to a lowering of interest rates.

However, the possibility cannot be ruled out that the return to fiscal control during the past two years actually contributed to the economic recovery or at least significantly offset the direct negative influence of deficit reduction on demand in the economy. This would have occurred through the contribution to investor and consumer confidence in the economy and to a lowering of interest rates, particularly following the fiscal crises of 2002 and 2003.[19] Various studies carried out worldwide indeed found that in recent decades the direct influence of an increase in government expenditure or a tax reduction on GDP in the short run is relatively small and its direction is unclear.[20] Thus, it appears that fiscal policy makers, especially in countries with a large deficit and debt, must deal not only with the choice of whether to improve welfare in the present (through increasing public expenditure and correcting market failures) or to reduce the burden of future generations (through reducing the public debt and developing infrastructure) but also with the question of whether expansionary policy can increase welfare in the present at all.

In addition to the question of how to interpret the influence of changes in the cyclically adjusted deficit, especially a reduction in the local deficit, this year it is important to stress that these deficit calculations are very sensitive to the estimate

[18] Lavi and Strawczynski, for example, show that reducing the deficit by reducing public consumption leads to a reduction in demand in the short run despite the offsetting expansionary influence on private expenditure. See Y. Lavi and M. Strawczynski (2003) "Does Fiscal Expansion Increase Aggregate Demand and Economic Activity in Israel? An Empirical Test for the Period 1960-2000," Economic Quarterly, 50, December.

[19] See also Chapter 1 of this report. For a more detailed discussion of the possibility that the deficit reduction in 2003 contributed to the acceleration of economic activity, see Text Box 3.2 in the corresponding chapter of the 2003 Bank of Israel Report.

[20] In an article which examines the influence of an increase in public expenditure and tax reductions on output, Perotti finds that even in more prosperous countries where this influence is expected to be relatively large, it is in fact relatively small and sometimes even negative. In studies which examined a larger variety of countries, it was found that in many cases contractionary fiscal policy actually contributed to an increase in output in the short run and that an expansionary policy had the opposite effect. See Perotti, R. (2004), "Estimating the Effects of Fiscal Policy in OECD Countries," IGIER Working Paper 276, December.

Table 3.8
The Cyclically Adjusted Deficit of the General Government, 1999 to 2004[a]
(percent of potential GDP)

	1999	2000	2001	2002	2003	2004
Total deficit of the general government[b]	-2.7	-2.1	-2.8	-3	-1.8	-2
Local deficit of the general government[b]	-2.9	-2.6	-3.1	-3.2	-2.1	-1.7

[a] The interest expenditures are calculated on the assumption that the rate of inflation increased by two percent over the year and not according to the actual rate of inflation.
[b] Since the item "Surplus Income of the Bank of Israel", as it is calculated in the National Accounts, is very volatile, it was not included in the estimate of the cyclically-adjusted deficit.
SOURCE: Central Bureau of Statistics and processed data of the Bank of Israel.

of potential output and the assumptions regarding the intensity of the reaction of tax revenues and public expenditure to an increase in GDP. On the one hand, the reaction of tax revenues to an increase in GDP at the end of a recession is usually stronger than average. On the other hand, the calculation assumes that public expenditure will not change when the gap between actual GDP and its potential level disappears, an assumption that has not been borne out by past experience in Israel. It has been found that each percent of growth in business sector output leads to an increase of about one half of a percent in real public expenditure (discounted by business sector output prices). This correlation reflects the wage increases in the public sector during periods of prosperity, the partial indexation of National Insurance benefits to past average wages, the increase in demand for public goods when the standard of living increases and the tendency of political decision makers to increase expenditure as tax revenues rise. Estimates of potential output are also notorious worldwide for significant retroactive changes over time.[21] In Israel, it is also possible that as a result of the last recession's length and depth, some of the production potential which was not used during the last three years was permanently lost to the economy. If this is the case, then it is possible that the output gap, which is measured on the basis of past trends, is an overestimate of the economy's ability to increase production at the end of the recession and the estimated cyclically adjusted deficit is biased downwards.

2. GENERAL GOVERNMENT EXPENDITURE AND ITS COMPONENTS

The share of public expenditure in GDP fell in 2004 by 1.6 percentage points following its decline of 1.1 percentage points in 2003, and it reached 51.6 percent of GDP.

The proportion of public expenditure in GDP fell this year by 1.6 percentage points which was a continuation of the decline of 1.1 percent in 2003. The proportion of public expenditure declined to 51.6 percent which was somewhat higher than in 2000, when it reached its lowest level in recent decades. The sharp fall in the proportion of public expenditure in GDP during the last two years reflects the real decline in

[21] See International Monetary Fund, World Economic Outlook, October 1999, Chapter III.

The sharp fall in the share of public expenditure in GDP in the last two years reflects the real decline in expenditure and not just an increase in GDP.

expenditure (discounted by business sector output prices) and not just an increase in output. During these two years, expenditure net of interest payments fell by a cumulative amount of 3.2 percent (Table 3.3). The decline encompassed all the expenditure components, apart from investment in transportation infrastructure and wages which grew sharply by 6.1 percent. The growth in wages reflects a quantitative reduction of 1.5 percent in labor input and a nominal increase in hourly wages of 7.2 percent which was a result, among other things, of the double payment of vacation pay due to the bringing forward of payments due in January 2005, in accordance with the agreement with the Labor Federation at the end of the year (which contributed 3.5 percent to the annual wage cost) and apparently of the payment of compensation to retirees from the defense sector.

In per capita terms, transfer payments have declined by 11.5 percent in real terms during the past three years, which offset most of the real increase during the years 2000 and 2001.

Child allowances and unemployment benefits were 40 percent lower than in 2001 and guaranteed minimum income payments 20 percent lower.

Transfer payments (primarily National Insurance benefits) fell be 2.2 percent this year which was a continuation of the 3.4 percent decline last year. In per capita terms, these payments have declined by 11.5 percent in real terms during the past three years, which offset most of the real increase during the years 2000 and 2001 as well as the increase relative to GDP. Not all benefits declined at the same rate with child allowances and unemployment benefits falling by 40 percent relative to 2001 and guaranteed minimum income payments falling by 20 percent. The proportion of total National Insurance benefits in GDP fell this year by 0.7 percentage points of output (resulting in a cumulative decline of 1.1 percent during the last two years) and thus returned to its 1997 level (Table A.3.14). The total proportion of unemployment benefits and guaranteed minimum income payments in GDP returned to its 1997 level but was still higher than in any of the years previous to 1997, including the period of high unemployment in the early 1990s.

Although transfer payments are not currently at low levels, viewed over the long term, there is no doubt that in recent years many of those in need of government assistance have been hard hit, particularly those of working age.

These figures indicate that although transfer payments are not currently at historically low levels, there is no doubt that in recent years many of those in need of government assistance have been hurt, particularly those of working age. This is especially true in view of the tightening of eligibility conditions which affected those genuinely in need of the welfare system since there is still no system in Israel which is able to reliably differentiate between those who are unable to work and those who choose not to. The development of such a mechanism would improve the tradeoff between maintaining fiscal balance and stability and the desire to provide sufficient assistance to those who need it. One of the main reasons for reducing benefits and tightening conditions of eligibility among the working age population was the desire to increase the rate of participation since benefits tend to encourage individuals to exit the labor market[22] and the key to breaking the cycle of poverty is employment.[23]

[22] A. Brender, A. Peled-Lavi and N. Kasir (2002), "Government Policy and Participation Rates in the Workforce among the Working Age Population—Israel and the OECD Countries in the 1990s," Bank of Israel Survey 74, November; D. Gottlieb (2002), "From Welfare to Work: Guaranteed Income for the Working Age Population in Israel," Economic Quarterly 49, March, 121-158; N. Zussman and D. Romanov (2001), "Guaranteed Income Supplements and their Influence on Labor Supply and Tax Evasion," Economic Quarterly 48, December, 607-647.

[23] See K. Flug and N. (Kleiner) Kasir (2001), "On Poverty, Work and Everything in Between," Economic Quarterly 48, 4 (December), 516-542.

However, current policy encourages entry into the labor market, primarily through the tightening of conditions of eligibility for those who do not work and the reduction in the number of foreign workers, while the complementary policy—to provide support for those joining the workforce—has not been widely implemented. This contrasts with the situation in most of the developed countries, which have expended large sums on training programs for workers and the subsidization of employment.[24] In this context, we would mention that the effect on employment of reducing taxes at low wage levels, which was implemented this year, is negligible.[25]

The tightening of eligibility conditions affected all those in need of the welfare system, since there is still no system in Israel which is able to differentiate reliably and efficiently between those unable to work and those choosing not to.

The policy measures taken during the last two years have worked to increase inequality of income, at least in the short run. Although the acceptable degree of inequality is essentially a socio-political issue, inequality also has economic consequences which must be taken into consideration, particularly if the degree of inequality raises the barriers to economic mobility. If the reduction in income of the weaker populations harms their ability to invest in human capital—of adults and particularly of their children—this will negatively affect not only these populations but also the ability of the economy to fully exploit its growth potential in the future. Therefore it is of critical importance to implement a policy of differential budgeting for students in the education system according to socioeconomic status, as proposed, among others, by the Dovrat Commission. (For a detailed discussion of the Dovrat Commission Report, see Chapter 4 of this report.)

The contribution of fiscal policy to sustainable economic growth and to the raising of the level of welfare is dependent not only on the size of the deficit and the magnitude of public expenditure but also to a large extent on efficient budget allocation.

The contribution of fiscal policy to sustainable economic growth and the raising of the level of welfare is dependent not only on the size of the deficit and the magnitude of public expenditure but also to a large extent on the efficient allocation of the budget which plays an important role in compensating for market failure in the supply of public goods, supporting efforts to increase productivity and adjusting the distribution of income according to society's preferences. Since the decision as to which public goods the government will supply and in what quantities should reflect public preferences and values and since too high a level of public expenditure is liable to harm economic activity due to its effect of increasing the tax burden and the public debt, the government's determination of preferences in allocating the budget is of critical importance.[26] However, government and Knesset discussions rarely include a systematic analysis of budget preferences which would include an examination of alternatives. The government does not define—at least not explicitly—what targets it is trying to achieve through the budget, what sums it is willing to allocate to these targets and what the sources of funding are for these targets. In particular, the government

[24] A. Brender, A. Peled-Lavi and N. Kasir, op cit.

[25] For a discussion of the magnitude of the effect of the tax reduction on entry into the labor market and employment, see A. Brender and M. Strawczynski (2005), "Characteristics of the Optimal Negative Income Tax System in Israel in Light of the Labor Supply Traits of Individuals with Low Earning Potential," Pinchas Sapir Forum for Economic Policy, January 13, 2005.

[26] For a detailed discussion of the process of determining preferences in the budget process (or the lack thereof), see Section 2 of the corresponding chapter in the 2001 Bank of Israel Report.

The government rarely determines which of its activities are less important, thus enabling their cancellation in order to allocate their funding to activities with a higher priority. This is evident in the prevalence of across-the-board cuts which are made to the budget.

rarely determines which activities are less important, thus enabling their cancellation in order to allocate their funding to activities with a higher priority. This is evident in the prevalence of "across-the-board" cuts which are made to the budget.[27] Even when targets are mentioned, they are usually defined in too general a manner (for example, education or transportation infrastructure) to be used in determining the specific goals that are to be achieved, how the additional budget is to be allocated and in what way the budget is to bring about the desired results.

In the absence of decisions regarding quantitative targets, the government does not demand and does not receive an accounting for expenditure in current and previous years according to target (for example, reducing socioeconomic gaps between the center and the periphery of the country) and therefore is not able to determine whether the implementation of the budget reflected the policy goals which were announced in previous years (even if they were not defined as such). Although in recent years the reporting of budget implementation has been greatly expanded for both current and previous years, the detailed reporting of hundreds and even thousands of budget lines is not a substitute for the summarization of data according to goals. This type of summarization, which enables focused analysis, exists for a few key areas, such as education and health, in the publications of the Central Bureau of Statistics. However, as an example, the recent publications regarding national expenditure on education and health at the end of 2004 provided detailed figures on the composition of expenditure only up to the year 2000 which reflect budget decisions made by the Barak government during the period prior to the intifada.[28] Even if the changes over time in the composition of the education and health budgets are not substantial, more up-to-date information is certainly required for the analysis of policy and the achievement of goals.

Despite the large changes in public expenditure—a rapid increase until 2002 and a decline since––the composition of government expenditure has remained almost unchanged since the late 1990s.

In the absence of a binding declaration of preferences regarding the composition of pubic expenditure, we can still try to say something about these preferences using hindsight. This is done by analyzing the trends in expenditure in previous years in order to identify "revealed preferences," at least for major items of expenditure. This analysis can be based either on estimates of the Central Bureau of Statistics for total public expenditure (Table A.3.8) or on budget figures for government expenditure and National Insurance Institute reports on its activities (Table 3.9). These estimates indicate that despite the large changes in pubic expenditure—a rapid increase until 2002 and a decline since—the composition of government expenditure has remained almost unchanged since the late 1990s. During this period, the proportion of public expenditure devoted to defense has grown by less than two percent and the proportion

[27] Nonetheless, the decision to reduce National Insurance benefits to the working age population (child allowances, unemployment benefits and guaranteed income supplements) can be seen as a substantive change in preferences.

[28] Since a major portion of government expenditure on health and education is implemented by the Sick funds and the local authorities, respectively, the State budget does not provide a complete picture of the expenditure in these areas.

devoted to infrastructure by one percent. In contrast, the proportion devoted to the support of the business sector (included in "other" in Table 3.9) has declined. The proportions of public expenditure for education and health, areas that are mentioned repeatedly as having high priorities, have remained almost unchanged during this period. However, it is important to mention that the results of an aggregate analysis of this type can only be partially valid in understanding the changes which have occurred in the order of priorities since changes in the allocation of expenditure do not necessarily indicate changes in the order of priorities, especially in the short run. For example, a general increase in wages in the public sector will increase the proportion of labor-intensive services (such as education) even if there was no intention of increasing their priority. Nonetheless, a longer run analysis, from the mid-80s until 2000, indicates a certain change in priorities. Thus, during this period, there was a continuous decline in the proportion of defense expenditure in total government expenditure, which came to an end only in 2000, and an increase in welfare expenditure.

Table 3.9
Government Expenditure Priorities, 1997–2004

(percent)

	1997	1998	1999	2000	2001	2002	2003	2004
Total government expenditure[a]	100	100	100	100	100	100	100	100
Education[b]	15.0	14.6	15.2	14.8	14.8	13.9	14.4	14.9
Health[c]	15.1	15.7	15.4	15.0	15.0	14.6	14.7	15.2
Defense	23.2	23.2	22.2	23.0	22.6	25.6	24.9	24.8
National Insurance benefits and disability pensions[d]	19.0	19.8	20.1	20.8	21.9	21.2	20.6	20.3
Infrastracture investments[e]	2.1	2.2	2.1	2.2	2.2	2.6	2.9	3.1
Other	25.6	24.4	25.0	24.2	23.5	22.0	22.6	21.9

[a] Excluding interest plus net National Insurance expenditure. This includes government hospitals, which have been removed from the government budget since 1998.
[b] The budget of the Ministry of Education and budgetary allocations to the universities and colleges.
[c] The budget of the Ministry of Health, government hospitals, and transfers of Health Tax from the National Insurance Institute to the Health Funds.
[d] Excludes payment for reserve duty which is included in defense expenditure.
[e] The government's nonresidential investment, excluding subsidies to government enterprises, and government participation in local authorities' highways.
SOURCE: Based on National Budget Summary, Ministry budgets, and Central Bureau of Statistics data.

The decline in the share of public expenditure in GDP in the past two years significantly reduced the gap between Israel and the developed countries which had developed in the previous ten years.

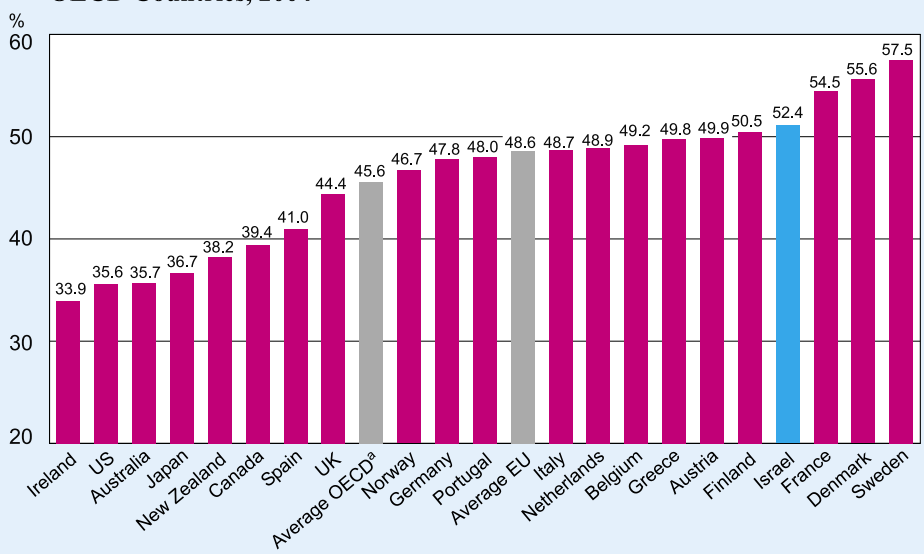
The decline in the proportion of public expenditure in GDP during the past two years significantly reduced the gap between Israel and the developed countries which had developed since the early 1990s (when this proportion was similar to the average of the developed countries). Although only three countries (Sweden, France and Denmark) had higher proportions of public expenditure in GDP than Israel, six additional countries had similar proportions (Figure 3.4), especially if it is taken into account that some of Israel's defense expenditure is financed by the US government on an

ongoing basis. A comparison of the components of the increase in public expenditure during the past decade shows that the increase in real per capita public expenditure (which is an indicator of the improvement in the quality of services) was less than that of the OECD countries while the relative price of public services[29] and also transfer payments increased. A comparison of public expenditure in Israel, according to the accepted international definition, to the average for the OECD countries shows that this gap is equal to about seven percent of GDP (Table 3.6). Although the majority of the gap is a result of defense expenditure, which is much larger in Israel, it is important to remember that this explanation, no matter how justified, does not reduce the harm done by the size of the public sector to Israel's ability to compete since defense expenditure in Israel goes on a product, security, which competing economies enjoy at a much lower price.

Despite the reduction of the deficit in 2004, it remains in the same narrow range it has occupied over the past ten years. This range is bounded by a ceiling dictated by the markets, and a floor reflecting the unwillingness of policymakers to reduce spending on an ongoing basis.

Despite the success of the government's policy during the past two years to reduce the deficit and public spending and in the adoption of reforms which reduce fiscal risks in the long run, the size of the current deficit remains in the same narrow range it has occupied over the past decade. It appears that this range is bounded by a "ceiling," which is dictated by the markets, particularly in light of the increasing openness of the

Figure 3.4
Share of General Government Expenditure in GDP; Israel and OECD Countries, 2004



[a] Arithmetic mean of the OECD countries shown in this figure.

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

[29] The price ratio of public consumption to output in Israel rose by an annual 2.5 percent annually during the period in contrast to an average increase of less than one percent in the OECD countries.

economy to international movements of goods, factors of production and capital, and a "floor," which is dictated by the unwillingness of policy makers to reduce spending on an ongoing basis. The change in the emphasis of policy towards the reduction of taxes should make it easier to begin slowing down the increase in spending and the developments in 2004 provide some indication of that. However, due to the high debt to GDP ratio, the government will eventually have to reduce the deficit to below the "floor" of the past decade, a step which will require maintaining a low rate of growth in spending, in accordance with the current targets, while tax revenues increase.

3. THE GOVERNMENT BUDGET AND THE DEFICIT TARGET

The composition of fiscal policy in 2004 supported sustainable economic growth.

The government deficit totaled 3.9 percent of GDP this year in accordance with the target set by the government. The deficit stabilized this year at a level it had reached during the second half of 2003 following the implementation of the Economic Recovery Plan and other contractionary measures, including the Arrangements Law and the 2004 Budget Law (Table 3.10). The composition of fiscal policy supported sustainable growth of the economy, even though the deficit had not been reduced relative to the second half of 2003. This outcome reflected two opposing forces at work this year: on the one hand, the control of government spending led not only to a drop of 2.2 percent in its proportion in GDP relative to 2003 as a whole[30] but

The reduction of tax rates offset the cyclical expansion in tax revenues, thus maintaining the share of government tax revenues in GDP at a level similar to that in 2003.

Table 3.10
The Government's Domestic Deficit,[a] by Half-Years, 2003 and 2004

(percent of GDP in annual terms)[b]

	2003		2004		
	First half	Second half	First half	Second half	Annual
Deficit	–7.4	–3.3	–3.3	–3.3	–3.3
Total domestic expenditure (net)	37.9	35.6	35.1	35.0	35.1
Total domestic revenues	30.5	32.3	31.8	31.8	31.8
Tax and bond receipts[c]	28.2	29.1	28.9	28.8	28.8
Investment by NII	1.6	2.2	2.1	2.1	2.1
Other	0.8	0.9	0.9	0.9	0.9

[a] Excluding credit.
[b] The division into halves of the year takes the seasonal distribution of revenues and expenditure into account.
[c] The effect of the postponement of tax rebates from the end of 2002 on the distribution of annual revenues was smoothed by distributing it evenly over the two halves of the year.
SOURCE: Based on data from the Acountant General.

[30] Essentially, the decline in government expenditure was larger than is reflected by the budget figures since part of the decline in National Insurance benefits was recorded in the budget as an increase in revenues in the budget line "Loans from the National Insurance Institute". (See Text Box 3.1.)

Table 3.11
Central Government Deficit,[a] Receipts and Expenditure, 1997–2004

(percent of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004
Government domestic deficit ceiling[b]	2.3	2.2	2.6	2.8	0.5	4.1	2.3	3.4
Actual government domestic deficit	3.0	2.8	2.8	0.5	3.5	3.5	5.4	2.8
Overall government deficit ceiling (including profits of the Bank of Israel)	2.8	2.4	2.0	2.5	–	–	–	–
Actual overall government deficit (including profits of the Bank of Israel)	2.6	2.2	2.4	0.1	–	–	–	–
Overall government deficit ceiling[c]	3.0	2.8	3.1	3.6	1.8	3.9 [d]	3.0	4.0
Actual overall government deficit	3.3	3.2	3.3	0.7	4.4 [e]	3.8 [e]	5.6	3.9
Total receipts[f]	40.0	37.4	38.5	36.8	35.1	36.2	34.0	33.9
Taxes and imposts	30.6	29.6	29.7	31.1	30.9	30.2	28.9	28.8
Interest, profits, royalties, revenue from land sales	1.7	2.2	1.9	1.7	1.3	1.4	1.1	1.3
Realized Bank of Israel profits	0.7	1.0	0.9	0.0	0.0	0.0	0.0	0.0
Loan from NII	1.6	1.4	1.4	1.5	0.9	1.6	1.8	2.1
US government grants	3.2	3.2	2.6	2.5	2.0	3.0	2.1	1.8
Total expenditure, net[f]	40.5	39.7	38.9	37.5	39.5	40.0	39.7	37.7
Of which: Interest, repayment of principal to NII, and credit subsidy	7.3	7.3	6.9	7.0	6.9	6.8	7.7	7.2
Defense expenditure, net	9.4	9.3	8.8	8.5	9.0	9.8	9.1	8.9
Total primary expenditure excl. defense	23.7	23.1	23.2	22.1	23.5	23.5	22.9	21.6

[a] According to various definitions.
[b] The difference between the planned and the actual deficit includes 0.15 percent of GDP receipts which are recorded as domestic receipts when the budget is being prepared, but as foreign receipts in expenditure data.
[c] From 2001, the deficit ceiling specified by law.
[d] The target set in the middle of 2002. The target set when the budget was approved by the Knesset (parliament) was 3.0 percent of GDP.
[e] The designated economic aid had not been received by the end of 2001, and hence was not recorded as receipts in that year. If it had been received on time, the actual total government deficit would have fallen to 4.0 percent of GDP. The aid was recorded
[f] Excluding expenditure contingent on receipts, and receipts used to finance contingent expenditure.
SOURCE: Based on the National Budget Summary and Central Bureau of Statistics data.

The deficit and recycling of the debt were financed this year at lower interest rates than in previous years; if this continues, it will contribute significantly to reducing the government's interest expenses in coming years.

even to a decline of 0.5 percent of GDP relative to the second half of 2003. On the other hand, the significant reduction of tax rates offset the cyclical expansion in tax revenues, thus maintaining the proportion of government tax revenues in GDP at a level similar to that of last year (Table 3.11). The reduction in spending this year was primarily focused on the civilian ministries and transfer payments. Thus, the proportion of civilian expenditures (net of interest payments and the payback of principal to the National Insurance Institute) in GDP declined from 22.9 percent in 2003 to 21.6 percent this year which translates into a real reduction of 1.3 percent (in terms of the CPI). The proportion of defense expenditure in GDP also declined somewhat while interest expenditure dropped significantly, though primarily due to technical factors which reflect the method of recording interest payments (Text Box

3.1) and the changes in the foreign exchange rate. Nonetheless, the deficit and the recycling of the debt were financed this year at low interest rates relative to previous years which, if it continues, will contribute significantly to reducing the government's interest expenses in coming years.

The management of the government budget this year emphasized the commitment to the deficit target and to the ongoing reduction in the tax burden.

The management of the government budget this year emphasized the commitment both to the deficit target and to the ongoing reduction in the tax burden. When it became clear at the beginning of the year that there were activities whose budgets had been cut by too much (in particular the defense budget and the Equalization Grants to the local authorities), the government decided to increase these budgets while simultaneously cutting others. Although at that stage (during the month of February), all the general budget reserve had been distributed, administrative measures were taken to restrict spending in order to prevent overspending for the year as a whole. And indeed, by the end of the year, the budget had not fully been spent in order to offset the shortfall in non-tax revenues (Table 3.12). During the same period, when it became clear that economic activity and imports were expanding faster than expected at the time the budget was prepared, the government immediately reduced tax rates (the adjustment of the lower income tax brackets in January and the reduction in value added tax and import taxes in February). When tax revenues continued to rise faster than expected, it was decided to make an additional cut in income tax rates (again at the lower income levels) and to initiate a gradual reduction in corporate income tax rates. Added to the reduction in taxes was the decision to reduce the cut in old age pensions. These measures illustrated the government's commitment to its declared policy of reducing tax rates and its desire to moderate the effect of many of the decisions taken during the past two years which significantly reduced the contribution of government expenditure in reducing inequality in income distribution.[31]

The tax cuts at low income levels underlined the government's commitment to its policy of reducing tax rates and its desire to moderate the effect of many of the decisions taken during the past two years which significantly reduced the contribution made by government expenditure to the reduction of economic inequality.

The large adjustments in the government budget during the past two years––through the Economic Plan in mid-2003, the 2004 Budget and changes made in February 2004—made it difficult for the government ministries and budgeted entities to operate. As a result of this and the need to compensate for the over-optimism in the forecast of revenues, the government spent a smaller proportion of its budget in comparison to previous years. This year, in addition to the low rate of spending, there was also an exceptionally high level of spending in December that offset much of the underutilization of the budget during the rest of the year (see Box 3.3). The low rate of utilization of the budget and the changes in the trend of spending during the course of the year were apparently the result of the difficulty in budgeting the various activities in an accurate manner. This situation was the result of the hundreds of decisions made by the government during this period with regard to the budget adjustments and

In the last two years the government spent a smaller proportion of its budget than in previous years.

[31] The overall effect of the many changes that were made in the tax system during the past two years on the distribution of income is unclear, particularly because of the tax imposed on individuals' income from capital which yielded 1.9 billion shekels in tax revenues, primarily from the top five percent of the income distribution. For a detailed analysis, see: A. Brender, "The Direct Tax System in Israel from an International Perspective," Bank of Israel, Research Department, February 2000. (bankisrael.gov.il)

Table 3.12
Components of Deviation from Original 2004 Budget

(NIS billion, net, excl. credit)

	Original budget	Performance	Difference between budget and performance[a]
Deficit (–)	–22.5	–20.3	2.2
Domestic	–19.3	–17.4	1.9
External	–3.2	–2.9	0.3
Revenue	182.2	178.4	–3.8
Of which: Domestic	168.4	167.0	–1.4
Taxes[a]	151.8	153.0	1.2
Loan from NII	11.2	10.8	–0.4
Other[b]	5.4	3.2	–2.2
Grants from US government	12.0	9.5	–2.5
Expenditure[d]	204.9	198.8	–6.1
Of which: Domestic	187.9	184.5	–3.4
Abroad	17.0	14.3	–2.7
Defense[c]	47.5	46.9	–0.6
Interest, repayment to National Insurance and credit subsidy	42.1	37.9	–4.2
Civilian ministries and transfer payments[c]	115.3	114.0	–1.4

[a] Including V.A.T. on defense imports.
[b] Income from interest, land sales, royalties, dividends, and other income.
[c] NIS 3 billion which was included in the inflation reserve in the budget book is shown here in the budget column as part of the defense budget.
[d] Including expenditure of NIS 1.9 billion on Israel Railways which was not included in the original budget but is included in the performance of the budget. For consistency, this expenditure is included also in the figure of the original budget shown in this table.
SOURCE: Based on data of the Acountant General regarding the performance of the 2004 budget.

legislative changes and directives which determine the activities of the government ministries. In addition, it appears that the Ministry of Finance was determined to meet the deficit target this year and therefore used administrative measures to restrict the expenditure of the ministries. The need for these measures has grown in recent years since the revenue forecasts for the budget have been, as mentioned above, overly optimistic. As a result, there was a need to adjust the actual level of spending during the course of the year to the (modified) target of the budget since the government and the Knesset had not cut the overall budget ceiling. Due to the multitude of budget lines in each ministry and government units, many of which cannot be changed without the approval of the Ministry of Finance (and in some cases its agreement is required in order to make a request to the Knesset Finance Committee), the Ministry of Finance's ability to restrain expenses is not negligible.[32] The slowdown in the utilization of the

[32] One of the ways of restraining spending is the use of the fact that about two percent of the budget (about $4 billion) is transferred to reserve budget lines for various purposes within the ministries' budgets. As opposed to the general reserves line in the budget, which is mostly allocated to various purposes already at the beginning of the year, the release of funds from these budget lines, which requires the approval of the Budget Division, and in some cases that of the Knesset Finance Committee, is delayed to a much later period.

budget, relative to the rate of utilization in previous years, was particularly evident in the middle of the year, when the increase in tax revenues slowed, thus creating concern that they would not reach the level forecast in the budget, and when it was realized that not recording the budget transfer of 1.9 billion shekels to Israeli Railways did not meet common accounting practices.[33] During the six months from the end of May till the end of November, the government's domestic spending was lower than the level consistent with full utilization of the budget by some 7 billion shekels. Only in December, when it became clear to what extent spending could be increased while still meeting the deficit target, was this gap substantially reduced.

Although it is difficult to quantify the weights of the various factors affecting the underutilization of the government budget, it is reasonable to assume that the inability of the government ministries and the executive units to find use for all the budgeted funds was not the only barrier to spending. This is particularly true since the low utilization rates were recorded during two years in which public spending declined. The maintenance of control over expenditure, such that government deficit targets are met, is of critical importance but it would be worthwhile for the process to be implemented with greater transparency. This can be accomplished, for example, through a clear allocation of a budget reserve, whose use is conditional on the level of revenues, already at the time the budget is prepared. In this manner, the government will make clear ahead of time its determination to meet the deficit target and priorities regarding expenditure whose implementation is dependent on revenues will be determined by the government and the Knesset, rather than by administrative measures. A first step in this direction was taken in the 2005 Budget (see Section 4 below).

Box 3.3
Utilization Rate of the Government Budget and the Distribution of Expenditure over the Course of the Year

During the past two years, the rate of utilization of the budget has substantially declined. While during the period 1999-2002, the government spent 99 percent of its budget (net of credit) on average, its spending in 2003 reached only 95.6 percent of the amount budgeted and in 2004, despite the exceptionally high level of spending in December (see below), spent only 97.1 percent of its budget (Table 1). These low rates of utilization

[33] In addition, funds that had not been utilized in the 2003 Budget were transferred to Israel Railways this year.

Table 1
The Government's Budgetary Performance, 1999-2004

(percent)

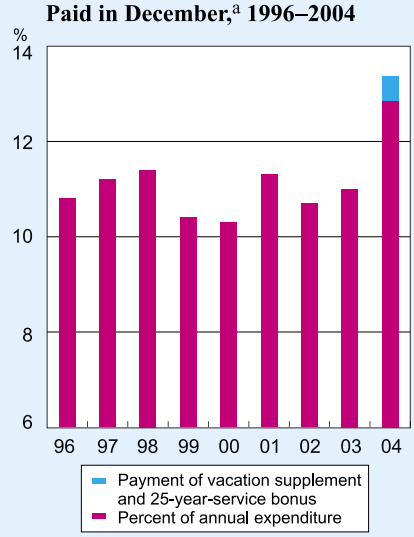
	1999	2000	2001	2002	2003	2004
Expenditure excluding credit	98.3	99.1	98.9	99.9	96.9	97.3
of which: Net	98.4	98.6	99.8	98.7	95.6	97.1

SOURCE: Based on "Government Revenue and Expenditure," from the office of the Accountant General.

contributed significantly to the sharp decline in the proportion of public spending to GDP in Israel during the past two years.[1]

The partial utilization of the State Budget does not violate the Budget Law which stipulates ceilings on expenditure. The Budget Law determines the amounts that are available to the government to allocate among the ministries, units and activities and there is no logic in mandating the utilization of the full allocation by those who don't need it. Nonetheless, non-utilization of significant budgeted amounts by the government ministries over a period of two straight years may be evidence of deficiencies in the budget process. Thus, if funds allocated by the government and the Knesset are put into budget lines in which they are not required or if those responsible for using the funds are unable to use them, perhaps it would have been better not to allocate them in the first place in order that the budget better

Figure 1
Share of Government Expenditure Paid in December,[a] 1996–2004



[a] Net domestic expenditure excluding credit granted

SOURCE: Based on Accountant-General data.

[1] The cuts in spending which the government decided on in 2003 and 2004 did not reduce the total expenditure which was budgeted but in fact allowed the increase of other lines in the budget without increasing total expenditure

Table 2
Net Expenditures of the Government Ministries in all of 2004 and in December 2004

	Expenditure in January-November 2004 (monthly average)	Expenditure in December 2004	Proportion of expenditure in December in total annual expenditure
	(NIS millions)		(percent)
All Government Ministries	12,678	23,913	14.6
Administrative Ministries[a]	1,893	4,759	18.6
Social Ministries[b]	6,255	10,239	13
Economic Ministries[c]	774	3,343	28.2
The Ministry of Defense[d]	3,756	5,572	11.9

[a] The President, the Knesset, the Prime Minister, Finance, Interior, Internal Security, Justice, the Foreign Ministry, State Comptroller, Pensions and Compensation, Science, Culture and Sport and Environment.
[b] Health, local authorities, Education and higher education, Religion, Labor, Welfare, transfers to NII, Housing and Absorption.
[c] Support, Agriculture, Energy and Infrastructure, fuel sector, Industry and Commerce, Tourist, Communication, Transportation, water sector, Israel Mapping Center and Public Works.
[d] Including emergency civilian expenditure, Coordination of Activity in the Territories, the Council for Atomic Energy and the Demobilized Soldiers Law.
Source: Accountant General, "State Revenues and Expenditures" and calculations of the Bank of Israel.

reflect the expected operations of the government and its order of priorities. Alternatively, these funds could have been allocated to other areas in which they would have been utilized.

In 2004, an additional characteristic of the management of government spending was clearly in evidence—the concentration of a substantial portion of spending in December, even beyond the magnitude of this phenomenon in previous years. While the first half of the year was characterized by a very low rate of expenditure relative to the path for full utilization of the budget and although the deficit target was met, spending increased by an exceptionally large amount in December, reaching 13.3 percent of annual expenditure. This compares to an average of 10.8 percent during the preceding 8 years (Figure 1). The spending in December includes the payment of vacation pay and the Jubilee Grant to government workers in the amount of 1.1 billion shekels, which was meant to be paid in 2005. The payment was brought forward in order to assist the government in meeting its fiscal targets in the coming year (though the magnitude of the spending surplus in December far exceeded the amount of this item). The spending surplus was distributed across the board and was not concentrated in any specific budget line or ministry (Table 2). The level of expenditure in December substantially reduced the annual underutilization of the budget.

In the absence of this additional spending in December (relative to previous years), which totaled about 5 billion shekels, government spending would have only been 95% of the amount budgeted.

The delay of a significant proportion of expenditure until December, as occurred this year, enables the government to fine-tune its expenditure so that it will exactly meet the deficit target and thus increase the target's credibility. However, the uneven trend in expenses this year and the size of the adjustment in December, reduced the public's ability to evaluate the developments in the budget during the course of the year. The uncertainty as to the path of expenditure during the course of the year is liable to make it difficult for the government to convince the markets of the credibility of fiscal adjustments, especially during future crises. Therefore, transparency in managing the budget during the course of the year along with an exact definition of the reserve lines in the budget and the conditions for their release, is of great importance, as is their more gradual release. A more gradual implementation of expenses will also contribute to the efficiency of the government's operations since the rushed implementation of expenditure in one single month, on the basis of the unutilized sums which have accumulated, is liable to result in an inefficient use of resources.

Two-thirds of the way into the fiscal year, the government had transferred to the local authorities only 46 percent of the Equalization Grants budgeted in those items which were not conditional on the implementation of recovery programs. This is about 500 million shekels smaller than the sum that would have been transferred in the case of a uniform distribution throughout the year

One of the sectors which had a particularly uneven distribution of expenditure over the course of the year was local government. Since the budgets of those local authorities with low socioeconomic status populations depend to a large extent on the Equalization Grants that are provided by the government,[34] the slowing of the release of these transfers caused real harm to their functioning. During the period up to September 13, 2004 (in other words, two-thirds of the way into the fiscal year), the government had transferred to the local authorities only 46 percent of the Equalization Grants budgeted (in those items which were not conditional on the implementation of recovery programs),[35] a gap of some 500 million shekels relative to the sum which would have been transferred in the case of a uniform distribution throughout the year (Table 3.13). At the same time, many of the weaker local authorities began experiencing liquidity problems that led to the unacceptable situation in which employees were not

[34] For more detail, see Section 7 in the corresponding chapter of the 2003 Bank of Israel Report.

[35] In addition, only 31.5 percent of the funds that were conditional on recovery programs had been transferred since many local authorities had not agreed to the implementation of these programs as of that date.

paid their salaries for a number of months. This situation led to a general strike in the economy and during the negotiations to end the strike, which took place in the Labor Court, it became apparent that some 400 million shekels in wages had not been paid. As a result of the settlement in the Labor Court, the share of the Equalization Grants, which were not conditional on the implementation of recovery plans, that was transferred by mid-October, approximately three quarters of the way into the year, rose to 72 percent. At the same time, almost all the arrears in the payment of salaries were eliminated except for a small number of local authorities which have been inefficiently run for a long period of time.

Until the outbreak of the general strike in September, salaries withheld by the local authorities totaled some 400 million shekels.

The gap between the government's local revenues and the budget forecast was much smaller this year than in previous years and was totally due to non-tax revenues—royalties, dividends and income from the sale of land by the Israel Land Administration (Table 3.12). As opposed to previous years, the surpluses of the National Insurance Institute this year were close to the budget forecast and thus, one of the main factors in the overoptimistic forecasts of revenues in previous years was eliminated.[36] However, the main difference relative to previous years was the level of tax revenues which was somewhat higher than the budget forecast even though tax rates had been reduced in such

The gap between the government's local revenues and the budget forecast was much smaller this year than in previous years.

Table 3.13
Actual Transfer of the Equalization Grants to Local Authorities during 2004

	Transfers up to September 13, 2004		Transfers up to October 27, 2004	
	as a percentage of the updated budget	The gap in comparison to uniform transfers during the year	as a percentage of the updated budget	The gap in comparison to uniform transfers during the year
		(NIS millions)		(NIS millions)
Total equalization grants	43.1	758.2	67.8	239.4
Of this: Recovery plans	31.5	234.4	59.6	104.9
Equalization grants not part of the recovery plans	46.0	527.4	71.6	135.5

SOURCE: Calculations of the Research Department using data of the Budget Branch.

[36] For an explanation of the recording of the activity of the National Insurance Institute within the government budget, see Text Box 3.3 in the corresponding chapter of the 2002 Bank of Israel Report.

a way as to reduce tax revenues by almost 4 billion shekels. These reductions were in addition to those legislative changes which were included within the original budget framework and therefore did not affect the deviation of total revenues from the budget forecast. The increase in tax revenues beyond the budget forecast (net of the influence of reductions which were not planned ahead of time) was made possible by a faster rate of growth than that forecast by the budget. This contributed about 3 billion shekels to surplus revenues; the exceptionally large increase in the import of consumption goods contributed 2.5 billion shekels; and the early payment of vacation pay and the Jubilee Grant in December (which increased revenues from taxes on wages) contributed another 800 million shekels.

Government tax revenues were not only higher than the budget forecast but were also higher than they were in 2003. Tax revenues (net of VAT on defense imports) grew this year by 8 billion shekels to a total of 151.5 billion shekels. This represents a real increase of 5.6 percent. Furthermore, if we discount the effect of legislative changes, which as stated above contributed to the reduction in tax revenues this year, the real increase rises to 8.5 percent.[37] An analysis of the real changes in tax collection in 2004 using the Research Department's tax model[38] shows that the increase in tax revenues is explained primarily by the real variables included in the model (Table 3.14).[39] These include: (1) an increase in GDP which contributed 4.4 percent to the increase in tax revenues; (2) an increase in the import of consumption goods beyond that explained by the growth in GDP this year, which contributed 3.6 percent (which substantially offset the decrease recorded in 2003 and is not expected to continue in coming years); (3) a recovery in the sale of new apartments during the first half of the year which contributed 0.4 percent; and (4) an increase in real wages which contributed an increase of 0.4 percent. The effect of the model's financial variables on tax revenues this year was relatively small.

In view of the government spending restraint, the continuing increase in investment in the transportation infrastructure was particularly noticeable.

In view of the government spending restraint, the continuing increase in the investment in transportation infrastructure was particularly noticeable (Figure 3.5). The implementation of this investment is primarily carried out by government corporations and authorities which are financed from the government budget or are under its supervision. This year the Public Works

[37] The legislative changes include both changes that went into effect only in 2004 and the effect of changes from prior years which influenced tax revenues in 2004. For a detailed discussion of the legislative changes in the area of taxation which were implemented during the past two years, see Text Box 3.3 in the corresponding chapter of the 2003 Bank of Israel Report.

[38] For a full description of the model, see A. Brender, "Estimates of the Tax Revenue Function in Israel," Bank of Israel, Research Department, Series of Articles for Discussion 2001.02, January 2001. As explained there, the contribution of each of the explanatory variables reflects not only the behavior of a specific tax base but also the correlation between the variables and other tax bases.

[39] The imports of consumption goods and wages are included in the model as deviations from the long run relations which were estimated between these variables and GDP.

Table 3.14
The Impact of Macroeconomic Variables on the Government's Tax Receipts in 2004[a]

(percent of total revenue)

	Contribution to change in receipts
Total change in tax receipts	8.6
Real variables	8.8
GDP[b]	4.4
Real wage per employee post[c]	0.4
Imports of consumer goods[d]	3.6
Sales of new apartments[e]	0.4
Financial variables	–0.2
Prices of shares on TASE[f]	–0.3
Share of sales by Israeli control holders abroad[g]	0.0
Outstanding foreign-currency credit by the banking system[h]	0.1

[a] The impact of the variables as estimated by the tax model of the Bank of Israel's Research Department. The government's tax receipts, at constant prices, were calculated while adjusting for the effect of the change in the law and without V.A.T on defense imports.
[b] The level of GDP, at current prices, deflated by the CPI, with a one-quarter lag; with the addition of the effect of the change in product, with a two-quarter lag.
[c] The extent of deviation of the real wage per employee post from its long-term association with GDP.
[d] The extent of deviation of total imports of consumer durables, in local currency at constant prices, from its long-term association with GDP.
[e] The number of new apartments sold two quarters previously.
[f] The real change, in basis points, in the General Share-Price Index in Tel-Aviv.
[g] Sales of shares by Israeli control holders abroad, including sales made in the framework of company mergers, with a three-quarter lag.
[h] Total bank credit in or indexed to foreign currency, with a two-quarter lag, calculated in local currency at constant prices.
SOURCE: Based on Bank of Israel data.

Department, which is responsible for most of the investment in inter-city roads, became a government corporation. The budget investment in transportation includes the financing and implementation of investment in inter-city roads, the direct financing of the Israel Railways investment program[40] and the financing of the majority of the investment in urban roads, a large part of which is carried out jointly with the local authorities. These investments grew by some 7.5 percent this year (discounted by the CPI), which was a continuation of the trend in previous years, and their proportion in GDP grew somewhat to 1.1 percent, a high level relative to previous decades.[41] This is an important accomplishment

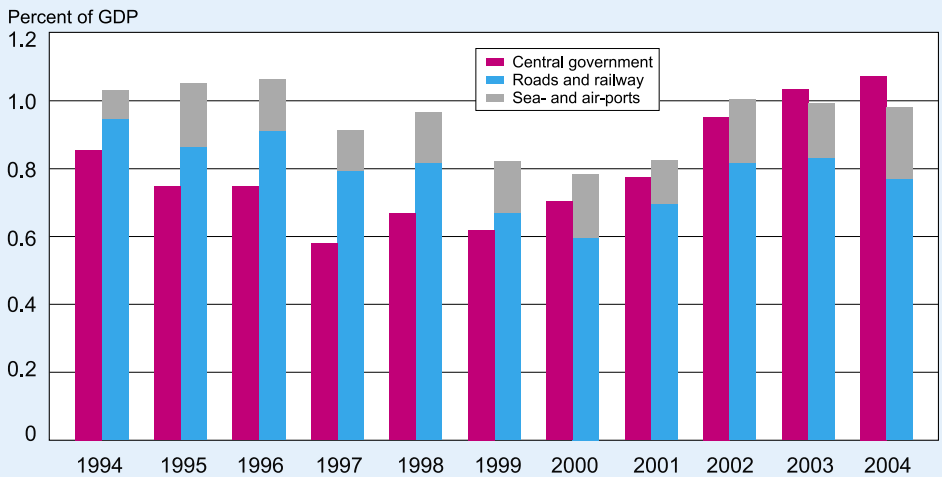
[40] As a result of Israel Railways becoming a government corporation starting in 2003, the budget records transfers of capital from the government rather than investment in equipment and railway tracks.

[41] There are differences between the data on investment which is reported by the Central Bureau of Statistics and that contained in the government budget which reflect, in part, the different methods of measurement. Nevertheless, the trends in expenditure on transportation infrastructure are similar according to both methods.

especially in view of the tendency, which has been documented in the economic literature and which has been prevalent in Israel in the past, to cut investment during periods of budget difficulties. However, in coming years, investment of an even greater magnitude will be required in order for the infrastructure to meet the needs of the economy.[42] It is important that the government's expected expenditure on important transportation projects, such as the light railway in Tel Aviv and Jerusalem and the extension of the Cross-Israel Highway, be anchored in a multi-year planning process as has been done with the development budget of Israel Railways. This will ensure that the necessary resources for these investments will be allocated despite the ambitious commitment to restrain the growth in government spending in coming years and will ensure that they will be considered according to the general order of priorities. In order to improve the ability to budget and physically plan in this area in coming years, the government will have to demonstrate its determination in ensuring that the commitments of those competing in tenders are met.

The government's determination to enforce commitments made by those competing in tenders will improve its budget and physical planning capability in this area in the next few years.

Figure 3.5
Central and General Government[a] Investment in the Transport Infrastructure, 1994–2004



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

SOURCE: Based on Accountant-General and Central Bureau of Statistics data.

[42] For a detailed discussion, see the section on Transportation and Communication in Chapter 1.

4. THE 2005 BUDGET

The 2005 budget is the first to be prepared according to the new fiscal targets determined by the government. These include a ceiling on the deficit of three percent of GDP and a real increase in expenditure of one percent. The initial conditions for this budget are far more accommodating than for the previous four budgets. Thus, this budget benefits from the following factors: a return to economic growth; the attainment of the 2003 deficit target and the realization of the forecast of tax revenues for 2003; a positive international environment; an improved security situation; the confidence of the financial markets in budget policy; and previous government decisions that support the continuation of spending restraint. As a result of all these factors, the extent of the supportive policy measures required to meet the expenditure and deficit targets is much smaller than was needed during the past two years. Nonetheless, the budget still does not include the cost of the disengagement plan and if it is in fact carried out in 2005, the deficit will grow. The government has decided that due to the one-off nature of this expenditure, it will allow the deficit and expenditure to grow accordingly even though the cost will be added to the public debt. The decision not to include this item within the budget targets is also liable to increase its cost since there will be less pressure during the decision making process to examine the operation's cost relative to alternative uses in the budget.

The 2005 budget includes three measures with significant financial implications: a reduction of 1.5 billion shekels in the defense budget; an across-the-board cut of 1.5 billion shekels in the spending of the ministries (and cuts of 750 million shekels per annum in 2006-8); and the payment of vacation pay and the Jubilee Grant in 2004 and 2006 instead of 2005 in order that the expenditure not be recorded in 2005.[43] In addition, the government came to an agreement with the New Labor Federation which delays the payment of the cost-of-living allowance to workers in the public sector by one year, representing a saving of 400 million shekels. Apart from reducing expenditure, the government took another important step by allocating 1.1 billion shekels from the budgets of the ministries, starting in 2005, to a reserve for meeting the expenditure ceiling. This sum will be released during the course of the year (until the end of June) according to budget developments in order to ensure that the government does not exceed the budget targets. This reserve will make it easier for the government to deal with unexpected developments during the year by creating an order of priority within the ministries' budgets although not between them.

The deficit target set for 2005 is 3 percent of GDP (16.7 billion shekels) which is 3.7 billion shekels lower than the actual budget deficit for 2004. The reduction in the deficit, according to the budget, will be based on a significant increase in government

[43] During the budget approval process in the Knesset, it was decided to increase the amounts of certain budget lines by some 750 million shekels and the government decided to simultaneously make an across-the-board cut of the same amount.

According to the 2005 budget, tax revenues are expected to grow by a real 5.0 percent, and by 6.2 percent if legislative changes are taken into account.

revenues totaling 14 billion shekels (Table 3.15). This represents a real increase of 6.4 percent[44] as compared to a real increase in expenditure of 3.8 percent relative to actual expenditure in 2004. Tax revenues are expected to grow, according to the budget, by 10.2 billion shekels which represents a real increase of 5.0 percent (6.2 percent if account is taken of the legislative changes which are expected to reduce revenues by 1.9 billion shekels or 1.2 percent). The surplus of the National Insurance Institute is expected to grow by one billion shekels due to the increase in employment and wages, the cancellation of the indexation of benefits and the cancellation of certain benefits in accordance with legislation approved in the past. Other revenues are expected to grow by 8.5 percent. These rates of growth raise the concern that the forecast of tax revenues will turn out to be overly optimistic, given the growth forecast of 3.8 percent on which the budget is based. Although the "reserve to meet spending targets" enables the government to deal with deviations from the revenues forecast, the size of the reserve is only sufficient to offset a deviation of 0.7 percent in the forecast of tax revenues. Furthermore, the lack of a substantial general reserve in the budget, as presented to the Knesset, will make it difficult to deal with unexpected needs that are liable to arise during the year.

Table 3.15
Net Government Revenues and Expenditures in 2004 and in the 2005 Budget

	Actual 2004	Budget 2005	Real rate of change[a]
	(NIS billions)		(percent)
Revenues without credit	178.4	192.7	6.4
Taxes	153	163.2	5.1
National Insurance	10.8	11.9	8.7
Grants	9.5	11.9	23.2
Other	5.1	5.6	8.3
Expenditure without credit	198.8	209.4	3.8
Of this: without interest and without principal to the NII	160.8	166.4	1.9
Defense[b]	46.9	46	-3.4
Civilian	114	120.4	4.1

[a] On the assumption that the average CPI in 2005 will increase by 1.5 percent relative to 2004.
[b] In 2004, includes NIS 3.5 billion for the budget reserve.
SOURCE: The Accountant General, "Government Expenditures and Revenues," mof.gov.il and calculations of the Bank of Israel.

[44] On the assumption that the average price index in 2005 will rise by 1.5 percent relative to 2004. This assumption corresponds to an increase in prices of 2.0 percent during the course of the year.

Despite the concern about attaining the deficit target due to the forecast of tax revenues, the partial utilization of the budget during the past two years indicates that the flexibility of the 2005 budget is sufficient to further curb the increase in spending if needed. Budget expenditure is expected to grow significantly relative to the budget utilization in 2004 though this expansion does not contradict the expenditure target. (For an explanation of the calculation of the expenditure target see Text Box 3.4.) Total budgeted expenditure is higher, as mentioned above, by 3.8 percent than the actual expenditure in 2004 and expenditure net of interest payments is budgeted to increase by 2.0 percent. The 3.4 percent real cut in the defense budget allows for a real increase of 4.0 percent in the budgets of the civilian ministries.

The partial utilization of the budget during the past two years indicates that the flexibility of the 2005 budget may be sufficient to further curb the increase in spending if needed.

Box 3.4
Determination of the Government's Fiscal Targets for 2005-2010

The 2005 budget is the first to be prepared on the basis of the new fiscal targets set by the government. The targets include a budget ceiling of 3.0 percent of GDP and a real increase of one percent in expenditure each year. These targets apply until 2010. In order to meet these two targets the government will have to annually reconsider the one percent restriction on spending in order to determine whether it is sufficient to ensure that the deficit will be under the ceiling of three percent. If the deficit is expected to be higher than the ceiling, the government will have to decide whether to reduce the rate of increase in expenditure or to increase revenues.

The deficit target will continue to be calculated each year as it has been in the past, i.e. the gap between the government's expenditures and expected revenues (at nominal prices and net of credit extended or redeemed). Given the forecast for GDP, the deficit that will meet the target can be calculated. In contrast, the calculation of the expenditure ceiling is made on a different and less transparent aggregate base than the calculation of the deficit, i.e. total expenditure including credit extended.

The ceiling on expenditure for any given year is calculated on the basis of the expenditure which was included in the original approved budget for the previous year,[1] without taking into account the actual expenditure in that year. Therefore, the comparison of government spending between years is irrelevant in determining whether a target was met. This base is adjusted to the gap between the forecasted CPI on which the original budget was

[1] The budget changes during the course of the year, particularly due to the addition of unused surpluses from previous years, but these changes do not affect the base used to calculate the expenditure ceiling for the next year.

based for the previous year (the year in which the budget is prepared) and the updated estimate of prices for that year as evaluated by the Ministry of Finance at the time the budget is prepared for the following year. If the evaluation shows that prices rose by less than the budget forecast, the base is reduced and vice versa. Needless to say, these price forecasts are not publicized.[2] The result is increased by one percent, in accordance with the rate of increase specified by the Law, and then translated into nominal prices according to the price forecasts for the next year, which are also not publicized.

The new targets have several disadvantages. Since the deficit ceilings established for the years 2006-2010 are not sufficiently low to ensure a substantial and ongoing reduction of the government debt to GDP ratio, a further reduction of the deficit during those years to below the ceiling is required. Although such a reduction is possible if the government exploits the restraint to reduce spending and not just to cut taxes, such a target has not been established until now. Thus, there remains uncertainty as to the intention of the government with respect to the size of the debt in the medium term. In order to reduce this uncertainty, it would be desirable for the government to at least establish a target for the debt/GDP ratio in the medium run—for example, for the year 2008. This would enable a certain amount of flexibility in the substitution between tax cuts and deficit reduction in the short run while creating transparency with respect to the multi-year fiscal targets. In the absence of targets such as these, and in the case that the deficit is below three percent of GDP, the government will easily be able to bypass the expenditure restriction by using tax benefits as a substitute for expenditure and through changes in administrative arrangements. Thus, for example, it will be able to meet the expenditure target by replacing subsidies to public transportation with selective tax reductions to its operators—for example, subsidies on diesel gasoline. In a similar manner, the government participation in the financing of National Insurance benefits could be reduced without reducing the benefits themselves. As a result, the transfer of funds from the government to the National Insurance Institute, which

[2] In the publication "Highlights of the Budget," a price coefficient appears which represents the expected change in prices next year relative to the prices which the writers of the budget assumed for the current year. Since for the current year and for those preceding it, the expected level of prices is not explicitly given, this information is not sufficient to deduce the assumptions regarding the expected level of prices. As an approximation, the price assumptions used for preparing the revenue forecast can be calculated but these are not identical to the assumptions used to budget expenditure.

appears as an expense in the budget, would decrease and at the same time the investments of the National Insurance Institute in government bonds, which are recorded in the budget as income, would decline. This provides a way of influencing the reported level of expenditure without any "real" change in government activity. In order to restrict these possibilities, it may be worthwhile to base the budget targets on general government activity which is the standard practice worldwide.

Total expenditure, for purposes of calculating the target, also includes, as mentioned above, the credit extended by the government in contrast to the deficit targets which do not.[3] Since this year many of the housing credit benefits granted by the government were cancelled, the credit utilization which the government budgeted for this purpose was substantially smaller and furthermore, this line had been budgeted with a significant surplus in recent years. Thus, the inclusion of credit contributes to the reduction in government expenditure in the 2005 budget by some 2 billion shekels (about one percent) relative to the original budget for 2004. This is in spite of the high rates of payback on this credit and therefore it is incorrect to treat this reduction as equivalent to a reduction in "regular" government expenses. Nonetheless, the inclusion of credit in the calculation of the spending target helps to increase its credibility since it prevents the possibility of bypassing the expenditure ceiling by granting loans whose redemption is uncertain. This is especially true since the proportion of total credit extended through housing loans, which as already mentioned have a high rate of payback, has substantially declined.

The comparison to last year's budget, as it is currently done, lacks transparency, primarily because the price assumptions are unclear. However, this problem could be solved relatively easily by publishing the figures used to calculate the expenditure ceiling. If transparency could be ensured, the decision to revise the expenditure base according to actual price changes would be correct, since it would prevent an ongoing real expansion of expenditure through a manipulation of the price forecast.[4] Nonetheless, it is important to continue the practice of allocating part of the budget to a price reserve which is released only if prices rise at the expected rate. The reason lies in past experience which has shown that when budget targets are exceeded (in real terms in this case), the government finds it

[3] The subsidy component of the loans was included in government expenditure in the past as well.

[4] There is no similar adjustment of the price stability target. Therefore, one cannot assume an upward revision of price levels following lower than expected inflation.

difficult to compensate for the deviation in the coming year and instead tends to revise the target.

The determination of an expenditure ceiling based on the budgets in previous years has the important advantage of stabilizing long run expectations as long as the government meets the targets. Although this method of calculation can result in large jumps in public spending from year to year (as, for example, in 2005), if the government sticks to the target, then its real level of expenditure for 2010 will be known already today and will not be dependent on annual deviations. As a result, the pressure for massive spending at the end of the year, which is meant to prevent the decrease in the budget base for the next year, will be reduced. The long term target also enables multi-year planning of various components of government activity. This is especially so if the government attains a level of deficit which is sufficiently lower than the ceiling that it reduces the probability of the need to reduce spending to below the path in order to meet the deficit target. Since this expenditure path, established in 2004, is in fact compatible with a substantial reduction of the deficit and the public debt to GDP ratio, it appears that it can contribute significantly to strengthening the credibility of fiscal policy and the efficient use of the budget in the medium run. This is especially true if a target for the debt to GDP ratio for the medium run were added to it.

5. MULTI-YEAR ANALYSIS OF THE GOVERNMENT BUDGET

The fact that the deficit has remained at the level at which it stabilized in mid-2003, similar to the level planned in the 2005 budget, is not enough to ensure a significant reduction in the public-debt/GDP ratio in the next few years.

The fiscal adjustment carried out by the government during the past two years has corrected the instability in the path of the budget which characterized the economy until mid-2003. However, the fact that the deficit has remained at the level it stabilized at in mid-2003, and that a similar level is planned for the 2005 budget, means that no substantial reduction will be made in the public debt to GDP ratio in coming years. Nonetheless, the government has also adopted an expenditure target which may enable a larger reduction in the deficit to below the ceiling, thus contributing to the more rapid decrease in the debt to GDP ratio. This is conditional on the government not utilizing the majority of the reduction in the proportion of its expenditure in GDP in order to reduce taxes. Past experience shows that when gaps are created between the overall budget targets and the actual trend of the budget, the government has tended to change the targets rather than adjusting the budget, particularly if the gaps are created when no crisis exists. Therefore, it is important to determine whether the expected path of the budget, according to the government decisions regarding specific measures that will affect expenditure and the deficit in coming years, is compatible with the budget targets.

In order to check the compatibility between the targets established by the government for coming years and the expected path of the budget in light of government decisions on specific policy measures, we analyzed the budget using a long run model which is based on the past trends of the various fiscal variables.[45] We input into the model estimates of the effect of government budget decisions for the period 2005-2010 and examined the expected trends of budget aggregates. The main assumptions of the analysis, including the macroeconomic scenario for coming years, are specified in Text Box 3.5. This analysis made it possible to estimate the magnitude of the additional budget adjustment required in order to meet the targets set by the government, to examine whether the relevant constraint on the government budget in coming years is the expenditure ceiling or the deficit ceiling and to analyze the expected trend of the debt to GDP ratio and budget aggregates.

Past experience shows that when gaps are created between the budget targets and the actual performance of the budget, the government has tended to change the targets rather than adjusting the budget, particularly if the gaps are created when no crisis exists.

Box 3.5
The Main Assumptions used in the Long-Run Forecast of the Budget Trend[1]

- GDP will grow by 3.5 percent in 2005, 3.8 percent in 2006 and 4.0 percent annually during the period 2007-2010. This is based on the assumption that employment will grow at a faster rate than the workforce, such that unemployment will converge to its natural level in 2010. In addition, it is assumed that output per worker will increase by 1.34 percent annually which has been the average rate over the last thirty years.[2]
- The government will spend the amounts included in the expenditure target reserve in 2005.
- The cost of the disengagement plan will total 3 billion shekels in each of the years 2005 and 2006.
- The real wage in the economy will rise by a rate equivalent to the rate of growth in output per worker.

[1] On the basis of individual decisions and measures which have already been approved.

[2] The rates of increase in the population and the workforce are based on the forecasts of the Central Bureau of Statistics for the years 2000-2020. For more detail, see: Kobi Braude (2003), "The Demographic Influence on Public Spending in Israel in the Long Run," Economic Quarterly, 50, December.

[45] For a detailed description of the analytical framework, see: Kobi Braude and Adi Brender, "The Influence of the Economic Plan on the Government Budget during the Years 2003-2008," Bank of Israel, July 2003.

- The real return on bonds to be issued by the government from 2005 onward will be 4.0 percent which is similar to the average for the past decade (6.5 percent on unindexed bonds). From 2006 onward, the interest rate on unindexed debt will fall to 6 percent.
- The government will implement its decision on the freezing of manpower and nominal budgets in the public sector and will fulfill the wage agreements with the Labor Federation. Furthermore, the rate of increase in public consumption prices (apart from education and health) will be similar to that of output prices. This is an optimistic assumption since the increase in public consumption prices in Israel in recent decades has exceeded that of output prices (as it did in the developed countries as well).[3] Taking this trend into consideration would have increased expected government spending, with a partial offset due to the increase in tax revenues.
- In the Knesset, the implementation of various private members' bills, which was delayed in the past, will again be delayed in the future.
- The civilian assistance from the US government will decline, in accordance with the multi-year agreement, by $120 million per year simultaneously with an increase in military assistance of $60 million per year.
- Tax revenues will increase with an elasticity of 1.1 relative to the growth in GDP, excluding the effect of legislative changes. This is the actual elasticity which has been calculated for the past decade.[4] The revenues in 2005 were estimated on the basis of the Research Department's tax model and the explicit assumptions regarding the trends in macroeconomic variables.
- The defense budget will increase in real terms by 0.6 percent annually as a result of the increase in military assistance that was promised as part of the agreement to reduce civilian assistance. Various reductions will be made in this rate of increase as decided upon by the government.
- The tax reform and the other tax cuts, including the reduction in payments by employers and the self-employed to the National Insurance Institute during the years 2005-2007, will be implemented as planned.

[3] The rate of increase in public consumption prices during the last thirty years has been higher than that of output prices by an average of 1.5 percent annually. (The same result is obtained for the last twenty years.)

[4] See Adi Brender (2001), "Estimates of the Tax Revenue Function for Israel," Bank of Israel, Series of Articles for Discussion, 2002.02 (January).

- The shekel/dollar exchange rate will be 4.5 shekels at the end of 2005 and 4.7 shekels at the end of 2006. The CPI will rise by 2 percent annually.
- The expenditure on education and health will increase in accordance with the changes in the size and composition of the relevant populations. The quantitative increase in these services per service beneficiary[5] will equal the growth in output per worker. Output productivity will remain unchanged while the rate of increase in wages in education and health will be similar to that of the average wage in the economy.[6] The cost of implementing the recommendations of the Dovrat Report will be offset from other expenses.
- Indexation differences on bonds issued by the government since 2001 and in coming years, will be recorded in the budget as an expense at the time of redemption.
- In 2005, the government will finance 3 billion shekels of its deficit through the sale of government corporations.
- The risk costs (scoring) paid to the US government on the issue of bonds within the framework of the guarantees will be recorded in the budget over the next 20 years.

[5] For example, per pupil in elementary school. This assumption is an illustration which is meant to also express the increase in the number of service beneficiaries following legislative changes. An example would be the extension of the Free Education Law to nursery school age.

[6] This assumption is compatible with the rate of growth in expenditure per pupil in primary school and high school during the years 1976-1999.

Strict implementation of the government decisions previously taken and the avoidance of further reductions in revenues should be sufficient to enable the fiscal targets in 2006 to be met as well.

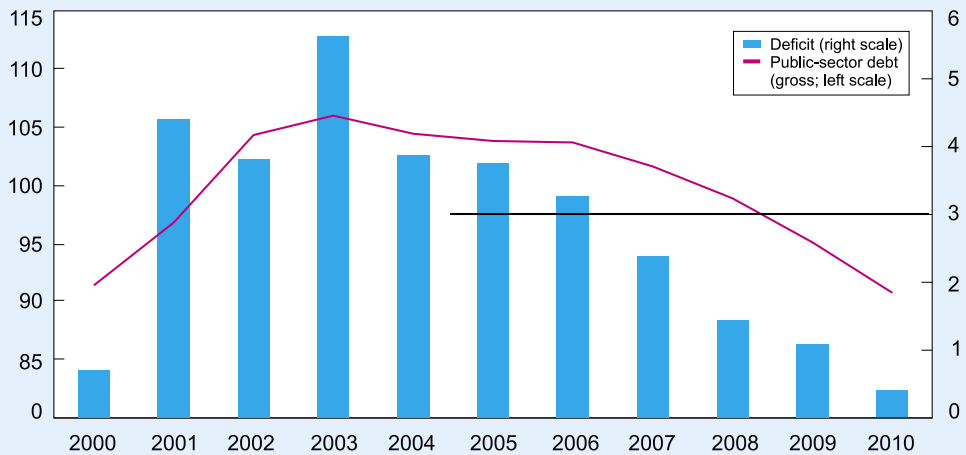
The analysis shows that the expected rate of growth in spending in 2006, based on existing government decisions, is compatible with the spending target and that the deficit in 2006 and onward is expected to be less than the ceiling decided on by the government[46] (Table 3.6 and Figure 3.6). Thus, if existing government decisions are implemented and there are no additional reductions in revenues, the government should be able to meet the fiscal targets in 2006 as well. In the years following 2006, the increase in spending is expected to exceed the range which is compatible with the target and therefore, the government will have to make additional adjustments. The required adjustments in 2007 and 2008 are also not large in comparison to those which were required in recent years. In later years, when the effect of the government decisions to slow the growth in spending weakens, spending is expected to grow at

[46] Without the costs of the disengagement plan.

It is important to start planning right away the measures needed to reduce the size of the public sector and public sector employment within the framework of a multi-year budget, at the same time adopting the structural changes that will increase its efficiency and thus maintain the quality of public services.

a faster rate and the government will have to decide on additional measures of a larger magnitude or extend existing decisions in order to meet the target. Since the government cannot in the long run restrict the increase in wages in the public sector to rates which fall short of those in the business sector, it is important to plan the measures needed to reduce the size of the public sector and public sector employment within the framework of a multi-year budget. This should be accompanied by structural changes that will at the same time increase efficiency and thus maintain the quality of public services.

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



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

SOURCE: Bank of Israel.

The future trend of the budget according to the above scenario will reduce the proportion of government expenditure in GDP by 3 percent by 2010, resulting in a cumulative reduction of 6 percent since 2002. Public expenditure is expected to continue to decline in quantitative terms though not in real per capita terms (deflated by business-sector prices) since real wages in the health and education sectors are expected to rise during the period 2006-2010 at a rate similar to that of the average wage in the economy, as indicated by past experience. The government deficit is expected to gradually decline to below one percent of GDP by 2010. The public debt to GDP ratio will begin declining at a rapid rate from 2007 onward and will reach 91 percent of GDP in 2010, the level it was at in 2000.

One of the most important achievements of the fiscal policy changes in the past two years is the savings in interest expenses.

One of the factors contributing to the decline in government expenditure during this period is the reduction in interest payments though an examination of the expected decline in interest expenses conceals the full impact of one of the most important achievements of the changes carried out in the past two years—the savings in interest

Table 3.16
The Expected Paths of the Main Budget Aggregates According to the Government's Decisions: 2002 to 2010
(percent of GDP)

			Estimate	Forecast					
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Basic scenario: Based on existing government decisions									
Revenues	39.2	37.1	36.2	36.1	36	35.8	36.1	36.2	36.3
Of this: Tax revenues	30.2	28.9	29	29	29	29.1	29.4	29.5	29.6
Expenditures (without granting of credit)	43	42.7	40	39.9	39.4	38.1	37.5	37.3	36.7
Net without interest and payment of principal to the NII	33.2	32	30.5	30.1	29.6	28.2	27.9	27.8	27.5
Deficit without credit	-3.8	-5.6	-3.9	-3.7	-3.3	-2.3	-1.4	-1	-0.3
Gross public debt	104.3	106.5	104.9	104.6	104.9	102.7	99.8	95.9	91.5
Of this: Government debt	101.7	103.8	102.3	102.2	102.6	100.5	97.7	93.9	89.6
Gap between expected expenditure and the expenditure target	…	…	…	…	0	0.4	0.8	1.7	2.1
Real change in expenditures (percent)[a]	1.1	0.4	-1.6	1.9	2.5	2	2.3	3.5	2.4
Scenario of tax reductions while meeting the deficit target									
Tax revenues	30.2	28.9	29	29	29	28.5	27.9	27.7	27.3
Deficit without credit	-3.8	-5.6	-3.9	-3.7	-3.6	-3	-3	-3	-3
Gross public debt	104.3	106.5	104.9	104.6	105.2	103.6	102.3	100.2	98.2
Scenario of meeting the expenditure target									
Expenditures (without the granting of credit)	43	42.7	40	39.9	39.4	37.7	36.6	35.6	34.5
Deficit without credit	-3.8	-5.6	-3.9	-3.7	-3.3	-1.9	-0.6	0.7	1.8
Gross public debt	104.3	106.5	104.9	104.6	104.9	102.3	98.6	93.1	86.7

[a] Not including expenditure on the disengagement plan.
SOURCE: Calculations of the Research Department of the Bank of Israel.

expenses. If interest rates had remained at their 2003 levels, expected interest expenses in 2010 would be higher by one percent of GDP than in the present scenario. This remains true even if the calculation is done on the basis of the level of debt which results from the expected deficit levels in the present scenario. If the calculation is based on a fixed deficit level of 5 percent of GDP for all the years, which was the average level in 2003, then interest expenses would reach 8.3 percent of GDP in 2010, which is 2.5 percent of output higher than in the present scenario. These simulations clearly illustrate the magnitude of budget resources that are freed up over time by spending restraint in the present.

As stated above, the government targets make it possible to cut taxes as long as the deficit is below the ceiling of 3.0 percent of GDP. If the expected decrease in the deficit indeed occurs from 2007 onwards, the government will be able to meet the targets while at the same time significantly reducing the tax burden. In order to analyze the possible impact of substituting a reduction in taxes for a reduction in the deficit, an alternative scenario is presented in Table 3.16 in which the government reduces tax rates while maintaining the deficit ceiling.[47] According to this scenario, the tax burden will decrease by 1.7 percent from 2004 until 2010 with a cumulative decline of 2.9 percent from 2002. The public debt will decline in this scenario by a slower rate than in the basic scenario and will reach 98 percent of GDP in 2010. Furthermore, the size of the deficit in later years, according to this scenario, is not compatible with the continuing decline in the debt to GDP ratio in following years when the rate of growth in GDP returns to its potential level.

Meeting the budget targets in coming years will enable rapid progress in reducing the public debt to GDP ratio towards the common levels in developed countries, and even leaves room for an additional reduction in tax rates without compromising the rapid downward trend in the debt to GDP ratio.

An additional scenario examines the situation in which the government carries out the adjustments required to ensure meeting the expenditure target in each year up until 2010 (without further adjustments in tax rates). According to this scenario, the proportion of government expenditure in GDP will decline by an additional two percent and will reach 34.5 percent of GDP. In this scenario, the budget will reach a surplus of two percent of GDP and the ratio of public debt to GDP will reach 87 percent. This scenario indicates that meeting the budget targets in coming years will enable rapid progress in reducing the public debt to GDP ratio towards the common levels in developed countries and even leaves room for an additional reduction in tax rates without compromising the rapid downward trend in the debt to GDP ratio.

[47] The scenario does not relate to the possibility that the reduction in tax rates, on the one hand, and the increase in the deficit, on the other, will influence the growth in GDP in the short run.