Chapter 6

The General Government, Its Services and Financing

- The government deficit totaled 2.8 percent of GDP in 2014—lower than the ceiling set in the budget and about 0.4 percentage points lower than the deficit of the previous year. The deficit narrowed in the past two years mainly as a result of the fiscal stabilization program approved by the government in the 2013–14 budget.
- The general government deficit in Israel (2.6 percent of GDP) was larger than the average deficit in the OECD, but the gap has narrowed markedly in the past two years.
- The volume of public debt relative to GDP did not change in 2014, and totaled 67.6 percent of GDP. Total debt in Israel is lower than the OECD average, but the interest payments on the outstanding debt are higher than the average in those countries.
- The increase in public expenditure slowed in 2014 compared to recent years. Total civilian expenditure (excluding interest payments) declined and totaled 30.8 percent of GDP—a very low rate by international comparison. In contrast, defense expenditures increased relative to total expenditures and relative to GDP.
- The government financed all of the costs (NIS 7 billion) of Operation Protective Edge, the military operation in the Gaza Strip, from the 2014 budget, without exceeding total expenditures. The financing was made possible through the use of budgetary reserves and a government decision to cut the budgets of civilian ministries.
- The government recently undertook to assist a number of public and private bodies that have encountered financial distress (Hadassah hospital, the Postal Company, and others). These bodies are considered too big or important to fail, and are basically benefitting from implied government guarantees. If it is not possible to increase competition in order to prevent dependency on these bodies, financial and material supervision over them must be tightened.
- General government tax revenue totaled 31 percent of GDP in 2014—an increase of 0.6 percentage points from 2013. Revenue increased due to tax measures included in the budget and due to increased imports of consumer products (particularly vehicles) and price increases in the capital market.
- A VAT reduction on necessities will assist those with low incomes, but to a lesser extent than other measures (such as expanding benefits), and it may increase the distortions in the tax system.
- The cost of raising tradable debt for financing the public deficit declined in 2014. Nontradable bond issues earmarked for the pension funds increased to about one-third of total issued debt, and the interest paid on those bonds is higher than the interest on tradable debt.
- The proportion of private financing of national healthcare expenditures has increased in recent years, as has the proportion of private supply of healthcare services. Their rapid expansion may threaten the efficiency and equity of the healthcare system.

1. MAIN DEVELOPMENTS AND FISCAL POLICY

The general government deficit declined by 0.5 percent of GDP in 2014, and public debt remained unchanged.

Fiscal policy in 2014 was based on the fiscal stabilization program implemented by the government as part of the 2013–14 budget. The results of this program, and the level of activity in the economy, contributed to a decline in the general government deficit[1], which totaled 2.6 percent of GDP in 2014–about 0.5 percentage points lower than the deficit in 2013 (See Table 6.1). The deficit declined even though economic growth slowed slightly during the year. Net of the effect of the slow growth, the cyclically adjusted deficit declined markedly, to 2.5 percent—one percentage point lower than the same figure for the previous year, and 2 percentage points lower than in 2012. The structural deficit also narrowed, by the same order of size—evidence that the decline in the deficit is not the result of one-time factors. In the past two years, the deficit in Israel has narrowed more rapidly than the average pace in the OECD, but it is still higher than the average in those countries. The prolonged downward trend in total public debt relative to GDP was halted last year, and remained unchanged at 67.6 percent of GDP—lower than the OECD average (86.2 percent). The central government deficit (excluding credit) declined by about 0.4 percentage points, to 2.8 percent of GDP in 2014—slightly below the ceiling set in the budget.[2]

Net of the effect of the slow growth, the cyclically adjusted deficit declined markedly in the past two years, as a result of the fiscal stabilization program implemented in 2013.

Defense expenditure increased by 6.9 percent this year compared to the previous year, as a result of Operation Protective Edge. The share of defense expenditures increased relative to the total budget and relative to GDP for the first time since 2006, when the Second Lebanon War took place.

The composition of government expenditures in 2014 was affected by Operation Protective Edge, the military operation conducted in the Gaza Strip: While total (nominal) public expenditure increased more slowly than in previous years (3.2 percent), defense expenditure increased by 6.9 percent—the largest increase since 2006, when the Second Lebanon War took place. Thus, defense expenditure as a share of total public expenditure and of GDP increased for the first time in seven years. The government financed all of the defense expenditures derived from the operation (NIS 7 billion) during 2014 by using budgetary reserves and budget surpluses generated due to the declines in interest payments and in inflation. In addition, the government cancelled or delayed planned civilian expenditures—particularly transport infrastructure expenditures, an investment that is occasionally delayed due to execution difficulties—in order to free up resources to finance the operation.

Despite the security incidents and the slight slowdown in growth, government tax revenue slightly exceeded the budget projection. The increase in tax revenue—4.1 percent higher, in real terms, than in 2013, net of legislative changes and one-time revenue—derived from GDP growth, increased imports of consumer goods (particularly the increase in vehicle imports that took place toward the end of the year), and the increase in asset prices in the capital market. There was a slight negative impact on revenue from the slowdown in new home sales, a development that was affected by expectations of VAT benefits on such homes.

[1] The general government includes the government, national institutions, public nonprofits, the National Insurance Institute, and the local authorities. More information appears in Table 6.A.9.

[2] The ceiling was set in terms of GDP before the Central Bureau of Statistics 2013 revision of the definitions that serve to measure GDP. At that time, the ceiling was 3 percent. According to the new definitions, it is 2.9 percent.

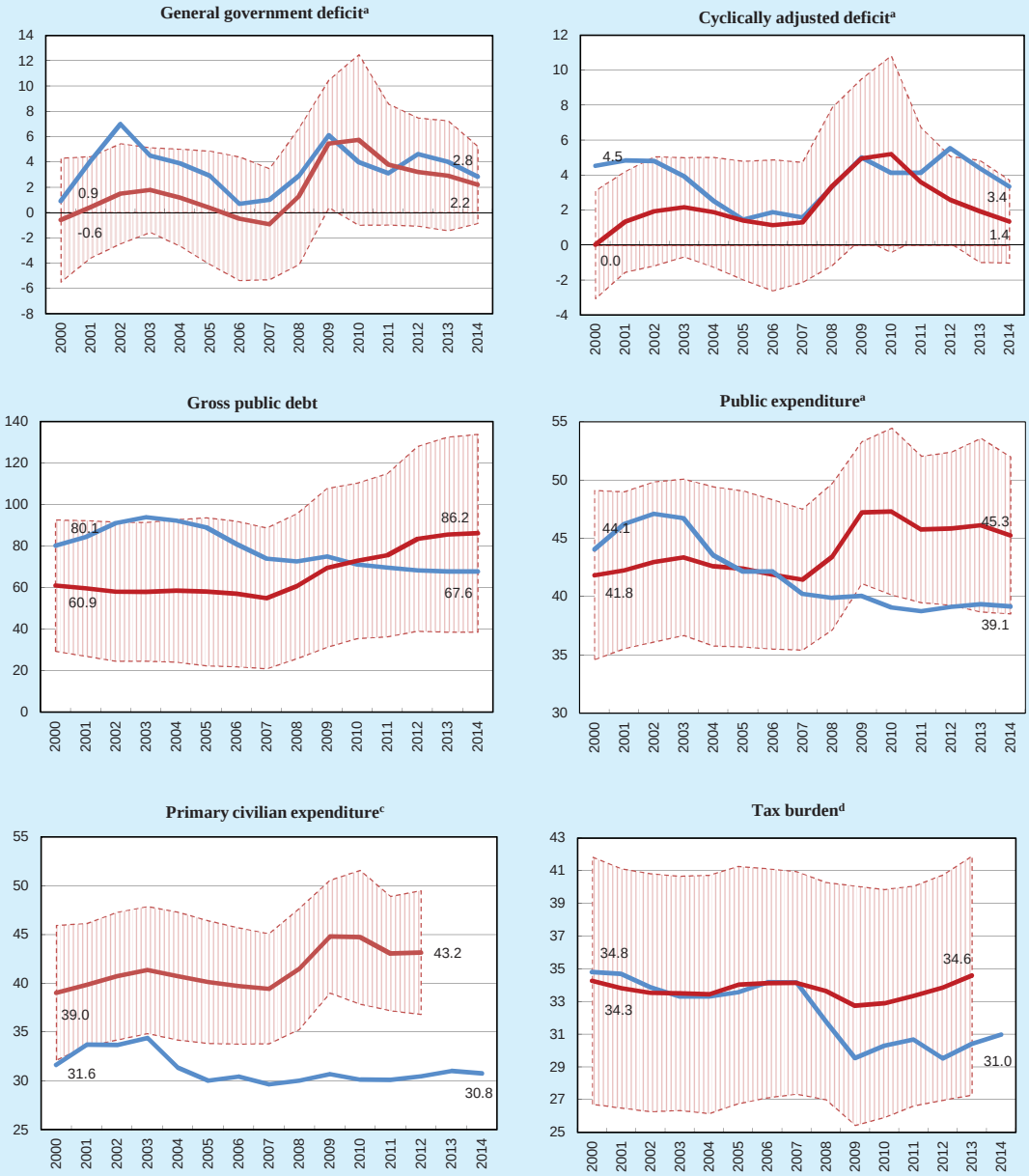
Table 6.1
The main components of the general government's revenue and expenditure, 2001–14

(percent of GDP)

	Average 2001–05	Average 2006–10	2011	2012	2013	2014
Total public revenue	**41.7**	**38.6**	**36.7**	**35.4**	**36.3**	**36.7**
Income from property	1.4	1.0	0.7	0.7	0.7	0.6
Total taxes	**33.7**	**32.0**	**30.7**	**29.5**	**30.4**	**31.0**
Indirect taxes on domestic production	11.6	11.6	11.7	11.3	11.7	12.3
Indirect taxes on civilian imports	3.7	3.9	3.9	3.6	3.4	3.8
Direct taxes, fees and levies	12.5	11.3	9.8	9.6	10.1	10.1
National Insurance Institute revenue	5.5	5.2	5.3	5.1	5.1	5.2
Grants	3.1	2.2	1.8	1.7	1.6	1.6
Other[a]	3.4	3.5	3.5	3.5	3.6	3.5
Total public expenditure	**45.3**	**40.4**	**38.7**	**39.1**	**39.5**	**39.3**
Current expenditure	42.0	37.2	35.8	35.9	35.9	36.2
Domestic civilian consumption	17.5	16.2	16.6	16.7	16.8	16.9
Domestic defense consumption	5.9	5.2	4.8	4.6	4.5	4.7
Defense imports	1.7	1.3	1.0	1.1	1.0	1.1
Direct subsidies	0.7	0.8	0.7	0.7	0.8	0.9
Transfer payments on current account	11.2	9.9	10.0	10.0	9.9	9.8
Interest payments	5.1	3.8	2.9	3.0	2.9	2.9
Transfer payments on capital account[b]	1.4	1.8	1.5	1.6	1.8	1.7
Investments of general government	1.9	1.5	1.4	1.5	1.7	1.5
Primary civilian expenditure	**32.6**	**30.2**	**30.1**	**30.5**	**31.0**	**30.8**
Total deficit of the general government	**3.6**	**1.8**	**2.0**	**3.7**	**3.1**	**2.6**
Deficit using international definition[c]	3.1	2.9	3.1	4.6	4.0	2.8
Current deficit of the general government	3.0	1.6	2.2	3.4	2.7	2.5
Total cyclically adjusted deficit[d]	1.7	2.3	3.0	4.5	3.4	2.5
Total cyclically adjusted deficit using international definition[e]	2.6	3.2	4.1	5.5	4.4	3.4
Net public debt[f,g]	77.3	66.8	64.0	63.0	62.7	63.4
Gross public debt[f]	90.1	74.7	69.7	68.3	67.6	67.6

[a] Includes transfer payments from the public on the current and capital accounts, imputed pensions, depreciation, capital transfers from abroad, and transfers from abroad to National Institutions and nonprofit organizations.
[b] Includes mortgage subsidies and transfers on the capital account to nonprofit organizations and businesses.
[c] The deficit in this item was brought in line with the accepted international definition by adding indexation differentials on indexed and unindexed shekel debt. Indexation differentials need to be added in respect of unindexed debt because the CBS imputes a reduction of these differentials when reporting interest payments.
[d] Interest expenses are calculated assuming that the inflation rate during the year was 2 percent, and not according to the actual inflation rate.
[e] The deficit in this item was brought in line with the accepted international definition by adding indexation differentials on the indexed and unindexed shekel debt, assuming inflation of 2 percent.
[f] Excluding municipalities' debts to the government.
[g] Net public debt equals the gross public debt minus active loans minus government deposits with the Bank of Israel.
SOURCE: Based on Central Bureau of Statistics data.

Figure 6.1
Fiscal Aggregates in Israel Compared to the OECD Average[b], 2000–14 (percent of GDP)



[a] Deficit and expenditure data for Israel were adjusted to the accepted international definition.
[b] Data for OECD countries are arithmetic averages of all countries for which there are data in the OECD's system.
[c] There are still no data for OECD countries for 2013 or 2014.
[d] There are still no data for OECD countries for 2014.
SOURCE:Based on OECD data, Central Bureau of Statistics, and OECD Revenue Statistics 2014.

At the end of 2014, the Knesset was dissolved without approving a new budget for 2015, and government ministries have been operating since the beginning of 2015 within a transition budget, meaning a budget that restricts monthly expenditures to 1/12 of total expenditure in the previous year. This is what happened around each of the last three elections. The result—a delay in budgetary changes and reforms to the period immediately following the elections—is common in other countries as well[3], where it derives from the fact that governments sometimes use elections to gain broad support for measures that are beneficial to the general public but negatively impact groups with interests who may torpedo them.

Passing a two-year budget following the elections instead of two budgets within a short timeframe avoids repeated political negotiations and preparatory work among the government ministries. However, it extends the use of a transition budget, which has a negative impact on the performance ability of civilian ministries and lowers the ability to make changes and reforms.

The lack of a budget (and of the Arrangements Law that accompanies it) during the last year of a government's term, alongside the fact that Israeli governments typically have a relatively short lifespan, basically leave a new government only a short timeframe in which to make changes to the State Budget and its composition and to promote reforms in the economy. The use of two-year budgets—and the difficulty in passing significant reforms outside the Budget Arrangements Law, particularly with an unstable coalition—narrow the window of opportunity even further. When a government elected in the middle of the year decides to pass a two-year budget for the next year and a half, it avoids preparing two budgets within a short timeframe, thereby avoiding repeated political negotiations and preparatory work among the government ministries. However, such a budget makes it difficult for the new ministers to get to know their ministries and to advance policies before the window of opportunity for change closes. In addition, passing two separate budgets makes it possible to more rapidly approve the budget for the current year, thereby reducing the time during which government expenditures are restricted each month by the transition budget—a situation which negatively impacts the ability of the government ministries (particularly civilian ministries) to fully implement the programs in the budget.

The rules for setting the budget framework

The outgoing government decided a number of times to change the two fiscal rules that set the framework for the state budget—the deficit rule and the expenditure rule. As part of the 2013–14 budget, the government changed the deficit rule in order to make it possible to delay the target dates of the outline for reducing the deficit. It also decided to make a one-time supplement to government expenditures in 2013, which led to exceeding the ceiling that was set in the expenditure rule that was in place at that time. At the end of 2013, the government decided to change the expenditure rule, and determined that it would increase every year in real terms in line with the average growth rate of the population plus a rate that depends on the size of the government debt: The latter would increase with the reduction of debt and would be 1 percent

[3] For instance, see, Alesina, A., S. Ardagna and F. Trebbi (2006), "Who adjusts and when? On the political economy of reforms", NBER Working Paper No. 12049.

when debt reached 50 percent of GDP.[4] As part of the discussions toward the 2015 budget, the government decided to again change the deficit rule in order to increase the deficit in 2015 and slow the pace of deficit reduction in the coming years. The government also decided on a one-time budgetary expenditure exceeding the new expenditure rule in order to increase the defense budget. The Knesset did not approve these two decisions before dispersing.

Fiscal rules are meant to prevent a situation in which the deficit and debt exceed sustainable levels. Achieving the main objective of the rules does not necessarily dictate any ideological choice concerning the size of the government, and is also possible when there are frequent changes in political preferences regarding the scope of government expenditures.

The main aim of the fiscal rules is to create an anchor for the government budget, with the objective of preventing a situation in which the deficit and debt exceed sustainable levels. Fiscal rules are meant to prevent a situation in which expenditures grow too rapidly and in an unbalanced way during periods of economic growth (when tax revenues are high), thereby making it possible to avoid sharp cuts in government services during recessionary periods (when revenues are low)—cuts that would make the recession and its negative impact on the public more serious.[5]

The economic discussion on realizing this target of the fiscal rules—achieving budgetary discipline—is of a professional-technical nature, and its objective is to design rules that will maintain a sustainable level of debt while simultaneously demonstrating the flexibility to avoid being jettisoned during times of economic shocks. In addition to this aim, fiscal rules may serve other objectives, including the narrowing of debt and changing the size of government (meaning a change in the volume of expenditures in relation to GDP). The decision on such objectives, the direction in which they should lead, and the pace of progress they dictate derives mostly from social preferences and from economic-ideological and political views. Achieving the main objective of the rules—the prevention of excessive deficit and debt—does not necessarily dictate any ideological choice of the desired size of government. The use of fiscal rules, particularly a rule that dictates the permitted rate of growth of government expenditures, may help create an anchor for budgetary planning as well, by setting out a stable multiyear path for budgetary aggregates. However, this stability

[4] The previous rule came into effect in 2011, and set out that the maximum growth rate of public expenditure would be obtained by multiplying two factors: 1) the average annual GDP growth rate in the past decade, and 2) the quotient obtained by dividing 60% by the public debt to GDP ratio. The new rule sets out that the expenditure growth rate will be obtained by totaling two factors: 1) The average growth rate of the population in the past three years, and 2) the quotient obtained by dividing 50% by the public debt to GDP ratio. According to estimations, the new rule makes it possible for public expenditure to grow in real terms by an average rate of about 2.5 percent per year in the coming years—lower than the rate that would have been dictated by the previous rule. More details appear in Chapter 6 of the Bank of Israel Annual Reports for the years 2012 and 2013.

[5] The economic literature identifies a number of processes that lead to the fact that, in the absence of fiscal anchors, governments tend to increase expenditures in an unbalanced manner (which increases future deficits): First, governments may suffer from shortsightedness and prefer present budgetary expansion over cautious behavior that will bear fruit only at the time of the next recession (perhaps during the next government's term). Second, government ministries, public groups, and parties with interests wishing to increase expenditures in areas close to their hearts do not take into account all of the costs involved in increasing expenditures that are imposed on the general public ("the common pool problem"). Third, high revenues during boom periods encourage demands to increase expenditures, and may thereby lead to procyclical policy that will cause cuts during recessionary periods.

depends on the stability of decision-makers' political preferences. In an environment where governments frequently change, there is instability in political preferences, which may also lead to instability in budgetary planning.[6] In any case, even in such an environment, the fiscal rules should continue to dictate disciplined budgetary behavior that will prevent the deficit and debt from growing at unsustainable levels.

The deficit rule was changed many times and has failed in achieving its objective—maintaining sustainable deficits and debt.

Israel first instituted a fiscal rule—the deficit rule—in 1992, and until 2004 this was the only fiscal rule. During this period, the deficit rule failed to achieve the main objective of fiscal rules: The deficit ceilings set in the rule were expanded many times, it did not prevent procyclical policy, and did not succeed in reducing the deficit or debt in a sustainable manner. In 2005, Israel instituted an additional fiscal rule—the expenditure rule—but in the absence of a rule that would control state revenues (i.e., control tax rates), the deficit rule still did not succeed in providing a stable anchor for the government budget, and it was changed a number of times: The rigid rule does not adjust the deficit ceiling to the business cycle, and the government changed it so that it would not be forced to adopt a procyclical policy during the 2008-09 global crisis. The rule was changed again in 2013 in order to make a gradual fiscal reduction possible after the slowdown in growth and the high deficit that was created in 2012. The outgoing government, as stated, wanted to change it again in order to enable an increase in expenditures beyond the ceiling set in the expenditure rule, and in order to lower taxes (to lower VAT to zero on new homes).

The expenditure rule was changed a few times, but has been much more successful in stabilizing public expenditure. In the absence of a limitation on revenue (tax rates), the rule made a limited contribution to stabilizing the deficit.

As stated, the expenditure rule joined the deficit rule in 2005, and had greater success in creating a non-cyclical anchor for government expenditure, since it created an operative ceiling for the real growth rate of expenditures. While the level of the ceiling was changed with each version of the rule[7], and one-time supplements were made four times (which led to a deviation from the rule in seven of the ten years that have passed since it was instituted)[8], the outline that the rule dictated remained the benchmark to which expenditures reconverged and around which the discussion of changes and supplements was conducted. The two most recent versions of the expenditure rule also included an implied target for reducing public debt (first 60 percent of GDP, and in the last version 50 percent). The expenditure rule has contributed to the reduction of the high deficit and debt that were created after the crisis at the beginning of the century, and assisted in avoiding procyclical policy during the last recession. However, since

[6] Such uncertainty may negatively impact the efficiency of government expenditure. For instance, Box 6.2 shows how the changes in the budget affect the government's investment programs in transport infrastructure.

[7] In the years 2005 and 2006, the ceiling allowed for an increase of expenditures by 1 percent in real terms. In 2007–10, the permitted increase was 1.7 percent per year, and in 2011–14, the permitted increase was 2.7 to 3.4 percent per year. The new rule from 2015 enables an increase of 2.6 percent per year.

[8] In 2005, there was a three-year supplement to finance the Disengagement Plan. In 2007 there was a two-year supplement to finance the Second Lebanon War. In 2009 there was a two-year supplement to deal with the financial crisis, and in 2013, there was a supplement due to the delay in approving the State Budget for that year.

the rule controls only the expenditure side and there is no limitation on changes in the tax rates, its contribution to stabilizing the deficit was limited.

The expenditure rule did not only serve as an anchor for the budget, but also to reduce the size of the government in the economy.

Since the expenditure rule took effect, Israeli governments have used it to set expenditure growth rates that were lower than GDP growth, and so, in effect, used it to continue decreasing the government's size in the economy, while also enabling significant tax reductions. The fact that the expenditure rule served to achieve such political-economic aims, as well as the frequent changes in government in Israel, contributed to its instability and led to frequent changes in the targets set in it.

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When countries have replaced the rigid deficit rule with a flexible rule that takes into account the business cycle, they made the rule much more durable, but also increased the concern over errors and deviations.

An assessment of the possibility of changing the existing rules may include consideration of both the technical-professional aspects and the political-ideological aspects. Two alternatives to the existing rules are discussed below. First, it is possible to replace the rigid deficit rule with a deficit rule that takes economic growth into account, thereby providing a better response to the technical requirements. Some of the countries that have adopted new fiscal rules or changed existing rules in the past decade created deficit rules that take into account the economy's phase in the business cycle. In other words, the new rules make it possible for the deficit to expand during downturns and require restraint during boom periods[9] (see Figure 6.2). These rules are

Figure 6.2
Deficit Rules in the 31 Advanced Economies[a], 2000, 2006 and 2013

[a] Advanced economies according to the International Monetary Fund classification.
SOURCE: International Monetary Fund.

[9] See Schaechter et al. (2012), "Fiscal rules in response to the crisis—Toward the "next generation" rules." A new dataset., IMF Working Paper 12/187.

more flexible, and are therefore more resilient to shocks than the rigid deficit ceiling that currently exists in Israel.

For the most part, the new rules clearly set out targets in cyclically adjusted terms (or in terms of the average over the course of the entire cycle), and they occasionally require corrections after some time with the objective of compensating for deviations that accumulated in the past. In most countries, the rules also include well-defined escape clauses, which make it possible to increase the deficit in extenuating circumstances (such as a deep recession, natural disasters, wars, and so forth) without changing the rule. The disadvantage of such rules is in their high level of complexity, since this reduces transparency and creates a wider opening for errors, disputes and manipulations regarding the determination of the phase in the cycle—a determination that decides the actual permitted size of the deficit.

The expenditure rule that accompanies the deficit rule has limited power, in accordance with changes in political preferences.

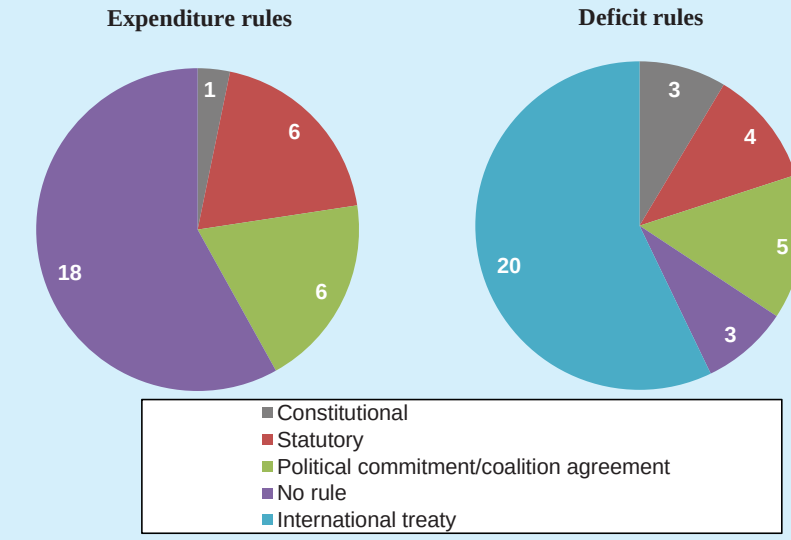
A deficit rule that takes the cycle into account can be joined by an expenditure rule that sets out that expenditures will increase at a relatively fixed rate over time, at rates that make it possible to meet the desired outline of the structural deficit and of debt. Such a rule, which currently exists in Israel, is an **operative** anchor for the budget and can enable a cycle-neutral expenditure policy. However, the political-ideological aspect limits the power of such a rule (and apparently also contributes to the fact that advanced economies use it less than deficit rules). When a new government is interested in realizing an ideological-economic view that is different than that of its predecessor, it will want to change the expenditure rule and the parameters set out in it in order to adjust them to its view. At this opportunity, it may also change the deficit rule and negatively impact the stability and credibility that it provides. The temptation to do this apparently leads to the fact that these two rules are treated differently by the law in the countries in which they exist. About half of the advanced economies that use an expenditure rule set it out in coalition agreements or in political commitments, without anchoring it in legislation at all. In contrast, a clear majority of countries that use a deficit rule anchor it through the adoption of an international treaty, through legislation, or even in the constitution, with the objective of leaving it in place even when there is a change in government[10] (see Figure 6.3).

A combination of the expenditure rule and a balance rule–a new rule that requires the balancing of expenditure and revenue measures made outside the expenditure rule—is an alternative that creates an anchor for the deficit and the debt and makes it possible to realize any ideology concerning the size of the government.

The second alternative to the existing rules does not try to make the deficit rule more flexible, but does away with it entirely. There are two components to this alternative. The first component is an expenditure rule that fixes the (basic) rate of increase of government expenditure, thereby in essence fixing the outline of the structural deficit and of debt—for instance, a rate of increase that is in line with the long-term pace of GDP growth will fix the structural deficit rate at its level when the rule takes effect. (It is therefore important to make sure that when the rule takes effect, the tax rates are at a level from which a sustainable structural deficit is derived.) The second component is a 'balance rule', a new rule that requires the immediate balancing of budgetary

[10] Ibid. if the rule is anchored through both arrangements, the Figure shows the stronger legal arrangement in each of the countries (in the descending order that appears in the study: 1. Constitutional; 2. International treaty; 3. Legislation; 4. Coalition agreement; 5. Political commitment).

Figure 6.3
The Legal Basis for the Expenditure and Deficit Rules in the 31 Advanced Economies, 2013



SOURCE: International Monetary Fund (see footnote 9 in the body of the Chapter).

measures made outside the expenditure rule (pay-as-you-go).[11] The balance rule requires balancing the effect of planned changes in tax rates on the structural deficit through a matching change in expenditures.[12] In other words, tax reductions will require a reduction in the growth of expenditures, and a further increase in expenditure will require tax increases.[13] The outline of additions or decreases included in the balance rule makes it possible to change the level of government expenditure (size of government), and makes it possible to realize the political-ideological preferences of the public: If the government wants to continue reducing its size relative to the economy, it will lower taxes while restraining the increase in expenditures[14], and if

[11] The US Congress adopted such procedural rules in 2006–08, which replaced the explicit law that had applied from 1991 to 2002. The Japanese government adopted such a rule in 2010.

[12] The Bank of Israel has raised a similar suggestion in the past. For details, see: Brender, A. (2012), "The story of Israel's new fiscal rule: Theoretical design meets politics", in Rules and institutions for sound fiscal policy after the crisis, Banca d'Italia.

[13] It is obviously also possible to discuss the question of who determines that the suggested measures are actually balanced. Currently, the Ministry of Finance bears responsibility for estimating the expected cost of budgetary measures or the revenue derived from them. A number of countries have created independent fiscal councils to supervise the budget and the projections on which it is based.

[14] The outgoing government did exactly that when it decided at the end of 2013 to cancel the planned increase in income tax and to finance it by permanently reducing expenditure. The growth rate in the expenditure rule for that year did not change, but essentially started from a lower level.

it wants to increase the volume of services and expenditures, it will be able to do so through a matching increase in tax rates. Such a combination of rules increases budgetary discipline, makes the deficit and debt path more stable, and reduces the chance of frequent changes in the path.[15] At the same time, and without changing the rules, it maintains the democratic principle that makes it possible for any government to realize its desired policy from the standpoint of the volume of services it provides, the social safety net it spreads, and the taxes it collects for these purposes.

2. THE DEFICIT

The general government deficit declined by 0.5 percent in 2014. Net of the slow growth, there was a marked decline in the cyclically adjusted deficit in the past two years, as a result of the fiscal stabilization program instituted in 2013.

In 2014, the general government deficit totaled 2.6 percent of GDP—a decline of 0.5 percentage points from its 2013 level, which took place despite the slight slowdown in economic growth. Net of the slow growth, there was also a marked decline this year in the cyclically adjusted deficit, which was estimated at 2.5 percent of GDP—a decline of one percentage point from its level of the previous year, and of two percentage points from its 2012 level. There was a similar decline in the structural deficit. Thus, the reduction in the deficit is not the result of one-time factors, but of the structural measures taken in mid-2013 as part of the 2013–14 budget. The deficit in Israel narrowed in the past two years more rapidly than the average pace in the other OECD member countries, although it remains at a high level compared to them.

The deficit of the central government totaled 2.8 percent of GDP—lower than the deficit ceiling set in the budget.

The deficit of the central government totaled NIS 29.9 billion—2.8 percent of GDP (see Table 6.2). The actual deficit is lower than the deficit ceiling set for 2014 in the budget (2.9 percent of GDP under its new definition), reflecting an improvement of 0.4 percentage points compared to 2013. This improvement derives from the measures taken in the 2013–14 budget, and helped lower the deficit by 1.2 percent of GDP since 2012. The reduction in the deficit is mostly derived from increased revenue, which totaled 26 percent of GDP. Central government expenditure totaled 28.8 percent of GDP—similar to its level since 2012.

[15] The expenditure rule fixes the basic growth rate of expenditures, which in turn must prevent debt and the deficit from reaching levels that will force the government to deviate from the rule and make cuts during recessions. However, this is basically a range of rates, and the choice of a particular rate within this rage is also affected to some extent by the economic-ideological preferences concerning the extent of risk to which the government is prepared to expose the economy, and to preferences regarding how the tax burden is divided between the present and the future and between this generation and the next.

Table 6.2
Central government deficit, revenue and expenditures, 2008–14

(percent of GDP)

	2008	2009	2010	2011	2012	2013	2014
Total government deficit ceiling excluding credit granted	1.6	6.0	5.5	3.0	2.0	4.3	2.9
Total actual government deficit excluding credit granted	**1.9**	**4.8**	**3.5**	**3.1**	**3.9**	**3.1**	**2.8**
Actual government domestic deficit	0.5	3.5	2.3	2.0	2.9	2.2	1.8
Total net revenues[a]	**28.3**	**26.6**	**25.6**	**25.8**	**24.9**	**25.7**	**26.0**
Taxes and imposts	24.1	22.8	22.5	22.9	22.1	23.1	23.6
Interest, profits, royalties, revenue from land sales	0.9	0.7	0.6	0.4	0.4	0.5	0.3
Loan from the National Insurance Institute (NII)	2.0	1.9	1.3	1.5	1.4	1.3	1.3
US government grants	1.3	1.2	1.2	0.9	0.9	0.8	0.8
Total net expenditure[a]	**30.3**	**30.1**	**29.1**	**28.9**	**28.8**	**28.8**	**28.8**
of which: Interest, repayment of principal to NII and credit subsidy	5.2	4.9	4.9	4.8	4.7	4.6	4.5
Net defense expenditure[b]	7.5	7.0	7.0	6.5	6.2	6.2	6.3
Total net primary civilian expenditure	17.6	18.1	17.2	17.6	17.8	18.1	17.9

[a] Excluding credit granted by the government and excluding credit repaid to the government.
[b] Defense expenditure in this table is larger than defense consumption shown in Table 6.1 because the Central Bureau of Statistics records pensions and other payments by the defense establishment as transfer payments, while recording an imputation of compulsory service.
SOURCE: Based on the State Budget—Major Provisions of the Budget, Central Bureau of Statistics data, and State of Israel Financial Statements as of December 31, 2014.

Table 6.3
Components of the deviation from the government's original budget for 2014

(NIS billion, net, excluding credit, at current prices)

	Actual performance in 2013	2014		
		Original budget	Performance	Deviation
Deficit (-)	**-33.2**	**-31.1**	**-29.9**	**1.2**
of which: Domestic deficit	-27.9	-28.9	-23.3	5.6
Deficit abroad	-5.4	-2.3	-6.6	-4.4
Revenue	**269.1**	**284.2**	**282.9**	**-1.3**
of which: Domestic revenue	258.4	273.7	272.0	-1.7
Taxes[a]	241.6	254.9	256.1	1.3
Loan from National Insurance Institute	14.2	16.2	14.5	-1.7
Other revenue[b]	4.9	4.4	3.7	-0.7
Grants from US government	8.4	8.63	8.57	-0.06
Expenditure[a]	**302.3**	**315.3**	**312.8**	**-2.5**
of which: Domestic expenditure	289.8	302.6	298.8	-3.8
Expenditure abroad[c]	12.6	12.7	14.1	1.3
Defense[c]	65.0	61.0	68.7	7.7
Interest, repayment of principal to National Insurance Institute, and credit subsidy	48.0	50.6	49.4	-1.2
Civilian ministries and transfer payments excluding miscellaneous	187.9	196.9	193.4	-3.5
Miscellaneous expenditures	1.9	7.8	2.6	-5.2

[a] Including VAT on defense imports.
[b] Revenue from interest, royalties, dividends and other sources.
[c] Including estimated transfers to defense from the economic reserve.
SOURCE: Based on the Accountant General's data on the performance of the 2014 budget.

3. GOVERNMENT EXPENDITURE

Growth of public expenditure slowed in 2014. Civilian expenditure excluding interest payments totaled 30.8 percent of GDP—a decline compared to the previous year, and very low by international comparison. Defense expenditure accelerated.

Nominal growth of public expenditure slowed in 2014 to 3.2 percent per year, after growing by 6.8 percent in 2013 and by 8.4 percent in 2012 (see Table 6.4). Total expenditure was 39.3 percent of GDP in 2014—a decline of about 0.1 percentage points compared to the previous year. Civilian expenditure excluding interest payments totaled 30.8 percent of GDP—a decline of about 0.3 percentage points compared to the previous year, and very low by international comparison (see Figure 6.1). In contrast, defense expenditure accelerated, growing by 6.9 percent in 2014 compared to the previous year, the largest growth recorded since 2006, the year in which the Second Lebanon War took place. For the first time since then, defense expenditure as a share of total general government expenditure (15.3 percent) and as a share of GDP (6.1 percent) increased slightly. Interest payments as a share of total general government expenditure continued to decline in 2014, to 7.1 percent, due to the decline in total debt in previous years, the decline in interest rates, and the slowdown in inflation.

Table 6.4
Rates of nominal increase of public expenditure in Israel, 2000–14

	Average 2000–2008	2009	2010	2011	2012	2013	2014
	(Rate of increase)						
Total public expenditure	3.6	6.7	4.8	4.6	8.4	6.8	3.2
of which: Interest payments	0.6	7.6	2.0	-7.0	13.3	2.3	0.9
Total primary public expenditure	4.0	6.7	5.1	5.6	8.0	7.1	3.4
of which: Current primary expenditure	4.0	6.7	6.0	6.0	7.3	6.1	4.6
Current primary civilian expenditure	4.1	8.4	6.3	6.6	7.7	6.5	4.1
Public consumption	4.0	4.4	6.6	6.0	7.3	6.1	5.0
Public consumption excluding defense imports	4.3	5.6	6.5	6.0	6.7	6.4	4.7
Civilian consumption	4.3	6.1	7.4	7.5	7.9	6.5	4.1
(Per-capita civilian consumption)	2.3	4.2	5.5	5.5	6.0	4.5	2.1
Wage expenditure	3.7	3.6	8.7	7.3	7.9	6.9	4.1
Purchases	4.9	9.7	6.7	7.9	8.0	6.2	4.1
Domestic defense consumption	4.2	3.1	3.4	3.2	2.6	5.1	6.7
Wage expenditure	2.8	4.9	3.3	3.4	3.9	4.3	2.6
Transfer payments on the domestic current account	3.9	11.6	5.6	5.7	7.2	4.6	3.4
(Per capita transfer payments on the domestic current account)	1.8	9.7	3.7	3.8	5.3	2.7	1.5
Investments of the general government	1.4	-0.8	2.4	9.2	16.7	17.9	-12.5
of which: Investments in land transport infrastructure	17.9	-1.3	4.3	-1.9	9.4	75.6	-7.8
Transfer payments on the capital account	8.3	11.9	-7.5	-4.6	16.1	17.9	-2.7
Change in the CPI (annual average)	1.9	3.3	2.7	3.5	1.7	1.5	0.5
Change in the GDP deflator	1.2	3.8	-0.1	1.2	4.3	2.3	0.4
Change in the public consumption price index	2.2	1.4	3.7	3.2	3.5	2.5	0.7
Change in nominal GDP	5.4	5.8	7.3	6.2	7.3	5.8	3.6

The government financed the full costs of Operation Protective Edge in 2014, which was made possible through the use of budgetary reserves and a permanent across-the-board cut in the budgets of the civilian ministries.

The development of civilian and defense expenditures was affected by Operation Protective Edge, which was conducted during the summer of 2014 in the Gaza Strip. The government managed to finance all the costs of the fighting—NIS 7 billion—in 2014, without increasing total expenditures beyond what was planned. Out of this amount, NIS 1.9 billion were diverted from the budgets of civilian government ministries as part of a broad cut decided upon by the government in August. The cut was made to the budgetary base, meaning that it permanently diverted budgets from these ministries, even though the expenditure for financing the operation is considered a one-time expense.[16] The defense establishment did not have a designated annual reserve for unexpected events. The existence of such a reserve would have made it possible to absorb some of the cost of the operation and moderate shocks to the budgets of the civilian ministries. The committee to assess the defense budget established in 2007 (the Brodet Committee) recommended maintaining such a reserve, and it was supposed to total NIS 1.2 billion as of 2013. However, it is clear that even such a reserve would not have covered the total cost of some of the military operations that have been conducted in recent years.

The government and the Knesset do not get a complete picture of the surpluses in the budget, and do not hold a significant discussion of the priorities in their use.

The defense establishment received the financing for the rest of the costs of the operation toward the end of the year, after the government raised it from reserves that had been maintained or created in the budget: budget surpluses in certain reserve items (for instance the "miscellaneous" item. Performance in that item was NIS 5 billion lower than budgeted, similar to previous years); lower than expected interest payments (due to the decline in the interest rates, the slowdown in inflation, and the lower-than-planned deficit in 2013); low expenditures (due to lower than expected inflation); and a decline in government investment, after two years of rapid increases (due to delays and difficulties in execution of transport infrastructure investments). As has happened in the past, this time as well a large portion of the reserves and surpluses were known a long time prior to the end of the year (or even at the end of 2013, when only some of the surpluses were used to cancel the planned increase in income tax). Even so, in such cases, the government and the Knesset do not receive a complete picture of the surpluses, and do not hold a significant discussion of the priorities for use of the surpluses. It is important to maintain sufficient reserves in the state budget, particularly in Israel's geopolitical environment. However, alongside this, it is recommended to set out rules for times to unfreeze them during the year, to increase transparency concerning the volume of reserves and surpluses and concerning how they are used, and to increase public control over them. Greater transparency will strengthen fiscal credibility, since the latter relies, *inter alia*, on the public's confidence in how the budget is managed. Such transparency will also increase the certainty surrounding the expected outline of the deficit and the debt over the course of the year.

[16] Government decision number 1998 dated August 31, 2014. In addition to financing the operation, the broad cut is also intended to finance a five-year plan to strengthen communities in the Western Negev, at a cost of NIS 1.1 billion (out of a budgetary diversion that totals NIS 9.5 billion over 5 years).

Government assistance for entities in distress

This year, the government advanced assistance programs for private entities and for public entities outside the central government. Such assistance indicates that the government and the public are exposed to risks from entities that are too important to fail, and that these entities benefit from implied government guarantees that may create a moral hazard.

This year, the government advanced—or committed to finance—a number of assistance programs for private entities or for public entities outside the central government. Such assistance indicates that policy makers view them as entities that are too large or important to fail, and thereby shows that they basically benefit from implied government guarantees. Such guarantees may create a moral hazard among the entities benefitting from the assistance. The entities that were in need of government assistance include:

- Hadassah Medical Organization, a private not for profit institution that operates hospitals. As part of the recovery program for the institution, the government undertook to provide it with about NIS 1.2 billion in assistance until 2020, to provide it with a loan of NIS 100 million, and to purchase assets totaling about NIS 150 million from it.[17]
- Israel Military Industries, a government company. In 2014, the Knesset Finance Committee approved an outline for privatization of the company, as part of which the government will bear a cost of NIS 7.6 billion, including a waiver of past debts, coverage of future deficits, financing of an employee retirement program, and financing the company's move to the Negev.[18]
- The Israel Broadcasting Authority, a statutory authority. The government and the Knesset approved the closure of the existing authority and the opening of a new broadcasting corporation in its stead. According to estimations, the costs of the retirement agreements and of establishing the new corporation will total NIS 1.3 billion, which will be financed in the future through the sale of land owned by the authority.
- Israel Postal Company, a government company. The Ministers of Finance and Communications agreed on an outline for recovery of the company. The outline will be financed directly by the public—through an increase in service fees—and by the state budget—through transfers for financing retirement expenses in the company.[19]
- Channel 10, a private company. The Knesset approved the station's continued operation until the middle of 2015, even though its concession expired and it did not meet the investment requirements included in it (requirements that defined the quality of the product that must be supplied by the concession holder). The channel will operate during the interim period under license conditions that impose lighter investment requirements.

[17] The government of Israel's financial report for 2013 ("Events following the report date").

[18] Ibid. It should be noted that the government loans in respect of which the Israel Military Industries debt was created were already recorded at the time they were made, as expenses and not as the provision of credit. Therefore, the write-off of the debt does not require further recording in the budget.

[19] According to the plan, NIS 300–350 million will be transferred in 2015 for this purpose.

Government assistance to these entities indicates that the government and the public face latent risks from entities that policy makers believe are essential, too large or too important to fail. The government bears a fiscal risk, and the public directly bears a risk of fee increases or negative impact to the quality of service. The assistance means that the government has basically issued a guarantee to these entities, which shows that too-important-to-fail entities exist even outside the financial system. A number of the entities that were given assistance operate in markets where there is widespread public regulation, as part of which the state requires operating licenses and imposes conditions to receive them. In other words, it imposes entry barriers that limit the number of players in the market and create too-important-to-fail entities. By way of illustration, in order to establish, operate and expand a hospital, a license is necessary from the state, because it implements a policy of close control in healthcare infrastructure. While such a policy helps restrain growth in the national healthcare expenditure and saves on surplus investment and capacity[20], under such a policy each large service provider (such as a hospital) becomes an entity the closure of which may have a negative impact on public health. The entity therefore benefits from an implied government guarantee of its existence. Such a guarantee may create a moral hazard among the bodies that benefit from it, since they know that even problematic financial management will not lead to their closure.[21]

Opening an essential market to stronger competition, and removing entry barriers into that market, reduce the risk of creating entities that are too important to fail and the exercise of the (implied) guarantee provided by the government to such entities.

Caution should be exercised as much as possible against creating markets and entities that benefit from such implied guarantees, particularly regarding private entities. An example is the commercial broadcasting field. Proposals to change regulation in this field are intended to remove entry barriers to it and to increase competition[22], and if they are accepted, these proposals may increase the number of broadcasters and prevent a situation in which each of them becomes too important to fail. The reform in the Israel Broadcasting Authority, which was intended, among other things, to rehabilitate the status of the public television channel as a main player in the market, will also enable far greater flexibility in determining the fate of private players in the field. However, it is in any case occasionally necessary to maintain a small number of players in order to regulate the use of a limited resource or to enable control over the volume of operations. This is apparently the situation in the healthcare field. Built-in market failures in this field arouse the concern that increased supply

[20] In the past decade, the infrastructure rationing policy has led to low fixed capital formation in the healthcare system and to a negative impact on the level of service provided in the system. See discussion in Bank of Israel (2015), Recent Economic Developments, 138.

[21] The concern over the exploitation of implied guarantees arises not only in the case of for-profit entities. Nonprofit entities that do not transfer profits to shareholders may also exploit some of the income to improve the terms of employment of workers (rent-sharing) and/or for initiatives that are close to the heart of the managers, at the expense of financial stability. A moral hazard may be created even where the implied guarantee derives from relying on nongovernmental sources of financing, such as contributions from abroad, to finance current deficits (as was done at Hadassah).

[22] An example of such proposals can be found in the interim report published in 2014 by the Committee to Assess the Regulation of Commercial Broadcasts.

will lead to increased demand and use[23], which may justify high entry barriers. Since government guarantees in these fields remain in place, it must be accompanied by very close financial and material supervision over the large entities operating in them. The supervision must make it possible to, among other things, monitor operational indices in an on-going manner, demand and receive essential information, set remuneration rules that will reduce the moral hazard, control the practice of proper corporate governance, and enforce means to correct problems. Such supervision will make it possible to identify behavior that endangers the institution's existence at a relatively early stage, and thereby prevent the exercise of the implied government guarantee as well as negative impact on the public. Consideration should be given to applying such supervision not only to government or public entities, but also to private entities that receive a license from the state or that act in essential markets where there are few players (like the financial regulatory authorities supervise the behavior of private entities that manage the public's deposits or savings). When setting out the scope of supervision, the ongoing costs inherent in it—both to the state and to the supervised entities—should be taken into account vis-à-vis the chance that it will save the state higher costs in the future by dictating more balanced behavior in the essential entities that benefit from an implied government guarantee.

Entities that continue to benefit from an implied government guarantee should be brought under more stringent financial and material supervision. When determining the scope of supervision, consideration should be given to the costs vis-à-vis the likelihood that it will dictate balanced behavior that will prevent the exercise of the guarantee.

In addition to the fact that the State occasionally imposes barriers that create too-important-to-fail entities, in some cases it also fills a significant role in the markets in which such entities operate. Occasionally, the government serves as a main purchaser or supplier, finances players in the market, or sets the prices in it, thereby greatly influencing the success or failure of those active in the market, even when the supervision is tight and moral hazard is reduced. When the state fills such a significant role, it must act in a way that will not lead to a risk of collapse of an essential entity and the realization of the guarantee.[24]

4. GOVERNMENT REVENUE

Government revenue totaled NIS 283 billion in 2014, an increase of 5.1 percent over the previous year. Government tax revenue totaled NIS 256.1 billion, slightly higher than the projection in the budget. Compared to 2013, and net of legislative changes and one-time revenue, tax revenue increased at a real rate of 4.1 percent in 2014. The Bank of Israel Research Department's tax model shows that in addition to the growth

Government tax revenue increased at a real rate of 4.1 percent relative to the previous year (net of legislative changes and one-time revenue).

[23] The phenomenon is known in the literature as "supplier induced demand", and derives mainly from the fact that there is an asymmetry of information between physician and patient. There is a dispute regarding the actual scope of the phenomenon. See a review in: McGuire, T. (2000), "Chapter 9: Physician Agency", in Culyer, A. and J. Newhouse (eds.) Handbook of Health Economics, Volume 1, pp. 461–536.

[24] For example, realistic prices must be set in the electricity and water markets as well as in the healthcare field. In the healthcare field, there must also be a realistic determination of the formulae for updating the budget for the healthcare basket, since under-revision of the budget forces the government to transfer increasing amounts, as part of stabilization programs, to the four health funds, all of which are too-important-to-fail.

in GDP, tax revenue was also affected by growth in exports of consumer goods (in shekel terms) and price increases in the capital market, particularly the capital gains on stocks and bonds. Tax revenue was negatively impacted to some extent by the fact that new home sales slowed as a result of the wait for legislative measures in the field. Legislated tax changes contributed NIS 5.1 billion to tax revenue in 2014 (in a static calculation[25]). The changes included an increase in corporate tax from 25 percent to 26.5 percent, and a freeze in the income tax brackets and credit point values. The increase in VAT and the increase in taxes on alcohol and cigarettes—measures that came into effect in mid-2013—also continued to have an effect.

The tax burden increased in 2014 due to the growth of indirect tax revenue and revenue from taxes in the labor market. The tax burden is still 3.2 percentage points of GDP lower than its level in 2007.

The tax burden—meaning the ratio between general government tax revenue and GDP—was 31 percent in 2014, an increase of 0.6 percentage points relative to the previous year, further to an increase of 0.9 percentage points in 2013 (see Figure 6.4). The tax burden increased in 2014 due to the continued growth of domestic indirect tax revenue (due to the increase in VAT and increased private consumption) and due to the increase in revenue from payroll taxes. Despite this increase, the tax burden remains low compared to the years preceding the global crisis: In 2007, it was 3.2 percentage points of GDP higher than in 2014.

The decline in the tax burden since 2007 is primarily the result of significant tax reductions made between 2003 and 2010. While the reductions in individual income tax during these years contributed rapidly to the reduction of the tax burden, the reduction in corporate tax left a significant impression only in the first years of the crisis—2008 and 2009. This late effect was the result of both the fact that there are temporary gaps between a change in corporate tax and its effect on revenue[26], and the fact that corporate profits grew during the period prior to the crisis and dropped during the crisis. Tax revenue again increased in relation to GDP in 2010 and 2011, because those years were characterized by relatively rapid growth due to the recovery from the crisis. However, against the background of the slowdown that took place in 2012 and the aforementioned tax reductions, revenue in that year again declined.

Proposals to institute differential VAT

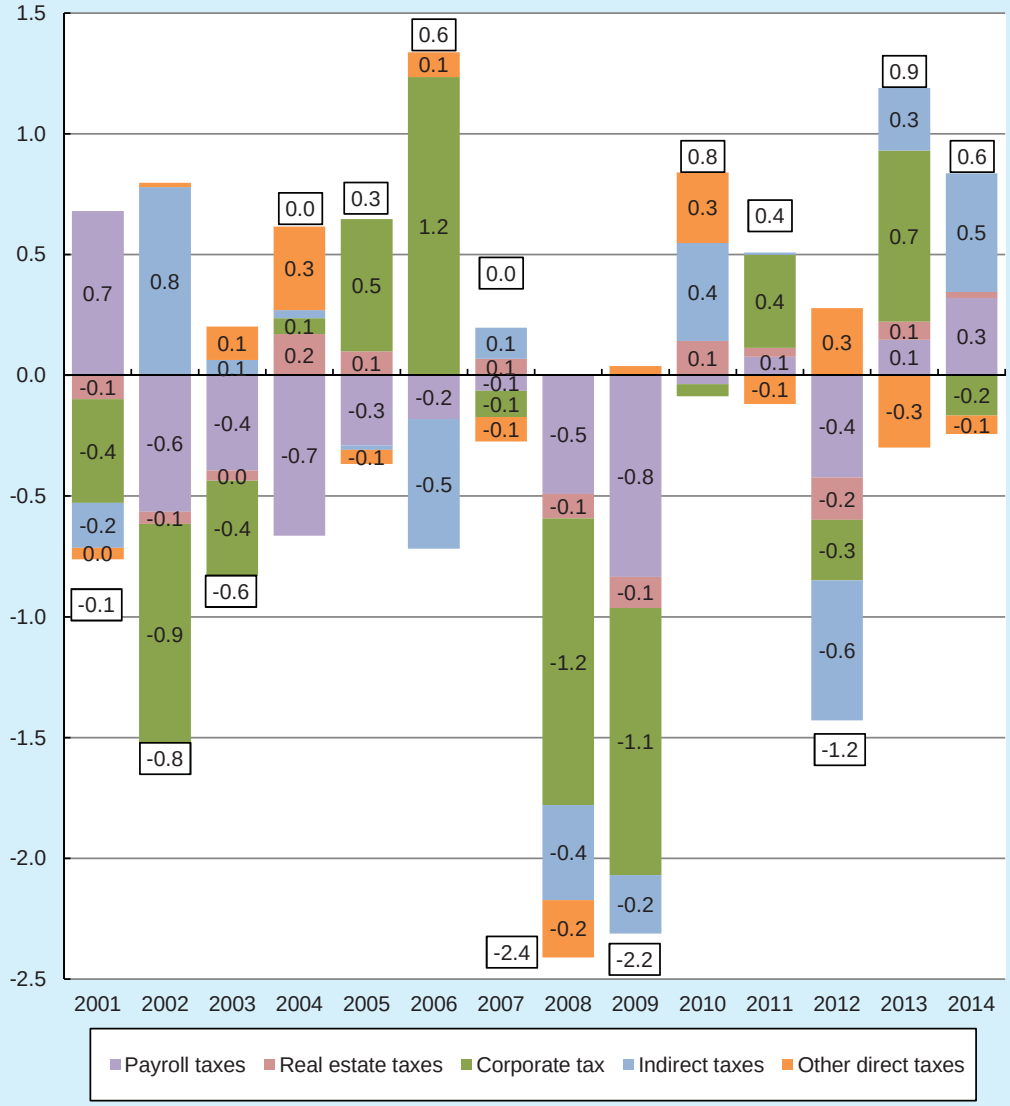
Relative to income, lowering VAT on food products will be of greater benefit to those with low incomes, but most of the benefit will reach those with higher income.

Many countries use reduced VAT rates and VAT exemptions. For the most part, they grant such benefits on necessity items—mainly food and medications, and sometimes water, electricity and clothing for infants—with the objective of helping those with low incomes. Sometimes countries also provide the benefits for products and services the consumption of which they want to encourage, mainly books, newspapers, and tickets to performances, movies and museums. In Israel there are also services and products that are subject to VAT benefits—fruits and vegetables, consumption in the

[25] The effect of the legislated tax changes on actual revenue is lower than the static estimation, particularly in the first two years of their applicability. See: Brender, A. and E. Politzer (2014), "The effect of legislated tax changes on tax revenues in Israel", Bank of Israel Research Department, Discussion Papers Series 2014.08 (in Hebrew).

[26] Brender and Politzer (2014) found that a change in corporate tax has little effect on revenue in the first two years of its application.

Figure 6.4
Change in the Tax Revenue to GDP Ratio ("Tax Burden") and Composition of Change by Type of Tax[a], Year-Over-Year, 2001–14 (percent of GDP)



[a] Types of tax: Other direct taxes—at source deductions (including capital gains tax), fees, levies and fines; Indirect taxes—indirect taxes on domestic production, taxes on defense and civilian imports; Real estate taxes—purchase tax and betterment tax (excluding VAT on the construction industry); Payroll taxes—taxes on wages, National Insurance payments and health tax; Corporate tax—corporate tax, executive tax, taxes on cooperative members and the self-employed.

SOURCE: Bank of Israel.

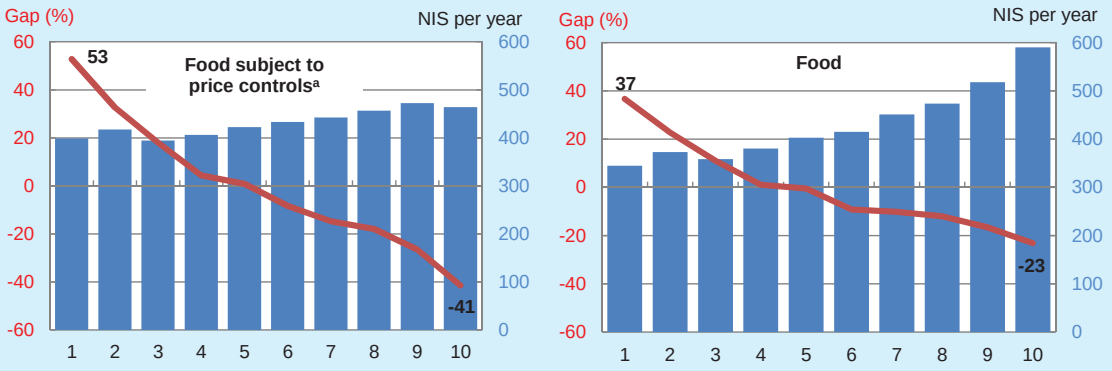
Eilat area, and tourism services[27]—but the scope of the benefits is smaller than in other countries, and the rate of VAT revenue out of the total tax base is therefore relatively high.[28]

If benefits are increased by an amount equal to the cost of reducing VAT, it will make it possible to transfer much more assistance to those with low income.

The following is a review of the proposal to reduce VAT on necessities, and it shows that relative to household income in each decile, such a progressive measure will help the lower deciles more, but a significant portion of its cost will reach those with high income. Increasing benefits by the same cost will make it possible to better assist households in the lower deciles. In addition, applying differential VAT may expand the opening for tax evasion and cause distortions in consumption decisions and in production in the economy.

Reducing VAT on necessities[29] is, in and of itself, a progressive measure, meaning that relative to income or consumption it provides more assistance to those with low incomes. Figure 6.5 shows how a VAT benefit costing NIS 1 billion affects households in each decile (static analysis, based on 2013 data). Such a benefit for all food products (in addition to the benefit on fruits and vegetables) is the equivalent of a VAT reduction from 18 percent to 16.1 percent. The red curve in the right-hand figure shows the extent to which the share of food expenditure of total consumption of a given decile

Figure 6.5
Imposing Reduced VAT on Food, at a Cost of NIS 1 Billion: Benefit's Value to the Average Household in Each Income Decile (columns, right scale)**, and Gap Between the Share of Food Expenditure in the Household's Total Consumption in that Decile and the Average Share for the Population** (red line, left scale)



[a] Details on the product groups included in this analysis appear in footnote 31 in the body of the chapter.
SOURCE: Simulation based on Central Bureau of Statistics Household Expenditure Survey data for 2013.

[27] As mentioned, the outgoing government advanced a proposal to reduce VAT on the purchase of new homes to zero for those eligible, but in the end the Knesset did not approve the proposal.

[28] The index for measuring this rate—the VAT revenue ratio—was 65.3 percent of the relevant consumption base in 2011, compared with an average of 55.5 percent in the OECD. See OECD (2014), Consumption tax trends, OECD publishing.

[29] Products or services for which the expenditure rate out of total consumption expenditure gets lower with an increase in income or in total consumption.

is higher or lower than the average in the population. The curve in the figure declines with the increase in income—in the lowest decile the food expenditure share is 37 percent higher than the average in the population, while in the highest decile it is 23 percent lower than the average. Therefore, reducing VAT on food is a progressive measure[30] (and its progressiveness is similar in scope to that derived from the existing VAT benefit on fruits and vegetables). If a measure grants a VAT benefit totaling NIS 1 billion for food products the prices of which are subject to price controls or similar products[31], it would be even more progressive, since the expenditure segment in the lowest decile is 53 percent higher than the average (see the left-hand figure). And if the measure grants a VAT benefit for goods and services for which actual expenditure declines with an increase in income, it would be even more progressive. For instance, the expenditure share for bus and train tickets is 93 percent higher in the lowest decile than the average for the population.[32]

Lowering VAT is a progressive measure in general, and when focusing the reductions on necessities, the progressiveness of the measure is amplified. However, Figure 6.5 also demonstrates one of the disadvantages of such tax benefits: A large part of the cost also benefits those with higher income. By way of illustration, a VAT reduction on food totaling NIS 1 billion would save a household in the lowest decile NIS 345 per year, while a household in the highest decile would save NIS 590 per year. Just 17 percent of the cost of the benefit would be directed toward households in the lowest two deciles of the income distribution. (In the case of a general VAT reduction, these deciles would receive 12 percent of the cost of the reduction, in a case of lowering VAT on food products subject to price controls they would receive 19 percent of the cost, and in a case of a benefit on bus and train tickets, they would receive 26 percent of the cost.)

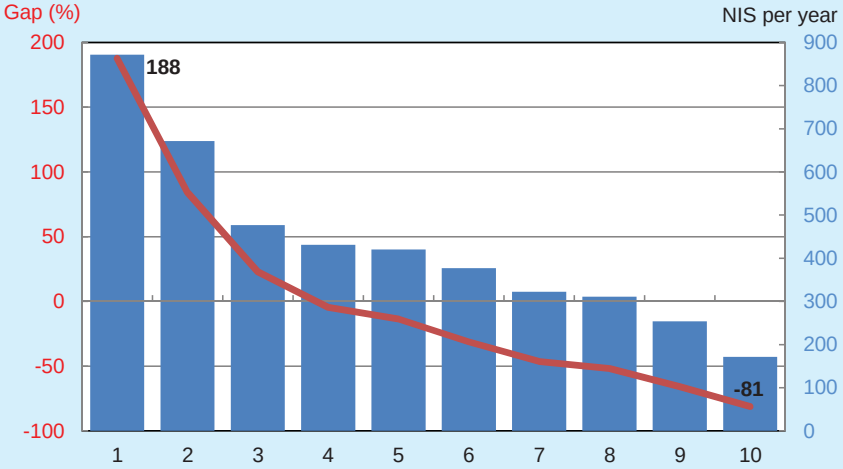
If policy makers wish to help the weaker levels, there are more efficient tools available to them to accomplish this. Figure 6.6 demonstrates that using NIS 1 billion to increase universal child allowances produces a very progressive measure because allowance as a share of consumption in the lowest decile is 188 percent higher than the average in the population, and because a more significant portion of the cost comes to those with lower income (36 percent to the lowest two deciles). An increase of the Earned Income Tax Credit (“negative income tax”) also focuses more on the lowest

[30] The progressiveness of the measure is even more prominent when assessing total expenditure on food relative to household income and not relative to consumption. However, since consumption serves as a better index of the household’s permanent standard of living, we used this index here.

[31] The analysis included the product groups in the Household Expenditure Survey, where some of the products are subject to price controls: Black and white bread, sliced bread, regular and sweet Challah, salt, pasteurized milk, White Eshel and yogurt, sour cream, sweet cream, butter, hard yellow cheese, white cheese, and nonorganic eggs. A benefit of NIS 1 billion will make it possible to almost completely lower the VAT imposed on this product group—to 1.1 percent instead of the current 18 percent.

[32] Lowering VAT to 0 percent on bus and train tickets would cost about NIS 250 million. Since many workers are entitled to transit reimbursement for such tickets, it is likely that lowering their cost would not be fully passed on to the consumers.

Figure 6.6
Increasing Child Allowances at a Cost of NIS 1 Billion: Benefit's Value to the Average Household in Each Income Decile (columns, right scale)**, and Gap Between the Share of Additional Income in the Household's Total Consumption in that Decile and the Average Share for the Population** (red line, left scale)



SOURCE: Simulation based on Central Bureau of Statistics Household Expenditure Survey data for 2013.

deciles (35 percent of the cost reaches the lowest two deciles, and another 53 percent reaches the third to fifth lowest deciles). As a rule, the use of allowances focused only on those with low incomes (for instance, income supplements for young people and the elderly) will make it possible to provide even more progressive supplements at a lower budgetary cost.

The manner of financing the VAT benefit will have an effect on how progressive the measure is. When a VAT benefit prevents an increase in government expenditure, it may be regressive.

Furthermore, in assessing a VAT benefit measure (or an increase in allowances), the manner in which it is financed must also be taken into account. Financing a VAT benefit through income tax on those with middle to high incomes will increase the overall progressiveness of the measure, but financing through a cut in government expenditures (or avoiding an increase in them) may negatively impact the progressiveness of the measure or even make it regressive. (This may happen, for instance, if a VAT reduction on food products is financed by reducing the subsidy on public transit tickets or not expanding it.) The need to finance the benefit may also lessen its effect on reducing the cost of living, since the financing may come from an expansion of tax revenue from middle income levels, or from a reduction in the provision of public services that would increase private expenditure among these population groups, such as on education and health care.

In addition to this disadvantage, the use of differential VAT rates has other shortcomings:

A decision on several different VAT rates will expand the opening for tax evasion, and will create pressure to provide additional benefits. Such a measure may distort decisions concerning production and consumption.

- Lowering the tax rate on a particular product does not get fully passed on to the consumer price of the product.[33] This makes assistance to households less efficient and a marked portion of the cost involved is passed on to the product's manufacturers and marketers. (In contrast, a benefit through allowances is generally fully passed on to the population group meant to receive it.) Tax reductions may only be partially shifted to price, particularly in markets with limited competition. It should be noted that a VAT benefit on products subject to price controls makes it possible to ascertain that the full benefit actually does get shifted to price, at least at the time the benefit is granted.
- Setting a number of VAT rates, or granting full VAT exemptions[34], provides a greater opening for tax evasion, avoidance and manipulation that will negatively impact tax revenue and increase the bureaucracy and litigation surrounding it. For instance, there may be legal debates regarding the classification of certain products, and business owners may make misleading reports—reporting that some income derives from products with lower VAT rates even if that is not the case—in order to evade taxes. A clear definition of the product groups eligible for the benefit—such as regarding the list of products that are subject to price controls—could perhaps reduce the possibility of manipulations, but will not eliminate it entirely.
- Providing a tax benefit in one area helps a certain population group, as well as the manufacturers and marketers in that field because demand for their products will grow. Therefore, it will lead to public pressure, as well as pressure on the part of interested parties, to grant a benefit or exemption in other areas as well. Expanding the benefits will negatively impact the efficiency of the tax system and its stability over time, and the broader cost will require tax increases in other areas. If price controls serve as a condition for granting a VAT benefit, it could lead to other products being made subject to price controls even where this is unnecessary, which may have a negative impact on competition in the market.
- It is very hard to cancel a VAT benefit, even if it becomes clear that the ramifications of the benefit are negative. In other countries as well, such benefits became entrenched over time, despite criticism of them.
- Tax benefits for certain products reduces their relative price, thereby distorting

[33] For instance, Zussman et al. (2007) examined the changes made in indirect taxation between 2000 and 2004 and found that changes in VAT had only a small effect on prices, and that only two-thirds of the reduction in purchase tax was passed on to lowering the consumer price. See: Zussman, N., D. Romanov, M. Oren-Yiftach, and N. Mironychev (2007), "Shifting of VAT and purchase tax rates onto consumer prices", in The Israeli Tax System, Discussion Paper 07.04B, The Maurice Falk Institute for Economic Research in Israel (in Hebrew).

[34] A VAT exemption, as opposed to zero percent VAT, does not allow the receipt of reimbursements on the VAT paid by the business. Therefore, the loss of direct revenue absorbed by the state budget from a VAT exemption is lower than the loss from zero percent VAT. However, the exemption creates a greater opening for manipulation, and may lead to other distortions since it contravenes the principle upon which VAT is based—that taxes apply to the value added at each stage and not on the production inputs.

production and consumption choices in the economy. This distortion, for its part, negatively impacts the social welfare and increases the deadweight loss derived from taxes. When a government uses differential VAT, it in essence invests money in order to convince the public to consume in a manner that is not derived from its preferences, given the cost of production of each product. For instance, when the government lowers VAT on food products that are subject to price controls, it basically invests money in order to convince the public to prefer butter (which is under price controls) over oil (which is not under price controls), and to consume white cheese that contains 5 percent fat (controlled) instead of white cheese with 3 percent fat (which is not controlled). It is doubtful whether there is any social benefit in such use of taxpayers' money, since the products that are not subject to price controls are not specifically products with negative externalities or products of which the public should be encouraged to decrease consumption.

It should be noted that measures to reduce inequality and poverty often involve some loss of efficiency. Even an alternative measure—such as increasing allowances—may cause distortions in the economy, because it may have a negative impact on work incentives or on employment. However, these distortions can be minimized through a variety of tools: 1. Direct supply of certain public products; 2. Provision of universal allowances, since they do not impose a tax on entering employment; 3. Granting allowances that are focused on working individuals, such as the Earned Income Tax Credit ("negative income tax"); and 4. Providing allowances to those who have already left the labor market (old age pensions).[35] This, in essence, is the challenge facing the planners of the tax and transfer system—collecting the volume of taxes required to finance the desired scope of public services, and realizing the income distribution desired by the public, while minimizing the negative impact to efficiency to the greatest extent (including minimizing the negative impact to work incentives, reducing distortions to relative prices, and so forth). If the tax and transfer system is called on to further reduce inequality and ease the cost of living, it is preferable that this be done through more efficient means, such as increasing allowances and providing services, and not through less efficient and more wasteful measures such as instituting differential VAT.

[35] Researchers have examined the use of differential VAT in other countries, and on more than one occasion they proposed advancing a reform that would reduce VAT benefits and increase transfer payments to the public. A proposal to enact such a reform was made, for instance, in the UK. The proposal would make it possible to maintain the level of support of weak population groups while using a combination of income tax changes and increased universal and income-dependent benefits to reduce the distortions derived from reduced VAT. See: Mirrlees, J. (ed.) (2011), "Chapter 9: Broadening the VAT base", in Tax by Design: The Mirrlees Review, Oxford University Press.

5. THE PUBLIC DEBT AND ITS FINANCING

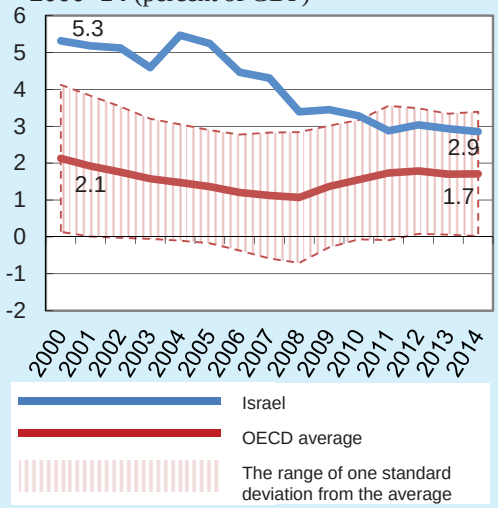
The public debt totaled 67.6 percent of GDP in 2014—unchanged from the previous year.

The public debt grew by 3.7 percent compared to the previous year, and totaled NIS 736 billion at the end of the year. Relative to GDP, public debt remained unchanged—67.6 percent (see Table 6.5). The debt to GDP ratio remained stable due to the high volume of loan repayments by the public (details appear below), and the use of government deposits accumulated in the banks (about NIS 5 billion) following surplus debt raising in previous years. The decline in the Consumer Price Index during the year, alongside the slight increase in GDP prices, eroded the ratio between the indexed component of the debt and GDP. In contrast, the depreciation of the shekel increased the revaluation of foreign-currency denominated debt (the large majority of which is not hedged). According to medium-range growth forecasts, the debt to GDP ratio will decline slightly during the rest of the decade if Israel maintains the existing deficit level.[36] Public debt in Israel relative to GDP is lower than the average in the OECD countries—86.6 percent of GDP in 2014. The burden of interest payments in Israel (2.9 percent of GDP) declined significantly in the past decade, but remains higher than the average burden in OECD countries (see Figure 6.7).

Greater issuance of earmarked bonds to pension funds increased the cost of issued government debt and extended the average term to maturity.

The cost of issuing the government's tradable debt continued to decline in 2014. The average yield on CPI-indexed government bonds was 0.65 percent at the time of issue (compared to 1.04 percent in 2013), and the yield on issue of unindexed bonds declined from 2.63 percent in 2013 to 1.82 percent[37] (see the left side of Figure 6.8). The average time to maturity of tradable debt in the issues made in 2014 remained similar to the level in the previous two years—about 8 years. Even so, the cost of issuing total debt (tradable and nontradable) increased in 2014, and the average time to maturity was extended to 10 years. This was because the volume of nontradable (earmarked) bonds issued to pension funds continued to grow, and these bonds are issued

Figure 6.7
The Burden of Interest Payments on the Public Debt, Israel and OECD, 2000–14 (percent of GDP)

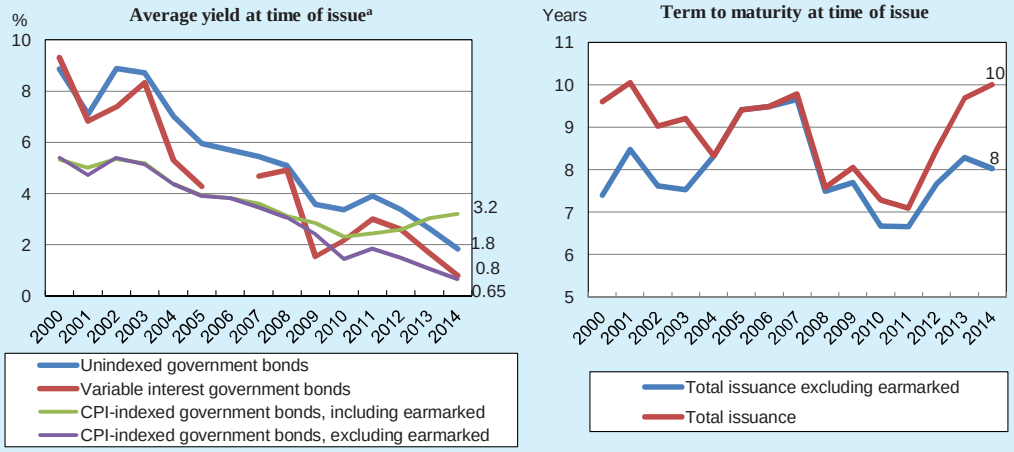


SOURCE: OECD.

[36] See: "Fiscal Survey: A look at the fiscal situation ahead of the preparation of the 2015 budget, and the expected budgetary trends in the rest of the decade" in Bank of Israel (2015,) Recent Economic Developments, 138.

[37] Yield data do not include offerings in swap tenders, because data on average yields in those offerings were not available.

Figure 6.8
Average Yield and Term to Maturity at the Time of Issue of Government Bonds, Yearly Weighted Average of Funds Raised, 2000–14



[a] Excluding issues in swap tenders, since data on the average yield for them were not available.
SOURCE: Ministry of Finance Accountant General.

for 15 years at a guaranteed interest rate of 4.8 percent—higher than the yield currently obtained on similar tradable bonds.[38] In 2014, a total of NIS 24.6 billion in such bonds were issued, constituting 28 percent of total government issues, compared to 21 percent the previous year, and 5 percent in 2011. The derived subsidy for pension savings from earmarked bonds increased in recent years because the interest rate in the markets declined, and because since 2012, large offerings of such bonds have been held. The yields on earmarked bonds were in the past generally similar to yields on similar bonds in the market, or even lower than them. Therefore, the volume of the subsidy was smaller, and the earmarked bonds even sometimes saved the government interest expenses.

The issuance of Israel Railways bonds makes it possible to finance infrastructure development outside the fiscal rules. The issuance raises the cost of financing government activity, and essentially relies on future government subsidies.

The government decided to advance the issue of bonds on behalf of Israel Railways (a government company). According to the decision, the railway is supposed to raise about NIS 1 billion in each of the years 2015 and 2016, and this money will compensate for the parallel cut in the development budget the railway receives from the government. The bond issue and the cut make it possible to finance the development of railway infrastructure outside the fiscal rules that limit expenditure and the deficit. There is a price to this process, since bond offerings by a government company will have a higher cost than offerings by the government itself, even though the backing for the bonds is basically a subsidy that the government itself will transfer to the railway in the future. These subsidies constitute about 60 percent of the railway's current income. While there may be advantages to the issue of tradable bonds by a

[38] The real yield (derived from the zero-coupon yield curve) for an identical term (15 years) was 1.5 percent on average in 2014.

government company—increasing transparency in the company and improving its financial supervision—the measure may in the end leave fewer means for investment, and will make the financing of government operations less efficient.

Table 6.5
Components of the increase in the gross public debt, 2009–14

(percent of GDP)

	2009	2010	2011	2012	2013	2014
Debt at the end of the previous year	72.9	75.3	71.5	69.7	68.2	67.6
Nominal growth of GDP	-4.0	-5.0	-4.5	-4.9	-3.7	-2.3
Net capital inflow	5.2	1.3	1.3	3.7	3.3	1.7
of which: Government's cash deficit	4.9	3.5	3.1	3.9	3.2	2.8
Net repayment of credit by the public[a]	-0.8	-0.7	-0.6	-0.4	-0.4	-0.4
Privatization proceeds	-0.3	-0.5	-0.8	-0.1	-0.1	-0.2
Funding beyond the financing deficit[b]	1.4	-1.0	-0.4	0.3	0.7	-0.5
Revaluation of the shekel-denominated indexed debt[c]	1.4	0.9	0.7	0.5	0.5	0.0
Revaluation of foreign currency-denominated debt	0.0	-0.6	0.7	-0.2	-0.6	0.9
Adjustment to issuance costs	-0.5	-0.2	-0.2	-0.3	-0.3	-0.3
Remainder[d]	0.2	-0.3	0.1	-0.3	0.1	0.0
Debt at year end	75.3	71.5	69.7	68.2	67.6	67.6

[a] Including the provision of credit and principal collection.
[b] Funding surplus.
[c] Effect of the increase in the Consumer Price Index during the year on indexed debt.
[d] As a result of roundings.
SOURCE: Bank of Israel.

Revenue in the capital account

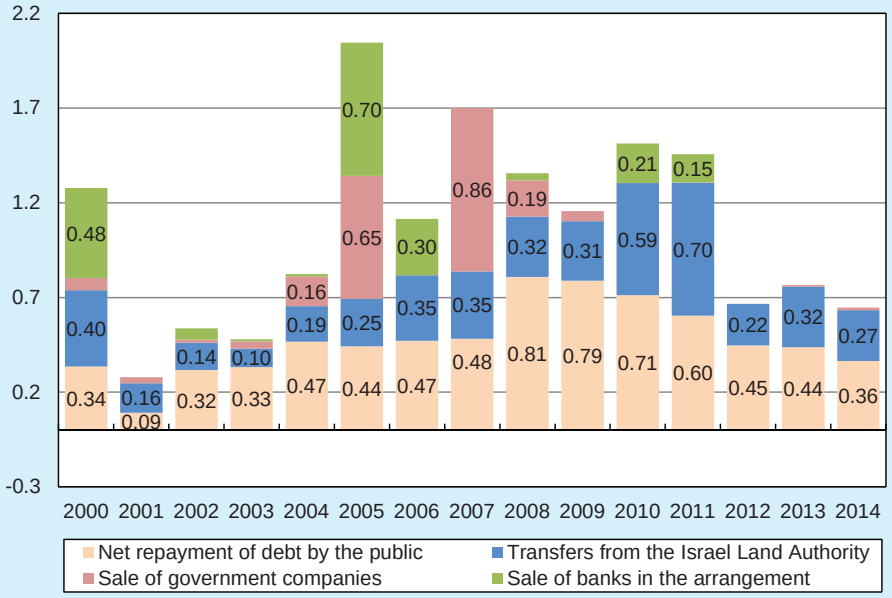
The government has revenue in the capital account from Israel Land Authority activity, from the sale of government-owned companies, and from the net repayment of credit issued to the public in the past.

In addition to the government's revenue in the current account—mainly from taxes and fees—the government also records revenue in the capital account due to the sale of assets to the public or the repayment of loans provided by the government in the past. This revenue is not usually included in calculations of the deficit, but it helps finance it, thereby contributing to the reduction of public debt and of future interest payments on that debt. Figure 6.9 presents some of this revenue and shows that its volume in the past three years was lower than in the seven preceding years.

First, the Israel Land Authority (ILA) leases and sells land owned by the public sector (the State and the Jewish National Fund) to the public. The ILA transfers some of its revenue from land tenders directly to the local authorities[39], and after financing its operations, it transfers the surplus (in the capital account) to the original landowners.

[39] "Betterment levy replacement". The current rate is 12 percent of the ILA's revenue from sales of land. The revenue from the levy replacement affects the deficit of the local authorities, and through it the deficit of the general government.

Figure 6.9
Public Sector Revenue from the Sale of Government Companies and the Sale of Bank Shares in the Arrangement, Transfers from the Israel Land Authority, and Net Repayment of Loans by the Public, 2000–2014 (percent of GDP)



SOURCE: Based on data from the Ministry of Finance Accountant General and Budget Department.

The transfers from the ILA to the public sector totaled NIS 2.9 billion in 2014, the equivalent of 0.3 percent of GDP—the average rate in the years 2012 and 2013. This rate is 60 percent lower than the volume of revenue generated by ILA operations in 2010–11. The blanket agreements currently being signed with local authorities are expected to lower the capital revenue of the central government from the sale of land, and to increase the portion transferred to the local authorities, since the agreements set out that the income from the marketing of land will also cover the development costs borne thus far by the local authority.[40] These agreements in essence make it possible to use capital revenue from the sale of land to finance investments and current expenditures related to land betterment and preparation for residential purposes. In the case of current expenditures, the expense is made such that it bypasses the fiscal rules that limit government expenditure and the deficit.

Second, the State has revenue from the sale of government companies and of the remaining shares in banks that were nationalized during the crisis in the 1980s. In

[40] The government limited the scope of the blanket agreements, and is designating them for particularly large developments. The blanket agreements are intended to serve as a temporary means for dealing with the increase in home prices, and they are necessary both because the local authorities are having difficulty raising cash for the advance financing of large investments in development, and because municipal tax on residences generates low revenues that lower the worthwhileness of new residential neighborhoods. More information on these agreements appears in Chapter 7A.

2014, the State sold its remaining holdings of Bezeq shares (0.97 percent) for NIS 151 million. The State asked the Knesset Finance Committee for approval to sell its remaining holdings of Bank Leumi (about 6 percent), but this sale has not yet been completed. In recent years, the State's revenue from the sale of state-owned companies has declined greatly, and this revenue is currently very small, after reaching significant amounts between 2004 and 2011.[41]

Third, the State records revenue from the repayment of loans it issued in the past—mostly mortgages to eligible homebuyers from the Ministry of Housing. The State generates actual revenue in the capital account when total loans repaid exceeds new loans issued.[42] Net revenue from the repayment of such loans increased between 2008 and 2011, and totaled 0.7 percent of GDP per year on average. In the past three years, yearly revenue totaled 0.4 percent of GDP. The large volume of repayments was also affected by the fact that with the decline in interest rates in the economy, the interest rate at which the State provided mortgages to eligible homebuyers became higher than the interest rates in the market, encouraging the refinancing of the existing mortgages and deterring new borrowers. The balance of outstanding long-term loans was NIS 24.6 billion at the end of 2013 (half of the balance in 2007). The actions intended to encourage eligible homeowners to refinance their mortgages will make it possible for them to benefit from the low interest rates in the economy[43] and lower their mortgage payments. This means that this item will continue to be a source of income in the capital account in the coming year as well (although current revenue in the budget from interest on these loans will be lower).

6. GOVERNMENT SERVICES: BUDGETING AND REGULATION OF THE HEALTHCARE FIELD

Health fund deficits increased in 2014, as did the operating deficits of the government hospitals.

The deficits in the healthcare system increased again in 2014, since two out of the four health funds have not yet signed stabilization agreements with the government for 2014–16, and the other two signed them just at the end of the year. Since the budget for the basket of health services has been insufficiently updated in recent years, the health funds' have become increasingly dependent on budgets transferred as part of the stabilization agreements. These agreements dictate three-year cycles in the revenue of the health funds, since they are signed with a lag within the period for which they are valid, thereby causing a high deficit at the beginning of the period

[41] The sale of government companies and banks in the arrangement increases revenue in the capital account, but lowers the potential for ongoing revenue from possible dividends.

[42] Net loan repayments lead to revenue in the capital account, which lowers the debt. But it reduces interest income from active loans, thereby increasing the deficit (if the interest on the loans was higher than the interest at which the State raises debt).

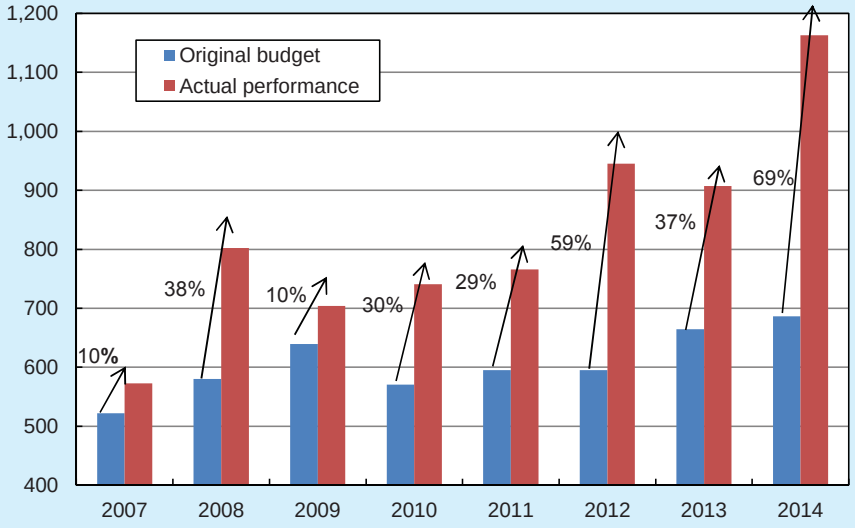
[43] At the end of 2014, the Ministry of Construction and the Supervisor of Banks announced the advancement of a process to encourage the early repayment, or refinancing, of mortgage loans issued by the government to eligible homebuyers. These loans were issued until 2012 at an interest rate of 4 percent, indexed to the CPI.

and a low deficit at its end. Even net of the cyclicality, there has been a marked trend of growth in the health funds' deficits in recent years (from an average annual deficit of NIS 261 million between 2008 and 2010 to an average deficit of NIS 842 million between 2011 and 2013). This trend results from the fact that costs have increased due to wage agreements signed in the system, and from population growth, among other things, but the budget for the basket of health services was not updated accordingly and the stabilization agreements did not fully compensate for it.[44]

In 2014, the operating deficits of the government hospitals also increased, and the hospitals required a larger subsidy from the government—about NIS 1.2 billion. The original budget subsidy was NIS 700 million, but as in each of the previous years, the financing actually transferred was much higher than the planned budget (see Figure 6.10). The agreement on the additional subsidy for the hospitals was only formulated at the end of the year, after they warned of a budgetary crisis that would bring activity to a halt.

The budgets transferred outside the official basket of health services are therefore growing. They are transferred retroactively, and set after negotiations the results of which are sometimes dependent on the balance of powers between the parties and on timing. This has a negative impact on the efficiency of the healthcare system and on its ability to plan for the long term. Such behavior also may increase the moral hazard

Figure 6.10
Support and Transfer Payments to Public Hospitals: Budget Compared to Performance, 2007–14 (NIS million)



SOURCE: Ministry of Finance—Accountant General and Budget Department data.

[44] See discussion in: Bank of Israel (2013), Recent Economic Developments, 136.

created when hospital managers get retroactive coverage of the deficits, and makes it difficult to demand that managers in healthcare institutions take upon themselves the responsibility for deviations from the budget and for unsuccessful financial behavior. Therefore, the intention to set the entire scope of the subsidy for the hospitals at the beginning of each year should be welcomed. It is also necessary to make sure that the subsidy makes it possible for the hospitals to provide a response to the public's needs throughout the entire year, and that the new authority for managing the government medical centers[45] receive all of the information regarding the on-going behavior of the hospitals, because they benefit from an explicit government guarantee (see discussion in Section 3).

The Ministries of Finance and Health agreed to increase the budgetary base for the public healthcare system and to index the budget for the basket of health services to the increase in population.

The need for a large amount of additional budgets, meaning budgets that exceed the budget set in the Public Health Insurance Law, is mainly the result of the fact that the public healthcare system suffers from a budgetary shortfall relative to the services it must provide by law. In 2014, the Advisory Committee for Strengthening the Public Healthcare System (the German Committee) dealt with this matter, and as a result of its conclusions, the Ministries of Health and Finance agreed to add NIS 700 million to the budgetary base (meaning permanently) in order to shorten waiting lines, and to invest a further NIS 300 million on a one-time basis in infrastructural development. In order to minimize the erosion of the budget in the future, the committee recommended fully indexing the budget for the basket of health services to the increase in population (although not to the equivalized increase that takes aging into account) and the government approved such a measure. While these supplements are not sufficient to cover the entire gap created in recent years in the budgeting of the basket of health services, they are a step in narrowing it, stopping its growth in the future, and improving service to residents.

The implementation of the recommendations of the Committee for Strengthening the Public Healthcare System will require diverting additional budgets to this system beyond what has been agreed to.

In addition, the committee recommended further measures to strengthen the public healthcare system, including: adding hospital beds or adding hospitalization alternatives in the community, with the objective of reducing the overcrowding in hospitals; employing physicians at public hospitals in exclusive positions with additional salary (full-timers); improving the infrastructure at psychiatric hospitals; expanding the ability to choose between hospitals; setting maximum waiting times for obtaining medical services; and training additional physicians and nurses. In order to implement these measures, it is necessary to divert additional resources to the healthcare system, in addition to the budget that was agreed upon. (The committee did not estimate the scope of the budget that will be required for this.) However, this may encounter difficulties since the existing expenditure rule limits the growth in government expenditure and leads to lowering expenditures as a share of GDP.

[45] This authority was established in 2014 following the recommendations of the Committee for Strengthening the Public Healthcare System. The authority will manage the government medical centers, and since it is directly subordinate to the Minister of Health, it will minimize the duplication of roles in the professional echelon of the Ministry of Health. This echelon is currently responsible for both the management of the government hospitals and the supervision of all hospitals.

Without additional resources for the public system, the use of the private healthcare system will increase.

The committee also discussed the regulation of private financing and private supply in the healthcare system, and recommended measures to restrain the rapid growth in their scope. Private financing currently accounts for close to 40 percent of national healthcare expenditure, and has increased markedly in the past two decades, partly as a result of the increase in the proportion of the population holding supplemental health insurance from the health funds (Shaban) and policies from the insurance companies.[46] The increase in private financing has fed the private supply system, and its share of performance in the national healthcare expenditure increased from 23 percent in 1995 to 31 percent in 2013 (see Box 6.1).

Expanding the scope of private financing and provision in the healthcare system may have a negative impact on its efficiency, particularly in terms of the cost-benefit ratio.

A broad scope of private financing and provision may negatively impact the efficiency of the healthcare system in Israel, particularly from a cost-benefit standpoint. First, because there is a high volume of nonmedical expenses in private insurance policies, particularly in individual policies in the insurance companies[47]; second, because the overall price of surgical procedures conducted under private insurance is higher than its price in the public system, and surgical procedures are responsible for the vast majority of the expenses of such insurance coverage[48]; third, because the private system includes the possibility of choosing a surgeon, which leads to a situation where specialists are not assigned for surgical procedures according to the complexity of the procedure and do not properly make use of their experience and training; and finally, because the high salaries in the private system attract physicians and nurses from the public system and affect the salaries in the entire system. The increase in the share of private financing also increases inequity in the healthcare system because those with low incomes have difficulty in purchasing and using private insurance policies[49], and because the insurance premiums are collected regressively (according to age or morbidity), particularly compared to the progressiveness of using tax revenue to finance public expenditure (which is done relative to income).

The committee recommended restraining the increase in private activity, first and foremost by improving the public system, since its weakness encourages the use of

[46] Ministry of Health (Department for the Supervision and Control of the Health Funds and Other Healthcare Services) data show that the rate of health fund members holding basic Shaban increased from 46 percent in 1999 to 74 percent in 2012. In 2012, 46 percent of all members also held enhanced Shaban. A survey conducted by the Brookdale Institute indicates that 43 percent of the adult population held commercial insurance through the insurance companies in 2012.

[47] Medical expenses accounted for just 42 percent of the premiums collected in individual private insurance policies in 2012. 45 percent of the premiums covered the payment of fees to agents, marketing expenses, and so forth. (Source: The Advisory Committee for Strengthening the Public Health System).

[48] The prices in the private healthcare system include a component for choosing a surgeon, which improves the service provided. However, most of those using the private system do so in order to benefit from shorter waiting lines and not in order to choose a surgeon. (Therefore, the added utility due to the payment for this component, had the public system offered shorter lines, would apparently be low.)

[49] There is evidence of such an economic barrier in the data on membership rates in Shaban insurance in 2013, which reached 73 percent in the entire country; 39 percent in the non-Jewish sector; and 64 percent among those receiving disability or old-age-plus-income-supplement benefits.

the private system. In parallel, the committee recommended measures to directly restrain private activity, reduce the incentive to direct patients to it, and regulate the private insurance market. Among other things, the committee recommended taxing the private institutions' income that exceeds a certain level of growth.[50] Such taxation may help internalize the costs and negative externalities of increased private activity on the public system and on the efficiency of healthcare expenditure: First, the private institutions compete with the public system over quality manpower (manpower which was trained in the public system). Second, these institutions contribute to increased salary in the system, which is financed by taxes imposed on the entire population. The salary increases make it difficult for the public system to provide the public with proper services. Third, these institutions are for-profit institutions, and have greater incentive to deal with easy and profitable cases and to send the complex and expensive cases to the public system ("cream skimming")[51], while payment for these services is currently not dependent, for the most part, on the complexity of the case. In addition, because of the incentives for private activity, and because there is less supervision over such activity, it sometimes leads to excess examinations or procedures, while the follow-up examination or treatment occasionally falls to the public system.

Box 6.1

The Flow of Funds in National Health Expenditure

In 2012, national expenditure on health in Israel totaled NIS 73.9 billion, which is equivalent to 7.5 percent of Israel's GDP. This box describes the flow of funds from sources to uses in the healthcare system. Figure 1 below presents the flow of funds and illustrates the complexity of the system and the numerous reciprocal relationships between its components. This box is a revision and expansion of one that appeared previously[1], which was based on 2007 data and examined only public expenditure. As will be explained below, the healthcare system in Israel is still based primarily on public funding and the public provision of services; nonetheless, the share of private funding and privately provided services has been rising continuously during the last two decades.

[1] See "Arbitration ruling on physicians' wages and public expenditure", in Recent Economic Developments no. 123, (2010), Bank of Israel.

[50] The proposal for taxation of the private system essentially mimics the rules that currently apply to the payments from the health funds to the general hospitals (the "cap"). This system requires the hospitals to provide discounts on the price of services when the volume of the services exceeds a certain rate. These rules impose a kind of global budget limit on public expenditure in the hospitals, and the proposal to tax the private system will impose a limitation on some of the private healthcare expenditure as well.

[51] According to Ministry of Health data, the operations at the private hospitals are performed on average on younger patients, and the surgical procedures are simpler than at the public hospitals.

The funding of health expenditure (gray boxes)

The **general government** funded 60.8 percent of the national expenditure on health in 2012. The major portion of this amount (44 percent of total expenditure) went to finance the health services basket provided by the health funds, in accordance with the National Health Insurance Law. The National Insurance Institute collects somewhat more than half of the cost of the basket of services by means of health insurance fees (the "health tax") and the rest is financed from other government revenues. In addition, the health funds receive additional resources from the government (1.2 percent) as part of stabilization agreements and support tests. The revenues from taxes also pay for health expenditure of other government ministries (such as the Ministry of Defense which makes payments to the hospitals and in some regions also to the health funds for the care of its soldiers)[2] and expenditure on health in the local authorities (which are also funded from local tax revenues). In addition to its share of the basket of services, the National Insurance Institute pays a hospitalization grant to hospitals for births (3.2 percent of national health expenditure) and also pays health funds for the care of work accident victims (0.6 percent).

Households financed 37.6 percent of national expenditure on health in 2012 (in addition to the taxes they paid to the government). About one-third of this amount is paid as part of an insurance framework: premiums paid to insurance companies (5.1 percent of expenditure), payments for additional health service insurance provided by the health funds (4.9 percent) and also copayments to the health funds for services included in the public healthcare basket (4.4 percent). About two-thirds is paid directly to suppliers of services and medical products: households purchase hospitalization services from the long-term care hospitals (4.9 percent) and pay directly for dentistry, oral hygiene products, private surgery, drugs, etc.

The rest of the funding for health expenditure (1.6 percent) comes from **income from abroad**. This includes donations as well as income from medical tourism, i.e., patients who come to Israel for medical care (according to estimates, the income from this activity amounts to about NIS 0.5 billion, or 0.7 percent of total funding).[3]

The share of private funding (including funds from abroad) in national health expenditure is relatively large from an international perspective and has become even larger over time (from 31.7 percent in 1995 to 39.7 percent in 2013) (Figure 2).

[2] The army provides soldiers with healthcare services on its bases as well, but this expenditure is not recorded as part of the national expenditure on health but rather as part of defense expenditure.

[3] The estimated scope of this activity appears in the report of the Advisory Committee to Strengthen the Public Healthcare System (2014), Chapter 4: Medical Tourism (Hebrew). It should be noted that the Central Bureau of Statistics currently includes the expenditure on the provision of medical tourism in Israel's health expenditures (and there is no way to differentiate them and include them in the export of services). Total revenues from medical tourism (and not just the profit from this activity) are considered to be a source of funding for health expenditure.

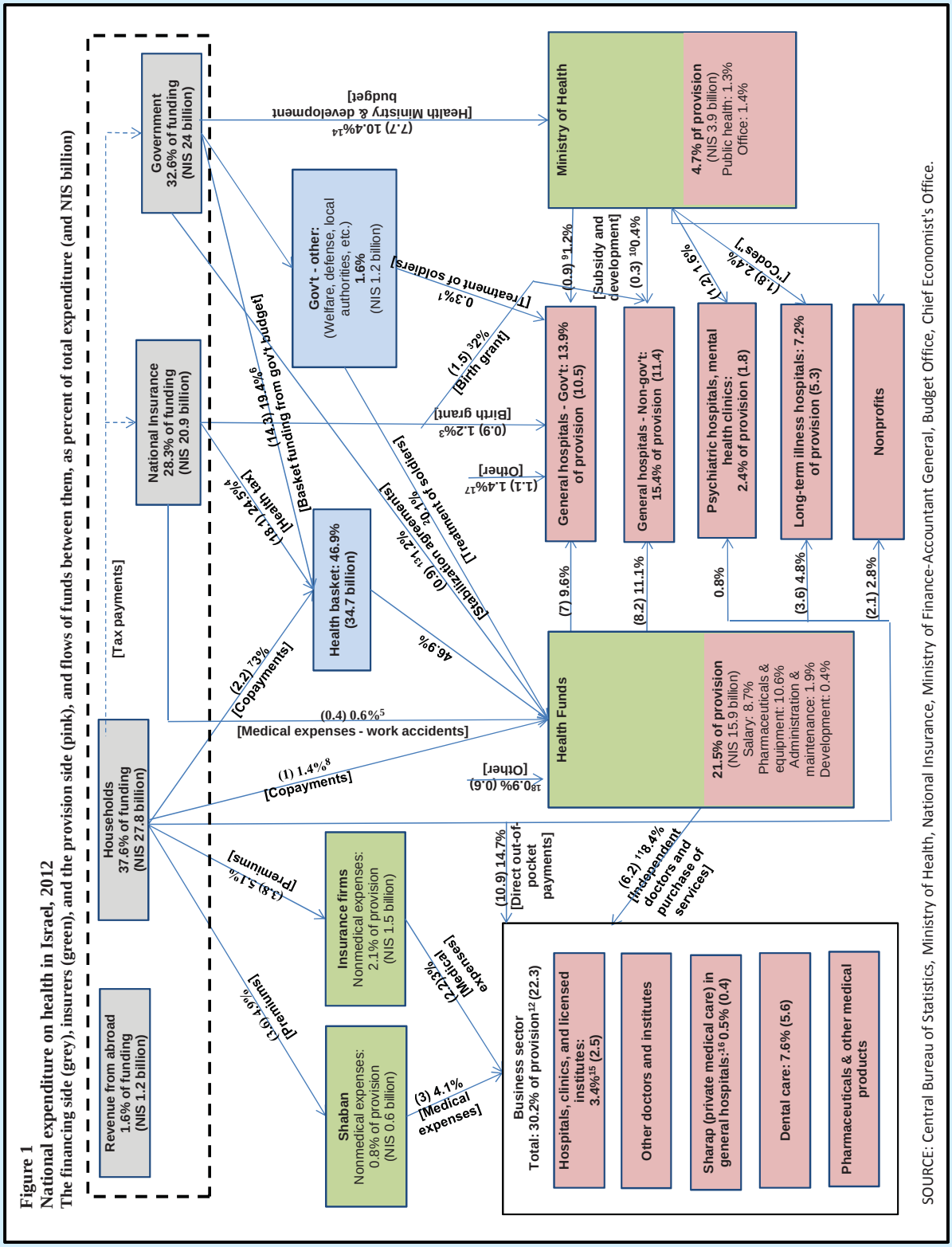


Figure 1
National expenditure on health in Israel, 2012
The financing side (grey), insurers (green), and the provision side (pink), and flows of funds between them, as percent of total expenditure (and NIS billion)

SOURCE: Central Bureau of Statistics, Ministry of Health, National Insurance, Ministry of Finance-Accountant General, Budget Office, Chief Economist's Office.

Notes to Figure 1:

1. The payment by the Ministry of Defense to government hospitals for the treatment of soldiers. We do not have data on the payments to other hospitals.
2. The payment by the Ministry of Defense to the health funds for the treatment of soldiers.
3. The hospitalization grant paid by the National Insurance Institute to the hospitals for births (1.2 percent to government hospitals and 2 percent to non-government hospitals).
4. The share of health insurance fees (which are collected by the National Insurance Institute) within the funding of the healthcare basket.
5. Payments by the National Insurance Institute for the treatment of work accident victims.
6. The share of the government budget in the funding of the healthcare basket (paid by means of a budget item in the Ministry of Health budget).
7. The share of self-earned (normative) revenues of the health funds in the funding of the healthcare basket (i.e., revenues from the collection of copayments from households).
8. Copayments which the health funds collect from households, in addition to the normative revenues.
9. Transfers from the Ministry of Health to the government hospitals: the budgets for subsidies (1 percent) and development (0.25 percent).
10. Transfers from the Ministry of Health to non-government hospitals (including development and support of the Clalit Health Fund).
11. Services that the health funds purchase from private laboratories and institutes (3.8 percent), in addition to payments to independent physicians (4.5 percent).
12. Share of usage in the business sector does not include non-medical expenses of the private insurers, expenses of the long-term care hospitals, and private medical services provided through the general hospitals (owned by private non-profit organizations).
13. Government support for the health funds, apart from the healthcare basket, i.e. stabilization agreements and support tests.
14. The Ministry of Health budget and the development budget for health.
15. Hospitals for general hospitalization, surgical clinics and dialysis institutes in the business sector, all of which operate under license.
16. Estimated. The revenues from private medical services (called by its Hebrew acronym, Sharap) in the Shaare Zedek hospital totaled about NIS 120 million (according to the minutes of the Advisory Committee to Strengthen the Public Healthcare System). The revenues from private medical services in the Hadassah Hospital totaled NIS 253 million in 2013 (according to the hospital's recovery plan). Includes salary payments and payment for Form 17.
17. Other revenues (totaling NIS 1.05 billion) include those from medical tourism (NIS 291 million), direct revenue from households, revenue from insurance companies (NIS 8 million), revenue from donations (NIS 384 million), etc. The revenues originate from households, the business sector and abroad.
18. The revenues of the health funds from the profits of subsidiaries, donations and rent (NIS 643 million).

The insurers (green boxes) and the intermediating mechanisms between funding and provision of services (blue boxes)

The **health funds** insure the public within the framework of the National Health Insurance Law. To this end, they receive government funding (45.1 percent of total funding, including stabilization agreements) and collect copayments from households (4.4 percent of funding). In addition to the basket of health services, the health funds receive funding from the National Insurance Institute for the care of work accident victims (0.6 percent) and payment from the army for the care they provide to some of its soldiers (0.1 percent). The health funds receive additional revenues from the profits of subsidiary companies, from donations and from rent (0.9 percent[4]). The health funds use this funding to purchase hospitalization services from the hospitals (20.7 percent) and to provide primary care services, either on their own (21.5 percent) or by means of payment to independent physicians (3.8 percent), and purchase of services from hospitals, clinics and institutes in the business sector (4.5 percent). In total, the health funds, in their role as insurers, receive funding in the amount of 51 percent of national expenditure on health and expend 50.6 percent of the total expenditure. Therefore, the insuring health funds (in the community sector) finished 2012 with a surplus of NIS 445 million.[5] It should be noted that this surplus is primarily due to the Clalit Health Fund, which can determine the division of its deficit between the community sector and the hospitals it owns (through the setting of internal transfer prices).[6] The other three health funds (Maccabi, Leumit and Meuhedet) finished 2012 with a combined deficit of NIS 421 million in the community sector.

The health funds also serve as private insurers as part of the supplementary health services they provide, called by their Hebrew acronym, **Shaban**. The public pays an amount equal to 4.9 percent of the national expenditure on health for this insurance and the health expenditures paid for by these insurance policies total 83 percent of the revenues, which is a much higher rate of utilization than among private insurance companies.

The insurance companies that provide private health insurance collect premiums from the public in the amount of 5.1 percent of national health expenditure.[7] Almost two-thirds of the total premiums are for 'individual insurance' that individuals purchase themselves, usually through an agent, while 'group insurance', which is usually purchased by an employer, accounts for the other third. Insurance companies spend less than 60 percent of the premiums collected for medical insurance in order to cover

[4] For simplicity, the sources of funding of this amount do not appear in the chart. These include the funds that the business sector, households and sources abroad transfer to the health funds (the division between these sources of funding is unclear).

[5] The surplus derived from the chart totals about NIS 300 million and it is unclear what the source of the discrepancy is between this amount and the actual surplus. It should be noted that the results of activity are influenced by the three-year cycle of the stabilization agreements, since they are generally signed with a delay. During the most recent agreement period (2011–13) the annual surplus in the community sector amounted to NIS 690 million on average (and the deficit for all the sectors amounted to an average of NIS 838 million per year, an increase relative to the average for the previous three years).

[6] Clalit recorded a deficit of NIS 1.3 billion in 2012 for its hospitals and a surplus of NIS 866 million in the community sector.

[7] This amount includes premiums paid for insurance against medical expenses, serious illness, dental care and disability. See the Annual Report for 2012 of the Capital Market, Insurance and Savings Division in the Ministry of Finance.

the claims of beneficiaries. The remainder is used to cover the costs of administration and marketing, commissions to insurance agents and reserves for future risks.[8]

The Ministry of Health also serves as an insurer in the areas it is responsible for, as specified in the Third Addendum to the National Health Insurance Law. In order to carry out this function, it purchases long term care hospitalization services (in an amount equal to 2.4 percent of national expenditure), which is supplemented (bringing it up to 7.2 percent) by the copayments of those eligible for subsidization and their families ("codes"), along with the purchases of other households. The Ministry purchases services from the psychiatric hospitals and clinics and also from the psychiatric departments of the general hospitals (1.6 percent). The responsibility for insurance in the area of mental health will be transferred to the health funds in July 2015. The Ministry participates in the cost of rehabilitation and mobility equipment purchased from external suppliers and also provides public health services (primarily on its own), such as vaccinations, baby clinics, etc. (1.3 percent).

The use of funds for healthcare (pink boxes)

The health funds, which on their own provide community health services (primary and secondary), are responsible for 21.5 percent of national health expenditure. This includes payment of salaries to employees of the health funds (8.7 percent), payment for drugs and equipment (10.6 percent),[9] administrative and logistic expenses (1.9 percent)[10] and expenditure on development.

The general hospitals provide 29.3 percent of the services within total health expenditure. While the budgets of the government hospitals are balanced every year by means of a subsidy provided by the Ministry of Health, many of the non-government hospitals are in deficit. In 2012, the deficit of the Clalit Health Fund hospitals funded 1.7 percent of health expenditure. The revenues from the sale of private medical services (called by their Hebrew acronym, Sharap) in the general hospitals owned by private nonprofit organizations totaled about 0.5 percent of health expenditure.[11] The public receives additional healthcare services from the **psychiatric hospitals and mental health clinics** (2.4 percent) and the **long-term care hospitals and institutions** (7.2 percent). The total proportion of expenditure on hospitals and research stood at 33.7 percent of national health expenditure in 2011 (see Figure 2). This proportion stood at 40 percent in 1995 and has exhibited a downward trend since then. On the other hand, there has been a rise in the proportion of expenditure on medical services in the community.

[8] Individual insurance is usually for the entire life and therefore the insurance companies need to maintain relatively large surpluses for future risks, such as changes in the incidence of disease or technological changes that require new and expensive treatments. (It should be noted that technological changes might also reduce the costs for insurance companies, since the payment is not revised when the prices of old technologies decline.) Because of the risk, insurance for such a long period is not common in other countries.

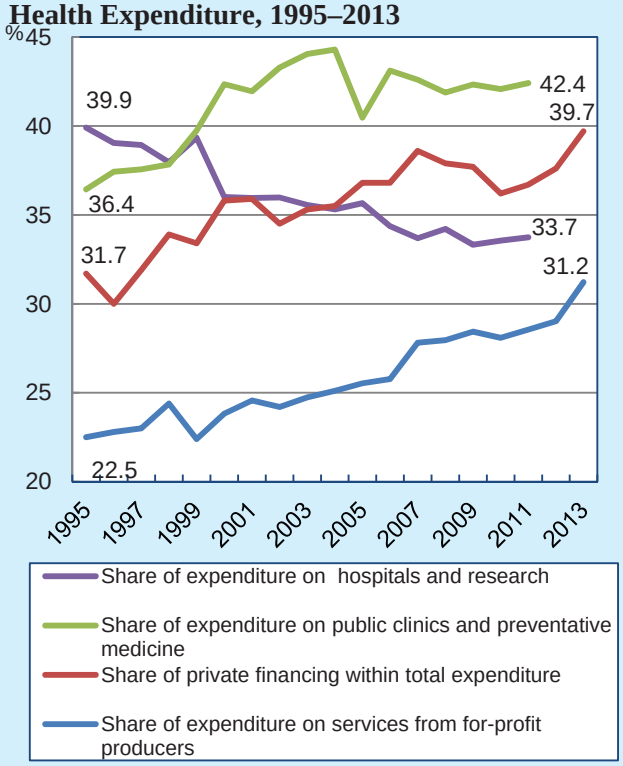
[9] The reported expenditure on drugs and medical equipment also includes the salaries of pharmacists in the health fund pharmacies.

[10] Since the health funds provide many services on their own, one cannot differentiate between administrative and marketing expenses that are the result of the funds' function as insurers and those that are a result of their function as service providers.

[11] Figure 1 presents private medical services (Sharap) in the business sector for simplicity only, since the sources of its income (private insurance and direct payments) are identical to those of the business sector. Currently, private medical services exist only in the general hospitals owned by private nonprofit organizations (the private hospital in Ashdod will also offer private medical services when it is completed, if such services are not canceled by then).

The business sector (i.e., for-profit producers) was responsible in 2012 for about 30 percent of health expenditure. This sector includes, among others, independent physicians, pharmacies, dentists (7.6 percent) and examination institutes. The business sector also includes entities that operate under licenses from the Ministry of Health, including private hospitals, surgical clinics and dialysis institutes. They were responsible for 3.4 percent of national health expenditure in 2012.[12] Their total revenues in that year totaled about NIS 2.5 billion, twice the amount for 2007 (when they accounted for 2.4 percent of expenditure). Their pre-tax profit amounted to NIS 123 million in 2012 (0.2 percent of health expenditure).[13] They also provided medical tourism services, which accounted for 6.9 percent of their sales (not including VAT), an increase relative to 2007 (6.3 percent). The increase in the proportion of private funding and the growing reliance of the health funds on the purchase of services in the business sector contributed to the increase in the business sector's share of services provided, from 23 percent in 1995 to 31 percent in 2013 (see Figure 2).

Figure 2
Shares of Financing and Provision in National Health Expenditure, 1995–2013



SOURCE: Central Bureau of Statistics.

[12] Aggregate figures of the Chief Economist in the Ministry of Finance. The figures include almost all of the aforementioned entities, which hold licenses from the Ministry of Health (entities were omitted if their annual revenue was lower than NIS 10 million or if an independent annual report was not available for them).

[13] The rate of profit (before tax and out of revenue not including VAT) was 5.5 percent in 2012 as compared to 3.9 percent in 2007.

Box 6.2

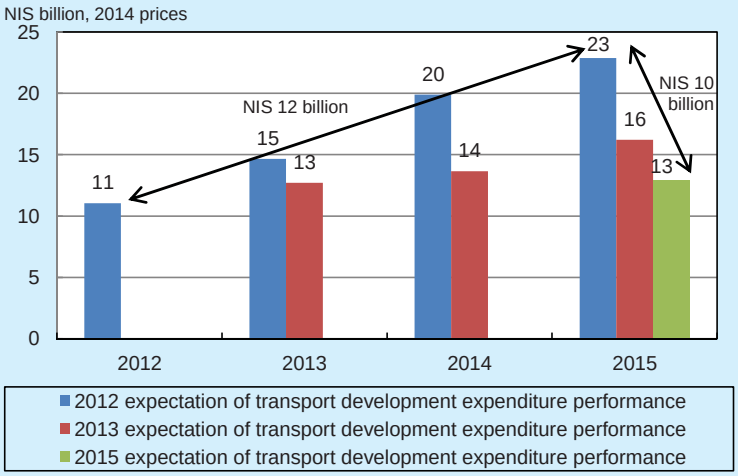
Transport development between 2012 and 2015: The plans and their execution

Box 2.2 explains the importance of investment in transportation infrastructure and in the development of public transport, and shows that such investment in Israel is low relative to other advanced economies. This box deals with the budgeting and execution processes of planned transportation infrastructure investments in Israel, and with some of the reasons that they have been carried out only partially.

In recent years, the government has made several decisions on transport infrastructure investment plans aimed at improving and expanding the roads network and the public transport system, including the "Netivei Israel" transport development plan, the light railways in Jerusalem and Tel Aviv, and the Jerusalem-Tel Aviv railroad. A substantial part were considered comprehensive reforms in the transport infrastructure, and these were budgeted accordingly and approved by the government. When the actual execution of the plans is followed up over time, it is found that they have run into problems and/or have been delayed. Consequently, only part of them has been carried out and most in this group have overrun the planned timetable[1] for their completion, leading in the medium term to a smaller investment than planned in the transport infrastructure.

Figure 1 illustrates this: It shows the changes that have occurred in the last few years in the expected expenditure on transport development. The extent of the changes in the expected plans of the relevant government ministries in 2012 can be seen in the figure. From 2012 to 2015, the expenditure was supposed to increase from NIS 11 billion to 23 billion—in other words, more than double. This increase was half of the total increase in the state budget which the existing expenditure rule allowed over this 3 year period, despite the fact that a considerable part of the budget increase was already earmarked for expenditure on other items.[2] The 2012 plans for 2015 included, among other things, an expenditure of NIS 4.9 billion on the light railway in Tel Aviv, NIS 3.6 billion on the Netivei Israel plan, NIS 1.5 billion on the light railway in Jerusalem, and NIS 1 billion on the railway electrification project.

Figure 1
Change over time in transport investment plans, 2012–15



SOURCE: Based on government budget and Ministry of Finance.

The figure also shows that the difference between the 2012 forecast for 2015 and the forecast for 2015 at the beginning of 2015 is NIS 10 billion, i.e., a decline of 45 percent, despite the fact that the government has not

1 See Box 6.3 in the Bank of Israel Annual Report for 2009.
2 See "The anticipated performance of the state budget in 2012 against the budget objectives" (December 2011), Bank of Israel.

cancelled any important transport development plans. Expenditure being less than forecast is no indication of any saving or efficiency since transport infrastructure projects in Israel overrun the original cost by 31 percent, on average.[3] The decline in the forecast shows that the transport infrastructures development plans are carried out at a slower pace than planned.

The slow progress has importance beyond the lack of transport infrastructures: The delay affects the ability to plan the location of dwellings and businesses, since the construction of residential neighborhoods requires roads and access to employment opportunities for future residents, and business operations are affected by their accessibility to transport infrastructures. Moreover, since investments in transport infrastructures are large and complex, they require multiyear budgeting and planning. Since the government is subject to a multiyear expenditure ceiling, surplus multiyear budgeting in the infrastructures item limits its ability to direct resources to other purposes. It is therefore important to improve the planning, budgeting and control abilities of the entities responsible for large transport infrastructure projects.

Plans that have already been assigned a budget therefore proceed at a slow pace for many reasons. Among the main ones are:

- Disagreement between government ministries, and between them and the contracting companies, on the extent of the project or on the content of the relevant government decision.
- Disagreement over the pricing of the elements of the project or over the method for indexing the budgets earmarked for it.
- Frequent changes in the project specification, for example converting junctions to interchanges, a change in a highway route, the addition of a road in order to link the project with another project, the addition of a railroad track, and a technological change requiring an infrastructure upgrade. The performance sometimes does not progress until agreement has been reached on all these.
- Overly optimistic estimates of the cost of the project and the ability to carry it out. These require changes in both the timetable and the cash flows necessary for the project.
- Delays in publishing tenders, checking them, and deciding on who has won them.
- Changes in the priorities of the relevant decision makers and of the government.
- Changes in the companies carrying out the projects and in their abilities.

In order to demonstrate some of these phenomena[4] we will review two of the largest and most important projects put together in the last few years for the purpose of transport development: The Netivei Israel plan and the red line in Tel Aviv.

Netivei Israel

On February 24, 2010 the government decided to adopt the Netivei Israel plan[5] and to invest NIS 27.5 billion in transport infrastructures over the years 2010–20. Half of the budget for the plan was allocated to interurban roads and to railways, and the other half to planning future projects and the railway electrification project (see Table 1). The decision stated that the budget for the plan would be added to the Ministry of

[3] See Box 6.3 in the Bank of Israel Annual Report for 2009.

[4] It should be noted that not all these changes are fundamentally negative—for example, changes in priorities and technological changes.

[5] Government decision number 1421 of February 24, 2010: "Netivei Israel – Transport Plan for the Development of the Negev and the Galilee, 5770-2010.

Transport budget and that there would be no option to cut it without a specific resolution. In 2013, the government decided to cut the Ministry of Transport's development budget and the decision gave details of which part of the cut applied to Netivei Israel.[6] The aggregate cut in 2013–20 is NIS 1.7 billion, around 6 percent of the total of the plan.

Table 1
The Netivei Israel Plan

The project	The cost (in NIS billion, at 2010 prices)
The Emek (Valley) Railroad – Connecting Afula and Bet Shean to the railway	3.4
Acco-Carmiel track	3.4
Cross-Israel Highway northbound	3.0
Highways in the north	2.5
Roads and railways in the south	1.5
Planning and eminent domain	2.5
Railway electrification, rolling stock and maintenance	11.2
Total	**27.5**

One of the main elements of the plan is the electrification project—the replacement of diesel trains with an electrified railway system. This project requires planning, the purchase of appropriate equipment and a comprehensive upgrading of the infrastructure. The cost of the project was NIS 11.2 billion in 2010—40 percent of the budget for the plan—and in the 2013–14 budget, its expected cost increased to NIS 14 billion. The State Comptroller's Office[7] examined the matter in 2013 and the examination showed that the original cost assessment was NIS 2 billion in 2004 (in 2014 prices), and it is unclear how the cost estimates in 2004 and 2010 were calculated. In the 2015 budget, the cost of the project again rose, this time to NIS 17 billion.[8] Part of the differences between the estimates derives from the fact that the Ministries of Finance and Transport do not agree between them on the content of the plan, and the lack of agreement concerns aspects whose cost, according to estimates, reaches NIS 4 billion. As of the beginning of 2015 the electrification project has not yet gotten underway. The fact that this project is not progressing may delay the operation of the railway line between Jerusalem and Tel Aviv once its construction has been completed,[9] since it is intended solely for electric trains.

6 Government decision number 192 of May 13, 2013: "A reduction in the budget of the Ministry of Transport, National Infrastructures and Road Safety".

7 State Comptroller, annual report 65a, 5775-2014: "Israel Railways Corporation Ltd. – Organization for the Electrification of the Railway Lines".

8 Ministry of Transport and Road Safety budget proposal for fiscal year 2015, page 50.

9 The original date for its completion was in 2008. At the beginning of 2015, it was expected to be completed at the beginning of 2018.

The Red Line in Tel Aviv

As described in Box 2.2 in this report, and in previous reports,[10] the level of development of public transport in metropolitan areas in Israel is below that of other advanced economies. The main project intended to deal with this problem—the light railway—is focused on the Tel Aviv metropolitan area and has been in development for more than two decades already. In 1997, NTA (the Tel Aviv Metropolitan Mass Transit System Ltd.) was set up as the government company to be in charge of the project's implementation, and the cornerstone of the railway was laid. In 2001, the route of the line between Bat Yam and Petah Tikva was approved, and in 2003, the first tender for its construction was published. In 2006, a group of companies was chosen to construct the line, and in 2008—eleven years after the cornerstone was set down—work began. In 2010, the project was nationalized due to dissatisfaction with the pace at which work was progressing, and it was decided that NTA would manage its continuation. In 2011, excavation work began in three different locations, but in view of the pace at which the work was progressing, it was decided, in 2014, that in order to provide a temporary solution a Metronit bus rapid transit system would operate on the route.

From the way things developed, this project was shown to suffer, among other things, from freezes, changes in concessionaires, financial problems, changes in the contracting entities, and many changes in both the anticipated completion date and the estimates of its overall cost. The current estimate for the cost of the Red Line is NIS 16.1 billion (at June 2014 prices), but this is now being re-examined. To date, NIS 2 billion has been expended on the project, NIS 1.5 billion of which on preliminary work on site; NIS 0.5 billion of this was invested in 2014. The expenditure on the Red Line is expected to increase to NIS 0.9 billion in 2015, and is expected to continue to increase over the next few years. For the sake of comparison, the 2012 estimate of the expenditure from 2013 to 2015 was NIS 8.5 billion, meaning that the project is progressing at an extremely slow rate in comparison with the estimate. The completion date is not known at this time, but the forecast is for around 2025. The lack of a transport solution for the Tel Aviv metropolitan area for such a long period of time entails high costs both in terms of economic productivity and in terms of the negative impact to the welfare of inhabitants, loss of time, and air pollution. Likewise, it is holding back high density building in the metropolis, which would have provided a response to housing demand.

[10] Bank of Israel Annual Report for 2011, page 114.