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Analysis of the 2011 and 2012 Draft Budget in View of Budget Targets and from a Long-Term Perspective

Public Sector Analysis Unit
Bank of Israel Research Department

Applying the policy measures that accompany the 2011 and 2012 state budget will facilitate staying within the expenditure and deficit ceilings set by the law. The level of expenditure in the budget program corresponds to the recently approved fiscal rule, and the revenue outlook is reasonable if taxes will be raised in accordance with the Government's proposal. The tax increases proposed for the next two years are immensely important in demonstrating the Government's commitment to the deficit ceiling and the lowering of the debt/GDP ratio, especially in view of its long-term policy of reducing the tax burden. However, since some of the tax increases are temporary and the existing legislation prescribes a significant cut in income-tax and corporate-tax rates between 2013 and 2016, the Government it will be challenging to attain the deficit target and significantly lower the debt/GDP ratio after 2012 unless economic activity expands at an especially rapid pace—about 5 percent per year—or unless the tax trajectory is modified again. This challenge intensifies because, in our estimation, the level of expenditure derived from Government resolutions relating to specific programs in the fields of defense, education, social services, and infrastructure surpasses the expenditure ceiling for 2013 and subsequent years. This makes it harder to contain the increase in spending below the ceiling in order to help lowering the deficit.

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A. The 2011 and 2012 budgets

Expenditure ceiling

The 2011–2012 draft budget, presented by the Government to the Knesset, is based on a new expenditure-growth rule that was approved this year. According to this rule, the real rate of expenditure growth will be set each year in view of the average rate of GDP growth in the previous ten years for which published data are available at the time the budget is drawn up.[1] This rate is reduced commensurate with the distance of the debt/GDP ratio from the level that was set as an interim target en route to lowering it—60 percent.[2] The upshot of the new rule is that, for 2011 and 2012, the **underlying** rate of increase in expenditure was raised to 2.7 percent as against 1.7 percent per year according to the previous rule. However, the rules used in calculating the expenditure ceiling required further adjustments (Table 1): (1) in the 2011 budget, the budget base was increased by 2.3 percent in order to correct the underestimate of the price level in the 2009 and 2010 budgets; (2) NIS 3.25 billion—1.3 percent—was subtracted from the budget on account of one-off expenditures that were approved for 2009 and 2010; (3) the budget is increased each year commensurate with the expected increase in prices over the previous year. The calculations in Table 1 show that, after these adjustments, the 2011 budget will be 3.7 percent larger in real terms than the 2010 budget and that the expenditure ceiling determined in the budget is compatible with the new rule.

The sizable raising of the expenditure ceiling in 2011 allows the Government to close much of the gap that had opened in recent years between the cost of financing multiannual programs that it had adopted in various fields and the level of expenditure that the ceiling allows. The increase in permissible expenditure under the new rule will help to narrow the gap by NIS 2.5 billion in 2011 and by NIS 5.5 billion in 2012, and the other budget adjustments specified in Table 1 will contribute another NIS 3 billion. Importantly, most budget items—including the wage item—are managed on a nominal basis (at least in the short term)[3]; therefore, the price adjustment in the 2011 budget does reflect, in greater part, a real increase in resources. However, the draft budget also includes meaningful steps to restrain the upward movement of expenditure. Absent these steps, the Government would find it difficult to stay under the budget ceiling, especially because this year, unlike past years, the interest budget is not much larger than foreseen expenditure on this account; therefore, it does not provide a safety margin for the expenditure level.

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[1] To prepare the 2011 and 2012 budgets, the arithmetic mean of the GDP growth rates in 2000–2009 was used.

[2] This rate is examined in regard to the past year for which data exist (2009 in the current budget). The exact calculation is as follows: the average rate of the GDP growth is multiplied by an offset coefficient that is the quotient of 60 percent divided by the debt/GDP ratio in the past year. In 2009, the debt/GDP ratio was 79 percent; therefore, the offset coefficient is 0.76. The more the debt/GDP ratio falls, the higher the offset coefficient will be and the closer the rate of expenditure increase will come to the average rate of GDP growth.

[3] For example, the public-sector wage accord determined nominal wage increases in 2008–2010, while inflation expectations were far below the actual increase in the CPI. These wage payments will not change pursuant to the unexpectedly rapid pace of price increase.

Table 1: Components of Change in Expenditure Ceiling in 2011 and 2012 Budgets

	2011 budget vs. 2010	**2012 budget vs. 2011**
	(Pct.)	**(Pct.)**
Real increase according to law[1]	2.7	2.7
Adjustment for one-off budget items in 2010	–1.3	—
Price adjustment on account of underestimate for 2010 (1–2)	2.3	—
1. Price-increase outlook in 2009–2010 budget	3.3	—
2. Actual price increase in 2009–2010	5.7	—
Total real increase in expenditure	**3.7**	**2.7**
Price-increase projection for next year	2.2	2.3
Nominal permissible increase in budget	**5.9**	**5.0**
Nominal increase in draft budget	**5.9**	**5.0**

1. The average real rate of GDP growth in 2000–2009 (simple average) multiplied by 0.76 (the quotient of 60 divided by the debt/GDP ratio at the end of 2009 (79 percent).
2. The Consumer Price Index was expected to rise by 1.8 percent in 2009 (annual average) and by 1.5 percent in 2010.

Source: Bank of Israel Research Department calculations.

Deficit ceiling and revenue outlook

In addition to the expenditure ceiling, the budget must comply with a deficit-reduction path that was set forth when the 2009–2010 budget was approved. According to this path, the deficit must not surpass 3 percent of GDP in 2011 and 2 percent in 2012—much lower than the expected deficit of 4 percent of GDP in 2010. According to an analysis performed by the Bank of Israel Research Department on the basis of the Department's macroeconomic outlook and budget-analysis models, the 2011 deficit will probably be slightly lower than the ceiling for that year, whereas the 2012 deficit will overshoot the ceiling slightly (Table 2)—assuming that the Knesset adopts the package of measures included in the draft budget and the government's Finance Bill for the two years at issue.

The tax-revenue outlook in the 2011 budget is largely compatible with that of the Research Department, despite minor differences in growth outlooks and the use of different models. According to the Research Department outlook, real tax revenues in 2011 will grow by 7.7 percent or, net of the effect of legislative changes, 6.5 percent. This is much faster than GDP growth, but such high elasticity was also typical of previous periods of recovery from recession. Although the level of GDP was already verging on the potential in 2010, tax revenues are received at enough of a lag (especially in corporate tax) to expect 2011 revenues to be affected by it as well. Furthermore, the increase in GDP deflator in 2010 has been relatively sluggish, and the assumption that it will revert to its "ordinary" growth rate in 2011 (even without correction for the slow increase in 2010) also contributes to the real expected increase in profitability and tax receipts.

Table 2: Expected Development of Main Budget Aggregates, 2008–2012[1]

			Est.	Outlook	
	2008	**2009**	**2010**	**2011**	**2012**
Expenditure (excl. issue of credit)	**33.8**	**33.3**	**33.6**	**33.7**	**33.3**
Real rate of change in net primary civilian expenditure	*1.9*	*3.9*	*4.7*	5.0	2.3
Thereof:	7.8	7.4	7.1	7.0	6.8
Defense expenditure[2]					
Interest (excl. interest paid to National Insurance Institute)	3.7	3.5	3.4	3.4	3.5
Interest payments and principal payback to National Insurance Institute)	1.8	1.8	1.8	1.8	1.8
Primary civilian expenditure [3]	19.5	19.8	20.3	20.5	20.2
Revenues (excl. repayment of credit)	**31.7**	**28.3**	**29.6**	**30.9**	**30.9**
Thereof: Tax revenues	25.5	23.3	24.2	25.1	25.1
Grants from abroad	1.4	1.1	1.1	1.1	1.0
Other revenues	4.9	3.9	4.3	4.8	4.8
Deficit excl. net issue of credit	**–2.0**	**–5.0**	**–4.0**	**–2.8**	**–2.3**
Public debt (gross)	76.8	79.2	77.7	76.1	74.6

1. Assuming that the 2011 and 2012 budgets will be approved in accordance with the Government's draft. The revenue outlook is based on the Bank of Israel's macro outlook and tax model.
2. In 2010–2012: including the Bank of Israel's estimate of transfers from other budget items to the defense item and reclassifications.
3. Not including payback of principal to the National Insurance Institute.

Source: Bank of Israel Research Department calculations.

Even though the Bank of Israel's projections resemble those in the budget, it is important to bear in mind that tax forecasts now days—not just in Israel—are marked by unusually high uncertainty. Tax revenues in 2009 were far below predictions based on long-term relations between revenues and macroeconomic variables; it is not clear whether this was a temporary or structural change in the relations among the variables due to the crisis. If so, one cannot be sure about the extent to which forecasting on the basis of past relations will yield reliable results in 2011 and subsequent years. Just the same, since the Bank of Israel's model successfully explained revenues in 2010 as it did in the past, its projection may evidently serve as a basis.[4]

The budget revenue forecast for 2012 is somewhat larger than that generated by our analysis. The main reason for the difference is the assumption in the budget projection that the elasticity of tax receipts to GDP growth will be 1.55 in 2012 as in 2011, even though the 2012 growth rate will not be faster than that in 2010 or 2011. In our estimation, the effect of the exit from the recession will run out of steam by 2011; therefore, tax-revenue elasticity will revert in 2012 to its long-term level, which is slightly greater than unit. The significance of the difference between the projections

[4] For an explanation of the model, see A. Brender and G. Navon (2008), "Predicting Government Tax Revenues and Analysis of Outlook Uncertainty," *Israel Economic Review* 7(2), 2010, pp. 81-111.

is that the expected deficit in 2012 according to the Bank of Israel estimate—2.3 percent of GDP—slightly overshoots the 2 percent ceiling. However, this gap is rather small, especially since it reflects an outlook to two years ahead.[5]

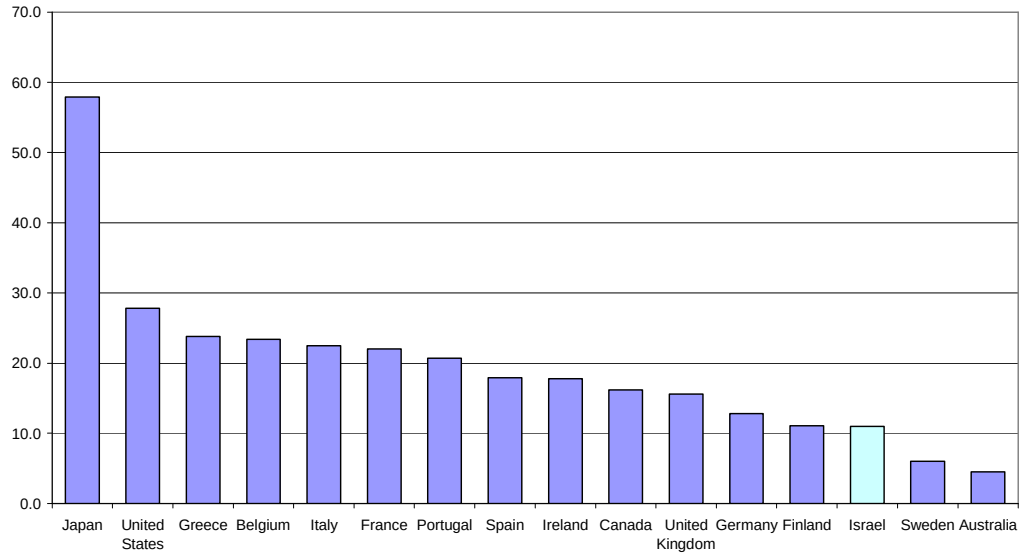
The draft budget includes far-reaching changes in tax rates, both relative to those prevailing in 2010 and, in particular, relative to the rates established in the law for 2011, which were supposed to come down considerably. The new taxation measures that the Government decided on for 2011 and 2012 include, mainly, increases in indirect taxes on fuels and cigarettes, which are expected to boost revenues by more than NIS 2 5 billion in 2011 and another NIS 1.7 billion in 2012. The Government also decided to defer the VAT tax cut from 2011 to 2013 (augmenting revenues by NIS 1.8 billion each year) and to raise National Insurance contributions (adding NIS 0.7 billion). In view of additional tax cuts that were established in legislation and will be applied, the total effect of the measures is expected to increase government tax revenues (including National Insurance contributions) by more than NIS 3 billion in 2011 relative to 2010 and leave them at roughly the same level in 2012. Relative to the legislation that was in effect before the budget was approved, tax revenues will grow by NIS 6 billion in 2011[6] and by another NIS 2 billion in 2012. These are large-scale measures that signal the Government's resolve to remain under the deficit ceiling and reduce the debt/GDP ratio in the next two years.

On the basis of the outlook described above, if the budget is passed in accordance with the Government's draft, we expect the debt/GDP ratio to fall by 3 percent of GDP in the next two years, to 74.6 percent at the end of 2012 (Table 2). This would present the Israeli economy in a positive light in an international environment that expects the debt/GDP ratios of most developed countries to rise rapidly. This advantage will also be manifested in Israel's financing needs in 2011, which will be much smaller than those of most developed countries (Figure 1). This situation, if accompanied by a credible fiscal path for subsequent years as well, may contribute to a perception of low risk among potential investors in Israel, abet economic activity, and lower the future interest burden of the government and the private sector.

[5] According to the budget projection, the share of taxes in GDP, net of the effects of legislative changes, will return to its 2008 level; in other words, the entire decrease in the tax burden was temporary. However, since the level of some of the macroeconomic variables was aberrant before the crisis, some of the decrease in the tax burden is likely to be permanent.

[6] In addition to a net increase in revenues of more than NIS 3 billion, the lowering of the VAT rate was deferred for two years and it has been proposed to lower the ceiling for National Insurance contributions and health tax to five times the national average wage gradually and not in one go as in the current law.

Figure 1: Total Financing Needs,[1] 2011 (Pct. of GDP)



[1] Financing needs are defined as payments of principal due plus the current year's budget deficit. To reconcile this with other countries' definitions, the statistic in Israel includes indexation differentials on CPI-indexed capital stock and net issue of credit by the government.

Sources: for Israel—Bank of Israel Research Department calculations; for the other countries—IMF, *World Economic Outlook*, October 2010.

B. Expenditure ceiling and composition of expenditure from a multiannual perspective

Israel has been using a multiannual expenditure ceiling since 2004 (ahead of the 2005 budget) setting the real annual growth rate at 1 percent; this rate was raised to 1.7 percent since 2006. The ceiling was overshot in each of the years 2005-2010 by one-off additions but these ended at the 2011 budget. An examination of the real increase of expenditure between 2004 (performance) and 2011 (budget) shows that it amounted to an annual average pace of 1.8 percent, very close to the rate derived from the deficit ceilings that were set for those years. This implies that the one-off additions did not turn into permanent ones. Furthermore, relative to the 2004 **budget**, the rate of increase was even lower—only 1.3 percent. This moderate increase abetted a 6 percentage-point decline in the share of government spending in GDP since 2003; it was attained largely due to many comprehensive measures that had been decided upon in 2003 and that established the expenditure trajectory for subsequent years.[7] Against this background, the steepening of the expenditure trajectory under the new rule adopted this year, which will make it possible to accommodate the gap that opened in 2011 and 2012 between the cost of multiannual programs that the Government has adopted in recent years in defense, education, welfare, and infrastructures, and the expenditure ceiling, appears to have struck a reasonable balance among the various targets. In contrast, the revision of budget targets whenever they do not correspond to the expenditure path derived from specific government programs endangers the credibility of policy; indeed, this kind of conduct

[7] See A. Brender (2008), "If You Want to Cut, Cut, Don't Talk: The Role of Formal Targets in Israel's Fiscal Consolidation Efforts 1985-2007", in *Fiscal Policy*: *Current Issues and Challenges*, Banca d'Italia March 2008, pp. 348-376.

lay at the root of the overshooting of deficit targets in the past decades. For this reason, it is important to make sure a-priori that the adjustment is nonrecurrent, that the government programs can be accommodated under the new expenditure ceiling, and that the requisite adjustments are made back at the decision stage—even if the program commitments relate to the medium-term.

Avoidance of accumulating budget commitments that overshoot the ceiling is especially important because the Government has little flexibility in changing the composition of its expenditures. What this rigidity means is that there is little likelihood of financing excess commitments by reducing lower-priority expenditures; in practice, such commitments lead to a retreat from some new programs or to the application of "across-the-board cutbacks" to most budget items. As a reflection of this phenomenon, the composition of primary civilian expenditure has hardly changed in recent years (Table 3); the main fluctuations in the composition of the budget relate to defense expenditure and largely correspond to security events. Admittedly, there has been a slight increase in infrastructure investment at the expense of direct subsidies for industries and support for municipalities, but the share of expenditure for education, healthcare, and welfare in the budget has been basically constant. The composition of Israel's budget is also rigid by international standards.[8]

Table 3: Composition of Primary Civilian Government Expenditure net of Pension Payments, 2004–2012

	2004	2005	2006	2007	2008	2009	2010	2011	2012
	(Pct. of total primary civilian expenditure)								
Education + higher education	26.7	26.9	26.5	27.6	26.7	27.5	26.8	26.3	26.0
Healthcare	14.2	14.5	14.6	13.5	13.7	13.8	14.1	13.9	13.7
National Insurance[1]	17.1	17.9	18.3	18.7	18.6	18.6	17.6	17.6	1.75
Transport and water infrastructure[2]	3.3	4.6	5.3	5.0	5.9	6.1	6.2	6.3	6.6
Ministry of Labor and Social Affairs	3.4	3.4	3.5	3.5	3.5	3.5	3.6	3.5	3.5
Municipal authorities	3.1	3.4	3.3	3.2	3.0	2.7	1.9	2.3	2.2
Construction and housing grants + subsidies for nonresidential industries	3.7	3.3	3.0	2.9	3.1	3.1	2.4	2.5	2.4
Other	28.5	25.9	25.4	25.7	25.4	24.7	27.5	27.7	27.9
Share of primary civilian expenditure excl. pensions in total budget	55.1	54.3	53.5	54.1	55.7	55.8	57.3	58.9	58.9

[1] Excl. interest payments and payback of principal to National Insurance Institute.
[2] Including transfers to municipal authorities for investment purposes.
Source: Bank of Israel Research Department calculations.

Examining the expenditure path derived from various programs adopted by the Government, we find that the gap between the path and the expenditure ceiling prescribed by the fiscal rule is much smaller than in previous years. In 2013, the projected disparity will be NIS 3.5 billion (in 2012 prices) and, on the basis of

[8] See A. Brender and A. Drazen, (2009), "Do Leaders Affect Government Spending Priorities?" *NBER Working Paper 15368.*.

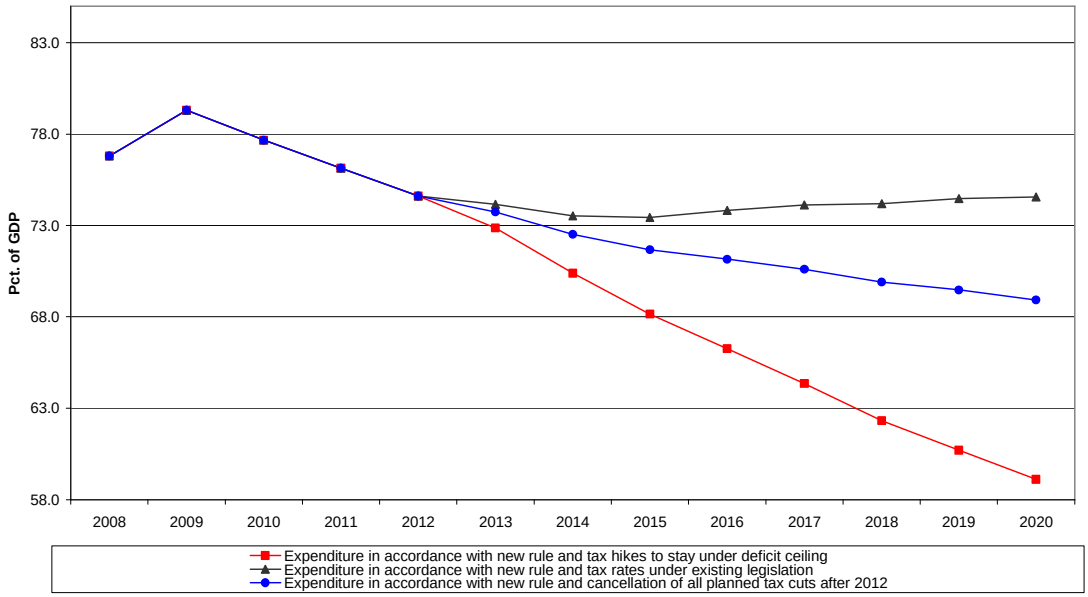
existing programs, it is not expected to widen in subsequent years. This marks a departure from previous years; it is due mainly to the faster pace of increase in the expenditure ceiling but also reflects the Government's acknowledgment of the need to avoid the accumulation of multiannual commitments. However, since the Government will probably wish to adopt additional programs in the next two years, an effort will probably be needed to avoid overshooting the expenditure ceiling. Therefore, it will be challenging for the Government to cut its spending to a level below the ceiling in order to help bring down the deficit. The fact that expected expenditure in 2013 already surpasses the new ceiling demonstrates the need to avoid further commitments as much as possible and to steer clear of any attempt to defer to subsequent years needs that surface at the time the budget is approved.

C. Outlook for fiscal developments after 2012

In addition to the expenditure ceiling, the budget is also subject to a multiannual deficit ceiling that caps the deficit at 1.5 percent of GDP in 2013 and 1 percent in subsequent years (Table 4, Scenario 1). If GDP grows at the rates that this scenario assumes, compliance with the deficit ceiling will assure a rapid decline in the debt/GDP ratio to less than 70 percent in 2015 and around 60 percent by 2020 (Figure 2).[9] However, while the measures accompanying the draft budget are roughly consistent with the attainment of the new deficit and expenditure ceiling targets that were set for 2011 and 2012, the picture is different where 2013 and subsequent years are concerned. This is so even if we assume that the Government will make the required adjustments to remain under the expenditure ceiling (reducing foreseen expenditure by NIS 3.5 billion). The reason is that the expenditure ceiling allows only a mild reduction in the expenditure/GDP ratio; therefore, the rest of the adjustment has to be made by increasing revenues. However, existing legislation and the changes proposed at the present writing determine major tax cuts in 2013 (Table 4, Scenario 2)—mainly further lowering of personal and corporate income tax rates between 2013 and 2016 and the lowering of the VAT rate, which the Government has postponed to 2013. Consequently, absent offsetting measures to raise revenues, the deficit is expected to increase in 2013 relative to 2012, coming to more than 2.5 percent of GDP. Furthermore, due to the continuing tax cuts (Figure 4), the deficit is expected to continue expanding until 2016 and the debt/GDP ratio will hardly decline after 2012. In years after 2015, too, the debt/GDP ratio is not expected to change significantly; its level in 2020 will resemble that in 2012 (Figure 2).

[9] The growth rate assumption for 2015–2020 is 3.1 percent per year, based on the growth rate of per-capita GDP in recent decades and the Central Bureau of Statistics' outlook for population increase in the coming decade. Estimates based on the increase in main working-age population cohorts are lower.

Figure 2: Government Debt/GDP Ratio, Various Scenarios, 2008–2020



The analysis above, as well as the alternative policy scenarios that we present below, are based on specific growth assumptions that are specified in Table 4. These assumptions were derived from the growth rates of per-capita GDP in recent decades and the Central Bureau of Statistics' population projections for the relevant period. Obviously, if GDP grows at different rates, the fiscal aggregates will also develop differently. For example, if GDP grows by 4.5 percent per year on average in 2012–2016, it will be possible to go ahead with the planned tax cuts and both ceilings—expenditure and deficit—will be accommodated. However, even though Israel achieved such growth rates between 2003 and 2008, it did so against the background of two macro situations at the beginning of the period—a level of GDP far below potential and a double-digit unemployment rate—that are not present today. Furthermore, population growth in the main working-age cohorts (25–64) will be slower than that of the population at large in the next few years, meaning that the GDP growth assumption underlying the analysis may be overly optimistic.

In order to examine the sensitivity of the estimates to assumptions regarding growth rates after 2012, two other scenarios are shown, one with faster growth than in the basic scenario, and another with slower one. The first assumes growth of 4.3 percent, in line with the average growth rate in 2004–09, and the second, growth of 2.5 percent, derived from the expected increase in the population aged 25 to 64 years. As expected, the faster the rate of growth, the greater the improvement in the forecast fiscal aggregates, but even at the higher-growth scenario the deficit will not be below the ceiling if the planned path of tax reductions is followed and if expenditure is raised according to the new rule. Such growth, however, would enable the debt/GDP ratio to be reduced significantly in the next decade, to about 60 percent in 2020 (Figure 3). Conversely, in the slower-growth scenario the debt/GDP ratio would increase continuously under the same policy.

Table 4: Expected Trajectory of Main Budget Aggregates, Various Scenarios, 2008–2015
(Pct. of GDP)

		Est.	Proj.				
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
*Growth rates**	*0.8*	*4.0*	*3.8*	*3.7*	*3.5*	*3.4*	*3.2*
(1) Inwith new rule and increase in revenues to comply with deficit ceiling crease in expenditure in accordance[1]							
Expenditure (excl. issue of credit)	33.3	33.6	33.7	33.3	33.1	33.0	33.1
Further measures needed to comply with expenditure ceiling	...	...	...	...	0.4	0.0	-0.2
Real rate of change in net primary civilian expenditure	*3.9*	*4.7*	5.0	2.3	3.1	3.3	4.3
Tax revenues	*23.3*	*24.2*	25.1	25.1	26.0	26.4	26.7
Deficit excl. net issue of credit	-5.0	-4.0	-2.8	-2.3	-1.5	-1.0	-1.0
Public debt (gross)	79.3	77.7	76.1	74.6	72.9	70.4	68.2
(2) Increase in expenditure in accordance with new rule and tax rates as set by existing legislation [1]							
Expenditure (excl. issue of credit)	33.3	33.6	33.7	33.3	33.1	33.0	33.0
Real rate of change in expenditure	*1.1*	*2.9*	*2.7*	*2.7*	*2.7*	*3.1*	*3.3*
Real rate of change in net primary civilian expenditure	*3.9*	*4.7*	5.0	2.3	3.1	3.0	3.7
Tax revenues	*23.3*	*24.2*	25.1	25.1	24.7	24.6	24.4
Deficit excl. net issue of credit	-5.0	-4.0	-2.8	-2.3	-2.8	-2.9	-3.2
Public debt (gross)	79.3	77.7	76.1	74.6	74.2	73.5	73.4
(3) Increase in expenditure in accordance with new rule and cancellation of all planned tax cuts after 2012 [1]							
Expenditure (excl. issue of credit)	33.3	33.6	33.7	33.3	33.1	33.0	33.0
Real rate of change in net primary civilian expenditure	3.9	4.7	5.0	2.3	3.1	3.1	3.9
Tax revenues	*23.3*	*24.2*	25.1	25.1	25.1	25.2	25.2
Deficit excl. net issue of credit	-5.0	-4.0	-2.8	-2.3	-2.3	-2.3	-2.4
Public debt (gross)	79.3	77.7	76.1	74.6	73.7	72.5	71.7

* After 2011: assumption based on past per-capita GDP growth rates and the population growth rate projection.

[1] Assuming that expenditure in 2011 and 2012 will be as set forth in the Government's draft budget and that the requisite spending cuts in 2013–2015 will be applied to civilian items. Also assuming implementation in 2011 and 2012 of all tax-related legislative changes that the Government has approved or presented to the Knesset along with the draft budget.

Source: Bank of Israel Research Department calculations**.**

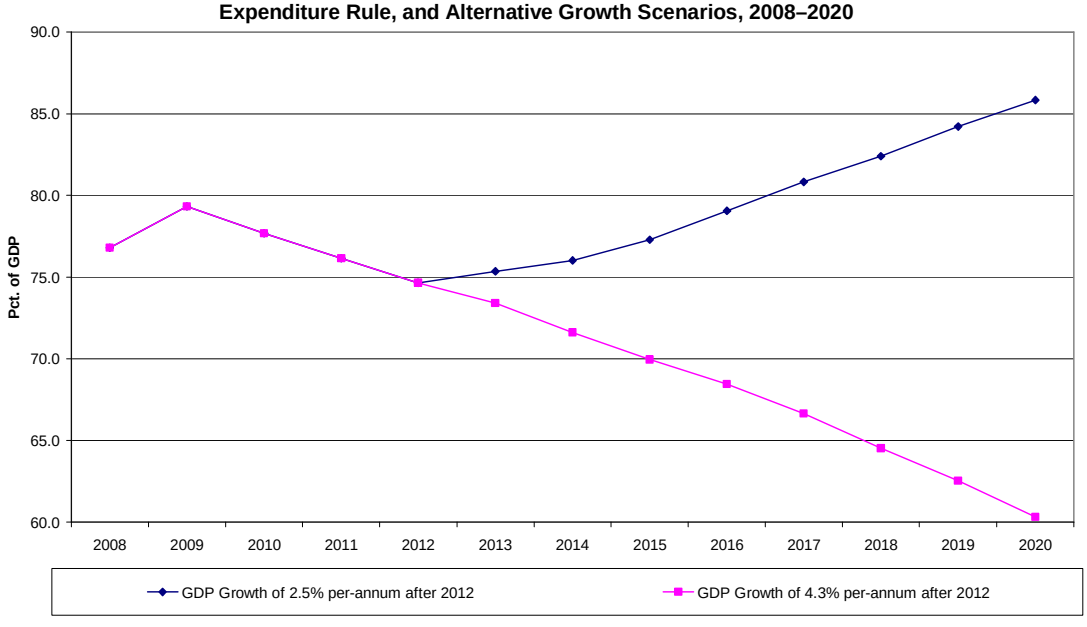
Table 5: Expected Development of Main Budget Aggregates, Alternative Growth Assumptions: 2008–2015
(Pct. of GDP)

		Est.	Outlook				
	2009	2010	2011	2012	2013	2014	2015
(1) Annual GDP growth of 4.3% from 2013*; Increase in expenditure in accordance with new rule and tax rates under existing legislation [1]							
Expenditure (excl. issue of credit)	33.3	33.6	33.7	33.3	32.8	32.5	32.2
Real rate of change in expenditure	*1.1*	*2.9*	*2.7*	*2.7*	*2.9*	*3.2*	*3.4*
Real rate of change in net primary civilian expenditure	*3.9*	*4.7*	5.0	2.3	3.2	3.1	4.1
Tax revenues	*23.3*	*24.2*	25.1	25.1	24.7	24.6	24.5
Deficit excl. net issue of credit	-5.0	-4.0	-2.8	-2.3	-2.5	-2.3	-2.3
Public debt (gross)	79.3	77.7	76.1	74.6	73.4	71.6	70.0
(2) Annual GDP growth of 2.5% from 2013; Increase in expenditure in accordance with new rule and tax rates under existing legislation [1]**							
Expenditure (excl. issue of credit)	33.3	33.6	33.7	33.3	33.4	33.6	33.8
Real rate of change in net primary civilian expenditure	3.9	4.7	5.0	2.3	3.0	2.8	3.4
Tax revenues	*23.3*	*24.2*	25.1	25.1	24.5	24.3	24.1
Deficit excl. net issue of credit	-5.0	-4.0	-2.8	-2.3	-3.2	-3.6	-4.2
Public debt (gross)	79.3	77.7	76.1	74.6	75.4	76.0	77.3

* After 2012, assumption based on the average growth during 2004-09.
** After 2012, assumption based on past GDP growth rates per person at ages 25-64 and predicted growth rate of the population at the ages.
[1] Assumes that expenditure in 2011 and 2012 will correspond to the Government's draft budget and that the cutbacks reuqired in 2013-2015 will be applied to civilian expenditure. Assumes implementation in 2011 and 2012 of all tax-related legislative changes that the Government approved or presented to the Knesset along with the draft budget.
Source: Bank of Israel Research Department calculations

One way in which the Government can cope with the gap between the deficit ceiling and the expected deficit due to policy measures already adopted is to cancel the planned tax cuts or offset them by raising other taxes commensurately and concurrently—as it did in the current budget. Scenario 3 in Table 4 presents the implications of such a policy, which would keep the share of taxes in GDP almost constant after 2012 and, in turn, allow the deficit to decline moderately. Admittedly, these measures would not suffice to lower the deficit to the level established in the law, but the smaller deficit than in Scenario 2 would permit a modest long-term decrease in the debt/GDP ratio.

Figure 3: Government Debt/GDP Ratio, Based on the Existing Tax Laws and Expenditure Rule, and Alternative Growth Scenarios, 2008–2020



To avoid overshooting the deficit ceiling at the level of expenditure that the expenditure ceiling allows, the Government would not only have to cancel the planned tax cuts (or replace them with other tax increases, as stated) but also raise tax rates considerably. Scenario 1 in Table 4 demonstrates the size of the adjustment needed, almost 1 percent of GDP in 2013 (the difference between tax revenues in Scenario 1 and those in Scenario 3) and, in cumulative terms, 1.5 percent in 2015 (Figure 4). Nevertheless, even after these adjustments, Israel's tax rates would not be higher than in most developed countries; current rates in Israel are relatively low and many of the other countries are expected to raise their tax rates even more in order to cope with their swollen deficits.[10]

An important implication of deciding about the level of the deficit relates to the relations that the new fiscal rule has created between the increase in spending and the development of the deficit and the debt, as stated above. This relation stands out in particular when one examines government primary spending, which is also affected by a decrease in interest payments due to the lowering of the debt.[11] Figure 5, showing primary civilian expenditure in the three policy scenarios presented in Table 4, indicates that by using tax increases to stay under the deficit ceiling (Scenario 1), it would be possible to increase primary civilian expenditure by more than 1 percent of GDP in 2020, relative to a scenario in which the deficit is allowed to grow as the result of tax cuts and expenditure under the ceiling.[12] This analysis highlights the decisions facing the government, when it determines the multiannual trajectory of the budget, between short-term and long-term considerations and between tax cuts and raising public spending. The analysis in this paper indicates the existence of a gap between the Government's long-term fiscal targets and the path derived from the expenditure ceiling and the tax-reduction path that the Government has adopted. For this reason, it is important for the Government to adopt, already now, a sustainable path for the fiscal aggregates and to choose the specific measures that will make its attainment possible. Such a decision will enhance the credibility of the targets, the tax cuts, and the spending programs all at once.

[10] OECD members that announced tax hikes during 2010 include Germany, the UK, Spain, Portugal, Greece, Finland, Hungary, Poland, Mexico, Iceland and the Czech Republic.

[11] The analysis relates only to interest-payment reductions occasioned by reduction of debt stock and not to the possible lowering of interest **rates** due to the downsizing of the deficits and the debt.

[12] All the scenarios assume identical growth rates, interest rates and defense expenditures.

Figure 4: Government Tax-Revenue/GDP Ratio, Various Scenarios, 2008–2020

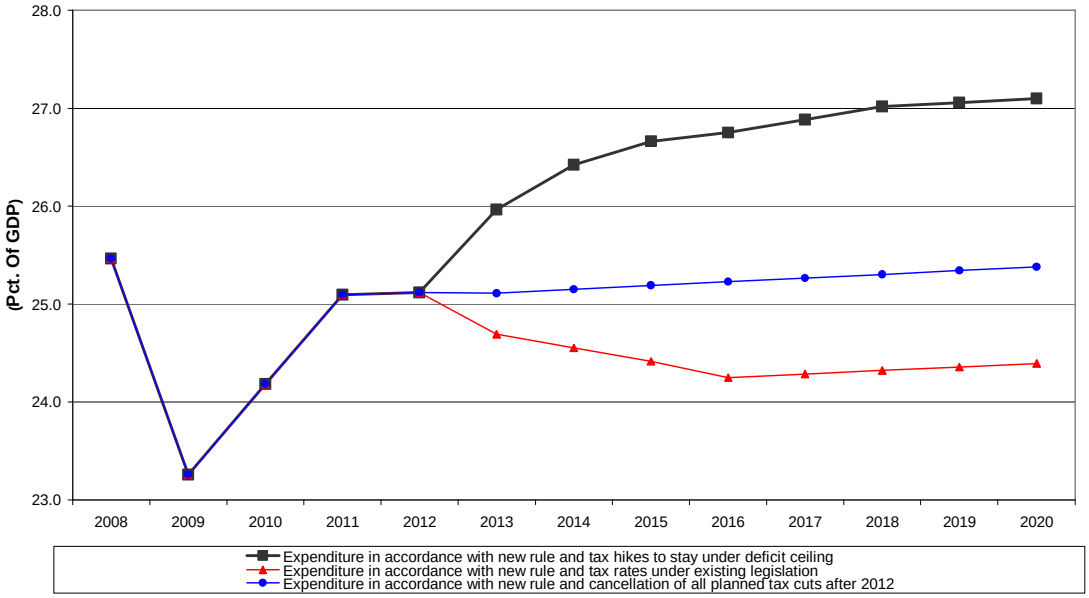


Figure 5: Primary Civilian Expenditure/GDP ratio, 2008–2020