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Assessment of the fiscal developments since the budget was approved, and their effect on the expected fiscal path

- **The measures adopted by the government within the framework of approving the budget for 2013 and 2014 strengthened the credibility of Israel's fiscal policy, and contributed to an improvement of Israel's standing in financial markets.**
- **The budget deficit in 2013 is expected to be below 3.5 percent of GDP, markedly lower than the deficit target of 4.65 percent of GDP.**
- **The below-target deficit reflects expenditures lower than the approved budget, and high tax revenues, most of which were exceptionally large one-off revenues.**
- **The budget deficit in 2014 is expected to be similar to the target set in law, 3 percent of GDP.**
- **If the government's proposal to cancel the income tax rates increase, which was set to come into effect in the beginning of 2014, alongside a similar reduction in the expenditure ceiling, is accepted, the government is expected to meet the deficit target in 2014, but it will be more difficult to meet the target in following years.**
- **Meeting the declining deficit targets set in law for 2015–17 requires additional policy measures—increased taxes, or reduction of the expenditure ceiling and a corresponding contraction of the government's expenditure programs—valued at 1 percent of GDP in 2015 and more than 2 percent of GDP, cumulative, by 2017.**
- **If the adjustment of the budget required to meet the deficit target is carried out solely by reducing expenditures, primary civilian expenditure per capita will not increase until 2017, compared with its current level.**
- **Fiscal data based on the new national accounting methodology adopted by the Central Bureau of Statistics highlights the extent to which Israel is characterized as a country with low public expenditure and tax burden. Based on the new calculations, as with the previous ones, the current general government deficit in Israel is high, compared with other countries.**

1. Introduction

The government faced a complicated fiscal challenge at the end of 2012 and in the beginning of 2013. The government deficit for 2012 deviated markedly from the target and led the government, in August 2012, to increase the deficit target for 2013 from 1.5 percent of GDP to 3 percent, along with raising tax rates. Despite this, the performance of budget in the beginning of 2013 indicated a high probability of the government deviating from the increased deficit target, as well. In addition to the development of the actual deficit, the government also faced numerous expenditure programs which were adopted in previous years, the cost of which deviated significantly from the expenditure ceiling set by the expenditure rule. This combination of a high current deficit and decisions on additional expenditures threatened to lead to a large and sustained increase in the debt to GDP ratio to dangerous levels.

In order to deal with the difficulties in the budget, the government put into effect a comprehensive fiscal adjustment plan which included an immediate increase in indirect tax rates, a decision to increase direct tax rates beginning in 2014, and a marked contraction of expenditures—by postponing or cancelling programs which were to be carried out in 2013 and 2014, by deferring wage payments, and by markedly reducing the defense budget and child allowances. It was assessed that the measures adopted by the government would be sufficient to halt the worsening of the deficit and to reduce it to a level of about 3 percent of GDP in 2014. These measures also contributed to strengthening the confidence of the capital markets in Israel's economy and in the government's fiscal control, and to a decline in yield spreads between Israel and the developed markets. With that, the plan left the government the complex challenge of carrying out the adjustments required for the deficit and expenditure levels in the years after 2014 to be in line with the targets set by law. Given that the deficit level was still high compared with other countries—and too high to allow a sustained decline in the debt to GDP ratio—and particularly since such a deficit level was achieved when the economy is at high employment levels, which help to reduce it, it is of great importance that the government continue to carry out the processes required to achieve the deficit targets.

The following section in the survey reviews several of the basic fiscal aggregates in Israel and their revised values based on the new national accounting methodology adopted by the Central Bureau of Statistics. Section 3 analyzes the 2013 budget performance, and Section 4 presents an updated forecast for the 2014 budget. Finally, Section 5 analyzes the expected development of the fiscal aggregates from 2015 and onward, based on alternative policy paths.

2. Revised fiscal data

In August, the Central Bureau of Statistics revised National Accounts data in accordance with the new international calculation method, SNA 2008. This adjustment included many changes in National Accounts components and in GDP level, including adjusting the method of calculating government expenditures, which changed the size of government expenditure and several of its components by several billion shekels. In addition, as every year, the National Accounts for previous years were revised based on various data and surveys conducted by the Central Bureau of Statistics, including revised input-output tables for 2006. As a result, the estimated level of Israel's nominal GDP in 2012 was about 7 percent higher than its level according to the previous calculation method, and the size of the fiscal aggregates in Israel, measured as a percentage of GDP, changed. This year, the tables and figures which appear in the fiscal policy chapter of the Bank of Israel Annual Report, and which the Bank revises once a year in November[1], reflect these changes for the first time. Due to the size of the changes, we present in short the main fiscal aggregates according to their new definition (Table 1).

The main changes in 2012 data, compared with the Bank of Israel Annual Report which was published in March 2013 are as follows:

1. The share of public expenditure in GDP is 39.2 percent, about 2.9 percentage points smaller than the figure published in March. Under the international definition, the share of expenditure in GDP declined to 40.2 percent.
2. The share of total revenues in GDP is 35.4 percent, about 2.2 percentage points smaller than according to the previous data. The tax burden declined by 2.1 percentage points, to 29.5 percent of GDP.
3. The overall general government deficit is 3.9 percent of GDP, about 0.6 percent of GDP lower than the previous data. The government budget deficit is 3.9 percent of GDP, 0.3 percent of GDP lower than the previous data. Using the international definition, the overall deficit of the general government is 4.8 percent, 0.4 percentage points lower than the previous data.
4. The debt to GDP ratio is 68.4 percent, 5.5 percentage points lower than the previous data.

There is some difficulty in conducting an international comparison of the new data, since most developed economies have still not adopted the SNA 2008 definitions.[2] With that, the move to these definitions is responsible, as noted, for only part of the changes in Israel's data, and since it is assessed that adoption of the method in other countries will influence the measurement of their GDP less than the change which was carried out this year in Israel, we present an international comparison of several major indicators of the fiscal situation.

[1] The complete set of updated tables and figures, including appendix tables, appears on the Bank of Israel's website at http://www.bankisrael.org.il/en.
[2] To date, only 4 OECD countries revised their National Accounts data due to the change in calculation method, other than Israel: the US, Canada, Australia, and Mexico.

Table 1

Main components of the general government's revenue and expenditure, 2007–2012

(percent of GDP)

	2007	2008	2009	2010	2011	2012
Total public revenue	**41.3**	**38.6**	**38.6**	**35.7**	**36.7**	**35.4**
Total taxes	34.5	31.9	29.7	30.5	30.7	29.5
Other[a]	6.8	6.7	8.9	5.2	6.0	5.9
Total public expenditure	**41.5**	**40.7**	**41.0**	**40.1**	**39.4**	**39.2**
Domestic civilian consumption	16.8	16.9	17.0	17.1	17.2	17.1
Domestic defense consumption	5.2	5.2	5.1	4.9	4.8	4.5
Interest payments	4.3	3.4	3.5	3.3	2.8	2.8
Current transfer payments	9.7	9.7	10.1	9.9	9.9	9.9
Investments of the general government and transfer payments on capital account[b]	3.3	3.5	3.5	3.2	3.1	3.2
Total deficit of the general government	**0.3**	**2.1**	**5.3**	**3.6**	**2.7**	**3.9**
Deficit per the international definition[c]	1.4	3.7	6.8	4.6	3.8	4.8
Gross public debt[d]	74.6	72.9	75.3	71.5	69.7	68.2

[a] Includes grants, income from assets, transfer payments from the public, 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] This line item adjusts the deficit to the accepted international definition by adding linkage differentials on to CPI-indexed and unindexed shekel debt.
[d] Percentage of GDP at year end.

SOURCE: Based on Central Bureau of Statistics data.

The comparison indicates that the share of Israel's public expenditure in GDP is lower than the advanced economies average (Figure 1). The share of primary civilian expenditure in Israel is lower by 13 percentage points than the average of those countries (Figure 2) and is lower than the share of all of them except for South Korea (data is unavailable for Mexico, Chile and Turkey, but it appears that they also have lower expenditure than Israel). The tax burden in Israel is lower by about 4 percent of GDP than the OECD average (Figure 3). The deficit is about 1.3 percent above the average (Figure 4), even though the output gap is low compared with other countries. The debt to GDP ratio in Israel is lower by about 15 percentage points than the average of advanced economies (Figure 5).[3]

[3] The OECD has recently used an additional definition of public debt, under which the public debt in Israel (in 2011) is NIS 100 billion greater than under the previous definition. Since Israel's data under this method are not up to date, and still suffer from various imprecisions, and since the additional method raises some complex methodological issues, we are not presenting, at this point, data based on the new definition.

Figure 1
Share of total public expenditure in GDP—Israel and other OECD countries, 2012

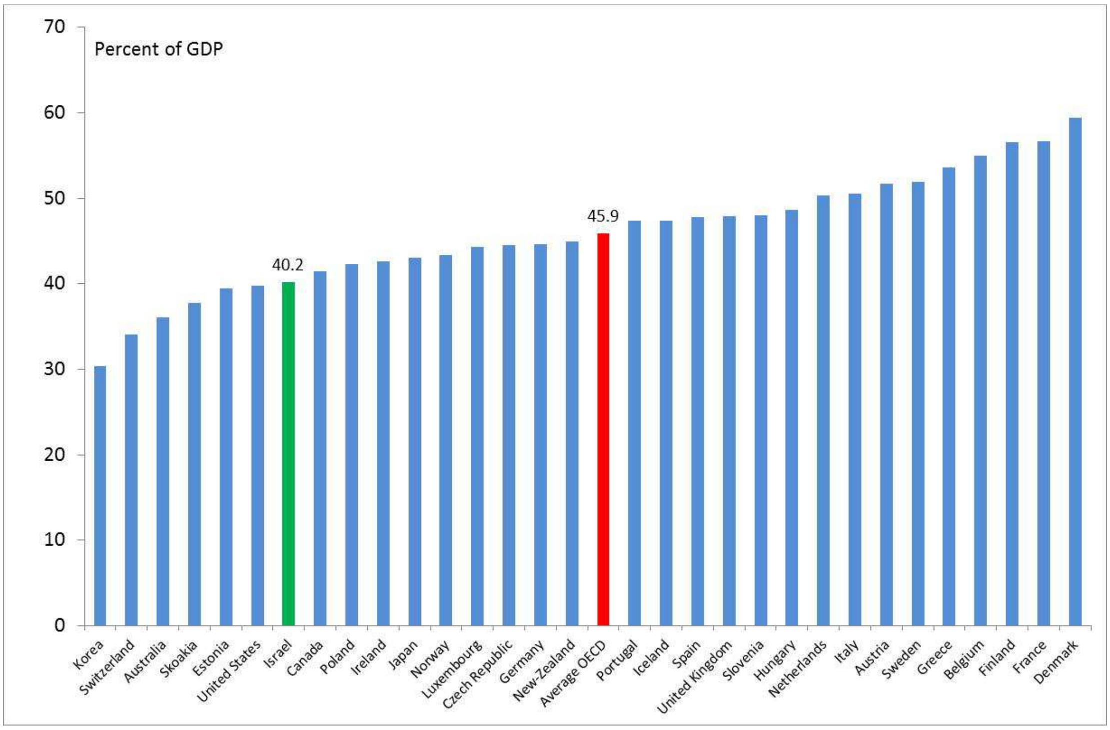


Figure 2
Share of public primary civilian expenditure in GDP—Israel (2012) and other OECD countries (2011)

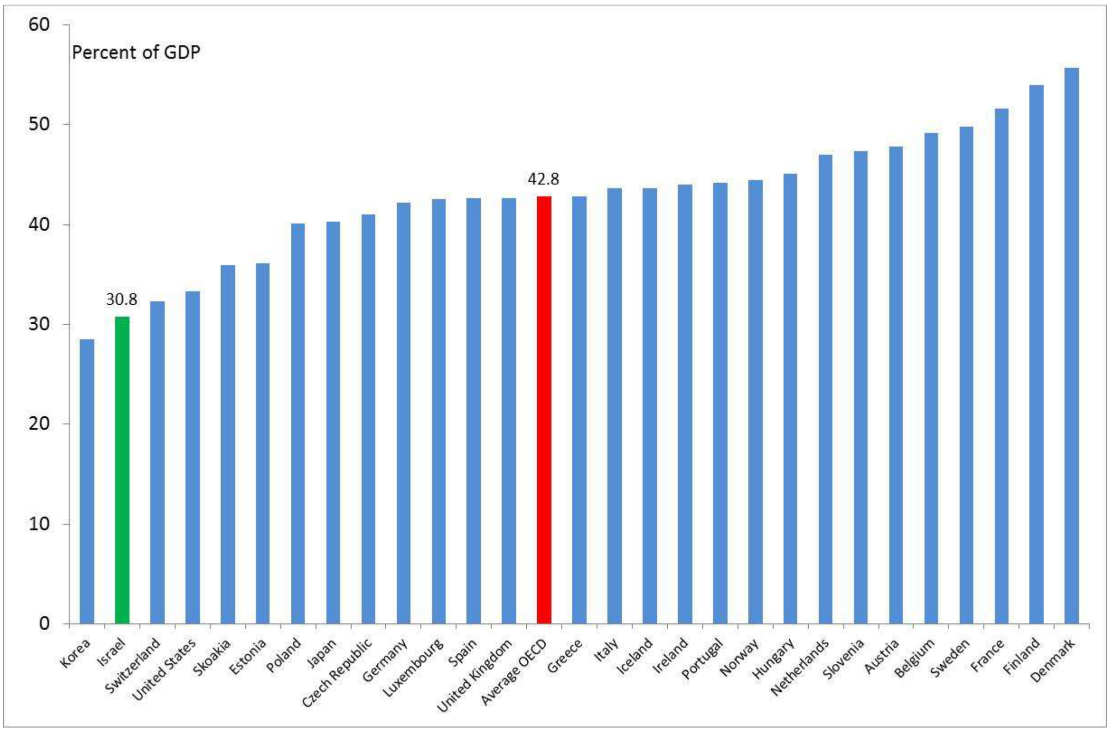


Figure 3

Tax burden—Israel (2012) and other OECD countries (2011)

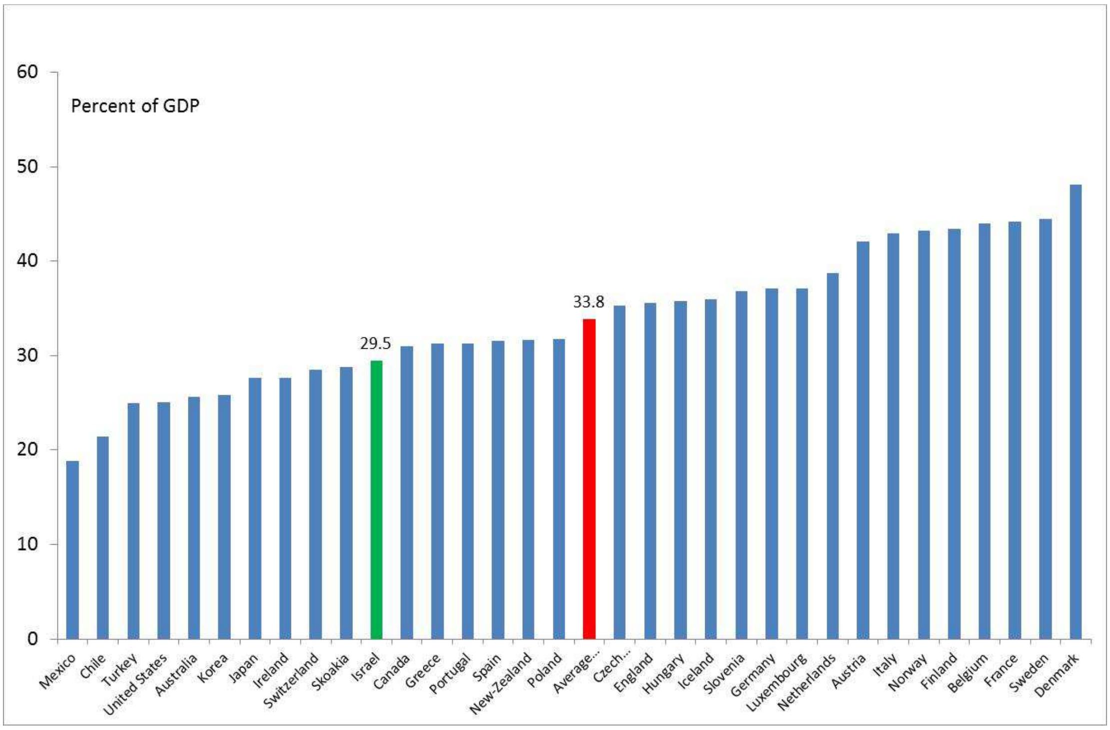


Figure 4

General government deficit—Israel (2012) and other OECD countries (2011) (Percent of GDP)

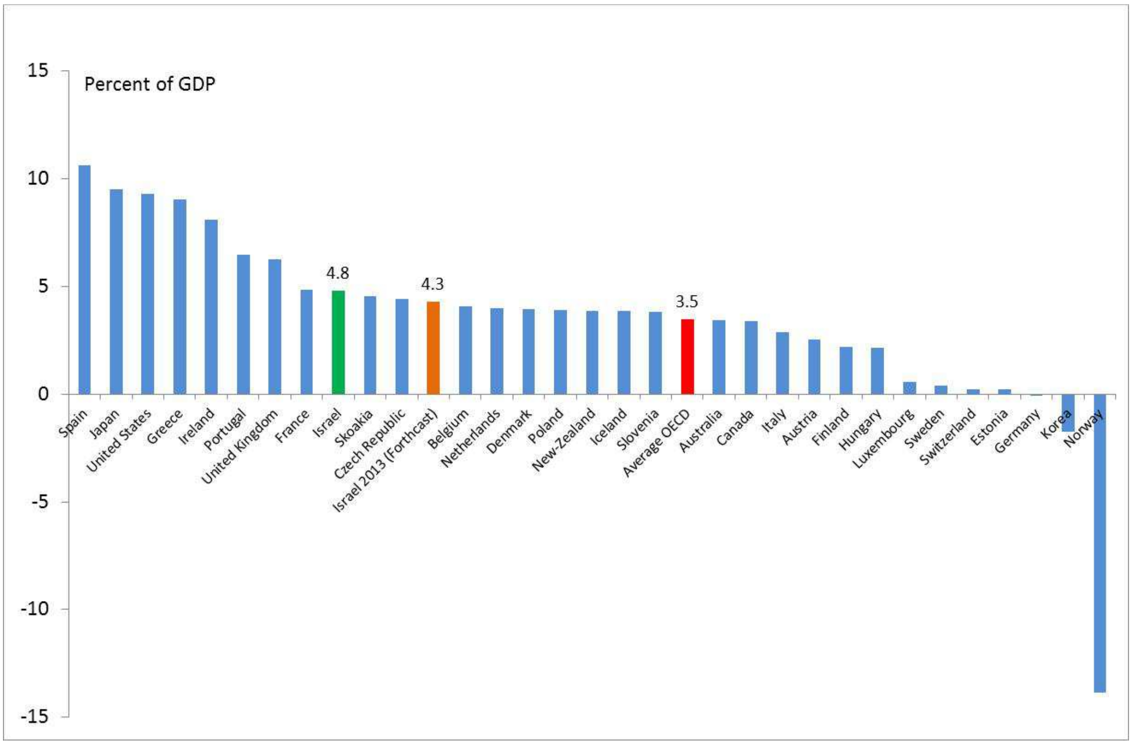
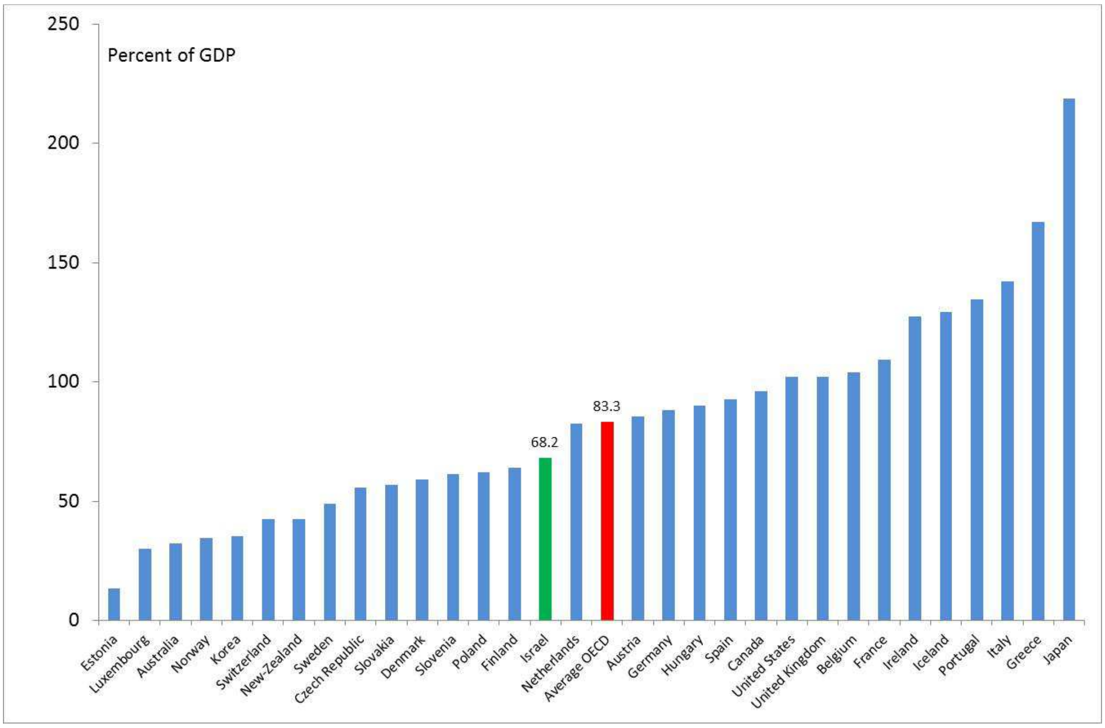


Figure 5
Public debt (gross) to GDP ratio—Israel and other OECD countries, 2012



3. Budget performance in 2013

Based on developments to date, it appears that the budget deficit in 2013 will be smaller than 3.5 percent of GDP, much below the ceiling of 4.65 percent of GDP set when the budget was approved at the end of July. The lower than expected deficit reflects a combination of three developments—expenditures which are lower than the approved expenditure ceiling, exceptionally large one-off tax revenues of around NIS 6 billion, and the change in GDP estimations implemented by the Central Bureau of Statistics which reduced the deficit to GDP ratio by about 0.25 percentage points of GDP (see the discussion in the previous section of this review).

Budget performance data as of the end of October indicate that expenditures were lower by about NIS 9 billion than the seasonal path consistent with full performance of the budget. An analysis of performance data based on budget components, as reported by the Ministry of Finance, indicates that expenditures by government ministries during that period (with the addition of the budget reserves) was within the seasonal path consistent with nearly full performance of their budgets by the end of the year. In contrast, under the "Miscellaneous" section, which was budgeted about NIS 7.5 billion, only NIS 900 million were spent through the end of October, and a cumulative NIS 1.4 billion through the end of November.[4] In addition, interest expenses were about NIS 2 billion lower than

[4] This aggregate includes Section 13, "Miscellaneous expenses", and Section 83, "Other development expenses". In 2012, Section 83 was budgeted a similar amount to this year's amount, and by year-end was fully utilized. In 2012, Section 13 was allotted NIS 3.5 billion, compared with NIS 4.7 billion this year, and by year end only about 17 percent of the budgeted amount was spent.

the path consistent with full performance of the budget. It is too early to tell how budget performance will look at year end, since expenditures each year in December are markedly higher than in the other months of the year, and they vary widely between years. However, it appears that government ministries are essentially fully utilizing the budgeted funds allotted to them, and that the low performance rate reflects sections mainly involving government administrative offices. There is some logic in the non-utilization of these amounts this year, if the deficit and the unusual expenditure levels set in the 2013 budget are taken into account, and particularly in light of the fresh experience with the heavy pressures on the 2012 budget framework, which were even reflected, in the end, in expenditures greater than originally budgeted. With that, to the extent that expenditure levels at the end of the year are in fact lower by the amounts they appear to be, there is some room for future improvement in the precision in budget allocation, in order to ensure that the use will be more efficient. This is particularly in light of the need, which was quite notable this year, to reduce important expenditure plans when the budget was prepared, in order to avoid deviating from the expenditure ceiling.

Government tax revenues through the end of October were about NIS 2 billion higher than the seasonal path consistent with revenue projections in the government budget. This surplus primarily reflects one-off revenues from the sale of a large company. By year end, the gap between actual and projected tax revenues is expected to increase to up to NIS 6 billion, due to tax payments on "trapped profits", which are also one-off occurrences.[5] Excluding these extraordinary revenues, tax receipts to date are about NIS 3 billion greater than the forecasts presented in the budget documents.[6] Other government revenues are approximately in line with those projections.

4. The 2014 budget

Since the 2014 budget was approved, there have not been any macroeconomic developments which are expected to lead to a significant change in tax revenue projections. Tax revenues in 2013 are greater than expected but, as noted, this derives primarily from extraordinary one-time revenues. On the expenditure side, the low performance of some of the sections in the 2013 budget is likely to indicate that there is a possibility of reducing the amounts budgeted for them in 2014, and to reallocate the sources which thus become available to enhance other government activities, including those which were pushed off due to initial assessments that there would be a lack of resources. Alternatively, the total expenditures in the budget can be reduced. Additionally, the expenditure level in 2014 is expected to be low due as well to an additional marked decline in interest payments—which are expected to be about NIS 3 billion lower than budgeted—and due to a restructuring of the transportation infrastructure investment plan. In accordance with these assessments, the Ministry of

[5] Considering one-off tax payments as extraordinary is, to a large extent, a judgment call. Every year the government receives such payments, in respect of large transactions, tax arrangements referring to previous years, and for other items. Thus, considerable care should be taken in labeling them extraordinary. Nonetheless, the revenues noted above are in fact especially large and are extraordinary in their nature. It is important to note that at times, one-off payments even reflect the forwarding of revenues from coming years.

[6] The forecast in the budget included an estimate of NIS 3 billion for revenue from "trapped profits".

Finance decided to request the approval of the government and the Knesset to cancel the plan to increase income tax rates in the beginning of 2014, effectively passing up about NIS 3.7 billion in revenue, and in parallel to lower the expenditure ceiling in the 2014 budget by NIS 3.3 billion. This decrease will also reduce the budgets for coming years, in accordance with the expenditure rule.[7]

The current revenue forecast for 2014, before the cancellation of the increase in income tax rates, is very similar to the revenue forecasts when the budget was approved. Expected tax revenues in 2014, based on the Bank of Israel Research Department's tax model, are projected to be about NIS 3 billion lower than the budget forecast. The Israel Tax Authority hopes to collect part of that amount through various processes to enhance collection.[8] Additionally, based on the current forecast, "other" revenues, mostly loans from the National Insurance Institute, are expected to be about NIS 2 billion higher than forecast in the budget. Thus, cancelling the increase in income tax rates that were to come into effect in the beginning of 2014 means that expected revenues for 2014 are about NIS 5 billion lower than forecast in the budget, or less than that if the Israel Tax Authority efforts to enhance collection are successful.

The revised revenues and expenditure forecast, and the proposed process of cancelling the increase in income tax rates and reducing the expenditure ceiling, bring the expected deficit for 2014 to a level of about 3 percent of GDP, similar to the deficit target set for that year.[9] That is, the government's planned adjustments based on developments since the budget's approval are not expected to increase the deficit to a level greater than the target on which the budget was constructed. Furthermore, it appears that should the revenue path be slightly lower than forecast, the government will be able to reduce the level of actual expenditure somewhat, as well, and thus maintain the appropriate deficit level. The proposed adjustment in the budget thus reflects the government's decision to take advantage of the lower than budgeted actual expenditures in order to reduce taxes, rather than to expand other expenditures or to reduce the deficit more rapidly than planned. This does not preclude achieving the original deficit target for 2014. However, the process is expected to make achieving the targets set for 2015 and onward more difficult, as detailed below.

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[7] The expenditure rule sets the rate of increase of the government budget each year. Therefore, a reduction of the government budget in one year reduces the expenditure levels for all following years accordingly.

[8] Tax revenues so far in 2013, net of extraordinary one-time receipts, are in line with the forecast presented at the time the budget was prepared.

[9] The estimated deficit in shekels, which was presented when budget was approved, was lower than the current estimate by about NIS 2–3 billion. However, since the CBS subsequently increased its estimates of GDP by about 7 percent, the deficit as a percentage of GDP is similar to the original estimate. Legally, there is no significance to a deviation of the actual deficit from the original estimate, since the deficit targets only obligate the government when the budget is being approved, based on the data existing at that time.

5. The expected development of budget aggregates from 2015 and onward

The government budgets for 2015 and onward are subject to 2 targets set in law—the deficit target sets a path of a declining deficit, from 2.5 percent of GDP in 2015 to 1.5 percent of GDP in 2019 (the green line in Figure 6), and the expenditure rule sets the rate of increase in the government's budget each year. The rate of increase is based on the long term growth rate of GDP and the spread between the actual debt to GDP ratio and 60 percent.[10] Meeting the deficit targets will ensure a sustained decline of the debt to GDP ratio to 60 percent by 2020 (the green line in Figure 7) and thus will contribute considerably to the credibility of Israel's fiscal policy and the reduction of the government's interest expenses. With that, the following analysis indicates that meeting these targets will require that the government carry out wide ranging policy measures in the coming years.

Based on existing tax rates, including the cancellation of the plan to raise income tax rates in the beginning of 2014, maintaining the expenditure ceiling at the level to which it is currently proposed to be reduced will not be enough to ensure that the deficit does not deviate from its target. In such a case, a deficit of 3 percent of GDP is expected in 2015, compared with a target of 2.5 percent of GDP. In the following years, the deficit is even expected to increase slightly (the blue line in Figure 6) and to widen the gap between it and the declining deficit targets set in law. This deficit path is expected to lead to Israel's debt to GDP ratio remaining virtually unchanged in coming years, staying at a level of 68 percent (the blue line in Figure 7). Thus, a marked tax increase will be required in order to ensure meeting the deficit targets at the same time as maintaining the expenditure ceiling—about NIS 5 billion in 2015 (taking into account the loss of NIS 3.7 billion in revenues due to the decision to cancel the plan to raise income tax rates in 2014), about an additional NIS 10 billion in 2016, and additional increases of about NIS 4 billion each year in 2017 and 2018.[11]

[10] The expenditure ceiling is calculated as the product of the real average growth rate over the past 10 years and the ratio between 60 percent and the debt to GDP ratio. All the data in the calculation refer to the most recent data available, not to estimates for the year in which the next budget is being discussed.

[11] The calculation includes the expected effect of increased taxes on economic activity as estimated in Y. Mazar (2013), "Fiscal Policy and its Effect on GDP and its Components", Bank of Israel Survey 87, page 31–66 (Hebrew).

Figure 6: The Deficit as a Share of GDP under Various Policy Alternatives, 2012–2020

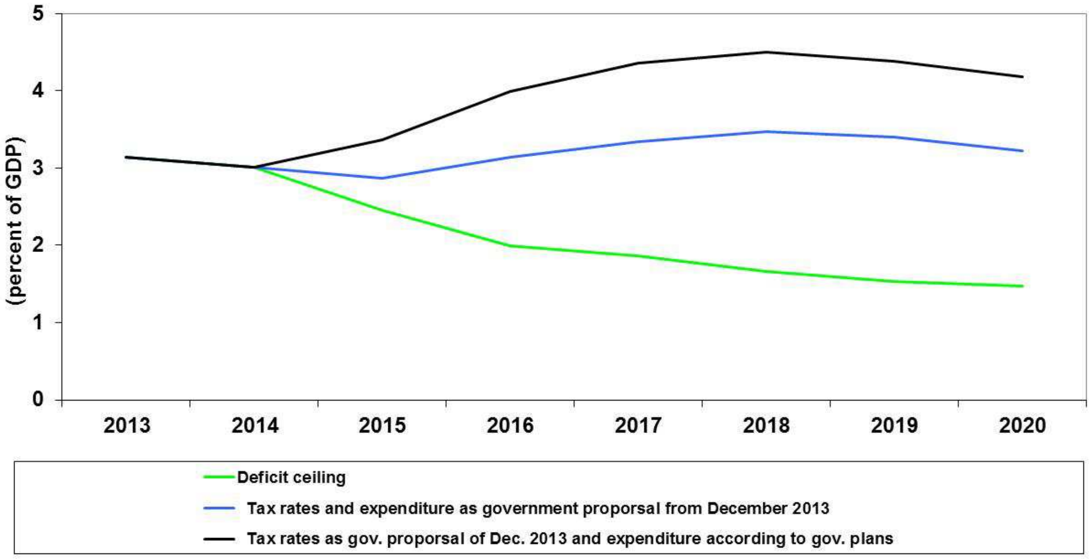
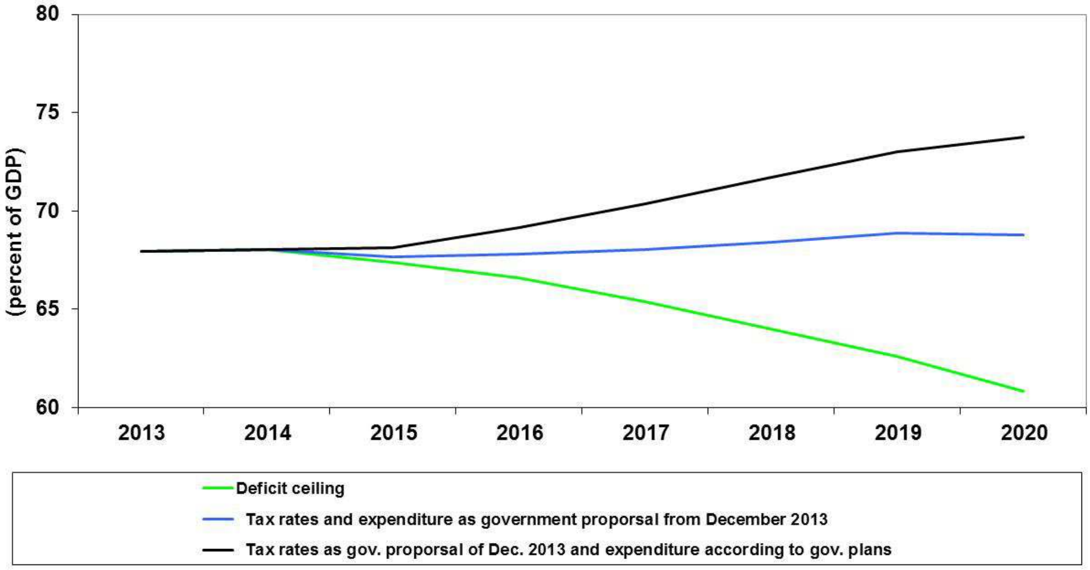


Figure 7: Debt to GDP Ratio under Various Policy Alternatives, 2012–2020



An analysis of the expected level of expenditures in 2015 and following years indicates that despite the decline in interest expenses and the deferral of some of the transportation infrastructure investment programs, estimated government expenditures, based on the cost of the approved plans[12], are about NIS 5.5 billion greater than the (adjusted) expenditure ceiling for that year. This is based on the assumption that from now until the beginning of 2015, the government will not approve additional plans that entail

[12] The increase in government expenditure in accordance with its approved plans assumes that the wage agreements that will be signed in the public sector will approximately maintain employees' real wages. An assessment of the cost of new plans adopted by the government is based in most cases on Ministry of Finance estimations, as they were presented to the government and Knesset.

significant budget costs without reducing other expenses.[13] Before the reduction in the expenditure ceiling, expenditures were expected to be quite close to the ceiling, but the reduction creates a more significant gap that will require the government to decide on the cancellation of some of the planned expenditures in order to avoid deviating from the ceiling. The gap between the government's expected expenditures and the expenditure ceiling widens by about NIS 4 billion in 2016 and by an additional NIS 2 billion in 2017. Should government expenditures increase in line with this path, the deficit is expected to increase gradually to more than 4 percent of GDP (the black line in Figure 6) and the debt to GDP ratio will increase slowly but steadily (the black line in Figure 7). Nevertheless, despite being the path which is furthest from the government's targets, it is in fact that path which indicates how much the government's economic plan of July 2013 improved fiscal control. The path which was set out before the program was approved, based on similar characteristics, indicated that the debt to GDP ratio was liable to increase to more than 90 percent by the end of the decade.

If the government increases its expenditures in accordance with the path derived from the programs it approved, the share of public primary civilian expenditure in GDP is expected to rise gradually until 2017, and to stabilize at around 32.5 percent of GDP (the black line in Figure 8).[14] In contrast, if the government limits its expenditure in order not to deviate from the expenditure ceiling, this share will stabilize at its expected level for 2014, around 31.5 percent of GDP (the blue line in Figure 8). However, as noted, maintaining the expenditure ceiling is not enough to maintain the targeted deficit. Should the government choose to meet the deficit target through increased taxes, it will even be able to slightly increase primary civilian expenditure, since the low deficit will reduce interest expenses.[15] In contrast, if the deficit target is attained solely through reducing the expenditure ceiling, the ratio of primary civilian expenditure to GDP will decline by almost 2 percent of GDP compared with 2014 (the purple line in Figure 8).[16] The result of such a process would be that real primary civilian expenditure per capita will remain at its current level until 2017, despite the sustained increase in GDP.

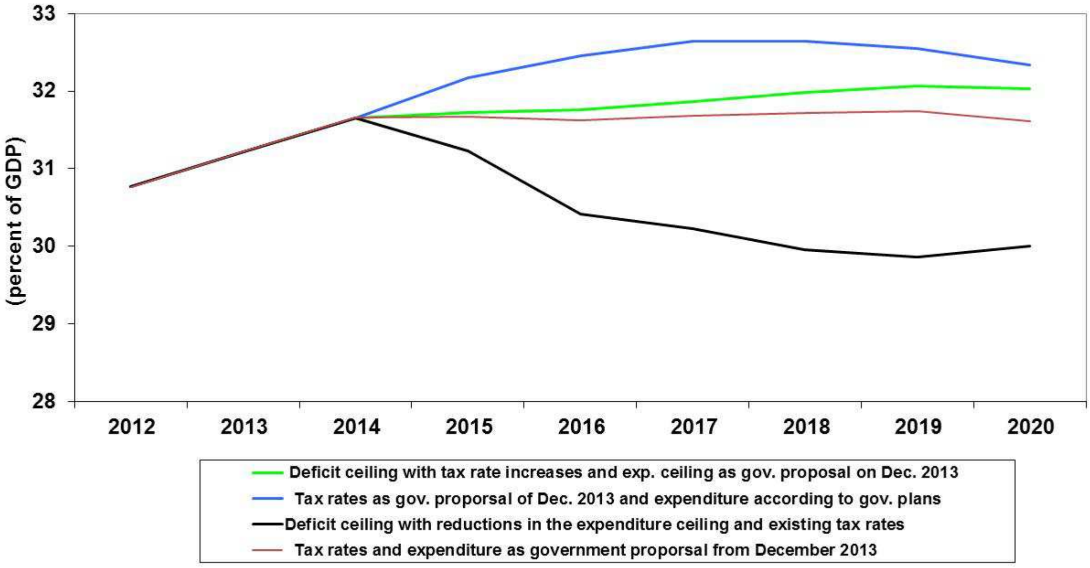
[13] For example, last week a new plan to extend the school year was presented, with an expected budget cost in 2015 of NIS 350 million, without presenting a parallel reduction in the budget.

[14] The calculation of primary civilian expenditure is sensitive to the expected development of defense and interest expenses. The analyses here assume that defense expenditure will increase in line with the multiyear outline adopted by the government. The results are less sensitive to assumptions regarding the development of the path of the interest rate and the adoption of assumptions according to which an increase in interest rates which is markedly slower than assumed under the baseline scenario increases civilian expenditure excluding interest payments at the end of the decade by only 0.3 percent of GDP.

[15] The analysis reflects both the decline in interest payments due to the lower debt itself, as well as the potential effect of a decline in the debt to GDP ratio on the interest rates paid by the government. This is based on an estimated parameter according to which every 1-percentage points decline in the debt to GDP ratio reduces the real interest rate on 10-year government bonds by 0.05 percentage points.

[16] The calculation includes the expected effect of reducing the increase in government expenditures on economic activity, per Mazar above (footnote 11).

Figure 8: Share of Primary Civilian Expenditure in GDP under Various Policy Alternatives, 2012–2020



In the scenarios above, we assumed that the average real growth rate of GDP in the remainder of the decade will be slightly greater than 3 percent per year. Clearly, to the extent that the growth rate will be greater than that, the adjustment required of the government will be smaller, and vice versa. With that, even if the average growth rate of the economy in the coming years will surprise and be 4 percent per year, the government will still need to carry out adjustments in order to converge to the deficit targets (the black line in Figure 9). Alternatively, if the average growth rate will be 2 percent, the deficit is forecast to increase to 5 percent of GDP (the red line in Figure 9) and the debt to GDP ratio will reach nearly 80 percent.

Figure 9: The Deficit as a Share of GDP Under Various Growth-rate Scenarios, 2012–2020

Tax rates and expenditures under each scenario are based on the government's proposal of December 2013