Fiscal Survey: The fiscal situation for 2016, and trends expected over the remainder of the decade

- **The government budget deficit declined to 2.15 percent of GDP (NIS 24.5 billion) in 2015, from 2.8 percent of GDP in 2014. The debt to GDP ratio declined to 64.9 percent at the end of 2015, from 66.7 percent at the end of 2014. The decline strengthens Israel's position in the capital markets and reduces the Israeli economy's risk premium.**
- **Tax revenues, adjusted for an increased provision of NIS 1.5 billion to the Property Tax Fund, were NIS 6 billion greater than forecast at the beginning of the year. This was primarily due to a more rapid than expected increase in wages, and due to the sharp increase in real estate activity.**
- **The decline in the ratio of public debt to GDP is mostly explained by an increase in the GDP deflator alongside a decline in the Consumer Price Index, to which about half the public debt is indexed. Also contributing to the decline in the debt to GDP ratio were debt repayments by the public to the government, and receipts from land sales.**
- **The government increased the deficit ceiling for the 2016 budget from 2 percent of GDP to 2.9 percent of GDP as a result of structural steps—an increase in the expenditure ceiling as well as tax reductions. This deficit level is not consistent with a prolonged reduction of the debt to GDP ratio. Based on current economic forecasts, and assuming that government expenditures will be in line with the ceiling, the government is expected to meet the target.**
- **The Ministries of Finance and Defense agreed on a new multiyear framework for the defense budget. Its implementation will contribute to stabilization in the process of building and managing the State budget, and to increased efficiency in the administration of the defense establishment. It is important for the government to approve a multiyear work plan for the ministry of defense that will be in line with the agreed upon budget framework.**
- **The government's expected expenditures in 2017—based on approved plans—are about NIS 14 billion higher than the expenditure ceiling for that year, assuming that the increase in the defense budget, in accordance with the framework, is financed in 2016 by a permanent reduction in civilian budgets.**
- **Based on an amendment to the law, which was approved at the end of 2015 (the "numerator"), the government must adjust—when the 2017 budget is approved—its forecast expenditures' deviation in 2018–19 from the expenditure ceiling set by the fiscal rule.**

- **At the end of December, public-sector wage agreements were signed, which include a moderate increase in public sector wages in 2016 and 2017, and which do not threaten the budget targets, even from a multiyear perspective.**
- **In the past year, the government expanded the use of budgetary recording methods which weaken the link between its activities and how they are presented in the budget, particularly in the area of housing. When expenditures in the housing sector are presented in a manner that is in line with common accounting standards, the expected deficit for 2016 increases to 3.3 percent of GDP.**

1. 2015 budget performance

Based on preliminary estimates published by the Ministry of Finance, the budget deficit for 2015 was 2.15 percent of GDP. This is a decline of 0.6 percent of GDP compared with the 2014 deficit, and is a continuation of the successful fiscal adjustment carried out by the government when approving the budget for 2013 and 2014. The deficit (measured in cumulative terms over the preceding 12 months) declined from over 4 percent of GDP in the middle of 2013 to about 2.5 percent of GDP in the middle of 2014, and stabilized at that level until the middle of 2015. It then declined sharply to about 2 percent of GDP beginning in July 2015 (Figure 1), due to particularly high revenues in July and August, and it stabilized at that level. From a full year perspective, the decline in the deficit reflects mostly an increase in the share of government revenues in GDP, as well as a moderate decline in the share of expenditure (Table 1).[1] The increase in the ratio of non-tax revenues to GDP derived mostly from an increase in National Insurance Institute surpluses (which are recorded as revenue in the budget), due both to a more moderate than expected increase in payment of allowances and to an increase in collection of National Insurance fees—partly due to the increase in employers' contribution rates.[2] In addition, the share of tax revenues in GDP increased by 0.1 percent of GDP.[3] The debt to GDP ratio declined from 66.7 percent at the end of 2014 to 64.9 percent at the end of 2015, largely due the decline in the ratio of the Consumer Price Index (CPI), to which half the debt is indexed, to the GDP deflator. The government chose to increase the deficit ceiling in 2016 to 2.9 percent of GDP, and to increase the path of the deficit over

---

[1] The discussion on 2015 budget performance refers to the net budget—that is, the budget net of expenditures contingent on income and net of the income earmarked for specific expenses. The deducted sections impact equally on the amount of expenses and revenues excluding taxes, and therefore do not impact on the deficit or on tax revenue data.
[2] Based on the forecast appearing in the budget foundations book for 2015–2016 (page 156 in Hebrew), total allowance payments, excluding military reserves compensation payments and including operational expenses, was to total NIS 75.1 billion. The actual payment was NIS 72.5 billion.
[3] In December, the government moved forward a provision to the Purchase Tax Fund totaling NIS 1.5 billion. An adjustment in respect of this provision will bring the increase in tax revenues to NIS 0.3 percent of GDP and will reduce the deficit to 2 percent of GDP.

coming years rather than perpetuating the achievements in budget performance in 2015. Furthermore, the government approved plans for the next several years that deviate markedly from the new—and higher—expenditure ceiling that the Knesset approved in November.

Figure 1
Cumulative deficit over the preceding 12 months, January 2011–December 2015

Table 1
Components of change in deficit, 2014 vs. 2015
(percent of GDP)

	2014	2015	Difference
Total revenue (excluding credit)	**25.9**	**26.3**	**0.4**
Grants from abroad	0.8	0.9	0.1
Taxes	23.4	23.5	0.1
Other revenue	1.7	1.9	0.2
Total expenditure (excluding cred	**28.7**	**28.5**	**-0.2**
Deficit excluding credit (-)	**-2.8**	**-2.2**	**0.6**

Source: Based on data from Accountant General and Central Bureau of Statistics.

Tax revenues (including VAT on defense imports) increased in 2015 by 5.9 percent[4], compared with an increase of 4.8 percent in nominal GDP, and revenues were about NIS 6 billion greater than expected in the beginning of the year.[5] An examination of the factors behind revenues increasing more than forecast, using the Research Department's tax model[6], indicates that most of the increase derives from the relatively rapid increase of wages in the economy, after several years in which they increased by a moderate rate (Figure 2). The sharp increase in real estate transactions—influenced by the cancellation of the zero-VAT on homes plan—also contributed to increased revenues. An additional contribution came from the more rapid than expected increase in nominal GDP, which reflected a rapid increase in the GDP deflator alongside real growth that was slightly lower than expected.[7] Actual revenues were very similar to the estimate calculated by the model on the basis of known (retroactively) macroeconomic data; when calculated with a lagged effect of tax rate increases in 2013, they were even slightly lower than forecast.[8]

Government expenditures increased in 2015 by 3.8 percent (a real increase of 4.6 percent). This is a rapid rate, which was made possible by the increase in the expenditure ceiling in the 2015 budget. Although the government operated until November 19th under an interim budget, which limits its ability to carry out some of its activities, and although the increase in the expenditure ceiling as noted only came into effect in November, the percentage of the original budget spent was 99 percent, similar to previous years. However, there was some variation in the budget execution rate: civilian ministries utilized 97 percent of their budget, and defense expenditures reached 105 percent of the original budget (after required adjustments to the budget presentation). The real increase in defense expenditures relative to performance in the 2014 budget was notable, about 8 percent, despite the defense budget receiving a one-off supplement in 2014, due to expenditures deriving from Operation Protective Edge.

---

[4] Net of the surplus allocation totaling NIS 1.5 billion to the Purchase Tax Fund.

[5] Based on the forecast used when writing the Fiscal Survey that appeared in Recent Economic Developments 138, April–September 2014 (Bank of Israel, 2015).

[6] Brender, A. and G. Navon, "Predicting Government Tax Revenue and Analyzing Forecast Uncertainty", *Israel Economic Review* 7(2), 2010, pp. 81-111.

[7] According to the model, the impact of an increase in the GDP deflator relative to the CPI, as occurred in 2015, is equal to an increase in real GDP. This apparently reflects the effect of a decline in import prices, which contributes to an increase in the GDP deflator and to a decline in the CPI, on disposable income and on profitability of companies in the economy.

[8] A discussion on the dispersal of the effect over several years appears in Brender, A. and E. Politzer, "The Effect of Legislated Tax Changes on Tax Revenues in Israel", Bank of Israel Discussion Paper 2014.08 (Bank of Israel, December 2014).

Table 2
Variables explaining the increase in tax revenues compared with forecast at the beginning of 2015

	2015 Forecast	2015 Estimate	Effect on the gap between forecast and actual tax revenues
	(Percent)		(NIS billion)
Total increase in tax revenues[a]	**3.5**	**5.9**	**6.0**
Nominal GDP growth rate	4.5	4.8	1.1
Increase in wages beyond that related to GDP[b]	0.0	1.5	4.6
Increase in sales of new homes	12.5	29.7	1.3
Additional variables in the model[c]	...	...	-0.7
Legislative changes (in percent of tax revenues)[d]	-0.4	-0.8	-1.0
"Adjusted" revenue forecast	...	...	**5.3**
Effect of legislative changes from previous years[e]	...	*0.6*	*1.5*

[a] Total government revenues from taxes, including VAT on defense imports. The figure for 2015 includes the atypical amount of the provision to the Purchase Tax Fund.
[b] Real increase in wage per employee post, beyond the increase that derives from the multiyear correlation between wages and
[c] Consumer goods imports, change in equity prices in Israel, bank credit denominated in and indexed to foreign curency, and Bank of Israel interest.
[d] Reduction of VAT rate to 17 percent in the final quarter of 2015; additional legislative and timing changes made in 2014 and 2015 were included in the original forecast.
[e] In percent of total revenues. Based on Brender and Politzer (see above).

The ratio of public debt to GDP declined from 66.7 percent at the end of 2014 to 64.9 percent at the end of 2015. This decline contributes to the strengthening of Israel's position in capital markets and to a reduction in the risk premium and the debt-repayment burden on the government and the Israeli economy.[9] This is particularly because the Public Debt Management Unit at the Ministry of Finance acted in parallel to lengthen the term to maturity of the debt issued and thus reduced its risk profile even further. The decline this year reflects in large part a contribution of 1.1 percentage points from the increase in the GDP deflator relative to the CPI (Table 3), an increase which eroded the CPI-indexed debt (about half the government debt) relative to the nominal CPI. Since over time, the GDP deflator and the CPI increase by a similar rate[10], this is a transitory effect, which cannot be used as a basis for the continued reduction in the debt to GDP ratio by a similar rate in coming years, though in 2016, it is still expected to contribute somewhat to its reduction. Also contributing to the decline in the debt were debt repayments by the public to the government (primarily mortgages to eligible borrowers, which had been granted in the past), and land sales totaling jointly approximately NIS 9.4

[9] An examination of the effect of the debt to GDP ratio on the cost of government debt appears in Brender, A. and Sigal R., "The Effect of Fiscal and Monetary Policies and the Global Economy on Real Yields of Israel Government Bonds", Bank of Israel Discussion Paper 2015.02 (Bank of Israel, January 2015).
[10] Since 2001, the year in which the permanent inflation target range of 1–3 percent was set, through the end of 2015, both the CPI and the GDP deflator increased by an annual rate of 1.9 percent. In 2015, the CPI declined by 1 percent during the year, the GDP deflator increased by 2.4 percent.

billion. The repayment of loans reduces the debt, but also the government's financial assets, and therefore does not reduce the net debt. The contribution of this factor is also expected to decline as the stock of mortgages gradually declines, as in recent years virtually no new mortgages have been granted through the government's eligibility program.[11] In terms of receipts from land sales, their amount clearly depends on the scope of transactions, but also on the manner of recording the costs of government programs in the area of real estate. (See discussion below.)

Table 3
Factors affecting the change in public debt to GDP ratio, 2014 (end of year) vs. 2015 (end of year)
(percent of GDP)

Debt to GDP ratio on December 31, 2014	**66.7**
Effect of deficit and real growth on GDP	0.5
Privatization revenues and public's debt repayment to government	-0.8
a. Effect of change in GDP deflator on unindexed debt and foreign-currency debt	*-0.7*
b. Effect of change in GDP deflator and CPI on CPI-indexed debt	*-1.1*
Total effect of GDP deflator and CPI (a+b)	-1.8
Increase in non-central-government public debt, excess debt raising, changes in currency rates, and change in accrued interest	0.3
Total change in debt to GDP ratio in 2015	**-1.8**
Debt to GDP ratio on December 31, 2015	**64.9**

2. The 2016 budget

The government decided to increase the deficit ceiling in 2016 from 2 percent of GDP to 2.9 percent of GDP, by markedly increasing the expenditure ceiling and reducing tax rates. The increase in the expenditure ceiling reflected the government's difficulty in achieving its social, defense, and economic targets within the framework of the existing expenditure ceiling, which dictates a continued decline in the share of public expenditure in GDP, even though the share of civilian expenditure in Israel is already very low compared with other advanced economies. This difficulty has been reflected continuously in recent years in the accumulation of expenditure programs whose total cost is higher than the expenditure ceiling, and with repeated adjustments of the budget targets alongside postponements, cancellations, and reductions of government plans shortly after they had been approved.[12] At the same time, the government decided to reduce tax rates,

[11] In 2016, the amount of net repayments is already expected to decline to NIS 3.8 billion.
[12] An expanded discussion appears in Chapter 6 of the Bank of Israel Annual Reports for 2013 and 2014.

and thus increase the structural deficit even more. Furthermore, the budget includes accounting treatments that reduce the reported deficit by accounting shifts of revenue and expenditure items between years, and presenting part of its activities in the housing sector in a manner that is not in line with generally accepted accounting practices.

The fiscal rule adopted by the government at the end of 2013 establishes that government expenditures are to increase in real terms in accordance with the population growth rate over the past three years (1.9 percent for the years 2012–14, the determining years for 2015 and 2016), plus the quotient that results from dividing 50 (the long term goal for the debt to GDP ratio) by the debt to GDP ratio in the most recent year for which it is known (67 percent at the end of 2014). Based on this calculation, the real increase permitted for the 2015 budget is 2.66 percent, which means an addition of NIS 8.4 billion.[13] The calculation of the expenditure ceiling for 2016 based on the rule is similar, as that year's budget was ratified together with the 2015 budget and the calculation is based on the same data. The only difference between the calculations is that the increase in 2016 is based on the 2015 budget rather than the 2014 budget, so the expenditure rule increased the 2016 budget by NIS 8.7 billion (Table 4).

[13] This calculation is based on the government's interpretation of the Budget Law. According to this interpretation, the reduction in expenses by NIS 3.75 billion in the beginning of 2014, in parallel with the reduction of taxes at the same time, cancels out the need to reduce the budget (by about NIS 6 billion) in respect of the fact that the increase in prices was lower than that used to construct the budget for 2013–2014 (See section 2, page 10, in the proposed government budget for 2015, which was submitted to the government on October 7, 2014).

Table 4
Calculation of expenditure ceiling for 2016

			(NIS billion)
1	Expenditure ceiling in 2014 budget (net, including credit)	319.3	
2	Reduction of base, in line with government decisions[a]	3.8	
3	Base for calculating expenditure ceiling for 2015 (1–2)		315.5
			(Percent)
4	a. Real rate of growth of expenditure, according to the rule		2.66
	b. Increase of budget base		2.00
			(NIS billion)
5	Addition to 2015 budget [(4a+4b)*3]		14.7
6	Addition in respect of inflation expected for 2015		-0.7
7	Nominal expenditure, per expenditure rule (3+5+6)		329.5
8	Addition to 2016 budget [4a*7], per expenditure rule		8.7
9	One-off addition of 0.25 percent to 2016 budget		0.8
10	Adjustment of budget ceiling to increase in government participation in National Insurance Institute budget		3.85
11	Addition in respect of expected inflation in 2016		4.8
12	Nominal expenditure in 2016, per expenditure rule (7+8+9+10+11)		347.7

[a] In December 2013, the government decided to reduce the expenditure ceiling in parallel with reducing income tax and National Insurance Institute fees.

[b] The adjustment in the budget is based on the assumption that the average of the Consumer Price Index in 2015 declined by 0.2 percent compared with the CPI for 2014. The actual decline was 0.6 percent. Based on the actual figure, a further reduction of NIS 1.5 billion was required.

c Based on the forecast that the CPI in 2016 will increase by 1.5 percent compared with the CPI average for 2015. Based on the Bank of Israel forecast from December 2015, the CPI is expected to decline by 0.1 percent. Based on this forecast, an additional reduction of about NIS 5 billion is required.

Source: Based on budget data.

As the cost of carrying out expenditure plans that were added to the budget, including the steps decided on by the new government, deviates from the permitted increase in expenditure based on the fiscal rule, the government, in the 2015 budget, increased the *base* for the expenditure ceiling by 2 percent (NIS 6.4 billion) and added another 0.25 percent on a one-off basis to the 2016 budget. Beyond that, the government used price coefficients that were much higher than the current prevailing inflation forecasts in preparing the 2015 and 2016 budgets (which were approved, as noted, on November 19, 2015). This increased the 2016 budget base by a further NIS 6.5 billion. Based on the budget rule, the government will need to subtract from the increase in the expenditure ceiling for 2017 the addition that derives from the spread between the inflation forecasts in the 2015 and 2016 budgets and the actual increase in prices. Despite the marked increase in the expenditure ceiling, the supplement to the defense budget, which was agreed upon within the framework of the outline being compiled between the Finance and Defense Ministers, was not reflected in the budget. When that will be approved, the government will need to shift over to the defense budget about NIS 4–5 billion from other sections.[14] In light of the budget performance rates by civilian ministries in recent years, and the large additions planned for their budgets, it is reasonable to assume that this shift will be possible without markedly impacting their activity in 2016. With that, the notable gap that will be created as a result, between the composition of the budget that was approved and the budget that will be executed, adversely impacts on the public and parliamentary discussion on the government's priorities, especially as the amount that will be redirected to the defense budget supplement was budgeted as part of specific civilian line items. Other than the defense budget supplement, the budget framework that was approved does not include the costs of some government programs in the housing area (see Section 3 below), and when these are added to the budget data, it may become difficult to meet the expenditure ceiling without negatively impacting other activities. The budget also does not reflect the cost of the addition to child allowances to be paid into savings accounts for children in respect of 2016. This cost totals around NIS 1.7 billion, and the government decided that the payment will be spread out evenly over the years 2017–19.[15]

The use of the higher price-forecast than the inflation forecast in constructing the budget, enables the government to increase the expenditure ceiling when preparing the budget for a given year, at the expense of a required reduction in planned expenditure for the following year, and thus to temporarily get around the expenditure rule. Such use becomes more attractive when the government operates on the basis of two-year budgets, when a government's term becomes shorter, and when a government chooses not to retroactively correct gaps between the price forecasts and actual inflation, as was done in the 2015 budget with regard to the gap in 2014. A solution to the lack of consistency in calculating the real increase in the budget, the calculation method set currently by the

---

[14] This amount is an estimate by the Bank of Israel of the budgetary cost of the agreement, and includes both the direct supplement to the defense budget as well as the cost of activities that were shifted from the defense budget to other budget sections but will be executed, such as protection of gas wells, IMI agreements, and constructing the eastern border fence. It is possible that some of the amount was already transferred to the Ministry of Defense as an advance at the end of 2015.

[15] An additional cost of about NIS 1 billion, in respect of the 2015 supplement, was spread out in the same manner.

expenditure rule, is to switch to nominal budgeting, based on the midpoint of the inflation target range.[16] Furthermore, since there is an only tenuous link between public expenditure and consumer prices, the adjustments that the current process necessitates are pro-cyclical—when there is a slowdown in the economy, and the inflation rate is low, a budget reduction relative to the original outline is needed, and when activity accelerates, an expansion is possible. In contrast, budgeting on the basis of the midpoint of the target is a-cyclical—that is, it does not strengthen macroeconomic shocks. Such a process will also bolster the transparency in budgeting: currently, there is marked uncertainty in the budgeting, in terms of the budget size, until the presentation of the calculation of the price adjustments in respect of previous years and the price forecast for the coming year.[17]

An additional process, which increased the expenditure ceiling in 2016 by NIS 3.85 billion, is the change in the manner of the government's participation in the National Insurance Institute budget. Although the change does not impact on the size of the deficit, as surplus revenues of the National Insurance Institute are recorded as revenue on the government's budget[18], it contributes to a clearer presentation of government expenditures. In the coming years, the change will also impact on government policy, as the increase in transfers to the National Insurance Institute from their current level will be recorded against the expenditure ceiling. The process has three components:

1. Payments for medical expenses in the work-injury division and hospitalization grants for women giving birth, which have been paid until now by the National Insurance Institute, will be paid, beginning in 2016, directly from the state budget (and therefore will reduce National Insurance Institute expenditures, and increase its surpluses).
2. The government will increase each year the payment that it transfers to the National Insurance Institute as participation in senior citizen and nursing-care allowances in accordance with the growth of the relevant population, and not in accordance with the increase in collection, which is lower. This means that in the coming years, government expenditure for this objective will increase by more than dictated by the previous rule, and the government will need to adjust its other expenditures in order not to deviate from the expenditure ceiling. This is an important change that incorporates a significant component of the effects of the aging of the population into the budgeting process.

[16] A broader discussion appears in Section A of the 2013 Bank of Israel Annual Report (2014) and in the fiscal survey that appeared in Recent Economic Developments 139, October 2014–March 2015 (Bank of Israel, 2015).
[17] These usually are not presented in government discussions to approve the budget, but are calculated later by the Ministry of Finance and are included in the budget proposal submitted to the Knesset.
[18] A description of the system of accounting between the government and the National Insurance Institute appears in Box C.3 of the 2002 Bank of Israel Annual Report (2003). The system has not changed markedly since then.

3. Combining all government participations in revenues of all National Insurance Institute branches into one amount. As a result, if there will be a deficit in one branch, the National Insurance Institute will cover it from sources of the other branches. The process is more lenient for the government, which will not have to deal with deficits in a specific branch as long as there are surpluses in others, although in actuality, the government nonetheless acted in that way in many cases in the past.

Assuming that government expenditures in 2016 will be in line with the ceiling that was set, the expected deficit is in line with the new target—2.9 percent of GDP. If the costs of government programs in the real estate sector, which are not included in the budget, would be recorded in accordance with common accounting principles, the deficit would reach 3.3 percent of GDP. Revenues from taxes are expected to increase this year by more than 2 percent, despite the reduction in value added tax (VAT) and corporate tax rates, which will reduce revenues by more than NIS 5 billion compared with 2015. The very rapid increase in revenues derives primarily from expectations of continued increase in wages, against the background of trends in the labor market, public sector wage agreements and the Minimum Wage Law, as well as from a forecast increase of the GDP deflator due to the decline in global commodity prices. In addition, the advanced allowance to the Property Tax Fund in 2015 will increase the recording of revenues in 2016 by NIS 1.5 billion.

A central component of government expenditures, which impacts on the ability to act within the framework of the fiscal targets, is the defense budget. Recently, the Ministries of Finance and Defense reached an agreement on a multiyear framework that sets the size of the defense budget until 2020, and includes a range of steps in the areas of wages, pensions, rehabilitation and transparency, which are intended to ensure that the budget in fact converges to within the agreed upon framework. In parallel, a multiyear work plan was prepared by the Israel Defense Forces (IDF) for the same period, which is in line with the agreed-upon budget framework. There is great importance to the framework, as it markedly improves the ability to plan the state budgets in coming years and enables the defense establishment to increase its efficiency by utilizing the advantages of budget stability and a planning horizon. With that, the test of the framework that was approved will be in its implementation, as sections of it (particularly related to pensions) have not yet been fully analyzed, and the experience with the previous multiyear framework for defense expenditures, which was based on the recommendations of the Brodet Committee, is that its advantages were not fully utilized due to disagreement on particulars of implementation.[19] In order to prevent the obstacles that adversely impacted the realization of the previous framework, it is important that the government adopt a

[19] A detailed discussion on budgeting defense expenditures appears in Brender, A. (2012), "On transparency and simplicity: Setting the size of the defense budget since the adoption of the Brodet Committee's recommendations", Economy and Society, Volume 8, Van Leer Institute.

clear plan that presents the IDF with a balance of risks and strategic targets that are in line with the budget framework.

At the end of December, the government and Histadrut (National Federation of Labor in Israel) agreed on a framework for public sector wage agreements through the end of 2018. Based on these agreements, the wage increases that will be paid in 2016 and 2017 are moderate and are not expected to weigh on meeting fiscal targets. The increases derived from the agreements for 2018 and 2019 are greater, but nonetheless are not out of line.[20] With that, the framework agreements in the public sector are not the end of the story in the process of determining wages, and over the course of the years individual agreements, in specific areas of the public sector, are added to it (such as wage agreements for teachers, physicians and nurses in recent years). The costs of those agreements could be significant.

3. Presenting the government's plans in the housing area in the state budget

One of the main targets that the government set for itself in recent years is reducing home prices. In order to promote this target, the government is working to vacate IDF bases from areas in high demand in order to make land available for construction. This plan has a notable cost, which is required to finance the construction of new bases, for the cost of relocating the various units, and developing the civilian infrastructures in areas where the bases are being set up. This is besides the cost of preparing the vacated land for residential purposes. In addition to this plan, the government is working to remove obstacles to promoting construction of residential neighborhoods through the budgeting and execution of development plans for local authorities in which the new neighborhoods will be located. These budgets are allocated after individual negotiations with the municipalities, with the goal of upgrading their infrastructure and developing public services for the existing and future populations. The budgets are necessary for, among other things, gaining the support of the local authorities, who can significantly delay the progress of construction plans in their area. These agreements are termed "umbrella agreements" and are intended to contribute to the welfare of the residents in localities where large projects are promoted.

The expenditure on the plans in the real estate area is required in order to attain the goals set by the government, and it is important to present it in the state budget in a clear and complete manner so that the budget properly reflects the priorities in government activity

[20] The wage additions will be paid until the end of 2018, but since part of them will only be paid toward the end of the year, they will impact on the increase in the average wage between 2018 and 2019. A description of the additional factors impacting on the path of wages in the public sector appears in Mazar, Y. (2014), "The development of wages in the public sector and their connection with wages in the private sector", Bank of Israel Survey 88, pp. 97–134 (in Hebrew).

and the plan's cost to the public. However, the cost of these plans, based on, for example, the presentation of the 2016 budget, is reflected only partially in the budget. This incomplete presentation reflects two accounting treatment processes: 1. Presenting Israel Land Authority (ILA) receipts from sales of state land that are transferred to the government as revenue in the budget, instead of as a financing item[21]; 2. Financing the cost of umbrella agreements through the ILA budget, including expenditure items that are not required for physical development of the land intended for construction but for the improved welfare of residents in the local authority where the project is located. As a result, these activities—which are public expenditure, as they replace activities that the public sector is supposed to execute—are not recorded in the budget, and the ILA (defined as an extra-budgetary business entity) pays directly for them with the receipts from the sale of government lands, and at the same time reduces the transfer of sales receipts to the government (recorded as a financing item of privatization revenues in the budget).[22] As a result of this accounting, the deficit presented in the 2016 budget is about NIS 3.5 billion smaller than the deficit according to accepted accounting treatment, as it does not take into account the expected costs of the "Shoham 3" ("Marketing and Moving Bases") program and the transfer of bases to the Negev region in the south. This, even though the Accountant General's division in the Ministry of Finance already determined that these expenditures should be recorded as regular expenses in the budget, and even recorded them that way in the performance estimates of the 2015 budget.[23] Likewise, the budget does not include the planned cost of the umbrella agreements, which will be paid by the ILA. From December 2013 through today, the ILA's Planning and Development Committee approved expenditure of more than NIS 3 billion, and it is expected that this amount will increase markedly with the signing of additional agreements.[24] The actual scope of expenditures, and how they are spread out over the coming years, will be determined in accordance with detailed plans that will be agreed on with local authorities.

[21] Such accounting of revenues allows presenting them in the budget in parallel with expenditures in respect of the projects as "income-contingent expenses", which by law is not included in the calculation of expenses for meeting the fiscal rule. The "income" against which this expense is recorded is the receipts from the sales of state lands.

[22] Privatization revenues are not recorded in the budget as income, as they reflect the change of a government asset (such as land) to a liquid one. In contrast with budgetary revenue, which increases total sources available to the government, privatization doesn't change them.

[23] In the 2015 budget, the amount is only NIS 200 million.

[24] This amount refers only to about one-fifth of the housing units included in seven existing agreements, and in the coming years it is expected that the committee will approve development budgets for the remaining units. Likewise, additional agreements, at a notable scope, are expected to be signed. Moreover, the Ministry of Construction and Housing signed similar agreements—in Beersheva (at a cost of about NIS 770 million) and Rosh Haayin (at a cost of about NIS 700 million), which will also be financed by the ILA. In examining the amounts approved, it is important to remember that the actual cost of development per housing unit, for the most part, is lower than the amount originally approved, due to price reductions during the process of the tender, as well as the existence of a reserve for unexpected expenses.

Another central component in government activity in the housing area is the "Dweller's Price" plan. According to the plan's goals, the government will reduce the prices of homes—by up to NIS 120,000 per home—for eligible buyers who meet the criteria it set, by reducing the price of land to contractors who build and market the homes, and through direct subsidy of development costs or a grant to buyers. In return for reducing the price of the land and development levies, the contractors commit to sell the homes at a below-market price, which is determined through a tender. Thus, this is essentially a government subsidy of a defined amount (for each home in the program), for a group of eligible people that is compiled in accordance with the government's policy. However, in this case, the government does not intend to record the full cost of the program in the budget, which in accordance with the goals is expected to reach NIS 1.5–2 billion per year. Instead, the part of the plan's cost derived from reducing the prices of land (estimated at more than NIS 1 billion per year) will be reflected in a reduction of revenues from sales of state land. As a result of this recording method, the deficit and the scope of expenditures presented in the state budget are lower than they are in actuality.

The under-presentation in the budget of the cost of government activities in the housing area, and its financing through the sale of land, is not solely a technical issue. These are expenditures of large amounts of money, from the public's funds, that are designated for a specific goal and are aimed at supporting a specific segment of the population—eligible people in the "Dweller's Price" program and residents of local authorities that benefit from umbrella agreements—and the defense budget. Even though the government's increased expenditures in the housing area are in line with the targets it presented, when they are not presented clearly in the budget, they do not reflect the burden they impose on the rest of the population and on the government's budgets in the future. This burden derives from the government sale of a public asset, the revenues from which could also have been used to finance other programs, in the present or in the future, if they would have been transferred to the budget or used to reduce debt, respectively. Moreover, the use of receipts from sales of land outside the budget prioritizes housing programs, since it is easier to use this source of funding for them than for other activities of the government.

The use of processes that bypass the budget, to finance activities in the housing area, are liable, as noted above, to distort the presentation of the fiscal picture through government accounts. This concern led the Accountant General's division at the Ministry of Finance to include the costs of Shoham 3 and the transfer of IDF bases to the south in government expenses as reported in preliminary estimates of budget performance for 2015, in contrast to the initial recording that appeared in the budget proposal. It is important to correct, accordingly, the presentation of budget data for 2016, a year in which the expenditure on these items is expected to be markedly higher, and it is important that the government act to present in an accurate and transparent manner, as a budget expense, the relevant costs of implementing the umbrella agreements and the “Dweller’s Price” program.[25] The correct accounting treatment in the budget does not require avoiding the carrying out of these activities, and the government can budget for them within the framework of the fiscal targets it sets, and even increase the expenditure ceiling and deficit for a limited period of time by the amount required for this goal, particularly as most of the additional deficit would be financed by selling properties without increasing the public debt. A deviation from the accepted accounting methods would negatively impact not only the precision of the presentation of the budget, but would also be an incentive for additional initiatives to bypass the limitations of the budget set by the fiscal targets and to distort the priorities in the government’s activities in accordance with the ease of use of budget-bypassing tracks (for example, the “Path to a Home” plan as well as several additional initiatives that were already adopted). Moreover, planning that is based on uncommon accounting methods is liable to ultimately adversely impact the execution of the plans, when the government will need to reflect their cost in its accounts.

4. Forecasts and scenarios for 2016–2020

The deficit and expenditure ceilings set in law are intended to create a stable multiyear path that enables the government to plan its expenditures and tax rates over time, and at the same time to support business-sector decision making processes and macroeconomic stability. As such, it is important to examine the ramifications of fiscal decisions that are made, not only with regard to the current year’s budget, but also with regard to fiscal policy over the remainder of the decade. The analysis below is based on the assumption that growth rates in the economy from 2017–20 will be 3 percent per year, on average—a rate that takes into account the expected moderation in growth of the working age population.

A very important factor in analyzing the expected development is that in addition to the marked increase in the expenditure ceiling described above, the government deferred, when approving the budgets of 2015 and 2016, the implementation of some of its decisions to coming years, so that it will again face complex challenges when preparing the budget for 2017. Due to a change in the Foundations of the Budget Law and in government procedures, which were approved within the framework of the Increasing Economic Efficiency Law, beginning with the 2017 budget, the government will need to handle, when approving the budget, the deviations from the expenditure ceiling expected in 2018 and 2019.[26] This is an important change: it increases the transparency in budget

[25] Relevant definitions regarding the issue appear in Sections 2.4 and 8.31 of Government Finance Statistics Manual 2014; Sections V.2.2.4, V.2.2.5, and Chapters 12 and 14 of Eurostat’s Manual on Government Deficit and Debt 2013, and in Sections 22.33 and 22.137 of System of National Accounts 2008.

[26] The Economic Efficiency (Legislative Changes to Achieving the Budget Targets for 2015–2016) Law, 5775-2015—preparing a three-year budget (numerator). When the 2017 budget is approved, excess commitments for 2018 and 2019 should be reduced to 100.5% of their respective expenditure ceilings.

administration and is intended to halt the process that has intensified in recent years—providing a response to budget problems by deferring them, while creating a surplus of commitments for future years. The significance of the new amendment to the law is that it will be difficult for the government to return to solve some of the budgeting problems in 2017 by deferring the execution of various plans, and it will require setting multiyear priorities for its activities in accordance with the fiscal goals it set.

According to current estimates, based on previous government decisions regarding various plans, and the expenditure path derived from various laws and demographic developments (such as education and health expenses, and National Insurance Institute allowances)[27], the size of the reductions required in government expenditure in order to meet the expenditure rule for 2017 is NIS 14 billion. This is assuming that the reductions to be made in civilian budgets in 2016 in order to allow the defense budget to increase in accordance with the framework will be permanent, and assuming that the supplements required in order to reflect in the budget the cost of government plans in the housing area will deviate from the expenditure and deficit ceilings. Of the required adjustment, about NIS 6.5 billion reflect an expected correction in the high inflation-forecasts used to construct the 2015 and 2016 budgets. To the extent that the government does not use these sums to finance current programs in 2016, the adjustment burden will be reduced.[28] In addition, the government, as noted, will need to present with the 2017 budget the adjustments required to converge expected expenditures in 2018 and 2019 to within the framework set by the fiscal rule. This will require implementing in these years additional steps totaling about NIS 2 billion (assuming that all the adjustments in 2017 are permanent, and assuming that between now and the approval of the 2017 budget the government will not decide on any new program that increases its expenditures over the remainder of the decade). To the extent that the government does not reduce its expenses in accordance with the gap in the price forecast, additional revenues of NIS 6–7 billion will be required in order not to deviate in 2017 from the deficit ceiling of 2.5 percent of GDP, set in law.

Figure 2 presents the path of deficit targets set by law, which were approved with the 2016 budget (the red line). Based on this path, the deficit is to decline gradually from 2.9

[27] The assumption regarding all the coming years is that the additional wage agreements that will be signed in the public sector, on top of the general agreements signed in December 2015, will not lead to the wage scale increasing in real terms by more than the increase in productivity in the economy.

[28] According to the Ministry of Finance's estimate (budget foundations book for 2015–2016 (page 90 in Hebrew), the required adjustment on the expenses side is NIS 5.7 billion, but this estimate was published before the agreement was reached on the addition to the Ministry of Defense budget within the multiyear framework, and does not account for the price adjustment expected in the 2017 budget. This is reflected in the Ministry of Finance's forecast presenting at the same time the need for "additional steps"—increasing revenues or slowing the growth of expenditures to a rate lower than that allowed by the fiscal rule—by NIS 8.7 billion. Cumulatively, the total adjustment necessary that was presented with the budget reaches NIS 14.4 billion.

percent of GDP in 2016 to 1.75 percent in 2020, and to 1.5 percent in 2021 and beyond. Figure 3 indicates that if this path is realized (the red line), the debt to GDP ratio will decline gradually from its current level and reach 63 percent of GDP in 2020. Meeting the target will require significant decisions by the government regarding its expenditures, assuming that the framework is based on the expenditure ceilings set in law, and it will also require prolonged dedication to implementing them. Likewise, an increase in revenues by about NIS 4 billion will apparently be required in 2018–20, even if the expenditure ceiling is adhered to.

The black lines in Figures 2–4 represent the outcomes of alternative policy scenarios, in which the government acts based on the specific expenditure plans that it approved—that is, does not bring its expenditures in line with the expenditure ceiling but also does not decide on additional expenditures until 2020, and does not change the tax rates.[29] In this scenario, the deficit is expected to increase to around 3.5 percent of GDP in 2017 (about 3.8 percent when including the plans in the housing area) and to stabilize at that level for the remainder of the decade. The debt to GDP ratio will increase gradually and reach 68 percent in 2020. Such a policy will also be reflected in a stable share of public expenditure in GDP, and the share of primary civilian expenditure in GDP will increase by about 0.5 percent. The blue lines in Figures 2–4 represent what is expected if the government adheres to the expenditure ceiling (without an adjustment to prices in the 2017 budget) but does not change tax rates. In this case, the deficit will decline gradually to about 2.5 percent of GDP, and will be higher than the targets set in law in all the years. Such a deficit will stabilize the debt to GDP ratio at its current level, while reducing the share of public expenditure in GDP by 0.7 percentage points by the end of the decade. In order to meet the expenditure ceiling in 2018–20, the government will need to reduce the expenditure plans by a cumulative NIS 4 billion. This is in addition to the reduction necessary in 2017, and subject to the assumptions that the adjustments in each year will be permanent and that the government will not decide on additional expenditures through the end of the decade.[30] This sharpens the expected challenge to the government in the years discussed, within the framework of the effort to meet the expenditures ceiling it set: not only does it not have the option of reaching decisions on increasing expenditures in any item without reducing expenditures in another item, but more than that, it will need to markedly reduce existing expenditure plans or those whose execution has already been decided on. This is even though already today the share of civilian public expenditure in GDP is one of the lowest among advanced economies.

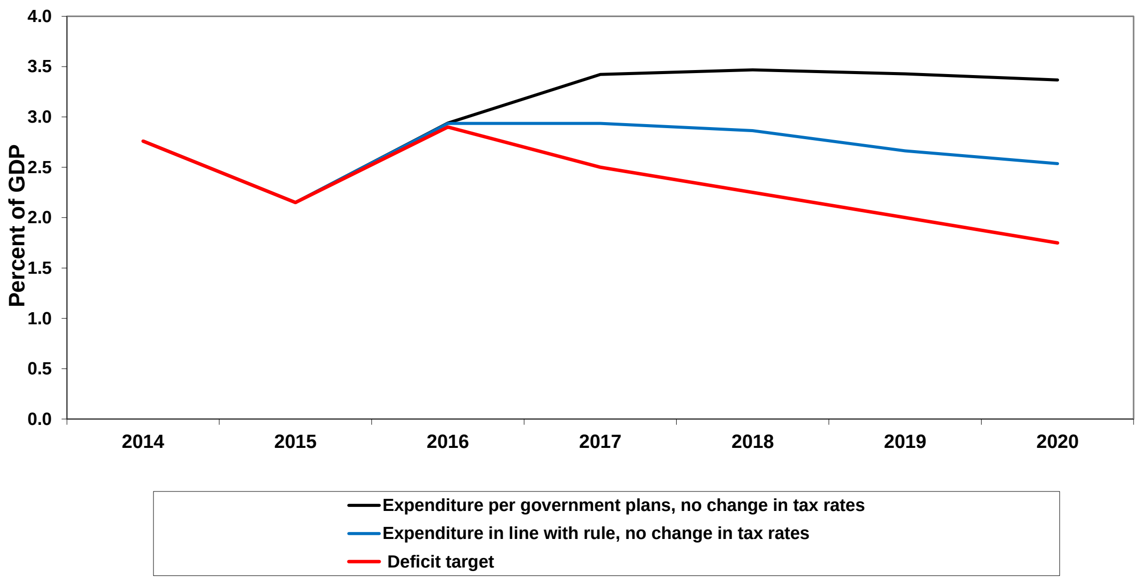
---

[29] Figures 2 and 4 are presented without the cost of the government's housing plans, a cost which has not yet been recorded in the 2016 budget. When it will be included in the budget, the deficit and expenditure levels will increase accordingly.

[30] The size of the required adjustment each year is impacted on by the adjustments made in previous years, both because the expenditure ceiling increased relative to the previous year's ceiling, and not relative to actual expenditure, as well as because the deficit in a specific year increases the interest payments in following years.

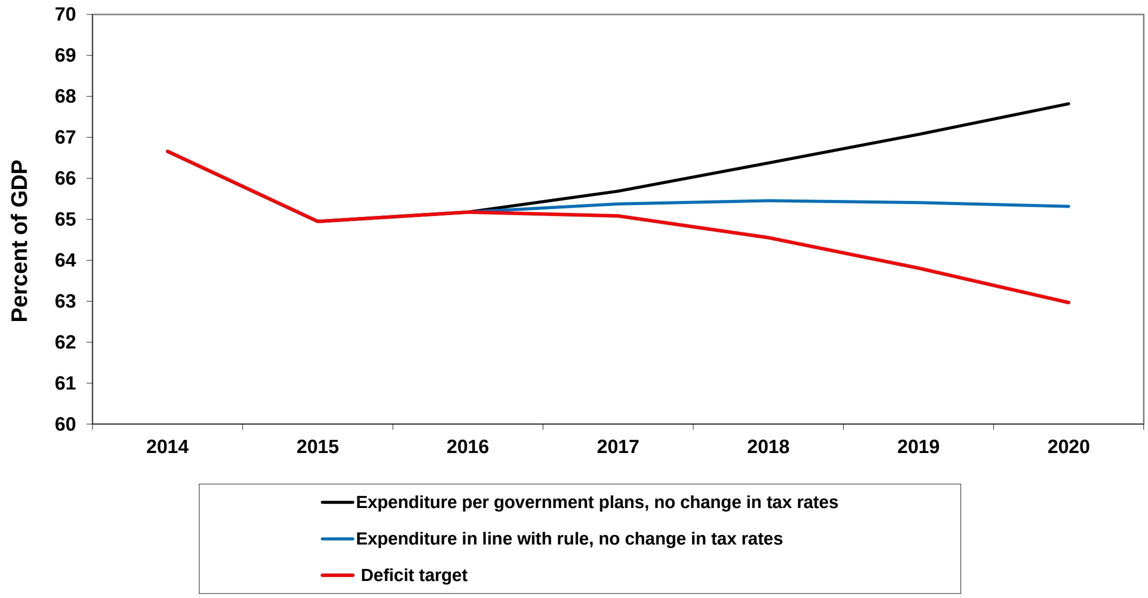
The analysis above indicates that meeting the deficit targets set in law will require notable budget adjustments of about 1.7 percent of GDP (about NIS 20 billion) in 2017–20 (the difference between the red and black lines in Figure 2), assuming that the deficit target is raised in line with the cost of the government's housing programs. The earlier the government makes such an adjustment, the smaller its scope can be, as the public debt—and related interest payments—will not increase. Clearly such an adjustment will require conceding numerous programs to which it attributes great importance, or markedly increasing tax revenues.

Figure 2
Share of deficit in GDP under various policy scenarios, 2014–20



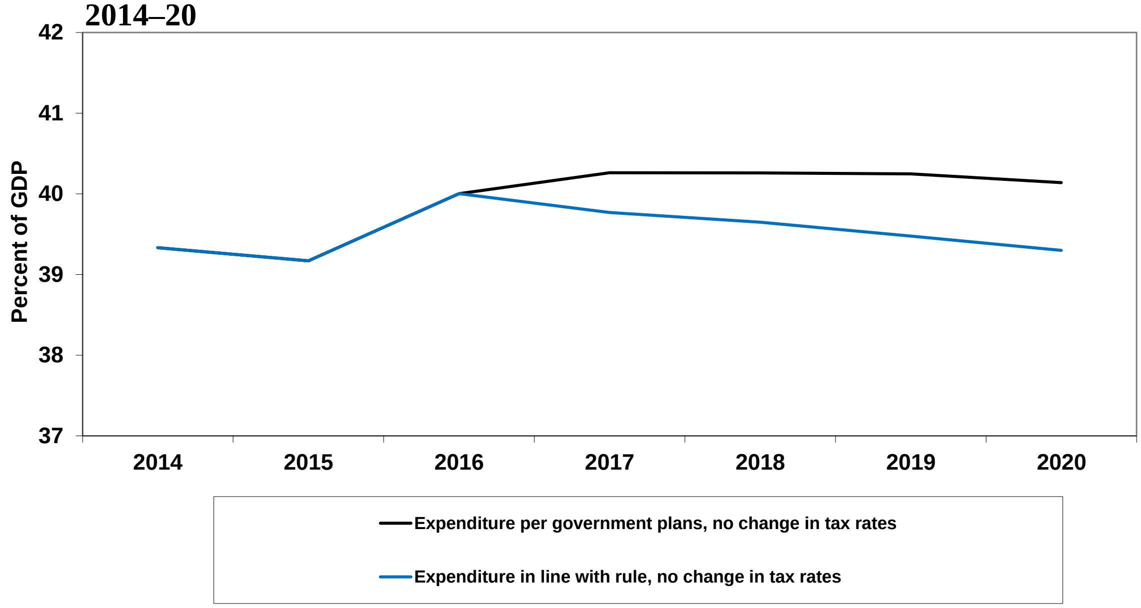
Source: Based on budget data.

Figure 3
Debt to GDP ratio under various policy scenarios, 2014–20



Source: Based on budget data.

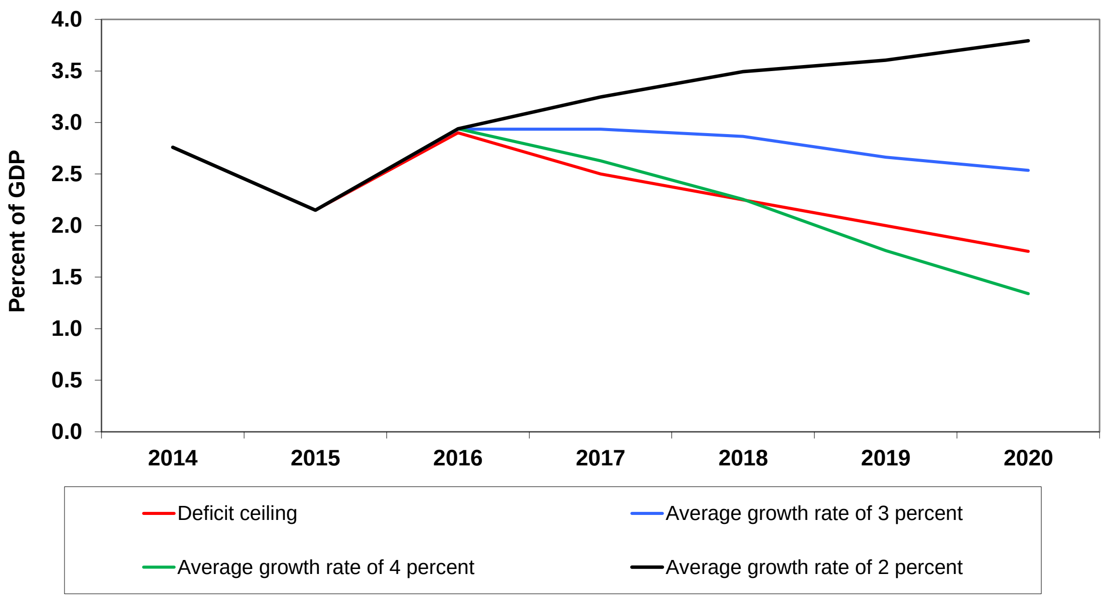
Figure 4
Share of total public expenditure in GDP under various policy scenarios, 2014–20



Source: Based on budget data.

The analysis presented here is sensitive to assumptions regarding the economy's future growth rate. The current evaluation is based on assumptions that are slightly higher than the growth forecasts of the OECD and other entities assessing Israel's economy, and there is some uncertainty regarding them. When analyzing how a change in the growth rate would impact on the path of the deficit, in the scenario in which the government meets the expenditure ceiling but does not increase revenues, it is found that if the growth rate is 4 percent per year, on average, the government will be able to meet the declining deficit targets (the green line in Figure 5). In contrast, a decline in the growth rate to an average of 2 percent is expected to lead to a gradual increase of the deficit to 3.8 percent of GDP (the black line in Figure 5). If the government increases its expenditures per the plans that it has approved, and growth is 2 percent on average, the deficit will increase to more than 4.5 percent, with a concurrent increase in the debt to GDP ratio to around 74 percent.

Figure 5
The deficit as a share of GDP under various growth rate assumptions, 2014–20
Tax rates and expenditures under each scenario are based on the 2016 budget.



Source: Based on budget data.