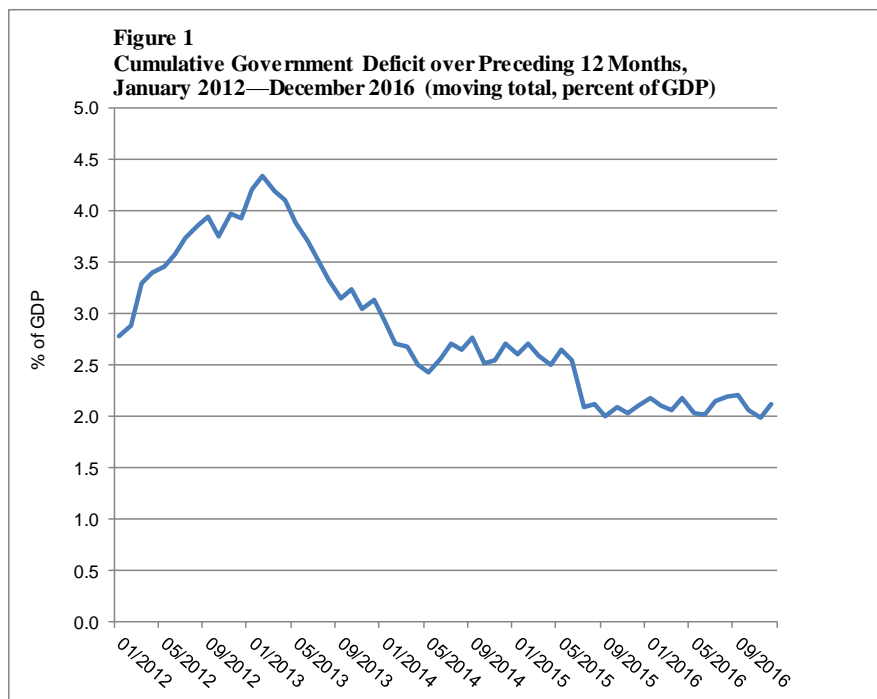


## **Analysis of fiscal developments in 2016, the fiscal situation for 2017, and trends expected over the remainder of the decade**

- **The government finished 2016 with a deficit of 2.1 percent of GDP, similar to 2015 and significantly lower than the deficit ceiling set in the budget. The public debt to GDP ratio declined to about 62 percent.**
- **The below-target deficit reflected a) unexpectedly strong tax receipts, tracing to unexpectedly vigorous growth, improved terms of trade, and an exceptional increase in imports of motor vehicles—a highly taxed product; b) surpluses in National Insurance Institute activity that reflected overbudgeting of benefit payments; and c) expenditure that was somewhat lower than budgeted.**
- **The deficit ceiling for 2017 and 2018 was set at 2.9 percent of GDP, but the deficit in 2017 is likely to be lower, at about 2.5 percent of GDP, and the 2018 deficit is also expected to be slightly below the ceiling.**
- **The below-target deficit is supported by the economy’s current near-full-employment environment and by the marked contribution of tax receipts from the volatile real estate and vehicle markets—which increased by 0.8 percent of GDP between 2012 and 2016.**
- **Primary civilian expenditure in Israel is almost the lowest in the OECD, making it difficult for the government to allocate resources to policy measures that will entrench long-term economic growth. In the last two budgets, however, the government significantly increased its primary civilian expenditure so that its share of GDP is expected to increase by about one percent of GDP. This expansion reflects the decision to relax the expenditure ceiling, both directly and indirectly, the only moderate increase in defense expenditure, and the decline in interest payments.**
- **According to the multiyear control mechanism over the budget aggregates (the “numerator”), the government must make sure that its decisions do not lead to a deviation from the expenditure and deficit ceilings even in the years following the current budget. At this stage, it appears that the mechanism has contributed to an improvement in budget discipline.**
- **Based on decisions made thus far, expected expenditure in 2019 approximates the ceiling but expenditure in 2020 is already expected to surpass the ceiling by at least NIS 2 billion. The expected deficit in those two years exceeds the ceiling set by law, even assuming that the high level of economic activity is sustained.**
- **Since the expected deficit in the medium term is higher than the ceiling set by law, government decisions on tax reductions or increased expenditure that will permanently raise the deficit must be accompanied by measures that will offset the increase in the deficit.**
- **The low deficits of the past two years supported the decline in the debt-to-GDP ratio, but most of that decline in recent years reflected a rapid increase of the GDP deflator relative to the Consumer Price Index, repayment of the public’s debts to the government, and receipts from land sales. Over time, one cannot assume that these sources will continue making significant contributions to the process of lowering the debt-to-GDP ratio.**

## 1. 2016 budget performance

The government ended 2016 with a budget deficit of 2.1 percent of GDP—approximating the 2015 deficit and far below the 2.9 percent deficit ceiling established in the budget. The below-target deficit was due to much stronger revenues than those envisaged in the original budget forecast and, to a lesser extent, lower-than-budgeted expenditure. The small deficit, the increase in the GDP deflator relative to the Consumer Price Index, and repayment of previously issued government housing loans allowed the government to lower the debt-to-GDP ratio to 62 percent. In several years' retrospect, the deficit has been stable at its current level since the middle of 2015 (Figure 1)<sup>1</sup> after having declined gradually since the middle of 2013 following tax increases in 2012 and 2013<sup>2</sup> and some restraint of growth in government spending in 2013 and, to a greater extent, in 2014.



The unexpectedly strong revenues in 2016 mainly reflected tax receipts that exceeded the original forecast by NIS 6 billion (or by NIS 7.5 billion if an unplanned provision to the Property Tax compensation fund is taken into account). NIS 4.5 billion of the disparity between the forecast and actual collection is explained by unexpectedly strong nominal GDP growth (Table 1).<sup>3</sup> The other factors that affect tax collection can be examined through the Bank of Israel tax model (Brender and Navon, 2011), which includes several additional financial and nonfinancial variables that influence receipts. According to the model, the variable that contributed the most to the unexpected increase in tax receipts was imports of consumer goods—chiefly motor vehicles—which expanded by 11.3 percent in real terms compared with a forecast of 2.6 percent in December 2015. This component by itself contributed NIS 5 billion to the gap between the original revenue forecast and the amount actually collected.<sup>4</sup> An unexpectedly large increase in wages contributed

<sup>1</sup> Cumulative deficit in the twelve months ending each month.

<sup>2</sup> Brender and Politzer (2014) show that it takes two years for changes in tax rates to be fully manifested in tax receipts.

<sup>3</sup> This assumes that the annual rate of increase in tax receipts resembles that of GDP, as has been found in the Bank of Israel tax model for years in which the growth rate is stable. Indeed, the relevant GDP variable (nominal GDP deflated by the CPI) rose at a similar 6 percent pace in 2015 and 2016.

<sup>4</sup> The import and wage variables in the model are calculated net of increases that originate in GDP growth.

another NIS 1 billion or so, whereas the other variables in the model made a negative contribution of around NIS 1 billion relative to the original forecast.<sup>5</sup> According to this analysis and following the model, macroeconomic developments in 2016 should have yielded NIS 2.0 billion more in tax receipts than actual receipts. At the present writing, it is premature to analyze the factors that caused collection to fall short of the level that the model predicted—assuming that such a shortfall existed at all, since some data on 2016 economic activity are still incomplete estimates.

**Table 1**  
**Tax revenues in 2016 - budget forecast vs. performance (NIS billion)**

	<b>Forecast</b>	<b>Actual</b>	<b>Difference</b>	<b>Difference (% of forecast)</b>
Total tax revenues	277.3	283.2	5.9	2.1
Adjusted for provision to Property Tax compensation fund	277.3	284.8	7.5	2.7
Nominal GDP forecast (adjusted for change in GDP definitions)	1,202.0	1,222.4	20.4	1.7
Revenue forecast adjusted for actual growth rate and provision to Property Tax compensation fund	280.4	283.2	2.8	1.0

Tax receipts increased in 2016 by NIS 13 billion—4.9 percent—over 2015.<sup>6</sup> This figure, however, disregards inter-year changes in tax rates and inter-year fluctuations in motor vehicle imports due to tax rate changes. The changes in tax rates—lowering Value Added Tax in late 2015, reducing corporate tax at the beginning of 2016, and, conversely, curbing the tax benefit on employer contributions to pension funds—reduced revenues by NIS 4.4 billion in 2016. In contrast, inter-year rescheduling of motor vehicle imports boosted revenues by NIS 0.8 billion (Table 2). After adjustments for these changes are made, tax revenues increased by NIS 15 billion (5.6 percent)—a rate exceeding that of nominal GDP growth (5.1 percent). Here, too, analysis by means of the tax model traces the extra increase in revenues—NIS 3 billion—to rapid growth in imports of consumer goods (net of the effect of inter-year volatility in motor vehicle imports).

<sup>5</sup> Compared with the corresponding analysis in our August 2016 survey, the increase in imports speeded up even more, wages grew at a similar pace, and new housing sales contracted and converged to the original forecast. However, since the contribution of imports and wages (both of which correlate positively with GDP) to revenues is calculated beyond the effect of GDP change, the nominal increase in GDP beyond the original forecast, caused largely by correction of the Central Bureau of Statistics estimates of growth in the first half of the year, offsets much of the additional upturn in imports and reduces the contribution of wage growth.

<sup>6</sup> This data point pertains to actual collection and not to budget data, which subtract government transfers to the compensation fund from receipts and make additional minor accounting adjustments.

**Table 2****Factors contributing to the increase in tax revenues - 2016 vs. 2015 (NIS billion)<sup>1</sup>**

Total revenues in 2015	271.6
Undercollection in respect of bringing imports forward to 2014	1.0
Effect of legislative changes in 2016 <sup>2</sup>	-4.4
2015 revenue adjusted for legislative changes	268.1
Effect of increase in nominal GDP (5.1 percent) <sup>3</sup>	13.6
Forecast adjusted to legislative changes - 2016	281.7
Actual revenues in 2016	284.9
Revenues net of bringing vehicle imports forward <sup>4</sup> from 2017	283.1

<sup>1</sup> Data on actual revenue collection, that are not affected by accounting transfers to the compensation fund.

<sup>2</sup> "Static" calculation that does not refer to effect of legislative changes on GDP, imports, and composition of demand.

<sup>3</sup> Assuming that the elasticity of tax revenues to GDP is unitary.

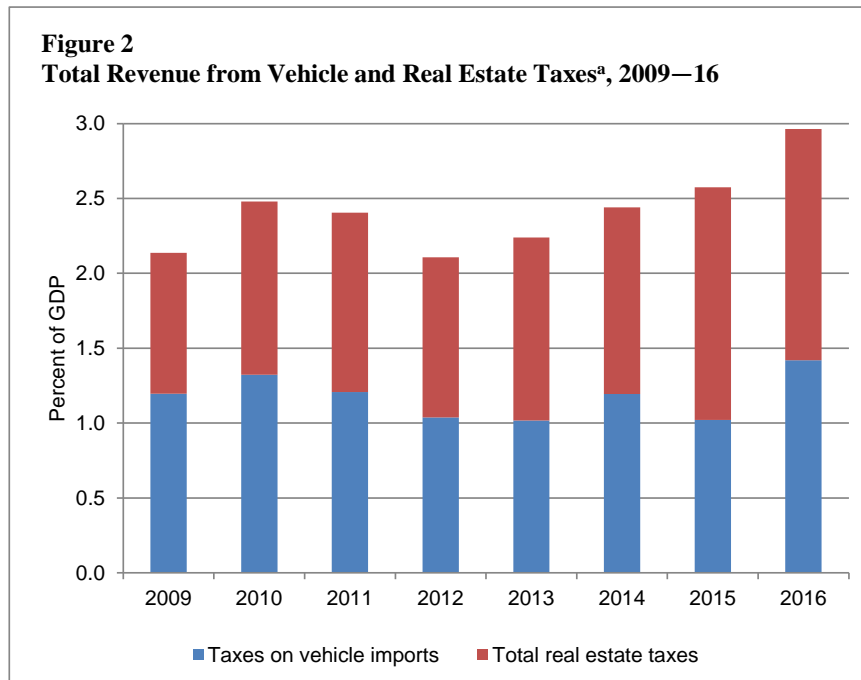
<sup>4</sup> This component includes NIS 5 billion discussed above.

The appreciable effect of the increase in imports on tax receipts also stands out when tax receipts on motor vehicle imports, which include purchase tax and Value Added Tax, are examined directly. In 2016, these taxes accounted for NIS 17.3 billion in collection, compared with NIS 11.9 billion in 2015 and NIS 11.5 billion on average in 2012–2015. The increase in revenue relative to the average for these years is equivalent to 0.35 percent of GDP. The steep upturn in receipts generated by these taxes in 2016 originates in a large increase in the number of imported motor vehicles, whereas the average rate of purchase tax—50 percent of imported vehicle value—resembles that in previous years and the VAT rate declined by one percentage point. Some of the upturn in imports seems to come from advancing of purchases in anticipation of an increase in tax rates at the beginning of 2017, at an intensity that was exceptional relative to previous tax hikes. The large share of motor vehicle tax revenues in total tax receipts indicates that the current level of receipts is unlikely to persist if the level of imports reverts to that of previous years. It is true that in some earlier years, tax revenues from motor vehicle imports were only 0.2 percent of GDP below their current level (Figure 2) but the tax rates on imported vehicles were 16 percentage points higher in those years.

In addition to the abundant import tax revenues, the government has enjoyed a strong upturn in revenues on real estate taxes in recent years (Bank of Israel *Annual Report* for 2015, Chapter 6). These mainly include real estate purchase tax, land betterment tax, and Value Added Tax on new dwellings.<sup>7</sup> Real estate tax revenues leveled off in the reviewed year (as a percentage of GDP) at a plateau approximating that of 2015, which was considerably higher than in previous years: 0.3 percent of GDP more than the 2012–2015 average and 0.45 percent of GDP more than the 2009–2011 average (Figure 2). Thus, the combination of brisk revenue from motor vehicle imports and

<sup>7</sup> Data relating to VAT collection on dwellings are not reported directly. They are based on Bank of Israel calculations.

real estate—two volatile components—augmented tax receipts by 0.5–0.7 percent of GDP in recent years.



In addition to the strong tax receipts, revenues were boosted in 2016 by an unexpectedly large NIS 4.1 billion surplus from the National Insurance Institute (NII).<sup>8</sup> The unexpected surplus came from two sources:

1. An unexpectedly large NIS 2.6 billion operating surplus, most of it due to more than NIS 2 billion less in benefit payouts than the sum appearing in the draft budget (*Main Provisions of the Budget 2015–2016*, p. 156). There is no economic or institutional explanation for this discrepancy; it reflects an overestimate that already appeared when the budget was prepared. As a reflection of this overestimate, benefit payments in 2015 were NIS 2.5 billion smaller than the estimate in *Main Provisions of the Budget*, even though that publication came out only in late 2015;
2. An accounting measure in late 2016: The government transferred NIS 1.5 billion to NII as an advance on account of payments in coming years but immediately “clawed it back” as part of NII’s operating surplus because NII was unable to spend the money in 2016. As a result, the expenditure side of the government budget was overstated by NIS 1.5 billion with a concurrent increase in revenue. This move had no effect whatsoever on the budget deficit in 2016.

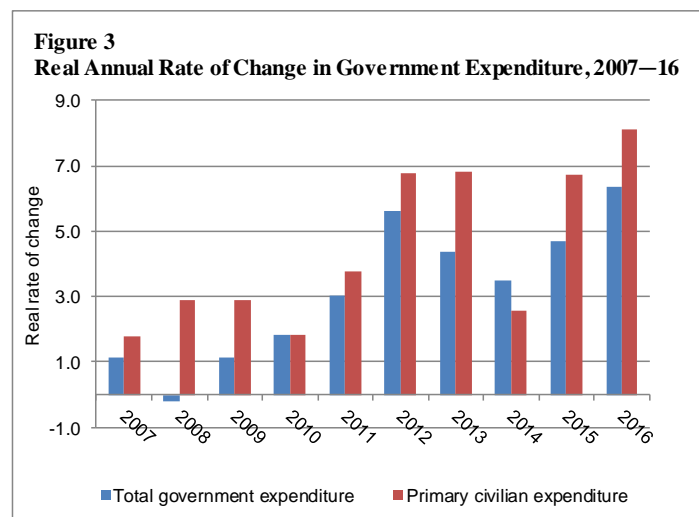
Total budget expenditure increased in 2016 by 6.4 percent over 2015 in real terms (deflated by the Consumer Price Index) or 5.9 percent net of the NIS 1.5 billion transfer to NII.<sup>9</sup> Excluding the

<sup>8</sup> National Insurance revenue includes insurance premiums remitted by the public, transfers from the government, interest earnings on special government bonds in which NII invests surplus revenues, and redemptions of bonds. This revenue is used to pay out benefits and cover operating expenses. For a detailed explanation of the structure of accounts between the government and NII, see the Bank of Israel *Annual Report* for 2002, Box 3.3.

<sup>9</sup> The rate of change is presented in accordance with accounting changes that were made in the transition from the 2015 budget to that of 2016, which increased reported expenditure by NIS 3.85 billion. (See the February 2016 *Fiscal Survey*.)

transfer, expenditure (net, not including revenue-dependent expenditure items<sup>10</sup>) was NIS 2 billion below the ceiling established in the budget. Divided by expenditure items, spending by civilian ministries was in line with the original budget whereas the “Miscellaneous” and “Interest” items were underspent—as in most previous years. The unutilized balance in these items was invoked to give the defense budget a NIS 5 billion supplement, in accordance with the long-term outline for the defense budget that was drawn up in late 2015. Importantly, even after this increase, defense spending as a share of the budget and of GDP (including expenditure for the relocation of army bases to the Negev) declined in the reviewed year, as it has in most previous years, and was half a percent of GDP lower in 2016 than at the beginning of the decade. This decrease, coupled with the contraction of interest payments and the upturn in total spending, caused primary civilian public expenditure as a share of GDP to rise in 2016 after declining in 2015 (Table 3).

An examination of the growth rates of spending in the government budget—primary civilian expenditure in particular—in recent years (Figure 3) finds rapid acceleration (with the exception of 2014) far exceeding the growth rates of real GDP and public expenditure since the middle of the previous decade. Nevertheless, government expenditure as a share of GDP declined (with the exception of 2016). This outcome reflects the spread that opened up in these years between the CPI—by which budget expenditure is deflated in order to calculate the real rate of increase (this is the index by which the budget expenditure ceiling is calculated)—and the GDP deflator. While the two indices develop similarly in the long term, a 7.5 percentage-point spread has opened between them in recent years, causing spending in CPI terms to surge ahead even as spending relative to GDP erodes.<sup>11</sup>



It is true that, according to the expenditure rule, spending should be cut back whenever the CPI rises more slowly than expected in order to maintain the real rate of increase that the rule establishes. The government, however, decided to refrain from making this adjustment and resolved to continue increasing its spending. It did this because much of the decline in the CPI

<sup>10</sup> Some budget expenditure items are performed only if revenue from specific sources is received. Detailed reportage on the performance of these items appears only in later reportage on budget performance. In recent years, such expenditure has fallen short of the amount allocated by NIS 2.5 billion per year.

<sup>11</sup> In 2012–2016, the GDP deflator rose by an annual average of 2 percent and the CPI rose by an annual average of 0.5 percent. In 1999–2016, in contrast, both indices advanced by an annual average of 2.1 percent.

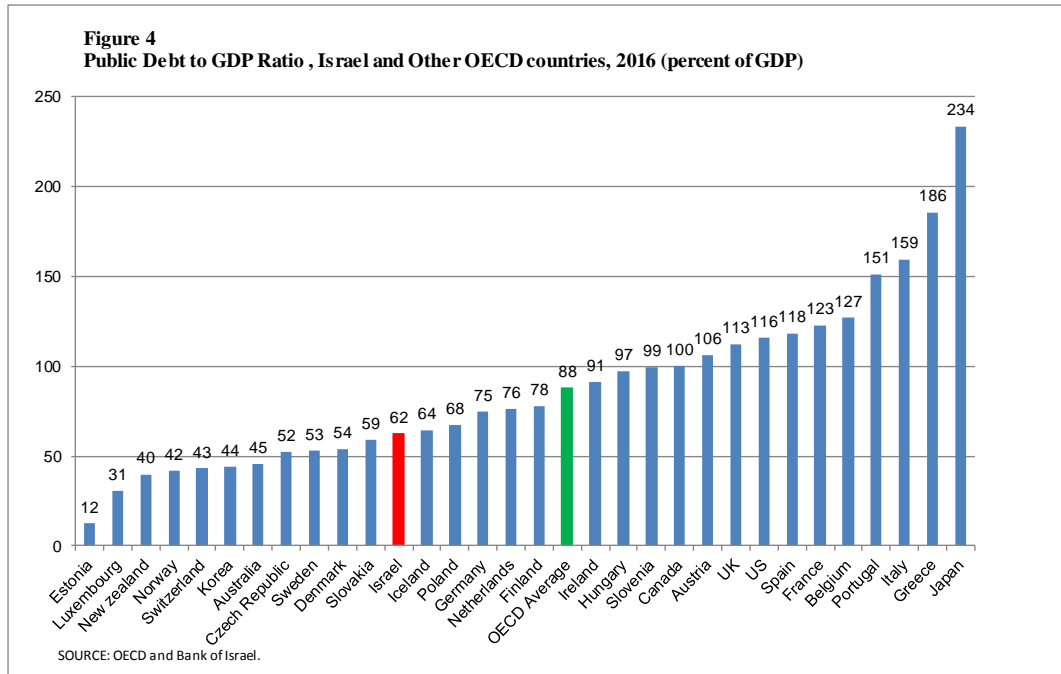
originated in a downturn in import prices, which do not reflect the composition of public expenditure, and in the low level of spending. Even though prices were not adjusted, the deficits remained small ex post because tax receipts grew in tandem with nominal GDP, since taxes are collected on the shekel value of economic activity. A similar development was observed in the business sector, where real wage per employee increased (in purchasing power terms) whereas wage expenses in terms of GDP prices did not grow. Therefore, a blow to profitability was avoided. However, if the price-ratio trend—which largely reflects global prices of imports and exports—turns around, one outcome may be a rapid increase in the deficit.

**Table 3**  
**Public expenditure 2012—16 (percent of GDP)<sup>1</sup>**

	2012	2013	2014	2015	2016
<b>Total expenditure (excluding credit)</b>	<b>40.0</b>	<b>39.9</b>	<b>39.6</b>	<b>39.0</b>	<b>39.0</b>
<i>Real change, percentage, (net of CPI)</i>	<i>7.1</i>	<i>4.7</i>	<i>3.1</i>	<i>4.4</i>	<i>5.6</i>
Defense - gross	6.1	5.9	6.0	5.9	5.8
Interest (excluding interest payments to National Insurance Institute)	2.8	2.7	2.5	2.7	2.6
Primary civilian expenditure	31.1	31.3	31.1	30.4	30.6
<i>Real change, percentage, (net of CPI)</i>	<i>7.9</i>	<i>5.8</i>	<i>3.2</i>	<i>3.5</i>	<i>6.5</i>

<sup>1</sup> Adjusted for accounting changes in 2016.

Alongside the unexpectedly small deficit, the public debt to GDP ratio continued to decline—by 1.8 percent of GDP—to 62.1 percent, low by the standards of the advanced economies (Figure 4). About half of the decline in this ratio in 2016 is explained by the small deficit and the erosion of debt that existed at the end of 2015 relative to nominal GDP (Table 4). The rest of the decline originated in repayment of the public’s debts to the government (mainly of previously issued housing loans) and a rapid increase in the GDP deflator relative to the CPI, to which about half of the public’s debt is indexed. This phenomenon is not unique to 2016. An analysis of the precipitants of the decline in the debt to GDP ratio from the end of 2011 to the end of 2016 shows that the dynamic of the government budget deficit and GDP growth is responsible for only a small portion of the decline, with most of it coming from the aberrant change in the GDP deflator relative to the CPI, payback of housing loans to eligible recipients, and privatization receipts (Figure 5). Since the government’s housing loan portfolio has contracted greatly and a large share of privatization revenue (foremost from land sales) is earmarked for extrabudgetary funding of government construction and housing activity, the government will find it difficult to continue lowering the debt to GDP ratio if the deficit rises to the levels that it has set as the ceiling in the next few years.

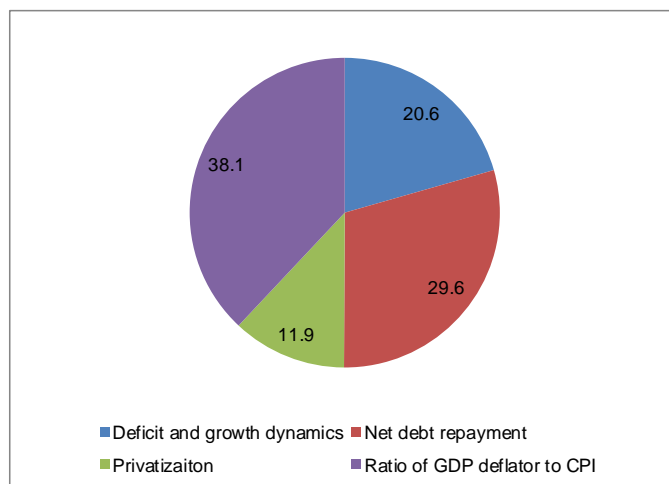


**Table 4**  
**Factors in the change of the public debt to GDP ratio, 2015 vs. 2016 (percent of GDP)**

<b>Debt to GDP ratio on December 31, 2015</b>	<b><u>63.9</u></b>
Effect of deficit and real GDP growth	-0.4
Effect of change in GDP deflator on unindexed debt and foreign currency-denominated debt	-0.4
Revenues from privatization and public's debt repayment to the government	-0.4
Effect of change in GDP deflator and in CPI on CPI-indexed debt	-0.5
Increase in public non-government debt, excess funding, changes in exchange rates and changes in accrued interest	-0.1
Total change in debt to GDP ratio in 2016	<hr style="width: 20%; margin-left: auto; margin-right: 0;"/> -1.8
<b>Debt to GDP ratio on December 31, 2016</b>	<b><u>62.1</u></b>



**Figure 5**  
**Distribution of Factors in Reduction of Debt to GDP Ratio,**  
**2011—16 (percent of total decline)**



The aforementioned perceptible and ongoing contribution of repayment of the public’s debt to the government to lowering gross public debt in the past decade is manifested in a rapid decline of gross public debt relative to net public debt (the total less the government’s financial assets). This trend, a continuing one in Israel, is unusual among advanced economies. In most OECD member states (with the exceptions of Switzerland, the Czech Republic, and Poland), the gap between gross public debt and net public debt has widened in the past decade (i.e., the government has accumulated net assets as opposed to realizing them) by 9 percent of GDP on average. Thus, much of the spread that has opened in Israel’s favor, traces to this realization of assets.<sup>12</sup>

## **2. The 2017 and 2018 budget**

The government’s budget ceiling for 2017 and 2018 is 2.9 percent of GDP, far beyond the 2.1 percent deficit recorded in 2016. The increase reflects a sizable upturn in the spending limit—by 6 percent in 2017 and another 3.7 percent in 2018 (adjusted for accounting changes)—and a minuscule adjustment of tax rates in 2017<sup>13</sup> and moderate tax cuts in 2018. Furthermore, the planned real increase in total expenditure—including, in addition to the spending limit, revenue-dependent expenditure items<sup>14</sup>—is 7 percent in 2017 (relative to estimated performance in 2016) and another 2.5 percent in 2018 (Table 5). This vigorous rate of increase reflects the low level of public expenditure and the government’s need to increase available resources in order to attain its goals. The upturn in revenue-dependent expenditure relies mainly on nonrecurrent or provisional revenues that the government is trying to obtain from various state-owned enterprises and public institutions such as the Jewish National Fund, the Airports Authority, and the state lottery. The

<sup>12</sup> Since comparing levels of net public debt is complicated, the common practice is to base cross-country comparisons on gross debt. Despite the disclaimers, it appears that Israel’s situation in terms of the size of its net debt is less auspicious than that of other countries— slightly less than 60 percent of GDP compared with 43 percent on average among OECD countries (excluding Norway, which has an aberrant assets surplus). The reason is that the average net share of portfolio assets in the OECD countries is 48 percent of GDP.

<sup>13</sup> Total tax increases and decreases basically offset each other in 2017.

<sup>14</sup> Revenue-dependent expenditure is expenditure performed only if revenues from a specific source, earmarked in advance for this expenditure, are received.

revenue-dependent component also includes budgets for relocating army bases to the Negev—NIS 2.8 billion in 2017 and NIS 2.1 billion in 2018—that can be performed only if receipts from land sales by the Israel Land Authority are received. Insofar as these earmarked revenues prove difficult to collect (some of them were already included in the 2015–2016 budget and not realized), the expenditure that depends on them—mainly for housing, school construction, infrastructure investment, and construction of army bases in the Negev—is likely to be delayed, impairing the attainment of important government objectives in these fields. While this method of recording expenditure makes it possible to except it from the spending limit, it is advisable that the government budget its investments—particularly in schools and infrastructure—directly, so these activities do not depend on the realization of revenues from these specific sources.

**Table 5**

**Expenditure and revenue<sup>1</sup> in government budget for 2017–2018**

	NIS billion		Real rate of change (%)	
	2017	2018	2016 to 2017	2017 to 2018
Net expenditure (expenditure ceiling, excluding credit)	359.4	376.4	6.2	3.7
Revenue contingent expenditure	44.9	42.0	...	-7.4
of which: civilian expenditure	23.0	23.0	15.0	-1.0
<b>Total expenditure</b>	<b>404.3</b>	<b>418.4</b>	7.0	2.5
of which: defense (including IDF move to the Negev)	82.8	82.4	6.2	-1.5
Total interest payments, including repayment of National Insurance Institute fund	49.1	50.4	0.5	1.6
Primary civilian expenditure	271.5	285.6	8.4	4.2
<b>Total revenues</b>	<b>370.9</b>	<b>382.2</b>	<b>5.6</b>	<b>2.0</b>
Taxes	298.8	309.9	4.6	2.7
Revenue from royalties, government companies, miscellaneous	5.0	6.5	50.8	28.7
Other	67.1	65.8	7.7	-2.9

<sup>1</sup> Data on revenues and its components are Bank of Israel estimates.

According to the Bank of Israel’s adjusted forecast, which reflects amendments to the budget since the government passed it last summer and recent domestic and global economic developments, the deficit in 2017 is projected at 2.5 percent of GDP—below the ceiling that the government has set. This forecast does not take account of potential tax revenues from Intel’s acquisition of Mobileye (which, insofar as they are received, may increase tax revenue in 2017 and/or 2018 by several billion shekels on a one-off basis). This assumes that the government will not adjust tax rates or levels of National Insurance benefits and will not perform revenue-dependent expenditure items unless their earmarked revenues arrive. The main precipitants of the below-target deficit are (a) favorable macroeconomic developments in the second half of 2016 and, particularly, rapid GDP growth coupled with the upward revision of data for early 2016, adding NIS 2.5 billion to the tax-revenue forecast, and (b) NII surpluses that are expected to surpass the budget by NIS 2 billion due to the aforementioned overestimation of benefits. As for 2018, expected tax revenues are similar to the budget forecast at the present writing but the NII surplus is poised to exceed the budget forecast by more than NIS 2 billion, probably leaving the deficit slightly under the ceiling. Importantly, at this early phase, one should treat the 2018 revenue outlooks very cautiously, especially since many tax-related legislative changes were approved along with the 2017–2018

budgets and developments in the real estate and motor vehicle markets have had powerful effects on revenues in the past two years.

To contend with the difficulty in predicting economic variables for 2018 in the summer of 2016, when the government approved the budget, and given the risk of new budget exigencies between the two dates, legislation established a control mechanism between the years of the two-year budget: the inclusion of a NIS 3.5 billion adjustment reserve in the budget.<sup>15</sup> According to the statute, in November 2017 the government must report to the Knesset Finance Committee on differences between the 2018 budget and expenditure forecasts and the budget as approved. If the foreseen differences exceed the adjustment reserve, the government will have to present the Knesset, in November 2017, with measures that will bridge the remaining gap. Otherwise, the budget for 2018 will be nullified, the year 2018 will begin with an interim budget (an allocation of one-twelfth of the 2017 budget each month), and the government will have to approve a new budget for 2018 within three months. Absent this, the Knesset will be dissolved. This mechanism responds to the forecasting problem effectively but minimizes the potential advantages of the biannual budget: a lengthier planning horizon for budget management than a one-year budget can provide.

The rapid growth rate of expenditure in the current budget continues the trend of acceleration of expenditure that began after the social protests in the summer of 2011 (Figure 3). This evidently reflects the government's realization that it cannot attain its social, economic, and defense goals at the limited level of expenditure that the ceiling dictates. The rate of budget increase far exceeds that established by the expenditure ceiling—2.7 percent of GDP per annum. In the current budget, as in the 2015–2016 budget, the government resolved to revise the budget rules by not adjusting the expenditure ceiling to a CPI that rose at a slower pace than had been forecast. This was a reasonable decision in view of the weak relationship, in the short term, between the Consumer Price Index and budget outlays.<sup>16</sup>

For the same reason, the government also resolved to revise the price-adjustment formula on a permanent basis starting with the next budget, so as to require no immediate adjustment for deviations of the Consumer Price Index from the forecast. Additionally, in the current budget the government raised spending by a much higher rate than the increase set forth by the expenditure rule. Both measures are meant to cope with the spread that has built up between the cost of the government's spending programs for the next few years and the long-term spending limit that it had adopted. In previous years, the government contended with these differentials by taking one-off measures, making accounting adjustments, and deferring some spending to a later time. In view of the continued expansion of the spending programs, however, and of the differential between their cost and the spending ceiling, the government decided in 2016 to broaden the budget framework. Contributing to this decision was the mechanism that controls long-term spending commitments (the numerator) that the government has adopted, making it difficult to create long-term budget commitments for which no source of funding has been established.

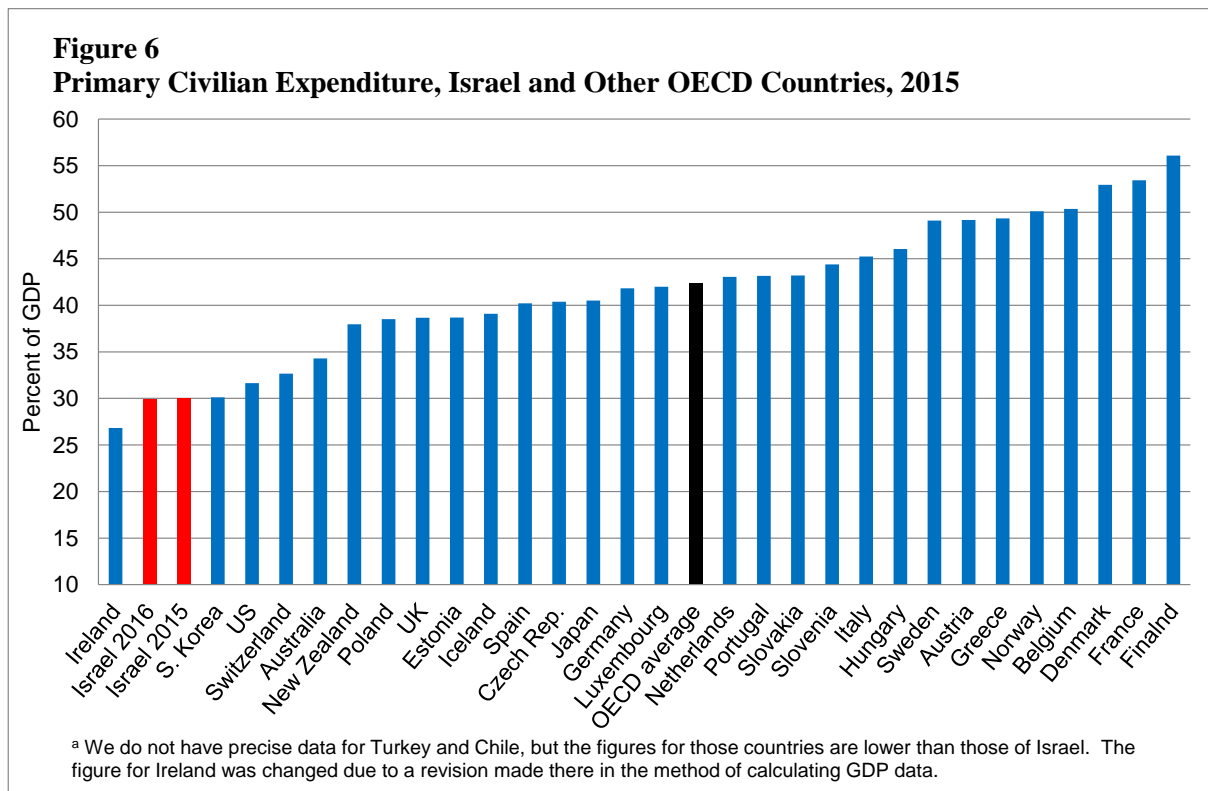
In the current budget, the government raised not only the spending ceiling but the deficit ceiling as well. On top of this, it lowered tax rates from 2018 onward in view of propitious macroeconomic conditions that are helping to boost tax revenues. Just the same, as stated above, in the current budget—as in its predecessors—much expenditure is funded by provisional transfers

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<sup>15</sup> Basic Law: State Budget for 2017 and 2018 (Special Provisions) (Ad Hoc Directive), *Sefer Huqim* (Israel lawbook), 2576, August 11, 2016, p. 1182.

<sup>16</sup> See detailed discussion in the previous fiscal survey: Bank of Israel, *Fiscal Survey and Selected Research Analyses* 141, October 2016.

from extrabudgetary entities or by recording the sale of assets (land) as budget revenue. Insofar as the government decides that spending should continue to accelerate—particularly given the very low level of primary civilian expenditure in Israel by OECD standards (Figure 6)—it will have to base implementation on more stable sources of revenue in order to avoid a permanent increase in the deficit and reversal of the downward trend of the debt-to-GDP ratio.



The expansion of public expenditure, coupled with the decrease in government interest payments (chiefly in 2017) and the mild upward slant of defense expenditure (most of which is in 2018), is manifested in a considerable increase in primary civilian expenditure, projected at more than 8 percent in 2017 and another 4 percent in 2018. Consequently, primary civilian expenditure is poised to increase considerably, by more than 1 percent of GDP, during the two years of the budget if the budget is fully performed. This will return civilian central government expenditure as a share of GDP to its level at the beginning of the previous decade, before the 2003 economic stabilization program. Even though some of the budgeted increase in expenditure will probably not be performed—particularly given the dependency of some expenditure items on realizing earmarked revenues from uncertain sources—this is a significant move that will give the government more maneuvering room to narrow economic gaps, invest in physical and human infrastructure, and improve its services.

However, several expenditure items that can be performed only if uncertain earmarked revenues arrive are of major importance, especially building schools and improving infrastructure and transport. The government would do well to prepare in advance for the possibility that the earmarked revenues will not materialize, for example by keeping sources from unused expenditure items in order to avert the possibility of nonperformance of such activities. It is worth emphasizing that even after the increase, Israel’s civilian expenditure as a share of GDP remains almost the

lowest among the OECD member states, making it difficult for the government to steer resources toward policy measures that would consolidate economic growth in the long run.

The defense budget for 2017–2018 is the first to be constructed on the basis of the new multiyear outline that the government approved. Alongside the complex and detailed agreements that the ministries of Defense and Finance concluded concerning the components of the plan, the budget anchors a multiyear IDF program that overlaps the term of the outline and was approved by the ministerial cabinet on diplomatic and security affairs. Government and defense establishment adherence to the outline will bolster both the effectiveness of the defense establishment’s activity and the stability of the government’s budget conduct.

In addition to adopting the multiyear outline and action plan, two changes were made in 2016 in the way defense spending is presented in the state budget, making the budget more transparent:

1. From this budget onward, all military aid will be reported as revenue-dependent expenditure, and will therefore not be subject to the expenditure ceiling.<sup>17</sup> Previously, \$2.4 billion in assistance was included in the net budget—meaning that it was subject to the ceiling—and only the remaining \$700 million was recorded as revenue-dependent expenditure. The importance of this change, which does not affect the size of the defense budget, is that it makes the expenditure ceiling less sensitive to the exchange rate and, in particular, obviates the need for unnecessary budget adjustments due to currency depreciation. The net spending limit of the budget was lowered commensurate with the recording change.
2. A section titled “Other Defense Expenditure” (Section 31) was added to the state budget. It aggregates several defense-spending items, some of which were presented in the past as part of the budget reserve. By linking this section with the defense expenditure that is included in the familiar budget items, it becomes possible to identify the total defense burden in the budget and, concurrently, the size of the effective reserve in the total budget (Section 47). Although the budget often includes “hidden reserves” in other items—such as “Miscellaneous”—that have been performed at a paltry rate for many years, the recent measure will help to make the budget more transparent.

Relative to the measures that are meant to improve the presentation of defense expenditure in the budget, the way spending related to relocating IDF facilities to the Negev is less transparent. In the 2016 budget, this expenditure (NIS 3.3 billion) was recorded under “Miscellaneous Development Expenses” in the Ministry of Finance budget, and in the 2017 and 2018 budgets they were moved to the “Government Housing” item, instead of appearing in the defense budget. Furthermore, most expenditure under this item is recorded as revenue-dependent, meaning that it is not subject to the expenditure ceiling. This, even though the “revenue” on which the construction of army facilities depends is the sale of land—that is to say, the realization of government assets that was recorded in the past, per the conventional practice, as a funding item. Thus, the government has excepted a national project—relocating army bases—from the public expenditure that has to be kept under the expenditure ceiling. Concurrently, it has lowered the reported deficit.

### **3. *Fiscal targets for 2019 and 2020***

According to the new statutory budgeting rules, the government must review the state of the budget not only for years in which a budget has already been approved (2017 and 2018 at the present writing) but also in regard to goals for years farther ahead. Thus, government resolutions that need

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<sup>17</sup> Value Added Tax on the transfers will still be recorded in the net budget.

a budget expenditure or a revenue cut for implementation require the examination of budget aggregates for years following the current budget as well. Insofar as such resolutions are expected to cause a breach in the expenditure or deficit ceiling, the government must concurrently make adjustments that will prevent the aberration. This rule was adopted in order to stop the process, which has repeatedly occurred since the beginning of the decade, of governments resolving to make various expenditures in years following the current budget without reconciling them with the multiyear budget targets. When it then came time to approve the budget, the government had to abrogate or postpone some of its resolutions and slash or revise the budget targets. The new budgeting rules are supposed to thwart this process, which impaired the efficacy of government activity and the public's trust—both in the government's promises to apply programs on which it had decided, and in the credibility of expenditure and deficit ceilings that changed again and again.

In the 2017–2018 budgets as approved, the government narrowed budgeting disparities for ensuing years considerably by raising the expenditure and deficit ceilings. Since the expenditure ceiling is set each year in terms of a rate of change relative to the previous year, the expansion of the current budget will allow the government to accommodate the inventory of surplus liabilities from the past and carry on henceforth under tougher auditing. Concurrently, by raising the deficit ceiling the government gave itself room to increase spending without raising tax rates, and may even lower them, as stated above, when tax receipts grow.

The expected spending path for 2019 and 2020 shows that the government has applied restraint in making new spending commitments since the budget was approved, and that the foreseen level of expenditure in 2019 is only slightly higher than this year's spending limit. Although the beginning of 2019 is still a year and nine months away at this writing, this is a major improvement in budget behavior in comparison with previous years because in the past a larger overrun became apparent at an early stage. Still any government decision to increase spending before the budget is approved (and, practically speaking, until the end of 2019) will have to be accompanied by a decision to reduce other expenditure items. It is important to stress that, according to the existing rules, an increase in revenue does not absolve the government from having to respect this limitation, since the spending limit remains in effect irrespective of the deficit ceiling. Although compliance with the spending limit for 2019 is a challenge that the government probably can meet, the fact that expenditure is already bumping against the ceiling today also shows how restrictive the spending limit is relative to needs—given the very low level of civilian expenditure in Israel. Furthermore, more than NIS 2 billion in spending beyond the ceiling is already expected in 2020, because the government set the rate of increase of expenditure that year especially low—2.2 percent—in order to offset some of the expansion in the current budget. Even though the budget at issue pertains to a relatively far-off year, the expected gap shows how stressed the budget is by the current expenditure limit. The rate of increase of expenditure closely resembles the supplement derived from demographic developments and benefit-adjustment mechanisms, National Health Insurance, and education services—alongside the cost of the multiyear investment plans and the defense budget outline.

The deficit ceiling enshrined in law for 2019 is 2.5 percent of GDP, down 0.4 percent of GDP from the limits in the current budget. According to the current forecast and assuming that the government indeed stays within the spending limit, the deficit for 2019 is expected to be quite similar to the target set forth, even given the uncertainty due to the time that remains until then. The discrepancy shows, however, that the government's decisions on permanent cutbacks in tax rates, even if not placing the deficit target at risk in the near term, will distance it from the possibility of staying within the deficit target in subsequent years—particularly given the tension between

spending needs and the expenditure limit. A lower deficit—2.5 percent of GDP— is foreseen in 2020, but this is mainly due to the tough spending limit that was set for that year. Given this year's deficit target (2.25 percent of GDP) and the fact that expenditure set forth in existing government resolutions already breaches the ceiling, the government will have to make a total budget adjustment of more than NIS 6 billion to safeguard the deficit ceiling. As stated, it is rather premature to make accurate forecasts for 2019, let alone 2020. The current estimates, however, indicate that the government will, from this year on, have to be cautious in adopting measures, such as tax cuts, that will structurally widen the gaps between the expected deficit and the deficit ceiling. This is particularly the case in view of recent years' experience showing that the government finds it hard to stay under the expenditure ceiling at its current level, as well as the cyclical nature of several factors behind the high level of revenues. It is also noteworthy that the deficit targets for 2019 and 2020 are set at the level that is needed to hold the debt to GDP ratio where it is today, and a deviation from these levels may cause the downward trend of the ratio to reverse itself.