

Chapter 6

The Public Sector and its Financing

- » The central government's budget deficit in 2025 amounted to 4.7 percent of GDP. The general government deficit totaled 6.5 percent of GDP—a decline from 9.0 percent in the previous year—while the debt-to-GDP ratio rose slightly, from 67.6 percent to 68.5 percent.
- » The budget deficit was broadly in line with the original target (4.9 percent of GDP), as the expenditure overrun was offset by a positive revenue surprise.
- » Defense expenditures in 2025 were only slightly lower than in 2024, despite the lower intensity of the war during most of the year. The fiscal cost of the war that began on October 7, 2023 is estimated at approximately NIS 350 billion over the years 2023–2026 (excluding decisions adopted since the beginning of Operation Roaring Lion—the military campaign against Iran that began in late February 2026), of which about NIS 116 billion were spent in 2025.
- » Roughly half of the war-related costs were financed through debt issuance. The share of debt financing declined during the year, reflecting an increase in tax revenues, which was largely due to tax measures amounting to about 1.5 percent of GDP that came into effect in 2025. The government also implemented expenditure-reducing measures, including a temporary freeze on public sector wages.
- » The adjustment programs approved alongside the supplementary 2024 budget and the original 2025 budget contributed significantly to strengthening market confidence in the government's capacity and commitment to address large-scale security shocks, particularly in view of the uncertainty prevailing at that time.
- » The structural deficit—which reflects the government's medium-term policy decisions and expectations regarding future measures—remains somewhat larger than the level necessary to stabilize the debt (around 3.2 percent of GDP), and certainly above the level needed to reduce it.
- » Following the war, Israel's debt-to-GDP ratio increased relative to that of the group of small, open, and advanced economies to which Israel was comparable on the eve of the COVID-19 crisis. The ratio of interest payments to GDP—which was already in the upper third among advanced OECD economies prior to the war—also rose.
- » The events of recent years have underscored Israel's exposure to global and domestic shocks that could sharply raise the debt-to-GDP ratio. It is therefore essential to restore orderly budgetary processes and to redefine fiscal targets, accompanied by credible measures aimed at reducing the debt-to-GDP ratio to a level that would provide Israel with the fiscal space needed to cope with future shocks.

350
billion shekels

The estimated **fiscal cost** of the war



Tax increases contributed to lowering the deficit this year to 4.7 percent of GDP

↑ 68.5%

The debt to GDP ratio **increased** due to the war



The deficit path for the coming years is **higher** than what is necessary to reduce the debt

1. MAIN POINTS

The fiscal cost of the war that began on October 7, 2023 is estimated at approximately NIS 350 billion.

The war that began on October 7, 2023 imposed a heavy fiscal burden on Israel. The defense and civilian fiscal costs of the war—estimated at NIS 350 billion—led to an increase in the deficit. As a result, the debt-to-GDP ratio, which stood at 60.5 percent at the beginning of 2023, rose sharply to 68.5 percent by the end of 2025, exceeding the OECD median of about 57 percent. In addition to the war-related expenditures already incurred, it appears that a substantial permanent increase in the defense budget will be required, the magnitude of which has yet to be determined, alongside civilian rehabilitation expenditures and higher interest payments resulting from the increase in debt.

The deficit declined, and was close to the original target, but remains higher than what is necessary to reduce the debt to GDP ratio.

Defense expenditures in 2025 were similar to those in 2024, despite the lower intensity of fighting during most of the year, and civilian expenditure also remained at its elevated level following last year's increase. Both the rise in defense spending and the increase in civilian expenditure included a temporary component, reflecting the war, and a structural component, related to the war's long-term implications and other structural factors. Consequently, the deficit remained higher than what is necessary to reduce the debt-to-GDP ratio, even though the general government deficit declined from 9.0 percent of GDP in the previous year to 6.5 percent in 2025. The decline in the deficit was supported by the government's decision, as part of the 2025 budget, to implement tax measures amounting to about 1.5 percent of GDP. Both these measures and the adjustment programs approved as part of the 2024 budget contributed significantly to strengthening market confidence in the government's capacity and commitment to address large-scale security shocks, particularly in view of the uncertainty prevailing at that time.

The uncertain security situation made it difficult to plan expenditures.

The year 2025 was characterized by high security and economic uncertainty, due to volatility in expectations regarding the duration, intensity, and implications of the fighting. This uncertainty made fiscal management and the assessment of required

expenditures particularly challenging. The materialization of the risk of security escalation required the use of the reserve allocated for 2025 and an update, in September 2025, of the expenditure framework and deficit ceiling. The use of the reserve (NIS 10 billion) increased the expenditure framework to NIS 619 billion, and it was subsequently expanded to NIS 650 billion (an addition of about 1.5 percent of GDP) due to Operation Rising Lion (the campaign against Iran in June 2025) and the continued fighting in Gaza. This was the fifth expansion of an approved budget framework since the outbreak of the war, reflecting the difficulty of planning expenditures under conditions of prolonged security uncertainty. Nevertheless, the 2025 deficit was similar to the level planned when the budget was approved by the Knesset (March 2025), as revenues were also higher than expected due to stronger-than-anticipated direct tax collection.

Despite the higher-than-expected expenses, the deficit remained close to what was planned thanks to surprising revenues.

Beyond the budgetary additions themselves, fiscal management in 2025 differed from the practices that prevailed prior to the war and the COVID-19 crisis. The 2026 budget process was delayed and conducted with limited transparency: the budget proposal was approved by the government only in early December, instead of at the end of August as would be optimal; the proposal that decision-makers submitted to the government left considerable uncertainty regarding the framework on which ministers would vote; and even after government approval, no detailed breakdown of civilian ministry expenditures was published. In addition, the budget passed its first reading in the Knesset only at the end of January 2026, a situation that required operating under an interim budget, limited in scope, during the first months of the year. At that time, Operation Roaring Lion (the campaign against Iran that began in late February) broke out, and the government was required to expand the 2026 budget framework before its approval by the Knesset. Furthermore, the payment mechanism for military reserve days without actual service, intended to encourage continued participation, was expanded in view of the heavy reserve duty burden on those serving.

The repeated expansions of the budget framework since the COVID-19 crisis and the war were received with acceptance by the markets, as reflected recently in the decline of the risk premium to levels close to those that prevailed before the war. This was partly due to the fact that the expansions were accompanied by permanent adjustment measures that offset a significant portion of the permanent expenditure increases. Nevertheless, it is important to prepare for potential future shocks. To support this, it is essential to return to institutional budgetary procedures and optimal approval processes, to redefine medium-term fiscal targets, and to establish a reliable multiyear planning framework that will lead to a gradual reduction in the debt-to-GDP ratio.

It is essential to return to institutional budgetary procedures and credible fiscal targets.

Budget Approval and Management Procedure

The budget preparation process in Israel is designed to enable informed decision-making, consistent fiscal planning, and parliamentary oversight. The process is based on the Basic Law: The State Economy (1975), on the fiscal rules formulated following the 1985 Economic Stabilization Program, and on the Deficit Reduction Law (1992), which for the first time established multiyear deficit targets and fiscal frameworks as a binding basis for budget preparation.

However, for several years—beginning with the sequence of biennial budgets and frequent elections at the end of the previous decade, through the COVID-19 pandemic, and up to the war years that began on October 7, 2023—Israel has not operated a regular and timely budgetary process. The orderly process, illustrated in the diagram below, begins with a discussion of the macroeconomic forecast, followed by a discussion of the budgetary frameworks, including the deficit target and the expenditure ceiling, which serve as anchors for budget planning. Subsequently, a detailed budget proposal is formulated in cooperation with the government ministries and submitted for government approval. The approved proposal is then presented to the Knesset for debate in the plenary and committees and for approval through the legislative process. The approved budget is binding on the government throughout the fiscal year, without ad hoc additions, except in exceptional circumstances (as indeed required in recent years).



Approval of the Budget Law – second and third readings
(during December)



Implementation, reporting, and monitoring during the fiscal year in
accordance with the approved budget
(during the fiscal year)

The economic literature that developed in the 1990s (for example, Von Hagen and Harden, 1995) emphasized that the establishment of binding fiscal frameworks at the outset of the budget approval process is a key condition for restraining excessive expenditure and improving fiscal performance. It transforms the resource constraint into a hard budget constraint, requiring ministries to align their demands with a predetermined framework that reduces “fiscal illusion”—that is, the tendency of ministers to overestimate the benefits of their ministries’ activities. This insight is consistent with more recent recommendations, including the International Monetary Fund’s Fiscal Transparency Handbook (IMF, 2018), which highlights the need for a clear distinction between the determination of the fiscal framework and the allocation of specific resources. The report also stresses the importance of adhering to the budget timetable, since without it, resources are allocated according to rules that have not been properly debated and with limited transparency. Both empirical research and international recommendations therefore indicate that an early and clearly defined framework is not merely a procedural component, but an essential institutional mechanism for strengthening fiscal discipline, enhancing transparency, and improving the credibility of fiscal policy and the efficiency of budgetary resource allocation.

Table 6.1 | The main components of the government's revenue and expenditures, 2015–2025

	percent of GDP						
	2015– 2019	2020	2021	2022	2023	2024	2025
Central government - budget definition							
Total public revenue	25.4	22.5	26.1	26.6	23.3	24.2	26.2
Total public expenditures	28	33.9	30.5	26.0	27.4	30.9	30.9
<i>of which</i> : Defense expenditures	5.3	5.0	4.7	4.2	5.2	8.4	7.8
Civilian expenditures	20.3	26.7	23.7	19.8	20.3	20.5	20.7
Initial deficit	0.3	9.3	2.3	-2.5	2.2	4.7	2.4
Interest expenditures	2.3	2.1	2.1	1.9	1.9	2.0	2.3
Total deficit	2.6	11.4	4.4	-0.6	4.1	6.7	4.7
General government - National Accounts definition							
Total public revenue	36.5	34.6	36.9	37.4	34.5	35.8	38.5
<i>of which</i> : Income from property	0.5	0.4	0.5	0.6	0.7	0.8	0.9
Total taxes	30.9	29.6	32.2	32.6	29.4	30.4	32.9
Indirect taxes on domestic production	12.3	11.5	12.5	12.2	10.5	11.1	11.7
Indirect taxes on civilian imports	2.8	2.7	2.8	2.8	2.5	2.6	2.4
Direct taxes, fees and levies	10.6	10.2	11.9	12.6	11.3	11.8	13.5
National Insurance Institute revenue	5.2	5.2	5.0	5.0	5.0	4.9	5.3
Grants	1.3	1.0	1.0	1.1	1.2	1.5	1.4
Other ^a	3.8	3.6	3.3	3.2	3.2	3.2	3.3
Total public expenditure^b	39.6	45.8	42.1	39.2	41.6	44.8	45.0
Current expenditure	36.8	42.5	39.3	36.2	37.9	41.0	41.3
Civilian expenditure on services and in-kind transfers	19.5	20.7	19.5	18.7	19.1	19.4	19.6
Domestic defense consumption	4.6	4.4	4.1	3.9	5.0	6.8	6.5
Defense imports	0.3	0.3	0.4	0.2	0.3	0.8	0.7
Direct subsidies	0.8	4.0	3.0	1.0	1.1	1.1	1.1
Transfer payments on current account	9.5	11.2	9.5	9.0	9.4	9.7	9.7
Interest payments ^c	2.2	2.0	2.8	3.4	2.9	3.1	3.6
Transfer payments on capital account ^d	0.6	0.5	0.6	0.8	1.3	1.4	1.0
Investments of the general government including investment grants ^b	2.2	2.8	2.2	2.2	2.5	2.5	2.8
<i>of which</i> : Net civilian investment	1.9	2.6	2.0	1.9	2.1	1.5	1.7
Primary civilian expenditure^b	32.4	39.0	34.6	31.4	33.0	33.1	33.1
Total deficit of the general government^{b,e}	3.1	11.3	5.1	1.8	7.1	9.0	6.5
Current deficit of the general government	1.7	9.4	4.3	0.7	4.7	6.5	4.3
Total cyclically adjusted deficit using international definition ^b	3.1	8.5	5.1	2.8	7.1	7.8	5.2
Net public debt ^{f,g}	58.0	67.0	64.1	58.3	59.2	64.9	66.4
Gross public debt ^f	60.8	71.1	67.8	60.5	61.3	67.6	68.5

^a Includes transfer payments from the public on the current and capital accounts, imputed pensions, civilian sales, capital transfers from abroad, and transfers from abroad to National Institutions and nonprofit organizations.

^b Excludes the reduction of expenses financed by the sale of land. Beginning with the 2022 statement, the recording of defense investments was moved from defense consumption and imports to government investments. Depreciation of defense fixed capital is recorded in domestic defense consumption.

^c Interest expenses are calculated on a cumulative nominal basis plus indexation differentials on the public debt.

^d Includes mortgage subsidies, discounts on state land, and transfers on the capital account to nonprofit organizations and businesses, including compensation from the property tax fund.

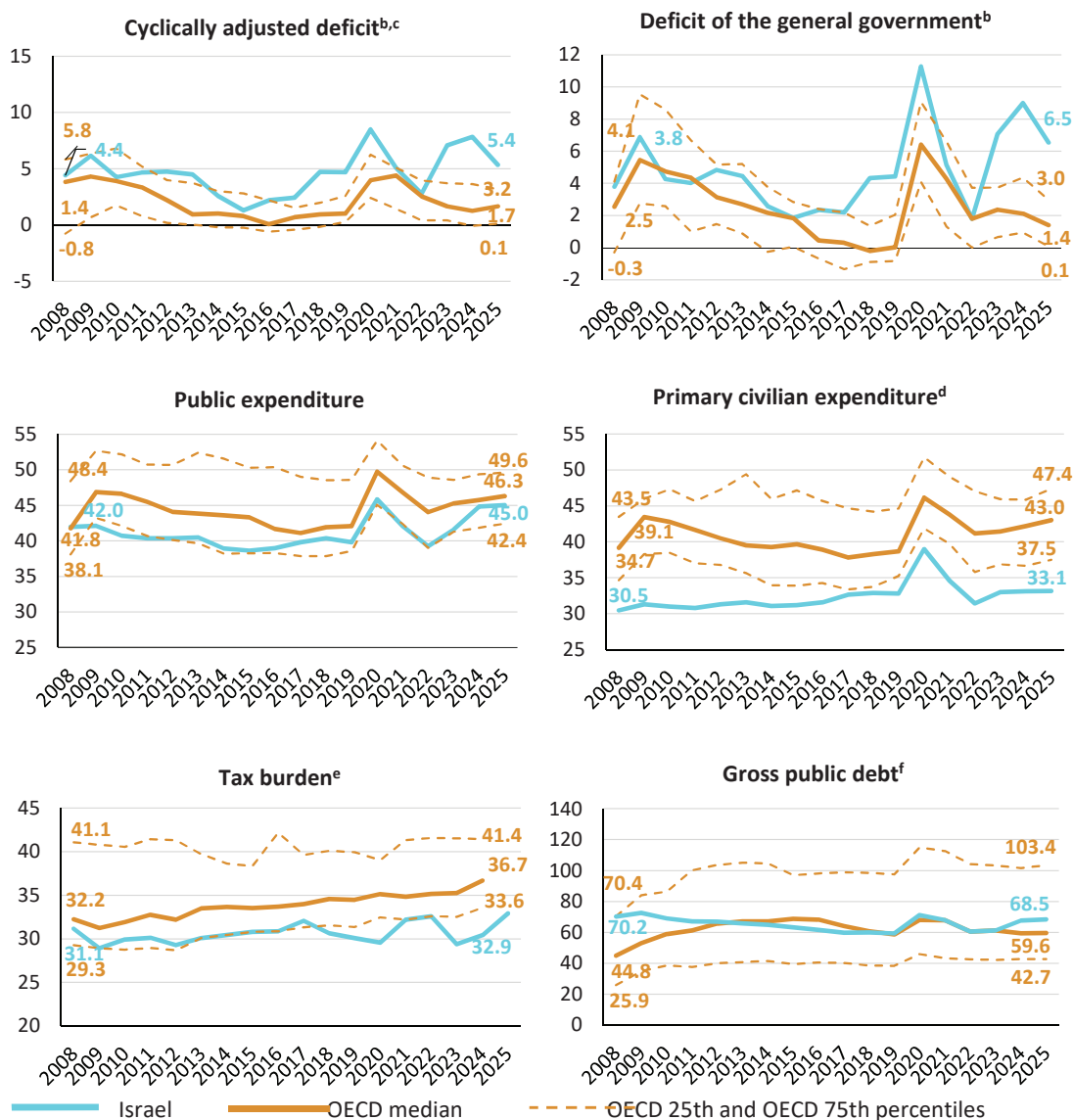
^e The general government's deficit is calculated in accordance with the National Accounts definitions, which differ from those used in calculating the central government's budget deficit.

^f Excluding municipalities' debts to the government.

^g Net public debt equals the gross public debt minus active loans minus government deposits with the Bank of Israel.

SOURCE: Based on Central Bureau of Statistics.

Figure 6.1 | The Fiscal Aggregates in Israel Compared to the OECD^a, 2008–2025
(percentage points)



^a Data for OECD countries are based on all member countries for which there are data.
^b According to the international definitions, excluding revenue from the sale of land.
^c The OECD estimates are as of February 2026.
^d Due to a lack of up-to-date data, defense expenditures in 2025 are equal to defense expenditures in 2023 for all countries, except for Israel.
^e The graphs are presented up to the last year for which there are data in the OECD systems (2024), except for Israel, for which there are data for 2025.
^f The data are in line with the International Monetary Fund's definition, and are taken from the IMF systems.
 SOURCE: Based on Central Bureau of Statistics data, OECD data (*Economic Outlook* 118, Dec. 2025, and Revenue

2. FISCAL AGGREGATES AND POLICY: CURRENT ANALYSIS

a. Public expenditures

Public expenditure remained about 3 percent of GDP higher than before the COVID-19 pandemic.

General government expenditure (according to the international definition of the national accounts¹) amounted to 45 percent of GDP—similar to the previous year (Table 6.1). In 2025, central government expenditure (net, according to the budget definitions²) totaled NIS 650 billion, equivalent to 31 percent of GDP. This ratio is similar to that of the previous year and is 3 percentage points higher than the average ratio during 2015–2019, mainly due to the war’s impact on defense spending and on various civilian expenditure items.

(1) Defense Expenditure

The cost of the war and its financing

Defense expenditures in 2025 declined only slightly compared with their level in 2024.

In 2025, defense expenditure declined only slightly compared with 2024 (Figure 6.2). This followed an addition of NIS 31 billion to the 2025 budget, approved by the Knesset in September. The addition financed Operation Rising Lion and the continuation of the fighting in Gaza beyond what had been anticipated when the original budget was approved. The high level of defense expenditure reflected an increase of about 6 percent (in current prices), and as a percentage of GDP, in the government’s domestic defense procurement. Both the rise in domestic government procurement and the higher payments to reserve soldiers represent a significant contribution of government activity to aggregate demand in the economy. (For further discussion, see Box 6.1 in this Report.)

The increase in the defense budget is expected to weigh on the budget in coming years.

Additional government expenditures resulting from the war are expected to total approximately NIS 350 billion for the years 2023–2026 (Table 6.2). This amount is considerably higher than the estimates made in the early stages of the war, which were reflected, for example, in the initial additions to the 2023 and 2024 budgets—about NIS 40 billion and NIS 70 billion, respectively. The escalation in cost is due to the war’s extension beyond expectations, the emergence of additional fronts, and a reassessment of the security challenges and the resulting need for ongoing military buildup. The increase in expenditure was gradual and manifested in four expansions of the budget frameworks during 2023 and 2024, as well as an addition to the 2025 budget. A substantial portion of the burden (about NIS 250 billion) was reflected in the defense budget, which grew beyond the original plan in each year of the war

¹ The general government comprises the central government, the National Insurance Institute, local authorities, and nonprofit institutions (such as health funds, universities, and religious seminaries) whose main source of income is the government, as well as the national institutions (the Jewish Agency, the Jewish National Fund, and the World Zionist Organization). Its activity is measured according to the national accounting definitions, which differ from those used in the state budget. Among other purposes, the definition of general government is used for international comparison.

² Central government expenditure (net) excludes expenditures that are conditional on revenues, such as defense assistance from the US.

(Figure 6.2). The increase in defense expenditure also includes the costs of military buildup, a significant part of which will weigh on the state budget in the coming years. Some of the civilian rehabilitation expenditures are also expected to persist in the medium term.

While most of the war expenditure in 2023 and 2024 was financed through the issuance of debt, the share of debt financing declined markedly in 2025, mainly due to tax increases and positive revenue surprises.

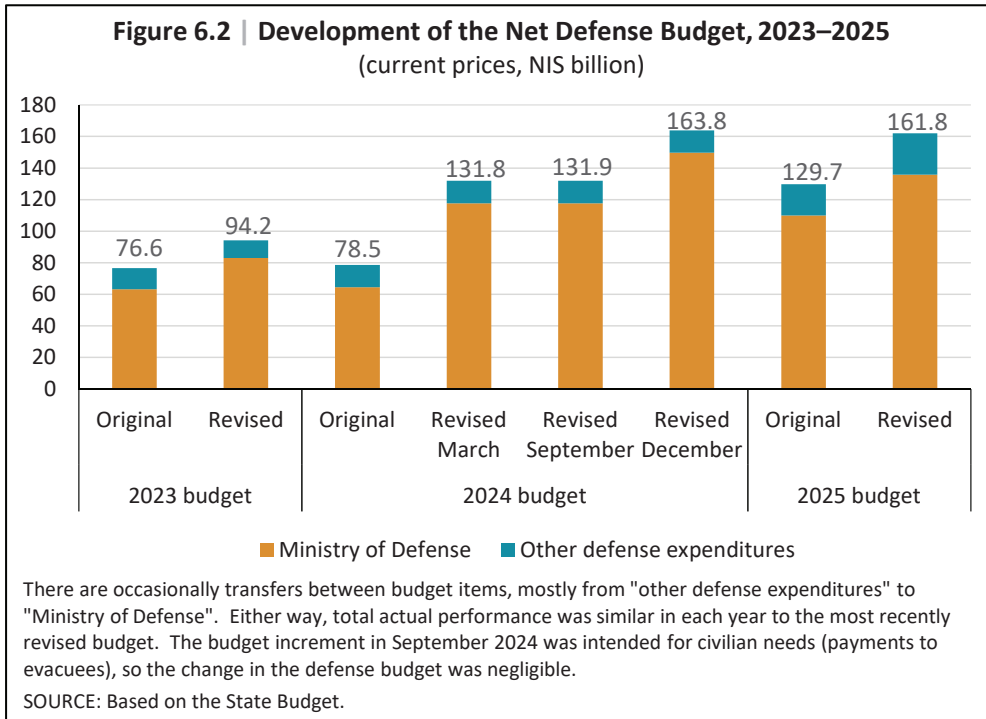


Table 6.2 | Government expenditures due to the war that began on Oct 7, 2023, and their financing

	NIS billion				
	2023	2024	2025	2026	Total
Costs					
Gross expenses increment	34	133	116	69	352
<i>of which:</i>					
Gross defense expenditures ^a	17	99	84	49	249
<i>of which:</i> Permanent increment to the defense budget ^b		10	28	29	67
Property tax fund: Compensation for direct and indirect damage	5	14	11	3	33
Other civilian expenditures ^c	12	19	15	11	57
Increase in interest payments on the government debt		1	6	6	13
Financing methods					
Tax increases		4	30	30	64
Anomalous taxes		32	30	10	72
Expenditure cuts			10	10	20
Special grant from the US		13	6	6	25
Total additional gross income and expenditure cuts		49	76	56	181
Debt and other (remainder) ^d	34	84	40	13	171

^aThe increase in defense expenditures includes all budget increments for the defense establishment beyond the multiyear agreement that was in place before the war, without the ability to separate between current budgeting and intensification budgeting. The increase does not include additional expenses that the government approved following the outbreak of Operation Roaring Lion, or the direct and indirect damages resulting from it.

^bThe permanent addition to the defense budget reflects an estimate based on the budget amount as part of the budget revision for 2023 and 2024 to the multiyear increment of NIS 82 billion until 2031, the increment required for rehabilitation of the disabled as a result of the war (NIS 3 billion in 2025 and NIS 4 billion in 2026), and an assumption that the government will adopt the Nagel Committee recommendations.

^c"Other civilian expenditures" includes the financing of evacuations, temporary reinforcement of internal security, expenses related to Operation "Rising Lion", and permanent increases due to the war, including internal security, mental health, rehabilitation and renewal programs in the north and the south, and expanded National Insurance expenditures for victims of war and terrorism.

^dThe "debt and other" component is a remainder component that includes the increase in debt, erosion of the nominal debt, diversion of expenditures from one year to the next, and other differentials.

SOURCE: Based on Ministry of Finance.

Developments in Payments to Reserve Soldiers

In 2025, according to National Insurance Institute data, reserve service compensation payments totaled NIS 21 billion, compared with NIS 26 billion in 2024. The decline in the volume of payments reflects the reduced intensity of the fighting.

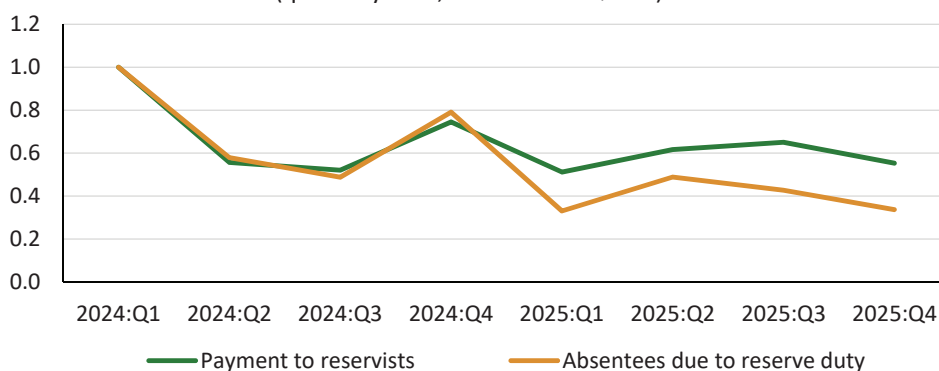
However, it appears that the decline in the total payments to reserve soldiers in 2025 was more moderate than the decline in the actual number of reservists, which can be estimated using the share of employees absent from work due to reserve duty, based on the Labor Force Survey (Figure 6.3).³ Although the Labor Force Survey data on the number of reservists do not cover the entire population of those serving, it is reasonable to assume that they reliably reflect the trend in this number. Therefore, the data as a whole suggest an expansion in the use of payments to reservists even during periods that did not include actual service.

³ It is not possible to identify all reservists in the Central Bureau of Statistics Labor Force Survey. In addition to those absent from work due to reserve duty, there are reservists who were not employed beforehand and therefore do not report absence from work, including regular soldiers who continued directly into reserve or career service as a result of the war.

Payments to reservists declined, but less than the decline in the actual service volume.

Figure 6.3 | Payment to Reservists^a, and Number of Work Absentees Due to Reserve Duty^b, 2024–2025

(quarterly data, index: 2024:Q1 = 1)



^a Payments to reservists are calculated using the Wage payments in the defense sector item from the National Accounts data. In each quarter since the beginning of the war, we deducted the average prewar wage payment for 2023, since the difference mainly reflects the increase in the volume of reservists due to the war.

^b The absentee number used to calculate the index includes absentees each week or part of a week due to reserve duty, from the Labor Force Survey.

SOURCE: Based on Central Bureau of Statistics.

Alongside the regular payments, the government also approved targeted grants and benefits intended to ease the financial burden resulting from prolonged service. As part of the extension of the “Reservists Program” for 2025, approved in December 2024, a total budget of approximately NIS 6 billion was allocated to finance monthly grants, family support, expanded mental health services, and additional benefits. These measures reflect recognition of the exceptional burden placed on reservists and the growing difficulty of relying on a limited supply of manpower under conditions of sustained demand for reserve forces. In the absence of a decision to increase the daily compensation rate, part of the response was provided through payments for days without actual service—a mechanism that lacks transparency and complicates reliable budget planning and oversight. In the medium term, reducing the exceptional burden on current reservists and the need for extraordinary compensation measures to offset it require an expansion of the regular army, alongside a transparent arrangement of compensation mechanisms for reserve soldiers.

(2) Civilian expenditures

In 2025, the general government’s primary civilian expenditure amounted to approximately 33 percent of GDP, similar to 2024, and 0.6 percent of GDP higher than the average during 2015–2019. Figure 6.4 provides a breakdown of the main components and aggregates of government expenditure. While most of the increase in total government expenditure compared with the pre-COVID-19 period was due

to the sharp rise in defense spending, civilian expenditure as a share of GDP also increased during this period. The increase reflects civilian war-related expenditures, primarily those of the “Reconstruction Administration,” which are expected to continue in the coming years. Excluding war-related expenditures, civilian spending (as a share of GDP) remained unchanged, with an increase in social insurance and welfare spending alongside a decline in education expenditure.

Civilian expenditures remained higher than in the years preceding COVID-19 and the war.

The stability of civilian expenditure relative to GDP (and its increase compared with the pre-COVID-19 years) occurred despite wage restraint in the public sector. As part of the fiscal consolidation measures due to the war, the government and the Histadrut agreed on steps that effectively froze across-the-board wage increases in this sector. This measure reflected the economy’s resilience, given the cooperation between the government and the Histadrut in addressing fiscal challenges. However, it also widened the wage gap between public sector employees and those in the business sector, where wages continued to rise rapidly (Figure 6.5). This gap may make it more difficult for the government to recruit high-quality employees. Moreover, the difficulty in reducing civilian expenditure relative to GDP, even when resources are needed for urgent purposes, reflects the fact that civilian expenditure in Israel is already very low by international comparison.

The difficulty in cutting civilian expenditures reflects their low level by international comparison.

Despite the increase in civilian expenditure relative to the pre-COVID-19 years, government civilian investment as a share of GDP has declined in recent years (Table 6.1). This trend has occurred despite population growth and the economy’s structural needs, and despite the importance of public investment as a foundation for long-term economic growth. Over the years, Bank of Israel reports have emphasized the contribution of public investment to increasing growth potential, as well as the persistent difficulties in implementing investment programs. The Bank of Israel has recommended considering the exclusion of investment in major infrastructure projects from the annual expenditure ceiling, alongside multiyear budgetary allocations for such investments, which would enable continuous planning and execution of projects.⁴ The erosion of public sector wages and the size of civilian public expenditure (particularly the scope of government investment) are among the structural challenges facing the government, which will be discussed further below.

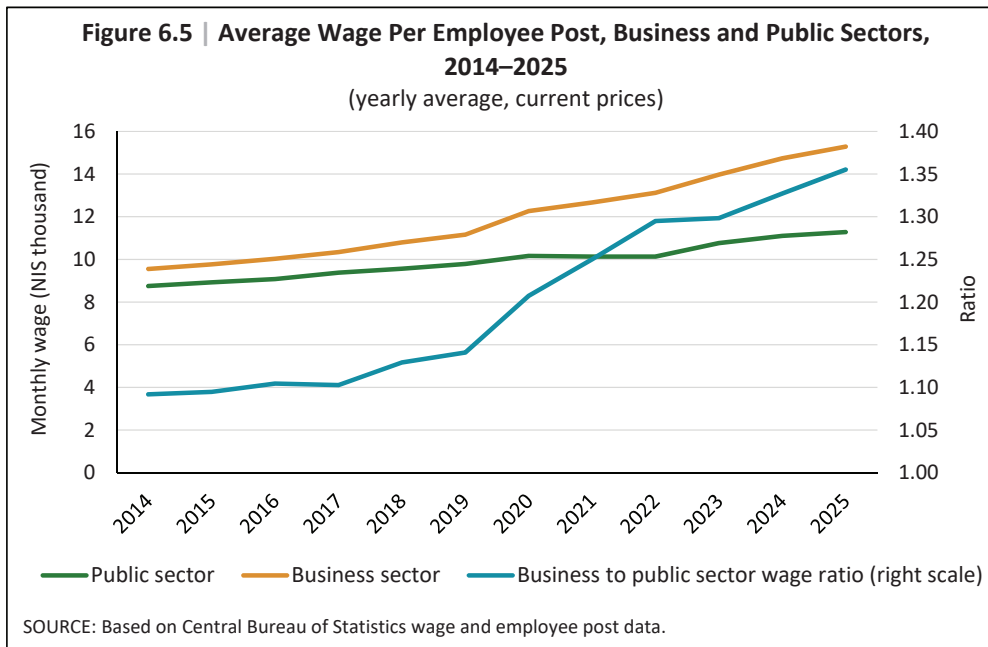
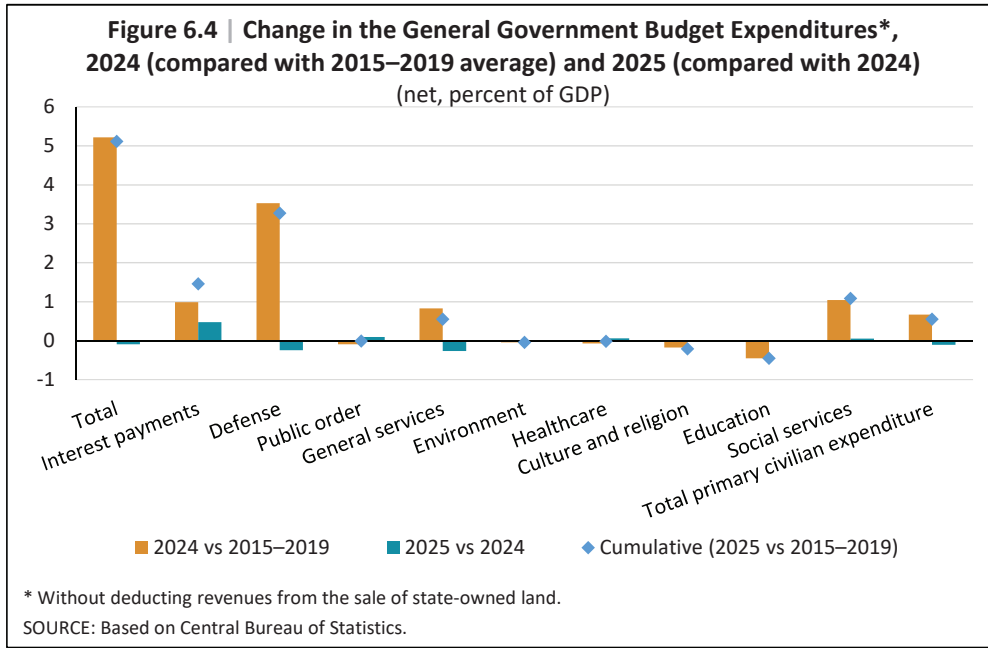
The government’s civilian investment has eroded, despite development needs and the increase in the population.

From the beginning of the war until the end of 2025, the Property Tax Fund paid compensation totaling approximately NIS 30 billion to those affected by direct and indirect war damage. A significant portion of these payments in 2025 was allocated to compensation for damages from Operation Rising Lion, estimated at about NIS 4 billion.⁵ The payments from the Property Tax Fund are reflected in the “Economic

⁴ See extensive discussion of this issue beginning on page 228 of the Bank of Israel Annual Report for 2021.

⁵ Some of the claims related to the operation are expected to be paid only in 2026, bringing the total amount to approximately NIS 6 billion. An additional portion of the damages from Operation Rising Lion was financed as part of the NIS 1.5 billion increase in the budgets of civilian ministries in 2025 in view of the operation.

services” item in Figure 6.4. They increase the general government deficit and contribute to the rise in the public debt-to-GDP ratio.



b. Revenues

Government revenues increased compared to the previous year.

General government revenue increased in 2025 both relative to 2024 (by 2.7 percent of GDP) and compared with the years 2015–2019—prior to the sharp fluctuations associated with the COVID-19 pandemic, the subsequent recovery, and the war that followed (Table 6.1). This increase largely reflects the tax hikes that came into effect at the beginning of the year, amounting to about 1.5 percent of GDP.

(1) Revenue-Side Measures Implemented in 2025

The tax increases that took effect explain a significant part of the increase in revenues.

In 2025, fiscal consolidation measures on the revenue side came into effect, totaling an estimated NIS 30 billion (Table 6.3). The main measures included: an increase in the VAT rate, effective January 2025, by one percentage point to 18 percent; the imposition of a tax on undistributed profits; the freezing of income tax brackets; and an increase in the rate of National Insurance contributions.⁶ Box 6.1 discusses the implications of these measures for the distribution of income.

Table 6.3 | Revenue-Side Measures that Took Effect in 2025

(NIS million in annual terms)

	2025	Full maturation ^a
Indirect taxation measures		
VAT increase by 1 percentage point to 18%	7,000	7,000
Direct taxation measures		
Taxation of undistributed profits in personal service	9,200	4,300
Increase in National Insurance premium rates	4,200	-
Freeze in the ceiling of the reduced National Insurance	1,800	3,200
Freeze in income tax brackets and credit points	2,600	7,300
Dividends from government corporations	2,000	-
2% surtax on capital gains above NIS 700,000	1,000	1,500
Other	2,600	3,800
Total	30,400	27,100

^a Full maturation - Expected receipts in the new permanent situation, after all legislative components take effect.

SOURCE: Based on Ministry of Finance budget booklet for the 2025 fiscal year.

⁶ For further discussion of the taxation of undistributed profits, see page 170 (Chapter 6) of the Bank of Israel Annual Report for 2024.

BOX 6.1: DISTRIBUTION OF THE TAX BURDEN ARISING FROM LEGISLATIVE CHANGES DURING THE WAR ACROSS INCOME QUINTILES

- » Several legislative changes to taxation were introduced during the war to assist in financing its costs. More than half of the additional burden was imposed on the top income quintile—higher than its share of total income.
- » The share of the additional tax burden borne by the two highest quintiles is slightly lower than their share of total tax payments prior to the war.

Several legislative changes to taxation were introduced during the war to help finance its costs, including various measures that increased taxes on consumption, labor, and capital gains. The overall tax increase amounted to about 1.5 percent of GDP. This box analyzes the distribution of the additional tax burden arising from all legislative changes that came into effect at the beginning of 2025 across income quintiles, defined based on total gross income per equivalized household member.

Table 1 describes about 85 percent of the total additional tax revenue associated with these legislative changes, for which a quintile breakdown can be performed. For the remaining measures, reliable data for such a breakdown are unavailable. Therefore, they are discussed qualitatively, alongside a sensitivity analysis of the estimates. The analysis is based on the revenue forecasts for each measure as estimated by the Ministry of Finance in the Numerator published in June 2025. We chose to rely on forecasted rather than actual revenues—both to better reflect policymakers’ intentions and because it is difficult to attribute excess actual revenue to specific measures based on available data. Moreover, a household’s avoidance of additional tax payments through behavioral changes, such as reduced consumption, does not imply that no additional burden was imposed on that household. The main measures analyzed are as follows¹:

Increase in VAT to 18 percent – The additional revenue from the one-percentage-point increase in VAT is estimated at about NIS 7 billion.² We assume that the burden of the VAT increase was distributed among quintiles according to each quintile’s share of total VAT-liable consumption, calculated using the Central Bureau of Statistics (CBS) 2022 Household Expenditure Survey. In this calculation, we assume—consistent with the research literature—that the increase in the VAT burden falls mainly on consumers rather than on producers and retailers (Benedek et al., 2015; Benzarti et al., 2020; Buettner & Madzharova, 2011). To the extent that part of the burden does fall on producers and retailers, this would likely increase the burden on the higher quintiles.

Taxation of Undistributed Profits (“Trapped Profits”) – This legislative change imposes an annual 2 percent tax on “trapped profits”—accumulated profits of companies that choose not to distribute them

¹ The findings reported here do not change significantly when using actual revenue estimates as published in the 2026 Budget Book.

² Part of the VAT is paid by the government. Reliable data on this share are unavailable, but we estimate it at about NIS 1.3 billion—approximately 18 percent of the total additional VAT payments—based on 2025 National Accounts data on public purchases and private consumption. We omit this amount from the analysis, but an alternative assumption that allocates the government’s VAT payments among quintiles according to the prewar distribution of tax payments does not materially change the results.

as dividends in order to defer tax payments and that are not used for real investment to expand the business.³ Unlike previous “dividend campaigns,” which generated one-off tax revenues at the expense of future collections, this measure creates a permanent source of revenue for the state budget. For further discussion, see Chapter 6 of the Bank of Israel Annual Report for 2024.

The total additional revenue from this measure is estimated at NIS 9 billion in 2025—NIS 5 billion of it permanent and the remainder one-off, resulting from the advancement of tax payments that would otherwise have been received several years later. We add one-quarter of the advanced amount to the permanent component, so that in the analysis we attribute an additional NIS 6 billion to the tax burden in 2025.

The phenomenon of deferred tax payments is common mainly among holding companies—legal entities that own other companies without additional real activity of their own—and among professional corporations whose profits derive from the services provided by the controlling owner. Ownership of such companies is highly concentrated among affluent groups, which use these structures as a means of tax deferral and savings. Accordingly, we attribute the entire tax burden arising from this legislation to the top income quintile.

National Insurance and Health Tax – The income brackets on which these taxes are calculated are indexed to the average wage in the economy. As part of the legislative changes, it was decided to freeze these brackets and to raise the health tax rate by 0.17 percentage points. The total expected revenue from these changes in 2025 amounts to NIS 5.3 billion. The distribution of the tax burden among quintiles for this measure was calculated according to labor income reported in the 2022 Household Expenditure Survey. Since these taxes are paid only up to a maximum wage of about NIS 50,000, with income above that threshold exempt, the distribution across quintiles is less progressive than that of other income taxes.

Freezing of Tax Credits and Income Tax Brackets – Similarly, the income tax brackets indexed to the Consumer Price Index were frozen this year. The impact of this freeze is estimated at NIS 2.5 billion, and we estimate its distribution among quintiles in the same way, based on labor income reported in the 2022 Household Expenditure Survey.

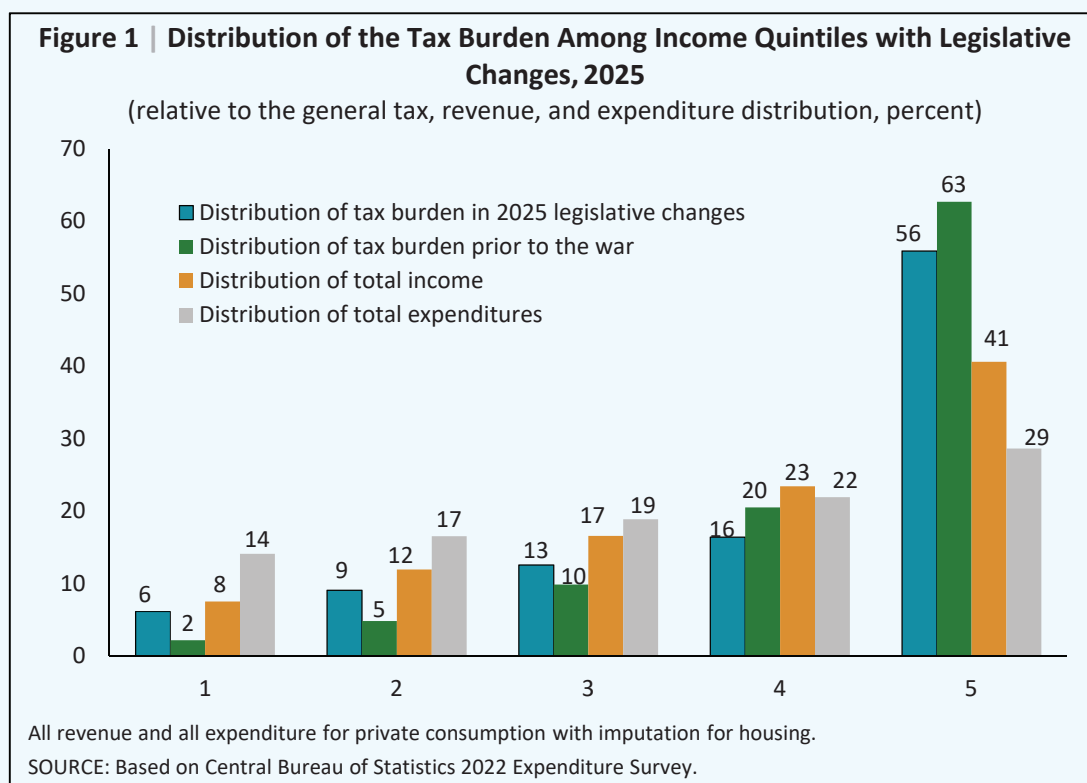
Increase in the Surtax on Capital Gains – The surtax on capital gains, with expected revenue of NIS 1.5 billion, is by definition levied on those at the very top of the income distribution and can therefore be attributed entirely to the top quintile.

Reduction in Convalescence Payments – Under an agreement between the Histadrut and the government, similar to that in 2024, it was agreed that for each employee entitled to convalescence days, the employer would pay the value of one convalescence day as tax instead of paying it to the employee. In addition, the value of the convalescence day was frozen. This measure was expected to increase tax revenue by NIS 1.1 billion. We distribute this cost among quintiles according to each quintile’s share of total employees in the survey, adjusted for the differing value of convalescence days in the public and private sectors.

³ In many cases, these profits are used to generate returns for controlling shareholders through passive investments in real estate or the capital market.

The distribution of the additional tax burden based on all the measures discussed here is presented in Table 1 and compared with the distribution of total income, total expenditure, and total tax payments prior to the war in Figure 1. The main additional tax burden was borne by the upper quintiles. In particular, the top quintile's share of the total additional burden is significantly higher than its share of total income or of total private consumption expenditure, while the shares of the other quintiles are lower than their shares of total income and expenditure. The combined share of the two highest quintiles is similar to, and only slightly lower than, their share of total tax payments prior to the war. By international comparison, the tax burden in Israel is relatively low for the third and fourth quintiles and high for the top quintile (see Box 6.2 in this Report). The legislative changes approved this year do not narrow these gaps.

Other measures not discussed here are mainly various vehicle-related tax changes, most of which involve the cancellation of benefits for electric vehicles and the reduction of the diesel subsidy in transportation (NIS 1.5 billion). We are unable to allocate these measures accurately.⁴



⁴ The taxation of banks, for which it is also difficult to determine the distribution across quintiles, was implemented in 2024, while the analysis here focuses on legislative changes enacted in 2025.

Table 1 | Distribution of tax burden among income quintiles due to legislative measures during the war

Quintile	Trapped profits	VAT increase	National insurance and health tax	Freezing credit points and income tax brackets	Surtax	Convalescence payments	Total
1	0	14	9	0	0	10	6
2	0	16	15	4	0	16	9
3	0	19	22	13	0	22	13
4	0	22	27	26	0	25	16
5	100	29	28	57	100	27	56
Total, NIS billion	6.0	5.7	5.3	2.5	1.5	1.1	22.1

SOURCE: Based on Central Bureau of Statistics 2022 Expenditure Survey and Ministry of Finance numerator.

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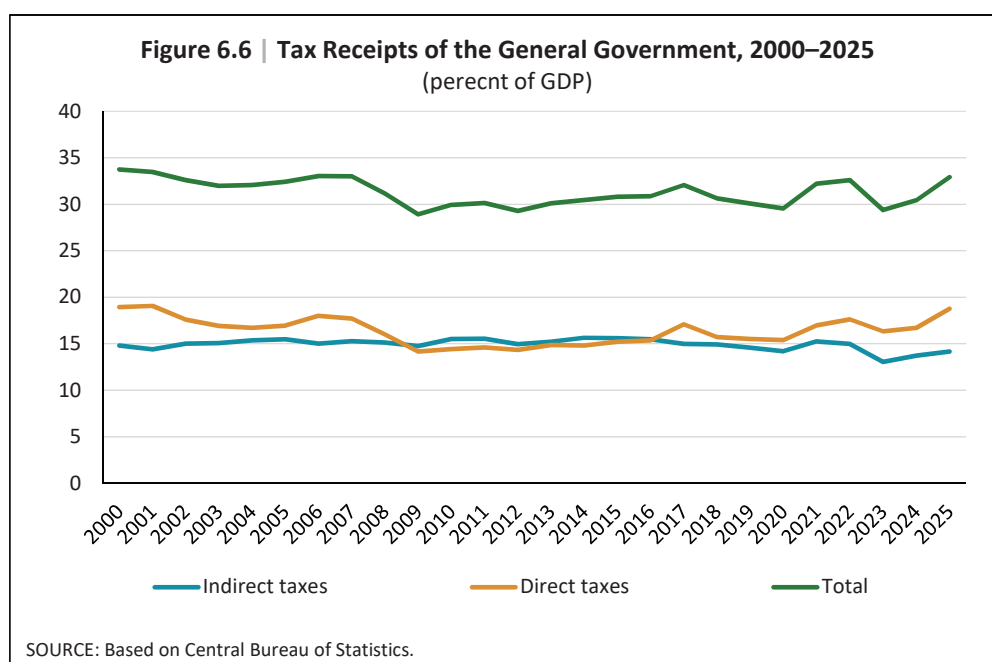
(2) Analysis of Tax Revenues and Surprises Relative to the Annual Forecast at the Time of Budget Submission

Tax revenues surprisingly exceeded the effect of legislative changes.

Tax revenues were pleasantly surprising from two perspectives. First, general government tax revenues were higher by 2 percent of GDP than the average during 2015–2019—a period that, as explained at the beginning of the revenue section, serves as a convenient reference point. Of this 2-percentage-point gap, 1.5 percentage points reflect the expected increase in tax revenues resulting from legislative changes, while the remainder reflects a positive surprise.

The surprise in revenues was mainly due to direct taxes, particularly corporate taxes.

As shown in Figure 6.6, the increase in the tax burden in 2025 mainly reflects higher revenues from direct taxes due to the government's measures. An analysis of the components of direct tax revenues indicates that the unexpected increase in direct tax receipts reflects higher corporate tax revenues, primarily in the financial, insurance, and information and communications industries. Indirect tax revenues rose by 0.6 percent of GDP, likely due mainly to the 1-percentage-point increase in the VAT rate—which was expected to yield about 0.4 percent of GDP—as well as the gradual increase in the tax on electric vehicles.



The second perspective concerns the surprise relative to the estimates made during budget preparation. Revenues exceeded those estimates by NIS 30 billion, equivalent to about 1.5 percent of GDP. An analysis using the Bank of Israel’s tax model (Brender and Navon, 2010) indicates that roughly two-thirds of the surprise relative to the forecast at the time of budget preparation (January 2025) came from better-than-expected economic performance—the nominal GDP was slightly higher than projected—and especially from a much sharper-than-expected increase in the general stock market index on the Tel Aviv Stock Exchange. In the Research Department’s tax model, this variable captures both the impact of the capital market on corporate and household capital gains and the business and consumer sentiment in the economy, partly through the wealth effect of a stock market boom on private consumption. The remaining third of the surprise reflects an unexplained residual, which may be related to behavioral changes following the taxation of undistributed profits or to other factors, such as the increase in profits of financial institutions, whose effective tax rate is higher than that of the rest of the business sector.

Following the Economic Efficiency Law (the “Arrangements Law”) for 2023–2024, the “Israel Invoices” model was implemented beginning in 2024, aimed at reducing the phenomenon of fictitious invoices. Under this model, which became mandatory in January 2024, the Tax Authority issues allocation numbers for tax invoices through an online system, and these numbers are required as a condition for input-tax deduction on transactions above a defined threshold. The threshold was reduced from NIS 20,000 in 2025 to NIS 10,000 in January 2026, and will be lowered further to NIS 5,000 in June 2026. These measures contribute to fairness and tax collection, but so far no exceptional increase has been observed in VAT revenues, as their growth is consistent with the VAT rate increase and the nominal expansion of economic activity.

c. The deficit

The general government deficit declined from 9.0 percent of GDP in 2024 to 6.5 percent in 2025, and the central government budget deficit fell from 6.7 percent of GDP to 4.7 percent between those years.^{7,8} The budget deficit reflects a primary deficit (the overall deficit excluding interest payments) of about 2.5 percent of GDP and interest expenditures of about 2.2 percent of GDP.

Despite the decline in the deficit, it remains higher than the level that would stabilize the debt to GDP ratio.

The reduction in the deficit resulted from three main factors: the fading of one-off war-related expenditures; the contribution of fiscal consolidation measures that came into effect at the beginning of 2025, particularly on the revenue side; and an improvement in the security and economic environment, which supported faster growth in tax revenues. Despite the decline, the budget deficit this year remained larger than the level necessary to stabilize the debt-to-GDP ratio (around 3.2 percent in the medium term; for a description of the calculation, see Section 3.d later in this chapter). Thus, although the fiscal contraction relative to the previous year—reflected in the decline in the deficit—was significant, the government still diverted resources from the private sector to the public sector compared with the prewar period, financing part of this shift through debt issuance.

3. THE FISCAL AGGREGATES FROM A STRUCTURAL PERSPECTIVE

a. Structural defense expenditure – The new normal and ongoing uncertainty

It appears that defense expenditure will remain significantly higher in the medium term than it was in the prewar period, although the precise magnitude is still unclear. In 2024, the “Committee to Examine the Defense Budget and Force Building” (the Nagel Committee) was appointed to determine Israel’s medium-term defense needs and to recommend a multiyear budgetary framework. At the beginning of 2025,

⁷ According to Central Bureau of Statistics (CBS) data, the general government deficit under the National Accounts definitions amounted to 5.2 percent of GDP. In this chapter, we refer to the central government budget deficit (4.7 percent) and to the general government deficit under the National Accounts definitions, with an adjusted calculation (6.5 percent). The reason for the gap between the CBS figure and the one presented here is that the CBS deducts the revenues from land sales (for housing purposes) from public investment, since the interpretation of the National Accounts rules is that land sales constitute negative government investment. An examination of OECD data in recent years shows that in most member countries such revenues are very small (about 0.05 percent of GDP on average), and that the deduction from investment reflects activities such as the sale of improved agricultural land or the purchase and renovation of public housing units and their sale to eligible households. In contrast, in Israel these revenues derive from the sale of land historically owned by the state—that is, from the realization of assets—and in 2025 they amounted to 1.3 percent of GDP. Since asset realization is essentially a financing transaction, we present public expenditure without this deduction and treat land sales as a financing item that moderates debt growth.

⁸ The sharper decline in the general government deficit (about 0.5 percentage points more) mainly reflects definitional differences, particularly regarding the timing of the recording of various transactions.

the committee submitted its recommendations. However, the government did not discuss them and did not adopt a clear multiyear budgetary path for defense. In parallel, in November 2025, the Prime Minister instructed that the defense budget be increased by NIS 250–350 billion over the coming decade (in addition to previously approved decisions)—an instruction that has not yet been formalized by a government resolution. A clear government decision is required regarding the scope of the permanent mediumterm defense budget, which would serve as an agreed basis for multiyear fiscal planning. Among other factors, this should take into account the economic and social implications of crowding out civilian budgets or raising taxes, as well as the uncertainty regarding the scope of US defense assistance in the coming years.

The increase in total expenditure, presented in Figure 6.7 in Section 3.d below, reflects the assumption that, in addition to the defense budget increases already approved in the 2024 and 2025 budgets, further defense expenditures will be added in line with the Nagel Committee’s recommendations (about NIS 13.5 billion per year). Under this assumption, defense expenditure during 2026–2030 will amount to approximately 5.5 percent of GDP—1.5 percentage points higher than the prewar estimate for those years. Defense expenditure could be even higher if, for example, the government adopts the Prime Minister’s proposed path for an additional increase in the defense budget.

b. Long-term trends in civilian expenditure and possible implications of its erosion

The government’s structural civilian expenditure is expected to increase in the coming years for two main reasons. The first is the financing of rehabilitation needs in the southern and northern regions affected by the war, budgeted at NIS 30 billion through the end of 2029, as well as compensation for civilian war victims. The second is accelerated growth in social assistance. Expenditure on the National Insurance Institute’s long-term care benefit has risen sharply beyond the growth rate of the elderly population, due to expanded eligibility following changes in the implementation of benefit entitlement rules, as discussed in the Bank of Israel Annual Report for 2024 (Chapter 7).

When defense spending, rehabilitation needs, and long-term care costs increase without full adjustment on the revenue side, debt is expected to rise. Under current circumstances, this indeed appears to be the case, despite the government’s revenue-side consolidation measures and the positive revenue surprise. The government therefore faces two undesirable alternatives. The first is to continue increasing the public debt-to-GDP ratio. This would lead to higher interest payments, which in turn come at the expense of other expenditure items (or generate further debt growth,

Civilian rehabilitation expenditures are expected to further pressure the budget in the medium term.

in a self-reinforcing cycle).⁹ Interest payments during 2026–2030 are expected to average about 2.5 percent of GDP—an increase of 0.5 percentage points compared with 2023—due to both the growth in the stock of debt and the rise in interest rates on the debt. The latter mainly reflects the global interest rate environment in recent years, but also, to some extent, the increase in Israel’s risk premium. Box 6.3 below discusses the challenge of reducing the debt-to-GDP ratio in the current interest rate environment.

The second alternative is to reduce civilian expenditure. Israel already has low civilian expenditure relative to GDP compared with the average in other advanced economies, including in growth-enhancing areas such as education, infrastructure, and research and development.¹⁰ This is despite the fact that Israel’s stock of public capital is low relative to those countries and its population growth rate is higher. The decision to freeze public sector wages in 2025–2026 in order to finance part of the cost of the war is an example of the potential cost of excessive restraint in civilian spending. Alongside the phenomenon of public sector wage erosion over the past decade (Figure 6.5), there has been a decline in the quality of human capital among younger public sector employees (Mazar, 2025). Prolonged wage restraint may exacerbate the difficulty of attracting and retaining skilled professionals—such as teachers, physicians, engineers, scientists, economists, and lawyers—in the public sector, with implications for the quality of services in key areas such as education, healthcare, planning, regulation, and enforcement.

Chapter 1 of this Report expands on the multidimensional dilemma facing the government: the need to reduce the debt-to-GDP ratio while simultaneously increasing the defense budget, addressing the economy’s development needs, and maintaining the public’s standard of living and the quality of public services.

c. Tax policy in view of the structural challenge

The positive surprise in tax revenues this year was concentrated in corporate tax receipts in certain industries. Such one-off surprises have occurred in the past, but over time, the ratio of tax revenues to GDP is stable in the absence of changes in tax rates and rules. For example, in 2021 and 2022, tax revenues increased due to significant expansion in high-tech activity, a boom in the capital market, and a surge in the housing market. However, in 2023 (even before the war), tax revenues declined and returned to the level that characterized the 2015–2019 period (about 22.5 percent of GDP).¹¹

The consolidation measures approved on the revenue side raise tax revenues by 1.5 percent of GDP in the medium term, but this increase is insufficient to offset the

The positive surprise in taxes this year is not an alternative to a structural fiscal solution.

⁹ The Chief Economist at the Ministry of Finance has addressed such implications of rising debt. See Gilad Brand and Gal Katz (2026), *The Implications of Stabilizing at a Higher Debt-to-GDP Ratio versus Reducing It*, Chief Economist Department, Ministry of Finance, February 2026.

¹⁰ For details, see Box 6.2 in the Bank of Israel Annual Report for 2024.

¹¹ See discussion on pages 180–181 of the Bank of Israel Annual Report for 2023.

structural increase in expenditures. Moreover, the decisions to raise the exemption threshold for personal imports to US\$ 130 and to widen income tax brackets—expected to reduce state revenues by about NIS 5 billion per year—precisely when further adjustments are needed to reduce the structural deficit, are inconsistent with the effort to rebuild the fiscal buffers that were eroded during the war.

Research by Brender and Politzer (2018) shows that, because tax changes affect economic activity in the short term, a tax increase yields, in that period, about 70 percent of the revenue that would be expected under a static calculation that does not account for changes in activity following the change in the tax rate. In contrast, the longer-term effect (three years and beyond) is roughly similar to the static estimate. More broadly, the research literature on fiscal multipliers of tax changes—the rate of decline of GDP growth in response to a one-percentage-point increase in the tax burden—presents a wide range of estimates, from 0 to 1 percent of GDP in studies using structural models (for example, Blanchard & Perotti, 2002) to about 3 percent of GDP after several years in studies examining exogenous tax changes in specific situations (for example, Romer & Romer, 2010). However, a comprehensive survey by Alinaghi and Reed (2021) found a much more moderate effect, consistent with the findings of Brender and Politzer: A one-percentage-point increase in the tax burden reduces the annual GDP growth rate by about one-tenth of a percentage point.

The tax increases that were approved are not sufficient to offset the structural increase in expenditures.

BOX 6.2: DISTRIBUTION OF THE TAX BURDEN BY INTERNATIONAL COMPARISON

- » The burden of indirect taxation—that is, tax payments relative to household income—in Israel is high by international comparison across all income deciles. In addition, it declines as income rises, and this decline is steeper in Israel than in the comparison countries.
- » The overall tax burden, comprising both direct and indirect taxes, is lower in Israel than internationally in Deciles 5–8, but is similar to, or higher than, that in the comparison countries in the remaining deciles.

During 2024–2025, a number of tax increases were legislated, each affecting the various income deciles differently and therefore influencing the distribution of income. As a basis for examining these measures, it is necessary to present a picture of the distribution of the tax burden¹ in Israel prior to the war, and particularly how it compares with that in other advanced economies. Box 6.2 of the Bank of Israel Annual Report for 2024 showed that the direct tax burden borne by income deciles 5 through 8 prior to the war was lower than that of their counterparts in most advanced economies.² By contrast, in the other

¹ Tax payments by a decile relative to its income.

² For the purpose of comparison, we selected OECD member countries in Europe and North America, as well as Australia. In our assessment, these countries are suitable comparators in terms of welfare policy and inequality on the one hand, and economic growth on the other. In addition, they are representative of the OECD as a whole with respect to relevant macroeconomic variables, such as direct and indirect tax revenues as a share of GDP, measures of inequality, and per capita private consumption.

income groups in Israel, the direct tax burden was similar to, or higher than, that in the comparison countries.³ The box also showed that the marginal tax rate in the top decile is very high relative to that in the comparison countries. This box expands the findings with regard to the overall tax burden.

The components of total taxation in Israel differ markedly in their levels. While in 2019 direct tax revenues as a share of GDP in Israel were more than 3 percentage points lower than the OECD average (15.8 percent, compared with 19.2 percent, respectively), indirect tax revenues as a share of GDP were, by contrast, higher in Israel by half a percentage point (10.2 percent, compared with 9.7 percent, respectively).

In order to estimate the distribution of indirect tax payments—taxes on consumption (VAT), purchase taxes (on alcohol and tobacco), excise taxes, and import and customs duties—we first examine, for each consumption category, the distribution of consumption across income deciles.⁴ This distribution is then used as an estimate of the distribution of the tax collected on that category in each comparison country.^{5,6} Detailed data on consumption and indirect tax receipts for the comparison countries were available only for 2019. However, that year was found to be similar to 2023 in terms of tax rates and the aggregate volume of tax collection and consumption, both for Israel and for the comparison countries.⁷

Formally, the methodology used to calculate the distribution is described in Equation (1). For each country, we calculated the total annual expenditure on consumption (C) of goods and services of type *J* by decile *i*, and divided this amount by total economy-wide consumption of that type (the sum across all deciles, 1 through 10). We then multiplied the ratio obtained in the parentheses in Equation (1) by total net tax receipts (T) from households in that economy for consumption of type *J*. Thus, T_{ij} represents the total tax payments of decile *i* for consumption of type *J*. Thereafter, Equation (2) sums, for each decile *i*, its tax payments on all types of consumption ($j=1, \dots, 12$), and divides that amount by the decile's total annual economic income (income from capital and labor, plus income from private transfers) (*Y*).

$$(1) T_{ij} = \left(\frac{C_{ij}}{\sum_{i=1}^{10} C_{ij}} \right) T_j \quad (2) Tax Burden_i = \frac{\sum_{j=1}^{12} T_{ij}}{Y_i}$$

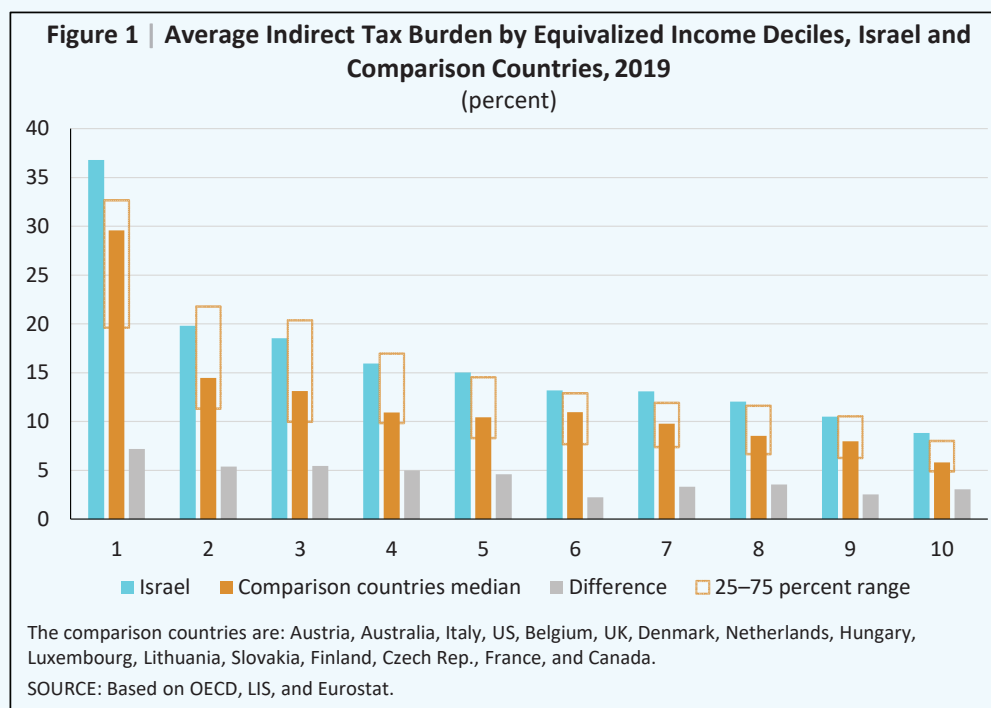
³ The analysis was based on 2019 data from the Luxembourg Income Study (LIS). An examination of more recent data for the period immediately preceding the war indicated that the findings of last year's box remain valid.

⁴ The deciles are ranked by equivalized per capita income. Specifically, the decile ranking is based on the OECD equivalence scale, which takes into account both the number of children in the household and their ages.

⁵ We used household consumption and income data from several sources: LIS, Eurostat, and additional national statistical agencies. For indirect tax receipts, we used the OECD's Supply and Use Tables (SUT) and Revenue Statistics databases, which include net taxes by product and tax revenues by tax type, respectively. Consumption is classified according to the COICOP classification of individual consumption by purpose.

⁶ The SUT database does not include Israel. Accordingly, for Israel we used revenue data from Revenue Statistics (RS), together with the estimated household share therein, in order to allocate tax payments.

⁷ Indirect tax revenues as a share of GDP declined between 2019 and 2023 in the comparison countries by about half a percentage point on average (SD=0.63), and in Israel by only 1 percentage point. The distribution of indirect taxes also appears not to have changed materially, in view of the following findings: Average per capita household consumption relative to the OECD average remained unchanged between 2019 and 2021; the distribution of consumption across purposes is generally stable over time (Eurostat data for 2005–2020); and the standard statutory VAT rates remained stable between 2019 and 2023, both in Israel and on average in the OECD (OECD, 2024).



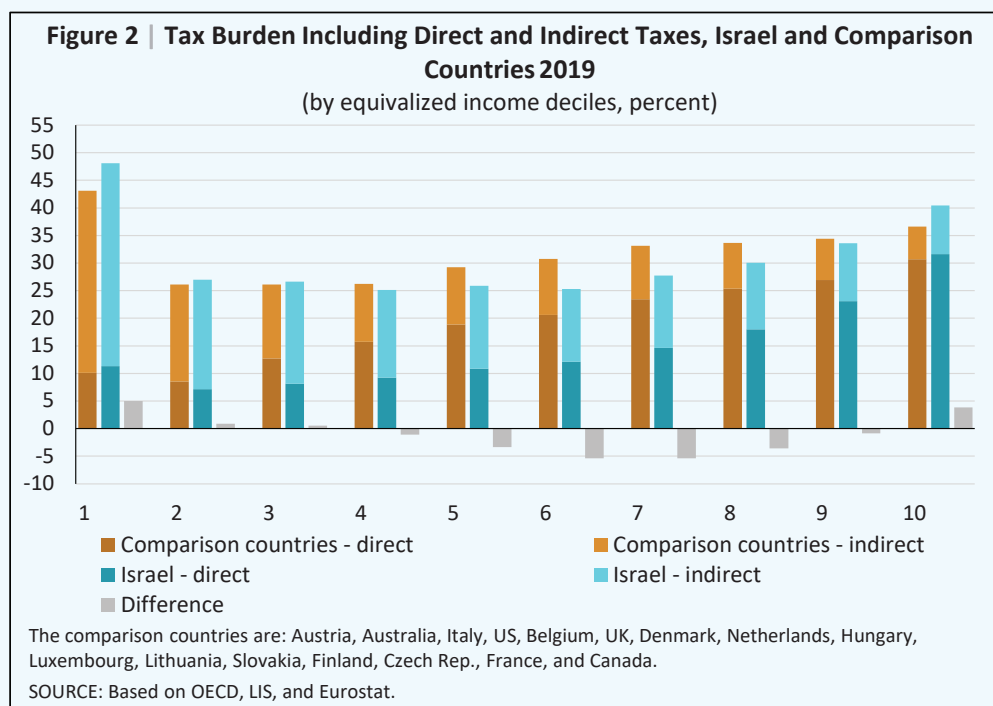
The findings of this analysis are presented in Figure 1. The burden of indirect taxation declines as income rises, both in Israel and in the comparison countries.⁸ The burden of indirect taxation in Israel is higher than in the comparison countries across all income deciles. However, the gap (shown in gray) is larger in the lower deciles. This finding in itself suggests that the substantial additional burden borne by the lower deciles in Israel should be taken into account when raising the VAT rate. Beyond that, the above analysis serves as the basis for our examination of the distribution of the overall tax burden.

Since the variation across deciles in the burden of indirect taxation is smaller than that observed for the direct tax burden, the distribution of the overall tax burden—including both direct and indirect taxes (Figure 2)—is similar to that found for direct taxes alone. In Israel, Deciles 5–8 pay less, relative to their income, than the median for those deciles in the comparison countries, with the gap reaching a trough of more than 5 percentage points (below zero) in Deciles 6 and 7.⁹ By contrast, the overall tax burden in Israel in the remaining deciles is similar to, or higher than, that in the comparison countries. These findings are largely maintained even when transfer payments are taken into account as a negative tax.

⁸ In this analysis, we assume that the burden of indirect taxation is fully borne by the consumer. However, adopting an assumption of only partial pass-through to the consumer—for example, in line with the estimates reported by Benedek et al. (2020)—yields an almost identical comparative picture.

⁹ For the comparison countries, each bar represents the median overall tax burden in a given income decile. It is important to note that this value is not necessarily equal to the median direct tax burden plus the median indirect tax burden. Accordingly, for each decile in each country, we first calculated the ratio between the direct taxes and the indirect taxes paid by that decile. We then calculated the median of this ratio for decile across all countries. The resulting value is therefore the ratio according to which direct and indirect taxes were allocated in the figure for the bar representing decile.

In general, the relative tax burden in Israel (that is, the gap) rises across all deciles—particularly in the lower deciles—but remains negative in Deciles 6–8, with the minimum in Decile 7.



Recently, the Israel Tax Authority published income estimates based on administrative data, which differ to some extent from those of the Central Bureau of Statistics (Israel Tax Authority, 2025). Nevertheless, the main discrepancies in the data relate to extreme values within the top decile and do not alter the principal conclusion regarding the gaps in the middle deciles—indeed, they sharpen it.¹⁰ In any event, an international survey contributes substantially in this context by maintaining consistency in definitions and reporting methods across countries, thereby supporting a reliable comparative analysis.

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¹⁰ We examined how these data, which include direct taxes, affect the distribution under review. In general, the tax burden declines across the upper half of the distribution and rises in the lower half, mainly because of the difference in the income distribution according to the Tax Authority data, which is considerably less equal and therefore affects the denominator. However, these changes mainly deepen the tax-burden gaps in Deciles 6–8, reaching a trough of more than 9 percentage points below zero in Decile 7.

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d. The structural deficit

The structural deficit reflects the gap between expected expenditures and revenues in the coming years, based on government decisions and other factors that influence spending, revenues, and growth—such as natural population increase and demographic composition. The structural deficit in the central government budget projected for the medium term (2026–2030) stands at about 3.7 percent of GDP. The structural primary deficit is estimated at about 1.3 percent of GDP, with the remainder consisting of interest expenditures.

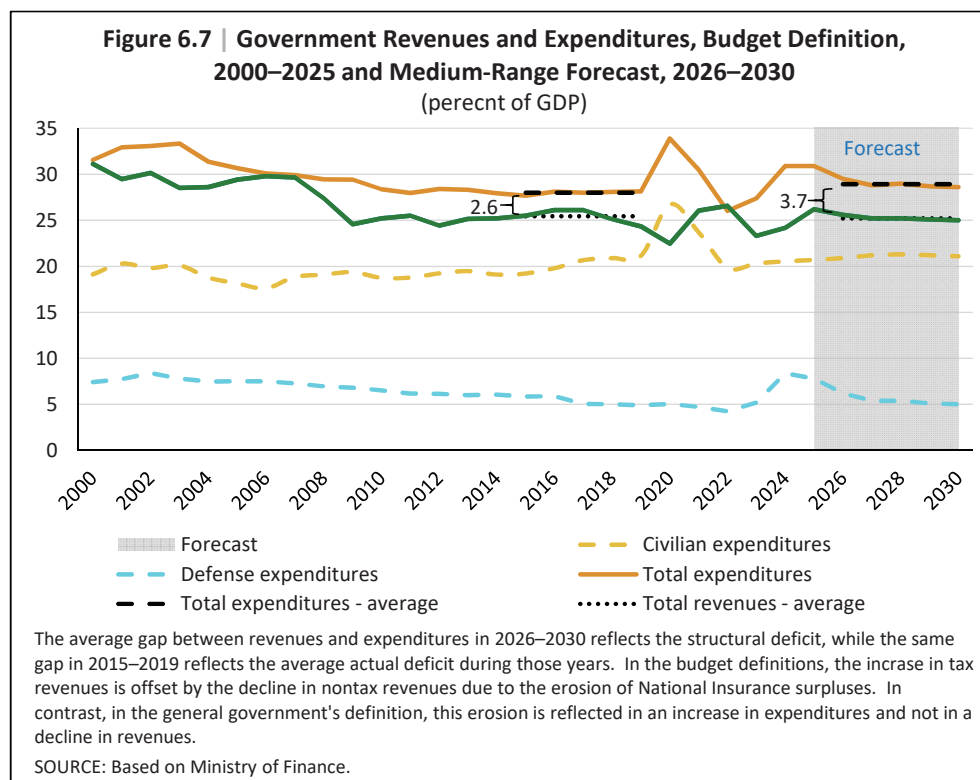
The gap shown in Figure 6.7 between expenditures and revenues in the medium term (2026–2030) represents the structural deficit. The increase in the projected medium-term deficit is primarily a result of the rise in total public expenditure relative to the 2015–2019 average, mainly due to a 0.5-percent-of-GDP increase in the defense budget. It is important to note that the defense budget prior to the war was on a downward trend relative to GDP, so the expected increase in 2026–2030 compared with prewar forecasts is even larger—particularly since defense spending may rise more sharply still.¹² In addition, civilian expenditures are also expected to grow in the coming years, mainly due to civilian rehabilitation spending following the war, as well as population aging and the easing of eligibility criteria for the National Insurance Institute’s long-term care benefit.¹³ The increase in the structural deficit resulting from higher expenditures is somewhat moderated by the tax increases, most of which took effect in 2025.

In the absence of further fiscal consolidation, the structural deficit is higher than the deficit level necessary to stabilize the debt-to-GDP ratio in the medium term (2026–2030). Under a scenario in which real GDP growth averages 3.5 percent, inflation averages 2 percent, and the government operates under a balanced budget, a debt ratio of about 68 percent of GDP would decline by 2.9 percent of GDP per year (CPI-linked debt erodes only relative to real growth, while shekel-denominated debt erodes relative to both real growth and GDP prices). Moreover, the government receives annual revenues averaging about 0.3 percent of GDP from the surplus income of the Israel Land Authority (which are not included in the deficit calculation but serve as a substitute for debt issuance). This means that the government can

¹² Defense expenditure during 2026–2030 is expected to be 1.5 percent of GDP higher than projected prior to the war.

¹³ For further discussion, see Chapter 7 of the Bank of Israel Annual Report for 2024.

finance a deficit of 3.2 percent of GDP per year without increasing the debt-to-GDP ratio, and that to achieve a sustained reduction in debt, a lower deficit is required.



4. PUBLIC DEBT AND THE POLICY NECESSARY TO REDUCE IT

a. Debt developments in 2025

The debt-to-GDP ratio increased for the third straight year.

In 2025, due to the high deficit (4.7 percent of GDP—about NIS 99 billion), the public debt-to-GDP ratio rose slightly, reaching 68.5 percent of GDP at year-end. This was the third consecutive year in which the debt ratio increased, bringing the cumulative rise over this period to about eight percentage points (Table 6.4).

The cost of financing the deficit declined compared with the peak reached during 2024, as did the spread relative to the government bonds of the United States and Germany (Figure 6.8). The decline in financing costs was particularly notable following Operation Rising Lion. About NIS 64 billion of the deficit was financed through net domestic debt issuance (that is, after deducting principal repayments), and about NIS 15 billion through net external debt issuance. Thus, foreign borrowing accounted for 18.5 percent of total new issuance—slightly higher than in the previous year and than the share of foreign sources in the total stock of debt (both around 15 percent). Part of the deficit was financed through privatization (about NIS 13 billion from land

Most of the financing for the deficit was through debt raised on the domestic market.

sales), and the remainder—about NIS 7 billion—through the use of government deposits at the Bank of Israel. The use of deposits narrowed the gap between gross and net debt (the latter defined as debt net of loans granted by the government and its deposits at the Bank of Israel).

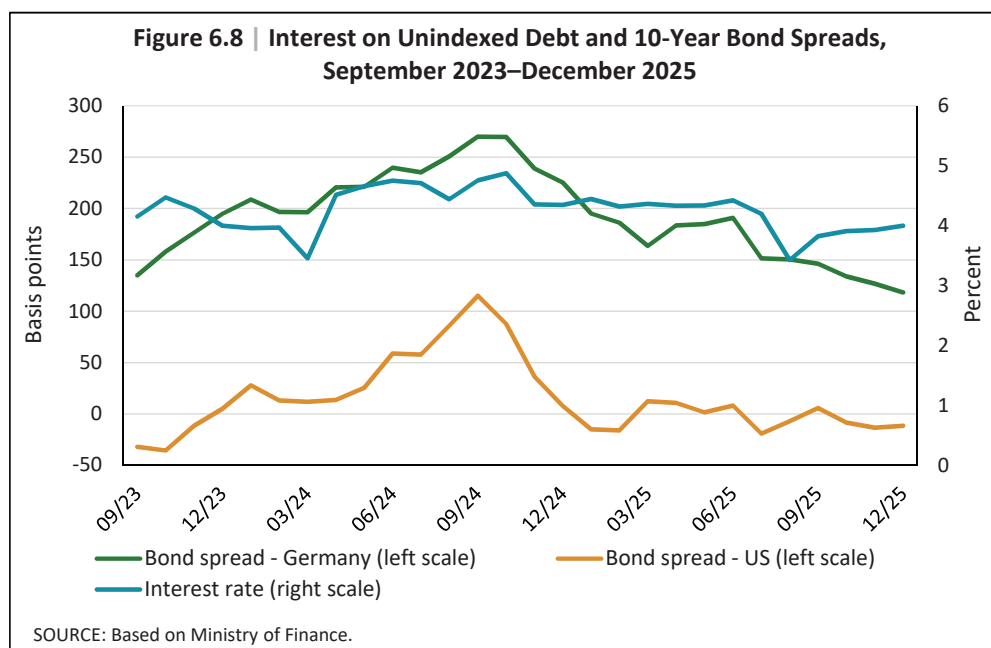


Table 6.4 | Components of the Increase in the Gross Public Debt to GDP Ratio, 2020–2025

	percent of GDP					
	2020	2021	2022	2023	2024	2025
Debt at the end of the previous year	59.3	71.1	67.8	60.5	61.3	67.6
Contribution of the change in nominal GDP to the debt to GDP ratio	0.4	-7.5	-7.0	-3.8	-3.8	-3.3
Net capital inflow	12.8	3.8	-2.7	2.9	8.3	3.7
<i>of which</i> : Government's cash deficit (excluding credit)	11.4	4.4	-0.6	4.1	6.7	4.7
Net repayment of credit by the public ^a	-0.04	-0.04	-0.04	-0.02	-0.04	-0.03
Privatization proceeds	0.0	-0.9	-0.9	-0.6	-0.2	-0.6
Funding beyond the financing deficit ^b	1.6	0.4	-1.2	-0.6	1.7	-0.3
Revaluation of shekel-denominated indexed debt ^c	-0.2	0.8	1.5	0.8	0.9	0.8
Revaluation of foreign currency-denominated debt	-0.4	-0.4	1.0	0.3	0.0	-1.0
Adjustment to issuance costs	-0.4	-0.2	0.1	0.4	0.5	0.1
Remainder ^d	-0.5	0.2	-0.3	0.2	0.4	0.5
Debt at year end	71.1	67.8	60.5	61.3	67.6	68.5

^a Including the provision of credit and principal collection.

^b Funding surplus.

^c Effect of the increase in the Consumer Price Index during the year on indexed debt.

^d As a result of roundings.

SOURCE: Based on Ministry of Finance and Central Bureau of Statistics.

The government also used deposits and land sales to finance the deficit.

The expansion of deposits in 2024 was consistent with the need to maintain a larger cash buffer to enable an immediate response to unforeseen expenditures under the fiscal and security uncertainty that characterized the wartime period. During 2025, the government financed its expenditures using this buffer, so deposits declined again—mainly after Operation Rising Lion and the ceasefire with Hamas, which reduced the risk premium in financial markets.

b. Considerations in determining the desired level and dynamics of public debt

The interest burden on the public debt is higher than in similar countries.

The rapid increase in debt in recent years, due to the need to finance the war, raises two key issues: the desirable level of Israel's debt ratio and its long-term dynamics. There is no definitive rule that determines the precise level of debt that is optimal or the level at which fiscal stability becomes endangered. A recent study by Berk and van Binsbergen (2026) demonstrates that different measures of government indebtedness present entirely different pictures of debt levels and dynamics: While in many countries the debt-to-GDP ratio (a stock-to-flow measure) has reached historical highs, other indicators—such as the ratio of interest payments to GDP (a flow-to-flow measure)—currently show a much more moderate picture and, in some countries, are even below their historical averages.

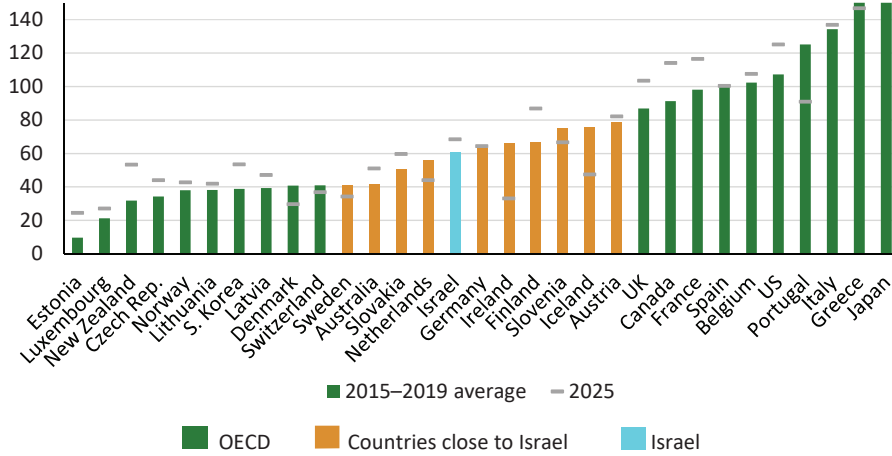
Israel's debt level is not low by international comparison, but is also not excessive.

Regarding the level of debt, Israel's debt-to-GDP ratio is not exceptional in international comparison, although it is higher than the median among advanced OECD economies (Figures 6.1 and 6.9a). However, an examination of the interest-payment burden presents a less favorable picture. Interest payments as a share of GDP in Israel are near the upper end of the distribution among comparison countries (Figure 6.9b). The gap is primarily due to Israel's relatively high risk premium, which was elevated even before the war and increased further during it. Despite the decline following Operation Rising Lion and the ceasefire in Gaza, Israel's risk premium remains higher than its level at the beginning of 2023. In addition, over the past two years, the composition of Israel's debt has also contributed to the rise in interest payments. A large portion of the debt is indexed to the Consumer Price Index (CPI), and under international definitions, interest payments include the revaluation of the indexed principal due to inflation. Although under Israel's budgetary definitions this revaluation is not included in interest payments, it is in practice a cost that must be taken into account—the indexed component of the debt increases with inflation, whereas in countries where only a small share of debt is indexed, inflation erodes the real value of the debt. This factor has become significant in recent years, unlike in the late 2010s, when inflation was near zero.

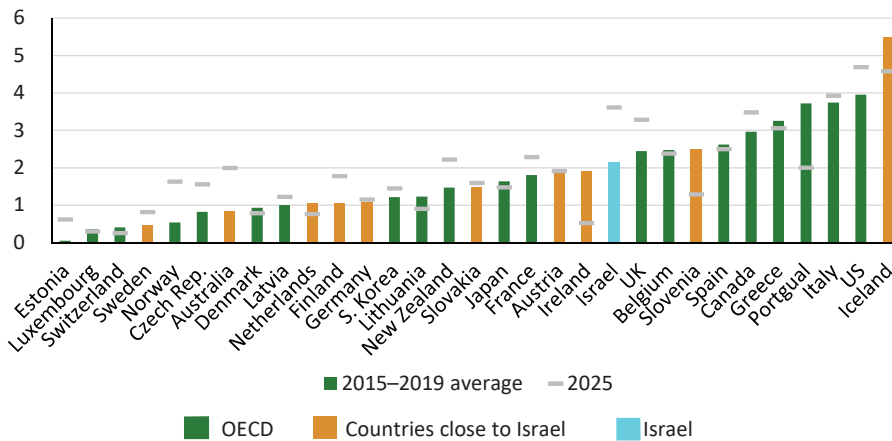
Figure 6.9 | Debt-to-GDP Ratio and Interest Payments, Israel and OECD

(percent of GDP)

a. Public debt (gross)



b. Interest payments (gross) on the debt



Interest rate data are under the National Accounts definitions. Interest payments under this definition include a revaluation of indexed debt. The comparison countries ("close to Israel") are the ten countries with debt-to-GDP ratios that were close to Israel between 2015 and 2019. Debt and interest data for the other countries are IMF forecasts from October 2025 and OECD forecasts from December 2025 respectively.

SOURCE: Based on Central Bureau of Statistics, OECD (Economic Outlook 118, December 2025 and Revenue Statistics, 2025), and International Monetary Fund.

Rising interest payments come at the expense of other government expenditures (or necessitate higher taxes or further debt accumulation). Moreover, financing a large share of war costs through debt means transferring the economic burden to future generations—both through ongoing interest payments and through the eventual need to repay the debt itself. This is therefore also an intergenerational issue: In which cases is it appropriate for the current generation to finance present consumption at

the expense of future generations, as opposed to financing infrastructure investment that will contribute to growth and benefit those future generations.

During 2015–2019, prior to the COVID-19 crisis, Israel’s debt ratio converged to around 60 percent of GDP. The ten countries whose debt-to-GDP ratios were closest to Israel’s during that period (marked in orange in Figures 6.9 and 6.10) consisted mainly of small, advanced economies—such as most Scandinavian countries, Slovakia, and the Netherlands. In general, small and open economies are more vulnerable to external shocks. Israel’s choice during those years to maintain a debt ratio within this range was historically linked to the European Union’s Maastricht Treaty, which limited member states’ debt ratios to 60 percent of GDP, but it was also consistent with Israel’s characteristics as a small and open economy, similar to the other countries in that group.

In addition to exposure to external economic shocks, Israel faces unique and significant security risks, as the war has demonstrated, and it lacks the fiscal-monetary backing enjoyed by the aforementioned countries as members of the European Union. A further increase in Israel’s debt ratio would bring it closer to the levels of larger economies (such as the United Kingdom) or those that have experienced debt crises (such as Spain). Moreover, the interest payment burden in 2024 in some of those countries is lower (for example, France and the United Kingdom, and even more so Japan—Figure 6.9b), as they benefit from more favorable financing conditions and can therefore sustain higher debt-to-GDP ratios.

The second—and perhaps more important—issue is debt dynamics. While the average debt ratio among the small, advanced economies to which Israel belonged in 2015–2019 declined by 2025 to below 60 percent following the shocks of the COVID-19 pandemic and the war in Ukraine (Figures 6.10a and 6.10b), Israel’s debt ratio surged from that level as a result of the war. Figure 6.10b shows that the cumulative change in Israel’s debt-to-GDP ratio since 2022 has been the largest among advanced OECD countries, except for Finland and Canada. The common perception that debt ratios are generally rising worldwide is not entirely accurate. While large economies—which account for a major share of global debt and output—have indeed experienced increases, in most advanced economies, including the group to which Israel previously belonged, the debt-to-GDP ratio has remained stable or even declined in recent years.

It is therefore important to halt the upward trajectory of Israel’s debt ratio and to aim for a return to lower levels, such as those that existed before the war—a debt ratio of around 60 percent of GDP, similar to other small and advanced economies. The events of the past two years have made such a necessity even more relevant now, clearly demonstrating that major security risks can materialize and sharply increase the debt ratio. While the recent rise in the debt ratio has not yet led to a significant increase in the risk premium or to debt divergence, it is impossible to predict how markets would react to a further increase to debt levels that Israel has not experienced in many years. Israel must return to a path of a stable debt ratio at a

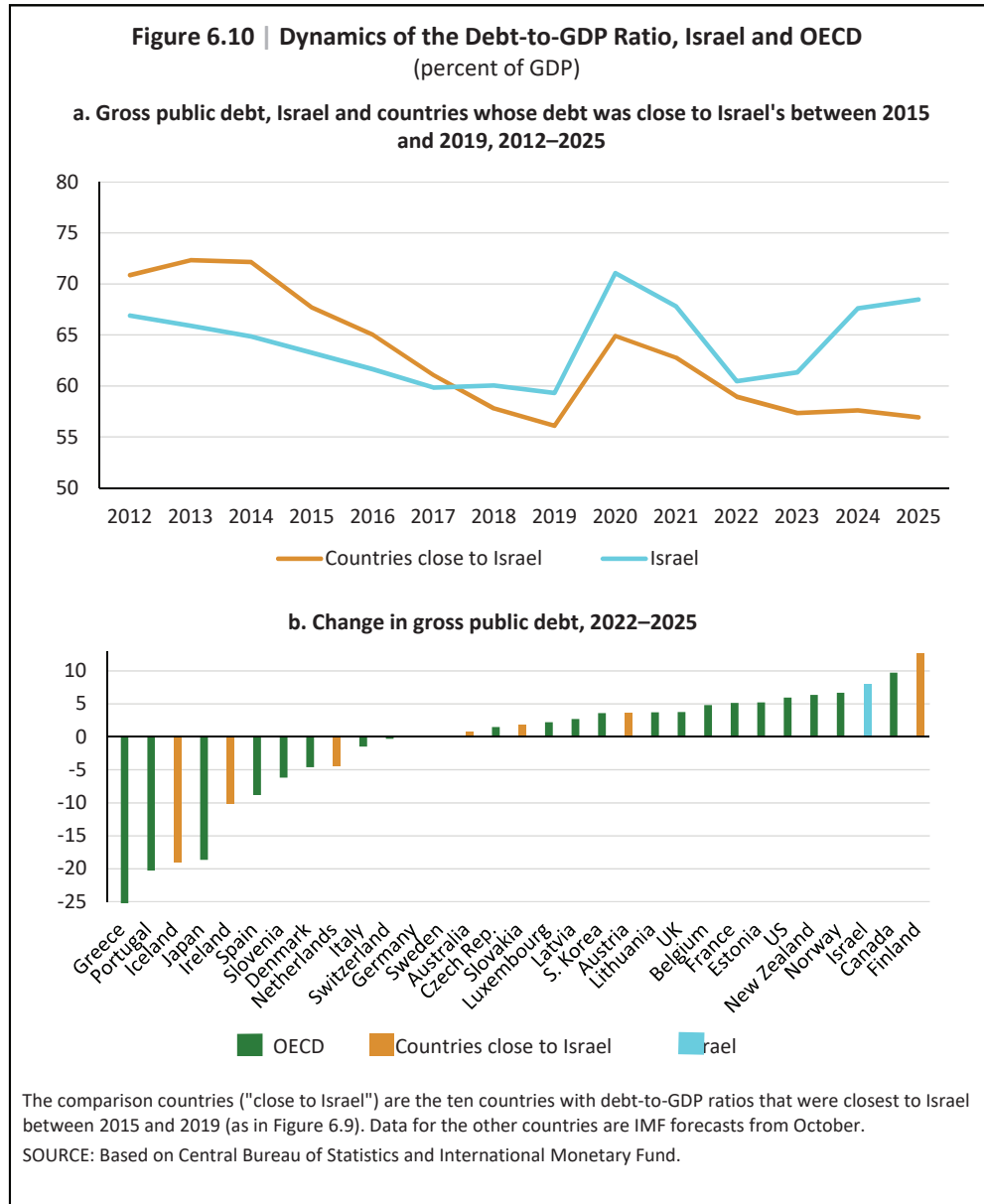
Prior to the war, Israel’s debt-to-GDP ratio was similar to other small, open, and advanced economies.

Due to the increase during the war, Israel’s debt-to-GDP ratio diverged from the comparison group.

A low debt-to-GDP ratio target is particularly important after the war.

Returning the debt-to-GDP ratio to a downward path is essential for rehabilitating the fiscal security margin.

lower level than the current one, thereby reducing the interest payment burden and enabling fiscal flexibility in coping with future security and other shocks.



BOX 6.3: THE CHALLENGE OF REDUCING PUBLIC DEBT IN THE HIGH-INTEREST-RATE ENVIRONMENT

This box defines two complementary diagnostic tools for assessing whether fiscal policy is consistent with stabilizing the debt-to-GDP ratio: (a) the stabilizing primary deficit (excluding interest), that is, the maximum primary deficit consistent with stabilizing the debt-to-GDP ratio, given the interest rate and growth rate; and (b) the fiscal equilibrium interest rate, namely, the effective real interest rate consistent with stabilizing the debt ratio, given the current primary deficit and the growth rate (Bolhuis et al., 2024).

The point of departure is the debt-to-GDP dynamics equation. Formally, the change in the debt-to-GDP ratio can be written as follows¹:

$$\Delta d_t \approx (r_t - g_t)d_{t-1} + pd_t$$

where Δd_t is the change in the debt-to-GDP ratio at time t , r_t is the real GDP growth rate, r_t is the real interest rate, d_{t-1} is the debt-to-GDP ratio in the previous period, and pd_t is the primary budget deficit as a percentage of GDP (expenditure net of interest payments on the debt, minus revenues).^{2,3}

Given equilibrium values for growth g , a target debt-to-GDP ratio d , and the interest rate r , it is possible to calculate the primary deficit that stabilizes the debt-to-GDP ratio, that is, a case in which $\Delta d = 0$:

$$pd^* = (\bar{g} - \bar{r})\bar{d}$$

This yields a useful rule of thumb: A 1-percentage-point increase in the equilibrium real interest rate reduces the primary deficit consistent with debt stabilization by d percent of GDP.⁴

The same condition can also be expressed in terms of the fiscal equilibrium interest rate, denoted as r_f^* , which is the real interest rate consistent with debt stabilization, given the current deficit:

$$r_f^* = \bar{g} - \frac{\overline{pd}}{\bar{d}}$$

¹ This equation is a linear approximation under the assumption that the interest rate and the growth rate are relatively small.

² Here, r denotes the effective real interest rate on the stock of debt, that is, a weighted average of real financing costs across debt instruments. When part of the debt is CPI-indexed, inflation does not erode the principal on the indexed portion. Therefore, indexation does not alter the stabilization formula, but it does affect the way in which the formula is calculated from nominal data.

³ Two additional factors that do not appear in the debt equation are the government's net capital receipts from asset sales (privatization) and debt revaluation resulting from relative changes in debt components, such as exchange rates and GDP prices. For further discussion, see Brender (2020).

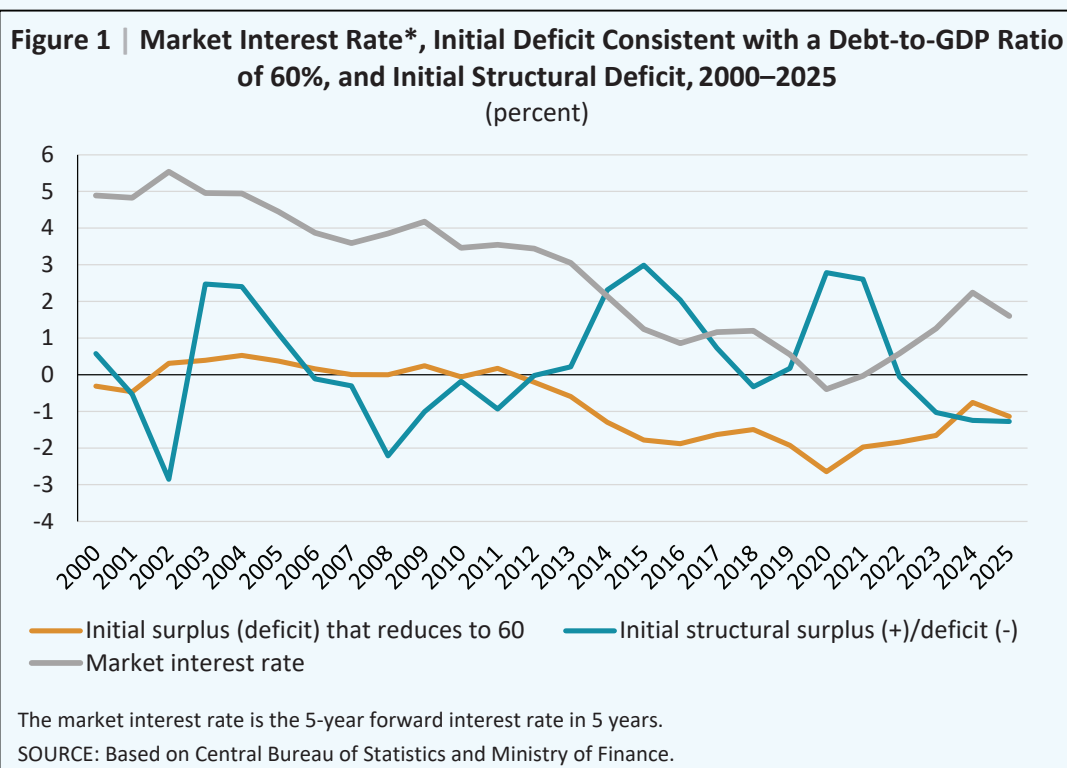
⁴ If the debt ratio is 70 percent of GDP, a permanent increase of 1 percentage point in the real interest rate changes the primary deficit required for debt stabilization by about 0.7 percent of GDP.

The interpretation is straightforward: If the effective real interest rate on the stock of debt is higher than r_f^* , the debt-to-GDP ratio tends to rise relative to the target. If it is lower than r_f^* , the debt ratio tends to decline relative to the target.

Calculating either the fiscal equilibrium interest rate or the debt-stabilizing deficit requires an assumption regarding equilibrium growth. For illustrative purposes, for 2025 we assume long-term real growth of 3.5 percent per year and a structural primary deficit of 1.3 percent of GDP. Under these assumptions, and in order to maintain the current debt-to-GDP ratio (68.5 percent), the implied fiscal equilibrium real interest rate is about 1.6 percent, similar to the prevailing market rate (for the 5–10 year horizon). Similarly, under the same growth assumption, and assuming the market rate is given at its December 2025 level (1.6 percent), the stabilizing primary deficit is:

$$pd^* = (0.035 - 0.016) \times 0.685 = 1.3\%$$

This value is similar to the actual structural primary deficit. The implication is that the gap between the structural primary deficit and pd^* is close to zero. If the effective real interest rate becomes persistently established above r_f^* (about 1.6 percent), fiscal tightening, that is, a reduction in the primary deficit, will be required in order to stabilize the debt ratio. A sustained increase of 1 percentage point in the interest rate above r_f^* would imply the need for tightening of about 0.7 percent of GDP.



As described in Section 4.b of this chapter, over recent decades the Government of Israel has aimed for a debt-to-GDP ratio of 60 percent, and even below that level. Accordingly, we present a historical perspective on the primary deficit required to move toward, or maintain, such a debt ratio, together with an estimate of the structural primary deficit and the market interest rates that prevailed. The decline in real yields globally and in Israel during the previous decade led to a decline in the primary deficit consistent with a 60 percent debt-to-GDP ratio, as emphasized by Blanchard (2019), such that even a primary deficit of 2 percent of GDP (about a 4 percent overall deficit) was consistent with maintaining a debt-to-GDP ratio of 60 percent. However, the increase in the global interest rate environment, alongside an increase in Israel's risk premium, has meant that the primary deficit now consistent with that outcome is about 1 percent of GDP. At the same time, the actual structural primary deficit has increased (that is, the surplus has declined), and now stands at 1.3 percent of GDP, slightly above the level required in order to reduce the debt-to-GDP ratio and bring it to 60 percent.

Debt duration, interest-rate scenarios, and an insight for fiscal policy under uncertainty

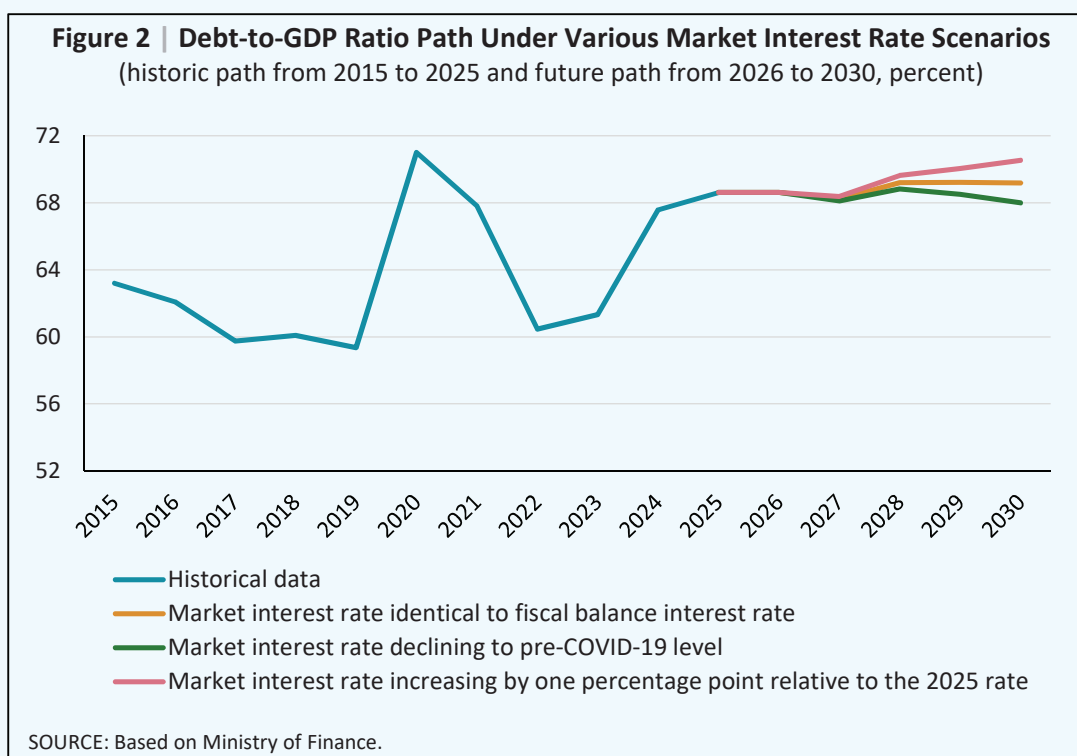
The fiscal equilibrium interest rate is a long-term anchor. In practice, however, government debt is not fully rolled over in each period at the current market rate. The interest rate that affects debt dynamics over the medium term is the effective interest rate on the stock of debt, namely, the average interest rate across outstanding bonds and new issuance.⁵ Because Israel's debt has a relatively long average maturity, about 9 years, the effective interest rate's convergence to the rate on new issuance is very gradual: roughly one-ninth of the stock matures and is refinanced each year.⁶ This is also the reason why the stabilizing primary deficit calculated here differs slightly from the effective stabilizing deficit discussed in the main text of the chapter.

Figure 2 presents three scenarios for the interest rate on new issuance and their implications for the debt-to-GDP ratio under the same primary deficit. In the baseline scenario, the interest rate on new issuance is around the fiscal equilibrium interest rate, and therefore, as the effective interest rate on the stock of debt converges to it, the debt ratio tends to stabilize. In an optimistic scenario, a decline in interest rates or in the risk premium allows for a gradual decline in debt, although it may also reflect expectations of lower growth, which in turn would contribute to an increase in the debt-to-GDP ratio. These were, for example, the conditions that prevailed for many years until the global interest-rate hiking cycle that began in 2022, partly under the influence of central bank bond purchases worldwide, and it does not appear likely that such conditions will return over the foreseeable horizon. In a pessimistic scenario, a persistent increase in the interest rate on new issuance creates upward pressure on debt

⁵ In practice, the interest rate on new issuance is not exogenous. In Israel the public debt-to-GDP ratio has been found to have a positive, statistically significant, and economically meaningful effect of on real yields of government bonds, with the effect stronger the longer the bond's maturity (Brender and Ribon, 2015). The transmission operates through two channels. A higher debt ratio increases the supply of bonds, putting downward pressure on prices and upward pressure on yields, and it also raises the risk premium perceived by investors.

⁶ This can be described approximately using a simple "transition equation": The effective interest rate this year is a combination of last year's effective interest rate and the interest rate on new issuance, where the weight of new issuance is determined approximately by the share of debt rolled over each year. In Israel, with an average maturity of about 9 years, this is on the order of about one-tenth of the stock of debt per year.

as the effective interest rate converges upward. At present, the 5-year real forward rate 5 years ahead is close to the fiscal equilibrium interest rate. Therefore, assuming stable growth and maintenance of the primary deficit at its current level, the debt ratio is also expected to remain around its current level over the medium term. Reducing the debt ratio in order to restore fiscal buffers to the Israeli economy would, under these conditions, require a reduction in the primary deficit. However, the margin of safety is small, and a moderate deterioration could shift the dynamics onto an upward path. Such deterioration could also occur as a result of the increase in the global debt-to-GDP ratio, which contributes to higher interest rates.



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