*Chapter 6*

# *The Public Sector and Its Financing*

- The Swords of Iron War has led to a significant increase in government expenditures for both security and civilian needs. The 2024 budget was revised three times to accommodate additional funding, amounting to approximately 5 percent of GDP, primarily to cover war-related costs.
- The growth in tax revenues compared to the previous year aligned with the increase in nominal GDP, which largely reflected the increased government activity.
- This year, the budget deficit was 6.8 percent of GDP, slightly above the expectations set during the approval of the revised budget in March 2024. The general government deficit reached 9.4 percent of GDP.
- At the end of 2024, the debt-to-GDP ratio was 67.8 percent, a sharp rise from 61.5 percent at the end of 2023.
- The government implemented significant convergence measures, effective at the beginning of 2025, which are sufficient to offset most of the permanent spending increases resulting from the war's impact.
- Despite these adjustment measures, the government's structural deficit (approximately 3.6 percent) is higher than the level required to reduce the debt-to-GDP ratio (around 3 percent). This is because, beyond the spending increase due to the war's medium-term effects, the government also raised other permanent expenditures.
- The rise in defense spending and interest payments due to the war reversed their long-standing downward trend, which had allowed for an increase in civilian spending over the past two decades without raising taxes and/or increasing the debt-to-GDP ratio.
- Given the structural risks and challenges facing the economy, a clear policy trajectory for the gradual reduction of the debt-to-GDP ratio over time is necessary in order to create renewed fiscal space while addressing the heightened security needs and promoting sustainable growth.
- Public spending on infrastructure and education is low by international standards, considering development needs and demographic trends.
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## 1. MAIN POINTS

### a. Background conditions and main developments in 2024

The Swords of Iron War led to a sharp increase in government expenditures.

The Swords of Iron War necessitated addressing the need to finance numerous reserve forces, armaments, evacuation of residents, rehabilitation of affected areas, and security enhancement, among other things. To this end, three budget increments totaling approximately NIS 106 billion were approved in 2024, following an increment of NIS 30 billion to the 2023 budget. The government's main fiscal dilemma was balancing the immediate needs of the war with the importance of maintaining the credibility of its commitment to a sustainable fiscal path. The government decided to finance the war expenses primarily by increasing the budget deficit to 6.8 percent of GDP. As the war continued and needs grew, particularly with the realization that security challenges would remain significant in the coming years, it became clear that substantial fiscal adjustments would be necessary. These were somewhat reflected in the 2024 budget and the decision to establish the Committee to Examine the Defense Budget and Force Building (the Nagel Committee), and more significantly in the 2025 budget.

The budget deficit was 6.8 percent of GDP this year.

The first update to the 2024 budget included a NIS 9 billion cut against unexpected civilian additions unrelated to the war, but the net addition to the budget for war expenses was substantial, at NIS 70 billion. The second update, in September 2024, was intended to fund payments to evacuees, amounting to approximately NIS 3 billion. The third update was required because the original budget assumed that the one-time US aid grant for the Swords of Iron War would be fully received during 2024, allowing it to fund ongoing defense expenses, although the grant was originally intended to finance investment in security enhancement. This assumption did not materialize, and alongside the need arising from intensified fighting in the north, it was necessary to reopen the budget again at the end of the year. The frequent budget framework revisions and the avoidance of cutting items that were not urgent increased uncertainty about the government's ability to make necessary adjustments in light of the changing reality.

The country's risk premium increased, and Israel's credit rating was downgraded by three rating agencies, primarily due to the war and the rise in geopolitical risk.[1] However, the uncertainty regarding the government's ability to adjust the budget framework and composition to the challenges posed by the war was also a contributing factor.[2] This difficulty was reflected in the three successive revisions of

[1] Moody's lowered Israel's credit rating cumulatively by three notches (to Baa1). Standard and Poor's lowered Israel's rating by two notches, to A. Fitch lowered Israel's rating by one notch to A.

[2] See, for instance, the discussion by Moody's in its announcement on the lowering of Israel's rating on September 27, 2024: "In our view, the significant escalation in geopolitical risk also points to diminished quality of Israel's institutions and governance, which have not fully mitigated actions detrimental to the sovereign's credit metrics." See also the discussion by Fitch in its announcement on August 12, 2024: "However, political fractiousness, coalition politics, and military imperatives could hinder consolidation plans and present a risk to our forecast."

the budget during 2024, the minimal cuts in expenditures that do not aid in financing war needs or economic growth, the retention of extraneous government ministries and the delay in 2025 budget discussions. Ultimately, the government implemented significant convergence measures on the revenue side in the 2025 budget against most of the permanent additions to its expenses, which helped strengthen market confidence. However, as elaborated in Section 1.c and the rest of the chapter, additional steps will be required to ensure a sustained reduction in the debt-to-GDP ratio and to improve the budget composition to better support economic growth.

The increase in expenditures in 2024, most of which was necessary due to the war, led to a shift of resources from the business sector to the public sector and contributed, along with the shortage of non-Israeli workers (Chapters 5 and 8), to the development of excess demand in the economy during the year (Chapter 2) and to rising inflation (Chapter 3). These factors, alongside other inflationary pressures and the increase in the country's risk premium, underscored the urgency of transitioning to fiscal restraint, and heightened the need to maintain monetary restraint.

Global background conditions also amplify Israel's fiscal challenge. Global public debt is at a historic high of over 90 percent of global GDP, creating significant risks to global fiscal stability. According to the International Monetary Fund, the convergence measures of various countries, particularly the major ones, are insufficient to reduce the debt-to-GDP ratio.[3] Furthermore, upward risks to government deficits worldwide and the slower-than-expected pace of inflation moderation in some major countries could lead to continued restrictive monetary policy and increase global financing costs.

The fact that the increase in debt as a percentage of GDP is not unique to Israel improves the country's relative standing. However, high global financing costs make the debt more expensive for the Israeli government as well, highlighting the importance of reducing it. This is especially pertinent given that Israel's debt-to-GDP ratio is higher than that of most countries with similar credit ratings; considering Israel's unique geopolitical risks, some of which have recently materialized with intensity; and in light of the expected decline in the growth rate of Israel's potential GDP. The following section will expand on this challenge.

The increase in debt as a share of GDP is not unique to Israel, but the increase in Israel this year was exceptional.

## b. The debt-to-GDP ratio and the deficit in 2024

In 2024, the public debt-to-GDP ratio increased from 62 percent to 67.8 percent as a result of the government's response to the urgent security and civilian needs dictated by the war (Table 6.1). Generally, the dynamics of the debt-to-GDP ratio are influenced by three main factors: the primary deficit (the deficit excluding interest payments on the debt), the interest on the debt, and GDP growth. In Israel, over the short term of several years, interest expenses are largely predetermined, as they are paid on debt mostly issued in previous years with an average term of about

The debt to GDP ratio was 67.8 percent at the end of 2024.

[3] See: IMF (International Monetary Fund), "Fiscal Monitor: Putting a Lid on Public Debt", October 2024.

nine years. Therefore, the main factor affecting changes in the overall deficit and debt dynamics, especially in the short term, is the gap between the government's expenditures excluding interest and its revenues.

Regarding expenditures, as described in the previous section, revisions to the 2023 and 2024 budgets were approved in December 2023 and throughout 2024, including expenditures amounting to nearly 7 percent of GDP in 2024 term (as detailed in Table 6.1). The central government's war expenditures, as defined in the budget descriptions above, do not include the full compensation for direct and indirect war damages. Most of this compensation, totaling NIS 19 billion (about 1 percent of GDP), were paid from funds accumulated in the Property Tax Fund in previous years (about 0.6 percent of GDP, recorded then in the budget deficit) and this year (about 0.4 percent of GDP, included in this year's budget deficit). As for revenues, they increased in 2024 along with nominal GDP, following a sharp decline in the initial months after the outbreak of the war. Some of the government's expenditures on local purchases and increased payments to reservists returned to the state coffers through the tax system, thereby mitigating the rise in the deficit.

The general government deficit, by the National Accounts definition, reflects the entire public sector's activity and is suitable for international comparisons. This deficit amounted to 9.4 percent of GDP in 2024.[4] Generally, the gap between the general government deficit and the budget deficit (6.8 percent of GDP) arises from methodological differences in deficit calculation, as well as the inclusion of government actions funded through land privatization and off-budget expenditures in the general government deficit. This year's gap of 2.6 percent of GDP reflects three main factors: differences in the calculation of interest payments and indexation differentials (1.3 percent of GDP), payments in 2024 from funds accumulated in previous years in the Property Tax Fund (0.3 percent of GDP), and the financing of some government actions through land sales (about 1 percent of GDP).[5]

[4] The general government includes the government itself, the National Insurance Institute, local authorities, nonprofit organizations (such as health funds, universities, and Yeshivot) primarily funded by the government, and the national institutions (the Jewish Agency, the Jewish National Fund, and the World Zionist Organization). Its activities are measured according to National Accounts definitions, which differ from those used in the state budget.

[5] According to the Central Bureau of Statistics, the general government deficit in National Accounts terms totaled 8.3 percent of GDP. In this chapter, we refer to the central government's budget deficit (6.8 percent) and the general government deficit in National Accounts terms, with adjusted calculations (9.4 percent). The reason for the discrepancy between the figure presented by the Central Bureau of Statistics and the one we present is that the CBS deducts from public investment (for housing purposes) the revenues from land sales, as the interpretation of National Accounts rules suggests that land sales are a negative investment by the government. An examination of OECD data from recent years shows that in most countries, such revenues are very low (about 0.05 percent of GDP on average), and the reduction in investment reflects activities such as the sale of improved agricultural land or the purchase and renovation of public housing apartments and their sale to eligible individuals. In contrast, in Israel, these revenues come from asset realization—the sale of land with historical state ownership—and in 2024 they amounted to 1 percent of GDP. Since asset realization is essentially a financial action, we present public expenditure without this reduction and land sales as a financial item that restrains debt growth.

In 2024, Israel's general government deficit was significantly higher than the OECD median, which stood at about 2.7 percent of GDP. This large gap reflects the sharp increase in war-related expenditures. Due to the large deficit, Israel's debt-to-GDP ratio—67.8 percent—diverged significantly from the OECD median, which is 60 percent.

## c. Fiscal policy in the medium term from the standpoint of the debt-to-GDP ratio

A one-time increase in the deficit can be somewhat absorbed, especially due to exceptional events like those experienced recently. However, it is particularly important to restrain a deficit that reflects permanent changes. Several permanent changes have occurred as a result of the Swords of Iron War. The Committee to Examine the Defense Budget and Force Building (Nagel Committee) recommended increasing defense expenditures by an average of NIS 13.5 billion per year from 2026 to 2034.[6] This recommended addition for the coming years is over and above the increases approved in the 2024 budget (a total of NIS 82 billion for 2024–2031) and beyond the additions for the Rehabilitation and Families Division (an average of about NIS 5 billion per year from 2025 to 2030). Additionally, there will be an increase in civilian rehabilitation expenses in the coming years, and gradually, in interest expenses due to rising debt and interest rates. These total approximately NIS 40 billion, with about three-quarters of that allocated for security needs. The 2025 budget includes further increases in medium-term civilian expenditures due to demographic needs and other government commitments and decisions unrelated to the war. Overall, medium-term expenditure is expected to be about NIS 50 billion per year higher than we estimated before the war.

The Committee to Examine the Defense Budget recommended increasing defense expenditures by an average of NIS 13.5 billion per year between 2026 and 2034.

Total expenditure in the medium term (2026–2030) is expected to be about NIS 50 billion per year higher than forecast before the war.

To balance the expenditure increase, the government decided on convergence measures worth approximately NIS 40 billion, of which about NIS 30 billion are permanent.[7] Most measures are on the revenue side, including a one percentage point increase in VAT (decided last year and effective from January 1, 2025), a tax on retained earnings, a freeze of income tax brackets, and an increase in National Insurance contributions. The last measure is temporary (set to expire in early 2027 unless extended by the Knesset Labor and Welfare Committee for another two years), as is the reduction in public sector wages that was decided upon. The total permanent measures (about NIS 30 billion) are significant but insufficient to balance the total expenditure increase (about NIS 50 billion) while reducing the debt ratio.

The government took adjustment measures to offset most of the additional permanent expenditures due to the war, but they are not sufficient to lower the debt to GDP ratio due to increases in expenditures that are not related to the war.

6 The "Nagel Committee on the Defense Budget and Force Building" report is available in Hebrew on the gov.il website. Up to this writing, the government has not yet discussed the report, and has not adopted its recommendations.

7 For full details of the convergence measures, see "Main points of the 2025 budget" (in Hebrew) on the Ministry of Finance website.

**Table 6.1 | Budgetary Policy in View of the War and the Expected and Actual Development of the Deficit**

| Date | Milestone | Details | Deficit (percent of GDP) 2023 | 2024 |
|---|---|---|---|---|
| May 23, 2023 | Approval of the original state budget for 2023 and 2024 | A conservative 2-year budget was passed despite optimistic revenue forecasts, to create saftey buffers | 0.9 | 0.8 |
| **Oct. 7, 2023** | **Hamas terrorist attack and outbreak of Swords of Iron War** | | | |
| Dec. 14, 2023 | Approval of the revised 2023 budget | Addition of NIS 17 billion for defense and NIS 9 billion for civilan needs for 2023 | 3.7 | - |
| Dec. 25, 2023 | Presentation of report on differentials for 2024 in the Knesset Finance Committee | An increase of NIS 50 billion in expected expenditures in 2024, of which about NIS 41 billion was connected to the war | - | 5.9 |
| Jan. 14, 2024 | First estimate for 2023 | | 4.2 | - |
| Mar. 13, 2024 | Approval of the revised 2024 budget | On the expenditure side: Net budget increment of NIS 70 billion, of which about NIS 55 billion was for the defense establishment and about NIS 15 billion was for war-related civilian needs. NIS 9 billion was cut from civilian budgets against deductions that were not war-related. On the revenue side, there were measures that brought about NIS 4 billion in revenues, ost of which were one-off. It was decided to raise VAT and health taxes beginning in 2025, such that they would bringin about NIS 8 billion per year. | - | 6.6 |
| Sep. 29, 2024 | Approval of the first additional budget for 2024 | Addition of NIS 3.3 billion, mainly to finance payments to evacuees | - | 6.6 |
| Sep. 30, 2024 | Entry of IDF land forces to Lebanon as part of Operation "Northern Arrows" | | | |
| Nov. 1, 2024 | Approval by the government of the 2025 budget, and start of discussions in Knesset committees | The convergence measures that were decided upon brought the total adjustments, including those decided upon in the 2024 budget, to NIS 40 billion. Some of this is expected to expire gradualaly, such that the permanent value is estimated at NIS 30 billion. The permanent measures are on the revenue side. The largest of them are the increase in VAT (approved as part of the first revision to the 2024 budget and takes effect at the beginning of 2025), the freeze in tax brackets, and the taxation of trapped profits (approved by the Knesset and takes effect at the beginning of 2025). | | |
| Dec. 24, 2024 | Approval of the second additional budget for 2024 | Addition of NIS 33 billion to the 2024 budget, due to the deferral of an increment in the American grant (18), Operation "Northern Arrows" (12) and an increase in interest expenses (2). | - | 7.7 |
| Actual / Expected | | The data as of the Report's publication date. | 4.1 | 6.8 |

The gap that remains to be closed to allow a sustained reduction in the debt-to-GDP ratio reflects the increase in structural civilian expenditures unrelated to the war in the 2025 budget, part of the multiyear addition recommended by the Nagel Committee (after budget was approved by the government), the conversion of some convergence measures to temporary after the government vote (increased National Insurance contributions), and the slight moderation of other measures (postponing most of the increase in purchase tax on electric vehicles). Due to these factors, we estimate that the structural budget deficit rate (the expected medium-term deficit, after deducting temporary changes) is about 3.6 percent—higher than the structural rate that reduces the debt-to-GDP ratio, which is around 3 percent or less. This estimate considers the expected moderation in potential GDP growth (GDP when all production factors are employed) in the coming years, both due to the war's consequences and fundamental—demographic and other—forces affecting it. For more on this topic, see Chapters 1 and 2.

**Table 6.2 | The main components of the government's revenue and expenditures, 2019–2024**

(percent of GDP)

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|---|
| **Central government - budget definition** | | | | | | |
| **Total public revenue** | **24.3** | **22.5** | **26.1** | **26.6** | **23.3** | **24.3** |
| **total public expenditures** | **28.0** | **33.8** | **30.4** | **26.0** | **27.4** | **31.1** |
| *of which* : Defense expenditures | 4.9 | 5.0 | 4.7 | 4.2 | 5.2 | 8.3 |
| Civilian expenditures | 21.0 | 22.2 | 20.9 | 19.2 | 20.3 | 20.6 |
| **Initial deficit** | **1.6** | **9.2** | **2.2** | **-2.5** | **2.2** | **4.6** |
| Interest expenditures | 2.1 | 2.1 | 2.1 | 1.9 | 1.9 | 2.2 |
| **Total deficit[a]** | **3.7** | **11.4** | **4.3** | **-0.6** | **4.1** | **6.8** |
| **General government by international definition** | | | | | | |
| **Total public revenue** | **35.2** | **34.6** | **36.9** | **37.4** | **34.6** | **35.7** |
| *of which* : Income from property | 0.5 | 0.4 | 0.5 | 0.6 | 0.6 | 0.6 |
| **Total taxes** | **30.0** | **29.6** | **32.2** | **32.6** | **29.6** | **30.5** |
| Indirect taxes on domestic production | 11.9 | 11.5 | 12.5 | 12.2 | 10.6 | 10.8 |
| Indirect taxes on civilian imports | 2.7 | 2.7 | 2.8 | 2.8 | 2.5 | 2.8 |
| Direct taxes, fees and levies | 10.2 | 10.2 | 11.9 | 12.6 | 11.4 | 11.9 |
| National Insurance Institute revenue | 5.2 | 5.2 | 5.0 | 5.0 | 5.0 | 5.0 |
| Grants | 1.1 | 1.0 | 1.0 | 1.1 | 1.2 | 1.5 |
| Other[b] | 3.7 | 3.6 | 3.3 | 3.2 | 3.2 | 3.1 |
| **Total public expenditure[c]** | **39.7** | **46.0** | **42.2** | **39.3** | **41.5** | **45.1** |
| Current expenditure | 36.9 | 42.6 | 39.3 | 36.3 | 37.8 | 41.5 |
| Civilian expenditure on services and in-kind transfers | 19.6 | 20.7 | 19.5 | 18.7 | 18.9 | 19.3 |
| Domestic defense consumption | 4.4 | 4.4 | 4.2 | 3.9 | 5.0 | 7.0 |
| Defense imports | 0.3 | 0.3 | 0.4 | 0.2 | 0.4 | 0.8 |
| Direct subsidies | 0.9 | 4.0 | 3.0 | 1.0 | 1.1 | 1.1 |
| Transfer payments on current account | 9.6 | 11.2 | 9.6 | 9.0 | 9.5 | 9.8 |
| Interest payments[d] | 2.1 | 2.0 | 2.8 | 3.4 | 2.9 | 3.4 |
| Transfer payments on capital account[e] | 0.5 | 0.5 | 0.6 | 0.8 | 1.3 | 1.4 |
| Investments of the general government including investment grants[c] | 2.3 | 2.9 | 2.3 | 2.3 | 2.4 | 2.3 |
| *of which* : Net civilian investment | 2.1 | 2.7 | 2.1 | 2.0 | 2.1 | 1.5 |
| **Primary civilian expenditure[c]** | **32.7** | **39.1** | **34.7** | **31.5** | **32.9** | **33.1** |
| **Total deficit of the general government[c]** | **4.5** | **11.4** | **5.3** | **1.9** | **6.9** | **9.4** |
| Current deficit of the general government | 3.1 | 9.5 | 4.3 | 0.8 | 4.6 | 7.1 |
| Total cyclically adjusted deficit using international definition[c,f] | 4.8 | 9.1 | 5.6 | 3.1 | 7.0 | 7.8 |
| Net public debt[g,h] | 57.1 | 67.0 | 64.1 | 58.3 | 59.4 | 65.1 |
| Gross public debt[g] | 59.1 | 71.1 | 67.8 | 60.5 | 61.5 | 67.8 |

[e] The central government deficit is calculated based on various definitions.

[b] 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.

[c] 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.

[d] Interest expenses are calculated on a cumulative nominal basis plus indexation differentials on the public debt.

[e] 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.

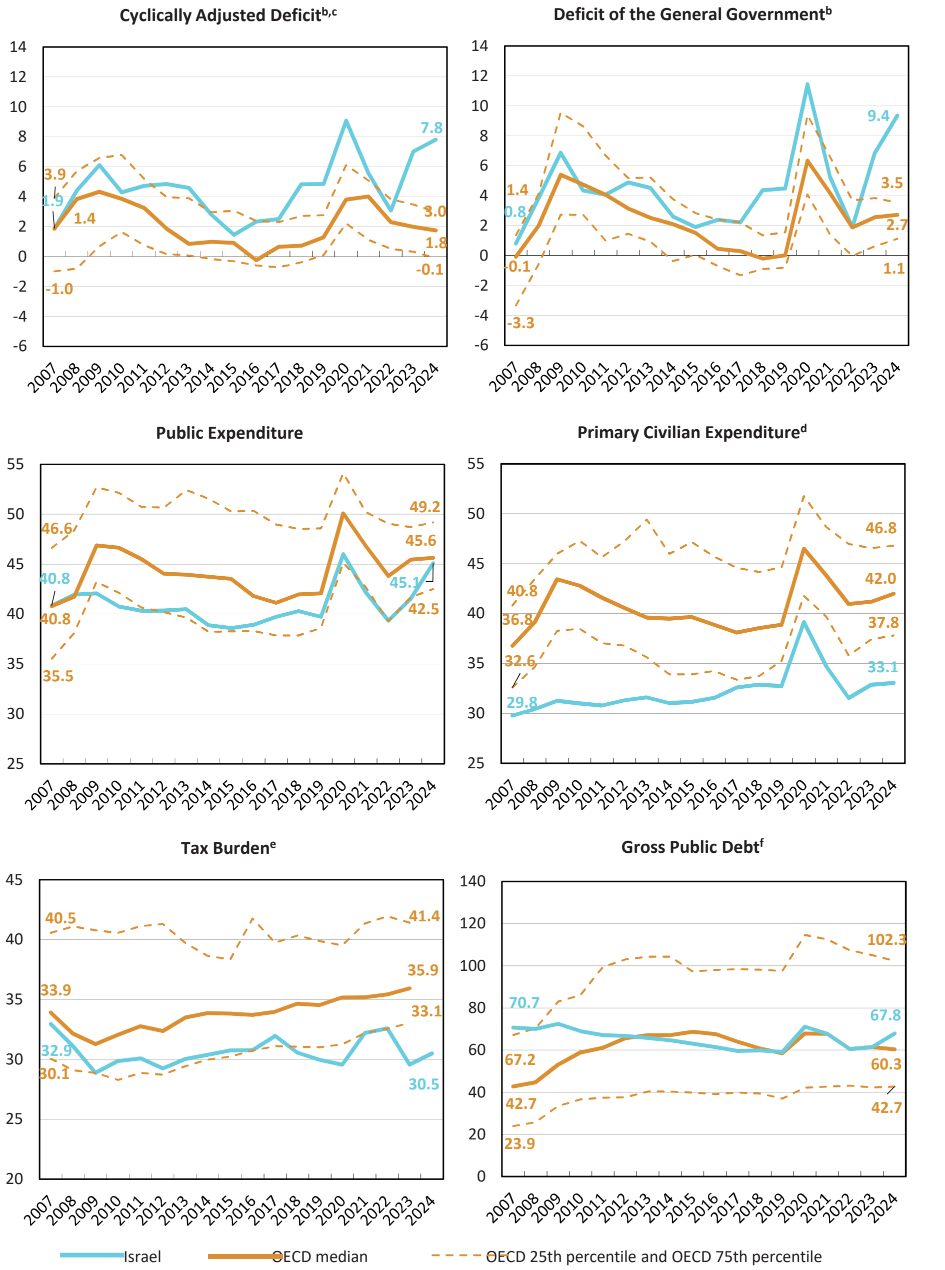
[f] Adjusted to Central Bureau of Statistics data. For more information, see Footnote 2 in Figure 6.1. SOURCE: OECD.

[g] Excluding municipalities' debts to the government.

[h] 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 data and Ministry of Finance.

**Figure 6.1** | **Israel's Fiscal Aggregates Compared to the OECD Average[a], 2007–2024** (percent of GDP)




[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 2025.
[d] Due to a lack of up-to-date data, defense expenditures in 2024 are equal to defense expenditures in 2022 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 (2023), except for israel, for which there are data for 2024.
[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* 116, Dec. 2024, and Revenue Statistics, 2024) and International Monetary Fund.

The low rate of primary civilian expenditure in Israel compared to most OECD countries and the need to maintain, and eventually increase, investment in growth drivers amplify the challenge of reducing the debt-to-GDP ratio, as the margin for significant cuts in civilian expenditures is limited. This difficulty, along with the geopolitical risks facing the economy, underscores the need to establish a binding and credible fiscal framework to reduce the debt-to-GDP ratio by reducing the structural deficit while addressing increased security needs and supporting sustainable economic growth.

The difficulty in cutting civilian expenditures is amplified, since such expenditures are already low by international comparison.

The rest of the chapter is structured as follows: Section 2 focuses on developments and policies since the outbreak of the war, especially in 2024, and Section 3 deals with fiscal aggregates from a structural perspective. Section 4 concludes with an analysis of the debt-to-GDP ratio, and discusses the policy that is necessary to reduce it.

## 2. THE FISCAL AGGREGATES AND POLICY IN 2024

### a. Public expenditure and its composition since the start of the war

In 2024, the central government's net expenditure (excluding expenditures contingent on revenues, such as US defense aid) increased by 27 percent compared to the planned expenditure according to the original 2023 budget (approved before the war), and by 20 percent compared to actual expenditures in 2023, which translates to 5.3 percent and 3.7 percent of GDP, respectively.[8] Direct war-related security expenditures were the dominant factor driving the increase in spending in 2023 and 2024. About half of the increase in defense spending was due to compensation for reservists, while the other half was allocated to funding defense procurement—ammunition, equipment, supplies, maintenance, and more.[9] The remaining increase in public expenditure was due to a rise in civilian purchases, particularly to finance alternative housing in hotels for evacuees. The budget for "supervisory authorities" (including rehabilitation administrations in the south and north) also increased as part of the war's impact. In contrast, only a few expenditure items were cut (Figure 6.2).

Public consumption in Israel increased significantly in 2024, mainly due to war-related needs.

Similar to the 2024 budget, the 2025 budget does not include significant cuts in government expenditures. The defense budget's share of GDP is expected to remain high even after a relative decrease from 2024, due to ongoing security challenges and force building plans. Additionally, civilian government ministries' budgets include significant additions, both related to the war and addressing other needs. Healthcare

[8] The source for the public expenditure data analyzed in this section is state budget data. The figures for 2024 and 2025 are data on budgeted amounts, not performance, and the figures for 2024 also include the increments that were budgeted during the year.

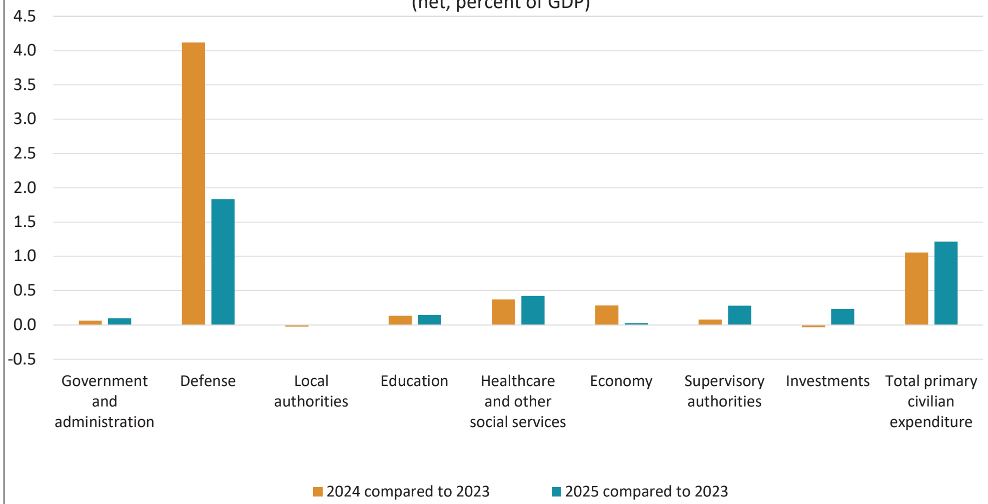
[9] The source for the calculation is data from the Central Bureau of Statistics, according to the National Accounts definitions. The calculation is based on a comparison between expenditure on the various components of public consumption at current prices in 2024 and this expenditure in the first three quarters of 2023 (prior to the war), inflated to annual terms.

expenditure is expected to continue rising in 2025 due to a significant increase in the health basket's cost, and the rehabilitation administrations' budget will remain high in the coming years. Ultimately, despite convergence measures amounting to about half a percent of GDP on the expenditure side, which were brought to a vote in the government and the Knesset, civilian expenditure as a percentage of GDP is expected to remain higher than before the war.

In the previous decade, convergence measures were also necessary to reduce the structural deficit. Despite a greater effort to cut expenditures at that time, the main success in stabilizing the fiscal situation then was due to a decrease in defense and interest expenditures as a percentage of GDP. The lack of success—both then and now—in sustainably reducing civilian expenditure indicates the difficulty of implementing sustainable cuts in civilian spending when it is already low, unlike the adjustments made in 2002 and 2003, for example, when civilian expenditure was higher and also high by international comparison. Since some of the convergence measures on the expenditure side are temporary (particularly the freeze on public sector wages), the government faces the challenging choice of whether to permanently reduce expenditures or increase tax rates to consolidate the structural deficit after 2026.

**Figure 6.2 | Change in the Main Budget Categories, 2024 and 2025 Compared with the Original 2023 Budget[a]**

(net, percent of GDP)




[a] The 2023–2025 figures are budget book figures, and include the increments approved during 2024.

SOURCE: Based on Ministry of Finance state budget figures.

## b. Public consumption's contribution to economic activity

Public consumption in Israel increased significantly in 2024, by 18 percent in real terms in the first three quarters compared to the same period in 2023 (before the war).[10] Additionally, there was an increase of about 8 percent in public consumption prices, primarily due to payments to reservists (recorded as wages) and the implementation of wage agreements signed with the Histadrut in 2023, and with the Medical Association and Teachers' Organization in September 2024.

Increasing reserve service has led to a significant increase in payment to employees in the defense sector.

**Table 6.3 | Change in the Quantity and Price of Public Consumption and its Components**

(2024:Q1–Q3 compared to the same period last year, percent)

| | Defense | | | Civilian | | Total public consumption |
|---|---|---|---|---|---|---|
| | Payment to employees | Domestic purchases | Defense imports | Payment to employees | Purchases | |
| **Quantitative change** | 62.2 | 114.2 | 206.2 | 3.3 | 9.8 | 18.1 |
| **Change in price** | 30.9 | 1.8 | 6.6 | 4.3 | 3.8 | 7.9 |

The comparison is relative to Q1–Q3 in order to compare to the prewar period.
SOURCE: Based on Central Bureau of Statistics National Accounts data.

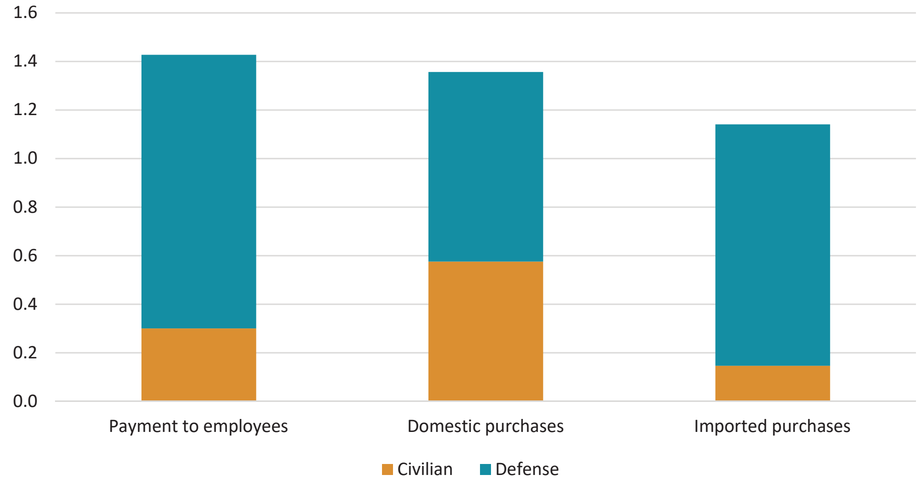
In GDP terms, public consumption rose from 20 percent in 2023 to 23.9 percent in 2024. A breakdown of this growth into its main components (Figure 6.3)—compensation to employees, domestic purchases, and imports—shows that compensation to employees contributed 1.4 percent of GDP to this increase, with a particularly large contribution of 1.1 percent of GDP from compensation in the defense segment. This growth was mainly due to the broad mobilization of reservists, which increased public sector output but simultaneously reduced the available labor force for the business sector.

Domestic purchases by the public sector, both civilian and defense, contributed at least 1.3 percent of GDP to the growth in public consumption and domestic demand. This contribution includes a component calculated using input-output tables from 2014, which indicate that about 80 percent of government purchases (not preclassified as imports or domestic purchases) are domestic. The remaining increase in public consumption resulted from a rise in foreign purchases, which increased the government deficit but did not affect domestic demand. Overall, the 3.9 percent-of-GDP increase in public consumption contributed about 3 percent of GDP to the rise in excess demand in the economy in two ways: reducing the labor supply in the business sector and increasing domestic demand. The impact of excess demand on inflation is discussed in Chapters 2 and 3 of this report.

The 3.9 percent-of-GDP increase in public consumption contributed about 3 percent of GDP to the rise in excess demand in the economy.

[10] The source for the public consumption data analyzed in this section is the National Accounts data published by the Central Bureau of Statistics, since the objective of the discussion is an analysis of the consequences of government activity in the economy.

**Figure 6.3 | Change in the Components of Public Consumption[a], 2024:Q1–Q3 vs 2023:Q1-Q3**
(percent of GDP)




[a] Government purchases classified as imports include defense imports as shown in the Central Bureau of Statistics data (government's direct imports), as well as some portion of the government's other purchases (which are not classified as imported or domestic purchases), according to the weight of imports in the government's purchases based on input-output tables for 2014 (about 20 percent).
SOURCE: Based on Central Bureau of Statistics National Accounts data at fixed prices.

The broad mobilization of reservists amplifies the need to expand military service among *Haredim*.

The sharp increase in the number of reservists called up under emergency orders (about 1 percent of the labor force for most of the year, Chapter 5) was exacerbated by delays in the legal arrangements for extending regular service and increasing the maximum number of reserve days allowed by law. The significant and sustained increase in reserve duty raises two fundamental issues: First, the supply constraints created by the large number of reservists support the assessment that expanding the pool of service members through broader recruitment of young *Haredim* (ultra-Orthodox) into regular service is important not only from security and social perspectives, which are not the focus of this report, but also to mitigate the expected economic damage from the increase in reserve days for employees.[11] Second, recruitment through emergency orders without a formal budgetary limit for such an extended period could lead to excessive or inefficient use of reserve days, with implications for both fiscal stability and economic growth.

Tax revenues increased by 7 percent this year, compared to their 2023 level—slightly more than the increase in nominal GDP.

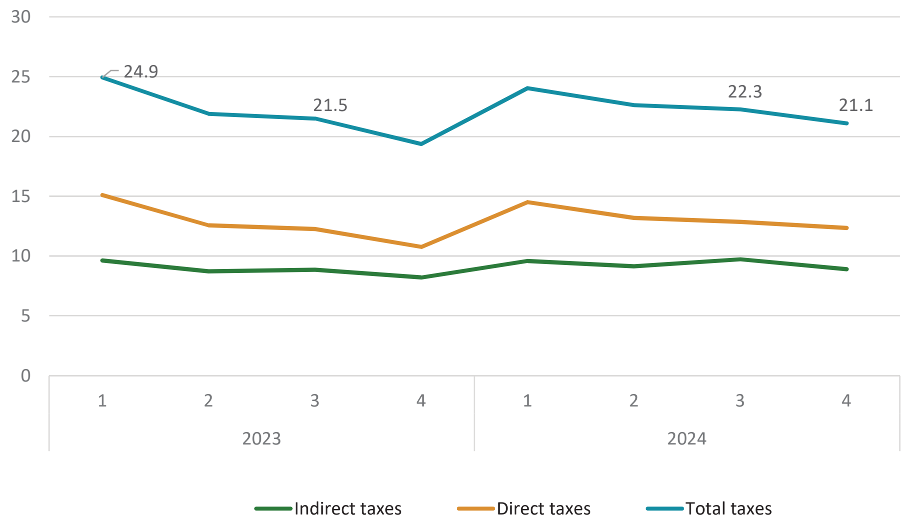
## c. Tax revenues in 2024

Tax revenues increased by 7 percent this year compared to 2023, which was slightly above the growth rate of nominal GDP (6.4 percent). The relatively rapid increase in tax revenues and nominal GDP is partly due to the relatively swift rise in GDP prices,

[11] See, for instance, the Bank of Israel Governor's presentation on the occasion of the publication of the Bank of Israel Annual Report for 2023; G. Gordon and S. Ravitsky Tur-Paz: "Quantity and Cost of Reserve Service in the Event that Haredim Enter Regular and Reserve Services in the IDF", Israel Democracy Institute, April 2024; and the general discussion on "Pricing the Alternatives to Increasing Manpower in the IDF", Ministry of Finance, Accountant General's Division, March 2024.

significantly influenced by the increase in public consumption prices (Table 6.3). The ratio of tax revenues to nominal GDP in the last quarter of 2024 was similar to the ratio in the quarter before the war (Figure 6.4).

**Figure 6.4 | Tax Receipts as a Share of GDP, 2023 and2024** (quarterly, percent of GDP)




SOURCE: Based on Central Bureau of Statistics.

The Swords of Iron War led to expectations of a decline in tax revenues due to the impact on business activity, as reflected in the Ministry of Finance's revenue forecast before the submission of the updated 2024 budget, and in the Bank of Israel's early forecasts. In reality, the revenue figures for 2024 surprisingly exceeded these expectations, especially given the downward trend before the war.[12] However, the war's consequences and government actions likely explain both the nominal GDP trajectory and the tax revenue trajectory.

**Direct taxes** – The monthly development of direct taxes was affected by the initial shock to activity with the outbreak of the war, along with the postponement of reporting and payment deadlines for self-employed individuals and companies. This measure deferred some revenues from the end of 2023 to early 2024, accentuating the V-shaped recovery in shekel revenues in the first two quarters of the war. Additionally, the recovery of stock indices in Israel and their continued rise globally contributed to increased revenues from capital gains and the taxes on them.

[12] These reflected "anomalous receipts" during the period immediately following the COVID-19 crisis, which were expected to decline. For more discussion, see Chapter 6 of the Bank of Israel's Annual Report for 2023.

During 2024, the broad unemployment rate fell to about 3 percent (after peaking at 9.4 percent at the beginning of the war), likely contributing to the rapid recovery of direct tax revenues at the beginning of the year and their moderate growth trend thereafter. Most workers who remained absent from work in 2024 were absent due to reserve duty. This likely contributed to the increase in tax revenues, influenced by increased payments to reservists, double payments to those who worked while on leave from service, and reservists who did not work or who did not reach the minimum tax threshold before the war but paid taxes on reserve income during the war. These factors were also reflected in the development of nominal GDP.

Government purchases increased sharply, and some of the war costs made their way back to state coffers through the tax system.

**Indirect taxes** – The increase in indirect taxes primarily reflects an increase in VAT revenues, explained by two main factors. First, government purchases (most of which are subject to VAT) rose sharply. The total increase in government purchases (at current prices) in the first 12 months of the war (October 2023 to September 2024) compared to the same period in the previous year was about NIS 36 billion. This increase was expected to contribute about NIS 5 billion in gross VAT revenues[13]—a significant increase considering that the total rise in VAT receipts during this period was about NIS 8 billion. Second, financial assistance to evacuees and increased payments to reservists boosted their purchasing power. Beyond these explanations, indirect tax revenues rose sharply toward the end of the year as vehicle purchases were brought forward due to impending tax increase in early 2025. Such revenues typically come at the expense of revenues at the beginning of the following year.

## d. The deficit in view of the Swords of Iron War

The budget deficit in 2024 amounted to 6.8 percent of GDP (Figure 6.5). Higher-than-expected revenues offset most of the unplanned expenditure, so the deficit was only slightly above the early forecasts (6.6 percent).

To isolate the war's impact on the government deficit and calculate the deficit excluding its effect, the impacts on both expenditure and revenue must be identified. Analyzing 2024 alone may be misleading, as some expenditures were arbitrarily recorded in one year or another, and some revenues were deferred from 2023 to 2024. Therefore, we will cautiously consider the estimates presented here and discuss the war's implications for both 2023 and 2024 together.

The budgetary cost of the war in 2023 and 2024 is reflected in additions totaling NIS 135 billion to the budget.

On the expenditure side, the budgetary cost of the war for 2023 and 2024 is reflected in the additions approved for those years (beyond the original budget approved in May 2023, as outlined in Table 6.1), totaling NIS 135 billion.[14] These additions resulted from the war's consequences, and thus reflect its impact on the expenditure side. In calculating the total cost for these years, an additional NIS 19 billion paid from the Property Tax Fund as direct and indirect compensation for war

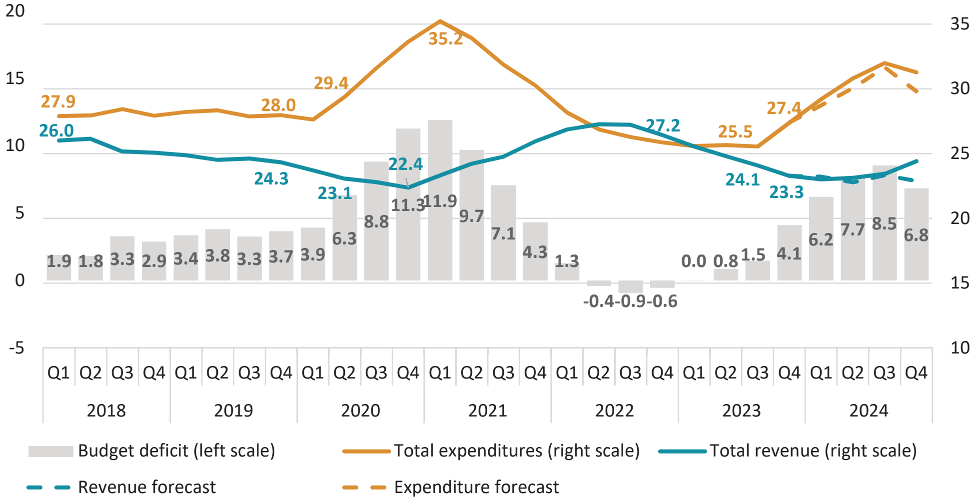
[13] Assuming that only one-third of defense imports were subject to VAT.

[14] NIS 3 billion of these expenditures were financed by a NIS 3 billion cut in expenditures from the 2023 budget.

damages must be considered. This brings the total expenditure cost for 2023 and 2024 to NIS 154 billion.[15] Table 6.4 shows these costs and the war's other ramifications on budget aggregates from the war's outbreak until the end of 2024 in GDP terms.

Revenues for 2023 and 2024 were NIS 5 billion lower than the Bank of Israel's forecast for those years published before the war (July 2023). This gap reflects the war's negative impact on revenues, as well as one-time measures in response to the war and the return of a small portion of war costs to the state coffers through the tax system.

**Figure 6.5 | Revenue, Expenditures[a], and the Cumulative Deficit in the Past Four Quarters, 2018–2024** (by state budget definitions, percent of GDP)




[a] Expenditures and revenue are in net terms: Excluding the provision of credit that the government grants and loan repayments that it receives, and excluding US grants and expenditures that they finance. The revenue and expenditure forecast reflects the Bank of Israel's assessment as of the date of publication of the April 2024 forecast.

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

Ultimately, the central government's deficit, excluding the war's impact, is estimated at 1.9 percent of GDP in 2023 and 1.6 percent of GDP in 2024, compared to the 0.9 percent planned for each year in the original budget approved in May 2023. A few months later, the Ministry of Finance already estimated that the 2024 deficit would be 1 percentage point higher due to a downward surprise in revenues and an upward surprise in expenditures unrelated to the war.[16] The deviation from the plan, even after excluding the war's effects, highlights the importance of the caution

The central government's deficit excluding the war's impact, is estimated at 1.9 percent of GDP in 2023 and 1.6 percent of GDP in 2024.

[15] The cost calculated here is the net cost until the end of 2024 (excluding expenses financed through American assistance received in 2024, totaling about NIS 11 billion). In addition, some of the war costs will be reflected only in future years, when the defense establishment's inventory is replenished. Considering this and the costs of fighting and other costs that are expected between 2025 and 2027, the total cost of the war is expected to reach about NIS 255 billion.

[16] As reported to the Knesset Finance Committee on December 25, 2023 as part of the discussion on the differentials report.

exercised in the two-year budget for 2023 and 2024. The need for caution is even more pronounced when the budget is biennial (which increases uncertainty), when there is a real risk that growth and revenue forecasts may prove overly optimistic in hindsight, and when inflation is relatively high. All these characterized the budget approval in May 2023. Indeed, according to the Ministry of Finance's variance report presented in December 2023, the expenditures required for 2024 (excluding the war's impact) were NIS 9 billion higher than expected, and revenues were NIS 10 billion lower than expected—due to price increases and other unexpected developments unrelated to the war.

**Table 6.4 | The War's Estimated Effect on Budgetary Aggregates, 2023 and 2024**

(percent of GDP)

| | | 2023 | 2024 | Notes |
|---|---|---|---|---|
| | **Actual deficit (including the war's impact)** | | | |
| 1 | Central government deficit | 4.1 | 6.8 | |
| 2 | General government deficit | 6.9 | 9.4 | |
| | **The war's estimated impact on:** | | | |
| 3 | Revenues | -0.6 | 0.0 | A positive gap in 2024 (0.4) between the Bank of Israel's revenue forecast from July 2023 and actual revenues, which was offest with the increase in deductions to the Property Tax Fund. |
| 4 | Expenditures | 1.6 | 5.3 | Budget increments that were approved by the Knesset due to the war, of which about 4% were to the defense establishment. |
| 5 | Compensation from the Property Tax Fund | 0.3 | 0.7 | The Property Tax Fund is included in the general government's aggregates, and affects the size of the debt. Until the end of 2024, the Fund paid out about NIS 21 billion, but NIS 8 billion were received from the increase in the government's deductions to the Fund since the outbreak of the war. |
| | **Estimated aggregates minus the war's impact** | | | |
| 6=1+3-4 | Central government deficit | 1.9 | 1.6 | |
| 7=2+3-4-5 | General government deficit[a] | 4.4 | 3.3 | |

[a] The general government's aggregates as defined by the Central Bureau of Statistics are determined by the date of performance of the economic activity, and not on the basis of cash expenditure. Therefore, the estimates of the general government's deficit net of the war's effect are a rough estimate, since the estimated impact of the war was calculated on the basis of the budget definitions and not the CBS definitions.

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

### e. Bond yields in view of policy in 2024

The yields on government bonds increased due to the increase in Israel's risk premium.

The yields on 10-year unindexed government bonds increased from an average of 3.8 percent before the war to an average of 4.6 percent from the outbreak of the war until the end of 2024. This rise in yields was primarily driven by an increase in Israel's risk premium.[17] The heightened risk premium was also reflected in a series of credit rating downgrades by international rating agencies. Moody's downgraded Israel's credit rating by three notches to Baa1, Standard and Poor's downgraded it by two notches to A, and Fitch downgraded it by one notch to A. Although yields remained relatively stable following the downgrades, this was because the markets had already priced in the increased risk before the downgrades occurred. However, the downgrades themselves could have a long-term impact on the volume of investments in Israel's debt, as some investing entities are required to differentiate between debt categories as part of their investment policies.

## 3. THE FISCAL AGGREGATES FROM A STRUCTURAL STANDPOINT

### a. The war's long-term impact on public expenditure

The long-term downward trend of defense expenditures and interest payments was reversed due to the Swords of Iron War.

The emerging permanent increase in defense spending and the growth in civilian expenditure since the outbreak of the Swords of Iron War highlight the need for a broad perspective and forward-looking approach. Figure 6.6 illustrates the development of civilian and defense expenditures (gross, including expenditures contingent on revenues) relative to GDP between 2003 and 2026. Between 2003 and 2011, both civilian and defense expenditures, as well as interest payments, declined. However, from 2011, there was a shift, largely influenced by the social protests that broke out that year, leading to a rise in civilian expenditure from 18.3 percent of GDP in 2011 to 20.9 percent in 2019 (just before the COVID-19 crisis).[18] This increase, without a rise in total expenditure or the deficit, was mainly possible due to a decline in defense and interest expenditures, the latter thanks to the reduction in public debt and the low interest rate environment in Israel and globally.[19,20]

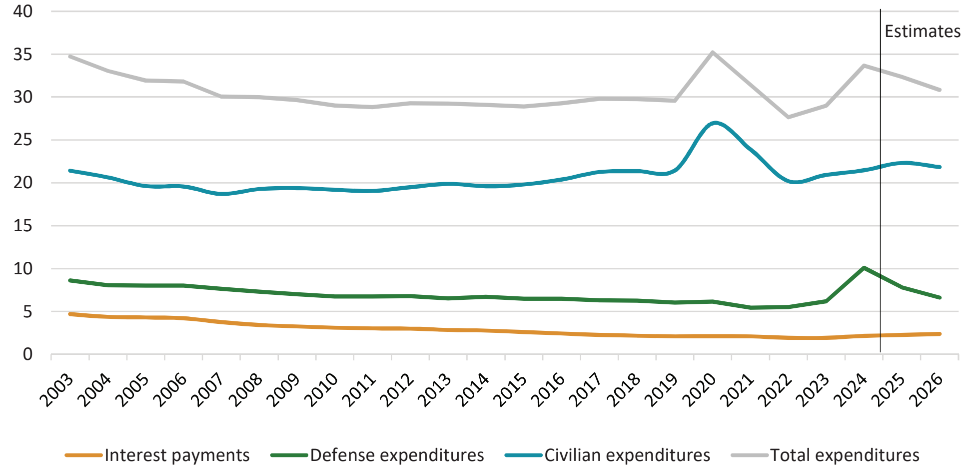
[17] The risk premium, as reflected in the dollar spread for Israel and the CDS (Credit Default Swap) of government bonds, rose from an average of about 50 basis points before the war to about 130 basis points on average since. Towards the end of 2024, with the ceasefire agreement on the northern front, the spread decreased to about 100 basis points, still significantly higher than before the war.

[18] The year 2019 is a convenient reference point. At that time, the economy was at full employment, with no inflationary pressures, and without volatility or anomalous government expenditures, which were created in the following years in view of the COVID-19 crisis, the recovery from it, and the war.

[19] For more discussion on the development of Israel's defense expenditures, see Box 6.1 of the Bank of Israel *Annual Report* for 2023.

[20] For more discussion on the growth of public expenditures and the change in their composition, see Chapter 6 of the Bank of Israel Annual Report for 2018.

**Figure 6.6 | Government's Gross Expenditures by Purpose, 2003–2024, and Estimate for 2025–2026 based on 2025 budget** (percent of GDP)




Note: The figures up to 2023 are budget performance figures, and the figures from 2024 onward are budget figures. Interest payments do not include interest to the National Insurance Institute, which are included in civilian expenditures.
SOURCE: Based on gross state budget figures.

Total expenditure in 2026 is expected to be 1.2 percent of GDP higher than in 2019.

This trend reversed due to the Swords of Iron War. Defense expenditures increased and are expected to remain higher than before the war based on the perception of heightened security risk, and interest payments are rising due to the need to finance the debt, which grew because of war costs. Civilian expenditure also continued to rise, and by 2026 (when most temporary war-related expenditures will have ended), it is expected to be 0.4 percent of GDP higher than in 2019. Thus, total expenditure (defense, interest, and civilian) will be 1.2 percent of GDP higher than its 2019 level. This situation likely necessitates further adjustments—beyond those already implemented in the 2025 budget—to enable a sustained reduction in the debt-to-GDP ratio.

The need to finance additional costs in the coming years due to the war requires a discussion of the government's priorities and a choice between increasing the tax burden and reigning in civilian expenditures.

The challenge outlined above requires a discussion of government priorities. If defense spending levels for the coming years align with the Nagel Committee's recommendations, the government will need to choose between further increasing the tax burden and restraining civilian expenditure, as well as prioritizing among civilian needs. The increase in civilian expenditure, particularly between 2016 and 2019, was directed toward several of the government's civilian objectives: reducing inequality by increasing spending on social insurance and welfare; accelerating growth through greater investment in education and infrastructure; and improving citizen services, in this case by increasing healthcare expenditure. Reducing expenditure on one or more of these objectives will require prioritization among different goals. It is essential to ensure that a sufficiently large portion of resources is directed toward genuinely improving the basic skills of the labor force and achieving sustainable, growth-supportive improvements in infrastructure. The Bank of Israel has dedicated several publications to this topic in recent years and provided detailed recommendations in this spirit.[21] Box 6.1 discusses the composition of expenditure from an international perspective, which may serve as a reference point for the discussion on priorities.

## BOX 6.1: INTERNATIONAL COMPARISON OF CIVILIAN EXPENDITURE AND ITS COMPONENTS

- Primary civilian expenditure (civilian public expenditure excluding interest expenses) as a share of GDP in Israel is among the lowest in OECD countries.
- A detailed examination of the expenditure categories available in OECD data, adjusted for the age composition of different countries where necessary, indicates that this gap encompasses most expenditure categories.
- Public spending on infrastructure and education, the quantity and quality of which are crucial for economic growth, is low by international comparison, taking into account development needs and demographic trends.

This box examines the level of primary civilian expenditure by category relative to GDP, compared to the level in European countries, to draw conclusions about the space for further cuts and their possible implications for growth and living standards in Israel. The importance of such an analysis is heightened by the need for budgetary adjustments due to the war and increased defense spending in the coming years. This analysis contributes an international perspective to the discussion.

### 1. COMPARISON OF TOTAL PRIMARY CIVILIAN EXPENDITURE

Primary civilian expenditure as a share of GDP in Israel is among the lowest in OECD countries (Figure 6.1 in the body of the Chapter) and remains so even after demographic adjustments.[1] A detailed examination of the expenditure categories available in OECD data, adjusted for the age composition of different countries where necessary, reveals that, with the exception of a few categories where civilian expenditure in Israel is higher than the European average, there is a significant negative gap (Figure 1). Expenditures on infrastructure, economy, and employment and on social protection in Israel are significantly lower than the sample average[2], with gaps of 3.1 and 1.3 percent of GDP, respectively. These account for approximately 70 percent of the total gap, which stands at 6.4 percent of GDP.

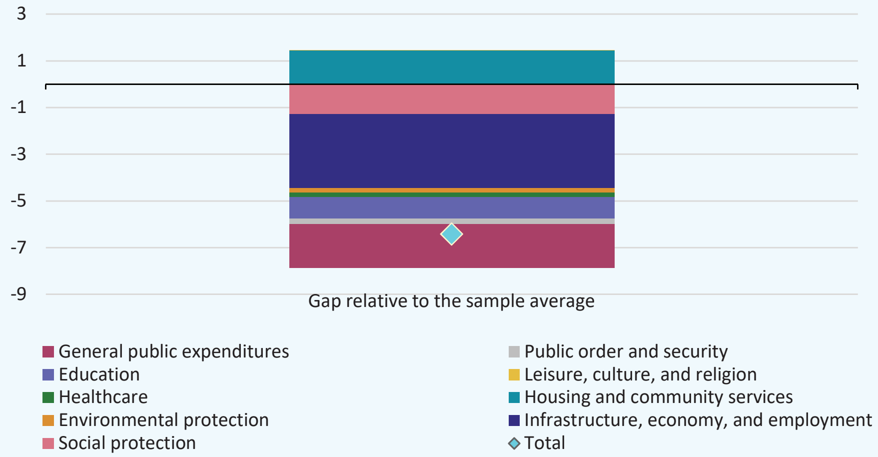
[1] A comparison of total expenditures after demographic adjustment shows that Israel is the fourth country from the bottom among the sample countries, following Ireland, Switzerland, and Lithuania.

[2] The comparison focuses on European countries, because detailed expenditure data are not available for most non-European OECD countries. In the total expenditure data that are available for all OECD countries (Figure 6.1), the average rate of total public expenditure as a share of GDP in the comparison countries is similar to the rate among all OECD countries.

[21] The most recent of these publications is “Recommended Strategic Pillars of Action for the Government”, January 2023.

The only category where expenditure in Israel is higher after adjustment is housing and community services, which includes housing development (including subsidies under programs like “Buyer’s Price”), community development, water supply, and street lighting. In this category, expenditure in Israel is about 1.4 percent of GDP higher than in European countries.

**Figure 1 | Gap in Civilian Public Expenditure between Israel and European Countries, 2022**
(percent of GDP)




The data on education and healthcare, as well as the unemployment, old-age, family assistance, and long-term care items, which are calculated as part of social protection, are adjusted to the age composition in each country. General public expenditures do not include interest payments, and housing and community service payments are reweighted after adding the sum for land sales. The sample average includes the following countries: Austria, Belgium, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Latvia, Lithuania, Luxembourg, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and Switzerland, and UK.

SOURCE: Based on OECD data and processing of the general government's expenses.

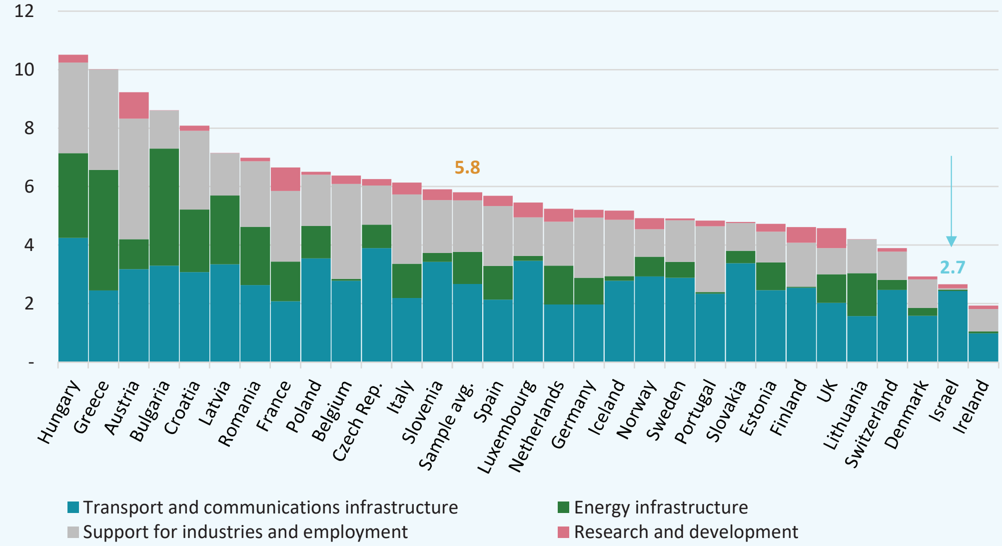
## 2. EXPENDITURE ON GROWTH-SUPPORTING ITEMS

Expenditure on the category of infrastructure, economy, and employment in Israel is approximately 3.1 percent of GDP lower than the average of the sample countries (Figure 2). A more detailed comparison, as shown in Figure 2, indicates that most of the spending on these growth-supporting categories in Israel is allocated to transportation and communication infrastructure (primarily transportation). This expenditure, 2.4 percent of GDP, is only slightly below the sample average of 2.7 percent of GDP.[3] However, the rapid population growth in Israel, along with increasing needs and a relatively low infrastructure capital stock, necessitates greater investment, as outlined in policy documents published by the Bank

[3] The infrastructure investment expenditure presented here includes capital transfers to government companies, which are considered part of the business sector, for investment purposes. This figure does not include privately financed investment. In Israel, the vast majority of investment in water, energy, and communication infrastructure is conducted within a "closed economy" through private and government companies operating in these fields, with costs covered by rates charged directly to consumers. This approach distinguishes Israel from some other countries in the sample, highlighting the importance of focusing on the transportation infrastructure segment.

of Israel in recent years.[4] Expenditure on other economic categories in Israel is negligible, totaling only about 0.24 percent of GDP, compared to an average of approximately 3.1 percent in the sample countries. Most governments invest a higher percentage of GDP in energy infrastructure. Expenditures to support economic industries and employment in Israel are the lowest among the countries examined, at only 0.04 percent of GDP. This category includes expenditures to promote employment and assist various populations in integrating into the labor market, as well as providing subsidies and support to industries such as construction, trade, manufacturing, hospitality, restaurants, and tourism. It also includes spending on administration and various public institutions, promoting competition, limiting monopolies, and maintaining essential regulations for an efficient and functioning economy.

**Figure 2 | Distribution of Public Expenditure on Infrastructure, Economy, and Employment, 2022** (percent of GDP)



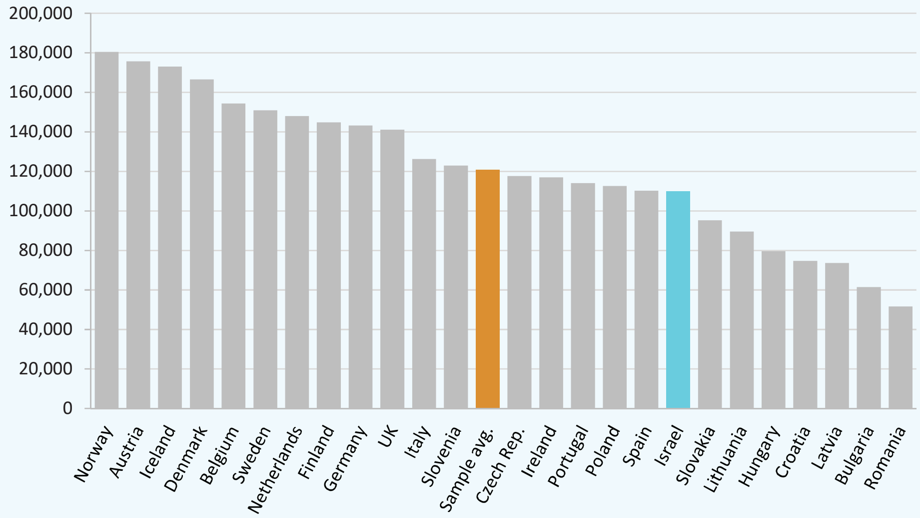

The categories of expenditure items presented are a condensed version of the detailed classification according to the COFOG (Classification of the Functions of Government) for the general government's expenditures.

SOURCE: Based on OECD data.

An examination of total education expenditure, comparing all sampled countries, shows that Israel's expenditure, after adjusting for age composition, reaches about 4 percent of GDP, compared to an average of approximately 5 percent of GDP in the sample. An analysis of cumulative expenditure per student aged 6–15 in 2021 indicates that Israel spends about $109,000 per student, below the sample average of approximately $120,994 (Figure 3).

[4] The most recent of these publications is "Recommended Strategic Pillars of Action for the Government", January 2023. Slide 24 in that document shows that the stock of government capital in Israel as a share of GDP is the second lowest among the advanced OECD countries.

**Figure 3 | Cumulative Expenditure per Student aged 6–15, 2021**
(standardized to purchasing power parity, US dollars)




SOURCE: OECD data.

The quality of education is crucial for accelerating growth, especially in Israel, where growth is largely based on the exceptional success of the high-tech industry. Hanushek and Woessmann (2012) demonstrated that an education system that develops cognitive skills can influence future economic development. Despite this, it is important to emphasize that budgetary investment in education may not lead to the expected achievements and growth if it is not allocated efficiently. This issue requires further in-depth examination, but one example is the significant and long-standing gap between the salaries of veteran teachers and those of younger teachers, which undermines the incentive for talented individuals to enter the education system (as extensively analyzed in the Bank of Israel's Productivity Report, 2019). The longstanding disadvantage for beginning teachers may have affected the quality of entrants into the system, as, despite the average teacher salary being similar to that of teachers in OECD countries, they have underperformed in PIAAC tests in mathematics and reading comprehension. The latest salary agreement with the Teachers' Union in 2022 is expected to somewhat reduce the gap between veteran and beginning teachers.[5]

## 3. EXPENDITURE ON HEALTHCARE AND WELFARE ITEMS

Civilian expenditure on welfare items in Israel is 5.6 percent of GDP lower than the sample average. After adjusting the expenditure according to the age composition of the population, the gap narrows

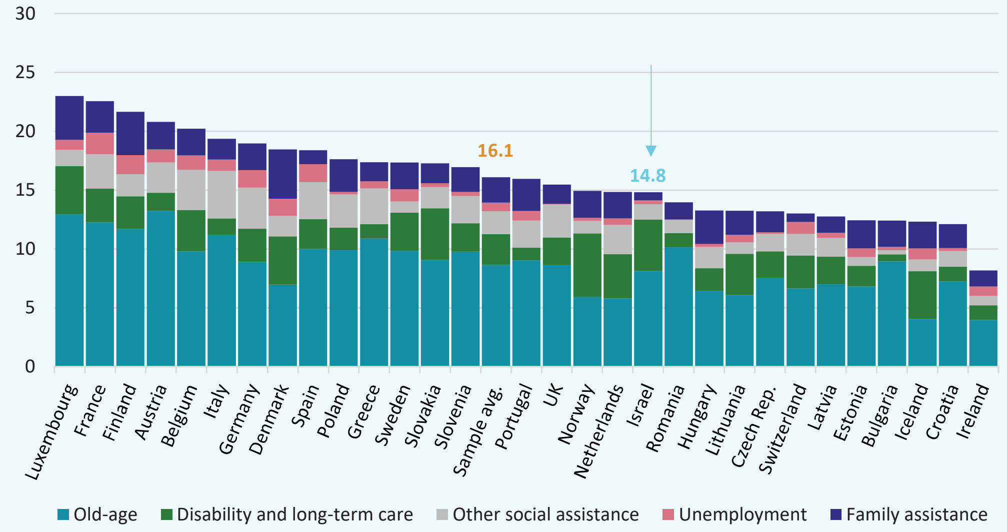
[5] For instance, according to the wage agreement between the Ministry of Finance and the Teachers' Association, teachers with low seniority levels received an increase of about NIS 2,400 per month (30 percent), compared with an increase of about NIS 1,400 (8–9 percent) in the wage of teachers with high seniority levels. (Based on an examination of the wages of first grade teachers.)

to approximately 1.3 percent of GDP. A detailed examination reveals expenditure that is about 1.8 percent of GDP higher in the disability and nursing care category, with negative gaps in expenditure on family assistance, old age, and unemployment, which together account for most of the welfare gap. The remaining gap reflects the government's low involvement in reducing income disparities.

Public healthcare expenditure in 2022 was lower compared to other countries in the sample—5.2 percent of GDP compared to the sample average of 6.7 percent of GDP. However, in European countries, which comprise the sample, the proportion of adults aged 60 and over is significantly higher than in Israel, leading to a greater burden on the healthcare system and a higher need for public expenditure. Adjusting healthcare expenditure using the capitation formula shows that expenditure in Israel is approximately 6.5 percent of GDP, reducing the gap to just 0.2 percent of GDP.

In summary, in an international comparison, Israel is characterized by low expenditure on growth drivers, particularly infrastructure and education, which Tsur and Argov (2023) demonstrated have a significant contribution to overall productivity growth in the economy. It was also found that, after adjusting for age composition, welfare expenditure in Israel is slightly lower than in most countries.

**Figure 4 | Public Expenditure on Social Welfare Items, 2022** (percent of GDP)




The data on the unemployment, old-age, family assistance, and long-term care items are adjusted to the age composition in each country. The categories of expenditure items presented are a condensed version of the detailed classification according to the COFOG (Classification of the Functions of Government) for the general government's expenditures.

SOURCE: Based on OECD data and processing of the general government's expenses.

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## b. Tax policy in view of the structural challenge

At the beginning of 2025, measures took effect to increase tax revenues totaling about NIS 30 billion.

At the beginning of 2025, measures were implemented to increase tax revenues by approximately NIS 30 billion. Once some measures expire and others fully mature, these steps are expected to contribute a similar amount in the medium term, equivalent to about 1.5 percent of GDP. The main and permanent measures include a one-percentage-point increase in VAT, effective January 2025, freezing income tax brackets in 2025, and changing the taxation on retained earnings.

The VAT increase and the freezing of tax brackets are types of tax hikes that have been implemented in the past, each expected to yield about NIS 7 billion annually in the medium term (in 2025 terms). Regarding the taxation of retained earnings, corporate taxation in Israel is based on a two-stage principle, where the company first pays corporate tax on its profits, and in the second stage, the shareholder pays tax on dividends when profits are distributed. This mechanism is intended to maintain tax equivalence between individual income and income generated through a company, while providing an incentive for real investments by deferring part of the tax payment. However, many companies, especially holding companies and self-incorporated individuals, exploit this mechanism to indefinitely defer tax payment by avoiding dividend distribution. According to the Tax Authority, these companies accumulated undistributed profits amounting to about NIS 140 billion between 2013 and 2021.[22] These profits are often invested in passive investments like real estate and the stock market, contrary to the original purpose of encouraging real investments for business growth.

The tax on retained earnings addresses these issues comprehensively through two complementary components, tailored to the different characteristics of holding companies and personal service companies. Holding companies will be subject to an annual tax of 2 percent on retained earnings above a "safety buffer." This buffer is determined as the higher of three options: the average allowable expenses over the last three years, the cost of the company's "active" assets (excluding financial assets and investment real estate), or a minimum amount of NIS 500,000. This mechanism ensures that the tax primarily applies to passively invested profits, not companies investing in real activities. Meanwhile, personal service companies with a turnover of up to NIS 30 million and profitability above 25 percent will be taxed at the individual's marginal tax rate on the excess profits, based on the assessment that such high profitability indicates income that is essentially personal labor income.

During discussions in the Knesset Finance Committee, several relief measures were added to the reform to prevent harm to real business activity. Among other things, an alternative taxation track was established for holding companies, allowing them to choose to pay an annual dividend tax on a portion of 6–8 percent of retained earnings. Under this proposed track, the tax would be applied on all of the company's

[22] For more discussion, see Ministry of Finance, Report of the Team to Examine Undistributed Profits, September 2024.

retained earnings, without considering any safety buffers. However, it will be possible to be credited for the tax paid against future dividend distributions. Additionally, companies in industries with high real activity, such as manufacturing, high-tech, and construction, were exempted. These steps enhance the reform's ability to achieve its goals—correcting tax distortions and increasing state revenues—while minimizing the impact on economic activity that the two-stage taxation is intended to support.

Imposing tax on retained earnings will provide a comprehensive response to deferring tax payments by holding companies and self-incorporated individuals.

Unlike past "dividend campaigns," which generated one-off revenues but harmed long-term revenues and created an incentive to wait for additional campaigns, the current reform creates a permanent revenue source that will help address structural increases in expenditures. According to the Tax Authority, the measure is expected to generate about NIS 9 billion in 2025 and about NIS 4.5 billion annually in the medium term. The commitment to structural reform, as opposed to temporary solutions, strengthens the government's fiscal credibility and corrects a tax distortion that has developed over the years.

## BOX 6.2: DISTRIBUTION OF THE DIRECT TAX BURDEN BY INTERNATIONAL COMPARISON

- Direct tax revenue in Israel, as a percentage of GDP, is low by international comparison. The level of inequality in the distribution of the direct tax burden is very high in Israel compared to other countries, primarily due to high marginal tax rates on the higher income deciles.
- The direct tax burden in Israel is low for income deciles 5–8 compared to most countries included in the international comparison, but it is high for the 10th decile. This remains true even when transfer payments received from the government are deducted from tax payments.

The fiscal challenge due to the war may necessitate further tax increases, which could lead to changes in the distribution of the tax burden in Israel—changes that could potentially impact both labor supply and income distribution in the economy.[1] Comparing the distribution of the tax burden between Israel and other advanced countries will provide an international perspective for considering tax measures (Brender, 2007).

To present the distribution of the direct tax burden in an international comparison, household data (hereafter referred to as microdata) from the Luxembourg Income Study (LIS) are used, allowing examination based on income deciles in the economy. Specifically, household income and tax data for 2019 in Israel and 18 other OECD member countries—hereafter referred to as the comparison countries—are utilized.

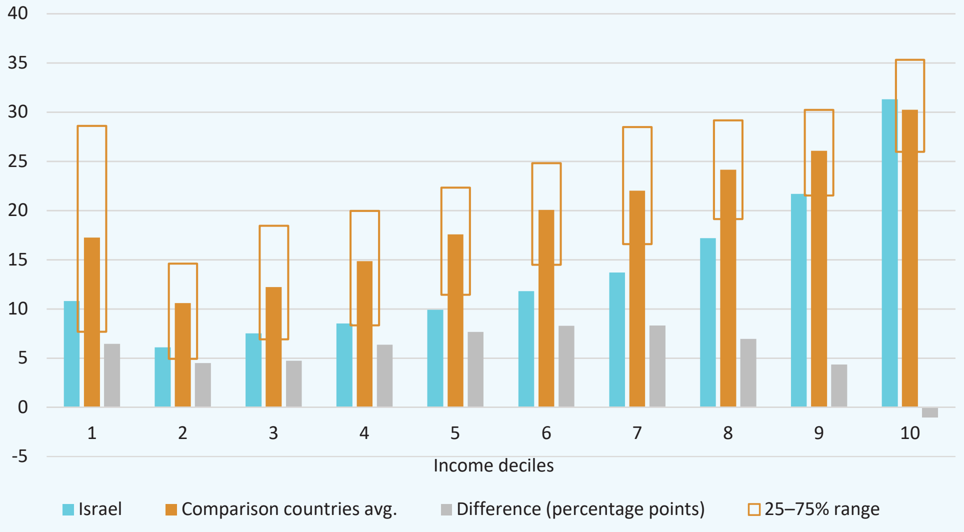
Comparing the tax burden based on 2019 microdata relative to the comparison countries in the sample requires validation. First, total direct tax revenue as a percentage of GDP (according to OECD macro data) in 2019 was found to be almost identical to the average tax burden (according to LIS microdata)

[1] The tax burden is defined in this Box as tax payments as a share of household income.

for that year, both in Israel and the comparison countries: approximately 16 percent and 22 percent, respectively. These macro values, as well as the average revenue in terms of GDP in the OECD, barely changed between 2019 and 2023. Second, the distribution of the tax burden, measured continuously by the ratio between the direct tax burden of those earning 67 percent of the average wage in the economy and those earning 167 percent of the average wage, also remained almost unchanged in Israel and most countries between 2019 and 2023. The average distribution of the comparison countries in 2019 is very similar to the OECD average in 2023 (a difference of only one percentage point).

For the purpose of analyzing the distribution of the direct tax burden in Israel by international comparison, the direct tax burden is defined as: total direct taxes (income taxes, national insurance fees and similar payments, and other direct taxes such as various forms of asset taxes) divided by economic income (income from capital and labor plus income from private transfers). The direct tax burden in Israel was found to be low in most deciles by international comparison (Figure 1): In deciles 1–4, the tax burden in Israel is similar to that of the lower quartile of the distribution in comparison countries (the lower line within the orange frame in Figure 1). In deciles 5–8, the tax burden in Israel is lower than in the lower quartile of comparison countries, and it gradually increases in deciles 9–10 to slightly above the average of comparison countries in the top decile. From this, we can infer that the marginal tax burden in Israel for the top three deciles is relatively high.

**Figure 1 | Average Direct Tax Burden by Equivalized Income Deciles, Israel and Comparison Countries[a], 2019** (percent)




[a] The comparison countries are Austria, Australia, Belgium, Canada, France, Germany, ireland, Lithuania, Luxembourg, Netherlands, Slovakia, South Korea, Spain, Sweden, Switzerland, UK, and US.

SOURCE: Based on LIS.

The analysis so far suggests that the burden of direct tax payments is relatively low in deciles 5–8, and that the incentive to increase income is relatively low in the higher deciles in Israel due to the high marginal tax rates on these deciles. However, it is difficult to draw conclusions from the analysis so far regarding the government's direct impact on relative economic welfare. To address this, a more comprehensive comparison is needed, which also considers the burden of indirect taxes and the assistance and services individuals receive from the government. Although not all the necessary data for such a comparison are available, it is possible to examine the robustness of the finding regarding the relative tax burden by using a broader definition of the direct tax burden, which takes into account the direct assistance that the government provides to individuals.

In some countries, government assistance to individuals and families is primarily provided through tax reductions (already considered in the previous calculation, such as tax credits), while in others, it is provided through public transfers (benefits). When public transfers—both income-dependent (such as negative income tax) and not income-dependent (such as child or old-age benefits)—are deducted from tax payments, and the net direct taxation is examined, the gaps between the comparison countries and Israel are smaller than the findings in Figure 1. This is because the transfer payments in the comparison countries are more generous than in Israel. Nevertheless, even with this calculation, the direct tax burden in Israel remains low compared to other countries in deciles 5–8, while in the other deciles, it is similar to or higher than that in other countries.[2]

In summary, the international comparison of the distribution of the direct tax burden indicates that the direct tax burden on the middle class in Israel (deciles 5–8)—both gross and net—is relatively low compared to the comparison countries, and it increases relatively quickly in the higher deciles. These findings can contribute to the discussion on the structure of the tax system and transfer payments in Israel, especially during this period of significant budgetary adjustments, with further adjustments likely needed in the coming years. The comparison is particularly important in a world where there is global competition for skilled workers.

## REFERENCES

Brender, A. (2007). "Tax Rates on Labor Income in Israel from an International Perspective: 2006–2007", Bank of Israel Research Department (in Hebrew).

[2] Deductions for pension and receipt of pension payments are not included in this analysis.

## c. The structural deficit

The structural deficit is the deficit that is expected to persist in the medium term, excluding temporary effects, given the current government policy. Changes in the structural deficit are mainly influenced by government decisions affecting permanent expenditure levels, and legislative changes altering various tax rates, reflecting the government's long-term policy. However, the structural deficit can also change in the long term due to structural changes, such as population aging or shifts in the economic structure affecting the tax base.

The Bank of Israel's forecast for the deficit in 2026–2030, absent the war, was about 2.3 percent, serving as a baseline for calculating the central government's new structural deficit. In Table 6.5, we add adjustments to this baseline due to permanent changes in various expenditures—resulting from the war, new government commitments, and the expected rise in interest payments—as well as the permanent convergence measures the government has implemented since the outbreak of the war.

**Table 6.5 | Estimate of the Central Government's Total Deficit in the Medium Term[a]**

(percent of GDP)

| | Item | Percent of GDP | Notes |
|---|---|---|---|
| 1 | **Medium-term deficit without the war** | **2.3** | Average deficit for 2026–2030 expected before the war. |
| 2 | Change in the defense budget | 1.4 | Due to the addition to the 2024 budgetary base and recommendations of the Nagel Committee. |
| 3 | Change in primary civilian expenditure | 1.0 | Mainly due to the budgeting of the rehabilitation administrations, the increase in the healthcare price index, National Insurance Institute budgets, and wage agreements. |
| 4 | Change in interest on the debt | 0.4 | Total interest payments are expected to grow by 0.4 percent of GDP relative to before the war. Half of this is due to an increase in the debt stock and half is due to the increase in its price. |
| 5 | Permanent adjustments on the expenditure side | 0.0 | The broad cuts and wage reductions in the public sector are not expected to persist in the medium term. |
| **6=2+3+4+5** | **Total change on the expenditure side** | **2.8** | |
| **7** | **Permanent adjustments on the revenue side** | **1.5** | The main measures are a one percentage point increast in VAT that took effect in January 2025, a freeze in the income tax brackets for 2025, and the imposition of tax on retained earnings. |
| **8=1+6-7** | **Medium-term deficit without additional adjustments** | **3.6** | |

[a] The calculation is based on a Bank of Israel assessment regarding the development of expenditures and revenues in the medium term (2026–2030).
SOURCE: Based on Ministry of Finance and Central Bureau of Statistics.

The analysis in Table 6.5 shows that the government's structural deficit, meaning the expected medium-term deficit given current policy and after one-off components fade, is about 3.6 percent of GDP. The 1.3 percent increase from the baseline reflects three main expenditure factors: a significant addition to the defense budget, assuming the Nagel Committee's recommendations are adopted; an increase in civilian expenditure due to the war's consequences; and other government commitments and rising interest payments due to the increased debt and its cost. Overall, structural expenditures are expected to rise by about 2.8 percent of GDP. This increase in expenditures will be only partially offset by the permanent convergence measures included in the 2025 budget on the revenue side. A total structural deficit of 3.6 percent of GDP is higher than the level consistent with stabilizing the debt-to-GDP ratio in the medium term—about 3.2 percent—indicating a need for additional convergence measures to bring the structural deficit below this level for a sustained reduction in the debt-to-GDP ratio.[23]

The government's structural deficit is about 3.6 percent of GDP—higher than the level that is consistent with reducing the debt to GDP ratio.

In discussing the desired structural deficit, upward risks to its level should be considered. Such risks include the possibility that the potential GDP growth rate will decline further than expected due to the war, and upward surprises in structural expenditures. An example of such a surprise is the increase in National Insurance expenditures in recent years. Specifically, spending on long-term care benefits grew from NIS 6.5 billion in 2017 to NIS 16 billion in 2023. This growth reflects an approximately 80 percent increase in the number of eligible recipients for public long-term care benefits, while the elderly population grew by less than 20 percent (Kedar et al, 2024).[24] The gap between these rates suggests that most of the increase is not due to population aging but rather to expanded eligibility for benefits. National Insurance activities in long-term care were considered in calculating the structural deficit, but the baseline scenario estimate may prove too conservative given the rapid growth rate of these expenditures in recent years. (For more discussion, see Part 3 of Chapter 7 in this Report.)

## d. A long-term view of the cost of the debt

Given the increases in debt and yields, the government's interest payments are expected to rise significantly in the coming years. Although the current increase in the interest burden is moderate because a substantial portion of the existing debt

The government's interest payments are expected to increase significantly in the coming years.

[23] The structural budget deficit that stabilizes the debt depends on the rate at which the existing debt stock erodes. The higher the real growth rate and the ratio of the GDP price deflator to the Consumer Price Index are, the faster the existing debt is expected to erode relative to GDP. In a scenario where real growth averages 3.5 percent, inflation is 2 percent, and the government does not issue new debt (i.e., operates in budgetary balance), a debt of about 67.8 percent of GDP is expected to erode by 2.9 percent of GDP annually. Additionally, the government receives annual revenues averaging about 0.3 percent of GDP from the Israel Land Authority's surplus revenues (not included in the deficit calculation but serving as a substitute for debt issuance). This means the government can finance a deficit of 3.2 percent of GDP each year without increasing the debt-to-GDP ratio, and a lower deficit is required to reduce the debt.

[24] N. Kaidar, N. Davidovitch, and A Weiss (2024). "Long-Term Care Insurance in Israel." Policy Paper No. 04.2024, Taub Center for Social Policy Studies in Israel.

was issued before the recent rise in yields, the continued growth of the debt and its issuance at higher costs is eventually expected to strain the state budget. Interest payments for the years 2026–2030 are projected to average about 2.5 percent of GDP, an increase of 0.5 percent of GDP compared to 2023 (and 0.4 percent of GDP compared to the medium-term forecast before the war). About half of this increase is due to the expected rise in government debt, primarily reflecting the need to finance relatively high deficits due to war expenditures. The other half is due to rising yields—as the interest rate environment is higher than in the past—and an increase in the perceived risk of the economy compared to the period before the war. This increase in the interest burden will require the government to allocate a larger portion of its budget to interest payments at the expense of other expenditures, potentially affecting the government's ability to fund public services and infrastructure in the long term.

## 4. CONCLUSION: THE PUBLIC DEBT AND THE POLICY NECESSARY TO REDUCE IT

### a. The change in the debt and its composition

The public debt to GDP ratio increased by about 6 percentage points in 2024, to 67.8 percent.

In 2024, the public debt to GDP ratio increased by 6.3 percentage points to 67.8 percent. This marks the second consecutive year in which the debt ratio increased, following the rise from 60.5 percent to 61.5 percent in 2023. The most significant factor contributing to this increase was the government deficit, resulting from the sharp rise in war expenditures. These factors were partially offset by the nominal growth of the economy and revenues from the sale of state assets. Unlike in 2021–2022, when rapid nominal growth contributed to a significant reduction in the debt-to-GDP ratio (an average of about 7 percentage points per year), its contribution in 2023–2024 was relatively moderate (about 3.5 percentage points per year).

This year, the gap between gross debt and net debt (debt minus government loans and government deposits at the Bank of Israel) widened due to debt issuances that were larger than needed to finance the deficit and payments from the Property Tax Compensation Fund. These issuances were intended to increase the safety buffer provided by the cash deposits at the Bank of Israel. By the end of the year, the volume of deposits grew even more due to a significant surprise in tax revenues, resulting from vehicle purchases that were brought forward. In the current situation, given the background conditions, it is prudent to maintain a certain level of safety buffer due to the increased risk of unexpected and urgent expenditures.

The vast majority of government debt at the end of 2024 (about 85 percent) was domestic debt, with approximately two-thirds of it being tradable. External debt in foreign currency constitutes only about 16 percent of the total debt—a relatively low proportion compared to other countries, which reduces the debt's exposure to

**Table 6.6 | Components of the Increase in Gross Public Debt, 2019–2024**

(percent of GDP)

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|---|
| **Debt at the end of the previous year** | 59.9 | 59.1 | 71.1 | 67.8 | 60.5 | 61.5 |
| Contribution of the change in nominal GDP to the debt to GDP ratio | -3.2 | 0.6 | -7.6 | -7.0 | -3.7 | -3.7 |
| Net capital inflow | 3.2 | 12.8 | 3.8 | -2.7 | 2.9 | 8.3 |
| *of which* : Government's cash deficit (excluding credit) | 3.7 | 11.3 | 4.3 | -0.6 | 4.1 | 6.8 |
| Net repayment of credit by the public[a] | -0.04 | -0.04 | -0.04 | -0.04 | -0.02 | -0.04 |
| Privatization proceeds | -0.1 | 0.0 | -0.9 | -0.9 | -0.6 | -0.2 |
| Funding beyond the financing deficit[b] | -0.4 | 1.6 | 0.4 | -1.2 | -0.6 | 1.7 |
| Revaluation of shekel-denominated indexed debt[c] | 0.2 | -0.2 | 0.8 | 1.6 | 0.9 | 0.9 |
| Revaluation of foreign currency-denominated debt | -0.6 | -0.4 | -0.4 | 1.0 | 0.3 | 0.0 |
| Adjustment to issuance costs | -0.2 | -0.4 | -0.2 | 0.1 | 0.4 | 0.5 |
| Remainder[d] | -0.1 | -0.4 | 0.3 | -0.3 | 0.2 | 0.3 |
| **Debt at year end** | 59.1 | 71.1 | 67.8 | 60.5 | 61.5 | 67.8 |

[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.

exchange rate risks.[25] The cessation of new debt issuance through earmarked bonds (at a fixed interest rate) at the end of 2022 (bonds that accounted for about 26 percent of the debt in 2024) gradually increases exposure to market fluctuations, but market yields have historically been lower than those on earmarked bonds. Additionally, despite a slight decline, the average term to maturity on the debt stands at about 9 years, providing some protection against short-term price shocks. However, the need for increased borrowing since the outbreak of the war highlights other risks, particularly the risk to fiscal credibility, and the need to address it.

## b. The stability of the debt and fiscal rules

Beyond geopolitical risks, Israel's fiscal risk at this time is due to the increase in the structural deficit without sufficient adjustments, and an anticipated decline in the economy's potential growth rate following the war. Reducing the structural deficit to a level that allows for debt reduction (around 3 percent) will help mitigate fiscal risk. This is not only due to the debt reduction itself but also by creating sufficient budgetary space to finance structural investments that support accelerating potential growth.

As detailed in the Bank of Israel's Annual Report for 2023, adherence to deficit and expenditure targets that allow control over the structural deficit has eroded over time, even in years without extraordinary expenditures (such as those related to the COVID-19 crisis and the Swords of Iron War). Regularly exceeding deficit ceilings and expanding expenditures beyond planned levels complicates the implementation of

[25] Some of the exchange rate risk of the external debt is hedged by the Government Debt Management Unit.

multiyear investment plans, as there is a need to balance deviations from targets. This often leads to cuts in these plans (Brender, 2020).[26]

To reduce the debt to GDP ratio, decision-makers must first and foremost be committed to supporting an appropriate institutional framework.

To reduce the debt-to-GDP ratio in Israel, a principled commitment from decision-makers is required. Enforced fiscal rules can help realize this commitment through a preplanned trajectory, contributing to government credibility. For example, adopting a framework similar to the one recently proposed by the European Union could be considered, as outlined in last year's Annual Report. The EU's new mechanism focuses on setting long-term structural adjustment paths tailored to each country's circumstances, rather than rigid, uniform deficit targets. Countries are required to present a multiyear plan (4–7 years) to reduce debt and deficit ratios, with the pace of adjustments determined by the initial debt level. For instance, countries with debt exceeding 90 percent of GDP are required to achieve an average annual reduction of one percent of GDP. The EU framework also provides more short-term flexibility, as long as expenditures are aimed at funding reforms and investments that support long-term growth (and common goals such as combating the climate crisis).

Adopting such a framework in Israel would require the government to formulate a multiyear plan for converging to debt and deficit targets, while addressing the need to invest in growth drivers (as outlined in Box 6.1), which is substantial in Israel. Such fiscal rules allow the government flexibility in distributing the adjustment burden between revenues and expenditures but also require clear convergence to targets, signaling a commitment to fiscal stability. Israel has unique constraints, primarily much greater security uncertainty than European countries and the absence of external institutions that can provide objective reviews of plans, frameworks, and targets. Once established, such institutions would require adjustments in any framework adopted in Israel.

Whether rules similar to those being implemented by the EU are adopted or other rules are chosen, it is important that they include binding timelines and allow for oversight, and above all, that they are enforced as part of the government's principled commitment, with the creation of an appropriate institutional framework such as an independent fiscal council to monitor compliance with the fiscal policy targets that are set.

[26] Adi Brender (2020). "Fiscal Policy: The Journey to Lowering the Public Debt to GDP Ratio and the Size of Government", in A. Ben-Bassat, R. Gronau, and A. Zussman (eds.) Lights and Shadows in the Market Economy: The Israeli Economy, 1995–2017.