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The State Budget in Light of the Social Protest

Working Group Chair: **Prof. Zvi Eckstein**

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Working Group

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The State Budget in Light of the Social Protest

Working Group Summary and Recommendations

In 2011, the Israeli government and parliament adopted a multi-year fiscal policy plan that includes an annual expenditure ceiling in the state budget for each of the coming years and a requirement that the deficit not exceed 1.5% of GDP in 2013 and 1% of GDP from 2014 onward. Nevertheless, since adopting these principles,[1] the government has passed numerous resolutions that influence the projected expansion of the budget over the next few years; likewise changes have taken place in the macroeconomic environment relative to the expectations at the time these principles were established. Moreover, during the social protests that erupted in Israel in the summer of 2011, a broad range of groups called for greater state involvement in the social sphere and for improvement of public services—all against the backdrop of a significant reduction in the weight of government expenditures in the GDP during the previous decade (from 51% to 42%), followed by a steep drop in the tax burden.

These developments confront the Israeli government with complex challenges in the area of fiscal policy. Under the present expenditure rule, in 2013 the state budget will grow by 4.8% in real terms—an exceptionally high increase that raises total government spending from 42% to 43% of GDP. However, estimates of the cost of the multi-year programs approved by the government over the past two years in the areas of education, health, social welfare, infrastructure, and defense are higher than the ceiling permitted under the expenditure rule. Assuming that the government carries out the necessary adjustments so that its expenditures do not exceed the spending cap, the projected revenue level based on current tax rates will be expressed in a deficit of roughly NIS 20 billion (some 2% of GDP) above the ceiling set by law, and a halt in the reduction of the debt-to-GDP ratio.[2]

Thus the government will have to reach a decision in the following areas:

1. To cancel or restructure the implementation of certain of the multi-year programs that it adopted, and to reduce expenditures on other items or raise the spending cap

1 Fiscal rules capping spending and deficits, as set forth in the Deficit Reduction and Budgetary Expenditure Limitation Law (Amendment No. 11), 5770-2010.

2 The figures without sources in this report are based on calculations by the members of the working group, and do not necessarily reflect the views of the Finance Ministry representatives who were part of the group.

2. To raise the deficit ceiling while halting the decline in the debt-to-GDP ratio, or to increase tax rates so as to enable the decline to continue, whether through the plan stipulated in the above law or at a slower pace.

In addition, as a result of the social protests and the report of the Committee for Socioeconomic Change (known as the Trajtenberg Committee), parts of the Israeli public are calling for curbing the decline in the percentage of the budget allocated for public spending in the GDP, as set forth in the current fiscal rule. They are also calling for for achieving growth in the percentage of public spending through a parallel increase in the tax burden.

Three Policy Alternatives for the Government's Budgetary Framework

The size of the gaps between the current estimates and the targets stipulated by law for each of the parameters cited above is substantial. Consequently, we are speaking not of technical adjustments but of major decisions that must reflect a broad, long-term policy approach. The latter should be grounded on a values-based economic and political choice, and on a determination of the "balance of risks" of Israel's medium-term fiscal strategy. For this reason, the working group chose not to recommend specific targets for the various budgetary aggregates but rather to describe in detail the implications of the different alternatives, both in terms of their impact on the fiscal and macroeconomic aggregates, and the type of measures that will be needed to achieve the various objectives to be selected. We perform this analysis by presenting three alternative scenarios for the government's budgetary framework of the next five years, reflecting various policy approaches. They are intended to demarcate certain boundaries that, if deviated from, would have significant, undesirable financial repercussions, in the opinion of the working group.

- **Alternative A:** Maintaining the existing fiscal rules of expenditures and deficit targets while simultaneously carrying out necessary adjustments in the government's spending programs and the tax rates. This would mean holding public spending to 43% of GDP and a genuine reduction in the debt-to-GDP ratio in 2014–2018.
- **Alternative B:** Maintaining the spending cap in accordance with the present rules without raising taxes, so that the debt-to-GDP ratio would not drop below the current level. The primary outcome is that the deficit would be 3.6%–3.7% of GDP for 2013–2018.

- **Alternative C:** Raising government spending from 42% to 45% of GDP from 2013 to 2016 by concurrently raising the tax burden so that the deficit targets of Alternative A are met.

We analyze the alternatives in light of the macroeconomic processes that have taken place over the last decade, the existing fiscal rules, the social protests, and the demographic changes projected for the coming decade. Israel's fiscal policy over the next few years will be influenced to a large extent by the policies of successive Israeli governments over the past decade, particularly from 2003 onward. These were marked initially by a curbing of the growth in government spending, a moderate reduction in the direct tax burden, and a decrease in the public debt-to-GDP ratio, whose current level—74.2%—is similar to the (simple) average of the developed nations. These measures contributed a great deal to the recovery of Israel's economy from the severe crisis of the early 2000s, to the rise in Israel's financial credibility, and to the economy's ability to withstand the recent global financial crisis. In the aftermath, the weight of public spending in GDP is the lowest it has been in several decades, and civilian public spending is among the lowest of the developed nations. At the same time, despite the continued curb on spending, the aggressive tax reductions carried out by the government between 2007 and 2011 brought its structural deficit back to the level preceding the reductions—which does not support a continued lowering of the debt-to-GDP ratio. Moreover, the slowing of the growth in government spending reduced the government's involvement in transfer payments as well as the scale of public services that it was able to provide.

The first section of the working group's paper offers an overview of the major developments in Israel's economy in 2011 and early 2012, the demographic changes expected to affect the GDP growth rate during the next decade, and the government's fiscal policy over the past decade. These serve as a basis for discussion of the budgetary framework for the next several years. The past year (2011) was characterized by positive macroeconomic data: The Israeli economy grew by 4.8%; per-capita GDP rose by 2.9%, and unemployment dropped to 5.6%, the lowest level in three decades (6.7% according to the new formula of the Central Bureau of Statistics' Manpower Survey). Despite concerns raised by the continuation of the financial crisis in Europe, the first-quarter results for 2012 indicate a stable unemployment level and employment rate, and a slight acceleration in business-sector activity. GDP is expected to grow by 3.1% this year, and by 3.5% in 2013.

In the medium term, current demographic projections of the Central Bureau of Statistics regarding population growth among working-age individuals show that

Israel's growth rate during the coming decade will almost certainly be very low in comparison to that of the previous decade (3.6%). These forecasts suggest that the growth rate of the work-age population (25–64) will most likely slow from 2.3% in the previous decade to roughly 1.2% over the next ten years, and that the composition of this group will change. Specifically, the proportion of Arabs and ultra-Orthodox Jews (groups that are characterized by low employment rates) in the overall population is expected to rise, while the weight of the non-Haredi Jewish population (which is marked by high employment levels) will drop.

These figures form the basis of the growth forecasts of the working group. Thus the GDP for 2014–2018 is expected to rise by an average of 3.3%, under the optimistic assumption that employment and productivity will continue to climb. This offers a further reason for the recommendation in the final chapter of large-scale investment in policies that promote employment.

Analysis of the Policy Alternatives

In the key section of the paper, the three policy alternatives for a budgetary framework are analyzed. As stated, the present expenditure rule will lead to a rise in spending of 4.8% in real terms in 2013. This stems from an increase of 2.9% in government expenditure, in keeping with the spending cap, as well as a one-time price adjustment of 2%. Examining **Alternative A**, it emerges that a gap of 2.2% of GDP is expected in 2013 between the projected deficit, derived from the expenditure rule (an increase of 4.8% in real terms) and the deficit target (1.5%). Closing this gap by raising taxes means adding statutory taxes of NIS 26 billion (in 2012 prices). Reducing the deficit to 1% of GDP in 2014 (in accordance with the deficit rule) would necessitate additional taxes totaling NIS 5 billion. In other words, a choice must be made between a sizeable increase in the tax burden, a higher deficit target, and a rise in spending below the ceiling set by law.

With regard to spending, the position of most members of the working group is that given the relatively low level of civilian expenditure and the government's existing commitments, it would not be advisable to raise spending to a level less than the ceiling. It would therefore be preferable to raise the tax burden or increase the deficit target. The former is likely to slow the rate of growth, at least in the short term, but also to contribute to the continued drop in the ratio of public debt to GDP. This will increase the credibility of the Israeli economy, lead to a reduction in interest payments, and allow for flexibility in carrying out an anti-cyclical policy in the event of a financial crisis.

Raising the deficit target yields precisely the opposite results. In the case of **Alternative B**, under the existing conditions, spending to the permitted ceiling without raising taxes is expected to halt the decline in the debt-to-GNP ratio; however, it will not cause the ratio to rise. In such a situation, we project an annual deficit of roughly 3.6% of GDP; the debt ratio will be based on a level of 75%, with an average projected growth rate of 3.3% as noted above. It should be noted that a high deficit is liable to limit the government's ability to respond to financial crises; similarly, a change in policy with regard to deficit reduction could damage the state's fiscal credibility, exerting a negative impact on its credit rating and on the costs of raising capital.

From the discussion on Alternative A, it is evident that raising the budget above the spending cap, as proposed in **Alternative C**, would require an extremely large tax increase. Boosting the weight of public spending to 45% of GDP by 2016, and meeting the current deficit target, will require a cumulative addition of NIS 53 billion in statutory taxes (at 2012 prices). Increasing expenses without raising taxes will lead to annual deficits of over 4% of GDP, and a rise in the public-debt-to-GDP ratio. The position of the working group is that the government should continue its course of lowering the public- debt-to-GDP ratio, and in any case should certainly avoid a policy plan that would lead to a rise in the debt-to-GDP ratio. Thus it is clear that choosing Alternative C would necessitate a tax increase equal to at least the level of additional spending over and above the existing ceiling.

Accordingly, it is the consensus of the working group that **a tax increase of at least NIS 10 billion shekel will be necessary in 2013**. We are not presenting a detailed plan for this increase but are proposing guidelines for discussion along with alternatives for raising revenues in keeping with the target selected.

- In the first stage, we recommend focusing on revoking unjustified exemptions and on taxes that improve the resource allocation of the economy.
- In the second stage, bearing in mind the tax increase required, we propose that the major taxes—income tax, corporate tax, and VAT—be raised.
- We further recommend that a professional working group at the Finance Ministry construct several detailed recommendations for more efficient tax allocation by increasing tax receipts, in accordance with the deficit targets and the planned decrease in the debt level.

A general discussion, including figures on the different exemptions that can be revoked as well as the implications of changes in the various tax components, is presented in a special chapter on taxation.

Recommendations

Against the backdrop of the social/economic protests and the plan to increase employment, the members of the working group recommend assigning greater priority in the budget to the areas of employment and education.

- In the context of employment, it should be stated that Israel's budgetary expenditure on active labor market policies is lower in comparison with other developed nations and in relation to the resources needed to promote employment. We recommend a substantial increase in investment in policies aimed at boosting employment; these should focus on various programs to increase human capital and improve the access of population groups characterized by low employment rates. Our position is that judicious investment will lead to a rise in employment rates and a lesser incidence of poverty, and will help integrate the Arab and ultra-Orthodox sectors into Israeli society.
- **We recommend a cumulative supplement of NIS 1 billion annually over the next five years** for investing in active labor market policies such as professional training for young people and adults, technological colleges, employment centers for preferred population groups, incentives for employing Israelis in agriculture, tuition vouchers for professional training while integrating in the labor market, a Welfare to Work program, and increased enforcement of labor laws.[3]
- The working group supports the recommendations of the Trajtenberg Committee with regard to daycare centers, and calls for their implementation, with emphasis on the areas of the country with low participation in the labor market. Several of the members favored making benefits contingent on the parents' employment.

In the area of education, we support the recommendations of the Trajtenberg Committee and call on the government to continue implementing them.

- The members of the working group view investment in education as an example of long-term thinking that is consistent with our recommendations in the area of employment, since devoting resources to education also has a positive effect on the acquisition of skills needed for the labor market and on increasing employee productivity. However, when developing the recommendation for free education for ages 3–4, it is advisable, first and foremost, to make this service contingent on both

3 The position of the Finance Ministry is that it would not be appropriate to recommend a specific sum in this context without a comprehensive examination of the government's priorities and of the budgetary resources at its disposal.

parents' working. Similarly, afternoon daycare for preschool children should be conditioned on the employment of both parents. Such a policy, of maximizing the parents' earning power by providing services that facilitate their participation in the work force, can be highly effective in encouraging employment at a time when the growth rate of the working-age population is on the decline.