New Fiscal Rule

On Thursday, March 4th, 2010, the Israeli government accepted the proposal of the Prime Minister and the Minister of Finance to enact a new fiscal rule for calculation of the central government expenditure ceiling, while maintaining the deficit ceiling. The bill passed its first reading in the Knesset on March 17th, 2010.

The Deficit Reduction and Budgetary Expenditure Limitation Law is of high importance for maintaining the fiscal stability of the State of Israel, by setting limitations on both the deficit level and the rate of growth of government expenditure. The existing legislation contributed to the reduction of the deficit in the last few years, and consequently, to a decline of the debt/GDP ratio, which serves as a key indicator of economic stability. Indeed, the global economic crisis induced a slowdown of domestic economic activity, a decline in tax revenues, an increase in the deficit, and a halt in the decline of the debt/GDP ratio; however, these developments mainly reflect the operation of the automatic stabilizers, and were quite moderate in Israel compared with the concurrent developments in the developed countries.

In light of the tight fiscal policy, which led to a significant improvement in Israel's fiscal stability during the last seven years, but also resulted in a sharp decline of the share of public expenditure in GDP, a professional team, consisting of representatives from the Ministry of Finance, the Bank of Israel and the National Economic Council, examined the long-term effects of the existing fiscal rules. The team discussed, among others, guidelines related to the economic policy objectives, described below.

The share of Israel's public expenditure in GDP has declined dramatically in the last few years: from more than 50 percent in 2003 (and 59 percent in 1987) to 43 percent in 2008. During the same period, the average share of public expenditure in GDP among OECD countries was stable at 44 percent. Therefore, the main objectives of the proposed fiscal rule are to balance between a continuing reduction of the public debt to GDP ratio - already reduced from a 99 percent rate on 2003 to a 79.6 percent rate on 2009 - and the share of public expenditure, as a foundation for supplying a proper level of public services. The reduction of the public debt and maintenance of fiscal credibility require reference to both the short term and the medium and long terms. A rapid return to a decreasing deficit trend (halted as a result of the global economic crisis) is the main goal for the short term. A decline in the debt/GDP ratio to about 60 percent within a decade, similar to the target set in the Maastricht Treaty of the European Union, serves as the main goal for the medium term. The long-term goal is to reduce the debt/GDP ratio further in the period that follows.

The fiscal rule decision determines that the real growth of central government expenditure will be at a rate equal to the ratio between 60 percent (the medium-term target) and the last known debt/GDP ratio, multiplied by the average GDP growth rates during the ten previous years for which the Central Bureau for Statistics has published GDP figures. Hence, the central government expenditure growth rate will be a derivative of the distance from the debt target and "long-term" growth rate. Nonetheless, the new expenditure ceiling will continue to be subject to the declining deficit ceiling as per the legislation, targeting 1 percent of GDP from 2014 onwards. If the increase in expenditure according to the new ceiling leads to a deviation from the deficit ceiling, the expenditure growth rate will be reduced accordingly, or government revenues increased.

This decision reflects the expenditure rule guidelines recommended by the team, namely, basing the ceiling on actual figures only (as opposed to using forecasts), the simplicity and transparency of the calculations; and the maintenance of the credibility of fiscal policy.