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THE POLITICS AND ECONOMICS OF THE ISRAELI BUDGET

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Although the 2003 state budget has passed its first reading in the Knesset, the crisis preceding the vote led to the collapse of the National Unity Government. As a result, the political drama surrounding the budget has overshadowed the economic implications, which are no less significant.

The budget is intended to promote two basic objectives. The first is to stabilize the economy by providing a short-term response to the recession and creating the conditions for sustainable growth over the longer term. The second is to reduce unemployment, which has risen significantly because of the economic slowdown. In the coming year, the government intends to accomplish this by replacing foreign workers with local workers.

Budgeted expenditures for 2003 are set at NIS 270 billion, which is equivalent to 45% of GDP or about 90% of the business-sector product. This represents a trend reversal; the budget's share of domestic product was rising in recent years and reached 48% in 2002. A comparison with OECD countries reveals that the relative weight of public expenditure has risen faster in Israel than elsewhere.

The budget process begins with a growth estimate that defines projected revenues. The second component is the size of the permitted budget deficit, determined in accordance with recommendations of the Treasury and government advisors. The deficit target is ultimately framed by the Growth and Stability Pact (the "Maastricht Guidelines") that constrain the budgets of the members of the European Monetary Union as well as by the rules used by international credit rating agencies to assess risk. Credit ratings are important because they influence the willingness of foreign investors to make resources available. Israel adopted the goal of reducing the deficit as a share of GDP to the level of the framework rules by 2004. The planned deficit in 2000, 2001, and 2002 was 2.5%, 1.75%, and 3.8% of domestic product, respectively, but adjusted actual rates were 0.7%, 4.5%, and 3.8%. Thus, efforts to meet Maastricht guidelines fell short of the mark. However, that is also true of some European states, where questions are being raised about the advisability of rigid adherence to these guidelines during times of large economic fluctuations.

Projected revenues and the permitted deficit define the limit of government expenditures, which is compared to the demands of various ministries and other budgetary agencies. The demands comprise the approved budget from the previous year plus the so-called "automatic pilot" – supplements approved during the course of the

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previous budget year. The two figures are compared and the result is usually a requirement to reduce requests, leading to the annual "budget cut" ritual. According to this definition, the Treasury's proposed 2003 budget of NIS 270 billion represents a cut of 7.8%.

The approved budget allocates 31% of expenditures to debt repayment, about 29% to social transfer payments (about NIS 6 billion less than in 2002), and about 19% to defense. All other expenditures, including those for expanded non-defense activity, amount to about 21% of the budget.

Because of their public sensitivity, the three main budgetary headings provoked widespread controversy and are likely to be amended. The reduction in defense expenditures, by about 2.6%, will be difficult to sustain. In fact, given the prospects for war in the region and the ongoing conflict with the Palestinians, defense expenditures will probably rise. But without a defense cut, it will be politically difficult to reduce the budgets of other ministries.

Transfer payments, defined as income support and other payments that produce no direct economic return, are also slated to drop, by more than 7% (or about NIS 6 billion). These figures basically reflect the budget planners' understanding of the need to reduce public allocations to those sectors that produce no added value for the economy. Transfer payments evolved over many years as a means to satisfy various interest groups, and they constrained the budget planners' flexibility. But any attempt to correct in one year the distortions that built up over a long time will result in serious hardship for the most vulnerable sectors of the population. It is therefore likely that the overall reduction in this heading includes some hidden reserves to finance anticipated concessions during the Knesset debate.

Finally, repayments of principal are slated to grow by about 17%, while interest payments will grow by approximately 9%. The government's growing debt and debt repayments will oblige it to raise more funds in the market. But internal (and external) debt as a proportion of GDP is one of the leading indicators of projected economic stability. And credit rating agencies have taken note of Israel's growing debt burden. Another indicator of concern is the rate of return on government bonds, which has risen to 12%. This reflects lack of confidence in the government's ability to service its debt.

All in all, the proposed 2003 budget is unlikely to accomplish the basic objectives of declared policy. It may help to slow the recession, but even that probably requires an increase in overall expenditures. The protracted Israeli recession is a function of two factors: the failure of the global high-tech economy to generate the greater demand for inputs that would spark a recovery of the Israeli high-tech sector, and the inability to shield the Israeli economy from the uncertainty created by the ongoing conflict with the Palestinians. Checking the recession depends on somehow isolating the economic impact of suicide bombers beyond the direct damage they inflict. The budget does not address this problem. Nor does it address the long-term dangers implicit in short- term measures, like loan guarantees and reductions in direct or indirect taxes, intended to help economic units weather the current recession. A return to the old system of government guarantees and directed credit is undesirable, to put it mildly, and such measures should include built-in mechanisms for self-termination.

The idea that the 2003 budget can halt the continuing recession will have to be constantly checked against unfolding developments over the coming year. Special attention must be paid to the impact of ongoing violence and to taxation issues, in the hope that the global high-tech sector will revive and spark a recovery from the current business cycle and economic slowdown. In any case, mid-course budget corrections will not come as any surprise.

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