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THE ISRAELI BUDGET FOR 2005**Imri Tov****With the assistance of Noam Gruber
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For the first three months of 2005, Israel operated on the basis of last year's budget. The Knesset only passed a new budget at the end of March, after much political wrangling based largely on the legislators' positions with respect to the disengagement or various internal party calculations.

Given the difficulty of putting together a majority to approve the budget, public attention focused on the funds promised to wavering parties in order to secure their support. In fact, those items amounted to little more than 1/2% of the total budget and they do not change the overall picture, particularly since part of those funds were set aside in advance as a reserve to overcome anticipated problems with various parties. The larger picture is about a budget of approximately NIS 266.6 billion, representing an increase of about 1% over the previous year. This relatively small increase does not reverse the trend of a gradually diminishing budget as a proportion of national product.

The government's operating plan, which derives from its macroeconomic policy, includes a number of obligations believed to be desiderata according to the prevailing economic culture. It

maintains a budgetary deficit of 3% of national product, keeps the growth in public expenditure under 1% while reducing overall taxes, and lowers national debt as a proportion of national income. Planned fiscal restraint will enable the Bank of Israel to carry out the expansionary monetary policy needed by the economy.

Estimated costs of the disengagement are not included in budgeted expenditures, but the one-time character and unknown timing of the event underlie the Treasury's operating assumption that the deviation on account of the disengagement in the current fiscal year will not exceed 1/2% of national income. On the other hand, it is doubtful whether government ministries will be able to carry out all their planned expenditures given that outlays in the first quarter are already lower than in the approved budget for 2005.

The government will continue with efforts to avoid financing the deficit from local sources, since that would hurt the business sector, the encouragement of which is defined as a priority in government policy. Instead, the intention is to seek foreign sources of financing.

From a macroeconomic perspective, the budget is not expected to disrupt the current recovery



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which began in early 2004, though it will allow the positive trends to continue. However, if it turns out that the slowdown at the beginning of 2005 is actually a turning point; the budget will not constitute a brake on a new recession.

The budget's breakdown reflects two strategic decisions. One is to expand welfare payments for a number of sectors hit particularly hard in recent years in ways deemed unacceptable by the decision makers. These sectors include social services for Jerusalem and for minority groups, the basket of health services, transfers to local authorities, and old-age pensions. The intention, however, is not to return to the system of wholesale support for all strata of society and certainly not to block the process of encouraging welfare recipients to join the work force.

The second decision is to continue to introduce structural changes in the economy. In this respect, the government has reiterated its intention to push for greater efficiencies in the public sector and to reduce labor costs there, to enhance transparency in economic operations, to encourage higher labor force participation rates, to increase competitiveness, and to privatize government operations wherever that is appropriate. To these ends, a number of reforms have been planned, including reforms in the capital markets (especially, implementation of the Bachar Committee Report), completion of privatization of the banks (i.e., the sale of government-held shares of Bank Leumi), separation and privatization of the Haifa and Ashdod refineries, creation of water and sewage corporations by local authorities to operate on a business basis, and privatization of parts of the electricity sector along with an increase in the proportion of electricity produced by companies other than the Israel Electric Corporation (which currently accounts for about 85% of total production). The government also plans to

continue reforms in the labor market and to encourage work instead of welfare (along the lines of the so-called Wisconsin Program).

Two additional reforms are targeted for implementation. One is educational reform, on the basis of the recommendations of the Dovrat Commission. For that to happen, the Commission's report must be translated into a work plan approved by the Treasury, the Knesset, and the teachers' and parents' organizations. The other, which has already begun, is the ongoing transfer of responsibility for infrastructure investment to the private sector, with a sharing of investment risks by the state, the entrepreneur, and the financing body. The expected result will be a substantial reduction in direct government outlays on infrastructure.

Not all of these reforms will be carried out in 2005, but their mere initiation will signal substantial change in the structure of the economy, and that will have a long-term macroeconomic impact. In the short term, however, the budget will not significantly influence economic performance. In brief, the budget approved after a three-month delay will stabilize the economy rather than introduce dramatic new developments, although it potentially lays the groundwork for more far-reaching changes in the future. Ultimately, however, the impact of any budget depends, not on legislation but rather on determined implementation of declared government policy. That is what creates confidence among investors and consumers, who are the real engines of economic growth.

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