IF YOU WANT TO CUT, CUT, DON'T TALK: THE ROLE OF FORMAL TARGETS IN ISRAEL'S FISCAL CONSOLIDATION EFFORTS, 1985-2007

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Each of the seven governments in Israel since the successful 1985 stabilization program stated a commitment to reducing the deficit, easing the public debt burden and curtailing the share of public expenditure in GDP. Beginning in 1992, formal multi-year declining deficit ceilings were also adopted. However, only two periods during the last 22 years, 1985-92 and 2003-06, can be characterized as episodes of sustainable consolidation, and one of them preceded the introduction of the ceilings. The formal targets were often missed, and they underwent frequent revisions, including each time there was a cabinet change. Furthermore, in the 10 years that followed the introduction of the ceilings, little progress, if any, was made toward fiscal consolidation. In light of these developments, this paper concludes that the contribution of fiscal rules to fiscal consolidation or policy credibility in Israel was minor, at most. We also find that the two successful consolidation episodes followed programs that included – at the outset – specific measures sufficient to cut expenditure substantially over the short and medium terms. This absolved future policymakers from the political responsibility for adopting the specific measures needed to meet the formal aggregate targets set by their predecessors. The key lesson, at least in the Israeli context, is that setting formal macro-fiscal targets for future governments is not an effective pre-commitment measure; credibility requires the current policymaker to take all the "heat" and implement the specific – even if gradual – measures that will lower expenditure over the medium term. The pessimistic finding is that such measures were adopted only at times of crisis and after less comprehensive policy changes failed. The optimistic observation is that once implemented, these measures appear to survive cabinet changes and economic fluctuations.

1 Introduction and background

Between 1983 and 1985, after more than a decade of large fiscal deficits which averaged more than 10 per cent of GDP, Israel suffered several economic and financial crises. These crises were reflected in what was in effect the bankruptcy of the banking system in late 1983, a mounting deficit in the current account of the balance of payments, an accumulation of public debt that exceeded 250 per cent of GDP by 1985 and accelerating price increases that, by 1985, reached hyper-inflation levels. In light of the repeated failures of various policy adjustments during the early

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1980s, these crises led policymakers to recognize that a comprehensive stabilization program, based predominantly on fiscal consolidation, was required. In June 1985 the government announced such a program, which had a lasting effect on the fiscal balance and the ratio of public debt to GDP, reduced the share of public expenditure in GDP and made a critical contribution to the deceleration of inflation. This program marked the end of fiscal dominance in Israel, as it was accompanied by a ban on government borrowing from the central bank.

Although the change in fiscal policy since the 1985 stabilization plan was dramatic, the resulting level of the deficit was not sufficient to reduce the public debt to GDP ratio to the common levels in the developed countries, even in the long run. These relatively high deficit and debt levels left the Israeli economy vulnerable to financial crises in the event of unfavorable external economic shocks or deterioration in the security situation. This risk, along with the stubbornly high inflation (although at much lower rates than in the early 1980s), suggested that further reduction of the deficit was called for.

However, along with the need for further fiscal consolidation, in the early 1990s Israel faced the challenge of absorbing a massive wave of immigration from the former Soviet Union. While promising a marked contribution to economic growth in the medium and long run, the absorption process required considerable public resources in the short run to pay for the living expenses and housing of the immigrants. The annual one-off costs of absorption were in the order of magnitude of 3.5 per cent of GDP in 1991 and 1992 and were expected to decline in later years as the numbers of new immigrants fell and as those who arrived in previous years settled in.[1]

Fiscal policy in the early 1990s, therefore, faced the contradictory challenges of absorbing the immigrants in a way that would allow them to become effective participants in the labor force as soon as possible, while persuading the markets that the government was committed to fiscal consolidation and would reduce the public deficits over the medium term. As Drazen (2000) suggests, there are two ways to tackle such conflicting targets: reputation or rules. Since reputation was still shaky, given the not-so-remote crises of the early 1980s, the government turned to rules: in late l991 – as part of the 1992 budget discussions – a multiyear deficit target was introduced. The target indicated that even though the near-term deficits would be high, due to the pressing needs of absorption, the government was committed to reaching a balanced budget within four years. This commitment fitted well within the global context of the time, as the Maastricht criteria were negotiated and similar arrangements were adopted in other countries. In Israel, the medium-term commitment took the form of a law, thus formally making it binding on future cabinets – an important credibility-enhancing feature, because 1992 was an election year.

[1] For detailed figures on the fiscal cost of the absorption process see Dahan and Strawczynski (2001).

While the medium-term deficit target of 1992 was adopted in the very specific circumstances of that period, formal medium-term deficit targets have been a permanent feature of Israel's fiscal policy ever since. This was also consistent with IMF recommendations (IMF, 1996b).[2] Kopits and Symanski (1998) argue that such fiscal rules can be very useful in overcoming the time inconsistency problem of a fiscal policy framework, by correcting the tendency of policymakers to run deficits.[3] They stress that, to be effective, the rules must be intended for permanent application by successive governments. This argument is strengthened by the IMF findings (IMF 1996a) that consolidation attempts based on one-off measures – rather than structural, long-term, ones – tend to fail. The political reasoning behind this argument, following Kydland and Prescott (1977) and Persson and Tabellini (1990), is that the policymaker who makes the original decision suffers most from the negative political consequences of reducing public expenditure.[4] Once the target is set, future policymakers bear a lower political cost for adhering to it. Moreover, if they divert from the target, they may be held responsible for damaging macroeconomic performance. Consequently, such rules would reduce the appetite of future policymakers to abandon the preset targets. Since this mechanism is also understood by the public, it is an important component of the credibility of such medium-term targets.

The Israeli experience with formal deficit targets since 1992 suggests that their use as an instrument to overcome the time inconsistency problem and increase the credibility of fiscal policy may be problematic. The legal numerical medium-term targets were repeatedly missed and often changed. While the potential contribution of the multiyear targets increased as the of governments' term-in-office kept getting shorter, in practice each new government changed the targets. Moreover, the fiscal aggregates themselves did not seem to improve during that period; such an improvement seems to have begun only in 2003, although the formal targets kept changing.

In the remainder of this paper we will examine Israel's attempts to consolidate her fiscal accounts since 1985, in light of the arguments about the usefulness of fiscal targets. To do so, we divide the period into four sub-periods – two of which can be characterized as representing successful consolidations and the other two as unsuccessful ones – and examine the characteristics of fiscal policy in each one. Then we discuss what seem to be the common features of the successful consolidation attempts and of the unsuccessful ones. Section 2 examines the fiscal developments from the implementation of the 1985 stabilization program until 1990. Section 3 examines the mass-immigration period of the early 1990s, the introduction of formal deficit targets in 1991, and the policy switch of the Rabin government,

[2] For a comprehensive discussion of the role of pre-specified fiscal targets in enhancing credibility see von Hagen (2006).

[3] However, Israel's medium-term targets do not strictly match the fiscal rule definition proposed by Kopits and Symansky, which refers to a much longer horizon.

[4] That logic is also supported by the analysis of Cukierman and Metzler (1986), who show that a rule is necessary for maintaining fiscal discipline by a government wishing to get reelected.

elected in late 1992. Section 4 examines the performance under fiscal rules until the 2003 crisis, and Section 5 discusses the 2003 consolidation program. In Section 6 we compare the performance in these sub-periods, and Section 7 analyzes the features that played a role in the successful and unsuccessful consolidation attempts and suggests some policy implications.

2 The 1985 stabilization program and the post-stabilization years

Following the 1973 war Israel's fiscal position deteriorated dramatically: general government deficits were rarely below 10 per cent of GDP and between 1980 and 1984 they averaged 12 per cent.[5] Based on the average growth rate during that decade, about 4 per cent annually, this magnitude of the deficit implied that the long-run debt to GDP ratio would stabilize at about 300 per cent – clearly not a viable policy option. As the debt ratio approached these levels in 1983, and as repeated attempts to moderately adjust the deficit and the nominal aggregates failed, financial and economic crises began to occur in an accelerating rate and policymakers could no longer avoid the necessary adjustment.

In June 1985 the coalition government of the two major parties decided on a stabilization plan which included a marked fiscal consolidation.[6] The fiscal measures included temporary steps, meant to tackle the immediate crisis, as well as structural reforms intended to handle the underlying weakness of the fiscal accounts. A key component of the program was a legal ban on government borrowing from the central bank, thus forcing the government to finance its deficits by borrowing from the public (or privatizing assets) from that time on. Although fiscal adjustment was the key component of the plan, no numerical targets were specified for the size of the deficit or the debt to GDP ratio in the years that followed. Nevertheless, many of the measures that the program introduced aimed at affecting the fiscal accounts in the medium term – rather than in the short run.

The key short-term fiscal measures adopted in the program were a suspension of the COLA arrangement for a one-year period, which resulted in a substantial temporary cut in real wages due to the very high inflation rate, an initial cut in product subsidies and a 42 per cent depreciation of the shekel during the month of June 1985 alone.[7] On the revenue side, a temporary surtax was imposed on the self-employed and local taxes were adjusted in a way that resulted in a temporary surge in the municipalities' revenues. Another important one-off factor was a special grant of $1.5 billion from the US government (about 6 per cent of GDP, spread over 2 years) which helped to reduce the debt burden and enhance confidence in the foreign exchange market. In addition to these direct policy measures the deceleration

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5 Bank of Israel Annual Report, 2006, Statistical Appendix, Table 6.A.3.

6 Although the "national unity" coalition enjoyed a strong majority in the Knesset (the Israeli parliament), the plan was approved in the cabinet with a margin of only one vote. For details of the political process of the program's approval see Bruno (1991) and Razin and Sadka (1993).

7 For a detailed description of the program see Bank of Israel (1985), *Annual Report*.

of inflation itself had a substantial effect on tax revenues due to the "reverse Tanzi effect", most of which was expected to fade out within a year or two.

To be credible, however, the program had to be perceived as having a lasting effect on the fiscal accounts. For that purpose the program also included medium – and long-term measures that would sustain the lower deficit as the effects of the short-term measures came to an end. There were three key permanent measures of the program: 1) a substantial cut in defense spending, reflecting the declining security risks due to the peace agreement with Egypt and the gradual withdrawal from South – Lebanon; 2) a cut in subsidized directed credits to the business sector; 3) a sharp reduction in product subsidies. Because all these measures required time until their full effects could be realized – due to pre-existing government commitments – temporary measures were needed to stabilize the fiscal accounts in the first few years; these measures were mostly on the revenue side. Also, the government benefited from an agreement with the US government to convert all future aid flows from loans to grants.[8]

An important medium-term revenue-increasing measure was a change in corporate tax legislation (the Steinberg Commission recommendations) which curtailed the negative effects of the remaining inflation (which averaged 20 per cent annually during 1986-91) on tax revenues. Along with the erosion of the Tanzi effect due to the reduction of inflation,[9] this measure was expected to increase business taxes substantially. Nevertheless, because the revenue measures were not intended to raise the tax burden permanently, the government almost immediately reduced the statutory corporate tax rates, and soon after that the personal income tax rates and social security contributions as well, to ensure that within a four-year period the tax burden would not exceed its pre-stabilization level. Thus, by 1989 and 1990 the full effect of the program's measures was in place, and it was fully on the expenditure side (Table 1).

The composition and structure of the program quite closely matched those characterizing sustainable consolidation efforts, as classified by Alesina, Perotti and Tavares (1998). The decline in the share of public expenditure in GDP exceeded the reduction in the deficit; tax rates – especially on profits and wages – decreased and the tax burden fell. Moreover, the ratio of public investment to GDP was not reduced, despite the sharp reduction in overall expenditure. Although the economy entered a deep recession in late 1988 and 1989, the deficit in 1989 and 1990 still averaged only 6 per cent of GDP – half the pre-stabilization level – and the sustained cyclically adjusted deficit was 5 per cent of GDP.[10] While the program did not at the

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[8] This was in addition to the one-off special grant mentioned above.

[9] In a period of sharp deceleration in inflation there are two components of the reverse Tanzi effect: one, which is temporary, is related to the deceleration itself, and the other, which is permanent, is related to the lower level of inflation.

[10] The sustained cyclically adjusted deficit is calculated in the usual manner, adjusting revenues and expenditures to the output gap. However, it takes into account the fact that, on average, the economy operates below the potential level of GDP – which is the full-employment level of output. By doing so this *(continues)*

Table 1

**Factors Contributing to the Decline
of Israel's General Government Deficit, 1980-90**
(percent of GDP)

	1980-84 Average	1985	1986	1987	1988	1989	1990
Total Revenue	**57.4**	**65.5**	**63.4**	**57.5**	**54.0**	**49.5**	**49.1**
o/w taxes	39.3	40.9	43.8	42.7	40.6	37.0	36.4
Total Expenditure	**69.2**	**64.5**	**59.7**	**57.3**	**56.3**	**55.6**	**54.8**
o/w Defense	19.5	18.5	15.9	14.5	12.9	12.1	12.4
Producer and credit subsidies	8.9	6.2	4.2	4.2	4.1	3.4	2.7
Investment	2.3	1.8	2.0	2.4	2.6	2.5	2.7
Interest	10.9	12.6	11.6	10.3	9.3	9.1	8.7
Other	27.6	25.5	26.1	26.1	27.5	28.4	28.4
General Government Balance	**–11.8**	**1.0**	**3.7**	**0.1**	**–2.3**	**–6.1**	**–5.7**

outset specify numerical targets that could be used as a benchmark, this was a dramatic improvement compared to the pre-stabilization decade. Still, in the early 1990s Israel was at a point where clearly further consolidation was needed.

3 Absorption of the mass-immigration wave and the introduction of multi-year deficit ceilings: 1990-94

Following five years of stabilization, and emerging from the deep recession of 1989, Israel faced a new challenge in the early 1990s: the absorption of a massive immigration wave. In just two years – 1990 and 1991 – about 380,000 immigrants (8 per cent of the 1989 population) came to Israel. Since Israel's absorption policy is to provide the basic needs of every immigrant, including living costs for the first 18 months, subsidized housing and language training, the budgetary costs of absorption were substantial. In 1991 and 1992 these costs peaked at about 3.5 per cent of GDP and pushed the general government deficit to 5 per cent of GDP (Table 2), well above the path envisaged by the government. Nevertheless, excluding the direct one-off absorption costs, the deficit declined to the levels achieved in 1987 and 1988 – prior to the 1989 recession.

measure provides a better approximation for the path of the fiscal accounts in a "no change in policies" scenario over the medium term.

Table 2

Key Components of the Change in the General Government Balance 1990-1994

	1990	1991	1992	1993	1994
Total Revenue	**49.1**	**49.1**	**48.7**	**48.7**	**47.9**
o/w taxes	35.7	35.5	36.1	36.0	36.6
bilateral transfers	7.2	7.4	6.3	5.9	4.8
Total Expenditure	**54.8**	**53.4**	**54.3**	**53.5**	**51.3**
o/w Defense	12.4	11.7	10.2	10.0	9.0
Interest	8.7	7.9	7.2	6.9	6.4
Absorption-related(1)	1.4	3.8	3.4	1.6	0.5
Other	32.3	30.0	33.5	35.0	35.4
General Government Balance	**–5.7**	**–4.3**	**–5.6**	**–4.8**	**–3.4**
General government balance excluding absorption costs	*–4.3*	*–0.5*	*–2.2*	*–3.2*	*–2.9*

(1) One-off expenditures related to the absorption of immigrants which included government payments for the construction of housing and the direct cost of the "absorption basket" paid for immigrants in their first two years in Israel.

Despite the temporary fiscal pressures arising from absorption costs, the underlying fiscal trends remained positive in 1991 and 1992. The erosion of defense expenditures – a key element of the stabilization strategy since 1985 – persisted and contributed more than 2 percentage points to the decline in the share of public expenditure in GDP. Additionally, the government began to "cash in" on the effects of stabilization with reduced interest payments, which reflected the decline in the debt to GDP ratio and lower interest rates. On the revenue side, the government adopted a medium-term plan to moderately reduce the statutory corporate tax rate and cut import duties. The cost of these changes was in the same order of magnitude as the expected rise in the tax/GDP ratio due to the progressive nature of the Israeli tax system[11] hence it was not expected to raise the deficit.

Faced with the challenge of proceeding with fiscal consolidation while bearing the temporary costs of absorption, the government decided in late 1991 to adopt a multi-year declining deficit ceiling, beginning with the 1992 budget. That multiyear framework was intended to reflect the government's commitment to eliminate the deficit as these costs phase out, and was based on the nearly balanced underlying fiscal position in 1991. Accordingly, the program specified a decreasing

[11] The elasticity of tax revenues to GDP growth in Israel is estimated at about 1.1 (Brender, 2001).

medium-term deficit path from 6.2 per cent of GDP in 1992 towards a balanced budget in 1995.[12] These targets did not require additional fiscal measures in the coming years, beyond those that were already in place. The continuing long-term plan to gradually reduce defense expenditures and the on going decline in interest payments were expected to reduce the share of expenditure in GDP by roughly 2 percentage points within three years. Combined with the effect of the phase-out of temporary absorption costs, this decline was sufficient to account for the required reduction in the deficit, as well as for the expected decrease of income from foreign transfer payments. Specifying a multi-year path was viewed as particularly important because 1992 was an election year.

In his budget speech Minister of Finance Modai detailed the strategy and some of the perceived advantages of multi-year budgetary planning and targets. *"Multi-year planning, which is beyond the planning of one year or another, will prevent shocks that result from political changes, which are typically focused on the short horizon"* (page 1, author's translation). He stated further *"In the next few years the government will free resources to the business sector by gradually reducing the deficit until its complete abolition by 1995. This is also a message to the business community abroad"* (page 2). And, he also described the strategy*: "The most significant budgetary decision by the government is the one on a declining deficit path. ... This is an achievable target based on the expected rise in economic activity and a substantial decrease in government expenditure, due to the ending of the immigration wave, and stability or a moderate rise in spending on other items, such as defense, social services and public administration"* (page 7).

While performance in 1992 through 1994 was broadly consistent with the medium-term strategy presented in 1991, the strategy itself was short-lived. The Rabin government that took office in July 1992, had to adopt the "old" target for 1993, and actually succeeded in achieving it. However, with a faster-than-expected decline in the number of immigrants – and the associated costs – this success masked a rise in non-absorption civilian primary expenditure (Table 2). Moreover, within its first year in office the government adopted various policies that implied a substantial increase in key expenditure items. Therefore, by the time the 1994 budget was prepared the government decided to abandon the medium-term deficit reduction path "inherited" from its predecessor. The decision included both an increase of the 1994 target by 0.8 per cent of GDP – despite the above-mentioned decline in absorption costs – and the abandonment of the 1995 target of a balanced budget. Instead, the government adopted a new multi-year target of "reducing the deficit every year compared to the previous year".

The upward revision of the deficit target marked the first failure of medium-term deficit targets in Israel. The main contribution of legislated multi-year targets is that they provide credibility and assure market participants and citizens about the future path of policies. The role of legislation in this context is particularly important in the transition between governments: laws are supposed to be more

[12] The targets from 1992 to 1996 were specified for the domestic central government deficit.

binding than cabinet decisions of a previous government. However, the Rabin government simply changed the target when it became inconvenient. The ineffectiveness of the pre-commitment mechanism was particularly daunting in this case because it took place against the background of high growth and diminishing exogenous budgetary pressures. In the event, the deficit in 1994 was actually smaller than the original target set in 1991.

The change in policy was not limited to the deficit targets. Beginning in 1993 the government began to raise civilian primary expenditure at an ever increasing pace. While absorption-related costs decreased between 1992 and 1994 by 3 percentage points of GDP, the government increased its other civilian primary expenditure by 2 per cent of GDP.[13] Therefore, by 1994 the sustained cyclically adjusted deficit (excluding one-off absorption costs) rose to 3.3 per cent of GDP, compared with 1.6 per cent in 1992. More importantly, the government embarked on a set of reforms that accelerated the growth rate of public expenditure: in some areas over the medium term, and in others, permanently. These reforms included, inter alia, a series of generous wage agreements in the public sector, changes in the promotion and wage-setting mechanisms in the public sector (Sussman and Zakai, 1997, 2001), higher transfer payments and more liberal criteria for entitlements.[14]

4. The era of revised fiscal targets: 1995-2003

Consistent with its new medium-term target of reducing the deficit every year with respect to the previous budget, the government set the deficit target for 1995 at 2.75 per cent of GDP. This target was well above the target of a balanced budget originally set for 1995 (Table 3) and also substantially higher than the actual deficits in 1993 and 1994 (Table 4). Even so, the actual deficit in 1995 exceeded the target (Figure 1). This recipe – unambitious short-term targets, which are missed anyway – characterized fiscal policy in most of the years that followed. In late 1995, consistent with the existing legislation, the government adopted a deficit ceiling for 1996 that was 0.25 per cent of GDP lower than the original target for 1995. In practice, however, the actual deficit in 1996 was much higher than the target, suggesting that the measures included in the budget were not suitable to meeting the target.

The new government headed by Prime Minister Netanyahu that took office in the second half of 1996 changed the definition of the target from domestic central government deficit to overall central government deficit, and set new medium-term declining deficit targets until 2001. The new target presented the government with the immediate task of reducing the deficit by 0.8 per cent of GDP in 1997 compared with the actual deficit in 1996. To achieve this target the government implemented a package of tax measures – equivalent to about 0.7 per cent of GDP – and reduced

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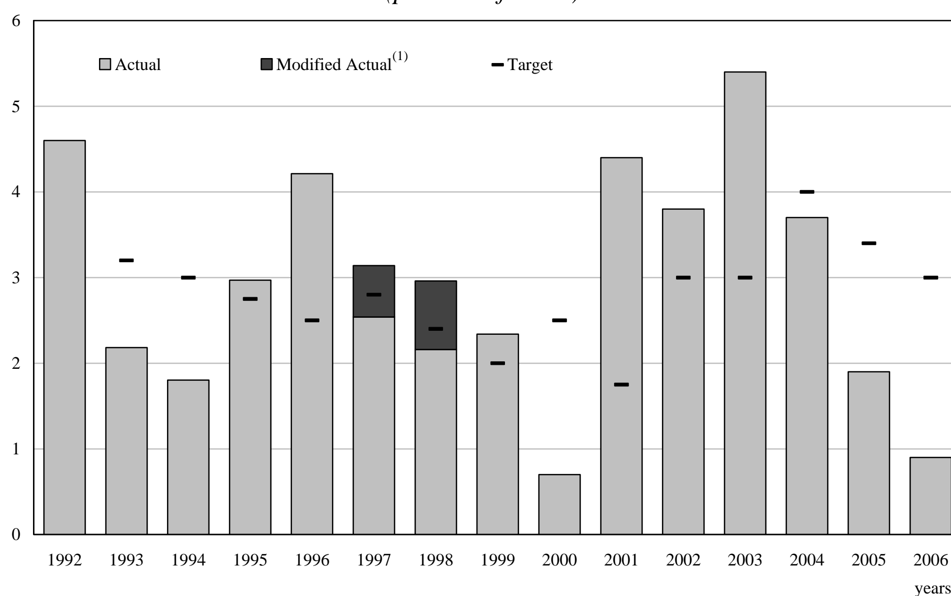
[13] Important components of this expansion were the roads infrastructure and the budget for teaching hours in the public education system.

[14] A detailed discussion of the development of the numbers of recipients of transfer payments relative to the size of the relevant populations appears in the Bank of Israel Annual Report for 1998 (Section 5.5).

Figure 1

Central Government Performance with Respect to the Official Deficit Targets
(percent of GDP)



(1) The "modified actual" deficit is the deficit excluding the unexpected component of the accounting revenues from "realized BOI profits".

transfer payments and infrastructure investment. Combined with the phasing out of absorption costs, as the numbers of new immigrants continued to decline, these measures reduced the deficit by about 1 per cent of GDP (depending on the definition used).[15] Technically, the government has also succeeded in keeping the deficit below the official ceiling, but this was only due to unexpected revenues resulting from new accounting procedures, which contributed about 0.6 per cent of GDP to the reported revenues. In line with its pre-stated target, the government adopted a deficit ceiling of 2.4 per cent of GDP for 1998, 0.4 per cent below the 1997 target, and also met it, due to the same technical surprise as in the 1997 budget.[16] In 1999 the deficit target was missed.

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15 For a detailed analysis of the composition of the 1996 policy package see Bank of Israel Annual Report, 1996, Chapter 3.

16 The change of the target from the domestic to the overall deficit implied that an item titled "Realized Bank of Israel Profits" would become part of the government's revenues for the purpose of meeting the deficit target. This item – which has nothing to do with the actual profits of the BOI, or with the transfer of profits to the central government, was expected to contribute less than 0.1 per cent of GDP in the 1997 budget. However, due to various financial developments this item "ballooned" to more than 0.6 per cent of GDP, a fact that was realized only after the 1998 budget was also approved. In 1998, these "profits" were budgeted again at less than 0.1 per cent of GDP but the recorded figure at yearend was 0.9 per cent of GDP.

Table 3

Budget Rules and Targets, 1991-2003

Decision Year	**Target Deficit** *(percent of GDP)*	**Notes**
1991	1992 – 6.2% 1993 – 3.2% 1994 – 2.2% 1995 – 0.0%	Adoption of declining deficit law. The deficit was specified in term of the domestic balance
1993	1994 – 3.0% Will be reduced each year over the next 3 years	Upward revision of the annual and medium-term deficit targets
1994	1995 – 2.75%	-
1995	1996 – 2.5%	-
1996	1997 – 2.8% 1998 – 2.4% 1999 – 2.0% 2000 – 1.75% 2001 – 1.5%	Moving from domestic deficit to overall deficit, including Bank of Israel's "realized profits"
1999	2000 – 2.5% 2001 – 2.25% 2002 – 2.0% 2003 – 1.5%	
2000	2001 – 1.75% 2002 – 1.5% 2003 – 1.25%	Downward revision. The deficit was redefined during the fiscal year to exclude the Bank of Israel's "profits"
2001	2002 – 2.4% 2003 – 2.0% 2004 – 1.5% 2005 – 1.0%	Upward revision. The target for 2002 was increased to 3.0 per cent before the budget was approved
2002	2003 – 3.0% 2004 – 2.5% 2005 – 2.0% 2006 – 1.5% 2007 – 1.0%	From 2007 onwards, 1 per cent

A new government, headed by Prime Minister Barak, took office in 1999 and raised the deficit target again: the ceiling for the year 2000 was set at 2.5 per cent of GDP, and the path for the subsequent years was raised accordingly. However, with the surge in economic activity during the year 2000, revenues increased dramatically and the year ended with a much lower-than-expected deficit – only 0.7 per cent of GDP. At that time the government decided to lower the deficit target for 2001 by 0.5 per cent of GDP – the only such incident since the adoption of the multi-year targets – but to a level that was 1 per cent of GDP higher than the actual deficit in 2000. At the same time the government introduced several expansionary policy initiatives – especially related to transfer payments – and loosened policies with respect to the public sector wage bill. By the time the 2001 budget was presented to the Knesset the government has already lost its parliamentary majority, the Palestinian uprising began and elections were called for February 2001.

The new government, headed by Prime Minister Sharon followed in its predecessors' footsteps, and raised the deficit ceiling for 2002, as well as the deficit path for the following years. In 2001 the deficit exceeded the target (set by the previous government) by nearly 3 per cent of GDP. In 2002, despite a second increase of the deficit target to 3 per cent of GDP, and a comprehensive deficit-reducing policy package in the middle of the year, the deficit exceeded even the revised target. Accordingly, the government raised the deficit ceiling for 2003 again – to 3 per cent of GDP. Nevertheless, keeping in mind that 2003 was an election year, the government did not neglect to specify a medium-term deficit path for its successor, reaching 1.0 per cent of GDP by 2007.

The technical view of the performance of deficit targets between 1994 and 2003 presented above clearly suggests that they did not contribute much to the credibility of fiscal policy during that period. Despite the multi-year legislation, each new government raised the deficit target, and in most years the target was missed anyway (Figure 1). While all the governments adopted the "magic numbers" of a deficit target of 1 or 1.5 per cent of GDP in the medium-term, the operative deficit target for the next year always hovered around 3 per cent of GDP – when measured according to the current definition. Moreover, actual deficits remained most of the time between 3 and 4 per cent of GDP, with few exceptions (Table 4). It appears that the deficit targets were not an effective instrument to overcome the time inconsistency problem – either within governments' terms of office, or clearly between them. A cynic may even argue that the deficit targets became an instrument enhancing time inconsistency, as they were used by governments to embarrass their successors.

Nevertheless, one may wish to take a broader view of that policy experience. Throughout that 10-year period policymakers presented three underlying policy targets: 1) to reduce the deficit as a per cent of GDP, 2) to lower the public debt to GDP ratio, 3) to cut the share of public expenditure in GDP. Examining the progress made throughout the period in achieving these targets may be more insightful in interpreting the policies than technically following the achievement of the formal

Table 4

Central Government Balance According to Various Definitions[1]

Year	Domestic Balance	Overall Balance Including the BOI	Overall Balance
1993	***–2.2***	–2.3	–2.3
1994	***–1.8***	–2.2	–2.2
1995	***–3.0***	–3.9	–4.2
1996	***–4.2***	–3.6	–4.0
1997	–2.9	***–2.5***	–3.2
1998	–2.7	***–2.2***	–3.1
1999	–2.7	***–2.3***	–3.2
2000	–0.5	–0.7	***–0.7***
2001	–3.4	–4.4	***–4.4***
2002	–3.4	–3.8	***–3.8***
2003	–5.2	–5.4	***–5.4***
2004	–3.1	–3.7	***–3.7***
2005	–1.1	–1.9	***–1.9***
2006	–0.2	–0.9	***–0.9***

(1) The effective definition for the purposes of the deficit target is shown in italics and bold type.

targets. To avoid repetition, this discussion is postponed to Section 6, following the discussion of the different policy experience in 2003-06.

5 The consolidation program of 2003 and its aftermath

Following the January 2003 elections Prime Minister Sharon formed a new government with former prime minister Netanyahu as Finance Minister. The new government had to deal immediately with an intensifying financial crisis. Against the background of two consecutive years of negative growth, security threats emerging from the imminent second Gulf war and Palestinian terrorist attacks, and slow global growth, Israel's fiscal position deteriorated – despite the adoption of the adjustment package of mid-2002. By early 2003 short-term interest rates approached 12 per cent, and the yield on 10 year indexed government bonds was 6 per cent. It was clear that the deficit target of 3 per cent of GDP was unrealistic and would be exceeded by a wide margin, and that the deficit and debt dynamics were on an unsustainable path (Table 5).

Table 5

Projected Budget Balance and Debt/GDP Ratios
Before and After the 2003 Adjustment Program[1]
(percent of GDP)[2]

	2003	2004	2005	2006
Before the Program: No Adjustment				
Central government balance	–6.0	–7.0	–7.1	–7.2
Public debt	105.7	109.5	111.5	113.6
After the Adjustment Program				
Central government balance	–5.4	–5.1	–4.4	–3.7
Public debt	105.0	106.9	106.4	105.0
After the 2004 Budget[3]				
Central government balance	–5.4	–4.1	–3.7	–3.2
Public debt	103.3	104.7	104.4	102.8
***Ex post* Balance Projection in Early 2004**[4]	…	–3.7	–2.6	–1.7
Actual Balance	–5.4	–3.7	–1.9	–0.9

(1) All the scenarios assumed the same growth rate - 4 per cent annually – and interest rates – for the purpose of illustration. The debt ratio in the scenario that presents the effects of the 2004 budget reflects valuation changes that took place between June 2003 and January 2004.
(2) All the figures are adjusted to the current, revised, GDP definition.
(3) A projection based on the specific measures adopted in the program and with the 2004 budget.
(4) A projection based on the measures adopted by early 2004 and the actual growth rate in 2004-2006.

The task of persuading the markets that the government was committed to fiscal adjustment was particularly daunting in light of the dismal fiscal performance in the previous decade and the surge of the deficit so soon after the 2002 package. The former suggested that yet another plan promising to reduce the deficit at some time in the future was unlikely to resume market confidence. The latter indicated that another package based only on short-term measures, which would not deal with the structural factors that keep pushing public expenditure up, would be unlikely to persuade the public that it was sustainable. Thus, the crisis called for a front-loaded program with measures that would also consolidate the fiscal position in the medium and long run.

In March 2003 the government presented a comprehensive fiscal adjustment program which was focused almost entirely on the expenditure side. The program included immediate reductions in a broad range of expenditure items as well as measures phased in to reduce spending over the longer horizon. While some of the measures did not survive the political approval process and the negotiations with the trade unions, the remaining measures still accounted for 0.6 per cent of GDP in 2003 and for an additional 1.3 per cent in 2004. These measures included mostly cuts in ministries' operational budgets, in transfer payments, and a dramatic reduction of housing subsidies. An important measure in the program was a two-year agreement with the trade unions on a 4 per cent reduction in public-sector nominal wages.

Although the immediate impact of the program was quite substantial, it was not sufficient to change the medium-term dynamics of the budget. To do that the program also included a broad range of structural measures that were designed to change the growth rate of expenditure over the medium (and long) run. These measures included 1) a nominal freeze of social security allowances for three years, to be followed by a change of their updating mechanism from indexation to the average wage to indexation to the CPI, 2) a gradual, although substantially front-loaded, reduction of child allowances, including an equalization of the allowance for all new-born infants at the level of a first child (the lowest level), 3) a reduction in all public-sector employees' budgetary pensions and the introduction of employee contributions to the program, 4) a nominal freeze of many budgetary items for a 5-year period, 5) a change in the promotion and wage adjustment procedures in the government sector, 6) comprehensive pension reform, including raising the retirement age from 65 to 67 for men (within 5 years) and from 60 to 64 for women (within 8 years),[17] and 7) a program for gradual downsizing of military personnel.

The measures implemented at the initial stage of the program succeeded in halting the rise in the deficit, and even allowed for a small decline in 2004. However, the projected decline was not sufficient to reverse the debt dynamics for at least two more years (Table 5). To achieve a speedier decline in the deficit, the government adopted a second set of budgetary cuts during the discussions on the 2004 budget. These measures were also predominantly (about 70 per cent) on the expenditure side, and brought the projected deficit close in line with the new deficit target of 4 per cent of GDP.[18] Moreover, that package included further specified cuts in the ministries' budgets for the years 2005 through 2010. Along with the approval of the 2004 budget the government also introduced a medium-term budget framework with a (legislated) deficit ceiling of 3 per cent of GDP, beginning in 2005. The medium-term framework was supplemented by a new component – an expenditure ceiling restricting its real annual growth to 1 per cent from 2005 until 2010.

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[17] The legislation provides for a further rise in the retirement age for women – to 67, by 2017 – unless a public committee recommends otherwise.

[18] The original 2004 budget included unsustainable cuts in defense spending and in government grants to the local authorities. These cuts were replaced in February 2004 by cuts in other budget items, a step that contributed to the credibility of the budget framework.

In addition to the budgetary cuts, the government also introduced severe procedures for approving spending and budgetary reallocations by the ministries. Since the Israeli budget is presented in great detail,[19] and because transferring even small amounts between items requires the approval of the Ministry of Finance, these new procedures became a significant barrier to government spending. The impact of these controls became especially significant because of the need to adjust the composition of the ministries' budgets in line with the hundreds of specific decisions introduced as part of the adjustment packages in 2003 and 2004. The effect of these procedures was reflected in significant under spending of the budget in the years 2003 through 2005, as well as in a higher than usual share of annual expenditure during the month of December in those years. In 2006, the low execution rate of the civilian ministries' budgets was used as a buffer that facilitated an increase in defense spending, due to the hostilities in the Lebanese border, within the expenditure ceiling.[20]

Examining the fiscal performance since the initiation of the 2003 program suggests a sea-change compared with the performance during the previous decade. The central government balance improved from a projected deficit of 6 per cent of GDP in 2003 – and an even higher deficit projected for the later years – to a deficit of 0.9 per cent of GDP by 2006 (Table 5). The entire decrease in the deficit was due to a reduction in the share of expenditure in GDP. Specific measures adopted with the adjustment program account for a decrease in the deficit of 4 per cent of GDP (from a projected level of 7.2 per cent for 2006 to 3.2 per cent). An additional decrease of 1.5 percentage points reflects the faster-than-projected growth. Furthermore, at least part of the remaining decline can be attributed to the effects of the administrative budgetary measures, discussed above, and to the decline in interest rates as a result of the unexpected improvement in the fiscal position. Therefore, almost all the decrease in the deficit from March 2003 can be attributed to the measures adopted in the context of the adjustment program.

While fiscal consolidation progressed substantially during 2003-06, the role of fiscal targets remained questionable. In 2003 the government abandoned the deficit ceiling. For 2004 the deficit ceiling was raised from the level of 2.5 per cent of GDP, set in 2002, to 4 per cent, a target that was actually achieved. At the same time the government adopted a deficit ceiling of 3.0 per cent of GDP for 2005 (Table 6) and a cap of 1 per cent on the growth rate of real expenditure (deflated by the CPI). During the preparation of the 2005 budget, however, the government decided to raise these ceilings to allow for the increased expenditures related to the disengagement from the Gaza Strip. In the event, though, the deficits in both 2005 and 2006 were well below the originally targeted ceilings (Figure 1). Expenditure in 2005 was also well below the original ceiling.

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[19] Ben-Bassat and Dahan (2007).

[20] In fact, expenditure in 2006 exceeded the ceiling by 0.45 per cent of GDP – the amount of government compensation for damages to citizens suffered during the war. Special accounting procedures allowed this expenditure to be recorded as a reduction in tax revenues.

Table 6

Budget Rules and Targets 2003-2006

Decision Year	**Deficit Target** *(percent of GDP)*	**Expenditure Growth**	**Notes**
2003	2004 – 4.0% 2005 Onward – 3.0%	2005-2010 1 per cent real growth every year	
2004	2005 – 3.4%	Expenditures equivalent to 0.4 percent of GDP related to the costs of disengagement are excluded from the ceiling	Deficit ceiling raised by 0.4 per cent of GDP to account for costs of disengagement
2006 - May	2007 – 3.0% 2009 – 1.0%	2007-2010 1.7 per cent real growth every year	Expenditure growth excluding disengagement
2006 - September	2007 – 3.0% 2009 – 1.0%	2007-additional 4.6 billion NIS, 2008-additional 2.5 billion NIS	Increased expenditure ceiling due to one-off costs related to the war in the Lebanese border

In May 2006 a government headed by Ehud Olmert, a senior member of Sharon's former government, took office. Despite the lower-than-budgeted spending in 2003-05, as well as in the first few months of 2006, the new government raised the permitted annual growth rate of expenditure to 1.7 per cent (approximately the population growth rate), beginning in 2007. However, later in 2006 that same government decided to raise the 2007 ceiling again – by 0.7 per cent of GDP – to account for the one-off expenditures related to the second Lebanon war. Additional one-off expenditure was provided for in an increased ceiling for 2008.

The experience of the consolidation effort in 2003-06 shows that pre-specified measures can go a long way in helping governments, including subsequent cabinets, to meet the original program targets. In the following section we will try to examine this particular sub-period in the broader context of the attempts to reach fiscal consolidation during the past 22 years.

6 Integrated analysis, 1985-2006

The development of Israel's main fiscal aggregates in the past 22 years varied substantially between the four sub-periods discussed above. While formal fiscal targets were set during most of that period, the key question, eventually, is how the

government progressed in each of these sub-periods towards fiscal consolidation. Specifically, the finding above that the official targets were constantly missed and often revised does not categorically imply that they were not useful. It may be argued that they served as a constraint that was instrumental in progress, even though formally they were missed. To be able to reflect on the targets' effectiveness one should also examine the development of the fiscal aggregates themselves with respect to the broad policy targets repeatedly stated by the government: 1) reducing the deficit: 2) cutting the share of public expenditure in GDP; 3) reducing the debt to GDP ratio.

In comparing the end-points of this 22-year period, Israel's general government deficit decreased by 10 percentage points of GDP: from an average 11.8 per cent in 1980-84 to 1.4 per cent in 2006.[21] However, this decline was not uniform throughout the period. In the immediate aftermath of the 1985 stabilization program the budget recorded a temporary surplus. Between 1989 and 1993, when the temporary measures and disinflationary effects on revenues faded away, the deficit stabilized at roughly 5 per cent of GDP and the cyclically adjusted deficit at 4.4 per cent (Table 7); excluding the one-off immigration absorption costs in the early 1990s, the cyclically adjusted deficit averaged about 2 per cent during that period (Figure 2). Even though there were no official deficit targets at that time (until 1992) the cyclically adjusted deficit (excluding absorption costs) was consistent with long-term convergence to a debt to GDP ratio of about 50 per cent.

The multiyear deficit ceilings adopted in 1991 were consistent with the underlying deficit in that year and were intended to send a message that as absorption costs phase-out the deficit would be reduced accordingly. With hindsight, 1991 was a year of an exceptionally low underlying deficit, so achieving the target required the new government to reduce the deficit by some 1.5-2 per cent of GDP until 1995. The new government, however, abandoned the consolidation process: generous expenditure programs were adopted and the deficit target was raised. Although the results were not immediately visible – due to the phase-out of absorption costs and high growth (Table 7) – the underlying cyclically adjusted deficit rose in 1993 and then surged in 1995 and 1996. The near-crisis deficit levels reached in 1996 forced the government to cut the deficit in 1997, but the cyclically adjusted deficit stayed above 4 per cent until 2003. Thus, between 1992 and 2003 there was no progress towards consolidation despite repeated government policy statements that the objective was consolidation and the constant presence of ambitious formal medium-term targets. Only in 2003, when the deficit surged and a financial crisis emerged, did effective fiscal consolidation take place, and the sustained cyclically adjusted deficit was reduced by almost 4 percentage points of GDP, to levels unseen since the 1980s.

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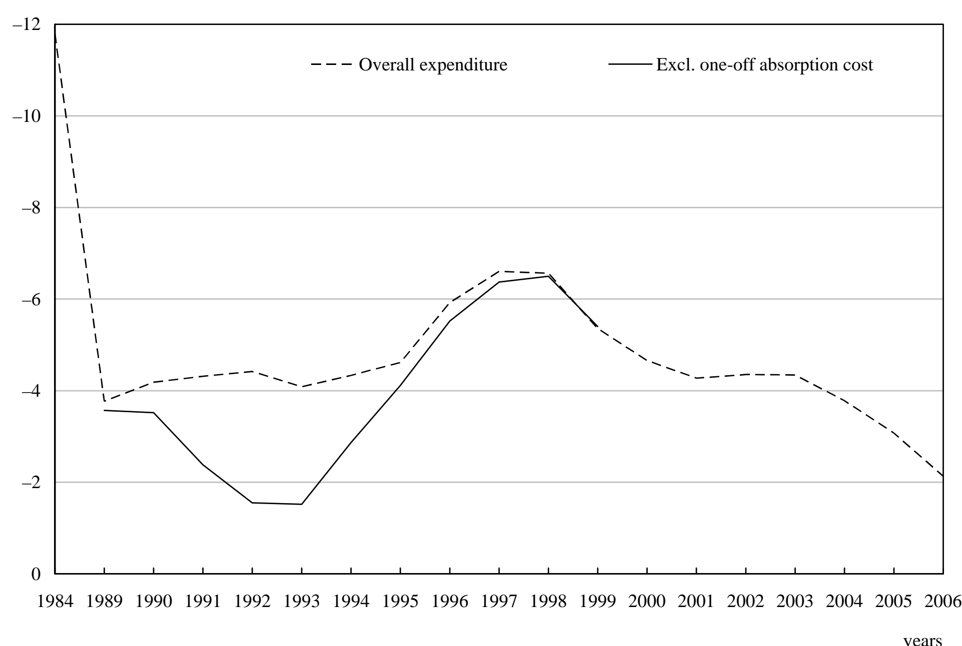
[21] The formal fiscal targets were set in terms of the central government budget. However, because the coverage of the budget and its accounting practices changed several times (for details see Bank of Israel Annual Report 2004, Box 3.A) we focus here on the more comprehensive, and internationally common, concept of general government.

Figure 2

Sustained Cyclically-adjusted Deficit, 1980-2006(1)
(percent of potential GDP)



(1) Three years moving average, from 1989. In 1984 average for 1980-1984.

The deficit path is also reflected in the development of the debt to GDP ratio during the period. The reduction of the deficit from 11.8 per cent of GDP before the 1985 stabilization program to just over 4 per cent in the early 1990s, and the fact that the deficit stabilized around that level (Figure 2), implied a convergence of the debt ratio to about 100 per cent (given Israel's average long-term growth rate of about 4 per cent and valuation effects).[22] This was indeed the case: until 1995 the debt ratio fell continually, although at a decelerating rate, as it converged to its new equilibrium level (Figure 3). Once that level was reached the trend decline stopped until 2005.[23] The decline of the debt ratio in 2005-06 reflects the lower cyclically adjusted deficit; if the average deficit level of the last 3 years persists, then this decline may be the beginning of the debt ratio's convergence to 50 per cent.

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[22] Because most of Israel's debt is indexed to the CPI, whose growth rate is lower than that of the GDP deflator, the long-term ratio was around 95 per cent.

[23] Substantial fluctuations between 1999 and 2002 reflected the growth spree of the year 2000 and the recession that followed.

Table 7

Sustained Cyclically-adjusted General Government Balance[1], 1988-2007

Year	General Government Balance *(percent of GDP)*	Output Gap[2] *(percent)*	Ratio of Actual GDP to Its Sustained Potential *(index)*	Sustained Cyclically-adjusted Balance[2] *(percent of potential GDP)*
1987	0.1	–1.5	101.6	–1.0
1988	–3.2	–4.3	98.8	–2.7
1989	–6.1	–6.0	96.9	–4.8
1990	–5.7	–4.4	98.6	–5.1
1991	–4.3	–6.0	97.0	–3.0
1992	–5.6	–4.2	98.8	–5.1
1993	–4.8	–4.7	98.3	–4.1
1994	–3.4	–2.2	100.9	–3.8
1995	–4.6	–0.1	103.1	–6.0
1996	–6.1	1.3	104.5	–8.0
1997	–4.5	0.0	103.2	–5.8
1998	–4.5	0.1	103.3	–5.8
1999	–3.6	–1.1	102.0	–4.4
2000	–1.5	3.0	106.3	–3.7
2001	–4.1	–1.6	101.6	–4.7
2002	–5.2	–5.9	97.0	–4.6
2003	–6.1	–7.7	95.2	–3.7
2004	–4.6	–6.4	96.6	–3.0
2005	–3.1	–4.8	98.2	–2.5
2006	–1.4	–3.2	99.8	–0.9

[1] The sustained cyclically-adjusted balance is calculated in the same way as the cyclically-adjusted deficit but with respect to an output level which is calculated by mutiplying potential GDP by the average ratio of actual GDP to its potential in the past 20 years.
[2] In percent of potential GDP.

The driving force behind the changes in the size of the deficit was the share of public expenditure in GDP, while the tax to GDP ratio was remarkably stable during most of the period, after its decline in the late 1980s (Figure 4). Public expenditure fell from 65 per cent of GDP in 1985 to 51 per cent in the early 1990s (excluding absorption costs) and stayed at that level until 2003. Despite the statements of successive governments on the need to contain public expenditure, only the 2003 stabilization plan succeeded in reducing its share in GDP again (Figure 4). The unsuccessful experience with meeting the deficit targets during 1995-2003 is especially surprising given the stable expenditure and tax ratios and in particular because there was never a need for an interim budget throughout the period.

Figure 3

Public Debt
(percent of GDP)

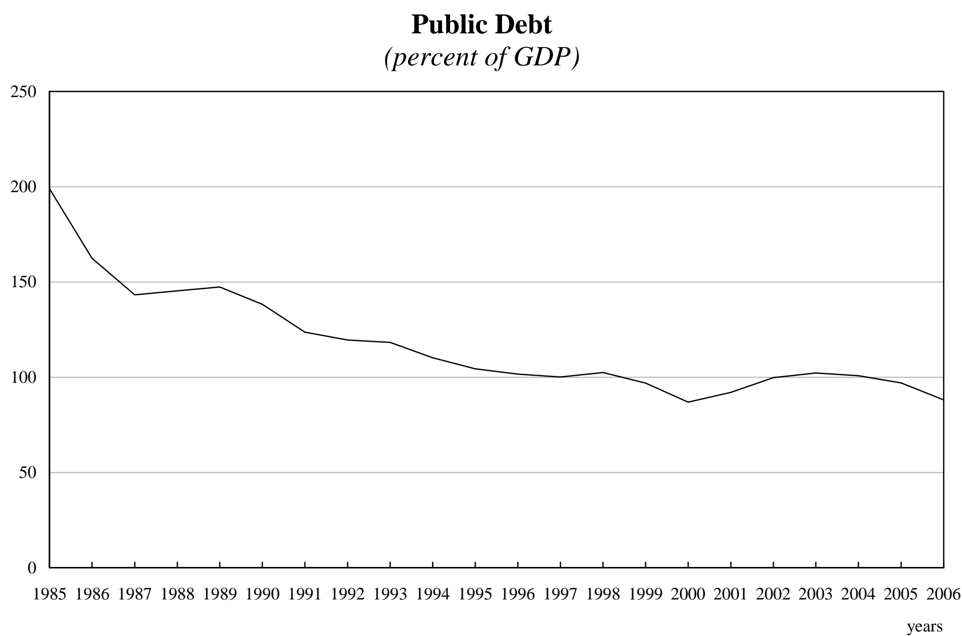

Figure 4

General Government Expenditure and Taxes
(percent of GDP)

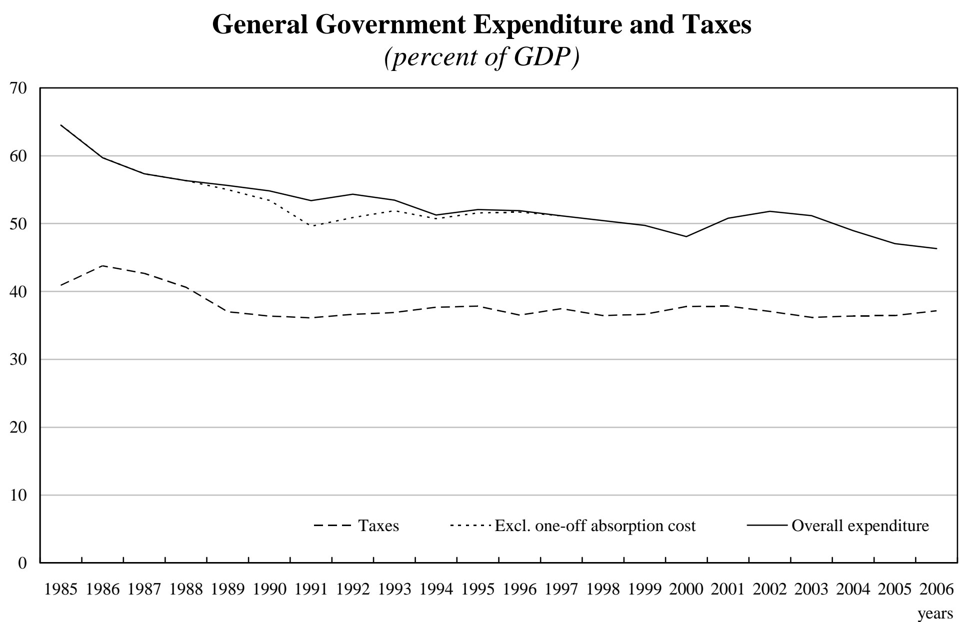

Table 8

Growth Rates of Public Expenditure in Israel, 1994-2006

(percent, deflated by implicit price index of business-sector product)

	1985-1989	1990-1993	1994-1999[1]	2000-2001	2002	2003-2005	2006
	(growth rate, annual average)						
Total public expenditure	0.0	6.0	4.4	5.8	1.9	0.4	3.6
Total primary public expenditure	0.4	7.1	4.6	6.2	3.1	0.0	4.8
Defense expenditure[2]	*–3.8*	*1.6*	*2.5*	*4.2*	*11.2*	*–2.1*	*7.7*
Current primary civilian expenditure	*–0.3*	*5.4*	*7.4*	*7.3*	*0.6*	*0.0*	*4.2*
Public consumption excluding defense imports	0.2	7.3	7.4	5.7	3.8	0.4	5.1
Civilian consumption	3.0	7.4	9.3	6.2	2.0	1.5	4.4
(Per capita civilian consumption)	1.3	3.3	6.6	3.6	–0.1	–0.3	2.6
Domestic defense consumption[2]	–1.4	0.6	2.7	4.9	8.9	–1.1	7.5
Transfer payments to households	9.1	9.3	6.3	9.6	–0.7	–1.2	1.9
(Per capita transfer payments)	7.3	5.2	3.7	6.9	–2.7	–3.0	0.1
Producer and price subsidies[2]	–13.0	–7.0	–7.7	6.4	–14.4	3.1	35.0
Transport infrastructure	…	…	–0.8	4.3	24.0	18.1	2.4
Transfer payments on capital account	–6.2	47.1	–4.7	1.9	5.4	3.2	3.7

[1] Since 1995, including expenditure due to the National Health Law.
[2] Expenditures on these items in 2006 reflect the direct costs of the war in the Lebanese border.
Source: Based on Central Bureau of Statistics data.

The analysis of the fiscal aggregates suggests that substantial progress towards fiscal consolidation was achieved between 1985 and the early 1990s and, again, beginning in 2003. On the other hand, between 1992 and 2003 performance was dismal. Table 8 compares the dynamics of public expenditure between the periods. During 1985-89 real public expenditure (nominal expenditure deflated by business-sector prices) did not rise at all. The two key components of the program are visible: defense expenditures decreased at an average annual rate of 3.8 per cent and producer and price subsidies by 13 per cent. At the same time civilian public consumption rose at a lower rate than the long-term growth rate of GDP. Although

transfer payments to households rose rapidly, this came from a low base and reflected the need to compensate low-income families for the reduction of subsidies.

The evident change in expenditure dynamics in the early 1990s is striking. Primary expenditure rose by 7.1 per cent annually, first reflecting absorption costs and then their replacement by other – mostly current – expenditure. Public consumption rose at an unsustainable annual average rate of 7.3 per cent (3.3 per cent per capita) and transfer payments by 9.3 per cent. Since the government policies in that period affected the dynamics of public expenditure and not only their level, they impacted on the following years – until 2002 – as well. Faced with such daunting dynamics, any subsequent government wishing to reduce the deficit would have had to break the mechanisms that raised transfer payments and the automatic wage crawl – a task that calls for a confrontation with many vested-interest groups. While the governments elected during that period recognized that such a change would have to be phased-in over a few-years, all four of them chose to set the medium-term deficit target for their successor while neglecting to make the required decisions to change the expenditure dynamics. Consequently, annual revenue projections had to be stretched in some of the years to match the increase in expenditure.

The change in expenditure dynamics due to the 2003 stabilization program is also evident in Table 8. During 2003-05 the level of primary public expenditure did not increase in real terms, as the measures implemented in 2003 gradually took effect.[24] Unlike in the 1985 program, in 2003 the change in expenditure dynamics was more broadly based, as reflected in the near freeze of real public consumption (aided again by a decline in defense spending) and the decrease in transfer payments.

7 Conclusions

The evolution of Israel's fiscal policy in the past 22 years highlights two periods of successful consolidation: 1985-92 and 2003-06; in the 10-year period between them very little progress was made towards consolidation – despite the repeated setting of policy targets to that effect. The key factor that is pointed out here as contributing to the success in these two episodes is tackling the underlying public expenditure dynamics upfront. In both cases the government at the outset adopted specific measures to contain expenditures in the following years. By doing so subsequent cabinets were relieved of the need to confront interest groups – although their perseverance in preventing the reversal of the measures should not be underestimated.

The arguments in favor of fiscal targets typically focus on the need to restrict macroeconomic manipulations, taking into account Keynesian considerations.

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[24] Developments in 2006 are primarily related to the war on the Lebanese border. See further discussion below.

However, the findings above seem to be more consistent with the perception of the deficit bias as a microeconomic phenomenon. the budgeting process may, in many cases, be dominated by political forces that focus on specific budget items, rather than on macro characteristics such as the deficit. Valesco (1999), Hallerberg and von Hagen (2006) and Persson, Roland and Tabellini (2005) discuss the "deficit bias" as a microeconomic phenomenon with macroeconomic consequences: the result of pressures by many interest groups pushing their own interests, while not fully accounting for the related cost[25] – the "common pool" problem. This problem is particularly relevant for coalition governments as is the case in Israel. In the current context this problem implies that even when a deficit target is set in advance a government that still has to decide on – and implement – the specific measures to cut the deficit would likely prefer to avoid the associated political cost and bear the cost of changing – or missing – the aggregate target. This may be especially true if the magnitude of the required measures is substantial or when the target was set by a former cabinet. To overcome this problem Tanzi (1994) highlights the need for consistency between the official targets and actual policy measures and stresses that medium-term targets need to be supported by well – specified future policy measures. Buti, Eijffinger and Franco (2003) also point out the need to distinguish between one-off and long-term structural measures in policy evaluation.

While adopting comprehensive programs that specify the policy measures over the medium term is clearly the prescription for fiscal consolidation that emerges from this analysis, the question is, how does a government generate the will and the political might to implement such a program? The common feature of the two successful episodes in Israel gives no reason for optimism: both episodes occurred at a time of emerging financial crisis, and both programs were adopted after failed attempts to stabilize the economy with less comprehensive programs. Paraphrasing Churchill, this experience suggests that "You can trust the government to do the right thing, after it exhausted every other possibility." A second important feature in both episodes, although much more so in 1985, is the reduction of defense expenditure as part of the program.

Formal fiscal targets seemed to have played a very limited positive role, if any, in Israel's progress towards fiscal consolidation. During the consolidation period of 1985-92 the government did not adopt official medium-term fiscal targets at all. This did not prevent the preservation of the substantial decline of the deficit and its continuation (net of absorption costs) until 1992. The initial introduction of the deficit target seemed as a plausible statement of policy intentions with respect to the phasing-out of the absorption costs. However, the immediate change of the target in 1992 turned this instrument into a platform for postponing policy efforts. Until 2003, with the exception of the 1997 budget, the governments preferred to pay the price for changing the pre-set fiscal targets, or simply missing them, rather than to tackle the underlying expenditure dynamics.

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[25] Phelps (1985) provides a detailed discussion of the conceptual issues underlying the suboptimal equilibrium reached in group decisions.

The successful consolidation of 2003 took place at a time where formal fiscal targets were present. However, their role in the initiation of the 2003 program was limited. In fact, in 2003 the government explicitly announced that it was abandoning the deficit target for that year and was not adopting a new one. In the process of preparing the 2004 budget the government raised the former deficit ceiling to match the projected effect of the adopted policy measures, so clearly the target was not a binding constraint, but rather a reflection of projected performance. The repeated upward revisions of both the expenditure and deficit ceilings in 2005-07, while performance was much better than the initial targets and in line with the estimates at the time it was introduced, suggest that the role of the formal targets remains limited. The formal targets did not – and still do not – serve as a mechanism for overcoming the time inconsistency problem for governments.

If formal policy targets are no credible guide to the evolution of Israel's fiscal aggregates, what can be implied about them? In the past 22 years changes in the underlying expenditure dynamics were relatively rare. Therefore, an analysis of the expected expenditure dynamics – based on existing policies – can provide guidance for future fiscal developments. Detailed publication of such estimates would provide the public with worthwhile information as to the sustainability of the fiscal targets and – more importantly – the expected development of the fiscal position. Past and current experiences suggests that in cases of a mismatch it is the targets that will usually change – not the policies. Nevertheless, in Israel, any forward-looking fiscal analysis should be conditional on the security situation, and the related defense expenditures, which remain the wild-card in all fiscal scenarios. This is particularly evident in the developments in 2006 and the looming threat of a substantial permanent increase in defense expenditures as a result of the war.

Finally, a word on the markets. In contrast to the proposal to use fiscal rules – or other fiscal policy guidelines – and support them with pre-specified measures (e.g., Tanzi, 1994; Buti *et al.*, 2003), it is argued by some scholars that market discipline may be a sufficient substitute. Kopits (2001), as well as many others in the fiscal institutions literature, points out the slow response of markets to expanding fiscal deficits and deterioration in the underlying fiscal position, and demonstrates it in the slow response of rating agencies. In the Israeli case, the study by Ber, Brender and Ribon (2004) shows that market interest rates in Israel respond not only to actual fiscal performance but also to the fiscal targets – despite their poor performance. Moreover, the data show no evidence for a decrease in the effect of the targets on interest rates, despite their dismal performance.

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