FOR

AGENDA

SM/08/30
Correction 1

February 8, 2008

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Israel—Selected Issues**

The attached corrections to SM/08/30 (1/23/08) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 49, para. 10, lines 4–6: for "This is for instance the case in the United Kingdom which combines…with a variant of the golden rule."
read "This is for instance the case in the United Kingdom which combines a debt limit (currently 40 percent of GDP) with a cyclical version of the golden rule (current spending less current revenue must be in balance over the cycle)."

Page 53, footnote 10, lines 2 and 3: for "comprises the deficits of the local governments (averaging about ½ percent of GDP over the past five years)"
read "comprises the deficits of the local governments (averaging about zero percent of GDP over the past five years)"

Page 57, para. 21, lines 4–7: for "In light of international experience (e.g., Sweden), a multi year (say 3 years)…without explicit reference to the output gap."
read "In light of international experience, a multi-year (say 3 years)… without explicit reference to the output gap."

Questions may be referred to Mr. Epstein (ext. 38452) and Mr. Cihak (ext. 38931) in EUR; Mr. Moore (ext. 38631) and Mr. Tower (ext. 37468) in MCM; and Mr. Debrun (ext. 38321) in FAD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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C. Lessons from International Experience

8.   **Countries have found the adoption of fiscal rules to be an important mechanism by which governments can either seek to contain imprudent use of discretion or to signal commitment to fiscal discipline.** This, in turn, helps reassure capital markets and thereby lowers interest rates on public debt. Rules have become an increasingly popular response to the deficit bias (see Debrun et al., 2008 for detailed evidence on rules in the EU-25). They tend to fall into four broad categories: (i) *deficit rules*, which include balanced-budget rules, the golden rule— requiring a balanced budget excluding investment spending— and deficit limits; (ii) *debt rules*, which place limits on gross or net public debt; (iii) *expenditure rules*, which impose ceilings on total spending (or spending growth in real or nominal terms) or on specific categories of spending; and (iv) *revenue rules*, which are meant to put a lid on the overall tax burden or to allocate ex-ante unexpected revenue windfalls.

9.   **Each of these rules has pros and cons, and there is a growing tendency to combine them in the hope to fully exploit their respective benefits.** While fiscal rules have generally been found to enhance fiscal discipline, they face three major criticisms. First, they may encourage procyclical policies. This is clearly the case for *tightly binding* deficit and debt rules because they are more likely to bind in bad time, forcing procyclical fiscal contractions, but often prove unable to encourage adjustment in good times. Revenue rules can also lead to procyclicality, especially if they are not specified in terms of a ratio to GDP. By contrast, expenditure rules let automatic stabilizers on the revenue side play fully and do not hinder an appropriate response to business cycle fluctuations, but they can allow drift in the underlying deficit and debt objectives. Second, rules are often blamed for deteriorating the quality of fiscal policies because they are generally silent on the nature of the required fiscal adjustment. This clearly depends on the extent to which "forced" fiscal adjustment is more likely to be based on distortionary tax increases or cuts in productive discretionary expenditure (e.g. investment). Third, if rules fail to reflect a genuine commitment to fiscal discipline, they are likely to encourage creative accounting and off-budget operations, which reduces the overall transparency of the budget and weakens democratic control over it.

10.   **More sophisticated rules have been proposed to alleviate those criticisms but they introduce new complexities.** [4] Concerns about procyclicality have led to the specification of targets in cyclically-adjusted terms, whereas "qualitative" issues have been addressed by excluding specific spending or revenue items from the target. This is for instance the case in the United Kingdom which combines a debt limit (currently 40 percent of GDP) with a cyclical version of the golden rule (current spending less current revenue must be in balance over the cycle). Also, under the EU's Stability and Growth Pact,

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[4] See Kopits and Symansky (1998) for detailed discussion on fiscal policy rules, including their key characteristics. They define a good rule as being simple, transparent, coherent with the final goal, but mindful of other goals of public policies.

budgetary developments are assessed in cyclically-adjusted terms (although targets remain unadjusted), and attention is paid to qualitative aspects of fiscal policy, including the costs of specific structural reforms. In Sweden, the quality issue is addressed by using expenditure rules to implement a budget-balance rule. While adding complexity can help avoid some of the problems inherent in rules, it raises serious implementation concerns, both from a technical and from an institutional perspective. On the technical side, cyclical adjustment is more an art than a science, and the definition of spending categories is always subject to interpretation. On the institutional side, complex rules are hard to implement, and possibly even harder to monitor, making them prone to manipulations and preventing democratic accountability mechanisms to operate fully.

11. **An effective implementation of fiscal rules requires supporting institutional arrangements, including a legal basis and mechanisms promoting self-compliance.** A strong legal apparatus supporting enforcement is an important dimension of a rules-based fiscal framework. Rules with a statutory or even constitutional basis are in principle more likely to discourage policymakers to deviate from the targets than a formal statement in a coalition agreement. Regardless of the type of "sanction" for violating the rule (pecuniary, reputational, etc.), an effective enforcement procedure must make deviations costly.[5] Moreover, the risk of manipulation and creative accounting calls for the rules to operate in a propitious institutional setting that minimizes opportunities for such manipulations and enhances real-time monitoring of budget performance. In this regard, non-partisan fiscal surveillance mechanisms, such as fiscal agencies or committees, can play a useful role (i) by providing specific inputs to the budget process, such as unbiased macroeconomic projections, (ii) by analyzing budget plans and their implementation, or (iii) by formulating recommendations (see Kumar and Ter-Minassian, 2007). For instance, in Chile, manipulations of the cyclically-adjusted-balance rule are minimized thanks to a panel of independent experts who assess the cyclical position of the economy and provide revenue projections. In Belgium, a non-partisan body makes recommendations on the coordination of fiscal policies among entities, supporting the implementation of rules that concern the general government. Sweden has recently established a Fiscal Policy Council (*Finanspolitiska rådet*) to monitor compliance with the objectives of fiscal policy, including long-run sustainability, a surplus target and an expenditure ceiling. The Council also assesses consistency of fiscal policy with macroeconomic stability, and evaluates the transparency and clarity of budget documents, as well as the quality of forecasts and forecasting methodologies.

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[5] Enforcement translates deviations from targets into some subjective cost ("disutility") for the decision-maker.

15.   **The ultimate objective would be to reduce the public debt to 60 percent of GDP by 2015.** This objective could be achieved by maintaining central government balance (which is typically equivalent to a general government deficit of 1 percent of GDP) over the cycle. For operational purposes, the central government balance (cash basis) constitutes the appropriate variable to target. The reasons are that the authorities have direct policy control over it and that local governments are relatively small and significantly under the control of the central government.[10] However, it will also be important that, relative to the existing rules, the coverage of the central government is wider, particularly if the new rule relies on an expenditure growth ceiling. A key item to include is government spending through the National Insurance Institute (NII), equivalent to about 5 percent of GDP, which is not included in the current budget growth ceiling.[11]

The Swiss Debt-Brake Approach

16.   **In the Swiss Debt-Brake approach, the government would target the deficit over the cycle to eliminate a pro-cyclicality bias that is otherwise inherent in nominal budget balance rules.** At the end of each year, any deviation from the budget balance target would be recorded in a fictional account, per the debt-brake concept. The planned deficit in the following year will be set according to two criteria: (i) the cyclical position and (ii) the amount accumulated in the fictional account (i.e., accumulation of past deviations). Thus, in periods when the economy is believed to be below (above) potential the deficit target will rise (fall) such that the structural deficit is unchanged. In addition, given the high debt to GDP ratio, and to minimize the risk of confusing a permanent shock with a cyclical downturn, the deficit target will decline (rise) if the debt in the fictional account increases.

17.   **The built-in error correction mechanism (ECM) serves to ensure that debt cannot permanently deviate from the path to 60 percent of GDP by 2015.** The ECM comprises of a linear and a quadratic term. The linear term acts mainly to reduce the countercyclical policy when the debt begins to deviate from its targeted path, while the quadratic term represents a more significant fiscal adjustment once the accumulated liabilities in the fictional account exceed a certain threshold (e.g., 2 percent of GDP) and

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[10] The difference between the central government balance (cash basis) and the general government balance (accrual basis) comprises the deficits of the local governments (averaging about zero percent of GDP over the past five years) and interest accrued on inflation-index-linked government debt. The latter can vary widely as a function of inflation but has averaged around 1 percent of GDP over the past five years.

[11] NII expenditure and revenue (vis-à-vis the public) amount to about NIS 45 billion and NIS 25 billion, respectively. To close the gap, the government transfers to NII, on a net basis, some NIS 20 billion. This allows the government to circumvent the expenditure growth ceiling, for example, by increasing its transfers to NII without reflecting the corresponding increase in spending in the budget. A similar loophole exists with respect to the collection and outlays of health related taxes.

achievement of the planned debt reduction is therefore considered at risk. Specifically, the deficit, in percent of GDP, for the budget year $t+1$ can be expressed as (a positive value):

$$def_{t+1} = defTAR - \alpha\, ygap_{t+1} + \beta FA_t - \gamma\left(FA_t\right)^2 \qquad\qquad \text{if } FA_t \geq 2$$

$$= defTAR - \alpha\, ygap_{t+1} \qquad\qquad\qquad\qquad \text{if } FA_t < 2$$

where $defTAR$ is the specified deficit target (1 percent of GDP for the general government deficit—this is the equivalent to the operationally-relevant target of central government balance);[12] $ygap_{t+1}$ is the output gap projected in period $t+1$; α represents a cyclical factor; FA_t denotes the accumulated balance in the fictional account at period t; while β and γ are parameter values (between 0 and 1) that determine the speed of adjustment as described above. If economic dynamics are governed mainly by cycles or transitory shocks, then one may consider setting $\gamma = 0$ and the level of β according to the preferred countercyclical policy. However, if the economic dynamics are more erratic and exposed to permanent shocks, one may want to set higher level of γ and hence adjust faster to unfavorable shocks and minimize the deviation of debt from its planned trajectory so as to protect the economy from adverse public debt dynamics.

18.   **Under a baseline scenario, in which the new fiscal rule takes effect in 2010, the public debt is expected to reach 60 percent of GDP by 2015 (Figure 3).** In the scenario analysis below, we assume that (i) the public debt reaches 78 percent of GDP at end-2009 and (ii) the output gap is zero when the rule takes effect. For the purpose of illustration, we also assume that $\beta = \gamma = 0.125$ and $\alpha = 0.4$ (revenue/GDP ratio)[13]. Therefore, a simplified version of the rule can be written as:

$$def_{t+1} = 1 - 0.4\, ygap_{t+1} + 0.125\left(FA_t - \left(FA_t\right)^2\right)$$

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[12] While, for operational reasons, the central government balance constitutes the appropriate variable to target, all further scenario analysis and simulations are based on the corresponding general government balance, since it is more closely associated with changes in the overall public debt.

[13] Sensitivity analysis suggests the results are robust to (small) changes in the parameters values.

An alternative Debt Brake

Trade-offs

20.   **The debt-brake rule described above fulfills many criteria of a good rule, but the explicit reference to the business cycle is a potential drawback.[15]** The Swiss-type debt-brake mechanism is arguably transparent, coherent with the final goal (putting a lid on the public debt), and mindful of fiscal stabilization. However, it raises a number of technical issues in terms of parameterization, and its implementation may be complicated by the explicit cyclical-adjustment mechanism for the deficit target. More specifically, while Switzerland is a mature economy with mild cyclical fluctuations, it is arguably more difficult to determine the cyclical position of a dynamic economy subject to potentially large shocks like Israel. Likewise, the permanent versus transitory nature of disturbances is harder to detect. One additional difficulty relates to the operation of the correction mechanism in case slippages result from significant mistakes in the estimation of the output gap (larger errors are likely at turning points).

21.   **Alternatives to the debt brake rule are potentially numerous, but involve trade-offs as regards the desirable characteristics of rules.** Expenditure rules have been tested quite successfully in Israel and could be redesigned to allow for greater short-run flexibility, while keeping debt firmly on a declining path. In light of international experience, a multi-year (say 3 years) rolling ceiling on nominal expenditure growth could effectively contain budget deficits, while preserving automatic stabilizers without explicit reference to the output gap.

22.   **There are, however, major drawbacks to an expenditure-rule-only approach.** The first is that undesirable slippages could still occur on the revenue side, undermining the discipline-enhancing effect of the rule. Second, and related, an expenditure ceiling per se does not map into a specific debt path, making the link between the rule and the ultimate objective questionable. Third, a strict expenditure rule hinders an appropriate response to unforeseen events such as natural disasters, wars, and social unrest. Escape clauses thus appear unavoidable, with potentially harmful effects on the credibility of the rule.

23.   **A budget-balance target with a binding deficit ceiling (like in the SGP) is closer to the debt reduction objective and provides room for automatic stabilizers without requiring explicit cyclical adjustment.** The challenge, however, is to give a prominent role to the budget balance target. If governments maintain deficits close to the ceiling in good

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[15] Another conceptual issue is that the debt brake leads to a debt-to-GDP ratio that is asymptotically zero. This is the reason why, in the version proposed in the previous section, the rule would be revisited once public debt has been reduced to 60 percent of GDP.

times, they would find themselves in the uneasy position to either contract fiscal policy in bad times, or change the rule when it imposes inadequate policies.

An expenditure rule anchored in a debt objective

24. **A valuable alternative rule could be based on the following principles:**

   a. The rule should trigger a correction when debt deviates excessively from a desirable norm (coherence with the final goal of bringing down the debt to an acceptable level);

   b. the rule should avoid explicit reference to a measure of the business cycle (simplicity);

   c. the rule should be easy to communicate to the public (transparency);

   d. the rule should reduce the likelihood of forcing pro-cyclical contractions, while encouraging the allocation of revenue windfalls to debt reduction when the latter is needed (mindful of other goals);

   e. the rule should allow for lower taxes in the case of more ambitious expenditure outcomes;

   f. the rule should be resilient in the face of unforeseen events unrelated to business cycle developments.

25. **One possibility would be to explicitly anchor an expenditure rule in a long-run debt objective.** Such rule would include (i) a specific debt path (the norm) leading to a certain long-run debt objective (in terms of GDP); (ii) a deficit norm consistent with the desirable debt path; and (iii) a medium-run expenditure growth cap consistent with the (ex-ante) deficit norm. As discussed above, an expenditure rule preserves automatic stabilizers in the face of unexpected shocks to economic activity. It would also appear as a natural continuation of the existing framework, reducing the risk of sending ambiguous signals to the public regarding the commitment to fiscal discipline.

26. **Given the possibility of ex post deviations from the debt norm, a feedback mechanism from debt to expenditure is required.** If debt is below the norm, there is admittedly no need for such automatic correction unless there are reasons to believe that the debt norm is somehow socially optimal. That said, as long as the desirable debt path is declining, there is a case for setting expenditure targets such that debt declines at the same pace as the norm until some long-run desirable ratio—say 60 percent of GDP—is reached.

27. **Two main approaches can be envisaged to make the ECM operational.** The *first* is to set a constant maximum growth rate for nominal expenditure consistent with the debt objective, and allow for adjustments of the expenditure growth ceiling only when actual