State Budget
Proposal for Fiscal Years
2011-2012

Major Provisions of the Budget
and Multi-Year Budget Plan

Jerusalem **October 2010**

To the Reader,

This booklet summarizes the major provisions of the budget proposal for fiscal years 2011-2012. Additional material on government activities within the 2011-2012 budget is available in the detailed booklets of this budget proposal, and can be found in the Budget Department website (Hebrew).

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Budget Bill for Fiscal Years 2011-2012

Definitions

1. In this law:

"**Budget item**" – A sum of money or number of salaried positions, stated in a title line and marked by a dashed double underline.

"**Area of operation**" – A sum of money or number of salaried positions, stated in a title line and marked by a dashed underline.

"**Plan**" – A sum of money or number of salaries positions, stated in a line with no marking.

"**Fiscal year 2011**" – The period commencing on January 1, 2011 and ending December 31, 2011.

"**Fiscal year 2012**" – The period commencing on January 1, 2012 and ending December 31, 2012.

Any other term – As defined in the Budget Principles Law, 1985 (hereinafter – Budget Principles Law).

The expenditure budget and its allocation

2. A. The Government is permitted to make expenditures of NIS 348,185,234 thousand during fiscal year 2011. This sum consists of the budget for calculation of the expenditure limit, in the amount of NIS 271,196,234 thousand, and the budget for debt repayments, excluding debt repayments to National Insurance, in the amount of NIS 76,989,000 thousand. The division of this sum into parts, and of any part thereof into budget items, areas of operation and plans, shall be as detailed in the first column of the first schedule titled "Expenditure."

B. The Government is permitted to make expenditures of NIS 365,916,172 thousand during fiscal year 2012. This sum consists of the budget for the expenditure limit calculation, in the amount of NIS 284,657,172 thousand, and the budget for debt repayments, excluding debt repayments to National Insurance, in the amount of NIS 81,259,000 thousand. The division of this sum into parts, and of any part thereof into budget items, areas of operation and plans, shall be as detailed in the first column of the first schedule titled "Expenditure."

Revenue-dependent expenditure budget

3. A. In addition to all the sums the Government is permitted to expend pursuant to Section 2(A), it may expend a sum of 18,652,664 thousand in fiscal year 2011 as revenue-dependent expenditures. The division of this sum into parts, and of any part thereof into budget items, areas of operation and plans, shall be as detailed in the second column of the first schedule titled "Revenue-Dependent Expenditure."

B. In addition to all the sums the Government is permitted to expend pursuant to Section 2(B), it may expend a sum of 19,072,349 thousand in fiscal year 2012 as revenue-dependent expenditures. The division of this sum into parts, and of any part thereof into budget items, areas of operation and plans, shall be as detailed in the second column of the first schedule titled "Revenue-Dependent Expenditure."

Maximum personnel

4. A. In fiscal year 2011, the Government is permitted to fill a maximum of 66,022.0 salaried positions. The division of this number into parts, and of any part thereof into budget items, areas of operation and plans, shall be as detailed in the fourth column of the first schedule titled "Maximum Personnel."

B. In fiscal year 2012, the Government is permitted to fill a maximum of 66,674.5 salaried positions. The division of this number into parts, and of any part thereof into budget items, areas of operation and plans, shall be as detailed in the fourth column of the first schedule titled "Maximum Personnel."

Business enterprise budget

5. A. In addition to the sums the Government is permitted to expend pursuant to Sections 2(A) and 3(A), it may expend, in fiscal year 2011, the sums appearing in the first column of the second part of the second schedule (hereinafter – business enterprise budget). The division of these sums into budget items, areas of operation and plans shall be as detailed in that part.

B. In addition to the sums the Government is permitted to expend pursuant to Sections 2(B) and 3(B), it may expend, in fiscal year 2012, the sums appearing in the first column of the second part of the second schedule (hereinafter – business enterprise budget). The division of these sums into budget items, areas of operation and plans shall be as detailed in that part.

C. In addition to the number of salaried positions the Government may fill pursuant to Section 4(A), it may fill 19,391.0 salaried positions in business enterprises in fiscal year 2011. The division of this number into budget items, areas of operation and plans shall be as detailed in the third column of the second part of the business enterprise budget.

D. In addition to the number of salaried positions the Government may fill pursuant to Section 4(B), it may fill 19,385.0 salaried positions in business enterprises in fiscal year 2012. The division of this number into budget items, areas of operation and plans shall be as detailed in the third column of the second part of the business enterprise budget.

E. The forecast revenue for coverage of the business enterprise budget in fiscal year 2011 shall be as detailed in the first part of the second schedule.

F. The forecast revenue for coverage of the business enterprise budget in fiscal year 2012 shall be as detailed in the first part of the second schedule.

Provisions concerning specific items

6. In fiscal years 2011-2012, at the request of the Minister of Finance, the notification regarding use of the general reserve pursuant to Section 12 of the Budget Principles Law, for a purpose within the activity of the Prime Minister's Office, shall be made to a special committee to be appointed by the Foreign Affairs and Defense Committee of the Knesset from among its members, instead of to the Finance Committee of the Knesset.

Adjustments budget	7.	Use of the budget in the "adjustments budget" plan in the general reserve item shall be in accordance with the provisions of Section 1(a)(5) of the Basic Law: State Budget for 2009-2012 (Special Provisions) (Temporary Order), and Section 179A of the Economic Efficiency Law (Legislative Amendments to Implement the Economic Plan for 2009-2010), 2009.
Inception	8.	This law shall become effective on January 1, 2011.
Publication	9.	This law shall be published in Reshumot (the Official Gazette of the Israeli Government) within three months of its ratification.

Budget Bill for Fiscal Year 2011

(In NIS Thousands)

	Summary of the First Schedule	Expenditure	Revenue-Dependent Expenditure	Spending Authorization	Maximum Personnel
Grand Total		**348,185,234**	**18,652,664**	**75,831,593**	**66,022**
Budget for calculation of expenditure limit *		271,196,234			
Debt repayments excluding debt repayments to National Insurance		76,989,000			
Part I:	Regular budget	247,116,515	14,937,189	49,905,107	66,022
Part II:	Development and capital account budget	101,068,719	3,715,475	25,926,486	
Part I:	**Regular Budget**	**247,116,515**	**14,937,189**	**49,905,107**	**66,022**
	Government and administration	**35,954,704**	**2,560,355**	**3,413,474**	**43,725**
01	President of the State	41,737	800		42.5
02	The Knesset**	496,557	180		558
03	Cabinet members	110,582			
04	Prime Minister's Office	2,005,160	13,979	577,038	926.5
05	Ministry of Finance	1,776,899	311,757		5,251
06	Ministry of the Interior	337,597	10,800	124,300	516.5
07	Ministry of Public Security	10,118,480	559,618	2,357,215	28,175.5
08	Ministry of Justice	2,419,678	674,964	3,000	5,288
09	Ministry of Foreign Affairs	1,570,559	50,497		1,058
10	National Security Council	32,832			1
11	State Comptroller***	266,933			559
12	Pension benefits and severance pay	11,882,604	657,350		
13	Miscellaneous expenses	2,994,100		209,205	
14	Financing of political parties	131,835			
19	Ministry of Science & Technology and Ministry of Culture & Sport	954,931	32,681	121,500	106
26	Ministry of Environmental Protection	296,724	235,232	21,216	501
68	Population, Immigration & Border Authority	517,496	12,497		742

* Net budget (NIS 348,185,234) less debt repayments (NIS 85,417,000) excluding debt repayments to National Insurance (NIS 8,428,000).

** The Knesset's annual budget proposal is submitted for approval to the House Committee of the Knesset by the Chairman of the Knesset, and is part of the Budget Law.

*** The State Comptroller budget is set by the Finance Committee of the Knesset, and is part of the Budget Law. Details of this budget are published separately, pursuant to the Basic Law: State Comptroller.

Budget Bill for Fiscal Year 2011 (cont.)

Summary of the First Schedule		Expenditure	Revenue-Dependent Expenditure	Spending Authorization	Maximum Personnel
	Defense	**49,424,434**	**5,075,025**	**32,476,432**	**2,447.5**
	======	========	=======	========	======
15	Ministry of Defense	49,132,073	4,952,858	32,334,000	2,232
16	Civil emergency expenses	206,093		112,432	12
17	Coordination of activities in the territories	86,268	122,167	30,000	203.5
18	**Local authorities**	**3,882,210**		**369,130**	
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	Social services	**106,406,913**	**6,364,914**	**1,783,266**	**15,047.5**
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20	Ministry of Education	34,901,335	1,595,386	171,500	2,092
21	Higher education	7,391,473			
23	Ministry of Social Affairs	4,467,569	1,421,965	83,683	2,636
24	Ministry of Health	19,867,335	3,284,233	194,755	9,180
27	Transfers to National Insurance	29,754,706			
25	Holocaust Survivors Rights Authority	2,937,803			61
29	Ministry of Construction & Housing	208,047	3,500		630
30	Ministry of Immigrant Absorption	1,277,187	24,830	615,334	418.5
32	Miscellaneous support	3,928,351	35,000	717,994	
46	Discharged Soldiers Law	1,665,829			21
56	Commission for Equal Rights for Persons with Disabilities	7,278			9
	Economy and administration	**8,349,106**	**936,895**	**1,862,805**	**4,502**
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33	Ministry of Agriculture & Rural Development	683,327	217,045	337,059	1,287
34	Ministry of National Infrastructures	132,566	49,000		283
35	Israel Atomic Energy Commission	147,927			
36	Ministry of Industry, Trade & Labor	2,389,214	65,839	60,000	1,591.5
37	Ministry of Tourism	353,272	8,668	15,814	136.5
38	Support for economic sectors	1,724,184	468,160	1,385,000	
39	Ministry of Communications	49,933	650		91
40	Ministry of Transport	417,383	94,438	15,000	691
41	Government Water & Sewage Authority	116,652	491		125.5
42	Construction and housing grants	2,020,664	4,820	49,432	
43	Israel Mapping Center	67,314	27,484	500	241.5
54	Regulatory authorities	246,670	300		55

Budget Bill for Fiscal Year 2011 (cont.)

Summary of the First Schedule		Expenditure	Revenue-Dependent Expenditure	Spending Authorization	Maximum Personnel
45	**Interest and commission payments**	**36,831,000**			
	Reserves	**6,268,148**		**10,000,000**	**300**
47	General reserve	6,268,148		10,000,000	300
Part II:	**Development and Capital Account Budget**	**101,068,719**	**3,715,475**	**25,926,486**	
	Development budget	15,651,719	3,715,475	25,926,486	
	Investments in government and administration	**645,001**	**82,393**	**3,040,181**	
51	Government housing	65,350	42,420	2,106,250	
52	Police and prisons	356,964	33,973	852,580	
53	Courts	190,372	1,000	63,915	
55	Treasury	32,315	5,000	17,436	
	Investments in social services	**2,506,001**	**2,083,823**	**4,666,102**	
60	Education	627,581		829,723	
67	Health	317,840	77,423	503,134	
70	Housing	1,560,580	2,006,400	3,333,245	
	Investments in economic sectors	**12,500,717**	**1,549,259**	**18,220,203**	
73	Water works	1,242,371	10,500	1,205,000	
76	Industrial development	52,719	40,000	148,383	
78	Tourism	72,442		53,394	
79	Transport development	8,267,618	98,500	16,021,396	
83	Miscellaneous development expenses	2,865,567	1,400,259	792,030	
84	Debt repayments	85,417,000			
	Of which: Debt repayments to National Insurance	8,428,000			

Budget Bill for Fiscal Year 2012

(In NIS Thousands)

Summary of the First Schedule		Expenditure	Revenue-Dependent Expenditure	Spending Authorization	Maximum Personnel
Grand Total		**365,916,172**	**19,072,349**	**79,247,057**	**66,674.5**
Budget for calculation of expenditure limit *		284,657,172			
Debt repayments excluding debt repayments to National Insurance		81,259,000			
Part I:	Regular budget	258,804,806	15,386,356	50,106,185	66,674.5
Part II:	Development and capital account budget	107,111,366	3,685,993	29,140,872	
Part I:	**Regular Budget**	**258,804,806**	**15,386,356**	**50,106,185**	**66,674.5**
	Government and administration	**38,828,745**	**2,570,659**	**3,194,532**	**44,074**
01	President of the State	43,484	800		42
02	The Knesset**	496,557	180		552.5
03	Cabinet members	111,361			
04	Prime Minister's Office	2,072,099	13,977	344,158	912.5
05	Ministry of Finance	1,789,970	314,444		5,217
06	Ministry of the Interior	344,268	10,800	130,300	533
07	Ministry of Public Security	10,558,735	559,618	2,362,278	28,572.5
08	Ministry of Justice	2,553,333	676,674	3,000	5,287
09	Ministry of Foreign Affairs	1,613,504	50,497		1,064
10	National Security Council	32,448			1
11	State Comptroller***	267,213			554
12	Pension benefits and severance pay	13,528,870	663,259		
13	Miscellaneous expenses	3,461,280		215,080	
14	Financing of political parties	137,737			
19	Ministry of Science & Technology and Ministry of Culture & Sport	1,020,201	32,681	121,500	108.5
26	Ministry of Environmental Protection	300,521	235,232	18,216	501
68	Population, Immigration & Border Authority	497,164	12,497		729

* Net budget (NIS 365,916,172) less debt repayments (NIS 95,356,000) excluding debt repayments to National Insurance (NIS 9,097,000).

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*** The State Comptroller budget is set by the Finance Committee of the Knesset, and is part of the Budget Law. Details of this budget are published separately, pursuant to the Basic Law: State Comptroller.

Budget Bill for Fiscal Year 2012 (cont.)

	Summary of the First Schedule	Expenditure	Revenue-Dependent Expenditure	Spending Authorization	Maximum Personnel
	Defense	**50,636,979**	**5,394,132**	**32,476,432**	**2,445**
	======	========	=======	========	====
15	Ministry of Defense	50,352,073	5,271,465	32,334,000	2,231
16	Civil emergency expenses	204,074		112,432	12
17	Coordination of activities in the territories	80,832	122,667	30,000	202
18	**Local authorities**	**3,886,609**		**359,158**	
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	Social services	**110,508,118**	**6,484,443**	**2,246,087**	**15,172**
	============	=========	=======	=======	=====
20	Ministry of Education	36,278,439	1,595,076	157,000	2,081
21	Higher education	7,464,569			
23	Ministry of Social Affairs	4,764,670	1,493,341	81,183	2,707.5
24	Ministry of Health	20,627,752	3,332,696	194,555	9,253.5
27	Transfers to National Insurance	31,089,182			
25	Holocaust Survivors Rights Authority	2,791,563			60.5
29	Ministry of Construction & Housing	206,175	3,500		624.5
30	Ministry of Immigrant Absorption	1,296,351	24,830	615,334	415
32	Miscellaneous support	4,216,318	35,000	1,198,015	
46	Discharged Soldiers Law	1,765,895			21
56	Commission for Equal Rights for Persons with Disabilities	7,204			9
	Economy and administration	**8,504,062**	**937,122**	**1,829,976**	**4,483.5**
	=====================	=======	======	=======	=====
33	Ministry of Agriculture & Rural Development	702,390	217,045	353,645	1,276
34	Ministry of National Infrastructures	138,554	49,000		283
35	Israel Atomic Energy Commission	147,927			
36	Ministry of Industry, Trade & Labor	2,419,722	65,839	60,000	1,593.5
37	Ministry of Tourism	354,914	8,668	15,831	135.5
38	Support for economic sectors	1,813,686	468,160	1,385,000	
39	Ministry of Communications	49,470	650		90
40	Ministry of Transport	414,329	94,438	15,000	687
41	Government Water & Sewage Authority	114,524	718		124.5
42	Construction and housing grants	2,029,034	4,820		
43	Israel Mapping Center	66,665	27,484	500	239
54	Regulatory authorities	252,847	300		55

Budget Bill for Fiscal Year 2012 (cont.)

Summary of the First Schedule		Expenditure	Revenue-Dependent Expenditure	Spending Authorization	Maximum Personnel
45	**Interest and commission payments**	**38,570,000**			
	Reserves	**7,870,293**		**10,000,000**	**500**
47	General reserve	7,870,293		10,000,000	500
Part II:	**Development and Capital Account Budget**	**107,111,366**	**3,685,993**	**29,140,872**	
	Development budget	16,755,366	3,685,993	29,140,872	
	Investments in government and administration	**722,758**	**79,911**	**2,476,741**	
51	Government housing	126,350	44,938	1,619,220	
52	Police and prisons	377,026	33,973	812,580	
53	Courts	187,051	1,000	30,315	
55	Treasury	32,331		14,626	
	Investments in social services	**2,451,601**	**2,056,823**	**4,684,825**	
60	Education	676,609		959,183	
67	Health	310,475	77,423	495,774	
70	Housing	1,464,517	1,979,400	3,229,868	
	Investments in economic sectors	**13,581,007**	**1,549,259**	**21,979,306**	
73	Water works	1,327,450	10,500	1,205,000	
76	Industrial development	50,980	40,000	148,383	
78	Tourism	88,071		53,394	
79	Transport development	8,283,142	98,500	19,515,324	
83	Miscellaneous development expenses	3,831,364	1,400,259	1,057,205	
84	Debt repayments	90,356,000			
	Of which: Debt repayments to National Insurance	9,097,000			

Budget Proposal for Business Enterprises, Fiscal Year 2011

(In NIS Thousands)

Summary of the Second Schedule		Revenue-Dependent Expenditure	Spending Authorization	Maximum Personnel
	Total revenues	**13,179,915**		
89	Prime Minister's Office and Ministry of Finance enterprises*	396,109		
94	Government hospitals	7,251,806		
95	Jaffa and Hadera Ports	32,000		
98	Israel Land Administration (ILA)	5,500,000		
	Total expenditures	**13,179,915**	**900,000**	**19,391.0**
89	Prime Minister's Office and Ministry of Finance enterprises*	396,109		97.0
94	Government hospitals	7,251,806		18,748.0
95	Jaffa and Hadera Ports	32,000		5.0
98	Israel Land Administration (ILA)	5,500,000	900,000	541.0

* Government Press Office and Government Printer

Budget Proposal for Business Enterprises, Fiscal Year 2012

(In NIS Thousands)

Summary of the Second Schedule		Revenue-Dependent Expenditure	Spending Authorization	Maximum Personnel
	Total revenues	**13,259,947**		
89	Prime Minister's Office and Ministry of Finance enterprises*	398,713		
94	Government hospitals	7,329,234		
95	Jaffa and Hadera Ports	32,000		
98	Israel Land Administration (ILA)	5,500,000		
	Total expenditures	**13,259,947**	**900,000**	**19,385.0**
89	Prime Minister's Office and Ministry of Finance enterprises*	398,713		96.0
94	Government hospitals	7,329,234		18,748.0
95	Jaffa and Hadera Ports	32,000		5.0
98	Israel Land Administration (ILA)	5,500,000	**900,000**	**19,385.0**

* Government Press Office and Government Printer

Forecast of State Revenues and Loans for Fiscal Years 2011-2012
(In NIS Thousands)

		2011 Budget Proposal	2012 Budget Proposal
	Total revenues and grants, net*	244,939,201	265,093,452
	Grand total	**348,185,234**	**365,916,172**
	==========	==========	==========
	Part I: Current receipts	247,116,515	258,804,806
	Part II: Receipts from loans and current account	101,068,719	107,111,366
	Part I: Current Receipts	**247,116,515**	**258,804,806**
	====================	==========	==========
	Taxes and compulsory payments	214,989,152	233.927.208
	Income and property taxes	103,500,000	111,800,000
001	Income tax	86,700,000	94,000,000
002	VAT on nonprofit organizations and financial institutions	10,500,000	11,300,000
003	Betterment tax	2,200,000	2,300,000
004	Purchase tax	3,900,000	4,100,000
005	Sales tax and purchase tax		100,000
007	Employers tax	200,000	100,000
	Expenditure taxes	111,489,152	122,026,297
011	Customs and import duties	2,900,000	3,100,000
012	VAT, including VAT on defense imports	69,489,152	75,026,297
013	Purchase tax	16,300,000	18,500,000
015	Excise tax	900,000	900,000
016	Fuel tax	16,500,000	18,800,000
020	Stamp duty		
024	Motor vehicle fees		
025	License fees and other levies	5,400,000	5,700,000
	Interest and earnings	2,334,900	2,230,900
034	Interest in foreign currency	48,300	13,300
035	Interest in NIS	2,286,600	2,217,600

***** Total current receipts less amount carried from Part II plus revenues from sale of state-owned lands, provisions for pension benefits and severance pay, loan from National Insurance Institute and defense grant from the USA.

Forecast of State Revenues and Loans for Fiscal Years 2011-2012 (cont.)

		2011 Budget Proposal	2012 Budget Proposal
	Royalties	1,940,500	2,134,750
042	Royalties from business enterprises	775,000	908,000
043	Royalties from natural resources	633,000	649,000
044	Royalties from government-owned companies	82,000	82,000
045	Dividends from government-owned companies	450,500	495,750
	Miscellaneous revenues	2,172,677	2,172,677
046	Reimbursement on account of previous years' budgets	144,282	144,282
047	Revenues from various services	1,483,283	1,483,283
050	Government asset utilization fees	274,252	274,252
048	Earmarked revenues in excess of estimate	270,860	270,860
049	Profits realized by Bank of Israel		
	Carried from Part II	25,679,286	18,440,182
	Part II: Receipts from Loans and Capital Account	**101,068,719**	**107,111,366**
	Repayment of government investments and loans	6,557,100	6,240,900
051	Collection of principal in NIS	6,331,100	6,005,200
053	Collection of principal in foreign currency	44,000	53,700
076	Revenues from sale of state-owned lands	182,000	182,000
	Provisions for pension benefits and severance pay	39,654	39,654
071	Provisions by economic units	8,911	8,911
072	Provisions by business enterprises	9,000	9,000
073	Provisions for pension – companies	21,743	21,743
	Capital revenues	3,813,000	1,813,000
075	Revenues from sale of companies and banks	3,813,000	1,813,000

Forecast of State Revenues and Loans for Fiscal Years 2011-2012 (cont.)

		2011 Budget Proposal	2012 Budget Proposal
	Domestic loans	99,628,933	99,785,820
081	Loan from National Insurance Institute	14,571,000	15,835,000
082	Revenue from emissions and deposits	85,057,933	83,950,820
	Loans and grants from overseas	16,709,318	17,672,174
900	Independence and development loan	4,000,000	4,000,000
901	Net of: Distribution expenses	-200,000	-200,000
	Loans and grants from the USA		
902	- Defense	8,709,318	8,672,174
904	- Civilian assistance		
907	- Other loans	4,200,000	5,200,000
908	Bank loans		
	Carried to Part I	-25,679,286	-18,440,182

Forecast of Tax Benefits for Fiscal Years 2011-2012*

(In NIS Thousands)

	2011	2012
Total	**38,420**	**39,600**
Direct taxes	**32,830**	**32,040**
A. Benefits for capital investments and industry	**5,860**	**5,680**
Encouragement of Capital Investments Law	5,300	5,500
R&D, gas exploration and film production	..	..
Credit for shift labor	160	150
Encouragement of Industry Law	..	..
Limited capital gains tax (excluding stock exchange)	210	220
Accelerated depreciation	–	–
Participation exemption	..	..
B. Benefits to the capital market	**17,100**	**16,400**
Provident funds:	8,800	**8,500**
- Benefits upon deposit	10,300	10,000
- Benefits net of taxation upon withdrawal	(1,500)	(1,500)
Advanced study funds	**2,400	2,300
Interest income on linked instruments	3,500	3,300
Interest income on unlinked instruments (real part)	–	–
Capital gains on stock exchange	2,400	2,300
Distribution of options to employees	..	..
C. Welfare and population distribution	**3,390**	**3,300**
Income tax exemption for nonprofit organizations	..	..
Exemption on Ministry of Defense allowances	430	420
Exemption on National Insurance allowances	1,570	1,520
- Child allowances	1,020	990
- Old age and survivors benefits	490	470
- Other benefits	60	60
Credit for new immigrants	30	30
Credit for institutionalization of a relative	30	30

Forecast of Tax Benefits for Fiscal Years 2011-2012 (cont.)

	2011	2012
Credit for parents of disabled children	30	30
Credit for charitable donations	220	230
Credit for the blind and disabled	200	200
Credit for residents of development areas	770	790
Credit for employers in Eilat	80	80
Negative income tax	..	..
D. Household benefits	**1,870**	**2,180**
Credit for single-parent families	100	100
Half credit point for women	610	600
Credit for children of working mothers	1,120	1,440
Credit for nonworking spouse	-	-
Credit for payers of child support and alimony	10	10
E. Miscellaneous income tax benefits	**1,080**	**920**
Exemption on income from gambling, lotteries and prizes	**300**	100
Exemption on rentals of residential apartments	490	510
Encouragement of construction of homes for rent	30	40
Credit for disabled soldiers	70	70
Credit for students	190	200
Credit for foreign athletes and journalists	–	–
F. Benefit-recipient funds and institutions	**..**	**..**
Edmond de Rothschild Caesarea Foundation	–	–
Israel Academy of Sciences and Humanities	–	–
Wolf Foundation	–	–
United States-Israel Binational Science Foundation	–	–
G. Fringe benefits	**300**	**300**
Company car	300	300
Cell phone	..	..
E. Real-estate tax benefits	**3,230**	**3,260**
Purchase tax	–	–
Betterment tax on residential apartments	2,200	2,200

Forecast of Tax Benefits for Fiscal Years 2011-2012 (cont.)

	2011	**2012**
Appreciation tax on historical properties	440	440
Land appreciation tax	590	620
Other real estate tax benefits	**..**	**..**
Indirect taxes	**6,260**	**6,650**
A. Customs and purchase tax	**2,970**	**3,220**
Diesel fuel	2,100	2,300
New immigrants	50	50
Returning residents	10	10
Tourists	350	370
Vehicle parts	240	260
Taxis	190	200
Other conditional exemptions	30	30
B. Value-added tax	**3,290**	**3,430**
Fruits and vegetables	2,040	2,120
Tourism services	660	690
Eilat Law	590	620
Levies	**120**	**120**

Source: State Revenue Administration

Benefits marked by "**..**" – There is no cost estimate due to a lack of databases.

* Full details on the tax benefits appear in the chapter "Forecast of Tax Benefits for 2011-2012."

** In 2012, an additional NIS 1.6 billion should be attributed to this tax benefit, putting it at an estimated NIS 4.0 billion (see additional details under "Benefits to the capital market").

Part II

General Overview

Key Economic Developments

Background

Israel's economy enjoyed rapid and sustained growth from the second half of 2003 until the end of the first half of 2008. Driven by the business sector, this growth was characterized by a significant rise in exports, a strong upturn in the job market, a consistent current-account surplus in the balance of payments, stable prices and improved budget stability, reflected in a decrease in the budget deficits and in the public debt as a percent of GDP.

The global financial crisis, which broke out in 2008, plunged the real economy of the majority of the developed and developing countries into a deep recession. In Israel, too, growth slowed sharply. However, the country's improved economic stability in the years leading up to the crisis, and the absence within the local economy of those central ills that led to the outbreak of the global crisis – such as the real-estate bubble, the financial sector's "over-sophistication" and the collapse of financial institutions – enabled Israel to weather the crisis better than most developed countries. Hardest hit were exports, due to the worldwide decline in demand and the sharp capital market downturn which caused nonbank credit sources to dry up. Domestic demand was affected as well, mainly due to the extreme uncertainty that prevailed at the height of the crisis. Slow domestic demand significantly weakened the job market, resulting in a sharp drop in private consumption and in investments.

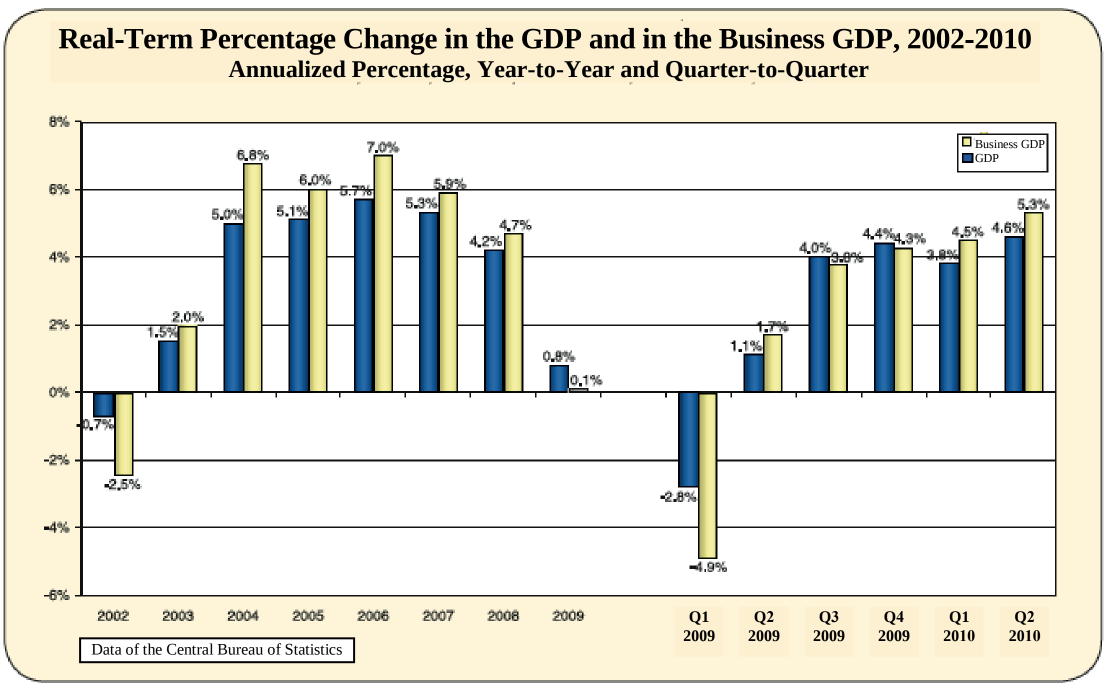
The Israeli economy is an open and export-oriented economy. As such, the effects of the economic crisis derived mainly from external factors. To minimize the negative effects of the crisis on the country's economic activity, measured and considered steps were taken, based on an expansionary monetary policy and a responsible and cautious fiscal policy. The latter centered on the full use of automatic stabilizers (raising of the deficit target following a decline in tax revenues), an increase in the budget, supported by additional revenues, adjustment of the budget mix and the provision of state guarantees. It should be emphasized that fiscal maneuvering and the ability to moderate the effects of the crisis were limited in Israel relative to other countries, largely due to the high debt level and the external crisis factors.

The global economic crisis and its effects on the Israeli economy peaked in the last quarter of 2008 and the first quarter of 2009. The relative strength of the Israeli economy is evidenced by the fairly late onset of the economic slowdown in Israel, the relatively weak recession compared to other countries as well as the rapid and early recovery. The turnaround came in the second quarter of 2009, when the economy posted a moderate positive growth rate which increased over the following quarters. Growth in the second half was led by exports in the high-tech and private consumption sectors. At the same time, local and international capital market indices recorded significant gains, while the nonbank credit market witnessed a gradual recovery. This improvement was also reflected in an earlier-than-expected drop in the unemployment rate and in a rise in the number of employed.

Although international markets remain unsettled, the economic upturn continued in the first half of 2010. Nevertheless, the debt crisis that is unfolding in some European countries illustrates the volatile state of the global economy and the threats to a sustained recovery.

Gross Domestic Product and Business Sector Product

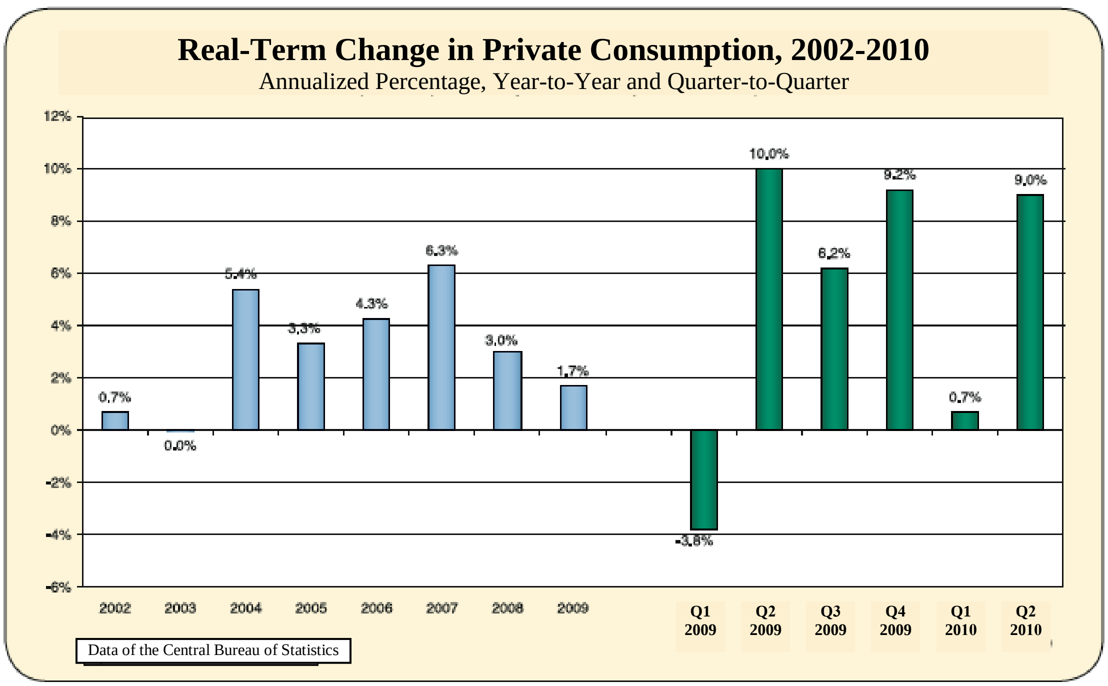
GDP rose 0.8% in 2009, equivalent to a 1.1% negative per capita growth rate, while the business sector product rose by 0.1%. The first quarter of 2009 saw continued GDP contraction that first began in the last quarter of 2008, followed by a gradual recovery throughout the rest of the year. The second quarter of 2009 was marked by moderate GDP growth, with the third and fourth quarter posting even stronger growth. This uptrend continued into the first half of 2010. In the second quarter of 2010 the GDP expanded at an annualized rate of 4.6% and the business product at an annualized rate of 5.3%.



Private Consumption

Private consumption rose by 1.7% in 2009, a lower rate than in previous years, reflecting a slight drop in per capita consumption. The main contraction was recorded in the consumption of durable goods, at a rate of 6.3%.

The slowdown in private consumption from the beginning of 2009 was caused by the worsening job market in the first half of the year (which reduced the number of employed persons and the level of real wages) and by the steep declines in the capital markets which affected private wealth and consumer confidence. The significant improvement recorded in the second half of 2009 is attributable to the sharp rises in the capital markets during that period and the greatly reduced economic uncertainty. This improvement in private consumption continued into the first half of 2010.



Investments

Investments are the component of the economy most sensitive to anticipated economic developments. Thus, investments were the first to react to the developments in the world economy, already in the first half of 2008. In order to cushion the blow to investments in the economy, in the course of 2008 the government decided to recognize accelerated depreciation for tax purposes.

Gross domestic investment contracted in 2009 by 8.9%, due to a 5.8% downturn in capital investments and a sharp drop in inventory, with the strongest hit recorded in machinery and equipment investments. This downturn was slightly moderated by the growth in housing construction.

The development of investments was inconsistent over the course of 2009. The first quarter of the year saw a continuation of the contraction that began in the second quarter of 2008. In the second and third quarters, capital investments expanded, and in the fourth quarter investments contracted again. In the first half of 2010, capital investments posted a 8.5% rise in annual terms. The strongest growth was recorded in construction investments.

Exports

The decline in global demand and in the volume of international trade resulted in an even greater slump in exports in 2009 than the one recorded at the height of the previous crisis in 2001 (which was brought on by the collapse of the dot-com bubble at the end of 2000). Israeli exports shrank in 2009 by 12.5%, and similar contraction rates were recorded both for exports of goods (11.9%) and for exports of services (12.7%).

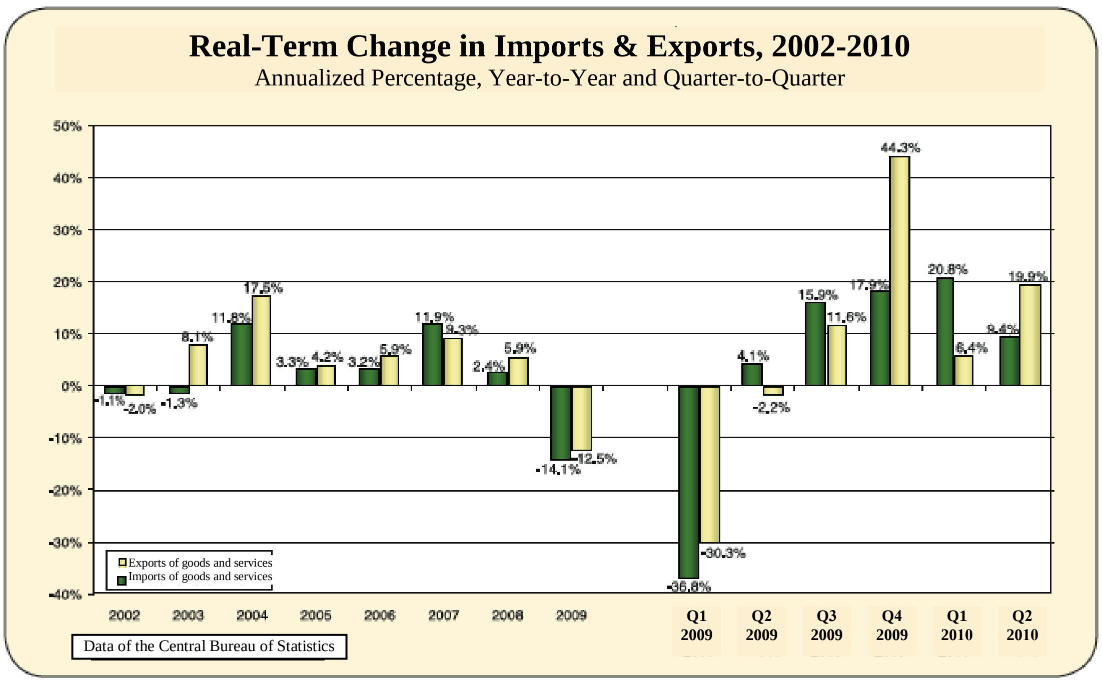
In the second half of the year exports began to expand rapidly, though still remaining below the level reached at the beginning of 2008. The rapid growth in exports continued in the first half of 2010, encompassing all export sectors except for the services sector.

The expansion in exports of goods beginning in the second half of 2009 and continuing in the first half of 2010, was led by the high-tech industry. An especially strong surge was recorded in exports of electronic components (attributable in great part to the start of exports from the new Intel plant in Kiryat Gat).

Imports

Imports of goods and services contracted in 2009 by 14.1%. The sharp downturn in imports stemmed from a slowdown in domestic activity and weaker demand for exports and was led by a decline in imports of investment products and raw materials.

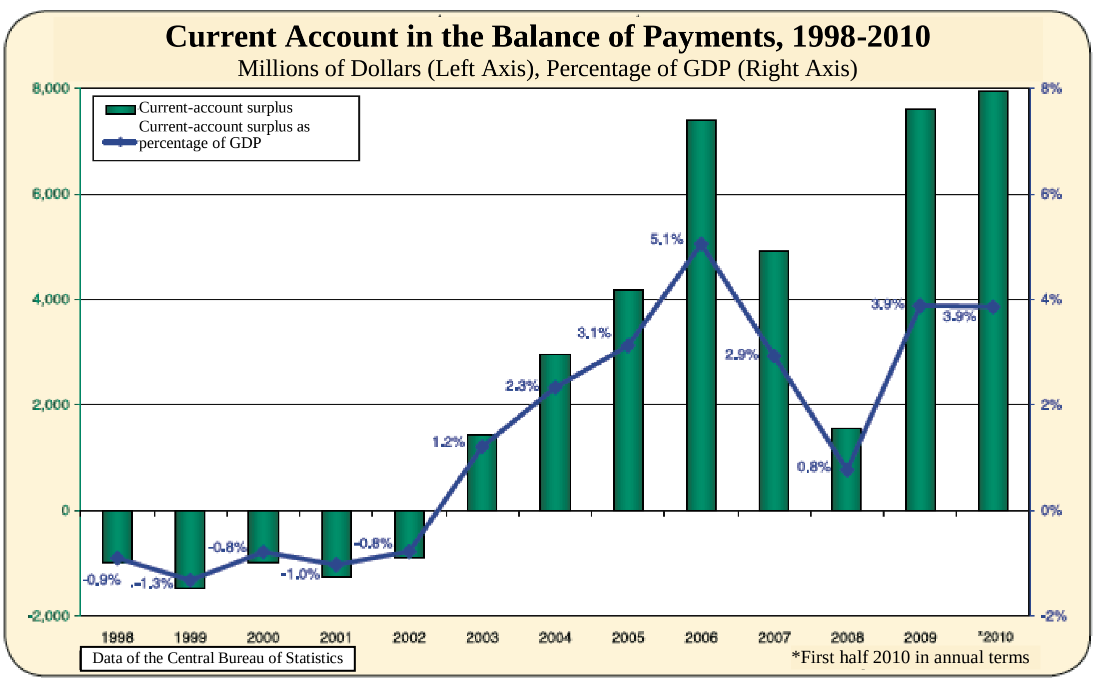
The contraction in imports beginning in the second quarter of 2008, came to a halt in the second quarter of 2009, followed by a significant expansion in the second half of the year. This trend continued into the first half of 2010, with imports growing by 17.1% in annual terms.



Balance of Payments

In the first half of 2010 there was a large current-account surplus in the balance of payments, which stood at 3.9% of GDP, further to the large surplus in 2009 which amounted to 7.6 million dollars, or 3.9% of GDP. The surplus trend starting in 2003 thus continued and even increased. By way of comparison, in 2007 and 2008 a surplus of 4.9 billion dollars (2.9% of GDP) and 1.6 billion dollars (0.8% of GDP) was recorded, respectively.

The increase in the surplus in 2009 was due to the lower deficit in the goods account compared to previous years, stemming from a stronger decline in imports than in exports. This development was impacted by the depreciation in the real exchange rate of the shekel and the significant improvement in Israel's terms of trade, resulting from the global decline in prices of goods, and fuel prices in particular, compared to average prices in 2008 (terms of trade are defined as the ratio between export and import prices. The improvement in the terms of trade in 2009 reflects an extremely sharp drop in import prices compared to export prices).



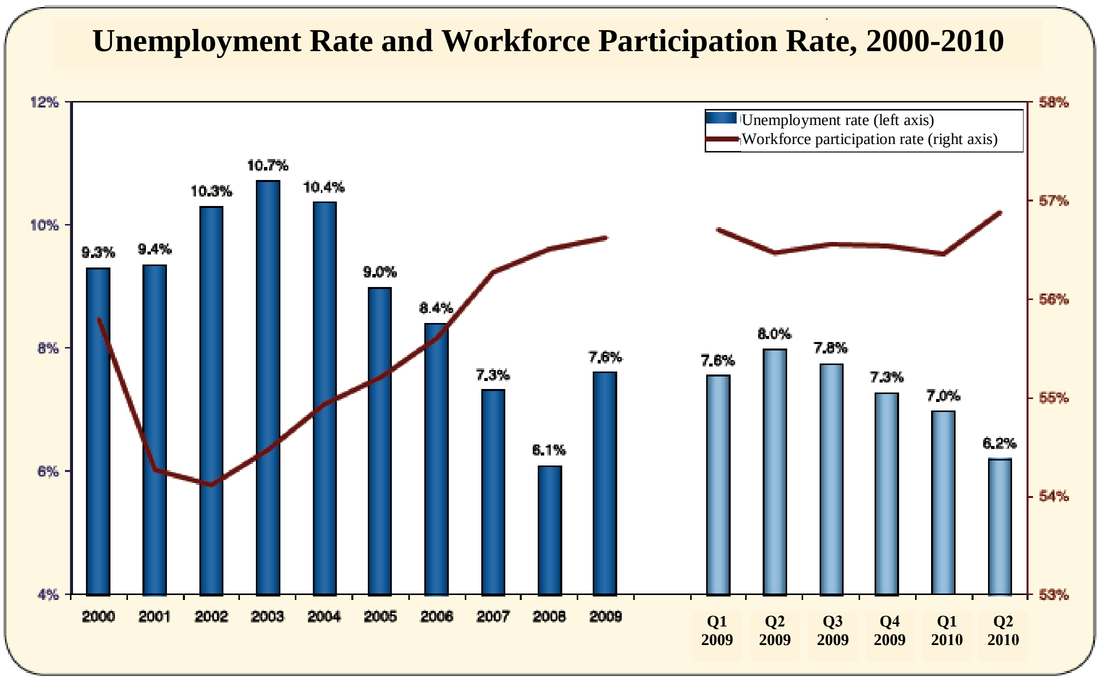
Labor Market

The worsening of the labor market at the end of 2008 continued in the first half of 2009, reflected in a sharp rise in the unemployment rate in the first quarter of the year, followed by a further, more moderate rise in the second quarter. The market improved in the second half of 2009 and the unemployment rate declined, but remained still higher than in 2008. The unemployment rate for 2009 stood at 7.6%, with the number of employed persons remaining the same as in 2008. Thus the rise in unemployment in 2009 was due to natural growth of the civilian workforce and stagnation in employment. In the first half of 2010 unemployment declined further to 6.6% and the number of employed persons rose by 59,000, an increase of 2.1% over the second half of 2009. The majority of the newly employed joined the construction sector and the health, welfare and social services sector. The rise in the number of employed persons is attributable to an increase in the number of part-time positions, while the number of full-time positions fell in the second quarter of 2010 from the previous quarter.

The deterioration in the labor market in 2009, caused by the economic crisis, came after several successive years of substantial improvement. The unemployment rate in 2008, which stood at 6.1%, was the lowest in the past 20 years, while the rate of participation in the workforce reached a record 56.5%, capping a rapid rise over the past decade. The workforce participation rate has remained level since the middle of 2007, after a rapid acceleration in previous years. In 2003 the participation rate in the working age group (15+) stood at 54.5%, compared to 56.5% in 2008, with no significant change observed in 2009. In the first half of 2010 the workforce participation rate rose, however the rate of participation in the Israeli workforce remains significantly lower than in other developed countries.

The labor market typically lags in its response to changes in business volumes, however, in the latest crisis its reaction was sharp and swift both on entering and emerging from the recession. Apparently, the key reason for this lies in the fact that the impact of the global crisis on the economy was foreseen, enabling employers to make advance adjustments. Thus, there was an increase in the number of part-time workers at the expense of full-time workers already in the second half of 2008. Likewise, the stabilization and recovery of the labor market occurred earlier than expected, relative to previous recessions and also relative to other developed economies. Accordingly, in parallel with the recovery of the economy in the second half of 2009, employers acted to increase the number of work hours per employee. The swift rebound can be explained by employers' expectations for a much longer and deeper recession, causing an initial "overreaction" of sorts that was subsequently offset.

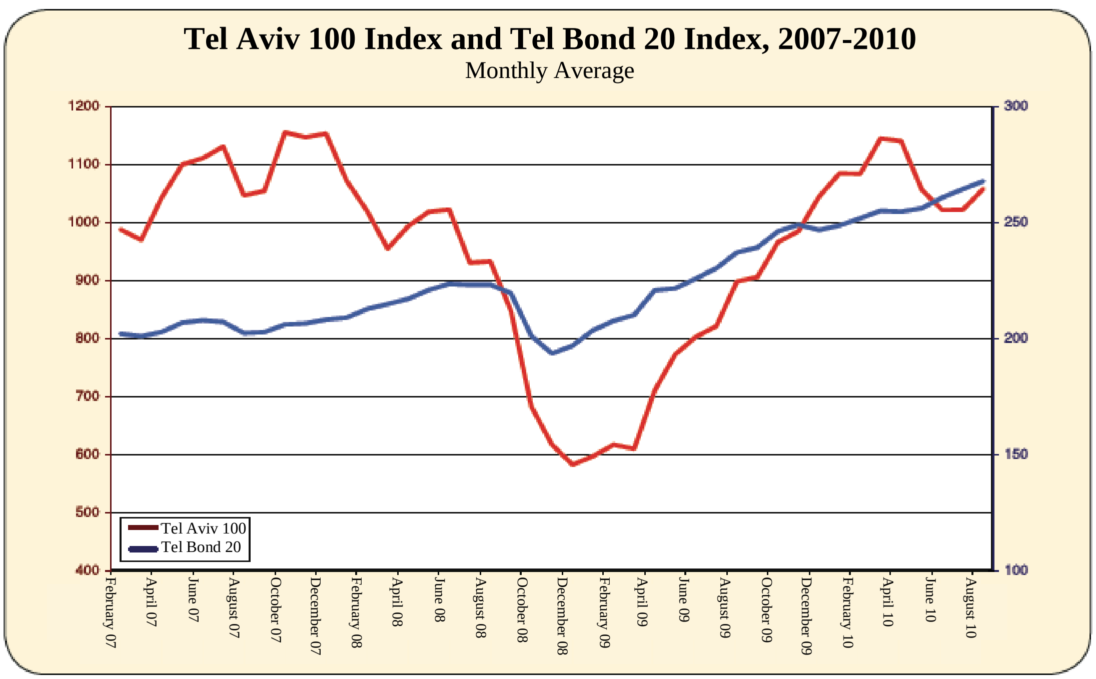
The downturn in the labor market in 2009 was not uniform across different sectors. The share of industrial workers out of the total number of workers in the economy decreased in 2009, with the industrial sector harder hit than other sectors apparently due to the contraction of exports and investments. The recovery, too, was not uniform, with the increase in the number of employed persons in the second half of 2009 led by the public services sector, and in the second half of 2010 by the health, welfare and social services sector and the education sector.



Capital Market

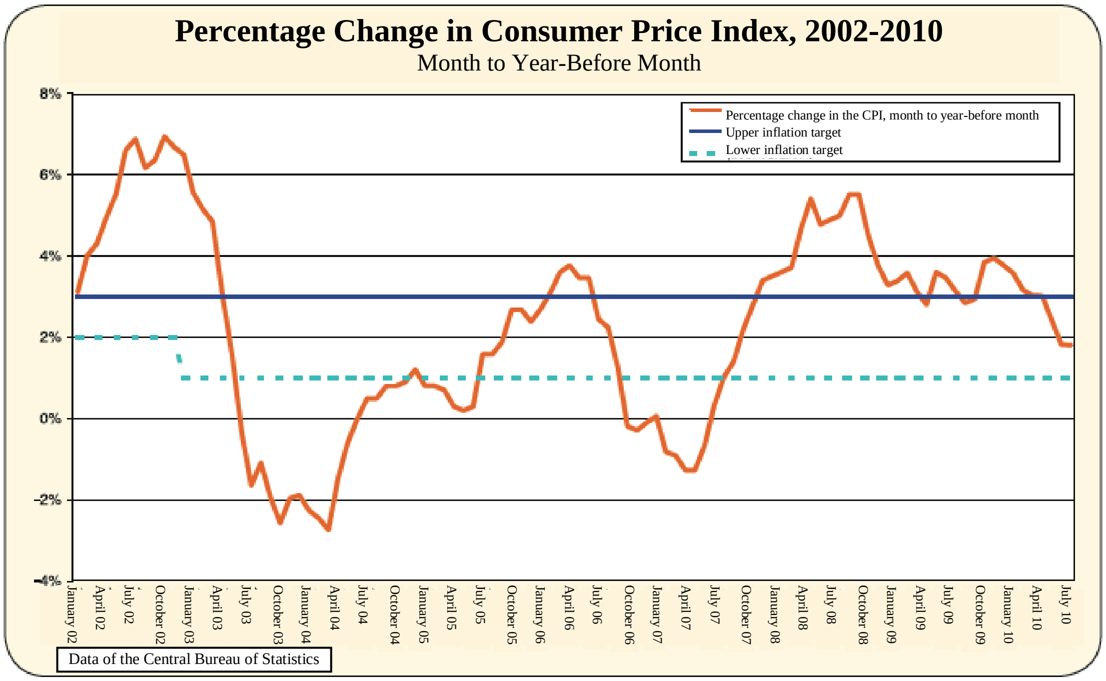
The second half of 2009 saw a significant turnaround in the capital market, following sharp declines in the share and corporate bond indices and stagnation in the issuance market during 2008, especially towards the end of that year, and in the first months of 2009. With the recovery of the economy in the second half of 2009, this trend reversed, with share and corporate bond indices rising steeply. This improvement was also reflected in the increased number of corporate bond issues.

The improvement in the share markets came to a standstill at the beginning of the second quarter of 2010, among other reasons, due to the public debt crisis in Europe which renewed fears regarding the stability of the economic recovery. In contrast, the corporate bond market continued to strengthen in this period. In May and June, yields in the corporate bond market fell further in all sectors (the calculation relates to tradable linked bonds, which comprise the majority of corporate bonds in Israel). The average yield, which peaked at 13.4% at the end of 2008, fell to a level of 7.1% at the end of 2009 and 5.1% at the end of the first half of 2010. The first half of 2010 also saw a continued rise in the number of issues in both the share market and the corporate bond market.



Inflation and Monetary Policy

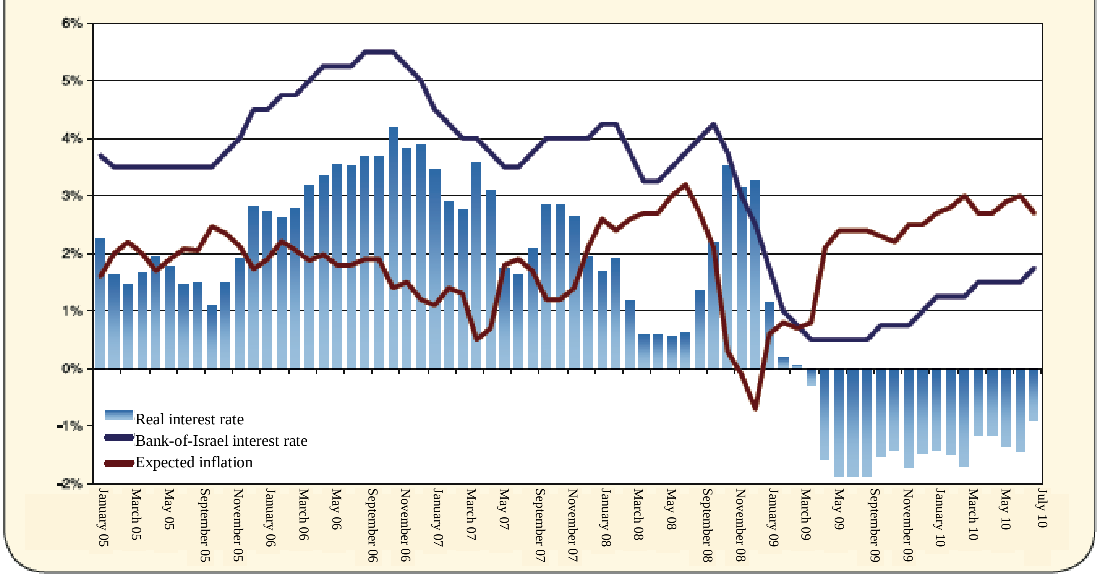
In 2009 the consumer price index rose by 3.9% (year end to year end), due to a sharp rise in housing prices as well as the one-time effects of an increase in indirect taxes such as VAT.



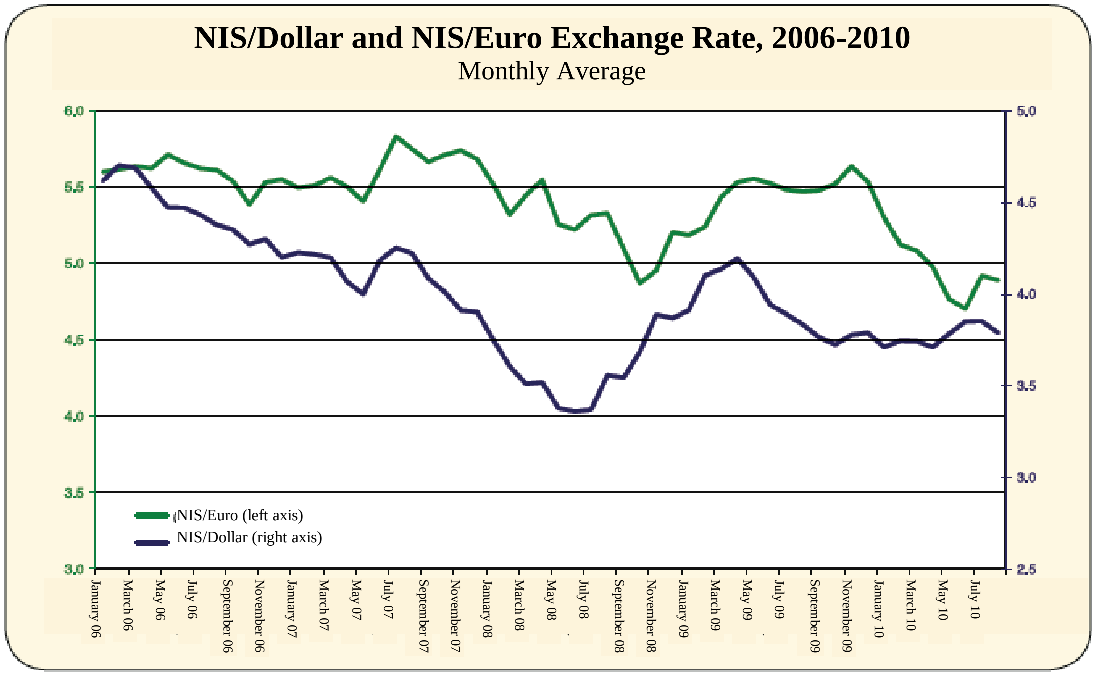
The monetary policy in 2009 was characterized by unprecedented expansiveness, similar to the monetary policy applied in other developed countries in response to the crisis. The Bank of Israel brought down the interest rate to a historical low of 0.5%, and at the same time took other expansive measures, such as the purchasing of government bonds in the secondary market to reduce long-term interest rates, and massive buying of foreign currency to increase the bank's reserves (already in the course of 2008) and prevent significant appreciation of the shekel. In the second half of 2009, as signs multiplied of a rapid improvement in the situation of the economy, the Bank of Israel began to gradually raise its interest rate. It should be noted that even the current level of the Bank-of-Israel interest rate, 1.75% in August 2010, is a negative real interest rate signifying a monetary expansion which could, over time, create upward pressure on prices. Compared to other countries with a low interest rate, the Israeli economy is enjoying more rapid growth and a stronger job market, with inflation expectations approaching the Bank of Israel's upper target boundary. Consequently, it is expected that together with the growth of the economy, the interest rate will continue to trend upward to a more neutral environment. The expansionary monetary policy implemented by the Bank of Israel has resulted in a 9%

increase in the quantity of means of payment over the past 12 months (June 2010 versus June 2009) and a slower rate of growth, which peaked at 64% in the 12 months ended in August 2009.

Bank-of-Israel Interest Rate, Real Interest Rate and Expected Inflation, 2005-2010



The Bank of Israel's foreign currency purchases, which began in March 2008, initially in a fixed daily amount and later in varying amounts as judged necessary by the bank, boosted the central bank's foreign currency reserves from 42.5 billion dollars at the end of 2008 to 63.1 billion dollars in June 2010. During this period the value of the shekel fluctuated widely against the dollar, but its level at mid-2010 was similar to its year-end 2008 and year-end 2007 levels.



Future Uncertainty

The global economic developments in the second half of 2009 and early 2010 point to a quicker rebound than foreseen a year ago in the capital markets, in the real economy and in international trade volumes. Persistence of the positive trend around the globe will enable the Israeli economy to continue its recovery and to return to growth rates approaching 4% in the coming years.

However, great uncertainty surrounds the continued recovery of the world economy, arising from several factors.

Firstly, the stabilization of the world economy stemmed in large part from expansive monetary and fiscal measures on an unprecedented scale by many countries. These measures are expected to be gradually scaled back in the course of 2010-2011, negatively impacting the future growth rate. The process of fiscal contraction will be reflected in reduced public spending and tax increases in numerous countries, in view of their high budgetary deficits and exploding debt, based on the clear understanding that failure to act to narrow the deficits could cast doubt on their ability to meet debt repayments and make it difficult for them to raise money to finance their activities. Monetary contraction, which is expected to be more gradual than fiscal restraint, will be reflected in increases in key interest rates and in less expansive central bank intervention in other means used during the crisis. A gradual contraction of the expansionary monetary policy will be necessary to prevent the development of upward pressure on prices as well as the development of price bubbles in various assets that could trigger another crisis in the future.

Secondly, some of the factors that caused the crisis and the resulting weaknesses still exist and can be expected to keep the global growth rates in the coming years at a lower level than recorded in the pre-crisis years. These factors include:

- Steps to increase the stability of the financial systems through the strengthening of regulatory controls. This process is expected to lead to slower growth in the credit supply compared to the pre-crisis years.
- Narrowing of the imbalance in the global economy, by reducing the balance of payments deficit of various countries, the United Stated among them, in view of the huge surpluses in major export countries such as China. Concurrently, it will be necessary to boost the savings of private households and reduce the reliance on cheap credit for financing private consumption, as was the case in the rapid growth years preceding the global crisis.
- The weakness of the labor market in many countries and the high unemployment rates are expected to slow the growth of private consumption.

Although the effects of the crisis on the Israeli economy, at the present point in time, are moderate compared to other countries, one must take into account, when setting policy, Israel's high debt rate, the government's limited ability to intervene in a crisis, and the complex geopolitical situation relative to comparable countries. Israel's local economy is a small and open economy with exports serving as the main growth engine, consequently the potential growth rates in the coming years could be significantly affected if the weaknesses in the global economy materialize.

Economic Policy and Budget Policy for Fiscal Years 2011-2012

This chapter presents the background for the state budget proposal for fiscal years 2011-2012, starting with a general analysis of the main challenges, threats and opportunities facing the Israeli economy in the coming years, and continuing with a discussion of the economic policy objectives. This is followed by a summary of the four budget chapters as reflected in the budget for 2011-2012. Finally, the economic measures in the state budget for 2011-2012 are presented and other key areas of the budget are highlighted.

The Israeli Economy: Strengths, Weaknesses, Threats and Opportunities

The Israeli economy presently stands at an important crossroads. At the end of a decade of structural reforms and growth-supporting macroeconomic policies, and after demonstrating an impressive ability to cope with the upheavals of the past decade and the global economic crisis, the Israeli economy is now presented with the opportunity to plan the directions its development will take in the coming years. Though positioned in this regard at a more favorable jumping-off point than competing countries, Israel nevertheless faces signs of erosion and threats that cast a shadow on its long-term ability to grow.

The strong points underpinning the country's economy are a longstanding tradition of structural reforms for upgrading the economy, increasing competitiveness, reducing and streamlining the public expenditure out of the GDP, and promoting a responsible and growth-supporting fiscal policy. The many comprehensive reforms undergone by the Israeli economy – such as in the fields of taxation, government expenditure and the public debt, labor market incentives, infrastructures and public transport and the capital, pension and savings market – as well as the measures taken to upgrade the economy and open it up to the global environment, have transformed it over the past decade into an open, competitive and more stable economy than in the past.

The Israeli economy also enjoys a distinct advantage in its human capital and high-tech industries. This advantage, along with the significant improvement in fiscal and monetary stability, was a key factor in the rapid growth recorded by the economy from the end of 2003 until the onset of the crisis, its ability to cope with the security challenges of the past decade, and its resilience in the midst of the global economic crisis. An indication of the strength of the Israeli economy is the high degree of confidence it enjoyed, and continues to enjoy, in the international markets, as evidenced by the volume of foreign investments in the economy and by Israel's credit rating.

The relatively moderate impact of the global crisis on the Israeli economy compared to many other developed countries, and Israel's responsible response to the crisis, as well as the absence of a need for wide-ranging cost-cutting programs such as those currently being implemented in Western countries, also place Israel in an advantageous position compared to other countries.

Consideration of the advantages of the Israeli economy thus indicates that it is at a good jumping-off point also by international standards, with a potential for strong growth in the coming years.

Despite the strengths enumerated above, there are significant signs of erosion in the advantages enjoyed by the economy and scenarios that threaten Israel's ability to grow if it persists in its "business as usual" attitude. Thus, Israel's comparative advantage in human capital is steadily diminishing: the achievement level of Israeli pupils, including high achievers, has declined according to a comparative analysis; the achievements of the higher education system are being eroded, while the academic staff is graying and a high percentage of Israeli academicians are assuming teaching and research positions in foreign universities; and investments in the Israeli venture capital industry have fallen, contrasted with the expansion of this industry in competing countries, which threatens its continued growth, especially when accompanied by a decline in the number of degree recipients in the sciences and engineering, compared to the accelerated development of these disciplines in many developing countries.

Furthermore, the Israeli economy is contending with infrastructure gaps, chief among them the increasing traffic congestion in the center of the country and its metropolises; a growing gap between supply and demand in the property and land market, which directly affects price levels in the housing market; and an inadequate level of service to private individuals and businesses, as an outcome of bureaucratic inefficiency and inflexibility.

However, at the core of the weaknesses and threats are the demographic trends and their implications for the future labor market and for the gaps in Israeli society. The composition of the school population in Israel has changed considerably in recent years, with the percentage of pupils in the Haredi (ultraorthodox) and Arab education systems out of the entire school population projected to rise from 34% at the beginning of the decade to 50% in 2014. This change has not been accompanied by a system of incentives and tools for ensuring the integration of pupils from these sectors into the labor market, or by processes designed to guarantee an equal opportunity for these populations by expanding their learning syllabus to include core subjects and the basic education essential for joining the future labor market and civil society. Israel is also characterized by low employment rates, by international standards, and by employment gaps between the different populations. The gap between Israel and other developed countries is attributable mainly to the low employment rates among Haredi men and Arab women. However, except for the population of non-Haredi Jewish women, all the rest of Israel's population groups are also characterized by lower employment rates than common in developed countries, due to the high proportion of welfare recipients among the working ages.

Given the expected demographic developments, without a meaningful change in the state education system, including the teaching of basic skills in all sectors, and without a change in the employment rates and wage levels, the Israeli economy will be faced with a worrisome situation of consistent, significant growth in the percentage of the nonworking population. This situation will necessitate increased public expenditure on transfer payments to the nonworking population, placing a growing tax burden on an ever-shrinking proportion of the population in order to finance these payments. Under such circumstances, the growth potential of the Israeli economy is likely be impaired and the level of inequality to grow to an extent that calls into question Israel's ability to maintain a stable and sustainable socioeconomic system.

Besides all the foregoing, at present there is a great degree of uncertainty concerning developments in the global economy, which have a real impact on Israel – a small and open economy. In addition, Israel's unique geopolitical situation only heightens this uncertainty. Hence, both these factors require policymakers to continue pursuing a responsible policy that will enable an effective and forceful response in coping with extreme scenarios (should they occur).

The development of Israel's economic growth engines and reinforcement of its economic advantages could steer the country onto a track of high and sustainable growth. However, a "business as usual" attitude in the face of the anticipated demographic trends and their impact on Israel's labor market and human capital could lead to real slowing of the growth rate and widening of the social gaps. This analysis of the Israeli economy, which explores several key development scenarios, forms the basis of the economic policy and the budget policy for 2011-2012, as set out below.

Economic Policy Objectives

Two main objectives underlie the socioeconomic policy: increasing the growth rate and reducing inequality. However, in view of the highly uncertain global economic environment and fears of further internal and external upheavals in the Israeli economy, a third objective has been added to the economic policy for the next two years, namely, ensuring the stability of the economic system, including the financial system, as an imperative condition for realizing the objectives of increased growth and reduced inequality. Accordingly, the following three policy objectives were defined in the framework of the economic plan:

- Stabilizing the economic system against external and internal upheavals
- Increasing the per-capita GDP and improving the Israeli economy's ranking
- Strengthening weaker population sectors and reducing social gaps

Chapters of the Economic Plan

To attain these objectives, an economic plan has been drawn up comprising four main chapters, along with a string of economic measures aimed at promoting competition and improving and streamlining the public sector.

Chapter 1 – Responsible Fiscal Policy

In June 2010 the Knesset approved an extension of the basic law governing the biennial budget by an additional two years. A biennial budget aids in short-term governmental planning, provides the economy with greater certainty regarding the government's fiscal policy, and directs managerial resources to strategic thinking and building long-term plans.

In this context, and in accordance with the amendment to the Deficit Reduction and Budgetary Expenditure Limitation Law adopted by the government and the Knesset, a series of measures is proposed for the convergence of budget expenditure growth and for the adjustment of the budget framework to that prescribed in the law, i.e. a real increase of 2.66% in each of the two years and a deficit of 3% and 2% in 2011 and 2012 respectively. It should be emphasized that some of these measures are aimed at ensuring the balance and stability of the National Insurance system through reduction of the National Insurance Institute deficit.

Chapter 2 – Augmenting the Comparative Advantages in Human Capital and High-Tech Industries

This chapter provides a comprehensive treatment of the following topics: R&D and the high-tech industry, strengthening education, introducing reforms in higher education, and amending the Encouragement of Capital Investments Law to increase the comparative advantage of the export industry, while prioritizing industry in the peripheral regions.

Chapter 3 – Dealing with the Labor Market and Expanding the Workforce

In this context, a set of targets and tools is proposed for dealing with the labor market, including: adopting policy objectives in employment, changing the regulatory structure in employment, adopting a nationwide plan for integrating welfare recipients into the workforce and encouraging the employment of members of the Haredi community and the minorities, while continuing to promote the government's policy for reducing the number of legal and illegal foreign workers and curtailing the infiltration of aliens.

Chapter 4 – Development of Infrastructures and Internal Growth Engines

This chapter deals with the promotion of supplementary measures in the land and real estate market, including planning and construction processes; measures to improve government service to private individuals and businesses, mainly in the areas of business licensing, setup of businesses and property registration; and a series of measures to improve and streamline the legal system – this, in addition to continuing the structural reforms in the land and real estate market and in the energy and defense industries, along with continued investment in and accelerated development of public transport infrastructures and mass transit systems.

The economic plan proposes further measures relating to three central areas: increasing domestic competitiveness, with emphasis on the communications market; the healthcare market, with emphasis on the promotion of triennial arrangements and improving the management of the health system; and the defense system, with emphasis on the adjustment of the defense budget and implementation of efficiency measures according to the recommendations of the Committee to Examine the Defense Budget (the Brodet committee).

Presented below are the main points of the economic policy and the budget policy according to the different chapters.

Chapter 1 – Responsible Fiscal Policy

The Biennial Budget

In April 2009, the Knesset passed the Basic Law: State Budget for the years 2009-2010 (Special Provisions) (Temporary Order) (hereinafter – the Basic Law). The justification for this move was the fact that no state budget for 2009 had been passed yet by April of that year, coupled with the unusual and special circumstances prevailing at the time, which included dealing with the global economic crisis. In July, the Knesset approved the biennial budget for the years 2009-2010.

Following implementation of the aforesaid legislation in the special circumstances that had led to its enactment, the government was exposed to the advantages of biennial budgeting, advantages that led to considering a change to the budgeting method in Israel and switching to a biennial budgeting method. The major advantages manifested are the ability of the government, in general, and of each government ministry, in particular, to plan the ministry's activity according to its budget; the engendering of greater certainty in the economy about government fiscal policy; and the freeing up of managerial resources for strategic thinking and building long-term plans. Such advantages also favorably influence the working capacity of non-governmental organizations working with government ministries or supported by the state. In addition, detailed biennial budget planning enhances fiscal credibility vis-à-vis domestic business sector entities as well as international (foreign) entities.

However, the biennial budgeting method has drawbacks as well that must be taken into consideration before making a permanent change anchored in legislation. These drawbacks stem largely from the Ministry of Finance's need to make projections for building a budget, on both the expenditure side and the revenue side. On the expenditure side, the Ministry of Finance must build a budget based on a projection of the main needs the government will be facing in the coming two years. On the revenue side, the Ministry of Finance is required to predict state revenues in the next two years, a figure that is affected by changes in numerous macroeconomic variables. The difference between the revenue projection and the aggregate expenditure ceiling, set by the Budget Law, determines the projected deficit, which must adhere to the fiscal framework, in accordance with the Deficit Reduction and Budgetary Expenditure Limitation Law, 5752-1992. In addition, the government must finance its own deficit at any given time. Government officials in the field possess many years' experience in making single-year forecasts, but no such experience in making two-year forecasts. To the extent that unforeseen changes occur in the economic environment, the government will have to address these appropriately during the coming two years (though it should be noted that such events could occur also during a year in which an annual budget is applied).

In view of the foregoing, the government decided to make a full evaluation of the biennial budgeting method by employing it once again in the years 2011-2012, through an extension of the Basic Law such that it should apply also to said years' budget. The government decision to extend the Basic Law was approved by the Knesset in a second and third reading on June 22, 2010. Since there is not much experience in other countries to draw on, learning the subject will be done in real time, while operating the first full biennial budget. What needs to be assessed during the biennial budget period is the very ability to build a biennial budget and operate by it, especially from the aspect of dealing with the difficulties in making a two-year forecast, both on the expenditure side and the revenue side.

The Fiscal Rule and Fiscal Frameworks

In May 2010 the Knesset passed in the second and third reading the Prime Minister's and Minister of Finance's proposal to set a new fiscal rule for calculating the government spending limit while maintaining the deficit ceiling extant in law.

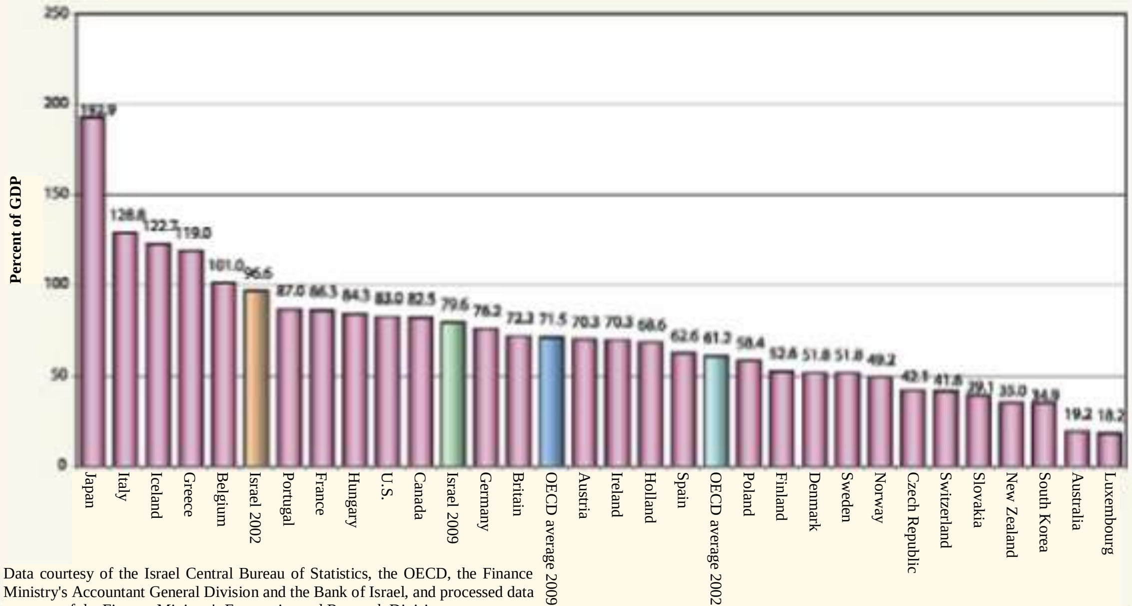
The Deficit Reduction and Budgetary Expenditure Limitation Law, which places caps on the overall deficit size as well as on the government spending growth rate, is of paramount importance in maintaining the economic stability of the State of Israel. In recent years, the existing legislation has contributed to deficit reduction, in turn, leading to a diminution in the debt-to-GDP ratio, a key indicator of the economy's stability in the face of shocks. Though the global economic crisis indeed caused a slowdown in domestic economic activity, a slump in tax revenues, an increased deficit, and an arrest in the downward trend of the debt/GDP ratio, these effects primarily reflected the action of automatic stabilizers and were limited in scope relative to parallel developments in the developed countries.

In the framework of the restraining fiscal policy, which led to a sharp decrease in government spending as a percentage of GDP over the past seven years, joint professional work was carried out by the Ministry of Finance, the Bank of Israel and the National Economic Council. This joint work included, among other things, evaluating the long-term effects of existing fiscal restrictions versus the desired economic effects, as well as drawing up guidelines for and addressing economic policy aims, as set out below.

Presented below are background data regarding broad government spending and public debt rates:

International Comparison of Public Debt as a Percentage of GDP

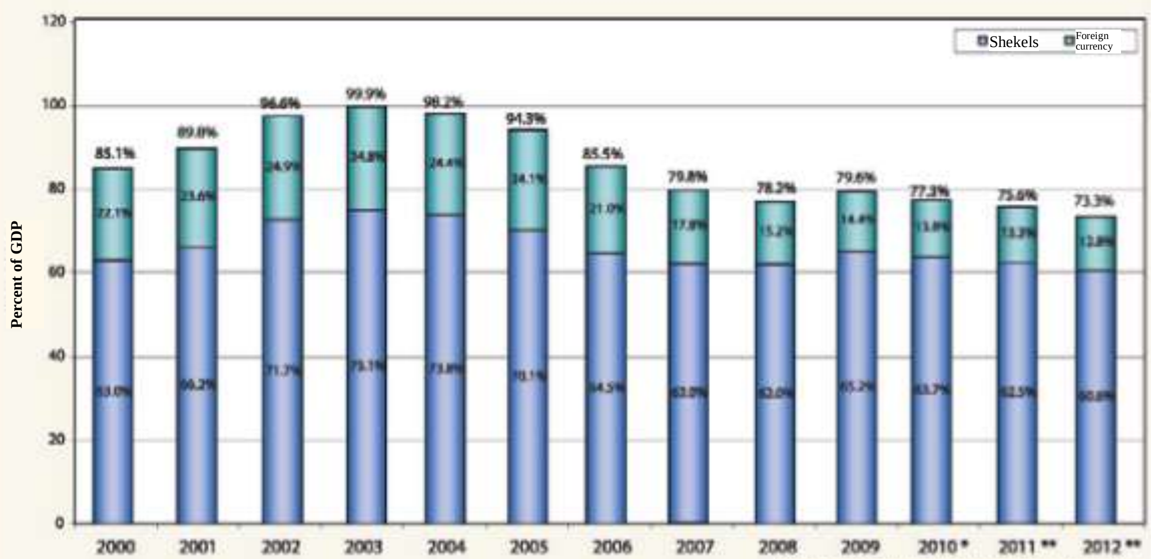
For 2009



Data courtesy of the Israel Central Bureau of Statistics, the OECD, the Finance Ministry's Accountant General Division and the Bank of Israel, and processed data courtesy of the Finance Ministry's Economics and Research Division.

Public Debt in Shekels and in Foreign Currency, 2000-2012

Percent of GDP

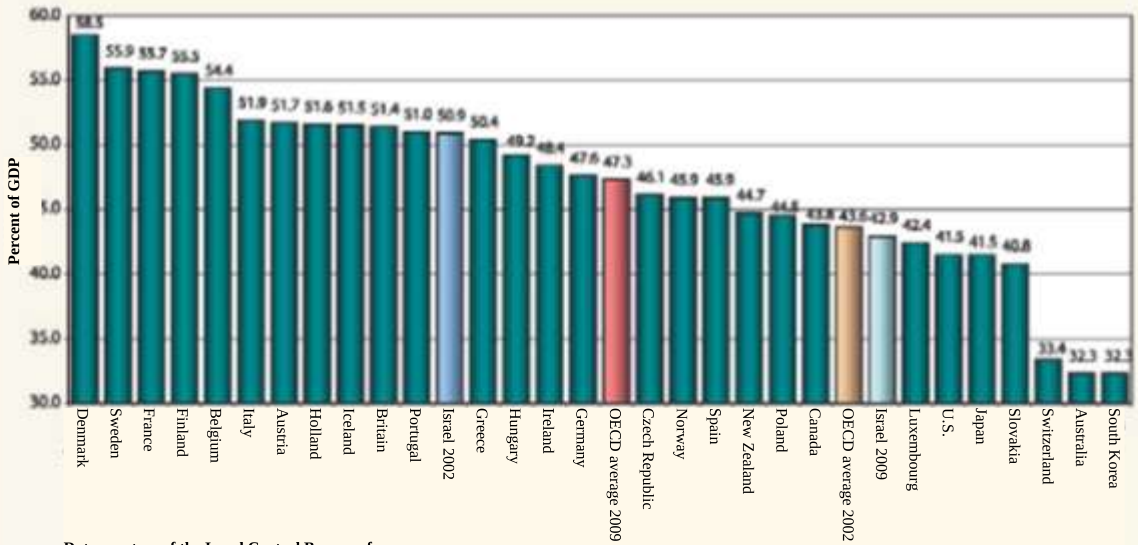


Data courtesy of the Bank of Israel and the Finance Ministry's Accountant General Division, and processed data courtesy of the Finance Ministry's Economics and Research Division

* Estimate of the Accountant General and the Economics and Research Division in the Finance Ministry
** Forecast for the years 2011-2012

Broad Government Spending* – An International Comparison

As a percent of GDP, 2009



Data courtesy of the Israel Central Bureau of Statistics and the OECD

* Broad government – according to the Maastricht Treaty definitions: the government together with local authorities, nonprofit organizations, health funds, and more.

The key objective in establishing the new fiscal rule is to balance between the continued reduction of public debt as a percent of GDP, which decreased from 99% in 2003 to 79.6% in 2009, and the government's share in GDP, as a basis for the provision of an adequate standard of public services. Reducing the public debt and maintaining fiscal credibility necessitates short-term consideration as well as mid- and long-term consideration. Rapid return to a downward deficit trajectory (disrupted by the global economic crisis) is the primary short-term objective.

Reduction of the debt-GDP ratio to below 60% of GDP, within a decade, similar to the target set in the EU's Maastricht Treaty, is the primary mid-term objective. The long-term objective is continued reduction of the debt-GDP ratio below 60% of GDP. A low debt-GDP ratio means a lower burden of interest payments, due to a lower principal and a lower country interest rate, stemming from a lower country risk. In addition, sources that are freed up from interest payments can be allocated to various public measures. For example, if the debt-GDP ratio were to stand at 60% of GDP (as required in the Maastricht Treaty), NIS 9.2 billion would be freed up in 2010 from interest payments for budgeting education, welfare, employment, health, infrastructures, and the like.

As part of the policy to introduce growth-supporting measures, the government will continue the implementation of the multi-year tax plan that was extended in 2009 until 2016. The plan consists of four major components: continued reduction of individual and corporate tax rates; elimination of tax distortions including various exemptions; raising of tax rates on products harmful to the economy; streamlining of the tax system and addressing collection enforcement (including false invoices, online reports to the Tax Authority, and more).

With the completion of the plan in 2016, the maximum marginal tax rate will stand at 39% and corporate tax will stand at 18%.

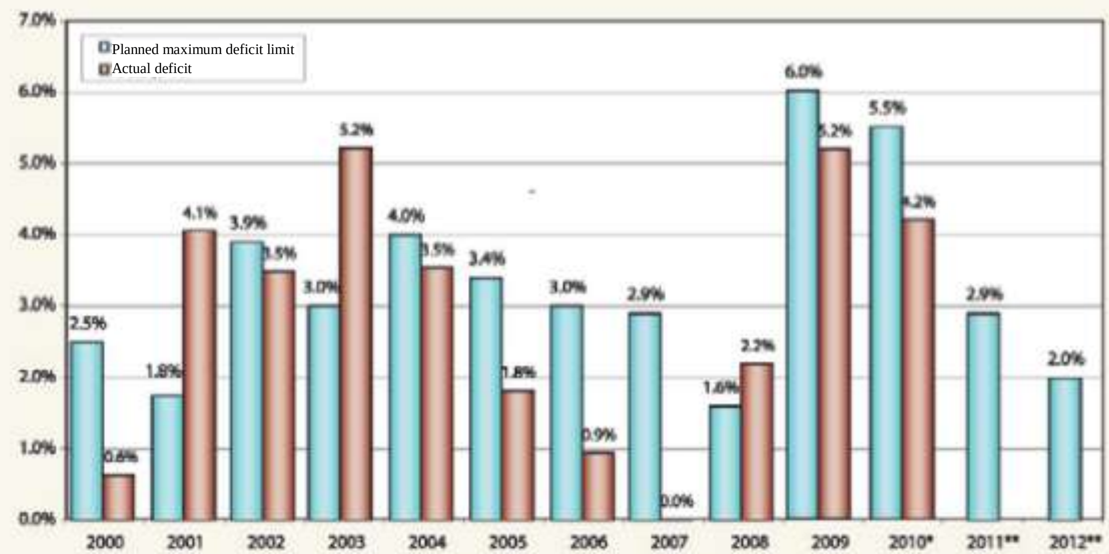
Other measures proposed besides continuation of the tax policy are the elimination of tax distortions, including, among others, reduction of the exemption on lottery winnings and raising of taxes on products with adverse external effects, such as fuel, polluting vehicles and cigarettes. The importance of such moves is highlighted by the fact that the new fiscal rule allows for a higher growth rate in government spending compared to previous years (2.66% versus 1.7%), and sets a diminishing deficit ceiling of 3% and 2% of GDP for the years 2011-2012, respectively. Aside from the reduction of tax rates on individuals and companies, these steps will allow for increased state tax revenues, leading to the enhanced allocation of the economy's resources.

The budgetary expenditure framework for calculating the expenditure limit in 2011 stands at NIS 271.2 billion, comprising real growth of 2.7% in relation to the 2010 budget, net of onetime expenditures (included in the years 2009-2010 for dealing with the impacts of the global economic crisis on the domestic economy). Said real growth consists of an increase of NIS 6.7 billion and a further addition of NIS 5.2 billion due to the budget's adjustment to 2010 prices, net of the aforesaid onetime expenditures, in conformity with the fiscal rule. The projected deficit stands at 2.9% of GDP, assuming 3.8% growth (the projected GDP for 2011 is NIS 864.1 billion).

The budgetary expenditure framework for calculating the expenditure limit in 2012 stands at NIS 284.7 billion, comprising real growth of 2.7% in relation to the 2011 budget. The projected deficit stands at 2.0% of GDP, assuming 4.0% growth (projected GDP for 2012 is NIS 918.6 billion).

Real growth in the state budget for the years 2011-2012 amounts to NIS 8.7 billion and NIS 7.0 billion, respectively. As noted, this growth is 1% higher than real growth in the previous years' budget. At the same time, the increases in government spending for the years 2011-2012, stemming largely from multi-year government decisions but also from legislation, adjudication, and government-binding agreements, are higher than the real growth permitted under the fiscal rule prescribed by law. Likewise, due to the impact of the global economic crisis on state tax revenues, and owing to the imbalance between the National Insurance Institute's revenues and expenditures (as detailed below), the government deficit arising from said government spending increases is greater than that allowed by law. For this reason, the government has been required to make adjustments in the years 2011-2012 both on the expenditure side and the revenue side.

Budget Deficit (Excluding Credit Granted) as Percent of GDP, 2000-2012



Source: Finance Ministry's Accountant General, the Central Bureau of Statistics
2010 State Budget and 2011-2012 State Budget Proposal

* Estimate of the Accountant General and the Economics and Research Division in the Finance Ministry
** Forecast for the years 2011-2012

To formulate the recommendation concerning the proposed adjustments, both on the expenditure side and the revenue side, various parameters have been evaluated, such as the economic efficiency; the contribution to growth; the contribution toward strengthening the weak population sectors and narrowing gaps; and the contribution toward rectifying distortionary allocation of the economy's resources.

The proposed mix of adjustments on the expenditure side combines adjustments to the defense budget with adjustments to various civil budgets, in such manner as to enable, insofar as possible, an increase in the civil services budget relative to that in 2010.

The adjustments proposed on the revenue side include extending the temporary order such that VAT will decrease from 16% to 15.5% in 2013 (instead of in 2011); taxing real estate transactions carried out by "acquisition groups"; raising the excise tax on benzene, diesel oil, biodiesel oil and coal; adjusting the green car tax brackets; raising the tax on cigarettes; reducing the exemption limit for lottery winnings; and automating attachment processes of banks and management companies. Also proposed are adjustments aimed at giving the National Insurance Institute the tools to reduce its operating deficit, such as reducing the abuse of transfer payments, streamlining alimony collection measures, postponing the grant of child allowance supplements and further measures, as set out below.

It should be stressed that the adjustments are consistent, even moderate, compared to the adjustments proposed and implemented these days in various European countries. Most

European countries (such as Britain, Germany, France, Italy, Spain, Ireland, Greece and Portugal) have a string of measures in place for handling many areas: extensive budget reductions, wage freezes in the public sector, raising of the retirement age, and other moves in the pension area, as well as allowance reductions and freezes. Likewise, said countries have set plans for raising direct and indirect taxes, such as income tax, corporate tax, VAT, capital gains tax, tax on capital movements, tax on alcohol, fuel and cigarettes, tax on CO2 emissions, and a green tax on flights.

Stability of National Insurance System

In recent years, the allowances paid out by the National Insurance Institute (NII) have grown considerably. In 2008, total NII expenditure stood at NIS 50.4 billion, with total expenditure for the years 2011-2012 expected to reach NIS 59.1 billion and NIS 61 billion, respectively (at fixed prices). This growth comprises a real increase of 21% within four years, stemming, among other things, from supplements established in the economic plan for 2009-2010, topping NIS 1.5 billion for child allowances, and a further addition of over NIS 1.4 billion for old age pensions (the supplements are being given in graded manner until 2012). These supplements, being paid out by law, were legislated without corresponding treatment of NII's monetary sources and without ensuring the NII's ability to meet these payouts over the long-term. Moreover, starting from 2005, several reductions have been made in the national insurance contribution fees collected from the public, leading to a loss of billions of shekels in NII revenues. In the face of increased allowances on the one hand, and shrunken revenues on the other, the NII is expected to end the years 2011-2012 with a current operating deficit of NIS 2.9 billion and NIS 3 billion, respectively. These deficits are part of the ongoing erosion of the NII's financial situation for some years already. Thus, for example, the NII ended 2005 with a current operating surplus of NIS 2.6 billion (2009 prices). Long-term analysis of the emerging trends shows that the aforesaid erosion is expected to deepen during the coming years.

In order to address this problem over the long term, Government Decision No. 186 was passed on May 12, 2009, concerning the establishment of a committee for the construction of a mechanism for the actuarial balance of NII expenditures. The committee is headed by the NII Director General and Director of Budgets Department in the Ministry of Finance, and members include the Head of the Bank of Israel research department, Chairman of the Israeli National Economic Council in the Prime Minister's Office, and representatives from academia. During the coming year the committee is expected to submit its recommendations concerning, among other things, the creation of a balancing mechanism for the correlation of NII expenditures and anticipated revenues, such as to ensure long-term budgetary balance at the NII.

Aside from the aforesaid, to immediately pare the deficit, the government has decided on a string of legislative amendments aimed at shrinking the deficit through the implementation of expenditure-curtailing measures and revenue-boosting actions, as detailed below:

Measures on the Expenditure Side of the NII

Curtailing the abuse of transfer payments – According to the assessment of professional officials at the NII, the rate of fraud in the unlawful receipt of allowances stands at 5% or more of total NII payments, accounting for NIS 2.7 billion per annum. In Israel there is no effective penalization of persons making unlawful allowance claims, but in Western European countries there are numerous types of sanctions and penal tools. In France and Germany, for example, an administrative fine may be imposed on false declarations to the social security administration. To solve the NII's deficit problem in the short term, the economic plan recommends aiming for deficit reduction in transfer payments through the amendment of the National Insurance Law, to allow for the establishment and imposition of effective sanctions on those obtaining an allowance benefit unlawfully, so as to create a sufficient deterrent against benefit fraud. Such an amendment coupled with an information campaign is expected to bring about a saving of over NIS 300 million in NII expenditures in 2011 and a further NIS 300 million in 2012.

Streamlining alimony debt collection – According to the Alimony (Payment Guarantees) Law, a person awarded alimony who meets the income test, is eligible to apply to the NII for an alimony benefit. Payment to the awardee is at the rates determined in the judgment and in amounts not exceeding those prescribed in the alimony payments regulations. The Alimony Law releases the awardee from the collection process, imposing on the NII the collection of the full amount due the awardee from the debtor, in accordance with the judgment. It should be noted that in 2009 some 20,000 women were eligible for alimony benefits, totaling on average NIS 1,600 per month. The NII pays out annually NIS 400 million in alimony benefits, but manages to collect only NIS 175 million from the debtors. The gap between payouts and actual collection from debtors is fully financed by the Ministry of Finance. The economic plan recommends expanding and streamlining the NII's existing collection tools. These measures are expected to save NIS 50 million in 2011 and a further NIS 50 million in 2012.

Partial linkage of benefits, allowances and various payouts – The economic plan recommends that during the period from January 1, 2011 to December 31, 2012, payments made under the National Insurance Law as well as the benefits granted hereunder, including by virtue of agreements under Section 9 of the Law, be adjusted at a reduced rate, which is the adjustment rate set under the aforesaid laws or agreements, less 1.5 percentage points. This measure is expected to produce a saving of NIS 535 million in 2011 and a further NIS 555 million in 2012, of which NIS 100 million in 2011 and a further NIS 105 million in 2012 will be directly financed by the Ministry of Finance. It is clarified that this freeze will not apply to disability pensions nor to pensions paid out under the Polio Law and the Compensation for Victims of Ringworm Law.

Postponement of the anticipated child allowance supplement – In the framework of the economic plan for 2009-2010, the National Insurance Law was amended to provide that the child allowance paid for the second, third and fourth child will be increased in graded manner up to 2012. As per the amendment, the child allowance for the second child will increase by NIS 57 in April 2011, and in April 2012 the allowances paid for the second, third and fourth child will rise by NIS 7, so that the allowance for these children will amount to NIS 259 per month. The economic plan proposes postponing the child allowance supplements by a year, a change that will defer an expenditure of NIS 360 million from 2011 to 2012 and an expenditure of NIS 80 million from 2012 to 2013.

Measures on the Revenue Side of the NII

Increasing the employer contribution fees in respect of wages higher than 60% of the national average wage – In 2005 a downward trajectory of the employer's Natural Insurance contributions rate in respect of employee wages higher than 60% of the national average wage was decided. Since then, the employer contributions rate has decreased from 5.93% to 5.43%. It is proposed to amend the National Insurance Law to provide that the employer contributions fees for wages higher than 60% of the national average wage be increased by 0.47 percentage points as of April 1, 2011. This measure is expected to boost NII revenues from the collection of contribution fees from the public by NIS 490 million in 2011 and by an additional NIS 290 million in 2012.

Graduated reduction of the ceiling for National Insurance contributions and health insurance contributions – In the framework of the economic plan for 2009-2010, it was provided in a temporary order that the ceiling for National Insurance contributions and health insurance contributions should be raised to equal the base amount times 10 for the years 2009-2010. A new proposal calls for the amendment of the National Insurance Law to provide that the ceiling be reduced such that in the period from January 1, 2011 to December 31, 2011 it will equal the base amount times 8, and in the period from January 1, 2012 to December 31, 2012 – seven time the base amount. The proposed amendment will boost NII revenues from the collection of National Insurance contributions from the public by NIS 440 million in 2011 and by NIS 350 million in 2012, compared to 2010. In addition, the collection of health insurance contributions will increase by NIS 180 million in 2011 and by NIS 140 million in 2012, compared to 2010.

Long-Term Budgetary Developments

The state budget and fiscal rules guide economic policy for the coming years and help to maintain short- and medium-term budgetary stability and budgetary credibility. At the same time, when setting budgetary policy and fiscal rules, long-term processes likely to affect the Israeli economy and society as well as budgetary sustainability over the long term, are taken into account.

Assessment of fiscal policy sustainability is characterized by the following aspects:

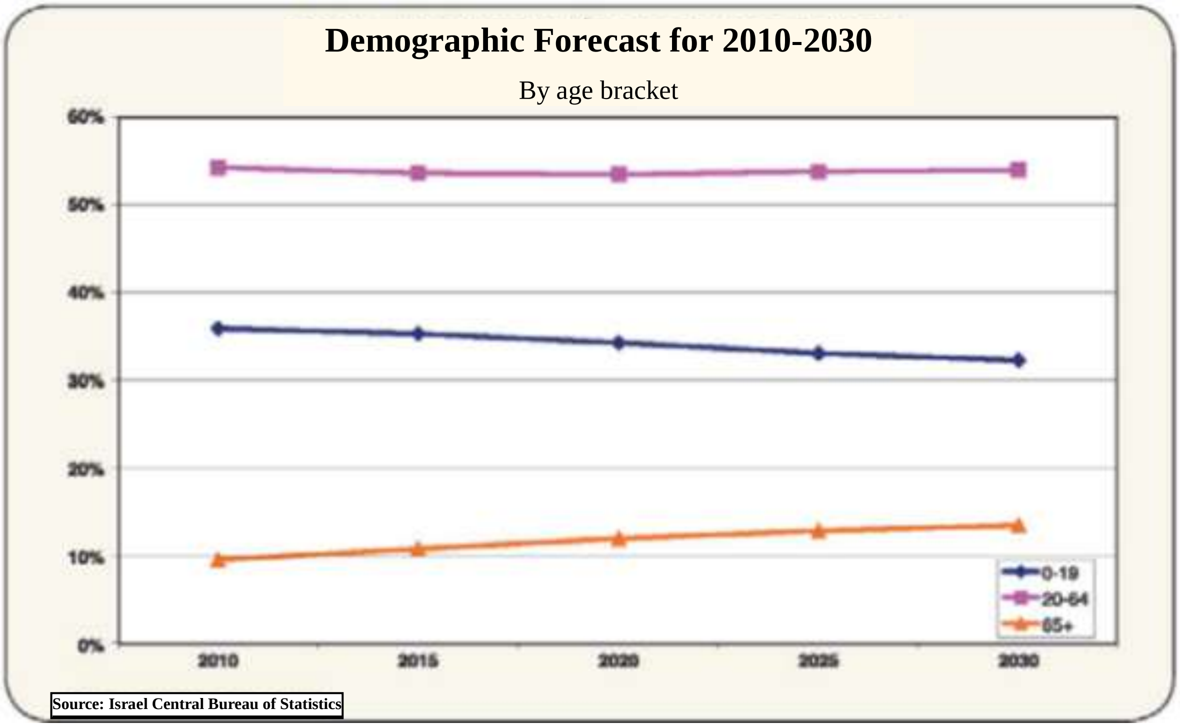
- Government ability to finance its existing and projected obligations.
- Government ability to sustain economic growth over time.
- Government ability to provide public services and supports on no lesser a scope than those given to day (intergenerational fairness) in the future.
- Government ability to finance future obligations without increasing the tax burden.

Israel's unique characteristics, such as its demographic composition and the geopolitical risks it is exposed to, heighten the importance of internalizing long-term thinking processes in setting economic policy, and as a derivative thereof – in the budgeting process.

Demographic Developments

Demographic developments in Israel over the coming decades are likely to have extensive implications for the Israeli society and economy. These developments will create significant challenges to long-term budgetary policy and thus require adopting an appropriate policy at as early a stage as possible. Anticipated demographic developments may be divided into two key significant processes:

Population aging process – This process is expected to significantly increase the proportion of Israel's elderly population in the overall population. Thus, for example, the proportion of the population aged 65 and over is expected to grow from 10% of the total population in 2010 to 14% in 2030. During that period, the proportion of the under age 20 population is expected to shrink from 36% to 32%. This process is expected to grow stronger in the subsequent decades, a development that will have a material effect on the budgetary expenditure composition and necessitate increased spending on such areas as health, long-term care and old-age pensions.



Demographic Forecast for 2010-2030

By age bracket

Source: Israel Central Bureau of Statistics

Change in population composition – Concurrent with the population aging process, a significant change is expected to occur in the population composition. The proportion of the non-Jewish sector and Haredi (ultraorthodox) sector is expected to grow considerably, both in the overall population and in the working age population. These two sectors are characterized, as of today, by a workforce participation rate and productivity rate that are significantly lower than those of the rest of the population. Absent a change in both these characteristics, the aforesaid demographic process will have a material negative effect on the economy's growth rate, and in turn, on Israel's standard of living. Moreover, this process will call into question the economic stability, due to decreased state tax revenues and increased expenditures on transfer payments. Such a development will necessitate raising taxes on an ever-declining population, lead to significant impairment of the government's ability to provide quality services, and could cause considerable social tensions.

Developments in Expenditure Components

Besides the projected demographic processes, there are other undergoing budgetary processes that should be considered. Thus, for example, one of the main components affecting the current budgetary expenditure, a fortiori future expenditure, is the budgetary pension. At the end of 2009, the actuarial liability of the Israeli government alone towards its employees insured under budgetary (unfunded) pension, including IDF career soldiers and office holders with budgetary pension, was estimated at a present value of NIS 451 billion (excluding rights that will accrue to the existing population). The present value including rights that will accrue to said populations is estimated at NIS 560 billion. Moreover, the growth rates of budgets designated for budgetary pension payouts are significantly higher than the projected state budget growth rate, despite the framework of budgetary pension insurees being closed to new members. Therefore, the proportion of the benefits-designated expenditure in the budget is expected to increase significantly at the expense of other important matters, such as: education, health, welfare, infrastructures and others. Central development trends in expenditure components can be seen also in public sector wage expenditures and in transfer payments, which have been marked by consistent growth in recent years.

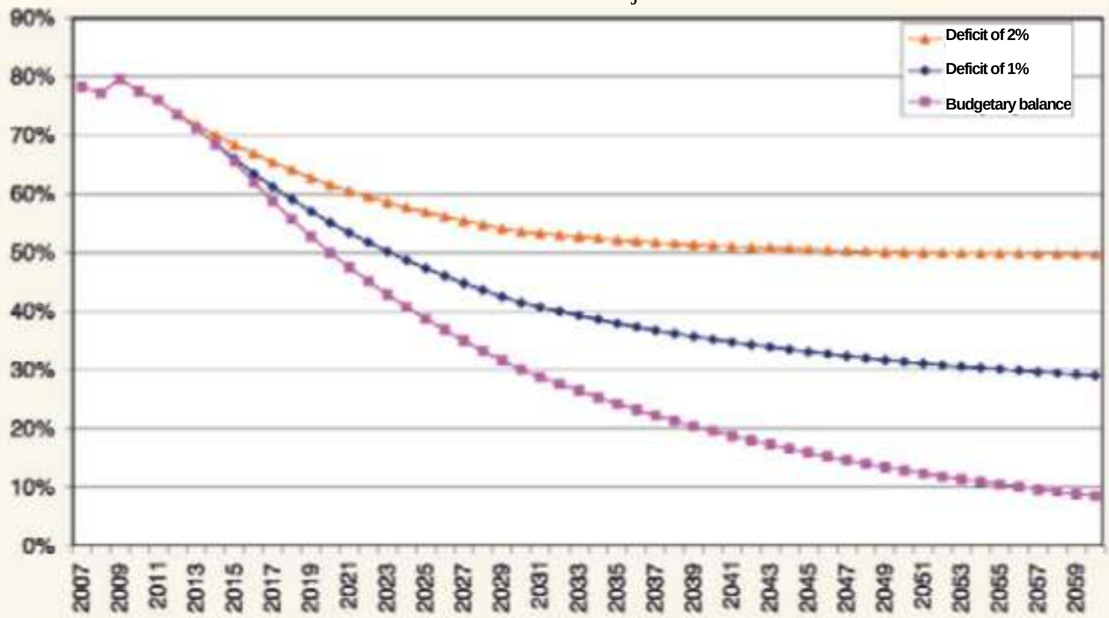
Sustainable Fiscal Policy

There are various means that can be employed to improve long-term budgetary stability and ensure that the fiscal policy adopted is sustainable. A key mean for grappling with projected budgetary needs is the freeing up of internal budgetary sources, such as public debt reduction. Such a measure will enable financing future budgetary expenditures without raising the tax burden. Maintaining a long-term downward debt trajectory, for instance, will augment budgetary stability and credibility, allowing the Israeli economy greater latitude to tackle future economic crises. The above said action will enable reducing interest costs that eat away a significant chunk of the budget and freeing up these budgets for other needs.

An evaluation of possible long-term debt-to-GDP ratio development scenarios shows that maintaining an average budgetary deficit trajectory of 1.0% of GDP (starting from 2014) will reduce the debt to lower than 60% of GDP towards the end of the decade, and over the long term will lead to the convergence of the said ratio to 30%. Thus, for example, if the debt-GDP ratio were to stand at 60% of GDP (as required under the Maastricht Treaty) then NIS 9.2 billion would be freed up in 2010 from interest payments. On the other hand, maintaining a budgetary deficit of 2.0% of GDP over time (which means noncompliance with the deficit limit rule), will put off attaining a debt-to-GDP ratio of 60% to the following decade, and worse yet, will call into question the fiscal policy's commitment to debt-to-GDP ratio convergence to an even lower level in the future. The reason for this: the moderate reduction rate of the debt-to-GDP ratio that will lead the debt to overshoot this threshold in the event of economic crisis.

Simulated Long-Term Development of Public Debt as One Percent of GDP

For different deficit trajectories



Note: The simulation is based on a growth rate of 3.5% per annum for the years 2013-2020, 3.3% until 2030, 3.1% until 2040, 3.0% until 2050, 2.9% until 2060 and 2.0% inflation per annum starting from 2011. What is meant by the simulation is not maintenance of a budgetary deficit of 1.0% each and every year, but rather maintenance of the above said deficit level over the business cycles. In other words, in high growth years the budget will post surpluses, while in slowdown years, the budgetary deficit may be higher.

Other key examples of the freeing up of sources are a reduction of the defense expenditure's portion in the budget; management of expenditure levels in respect of wage payments in the governmental and public sectors; and national insurance transfer payments at levels sustainable over time.

Setting in Motion a Long-Term Budgetary Planning Process

Contending with long-term projected trends (demographic, budgetary and others) requires an in-depth analysis of each of the trends and building a macroeconomic model with assumptions regarding the long-term growth trajectory of Israel's economy. Also needed is an analysis of developments in the various expenditure components, such as the expenditure in respect of health, education, transfer payments, infrastructures, wages and benefits, coupled with an evaluation of various scenarios for macroeconomic developments and of different expenditure patterns (in a "business as usual" scenario and other scenarios). Such analysis will allow for the early identification of long-term processes likely to impair the growth capacity of the Israeli economy and the government's ability to provide, over time, a reasonable standard of services to its citizens.

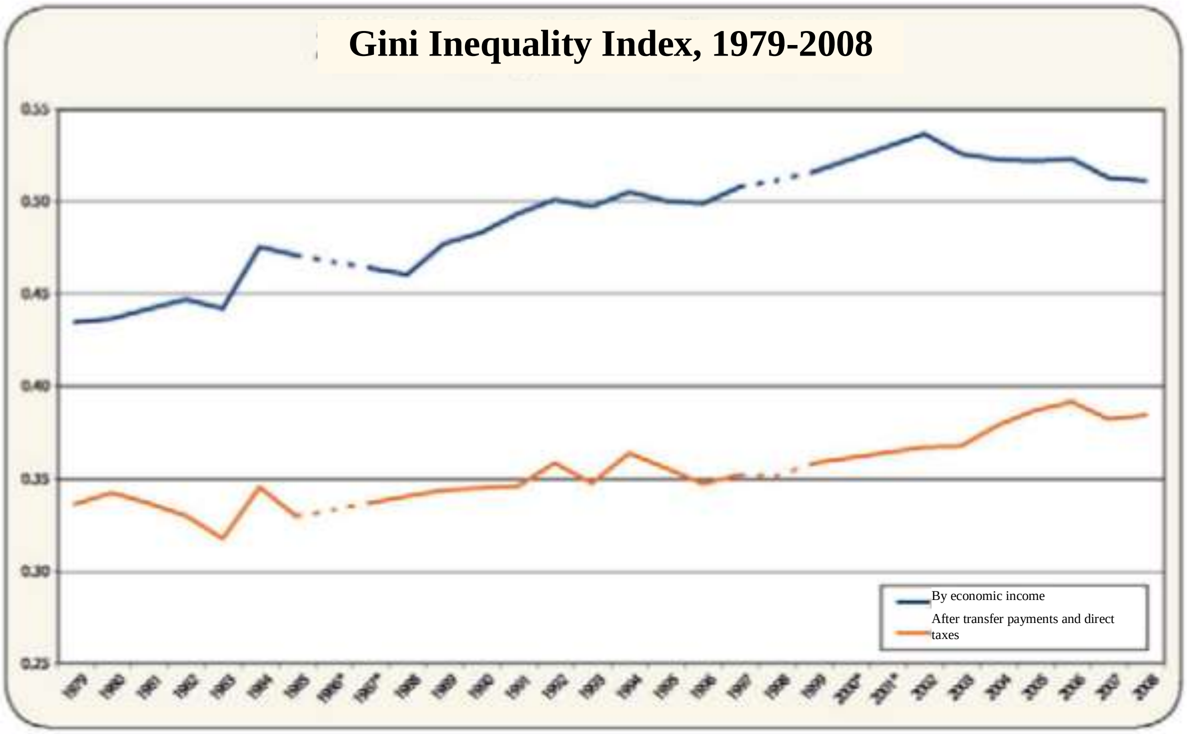
In recent years, many countries have been conducting comprehensive analytical processes to assess the long-term fiscal sustainability of their economies, taking into consideration macroeconomic processes and demographic features unique to them. Such processes are incorporated nowadays in the framework of decision-making and socioeconomic policy setting processes, thereby contributing toward the internalization of long-term thinking and adoption of policy measures having intergenerational implications.

A process of analysis of long-term budgetary developments in Israel's economy is expected to be carried out in 2011, as a foundation-laying step that will help formulate a socioeconomic policy for the coming years. It should be noted that an important stage in this process has already begun in the framework of the work conducted by the Committee for the Construction of a Mechanism for the Actuarial Balance of NII Expenditures, as detailed above, which is expected to expand next year to an analysis of other expenditure components; and in the framework of processes being promoted by the government for encouraging the full integration of minorities and Haredi (ultraorthodox) sectors into the workforce along with measures to ensure their increased productivity.

Inequality

Long-term demographic developments coupled with the increasing proportion of populations marked by low workforce participation rates have a direct effect also on forecast trends in the area of inequality and social gaps.

The Gini inequality index by economic income (income from labor, capital and pension before deduction of direct taxes and addition of transfer payments) showed a consistent downtrend since 2003, which continued into 2008. Inequality in Israel, measured by the Gini index, had been on an uptrend since the mid-1990s, a process leading the level of inequality in Israel, along with its poverty dimensions (derived from the inequality level) to be one of the highest among the developed economies. In 2007, a downtrend was recorded for the first time in a decade by the Gini index by net income (income after transfer payments and direct taxes); however, a slight uptrend recorded in 2008 partially offset the downtrend recorded in 2007. The above said uptrend returned the Gini index to a slightly lower level than that recorded for 2005. At the same time, the rate of poor families remained stable in 2008, following a slight drop in the poverty rates recorded for the preceding two years.



Reducing economic gaps and inequality in the economy is a challenge requiring varied policy measures over time. The key measure for improving the situation of the weak population sectors in the long run is improving the education system on all its levels and narrowing the wide gaps in education and human capital existing between the various population sectors. This process will enable different demographic sectors to fully exploit their skills and talents, boost intergenerational economic mobility and reduce social frictions. To narrow gaps already in the short term, actions supporting the integration within the labor market of population segments with a low workforce participation rate are being implemented. Such actions include enlarging budgets for day care centers; launching on a national scale the program for the integration of welfare-recipients in the workforce patterned on the model of the experimental program "Orot Letaasuka" (the Israeli Wisconsin Plan); expanding the negative income tax plan; and adopting an employment-supporting policy in the area of transfer payments, which seeks to reduce negative incentives to find employment. Increased government support of the elderly population has also contributed to the reduction of inequality and poverty.

Chapter 2 – Augmenting the Comparative Advantages in Human Capital and the High-Tech Industries

R&D and Industry

The high-tech industry is a key sector and growth leader of the Israeli economy. Its importance being expressed, inter alia, by its high contribution to GDP, to the economy's growth, including exports, employment and attraction of foreign investments, and by its spillover effects on other sectors of the economy.

In 2009, high-tech industry exports accounted for 41.2% of total exports. The number of employees in this industry in 2008 stood at 268,000, constituting 14% of total employed in the business sector.

The national research and development expenditure in Israel as a percentage of GDP is the highest in the world, standing at 4.9% for 2008.

Despite the great success enjoyed by this industry over the last two decades, there are several identifiable signs of erosion in its future growth capacity, namely: high salaries relative to emerging economies, academic research with unexploited application potential, a decline in the number of degree recipients in sciences and engineering, an increase in the number of Israeli students remaining abroad after completing their studies, absence of focused government R&D support, considerable dependence on the ICT (Information and Communication Technologies) sectors, limited penetration into new fields, rising R&D investments in emerging economies, a venture capital funds industry based almost entirely on foreign capital that is having difficulty recruiting investors and scant development of large companies in the Israeli economy. It should also be noted that the scope of investments in this industry has been greatly affected by the global economic crisis, as manifested by the low level of investment in the industry in the past two years.

Expansion and Perfection of Government's Suite of Tools in R&D and High-Tech Industries

The economic plan for 2011-2012 recommends several policy tools for strengthening and amplifying the high-tech industry, by way of contending with the signs of erosion in the industry and bolstering it at all stages of its development, starting from basic research at academe and research institutes to the establishment and formation of large companies.

In the framework of the economic plan, the government has decided to establish a new track in the office of the chief scientist at the Ministry of Industry, Trade and Labor to support academic research with application potential, which addresses the barriers in getting budgets for early-stage research, due to the high risk involved. Likewise, it has also been decided to buttress existing tools for this purpose.

The government has established principles for updating and adjusting the support tools provided by the chief scientist in the Ministry of Industry, Trade and Labor to suit the situation in the high-tech industry, also recommending tools for the encouragement of private investments in R&D companies in comparable stages. In addition, tools have been proposed for the establishment and formation of large companies in Israel.

In order to reduce the high-tech industry's great reliance on foreign capital and increase the scope of investments in the industry that have dwindled significantly in the wake of the global economic crisis, the government has decided to devise a mechanism for state participation in part of the risk entailed in investing in this industry, aimed at encouraging Israeli institutional investors to invest in venture capital funds operating in Israel.

Also, in order to expand the industry's activity in Israel into new fields, it has been decided to establish a new track to support R&D for the international finance industry.

With the vision of promoting the high-tech industry and innovation in Israel, the government has decided, in the framework of the economic plan, that the Minister of Industry, Trade and Labor shall appoint an official in his ministry to regularly advise the government on this matter, follow key processes in the high-tech industry, analyze their significance and recommend to the government the desirable policy for advancing this issue.

To round out all the foregoing, it has been decided to significantly increase the budget baseline for the chief scientist in the Ministry of Industry, Trade and Labor to NIS 1.3 billion for each of the years 2011-2012 (versus NIS 1 billion for 2010).

Amplifying the Industry's Comparative Advantage and Prioritizing Israel's Periphery

Industry exports comprise 24% of the business sector product, and the industry is the largest employer in the business sector, with the number of employed in it out of total employed in the business sector constituting an average of 22% for the period 2004-2009, compared to just under 20% for business services and 19% for the trade sectors.

The industry's weight as an employment generator in Israel's periphery regions is even greater, with 35% of total employed in the business sector in the periphery employed in the industry, compared to 20% in the wholesale and retail trade sectors and 11% in the business services.

As part of efforts to promote growth, the government grants investment incentives to increase the economy's production capacity and consolidate the competitive edge of Israeli industry. Key tools used to attain these targets are the Chief Scientist's R&D investment grants as well as the grants track and tax benefits track provided under the Encouragement of Capital Investments Law, 5719-1959 (hereinafter – the Law). Such incentives amplify the attractiveness of the Israeli economy in the international competition over local and foreign capital for investment and development. Likewise, through the set of incentives prescribed by it, the Law promotes a more geographically balanced distribution of the population across the country and strengthening of the peripheral regions.

Even so, studies that have examined the Law over the years have indicated inefficiency in the allocation of resources according to the Law's provisions. More specifically, these studies have shown a distortion in the allocation of resources by the industry, due to the focus of support tracks on capital investment, favoring physical capital investment over investment in other areas, such as tracks supporting the boosting of industry worker productivity. Another major issue concerns the tax benefits track, whose scope in 2008 was estimated at NIS 6 billion. This track is complex and cumbersome in nature as well as lacking in transparency and clarity, which is why many industrialists avoid joining it, thereby reducing its potential contribution to the industry's growth. Generally speaking, the tax track leads to the concentration of benefits within a limited number of enterprises located for the most part in the center of the country.

Aside from the foregoing, the tax benefits track existing today allows for the grant of benefits to a group of enterprises, benefits for which there is no room, as concluded by an economic evaluation. Under this tax benefits framework, foreign investors enjoy greater benefits than Israeli investors, and tax breaks are granted to companies whose revenue generation is based on natural resources as well as to companies wholly owned by the government. From an economic standpoint, economic efficiency in the allocation of resources is impaired by the conferral of extensive tax breaks to companies with limited independence in decision-making concerning investment and operations in Israel, which depends in fact on the government, such as in the case of government companies. Furthermore, there is relatively little economic efficiency in granting tax breaks to an enterprise whose income is based on the exploitation of the state's natural resources (and thus needs no incentive for operating in Israel).

The outcome of the policy implemented under the law in its present format has been a high capital-worker ratio in Israeli industry not reflected in the GDP-worker ratio, as well as a low level of innovation, and low productivity in the traditional industry. Also, it was found that the Law was rather ineffective in achieving the aim of strengthening the peripheral regions.

Due to the foregoing and as directed by the Minister of Finance and Minister of Industry, Trade and Labor (MOITAL), an interministerial committee was established, headed by the directors-general of the Ministry of Finance and MOITAL, to examine the Law's objectives and make recommendations for updating the policy tools applied under the Law.

Pursuant to the committee's recommendations, it was proposed in the framework of the economic plan to revise the Encouragement of Capital Investments Law by:

- Updating the Law's objectives in line with the changes that have taken place in the Israeli economy characteristics, placing emphasis on encouraging investments generating added value in innovation and heightened competitiveness of Israeli industry;
- Allowing the Israel Investment Center flexibility to establish other support tracks besides the existing track, for a range of investments, including investments in human capital and in line with industry characteristics at any given time;
- Prioritizing the peripheral regions through the grants track;
- Simplifying the tax benefits track, establishing flat tax rates on all income of the beneficiary companies and giving preference to the peripheral regions by lowering the reduced tax rate for companies in those regions;
- Eliminating the distortions created through the concentration of resource allocation in the tax benefits track, by preventing the grant of greater tax benefits to foreign investors, and by excluding companies based on the exploitation of natural resources, including petroleum and natural gas, and other companies for which there is no room for granting incentives through tax breaks, such as state-owned companies.
- Customizing a dedicated tax track aimed at promoting the operation of huge companies in Israel.

Human Capital

Education

Education is key to narrowing the gaps and creating job opportunities. Studies conducted in Israel and abroad show a distinct positive correlation between education level and wage level.

The achievements of Israeli pupils in comparative international tests have been lower than those in most western countries. In the TIMSS test, Israel was ranked 24-25 among the countries tested, with large gaps apparent between the various population sectors. The PISA test scores from 2006 show that not only are Israeli pupils' achievements lower than pupils' achievements in the developed countries, but also the percentage of outstanding pupils in Israel is lower than the average percentage of outstanding pupils for the OECD countries.

According to Ministry of Education figures, some 50% of pupils in the elementary school system in 2010 come from the Haredi and minorities sectors, with their proportion projected to increase over the coming years. As noted above, the processes of change in the pupil population composition have not been accompanied by processes ensuring equal opportunity and provision of the tools required for their future integration in the labor market.

The pupils' achievements coupled with the gaps between population sectors along with the demographic trends pose significant challenges to the education system in terms of narrowing the gaps and improving scholastic achievements by imparting the knowledge and skills required for integration in the labor market.

These challenges are reflected in the government's budgetary priorities and in the structural changes recommended in the economic plan for 2011-2012.

Additions to the Ministry of Education's budget total NIS 2.5 billion for 2011 and a further NIS 1.4 billion for 2012.

Following are the major changes:

The Education Ministry's budget proposals for 2011-2012 include an addition of NIS 620 million earmarked for the continued implementation of the "New Horizon" reform in the education system. Under this reform program, every teacher is obligated to devote five hours a week, among other things, to coaching underachieving pupils in core subjects. Additionally, NIS 100 million are to be allocated, besides the NIS 130 million already allocated, for increasing the number of teaching hours in first and second grade, with the aim of reducing class size in the instruction of basic subjects in these grades.

In the years 2009-2010, a total of NIS 370 million was added to the budget baseline for the Ministry of Education's strategic program. This program aims to improve the scholastic achievements in the Meitzav exams (national standardized tests) and comparative international achievement tests through the improvement of language, mathematics and science skills; raise the number of pupils eligible for a full matriculation certificate; narrow gaps; strengthen democratic and social values; deepen Jewish identity and more.

Besides continuing with the achievements program, the Ministry of Education is expected to commence in 2011 the implementation of a program aimed at integrating the use of telecomputing tools in the education system. The telecomputing program is intended to create the conditions for the development of innovative classroom teaching, through the assimilation of information technology.

In order to realize the achievements program and telecomputing program, NIS 410 million were added to the Ministry of Education's budget for 2011, a further NIS 140 million for 2012, and subsequently NIS 80 million more upon authorization to continue with the telecomputing program.

In the secondary education system, according to Government Decision 4018 from August 24, 2008, NIS 30 million are to be allocated each school year, starting from the school year 2009/2010 (5770) until the school year 2019/2020 (5779), for the addition of teaching hours. Likewise, starting from the school year 2010/2011 (5771), NIS 200 million are to be allocated each school year for the reduction of class size (besides the NIS 180 million allocated up to the school year 2010/2011 (5771)).

Apart from this, NIS 150 million have been added in 2011-2012 for the upgrade of educational institutions, as well as NIS 50 million for setting up technology centers in the peripheral regions with industrial collaboration, for use in technology education.

These measures are meant to help reduce the scholastic gaps existing between pupils from different backgrounds. However, there is substantial evidence of a lack of relationship between costs and education outcomes. Hence, the challenge faced by the education system is an administrative one that includes the informed use of resources and the setting of priorities, which will lead to improved outputs and the meeting of targets defined by the Ministry of Education.

In view of the foregoing, besides the budget additions presented, the Ministry of Education is promoting changes intended to create a supportive organizational basis for improving achievements, as described below:

Empowering the principal – The principals are school leaders that steer educational activity. Expansion of principals' powers and decision-making on a level more closely associated with the pupil and his/her needs lead to improved scholastic achievements. In order to increase the principal's authority and responsibility, it was agreed to establish a team headed by the director-general in the Ministry of Education to see to the implementation of the decision in terms of direct per pupil budget allocations for schools, drawing up and implementation of work programs by the school principal, establishment of an accompanying steering committee, and reporting by the principal on revenues, expenditures, teaching schedule, etc.

Expanding the registration districts – Studies have found that the controlled opening of registration districts leads to improvement in pupils' achievements. Researchers contend that controlled selection increases parental involvement, which also leads to improved scholastic achievements. In view of the above said, the government has decided that the Ministry of Education will act to allow the local authorities to expand the registration districts within their jurisdiction, so as to allow for school selection based on an equal opportunity model. It has also been decided that schools will not screen pupils.

Restructuring of administrative tools in the education system – In order to give a broader picture on the various schools' characteristics, particularly in terms of the state-provided inputs to schools, it has been agreed that the Ministry of Education will set up an integrative data system that will centralize data on inputs and outputs, including figures provided by the local authorities and various ownerships.

Higher Education

Human capital and higher education have been key advantages of the Israeli economy and its source of growth over the years.

Besides increased accessibility to the higher education system and a rise in academic degree recipients, the last decade has seen an erosive trend in the system's achievements, in teaching quality and in the level of its research products. Thus, for example, there has been a steady uptrend in the students/staff ratio in the higher education system, directly affecting the quality of instruction. Other erosive signs include the decrease in absolute number of staff members, stemming in part from the "Brain Drain" phenomenon, and the increasing average age of academic staff members resulting, in part, from the hiring of fewer new staff members than in the past. It should be noted that this process of aging academic staff members in Israel adversely affects the potential research innovation of the higher education system, because studies have indicated that the ages of greatest scientific productivity are 35-37, while the average age in Israel today is 55.

Additional significant erosive signs are evident in the area of academic research, manifested, among other things, by the reduction in university research departments and the scattering of research efforts. Reasons for the reduction in the scope of research include the incentives method applied in the current budgeting model and the curtailment of the universities' discretionary budget, due to increased budgetary pension payments.

Several recent changes in the higher education system have created the suitable conditions for a comprehensive reform of Israel's higher education, namely: the growing influence of the Planning and Budgeting Committee (PBC) as a leading body in the system; the higher education institutions' recognition of the necessity for change; a high natural retirement rate of staff members that creates an opportunity for influencing staff excellence, the mix of disciplines, the age of newly employed individuals, etc; and extensively increased accessibility that allows focusing on the improvement of excellence.

The higher education reform, manifested, among other things, by a multi-year plan finalized between the PBC and Ministry of Finance, subsumes components aimed at steering the system towards meeting targets of excellence. These include: increasing the share of the competitive research budget, modifying PBC's budgeting model through the proposition of excellence incentives, employment of outstanding staff, improvement of the teaching and research infrastructure and the diversion of additional resources to the system from overall sources, inter alia, through the regulation of the budgetary pension issue in the higher education system. The reform program provides a budget supplement for the higher education system totaling NIS 7.5 billion over the duration of the program's implementation, which commences in the academic year 2010/2011 (5771).

Chapter 3: Dealing with the Labor Market and Expanding the Workforce

Background and Problems

The Israeli labor market came through the global crisis that began in late 2008 with a moderate rise in unemployment compared to other developed countries. The market began showing signs of recovery in the second half of 2009, with a decline in the unemployment rate, a trend that continued in the first half of 2010. Nonetheless, a basic problem in the Israeli economy remains the significantly lower rate of participation rate in the labor market compared to other developed countries, and the accelerated demographic growth in populations with a low participation rate.

Increasing the rate of participation in the labor market, especially among populations with low participation, is a major tool for strengthening economic growth as well as reducing poverty and narrowing gaps. To illustrate, the incidence of poverty among households with two wage earners stands at only 3%, compared to 70% among households with no wage earner.

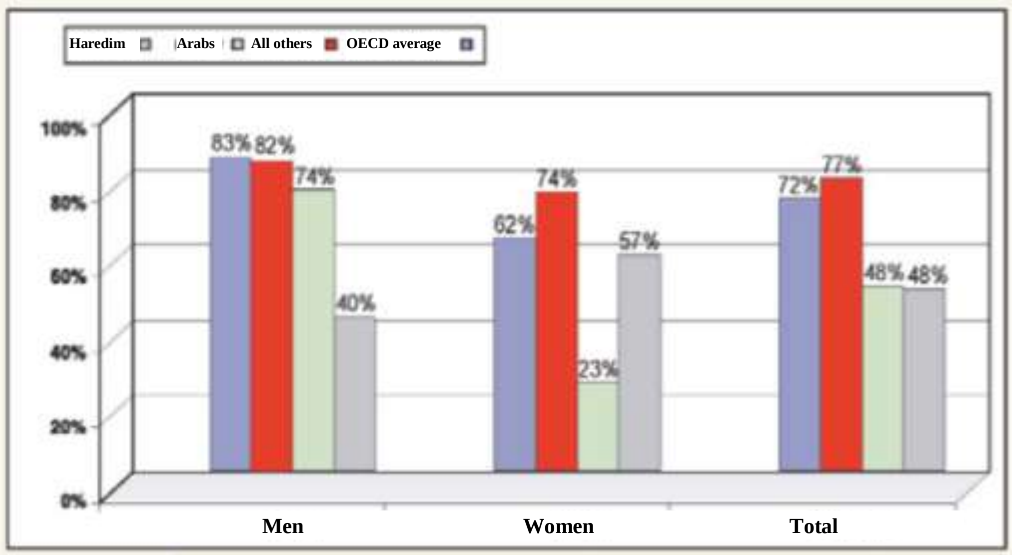
In order to significantly increase the participation rate in Israel, a comprehensive plan is needed, including the implementation of major structural changes for realizing the economy's growth potential.

In 2008, the average participation rate among the 25-64 age group stood at 76.1% in the OECD countries, and at 79.2% in the US, compared to only 74.9% in Israel. Apart from the population of non-Haredi Jewish women, all sectors in Israel are characterized by low participation and employment rates relative to the OECD countries. Haredi men and Arab women are the weakest sectors, with significantly lower participation and employment rates compared to the rest of the Israeli population and relative to the OECD.

Unemployment, which reached a record 10.9% in the second half of 2003, fell to 8.4%, 7.3% and 6.1% respectively in 2006, 2007 and 2008. In the wake of the economic crisis the trend reversed, and unemployment in 2009 rose to 7.6%. However, the labor market began to recover in the second half of 2009, in which unemployment stood at 7.5%, declining to 6.6% in the first half of 2010.

In order to obtain an overall picture of the Israeli labor market, one must examine the employment rates of the different population sectors. The employment rate takes into account both the participation rates and the unemployment rates. The employment rate among the main working ages (25-64) fell from 71% in 2008 to 69.9% in 2009 and is significantly lower compared to other developed countries. Thus for example, in 2008 the average employment rate among the 25-64 age group in the OECD countries stood at 72.3%. Employment rates are especially low among two population groups in Israel: Haredi men (40.4% in the 25-64 age group in 2008), and Arab women (23% in the 25-64 age group in 2008).

Employment Rates in the 25-64 Age Group, by Gender and Population Type, 2008



Source: Labor Force Survey Data for 2008

The main barriers preventing integration of Haredi men into the workforce are the legal barrier (work restrictions on those included in the military service deferral arrangement under the Deferral of Military Service for Yeshiva Students Law, 2002), the economic-cultural barrier (the government stipends available to yeshiva students in place of wages), and inadequate basic education. The main barriers preventing the integration of Arab women into the workforce are inadequate access to transportation means, the economic-cultural barrier, including a lack of child-care support, and insufficient employable human capital.

It is important to note that given the accelerated demographic growth in populations with relatively low employment participation, if each population group maintains its present employment rate, by 2020 the overall employment rate will decrease by 2 percentage points, significantly affecting the GDP. Apart from this, there are significant wage gaps between non-Haredi Jewish employed and Arab and Haredi employed.

Policy Objectives

In order to promote government handling of the labor market and boost employment rates in the different sectors, the Minister of Industry, Trade and Labor established the Committee to Examine Employment Policy, headed by the Deputy Governor in the Bank of Israel, Prof. Zvi Eckstein ("the Eckstein committee"). The Eckstein committee recommended setting high long-term employment goals, with a view to narrowing gaps and realizing the economy's full growth potential. The committee also recommended a series of steps for achieving these goals, including the promotion of structural changes and implementation of plans aimed at encouraging the employment of Israelis, while focusing on low-participation populations.

The object of these employment goals is to reach employment levels on a par with the world's developed countries, and to add 33,000 workers a year beyond the number of workers added due to natural increase of the population. This addition to the number of workers is consistent with a rise of 0.5-1 percentage points in the annual GDP growth rate (or an increase of NIS 3.75-7.5 billion in the annual GDP), making this one of the most significant growth engines of the Israeli economy.

The employment goals subsume sub-goals, including those specifically targeting low-participation populations, and they provide for the following distribution of the added number of workers by type of population: 42% newly employed persons in the minorities sector and in the Haredi sector; 11% persons with disabilities, and 46% persons from the rest of the population (by boosting the participation rate, reducing the unemployment rate and increasing employment among various population groups such as Ethiopian and Russian immigrants, residents of peripheral communities and recipients of subsistence allowances in the working age group).

It should be noted that the employment goals set by the Eckstein committee, which were adopted by the government in the framework of the economic plan, are ambitious and challenging ones, necessitating the implementation of far-reaching and complex structural changes in the labor market. Without such changes, and without the promotion of focused plans for encouraging the employment of low-participation populations and making employment participation more worthwhile than the alternative of nonparticipation, it will not be possible to achieve these goals and to reach the per-capita GDP levels of the 15 most developed countries.

Policy Means

In order to achieve the employment goals and improve the growth potential of the economy as a whole, while reducing social gaps, the economic plan offers an array of tools in the labor market designed to promote a growth-supporting policy with emphasis on increasing participation in the workforce and encouraging employment among low-participation populations. In this context, the government has decided on the implementation of a number of structural changes needed to realize the employment goals, including restructuring of the regulatory system in the Ministry of Industry Trade and Labor, improving the vocational training program, increasing the effectiveness of the employment test used by the Employment Services, promoting focused plans for the removal of barriers and increasing encouragement of employment among low-participation populations (such as Haredi men and Arab women).

The Government of Israel has likewise decided on the nationwide deployment of a plan for integrating welfare recipients in work patterned on the model of the experimental program "Orot Letaasuka" (the Israeli Wisconsin Plan), further to the recommendations of the Eckstein committee and the OECD. Both the committee and the OECD, in a comprehensive survey of the Israeli economy published in 2009, see great importance in the nationwide deployment of this plan, in light of its success in integrating welfare recipients in work. It is important to note that nationwide implementation of the plan is essential for achieving the employment goals and realizing the economy's full growth potential.

With a view to increasing employment rates, as stated, the government follows a proactive policy in the labor market, in line with accepted policy in the OECD countries. In recent years it has substantially increased the allocation of resources in the framework of its policy for the encouragement of employment

Achieving the stated employment goals entails the promotion of significant structural changes in the labor market. Given the accelerated demographic growth trend among nonparticipating populations, the current employment rates are expected to fall significantly, with a resulting drop in the per-capita GDP, accompanied by significant widening of social gaps and inequalities. The structural changes in the labor market, which form part of the economic policy outlined for 2011-2012, are essential for realizing the economy's full growth potential. Their full implementation will facilitate meeting the employment goals that have been set and reaching the per-capita GDP levels of the 15 countries with the highest per-capita GDP.

Reducing the Number of Foreign Workers

The employment of foreign workers has numerous implications for the job market, economy and society. Thus for example, the use of foreign labor causes a change in the employment and wage structure, harms the weaker and mainly the uneducated population sectors, which compete with the foreign workers for jobs, it also reduces the incentive for Israelis to seek employment in industries where there is a demand for foreign labor. Furthermore, this phenomenon leads to a loss of foreign currency, creates dependency on the importation of cheap foreign labor, holds back technological innovation and economic efficiency and expands the boundaries of poor and neglected inner-city neighborhoods.

In Israel, some 74,000 foreign workers are employed under permits in agriculture, construction, industry and ethnic restaurants. In addition, around 25,000 permits are issued to Palestinian Authority residents for work within the Green Line and another 25,000 permits for work beyond the Green Line. In order to reduce the number of legally employed foreign workers, the government has decided on a gradual reduction in the number of permits issued for foreign workers in the different industries, excluding the caregiving industry, in which there are no quotas but permits are issued to eligible persons. It should be noted that in addition to the gradual reduction in the number of permits, the government has decided on other measures to increase the cost of employing foreign workers and thus reduce the incentive to hire them.

Alongside the foreign workers employed under permits, some 125,000 foreign workers are employed in Israel illegally, most having entered Israel on a tourist visa and remained after the visa expired. In addition to this group, there are more than 25,000 illegal immigrants who infiltrated into Israel through the border with Egypt, the majority of whom have found work. According to estimates, there are also more than 20,000 Palestinian workers who are employed illegally in Israel. Apart from the negative implications arising from the employment of foreign workers, as detailed above, these workers are more liable to be exploited by their employers and are mostly employed without assurance of their social rights. In an effort to combat the phenomenon of illegal employment of foreign workers, the government is focusing enforcement efforts on the employers of illegal foreign workers, along with enforcement of the Entry into Israel Law.

It is proposed to complete the process of implementation of the government decision from January 24, 2010 to strengthen enforcement and reduce the illegal employment of foreign workers. This is to be done by increasing fines, conferring additional powers on the Fine Collection Center, upping the penalties for the collection of illegal brokerage fees from job seekers, fixing a cooling-off period outside Israel before illegal residents can apply for a visa or residency permit and establishing other restrictions

The government is also considering ways of dealing with the growing phenomenon of work migrants infiltrating into Israel through the Egyptian border. Thus, the government decided on March 14, 2010 (Decision No. 1506) that the Ministry of Defense should build a barrier on Israel's western border. In two discussions held on the subject, on July 18 and 19, 2010, the government decided to set up two working teams, one headed by the Director General of the Prime Minister's Office and the other by the Director General of the Population, Immigration and Border Authority. In the coming months, the teams will formulate recommendations for action on the subject and for the advancement of the necessary legislative amendments.

Chapter 4: Development of Infrastructures and Internal Growth Engines

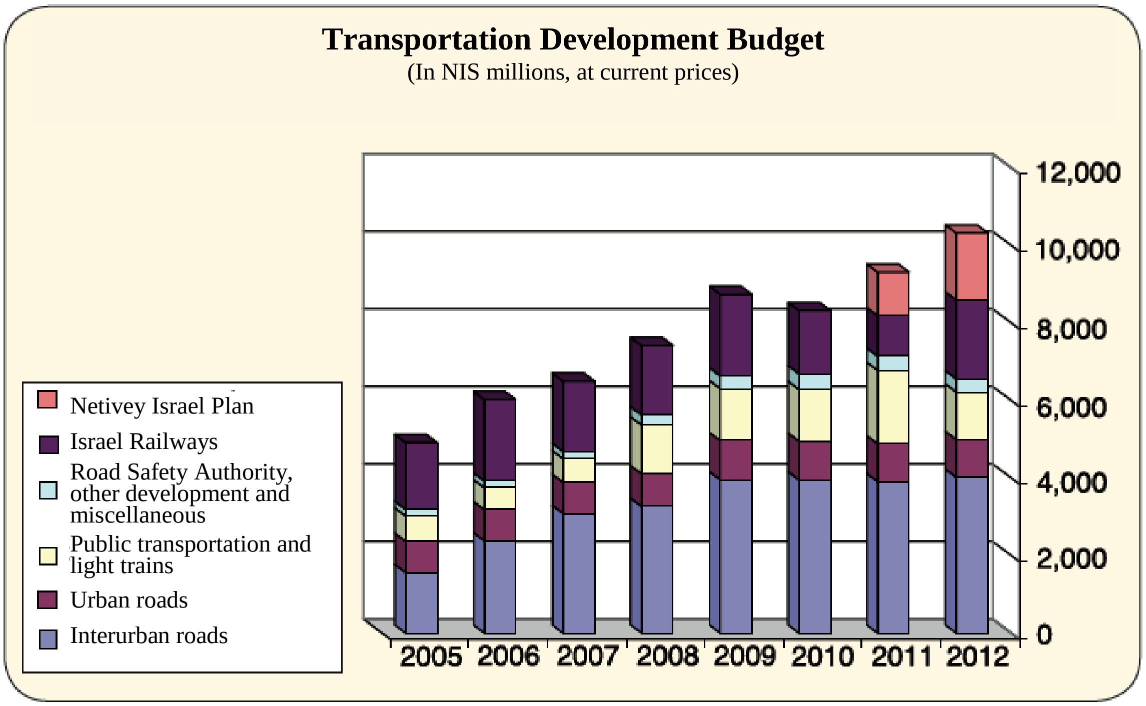
Development of Transportation and Mass Transit Infrastructures

Advanced transportation infrastructures are a vital component of economic growth, mainly because they are a necessary condition for a rapid, reliable and affordable connection between the different production facilities in the economy. Population growth and a rising standard of living are attended by a significant increase in the domestic traveling by the public, and especially an increase in the usage of private cars. The number of vehicles in Israel has risen in the past decade by more than 50% which causes significant congestion on the road network. Whereas the usage of an average private vehicle in Israel has almost not changed in recent years, the number of private vehicles in Israel is growing every year by about 100,000, reaching more than 2 million today. The cost of the road congestion to the economy, reflected mainly in loss of time, is estimated conservatively at NIS 14 billion per year.

The government's transportation policy includes the allocation of resources for investment in the different kinds of transportation infrastructure, support for public transportation and policy steps for the regulation of the transportation sectors, and the creation of economic and competitive incentives in the vehicle, aviation, shipping and public transportation sectors. The main objectives underlying the transportation policy are:

- Providing an appropriate solution for the increase in demand for domestic traveling, mainly by upgrading and widening existing urban and interurban roads.
- Developing advanced public transportation systems, such as light trains and bus rapid transit (BRT), and improving the public transportation network so as to increase accessibility and reduce congestion, pollution and accidents.
- Improving efficiency in the allocation of road networks and vehicles, through the construction and expansion of toll roads and express lanes and enhancement of the economic incentives within the tax system.
- Bringing the periphery closer to the center by means of a system of expressways and trains.
- Encouraging competitiveness and removing barriers in aviation, the vehicle market, public transportation, shipping and seaports.

In recent years government investments in transportation development have increased significantly, because of the perception that the provision of transportation services by the government as a public product is essential for sustaining economic growth.



As shown above, transportation development budgets have grown from NIS 5 billion in 2005 to NIS 8.5 billion and more in 2009-2010. This trend is slated to continue also in the biennial budget for 2011-2012, as detailed below:

Netivey Israel (Israel Routes) Plan – To enable implementation of its development goals for the Negev and the Galilee, the government decided on this NIS 27.5 billion plan. The plan includes the development of the road network in the north: extension of the Trans-Israel Highway in the direction of the Somekh Junction and construction of an expressway from the eastern branch of Yokne'am up to the Amiad Junction. The plan also includes the laying of railway tracks to Karmiel, Afula and Beit She'an, electrification of the national railway system, procurement of railroad rolling stock and extension of the Trans-Israel Highway southward, as well as advancement of the planning of other projects.

Investment in road and mass transit infrastructures – Since 2005 the government has invested NIS 26.6 billion in the urban and interurban road network, inter alia, in the framework of the five-year plan of the Israel National Roads Company, which is due to be completed this year, and in the framework of the Ministry of Finance's economic acceleration plan. A new five-year plan is presently in the works for the National Roads Company, to include the completion of the existing projects as well as the planning and execution of projects on an annual scope of more than NIS 3.5 billion.

In addition to this Israel's first mass transit system is being set up in Jerusalem with the BOT method, with a government investment of NIS 3.2 billion, is set to become operational in 2011. A mass transit (BRT) system based on high-capacity buses, at a budgetary investment of NIS 1 billion, is expected to begin operating in Haifa in 2012. Preparatory works for building the Red Line of Tel Aviv's light train are nearing completion, at a government investment of NIS 1.2 billion, and construction works on the system by the concessionaire are slated to begin in 2011. Concurrently, work on several other systems will be advanced: in the Tel Aviv metropolis – the Green Line and the Purple Line, in the Jerusalem metropolis – BRT lines and branches and extensions to the light railway line, a BRT system in the Sharon area and a BRT system in Netanya.

Besides these processes, several supplementary policy steps have been proposed in the framework of the economic plan:

In the area of public transportation – The economic plan for 2011-2012 proposes passing regulation on the public transportation licensing system in Israel. the goalsto improve the government's management tools in the public transportation sector and the level of service provided to the public, while increase competition in the sector and incorporate technological systems. Over the past decade, the public transportation sector has been undergoing comprehensive reform, which began with the opening of the sector to competition as a key element of the public transportation management policy. As an outcome of this reform, public transportation operators have been added to the sector, the public transportation operating areas have been expanded and service to the citizen has been improved, in parallel with a reduction in operating costs.

Economic incentives in the area of demand management – The economic plan for 2011-2012 includes the establishment of a team that will examine all aspects related to taxes on vehicles so that the taxation system should also reflect the need for managing demand for traveling in general, and in congested areas in particular. In addition, the plan advances a proposal for completing the necessary legislation for the operation of an express lane at the entrance to Tel Aviv.

Advancement of the Reform in the Property and Land Market

Recent years have witnessed a rise in residential housing costs, mainly in the center of the country. A low prime interest rate, long-term interest rates and a limited supply of land zoned for construction, coupled with a tax policy that favors other investment channels, have pushed up prices of properties in the housing market, resulting in increased rental prices. Since the supply of apartments in the short-term is inelastic, a significant part of heightened market demand has led to a substantial price increase. In order to moderate price increases it is necessary to increase the housing supply. At the same time, an action that spurs market demand, such as subsidization of mortgages and tax benefits on apartments and the like, will immediately translate into a further rise in apartment prices and in rent.

Given the shortage in land zoned for construction in approved plans for the center of the country, the possibility of influencing housing prices in the short term is limited. Therefore, and concurrently with specific action to remove barriers in the short-term, several steps are proposed that will enable an increase in the housing supply in the medium and long term.

- It was decided to work to remove the planning and development barriers preventing the realization of residential projects by setting up a committee for the removal of barriers, headed by the Prime Minister. The committee will solve disagreements between government ministries on planning and development issues.
- It is proposed to consider a policy aimed at encouraging the rapid return of agricultural land that has been rezoned for another purpose. To this end, it is suggested to expand the legal tools available to the government for evicting holders of land whose lease contract has expired and which is needed for residential construction.
- It is proposed to act to increase urban density by removing barriers and enhancing the economic viability of implementing vacate-and-build ("Pinuy-Binuy") plans and for reinforcing buildings against earthquakes through increased efficiency in handling recalcitrant residents, granting tax benefits and municipal property tax breaks and facilitating the declaration of vacate-and-build sites. It is further proposed to act to increase the economic feasibility of national outline plan TMA 38, by increasing the building percentages permitted under the plan, allowing migration of building rights, expanding the application of the outline plan to building protection and easing conditions for reinforcement plan approvals by the Supervisor of Lands.
- Dealing with problems related to the shortage of lands zoned for construction in approved plans in high-demand areas. For this purpose, as part of the economic plan, the planning policy was updated and quantitative targets were set for the promotion of plans and their approval by the planning institutions, in order to meet the housing demand.

These steps will accompany other basic reforms promoted by the government concerning land and planning, among them the implementation of the reform program at the Israel Lands Administration. The main points of this reform are the transfer of land ownership to lessees and establishment of an Israel Lands Authority, as well as the promotion of comprehensive reform in construction planning and licensing, which is concerned primarily with the decentralization of powers to the local planning and building committees, shortening of planning and licensing processes, reducing the number of committees examining plans, gradual cancellation of the district plans and limitation of compensation in respect of plan approval.

Improving Service to the Citizen and Reducing Bureaucracy

The state is responsible for providing various public services, which are provided by the state or by public bodies, such as statutory authorities and government companies, or by the public sector which provides the services on behalf of the government. In addition, the local authorities provide various services. A key parameter in competition is the "quality of service," and therefore the service provided by the private sector has a built-in incentive for improvement of the service. In contrast, in public services, which are generally provided without competition, there is mostly no built-in incentive to provide better service.

As a general rule, public services can be divided into services provided to citizens and services provided to businesses in connection with their activity. The state provides a broad range of services to its citizens, including service at branches, by telephone and over the Internet. In the absence of a built-in incentive for improving the service, it is necessary to manage and monitor the services provided to the citizen in order to maintain a high service level.

Facilitating "Doing Business"

A major hardship faced by businesses is the bureaucratic burden, which exacts a heavy toll in resources. Improving the ease of doing business could result in a savings of these resources and channeling them to productive activities. Reducing the bureaucracy entailed in doing business, such as the ability to effectively enforce business contracts and receive permits from the authorities in a transparent and efficient manner, could aid the growth of the business sector, mainly of small and medium sized businesses.

There are several international economic bodies that issue comparative reports and periodical publications reflecting Israel's ranking compared to other countries in the of ease of doing business, based on recognition of the importance of the issue of bureaucratic conduct and the burden it imposes on the business sector.

The Doing Business report, published every year by the World Bank, examines the ease of doing business in 183 economies worldwide. The report ranks these economies in ten different areas related to doing business. In this report Israel was ranked 29th in the world place in 2010. It should be noted that, the Ease of Doing Business Index serves as the key index in the decision-making processes of investment consultants and international corporations.

Under Government Decision No. 452 from June 21, 2009, an interministerial committee was set up, headed by the Ministry of Finance's director-general, to examine the report's results. The committee focused on two main topics which the World Bank report indicated are especially problematic in Israel: starting a business, in which Israel is ranked 34th in the world, based on the fact that registering a new business with the relevant authorities in Israel takes an average of 34 days; and registering property, in which Israel is ranked 147th in the world, based on the fact that property registration takes an average of 144 days. The economic plan for 2011-2012 includes a proposal to adopt the committee's interim conclusions, both regarding starting a business, as detailed above, and regarding registering property, so as to shorten the time of registration of a transaction and render the land assessment process more efficient. In addition, an amendment to the Business Licensing Law, 2009, is being advanced in the Knesset, aimed at reducing the bureaucracy entailed in doing business in Israel. An improvement in these processes is expected to result in an improvement in Israel's business environment.

The interministerial committee will continue its activity during 2011-2012, focusing on other topics that make it difficult to do business in Israel.

On August 8, 2010 Government Decision No. 2201 was adopted, for improving government service to the public. The decision determines that measurements will be taken in government units that serve the public, and a Government Public Service Index will be published regularly. In addition, a government customer service unit will be set up and a pilot will be run for a unified government call center. Pursuant to the decision, an interministerial committee was set up to submit a plan for the implementation of decision's principles.

Increasing the Court System's Efficiency

Since the mid-1970s, the legal system has been contending with continual growth in the scope of court activities, as a derivative of the economic growth and increased market sophistication experienced by Israel in this period, coupled with a steep rise in the number of lawyers and growth in various social phenomena, such as an increase in crime (including organized financial crime). The burden imposed on the legal system is reflected in the protracted time of handling cases, the number of cases closed in a year, a steady rise in the system's inputs, and more. Thus for example, the inventory of pending cases in any given year in the past decade stands at 450-500 thousand, while the number of closed cases per judge decreased from 1,500 cases in 2004 to 1,080 cases in 2009. This situation prevails in spite of substantial injections of resources into the system in recent years, including a significant increase in the number of judges and registrars (from 462 judges in 2000 to 623 judges in 2010).

In recent years, several changes have been implemented aimed at improving and increasing the efficiency of the court system. These include an increase in the number of judges and registrars as well as in the number of court secretaries, the construction of new courthouses, the establishment of departments for routing cases, the allocation of legal aides and interns to assist in the work of the judges, the reduction of judicial panels in order to save judicial time, referral to mediation or arbitration processes, assimilation of judicial time management methods, training and instruction in the field of judicial administration, etc. However, these steps have not been enough to meet the rising demand for the system's services. Hence, it is necessary to institute a wide-ranging and inclusive process that will lead to a significant reduction in the inventory of cases, shorten the duration of handling of cases and lighten the load on the courts. Implementing this process entails a careful and in-depth examination of the court system at all its levels, studying the relevant processes and drawing operative conclusions, while taking into consideration the accepted norms in this regard around the world.

Already at this stage it is possible to point to some of the defects that contribute to the increased load described above, and the tools for dealing with them, based on the recommendations of the Committee to Examine Ways of Increasing the Efficiency of Legal Proceedings, headed by Judge Ruth Ronen, which was set up in 2008. The committee has pinpointed various problems in the system, such as no fees for interim motions, no duty to impose legal costs and attorneys' fees on the litigants, various legal procedures which are ineffective and needlessly complicate the system, etc. The committee has also suggested various ways of streamlining and improving the work processes, so as to lighten the burden on the system and improve the service to the citizen.

Accordingly, the economic plan proposes to act simultaneously on two fronts – to implement specific steps in the immediate term, based on the committee's recommendations, and concurrently – to conduct an in-depth examination of the system as a whole. As stated, these actions will lead to an improvement in the service to the citizen, in a manner contributing to private business activity in the economy and increasing public satisfaction with the system.

Other Key Economic Steps

Improving Competitiveness in Domestic Markets

The Communications Market

Cell phone industry – The cell phone industry is central in the Israeli communications market. In 2008 it had an operating turnover of NIS 18 billion, with the average annual household expenditure on cell phone services that year amounting to NIS 4,000. It is important to note that the household expenditure on cell phone services increases as a percentage of income, as the level of household income decreases. Thus, a household in the lower five deciles spends 5% of its income on cell phone services, compared to 1.5% in the upper five deciles. In other words, the burden on lower-decile households is significantly greater than on upper-decile households.

The cell phone industry is highly centralized and has barriers that prevent the entry of new competitors into the market, in spite of the industry's enormous profitability (EBITDA of NIS 6 billion per year) – approximately 35% of the sales turnover. This is indicated, among other things, by price levels in the industry, low portability, barriers to consumer migration and wide differences between the prices offered to corporate consumers and those offered to private consumers.

Given the clear and natural advantage enjoyed by existing operators over a new operator entering the cellular market, mainly in the field of infrastructures, and owing to the high entry barriers to this market, intervention is required for promoting competition in the field and enabling the entry of an additional cellular operator.

To this end, and further to related government decisions, the economic plan proposes a set of tools for enabling the entry of additional operators, key among which are:

- Obligating existing operators to provide a new operator with roaming services (use of the existing operators' networks).
- Removing consumer migration barriers.
- Reform in the field of cellular end equipment.
- Creating a reasonable planning track for the setup of a network by a new operator.
- Issuing licenses to cell phone operators operating on the Internet (VOB).

Broadband sector – The broadband sector is another significant component of the communications industry, in terms of high-speed Internet access and advanced content services, and as a basis for other communication services reliant on this infrastructure. In Israel there are two broadband infrastructures – the one, a DSL infrastructure used by Bezeq, and the other, a cable infrastructure used by Hot. Numerous studies conducted on the effects of expanding broadband penetration and usage have shown the great importance of Internet infrastructure deployment in promoting economic growth. Benefits include: contribution to economic growth, narrowing of social gaps and encouragement of innovation in various fields.

The existing infrastructure providers (Bezeq and Hot) are presently upgrading their networks. These upgrades are expected to enable the Israeli consumer in the near future to enjoy Internet access at speeds and prices approaching today's internationally accepted standard, but nevertheless will not place Israel at the forefront of global development of infrastructures and Internet access. Moreover, the limited competition between the infrastructure providers and their respective different interests along the market's value chain (in the television, telephony and cellular sectors), calls into question whether in the medium and long term as well, Israel will succeed in developing infrastructures enabling the provision of efficient and advanced service to the Israeli consumer.

In contrast to other corporations, the Israel Electric Corporation enjoys the advantage of overhead deployment of the electricity network up to the customer's home (according to IEC data, some 90% of the network, compared to a negligible percentage for Bezeq and Hot), which will enable rapid and inexpensive deployment of a fiber optic network on the IEC electricity network.

In light of this, the government has decided to permit the IEC to operate in the communications market as an additional operator of a fiber optic-based broadband infrastructure (Fiber to the Home – FTTH). This activity will be carried out in the framework of a mixed company, which will be privately controlled and structurally separate from the IEC. The company will be subject to additional limitations forbidding cross-subsidizing between electricity and communications activity. Apparently, this decision does not require legislative amendments.

The establishment of such infrastructure will position Israel at the cutting edge of global technology and allow the economy to benefit from significant advantages in this field.

Prevention of Trade Restraints in the Shipping and Agriculture Sectors

Israel's shipping sector enjoys a historical exemption from the restraint of trade laws. This exemption allows shipping companies to enter into agreements with each other for the fixing of prices and coordination of services, without the Anti-Trust Commissioner being able to examine these agreements. In recent years there is a prevailing trend among developed economies to limit exemptions from the restraint of trade laws, out of an understanding that competition in the sector increases benefits to users. Thus, for example, a report of the OECD recommended member countries to limit such exemptions, and in Europe, in 2008, the exemption on conference agreements was cancelled and the one on consortium agreements was revised, including a change in the conditions for its application.

Application of the restraint of trade laws in the shipping sector is consistent with the desire to increase competitiveness so as to reduce payments on transport services and raise the level of service. Applying these laws will bring the regulatory situation in the area of trade restraints in line with global trends and with the situation in the European Union. Furthermore, this step supplements the reform in port tariffs which is expected to be implemented in the course of the year.

A similar step was taken in 2006 in the airline industry, and since 2009, in parallel with the institution of a class exemption, airlines submit various agreements for approval by the Anti-Trust Commissioner. It should be noted that some of the agreements submitted to the commissioner were not approved, since, in the commissioner's opinion, they imposed a restraint on trade and harmed consumers' welfare.

The exemption granted for agreements in restraint of trade relating to the cultivation and marketing of agricultural produce is intended first and foremost to protect the farmers, due to the imbalance between them and the retailers, given the short shelf life and seasonality characterizing agricultural produce, as well as the scope of operations of the individual farmer. At the time the law was enacted, the exemption was also granted to wholesalers, since most wholesalers were actually the farmers themselves through various grower organizations. However, over the years the large retailers in the market also began wholesale marketing, a change that undermined the balance the lawmaker was aiming at, thus enabling retailers to reap both the producer's surplus and the consumer's surplus.

Accordingly, it is proposed to apply the Restrictive Trade Practices Law to any wholesaler who is also a retailer, and to allow farmers and nonretail wholesalers to benefit from the exemption on agreements in restraint of trade.

Health System

During 2008-2010, NIS 1.3 billion were added to the health services basket provided through the health funds, to cover the inclusion of new technologies and services in the basket. In 2010 the government decided to allocate out of this amount a sum of NIS 65 million for the inclusion of a new area in the public health basket – children's preventive and maintenance dental care.

With the approach of 2011, the government approved the agreement between the minister of health and the minister of finance for the years 2011-2013. The agreement provides that in each of these years, a sum of NIS 300 million will be added to the health services basket, to cover the inclusion of new technologies and services in the basket. Apart from this, in 2011 a sum of NIS 127 million will be added to the health services basket, and in each of the years 2011-2012 a sum of NIS 80 million will be added for expanding dental care for children up to age 14.

In addition to these amounts, the government increased the budget given to health funds in respect of population growth and aging by NIS 90 million per year, relative to the amount set in 2008-2010. Accordingly, a total of NIS 1.45 will be added for health services provided through the health funds.

During 2008-2010 all government hospitals operated in accordance with procurement agreements that were signed with all the health funds. Within the framework of its budgetary decisions, the government adopted the recommendations of an interministerial committee concerning accounting arrangements between the hospitals and the health funds for 2011-2013. Such accounting arrangements are established every three years in temporary orders, and they serve as the basis for procurement agreements between the health funds and the hospitals.

Another challenge facing the health system in the coming years is the need to improve the management of the system's resources, including manpower planning and management and the allocation of manpower according to national needs. Accordingly, the government adopted, within the framework of the economic plan, several proposals aimed at improving the management of the health system, as detailed below.

- Establishment of a team to examine overall manpower management in the health system, including planning of the specialization system and the allocation of powers among the different professions in the health system.
- Improving the method of selection of hospital directors.
- Establishment of a team to lay down rules for additional work of doctors in the government service.
- Possibility of the issuance of prescriptions by pharmacists.

It is further proposed to institute the temporary order for reporting of donations in the health system as a permanent statute, to extend the reporting obligation to additional bodies and to add requirements for reporting the amounts of the donations. In addition, it is proposed to act to improve the efficiency of the appointment scheduling system for visits to medical specialists and other visits that entail a co-payment, by allowing the health funds to charge up to NIS 10 for unjustified failure to cancel a prescheduled appointment.

Defense

On July 29, 2007 the government adopted, in Decision No. 2119, the main recommendations of the Committee to Examine the Defense Budget ("the Brodet committee").

The Brodet committee's recommendations comprise two main elements: a significant budget increase, subject to efficiency measures enabling the defense establishment to meet the task of strengthening the IDF. Accordingly, the committee recommended a budget increase of NIS 46 billion for the defense system, to be implemented gradually over a decade, together with efficiency measures meant to free up internal resources totaling NIS 30 billion from the baseline budget, gradually over a decade (sections 31-35 of the main recommendations).

In this connection, the committee emphasized, as a guideline for its work, knowing the scope of the budgets required by the defense system over the years and the challenges facing Israel, that "a solution based solely on a budget increase to the exclusion of all other components, will not only fail to solve the problem but exacerbate it and drive other parts of the economy as well as Israeli society into crisis" (page 29 of the report).

The committee also recommended main efficiency aspects to be led by the defense system in its field, including streamlining the manpower department – i.e. permanent army personnel, civilian employees of the army and Ministry of Defense personnel; savings in the areas of retirement and pensions; outsourcing and transfer to civilian responsibility, and elimination of redundancies between the IDF and the Ministry of Defense and within the army itself (section 15 of the main recommendations), while emphasizing that the proposed efficiency plan does not exhaust the full potential for efficiency measures (section 1 of the main recommendations).

Another committee recommendation is shortening the duration of mandatory army service starting from 2011, as determined in Government Decision No. 4711 from February 26, 2006, which adopted the recommendations of the Ben Bassat committee dealing with this subject. It should be emphasized that these recommendations were adopted about a year after the end of the Second Lebanon War, when challenges and threats facing Israel stood before the members of the committee and the government.

The government's decision regarding the defense budget was fully implemented in terms of the budget increase. However, most of the efficiency measures recommended in the Brodet committee's report were not implemented at all, or only partially. Thus, for example, the subjects of retirement age, elimination of redundancies and others were not dealt with.

The defense system began considering aspects for streamlining some two years after adoption of the report, even retaining an outside consulting firm for this purpose, but has still not begun implementing the conclusions, which relate only to certain efficiency aspects from the outset, and has not addressed any of the central manpower issues adopted by the government (as detailed above).

Moreover, even after the adoption of the government decisions on the defense budget and their full implementation in terms of budgetary increases, the defense system adopted decisions and summaries that overrun the budgetary framework established by the government.

Consequently, it was decided, in the framework of the economic plan for 2011-2012, to adjust the rate of increase of the defense budget to the rate set in the Brodet committee's main recommendations (with the budgetary amounts granted or earmarked for the defense establishment beyond this framework to be diverted to civilian areas). Furthermore, it was decided that the defense budget baseline should increase only in accordance with the recommendations in the Brodet report, i.e. a deduction of NIS 1.4 billion in 2011 and a deduction of NIS 1.3 billion in 2012.

In addition, it was decided in the framework of the economic plan to raise the average retirement age for all IDF soldiers from the current age of 45 to age 50, in a process to be finalized between the Ministry of Finance and the IDF.

Besides these decisions, the Prime Minister instructed the Ministry of Finance and the Ministry of Defense to hold discussions on the Ministry of Finance's proposal to shorten the duration of compulsory military service by a month for each recruitment cycle during the next six years, and in the absence of agreement – to refer the subject to the Cabinet for a decision.

To improve the efficiency of Ministry of Defense contracts, and as part of the process of equalizing the Ministry of Defense with other government ministries, the Prime Minister gave instructions for the continued work of the interministerial committee on the subject of the Tender Obligation Regulations. The fact that the IDF is one of only a few public bodies whose wage system is not managed by the Office of the Accountant General in the Ministry of Finance and is not under the direction of the Accountant General, necessitates regulating this area in such a manner as to gradually bring the IDF wage system under the management and direction of the Ministry of Defense's accountant.

Budget Proposal for Fiscal Years 2011-2012

Expenditure Frameworks

- The gross state budget proposal for fiscal years 2011-2012, including the revenue-dependent expenditure, totals NIS 366.8 billion in fiscal year 2011 and NIS 385.0 billion in fiscal year 2012.
- The budgetary expenditure for calculating the expenditure limit in fiscal years 2011-2012 stands at NIS 271.2 billion in fiscal year 2011 and at NIS 284.7 billion in fiscal year 2012.
- The budgetary expenditure for 2011, as defined for calculating the expenditure limit, is 2.7% higher in real terms than the budgetary expenditure for calculating the expenditure limit for 2010 (original budget net of onetime expenditures added in the years 2009-2010 to cope with the effects of the global economic crisis on the domestic economy). The above mentioned real growth consists of an increase of NIS 6.7 billion as a derivative of the total expenditure, a further addition of NIS 5.2 billion due to price adjustments, and the aforesaid onetime deduction of expenditures, in conformity with the fiscal rule.
- The budgetary expenditure for 2012, as defined for calculating the expenditure limit, is 2.7% higher in real terms than the budgetary expenditure for calculating the expenditure limit for 2011 (the budget proposal).

Changes in the Budget Proposal

The budgetary expenditure for calculating the expenditure limit grew in the years 2011-2012 by 7.3% and 5% respectively. In accordance with the government's policy, the main increases in the state budget for 2011-2012 will be in social issues (education, health and National Insurance), in transportation infrastructures, in public security and in transfers to the local government and the business sector.

These increases, as prioritized by the government, are enabled due to the fiscal responsibility shown by the government, which led to a decrease in the public debt and in the government deficit as a percent of GDP and to a reduction in interest payments, and also due to the government's decision to implement a real cut in the Ministry of Defense budget.

Below are the main changes in the budget proposal for fiscal years 2011-2012 relative to previous year:

- Interest payments will be reduced in fiscal year 2011 by 3.1% relative to the Budget Law for 2010. The decrease in interest payments in 2011 stems from a lower government deficit than expected in the years 2011-2012, as well as expectations of a relatively low interest environment and a decline in the value of the dollar-denominated debt due to the shekel's appreciation against the dollar. In the fiscal year 2012, interest payments will grow by 4.7% relative to the budget proposal for the fiscal year 2011. The expected increase in interest payments in 2012 stems primarily from the projected rise in interest rates and the continued growth in the government debt due to the budgetary deficit. We note that interest payments in fiscal year 2012 will rise relative to the Budget Law for 2010 by only 1.5%. It should be borne in mind that this is a nominal increase due to the growth in the nominal debt. An examination of the proportion of interest payments in the GDP shows a decline from 4.7% of GDP in 2010 to 4.2% of GDP in 2012. This increase of 1.5% is also significantly lower than the increase in the budgetary expenditure for calculating the expenditure limit.
- Civil expenditure for the fiscal year 2011 will increase by 6.7% relative to the Budget Law for 2010. In the fiscal year 2012, the civil expenditure will increase by 5.3% relative to the budget proposal for the fiscal year 2011. These budget increases are similar to the increase in the budgetary expenditure for calculating the expenditure limit in the years 2011-2012, and they derive from the government's policy of comprehensive treatment of the R&D and high-tech industries, strengthening of education (including the continued implementation of the New Horizon reform in the education system), implementation of the reform in higher education and bolstering of the internal security system.
- Defense expenditure for the fiscal year 2011 will increase by 1.9% relative to the Budget Law for 2010. In the fiscal year 2012, the defense expenditure will increase by 2.9% relative to the budget proposal for the fiscal year 2011. These budget increases are lower than the increase in the budgetary expenditure for calculating the expenditure limit in the years 2011-2012, and enable, as noted, increases in other areas of expenditure. The moderate growth in defense expenditure in the fiscal years 2011-2012 is a result of the government's decision from July 15, 2010 to implement a real cut in the Ministry of Defense budget, deriving from the Brodet committee recommendations and other considerations. In addition, the U.S. aid budget increased between 2010 and 2011 by 225 million dollars (at the same time, the sharp appreciation of the shekel between 2010 and 2011 reduced the shekel-denominated value of the aid). Between 2011 and 2012 the U.S. aid budget grew by a further 75 million dollars (which will be reflected in an increase in the shekel budget, assuming the shekel stops appreciating).
- Transfer and support payments will increase in the fiscal year 2011 by 11.2% relative to the Budget Law for 2010. In the fiscal year 2012, transfer and support payments will

increase by 5.4% relative to the budget proposal for 2011. These budget increases are significantly higher than the increase in the budgetary expenditure for calculating the expenditure limit in the years 2011-2012. The growth in transfer and support payments in the fiscal years 2011-2012 stems from the government's policy of significantly raising the allowances paid by the National Insurance Institute, increasing government offset grants to cover the difference between the income and expenditure of local authorities, funding local government recovery plans, incorporating new technologies and medications in the health services basket, and increasing the budget transferred to the business sector.

- Investments and credit granted will increase in the fiscal year 2011 by 14.2% relative to the Budget Law for 2010. In the fiscal year 2012, investments and credit granted will increase by 5.5% relative to the budget proposal for the fiscal year 2011. As with the transfer and support payments, these budget increases as well are significantly higher than the increase in the budgetary expenditure for calculating the expenditure limit in the years 2011-2012. The growth in investments and credit granted in the fiscal years 2011-2012 stems mainly from government decisions to increase expenditures on transportation infrastructures, including accelerated development of public transportation infrastructures and mass transit systems.
- Principal payments (loan principal repayments), excluding principal repayments to the National Insurance Institute, will increase in the fiscal year 2011 by 11.2% relative to the Budget Law for 2010. In the fiscal year 2012, principal payments, excluding principal repayments to the National Insurance Institute, will increase by 5.5% relative to the budget proposal for 2011. The changes in principal payments are an outcome of the structure of the debt amortization schedules. These payments are not included in the calculation of the deficit and in the calculation of the permitted expenditure under the Deficit Reduction and Budgetary Expenditure Limitation Law, 1992.

Gross Expenditure by Economic Classification

(In NIS thousands)

	2009 Budget Performance	2010 Original Budget	2011 Budget Proposal	2012 Budget Proposal
Net expenditure	**306,836,623**	**325,287,959**	**348,185,234**	**365,916,172**
Revenue-dependent expenditure	11,687,002	16,511,485	18,652,664	19,072,349
Total gross budget (1+2)	**318,523,625**	**341,799,444**	**366,837,898**	**384,988,521**
1. Total expenditures and credit granted	**257,932,911**	**272,554,444**	**289,848,898**	**303,729,521**
1.1 Civilian consumption	54,868,514	63,287,684	67,382,623	70,292,079
Domestic payroll	36,108,867	39,125,472	42,446,777	44,008,434
Domestic procurement	16,863,186	21,839,411	22,786,220	24,082,734
Payroll and procurement overseas	1,896,461	2,322,801	2,149,626	2,200,911
1.2 Defense consumption	58,369,906	53,782,582	54,094,605	55,627,109
Payroll	20,756,058	22,515,432	22,131,433	22,831,778
Transfer payments	2,300,265	2,219,208	2,234,275	2,256,393
Procurement	23,313,128	17,232,029	18,540,836	19,114,180
Construction	3019735	1,005,405	1,005,405	1,005,405
Overseas procurement	8,619,736	10,480,816	9,768,128	10,011,780
Emergency expenditures and coordination of operations in the territories	360,984	329,692	414,528	407,573
1.3 Transfer and support payments	88,807,256	87,463,127	96,942,527	101,283,083
To local authorities	12,875,996	12,340,450	14,185,339	14,257,990
To religious councils	189,179	230,193	235,839	238,707
To individuals and institutions	46,885,023	45,121,749	49,909,736	52,545,170
Subsidies for basic commodity prices	2,359,469	2,690,683	2,880,395	3,175,926
Transfers to National Insurance Institute	26,497,589	27,080,052	29,731,218	31,065,290
1.4 Investments and credit granted	14,932,682	17,417,890	19,894,819	20,982,781
Direct investment	13,487,126	14,914,338	17,416,610	18,309,547
Of which: Housing	1,907,433	1,997,148	2,898,219	2,765,983
Of which: Credit granted	1,445,556	2,503,552	2,478,209	2,673,234
Of which: Housing	519,841	819,232	706,425	714,177

Gross Expenditure by Economic Classification (cont.)

		2009 Budget Performance	2010 Original Budget	2011 Budget Proposal	2012 Budget Proposal
1.5	Interest payments and credit subsidies	33,572,019	38,039,320	36,838,176	38,,577,176
	Domestic interest payments	27,942,325	30,962,000	30,887,000	31,673,000
	Credit subsidies	4,345	22,320	7,176	7,176
	Overseas interest payments	5,625,349	7,055,000	5,944,000	6,897,000
1.6	Miscellaneous expenses	7,382,534	7,523,000	8,428,000	9,097,000
	Principal repayment to National Insurance	7,382,534	7,523,000	8,428,000	9,097,000
1.7	Reserves		5,040,841	6,268,148	7,870,293
2.	**Debt repayment – principal**	**60,590,714**	**69,245,000**	**76,989,000**	**81,259,000**
	Domestic repayment to the public	52,928,982	55,840,000	71,345,000	72,601,000
	Debt repayment overseas	7,661,732	13,405,000	5,644,000	8,658,000

Analysis of Budget Proposal Development in Fiscal Years 2005-2012

The section presents an analysis of the budgetary expenditure development between the years 2005-2012. The first part shows the development of the budgetary expenditure by main areas of operation, such as defense and public order, education, health, etc. The second part shows this development by economic classification, that is, the development of the expenditure on payroll, procurement, transfer payment, etc. These analyses are presented in two ways: The first presents the real change in each of the areas over time. The second presents the change in the distribution of the budgetary expenditure, that is, the change in the share of each area out of the total budgetary expenditure. One can see from this comparison which areas of expenditure increased their relative proportion in the budgetary expenditure over the period and which areas of expenditure contracted and freed up funds within the budgetary framework. These changes in the budgetary distribution can stem from changes in priorities, but also from the creation of extra-budgetary mechanisms as well as internal dynamics within the budget that lead to different behavior of each expenditure component.

Although the budgetary expenditure represents the substance of the government's budgetary policy, there are other operations and expenditures which are funded by the public that are not given full expression in the budget itself. Therefore, in order to gain a complete picture of the development of the government expenditure, these too must be taken into account. The most notable expenditures in this context are the expenditures of the National Insurance Institute and the expenditure on the health basket, which will be discussed in the analysis of the areas of expenditure. Other operations of the government which are not given full expression in the budgetary expenditure are discussed in brief in the third part.

Development of the Budgetary Expenditure by Main Areas of Operation

Between 2005-2012, the total budgetary expenditure (excluding revenue-dependent expenditures) grew by 12% in real terms, a real average annual increase of 1.6%. As a result of the decrease in the proportion of the expenditure on interest in the total budget, due to relatively low government debt growth and lower interest rates on the debt, the total budgetary expenditure net of interest expenses grew in these years by 16% (2.1% real average annual increase).

The main areas of expenditure in the budget proposal for 2011-2012 are defense and public order, which account for one-quarter of the budget, schooling and higher education (15%), welfare and social security (14%) and interest (14%).

The main areas of expenditure whose proportion in the total budgetary expenditure grew over these years are: welfare and social insurance, on which the expenditure rose at a real average annual rate of 3.2% (causing the share of this expenditure to increase by 1.4 percentage points), schooling and higher education, on which the expenditure rose at a real average annual rate of 2.7% (increase of 1.1 percentage points), and transportation, on which the expenditure rose at a real average annual rate of 4.7% (increase of 0.9 percentage points). The main area of expenditure in which a decrease was recorded is interest, which decreased at a real average annual rate of 1.4%, as a result of which its proportion in the budget contracted significantly (decrease of 3.2 percentage points).

An examination of the developments between 2009-2012 shows that the areas whose proportion increased significantly are health and education, while the main decrease was in interest. It should be noted that the calculations presented in this section are based on the net expenditure, and therefore they do not take into account the expenditures of the different ministries which are dependent on earmarked revenues. Thus for example, in recent years the increase in U.S. defense aid was recorded as a revenue-dependent expenditure, and therefore the overall increase in the defense expenditure is greater than the increase appearing under the net expenditure.

Net Budgetary Expenditure, 2005-2012, and Distribution by Main Areas of Expenditure

Original Budget, NIS Billions, at Current Prices

	2005	2006	2007	2008	2009	2010	2011	2012	Change in Percentage Points between 2005 and 2012	Cumulative Change in Real Terms*
Total expenditure	215.5	219.0	230.0	235.7	248.2	256.0	271.2	284.7		12%
Distribution of main areas of expenditure out of the budgetary expenditure										
Defense and public order	25.5%	25.2%	26.9%	26.6%	24.7%	25.7%	24.9%	24.4%	-1.1%	7%
Schooling and higher education	14.5%	14.7%	14.1%	14.5%	15.0%	15.6%	15.8%	15.6%	1.1%	20%
Welfare and social insurance	12.6%	12.9%	12.9%	13.8%	14.4%	13.7%	14.2%	14.0%	1.4%	24%
Economic and infrastructure ministries	9.8%	9.6%	9.0%	8.9%	9.2%	8.9%	9.0%	9.1%	-0.8%	3%
Health	6.9%	7.0%	7.1%	6.6%	6.6%	7.2%	7.4%	7.4%	0.5%	19%
Administrative ministries	4.3%	4.7%	4.7%	4.8%	3.9%	4.1%	4.2%	4.2%	0.2%-	7%
Interest	16.7%	16.2%	15.4%	14.6%	14.4%	14.8%	13.6%	13.5%	3.2%-	-10%
Other expenditures	9.6%	9.8%	9.8%	10.2%	11.7%	9.9%	10.9%	11.8%	2.2%	37%
Total expenditure net of interest	179.4	183.5	194.5	201.1	212.6	218.0	234.4	246.1		16%
National Insurance Institute Expenditures**	41.6	43.9	45.3	48.0	53.1	57.3	60.4	63.3		29%
Health basket	22.8	24.0	24.9	26.6	28.1	29.3	31.8	33.3		24%

* The real change is calculated on basis of the change in the consumer price index, including forecasts for the coming years.

** Excluding operational and army reserve expenditures.

A methodological comment: The data are presented according to the original budget submitted to the Knesset. In practice, budgetary items may change due to alterations in the Knesset, the carrying of surpluses from year to year, urgent needs which arise in the course of the year, etc. An example of an expenditure that undergoes relatively frequent changes is the defense expenditure. Therefore, the distribution of the actual expenditure in each year in the different areas is likely to be somewhat different than what is shown in the table. Nevertheless, the cumulative changes reflect to a reasonable extent the developments over time, and as an outcome also the budgetary priorities. Furthermore, to maintain consistency, all the real changes are calculated according to the consumer price index. In practice, in order to carry out a complete analysis of the quantitative change in each area, it is necessary to use various indices. For a specific analysis of the individual areas of expenditure, see the budget proposal booklets of the different government ministries.

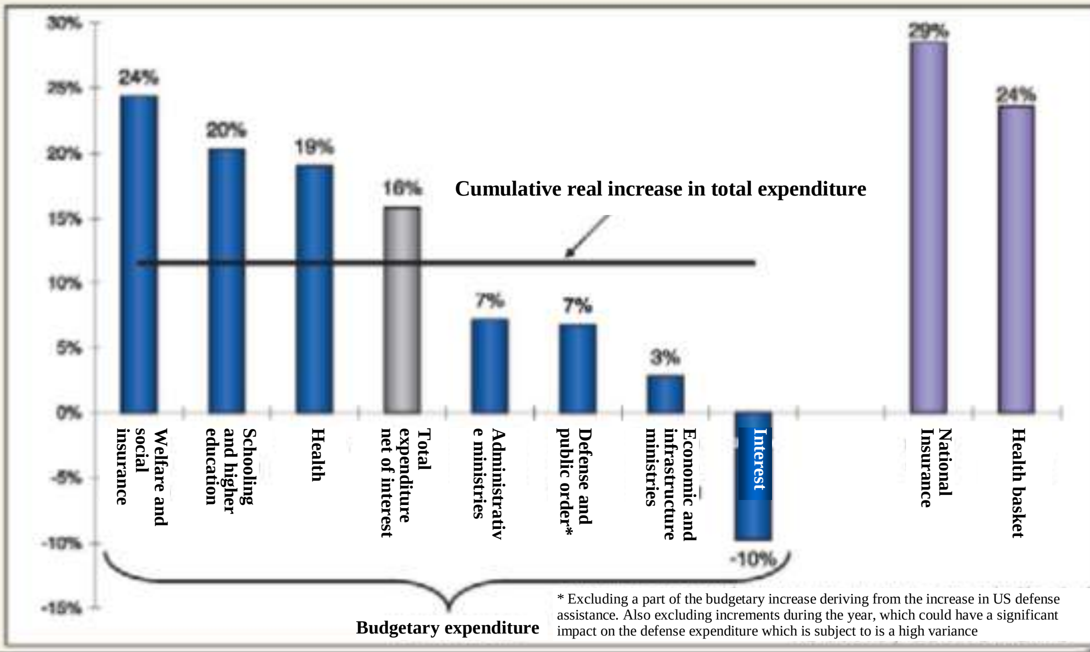
An examination of the overall fiscal policy and of the budget priorities also necessitates an examination of the public expenditure components not included directly in the budgetary expenditure. Thus for example, between 2005 and 2012 the National Insurance Institute expenditures (excluding operational expenses and excluding reserve duty payments) increased at a real cumulative rate of 29%, equivalent to an annual rate of 3.5% – a much higher rate than the rate of increase in the budgetary expenditure, which stood in this period, as stated, at 1.6%. This increase stemmed to a great extent from the increase in old-age pensions and child allowances in the past two years. Also, the expenditure on the health basket grew in this period at a rapid rate of 3% per year in real terms.

Budget Developments by Economic Classification

An analysis of the budgetary changes over time distributed by economic classification shows that the principal change recorded in these years was an increase of 3% in the share of the expenditure on payroll and benefits (out of the total budgetary expenditure), coming mainly at the expense of a decrease in the expenditure on interest payments.

It should be noted that segmenting of the change between payroll and benefits shows that slightly more than half of the increase derived from a rise in benefit payments (their share in the total budgetary expenditure rose from 4.7% in 2005 to 6.2% in 2012), despite the fact that the total expenditure on benefits is less than 40% of the expenditure on payroll. The rapid growth in the expenditure on benefits (5.7% real average annual growth % in these years compared to 2.8% in the expenditure on payroll) stemmed in part from onetime additions allocated to the pension baseline of pensioners insured in budgetary (unfunded) pension funds (as part of the agreement for transition to linkage to the consumer price index). Nevertheless, it reflects the increasing burden of the benefits on the total budgetary expenditure.

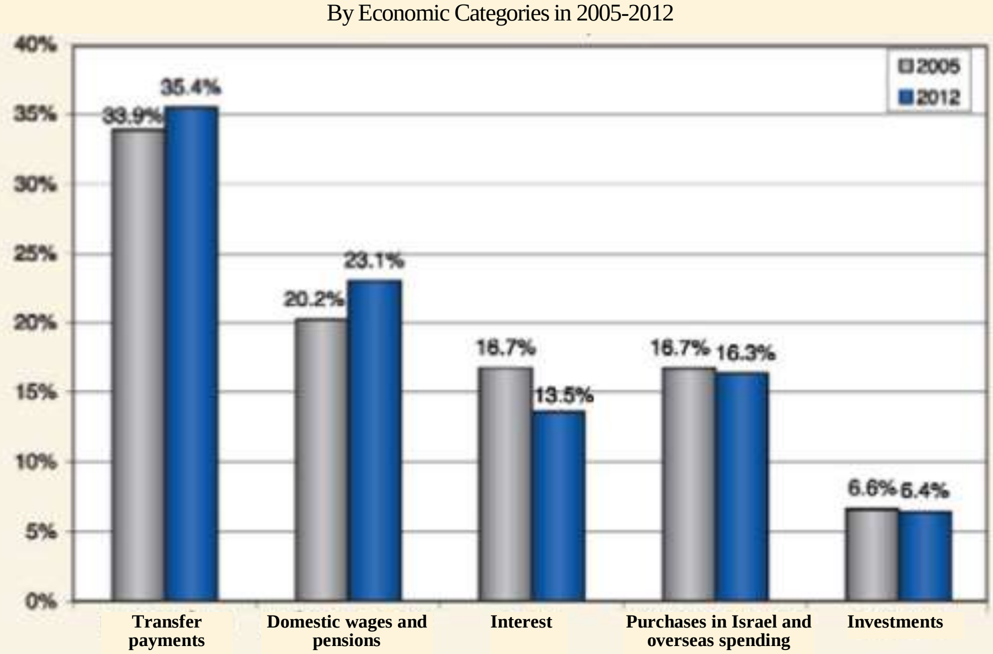
Cumulative Real Change by Expenditure Categories, 2005-2012



* Excluding a part of the budgetary increase deriving from the increase in US defense assistance. Also excluding increments during the year, which could have a significant impact on the defense expenditure which is subject to is a high variance

Change in Expenditure Components as a Percentage of the Budgetary Expenditure

By Economic Categories in 2005-2012



Note: The expenditures shown in the graph amount to 94% of the total budgetary expenditure. The additional expenditures at a rate of 6% are not classified under these economic categories. Their relative share in the budget remained unchanged at the two points in time shown.

Other Government Activities Not Reflected in the Budgetary Expenditure

A significant area that does not appear directly in the budgetary expenditure, but which must be taken into account in an analysis of the budget policy and budgetary priorities, is tax benefits. Tax benefits are in sorts a "subsidy," and therefore they should be treated, when setting economic policy and budgetary priorities, as any other budgetary expenditure. Many of the tax benefits are embodied in assistance to industry and employment, for example through the Encouragement of Capital Investments Law or through various tax credits that increase the net wage, affecting work incentives and reducing employers' payroll expenses (for a broader discussion of tax benefits, see the chapter on state revenues from taxes).

Other relevant activities are joint projects with the private sector that affect the total public investment although they do not appear fully in the budgetary expenditure, and guarantees granted to various bodies that constitute a subsidy for their operations. Additional investments made outside the framework of the state budget are investments financed directly by the public, such as investments in the electricity and water economy, which are financed fully or partially through the product tariffs.

State Deficit and Deficit Financing in Fiscal Years 2011-2012

Expenditures and Revenues for the Deficit Calculation

- The budgetary expenditure for calculating the expenditure limit stands at NIS 270.1 billion in fiscal year 2011 and at NIS 283.4 billion in fiscal year 2012.
- The forecast of revenues and grants for the years 2011-2012 stands at NIS 244.9 billion in fiscal years 2011 and at NIS 265.1 billion in fiscal year 2012.

Details of the forecast of state revenues from taxes appears in the chapter on state revenues from taxes for 2011-2012.

State Budget Deficit

The overall deficit excluding credit in 2011 is expected to amount to NIS 25.2 billion, equivalent to 2.9% of GDP, based on assumed growth of 3.8% (the forecast GDP for 2011 is NIS 864.1 billion).

The domestic deficit excluding credit in 2011 is expected to amount to NIS 22.0 billion, equivalent to 2.5% of GDP.

The deficit abroad excluding credit in 2011 is expected to amount to NIS 3.2 billion, equivalent to 0.4% of GDP.

The overall deficit (including net credit) in 2011 is expected to stand at NIS 19.9 billion, equivalent to 2.3% of GDP.

The overall deficit excluding credit in 2012 is expected to amount to NIS 18.3 billion, equivalent to 2.0% of GDP, based on assumed growth of 4.0% (the forecast GDP for 2012 is NIS 918.6 billion).

The domestic deficit excluding credit in 2012 is expected to amount to NIS 14.1 billion, equivalent to 1.5% of GDP.

The deficit abroad excluding credit in 2012 is expected to amount to NIS 4.2 billion, equivalent to 0.5% of GDP.

The overall deficit (including net credit) in 2012 is expected to stand at NIS 13.5 billion, equivalent to 1.5% of GDP.

Overall Deficit Financing in Fiscal Years 2011-2012
(In NIS billions)

Deficit Financing Sources	2011 Total	2012 Total
Net revenues from sales of companies, banks and land, net	3.8	1.8
Loans from abroad (net)	2.4	0.3
Loans from the public (net)	13.7	11.4
Total	**19.9**	**13.5**

Note: Substitution is possible among the various components of deficit financing.

Budget Deficit and Financing
(In NIS thousands)

		2009 Budget Performance	2010 Original Budget	2011 Budget Proposal	2012 Budget Proposal
	Expenditure for calculating the expenditure limit		***252,796,868**	**271,196,234**	**284,657,172**
	Net credit expenditures		1,103,552	1,078,209	1,273,234
	Expenditure for calculating the deficit		**254,939,407	270,118,025	283,383,938
	Total revenues and grants, net***		212,009,394	244,939,201	265,093,452
	Surplus (+) [deficit (-)] excluding net credit****		42,930,013	25,178,824	18,290,486
	Forecast GDP		779,868,000	864,100,000	918,600,000
	Deficit percent of GDP		5.5%	2.9%	2.0%
1.	**Total expenditures and credit granted*******	**257,932,911**	**272,554,444**	**289,848,898**	**303,729,521**
	==============================	==========	==========	==========	==========
	Of which: Domestic	241,791,144	252,695,768	271,987,144	284,619,830
	- Consumption and investment	125,627,150	129,870,392	136,756,542	142,070,602
	Of which: Domestic	115,110,732	117,066,716	124,838,788	129,857,911
	- Transfer and support payments	91,107,521	89,682,335	99,176,802	103,539,476
	- Interest payments and credit subsidies	33,572,019	38,039,320	36,838,176	38,577,176
	Of which: Domestic	27,946,670	30,984,320	30,894,176	31,680,176
	- Credit granted	1,445,556	2,503,552	2,478,209	2,673,234
	- Other expenditure	6,180,665	12,458,845	14,599,169	16,869,033
2.	**Total revenues and grants**	**224,718,683**	**233,752,184**	**269,966,965**	**290,224,701**
	=====================	==========	==========	==========	==========
	Of which: Domestic	214,253,931	218,713,037	255,287,718	275,252,146
	- Tax revenues	178,688,874	184,434,664	214,989,152	233,826,297
	- Other revenues	38,046,445	39,417,440	46,268,495	47,726,230
	Of which: Credit repayment	7,862,474	6,631,305	7,775,100	7,458,900
	- Grants from abroad	7,983,364	9,900,080	8,709,318	8,672,174

* Net budget (325,287,959), net of the onetime expenditure added to the budget for 2009-2010 for coping with the global economic crisis (3,246,091), and net of debt repayments (76,768,000) excluding debt repayments to National Insurance (7,523,000).

** Expenditure for calculating the expenditure limit, net of net credit expenditures and with the addition of the onetime expenditure added to the budget in 2009-2010 for coping with the global economic crisis.

*** Total revenues and grants net of earmarked revenues, excluding earmarked credit revenues, and net of credit repayments.

**** Used for calculating the deficit percent of GDP.

***** Budget for calculating the expenditure limit with the addition of the revenue-dependent expenditure.

Budget Deficit and Financing (cont.)

		2009 Budget Performance	2010 Original Budget	2011 Budget Proposal	2012 Budget Proposal
3.	**Surplus (+) [deficit (-)]**	**-33,214,228**	**-38,802,260**	**-19,881,933**	**-13,504,820**
	==================	==========	==========	==========	==========
	Surplus (+) [deficit (-)] excluding net credit	-39,631,146	-42,930,013	-25,178,824	-18,290,486
	Of which: Domestic	-33,656,291	-38,053,184	-21,952,317	-14,099,650
	Of which: External	-5,974,855	-4,876,829	-3,226,507	-4,190,836
	Net credit	6,416,918	4,127,753	5,296,891	4,785,666
4.	**Financing******				
	========				
4.1	Overseas loans (net)	4,446,457	3,601,500	2,356,000	342,000
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	Loans received	12,108,189	17,006,500	8,000,000	9,000,000
	Debt repayment	7,661,732	13,405,000	5,644,000	8,658,000
4.2	Domestic loans (net)	37,570,722	34,700,760	13,712,933	11,349,820
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	Loans received	90,499,704	90,540,760	85,057,933	83,950,820
	Debt repayment	52,928,982	55,840,000	71,345,000	72,601,000
4.3	Net capital gains	1,576,995	500,000	3,813,000	1,813,000
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	Privatization and sale of land	1,576,995	500,000	3,813,000	1,813,000

Note: Substitution is possible among the various components of deficit financing.