

An Economic Agenda for the New Government

Imri Tov

Opening Conditions

The strategic economic objective which the new Israeli government adopts will be geared toward optimally fulfilling its political goals, as these have been agreed upon among the coalition partners upon their entry into the government. In reality, this policy will be affected by a number of limitations. A comprehensive assessment, one which takes these limitations into account, casts in doubt the ability of the government to do much more than stabilize the economic reality it inherited. The opening conditions for the government – as of the time of this article's writing – are difficult and rife with threats, including processes which, given the small size of Israel's economy, will be difficult or perhaps impossible to affect by means of unilateral government policy alone.

The economic crisis developing in the United States, exemplified by declines in the stock market and in demand, will cause significant difficulties to the Israeli economy: The American market will reduce its imports, and Israeli high-tech industries, which had been the prime movers of economic growth, will be harmed. The harm to this sector will appear in the form of difficulties in finding new funding sources for start-up companies. This is due to the general reduction in demand and disillusionment over the dream of the "new economy," wherein future estimated profits are translated

directly into present-day market valuation. This is an illogical situation. Now, the advantages of the "old economy" – which, to maintain viability, requires a sustained and protracted continuum of success – are being recognized with greater clarity. Nonetheless the high-tech industry is of major importance to the Israeli economy, as illustrated by the growth in foreign investments: from US \$2.5 billion in 1990 to US \$13 billion in 1999. While final figures are not yet available for the year 2000, it would appear that the volume of foreign investments has not decreased from the 1999 level.

These processes – the decline in general demand and damage done to start-ups – will engender a decline in tax revenues to a degree which will likely endanger the deficit target set for the FY2001 budget. Attempts to maintain the target by raising taxes will only amplify the slowdown of the economy. Moreover, the influence of the crisis in the US economy on the economies of additional countries in Southeast Asia, South America, and even Europe will exacerbate the decline in demand for Israeli goods. The outcomes of this that can be expected include a decline in exports, a lowering of the foreign-currency exchange rate, an additional slowdown in the rate of growth, and possibly even an increase in inflation. Later, if the negative trends are not contained, the following may take place, for the first time in a decade:

capital drain, a decline in foreign-currency reserves, and problems with the balance of payments. The dimensions of these aforementioned economic developments are unclear, and there is no assurance that government policy will be able to curb them.

An additional factor which will influence economic policy is the escalation in violence between the Palestinian Authority and Israel. Since the beginning of the Al-Aqsa Intifada in late September, 2000, this violence has caused direct damage to the Israeli economy, particularly the construction, agriculture, and tourism sectors. The continuation of violence over a protracted period risks causing damage to additional sectors and, in their wake, to the capital and financial markets.

Similarly, economic policy will be influenced by the globalization processes presently affecting the Israeli economy. The significance of these processes relate to internationally-set "rules" of the economic "game" which now are dictating the actions of the local economy. Deviating from these rules would incur reactions by the international market, such as drops in Israel's credit rating, flight of capital, and burdensome demands when executing transactions.

Finally, economic policy will be influenced by the desire to preserve Israel's economic accomplishments of recent years, which were achieved at

a cost of unemployment, reduced Gross Domestic Product (GDP), and amplification of the social tensions connected with growing economic divisions within Israeli society.

Domestic political instability must also be factored into these opening conditions, instability whose result is uncertainty as to the expected political lifespan of the new government. As a result of this situation, from its first day of inception, this government will be run under the looming shadow of the next elections.

Principles for Shaping Economic Policy

The comprehensive result of the conditions described here is that the government will be given only very limited freedom of action to initiate changes. Accordingly, its efforts will be devoted – particularly in the near period – to stabilizing the economy and reducing the damage deriving from the negative developments described above.

Parallel to stabilizing the economy, the new government must reexamine the policy of balance and fiscal discipline which has prevailed in recent years and which involved giving priority to long-range goals by paying a heavy economic and social price in the short term. These goals – including containing inflation, reducing the deficit rate in the state budget, increasing foreign-currency reserves, and reducing the national debt – were achieved at the cost of unemployment, social tension, and significant loss of GDP. The new government must adopt a different policy than that of the previous government, particularly in all regards connected to the size of the deficit in

the state budget. More private and public resources must be targeted at reducing the damage which has aggregated, without harming the macro-economic achievements of previous governments.

The new government must act to bring about reduction in interest rates, while carefully following changes in the exchange rate, so that any reversals which might take place do not develop to such levels as could cause the

The continuation of violence over a protracted period risks causing further damage to the construction, agriculture, and tourism sectors and, in their wake, to the capital and financial markets.

eruption of inflation. Similarly, it must act to maintain economic achievements via investments in infrastructure – particularly in the areas of water and transportation – further opening the economy to external competition, additional encouragement of domestic competition, and completion of reforms in the tax structure. It is, likewise, necessary to balance the various social needs as part of a comprehensive approach to the economy. The practice that has developed of late, by which individual Members of Knesset have introduced expensive social programs in the form of 'wildcat' private-member bills, some of which then earned retroactive

seals of approval via coalition agreements, has caused serious macro-economic harm and needs to be ended. The comprehensive approach to the economy must balance the various needs of society, including security, education, health, and infrastructure.

The new government will not be able to exist without an approved national budget for 2001. However, sticking to this year's deficit target – 1.75% of GDP – is less crucial, for a number of reasons. First, the likelihood of sticking to the target appears to be at near-zero. Second, if adhering to the deficit goal results in reducing public expenditures and intensifying tax collection, the tensions which exist in the economy might be exacerbated, causing further slowdown. It is fitting, therefore, that the Knesset approve the 2001 budget in its present form, in the hopes that, in the meantime, the balance of political and economic forces affecting the economy will become clearer.

Body for Comprehensive Assessment

Under current conditions, there is no body in Israel that conducts integrated and comprehensive assessments of the country's capabilities, needs, goals, and priorities. The government's economic assessments, the result of which appear as the state's budget proposal, are conducted by the Ministry of Finance. Similarly, the security-military assessment is made by the defense establishment.

It would be fitting to establish an economic body which would examine national goals. This body would be part of the Prime Minister's Office; like the US Office of Management and

Budget, which reports to the President and is part of the White House. This body would weigh needs in the areas of the economy, security, education, health, and physical infrastructure, enabling the government leaders to shape the reality and the officials of the administrative authorities to understand what is required of them.

The Allocation to Security

The change in the intensity of the conflict between Israel and its geopolitical environment necessitates giving priority to preparation for continuing confrontation with the Palestinians and the possibility that this violence will escalate into a comprehensive conflict in the region. This is based on the assumption that the Palestinian Authority is aiming at escalation, in the hopes that intensified violence will cause greater losses in lives and property, dragging Israel into reacting in a way that can be depicted internationally as being inhumane. The PA's assessment is that such reactions will awaken support for the Palestinians, will make it politically difficult for the Arab states to oppose PA actions, and will force the international community to become involved in forcing a solution on Israel.

Budgets for coping with the ongoing violence must therefore be enlarged. The sources for this will be either shifts in the defense budget, which will only partially answer defense needs, or increased foreign assistance. The Treasury will be required to cope with the needs of the security apparatus via decisions about financing changes which will be taken during the course of the budget year,

without abrogating the budget framework. If answers for underwriting security needs are not found, it will be necessary to cut other expenditures and redirect them to the defense budget. In addition, it will be necessary to examine a number of budget elements having direct ramifications for the civilian sphere. Two of these are particularly noteworthy: US aid and the Israeli military industries.

It would be fitting to establish an economic body which would examine national goals, like the US Office of Management and Budget, which reports to the President and is part of the White House.

US Aid

The starting point for discussion is that the assistance received from the United States is a principal tool in Israel's security apparatus, contributing to the strengthening of the IDF and the maintaining of its qualitative advantage. In this context, it is clear that Israel's dependence on US military aid is crucial. At the same time, efforts to support local defense industries by increasing acquisition of Israeli high-tech products should be made, while US aid should be used to the greatest extent possible on low-tech products and services. While the purchase of low-tech products (i.e., uniforms, canned foods, and the like) abroad has dire ramifications for

Israel's low-tech sector and its economic periphery, solutions to these problems must be found outside of the defense budget.

In any event, efforts must be made not to reduce the extent of American aid on the basis of the flawed assumption that doing so might somehow encourage domestic defense purchases from Israeli low-tech suppliers. This assumption is flawed because, given macro-economic considerations, it is doubtful whether it will be possible to expand domestic financial outlays to compensate for a change in the level of foreign assistance.

Israeli Defense Industries

Israel's military industries are operating under increasingly disadvantageous market conditions, the result of growing competition in international arms sales. Both US and EU-based arms manufacturers benefit from the political support which they receive from their respective governments – support which the government of Israel cannot provide. The emergence of these two blocs reduces the ability of the smaller Israeli industries to compete.

As a result, it will be necessary to make a decision soon: Should these Israeli industries will continue operating independently, by limiting themselves to problematic market niches, or should they try to integrate into one of the larger blocs? In this framework, it will be necessary to discuss the question of whether there can be foreign ownership of Israeli defense industries without harming the country's security interests. This issue – which includes economic,

social, industrial, and security factors – requires examination by the body for comprehensive assessment suggested above.

If the decision is taken to adopt the

approach which calls for integration of Israel's military industry into one of these blocs, preference should be given to the US option, in view of the crucial importance of US aid to Israel.

Nonetheless, the possibility of partnerships with European industry should not be dismissed, whether for company ownership or for specific projects.

Conclusions

The economic and defense realities which the new Israeli government has inherited obligates the government to take several actions:

- To slow the rate of reduction of the state budget deficit while reducing interest rates in a controlled manner.
- To define a basket of social goals, including a timetable for their execution.
- To establish a body for comprehensive assessment that will deal with the contact points between the economy, society, and national security. The role of this body will be to make integrated policy recommendations which look beyond the range of a single budget year.
- To increase the defense budget while conducting ongoing examination (including via the external

assessment body) of Israel's security needs vis-à-vis changing realities.

- To amplify cooperation with the United States, preserving the level of US aid and examining the possibility of permitting foreign ownership of Israeli military industries.

Achieving Israel's goals within the framework of a limited national budget requires broad cooperation between the commercial and governmental sectors. Ownership, financing, operation, and supply of public services by commercial elements can serve as a key for achieving Israel's social and security goals, without abrogating the budget framework. Israel's economic strategy will, thereby, be preserved in a manner which assures long-term stability.

The Jaffee Center for Strategic Studies expresses its deep gratitude to
The Goldberg Family (Toronto, Canada)

**Martin and Susan Goldberg
Gary and Linda Goldberg
and David and Carla Goldberg**

For the support they provided to the Center's Outreach Program,
in the framework of which *Strategic Assessment* is published.