Key Challenges Facing the Israeli Economy and their Ramifications for National Security

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Two topics taking center stage in Israel's public economic discourse are the nation's fiscal policy, especially the defense budget, and the various factors contributing to economic inequality. This essay surveys the latest developments in both topics and discusses their ramifications for national security. As background to these topics, the essay begins by surveying the main developments that occurred in the Israeli economy in 2015. It then discusses the government budget in general and the defense budget in particular, and economic inequality and its ramifications for Israeli society and social cohesion in the face of this challenge. The essay makes some proposals for improved fiscal policy planning and the ways the government could tackle inequality.

Major Macroeconomic Developments in 2015

The Israeli economy experienced a slowdown in 2015, primarily because of a global slowdown in economic activity. GDP growth dropped from 2.6 percent in 2014 to 2.3 percent in 2015, and the business sector product growth rate dropped from 2.3 percent to 2.1 percent. Israeli exports, which in 2014 rose by 4.9 percent, dropped by about 1.3 percent in 2015, according to the December 31, 2015 estimate of the Central Bureau of Statistics. The global slowdown is to a large extent a consequence of the slowdown in China's economy, where the annual growth fell from 7.3 percent in 2014 to 6.9 percent in 2015. On January 19, 2016, as a result of this slowdown,

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which sent shockwaves through the global economy, the International Monetary Fund (IMF) lowered the 2015 assessment of global growth from its 3.3 percent estimate in July to 3.1 percent.

Looking ahead to 2016, IMF economists predict a global growth of 3.4 percent with another drop in China's growth rate to 6.3 percent. On December 28, 2015, the Bank of Israel predicted a 2.8 percent growth rate for Israel for 2016. Table 1 shows a breakdown of Israel's growth rate by macroeconomic variables.

Table 1. Key Macroeconomic Variables

Variable	2014 (%)	CBS estimates (Dec. 31, 2015; %)
GDP	2.6	2.3
Business GDP	2.3	2.1
Private consumption	3.7	4.5
Public consumption (without defense imports)	3.3	2.8
Investment in economic branches	-2.8	-3.3
Investment in housing	-0.5	2.1
Exports (excluding diamonds and startups)	4.9	-1.3
Imports (excluding defense, ships, planes, and diamonds)	3.3	1.9

Source: Central Bureau of Statistics[1]

When examining the development of the other GDP components this year, the drop in business investment is clearly evident. This development is worrisome because it involves investment in the economy's capital stock, which serves production in the present and future. Therefore, a drop in investment hurts economic growth. As it is, the capital stock in Israel and investment are low when compared to other countries, making this development all the more problematic. The government could encourage investment and work to increase the capital stock, both by investing more in infrastructure – necessary given its state in Israel – and by implementing a better tax and subsidies policy. The present conditions with low interest rates offer a particularly convenient window of opportunity, and economists, including those of the IMF, recommend this policy to many countries around the world (including the United States), as it may have a very positive effect on economic growth.

Fiscal Policy

Against the background of these macroeconomic developments, the 2015-2016 government budget was formulated and approved by the Knesset on November 19, 2015. What follows is a discussion of the budget's composition, implications for deficits and public debt, the problems associated with the budget process, and issues specific to the defense budget.

Budget composition. The original government budget for 2015 consisted of NIS 331 billion (about 29 percent of GDP) for expenditures, and NIS 260 billion (about 24 percent of GDP) as income from taxes. When adding other sources of income (about 2.6 percent of GDP), one arrives at a deficit of NIS 34 billion, representing about 2.7 percent of GDP.[2] In January 2016, the estimate was that the 2015 deficit in practice would amount to only 2.15 percent of GDP.

Around 40 percent of expenditures are budgets for social services (primarily education and healthcare), around 23 percent for defense and public security, about 15 percent for interest and debt payment, 6 percent for infrastructure, and the rest for other expenses.[3] Prominent in this breakdown are the large parts apportioned for defense and debt payments, representing a significant limit to spending on civil matters. The economic slowdown discussed above further reduces the fiscal policy space, because income from taxes depends on economic activity. The defense budget too is, of course, subject to this limitation.

The deficit framework and the debt. It is common practice to assess fiscal policy in terms of the deficit-to-GDP ratio, in which the deficit measures the gap between the expenditures and income. A decrease in economic activity automatically reduces tax income and raises the deficit.

In early August 2015, the Bank of Israel warned of coming difficulties in the fiscal framework. The governor of the Bank of Israel noted the following:[4]

a. By law, the deficit is supposed to drop to 2 percent of GDP in 2016 (about NIS 23 billion); at present, this looks like a very ambitious goal.
b. After an ongoing decrease in the percentage of the debt-GDP ratio, it has, since 2013, stabilized at 67 percent. Interest payments on the debt represent 3 percent of GDP, or about NIS 30 billion, compared to an average of 1.7 percent in developed nations.
c. According to the Bank of Israel, it is very important that the 2016 deficit not exceed 2.5 percent of GDP, representing a deficit level that stabilizes the debt-to-GDP ratio. The farther Israel moves from the 2.5 percent deficit level, the more this will be seen as the government's lack of

commitment to fiscal responsibility and will generate an increase in the debt-to-GDP ratio.

d. To reduce the deficit to a level of 2.5 percent of GDP – the maximum that ensures that 2016 will not see an increase in the debt-to-GDP ratio compared to 2014 – there is the need for cutting about NIS 15 billion according to the Bank of Israel estimates; of this, the cost of the coalition agreements is NIS 8 billion.

Despite the economic slowdown, the law on reducing the deficit, and the Bank of Israel warning, the government determined that the 2015-2016 debt would be 2.9 percent of GDP for both years. The Ministry of Finance also announced a cut in VAT from 18 to 17 percent starting October 1, 2015, and a reduction in corporate profit taxes from 26.5 to 25 percent on January 1, 2016. Should the slowdown continue and if the Bank of Israel warnings are realized, we can expect the public debt to grow and fiscal space will be even more constrained than before. This means that at a time when the world is extremely worried about deficits and public debt and is taking steps to rein them in, Israel is adopting a contradictory policy. This has implications for the interest the Israeli government will have to pay on its debt. However, the debt in practice in 2015 was lower than expected (as noted above), and the public debt-to-GDP ratio in 2015 decreased from 66.7 percent at the end of 2014 to 64.9 percent at the end of 2015.

A key issue in this context is the defense budget. When the Knesset approved the budget in mid November 2015, the defense budget was NIS 56 billion, and it was clear that between NIS 4-7 billion would be added in the course of 2016. This means that the government is liable to exceed the desirable level of debt. Any further slowdown to the economy will only exacerbate this deviation because of the decreased income from taxes.

Fundamental problems in the process of budget formulation and ways to resolve them. The process by which the government budget is formulated involves three major problems: a) Drafting the budget is done mainly in incremental fashion. It is therefore impossible to re-examine national priorities on which it is based. b) There is no body (except for, potentially, the budgetary division of the Ministry of Finance) that has the tools and time to come up with alternatives and present them to the government. c) The budget doesn't usually reflect multiyear planning, i.e., the annual budget is not based on the perspective of multiyear planning. The result of these problems is that the process is not informed, and is swayed by political battles and coalition and sectorial pressures. In practice, this process gives preference to the short term and reduces the budgetary field of vision. Under such circumstances, it is very difficult to promote issues that could serve as a response to the social protest movement that began in the summer of 2011 about civil spending and, in that sense, systemically confront the high cost of housing or promote tax reforms. The government does not have the tools to decide knowledgeably on a division of the budget among the needs of defense, education, healthcare, welfare, and other fields.

There are solutions to these problems that are successfully applied in other countries, such as the United States, the United Kingdom, and the Netherlands. One possible solution that can be applied in Israel is the establishment of a fiscal council. The IMF recently published a survey of the activities of such councils in various counties; its conclusion was positive. The head of the fiscal council would be a senior, established, government-appointed expert. The relevance of this council in Israel's governing system would be ensured if it becomes part of the budgetary division of the Ministry of Finance. As part of this fiscal council, a committee of experts – senior economists and contents experts – would closely examine the various budgetary issues. Just as the monetary policy committee of the Bank of Israel (established by former Governor of the Bank of Israel Stanley Fischer) outlines monetary policy, so would the fiscal council be able to engage in multiyear planning that would shape the budget structure while formulating alternatives to be decided on by the government. The establishment of the council must be enshrined in legislation so as to guarantee its independence and position in the government system. The budget could remain annual but would be part of a longer term and broader vision than at present.

The defense budget. The argument over the defense budget was especially vehement in 2015, both because of media attention and because of the publication of the Locker Committee recommendations in July 2015 and their rejection by the defense establishment. At the same time, the IDF announced Chief of Staff Gadi Eisenkot's multiyear Gideon Plan, which became part of the public debate. Critics of the defense establishment and the establishment in general both share the sense that one must take Israel's changing threats into account. The critics claim that the system is not reducing spending on means that are currently less relevant than they were in the past, and stress the need for budgets to handle new threats, such as the Iranian nuclear program, cyberwarfare, missiles and rockets on civilian targets, and more. Others, however, contend that the defense budget has already been severely slashed and that the Gideon Plan relates to current threats. The mechanism proposed above should be prepared to consider changes in the nature of the country's security threats. Therefore, professional experts must participate in formulating alternatives as part of an ongoing, continuous process that is part of the formulation of the defense budget. These experts can be former members of the defense establishment, especially those who dealt with budgetary matters during their military service.

The most recent negotiations between the Ministry of Finance and the defense establishment revisited the topic of pensions for standing army personnel given the agreement signed with them in 2008 and new proposals, including those of the Locker Committee in June 2015. The crux of the debate was the bridging pension paid out starting at the military retirement age of 45 until 67, the retirement age stipulated by law. A study conducted by the accountant general at the Ministry of Finance of salary and pension data received from the IDF revealed that the cost of the bridging pension was dozens of percentage points higher than that of the current budgetary pension. These figures are the basis for the new agreement between the Ministry of Finance and the Ministry of Defense, which involves the following amendments to the pension formula: the retirement grant will no longer serve as the base for calculating the bridging pension, the bridging pension formula will be revoked, and the budgetary pension formula will be restored with a reduction component that is still to be negotiated. This new agreement does not meet the Locker Committee recommendations, whereby the budgetary cost to the state would have been significantly reduced. Because the agreement will cost about NIS 2.6 billion a year, it would be wise to appoint a special committee to evaluate the various alternatives in conjunction with the Ministry of Finance and the defense establishment, as well as independent pension experts.

Inequality and its Implications

One of the fundamental problems of the Israeli economy is a high level of inequality; which has grown worse in recent decades, even if there has been some stabilization in the last few years. A high level of inequality causes social tensions and exacerbates the divisions within an already fragmented society, manifested in many types of social strife: between religious, ultra-religious, and secular; between Jews and Arabs; between new immigrants and native and/or long-time Israelis; between residents of the center and those on the geographical periphery; and more. The protests of the Ethiopian community in 2015 and the harassment of Israeli Arabs during times of security tensions were stark expressions of this strife.

Income inequality. Inequality is measured in various ways, including the incidence of poverty (a relative measure), income gaps among different population sectors, and more complex statistical indices, the best known being the Gini Index. Below are some comparative figures from the 2014 Annual Report: Poverty Indices and Social Gaps, published by the National Insurance Institute of Israel in December 2015:[5]

a. The gaps between the top tenth percentile and the bottom tenth percentile in net monetary income in 2014 were very wide.
b. The top decile's income is 8.1 times greater than that of the bottom tenth percentile, and spends 2.5 times as much.[6]
c. The incidence of poverty has risen over time and reached 25 percent at the end of the previous decade; since then, there has been a small drop, to 22 percent.
d. On the basis of the most recent available data from 2014, 444,900 families are living below the poverty line, affecting 1,709,300 people, including 778,500 children.
e. In terms of the poverty rate, Israeli society is heterogeneous. While in 2014, the average poverty rate for families was 29.1 percent, the poverty rate among Israel's Arab citizens was 57.2 percent and among the country's ultra-Orthodox Jews 66.7 percent.
f. The percentage of families in the poor population at large suffering from *persistent* poverty rose continuously over time and now stands at 58 percent.
g. Israel is very high on the poverty scale relative to OECD nations – second only to Mexico in the 2013-2014 rankings.
h. The Gini Inequality Index for disposable income attributes the value of 0 for total equality and 1 for extreme inequality. In 2014, Israel's index was 0.37, representing an increase of 4 percent compared to 1999.[7] Among OECD nations, this index places Israel fourth in the level of inequality, after Mexico, Turkey and the United States.

Asset inequality. In addition to income inequality, there is also asset inequality. Apartments and houses are the main assets for the vast majority of households. A study by the Institute for Structural Reforms[8] shows that the wealth gaps in Israel are greater than the income gaps. The upper tenth percentile controls about half of the assets, whereas the top percentile controls 23 percent of national assets. Based on the study, the average wealth of Israeli households is NIS 2.1 million, compared to the average of NIS 10.8 million in the top tenth percentile and NIS 47.9 million in the top percentile. By contrast, 11 percent of Israeli households have assets totaling less than NIS 1,000, and 5 percent of households have debts that are greater than their assets. About 17 percent of the Israeli population (about 425,000 households) suffer from asset poverty, and the total value of their assets is enough to support them for only less than three months.

The implications of these figures. What emerges is that Israel is notable for high inequality both in income and in assets compared to developed nations, and that this situation is persistent. A key challenge for the economy is confronting this inequality and preventing its perpetuation. This type of inequality has several important implications for Israel's national security. First, the poorer groups – the ultra-Orthodox and the Arabs – are precisely the groups whose demographic weight is rising. According to the Central Bureau of Statistics, each of these groups is expected to reach one quarter of the population by the middle of this century. Currently, the rate of IDF enlistment among these groups is very low and their contribution to the economy's GDP is likewise relatively low. Should these trends continue, the army's resources – both in terms of recruits and budgets (as taxes are a function of the size of GDP) – will be greatly reduced.

Second, inequality contributes to social rifts and, as a direct consequence, to political schisms. Even now, the above-mentioned poorer groups have 26 members of Knesset representing totally sectorial political parties, which is more than one fifth of Israel's parliament. Studies from around the world note that a rise in inequality is closely related to political divisions and a decline in democracy. Third, economic inequality is closely associated with inequality in contributions to national security via military service and tax payments. This creates social tensions and raises the rate of social disagreement over the very objectives of Israeli policy. These tensions were evident in the social protests in 2011. As the above data demonstrate, there has been no improvement in the relevant indices in recent years.

Thus, inequality influences security. While the sharpest political disagreements center on relations with the Arab world (both near and far); the territories and the Jewish settlements; the country's culture of democracy; and the state's involvement with religion, there is also a connection between all of them and economic inequality. Israel will find it difficult to maintain a functioning democracy with so profound a political rift, part of which is a direct consequence of inequality. Another difficulty will be maintaining the nation's technological prowess if the population segments responsible for that strength leave because of social tensions, the gradual loss of the culture of democracy, and an unequal sharing of the national burden.

Policy to reduce inequality. There are many ways to change the situation, three of which are particularly prominent. One is expanding the negative income tax program, currently called the Work Grant Program. This grant is given to low income earners in order to incentivize them to continue working and to incentivize others to join the labor force. This policy works well in the United States. In Israel, it is used to a relatively low extent both in terms of the size of the grant and in terms of its coverage. Thus, for example, the maximal grant in Israel is 6.8 percent of the average wage for women and 4.5 percent of the average wage for men; by contrast, in the United States, it is 11 percent of the average wage. The rate of people actually taking up the grant in 2012 was 62 percent; among Arabs, that rate was even lower – 53 percent. One could increase the size of the grant to that of the United States and change the way the payment is made in order to increase its take-up rates, making the assistance much more effective. Recommendations of this sort were provided by the Committee to Fight Poverty in Israel (the so-called Alalouf Committee) in July 2014.[9]

The second way of changing the situation would be investing in the human infrastructure. There is room for a wide array of policy steps to strengthen weak population segments, first and foremost the Arabs, the ultra-Orthodox, and the Ethiopian immigrants. These are the primary groups representing the vast majority of the poor. These steps include essential improvements in the level of education, transportation infrastructure, help to working mothers (such as day-care centers), employment matching centers, legislation against discrimination and effective enforcement of such laws, encouraging the employment of academics, and more. Such steps are being taken today, but at a much lower scope than needed.[10]

The third way to reduce inequality concerns the existing distortions in the tax system, which deepen inequality, especially via very high indirect taxes – first and foremost the value added tax – and the many tax benefits. Reducing indirect taxation while abolishing many tax benefits could create more scope for maneuvering to increase social expenditures, including incentivizing work and investing in the human infrastructure, as explained above.

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Conclusion

Israel is facing serious policy challenges when it comes to its fiscal policy and inequality. While these two topics top the agenda in many economies, in Israel the scope of these problems is large. The defense budget, for example, represents a large segment of the budget, unlike in many economies, and Israel has a very high degree of inequality compared to other countries.

This paper has suggested some solutions, although the probability of their implementation is low, because the severely divided political field makes it very difficult to implement reforms and the legislative changes required by these solutions. Thus the large gap between the scope and severity of the problems and the government's ability to resolve them to a significant degree remains intact. The many discussions and debates on these topics, both in the government and in the public sphere and media, do not translate into action of commensurate scope.

Notes

1 See Central Bureau of Statistics, "Preliminary National Accounts Estimates for 2015," http://goo.gl/H0Tmgr.

2 The Ministry of Finance, "2015-2016 Budget Synopsis," September 2015.

3 See Ministry of Finance, Budget Department, https://goo.gl/PpCkEj.

4 Taken from a publication called "Statement of the Governor at a Government Session: Budget Aggregates and the Deficit," August 2, 2015, http://goo.gl/FNsmkA.

5 National Insurance Institute of Israel, "2014 Annual Report: Poverty Indices and Social Gaps," http://goo.gl/YeibU9.

6 Initial data from "Findings from the Household Expenditure Survey 2014 Data on the Israeli Households Income, Expenditure and Durable Goods," Central Bureau of Statistics, for 2014, http://goo.gl/q4KSaQ.

7 "2014 Annual Report: Poverty Indexes and Social Gaps."

8 Maor Milgrom and Gilad Bar-Levav, "Inequality in Israel: How Is Wealth Distributed?" Institute for Structural Reforms, November 2015.

9 Data from Ilanit Bar, "Description and Analysis of Implementation of Work Grant Program by National Distribution," Research and Information Center of the Knesset, January 22, 2015.

10 For specific and detailed examples, including budgetary costs, see: Eran Yashiv and Nitza Kassir (Kleiner), "Israel's Arab Labor Force: A Survey of Characteristics and Policy Alternatives," Tel Aviv University, 2013.