

# Developments in the Israeli Economy and the Implications for National Security

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In 2014 the Israeli economy was on a sound, if unexceptional track, despite some limited turbulence. No significant changes in government policy took place, although important questions surfaced at the end of the year about the future fiscal path in general, and about the defense budget in particular. Moreover, during Operation Protective Edge, some long term issues came to the fore.

What follows is a survey of the key economic developments in 2014, with a focus on the various issues and upsets from the perspective of the economy and national security. The survey includes proposals for change in government policy.

## **Principal Macroeconomic Developments**

According to preliminary estimates by the Central Bureau of Statistics published in late December 2014, the economy's performance in 2014 showed some slowdown, though not a significant recession. GDP was up 2.6 percent in annual terms, and business sector GDP rose 2.5 percent, a decline in comparison with the 3.2 percent growth in 2013 and the growth forecasts earlier in the year. The economy's annual growth potential is estimated to be in the 3-4 percent range, so that the slowdown was manifested in growth that is lower than potential. Per capita GDP growth stood at 0.7 percent

in 2014, compared to 1.3 percent in 2013. Table 1 presents the key macro indicators in this context.

**Table 1.** Key Macroeconomic Variables: Rates of Change

Variable	Change in 2014 (in %)
GDP	2.6
Business product	2.5
Private consumption	3.8
Public consumption	3.8
Investment in economic sectors	-3.4
Investment in construction	-1.2
Exports (excluding diamonds, which rose 2.4%)	0.6
Imports (excluding defense imports and imports of ships, airplanes, and diamonds, which rose by 1.3%)	0.9

**Source:** Central Bureau of Statistics<sup>1</sup>

Examination of the components of GDP shows a decline in investment. This is a negative development, because it involves investment in physical capital for current and future production, and a decline in investment therefore detracts from future economic growth. Another negative development is the relatively slow growth of exports, due to the prolonged appreciation of the shekel (which came to an end only in the summer of 2014) and the slowing of foreign demand. The poor performance of these two growth engines, investment and exports, is problematic for the economy.

Operation Protective Edge in July-August 2014 imposed a burden. Israel's annual GDP is NIS 1.05 trillion, or NIS 4.2 billion per workday (248 workdays a year). A loss of 10-20 percent in daily GDP during the war is a reasonable estimate. If we calculate according to 43 workdays, the estimated loss in GDP is NIS 18-36 billion, amounting to 1.7-3.4 percent of annual GDP. However, a precise estimate of the costs is difficult to make, even when knowing the growth in GDP in all of 2014. It should be noted that this is a one-off cost, part of which was made up after the operation, and not a permanent fall in the growth rate.<sup>2</sup>

## **The Government Budget**

The aforementioned developments reduce the room to maneuver in the state budget, because fiscal policy is usually evaluated in terms of the ratio of the deficit to GDP, where the deficit equals spending minus income. Three concomitant trends marked the recent developments: tax revenues grew more slowly; GDP, which appears in the denominator of this ratio, grew more slowly; and spending grew more rapidly as a result of Operation Protective Edge. All three developments have the effect of increasing the deficit to GDP ratio, which was the background to the budget disputes during the months of September and October 2014. Once the Knesset was dissolved with new elections scheduled for March 17, 2015, the debate on the new budget was suspended, and it will become effective only in June or July 2015.

These developments are not unique to Israel. Since the global financial crisis began in 2008, many countries have been mired in recession, and their deficit to GDP ratios have risen. These countries also face the dilemma of what fiscal policy they should adopt. However, the dilemma in Israel is made more acute by the relatively high defense spending. According to the World Bank rating, Israel is in fourth place in the world in defense spending as a percentage of GDP. The difficulty in deciding how to allocate the budget and how large the overall budget should be has become more poignant in recent years as a result of three developments:

- a. The social protests in the summer of 2011, which increased awareness of the needs in the civilian budget. The protests reflected dissatisfaction with the existing fiscal priorities.
- b. Large scale spending on deployment against the Iranian threat.
- c. New demands by the Ministry of Defense for dealing with threats such as rockets and missiles, offensive tunnels, and cyber warfare.

At the same time, the prevailing impression is that the budget process in the government is conducted like an oriental bazaar. In considering the defense budget, for example, both sides use numbers for bargaining purposes as if they were bargaining over the price of a carpet in the market. This process, which is both irresponsible and damaging to the economy, results from the institutional structure of the fiscal process in Israel. This process is in major need of reform.

The budget is drafted in an incremental process: the budget of the preceding year is used as a base, with various sums added or subtracted. This process impedes long term planning, and annual negotiations become a theater for political brawling. Various interest groups, including the defense establishment, fight over shares of the budget. In this state of affairs, the defense establishment has an incentive to inflate amounts in negotiations in order to get what it wants. For example, it was reported that the Ministry of Finance had made a detailed calculation of the costs of Operation Protective Edge, but the Defense Ministry presented much higher numbers. This is not meant as criticism of the various parties; it lies in the nature of the current process and applies to all those involved. An optimal budget cannot be generated in this way, and certainly not one that reflects a rational choice over priorities.

Under this system the Prime Minister is also unable to make an informed decision, and he is subject to an array of pressures for additions to a given budget base. The same is true of the Ministry of Finance Budget Department. Is a different process possible? In an advanced economy, typically a body such as a fiscal council proposes a multi-year budget outline that offers priorities for selection by the elected representatives. For example, the United States has the Office of Management and Budget in the administration and the Congressional Budget Office in Congress. In Israel, the deficit or spending target is changed frequently; an agency like a fiscal council would also set a realistic deficit path. In such a situation the government would decide the national priorities explicitly and consciously on the basis of professional recommendations by the fiscal council. Formulating such an outline should be done for both the defense budget and the main civilian budgets. The Locker Commission, which was formed to serve as a second Brodet Commission for the defense budget, is not entirely the correct mechanism, because it does not address the budget as a whole. In this context, it is important to adhere closely to the principle that the defense budget should be devised on the basis of up-to-date assessments of current threats and those expected in the future. For further discussion of this subject from various angles and with various emphases, see the chapter that follows by Shmuel Even on the defense budget.

## Long Term Issues

Operation Protective Edge brought to the surface long term problems with respect to two disadvantaged groups:

a. *The southern periphery.* The area affected by the fighting is geographically and economically remote, and is not prosperous even in peacetime. Sderot is classified in the low socioeconomic group (rated 4 on a scale of 1 to 10), and the communities represented by the Eshkol Regional Council have a medium socioeconomic rating (rated 6). The following data for a number of variables, referring to the period before Operation Protective Edge, reflects the relative situation of the southern periphery. Note that the military operation did not necessarily exacerbate them.

- The incidence of poverty in southern communities in 2012 was 18.4 percent of all residents and 18.2 percent of the Jewish residents, compared with a 10.9 percent incidence of poverty in the stronger communities in the center of the country.<sup>3</sup>
- The unemployment rate in southern communities in 2014 was 6.9 percent, compared with a 6 percent national average. Participation in the labor force was 62.2 percent, lower than the national average of 63.7 percent.
- Scholastic achievement by students in these areas, both in terms of the Meitzav (School Effectiveness and Growth Index) examinations and in terms of the percentage of students eligible for matriculation certificates, is lower than in other districts. For example, the proportion of students in the south eligible for matriculation certificates in 2014 was 73 percent, compared with 80 percent in the center.
- 2011 figures show relatively high rates of criminal convictions in the southern communities from age 15.5: 0.6 percent in Ashdod, 0.7 percent in Ashkelon, and 0.8 percent in Beer Sheva, compared with 0.5 percent in Jerusalem, 0.6 percent in Tel Aviv, and 0.4 percent in Haifa.
- These communities have a higher proportion of people in need of social services than other communities in Israel.<sup>4</sup> A sample of a number of southern communities – Sderot, Kiryat Malachi, and Ofakim – shows that the proportion of people registered with the social services departments was 27.7 percent, 31.6 percent, and 18.7 percent, respectively. These proportions are higher than the proportions

sampled in other communities in the other parts of Israel, for example Tel Aviv (15.5 percent), Kfar Saba (13.1 percent), Haifa (11.6 percent), and Jerusalem (14.9 percent).

Costs of the war, both direct and indirect, mainly to agriculture and small and medium-sized businesses, should be added to this picture. Economic activity in the area near the Gaza Strip was affected even more than elsewhere in the south. Here the affected population groups were already disadvantaged, which raises questions about their readiness to return to normal functioning.<sup>5</sup>

b. *The Arab population in Israel.* The socioeconomic state of Arabs in Israel clearly lags behind that of the Jewish public. This situation is not new; it has characterized the Israeli economy for many years,<sup>6</sup> and clearly the harsh economic background feeds feelings of discrimination and alienation from the government and society in general. For example:

- On average, Arab men earn 60 percent of what Jewish men earn per hour, and there is early retirement of many Arab men in the 40-45 age bracket. Rates of participation in the labor force are particularly low among Arab women (which stood at 22 percent, according to the 2012 Labor Force Survey).
- The employment rate in the 18-22 age bracket is especially low – 26 percent.
- The incidence of poverty is 48 percent of all persons (compared with 15 percent among the non-ultra-Orthodox Jewish population).

No substantial change took place in this field before the recent events. A study by Miaari, Zussman, and Zussman found that the events of October 2000 had increased layoffs among Arab workers.<sup>7</sup> Similarly, reports received by the Ministry of the Economy indicate substantial damage to Arab businesses during Operation Protective Edge, inter alia due to a significant decrease in purchases by Jews in Arab-owned businesses. A Geocartography survey commissioned by *Globes* and published on September 30, 2014<sup>8</sup> found that during Operation Protective Edge, 29 percent of Jewish shoppers refrained from buying from Arab businesses, 47 percent stated during the fighting that they would stop buying from them, and 24 percent continue to refrain from shopping in the Arab sector. Fifty-seven percent said they would boycott stores whose workers criticize the IDF. On July 21, 2014 Minister

of Foreign Affairs Avigdor Liberman called for a boycott of businesses in the Arab sector that participated in the solidarity strike with Gazan residents. These developments exacerbated the already existing rift in Israeli society between Jews and Arabs and make the integration of the Arab minority in Israeli society all the more difficult.

There were also developments regarding another economically disadvantaged group, the ultra-Orthodox. Note that the ultra-Orthodox were not part of the government in 2013-2014, and according to media reports, their portion of the education and welfare budget was cut to some extent. While there is no reliable data on these fiscal allocations, there is relevant data on the ultra-Orthodox in the labor market (table 2).

**Table 2.** The Ultra-Orthodox Population in the Labor Market (in percent)

	Men	Women	Total
Rate of participation in 2012	48.5	71	60
Rate of participation in 2013	52.3	73.2	64.1
Employment rate in 2012	45.4	64.4	55.1
Employment rate in 2013	48.3	66.6	57.3

**Source:** “The Social Survey,” available on the Central Bureau of Statistics website

Table 2 shows that both the rate of labor force participation and the employment rate in the ultra-Orthodox population rose in 2013, in comparison with 2012, for both men and women. These changes are a continuation of a trend that has already been in place for several years. The trend is consistent with a decline in government support for this population. At the same time, labor force participation among ultra-Orthodox men is still low, compared with the rate of participation among non-ultra-Orthodox men, and the poverty rates among them are still high. Finally, it should be noted that the ultra-Orthodox population suffers from long term problems, even if no dramatic changes have occurred in its situation over the past year. These problems involve the low level of contribution to military service, a subject that was high on the agenda of the Knesset and the government a number of times during the period 2012-2014. No dramatic changes took place on this issue either, although the acrimonious arguments accompanying these

discussions attracted a great deal of public attention (for example with respect to the activity of the Plesner Committee in the Knesset in 2012 and the legislative processes relating to the IDF recruitment law in 2013-2014 in the outgoing Knesset).

Failing to address all these issues now, including an effort to provide tools (in the form of investment in education and infrastructure) to these populations in order to narrow the existing gaps is liable to prove very costly to the country in the long run. It would imply increasing spending on social services, and depriving the economy of the additional potential growth engine that these populations represent.

## Notes

- 1 See “Preliminary National Accounts Estimates for 2014,” Central Bureau of Statistics, [http://www.cbs.gov.il/reader/newhodaot/hodaa\\_template.html?hodaa=201408360](http://www.cbs.gov.il/reader/newhodaot/hodaa_template.html?hodaa=201408360).
- 2 For a detailed discussion of the costs of Operation Protective Edge, see “Operation Protective Edge: Economic Summary” in *The Lessons of Operation Protective Edge*, Anat Kurz and Shlomo Brom, eds. (Tel Aviv: Institute for National Security Studies, 2014).
- 3 According to the 2012 report on poverty and social gaps on the National Insurance Institute website.
- 4 Data from the Statistical Abstract of Israel 2014, Central Bureau of Statistics website.
- 5 See Meir Elran and Eran Yashiv, “Operation Protective Edge: The Real Victory is the Social and National Resilience,” *The Marker*, August 17, 2014.
- 6 For a comprehensive description, see Eran Yashiv and Nitza (Kaliner) Kasir, “Patterns of Labor Force Participation Among Israeli Arabs,” *Israel Economic Review* 9, no. 1 (2011): 53–101; Eran Yashiv and Nitza (Kaliner) Kasir, “Arab Women in the Israeli Labor Market: Characteristics and Policy Proposals,” *Israel Economic Review* 10, no. 2 (2013): 1-41.
- 7 Sami Miaari, Asaf Zussman, and Noam Zussman, “Ethnic Conflict and Job Separations,” *Journal of Population Economics* 25, no. 2 (2012): 419-37.
- 8 “24% of Jewish Consumers Continue to Boycott Arab Businesses,” *Globes*, September 30, 2014, <http://www.globes.co.il/news/article.aspx?did=1000974929>.