The landscape of the Israeli economy, society and policy after 1200 days of Intifada
A Saban Center Luncheon Briefing with
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0n the eve of the Palestinian Second Intifada, the economic integration between Israel and Palestine reached new heights. Following three years of relative calm on the terror front, Israelis felt safe traveling to and through the West Bank and Gaza, and Palestinians flooded the labor market in Israel.
Thousands of Israelis traveled daily by bus to Jericho, to gamble in the shining casino built there as a joint venture of Casino Austria, the Palestinian security apparatus and private Israeli investors. The daily take of the casino, although exaggerated in press reports was nevertheless very substantial, approaching 500 million dollars on an annual basis, and providing one of the main sources of cash for Arafat, Dahlan and their friends.

And what then, in the summer of 2000, was the main worry of Israeli businesses allocated along the "Green Line" – the former border between Israel and Jordan? That their clients were buying more and more goods and services in the nearby Palestinian outlets: furniture and fruits, car parts and textiles, dental treatment and personal services . The cash turnover of that "border trade" was estimated at few hundred millions dollar. Contrary to some unfounded claims, in the late 90's the Palestinian economy was booming – much more than the Israeli economy. Despite unprecedented population growth rate of 4.2% annually, real per capita National Income in Palestine expanded by 25% from late 1996 until late 2000, reaching 2,000 US dollars – the highest per capita income in the non-oil Arab world.

The unemployment rate went down from 24% of the labor force to 10%. Before the Intifada started, 150 000 Palestinians (about 22% of Palestinian employment) worked in Israel, commuting daily from the West Bank and Gaza, and earning wages considerably higher than those paid by the Palestinian Authority. "A general sense of optimism prevailed during these years and was reflected in the fact that investment almost doubled," concludes a recent report on the Palestinian economy by special team of IMF economists ("West Bank and Gaza: Economic Performance and Reform under Conflict Conditions," IMF, September 2003). Official and private aid flowed into Palestine at a rate of 400 to 500 million dollars a year – roughly 12% of GDP.

According to the so-called "Paris Agreements," Israel collects the sales taxes and duties on goods imported to Palestine – it does so on behalf of the Palestinian Ministry of Finance – and transfers the money to the Palestinian Authority. All in all, Israel's treasury transferred to Palestine (until summer 2000) 4.7 billion U.S. Dollars – an amount equal to the entire GDP produced in Palestine during 1999. What happened to the money? We already know – from the same IMF report – that Mr. Arafat diverted approximately one billion U.S. Dollars to some secret "special" accounts. The rest financed an excessively growing civil service and security apparatus.

Labor income from Israel and the revenue clearance transfers from Israeli Ministry of Finance provided the Palestinian economy with 2 billion dollars a year, approximately 44 percent of Palestinian GDP. On the other hand, two important sectors of Israeli's economy, construction and agriculture, were substantially dependant on the Palestinian workforce. And by growing, Palestine became an important market for Israeli products: according to published statistics, Israeli exports of goods to PA territory reached 1.7 billion dollars, 7% of total exports (excluding diamonds). Without custom barriers, trade flourishes.

All this came to a sudden stop in the first week of October 2000. The economic agreement, although formally still binding, was quickly replaced by a new regime of closures, restrictions, curfews, military checkpoints and a rising wave of terror. The place became a war zone. The Intifada devastated the Palestinian economy and society. It pulled back the standard of living in Palestine fifteen years, it made the live of the Palestinians miserable, and 30% to 40% of the population unemployed.

Clearly, there is no purely economic explanation for the outbreak of the Intifada. But there is a likely political-economic one. Mr. Arafat made a deliberate decision to undermine what he saw as dangerous signs of stabilization and prosperity in the West Bank and Gaza. Being a revolutionary leader he was deeply worried about Palestinians becoming more involved in doing business with Israel than fighting for national liberation. He disliked the new mentality on the Palestinian street: make money not revolution. By initiating the Intifada, Mr.Arafat was able to change the agenda of the Palestinian people, bring back the national ferment and exaltation, and thus regain his influence as a leader of the people. And never mind the price they paid and are still paying.

The Intifada threw the Israeli economy into a prolonged recession. "The Intifada has affected economic activity through five channels," states an IMF Staff Report on Israel. "A fall in tourism, a reduction in trade with the PA, a fall in Palestinian labor supply, an increase in defense expenditures and a rise in the level of uncertainty" ("Israel – Article IV Consultation and Staff Report", IMF, March 2003). When the violence erupted, the Palestinian workers left in hurry. The trade with the PA plunged and gradually degenerated into a very unstable and thin stream of basic goods. Many Israeli products were, and still are, subjected to a Palestinian consumer boycott. Israel lost an important market for consumer goods.

During the Millennium Year, foreign tourists spent 3.5 billion dollars in Israel (and many additional millions in East Jerusalem and West Bank's Holy Places). The Pope made a historic pilgrimage to Jerusalem, Bethlehem and Nazareth. With the outbreak of the Intifada, and the subsequent waves of terror and suicide bombers, tourists erased Israel from their holiday plans. Income from incoming tourism fell by two-thirds, hotels and tourist attractions stayed empty, and thousands of workers were fired.

As time passed and the conflict intensified, the damage spread. It affected centers of civilian population, bringing with it a change in the general way of life. Businesses cut investment plans and consumers cut consumption. There was a substantial increase in the police force, in payments to victims of terror attacks, in hospitalization costs, and in installation of security measures. Budget deficits expanded and exploded, reaching 6.5% of GDP. The national income per capita in Israel was 18,200 dollars in 2000. It will be in the range of 16,000 this year.

Taking all of this into account, the Bank of Israel estimates the damage to the Israeli economy from just one year of Intifada – the year 2002 – at 3.8% of GDP. Following its conceptual framework and assuming the Intifada had ended by the end of year 2000, the accumulated three-year loss is enormous: in the range of 90 billion NIS - 22 billion dollars or one-fifth of one years' gross domestic product. These are not "what if" numbers. They express real loses that will never be recovered, even if the Israeli economy starts growing, from next year on, by its full potential.

In October 2000, the unemployment rate was 8.5% of the workforce. Now it stands at 10.6% - the highest unemployment rate ever known in Israel, except for the first two years of massive immigration from the former Soviet Union. The unemployment would have been even higher, had the public sector not expanded its employment and absorbed the "surplus labor".

Since the outbreak of the Intifada, total productivity also shrank. Israel is in midst of deflation. Prices are now 2% lower than one year ago. The real wage of a typical worker is now 8% lower than in 2001. Those statistics speak for themselves, but not loudly enough. No other modern society ever experienced the unique situation of living and functioning under the daily threat of suicide bombers. Widespread feeling of personal insecurity affects all families, all decisions. It is impairing investments, shortening the planning horizon, and shifting activities from productive to unproductive (see for example the rapid popularity of private security guards). There is an existential risk of living in Israel today; a psychological risk premium that makes the welfare of the whole community lower than the market value of its product. A much milder level of personal terror reduced the GNP of the Basque region in Spain by ten percent. Yet, the Basque terrorists never intended to destroy the Spanish state.

During the last few years the poverty level in Israel rose rapidly, from 15.4% of families living under the poverty line in 1995 to 17.6% in the year 2000 to a current level of 19%. The absolute number of poor people, since the Intifada started, increased by 22%. Today one in five Israelis is poor. The number of poor children rose by 30%. Almost one in three children in Israel now lives in a poor family.

Those are the highest rates of poverty in the West (Luxemburg Income Study). According to the latest census published in the U.S., 9.6% of all American families, and 16.2% of all American children are poor, half of the corresponding rates in Israel. The distribution of incomes in Israel is dangerously unequal – probably the most unequal in the West – and became more so since the outbreak of Intifada. The statistical measure of the economic gaps in a society, the "Gini Coefficient of Inequality", quickly approaches limits found only in third world countries. In the past three years the most fortunate 10% of the population has seen its share of the national pie expanding while the lower 10% has its share shrinking.

The budgetary policy from the summer of 2001 on put the burden of financing the growing needs of the defense budget on the people receiving social security assistance and welfare transfers. For example, child allowances for a family with more than three children were reduced by 15% in 2002 and additional 17% in 2003. Crucial Social Security benefits were cut by 14%. The welfare state of Israel, says the latest Social Security Institute Survey, is crumbling. There is no escape from the evident conclusion: the poor pay the highest price for the war on terror.

The response of economic policy-makers in Israel to the Intifada only worsened these negative economic trends. The first response by the Ministry of Finance and the Bank of Israel was denial. Prior to the general elections for the Knesset in 2001, the Bank and Ministry had persuaded themselves and the public that the War on Terror would only produce a minor and temporary slowdown of the overheated economy. The second response was panic. Interest rates went rapidly down and rapidly back up. Government budgets were approved and then immediately put on hold. Expenditures were cut only to expand again. One emergency program followed the other. For example, in the spring of 2002, the government initiated the emergency package known as the "Economic Operation Defense Shield" to counter the free fall of economic and financial stability. Yet the combination of these pro-cyclical, unbalanced and contradictory policies only pushed the economy deeper into recession. 2002 signaled the worst year in Israeli economic history since the end of The Big Inflation. Then, Benjamin Netanyahu appeared.

Mr. Benjamin Netanyahu was appointed Minister of Finance at the end of February 2003. A few weeks after his nomination, Mr. Netanyahu initiated a Ronald Reagan style revolution in political economy in Israel (the phrase "Netanyahu's Revolution" was first used in a leading article in "Yedioth Ahronoth" just a week after Netanyahu's nomination). Netanhayu declared that Israel was lagging behind in the world economic race, not because of the Intifada and high defense spending, but because of "a system in which a smaller business sector must feed and support an enormous and expanding public sector" (interview with "Yedioth Ahronoth" on 22.04.2003).

Quoting the first inaugural speech of his mentor, Ronald Reagan, Netanyahu presented the Israeli public with a new vision. The government, he said, is not the solution to Israel's economic crisis, it is the source of the crisis. Since then, in all his public appearances, Mr. Netanyahu has repeated one central message: cut the public sector, cut income taxes, free the business sector from excessive regulation, sell all the government-owned companies, and the economy of Israel will grow rapidly, fueled by the sheer power of the liberated competitive private market.

The principles of Netanyahu's "Israel Economic Recovery Plan" and "Economic Policy of 2004 Budget" (as published in English by the Ministry of Finance) are clearly formulated in Ministry of Finance official documents. Here are some examples: "Income taxes will be reduced…the overall tax burden will continue to decrease and the plan for the reduction of the public sector will continue at full speed, in order to channel resources toward the business sector… Raising taxes is incompatible with the desire to encourage growth in the business sector…Government and public spending in Israel is one of the highest in the world...Lowering (it) would potentially encourage growth."

The wording of these messages closely resemble the speeches of Ronald Reagan and even more those of David Stockman, Reagan's Head of the Office of Management and Budget (OMB). They contain the same phrases, the same concepts and the same burning free market radicalism.

One graphic explanation given by Mr. Netanyahu to illustrate the zero per capita growth rate of the Israeli GDP since 1995 referred to a skinny guy with his legs chained, carrying a fat man on his shoulders, the weight steadily growing. The Israeli public sector is the fat man and the Israeli business sector is the thin and lean one. Little wonder he can't run fast enough.

Netanyahu also removed the blame for the dismal performance of the Israeli economy from the Intifada. Instead, he says to blame the "Paris Commune" mentality of public opinion and the iron grip of the trade unions or the Histadrut on the economy. The Histadrut is responsible for the overgrown government, high taxes, powerful infrastructure monopolies, and too much bureaucracy. Mr. Netanyahu has, therefore, cast himself, as a Super Mrs. Thatcher of the Israeli Economy, liberating it from its, in his words, "Bolshevik traditions". It is not the Intifada, stupid, it is the "Israeli Socialism".

Do the facts support Netanyahu? No question about it**.** The public sector's share in the Israeli economy is one of the highest in the West. But if one looks at the fine print, a large part of the exceptional size of government expenditure can be explained by two exceptional factors. The first factor is that the domestic defense budget in Israel takes 10% of GDP, versus the 2% in a typical European industrial country. The second factor is that the government of Israel pays heavy interest on its high debt incurred in the past in order to finance the defense and the immigration costs. The share of social expenditures in Israeli GDP such as public health insurance, public education, public pensions and welfare payments is roughly in line with wealthy European countries. But, says Mr. Netanyahu, Israel is not (yet) a wealthy western country. It is an emerging market with a different set of priorities, the first one being the growth of the economic pie rather than the way it is distributed. In other words, Israel just can't afford what Sweden can.

The picture in taxes is even more complicated. Total tax revenue as a percentage of GDP in Israel is not significantly higher that the OECD average (and lower than the tax intake in the EU). But the structure of taxation is problematic because income taxes are unusually progressive, capital taxes low, and so the burden falls almost exclusively on the working middle and upper classes.

Is the diagnosis presented by Mr. Netanyahu factually correct? Only to a limited extent. Political instability, institutional failures and socio-ethnic ferment were the primary factors, and not "socialism," which led to the deeply disappointing rate of growth since the assassination of the late Prime Minister Yitzhak Rabin. In the years 1995 to 2003 Israeli GDP expanded cumulatively by 23%, but during the same time the population grew by 21%. Thus, real GDP per capita was just stagnant, versus very rapid growth of GDP per capita in countries which can be compared to Israel such as Ireland (65%), Finland (32%), Korea (42%) and Spain (24%). Israel, with zero growth, trailed behind, loosing ground.

Wasteful and unproductive government expenditures have contributed to this relative decline, but they were not the main cause of it. Although the *Histadrut* is an easy target and public sector employees do not enjoy a great respect in Israeli public opinion (and people always dislike strikes in public service, especially those disturbing their everyday life), Israel today does not resemble Britain thirty years ago. There are no heavy-subsidized industries and no Trotskyite militant trade unions. Israel already ranks high as the world's 20th most competitive economy. Its labor market is flexible and its business sector efficient and creative. Yet, there is a huge problem with the occupational pension schemes run by the trade unions and subsidized by the Treasury. The source of the problem is clear: Israelis live longer and work less. Who actually runs those schemes, the government or the *Histadrut*, is not so important. There are examples of excessively tight regulation and extensive public monopoly, especially in the energy and infrastructure sectors in Israel. Yet these are the exceptions, not the rule.

Still, Mr. Netanyahu is set to teach the *Histadrut* a lesson in political determination and strong will, just like Ronald Regan did to the Air Traffic Controllers Organization when its members went on strike in his first year in office. He broke the strike and won. Mr. Netanyahu is following in his footsteps.

Most of Netanyahu's reforms are, by and large, a necessity for the Israeli economy, hurt by three years of an intensive war of terror. For the economy to recover the budget must be balanced, the public debt needs to go down, and the privatization and encouragement of competition must continue. But Netanyahu's methods of reform remain questionable.

Will he succeed?
Mr. Netanyahu has already succeeded in cutting the budget, cutting social cash payments to large families and to the non-working poor, partially privatizing EL AL, the national airline, and changing the parameters and the ownership of the public pension plans. Judging from the latest data, the economy of Israel finally has turned the corner and is slowly emerging from the longest and deepest recession in its history. The stock market is roaring , the balance of international payments is positive, and investor mood is notably less pessimistic. The economic activity has finally stopped its decline and stabilized, although at a very low level.

But Mr. Netanyahu's main success is not in changing the course of the Israeli economy - he should wait at least another half year before taking credit for it - but in reshaping the agenda and narrative of public discourse. His main imprint is ideological and conceptual. Now, more and more Israelis are worried about "an overstretched government" and less and less about "too little help from government". That is new and revolutionary.

Israel is not (and never was) a socialistic state. It has a very competitive and flexible market economy. But the prevailing political and social mood in Israel exhibits all the shortfalls of a deeply entrenched *etatism*. People expect "the government" to come with a ready answer for all of life's pitfalls. Not enough rain in the winter? "The Government" should do something about it. Businesses cutting wages because of falling demand for their products? "The Government" should fix it. Voters for the two largest political parties share equally in this paternalistic vision of the role of "The Government" in economic and social life .

But already six months into Netanyahu's Reagan Revolution and suddenly people were ready to consider things they would reject just a few months earlier. They believe Mr. Netanyahu is basically right in his diagnosis, that the main reason for Israeli economic weakness is the size of the government. However, the political history of Israel is against Netanyahu.

Finance Ministers in Israel change very frequently. From late 1995 to late 2003 Israel has had no less than eight ministers of finance. Actually, the average term of a finance minister is one year, just enough to install his men in the ministry, to formulate a new economic policy, to change the budget assumptions, and to give many provocative interviews to the press. Last but not least, each minister has the time to open a new quarrel with the governor of the Bank of Israel, a rift which has become a constant and frustrating feature of the political-economic landscape in Israel.

Netanyahu, however, has used fascinating and radical rhetoric to uplift the mood of the business community and earn its blessings. He also received the blessing and strong support of the current American administration, to which Mr. Netanyahu belongs, conceptually and mentally. But he still has a lot to do, to persuade and to prove to the vast majority of the public in Israel, who remain skeptical of his intentions and even hostile to his radicalism. Most Israelis remember his political past as an unstable prime minister, his weak personality, and his credibility problems. At home, Netanyahu's actions are perceived as conflict-seeking and not conflict-solving, unilateral and not cooperative. These actions present a threat to society, which is already exhausted and stretched to its limits by more than 1200 days of terrorism, and facing still more.

For the past thirty years Mr. Netanyahu's party, the Likud, positioned itself as the voice and representative of lower social classes, which became more and more dependent on the good will of and cash transfers of the government. Its natural ally was the Sephardic religious party, "Shas", an anti-liberal, anti-elitist and anti-middle-class grassroots social movement, without a trace of Reaganism.

By accepting the job of minister of finance, Mr. Netanyahu decided, deliberately and openly, not only to divorce his economic policy from the populism of Shas but to break once and for all the ideological ties with it. His appeal is now directed towards the upper and middle class, the more secular segments of society. Their incomes are above average and they pay high income taxes. They serve in the reserve army, fight terror, produce the blooming Israeli culture, are open to the world and regard themselves as the neglected backbone of Zionist Israel. Many of them work in the technologically advanced sectors of the economy.

In the past elections, a significant part of the upper middle class voted for Shinui, a centrist party. After the elections, Mr. Netanyahu found in the leaders of Shinui his most credible and enthusiastic supporters. His and their ideologies are almost identical. They are both conservative on the economy, moderate on policy, and push for a free market and a high fence. Both, Mr. Netanyahu and Mr. Lapid, the head of Shinui, favor the "separation solution": build a security fence to separate Israel from Palestine (and vice versa) and concentrate on domestic problems only. They do not dream about the "New Middle East" and do not try nation-building in Palestine. It is not their business. Instead, the business of the Israeli leadership, according to Netanyahu and Lapid, is to ensure a reasonable level of personal and national security and to promote growth, competition and globalization in Israel . Let the Palestinians take care of themselves. Comprehensive peace? Probably not in our time.

Shas, the party of the social transfers, is now in retreat with its narrative silenced and its agenda in shambles. It suffers from a lack of money and diminishing leadership. In its place, a new class is rising – urban, educated, republican, moderate, non-religious, pro-American, anti-etatist and openly capitalistic. Its members may discover in Mr. Netanyahu a natural leader and in his economic credo a vision to follow. His narrative echoes theirs.

When Benjamin Netanyahu was given the portfolio of finance by Prime Minister Ariel Sharon, political commentators interpreted the move as a gimmick of an old man and a political trap, which canny Mr. Sharon prepared for the unprepared Mr. Netanyahu. They predicted that it would finish Mr. Netanyahu's career.

Economic commentators had a different interpretation, however. They were much more impressed by Netanyahu's passion, commitment and knowledge. They pointed to a connection between the nomination of Netanyahu as the minister of finance and the structure of the coalition Mr. Sharon built, with Shas out, and Shinui in.

It seems now the economists were right. Mr. Netanyahu is using his position in the government to leverage political power. He is presenting his potential political clients of the rising middle-upper class a "new Netanyahu". Somebody who learns from his past mistakes. Somebody who has all the virtues the "old Netanyahu" has not had: clear vision, readiness to take chances and sacrifice short-term popularity for long-term achievements, the will to lead, the ability to listen, clean hands, credible plans and a lot of stamina.

Looking upon the new landscape of Israeli society and economy after three years of the Intifada, Mr. Netanyahu dreams of establishing the Israeli Republican Party and winning, as its leader, the next elections. He may well realize his dream.

Or not. One should always remember that as a prime minister, Mr. Netanyahu had one powerful enemy. His name was Bibi, Bibi, The Terrible, the "alter ego" of himself. During the fateful year 1999 Bibi finally took over Netanyahu and defeated him.

Can Israel's economy prosper while the Intifada of terror continues in its present form? The answer is no. The economic recession in Israel is over, but the slowdown is not. The Bank of Israel, exceptionally affirmative of Netanyahu's budgetary and structural policy, just published two scenarios for 2004 ("Economic Developments and Macro-economic Policy for the Years 2002 to 2005", Bank of Israel, October 2003, Hebrew). In the positive scenario the economy of Israel expands in next year by 2.4%. The rate of unemployment and the budget deficit both go down substantially. In the negative (or realistic ?) scenario the economic stagnation continues, per capita national income falls, unemployment and deficits rise to new heights.

What makes the two scenarios so different is the political assumptions about the current Intifada. In the best case scenario, Israel reaches a ceasefire with the Palestinians and there is "progress towards political agreement". In the second scenario "the violent conflict continues". And this makes all the difference for the economic future.
In the above mentioned Staff Report on Israel the IMF concluded: "The economic impact of the ongoing security problem was initially limited to certain sectors but has gradually spread to the whole economy by aggravating investor and consumer sentiment. What is especially damaging is the uncertainty regarding when the violence will ever end…"

Will it ever end? The Intifada, though it is perceived as a war for the right to exist, cannot undermine the basic solidarity of Israeli society. Now; however, the economic and social burden of living with it and the problematic ways of financing it are gradually reshaping and changing people's attitude to life in Israel, from strength to despair.
And that is the greatest danger facing Israel today. Mr. Netanyahu's Reaganite Revolution, although far-reaching in its economic and social aspirations, still provides no remedy to it.