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THE EFFECT OF THE DEFENSE BUDGET ON ISRAEL'S ECONOMY *

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The Knesset budget speech of Israel's Minister of Finance Yigael Hurwitz, inaugurated a comprehensive discussion on the implications of the budget for Israel's economic activity during the new fiscal year. Mr. Hurwitz stressed the two-fold goal of the budget: a slowing-down of the rate of inflation and improvement in the balance-of-payments situation. Critics of the budget - economists and Members of Knesset (some of whom are members of the governing coalition) - raised several questions with regard to the degree to which the proposed budget can attain its declared goals.

Mr. Hurwitz stressed that the attainment of the goals of current economic policies requires a strict adherence to budget policies, the continuation of restrictive monetary policies, and the implementation of a wage policy, in accordance with the budgetary guidelines. The Government apparently assumes that the atmosphere of restraint and deceleration that is evident at present in the economy will persist throughout the next year if the Treasury continues to carry out activities that will strengthen this trend from a psychological point of view, although there will be no real cuts in the total domestic spending of the Government and its present deficit spending will be maintained.

Opponents of the budget deny the validity of this assumption and emphasize the potential danger lurking in the fact that the constructive psychological measures adopted with the start of Mr. Hurwitz's term of office as Finance Minister have not been accompanied by any appropriate comprehensive fiscal policy. Psychological measures alone can be relied upon for only short-term effectiveness and must be supplemented with concrete economic

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measures. Thus there is a need for a budget that will serve to moderate, or, at least not expand, current economic activities. The Government must stop the monthly flow of billions of Israel pounds into the economy; this flow has been taking place for the past four months. In this respect, the crucial factor is the aggregate effect of the total government budget, and not its breakdown into the individual budgets of the separate government ministries or into the various categories of expenditure. For example, if a cut in the budget for health services is accompanied by an expansion of the activities of the Ministry of Housing, the net effect will be negligible.

The proposed budget is quite inadequate, because of the considerable increase in activities in the areas of housing and defense, because of exaggerated estimates of future revenues, and because of other factors, which have been described in detail in articles by two distinguished Israeli economists, Professor Razin ("A Budget with Gloomy Prospects") and Professor Barkai ("The Budget: Question Marks and Exclamation Marks"). In view of the heavy defense budget totalling IL 211 billion, and in view of its relatively large share (nearly one-third) of the total government budget, and especially in view of the significant spending increase planned for local defense procurement (a 16% increase in terms of 1979 prices), it is necessary to carry out an in-depth analysis of the defense budget that will uncover ways to end the contradiction between the constructive goals of the Government's economic policies, on the one hand, and on the other, the proposed measures which will prevent the implementation of those goals.

In this context the words of Professor Barkai, in his aforementioned article, bear repeating:

The inflationary potential of the defense budget stems from the factor of local defense procurement, which must, therefore, be reduced. In view of the general nature of Israeli society, I find it difficult to believe that the vast defense network even today could not benefit from "dieting." In any event, the increase in local procurement spending as opposed to last year's budget can be spread over 18-20 months. A spreading of this increase would be expressed in a cut of between about IL 7 and 8 billion; the importance of such a reduction should not be underestimated under present circumstances.

Mr. Hurwitz's rebuttal of the argument for a reduction in local defense procurement spending is irrelevant. He recently put forth the following contention: "If the Israel Defense Force reduces local spending by IL 10 billion, the result might be a need to shut down manufacturing companies like Soltam that supply products to the IDF. There is another reason as well. If the IDF starts to go in for a lot of spending abroad, Israeli exporters will suffer: foreign buyers will simply conclude that if the IDF does not buy local products, there must be a good reason."

That line of reasoning could be applied to any budget cut and not only to reductions in the IDF's purchasing of local products. Anyone who wants to combat inflation and balance-of-payments difficulties and is willing to risk a certain amount of unemployment, cannot ignore either the problem of the total dimensions of defense spending or the need for a reduction in these dimensions.

Any discussion of defense spending naturally entails profound emotional elements, especially in the wake of the Yom Kippur War. The fact that most defense items are classified information makes it difficult to carry out a comprehensive analysis of defense spending, despite the need for such an analysis in light of its absolute size and relative "weight." Nonetheless, despite all of the limitations involved, the subject of defense must be dealt with in both economic and social terms. Israel's strength, its "stamina" in wartime, and its ability to withstand international pressure in peacetime, are at least as much dependent on social and economic factors as they are dependent on military might.

The link between economics and social issues is tellingly expressed in military reserve duty. The IDF is built, to a very basic extent, on reservists whose moral and spiritual strength is determined in civilian life and not necessarily during military service. It would be superfluous to point to the close link between the strength of the IDF and large-scale unemployment among the members of the families of soldiers. The importance of the level of educational and health services for the civilian population should not be underestimated in terms of the military prowess of Israel's fighting personnel.

Israel's imports exceed its exports by between \$4 - 5 billion per year. This trade deficit, which increasingly requires financing through foreign loans, increases our dependence on those who supply us with these loans as well as on the suppliers of military equipment. In view of the fact that Israel's foreign debts are increasing at the rate of about \$2 billion per year, and in view of the fact that the over-optimistic national budget anticipates a total of \$17 billion in foreign debts by the end of this year, the mutual dependence between economics and defense should not be underestimated.

When the monthly rate of inflation rate exceeds 5%, economic activity must be restricted and thus increases in defense spending are - in short-range terms - at the expense of other public services. Moreover, if the increases in local spending on defense are at the expense of investments; then the defense budget reduces the economy's growth potential and has a detrimental effect on the country's future gross national product.

The defense budget burden is a relative concept, like the relationship between defense spending and the GNP, thus any blow to the country's growth process will, on the one hand, result in

a situation whereby defense spending will increase at a faster rate than the GNP and, on the other, automatically lead to a heavier defense budget burden in the future. In other words, if the productive base of the economy does not develop at a reasonable pace, the defense budget will become a growing burden. Peace was supposed to produce precisely the opposite effect: the economic infrastructure and the productive base were going to expand more quickly than in the past and were going to bear lower defense expenditures. But does the peace treaty with Egypt in fact present us with this prospect over the next few years? The proposed defense budget does not indicate that sort of development.

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The burden of defense spending is generally, but not exclusively, measured in dollars and cents. The greater the number of persons engaged in defense work within the framework of military service (soldiers in compulsory military service, reservists, and those in the standing army), within the framework of civilian work (in the Israel Defense Forces, in military industries, in aircraft industries, in the Ministry of Defense, etc.), or within the framework of plants and firms supplying goods and services for defense needs, the lower will be the number of persons engaged in production aimed at the export market, or aimed at the reduction of imports, and the fewer will be the opportunities for investment in the manufacturing sector or in firms that are part of the country's economic and social infrastructures.

A glaring element in the proposed budget is the fact that, whereas all government ministries and local authorities are required to reduce their staffs by six percent, the defense budget is built on a seven percent increase in its personnel. Total expenditures for salaries in the defense budget constituted 38% of total expenditures on direct salary payments in the government budget in 1978. However, this percentage constantly increases and the corresponding figures for 1979 and 1980 were 40% and 44% respectively. Naturally, the more military equipment we buy, the greater will be the need for maintenance and operational personnel for that equipment. The more sophisticated the equipment purchased, the higher will be the need for highly skilled maintenance and operational personnel. However, the fewer such personnel available, the heavier will be the burden on existing personnel. In this context, the explanatory comments in the defense budget proposal therefore seem quite strange: "The personnel requirements of the IDF for 1980 will be met by the increased personnel mobilization, which took place in 1979 in the light of decreased demands for personnel in the civilian economy. This decrease enabled the mobilization of a larger number of personnel, who were also more highly skilled, and also led to the filling of posts that had up to now been empty."

Thus the burden of defense spending should be measured in terms of the reduction in the GNP and in the potential growth of the economy's productive base, a reduction brought about through

the transfer of personnel and investment capital from the civilian sector to the military. This "measurement" does not take into consideration defense spending financed directly by funding sources that would have been unavailable were it not for the need for defense spending; the reference here is primarily to American military aid.

One must be careful to distinguish between a grant, which we do not have to pay back, and a loan, which must be repaid, sooner or later, and with interest. We are making a very great mistake when we ignore this distinction in our discussion of the size of the aid requested from the American Government. The effect of financing on an estimate of the real burden on the economy is certainly no easy matter and an analysis of this effect will not be dealt with here. Mention should, however, be made of the fact that even when complete outside financing is promised for the purchase of specific equipment, we must still provide personnel for the absorption of this equipment, etc., and this need will not be limited to one-year periods. On the other hand, if the purchase of a plane, or some other piece of equipment, is so essential for national defense that we would in any event have purchased this item, even at the cost of a considerable lowering in our standard of living, then clearly this outside financing will considerably ease the burden in real terms.

Aid in the form of loans certainly eases our burden in the short-term, but does place a burden on us over a period of years. This year's budget, for example, includes \$469 million for repayment of loans to the U.S. Government. This sum, of course, is included not in the defense budget, but rather in the section entitled "Repayment of loans."

For a similar reason, the movement of goods does not correspond to the transfer of payments. The government budget for 1980 notes a reduction of \$150 million in foreign currency spending for defense needs, but it also notes, in the section dealing with import estimates, an increase of 24% in direct imports for defense needs - from 1.45 to 1.8 billion dollars. In other words, in the first year of normalization vis-a-vis Egypt, defense spending in Israel pounds will increase by 16% or more in real terms and direct imports for defense needs will in 1980 cost \$350 million more than they did in 1979.

Spending for defense procurement within Israel in relation to the GNP will reach a record 18%, which is only slightly less than the corresponding figure for 1973, the year of the Yom Kippur War. If a visitor from another planet were to analyze the above data on the defense budget burden, and if he did not know about the developments in our region, he would certainly come to the conclusion that the Government of Israel is convinced that at present the outbreak of a new war is "highly probable." But what would he think if he were to find out that only recently we hosted the Egyptian Minister of War, who came here with a large entourage of military experts, that we opened up the gates - that are generally locked - of our Aircraft Industries and that, with a

considerable feeling of pride, we showed him the production process of the Kfir fighter plane and the production plans for the fighter plane of the future, the Lavi? He would ask whether Israel expects peace or war? And, if Israel is both seeking peace and preparing for war, how can she handle the burdens involved in this two-directional approach? We would have very great difficulty in providing him with a logically acceptable answer.

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In his budget speech, Mr. Hurwitz's motto was that we must cut "into the living flesh." With regard to the defense budget, it has sometimes been remarked, perhaps with some measure of exaggeration, that the living flesh is surrounded by a considerable amount of "fat," which could be reduced without our having to cut "into the living flesh." In my humble opinion, this point is not the main issue; the main issue is the plain, bitter fact that because of the absolute and relative dimensions of the defense budget there is apparently not the slightest chance for an improvement in the situation of our "civilian" sector, unless we postpone certain items of defense spending for another year, unless we spread our re-equipping and redeployment over a longer period than originally planned, unless we take into more serious account the effect of the real burden of defense spending, at present and in the future, on our ability to maintain a reasonable level of national defense, and unless we resolve not to become completely "enslaved" to those who provide us with aid.

It has recently been reported in the press that in their discussions with the members of the Knesset's Foreign Affairs and Security Committee, Mr. Hurwitz and his staff admitted to not having had a part in the decision taken on the start of production work on the Lavi fighter plane, although this decision involves the spending of very considerable sums of money during the current decade. At the same time, the Director-General of Israel Aircraft Industries stated over the radio that the decision to manufacture the Lavi was partially based on the assumption that the U.S. Government would continue to provide us with an annual "ordinary" military aid grant of one billion dollars during the entire decade. Should such a far-reaching conclusion be based on such an unrealistic assumption, even if the Minister of Defense supports President Carter and is sure of his re-election? Perhaps, after all, a breakdown in communications did in fact take place between the White House and the U.S. Ambassador to the U.N. and that this breakdown accounted for McHenry's condemning us over the settlements in Judea and Samaria and over the issue of Jerusalem.

One of the Treasury's publications on defense matters states:

Because of the dimensions of defense spending and because of the number of people connected with defense work, there is a need for in-depth discussion of defense spending - with regard to the manner in which decisions on defense spending are taken, with regard to the nature

and extent of this spending, and with regard to the economic, social, and political implications of defense spending. The maintenance of the defense network and its vital place in national defense are matters that are too important to be left only to the decisions of military personnel.

This statement speaks for itself.

Israel's civilian Ministers of Defense took personal responsibility in defense matters. Ben-Gurion took it upon himself to arm the IDF for only a limited number of days of fighting and to thereby enable the allocation of resources for the absorption of the mass waves of immigration to Israel, for the creation of new jobs, and for the expansion of both the school system and social services. Eshkol decided on a "period of waiting" before the Six-Day War and met with total opposition from various well-known generals; through his decision he reduced in advance, and to very significant extent, the pressure that was applied on us to withdraw from the territories captured in 1967. Because of his policies, we are still holding onto a portion of these territories and we were able to use the other portion in order to obtain interim agreements and a peace treaty with Egypt.

Maximum defense is not necessarily assured by maximum transferral budget at resources to direct defense matters. In wartime yes, but in peacetime - not. The decision on this matter should be taken only after very serious considerations of all the relevant aspects involved in national defense in its widest meaning.

Moshe Sanbar is an economist of note and former Governor of the Bank of Israel. Presently the head of Israel's largest private corporation, he is pursuing his work on the economic dimensions of peace with Israel under the auspices of the Jerusalem Institute for Federal Studies, of which he is a Fellow.

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