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ISRAEL'S ECONOMIC DILEMMA

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When Arthur Ruppin told a Zionist Congress in 1913 that economics in Palestine would probably take a back seat to the exciting political debate, in fact, he was right then and this is still true today. Yet looking at Israel from an economic point of view adds an important perspective to the political debate.

The Israeli economy has been booming in the last few years, especially in the last two years, no doubt due largely to the immigration wave from the former Soviet Union. Israel has always experienced economic booms in the wake of waves of aliya. It remains to be seen whether we can continue on this path now that aliya has been reduced to more modest levels and now that Israel is returning to its natural rate of growth based upon the rate of reproduction, a rate that is still higher than in the West, but relatively low, especially among the Jews.

Two questions need to be asked. The first is: Why does the economy exist? What is the purpose of all this huffing and puffing? The other is: Once we determine what it is all for, can the economy deliver what it is supposed to deliver and can it

fulfill its objectives?

A Socialist Economic Heritage

Not very long ago Israelis were told and believed that the economy existed in order to build a nation. The ideas, conceptual framework, and underlying ideological underpinning of economic activity in Israel were largely borrowed from the socialist-communist study book in countries from which the early politically-directed immigrants came.

Looking back on the history of aliya, the first thirty years of the settlement of Palestine were without any ideological direction to speak of; it was settlement for the sake of settlement. Jews simply came to Palestine in order to settle here and they had no ideology except Zionist ideology. That changed after the Second Aliya from Russia and the Ukraine which brought people who had long been active in a political movement whose ideological makeup was socialist. This was reflected in their beliefs, in what they advocated, in the sorts of institutions that they erected — primarily the

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Histadrut. Zalman David Levontine, one of the first chief executives of what is now Bank Leumi, said of the Histadrut's founding that the fight of labor against capital in Palestine began before capital ever arrived here. This describes well the economic setting of the period.

This has been true for most of the existence of the Jewish entity in Eretz Israel — first in the Yishuv and then the state. The accepted wisdom held that there was something sinister about consumption, and that private consumption was something to be avoided, even condemned to a certain degree. There was a flavor of obesity about any kind of private consumption. People were supposed to work in order to create jobs for new immigrants, build just social institutions, and do all manner of things except to personally enjoy the fruits of their labor.

The Legitimation of Consumption

It is only in recent years that private consumption has received a certain degree of legitimacy and is no longer viewed as a sin. One example of this from not so long ago is the *mechikon*, a device employed as late as 1981 by Israel Television to erase the color from its broadcasts, even though it was broadcasting with color equipment, because the government did not want to encourage people to buy color TVs. Today, however, consumption has gained legitimacy, which means that more people are inclined to respond with the liberal answer, whereby the whole institutional framework of a society of a state is there to ensure individual happiness, which in materialistic terms means standard of living — consumption.

Viewing the Israeli economy in that framework, Israelis are now at a stage where we roughly share the Western, capitalist outlook that seeks to afford people the opportunity to earn as much as they can, to express their potential to the fullest in terms of earning power so that they can live as well as their potential will allow them to. Viewed in this way, the role of an economy is to deliver the highest possible sustainable stream of consumption over time. The question today is whether Israel is indeed on such a sustainable path.

Economic growth in Israel over the past two years has indeed been led by private consumption, which is increasing much faster than the gross national product. Much of this increase in consumption has been directed toward service industries such as the retail industry or personal services. Indeed, you hear a lot of Russian being spoken in such places. Many new immigrants were absorbed into relatively low paying jobs in service

industries that are sustained by this boom in private consumption. If this trend were to let up, we would probably see an increase in unemployment and, in fact, the first signs of such an increase may already be seen. There is currently an increase in job seekers, a factor which always precedes a rise in unemployment by three to six months.

A Reduced Defense Burden

During most of the period since the Six-Day War, Israel's defense burden has been horrendous by any measure. Even the official numbers tell us that Israelis were using upwards of one-fifth, sometimes a quarter, of the resources that they produced for purposes of defense. Under these circumstances there was no chance that a democratic society could survive without some assistance from the outside. Israel was allocating the sort of portion of its resources that could be found only in places like North Korea and North Vietnam. No democracy ever shouldered defense burdens like these except during short wars, and even then it usually never reached such proportions. In other words, Israel has been a country under constant siege and its survival as a democracy could not have been maintained without some outside assistance. And even that assistance was not enough, so Israel borrowed heavily around the world in order to finance excess imports over exports, a situation which it has always had. The question was only the extent to which it imported more than it exported.

Now those times have passed. In 1995 the total defense burden was down to around 11 percent of the resources that Israel produces. Some seven and a half percent of that is domestic defense expenditure. The rest is defense assistance from the United States. Some \$1.4 billion is used to pay for importing defense material, while Israel is allowed to convert \$450 million into shekels and spend it domestically on procurement from local defense producers.

The Impact of Foreign Aid

Israel's total foreign assistance includes all the foreign exchange that Israel receives without creating any future obligations. It comes in the form of U.S. aid, UJA, all sorts of funds that are run by various institutions like Hebrew University and the Technion, reparation payments from Germany which still total around one quarter of a billion dollars annually, and the like. This aid is known as unilateral transfers from abroad, and for the past few years it has nearly equalled Israel's entire defense budget.

The flip side of this picture is that Israelis are saving much less than they used to. The proportion of savings out of income in the Israeli economy has dropped markedly over the last few years. Part of it is no doubt attributable to the fact that there has been a substantial addition to the population of people who are in no position to save, namely, the immigrants from the former Soviet Union and from Ethiopia. They, in many cases, still consume more than their income would allow them, simply because they do not yet have the earning capacity that the average Israeli has. But in addition to this there has been a decline in saving rates among veteran Israelis, excluding the new olim.

As a consequence, in 1995, Israel's excess imports totalled around \$10 billion, which is more than its entire defense burden. In other words, Israel's excess imports allow it to finance all of its defense burden and then some. This is because what a nation has at its disposal for domestic uses is what it produces, plus the excess of imports over exports. For every dollar of such excess, the public can divert a dollar from defense spending to private or civilian public consumption. If excess imports are equal in size to defense spending, this means that the public does not have to shoulder any of the defense burden.

This is one aspect of the question of the trajectory of Israel's economy — is its growth sustainable? Can Israelis realistically look forward in the future to receiving foreign aid in all forms approaching 10 percent of what they generate themselves, on a relatively regular basis?

Ten years ago I would have told any politician that he was crazy to rely on the continuation of such levels of foreign aid, and today he would be laughing at me because the fact is that it has continued all these years. First there was the stabilization program of 1985 for which Israel received several billion dollars in additional aid from the United States. Then there was the Gulf War for which Israel got additional aid from both the United States and Germany. Israel is still getting aid from Germany in the form of two submarines the Germans are building for the Israeli navy.

Looking into the future, can we really expect this stream to continue? The answer has nothing to do with economics and has everything to do with politics and all sorts of other consideration.

The Fight Against Inflation

Another aspect of sustainability is stability. Even though ten years ago Israel adopted a stabilization program that was designed to kill inflation, its rate of

inflation is still three times higher than what is common in the industrial world. Relative to what it used to experience, Israel has achieved fabulous stability, but relative to what is acceptable in the industrialized world, Israel is not yet stable and the difference is not minor. There is a significant difference between 8 percent inflation and 3 percent inflation. For many economic reasons, this is a serious gap which impairs Israel's competitiveness and is injurious in many respects, most of them unquantifiable in the sense that economists still do not know enough about the intricate workings of inflation to be able to put numbers on the damage it causes. The almost daily battle between the Bank of Israel and the Association of Industrialists about whether or not the shekel should be devalued is just one indication of the stress created by continued inflation.

The bad news is that the government in Israel, unlike the government of every other industrial country in the world, is still not prepared to pay the price for the final drive to kill inflation, and in this we are more akin to the Greeks or the Italians. The government is unwilling to undertake that kind of responsibility and lacks the leadership and courage to do what everybody knows is necessary. But a government like that puts the economy in jeopardy, regardless of whether we are really on the right track.

The Question of Land Ownership

The third aspect of the sustainability of economic growth has to do with individual policies, the most important of which is the policy concerning land use.

Land is the most fundamental factor of production in any economy; you can do virtually nothing without land. As a consequence, of fundamental importance to any economy are the kinds of institutions and markets that determine how land is traded, who owns land, what ownership rights are, and what they mean. There is an entire branch of economics that deals solely with these questions. Let us call it the economics of zoning.

Israel is still a country in which there is a wedge between the inventory of land and the availability of land. In every normal country, all of the land within its territorial boundaries is, in principle, available for economic purposes at all times. This does not mean that everybody can do whatever they please. There is land regulation to make sure that the use of land conforms to some system of preferences, set by law, that relates to such matters as the environment or infringement on neighboring property rights. In Israel, however, this is not true. Here there is a pool of land

under the ownership of the Israel Land Authority which is not available for any use. It is simply not part of the land supply. Yet within a few years the area of this country north of Ashkelon is going to become the most densely populated in the entire world. If you take away the Beersheva district, Israel may already be in second place in terms of population density, and the traffic jams prove it.

Under these circumstances, to withhold land from any use at all is sheer lunacy. The only reason for the existing situation is that the Land Authority behaves like any monopoly would behave that had rights to a restricted natural resource, seeking to maximize the amount of income to the state treasury from land deals. Yet this has no relation to the economic well-being of the country or of its population.

Is there any good reason now to have most of the land in Israel under public ownership? Before the state was founded, land was kept under public ownership ostensibly in order to prevent its sale to the Arabs, which, by the way, was never true. Not a single dunam of land was ever sold to an Arab by a Jew.

On the eve of the establishment of the State of Israel, half of the land under Jewish ownership at that time was under private ownership, owned by individuals. Only half was owned by the JNF. However, people thought there was a real danger and therefore advocated public ownership of land to secure eternal Jewish control over the land. This may all be unnecessary now that Israel is sovereign, and stems from confusion between property rights and sovereignty. If we are sovereign over this land, why do we also need to have public economic ownership over it?

The consequences of such a policy are absolutely abhorrent. I live today in an apartment in Rehovot. For the amount I could get if I sold it, I could buy a spacious house fifteen minutes from downtown Washington and still have enough left over to buy a new car and live for a year without working. Even more ridiculous is the fact that, on my current income, I could never afford to buy the apartment where I live. I would need to take a mortgage of such size that the payments would swallow up half of my monthly income, which means I cannot afford to purchase my own apartment. This is now true for a majority of Israelis.

Tel Aviv has become one of the most expensive cities in the world. Yet housing prices will not be able to maintain their current trajectory and it is all going to blow up in our faces one day.

There is one other reason for the current policies of the Land Authority. Israelis have this peculiar

characteristic by which it makes them feel good when the value of their place of abode appreciates. They feel satisfaction from knowing that the apartment they live in has appreciated in value, but they never get anything out of it. It may seem to make them richer, but this is strictly a "paper" gain, since even though the dwelling services which are derived from the appreciated apartment increase in value, their quantity, and therefore the level of enjoyment, remains unchanged. In some respects, they are now in a worse position because if they ever wanted to upgrade their place of abode, sell their existing place and buy a better one, the more prices climb, the more difficult this becomes because, percentage-wise, all housing prices are increasing at a roughly equal rate and they would never be able to afford a better place.

Not only is the Land Authority policy at fault here, but also Israel's pattern of settlement. Israelis have developed a tremendous taste for living like Americans in individual houses, as in Greater Los Angeles, and the laws governing land use and zoning regulations allow them to do that. This means we are using land very inefficiently in a country where land is quite scarce. We should be living like the people in Hong Kong do, vertically, not horizontally.

Not only does land appreciate faster than it should because of inefficient and uneconomical use, but this also leads to the terrible transportation problems we now have. Scores of bedroom communities have been built where people have no local employment. They all must travel back and forth every day to their places of work, clogging the existing roads. Such a system is unsustainable and much too expensive for a country like Israel.

Health System Problems

The Israeli health care system represents another economic time bomb. The economics of health is a very difficult subject. The main problem is that the demand for health and the supply of health cannot be separated, in the sense that the suppliers of health determine what the demand is. The doctor who supplies the health services tells you what you need. It is as if you went into a grocery store and asked the grocer to tell you what you should buy. This creates an economic system that has the wrong incentives built into it from the start. Israel has a new National Health Law that has been in operation for one year. Israel finally adopted its law when, all over the Western world, countries are coming to realize that such a system cannot be sustained. The Canadian health

system is breaking down because they have attempted to do exactly what we are now attempting to do. Canadians are now going across the border to obtain medical care in the United States. The British health system is also in difficult straits.

A national health system absolves people of all decision-making concerning health. All they have to do now is go to the doctor. But if Israel is going to adopt such a system, it should at least try to configure it in such a way that it contains the best incentives possible to avoid misuse of that system. It should include, for instance, complete separation between the insurer, the provider of health care, and hospitals. For example, there should be some incentive whereby hospitals do not simply let patients lie there for days on end because the state automatically pays. But no such reconfiguration of the system was attempted. The Kupat Cholim health insurance fund still owns hospitals and there is a good chance that when they send a patient to a hospital, they will not choose the hospital that provides any particular service most efficiently. They will simply send the patient to their own hospital. Government hospitals as well have not been privatized, meaning that there is no incentive for them to be efficient either. Under these circumstances, the health system is going to swallow up increasing portions of our income and this is not sustainable.

The Peace Process

Much speculation has been made concerning a "new Middle East" and the economic benefits of the peace process. Yet I do not foresee any big economic deals resulting from the changing relations between Israel and the Arabs. The fact is that there is not much Israel can do with either Jordan or Egypt which will suddenly create an economic panacea.

It is true that the Israeli economy has been reforming in some very important areas over the past ten years. Is foreign investment increasing because Israel is supposedly at peace with the Arabs or is it increasing because Israel is now economically a better place to invest in? It is my guess that foreign investment is increasing not because of the peace process but because Israel has created better economic opportunities by reforming its capital market, by relaxing all manner of regulations in various fields, and by enabling increased competition. Indeed, because of the high interest rates in Israel relative to other parts of the world, there has been a considerable influx into Israel of foreign exchange and foreign credit, all being used by the private sector.

The Stock Market

The difficulties with the Israeli stock market are fundamental, and are not a reflection of the peace process or any other particular kind of behavior. In order to understand this we have to recognize two basic principles about corporate Israel. The first is the enormous concentration of ownership in the Israeli economy which leads to the result that only one-third of the outstanding stock is actually traded. Roughly two-thirds is held by major investors owning 10 percent or more of a company. Looking at the ownership structure, virtually all public companies of any significance are owned by a combination of Koor, Clal, Bank Hapoalim, Discount Holdings, the Israel Corporation, and government corporations.

The other problem is that Israeli companies do not distribute dividends. As a consequence, the only reason to be in the stock market is to guess at what other players will do, not because you stand to gain from the profits of the company in terms of dividends. This causes the Israeli stock exchange to assume the nature of a casino. As a consequence, collapses in the stock exchange are much more pronounced, hitting people over the head and causing them to stay away from the stock exchange for a long time. After the collapse of the stock exchange in January 1983, it took seven years to recover because people were afraid of it.

In sum, looking back over these major economic issues and how they relate to the overall question of sustainable economic growth, we can take satisfaction with many of the good things that have happened in the Israeli economy over the past ten years. However, in my professional judgement, not enough good things have happened to assure Israelis of continued prosperity.

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