Israel

In 2005, the Israeli economy started to show the first signs of a long-awaited economic recovery. The overall economic growth rate exceeded 5%, and more significantly, the business sector grew at an even more impressive rate of 6.4%.

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The recent spurt of growth can be explained by a number of factors. One is the relative improvement in the security situation, which resulted in an immediate increase in the number of tourist arrivals and a recovery in the tourism sector, which accounts for 4% of GDP. However, Israeli experience demonstrates that a calm security situation does not ensure economic growth; sound economic policies and fiscal discipline are much more essential ingredients. Benjamin Netanyahu, the former Prime Minister and Finance Minister, clearly understood this and pushed for a more reasonable fiscal policy consistent with deficit targets. A more favourable environment for private businesses was created through his economic policies. The privatisation of several public companies and the cancellation of bank monopolies helped create more competitive markets and lowered prices. The move towards a new welfare system influenced by US welfare-to-work reform also led to necessary changes in the labour market.

The recent recovery of the Israeli economy is, however, still fragile and strongly dependent on economic policies that will be implemented after the elections in March 2006. The Israeli economy continues to suffer from the vestiges of a heavily centralised economy. The public sector in Israel currently controls 51.5% of the economy, compared to an average of 41.6 % among OECD countries, and 34% in the United States. Note that large military expenditures do not fully account for this discrepancy. The government debt to GDP ratio in Israel is also expected to reach 101.5% in 2005. Netanyahu's push to liberalise the economy and reduce the weight of the public sector promises to help sustain and further accelerate economic growth. On the other hand, the fragility of the recent growth will be quickly demonstrated if the statist programs presented by all other candidates in the election prevail.

Breaking with a long tradition of interventionist economic policies and a continuously growing public sector, Finance Minister Benjamin Netanyahu launched a series of reforms that helped contain public expenditures and spur economic growth. After much social unrest and loud demonstrations, the bankrupt welfare system was finally reformed along the lines of the welfare-to-work reforms adopted nationally in the United States in 1996. Before the new reforms, average welfare payments in Israel exceeded the average wage that most welfare recipients would have received in the labour market, leaving them with very little incentive to look for work. The Israeli welfare-to-work plan was first implemented in the beginning of 2005, and the immediate effect was a reduction of transfer payments from 7.3% of GDP in 2004 to 7% in 2005. At the same time, unemployment decreased from 10.4% to 9.1 % in the first and second quarters of 2005, accompanied by an increase in the number of transitions from part time to full time employment.

In addition, the long awaited privatisation of public companies was launched in full force in 2005. Workers employed in public-sector monopolies were earning five times the average Israeli salary and were enjoying exceedingly advantageous retirement plans. Thus, it is not at all surprising that the privatisation plan was met with fierce opposition by public sector labour unions. But in March 2005, after two months of strikes that literally shut down the country, the Israeli taxpayer won a small victory against privileged public sector employees. In a first step towards privatising Israel's seaports, the government signed an agreement with the Histadrut (General Federation of Labour) resulting in the breaking up of the port authority. Each port will be transformed into a different public company that will have to compete in the market. These public companies will then be privatised in the

future. The oil refineries are also planned to be split into two competing public companies that will be privatised in a second stage. A similar initiative was partially introduced for Israel Military Industries Ltd.

In 2005, Netanyahu also succeeded in slightly lowering individual income tax rates and the VAT without significantly increasing the budget deficit as a percentage of GDP. Tax brackets were widened at all wage levels and the highest marginal tax rate was lowered to 49% from 60% in 2003. The VAT was lowered by .5% from 17.5% to 17%. These fiscal changes increased the disposable income of Israelis and domestic demand, creating growth in the commerce and service industries. In July 2005, the Knesset approved a tax reform bill that will gradually reduce the corporate income tax rate from 34% in 2006 to 25% in 2010. On a less upbeat note, capital gains taxes for individuals will grow from 15% to 20% in 2006.

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The above reforms were also accompanied by a much needed overhaul of the banking system in which more competition was introduced. Israel's banking system has been historically dominated by two banks, Bank Hapoalim and Bank Leumi. These two banks control almost half of all tradable assets. This duopoly received almost all national savings and enjoyed exclusive powers in the lending market because only banks can offer credit in Israel. There are no other lending institutions. One of the results of this corrupted system was that 70% of all credit went to 1% of borrowers (insiders). Unfortunately, the vast majority of 'outsiders', other businesses and entrepreneurs, struggled to raise capital. Profit opportunities were stymied because of lack of competition in the lending market. This damaged economic growth.

The 2005 economic reforms have already borne fruit. The high-tech industry had its best year in 2005 since the dotcom bust of 2000. The high-tech sector generates 40% of all Israeli exports, amounting to $13 billion a year. Israel's high-tech sector includes within its ranks Intel, the world's largest chip maker. Intel already has six production and design plants across Israel and is opening a new plant in the southern town of Kiryat Gat. This new plant will add another 2000 jobs to Intel's large Israeli workforce of 6000 men and women.

The Intel success story is accompanied by the notable number of Israeli companies listed on NASDAQ (New York's technology stock market). Israel has more listed companies on NASDAQ than any other country outside of the United States. Israel's highly skilled and well educated workforce bestows on the country a competitive advantage that is attractive to high-tech businesses. A more competitive lending market will further foster the growth and creation of new high tech firms.

Overall, 2005 was the start of a new vision for the Israeli economy, but last year's economic recovery is still very fragile and, at this time, it is not at all clear that the policies of fiscal discipline, privatisation and deregulation will continue in the future. The unions will undoubtedly fight every move towards modernisation that encourages economic growth, in a country that already loses more workdays to union-led strikes than any other industrialized nation. In fact, the national labour union leader, Amir Peretz, has recently taken over the leadership of the Labour Party and is running for Prime Minister in 2006. Note that Peretz has earned the nickname of Stalin, not just because of his physical appearance, but because of his lifelong economic philosophy. If elected Prime Minister, Peretz has already pledged to cancel proposed cuts in education, health, and welfare and at the same time raise the minimum wage by 30%. Economists have assessed the costs of Peretz's proposal to be over $2 billion.

The business community is correct in voicing serious concerns over the potential impact of Peretz's proposals. The Israel Manufacturers Association already warned that raising the minimum wage will lead to the firing of thousands of workers, the shut down of factories and the transfer abroad of production facilities. If Peretz's plan was to be put into action, Israeli private businesses will once again suffer from high taxes, excessive government oversight, new tariffs, and endless bureaucracy. Further signs of uncertainty have been introduced following the appointment of Ehud Olmert as Finance Minister, following Benjamin Netanyahu's resignation over Sharon's disengagement and expulsion of settlers from Gaza. Olmert, like Peretz, is also known to believe in old-style economic interventionism and statism that has proven to cripple economic growth in the past. Only hours after Peretz was elected as head of the Labour Party, Olmert announced a new plan to combat poverty through public spending.

The Israeli economy has enormous potential. The possibility of a Hebrew Tiger is within reach. However, the overwhelming majority of Israeli politicians remains short-sighted and unfortunately eschew policies consistent with economic freedom and economic growth. 2006 will certainly be a critical year for the future of the Israeli economy.