No Paradigm Change in Sight

The Economic Policies of the Second Netanyahu Government (2009-2012)

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Introduction

The Adva Center analyzes the government's socioeconomic policies on an ongoing basis, while studying the effect of these policies on equality and social justice in Israel.

In this paper, Adva reaches beyond its usual analysis, to examine the socioeconomic policies during the course of one entire term of office – the second term of Benjamin Netanyahu as Prime Minister of Israel, which lasted 4 years and 2 weeks, from 31 March 2009 to 18 March 2013. Only two other Israeli governments lasted this long: that of Golda Meir (4 years and 4 months) and the first Begin government (4 years and 1.5 months).

Even before his second term, Netanyahu had played a key role in shaping Israel's socioeconomic policies – during his first term as Prime Minister, from 1996 to 1999 (3 years and one month), and later as Finance Minister in the government of Ariel Sharon, from 2003 to 2005.

This document focuses on several core elements of governmental activity – not budgetary policy alone, but other policy areas as well, such as monetary policy, investment, and taxation of natural resources.

In examining the macro-economic policies of the second Netanyahu government, we must bear in mind that they were based on principles that had been established a generation earlier with the enactment of the 1985 Economic Emergency Stabilization Plan. That plan had challenged the principles reigning until then – first and foremost the principle of state developmentalism, which views the state as the main actor shaping and implementing macroeconomic policy, and consequently controlling the main sources of capital and its allocation. Since 1985, this principle has been replaced by three others: (a) downsizing the government's role in the economy; (b) setting growth as the main goal of economic policy; and (c) assigning the role of leading economic growth to the business sector, rather than the government.[1] These three principles have, ever since, driven the policies of all Israeli governments, whether led by the Labor Party, the Likud, or Kadima.

Although Benjamin Netanyahu was not one of the decision makers in 1985, he has served over the last two decades as the foremost and most articulate spokesperson on behalf of these policies. In particular, he made famous the metaphor that in the Israeli economy, "The fat man [the public sector] is being carried on the back of the thin man

1 Avi Ben-Bassat, "The Obstacle Course to a Market Economy in Israel", in A. Ben-Bassat (ed.), *The Israeli Economy, 1985-1998: From Government Intervention to Market Economics* (MIT Press, 2002).

[the private sector].” As Finance Minister during the crisis years of the second Intifada, Netanyahu adopted a set of measures that were an extreme version of the 1985 policy, including unprecedented budget cuts and the transfer of retirement savings plans (pensions) to commercial insurance companies. Therefore, for some issues, we present data not just for 2009-2012, but also for the entire decade since 2003.

Netanyahu’s second government took office shortly after the outbreak of the global financial crisis. The Israeli economy emerged from this crisis more rapidly than the economies of most western countries – its main trade partners – showing higher rates of growth. Economic activity benefited from the prolonged hiatus in the Israeli-Palestinian conflict, even though no progress was made in resolving it. The gas fields discovered at the time the second Netanyahu government took office added to the optimism, whether because they held promise of a cheap source of energy independent of the caprices of foreign governments or because they carried tidings of future state revenues.

The other side of the coin was less optimistic: increasingly concentrated wealth in the hands of a small number of business groups, exorbitant wages for a narrow stratum of senior executives, increases in the employers’ share of the national income while the workers’ share steadily diminished, ongoing shrinking of the middle class, and a high, unwavering incidence of poverty.

In August 2011, about two and a half years into the term of the second Netanyahu government, a social protest movement emerged under the banner, “The people demand social justice”. In retrospect, this movement can be seen as the delayed reaction of the urban middle class to the policies set in motion by the 1985 stabilization plan. While the large budget cuts of 2003 primarily harmed low-income earners, the bulk of the demonstrators of 2011 were from the frustrated middle class, who were finding it more and more difficult to provide economic security to their children.

The protest in the summer of 2011 did not trigger any rethinking of the macro-social and economic policies of 1985. Indeed, the Trajtenberg Committee, appointed by the second Netanyahu government in response to the protest, declared at the outset of its deliberations that it would not touch one of the main pillars of the “paradigm of 1985” – fiscal austerity.

The Economy Spearheaded by the Business Sector

The business sector in the lead

Ever since 1985, the Israeli government has sought to reduce the functions and expenditures of state institutions and to bolster the functions and funding of the business sector. Economic growth, defined as the paramount macro-economic goal, was to be spearheaded by the business sector, and – to help business accomplish this mission – the government would strive to reduce the state budget and thereby "release financial resources for use by business", i.e., expand the share of the business sector in the socially accumulated capital. Underlying this approach was the assumption that the business sector would increase its investments in Israel with the capital made available to it, and that this would stimulate economic growth and thereby benefit the public at large. Another assumption was that the business sector would make better use of credit than the government.

Increasing credit to the business sector

Throughout the term of the second Netanyahu government, the business sector enjoyed a bigger share of credit than the government: 54-56% of the total credit (not including credit to households and local authorities) was held by business, while the government held 44-46%. In 2003 the government had held 52% of the total credit, while the business sector held 48%.

Between 2003 and 2013, the final year of the second Netanyahu government, the total amount of credit going to the business sector rose by 29%, from NIS 607 billion in 2003 to NIS 782 billion in 2012. This leap took place in the five years between 2003 and 2007. In 2008 and 2009, following the world financial crisis, the numbers declined, but then remained virtually unchanged through 2012.[2]

The policies implemented since 1985, and particularly after 2003, succeeded: More credit is available now to business than to government.

The increase in credit available to business is the product of two measures taken by the government: first, a consistent policy of fiscal austerity; and, second, transfer of the public's retirement savings plans to the capital market.

2 In constant prices of December 2012. Source: Analysis by the Adva Center of Bank of Israel, *Report*, various years.

We talk more about the policy of fiscal austerity later in this paper, but here we note that this measure has been successful from the standpoint of its proponents: The size of the Israeli state budget in GDP terms has dropped from 47% of GDP in 2003 to 38% in 2012 (below the OECD average).[3] At the same time, the government debt fell from 98% of GDP in 2003 to 67% in 2012.[4]

The second measure taken by the government – in 2003 -- was the privatization of retirement savings plans by selling the new pension funds, which had first been nationalized from the Histadrut, to commercial insurance companies. Privatization was accompanied by government permission to insurance companies to invest the major share (70%) of pension funds under their management in the capital market, such as corporate bonds; previously, the companies had been obligated to invest most of the funds in special government bonds. As a result, there was an infusion of money from pension funds into the capital markets.

The privatization of pension savings has transformed the Israeli credit market: In the past, banks had been virtually the only source of business credit. Now, insurance companies are the second most important source of business credit, climbing from under 30% to almost 47% of the total business credit.[5]

In 2008, one year prior to election of the second Netanyahu government, two important changes in the realm of retirement savings led to a further increase in the amount of credit available to the business sector. The first was an order making pension plans mandatory for all wage-earners in Israel (a decision to similarly obligate the self-employed has not yet been made). This order enlarged the pool of those saving for retirement, increasing the money injected into the capital market, since all new pensions are held by the new funds, which regulations require to invest most of their money in the capital market.

The second change was a decision to equalize taxation on the three types of retirement savings plans – pension funds, provident funds, and life insurance – and to ease transfers from one to another. These changes had a devastating effect on the provident funds, since equalizing the taxation removed the option of pre-retirement equity withdrawal and cancelled the tax benefit of medium-range savings, which effectively eliminated the relative benefit of provident funds as a medium- and long-range capital instrument. Prior to this change, money could have been withdrawn from a provident fund as untaxed capital 15 years after the fund was first opened; now such withdrawals are subject to heavy taxation. Another effect of the change was to provide many more years of credit to business from the monies of provident funds. Provident funds were a perk of the middle class, especially those employed in the public sector.

The business sector's use of enlarged credit

Having more credit was intended to allow the business sector to increase its investments at home and stimulate growth.

During the second Netanyahu government, levels of investment did not change dramatically. We are referring to

3 Calculation of the GDP was revised in 2006 in keeping with *SNA 2008*. According to the previous system of calculation, the 2012 state budget would have been 40% of the GDP, which is a more accurate comparison with the figures from 2003.

4 Using the previous system of calculation, the government debt in 2012 would have been 72% of the GDP.

5 Or Sofer, "Bank and non-bank credit after the crisis," slide presentation, Ministry of the Treasury, Capital Market, Insurance and Savings Division, 11 March 2012.

Government and Business Debt , 2003-2012

Of the total business and government debt, excluding households

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Government	52%	51%	49%	46%	42%	42%	45%	44%	45%	46%
Business sector	48%	49%	51%	54%	58%	58%	55%	56%	55%	54%

Source: Adva Center analysis of CBS, *Statistical Abstract of Israel*, various years; Bank of Israel, *Report*, various years.

"investment in fixed assets", that is investment in equipment, machines, and housing and business construction, which is measured as a percentage of GDP. Over the past decade, investment in fixed assets ranged between 18% and 20% of GDP.[6]

This is slightly lower than the average for OECD countries.[7] Throughout most of the past decade, investment was smaller in Israel than in Europe or the United States. During the second Netanyahu term, at a time when many western countries were reeling from the international financial crisis, Israeli investment increased relatively more than that of its OECD counterparts.[8]

Some of the lower level of investment in Israel can possibly be attributed to the fact that high-tech industries and services, a major economic force in Israel, do not require high levels of leveraging.[9]

While the overall level of investment did not change dramatically, the distribution between business and government changed significantly: government investments declined from 16% of the GDP in 2002 to 7% in 2012 (or 9% under the previous system of calculation).[10] Clearly this is one result of the policy of budget cuts and passing the baton of growth on to business.

An important point to note is that out of the total investment in fixed assets, while investment in housing increased from approximately 26% to 30%, investment in machines and equipment dropped from 34% in 2007-2008 to approximately 30% in 2012.[11] This is one reflection of the recently much discussed "real estate bubble".

Another point to note is that a significant portion of the credit at the disposal of the business sector has been used for investing outside Israel. Between 2000 and 2012, direct investment of Israelis abroad increased 8.2-fold – from approximately $9 to $74.7 billion. On the other hand, direct foreign investment in Israel during this period grew 3.7-fold – from approximately $20.4 to $75.9 billion.[12]

Note that during the years that the state controlled capital and its allocation, the funds were expended primarily within the boundaries of the country to enhance domestic economic growth. As soon as the business sector – the banks and insurance companies – took over the management and allocation of capital, a significant share was invested abroad. And this took place at a time when entire regions and population segments of Israel were crying out for investment.

Investments abroad are of course to some extent the product of a legitimate desire to earn better returns than can be had in Israel, which is especially important for retirement savings. Thus, as the insurance companies (referred to in Israel as "institutional investors") came to manage increasingly more pension savings – about NIS 1.1 trillion in October 2013 – the Finance Ministry pushed for moving more investments abroad. Ironically, it was the Finance Ministry itself that was most responsible for privatizing pension plans and transferring the funds to the insurance companies, either to increase the credit available to the business sector or to create competition with the banks, which dominated the credit market at the time. In late December 2012, investment in foreign markets was roughly 55% of all institutional investment, exceeding the 45% invested in the Israeli capital market. One result of this was the "drying up" of the Israeli stock exchange.[13]

The insurance companies learn to manage credit

One final comment concerning the policy of reducing the state budget in order to free resources for the use of business has to do with the safety of pension savings. Shifting the retirement savings plans from special government bonds to corporate bonds was beset by many missteps, primarily due to the inexperience of the insurance companies at managing so much money – inexperience that

6 According to the new system of calculation. Note that changes in the way the Central Bureau of Statistics calculates the GDP resulted in a spike in 2006, but no real change occurred.

7 *OECD Factbook 2011-2012*.

8 *OECD Factbook 2013*.

9 Bank of Israel, *2012 Annual Report*, p. 121.

10 CBS, *Statistical Abstract of Israel*, various years.

11 To allow for comparison, the 2012 figure was generated using the previous system of calculating investment in fixed assets, as was the figure for 2013. According to the new system of calculating investment, the percentage investment in housing in 2012 was 30% of the total investment in fixed assets. Source: Adva Center analysis of CBS, *Statistical Abstract of Israel*, various years.

12 UNCTAD, *World Investment Report 2013*, Annex table 2.

13 Boaz Nagar, "The stock exchange dried up because the institutions are buying abroad only", *The Marker*, 17 October 2013 (Hebrew).

put pension savings at risk. In 2009, the government appointed the Hodek Committee to set guidelines for investing in corporate bonds. In light of the investment practices that were undermining the rights of those saving for retirement, this committee set a goal of providing "better protection for pension savings".[14] The committee obligated the institutional bodies to conduct a preparatory analysis before undertaking an investment and to set minimal, recommended, contractual covenants. In other words, the monies of those saving for retirement had been transferred to bodies that had not developed basic investment guidelines prior to infusing funds into the capital market.

14 Hodek Committee, "The Committee for Establishing Parameters for Institutional Bodies' Investments in Nongovernmental Bonds", slide presentation, Final Report, February 2010.

Contracting the Role of the State in the Economy

Downsizing the state

A two-year budget

The policy of downsizing the state has been in place for some time, adopted by all Israeli governments and implemented by various methods, particularly the Reduction of Deficit and Limitation on Budgetary Expense Law (1992).

The second Netanyahu government added an invention of its own: a two-year budget. This contrivance is highly problematic for several reasons. First, it undermines the standing of the legislature, whose most important function is the annual deliberation of national priorities, including oversight of government activity during the previous year and approval of the budget for the coming year. Limiting parliamentary deliberations to once every two years saves the government the need to present and justify its order of priorities. What is more, conducting annual budget deliberations allows the legislative body to be relatively responsive to economic events in Israel and the world. A two-year budget is open to more error as changes are less predictable two years in advance. In 2012, for example, which was the second year of the 2011-2012 two-year budget, a substantial budgetary deficit came to light; though generated over a long period, it was raised for serious discussion only upon presentation of the budget bill for the following two years, 2013-2014.

The first two-year budget bill was submitted upon formation of the Netanyahu government in late March 2009, at a time when the Knesset had not yet approved a budget for 2009. Until the budget bill was actually tabled, several more months had passed; thus it made sense to deliberate the 2010 budget together with what remained of 2009. A year later, however, the government instituted the two-year budget as a regular practice and submitted to the Knesset a budget for 2011-2012. Despite widespread criticism, the Knesset elected in 2012 approved a two-year budget for a third time, for the years 2013-2014.

Deficit ceiling

The Reduction of Deficit Law was passed in 1992. The deficit is the difference between state revenues and expenditures; the amount of the deficit is set relative to the

GDP.[15] Since 1992, the deficit level not to be exceeded in the coming year (called the “deficit target”) has become part of the state budget bill submitted by the Cabinet to the Knesset.

At the time of the economic crisis caused by the second Intifada, there had been large yearly budget deficits – between 4% and 5.2% of the GDP. During the growth years following the Intifada, deficits shrank as low as zero (in 2007).

The second Netanyahu government, which took office in 2009, was expected to maintain and even reduce the low deficit levels set by the previous government, an expectation based on Netanyahu’s ideological views. This did not happen, however, and his government’s fiscal policy fluctuated as had that of the other governments. There were many reasons for this, including a decline in state tax revenues as a result of the multiyear plan to reduce corporate and personal income taxes; diminished growth caused by the global financial crisis with the resulting reduced tax revenues; and unexpectedly greater expenditures, partly due to clashes with the Palestinians – Operation Cast Lead in 2008 and Pillar of Cloud in 2012. Thus the budget deficit in 2009 reached 5.1%; in 2010, it was 3.7%; and in 2011, 3.3%. The target for 2012 had been 2%, but the deficit actually came in twice as high – 4.2%. The government itself did not meet the targets its prime minister had been advocating over the years.

The new government elected in 2013, the third headed by Benjamin Netanyahu, submitted a budget for 2013-2014 when it had already become evident that the economy was in recession and tax revenues would contract. Thus, another high deficit target, 4.65%, was set for 2013. But the government undertook the more ambitious target of 3% for 2014.

The expenditures cap (“spending rule”)

The policy of a lower budget includes not just a “deficit target”, but also a “spending rule”. In 2003, Netanyahu, then Finance Minister in the Sharon government, initiated an amendment to the 1992 Reduction of Deficit Law, adding a cap on expenditures. This was done through adoption of a “fiscal rule” that limited spending relative to the previous year’s expenditures. The amendment stated that the annual increase in government spending must not exceed a certain percentage, regardless of the revenues or amount of the deficit. At first the increase was set at 1%; later it was raised to 1.7% – which parallels the annual growth rate of the population, but is significantly below the growth rate of the economy for most years since this rule was set.

In 2010, the government adopted a new fiscal rule, one that does take growth into consideration: Under this rule, the increase in government spending is to be calculated according to a formula: the average growth of the GDP over the previous ten years times the ratio between 60% (the debt/GDP ratio set by the European Union’s Maastricht Treaty and adopted by Israel) and the last known debt/GDP ratio. In 2010, this new formula allowed for an increase in spending of 2.6% a year rather than 1.7% (an increase of some NIS 2 billion at the time).[16]

The change in the spending rule was remarkable in light of the global economic crisis and the austerity policies adopted by most European economies. Note that in 2010, the tax-reduction plan that Finance Minister Netanyahu had instituted in 2003 was coming to an end, and another series of reductions was set to begin in 2011. In other words, the government decided to slightly increase spending while continuing to cut revenues.

Two years later, in late 2012, when it became clear that the government was facing a deficit of some NIS 39 billion, the Budget Division of the Finance Ministry instigated a modification of the spending rule that would obligate even multiyear commitments – wage agreements in the public sector, for example – to comply with the spending rule or find an alternative source of funding.

Reducing direct personal taxes and raising indirect taxes

As noted, the multiyear plan launched in 2003 to reduce

15 For example, if the deficit is forecast to be NIS 10 billion and the GDP (Gross Domestic Product) is forecast to be NIS 1,000 billion, the deficit would be 1%.

16 For example, if the average growth over the previous ten years was 3.5% and the actual debt/GDP ratio was 80%, the calculation is 60 divided by 80 times 3.5%: the result is 2.625, which would be the percentage the government may increase its budget expenditures.

direct taxes was scheduled to come to an end in 2010. Lowering the tax rates – initially justified by the claim that the tax burden in Israel was onerous – eased the tax burden in Israel to levels below the average of western countries. This gap even widened a bit more in 2010-2012 as some OECD countries instituted tax hikes.

The second Netanyahu government wished to further reduce taxes. In the 2009-2010 budget bill, it sought to extend the income tax reductions to 2016, such that the maximum income tax, 45% in 2010, would gradually drop to 39% in 2016. The only ones who would have benefitted from this reduction would have been higher than average wage earners – a mere third of salaried workers.[17]

Many objected to the ongoing reduction of income tax, including the Bank of Israel. Ultimately, this opposition culminated in a recommendation by the Trajtenberg Committee – formed in the wake of the social protest in the summer of 2011 – to freeze the planned extension of tax cuts. This recommendation was among the few made by the Trajtenberg Committee that were actually implemented. As a result, the tax brackets from 2010 remain in place.

In addition to reducing direct taxes, which contracted revenues coming from the wealthier income brackets, the government raised indirect taxes, particularly Value Added Tax (VAT). Low income earners, who had not benefited at all from the direct tax reductions, could not avoid the rise in VAT, which applies equally to rich and poor. State revenues from indirect taxes – VAT and excise tax – which are regressive, bring in more revenues to Israel today than direct taxes – such as income tax – which are progressive.

During the four years of the second Netanyahu government, VAT was raised twice: On 1 July 2009, it went up from 15.5% to 16.5%; on 1 January 2010, it was lowered to 16%; and on 1 September 2012, it was raised to 17%. In Netanyahu's third term of office, on 2 June 2013, it was raised once again to 18%.

17 The Budget Bill and Arrangements Bill 2011-2012: A blow to democracy and tight-fisted on civilian allocations. Adva Center, 2 November 2010, p. 24 [Hebrew].

Corporate tax breaks

The policy of empowering the business sector that had begun in 1985 was reflected not just in expanding the credit available to it, but also in lowering taxes imposed on it, whether by legislation or by concessions on the tax rates set by law.

The second Netanyahu government instituted two significant measures in this regard. The first was a continued lowering of corporate taxes. In 2004, a decision had been made to lower this tax gradually from 36% to 30% by 2007, but as early as 2005, in keeping with recommendations of the Kapota-Matza Committee, a decision was made to further lower this tax to 25% by 2010. The 2009 tax reduction plan of the second Netanyahu government had intended to reduce this tax even further to 18% by 2016, i.e., exactly half what the tax rate had been when the reductions began in 2004. This additional decrease was never implemented, however, as a result of the social protest in 2011 and the Trajtenberg Committee recommendations that followed. In 2012, the corporate tax was raised from 24% to 25%, and then to 26.5% in 2013.

The second measure was reform of the Encouragement of Capital Investments Law – Amendment 68, which fundamentally altered the original law and eliminated some of the original requirements. The amendment left the "grants track" in place, but stipulated beyond this that henceforth there would be only one main benefit – a lower corporate tax for every industrial enterprise that exports 25% or more of its turnover. This change included a gradually declining corporate tax rate for "preferred enterprises": In 2011-2012, this applied to 10% of the enterprises in Development Area A and 15% of enterprises elsewhere; in 2013-2014, it applied to 7% and 12.5%, respectively; and from 2015, to 6% and 12% respectively. The law also stated that large corporations that receive special approval from the government and have revenues of over NIS 20 billion were eligible for a reduced tax of 5% in "development areas" ("strategic investments") and 8% in the rest of Israel. After the 2013 election and following revelations about the deficit in 2012, the reductions were halted and, as part of the Budget Arrangements Law of 2013-2014, the reduced tax rate for benefitting enterprises was set at 9% for companies in development areas and 16% for companies elsewhere. The reduced tax rate for large companies was not altered.

A key component of the reform relates to the conditions for receipt of the benefits. Following passage of the amendment, the enterprise is no longer required to make a "minimal investment" in fixed assets in Israel in order to qualify, and benefits are to be granted not only for investment in physical capital, but also in human capital, e.g., employee training.[18] Prior to the reform, benefits were granted only to industrial enterprises making new investments and thus contributing to the GDP and to job creation; after 2011, all industrial enterprises meeting the export criterion were eligible for corporate tax discounts. Thus, with the exception of the grant track with its small budget, the Encouragement of Capital Investments Law eliminated the "investments" dimension and was essentially transformed into a law for the encouragement of capital.

In another key change, companies eligible for tax benefits were no longer obligated to pay full corporate tax on dividends. Thus the problem of "trapped profits" was eliminated – monies that companies wished to distribute to shareholders, but refrained from doing so to avoid having to pay full corporate tax on the dividends. This fundamentally altered the original intent of the law, which had been to exempt from tax any gains that were plowed back into the Israeli economy by the eligible companies. The amendment set a 15% corporate tax on dividends. In November 2012, the Knesset approved the 'Trapped Profits' Law, which completed this gambit, giving a tax break to companies that benefit from the Encouragement of Capital Investments Law on dividend income earned under the previous law, if they were paid by January 2011.[19]

There were also positive aspects to the amendment, including termination of the full exemption from corporate taxes given to large companies (instituted in 2005), and excluding mining and quarrying companies from benefiting from the law (thereby denying tax benefits to Israel Chemicals Ltd.).

In consequence of all these benefits, as well as aggressive tax planning by major corporations, a growing discrepancy emerged between the reported profits of the top percentile of companies and the payment of their taxes, according to the Director of State Revenues. Thus, rather than stimulating new investment, reform of the Encouragement of Capital Investments Law brought about a differential corporate tax, in which export companies (which are generally bigger and stronger) pay a reduced corporate tax, while other Israeli companies and businesses pay the full corporate tax. This has made corporate tax regressive, unlike the situation in many countries in which corporate tax is generally progressive, i.e., smaller companies and businesses pay lower tax than larger companies and businesses. Thus, even after the reform of 2011, the Encouragement of Capital Investments Law can be expected to create benefits enjoyed primarily by a few mega-corporations.[20] Furthermore, the benefit comes in the form of a reduced tax, thus there is no defined upper limit – the amount is based upon the profit reported by the company.

18 Income Tax Circular 322102 on Amendment 86 of the Encouragement of Capital Investments Law.

19 By 12 November 2013, the last day of the tax collection drive for "trapped profits", a total of NIS 4.2 billion in revenues were reported. See Moti Bassok, "At the last minute: Teva will pay the state NIS 2 billion in taxes on trapped profits", *The Marker*, 12 November 2013 [Hebrew]. The State Comptroller noted that the tax that should have been collected was actually NIS 21 billion (State Comptroller, Report 64A, Tax Authority, p. 183) [Hebrew]. Meirav Arlosoroff, "In the money: Tax authority celebrating what was really a disaster", *Ha'aretz*, 14 November 2013.]

20 Ministry of Finance, State Revenues Administration, "Corporate Tax Collection in 2011".

Bank of Israel

Interest rates

One of the primary tasks of the Bank of Israel is to set the monthly interest rate as part of its supervisory role over the supply of money and its value relative to other currencies. In the spirit of the policy to encourage the business sector and increase growth, the Bank of Israel, since the end of the second Intifada, has consistently adopted a policy of lowering the interest rate.

Lowering the interest rate is a tool for stimulating economic activity: It makes loans less expensive and thereby encourages individuals and companies to borrow money and invest it; at the same time, a lower interest rate reduces the economic incentive to save money, as the return on savings is low. This combination should incentivize economic activity, particularly in a period of economic instability and global economic crisis, in which the tendency is to save money rather than spend it or raise capital.

Throughout the entire term of the second Netanyahu government, the Bank of Israel interest rates stayed below 4%. In 2010-2012, the average monthly interest rate was 2.31%. At the height of the global economic crisis in 2009-2010, the interest rate was below 1%. Most western countries adopted a similar interest policy.

Purchasing foreign currency

While Prof. Stanley Fischer, the former governor of the Bank of Israel ,is known for advocating minimal government intervention in the market, he broke this rule during his term and engaged in a massive purchase of dollars. Fischer's activity can be understood in the context of the global economic crisis, in which central banks in many countries were encouraged to act exceptionally in order to grapple with the crisis.

The Bank of Israel's policy of buying foreign currency, specifically dollars, was intended to offset the growing strength of the shekel vis-à-vis the dollar, which raised the cost of Israeli exports and lowered the cost of imports, thereby hurting Israeli economic activity in general and employment in particular. To correct this, the Bank of Israel launched a program in March 2008 to increase its dollar reserves through the steady purchase of dollars. In late

2012, the final year of the second Netanyahu government, the foreign currency reserve of the Bank of Israel was $76 billion – more than double the balance four years earlier.

Fear of monetary regulation

The measures taken by the Bank of Israel regarding interest and foreign currency purchases were unequivocally positive from the perspective of Israeli exports, particularly the high-tech and defense industries. Nevertheless, each of these measures also had negative repercussions: The low interest made it easier to take out a housing mortgage, particularly for those with higher income, thereby inflating the price of real estate and making it difficult for young couples with moderate incomes to acquire housing. And the purchase of foreign currency created a "mountain of dollars", which – under other circumstances – could have served more usefully to help defray the state budget or stimulate economic activity.

Each of these measures had alternatives: The real estate bubble could have been deflated by regulation, as the government actually began to implement when it capped the level of a home mortgage; the taxation on purchase of a second home could also have been raised significantly. This is also true for foreign currency: Rather than wage an exorbitantly expensive battle on the weak dollar – a situation that was wonderful for the American economy – a tax could have been imposed on foreign currency speculation in Israel, such as a Tobin tax.[21]

Production and employment – no longer the main goals of the Bank of Israel

In June 2010, the Knesset passed a new Bank of Israel Law, which replaced the original statute from 1954. Enactment of this law had been a goal of Benjamin Netanyahu from his first stint as prime minister in 1996-1999. The new law makes several basic changes in the definition and functions of the Bank, the most important of which concern its goals. While the original law stated that it was the Bank's function to employ monetary tools in order to promote "(1) the stabilization of the value of the currency in Israel and outside Israel; and (2) a high level of production, employment, national income, and capital investments in Israel" (parag. 3), the new law asserts that the main goal of the central bank is to maintain price stability.

The new law is in keeping with "the spirit of '85": It shifts from the perception of the state as contributing to development, imposing relatively high direct taxes, and using pension funds for the general public good by investing in infrastructure and public services, to the perception of a state that passes the baton of economic leadership to the business sector – shrinking the budget, lowering taxes, and privatizing infrastructure and services. Similarly, the functions of the Bank of Israel were transmuted from encouraging currency stability, a strong local industry, and extensive employment to holding down inflation.

The second function of the bank, according to the new law, is "to support other objectives of the government's economic policy, especially growth, employment, and narrowing social gaps, provided that, in the opinion of the Bank's Monetary Committee, this support shall not prejudice the attainment of price stability over time." The clause of "narrowing social gaps" was added in the Knesset Finance Committee at the urging of MK Shelly Yachimovich, even though objections were raised during the Committee deliberations by Governor Stanley Fischer on the grounds that the Bank has no tools to implement it. As a result, a qualification stipulated that the entire second objective is conditional upon it not being in conflict with the first objective – price stability.

21 See the blog by Gideon Eshet, "When the dollar makes a muscle", *Black Economics*, 26 October 2013 [Hebrew] http://gidioneshet.blogspot.co.il/2013/10/blog-post_26.html#more. The problem with this kind of tax is that it is effective only if it is also adopted by other countries.

The State and Business Sector Face-Off

The state versus the business sector: gas taxation

In January 2009, gas fields were discovered in the Mediterranean off the Haifa shore, and more fields were later discovered. Clearly this is a very positive economic event. To the credit of the second Netanyahu government, it worked to ensure that the state's share of revenues from the gas would exceed what was then stipulated by law. At the same time – under the pressure of the gas corporations – the government approved the export of a large amount of the gas rather than keeping the gas in Israel to serve the domestic market.

It is estimated that the gas reserves discovered can supply most of Israel's gas needs for some 30 years (at the 2010 consumption rate), or for up to 20 years given a steady increase in gas consumption and ongoing transition from oil to gas by the Israel Electric Company and by the rest of Israeli industry. Note that all these figures are estimates, given the great uncertainty about everything related to the energy market and the future price of these resources.[22]

The discoveries sparked public debate on two main issues: the amount of royalties due the state from the gas profits, and whether some of the gas would be exported or all of it would be kept for the energy needs of Israel. The corporate partners to the discoveries demanded that a significant share of the gas be for export, on the grounds that ensuring the gas needs of the Israeli market for 20 years would require only about a third of the known reserves, leaving approximately two-thirds for export. This demand aroused ardent public debate, pitting the short-range desires of the corporations against the long-range needs of the Israeli populace and market.

No less important was the debate over the question of royalties due the state and the tax rate that should be imposed on the profits of the gas and oil corporations. Public demand to raise the tax rates set in the 1952 Petroleum Law led to the government's establishment of the Committee to Examine the Fiscal Policy concerning the Oil and Gas Resources of Israel, known as the Sheshinski Commit-

22 See Ministry of Energy and Water, Natural Gas Authority, "The natural gas market in Israel", slide presentation, May 2013 [Hebrew]; Zemach Committee Report, p. 34.

tee. This committee, which began its deliberations in April 2010, submitted recommendations in January 2011, as follows:

Allow the existing royalty rates to stand: 12.5% of the market value of the oil or gas at the wellhead without change, as set in the 1952 Petroleum Law.

Abolish the depletion allowance: The depletion allowance is a tax benefit unique to the field of oil and gas exploration intended to encourage investment. This is an annual deduction in taxable income due to the ongoing exhaustion of the oil or gas reserve. In other words, the state gives the rights-holders monetary compensation for the fact that while the oil and gas are being pumped and sold – and income and profits are being generated – some gas at the site is being depleted. This deduction exists in a small number of countries, including the United States, Canada, Pakistan, Barbados, and the Philippines. In the case of Israel, however, the depletion allowance does not take into consideration the fact that the rights-holders to the Israeli gas fields are not the owners of the gas itself. They did not buy the gas field from the state, as happened in the United States, so that the content of the field does not belong to them, but to the state. The depletion allowance allows for a deduction of 27.5% of the gross revenues, but no more than 50% of the profits from the oil or gas. The Sheshinski Committee recommended abolishing the depletion allowance on the grounds that "the oil and gas exploration industry was awarded significant tax benefits that are inconsistent with international practice". Perhaps in compensation for abolishing the depletion allowance, the Committee's final conclusions included a recommendation to allow accelerated depreciation at a rate of 10% for the development costs incurred.

Impose a levy on oil and gas profits: The rate of this levy will be set in accordance with the excess profits calculated according to the ratio of the cumulative revenues (after deducting ongoing expenses, royalties, and the levy paid in previous years) divided by the total costs for exploration and initial development. The committee recommended that this be imposed only at the stage when the ratio between revenues and expenditures is 1.5, i.e., when the company had recouped 150% of its investment before corporate taxes. The initial levy is to be 20%, and it is to rise gradually to 50%, commensurate with the excess profits. (The interim conclusions had set the cap at 60%, but this was reduced to 50% in the final conclusions.) This is actually future income – according to various estimates, it will be seven or more years until the gas companies pass the threshold for paying this levy.

Immediately upon publication of the Sheshinski Committee recommendations, Prime Minister Netanyahu declared that he adopted them in their entirety – but decided to add that half the cost of the pipelines and securing the offshore drilling would be borne by the state. This cost is estimated by various sources to be several billion NIS a year.

The bottom line of the Sheshinski Committee recommendations is expansion of the state share of the income from gas beyond the 12.5% royalties set in the Petroleum Law of 1952. Gas is a natural resource that belongs to the state, however, and one would have expected a larger share for the state and its population: The Civil Action Forum, for example, founded by former Knesset Member Michael Melchior, advocates that the total share of the state – from royalties, corporate tax, the surplus profits levy, etc. – amount to 80%. In reality, the state's share is considerably less than this.[23]

With regard to the use of the gas, the gas companies pressured the government to allow them to sell a large part of the gas to other countries, which would ensure immediate revenues. The counter claim was that, in all fairness, the gas should serve the Israeli economy, and this would lower the price of numerous services from electricity to transportation.[24] To grapple with this issue, the government in October 2011 appointed an inter-ministerial Committee to Examine Government Policy Regarding Natural Gas in Israel, known as the Zemach Committee. In June 2013, based upon the recommendations of the Zemach Committee, the third Netanyahu government decided to limit exports of the gas companies to 40% of production. In the wake of this decision, petitions were submitted to the High Court of Justice claiming that "The government decision has long-range strategic implications and reper-

23 Civil Action Forum, "It's the future of all of us", July 2010.

24 Position paper of the Israel Energy Forum and the Israeli Society for Sustainable Economics, *The export of natural gas resources from Israel*, May 2012.

cussions for the citizens of this country, the company, and the Israeli economy, and therefore the decision should be taken only after deliberation in the Knesset". The Court denied the petition.

To sum up, even though the government succeeded in enlarging the share of the state and the Israeli public in the harvest of the gas fields, it could have done better.

The state versus the business sector: The case of cell phone costs

The cost of living was the primary motivation for the social protest movement in 2011: rental housing, home purchase, preschool tuition, childcare costs, the price of an imported vehicle – all these and more brought hundreds of thousands of protesters onto the streets of Israel's major cities.

The government responded in various ways, including formation of the Trajtenberg Committee and later a Cost-of-Living Cabinet (in the third Netanyahu government).

The second Netanyahu government, staunch in its belief in the benefits of a free market economy, was reluctant to use the tools available to it for market interventions or price control. Instead, it chose to focus on increasing competition. One example of this was the establishment of a Committee on Increasing Competitiveness in the Economy (see below). The Trajtenberg Committee also recommended that competition be increased in various industries in order to bring down prices. Increasing competition was also a guiding principle of the Cost-of-Living Cabinet set up by the third Netanyahu government.

Of course, increasing competition is not a simple matter, whether because the investment required in some industries is enormous – such as generating electricity – or because even after a monopoly has been dismantled into competing companies, it is hard to prevent these new firms from engaging in price fixing.

One field in which competition has been created in Israel and elsewhere is cell phone services.[25] In Israel, an area of pride for the second Netanyahu government and its Minister of Communications at the time, Moshe Kahlon, is the creation of aggressive competition in the cell phone market, which had been dominated until then by three large companies. This change is one of the few cases in which competition did manage to lower the price of goods significantly.

This change, which took effect on 1 January 2011, included elimination of the service cancellation fines imposed on customers who switch companies, and obligating the existing companies to host the new cell providers on their frequencies – internal roaming services. These changes allowed for increased competition in the market with the entry of six new companies into the field.

In June 2012, a related reform was introduced on the import of cellular terminal equipment, rescinding the requirement of cell phone importers to obtain a Type Approval and a trade license for importing cell phones. This reform allows every importer to bring in cell phones, and it is likely to reduce the price of phones, as it eliminates the need to purchase them from service providers.

25 Another striking example is airfare following institution of the "open skies" policy in various parts of the world.

The State as Service Provider

State systems lose control

The policies implemented by the Israeli governments since 1985, and more intensively under the current leadership of Prime Minister Benjamin Netanyahu, can be examined from two angles: The first, how they affect the business sector – as discussed above; and, second, how they affect the state apparatus, which will be examined in this section.

The policy of empowering business greatly bolstered – and sometimes even created – corporate groups that took advantage of the privatization of government activities and the easy credit "released" by the government in order to expand and enrich themselves, and to dominate industries and services within Israel and even beyond its borders.

On the other side of the coin, reducing the state budget wreaked severe damage upon many state systems built over many years. Some shriveled until they lost any real influence, such as the Ministry of Construction and Housing, most of whose functions were handed over to the business sector (see details below), or the employment and professional training services of the Ministry of the Economy, which in the past had been key to economic development and industrialization, and are today drastically reduced and entirely sidelined.

Other ministries have lost the control they once had over their fields of responsibility, the most glaring examples being the ministries of Education and Health. This has come about primarily because of the infusion of private money to replace budget shortfalls: In the school system, parents who want to ensure their children's rise through the system are now asked to pay out of pocket for a range of services and enrichment programs; in the health system, the change is visible in the fees charged by doctors, Health Funds, and hospitals for private services or supplemental insurance, against the background of the government 's unwillingness to add public funds to the health services. Even families who are not wealthy find themselves paying out of pocket so that ill family members will have access to services that had once been free of charge.

Private money has become a major factor that distorts the operation of state services. Although formal control remains with the various ministries in Jerusalem, in practice the consumers who can afford them and the service providers who stimulate demands are increasingly the ones in control. Should the government ever decide to institute reforms that would ensure equality of education and health services for all, they will first have to deal with these newly arisen interest groups.

The Ministry of Education is supposed to provide a decent education to all children in Israel. In reality, parental payments to schools build walls that separate those with private resources from others. Parents who pay for schooling out of their own pockets create exclusive learning tracks, while elbowing other students out of the competition for matriculation and academic studies. Private money, more than government regulation, now controls educational outcomes.

The health system ought to provide decent services to all Israelis. In actuality, healthcare is often given first to those with deeper pockets, not those with a greater medical need. Patients who pay out of their own pockets and/or have acquired insurance beyond the basic national insurance have access to prompt treatment from the best doctors, at the expense of "regular" patients.

Significant amounts of money are at stake here. The increase in private money can be monitored easily in the health system: In 2009, the first year of the second Netanyahu government, the total amount of private money –Health Fund income from supplemental insurance, Health Fund income from members' copayments , and the income of commercial insurance companies from the sale of medical insurance policies – reached NIS 8.9 billion. In 2010, this increased to NIS 9.2 billion. In 2011, the most recent year for which data have been published, the total increased by NIS 0.5 billion for two of the above components (the figure for Health Fund copays has yet to be published).[26]

Another way to monitor this phenomenon is to look at data from the Central Bureau of Statistics on national expenditures for health: During the second Netanyahu government, the share of households outlays for health care rose from 37.9% in 2009 to 39.2% in 2012, while public funding of health care declined from 35.5% to 34.6%.

In the education system, it is harder to monitor the rise of private funding – funds from parents, donors, the local authority, or even businesses for services rendered. At the start of the 2010-11 school year, the second year of the second Netanyahu government, the Education Ministry estimated that parents were paying some NIS 2-3 billion to schools every year, which constituted some 10-15% of the Ministry's budget for primary and secondary schools.[27]

Housing: From social concern to real estate

The Ministry of Construction and Housing has been one of the institutions most adversely affected by the policy of downsizing the state. The state, which had previously taken responsibility for ensuring affordable housing for all, now shirks this obligation, shifting it to market forces. The most concrete expression of this can be seen in the Ministry budget, which had been NIS 9.54 billion in real terms in 2000,[28] and shrank to a quarter of this – NIS 2.49 billion – in 2011. During the first three years of the second Netanyahu government, the Ministry of Housing budget dropped from NIS 3.75 billion to NIS 2.49 billion: The allocation of grants for apartment purchases was slashed from NIS 2.03 billion in 2000 to NIS 0.15 billion in 2011; funding for household mortgages contracted from NIS 3.74 billion to NIS 0.12 billion; the number of public housing units declined by 30% to a mere 60,000 homes today; and existing public housing units are being sold off without purchasing any new ones.[29]

Another manifestation of the government's shedding of responsibility is a lack of planning and goal-setting to keep pace with the increased number of households. The number of construction starts in 2002-2009 was on average 32,000 units per year, as opposed to an average annual growth rate of 40,000 households. In 2010, however, an unusual year, there were some 40,000 or more housing starts.[30]

26 Shlomo Swirski and Etty Konor-Attias, *Israel: A Social Report 2012*, Adva Center, December 2012.

27 State Comptroller, *Annual Report 2012*, p. 575 [Hebrew].

28 At the time there were relatively many new immigrants.

29 Adi Sofer and Shlomo Swirski, *The Budget of the Ministry of Construction and Housing: From State Responsibility to the Hidden Hand of the Free Market*, Adva Center, December 2012 [Hebrew].

30 Adva Center analysis of CBS, *Statistical Abstract 2013*.

The weakening role of state regulatory mechanisms and the rising power of business interests and high-income households can be seen in the negative trends of the housing market. The proportion of high-end apartments constructed has grown: The gross size of an average apartment increased from 143 sq.m. in 2000 to 178 sq.m. in 2011. The number of small apartments (three rooms or less) decreased during these years from about 20% of the new construction starts in 2000 to 9% in 2011. Home ownership declined, particularly among the middle class – income deciles 5, 6, and 7.[31] And the acquisition of apartments as an investment reached an all-time high of 30% of total apartment purchases in 2009.[32] Low interest rates and capital market instability since the global slowdown have made real estate investment more attractive, particularly for people of means who have benefitted from tax reductions since 2003.

With the rise in apartment prices, the credit held by households also rose by some 51% between 2007 and 2012. Of this, the proportion of total credit used on housing increased from 67% in 2009 to 70% in 2012. The Bank of Israel policy – limiting the size of the mortgage relative to the borrowers own capital and placing constraints on the provisions of the mortgage, in parallel with its low interest policy – seeks to ensure financial stability in the mortgage market, but does not contribute to a family's ability to purchase its first home.

The state as investor: Development of transportation

The main arena of direct economic intervention by the second Netanyahu government was transportation – land, sea, and air. Investment in transportation was extensive, presented as a way to connect the periphery with central Israel, and it consisted of several measures:

- Significant expansion of the railway system while beginning the process of privatizing the trains and undermining the rail workers' unions;
- Construction, rehabilitation, and expansion of the roads in the center and periphery, including continued construction of Highway 6 and other toll roads privately managed and operated, including the fast lane to the Dan Region and the Carmel tunnels;
- The "open skies" air transport agreement, as well as privatizing the ports and debilitating organized labor in the ports, a measure that took shape as Netanyahu began his third term of office with the decision to construct two new private ports.

Over the past decade, budget allocations for land transport infrastructure have grown from NIS 5.9 billion in 2000 to NIS 9.88 billion in 2011 – an increase of 67%. This accelerated investment is particularly striking in the context of government cutbacks to other development budgets. In GDP terms, however, the investment in transport infrastructure remained a steady 1% of the GDP, approximately, over most of the decade and throughout the second Netanyahu government – a rate resembling that of other OECD countries.

The most ambitious program, which has already commenced and which constitutes one of the largest infrastructure investments of the past decade, is the Netivei Israel [routes of Israel] Plan. Approved by the government in February 2010, Netivei Israel was proposed by Ori Yogev, then chair of the National Economic Council Advisory Committee and, a year later, appointed chair of Israel Railways. The plan includes development of a network of roads, railway lines, interchanges, and bridges by the year 2020 at a budget of NIS 27.5 billion (at 2010 prices), in addition to the development budgets for transport already approved in the amount of NIS 42 billion. The goal of the plan, in the words of the government decision, is "to achieve a balanced distribution of the population of the country and to expand employment and economic activity into the towns of the periphery".

The Netivei Israel Plan includes two new railway lines in the north: the Jezreel Valley Line, which will link Haifa Bay to Afula and Beit Shean, and the Acre-Carmiel Line. As of the summer of 2013, these two lines are in the process of construction.

Nevertheless, a significant portion of the investment in public transport is directed at the paving of roads. In

31 Sofer and Swirski, *op. cit.*

32 Ministry of Construction and Housing, *Economic Analysis*, Quarterly 2, 2013 [Hebrew].

2010, investment in the railway system comprised less than a quarter (some 23%) of the transport development budget, compared with some 68% invested in roads. The remaining 9% were invested in urban public transportation, divided between the light rail in Jerusalem and roads for public transport. In comparison, OECD countries that year allocated 40% of the transport development budget to the railway system, with 60% allocated to roads. The division of investment in Israel between roads and railway transport more closely resembles that of eastern European countries, in which only 20% of the development budget for transport in 2010 was allocated to the rail system and 80% to roads.

Thus, the Netivei Israel Plan includes, together with development of the railway system in the north, continued construction of the Trans-Israel Highway north and south – in the north, to the Somekh Junction and the next segment to the Kabri Junction. It also includes the construction of interchanges on the main east-west roads in the north – 77, 65, and 85. These projects commenced as of the summer of 2013. In the south, the plan includes detailed planning, but not construction, of the extension of the Trans-Israel Highway southwards and of the railway line to the Negev Junction.

The importance of investing in public transportation and prioritizing it over roads is particularly critical given the data that show a rise in the use of private vehicles for travel to work between 1995 and 2008, while bus use declined and train travel, though expanded, remains marginal.

One key component of the plan is the project to electrify the railway – to convert all the trains to electric power and build an infrastructure to provide electricity along the route of the train lines throughout Israel. The project, which received approval from the National Infrastructure Committee, is designed to provide faster travel and to increase passenger capacity, but it has been held up since 2011, following objections submitted by the Haifa municipality and environmental groups to electrification of the train track within the city and a demand that some of the line be routed through a tunnel, at a cost of several billion dollars.

A key component of investment in the railway is the partial privatization of the maintenance services and the weakening of the rail workers' union. In the summer of 2012, the Board of Directors of Israel Railways, under its chair Ori Yogev, passed an initiative with two main elements: The first included outsourcing 30% of the maintenance work on the locomotives and railroad cars from railway employees to the companies that supply the rolling stock, which means creating competition between the sub-contracted maintenance companies and the maintenance employees of Israel Railways. The second part of the initiative called for establishment of a governmental subsidiary that would manage the freight transport and the real estate assets of the railways. The freight company would offer a private, rail-based freight transport service that would compete with the various freight firms. The real estate company would manage the properties, primarily the stations, owned by Israel Railways, with the primary intent of marketing commercial areas in the stations to generate profit to the railways.

In July 2012, rail workers took to the streets in sanctions and strikes to prevent implementation of this initiative. The face-off ended with an agreement between the Railways management and the Histadrut in which the Histadrut agreed to reforms in exchange for raising wages and allowing the station ticket sellers to become employees of Israel Railways, meaning that they would be covered by collective agreements with the rail workers.

The state as employer: "New Horizons" and "Courage to Change"

The economic growth experienced by Israel since the end of the second Intifada, which includes the period of the second Netanyahu government, failed to find expression in any significant wage increases for most Israelis. Nevertheless, several wage agreements in the civil service did buff the image of the second Netanyahu government as one of expansive budget policies. These agreements were signed with doctors, social workers, nurses, and the teachers of elementary and secondary schools. Here we look more closely at the agreements with two teachers' organizations: the "New Horizons" agreement with the Histadrut of Teachers, which represents teachers of elementary schools and some middle schools, and the "Courage to Change" agreement with the independent Teachers'

Union, which represents some middle school and all high school teachers.

"New Horizons" was implemented in 2008, as the Olmert government was drawing to a close, shepherded by then Minister of Education Professor Yael Tamir. In 2011, a parallel agreement – "Courage to Change" – was reached with the high school teachers' union. The ideological basis of both agreements was the "No Child Left Behind" reform under President George W. Bush and a report by McKinsey & Company, a management consulting firm,[33] published in the United States in 2008. The essence of the report and the reform consisted of increasing the personal responsibility of teachers and principals, expanding managerial autonomy, including budgetary independence for the principals, extensive use of quantitative evaluation tests, and increasing teachers' working hours in exchange for a raise in their salaries.

The workweek of a full-time teacher was increased to 36 hours (from 24), of which 26 hours are frontal teaching in elementary schools and 23 hours in middle schools; additional hours (5 in elementary schools and 9 in middle schools) were designated for meetings, preparation of lessons and teaching materials, conferences with parents, and checking schoolwork and exams; and individual teaching hours were also set aside (5 hours in elementary schools and 4 in middle schools). The individual teaching hours are intended for working with groups of up to 5 pupils, with the subject matter decided by the school in keeping with directives from the Ministry of Education.

While both agreements met with extensive criticism and objections, teachers' wages rose a similar amount in both. In the middle schools, "New Horizons" raised salaries 27-37% for 36 hours, while "Courage to Change" raised them 42% for 40 hours.

During the deliberations of the 2013-2014 budget, these two agreements were cited as if they bore some responsibility for the budget deficit. In response, the Bank of Israel noted that not only was this *not* a "wasteful" wage hike; it was perhaps not a hike at all. In the words of the Bank, these agreements were "quite moderate and based on maintaining the real wage, not more".[34]

The state as reformer: Implementation of the Trajtenberg Committee recommendations

In the summer of 2011, an unprecedented wave of social protest swept Israel – far more extensive than the protests over budget cuts during the years of the second Intifada, epitomized by Vicki Knafo's protest march from Mitzpe Ramon to Jerusalem. In retrospect, it can be said that the demonstrations in 2011 were a delayed reaction to those same budget cuts, and perhaps even to the macro-socio-economic policy launched in 1985.

The protest movement of 2011, which had at its height hundreds of thousands of people marching in the streets, forced the government to respond, which it did by setting up a Committee for Socioeconomic Change, headed by Prof. Manuel Trajtenberg. Over the course of eight weeks, the Trajtenberg Committee listened to representatives from the protest tents, social organizations, and the academy and, in keeping with the appointment letter, worked through subcommittees to formulate recommendations in four areas: taxation; social services; competition and the cost of living; and housing prices (which had been the original subject of protest). The committee's recommendations were published on 26 September 2011 and officially approved by the government two weeks later.

Although the recommendations were approved, a significant number were never implemented. According to *The Marker*, only 27 out of 139 committee recommendations were executed: the rest were buried in Knesset committees or never adopted by the Cabinet.[35] The recommendations that were implemented deal mainly with changes in taxation and extending free education to 3-year olds, changes that are important in themselves.

The government policy of lowering taxes had drawn fire before the social protest movement arose, even from the Bank of Israel. Among the Trajtenberg Committee recom-

33 M. Barber and Mona Mourshed, *How the World's Best-Performing School Systems Come out on Top*. New York: McKinsey & Company, 2007.

34 Bank of Israel, "State budget expenditures in 2012 and status report for the coming years", 13 February 2013 [Hebrew].

35 Lior Dattel, "The report is wonderful, implementation is stuck", *The Marker Magazine*, September 2013, p. 106 [Hebrew].

mendations were the following: end the reductions on income tax and corporate tax; increase taxes by 3% on the highest income bracket to 48%; impose a 2% surtax on income from work and/or capital above NIS 83 thousand a month (a million shekel a year); raise corporate taxes from 24% to 25% and possibly another 1% in 2013; raise the capital gains tax from 20% to 25%; cancel the temporary order that raised the ceiling on payments to the National Insurance Institute, and restore the limit to five times the average wage (on the grounds that the high ceiling led those with high wages to create "wallet companies"); and award two additional tax credit points to men for every child under age 3. The Committee also recommended rejecting various changes proposed in taxation, most prominently the proposed inheritance tax and institution of a differential Value Added Tax. On 5 December 2011, the Knesset approved all the recommendations, with the exception of the surtax, which was eliminated by the Knesset Finance Committee. This tax was ultimately instituted in early 2013 in the framework of measures to reduce the 2012 deficit.

Unlike the tax-related recommendations, most of which were implemented, other recommendations of the Trajtenberg Committee were only partially implemented. One of the main implemented recommendations was extending free public education to 3 year-olds. To implement this, a decision was made to set up hundreds of public preschools throughout Israel, accelerate the training of preschool teachers and assistants, and provide a government subsidy to private preschools supervised by the Ministry of Education equal to the tuition at public preschools prior to the reform (some NIS 700 a month).

It should be noted that extending free education to 3-year olds is in stark contrast with the trend to privatize and outsource the school system, marking a significant expansion of public education. The new public preschools are fully subsidized, meaning that preschools (though not daycare centers) are free to parents, while only a partial subsidy is given to private preschools, and only to those supervised by the authorities. In other words, a rare incentive has been given to parents to choose the public system over the private one, which translates in practice to the transfer of children from private to public preschools throughout Israel.

Yet, at the same time, the government chose to implement another Trajtenberg Committee recommendation – to create afternoon care centers for 3-9 year olds by outsourcing.

The state and security: The Israeli economy in the shadow of the Israeli-Palestinian conflict

During the period of the second Netanyahu government, the Israeli economy enjoyed relative calm in terms of Palestinian protest against the ongoing Israeli occupation. The importance of this becomes clear in light of how vulnerable the Israeli economy is to volatility in matters of security. Indeed it is the quiet on the Israeli-Palestinian front that was cited by the Bank of Israel as the main factor responsible for the rapid economic growth after 2003.[36]

Generally speaking, the Israeli economy is vulnerable to two main dangers: The first, shared by all countries, is the risk of a global economic crisis, such as that which erupted in 2007-08 and plunged growth in Israel from 4.1% in 2007 to 1.1% in 2008. The second is a security crisis, like that during the second Intifada, when the Israeli economy experienced negative growth two years in a row and a decline in per capita GDP three years in a row.

The second Netanyahu government did little, if anything, to make this calm permanent by pursuing a political agreement with the Palestinians. It would be correct to say that the second Netanyahu government excelled at conflict management rather than conflict resolution. Negotiations between the sides were renewed only under the newly formed government in 2013.

Israeli occupation of the Palestinian territories contributes to the Israeli business sector in several ways, including:

- Cheap labor, benefiting Israeli industries and services that operate in settlements as well as within Israel, above all in construction and agriculture;
- A captive market for industries in which residents of the territories are dependent upon Israeli imports, primarily electricity, water, and agricultural produce; and

36 Karnit Flug and Michel Strawczynski, "Persistent growth and macroeconomic policy performance in Israel", *Bank of Israel Survey 80*, 2007, pp. 73-103 [Hebrew].

- The defense industry, in which some products depend on the expertise, experience, and prestige accrued as a result of IDF clashes with the Palestinians; and security service providers, such as contractors erecting the Separation Barrier.

But profits to these Israeli businesses are dwarfed by the damage wrought to the Israeli economy as a whole due to the contraction of economic activity during times of conflict with the Palestinians, or due to changes in the credit rating of Israel and its corporations because of ongoing concern about conflict with the Palestinians or with Arab countries, in general. The lack of a political accommodation is a continuous potential threat to the Israeli economy.

The state and security: The defense budget

As we have seen, the policy of budget cuts has had an adverse effect on large portions of state apparatus.

The Ministry of Defense, however, has not been harmed: It was and remains strong, even the strongest, ministry. Although its budget had also been dramatically cut under the economic stabilization plan of 1985 – after having been hugely expanded in the wake of the Yom Kippur War – the ministry is protected from further cuts due to the steady stream of violent clashes with protesting Palestinians: the first Intifada, the waves of suicide bombings, the second Intifada, the Second Lebanon War, the Cast Lead Operation, and Pillar of Defense. And in recent years, there is also the potential of a clash with Iran.

For years, the defense budget has been at the heart of a public debate that pits security against social needs. Given the policy adopted by all Israeli governments "to release financial resources for use by the business sector" and to minimize taxes, particularly corporate taxes, the defense budget becomes the main potential source of funding for social needs. In this debate, the Ministry of Finance (which is the main advocate of lowering taxes and diverting pension savings to the capital market) has taken the position of "the social camp" in its claim that every addition to the defense budget means a cut in social budgets.

The defense budget is very big; relative to the GDP, it is much bigger than its counterparts in the European countries that Israeli leaders seek to emulate. Bear in mind, however, that this budget is far from being merely a "waste of money". The defense establishment is a key player in the Israeli economy: The IDF employs a standing army as well as civilian employees. The defense budget also funds defense industries owned by the government, which employ thousands of people and contribute significantly to Israel's industrial exports.

The defense budget evokes criticism both because of its lack of transparency and, above all, because of its practice of seeking additional budget appropriations after the budget is first approved in the Knesset, and this is while a large number of civilian ministries practice under-spending, i.e., do not have a chance to expend all the monies approved by the Knesset. Every year, the Knesset approves a specific amount for the defense budget and, several months later, when the Accountant General of the Ministry of Finance publishes the Expenditures Report, it learns that the amount actually spent was significantly higher than the original budget allocation. Below are the figures during the four years of the second Netanyahu government (at 2012 prices):

- In 2009, the Knesset approved NIS 49.7 billion for the Ministry of Defense; the Expenditures Report showed that NIS 59.5 billion was actually spent – a difference of NIS 9.7 billion.
- In 2010, the Knesset approved NIS 51.4 billion; the Expenditures Report showed that NIS 59.2 billion was actually spent – a difference of NIS 7.8 billion.
- In 2011, the Knesset approved NIS 50.0 billion; the Expenditures Report showed that NIS 57.9 billion was actually spent – a difference of NIS 7.9 billion.
- In 2012, the Knesset approved NIS 50.4 billion; the Expenditures Report showed that NIS 60.0 billion was actually spent – a difference of NIS 9.6 billion.

It is known that some of these extra appropriations are transferred to the General Security Services and the Mossad. But the budgets of these two entities are presumably fairly stable, yet there are large differences from year to year in the size of the appropriation.

Concluding Remarks

In October 2010, the Netanyahu government established the Committee on Increasing Competitiveness in the Economy. How ironic – the committee was convened to grapple with problems caused by the policies that have been promoted so avidly and persuasively by none other than Prime Minister Netanyahu.

One might add that the second Netanyahu government was the first government called upon to cope with the long-term repercussions of the 1985 stabilization plan, and more specifically with the measures taken in 2002-2003by then Finance Minister Benjamin Netanyahu. The most significant challenge came from the social protest movement in 2011. In response, the government convened the Trajtenberg Committee. However, the letter of appointment of the Committee stated that it was not to undermine one of the basic principles of the 1985 stabilization plan – to "release financial resources for use by the business sector". The phrasing of the letter was, "The Committee's recommendations shall reflect the need to preserve fiscal responsibility regarding the state budget".[37] Even so, most of the Trajtenberg Committee recommendations have not been implemented. Thus, the social protest movement did not bring about a re-thinking of the basic tenets of Netanyahu's macro-economic/social paradigm.

Another challenge concerned the concentration of the Israeli economy. Ironically, this is one of the most noteworthy results of 1985 – the formation of a very "fat" corporate sector. With privatization, government ownership in the business sector dwindled within ten years from some 27% (1985) to 6% (1995); most of the privatized companies were quickly transferred to private business groups,[38] which began to demand, and obtain, extensive government assistance, primarily vast amounts of cheap credit.

The Committee on Increasing Competitiveness in the Economy, appointed by the Netanyahu government 25 years later, found that "…the Israeli economy is characterized by a concentrated ownership structure, with most of the companies that are traded on the Tel Aviv Stock Exchange having a principal shareholder who is capable of directing the corporation's activity. Another characteristic of the structure of the Israeli economy is the not inconsiderable portion of public companies that are controlled by a limited number of business groups, the majority of which

37 *Report of the Committee for Socioeconomic Change*, Jerusalem, 26 September 2011.

38 Konstantin Kosenko, *Evolution of Business Groups in Israel: Their Impact at the Level of the Firm and the Economy*, Bank of Israel, 16 April 2008.

are characterized by pyramid control structures. . . The majority of the companies listed in the Tel Aviv 100 Index are controlled by the 23 largest business groups in the economy. . . A huge slice of economic activity in Israel is controlled by a relatively small number of capital holders."[39]

The Committee did note that the existence of business groups is not unique to Israel, but common to most world economies. However, as Konstantin Kosenko of the Bank of Israel pointed out, "the 10 largest groups' segment of the market is among the largest in the western world and amounts to 30 percent."[40]

The measures taken in 1985 did not bring about an economic and social "miracle". Although the Israeli economy has seen periods of significant growth since then, it is hard to argue that such growth would not have taken place without the legislation of 1985. Moreover, much of the growth infrastructure was created by the state prior to 1985 and continued even afterwards, the most prominent examples being high-tech, the defense industries, energy sources, and the systems of health, schooling, and higher education.[41]

During the four years of the second Netanyahu government, 2009-2012, the economy grew at an average of 3.7% annually, a brisk pace compared to that of western countries. The per capita GDP, commonly used as an indicator of the standard of living, also rose, naturally at a slower rate – 1.8%.[42]

We do not have the tools to determine what was the actual contribution to that growth of fiscal austerity and the "release" of resources for use by the business sector. But it is doubtful that this policy can claim sole or even primary responsibility: the Israeli economy showed much higher growth rates in the past, when the state controlled capital and its allocation. Even today, the state continues to control a significant slice of the export business, particularly defense industry merchandise.

Note that in the not too distant past, when Finance Minister Benjamin Netanyahu sought to attribute growth in the post-second Intifada years to the policy of fiscal austerity under his tutelage, the Bank of Israel turned up more important causes. A Bank report cited three main factors: suppression of the Intifada, in first place, followed by the expansion of global trade, and, in last place, government fiscal policy.

Although the recent growth in Israel is relatively higher than that of most western countries, the standard of living in Israel still has a long way to go: in most of these countries, the per capita GDP is significantly higher than in Israel. In other words, if Israel wants to benefit from a standard of living comparable to that of western countries, it needs to accelerate the rate of growth of its per capita GDP. The huge reserves of cheap credit made available to the business sector over the past two decades have not had this effect, at least not yet.

To that end, there is a need, inter alia, for greater investment. The business sector, which today enjoys unprecedented access to credit, does not appear to be taking the lead. Investment in fixed assets is lower in Israel than in other OECD countries, on average. A significant part of the credit in Israel is invested abroad, to some extent as a result of pressure from the Finance Ministry, which fears for the fate of retirement savings funds. Investments within Israel are concentrated in the center of the country, with entire regions and population groups finding themselves outside the circle of investment and growth.[43]

Passing responsibility for spearheading growth on to the business sector has not yielded an economic miracle. It did not create a large wave that lifted all boats, to use the American metaphor. On the contrary, while some ships sailed blithely on, others barely kept above water, and some sank. The most glaring product of this policy, for which Netanyahu is the foremost spokesperson, is the development of an unprecedented level of inequality: in entrepreneurial opportunities, access to decision makers, access to credit, taxation, asset ownership, employment, and wages.

39 *The Committee on Increasing Competitiveness in the Economy, Interim Recommendations*, Jerusalem, 22 February 2012.

40 Kosenko, op. cit. See also Daniel Maman, "Structural changes in the Israeli business groups", *Law and Business*, 8, September 2008 [Hebrew]; Knesset Research and Information Center, *Business Groups in Israel: Description, Analysis, and Ramifications*, 20 June 2010 [Hebrew].

41 On the centrality of the state in economic entrepreneurship, see Mariana Mazzucato, *The Entrepreneurial State: Debunking Public vs. Private Sector Myths*. London: Anthem Press, 2013.

42 Adva Center analysis of CBS, *Statistical Abstract of Israel 2013*, Table 14.3.

43 Shlomo Swirski and Safa Sabah Agbaria, *Israel's Unbalanced Economic Development: Construction of Buildings for Industry, Commerce and Public Use, by Region and Population Group (2000-2009)*, Adva Center, March 2011.

Statistically one of the clearest reflections of these dynamics is the changing share of the national income pie between employers and employees: Over the past decade, the employers' share grew from a low of 8% in 2002, during the economic crisis of the second Intifada, to 14% in 2009, the year the second Netanyahu government took office, and it grew by one more percentage point by 2012. In parallel, the share of workers contracted from 67% in 2002 to 62% in 2009, and it continued to contract by one percentage point during the course of the second Netanyahu government.[44]

The middle stratum,[45] which comprised about a third of all Israeli households in the 1980s, shrank to 27.5% in 2011. The middle stratum has been the hardest hit by the policy of budget cuts, since the public sector – one of the main branches of the economy on which this stratum depends – lost a great deal of money as privatization got underway, and workers were increasingly hired by employment or service contractors.

The senior managers of the large corporations receive unprecedented remuneration. In 2011, the average monthly salary of a CEO in the Tel-Aviv 100 (the hundred largest Israeli companies traded on the Tel Aviv Stock Exchange) cost the company NIS 549 thousand. One year later, this dropped to NIS 377 thousand, to some extent in reaction to the public outcry at the exposure of these figures. Naturally even the new, lower salary bill is 42 times the average salary in the economy and 87 times the minimum wage.[46]

Behind the CEO salaries are the owners of the largest business groups. These owners profit not just from wages and business income, but also from capital transactions. Data about capital income are sparse in Israel, but the little available is quite revealing. According to figures from the Director of State Revenues, the total capital income for 2007 of the highest 1% (not from wages or business) was NIS 13.5 billion. By comparison, the total income of the nine lower income deciles that year in Israel – the 90% of the population not in the highest income decile – was NIS 1.9 billion.

44 Shlomo Swirski, Etty Konor-Attias and Ariane Ofir, *Workers, Employers and the National Income 2012*, Adva Center, May 2013 (Hebrew).

45 All households with incomes between 75% and 125% of the median household income. See Shlomo Swirski and Etty Konor-Attias, *Israel: A Social Report 2012*. Adva Center, December 2012.

46 Swirski, Konor-Attias and Ofir, op.cit.

It is worth noting the words of Bill Gross, head of the PIMCO investment company and known as the "bond king", from his letter to investors about the socioeconomic developments in the U.S., which greatly resemble those in Israel:

> "Admit that you, and I and others in the magnificent "1%" grew up in a gilded age of credit, where those who borrowed money or charged fees on expanding financial assets had a much better chance of making it to the big tent than those who used their hands for a living . . . and had the privilege of riding a credit wave and a credit boom for the past three decades. You did not, as President Obama averred, "build that," you did not create that wave. You rode it. And now it's time to kick out and share some of your good fortune by paying higher taxes or reforming them to favor economic growth and labor, as opposed to corporate profits and individual gazillions."[47]

The second Netanyahu government appointed a committee to figure out how to increase competitiveness in the business sector. A goal no less important should be figuring out how to prevent the concentration of wealth that is generated by the entire society. To that end, new thinking should be applied to the principles that have guided the policymaking of Israeli governments since 1985, with particular attention to dwindling state responsibility for the development and welfare of the entire Israeli population.

What we have discovered since 1985 is that it is relatively easy to dismantle entire governmental agencies, or to make them dysfunctional or defunct by cutting their budgets or demoralizing their employees. It is much more difficult to create a business "sector" that is efficient, competitive, productive, creative and capable and willing to lead the economy as a whole to levels of performance higher than those achieved in the past by the state, so that when economic growth comes, it lifts all boats, and not just those of the business elite themselves.

47 Bill Gross, "Scrooge McDucks", *Investment Outlook*, November 2013. https://investments.pimco.com/insights/External%20Documents/PIMCO_Investment_Outlook_Scrooge_McDucks_PCIO036.pdf.

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