



# The battle of the budget

Who will pay for the Gaza war?  
A three-way conflict between security,  
social and fiscal considerations

**THE 50-DAY** Gaza War has ended. Inevitably, another fierce, protracted conflict has broken out – the political battle of the 2015 budget to determine who will pay for it.

This three-way conflict pits Finance Minister Yair Lapid against Prime Minister Benjamin Netanyahu, and Bank of Israel Governor Karnit Flug disagreeing with both. Without exaggerating, the outcome of this battle will be as important for Israel's future as was the outcome of Operation Protective Edge.

Military strategists speak of "asymmetric warfare," which means that in the battle against terror costly conventional weapons (missiles, jet aircraft, tanks) are used against inexpensive improvised weapons, including homemade Kassam rockets. One of Hamas's most effective weapons was the 120 mm mortar – a relatively cheap, primitive device that took a heavy toll on life and property in the areas bordering Gaza.

Defense Minister Moshe Ya'alon says the Gaza military operation, which begun on July 8, in Gaza cost more than NIS 9 billion (\$2.5 billion) in added defense spending. The overall direct cost is estimated at more than NIS 15 b. (\$4.3 billion), including compensation for civilian damages.

In his overview of the war's price tag, Ya'alon noted that the IDF attacked more than 6,000 targets, of which 5,000 were hit from the air and the rest by land and sea. Hamas and other terrorist groups fired some 4,500 rockets at Israel, while the IDF destroyed around 2,000 rockets, leaving an estimated

2,000 more rockets in their arsenal.

The Iron Dome anti-missile system brought down over 700 Gaza-launched rockets during the war. Each Tamir interceptor missile costs \$100,000, Ya'alon noted, so the interceptor missiles alone cost well over \$70 million. Sometimes, two Tamir missiles were launched to ensure the destruction of one rocket, when it targeted a large urban area or Ben-Gurion international airport.

The economy was slowing even before the Gaza war, which caused a further slowdown equal to 0.5 percent of the annual Gross Domestic Product (GDP), or close to NIS 5 billion (\$1.3 billion), according to Tax Authority Director Moshe Asher. Tourism was hard-hit and consumer spending slowed, too.

The first act of the government was to slash spending for the 2014 budget by two percent across the board, across all ministries, excluding defense. But the real cost will be felt in Israelis' pockets only in the 2015 budget. The three warring sides – Lapid, Flug and Netanyahu – have fired their opening salvos.

Flug advocates fiscal responsibility. She insists there must be a tax increase to avoid increasing the budget deficit and the burden of public debt. And she is partly right. We've seen many countries collapse – Ireland, Portugal, Spain, Greece – when runaway deficits caused capital to flee, and governments' borrowing costs soared as a result.

Lapid is bitterly opposed to tax hikes. He, too, is partly right. In the past, Lapid's austerity budget hurt the middle-class constituents who voted for his party, Yesh Atid, and

Safeguarding the cash: Bank of Israel Governor Karnit Flug holds up the newly issued 50 shekel banknote at a news conference, September 10



brought Lapid's approval ratings to the lowest of any cabinet minister. Lapid claims rightly that his previous austerity budget left Israel better able to boost government spending today without causing big deficits.

**LAPID DESPERATELY** wants to keep his "no new taxes" promise. I'm certain he recalls former US president George H. W. Bush's pledge, made at the 1988 Republican National Convention, "Read my lips, no new taxes," a pledge he broke, which partly resulted in his lost reelection bid against Bill Clinton in 1992.

Lapid, therefore, opposes large defense-spending hikes. His Finance Ministry has presented an initial budget proposal to Netanyahu calling for a budget deficit equal to 3.2 percent of GDP, no new taxes and providing only an additional NIS 2.5 billion to the defense budget, far less than the Defense Ministry's demand for an additional NIS 9 billion.

Netanyahu supports Ya'alon's demand for a major increase in the defense budget. Netanyahu, too, is partly right. For most Israelis, security is foremost. But Lapid says this increase is "excessive."

The result is a three-way conflict between opposing scenarios for distributing the cost of the war – the Security budget (Netanyahu), with huge defense spending paid for by major cuts in social spending; the Financial budget (Flug), where large spending hikes are paid for by big tax increases; or the Social budget (Lapid), where defense spending increases are modest, taxes are kept steady and social spending is more or less maintained.

The battle lines have been drawn. Lapid's close friend and ally Ofer Shelah has said that Yesh Atid will initiate new elections if it loses the Battle of the Budget. Most observers doubt this is credible given Yesh Atid's abysmal ratings in the polls. But it is clear that the stakes in the Battle of the Budget are high for everyone, not just Yesh Atid.

The budget conflict is classic guns or butter. And it is that old *déjà vu* all over again because similar battles were fought after the Second Lebanon War in 2006, Operation Cast Lead (2008-9), and Operation Pillar of Defense (2012). In all three cases, the security proponents won and defense spending rose substantially. I expect they will win this time, too.

The background to the Battle of the Budget is the slowing economy, with annualized second-quarter GDP growth of just 1.7 percent. The slowdown was driven by a sharp 18 per-

cent decline in exports and a 5 percent slump in fixed capital formation. GDP for the third quarter of 2014 may not grow at all.

Israel's economy and its people are resilient. They have been through war before and they bounce back. The tourists will return eventually and consumer spending will rise.

## WITHOUT INTERNAL COHESION, WITHOUT MUTUAL SUPPORT, IT WILL BE VERY DIFFICULT TO MEET EXTERNAL THREATS

Dr. Yaakov Sheinin, head of the consultancy Economic Models, told the Hebrew financial daily *TheMarker* that Israel's economy will rebound, as it has after other conflicts; he believes the high-tech sector will continue to attract foreign investors. But high-tech companies themselves are far more concerned with the stagnating global economy than the Gaza War, and some multinationals with operations in Israel, like giant Cisco, have announced sweeping layoffs as a result, including 300 Israelis.

In this space, I have been severely critical of Finance Minister Lapid, who scorns economists, backs bad policies (the zero Value Added Tax for apartment buyers), and lacks even basic understanding of budget principles. But in the current Battle of the Budget, I support his position, for several reasons.

First, social cohesion. I agree with Avi Temkin, writing in the business daily *Globes*, who argued, "We are becoming an economy and a society in which there is a high-tech and financial elite, with very large groups of workers beneath it whose entire employment horizon is rapidly shrinking. Job security for these employees ceased to be a consideration a long time ago, and many of them will become workers for contractors in the near future."

Israel faces severe external threats. It will deal with them. But Israel also faces a critical internal threat, as the cohesion of society crumbles owing to the huge rich-poor gap. Without internal cohesion, without mutual support, it will be very difficult to meet external threats no matter how much money Israel spends on costly defense technology.

Second, evidence from recent and distant

history. The US and the EU dealt with stagnating economies in the wake of the 2008-12 economic and financial crises, largely through austerity – sharp spending cuts. They slashed government spending, cut deficits and curried favor with financial markets in the hope of restoring economic growth

This has failed and was doomed from the start. When businesses stop investing and consumers cannot spend because they lack jobs and their incomes are falling, and exports slump, only the government is left to supply the demand needed for growth in jobs, as J.M. Keynes explained 80 years ago.

Both the US and EU economies have failed to return to robust growth, and austerity policies are largely to blame, even though the central banks in both regions have flooded their economies with massive amounts of money and credit.

Money does no good if it does not circulate. And it will not circulate if everyone is afraid to use it and banks are afraid to lend it.

Massive defense spending will in the long run weaken Israel, not strengthen it. Let's recall that US president Ronald Reagan, elected in 1980, ran on a platform of matching Soviet Union defense spending. The resulting arms race bankrupted Russia, which could ill afford it. Many believe the ultimate collapse of the USSR, in December 1991, was caused by a voracious defense budget.

**ISRAEL MUST** not follow suit. There is an urgent need to revamp high tech; invest in communications and transportation infrastructure; revitalize higher education and high schools; and rebalance the rich-poor gap. None of this will happen if resources are poured into defense.

Thanks in part to the wisdom and stature of former Bank of Israel governor Stanley Fisher, now deputy head of America's Federal Reserve, Israel's economy slid through the 2008-9 global financial crisis almost unscathed, with GDP growth of nearly 6 percent in 2010 and over 4 percent in 2011.

But with GDP growth plummeting this year, the Bank of Israel has slashed interest rates from three percent in 2011 down to virtually zero in August 2014. It has not helped much and, in fact, has exacerbated the housing bubble. Israel should avoid austerity, embodied in the Bank of Israel's financial scenario. The evidence from abroad is compelling that financial austerity does not work.

Third, happiness. Three eminent economists – Richard Layard, Jeffrey Sachs and



RONEN ZVULUN / REUTERS

All smiles, but the differences remain: Finance Minister Yair Lapid and Prime Minister Benjamin Netanyahu

John Helliwell – prepare an annual World Happiness Report, which ranks countries based on self-assessed happiness, interpreted as “satisfaction with life” and as the sense of well-being. In their latest report for the years 2010-12, which for Israel include the aftermath of the Second Lebanon War and two Gaza conflicts, Israelis rank a surprising 11th in the world in overall happiness, just behind Australia (10) and well above even the US (17).

How can one explain Israel’s happiness given the very bad unstable neighborhood in which Israelis live and the ongoing Israeli-Palestinian conflict? The answer is simple. Happiness, note the authors, is driven in part by the standard of living (per capita GDP), but also by life expectancy, social support, freedom to make life choices, and generosity.

This is why Qatar, the wealthiest country in the world by far with per capita GDP of nearly \$100,000, ranks only 27th, because it is a rigid autocracy.

If defense spending drains resources from social support and health care, and diminishes perceived generosity, if it impairs GDP growth, in the long run it will weaken Israel, rather than strengthen it.

The best summary of Mideast conflict

was given by former US secretary of state Hillary Clinton in only four words: “It’s all one problem,” she said. She meant that the Muslim world is at war with itself. In a huge geopolitical crescent sweeping from Nigeria where the murderous Boko Haram now also seek a caliphate and control territory, through the festering Tuareg revolt in Mali, to the civil war in Libya, the conflict with the Muslim Brotherhood in Egypt, Hamas in Gaza, Hezbollah in Lebanon, the civil war in Syria, dissent in Iraq, Islamic State jihadists in Iraq and Syria, the Kurdish revolt, Wahhabi extremists in Saudi Arabia, al-Qaida in Yemen, the Taliban in Afghanistan, and jihadist rebels in Pakistan, the Muslim world is engaged in a bloody internal religious war.

And stuck right in the geographic middle of this huge mess is Israel.

It was once widely claimed that the root of Arab nations’ problems is the Israeli-Palestinian conflict. Solve that, it was said, and the Arab world would be united and at peace. We now understand that this is utterly false. The Israeli-Palestinian conflict is, at present, a very minor, almost irrelevant part of the internal conflicts in the Arab world, which pits Shia against Sunni, Sunni against Sunni, and tribe against tribe.

Israel must take a long-run view in its

budget debate. The question is, how must Israel allocate its scarce resources to defend itself, secure its borders, strengthen its economy and society, fairly share the defense burden, and ensure a strong cohesive society able to meet severe challenges that lie ahead, ones that we can at present barely imagine?

The Gaza War has probably ended, even though technically a temporary cease-fire prevails. But the Budget War has just begun. Its result will have a major impact on Israel’s economy and society for years to come.

**Postscript:** As this issue goes to press, according to the Jerusalem Post Prime Minister Netanyahu and Finance Minister Lapid have hammered out a deal, just hours before the New Year began. In the 2015 budget, defense spending will rise by 6 billion shekels (1.6 billion dollars) to a total of 57 billion shekels (15.4 billion dollars). Tax rates will remain steady. The deficit will rise from the planned 2.5 percent to 3.4 percent of GDP. A significant part of the defense budget will be labelled “one-time,” meaning it will not automatically remain in future budgets. Everyone is happy, with the possible exception of Governor Karnit Flug. ■

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